Separate report of the National Audit Office to Parliament: Fiscal policy monitoring report

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Separate report of the National Audit Office to Parliament: Fiscal policy monitoring report 2023

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To Parliament

The National Audit Office monitors and assesses fiscal policy in its role as a national independent fiscal institution as referred to in the European Union's Fiscal Compact and the European Union law. Provisions on the monitoring task are laid down in the Act on the National Audit Office (676/2000) and the Fiscal Policy Act (869/2012).

The monitoring includes assessment of the setting and implementation of the rules and binding objectives that steer fiscal policy. It comprises monitoring of compliance with the Medium-Term Objective (MTO) set for general government finances and the related correction mechanism, monitoring of the preparation and implementation of the General Government Fiscal Plan, and monitoring of compliance with the EU Stability and Growth Pact. It also comprises assessment of the realism of the macroeconomic forecasts used in fiscal policy-making as well as ex-post assessment of the reliability of the forecasts as laid down in the Government Decree on the General Government Fiscal Plan (120/2014). By monitoring fiscal policy, the National Audit Office promotes the transparency and intelligibility of fiscal rules as well as stable and sustainable general government finances.

Under section 6 of the Act on the National Audit Office of Finland, the National Audit Office submits this separate report on fiscal policy monitoring to the 2023 parliamentary session.

Helsinki, 15 December 2023

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Main content

The economy in Finland has continued to cool this year, and the economic outlook is weak. The economy is slowed down by high inflation, higher interest rates, the consequences of Russia's war of aggression, and increased uncertainty. The recovery in 2024 is likely to be slow and fragile, but it is still possible that the economy will experience a soft landing instead of a sharp drop. However, the risks of worsening economic development have increased.

Many general government actors in the EU Member States have accumulated debt during the last two decades. The general government bodies in Finland, with the exception of earnings-related pension funds, have been accumulating debt especially since the financial crisis of 2008. The main factor behind the increase in debt is negative primary balance, i.e. deficit net of interest payments. In recent years, a significant factor explaining the increase in debt has also been the stock-flow adjustment, i.e. typically leveraged net acquisition of financial assets. In Finland, the development of the effective real interest rate on general government gross debt has been favourable compared with the change in GDP volume, which has reduced the debt-to-GDP ratio. However, Finland should not rely on this development to continue in the future.

According to fiscal forecasts, Finland's economic growth prospects are challenging. Economic growth is expected to stop or be reversed this year and to remain moderate in 2024. The real economic forecast of the Ministry of Finance is more optimistic than those of other forecasters, especially for 2024. On the other hand, in terms of the general government deficit, the Ministry forecasts more pessimistic development than the other forecasters. However, the forecast of the Ministry of Finance, which underlies the budget proposal, is realistic overall.

Through its fiscal policy, the Government aims to strengthen general government finances and reverse the development of public debt. The objective set by the Government for the general government fiscal position, or fiscal balance, is too flexible in view of the legislation valid in normal circumstances. However, this is allowed in the exceptional circumstances that prevail until the end of 2023 and under the escape clause activated as a result of them. In the light of recent forecasts, it is unlikely that the objectives set by the Government will be achieved.

The Government's set of measures aimed at strengthening public finances by EUR 6 billion covers only part of its fiscal decisions. The implementation of the investment programme set out in the Government Programme will take the development of general government finances further away from the Government's target path. In addition, the Government Programme does not contain any taxation or other public-revenue-related objectives that would support the achievement of the fiscal position objective set for 2027. The risk is that measures outside the EUR 6 billion set of measures significantly reduce the strengthening effect of the Government's fiscal policy on general government finances. Achieving the fiscal position objective is likely to require additional measures and extending the range of measures.

The level of fiscal policy is counter-cyclical, i.e. slightly stimulating in a negative business cycle, in forecast years 2023–2024. Based on the composite indicator of the fiscal policy monitoring function, the fiscal impulse, i.e. the change in fiscal policy, is somewhat pro-cyclically contractionary in 2023. However, based on the EU Commission's output gap method, it is slightly counter-cyclically expansionary. According to both business cycle indicators, the fiscal impulse in 2024 is roughly neutral in a business cycle that remains weak.

The Government has set the spending limits for the parliamentary term contrary to the policy lines of the Government Programme and presented the expenditure within the spending limits vaguely. The level of spending limits expenditure set out in the Government Programme is not met in the spending limits decision, and the Government's investment programme is only partly included in the spending limits. However, with the exception of the investment programme, the spending limits rule of the parliamentary term has been formulated to ensure that expenditure is maintained at the level decided by the Government.

The EU fiscal framework has become complex, and it has not worked in practice as intended. The problems with the framework have included weak compliance with it and its inefficiency in preventing pro-cyclical fiscal policy. The reform of the fiscal framework aims, among other things, to simplify the rules and to pay more attention to Member States' debt sustainability than the current framework. A key element of the reform is that compliance with the rules would no longer be monitored based on the development of the general government structural balance relative to GDP or directly on the basis of the development of the debt-to-GDP ratio. These would be replaced by monitoring the net expenditure path specified for each Member State. However, the reference values for general government deficit and debt would remain unchanged.

The net expenditure path, which is included in the proposed new framework and based on debt sustainability analysis, can provide a good basis for a realistic fiscal policy that takes the debt ratio in a favourable direction. However, compliance with the net expenditure path would not automatically mean a reduction in debt ratios. The debt sustainability analysis, on which the setting of the net expenditure path would be based, is built on assumptions made about several factors affecting the debt ratio. If the actual development of these factors does not correspond to the assumptions made when the net expenditure path was set, the debt ratio will not develop as originally estimated, even if the net expenditure objective is complied with.

The Commission's debt sustainability analysis enables Member States to be examined separately, which in turn allows the level and nature of debt risks to be assessed. The technical analysis aims to model Member States' debt sustainability risks in different economic situations in a realistic manner. No decisions have yet been made on the detailed content of the debt sustainability analysis, the background assumptions, or its application in the new framework. The underlying assumptions should be particularly carefully selected, as they have a significant impact on the adjustment path that the analysis produces for the Member State.

The general government deficit is subject to the 3% criterion, which will continue to be in force even if the EU framework is reformed in line with the Commission's proposal. Finland risks breaching this reference value in the next few years. The general escape

clause of the EU fiscal framework has been active because of the Covid-19 pandemic, the Russian invasion, and the energy crisis. It will be deactivated at the end of 2023. Differing forecasts and views of the business cycle have a significant impact on the conclusions about whether the development of Finland's public finances complies with the current EU criteria. Even though forecasts involve high uncertainty, the Government's fiscal policy should take into consideration the limits set by the EU framework valid at any given time.

1 The business cycle and the state of general government finances

The economy in Finland has continued to cool this year, and the economic outlook is weak. The economy is slowed down by high inflation, higher interest rates, the consequences of Russia's war of aggression, and increased uncertainty. The recovery in 2024 is likely to be slow and fragile, but it is still possible that the economy will experience a soft landing instead of a sharp drop. However, the risks of worsening economic development have increased.

Many general government actors in the EU Member States have become indebted during the last two decades. The general government bodies in Finland, with the exception of earnings-related pension funds, have been accumulating debt especially since the financial crisis of 2008. The surplus of earnings-related pension funds cannot be used to reduce general government debt, and earnings-related pension funds are therefore excluded from this examination. The main factor behind the increase in debt is negative primary balance, i.e. deficit net of interest payments. In recent years, another significant factor explaining the increase in debt has been the stock-flow adjustment, i.e. typically leveraged net acquisition of financial assets. In Finland, the development of the effective real interest rate on general government gross debt has been favourable compared with the change in GDP volume, which has reduced the debt-to-GDP ratio. However, Finland should not rely on this development to continue in the future.

According to a compiled sample of forecasts, Finland's economic growth prospects are challenging. Economic growth is expected to stop or be reversed this year and to remain moderate in 2024. The real economic forecast of the Ministry of Finance is more optimistic than those of other forecasters, especially for 2024. On the other hand, in terms of the general government deficit, the Ministry forecasts more pessimistic development than the other forecasters. However, the forecast of the Ministry of Finance, which underlies the budget proposal, is realistic overall.

1.1 The business cycle outlook continues to be weak

The economy has continued to cool this year. In September 2023, the colour code of the business cycle heat map of the fiscal policy monitoring function turned blue, which illustrates a weaker business cycle (Figure 1).[1] The main factors underlying this are the high inflation, higher interest rates, the consequences of Russia's war of aggression, and increased uncertainty.

1 The business cycle heatmap is a tool that describes the business cycle in Finland by means of colour codes and is based on indicators illustrating the state of the Finnish economy. The higher the share of red indicators at the same time, the more likely it is that the economy is experiencing good times, and the higher the share of blue, the more likely it is that the economy is experiencing bad times. Further information on the business cycle heatmap is available on the web page of the heatmap and in the fiscal policy monitoring report of December 2021, the fiscal policy monitoring assessment of June 2021, and Strifler and Kokkinen, 2021a.

In Finland, inflation had already been above the European Central Bank's 2% target since August 2021 and reached 4.4% in January 2022, before the beginning of Russia's war of aggression in Ukraine. The development of inflation was partly affected by the fact that demand recovered faster than supply. In 2021, national economies, including Finland, continued to suffer from supply disruptions caused by the Covid-19 crisis. At the same time, the lifting of restrictions on human mobility and the continued global fiscal stimulus seem to have contributed to the rapid recovery and even overheating of the Finnish and other national economies. Since then, Russia's war of aggression, which started at the beginning of 2022, the economic sanctions against Russia following the war, and the energy crisis have led to even higher inflation. High inflation, in itself, has had a negative impact on consumer confidence, consumption, and the economic outlook.

The European Central Bank reacted to the increased inflation by raising interest rates from July 2022 to September 2023 by a total of four percentage points. The rapid increase in interest rates resulted in a temporary suspicion of a deterioration in the financial stability in spring 2023. Inflation peaked at 9.1% in December 2022 and has since then come down to 5.5% in September 2023. Although inflation is declining, it will continue to reduce the purchasing power of consumers and have a negative impact on the economy. At the same time, higher interest rates have begun to hold back the economy this year, especially the construction sector. The business cycle heatmap (Figure 1) shows that construction confidence, which is sensitive to economic cycles, has decreased, i.e. it has turned bluer in the map, especially in the summer and early autumn of this year.

Consumer prices have developed differently from the other heatmap indicators, i.e. they have increased substantially, and the increase was highest at the turn of 2022 and 2023. At that time, the glowing red colour code of inflation (annual change in the consumer price index) indicated overheating of the economy, while the other variables in the heatmap had already faded or turned blue, which indicates slowdown in the economic activity (Figure 1). Consumer confidence has been the mirror image of inflation. Confidence has somewhat increased, and its colour code has turned less dark blue this year, as inflation has been slowing down.

According to the heatmap, the economy cooled rapidly after Russia's invasion of Ukraine at the end of February 2022. The macroeconomic deterioration was at first reflected in consumer confidence, which fell as soon as the war started in March 2022 (Figure 1). Economic development was also adversely affected by the economic sanctions imposed as a result of the war, concerns about the adequacy of energy supply in Europe, and increased uncertainty about the economic development.

In 2023, the weak business cycle has also spread to the labour market. For a long time, the labour market reacted little to the weakening of the economy. Since summer 2023, the heatmap has also shown signs of a weakening labour market. The number of vacancies began to fall first, and the colour code of this indicator turned blue already at the end of 2022. Employment and unemployment, on the other hand, have reacted with a delay to the weakening of the economy, and the colour code of these indicators turned pale blue only in the summer of 2023.

Year	Vacancies, change	Capacity utilization	Consumer price index, change	Consumer confidence	Wages and salaries, change	Services confidence	Construction confidence	Industrial confidence	Employment rate, change	Unemployment rate, change	Retail trade confidence	Composite indicator (weighted)
2023												
9		-1.02		-1.62		-1.07	-1.67	-1.57			-0.85	-0.66
8	-2.02	-1.01	1.70	-0.89		-0.75	-1.38	-1.33	0.03	-0.06	-0.47	-0.55
7	-2.03	-0.95	2.12	-1.05	-0.38	-0.78	-1.39	-1.35	-1.37	-0.16	-1.12	-0.72
6	-2.15	-0.81	2.03	-1.03	2.59	-0.76	-0.93	-1.14	-0.31	0.00	-0.31	-0.24
5	-1.94	-0.58	2.26	-1.09	0.99	-0.61	0.02	-0.83	-0.04	0.13	-0.20	-0.21
4	-1.74	-0.45	2.78	-0.93	0.24	-0.51	-0.98	-0.85	0.03	0.00	-0.12	-0.21
3	-1.49	-0.56	2.78	-1.52	1.18	-0.36	-0.50	-0.80	0.10	0.07	-0.01	-0.09
2	-1.22	-0.13	3.21	-1.64	0.33	-0.56	-0.75	-0.40	-0.11	0.24	-1.16	-0.07
1	-0.95	-0.35	3.02	-1.76	0.56	-0.73	-0.85	-0.20	-0.04	0.42	-1.35	-0.03
2022												
12	-1.43	0.06	3.35	-2.76	0.66	-0.57	-0.43	-0.47	-0.18	0.36	-1.94	-0.13
11	-1.45	0.11	3.35	-2.56	1.41	-0.59	-0.26	-0.48	0.93	0.54	-1.20	0.11
10	-0.57	0.14	2.97	-2.72	0.53	-0.53	-0.02	-0.25	1.14	0.70	-1.32	0.14
9	-0.13	0.90	2.88	-2.98	1.51	-0.56	0.16	0.04	0.94	0.83	-1.84	0.36
8	0.31	0.55	2.64	-2.23	1.35	-0.65	-0.33	0.22	0.30	0.89	-1.89	0.34
7	0.68	0.57	2.74	-2.29	0.73	-0.12	-0.58	0.52	0.29	0.92	-0.15	0.46
6	1.30	1.14	2.74	-2.01	1.02	0.18	-0.38	0.78	0.48	1.03	-0.16	0.75
5	1.44	1.45	2.36	-1.64	1.08	-0.09	-0.36	1.06	0.92	1.18	-0.44	0.85
4	2.14	1.55	1.74	-1.68	1.67	-0.11	0.49	1.18	1.61	1.41	-0.52	1.05
3	2.68	1.60	1.79	-1.32	1.64	0.27	0.70	1.24	1.03	1.38	-0.60	1.14
2	2.17	1.69	1.18	0.65	1.28	0.58	1.10	1.70	1.69	1.11	-0.29	1.32
1	1.82	0.97	1.13	0.39	1.38	0.57	1.02	1.43	1.49	1.06	0.26	1.14

Figure 1: Heatmap produced by the fiscal policy monitoring function (3 November 2023).
Sources: Statistics Finland, Ministry of Economic Affairs and Employment, European Commission, Confederation of Finnish Industries, and calculations by the fiscal policy monitoring function (Strifler and Kokkinen, 2021a).

The monthly composite indicator has fallen rapidly from the peak of early 2022. Since December 2022, it has been below zero, which means that the economic outlook has been negative ever since. Contrary to what the fiscal policy monitoring function forecasted last spring, the composite indicator continued to fall rapidly during the summer months of 2023. In autumn 2023, the rising interest rates started to slow down the economy even more strongly, and geopolitical risks, in particular, continue to grow. The development of world trade is sluggish (IMF, 2023). The economic outlook in autumn 2023 is uncertain and weak.

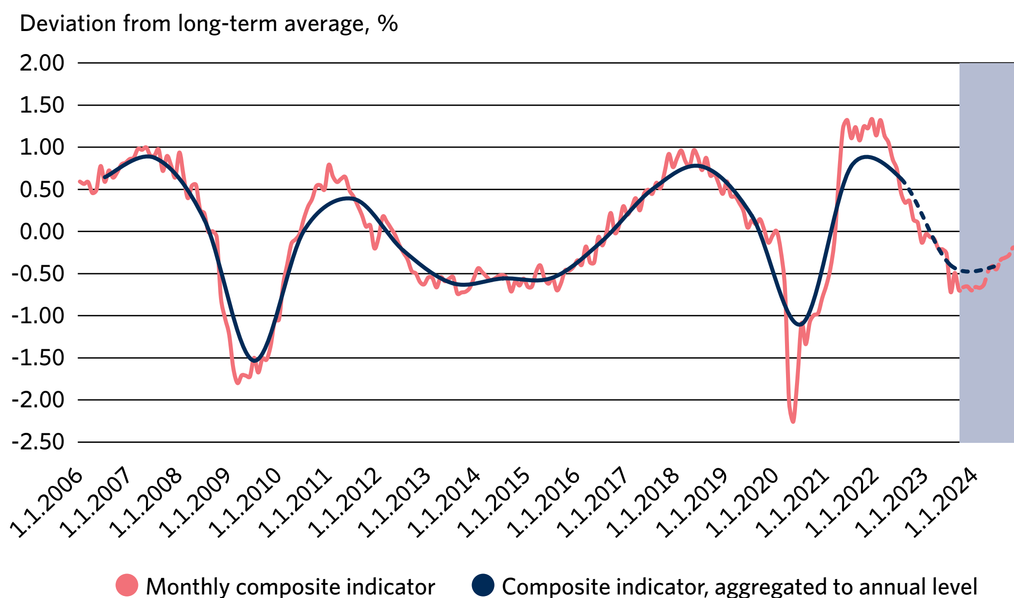


Figure 2: Monthly (red line) and annual (blue line) composite indicator illustrating the business cycle in Finland, and forecast for the next year (grey background). The forecast is based on the heatmap data and other statistics available by 3 November 2023. Sources: Statistics Finland, Ministry of Economic Affairs and Employment, Confederation of Finnish Industries, European Commission. Calculations and forecasts: fiscal policy monitoring function (Strifler and Kokkinen, 2021b).

According to the current and next year's forecast of the composite indicator of the fiscal policy monitoring function, the economy will continue to adapt to the adverse impacts of the war, economic sanctions, energy crisis, high inflation, and rising interest rates, and the business cycle will develop very slowly in the near future (see Figure 2).

In 2023, the development of the business cycle is forecast to be weak, and the indicator is forecast to remain clearly below zero and hit rock bottom at around the turn of the year. According to the forecast, the recovery in 2024 will be slow and fragile, and the composite indicator will remain below zero in 2024.

It should be noted that the forecast of the business cycle indicator of the heatmap currently involves a high level of uncertainty. The autumn forecast supports the view that the rising interest rates will curb inflation without affecting the economy severely and that a soft landing without a sharp drop would still be possible (see, for example, IMF, 2023). However, the risks of worsening development have increased.

The key macroeconomic conditions are clearly weaker in autumn 2023 than they were after the Covid-19 crisis, which makes a rapid recovery unlikely. First, the high prices following the inflation, the decreased purchasing power, and the higher interest expenses have burdened the economy more permanently. Second, the spirit in global markets has shifted from cooperation towards confrontation and strategic competition. Should this remain permanent, it may slow down world trade and investments. This would be detrimental especially to a small open economy such as Finland. The growth prospects of the global economy are exceptionally weak (IMF, 2023).[2]

2 see IMF WEO, October 2023.

In addition, there are plenty of risk factors that may further weaken the business cycle. The concerns of spring 2023 about the emergence of a new crisis on financial markets, or possibly the property market in the United States and Europe, have receded for the time being. On the other hand, there are concerns as to whether the governments in EU countries can continue to borrow from the markets at a reasonable interest rate. If not, the European Central Bank will face difficult decisions. Other sources of concern include the weakened geopolitical stability, an increase in barriers to international trade, and the possibility of recurring energy shortage in Europe next winter. Finland's membership in NATO will stabilise Finland's investment environment and dampen the effects of the weakening of geopolitical stability. If wages and prices develop more slowly in Finland than in the key competitor countries, this may strengthen Finland's cost competitiveness.

The business cycle heatmap of the fiscal policy monitoring function and its composite indicator produce a picture of the business cycle in Finland directly on the basis of business cycle indicators. The composite indicator complements the picture of the business cycle provided by the difference (i.e. gap) between the indirectly estimated observed GDP and the GDP trend (i.e. long-term potential output).[3] Output gap estimates describing the business cycle are also calculated and published regularly by the Ministry of Finance, the European Commission, the Bank of Finland, the International Monetary Fund (IMF), and the Organisation for Economic Co-operation and Development (OECD). In addition, the difference (gap) between the observed GDP and the GDP trend, which describes the business cycle, can be calculated by means of different filters, such as the HP filter. The European Commission and the Ministry of Finance use the same production function method, jointly agreed by the EU Member States.[4] To get a broader picture of the annual business cycle, it is possible to compare the annual composite indicator and the results of the annual HP filter with the output gap estimates calculated by the above-mentioned organisations (Figure 3).

The composite indicator of the heatmap aggregated to annual level and the annual output gap estimates develop largely in line with each other (Figure 3). However, in cyclical changes, such as the financial crisis or the Covid-19 crisis, there are clear differences between the indicators. When the recovery from the Covid-19 crisis is examined, the composite indicator showed already in 2021 that the output gap had closed rapidly. The HP filter also showed rapid recovery[5], whereas according to the estimates produced by the European Commission and the Ministry of Finance, the output gap would have continued

3 When the business cycle is assessed, the observed GDP growth is divided into the business cycle component and the long-term trend growth component. The composite indicator of the heatmap observes the business cycle component of the growth directly, while the long-term trend growth can be derived from the difference between the observed GDP and the business cycle component. In the output gap methods, trend growth is first separated from GDP growth, whereafter the gap describing the business cycle component is calculated as the difference between the observed GDP and the trend growth.

4 This is the production function method which has been developed by the Commission and which is jointly agreed by the EU Member States, and the Commission uses this method when assessing Member States' structural balance. The Ministries of Finance of all Member States do not use this method in their own calculations. For example, the Danish Ministry of Finance uses its own method, which is revised to a lesser extent.

5 Other calculations also indicated a more rapid recovery. See Fiscal Policy Monitoring and Audit Report on the 2019-2022 Parliamentary Term (fiscal policy monitoring function, 2022). The robustness of the output gap produced using the HP filter has also been examined in the same report (see Appendix 2 to the report).

to be negative after 2020, i.e. the economy would have remained continuously clearly below the potential output. The same applies to the OECD's estimate, which differs even otherwise from all the other estimates: according to it, the economy would have been continuously in recession since 2012. Since then, the Bank of Finland and the IMF have revised their own estimates of the output gap so that they are at least close to zero, and the Bank of Finland's output gap even turns positive in 2022.

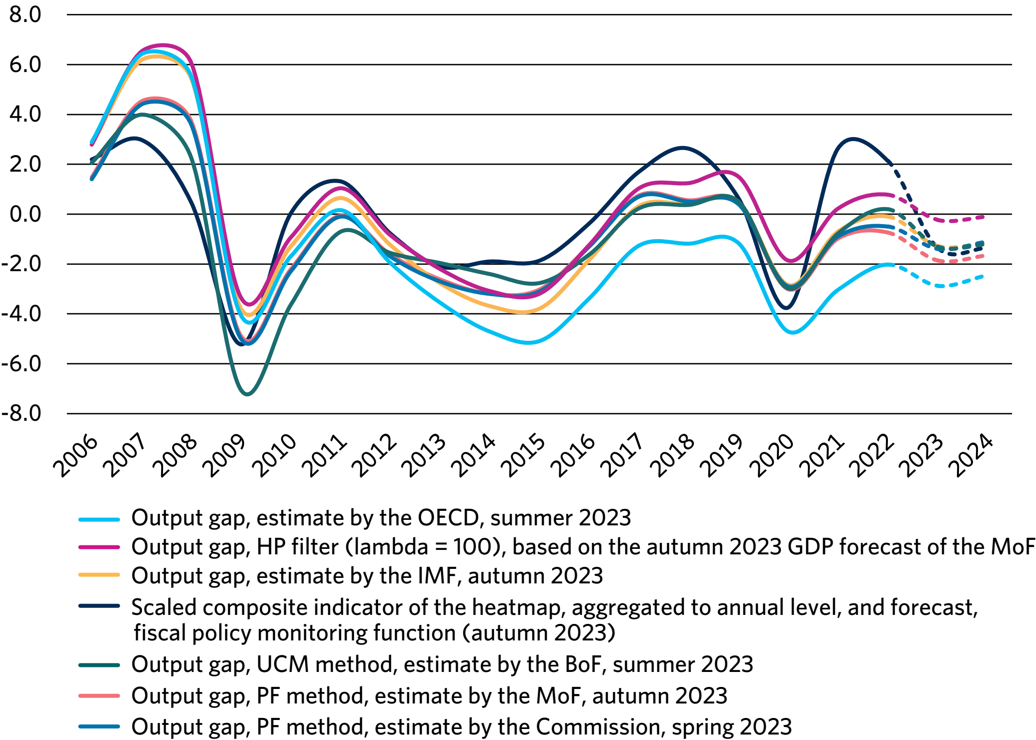


Figure 3: Composite indicator of the heatmap aggregated to annual level and its forecast, the HP filter (λ=100), and the annual output gap estimates of the following actors: Ministry of Finance (MoF), Bank of Finland (BoF), EU Commission, International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD). Forecast for 2023 and 2024 (dashed line). The variation (standard deviation) of the business cycle indicator of the heatmap has been scaled to be comparable with the variation (standard deviation) of the output gap. Sources: MoF, BoF, EU Commission, IMF, OECD and the fiscal policy monitoring function.[6]

6 Sources of the composite indicator of the heatmap: Statistics Finland, Ministry of Economic Affairs and Employment, Ministry of Finance, European Commission, Confederation of Finnish Industries. Calculations by the fiscal policy monitoring function (see Strifler, M. and Kokkinen, A., 2021b).

It should be pointed out that inflation started to rise already in the second half of 2021. According to economic theory, a positive output gap cannot be maintained without upward pressure on wages and prices (see Forecast for the Finnish Economy by the Bank of Finland, 16 December 2022). The composite indicator of the heatmap was the only output gap estimate that indicated a positive output gap before the end of 2021.

Unlike in the case of 2021 and 2022, the various annual output gap estimates now appear to develop in line with each other. According to all forecasts, the upturn in 2021–2022 following the Covid-19 crisis is over, and the business cycle deteriorates in 2023 as a result of the high inflation, interest rate increases, Russian war of aggression, and energy crisis. The weak development is forecast to continue in 2024 as well, and the recovery is forecast to be very slow.

1.2 Factors underlying the development of general government debt

The increasing general government debt has become a constant concern in many European countries, including Finland. The best-known way to consider general government debt is to examine it in relation to GDP. This ratio indicates, better than an amount in euros, how government debt develops in relation to the size of the economy, enabling thus international comparisons. The ratio also shows how the general government's ability to manage and repay debt develops. For example, the possibility of the state to generate income through taxation depends largely on the size of the economy. Therefore, debt-related fiscal rules and targets are typically expressed in relation to GDP.[7]

Over the past 22 years, the average debt-to-GDP ratio of the EU countries has grown, with a few exceptions (Figure 4). In four countries, the debt-to-GDP-ratio has increased by more than 50 percentage points (Greece, Portugal, Spain, France). In only three countries, the debt ratio has decreased significantly, i.e. by 17 percentage points or more (Bulgaria, Denmark, Sweden). The other countries are between these extremes. In the whole EU, the average debt-to-GDP ratio has grown by around 17 percentage points and in the euro area, by around 22 percentage points. In Finland, the debt-to-GDP ratio has grown by around 28 percentage points.

7 As a fiscal rule, the ratio is not without problems. It takes into account only debt and not financial assets. In addition, it is dependent on cyclical fluctuations as GDP is the denominator in the ratio. This causes pro-cyclicality in the ratio (see e.g. Kokkinen and Strifler, 2021). In addition, tax revenue, which is dependent on GDP, is not the only source of income for the state, for example. The state also receives interest and dividend income on its financial assets.

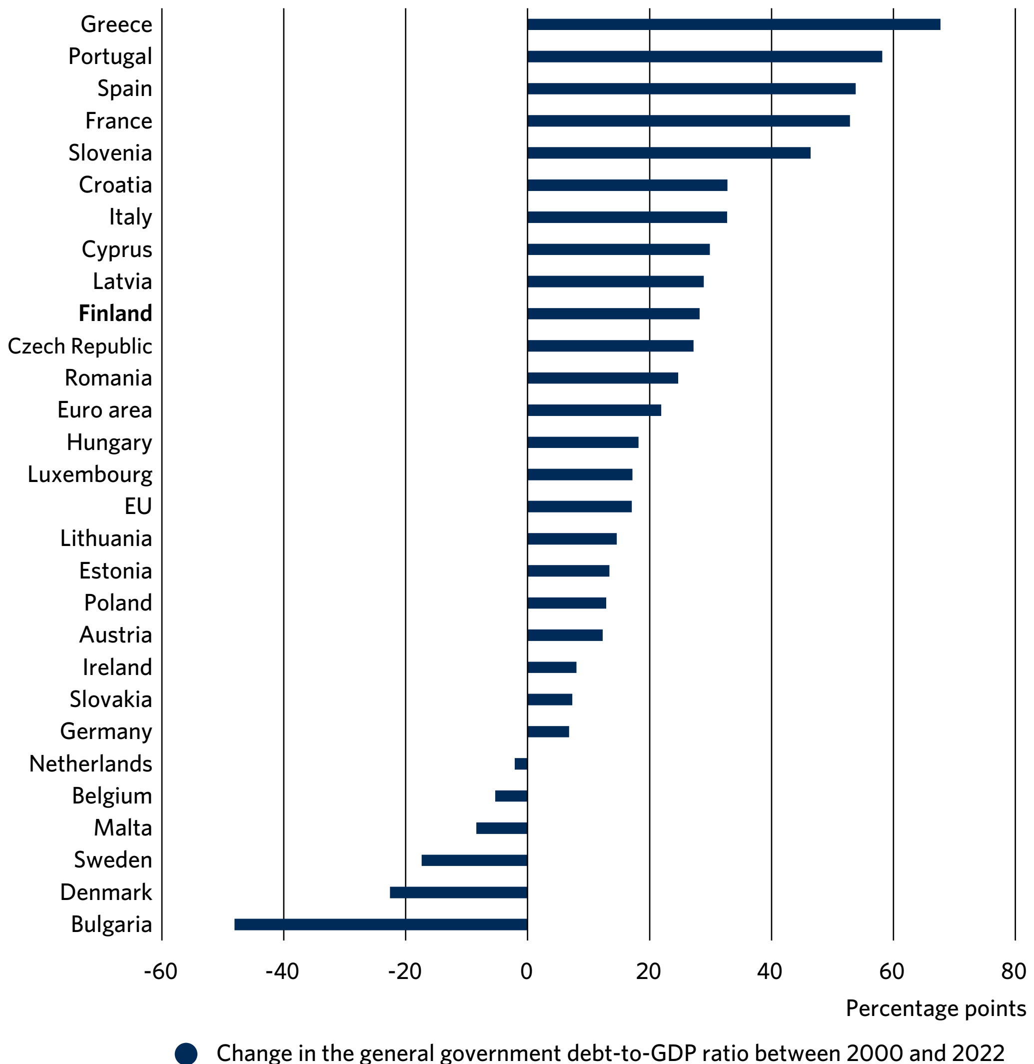


Figure 4: Change in the general government debt-to-GDP ratio between 2000 and 2022, percentage points. Source: Eurostat (2023).

The growth of the debt ratio is due to, for example, the continuous (primary) deficit and economic slumps, such as the financial crisis or the Covid-19 crisis. Interest payments have grown recently due to the increases in interest rates. To get a better picture of the factors that have an impact on the accumulation of debt and the extent of their impact, the change in the debt ratio is divided into four components: gross interest payments, the impact of GDP growth, the primary balance, and the stock-flow adjustment (see information box 1). Accumulated debt generates interest payments, which in turn increase financing needs and thereby debt. On the other hand, as GDP grows, the debt-to-GDP ratio falls. Primary balance refers to balance net of gross interest payments, and it may either increase debt (deficit) or decrease it (surplus). The same applies to the stock-flow adjustment: a positive stock-flow adjustment increases the debt-to-GDP ratio, while a negative adjustment decreases it.

Information box 1: Accumulation equation for the general government debt-to-GDP ratio

The annual change in the debt-to-GDP ratio can be divided into the following factors in accordance with equation (1): (nominal) interest payments, (nominal) impact of GDP growth, primary balance, and stock-flow adjustment (see e.g. Escolano, 2010[8]). All terms are figures relative to GDP.

$$\Delta d_t = \frac{i_t}{(1+g_t^{nim})} d_{t-1} - \frac{g_t^{nim}}{(1+g_t^{nim})} d_{t-1} - p_t + sfa_t \qquad (1)$$

The first term of the equation indicates that interest on already accumulated debt must be paid to the investors. Nominal gross interest payments depend on the effective nominal interest rate[9] (i_t), the growth rate of nominal GDP (g_t^{nim}), and the debt relative to GDP accumulated until the previous year (d_{t-1}). The second term represents the debt ratio reducing effect of the nominal GDP growth rate. When GDP grows, it reduces the debt-to-GDP ratio. The third term affecting the growth of the debt ratio is the primary balance of the current year (p_t). It is preceded by a minus sign because primary deficit increases debt and primary surplus decreases debt. Primary balance refers to balance net of gross interest payments (they are taken into account in the first term).

The fourth and last term is the stock-flow adjustment (sfa_t).[10] The stock-flow adjustment (debt-deficit adjustment) describes the part of the change in debt that is not explained by the change in the deficit. It consists of different subitems, which according to the European Commission and Eurostat (2023) are net aquisition of financial assets, adjustments, and statistical discrepancy. The stock-flow adjustment describes several different factors, such as the extent to which a potential surplus is not used to reduce debt but to acquire financial instruments or, correspondingly, that debt is reduced by income from the sale of financial instruments.

The impact of the annual change in inflation, or more specifically the GDP deflator, on the change in the debt-to-GDP ratio cannot be shown directly. However, the effect of the GDP deflator can be removed from the accumulation equation. The GDP deflator affects the first two elements of the equation: nominal gross interest payments and the impact of nominal GDP growth. When the impact of the GDP deflator is eliminated from these elements, the change in the debt-to-GDP ratio can be divided into the following four factors: real gross interest payments, impact of real GDP or GDP volume growth, primary balance, and stock-flow adjustment (see equation 2). The GDP deflator does not affect the latter two factors. Real gross interest payments depend on the effective real interest rate (r_t), the growth rate of GDP volume (g_t), and the previous year's debt ratio (d_{t-1}). The second term represents now the positive effect of the GDP volume growth rate. Taking into account the change in inflation, or more specifically the GDP deflator, reduces the impact of interest payments and GDP growth to exactly the same extent.

$$\Delta d_t = \frac{r_t}{(1+g_t)} d_{t-1} - \frac{g_t}{(1+g_t)} d_{t-1} - p_t + sfa_t \qquad (2)$$

8 Unfortunately, Escolano (2010) has excluded the stock-flow adjustment from the analysis. Nevertheless, the derivation of the debt ratio accumulation equation is presented transparently in the paper.

9 The effective interest rate takes into account the different interest rates and other costs of all liabilities issued (see below).

10 The stock-flow adjustment (SFA) can also be referred to as the debt-deficit adjustment (DDA).

The equation is the core of the debt sustainability analysis (see also section 3.3). Assuming that the primary balance and the stock-flow adjustment are close to zero, the effective real interest rate (r_t–g_t) and the change in GDP volume (r_t), or more specifically the difference between them (g_t), determines the development of the debt-to-GDP ratio. The debt ratio decreases when the change in GDP volume exceeds the real interest rate (r_t<g_t). Correspondingly, the debt ratio grows when the real interest rate exceeds the change in GDP volume (r_t>g_t). From the above, it follows that, when the change in GDP volume is higher than the real interest rate, it is possible to maintain a primary deficit or a positive stock-flow adjustment without an increase in the debt ratio. Correspondingly, when the change in GDP volume is lower than the real interest rate, a primary surplus or a negative stock-flow adjustment must be maintained to prevent the debt ratio from increasing.

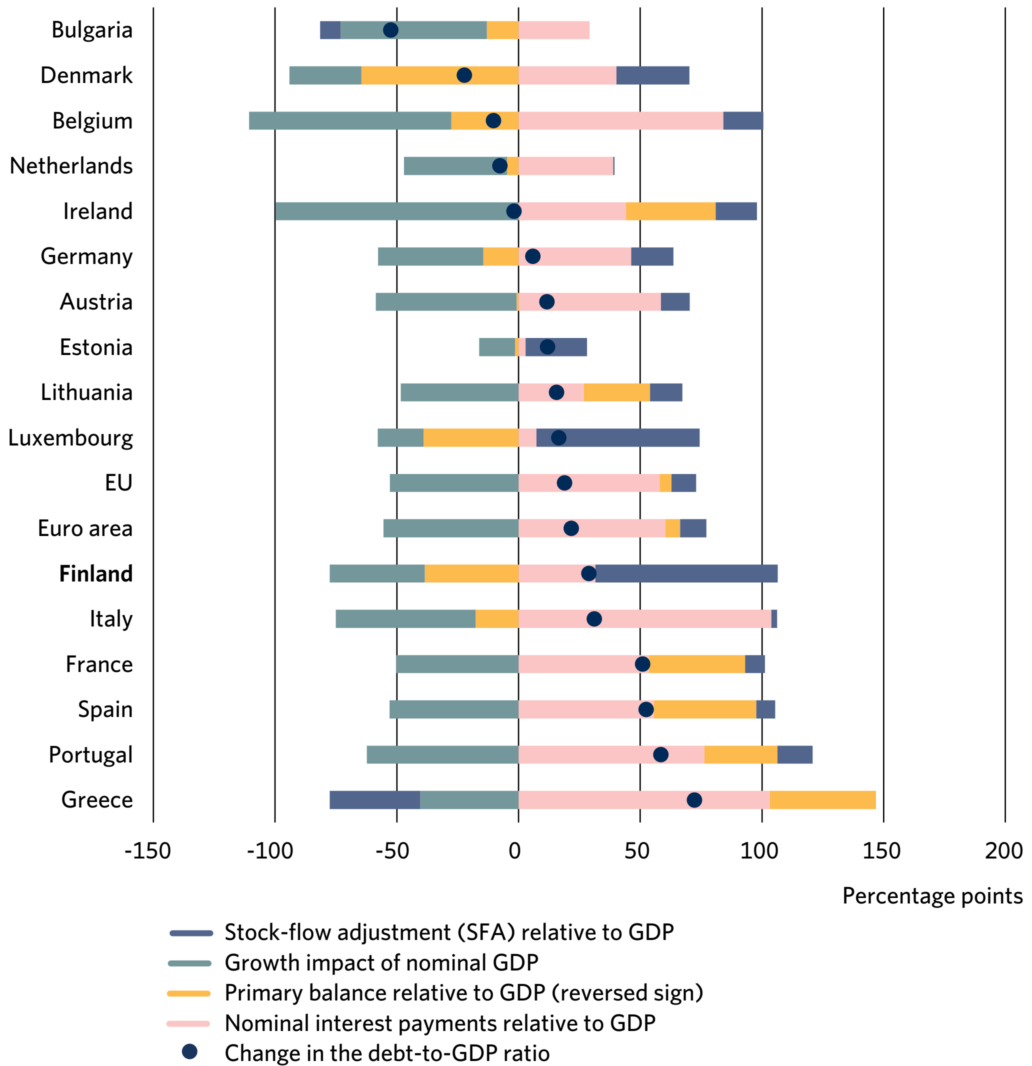


Figure 5: The change in the debt-to-GDP ratio in certain EU Member States between 2000 and 2022. Source: Eurostat (2023), European Commission (2023a), calculations by the fiscal policy monitoring function.

Dividing the change in the debt ratio into the elements of equation 1 (information box 1) gives a more accurate picture of the extent to which the different components have affected the change in the debt ratio on average in the different EU countries between 2000 and 2022 (Figure 5)[11]. Nominal GDP growth reduces the debt ratio in all the countries examined. Depending on the rate of GDP growth, for example, GDP growth has only a minor impact on the change in the debt ratio in some countries, while in some other countries – e.g. Bulgaria and Ireland – it is the most important factor. Nominal gross interest payments, in turn, increase the debt-to-GDP ratio and are an important component of the change in the debt ratio in many countries. For example, in Greece, Portugal, Spain, and France, where the government debt has grown by more than 50 percentage points relative to GDP over the past 22 years, nominal gross interest payments are the single most important component of the change in the debt ratio. Italy differs from the other countries in that, over the same period, its debt ratio has been growing almost exclusively because of nominal interest payments.

The primary balance is also a significant factor in the change of the debt ratio in many EU countries. In some countries, such as France and Spain, the primary balance is negative on average, i.e. the deficit net of gross interest payments increases the debt ratio. In the other countries, the primary balance is positive and reduces the debt ratio. This is the case for example in Denmark, where the general government debt ratio has decreased significantly in the last 22 years.

In Finland, the debt-to-GDP ratio has grown by around 28 percentage points in 22 years. The primary balance has also been positive on average, which has reduced the debt ratio. It should be borne in mind that the review period also includes such pre-financial crisis years when general governments reported surplus. The primary balance of general government is also affected by other factors. In Finland, for example, an important factor is the stock-flow adjustment, which results particularly from the use of the surplus of earnings-related pension funds for net acquisition of financial assets. These other factors will be discussed in greater detail below in connection with Finland.

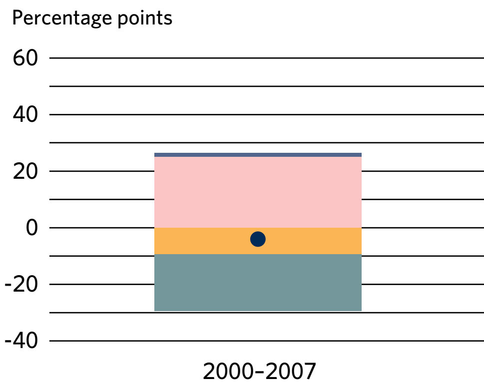
Between 2000 and 2022, the stock-flow adjustment has been on average the most significant factor increasing the debt ratio in Finland[12], Luxembourg, and Estonia. In many other countries as well, the stock-flow adjustment is also on average clearly different from zero. The impact of the stock-flow adjustment in both the euro area and the whole EU area is clearly greater during the period in question, although nominal interest payments and the impact of GDP growth are the key components in the growth of the debt ratio.[13]

11 In some EU Member States, the statistical difference between the change in the debt-to-GDP ratio and the sum of the different components has been quite big throughout the period (2000–2022). Only the countries where the difference has been very small were included in this examination.

12 However, a more detailed analysis (see below) shows that the exclusion of the surplus of earnings-related pension funds reduces the general government stock-flow adjustment in Finland and increases the importance of primary balance.

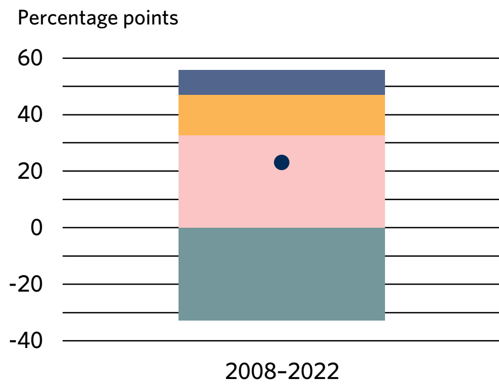
13 Larch et al. (2022) examined a slightly shorter period (2000–2019). They divide the EU Member States into three different categories based on the size of the debt ratio. In their analysis, interest payments and the impact of GDP growth are clearly the key components in the debt ratio when the stock-flow adjustment is of approximately the same magnitude as the primary balance.

Change in the debt-to-GDP ratio in the EU.
2000–2007 (Nominal interest payments
and impact of nominal GDP growth)



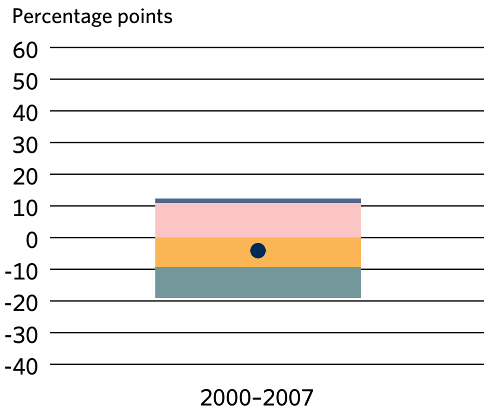
- Stock-flow adjustment (SFA) relative to GDP
- Nominal interest payments relative to GDP
- Primary balance relative to GDP (reversed sign)
- Growth impact of nominal GDP
- Change in the debt-to-GDP ratio

Change in the debt-to-GDP ratio in the EU.
2008–2022 (Nominal interest payments
and impact of nominal GDP growth)



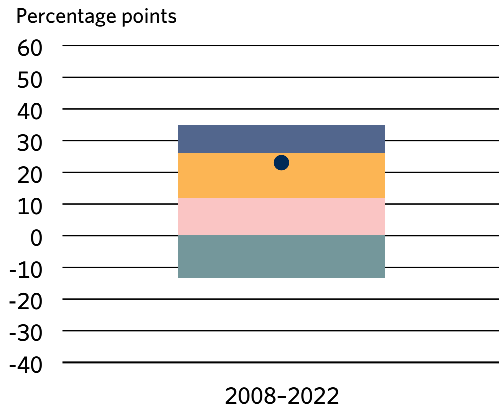
- Stock-flow adjustment (SFA) relative to GDP
- Nominal interest payments relative to GDP
- Primary balance relative to GDP (reversed sign)
- Growth impact of nominal GDP
- Change in the debt-to-GDP ratio

Change in the debt-to-GDP ratio in the EU.
2000–2007 (Real interest payments
and impact of real GDP growth)



- Stock-flow adjustment (SFA) relative to GDP
- Real interest payments relative to GDP
- Primary balance relative to GDP (reversed sign)
- Impact of change in GDP volume
- Change in the debt-to-GDP ratio

Change in the debt-to-GDP ratio in the EU.
2008–2022 (Real interest payments
and impact of real GDP growth)



- Stock-flow adjustment (SFA) relative to GDP
- Real interest payments relative to GDP
- Primary balance relative to GDP (reversed sign)
- Impact of change in GDP volume
- Change in the debt-to-GDP ratio

Figure 6: The change in the debt ratio in the EU before and after the financial crisis, in both nominal and real terms. Source: Eurostat (2023), European Commission (2023a), calculations by the fiscal policy monitoring function.

The role of the stock-flow adjustment as a component of the change in the debt ratio deserves more attention (see Jaramillo et al., 2017). Unfortunately, the EU's fiscal rules have so far not attached any greater importance to the stock-flow adjustment as a factor in the growth of the debt ratio (Afonso and Jalles, 2020, see also chapter 3).[14] Instead, the current rules focus mainly on the debt-to-GDP ratio and the (primary) balance. However, it appears from the debt accumulation equation and particularly from the data describing the components of the change in the debt ratio (Figure 6) that the stock-flow adjustment has played a significant role, especially after the financial crisis.

At EU level, the stock-flow adjustment has been significantly higher after the financial crisis. Before the financial crisis, the SFA was 1.4% relative to GDP, whereas after the crisis, it has been 8.8% relative to GDP (Figure 6, upper row). The substantial increase in the SFA is due to the fact that, at the time of the financial crisis, the central government in many EU countries made capital injections into private banks, which directly increased general government debt and particularly central government debt. The stock-flow adjustment is linked to the business cycle and economic slumps, in particular (Xuehui et al., 2023). However, the relative importance of the SFA is somewhat reduced by the fact that other components have also been greater after the financial crisis. Overall, it is nevertheless clear that the SFA is clearly different from zero and therefore an essential component in the change of the debt ratio.

The relative importance of the SFA increases further if the impact of the GDP deflator is removed from the numerator of the debt ratio, i.e. gross interest payments, and the denominator, i.e. the effect of nominal GDP growth (Figure 6, lower row). Real interest payments and the effect of the change in real GDP volume decrease to less than half of the corresponding nominal factors. This also highlights the fact that in magnitude, the SFA is almost as important as the other components in the growth of the debt ratio (Figure 6, lower row, right). Accordingly, more attention should be paid to the stock-flow adjustment in discussions on the sustainability of public finances and the fiscal rules (see also chapter 3).

Primary balance has been the most significant factor affecting debt development in Finland

In Finland, the general government debt-to-GDP ratio declined before the financial crisis but has grown almost continuously since then. When the factors affecting the change in debt are examined, there are a few special factors that should be considered in the case of Finland.

The stock-flow adjustment of the Finnish general government has been significant in the 2000s, but most of it is explained by the impact of earnings-related pension funds. Earnings-related pension funds use their income (= pension contributions and property income received) mainly for the payment of pensions and for net acquisition of financial assets, which is part of the SFA. The surplus of earnings-related pension funds cannot be used to reduce the debt of other sub-sectors of the general government. Earnings-related pension funds should therefore be excluded from the examination of factors affecting the development of general government debt in Finland. This emphasises the importance of primary balance and interest payments on debt as government debt-increasing factors,

14 However, in the new framework, it is possible to attach more importance to the stock-flow adjustment specifically in the case of each country (see also chapter 3).

while the SFA is clearly less important (Figure 7). However, since 1996, the SFA has been on average positive, increasing the debt ratio annually by around 0.2% relative to GDP. In the same period, negative primary balance (i.e. deficit net of gross interest payments) has increased debt annually by around 0.7% relative to GDP, i.e. more than three times more rapidly. The general government sub-sector that most clearly underlies the negative primary balance is the central government, but the local government primary balance has also been negative almost throughout the period under review.

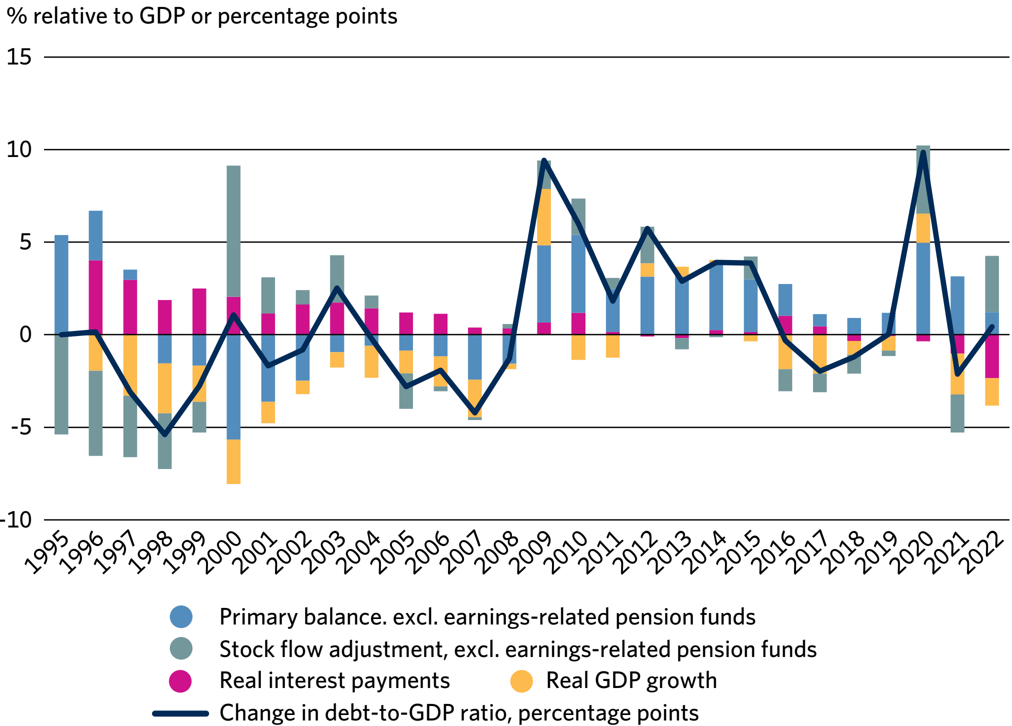


Figure 7: Factors affecting the development of the debt ratio in the general government (excluding earnings-related pension funds), presented in accordance with equation (2). Sources: European Commission (2023a), Eurostat (2023), Statistics Finland (2023c), fiscal policy monitoring function.

However, the importance of the stock-flow adjustment should not be underestimated, and its closer examination provides useful information on the factors affecting the debt sustainability of Finland. According to Eurostat (2023), the three components of the SFA are the net acquisition of financial assets, adjustments, and statistical discrepancy. In Finland, the most important one of these is net acquisition of financial assets even when earnings-related pension funds are not considered as part of the general government (Figure 8). In 2020 and 2022, in particular, the SFA has been a significant factor in increasing general government debt. In those years, the underlying factor was the net acquisition of financial assets.

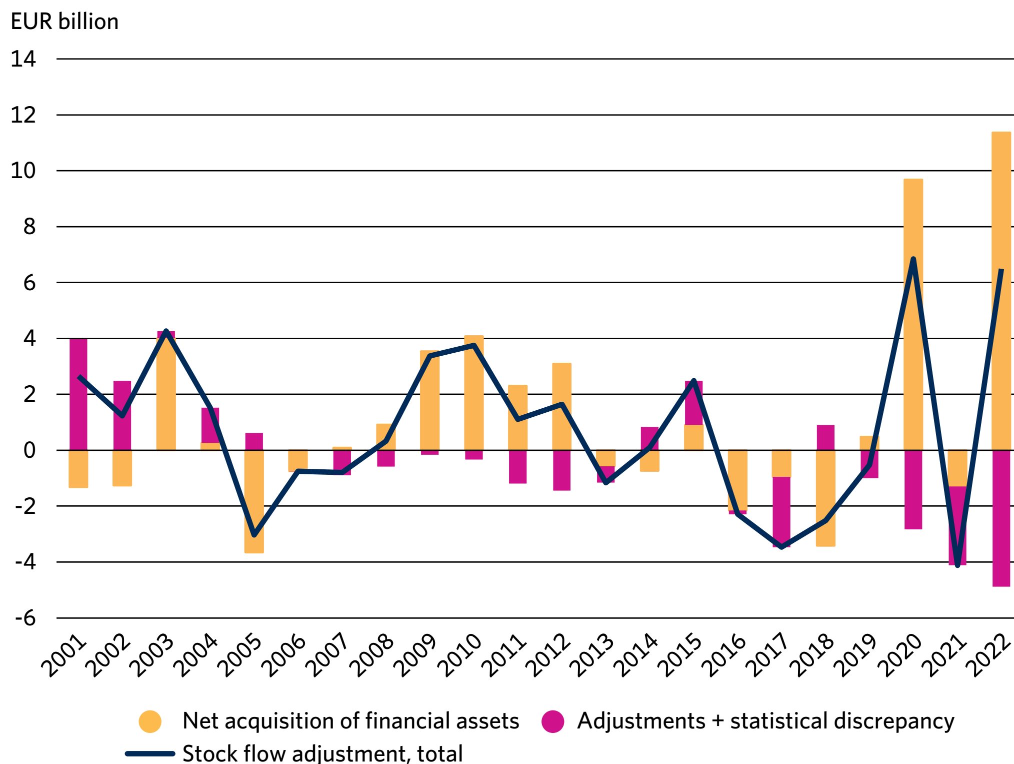


Figure 8: Stock-flow adjustment of the Finnish general government, excluding earnings-related pension funds. Sources: Statistics Finland (2023a; 2023c).

In 2020, the large share of the net acquisition of financial assets in the stock-flow adjustment was mainly due to the fact that central government cash was increased by nearly EUR 8 billion with debt. The change was about five times greater than normal changes in cash (Figure 9).[15] In 2022, general government debt increased as a result of the growth of guarantee claims on derivatives related to the management of the interest rate risk position of central government debt (Finnish Government, 2022). During and after the financial crisis, the state granted loans which it financed by borrowing[16] (Figure 9).

15 This was at least partly due to the fact that a significant part of the funds budgeted for 2020 in the state budget remained unused. In 2020, the appropriations carried over in the budget were significantly higher than before: about twice the normal. In 2020, around EUR 8.5 billion was carried over to the following year, which corresponded to about 12% of the appropriations available for 2020. For example, in 2018 and 2019, around 8% of the available appropriations were carried over.

16 The central government granted loans to different states, such as the state of Iceland in 2009 (EUR 350 million) and the state of Greece in 2010 (EUR 1.6 billion). The state also granted loans to domestic entities, e.g. around EUR 295 million for the Finnish Export Credit Ltd's refinancing activities in 2011.

The general government (excluding earnings-related pension funds) has made significant net sales of shares and investment fund shares, for example in 1998–2000 and 2004–2007. The proceeds received were used to reduce central government debt. On the other hand, however, the sales meant, for example, that dividends were no longer received. The biggest net sales were made by the state during Prime Minister Lipponen's second government term between 1999 and 2003. At that time, the state sold shares and investment fund shares for around EUR 6.5 billion. Since then annual sales have amounted on average to around EUR 3.5 billion.

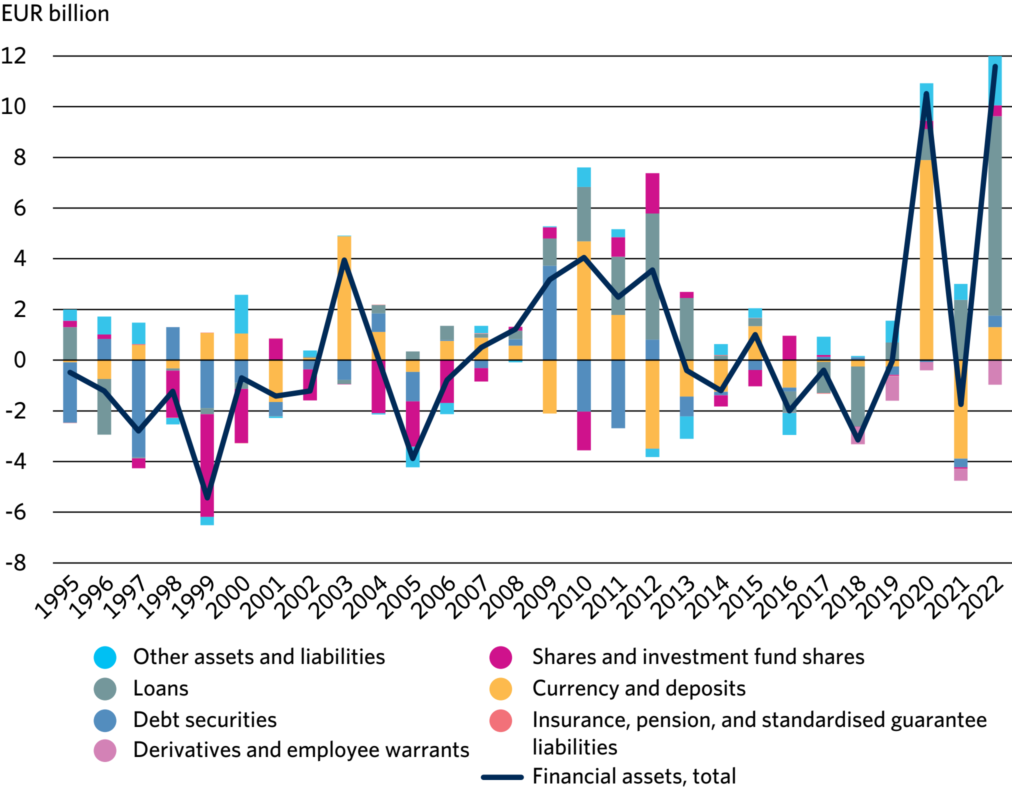


Figure 9: Net acquisitions and sales of financial assets by the Finnish general government (excluding earnings-related pension funds), EUR billion. Source: Statistics Finland (2023b).

The development of effective interest rate on Finland's general government debt has been positive in relation to the economic growth after the financial crisis, but this is about to change

The higher the government debt-to-GDP ratio, the more important it is to monitor the development of interest payments and GDP growth (see equation 2, information box 1). If the debt ratio is low, an increase in effective real interest rates on general government gross debt has only a minor impact on the change in the debt ratio. If the debt ratio is high, even small increases in the effective real interest rate may affect and even determine the change

in the debt ratio. In recent years, the general government debt-to-GDP ratio in Finland has become so high that it is increasingly important to monitor the development of the effective real interest rate on general government gross debt and the change in GDP volume. In 2022, the general government debt-to-GDP ratio in Finland amounted to 73%.

After the financial crisis, the development of real interest rates has been very favourable to the general government in Finland (see Figure 10). The real interest rates have decreased and been typically at a lower level than the change in GDP volume (*rt<gt*), or the difference between them has been close to zero. This means that the debt ratio would have decreased if the primary balance and the stock-flow adjustment had been zero. In other words, the favourable development of economic growth and interest rates reduced the debt-to-GDP ratio. However, their effect was offset by the simultaneously significant primary deficit and positive stock-flow adjustment. As a result of this, Finland's debt-to-GDP ratio has increased.

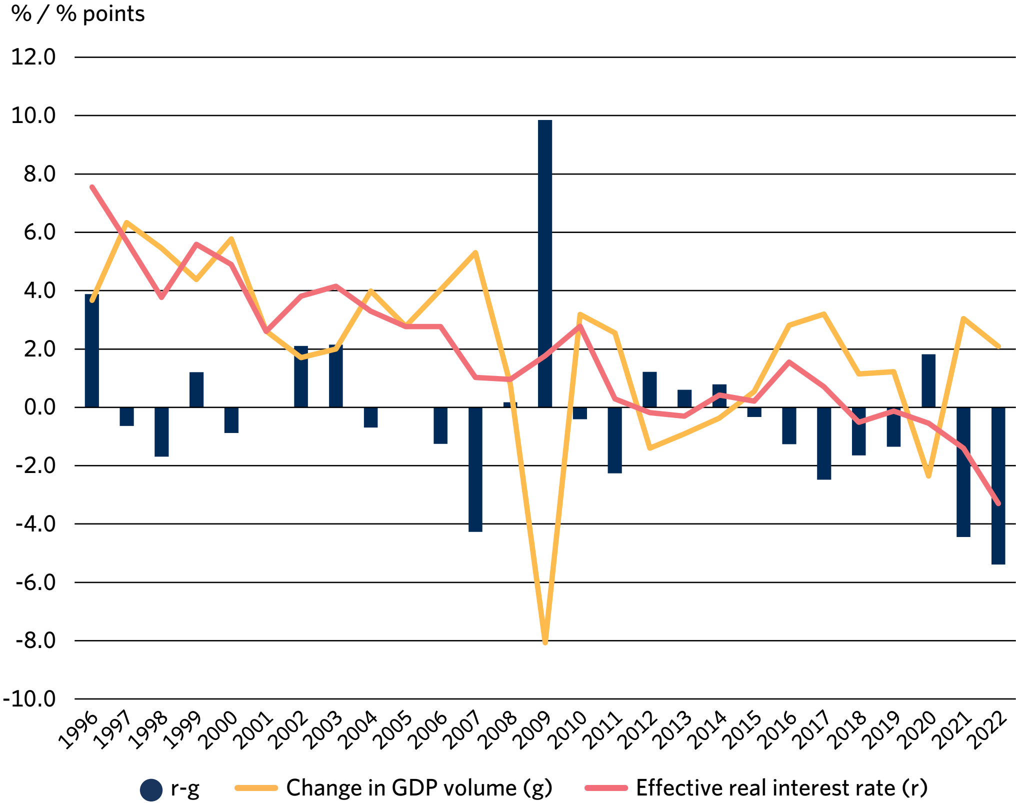


Figure 10: Real interest rate on Finland's general government gross debt, change in Finland's GDP volume, and their difference. Source: Eurostat (2023), European Commission (2023a), Statistics Finland (2023), and calculations by the fiscal policy monitoring function.

The effective real interest rate on general government gross debt depends on a number of factors, such as nominal effective interest rates and inflation, or more specifically the change in the GDP deflator. The nominal effective interest rates depend mainly on the time structure of the debt, the variation in interest rates, and the effects of interest rate

derivatives (e.g. swaps)[17]. The effective interest rates are also affected by current market interest rates. When the amount of debt to be rolled over and the amount of bonds issued at a given time are high, the effective interest rate follows the market interest rate rapidly.[18] If the amount of bonds issued is relatively high, the effective interest rate may change rapidly, whereas, if the amount remains relatively small for a long time, the effective interest rate will change slowly (see also chapter 3).[19]

In Finland, the amount of central government bonds issued has been relatively high in recent years (see Figure 11).[20] Particularly in 2021 and 2022, it was profitable for the central government to roll over debt as the real market interest rate on general government debt was negative due to the low nominal interest rate and high inflation. The roll-over of debt caused the effective real interest rate on general government gross debt to drop clearly in those years (see Figure 10).

The volume of bonds issued remains relatively high during the current year as well (see Figure 11), as the change in inflation, or the GDP deflator, has already decreased and the nominal market interest rates on general government gross debt have increased. As a result of this, the effective real interest rate may increase and even turn positive. In addition, the growth prospects of Finland's GDP are not very favourable in the short term (see section 1.3). Based on the assumption that policies will remain unchanged, Finland's long-term growth prospects are particularly gloomy due to the low birth rate, the fall in the education level of young people, and the ageing of the population (Kokkinen et al., 2021).

If the change in Finland's GDP volume remains small in the coming years and if the effective real interest rate on general government gross debt starts to increase, it is highly possible that the favourable development of the economy and interest rates will become unfavourable. If the real interest rate becomes higher than the change in GDP volume ($r_t > g_t$), the debt ratio remains stable only if the primary balance is positive or the stock-flow adjustment is negative, or if both of these are true. Finland cannot rely on the favourable $r_t - g_t$ difference to continue in the future after the recent years' inflation, development of interest rates, and sluggish GDP growth prospects. If the effective interest rate on general government debt developed unfavourably in relation to the economic growth, this would further shrink the fiscal space.

17 The impact of interest rate swaps on interest payments has not been taken into account in Figure 10. The analysis is based on data according to the National Accounts on interest payments, which are not affected by interest rate swaps.

18 There may also be such a connection between the effective real interest rate and the debt ratio that is not evident from the debt accumulation equation. Looking ahead, it is also a fact that the real interest rate is affected by market expectations (see e.g. Lorenzoni and Werning, 2019). The higher the debt-to-GDP ratio, the harder it is to convince investors that public finances are on a sustainable footing. In exchange, investors require higher risk premiums, which increase the real interest rate.

19 In addition to gross interest payments, net interest payments should also be monitored. In addition to debt, the general government also has financial assets that generate interest income. The general government net financial assets (financial assets – debt) in Finland are negative if earnings-related pension funds, whose assets are tied to future pension contributions, are not taken into account. In addition to net financial assets, the development of net interest payments depends on the structure of assets and liabilities and the maturity of liabilities. As a result of this, the effective interest rate on assets, for example, may follow the market interest rate more rapidly than the effective interest rate on liabilities.

20 In Finland, the central government accounts for the largest share of general government gross debt. Therefore, the effective interest rate on the entire general government gross debt is steered by the volume of central government bonds issued.

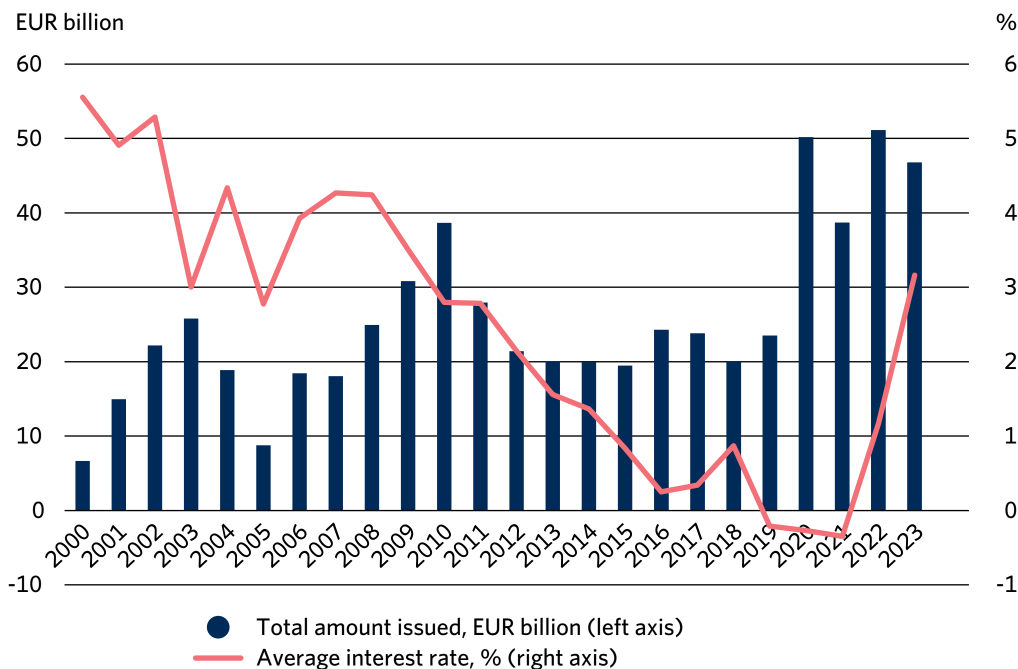


Figure 11: Central government bonds issued in 2000–2023 and actual average interest rates (yield) on the issues. The average interest rate has been calculated as a weighted average based on the issues whose interest rates have been published on the website of the State Treasury. The issuing methods and maturities of the bonds vary, and therefore the interest rates shown in the figure for different years do not reflect the interest rates on bonds of equal maturity. The impacts of interest rate swaps have not been taken into account in the data. As for 2023, the figure is based on information up until 12 October 2023. Sources: State Treasury (2023), Bank of Finland (2023), and calculations by the fiscal policy monitoring function.

1.3 The Ministry of Finance's forecast of economic growth is more optimistic than those of other forecasters

The business cycle in Finland has deteriorated, and in the light of forecasts, the economic growth prospects in Finland are challenging. Based on the sample of forecasts compiled by the fiscal policy monitoring function, forecasters expect economic growth in Finland to stop or be negative this year and to remain very moderate next year. The general economic uncertainty and tightened monetary policy are also expected to slow down the development of GDP in 2024.

A closer look at the overall picture of forecasts shows that there are few factors driving economic growth in Finland. Of the demand items in the national economy, only public final consumption and net exports[21] are expected to grow this year. The higher inflation and

21 The impact of net exports on economic growth is positive although both imports and exports have decreased, as exports are projected to decrease significantly less than imports.

interest rates are reflected in private consumption, and in addition, investments – construction investments, in particular – are projected to fall sharply this year due to interest rates, which have increased rapidly.

As part of the assessment of the realism of the forecasts, the Ministry of Finance's forecasts were examined by comparing them with the those of other forecasters[22] and with the 95% prediction intervals established by means of them to describe the bounds within which 95% of the forecasts are estimated to fall. Deviations alone do not define whether the forecast is realistic, but they made it possible to examine whether the forecasters' overall picture of the economic development was consistent.

The examination includes forecast[23] for 2023–2024 on both supply and demand items and other key forecast variables. The consensus forecast is defined by means of the forecast time trend, and the line in the figure describes the value of the consensus forecast on the date when the Ministry of Finance published its forecast. It should be noted that the forecasts of the sub-items of the consensus forecast are not necessarily in line with each other, as the consensus forecast is calculated as an average, while taking into account the publication dates of the forecasts. The forecasts included in the comparison were prepared between 1 June 2023 and 11 October 2023.

As regards this year's development, the forecasts of the Ministry of Finance reflect similar general development as those of other forecasters, and the forecasts of the Ministry are within the prediction bounds formed. The most significant deviations from the consensus forecast are the forecast on public consumption, where the Ministry of Finance's estimate is lower than those of other forecasters, and the forecast on investments, where the Ministry gives a slightly more optimistic picture than the other forecasters (Figure 12).

The Ministry of Finance forecasts that the economic contraction is temporary and expects that the factors currently limiting economic growth are short-term. The Ministry presents a largely more optimistic picture of Finland's economic development than the consensus forecast (Figure 13). The Ministry projects Finland's GDP volume to grow by 1.2% from the previous year, which is a more optimistic estimate than the consensus forecast (0.55%). The forecasts of the Ministry of Finance on demand and supply items in 2024 (especially the forecasts on GDP, imports, exports, and investments) are more positive than those of the other forecasters. On the other hand, the forecasts on imports and exports involve a high level of uncertainty regarding the development of world trade, which is reflected particularly in increased standard deviation and wide prediction intervals.

22 The prediction intervals have been formed on the basis of the forecasts of 17 forecasters other than the Ministry of Finance and the statistical T-test variable. These forecasters are Akava Works, Aktia, Danske Bank, the Research Institute of the Finnish Economy (ETLA), the Finnish Centre for Pensions, Handelsbanken, the International Monetary Fund (IMF), MuniFin, Labore, Nordea, the OECD, OP Group, Pellervo Economic Research (PTT), POP Bank, the Mortgage Society of Finland (Hypo), the Bank of Finland, and Savings Bank. All of these forecasters do not produce forecasts in the same scope as the Ministry of Finance.
23 Demand and supply items refer to the account of goods and services in the National Accounts. The account also includes change in inventories, net acquisition of valuables, and statistical discrepancy, which are not presented in this figure.

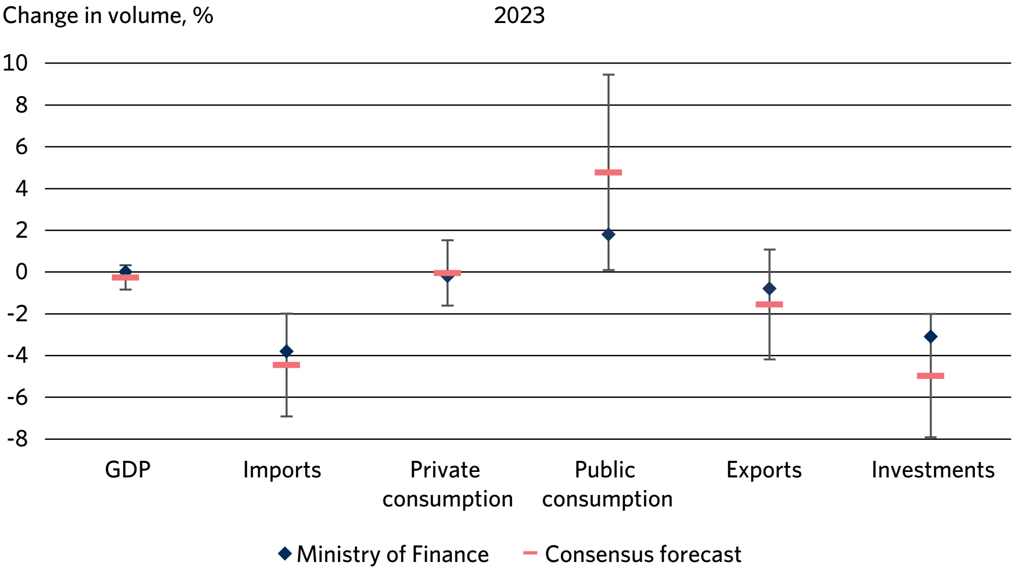


Figure 12: The Ministry of Finance's forecasts on demand and supply items for 2023, the corresponding values of consensus forecasts on the date of publication of the Ministry of Finance's forecast, and the upper and lower bounds of the 95% prediction intervals. Source: forecasters, fiscal policy monitoring function.

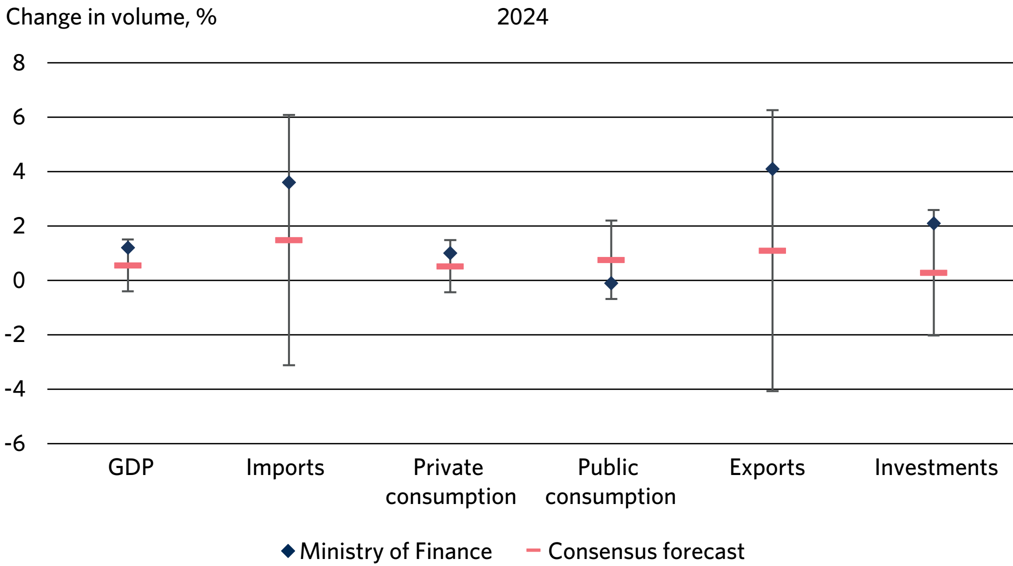


Figure 13: The Ministry of Finance's forecasts on demand and supply items for 2024, the corresponding values of consensus forecasts on the publication date of the Ministry of Finance's forecast, and the upper and lower bounds of the 95% prediction intervals. Source: forecasters, fiscal policy monitoring function.

The Ministry of Finance's independent forecast for the coming year is slightly more optimistic than those of the other forecasters, but it can be considered realistic within the meaning of the EU framework. The forecasts on GDP for 2024 made after August are more pessimistic than the forecasts published earlier. On the other hand, dispersion also increases in them, and the development of Finland's economy in 2024 looks uncertain. The Ministry of Finance lowered its autumn GDP forecast by 0.2 percentage points from its spring forecast, but it is still the highest of the autumn forecasts (Appendix 2). However, it is important to identify the uncertainties associated particularly with private consumption and foreign trade, as they may change the course of the economy.

All forecasters have similar expectations for the development of other key forecast variables (see Figure 14 and Figure 15). According to an assessment by the Governing Council of the European Central Bank (ECB), the key interest rates are at a level that significantly promotes the return of inflation to the target level of the ECB (European Central Bank, 2023). On the basis of the information compiled by the fiscal policy monitoring function, the majority of forecasters also expect inflation to fall in 2024. The current account is also forecast to remain in deficit. However, the forecasters have different views on the impact of the weakened business cycle on unemployment: some expect unemployment to remain relatively unchanged, while others expect it to increase.

The Ministry of Finance forecasts general government gross debt to be 74.2% relative to GDP in 2023 and to grow to 76.8% in 2024, and to 78.9% in 2025. Other forecasters also expect the general government debt ratio to continue to be on the rise and to grow steadily in the next few years, despite adjustment measures. On the other hand, there is dispersion in the baseline level of debt ratios in the forecasts, and the number of forecasts for 2025 is relatively small. Furthermore, all forecasters do not produce forecasts in the same scope as the Ministry of Finance as regards the forecast horizon or the forecast variables.

The Ministry of Finance forecasts that the general government fiscal position will fall in the coming year to 3.2% relative to GDP, which is an about 0.9 percentage point more pessimistic forecast than the consensus forecast. The result is surprising because the Ministry's GDP forecast for the coming year is more optimistic than the consensus forecast. The more pessimistic fiscal position (or fiscal balance) forecast means that the Ministry projects the general government deficit in euro to be larger than projected by the other forecasters. When examined by sub-sectors, the revision of the Ministry's forecast is affected by the fiscal position of both earnings-related pension funds and other social security funds, whose forecast the Ministry has revised downwards from its summer forecast. Comparison of the figures shows that this is due to the Ministry of Finance's more pessimistic estimate of the return of earnings-related pension funds and the decrease in the Employment Fund's contribution revenue due to the reduction in unemployment insurance contributions. In addition, the Ministry has adjusted its forecasts on the local and central government fiscal position downwards by 0.1 percentage point.

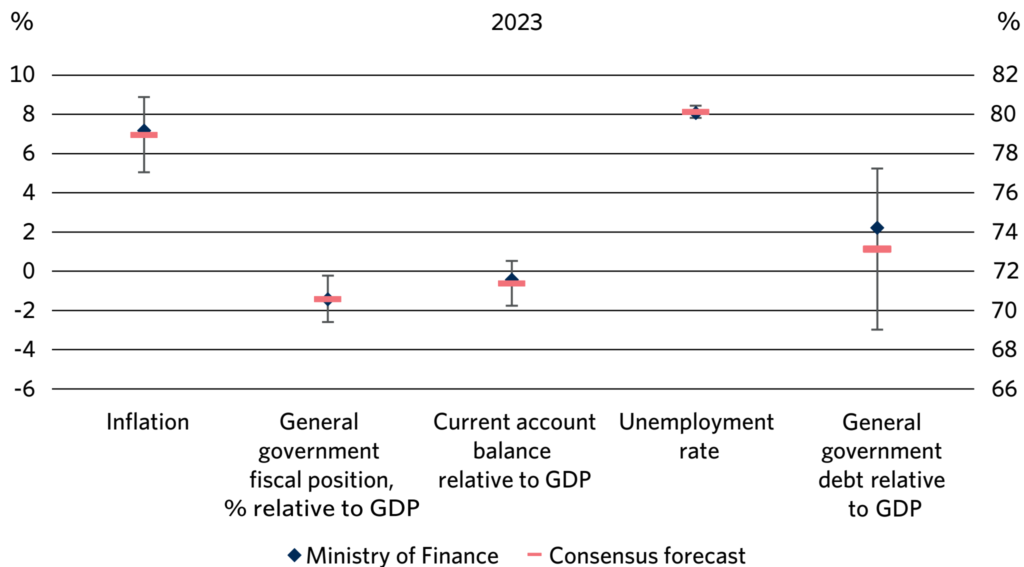


Figure 14: The Ministry of Finance's forecasts on inflation, general government fiscal position relative to GDP, current account balance relative to GDP, unemployment, and general government debt-to-GDP ratio for 2023, the values of the corresponding consensus forecasts on the publication date of the Ministry of Finance's forecast, and the 95% prediction intervals. Source: forecasters, fiscal policy monitoring function.

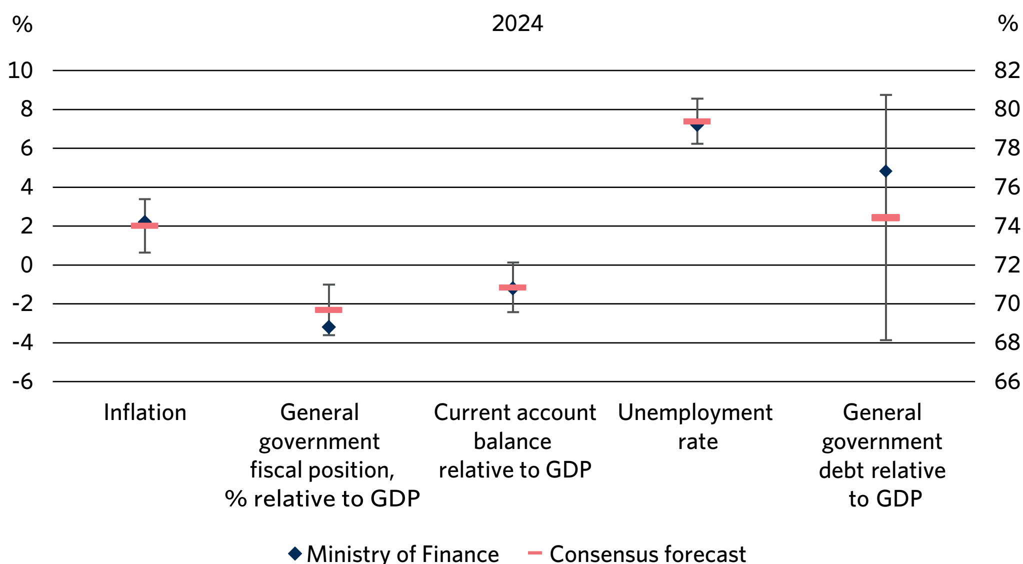


Figure 15: The Ministry of Finance's forecasts on inflation, general government fiscal position relative to GDP, current account balance relative to GDP, unemployment, and general government debt-to-GDP ratio for 2024, the values of the corresponding consensus forecasts on the publication date of the Ministry of Finance's forecast, and the 95% prediction intervals. Source: forecasters, fiscal policy monitoring function.

2 Assessment of the Government's fiscal policy

Through its fiscal policy, the Government aims to strengthen general government finances and reverse the debt development. The objectives set by the Government for the general government fiscal position, or fiscal balance, are too broad in view of the legislation valid during normal circumstances. However, they are permissible in the exceptional circumstances that remain in force until the end of 2023 and under the escape clause activated as a result of them. In the light of recent forecasts, it is unlikely that the objectives set by the Government will be achieved.

The Government's set of measures, aimed at strengthening public finances by EUR 6 billion, covers its fiscal policy decisions only partly. The implementation of the investment programme set out in the Government Programme will take the development of general government finances further away from the path pursued by the Government. In addition, the Government Programme does not contain any taxation or other public-revenue-related objectives that would support the achievement of the fiscal position objective set for 2027. The risk is that measures outside the EUR 6 billion set of measures significantly reduce the strengthening effect of the Government's fiscal policy on general government finances. Achieving the fiscal position target is likely to require additional measures and extending the range of measures.

The fiscal policy monitoring function assesses the suitability of the orientation of fiscal policy to the business cycle by means of both fiscal stance and fiscal impulse. The business cycle is assessed using both the EU Commission's output gap and the business cycle heatmap of the fiscal policy monitoring function. The level of fiscal policy is counter-cyclical, i.e. slightly expansionary in the negative business cycle in forecast years 2023–2024.

Based on the composite indicator of the business cycle heatmap, the fiscal impulse in 2023 is somewhat pro-cyclically contractionary. However, based on the EU Commission's output gap method, it is slightly counter-cyclically expansionary. According to both business cycle indicators, the change in fiscal policy in 2024 is roughly neutral in a business cycle that remains weak.

The spending limits for the parliamentary term have been set contrary to the policy lines of the Government Programme, and the spending limits expenditure has been presented in an ambiguous manner. The level of spending limits expenditure set out in the Government Programme is not met in the spending limits decision, and the Government's investment programme has been included in the spending limits only partly. However, with the exception of the investment programme, the spending limits to be complied with during the parliamentary term have been set to ensure that expenditure is maintained at the level decided by the Government.

2.1 The Government aims to achieve nearly balanced public finances and to reverse the debt development

The Government outlined its fiscal policy objectives for the parliamentary term in its Government Programme (Finnish Government, 2023, p. 13) and specified them in its first General Government Fiscal Plan of the parliamentary term (Ministry of Finance, 2023b, p. 22). The fiscal policy objective of the Government is for public finances to be close to balance and for the debt ratio to be stabilised by the end of the parliamentary term (Table 1).

Table 1: The Government's fiscal policy objectives, outturns, and forecasts of the Ministry of Finance. Sources: The General Government Fiscal Plan (Ministry of Finance, 2023b, p. 22) and Economic Survey, Autumn 2023 (Ministry of Finance, 2023e, p. 70).

Variable	Objective for 2027	Outturn in 2022	Forecast for 2027
General government debt in relation to GDP	77.3%	72.9%	81.6%
General government fiscal position in relation to GDP	–1%	-0.9%	-2.8%

The Government will pursue these objectives by: (1) adjusting public finances; (2) increasing employment; and (3) boosting economic growth (Finnish Government, 2023, p. 11). The activities under the Government Programme and their relationship with each other are illustrated in Figure 16.

The Government's EUR 6 billion set of measures includes permanent measures: firstly, direct adjustment measures of EUR 4 billion, which, in practice, are expenditure cuts. The Government aims to ensure that the overall tax rate does not increase and that the central government spending limits are adhered to. Secondly, the Government strives to achieve the EUR 6 billion adjustment objective through structural measures aiming to increase employment and to strengthen public finances by EUR 2 billion. In practice, the aim is, for example, to encourage unemployed people to accept work through tax solutions and social security changes. The total of EUR 2 billion includes the estimated savings in public finances resulting from behavioural impacts to be achieved over time. The Government's structural measures, i.e. employment measures, aim at 100,00 new employed people by 2027 and an employment rate of 80% by 2031. In 2022, the employment rate was 73.8%, which means that the employment rate should increase by 6.2 percentage points during two parliamentary terms.

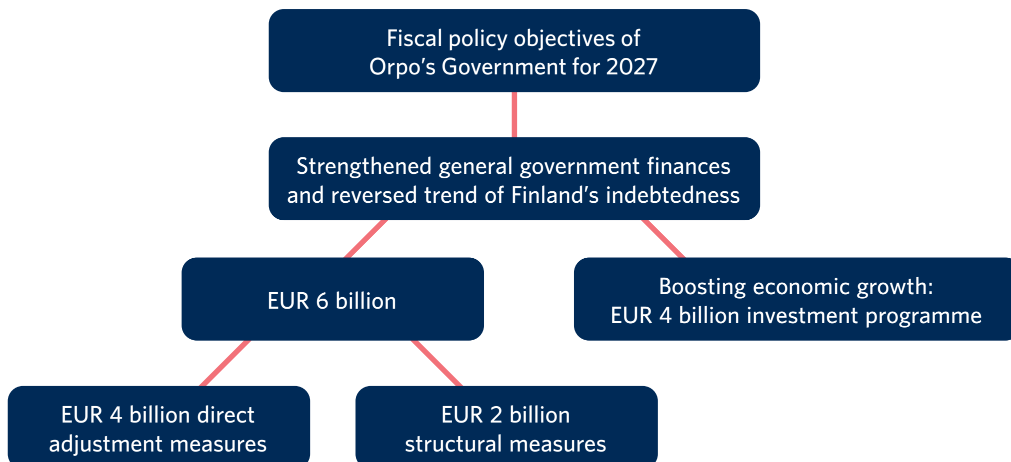


Figure 16: The Government's fiscal policy objectives. Source: Prime Minister Petteri Orpo's Government Programme and the fiscal policy monitoring function.

In addition, the Government aims to improve the general government budgetary balance-to-GDP and debt-to-GDP ratio by accelerating economic growth through direct temporary additional appropriations of EUR 4 billion, which the Government calls an investment programme. However, some of these expenses are not investments according to the National Accounts but current expenditure that has an effect within the financial year in question (see section 2.2). Consequently, there is a risk that their GDP growth-enhancing effect remains small.

As the general government fiscal position targeted by the Government remains in deficit throughout the government term, the debt ratio could be put on a downward path either through the impact of GDP growth or through the stock-flow adjustment, i.e. through net sales of assets, in practice, provided that the (net) proceeds would be used for repayment of the debt (see section 1.2). The achievement of this objective is hampered by a significant increase in net interest payments in the indebted central and local government sectors.

Based on the autumn forecast of the Ministry of Finance (Ministry of Finance, 2023e, p. 70), the Government's objectives will not be achieved by the end of the parliamentary term (see Figure 17). However, the forecast does not take into account some of the economic impacts of the measures included in the Government Programme[24] due to their unspecified or uncertain nature.

24 The Ministry of Finance's autumn forecast includes only sufficiently specified fiscal measures, such as those decided in the budget and the General Government Fiscal Plan. The forecast does not include curbing the growth of costs in wellbeing services counties as required, the measures planned by the counties themselves, or the economic growth-enhancing impacts of employment measures. However, the direct savings resulting from employment measures are included in the forecast. (Ministry of Finance, 2020d, p. 16). In the material submitted by it, the Ministry of Finance has also stated that the autumn forecast does not take into account the compensation of the reduction in social security contributions by tax increases or other measures.

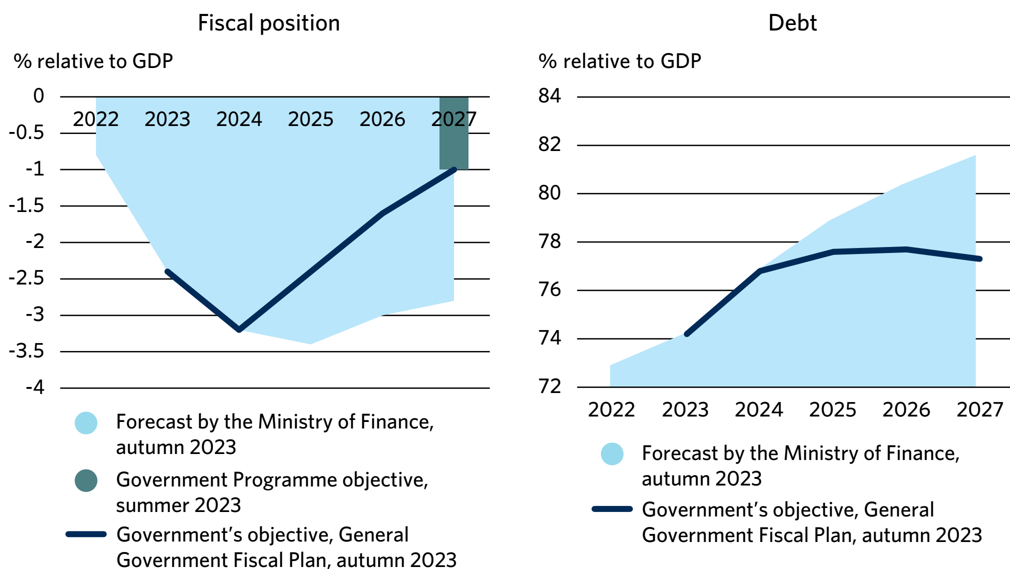


Figure 17: The Government's objectives and the Ministry of Finance's forecasts for general government fiscal position (left) and debt (right), % relative to GDP. Sources: Ministry of Finance (2023e) and the fiscal policy monitoring function.

In the light of the autumn forecast of the Ministry of Finance, it seems that, in order for the fiscal position and debt objective to be achieved, one or more of the following must be realised: general government expenditure must be reduced or revenue increased more than planned, economic growth must be faster than projected, or the impacts of the Government's employment measures must be greater than estimated in the forecast.

The General Government Fiscal Plan presents sensitivity analyses, which help to assess the significance of economic growth for achieving the objectives (Ministry of Finance, 2020b, p. 153). According to the sensitivity analyses, a rapid annual economic growth of more than 2% would result in a slight surplus of public finances (fiscal position of 0.1% relative to GDP) and a government debt-to-GDP ratio at a level close to the current one. A slow annual economic growth of less than 1% of GDP, in turn, would result in a general government deficit of more than 5%, while the government debt-to-GDP ratio would rise to more than 81% by 2027.

The general government fiscal position target set by the Government in the General Government Fiscal Plan (–1% in ratio to GDP in 2027) is broken down by sub-sector as follows: the Government aims at a central government deficit of a maximum of 2.5% and a surplus of earnings-related pension funds of 1.5%, while the fiscal position of the local government, wellbeing services counties, and other social security funds would be close to balance (Ministry of Finance, 2023b, p. 22). In the light of the Ministry of Finance's latest forecast[25], it is possible to come close to the objectives of other sub-sectors than the central government. The central government sector would fall around 1 percentage point

25 The Ministry of Finance forecasts a budgetary balance of –3.5% in ratio to GDP for the central government, –0.4% for the local government, –0.5% for the wellbeing services counties, 1.3% for earnings-related pension funds, and 0.1% for other social security funds (Ministry of Finance, 2023d, p. 69; 2020b, p. 138 and 139).

short of the target, while the local government and the wellbeing services counties in total would fall around 0.9 percentage point short of the targets.

In previous government terms as well, there has typically been a difference between the forecasts and the targets. However, in this government term, the difference between the forecasts and targets is greater than before. For example, in the case of fiscal position, the difference is 1.8 percentage points, while it was 1 percentage point at the beginning of Rinne–Marin's government term and 1.4 percentage points at the beginning of Sipilä's government term.

In the previous government terms, the targets were not achieved. Rinne–Marin's Government seems to fall around 2.4 percentage points short of the balance target it set at the beginning of the parliamentary term, whereas Sipilä's Government came closer and fell around 0.9 percentage point short of its target.

Does the General Government Fiscal Plan and its targets comply with the Decree?

The Fiscal Compact (24/2013), the Fiscal Policy Act (869/2012), and the Government Decree on the General Government Fiscal Plan (13 February 2014/120) steer the content of the General Government Fiscal Plan and provide a framework for the targets set by the Government in the General Government Fiscal Plan.

Under the Fiscal Compact and based on the current debt level and sustainability prospects, Finland is expected to pursue a structural deficit of 0.5% or a stronger general government structural balance in the medium term (MTO, medium-term objective). Accordingly, the balance targets set by the General Government Fiscal Plan should lead to at least achieving the structural balance[26] target of the general government.

However, the exceptional circumstances that are in force until the end of 2023 (see the Decree on the General Government Fiscal Plan, 13 February 2014/120) allow a temporary deviation from the fiscal position target, i.e. they bring flexibility to the tightness of the targets. In exceptional circumstances, the multi-annual sector-specific objectives need not lead to the achievement of the medium-term objective (general government structural balance –0.5% of GDP).

Therefore, in autumn 2023, the Government is not obliged to present such nominal balance targets that will lead to achieving the medium-term fiscal position objective[27]. However, under the current legislation, the Government must in the General Government Fiscal Plan of spring 2024 set such targets as make it possible to achieve the medium-term structural balance objective. However, it is likely that the EU fiscal rules will change in the near future, which will have an impact on the interpretation of compliance.

Appendix 1 contains observations of the fiscal policy monitoring function on the content of the latest General Government Fiscal Plan in relation to the Decree regulating it. The General Government Fiscal Plan does not meet all the requirements set by the Decree. The fiscal position objectives presented by the Government meet the requirement set by the

26 Structural balance, i.e. structural fiscal position, refers to the fiscal position net of the impact of cyclical fluctuations and government measures, and net of temporary one-off revenue and expenditure.

27 On page 22 of the General Government Fiscal Plan, it is stated that "With this target setting, the MTO (a general government structural budgetary balance of –0.5% in ratio to GDP) will not be reached until after 2027."

Decree, as the Decree does not provide for tightness of the objectives in a situation where the escape clause is applied. On the other hand, the Government's General Government Fiscal Plan does not present such a comparison between government terms in accordance with section 5 of the Decree as would show how the fiscal position and debt targets differ from the last General Government Fiscal Plan of the previous Government.

2.2 The EUR 6 billion set of measures does not cover all of the Government's fiscal decisions

In its programme, the Government has set itself the objective of strengthening public finances by EUR 6 billion during the parliamentary term. The objective has been defined in relation to the last General Government Fiscal Plan of the previous parliamentary term. The need to strengthen public finances and the timing of consolidation measures can be defined on several alternative grounds. The public finances outlook (and even the situational picture) is partly based on uncertain estimates, which is one of the reasons why the strengthening need cannot be unequivocally defined as an exact amount in euros. In any case, the strengthening by EUR 6 billion can be considered justified in magnitude, as the public finances are projected to be structurally imbalanced during the parliamentary term.

In the Government's target setting, the EUR 6 billion set of measures is a means of achieving the Government's fiscal position target (see section 2.1) in 2027. The measures included in the set are described in Annexes B (direct adjustment) and D (structural policy measures) to the Government Programme, and they have been considered and concretised in the first General Government Fiscal Plan of the parliamentary term. It is good that the Government has presented concrete measures in the General Government Fiscal Plan, as this makes it possible to start the implementation at the beginning of the Government term. On the basis of the current forecasts, it is unlikely that the targets will be achieved (see section 3.1). Therefore, the statement in the Government Programme that the strengthening of public finances should be continued during the following parliamentary term can be considered justified. It is also justified that it is stated in the minutes of the budget negotiations of autumn 2023 that the need for further measures will be reviewed in the mid-term review in 2025.

The measures included in EUR 6 billion set of measures vary in concreteness. Some of the measures are such that it is possible to calculate at least static impact assessments of them. Thus, the direct impact of the measures on public finances can be assessed, but it may be more difficult to assess their behavioural impacts. The impacts of some measures involve greater uncertainty than others. A large part of the direct adjustment, about EUR 1.3 billion, is directed at health and social services. It is partly based on measures to reduce the need for government funding for wellbeing services counties and partly on measures taken by the wellbeing services counties themselves (around EUR 0.9 billion). The savings related to the wellbeing services counties are uncertain for several reasons. For example, under the counties' funding model, the funding is in any case adjusted to correspond – at the national level – to the counties' actual costs, which means that the planned savings may not be realised. In addition, the funding model makes it possible for the wellbeing services counties to apply for additional funding, if necessary. Moreover, EUR 0.9 billion

of the savings are based on the assumption that the wellbeing services counties manage to achieve savings by increasing the efficiency of their own operations. There is no actual impact assessment available of these savings, which makes it difficult to estimate the realism of the savings target.

The structural measures of the Government Programme aim to strengthen public finances by increasing employment[28]. The impacts on public finances are thus based on the estimated employment impacts of the measures. As always in the case of measures of this type, the estimates are inevitably and naturally uncertain.

The EUR 6 billion set of measures does not represent the entire impact of the Government's fiscal policy on achieving the fiscal position target of 2027. Several fiscal measures fall outside the scope of this set of measures. As regards the measures included in the Government Programme, the impacts of Annex C (tax policy) and Annex E (temporary investment programme) to the Government Programme are not included in the set of measures. As regards tax policy (Annex C), the impact assessments included in the Government Programme show a EUR 43 million weakening impact on public finances. This means that, based on this information, the implementation of these tax measures will not have any significant impact on the achievement of the fiscal position target. The investment programme will have a potentially greater impact on the achievement of the fiscal position target. In addition, some fiscal policy decisions that affect public expenditure and revenue are completely outside the Government Programme. It is typical that not all fiscal measures are included in the Government Programme.

When the prospects for achieving the fiscal position target are considered, it is necessary, in addition to the actual fiscal decisions, to take into account such spending needs and tax revenue developments that existed already before Orpo's Government took office. These are not presented in the General Government Fiscal Plan of autumn 2023 as decisions of the present Government insofar as they were already included in the technical General Government Fiscal Plan of spring 2023.

When the state budget for 2024 is examined, it can be observed that the measures included in the Government Programme play a relatively minor role in the development of the expenditure of on-budget activities (Figure 18). In net terms, the measures included in the Government Programme will reduce the expenditure of on-budget activities by around EUR 0.2 billion (the investment programme will increase it by EUR 0.3 billion, while other Government Programme measures will reduce it by EUR 0.5 billion) compared with the regular budget of the previous year. Compared with the previous year's regular budget, the funding of the wellbeing services counties has increased by nearly EUR 4 billion when the impacts of the Government Programme are not taken into account[29]. The increase in gross interest payments is about EUR 1.7 billion compared with the regular budget for 2023 (see also section 1.2). The situation reflects the central government's significant spending needs. Compared to them, the impacts of the measures in the Government Programme will be rather small in 2024.

28 Structural measures refer, to a large extent, to the measures included in Annex B to the Government Programme. The employment impacts of these measures are presented in Annex D, while their direct impacts are presented in Annex B.

29 The figure for 2023 is smaller because around EUR 1.9 billion of the funding of the wellbeing services counties for 2023 was already paid in advance in the budget for 2022.

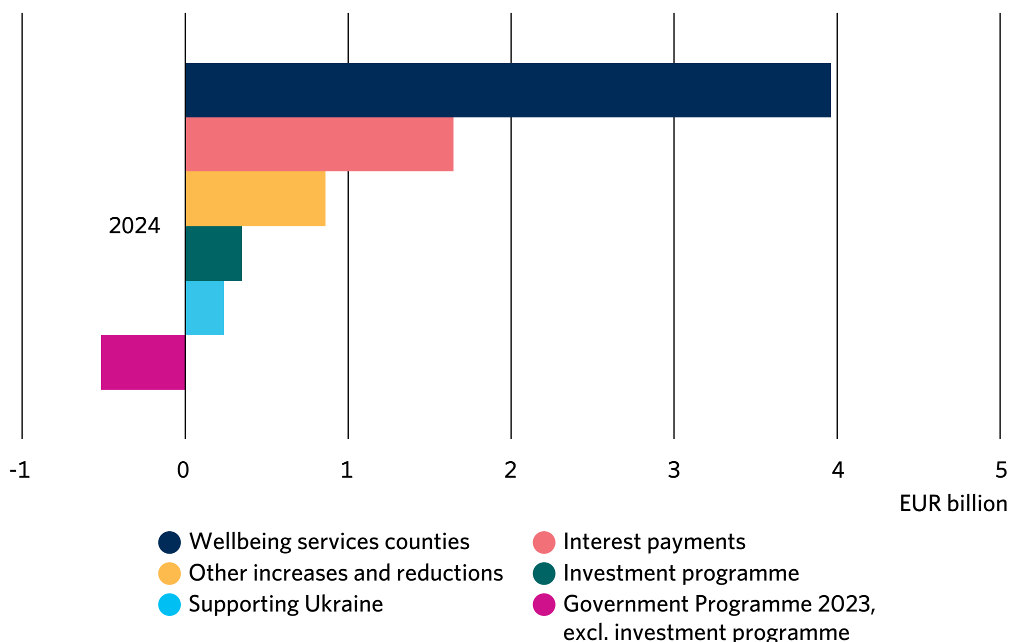


Figure 18: Increases and reductions in appropriations in the budget proposal for 2024 compared with the regular budget for 2023, net. Sources: Ministry of Finance (2023f) and the fiscal policy monitoring function.

The expenditure adjustment measures and additional expenditure (including the investment programme) included in the Government Programme are allocated differently at different activities in the budget for 2024 (Figure 19). The most significant adjustments of expenditure are made on social security, such as housing allowance and unemployment security. On the other hand, there is also additional expenditure targeted at social security, such as child benefits. In net terms, the most significant adjustments of expenditure made by the Government are directed at the general government, and the majority of them are reductions in development cooperation.

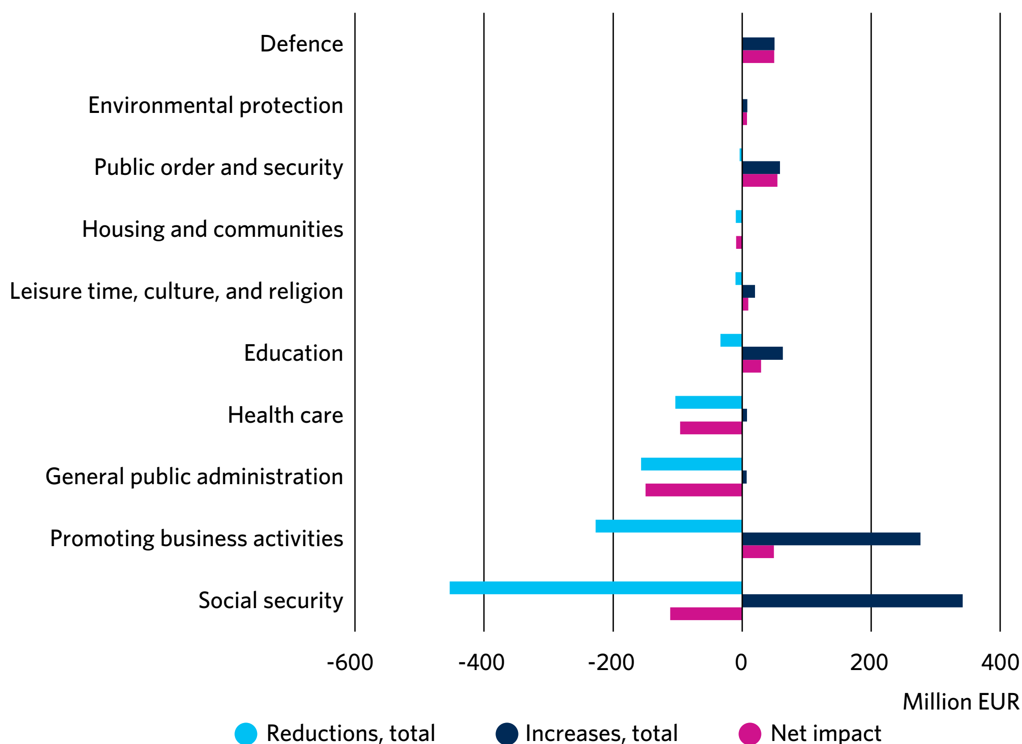


Figure 19: Increases and decreases in expenditure according to the Government Programme and their net impact on the budget proposal for 2024 by COFOG category (including the investment programme). Source: Ministry of Finance (2023f) and the fiscal policy monitoring function.

The investment programme hampers the achievement of the target path of public finances

The investment programme included in the Government Programme (Annex E) obscures the significance of the EUR 6 billion set of measures in the setting of fiscal objectives. The investment programme weakens the general government fiscal position, as the expenditure resulting from the programme increases central government expenditure but the programme funding does not increase public revenue. The programme is funded by selling central government assets, liquidating the overcapitalisations of unlisted state-owned companies, and making transfers from the National Housing Fund. However, the investment programme is not included in the EUR 6 billion set of measures. Despite its name, the programme also includes other expenses than those classified as investments: in 2024, considerable funding is allocated for the elimination of treatment queues.

The more extensive the implementation of the investment programme, the more the general government fiscal position will fall behind the target path defined for it in the General Government Fiscal Plan. According to the Government Programme, the investment programme will not increase borrowing during the government term. This is true if we examine gross debt, which is the most typically monitored measure. However, it should be

noted that, as a rule, the sale of assets or the dissolution of funds to cover expenditure is not a better option than additional borrowing in view of the sustainability of public finances: it also reduces general government net assets and, at the same time, future property income. The decisions on the sale of central government assets should therefore be based on an analysis of the long-term relationship between the revenue and expenditure of asset and debt items.

The practice of treating part of the additional expenditure planned by the Government as a programme outside the actual set of measures has already been applied in several parliamentary terms. In the past as well, this practice has led to uncertainty about the Government's actual fiscal policy. The problem is particularly pronounced in Orpo's Government Programme, where additional expenditure has not been defined to end before the end of the parliamentary term. In addition, one set of expenditure – transport network development – is subjected to savings under the EUR 4 billion adjustment package (Annex B to the Government Programme) but, on the other hand, it will also be allocated additional expenditure in the investment programme of Annex E to the Government Programme. The final size of the investment programme remains uncertain because, according to the General Government Fiscal Plan, the programme will be implemented when funding matching the expenditure is secured. The working group of the Ministry of Finance on developing the steering of general government finances discussed programmes financed by property income on the basis of experience from previous parliamentary terms (Ministry of Finance, 2022). The working group rightly stated that similar arrangements should not be implemented in the future because, for example, the fixed-term nature of the expenditure included in the programmes and the realisation of revenue matching the expenditure have proved uncertain.

So far, EUR 745 million of the investment programme, the maximum size of which is EUR 4 billion, has been included in the General Government Fiscal Plan. According to the General Government Fiscal Plan, the programme will still require EUR 80 million in appropriations in 2027, the last year of the Government Programme. It is also stated in the Plan that based on the current decisions, the programme will require EUR 102 million in appropriations after the end of the current government term. When the impacts of the investment programme on the achievement of the fiscal position target are assessed, it should be taken into consideration that the amounts may be recorded as public expenditure in a year other than the appropriation year.

The investment programme also includes projects that have not yet been included in the General Government Fiscal Plan. One of these is the capitalisation of the Turku One Hour Train by EUR 460 million during the parliamentary term. The total cost of the project has previously been estimated at EUR 3.4 billion (Ministry of Finance, 2023d). In practice, the investment programme will lead to the implementation of the Government's set of savings measures partly during the following parliamentary term. Thus, additional investments within the investment programme will offset savings targeted at the development of transport infrastructure projects in Annex B to the Government Programme. Some of the savings according to Annex B will therefore not be realised by the end of the parliamentary term, but their realisation can only be verified later. The scale of the problem depends on the extent to which the programme is implemented and the extent to which it includes expenditure that will continue to have an effect even on the years after 2026.

The tax policy outlined in the Government Programme causes uncertainty in the overall fiscal target-setting

In addition to the measures included in the Government Programme, the Government implements fiscal decisions outside the Programme, and the direct impacts of these decisions either weaken or strengthen public finances. This has also been the case in the previous government terms. Of the decisions taken in autumn 2023, the reduction of social security contributions will, according to the General Government Fiscal Plan, have an adverse net impact of EUR 1.5 billion on public finances in 2027 (see Table 25 of the Plan). This is mainly due to the reduction of unemployment insurance contributions. The reduction is due to both the economic and employment situation and the cuts the Government has made in the benefit expenditure.

According to the Ministry of Finance, the review of the savings effects it has published "does not take into consideration the fact that, under the valid legislation, social security contributions shall be reduced when the fiscal position of social security funds improves" (Ministry of Finance, 2023a). It is indeed true that it is not simple to channel the benefits of lower unemployment expenditure to the central government in full, even if this is possible through legislative amendments. However, the level of taxation is ultimately determined by the Government. Therefore, in practice, the Government can make other changes in taxation to compensate for the changes in social security contributions and thereby ensure that the level of taxation it has selected is realised overall. For these reasons, changes in unemployment insurance contributions should be taken into account when the Government's fiscal policy is assessed.

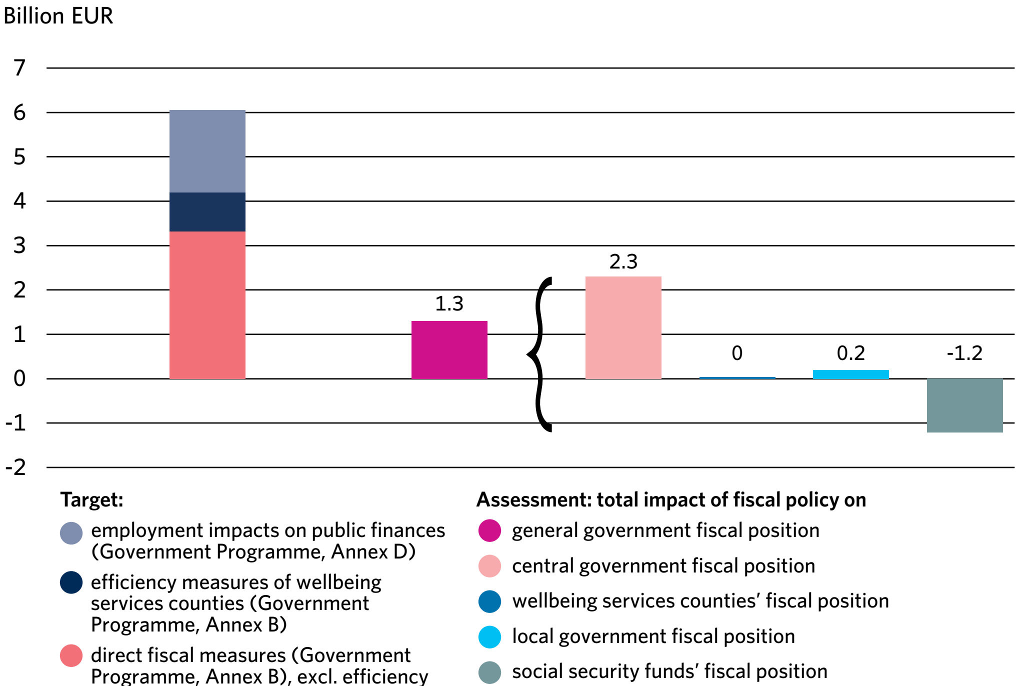


Figure 20: The target of strengthening public finances by EUR 6 billion and estimated impacts of all fiscal policy decisions on public finances in 2027 according to the General Government Fiscal Plan. Source: General Government Fiscal Plan for 2024–2027.

The General Government Fiscal Plan includes an overall assessment of the impact of all fiscal measures taken by the Government on the general government fiscal position (Figure 20). According to the assessment, public finances will strengthen by EUR 1.3 billion by 2027 as a result of the fiscal policy decisions. This differs considerably from the EUR 6 billion set of measures in the Government Programme. The difference is considerable even if it is considered that, due to the incompleteness and uncertain impacts of the measures, the calculations of the General Government Fiscal Plan have not taken into account the savings of EUR 2.8 billion that may result from the employment impacts of structural reforms (EUR 1.9 billion) and the streamlining carried out by wellbeing services counties (EUR 0.9 billion).

The working group of the Ministry of Finance on the steering of general government finances (Ministry of Finance, 2022) also discussed the relationship between fiscal position targets, spending limits, and tax policy. The working group was of the opinion that the central government spending limits and the tax policy outlined in the Government Programme should be determined in accordance with the central government's fiscal position objective. According to the working group, this would ensure the sufficient coverage of fiscal steering: both expenditure and revenue contribute to the achievement of the fiscal position objective. The National Audit Office (National Audit Office, 2021) has also stated that it is essential for the achievement of the fiscal position objectives that the expenditure policy and revenue policy function as a whole: clear revenue policy objectives that can be monitored complement expenditure policy objectives.

The tax policy outlined in the Government Programme[30] differs from the recommendations of the ministerial working group and the National Audit Office and creates a risk to the achievement of the fiscal position objectives. The risk would materialise if the tax rate fell based on discretion or without active decisions, and this had an adverse impact on the achievement of the fiscal position target. According to the tax policy outlined in the Government Programme, the tax rate should not increase during the parliamentary term because of the Government's decisions. The policy restricts only the rising of the tax rate but allows the revenue-to-GDP ratio to decrease both on a discretionary basis and without active decisions. Thus, the tax policy formulation does not ensure a sufficient revenue accumulation in view of the expenditure and revenue policy as a whole.

The EUR 6 billion set of measures included in the Government Programme reflects only the impact of a limited set of measures and does not cover all of the fiscal measures affecting the general government fiscal position. Even if the EUR 6 billion set of measures were implemented, the expenditure and tax measures taken outside it cause uncertainty regarding the achievement of the fiscal position target in line with the Government's fiscal policy. Based on the current information according to the General Government Fiscal Plan (see Table 25 of the Plan), measures outside the Government Programme's set of measures will weaken public finances and substantially reduce the impact of the EUR 6 billion set of measures.

As regards direct strengthening of public finances, the Government's plans have focused on expenditure measures. The measures are targeted at different types of expenditure: in the direct savings measures of EUR 4 billion included in Annex B to the Government Programme, the focus is on savings in social benefits and in the consumption and investment

30 The measures included in Annex C to the Government Programme are entitled "Revenue policy". In this report, "the tax policy outlined in the Government Programme" refers, in turn, to the policy lines in the text part of the Government Programme concerning the development of the overall tax rate.

expenditure of public administration (including the wellbeing services counties). According to calculations by the fiscal policy monitoring function (Figure 21), these items account for more than 80% of the savings effect of 2027. Compared with them, the share of other expenditure items in the savings is very small.

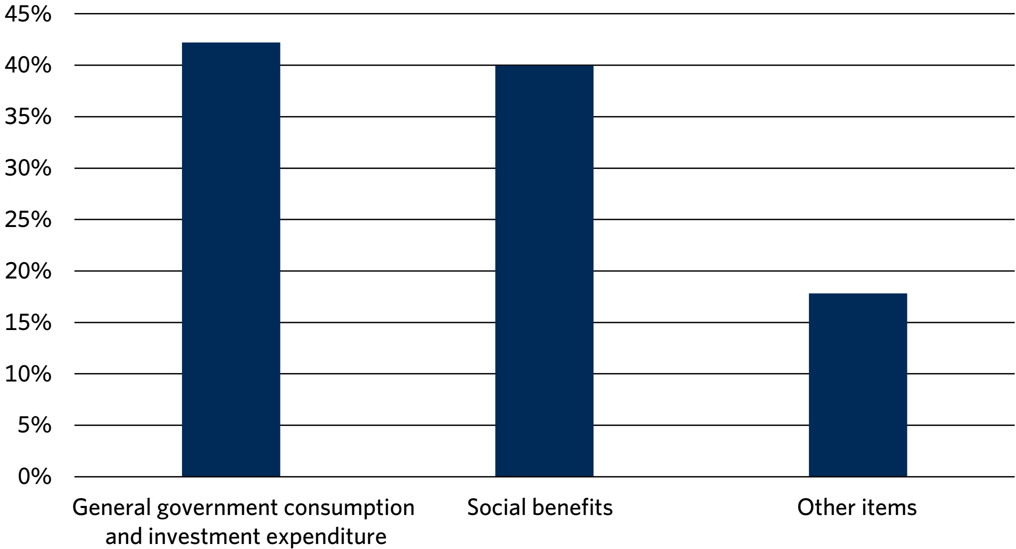


Figure 21: An indicative illustration of how the direct adjustment measures set out in Annex B to the Government Programme are targeted at different expenditure types. Source: Government Programme (Finnish Government, 2023) and calculations by the fiscal policy monitoring function.

Based on the currently available data, achieving the fiscal position objective requires additional measures and probably also extension of the range of measures. Public finances should be strengthened extensively by means of both expenditure and tax measures. When planning both expenditure and revenue measures, the Government should utilise as extensive surveys and impact assessments as possible to be able to select the best possible measures for achieving the targets.

2.3 A slightly expansionary fiscal stance is suited to a weak economic outlook – provided that inflation starts to decline

An appropriate fiscal stance refers to adjusting general government expenditure and revenue in relation to the business cycle in such a manner that during a downturn, general government finances support aggregate demand, and during an upturn, they accumulate fiscal buffers while also curbing economic overheating.

In 2023 and 2024, the level of fiscal policy is projected to be counter-cyclically expansionary and thus appropriate in the weak business cycle, provided that inflation starts to decline. Depending on the business cycle indicator used, the fiscal impulse (i.e. the change in fiscal policy) in 2023 is either slightly pro-cyclically contractionary or slightly counter-cyclically expansionary. The impulse in 2024 is projected to be neutral in a business cycle that remains weak.

Examination of the fiscal stance is based on the general government nominal primary balance in statistical years 2019–2022 according to the National Accounts and the independent forecast of the Economics Department of the Ministry of Finance for its development in 2023–2024. It should be taken into consideration that some of the fiscal measures decided by Orpo's Government both in the Government Programme and in other contexts are such that their impacts on the balance of general government finances cannot be verified directly. Such measures are not included in the independent forecast for the primary balance.

In addition to the above, the examination of the appropriateness of the fiscal stance is influenced only by the picture of the business cycle. For this reason, the business cycle is assessed in the fiscal policy monitoring reports based on two different business cycle indicators:

1. the composite heatmap indicator that is produced by the fiscal policy monitoring function and that is compiled directly on the basis business cycle indicators (and their forecasts)
2. the output gap produced by the indirect method of the EU Commission (and the Ministry's potential output forecasts).

It must be underlined that any differences in the assessments of the appropriateness of the fiscal stance in view of the business cycle are only due to differences in the business cycle assessments. Both methods use the same statistical observations of the nominal primary balance and independent forecasts of the Ministry of Finance for the primary balance before a cyclical adjustment.

In forecast years 2023 and 2024, the assessments of the business cycle based on these two business indicators converge (Figure 22, points in the horizontal axis). According to both methods, the business cycle is negative. In 2021 and 2022, the assessments of the business cycle based on the different methods continue to differ even now that statistical data are available. This has already been highlighted in the fiscal policy monitoring reports of the past few years as an ex-ante assessment and partly based on forecasts.

According to the forecast of the heatmap composite indicator, the business cycle in 2023 and 2024 is below the long-term average. Correspondingly, according to the forecast by the Ministry of Finance and the potential output calculated using the EU Commission's production function method, GDP is below the long-term potential output in 2023 and 2024. On the other hand, according to the production function method, the output gap would have been continuously negative from 2020 to 2024 without that GDP growth would have recovered above the long-term potential even once after the Covid-19 crisis.

The discretionary fiscal stance in 2019–2024 is examined based on structural primary balance. In it, the nominal primary balance has been cyclically adjusted by means of both the output gap and the heatmap composite indicator (See Figure 23: the structural primary balance values are represented by the points in the direction of the vertical axis).

Based on both methods of cyclical adjustment, the general government structural primary balance is projected to be slightly negative in 2023. Both methods also project a slight deterioration of the primary balance in 2024.

When the estimates of structural primary balance are examined in relation to the assessments of the business cycle, it can be seen whether the discretionary fiscal policy is counter-cyclical or pro-cyclical relative to the business cycle (Figure 22). In forecast years 2023–2024, the level of fiscal policy is slightly counter-cyclical in a negative business cycle, based on both the output gap and the composite indicator of the heatmap.

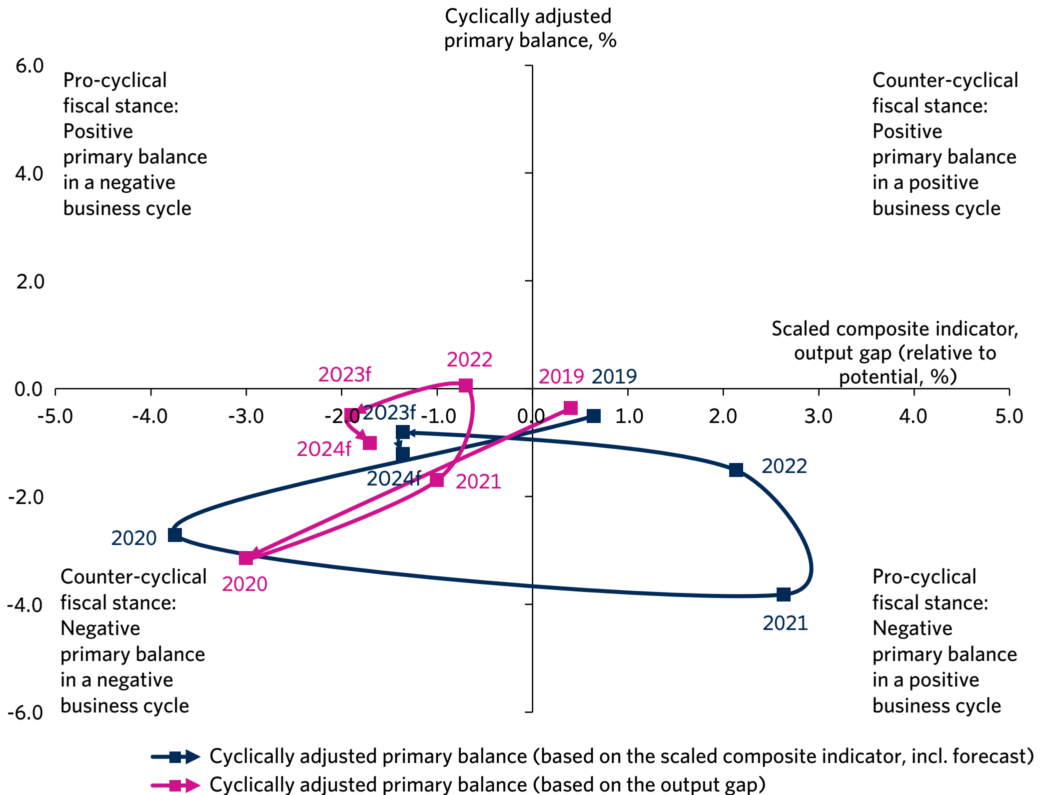


Figure 22: Fiscal stance in relation to the business cycle: structural primary balance based on the output gap and the business cycle indicator of the heatmap in relation to the business cycle based on the output gap and the business cycle indicator of the heatmap in 2019–2024. The primary balance has been cyclically adjusted by means of both the output gap (pink dots) and the composite indicator of the heatmap (blue dots). The variation (standard deviation) of the business cycle indicator of the heatmap has been scaled to be comparable with the variance (standard deviation) of the output gap. (See Strifler and Kokkinen, 2021c) The estimates of both the business cycle and the cyclically adjusted structural primary balance based on the output gap method may be revised later even to a significant extent. Source: Ministry of Finance and the fiscal policy monitoring function.

The use of a fiscal policy that stimulates the economy as a whole by increasing public expenditure in 2023 and 2024 is restricted by the significant growth of general government debt since the Covid spring 2020. The Government that has just started its work seems to have solved the matter by simultaneously striving to reduce public expenditure and increase both households' consumption opportunities and private investments with tax cuts and subsidies granted for research and development. Households' consumption is also promoted by the reversal of the growth of inflation, which, if realised, prevents households' purchasing power from declining as in previous years.

The policy chosen by the Government can work if inflation falls to around the 2% target of the European System of Central Banks. If inflation remains higher than this, the policy can be criticised, as the aggregate demand-supporting effect of fiscal policy works in the opposite direction than the demand-reducing effect of monetary policy. In order to avoid

problems caused by long-term inflation, fiscal policy should support monetary policy in a situation where inflation is above the central bank's target.

The Government seems to have confidence in the central bank's determined efforts to restore inflation to the central bank's target value, which is, of course, justified. A slightly stimulating cyclical policy as described above is also justified in the sense that at the same time, the Government is trying to bend the growth curve of general government debt. It remains to be seen whether the growth of debt can be reversed. In Finland, the growth of general government debt is also affected by structural factors, such as the ageing of the population, the decreasing number of working-age people, and the simultaneous fall in the education level of young people.

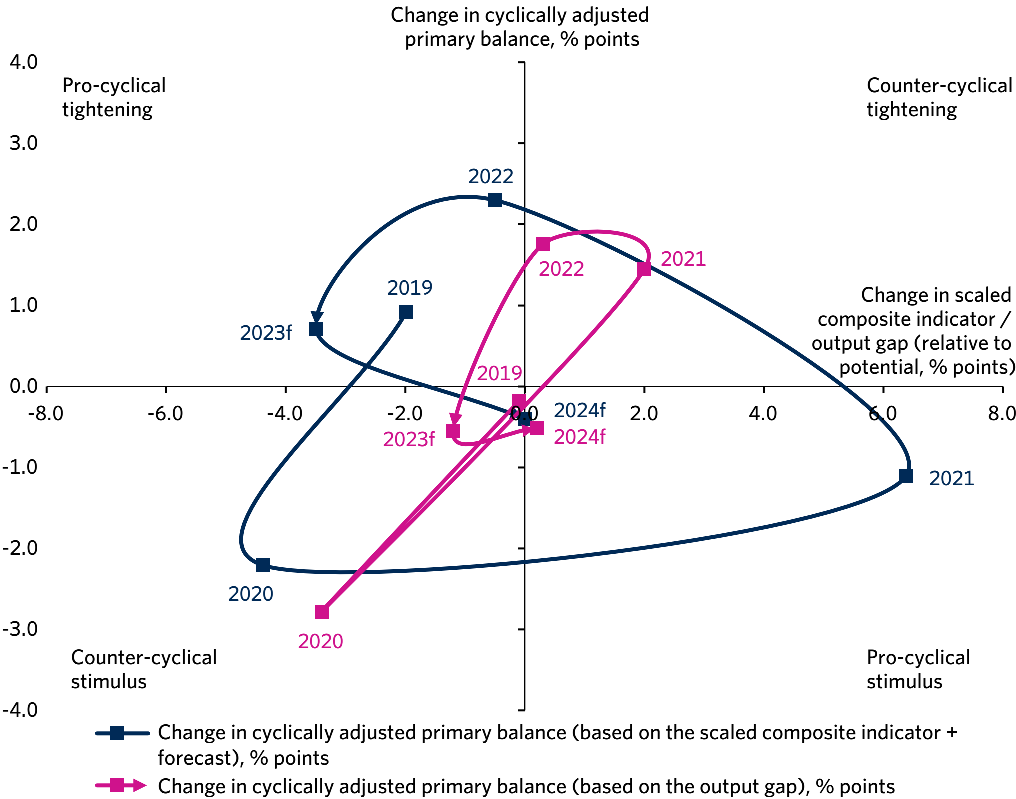


Figure 23: Fiscal impulse in relation to the change in business cycle: the change in structural primary balance (cyclical adjustment based on the output gap and the composite indicator) in relation to the change in both the output gap and the composite indicator produced by the fiscal policy monitoring function. The estimates for 2023 and 2024 are based on forecasts. Source: Ministry of Finance and the fiscal policy monitoring function.

When the situation is examined by means of the fiscal impulse, i.e. the indicator describing the change and direction of fiscal policy from the previous year[31] 2023 is slightly pro-cyclically contractionary based on the heatmap composite indicator. Based on the composite indicator, the change in the cyclically adjusted primary balance is estimated to be +0.7 percentage point relative to GDP (Figure 23: the values of primary balance are shown on the vertical axis). The structural primary balance thus becomes more positive, i.e. decreases from 2022, in the weakening business cycle. Based on the composite indicator, the impulse in 2024 is roughly neutral in a business cycle that remains weak.

According to the estimate based on the output gap, the impulse in 2023 is slightly counter-cyclically expansionary (change in the cyclically adjusted primary balance is –0.6 percentage point in relation to GDP) in a weakening business cycle, and the impulse in 2024 is roughly neutral in relation to a business cycle that continues to be weak.

The different estimates of the fiscal impulse in 2023 that are based on different business cycle indicators highlight again the fact that merely the use of different business cycle indicators can give a very different picture of the fiscal impulse (and the fiscal stance).[32]

2.4 The targets of the Government Programme have not been complied with in the setting of the spending limits

A new Government sets the spending limits for the parliamentary term in its first General Government Fiscal Plan. The spending limits refer to the expenditure ceiling defined for each year of the parliamentary term. The ceiling limits additional expenditure and cannot be changed afterwords except within the limits of the spending limits rule. The spending limits rule enables changes that are neutral from the perspective of the taxpayer's burden. Therefore, the spending limits should provide a reliable and transparent understanding of the level of spending in the government term and of the expenditure included in it. The spending limits are set in relation to the so-called technical spending limits defined by the previous Government.

The setting of the spending limits is not steered by specific rules or principles. When setting the spending limits, the Government may decide on both additional expenditure and savings, and it may also leave room for unexpected expenditure during the government term. The setting of the spending limits is steered only by the expenditure target specified in the Government Programme for the last year of the government term, which should be realised when the spending limits are set. The expenditure target of Orpo's Government has been formulated as follows: "The Government is committed to ensuring that the permanent appropriation decisions outlined in the Government Programme lead to expenditure within the spending limits being EUR 1.5 billion smaller in 2027 than in the central government spending limits decided on 23 March 2023 (at 2024 prices)." When the spending limits are set, it is also important to transparently present the expenditure decisions taken by the Government and their impacts on the spending limits.

31 The fiscal impulse is assessed by examining the change in structural primary balance in relation to the change in the business cycle indicator. For more information on how to assess the fiscal stance, see the fiscal policy monitoring report of autumn 2021 (NAOF, fiscal policy monitoring function, 2021).
32 The estimate based on the output gap will typically be revised in the coming years, whereas the estimate based on the composite indicator of the heatmap will hardly be revised afterwards.

The spending limits decision of Orpo's Government is presented in section 5.1 of the General Government Fiscal Plan. The spending limits for the parliamentary term are presented in an exceptional manner in the table. The presentation may give the impression that the Government Programme's target of EUR 1.5 billion smaller spending limits expenditure will be achieved even though the EUR 1.5 billion presented in the table also includes expenditure outside the spending limits. Moreover, the spending limits include only part of the investment programme and only part of potential new expenditure decisions related to assistance to Ukraine. The fiscal policy monitoring function considers the presentation used in the setting of the spending limits misleading, as it may lead to a misunderstanding of the achievement of the Government's objectives. At the same time, some expenditure has been excluded from the spending limits.

The Government's target of a EUR 1.5 billion reduction in spending limits expenditure will not be achieved in 2027

Section 5.1 of the General Government Fiscal Plan contains a table describing the spending limits for the parliamentary term. In the row "Total spending limits expenditure according to the Government Programme", the savings presented for 2027 amount to EUR 1.455 billion. This figure has been obtained by calculating the sum of the savings and additional expenditure decisions made by the Government (Annex B to Orpo's Government Programme), the unallocated reserve, and the supplementary budget provision. However, the savings and additional expenditure decisions made in the Government Programme also include expenses that fall outside the spending limits and do not lead to savings in spending limits expenditure. This expenditure outside the spending limits has been excluded in the row "Technical correction to spending limits level: expenditure outside the spending limits to which savings will be directed, will be added to the level of spending limits expenditure". In practice, when setting the spending limits, the Government thus, by the use of the correction row, took into account the fact that all of its expenditure decisions were not directed at spending limits expenditure. However, it does not appear clearly from the table or the General Government Fiscal Plan that the EUR 1.5 billion target includes expenditure outside the spending limits, as the target and the table row related to it have been defined to apply to spending limits expenditure.

The spending limits should have been set transparently, in the same way as with previous governments, so that only spending limits expenditure had been presented when the spending limits were set. The fiscal policy monitoring function has been given access to the calculations of savings and additional expenditure, on the basis of which it is possible to present spending limits data without expenditure outside the spending limits. From the calculation, it can be seen that the Government's actual initial target was to reduce spending limits expenditure by EUR 944 million in 2027. Thus, the target of saving EUR 1.5 billion in spending limits expenditure, as set out in the Government Programme, was not implemented in the setting of the spending limits.

Table 2: The spending limits decision of Orpo's Government when expenditure outside the spending limits has been excluded from the data presented in the General Government Fiscal Plan. The investment programme is partly included in the row "Other structural adjustments to spending limits level". Source: Ministry of Finance.

Government decision on spending limits	2024	2025	2026	2027
Level of spending limits expenditure in the technical spending limits decision 23.3.2023	**74,840**	**75,473**	**75,382**	**75,541**
Total spending limits expenditure according to the Government Programme, of which	**132**	**-164**	**-471**	**-944**
— savings	-773	-1,349	-1,761	-2,382
— additional expenditure	385	635	710	787
— unallocated reserve	120	150	180	250
— supplementary budget provision	400	400	400	400
Preparedness for unforeseen expenditure needs	**42**	**127**	**130**	**244**
Adjustment of wellbeing services counties' spending limits provisions	**-**	**680**	**340**	**-**
Transfer to spending limits of previous parliamentary term's compensation for municipalities' tax revenue losses	**275**	**275**	**275**	**275**
Transfer of National Housing Fund grants to within the spending limits	**98**	**98**	**98**	**98**
Transfer of Makera grants to within the spending limits	**10**	**10**	**11**	**11**
Parliamentary term expenditure ceiling (incl. supplementary budget provision)	**75,398**	**76,499**	**75,766**	**75,225**
Price and cost adjustments to the spending limits level, GGFP	**79**	**-45**	**-46**	**-45**
Structural adjustments to spending limits level, GGFP	**33**	**130**	**356**	**420**
Spending limits level at the GGFP 2024 stage	**75,510**	**76,584**	**76,076**	**75,601**

Expenditure outside the spending limits	2024	2025	2026	2027
Savings in expenditure outside the spending limits (incl. higher index saving)	**-686**	**-1,071**	**-1,188**	**-1,189**
Additional expenditure outside the spending limits	**228**	**495**	**616**	**622**
Total	**-458**	**-576**	**-572**	**-567**

The EUR 944 million saving in spending limits expenditure that was targeted when the spending limits were set is significant, even though the EUR 1.5 billion savings targeted in the Government Programme are not met. The most important thing for the achievement of the savings target is that a corresponding decrease in the spending limits is linked with it. The savings will then be implemented plausibly – by adhering to the spending limits decision and by preparing budgets in compliance with the spending limits. Despite the decrease in the spending limits level, it is still possible to re-prioritise expenditure decisions within the spending limits. The Government has also made a larger supplementary

budget provision than before for all the years of the Government term, which also brings fiscal space to the spending limits. The fiscal policy monitoring function will monitor the achievement of the savings target during the parliamentary term as part of the monitoring of compliance with the spending limits.

More than EUR 3 billion of investment programme expenditure is missing from the spending limits but will be added to the spending limits during the parliamentary term

It is important that the Government's spending limits decision makes it possible to form an overall picture of the expenditure decisions to be taken by the Government during the government term. If the timing or level of expenditure decisions is uncertain when the spending limits are set, it is possible to make a provision for such expenditure. The impact on expenditure of ex-post revisions related to the funding of wellbeing services counties is a good example of a situation where the expenditure level will only be specified over time. However, for reasons of transparency, it is important to assess the impact of the provision made for wellbeing services counties on expenditure. When the spending limits were set, the spending limits provision for wellbeing services counties was revised upwards: the total provision including the previous provision made in the technical spending limits is now EUR 1 billion for 2025, EUR 910 million for 2026, and EUR 820 million for 2027.

EUR 3.4 billion of the investment programme expenditure is missing from the table describing the spending limits in section 5.1 of the General Government Fiscal Plan. The row "Other structural adjustments to spending limits level" in the table presents a total of EUR 631 million of the investment programme expenditure as part of other structural adjustments. It would have been more transparent and in line with the spending limits principles to present the investment programme expenditure as a separate provision in the same manner as the spending limits provision for the wellbeing services counties. Moreover, the selected method does not comply with the recommendation of the working group on the development of fiscal steering (Ministry of Finance, 2022). When the spending limits were set, the Government's expenditure decisions remained incomplete as a whole because the investment programme was only partly included in the calculation.

The fiscal policy monitoring function points out that, when deciding on the spending limits, the Government did not comply with the Government Programme's objective of reducing spending limits expenditure by EUR 1.5 billion. The facts that the investment programme is partly missing from the spending limits and that structural adjustments are used both for the investment programme and for new expenditure decisions related to assistance to Ukraine further obscure the setting of the spending limits and hamper the overall assessment and monitoring of the Government's expenditure decisions.

The formulation of the spending limits rule has mainly succeeded

The spending limits rule of central government finances is a key tool for implementing the spending limits set by the Government and the expenditure targets determined by it. The spending limits rule of Prime Minister Orpo's Government has been formulated clearly, and in its content, it conforms to the tradition of previous parliamentary terms. It gives the impression that the Government has strived to restore the credibility of the spending limits

system as an instrument limiting the growth of expenditure during the parliamentary term. For example, the Government undertakes to implement the Government Programme only within the scope of the spending limits and to cover all unforeseen expenditure needs with an unallocated reserve and a supplementary budget provision. The credibility of the Government's commitments is enhanced by the fact that the supplementary budget provision was raised to EUR 400 million for each year of the government term, while it had previously been EUR 100–300 million a year.

The Government's spending limits rule specifies the unclear situations associated with expenditure outside the spending limits, which the fiscal policy monitoring function has also drawn attention to in the past. The most important amendment is the addition made to the spending limits rule that eliminates the previous possibility of using savings in social security and unemployment security made outside the spending limits for other spending limits expenditure. As a result of the addition, cuts to social security and unemployment security should no longer be automatically available for use for other expenditure. It will thus be possible to pursue savings impacts on public finances through spending cuts. In addition, according to the amended spending limits rule, it is possible to classify a financial investment as a spending limits expenditure if, at the time of the decision-making, the investment is considered to be definitive expenditure. These amendments contribute to the functioning of the spending limits rule in view of its objective to not increase the taxpayer's burden during the parliamentary term.

The Government has decided to simplify the price adjustments made to the spending limits for all spending limits expenditure except for those falling within the scope of statutory or contractual price adjustments. The price and cost adjustments also include a EUR 131.9 million increase in the spending limits, which corresponds to the estimated exchange rate loss on the Ministry of Defence's procurements in 2024. The increase is made possible by the policy outlined in the spending limits rule that fighter procurements are taken into account in the spending limits and that the index and exchange rate expenditure under the procurement agreement are taken into account as part of the price adjustment of the spending limits. The fiscal policy monitoring function is of the opinion that foreign exchange gains should adjust the spending limits downwards by an equivalent amount.

The mechanism for exceptional circumstances, which was introduced for the first time during the previous parliamentary term, has been retained in the spending limits rule. During the previous parliamentary term, it was also used in expenditure decisions related to the Covid-19 pandemic. Orpo's Government has updated the definition of the mechanism in an appropriate direction: the high threshold for its activation has been retained, but at the same time, the mechanism enables justified expenditure decisions if they are in proportion to the unusual event that has triggered them.

The coverage of the spending limits in relation to public finances has improved significantly at the beginning of the parliamentary term, as the wellbeing services counties' finances are included in the spending limits expenditure. During the previous parliamentary term, expenditure financed by Veikkaus Oy's proceeds were also transferred to the scope of the spending limits. In addition, in Orpo's Government Programme, part of the finances of the National Housing Fund and the Development Fund of Agriculture and Forestry has also been included in the spending limits. The increase in the coverage of spending limits expenditure is a positive change that increases Parliament's decision-making power over public expenditure.

The spending limits rule enables the EUR 4 billion investment programme and assistance to Ukraine to be taken to the spending limits

The Government has added to the spending limits rule an opportunity to raise the spending limits whenever it takes decisions on the investment programme or on additional expenditure related to new and temporary support for Ukraine in the form of defence materiel, civilian material, and humanitarian aid. In the previous government term, additional expenditure related to security and support for Ukraine was also taken directly to the spending limits. Of these decisions taken by the previous Government, the following amounts were carried over with the technical spending limits as part of the so-called exceptional security situation: EUR 2.125 billion to 2024, EUR 1.884 billion to 2025, EUR 1.385 billion to 2026, and EUR 1.016 billion to 2027. So far, Orpo's Government has decided on additional expenditure of EUR 376 million in total for assistance to Ukraine in 2023–2027.

It is stated in the Government Programme that the Government has made a separate spending limits provision of up to EUR 4 billion for the investment programme. In the autumn 2023 Economic Survey of the Ministry of Finance, it is stated that in its budget session, the Government allocated EUR 0.6 billion of the measures included in the investment package, while the rest of the investment package will remain as a spending limits provision. However, the General Government Fiscal Plan states that the EUR 4 billion fixed-term investment programme under the Government Programme will be considered a structural adjustment to the spending limits, which means that the spending limits for the parliamentary term will be raised in line with expenditure.

The fiscal policy monitoring function considers it exceptional that the policy lines set out in the Government Programme and the General Government Fiscal Plan in relation to the spending limits rule differ from each other. The fiscal policy monitoring function does not consider it justified to abandon the policy outlined in the Government Programme to use a provision for the implementation of the investment programme. In addition, the Government's spending limits expenditure as a whole is obscured by the Government's decision to transfer investment programme expenditure to the spending limits during the parliamentary term as it makes new expenditure decisions. For this reason, EUR 3.4 billion of the estimated spending limits expenditure were missing from the spending limits decision. In practice, this procedure also enables some of the central government's investments to be treated in a special manner within the spending limits. The fiscal policy monitoring function and the working group of the Ministry of Finance on the steering of general government finances have not considered it justified to treat investments in a special manner in the spending limits system (Ministry of Finance, 2022).

The practice that began in the previous government term and that makes it possible to bring new expenditure decisions and expenditure directly to the spending limits in the form of structural adjustments has been justified in the exceptional circumstances. However, if this practice is continued, it will threaten the credibility and transparency of the spending limits rule. A more transparent method would be to treat unforeseen and exceptional expenditure outside the spending limits or as provisions. This would promote the maintenance of an overall picture of the expenditure decisions taken during the government term.

Expenditure outside the spending limits

The spending limits rule covers around 85% of the budget expenditure, while the remaining expenditure is classified as expenditure outside the spending limits. Expenditure outside the spending limits includes cyclical expenditure, such as unemployment security and social assistance expenditure. In addition, it also includes financial investments, interest payments on central government debt, transfers to the State Television and Radio Fund, and compensation to the local government for tax cuts. Some of the expenditure outside the spending limits are pass-through items, which means that revenue has been allocated in the budget to offset the expenditure in question. Such items include expenditure corresponding to revenue from the EU, VAT appropriations, and pension expenditure paid to other pension institutions.

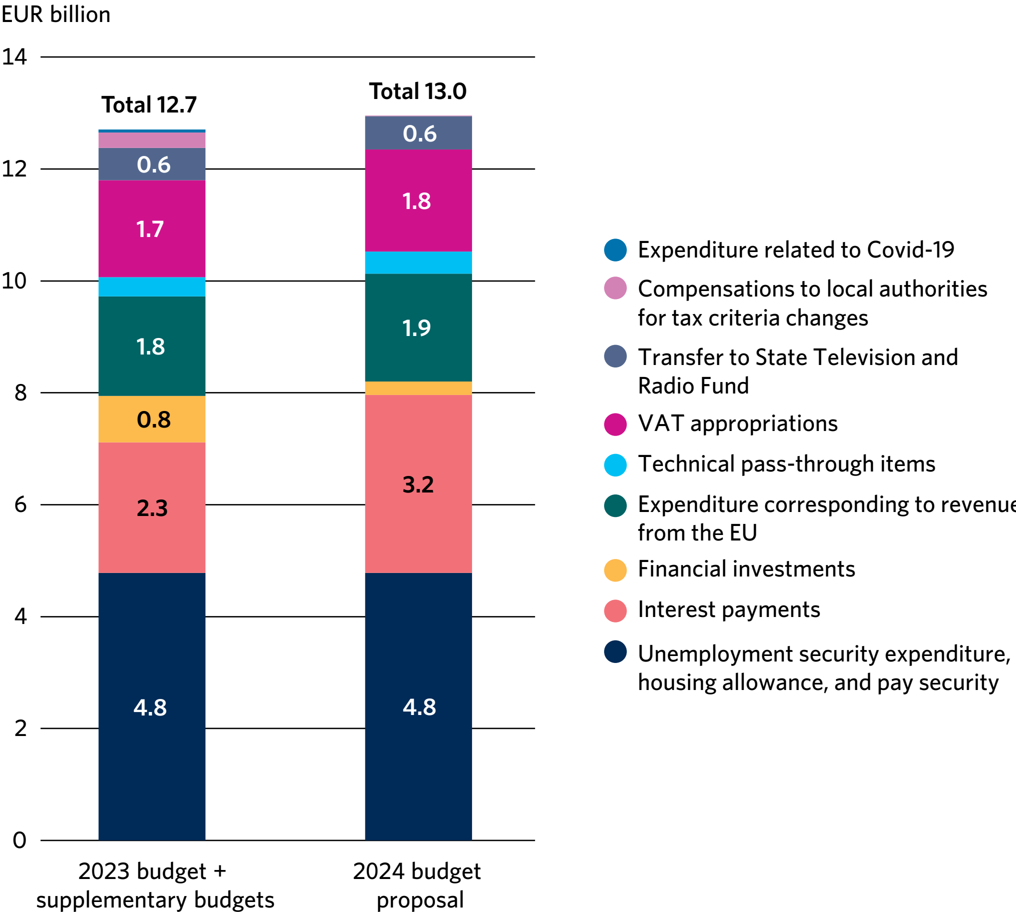


Figure 24: Expenditure outside the spending limits in 2023 in accordance with the budget and supplementary budget decisions, and the estimate for 2024 according to the budget proposal.

The most significant expenditure items falling outside the spending limits in the budget proposal for 2024 are cyclical expenditure and interest payments on central government debt. The Government has proposed savings measures and additional expenditure related to cyclical expenditure, i.e. unemployment security and social security expenditure. They are estimated to reduce expenditure in 2024 by EUR 458 million. It is difficult to monitor how these savings impacts are implemented, as in addition to Government decisions, the level of expenditure is also influenced by a number of other factors. Unlike in the case of spending limits expenditure, there is no limit on expenditure outside the spending limits, but the expenditure is determined by its use. This is because part of the expenditure outside the spending limits acts as counter-cyclical automatic stabilisers (NAOF, fiscal policy monitoring function, 2023b). The interest payments on central government debt have increased significantly in a short period of time and constitute the second largest item in the expenditure outside the spending limits.

3 Reform of the EU fiscal rules and the status of meeting the current EU criteria

The EU fiscal framework has become complex and it has, in practice, not worked as intended. One of the problems with the framework has been weak compliance with it and its inefficiency in preventing pro-cyclical fiscal policy. The reform of the fiscal framework aims, among other things, to simplify the rules and to pay more attention to Member States' debt sustainability. A key element of the reform is that compliance with the rules would no longer be monitored on the basis of the development of the general government structural balance relative to GDP or directly on the basis of the development of the debt-to-GDP ratio. These would be replaced by monitoring the net expenditure path specified for each Member State. However, the reference values for general government deficit and debt would remain unchanged.

The net expenditure path, which is included in the proposal for a new framework and based on debt sustainability analysis, can provide a good basis for a realistic fiscal policy that takes the debt ratio in a favourable direction. On the other hand, even the proposed framework involves significant uncertainties. Compliance with the net expenditure path would not automatically mean a reduction in the debt ratio. The debt sustainability analysis, on which the setting of the net expenditure path would be based, is built on assumptions made about several factors affecting the debt ratio. If the actual development of these factors does not correspond to the assumptions made when the net expenditure path was set, the debt-to-GDP ratio will not develop as originally estimated, even if the net expenditure benchmark is complied with.

The Commission's debt sustainability analysis enables Member-State-specific analysis, which allows the level and nature of debt risks to be assessed. The technical analysis aims to model Member States' debt sustainability risks in different economic situations in a realistic manner. No decisions have yet been made on the detailed content of the debt sustainability analysis, the background assumptions, or its application in the new framework. The background assumptions should be selected particularly carefully, as they have a significant impact on the adjustment path that the analysis produces for the Member State.

General government deficit will continue to be subject to the 3% criterion even if the EU framework is reformed in line with the Commission's proposal. Finland risks breaching this reference value in the next few years. The general escape clause of the current EU fiscal framework has been active because of the Covid-19 pandemic, Russia's war or aggression, and the energy crisis. It will be deactivated at the end of 2023. Differing forecasts and views of the business cycle have a significant impact on the conclusions about whether the development of Finland's public finances complies with the current EU criteria. Even though forecasts involve high uncertainty, the Government's fiscal policy should take into account the limits set by the EU framework valid at any given time.

3.1 The EU fiscal rules are under reform

The Maastricht Treaty on the European Union (European Union, 1992) was signed in 1992. The 3% reference value for general government deficit and the 60% reference value for government debt-to-GDP ratio, intended to provide a framework for the management of public finances, were included in the protocol annexed to the Treaty. The reference values were not based strongly on the theory of economics or empirical research (Buti and Gaspar, 2021). Their application was agreed in practice in the Stability and Growth Pact (European Council, 1997), which entered into force in 1998 and 1999. In 2005, a medium-term objective, based on the concept of structural balance, was also introduced into the fiscal framework. At that time, the aim was to ensure that the framework could take cyclical fluctuations better into account.

The 2008–2009 financial crisis and the resulting euro crisis caused a need to strengthen the framework, and amendments to the Stability and Growth Pact that applied to all EU Member States entered into force in 2011 (see European Commission, 2011). The EU fiscal framework with its current content has been in place since 2013, when the amendments to the EU fiscal framework resulting from the financial crisis and concerning the euro area entered into force ("two-pack", see European Commission, 2013). The Fiscal Compact entered into force in the same year. Pursuant to the Fiscal Compact, part of the EU framework was transposed into the national legislation of the Member States. The Fiscal Compact is part of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (24/2013). The purpose of the amendments made to the framework due to the financial crisis was, among other things, to emphasise the importance of the debt criterion included in the framework and thus to limit the growth of general government debt.

The measures taken to strengthen the EU framework laid the foundation for a later reform of the framework, as the amendments increased the complexity and ambiguity of the framework. The 2015 report of five EU Presidents responded to the need expressed at the 2014 Euro Summit for preparing better economic governance in the European Union. It was stated in the report that the framework was complex and that the future review of the framework should clarify the system and improve its transparency, compliance, and legitimacy. The report also proposed the establishment of an independent fiscal advisory body for the European Commission. (Juncker et al., 2015.) The European Fiscal Board (EFB) started its operations in 2016.

The European Court of Auditors (ECA) addressed the economic governance framework in four audits between 2016 and 2019. Based on the audits conducted by the ECA, the Stability and Growth Pact does not reduce debt levels as intended. According to the ECA, a lot of flexibility has been used in the assessment of compliance with the medium-term objective for general government fiscal position and the objective to reduce the debt ratio. As a result of this, debt levels may have been rising even when the Commission has interpreted that the framework has been complied with. (European Court of Auditors, 2016 and 2018)

The Communication from the Commission in 2017 on completing the EMU with its various dimensions anticipated the possibility of simplifying the EU fiscal framework by 2025 (European Commission, 2017). In January 2019, Jean-Claude Juncker, President of the European Commission, asked the European Fiscal Board to assess the current frame-

work and to present ways to simplify it. The EFB discussed the matter in its report published in August of the same year (European Fiscal Board, 2019). The EFB considered the framework unnecessarily complex. According to the EFB, it was particularly problematic that the framework had not prevented pro-cyclical fiscal policy and that it had led to public invest-ment cuts. As a solution, the EFB proposed a rule for expenditure growth based on a long-term debt anchor. The rule would also take into account measures concerning public revenue, and it would be defined for the medium term (three years to come). According to the EFB's plans, the debt anchor could be country-specific. In addition, the EFB proposed that the framework should treat investments differently from other expenditure.

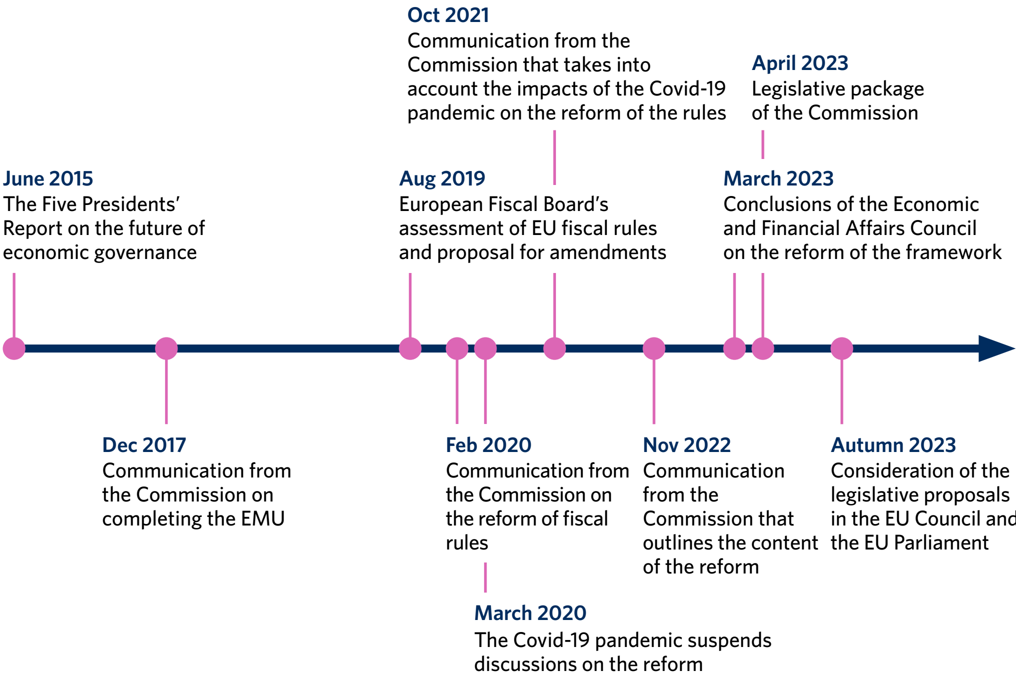


Figure 25: Timeline of the reform of the EU fiscal rules.

In early 2020, the EU Commission presented its assessment of the economic governance framework and opened public consultation on the subject. The Commission assessed that the complexity had reduced the transparency of the framework, which in turn had weakened its predictability and Member States' political commitment to it. (European Commission, 2020.) The Covid-19 pandemic caused a break in the consultation. Under the escape clause, the pandemic also suspended the application of the rules in practice, and the validity of the escape clause was later extended until the end of 2023 (see section 3.4). At the end of 2021, the Commission reopened the consultation and published a new communication, where it assessed the impact of the Covid-19 pandemic on the need for a reform (European Commission, 2021).

In late 2022, the Commission published a communication on orientations for the reform (European Commission, 2022b). The communication presented similar observations as had been presented in academic publications on the EU's fiscal rules (see e.g. Blanchard et al., 2021; Darvas et al., 2018; Martin et al., 2021): it has generally been considered that the problems with the current framework are related to its complexity, weak compliance with it, and its inefficiency in preventing pro-cyclical fiscal policy. In its communication, the Commission stated that experience had confirmed the difficulties associated with designing policy recommendations on the basis of unobservable indicators that are subject to frequent revisions (such as the output gap and the structural balance derived from it).

In February 2023, the Heads of State or Government of the EU Member States supported the swift progress of the reform (European Council, 2023). In March 2023, the ECOFIN Council of Ministers issued its conclusions, on the basis of which the EU Commission published legislative proposals for the content of the reform in April 2023 (Council of the European Union, 2023b; European Commission, 2023b, 2023c, and 2023d).

The reform will be discussed in the Council and the EU Parliament in autumn 2023. It is essential in the negotiation process related to the legislative proposals that the adoption of the total package requires the approval of the EU Parliament: the amendment to a regulation on the preventive part must be approved by a simple majority in the EU Parliament. The adoption of the package also requires the unanimity of the Member States in the Council, as the amendment to a regulation on the corrective part will be approved in accordance with a special legislative procedure.

3.2 The Commission's proposal aims to strengthen long-term approach in fiscal policy – expenditure growth would be steered by a net expenditure indicator

The legislative proposals consist of two amendments to regulations and one amendment to a directive. The Commission proposes amendments to the Regulation on the corrective arm of the Stability and Growth Pact (European Commission, 2023c). In addition, the Commission proposes a new regulation to replace the Regulation on the preventive arm of the Stability and Growth Pact (European Commission, 2023b). The Commission also proposes amendments to the Budgetary Frameworks Directive, which regulates the Member States' national, multiannual budgetary frameworks (European Commission, 2023d).

The new framework proposed by the Commission would focus on Member States' debt sustainability and four-year fiscal-structural plans, which would limit the growth of public expenditure. The focus in the time span of the EU's economic governance would shift from an annual review to an assessment of the medium-term development of debt and expenditure. The longer review period is justified, as it would ensure that the framework would not steer Member States to pursue short-term fiscal policy.

The 3% reference value for general government deficit and the 60% reference value for general government debt relative to GDP, as specified in the Treaty, remain unchanged in the Commission's proposal. However, the Commission proposes to abandon the 1/20 rule for debt adjustment, according to which the amount of debt ratio exceeding the reference

level of 60% of GDP should be reduced by one-twentieth of the amount each year. Instead, based on the Commission's proposal, a debt-to-GDP ratio exceeding the 60% reference value should be put on a *plausibly downward* path during a four-year plan. In addition, it would be possible to apply for an extension of three years on the basis of, for example, green transition investments and structural reforms boosting economic growth. The Commission would assess whether the investments and reforms proposed by a Member State as a whole meet the criteria for granting an extension period.

The application of the Commission's debt sustainability analysis involves different stages (see Figure 26). The adjustment period is 4–7 years, depending on the length of a potential extension period. The adjustment period is followed by a ten-year review period, during which the debt ratio should be on a downward path.

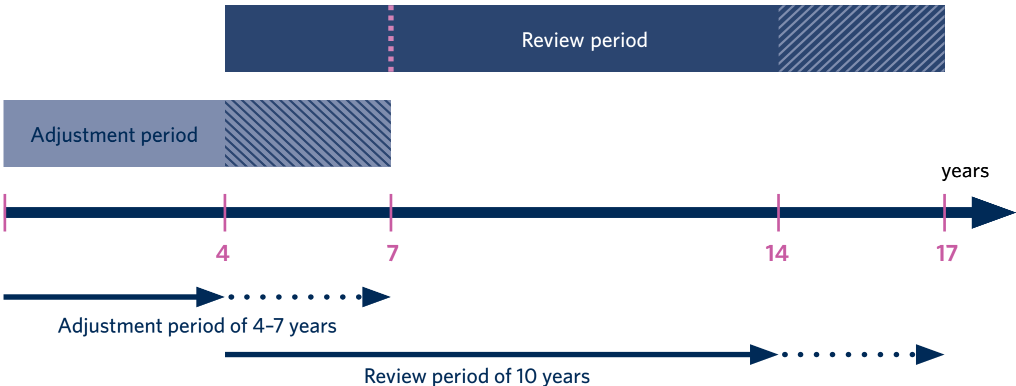


Figure 26: Stages related to the application of the debt sustainability analysis. The 4-year adjustment period and the 10-year review period are illustrated with a uniform pattern. A possible extension granted to the adjustment period is illustrated in the figure with a striped pattern, and it postpones the beginning of the review period by a corresponding period of time.

Focusing attention on the development of the debt ratio is also supported in economic literature, where the debt ratio trajectory has been found to be significant to economic growth. It is important that a highly indebted country has a plausible plan to reduce its debt ratio over the medium term (Chudik et al., 2017).

This observation serves as the basis for the Commission's proposal according to which the debt ratio trajectory must be on a *plausibly downward* path. In the Commission's proposal, plausibility is measured by means of a scenario which involves uncertainty and where several alternative development paths are produced for the debt ratio. When a sufficient number of trajectories are on a downward path during the review period, the rate of adjustment is adequate, and the debt-to-GDP ratio can be considered to be on a plausibly downward path.

According to the Commission's proposal, fiscal adjustment would be steered by the *debt sustainability analysis* (DSA), the purpose of which is to define, specifically for each Member State, a manageable debt development path and the expenditure and revenue development

leading to it. The general government net expenditure would be monitored by a fiscal-structural plan. According to the legislative proposal, the formula for calculating the net expenditure indicator is as follows: total public expenditure net of interest payments, cyclical unemployment expenditure, and expenditure of EU-funded EU programmes, in addition to which the impact of discretionary revenue measures is also taken into account. In practice, taking into account discretionary revenue measures would mean, for example, that tax increases would give a Member State more space for expenditure growth. Tax reductions, in turn, are reflected in the indicator as expenditure growth, whereby they reduce the space for actual expenditure.

The rule that is proposed by the Commission and that is based on the net expenditure indicator may have advantages over the current framework. Compared with structural balance, which is a key concept in the current framework, the net expenditure indicator is more strongly based on observable variables that are not revised afterwards in the same way as structural balance. In practice, the net expenditure indicator is also more clearly linked to items that the Government may influence directly by its fiscal decisions. This may improve the national ownership of the framework, and ultimately, for example, Governments' commitment to compliance with it. The net expenditure indicator also provides a better basis for formulating national fiscal frameworks and the objectives and rules included in them in line with the EU rules. The Commission's proposal is in line with the proposals of several expert bodies (particularly European Fiscal Board, 2019).

However, it should be observed that the rule based on the net expenditure indicator involves the significant risk that it does not guarantee a reduction in the debt ratio. The debt sustainability analysis, on which the setting of the net expenditure path would be based, also includes forecasts of several other factors affecting the debt ratio, such as inflation, interest rates, real economic growth, and the stock-flow adjustment (see section 1.2; for the impact of different factors, see, for example, Larch et al., 2022, p. 6). If the development of these factors does not follow the assumptions of the debt sustainability analysis, mere compliance with the net expenditure path will not lead to the targeted debt ratio. As emphasised by Larch and Malzubris (2023), an estimate (involving uncertainty) of longer-term potential GDP growth will continue to be needed, which means that unobservable variables will have to be used even in the proposed framework. Nevertheless, it is significant that the new framework can reduce the problems caused by the difficulty of measuring the real-time business cycle.

A net expenditure path based on the debt sustainability analysis can provide a good basis for a realistic fiscal policy that takes the debt ratio in a favourable direction. In addition, the safeguards included in the proposal may contribute to the net expenditure path leading to positive development of the debt ratio. On the other hand, there is no information available yet on how the safeguards would actually influence the required adjustment rate and thus the net expenditure path. In the Commission's proposal, the safeguards are only examined when the net expenditure path is set, and they are not intended to be applied in the assessment of compliance with the rule. Therefore, even the safeguards do not guarantee the development of debt levels in line with the objectives set.

In the Commission's proposal, an excessive deficit procedure (EDP) based on the debt rule can only be initiated as a result of a breach of the net expenditure rule and not directly

based on the level of the debt ratio. Therefore, there is a risk that the debt ratio will not develop as desired even if the debt rule is complied with. The net expenditure rule may thus prove to be ineffective. The risk could be reduced by redefining the permitted net expenditure path from time to time. This would provide an opportunity to tighten the net expenditure path if it seems that debt development in line with the framework will not be achieved. However, because the time span proposed for the framework is relatively long (4–7 years for reversing the debt development), it is possible that undesirable development is not timely intervened in.

The Commission's proposal increases Member-State-specific analysis in the setting of objectives. This can be regarded as positive if it increases the realism and national ownership of the objectives, and, consequently, commitment to the objectives. The proposal also simplifies the framework in the sense that the net expenditure path to be monitored by fiscal policy-makers would be conceptually easier than the concept of structural balance in the current framework.

However, the proposed changes may increase the complexity of the calculations underlying the framework. The complexity of the definition of the net expenditure path and the process between the Member States and the Commission (and the Council) for setting the path may weaken the transparency and fairness of the framework and its application. Therefore, it is particularly important that the fiscal framework is monitored independently. This would also improve its transparency. Consequently, the Commission proposes that the role of Independent Fiscal Institutions (IFIs) be strengthened in the reform, for instance by involving the national IFIs more closely in the monitoring of compliance with the EU rules.

The debt sustainability analysis is based on technical calculations and assumptions, which may be difficult for policy-makers. On the other hand, the analysis aims to model the debt sustainability risks of Member States in different economic situations realistically, which means that it must be based, at least at some level, on technical calculations and assumptions. Many of the elements of the analysis framework proposed by the Commission are similar to those that are an integral part of the debt sustainability analyses of the European Central Bank, the IMF, and other international organisations. The debt sustainability analysis proposed by the Commission has already been used for several years to provide policy-makers with additional information on the state of public finances and on debt sustainability risks.

For countries breaching the debt or deficit criteria, the Commission publishes a reference path for general government (net) expenditure based on debt sustainability. The proposed rule includes a total of six criteria that the reference path should comply with:

a. by the end of the adjustment period, at the latest, the 10-year debt trajectory is on a *plausibly downward* path
b. the government deficit is maintained below the 3% of GDP reference value over the same 10-year period
c. excessive deficit is temporary
d. the adjustment effort is not postponed towards the final years of the adjustment period
e. the public debt ratio at the end of the adjustment period is below the public debt ratio at the beginning of it
f. net expenditure growth remains below medium-term output growth.

The first criterion can be called the debt sustainability criterion. Criteria (c) to (f) are safeguards, the most important of which are criteria (c) and (e). As regards safeguards, their exact content is still under discussion. Darvas et al. (2023) have argued that criterion (e), for example, should be completely removed from the proposed rules. According to their analysis, the debt sustainability criterion already restricts the debt ratio trajectory adequately, and therefore additional criteria do not bring any significant added value.

On the basis of the reference path for the development of net expenditure published by it, the Commision would engage in discussions with Member States on their fiscal-structural plans, fiscal adjustment path, and structural reforms and investments. The final adjustment path will be determined after the fiscal-structural plans have been assessed (European Commission) and approved (Council of the European Union).

3.3 According to the debt sustainability analysis, putting the debt ratio on a downward path requires adjustment measures – the significance of assumptions is emphasised in the analysis

D*ebt sustainability analysis* (DSA) is a framework for assessing debt sustainability risks. The framework often contains many complementary elements, depending on the nature of the debt sustainability analysis. The elements of the framework can be divided, for example, on the basis of their nature or time span. The Commission's debt sustainability analysis focuses on medium-term debt risks, which are assessed by means of various debt scenarios.

The Commission's debt sustainability analysis is described in full in *Debt Sustainability Monitor 2022* (European Commission, 2022a). The debt sustainability analysis is based on debt accumulation equation (3), where the debt-to-GDP ratio, d_t, in year t depends on its components:

$$d_t = \frac{1+i_t}{(1+g_t^{nim})} d_{t-1} - p_t + \Delta coa_t + sfa_t \quad (3)$$

The main components of the debt-to-GDP ratio are the nominal interest rate i_t, the nominal GDP growth rate g_t^{nim}, and the primary balance p_t (see information box 1 in section 1.2). Other factors can be taken into account when necessary. The Commission's debt sustainability analysis would take into account at least the change in ageing-related expenditure Δcoa_t in relation to the final year of the adjustment period, and the stock-flow adjustment sfa_t. The debt ratio projection can be calculated when assumptions have been made about the components' medium-term development. In the short term, the components are assumed to follow the Commission's own forecasts. In the medium term, the Commission assumes the future interest rate and inflation development to meet market expectations. The nominal GDP growth rate is determined by inflation (GDP deflator) and the real GDP growth rate (change in GDP volume). The medium-term real GDP growth is derived by the production function method used by the Commission through potential GDP and output gap (for assumptions, see information box 2).

The debt sustainability analysis focuses on different scenarios aimed at identifying key country-specific debt risks

In the European Commission's analysis framework, debt risks are assessed using four scenarios, which completely ignore the impact of uncertainties. The scenarios aim at modelling potential shocks, i.e. unexpected changes affecting macroeconomic development, which may have a negative impact on the development of the debt ratio. The debt sustainability analysis provides the minimum annual adjustment (measured as structural primary balance) with which the debt ratio development meets criteria (a) to (f) of the proposed rules.

The scenarios begin at the beginning of the review period, which in turn depends on the length of the adjustment period (see Figure 26). The scenarios are:

i. baseline scenario[33]
ii. unfavourable structural primary balance
iii. unfavourable *r*–*g*
iv. financial market failure.

In the first scenario, i.e. the baseline scenario, the debt ratio trajectory is examined by setting the general government structural primary balance at the level of the year preceding the adjustment period, i.e. 2024[34], and keeping it at that level throughout the review period. In the second scenario, the structural primary balance is reduced by a total of 0.5 percentage point in the first two years of the review period, when the adjustment period is four years. In the case of a seven-year adjustment period, the structural primary balance is reduced in the first three years.

In the third scenario, the difference between the interest rate and nominal GDP growth is expected to grow by one percentage point. Nominal GDP growth slows down permanently, and interest rates on new loans increase by 0.5 percentage point permanently throughout the review period. It should be observed that the increase in interest rates does not apply to the entire general government loan portfolio but only new loans. This means that the interest rates on the entire loan portfolio increase only gradually as old loans mature and new loans are issued. In the last scenario, interest rates increase by one percentage point in the first year of the review period in countries with a debt-to-GDP ratio below 90%. For countries with a higher debt ratio, a formula for raising the interest rate has been specified.

In the rules proposed by the Commission, the debt sustainability analysis plays a key role in the assessment of the Member States' annual minimum fiscal adjustment required to put the debt ratio projection on a path according to criteria (a) to (f) presented on page 62 after the adjustment period. Due to the technical nature of the debt sustainability analysis, it is difficult to assess in advance what kinds of adjustment paths compliance with criteria (a) to (f) would, in practice, require of different Member States.

33 This scenario is also called the unchanged policy scenario because in it, fiscal policy (measured as primary structural balance) is set at the level of the first year and kept at it until the end of the debt ratio projection.

34 The Commission's forecast for Finland's structural primary balance in 2024 is –0.67.

In the above scenarios, it is possible to calculate an exact debt ratio trajectory, as the development of the components do not involve uncertainty (see Figure 27, left side). In reality, it is impossible to know exactly how the interest rates r_t, GDP growth rate g_t, and primary balance p_t will develop in the future. However, we can model deviations in these components from the predefined trajectories.

By means of certain statistical assumptions, we can produce many (even millions of) alternative trajectories for the components of the debt ratio.[35] These trajectories, in turn, make it possible to calculate several alternative trajectories for the debt ratio using the debt accumulation equation (see equation 3). Drawing them in the same figure using a fan-like pattern provides information on the uncertainty of debt ratio trajectories when the components are not expected to remain precisely on a predetermined path.

In the proposed rules, criterion (a), or the "debt sustainability criterion", includes the requirement that the debt ratio should be put on a *plausibly downward* path. This plausibility of the downward path is assessed by means of an uncertainty-involving scenario where five years after the end of the adjustment period, the debt ratio must, with a sufficiently high probability, be at a lower level than at the end of the debt ratio adjustment period. In other words, in order for the debt ratio to be considered to be on a *plausibly downward* path, sufficiently many alternative debt ratio trajectories must fall for five years after the adjustment period.

Based on the Commission's debt sustainability analysis, sufficiently high probability refers to a 70% probability. The higher the probability required to satisfy the requirement for plausibility, the higher the target level set for structural primary balance SP^* should be in order to put sufficiently many alternative debt ratio trajectories on a downward path. For example, in its debt sustainability analysis, the IMF (2021) requires a stricter 80% probability in order for the requirement for plausibility to be met.

Assumptions and the selected scenarios play an important role in the debt ratio projections and adjustment paths produced by the debt sustainability analysis

The debt sustainability analysis aims to ensure that the debt ratio is maintained on a *plausibly downward* path after the adjustment period. In addition, the above-mentioned safeguards must be complied with. The debt ratio is considered to be on a downward path if it decreases continuously for ten years after the end of the adjustment period.

In the following, we will discuss the application of the debt sustainability analysis to Finland within the scope of the proposed rules. The purpose is to illustrate how the Commission's debt sustainability analysis guides the adjustment requirements specific for each Member State, when the only requirement set is compliance with the debt sustainability criterion (criterion (a)). The examination focuses only on a case where the adjustment period is four years. The possibility of a three-year extension, which would extend the

35 In the Commission's debt sustainability analysis, shocks in the components of the debt ratio are produced using the components' historical covariance matrix and the assumption of the shocks' normal joint probability distribution. These statistical assumptions have been addressed by, for example, Darvas et al. (2023), IMF (2021), and the Ministry of Finance (2023c).

adjustment period to seven years in total, is thus not examined. The three-year extension may have a significant impact on the minimum annual adjustment produced by the Commission's debt sustainability analysis specifically for each Member State. According to calculations by Darvas et al. (2023), the three-year extension would reduce the required minimum annual adjustment in nearly all countries. The result they receive is natural, as the extension divides the required adjustment over several years, in which case the annual adjustment decreases.

The Member States have not yet reached agreement on all the technical details related to the debt sustainability analysis. In unclear cases, the fiscal policy monitoring function has interpreted the content of the debt sustainability analysis as it considers best and relied on the existing knowledge base insofar as it has been available.

In the rules proposed by the Commission, the debt sustainability analysis is applied when it is assessed whether the debt-to-GDP ratio is *plausibly on a downward* path according to the debt sustainability criterion. The necessary adjustment a to put the debt ratio on a downward path is measured through the strengthening of structural primary balance. Therefore, a contractionary fiscal policy refers to a fiscal adjustment where $a>0$. Correspondingly, an expansionary fiscal policy means that $a<0$. The minimum possible adjustment putting the debt ratio on a downward path is written as a^*. The minimum annual adjustment a is measured as percentage points relative to GDP.

When the assumed short and medium-term trajectories of the components of the debt ratio and other factors and the baseline level of primary structural balance forecast by the Commission are as given, it is possible to calculate an annual minimum adjustment a with which the debt ratio to be put on a downward path after the end of the adjustment period. In the case of deterministic scenarios that ignore uncertainty, the result of the debt sustainability analysis is therefore a minimum adjustment that puts the debt ratio on a downward path a. The adjustment and the target level of structural primary balance SP^* are determined based on the deterministic scenario that requires the highest minimum adjustment a (for the impact of the adjustment on the debt accumulation equation, see information box 3).

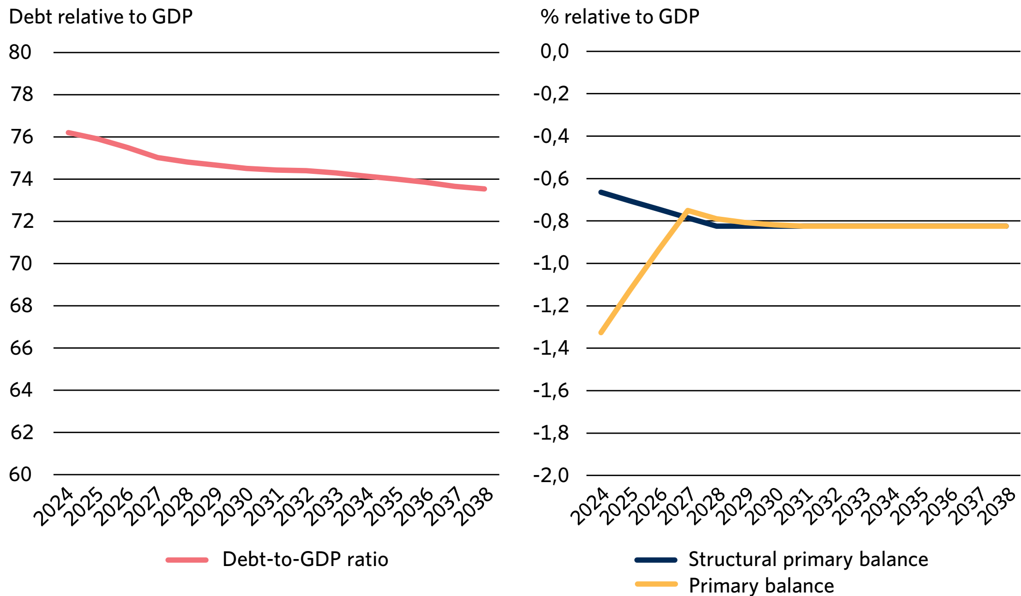


Figure 27: Development of the debt ratio (left, broken y-axis) according to the baseline scenario in a four-year adjustment period 2024–2028 and thereafter in a ten-year review period 2029–2038, where the structural primary balance weakens (right) at the rate required by the minimum adjustment ($a=-0.04$). Source: calculations by the fiscal policy monitoring function, the European Commission (2023a), and Darvas et al. (2023).

The minimum annual adjustment required from Finland in the case of the baseline scenario is $a^*=-0{,}04$ percentage point relative to GDP. This fulfils the requirement for a downward path of the debt ratio set by the debt sustainability criterion[36] (Figure 27, left). During the four-year adjustment period, the structural primary balance (taking into account ageing) may thus decrease by a total of approximately 0.2 percentage point relative to GDP. In the baseline scenario, the debt ratio is on a downward path after the adjustment period, as required by the debt sustainability criterion. The structural primary balance weakens to a deficit of approximately 0.8% relative to GDP (Figure 27, right). The deterioration of structural primary balance means expansionary fiscal policy, which has a positive impact on the output gap in line with the assumed fiscal policy coefficient. From 2027 onwards, the primary balance exceeds the structural primary balance, which signifies an economic upturn. According to the assumptions, the output gap will close in 2031, when the dynamic multiplier effect of fiscal policy will die down[37] completely (Figure 27, right).

In the analysis framework, a contractionary fiscal policy ($a>0$) weakens economic growth during the adjustment period, but at the beginning of the ten-year review period, the growth accelerates, as the output gap is expected to close. Correspondingly, an expansion-

36 For the 2024 debt ratio, we use the Commission's forecast of 76.2% relative to GDP. The corresponding forecast of the Ministry of Finance is 76.8% relative to GDP.

37 Fiscal adjustment or tightening in year *t* will no longer have an impact in year *t+3*. The last year of adjustment in the four-year adjustment period will be 2028, which means that the impact will come to an end in 2031.

ary fiscal policy ($a<0$) weakens economic growth during the adjustment period, but at the beginning of the ten-year review period, the growth accelerates, as the output gap is expected to close. Correspondingly, an expansionary fiscal policy a).

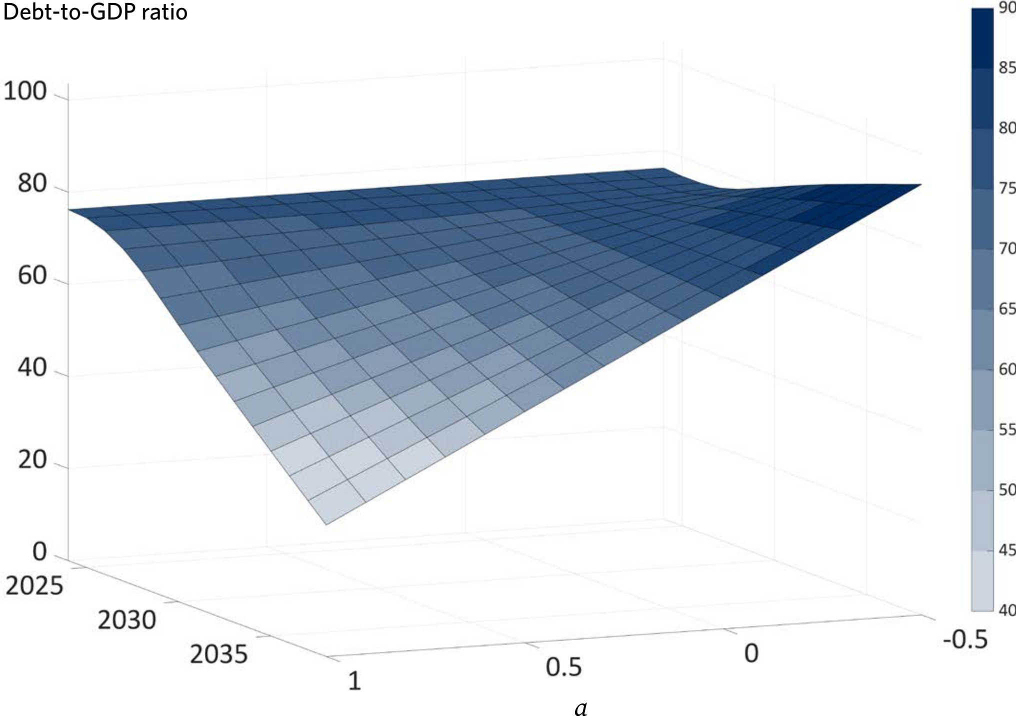


Figure 28: The impact of annual adjustment a on the debt-to-GDP ratio during the adjustment and review period 2024–2038 in the baseline scenario. Darker colour illustrates a higher and lighter colour a lower debt ratio. Adjustment a is expressed in percentage points relative to GDP. Source: calculations by the fiscal policy monitoring function, the European Commission (2023a), and Darvas et al. (2023).

In the analysis framework, the annual adjustment can have an impact on the debt ratio trajectory. With a major annual adjustment (e.g. $a>0,5$) , the debt ratio decreases significantly by the end of the review period (Figure 28). A rapid fall in the debt ratio is possible because even a major fiscal adjustment has no impact on potential GDP (see information box 2). This assumption is natural with a moderate adjustment (e.g. $0<a<0,5$). A major annual adjustment may have negative impacts[38] on potential GDP, in which case the decrease in the debt ratio remains smaller than expected due to lower GDP growth. With expansionary fiscal polic ($a<0$) , in turn, the debt ratio will start to grow in the baseline scenario from its assumed baseline level of 76.2% relative to GDP in 2024 (Figure 28).

38 Economists call these negative effects on long-term economic growth hysteresis. Cerra et al. (2023) have written a good overview of the subject.

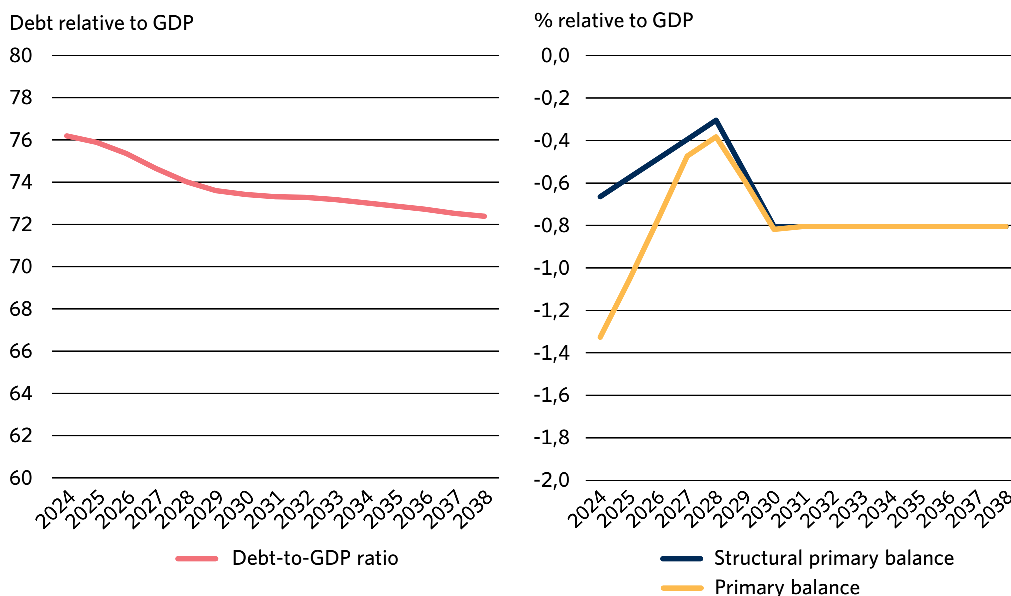


Figure 29: Development of the debt ratio (left, broken y-axis) according to the unfavourable structural primary balance scenario in a four-year adjustment period 2024–2028, where the structural primary balance is strengthened (right) at the rate required by the minimum adjustment (*a*=0,09*). During the review period, the structural primary balance decreases gradually in the first two years by 0.25 percentage point relative to GDP. Source: calculations by the fiscal policy monitoring function, the European Commission (2023a), and Darvas et al. (2023).

The minimum annual adjustment required in the unfavourable primary structural balance scenario to put the debt ratio on a downward path is *a*=0,09* percentage point relative to GDP (Figure 29, left). In this scenario, the level of structural primary balance at the end of the adjustment period is −0.3% in relation to GDP, with which Finland complies with the criterion concerning putting the debt ratio on a downward path over a review period of ten years (Figure 29, right). In this scenario, the structural primary balance will gradually deteriorate after the adjustment period, during the first two years of the review period, by 0,25 percentage point in relation to GDP. The minimum adjustment *a** is now higher than in the baseline scenario due to the negative development of the structural primary balance in this scenario.

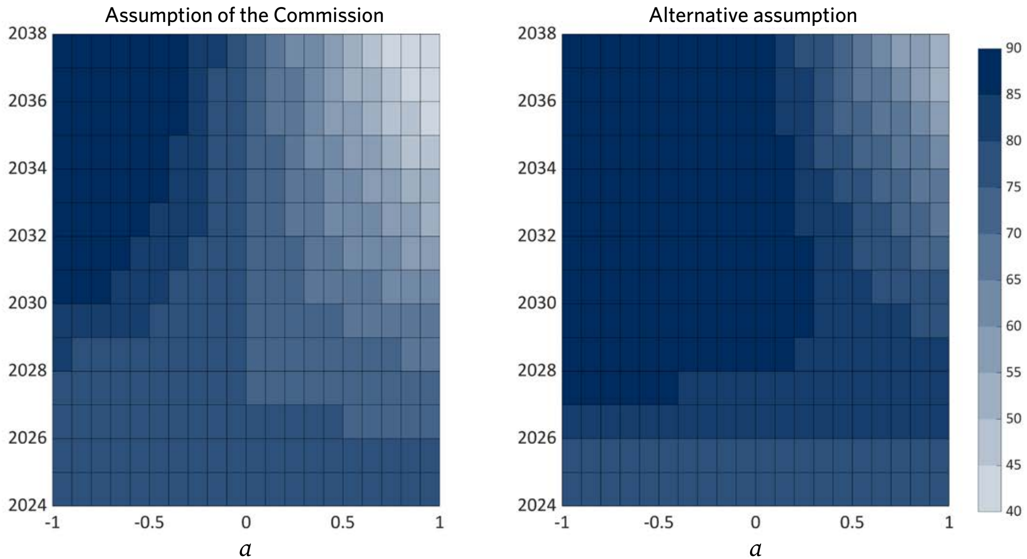


Figure 30: The effect of the assumption related to the stock-flow adjustment on debt ratio projections. According to the Commission's assumption, the SFA will be zero from 2025 onwards (left). In the case of the alternative assumption, it is assumed that the SFA will fall steadily towards zero from its projected level in 2024 (right). Adjustment *a* is expressed in percentage points relative to GDP. Source: calculations by the fiscal policy monitoring function, the European Commission (2023a), and Darvas et al. (2023).

One important assumption in the Commission's debt sustainability analysis is related to the stock-flow adjustment sfa_t, which is assumed to remain zero throughout the adjustment and review period. In the case of Finland, the assumption is not realistic, as explained in section 1.2. In its Fiscal Sustainability Report, the Commission has also drawn attention to the atypical size of the SFA in Finland (European Commission, 2021b).

The assumptions related to the Commission's debt sustainability analysis have a significant impact on the debt ratio projections. For example, the impact of the stock-flow adjustment on the debt ratio projections is clear (Figure 30). With the assumption used by the Commission and a moderate fiscal adjustment (e.g. $0<a<0,5$) , the debt ratio decreases by the end of the review period (Figure 30, left). Instead of the Commission's assumption, it is possible to use an alternative assumption where the SFA decreases gradually over a period of ten years from the value projected by the Commission, 2.5% of GDP in 2024. In this case, the SFA will thus remain positive throughout the adjustment and review period.

With the alternative assumption and equally contractionary fiscal policy (e.g. $0<a<0,5$) , the debt ratio will no longer decrease significantly or will even increase by the end of the review period (Figure 30, right). The debt-to-GDP ratio will thus develop more favourably when the Commission's assumption is used. With the alternative assumption, the debt ratio will not decrease as rapidly due to the positive flow-stock adjustment during the adjustment and review period. In the light of these results, it would be important for the new framework to be able to take into account the different assumptions applied to the Member States, for example in relation to the SFA (for Finland, see e.g. section 1.2). These assumptions may have a significant impact on the debt ratio projections and thereby on the required annual adjustment rate.

Information box 2: Key assumptions in the European Commission's debt sustainability analysis

The debt sustainability analysis is based on debt ratio projections, which in turn are based on a large number of modelled assumptions. The main assumptions concern the trajectories of the debt ratio components or their background variables. The potential GDP estimate is based on the production function method jointly approved by the EU Member States. Real GDP is obtained on the basis of the Commission's forecast until the last forecast year t+2. From year t+3 onwards, the real GDP trajectory is in line with the assumptions related to potential GDP and the output gap.

The Commission's growth projections assume that the output gap will gradually close between the last forecast year t+2 and t+5, which means that from t+5 onwards, the business cycle is neutral, and the economy is neither in an upturn nor in a downturn. This means that potential and real GDP grow at the same rate.

The trajectories of inflation and interest rates are obtained from the Commission's forecast until year t+2. From then on, inflation is expected to converge, i.e. to approach linearly the level of year t+10 according to market expectations. After this, the inflation trajectory is considered to reach the 2% inflation target of the European Central Bank by year t+30. As regards interest rates, after year t+2, the interest rates on new long-term loans are approaching market expectations by year t+10 and 4% nominal interest rates by year t+30. The interest rates on new short-term loans differ from the above only in that it is assumed that they approach 2% nominal interest rates by year t+30. The average interest rate of the entire loan portfolio is called the implicit interest rate, the calculation and background assumptions of which are described in more detail in Box 1 of Debt Sustainability Monitor 2022 (European Commission, 2022a).

The costs of ageing are based on the Commission's Ageing Report 2021 (European Commission, 2021a). As regards the stock-flow adjustment, the Commission assumes that it will be zero after the last forecast year t+2. In the case of Finland, in particular, this assumption is unrealistic, which the Commission has also pointed out in Box I.2.3 of its Fiscal Sustainability Report 2021 (European Commission, 2021b). Non-recurring items and other measures are also set at zero after the last forecast year t+2.

In the Commission's debt sustainability analysis, one important assumption relates to the multiplier effect of fiscal policy, which describes how fast real GDP grows when public expenditure (measured as structural primary balance) increases by one percentage point. The Commission assumes that a one percentage point fiscal impulse (increase in public expenditure) in year t relative to GDP increases the real GDP growth rate by 0.75 percentage point in the same year t. This assessment is based on the Commission's analysis (Carnot and de Castro, 2015).

In addition, the adjustment in year t has a dynamic impact on real GDP growth rate in years t+1 and t+2. The dynamic impact is expected to weaken over time, so that the impulse in year t will strengthen the real GDP growth by only 0.5 (0.25) percentage point in year t+1 (t+2). A fiscal impulse of one percentage point in year t will thus strengthen real GDP by a total of 1.5 percentage points over a period of three years. The Commission assumes a symmetrical multiplier effect, i.e. that contractionary and expansionary fiscal policy have an equal impact on real GDP.

The multiplier effect of fiscal policy depends on a large number of factors, and therefore it is difficult to give a simple answer on the exact size of the multiplier effect. The latest research suggests that a negative fiscal impulse (adjustment) in a downturn gives a higher multiplier effect than one (Barnichon et al., 2022). The Commission's debt sustainability analysis is applied in a situation where the focus is on fiscal tightening, in which case the Commission's assumption of a multiplier effect of 1.5 can be considered natural. On the other hand, recent research has also shown that in highly indebted countries, fiscal policy is optimal when public debt is reduced even when large multiplier effects are assumed (Bianchi et al., 2023).

The Commission's assumption of the size of the multiplier effect of fiscal policy can be considered a good compromise. Taking the different factors affecting the size of the multiplier effect into account would make the analysis framework even more complex, which would not necessarily be desirable, as the debt sustainability analysis is already technical in nature.

The impact that fiscal policy has on real GDP is due to the negative impact of adjustment on the output gap. The output gap describes the business cycle and is obtained as the difference between potential and real GDP. The growth of the output gap in years t+1 and t+2 means that real GDP growth must slow down, as fiscal policy has no impact on potential GDP. As a result, fiscal adjustment increases the output gap, as only real GDP can be affected by fiscal policy.

The lack of a link between fiscal policy and potential GDP and the closing of the output gap together lead to an (unrealistic) situation where, after the adjustment period, real GDP growth rate must accelerate in order for the output gap to be closed as assumed. The larger the size of adjustment, the faster the resulting growth of the output gap. This means that real GDP must also grow faster in order for the output gap to be closed.

The significance of all assumptions for the results should be assessed on the basis of different sensitivity analyses where some of the selected assumptions are changed to find out what impact the change has on debt ratio projections. If the changes are significant, the assumptions should be reviewed. It is unclear to what extent the Commission's debt sustainability analysis includes such sensitivity analyses. In the case of Finland, for example, the Commission's assumption of the stock-flow adjustment is not realistic.

Information box 3: The impact of adjustment on the debt accumulation equation

In the analysis framework, structural primary balance sp_t is a policy variable that can be changed to influence the debt ratio trajectory. The adjustment period lasts four years, and during this time the baseline level of the structural primary balance sp_{2024} is strengthened linearly. At the end of the adjustment period, the structural primary balance will then be at the target level (which puts the debt ratio on a downward path) $SP^*=sp_{2024}+4a^*$, where sp_{2024} is the Commission's forecast for the structural primary balance in 2024 and a^* is the annual minimum adjustment required to put the debt ratio on a downward path.

Changes in age-related expenditure after the adjustment period have been taken into account in the calculation of the target level for the structural primary balance. In practice, this means that the target level SP^* should be set higher if the costs resulting from ageing increase significantly over the ten-year review period. This is the case, for example, in Italy, Germany, and Slovenia. In Finland, the costs of ageing remain approximately at the same level over the ten-year review period.

The primary balance p_t can be expressed as the sum of the structural primary balance sp_t and the business cycle component $cc_t=\varepsilon^*OG_t$, where ε is the semi-elasticity of the budget and OG_t the output gap in year t. The semi-elasticity of the budget is based on the Commission's estimate (Mourre and Poissonnier, 2019). The semi-elasticity of the budget measures how sensitive the general government budgetary balance (the difference between general government revenue and expenditure) is to changes in cyclical fluctuations. The Commission's estimate for the semi-elasticity of Finland's budget is 0.6. The output gap refers to the difference between potential and real GDP. The cyclical component, in turn, indicates the extent to which the output gap (the business cycle) affects the primary balance. The following applies to the connection between the primary and structural primary balance:

$$p_t=sp_t+\varepsilon^*OG_t \qquad (4)$$

The structural primary balance and the primary balance correspond to each other when the output gap has closed ($OG_t=0$). The structural primary balance and fiscal adjustment in year t a_t are governed by equation

$$sp_t=sp_{t-1}+a_t \qquad (5)$$

By combining equations (4) and (5), we can write

$$p_t=sp_{t-1}+a_t+\varepsilon^*OG_t \qquad (6)$$

The Commission's debt sustainability analysis assumes that fiscal adjustment a_t in year t affects real GDP (negatively) with the multiplier effect $m_t^t = 0{,}75$ during the same year t. In addition, the Commission assumes a dynamic impact, where the adjustment in year t continues to have an impact on real GDP for the next two years t+1 and t+2 with a downward profile. The impact of adjustment in year t on real GDP in years t+1 and t+2 with the multiplier effect

$$m_t^{t+1}= \frac{2}{3}\, m_t^t=0{,}5$$

$$m_t^{t+2}= \frac{1}{3}\, m_t^t=0{,}25$$

The impact of fiscal adjustment a_t on the output gap OG_t (through real GDP) can be taken into account by modifying equation (6) to the form

$$p_t=sp_{t-1}+a_t+\varepsilon*(OG_t-m_t^t*a_t-m_{t-1}^t*a_{t-1}-m_{t-2}^t*a_{t-2})$$

By placing the multiplier effects of different times in this equation, we can write as follows for the primary balance in year t (the multiplier effects are moved backwards by one and two years)

$$m_t^{t-1}=m_{t-1}^t=0,5 \text{ and } m_t^{t+2}=m_{t-2}^t=0,25).$$

$$p_t=sp_{t-1}+a_t+\varepsilon*(OG_t-0,75a_t-0,5a_{t-1}-0,25a_{t-2}) \qquad (7)$$

Equation (7) shows how fiscal adjustment in years t, t–1 and t–2 affects the primary balance of year t. By placing equation (7) in debt accumulation equation (3), we can rewrite it in the form

$$d_t=\frac{1+i_t}{1+g_t^{nim}}\ d_{t-1}-sp_{t-1}-a_t-\varepsilon*(OG_t-0,75a_t-0,5a_{t-1}-0,25a_{t-2})+\Delta coa_t+sfa_t$$

The updated debt accumulation equation enables us to estimate the required annual minimum adjustment when criteria (a) to (f) according to the rules proposed by Commission are applied to the debt ratio trajectory.

The annual minimum adjustment a^* is the same during the four-year adjustment period, as we expect it to remain unchanged throughout the four-year adjustment period. The following equations are obtained for the debt ratio trajectory in the adjustment period t = 2025–2028 when we use the Commission's assumptions $\Delta coa_t=0$ and $sfa_t=0$, and the updated debt accumulation equation and equation (3)

$$d_{2025}=\frac{1+i_{2025}}{1+g_{2025}^{nim}}\ d_{2024}-sp_{2024}-a^*-\varepsilon*(OG_{2025}-0,75a^*)$$

$$d_{2026}=\frac{1+i_{2026}}{1+g_{2026}^{nim}}\ d_{2025}-sp_{2024}-2a^*-\varepsilon*(OG_{2026}-1,25a^*)$$

$$d_{2027}=\frac{1+i_{2027}}{1+g_{2027}^{nim}}\ d_{2026}-sp_{2024}-3a^*-\varepsilon*(OG_{2027}-1,5a^*)$$

$$d_{2028}=\frac{1+i_{2028}}{1+g_{2028}^{nim}}\ d_{2027}-sp_{2024}-4a^*-\varepsilon*(OG_{2028}-1,5a^*)$$

In these four equations, the only variable is a^*. In the debt sustainability analysis, the task is to select the lowest value with which the minimum adjustment a^* will put the debt ratio d_t on a downward path during the ten-year review period t = 2028–2038, as required by the debt sustainability criterion. In addition, criterion (b) and the safeguards also set limits for acceptable minimum adaptation. For example, criterion (e) sets the limit $d_{2025}>d_{2028}$, according to which the debt level must be lower at the end of the adjustment period than at the beginning of it.

3.4 Differing forecasts and views of the business cycle have a significant impact on the conclusions about compliance with the current EU criteria

The situation with the EU fiscal rules is unclear in autumn 2023. Since the outbreak of the Covid-19 pandemic, the current legislation has been subject to an escape clause that has enabled Member States to deviate from the requirements of the framework. The validity of the escape clause was extended due to the Russian invasion and the energy crisis, and it will be deactivated at the end of 2023. The EU Commission has announced that the plan is to return to more conventional application of the framework in spring 2024 in such a manner that excessive deficit procedures (EDP) could be initiated under the deficit criterion on the basis of the outturn data for 2023 (European Commission, 2023e).

Otherwise the prospects for applying the framework are uncertain, especially because of the ongoing reform of the rules. The reform concerns directly both the preventive arm and the corrective arm of the Stability and Growth Pact. If the reform is implemented as proposed by the Commission, it would fundamentally change the assessment of the debt criterion in the corrective arm of the Stability and Growth Pact and the assessment of the preventive arm as a whole. The implementation and timetable of the reform are still uncertain. However, when presenting and issuing country-specific fiscal recommendations to the Member States in spring 2023, the Commission and the Council already took a step towards the proposed revamped framework (Council of the European Union, 2023a).

In the following, we will assess particularly how the key figures under the current legislation develop in Finland. The assessments have been made using both the Ministry of Finance's forecasts and consensus forecasts formed by means of the forecasts of a wider range of forecasters (see section 1.3). In addition, cyclical adjustment based on the composite indicator of the heatmap of the fiscal policy monitoring function (see section 1.1) has been used in the consensus forecast for the estimate of the structural balance (instead of the Ministry of Finance's output gap estimate, which corresponds methodologically to the estimate of the EU Commission). The analyses are conducted in two different ways, as this makes it possible to illustrate the uncertainty that the forecasts involve. With regard to the business cycle, uncertainty also applies to the past. The cyclical adjustment method used may influence the conclusions drawn of compliance with the criteria set out in the fiscal rules. It is therefore important to also try to assess the uncertainty arising from the selection of a method.

In the next few years, there is a risk of breach of the deficit criterion

The corrective arm of the Stability and Growth Pact deals with the deficit and debt criteria. In the next few years, Finland's compliance with the deficit criterion is uncertain. There is a risk that the deficit will exceed the 3% reference value. Based on the forecast of the Ministry of Finance, the deficit will slightly exceed the reference value in 2024 and 2025 (Figure 31). It should be observed that according to the target path that the Finnish Government has reported to the EU as part of the Stability Programme, the deficit would fall below 3% relative to GDP in 2025, which would mean that the reference value would be exceeded in one year only. According to the consensus forecast as well (see section 1.3), the general government deficit is increasing but would remain below the reference value until 2025.

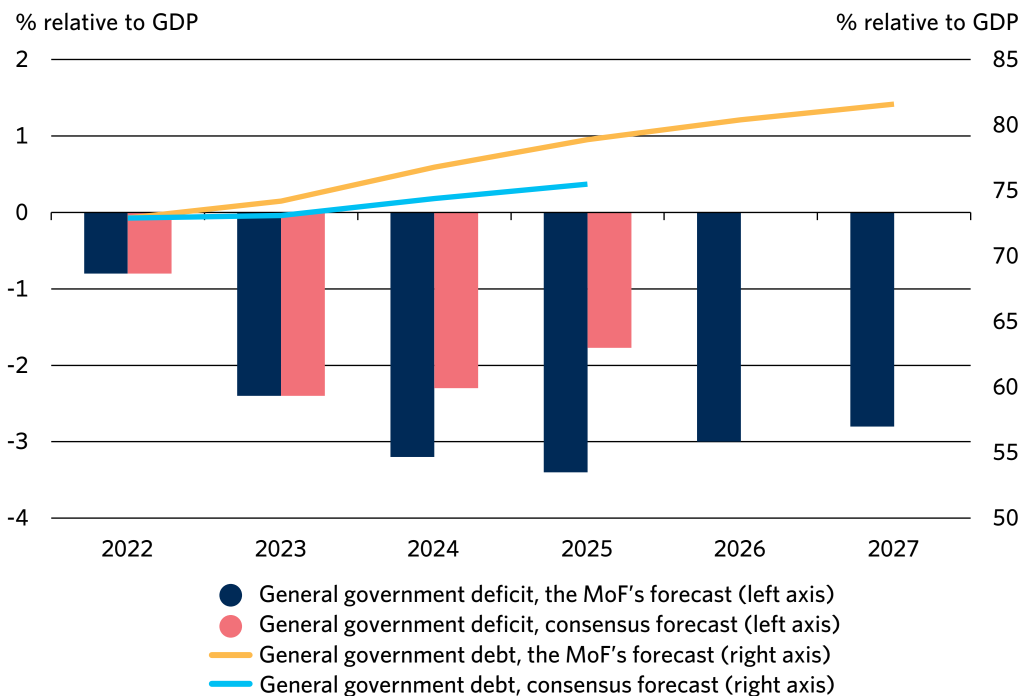


Figure 31: Development of the general government deficit based on the Ministry of Finance's forecast and the consensus forecast. Source: General Government Fiscal Plan 2024–2027 and the fiscal policy monitoring function.

Exceeding the reference values may lead to an EDP procedure, which means that the Member State must adjust its public finances, and the EU Commission and the Council will monitor the progress of the adjustment. When assessing whether an EDP procedure is to be initiated on the basis of the debt and deficit criterion, the Commission takes into account relevant factors that have contributed to the exceeding of the reference value. However, under the legislation, when the debt ratio exceeds the 60% reference value, these factors are taken into account with the deficit criterion only when the excess over the deficit criterion is considered minor and temporary. The relevant factors may be based, on the one hand, on matters listed directly in EU legislation and, on the other hand, on such other factors presented by the Member State that the Member State considers to have contributed to exceeding the reference value. The Government mentions in its Stability Programme that the exceeding of the reference value set for the deficit in 2024 is explained by, for example, the increased expenditure related to supporting Ukraine and to security.

In the case of the debt criterion, analyses based on the Ministry of Finance's forecast and the consensus forecast produce the same conclusions. The debt-to-GDP-ratio is substantially more than 60%, thus exceeding the reference value, even when cyclically adjusted (not shown in Figure 31). The debt criterion is considered to be complied with if the debt-to-GDP ratio decreases sufficiently, i.e. by an average of 1/20 a year for the part exceeding the 60% reference value. The analysis is carried out separately on the basis of backward-looking criteria (the previous three years) and forward-looking criteria (the previous year, the current year, and the following year). Neither of the criteria concerning the reduction of the

debt ratio is met during the assessment period on the basis of the forecast of the Ministry of Finance or the consensus forecast: in both cases, the debt ratio will continue to grow. The assessment of the debt criteria has been presented in more detail in the fiscal policy monitoring report of 2018 (NAOF, fiscal policy monitoring function, 2018).

The objective that the preventive arm of the Stability and Growth Pact sets for the structural balance is −0.5% of GDP. Based on the information provided by the Ministry of Finance, the objective was achieved in 2022, for the first time since the financial crisis of 2008–2009 (Figure 32). After this, the structural balance weakens in the Ministry's forecast. However, when calculated according to the cyclical adjustment method used by the fiscal policy monitoring function, the structural balance of 2022 did not reach the target of −0.5% of GDP. The picture that the two analyses provide of the development of general government finances differs for 2023 and 2024 as well: based on the consensus forecast and the business cycle indicator of the fiscal policy monitoring function, the development of the structural balance is more favourable than in the Ministry of Finance's forecast.

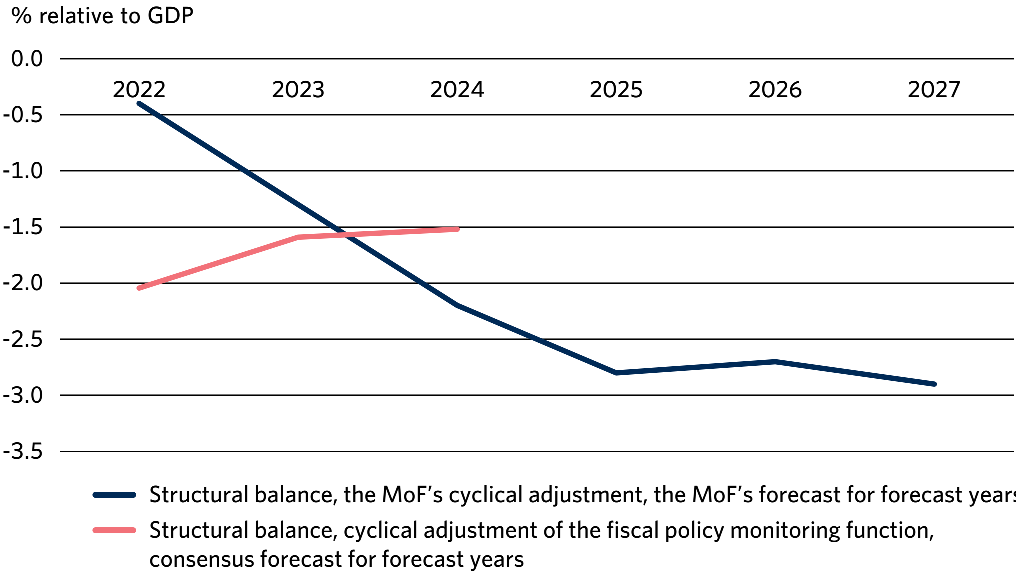


Figure 32: Development of the general government structural balance, including forecasts, between 2022 and 2027. Source: General Government Fiscal Plan 2024–2027 (Ministry of Finance, 2023b) and the fiscal policy monitoring function.

The EU Commission and the Council already partly applied the terminology of the proposed new framework in its fiscal policy recommendations to Member States in 2023. The Council recommended that Finland should "ensure prudent fiscal policy, in particular by limiting the nominal increase in nationally financed net primary expenditure in 2024 to not more than 2.2 %" (Council of the European Union, 2023a). According to the Council's recommendation, this corresponds to an improvement of 0.3 percentage point in the

structural budget balance. Based on current information, the recommendation will not be realised, but the increase in net expenditure will be about 4% in 2024, calculated on the basis of the information in the General Government Fiscal Plan of autumn 2023. In addition to increasing expenditure, the excess is caused by the fact that the reductions in social security contributions decided in autumn 2023 increase the growth of net expenditure: discretionary changes in taxation and other public revenue are taken into account in the calculation. In November 2023, the European Commission assessed that Finland is one of the four Member States (Belgium, Croatia, France, Finland) with which there is the risk that their draft budgetary plans for 2024 do not comply with the Council's recommendations (European Commission, 2023f).

The Fiscal Policy Act (869/2012) links the EU fiscal policy rules with the national legislation. The Act contains provisions on a correction mechanism that is activated if the EU has detected a significant deviation in the development of Finland's general government structural balance in relation to its medium-term objective. The size of a significant deviation is defined separately in EU legislation. If the EU Council detects a deviation, the Government shall provide the Parliament with a report referred to in section 44 of the Constitution and an estimate of the amount of the deviation in the structural balance in relation to the medium-term objective (MTO), as well as a report of the measures to be taken to rectify the deviation by the end of the following calendar year. The obligation is not valid if the EU Council has stated that exceptional circumstances are prevailing.

Since spring 2020, the general escape clause has been active in the EU regulation due to exceptional circumstances, and the EU Council has not detected any significant deviation. Under the Fiscal Policy Act, if the Council expressly states that exceptional circumstances no longer prevail in Finland, the Government shall decide on measures to be taken in the same or at the latest the following calendar year to improve the general government structural balance by at least 0.5 percentage point. Under the Act, the National Audit Office of Finland shall issue an opinion on the adequacy of the measures.

As the general escape clause is deactivated at the end of 2023, there are uncertainties related to the interpretation of the Fiscal Policy Act. The fiscal policy monitoring function of the National Audit Office has pointed out that, in the present situation, there is room for interpretation in the application of the Act, as the exceptional circumstances will cease, but the correction mechanism defined in the Act was never activated. (NAOF, fiscal policy monitoring function, 2021b, and NAOF, fiscal policy monitoring function, 2022). In addition, the EU is in the process of reforming its fiscal rules, and structural balance is likely to play a less important role in the new framework. The EU Council has also stated that consistency of the Fiscal Compact with the reformed EU fiscal framework should be ensured if the EU legislation is amended (Council of the European Union, 2023b).

In their present form, the requirements set for the Government after the general escape clause has been deactivated are therefore somewhat uncertain. Therefore, national legislation should be updated as quickly as possible, especially if the reform of the EU rules gives rise to amendment needs. However, it can be stated that, based on the forecasts, the development of the structural balance in 2024–2025 does not comply with the criteria that the current EU regulation and the national Fiscal Policy Act set for its improvement. Nor do the estimated overall impacts of the Government's fiscal policy on public revenue

and expenditure in 2024–2025 comply with the criterion set by the Fiscal Policy Act (0.5 percentage point improvement in the structural balance) based on the information in the General Government Fiscal Plan (Table 25 in the Plan).

The future deficit and debt trajectories involve a great deal of uncertainty, which is directly reflected in ex-ante conclusions about whether the criteria contained in the rules are complied with. In any case, the outlook is worrying. This means that, when planning its fiscal policy, the Government should also carefully consider the limits set by the EU fiscal framework. Even though the content of the framework may change, the Government should ensure that Finland remains within the limits set by the rules valid at any given time.

Appendix 1: Observations on compliance of the General Government Fiscal Plan 2024–2027 with the requirements set by Decree 13 February 2014/120

Section	Requirement set by the Decree	Assessment of compliance
Section 3	The General Government Fiscal Plan shall cover all parts of general government finances. The plan contains sections on central government finances, finances of the wellbeing services counties, municipal finances, and statutory earnings-related pension funds and other social security funds.	The coverage and structure of the plan comply with the requirements. The plan also describes the establishment of wellbeing services counties and presents information on them.
Section 3	The General Government Fiscal Plan sets multi-annual objectives for the fiscal position in relation to GDP at market prices for the entire general government and, in addition, a separate objective for each sub-sector of general government listed in paragraph 1. The fiscal position objectives shall be set in such a manner that, based on the forecast of the Ministry of Finance, they lead at least to the achievement of the objective set for the general government structural balance. Temporary deviation from this is permitted if exceptional circumstances as referred to in Article 3(3)(b) of the Treaty referred to in section 1 of the Act referred to in section 1 are prevailing in Finland.	The Government has set objectives for the fiscal position in relation to GDP until the end of the government term, i.e. until 2027, (sub-sectors of the general government) and a multi-annual target path until 2027 (general government as a whole). The objectives set for the general government sub-sectors for 2027 have been expressed at a different level of precision than the objectives set for the general government as a whole. Given the differences in the level of precision, the objectives set for the sub-sectors correspond to the objective set for the general government as a whole. Taking into account the cyclical conditions, the objective set for the nominal balance in 2027 (−1% of GDP) would not quite lead to the achievement of the objective set for the structural balance (−0.5 percentage point of GDP). However, because exceptional circumstances as referred to in legislation are in force until the end of 2023, the target-setting complies with the requirements of the Decree.
Section 3	The General Government Fiscal Plan sets multi-annual targets for general government debt and expenditure relative to GDP at market prices. These targets are in line with the targets set for the fiscal position of the general government as a whole.	The multi-annual targets set for general government debt and expenditure relative to GDP have been expressed in accordance with the decree.

Section	Requirement set by the Decree	Assessment of compliance
Section 3	The General Government Fiscal Plan presents estimates of the key revenue and expenditure items of the general government and its sub-sectors referred to in paragraph 1. The estimates are drawn up on the assumption that the legislation affecting revenue and expenditure is not amended and on the assumption that the legislation affecting revenue and expenditure is amended as specified by the Government. The Plan describes the impact of both options on the medium-term structural balance and long-term sustainability of the general government.	The estimates of the key revenue and expenditure items are presented for the general government as a whole and separately for the central government, local government, wellbeing services counties, earnings-related pension funds, and other social security funds (p. 135–139). The Government's target path differs from the forecast from 2025 onwards. The target path has been used in the stability programme. The information the Plan provides on revenue and expenditure if the policy remains unchanged (Table 31) includes information according to the independent forecast. The relationship between the different paths (independent forecast, target path, unchanged policy path) has not been analysed in the Plan. The Plan does not disclose information according to the two alternatives as laid down in the decree.
Section 3	The General Government Fiscal Plan also specifies the measures required for achieving the fiscal position targets set pursuant to paragraph 2 and their estimated financial impact.	As the fiscal position targets presented in the Plan do not correspond to the trajectory according to the independent forecast of the Ministry of Finance, further measures are therefore needed to achieve the targets. The Plan describes, for example, the positive impacts of employment measures on public finances, which are not included in the forecast.
Section 3	The General Government Fiscal Plan presents a comparison between the most recent macroeconomic forecasts and fiscal forecasts of the Ministry of Finance and the European Commission, and if necessary, the Ministry of Finance and other independent actors, and explains any significant differences between the assumptions on which the forecasts are based.	Appendix 5 presents a comparison between the latest forecasts, published in spring 2023, of the Ministry of Finance and the EU Commission for six variables.
Section 3	The General Government Fiscal Plan presents the impact of various growth and interest rate assumptions on the macroeconomic forecast and the fiscal forecast, as well as on the key figures related to general government finances.	Appendix 4 presents sensitivity analyses on the effect of different growth and interest rate assumptions.
Section 3	A list of the general government units that are not part of the regular budgets at the sub-sector level shall be published in connection with the General Government Fiscal Plan. The Plan describes the combined impact of these units on general government fiscal position and debt.	In accordance with the Decree, the Plan contains a reference to the list maintained by Statistics Finland (p. 29). The combined impact of these units on the fiscal position and debt has been presented. Thus, the requirement of the Decree is met although the presentation of information at this highly aggregated level does not significantly increase transparency.
Section 5	The first General Government Fiscal Plan of the parliamentary term shall include a comparison with the last General Government Fiscal Plan of the previous parliamentary term, including the information referred to in section 3(2) and (4) .	Annex 3 compares the changes in fiscal forecasts with the previous General Government Fiscal Plan. Government decisions are partly included in the forecast. No comparison of the targets has been presented.

Section	Requirement set by the Decree	Assessment of compliance
Section 5 a	When preparing its economic forecasts, the Ministry of Finance should take into consideration the National Audit Office's conclusions on the macroeconomic forecast and the fiscal forecast. If, according to the conclusions, the macroeconomic forecasts have included a bias that has had a major impact on at least four consecutive years, the Ministry of Finance shall publish the actions it has taken to correct the bias.	The fiscal policy monitoring function of the National Audit Office has not detected a bias as referred to in the Decree in the Ministry of Finance's macroeconomic forecasts.

Appendix 2: Forecasts of the change in GDP volume for 2024

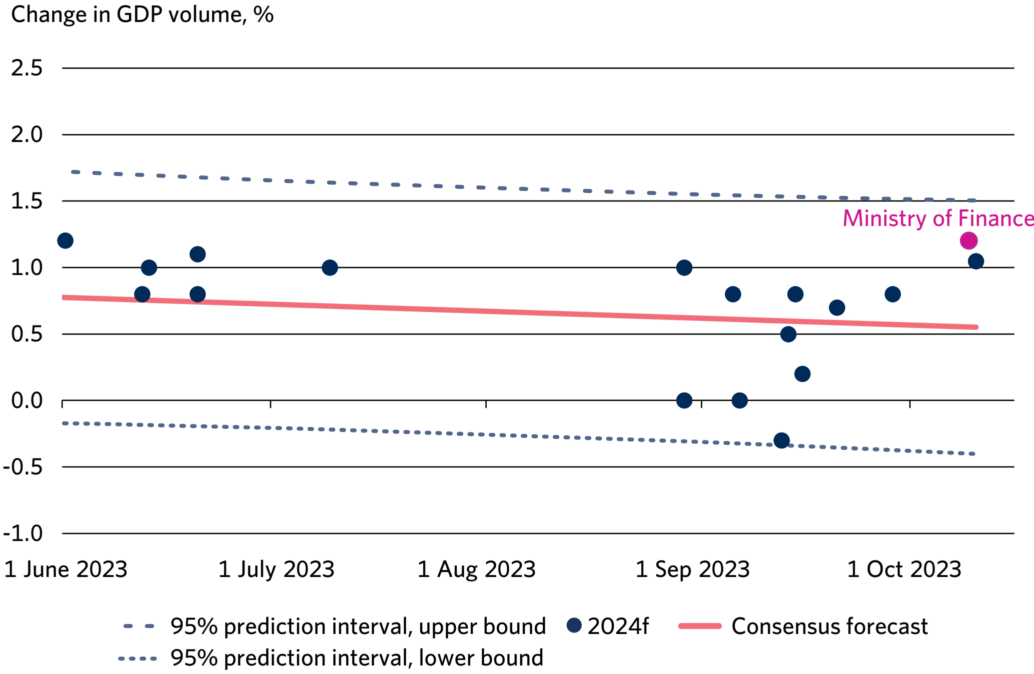


Figure 33: Forecasts of the change in GDP volume for 2024, consensus forecast, and upper and lower bounds of the 95% prediction interval. Sources: forecasters and the fiscal policy monitoring function.

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