



Fiscal policy monitoring report spring 2017



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The National Audit Office monitors and evaluates fiscal policy in its role as an independent national fiscal policy evaluation body under the Stability Pact (Fiscal Compact) and within the meaning of European Union law. Provisions on the evaluation task are laid down in the Act on the National Audit Office of Finland (676/2000) and the Act on the implementation and application of the provisions governed by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on requirements concerning multiannual budgetary frameworks (869/2012, 'Fiscal Policy Act'). Evaluation comprises the assessment of the setting and implementation of the fiscal policy rules steering the fiscal policy. It also covers monitoring the preparation and implementation of the General Government Fiscal Plan, assessing the reliability of the macroeconomic forecasts and budgetary projections used as a basis for the fiscal policy and evaluating compliance with the Stability and Growth Pact. The National Audit Office also monitors compliance with the Medium-Term Objective (MTO) and its correction mechanism. By evaluating fiscal policy, the National Audit Office promotes transparent and easy-to-understand regulations and stable and sustainable general government finances.

This report presents the findings made by the National Audit Office as part of fiscal policy evaluation in spring 2017.

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As part of its statutory fiscal policy evaluation task, the National Audit Office has assessed the overall steering of general government finances, compliance with central government spending limits and the Stability and Growth Pact in 2016 and whether the Ministry of Finance forecasts used as a basis for the General Government Fiscal Plan published in spring 2017 are realistic. The conclusions and observations made by the National Audit Office on the basis of its evaluation are as follows:

1. The measures presented in the General Government Fiscal Plan for 2018–2021 are not sufficient for achieving the Medium-Term Objective (MTO) set for the structural balance of general government finances.
2. The multiannual target path presented by the Government towards achieving the MTO set for the structural balance of general government finances support the implementation of results-oriented fiscal policy.
3. The Government target path does not aim towards achieving the binding financial position targets set for the central government and social security funds in the first General Government Fiscal Plan for the parliamentary term.
4. The central government spending limits were complied with in 2016.
5. Finland complied with the preventive arm and the corrective arm of the Stability and Growth Pact in 2016.
6. The Ministry of Finance forecast used as a basis for the General Government Fiscal Plan is cautious, yet realistic.

The National Audit Office has assessed the overall steering of general government finances and compliance with the fiscal policy rules. The measures concerning the balancing of general government finances decided by the Government in its mid-term review in spring 2017 focus more strongly on the improvement of the employment situation. Achieving the medium-term objective (MTO) by the year 2019 is based on reaching the Government's 72% employment rate target and on the resulting economic growth. The National Audit Office considers the employment target to be important and the already decided and partly implemented Government measures aiming at increasing the employment rate as positive developments in terms of stabilisation of public finances.

However, on the basis of the measures decided in the mid-term policy review in spring 2017, the objectives set by the Government cannot be achieved by the year 2019. According to the forecasts prepared in spring 2017, the Government is falling behind schedule to achieve its general government structural balance target. Of the subsectors of general government, in particular, the central government is falling below its financial position target without initiating additional measures, because not even reaching the 72 per cent employment target would be enough to achieve the central government target level during the parliamentary term. Even if the employment rate exceeded the forecasts, the Government must still commit to implementing additional measures to ensure that the structural balance target can be achieved.

The forecasts of the Ministry of Finance concerning the GDP growth and development of the general government budgetary position in 2017–2019 are cautious, but have been revised towards a more positive trend since last autumn for legitimate reasons. The forecasts may need to be further revised upwards, particularly for the year 2017.

According to the findings of the National Audit Office, the central government spending limits have been complied with in 2016 and expenditure outside the spending limits has remained stable. The latitude within the spending limits was used almost in full in the drafting of the budget, which indicates that there were significant expenditure pressures in 2016.

Finland complied with the preventive arm of the Stability and Growth Pact in 2016. On the basis of the forecasts prepared in spring 2017, Finland will also meet the criteria of the preventive arm in 2017, even though the structural balance will significantly deteriorate, according to the forecasts. Compliance with the criteria is possible due to the flexibility granted by the European Commission. According to the Commission's assessment, Finland has also complied with the criteria of the corrective arm in 2016, even though the general government debt-to-GDP ratio has exceeded the 60% reference value.

The introduction of flexibility within the rules of the Stability and Growth Pact has increased the need for interpretation and, thus, decreased the transparency of the rules. Although the flexibility created within the rules can be considered generally justified, it may also weaken the predictability and consistency of fiscal policy. In the case of Finland, adding flexibility within the criteria of the preventive arm impedes the levelling off of the debt ratio.

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1 The General Government Fiscal Plan and the Government's fiscal policy targets

The National Audit Office has assessed the achievement of the Government's fiscal policy targets on the basis of the General Government Fiscal Plan for 2018–2021 and the independent forecast of the Ministry of Finance included in the plan. The General Government Fiscal Plan serves as Finland's stability programme and as Finland's medium-term budgetary plan required by the European Union (Regulation (EU) No 473/2013, Council Directive 2011/85/EU). The Government Decree on the General Government Fiscal Plan (120/2014) has been issued under the Fiscal Policy Act (869/2012). Monitoring compliance with the Fiscal Policy Act and the statutes issued under it is the statutory task of the National Audit Office.

Achieving the medium-term objective set by the Government in this parliamentary term is largely based on a stronger economic and employment development than projected in the forecast of the Ministry of Finance. In the long term, there are significant uncertainties involved in the balancing of general government finances, and the risk is that public indebtedness continues to grow, despite economic growth. In its mid-term review, the Government did not decide on any new measures aimed at balancing public finances, even though, in particular, the central government is falling far below its financial position target. Furthermore, the multiannual target path presented by the Government in the General Government Fiscal Plan for 2018–2021 is not sufficient for achieving the target that the central government should achieve by 2019.

The general government financial position target is based on increasing economic growth.

The main fiscal policy objective of the Finnish Government is to level off public indebtedness and to bridge the sustainability gap through savings, by cutting duties and by implementing measures supporting employment and growth, as well as through structural reforms. In addition to the Government Programme, general government finances are also steered by binding statutory and contractual objectives. The most significant of these is the Medium-Term Objective (MTO) set for the structural balance of the general government finances pursuant to the Fiscal Policy Act. Finland's MTO is to achieve a structural balance of -0.5% in ratio to GDP at a minimum. Structural balance is defined as general government net lending i.e. the difference between revenue and expenditure, with the impact of cyclical factors and one off measures removed.

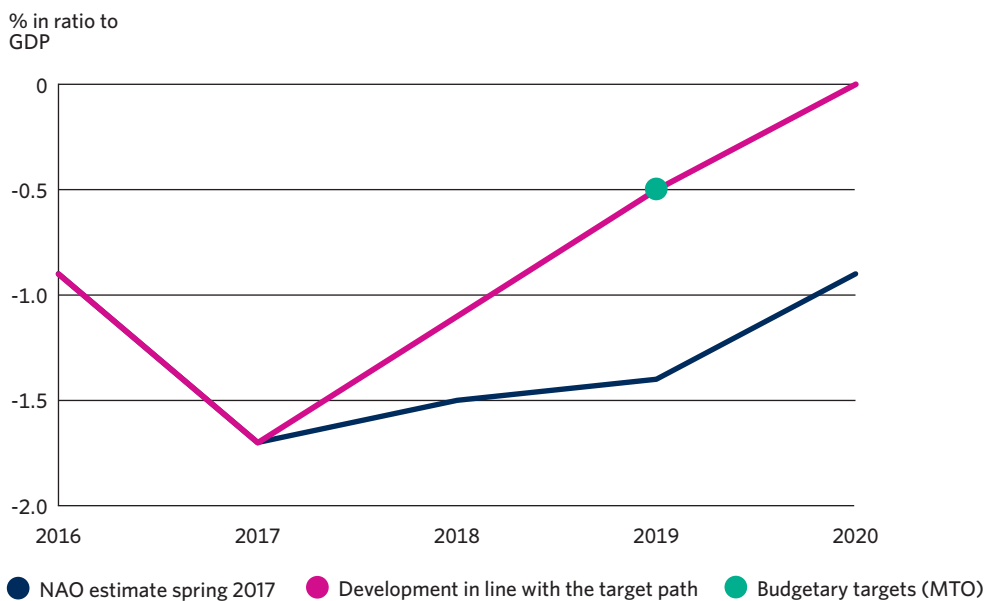
In the General Government Fiscal Plan for 2018–2021, the Government presents for the first time a multiannual target path built upon the established fiscal policy targets. According to the target path, the aim is to ensure that Finland will achieve its MTO, i.e. a structural balance of at least -0.5% in ratio to GDP, by the year 2019. The Government has also set sub-sector-specific financial position targets in line with the target path. The Stability Programme appended to the General Government Fiscal Plan also includes forecasts on the general government revenue, expenditure and debt ratio in line with the target path.

The Government has presented a multiannual target path towards achieving the general government financial position target

Achieving the figures in accordance with the target path is based on the assumption that the 72% employment rate target set by the Government will be achieved in 2019. The increase in the employment rate is based on the already decided upon Government measures boosting employment. The target path calculations presented by the Ministry of Finance are based on the increase in the employment rate achieved through increasing labour supply. The assumption is that the Government measures boosting employment will primarily be focused on structural unemployment. This will increase the labour supply, but productivity would remain largely at the current level. The Ministry of Finance expects that the increase in the general government financial position following the increase in employment will mainly occur due to a decrease in expenditure and, to a lesser degree, an increase in revenues.

However, according to the independent forecast of the Ministry of Finance used as a basis of the fiscal policy, the 72% employment rate target will not be achieved, but the employment rate will remain at 70% in 2019. This means that the forecast economic growth would also clearly fall short of the growth required by the target path in 2018–2019. And, thus, the objectives set by the Government would not be met either. According to calculations by the National Audit Office, the general government structural balance would clearly fall below its target level to around -1.4% in ratio to GDP in 2019, if no additional measures are initiated. Figure 1 presents the estimate of the development of the structural balance in accordance with the Government’s target scenario and the estimate of the National Audit Office made on the basis of the Ministry of Finance forecast.

The target path is based on a stronger employment development than forecasted



Source: Ministry of Finance, General Government Fiscal Plan for 2018–2021; calculations of the National Audit Office

Figure 1: Development of the structural balance of general government finances according to the Government target path and forecasts

The multiannual target path promotes results-oriented and transparent fiscal policy. According to the fiscal policy assessment estimate, the calculations and assumptions used as a basis for the target path regarding the balancing of public finances can be considered realistic.

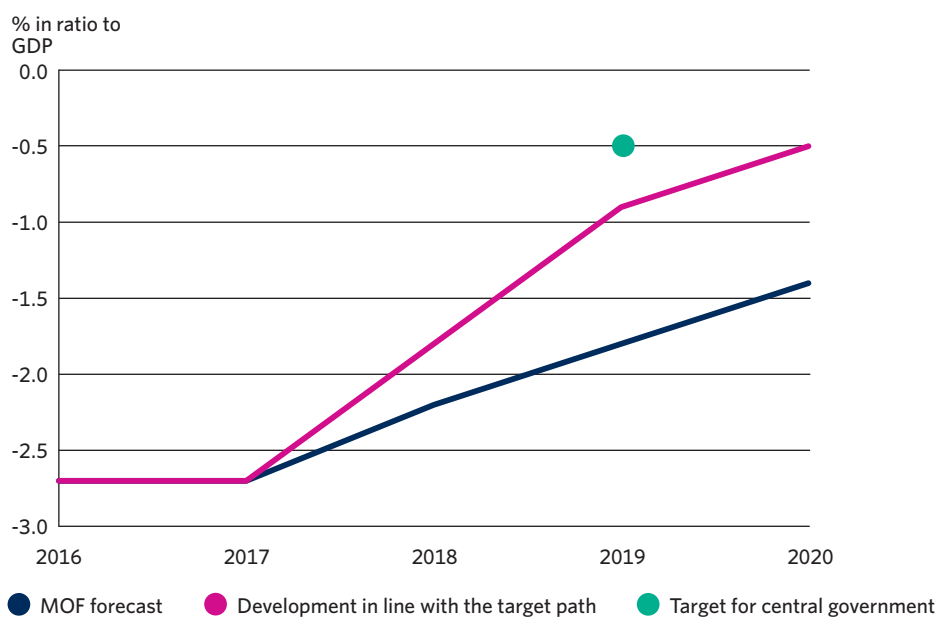
Central government and social security funds are falling below their financial position targets

The Government maintains the binding nominal financial position targets it has set for the general government subsectors in the first General Government Fiscal Plan for the parliamentary term. Pursuant to the targets, the general government should achieve an overall balance in 2019. According to the targets, the central government and local government deficit should be, at most, 0.5% in ratio to GDP and the surplus of social security funds, at least, 1% in ratio to GDP.

According to a forecast taking account of the already decided upon measures, the central government financial position will improve significantly slower, compared to the target. The central government deficit is projected to be EUR 4.1 billion in 2019, which is 1.8% in relation to GDP. Social security funds are also falling below the target, because pension expenditure will grow faster than fee income. Local government has already achieved its target, and, according to forecasts, its financial position will remain stable. The general government deficit in ratio to GDP is projected to be 1.7% in 2019, which means that achieving balance would require a significant improvement in the financial position.

The National Audit Office would like to draw attention to the fact that the target path presented by the Government is not sufficient for achieving a balanced budget target for general government; instead, the general government will remain 0.8% in deficit in 2019, due to the weaker than targeted development of the central government finances and social security funds. According to the subsector-specific target path presented in the Stability Programme, central government will not achieve the target balance of -0.5% until the year 2020 (Figure 2). Thus, central government will fall below the target set by the Government for the year 2019, even if employment would improve as envisaged. Therefore, the setting of targets for the central government finances remains unclear. Furthermore, the target path set for social security funds will not be sufficient for achieving the target set for the sector for 2019.

The Government target path does not lead to a general government balance in this parliamentary term



Source: Statistics Finland, Ministry of Finance, General Government Fiscal Plan for 2018-2021

Figure 2: Central government net lending, according to forecasts and according to the Government target path

Development of the general government financial position is partly dependent on the future economic development. Achieving a general government budgetary balance in 2019 would require significantly faster (over 2%) annual growth in GDP over the coming years than forecasted. This can be seen from the fast growth scenario presented in the Ministry of Finance forecast. Chapter 4 examines in more detail how realistic the Ministry of Finance forecasts are.

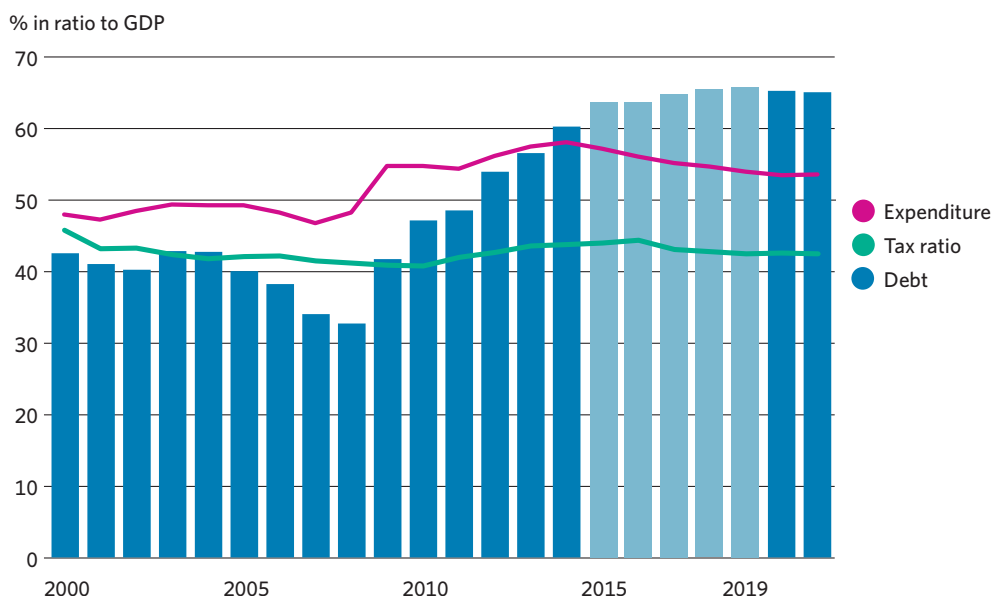
Tax ratio will decline in the parliamentary term

Improving the general government financial position through supporting opportunities to boost employment and economic growth is largely based on the measures agreed upon in the Competitiveness Pact signed in 2016 and on the individual measures aimed at increasing labour supply decided on by the Government in its mid-term review. It is difficult to accurately assess the impact of these measures on the general government financial position, and achieving the MTO also depends on the general developments in the export market. In terms of on-budget economy, the Ministry of Finance has assessed that the Competitiveness Pact will adjust the 2017 expenditure ceiling upwards by EUR 229 million. In the mid-term review, the Government also decided on the re-budgeting of certain expenditure items, but, overall, no additional consolidation measures were initiated.

The Government left possible additional measures concerning taxation and the tax system open for assessment at a later stage. The National Audit Office has previously highlighted, for example, the need to reduce the increased number of tax subsidies and to simplify the tax system. In the current parliamentary term, the Government is exceeding its tax rate stabilisation target: the tax rate is expected to end up 1.5 percentage points lower in 2019, compared with the 2014 level. This would enable the utilisation of taxation-related measures as part of the required consolidation measures without jeopardising the objectives of the Government Programme. Thus far, consolidation of public finances has mainly been implemented by reducing expenditure (Figure 3).

The Government did not decide on any additional consolidation measures in the mid-term review

Consolidation of public finances has mainly been implemented by reducing expenditure



Source: Statistics Finland and the Ministry of Finance

Figure 3: Actual (2000–2016) and forecasted (2017–2021) development of the public debt, public expenditure and tax ratio

The general government deficit outturn for 2016 (1.9% in ratio to GDP) published by Statistics Finland was significantly better than expected, and was among other things due to the higher than anticipated tax revenue. In 2017, the deficit is envisaged to temporarily grow, mainly due to the tax and employers' contribution concessions agreed upon in the Competitiveness Pact. The general government debt-to-GDP ratio remained almost stable last year at 63.6%, but it is estimated to grow in 2017 by around one percentage point.

There are risks associated with bridging the sustainability gap

According to an assessment made on the basis of the already decided measures, the general government debt-to-GDP ratio will start to decline in 2020. However, the structural imbalance between revenue and expenditure threatens to lead to an increase in the long-term debt-to-GDP ratio. This would also mean that not even an economic upturn could guarantee sustainability of the public finances.

The Ministry of Finance estimates the sustainability gap to be nearly 3% in ratio to GDP at the 2021 level. Successful implementation of the health, social services and regional government reform plays a key role in the bridging of the gap. The reform aims at achieving savings of EUR 3 billion in the long term, but its impact mechanisms involve great risks, which is partly due to the fact that the preparation of the reform was also steered by other objectives than only those aiming at securing the sustainability of the public finances. The central government-centred county financing model and the economic governance model presented in the reform proposal help to create the required conditions for cost control, but at the same time they will also eliminate incentives to search for cost-efficient and innovative solutions. The reform's transition costs are significant, which poses a risk to the long-term development of the public finances. Cost control requires systematic monitoring of the effectiveness of the solutions and readiness to implement corrective measures, as required.

The impact of the sizeable fighter aircraft purchases has not been taken into account in the sustainability gap calculations. Due to being one-off replacement purchases in nature, they are not expected to have a significant impact on the sustainability gap. However, it should be noted that the operating and other life-cycle expenses related to the fighter aircraft purchases form a permanent increase in expenditure, which could exceed the current level, due to increased requirements in the security environment. This, in turn, could increase the pressure of making additional consolidation measures elsewhere in the state budget.

In the General Government Fiscal Plan, county finances are handled as part of the central government finances starting from 2019. The impacts of the regional government reform have been taken into account in the General Government Fiscal Plan, as far as possible. However, no separate budgetary target has yet been specified for county finances; according to the proposal for the Counties Act, the target must be specified in the first General Government Fiscal Plan for the next parliamentary term. Handling county finances as a separate entity in the General Government Fiscal Plan is justified, considering counties' important duty to arrange public services.

Transition costs of the health, social services and regional government reform are significant

County finances are part of the central government finances in the General Government Fiscal Plan

2 Compliance with central government spending limits

According to the findings made by the National Audit Office as part of the fiscal policy evaluation, the Government has complied with the central government spending limits in the drafting of the 2016 spending limits. The final 2016 state budget totalled around one million euros below the 2016 spending limits. The adjustments made to the spending limits are in accordance with the principles governing the spending limits procedure. Transfer of the appropriations made to the Finnish Broadcasting Company YLE back outside the spending limits in the 2018 spending limits poses a risk to the compliance with the spending limits for the parliamentary term.

The expenditure rule laid out in the Government Programme and the central government spending limits are an important part of Finland's national fiscal policy framework. The central government spending limits decision is included in the General Government Fiscal Plan.

In Finland, central government spending limits are in real terms, and for this reason, price adjustments and structural changes are made to them during the parliamentary term. This makes the spending limits scheme opaque, and it is difficult for outsiders to monitor compliance with the spending limits rule.

The National Audit Office audits compliance with the spending limits each year. In this connection, the National Audit Office also monitors trends in budget expenditure outside the spending limits and tax subsidies. This helps to ensure that there is no inappropriate growth in expenditure outside the spending limits or tax subsidies, as a result of the spending limits.

2.1 Findings concerning the 2016 spending limits calculation

The purpose of the fiscal policy evaluation is to assess the correctness and transparency of the information provided in the Government's annual report for 2016 regarding compliance with the spending limits. Since spending limits are always drafted for the following four-year term, the findings made by the National Audit Office may also concern other years of the parliamentary term. The adjustments made to the 2016 spending limits are reviewed from the first spending limits decision of the 2016–2019 parliamentary term to the final accounts of the 2016 budget year.

The expenditure within central government spending limits in the final 2016 state budget remained about one million euros below the 2016 spending limits. Thus, the estimate presented in the Government's annual report for 2016 that the actual spending was about one million euros below the spending limits can be considered to be correct. According to the Government Programme, a total of one million euros can be carried over to 2017, notwithstanding the spending limits rule. As in previous years, the Government's annual report contained a table form presentation of the expenditure included in the 2016 state budget and all supplementary budgets and

The central government spending limits were complied with in the drafting of the 2016 spending limits

The estimate in the Government's annual report for 2016 that the actual spending was about one million euros below the spending limits can be considered to be correct

the price-adjusted and structurally adjusted spending limits and the unallocated reserve, which is a transparent method of presentation.

The National Audit Office has also compared the 2016 spending limits with the outturn detailed in the 2016 final accounts. The spending limits rule does not restrict expenditure under the final accounts. By making the comparison with the final accounts, the National Audit Office has endeavoured to verify the fundamental purpose of the expenditure rule contained in the spending limits, i.e. the successful curbing of central government expenditure financed through tax revenue. According to the budgetary outturn statement for 2016, the appropriations were EUR 622.3 million under the budget. According to the calculations of the National Audit Office, spending limits expenditure accounted for EUR 387.9 million and the expenditure outside the spending limits for EUR 234.4 million of this total, indicating that the spending limits had also been complied with in terms of budgetary outturn.

Although, according to the spending limits manual, the spending limits scheme does not take account of the outturn data concerning central government expenditure, the findings of the spending limits calculation performed by the National Audit Office indicates a link between the budgetary outturn and the final state budget in 2016. The appropriations allocated in or by the second supplementary budget of 2016 that were exceeding or remaining below the outturn data, were largely corrected in the third supplementary budget to match the outturn data.

Unforeseen expenditure pressures posed a challenge for complying with the 2016 spending limits

The 2016 spending limits included a supplementary budget reserve of EUR 300 million, an unallocated reserve of EUR 206 million and the unallocated reserve of EUR 200 million carried over from 2015 to be used for new spending limits expenditure budgeted during the drafting of the budget and the supplementary budgets. After the third and final supplementary budget for 2016, one million euros remained of the reserves, which indicates that the 2016 spending limits involved significant expenditure pressures.

The largest additional appropriations during the drafting of the 2016 budget were allocated to the Ministry of the Interior spending limits to be used for immigration expenditure, which grew from the estimate provided in the General Government Fiscal Plan for 2016–2019 to the final state budget for 2016 (incl. the supplementary budgets) by a total of EUR 547 million. The budgeting for the additional spending limit expenditure was implemented as part of the central government spending limits procedure, as well as through structural changes increasing the spending limits (utilising the provisions carried over from 2015), by utilising the reserve for 2016 and by re-budgeting spending limits expenditure.

The next highest increase in the 2016 spending limits expenditure resulted from the cancellation of the Government project aiming at combining the housing allowance for pensioners and the general housing allowance, which is why the Government made a structural change of EUR 206 million to increase the 2016 spending limits and budgeted additional EUR 224 million to spending limits expenditure. The structural changes and corresponding increases made to the 2017–2019 spending limits amount-

The budgetary outturn of the 2016 final accounts remained within the spending limits

Using the latitude within the spending limits almost in full in the drafting of the budget indicates that there were significant expenditure pressures in 2016

The 2016 spending limits expenditure was increased by the increase in the immigration expenditure, cancellation of the pensioners' housing allowance reform and aid-type investment expenditure

The expenditure savings decided upon by the Government at the beginning of the parliamentary term only reduced the overall expenditure to some extent

ed to more than EUR 0.5 billion per year. The structural change increasing the spending limits was justified by stating that Prime Minister Juha Sipilä's Government had made corresponding permanent savings during the drafting of the spending limits for the parliamentary term. However, these savings cannot be considered to be actual savings, since the corresponding amount of euros was budgeted to increase appropriations allocated to expenditure outside the spending limits, specifically to the general housing allowance. The permanent savings decided on by the Government also covered a reduction of EUR 317 million in the development aid expenditure included in the spending limits. However, part of this reduction (EUR 140 million) was later budgeted to financial investment expenditure, which fall outside the spending limits.

The increase in the spending limits for 2017–2019 concerning the housing allowance for pensioners was partly compensated for by a structural change concerning the combination of the student housing supplement scheme and the general housing allowance scheme. This enabled reducing the spending limit level and the spending limits expenditure by EUR 122 million for the year 2017 and by EUR 250 million for the years 2018 and 2019 but, on the other hand, the housing allowance expenditure outside the spending limits grew by corresponding amounts.

The third significant element that increased spending limits expenditure was the transfer of the additional appropriation of EUR 182.5 million intended for purchasing shares of Terrafame Oy within the spending limits expenditure in accordance with the recommendation by the National Audit Office. In accordance with the principles governing the spending limits procedure, financial investment expenditure is typically budgeted outside the spending limits, but aid-type investment expenditure should be budgeted within the spending limits.

The main decreases in the 2016 spending limits covered a reduction of EUR 180 million in the payments made to the European Union, carrying over part of the financing for the Government's key projects to later years of the parliamentary term, and freezing statutory index increases or adjusting indexes, according to the latest index forecasts, which altogether decreased the 2016 spending limits by EUR 167.5 million, compared to the Government's first spending limits decision. It is rare for the price adjustments to lower the expenditure ceiling and reduce spending limits expenditure. Furthermore, the price adjustments made to the 2016 spending limits were limited to statutory index adjustments, meaning that no discretionary or contractual price adjustments were made.

The nominal spending limits for 2016 were increased by structural changes totalling EUR 437 million, which mainly resulted from the carrying over of the 2015 unallocated reserve of EUR 200 million to the year 2016 and from the structural change of EUR 206 million caused by the cancellation of the reform of the pensioners' housing allowance scheme.

As a whole, the adjustments made to the 2016 spending limits can be considered to comply with the principles of the spending limits procedure.

Including the aid-type investment expenditure in the spending limits, expenditure was in accordance with the recommendation of the National Audit Office

The adjustments to the 2016 spending limits were implemented in compliance with the principles of the spending limits procedure

EUR -85 million
Changes in the timing of
expenditure categories
EUR -32 million
Adjustment of tax compensations

EUR 213 million
Transfer of
appropriations outside
the spending limits
within the limits
EUR 200 million
Use of provisions carried
over from the previous
year for additional
expenditure
EUR 88 million
Expenditure
re-budgeting
EUR 43 million
Changes in expenditure timing
EUR 7 million Pass-through funding
EUR 3 million Gross/net changes in budgeting

Impact of structural changes on spending limits: EUR 437 million

Source: Spending limits decision for 2016–2019, General Government Fiscal Plan for 2016–2019 and 2016 budget proposals and supplementary budget proposals

Figure 4: Structural changes to the 2016 spending limits, breakdown in euros

New flexibility within the 2017 and 2018 spending limits

The small amount of appropriations carried over from 2016 to the next year is compensated for by the reserve of EUR 150 million included in the first spending limit decision of Prime Minister Juha Sipilä's Government and intended for unforeseen expenditure pressures emerging in 2017 and 2018. The reserve is included in the spending limits, in addition to the supplementary budget reserve of EUR 300 million for both years and the unallocated reserve of EUR 47 million and EUR 106 million included in the 2017 and 2018 spending limits, respectively. The spending limits rule does not limit the decisions made by the Government in its first spending limits decision, since the spending limits for the parliamentary term are set after the Government has made its policy decisions. Since supplementary budget reserves and unallocated reserves can also be used in the budgeting of unforeseen spending limits expenditure, the adoption of a third general reserve, i.e. a reserve not allocated to specific appropriations, can be considered to be an exceptional measure, compared to the established practices of the spending limits procedure.

The spending limits calculation revealed that in the General Government Fiscal Plan for 2017–2020, the 2017 and 2018 spending limits were reduced by EUR 151.1 million and 143 million, respectively, through structural changes. According to the reasons provided for the structural changes, the appropriations were only temporarily transferred under unemployment security items outside the spending limits. According to the principles of the spending limits procedure, the purpose of the expenditure rule is to curb central government expenditure financed through tax revenue. Con-

In its policy decisions made at the start of the parliamentary term, the Government anticipated the future expenditure pressures by adopting an additional reserve

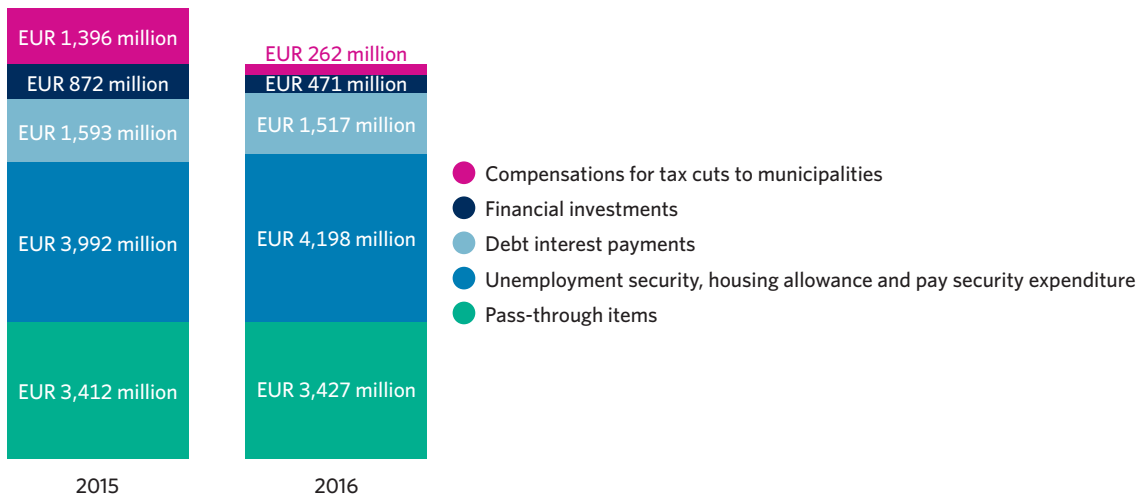
sequently, if neutral changes are made to the budget, similar changes can be made to the parliamentary term spending limits. On the basis of the findings made in the spending limits calculation, since 2015, structural changes have been increasingly used in the spending limits procedure, meaning that savings made in appropriations outside the spending limits have been transferred as additional appropriations to items within the spending limits. Provided that the changes concern operational reorganisation and the costs to taxpayers remain unchanged, such changes can be considered to be acceptable in terms of compliance with the principles of the spending limits procedure.

According to the findings of the spending limits calculation, the General Government Fiscal Plan for 2017–2020 states that a structural change has been made to the 2018 spending limits. According to the change, the appropriations made to the Finnish Broadcast Company YLE will be transferred back outside the spending limits starting 2018. Since the principles agreed upon in the Government Programme restrict the budgeting of appropriations, budgeting the same appropriation within the spending limits and later outside the spending limits should not be possible, according to the principles of the spending limits procedure. According to the principles, if there are no fiscal policy reasons based on the spending limits rule to budget the appropriation outside the spending limits, the appropriation in question must be financed as expenditure within the overall spending limits. Transfer of the appropriations made to the Finnish Broadcasting Company YLE back outside the spending limits in the 2018 spending limits may pose a risk to the compliance with the parliamentary term spending limits.

There should be no room for interpretation whether appropriations should be within or outside the spending limits

2.2 Expenditure outside spending limits

Since 2004, the budget expenditure has been divided into spending limits expenditure and expenditure outside the spending limits. Cyclical expenditure, such as allowances arising from the unemployment situation and income security, are included in the expenditure outside the spending limits. Debt interest payments, compensations to municipalities arising from tax cuts and expenditure generated by financial investments are also outside the spending limits. Some of the expenditure items outside the spending limits are different types of pass-through items, which means that the revenue offsetting the expenditure in question is also allocated in the budget. Expenditure corresponding to the revenue from the EU and the revenue generated by the national lottery are examples of such expenditure. A total of about EUR 3.3 billion of pass-through items was classified as expenditure outside the spending limits in 2016.



Source: Budget proposals, amendments to the budget proposals and supplementary budget proposals 2014 and 2015

Figure 5: Expenditure outside the spending limits in 2015 and 2016

In 2016, expenditure outside spending limits was mainly reduced by the transfer of the compensations made to municipalities for tax criteria changes (compensations for tax cuts) within the spending limits. The transfer was implemented in connection with the change of the parliamentary term, as compensations implemented by the previous Government were transferred as part of the central government transfer for basic public services within the spending limits.

The interest expenditure on central government debt amounted to around EUR 1.4 billion, which means a slight decrease, compared to the interest expenditure in the previous year. The interest level has remained at an exceptionally low level, which can be seen in the continuous decrease in the interest expenditure since 2012, despite the increasing amount of central government debt.

The largest expenditure items outside the spending limits (around EUR 4.2 billion per year) include unemployment security, housing allowance and pay security. These expenditure items function as an automatic stabiliser, which means that they are expected to increase in a downturn and decrease during a period of economic growth. As a whole, there has been a slight increase in unemployment security, housing allowance and pay security expenditure since 2015, which is mainly the result of the increase in housing allowance expenditure.

Financial investments outside the spending limits have remained high since 2009. Financial investments are outside the spending limits, since they are expected to retain their value and are, thus, not considered to represent final expenditure. In addition to revenue targets, societal objectives are also often set for financial investments. The 2016 budget included a new item for development cooperation financial investments outside the spending limits. The budget proposal states that due to the cuts made to the development cooperation appropriations, part of aid-type assistance are transformed into financial investments.

Expenditure outside the spending limits has remained stable

The National Audit Office notes that development cooperation financial investments are not allocated in the same way as actual development cooperation aid. Development cooperation financial investments are not considered to be aid-type assistance, as they involve a revenue requirement. A majority of development cooperation financial investments are used to operate Finnfund and are allocated to the private sector and private companies operating particularly in poor and fragile states. Finnfund's duties concern promoting sustainable development, environmental and social responsibility, interests of Finland and financial profitability. The financing provides indirect means to achieve the objectives of the development cooperation. Due to the complicated operating environment and goal setting, it is important that the achievement of the goals set for development cooperation financial investments are reported as openly and transparently as possible.

2.3 Tax subsidies

Tax subsidies cause deviations from the normal taxation structure. The purpose of tax subsidies is to support specific activities or groups of taxpayers through deductions, tax exemptions, reduced tax rates, tax rebates or provisions postponing tax payments. According to the Government's annual report, a total of 185 different tax subsidies were identified in 2016. The total for those subsidies that could be estimated was EUR 25.1 billion, which amounts to around a billion euro increase compared to 2015. Tax subsidies have become a permanent and common type of subsidies also globally. The spending limits may lead to an impractical use of tax subsidies, if the spending limits prevent the use of direct aid. For this reason, it is important to monitor the number of different tax subsidies.

In the previous parliamentary terms, the Government has stated in its spending limits rule that it will not use tax subsidies to circumvent the spending limits. No such statement is included in the Programme of Prime Minister Juha Sipilä's Government. Instead, it is stated that all changes in taxation are treated in the same manner if they have similar impact on general government finances. The use of tax subsidies should be viewed critically and they should be avoided. The number of tax subsidies should also be reduced, so that the tax system can be simplified and thus made more efficient.

Since 2012, the Government's annual report has contained an assessment of the effectiveness of tax subsidies. The report also presents information about the impacts of individual tax subsidies. In the view of the National Audit Office, such an assessment is important so that tax subsidies found to be ineffective can be abolished. The effectiveness of tax subsidies should, however, be assessed on a more systematic basis. The current practice in which the effectiveness of tax subsidies is assessed each year to the extent that research information is available is not an adequate method for reviewing the effectiveness of the subsidies in a systematic manner. A more systematic approach for reviewing the effectiveness of the subsidies is, thus, needed.

The number of tax subsidies should be reduced

Assessment of the effectiveness of tax subsidies should be done on a more systematic basis

3 Compliance with the Stability and Growth Pact

Finland is committed to comply with the rules of the EU's Stability and Growth Pact, in accordance with the Fiscal Compact. The National Audit Office has performed an ex-post examination on the compliance with the rules of the Stability and Growth Pact in 2016. The National Audit Office also presents an in-year examination for 2017.

Compliance with the preventive arm of the Stability and Growth Pact is assessed on the basis of two pillars: structural balance and expenditure benchmark. According to the assessment of the National Audit Office, Finland has complied with both pillars in 2016. According to the in-year examination, Finland will also comply with the criteria of the preventive arm in 2017. The National Audit Office notes that without the flexibility granted by the Commission with respect to the criteria of the preventive arm, there would be a risk of a significant deviation in 2017.

The corrective arm of the Stability and Growth Pact include the 3% deficit criterion and the 60% debt criterion. Finland also complied with these criteria in 2016.

The National Audit Office assesses compliance with the Stability and Growth Pact on the basis of the General Government Fiscal Plan for 2018–2021 prepared by the Ministry of Finance and the Stability Programme appended to the plan. The National Audit Office has independently verified the calculation of the structural balance included in the preventive arm of the Stability and Growth Pact on the basis of the material supplied by the Ministry of Finance and calculated, in accordance with the expenditure benchmark, the trends in total general government spending on the basis of the Stability Programme.

The figures presented for 2017 in the Stability Programme are based on the forecast of the Ministry of Finance. The figures for 2018 and 2019 are based on development according to the Government target path and on the achievement of the 72% employment rate target set by the Government. Thus, assessment of the years 2018–2019 on the basis of the figures in the Stability Programme involves several uncertainties at this stage.

3.1 Assessing the preventive arm

In accordance with the preventive arm of the Stability and Growth Pact, the Medium-Term Objective (MTO) is set for three years in terms of structural balance. Setting the MTO is also required by national law, in the Fiscal Policy Act (869/2012). Structural balance is defined as the cyclically adjusted general government balance net off one-off and other temporary measures.

In autumn 2015, the Government confirmed that Finland's MTO is to achieve a structural balance of, at least, -0.5% in ratio to GDP. Achievement of the MTO is reviewed on the basis of two complementary pillars. First, it is examined whether the MTO or the required change in structural balance has been achieved. In the expenditure benchmark, the second pillar of the preventive arm, the growth of the general government expenditure is assessed according to the expenditure benchmark.

Finland's MTO is to achieve a structural balance of, at least, -0.5% in ratio to GDP

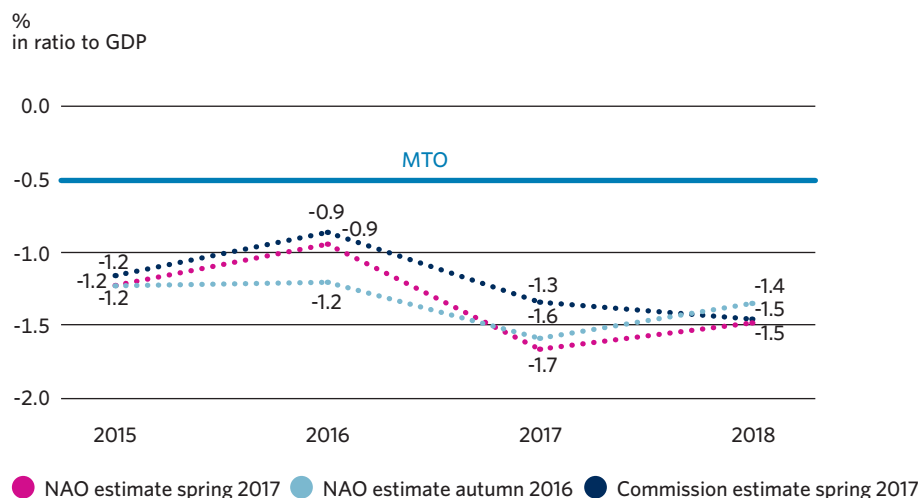
The calculations concerning the preventive arm of the Stability and Growth Pact are mainly based on the methods presented by the Commission in the report *Vade Mecum on the Stability and Growth Pact*.¹ More specific calculations are presented in the workbook published appended to this report.

Structural balance

The first pillar of the preventive arm concerns the level of structural balance that is in accordance with the MTO or the adjustment path towards it. Based on the ex-post examination carried out in spring 2017, the National Audit Office concludes that Finland achieved the required change in structural balance in 2016 and, thus, complied with the criteria of the first pillar of the preventive arm.

Finland achieved the required change in structural balance towards the MTO in 2016

According to the estimate of the National Audit Office, the structural balance of Finland was -0.9% in ratio to GDP in 2016. Figure 6 shows the National Audit Office's estimate of the level of structural balance in 2015–2018. The figure also presents a comparison with the National Audit Office's own estimate made in autumn 2016 and with the estimate presented in the Commission's forecast of spring 2017. The estimates of the Commission and the National Audit Office regarding the structural balance for 2016 are similar. The Commission's estimate on the structural balance for 2017 is slightly higher, due to the Commission's slightly more optimistic deficit forecast, compared to the forecast of the Ministry of Finance.

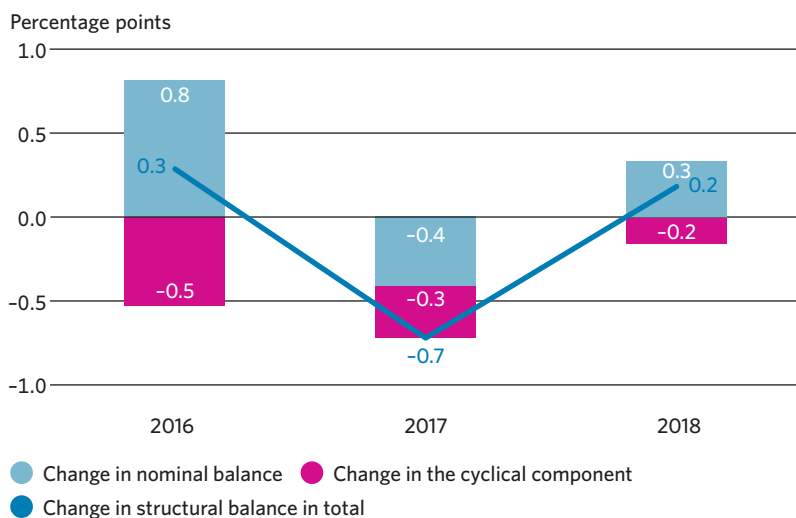


Source: Calculations made by the National Audit Office on the basis of the material obtained from the Ministry of Finance; European Commission

Figure 6: Level of structural balance between 2015 and 2018

In 2016, the structural balance improved by 0.3 percentage points, compared with the 2015 level. This was mainly due to the improvement in the nominal budgetary position. According to the data published by Statistics Finland on 31 March 2017, the general government net lending improved by around 0.8 percentage points, compared with the 2015 level. The improvement in the nominal balance did not, however, fully translate to the structur-

al balance because as the economic situation improved in Finland, the output gap contracted in 2016. The contraction in the output gap also reduced the cyclical component of the balance. Figure 7 shows the change in structural balance divided into the change in nominal balance and the change in the cyclical component of the balance.



Source: Calculations made by the National Audit Office on the basis of the material obtained from the Ministry of Finance

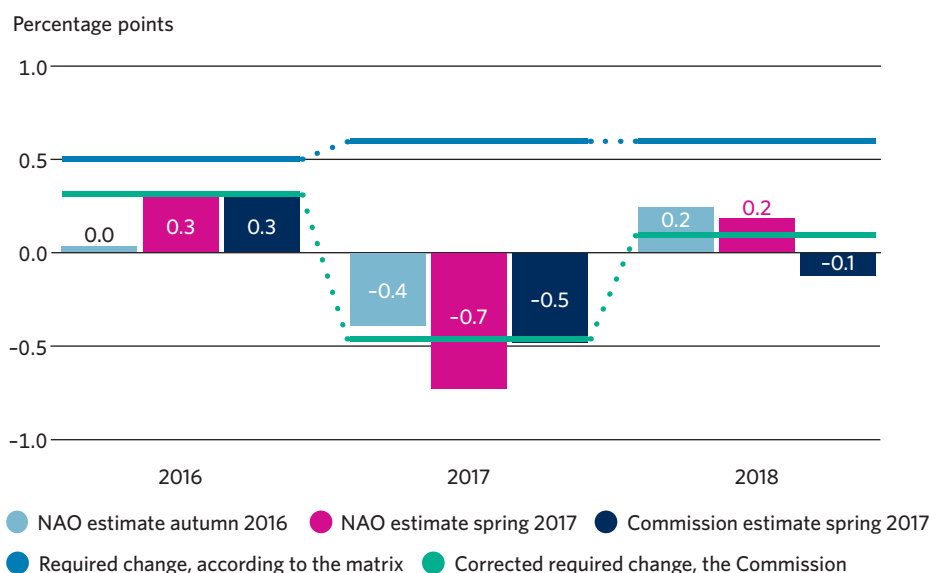
Figure 7: Change in structural balance, divided into change in nominal balance and change in the cyclical component

According to forecasts, the structural balance for 2017 will decrease by around 0.7 percentage points, compared with the 2016 level. Figure 7 shows that in 2017, the structural balance will be weakened by a decrease in the nominal balance and in the cyclical component, due to the continuing contraction in the output gap. The decrease in the nominal balance is mainly the result of the tax cuts and other revenue reductions related to the Competitiveness Pact, which will reduce the nominal balance by around 0.4 percentage points.

Since Finland did not achieve its MTO in 2015, it is assessed whether the required change for the structural balance was achieved in 2016. According to the country-specific recommendations approved by the Council of the European Union in summer 2015, Finland’s structural balance should have improved by 0.5 percentage points in 2016, compared with the 2015 level.² However, for 2016, the additional public expenditure caused by the immigration crisis that started in 2015 was taken into account and required adjustment for structural balance was adjusted to be 0.3 percentage points.³

In 2016, Finland’s structural balance improved by 0.3 percentage points, compared with the 2015 level, meaning that Finland achieved the required change in structural balance in 2016. Figure 8 shows the National Audit Office’s estimate of the change in structural balance in relation to the required change, on the basis of the calculations made in autumn 2016 and in spring 2017. For comparison purposes, the figure also shows the figures in accordance with the Commission’s forecast of spring 2017.

For the preventive arm of the Stability and Growth Pact, the actual change in structural balance is examined in relation to the required change



Source: Calculations made by the National Audit Office on the basis of the material obtained from the Ministry of Finance; European Commission

Figure 8: Required change in structural balance and actual changes in it between 2016 and 2018

According to the in-year examination performed by the National Audit Office in autumn 2016, the structural balance was at risk of deviating from the required level by around 0.3 percentage points in 2016. The estimate was revised particularly due to the general government nominal balance, which, according to the first outturn data published by Statistics Finland in spring 2017, remained at around 0.3 percentage points below the estimate forecasted by the Ministry of Finance in autumn 2016.

In autumn 2016, the National Audit Office anticipated that Finland was at risk of significantly deviating from the criteria of the structural balance pillar in 2017. A deviation is considered significant when it deviates by, at least, 0.5 percentage points, either from the MTO or the adjustment path leading to the MTO. A significant deviation may be formed either over one year or cumulatively over two consecutive years.

On the basis of the estimates made in spring 2017, there is no longer a risk of a significant deviation. The estimate was revised after the required change in structural balance was updated. According to the country-specific recommendations⁴ approved by the Council in summer 2016, Finland should adjust its structural balance by 0.6 percentage points towards the MTO in 2017.

In its Stability Programme for 2017, Finland has sought flexibility with respect to the criteria on the basis of the structural reform clause and the investment clause, so that together these clauses would reduce the change requirement by 0.6 percentage points. In its assessment of 22 May 2017, regarding the Finnish Stability Programme, the Commission proposed that Finland be granted the permission to deviate from the requirements of the structural reform clause and the investment clause. When taking into account the additional expenditure from immigration and the impact of the flexibility clause of the rules, as well as the fact that in 2016, the structural balance was only less than 0.4 percentage points below the MTO, the structural balance may decrease by nearly 0.5 percentage points in 2017.⁵

Thus, the required structural balance change has been adjusted by around 1.1 percentage points downwards from the original requirement set in summer 2016. On the basis of the in-year examination based on the figures by both the Ministry of Finance and the Commission, the structural balance will weaken in 2017. Thus, although Finland has been granted with flexibility with respect to the structural balance requirements, Finland is still at risk of deviating even from the adjusted requirements in 2017. Without the flexibility granted, there would have been a risk of a significant deviation in terms of the structural balance pillar in 2017.

Even with the flexibility granted, there is still a risk that Finland will deviate from the structural balance requirements in 2017

Measuring structural balance

Structural balance is obtained by deducting the cyclical component and one-off measures from the balance determined on the basis of the net lending according to National Accounts. The cyclical component is the product of the output gap and the semi-elasticity measuring the reaction of the budget balance to the cycle. Thus, when measuring structural balance, it is essential to assess the width of the output gap.

The Commission has developed, together with Member States, the production function method to calculate potential output. In the method, potential output is the product of three production factors: labour supply, capital stock and total factor productivity. The Finnish Ministry of Finance also uses the production function methodology to calculate output gap.

Uncertainties related to measuring structural balance

The Pellervo Economic Research (PTT) has published a study⁶ which assesses the suitability of the production function methodology in the case of Finland. According to the results of the PTT study, the method is sensitive to baseline assumptions. The method is specifically sensitive in terms of the assessment of the potential labour supply, which is particularly affected by baseline assumptions concerning the unemployment trend and participation rate.

Since the baseline assumptions used impact the determination of the output gap, the sensitivity of the method can also affect the structural balance assessment.

The Commission has also used an alternative method to determine the level of Finland's output gap

The Commission has also applied an alternative method to assess the level of Finland's output gap.⁷ Taking various business cycle indicators and the slow wage growth in the labour market into consideration, the Commission has estimated Finland's output gap to be wider than estimated by using the common production function methodology.

According to the Commission's forecast, the gap is estimated to have reached the level of around -1.8% in ratio to potential output in 2016 when using the production function methodology. On the basis of the alternative methodology, the Commission has estimated the gap to have widened to around -2.5% in ratio to potential output in 2016.

The size of the output gap has particular impact in terms of the flexibility sought by Finland: one criterion for granting flexibility is that the country must be able to secure a sufficient safety margin towards the 3% deficit margin. According to this minimum benchmark, Finland's structural balance should not fall below -1.1% in ratio to GDP.

However, according to the estimate of the National Audit Office made in spring 2017, Finland's structural balance will decrease to -1.7%, while the Commission's estimate is that the structural balance will weaken to -1.3% in ratio to GDP in 2017. By using the alternative methodology, the Commission considers that Finland's structural balance was around -0.5% in ratio to GDP in 2016 and it will reduce to around -1.0% in ratio to GDP in 2017. Thus, Finland is considered to meet the minimum benchmark required to be eligible for flexibility concerning the structural reform clause. Furthermore, on the basis of the alternative method, the Commission also considers that Finland meets the output gap condition of at least -1.5% associated with the investment clause.

Expenditure benchmark

In the expenditure benchmark, the second pillar of the preventive arm, the growth in total general government expenditure are examined in relation to the reference growth rate set for the spending. According to the calculations of the National Audit Office, Finland complied with the expenditure benchmark in 2016. On the basis of an in-year examination, there is a risk that Finland will deviate from the expenditure benchmark criteria in 2017. Without the flexibility granted by the Commission with respect to the criteria of the preventive arm, there would have been a risk of a significant deviation from the expenditure benchmark.

Under the expenditure benchmark, the cyclical component of the unemployment expenditure, debt interest payments and the spending arising from EU programmes that are funded directly from EU aid are eliminated from total general government spending. This expenditure is considered to be such that it cannot be influenced through economic policy. In investment expenditure, the four-year average is examined, which means that the rules allow an increase in investments during the year in review. The expenditure benchmark also allows an increase in spending, if the increases are funded with corresponding increases in revenue.

The change in adjusted general government expenditure in relation to the previous year is compared with the reference growth rate set for it. The reference growth rate is set on the basis of the potential medium-term growth rate, considering the size of the public sector and the required change in structural balance. In 2016, the adjusted total public expenditure should have grown by a maximum of 0.2 percentage points in real terms, compared with 2015.

On the basis of the National Audit Office's calculations, adjusted total public expenditure in accordance with the expenditure benchmark contracted by 0.8% in 2016, compared with 2015. In euro terms, real spending was 0.6% lower than the spending-to-GDP ratio set for it. This means that Finland complied with the expenditure benchmark in 2016 by a wide margin. The National Audit Office's calculations concerning the expenditure benchmark are shown in Table 1.

Finland complied with the expenditure benchmark in 2016 by a wide margin

Table 1: Finland's total general government expenditure, adjustments made to it and the applicable expenditure benchmark in 2015–2018, as calculated by the National Audit Office

Expenditure benchmark items, EUR billion	2015	2016	2017	2018*
1 Total general government expenditure	119.4	120.1	121.1	122.2
-2 Debt interest payments	2.4	2.3	2.1	2.0
-3 Expenditure arising from EU programmes, fully compensated by income from EU funds	1.1	1.2	1.1	1.2
-4 Cyclical changes in unemployment expenditure	1.0	0.8	0.7	0.5
-5a Fixed capital (gross)	8.2	8.3	8.6	9.0
+5b Average for fixed capital (over four years)	8.3	8.4	8.4	8.5
= AEA1 Adjusted expenditure aggregate (AEA1)	115.0	116.0	117.1	118.0
-6 Effect of discretionary measures on income, DRM	0.6	0.4	-1.6	-0.4
-7 Expenditure financed from earmarked revenue	0.05	0.05	0.05	0.05
= AEA2 Adjusted expenditure aggregate (AEA2)	114.3	115.5	118.7	118.4
Growth in total general government spending				
Nominal growth in total spending (calculated in accordance with the expenditure benchmark)	-0.5%	0.4%	2.3%	1.1%
GDP deflator	1.4%	1.3%	0.9%	0.9%
Real growth in total spending (calculated in accordance with the expenditure benchmark)	-1.8%	-0.8%	1.4%	0.2%
Applicable expenditure benchmark	0.7%	0.2%	1.0%	0.3%
Significant deviation				
Difference between the rate of growth under expenditure benchmark and total spending (percentage points)	2.5%	1.0%	-0.4%	0.1%
Deviation, EUR billion	2.9	1.2	-0.4	0.1
GDP, EUR billion	210	214	219	227
Deviation in relation to GDP (%)**	1.4%	0.6%	-0.2%	0.0%
Is the deviation significant (<-0.5)?***	No	No	No	No

*The figures for 2018 are in accordance with the target path presented by the Ministry of Finance.

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

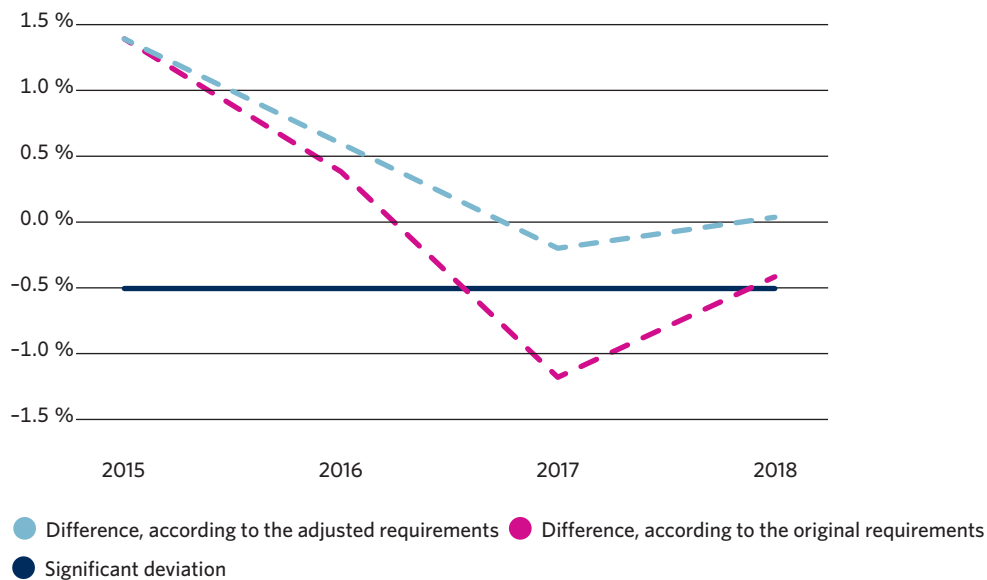
***Significant deviation means a deviation (in euro terms), which in relation to GDP is less than -0.5% for the preceding year or, in cumulative terms, for the two preceding years.

The expenditure benchmark will be relaxed in 2017. Although the potential output growth in the medium term used as a basis when determining the 2017 expenditure benchmark is significantly slower compared with the 2016 level, relaxation of the benchmark overall results from the adjusted structural balance change requirement. According to the original requirement set in summer 2016, the general government expenditure, in accordance with the expenditure benchmark, should have contracted by around 0.8% in 2017. According to the updated requirements, the general government expenditure, in accordance with the expenditure benchmark, may now increase by around one per cent in 2017.

On the basis of the in-year examination, there is still a risk that Finland will deviate from the expenditure benchmark criteria in 2017. Figure 9 shows the difference between the expenditure calculated, in accordance with the expenditure benchmark and the expenditure limit in euros, in relation to GDP, according to the original requirements and the requirements taking account of the flexibility granted by the Commission in spring 2017. If the difference between the total expenditure growth and the growth, in accordance with the expenditure benchmark, is more than -0.5 percentage points,

The expenditure benchmark is relaxed for 2017, due to the flexibility granted by the Commission

the deviation from the expenditure benchmark is considered significant. Figure 9 shows that without the flexibility granted by the Commission with respect to the criteria of the expenditure benchmark, there would have been a risk of a deviation of around one percentage point in 2017, which would have been considered a significant deviation.



Source: Calculations made by the National Audit Office on the basis of the material obtained from the Ministry of Finance

Figure 9: Difference between the expenditure calculated, in accordance with the expenditure benchmark and the expenditure limit in euros, in relation to GDP

Compliance with the preventive arm in 2016 and in-year examination in 2017

As Finland complied with both pillars of the preventive arm in 2016, the conclusion of the National Audit Office is that Finland was in compliance with the preventive arm of the Stability and Growth Pact in 2016.

The National Audit Office notes that without the flexibility granted by the Commission in May 2017 with respect to the criteria of the preventive arm, there would have been a risk of a significant deviation in terms of both the structural balance and the expenditure benchmark in 2017.

The Government aims to achieve the MTO by the year 2019 at the latest. According to the Ministry of Finance forecast of spring 2017, Finland will not achieve the MTO by the end of the parliamentary term because, according to forecasts, the structural balance will weaken from the 2016 level. The Commission has calculated the structural balance level by using the figures concerning the Government target path presented in the Stability Programme and has estimated that without any extensive additional measures, Finland will not achieve the MTO in 2019. Therefore, even if the employment target behind the target path would be achieved, the MTO will not be achieved until the year 2020.

Finland has complied with the criteria of both pillars of the preventive arm in 2016

Finland will not reach the MTO by the year 2019

3.2 Corrective arm

According to Statistics Finland, the general government deficit reduced to 1.9% in relation to GDP in 2016. The deficit determined on the basis of the net lending, according to National Accounts, contracted clearly compared with the previous year and the earlier forecasts of the Ministry of Finance and the Commission. The central government and local government deficits also contracted, compared with the previous year. The surplus of earnings-related pension funds reduced, but, contrary to the previous year, other social security funds were also in surplus. The budgetary position of other social security funds was enhanced, due to, for example, an increase in the unemployment insurance contributions. Thus, Finland has complied with the deficit criterion of the corrective arm in 2016.

According to the Ministry of Finance forecast of spring 2017, the general government deficit will remain below the 3% limit until the end of the forecast period, i.e. the end of 2021. In 2017, the deficit is expected to grow to 2.3%, in relation to GDP, particularly due to the tax cuts and other revenue loss associated with the Competitiveness Pact. Despite the deficit growth, according to forecasts, Finland will also be in compliance with the deficit criterion in 2017.

Finland's general government debt ratio has increased in the past decade from around 40% to 63.6% in relation to GDP in 2016. This means that Finland has exceeded the reference value of 60% determined in the Treaty. According to the forecast of the Ministry of Finance, the debt ratio will continue to grow until 2019, after which it will temporarily level off.

Since the nominal debt ratio exceeds the reference value of 60% and the Commission expects the debt ratio to continue to grow, the Commission has analysed Finland's compliance with the debt ratio criterion in its report of 22 May 2017 prepared in accordance with Article 126(3) of the Treaty⁸. In assessing the need to implement the excessive deficit procedure (EDP), in addition to debt ratio, the Commission also considers other relevant factors which could affect the debt level. The relevant factors considered by the Commission include the following:

- the medium-term economic position, in particular, the cyclically adjusted debt and structural reforms;
- the medium-term budgetary position, i.e. adjustment towards the MTO, as well as public expenditure and investments;
- the developments in the medium-term government debt position, including the long-term sustainability of public finances, stock-flow adjustment and debt guaranteed by the government;
- other factors considered relevant by the Commission or put forward by the Member State.

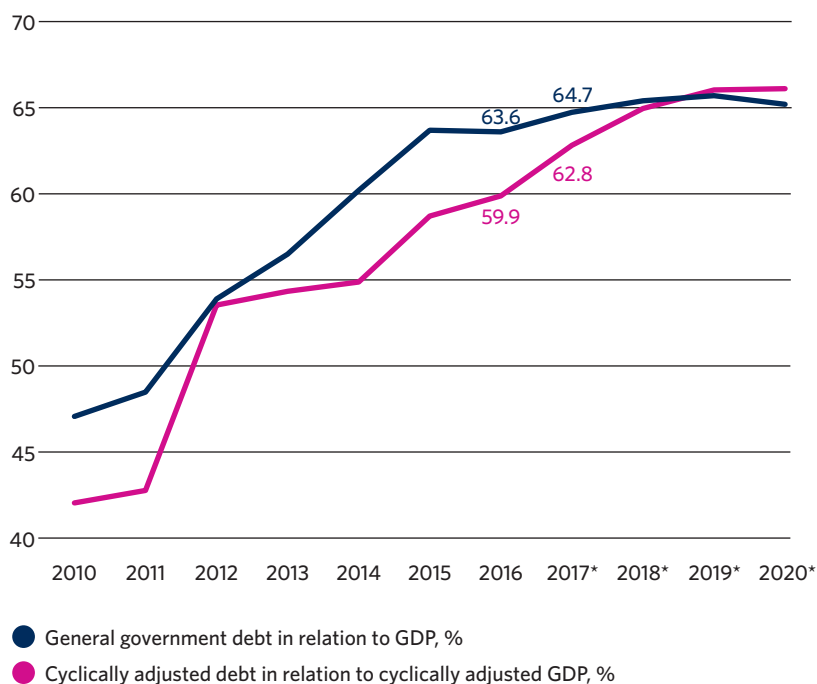
According to estimates of both the Commission and the National Audit Office, the cyclically adjusted general government debt ratio remained below 60% of GDP in 2016. The Commission estimates that the structural reforms already decided or planned in Finland will have a positive impact on debt development in the medium term. Furthermore, the Commission estimates that Finland will comply with the recommended adjustment path towards the MTO in 2017 and 2018, which will help to decrease the debt ra-

According to forecasts, the general government deficit will remain below the 3% reference value over the coming years

tio. Consequently, the Commission also considers that Finland will also be in compliance with the debt criterion in 2016.

In addition to nominal debt ratio, also the cyclically adjusted debt ratio, which is considered a relevant factor, will exceed the 60% reference value in 2017. Figure 9 shows the development of the general government debt ratio and the cyclically adjusted debt determined on the basis of the National Audit Office’s calculations, in relation to cyclically adjusted GDP.

It should be noted that also considering relevant factors in the analysis of the compliance with the criteria brings significant flexibility within the analysis. Taking relevant factors into consideration is justified, because some of the relevant factors may be outside the influence of national fiscal policy. On the other hand, flexibility can weaken the predictability of the interpretations.



Source: Statistics Finland, General Government Fiscal Plan for 2018–2021, calculations of the National Audit Office

Figure 10: General government debt ratio and cyclically adjusted debt ratio between 2010 and 2020

3.3 Flexibility within the rules of the Stability and Growth Pact

The preventive arm of the Stability and Growth Pact is based on the Medium-Term Objective, determined on the basis of the structural balance towards which each Member State must adjust their finances each year. The adjustment requirements are presented in the matrix appended to the Communication on Flexibility.⁹ According to the view of the National Audit Office, the matrix provided in the Communication on Flexibility provides a

transparent and equal way to determine the required adjustment by also taking into account the economic cycle, debt ratio and fiscal sustainability risk of each Member State.

In addition to the above, in determining the required adjustment, the Commission can also consider exceptional circumstances, short-term costs of implementing structural reforms and certain co-financed investments, provided that these are considered to have an impact, either on the sustainability of public finances or the growth potential in the medium term. In terms of exceptional circumstances, in the case of Finland, the Commission has taken into consideration the additional public expenditure arising from the refugee crisis which started in 2015.

The Council of the European Union approves the adjustment requirement towards the MTO for the following year on the basis of the Commission's spring forecasts as part of the country-specific recommendations. The adjustment requirement is mainly determined on the basis of the matrix presented in the Communication on Flexibility. However, the Commission may revise the adjustment requirement afterwards, if there emerges relevant factors concerning Member State economy or public finances that support revising the adjustment requirement from the original country-specific recommendation.

Finland's structural balance adjustment requirement has been revised for the years 2016 and 2017, as described earlier. For 2017, the adjustment requirement was revised particularly on the basis of the structural reform clause. The National Audit Office considers it important that the Government has undertaken to implement and execute the structural reforms in accordance with the Government Programme with the aim to promote employment and economic growth and balanced public finances. However, the view of the National Audit Office is that the reforms implemented by Finland do not fully meet the eligibility criteria to activate the structural reform clause. The National Audit Office finds the technical nature of the flexibility clauses proposed by the Commission problematic, as well as the need for interpretation within the criteria on the basis of which flexibility may be granted.

The National Audit Office considers that by increasing the level of discretion in terms of the annual adjustment requirement, the Commission has also increased the need for interpretation within the analysis concerning compliance with the criteria of the preventive arm. The National Audit Office considers it positive that the Commission also considers country-specific circumstances in its assessment and that the rules of the Pact facilitate the implementation of structural reforms. However, at the same time, revising the requirements and the unpredictable nature of the discretion exercised by the Commission may also make the rules more complex and less transparent. The National Audit Office considers that increasing the powers of discretion and revising the interpretation rules of the Pact may weaken the opportunities to practice predictable and consistent fiscal policy.

Complexity and the need for interpretation within the rules of the Pact weaken the opportunities to practice predictable and consistent fiscal policy

Structural reform and investment clauses

With respect to structural reforms and investments, the Commission may also consider short-term costs of implementing structural reforms and certain co-financed investments, provided that these are considered to have an impact, either on the sustainability of public finances or the growth potential in the medium term.¹⁰

The Commission has set certain criteria, which must be met in order for a country to benefit from the flexibility, in accordance with the structural reform and investment clauses. Some of the criteria are technical in nature and their interpretation is straightforward. Some of the criteria concern an assessment of the short-term costs of implementing structural reforms and the medium-term benefits. Assessing compliance with these latter criteria is significantly more difficult.

According to the structural reform clause, (i) the reform must be major, (ii) it must have a positive impact on the long-term sustainability of public finances and (iii) it must be fully implemented. Costs of the implementation phase may be taken into account in the structural balance adjustment requirement, provided that certain conditions are met. In order for a country to benefit from the structural reform clause, it must present calculations of the short-term costs of the reform and estimates of the medium-term effects of the reform on the balancing of public finances.

Another criterion for granting flexibility is that the country is able to secure a sufficient safety margin towards the 3% deficit margin.¹¹ According to this minimum benchmark, Finland's structural balance should not fall below -1.1% in ratio to GDP. Furthermore, certain technical criteria must also be met.

In its Stability Programme for 2017, Finland has stated that the Government's structural reform programme, particularly the Competitiveness Pact, the pension reform and the health, social services and regional government reform, is critical for the balancing of general government finances and is in compliance with the requirements of the structural reform clause

The Competitiveness Pact includes elements that may enhance or weaken public finances. The short-term net expenses of the Competitiveness Pact, which mainly manifest as a decrease in tax and social security contribution revenues, are fairly easy to itemise. The assessment of the impacts of the reform is one of the main criteria for granting flexibility. However, the impact of the Competitiveness Pact on employment in the medium term and, consequently, on the economic growth is difficult to estimate. According to the estimate of the Ministry of Finance, the Competitiveness Pact may have only a minor impact on the general government balance in the medium term.¹²

According to the Ministry of Finance, the pension reform is expected to strengthen public finances by approximately one percentage point in ratio to GDP. According to the estimate of the National Audit Office, this impact assessment does not involve any significant risks. At this stage, it is too early to assess the cost impacts or the impacts affecting the general government balance of the ongoing health, social services and regional government reform.

In addition to the difficulty of assessing the short-term costs and elements enhancing public finances of reforms, an assessment of the meeting of the minimum benchmark required to activate the structural reform clause is also not straightforward. Consequently, it is difficult to assess whether Finland meets the required technical criteria.

In terms of the investment clause, the flexibility concerns investment projects co-financed by a Member State and the EU, provided that these are shown to have a positive impact on the medium-term potential growth. The criteria for utilising the investment clause are largely the same as with the structural reform clause. In addition to those, the deviation from the adjustment path towards the MTO must result from a co-financed investment project within the meaning of the investment clause.

Finland does not necessarily meet all the criteria of the investment clause. One technical criterion requires that the output gap must be greater than -1.5%, in relation to potential output. As described earlier in this report, in the case of Finland, meeting this criteria depends on the method used to measure the output gap, and, thus, it is difficult to assess whether this criterion is met.

4 Economic forecasts behind the General Government Fiscal Plan

Under the Fiscal Policy Act (869/2012) and the Budgetary Frameworks Directive (2011/85/EU), Member States must ensure that the planning of general government finances is based on realistic macroeconomic and budgetary forecasts. In addition, fiscal policy planning has to be based on the most likely macroeconomic and government budgetary development scenario or on a more prudent scenario. The macroeconomic forecasts must also be made by an independent body. In Finland, these forecasts are produced at the Economics Department of the Ministry of Finance. According to the audit performed by the National Audit Office on the reliability of macroeconomic forecasts in 2016 (Fiscal Policy Audit Report 11/2016), no factors that would have compromised the independence of the Ministry of Finance as a forecasting body emerged in the audit.¹³

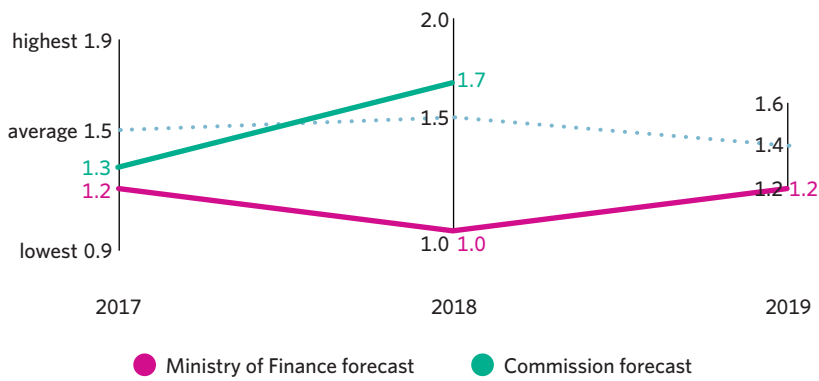
In this chapter, the forecasts published in connection with the General Government Fiscal Plan for 2018–2021 are compared with the forecasts produced by other important forecasting bodies, and an assessment whether the forecasts central to the projections and changes in them are realistic is produced. The forecasts of the Ministry of Finance concerning the GDP growth and development of the general government deficit position between 2017 and 2019 are cautious, but have been adjusted towards more positive growth figures since autumn. Compared to other forecasting bodies, the forecasts of the Ministry of Finance locate at the lower end of the range and are more pessimistic than the average of the forecasts or the forecasts of the Commission published later in the spring. The economic statistics for the first months of the year, which were published after the preparation of the forecasts of the Ministry, show better than predicted development. Thus, the forecasts may need to be further revised upwards, particularly for the year 2017. The price forecast is realistic, but cautious. The inflation is expected to grow slower than in the rest of the euro area throughout the forecast period.

The General Government Fiscal Plan is based on a cyclical forecast and on a prediction of medium-term and long-term economic growth produced by the Ministry of Finance. For this year, the Ministry of Finance is forecasting a GDP growth of 1.2%. The drafting of the state budget last autumn was based on a growth estimate of 0.9%. The upwards change in the growth forecast is well-grounded. The general government deficit forecast has also been adjusted upwards, compared to last autumn, however, without changing the overall view of general government financial position.

The GDP growth forecast for the years 2017–2019, used as a basis for the General Government Fiscal Plan, is cautious, compared to the forecasts produced by other forecasting bodies in spring 2017. The average forecast predicts that the growth will accelerate to 1.5% during 2017 and 2018 and that the long-term growth rate will be slightly more than one per cent annually starting 2019. The forecasts of the Ministry of Finance for the years 2017–2019 are more cautious, and located at the lower end of the range of the forecasts.

General government fiscal planning must be based on realistic forecasts

GDP growth forecast, %



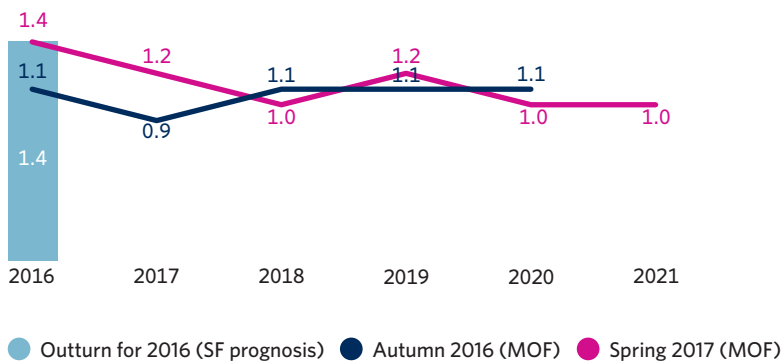
Sources: Ministry of Finance, Bank of Finland, ETLA, PTT, PT, European Commission, IMF, OECD, Nordea, Danske Bank

Figure 11: Variation between the GDP growth forecasts produced for 2017-2019 in spring 2017

In 2016, GDP grew more rapidly than what was predicted in the forecast of the Ministry of Finance produced in autumn, and the growth forecasts for 2017 and 2018 have been slightly adjusted upwards. In contrast, the GDP growth forecast for the year 2018 has been slightly revised downwards. The medium-term growth forecast extending to the end of the forecast period in 2021 has also been revised downwards. The growth forecast produced by the Ministry of Finance is more pessimistic than the forecast produced by the Commission later in spring, especially for the year 2018. Since the forecast of the Ministry of Finance was published, economic statistics showing a more positive trend in the GDP growth have been published.

Several statistics showing a more positive growth trend in early 2017 have been published since the forecast was produced

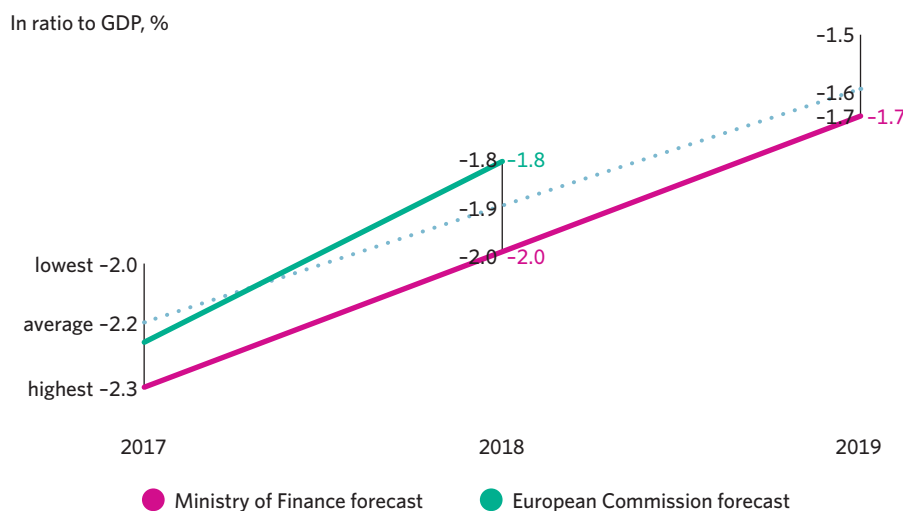
Change in volume, %



Sources: Ministry of Finance (MOF), Statistics Finland (SF)

Figure 12: Change in GDP growth forecast

The trend in general government net lending in ratio to GDP is not expected to significantly improve in 2017–2019 despite the budding economic recovery. The general government deficit was smaller than forecasted in autumn 2016. Consequently, the forecast on the 2017 deficit has been slightly revised upwards. Between the different forecasting bodies, the deficit forecasts deviate less from one another than the growth forecasts. However, the forecast of the Ministry of Finance is more cautious than the general trend in the forecasts, locates at the lower end of the range and is more pessimistic than the forecast of the European Commission published later in the spring.

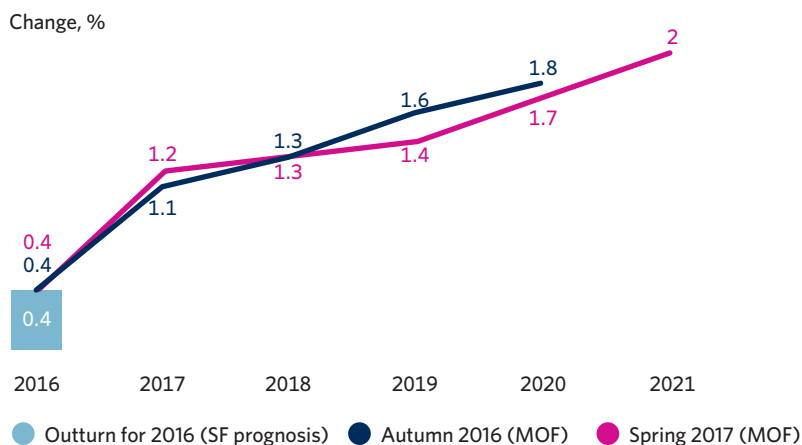


Sources: Ministry of Finance, Bank of Finland, ETLA, European Commission

Figure 13: Variation between the general government net lending forecasts produced for 2017–2019 in spring 2017

The price forecast has a direct impact on the price adjustments made as part of the central government spending limits procedure and the assessment of the trends in tax bases. Compared with the forecast used as a basis for the state budget proposal in the autumn, growth in consumer prices has not substantially changed. However, the export prices have increased faster than expected in the autumn forecast, and the increase in the crude oil price has increased the import prices even more, compared to the export prices. The increase of consumer and export prices have had a raising effect on the GDP deflator and the decrease of import prices a declining effect, but, overall, the GDP price forecast has been revised slightly downwards. Because the volume growth has been revised to be faster than the price growth, growth of the GDP value has been revised slightly upwards from the autumn forecast.

The price forecast is realistic, but cautious. Increase in the consumer prices, i.e. the inflation is expected to grow slower than in the rest of the euro area throughout the forecast period. Oil prices are predicted to increase slowly in the coming years, but the energy prices are not expected to have as significant an impact on the increase of the consumer prices as during this year.



Sources: Ministry of Finance (MOF), Statistics Finland (SF)

Figure 14: Change in consumer price index forecast

The economic forecast published in connection with the General Government Fiscal Plan in spring 2017 is more cautious than the average of the forecasts. Revising the forecast upwards compared to the autumn 2016 budget forecast is justified. On the other hand, economic statistics for the early 2017 published after the forecast was produced indicate that the forecast is slightly cautious, at least for the year 2017.

Under the Budgetary Frameworks Directive, the macroeconomic and budgetary forecasts must be made within the framework of a sensitivity analysis which examines the main fiscal variables under different assumptions as to growth and interest rates. The sensitivity analysis included in the General Government Fiscal Plan for 2018–2021 also includes an examination of the impacts of an increase in the interest level on the general government expenditure. The range of alternative assumptions used in macroeconomic and budgetary forecasts must be guided by the performance of past forecasts.

The Stability Programme appended to the General Government Fiscal Plan presents the alternatives to the forecast (growth rate that is one percentage point faster/slower than in the baseline scenario). In its forecasts for 2011–2015, the Ministry of Finance predicted growth that was faster than the actual rates. However, the growth in 2016 was faster than predicted. Similarly, the spring 2017 forecast is more optimistic than predicted and the forecast for 2017–2018 is more pessimistic than, for example, the forecast of the European Commission.

The National Audit Office has previously emphasised the importance of a more thorough examination of the impacts of slower-than-predicted growth in fiscal planning. In terms of 2017, the budget forecast cannot be considered to overestimate the economic performance.

The projections are realistic, but at the same time more cautious than the general trend in the forecasts.

The forecasts for 2017–2019 may need to be revised upwards

- 1 Vade Mecum on the Stability and Growth Pact – 2017 Edition. Institutional Paper 52. European Commission.
- 2 COUNCIL RECOMMENDATION of 14 July 2015 on the 2015 National Reform Programme of Finland and delivering a Council opinion on the 2015 Stability Programme of Finland (2015/C 272/04).
- 3 Assessment of the Commission of the 2017 Stability Programme for Finland, 23 May 2017.
- 4 COUNCIL RECOMMENDATION of 12 July 2016 on the 2016 National Reform Programme of Finland and delivering a Council opinion on the 2016 Stability Programme of Finland (2016/C 299/19).
- 5 Assessment of the Commission of the Stability Programme for Finland. The Council is to approve the Commission recommendations in summer 2017.
- 6 Assessment of the EC cyclical adjustment methodology for Finland - impact on budget balances (2017), Huovari Janne, Jauhiainen, Signe and Kekäläinen, Antti. PTT Working Papers 191.
- 7 Hristov, Atanas, Raciborski, Rafal and Vandermeulen, Valerie (2017), Assessment of the Plausibility of the Output Gap Estimates. Economic Brief 023. European Commission. See also the assessment of the Commission of the Stability Programme for Finland.
- 8 Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union. 22 May 2017.
- 9 Communication on Flexibility and the related matrix are described in Vade Mecum on the Stability and Growth Pact – 2017 Edition, Annex 16.
- 10 The structural reform and investment clauses are described in Vade Mecum on the Stability and Growth Pact – 2017 Edition, Annex 16. See also the 2017 Draft Budgetary Plan.
- 11 Vade Mecum on the Stability and Growth Pact – 2017 Edition, p. 39.
- 12 2017 Draft Budgetary Plan; see the box on page 36.
- 13 Reliability of macroeconomic forecasts. Fiscal policy audit report. Fiscal policy audit report of the National Audit Office, 11/2016.

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