



Fiscal policy monitoring report spring 2016



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The National Audit Office 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 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the implementation of Treaty provisions of a legislative nature as well as requirements concerning multi-annual budgetary frameworks (Fiscal Policy Act; 869/2012). Evaluation comprises the assessment of the setting and implementation of the fiscal policy rules steering the fiscal policy. By evaluating fiscal policy, the National Audit Office promotes transparent and easy-to-understand regulation and stable and sustainable general government finances. As part of its fiscal policy evaluation task, the National Audit Office is responsible for monitoring the preparation and implementation of the General Government Fiscal Plan, for ensuring the reliability of macro-economic forecasts and for 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.

This report presents the observations made by the National Audit Office as part of fiscal policy evaluation in spring 2016.

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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 2015 and whether the Ministry of Finance forecasts used as the basis for the General Government Fiscal Plan prepared in spring 2016 are realistic.

1. The conclusion of the National Audit Office is that the sub-sector budgetary targets are sufficient for achieving the Medium-term Objective (MTO) for general government finances. According to the fiscal policy evaluation assessment, the measures presented in the General Government Fiscal Plan in spring 2016 are, however, not adequate for achieving the sub-sector budgetary targets.
2. In the view of the National Audit Office, the central government spending limits were complied with in 2015. However, the 2015 spending limits would have been exceeded unless two supplementary budget provisions had been used, which was an exceptional measure. Furthermore, the spending limits do not support the achievement of the central government budgetary target.
3. The conclusion of the National Audit Office is that Finland complied with the preventive arm and the corrective arm of the Stability and Growth Pact in 2015.
4. The conclusion of the National Audit Office is that the Ministry of Finance forecast used as the basis for the General Government Fiscal Plan is realistic and the forecast has been prepared in an independent manner.

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 2015 and whether the Ministry of Finance forecasts used as the basis for the General Government Fiscal Plan prepared in spring 2016 are realistic. This report presents the findings made by the National Audit Office as part of fiscal policy evaluation in spring 2016.

The National Audit Office takes a positive view of the fact that the Government aims to promote employment and economic growth but considers it problematic that the achievement of the general government deficit targets is largely dependent on factors that are beyond the control of the Government.

The conclusion of the National Audit Office is that the sub-sector budgetary targets given as binding by the Government are adequate for achieving the MTO. At the same time, however, it should be noted that the measures decided in spring 2016 are not sufficient for meeting the sub-sector budgetary targets. It will be particularly difficult to achieve the budgetary targets laid out for central and local government. If realised, the targets set would ensure the achievement of the MTO and help to put the debt-to-GDP ratio on a downward trend.

The conclusion of the National Audit Office is that the forecast published in connection with the General Government Fiscal Plan is realistic and it has been prepared at the Economics Department of the Ministry of Finance in an independent manner. The change in the forecast compared with the forecast produced as a basis for budget planning in autumn 2015 is justified.

The central government spending limits and the expenditure rule contained in them are the most important instruments for steering national fiscal policy. According to the observations of the National Audit Office, the Government was in compliance with the central government spending limits in 2015. Expenditure outside the spending limits has remained stable despite the economic downturn.

The National Audit Office draws attention to the use of supplementary budget provisions. In 2015, in accordance with the previous Government Programme, the Government introduced an annual supplementary budget provision of 200 million euros and in addition to this, in 2015 the Government introduced, in accordance with the new Government Programme, a supplementary budget provision of 300 million euros. Without the supplementary budget provision of 300 million euros laid out in the new Government Programme, the spending limits would have been exceeded in 2015. In the view of the National Audit Office, the introduction of a new supplementary budget provision in the middle of a budget year is not an appropriate way to provide more room for manoeuvre within the spending limits.

The National Audit Office is also of the view that the connection between central government spending limits and the numerical fiscal policy rules is not very clear and the central government spending limits do not adequately support the achievement of the deficit target laid out for central government finances.

In addition to the setting of the objective for local government, the Government also aims to slow down the growth in local government expenditure by setting a limit to local government spending. However, its steering impact is weakened by local self-government under which the municipalities are not obliged to implement all the spending cuts authorised by the state.

The National Audit Office has prepared an assessment of the compliance with the Stability and Growth Pact in 2015. Finland complied with the preventive arm and the corrective arm. However, there is a risk that Finland will breach the rules in the coming years. The National Audit Office draws attention to the structural balance, which is well below the MTO of -0.5 per cent of GDP and the risk of a significant deviation from the requirements in 2016.

Furthermore, an in-year examination suggests that Finland will be in breach of the debt criterion of the corrective arm for 2016. According to the Ministry of Finance forecast, the general government debt-to-GDP ratio will only start to decline in 2018-2019.

The National Audit Office draws attention to the functioning of the preventive arm of the Stability and Growth Pact. Taking into account the economic situation in the required change for the structural balance has increased flexibility in the preventive arm. This helps to avoid deep spending cuts in a situation where the economic downturn is still continuing. However, Finland has been suffering from a prolonged economic downturn, which means that compliance with the preventive arm will not provide us with sufficient margin for the criteria laid down in the corrective arm. The National Audit Office also considers it problematic that in Finland's case compliance with the preventive arm would provide justification for adhering to the debt criterion, especially when consideration is given to the anticipated risk of a significant deviation from the requirements in 2016 and the level of the structural balance, which is well below the MTO.

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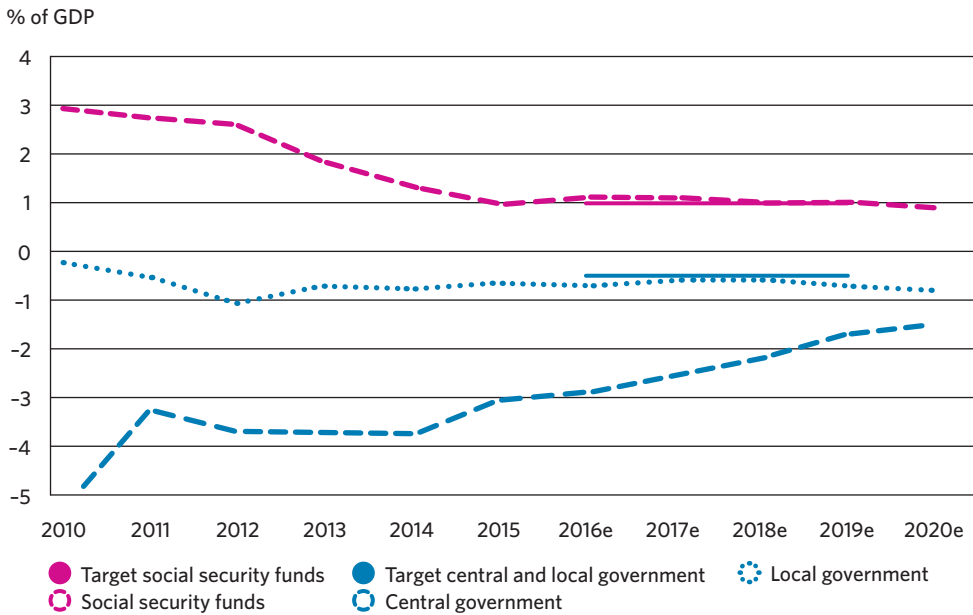
1 Overall steering of general government finances

The National Audit Office has assessed the achievement of the Government's fiscal policy targets and the overall steering of general government finances on the basis of the General Government Fiscal Plan 2017-2020¹ presented in spring 2016. The General Government Fiscal Plan serves as Finland's stability programme and as Finland's medium-term budgetary plan required by the European Union (EU No 473/2013). The Government Decree on the General Government Fiscal Plan (120/2014) has been issued under the Fiscal Policy Act (869/2012)². Supervising compliance with the Fiscal Policy Act and the statutes issued under it is the statutory task of the National Audit Office.

The main economic policy objective of the Finnish Government is to stop the growth in general government debt and to close the sustainability gap by means of spending cuts and measures supporting growth and more efficient public-sector service production. The adjustments proposed by the Government are intended to strengthen general government finances by about four billion euros during the parliamentary term. In its programme, the Government also announced that it will not increase the total tax rate.

In the first General Government Fiscal Plan of the parliamentary term, the budgetary targets of the general government subsectors laid out in the national accounts were made binding with the aim of ensuring that overall general government revenue and expenditure is balanced by the year 2019 (see Figure 1). Under the plan, the total central government and local government deficit should be one per cent of the gross domestic product. In the plan, local government mainly refers to the municipalities. According to the sector-specific estimates contained in the General Government Fiscal Plan, central government deficit in 2019 should be 1.7 per cent and local government deficit 0.7 per cent of the gross domestic product. The Government's aim of balancing general government finances by the year 2019 will only become reality if there are substantial improvements in general government fiscal position and especially in central government fiscal position.

Achieving the deficit targets will require additional measures



Source: Statistics Finland and Ministry of Finance

Figure 1: Changes in sub-sector deficits and Government-set targets

In addition to introducing spending cuts, the Government also aims to provide a stronger basis for employment and economic growth by means of taxation and by taking measures supporting economic competitiveness and productivity. With these measures, the Government aims to strengthen the fiscal position by more than one billion euros. In these measures, the Government relies on moderate pay increases and changes to the pay formation model. It is difficult to give an exact assessment of the impacts of these measures on the national economy and the general government deficit. Furthermore, the details and implementation of these measures are beyond the Government’s control as they largely depend on the results of negotiations between the social partners. Even though the National Audit Office takes a positive view of the fact that the Government is taking measures aimed at promoting employment and economic growth, it considers it problematic that the proposals for achieving the general government deficit target do not include any measures within the Government’s decision-making powers. From the perspective of the predictability of fiscal policy it would be important to present the requirements for change in fiscal policy at an early stage.

The aim of the Government’s economic policy is to close the sustainability gap through spending cuts and measures supporting growth and efficient public-sector service production. It is estimated that the sustainability gap will amount to slightly over three per cent in 2020. The estimates of the sustainability gap have been reduced considerably during the government term; in the technical update of the General Government Fiscal Plan presented in spring 2015, the sustainability gap was put at 4.6 per cent of the GDP. The measures reducing the general government deficit have helped to narrow the sustainability gap. According to the latest General Government Fiscal Plan, the general government deficit in 2019 will be 2.3 billion euros lower than what was estimated in spring 2015. As the sustainability gap estimate is sensitive to background assumptions concerning long-term eco-

The proposals for achieving the general government deficit target do not include any measures within the decision-making powers of the Government

The uncertainty concerning the sustainability gap calculations should be clearly presented

conomic trends, the reports on the matter should highlight the uncertainty concerning the calculations.

According to an assessment based on measures already taken, the general government debt-to-GDP ratio will start to decline in 2020 but the general government sustainability gap will nevertheless remain wide. This means that if no additional measures are taken, the fulfilment of the existing service promises will lead to an increase in the long-term debt-to-GDP ratio after the planning period. In addition to taking short-term adjustment measures, the Government also aims to reduce general government costs and in this manner narrow the sustainability gap through measures that will have a long-term impact. The National Audit Office takes a positive view of the fact that long-term trends in general government finances are taken into account in the planning of general government finances.

There has been a slight improvement in the estimates of the state of general government finances in 2016, compared with the plan presented in autumn 2015. It is estimated that in the current year, general government expenditure will amount to 58.2 per cent, general government deficit to 2.5 per cent and gross debt to 65 per cent of the gross domestic product. The outlook for general government fiscal position is better than was anticipated in the autumn, a result of a higher-than-expected surplus recorded by employment pension institutions in 2015. The estimate of the deficit in central and local government over the next few years has remained unchanged. There will be a slow reduction in the high central government deficit and the local government deficit will remain more or less unchanged. According to the Ministry of Finance forecast, a slight reduction in the surplus of the employment pension institutions is expected in the next few years as pension expenditure increases and there will only be slow growth in property income. During the expected period of slow growth, the general government fiscal position can be primarily improved by taking measures strengthening central and local government finances. It should also be noted that the surplus of the employment pension and social security funds is not used for reducing general government debt. For this reason, in the efforts to slow down the increase in general government debt the focus should be on the deficits in central and local government.

Compared with the technical general government fiscal plan prepared in spring 2015, Government measures have helped to reduce local government operating expenditure by 770 million euros (net impact). The reduction in local government operating expenditure has been made possible by changing the requirements concerning statutory local government tasks. The Government has also introduced legislation allowing municipalities to raise the fees they charge for their services. The tightening of the expenditure limit does not necessarily lead to a reduction in the local government deficit because municipalities can independently decide on maintaining their service levels despite having fewer obligations. The aim of the Government is to reduce the number of local government tasks and obligations by one billion euros. The National Audit Office takes a positive view of the Government's decision to tighten the expenditure limit so that local government finances can be strengthened. Because of extensive local self-government, the expenditure limit is only of limited use in the steering of local government finances.

In its General Government Fiscal Plan, the Government has lowered

the spending limits for the parliamentary term by 80 million euros both in 2017 and 2018 and by 120 million euros in 2019. The tightening is a small one and will only mean a reduction of 0.2 per cent in the overall spending limits in 2017. As a whole, the expenditure rule will reduce central government spending. When no consideration is given to changes in prices and cost levels, it is estimated that central government spending will be reduced by about 1.2 billion euros by the year 2020, which means a decrease of about two per cent in central government expenditure. In the previous General Government Fiscal Plan, the measures aimed at strengthening central government finances were mainly based on the elimination of a number of price adjustments within the spending limits in 2016. Slow price rises have forced the Government to make genuine spending cuts. The deficit target set for central government finances can only be achieved if the spending limits are further tightened during the current parliamentary term. In the view of the National Audit Office, the main central government steering instruments should more strongly contribute to the achievement of the targets set for central government finances.

The General Government Fiscal Plan only includes the economic policy measures that are sufficiently detailed and that have already been put into practice. The plan shows that the already decided measures are not sufficient to achieve the sub-sector deficit targets presented by the Government and contained in the MTO. In the National Audit Office's view, it is problematic that achieving the above-mentioned targets largely depends on planned measures aimed at improving competitiveness the impacts and implementation of which remain uncertain. It should also be noted that in a situation with slower-than-expected GDP growth, putting the debt-to-GDP ratio on a downward trend and adhering to the deficit rule will require extensive additional adjustments and in that case consideration should be given to increasing tax rates. However, even though in international comparisons, Finland's tax-to-GDP ratio is high there is no evidence that increases in some types of tax would not lead to a reduction in tax revenue.

The structural reforms aimed at closing the general government sustainability gap now under way are extremely important but their impacts will only be felt after the current parliamentary term.

2 Compliance with central government spending limits

The expenditure rule laid out in the Government Programme and the central government spending limits are an important part of Finland's national fiscal 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 and structural adjustments are made to them during the parliamentary term. This makes the spending limits system 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 Calculating the 2015 spending limits

According to the observations made by the National Audit Office as part of fiscal policy evaluation, the expenditure within central government spending limits in the final 2015 state budget remained about 208 million euros below the 2015 spending limits. Thus, the estimate presented in the Government's annual report for 2015 that the actual spending was about 208 million euros below the spending limits can be considered correct. According to the Government Programme, a total of 200 million euros can be carried over to 2016, notwithstanding the spending limits rule.

The National Audit Office has also compared the 2015 spending limits with the outturn detailed in the 2015 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 2015, the appropriations were 686.6 million euros under the budget. According to the calculations of the National Audit Office, spending limits expenditure accounted for 460.4 million euros and the expenditure outside the spending limits for 226.2 million of this total, indicating that the spending limits had also been complied with in terms of budgetary outturn.

There was a change in Government after the first supplementary budget of 2015, which means that the second, third and fourth supplementary budget for the budget year 2015 were approved during the Government of Prime Minister Juha Sipilä. As the Government of Prime Minister Juha Sipilä took office, the unallocated reserve within the spending limits had been reduced to 30 million euros. The Government therefore decided to introduce a new supplementary budget provision of 300 million euros, which was in addition to the supplementary budget provision of 200 million included in the first supplementary budget for 2015. This means that supplementary bud-

The Government was in compliance with the spending limits in 2015

The spending limits would have been exceeded without the introduction of an additional supplementary budget provision

get provisions totalling 500 million euros were available for the year 2015.

The Government's spending limits rule is based on a political commitment. In the view of the National Audit Office, the introduction of a new full-amount supplementary budget provision in the middle of a budget year is not a good way to provide more room for manoeuvre within the spending limits from the perspective of the credibility of the spending limits rule. The new supplementary budget provision increased the nominal spending limits by about 270 million euros when consideration is given to the fact that the unallocated reserve of 30 million euros remaining after the first supplementary budget proposal for 2015 was reduced from the new supplementary budget provision of 300 million. This means that the 2015 spending limits would have been exceeded unless the supplementary budget provision had been used twice.

In previous years, the Government's annual report contained a table-form presentation of the expenditure within the spending limits included in the state budget and all supplementary budgets and the price-adjusted and structurally adjusted spending limits during the budget year in question. Thus, the table showed how much the budget in question was below the spending limits. No such table for the year 2015 was included in the 2015 annual report. In the view of the National Audit Office, the omission of the table means that the reporting on compliance with the spending limits is incomplete. The National Audit Office expresses the wish that the Ministry of Finance will again provide accurate reports on compliance with the spending limits in the coming years.

Price and structural adjustments to the spending limits

According to the observations of the National Audit Office, the adjustments made to the 2015 spending limits are in accordance with the principles governing the spending limits procedure. The spending limits adjustments made for 2015 up to the first supplementary budget proposal have been discussed in the separate report of the National Audit Office to Parliament: Fiscal policy monitoring report 2015. The report covers all adjustments made to the 2015 spending limits from the first spending limits decision of the 2011-2015 parliamentary term to the final accounts of the 2015 budget year.

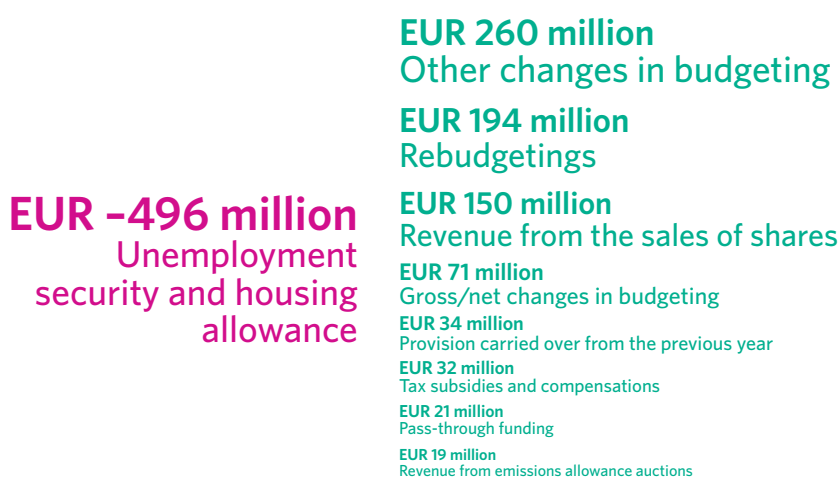
The nominal spending limits for 2015 were increased by structural adjustments totalling 285 million euros and price and cost level adjustments of 1,030 million euros.

Of the structural adjustments totalling 285 million made to the 2015 spending limits, a total of 781 million increased the spending limits, while a total of 496 million decreased the spending limits. The structural adjustments increasing the nominal spending limits were based on rebudgeting of appropriations, changes in gross/net budgeting, other changes in budgeting and pass-through funding. Revenue from the auctioning of emissions allowances, revenue from the sales of shares exceeding 400 million euros and an unallocated reserve carried over from the previous year were used as a basis for budgeting one-off additional expenditure corresponding to the revenue. The structural adjustments reducing the spending limits were the result of the fact that in the spending limits consideration was given to the changes in justification concerning the items covering unemployment security and housing allowance outside the spending limits. After

The price and structural adjustments made to the spending limits are in accordance with the principles of the spending limits system

the Government of Prime Minister Juha Sipilä had taken office, structural adjustments were made as part of the drafting of the fourth supplementary budget. The structural adjustments concerned rebudgeting of appropriations, changes in project timetables and adjustments to the tax compensations for universities of applied sciences.

Figure 2 presents the justification for structural adjustments to the 2015 spending limits. It includes the structural adjustments made by the Government of Prime Minister Juha Sipilä to the fourth supplementary budget. The classification of the structural adjustments has been carried out by the National Audit Office in accordance with the principles laid out in the Government Programme of Prime Minister Jyrki Katainen and those set out in the spending limits manual of the Ministry of Finance.



Impact of structural changes on 2015 spending limits EUR 285 million

Source: Spending limits decisions 2012-2015, 2013-2016 and 2014-2017, General Government Fiscal Plan 2015-2018 and 2015 budget proposals and supplementary budget proposals

Figure 2: Justification for structural adjustments to the 2015 spending limits, breakdown in euros. Impact of structural changes on 2015 spending limits EUR 285 million (including the fourth supplementary budget proposal for 2015).

Most of the structural adjustments included in the category “Other changes in budgeting” were made in the framework of the two last years of the spending limits of the 2012-2015 parliamentary term (especially in 2015). More than half of the adjustments were made as part of the drafting of the 2015 state budget proposal and the finalised budget proposal. The changes are based on operational reorganisation of on-budget entities that have an impact on the distribution of appropriations within the spending limits and outside the spending limits. Other changes in budgeting include the structural adjustments in which the division of appropriations within and outside the spending limits is adjusted or in which spending limits expenditure is transferred outside on-budget entities. The spending limits principle can be applied when the acceptability of these changes is assessed. If there is a final decision on funding a new appropriation or an increase in an appropriation with tax revenue and 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. At the same time, the principle under which the changes in the spending limits should not increase the total expenditure funded through tax revenue may also be applied.

More than half of all price and cost level adjustments (about one billion euros) were statutory price adjustments. During the updating of the 2015 spending limits, statutory index increases were frozen in the administrative branch of the Ministry of Education and Culture, central government transfers to local government, state funding of universities and child benefits. Corresponding sums were deducted from annual price adjustments.

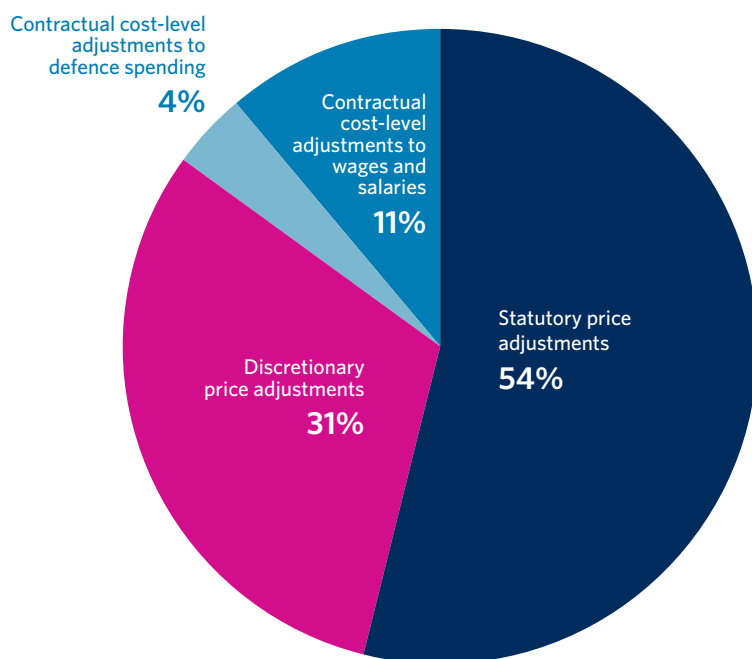
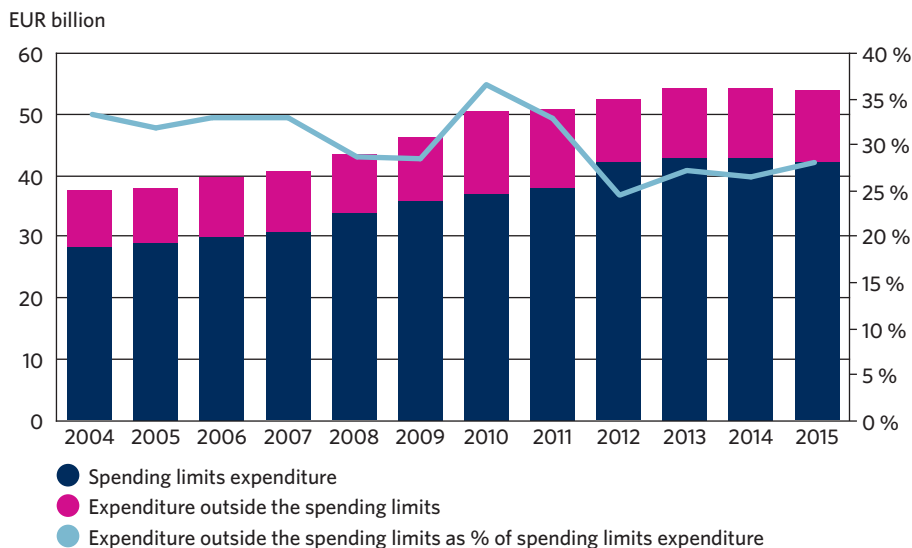


Figure 3: Breakdown of price adjustments to the 2015 spending limits

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 the revenue from the EU and the revenue generated by the national lottery are examples of such expenditure. The budget also contains VAT revenue offsetting the VAT expenditure outside the spending limits. A total of about 3.9 billion euros of pass-through items was classified as expenditure outside the spending limits in 2015.

Expenditure outside the spending limits has remained stable despite the economic downturn



Source: Budget proposals

Figure 4: Spending limits expenditure and expenditure outside the spending limits 2004-2015

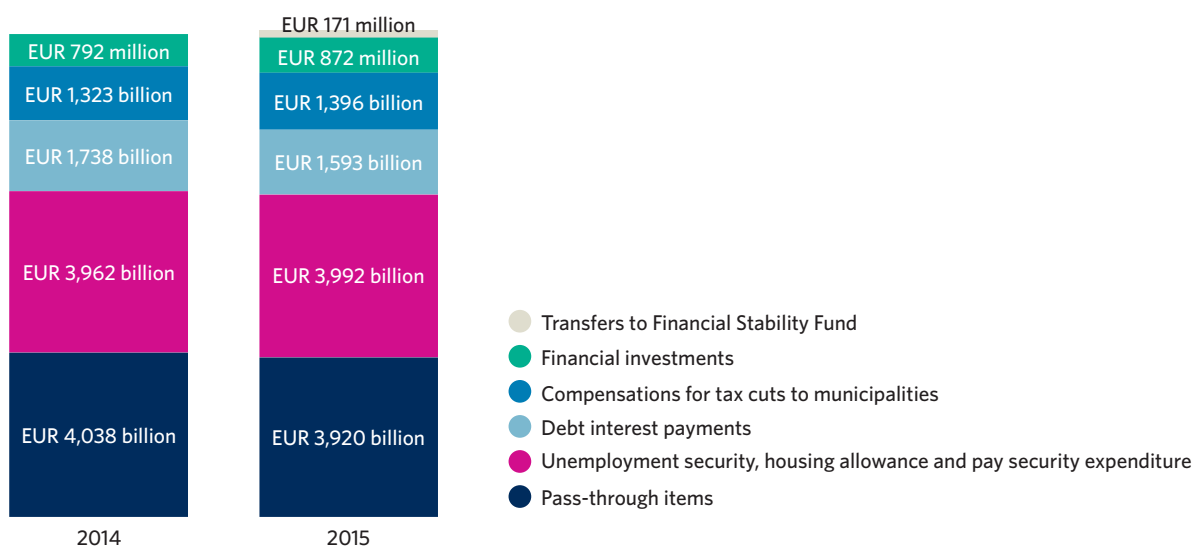
The largest expenditure items outside spending limits (about 3.9 billion euros each year) are unemployment security, housing allowance and pay security. This expenditure functions as automatic stabiliser, which means that it is expected to increase in a downturn and decrease during a period of economic growth. In 2015, unemployment security, housing allowance and pay security expenditure remained at 2014 levels. As a whole, there has been a slight reduction in unemployment security expenditure since 2014, which is mainly the result of the changes in the Unemployment Security Act. Under the changes, which entered into force at the beginning of 2015, municipalities now have to fund a larger proportion of the labour market subsidy. According to Kela's statistics, as a result of the changes in the Unemployment Security Act, municipalities are now responsible for 58 per cent of the funding of the labour market subsidy part-funded by municipalities. Before the changes, the figure was 50 per cent. At the same time, housing allowance expenditure in 2015 was 181.3 million euros higher than in 2014 and, according to the 2016 state budget, the upward trend is continuing.

In this connection, the National Audit Office would like to draw attention to the consideration of the changes in justification made to cyclical expenditure outside the spending limits. In changes to justification for cyclical expenditure outside the spending limits, the structural adjustments are made so that the decision to increase spending will lower the spending limits. Introducing structural adjustments in a situation where a decision is made to increase cyclical expenditure is an essential principle concerning the implementation of the expenditure rule. This is because a reduction in spending limits corresponding to the estimated increase in expenditure will balance the total expenditure to be paid by the taxpayers. However, the clarity of the structural adjustments is negatively affected by the fact that the changes have to be made on the basis of estimated expenditure or savings impacts. When there are changes in the expenditure or savings estimates, the spending limits may be adjusted upwards or downwards several times, as required. In the budgets, structural adjustments are rarely justi-

More consideration should be given to the documentation of the changes in justification for cyclical expenditure

fied and it may be difficult to trace structural adjustments connected with individual decisions. The National Audit Office recommends that the Ministry of Finance should pay attention to the documentation of the structural adjustments connected with changes in justification so that the changes could be made more transparent and easier to understand.

Other important expenditure items outside the spending limits are debt interest payments, compensations to municipalities arising from tax cuts and financial investments. Interest on central government debt has remained unusually low, which continued to reduce interest payments in 2015 even though the central government debt has increased. A total of about 156 million euros was paid to municipalities in compensations for tax cuts. Central government transfers paid to municipalities as compensations for tax cuts were increased by higher earned income tax credits and basic deductions and higher pension income deductions in municipal taxation as well as the introduction of deductions for families with children. The compensations arising from tax changes introduced in 2015 and earlier during the government term total 1.4 billion euros. With the start of the new government term, the compensations for tax cuts introduced by the previous Government were made into spending limits expenditure and only the compensations for tax cuts entering into force from 2016 will remain outside the spending limits.



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

Figure 5: Expenditure outside the spending limits in 2014 and 2015

Financial investments are usually one-off loans, expenditure arising from the purchase of shares and other securities and investments in limited liability companies comparable to shares. Most financial investments are expected to retain their value. In 2015, a total of 872 million euros was appropriated to financial investments, which means that the financial investments have remained high since 2009. As the expenditure has remained at high level for many years, it is important to assess whether the investments will retain their value or do they include expenditure that could be categorised as state aid. It is also important to monitor the risks in the financial markets and the trends in state guarantees and liabilities as a whole.

2.3 Tax subsidies

Tax subsidies mean 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. The spending limits may lead to 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.

According to the Government's annual report, a total of 186 different tax subsidies were identified in 2015. In the absence of an adequately broad and reliable knowledge base, it has been impossible to calculate the sums for about one third of all identified tax subsidies. Thus, it has been impossible to estimate the total number of tax subsidies. The total for those subsidies that could be estimated was 24.2 billion euros. Correspondingly, a total of 188 different tax subsidies were identified in 2014 and they amounted to 23.9 billion euros. This means that there were only minor changes in tax subsidies compared with the previous year. The state accounted for about 70 per cent of all tax subsidies and the remainder was divided between municipalities, the Church and Kela.

Since 2012, the Government's annual report has contained an assessment of the effectiveness of 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. It should be noted that abolishing a tax subsidy will not mean a corresponding increase in tax revenue. In the view of the National Audit Office, the assessment of the effectiveness of tax subsidies should, however, be 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 and, consequently, for abolishing subsidies that are considered to be ineffective. A more systematic approach for reviewing the effectiveness of the subsidies is thus needed.

There were only minor changes in tax subsidies compared with the year 2014

3 Compliance with the Stability and Growth Pact

In this fiscal policy monitoring report, the National Audit Office assesses compliance with the provisions of the Stability and Growth Pact in 2015. The National Audit Office also presents an in-year examination for 2016. Provisions of the Stability and Growth Pact are partially incorporated in the Finnish legislation on the basis of the Fiscal Policy Act (869/2012), which entered into force at the start of 2013.

The National Audit Office assesses compliance with the Stability and Growth Pact on the basis of the calculations and forecasts presented by the Ministry of Finance in its General Government Fiscal Plan for 2017-2020. The plan contains the stability programme submitted to the European Commission. 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. In this connection, the National Audit Office has discovered outdated information in the material supplied by the Ministry of Finance. The National Audit Office urges the Ministry of Finance to pay attention to internal quality assurance of the calculations.

The calculations of 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.³

3.1 Assessing the preventive arm

In accordance with the preventive arm of the Stability and Growth Pact, the MTO is set for three years in terms of structural balance. Structural balance is defined as the cyclically adjusted general government balance net off one-off and other temporary measures.

In 2013, Finland set its MTO at -0.5 per cent of the gross domestic product in structural balance terms. In autumn 2015, the Government decided that Finland's MTO will remain unchanged.

In the setting of the MTO, consideration is given to ensuring an adequate margin for the three per cent deficit criterion, trends in the debt-to-GDP ratio and long-term sustainability challenges. Finland has, under the Fiscal Compact, agreed to achieve a structural balance of at least -0.5 per cent when its general government debt-to-GDP ratio exceeds 60 per cent. The conclusion of the National Audit Office is that the MTO approved by the Government is adequate for Finland, considering the deficit and debt criteria and the sustainability challenges when the adequacy of the MTO is examined using the methodology applied by the European Commission to all Member States.

Finland has set a structural balance of at least -0.5 per cent of the gross domestic product as its MTO

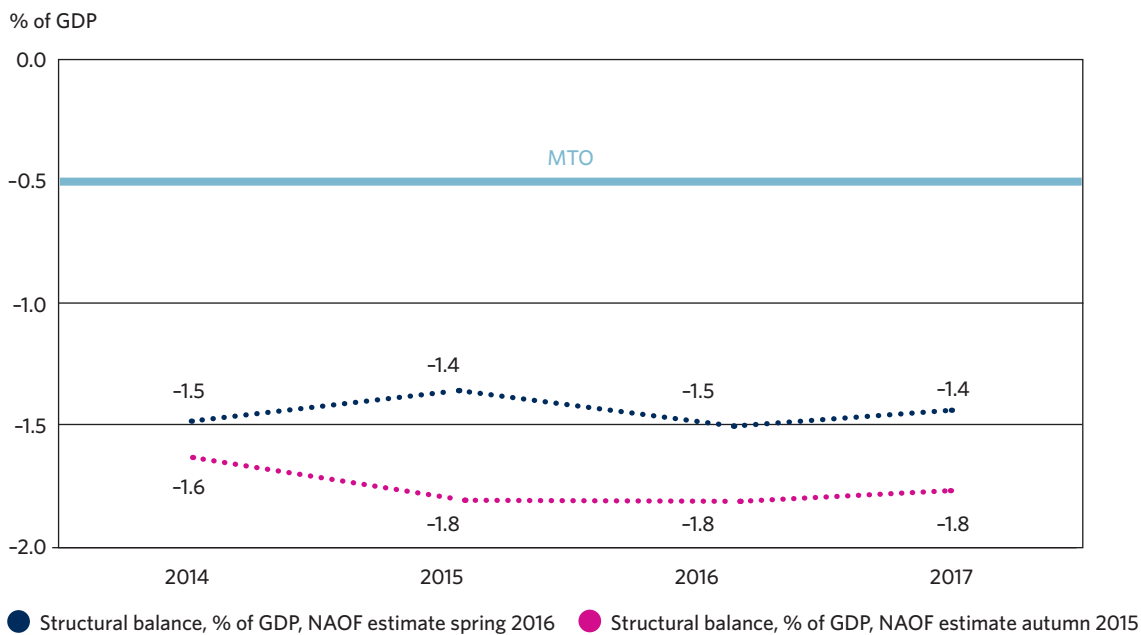
Structural balance

The first pillar of the preventive arm concerns the level of structural balance that is in accordance with the MTO or the path of adjustment leading to it. Based on its ex-post examination carried out in spring 2016, the National Audit Office concludes that Finland achieved the required change in structural balance in 2015.

As Finland failed to achieve the MTO in 2014, an improvement of at least 0.1 percentage points in structural balance was required in 2015, compared with the 2014 level.⁴ Based on its in-year examination carried out in autumn 2015, the National Audit Office concluded that Finland will not achieve the required change in structural balance in 2015. The National Audit Office has updated its ex-post assessment of the year 2015, which it produced in spring 2016, both in terms of the level of structural balance and the change.

According to the in-year assessment carried out in autumn 2015, the structural balance was -1.8 per cent of the gross domestic product, whereas, according to the calculations made in spring 2016, structural balance was -1.4 per cent of the gross domestic product in 2015. The improvement in structural balance has been the result of an improvement in nominal fiscal position. There was an improvement of 0.6 percentage points in the nominal fiscal position of the year 2015 from the forecast produced last autumn to the statistical information of spring 2016. Figure 6 shows the National Audit Office's estimate of the level of structural balance, based on the calculations made in autumn 2015 and spring 2016.

Finland achieved the required change in structural balance towards MTO in 2015



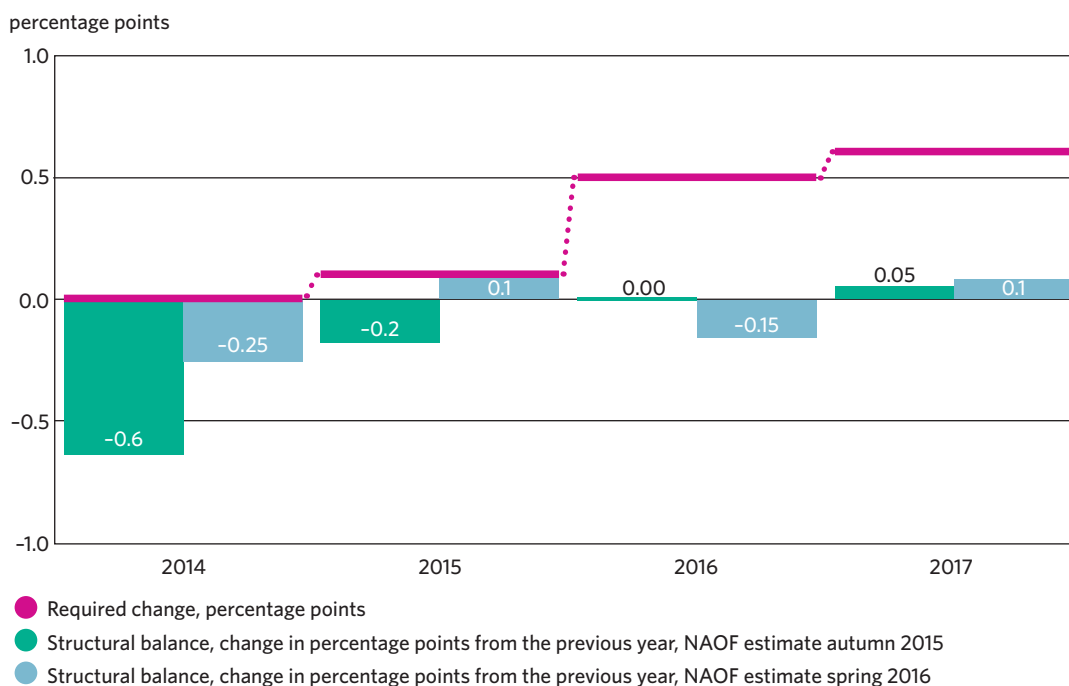
Source: Calculations made by the National Audit Office on the basis of the material obtained from the Ministry of Finance

Figure 6: Trends in Finland's structural balance between 2014 and 2016

An improvement in the nominal fiscal position has also led to an update of the change in structural balance so that, based on an ex-post examination, Finland achieved the required change in 2015.

Based on an in-year examination carried out in autumn 2015, there was a risk of a deviation of about 0.3 percentage points from the required change.

Figure 7 shows the National Audit Office's estimate of the change in structural balance in relation to the required change, based on the calculations made in autumn 2015 and in spring 2016.



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

Figure 7: Required change in structural balance and actual changes in it between 2015 and 2017

In 2016, the structural balance should improve by 0.5 percentage points, compared with the 2015 level. However, based on an in-year examination, the structural balance will weaken by 0.15 percentage points, compared with 2015. As the deviation from the requirement is more than 0.5 percentage points, there is a risk of a significant deviation from the structural balance pillar in 2016. In 2017, the required change will already be 0.6 percentage points. Based on an ex-ante examination, there will be a slight improvement in structural balance in 2017. However, the improvement will not be adequate, which means that there is again a risk of a significant deviation in 2017.

Based on an in-year examination, there will be a significant deviation from structural balance requirements in 2016

Expenditure benchmark

In the expenditure benchmark, the second pillar of the preventive arm, the trends 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 2015. Based on an in-year examination, Finland will also be compliance with the expenditure benchmark in 2016. The National Audit Office draws attention to the tightening of the expenditure benchmark in the coming years, which means that Finland will only start achieving its MTO if there is a substantial slowdown in the rate of increase in spending in real terms.

Finland complied with the expenditure benchmark in 2015 by a wide margin

Under the expenditure benchmark, the cyclical part 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 2015, the adjusted total general government expenditure should have grown by a maximum of 0.6 percentage points in real terms, compared with 2014.

However, based on the National Audit Office's calculations, adjusted total general government expenditure contracted by 0.8 per cent in 2015, compared with 2014. In euro terms, real spending was 0.8 per cent lower than the spending-to-GDP ratio set for it. This means that Finland complied with the expenditure benchmark in 2015 by a wide margin. The National Audit Office's calculations concerning the expenditure benchmark are shown in Table 1.

Table 1: Finland's total general government expenditure, adjustments made to it and the applicable expenditure benchmark in 2014-2017, as calculated by the National Audit Office

Expenditure benchmark items, EUR billion	2014	2015	2016e	2017e
1 Total general government expenditure	119.2	120.8	122.5	124.0
-2 Debt interest payments	2.5	2.5	2.5	2.4
-3 Expenditure arising from EU programmes, fully compensated by income from EU funds	0.9	1.1	1.1	1.0
-4 Cyclical changes in unemployment expenditure	0.6	0.9	0.9	0.7
-5a Fixed capital (gross)	8.5	8.3	8.6	8.8
+5b Average for fixed capital (over four years)	8.1	8.3	8.5	8.6
= AEA1 Adjusted expenditure aggregate (AEA1)	114.9	116.2	117.9	119.6
-6 Effect of discretionary measures on income, DRM	0.8	0.6	0.6	-0.1
-7 Expenditure financed from earmarked revenue	0.11	0.05	0.05	0.05
= AEA2 Adjusted expenditure aggregate (AEA2)	114.0	115.5	117.2	119.7
Growth in total general government spending				
Nominal growth in total spending (calculated in accordance with the expenditure benchmark)		0.6 %	0.9 %	1.5 %
GDP deflator*		1.4 %	1.3 %	1.7 %
Real growth in total spending (calculated in accordance with the expenditure benchmark)		-0.8 %	-0.4 %	-0.2 %
Applicable expenditure benchmark		0.6 %	-0.1 %	-0.9 %
Significant deviation				
Difference between rate of growth under expenditure benchmark and total spending (percentage points)		1.4 %	0.3 %	-0.7 %
Deviation, EUR billion		1.6	0.3	-0.8
GDP, EUR billion		207	211	215
Deviation in relation to GDP (%)**		0.8 %	0.2 %	-0.4 %
Is the deviation significant (<-0.5)? ***		No	No	No

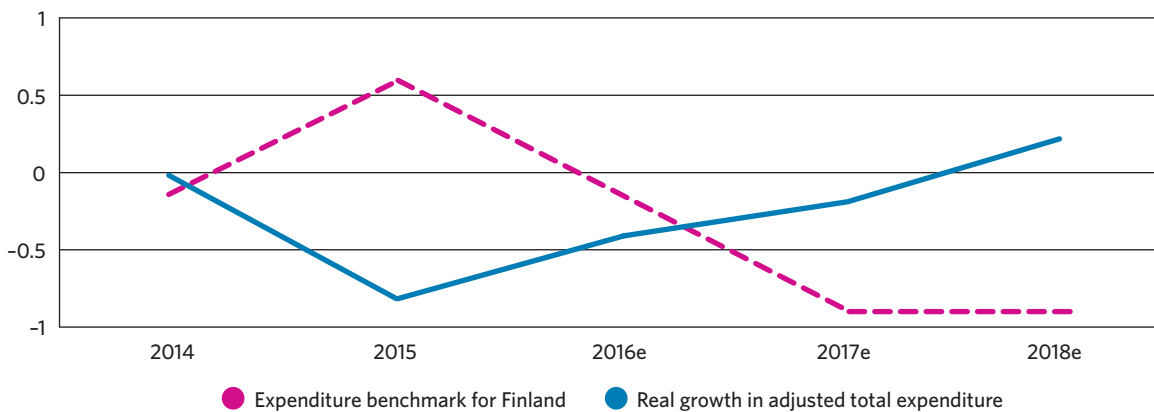
*An average of the GDP deflator of the Commission's spring and autumn forecasts for the preceding year is calculated for each year. The deflator of the winter 2016 forecast is used for the year 2017.

** 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) that in relation to GDP is less than -0.5 per cent for the preceding year or, in cumulative terms, for the two preceding years.

The expenditure benchmark will be tightened in 2016 and 2017. The more substantial change required in structural balance will tighten the benchmark in 2016. However, based on an in-year examination, Finland will still be in compliance with the expenditure benchmark in 2016. In 2017, the benchmark will be tightened by the higher required change in structural balance and a slowdown in the growth of potential output. Thus, the National Audit Office would like to draw attention to the fact that Finland can only comply with the expenditure benchmark and start achieving its MTO if the adjusted total expenditure is reduced in real terms in the next few years. The tightening of the expenditure benchmark and an estimate of the real growth rate in total general government expenditure, as calculated by the National Audit Office, are shown in Figure 8.

Tightening of the expenditure benchmark in the next few years will limit growth in expenditure



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

Figure 8: Trends in total expenditure and expenditure benchmark, 2014-2018

Compliance with the preventive arm in 2015 and in-year examination in 2016

As Finland complied with both pillars of the preventive arm in 2015, the conclusion of the National Audit Office is that Finland was in compliance with the preventive arm of the Stability and Growth Pact in 2015.

Finland was in compliance with both pillars of the preventive arm in 2015

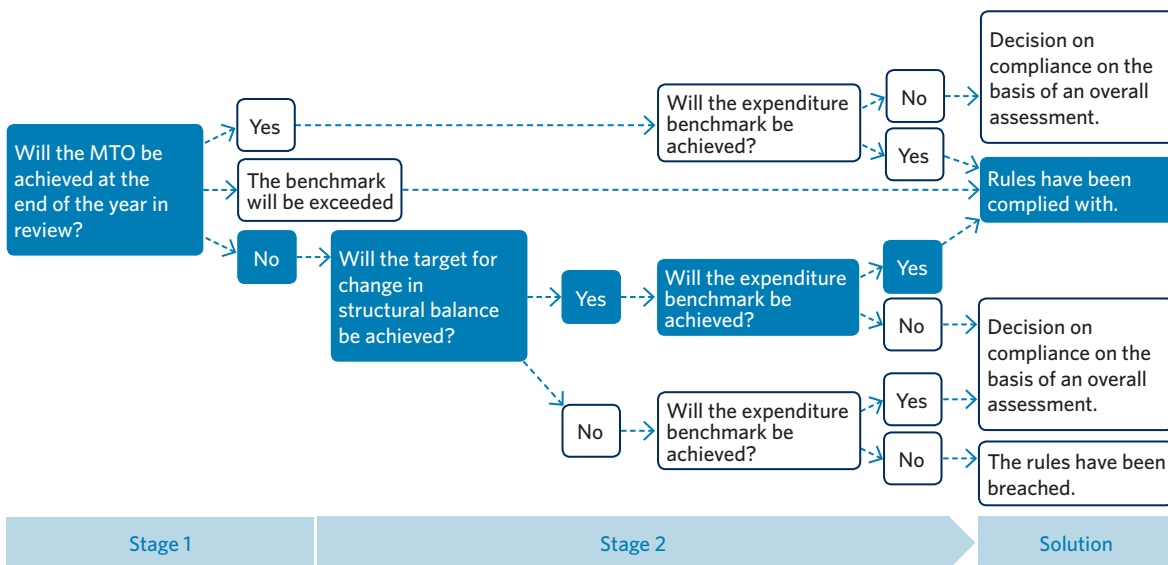


Figure 9: Ennaltaehkäisevän osan sääntöjen noudattaminen 2015

The National Audit Office would like to draw attention to the level of structural balance. The structural balance is significantly weaker than MTO even though Finland achieved the required change in structural balance in 2015. According to the General Government Fiscal Plan published in spring 2016, the Government aims to achieve the MTO by the year 2019. In the view of the National Audit Office, this aim is unrealistic because, based on an in-year examination, Finland will not achieve the required change in structural balance in 2016 or 2017.

The National Audit Office would also like to draw attention to the fact that based on an in-year examination, there is a risk of a significant deviation of about 0.65 percentage points from the requirements for structural balance in 2016.

According to a communication issued by the Commission to the Member States in autumn 2015, temporary deviations from the requirements laid down in the preventive arm are permitted on account of exceptional circumstances. In accordance with the communication, the additional costs arising from the refugee crisis can be considered to have been exceptional in 2015 and 2016 and thus they provide justification for deviations in the years in question.

In Finland's case, consideration for the higher costs arising from immigration can be considered for the year 2016. It is proposed in the General Government Fiscal Plan that the higher costs arising from immigration in 2016 would be about 0.2 per cent of the GDP, which would permit a corresponding deviation from the required change in structural balance.

However, the National Audit Office is of the view that it is too early to give any precise estimate of the impacts of increased immigration on general government fiscal position in spring 2016. Thus, the National Audit Office would like to emphasise that even if the additional costs arising from asylum seekers were considered in the requirements, there is still a risk of a significant deviation from structural balance.

Costs arising from the refugee crisis can be taken into account in the requirements laid down in the preventive arm in 2016

3.2 Corrective arm

Finland also complied with the corrective arm of the Stability and Growth Pact in 2015. According to the statistics that were published by the Statistics Finland on 31 March 2016 and that the agency has submitted to the Commission, the general government deficit was 2.7 per cent of the gross domestic product in 2015. This means that the deficit was below the three per cent limit set for it. The deficit decreased by 0.5 percentage points from 2014. According to the forecast published by the Ministry of Finance in spring 2016, the general government deficit will remain below the three per cent limit between 2016 and 2020.

Finland's general government debt amounted to 63.1 per cent of the gross domestic product in 2015. This means that the debt-to-GDP ratio has exceeded the 60 per cent limit laid down in the Stability and Growth Pact. The backwards-looking criterion, the forward-looking criterion and the cyclically adjusted debt ratio, as well as other relevant factors are examined when the nominal debt ratio has exceeded the 60 per cent limit. The National Audit Office's calculations concerning the cyclically adjusted debt are shown in Table 2. As is shown in the Table, the cyclically adjusted debt-to-GDP ra-

tio remained below 60 per cent in 2015.

Thus, even though the National Audit Office is of the view that in 2015 Finland was still in compliance with the debt criterion laid down in the corrective arm, it would like to draw attention to the fact that in 2016 the cyclically adjusted debt-to-GDP ratio will also exceed the 60 per cent limit. According to the Ministry of Finance forecast, the debt-to-GDP ratio will only start to decline in 2018-2019.

Table 2: General government debt in relation to GDP and cyclically adjusted debt 2013-2020

	2013	2014	2015	2016e	2017e	2018e	2019e	2020e
General government debt, % of GDP	55.5	59.3	63.1	65	66.7	67.4	67.4	67.2
Cyclically adjusted debt, % of GDP*	52.9	53.7	57.7	60.9	63.9	65.8	66.5	67.2

*Cyclically adjusted GDP

As the nominal debt-to-GDP ratio has exceeded the 60 per cent limit, the Commission will produce a report in accordance with Article 126(3), in which it will assess the trends in Finland's debt-to-GDP ratio, considering both the cyclical adjustment and compliance with the preventive arm.⁵

The National Audit Office draws attention to the functioning of the preventive arm. Taking into account the economic situation in the required change for the structural balance has increased flexibility in the preventive arm. This helps to avoid deep spending cuts in a situation where the economic downturn is still continuing. However, Finland has been suffering from a prolonged economic downturn, which means that compliance with the preventive arm will not provide us with sufficient margin for the criteria laid down in the corrective arm. The National Audit Office also considers it problematic that in Finland's case compliance with the preventive arm would provide justification for adhering to the debt criterion, especially when consideration is given to the anticipated risk of a significant deviation from the requirements in 2016 and the level of the structural balance, which is well below the MTO.

Finland will be in breach of the debt criterion in the next few years

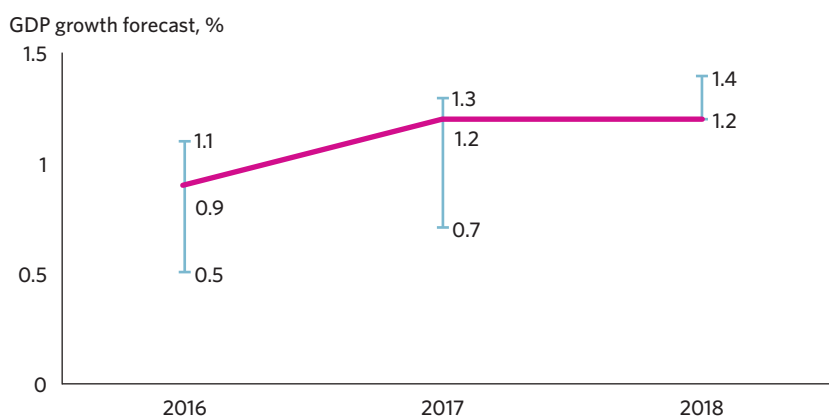
4 Forecast behind the General Government Fiscal Plan

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. Fiscal policy planning must also be based on the most likely macrofiscal scenario or on a more prudent scenario. In this chapter the forecast published in connection with the General Government Fiscal Plan is compared with the forecasts produced by other important forecasting institutes, and an assessment of the credibility of the forecasts central to the projections and changes in them is produced.

The General Government Fiscal Plan is based on a cyclical forecast and an assessment 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 0.9 per cent. The drafting of the state budget last autumn was based on a growth estimate of 1.3 per cent. However, the change in the growth forecast has not significantly changed the picture of the state of general government finances.

The forecast for the years 2016-2018 used as a basis for the General Government Fiscal Plan is similar to the forecasts produced by other forecasting institutes in spring 2016. The general trend in the forecasts is that the growth that started in 2015 will accelerate during 2016 and that the long-term growth rate will be achieved in 2017. Long-term GDP growth is estimated at slightly more than one per cent annually, which is substantially less than in the past decades.

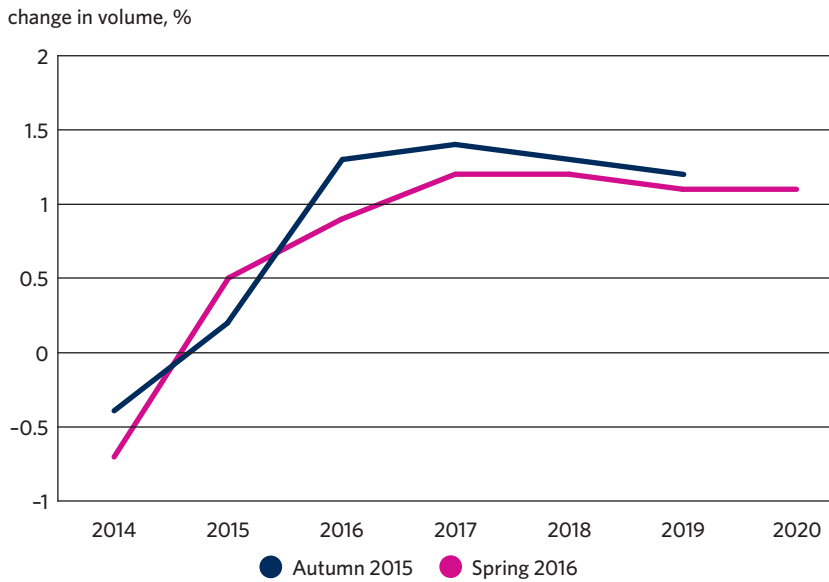
General Government Fiscal Plans must be based on realistic forecasts



Source: Ministry of Finance, Bank of Finland, ETLA, PTT, PT, European Commission, IMF

Figure 10: Variation between the Finnish GDP growth forecasts produced by the Ministry of Finance for 2016-2018 and other forecasting institutes in spring 2016

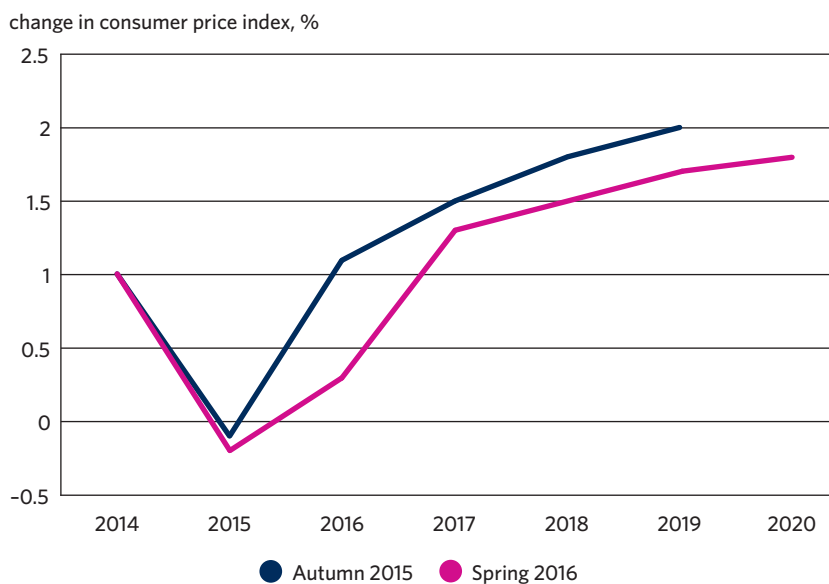
In 2015, GDP grew more rapidly than what was predicted in the forecast used as a basis in the budget process but the growth forecast for the year 2016 has been revised downwards. The change in the growth forecasts is mainly due to changes in the export forecast, which reflects the weakening of world trade during the entire forecasting period. The growth forecast for the end of the forecasting period has also been revised slightly downwards. The growth forecast produced by the Ministry of Finance is more optimistic than the forecast produced by the Commission in spring, especially for the year 2017.



Source: Ministry of Finance

Figure 11: Change in GDP growth forecast

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 foreign trade prices and consumer prices has been substantially slower, which is also reflected in slower growth in GDP deflator. Because of a slower forecast for volume and price growth, growth of the GDP value in 2016 will be almost one percentage point slower than what was predicted in the previous forecast. The change in price level forecast is justified. Oil prices have remained low longer than predicted, which has also slowed down price increases in other products.



Source: Ministry of Finance

Figure 12: Change in consumer price index forecast

Compared with the forecast used as a basis for budget planning, the estimates of the growth in tax bases in 2016 have been revised downwards. The most substantial change has concerned the estimate of the operating surplus, which steers the growth in the corporate tax base. This reflects the weaker-than-expected growth in 2015. As a whole, the Ministry of Finance estimates that the change in the projections will weaken the general government fiscal position in 2016 by a total of about 0.4 percentage points. The general government fiscal deficit is expected to decrease more slowly in 2016 and 2018 than what was predicted in the previous forecast, which will lead to a more rapid growth in the debt ratio. The change in the forecast can be justified on account of a more accurate statistical base.

The National Audit Office is of the view that the forecast published in connection with the spring 2016 General Government Fiscal Plan is realistic. The forecast was prepared independently at the Economics Department of the Ministry of Finance. The change in the projections compared with the forecast made as a basis for budget planning in autumn 2015 is justified.

Under the Budgetary Frameworks Directive, the macroeconomic and budgetary forecasts must examine paths of main fiscal variables under different assumptions as to growth and interest rates. The forecasts must be made within the framework of a sensitivity analysis. 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 2011-2014, the Ministry of Finance predicted growth that was faster than the actual rates. In the spring 2016 forecast, the risks are downbound and the Ministry of Finance forecast for the year 2017 is more optimistic than the spring forecast of the European Commission. The National Audit Office emphasises the importance of a more thorough examination of the impacts of slower-than-predicted growth in fiscal planning.

The projections are realistic

The risks presented by the Ministry of Finance in its forecast are downbound

- 1 General Government Fiscal Plan for 2017-2020. Ministry of Finance. 14 April 2016.
- 2 Act on the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the implementation of Treaty provisions of a legislative nature as well as requirements concerning multi-annual budgetary frameworks.
- 3 Vade Mecum on the Stability and Growth Pact, 2016 edition. European Commission, Institutional Paper 021.
- 4 The required change in structural balance depends on economic cycles, debt-to-GDP ratio and the sustainability risk. The Commission's matrix for specifying the required change is presented in the Annex to the communication on flexibility (Page 20 of the document Making the best use of the flexibility within the existing rules of the Stability and Growth Pact, 13 January 2015).
- 5 Vade Mecum on the Stability and Growth Pact, 2016 edition. European Commission, Institutional Paper 021.



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