



National Audit Office's Fiscal Policy Audit and Monitoring Report on the 2011–2014 Parliamentary Term



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on the 2011–2014 Parliamentary Term**

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To Parliament

The National Audit Office conducts fiscal policy audits in accordance with the guidelines based on the international ISSAI audit standards and its own audit plan. The audits cover the reliability of the fiscal policy knowledge base and the reporting on fiscal policy, functioning of the fiscal policy management tools and rules and the prerequisites for achieving the objectives and the extent to which the objectives are achieved. The National Audit Office monitors and evaluates fiscal policy as an independent monitoring body referred to in the Stability and Growth Pact and in the EU and national legislation. The National Audit Office reports on the most important findings and recommendations that it makes as part of fiscal policy audits and monitoring in separate reports submitted to Parliament in the middle and at the end of each parliamentary term. The fiscal policy audit and monitoring reports submitted during the parliamentary terms are part of the process of independent fiscal policy monitoring carried out by external parties, as referred to in the EU law and the recommendations issued by the IMF and the OECD.

In its report on the 2011–2014 parliamentary term, the National Audit Office evaluates the implementation and achievement of the fiscal policy objectives set for the parliamentary term, the basis for the fiscal policy for the next parliamentary term, stabilisation of local government finances, tax policy and economic impacts of changes in taxation. In a separate report, the National Audit Office also gives its opinion on how the implementation of fiscal policy supports the process of balancing central government finances and the long-term stability and sustainability of general government finances.

Referring to above and on the basis of section 6 of the Act on the National Audit Office (676/2000), the National Audit Office submits this separate report.

Helsinki 16 December 2014

Auditor General

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Executive Director of Fiscal Policy Evaluation

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This separate report to Parliament contains the fiscal policy auditing and monitoring report of the National Audit Office on the 2011–2014 parliamentary term. The report examines the implementation of fiscal policy during the 2011–2014 parliamentary term and the achievement of the fiscal policy objectives set out for the term. The main aim of the Government has been to stabilise general government finances.

Slow economic growth has been the most serious challenge during the 2011–2014 parliamentary term and as a result, it has been necessary to take more substantial economic adjustment measures than envisaged. Despite the adjustments, few of the fiscal policy objectives set out in the Government Programme have been achieved. The Government has failed to stabilise general government finances. The adjustment measures have slowed down the growth of deficits but have failed to stop the growth of the central government debt-to-GDP ratio. The process of implementing the measures aimed at closing the sustainability gap in general government finances during the 2011–2014 parliamentary term has been extremely slow. Moreover, the measures have only been partially implemented.

As a result of the ageing of its population and structural changes in its economy, Finland is in a situation where general government expenditure is in danger of exceeding revenue in the long term. The National Audit Office is of the view that the Government's structural policy programme is an important tool in stabilising general government finances. However, the measures taken to achieve the objectives have been inadequate. The measures aimed at increasing the output potential and productivity of the national economy will not have an immediate effect and for this reason decisions must be made at the start of the 2015–2019 parliamentary term. The current weakness of the Finnish economy, in which substantial additional adjustment may slow down economic growth, highlights the importance of the structural policy programme. If implemented, the structural policy programme will also help Finland to comply with the new EU rules.

There have been conflicting pressures on the tax system. Taxes have been raised as part of the adjustment measures but at the same time, the incentives provided by the tax system and its systematic nature should also be examined as a whole. There was no simplification of the Finnish tax system during the term of Prime Minister Jyrki Katainen's Government. When decisions on taxation have been made, there has been no systematic consideration of the tax system as a whole. Decision-making has also been characterised by unpredictability. Decisions have been made and cancelled. From the perspective of a credible fiscal policy and private sector decision-making, predictability and systematic approach are important.

Even after the tax reform introduced in spring 2013, complexity and lack of neutrality remain the dominant features of the Finnish system of corporate and capital taxation. There are several different deductions that can be made from income and capital taxation. From the perspective of taxpayers, this makes the system less transparent. One option would be to have a system in which all deductions are based on the same format, which would make it easier to calculate them. This would reduce the administrative burden, might change the behaviour of taxpayers and result in a more equal tax burden among different taxpayer groups.

In the view of the National Audit Office, the general policies and main objectives concerning the tax policy should be set out in the Government Programme. The Government Programme should not be too detailed in this respect. In the political decision-making process, more consideration should be given to the preparatory work carried out by public servants. A more thorough preparatory process would help to keep the tax system under better control, the tax base more cohesive and the system simple. In particular, there should be a critical examination of tax subsidies. The tax system should be simplified.

The state of the Finnish local government finances has weakened to a worrying degree during the last 15 years. There are substantial differences between municipalities in terms of their financial position and the wide differences in population growth rates based on population forecasts will only accentuate the situation.

Too much importance may have been attached to the local government reform as an instrument for reducing the sustainability gap as it has also been seen as a way of stabilising local government finances in the long term. The reduction of local government tasks by about one billion euros should be completed during the next parliamentary term. Reducing the statutory tasks of municipalities requires political leadership and the setting of priorities.

In the view of the National Audit Office, the decision to finance the growing list of local government tasks exclusively by means of central government transfers is a step in the right direction as it eliminates the incentive contained in the previous system under which new local government tasks could be introduced even though there was no need to secure immediate financing for them under the Government spending limits.

There are good grounds for taking an extremely careful approach to binding normative steering in legislation on municipalities, local government services and social and health care services. This would make it possible to improve productivity and economic efficiency by means of new innovations and operating practices.

Contents

1	Achievement of fiscal policy objectives	9
1.1	Summary of the findings	9
1.2	Compliance with national fiscal policy rules	11
1.3	Compliance with the fiscal policy rules of the EU that are binding on Finland	15
1.4	Stabilising general government finances	22
1.5	Economic forecasts and fiscal policy framework in the 2011–2014 parliamentary term	25
2	Implementing tax policy	28
2.1	Summary of the findings	28
2.2	Tax policy in the programme of Prime Minister Jyrki Katainen's Government	30
2.3	Assessing tax changes - indirect taxation	33
2.4	Assessing changes in taxation - corporate and capital income taxation	35
2.5	Assessing changes in taxation - taxation of earned income	40
2.6	Decision-making in practice - there is not enough room for thorough preparation by public servants	43
2.7	Complicated tax system - problematic for both decision-makers and taxpayers	45
3	Ensuring the stability and sustainability of local government finances	49
3.1	Summary of the findings	49
3.2	Division of responsibility between different administrative levels	53
3.3	Situation report on the municipal sector	55
3.4	Most important programmes with impact on local government finances	62
References:		74
Sources		76

1 Achievement of fiscal policy objectives

1.1 Summary of the findings

Slow economic growth has been the most serious challenge during the 2011–2014 parliamentary term. Finland's gross domestic product has contracted for three consecutive years since 2012. As a result, it has been necessary to take more extensive adjustment measures during this parliamentary term than envisaged. Despite the adjustments, few of the fiscal policy objectives set out in the Government Programme have been achieved.

The fiscal policy framework during the 2011–2014 parliamentary term was based on the growth envisaged at the time when the Government Programme was prepared. For this reason, the National Audit Office recommends that in the planning and laying of the fiscal policy framework for the next parliamentary term, consideration should be given to the long-term prospects of the Finnish economy and the structural factors affecting economic growth.

The Government has failed in its efforts to stabilise Finland's central government finances. The adjustment measures have slowed down the growth of deficits but have failed to stop the growth of the central government debt-to-GDP ratio. The process of implementing the measures aimed at closing the sustainability gap in general government finances during the 2011–2014 parliamentary term has been extremely slow. Moreover, the measures have only been partially implemented.

The new fiscal policy rules introduced by the European Union are not the main reason why Finland should stabilise its central government finances and introduce structural reforms. As a result of the ageing of its population and structural changes in its economy, Finland is in any case in a situation where general government expenditure is in danger of exceeding revenue in the long term.

The National Audit Office is of the view that the Government's structural policy programme is an important tool in stabilising general government finances. However, the measures taken to achieve the objectives have been inadequate. Little concrete action had been taken to implement the programme by autumn 2014. The measures aimed at increasing the output potential and productivity of the Finnish economy will not have immediate effect, which means that quick decisions are needed. For this reason the Government's structural policy programme should be implemented effectively and without delay.

The current weakness of the Finnish economy, in which substantial additional adjustment may slow down economic growth, highlights the importance of the structural policy programme. When implemented, the structural policy programme also helps Finland to comply with the new EU rules.

During the 2011–2014 parliamentary term, Finland has complied with the deficit and debt rules of the Stability and Growth Pact and has achieved the objective for general government structural balance laid down in the preventive arm of the Stability and Growth Pact.

However, Finland will probably be in breach of the general government debt rule of the Stability and Growth Pact in 2015. In Finland, social security funds, which are in surplus, are also considered part of general government. It should be noted that the surplus of the social security funds is not used for reducing general government debt. Deficits in central and local government are the main factors increasing general government debt. As a result, changes in general government fiscal deficit are not reflected in general government debt. Thus, achieving the overall general government deficit objective does not guarantee that Finland's general government debt will remain within the limits laid down in the Stability and Growth Pact. The fiscal deficit rules can only keep the debt under control if the rules apply to the combined fiscal deficit of central and local government.

1.2 Compliance with national fiscal policy rules

The Government of Prime Minister Stubb has continued the economic policy of its predecessor and its programme is based on the programme of Prime Minister Katainen's Government. During the 2011–2014 parliamentary term, the priority in the Government's economic policy has been on the reduction of the central government deficit and the central government debt-to-GDP ratio.

Debt and deficit objectives laid out in the Government Programme

Turning the central government debt-to-GDP ratio into a clear downward trend by the end of the parliamentary term is the main fiscal policy objective laid out in the Government Programme. The Government will introduce additional adjustment measures if there are no signs of this and the central government deficit is likely to remain more than one per cent of the GDP. As laid out in the Government Programme, the conditional measures affecting revenues and expenditure will be applied in equal proportions. The conditional measures would involve additional freezing and adjustment of central government expenditure and government aid to municipalities, additional tax increases and reducing the number of tax deductions. The timing of the measures will be on the basis of ensuring that, if possible, they will be introduced early in the parliamentary term and that they are correctly timed so that the adjustment will not weaken the basis for future economic growth.¹

As laid out in the Government Programme, the need for additional adjustment in revenue and expenditure has been examined as part of the spending limits discussion each spring. Numerically, the one per cent deficit rule laid out for the 2011–2014 parliamentary term has been stricter than the rule introduced in the previous parliamentary term. The strict deficit rule has proved a challenging objective during a period of weak economic growth. The prolonged debt crisis in the euro area and the renewed escalation of the situation in spring and summer 2012 led to a weakening of the economic outlook. As a result, it became highly unlikely that the deficit objective laid out in the Government Programme would be achieved during the 2011–2014 parliamentary term. Likewise, as part of its mid-term policy review, the Government abandoned the deficit objective of 2.5 per cent laid out for central government finances in the previous parliamentary term. This was because of

Weak economic growth has made it difficult to comply with the deficit and debt rules concerning central government finances

the downturn resulting from the debt crisis in the euro area following the financial crisis.

In fact, during the 2011–2014 parliamentary term, the priority has been on putting the central government debt-to-GDP ratio on a downward trend. The Government has also failed to achieve this objective. Faster economic growth, which was set as an objective in the Government Programme, would have made it easier for the Government to put the central government debt-to-GDP ratio on a downward trend. However, structural changes in the Finnish economy, continuing uncertainty in the world economy and especially the prolonged downturn in the euro area made it impossible to achieve the objective during the parliamentary term.

The scale of the adjustment measures has been based on the forecast for economic growth in the coming years presented by the Ministry of Finance each spring. Economic growth in 2012 and 2013 was weaker than expected, which means that the adjustment measures have proved inadequate for achieving the objectives. Achieving the deficit and debt objectives laid out in the Government Programme would have required adjustment measures well beyond those that were implemented during the parliamentary term.

It should be noted, however, that during a period of weak economic growth strict balance rules may lead to a pro-cyclical fiscal policy. For this reason, the National Audit Office is of the view that there have been good grounds for not complying with the deficit rule during the 2011–2014 parliamentary term.

Spending rule laid out in the Government programme and spending limits for the 2012–2015 parliamentary term

The spending rule laid out in the Government Programme and, consequently, central government spending limits are an important part of the regulatory framework of Finland's national fiscal policy. The Government commits itself to observing the spending rule laid out in the Government Programme and the first spending limits decision of the parliamentary term based on it. Under the spending rule laid out in the Government Programme, in 2015 the expenditure under the spending limits should, in real terms, be 1.2 billion euros lower than the expenditure under the technical spending limits (the last spending limits laid out in the preceding parliamentary term) approved on 23 March 2011.

The level of the spending limits has been lowered during the current parliamentary term. This means that, as part of the adjustment measures, the spending rule has been tightened each spring after the first spending limits decision of the parliamentary term.

There were good grounds for abandoning the deficit objective for central government finances

Readiness to reduce spending limits has been important for the credibility of the fiscal policy

In net terms, the adjustment of expenditure during the 2011–2014 parliamentary term has amounted to about three billion euros (at 2015 level). The readiness to lower the level of spending limits has been important for the credibility of the Government's fiscal policy even though at the same time achieving the debt and deficit objectives has become increasingly difficult during a period of lower than expected economic growth.

Compliance with central government spending limits is detailed in the Government's annual report. The National Audit Office has audited compliance with central government spending limits each year. The audits have covered the spending limits decisions, budget proposals and the budgets themselves with their drafting material, and financial statements. Based on the audit findings, the conclusion is that the central government spending limits have been complied with in the 2012 and 2013 budget years. The National Audit Office has also made spending limits calculations for the years 2014 and 2015. The calculations show that the expenditure in the state budget and supplementary budget proposals for these years submitted to Parliament has been in accordance with the spending limits.

As for the spending limits calculations for 2015, the conclusion was that the discretionary appropriation specified in the spring 2014 spending limits decision was negative. This was because the Government had decided to allocate a total of 150 million euros generated by the sales of shares for financing its growth package. Under the spending rule laid out in the Government Programme, if the revenue from the sale of shares exceeds 400 million euros, a maximum of 150 million of the excess can be spent on one-off measures promoting growth. The National Audit Office examined whether 550 million euros in revenue from the sale of shares had been entered in consolidated accounting, as required under the spending rule. It was noted that only about 147 million euros in revenue from the sale of shares had been entered in consolidated accounting. The proceeds are from the sale of Destia.

The Ministry of Finance has determined that the revenue also include proceeds of 450 million euros from the sale of shares that Solidium Oy has transferred to the state. According to the interpretation of the Ministry of Finance, the proceeds from the sale of shares may, under the spending rule, include sales of shares by the state and sales organised by Solidium Oy, which is wholly owned by the State of Finland. According to the information obtained in the audit, the sales of Sampo shares in February 2014 account for 450 million euros of the 900 million in dividends transferred by Solidium Oy to the state on 26 August. In the view of the National

The spending limits system should have clear rules for dealing with the state's corporate assets

Audit Office, the Ministry of Finance interprets the spending rule in a flexible manner when it considers the sales of Sampo shares as sales of state-owned shares even though it is Solidium Oy that is carrying out the sale. The Ministry of Finance can, however, justify its decision by pointing out that the company is wholly owned by the state and comes under the state sector in the national accounts. This means that the debts accumulated by the company are considered part of central government debt. The spending limits system should have clear rules for handling the assets held by the state in companies and the items of the companies.

The National Audit Office also draws attention to the fact that two exceptions have been made to the spending rule during the 2011–2014 parliamentary term. The first exception was made in connection with the spring 2012 spending limits decision when it was decided that the proceeds of the public broadcasting tax introduced in 2013 would be transferred to an off-budget fund. Treating the earmarked revenue of the public broadcasting tax as off-budget expenditure was an exception to the spending rule and previous practice. Under the spending limits rule laid out in the Government Programme, certain expenditure, especially the expenditure varying in accordance with cyclical trends, is outside the scope of the spending rule. Treating the proceeds of the public broadcasting tax as an off-budget entity is not comparable with treating it as expenditure outside the spending limits. The second exception was made in 2014 when it was decided to transfer the proceeds of the bank tax (which will enter into force in 2015) into a fund outside the spending limits.

It is clearly stated in the 2013 and 2015 state budget proposals that both cases are exceptions to the spending rule. However, no justification for the exceptions have been given. The National Audit Office takes a positive view of the fact that the Government is transparent about the exceptions. The purpose of the spending rule is to limit the total expenditure payable by the taxpayers. For this reason, spending limits can only be used as an effective fiscal policy management tool if they are applied as extensively as possible. For this reason, there are grounds for taking a negative view of the exceptions to the spending limits system.

Exceptions to the spending limits rule should be rejected

1.3 Compliance with the fiscal policy rules of the EU that are binding on Finland

Debt and deficit rules laid down in the Stability and Growth Pact

Finland has complied with the debt and deficit rules of the Stability and Growth Pact during the 2011–2014 parliamentary term. However, Finland is only able to meet the three-per-cent rule concerning general government finances because of a surplus in its social security funds.

Under the Stability and Growth Pact, general government debt should not be more than 60 per cent of the gross domestic product, while general government deficit should not be more than three per cent of the gross domestic product. Medium-term trends in Finland's general government deficits and debts according to the latest forecasts published by the Ministry of Finance, Bank of Finland and the European Commission are shown below.

Table 1: General government fiscal balance ²

% of GDP	2012	2013	2014*	2015*	2016*
MoF	-2,1	-2,3	-2,7	-2,4	-1,7
BoF (edp)	-2,2	-2,4	-2,6	-1,6	-1,4
EC	-2,1	-2,4	-2,9	-2,6	-2,3

Table 2: General government debt ³

% of GDP	2012	2013	2014*	2015*	2016*
MoF	53	55,9	59,6	61,2	62,1
BoF (edp)	53,6	57	60,3	61,6	62,9
EC	53	56	59,8	61,7	62,4

The tables show that according to the latest forecasts Finland is not in danger of breaching the deficit rule of the Stability and Growth Pact. The adjustment measures implemented during the parliamentary term have helped to slow down the growth of general government deficit. At the same time, all forecasts suggest that the debt threshold of 60 per cent laid down in the Stability and Growth Pact will be exceeded in 2015. However, exceeding the debt threshold will not directly lead to the excessive deficit pro-

cedure as the Commission gives consideration to the support provided to euro area countries as part of solidarity operations and weak economic growth when it makes its assessment. Nevertheless, the European Commission will probably prepare a report on the exceeding of the debt limit, as laid down in Article 126(3). Finland has already been the subject of two such reports (in autumn 2013 and spring 2014). According to the reports, despite exceeding the reference value Finland is in compliance with the debt criterion laid down in the Stability and Growth Pact. This is because of the support provided to euro area countries as part of solidarity operations and weak economic growth.

In Finland, social security funds, which are in surplus, are also considered part of general government. However, in recent years, the funds have no longer accumulated surpluses in the same scale as before, a result of the growth in pension expenditure. It should be noted that the surplus of the social security funds is not used for reducing general government debt. Deficits in central and local government are the main factors increasing general government debt. In spring 2014, the National Audit Office presented a fiscal policy monitoring report (K 15/2014 vp.), in which NAOF highlighted its concern that this will lead to a situation where general government debt fails to reflect the changes in general government fiscal deficit. Thus achieving the overall general government deficit objective does not guarantee that Finland's general government debt will remain within the limits laid down in the Stability and Growth Pact. The fiscal deficit rules can only keep the debt under control if the rules apply to the combined fiscal deficit of central and local government.

The table below shows the trends in combined central and local government fiscal deficits, as presented in the latest forecasts of the Ministry of Finance and the Bank of Finland.

Table 3: Combined fiscal balance of central and local government ⁴

% of GDP	2012	2013	2014*	2015*	2016*
MoF	-4,8	-4,3	-4,2	-3,7	-3,4
BoF (edp)	-4,9	-4,5	-4,4	-3,5	-3,3

The table shows that the combined central and local government deficit exceeds the three-per-cent deficit limit laid down in the Stability and Growth Pact. This means that Finland is only able to comply with the three-per-cent rule laid down in the Stability and Growth Pact because of a surplus in its social security funds.

Surplus in social security funds allows Finland to comply with the deficit rule of the Stability and Growth Pact

Achieving the medium-term objective (MTO)

As part of its fiscal policy monitoring task, the National Audit Office evaluated compliance with the Stability and Growth Pact in spring 2014. According to the assessment, Finland complied with the Stability and Growth Pact in 2013. However, there may be a significant deviation in the structural balance in 2014, if economic growth is slower than expected. According to the forecast produced by the Ministry of Finance in autumn this is indeed the case; the deviation is significant and the structural balance is no longer on the path towards the medium-term objective. Likewise, according to the forecast published by the Bank of Finland in summer 2014, the medium-term objective will not be achieved.

In spring 2014, the National Audit Office also drew attention to the fact that in the future, the general government expenditure benchmark will probably be stricter than at present. This is because of a slowdown in the growth of potential output. A stricter expenditure benchmark will mean that there is very little room for real growth in general government expenditure.

Economic growth has direct impact on the estimate on structural balance. Structural balance contains cyclical adjustment but it is nevertheless sensitive to changes in nominal deficit. This can be simplified by saying that structural balance is nominal deficit minus cyclical deficit.

Economic growth forecasts will change as more information becomes available. Updated growth forecasts will also impact the forecast on nominal fiscal deficit. Thus, the slower than expected economic growth is reflected in this forecast and, consequently, in the structural balance forecast. For this reason, the correction of the Ministry of Finance's growth forecast for this year led to the development seen in autumn in which the ministry's estimate of the general government structural balance changed substantially from what had been presented in spring.

In addition to the nominal fiscal deficit, an estimate of cyclical deficit is also required in the calculation of the structural balance. Defining the cyclical balance requires an estimate of the output gap and, consequently, of the potential output. The estimate of potential output helps to predict the level of gross domestic product in a situation where the economy is stagnating. The output gap is the difference between actual gross domestic product and potential output. Calculations of potential output involve a great deal of uncertainty and they are extremely sensitive to assumptions. For this reason, estimating the size of the output gap is the greatest uncertainty factor in the calculation of the structural bal-

According to domestic estimates, there will be a substantial deviation from the structural deficit in 2014

ance. The National Audit Office has on several occasions highlighted the uncertainty in the estimates of potential output (K 21/2010 vp. and K3/2013 vp.).

According to the estimates made in autumn 2014, both the growth in potential output and GDP growth had slowed down compared with the forecasts made in spring 2014. As a result, the output gap has remained unchanged, while at the same time the growth in nominal deficit manifests itself as growth in structural deficit. In Finland, a prolonged downturn seems to have led to a situation where the deficit, as calculated on this basis, is of structural nature.

It should be noted, however, that during the last few decades, the structural deficit has closely followed the EDP deficit. In other words, cyclical fluctuations would only explain a small proportion of the changes in fiscal deficit as they are, according to the interpretation of the calculation framework used, of structural nature or a result of a discretionary fiscal policy. Output gaps have been too small to explain a larger proportion of the changes in fiscal deficit (VTV 13/2013).

The figure below (Figure 1) shows EDP deficit and structural balance between 1975 and 2013. It shows that during the recession of the 1990s and the downturn that started in 2008, the structural deficit was substantially larger than the EDP deficit. This means that the deficit is partially of cyclical nature. However, it can be concluded that the structural deficit in Finland has closely followed changes in the EDP deficit, which means that in the long term a large proportion of the deficit can be interpreted as a structural phenomenon. This means that an economic recovery will not eliminate the deficit.

Substantial negative shocks may cause a permanent slowdown in the growth of potential output. It is still too early to say whether we are witnessing a permanent change in the Finnish economy or whether it is the question of a prolonged cyclical phenomenon.

In the long-term, most of the deficit in Finland's general government finances can be interpreted as a structural phenomenon

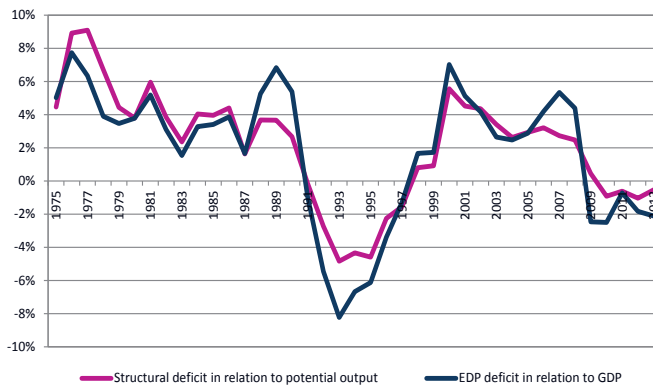


Figure 1: EDP deficit and structural deficit 1975-2013⁵

As part of its fiscal policy monitoring task, the National Audit Office will also assess how well EU rules and the manner in which they are interpreted are applicable to Finland. In this work, consideration will also be given to the manner in which potential output is calculated.

The National Audit Office will produce its next assessment of compliance with the Stability and Growth Pact and the replication of the structural balance and expenditure benchmark used in this assessment on the basis of the review of the spring 2015 stability programme.

General government structural balance in the estimates produced in autumn 2014

The Figure 2 below shows the estimates of structural balance presented by the Ministry of Finance in spring and autumn 2014. The figure shows that the updated view of future economic growth has had a substantial impact on the estimates of the structural balance.

On its plenary session on 2 October 2014, the Government adopted a resolution and issued an estimate of the significant deviation endangering the achievement of the medium-term objective concerning the structural fiscal position of general government. According to the estimate, the significant deviation in the structural financial position of general government which is endangering the achievement of the medium-term objective means that the structural measures helping to close the general government sustainability gap on which the Government has decided in its structural policy programme must be fully implemented.

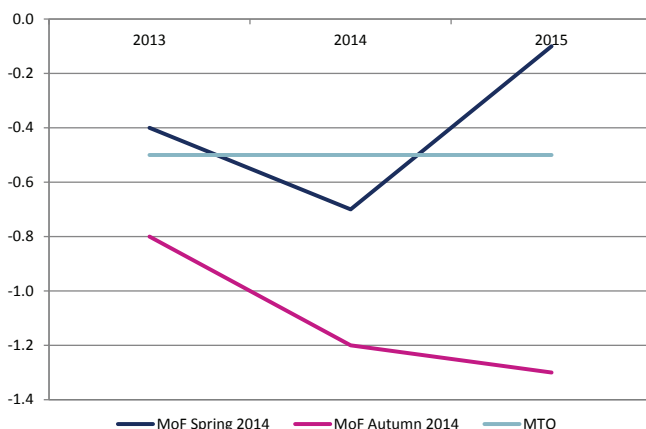


Figure 2: Structural deficit forecasts presented by the Ministry of Finance in spring and autumn 2014 ⁶

In accordance with its fiscal policy monitoring task, the National Audit Office has assessed the Government resolution issued on 3 October 2014.⁷ The National Audit Office is of the view that the Government resolution is in the spirit of the Fiscal Policy Act. In its assessment, the National Audit Office emphasised that it is extremely important to implement the structural policy programme.

Thus, according to the autumn estimate of the Ministry of Finance, there will be a significant deviation in the structural balance and the structural balance is no longer on a path towards the medium-term objective.

In its autumn 2014 assessment, the European Commission took a different view of the trends in Finland's structural balance than the Ministry of Finance. Figure 3 shows Finland's structural balance according to the estimates produced by the European Commission in spring and autumn 2014.

According to the autumn forecast of the European Commission, there will not be any significant deviation in the general government structural balance in 2014. This is in contrast to the estimates produced by the Ministry of Finance. The objective was reached in 2013, which means that change required for 2014 is zero. According to the autumn forecast of the European Commission, Finland had a structural deficit of 0.7 per cent of the gross domestic product in 2013. For 2014, the Commission is forecasting a structural deficit of 1.1 per cent. Thus, the change would be -0.4 percentage points, which is not a significant deviation from what is required.

The revised view of the economic growth is reflected in the estimates of the structural balance

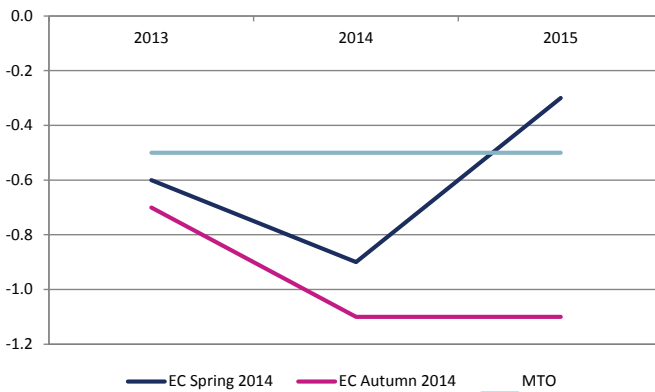


Figure 3: Structural balance forecasts presented by the European Commission in spring and autumn 2014⁸

Moreover, Finnish GDP growth was negative in 2014. Based on an overall assessment, the conclusion is that the European Commission will not, in its preliminary budget plan assessment, warn Finland of a significant deviation from the general government medium-term objective

According to the European Commission, there is no significant deviation in Finland's structural balance

Suitability of the new EU rules from the Finnish perspective

Closer coordination of economic policy in the EU has led to the tightening of the fiscal policy rules and their supervision. Fiscal policy rules and objectives must be transparent and easy to interpret. In this respect there are problems with the medium-term objective (MTO), which has been set for general government finances as a whole and which is based on structural balance terms. As already stated before, there are many uncertainties concerning the calculation of the structural balance.

Appropriate bodies must be able to monitor compliance with the rules so that the problems with interpretation will not generate incentives for circumventing the rules. Credibility of the rules will suffer if exemption clauses are used as a general argument for circumventing them and if the exemption clauses leave room for interpretation.

Generally speaking, it can thus be said that the implementation of the new rules concerning general government finances in the Member States, especially those promoting the stability of fiscal policy, is also in Finland's interest. For creating a basis for economic growth in Finland, it is important that the uncertainty affecting the European economy can be eliminated. A credible fiscal policy is of great value as a factor reducing such uncertainty. Failure to comply with the new regulation that has now entered into force would significantly weaken the credibility of the fiscal policy.

The new fiscal policy rules of the EU will limit Finland's room for manoeuvre in its fiscal policy and complying with the stability programme might slow down Finland's economic growth if it becomes necessary to adjust general government finances in a situation characterised by slow economic growth. It should be noted, however, that in Finland's case, the new EU rules are not the main reason for stabilising general government finances and introducing structural reforms. Because of an ageing population and structural changes in its economy, Finland is in any case in a situation where general government expenditure is in danger of exceeding revenue in the long term.

Credibility of the fiscal policy rules will suffer if they are not generally complied with

1.4 Stabilising general government finances

The focus of the Government Programme was on the stabilisation of general government finances. The Government has failed to achieve this objective. The adjustment measures have slowed down the growth of deficits but have failed to stop the growth of the central government debt-to-GDP ratio. The process of implementing the measures aimed at closing the sustainability gap in general government finances during the 2011–2014 parliamentary term has been extremely slow. Moreover, the measures have only been partially implemented.

The structural policy programme adopted on 29 August 2013 is the instrument by which the Government has aimed to eliminate the structural deficit. The programme was made more specific and a decision on its implementation was made on 29 November 2013. The Government strengthened the decisions made as part of the structural policy programme in its spending limits discussions in spring 2014 and in its budget session on 28 August 2014.

In the programme, the overall goal of eliminating the sustainability gap has been divided into following subgoals:

- 1 local government finances will be balanced
- 2 productivity of public service provision will improve
- 3 working careers will be extended and supply of labour will increase
- 4 structural unemployment will decrease
- 5 output potential of the economy as a whole will grow.

The National Audit Office is of the view that the Government's structural policy programme is an important tool in stabilising general government finances. Even though the subgoals laid out in the programme are good, the measures for achieving them have not been adequate.

The National Audit Office has drawn attention to the fact that especially the reduction of local government tasks, the purpose of which is to balance local government finances, has made only slow progress. One aim of the programme is a reduction of the tasks of municipalities by one billion euros at 2017 level. In spring 2014, it was possible to include about a third of these savings in 2015–2018 central government spending limits. In other respects the proposals were not yet concrete enough so that it would have been possible to assess their impacts.

Efforts to stabilise general government finances have failed

The Government strengthened the implementation of the programme in its autumn 2014 budget session. However, few of the programme goals have been translated into concrete measures. Moreover, it is very difficult to see how the goals presented in the programme can be achieved with the measures laid out in the document. By its autumn budget session, the Government had only been able to specify savings of about 350 million euros in local government expenditure.

In spring 2014, the National Audit Office pointed out that it takes time to implement the reforms and make the measures effective. For this reason the programme should be implemented and translated into concrete action without delay. Even if they are implemented, any reforms would only have a medium-term impact. Many of the decisions will now have to be made by the next Government.

In practice the savings envisaged in the structural policy programme can be included in the spending limits and budget proposals as accurate information on the measures and reliable estimates of their impacts become available.

The National Audit Office has monitored the implementation of the structural policy programme in the general government fiscal plan for 2015–2018 and the state budget proposals for 2013–2015. It was found out in the audit that in about half of all structural policy measures requiring supplementary appropriations in which appropriations had been adjusted, the adjustments had been made by reallocating budgetary appropriations. In its interim fiscal policy audit report (K 2/2013 vp.), the National Audit Office recommended that because only slow economic growth is expected the reforms should be carried out by means of reallocations within the spending limits.

In a situation characterised by slow economic growth, it is not possible to implement the reforms by means of supplementary appropriations. The National Audit Office takes a positive note of the fact that the carrying out of the reforms set out in the structural policy programme has proceeded in accordance with this principle. The principle is also laid out in the programme itself.

In a period of slow growth, correct measurement of expenditure in relation to the revenue becomes more important. In its interim fiscal policy audit report (K 2/2013 vp), the National Audit Office recommended that spending reviews should be introduced as a basis for expenditure adjustment before the end of the parliamentary term.

Detailed spending reviews become more important if the aim is to achieve substantial reductions in expenditure. Most of the expenditure is closely tied with legislation, which means that expend-

The process of reducing local government tasks has made only slow progress

Decisions and implementation will be left to the next Government

Implementing the reforms by means of reallocations is justified

iture adjustment would require legislative measures. Spending reviews should cover the entire general government finances. Such background work would have been of great value in the reduction of local government tasks and obligations set out in the structural policy programme. It has proved difficult to find savings within a short period of time.

The Ministry of Finance started a general government expenditure and structural survey project in summer 2014. The aim of the project is to produce a system description of general government expenditure and an assessment of the effectiveness of the expenditure. Even though the project involves general government expenditure, it only covers the expenditure financed solely by the state or expenditure jointly financed by the state and a central government actor. This means that there will not be any comprehensive examination of local government tasks and obligations in this project.

The National Audit Office recommends that there should be spending reviews covering the entire general government in the coming parliamentary term.

The slow pace of the structural reforms and the weak outlook for the Finnish economy prompted one of the three credit rating agencies to lower Finland's credit rating. Under the Government Programme, the aim of Finland was to ensure that all credit rating agencies would keep Finland's credit rating at AAA. Even though the lowering of the credit rating did not have any immediate effects on the access of the State of Finland to financing it nevertheless demonstrates the need for a clear and credible fiscal policy.

Tightening the fiscal policy is problematic during a prolonged downturn. In the current situation, spending cuts and tax increases may weaken economic growth prospects. Most of the negative effects of the adjustment measures on economic growth can be seen in the short term. Structural policy reforms may also weaken economic growth in the short term. Structural reforms are nevertheless important for increasing the future output potential of the economy.

Spending reviews covering the public sector as a whole are needed

Additional adjustments are not unproblematic in a situation where the downturn is continuing

1.5 Economic forecasts and fiscal policy framework in the 2011–2014 parliamentary term

In fiscal policy planning and the laying out of the fiscal policy framework, consideration should be given to the long-term outlook and structural factors affecting the Finnish economy. The fiscal policy framework laid out in the Government Programme of Prime Minister Jyrki Katainen's Government was based on the growth envisaged at the time when the programme was prepared. It is also stated in the Government Programme that the Government will take determined and swift action to balance central government finances and to deliver stronger than expected economic growth.

Stronger than expected economic growth would have made it easier to achieve the objectives set. There were no grounds for setting stronger than expected economic growth as an objective for the Government Programme in a small and open economy like Finland, which is extremely sensitive to external shocks. The long-term challenges facing the Finnish economy were already well-known when the Government Programme was being written.

Complying with extremely strict fiscal balance rules is difficult if the economic growth is significantly below expectations. It should be possible to temporarily deviate from the balance rules on cyclical grounds without any damage to the credibility of the fiscal policy. However, the deviations should be well-justified. The rules should be such that they support the balancing of central government and general government finances in the medium and long term. In the planning of the fiscal policy framework for the coming parliamentary term, particular consideration should be given to the challenges to Finland's national economy arising from long-term structural factors.

Economic forecasts are inaccurate

In the domestic debate, the Ministry of Finance has been criticised for presenting economic forecasts in which the predicted growth rates are below the actual figures. According to the critics, this leads to strict central government spending limits and, consequently, to a situation where there is little room for manoeuvre in the discretionary fiscal policy. A comparison made by the IMF also suggests that, on average, the forecasts produced by the Ministry of Finance between 1998 and 2007 were pessimistic.⁹ In the 2011–2014 parliamentary term, the situation has been the opposite as the actual economic growth has repeatedly been weaker than expected.

Structural factors and long-term economic growth must be taken into account in the next parliamentary term

Commissioned by the Parliamentary Audit Committee, Pellervo Economic Research PTT conducted a study on the accuracy of the budgetary tax revenue forecasts between 1998 and 2007. The conclusion was that even though the economic forecasts produced by the Ministry of Finance and used in the preparation of fiscal policy have been inaccurate, the forecasts made by the ministry have not been better or worse than those produced by other Finnish forecasting agencies. Difficulty in anticipating cyclical turning points has been the biggest source of inaccuracy in the forecasts. On average, GDP growth during periods of rapid economic growth has been underestimated, while GDP growth during economic downturns has been overestimated. The difficulty in anticipating turning points in overall economic trends has also been noted in international studies.

Figure 4 shows the spring and autumn forecasts of the Ministry of Finance against actual growth in 2008–2013. The forecast cover the two years after the latest actual figures. For example, in the forecasts made in spring and autumn 2008, the latest actual figures were from 2007. Figure 4 shows the forecasts by means of dashed lines and they give the GDP growth predicted for the two years following the presentation of the forecasts. Figure 4 also shows that, as a rule, GDP growth during periods of rapid economic growth between 2008 and 2013 has been underestimated, while at the same time, growth rates during a downturn has been overestimated. During the 2011–2014 parliamentary term, forecasts have overestimated economic growth every year.

It is difficult to anticipate turning points



Figure 4: Spring and autumn forecasts produced by the Ministry of Finance against actual growth in 2008–2013¹⁰

Figure 5 shows the revisions to the forecasts for 2013 produced by the Ministry of Finance and the Bank of Finland between 2011 and 2013 during successive forecasting rounds against actual growth.

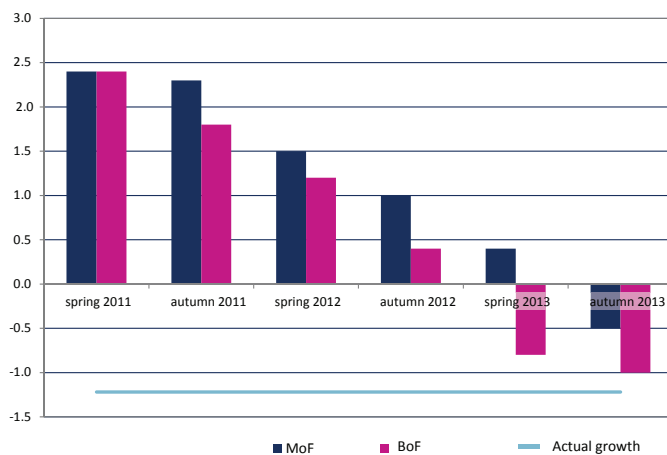


Figure 5: Corrections to the economic forecasts for 2013 produced by Ministry of Finance and the Bank of Finland ¹¹

The figure shows that both the Ministry of Finance and the Bank of Finland were still too optimistic about the economic growth for 2013 in the forecasts made in the same year. The economic forecast for 2013 produced by the Ministry of Finance in the spring of the same year still predicted positive growth for the year. However, the manner in which the forecasts are corrected also depends on when they are published. This is because the Ministry of Finance publishes its forecasts before the Bank of Finland.

It is clear that any forecasting agency can produce inaccurate cyclical growth forecasts. For this reason, there should not be too much attention on the accuracy of point forecasts. When the accuracy of point forecasts is assessed, it is easily overlooked that a forecast is the sum of impacts generated by overall economic and fiscal policy variables. From the perspective of fiscal policy planning and framework, it would be more important to consider medium-term and long-term analyses.

For this reason, the National Audit Office recommends that in the planning and laying of the fiscal policy framework for the next parliamentary term, consideration should be given to the long-term prospects of the Finnish economy and the structural factors affecting economic growth.

There should not be too much attention on the accuracy of point forecasts

2 Implementing tax policy

2.1 Summary of the findings

Indirect taxes were increased in all areas, which was mainly the result of the adjustment measures affecting general government finances. Likewise, contrary to what had been set out in the Government Programme, there were small increases in the taxation of labour. The taxes of many entrepreneurs were lowered, however. Corporate taxes were lowered, while capital income taxation increased. Except for the tightening of the taxation of labour, these trends can generally be considered to be in accordance with expert recommendations.

The aim of the Government was to broaden the tax base. The number of tax subsidies, which has a major impact on the tax base, remained largely unchanged during the government term. The Government also introduced a small number of measures that broadened the tax base but also created new exemptions.

In the view of the National Audit Office, there was no simplification of the Finnish tax system during the term of Prime Minister Jyrki Katainen's Government. For example, despite the tax reform, lack of neutrality remains the dominant feature of the Finnish system of corporate and capital income taxation. The dividend tax system remains complicated. At the same time, there are several different deductions that can be made from income and capital income taxes. For taxpayers, this is not a transparent system and taxpayers are not able to make use of all the deductions. This remains a problem even though a large proportion of the deductions are made ex officio by the tax authorities without a separate request by taxpayers.

According to the audit findings, when decisions on taxation have been made, there has been no systematic consideration of the tax system as a whole. Decision-making has also been characterised by a certain degree of unpredictability. Decisions have been made and cancelled. However, from the perspective of a credible fiscal policy and corporate decision-making, predictability and systematic approach are important.

In the view of the National Audit Office, more consideration in the political decision-making process should be given to the preparatory work carried out by public servants. A more thorough preparatory process would help to keep the tax system under better control, the tax base more cohesive and the system simple. In

particular, there should be a critical examination of tax subsidies.

It is important to examine the tax system as a whole on a regular basis. The Ministry of Finance should produce extensive expert surveys each parliamentary term well before the elections. The surveys should include an assessment of how the tax policy and the tax system as a whole should be developed.

In the view of the National Audit Office, the general policies and main objectives concerning the tax policy should be set out in the Government Programme. The Government Programme should not be too detailed in this respect. Shifting the emphasis of taxation to the taxation of consumption can be considered a correct approach. At the same time, however, the new limitations to taxation of consumption arising from economic restructuring and digitalisation should also be considered.

2.2 Tax policy in the programme of Prime Minister Jyrki Katainen's Government

The Government of Prime Minister Jyrki Katainen included a large number of taxation-related targets in its programme. The aim was to use the tax policy both as a traditional fiscal instrument and a tool for strengthening the sustainability of general government finances and achieving economic growth. In its programme, the Government stated that it would broaden the tax base and lower the taxation of labour and enterprises. The Government also set a number of other tasks for taxation.

The Government aimed to balance central government finances and boost growth and employment through tax policy. According to the Government's tax policy, the basic objective of taxation is to ensure adequate financing for the delivery of welfare services and at the same time to achieve balance in central government finances. The tax base will be broadened with a view to strengthening central government finances. The level and structure of taxation will be revised with a view to fostering economic growth, employment and entrepreneurship. By introducing tax measures supporting economic growth and employment, the Government aims to create an attractive and smoothly functioning environment and strengthen competence.

Fair and ecological taxation is also one of the aims laid out in the Government Programme. Taxation will be used as an instrument for making production and consumption more environmentally sustainable and health-motivating. The Government will act to ensure that taxes on labour do not increase during the parliamentary term.

The tax policy measures set out in the Government Programme are not linked with the overall objectives of the document. This is partially because of the adjustment measures aimed at balancing central government finances.

The objectives set out for taxation can only be achieved in their entirety if the implementation of taxation is carefully planned. When the Government puts forward a proposal for a tax reform it should at least state the most important objectives for the reform. Or it should, as part of the overall objectives, detail the tax changes that will help to achieve the objectives. This would make tax solutions more acceptable and transparent and create a situation where practical changes in taxation would reflect the main taxation trends.

The Government aimed to promote economic growth, employment and entrepreneurship by means of tax policy

The Government also aimed to make taxation fair and ecological

The link between the overall objectives set out in the Government Programme and the tax policies laid out in the document is not transparent

In fact, from the economic policy perspective, taxation policy decisions should in the future be derived from long-term fiscal policy objectives. The Government Programme and the first general government fiscal plan of the parliamentary term to be prepared after it should lay out the general policies and main objectives. At the same time, the manner in which individual tax changes are connected with the achievement of more general objectives should be described and assessed in the rationale of Government proposals.

Practically all tax changes promised in the Government Programme were implemented in the 2011–2014 parliamentary term though not all of them were put into effect in the manner envisaged in the Government Programme. Detailed implementation of the changes in capital income and corporate taxation differed from what had been set out in the Government Programme, while at the same time, the Government introduced tax changes that had not been mentioned in the Government Programme.

One of the most important tax changes during the government term was the raising of VAT rates by one percentage point. Central government finances were used as the justification for the measure, as the economic situation was becoming worse than anticipated.

Principles of a good tax system

The National Audit Office has assessed the tax changes made during the 2011–2014 parliamentary term from the perspective of the principle of a good tax system.

According to the economic theory, the tax system should be simple, neutral and in accordance with overall needs of the national economy. According to economics literature, the tax system should be examined in its entirety. The most important aim is to find the appropriate tax policy instruments for achieving the desired objectives. This is closely connected with the effectiveness of taxation or a situation where the tax revenue can be collected so that there is only minimum market distortion and the system supports economic growth and secures an adequate amount of tax revenue for the provision of public services. The third main feature is neutrality. A good tax system treats similar economic activities in the same manner. A neutral system usually also means a simple system that treats individuals in a fair manner and reduces welfare losses.

Moreover, a tax system should be foreseeable so that economic actors can plan their activities on a long-term basis.

Taxation should support economic growth and work so that the prerequisites for the welfare state can be maintained and the general government sustainability gap can be closed. Lowering the taxation of labour helps to cut the tax wedge, which provides

Most of the tax changes set out in the Government Programme have been implemented but the adjustment of general government finances has required additional changes

A good tax system must be foreseeable

more incentives for work and providing work. To support economic growth, corporate and capital income taxation should be competitive so that the prerequisites for entrepreneurship can be maintained. However, the general government sustainability gap does not allow the lowering of the overall tax burden without limitations. For this reason, particular consideration should be given to the taxation elements providing incentives and boosting economic growth. A broad tax base should also be maintained.

2.3 Assessing tax changes – indirect-taxation

Indirect taxes were increased several times during this government term. In most respects, this can be considered in accordance with economic theory and expert recommendations (Mirrlees Review 2011, Verotuksen kehittämistyöryhmä 2010a, 2010b) as the raising of consumption taxes is considered less harmful than the raising of other taxes. Taxing consumption may simplify the tax system and make it more effective. Secondly, taxing consumption does not distort taxation of savings, which means that the harmful impacts on economic growth arising from the reduction of capital can be avoided.

According to the literature on economic theories, the most effective way to collect indirect taxes would be to introduce a uniform VAT rate treating all items in the same manner. In the tax theory, a deviation from a uniform VAT rate is recommended on following grounds: i) it will help to correct externalities, in which case a deviation from a uniform tax rate will improve economic efficiency; ii) consumers are assumed to be in need of "guardianship" (paternalism); and iii) it will increase the supply of labour by increasing the relative price of leisure time. Taxation of consumption also has negative effects. Empirical observations (Dynan et al. 2004) have shown that high-income earners save more than low-income earners over the life cycle, which will result in regressive taxation of consumption. Secondly, taxing consumption distorts the decision concerning the supply of labour.

Taxation of consumption should be simple and transparent

Indirect taxes were increased

Adjustment measures have been one reason why indirect taxes were increased during the 2011–2014 parliamentary term. Most of the increases took place in 2011 and 2013. The changes also reflect the objective set out in the Government Programme under which the emphasis of taxation will be shifted to taxation of consumption. The shift can be considered to be in accordance with expert recommendations. At the same time, however, the changes have failed to simplify the system.

The table below presents a summary of the changes in indirect taxation during the 2011–2014 parliamentary term. The table shows the Government proposals for changes in indirect taxation submitted before the 2014 state budget proposal. The red arrow pointing upwards denotes tax increases, while the green arrow pointing downwards denotes tax cuts.

Table 4: Changes in indirect taxation during the term of Prime Minister Jyrki Katainen's Government ¹²

Changes in indirect taxation during the term of Prime Minister Jyrki Katainen's government	2011									2012	2013				
	HE 51/2011	HE 52/2011	HE 53/2011	HE 54/2011	HE 55/2011	HE 56/2011	HE 57/2011	HE 94/2011	HE 129/2011	HE 89/2012	HE 109/2013	HE 110/2013	HE 111/2013	HE 140/2013	HE 151/2013
Lottery tax	↑														
Broadening VAT base (newspapers and magazines)		↑													
Changes in agricultural energy tax refund			↓												
Carbon dioxide tax on bio-based transport fuels		↓													
Carbon dioxide tax on diesel oil and petrol		↑													
Level of peat taxes		↑													
Alcohol excise duty			↑												↑
Excise duty on sweets and ice cream				↑							↑				
Excise duty on soft drinks				↑							↑				
Vehicle tax					↑										
Revision of car tax						↑									
Cigarette tax							↑						↑		
Energy taxes on energy-intensive sectors								↓							
VAT rates										↑					
Tax on insurance contributions										↑					
Energy tax											↑				
Introduction of windfall tax														↑	

↑ increasing taxation
 ↓ lowering taxation
 ⇕ no impact

2.4 Assessing changes in taxation – corporate and capital income taxation

Lack of neutrality is a major feature of the Finnish system of corporate and capital income taxation.

There is lack of neutrality between different company forms and sources of capital income. Limited liability companies, cooperatives and other corporations pay corporate taxes on their profits. The dividends that they distribute and the capital gains on shares that they sell are also subject to income taxation at individual level. This means that corporate profits are taxed twice: first as corporate income after which the owners have to pay income taxes on them. In some matters, there are substantial differences between the treatment of partnerships (general partnerships and limited partnerships) on the one hand and corporations and cooperatives on the other and their profits are taxed directly as owners' income. There are differences between the tax treatment of listed and non-listed companies. There is also lack of neutrality in capital income taxation. Dividends receive different tax treatment than profits from selling property.

No clear recommendation for corporate and capital income taxation can be derived from the economic theory. In corporate taxation, consideration should be given to the openness of the economy and the sensitivity to tax competition. High corporate taxes may lead to a low capital base in the areas located at the edges of economic centres, which will slow down economic growth and lower pay levels. International investors may direct investments into countries with low corporate taxation. Moreover, when changes in taxation are introduced, their impacts on effective tax rates (the proportion of profits on which the companies pay taxes) should be assessed.

According to economists, dividend taxation has an impact on the establishment and growth of companies. Dividend taxes may weaken the investment incentives of new and growth companies. The reason for this is that dividend taxes reduce the proportion of equity as companies attempt to finance their investments with taxed profits. As a result, dividend taxes weaken investment opportunities, which in turn leads to lower output.

As shown in Table 5, there were a number of changes to corporate and capital income taxation during the 2011–2014 parliamentary term. With few exceptions, capital income taxes were raised, while corporate taxes were lowered even though a small number of tax deductions were eliminated or narrowed.

The Finnish system of corporate and capital income taxation has been characterised by a lack of neutrality

Dividend taxation affects the establishment and growth of companies

The most important reforms concerning corporate and dividend taxation were made as part of the spending limits decision in spring 2013. The corporate tax rate was lowered by 4.5 percentage points, to 20 per cent, and reforms to dividend taxation were also introduced. When reforming corporate and capital income taxation, the aim of the Government was to cautiously shift the emphasis of corporate taxation from the taxation of assets remaining available to companies towards taxation of assets withdrawn from them. The purpose of these changes was to prompt a growth spurt, make companies more competitive, make them more willing to invest and to promote employment.

There was no simplification of corporate and capital income taxation

Even after the tax reform implemented in 2013, the corporate and capital income tax system is characterised by lack of neutrality. This will lead to higher costs in the economy by weakening the allocation of capital and by providing an incentive for tax planning.

According to the Government proposal concerning the corporate taxation decision (HE 185/2013), the change in taxation is not expected to have any dynamic impacts on economic growth. However, under the spending limits decision of 2013, this was the main aim of the tax reform. In the view of the National Audit Office there is a great deal of evidence in the research literature that the lowering of the corporate tax rate may lead to higher economic growth and more investments, as envisaged by the Government.

The way in which the decision-making process concerning the dividend taxation reform evolved could not be predicted and in the end, few changes were made in the taxation of dividend income. After the dividend taxation reform, non-listed companies are no longer allowed to distribute entirely tax-free dividends. However, this is largely compensated by the fact that the euro-denominated upper limit of the dividends that are subject to tax relief was increased. There are still deficiencies in dividend taxation, such as the lack of neutrality concerning dividend distribution in listed and non-listed companies. Moreover the euro-denominated upper limit to dividends that are subject to tax relief has not been abolished.

In 2014, ETLA and VATT produced a study for the National Audit Office (Määttänen and Ropponen 2014) in which they examined how the changes in taxation have affected investments in non-listed companies. According to the results, the euro-denominated limit to dividends that are subject to tax relief slows down the optimal growth of a company's capital stock. In other words, entrepreneurs are making use of their right to take out more lightly taxed dividends when their companies are growing.

The euro-denominated limit to dividends that are subject to tax relief may slow down the growth in capital stock

At the same time, the limit for dividend returns also provides an incentive for less profitable investments. This is especially the case when the returns limit is high (8%). In other words, companies also have an incentive to make relatively low-profit investments.

Grönberg et al. (2013) have examined the incentives of entrepreneurs to pay salary (dividends) to company owners, in other words, how the income conversion problem has changed. According to the calculations provided as an example, the tax change has provided an added incentive to pay salary with high gross income, irrespective of whether the net assets of the entrepreneur are 300,000 or three million euros. Under the previous system, with high gross income, there were enough incentives to pay a salary of less than 1,000 euros, whereas under the new system, the sum is almost 40,000 euros. Thus, with high income, the problem of income conversion has become slightly less serious. In the lowest income categories, the results are less clear.

Even after the tax reform, the corporate and capital income tax system is characterised by lack of neutrality. This will lead to higher costs in the economy by weakening the allocation of capital and by providing an incentive for tax planning. The fact that in the private sector, resources are spent on tax planning, while in the public sector resources are allocated to combating it is one concrete cost item in this area. These costs would be substantially reduced if the tax system was as simple, neutral and efficient as possible.

The measures taken to reduce the problem of income conversion were not entirely successful

In the end, there were few improvements in the dividend taxation system

Table 5: Changes to corporate and capital income taxation in 2011–2014parliamentary term ¹³

Changes to corporate and capital income taxation in 2011-2014	2011			
	Government Programm	Central government spending limits	HE 50/2011	HE 130/2011
	2011	2012-2015		
1. Corporate tax	↓	↓	↓	↓
1.1 R&D deduction	↓			
1.2 Accelerated depreciation on production investments				
1.3 Abolishing deductibility of entertainment expenses				
1.4 Introducing asset-based depreciations on long-term investments				
1.5 Restricting deductibility of corporate interest expenses				
1.6 Accelerated depreciation on investments in less-developed regions			↓	
1.7 Education deduction				
2. Capital income tax	↑		↑	
2.1.1 Dividend tax (publicly listed companies)	↑		↑	
2.1.2 Dividend tax (other than publicly listed companies)			↑	
2.2 Tax incentive for private investors ("business angel deduction")				
2.3 Higher assumed acquisition cost concerning private investments made in non-listed growth companies				
2.4 Restricting deductibility of housing loan interest			↑	
2.5 Increasing tax at source on interest income	↑		↑	
3. Bank tax	↑	↑		
4. Reducing YEL discounts granted to new entrepreneurs				

*Note Accelerated depreciation may not be applied to acquisition cost of fixed assets to which accelerated depreciation has been applied under the Act on accelerated Depreciation on Investments made in Less-developed Regions. The taxpayer can thus choose under which act it would like to enter the accelerated depreciation if both acts are applicable.

- ↑ increasing taxation
- ↓ lowering taxation
- ↕ no impact

2012							2013			
Central government spending limits	HE 94/2012	HE 118/2012	HE 146/2012	HE 167/2012	HE 175/2012	HE 177/2012	Central government spending limits, 27 March 2013	Corrected central government spending limits, 8 April 2013	HE 95/2013	HE 185/2013
2013-2016							2014-2017	2014-2017		
	↓						↓	↓		↓
	↓					↓	cancelled for 2015	cancelled for 2015		cancelled for 2015
	↓	↓*					cancelled for 2015	cancelled for 2015		cancelled for 2015
							↑	↑		↑
							↑	↑		
			↑				↑	↑		↑
									↓	
							↑	↑		↑
							↑	↑		↑
							↓↑	↑		↑
	↓					↓				
	↓									
							↑	↑		
				↑						
		↑								

Note

HE 50/2011

2.1.1 Dividend tax, publicly listed company At company level, taxes on dividends from publicly listed companies would be one percentage point lower than now. At the same time, however, taxation of dividend recipients would increase slightly. As a result of the changes, taxes on dividends from listed companies would be 40.75 per cent (currently 40.50 per cent). If the proposal to introduce progressive capital income tax becomes law, a dividend recipient with taxable capital income of more than 50,000 euros would pay a tax of 41.80 per cent on the portion exceeding that amount.

2.5 Assessing changes in taxation – taxation of earned income

According to the Government Programme, the focus of taxation will be shifted away from the taxation of labour and entrepreneurship. Taxation of labour means direct taxation of labour such as taxation of earned income and social security contributions. At the same time, corporate and capital income taxation affecting investments can also be considered taxation of labour because ultimately they affect wages and salaries and demand for labour.

In recent expert recommendations (Mirrlees Review 2011, Verotuksen kehittämistyöryhmä 2010a, 2010b), the emphasis has been on lowering the taxation of labour because high taxation of labour lowers employment rates through the demand for and supply of labour. Thus, what is laid out in the Government Programme can be considered to be in accordance with expert recommendations.

In the taxation of earned income, the aim is to find a balance between income distribution and efficiency. When income distribution is made more equal by means of progression, which ensures that high-income earners pay higher taxes than low-income earners, the economy will suffer welfare losses because there are less incentives to work hard and engage in self-development. At the same time, if the progression is very low, it will contribute very little to more equal income distribution. The incentives generated by the joint impact of the taxation of individuals and social benefits has an effect on the supply of labour, which should also be taken into account.

Table 6 shows that the taxation of earned income was both increased and lowered during the term of Prime Minister Jyrki Katainen's Government.

The decisions concerning taxation of earned income have been characterised by a certain degree of unpredictability. For example as part of its spending limits decision in spring 2012 the Government decided to phase the kilometre allowance (HE 88/2012) only to cancel the decision in autumn 2013. In 2011, the Government decided to lower the tax credit for domestic help (HE 50/2011) but two years later, it was raised again (HE 105/2013).

The policy laid out in the Government Programme is in accordance with international expert recommendations

In the taxation of earned income, decisions have been made at short notice

Table 6: Government policies and action in taxation of earned income ¹⁴

Changes in income taxation during 2011 –2014 parliamentary term	2011		2012		2013	
	Government Programme	Central government spending limits	Central government spending limits	Central government spending limits	Central government spending limits	Central government spending limits
2011		2012-2015	2013-2016	2014-2017	HE 181/2013	HE 105/2013
1.1 Tax scale for earned income	↕	↕	↕	↕	↕	↕
1.2 Deduction for work income	↕	↕	↕	↕	↕	↕
1.3 Basic deduction	↕	↕	↕	↕	↕	↕
2. Deduction from housing loan interest	↕	↕	↕	↕	↕	↕
3. Tax credit for household expenses	↕	↕	↕	↕	↕	↕
4. Kilometre allowance	↕	↕	↕	↕	↕	↕

↕ increasing taxation
 ↕ lowering taxation
 ↕ no impact

The overall impact of the taxation of labour and entrepreneurship can be assessed by comparing the state budget proposals for the years 2012–2014. This makes it possible to assess the success of the shift in emphasis. In this assessment, taxation of earned income and capital income and corporate taxation are considered taxation of labour and entrepreneurship. The manner which the Government decisions have impacted taxation priorities in the budget proposals has been included in the calculations.

Comparisons between the 2011 and 2014 state budget proposals show that the proportion of labour and entrepreneurship of all tax revenue has decreased by more than three percentage points, while in some cases the discretionary reduction is more than four percentage points. This suggests that the Government has succeeded in lowering the taxation of labour and entrepreneurship.

If the changes in corporate taxation are not included in the above calculations and only the taxation of labour is considered, the Government has actually increased the taxes on labour. Between 2011 and 2014, discretionary taxation of earned income and capital income in state taxation increased by about one percentage point. At the same time, the average nominal income tax rate in municipalities increased from 19.2 to 19.8 per cent. At the same time, however, the Government increased the deductions from earned income, as a result of which the average effective municipal tax rate remained unchanged in 2011 and 2013. Thus, as a whole, taxation of labour increased, while taxation of at least some entrepreneurs was lowered.

In fact, the impact of municipal taxation should be taken into account in the taxation of earned income. Savings and adjustment in local government finances create additional pressures to increase municipal taxation.

Taxes on labour
were increased

2.6 Decision-making in practice – there is not enough room for through preparation by public servants

According to the observations of the National Audit Office, political decision-making fails to give adequate consideration to the overall picture of taxation, carry out comprehensive effectiveness evaluations or make adequate use of the preparatory work carried out by public servants. Effectiveness evaluations are often only made after final decisions on tax changes or on politically important parameters have been made. As a result, the effectiveness evaluations may be superficial in nature. The second problem is that if the process has already reached an advanced stage without careful preparations, it is difficult to make any decisions that are workable in terms of overall taxation.

In addition to law drafting, the Tax Department of the Ministry of Finance also produces evaluation and background papers at the request of political decision-makers. However, the questions and requests for information are usually very narrow in scope. Political decision-makers rarely request more extensive tax-analyses connected with the development of taxation as a whole. In this respect, little use is made of the expertise of the Ministry of Finance and its Tax Department. The risk is that when decisions are made too much consideration is given to the details at the expense of the system as a whole.

In the view of the National Audit Office, priority has been given to individual measures when decisions have been made, and only rarely to the system as a whole. For example, in its spring 2012 spending limits decision, the Government decided to introduce an R&D tax incentive and tax incentive for business angels. These measures were problematic from the perspective of the overall tax system as they created exemptions to the tax base, which was not in line with the objective set out in the Government Programme. Allocation of the subsidy and administrative burdens may also create problems when decisions on innovation and R&D subsidies are made. The Government decided to cancel the R&D deduction for 2015.

Political steering has not left any room for expert preparation in which consideration is given to the system as a whole

In political decision-making priority is given to targeted measures over policies laying out overall needs

Dividend and capital income taxation reform in spring 2013 was inadequately prepared

As part of its spending limits decision in spring 2013, the Government of Prime Minister Jyrki Katainen lowered the corporate tax rate from 24.5 to 20 per cent. A multi-stage dividend tax reform was also introduced. The Government changed the parts of the spending limits decision concerning dividend taxation (VNS 3/2013) and issued a revised spending limits decision (VNS 4/2013). The biggest change in the revised spending limits decision was the setting of a limit of 150,000 euros for non-listed companies' dividends that are subject to tax relief.

According to the information obtained by the National Audit Office, the Tax Department did not receive a request to carry out thorough preparations of the corporate and capital income taxation. This was in sharp contrast to the spending limits preparations in spring 2012 when the Tax Department prepared a comprehensive set of documents for the Government's spending limits discussion. The preparation in spring 2013 was under a tight schedule and the decision process did not involve any clarifications as a number of options were considered until the end of the preparatory process. Even though the public servants received a large number of requests to calculate the impacts of certain parameters thorough preliminary reports were not requested.

More detailed effectiveness evaluations for the corporate and capital income taxation reforms could have been requested in good time. Political decision-makers could also have given a clear signal to this direction. Well-documented studies became available in August 2013 (VATT valmisteluraportti 18) in which the changes in dividend taxation are thoroughly reviewed. The study discusses such issues as the problem of income conversion, which was tackled in the revised spending limits decision. If the preparatory process had gone smoothly these effectiveness evaluations would already have been completed before the spending limits discussion.

2.7 Complicated tax system – problematic for both decision-makers and taxpayers

Because of a multitude of tax deductions and subsidies, the Finnish system is not transparent or simple, which creates problems for both taxpayers and decision-makers.

According to the Government Programme, there were plans to broaden the tax base, which can generally be considered to increase efficiency and simplify the system. In practice the tax base remained largely unchanged during the term of Prime Minister Jyrki Katainen's Government.

Tax subsidies are problematic from the perspective of the tax system as a whole

The tax base can be broadened by introducing new taxes, by combating the shadow economy and by reducing the number of tax subsidies. Cutting the number of tax subsidies would probably have the most substantial impact. According to the Government's annual report, a total of 185 different tax subsidies were identified in 2013, compared with 176 in 2012. Not all tax subsidies can be calculated in euro terms. The total amount of the tax subsidies that could be calculated was 22.8 billion euros in 2012 and 23.6 billion euros in 2013. This means that there has been little broadening of the tax base in this respect.

The Government has also introduced measures broadening the tax base while at the same time it has created new tax exemptions. For example, the Government limited the tax deductibility of housing loan interest payments and lowered the upper limit of the tax credit for domestic help. At the same time, the Government also narrowed the tax base by raising the basic deduction in municipal taxation and the deduction from earned income.

Tax subsidies do not compete within the spending limits in the same manner as proposals concerning expenditure. In the future, more consideration should be given to the assessment of the economic effects of tax subsidies. This would also make it easier to assess the appropriateness of the tax subsidies.

Another problem with tax subsidies is that they are often ineffective. The benefits of the tax subsidies may go to actors other than those for whom they were originally intended. For example, the lower VAT rate for food, which applies to all taxpayers, is of limited benefit to low-income earners.

No major changes have been made to the tax base during the parliamentary term

Tax subsidies have many negative impacts that are easily overshadowed by their supposedly positive impacts

Tax subsidies may cause substantial administrative costs. For example, according to a report published by the Ministry of Trade and Industry in 2007, the yearly administrative costs to companies generated by the VAT system are fairly high, when compared with the situation in other Nordic countries (von Hertzen, Kauppinen, Niinikoski 2007). The administrative costs are more than twice as high as in Denmark, which has only one VAT rate.

Tax deductions are not transparent to taxpayers

Under the Income Tax Act, a taxpayer can make a total of 10 different deductions from capital income and 14 different deductions from earned income. For taxpayers, this is not a transparent system and not all taxpayers can be expected to be familiar with all the available deductions. There are also large number of small deductions in individual taxation that nevertheless create a great deal of administrative work. For this reason, consideration should be given to reducing the number of tax deductions and simplifying the system.

According to the final figures for 2012 taxation, the total value of the deductions made from income taxation was 39.9 billion euros (Finnish Tax Administration 2012). The most important deductions from income taxation are shown in Table 7. A small number of low-value deductions (such as chainsaw and forestry deduction or deduction from seaman's income) are not included in the Table. A total of more than 24 million deductions were made in 2012. The most widely used of them are the pension income deduction and earned income deduction, which have the highest average value and apply to a large number of taxpayers. The deduction from pension insurance contributions, which is on the basis of the obligatory pension insurance contribution, also applies to a fairly large number of taxpayers. Other deductions can be characterised as tax subsidies. About 16 million such deductions were made and their combined total value is about 11 billion euros. Among the other tax deductions, those concerning housing are particularly extensive (Niskakangas 2009).

For ordinary taxpayers, it is all but impossible to be familiar with all tax deduction regulations. There are a large number of small deductions in individual taxation that nevertheless create a great deal of administrative work and should be eliminated. One option would be to have a system in which all deductions are based on the same format, which would make it easier to calculate them. This would reduce the administrative burden, might change the behaviour of taxpayers and result in a more equal tax burden among different taxpayer groups.

The broad range of different deductions make the system complicated and difficult to understand. On the basis of the audit, the recommendation is that the number of deductions should be reduced so that the system can be made more transparent and easier to understand. The administrative burden can be reduced by making deductions automatic.

Table 7: Most important deductions in the final taxation for 2012. ¹⁵

	EUR million	Number (1,000)	Average in EUR
State and municipal taxation:			
Work-related expenses deduction	1 676	2 787	602
Deduction from commuting expenses	1 545	831	1 860
Trade union membership fees	619	1 975	313
Housing loan interest payments	1 424	1 244	1 144
Student loan interest payments	39	339	116
Deduction from pension insurance contribution	5 073	2 639	1 922
State taxation:			
Pension income deduction	11 270	1 412	7 979
Municipal taxation:			
Basic deduction	2 763	1 957	1 412
Deduction for disability	66	196	337
Study grant deduction	181	179	1 011
Earned-income deduction	6 433	2 586	2 488
Pension income deduction	5 685	1 145	4 963
Tax credit on taxes	418	1 547	270
Tax credit on housing loan and other interest payments	318	1 309	243
Tax credit for first-time home buyers	67	197	343
Deductions from taxes:			
Deduction for work income	1 972	2 624	751
Tax credit for household expenses	302	360	839
Deduction for disability	72	680	105
TOTAL	39 923	24 007	1 663

Entrepreneurs pay taxes on the basis of a wide range of different criteria

Business income taxes are calculated on the basis of earned income and capital income (Kari 2001). The purpose of the division is to ensure that salary and wage earners on the one hand and entrepreneurs on the other are treated on an equal basis and to prevent conversion of income. Taxation of earned income is progressive, while capital income is taxed on the basis of a proportional tax rate. This means that in order to optimise their taxation, entrepreneurs can divide their income between earned income and capital income.

Taxpayers do not always submit applications for the tax relief that they are entitled to. An example of this is the rolling VAT relief (basic deduction). It is applied when the turnover of the enterprise is higher than 8,500 euros (lower limit for taxable operations) but under 22,500 euros. Under this scheme, companies can claim a proportion of the taxes paid on the basis of the turnover within this bracket as phased deduction. However, many small enterprises fail to claim the relief because they are not aware of it or because the applications are incorrect.

3 Ensuring the stability and sustainability of local government finances

3.1 Summary of the findings

Both national and local government accounts indicate that there are reasons to be concerned about the weakening of local government finances over the past 15 years. Local government finances suffer from structural imbalance. According to forecasts, the weakening will continue and may even accelerate. Under the current system of providing welfare services, municipalities and local government finances will bear the brunt of the spending pressure arising from demographic changes.

There are substantial differences between municipalities in terms of their financial position and the wide differences in population growth rates based on population forecasts will only accentuate the situation. The differences between municipalities should be taken into account in the steering of general government finances and in the legislation on local government tasks and obligations.

There has been only cursory assessment of economic effects in the reforms concerning local government and service structures. An adequately long-term perspective should be taken when the targets for the reforms are set and their effectiveness is evaluated.

The aim of the local government reform was to create a service structure in which one unit with an adequately broad population and competence base would be responsible for the provision and financing of the services (Table 8). The reform in local government structures could also be seen as a way of stabilising local government finances in the long term. As a result, too much importance may also have been attached to the local government reform as an instrument impacting the sustainability gap.

In the view of the National Audit Office, there are good grounds for introducing a system in which the organisation and provision of social and health care services is the responsibility of units that are significantly larger than the current municipalities and health care districts. If the reform is successful, it may make the provision of services more efficient and generate savings without substantial cuts in the quality and availability of the services.

Table 8 NAOF's assessment of the measures concerning the local government and service reform

Target set out in the Government Programme		Concrete measure
Stabilising general government finances. Decisions will be made to reduce sustainability gap. No targets for local government finances. The long-term and binding nature and steering effect of the basic public services programme will be strengthened.		Structural policy programme, Local Government Act
	The system of central government finances will be reformed.	The Act on Central Government Transfers to Local Government for Basic Public Services
	Revenue base of the municipalities will be strengthened.	Taxation
	Expansion of the municipal tasks will be slowed down. There will be better cost and effectiveness evaluation of the tasks allocated to municipalities. No targets concerning the reduction in municipal tasks.	Structural policy programme
A local government and service reform will be introduced. Consideration will be given to regional differences.		Act on municipal division, Local Government Act, Act on organising social welfare and health care services
	A local government reform will be carried out. Strong basic municipalities and fewer cooperation structures. A host municipality model is used in remote regions.	Act on municipal division
	Drafting of the act on organising social welfare and health care services and other sectoral laws will be coordinated with the content and timetable of the local government reform. Municipalities will remain responsible for organising social welfare and health care services. For this reason, strong basic municipalities are needed. Consideration will be given to demands that residents should be given more freedom of choice.	Act on organising social welfare and health care services
	Municipalities will remain responsible for the financing of social welfare and health care services.	Act on organising social welfare and health care services, structural policy programme
	Structural factors hampering municipal mergers laid out in the legislation and the financing system will be eliminated.	The Act on Central Government Transfers to Local Government for Basic Public Services
	Local government productivity. In the change process, the status of the personnel will be in accordance with the current legislation.	The act on organising social welfare and health care services and the act on municipal division

NAOF's estimate on achieving the target and on the relevance of the target in relation to sustainability of local government finances

<p>The structural policy programme contains clear guidelines for stabilising local government finances and reducing the sustainability gap in local government finances. Municipalities are expected to achieve savings totalling one billion euros. When workable, the new steering model for local government finances and the funding limit system for social welfare and health care will stabilise local government finances. A provision under which municipalities must cover their deficits will be added to the Local Government Act. Implementation lags behind targets. The provision on balanced local government finances and balanced finances of joint municipal authorities will also be important but the requirement is that the Government will make use of its powers and decide on municipal mergers in accordance with the crisis municipality procedure.</p>
<p>The system of central government transfers has been successfully updated. Under the updated system of central government transfers, municipalities have more incentives to control the costs arising from the provision of services. Criteria of the system now tied more closely to service needs than costs.</p>
<p>Temporary increase in the corporation tax distribution quota, adjustment no longer applies to real estate tax , municipal tax base has been widened (nominal tax rates have risen). No effect on sustainability gap.</p>
<p>Implementation of the measures concerning the balancing of local government finances lags behind targets. Under the structural policy programme, the tasks and obligations of municipalities will also be cut by one billion euros. Implementation of the structural policy programme measures aimed at stabilising local government finances is crucial to the balancing of local government finances. The Government counts on productivity improvements even though few measures raising productivity have been put into effect. The new steering model for local government finances and social welfare and health care is not yet in use.</p>
<p>The municipal division reform has not become a reality. A new act on municipal division is now in effect. The system of central government transfers has been successfully updated. The Local Government Act will be updated. The act on organising social welfare and health care services will be updated. Reforming service structures is essential; the role of social welfare and health care services becomes more important as the population is ageing. Reforming of service structures is essential to the stability of general government finances. There are problems with the coordination of legislation.</p>
<p>The aims set for the local government reform have not become a reality. Municipal mergers contribute little to the elimination of the sustainability gap.</p>
<p>The Government and the opposition have agreed on a comprehensive social welfare and health care reform. Under the reform there will be total integration of social welfare and health care services in five social welfare and health care regions. Five social welfare and health care regions (joint municipal authorities) responsible for organising the services and a maximum of 19 joint municipal authorities responsible for providing the services. Reforming the municipal structure in accordance with social welfare and health care needs has been a problematic objective, which has mostly been abandoned during the government term. A successful social welfare and health care reform is crucial to solving the sustainability gap and stabilising general government finances. Savings can only be achieved if local government tasks are reduced and a binding macro-economic steering system for local government finances and social welfare and health care expenses is created. Both elements only exist as ideas and objectives.</p>
<p>A report on the options concerning the dissolution of the multi-channel social welfare and health care financing and their impacts will be prepared. Reforms concerning financing and organisational responsibilities have been divided into two separate elements. Successful integration of the financing system will make part-optimisation less likely and will generate savings.</p>
<p>A new act on municipal division is now in effect and the system of central government transfers has been successfully updated. Some of the productivity obstacles resulting from municipal mergers (job security) still remain. However the new act on central government transfers will reduce the number of obstacles to municipal mergers.</p>
<p>Implementation of the social welfare and health care reform is crucial. The practical decisions will have to be made by the management of social welfare and health care regions. The social welfare and health care reform contains few effective productivity incentives and tools for improving productivity. Obstacles to productivity improvements (incl. the five-year job security in municipal mergers) should be repealed.</p>

Despite their significance and interdependence, the social and health care service structure reform and the local government reform have proceeded at different speed during the government term. The vision of the future role of municipalities as providers of social and health care services has been lacking.

The reform projects that are currently at drafting stage, such as the reform of the Local Government Act, the social and health care service structure reform and the separate spending limits planned for social and health care may also have conflicting impacts. The Ministry of Finance should monitor the combined effects of the acts that are still at drafting stage or that have recently been approved by Parliament. Any discrepancies should also be eliminated without delay.

Reduction of local government tasks and productivity improvements in public services, two of the aims set out by the Government in its structural policy programme, are important instruments for meeting the sustainability challenge. So far, there have been no workable steering instruments for improving productivity in local government. For this reason, the aim can only become a reality if there is extensive development of steering instruments concerning municipalities and local government finances.

The reduction of local government tasks by about one billion euros should be completed during the next parliamentary term. Reducing the statutory tasks of municipalities requires political leadership and the setting of priorities.

In the view of the National Audit Office, the decision to finance the growing list of local government tasks exclusively by means of central government transfers is a step in the right direction as it eliminates the incentive contained in the previous system under which new local government tasks could be introduced even though there was no need to secure immediate funding for them within the Government's spending limits.

There are good grounds for taking an extremely careful approach to binding normative steering in legislation on municipalities, local government services and social and health care services. This would make it possible to improve productivity and economic efficiency by means of new innovations and operating practices. However, the most important prioritisations of services should be made as part of national legislation. The reduction of obligations should be founded on a good knowledge base, in which the effects of the abolishment of the obligations on local government finances, on society at large and on different population groups are also assessed.

3.2 Division of responsibility between different administrative levels

The public sector has three functions: provision of public services, income redistribution, which takes place between individuals and regions, and economic stabilisation (Musgrave, 1959).¹⁶ Economically appropriate division of tasks between central and local government depends on three factors: any economies of scale, externalities and differences between regions. There are grounds for making an efficient division of labour between different administrative units an aim in the allocation of organisational responsibility (e.g. Parviainen 1996, pp. 7–9).

The “right” number of municipalities depends on the division of tasks between central and local government. The appropriateness of the municipal structure also depends on the prioritisation of tasks and objectives and the impacts of the division of labour (Tiebout, 1956). Centralisation of services is an economical solution when producing services in large units means lower costs and higher efficiency. For example, it is more efficient to provide services requiring special expertise, such as specialised medical care, in large units. At the same time, decentralisation becomes more important as differences in demand for local public services between regional units increase (regional needs-based differences, Oates, 1997).

Increasing the size of municipalities is practicable when municipalities are very small and all residents have similar needs. Less overlapping work is an argument in favour of decentralisation. Any economies of scale and major externalities (both negative and positive) are arguments in favour of centralisation.¹⁷ Moreover, if municipalities are in a position to accumulate excessive debts, there will be substantial harmful externalities affecting other municipalities and the state. For this reason, the widely held view is that the distribution of income and economic stabilisation are the responsibilities of the central government. The bearing of the risk connected with economic cycles and cyclical policy are thus tasks that are best-suited for the state.

The most important finding of Borge and Rattsø (2012) is that the Nordic welfare model is in need of a reform. The welfare model can be reformed by creating a strong local level that is responsible for a broad range of tasks of the welfare state or by centralising welfare services. The tasks of the municipalities and the right size of a municipality are connected with each other.

Finnish municipalities are responsible for a broad range of welfare services and partially also for financing the services. The state has transferred important tasks to the municipal sector that in many other OECD countries are the responsibility of the central government.

3.3 Situation report on the municipal sector

As a result of the division of tasks between central and local government, municipalities are bearing the brunt of the increases in health care and other care and treatment costs resulting from the ageing of the population.

At the end of 2013, the average population of a Finnish municipality was 17,840. However, the median size of Finnish municipalities is only 6,480, and thus on the basis of the number of residents, Finnish municipalities can definitely be considered very small. At the same time, Finland has sparsely populated municipalities that are large in size, which poses challenges to service provision, especially in the area of more efficient service provision.

Efforts have been made to reform Finland's local government and service structures in the 2011–2014 parliamentary term and the two parliamentary terms preceding it. At the start of the local government and service structure reform (PARAS project) in 2005, there were a total of 432 municipalities in Finland. Municipal mergers reduced this number to 320 by 2014. A total of 16 of the municipalities are located in the Province of Åland.

Studies suggest that increasing the size of municipalities and the reduction of their number will not as such solve the problems facing local government finances. However, increasing the size of municipalities has been a central element in the municipal policy of the state.

As a result of demographic changes, long-term sustainability of local government finances is in danger. The proportion of those aged over 65 is expected to increase from the current 20 per cent to an average of 26 per cent in 2030. According to the forecasts, there will be substantial differences in the proportion of ageing residents between municipalities. The percentage of those over 65 is lowest in growth centres and in largest cities. With the concentration of jobs, the population in working and childbearing age is concentrating in large cities and the municipalities surrounding them, which emphasises the difference between growth centres and areas in economic decline (Figure 6a). For this reason, small and remote municipalities will suffer most from the ageing of the population even though the process will also affect the national economy as a whole. In sparsely populated areas, providing elderly residents living in dispersed settlements with care will be expensive.

On average, Finnish municipalities are still fairly small

Figure 6: Long-term expenditure pressures in local government finances

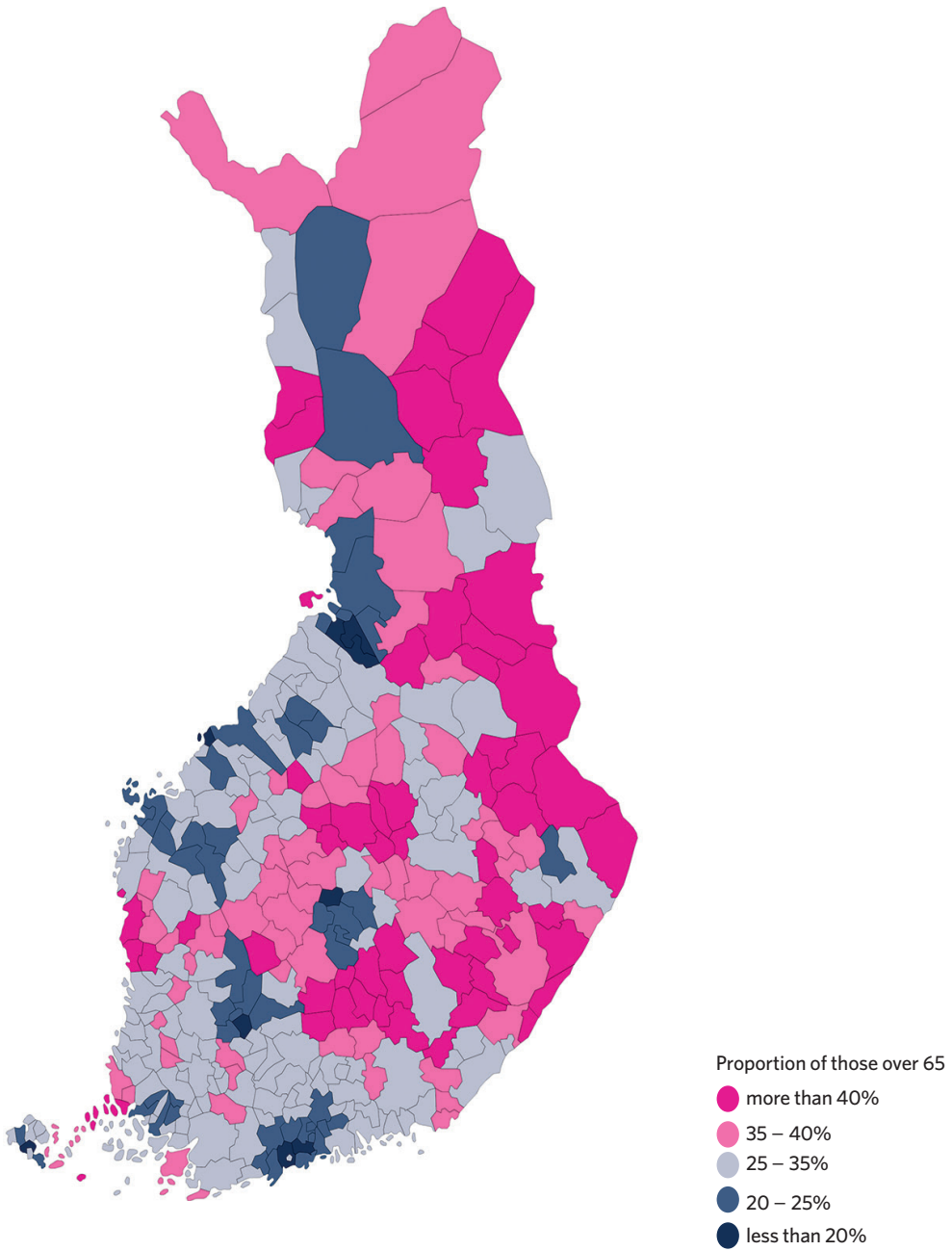


Figure 6a Percentage of those over 65 of the population in 2030 ¹⁸

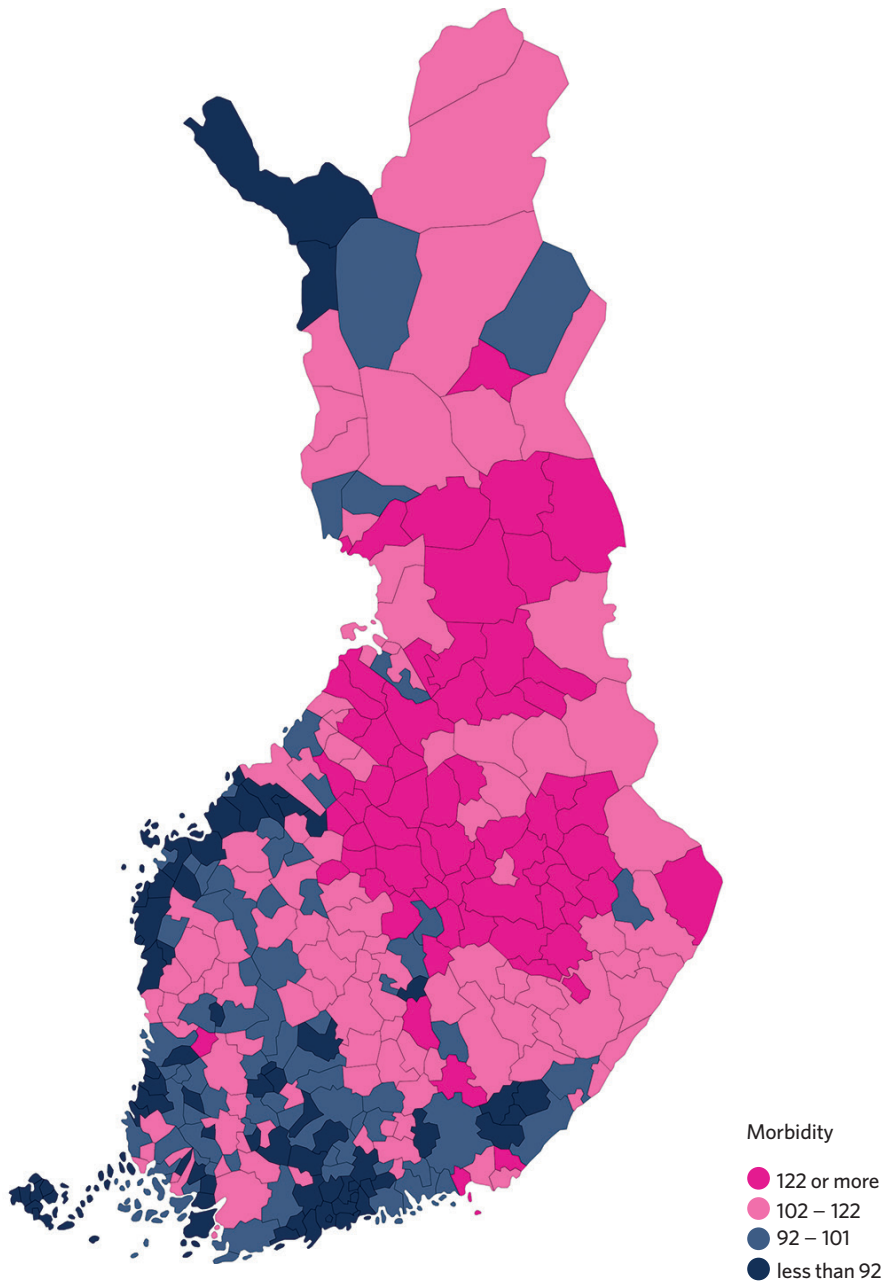


Figure 6b. Morbidity in 2010, age-adjusted¹⁹

There are also substantial health differences between regions. The morbidity indicator of the National Institute for Health and Welfare describes regional morbidity in relation to national situation (value 100)²⁰. Morbidity seems to be concentrated in declining areas (Figure 6b). Migration accentuates the polarisation process as healthy people in working age are the first ones to move to growing urban areas. Because of differences in morbidity, there are differences in the need for treatment and care services between regions. This should also be a consideration.

Sustainability of general government finances is assessed by means of different stress calculations. Comparisons between the calculations show that the most widely used sustainability indicator is particularly sensitive to assumptions concerning trends in treatment and care costs (Klavus and Pääkkönen, 2014).

The two main factors in the efforts to keep treatment and care costs under control are productivity improvements in the health care sector and a gradual shift towards older age groups in the use of health services and long-term care for the elderly. By taking measures directed at health care, it is possible to achieve substantial improvements in the sustainability of the public sector (especially the local government sector). At the same time, however, Pääkkönen and Seppälä (2014) have shown that, when consideration is given to the differences in the need for health care between regions, the efficiency differences between municipalities in health care are smaller than expected. In other words, there may be less potential for higher efficiency at local government level than anticipated.

In the medium term, sustainability can be assessed by means of debt and deficits. There has been a rapid rise in local government debt over the last 15 years. At the end of 2013, local government debt totalled 13.8 billion euros or an average of 2,540 euros per resident.

Figure 7 shows that there has been a rapid growth in local government debt since 2011. Uncontrolled growth of local government debt may have consequences for the entire national economy.

There are substantial differences between municipalities in terms of their economic situation. There are a large number of municipalities in Finland that seem to suffer from chronic deficits (Figure 8). In 2013, a total of 76 municipalities had accumulated deficits in their balance sheets. In 25 of these municipalities, the deficit was more than 500 euros/resident (marked with dark red in the Table). If no substantial measures are taken, it will take years to eliminate the deficits accumulated in the balance sheets.

Morbidity is concentrated in declining areas

Improving productivity is essential in the management of age-related care and treatment expenditure

Local government finances are out of balance

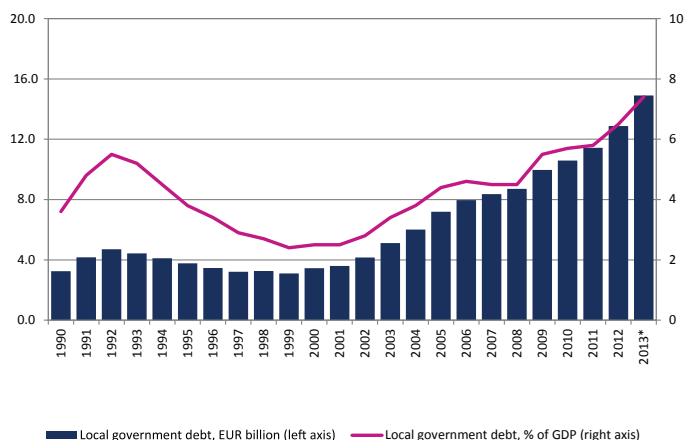


Figure 7: Local government debt²¹

The balance of local government finances can also be examined from another perspective: In 2013, the self-sufficiency rate among Finland’s municipalities averaged 52.9 per cent (population-weighted rate 60.4 per cent), which is considerably below the targeted 70 per cent. Only 41 of the 304 municipalities in mainland Finland exceeded the target level. The fiscal position of Finnish municipalities cannot be considered good.

Examination based on local government accounts also shows that local government finances are weakening. According to local government accounts, the finances of a municipality are in balance if the annual margin covers all depreciations. However, in many municipalities, the depreciations are not equal to average yearly investments.

In the medium term, the need for average yearly investment can be estimated on the basis of the self-acquisition expenses. A rough estimate can be produced by calculating the three-year averages of the annual margin and the self-acquisition expenses. On this basis, only 16 municipalities have an annual margin that covers self-acquisition expenses. In other municipalities, income financing failed to cover the average need for replacement investments. It seems that in many municipalities, replacement investments have been made with debt financing or by reducing operating capital.

Annual margins do not fully cover the depreciations

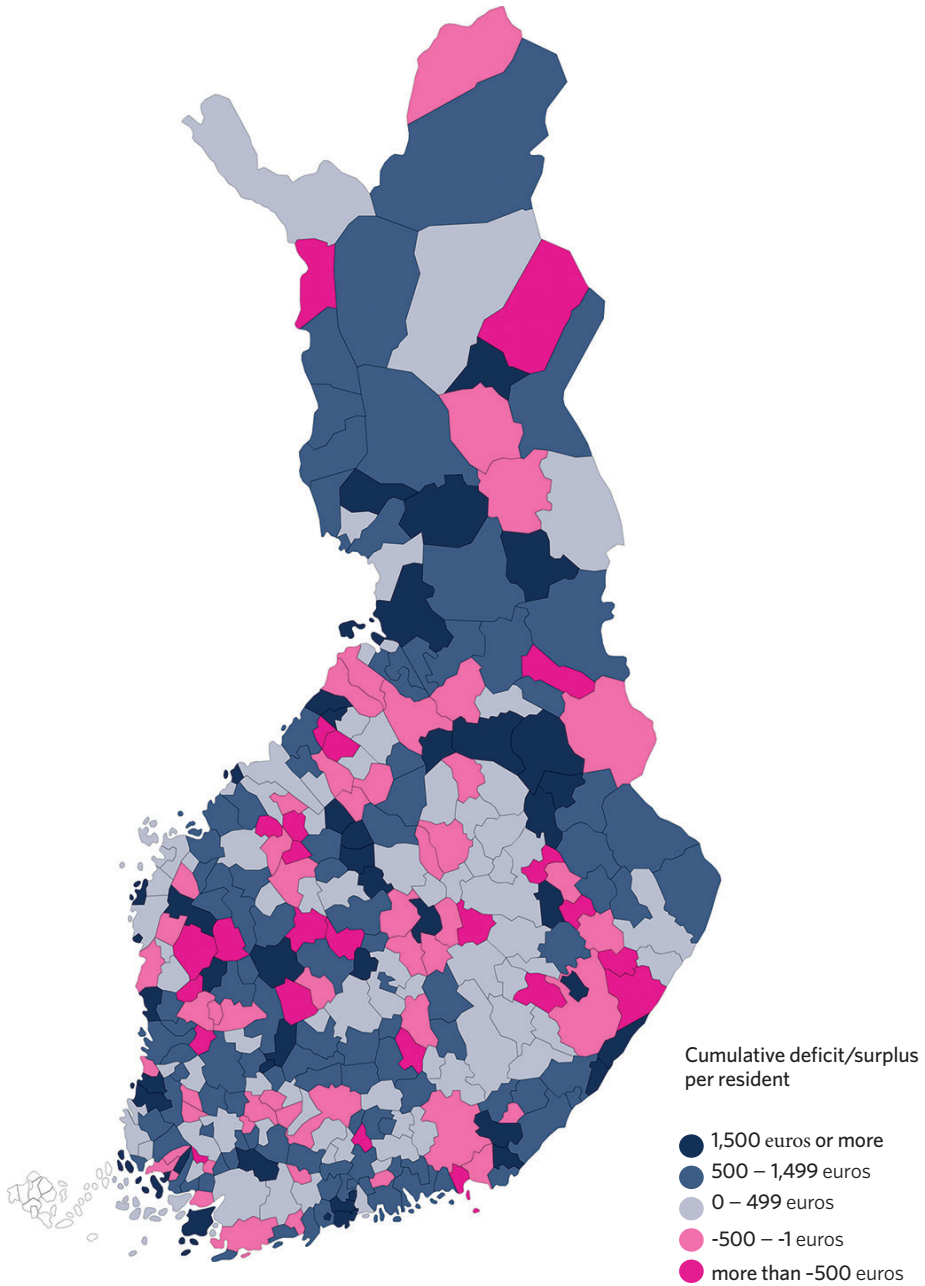


Figure 8: Accumulated surplus/deficit in 2013²²

Furthermore, at the end of 2013, a total of 28 municipalities had a negative annual margin, which means that their economic situation was weak. This means that these municipalities have been forced to borrow money, realise their assets or reduce their operating capital so that they can cover their day-to-day expenses. The conclusion is that local government finances are also out of balance when examined on the basis of local government accounts.

The measures taken by the state sector have an impact on the financial position of municipalities in many ways. The state may impose tasks on municipalities as a result of which they will incur expenses. At the same time the state supports municipalities and reduces differences between them in the financing of tasks by providing central government transfers. In recent years, central government transfers to municipalities have also been cut.

Municipalities dependent on current transfers are particularly sensitive to the increases in the number of deductions from municipal taxation.

The action taken by the state has fragmented the base of municipal taxation. Even though municipalities have increased municipal taxes throughout the 2000s, the deductions from municipal taxation have increased so that there has been little increase in the average effective tax rate. At national level, the average effective tax rate stood at 14.4 per cent in 2001 and at 14.6 per cent in 2013. As the increases in deductions from earned income taxation have affected people in the low-income bracket more than other groups, municipalities where the proportion of employed people of the working-age population is low (municipalities where a substantial proportion of the population lives on current transfers) are hardest hit by the fragmentation of the income tax base. These municipalities are marked with red in maps 6a and 6b.

There are municipalities where the economic situation is already weak. There are municipalities where the measuring of the tasks and their financing are, for one reason or another, out of balance.

3.4 Most important programmes with impact on local government finances

The Government of Prime Minister Jyrki Katainen launched a number of related projects aimed at solving the problems facing the local government sector. However, the implementation of the reforms has been slow and the next Government will have to complete the process.

The Government decided to reform local government structures and social and health care service structures. The provision of financing for municipalities was reformed by introducing a reform of central government transfers. The aim is also to reduce the number of local government tasks. It is also essential to reform the local government and service structures.

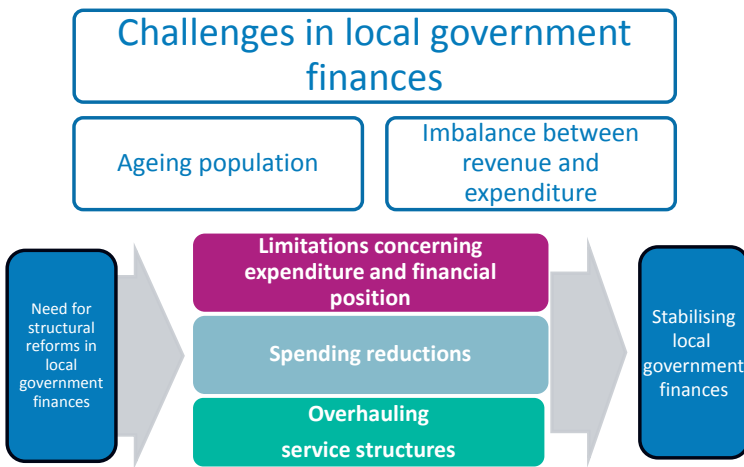


Figure 9: Basis for the development of local government finances and the measures required

The need for reforms is the result of two economic facts: ageing of the population, which will lead to a risk concerning the long-term financial position (sustainability gap), which will hit municipalities particularly hard. The revenue base of municipalities has weakened as a consequence of the prolonged economic downturn. As a result, there is a need to reform the structures of local government finances and services.

According to the programme of Prime Minister Jyrki Katainen's Government, the objective of the local government policy is to safeguard high-quality and equitable municipal services in all parts of Finland in a customer-oriented manner, to create a basis for development strengthening local government finances and for more cohesive urban structure and to strengthen local democracy. According to the Government Programme, the Government also aims to close the sustainability gap in general government finances and prepare for the growing demand in services resulting from the ageing of the population.

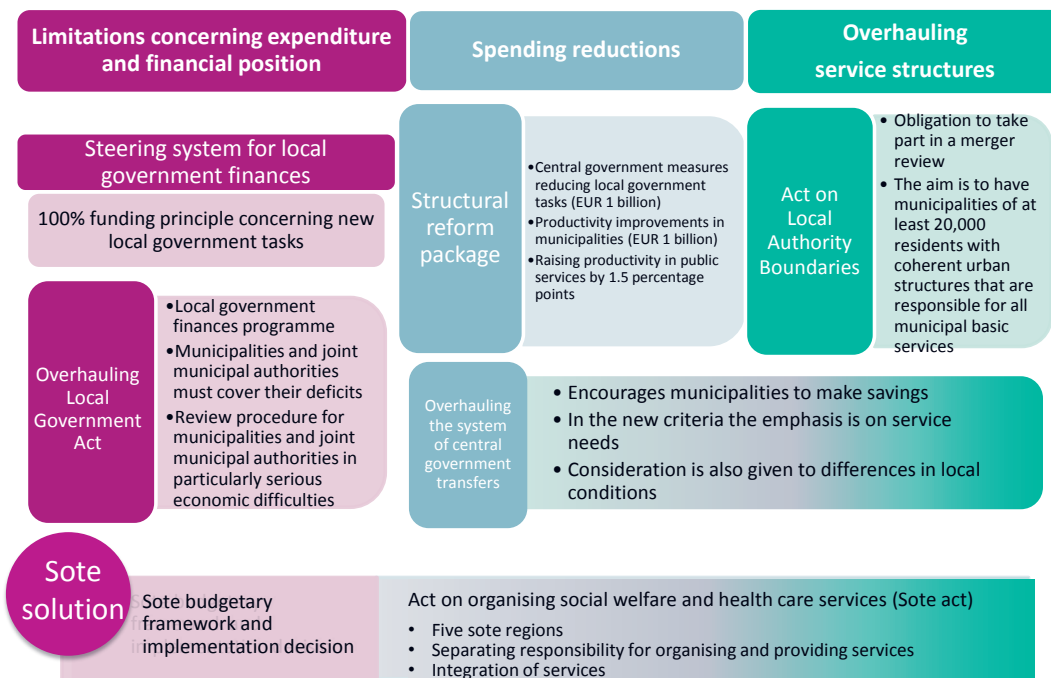


Figure 10: The most important reform projects of Prime Minister Jyrki Katainen's Government

The Government introduced its most important measures concerning local government finances as part of its structural policy programme, which was presented on 29 August 2013. Direct measures impacting municipalities included the savings of two billion euros, one billion of which will be achieved through measures improving local government productivity and revenue and one bil-

lion by means of reducing local government tasks. Social and health care services (SOTE) account for an average of 60 per cent of all local government expenditure and, as the population is ageing, the biggest growth pressures in general government expenditure concern the social and health care sector. The aim is to achieve a yearly productivity improvement of 0.5 percentage points in public services, especially in social and health care services.

In autumn 2013, when the Government adopted the structural policy programme, the sustainability gap was estimated at 4.8 per cent of the GDP. According to the Ministry of Finance, the balancing of local government finances and a more rapid productivity growth in public services would narrow the sustainability gap by 2.4 per cent, which accounts for about one half of the estimated gap. Thus, in the elimination of the sustainability gap, a great deal of emphasis has been placed on the balancing of local government finances and productivity improvements in the public sector.

In its structural policy programme, the Government aims to achieve substantial reductions in the sustainability gap by increasing the productivity of activities that are under the responsibility of the municipalities. In the target-setting of the structural policy programme, the productivity measures are expected to improve the fiscal position of local government finances, to reduce expenditure and to lessen the need for additional personnel.

Improving productivity in municipalities and in the welfare services provided by municipalities has also been an objective in earlier programmes. Under the 2011 basic services programme, which covered the years 2013–2015, the average real growth in municipal operating expenditure until the year 2020 should not exceed 0.4 per cent. In the programme, this target is described as a productivity target. (VM 37a/2011). It should be noted that this is not a productivity target setting targets for the output-input ratio but a target concerning expenditure trends (Pursiainen-Pääkönen-Seppälä 2011).

The achievement of the target set in the 2011 basic services programme has been monitored in the basic services programmes and the Ministry of Finance's evaluation reports covering the state of basic services (see overall evaluation: Basic Services Programme for 2015–2018, VM 14a/2014). In practice, the productivity target set out in the basic service programmes has remained fairly weak.

According to the calculations of the National Audit Office, the real growth in operating expenditure during the 2011–2014 parliamentary term has exceeded the target by 2.5 percentage points in cumulative terms.

Stabilisation of local government finances only became focus of attention in the 2013 structural policy programme.

In practice, the productivity targets set have been weak

According to the calculations of the National Audit Office, the real growth in operating expenditure during the 2011–2014 parliamentary term has exceeded the target by 2.5 percentage points in cumulative terms.

The target concerning the raising of productivity in public services set out in the structural policy programme depends solely on the measures taken by municipalities. Judging from previous experience, it may well be that the objective of improving productivity in services may well remain unattainable. This is because there are no concrete tools for achieving the aim.

Tasks and obligations of municipalities

Under the Finnish system of local self-government, the tasks of municipalities must be laid down by law. According to an estimate produced by the Ministry of Finance in 2013, municipalities had 535 different tasks in 2012.²³ Municipalities have tasks coming under the administrative branches of ten ministries and under 138 acts and decrees. Slightly over one third of the tasks come under the administrative branch of the Ministry of Social Affairs and Health, followed in close succession by the Ministry of Education and Culture, Ministry of the Environment and the Ministry of Transport and Communications.

The number of statutory local government tasks has increased every year. The assessment of the cost impacts of the tasks, especially of the new tasks, laid down for municipalities has been widely criticised (Moisio, 2011; VM, 2011; VM, 2014b; VTV, K 21/2010 vp.; VTV, K 2/2013 vp.).

A working group appointed by the Ministry of Finance has examined how the number of local government tasks and obligations could be reduced. According to the working group, reducing the tasks requires strong political steering. The working group also proposed that there should be a system for keeping details of the number of the statutory tasks and that the tasks of the municipalities coming under local self-government should be charted. The process would be useful for the general government fiscal plan and the new programme for local government finances. (VM, 2014b).

Under the general government fiscal plan for 2015–2018, the Government will not introduce new tasks and obligations increasing local government expenditure unless it also decides on equal reductions in tasks and obligations or full financing of the new tasks and obligations. This principle will be applied to new projects under the 2014–2017 spending limits decision. The decision is in accordance with the 100 per cent financing principle.

Municipalities have more than 500 statutory tasks

Reducing the obligations of municipalities requires political leadership and the setting of priorities

The decision to finance the growing list of local government tasks exclusively by means of central government transfers is a step in the right direction as it eliminates the incentive contained in the previous system under which local government tasks could be introduced even though there was no need to secure immediate financing for them under the spending limits. From the perspective of ensuring the success of the reform, it is essential to develop the assessment of the cost impacts arising from the new tasks. However, the fact that limits are imposed on the number of new Government-allocated tasks and that the Government may be obliged to provide 100 per cent of the financing does not correct the problem that municipalities are in economic difficulties because of the tasks that have already been laid down for them.

The implementation of the structural policy programme is based on the assumption that a substantial proportion of the savings generated by the elimination of the tasks will be through the new social and health care financing framework.

Reducing local government tasks is necessary from the perspective of the stabilisation of local government finances. It is difficult to see how municipalities would be able to generate substantial savings without the reduction of their tasks or limits to subjective rights. The targets can only be achieved if legislative objectives are clarified and prioritised.

There should also be discussion on whether some of the tasks could be abolished altogether. Municipalities should be provided with the opportunity to organise their activities in a flexible manner. The five-year job security guaranteed in connection with municipal mergers makes it more difficult to achieve savings by reducing local government tasks.

There should be discussion on whether some of the tasks could be abolished

Social and health care service structure reform and local government reform

The reform in local government structures was launched on the basis of the programme of Prime Minister Jyrki Katainen's Government. The aim was to reform local government and service structures and to create a network of economically robust municipalities in Finland. According to the Government Programme, an economically robust municipality is a customary commuter area that is large enough to be able to provide basic public services, with the exception of specialised medical care and demanding social welfare services. According to the Government Programme, the local government reform is necessary because municipalities with a stronger population and competence base would reduce the need for inter-municipal cooperation, which in turn would make

administration simpler and bolster local democracy. The aim was to create a service structure in which one party with an adequately broad population and competence base would be responsible for the provision and financing of the services.

The reform in local government structures could also be seen as a way of stabilising local government finances in the long term. In this respect, too much importance may also have been attached to the local government reform as an instrument for reducing the sustainability gap. There is little research evidence of the benefits of municipal mergers.

Even economically robust municipalities are unable to manage social and health care services on their own. For this reason, the Government launched a social and health care service structure reform as a separate project. The welfare model can be reformed by creating a strong local level that is responsible for a broad range of tasks of the welfare state or by centralising welfare services. Despite their significance and interdependence, the social and health care service structure reform and the local government reform have proceeded at different speed during the government term. The vision of the future role of municipalities as providers of social and health care services has been lacking.

Only a small number of effectiveness evaluations have been carried out as part of the preparation of the local government reform and the social and health care service structure reform. Moreover, the evaluations have been based on the grounds for the reform in question and not on an extensive analysis of different alternatives and their impact mechanisms. In changes of this scale, carefully prepared evaluations of the impacts of the proposals on local and central government and service users should be presented well in advance. Especially the sources of the envisaged savings and the manner in which they would be achieved should be presented and justified in an open manner. The fragmented nature of the preparatory process and the fact that they have not proceeded at the same pace have led to a situation where there is no overall picture of the impacts of the reform. The uncertainty arising from unfinished reforms may also postpone decision-making and development work at local government level (VTV, 2013b).

Only a small number of effectiveness evaluations have been made

Social welfare and health care service structure reform

The social and health care service structure reform has made only slow progress. For example, Loikkanen (2014) has criticised the reform for the fact that research has only played a minor role in the process. Few comparisons with reforms implemented in oth-

er countries or the manner in which they have organised their social and health care services have been made.

In the model, which is based on an agreement between the Government and the most important opposition parties, the responsibility for organising and providing the services has been separated. Five social and health care regions (joint municipal authorities) will be responsible for organising the services. They will roughly have the same borders as the current expert responsibility areas. Every municipality will belong to one of the five regions. Municipalities will have representation in the supreme decision-making body of the social and health care regions. Responsibility for providing the services would rest with the joint municipal authority or the municipal responsible for providing the services in a service provision area.

The aim of the reform is to make service integration possible and in this manner ensure a customer-oriented provision of services and the benefits of the economies of scale. It is hoped that by concentrating the responsibility for the services in social and health care regions, the services can be provided in a more efficient and high-quality manner. Strong state steering is expected to ensure a more equal provision of services and harmonisation of information systems.

The social and health care service structure reform is creating a new administrative tier under which all existing organisations will remain unchanged. In order to ensure adequate size of the service providers, it has been decided that all existing cooperation structures between municipalities will remain unchanged and that additional cooperation structures can also be created. Such a solution would be against the aim laid down in the Government Programme under which the number of cooperation areas will be reduced and in violation of the local government democracy principle laid down in the Constitution of Finland (OM, 2014).

Even though the service provision areas would still be able to use purchased services, the private and third sectors may not benefit from the new system as service providers (Ekström et al. 2014). This has relevance from the perspective of achieving the productivity targets as the multiple-provider model may improve service quality and promote the development of innovative service approaches.

The National Audit Office is of the view that in the best case the reform may generate savings because the service network is reorganised and new cost-effective ways of providing services will be introduced. In the view of the National Audit Office, it may, however, well be that for political reasons, decision-makers at local lev-

el are reluctant to accept reductions or closure of services in their own municipalities. In order to ensure local services, municipalities have an incentive to invest in services in their own areas or to conclude binding long-term agreements on the provision of services before the social and health care regions are established.²⁴

There are grounds for reducing detailed normative steering as part of the social and health care service structure reform. New innovative operating methods and forms of cooperation can only be introduced if normative steering is reduced.

The reform aims to integrate social and health care services both horizontally and vertically. There will nevertheless be areas of service discontinuity in which the status of the client (employed, unemployed, student, pensioner) impacts access to services and financing of care and treatment. The problem will probably be dealt with at a later stage when the dismantling of the multiple-provider financing system, which is now under preparation, will make additional progress.

Successful integration of services requires the merging of financing channels. It should be noted that the harmonisation of information system is a requirement for successful integration of services.

The social and health care service structure reform can be assessed on the basis of the welfare service goals presented by Le Grand (2007). The goals are high quality, efficiency, accountability concerning the use of taxpayers' money, responsiveness and social equality. According to Le Grand, these goals can best be achieved in a model where the service user has maximum freedom of choice between service providers irrespective of whether the providers are from the private or public sector. In the view of the National Audit Office, the clients should also be able to base their decisions on adequate information about the operations of the different health care units. Financing should also follow the client.

Act on Local Government Structures

The Act on Local Government Structures, the purpose of which is to implement the local government reform, entered into force in June 2013. Under the Act on Local Government Structures, municipalities must examine the option of merger if a municipality meets at least one of the criteria laid down in the act. The criteria are as follows: population base needed for services (less than 20,000 residents), economic situation of the municipality, workplace self-sufficiency and criteria concerning commuting and urban structures. All municipalities in mainland Finland submitted their opinions on the examination obligation by the end of November 2013. By the

Integration of services was only half completed

The Act on Local Government Structures and the new Local Government Act are the most important tools of the local government reform

deadline, about 250 municipalities announced that, as laid down in the act, they will examine merger with other municipalities, while 41 municipalities announced that, at this stage, they will not take part in the process of examining mergers required under the Act on Local Government Structures. It seems that the new Act on Local Government Structures and the reform of the Local Government Act will be the most important results of the local government reform process in the 2011–2014 parliamentary term.

Reform of the Local Government Act

The reform of the Local Government Act is a response to the reform needs arising from the changes in the municipalities' operating environment and the new administrative structures at local government level. The main aim of the reform process is to ensure the sustainability of local government operations and to emphasise long-term responsibility in decision-making.

Generally speaking, the changes in the economic operating environment make the reform of the Local Government Act necessary. The objectives laid down in the act point at the right direction.

Compared with the existing act, the proposed act tightens the regulation of local government finances. Under the proposed act, both municipalities and joint municipal authorities must cover the deficits that they have accumulated. Furthermore, the assessment procedure will be on the basis of the key indicators of the local authority corporation. A change-over to a corporation-level assessment is justified because municipalities have organised their activities in many different ways. This gives a better view of the state of the local government finances.

Under the proposed reform, the obligation to cover deficits also applies to joint municipal authorities. Under the new Act on Social and Health Care Service Structures, the social and health care regions constitute joint municipal authorities and every municipality must belong to one of them. It is essential to coordinate the two acts so that it is possible to have more effective mechanisms for ensuring that expenditure and productivity in social and health care are under tighter budgetary control. The obligation to cover deficits is an important instrument for meeting overall balance objectives in local government finances and the general government stabilisation objectives that are also based on the economic policy steering system of the reformed European Union, especially the European Union budgetary frameworks directive 2011/85/EU.

On 12 June 2014, the Government made for the first time use of its right to merge a municipality in severe financial difficulties with another municipality against the will of at least the other mu-

There are substantial differences between Finland's municipalities in terms of population and economic position

The obligation to cover deficits will be tightened

nunicipality involved. As a rule, forced mergers do not make the parties to the merger more committed to merging the operations of the new municipality. Despite this, the right of the Government to put into effect changes in boundaries affecting municipalities in severe financial difficulties provides credibility to the requirements concerning local government finances laid out by the state. In the view of the National Audit Office, the criteria applied for identifying municipalities in particularly difficult financial position provide an adequately comprehensive picture of the financial situation of the municipalities concerned.

Practical implementation of a binding budgetary limit is much more difficult in joint municipal authorities constituting the social and health care regions than in individual municipalities. The risk is that a conflict may arise between more binding budgetary limits and subjective care and treatment rights. In order to avoid such conflicts, it is essential to have clear, legislation-based priorities.

At the same time, the management of the social and health care regions should also have strong incentives to raise productivity and eliminate legislative and administrative obstacles to productivity improvements. The productivity and economic efficiency targets can only be achieved if the infrastructure, service network and operating practices are reorganised. Even though such practical development work will take years, efforts should be taken to dismantle different types of obstacles to it so that the general government stabilisation targets can be achieved.

Steering system for local government finances

Compared with other countries, the current Finnish system provides municipalities with exceptionally wide freedom to accumulate deficits and debts. According to the balanced budget rule, municipalities must balance their budgets during a planning period of four years. Four years is a long period and breaching the rule has not resulted in any sanctions. There have been no restrictions to accumulating debts. Thus, in practice the budgetary limit for local administration (local government finances) has been a flexible one. The flexible budgetary limit provides individual municipalities with an incentive to pass on costs to other municipalities, the state or future generations (Moisio, 2011). The central government (the state) will ultimately rescue municipalities that run into economic difficulties. This is because in the Nordic welfare model, municipalities carry out the service tasks laid down by the state by law in which the financial, social and cultural rights laid down in the Constitution also play a major role. The aim of macro-steering is to make the monitoring of local government finances more effective so that problems can be avoided.

The Government has presented its concept for the steering system of local government finances (VNT 2/2013 vp). At the same time, a working group appointed by the Ministry of Finance justified the need for macro-steering and clarified the steering described in the Government statement (VM 2014a).

The basic services programme procedure will be replaced by the local government finances programme from 2015 because there have been a number of major inadequacies in the implementation of the programme. For example, it seems that the sectoral ministries have underestimated the impacts of the new tasks on local government expenditure (VTV, 2013b). As a result of the distribution of costs, which is part of the system of central government transfers to local government, the central government transfers are also tied to costs, which does not provide municipalities with incentives to raise productivity (Moisio, 2011).

The steering of local government finances is part of the general government fiscal plan, which is in accordance with the budgetary frameworks directive, the Fiscal Policy Act (869/2012), and the annual review of the plan. Steering of local government finances provides a response to many of the inadequacies identified in the implementation of the basic services programme. However, there are no restrictions to indebtedness and the municipalities are not explicitly obliged to accumulate funds during times of economic growth.

From 2015, the section on local government finances in the general government fiscal plan will lay out an objective for the fiscal position of local government finances. In addition to the fiscal position objective, there will also be a euro-denominated limit to the changes in local government expenditure resulting from state measures (expenditure limit). In the view of the National Audit Office, this limit alone will not stabilise local government finances because municipalities have ran into economic difficulties as a result of the tasks already allocated to them. For this reason, too, completing the process of reducing local government tasks as set out as an objective in the structural policy programme is justified.

Realistic assessments of the impacts of the planned measures are required as policy support. For this the reason, the independent unit steering and monitoring effectiveness evaluations of statute proposals outlined in the National Audit Offices' report on its activities to the 2014 parliamentary session is needed for ensuring the achievement of the financial policy objectives concerning the stabilisation of local government finances.

Reforming the system of central government transfers

The aim of the reform of the system of central government transfers is to simplify the system and to provide it with additional incentives. There is a need to simplify the system of central government

A macroeconomic steering system for local government finances is needed but it may not be enough to stop the accumulation of debts

Evaluation of the effectiveness of statutes should be strengthened

transfers. The new system will have fewer criteria. The adjustment to shared costs between local and central government will also be on the basis of yearly adjustment periods.

The simplification makes the system more transparent and easier to understand. Under the new system there are fewer criteria and an arrangement under which the adjustment to shared cost is made each year. This makes it easier for municipalities to anticipate the amount of the central government transfers that they can expect. The new system of central government transfers takes better account of the need for care and treatment services than the system that is still in force. Especially the consideration of morbidity and providing it with added weight in the definition of central government transfers are major improvements. This is because morbidity determines the use of care and health services and also has an impact on municipalities' revenue base. Financing is no longer tied to costs as closely as before.

Compared with the current system, there will be new unit prices, which make the age structure less important. The new system is in line with the study showing that health care costs do not increase with age but rather in accordance with the morbidity, which increases with age. The new system also gives consideration to "difficult conditions" by applying unemployment, foreign language and other coefficients even though they are given less weight than before.

In the new criteria for central government transfers, consideration is given to the differences between municipalities in such areas as the population base. The criteria for the new system of central government transfers have been selected so that it is difficult for municipalities to manipulate them. The indicators used are fairly easy to measure and no new data needs to be produced for the calculations. The new system of central government transfers does not provide municipalities with incentives to consolidate their services but rather encourages them to take a critical view of their service production. Moreover, it does not provide an obstacle to municipal mergers, while at the same time it does not "force" municipalities to merge with each other.

The National Audit Office shares the view expressed by the Parliamentary Administration Committee in its report (HaVM 20/2014 vp) that the functioning of the proposed definition factors and weightings should be monitored and, if necessary, corrected and that the chances of giving better consideration to factors concerning health promotion and prevention of diseases should be assessed. The costs arising from the organisation of municipal basic services should also be monitored in the future on a task-specific basis.

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- 2 Sources: Ministry of Finance Economic Survey autumn 2014, Bank of Finland Economic Outlook 3/2014 and European Commission European Economic Forecast Autumn 2014.
- 3 Sources: Ministry of Finance Economic Survey autumn 2014 and Bank of Finland Economic Outlook 3/2014.
- 4 Sources: Ministry of Finance Economic Survey autumn 2014 and Bank of Finland Economic Outlook 3/2014.
- 5 Source: Calculations of the National Audit Office.
- 6 Source: Ministry of Finance Stability Programme for Finland 2014 and draft budgetary plan for 2015. The change in the structural deficit forecasts shown in the figure is partially explained by the ESA statistics reform as a result of which the difference between the EDP deficit and the deficit entered in the national accounts arising from swap interest payments was eliminated. The reform accounts for 0.3 percentage points of the weakening of the structural deficit forecast.
- 7 NAOF's comment on the Government resolution of 2 October 2014 (http://www.vtv.fi/files/4247/VTVn_kommentti_valtionuoston_periaatepaatoksesta_02102014.pdf).
- 8 Source: European Commission European Economic Forecast Spring 2014 and Autumn 2014.
- 9 IMF The Functions and Impacts of Fiscal Councils, July 16, 2013.
- 10 Source: Statistics Finland Annual National Accounts and Economic Surveys of the Ministry of Finance 2008–2013.
- 11 Source: Statistics Finland Annual National Accounts, Ministry of Finance Economic Surveys 2011–2013 and Bank of Finland Economic Outlook 2011–2013.
- 12 Source: Government proposals.
- 13 Source: Programme of Prime Minister Jyrki Katainen's Government, central government spending limits and Government proposals. It should be noted that accelerated depreciation may not be applied to acquisition cost of fixed assets to which accelerated depreciation has been applied under the Act on accelerated Depreciation on Investments made in Less-developed Regions. The taxpayer can thus choose under which act it would like to enter the accelerated depreciation if both acts are applicable.
- 14 Source: Government Programme, central government spending limits and Government proposals.
- 15 Source: Finnish Tax Administration, Brief Statistics 2014.
- 16 The income distribution tasks includes current transfers in the tax and social security system and the provision of such services as health care, education and training and day care, as these too contribute to the redistribution of income.
- 17 Positive external effects mean that the service also benefits residents outside a specific region. If other groups do not contribute to the financing of the service, they will be able to benefit from it at the expense of others.
- 18 Source: Statistics Finland, Preliminary Population Statistics 2012.

- 19 Source: THL, Sotkanet.
- 20 The index takes into account seven different groups of diseases and four different aspects of weighting to evaluate the significance of diseases. The prevalence of each disease group is weighted on the basis of the significance of that group in terms of mortality, disability, quality of life, and health care expenditure.
- 21 Source: Statistics Finland Annual National Accounts.
- 22 Source: Municipal scorecards of the Ministry of Finance 2014.
- 23 The details of the number of tasks alone do not tell much about their importance to municipal residents or about the financial burden incurred by municipalities as they carry them out.
- 24 Opportunism is also common in connection with municipal mergers (see e.g. Hyytiäinen et al. 2014; Pääkkönen et al. 2013; Saarimaa and Tukiainen, 2010). The implementation of the mergers, especially forced mergers, should be planned so that there is only limited room for opportunism.

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HE 53/2011 vp: Hallituksen esitys eduskunnalle energiaverotusta koskevan lainsäädännön muuttamiseksi

HE 54/2011 vp: Hallituksen esitys Eduskunnalle laiksi alkoholi- ja alkoholijuomaverosta annetun lain liitteen muuttamisesta.

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HE 94/2012 vp: Hallituksen esitys eduskunnalle laeiksi tuotannollisten investointien korotetuista poistoista verovuosina 2013—2015 ja tuotannollisten investointien väliaikaisesti korotetuista poistoista annetun lain kumoamisesta.

HE 118/2012 vp: Hallituksen esitys eduskunnalle laiksi yrittäjän eläkelain 115 §:n muuttamisesta.

HE 146/2012 vp: Hallituksen esitys eduskunnalle laeiksi elinkeinotulon verottamisesta annetun lain ja verotusmenettelystä annetun lain 65 §:n muuttamisesta.

HE 167/2012 vp: Hallituksen esitys eduskunnalle laiksi väliaikaisesti pankkiverosta sekä laeiksi elinkeinotulon verottamisesta annetun lain 16 §:n ja verotustietojen julkisuudesta ja salassapidosta annetun lain 18 ja 20 §:n muuttamisesta.

HE 175/2012 vp: Hallituksen esitys eduskunnalle laiksi tutkimus- ja kehittämistoiminnan lisävähennyksestä vuosina 2013—2015.

HE 177/2012 vp: Hallituksen esitys eduskunnalle laiksi sijoitustoiminnan veronhuojennuksesta verovuosina 2013—2015 ja laiksi verotusmenettelystä annetun lain 16 §:n muuttamisesta.

HE 22/2013 vp: Hallituksen esitys eduskunnalle laiksi sijoitustoiminnan veronhuojennuksesta verovuosina 2013—2015 annetun lain 8 §:n muuttamisesta.

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HE 105/2013 vp: Hallituksen esitys eduskunnalle vuoden 2014 tuloveroasteikkolaiksi sekä eräiksi muiksi laeiksi.

HE 109/2013 vp: Hallituksen esitys eduskunnalle laiksi makeisten, jäätelön ja virvoitusjuomien valmisteverosta annetun lain muuttamisesta.

HE 110/2013 vp: Hallituksen esitys eduskunnalle energiaverotusta koskevan lainsäädännön muuttamiseksi.

HE 111/2013 vp: Hallituksen esitys eduskunnalle laiksi tupakkaverosta annetun lain liitteen muuttamisesta.

HE 140/2013 vp: Hallituksen esitys eduskunnalle voimalaitosverolaiksi sekä laeiksi elinkeinotulon verottamisesta annetun lain 16 §:n muuttamisesta ja verotilistä annetun lain 1 §:n muuttamisesta.

HE 151/2013 vp: Hallituksen esitys eduskunnalle laiksi alkoholi- ja alkoholijuomaverosta annetun lain liitteen muuttamisesta.

HE 181/2013 vp: Hallituksen esitys eduskunnalle vuoden 2014 tuloveroasteikkolaiksi sekä eräiksi muiksi laeiksi annetun hallituksen esityksen (HE 105/2013 vp) täydentämisestä.

HE 185/2013 vp: Hallituksen esitys eduskunnalle laeiksi tuloverolain, elinkeinotulon verottamisesta annetun lain sekä eräiden muiden verolakien muuttamisesta.



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