



**National Audit Office's separate report to Parliament:
Fiscal Policy Audit and Monitoring Report 2014**

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To Parliament

As part of its remit under section 90 of the Constitution of Finland, the National Audit Office examines the reliability of the fiscal policy knowledge base, the viability of rules and administrative tools and the achievement of targets. The National Audit Office also monitors fiscal policy under the Stability Pact (a fiscal policy agreement) and in its role as an independent national fiscal policy supervisory body within the meaning of European Union law. Its monitoring tasks are laid down in the Act on the National Audit

Office of Finland (676/2000, amended by 870/2012) and Act on the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on multi-annual budgetary frameworks (869/2012).

Under section 6 of the Act on the National Audit Office of Finland, the National Audit Office hereby presents Parliament with this separate report on its principal findings with respect to fiscal policy and monitoring for 2014.

Helsinki 22 May 2014

Auditor General

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Main content

On the basis of the National Audit Office's audit, the assessment in the Government's Annual Report for 2013 that in fiscal year 2013 spending fell below the limits set would appear to be correct. Consequently, under the rule on spending limits in the Government Programme, EUR 61 million may be carried across to 2014, notwithstanding the limits. The National Audit Office is satisfied that the Government's Annual Report has continued to comment accurately on adherence to the spending limits.

Expenditure outside the spending limits has remained relatively stable in the period in which the central government spending procedure in its current form has been employed. Cyclical expenditure relating to unemployment security, housing allowances and income security have increased, though interest rates have remained exceptionally low. The rise in central government debt and interest rates will push up the amount of interest paid in the future and, as a result, expenditure outside the spending limits. The main factor explaining the increase in expenditure outside the spending limits in 2013 was the continuation of the refinancing of exports as part of financial investments using credits granted out of the state budget.

On the basis of the audit, the National Audit Office finds that Finland complied with the Stability and Growth Pact in 2013. The Office will focus its attention on spending limits for the current year. If the trend in 2014 is less favourable than is now predicted, in 2015 it may have to be declared that the preventive arm of the Stability and Growth Pact was breached in 2014. This could lead to a

warning from the European Commission and the need to take corrective action.

The National Audit Office has evaluated the situation in the public sector and how it relates to the rules of the Stability and Growth Pact in the medium term. In 2013, a clear breach of the preventive arm was predicted in the medium term. According to forecasts made in spring 2014, Finland would seem to be complying with the Stability and Growth Pact in the medium term. The Stability and Growth Pact targets applicable to Finland will probably change. The expenditure benchmark associated with the preventive arm of the Stability and Growth Pact is likely to be more stringent for Finland in the future than it is now, because potential growth is predicted to slow down. Parliament and the Government should now prepare for a situation where the expenditure benchmark requires public expenditure in the near future to barely increase at all in real terms; either that, or increases in expenditure will have to be matched by equivalent levels of income. There will be greater insistence on discipline in fiscal policy stance and public expenditure.

The long-term challenges to central government finances are still there in the Finnish economy: slow GDP growth and the growing pressure on expenditure due to an ageing population. Slower economic growth results in a lower increase in tax revenue, and public expenditure has to be set with reference to that. For this reason, the National Audit Office wishes to give attention in its report to the need for the kind of continued structural reforms that would speed up the rise in po-

tential output and slow down the increase in expenditure.

The National Audit Office is of the view that the Government's structural policy programme is an important tool in stabilising central government finances. However, the programme's implementation has been very slow in parts and is still largely an abstract concept. It takes time to introduce the reforms and feel the impact of measures, so there should be no postponement of the programme's implementation and its delivery. The National Audit Office is of the opinion that the structural policy programme should be implemented and put into effect without delay and in an efficient manner.

In addition to direct and indirect liabilities (such as central government debt), there are also indirect contingent liabilities outside the budget economy affecting the country's economic position, for example, among state-owned companies. A more comprehensive report on the country's total liabilities would give a better picture of the factors affecting the central government finances. However, more reports will not necessarily be enough to understand what position to adopt on uncertain liabilities. Some are never actually realised, i.e. they do not appear as financed from the state budget or as central government debt in the country's balance sheet.

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1 Fiscal Policy Monitoring

The National Audit Office is an independent monitoring body for fiscal policy within the meaning of the EU's Stability Pact (a fiscal policy agreement), the Directive on requirements for budgetary frameworks of the Member States (2011/85/EU) and Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. Its task entails monitoring the production and execution of the multi-annual plan for central government finances, ensuring the reliability of macro forecasts and supervision of compliance with the Stability and Growth Pact. The results of the National Audit Office's monitoring exercise are reported annually in a separate Fiscal Policy Audit and Monitoring Report to Parliament.

Under EU Directive 2011/85/EU and Regulation (EU) No 473/2013, Member States must draw up a medium-term fiscal plan. The Government approved the first plan for general government finances in Finland on 3 April 2014. The plan contains sections on the central government finances, local government finances, statutory employment pension institutions and other social security funds. It includes a target for a financial balance target for the entire public sector and, from 2015, will contain one for each element of public finances separately. The purpose of the finance plan is to support policy-making in the area of general government finances and to achieve the medium-term target set

for its structural financial position. The plan forms part of the Finnish Stability Programme for 2004–2018. The plan also contains a decision on central government spending limits. The expenditure benchmark in the system of spending limits is Finland's most important national financial policy administration tool. The National Audit Office has overseen compliance with central government spending limits since 2008.

Under regulation (EU) No 473/2013, independent forecasts mean forecasts produced or endorsed by independent bodies; Under Directive 2011/85/EU, the forecasts must be evaluated regularly and comprehensively on the basis of objective criteria. The methodologies and assumptions parameters that underpin forecasts must be made public.

As part of its monitoring task, the National Audit Office is responsible for monitoring the reliability and transparency of forecasts. The National Audit Office reports have previously contained recommendations for the transparency of the policy-making knowledge base for fiscal policy. Examples of such recommendations are those on the Ministry of Finance website on the publication of methodological descriptions and a clearer presentation of background assumptions for official estimates in reports. The fiscal policy audits will in future also include checks on the quality of forecasts by the Ministry of Finance and the transparency of reports. Part of the tasks of monitoring and auditing fiscal policy is the continuous monitoring of

forecasts by the Ministry of Finance, which concentrates on their internal consistency and the presentation of key assumptions. In addition, the Ministry of Finance, as an institution that presents forecasts, is compared with other Finnish and foreign economic forecasters.

Under the preventive arm of the Stability and Growth Pact, the Government must set a medium-term objective for the structural balance in Government finances (MTO). The National Audit Office ensures that the objective has been set and that it is in accordance with EU requirements, and oversees achievement of the objective. Monitoring entails the verification of the estimate given by the Ministry of Finance for the structural balance, every year in the spring. Continuous monitoring ensures that the required public

assessments can be given of the achievement of the medium-term objective and the adequacy of corrective measures. The task of fiscal policy monitoring requires the National Audit Office to assess publicly whether there is any substantial deviation, correction of the deviation will go ahead in accordance with national rules and plans, and the criteria for exceptional circumstances are met, and an assessment to be made, when the exceptional circumstances have passed, as to the adequacy of the corrective measures. The Government must either defer to the opinions publicly adopted by the National Audit Office or publicly state why not. Monitoring is a means whereby the National Audit Office can promote the transparency and comprehensibility of the rules.

2 Compliance with central government spending limits

2.1 Summary

On the basis of the National Audit Office's audit, the assessment in the Government's Annual Report for 2013 that in fiscal year 2013 spending fell below the limits set would appear to be correct. Consequently, under the rule on spending limits in the Government Programme, EUR 61 million may be carried across to 2014, notwithstanding the limits. The National Audit Office recommends that the Ministry of Finance should improve the transparency of the spending limits procedure inasmuch as the share of expenditure outside the spending limits should be itemised more precisely in the detailed rationale for the item central government transfers to local government for the organisation of basic services. Alternatively, a more detailed analysis could be given in the draft budget explanatory memorandum.

Expenditure outside the spending limits has remained relatively stable in the period in which the central government spending limits procedure in its current form has been

employed Cyclical expenditure relating to unemployment security, housing allowances and income security have increased, though interest rates have remained exceptionally low. The rise in central government debt and interest rates will push up the amount of interest paid in the future and, as a result, expenditure outside the spending limits. The main factor explaining the increase in expenditure outside the spending limits was the continuation of the refinancing of exports as part of financial investments using credits granted out of the state budget.

According to the Government's Annual Report, 185 categories of tax subsidy were identified in 2013, while in 2012 there were 176. The National Audit Office believes that it is important that the evaluation of the efficacy of tax subsidies begun in 2012 should continue. Carefully produced impact assessments allow for a debate on the expediency of tax subsidies and therefore aid the process whereby they might be cut.

2.2 Compliance with central government spending limits and the transparency of the spending limits procedure in fiscal year 2013

To achieve a credible and stable fiscal policy, Finland is committed to fiscal policy rules designed to curb central government expenditure. At the start of the parliamentary term, the Government decides the ceiling for expenditure in the central government spending limits in the state budget for the entire parliamentary term (parliamentary term framework). The allocation of appropriations is reviewed annually in the decision on central government spending limits. The spending limits constitute a fiscal policy rule that steers Government financial policy. The Government's Annual Report gives details of compliance with spending limits. Furthermore, the explanatory memoranda in the state draft budget and supplementary draft budget report on compliance with the spending limits for the parliamentary term and on how they relate to the limits. Compliance with spending limits at the Ministry of Finance is monitored by comparing the price- and structure-adjusted spending limits with the budget.

The National Audit Office audits the knowledge base for decisions on fiscal policy, compliance with central government spending limits and the achievement of the objectives laid out for fiscal policy. The areas of audit are decisions on spending limits, draft budgets and budgets proper with their drafting material, and final accounts.

The first decision on spending limits of Prime Minister Jyrki Katainen's Government, that for the parliamentary term 2012–2015, was presented to Parliament on 5 October 2011. The second, for 2013–2016, was pre-

sented to Parliament on 4 April 2012. According to this, spending levels for 2013 stood at EUR 42,801 million.

Spending levels in the Government's draft budget for 2013 stood at EUR 42,735 million. In autumn 2012, and before Parliament had considered it, the Government's draft budget of 17 September 2012 was supplemented with a proposal for reviewing the spending limits upwards by a total of EUR 101 million in accordance with price and structural changes. Following the reviews, spending levels for 2013 stood at EUR 42,836 million. The Government's proposal for expenditure included in the spending limits for 2013 was EUR 42,530 million. Thus, a total of EUR 106 million was left as discretionary appropriation for 2013 in addition to the supplementary budget of EUR 200 million. Parliament added EUR 51 million in expenditure to be included in the spending limits to the budget proper, with EUR 55 million remaining as discretionary appropriation for 2013 in addition to the supplementary budget reserve of EUR 200 million.

In the year under review, five supplementary draft budgets were submitted to Parliament. In the third and fourth, spending levels for 2013 were raised technically by a total of EUR 144.9 million. According to entries in the Government Programme, this was covered in a reserve of EUR 200 million carried across from 2012.

The National Audit Office compared the 2013 draft budget and the budget to the second spending limits decision for the parliamentary term issued in Autumn 2012 and

the price- and structure-adjusted spending levels decided when the budget was being drawn up at the Ministry of Finance. To ensure the existence of a disciplined expenditure budget line, the National Audit Office also compared the final central government accounts for 2013 with the price- and structure-adjusted spending levels. The National Audit Office used the decision on spending limits dated 4 April 2012, which had been used as a basis for the calculations. The National Audit Office also had access to the material used for drafting the budget used by the Ministry of Finance, which gave the indices used and the revisions to prices and costs. The National Audit Office recalculated the 2013 price revisions, taking the index and price adjustment percentages used in the revisions to prices and costs from the calculations made by with Ministry of Finance, without altering them. The audit exercise resulted in the discovery that it was not possible to recalculate the statutory and agreed index rises with the information available, unlike with discretionary price increases. The annual change in the index and the total in the item cannot solely be used to calculate the size of each statutory price adjustment, as the items frequently contain amounts that the index rises do not relate to. The National Audit Office recommends that the Ministry of Finance should improve the comprehensiveness of the data available on the criteria for calculating the statutory and agreed price reviews.

With respect to 2013, the National Audit Office tried to allocate the changes to prices and structures while the budget was being drafted and using the data available to the main titles, and where possible the items, making it possible to judge the adequacy of the information on changes to the spending limits. During the audit, it was found that,

apart from the reserve that had been carried across from 2012, whose breakdown of items were not included in the analyses of structural changes, the allocation to main titles was possible and the information available was therefore considered adequate.

The allocation used in the calculation to expenditure within and outside the spending limits was obtained from the Ministry of Finance in connection with the second decision on spending limits of the parliamentary term. The allocation of changes and additions to the draft budget and the supplementary draft budgets that followed it prior to the budget proper to expenditure within and outside the spending limits has also been done by the National Audit Office. The changes in 2013 applied, for example, to items that had not been included in the decision on spending limits made on 4 April 2012, or allocated items where there had been changes to those within and those outside the spending limits.

With respect to the allocated items, the National Audit Office examined the item's detailed rationale in the draft budgets. The aim was to ensure that there was sufficient data on the area of expenditure outside the spending limits for the allocated items. The National Audit Office discovered that, using the data in the explanatory memoranda in the draft budget for item 28.90.30 (Central government transfers to local government for the organisation of basic services), it was not possible to derive the expenditure outside the spending limits for item 28.90.30, owing to which the data available might be considered unsatisfactory from the perspective of the transparency of the spending limits procedure. According to a statement by the Ministry of Finance, the basis for the expenditure outside item 28.90.30 is the technical decision on spending limits of 23 March 2011, to which there have not been any changes

other than those due to compensation for tax cuts. The National Audit Office recommends that the Ministry of Finance should improve the transparency of the spending limits procedure inasmuch as the share of expenditure outside the spending limits should be itemised more precisely in the detailed rationale for item 28.90.30 (Central government transfers to local government for the organisation of basic services). Such a move would help to strengthen the binding nature of the spending limits and their transparency as an expenditure benchmark.

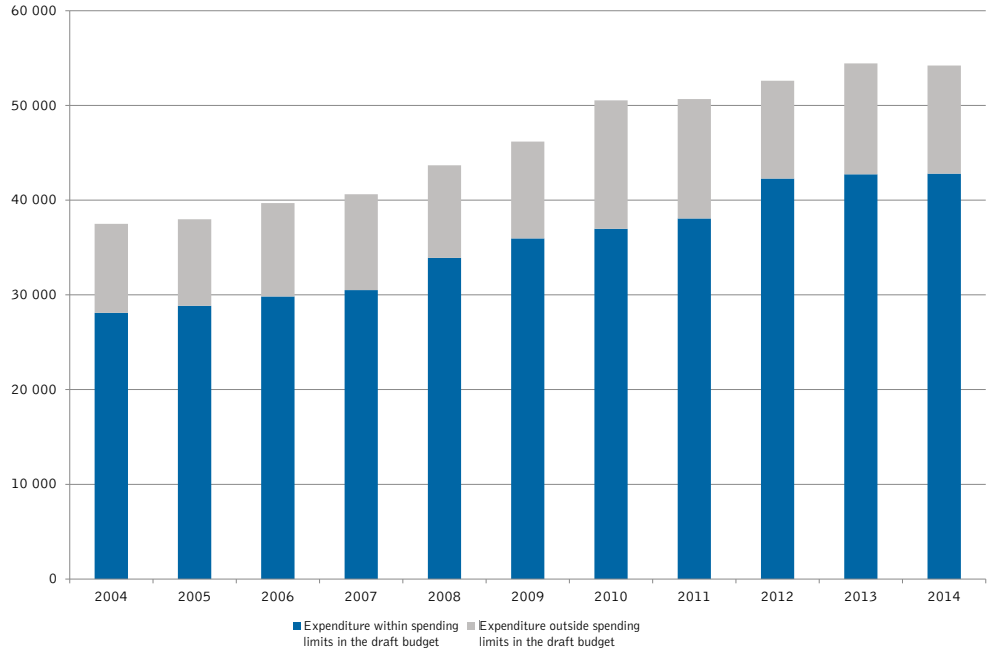
On the basis of the audit by the National Audit Office, the estimate in the report on final central government accounts for fiscal year 2013 that spending had fallen below the spending limits by approximately EUR 61 million in fiscal year 2013 would appear to be correct, as the calculation by the National Audit Office arrived at the same result. Consequently, according to the entries in the Government Programme, it is possible to carry EUR 61 million across to 2014, notwithstanding the rule on spending limits.

The National Audit Office has also compared the spending limits to what is stated in the final accounts. The rule on spending limits does not restrict expenditure under the final accounts. By making the comparison between final accounts, the National Audit Office has endeavoured to verify the fundamental purpose of the expenditure benchmark contained in the spending limits, i.e. the successful curbing of central government expenditure. According to the budgetary outturn for 2013, appropriations were EUR 703.5 million under budget. The National Audit Office's calculation showed that the expenditure within the spending limits accounted for EUR 545.8 million of this and the share of expenditure outside the spending limits was EUR 157.7 million, indicating that the spending limits had also been complied with in terms of budgetary outturn. However, the calculation contains a degree of uncertainty of the allocated items, because the results are divided into those within in the spending limits and those outside them in relation to the budgeted sections.

2.3 Trend in expenditure outside the spending limits

It is mainly the expenditure that varies with economic trends and funding on an automatic basis that is outside central government spending limits under the expenditure benchmark and pursuant to it. The largest single items for expenditure outside the spending limits are unemployment security, housing allowances and income security.

Other significant items include interest, financial investments and compensation for tax cuts to local authorities. Expenditure outside the spending limits has remained relatively stable in the period in which the central government spending limits procedure in its current form has been employed (Figure 1).



Source: Draft budgets for 2004–2014, nominal values.

Figure 1 Allocation of budgetary expenditure within spending limits and outside them 2004–2014, EUR million

The first decision on spending limits of the parliamentary term, taken in 2011, made a technical change to the relative scale of spending limits and expenditure outside them. In a technical adjustment, approximately EUR 3 billion of what had been expenditure outside the spending limits in the allocated item was transferred to the spending limits. At the same time, a total of three formerly allocated items were transferred outside the spending limits, with the result that expenditure outside the spending limits grew by EUR 199 million. Consequently, in

2012 expenditure on unemployment security, housing allowances and income security outside the spending limits was reduced at the same time as the expenditure within the spending limits increased by more than EUR 2 billion. In the current parliamentary term the increase in expenditure outside the spending limits has mainly been explained by declining employment. The effect on costs of the improvement to basic security in 2012 is likewise reflected in the addition to expenditure outside the spending limits in 2012 and 2013.

Table 1: Breakdown of expenditure outside the spending limits 2011–2014

	2011	2012	2013	2014
Financial investments	825	515	1,125	711
Compensation for tax cuts to local authorities	1,002	1,265	1,313	1,266
Debt interest payments	1,933	2,185	1,866	1,814
Unemployment security, housing allowances and income security	5,707	3,072	3,542	3,654
Other	3,129	3,289	3,853	3,962
	12,596	10,326	11,699	11,407

Source: Draft budgets for 2011–2014, nominal values.

Financial investments grew considerably in 2013, compared to 2012. In 2012 they stood at EUR 515 million and in 2013 at more than EUR 1 billion. The main factor explaining the increase in expenditure outside the spending limits was the continuation of the refinancing of exports as part of financial investments temporarily using credits granted out of the state budget. In 2014, the main single factor explaining the cut in expenditure outside the spending limits is the reduction in appropriations for loans granted for refinancing on the part of Finnish Export Credit Ltd included in the financial investments and the termination of one-off mandatory state payments for home-market deliveries of vessels.

The programme of Jyrki Katainen's Government states that changes to the income of local authorities due to tax changes will be fully compensated. Compensation for tax cuts has remained at high levels during the parliamentary term. They have been at more than one billion euros annually during the current parliamentary term.

Interest paid on central government debt included in expenditure outside the spending limits has remained low throughout the parliamentary term, and, especially in 2013 and 2014, the interest rates have been exceptionally low. The rise in central government debt and levels of interest paid will probably push up the amount of interest paid in future, and,

thus, the amount of expenditure outside the spending limits.

Expenditure outside the spending limits has remained relatively stable in the period in which the central government spending limits procedure in its current form has been employed Cyclical expenditure relating to unemployment security, housing allowances

and income security has increased though interest rates have remained exceptionally low. During the parliamentary term, the trend in expenditure outside the spending limits has shown no obvious signs that the additional expenditure resulting from the economic downturn will be falling off.

2.4 Tax subsidies

According to the entries in the Government Programme, the Government does not use tax subsidies to avoid spending limits contrary to the purpose of the expenditure benchmark. There have been attempts to improve the way in which reports on tax subsidies are compiled, and the Government's Annual Report currently has a description of the most relevant tax subsidies.

According to the Government's Annual Report, 185 categories of tax subsidy were identified in 2013, while in 2012 there were 176. In the absence of an adequately broad and reliable knowledge base, it has been impossible to calculate the sums for some 40% of them. It has therefore not been possible to estimate the total cost of tax subsidies. The total for those subsidies that could be estimated was EUR 23.6 billion. Around 70% of tax subsidies relate to central government tax revenues, the remaining 30% being split between the local authorities, the Church and Kela (Social Insurance Institution of Finland).

The total for subsidies was up by approximately EUR 550 million compared to 2012.

The Government's Annual Report for 2012 also gave an assessment of the impact of state subsidies. There was no such assessment in the Government's Annual Report for fiscal year 2013. The next such assessment will be made in 2014, and the report for that year describes them. The National Audit Office believes that it is important that the evaluation of the efficacy of tax subsidies should continue. In the future it will be important to focus particular attention on evaluating the economic effects of tax subsidies. This will enable a debate to take place on the expediency of tax subsidies. It is the view of the National Audit Office that cutting tax subsidies is justified from the perspective of a viable tax system and effective allocation of resources. A careful assessment of the efficacy of tax subsidies might also aid the process of cutting them.

3 The implementation of fiscal policy in the government spending limits discussion in 2014

The Government supplemented its decisions under the Structural Policy Programme in the spending limits discussion in spring 2014. The aim of the Structural Programme is to eliminate the sustainability gap in general government finances. The Government decided on its Structural Policy Programme and set its targets on 29 August 2013, and finalised it and decided on its implementation on 29 November 2013. The aim in the Programme to close the sustainability gap entails four separate objectives relating to 1) the local government finances, 2) an increase in productivity in public services, 3) work careers and employment, 4) structural unemployment and 5) potential output in the economy as a whole.

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 Programme's implementation has been very slow in parts and is still largely an abstract concept. It takes time to introduce reforms and feel the impact of measures, so there should be no postponement of the programme's implementation and its delivery. A key part of the Programme is a reduction in the tasks of local authorities by 2017, saving a billion euros. The Ministries had to submit their proposals for reductions in the tasks of local authorities by the end of November 2013. There were none, however. The

Government has supplemented its earlier decisions and laid down policy for the Programme's implementation as part of the plan for general government finances in spring 2014. It was possible to include in the central government spending limits for 2015–2018 about a third of the target savings amount of EUR 1 billion. The Government's proposals for the changes will be presented to Parliament in autumn 2014. The National Audit Office is of the opinion that the Structural Policy Programme should be implemented and put into effect without delay and in an efficient manner.

The objective in the Government Programme to bring the central government debt ratio down during the parliamentary term has significantly influenced the implementation of fiscal policy, as direct adjustment measures have been employed to try to ensure that the objective is achieved. Forecasts made in spring 2014 suggest that the central government debt ratio will start to come down in 2016 and that the deficit target would be achieved in 2018. According to a forecast made in spring 2014 by the Ministry of Finance, the objectives under the Government Programme would be achieved, though with the delay. The scope of adjustment measures is based on forecasts, so there is a lot of uncertainty associated with the achievement of the targets.

4 Compliance with the Stability and Growth Pact

4.1 Summary

On the basis of the audit, the National Audit Office concludes that Finland complied with the Stability and Growth Pact in 2013. The National Audit Office will focus its attention on spending limits for the current year. If the trend in 2014 is less favourable than is now predicted, in 2015 it may have to be declared that the preventive arm of the Stability and Growth Pact was breached in 2014. This could lead to a warning from the European Commission and the need to take corrective action.

The National Audit Office has evaluated the situation in the public sector and how it relates to the rules of the Stability and Growth Pact in the medium term. In 2013, a clear breach of the preventive arm was predicted in the medium term. According to forecasts made in spring 2014, Finland would seem to be complying with the Stability and Growth Pact in the medium term. The Stability and Growth Pact targets applicable to Finland will probably alter. The expenditure benchmark associated with the preventive arm of the Stability and Growth Pact is likely

to be more stringent for Finland in the future than it is now, because potential growth is predicted to slow down. Parliament and the Government should now prepare for a situation where the expenditure benchmark requires public expenditure in the near future to barely increase at all in real terms; either that, or increases in expenditure will have to be matched by equivalent levels of income. There will be greater insistence on discipline in fiscal policy stance and public expenditure.

The long-term challenges to general government finances are still there in the Finnish economy: slow GDP growth and the growing pressure on expenditure due to an ageing population. Slower economic growth results in a lower increase in tax revenue, and public expenditure has to be set with reference to that. For this reason, the National Audit Office wishes to give attention in its report to the need for the kind of continued structural reforms that would speed up the rise in potential output and slow down the increase in expenditure.

4.2 Stability and Growth Pact

The European Union's Stability and Growth Pact is divided into two arms: the preventive and the corrective. The aim of the preventive arm is to control general government finances in such a way that they are sustainable in the short and long term. The purpose of the corrective arm is to correct any flaws in policy that pose a risk to the sustainable development of general government finances. The corrective arm is also known as the excessive deficit procedure. The preventive arm is in effect continuously, whereas the corrective arm is brought into play when the limits for debt and the deficit threshold are exceeded and, on a recommendation of the European Commission, the European Council adopts the view that the country must be subjected to the excessive deficit procedure.

Preventive arm

The interpretation of compliance with the preventive arm of the Stability and Growth Pact comprises three parts:

- 1 Achievement of the Medium-Term Objective (MTO) or remaining on a path leading to its achievement at an adequate rate of progress
- 2 Compliance with the expenditure benchmark
- 3 Comprehensive assessment of compliance with points 1 and 2.

The preventive arm has two separate rules or pillars that aid the achievement of each other: the medium-term objective and the

expenditure benchmark. In the context of these rules, targets are set for a change to structural financial status and increases in expenditure. The third part entails a comprehensive assessment of compliance with the rules, which serves as a basis for assessing compliance with the preventive arm.

The main assessment criterion for compliance with the rules is substantial deviation: if there is no substantial deviation, the rule has been complied with. In normal circumstances, substantial deviation from both objectives leads to a breach of the rules of the preventive arm of the Stability and Growth Pact. If a substantial deviation in only one objective is discerned, compliance with the rules is based on discretion in the comprehensive assessment. The discretionary process looks at why a substantial deviation from an objective came about. On the basis of the discretionary process and other information, a decision is taken on whether the country is on the path to the MTO or not. If it is not, the country is in breach of the preventive arm of the Stability and Growth Pact.

A substantial deviation from both rules can come about in two different ways. Firstly, there can be a substantial deviation if over one period the objective under the rule is deviated from by 0.5 percentage points. Secondly, a substantial deviation can occur if the average deviations for two successive periods exceeds 0.25 percentage points. The aim with the latter procedure is to prevent situations where every year there is a slight deviation from the targets for change to the structural deficit, with the cumulative devia-

tion reaching excessive proportions.

The audit of compliance with the rules of the preventive arm is divided into two temporal dimensions: the ex-post examination and ex-ante and in-year examination. The ex-post examination assesses compliance with the Pact in the year preceding the examination. In 2014 this means 2013. If there is a substantial deviation in compliance with the Stability and Growth Pact, the European Commission may issue a warning pursuant to Article 121(4). If the Council accepts the Commission's proposal, the Government has five months to start implementing measures to correct the deviation. After the deadline has passed, the Commission assesses the adequacy of the measures and submits a proposal to the Council. If the Council is of the opinion that the measures are inadequate, the Council may make new recommendations or approve a sanction in the form of an interest-bearing deposit.

Compliance with the Pact in the ex-ante and in-year examination is monitored for the current year and for future years. In this examination, a Member State cannot face sanctions, its aim being to ensure that the general government finances in the Member State implement the preventive arm of the Stability and Growth Pact in the future. In the context of this examination, the Commission may warn a Member State about a possible breach of the Pact in the future. Issuing warnings with reference to an ex-ante and in-year examination will not result in other measures being taken. With ex-ante and in-year examinations, the aim is to highlight possible substantial deviations in the future that can be avoided with a change in economic policy.

The corrective arm or excessive deficit procedure

The corrective arm of the Stability and Growth Pact takes effect when a Member State is in the Excessive Deficit Procedure (EDP). The Commission considers a recommendation to the Council to make the country subject to the EDP if its public sector deficit is more than three or debt is over 60% in relation to GDP, and the debt cannot be adjusted towards the 60% threshold with sufficient speed.

Debt and debt trends are assessed with reference to four criteria. The commencement of the assessment process with respect to a debt criterion requires the following conditions to be infringed:

- 1 the 60% debt threshold is exceeded
- 2 the retrospective condition that over the past three years the debt must be reduced by an average of 5% in relation to the 60% threshold
- 3 the forward-looking condition that the retrospective condition must be achieved when it is examined with the help of a forecast made for up to two periods
- 4 acknowledgement of fluctuations in the economy: fulfilment of the retrospective condition is examined, taking account of the effect of fluctuations on debt.

In practice, the different conditions provide debt with a target that the actual debt can be compared to. If the perceived level of debt is above the target for a condition, that condition has not been met. If a single condition is met, debt is regarded as have been reduced with sufficient speed. The final assessment by the Commission regarding whether a country should be subject to the excessive deficit procedure is made taking everything into account. Other factors are also considered in this assessment.

4.3 Performing the audit

In this audit, the National Audit Office does not judge the expediency of the rules of the Stability and Growth Pact and their application, but merely assesses compliance with them. Some of these rules are also in effect in Finland based on Finnish legislation. The Act on the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on multi-annual budgetary frameworks (869/2012)¹, which entered into force from the start of 2013, provides for a medium-term objective for general government finances and the relevant correction mechanism. The Act also provides for the obligation of the National Audit Office to monitor compliance with the rules.

The National Audit Office assesses compliance with the Stability and Growth Pact by using data from the Ministry of Finance, as well as its calculations and forecasts, which the Ministry has published in the reports 'Plan for General Government Finances 2015–2018' and the 'Finnish Stability Programme 2014'. The National Audit Office has independently produced estimates of the degree of compliance with the rules and verified the Ministry's calculation for potential output.²

Since the forecast published at the start of April by the Ministry of Finance, Statis-

tics Finland has obtained more detailed information on the EDP deficit in the public sector. The estimate at the end of March for the 2013 deficit is -2.1% in relation to GDP. The Ministry used an estimate of -2.0 in the calculation in the Stability Programme. To achieve the optimum degree of accuracy, in its own calculations, the National Audit Office has corrected the 2013 figures so that the deficit stands at -2.1. Furthermore, other values henceforward will be corrected in the same way as was the case for 2013. Making a correction in such a straightforward manner is not without its problems, but the National Audit Office is of the view that corrected figures represent a better basis for the examination than uncorrected ones.

The data produced by the Ministry of Finance served as a basis for calculating the expenditure aggregate under the expenditure benchmark for the period 2011–2018. The figures for 2012 are finalised, those for 2013 are advance data and those for 2014–2016 are forecasts. The forecasts include an estimate of the impact on general government finances of the adjustment measures drafted by the Government in its spending limits discussion in spring 2014. The increase in expenditure was put on real basis by using the Commission's GDP deflator.³

The European Commission assesses com-

1 As shown, the Act's full name is the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on multi-annual budgetary frameworks.

2 The National Audit Office has compared the calculations made using the Ministry of Finance data with those using the Commission's data (Commission winter forecast, 2014). The differences are small, which means that, as a rule, they are not reported.

3 For the sake of comparison, a true aggregate was also produced using the Ministry of Finance deflator. The estimates of the Commission and the Ministry regarding price trends in 2013 were very much the same, but for 2014, the Ministry expects a slower rate of inflation, which will in turn result in a faster increase in expenditure in real terms. The rate in the rise in prices for the period 2016–2018 has been assumed to be 2.0% a year.

pliance with the Stability and Growth Pact annually in June when the review of the Finnish Stability Programme takes place. The National Audit Office oversees compliance with the rules independently, and may, within its remit, recommend corrective measures to be taken, though only the Commission may recommend the imposition of sanctions on Member States. Owing to the differences in its mandate, the National Audit Office carries out a confirmatory calculation and endeavours to interpret the Stability and Growth Pact in exactly the same way as the Commission, where that is possible. The European Commission's interpretation of the Stability and Growth Pact is given in the report entitled 'Vade Mecum on the Stability and Growth Pact'. The Commission's

interpretations in the Vade Mecum are not legally binding, but the report also contains references to legally binding documents.

The Vade Mecum is not an adequately detailed description of the rules of the Stability and growth Pact, so the National Audit Office has given its own interpretations. For example, there are no unambiguous criteria for discretion in the comprehensive assessment. In these cases, the interpretations by different institutions can obviously differ. If the National Audit Office notices anything inappropriate in the rules or their application, it will highlight the fact. The National Audit Office is currently studying how an interpretation of the Stability and Growth Pact suits Finland.

4.4 Audit of compliance with the preventive arm

4.4.1 Structural balance

The first pillar of the preventive arm is the achievement of the Medium-term Objective (MTO). The rule requires the MTO to be achieved or to there to be a path of adjustment leading to the objective. The required path of adjustment is determined as a change to the structural balance. The target for change to the structural balance is always determined with reference to the year preceding that under scrutiny. In the year under scrutiny, the structural balance should be changed to reflect the target for change. The extent of the required change is influenced by the achievement of the MTO, economic circumstances, public sector debt, the sustainability of general government finances and possible structural reforms. In a normal economic situation, the required change to the structural balance is 0.5 percentage points if the MTO has not been achieved. In an economic downturn, the target is lower – the value used by the National Audit Office is 0.1 percentage points – and when the economy is growing and the sustainability of general government finances is in greater danger – the value used by the National Audit Office is 0.6 percentage points. In a situation where the MTO has been achieved, the required change to the structural balance is 0.

The MTO is determined in terms of a structural balance. In this context, the structural balance reflects the difference (structural balance) between income and expenditure for the entire public sector (central and local government and social security funds) in relation to potential output, when the effects of fluctuations in the economy and one-off and temporary measures are eliminated from income and expenditure. A more detailed description of how the structural balance is calculated is given in the National Audit Office fiscal policy audit report Auditing the computation of structural balance (National Audit Office 13/2013). The aim of the structural balance is to measure the balance of finances in the public sector in the long term, when fluctuations in the economy or one-off items have no effect on the balance. In this way the balance is altered by permanent or long-term changes in GDP and decisions on economic policy. Table 2 gives estimates of the achievement of the target for change for the structural balance using Ministry of Finance data.

Table 2: Achievement of the change required of the structural balance based on Ministry of Finance data for 2014

	2012	2013	2014	2015	2016	2017	2018
Structural balance	-1.0	-0.5	-0.8	-0.2	-0.2	0	0.2
MTO	0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
Was the MTO achieved by the end of the period?		Yes	No	Yes	Yes	Yes	Yes
Required change to structural balance*		0.50	0.00	0.10	0.00	0.00	0.00
Actual change to structural balance		0.51	-0.24	0.56	0.02	0.22	0.18
Deviation from requirement		-0.01	0.24	-0.46	-0.02	-0.22	-0.18
Is the deviation > 0.5 percentage points?		No	No	No	No	No	No
Two-year average for deviations		0.46	0.12	-0.11	-0.24	-0.12	-0.2
Is the deviation substantial?		MTO achieved	No	MTO achieved	MTO achieved	MTO achieved	MTO achieved
Substantial deviation		No	No	No	No	No	No

*When the MTO is achieved, the country must stay on target. In this case, the required change to the structural balance is 0.

The ex-post examination starts with an examination of whether the country has achieved the MTO by the end of the year under scrutiny, i.e. the end of 2013. This has been done for 2013. The conclusion is that the target for change to the structural balance in 2013 has been adhered to: the structural balance improved from 2012 to 2013 by approximately 0.5 percentage points, which corresponds to the target set. Because the MTO has been achieved in the year under scrutiny, there is no need to examine the average deviation over two years: the country has achieved its target for the structural balance anyway. It can be said of the ex-post examination in 2014 based on Ministry of Finance data that there was no substantial deviation in 2013.

In the ex-ante and in-year examination, the greatest interest lies in the next few years to come. Because the MTO was achieved in 2013, the target for change to the structural balance for 2014 is 0. When setting the target for change for 2014, the National Audit Office did not think that there were sufficient grounds for supposing that Finland would

deviate from the path towards the MTO due to planned structural reforms. There are two reasons for this. First of all, many of the planned structural reforms have not as yet actually gone ahead to the extent that their economic effects can be assessed. Secondly, not all of the effects of the planned reforms have been assessed.⁴ The predicted change for 2014 is -0.24 percentage points, the deviation from the required figure being 0.24 percentage points. However, the deviation is not substantial, because it is under the 0.5 percentage point threshold. Furthermore, the average for the deviations in 2013 and 2014 is under the 0.25 percentage point threshold, at 0.12.

From 2014 onwards, the structural balance will be above the MTO level and will improve, so the forecast is that there would seem to be no deviations from the objective occurring. The conclusion is that in 2014 Finland is complying with the rule on the change to the structural balance in the preventive arm of the Stability and Growth Pact. However, if the economic growth is slower than predicted it is possible that there will be

⁴ Even when the measures are being implemented, their effects will not necessarily be felt within a four-year period.

a substantial deviation in 2014. In the current year, therefore, there is every reason to monitor the trend in the structural balance.

4.4.2 Expenditure benchmark

The expenditure benchmark determines the maximum growth rate for expenditure that allows MTO to be achieved. Because the target for the increase in expenditure is set for an adjusted, 'net' expenditure aggregate, it does not directly restrict the increase in expenditure: instead, expenditure can be raised using discretion, if the decisions taken are financed using income that is of the same amount.

The target for the rate of increase of expenditure – the expenditure benchmark – depends on whether the country has achieved the MTO or not. If it has, the annual increase in expenditure may not exceed the growth in medium-term potential output, unless the additional expenditure is covered using an equivalent amount in additional income. If the country has not achieved the MTO, annual expenditure must increase more slowly than potential output, unless the excess increase in expenditure is financed from additional income. In addition, if an item of public income is reduced on the basis of discretion, either expenditure must be cut accordingly

or another income item has to be increased. Any deviation detected in the expenditure benchmark cannot be regarded as substantial if the country surpassed its medium-term objective in the previous year and does not deviate from the MTO in the year under scrutiny. In that case, it has to be established in the ex-post examination whether surpassing the MTO is due to a 'windfall'.

Compliance with the expenditure benchmark is assessed at the level of the entire public sector. However, not all public expenditure is taken into account: certain adjustments are made to the total expenditure, thus obtaining the adjusted expenditure aggregates AEA1 and AEA2. The first expenditure aggregate (AEA1) represents expenditure that can be affected by measures by public sector policy-makers. The second (AEA2) is obtained when discretionary income and expenditure funded from earmarked income are deducted from the first (Table 3).

No comparison is made in the assessment of the expenditure benchmark between the two expenditure aggregates arrived at in the same way: instead, the second adjusted sum for public expenditure (AEA2) is compared to the AEA1 for the previous year, to obtain the net increase in expenditure. The aim of such comparison is to take account of the effect of discretionary income on the way expenditure is covered.⁵

⁵ Point 6 in Table 2 'Effect of discretionary measures on income' includes changes to taxation. These estimates are mainly produced by the Ministry of Finance. The Ministry's estimate of the effects of changes in taxation on general government income is given on page 82 of its Financial Review of spring 2014. Point 7 in Table 2 'Expenditure financed from earmarked income' includes public broadcasting tax, which is also featured in the Ministry's spring Financial Review. The estimates include the anticipated increases in social insurance contributions for 2014–2018 (including the agreed increases in the pension insurance contribution). Although the actual effects may differ from the estimates, it is the opinion of the National Audit Office that the estimates given are credible in terms of their accuracy.

Table 3: Adjusted expenditure aggregate 2012–2015e

Expenditure benchmark figures, EUR billion		2012	2013	2014e	2015e
- 1	Total public expenditure	108.3	112.2	115.3	117.5
- 2	Debt interest payments	2.0	1.8	2.0	2.2
- 3	Expenditure incurred in EU programmes, fully compensated by income from EU funds	1.2	1.2	0.9	1.3
- 4	Changes in expenditure on unemployment due to economic fluctuations	0.4	0.6	0.7	0.6
- 5a	Fixed capital (gross)	5.0	5.4	5.5	5.5
+ 5b	Average for fixed capital (over four years)	4.8	4.9	5.2	5.4
=	AEA1 Adjusted expenditure aggregate (AEA1)	104.5	108.1	111.5	113.5
- 6	Effect of discretionary measures on income	0.6	1.5	0.8	1.1
- 7	Expenditure financed from earmarked income	0.0	0.4	0.0	0.0
=	AEA2 Adjusted expenditure aggregate (AEA2)	103.9	106.2	110.7	112.3

Source: Ministry of Finance and National Audit Office's own estimates

The expenditure benchmark is calculated for 2013 and 2014 using different figures, as the benchmark was updated as from 2014.⁶ The expenditure benchmark for 2014 is stricter for Finland than previously, because the estimate for the growth for medium-term potential output has gone down. In addition, the benchmark to be complied with is influenced by whether a Member State has achieved the medium-term objective by the end of the previous year. At the end of 2012, Finland had not achieved the MTO, so an expenditure benchmark with a value of 0.5 is being used in the ex-post evaluations for 2013. As Finland achieved the MTO at the end of last year, the more flexible value of 0.8 is being used in the evaluations for the current year. If the adjusted expenditure is expected to increase faster than the benchmark, the resultant deviation is examined using the deviation rule.⁷

Table 4 gives the expenditure benchmarks for 2013–2016 according to whether Finland achieves the MTO or not. The figures for 2017 and 2018 are the National Audit Office's own estimates, and they are based on the Commission's forecast for the growth in potential output. Consequently, the actual final expenditure benchmark may differ from that given here. Row 4 shows the increase in expenditure under the expenditure benchmark calculated from the Ministry of Finance data.

In 2013, expenditure under the expenditure benchmark fell by 0.4% in real terms. Finland fulfilled the target for the increase in expenditure (0.5%). The Ministry of Finance predicts an increase in expenditure under the expenditure benchmark in real terms of 0.4% for the current year. Thus, for the current year, the anticipated increase in expenditure falls below the target figure (0.8%).

⁶ The Commission is now considering a proposal for the expenditure benchmark to be updated annually. In that case the expenditure benchmark would change in accordance with the target for change required of the structural balance. At present the benchmark is updated every three years.

⁷ The deviation is calculated as the difference between the increase in expenditure and the benchmark, which is weighted by the size of the public sector in relation to GDP.

Table 4: The expenditure benchmark for 2013–2016 and the estimate for 2017 and 2018.

	2012	2013	2014e	2015e	2016e	2017e	2018e
Expenditure benchmark if not in the MTO	0.5	0.5	-0.1	-0.1	-0.1	-0.55	-0.55
Expenditure benchmark if in the MTO	1.4	1.4	0.8	0.8	0.8	0.3	0.3
Was the MTO achieved at the start of the period?	No	No	Yes	No	Yes	Yes	Yes
Growth in expenditure under the expenditure benchmark, %	1.5	-0.4	0.4	-1.2	0.4	0.4	1.2
Difference between the growth in expenditure and the expenditure benchmark	1.0	-0.9	-0.4	-1.1	-0.4	0.1	0.9
Deviation for one year	0.52	-0.49	-0.23	-0.61	-0.22	0.05	0.47
Deviation for two years		0.01	-0.36	-0.42	-0.42	-0.09	0.26
Is the deviation substantial?		No	No	No	No	No	Yes

The anticipated fall in expenditure for 2015 will keep Finland within the expenditure benchmark, whether or not Finland achieves the MTO for 2014 or not. In 2016, expenditure calculated according to the expenditure benchmark is expected to increase by around 0.4 %.⁸ Since Finland is expected to achieve the MTO, the increase in expenditure is compared to a more flexible benchmark (0.8). Expenditure in Finland will increase more slowly than the benchmark.

The next time the expenditure benchmark will be changed is in 2017. The future benchmark will be based on an estimate of the growth in potential output for 2011–2015 and of the predicted growth in potential output for 2016–2020. The expenditure benchmark for 2017 and 2018 given here is based on the National Audit Office's own estimates, and is not a calculation produced by the Commission. In reality, the value of the expenditure benchmark can differ considerably from what is predicted here. However, future policy-makers should be aware of the fact that the expenditure benchmark over the next few years may be much stricter than what it is now.

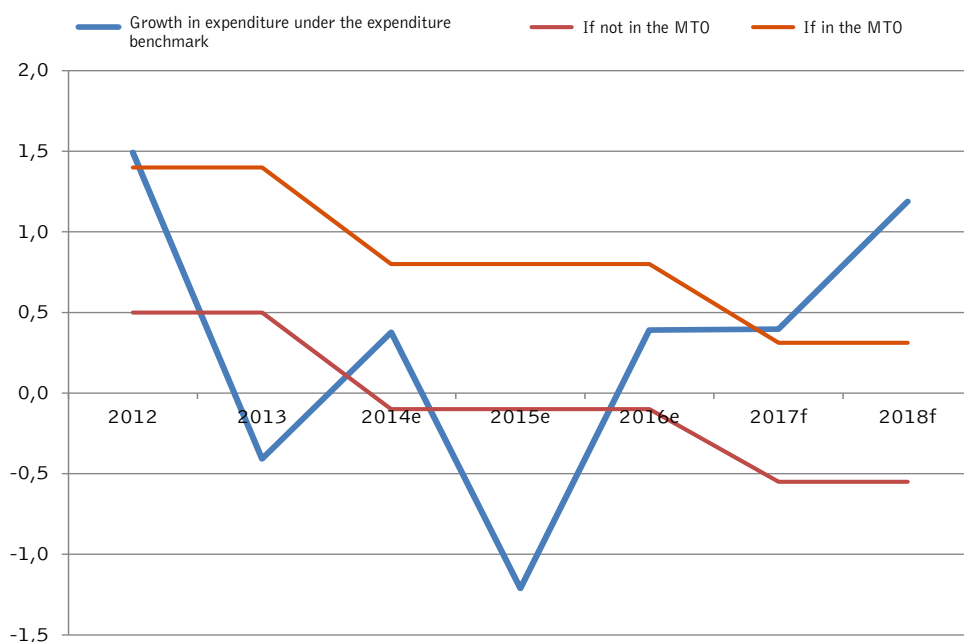
The growth in potential output calculated from the Commission's data would be 0.3% in real terms. The virtually zero growth as an

average over 10 years is exceptionally low. An average rate in the growth in potential output such as that would be incredibly slow for Finland.⁹ On this assumption, the average expenditure threshold obtained is either -0.55 or 0.3, depending on whether Finland achieves the MTO or not. In the worst-case scenario, the expenditure aggregate for Finland should be reduced by over 0.5% a year. The forecast by the Ministry of Finance for growth in potential output is more optimistic than that of the Commission, and the expenditure benchmark would also be more flexible.

In the absence of any systematic policy measures, expenditure calculated under the expenditure benchmark are likely to increase from 2016 onwards (Figure 2). The reason for the increase is that public sector expenditure is predicted to increase by 2.6% a year in real terms over the period 2014–2018. According to a forecast by the Ministry of Finance, the effects of the known public income adjustment measures hitherto will peter out towards the end of the period for which the forecast has been made. In the years to come, the expenditure benchmark will be breached, unless the increase in expenditure can be curbed.

⁸ The Commission's deflator forecast only covers the two years from the time of the forecast. From 2016, the value of the deflator will correspond to the Commission's forecast for price rises in 2015.

⁹ For example, the average growth in the period 2004–2013 was 1.3% a year, according to the Commission's calculations.



Source: Ministry of Finance, European Commission and the National Audit Office's own estimates

Figure 2: Increase in expenditure under the expenditure benchmark in real terms and Finland's expenditure benchmark for 2012–2018f

4.4.3 Comprehensive assessment

In the comprehensive assessment, both pillars of the preventive arm of the Stability and Growth Pact are examined together and an assessment is made as to whether the preventive arm has been complied with. The key area for scrutiny in both pillars is the occurrence of a substantial deviation. There are also two temporal dimensions in the examination of compliance with the rule: the ex-post examination, which applies to 2013, and the ex-ante or in-year examination, which applies to 2014 and the years to come. The discovery of a substantial deviation in the ex-post examination may lead to possible further procedures and, ultimately, the start of the correction mechanism, unless corrective measures are carried out. The occurrence of a substantial deviation only in the second rule does not yet constitute a

breach of the rules of the preventive arm – it has to be confirmed in the comprehensive assessment.

Table 5 gives a summary of compliance with the structural balance and expenditure threshold in the period 2013–2018. Both pillars have been complied with in the ex-post examination of the preventive arm of the Stability and Growth Pact. The MTO for 2013 was -0.5% of GDP, while at the end of 2013 the structural balance was -0.53% of GDP. Because the deviation is under 0.25 percentage points of the MTO, the MTO is regarded as achieved. The achievement of the MTO in 2013 in practice confirms that the target for the change to the structural balance is considered to be met. The achievement of the MTO does not yet mean that the achievement of the expenditure benchmark

should not be examined.¹⁰ Because the MTO had not been achieved by the beginning of 2013, expenditure may increase by 0.5%

under the expenditure benchmark. In 2013, expenditure fell by 0.4%, so the expenditure benchmark was complied with.

Table 5: Comprehensive assessment of the preventive arm in the period 2013–2018

	2013	2014	2015	2016	2017	2018
Structural balance	Rule complied with	Deviation	Rule complied with	Rule complied with	Rule complied with	Rule complied with
Expenditure benchmark	Rule complied with	Rule complied with	Rule complied with	Rule complied with	Rule complied with	Substantial deviation
Preventive arm	Agreement complied with	Partial compliance	Agreement complied with	Agreement complied with	Agreement complied with	Agreement* complied with

*the MTO would be surpassed according to the spring 2014 forecast. Accordingly, the deviation from the expenditure benchmark is not taken into account in the comprehensive assessment for 2018, i.e. the Pact would be complied with..

In 2013, the result of the ex-post examination was that Finland had complied with the objectives set for it, i.e. it has demonstrated compliance with the preventive arm of the Stability and Growth Pact. Figure 3 gives a

summary of the results of the ex-post examination for 2013 conducted in spring 2014 in the form of a decision tree. For the sake of simplicity, the stages of the examination are shown in succession.

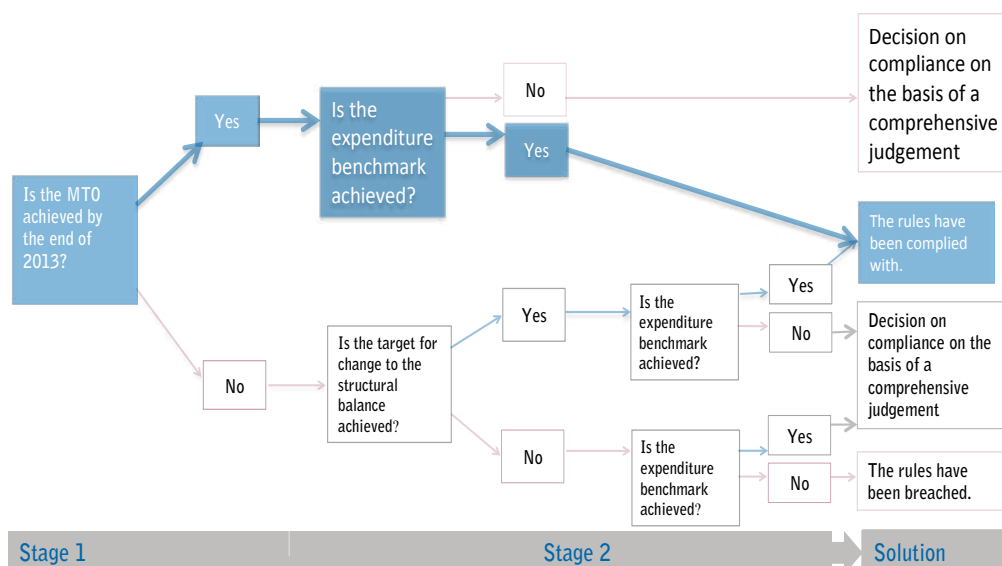


Figure 3: Result of the ex-post evaluation for 2013 conducted in spring 2014.

¹⁰ The achievement of the MTO may be due to problems in measuring it, and to rule out this possibility the examination of the expenditure threshold must support the above conclusion.

The examination in 2014 is based on forecasts and the actual values may differ from predictions. A current forecast by the Ministry of Finance would suggest that Finland will not achieve its MTO by the end of the year, because the structural balance is expected to be -0.8% of GDP. As at the start of the year Finland was on target, the target for the change to the structural balance is 0. As the balance is down by 0.3 percentage points, the deviation from the objective has the same value. The deviation is less than 0.5 percentage points and the deviations for two consecutive years do not exceed 0.25 percentage points. The deviation is therefore not to be considered substantial. For 2014, an increase in expenditure under the expenditure benchmark of 0.4% in real terms is predicted. The expenditure threshold for the current year is 0.8%. The increase in expenditure under the expenditure benchmark is less than the target figure, however, and so the expenditure benchmark is complied with.

In 2014, Finland will only partially comply with the Stability and Growth Pact. This is because the country is off-target as far as the MTO is concerned. The deviation is not substantial, so Finland is not in breach of the rules on the basis of the current forecast. The risk of the occurrence of a substantial deviation with respect to the structural balance for 2014, however, does exist, because the deviation is close to the 0.5 percentage point threshold. If the economic growth is not what the Ministry of Finance predicts, a situation may arise where the correction mechanism has to be brought into play. Since the risk of a substantial deviation exists, the trends in general government finances need to be monitored this year.

According to the spring 2014 forecast, Finland will achieve the objectives set for 2015–2017 for both growth in expenditure and the structural balance. For 2018, a substantial deviation from the expenditure benchmark is forecast. It will not be taken into account, because the MTO would be surpassed. It should be noted here that in 2016 the MTO and expenditure benchmark are to be updated, so the target values used then may differ from those used here.

According to the forecast by the Ministry of Finance, potential output will grow in the next few years faster than the average for the growth in potential output for the period 2011–2020, which is based on the Commission's data and used in the predictions for the expenditure benchmark. If the growth in potential output is in accordance with the Commission's estimates, it is possible that the change to the structural balance will not achieve the targets set for it.

General government finances in Finland would seem to be making favourable progress in the medium term. The improvement in economic growth predicted by the Ministry of Finance and the adjustment measures carried out by Jyrki Katainen's Government would appear capable of restoring general government finances in Finland to health in the medium term.

4.5 Audit of compliance with the corrective arm

Finland will not be in breach of the 3% threshold for the deficit in the light of the spring 2014 forecasts. Either the surplus (balance) or development in GDP must differ

considerably from the forecasts for Finland to be in breach of the deficit. Table 6 shows the public sector surplus (balance) in relation to GDP.

Table 6: Public sector surplus (balance) (EDP) based on Ministry of Finance data

	2011	2012	2013	2014	2015	2016	2017	2018
Public sector surplus (balance) (EDP) in relation to GDP, %	-0.7	-1.8	-2.1	-2.1	-1.2	-0.6	-0.1	0.2

Table 7 gives an evaluation of compliance with the rules on debt based on Ministry of Finance data. Only one condition has been calculated for a satisfactory rate of reduction (of debt), as retrospective and forward-looking conditions give the same target levels

and only the times when the comparison are made differ. The retrospective condition always examines the year in question, but a forward-looking condition examines the prediction made at the end of a two-year period.

Table 7: Compliance with the rules on debt based on Ministry of Finance data

	2012	2013	2014	2015	2016	2017	2018
Level of debt in relation to GDP	53.6	56.9	59.8	61	61.4	61.3	61.2
Debt more than 60% in relation to GDP	No	No	No	Yes	Yes	Yes	Yes
Target for debt set under the debt reduction condition	48.5	51.5	54.0	57.2	59.4	60.7	61.1
Debt < target set previously	No	No	No	No	No	No	No
Cyclically adjusted debt	53.6	54.2	54.6	56.7	59.9	61.3	61.9
Adjusted debt below the target set under the debt reduction condition	No	No	No	Yes	No	No	No
Has the debt rule been complied with?	Yes	Yes	Yes	Yes	No		

Finland is complying with the rules on debt until 2015. In 2014, debt is predicted to remain under the 60% threshold and in 2015 cyclically adjusted debt will not exceed the target under the retrospective rule. In 2016, it appears that the rule on debt will be breached. Henceforward, no estimate can be made because the forward-looking condition cannot be calculated. If the amount of debt is reduced in the forecasts fast enough, it is possible that in 2017 Finland will meet the forward-looking condition for reduced debt.

It is the view of the National audit Office that it is unlikely that Finland will be subject to the excessive deficit procedure on account of debt, even if the rule is breached in the manner calculated above. There are two main reasons for this. Firstly, the funds granted for European Union solidarity programmes are deducted from debt: EFSF loans by 2013 had pushed up the amount for debt recorded for Finland by EUR 3.4 billion, meaning that debt may also remain under the 60% threshold in 2016. Secondly, if the

GDP share of debt falls, exceeding the 60% threshold can be seen as short-term, and, on the basis of a comprehensive assessment, Finland will not be subject to the EDP. Finland may be subject to the EDP in a situation where the GDP share does not fall. The way in which the debt evolves will still need monitoring.

Finally, it should be pointed out that the debt presented here is mainly increased by central and local government surplus funds. Changes in the financial situation of social security funds is not taken account of in the debt. Thus, the changes to the entire public sector do not reflect changes to the debt. So, for example, the achievement of the MTO or any other target for surplus (balance) in the public sector does not guarantee that the debt will evolve in accordance with the rules. For the evolution of the debt to be controlled using the rules on surplus (balance), this rule should be imposed on total surpluses (balances) for central and local government.

5 Central government liabilities and debt

5.1 Overall picture of central government liabilities

Under section 18 of the (Finnish) State Budget Act (423/1988), the state annual accounts and information on the central government finances and the state's financial management and operative performance included in the report on the state annual accounts shall provide true and fair information on compliance with the budget, state revenues and expenditure, the state's financial position, and performance (true and fair view). The detailed rationale for the Government proposal amending the State Budget Act relating to the reform of the report on final central government accounts in 2003 (HE 56/2003 vp) stated that the requirement for a true and fair view would be made more specific in the section so that it would apply to compliance with the budget, central government revenue and expenditure, central government finances and performance. According to the detailed rationale, central government finances refer in particular to the information given in the balance sheet and its notes on central government assets, debts and liabilities. The information on central government debt and debt management as well as state guaranties and warranties would also be included. The requirement for true and fair information would be restricted in the section to apply to the final central government accounts and notes to them and descriptions of the central government finances, financial management and

performance included in the report on final central government accounts (currently the Government's Annual Report).

The National Audit Office wishes to point out that, in addition to direct and indirect liabilities (such as central government debt), there are also indirect contingent financial liabilities outside the budget economy affecting the country's economic position. For example, in state-owned companies that report to the state. Off-budget funds, state commercial enterprises and state-owned companies are not included in the central government balance sheet, their financial statements and balance sheets being presented as separate documents accompanying the report on final central government accounts. For example, any liabilities on the part of commercial enterprises to the state form part of the central government balance sheet only when they are realised, so these are referred to as uncertain liabilities.

Numerous risks are associated with the central government finances, such as those attached to decisions on guarantees and credits. Guarantees, as off-balance sheet items, are reported separately in the notes to the financial statements as they have an impact on the degree of risk associated with the balance sheet. In addition to the report on final central government accounts, information on state guarantees is published by Statistics Finland in the statistics it compiles on

the subject. The stock of guarantees indicated in the report on final central government accounts is considerably lower than that given in the statistics compiled by Statistics Finland. This is because the report on final central government accounts only mentions the guarantees included in the state budget. But the statistics on state guarantees compiled by Statistics Finland include all the guarantees that the state is ultimately liable for. According to the Government's Annual Report, the value of state guarantees and warranties at the end of 2013 totalled around EUR 15.6 million. According to Statistics Finland, the figure was EUR 33.2 billion.

A more comprehensive report on total central government liabilities would give a better picture of the factors affecting central government finances. In addition to the certain

liabilities, the uncertain liabilities are also an important part of the knowledge base underlying the planning of central government finances and fiscal policy. It should be noted, however, that simply increasing the amount of reporting will not necessarily help in trying to understand what view to take of uncertain liabilities. Some are never actually realised, i.e. they do not appear as financed from the budget or as central government debt in the central government balance sheet. The Government's Annual Report contains no overall picture of the effects of state liabilities and the risks attached to them on the central government's ability to fulfil its obligations under the law. There is still a need to improve the way in which the risks contained in the Report are examined and analysed.

5.2 Liabilities incurred in the stabilisation of the euro area

In 2013 the economic situation in the euro area stabilised. With the bailout programme for Greece, Portugal, Ireland, Spain and Cyprus, the economic situation appears to be brighter than during the darkest days of the euro crisis. In 2013 both Ireland and Spain came out of the programme and have managed to obtain financing from the markets. The Economic Adjustment Programme for Portugal has made good progress, and it ends on May 17. One indication of positive economic developments is the interest on Portugal's ten-year state loan, which at one point dropped below 4%. With regard to Greece, the Troika (The European Commission, International Monetary Fund and the European Central Bank) completed its fourth interim evaluation in March 2014 and issued a favourable statement on the progress of the Greek programme.¹¹ The Eurogroup gave its conditional policy approval of the next loan instalment, to which the EFSF contributed EUR 8.3 billion. The Greek banking sector has also seen some positive developments. Two major banks have managed to obtain finance from the markets. However, Greece's partial debt arrangement has sparked a new debate and this raises the possibility of bad debts.

In 2013, not one new euro country applied for financial support from the European Financial Stability Facility (EFSF). Consequently, Finland did not make new com-

mitments in respect of euro countries either. The Government's Annual Report describes in detail Finland's liabilities in respect of the European Stability Mechanism (ESM) and the EFSF, and the securities received by Finland from Greece and Spain. The table in Appendix 12 gives a simpler picture of the state guarantees and liabilities. There is a reference in the section of the Government's Annual Report on Finland's financial liabilities in the euro crisis to a memorandum of the Ministry of Finance¹², which deals with the matter in greater detail. According to an estimate by the National Audit Office, the value of guarantees resulting from the euro crisis totals EUR 2,585. Finland's contributions are made up of: liabilities of EUR 593 million via the EFSF, bilateral loans of EUR 1,612 million, and an IMF guarantee of EUR 380 million for the euro area. According to Appendix 12, state guarantees and warranties totalled EUR 15,566 million in 2013.

The most significant change in guarantee liabilities in 2013 took place with respect to the IMF. Finland granted EUR 3.76 billion in a state guarantee to the IMF as security on a bilateral loan, should it incur losses.¹³ The guarantee relates to the financial crisis that dramatically increased demand for credit from the IMF. In practice, the guarantee was such that the Bank of Finland was given a state guarantee worth EUR 3.76 billion as security on a loan to the IMF. The Nation-

¹¹ Eurogroup statement on Greece 1 April 2014.

¹² Ministry of Finance memorandum of 31 January 2014: 'Finland's Financial Commitments, Liabilities and Accounts Receivable in connection with Europe's Economic and Debt Crisis – Situation as on 31 December 2013'.

¹³ HE 147/2012.

al Audit Office has found that, according to Appendix 12, the liability stated is EUR 8.562 billion, although the Ministry of Finance memorandum¹⁴ indicates that the actual liability is EUR 7.43 billion (6.65 SDR = EUR 7.43 billion at a rate of exchange of 0.895 as on 31 December). The error due to this currency conversion has remained in Ministry of Finance Appendix 12. Thus, the same error of about one billion euros due to the currency conversion has also remained in Appendix 12 to the final central government accounts.

The method of presenting commitments relating to financial stability arrangements in the euro area given in the final central government accounts and the report on them for fiscal year 2011 accorded with the National Audit Office's earlier views on the matter. The relevant text in the report on final central government accounts for 2011 contained a very lucid and comprehensive description of Finland's financial commitments and liabilities in connection with the crisis in the euro area. The guarantee commitments given for EFSF fund-raising were presented broken down in tabular format. It was possible to see from the Table how the liabilities connected with the funding programmes in Appendix 12 in the report on final central government accounts were made up. However, this procedure was discontinued in 2012 and 2013. The National Audit Office believes that the presentation method for fiscal year 2012 is clear, and recommends that in the future there should be a more detailed description in the Government's Annual Report of liabilities incurred in the management of the European debt crisis.

In 2013 and spring 2014, the institutions of the European Union strengthened the bank-

ing union by introducing several key acts and one international legal agreement. The fundamental purpose of the banking union is to reduce the taxpayers' burden should a banking crisis occur and develop methods gradually to wind down banks that drift into difficulties. The Regulation on a Single Supervisory Mechanism entered into force in November 2013 and the Supervisory Mechanism gets under way under the auspices of the ECB as from November 2014. Thus, within the ECB decision-making on monetary policy and the preparatory work and the supervision of banks will be become separate. Before the supervisory work commences, the ECB will undertake 1) an overall risk assessment of banks, ii) an evaluation of the assets of banks, and iii) a stress test in collaboration with the European Banking Authority (EBA). The purpose of these measures is to assess the situation in the banking sector and any potential need for capitalisation.

The aim of the new crisis resolution procedure is to focus on early intervention. In practice, this means that there is intervention in the activities of a bank before it becomes insolvent. The supervisory authority will judge whether a bank is likely to 'go under' or not, after which the crisis resolution authority takes action. The objective is prompt crisis resolution, where poorly performing banks can be gradually wound down. In this way the responsibility of investors increases, as the bank's owners and creditors suffer the loss. If a bank needs capitalisation, the Ecofin Council has agreed the following order of precedence: i) initially, financing is applied for on the private markets, ii) then capital is sought using national solutions, iii) and thirdly, common EU preparedness arrangements

¹⁴ Ministry of Finance memorandum 'State Guarantee to the Bank of Finland as Security on a Loan to the International Monetary Fund, 16 November 2012'.

come into play. This is the common crisis resolution approach and it takes effect from the start of 2015. With regard to the euro area, the solution is support in the form of a loan or direct capitalisation with the aid of the ESM.

From the perspective of possible future risks and liabilities for the State of Finland, the banking union has evolved favourably in all aspects. Investors now have greater responsibility. Furthermore, banks have also been substantially capitalised with private funds during the crisis and there has been faster intervention in their problems.

The favourable developments do not mean that the risks have completely gone away, though. The responsibility of investors for managing crises has increased, but if the need for capitalisation becomes substantial, the joint preparedness arrangements may

not be enough. Then it is possible that the taxpayer will have to cover the costs. Secondly, early intervention associated with the crisis resolution procedure does not in itself guarantee that the winding down of banks will actually go ahead. Before the crisis resolution authority intervenes, the Council will be asked to take swift decisions and vote on various matters. Thirdly, the IMF recently stated that the 'too-big-to-fail' problem is still unsolved. In other words, the potential problems associated with the insolvency of big banks are still unsolved. Fourthly, it is possible that stricter monitoring of banks and the rules will increase the temptation to move financing channels elsewhere. In practice, this would mean a new type of shadow banking.

15 IMF (2014): Global Financial Stability Report, Moving from Liquidity- to Growth-Driven Markets, March 2014.

5.3 Central government debt and information on debt management

Central government debt management covers state borrowing, debt management itself, the investment of cash assets and risk management. The strategic goal of central government debt management is satisfying the need for loans and minimising the long-term costs of debt to make them acceptable at a level of risk that can be assessed, and to safeguard the country's liquidity in all circumstances. The risks include interest risk, financing risk, credit risk and operational and legal risks.

Information of central government debt and debt management is given in the Government's Annual Report in the chapters on the effectiveness statement titled Budget Economy Income and Debt Evolution and The State's Economic Position, Central Government Debt and State Liabilities. In previous years, the matters reported on state financial management in the performance section of the administrative branch of the Ministry of Finance were combined with the latter chapter. This was a way to reduce overlap regarding the information in the report, making for a more succinct document.

In the area of central government debt, there is information on the following: the aims of central government debt management, associated risks, central government borrowing, trends in the debt structure and total amount of debt, the amount held in cash assets at the end of 2013, and a number of central government debt indicators for the last five years.

At the end of 2013, central government debt had a nominal value of EUR 89.7 billion

(2012: EUR 83.9 billion). By the end of 2013, 95.5% of the total liability was long-term and 4.5% short-term. The amount of central government debt increased by around EUR 5.8 billion compared to the previous year. In 2013, the interest paid on central government debt came to approximately EUR 1.8 billion (EUR 1,762 billion). Despite the increase, interest paid fell slightly compared to the previous year (2012: EUR 1,806 billion). The Government's Annual Report states that this is due to low interest rates in 2013. The cost of Finland's long-term borrowing in relation to that for Germany as a general area of comparison in the market fell in 2013 to an average of around 0.24 percentage points, having been around 0.33 percentage points in 2012.

The costs of central government debt management are mainly minimised through a strategic choice of the debt interest risk position. With this the aim is for an annual impact on costs of approximately EUR 150 million. The Government's Annual Report states that, according to the State Treasury, the cumulative result of active strategic interest risk management in the period 2001–2013 was around EUR 2 billion, at a conservative estimate. In other words, the interest paid on debt for that period would have been greater than actual expenditure, had it not been for discretionary and goal-oriented debt interest risk position management. Thus the effect on costs is thought to have been what was aspired to in the period referred to.

Central government debt increased in the period 2008–2013 by approximately EUR 35 billion. At the end of 2013, the amount of

central government debt in relation to GDP was 46.4% according to the Stability Programme of spring 2014, while the debt ratio in 2012 was 43.6% in relation to GDP. Under the Stability Programme of spring 2014, the amount for state debt is expected to grow to EUR 96.2 billion in 2014. Central government debt is predicted to be around EUR 106 billion in 2017, which is thought will be approximately 49% in relation to GDP.

Finnish promissory notes still have the best possible credit rating among the three biggest credit rating agencies internationally (Fitch Ratings, Moody's Investors Service and Standard & Poor's), of which S&P on 11 April 2014 lowered Finland's rating prospects from stable to negative. The best possible credit rating guarantees huge opportunities for fund-raising and has a positive effect on central government debt management expend-

iture. As the total for central government debt grows, and owing to uncertainties in the international financial operating environment, it is especially important to ensure that Finland keeps its top credit rating through a commitment to responsible management of general government finances.

As from 13 March 2014, the State Treasury took over the management of state credit agency tasks from the Ministry of Finance. The new division of responsibility corresponds to international practice, with the issuer of loans also being responsible for relations with credit agencies.

It is the opinion of the National Audit Office that the information reported in the Government's Annual Report gives a true and fair view of central government debt and the risks associated with debt management.



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