National Audit Office's separate report to Parliament: Interim fiscal policy audit report for the 2011–2014 electoral term

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To Parliament

The National Audit Office conducts, in accordance with audit manuals based on the international ISSAI standards and its audit plan, fiscal policy audits of the reliability of the fiscal policy information base and fiscal policy reporting, the functioning of fiscal policy instruments and rules as well as the preconditions for attaining the objectives set and progress made towards the objectives. The National Audit Office monitors and evaluates fiscal policy as an independent monitoring institution referred to in the European Union Treaty on Stability, Coordination and Governance (TSCG) and national legislation. The National Audit Office reports on its most important fiscal policy audit and monitoring findings and recommendations for measures in separate interim and full-term reports submitted to Parliament for each electoral term. These fiscal policy audit reports for each electoral term constitute external fiscal policy evaluation independent from the Government referred to in OECD recommendations.

The interim report for the 2011–2014 electoral term provides an evaluation of how fiscal policy implementation supports the efforts to achieve balance in central government finances and the long-term stability and sustainability of general government finances. The separate report also covers compliance with fiscal policy rules and progress made from the previous electoral term towards increased openness and transparency in the information base.

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

Helsinki, 14 February 2013

Auditor General Tuomas Pöysti

Director of Fiscal Policy Audit Heidi Silvennoinen

Main content

This separate report to Parliament contains the interim report for the 2011–2014 electoral term concerning fiscal policy auditing and monitoring conducted by the National Audit Office. This electoral term's fiscal policy regulatory framework and fiscal policy targets viewed against the previous electoral term were used as the starting points for this report.

The Government Programme's spending rules and, consequently, the spending limits for the electoral term, are key elements of the fiscal policy regulatory framework. During previous electoral terms the limits were raised in order to implement reforms included in the Government Programme. During the current electoral term, however, the level of spending limits has been lowered from the preceding term's last decision on spending limits and again in conjunction with the spring 2012 spending limits decision. Despite this, in the light of autumn 2012 forecasts it strongly appears that the deficit and debt objectives included in the Government Programme will not be reached during the 2011–2014 electoral term. It can, however, be stated that the connection between the spending rules and the balancing and debt objectives included in the Government Programme is clearer than before during the current electoral term. In addition, preparedness to lower the spending limits level increases the Government's fiscal policy credibility.

Increases in reallocations and improved harmonisation of the Government Programme's strategic objectives and the spending limits have been achieved in the context of spending limits. There is still, however, clear room for improvement in this respect for the Government's strategy decision to be as uniform and economically realistic as possible. Reforms based on reallocations will continue to be necessary in efforts to address the sustainability gap in public finances and balance central government finances. Therefore it is important to have clear rules of play concerning reallocations. Expenditure reviews are necessary for reallocations and expenditure level balancing, and these reviews call for a thorough examination of the bases of expenditure and the expenditure structure.

The bulk of public service expenditure is covered by municipalities. This expenditure is only regulated by central government spending limits via the central government transfers to local government included in the spending limits system. The problem that still remains from the perspective of addressing the general government sustainability challenge is the narrow coverage of the central government spending limits.

In the light of the current practice, the Finnish local government sector has a poor capacity to contribute towards the long-term sustainability of general government finances on the whole. The local government sector has underlined the role of central government measures as a key source of uncertainty for local government finances. The National Audit Office finds that special attention must be paid to the assessment of the local government finances impact of new duties assigned to municipalities in Government proposals. In this context assessments must be made of the financial impacts of new duties from the perspectives of municipalities with differing revenue and expenditure structures.

Efforts to curb growth in local government expenditure have yet to bear fruit, but many important reforms are still ongoing. Prepared in conjunction with the spending limits decision, the Basic Public Services Programme contains an assessment of the local government financial development outlook and changes in the operating environment. The Programme also contains measures to achieve a balance in local government revenue and expenditure. Predictability in the local government sector could be improved through the development of the Programme under municipal guidance.

There is a sustainability gap in public finances, and closing this gap should be a priority in fiscal policy target-setting. The assessments made in 2012 of the Finnish sustainability gap differ considerably from each other, but it is undisputable that there is a sustainability gap that calls for policy measures. The sustainability gap assessments presented in autumn 2012 are particularly uncertain as regards the starting point of the calculations. Therefore, in addition to individual point estimates, attention should be paid to the assumptions underlying the calculations as well as the structural factors behind the sustainability gap.

It is difficult to bridge the sustainability gap by merely using direct fiscal policy adjustment measures. Measures necessary to close the gap and consolidate public finances include structural reforms that will extend working careers, strengthen the growth potential of the economy, improve cost-efficiency in public service production and increase competition. The broad-based and rapid implementation of the programme for promoting healthy competition launched by the Government will be needed in all of the programme areas. New measures promoting competition, particularly in the service sector, will also be required

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1 Introduction

Fiscal policy auditing conducted by the National Audit Office concerns the fiscal policy information base, setting of and compliance with fiscal policy rules, functioning of steering and management instruments as well the prerequisites for the achievement of fiscal policy objectives and progress made towards their achievement. As part of the auditing of the reliability of the fiscal policy information base, specific assessments are conducted of Government reporting to Parliament concerning fiscal policy implementation and outcomes. The results of fiscal policy audits are reported in fiscal policy audit reports and separate reports of the National Audit Office to Parliament.[1]

Submitted to Parliament every year in the spring, the separate report to Parliament on the audit of the final central government accounts and the Report on the Final Central Government Accounts contains an annual report on the findings from the continuous auditing of fiscal policy. This provides an assessment of compliance with the central government spending limits and other fiscal policy rules. In the middle and at the end of each electoral term, the National Audit Office submits a separate report to Parliament on fiscal policy auditing for the electoral term. These reports provide more extensive assessments of the fiscal policy information base, compliance with and functioning of rules and level of achievement of fiscal policy objectives. Covering the 2007–2010 term, the first electoral term report was submitted in early 2011 and examined the effectiveness of the central government spending limits procedure as a fiscal policy instrument (R 21/2010 vp). That separate report was the first external evaluation of the entire electoral term carried out in accordance with the OECD recommendations.

Submitted in the middle of the 2011–2014 electoral term, the starting points for the present interim report are the electoral term's fiscal policy regulatory framework and fiscal policy targets viewed against the previous electoral term. This interim report also provides follow-up on the electoral term report concerning the previous electoral term as well as an assessment of the extent to which the National Audit Office's conclusions and Parliament's positions have been taken into consideration in fiscal policy preparation and reporting.

This interim report for the 2011–2014 electoral term is submitted to Parliament before the Government's February 2013 strategy session in order to make the observations made by the National Audit Office available to preparing officials before the mid-term assessment of the economic strategy. Where necessary, any further measures to strengthen general government finances and reach the objectives set in the Government Programme will be determined in the Government's strategy session for the rest of the electoral term.

1 National Audit Office 2011.

2 Audit framework

2.1 Subject of the audit

According to the Government Programme, the consolidation of public finances and sustainability over the long term are Finland's key fiscal policy objectives. Fiscal policy rules are employed to help secure the sustainability of public finances. Deficit and balancing rules limit central or general government finances deficit relative to gross domestic product (GDP). Growth in central or general government debt is curbed by setting limits to central or general government debt relative to GDP. Spending rules, such as the central government spending limits procedure, in turn restrict public expenditure. The purpose of the spending rules is to limit the total amount of expenditure incurred by the taxpayer.[1]

Fiscal policy is implemented through the regulation of general government expenditure and revenue. Structural reforms can also be employed to produce public services more cost-efficiently. Furthermore, structural reforms can improve economic growth prospects, increasing tax revenue and decreasing costs arising from automatic stabilisers and improving the financial position of general government.

The subject of audit is compliance with fiscal policy rules and achievement of fiscal policy objectives in the 2011–2014 electoral term, particularly as regards response to the general government sustainability challenge.

The balancing of central government finances and the consolidation of public finances are among the main objectives of the Government Programme. Measures taken to achieve these objectives include reducing public expenditure, increasing tax revenue and carrying out structural reforms. In addition to the measures related to appropriations and revenue listed in the Government Programme, the Government has made a commitment to undertake further adjustment measures if indications are that the central government debt-to-GDP ratio is not shrinking and if the central government deficit shows signs of settling at over 1% of GDP. The achievement of these objectives is monitored annually in the context of the spending limits decision in particular but also in conjunction with the Government's strategy session.

The Government Programme's spending rules and, consequently, the central government spending limits are key elements of the fiscal policy regulatory framework. In addition to compliance with the spending rules, the sustainable management of central government finances depends a lot on the practices and structures prevailing in spending limits and budget preparation.

2 Ministry of Finance 17/2011. The Programme of Prime Minister Jyrki Katainen's Government does not specify the purpose or general application principle for central government spending limits.

As well as the fiscal policy objectives set in the Government Programme, the deficit and debt criteria of the EU Stability and Growth Pact are important elements of the fiscal policy rules framework to which Finland is committed. Therefore the audit also covers the achievement of the objectives set in Finland's Stability Programme and the information base of reporting concerning the Stability Programme. The examination in this context focuses on how the Commission's recommendations have been taken into consideration in fiscal policy preparation.

Requirements concerning fiscal policy preparation and related reporting will be set by the coordination of economic policy at the European level. The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the requirements set for the framework for public finances entered into force on 1 January 2013. Compliance with these is monitored by the National Audit Office.

This interim report for the 2011–2014 electoral term contains follow-up on the conclusions of the first electoral term report (R 21/2010 vp) published in January 2011. In its report 10/2010 vp on the National Audit Office's separate report to Parliament R 21/2010 vp, the Parliamentary Audit Committee provided Parliament with proposals for Parliament's positions on the basis of the National Audit Office's separate report. The Audit Committee's positions were adopted by Parliament (Parliamentary Communication 50/2010). The Report on the Final Central Government Accounts for 2011 contains the Government's report on the measures required on the basis of Parliament's positions. In this audit report the sufficiency of the measures is assessed on the basis of the National Audit Office's audit findings.

2.2 Audit questions and criteria

The consolidation of public finances and sustainability over the long term are Finland's key fiscal policy objectives. This is the prerequisite for fiscal policy credibility, which in turn is the basic requirement of a well-functioning fiscal policy. Fiscal policy credibility is increased by openness and transparency of the information base available for fiscal policy preparation and decision-making Fiscal policy rules are employed to help secure the sustainability of public finances. Consequently, the audit questions are as follows:

1 How well does fiscal policy implementation support the balancing of central government finances and the long-term stability and sustainability of public finances?
2 Have the fiscal policy rules been complied with?
3 Has the openness and transparency of the information base used in fiscal policy preparation and decision-making improved from the previous electoral term?

As regards audit questions 1 and 2, this separate report, which is drawn up on the basis of the audits, reports on compliance with the fiscal policy regulatory framework and achievement of the key fiscal policy objectives specified in the Government Programme during the current electoral term.

The sustainable management of central government finances also depends on the practices and structures prevailing in spending limits and budget preparation. Due to the adjustment measures relating to central government finances, it is important to achieve the appropriate allocation of appropriations within the spending limits as well as genuine prioritisation. The prerequisites for the appropriate allocation of central government appropriations are examined from the perspective of spending limits flexibility.

A considerable share of the general government sustainability challenge falls on local government. At the moment the local government capacity to contribute towards reducing the sustainability gap is rather low. The audit examines the challenges faced in the central–local government relationship and opportunities for the development of existing steering instruments from the perspective of improving the productivity of local government services.

Audit question 3 concerning the openness and transparency of fiscal policy information base and implementation is based on the constitutional status and duties of Parliament and the prerequisites for fiscal policy performance. Parliament has the constitutional right to receive true and fair information about the alternatives and grounds of fiscal policy decision-making. The information base and preparation of fiscal policy decisions as well as the performance and societal impacts of fiscal policy are also within the scope of the monitoring of central government finances carried out by Parliament.

The audit pays attention to the information base of fiscal policy decision-making, i.e. how well the assumptions underlying the authorities' calculations carried out to support the decision-making process have been presented and justified. This is the viewpoint of the examination of issues such as reporting by the Ministry of Finance as regards the sustainability gap estimate included in the update of Finland's Stability Programme. The development of the public finances sustainability gap is examined on the basis of a comparison of the estimate provided by the Ministry of Finance and its development with other Finnish and international estimates. The audit also pays attention to the application of the fiscal policy regulatory framework and reporting on progress made towards the objectives set.

Good governance and financial management entails the use of an information base that is objective and transparent and provides sufficient information for decision-making purposes. This means that the audit criteria are, firstly, the transparency of decision-making and preparation and, secondly, the functioning and performance of the instruments employed from the viewpoint of the targets set for fiscal policy. The audit criteria also include whether or not a true and fair view is provided by fiscal policy reporting to support Parliament's decision-making.

Other audit criteria used include European Union legislation that is binding on Finland, with Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States being of particular importance in this context. The recommendations and best practices of the European Commission and international organisations (IMF, OECD) relating to fiscal policy preparation, decision-making and reporting are also used as audit criteria.

3 IMF 2007. See also OECD 2002 and OECD reviews of national budgeting systems and best budgeting practices, with the final reports on country reviews published in the OECD Journal of Budgeting. The list of reviews can be found at www.oecd.org/gov/budgetingandpublicexpenditures/seniorbudgetofficialcountryreviewsofbudgetingsystems.htm [accessed 7.1.2013]. OECD recommendations concerning best practices are included in the OECD economic reviews on member states. Documents particularly worthy of a mention as regards Finland are OECD 2012 and OECD 2010a and 2010b as well as OECD 2010 concerning tax subsidies.

2.3 Audit material and methods

The material used in the audit includes the spending limits decisions, budget proposals, budgets[4] and supplementary budgets, including preparatory documents, and Reports on the Final Central Government Accounts for 2011–2012. Also used as material were the updates of the Finnish Stability Programme and recommendations made by the European Commission.

Compliance with the spending rules set in the Government Programme is monitored on the basis of the National Audit Office's spending limits accounting. The data used in this is submitted by the Ministry of Finance to the National Audit Office in conjunction with the spending limits price reviews. Data for final accounts comparisons is obtained from the consolidated central government accounting system. The results of spending limits accounting are reported annually in the separate report to Parliament on the audit of the final central government accounts and the Report of the Final Central Government Accounts.

Reporting relating to fiscal policy preparation and decision-making is compared with Finnish and international forecasts and statistics concerning Finland's general government finances. Therefore statistics published by Statistics Finland on national accounts and general government finances as well as OECD and Eurostat statistics are used as audit material. Also used are Finnish and foreign economic reviews and forecasts as well as academic literature. Reporting on Finland provided by the OECD, IMF and the European Commission is followed particularly closely.

As regards spending limits flexibility, the audit utilises the National Audit Office's fiscal policy audit report on the relation between the Government Programme and the spending limits procedure[5], which focuses on the connection between the objectives of Prime Minister Jyrki Katainen's Government and the allocation of appropriations. The audit covered the coordination procedures during the Government term following the 2011 parliamentary elections and Government's strategy session and spending limits discussion in 2012.

As regards local government, examination based on literature and statistics provided by Statistics Finland is supplemented by the results of the National Audit Office's research project with the University of Tampere. The data used in the Tampere University research project comprised responses obtained in the ARTTU survey, as appropriate, and interviews with representatives of various levels of the day care steering chain as well the Basic Public Services Programmes for 2008–2012.

Also utilised as audit material were the National Audit Office's performance audit reports and risk analyses as well analyses and studies conducted for the National Audit Office's annual reports to Parliament.

For the purpose of assessing the general government sustainability challenge, a general government finances sustainability calculation was requested from the ETLA, the Research Institute of the Finnish Economy. A baseline scenario concerning the sustainability gap of public finances is first presented for the 2012–2060 period. The

4 The audit also took the 2013 budget proposal and budget, including preparatory documents, into consideration.
5 National Audit Office 17/2012.

main assumptions of the baseline scenario were compared with the assumptions used in the latest Ageing Report of the European Commission (European Commission, 2012) and the assumptions used in the Commission sustainability calculations published in December 2012 and in the calculations of the Ministry of Finance.

Comparisons between the results produced by the models and comparisons carried out using the same model and but different assumptions are a good way to discern the factors affecting the sustainability gap. This is because the models have to take an explicit stand on the development of the factors affecting the sustainability gap and their impact on the rest of the economy. This helps clearly illustrate the impacts of the various factors on the sustainability gap, allowing an analytical approach to the role played by them as regards the size of the gap.

The auditing and analyses included in fiscal policy audits take place in compliance with the National Audit Office's fiscal policy audit manual.[6]

Director of Fiscal Policy Audit Heidi Silvennoinen was in charge of the preparation of the audit and the report submitted to Parliament. Also participating in the audit was Deputy Head of Executive Office and Fiscal Policy Audit Nina Alatalo (audit of the relation between the Government Programme and the spending limits procedure). In charge of quality assurance concerning the report to Parliament and the audit were Deputy Auditor General Vesa Jatkola (NAOF/Performance Audit) and Deputy Auditor General Tytti Yli-Viikari (NAOF/Fiscal Policy Audit). Auditor General Tuomas Pöysti participated in the formulation and steering of the audit and the formulation of the report to Parliament.

Opinions on the draft audit report were obtained from the Ministry of Finance, Prime Minister's Office, the Association of Finnish Local and Regional Authorities and the Finnish Competition and Consumer Authority. The opinions were taken into consideration in the finalisation of the audit report, and the draft report was edited on the basis of the opinions where found necessary by the National Audit Office. The opinions are public and published in Finnish on the National Audit Office website in conjunction with the audit report.

6 National Audit Office 2011.

3 Audit findings

3.1 Compliance with fiscal policy rules and progress made towards fiscal policy objectives during the current electoral term

This chapter contains an assessment of compliance with the fiscal policy rules specified in the Government Programme as well as progress made towards the objectives set for fiscal policy and related reporting. This interim report on the 2011–2014 electoral term covers fiscal policy preparation and reporting in 2011–2012. The key issue concerning compliance with fiscal policy rules and reporting relating to the fiscal policy information base is how well reporting relating to fiscal policy preparation and documentation concerning the information base have been developed. The starting points are the fiscal policy regulatory framework for the 2011–2014 electoral term as well as the key fiscal policy objectives viewed against the previous electoral term.

3.1.1 Government Programme's spending rules and spending limits for the electoral term 2012–2015

The Government Programme's spending rules and, consequently, the spending limits for the electoral term, are key elements of the fiscal policy regulatory framework. The Government is committed to observing the spending rules it has set in the Government Programme and the first spending limits decision based on them. According to the Government Programme, the Government's rule for spending is that central government expenditure as specified in the spending limits is in real terms €1.2 billion less than the figure recorded in the technical spending limits on 23 March 2011. In addition, a decision was made by the Government in the spring 2012 spending limits negotiations to undertake further adjustment measures in accordance with the Government Programme to achieve consolidation on the basis of the March 2012 forecast of the Ministry of Finance. The further adjustment measures result in a reduction in expenditure under the spending limits set in the electoral term's first spending level decision by €1.2 billion at the 2015 level. Accordingly, the electoral term's overall spending level and annual spending limit levels were dropped by amounts corresponding to the extra savings targeted at spending limits expenditure. This means the spending rules for the 2011–2014 electoral term are in compliance with the spring 2012 spending limits decision.

In its separate report to Parliament (R 21/2010 vp), the National Audit Office pointed out the looseness of the connection between the spending rules and the balance objectives set in the Government Programme for the 2007–2010 electoral term. During previous electoral terms the limits were raised in order to implement reforms included in the Government Programme. As stated above, during the current electoral term, however, the level of spending limits was lowered from the preceding term's last decision on spending limits and again in conjunction with the spring 2012 spending limits decision. Despite this, in the light of Finnish and foreign forecasts from autumn 2012, it appears strongly that the deficit objective specified in the Government Programme will not be reached during the 2011–2014 electoral term. It can, however, be stated that the connection between the spending rules and the balancing and debt objectives included in the Government Programme is clearer than before during the current electoral term.

Preparedness to lower the spending limits level increases the Government's fiscal policy credibility. Cutting the expenditure level is a historic move. The spending limits level was now cut for the first time since the 2003 reform that resulted in the introduction of the current spending limits procedure.

The narrow coverage of the central government spending limits still remains a problem from the perspective of responding to the general government sustainability challenge. Central government spending limits only provide limited support to objectives concerning the consolidation of public finances. The bulk of public service expenditure is covered by municipalities. This expenditure is only regulated by central government spending limits via the central government transfers to local government included in the spending limits system. According to the 2012 OECD Economic Survey on Finland, public spending has increased more rapidly in Finland than in the comparison countries, with particular growth seen in local government expenditure.[7] Attention to this problem was also paid in National Audit Office's separate report R 21/2010. In its 2012 Economic Survey, the OECD recommended the expansion of the expenditure ceiling.[8]

The insufficient steering impact of the spending limits on local government finances reduces their efficiency in efforts to ensure the long-term sustainability of general government finances and the bridging of the sustainability gap. At the same time the spending limits system has also created some of the vital prerequisites for this. At this point important measures to address the sustainability gap include structural reforms relating to employment and general government finances as well as the health and care sectors. These cannot, however, be directly steered on the basis of spending limits scaling. Instead, measures are needed in the labour market and legislation.

Therefore it would be justifiable from the viewpoint of the functioning of the spending limits system as part of the economic and fiscal policy steering system to further strengthen the integration of the Government strategy and the spending limits with each other. The fiscal policy audit conducted by the National Audit Office on the relation between the Government Programme and the spending limits recommends that the Government Programme's strategic implementation plan and the central government spending limits be combined into a single document, with the Ministry of Finance in charge of its presentation.[9] This would also

7 So-called technical spending limits decision
8 OECD 2012, 20.
9 OECD 2012.

enable more efficient attendance to structural and legislative reforms using fiscal policy instruments.

Achieving the fiscal policy objectives set for the previous electoral term 2007–2010 depended considerably on economic growth, which can only be affected to a limited extent in a small open economy like Finland. According to the Government Programme, the Government aimed at economic growth exceeding the forecasts. It would have been impossible to anticipate the severity of the financial crisis that unfolded in 2008 and the resulting recession when the Government Programme was being formulated in 2007. Therefore the objectives concerning central government balance and the creation of a buffer required for preparation for ageing were not achieved.

In 2011 the Ministry of Finance working group developing the central government spending limits procedure recommended that in the 2011–2014 electoral term the fiscal policy objectives be based on official expert assessments of economic development for the coming electoral period.[10]

The political parties participating in the preparation of the Government Programme for the 2011–2014 electoral term did not have a shared view about economic development. The international recession had generally turned into uncertain growth in countries excluding the crisis nations of the euro area. In Finland total output had taken a reasonably rapid upturn following a historically steep fall. The 2011–2014 Government Programme also states that the Government will take firm action and move as swiftly as possible to reach central government balance and to deliver stronger-than-predicted economic growth.[11]

In its 2011 Economic Survey and the Policy Choices in Public Finances report published earlier, the Ministry of Finance recommended speedier adjustment measures than were adopted for the Government Programme. According to a Ministry of Finance expert opinion, annual adjustment measures amounting to around 1 ½ billion or ¾% of GDP would have been required in 2012–2015. Also required would have been decisions during the electoral term on structural reforms to improve the sustainability of public finances to achieve a reduction of 2 percentage points in the sustainability gap in relation to GDP.[12]

The developments seen in the economy and related forecasts have been unfavourable to the achievement of the objectives set in the Government Programme (Table 1).

Table 1: Spring 2011 economic forecasts and outcome

	Ministry of Finance forecast spring2011					Outcome/further specified forecast 2012*			
	2011	**2012**	**2013**	**2014**	**2015**	**2011**	**2012**	**2013**	**2014**
GDP change, %	3,6	2,7	2,4	2,1	1,9	2,7	-1,2*	0,5	1,7
Unemployment rate, %	7,6	7,2	6,9	6,5	6,3	7,8	8,0**	8,1	8,0
Employment rate, %	69,1	70,0	70,7	71,1	71,4	68,6	68,9**	69,1	69,3

Source: Ministry of Finance, Economic Survey, Spring 2011 and Economic Bulletin 2/2012. Statistics Finland[14].

10 National Audit Office 17/2012.
11 Ministry of Finland 17/2011, 15 and 28.
12 Programme of Prime Minister Jyrki Katainen's Government, Chapter 2, p. 10.
13 Ministry of Finance 17/2011, annex 1. Ministry of Finance 15b/2011, Economic Survey, Spring 2011.

The table is based on the spring 2011 Economic Survey of the Ministry of Finance as this was the Ministry's most recent economic survey before the Government Programme negotiations and therefore the official information base provided by the Ministry of Finance for the election debate and Government Programme negotiations. The forecasts were further specified in the Economic Bulletin published by the Ministry of Finance on 20 June 2011, but the key information contained in the bulletin was not as such available to the Government Programme negotiators. The spring Economic Survey is, however, important in that it also presents the medium-term outlook, which is not included in economic bulletins. The Ministry of Finance Economic Bulletin published on 20 June 2011 clearly states that the projected growth rate will not be able to correct the imbalances in the Finnish economy in the near future.[14]

In the central government spending limits decision for 2013–2016, the Government decided on considerable further adjustments on the basis of a grimmer economic outlook. According to the decision, the further measures would result in a net improvement of €2.8 billion in the central government economic position as of 2016. Further according to the decision, at 2015 price levels the further adjustment measures would reduce central government expenditure by €1.2 billion and increase revenue by a net total of €1.2 billion.[15]

Tables 1 and 2 do not seek to assess the activities of the Ministry of Finance as forecaster of economic development. Instead, they illustrate the impact of the changed economic development and views concerning it on fiscal policy target-setting and fiscal policy implementation.

The tables show that deviations from the projections are particularly to do with GDP development. The development of the employment rate has not been in line with original forecasts and the objectives set in the Government Programme either. According to the Government Programme, the Government aims at increasing the employment rate to 72% and decreasing the unemployment rate to 5% by the end of the electoral term. The employment situation has, however, remained good considering the cyclical situation.

Table 2: Forecasts used for the 2012 spending limits decision and their further specification.

	Ministry of Finance forecast spring2011				Outcome/further specified forecast 2012			
	2012	2013	2014	2015	2011	2012	2013	2014
GDP change,%	0,8	1,5	2,1	1,9	2,7	-1,2	0,5	1,7
Unemployment rate,%	8,0	7,9	7,7	7,4	7,8	8,0**	8,1	8,0
Employment rate, %	68,6	69,0	69,6	69,9	68,6	68,9**	69,1	69,3

Source: Statistics Finland and Ministry of Finance[17].

14 Further specified forecaste Ministry of Finance Economic Bulletin 2/2012. **Statistics Finland: Labour Force Survey (trend).
15 Ministry of Finance: Economic Bulletin 1/2011, 20.6.2011.
16 Revised central government spending limits for 2013–2016, p. 4.
17 **Statistics Finland: Labour Force Survey (trend). Other elements of the specified forecast based on Ministry of Finance Economic Survey 2/2012.

3.1.2 Objectives concerning central government debt and deficit set in the 2011–2014 Government Programme

According to the Government Programme, the key fiscal policy objective is to achieve a clear reduction in the central government debt-to-GDP ratio by the end of the electoral term. The Government is committed to undertake further adjustment measures if indications are that the central government debt-to-GDP ratio is not shrinking or if the central government deficit shows signs of settling at over 1% of GDP. The Government will annually monitor the achievement of the objective and, where necessary, implement conditional measures that will be applied in equal proportions. The conditional measures include the additional freezing and adjustment of central government expenditure and transfers to local government, further tax increases and trimming of tax deductions. Maximising the frontloading of the measures and at the same time ensuring their timeliness as regards the cyclical situation will be taken into consideration in the timing of the measures, ensuring the adjustment measures will not reduce capacities for future growth.[18]

The corresponding key fiscal policy principles included in the Government Programme for the 2007–2010 electoral term were, firstly, to achieve a 1% structural surplus in central government finances at the end of the electoral term and, secondly, to never show a deficit of more than 2.5% of GDP even in an exceptionally weak economy. In the 2007–2010 electoral term the Government, however, gave up this objective in conjunction with the spring 2009 policy review. It was outlined in this context that the objective set in the Government Programme could be temporarily relaxed for cyclical reasons.

The National Audit Office stated in its separate report to Parliament (R 21/2010 vp) that it was justifiable to relax the Government Programme's balance rule. It would have been impossible to anticipate the severity of the financial crisis that unfolded in 2008 and the resulting recession when the Government Programme was being formulated in 2007. Central government cuts in the middle of the recession would have contributed unnecessarily to the severity of the recession.

During the 2011–2014 electoral term the central government balance rule is numerically stricter than during the preceding electoral term. This has proven to be a challenging objective in conditions of unfavourable economic development. A further risk is that absolute compliance with the deficit rule included in the Government Programme might result in pro-cyclical fiscal policies.

It is difficult to implement very strict balance rules if the economic development differs considerably from the forecasts. It should be possible to temporarily deviate for cyclical reasons from the balance rules set without compromising fiscal policy credibility. Any deviations should, however, be carefully justified. The rules should be such that they support the balancing of central and general government finances over the medium and long term.

The external evaluator plays a key role in the determination of exceptional circumstances. This also applies to the structural deficit requirement and the functioning of the correction mechanism included in the Treaty on Stability, Coordination and Governance (TSCG).

18 Programme of Prime Minister Jyrki Katainen's Government.

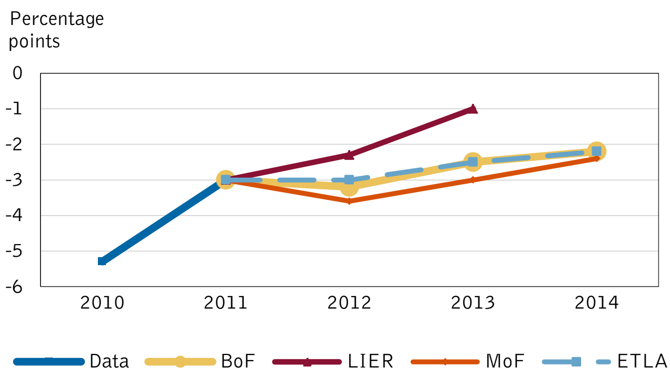
Fiscal policy rules and target-setting should be based on reasonably conservative estimates of future economic growth. As regards the fiscal policy information base, a relevant point is also that achieving the medium- and long-term general government sustainability objectives depends considerably on the economic development. This in turn leads into the need to focus sufficiently on not only the cyclical situation but also the longer-term structural factors.

If realised, the accelerated economic growth set as an objective in the Programme of Prime Minister Jyrki Katainen's Government would support the objective of reducing central government debt in relation to GDP. However, continuing uncertainties of the world economy and the persistence of the debt crisis of the euro area as well as the structural change of the Finnish economy represent a risk to the achievement of this objective as well. The autumn 2012 forecast of the Ministry of Finance still anticipated that the decrease in central government debt-to-GDP ratio set as an objective in the Government Programme for the 2011–2014 electoral term would be achieved. The Bank of Finland also still forecast in summer 2012 that the objective of bringing the increase in the central government debt ratio to a halt during the electoral term would be reached. The medium-term outlook has, however, weakened considerably. In its December outlook the Bank of Finland stated that the Government's objective of turning the trend in the central government debt ratio downwards will not be achieved without additional measures.

The OECD Economic Survey on Finland published in spring 2012 also points out that the fiscal policy measures included in the 2012 budget are not enough to achieve the decrease in central government debt-to-GDP ratio specified as an objective in the Government Programme.

According to the forecasts, the objective of central government deficit not exceeding 1% of GDP will not be reached either during the 2011–2014 electoral term. Figure 1 shows the outlook for central government deficit for the 2011–2014 electoral term in the light of economic forecasts published in autumn 2012.

The further deterioration of the European economic outlook as well as the halt of Finnish exports have led into a situation where major further adjustments through spending cuts or tax increases would result in the



Sources: Statistics Finland, Bank of Finland, Labour Institute for Economic Research, Ministry of Finance and ETLA.
FIGURE 1. Central government deficit as % of GDP: forecasts for 2012–2014.

weakening of the economic conditions. In its Economic Survey on Finland published in spring 2012, the OECD even recommends short-term fiscal stimulus should the economic recession prove more severe than expected. From the perspective of fiscal policy credibility, however, the use of stimulus measures would absolutely require that at the same time an agreement can be reached on structural reforms that will bolster the long-term stability of public finances.[19]

In its report, the OECD places a particular focus on reforms to increase the employment rate and to improve private and public-sector productivity. Particularly important from the perspective of improved public-sector productivity and strengthened economic growth potential is to invest in education, innovation and support to entrepreneurship.

According to the Bank of Finland, it is important to stick to the debt objective set in the Government Programme. Reaching the objective would require dropping the spending limits level from that agreed upon in spring 2012. According to a technical calculation provided in the Bank of Finland economic outlook of December 2012, in 2014–2015 the deficit would need to be reduced by a total of €1 billion to bring the increase in the debt ratio to a halt. According to Bank of Finland estimates, it would also be important to adhere to the decision to split adjustment measures in half into tax increases and spending cuts for the sake of consistency and predictability. The Bank of Finland finds that compromising on the targets set would be detrimental to fiscal policy credibility. Over the medium and long term, credibility is also important in order to maintain international financial institutions' confidence in Finland's financial management. The level of confidence is directly reflected in the cost of financing available.

It should, however, be noted that the economic outlook has changed considerably from the situation at the time of writing of the Government Programme. During the current electoral term the spending rules set have been complied with and tightened by dropping the spending limits level, which provides a considerable boost to the credibility of the Government's fiscal policy.

Fiscal policy tightening is not unproblematic in the context of persisting recession. In the current situation expenditure cuts and tax increases can weaken the capacities for economic growth for a longer term. This risk is also clearly expressed in the Bank of Finland forecast.[20] Analyses conducted by the International Monetary Fund (IMF) have produced evidence of the multiplier effect of fiscal policy having been systematically underestimated in countries where the base rate is exceptionally low. In such cases spending cuts or tax hikes lead into a larger decrease in GDP growth than anticipated.[21]

Measures to bolster economic growth were agreed upon under the spring 2012 spending limits decision. These include temporary incentives for investments, product development and investment in growth enterprises. According to an estimate provided by the Bank of Finland in conjunction with the summer 2012 economic outlook bulletin, these measures will temporarily weaken central government finances by around 0.1%. Reforms aiming at the extension of working careers were also proposed by the labour market confederations in conjunction with the spending limits decision made by the Government in spring 2012. These included raising the minimum age for the

19 OECD 2012.
20 Bank of Finland 2012.
21 IMF WEO 2012, Box 1.1., 41 43. Blanchard & Leigh 2013.

unemployment path to retirement by one year, abolishing the early old-age pension and raising the age limit for part-time pension from the current 60 to 61 years of age. Measures to increase the supply of labour contribute towards better conditions for economic growth, but these are not in themselves enough.

Until autumn 2012, the main focus in the implementation of the 2011–2014 electoral term fiscal policy was on central government adjustment to reach the objectives set in the Government Programme. In its separate report R 14/2012 vp submitted to Parliament in spring 2012, the National Audit Office pointed out that in Finland the cyclic aspects and long-term objectives of fiscal policy are in conflict with each other. Therefore special attention must be paid to structural reforms supporting long-term sustainability as time will be required for the reforms to be implemented and take effect. When assessing the updates of the Finnish Stability Programme during the 2007–2011 electoral term, the European Commission drew attention to no decisions having been made on structural reforms.

On the other hand, any spending limits savings made can also steer the administrative sectors towards bold renewal of their activities and legislation. The timing of the adjustment measures must be considered carefully as, for example, an unemployment rate that has managed to creep up tends to come down very slowly and, at the individual level, longer-term unemployment rapidly turns into a considerable obstacle to access to employment in practice. According to observations made in the National Audit Office's performance audits, the eradication of structural unemployment is very difficult and calls for changes in approaches and appreciations in the labour market.[22]

3.1.3 EU and euro area fiscal policy rules and objectives that are binding on Finland

As well as the fiscal policy objectives set in the Government Programme, the deficit and debt criteria of the EU Stability and Growth Pact are important elements of the fiscal policy rules framework to which Finland is committed. The agreements and objectives relating to increased coordination in the economic policy of the EU and the euro area also set requirements for fiscal policy preparation and implementation and related reporting. The rule concerning structural deficit contained in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) is an important complement to the fiscal policy regulatory framework.

According to the Stability and Growth Pact, the ratio of general government debt to GDP should not exceed 60% and general government deficit should not exceed 3% of GDP. The assessments presented by the OECD in summer 2012 of the development of Finland's general government debt ratio provide a grimmer outlook than those made by other forecasters. Correspondingly, according to the December 2012 outlook of the Bank of Finland, Finland's general government debt will be 55.9% of GDP in 2013 and 59.1% of GDP in 2016. According to the forecast, Finland's general government debt will exceed the 60% threshold set in the Stability and Growth Pact in 2018. According to the forecast published by the Commission in

22 National Audit Office R 17/2012 vp., 16–17 and 37–43. National Audit Office 229/2011.

autumn 2012, Finland's general government debt will be 54.7% of GDP in 2013.

Figure 2 illustrates the development of Finnish public-sector debt-to-GDP ratio for the 2011–2014 electoral term in the light of forecasts made in autumn 2012.

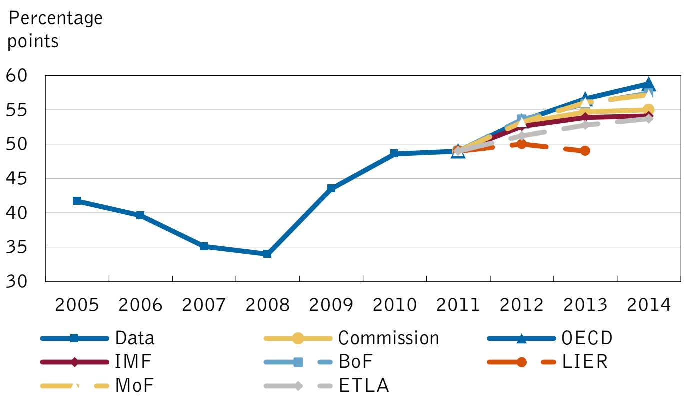
Inversely, the development of general government deficit will, according to Finnish and international assessments alike, remain within the general limits set by the Stability and Growth Pact. For example, the December 2012 outlook of the Bank of Finland estimates the general government deficit to be 1.3% of GDP in 2013.

Figure 3 illustrates the development of Finnish general government deficit for the 2011–2014 electoral term in the light of forecasts made in autumn 2012.

The Stability and Growth Pact further requires that each Member State sets a medium-term budgetary objective (MTO) for the general government budgetary position. The MTO must ensure a sufficient safety margin with respect to the 3% of GDP deficit limit set in the Stability and Growth Pact, ensure progress towards sustainability and allow room for budgetary manoeuvre for public investment in particular. In February 2010 Finland set a structural surplus of 0.5% as its MTO. This objective must be updated at three-year intervals, which means the next update will take place in spring 2013.

The cyclically-adjusted budget balance describes where the government budgetary position would stand if all production resources in the economy were in full use. In such a situation there would only be structural unemployment in the economy. The cyclical adjustment is based on an estimate of potential output development. Potential output describes the output capacity of the economy determined on the basis of production inputs, i.e. capital and labour, and productivity. Economic growth is assessed over the medium term on the basis of growth in potential output. In the update of Finland's Stability Programme, the level of potential output is estimated using the production function method agreed by the Ecofin Council. The cyclical position is illustrated by the output gap, i.e. the difference between potential output and total actual output.

The 2012–2015 Stability Programme is based on the spring 2012 forecast of the Ministry of Finance. The MTO set on the basis of the forecast will be achieved du-



Sources: Statistics Finland, European Commission, OECD, IMF, Bank of Finland, Labour Institute for Economic Research and ETLA.

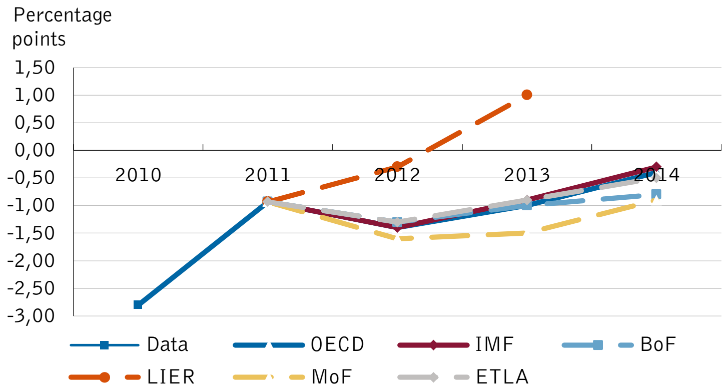
FIGURE 2. Public-sector debt-to-GDP ratio forecasts 2012–2014

ring the programme period thanks to the Government's adjustment measures. In its opinion on the Stability Programme of Finland of 10 July 2012, the European Commission states that the MTO reflects adequately the requirements of the Stability and Growth Pact and that Finland met the MTO in 2011 but will marginally deviate from it over 2012–2015. In its autumn 2012 forecast the Commission anticipates Finland to have a structural surplus of 0.3% of GDP in 2011 but a structural deficit of 0.3% at the end of the electoral term in 2014.

Correspondingly, the Bank of Finland still anticipated in summer 2012 that Finland's structural fiscal position will show a surplus in 2013 and further strengthen in 2014 close to the 0.5% structural surplus objective set in Finland's Stability Programme. However, according to the December 2012 outlook, Finland will not be able to reach the MTO set for general government structural surplus in the Stability Programme. According to the Bank of Finland forecast, it would be possible to reach the structural deficit of 0.5% determined in the Treaty on Stability, Coordination and Governance (TSCG) if the rise in the debt ratio could be halted by the middle of the decade in accordance with the objectives set in the Government Programme. This is, however, stated following a statement whereby this objective cannot be achieved without much more extensive consolidation measures.

In force from the beginning of 2013, the EU Treaty on Stability, Coordination and Governance (TSCG) sets a reference value for structural deficit. According to the TSCG, general government structural deficit may not as a rule exceed 0.5% of GDP over the medium term. For countries where the ratio of the general government debt to GDP is significantly below 60% the objective may be to reach a structural deficit of at most 1.0% of GDP. A further requirement is that the country's risks in terms of exceeding the limit set for debt-to-GDP ratio are low. This still appeared to be the case concerning Finland in spring 2012 in the light of medium-term forecasts. All in all in the light of the outlook of spring 2012, the reference value set in the TSCG for general government structural deficit did not entail any tightening for any country from the objectives set in their Stability Programmes.[23]

However, the medium-term outlook dete-



Sources: Statistics Finland, European Commission, OECD, IMF, Bank of Finland, Labour Institute for Economic Research and ETLA.

FIGURE 3. General government net lending (budget balance) to GDP ratio forecasts for 2012–2014.

23 Kurri 2012.

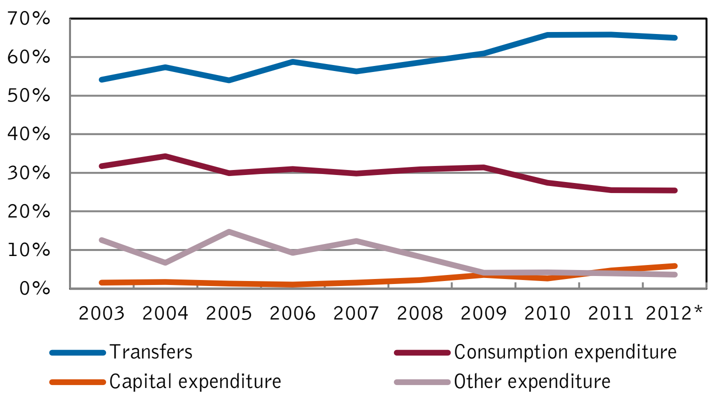
riorated considerably during autumn 2012, and assessments anticipating general government structural deficit for Finland have increased. It should, however, be noted in this context that structural deficit assessments are subject to major uncertainties. The uncertainties relating to the calculation of potential output and, consequently, structural deficit, are emphasised during cyclical turns. The assessments presented in autumn 2012 are particularly uncertain as regards the starting point of the calculations. Therefore they should be taken with caution.

The level set for central government spending limits may prove problematic as regards the achievement of objectives set in the context of weaker economic development. In the context of weaker economic development, the link between the central government spending limits and the objectives set concerning the structural – or cyclically adjusted – balance of general government finances has become a lot weaker.

3.1.4 Assessment of prerequisites for spending adjustment and structural reform implementation

The role played by careful expenditure reviews is emphasised if the aim is to considerably drop the level of spending. The majority of spending is rather strongly governed by legislation, whereby spending level adjustments also require considerable legislative measures. According to the view obtained in audits conducted by the National Audit Office, the connection between law-drafting and budgeting should be improved further. At best this results in the ability to combine changes in spending limit level with sufficiently bold reforms.

Central government operating expenses are around 7% of GDP and account for around 28% of total general government consumption expenditure according to national accounts. Central government spending limits have helped keep operating expenses reasonably well under control. Therefore the statutory duties of central government



Source: Finnish State Internet Reporting System (Netra).

FIGURE 4. Breakdown and development of central government expenditure by type.

need to be assessed where central government operating expenses are subjected to further adjustment. Central government should continue to perform those duties that are best suited for it as they are public or collective goods. Such assessments could in part be based on the core functions analysis conducted in the central government Effectiveness and Productivity Programme.

The breakdown of central government consumption expenditure is presented in Table 3.

Around two-thirds of central government expenditure are transfers, i.e. benefits received by individuals and households as well as government transfers and grants and other transfers to local authorities and other general government authorities as well as businesses. It is obvious on the basis of the breakdown of central government expenditure that – if the adjustment need was estimated at around €1–2 billion – any expenditure adjustment would also have to entail adjustment measures also applying to transfers. A more detailed breakdown of transfers by recipient is provided in Table 4.

When adjustment measures affecting transfers are made, it is important to consider their impacts on the conditions for the realisation of the economic, social and cultural rights guaranteed under the Constitution of Finland and international human rights instruments. Another issue that should be assessed as an issue affecting the targeting of savings is the impact of adjustment measures on the supply of employment and incentives to work. This way adjustment measures can provide good opportunities to develop incentives relating to current transfers.

On the other hand, savings targeted at central government transfers to local government have very different impacts from one municipality to another and are likely to result in at least short-term increases in funding deficit for municipalities that are strongly dependent on central government transfers. A review of local government duties is underway at the Ministry of Finance in conjunction with the local government reform. Consequently, any adjustment measures aimed at central government transfers to local government should involve assess-

Table 3. Breakdown of central government consumption expenditure

	Cumulative accrual 2011 (€ million)	Total share of budget expenditure (%)
Operating and remuneration expenditure(01-14)	6 170	12 %
Pensions (15–17)	3 823	8 %
Procurement of defence materials(18–19)	598	1 %
Other consumption expenditure (20–28)	1 496	3 %
Value added tax expenditure29	1 001	2 %
Total consumption expenditure (01–29)	13 088	26 %
Total budget expenditure accrual	50 382	100 %
Adjusted by supplementary budget	51 417	

Source: Finnish State Internet Reporting System (Netra) ments of the sufficiency of measures targeted at economy in local government structures and activities and municipalities' tasks. It appears on the basis of performance audits conducted by the National Audit Office that there is a conflict between the standards set in legislation concerning the objectives and quality of local government tasks and basic public services and the financial resources of certain municipalities. To some extent this can be eliminated through prioritisation and more efficient resource allocation to the various functions within municipalities. Some municipalities do not have enough resources to produce basic public services at the level set as the objective in legislation.[24]

The scale of measures aimed at business subsidies is limited by the justified need to maintain a high level of research, development and innovation (RDI) activities. On the basis of the National Audit Office's audits, there are opportunities for reallocations and some adjustments measures in this sector as well.[25] It would be particularly appropriate to review any overlaps in business subsidies and end any programmes that are failing to produce results.

As regards taxation, central and local government leeway is restricted by tax increases (rise in tax ratio) and their restricting impacts on growth in total output. Therefore a balance should be sought in tax policy between the clarity of the tax system, the creation of incentives targeted at the prerequisites of economic growth and government steering and aspects of fairness. Therefore there is a need in tax policy to also leave room for the use of taxation as a social policy instrument.

Table 4. Breakdown of central government transfers

	Cumulative accrual 2011 (€ million	Share of budget expenditure (%)
Government transfers and grants to local authorities, joint municipal authorities, etc. (30–39)	11 456	23 %
Central government aid to trade and industry(40–49)	3 383	7 %
Central government aid to households and non-profit-making organisations(50–59)	9 877	20 %
Transfers to off-budget activities and the Social Insurance Institution of Finland(60)	4 830	10 %
EU Structural Fund contributions, other EU fund contributions, corresponding central government contributions (61–65)	1 066	2 %
Transfers abroad(66–68)	993	2 %
Transfers to the EU (69)	1 822	4 %
Total transfers (30–69)	33 427	66 %
Total budget expenditure accrual	50 382	
Adjusted by supplementary budget	51 417	

Source: Finnish State Internet Reporting System (Netra)

24 See Report of the Parliamentary Audit Committee 9/2012 vp on National Audit Office's annual activity report to Parliament 2012. National Audit Office's annual activity report to Parliament 2012 R 17/2012 vp.
25 National Audit Office R 17/2012 vp., 17–20 and 67–75.

It should also be remembered when considering the choices available for Finland's economic policy that direct spending and revenue adjustment measures cannot alone be enough to guarantee long-term sustainability of public finances if nothing is done about the structural factors causing inefficiencies. According to an assessment provided by the Ministry of Finance prior to the Government Programme negotiations concerning the 2011–2014 electoral term, half of the sustainability gap should be closed using structural reforms.[26]

Recommendations and assessments concerning Finland's economy and economic policy made by international organisations such as the OECD and the European Commission contain several proposals concerning structural reforms that are worth considering.[27]

As regards the consolidation of public finances and the safeguarding of sustainability, four important components can be found for structural reforms: (1) lengthening of working careers; (2) restoring economic growth potential and improving the conditions for industrial operations and competitiveness; (3) breaking the rapid price development in public services and increasing efficiency in service production and (4) improving competition policy efficiency.

As regards the lengthening of working careers, one of the key economic policy objectives should be to maintain the number of working hours in the economy at the highest possible level. In addition to measures already decided upon, the lengthening of working careers also requires new decisions that improve access to education and training and placement in studies that result in employment, bring forward the transfer from studies to employment, reduce premature exit from employment due to disability or unemployment, postpone retirement and improve participation in employment.[28]

The creation of a labour market for those who have already retired is one important opportunity. According to the European Commission's analyses, the statutory retirement age has a major signal effect, whereby it is not justifiable from the economic perspective to rule out an increase in the retirement age as one of the possible measures. The European Commission Fiscal Sustainability Report recommended a system with a link between the statutory retirement age and increases in life expectancy. Such a system is already in use in Denmark and would also offer Finland an opportunity for solutions with long-term sustainability that is worth considering.[29] Raising the statutory retirement age alone is not, however, enough. It is also important to be able to postpone the actual retirement age.

The National Audit Office's annual activity report to Parliament 2012 provides a compilation of assessments based on audits concerning the need to develop Finnish research, development and innovation (RDI) policy. From the overall economic perspective, the most beneficial measure towards the maintenance of economic output potential would be to maintain high enough industrial production levels in a sustainable and competitive manner. The broad-based and systematic development of RDI activities and incentives should be continued. At the same time efforts should be made to eliminate obstacles to the creation of growth enterprises. In this context there is also a need to take

26 Ministry of Finance 17/2011 and Ministry of Finance 49/2010.
27 OECD Economic Surveys Finland, February 2012; IMF Finland 2012 Article IV Consultation, IMF Country Report No. 12/253.
28 National Audit Office R 17/2012 vp, 39–42.
29 European Commission 2012.

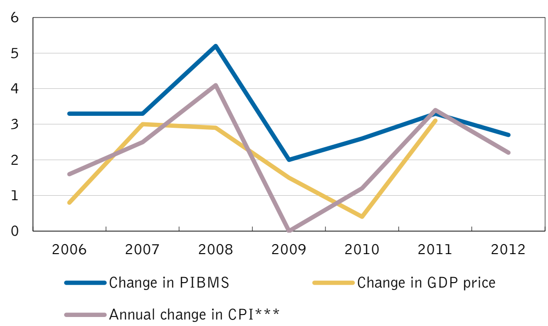
legislative measures to address the mental atmosphere and willingness for healthy entrepreneurial risk-taking, which is practice means issues such as reforming debt adjustment and bankruptcy legislation.[30]

As regards the consolidation of public finances and safeguarding sustainability, it is vital to break the rapid price development of public services and increase the efficiency of public service production. The weakening of the financial position of local government in particular is partly due to an increase in public service production costs at a rate exceeding GDP price development and income development.

Structural reforms should be targeted particularly at municipal health and social welfare services, the expenditure from which accounts for 54.8% of municipal operating costs and which are under particular growth pressure due to population ageing. It is important in the local government reform and the closely related structural reform of social and health care services to find solutions that can ensure public service price development will not exceed GDP price development. Over the longer term it is necessary for the care sector in particular to develop innovative solutions that enable the coverage of care costs arising from population ageing without a considerable increase in expenditure and need for labour. Knowledge management and ICT can provide considerable potential to reduce the level of public expenditure.[31]

The existence of de facto restrictions of competition has been repeatedly pointed out in Finnish and international assessments of public service production costs and opportunities to strengthen economic growth.[32] OECD reports on the Finnish product market and economic and fiscal policy have stated that the market is concentrated in the retail and service sectors in particular and that competition is restricted by various regulatory and permit procedures and location steering.[33]

In its statement on Finland's National Europe 2020 Reform Programme and updated Stability Programme, the Council of the European Union recommended that Finland enhance service sector competition, including in the retail and wholesale sectors. Ac-



Source: Statistics Finland. *** PIBMS = Price Index of Basic Municipal Services, CPI = Consumer Price Index

FIGURE 5. Basic service price index development against GDP price.

30 National Audit Office's annual activity report to Parliament 2012 R 17/2012, vp, 23–24.
31 National Audit Office R 17/2011 vp, 106–111. National Audit Office 217/2011. Pöysti 2011. Reviisori 1/2011.
32 Finnish Competition Authority /Ahonen 2011. Finnish Competition Authority 2008.
33 OECD 2011 and OECD 2012a. Also see the OECD Product Market Regulation Database, www.oecd.org/economy/pmr.

cording to the EU, the Finnish price level can in part be attributed to weak competition in the domestic market. This also decreases productivity, resulting in the productivity development of service production co-funded by the government remaining below the overall development level. The EU has recommended that Finland take further measures to open up further the service sector by redesigning the regulatory framework and removing restrictions in order to facilitate new entry into service sector markets.[34] Increasing competition is one of the commitments made under the Euro Plus Pact aimed at increasing economic competitiveness and employment in Finland's Europe 2020 strategy.[35] Increasing competition is also one of the measures relating to Finland's Stability Programme.[36] In its statements concerning stability programme updates and national reform programmes, the European Union has particularly emphasised the importance of the promotion of competition, including as a way to improve public-sector productivity. In addition to previous observations, the statements also point out the need to improve competitive neutrality in the public sector and competitiveness in public service provision and related procurement.[37]

Calculations made using the Bank of Finland dynamic general equilibrium model of the economy show GDP at a level 3.5% higher than in the basic forecast six years after the commencement of reforms to increase competitiveness.[38] On the basis of the view obtained by the National Audit Office during audits, increased competitiveness would also considerably reduce pressure towards general government price increases.[39] The Government has launched a programme for promoting healthy competition.[40] It aims to implement the commitments made under the update of the Stability Programme and Finland's National Europe 2020 Programme. The market covered by the programme has a value of around €50 billion or around a quarter of Finland's GDP. The general aim of the programme is to intensify competition in the Finnish market, and three areas have been selected for the programme in which the promotion of competition would be particularly important or urgent.[41] To implement the programme, the Government has already submitted a proposal concerning the enhancement of competition in the grocery trade sector.[42] According to information available at the time of the audit, the preparation of other measures included in the programme is taking place at relevant ministries. A section important to general government productivity is the one concerning legislation and me-

34 Council Recommendation (2011/C 216/02) of 12 July 2011 on the National Reform Programme 2011 of Finland and delivering a Council opinion on the updated Stability Programme of Finland, 201–2014, OJEC C 216, and the working document preceding its preparation, Commission recommendation SEC (2011) 734 final and working document SEC (2011) 805 final, particularly pages 10–12.

35 Ministry of Finance 16c/2012.

36 Ministry of Finance 15c/2012.

37 Council Recommendation 2012/ C 219/08 on the National Reform Programme 2012 of Finland and delivering a Council opinion on the Stability Programme of Finland, OJEU C 219, 24.7.2012 and Commission recommendation COM (2012) 312 final and Commission working document SWD(2012) 312 final, particularly pp. 16–17.

38 Bank of Finland 2012, Box 5, 48–50.

39 This has been brought up in performance audits of ITC activity in particular. Difficulties in the application of regulations concerning public procurement and competitive tendering regularly come up in performance audits and compliance audits, see National Audit Office 217/2011 and 1/2012. Also see Parliamentary Audit Committee report on social and health care information systems and funding, Audit Committee Report 2/2012 vp. For competition policy opportunities at a more general level see National Audit Office's annual activity report to Parliament 2012 R 17/2012 vp, 20–21.

40 Programme of Prime Minister Jyrki Katainen's Government. Government's structural policy statement 22 March 2012. European Union's Europe 2020 Strategy, Finland's National Programme.

41 Ministry of Employment and the Economy, Programme for promoting healthy competition 19 September 2012 (memorandum at cabinet evening session).

42 Government Proposal 197/2012 vp.

asures relating to competition neutrality in public sector business activities considered by the Government in spring 2013.

The programme for promoting healthy competition does not cover all sectors. Therefore it may be justifiable to also review and reduce any structural obstacles to healthy competition in other sectors as well. Competition aspects should also be taken into consideration in the review of business subsidies referred to in Finland's National Programme under the Europe 2020 Strategy.[43] The Government has also provided Parliament with a report in response to the Parliament position issued on the basis of Audit Committee report 2/2012 vp. Parliament called for measures including assessment of the impacts of discretionary government transfers on competition.[44] Parliament also required that the report be included in the Report on the Final Central Government Accounts for 2012. At this point the report submitted to Parliament mainly contains a description of various financing systems. There is hardly any assessment of actual impacts on competition in the report. The competition impacts of various subsidy and government transfer systems should be identified and assessed better. This is also required by the Act on Discretionary Government Transfers.

In the opinion of the National Audit Office, the speedy implementation of the programme for promoting healthy competition in all administrative sectors covered by the programme as well as increasing competitiveness on the whole are essential elements of structural reforms that require urgent implementation. Lack of competition in Finland increases the Finnish price level, reduces incentives for innovation and therefore decreases productivity and growth. The general goal of competition policy is for consumers to be able to make choices from a large range at competitive prices. Indirectly this has major impacts on the economy on the whole as well as major impacts on general government finances. As regards general government finances and service production, increased competitiveness can result in broader innovation and reduced general government cost pressures as competition becomes healthier.

On the basis of audit findings, it is necessary as part of the local government reform and structural reforms of social welfare and health care to strengthen the prerequisites for efficient competitive tendering and clearly differentiate regulation concerning responsibility for the provision and production of services from each other.

43Ministry of Finance 16a/2012 vp, 19 as well as 34–36.
44Government report M 3/2012 vp.

3.2 Functioning of the preparatory process of central government spending limits

The functioning of fiscal policy instruments in accordance with the objectives set is affected by the practices and approaches adopted. The spending limits procedure is the most important fiscal policy instrument.

3.2.1 Openness and transparency of the spending limits procedure

In its separate report to Parliament on the effectiveness of the central government spending limits procedure as a fiscal policy instrument (R 21/2010 vp), the National Audit Office recommended that reporting on the final central government accounts should be made more specific.

According to the National Audit Office's opinions, to increase transparency, the Report on the Final Central Government Accounts should clearly indicate which appropriations in the Government proposal are covered by spending limits. Furthermore, with regard to supplementary budgets as well as appropriations added by Parliament, appropriations should be broken down according to whether or not they were covered by spending limits. In this way an outsider could easily check whether the appropriations in the final budget comply with the revised spending limits for the year.

Reporting on the Final Central Government Accounts has for the 2010 and 2011 budget years been changed in accordance with the National Audit Office's opinions. The Report on the Final Central Government Accounts for 2010 and 2011 contained tables presenting the amount of expenditure covered by the spending limits as regards the budget and all supplementary budgets as well as the price-adjusted and structurally adjusted spending limit level. This illustrates how much the amount of expenditure covered by the spending limits has fallen below the spending limits level. The National Audit Office regards this manner of presentation as clear, and welcomes its introduction as a permanent practice in Reports on the Final Central Government Accounts. A corresponding clear table and explanation of the price and structural adjustments made to the spending limits level and the realisation of the spending limits have also been included in the General Strategy and Outlook of the budget and supplementary budgets. Therefore the spending limits level can be monitored regardless of the complex features of the spending limits system and the price adjustments of the spending limits.

To increase the transparency and openness of the spending limits procedure, the Ministry of Finance has drawn up a description of the preparation and maintenance of the spending limits for 2012–2015, which can be found on the Ministry's website. The methods description is to be updated for each new electoral term. The National Audit Office regards this as a good way to improve the transparency and information base of the central government spending limits.

3.2.2 Tax subsidies and the spending limits procedure

Tax subsidies or tax expenditures refer to deviations from the normal structure of taxation. The calculation of tax subsidies involves an assessment of how much tax revenue is reduced by tax exemptions, tax deductions, lowered tax rates and other tax reductions.

The Audit Committee required in its report on the basis of the National Audit Office's separate report R 21/2010 vp that an assessment be conducted on whether tax subsidies should be included in the spending limits procedure.

It should be noted in this context that the calculation and monitoring of tax subsidies is extremely complicated. Tax subsidies are determined in relation to the normal structure of taxation, the determination of which is not always clear. Some tax subsidies affect tax incidence, while central government spending limits regulate the overall spending level and not the incidence of expenditure. According to the Action Report on parliamentary objections to the final accounts included in the Report on the Final Central Government Accounts submitted by the Ministry of Finance for 2011, the inclusion of tax subsidies in the spending limits system is not without its problems. The inclusion of tax subsidies in the spending limits procedure was considered by working groups on the development of the spending limits system in 2007 and 2011. Both working groups ended up proposing that tax subsidies should not be included in the spending limits procedure in order to preserve the system's openness and transparency.[45]

The risk of tax subsidies being used to circumvent the spending limits system does, however, exist, and reporting on tax subsidies has therefore been considerably increased and further specified in recent years. According to the Government Programme, the Government will not use tax subsidies to circumvent the spending limits in conflict with the purpose of the spending rules. Efforts have been made to develop tax subsidy reporting, and the Report on the Final Central Government Accounts now contains a description of the most important tax subsidies and, for the first time for the 2011 budget year, an assessment of the effectiveness of tax subsidies.

In conjunction with the continuous auditing of fiscal policy, the National Audit Office monitored reporting relating to tax subsidies in 2009–2011. According to the National Audit Office's view, the review of the extent and coverage of tax subsidies conducted in 2010 and the updating of the calculation methods enable the provision of a true and fair view of the amount of tax subsidies. Continuous work is, however, required for the monitoring of the up-to-dateness of tax subsidies and development and maintenance of calculation methods. Therefore the National Audit Office will continue to monitor the development of tax subsidies and reporting relating to them. The National Audit Office regards the continuous development of tax subsidy calculations and monitoring as a good practice.

The need for tax subsidy calculations and monitoring46 is also emphasised by the increased use of tax incentives as economic policy as well as innovation policy instruments. Several tax incentives have been introduced in accordance with the central government spending limits decision for 2013–2016. The most important of these include the act on further tax allowances in research and development activity in 2013–2015, act on increased depreciations of production investments in 2013–2015 tax years, and act on tax reductions for investment activity in 2013–2015. On the basis of the Finance

45 Ministry of Finance 17/201. Ministry of Finance 5b/2007.
46 Government Proposal 175/2012 vp.

Committee's report drawn up on the basis of the Government's proposal, Parliament has approved a resolution whereby Parliament requires that the Government monitor the impacts of the proposal as well as the functioning of the temporary growth incentive in practice and assess the need for further development of the act on the basis of information obtained by the Government. According to the resolution, the Government must, where necessary, make any proposals for amendments proven necessary as regards the objectives of the proposal.[47] The loss of tax revenue resulting from the additional research and development activity deduction was estimated to total €190 million in the Government proposal. No attempt was made to assess the economic impacts of the system in the justifications of the Government proposal, and thus more concrete objectives were not set for the incentive. A resolution of corresponding content concerning the monitoring and assessment of the impacts of the act was also approved by Parliament on the basis of the Finance Committee's report in conjunction with the consideration of the Government proposal for the act on tax reductions for investment activity in 2013–2015.[48]

It is justifiable to extend the assessment presented in the Parliamentary resolutions to also cover all other tax incentives introduced or already in use. The National Audit Office's annual activity report to Parliament 2012 also provides a brief account of issues relating to the use of direct support and tax incentives for RDI activity. The introduction of tax incentives is often justified with international competition and the strengthening of the country's competitive position rather than uncovering the impacts of the setup in greater detail. Decisions on tax incentives should be based on an in-depth and analytical information base and careful analyses of the objectives as well as the context. As regards the growth of enterprises and total output, the decisive role is not played by individual tax incentives but rather by the tax system as a whole and the administrative burden caused by taxation. The target-setting for tax incentives and the ex-ante and ex-post assessment of their cost effectiveness should be developed further. Assessment data should also be utilised in decision-making.[49] For example, critical views based on research have been presented by the Government Institute for Economic Research (VATT) concerning the significance of increased deductions of production investments as investment incentives.[50]

The results of assessments and the need for tax policy development on the whole can be examined in conjunction with the spending limits procedure by putting all of the different subsidies and incentives on the table at the same time.

3.2.3 Off-budget activities – funds

Finnish central government has 11 off-budget funds. Their total combined balance sheet was around €26.5 billion at the end of 2011, while the balance sheet to GDP ratio was around 14% in 2011. Fund revenue in 2013 is anticipated to total around €5 billion, and central government expenditure paid from the funds around €4.6 billion. This means revenue of around 10% and expenditure of around 9% of the budget.

47 Finance Committee Report 35/2012 vp, Parliamentary reply 168/2012 vp.
48 Finance Committee Report 37/2012 vp, Parliamentary reply 170/2012 vp.
49 National Audit Office R 17/2012 vp, 22–23.
50 Government proposal 94/2012 vp, Ministry of Finance 20/2012 vp.

Each of the off-budget funds are products of history. There is great variation in the legislation governing their activities and the economic extent of their activities.

In 2009 the National Audit Office conducted a performance audit on the steering and administration of off-budget funds covering the steering of off-budget funds and Parliament's access to information about the funds.

Follow-up on the performance audit took place in autumn 2012. On the basis of the performance audit as well as the follow-up, the provisions concerning the funds have not been harmonised in the manner set as an objective in Government Proposal HE 56/2003 concerning the central government accounting reform, including as regards the steering and administration model.

The State Pension Fund is classified under social security funds in the national accounts, while the other off-budget funds are classified under central government administration. The most important funds from the fiscal policy perspective are the State Pension Fund, the National Housing Fund and the Development Fund of Agriculture and Forestry.

Off-budget funds form an exception to Parliament's budgetary power and therefore restrictions are laid down under section 87 of the Constitution of Finland on their creation and essential extension. The funds are only partially covered by the current central government spending rules set under the central government spending limits system.

Transfers from state budget economy to the funds are, as a rule, covered by the central government spending limits system. Transfers from the state budget economy to the funds are usually classified as covered by the spending rules specified in the central government spending limits. As of the beginning of 2013, however, a major exception to this is the transfer of the revenue from the new public broadcasting tax to the State Radio and Television Fund, which is handled as spending outside the spending limits.

Expenditure paid from the funds is not covered by the spending limits. During the recession following the 2008 financial crisis the funds, especially the National Housing Fund, provided a major flexibility element for the spending limits system.

Submitted as a separate report to Parliament, the National Audit Office's fiscal policy audit report for the electoral term 2001–2010 (R 21/2010 vp) recommended a study of the need for and propriety of off-budget funds. On the basis on the National Audit Office's separate report, Parliament approved a resolution in accordance with Audit Committee Report 10/2010, whereby Parliament requires that an assessment be conducted specifically for each fund of whether the necessary grounds referred to in section 87 of the Constitution still exist for the arrangement of the activities and funding under a fund outside the budget. The working group appointed by the Ministry of Finance to assess the central government spending limits procedure stated that, from the fiscal policy perspective, the inclusion of the National Housing Fund and Development Fund of Agriculture and Forestry in particular as on-budget entities should be considered, and these funds in particular should be clearly brought within the spending rules included in the central government spending limits procedure. The working group further stated that the Government Programme should include a policy whereby off-budget funds are not used to circumvent the central government spending limits.

Under the guidance of the Ministry of Finance, the Government conducted the assessment required by Parliament and reported on its results to Parliament in the Report on the Final Central Government Accounts for 2011. The Report contains assessments of each fund conducted by the ministries responsible for the funds independently and from the perspective of their respective administrative sector. The ministries responsible for the funds had been provided by the Ministry of Finance with preparation instructions that required the integration of the assessed funds into the budget economy or, where this is not regarded as possible, their inclusion in the central government spending limits system. According to the report provided by the Ministry of Finance in the Report on the Final Central Government Accounts, in the next stage it is necessary to conduct an overall assessment of funds in the light of fiscal policy and central government finances as well as section 87 of the Constitution of Finland. This assessment from the fiscal policy and overall central government perspective has yet to be conducted.

The ministries' fund-specific assessments mainly provide justifications for the preservation of the funds. The Ministry of Finance report on the State Pension Fund states that the fund's role should be reassessed and clarified. The Programme of Prime Minister Jyrki Katainen's Government states that the National Housing Fund's position as a fund existing outside the state budget will be retained. In its report 4/2012 provided on the basis of the Report on the Final Central Government Accounts, the Parliamentary Audit Committee regarded the Government's report as sufficient, with the Audit Committee not requiring any further reporting on this parliamentary resolution in the Action Report on parliamentary objections to the final accounts. According to the Government Programme, the functioning of the Development Fund of Agriculture and Forestry as a channel of financing investments in its present form will be evaluated.

The Programme of Prime Minister Jyrki Katainen's Government does not contain a clear prohibition, as recommended by the working group appointed by the Ministry of Finance on the development of the spending limits procedure, of the use of funds to circumvent the spending limits or a more general principle concerning the prohibition of any circumvention of the spending limits. No cases of funds being used to circumvent the spending rules have been detected during the 2011–2014 electoral term either.

Excluding the State Radio and Television Fund, there have been hardly any changes of fiscal policy importance relating to the spending limits procedure in the funds since the previous fiscal policy report for the electoral term. The level of central government expenditure paid from the funds will remain at around €4.5 billion in 2011–2013. According to the budget, in 2013 a total of around €1.8 billion will be entered as revenue from the funds, with the amount consisting mainly of a transfer of €1.689 billion made from the State Pension Fund to the budget. The budget use of this fund is within the spending limits system.

In 2013 a total of around €0.5 billion will be transferred from the budget to funds, consisting mainly of the transfer of revenue from the new public broadcasting tax to the State Radio and Television Fund for use to fund the Finnish Broadcasting Company in accordance with the relevant new legislation. The transfer of the public broadcasting tax from the budget to the fund has been determined by the Government as spending outside the central government spending limits, which is and which has openly been stated as being a deviation from the central government spending limits procedure. In its annual report on the findings from continuous auditing of fiscal policy, the National Audit Office stated that the deviation has not been sufficiently justified from the viewpoint of consistent application of fiscal policy rules.

Off-budget funds can still be regarded as major deviations from Parliament's budgetary power. At the same time provisions are enacted by Parliament concerning the operating principles of off-budget funds and the relationship between the funds and the budget economy. Parliament's access to information about the funds has been improved to some extent. The scrutiny of the funds and their development is still, however, rather limited. No fund-specific analyses of the final accounts are carried out concerning the funds. With no aggregated central government balance sheet available, analyses of final central government accounts do not contain fully consistent and clear examinations of off-budget activities either. Central government spending limits decisions, the General Strategy and Outlook of the budget and the Report on the Final Central Government Accounts do, however, as such provide clear coverage of funds as an individual whole.

From the fiscal policy perspective the main weakness of the current fund system is that off-budget funds reduce the transparency of central government's economic position. Finland is incurring further debt. At the same time funds are transferred by central government to funds for special purposes. In the absence of single consolidated final accounts and balance sheet management based on them, there is a risk of the picture obtained of the overall fiscal position of central government becoming dimmer. This is because the examination of individual financial items separately from other central government responsibilities and assets can easily lead into erroneous assessments of central government capacity to meet its obligations. On the basis of follow-up on the performance audit of fund steering and administration, the amount of information concerning funds in the Report on the Final Central Government Accounts has, however, been increased and information about any hidden debts relating to the funds is now also collected.

The features of good fiscal policy rules include comprehensive and consistent coverage so that there are no deviations from the rules that are unjustifiable or in conflict with the purpose of the rules. The purpose of fiscal policy rules and, consequently, of central government spending limits is to restrict the total amount of expenditure payable by the taxpayer. Coverage is also one of the pillars of the European Union's Budgetary Frameworks Directive 2011/85/EU.

The state employer's pension contributions paid to the State Pension Fund and the budgetary use of State Pension Fund expenditure are covered by the spending limits rules. In the system under the EU Budgetary Frameworks Directive and the Treaty on Stability, Coordination and Governance (TSCG), the fiscal policy target-setting relating to the State Pension Fund is to take place as part of social security funds. Excluding the exception concerning the transfer of public broadcasting tax revenue, transfers from the budget to off-budget funds are covered by the spending limits. Central government expenditure paid directly from the funds is not covered by the spending limits system. The principle of fiscal policy rules coverage and the purpose of restricting the total expenditure payable by the taxpayer is not, however, systematically realised with off-budget funds. This, however, is not the biggest problem in Finnish fiscal policy at the moment.

The TSCG and the EU Budgetary Framework Directive require that fiscal rules consistent with the Stability and Growth Pact are set for general government as a whole as well as for all of its sub-sectors in accordance with the national accounts. Therefore objectives also covering off-budget funds, excluding the State Pension Fund, should be set for central government. Under the current classification, the State Pension Fund should, however, be handled as part of social security funds despite the fact that, in terms of the actual nature of its operations, it is closer to a state investment fund than a genuine pension fund. Union legislation does not as such require the inclusion of off-budget funds within the spending rules included in the central government spending limits. Instead, the examination of balance in central government finances on a more general level, in which off-budget funds are also included, can presumably be regarded as sufficient. Having the expenditure paid from the funds covered by the spending rules is, however, justifiable to achieve the coverage of the national spending rules, which have proven to function well.

The National Audit Office recommends that off-budget funds be included in the central government spending limits system and the spending rules included therein as of the beginning of the 2015–2018 electoral term.

The National Audit Office finds it important to conduct the evaluation of off-budget funds and the propriety of the fund format on the whole in the light of fiscal policy, central government finances and section 87 of the Constitution of Finland under the leadership of the Ministry of Finance during the current electoral term as stated in the Action Report on parliamentary objections to the final accounts included in the Report on the Final Central Government Accounts for 2011. At the same time it is necessary to evaluate the harmonisation of provisions relating to the funds from the perspective of central government finances and related steering provided that the fund format still proves to be a justifiable way of arranging for the performance and funding of permanent central government tasks.

3.2.4 Flexibility of central government spending limits

Attention to the inflexibility of the spending limits was drawn in the National Audit Office's separate report to Parliament on the effectiveness of the central government spending limits procedure as a fiscal policy instrument (R 21/2010 vp). As a result of this inflexibility, reforms take place on the basis of additional appropriations on top of the old expenditure structure instead of considering opportunities to carry out reforms by changing focuses and making reallocations within or between administrative sectors.

The audit of the administrative preparation of spending limits during the 2007–2010 electoral term found that very little active reallocation of expenditure has taken place within the spending limits system. This applies to reallocations of expenditure across as well as within administrative sectors. According to the audit findings, ministries have not proposed many reallocations within their administrative sector.

Reallocations within administrative sectors are, however, important from the perspective of administrative sectors' good financial management and the flexibility of the spending limits. In its reporting concerning the development of the spending limits system, the Ministry of Finance has also pointed out that the flexibility aimed at in conjunction with spending limit reforms has not been achieved.[51]

Structural changes in society and the economy may require the reallocation of resources during the electoral term in a manner differing from previous spending limit decisions and budgets. In the current economic situation the need to allocate appropriations as appropriately as possible is emphasised as reforms cannot be funded through increases in appropriations. The need to adjust expenditure underlines the importance of targeting appropriations in a manner that is as appropriate as possible as regards central government financial management on the whole. Spending limits budgeting as such does not prevent such reallocations of expenditure. If changes are necessary during the electoral term, reallocations can take place within the spending ceiling set.

The sectoral-focused approach in spending limits and budget preparation led into ministries holding onto their administrative sector's resources and not being willing to allocate their resources to the implementation of cross-sectoral policy programmes during the 2007–2010 electoral term. On the other hand it should be remembered that the development of their own administrative sector should indeed be each ministry's primary objective within the limits provided. An overall view of the fiscal policy and the prioritisation required by it is obtained through political steering. In the absence of this, the changes of focus needed between administrative sectors will not take place. For the 2011–2014 electoral term, savings aimed at expenditure adjustment and spending increases carried out through reallocations of expenditure are specified in an annex to the Government Programme. Together with the Government's Strategic plan for the implementation of the Government Programme[52], this has improved the prerequisites for the achievement of the objectives set by the Government in spending limits and budget preparation.

In its report 10/2010 provided on the basis of the National Audit Office's separate report R 21/2010, the Parliamentary Audit Committee regarded the spending limits procedure being politically binding and credible as the procedure's clear strengths. A downside found by the Committee is the inflexibility of the spending limits, visible in issues including the difficulty of legislative needs detected during the electoral term but not included in the Government Programme to progress in the process. In its report the Audit Committee required that the flexibility of the spending limits be increased to enable the better allocation of appropriations within as well as between administrative sectors.

In the Action Report on parliamentary objections to the final accounts included in the Report on the Final Central Government Accounts for 2011, the Ministry of Finance underlines in the context of increasing spending limits flexibility that the spending limits system does not prevent reallocations between administrative sectors. The Action Report emphasises the role of the prevailing decision-making culture as a cause of inflexibility. On the other hand, the Action Report does not mention the low occurrence of reallocations within administrative sectors or

51 Ministry of Finance 5b/2007. Ministry of Finance 17/2011.

52 The document supplementing the Programme of Prime Minisiter Jyrki Katainen's Government is entitled Strategic plan for the implementation of the Government programme - key projects and responsibilities. It contains the objectives for each strategic priority as well as the measures to be taken to achieve the objectives, i.e. key projects, the responsible ministries and the projects' funding situation.

the underlying factors at all. Instead, it states that sector-specific spending limits have aimed to facilitate the flexible allocation of expenditure within the limits.

There is a focus in the monitoring of compliance with the spending limits on the overall level of spending, while the more specific allocation of expenditure is intended to take place under annual budgets. The item-based preparation of spending limits is found to have resulted in item-based expenditure calculations of spending limits decisions possibly being applied too specifically in budget preparation. According to the Ministry of Finance, the purpose of spending limits calculations is merely to provide an indication of the expenditure structure. It can be stated on the basis of the Action Report that the situation relating to the flexibility of the spending limits has remained unchanged from the preceding electoral term, 2007–2010. In the National Audit Office's opinion this means active measures must be taken and recommendations for action must be issued to improve capacities for spending limits flexibility.

The need for increased flexibility is further emphasised because, as described in chapter 3.1 of this report, the persistence of the euro area debt crisis has resulted in weaker-than-projected economic development. In addition to the adjustment measures included in the Government Programme, the Government decided in conjunction with the spring 2012 spending limits decision to take further adjustment measures to strengthen central government finances. The adjustment measures already decided upon by the Government and the need for possible further adjustment measures emphasise the need to target the appropriations as well as possibly within the spending limits. In this a key role is played by the fact that in the current situation reforms necessary for the development of administrative sectors cannot be implemented on the basis of increased appropriations.

In its separate report to Parliament (R 21/2010 vp) the National Audit Office stated that the general principles that the Ministry of Finance applies in submitting proposals that differ from ministries' proposals and in accepting and rejecting ministries' reallocation proposals should be presented more clearly and openly. The realisation of reallocations at the beginning of the 2011–2014 electoral term was examined in the fiscal policy audit on the relation between the Government Programme and the spending limits procedure.[53] It can be stated on the basis of the audit that the rules of play concerning reallocations within administrative sectors are mostly clear and cooperation between the Ministry of Finance and the sectoral ministries functions properly. Cases were, however, detected in the audit where the approaches on both sides were not fully clear and there were inconsistencies in practices. It should also be noted that the principles of reallocation are yet to be specified in any document.

A generation shift will take place in Finnish central government in the next few years, which further emphasises the need to have guidelines. This will ensure a uniform approach in the future too. On the other hand, the existence of clear guidelines could provide sectoral ministries with an incentive to carry our prioritisations within their sector. There is an increased need for this as sectoral reforms can to a decreasing extent be implemented on the basis of increased

53 National Audit Office 17/2012.

appropriations.

In the National Audit Office's opinion the administrative sectors should have incentives for good financial management so that it would be worth their while to actively seek savings in their own sector and thus be able to implement reforms. This would be supported by the availability of rules concerning the reallocation of appropriations that are as clear as possible. Such rules could be provided in a format such as the Spending Limits Manual made available to everyone and therefore applicable in practical spending limits and budget preparation. The Spending Limits Manual describes the methods used to monitor compliance with the spending limits as well as the key principles of the spending limits system. Introduced during the current electoral term, the manual will be updated for each new electoral term. The manual can be found in Finnish on the Ministry of Finance website. Reallocations should not be seen as exceptions. Instead, they should be part of everyday financial management and prioritisations within administrative sectors.

Adding the spending needs arising from new policy measures on top of the old expenditure structure is not justifiable from the viewpoint of the sustainability of public finances. In the Programme of Prime Minister Jyrki Katainen's Government, new policy measures are funded by reallocations and savings. Reforms based on reallocations will continue to be necessary in efforts to address the sustainability gap in public finances and balance central government finances. Therefore the National Audit Office finds it necessary to improve the practical capacity to carry out reallocations.

It was found in the National Audit Office's separate report (R 21/2010 vp) that it is difficult to obtain an overall view of the state of central government finances, each administrative sector's finances and future needs as well as the relation between the Government Programme and the spending limits within the framework allowed by the scheduling of spending limits and budget preparation. The preparation of important reallocations and genuine strategic planning would require more time and opportunities to focus on the essentials. In addition to this, in practice financial and policy planning are separated from each other due to the dominant role played by item-specific budget formulation and examination in the process of spending limit preparation.

The implementation of more extensive cross-sectoral reallocations would call for a thorough examination of existing expenditure and the expenditure structure. In addition to the clarification of the rules applied to reallocations within administrative sectors, spending reviews could become a key component of the decision-making information base.

The expenditure review conducted before the spring 2011 parliamentary elections had a rather tight schedule. The National Audit Office recommended in its audit of the relation between the Government Programme and the spending limits procedure published in December 2012 that the most ambitious reallocations should be based on expenditure reviews in which the grounds for the expenditure should be assessed. The mid-term review of the Government Programme and the turn of the electoral term could be suitable points in time for this. The annual spending limits and budget preparation processes do not provide sufficient opportunities for an in-depth review of the expenditure structure.

It was already recommended by the National Audit Office in its separate report to Parliament (R 21/2010 vp) published before the elections in January 2011 that sectoral ministries should be encouraged to continuously evaluate their administrative sector's expenditure structure. Such continuous re-evaluation and the related prioritisation would also facilitate the preparation of more extensive expenditure reviews.

The current central government reform project is tasked with the preparation of a central government reform, with the aims including increasing the mobility of financial resources and promoting the creation of a uniform operational culture in central government. In this context it would be appropriate to assess how the continuous evaluation of the expenditure structure could be carried out in practice.

3.3 Sustainability of local government finances and the Basic Public Services Programme

The aim of the decentralisation of public decision-making to the various levels of government has been to bring decision-making relating to basic services as close to citizens and service users as possible. The goal has been to create a service system that is as efficient as possible. To meet local service needs, it is justifiable for municipalities to be responsible for their area's service provision. This is further emphasised the more differences there are between local service needs and local conditions for service provision. This enables the achievement of efficiency benefits as decisions relating to services and, in part, also service funding is decentralised to municipalities.

The Finnish local government sector bears extensive responsibility for the provision of welfare services and, in part, also the funding of these services. Important tasks that in many OECD countries fall under central government have in Finland been transferred from the central to the local government level.

The Nordic model of welfare service provision does not correspond to the international model of fiscal federalism. Instead, it is more akin to administrative federalism where municipalities are responsible for the provision of statutory basic public services and not only for the production of local public goods. In fiscal federalism tasks and their funding are genuinely local. A transition in terms of funding and division of tasks towards genuine fiscal federalism would require the transfer of tasks from local government authorities to central government. Correspondingly, the provision of welfare services in accordance with the administrative federalism model would appear to require increases in the size of municipalities and the strengthening of municipalities.[54] This is also one of the starting points of the local government reform in accordance with the Government Programme.

The division of tasks between local and central government results in municipalities being in the front line facing the increase in health care and other care expenditure arising from population ageing. The expenditure pressures arising from population ageing are therefore a major challenge for local government finances.

In the light of the current practice, when compared internationally, the Finnish local government sector has a poor capacity to contribute towards the long-term sustainability of general government finances on the whole. In its separate report to Government (R 21/2010 vp), the National Audit Office pointed out the narrow scope of the central government spending limits and the consequent limited capacity to respond to the general government sustainability challenge. The OECD and European Commission have also recommended the improved inclusion of local government within the central government spending limits. They also repeated their recommendations in their surveys on Finland published in 2012. In addition to this, the efforts to develop fiscal policy coordination within the EU also create increasing pressure to develop national regulation of general government finances on the whole.

54 Moisio 2012. Borge–Rattsø 2012.

3.3.1 Central government impact on local government finances

Central government affects local government finances through expenditure as well as revenue. Central government decisions concerning new municipal tasks also affect local government expenditure development. At the same time municipal revenue is affected by decisions relating to taxation and central government transfers to local government.

In its report 10/2010 provided on the basis of the National Audit Office's separate report R21/2010, the Parliamentary Audit Committee required that a firm limit to the extent of expenditure that can be allocated by central government to the local government sector through legislative and other measures during a spending limits period be included in the central government spending limits.

Central government transfers to local government

The Finnish system of central government transfers to local government consists of transfers for municipal basic public services administered by the Ministry of Finance and transfers for secondary education administered by the Ministry of Education. Central government transfers to local government are funded from the state budget and covered by the central government spending limits procedure.

Determined on an imputed basis in accordance with population size, the central government transfers for basic public services balances out expenditure variation caused by service needs and service production conditions between municipalities. Differences between expenditure needs between municipalities arise from differing local service needs and service production costs. Production costs may be above the average due to reasons including long distances. The central government transfers for secondary education are student-specific and paid directly to the service provider.

The system of central government transfers to local government also features the equalisation of transfers based on imputed tax revenue. The threshold set for this is 91.86% of the mean of the entire country's imputed tax revenue per inhabitant. Municipalities with income above the threshold lose 37% of the amount exceeding the threshold. Correspondingly, those below the threshold receive 100% compensation for the difference from the threshold. The deductions are made from the transfers received by the municipalities and the increases are added to the transfers received by them. Municipalities undergoing particular financial difficulties may also apply for a discretionary increase to their transfer for basic public service provision.

Tax revenue

As regards tax revenue, Finnish regulation does not differ considerably from the average OECD level. Municipalities cannot decide on the breadth of the tax base or tax deductions. There are maximum and minimum levels for real estate tax set by central government, and decisions on revenue from corporate income tax are made by central government. Municipalities are allowed to decide on the municipal income tax rate, but decisions on municipal income tax deductions compensated for as central government transfers to local government are made at the central government level.

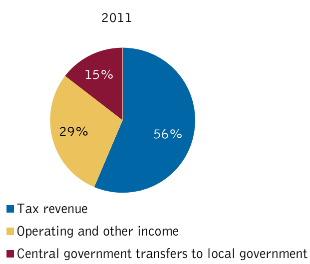
Almost half of municipal revenue comes from taxation. Of this around 85% consists of municipal income tax and the remaining 15% of real estate tax and corporate income tax, with each contributing approximately the same rate. Central government transfers account for around 30% and fee income for 5% of municipal revenue. The municipal spread as regards income structure is, however, very large as the share of tax revenue ranges between 20% and 80% and that of central government transfers between 2% and 60%.

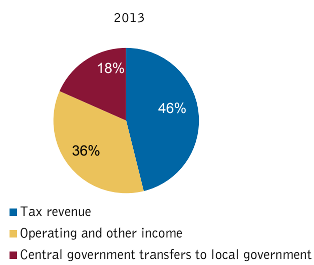
The downside of corporate income tax as a source of municipal revenue is its major cyclical sensitivity. Cyclical changes may result in double-digit increases or decreases in the rate of revenue from corporate income tax. During the financial crisis municipal tax revenue threatened to decrease dramatically, which is when central government temporarily increased the local government share of corporate income tax revenue as part of the stimulus measures. On the other hand, during periods of economic boom high revenue from corporate income tax can easily increase municipal expenditure. The reason behind maintaining the municipal share of corporate income tax has been that it is regarded to encourage municipalities to pursue an active industrial policy.

Deductions in municipal income taxation have been increased, and in recent years the impacts of deductions affecting revenue from municipal income tax have been compensated for through increases in central government transfers to local government. Municipal dependence on central government transfers has increased as municipal tax revenue has been turned into central government transfers in conjunction with tax cuts.[55] According to criticisms presented, this increases the uncertainties relating to local government finances as central government transfers to local government may be cut by central government to balance its own finances regardless of whether or not some of the transfers might be former municipal tax revenue. It should, however, be noted that cuts in central government transfers to local government may also be motivated by a desire to steer municipalities towards increased cost efficiency.

The graphs below present the change in the relative shares of municipal sources of revenue from 2011 to 2013.

Loss of revenue to municipalities is also compensated for in the other direction as major cuts in central government spending were decided upon in conjunction with the spring 2012 spending limits decision. In these the biggest individual target was central





Source: Statistics Finland.

FIGURE 6. Relative shares of local government revenue sources of total revenue in 2011 and 2013.

55 Huovari 2012.

government transfers to local government. The transfers will be cut by €0.5 billion in 2013–2015. Most of these cuts will be compensated for by allowing municipalities to continue to receive an increased share of corporate income tax revenue.

It should also be noted that, in addition to the cuts made in the spring 2012 spending limits decision, central government transfers to local government had already been cut under the Government Programme by €631 million. This was implemented in the 2012 budget. The impact of the cuts on local government finances was compensated for by continuing the increase in the municipal share of corporate income tax revenue over a fixed term at five percentage points.

Decisions on tax deductions are made by central government. The biggest deductions available in municipal income taxation are the earned income allowance, pension income allowance and basic allowance for individuals with a low income. Deductions from municipal income tax have resulted in an increase in the difference between the nominal income tax rate and the actual (effective) tax ratio. The effective or actual tax ratio is the ratio of municipal income taxes debited of earned income. Many municipalities have compensated for the impact of deductions by increasing their income tax rate. This has resulted in an increase in the average municipal income tax rate although the effective tax ratio has remained practically unchanged. Tax deductions have increased progression in municipal income taxation.

In 1998 the weighted average of municipal income tax rates was 17.5% and, correspondingly, the effective tax ratio was 14.5%. In 2012 the income tax rate had risen to 19.3% while the effective tax ratio was 14.3%. The nominal tax rate and effective tax ratio do not correlate very strongly with each other. Instead, the difference between the nominal and effective tax ratio varies from one municipality to another. The difference is the smallest in the Helsinki Metropolitan Area, being 3.4 percentage points in Helsinki, 2.8 in Espoo and 1.6 in Kauniainen. Correspondingly, the biggest differences are found in Rääkkylä at 8.2 and Tervo at 8.1 percentage points. Deductions affecting municipal income taxation result in smaller cuts in Helsinki Metropolitan Area municipalities' tax revenue as these municipalities have more high-income taxpayers and the majority of deductions are aimed at low income brackets. This in turn allows municipalities in the Helsinki Metropolitan Area to keep their municipal income tax rates lower.[56] These municipalities' overall income base is strong as their corporate income tax and real estate tax revenues are clearly above the national average. Correspondingly, smaller municipalities in particular have to increase their income tax rate to be able to perform their duties.

The Programme of Prime Minister Jyrki Katainen's Government states that, to narrow the gap between the nominal and real levels of municipal taxation, the Government will seek measures to shift the burden caused by

Table 5. Tax cut compensations to municipalities in the 2010–2013 budgets, € million.

2010	2011	2012	2013
873	1 002	1 265	1 313

Source: Budgets 2010–2013, Chapter 5 General Strategy and Outlook.

56 Huovari 2012.

deductions in municipal taxation to be borne to a greater degree by central government. Any changes to local government revenues deriving from adjustments in taxation will be compensated in full.[57] The table below presents the tax cut compensations to municipalities in the 2010–2013 budgets.

Tax cut compensations to municipalities affect the central government financial position. Without these compensations outside the central government spending limits, the financial position of local government would be even weaker than it is.

According to the Government Programme, the Government endeavours to achieve a situation where the ratio of real estate taxes of overall local government tax revenues rises. This is also in line with the compilation of expert opinions provided in the National Audit Office's separate report R 21/2010 concerning the optimal types of funding for local government.

Real estate revenue has already been excluded from the tax revenue equalisation scheme. This strengthens the role of the real estate tax as each municipality's own source of revenue. The measure has no impact on the amount of revenue from real estate tax.

Efforts have been made to compensate for changes in the tax basis reducing revenue from corporate income tax by increasing the municipal share of the revenue received from corporate income tax, while the method of compensation for changes in the basis of income taxation and tax deductions has been to increase central government transfers to local government for basic public services by an amount corresponding to the change in tax basis.[58]

New duties

The local government sector has underlined the role of central government measures as a key source of uncertainty for local government finances. The majority of municipal duties are determined by central government. According to criticism voiced, municipalities have been assigned duties without a clear idea of the costs arising from the new duties. It is considerably difficult to determine the cost impacts of new duties. Certain problems are also brought to this by the difference between the municipalities and their cost structures.

It is difficult to evaluate what reforms really mean from the perspective of an individual municipality.

According to the Programme of Prime Minister Jyrki Katainen's Government, new and broadening obligations account for over a half of the costs. In conjunction with the cost division review, a review takes place every four years to check whether costs have increased as anticipated. If the increase in costs exceeds the anticipated level, central government pays its share of the amount in excess. This secures the local government position at least to some extent.

Cost division reviews have involved reviews of the unit prices used in the system of central government transfers to local government to reflect the actual cost level seen in the local government sector. The system has resulted in imputed transfers being dependent of costs. According to Moisio (2011), this means there is no incentive to improve productivity.[59] On the other hand, Oulasvirta (2012) states that the incentives are in other respects appropriately in place in the system

57 Programme of Prime Minister Jyrki Katainen's Government, 134.
58 Summarised data, see budget proposal for 2013, General Strategy and Outlook, basic service budget deliberations, GSO90–93 and GSO100–101 and budget proposal for 2012, General Strategy and Outlook, basic public service budget deliberations, GSO86–89 and GSO91–Y93.
59 Moisio 2011.

of central government transfers to local government as, due to the imputed nature, municipalities cannot receive further transfers from central government through their own spending decisions.[60]

The system of central government transfers to local government and the equalisation of cost division included in the system concerning new duties have also been criticised. Representatives of the local government sector find that costs are deliberately assessed as too low and that central government has been reluctant to make the review payments on time. It has been presented that the tightness of the central government spending limits has resulted in costs arising from new municipal tasks being underestimated. In its separate report to Parliament (R 21/2010 vp), the National Audit Office stated that the problem in the Basic Public Services Programme procedure is that the impacts of different legislative projects on local authorities' finances are not evaluated adequately.

Before the Government Programme negotiations, various ways of improving the evaluation of the cost impacts of duties assigned by central government to municipalities were explored by expert working groups. The Ministry of Finance working group developing the spending limits procedure presented alternatives that could be employed to tighten the management of the cost impacts of duties assigned or transferred to municipalities by central government. These included an obligation ceiling for the transfer of duties or a higher rate of up to 100% of central government transfers to local government for additional costs incurred by municipalities from new duties. The development and management of local government finances were also considered at the Prime Minister's Office under the Economic Council. The need to re-evaluate the central–local government relationship and improve the information base of decision-making has also been pointed out in the context of the project for developing the effective implementation and monitoring of the Government Programme, prepared under the leadership of the Prime Minister's Office (the KOKKA project). This also applies to the improved evaluation of the effectiveness of the tasks laid down to municipalities as well as the related costs. The KOKKA project saw the Basic Public Services Programme as the information base for the overall handling and evaluation of local government finances.[61]

The Government Programme sets the objective of strengthening the steering role of the Basic Public Services Programme and improving the procedure of negotiation between central and local government so that the assessment of the costs and impact of any duties that might be transferred or allocated to municipalities will be enhanced.[62] In practice, no major structural changes have taken place in steering, but the content of the Basic Public Services Programme and the evaluation carried out under it have been developed to also cover issues such as productivity. There is still no systematic formulation of a 'price tag' – a cost and impact assessment – produced by an external evaluator in the context of impact assessments on new obligations and legislative projects. Efforts have been made by various ministries to develop the impact assessment of Government proposals, but there is still room for development in this.[63]

60 Oulasvirta 2012.
61 Prime Minister's Office 2012.
62 Programme of Prime Minister Jyrki Katainen's Government, 134.

The National Audit Office finds that special attention must be paid to the assessment of the local government finances impact of new duties assigned to municipalities in Government proposals. In this context assessments must be made of the financial impacts of new duties from the perspectives of municipalities with differing income and expenditure structures.

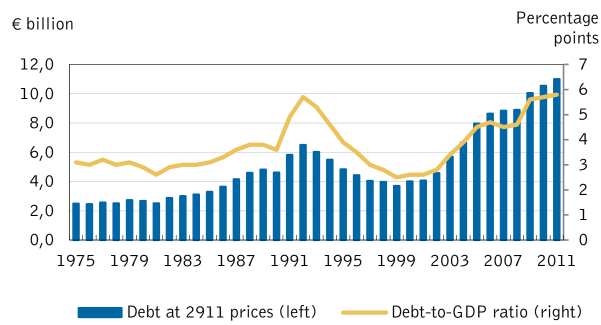
3.3.2 Need for regulation of local § government finances

Since 2005 local government reforms have aimed to increase the size of municipalities and cooperation between municipalities. In 2005 there were 416 municipalities in Finland, while their number from the beginning of 2013 totals 320. There is still a considerable number of small municipalities, which means it is challenging for many municipalities to fulfil their extensive service obligations.

Municipal expenditure has increased and municipal indebtedness has accelerated in recent years. Municipal expenditure has increased more rapidly than municipal revenue. In addition to the rise in cost level, the increase in expenditure is due to new statutory duties assigned by central government to municipalities. According to preliminary data provided by Statistics Finland, the municipal loan portfolio was around 6% of GDP in 2011. The amount of loans guaranteed by municipalities is even larger.

When viewed in the international context, the current Finnish system provides municipalities with exceptionally large freedom as regards budget deficit and indebtedness. According to the budget balancing rule, municipalities must balance their budgets over a planning period of four years. There are no sanctions if the rule is broken. Continuous imbalance may, however, result in the procedure applied to crisis municipalities under the Act on the Reform of Municipal and Service Structures. According to Moisio (2011), four years is a long timespan for budget balancing.[64]

The rapid growth of the loan portfolio and the cost pressure arising from population ageing seen in recent years increase pressure for tighter regulation of local government finances. This could entail debt or balancing rules set for municipalities or the strengthening of existing steering instruments, such



Source: Statistics Finland.

FIGURE 7. Level of local government debt and debt-to-GDP ratio in 1975–2011.

63 Issues affecting local government finances include legislative drafting taking place at the Ministry of Social Affairs and Health, the processes of which have been audited by the National Audit Office, see. National Audit Office 12/2012.
64 Moisio 2011.

as the Basic Public Services Programme procedure. Here it should, however, be noted that major tightening of the balance objective can lead into increased pro-cyclicality of local government finances.

Fiscal policy rules have traditionally been applied to central government financial management. Good Finnish examples of this include the central government spending limits procedure and the limit set therein to growth in central government expenditure. Internationally, fiscal rules set on local government usually cover budget balancing, indebtedness, tax ratios as well as restrictions and guidelines on rise in expenditure. The European Commission Report on Public finances in EMU – 2012 gives an overview of local government fiscal rules used in EU countries.

According to research, the local government income base affects the need for regulation in a manner whereby there is less need for regulation when the local government's own revenue accounts for a large share of the overall budget.[65]

This provides local government with the incentive to avoid budget deficit as increases in expenditure have to be covered by revenue generated by the local authority.

On the other hand, a large share of tax revenue in local government income leads into the local government income base being dependent on cyclical conditions. This increases the pro-cyclicality of municipal sector expenditure if income generated during an upturn is used to cover rises in expenditure and no cuts can be made in expenditure in response to a drop in income caused by a downturn. This results in municipalities incurring debt during periods of downturn.

Correspondingly, major local-level dependence on central government transfers to local government increases the possibility of soft budget restrictions as transfer recipients may be provided with an incentive to accrue deficit that will eventually have to be covered by central government. From the central government perspective this creates the need to restrict indebtedness at the local level. This is more likely in situations where the municipality's own sources of revenue account for a smaller share of its total revenue than support received from central government. It is almost impossible for central government to avoid this situation in a system where municipalities perform duties of societal importance. The more important the duties carried out by municipalities the bigger the chance that central government will sooner or later have to help them by, for example, making discretionary government transfers.

It was stated above that, according to research literature, the need for local government fiscal policy rules depends on whether the municipalities have their own sources of revenue or whether they are dependent on central government transfers. In should be noted in this respect that Finnish municipalities are very different from each other in terms of the extent to which their revenue consists of their own tax revenue and, correspondingly, of central government transfers. Against this background it can be stated that there is no single fiscal policy rule suitable for every municipality in Finland. Nevertheless, the need for regulation should be considered to curb municipal indebtedness and ensure the stability of public finances.

65 Sutherland 2005.

3.3.3 Local government steering instruments and need for their development

One of the aims of the overhaul of the Local Government Act currently underway is to develop the steering of local government finances and renew the financial provisions of the Act. The aim is for the new act to enter into force at the beginning of 2015. Any reforms should take into consideration the EU requirements whereby the Member States must introduce mechanisms that can be used to ensure stability and sustainability across the board in general government finances, including the local government sector.

In its report 10/2010 provided on the basis of National Audit Office report R 21/2010, the Parliamentary Audit Committee stated that the Basic Public Services Programme included in the central government spending limits should address more efficiently than is currently the case the measures taken to secure the sustainability of funding for the welfare state and that of health care and other care services in particular.

Local government finances and their development prospects are evaluated in conjunction with the Basic Public Service Programme and Budget. The local government policy pursued jointly by central government and municipalities is implemented through the statutory Programme and Budget for Basic Public Services. Prepared in conjunction with the central government spending limits decision, the Basic Public Services Programme and its annual budget improve the balance between municipal obligations and municipal funding. According to the Local Government Act, the Programme's purpose is to assess changes in the operating environment of municipalities and in demand for their services. It also seeks to study trends in municipal finances and changes in municipal functions. It also involves the launch of a programme on the measures needed to balance income and expenditure. Municipal finances are assessed holistically as part of public finances and with respect to groups of municipalities. The programme also examines issues such as municipal funding requirements, how municipalities' statutory duties should be developed and how their productivity might be increased.

It is pointed out by the Ministry of Finance in the Action Report on parliamentary objections to the final accounts included in the Report in the Final Central Government Accounts for the 2011 budget year that the development outlook of local government finances will be assessed in conjunction with the annual central government spending limits decisions over the next period of four years. Prepared in conjunction with the spending limits decision, the Basic Public Services Programme contains an assessment of the local government financial development outlook and changes in the operating environment. The Programme also contains measures to consolidate local government revenue and expenditure. This means that in its Action Report the Ministry of Finance underlines the importance of the Basic Public Services Programme in efforts to balance local government finances. It should, however, be noted that there is bound to be room for development for the Programme to function better in this respect.

The spending limit decisions also include decisions concerning central government transfers to local government during the spending limits period. Central government transfers and grants to municipalities fall within the sphere of the central government spending limits procedure which, according to the Action Report, directly or indirectly also constrains growth in local government spending. This, however, does not take into consideration the fact that in Finland municipalities are reasonably free to accrue debt, whereby the regulation of central government transfers to local government can only have a limited impact on expenditure development. It is also underlined in the Action Report that municipalities may only be assigned further duties by means of legislation. Central government must make sure municipalities have the opportunity to be able to perform their duties. With regard to new or expanding duties, central government transfers should cover 50%. This means municipalities in any case cover a major proportion of the funding of new duties. This emphasises the need to carefully assess the impacts new duties assigned by central government have on local government finances and future cost development.

Predictability in the local government sector could be improved through the development of the Basic Public Services Programme under municipal guidance. According to Moisio (2012), this could involve increasing the efficiency of the systematic assessment of municipalities' overall financial situation, in particular the municipalities' duties and related cost impacts.[66] This would include the annual determination of the division of costs between local and central government, balance of local government funding, target level of municipal taxation and productivity development of municipal services. The government transfer percentage could be used to help prepare for cyclical fluctuations by applying downward flexibility in the percentage rate during upturns and upward flexibility during downturns.

According to the Programme of Prime Minister Jyrki Katainen's Government, the long-term nature, binding effect and steering role of the Basic Public Services Programme will be strengthened. The aim of this is to achieve better foresight in local government finances.

The University of Tampere has carried out a research project for the National Audit Office on the role of steering in the development of local government service productivity from the perspective of the central–local government relationship (Mänttäri, Oulasvirta and Vakkuri, 2013). A key focus in this is on the Basic Public Services Programme procedure and its development.

Conducted in 2010–2012, the study covers the problems related to measuring public service productivity and the work carried out to develop productivity indicators for local government services.

The general objective of the study is to analyse productivity steering in the central–local government relationship. Local government decision-makers' views on the productivity steering framework and decision-making opportunities in particular were mapped out using data from the Evaluation Research Programme ARTTU. According to the results, local government decision-makers' view is that the productivity of their activities is quite high. According to the respondents, service provision is efficient and municipal residents are satisfied with the services. On the other hand, the respondents regarded it as difficult to assess the central government role to municipal activities. The role of the Basic Public Services Programme from the perspective of municipal activities was regarded as particularly difficult to assess.

The second part of the study examined the Basic Public Services Programme procedure from the viewpoint of productivity steering,

66 Moisio 2012.

starting from the first Programme covering the 2005–2008 period. The Programme's aims include promoting a balance between local government duties and funding through measures such as productivity development. This is the first study on the Programme's role from the perspective of the steering of local government finances. According to the study, the first Basic Public Services Programmes mainly emphasised the need to improve municipal service productivity and highlighted problems relating to the measurement of municipal service productivity. Problems relating to service quality and effectiveness are pointed out in particular. The productivity steering perspective was not, however, concretised in the first Programmes.

The Basic Public Services Programme is prepared in conjunction with the central government spending limits decision. The year 2011 was a parliamentary election year, so the Programme was also updated in conjunction with the first spending limits decision for the electoral term to reflect the policies adopted under the new Government's Programme. Adopted on 6 October 2011, the Basic Public Services Programme for 2013–2015 is more concrete as regards productivity steering. The Programme emphasises the importance of utilising evaluation data on basic public services and sets productivity targets for municipalities and joint municipal boards. Municipalities are also obliged to draw up their own productivity programmes.

The study also brings up the role of the municipalities' internal steering chain in efforts to increase municipal service productivity. To secure the delivery of welfare services, it is vital to increase the productivity of service production in order to curb the cost development. Productivity steering has been a key objective of the Basic Public Services Programme since the first Programme published in 2004. Over the years steps have been taken towards more concrete measures in the productivity steering included in the Programmes. Regardless of this, the Basic Public Services Productivity Programme is hardly utilised at all at the end-user level – the municipalities. The study points out that the Programme should be more detailed for it to be more useful at the municipal level.

The study concludes that there is a steering chain in place in the central–local government relationship. There is, however, mutual distrust that widens the gap as regards productivity concepts and productivity steering. Central government does not have confidence in local government authorities genuinely seeking improved productivity, while local government authorities do not have confidence in central government exercising care when setting obligations for municipalities. It should further be noted that guidelines that are uncompleted or under preparation also postpone municipal decision-making and development work. Steering must be targetable so that the target is aware of who is providing the steering. Objectives must be as unambiguous as possible.

This calls for the cascading of productivity objectives to the user level.

Guidance measures must be commitment-building by influencing the user either through an incentive or a sanction. This calls for commitment to the objectives and related measures throughout the steering chain. The study also points out the major role played by standards and quality recommendations in the steering of basic public services based on various expert professions. In efficient productivity steering productivity thinking can be written into these standards and recommendations.

Local government structure

There are municipalities in Finland that cannot fulfil their obligations in the current system. This has resulted in debate about the need to increase the municipal size to solve the problem. According to the Government Programme, the Government will carry out reforms in municipalities across the country. The aim is to create a thriving municipal structure built on economically robust municipalities. The aim of the structural reform is to achieve a thriving municipal structure to make municipalities strong enough to provide basic public services.

Problems related to health care service provision play a key role in the debate concerning the reform of the local government structure. Unlike in most other OECD countries, in Finland municipalities are largely responsible for the provision as well as the funding of health care services. According to the OECD Economic Survey on Finland published in February 2012, the inefficiencies in health care provision are due to the excessive fragmentation of service provision.

There are also inequalities between municipal residents as service access and quality differ from one municipality to another.[67] The OECD report underlines the importance of increasing municipal size to achieve economies of scale in basic service provision.[68]

Existing studies do not, however, support the idea of increased municipal size affecting the costs. According to Loikkanen (2012), the local government reform work carried out by the Ministry of Finance and assessments of municipal mergers do not provide references to relevant research literature on the impacts of municipal reforms.[69] Despite this, the reports emphasise the economies of scale achieved.

According to research, there are major cost and efficiency differences between municipalities and units producing services, but these can to a large extent be explained by factors other than the size of the municipality or the operating unit (Luoma and Moisio, 2005). There are economies of scale, but their extent varies from one service to the next. Municipal service efficiency is increased by municipal mergers if there are unused economies of scale in the services. A downside of municipal mergers is that, to begin with, more costs are often incurred. This has been the case in countries such as Denmark. Municipal mergers also eliminate the need to compete for taxpayers, reducing the pressure to increase cost efficiency. Therefore the productivity impacts of mergers may take a long time to appear. (Moisio, 2011).

A specifically Finnish characteristic is the highly fragmented nature of the community structure and very important basic welfare services having been assigned to local government by central government. According to Loikkanen (2012), it is the fragmented community structure rather than the municipal structure that is the key cause of the efficiency problem in public welfare service provision. This also partly explains why Finland's large cities are ranked reasonably low in studies of efficiency in service provision, i.e. the amount of service outputs produced on the resources available. If the community structure remains unchanged in the context of reforms of municipal structure, one of the key causes of inefficiency will remain unchanged.[70]

67 National Audit Office R 17/2012 vp, 44–49. National Audit Office R 17/2011 vp, 64 and 72–83.
68 OECD 2012.
69 Loikkanen 2012.
70 National Audit Office 208/2010.

The National Audit Office recommends that these aspects also be considered in conjunction with the municipal structure reform.

3.4 Sustainability of public finances

3.4.1 Sustainability scenario of the Ministry of Finance

The estimate of the Ministry of Finance of the sustainability of public finances in Finland was drawn up using commonly agreed EU methods and calculation principles. The assumptions underlying the calculations are based on the assumptions used in the 2012 Ageing Report of the European Commission. The scenario produced by the Ministry of Finance deviates from these assumptions in the assessment of population development as the Ministry uses the 2009 national population projection provided by Statistics Finland instead of the Eurostat population projection. The Statistics Finland projection anticipates speedier increases in life expectancy and immigration than the Eurostat projection. The estimate of Finland's medium-term economic development is based on the March 2012 economic forecast of the Ministry of Finance. In the Ministry's scenario Finland's employment rate is higher than the level seen in the assumptions of the EU Working Group on Ageing Populations. This is due to the pension system and unemployment security reforms agreed upon in conjunction with the spring 2012 spending limits decision.

The 2012 Stability Programme estimates the sustainability gap of Finland's public finances to be 3.5% of GDP. Correspondingly, the December 2010 assessment of the Ministry of Finance placed the sustainability gap at 5.5% of GDP, while the corresponding figure in the 2011 programme was 4.5% of GDP.

The OECD estimate of spring 2012 of Finland's sustainability gap was 4.5% of GDP, while in 2010 it had been 8% of GDP. In December 2012 the Bank of Finland estimated Finland's sustainability gap to be 4% of GDP. This estimate is half a percentage point higher than the one provided by the Bank of Finland after the spring 2012 spending limits decision. In contrast, the European Commission projection of the sustainability of Finland's public finances published in December 2012 was 5.8% of GDP.

In its statement on the 2012 Stability Programme for Finland, the European Commission regards the medium-term projections as being based on realistic assumptions. Correspondingly, the Commission points out as regards the 2011 and 2010 programmes that they were based on very optimistic assumptions, particularly towards the end of the programme periods.

The sustainability gap illustrates how much the budgetary position should improve to avoid uncontrollable growth in public debt. The sustainability gap estimate is a pressure calculation that shows the impact of the current expenditure and revenue structure on the development of general government finances if no adjustment measures are taken. The estimates project far into the future, which is why they are highly sensitive to changes in the underlying assumptions.

In its separate report to Parliament on the effectiveness of the central government spending limits procedure as a fiscal policy instrument (R 21/2010 vp), the National Audit Office drew attention to the uncertainties related to sustainability gap estimates. In this context the National Audit Office recommended that the Ministry of Finance pay attention in its reporting to describing the uncertainties relating to the calculations and that the factors behind the sustainability calculations also be described in addition to the point assessments of the need to adjust public finances. The separate report underlined the sensitivity of sustainability calculations to changes in the balance of public finances at the starting point.

The sensitivity of sustainability gap indicators to changes in the balance of public finances at the starting point means that when the recession eases off and medium-term outlooks improve, the estimate of the sustainability gap also gets smaller and, correspondingly, when the medium-term outlook gets worse, the estimate of the sustainability gap gets bigger.

The difference between the estimates provided in the 2010 and 2011 programmes was largely due to the improved financial position brought about by the upturn during the starting year of the calculation. Correspondingly, the difference between the 2011 and 2012 programmes can be attributed to the central government adjustment measures decided upon by the new Government and the resulting improvement in the primary balance of the starting year.

In its reporting the Ministry of Finance clearly states that the sustainability gap indicator is quite sensitive to assumptions concerning the cyclically adjusted, or structural, balance of the starting year. The uncertainties relating to the calculation of potential output and, consequently, structural deficit, are emphasised during cyclical turns. The sustainability gap estimates presented in autumn 2012 are particularly uncertain as regards the starting point of the calculations. Therefore they should be taken with caution. The uncertainties relating to the calculation are clearly pointed out in the 2012 programme, but on the whole the reporting is still rather limited.

References are made in reports to the use of methods and assumptions recommended by the Ecofin Council but, to increase transparency, the Ministry of Finance should consider the formulation of a separate methods description. The need for increased transparency is emphasised by the limit set on general government structural deficit in the Treaty on Stability, Coordination and Governance (TSCG). The methods description could be made available at a location such as the ministerial website.

3.4.2 Sustainability scenarios of the Research Institute of the Finnish Economy (ETLA)

The Research Institute of the Finnish Economy (ETLA) is conducting a study for the National Audit Office on the financial sustainability of Finnish general government. This audit report provides a report on the estimate of the financial sustainability of Finland's general government for the 2012–2060 period included in the first subreport on the study.[71] ETLA's previous assessment of the financial sustainability of general government was conducted in 2010.

The ETLA sustainability estimate published in January 2011 stated that the financial crisis that broke out in 2008 has two major impacts on sustainability estimates. Firstly, it plays a role as regards the starting point of the estimates. Public assets are smaller and

71 Lassila & Valkonen, Julkisen talouden rahoituksellinen kestävyys, ETLA Raportit No 3, 2013.

debts bigger. The other and more important role played by the financial crisis is to remind us why we must in general prepare for worse-than-projected development and why, even if such development comes true, we must preserve enough financial leeway in case we are hit by yet another big crisis.

The persistence of the crisis underlines the importance of both of the above points. It has become very difficult to assess the starting situation, and the risk of rises in interest rates related to indebtedness has become clearer.

There is also a third aspect that should be remembered in the financial crisis context. The European economic policy operating environment has changed. Excessive debt accumulation has focused on a few countries experiencing problems, but the impacts are large on all European countries. The problems have resulted in new fiscal policy rules in EU and euro area countries which, through legislation, will also affect future policies in Finland.

ETLA's calculations are based on the population projection published by Statistics Finland in September 2012, as was the case with the Bank of Finland in its December 2012 outlook on the sustainability of Finland's public finances. Statistics Finland's September 2012 projection differs in a few respects from the 2009 projection. The projection on the working-age population has increased because of an increased net immigration assumption. At the same time the projections regarding the numbers of those over the age of 65 and over the age of 80 have come down slightly because in the latest projection mortality is estimated to fall at a slightly lower rate. These changes result in a smaller increase in the old-age dependency ratio than was seen in projections made in the first decade of the 2000s. The projection changes are based on the latest observed total fertility and net immigration figures and the change in mortality seen in the 2007–2011 and 1987–1991 periods.

The new population projection improves the sustainability outlook of Finland's public finances. The increases in earnings-related pension expenditure and earnings-related pension contributions will be smaller than in calculations based on the 2009 projection. According to the new projection, there will be fewer pension recipients and more payers of pension contributions. The lower rate of decrease seen in mortality will only have a small impact on total pensions expenditure as pensions will increase from the previous forecast due to the life expectancy coefficient. The development outlook concerning health expenditure will not change, but care expenditure focusing on the 80+ population will increase less than anticipated on the basis of the earlier projection.

Baseline scenario

According to ETLA's baseline scenario, the crisis will not get any worse and, once the crisis abates, productivity will resume its previous growth path. The Finnish economy will still remain in a situation where public debt or deficit will not exceed the limits set by the EU.

The economic outlook for the next few years has deteriorated considerably due to the persistence of the debt crisis and the structural change underway in the corporate sector. Important issues include how quickly economic growth will be stimulated in the next few years and whether or not the crisis has affected the long-term growth path. According to ETLA's background assumptions, before the financial and debt crisis Finnish private-sector productivity was as close to the topmost international level as can be without major changes in institutions and the operational dynamics of the economy. The baseline scenario could also be referred to as a rapid productivity growth scenario; private-sector labour productivity is anticipated to increase in ten years to the above-described potential output level and, following that, to increase at the same annual rate as in the leading countries. No changes are anticipated in labour productivity in the public sector, which accounts for around one-third of the working hours at the national level.

These assumptions provide a sustainability gap of one percentage point for general government as a whole. Costs should be cut permanently or taxation increased by 1% of GDP for public-sector debt not to increase.

The prolonged crisis and slow growth scenario

Because of the particularly high level of uncertainty involved in the assessment of the starting situation, ETLA also provides an alternative sustainability scenario. It is partly based on the worse alternative presented in the ETLA forecasting publication (Suhdanne 2012:2), with the slow-growth trend extended to 2020. Even after that the rate of productivity growth is anticipated to remain slower than in the baseline scenario. This assumption is based on the prospect that the rate of growth will be lower than expected in the leading nations as well. Therefore Finland's relative position will remain unchanged. In conditions of slow growth it can be expected that unemployment rates will be higher and the real interest rates of central government debt as well as revenues from pension funds will be lower.

The sustainability gap is larger than in the baseline scenario, but not by much. In the slow-growth scenario the sustainability gap of public finances is estimated to be 2.5% of GDP.

Why such small differences between the sustainability scenarios?

Compared with the 2010 situation, Finland's GDP per capita in 2060 is almost 2.5-fold in the baseline scenario and around double in the slower-growth scenario. In the baseline scenario, GDP per capita in 2060 is a quarter higher than the level forecast by the slow-growth scenario. This means the scenarios are far from each other when viewed from the perspective of economic wellbeing. It should be noted that Finland's productivity is anticipated to follow the productivity of the rest of the world, with Finland not lagging behind the rest of the world in the slower-growth scenario either.

As regards general government financial sustainability, however, the scenarios differ a lot less from each other. For example, the sustainability gap only increases by 1.5 percentage points from the baseline scenario to the slower-growth scenario. Of this, 0.2 percentage points can be attributed to unemployment and 0.8 percentage points to productivity. Debt maintenance is more expensive during slower growth periods, but the projected interest rate level is also lower. Rates of return on pension fund investments are lower and the sustainability gap of the earnings-related pensions sector larger.

The small differences are due to the fact that the market economy adapts to different rates of productivity development. Enterprises and households adjust their decisions to circumstances that they cannot influence directly. The labour market also adapts, although not fully, as is illustrated by the difference in unemployment rates. From the general government perspective the slower rate of productivity growth can be seen in the growth rates of tax bases and, consequently, of tax revenues, but also in the growth rates of expenditure, particularly salary expenditure.

In the model analysis, households and enterprises live within their budget limits and do not encounter indebtedness problems. As regards the public sector, however, it does not automatically adjust its expenditure and revenue in the model. Instead, this requires separate decisions. The sustainability calculation shows the size of decisions needed for the indebtedness to remain within the limits set.

Comparison with other sustainability estimates

Two estimates of the sustainability of Finland's public finances were published in December 2012. One of these was provided by the Directorate-General for Economic and Financial Affairs of the European Commission (European Commission, 2012) and the other by the Bank of Finland (Kinnunen et al., 2012). The Commission estimates that Finland has a sustainability gap of 5.8% GDP, while the Bank of Finland figure is 4%. These are clearly above the ETLA estimates.

The European Commission group carrying out sustainability assessments regards 6% as the threshold to high sustainability risk. Finland is also one of the few countries that have seen a turn for the worse in their sustainability gap estimate since 2009. The average sustainability gap among the EU countries covered by the report dropped from 6.5% to 2.7% due to measures such as savings and tax hikes and structural measures such as increases in pensionable age. The increase in Finland's sustainability gap is regarded as considerably high at 1.8 percentage points.

The view of Finland's sustainability gap having increased is interesting in that it does not correspond to recent estimates produced concerning Finland by other institutions. The OECD estimate of Finland's sustainability gap has dropped from 8% to 4.6% in the 2010–2012 period, and the estimate made by the Bank of Finland from 6% to 4.2% for the same period. The Ministry of Finance will update its own estimate later in spring 2013.

The conflicting estimates justify a closer look at the background to the Commission's figures. The most important component in the change in the sustainability gap is the 1.4 percentage point increase in structural deficit at the starting point. It is obvious that the Commission finds that the persistence of the debt crisis will also have a major long-term impact on potential output as the productivity growth forecast has been decreased slightly and the 2060 unemployment rate has been increased considerably for Finland. Another issue producing a larger gap estimate is the fact that the Commission only includes policy measures up to the end of 2011. Following that, an agreement concerning the extension of working careers has been concluded and taxation has been increased in Finland.

The Bank of Finland estimate of the pace of productivity growth for the Finnish economy as a whole is 1.5%, which is close to the ETLA baseline scenario where private-sector productivity grows at an annual rate of 1.75% and there is no increase in public-sector productivity. The Bank of Finland anticipates the annual real rate of return on pension investments to be 3.5%, which is slightly below the ETLA baseline scenario. In the Bank of Finland estimate the unemployment rate is 6.5%, which is 0.5 percentage points higher than in the ETLA baseline scenario. The higher sustainability gap estimate made by the Bank of Finland can in part be explained by the lower expected return on investment and the higher unemployment rate.

The European Commission's assumptions concerning productivity and unemployment are almost identical to those used by the Bank of Finland. As regards pension investments, the Commission is likely to use its common real interest rate assumption of three per cent, which in this case results in a larger sustainability gap. It should be noted that the Commission's estimate concerning Finland is based on the Eurostat population projection.

The differences between the estimates mainly arise from the different ways of estimating the costs relating to ageing. According to Kinnunen et al. (2012, p. 75), the Bank of Finland's assumptions follow the practices agreed upon by the Commission Working Group on Ageing Populations (AWG). The assumption is that 'the volume per person of individual public service expenditure, such as health care, education and social expenditure, grows in step with productivity, i.e. GDP per person employed. Hence the volume of services increases along with rising living standards. It is also assumed that service price growth follows overall price developments. Based on these assumptions, the GDP share of public service expenditure is only affected by changes in age structure or employment.' As regards the impacts of age structure, the Bank of Finland states that age-related weights for health care, long-term care and education are also selected in accordance with the recommendations of the AWG.

The ETLA calculations assume, as regards intermediate consumption, that social and health service expenditure other than labour costs remain constant in relation to GDP. If the price of these products used for intermediate consumption followed overall price developments, the increase in their use would be 2.5-fold from 2010 to 2060 in the baseline scenario and almost double in the prolonged crisis and slower-growth scenario. Based on population ageing, the care service index will increase by a little under 50% over the same period. Accordingly, the ETLA calculations also show an increase in intermediate consumption exceeding the rate of increase in the labour input required by social and health care services, but the growth rate is slower than seen in the EU and Bank of Finland estimates.

In addition to non-labour costs, the estimates also differ from each other as regards the age-specific weights for health care, long-term care and education. ETLA weighs expenditure relating to the proximity of death more heavily than the EU. The calculation method used by ETLA is likely to produce smaller impacts of ageing, although no systematic comparison between the reasonably laborious calculation methods has been carried out. ETLA's calculation methodology is described in Annex 1 to the ETLA report, and the AWG's practices are described in the European Commission (DG ECFIN) and Economic Policy Committee (AWG) report (2012).

The comparison illustrates the large impact of health care expenditure on sustainability gap estimates. Therefore a vital role will be played by the future development of this expenditure. Comparisons between the results produced by the models and comparisons carried out using the same model and but different assumptions are a good way to discern the factors affecting the sustainability gap. This is because the models have to take an explicit stand on the development of the factors affecting the sustainability gap and their impact on the rest of the economy. This helps clearly illustrate the impacts of the various factors on the sustainability gap, allowing an analytical approach to the role played by them as regards the extent of the gap.

Produced before the financial crisis, an ETLA estimate of the sustainability of public finances is reported upon by Lassila and Valkonen (2008). Based on a stochastic simulation, the median estimate of the sustainability gap was 1.4% of GDP. The baseline scenario produced in 2010 gave 2.5% (Lassila and Valkonen, 2011), while the estimates produced in December 2012 ranged between 1 and 2.5 percentage points.

Compared with the previous estimate, the gap is made smaller by decisions resulting in tax hikes and working career extensions and changed population projections. At the same time the gap is increased by the persistence of the financial crisis, but the impacts are small in both scenarios and the most important factor is the path taken by the economy after the crisis. The changes in the sustainability gap estimates are not particularly big when compared with the uncertainties relating to the gap estimates. The 50% confidence interval that takes the uncertainties relating to demographic projections and return on investments into consideration is around 2 percentage points and the 80% confidence interval around 4 percentage points (Lassila and Valkonen, 2008).

4 National Audit Office's positions

4.1 Summary of audit observations

The consolidation of public finances and sustainability over the long term are Finland's key fiscal policy objectives. Fiscal policy credibility is the basic requirement for well-functioning fiscal policy. Fiscal policy credibility is increased by the openness and transparency of the information base available for fiscal policy preparation and decision-making. Furthermore, fiscal policy rules are employed to help secure the sustainability of public finances. Consequently, the audit questions were as follows:

1. How well does fiscal policy implementation support the balancing of central government finances and the long-term stability and sustainability of public finances?
2. Have the fiscal policy rules been complied with?
3. Has the openness and transparency of the information base used in fiscal policy preparation and decision-making improved from the previous electoral term?

As regards audit questions 1 and 2, this separate report drawn up on the basis of the audits conducted reported on compliance with the fiscal policy regulatory framework and achievement of the key fiscal policy objectives specified in the Government Programme during the current electoral term.

The Government Programme's spending rules and, consequently, the spending limits for the electoral term, are key elements of the fiscal policy regulatory framework. During previous electoral terms the limits were raised in order to implement reforms included in the Government Programme. During the current electoral term, however, the level of spending limits has been lowered from the preceding term's last decision on spending limits and again in conjunction with the spring 2012 spending limits decision. Despite this, in the light of autumn 2012 forecasts it appears strongly that the deficit and debt objectives specified in the Government Programme will not be reached during the 2011–2014 electoral term. It can, however, be stated that, during the current electoral term, the connection between the spending rules and the balancing and debt objectives included in the Government Programme is clearer than before.

Until autumn 2012, the main focus in the implementation of the 2011–2014 electoral term fiscal policy was on central government adjustment to reach the balance and debt objectives set in the Government Programme. Preparedness to lower the spending limits level increases the Government's fiscal policy credibility. Cutting the spending level is a historic move. The spending limits level was now cut for the first time since the 2003 reform that resulted in the introduction of the current spending limits procedure.

Central government spending limits only provide limited support to objectives concerning the consolidation of public finances. The bulk of public service expenditure is covered by municipalities. This expenditure is only regulated by central government spending limits via the central government transfers to local government included in the spending limits system. The problem that still remains from the perspective of addressing the general government sustainability challenge is the narrow coverage of the spending limits of central government finances.

The medium-term outlook has, however, weakened considerably during autumn 2012. The objective set by the Government Programme concerning the halting of the rise in the debt ratio will not be achieved without further measures. The role played by careful expenditure reviews is emphasised if the aim is to considerably drop the level of spending. In this context it should also be noted that direct adjustment measures cannot alone be enough to guarantee the long-term sustainability of public finances if nothing is done about the structural factors causing inefficiencies.

There is a sustainability gap in public finances, and closing this gap should be a priority in fiscal policy target-setting. The room for manoeuvre available in general government finances has become smaller. Assessments made in 2012 of the Finnish sustainability gap differ considerably from each other, but it is undisputable that there is a sustainability gap that calls for policy measures.

Presented in conjunction with the 2012 update of Finland's Stability Programme, the Ministry of Finance estimate of the sustainability gap in Finland's public finances is 3.5% of GDP. The Ministry will update its estimate in spring 2013. Published in December 2012, the Bank of Finland's sustainability gap estimate is 4% of GDP, while the European Commission's estimate published in December 2012 places the sustainability gap at 5.8% of GDP.

To verify the data relating to the sustainability of public finances, as part of the audit a calculation was requested from ETLA concerning the sustainability of Finland's public finances. Published in January 2013, ETLA's estimate of the sustainability of Finland's public finances provides a baseline scenario of 1% of GDP and a slower-growth scenario of 2.5% of GDP.

It should, however, be noted that there are major uncertainties relating to the starting point of the calculations. Sustainability gap estimates are quite sensitive to assumptions concerning cyclically adjusted, or structural, balance. The uncertainties relating to the calculation of potential output and, consequently, structural deficit, are emphasised during cyclical turns. The sustainability gap estimates presented in autumn 2012 are particularly uncertain as regards the starting point of the calculations. Therefore attention should, in addition to individual point assessments, be paid to the background assumptions of the calculations and the structural factors relating to the creation of the sustainability gap in particular. The 2012 population projection provided by Statistics Finland changes the picture concerning the impacts of ageing and immigration. The new population projection improves the sustainability outlook of Finland's public finances.

So far the structural reforms implemented to reduce the sustainability gap have been insufficient. In addition to measures already decided upon, examples of structural reforms relating to the extension of working careers include the development of working life in order to reduce premature incapacity for work and also achieving an increase in the actual retirement age through new measures that should also involve the consideration of linking the statutory pensionable age with increases in life expectancy. The pension solutions included in the agreement concerning the extension of working careers already concluded have, according to the calculations based on the ETLA model, reduced the sustainability gap by around 0.5 percentage points of GDP.

Other important fields in need of structural reform are tax and innovation policy reforms to boost the prerequisites of economic growth and competitiveness. A third important area of structural reform is the development of the structures and approaches of public service production towards increased cost efficiency. Key roles in this are played by the speedy and successful implementation of the local government reform and the reforms of the structures and approaches of social and health care as well as the efficient utilisation of ICT. A fourth important area of structural reform is increasing the functioning of competition and competitiveness. Prepared by the Ministry of Employment and the Economy, the speedy implementation of the programme for promoting healthy competition and further measures to increase competition would increase total output and employment and reduce general government cost pressure.

On the basis of the audit it can be stated that the most important fiscal policy rule – the spending rules set under the central government spending limits – has been complied with. The coverage of the spending limits and fiscal policy rules is, however, too limited to achieve the sustainability objectives set for public finances.

The functioning of fiscal policy instruments in accordance with the objectives set is affected by the practices and approaches adopted. The spending limits procedure is the most important fiscal policy instrument. The sector-focused approach employed in spending limits preparation has resulted in inflexibility in resource allocation and, consequently, reforms have been implemented on the basis of increased appropriations.

Adding the spending needs arising from new policy measures on top of the old expenditure structure is not justifiable from the viewpoint of the sustainability of public finances. In the Programme of Prime Minister Jyrki Katainen's Government, new policy measures are funded with reallocations and savings. Increases in expenditure based on reallocation will continue to be necessary in efforts to address the sustainability gap in public finances and balance central government finances. Therefore the National Audit Office finds it necessary to improve the practical capacities for reallocations.

In the light of the current practice, when compared with other countries, the Finnish local government sector has a poor capacity to contribute towards the long-term sustainability of general government finances on the whole. The local government sector has underlined the role of central government measures as a key source of uncertainty for local government finances. The National Audit Office finds that special attention must be paid to the assessment of the impacts on local government finances caused by new duties assigned to municipalities in Government proposals. In this context assessments must be made of the financial impacts of new duties from the perspectives of municipalities with differing revenue and expenditure structures.

Prepared in conjunction with the spending limits decision, the Basic Public Services Programme contains an assessment of the local government financial development outlook and changes in the operating environment. The Programme also contains measures to consolidate local government revenue and expenditure. Predictability in the local government sector could be improved through the development of the Programme under municipal guidance.

Audit question 3 concerning the openness and transparency of fiscal policy information base and implementation is based on the constitutional status and duties of Parliament and the prerequisites of fiscal policy performance. The audit paid attention to how well the assumptions underlying the authorities' calculations carried out to support the decision-making process were presented and justified. The audit found that the transparency and information base of central government spending limits have been developed and that reporting concerning compliance with the spending limits has developed in accordance with the National Audit Office's positions. Reporting on tax subsidies has also improved. Reporting relating to the Ministry of Finance sustainability scenario still remains rather limited in scope, and the transparency of the scenario should be increased.

It can be stated on the basis of the audit that, from the fiscal policy perspective, the clearest weakness of the current fund system is the fact that the transparency of the financial position of central government is weakened by off-budget funds. Finland is incurring further debt. At the same time funds are transferred by central government to funds for special purposes. In the absence of single consolidated final accounts and balance sheet management based thereon, there is a risk of the picture obtained of the overall fiscal position of central government becoming dimmer.

4.2 National Audit Office's recommendations

1 Direct spending and revenue adjustment measures cannot alone be enough to guarantee the long-term sustainability of public finances if nothing is done about the structural factors causing inefficiencies. The implementation of reforms will take time, so decisions must be made soon.

2 It is important to quickly achieve ambitious structural reforms during the second half of the 2011 2014 electoral term. Before decisions are made on revenue and expenditure adjustments, clear decisions are needed on structural reforms. With adjustment measures it is vital to evaluate the duties of local and central government and also target them at transfers, i.e. benefit systems and government transfers and grants.

3 During the current electoral term, there is a better connection between the central government spending limits and the included spending rules and the deficit and debt objectives specified in the Government Programme. The spending rules are the most important fiscal policy instrument in Finland, and the cuts made in conjunction with the Government Programme and the 2012 government spending limits discussion were historic. This increases the credibility of the fiscal policy pursued. Regardless of this, the deficit and debt objectives set in the Government Programme will not be achieved during the electoral term.

4 We are likely be approaching a period of slower economic growth. Therefore it would be important during the coming electoral terms to scale the central government spending rules and balance objectives in accordance with a relatively cautious estimate of economic growth.

5 In the likely conditions of slower economic growth, reforms, including essential ones, cannot be implemented on the basis of increased appropriations allocated for each administrative sector. Instead, funding must be found through reallocations. Therefore it is important to have clear incentives for reallocations. Furthermore, the continuous evaluation of the expenditure structure provides better capacities for more in-depth expenditure reviews, which are necessary to ensure the appropriate allocation of appropriations. Expenditure reviews form the basis for the adjustment of the spending limits level to conditions of more modest economic growth.

6 The sectoral focus of the spending limits preparation process has resulted in inflexibility in resource allocation. An overall view of the fiscal policy and the prioritisation required by it in spending limits and budget preparation can be obtained through political steering. In the absence of this, the changes of focus needed between administrative sectors will not take place.

7 From the perspective of local government sustainability, improved attention must be paid to the assessment of the economic impacts of statutory duties assigned to municipalities. The impacts of decisions on different kinds of mu-

nicipalities and their expenditure and revenue structures must be assessed in particular. The evaluation conducted by the Ministry of Finance of the municipalities' duties and obligations needs to be continued through an evaluation of the adjustment needs relating to municipal duties and obligations. Data produced by independent research institutions should be increasingly utilised in the assessment of the impacts and costs of proposed legislation.

8 Existing instruments for the steering of local government finances must be developed to better meet the needs arising from the general government sustainability gap. It is justifiable to continue the development of the Basic Public Services Programme procedure specifically as an instrument of assessment and steering concerning legislation and measures targeted by central government at municipalities. The Basic Public Services Programme can also be used as a basis for the setting of fiscal policy rules concerning local government finances in the manner required by the new EU economic governance rules, particularly the Budgetary Framework Directive.

9 Reporting relating to sustainability gap calculations carried out the Ministry of Finance is still rather limited. The Ministry of Finance should consider the formulation of a methods description. The methods description could be made available at a location such as the ministerial website.

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