Separate report of the National Audit Office to Parliament: Fiscal policy monitoring report 2019

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To Parliament

The National Audit Office monitors and evaluates fiscal policy in its role as a national independent fiscal institution within the meaning of the European Union Stability Pact (Fiscal Compact) and European Union law. Provisions on the monitoring task are laid down in the Act on the National Audit Office of Finland (676/2000) and the Fiscal Policy Act (869/2012).

The monitoring comprises the assessment of the setting and implementation of the rules and binding targets that steer the fiscal policy. It covers the monitoring of compliance with the Medium-Term Objective (MTO) set for general government finances and the related correction mechanism, monitoring of the preparation and implementation of the General Government Fiscal Plan, and monitoring of compliance with the EU Stability and Growth Pact. It also covers the assessment of whether the macroeconomic forecasts used in fiscal policy-making are realistic as well as the ex-post assessment of the reliability of the forecasts as laid down in the Government Decree on the General Government Fiscal Plan (120/2014, as amended by decree 601/2017)[1]. By monitoring the fiscal policy, the National Audit Office promotes the transparency and intelligibility of the fiscal rules as well as stable and sustainable general government finances.

Under section 6 of the Act on the National Audit Office of Finland (676/2000), the National Audit Office hereby presents Parliament with this first report on its fiscal policy monitoring during the current parliamentary term for the 2019 parliamentary session.

Helsinki, 12 December 2019

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Auditor General

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Director

Main content

The economic policy objectives set for the new government term are extensive. When the Government Programme was prepared, the balance target did not seem particularly tough, but the weakening of the economic situation at the beginning of the government term and the outlook for the next few years have made it challenging.

The National Audit Office has found no grounds to question the compliance with the fiscal policy legislation, and the General Government Fiscal Plan for 2020–2023 corresponds in material respects to the statutory requirements. The targets have been set according to the obligations, but, based on current forecasts, they will not be achieved without additional measures. In this General Government Fiscal Plan, the Government has not yet proposed detailed measures for turning the trend so that the targets could be achieved.

According to the current estimate, there is a risk that Finland fails to comply with the preventive arm of the EU Stability and Growth Pact in 2020. This is influenced, for example, by the launch of a one-off future-oriented investment programme in 2020 and the fact that the permanent increases in expenditure during the government term are front-loaded as compared with the increases in tax revenue, which will improve the general government structural balance. A significant deviation from the Pact may thus arise in the development of general government structural balance and expenditure.

However, in light of the information presently available, the limit of a significant deviation would be exceeded by only a small degree in the case of structural balance. Despite the uncertainty involved in the assessments, the National Audit Office encourages the Government to pay attention to the risk of a significant deviation from the obligations set by the preventive arm of the Stability and Growth Pact. In the spring of 2021, the National Audit Office will make a final assessment on Finland's compliance with the Pact in 2020.

The Government Programme takes the long-term sustainability of general government finances into account appropriately by setting targets related to the improvement of the employment rate and the productivity of public service provision. Achieving these goals would improve the sustainability of general government finances. The Government Programme provides good starting points for preparing the reform of the social and health care system.

The Government's employment policy measures aim at 60,000 new employed persons. Based on the employment potential, it is possible to achieve this target, provided that measures are prepared and implemented resolutely. Considering the differences between the employment potential of different population groups, the most effective way to proceed towards the employment rate target would probably be targeted reforms.

At present, it seems that the fiscal policy at the beginning of the parliamentary term is neither clearly pro-cyclical nor clearly counter-cyclical. Appropriate reviews are planned under the Government Programme and the General Government Fiscal Plan in 2020 on the implementation of the measures for improving the employment rate, the permanent increases in expenditure, and the latter part of the one-off investment programme.

The so-called mechanism for exceptional circumstances, which has been incorporated into the spending limits rule of central government, is a justified solution to prepare for a severe recession. The spending limits rule of central government has been complied with in the preparation of the budget for 2020 and the supplementary budgets for 2019.

The GDP forecast of the Ministry of Finance for 2019 is among the highest forecasts, whereas the GDP growth forecasts of the Ministry for 2020 and 2021 are lower than the median forecast and the average. On the basis of the assessment, the economic forecast of the Ministry of Finance on which the General Government Fiscal Plan is based cannot be considered unrealistic in the sense referred to in legislation.

Contents

1 Economic and fiscal policy objectives for the parliamentary term 2019–2023

The Government aims at balance in general government finances by the end of the parliamentary term. As the forecasts have weakened, this target has become tough. The target is valid under normal global economic circumstances, which is a useful specification although it leaves room for interpretation. It is also justified that, under the Government Programme and the General Government Fiscal Plan, expenditure decisions and the progress of employment-policy measures are reviewed as a whole during the government term. The mechanism for exceptional circumstances incorporated into the spending limits rule provides leeway in case of an exceptional recession.

It is possible to achieve the Government's target to improve the employment rate by 60,000 new employed people, but this requires resolute preparation and implementation of employment measures. The preparation of the measures should observe the differences between the employment potential of different population groups and the factors underlying these differences. When the employment rate of different age groups in Finland is compared with that of the other Nordic countries, the highest employment potential resides in the oldest age groups.

Supporting sustainable general government finances also requires improving the efficiency of public service provision. The Government Programme provides good starting points for preparing the reform of the social and health care system. In view of the sustainability and risk management of general government finances, it is also important to take the risks related to state guarantees into account comprehensively before increasing the contingent liabilities.

The tax rate in Finland is slightly down from the millennium 2000, when it was at its highest. It is good that no separate tax rate targets have been set during the government term, as this would have unnecessarily restricted the available fiscal policy measures. The aim should be to decrease tax subsidies.

1.1 The economic policy objectives set are mainly consistent

The economic policy objectives set for the government term are extensive. They include a target related to balanced general government finances, a target related to improving the employment rate, a target related to decreasing inequality and narrowing the income gaps, and a target related to achieving carbon neutrality (see Table 1). The Government Programme thus also highlights other targets than those related to general government finances and specifies that the aim of economic policy is to increase wellbeing and prosperity. All of the targets are also measurable in principle, although inequality is not specified in the target-setting except for income gaps.

The balance target is closely connected with the employment rate target as regards both the time frame and the impacts, although the different methods for improving the employment rate target may have different kinds of impacts on the balance of general government finances. The connection of inequality, income gaps and carbon neutrality with general government finances is more complicated, and the target related to carbon neutrality has, moreover, a different time span than the other targets.

Based on forecasts, the target of balanced general government finances in 2023 is tough

According to the target set for general government finances in the Government Programme and the first General Government Fiscal Plan of the parliamentary term, revenue and expenditure should be in balance in 2023. The target set is tough. According to the forecast of the Ministry of Finance, which is included in the General Government Fiscal Plan and which takes into account the measures already decided by the Government, general government finances are expected to show a deficit of 1.4 per cent relative to GDP in 2023. However, when the Government Programme was drafted, the target did not seem particularly tough considering the forecasts at the time. Based on the projection by the Ministry of Finance, a deficit of about 0.6 per cent was then projected for 2023. This was lower than, for example, the deficit that was forecast in the autumn of 2015 for the end of the then-ongoing parliamentary term.

It is justified to take the global economic circumstances into account in the balance target set for general government finances

The target related to balanced general government finances is subject to a condition according to which the target is valid under normal global economic circumstances. The wording of this condition leaves some room for interpretation. Generally speaking, it is still justified. Should the global economic circumstances during the parliamentary term prove to be very weak, keeping the balance target valid might lead to unjustified pro-cyclical fiscal policy. In view of the transparency of the target setting, it is also good that the reservation related to the target has been presented in advance, so that it will not be necessary to adjust the target in the middle of the parliamentary term. The condition is also in line with the logic of fiscal policy legislation, as fluctuations in global economic circumstances can be interpreted as a cyclical factor, and the primary target set by the fiscal policy legislation is the structural balance target (net of cyclical factors).

It is good that the Government Programme does not set any targets related to the amount of government debt or the tax rate. For debt sustainability, the development of the amount of government debt is secondary to the development of ratio of debt and net debt (taking also into account government assets where appropriate) to GDP. A tax rate target, in turn, would unnecessarily restrict the fiscal policy methods available during the government term.

Table 1: Economic policy targets set by the Government Source: General Government Fiscal Plan for 2020–2023, Ministry of Finance, Statistics Finland

Objective	Initial status	Forecast
General government finances will be in balance in 2023.	General government finances show a deficit of 0.8 per cent relative to GDP in 2018.	Based on the projection of the Ministry of Finance, general government finances will show a deficit of 1.4 per cent relative to GDP in 2023.
The employment rate will be 75% in 2023; the measures taken by the Government will result in 60,000 new employed people.	The employment rate trend is 72.4% in April 2019.	According to the forecast by the Ministry of Finance, the employment rate will be 73.1% in 2023.
The Government's decisions will decrease inequality and narrow the income gaps	The relative Gini coefficient, one of the indicators illustrating income gaps, is 27.7 in 2017.	Not available.
The Government's decisions will put Finland on a path towards achieving carbon neutrality by 2035.	In 2018, greenhouse gas emissions totalled 56.5 million tonnes of carbon dioxide (CO2) equivalent, excluding carbon sinks.	Not available.

Although the target set for general government finances is difficult to achieve according to forecasts, the target included in the General Government Fiscal Plan could not be considerably looser under the valid legislation. Finland is committed to complying with the Fiscal Compact. Under the Compact and based on the country's current debt level and sustainability outlook, Finland shall strive to achieve a deficit of 0.5 per cent or a stronger structural fiscal position in the medium term. Accordingly, the balance targets set by the General Government Fiscal Plan should lead to at least achieving the structural fiscal position. Striving for balance is therefore justified in order to leave a safety margin between the nominal targets and the structural target.

The Fiscal Compact provides a framework for the targets set for general government finances

The fiscal stance at the beginning of the parliamentary term is neither clearly pro-cyclical nor clearly countercyclical

The Government Programme and the General Government Fiscal Plan increase the permanent general government expenditure by about EUR 1.4 billion. It is stated in the General Government Fiscal Plan that most of the additional expenditure will become effective in 2020. Discretionary increases in expenditure will be funded mainly by increasing tax revenue. The Government Programme includes a one-off investment programme of EUR 3 billion in total for 2020–2022. The General Government Fiscal Plan included decisions on the use of EUR 1.4 billion in 2020–2022.

According to plans, the one-off investment programme will be funded with property income. However, it will primarily not be funded with such property income as would be considered revenue in general government statistics. This is because only the divestment of fixed assets improves the general government fiscal position, whereas the divestment of financial assets has no impact on the deficit. The one-off investment programme will therefore increase the general government deficit, depending on the share of the programme funded by divesting fixed assets.

According to the General Government Fiscal Plan, the permanent increases in expenditure decided by the Government will be front-loaded during the government term as compared with the increases in tax revenue following the changes in tax criteria. One of the tax criteria changes was the removal of tax subsidy for paraffinic diesel, which complies with the cutbacks in business subsidies laid down in the Government Programme. In the future, it would be important to strive to prioritise business subsidies based on their effectiveness and to abandon subsidies that have been found to be ineffective.

Increases in expenditure during the government term will be front-loaded

It is justified to review the expenditure decisions when the budget for 2021 is prepared, as stated in the Government Programme, if impact assessments show that the Government decisions have not succeeded in improving the employment rate according to the milestone set. It is also appropriate for the General Government Fiscal Plan to link the decisions on the implementation of the latter part (EUR 1.7 billion) of the one-off investment programme with the review of the increase in expenditure and the impact of the measures for improving the employment rate.

However, because there is a need for counter-cyclical fiscal policy, the review involves a risk related to cyclical conditions. This might lead to a problem if the cyclical conditions and their outlook were very weak at the time of the review and, at the same time, the decisions taken were found not to promote the achievement of the employment rate target. In this case, any fiscal adjustment might be pro-cyclical and thus cause the economic trend to weaken further.

Estimates of the cyclical conditions may be revised afterwards

The fiscal stance can be assessed in relation to cyclical conditions in several alternative manners, all of which involve uncertainty. It is, for example, difficult to forecast what the cyclical conditions will be the next year – and even during the current year. Based on the indicators used by the National Audit Office (see Figure 1), the fiscal policy will be expansionary in 2020. The indicators show mild pro-cyclicality, which is, however, weaker than in 2018 and 2019. Based on the available assessments, the fiscal policy will be close to neutral in 2021. The assessments of the cyclical conditions may still change, which may later change the conclusions made of the fiscal policy stance in relation to the cyclical conditions.

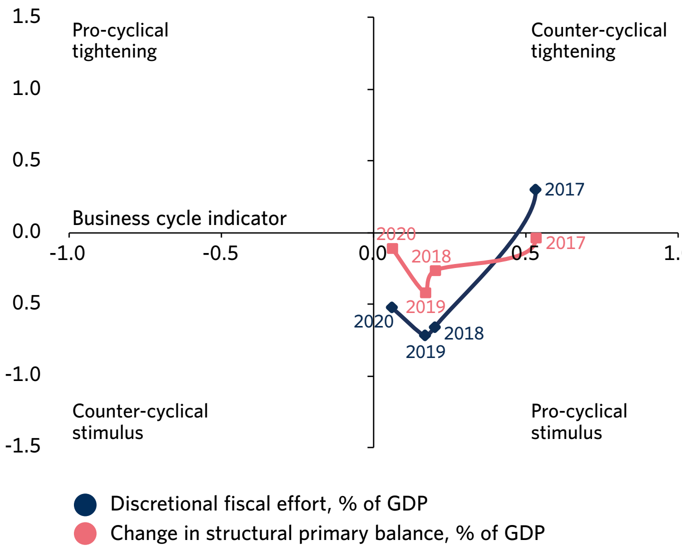

Figure 1: Fiscal policy stance in 2016–2020: indicator for discretionary measures and change in cyclically adjusted primary balance, % of GDP. Source: The Ministry of Finance, calculations by the NAOF

1.2 The new mechanism to be used in severe economic downturn, incorporated into the spending limits system, does not jeopardise the credibility of the system

According to the Government's spending limits rule, tax subsidies shall not be used for circumventing the spending limits

The spending limits rule of Rinne's Government conforms largely to those of the previous Governments. The biggest change is the incorporation of the so-called mechanism for exceptional circumstances into the rule. In addition, a statement that tax subsidies shall not be used for circumventing the spending limits was returned to the rule. In connection with the Government's one-off future-oriented investment programme, it is stated that, if the EUR 1.7 billion provision made for the latter part of the programme is not used, the level of the spending limits will be lowered accordingly. This kind of a conditional entry, according to which the spending limits will be lowered accordingly if certain expenditure within the limits is not realised, has also been made in connection with fighter aircraft purchases and the energy tax refund system. In view of the nature of the expenditure in question, it is justified to use this kind of a conditional entry to lower the spending limits, if necessary. It also provides the spending limits with the flexibility needed if the expenditure proves not to be necessary after all during the spending limit period.

The National Audit Office has commented on the previous Governments' spending limits rules in its fiscal policy monitoring reports. Some of these comments are still relevant. It would have been important, for example, to define financial investments in greater detail in the spending limits rule. As regards compliance with the principles of the spending limits rule, it is essential that the financial investments falling outside the spending limits maintain their value. To increase transparency, it would be important to define the use and possible life cycle of financial investments clearly and to ensure that financial investments are not used for operating expenses, subsidies or similar expenditure. It would also have been important to clarify the processing of donated shares from the perspective of the spending limits rule. The report *Kehysjärjestelmän kehittäminen vaalikaudelle 2019–2023* (Development of the spending limits system for the parliamentary term 2019–2023), published by the Ministry of Finance earlier this year, includes well-grounded proposals for clarifying these issues.

The mechanism for exceptional circumstances aims at providing flexibility to the spending limits in the event of a severe economic downturn. The existence of such a mechanism is justified: when spending limits are determined for a period of four years, it is not always possible to anticipate a severe recession that might occur during the period and that might justify an increase in expenditure to smooth the business cycle, notwithstanding the spending limits. The criteria for the activation of the mechanism have been specified in the Government Programme. The increase in expenditure enabled by the mechanism is also clearly defined. Both of these are important features for a credible mechanism.

The mechanism for exceptional circumstances aims to provide flexibility to the spending limits in the event of a severe recession

The mechanism for exceptional circumstances cannot be assessed comprehensively until it has been used for the first time, as the criteria for its activation leave room for interpretation. However, it is possible to comment the usability and the criteria set for the activation of the mechanism on the basis of the Government Programme. The activation of the mechanism is partly dependent on indicators that determine the severity of a recession and that are assessed on the basis of independently provided information and partly on the complete picture of economy. This ensures that cyclical conditions are assessed in a balanced manner. However, in practice, it may be difficult to react to a recession in a timely manner: it takes time, for example, before the data describing the GDP trend becomes available and the decisions required to activate the mechanism are taken, and, in any case, unemployment reacts to a recession with a delay.

If the numerical indicators linked to the mechanism are examined to find out when the mechanism could have been activated previously in history, the data on actual GDP shows that the mechanism could have been activated, for example, at the end of 2008 or at the beginning of 2009 and in 1990–1991. In both of these periods, there was an exceptional recession. Thus, it seems that the mechanism does not involve a major risk that the indicators might react too easily to economic cycles and that the mechanism might be activated on too vague grounds. A bigger risk might be rather that the mechanism will not be activated quickly enough and in a timely manner. Because the threshold for activating the mechanism is high, it seems more likely that stimulus measures might be launched too late. On the other hand, reacting very fast – before the economic outlook is clarified – would weaken the credibility of the mechanism.

The numerical indicators linked to the mechanism can identify a severe recession

1.3 In addition to employment-policy measures, the sustainability of general government finances can be strengthened by reducing risks and improving productivity

The Government Programme takes the long-term sustainability of general government finances into account by setting targets related to the improvement of the employment rate and the productivity of public service provision. Achieving these goals would improve the sustainability of general government finances. The Government Programme does not set a separate target for the development of the sustainability gap indicator, which is a justified solution. In its audit targeted at the sustainability assessments of general government finances[2], the National Audit Office considered that there is no need to set separate targets for the development of sustainability indicators in the fiscal policy framework, and that the fiscal stance should not be based primarily on the information provided by the sustainability indicators.

The economic policy targets should include measures for supporting the sustainability of general government finances

Due to their nature, sustainability assessments are best suited for assessing the need for structural reforms and for creating a picture of the status of general government finances. According to the audit results, the assessment of the sustainability of general government finances should be expanded outside the S2 indicator, which illustrates long-term sustainability. It should also be ensured that sustainability is dealt with comprehensively in the General Government Fiscal Plan. In addition, it is important that measures supporting the sustainability of general government finances are continuously taken into consideration in the economic policy targets, such as the employment rate targets.

The use of sustainability indicators in fiscal policy is limited by several factors. The indicators are extremely vague. They are, for example, affected substantially by the background assumptions of population projections, and there can be significant changes in the demographic factors (e.g. birth rate and immigration). Some of the factors that have a material effect on sustainability are beyond the direct control of political decision-making.

Mechanical application of a sustainability gap indicator might also give a false picture of the impacts of fiscal adjustment on the sustainability of general government finances. This is because, in sustainability calculations, it is difficult to assess the impacts of adjustment measures for instance on long-term economic growth. Changes in calculation methods and assumptions can result in substantial fluctuation in the value of the long-term sustainability indicator. In addition, the long-term sustainability indicator is built into the EU-level medium-term fiscal policy regulation, which also decreases the need to set a separate target for the development of this indicator.

The social and health care reform can enhance sustainability in the long term

A key method for enhancing the sustainability of general government finances is the development of the social and health care system, taking into account both the needs of general government finances and the need for available high-quality care. The current level of total social and health care expenditure in Finland corresponds to the EU average, but the ageing population puts an upward pressure on it. It is useful to consider the upward pressure per factor, e.g. according to the division applied by the Working Group on Ageing Populations and Sustainability (AWG) of the EU Member States and the EU Commission.

According to the AWG's analysis, the situation in the actual health care in Finland is not exceptional compared with the other countries. In the initial status, the health care expenditure of Finland is below the EU average (Figure 2). In the long term, by 2070, the health care expenditure of Finland is forecast to grow by 0.8% relative to GDP (the EU average being 0.9%) according to the working group's so-called reference scenario. By 2030, the health care expenditure in Finland is also expected to grow very typically, by 0.4% relative to GDP.

The upward pressure of social and health care expenditure is focused on long-term care

The upward pressure, in turn, concerns mainly long-term care, such as care for the elderly. According to the AWG's reference scenario, long-term care expenditure, which is already higher in Finland than the EU average in the initial status, will increase by 2.1% relative to GDP in the long term, the EU average being 1.2%. The expenditure ratio of long-term care will grow mainly after 2030. By 2030, the growth is estimated to be 0.8%

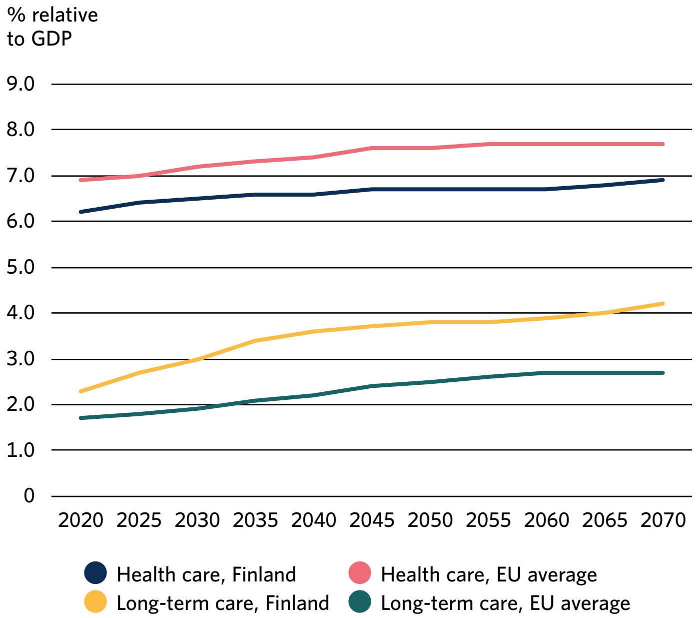

Figure 2: Development paths of health care and long-term care until 2070. Source: EU Commission, Ageing Report 2018, reference scenarios of the AWG working group

Larger service organisation units promote the achievement of economic benefits

The Government Programme provides good starting points for preparing the reform of the social and health care system. Transferring the responsibility for service organisation to areas with a clearly larger population is necessary to ensure both economical and effective service provision in the future. Although it will take time before cost benefits are realised, and they will not be automatic, larger service organisation units will nevertheless make it easier to achieve economic benefits for instance through economies of scale in production, bargaining power related to purchases, and faster changes to improve productivity (e.g. changes related to digitalisation or management systems).

The Government has also launched a survey on a separate solution for the Greater Helsinki Area as part of the social and health services reform. This is justified, as the population in the Greater Helsinki Area is so high that the success of the reform in this area will have a significant effect on the success of the entire reform.

The Government Programme limits the responsibilities of the self-governing regions (counties) at least initially to social, health and rescue services. This speeds up the preparations of the reform, promotes the progress of legislation and simplifies the implementation phase, which will be challenging in any case.

As the preparations of the reform proceed, it will probably be necessary to set quantitative economic goals for the reform. It would be useful if the economic goals were based on the identified potential for efficiency gains. The setting of economic goals should also take into account measures that will increase costs, such as the improvement of service availability or quality. If this is not done, the economic goals will not be realistic.

The economic goals set for the social and health services reform should be realistic

According to the Government Programme, the Government will start preparations for the introduction of county income taxation. As the country income tax may have a significant impact on the counties' economic incentives, for example, it is justified to look into its introduction.

State guarantees set a higher risk to general government finances

When the sustainability of general government finances is assessed, it is necessary to take into account not only the known expenditure pressures but also contingent liabilities, which may result in expenditure on a large scale, even though this is unlikely. The ratio of public-sector guarantees to GDP in Finland has risen to the top in the EU, and the number of state guarantees has continued to grow rapidly (see Figure 3). When decisions are made, it is therefore important to consider the risks involved in public-sector guarantees, in particular. The factors underlying this trend include the rapid growth in export guarantees and home loan guarantees.

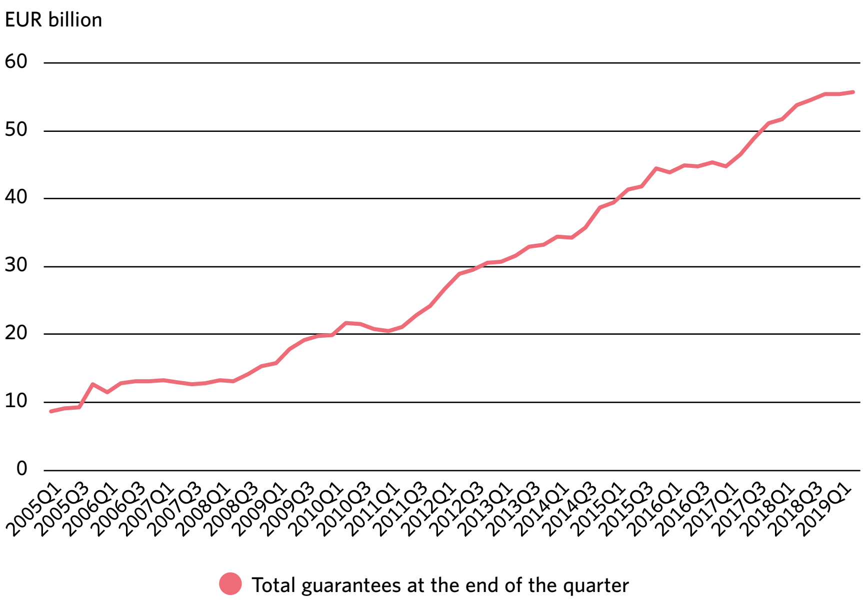

Figure 3: Development of state guarantees 2005–2019. Source: Statistics Finland

The fiscal policy steering mechanisms do not in any way restrict the growth of contingent liabilities. From the perspective of economic policy, it is an attractive option to increase contingent liabilities, as they sometimes help to ensure the implementation of projects promoting employment.

The risk management of state guarantees should be improved[3] to prevent too high risk exposure. Increasing contingent liabilities is subject to a government proposal and a decision by Parliament. However, in practice, this has not prevented the rapid increase in the liabilities. Although the positive impact of the export funding system on the employment rate is established in a recently published survey[4], the results also indicate that activities falling within the scope of the export credit guarantee displace other economic activities in the same area to some extent.

Export financing has a positive impact on the employment rate, but it may also displace other economic activities

According to the Government Programme, Finnvera will be provided with a sufficient level of authorisations, considering also its risk management needs. During this government term, it would be extremely important to focus on the risk management perspective when considering increasing the authorisations. It is important to take into account both the riskiness of increased authorisations and the entire risk-bearing capacity of central government when all existing liabilities are taken into consideration.

1.4 It is possible to achieve the employment rate target if measures are targeted successfully

The Government aims to achieve an employment rate of 75 per cent (60,000 new employed people) by 2023. So far only a few concrete details have been disclosed of the employment-policy measures, which makes it difficult to assess its impacts on the employment rate. The measures set out in the Government Programme may also have an adverse effect on the employment rate. The Government Programme outlines abandonment of the activation model. According to a report[5] ordered by the Ministry of Economic Affairs and Employment, the model may have increased the probability of termination of unemployment among those who receive earnings-related unemployment benefit. It is, however, difficult to assess the impacts of the activation model.

The preparation of employment-policy measures should observe the differences between the employment potential of different population groups and the factors underlying these differences. A comparison between the employment rate in Finland and the average of the Scandinavian countries per age and gender group reveals three groups with the highest employment potential: older people, women of child-bearing age, and young people. However, it should be noted that the employment rate of young people in Denmark differs considerably from that of the other Nordic countries. If Denmark were excluded from the comparison (leaving only Norway and Sweden), the employment potential of only young women and older people would stand out in Finland (Figures 4 and 5).

A Nordic comparison shows that differences in the employment rate vary in different population groups

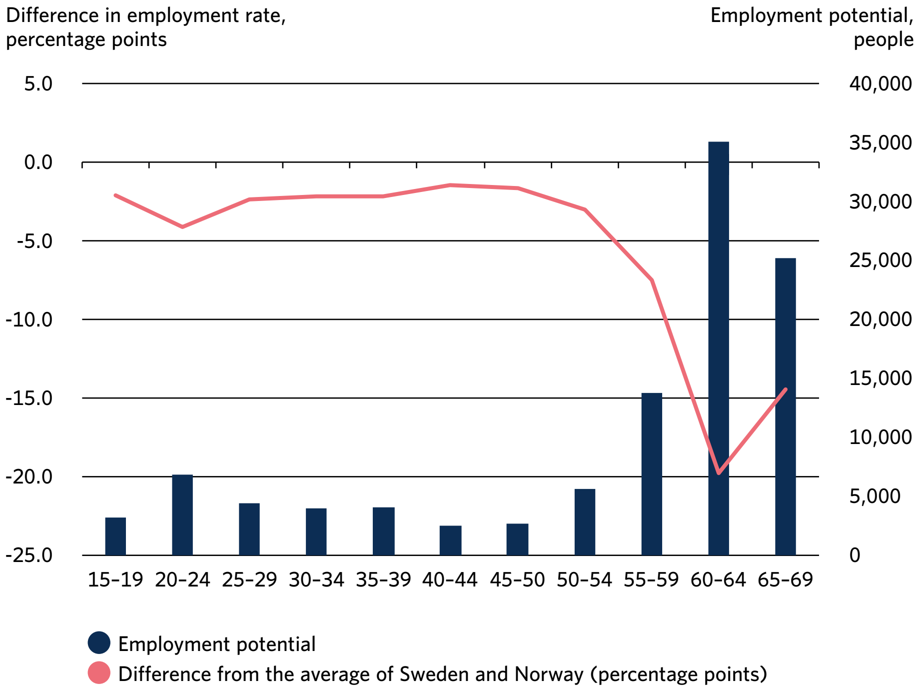

Figure 4: The difference of the employment rate in Finland from the average of Sweden and Norway, and the employment potential – men by age group Source: The NAOF's calculations based on the information provided by Eurostat and Statistics Finland

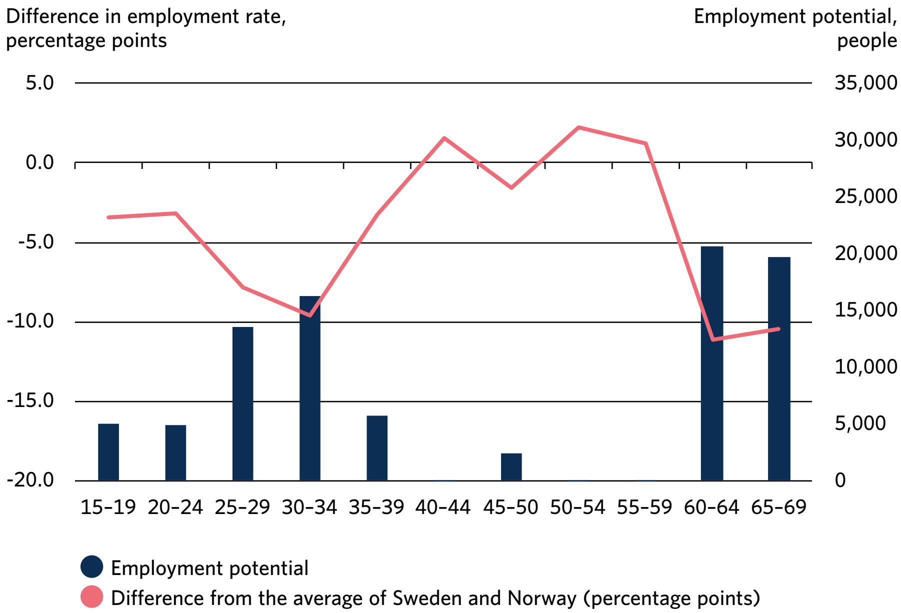

Figure 5: The difference of the employment rate in Finland from the average of Sweden and Norway, and the employment potential – women by age group Source: The NAOF's calculations based on the information provided by Eurostat and Statistics Finland

The highest employment potential lies with men over 55 years

A direct comparison with Sweden yields qualitatively similar results. However, if it is considered how common part-time work is particularly in Sweden, the potential of young women becomes somewhat questionable in view of the employment rate, as part-time work is not very common in Finland. The comparison is further complicated by the fact that, in Sweden, statistics show people on family leave as employed, whereas in Finland they are considered non-employed[6]. For this reason, a comparison merely between the employment rates does not give a clear picture of the differences between the countries, particularly in the case of women with small children. The fact that Finland and Sweden have different family leave systems makes the problem even more challenging.

In labour force surveys in Finland, a person who has worked at least one hour during the survey week is considered to be employed. Those salary earners who have a job but who have been absent from work during the survey week because of a maternity or paternity leave are also considered to be employed. As there are differences between Finland and Sweden in the way statistics are kept and in the family leave systems, the comparison should be made between those who have been working during the survey week. The concept ‘work attendance rate’ is applied to the share of those who have been working during the survey week. When this indicator is used, there are no significant differences between women in Finland and Sweden (Figure 6). Nevertheless, there is still a considerable difference between mothers of children under three years. If the work attendance rate is used as an employment indicator, the difference between women in Finland and Sweden is narrowed from six to about two percentage points.

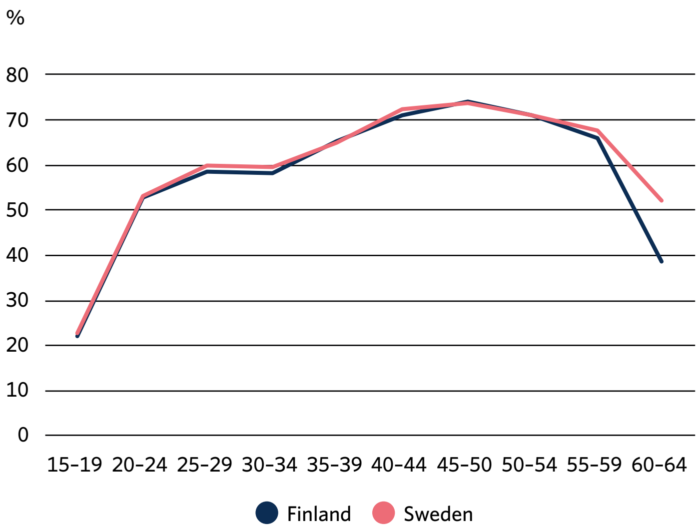

Figure 6: Work attendance rates of women. Source: Statistics Finland

The working age profile shows clearly that the most significant potential for improving the employment rate resides among older people – particularly among older men. Employment potential of more than 60,000 people, which is higher than the Government’s employment target, can be found among men of 55 to 69 years alone. As regards women, the greatest potential is found in the age group 60 to 69 years (40,000 people).

Men’s employment rate in all age groups is lower than in the other Nordic countries

On a more general level, it can be pointed out that the employment rate of Finnish men, in particular, is not higher than in the other Nordic countries in any age group. Reforms not targeted at any specific age group can therefore be considered justified. However, in view of the differences in the employment potential between different age and gender groups, targeted reforms would still be the most probable way of achieving the employment rate target without too high costs. As regards older people, in particular, it might be useful to review the entirety of the incentive and support systems, training and job-search assistance, and active labour market policies applicable to them.

1.5 The tax policy needs to strengthen the tax base

According to the Government Programme, the Government is seeking to secure the financing base for an affluent society in a rapidly evolving global digital economy by strengthening the tax bases both internationally and nationally. A robust tax base also enables low tax rates and equitable taxation, promoting free enterprise, employment, growth, wellbeing and prosperity. A sustainable taxation roadmap will be drawn up to serve the Government's climate goal. The first stage of this roadmap will be completed in time for the 2020 government discussion on spending limits. The package will include a reform of energy taxation, a reform of transport taxation, promotion of circular economy, and a study of emissions-based consumption taxation. The first General Government Fiscal Plan discloses few concrete details related to these.

Tax policy is one of the key tools with which the Government implements its objectives: improvement of the employment rate, decrease in inequality and narrowing of the income gaps, carbon neutrality, and increase in wellbeing and prosperity. Tax revenue is used for funding public services and benefits and also for narrowing the income gaps. Taxation is also used for steering citizens' and companies' behaviour.

The tax rate has fallen from the turn of the millennium

The tax rate represents the ratio of taxes and mandatory social security contributions to GDP. The tax rate in Finland rose from approximately 35% at the end of the 1970s to approximately 46% at the turn of the millennium (Figure 7). At the beginning of the 21st century, the tax rate has fallen, being at its lowest, 40.5%, in 2010, after which it has again risen slightly. In the past few years, the tax rate has again fallen somewhat. In 2018, the tax rate was 42.1%. The focus in taxation has moved slightly from income and capital income taxation to the taxation of goods and services. The share of the obligatory social security contributions has also grown. As a whole, the change in the focus of taxation has, nevertheless, been quite small.

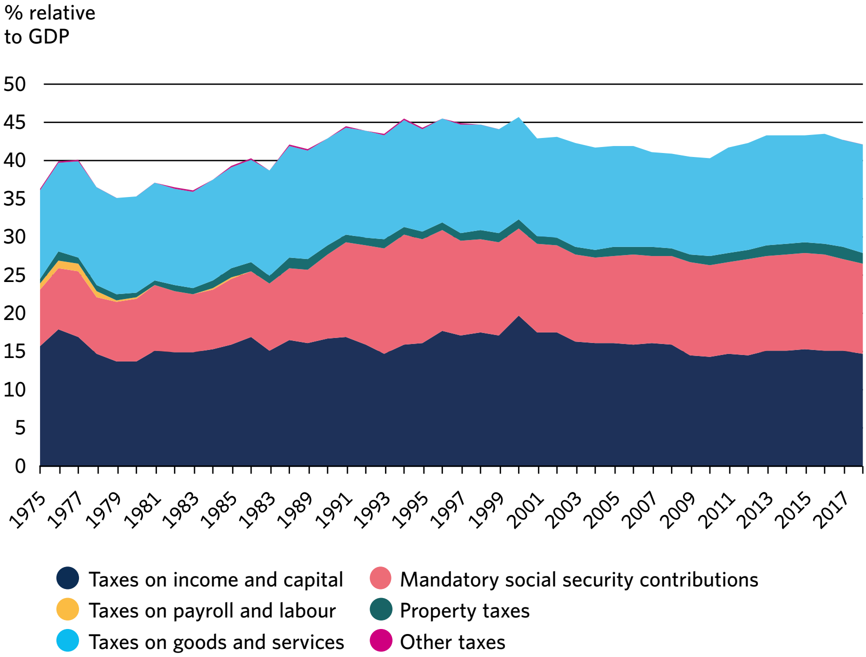

Figure 7: Development of taxation per tax type 1975–2018, tax revenue relative to GDP, %. Source: Statistics Finland

Tax rate is one of the most common indicators for the size of the public sector in international comparisons, although the data is not fully comparable for this purpose. The tax rates in Finland and Sweden have shown similar trends for the past few decades. The tax rate in Finland has, nevertheless, been slightly higher. However, in the past few years, the tax rate has been higher in Sweden than in Finland.

The total tax rate is not a functional economic steering instrument

The total tax rate is not a particularly functional instrument for steering central government finances, as taxation often has contradictory impacts on economy. Tying measures to be taken during the government term in advance to funding through taxation can restrict the scope of economic policy measures and lead to inappropriate tax policy measures in view of employment or income distribution, for example. Refraining from raising the tax rate likewise limits the methods available to the Government. It is good that the Government has not tied the total tax rate to a certain level in its Government Programme.

Tax subsidies continue to grow

Tax subsidies refer to such deviations from the normal basic structure of taxation, i.e. the so-called normal tax system, that are specified in tax legislation and intended to provide support. In practice, tax subsidies refer to tax exemptions, tax deductions, lower tax rates, and similar means to support a specific business or group of taxpayers.

The estimated amount of tax subsidies in euros has increased year by year (Figure 8). For one third of the tax subsidies, it is not possible to give an estimate in euros. It is estimated in the budget proposal for 2020 that the total of tax subsidies is about EUR 29.2 billion. In the budget proposal for 2015, the amount of tax subsidies was estimated at EUR 24.4 billion. In the budget session, the Government decided to remove the tax subsidy for paraffinic diesel during the government term. The removal of the tax subsidy is expected to increase tax revenue by about EUR 120 million.

The estimated amount of environmentally harmful subsidies is expected to grow from EUR 3.5 billion in the budget proposal for 2019 to EUR 3.6 billion in the budget proposal for 2020. Environmentally harmful subsidies are included particularly in the tax system, but they can also be found among appropriations.

The Government has also decided to continue to limit the tax deductibility of interest payments on home loans and to reduce the domestic help credit. However, at the same time, the Government has decided on a new tax subsidy: granting a partial tax exemption on removal costs paid by an employer. The decisions taken at the Government's budget session to accelerate the depreciation for investments and to increase the VAT relief will also increase the amount of tax subsidies. Tax subsidies narrow the tax base and often also complicate the tax system.

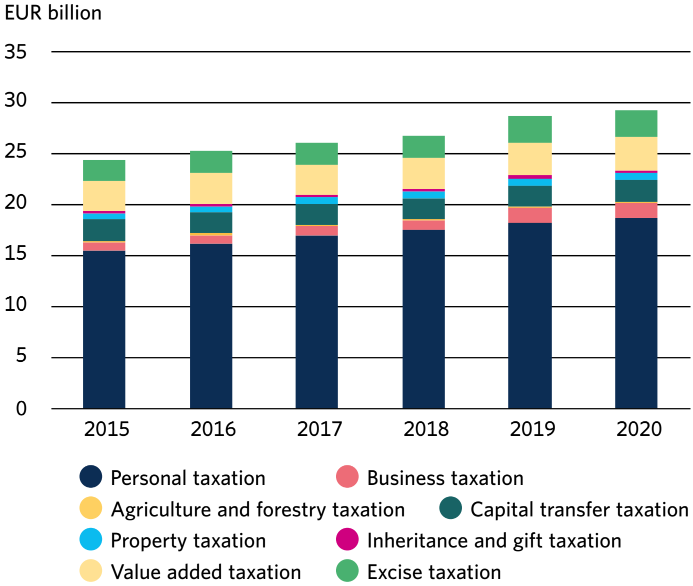

Figure 8: Development of tax subsidies 2015–2020, EUR million. Source: Budget proposal for 2020 and up-to-date budgets for 2015–2019

2 Compliance with the EU fiscal policy rules and the spending limits rule

According to the ex-ante assessment by the National Audit Office, Finland will deviate from the structural balance rule of the preventive arm of the Stability and Growth Pact and from the expenditure benchmark in 2019, but the deviations will not be significant. As regards 2020, there is a risk that the deviations from the rules will be significant. This is influenced, for example, by the launch of a one-off future-oriented investment programme in 2020 and the fact that the permanent increases in expenditure during the government term are front-loaded as compared with the increases in tax revenue, which will improve the general government structural balance.

Although the estimates involve uncertainty, the National Audit Office encourages the Government to pay attention to the risk of a significant deviation. In the spring of 2021, the National Audit Office will make a final assessment on Finland's compliance with the Pact in 2020.

According to the preliminary assessment, Finland will comply with the criteria of the corrective arm of the Stability and Growth Pact in 2019 and 2020. The ratio of general government debt to GDP is very close to the limit value of 60 per cent, and it is forecast to exceed the limit value in 2022.

As regards the national spending limits rule in Finland, the National Audit Office has gone through the numeric preparation of the spending limits for the new parliamentary term, the budget proposal for 2020, and the supplementary budgets for 2019. In its assessment, the National Audit Office ensured that the spending limits calculations of the Ministry of Finance had been implemented in compliance with the spending limits rule and principles laid down in the Government Programme. On the whole, the central government spending limits have been complied with.

2.1 There is a risk of a significant deviation from the preventive arm of the Stability and Growth Pact in 2020

In this section, the National Audit Office makes an ex-ante assessment of Finland's compliance with the rules of the Stability and Growth Pact in 2019 and 2020. The final assessments will be made in the spring following each year under review. The assessment of compliance with the Stability and Growth Pact is based on the information provided by the Ministry of Finance on the Stability Programme, the draft budgetary plan for 2020, and the Economic Survey of autumn 2019. The calculations are based on the methods presented by the European Commission in the report Vade mecum on the Stability and Growth Pact.[7]

The aim of the preventive arm of the Stability and Growth Pact is to prevent excessive deficit and debt

The aim of the preventive arm of the EU Stability and Growth Pact is to ensure balance in general government finances. Furthermore, compliance with the rules of the preventive arm should prevent excessive deficit and debt. The preventive arm focuses on a Member State-specific medium-term objective (MTO), expressed as a target level for the structural balance. Finland's MTO is to achieve a general government structural balance of –0.5 per cent relative to GDP.

The structural balance describes the general government fiscal position relative to GDP when the impact of economic cycles and temporary and one-off measures has been eliminated from the nominal fiscal position of general government.

The achievement of the MTO is assessed on the basis of two separate criteria. First, it is assessed whether the targeted structural balance has been achieved or whether the general government finances in the Member State have progressed towards the targeted balance as required. With regard to the second criterion, i.e. the expenditure benchmark, the increase in general government expenditure is compared with the expenditure limit set for it. Compliance with the expenditure benchmark supports the achievement and maintenance of the structural balance in accordance with the MTO.

In the process for assessing compliance with the Stability and Growth Pact, the targets for each year are set in the summer preceding the year under review. The final assessment of the compliance is made in the spring following the year under review. Between these milestones, different actors assess the current situation and progress towards the targets.

Structural balance is far from meeting the target

Structural balance will weaken in 2019–2020

The forecast for general government structural balance in 2019–2020 has weakened from the assessment made by the National Audit Office in the spring of 2019. The change is attributable to the weakening of the forecast for nominal balance, in particular. The assessment of cyclical conditions has also been specified to some extent. The cyclical conditions are illustrated by the output gap, i.e. the difference between the observed GDP and the potential GDP. The potential GDP describes the long-term economic trend, which cannot be observed but has to be estimated. According to the assessment of the National Audit Office, the structural deficit will be –1.3% relative to GDP in 2019 and grow further to –1.4% relative to GDP in 2020, as illustrated in Figure 9.

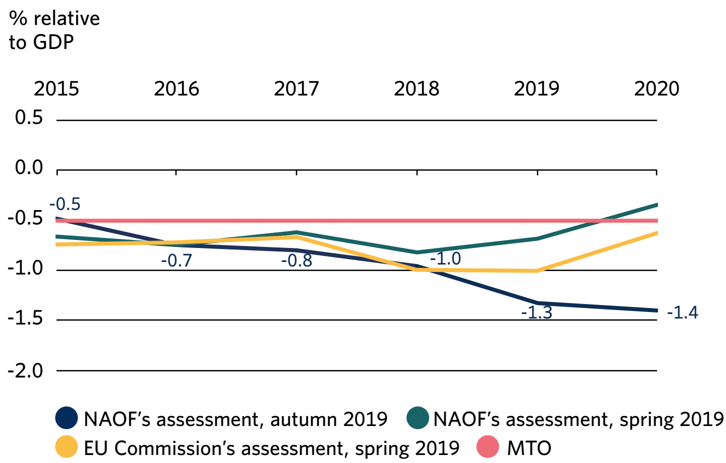

Figure 9: The level of structural balance in 2015–2020, % relative to GDP.

If the target set for structural balance is not achieved, it will be assessed according to the Stability and Growth Pact whether the change towards the target level is sufficient. The structural balance in 2019 will weaken by 0.4 percentage points from the previous year. The nominal balance will weaken in 2019 (see Figure 10). In 2020, the structural balance will weaken by 0.1 percentage points, and the output gap is expected to decrease.

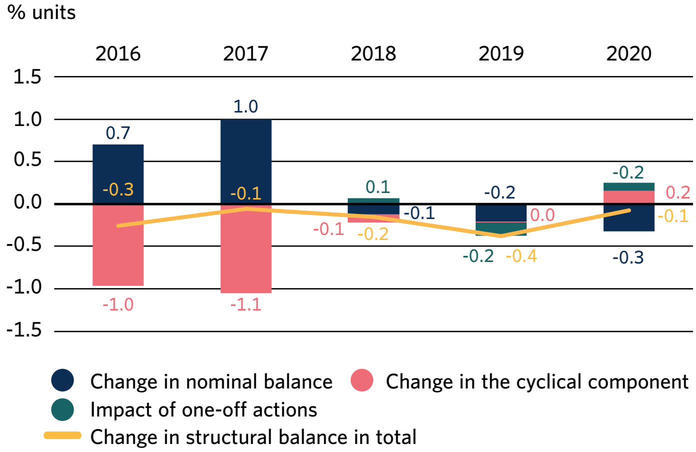

Figure 10: Change in the structural balance divided into the change in the nominal balance and the change in the cyclical component

The required adjustment of structural balance can be updated in reviews

The change, or adjustment, required to be made in the structural balance towards the MTO is defined in the Council's recommendation in the summer preceding the year under review. The recommendation is based on the fiscal policy rules and on the Commission's forecast from the corresponding spring. According to the rules, the adjustment requirement can be updated in the autumn preceding the year under review and in connection with the final assessment in the spring following the year under review. An update is made if the economic situation weakens significantly or if the structural balance is assessed to be closer to the MTO (than the adjustment requirement). According to the current estimate, the structural balance is allowed to weaken by 0.2 percentage points in 2019. In the summer of 2019, the Council recommended an adjustment of 0.5 percentage points for 2020.

The flexibility granted to Finland has made it easier to comply with the rules in 2017–2019

Finland has benefited from the flexibility offered by the Pact: under the structural reform clause, Finland was granted relief of 0.5 percentage points relative to GDP from the requirements for 2017–2019. In this assessment, the flexibility affects Finland's compliance with both the structural balance rule and the expenditure benchmark in 2019.

According to the preliminary assessment, Finland will deviate from the structural balance rule in 2019, but the deviation will not exceed 0.5 percentage points, and thus it will not be significant. A significant deviation is a deviation of over 0.5 percentage points from the requirement in one single year or a cumulative deviation of 0.25 percentage points on average per year in two consecutive years.

According to the current assessment, the structural balance in 2020 will deviate from the requirement by 0.6 percentage points, which constitutes a significant deviation. The current assessment involves uncertainty, as the assessments of the structural balance and the adjustment requirement may still be updated before the final assessment.

The assessment made by the National Audit Office may differ from that of the European Commission particularly because the calculations of the National Audit Office are based on the forecast by the Ministry of Finance, whereas the Commission bases its assessment on its own forecast.

Public expenditure is growing faster than allowed by the rules

The aim of calculation in accordance with the expenditure benchmark is to assess the development of general government expenditure in relation to the maximum rate set for an increase in expenditure. The maximum rate, i.e. the limit for an increase in expenditure, indicates how much the expenditure can increase in order for the development to either still keep up with the MTO or remain on the adaptation path leading to the MTO.

In the calculation, the cyclical component of unemployment expenditure, debt interest payments, and spending arising from EU programmes funded directly with EU subsidies are deducted from total general government expenditure. These expenditure items are considered to be such that they cannot be influenced through fiscal policy. In terms of investment expenditure, a four-year average is examined, which means that the rules allow an increase in investments during the year under review. Furthermore, the expenditure benchmark allows an increase in expenditure, provided that the increase is funded with a corresponding increase in revenue. Table 2 presents the ex-ante calculations for 2019 and 2020 in accordance with the expenditure benchmark. One-off measures have also been taken into account in the calculation of the expenditure benchmark as part of the overall assessment.

Table 2: Calculation under the expenditure benchmark

	2018	2019	2020
Expenditure benchmark items, EUR billion			
Total general government expenditure	124.4	127.7	132.4
– Debt interest payments	2.1	2.0	1.8
– Expenditure arising from EU programmes, fully compensated by income from EU funds	0.5	0.5	0.5
– Fixed capital (gross)	9.8	10.1	10.6
+ Average for fixed capital (four years)	8.9	9.4	9.9
– Cyclical changes in unemployment expenditure	0.4	0.1	0.0
+ One-off expenditure items	0	0	0
= Adjusted expenditure aggregate 1 (AEA 1)	**120.6**	**124.5**	**129.4**
– Expenditure financed with earmarked revenue	0.1	0.1	0.1
Effect of discretionary measures on revenue	–0.7	–0.4	0.4
One-off revenues	–0.2	0.2	0.0
– Effect of discretionary measures on revenue, incl. one-off revenues	–0.6	–0.7	0.6
= Adjusted expenditure aggregate 2 (AEA2)	**121.0**	**125.1**	**128.7**
Growth in general government expenditure			
Nominal growth in total spending (calculated in accordance with the expenditure benchmark), %	3.3	3.8	3.4
GDP deflator	1.2	1.6	1.9
Growth in total spending, calculated in accordance with the expenditure benchmark (real), %	2.0	2.1	1.5
Applied expenditure benchmark, NAOF's estimate, real	**1.1**	**1.3**	**-0.1**
Applied expenditure benchmark, NAOF's estimate, nominal	**2.3**	**2.9**	**1.9**
Deviation			
Difference between the growth rate under the expenditure benchmark and total spending (% units)	–0.9	–0.9	–1.6
Deviation, EUR billion	–1.1	–1.1	–1.9
GDP, EUR billion	234	242	249
Deviation, % relative to GDP	–0.5	–0.4	–0.8
Is the deviation significant (<–0.5)?	**No**	**No**	**Yes**
Cumulative deviation		–0.5	–0.6
Is the cumulative deviation significant (<–0.25)?		Yes	Yes

According to the calculations of the National Audit Office, the rate of growth of the total adjusted general government expenditure as referred to in the expenditure benchmark will exceed the limit set for it in both 2019 and 2020. According to the ex-ante assessment, a deviation from the expenditure benchmark will thus arise in both years. In 2020, the deviation from the expenditure benchmark will be significant according to the rules. The cumulative deviation in 2019–2020 will also exceed the limit set for a significant deviation. If the difference falls below –0.5 percentage points, the deviation from the expenditure benchmark is considered significant. If the difference falls below –0.25 percentage points on average per year in two consecutive years, the deviation is also considered significant.

The rate of growth of public expenditure exceeds the limit set by the rules

There is a risk of a significant deviation from the preventive arm in 2020

According to the ex-ante assessment of the National Audit Office, compliance with the structural balance rule will not be achieved in 2019, but the deviation will not be significant. Neither will the expenditure benchmark be complied with in 2019, but the deviation will not be significant in this case, either.

However, there is a risk that Finland fails to comply with the preventive arm of the EU Stability and Growth Pact in 2020. This is influenced, for example, by the launch of a one-off future-oriented investment programme in 2020 and the fact that the permanent increases in expenditure during the government term are front-loaded as compared with the increases in tax revenue, which will improve the structural balance.

Although there is uncertainty involved in the ex-ante assessments, the National Audit Office encourages the Government to pay attention to the risk of a significant deviation from the obligations set by the preventive arm of the Stability and Growth Pact. In the spring of 2021, the National Audit Office will make a final assessment of Finland's compliance with the Pact in 2020.

The final assessment of 2020 will be made in spring 2021

2.2 Finland will comply with the corrective arm of the Stability and Growth Pact in 2019 and 2020

The aim of the corrective arm of the Stability and Growth Pact is to ensure compliance with the deficit and debt criteria specified in the EU Treaty. According to the debt criterion, central government gross debt may not exceed 60 per cent of GDP. Correspondingly, according to the deficit criterion, the nominal deficit of general government shall not exceed 3 per cent of GDP.

According to the information published by Statistics Finland on 21 October 2019, the general government debt was 59 per cent of GDP in 2018, and the Ministry of Finance forecasts that the debt ratio will remain at around 59 per cent in 2019 and 2020. The debt ratio is expected to be below the 60 per cent reference value in the years under review. According to the ex-ante assessment, Finland will thus comply with the debt criterion during the years under review.

The ageing population automatically increases expenditure

According to the forecast by the Ministry of Finance, the debt ratio will start to grow in 2021, wherefore the reference value is expected to be exceeded. The debt ratio is forecast to exceed the reference value of 60% for example as a result of the Government's discretionary increases in expenditure and the automatic increases in expenditure related to the ageing population. The decided tax increases will not be sufficient to offset these. The debt ratio will be further increased by the funding of the fighter aircraft purchases, which is included in the general government spending limits.

According to Statistics Finland (21 October 2019), the general government deficit was 0.8 per cent of GDP in 2018, and the Ministry of Finance forecasts that it will grow to 1.4 per cent of GDP by 2020. During the period under review, the deficit will thus be clearly below the reference value of 3 per cent. However, in spring 2019, the Ministry of Finance still forecast that the general government finances would be in balance in 2020.

The deficit in the general government finances will be about 1 per cent of GDP. The fiscal position of local government deteriorated in 2018 as a result of the weak growth of tax revenue and the simultaneous increase in consumption expenditure. According to the forecast by the Ministry of Finance, the local government deficit will continue to grow in 2019, as the consumption expenditure has continued to grow rapidly. The fiscal position of local government is burdened by the increasing need for services and the constantly high level of investments.

	Structural balance	Expenditure benchmark	Deficit criterion	Debt criterion
2019	Risk of a deviation	Risk of a deviation	Compliance	Compliance
2020	Risk of a significant deviation	Risk of a significant deviation	Compliance	Compliance

Table 3: Preliminary assessment of the National Audit Office on compliance with the Stability and Growth Pact in 2019–2020

2.3 The central government spending limits have been complied with

The National Audit Office has gone through the numeric preparation of the supplementary budgets for 2019, the spending limits for the new parliamentary term, and the budget proposal for 2020. In the assessment, the National Audit Office ensured that the spending limits calculations of the Ministry of Finance had complied with the spending limits rule and principles laid down in the Government Programme.

There was a change of Government after the first supplementary budget for 2019. The second and third supplementary budget for 2019 were thus submitted during Prime Minister Antti Rinne's government term. When Rinne's Government took office, the unallocated reserve allowing leeway within the spending limits amounted to EUR 260 million. The Government decided to replace this remaining reserve with a new supplementary budget reserve of EUR 300 million. The change in the unallocated reserve within the spending limits raised the spending limits by EUR 40 million.

The new Government may adjust the spending limits for the election year

The spending limits procedure is based on a political commitment. The new Government may thus adjust the unallocated reserve within the spending limits during the election year.

According to observations made by the National Audit Office, the four-year spending limits for the parliamentary term 2020–2023 have been set in compliance with the spending limits rule of the Government Programme. Under the spending limits rule, the spending limits for 2023 will be EUR 1.4 billion higher, according to the price level of 2020, than in the so-called technical spending limits (4 April 2019). The spending limits for 2023 include an unallocated reserve of EUR 0.1 billion and a supplementary budget reserve of EUR 0.1 billion, which were not included in the technical spending limits. The spending limits for 2023, which is the last year of the parliamentary term, have been budgeted to be EUR 1.4 billion broader than the technical spending limits if the EUR 1 billion tax compensation to municipalities, decided during the previous parliamentary term, is not taken into account. Excluding the tax compensation can be considered justified, as the expenditure falling outside the spending limits will decrease by a similar amount, which means that the total of expenditure to be paid by taxpayers will not increase.

The National Audit Office has gone through the numeric deduction of the spending limits for the parliamentary term from the technical spending limits prepared by the previous Government. The spending limits for the parliamentary term have been set in compliance with the spending limits principles.

Table 4: Numeric monitoring of the spending limits figures from the technical spending limits to the spending limits for the parliamentary term 2020–2023

	2020	2021	2022	2023
Spending limits expenditure in the technical spending limits of 4 April 2019, EUR million	44,853	46,417	46,582	46,716
Reserves in the technical spending limits	0	0	0	0
Spending limits for the parliamentary term, 7 October 2019	47,778	50,329	49,915	48,706
Change in the spending limits for the parliamentary term compared with the technical spending limits	2,925	3,912	3,334	1,990
Spending limits expenditure of the parliamentary term, BP 2020 and GGFP 2021–2023 (source: MoF)	47,378	49,039	48,615	48,462
Change in the spending limits expenditure BP 2020 and GGFP 2021–2023 – technical spending limits	2,525	2,622	2,034	1,746
The remaining change from the technical spending limits to the spending limits of the parliamentary term	400	1,290	1,300	244
Reserves according to GGFP 2021–2023 (source: MoF)				
Supplementary budget reserve	300	300	300	100
Reserve for the funding of future-oriented investments	0	840	850	0
Unallocated reserve	100	150	150	144
Total reserves in the spending limits for the parliamentary term	400	1,290	1,300	244
Difference between the reserves reported in the spending limits for the parliamentary term and the remaining change from the technical spending limits to the spending limits of the parliamentary term as calculated by the NAOF	0	0	0	0

In addition to the traditional supplementary budget reserve and unallocated reserve, Prime Minister Antti Rinne's Government provided the spending limits with some leeway by a reserve for the funding of future-oriented investments. The use of the reserve will be decided in connection with the preparation of the budget proposal for 2021. The spending limits for 2021 and 2022 thus have considerably more leeway than those for the other two years.

In the spending limits procedure, the Government introduced a new reserve of a considerable amount for the funding of future-oriented investments

Statutory and contractual price index adjustments have been included in the spending limits in full unlike in the previous parliamentary term when index adjustments were mainly frozen. Because of the change in the price forecast, the price and cost-level adjustments for 2020 that are included in the final spending limits are, however, smaller than in the technical spending limits. The budget proposal for 2020 conforms to the spending limits of 2020, as they were both prepared at the same time.

Expenditure outside the spending limits

Cyclical expenditure, such as allowances related to unemployment and income security, fall outside the scope of the spending limits. Debt interest payments, compensation to municipalities arising from tax cuts, and expenditure generated by financial investments also fall outside the scope of the spending limits. Some of the expenditure items outside the spending limits are different types of pass-through items, which means that the budget has allocated revenue to offset the expenditure in question. Examples of pass-through items are expenditure corresponding to the revenue received from the EU and betting proceeds.

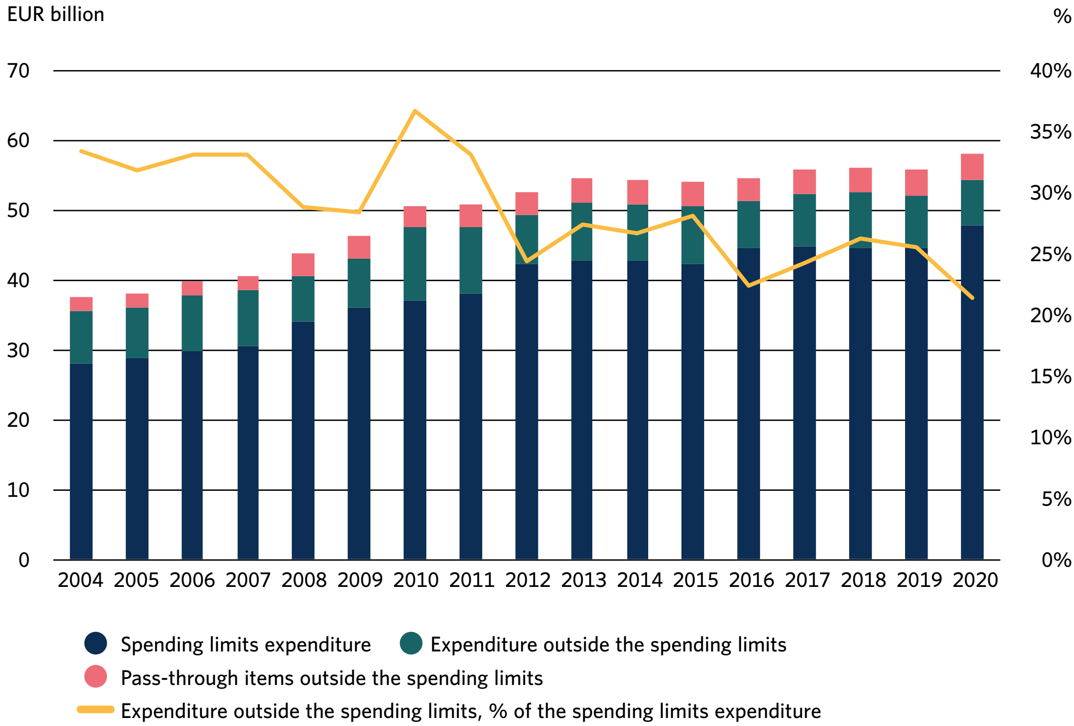

Figure 11: Development of expenditure outside the spending limits in 2004–2020, EUR billion. Source: Ministry of Finance

Cyclical expenditure has started to decrease in 2019 and 2020 in the case of all appropriations. However, the changes made to the justification of appropriations in different years make it more difficult to assess the extent to which the decrease is caused by the improved employment rate. Debt interest payments are also expected to decrease in 2019 and 2020. When the government term changes, the compensations paid to municipalities for tax cuts, EUR 1.012 billion, will be transferred to the scope of the spending limits. This is the most significant single factor that will reduce the expenditure falling outside the scope of the spending limits in 2020. The changes in tax revenue decided during Rinne's government term and the compensations paid for them to municipalities fall outside the scope of the spending limits until the government term changes. The total of financial investments in 2019 and 2020 is lower than in the previous years.

3 The General Government Fiscal Plan and the underlying forecasts of the Ministry of Finance

The targets set for general government finances in the General Government Fiscal Plan comply with legislation, and fiscal policy legislation has been complied with. However, the measures to be taken to achieve the targets have not been specified at this stage.

The GDP forecast of the Ministry of Finance for 2019 is among the highest forecasts, whereas the GDP growth forecasts of the Ministry for 2020 and 2021 are lower than the median forecast and the average. On the basis of the assessment, the economic forecast of the Ministry of Finance on which the General Government Fiscal Plan is based cannot be considered unrealistic as a whole in the sense referred to in legislation.

3.1 The General Government Fiscal Plan meets the statutory requirements in material respects

The Medium-Term Objective (MTO) set by the General Government Fiscal Plan for the general government structural balance relative to GDP, as referred to in Section 2 of the Fiscal Policy Act (869/2012), is 0.5 per cent. The objective complies with the minimum level of the Fiscal Compact. The General Government Fiscal Plan sets multi-annual objectives for the ratio between the general government fiscal position and GDP and, in addition, separate targets for the different sub-sectors of general government. These targets have been set in such a manner that the objective set for the structural fiscal position of general government will at least be achieved.

Based on the forecast, the structural balance will not reach the target in 2023

However, in light of the forecast by the Ministry of Finance, these fiscal position targets will not be achieved (see Figure 12). According to the forecast by the Ministry of Finance, the general government structural balance will be –1.4 % relative to GDP in 2023. This is 0.9 percentage points lower than the MTO set for the structural balance by the Government, which is also the minimum level set by the Fiscal Compact. The nominal fiscal position target set by the Government for 2023 is 0.0% of GDP. The forecast by the Ministry of Finance for the fiscal position in 2023 is –1.4% of GDP.

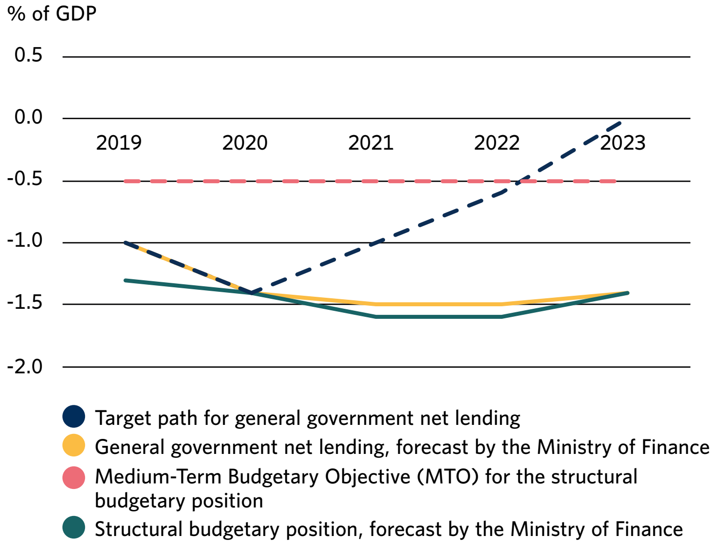

Figure 12: The fiscal position targets set by the Government and the forecasts by the Ministry of Finance. Source: Ministry of Finance, General Government Fiscal Plan 2020–2023

According to Section 3 of the Decree on the General Government Fiscal Plan (120/2014), the General Government Fiscal Plan shall include assessments of the key revenue and expenditure of general government and its sub-sectors both without legislative amendments and with the legislative amendments specified by the Government. Under the Decree, the Plan shall present the impact of both of these options on the medium-term structural fiscal position and long-term sustainability of general government finances. In addition, the General Government Fiscal Plan should specify the measures required for achieving the fiscal position targets and their estimated financial impact. The General Government Fiscal Plan has not yet specified these measures. This is partly explained by the fact that the government term has only just begun.

Central government measures have an almost neutral effect on local government finances

According to the forecast by the Ministry of Finance, the deficit of local government in 2023 will be EUR 3.1 billion, i.e. –1.2 per cent of GDP. According to Section 3 of the Decree on the General

Government Fiscal Plan (120/2014), the Plan shall set a cap in euros for the changes in local government expenditure caused by central government measures. This cap shall be in line with the target set for the fiscal position of local government. According to the target set for the fiscal position of local government, the deficit should be no more than 0.5 percentage points relative to GDP in 2023.

In its General Government Fiscal Plan, the Government has laid down that the net impact of its measures in 2023 will not increase the operating expenses of local government by more than EUR 520 million. However, the measures included in this expenditure limit and the change in the related government transfers and grants are estimated to have an almost neutral combined impact on local government finances. Thus, the total level of the expenditure limit will not bring local government closer to its fiscal position target; nor will it complicate the achievement of the target.

In material respects, the General Government Fiscal Plan meets the requirements set by the decree that regulates its contents. The Government has also set a medium-term objective for the structural general government fiscal position in compliance with the Fiscal Compact[8]. Based on the monitoring by the National Audit Office, the forecast practices of the Ministry of Finance have complied with the Fiscal Policy Act[9]. Thus, the Fiscal Policy Act has been complied with.

3.2 The forecast of the Ministry of Finance underlying the General Government Fiscal Plan does not differ significantly from other forecasts

Under the Fiscal Policy Act (869/2012) and the Budgetary Frameworks Directive (2011/85/EU), the Member States must ensure that the planning of their general government finances is based on realistic macroeconomic and fiscal forecasts. Under the Government Decree on the General Government Fiscal Plan (120/2014; as amended by Government Decree 601/2017), the Ministry of Finance shall, when preparing economic forecasts, also take into consideration the conclusions of the National Audit Office on the macroeconomic and fiscal forecasts.

The budget proposal and the General Government Fiscal Plan are based on the macroeconomic forecast and the assessment of medium-term and long-term economic growth produced by the Ministry of Finance. The Ministry of Finance projects GDP growth of 1.5 per cent for 2019, 1.0 per cent for 2020, and 0.9 per cent for 2021. The preparation of the spending limits last spring was based on estimated economic growth of 1.7, 1.4 and 1.2 per cent for the above years, respectively.

The fiscal planning of general government should be based on realistic forecasts

This autumn's forecast for 2019 is higher than the median forecast (1.3) or average (1.4) of the followed forecasters of the Finnish economy and among the highest forecasts. Of the forecasters followed, seven projected growth of at least 1.5 per cent for 2019, whereas thirteen projected growth of no more than 1.4 per cent. Taking into account the dates on which the latest forecasts of all forecasters were published, it also appears that the forecasts are becoming more downbeat over time.

GDP growth forecasts have deteriorated

Figure 13 shows the latest GDP forecasts for 2019 of the forecasters of the Finnish economy in relation to the date of issue. The middle line shows the linear trend of the forecasts (excl. the forecast by the Ministry of Finance), while the upper and lower lines illustrate the t-distributed 95% prediction interval. The figure illustrates the development of forecasts over time: more information and data updates from the National Accounts by Statistics Finland have been available for forecasts issued later. The forecasts issued closer to the end of the period are thus likely to be more accurate than those issued at the beginning of the period. In view of this, the GDP forecast issued by the Ministry of Finance for 2019 can be considered optimistic, as it is approximately at the same level as the upper limit of the 95% prediction interval at the time it was issued.

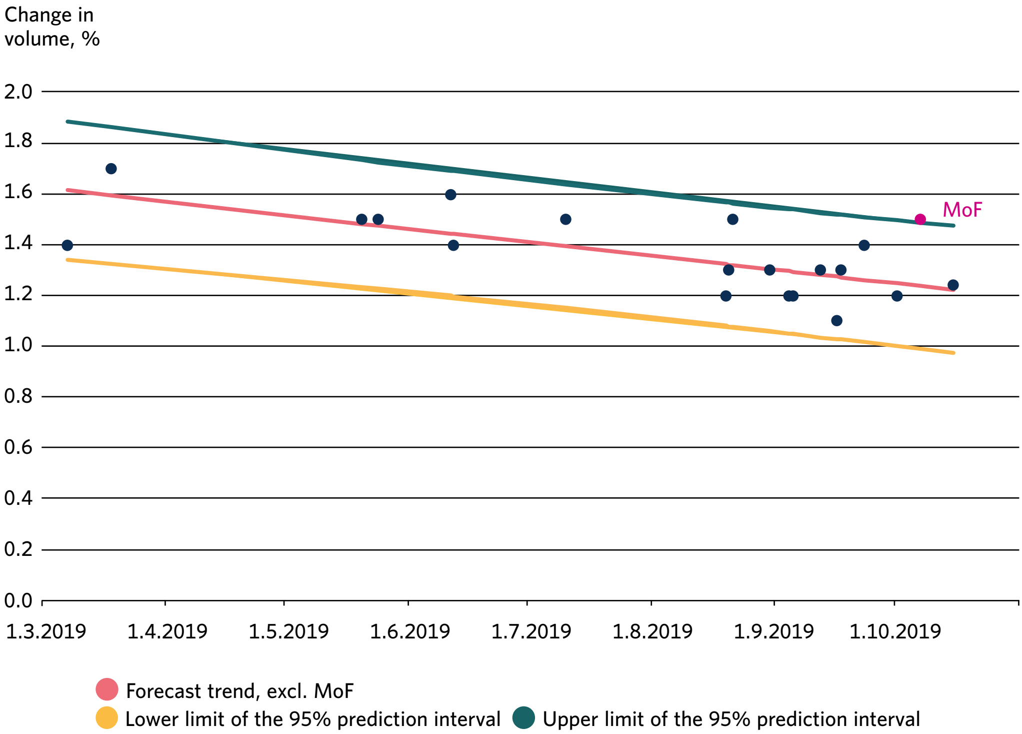

Figure 13: GDP forecasts for 2019. Source: Different forecasters, the NAOF

The GDP growth forecasts of the Ministry of Finance for 2020 and 2021 are, in turn, lower than the median forecast and the average and somewhat more conservative than the linear trend. They also fall within the 95% prediction interval of the linear trend based on the sample of forecasts. On the same basis, the other key figures in the forecast of the Ministry of Finance also fall within the prediction intervals with the exception of the forecast employment rate and consumer price index in 2021 and the forecasts private consumption in 2019 and 2020.

The employment rate forecast of the Ministry of Finance is more optimistic for all years than the linear trend of the other forecasts; however, it falls between the minimum and maximum of the other forecasts and within the prediction interval only in 2019 and 2020. The forecast of the Ministry of Finance is outside the prediction interval and higher than the maximum of the other forecasts only in 2021. However, it should be noted that the sample of forecasts is very limited, as there are only three forecasters for 2021 in addition to the Ministry of Finance. Moreover, the prediction interval is quite narrow, as the forecasts are very close to each other.

The economic forecast of the Ministry of Finance can be considered consistent: as a result of the optimistic employment rate forecast, the Ministry's forecast of private consumption is also higher than the calculated linear trend (and higher than the maximum of the other forecasts in 2021), and, in addition to driving the growth of export, it also seems to drive GDP growth. However, this proves that the relatively optimistic economic outlook of the Ministry is based on continuous improvement of the employment rate.

The employment rate forecast of the Ministry of Finance is in line with the forecast for private consumption

Compared with the other forecasters, the Ministry of Finance has a more pessimistic forecast of the general government fiscal balance. However, according to the forecast, the deficit will in any case remain lower than the three per cent reference value. The forecast of the Ministry of Finance for the general government gross debt (EDP debt) is close to the linear trend of the other forecasts and slightly more optimistic than it for 2021. In the trend projection of the Ministry of Finance, the general government gross debt will not exceed 60% of GDP until in 2022, whereas according to the linear trend of the other forecasts, this will take place as early as in 2021.

	GDP	Imports	Private consumption	Public consumption	Exports	Investments	Unemployment	Employment rate	Inflation	Current account	General government fiscal balance	General government gross debt
2018	1	2	1	2	2	2	2	2	2	2	1	2
2019	2	2	1	2	2	2	2	2	2	2	2	2
2020	2	2	1	2	2	1	2	0	0	1	1	2

2 The MoF forecast falls within the 95% prediction interval and the minimum-maximum interval

1 The MoF forecast falls outside the 95% prediction interval or the minimum-maximum interval

0 The MoF forecast falls outside the 95% prediction interval and the minimum-maximum interval

Figure 14: Realism of the MoF forecasts. Source: The NAOF's calculations based on forecasts

Figure 14 shows whether the Ministry of Finance (MoF) forecasts fall outside the minimum–maximum interval of the other forecasts and/or the 95% prediction interval of the linear trend. On the basis of the assessment, the forecast of the Ministry of Finance underlying the General Government Fiscal Plan cannot be considered unrealistic as referred to in legislation.

Medium-term projections make it easier to prepare fiscal policy

There are several natural reasons for deviations from the forecasts

The General Government Fiscal Plan is based on the medium-term projection of the Ministry of Finance on macroeconomics and the development of general government finances. According to an audit[10] completed by the National Audit Office in the autumn of 2019, the methods for drafting medium-term projections are, as a rule, appropriate. Based on the audit, the Ministry of Finance has included discretionary policy measures in its projection, following appropriate practices and in compliance with the guidelines issued by the EU Commission. There are several natural reasons for the rather big differences between the budget outturns and the original projections.

First, it is difficult to prepare even short-term projections, and the effects of deviations from the projections are multiplied in the longer term. Second, projections are adjusted because policy measures are decided and taken after the projections are made. For the above reasons, rather than providing an exact projection of the most likely development path, a medium-term projection makes it easier to prepare fiscal policy.

Based on the calculations made by the National Audit Office, the general government revenue accrued in the following four years has been overestimated as a rule. This is line with the fact that the real-time economic cycle has been underestimated as a rule. This has probably led to the overestimation of the medium-term economic growth, wherefore the revenue has been lower than expected. On the other hand, total expenditure has been overestimated as a rule. The projections of the fiscal balance of general government have therefore hit the mark fairly well during the past few years under review.

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