MINISTRY OF FINANCE

FISCAL POLICY RULES

and the Reform of Spending Limits in Finland

5b/2007

PUBLICATIONS

FISCAL POLICY RULES

and the Reform of Spending Limits in Finland

5b / 2007

MINISTRY OF FINANCE
BUDGET DEPARTMENT

PUBLICATIONS

MINISTRY OF FINANCE
Snellmaninkatu 1 A
P. O. Box 28
FI-00023 GOVERNMENT
FINLAND

Tel.
(09) 160 01

Fax
(09) 160 33123

Internet
www.vm.fi

Layout
Ministry of Finance/
Media and Communication Unit

ISSN 1459-3394
ISBN 978-951-804-706-6 (pdf)

HELSINKI 2007

FACT SHEET

Publisher and date	Ministry of Finance, February 2007		
Author (s)	Working group chairman Hannu Mäkinen Working group secretaries Taina Eckstein, Kati Jussila and Annika Klimenko		
Title of publication	Fiscal Policy Rules and the Reform of Spending Limits in Finland		
Parts of publication/ other versions released	The publication is available on Internet at our website www.vm.fi/julkaisut		
Keywords	Fiscal policy, spending limits budgeting, spending limits system		
Publications series and number	Publications, 5b/2007		
Indetifications	**ISSN** 1459-3394	**ISBN** 978-951-804-706-6 (pdf)	
	No. of pages 130	**Language** Enligsh	**Price** -
Sales distribution	The publication is available on Internet at our website www.vm.fi/julkaisut		
Printing place and year			
Abstract	The spending limits system has worked well in the main, but on the basis of experiences gained in the 2004-2007 spending limits period, certain changes are proposed in order to improve the system. The aim is to increase flexibility through various measures without compromising the fiscal policy impact of the system. The division of expenditure items into those excluded from the spending limits and those included should be reviewed to improve the functioning of the system. Changes are proposed to transport route construction funding and decision-making. The rule regarding revenue from sales of shares should be retained. Added external monitoring with sufficient expertise is considered important.		

Foreword

The reformed spending limits system for central government finances was introduced at the beginning of the 2003-2007 electoral period. On 1 June 2006, the Ministry of Finance appointed a working group to explore needs for developing the system further.

The working group was required to identify any points where the spending limits system for central government finances needed improvement and to submit a proposal for the spending limits system to be used in the 2007-2011 electoral period. The working group was required to use fiscal policy aspects as a basis for its work, with a view to the practical functioning of the system. The working group was further called on to review international material related to the subject and to assess any shortcomings noted in the spending limits system used in the 2003-2007 electoral period on the basis of experiences gained. The working group was to take into account the statements made by the Public Finance Committee on the spending limits system.

The working group was chaired by Hannu Mäkinen, General Director, Head of Budget Department, and its members were: Marja Paavonen, Financial Adviser; Tuomas Pöysti, Government Financial Controller (Director General as of 1 January 2007); Tuomas Sukselainen, Budget Counsellor; Arvi Suvanto, Financial Counsellor; Marko Synkkänen, Financial Counsellor; Helena Tarkka, Budget Counsellor; and Sami Yläoutinen, Financial Counsellor. Financial Advisers Taina Eckstein, Kati Jussila and Annika Klimenko were secretaries to the working group.

Experts consulted included the secretariat of the economic council of the Prime Minister’s Office, the Government Institute for Economic Research, the Labour Institute for Economic Research, a representative from the working group on the long-term approach in transport route decisions, the Bank of Finland and the Pellervo Economic Research Institute.

Chairman Hannu Mäkinen excluded himself from the working group’s discussion of the Slot Machine Association because of his vested interest.

Helsinki, 13 February 2007

Contents

SUMMARY OF THE WORKING GROUP PROPOSALS AND THEIR JUSTIFICATIONS

Is the spending limits system necessary?

The spending limits system has been in use in central government finances since 1991; its basis was reformed when the Government took office in 2003. The reform involved, for instance, excluding some central government expenditure from the spending limits and in turn including the supplementary budgets in the limits. The Government committed itself to adhere to the spending ceiling it had set for the whole electoral period.

The spending limits system as reformed in 2003 has served quite well. This success has partly been due to favourable conditions. However, the most significant factor is the political commitment of Parliament and the Government to stay within the set spending limits.

The spending limits system has produced good results. Even though central government revenue has increased by more than was estimated in 2003, this increase has not trickled through to growth in expenditure. Expenditure has been kept within the limits decided on in the Government Programme in 2003 in real terms. The rigid spending ceiling has been one factor causing central government finances to show a clear surplus in 2007, even though in 2003 the predictions indicated a considerable deficit.

International assessments and domestic experience indicate that for a successful fiscal policy it is more important to regulate the growth of expenditure than, for example, to try to balance central government finances. This is because expenditure that has grown excessively is very difficult to curb later.

The working group estimates that there is no reason for fundamentally overhauling the spending limits system but proposes several development measures.

The aim is to add flexibility to the spending limits system without compromising its general fiscal policy effect. On the other hand, the delimitation of expenditure excluded from and included in the spending limits should be adjusted to improve the functionality of the system.

Changes in the spending limits system to increase flexibility

To increase the flexibility of the spending limits system, the working group proposes the following changes, which will be described in more detail below:

- *a fixed annual provision of EUR 300 million for supplementary budgets (section 3.2)*
- *a provision increasing stagewise to EUR 300 million by the end of the electoral period for recognition of new expenditure (section 3.2)*
- *the option of allocating unbudgeted funds within the spending limits to the next budget year (section 3.2.1)*
- *the option of revising the overall spending limits level to reflect changes in the timing of expenditure (section 3.2.3)*
- *excluding real re-budgeting from the spending limits (section 3.2.3)*
- *systematic preparation of focus shifts in expenditure managed by the Government (section 3.1.3)*
- *excluding certain new items of expenditure from the spending limits (section 3.4)*

One of the problems of the past electoral period was the limited room for manoeuvre in the spending limits originating from the starting phase. This has been particularly highlighted in cases where **unforeseen or otherwise new expenditure needs** have arisen. That the spending limits were in fact adhered to successfully was due to a significant extent to favourable economic development and random factors, making it possible to offset unforeseen expenditure with unforeseen savings. However, the expectation is that under less favourable economic conditions there will mainly be disappointments, i.e. unforeseen expenditure that will break the spending limits unless there is room for manoeuvre within the spending limits.

To increase the flexibility of the system, the working group proposes that the expenditure amount to be decided for the future electoral period should not be wholly allocated but that part of the total should be reserved for future unforeseen needs or needs to be specified later. There could be two such provisions: firstly, a provision of EUR 300 million for supplementary budgets every year, as experiences during the last few years indicate that this should be enough to cover inevitable unforeseen extra expenditure; and secondly, a sufficiently large provision to be set aside for future recognition; again, recent experiences show that new expenditure that needs to be recognised can and will emerge during the electoral period. Because uncertainty concerning needs increases over time, the unallocated provision could be the smallest in the first year and increase gradually. The working group proposes that in the first spending limits decision of the electoral period an increasing provision, that could reach for instance the level of EUR 300 million by the end of the electoral period would be reserved in the overall spending limits; this provision would be available for future Government decisions. Naturally, expenditure decisions would gradually decrease this provision in the course of the electoral period.

To increase the flexibility of the spending limits system, the working group also proposes **the option of carrying over funds unbudgeted within the spending limits** to the following budget year. This also would remove the temptation to increase expenditure spuriously. On the other hand, what must be avoided is a snowball effect, which could arise if the savings accumulated within the spending limits over several budget years were suddenly used for extra expenditure all at once. It is very difficult to decrease expenditure once it has been increased. For this reason, the working group proposes that savings within the spending limits could only be allocated to the immediately following budget year and could be only used for one-off expenses, and that the maximum sum of such a transfer would be EUR 100 million.

The working group proposes that the **adjustment of the spending limits to changes in the timing of expenditure** be made more flexible. Especially expenditure related to the realisation of projects may be brought forward or pushed back from the schedule that was anticipated when the spending limits were set. In principle, it could be allowable to increase the overall spending limit in one budget year by the amount required due to the bringing forward of expenditure, provided that in a later year in the same spending limits period a corresponding decrease is made. The opposite should be the case when expenditure is pushed back. Timing adjustments should be used relatively rarely and only for significant changes, so that monitoring the spending limits is not compromised. Thus, the default approach is to fund any expenditure brought forward without adjusting the spending limits.

In the case of expenditure pushed back, a **re-budgeting** situation often emerges. Here, a new appropriation must be entered in the next budget for expenditure for which the appropriation in the previous budget was never used. This is a very common situation for instance with Structural Fund funding, where amounts are limited by a multi-annual fixed funding framework. The working group feels that if the first appropriation has not been specifically cancelled in a supplementary budget, it should be possible to budget the second appropriation without reference to the spending limits. It should not be allowed to happen that the same cost is deducted twice from the spending limits. However, in such situations the requirement is that the procedure genuinely involves the re-budgeting of the same expenditure and not, for example, a final account saving on an appropriation that is allocated annually anyway.

The working group further proposes that the practical flexibility of the spending limits system be increased by having **the Government review the needs and potential for the re-allocation of expenditure** within the set overall spending limits. What this means is that new items could be introduced by transferring funds from other items that are to be reduced or discontinued. This review could be based on initiatives made by the leaders of the governmental party groups with a view to structural reform or transfers across administrative branches within the set overall spending limits. The Prime Minister (the Prime Minister's Office) and the Minister of Finance (the Ministry of Finance) could take a more active role in opening up debate on the possibility for re-allocation. At the very least, they could call for a mid-term review of proposals for transfers between administrative branches or other focus shifts.

Finally, the working group proposes that **certain new expenditure be excluded from the spending limits.** The justifications for this are given later in this document. These new items are pay security expenditure, expenditure corresponding to totalisator betting revenue, VAT expenditure, technically transmitted payments and expenditure corresponding to external funding contributions.

Expenditure proposed to be excluded from the spending limits

The working group has estimated what kind of expenditure should be excluded from the spending limits from the point of view of steering fiscal policy, but has not ranked these items on the basis of acceptability or merit, since such evaluation must be based on political considerations and in any case should not affect the spending limits structure itself but only the distribution of expenditure within it.

In the past electoral period, there have been calls for certain expenditure to be excluded from the spending limits. The working group notes that in many cases this has happened because the body proposing this considers the expenditure item in question to be inadequately resourced and hopes that more funding would be forthcoming outside the strict spending limits. The working group stresses that this is no way to build a fiscally sustainable spending limits system. If an appropriation is considered inadequate in relation to the social significance of the item it is funding, then a political decision must be taken to increase the appropriation for that item at the expense of something else. In other words, the answer is in how to distribute expenditure within the spending limits, not in gradually dismantling the spending limits.

The working group considers that there is still a case for continuing to exclude most of the expenditure currently excluded from the spending limits.

Changes in expenditure that show counter-cyclical variation, i.e. automatic fiscal stabilisers (unemployment security, housing allowance, transfers to the Social Insurance Institution), have not been so dramatic that these expenditure could perhaps also have been included in the spending limits. This is due to a steady and favourable trend in economic growth and employment. However, the spending limits system is not designed for fair-weather conditions; it needs to be able to sustain considerable cyclical disruption too.

The central government's contribution to the Social Insurance Institution for covering expenditure under the Sickness Insurance Act is no longer dependent on cyclical fluctuations, following the amendment of the Act. The change in the central government's contribution no longer reflects changes in the solvency of those liable for insurance contributions; instead, these are buffered within the system, for instance by adjusting payment levels. The central government's contribution to switch-leave compensation is also excluded from the spending limits, even though this item too is independent of cyclical fluctuations.

In the past electoral period, a new appropriation was introduced into the central government contribution to social assistance expenditure. Central government is liable for 50% of social assistance expenditure, and changes to this item correlate closely with cyclical fluctuations. The appropriation adjusts to changes in expenditure with a delay of less than one year. Another expenditure item, which correlates closely with cyclical fluctuations is pay security, i.e. payments made by the central government to cover pay receivables on behalf of insolvent employers.

The working group proposes that automatic fiscal stabilisers (section 3.3) continue to be excluded from the spending limits.

The working group proposes that the central government's contribution to social assistance expenditure (section 3.4.5) and pay security expenditure (section 3.4.4) be excluded from the spending limits like other automatic fiscal stabilisers but that the central government's contribution to switch-leave compensation (section 3.3.2) and to the Social Insurance Institution for sickness insurance expenditure (section 3.3.1) be included in the spending limits. The expenditure impact of any changes to be made to the benefit criteria of the automatic fiscal stabilisers (e.g. adjustments to daily allowances) are not dependent on cyclical fluctuations and thus should continue to be included in the spending limits.

Excluding **debt interest payments** from the spending limits has been a successful solution from the point of view of fiscal policy in the past electoral period. Interest payments have decreased considerably because of falling interest rates. If interest expenditure had been included in the spending limits, the majority of this benefit would probably have been used up in increasing other expenditure. In the coming electoral period, interest rates are likely to rise rather than to fall, and accordingly debt interest payments are not expected to decrease even if the central government debt is reduced. The situation is thus different from what it was.

The relation of debt interest payments to the spending limits can be evaluated from a number of viewpoints. There are not necessarily any counter-cyclical economic policy grounds for excluding interest payments from the spending limits, since interest payments would be more likely to function as an automatic fiscal stabiliser within the spending limits rather than outside them, depending on the situation. However, interest expenditure could be a relatively unstable and unpredictable factor compared with the size of the unallocated reserve; but on the other hand, including interest expenditure in the spending limits would encourage reduction of the central government debt, i.e. achieving a surplus in central government finances.

The purpose of government debt servicing measures is to keep debt interest payments as low as possible over a period longer than the electoral period. Active market operations in government debt servicing may lead to spikes in interest expenditure, which are expected to be off-set by increased benefits in future years. Such spikes might cause a need for cuts in other expenditure within the spending limits, which in turn could create pressure towards re-evaluating the most economical policy of government debt servicing. If the spending limits were tight, there might be pressure towards changing government debt servicing policy so as to create momentary savings in interest expenditure at the expense of revenue in future years. This aspect is an argument for the exclusion of interest expenditure from the spending limits. Discretionary leeway also allows for focusing on the continuity of the system, which also is an argument for continuing to exclude interest expenditure from the spending limits.

The working group considers that debt interest payments should remain excluded from the spending limits. (section 3.3.4)

Compensations to other tax recipients for tax changes decided by the central government (section 3.3.5) should remain excluded from the spending limits so that the expenditure impact of tax changes does not skew tax-policy consideration.

From the point of view of central government finances, it makes no difference whether a tax cut is made directly, reducing the central government tax revenue, or in municipal taxation with the municipalities being compensated for the tax loss. A closely related case is that of repercussions of changes in social security fees (i.e. changes in the tax base) on transfers paid by the central government to the Social Insurance Institution, which would also remain excluded from the spending limits.

It is proposed that expenditure corresponding to the revenues from betting and the lottery and from the Slot Machine Association remain excluded from the spending limits.

This is revenue generated by voluntary gaming activities undertaken by citizens. The purposes for which this revenue may be used are delineated by law. As far as fiscal policy is concerned, there is no great interest in restricting this expenditure, i.e. in restricting gaming. On the other hand, if expenditure financed with gaming revenues were to be brought under the principle of universality, it would form part of the spending limits in the normal manner and reduce flexibility within them. In the opposite case, more flexibility for other expenditure would be created within the spending limits. The proposal of the working group follows the current practice, which is logical in terms of fiscal policy. (section 3.3.6)

The working group proposes that the expenditure corresponding to totalisator betting revenue be added to this group. (section 3.4.3)

It is proposed that financial investment expenditure should remain excluded from the spending limits.

In practice, the latter involves central government stock investments or lending. In both cases, central government retains, at least in principle, a receivable at least equal in value to the investment made; this receivable may increase or decrease as its value changes. Financial investments represent a conversion of central government assets to a different form and not final expenditure as such. Financial investments can be re-converted to their prior monetary form. Therefore there is no fiscal policy case for restricting them as there is for restricting actual expenditure. (section 3.3.7)

In addition to the pay security expenditure mentioned above, the working group proposes that certain new items be excluded from the spending limits. These are technically transmitted payments (section 3.4.3), appropriations corresponding to external funding contributions (section 3.4.2) and appropriations allocated to VAT expenditure (section 3.4.1).

These involve situations where the central government serves as an intermediary, receiving full compensation — either in advance or after the fact — for a payment which it makes on behalf of another party. An example is the pension expenditure paid by the central government on behalf of other pension institutions on the last institution principle, for which the central government is fully compensated by those pension institutions. Other similar situations arise in jointly funded projects or functions, where the central government receives funding contributions from other parties (e.g. municipalities in transport route projects) and then pays the entire expenditure. There is already an item like this outside the spending limits: expenditure corresponding to revenue from the EU. From a fiscal policy point of view, such financial throughput or external funding contributions should not be capped. Actual central government expenditure in any given project (i.e. central government funding contributions) is as normal included in the spending limits. In some expenditure items in the central government budget, external funding is included as net budgeting, meaning that there is no corresponding appropriation, and thus they do not need to be excluded from the spending limits.

If the expenditure proposed to be excluded from the spending limits is minimal and forms part of a larger budget item, there is no practical management reason to exclude it. Fiscal policy does not require detailed classification; a judicious amount of leeway adds to the transparency of the system.

The central government also incurs VAT expenditure on the purchase of goods and services. There is an appropriation for VAT expenditure under each main title of expenditure. VAT expenditure can also come under certain other items, for example when current expenditure is budgeted under a transfer item. From the point of view of central government finances, it is not necessary to restrict VAT expenditure as such, since corresponding revenue exists in the same budget. The inclusion of VAT in the spending limits may skew the choices a government agency makes between in-house work and purchased services, since the former does not involve VAT expenditure. For these reasons, the working group proposes that VAT expenditure be excluded from the spending limits, though the proportion of purchasing expenditure that is not VAT would remain within the spending limits. For practical manageability, only VAT expenditure budgeted under a separate, centralized VAT item should be excluded from the spending limits.

Transport route construction expenditure in the spending limits

In the past electoral period, the relationship of transport route investments to the spending limits has been much discussed. This issue has often featured in the statements of the Finance Committee of Parliament. There seem to be two main problems in transport route construction: inadequate financing or an inadequate number of projects; and the instability or uneven pacing of construction (section 3.5).

The working group considers that the major cause of the first problem is that when the Government Programme was drawn up in 2003, distinctly too little money was reserved for transport route construction compared with actual construction pressures in society. When the new Government Programme is drawn up, the resources allocated to transport route construction should be considered so carefully that there is no acute shortfall. On the other hand, the working group does not think that the issue of inadequate funding should be resolved by changing the structure of the spending limits in violation of their basic principles. Excluding transport route investments from the spending limits has been justified on the basis of their substantial impact they will have on future economic growth potential. However, if this is used as a criterion for classifying expenditure, there are many other candidates for exclusion from the spending limits, such as some R&D expenditure and education and training expenditure (investments in human capital).

From a fiscal policy point of view, excluding expenditure items from the spending limits because of their assumed benefits is a slippery slope. This approach would mean that only expenditure of lesser social importance would remain within the spending limits. This is very much a value-based choice, and it should first be agreed whether immediate or future benefits are the more important, and how future benefits are to be evaluated. Fundamental deliberation of this kind is the job of the political process, and decisions should focus on the allocation of expenditure, not the structure of the spending limits themselves.

The working group proposes that transport route construction expenditure be kept within the spending limits.

However, the working group proposes several changes in the decision-making concerning transport route construction. The following decisions should be taken immediately at the beginning of the electoral period, for instance in the Government Programme or in connection with it:

- *projects to be begun in the electoral period or included in the budget,*
- *procedure when a decision is made on exceptional additional projects or major changes,*
- *sufficient scaling of appropriations for basic road maintenance and basic track maintenance in the overall spending limits,*
- *commitment to aim to achieve evenness in the pacing of construction,*
- *procedure in case of excessive rise in costs, and*
- *ceiling for building costs from projects agreed to be begun and which incur in future electoral periods.*

The working group considers that it would be advantageous for an estimate of all planned projects and their cost estimates for a period of 10 to 15 years to be available when decisions are being made in the Government Programme and thereafter.

Many of the problems involved in traffic route construction in the past electoral period are being essentially mitigated, since the number of projects and the requirement for funding that have already been decided for the next electoral period are exceptionally high. Whereas the average annual expenditure for road and rail projects was EUR 197 million in the past electoral period, corresponding amounts in 2008 and 2009 are at least EUR 460 million and EUR 521 million due to decisions already made. The expenditure already allocated for 2010 and 2011 are high, but allow more potential for starting new projects.

In addition to the financing of transport route projects, particular attention has been paid to ensuring adequate appropriations for basic road maintenance and basic track maintenance. **When the new Government takes office, it will have the opportunity to scale these appropriation reserves properly this time in relation to other needs.**

A new problem arising from large volumes of construction is the exacerbation of resource bottlenecks and rising costs, symptoms of which are already visible. Another obvious problem is the uneven timing of construction and the repeated, random and disjointed nature of decision-making situations that has partly contributed to it.

The working group ended up looking for solutions which would have an impact on the perceived disadvantages or risks but would not unnecessarily complicate the spending limits system. The working group abandoned the idea of governing infrastructure expenditure within the spending limits with cost ranges, rolling maximums, authorisation limits or other additional restrictions that would probably make proceedings unduly rigid without sufficient corresponding benefits.

The principal decisions of the new Government are taken in the Government Programme. This should include transport route projects, where needs and expenditure are known years ahead. **The working group recommends that all projects that are to be started or for which authorisations are to be made during the electoral period should be listed in the Government Programme on the basis of comprehensive information obtained on the overall situation in transport route construction. If the Government, in addition to this, should want to decide on an additional project during the electoral period, it should first take a thorough look at the costs of projects decided on earlier and of other transport route construction and their timing, the capacity situation in the sector and price trends.** This procedure could prevent sudden random decisions being made without reference to how such an additional project is related to other construction. It would further ensure the attainment of a result that is justified and appropriate with a view to the use of resources that **the Government make a commitment in the Government Programme to the basic aim of evenly paced infrastructure construction.**

When construction capacity limits are reached, prices can rise. In order to curb this, it should be specified in the Government Programme at what point and how the Government will react to costs rising above an acceptable limit. **One possibility would be to note that if the cost of earthwork is anticipated to increase substantially due to a high capacity utilisation rate, the Government will decide to postpone project starts and other transport route construction.**

It would be advantageous for long-term decision-making that a vision of the projects planned for implementation over the next 10 to 15 years was available when negotiating the Government Programme. The statement of the ministerial working group that dealt with the transport policy outlines of the past Government for 2004-2013 could be used as a basis for this. However, it is not necessary to commit to a specific long-term project list. Indeed, any direct comment by the Government on them would be tantamount to meddling in choices to be made in future electoral periods.

Nevertheless, there is already a dangerous trend towards Parliament and Government effectively deciding the major infrastructure projects of the next electoral period. This is not a positive development, because it decreases the room for manoeuvre of fiscal policy. Every Government should be able to exert maximum influence on the volume of construction to be undertaken during its term of office. **The working group thus recommends that in the Government Programme a ceiling for construction expenditure in future electoral periods that is incurred due to projects that are agreed to start under the present Government would be determined.** This limitation would also cover projects on which political agreement has been reached but which have not yet been formally budgeted for, but which are publicly announced and which therefore in practice are binding on future Governments. The limitation could be defined as applying only to actual construction costs, so that projects to be implemented on construction-time funding and secondary funding would be treated equitably.

In a spending limits system spanning an entire electoral period, secondary-funding projects (lifespan projects) have a clear advantage over projects with construction-time funding, because the former have a much lesser impact on the spending limits as the major proportion of their expenditure is postponed beyond the electoral period. On the other hand, the overall costs of secondary-funding projects are always much higher than projects with construction-time funding in the calculations, mostly because the financial costs of the builder are included in the overall cost of secondary-funding projects. However, it would be important to estimate the cost impact of construction commitments without regard to how they are financed. The proposed ceiling on construction expenditure committed for future electoral periods combined with the spending limits system spanning the electoral period would help this.

By contrast, the working group does not consider it justified in the spending limits system to switch to expenditure-based cost accounting in projects differing from the basis of budgeting, which would substantially improve the status of infrastructure projects with regard to other expenditure items. Such a change could, in the long term, skew the use of public resources in favour of infrastructure construction at the cost of other expenditure or increase the funding burden on the decreasing labour force over and above the increasing burden already known.

Price adjustment to the spending limits

In the 2003-2007 electoral period, the spending limits system has been fixed in real prices. The alternative would be to have the spending limits evaluated in nominal prices, in which case the system would include an annual adjustment equal to the predicted cost trends. Nominal price evaluation would make the system more transparent, because no price adjustments would need to be made to it during the electoral period. A nominal spending limits system would also by its nature be counter-cyclical. If costs were to rise more rapidly than predicted, the system would become tighter, and the opposite would also be true (section 3.1.1).

Spending limits in nominal prices would allow the increasing of expenditure if inflation were to progress at a slower rate than expected. This could lead to a permanent increase in expenditure. Reducing expenditure, which in practice takes the form of 'cutting costs' (in discretionary spending, in practice), could be difficult to accept if caused by inflation progressing at a faster rate than expected. Criticism might be voiced at the accuracy of the predictions, and the reduction of expenditure for a reason such as this would not be seen as legitimate. Also, price predictions would also need to allow for future wage agreements. The net effect might be that price predictions and those who make them could acquire a far too dramatic role.

The real price spending limits system is adjusted every year during the electoral period according to changes in prices. This system is the best guarantee of the level of resource use which was originally intended.

The working group has thus concluded that the spending limits system should continue to be set in real terms.

The working group has studied various price adjustment mechanisms. Adjustments could be made for instance according to the consumer price index, the GDP price index, or an applied consumer spending and gross capital formation price index.

However, the working group considers it justified that the price adjustment should be neutral from the point of view of the distribution of expenditure, which is best guaranteed by the central government price index currently used.

The effect of a rise in prices exceeding the price development of the GDP can be taken into account once every four years when setting the level of the spending limits.

Revenue from sales of shares and tax revenue

In years when revenue from sales of shares has exceeded EUR 500 million, a maximum of 20% of the excess amount has been made available for one-off expenditure. The Government decided in the middle of the electoral period to increase this maximum from its original 10% to 20%, hence sales of large blocks of Government-owned shares enable a sudden spike in spending. This does not seem feasible, as it may lead to expenditure being decided upon more casually than would otherwise be the case. Such a windfall could contribute, for instance, to infrastructure projects accumulating towards the end of the electoral period if revenue from sales of shares were used to finance only the starts of such projects. Indeed, there is no fiscal policy case for having such a rule regarding revenue from sales of shares; the most feasible use for such revenue would be to pay off central government debt. After all, selling shares only amounts to converting assets into another form. Using revenue from sales for any other purpose than paying off debt decreases the Government's assets. Sales of shares also decrease revenue from dividends, which should be taken into account in the rule regarding revenue from sales of shares. Nevertheless, there is still considerable pressure for additional expenditure from the revenue incurred by selling off Government-owned shares,

The working group therefore considers it justifiable to keep the rule regarding revenue from sales of shares in force but to return the maximum limit to 10% of the amount exceeding EUR 500 million instead of 20% (section 3.6.2).

The rule can be used to ensure the transparency of procedure in cases where shares are sold. Without the rule, each such transaction would be subject to pressure from actual needs for expenditure, and it would not necessarily be an easy task to manage the situation with a view to the spending limits. The rule guarantees that the majority of revenue from sales of shares in any case will be used towards paying off central government debt. A lower debt level translates into flexibility for new expenditure through the related reduction in interest expenditure.

A similar rule could in principle apply to tax revenue whenever that revenue exceeds expectations. However, in this case such a rule would work in tandem with the economic cycle and could lead to permanent increases in expenditure. The strength of the current system has been that expenditure is independent of tax revenue trends, which has contributed to the central government finances showing a surplus — which is crucial for sustainable development — instead of the deficit trend predicted four years ago.

The working group does not propose that expenditure be linked to tax revenue development in the spending limits period (section 3.6.3).

Tax subsidies

It is sometimes proposed that subsidies granted through taxation, i.e. tax subsidies, should come under the spending limits system just like expenditure. In many cases, subsidies can be provided as tax subsidies instead of a comparable appropriation (section 3.6.1).

The working group has evaluated the potential for including tax subsidies in the spending limits and has concluded that this would represent a jump too difficult to make. Firstly, it should be unambiguously established which provisions in tax legislation constitute tax subsidies. Secondly, it should be assessed whether the scaling of all such subsidies should indeed be covered by the spending limits. Different tax subsidies have different justifications against which the need for including them in the spending limits should be evaluated. If there were to be a system for regulating tax subsidies, solid taxation expertise would need to be involved in the preparation work.

Tax subsidies could not relevantly be considered as expenditure under the spending limits system, because tax subsidies are always statutory, and their level cannot be changed by budget decisions. If any existing tax subsidies were to be included in the spending limits system, they could in some cases exceed the spending limits. Dismantling such a situation would require a legislative amendment. On the other hand, if the spending limits system were only to include any new tax subsidies, it would have to be possible to estimate their impact on central government revenue reliably in advance. However, new tax subsidies are often very sensitive to assumptions regarding behavioural and other properties, and any such impact assessments are uncertain.

Tax subsidies form a part of taxation policy, i.e. they constitute a policy statement regarding the focusing of the tax burden. The fiscal effect of tax subsidies can be neutralized by adjusting the rates of various taxes. This issue could thus be viewed as involving the focusing of a specific tax burden, and accordingly the spending limits system could not consider just tax subsidies separately; the entire taxation structure should be taken into consideration. In expenditure too, the spending limits system would involve not only the tax subsidies themselves but also other expenditure which can change flexibly when the subsidies change.

The existence of spending limits may cause certain subsidies to be planned for inclusion in the tax system. There are examples of this in certain countries. In Finland in the past electoral period, there has been no evidence of tax subsidies enacted because of the spending limits system. Although some subsidies have been enacted as part of the tax procedure, these subsidies have been included in the spending limits or, in the case of subsidies to employers, they have been specifically declared an exception to the rules of the spending limits system. What is important is that tax subsidies should not be increased just to avoid the limitations of the spending limits. Indeed, it is vital for the integrity of the spending limits system that it is not circumvented through increased tax subsidies.

The working group does not propose that tax subsidies be included on the expenditure side of the spending limits system. Instead, the working group proposes that the next Government commit itself to not introducing new tax subsidies for the purpose of circumventing the spending limits. The working group considers the follow-up of the effects of tax subsidies, regular evaluation and reporting in relevant publications to be useful.

The deficit rule

There has been a rule in the central government spending limits decision whereby the Government will not allow the deficit in central government finances, measured by national accounting principles, to exceed 2.75% of GDP even when the economy is weak. If predictions show that the deficit threatens to exceed this limit, the Government is committed to perform necessary reductions in expenditure immediately and to take any other action required to avoid exceeding the limit. Because the national economy and central government finances have developed very positively in recent years, the deficit rule has not even been close to being invoked. This was, of course, the goal, and the situation will remain the same in the future. However, the deficit rule does have the effect of stabilizing the financial environment, because it defines in advance what must be done if a vicious circle is in danger of forming. The spending limits system only covers part of central government expenditure, but the deficit rule covers all expenditure with the exception of financial investment. When the rule is followed, the increase in automatic fiscal stabilizers under conditions of weak economic growth cannot lead to a deep deficit. Therefore, not even the expenditure excluded from the spending limits can grow unchecked without balancing measures being taken.

The working group considers it necessary for the deficit rule to be retained and included in the Government's fiscal policy outlines.

External evaluation of the implementation of the spending limits

An external, independent monitoring of the implementation of the spending limits could strengthen their credibility. At present, monitoring is almost solely the responsibility of the Ministry of Finance, which prepares the spending limits decisions and budget proposals. There is a danger of tendentious presentation here. Other countries have various fiscal policy monitoring bodies independent of their parliament and government. Finland has no such body dedicated to fiscal policy issues (section 3.7).

Certain international bodies regularly monitor how Finland's central government finances are run and draw up evaluation reports based on their observations. These bodies are also well placed to compare Finland's performance with that of other countries.

In Finland, there are no formal sanctions for exceeding the spending limits; instead, sanctions can be seen in the form of eroded confidence and declining economic development. Political sanctions through the opposition in Parliament and through the media are also important. But for this mechanism to operate, absolutely correct information on how the spending limits are being realized must be available.

However, domestic external evaluation is only useful if it is backed by solid expertise. Shortcomings in expertise could easily lead to erroneous statements, which would cause confusion, unfounded mistrust in the functioning of the spending limits system, and possibly even unnecessary measures. Attaining sufficient expertise would require a conscious study of central government finances down to the finest details. Keeping up to date with these matters outside the Ministry of Finance is a major challenge. The Ministry of Finance has aimed at being comprehensive and transparent in explaining any technical adjustments to the spending limits and the impact of those decisions in the General Strategy and Outlook part of the budget proposal and in the spending limits decisions, together with their published background memoranda. More information and advice in how to interpret it is available as required.

The working group considers that the Ministry of Finance should aim to provide more illustrative and open information in order to increase the transparency of the spending limits system and its implementation. The working group takes a positive view on external, independent evaluation of the implementation of the spending limits, provided that a sufficient level of expertise is ensured. In the absence of external evaluation, the working group considers it desirable for the political leadership consciously to abstain from influencing the technical evaluation of the implementation of the spending limits.

Other issues discussed by the working group

The working group also discussed certain ideas on how to change the spending limits system which on careful consideration it could not recommend. These were the following:

Using final accounts savings to increase the spending limits (section 3.2.2)

In the final accounts, the actual expenditure usually falls short of the budgeted expenditure by several hundreds of millions of euros. This is a familiar phenomenon and is a natural feature of budgeting on the one hand and its realisation and the management of finances on the other. In recent years, the amount of financial accounts savings has been declining due to active measures undertaken specifically to achieve this. If final accounts savings were used to increase the spending limits, this should be taken into account as a reduction factor in setting the starting level of the spending limits. Otherwise, fiscal policy would grow looser. Also, the amount of final accounts savings may fluctuate unpredictably from one year to the next. It would become more difficult to control expenditure if budgeted expenditure were allowed to fluctuate in a similarly random fashion.

The working group does not consider it appropriate to use final accounts savings to adjust the spending limits.

Mid-term re-evaluation of the overall spending limits (section 3.1.3)

Before the year 2003, the level of the spending limits was re-evaluated annually. The previous spending limits decision was not binding on the next in terms of overall expenditure. In some cases, expenditure decreased (in certain years when savings decision were taken), but in general, expenditure increased from one spending limits decision to the next (particularly in the 2000s). Both foreign and domestic experts criticized the instability of the system, because its expenditure limit commitment did not extend beyond (and sometimes not even to) one year.

One reason for the positive overall economic effects achieved in the past electoral period is that the spending limits have in real terms remained at the same level for the entire four-year period. If the overall spending limits were to be re-evaluated in mid-term, this would undoubtedly mean an increase in the spending limits, i.e. an increase in expenditure in the long term. This would represent a major step backward from the stability achieved. It is possible that in such a system, the increases in expenditure outlined at the beginning of the electoral period might be somewhat less, as a re-evaluation would be coming up in two years. However, the working group considers that this lessening effect would be more than offset by the increase in expenditure in the mid-term re-evaluation.

If estimates for a sustainable level of expenditure are to be made on the basis of overall economic development and tax revenue, a two-year period is too short for reliable trend predictions. A four-year period is better suited for estimating overall expenditure, because it is closer to the period of economical cycles. Also, because of the ageing of the population, a long-term approach is justified in determining the expenditure level.

Leaving the provisions proposed above by the working group within the spending limits will make it possible to respond to new needs. If a sufficiently large amount is left unallocated in the spending limits, new expenditure decisions can be made in the middle of the electoral period just as if there had been a mid-term re-evaluation.

The working group considers that setting the level of the spending limits every four years is the best safeguard of the positive impacts of the system on expenditure management: a long-term approach and credibility.

Certain expenditure corresponding to payments (section 3.4.3)

In the main title of the Ministry of Agriculture and Forestry there are certain appropriations that have statutory corresponding revenue in certain fees. They are:

- 30.40.25 obligation to manage fish stocks (riparian fishery fees);
- 30.40.41 compensation for damage caused by deer (deer hunting permit fees);
- 30.40.50 promotion of hunting and game management (game management fees);
- 30.40.51 promotion of the fishing industry (fishery fees);
- 30.40.52 Tenojoki fishing licence fees and lure fishing fees (Tenojoki fishing licence fees).

The fact that revenue is earmarked by law for specific purposes is not in itself a sustainable argument in fiscal policy terms for excluding an appropriation from the spending limits. If the revenue consists of a tax, earmarking it for specific expenditure is problematic for fiscal policy, because it erodes the efficient focusing of revenue raised by the tax burden. Such revenue either restricts the flexibility of other taxation or alternatively increases the tax rate, which has a disincentive effect. Some items of expenditure cannot be treated with greater laxity than others on the basis that they are funded from earmarked tax revenue rather than from tax revenue in general.

For the three middle items in the list, the corresponding revenue — the deer hunting permit fees, the game management fees and the fishery fees — is included in the tax rate. Tax-like fees and corresponding expenditure are also found in the areas of transport and environmental protection (see class 11.19 of the budget).

Expenditure covered with corresponding earmarked tax revenue should not be excluded from the spending limits.

The appropriations can also in part be higher than the statutory tax revenue. The other two payments on the list — the riparian fishery fees and the Tenojoki fishing licence fees — are not taxes, so from this viewpoint there would be no obstacle for excluding the corresponding expenditure from the spending limits. However, the working group does not propose this, because these appropriations are relatively stable and total only about EUR 5 million. The spending limits system must be simple enough and transparent enough.

Excluding the mentioned items from the spending limits would unduly complicate the system without a fiscal policy advantage being gained.

Externally determined items (section 3.4.6)

Certain substantial items of expenditure are beyond the control of decision-makers. Although in theory all expenditure can be affected, through the procedure for the enactment of constitutional legislation if nothing else, in practice some such items are of such a nature that it is almost impossible or very difficult to affect them. One such item is the EU membership fee. It has also been proposed that development cooperation expenditure constitutes such an item because of international commitments and that it should thus be excluded from the spending limits. Actually, the scaling of development cooperation expenditure is largely discretionary. There are many expenditure items where the scope for influence is much more restricted, such as many international membership fees, some nationally funded EU expenditure, transfers to Åland, constitutionally enacted expenditure (e.g. benefits and pensions covered by basic security), the bulk of the operating expenses of the key government agencies, and so on.

The working group has decided not to propose excluding any item of expenditure from the spending limits simply because it cannot be influenced.

If this criterion were accepted, it would precipitate a difficult classification task, and the spending limits would probably be much reduced. The working group considers that such expenditure should continue to be included in the spending limits, because ultimately they are funded out of tax revenue. Therefore, if they increase, they should affect the level of other discretionary expenditure within the limits of the chosen tax rate and other resource limitations.

FISCAL POLICY DRAFT

To illustrate its proposals, the working group has summarized them in the form of an imaginary Government Programme text based on the fiscal policy outline of the previous Government Programme. The fiscal policy outline for the next electoral period might look like this:

” To secure the sustainability of the general government finances, the target is to maintain a surplus in the central government finances in national accounting terms throughout the electoral period, the surplus being on average X% of GDP. Another target is to help achieve a surplus in local government finances throughout the electoral period.

(Tax policy target-setting / eventual tax cuts and their scaling)

The spending limits system of the central government finances used in the previous electoral period will be adopted in a revised form. The fiscal policy outline aiming at a healthy surplus in central government finances calls for great restraint in increasing expenditure. The previous spending limits decision showed that the increase in expenditure over the current year would be about EUR xx million in 2008 and about EUR yy million in 2011. New measures will be implemented during the new electoral period so that the change in the spending limits in 2011 will be EUR zz million in total compared with the spending limits decision confirmed on 1 March 2007. EUR 300 million per annum will be reserved in the overall spending limits for supplementary budget proposals. Also, in a spending limits decision to be made in May 2007, a provision to be increased stagewise to EUR 300 million by 2011 will be reserved for unforeseen new needs.

The Government is committed to following the spending rules it has set and the first spending limits decision based on them. Measures entered in the Government Programme will be implemented insofar as it is possible within the framework of the spending limits decision. The Government will not introduce tax subsidies to circumvent the spending limits. The Government will review annually the need for changing focus in expenditure, for example through structural reform or cross-branch transfers, on the basis of submissions from the leaders of governmental party groups.

The overall level of the spending limits will be adjusted annually only for price level or for changes in the structure of the budget. The spending limits decision will enable a more flexible procedure for adapting to changes in the timing of expenditure and for re-budgeting expenditure.

Compared with the spending limits system used in the last electoral period, the following will be excluded from the spending limits: pay security expenditure, the central government contribution to social assistance expenditure, appropriations for VAT expenditure and expenditure corresponding to technically transmitted payments and external funding contributions. The central government's contribution to the sickness insurance expenditure incurred by the Social Insurance Institution and the central government's contribution to switch-leave compensation are currently excluded from the spending limits but will now be included in them.

In summary, the following items are excluded from the spending limits:

- unemployment security, the central government contribution to expenditure incurred by the Social Insurance Institution under the National Pensions Act, the central government's contribution to social assistance, pay security and housing allowances (however, expenditure caused by changes in the basis of these items will be included in the spending limits),
- debt interest payments,
- eventual compensation to other tax recipients for tax changes decided by the central government,
- changes in the transfers paid to the Social Insurance Institution caused by changes in social security contributions,
- expenditure corresponding to technically transmitted payments and external funding contributions,
- expenditure corresponding to the revenue from betting and lottery, totalisator betting and the transferred earnings of the Slot Machine Association,
- financial investment expenditure,
- appropriations for VAT expenditure.

Decision-making concerning transport route construction will be improved. the transport policy section of the Government Programme lists the projects that will be started or entered in the central government budget in this electoral period. If there are additional needs to decide on other projects or expansions, the Government will first review a comprehensive report on the overall transport route construction situation before taking a decision. The aim is to keep transport route construction and its funding stable every year. If costs for civil engineering works are anticipated to increase substantially because of a high capacity utilisation rate, project starts and other transport route construction will be postponed. The cost impact on future electoral periods of transport route projects decided on during this electoral period will amount to no more than EUR Z million.

The joint basic public services programme of central and local government and the basic public services budget will be taken into account in the spending limits decision.

If the annual revenue from the sales of shares exceeds EUR 500 million, a maximum of 10% of the excess can be used for one-off expenditure without reference to the spending limits.

If total annual expenditure falls below that specified in the spending limits even after supplementary budgets, the surplus, to a maximum of EUR 100 million, may be used for one-off expenditure in the following year without reference to the spending limits.

The Government declares that the central government finances must never show a deficit of more than 2.75% of GDP even in a weak economy. If prognoses show that the deficit is in danger of exceeding this limit, the Government will immediately propose action necessary to cut costs and other measures to avoid the deficit exceeding the limit. ”

1 FISCAL POLICY RULES

This section is a review of the theoretical foundation for fiscal policy rules and why they are needed. There is also a description of Finland's fiscal policy rules in the 2004-2007 electoral period and the underlying fiscal policy rules and spending limits practices of earlier electoral periods.

1.1 Why are fiscal policy rules needed?

The increase in deficit and indebtedness witnessed in many countries over the past few decades is the result principally of a rapid growth in public expenditure; the controlling of this expenditure has thus emerged as a vital factor in securing the sustainability of public finances. National fiscal policy rules have received increasing attention. This has also happened because of the creation of the common currency, the euro, and processes coordinating the economic policy of the EU, such as the Stability and Growth Pact. Academic research in this field has also been stimulated and has focused for instance on the balanced-budget rules of the states of the USA.

The purpose of fiscal policy rules is above all to control public spending.[1] In economics, fiscal policy rules are discussed from several viewpoints. Political economics theories are perhaps the most frequently cited grounds for the necessity of these rules, with specific reference to the political pressures that democratically elected governments face. There are features in the political decision-making process that may lead to excess growth in public spending.[2] This risk is particularly great in a strong economy, since an increase in revenue easily translates into an increase in expenditure. Also, in a strong economy the incentives to undertake vital structural reforms to prepare for long-term challenges do not necessarily exist.

1 The ‘efficiency’ of fiscal policy rules typically refers to the correlation between the rules and how disciplined and sustainable general government or central government finances are. Spending limits can also aim to improve the allocation of public spending, for example so as to support long-term economic growth.

2 See Tabellini and Alesina (1990), Persson and Svensson (1989) and Roubini and Sachs (1989).

The potential benefit of fiscal policy rules as opposed to a completely decision-based political process stem from a credible commitment to budgetary discipline. It has been demonstrated that decision-makers can improve their chances of attaining their political goals if they can guide the expectations of economic players — businesses and consumers — regarding the future. This can be achieved through credible policy rules.[3]

1.2 What kind of fiscal policy rules are needed?

The academic literature which stresses the rules and institutions of fiscal policy discusses the impact that the practices and codes governing the preparation of, decision-making on and implementation of fiscal policy have on the fiscal policy itself and on how disciplined it is. The focus is thus largely on the budgeting process, within which various political interest groups strive to achieve their ideological aims. If the purpose is to improve discipline in fiscal policy, what must be addressed is the code within the bounds of which fiscal policy is planned and implemented.[4]

Studies strongly suggest that there is no such thing as a 'one-size-fits-all' fiscal policy code applicable to all countries; instead, the incentives created by such codes — and thus their effectiveness — depend on the political environment in each country. The choice of fiscal policy institutions seems to correlate with the form of government.[5] With multi-party governments, the best approach is for the government parties to agree jointly on goals spanning several years: entering these goals into the government programme makes them binding upon the parties. In countries that mainly have one-party governments, the best tools for budgetary discipline are vesting substantial powers of decision in the finance minister and creating a rules framework to strengthen this position.

Kopits and Symansky (1998) have defined fiscal policy rules as a permanent limitation on fiscal policy that can be illustrated with an indicator. Hallerberg, Strauch and von Hagen (2001) use a wider definition for the rules. According to them, fiscal policy rules can be understood more broadly to include not only the numerical goals of the public finances or central government finances but also various features of the budget process. This definition is suitable for examining multi-annual spending limits systems, which in many cases can only be binding for the duration of a single term of government.

3 See Kydland and Prescott (1977 and 1980).

4 See von Hagen (1992), von Hagen and Harden (1994 and 1996).

5 Hallerberg and von Hagen (1999), Hallerberg, Strauch and von Hagen (2001 and 2004). The reasons why the form of government influences the choice and efficiency of fiscal policy institutions have to do with the differences in ideological makeup and in the interaction between governmental parties and members of the Government in one-party government systems on the one hand and multi-party government systems on the other.

Which fiscal policy rules and goals are the most efficient in terms of promoting budgetary discipline? Research on fiscal policy rules has aimed to identify properties of 'ideal' rules. The rules are more efficient if they are operationally simple and transparent, if they agree with other macroeconomic targets, and if their implementation and monitoring mechanisms are as efficient as possible. Since deficit increase is often caused by public expenditure increase, the rules should address public expenditure in particular. Also, tax revenue is more vulnerable to cyclical fluctuations. Targets set within multi-annual spending limits systems are more difficult to water down than annual targets, because it is not possible to circumvent the spending limits by postponing expenditure to the following year. Multi-annual spending limits systems also force the government to take a position on long-term economic policy outlines, which helps dispel uncertainty for individual economic operators in making long-term financial decisions. Multi-annual spending limits systems also enable more efficient planning of public expenditure allocation and more discussion of issues concerning its efficient use than if the expenditure were only planned for one year at a time.

Empirical research on fiscal policy rules has focused mainly on the EU Member States.[6] The results have largely confirmed the theoretical basis: 'strong' codes improve budgetary discipline. According to a Commission study (2006), even though it only focused on numerical rules, the role of fiscal policy rules in EU Member States is constantly growing. The Commission has found a clear correlation between numerical fiscal policy rules and improved budgetary discipline. The findings of Hallerberg, Strauch and von Hagen (2001 and 2004) also confirm that fiscal policy rules do have an effect; but this effect depends on the type of government. Increasing the powers of the minister of finance has only brought added value in countries that principally have one-party governments, which is of course what the theory says. By comparison, it has been shown that multi-party governments should aim to agree jointly on credible and binding multi-annual spending limits systems and record them in the government programme.

6 von Hagen (1992), von Hagen and Harden (1994 and 1996), Hallerberg and von Hagen (1999), Yläoutinen (2005), Alesina et al. (1996), and Stein, Talvi and Grisanti (1999) have applied the same research tradition in the countries of Latin America and the Caribbean.

1.3 Fiscal policy rules in Finland

1.3.1 Fiscal policy goals for the 2004-2007 electoral period and the reformed spending limits system

In February 2003, a Ministry of Finance working group proposed a thorough reform of the spending limits system;[7] this was agreed on in the government negotiations in spring 2003. The principal features of the system were entered in the Government Programme, where it was noted that the aim for the 2004-2007 term of office was to maintain strong central government finances so that the increasing responsibilities caused by the ageing of the population can be met without imposing an unreasonable tax burden on future generations.

The Government's fiscal policy targets were set as follows:

- The central government debt-to-GDP ratio must be reduced (excluding cyclical deviations).
- The Government aims to secure balanced central government finances under normal conditions of economic growth at the end of the electoral period, measured in terms of national accounting. Cyclical or other short-term deviations from the path of balanced central government finances are permitted, provided that they do not jeopardize overall reduction of the central government debt-to-GDP ratio.
- The Government is committed to the spending limits for 2004-2007.

The balance target was set even though the then current predictions showed a deficit in the central government finances for 2007.

The reformed spending limits system introduced in spring 2003 was the first of its kind to cover the entire electoral period. The distribution of appropriations between administrative branches has been reviewed annually in central government spending limits decisions taken in the spring. The overall level of expenditure decided on in 2003 has not been changed in real terms; this is a departure from earlier spending limits practices, where an annual revision of the spending limits in real terms was allowed. The central government spending limits decision taken by the Government has served as the guideline for budgetary preparation in the administrative branches for the following year.

7 Finanssipolitiikan sääntöjen ja kehysmenettelyn kehittäminen Suomessa. VM, Julkaisuja 3/2003. [Ministry of Finance]

The spending limits for the electoral period cover some 75% of all on-budget expenditure. The spending limits were scaled appropriately so as to be binding throughout the electoral period and set against the price and cost level of 2004. In the course of the electoral period, the spending limits have been reviewed annually in central government spending limits decisions in accordance with price and structural changes of the central government budget.

The following items were excluded from the spending limits as a technical matter in order to secure the sustainability of the spending limits:

- housing allowances, unemployment benefit expenditure and transfer expenditure to the Social Insurance Institution, which vary according to cyclical fluctuations, (however, expenditure caused by changes in the basis of these items is included in the spending limits),
- central government debt interest payments,

  compensation to other tax recipients for tax changes decided by the central government,
- expenditure corresponding to revenue from the European Union,
- expenditure corresponding to betting and lottery revenue and the transferred earnings of the Slot Machine Association, and
- financial investment expenditure.

The supplementary budget proposals were included in the spending limits.

It was agreed in connection with the Government Programme that expenditure would be increased by EUR 1.12 billion in 2007 terms over the electoral period, and the spending limits, i.e. the ceiling for expenditure included in the spending limits, was set accordingly. The expenditure increase of EUR 1.12 billion was entirely allocated to pre-determined appropriations, leaving no unallocated reserve.

In May 2003, the Government agreed in addition to the Government Programme that if annual revenue from sales of shares exceed EUR 500 million, a maximum of 10% of the excess can be used on a discretionary basis on one-off additional expenditure, mainly infrastructure investments and R&D promotion, without reference to the spending rules or the spending limits for the electoral period. This rule, which increased the room for manoeuvre, was further revised in the spending limits decision for 2007-2001 in March 2006 so that a maximum of 20% of the excess could be used for one-off expenditure.

In the spending limits decision of 22 May 2003, it was also stated that central government finances must never show a deficit of more than 2.75% of GDP, measured in terms of national accounting, even in a weak economy. If prognoses show that the deficit is in danger of exceeding this limit, the Government will immediately propose action necessary to cut expenditure and other measures to avoid the deficit exceeding the limit.

1.3.2 Earlier fiscal policy rules in Finland

The spending limits procedure has gone through a number of stages, but the most significant step was the introduction of the present system in spring 2003.

Spending limits decisions have been made since 1991. The system was introduced in the early 1990s to help prepare for a weak economy among other things. Of course, it was not known at the time how deep the recession would be. The Government decided on the spending limits, and the Prime Minister communicated them to Parliament.

During the 1991-1995 term of office, the focus in fiscal policy was to combat the recession, and when the Government took office, its first task was to cap public spending. This electoral period saw the making of drastic, unprecedented savings, which caused the spending limits to be substantially undershot.

During the 1995-1999 term of office, the focus in central government finances was to reduce central government debt. Expenditure was cut, and rigorous savings measures were continued until 1999. Active savings were enacted above and beyond the target level, yet total expenditure did not decrease as expected due to increased debt interest payments and increased transfers to the Social Insurance Institution. However, measured as a percentage of GDP, central government debt did decrease according to the target.

During the 1999-2003 term of office, the spending limits system continued to focus on budget proposals, excluding any additions made in the budget debate in Parliament and any supplementary budgets. The added expenditure from supplementary budgets (except for debt servicing expenditure) amounted to about EUR 700 million every year.[8] The spending limits level was determined on a yearly basis, based mainly on the expenditure in the previous year's budget proposal. The average annual growth in expenditure over the electoral period (except for interest expenditure) was 1.8% in real terms. Compared with the present spending limits system, there was less discipline in expenditure, and the Government failed to attain the target of keeping expenditure at a steady level in real terms. Expenditure increased particularly towards the end of the government's term of office. Only with the current system have the desired fiscal policy results been achieved. Indeed, Finland has now become a model state in international comparisons of spending rules.

The introduction and development of spending limits in Finland arose mainly from a need to bring central government finances onto an even keel and to improve their credibility internationally. The spending limits helped increase confidence in Finland's ability to manage her debts and were used to stabilize central government finances. Unlike many EU Member States and euro zone countries, Finland did not introduce reforms in the spending limits system because of EU membership or EMU membership, although it was only

8 The additions included in the current spending limits totalled about EUR 400 million per annum.

natural for fiscal policy to support the membership process. One of the main aims of the current spending limits level is to prepare for the increased expenditure pressures caused by the ageing of the population so that central government finances will remain stable.

1.3.3 International fiscal policy rules applying to Finland

Membership of the European Monetary Union defines the framework for fiscal policy rules which apply to Finland too. According to the treaty, general government debt must not amount to more than 60% of GDP, and general government finances must not show a deficit of more than 3% of GDP. There is also a Stability and Growth Pact further specifying the treaty provisions.

The Stability and Growth Pact was revised in 2005. The main aims of this revision were to respond to the credibility problems and shortcomings that had arisen in applying the Pact. The revised Pact aims at increasing national ownership and credibility of its provisions by allowing Member States to take into account the considerable differences and sustainability risks between economies. The earlier reference values regarding deficits and debt proportion remain important.

The Stability and Growth Pact consists of two Regulations, one on strengthening of the surveillance of budgetary objectives and the surveillance and coordination of economic policies and the other on the excessive deficit procedure. Both Regulations have been amended, chiefly to extend deadlines for taking action, to define or re-define key concepts (medium-term budgetary position, severe economic downturn, good economic times, exceptional circumstances, other relevant factors). The new Pact also includes new operative rules on fiscal policy, including the fiscal policy minimum correction rule and taking into account pension reforms aimed at fully fund-based systems when considering excess deficit.

Under the old Stability and Growth Pact, all Member States were required to present a medium-term budgetary position in their Stability and Convergence Programmes — balanced general government finances or a surplus — and the adjustment pathways required to attain the objective. Under the revised Pact, every Member State must have a specific medium-term budgetary objective which can deviate from the earlier 'balance or surplus' objective. It must take into account the 3% limit so that under normal cyclical circumstances this limit would not be exceeded. Also, it must lead to rapid improvement in long-term sustainability. This is a transitional solution; during the transitional period, the objective must be set so as to take into account the country's current debt ratio and potential long-term growth. The final goal, towards which sustainability evaluation is being developed, is also to take into account implicit liabilities, meaning increases in expenditure due to the ageing of the population. It has also been specifically emphasized in this reform that national fiscal policy codes must not conflict with the Stability and Growth Pact.

FISCAL POLICY AIMS DURING PREVIOUS GOVERNMENTS' TERM OF OFFICE

The 1991–1995 term of office

The recession began at the beginning of the term of office of Prime Minister Aho's Government. In 1991, central government showed a deficit amounting to 4.4% of GDP. Economic policy goals in the Government Programme included:

- Reducing the deficit in the balance of payments and halting the increase of foreign debt, securing employment, making the general government finances more efficient and reversing the decline of the private sector measured as a percentage of GDP.

In order to attain these goals, it was necessary to freeze central government expenditure and considerably curb the growth of local government expenditure.

The Government also pledged to implement immediate measures to improve competitiveness and to make cuts in public spending so as to combat the recession and to correct structural anomalies in the economy.

The 1995–1999 term of office

The Government Programme of the first Government of Prime Minister Lipponen had a fiscal policy goal as one of its four main pillars:

- Reversing the growth of government debt measured as a percentage of GDP during the electoral period. This required structural spending cuts of at least FIM 20 billion [20 billion marks, about EUR 3.3 billion] compared with the then current level of spending.

The Government's economic policy aimed at getting Finland to fulfil the criteria for joining the EU's Economic and Monetary Union, with a view to gaining Finland the option of joining the third stage of the EMU when it started.

The 1999–2003 term of office

The Government Programme of the second Government of Prime Minister Lipponen contained these fiscal policy goals:

- Creating a structural funding surplus in central government finances in terms of national accounting in the course of the electoral period.
- Reducing the central government debt so that at the end of the electoral period it would be less than 50% of GDP. This would create leeway for coping with cyclical fluctuations and with funding and spending pressures generated in the future by the ageing of the population.
- Keeping central government expenditure at the level of the 1999 budget in real terms for the whole of the electoral period.

It was also observed with regard to the use of revenue from sales of government assets that this revenue should be primarily used towards paying off government debt, securing the existing level of R&D funding, and strengthening the operating potential of Finnish Industry Investment Ltd.

Finland's fiscal policy rules have been more ambitious than the requirements of the Pact. Finland has been fulfilling the requirements regarding public finances since 1997, when the deficit in general government finances fell to 1.2%. General government debt measured as a percentage of GDP peaked at 57.8% in 1994, calculated in EMU terms, and has never exceeded 60%. The debt ratio in EMU terms is expected to fall to less than 37% by the end of 2007.

2 EXPERIENCES OF THE REFORMED SPENDING LIMITS SYSTEM

The reformed spending limits system for central government finances that was introduced in spring 2003 has, in the main, been functional and feasible. It has brought a long-term approach to economic planning, and stability and predictability to fiscal policy, while also curbing the growth of public spending. The spending limits were set for the entire term of office for the first time, and they have been adhered to during the term of office, several unforeseen new expenditure needs notwithstanding. This is because Prime Minister Vanhanen's Government was firmly committed to observing the spending limits. The strong economy has also helped.

The spending limits system has also served to restrict added expenditure in supplementary budgets: annual expenditure in supplementary budgets has decreased to less than EUR 250 million in the last electoral period from about EUR 400 million in the electoral period before that. The autumn supplementary budgets have been used for defusing future expenditure pressures through funding one-off projects with the leeway available within the spending limits. Originally set at the price and cost level of 2004, the spending limits have been revised annually only for price and cost level, and structural changes in the budget. In the central government budget proposal for 2007, Prime Minister Vanhanen's Government stressed that the spending limits are only binding upon the Government which set them and thus apply to the Government's last budget but not to the supplementary budgets appended to it in the next electoral period.

2.1 Integrity of the spending limits and unforeseen situations

The Government Programme confirmed the key fiscal policy outlines for the term of office by setting an overall limit for expenditure development and indebtedness. In order to attain these fiscal policy goals, binding spending limits were set covering about 75% of central government expenditure; these were further divided among the administrative

Table 1. ***Price and cost level adjustments as well as structural changes in the spending limits decisions made during the spending limits period 2004-2007, in EUR million***

	2004	2005	2006	2007
Decision on spending limits, 22 May 2003, in price level of 2004	**28 049**	**28 311**	**28 534**	**28 647**
Price and cost level adjustments	-22	442	445	447
Structural changes	63	82	43	43
The electoral period spending limit 31.12.2004	*28 089*			
Decision on spending limits, 11 March 2004, in price level of 2005		**28 835**	**29 022**	**29 137**
Price and cost level adjustments		6	353	357
Structural changes		12	93	89
The electoral period spending limit 31.12.2005		*28 853*		
Decision on spending limits, 11 March 2005, in price level of 2006			**29 468**	**29 583**
Price and cost level adjustments			45	431
Structural changes			335	336
The electoral period spending limit 31.12.2006			*29 847*	
Decision on spending limits, 23 March 2006, in price level of 2007				**30 350**
Price and cost level adjustments				93
Structural changes				74
The electoral period spending limit 31.12.2006				*30 517*

sectors in the Government's spending limits decision. The purpose of the system is not to limit the increasing of any specific appropriation but to focus on overall expenditure and leave their detailed distribution to be defined in individual budgets. However, in practice the material that underlies the preparations for the spending limits decision is discussed at the budget item level, and the process produces expenditure calculations for each budget item compatible with the overall spending limits decision. This has led to these item-specific calculations being applied too literally at the budget preparation stage, even though they are only intended to give an indication of the expenditure structure, and deviations from the spending limits decision are much debated. This is the principal reason for the inflexibility for which the system has been criticized. However, this inflexibility is not due to the system itself but to the dominant decision-making practice where all parties hold on to their appropriations, and even the tiniest details are subject to agreement by consensus. This would be the case even if the spending limits system had never existed at all.

In connection with the preparation of the Government Programme in April 2003, no unallocated reserve was left for unforeseen expenditure and thus for supplementary budgets. In the first spending limits decision taken in May 2003, an unallocated reserve for unforeseen expenditure and political decisions was created by reducing additional expenditure already agreed. Nevertheless, the unallocated reserve remained at only EUR 120 million per year. In the light of earlier experiences, this was too slim a margin, as in the previous electoral period the additional expenditure within the spending limits entered in supplementary budgets had been considerably higher. Later, the expenditure estimates of several appropriations in the spending limits were adjusted downwards. Particular cases in point were EU payments and central government transfers to local government, which decreased i.a. because of the decrease in the number of schoolchildren. The combined effect of these decreases was that expenditure was several hundred million euros less than had been anticipated in spring 2003. This created leeway within the spending limits and helped the Government adhere to the spending limits throughout the electoral period.

On the other hand, an unforeseen statutory need for adjusting the division of costs between central and local government (totalling some EUR 500 million annually) emerged during the electoral period, and because of the narrow margin in the spending limits, this had to be enacted through a special savings act, and it was decided to phase this expenditure in. No new transport route projects were proposed to start between 2004 and 2007 in the first spending limits decision of the electoral period. Road maintenance and track maintenance funding proved inadequate; maintenance appropriations were increased by only EUR 25 million in all at the beginning of the electoral period. However, funding has been allocated to 18 new transport projects during the electoral period, and three further projects are scheduled to start in the next electoral period. The total costs of these 21 projects amount to about EUR 2 billion (excluding VAT expenditure).

Adhering to the spending limits has required restraint in increasing expenditure throughout the term of office. Expenditure has been reallocated between and within administrative branches, and as a rule no cost-based increases were made to discretionary appropriations. A savings programme was put in place in the spending limits decisions of 2005 and 2006, involving proposals to cut annual expenditure by about EUR 150 million.

The reformed spending limits system has also led to a reluctance to introduce discretionary spending into the spring supplementary budgets unless considered absolutely necessary. The purpose of this procedure was to evaluate all discretionary spending in the autumn supplementary budgets, at which time it was easier to assess the overall state of the economy and of the spending limits and to allow for final accounts savings expected to be gained due to changes in the timing and level of various items of expenditure. This procedure has yielded good experiences, and many discretionary spending needs have been met in the autumn supplementary budgets. The procedure also guarantees equitable treatment for the various spending proposals and leads to more efficient allocation and spending discipline than if the discretionary spending items were decided on individually.

Revenue has increased faster than anticipated

In the past spending limits period, central government revenue has improved more than was anticipated at the beginning of the period. The tax pressures foreseen four years ago were not realized as expected, and the economy has been faster than anticipated, resulting in higher tax revenue despite substantial tax cuts. The spending limits system can be credited with the unforeseen surplus being used for balancing central government finances and for contributing to the State Pension Fund rather than for increased spending. During the electoral period, the central government debt measured as a percentage of GDP has come down to slightly under 34% from 41.2% at the end of 2002, and an extra EUR 2.5 billion was paid into the State Pension Fund in the 2007 budget. In 2006 and 2007, practically no funds were transferred to the budget from the State Pension Fund. Under the Pension Fund Act, a maximum of 40% of the annual pensions expenditure can be transferred out of the fund to the budget, in practice to cover pensions expenditure.

That revenue increased faster than anticipated was partly due to economic growth being better than predicted during the electoral period. The estimates underlying the May 2003 spending limits decision underestimated the baseline and development of the GDP during the electoral period. In May 2003, it was estimated that annual economic growth between 2004 and 2007 would be 2.6%. The current prediction shows annual GDP growth as 3.8%. The annual tax revenue growth between 2004 and 2007 was estimated at 2%, but the prediction updated in January 2007 shows an actual average annual increase in tax revenue of 3.3% (excluding structural changes). Also, sales of shares yielded EUR 3.6 billion more than was anticipated at the beginning of the electoral period.

The first spending limits decision of the government's term of office contained an estimate of tax pressures that would slow down the growth of tax revenue, specifically the impact of the removal of restrictions on the import of alcohol and tobacco by passengers and of the change in vehicle taxation. Also, international pressures against corporate taxation were estimated to reduce revenue from corporate tax by almost 0.5% of GDP. In all, tax pressures were estimated to decrease tax revenue by about EUR 1.5 billion. Not all the anticipated tax pressures were realized, however, and their impact was far less than was estimated.

Procedures prompted by the spending limits system

The spending limits system has prompted certain procedures the purpose of which may have been to circumvent the expenditure limitations of the spending limits or which interpreted the spending limits system rather creatively. Passenger vessel support (seamen's income support) and low-wages employer support were introduced during the 2003-2007 term of office. These two are very similar in concept and execution. In both cases, the recipient of the support is the employer, who under certain conditions is exempt from paying to the tax authority all or part of the tax withholding deducted from the employee's wages. The central government compensates other tax recipients for tax revenue lost through this procedure. Although these subsidies are covered by appropriations in the budget and should therefore fall within the spending rules, a conscious deviation (exceeding the spending limits) has been enacted in the case of these subsidies, excluding the expenditure from the spending limits. The justification for this in the case of low-pay employer support was that it is tantamount to a tax subsidy. Seamen's income support was seen as compensation to other tax payees for tax cuts (for a more detailed discussion, see section 3.6.1).

The opposite approach was taken in the 2007 budget proposal, where payment of the final instalment of the adjustment to the division of costs between central and local government, EUR 185 million, was brought forward. This payment to local government will be made by reducing the earned income deduction in municipal taxation, which will increase municipal tax revenue. This will in turn reduce central government tax revenue, because central government taxation will be cut accordingly to avoid increasing the tax burden. In this case, the tax decision was considered to decrease the unallocated reserve in the 2007 spending limits, because it is tantamount in its impact to the adjustment to the division of costs between central and local government which is paid for through the system of central government transfers to local government and which increases central government expenditure. Because this procedure involved a change in the basis of taxation, it could have been considered to be excluded from the spending limits, which would have resulted in the unallocated reserve being EUR 185 million higher. The strict interpretation in a way compensated for the Government deciding not to define an unallocated reserve for supplementary budgets in 2007.

The spending limits may cause some subsidies to be designed as tax subsidies, with no corresponding structural change to the spending limits. Examples of this have been seen in some countries, but in Finland in the past electoral period there is no evidence of tax subsidies being enacted just to circumvent the spending limits.

In the Government Programme and the development policy programme, the Government set itself the goal of increasing development cooperation appropriations to 0.7% of GDP by 2010. These have indeed been increased steadily throughout the electoral period, and in the 2007 budget they totalled 0.43% of GDP. In spring 2006, the Government outlined in connection with its spending limits decision for 2007-2011 that development cooperation appropriations should be increased in the coming electoral period so as to attain the 0.7% goal but then decided to set the limit for development cooperation and the entire administrative branch of the Ministry for Foreign Affairs at a lower level for 2008-2011, because increasing the development cooperation appropriations in the agreed manner would have caused a substantial increase in expenditure and either prevented other expenditure from being added within the spending limits or caused the spending limits to be exceeded.

In order to increase room for manoeuvre, the Government agreed in spring 2003 that if the revenue from sales of shares exceeded EUR 500 million in any given year, 10% of the excess could be used for one-off extra expenditure, mainly infrastructure investment or

R&D, without reference to the spending rules or the spending limits for the term of office. This rule was relaxed in the spending limits decision taken in March 2006 for 2007-2011 to 20% of the amount exceeding EUR 500 million.

In the use of revenue from sales of shares, it has been the norm to allocate funding to an entire project. An exception to this practice was made in the preparation of the 2007 budget proposal, and the EUR 9.3 million left over from 2005 was instead used to launch four new transport route projects, whose funding will total EUR 240 million by 2011. The budget proposal also contained an increase of EUR 42 million in R&D appropriations and an increase of EUR 72 million in funding for transport and other investment projects between 2007 and 2011, where the bulk of the funding would be covered by share sales revenue that did not yet exist but which was likely to materialize by the end of the term of office on the basis of selling authorisations granted by Parliament. In autumn 2006, the government sold its entire holding in Kapiteeli Oyj and its shares in Outokumpu Oyj, and under the revenue rule this yielded EUR 148 million to cover the above expenditure that had already been budgeted.

In some cases, expenditure that under the rule of annuality applies to coming years has been budgeted as transferable appropriations. The purpose of this is to relieve the pressure on the spending limits in the future.

2.2 Strengths and weaknesses of the present system

The economy has developed much more briskly than expected during the past electoral period, and as a result central government revenue has improved more than expected. Under earlier spending limits rules, this might have led to increased spending, but thanks to the reformed spending rules, there is less scope for pro-cyclical[9] fiscal policy. In the past electoral period, expenditure development has not depended on revenue development. The surplus generated in central government finances has been used to balance the public finances and to augment the State Pension Fund. On this basis, it can also be noted that excluding the automatic fiscal stabilizers from the spending rules was a good idea. With a strong economy, the automatic fiscal stabilizers could have left a margin in the spending limits for allocating to other expenditure, leading to increased spending in a strong economy. By contrast, in a weak economy the applying of the spending rules could require other expenditure to be cut as cyclical expenditure increases.

9 i.e. contributing to strengthen upswings and downturns.

The strength of the present spending limits system with regard to political commitment is that it sets clear rules and a numerical appropriations ceiling the attainment of which can be noted in advance, at the budget preparation stage. International support and positive attention has also helped commitment to the system. Attention in Finland has been limited, but this does not seem to have been detrimental.

More flexibility has been called for in the spending limits and for infrastructure expenditure and a few other items of expenditure to be excluded from the spending rules.

Another problem is that the spending limits system can be circumvented through taxation and by using various funding schemes such as public-private-partnership for projects. In PPP projects, even a major investment can be started with a small initial investment, and the expenditure is spread over a long period of time, whereas in construction-time financing the entire cost is realized over the construction time, which is rarely more than five years. PPP projects and lifespan projects are easier to implement under a spending limits system, since their expenditure burden falls mainly on future spending limits periods and future Governments. Changes in the payment schedules for long-term projects cause problems in the present system. The annual costs of projects are taken into account according to the planned schedule of payments at the beginning of the project; but if the payment schedule changes, for instance because the project is delayed, the expenditure has to be re-budgeted, and this narrows the margin of the spending limits.

Generally, the problem with the spending rules is that in practice they dictate the level of expenditure, and the spending limits level chosen thus becomes a crucial factor. An error of judgment in scaling may lead to indispensable measures being left untaken because of the strict spending limits set. On the other hand, a ceiling on spending loses its fiscal policy meaning if it is set too high, and it will also not serve to curb the growth of expenditure.

Systems like the Finnish spending limits system are also criticized because they are not statutory but are agreed on by coalition partners. However, experience from the past term of office shows that this has not eroded the importance of the spending limits system or lessened the Government's commitment to observing it. On the contrary, political commitment has been the strongest factor in adhering to the spending limits. Even if the spending limit system were based on law rather than a Government decision, the law could be changed by majority decision in Parliament in a majority-parliamentary system. To be sure, a legislative process is more complicated than a Government decision-making process and contains several more thresholds that proposed changes have to cross.

2.2.1 Comments of the Finance Committee on how to develop the spending limits system

In its report on the 2007 budget proposal, Parliament's Finance Committee states: "*The spending limits procedure has proved to be a functional and necessary tool for central government finances, bringing stability and credibility to fiscal policy*." However, the Committee also states that the functionality and development needs of the spending limits procedure should be evaluated on the basis of experiences gained with the next Government Programme and the next spending limits period in mind.

The Committee has noted the spending limits level and proposes that there should be an opportunity for a mid-term evaluation of appropriation levels. This is considered necessary because circumstances may have changed or the level of appropriations may have been set too low to begin with. The Committee further considers that savings generated within the spending limits should be available for use in other years in the spending limits period. Such a rule is seen to be conducive to achieving savings and to the long-term planning and use of resources.

The Finance Committee also encourages reconsidering the status of investment expenditure in the spending limits. Because investment expenditure is typically a long-term item, the spending limits regarding them could cover a longer period, spanning more than one electoral period. Transport infrastructure projects have a different impact on the spending limits due to the way they are financed and implemented, and the Committee hopes for a change here. In lifespan projects, the financing expenditure is divided up into the service fees paid by central government to the producer and budgeted under the administrative branch of the Ministry of Transport and Communications. In traditionally executed projects, funding is obtained through a government loan or budget funding, meaning that the costs are lower and the expenditure is not included in the appropriations of the Ministry of Transport and Communications and hence not included in the spending limits.

Concerning budgeting procedures, the Committee requires a clarification of anomalies in how VAT expenditure is budgeted, since strict spending limits may lead to ministries and agencies favouring in-house work over purchased services even in cases where purchasing services would make better financial sense.

Concerning the division of costs between central and local government, the Committee proposes that an investigation should be carried out to see whether substantial statutory expenditure items based on existing legislation and actual cost trends could be excluded from the spending limits.

The Committee also emphasizes the importance of strengthening the governance of public finances. This should be done in such a way that the planning of actions and finances and the monitoring of their realisation would be closer to each other than at present. Monitoring of the use of appropriations should also be more efficient than is now the case so that appropriations can be more accurately reallocated within the spending limits in supplementary budgets.

2.2.2 Statements of international organisations and credit rating agencies

International organisations, such as the Commission of the European Communities, the OECD, the International Monetary Fund (IMF) and foreign credit rating agencies, have observed Finland's spending limits system and have evaluated it in their publications and reports. These evaluations have not involved the form of the spending rules as such; instead they have highlighted their importance in achieving a better than expected improvement in Finland's public finances and in curbing expenditure growth. In practice, Finland's spending limits system is considered functional. Credit rating agencies have voiced criticism of the time span of the spending limits system, noting that it should extend further into the future so as to enable a better response to the challenges of the ageing of the population and of the labour market.

The Commission, in its statement on Finland's stability programme issued in 2006, observed that the multi-annual spending ceiling has worked well during the term of the previous Government, since the spending ceiling set for the past electoral period was not exceeded; this has improved the predictability of central government finances.

The OECD, in its fiscal policy recommendation issued to Finland in spring 2006, encouraged the Government to keep to the spending limits it had set. The recommendation also notes that central and local government finances should show a structural surplus for this entire decade, establishing the surplus of public finances at between 3% and 3.5% of GDP. The OECD considers that this goal would confine tax cuts, even though on the other hand the OECD recommends that the focus in taxation be shifted so that it is less of a burden on employment.

The IMF has observed, in its evaluations on Finland as per Article IV, that Finland's spending limits system functions well in reducing expenditure pressures.

2.2.3 Comments from bodies consulted on how to develop the spending limits system

The working group consulted expert bodies from outside the Ministry of Finance with a view to exploring opinions on the spending limits system. These bodies included the secretariat of the Economic Council of Finland, the Government Institute for Economic Research, the Labour Institute for Economic Research, the working group for a long-term approach in transport route decisions, the Bank of Finland and the Pellervo Economic Research Institute. The Research Institute of the Finnish Economy and professors Seppo Honkapohja and Erkki Koskela were also invited for consultation.

The comments of the various bodies revealed very different themes with regard to the spending limits system. Attention was drawn to the handling of infrastructure investments in the spending limits system, the nominal price aspect, and the extension of spending limits decisions beyond the current electoral period. The limiting of local government spending using the spending limits system was also called for. Structural expenditure changes in the future with regard to the ageing of the population were also brought up. In general, however, the effectiveness and functionality of the current spending limits system were appreciated.

Spending limits are a good tool

In some evaluations it was stated that the current spending limits system is a good tool for attaining the targets of economic policy. The system was deemed credible and was seen to have reduced the risk of random tax policy and to have stabilized the business environment. Evaluations also showed that the spending limits system has reduced the defending of interests by main title and has increased the attention being paid to the bigger picture. On the other hand, criticism was voiced at the spending limits system not clearly indicating its relationship to the Government Programme and its targets.

Spending limits time period

In some statements, the time span for the spending limits decision (2004-2007) was considered too short. It was proposed that the spending limits procedure extend beyond the current term of office so that it would be impossible to heap expenditure pressures caused by structural changes onto following governments.

In one statement, the technical nature of the spending limits was considered a risk in view of future structural changes such as the ageing of the population and the expenditure impact of globalisation. Ageing-related expenditure will increase, particularly after 2011. It was proposed that the impact of ageing on expenditure within the spending limits be considered particularly carefully in the run-up to the 2011 election, so that they could be accurately estimated in the spending limits decision taken at the beginning of the electoral period immediately following.

Nominal and real spending limits

Currently, the spending limits are given at fixed price. Some of the bodies consulted proposed that the spending limits be given in current prices in the future. Real spending limits were criticized for causing the relative volume of central government finances in the national economy to grow. Because costs in public spending have risen faster than price trends in GDP in recent years, central government spending measured as a percentage of GDP has increased. Nominal spending limits could help curb expenditure increases, since in such a case if the price development of central government spending were more rapid than anticipated, the result would be a pressure to adjust the level of expenditure, and the percentage measuring expenditure against overall production would not be allowed to grow.

However, some of the bodies consulted felt that spending limits expenditure should grow more slowly than GDP, which would reduce public spending as a percentage of GDP. This would also help prepare for the effects of ageing in central government finances.

Another argument for the nominal approach was that it would help compare expenditure with the funding base, i.e. the revenue estimates.

Lack of transparency towards external parties

It was observed that it is difficult for others than Ministry of Finance to monitor changes which take place inside the spending limits. These observations indicate that transparency is weakened by the price component of the real spending limits and the exclusion of cyclical expenditure from the spending limits. Transparency was not considered an actual problem as such, since there is sufficient reporting on the spending limits decisions, and in the past term of office the Government adhered to the spending limits. If there were a danger of the spending limits being exceeded, transparency of monitoring would be especially important.

Political room for manoeuvre

The spending limits were criticized for restricting political room for manoeuvre, since most matters are decided at the beginning of the term of office. At the same time, it was noted that the multi-party system creates a situation where it is politically difficult to achieve an unallocated reserve in government negotiations.

Rules for using unforeseen revenue

A desire was expressed for having a rule to allocate unforeseen revenue partly to paying back debt, partly to extra expenditure items prioritized beforehand. It was also noted that such a rule should be symmetrical, meaning that if revenue falls below the expected level, this should automatically lead to cost cutting (or savings). It was admitted that such a rule could have an effect on revenue predictions. It was also noted that consumption expenditure should not be increased on the strength of unforeseen one-off increases in revenue.

Expenditure included in and excluded from the spending limits

In one statement, the division of expenditure items into those included in and those excluded from the spending limits was largely framed in the present terms, with unemployment benefits and interest expenditure excluded. In one statement, expenditure related to ageing was proposed for exclusion from the spending limits.

Investment and the spending limits

Some statements proposed that investments be excluded from the spending limits. The idea of a separate spending limits system for investments was also floated. Funding investments out of sales of shares was considered a bad idea because of the irregularity of revenue from sales of shares.

However, it was noted in one statement that excluding investments from the spending limits would create a risk of the spending limits system being eroded. This risk was considered to be greater than the potential benefit of such an exercise from the viewpoint of boosting economic growth. The same observation was made regarding the excluding of R&D expenditure from the spending limits.

It was also noted that there are political and regional interests causing great increase pressures related to infrastructure investments in particular, and for this reason investments should be retained within the spending limits.

The representative of the transport working group proposed a long-term approach for transport route decisions, supported by a 'report model' whereby transport route decisions would be taken with a perspective of 10 to 15 years and the role of Parliament in decision-making would be enhanced. The representative also suggested that a four-year programme on the starting of major projects be drawn up by Government decision and that a separate investment spending limits system be set up for them.

Inadequately scaled spending limits / unallocated reserve

The inadequacy of the expenditure level in the 2004-2007 spending limits decision was criticized. It was stated that the unallocated reserve should be larger in the future. On the other hand, some statements considered that undue laxness in setting the spending limits would be a risk because of the challenges involved in the ageing of the population.

Curbing local government spending

The strong growth in local government spending was criticized, as municipalities account for one third of all public spending and thus have considerable influence on the balance of the public finances. Since the central government spending limits system was considered to work well, it was proposed that a separate spending limits system be introduced to control local government spending.

SUMMARY OF THE STRENGTHS AND WEAKNESSES OF THE CURRENT SPENDING LIMITS SYSTEM:

+ It has restricted the growth of central government expenditure and reduced the size of supplementary budgets.
+ It has helped limit the central government debt and strengthen the State Pension Fund.
+ It has functioned as a restraint on pro-cyclical fiscal policy.
+ It contains clear numerical goals whose attainment can be reliably evaluated when making decisions on appropriations (cf. the balance rule, whose success can only be ascertained ex post facto).
+ It is simple enough and easy to understand.
+ It has prompted strong political commitment.
+ It has helped attain the goals of economic policy.
+ It has attracted international support and positive attention.

– It has limited room for manoeuvre and is in some ways unnecessarily rigid.
– It is dependent on political will.
– In practice, it determines at the same time the level of spending.
– At present, it can be circumvented, for example through taxation or funding arrangements.
– It has difficulty accommodating changes in payment schedules compared with the original plan.
– It creates inequalities for instance in the choice between in-house work and purchased services, or in transport projects according to their funding structure.
– Its time span is relatively short.
– It being stated in real prices makes it less transparent.
– It does not cover general government finances as a whole.

3 DEVELOPING THE SPENDING LIMITS SYSTEM

This section discusses development proposals concerning the current system brought forth earlier and the issues the working group proposes for consideration on the basis of experiences from the 2004-2007 spending limits period. The principal aim is to increase the flexibility of the system without detracting from its fiscal policy impact.

The topics discussed include price adjustments; classification within the spending limits; the need for mid-term review; the unallocated reserve; external funding contributions under the spending rules; funding for transport route projects within the spending limits; extending the framework system to revenue; and the need for external monitoring of the spending limits system.

Furthermore, various items have been proposed for exclusion from the spending limits. The working group has evaluated whether such exclusions would make sense from the fiscal policy viewpoint. There are certain items in the spending limits in the current system which, by their nature, should be excluded, for instance because they are automatic fiscal stabilizers. The working group has tried to consider how to improve the transparency of the system in its proposals.

3.1 Spending limits level

3.1.1 Real or nominal spending limits

The spending limits can be given at current price for each year covered or at fixed price with reference to a specific chosen year; the latter was the case in the 2004-2007 spending limits decision.

Nominal spending limits define expenditure in euros, including an adjustment for anticipated cost trends in the relevant years. Nominal spending limits are used for instance in Sweden and Ireland. Nominal spending limits are unambiguous and transparent, because no cost adjustments need to be made during the spending limits period. They also have a counter-cyclical effect in that if inflation were to increase beyond that which was predicted, expenditure would automatically be restricted during the spending limits period, thus reducing the risk of the economy overheating. By contrast, if inflation is lower than predicted, added flexibility is created within the spending limits, and in a slow economy (which usually accompanies slow cost trends) this can be used to fund an expansive fiscal policy to boost economic growth. Moreover, nominal spending limits encourage to increase productivity to match price trends, particularly in expenditure on consumption.

The nominal spending limits allow the increasing of expenditure if inflation is lower than predicted. This could lead to a permanently higher level of expenditure. In the opposite situation, i.e. a higher inflation than predicted leading to expenditure reductions or cost-cutting could be difficult to accept and might lead to the spending limits being broken. Also, when the spending limits are set, future pay rises have to be anticipated before salary negotiations have even been conducted. This might lead to the incomes policy negotiation process involving an agreement on a cost-cutting ban, in which case higher pay claims could lead to the spending limits being exceeded.

In **real spending limits,** the volume of expenditure remains the same regardless of cost trends, because both the level of the spending limits and price-dependent items are adjusted according to any rise or fall in prices. Real spending limits are used in Finland and for instance in the Netherlands. The advantage of this system is that it is flexible: changes in expenditure items caused by price changes do not require other expenditure items to be cut for the spending limits to be upheld. On the other hand, if prices fall, this does not create a surplus usable for increasing other expenditure. Real spending limits also safeguard the usage and relative allocation of resources already dedicated.

What is considered the disadvantage of the real spending limits is its poorer transparency in comparison with the nominal spending limits. It is difficult for external parties to monitor whether the spending limits are being adhered to. Real spending limits more easily lead to a pro-cyclical fiscal policy, since when inflation is boosted by economic growth, expenditure increases in nominal terms, and vice versa.

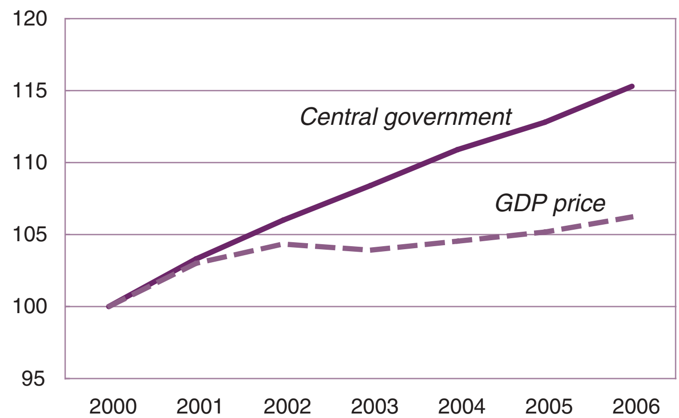
In Finland, the real spending limits are adjusted using the price index of central government expenditure, which consists of a weighted combination of the Employee Pensions Act (TEL) index, the National Pensions Act (KEL) index, the consumer price index, the state subsidy index, the building cost index, the domestic and EU GDP index, the basic price index for domestic supply, central government pay rises and changes in social security contributions. The price adjustment procedure has been criticized for being opaque to external monitoring. Currently, an appendix to the spending limits decision explains the structural and cost adjustments made to the spending limits level and the underlying price trend assumptions. It would be advisable also to publish the calculations on which the price adjustment is based in connection with the spending limits decision and the budget proposal, because then it would be easier for interested parties to monitor how well the spending limits are being adhered to.

Instead of using the price index for central government expenditure, the cost adjustment could be made using just the consumer price index, the GDP price index or the consumer spending and gross capital formation price index, as is the case in the Netherlands, for example. However, in such a case the cost adjustment would be based on general price trends in the national economy rather than changes in central government expenditure prices specifically.

The consumer price index illustrates price trends in goods and services purchased by Finnish households in Finland. Because the consumer price index illustrates the prices that are actually paid by consumers, changes in indirect taxation have an impact on it. In the past electoral period, one such change was the cutting of the alcohol tax, which served to slow down the general upward price trend. The effect on central government expenditure costs is indirect, through expenditure tied to the KEL and TEL indices, but on the whole, the tax cut had a lesser effect on central government expenditure than on household consumption.

The consumer spending and gross capital formation price index used in the Netherlands covers cost trends in both private and public spending and investments. Compared to the GDP price index, it eliminates the effect of the change in inventories and the price effect of the import and export of goods and services, which cause variation in the GDP price index through changes in the terms of trade.

Figure 1. ***Price trends in central government expenditure and GDP***
2000 = 100



Source: Statistics Finland

If the indices used as a price index grow more rapidly than the GDP price index, central government spending as a percentage of the GDP will grow even if the volume of expenditure stays the same. This can be corrected through level adjustments in Government Programme negotiations undertaken every four years. Using too strict an index would in practice lead to repeated cutting of discretionary expenditure, because statutory index-linked expenditure would increase at a higher rate than the price index to which the overall spending ceiling is tied. Also, using a price index incompatible with actual price trends might make a political issue out of the making of price predictions. For example, in the Netherlands the Government set the level of the GDP deflator used for determining cost adjustments to the spending ceiling until 2002, at which time a price index allowing a more rapid increase in expenditure was adopted. In Finland, inflation was low in the 2003-2007 spending limits period, so the various price indices would only have had a marginal effect on the spending limits level. Under normal conditions, however, the differences would be greater.

Finland's spending limits system incorporates the principle that the price adjustment element is neutral with regard to expenditure distribution. This has made it possible to implement price adjustments so that they correspond to expenditure increases due to price increases as closely as possible. The price adjustment element comprises the weighted average of several different indices. This has the effect of making the system less transparent but helps safeguard the distribution of expenditure and volume trend agreed in the Government Programme.

The working group proposes that the current fixed-price approach for the spending limits be continued. Price adjustments to the spending limits level are to be made using the price index for central government expenditure. To increase transparency, the calculations on which the price adjustments are based should be published in the form of a technical bulletin appended to the spending limits decisions and budget proposals.

3.1.2 Spending limits defined by administrative branch or policy sector?

In the spending limits decision, the overall spending limits for central government finances are divided up by administrative branch, leaving an unallocated reserve to account for unforeseen expenditure needs. The purpose of defining spending limits by administrative branch is to help flexible allocation of expenditure within the administrative branches and between them. The spending limits system is not intended to limit how individual appropriations evolve; they govern overall spending and leave the detailed allocation of expenditure to the annual budgets. In practice, the material that forms the basis for the preparation of the spending limits is processed at the budget item level, and the process generates a listing of expenditure for each budget item under the spending limits. Indeed, these item-specific calculations are sometimes the focus of heated arguments. Later, in preparing the budget proposal, these item-specific calculations — which were never intended to be more than indicative — are often followed very precisely.

In other countries that have spending rules similar to Finland's spending limits system, spending ceilings are set by function or policy sector, for example. In Finland too, it would be quite possible to abandon the item-specific definitions in the spending limits simply by formulating the spending limits decision in other terms. This would lead to having to decide how much money to put in the spending limits without knowing what that money is supposed to be funding. This would be problematic for practical decision-making, and it would shift the focus in central government finances back to the preparation of the annual budget proposals instead of the multi-annual spending limits decision. It would be better for long-term fiscal policy if any new revenue and expenditure outlines were set in the spending limits decisions, where the impact of measures is assessed for at least the spending limits period. If the focus in planning were on the annual budget proposal, such assessments would not necessarily be carried out, which would lead to new measures being started with small funding investments without regard to how they will be continued in the following years. The full impact of their costs would often not be realized until years later. Without an accurate spending limits calculation, it is difficult to comprehend what a particular sum in the spending limits can achieve, and this could weaken commitment to the decisions made. If the spending limits were defined by function or policy sector, probably nothing would change, since each minister and ministry would hold on tightly to their item-specific provisions in the spending limits.

> The working group proposes that the spending limits continue to be set by administrative branch. The distribution of appropriations will be adjusted through annual spending limits decisions, in which expenditure can be freely reallocated within the overall spending limits.

3.1.3 Revising the spending limits level

Before 2003, the spending limits level was revised annually. This practice attracted strong criticism from international institutions, for example. In practice, these annual revisions led to increases in expenditure apart from a number of years in which cuts were decided on; in real terms, expenditure did not remain at the level of the budget for 1999, which was the aim of the then current Government Programme. The practice of revising the spending limits level easily leads to a pro-cyclical fiscal policy and to expenditure higher than intended.

The Finance Committee and other bodies have suggested that the spending limits system should include a mid-term review, whereby the spending limits level would be revised once every two years. However, this would necessarily undermine the stability and coherence of the current system and would represent a step backward in fiscal policy. One of the perceived strengths of the current system is that changes in expenditure are neutral with regard to revenue and economic growth development. Accordingly, it has been easier to avoid a pro-cyclical fiscal policy. In the future, the long-term approach to expenditure levels will become increasingly important, since expenditure pressures on the central government finances connected with the ageing of the population will require a long-term perspective.

Flexibility can be increased by other fiscal policy means (see summary). Currently very little use is made of the possibility of transferring appropriations between main titles with changes in political focus. Re-allocating appropriations among main titles has been difficult after the first spending limits decision, even though in the current system there is no obstacle to re-allocating appropriations to different main titles as long as their sum remains within the spending limits. It would be advisable to review the allocation of resources by main title within the confines of the spending ceiling at the midpoint of the term of office at the latest; at this point, changes could be made if some appropriations are seen to be not appropriately dimensioned. The leadership of government parties and at least the Prime Minister (the Prime Minister's Office) and the Minister of Finance (the Ministry of Finance) could make proposals annually or at mid-term concerning changes in focus between administrative branches that the Government could then discuss.

The working group proposes that the spending limits should continue to be set for the entire term of office to maintain the stability of and long-term approach to expenditure and the credibility of the system. Evaluation of the overall level of expenditure once every four years is sufficient for adapting expenditure to revenue trends with regard to the economic cycle, for instance.

To increase the practical flexibility of the spending limits, the working group proposes that the Government should review needs and opportunities for re-allocation of expenditure within the spending limits every year. The Government leadership, and particularly the Prime Minister (the Prime Minister's Office) and the Minister of Finance (the Ministry of Finance) could take a more active role in initiating discussion on re-allocation potential. They could, at mid-term at least, bring proposals for changes in focus, between administrative branches or otherwise, to the Government for discussion.

3.2 Unallocated reserve

In the 2003-2007 electoral period, the expenditure increase agreed for the term of office was completely allocated to predetermined appropriations at the Government Programme stage, and no unallocated reserve was left for new expenditure. The unforeseen expenditure that later arose, such as the revision of the division of costs between central and local government, were accommodated under the spending ceiling largely because certain other expenditure within the spending limits decreased sufficiently in the same period.

In the spending limits decision for each year, an unallocated sum must be left as an unallocated reserve for supplementary budgets. This reserve must be large enough so that the spending limits will not be broken if and when unforeseen events and the inevitable extra expenditure occur. An unallocated reserve for supplementary budgets must be included in the spending limits even in election years, to avoid the next budget proposal including an expenditure increase equal to the unallocated reserve that was never created.

In addition to the basic unallocated reserve, the spending limits as set in the Government Programme should include a sufficiently large provision to be set aside for future political decisions; recent experiences show that these can and will emerge during the term of office. Because uncertainty concerning needs increases over time, the unallocated provision could be the smallest in the first year and increase gradually. Naturally, expenditure decisions would gradually decrease this provision in the course of the term of office.

The working group stresses that in the next spending limits period it would be important to leave a sufficiently large unallocated reserve within the overall expenditure decided at the beginning of the period. In order to avoid the expenditure level rising in an election year as a consequence of the system, the working group proposes that a fixed provision (e.g. EUR 300 million) be made within the spending limits for supplementary budgets in every year, even in election years.

Moreover, in the first spending limits decision of the term of office an incremental provision should be specified, to reach for instance the level of EUR 300 million by 2011, for future Government decisions. Naturally, expenditure decisions would gradually decrease this provision in the course of the term of office.

3.2.1 Unbudgeted portion of the unallocated reserve

The unallocated reserve has not been completely used in every year. Unbudgeted funds amounted to EUR 78 million in 2004, EUR 24 million in 2005 and EUR 9 million in 2006. It has been proposed (by the Finance Committee) that unbudgeted unallocated reserve, or 'spending limits savings', could be made available in future years. When some of the unallocated reserve remains unused, overall central government expenditure remains under the spending limits. The use of spending limits savings in later years would not cause the spending limits in those years to be exceeded; only the time profile of the expenditure would change. The working group thus considers it possible for spending limits savings to be carried over to the following year. However, the savings accrued in one year should only be available for the immediately following year. Otherwise, there might be a danger of a cumulative reserve being built up, say, for election year, and being used to increase expenditure at that point, leaving the next Government to deal with the increased expenditure. Also, the use of funds saved in the unallocated reserve should be capped for instance at EUR 100 million per year, since the carrying over of an exceptionally large unbudgeted unallocated reserve might lead to a permanent increase in expenditure. The Government and Parliament would be free to choose how to spend such savings, as long as it is allocated to one-off expenditure items.

The working group proposes that annual spending limits savings (though no more than EUR 100 million) be transferred to the following year for one-off expenditure that will not increase the spending level in the years after that.

Table 2. ***Unallocated reserve in the spending limits decisions and in the budgets approved by Parliament, in EUR million***

	2004	2005	2006	2007
spending limits decision 2004 –2007	120	120	120	120
spending limits decision 2005 –2008		342	259	255
spending limits decision 2006 –2009			342	215
spending limits decision 2007 –2011				139
budget	316	307	163	6
supplementary budget	225	117	39	5
supplementary budget II	193	80	11	
supplementary budget III = unbudgeted portion	78	24	9	

3.2.2 Final accounts savings

Every year, some of the appropriations budgeted remain unused. Central government finances produce between EUR 200 million and EUR 700 million in savings every year. Of this, about three-quarters is in items that fell within the spending rules, the rest being in items excluded from the spending limits.

It has been proposed that final accounts savings should be carried over to cover expenditure in the following years. But if final accounts savings were available for increasing expenditure in the future, the spending limits level in the original spending limits would have to be reduced so as not to change the scaling of fiscal policy overall. Thus, in the long term the use of final accounts savings would not affect the overall expenditure level. Since the final accounts savings vary considerably from year to year, annual expenditure would also vary in tune with rather random factors, which would add instability to fiscal policy and entail the risk of permanent expenditure increasing due to temporary factors.

Table 3. ***Final accounts savings in the administrative branches, total in EUR billion***

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Budgeted	28.9	27.8	28.0	27.6	28.5	30.2	31.6	32.7	34.6	35.7
Final accounts	28.7	27.6	27.7	27.3	28.1	29.7	30.9	32.2	33.9	35.2
Final accounts savings	0.2	0.2	0.3	0.3	0.4	0.5	0.7	0.5	0.6	0.5
as a percentage of budgeted expenditure	0.9%	0.7%	1.1%	0.9%	1.3%	1.7%	2.2%	1.5%	1.9%	1.3%

In recent years, final accounts savings have been reduced thanks to active measures that have rendered budgeting more accurate. The working group is of the opinion that it is better to reduce final accounts savings by improving administrative procedures and budgeting than to use those savings to increase expenditure. Enabling the carrying over of final accounts savings would also require the development of financial statements so that the budget report on actual expenditure would also report unused appropriations within the spending limits and expenditure excluded from the spending limits separately.

The working group proposes that final accounts savings be reduced through improved budgeting and administrative procedures. Final accounts savings should not be made available for covering expenditure in the following year.

3.2.3 Re-budgeting and changes in payment schedules

Problems caused for the spending limits by changes in payment schedules often have to do with the budgeting of payment appropriations based on authorisations. Budgeting problems restrict or loosen the flexibility available within the spending limits. Over-budgeting or under-budgeting of expenditure and changes in payment schedules can make the unallocated reserve seem either smaller than it actually is or deceptively allow for added expenditure. These problems occur most seriously in the budgeting of the national funding contribution in Structural Fund programmes and in budgeting appropriations for major transport infrastructure projects, but similar situations may arise in other expenditure too, for instance when projects are delayed.

Transport infrastructure projects

In deciding on a transport infrastructure project, the authorisation required for the entire project is allocated, the projected schedule for progress is outlined, and the corresponding payment appropriations are budgeted. As a project progresses, its funding may undergo two kinds of changes. The project may overshoot (or undershoot) its budget, in which case the overall authorisation and appropriation can be changed. There may also be changes in the progress and payments of the projects within the limits of the authorisation allocated, affecting the annual payment appropriations. The appropriations allocated annually to projects in the budget are given as estimates, and any corrections required because of overshooting (or undershooting) are usually entered in a supplementary budget. In practice, changes to the schedule of a project within the authorisation granted that affect the payment schedule are approved as a matter of course.

Structural Fund programme projects

Structural Fund programme projects are partly EU-funded. The expenditure corresponding to the EU funding is excluded from the spending limits, but the national funding contribution entered in the central government budget is not. Programme expenditure is committed expenditure the timing of which is determined according to the timing of the payments on thousands of individual commitments.

The scaling of the annual payment appropriations is based on schematic estimates made by the ministries on the payments arising from the authorisation budgeted in the current year and the years before. The aim is to avoid over-budgeting in payment appropriations. In practice, however, the appropriations have so far been higher than needed, and there has not been sufficient scope to intervene in this even through the supplementary budgets. Table 4 shows the under-use of the national funding contribution for ERDF and ESF programme projects and the national contribution for project-type rural development measures funded by EAGGF-Guidance and EAGGF-Guarantee.

Inaccuracies in estimating the payment times of national funding contributions to Structural Fund programme projects are problematic in two ways: too large a payment estimate makes the unallocated reserve seem smaller than it is, and too small a payment estimate gives apparent room for added expenditure. As the commitments amount to almost the total amount of the authorisation, the expenditure that remains unrealized in the budget year will then be realized, contrary to plan, in later years. The problem is thus cumulative: realized over-budgeting unnecessarily reduces the flexibility within the spending limits in the year in question, and payments carried over reduce the unallocated reserve in future years, because they have to be re-budgeted.

Table 4. ***Actual under-use of the national funding contribution in Structural Fund projects, in EUR million***

	2001	2002	2003	2004	2005
Ministry of the Interior	1.3	0.8	0.4	1.4	3.2
Ministry of Education	15.6	25.2	12.3	19.0	6.4
Ministry of Agriculture and Forestry	28.8	30.7	22.6	27.6	6.6
Ministry of Transport and Communications	-	-	0.9	0.5	0.6
Ministry of Trade and Industry	25.3	14.9	26.3	6.5	8.6
Ministry of Social Affairs and Health	1.1	1.5	3.1	2.2	0.2
Ministry of Labour	-14.1	29.1	9.0	4.8	8.0
Ministry of the Environment	-1.4	2.8	3.6	2.1	2.4
Total	56.6	105.1	78.1	64.0	36.0
Actual over-budgeting	19%	29%	21%	17%	10%

The situation is the same in infrastructure projects, where changes in the progress schedule introduce restrictions in some years and give more leeway in others. If the project budget and project authorisation remain stable, the overall expenditure for the project does not change, but from the viewpoint of the spending limits system, changes in the payment schedule affect the room for manoeuvre of the spending limits in any given year.

The same item should not be deducted twice in the spending limits, which is why the working group feels that a more flexible procedure for the spending limits to react to changes in the timing of expenditure and to re-budgeting should be introduced. In principle, both changes in timing and re-budgeting could be processed as structural adjustments to the spending limits. It could be allowable to increase the overall spending limits in one budget year by the amount required through the bringing forward of expenditure, provided that in a later year in the same spending limits period a corresponding decrease is made. This should not be made an automatic procedure; timing adjustments should be used relatively rarely and only for significant changes, so that monitoring the spending limits is not compromised. Thus, the default approach is to fund any expenditure brought forward without adjusting the spending limits. In cases of re-budgeting, the requirement is that the procedure genuinely involves the re-budgeting of the same expenditure and not, for example, a final account saving on an appropriation.

The working group proposes that significant expenditure shifts arising from changes in payment schedules be handled as structural adjustments to the spending limits. This would involve increasing the overall spending limits in one budget year by the amount required through the bringing forward of expenditure, provided that in a later year in the same spending limits period a corresponding decrease is made. The opposite should be the case if expenditure is pushed back. The default approach would still be to fund any expenditure brought forward without adjusting the spending limits. The working group further proposes that cases of re-budgeting which genuinely involve the re-budgeting of the same expenditure be handled without being restricted by the spending limits, provided that the appropriation was not cancelled in an earlier supplementary budget.

Changes in cost estimates should be handled within the spending limits just like the original cost estimates.

3.3 Items excluded from the spending limits

3.3.1 National pensions and sickness insurance appropriations in the spending limits system

In the spending limits decision of 22 May 2003, budget items 33.18.60 and 33.19.60 (central government contributions to expenditure under the Sickness Insurance Act and central government contributions to expenditure under the National Pensions Act, respectively) were excluded from the spending limits. It was specified in the decision that only the impact on appropriations caused by changes in the basis of actual benefits covered by these items (i.e. the amount of the national pension or other benefits, or the coverage of family leave benefits) would be included in the spending limits. By contrast, changes in the central government contributions arising from changes in the basis of employer and employee contributions (percentages) remained excluded from the spending limits, being considered compensation to the Social Insurance Institution for changes in taxation (an example of this is the effect of the experimental lowering of social security contributions on the central government guarantee payment).

The justification for excluding the contributions to the Social Insurance Institution from the spending limits was that these are seen as cyclically sensitive payments, specifically that the amount of the central government contribution depends on payment revenue from employers and employees, which varies according to cyclical fluctuations. This view was evidently based on the cyclical variation in the central government guarantee payment rather than that of the benefit expenditure itself. The guarantee payment has been seen as an automatic fiscal stabilizer for the employer and employee contributions that change according to cyclical fluctuations.

Evaluating the current spending limits system

Experiences of the past spending limits season and changes in funding systems (specifically the sickness insurance funding reform but also gradual changes in national pensions insurance) have prompted a re-evaluation of the handling of the national pensions and sickness insurance expenditure items in the spending limits system. The following is a detailed discussion of the nature of these appropriations with a view to the basic aims of the spending limits system. The principal focus is on how the current benefits and funding system works. Significant and fundamental changes have occurred in the funding of sickness insurance on the one hand and national pensions insurance on the other, and the most recent changes must be taken into account in any evaluation conducted with a view to the future.

Sickness insurance and the central government contribution to expenditure under the Sickness Insurance Act (33.18.60)

From the beginning of 2006, sickness insurance was split into earnings security insurance (sickness allowances, rehabilitation allowances, parental allowances and occupational health care) and medical care insurance (medicines, doctors' and dentists' fees, examinations and treatment, and travel costs). Sickness insurance funding is based on insurance premiums determined annually on the basis of estimates of costs and salaries on the one hand, and on fixed (relative) central government contributions on the other. As of 2006, central government no longer has a residual funding provider role as was previously the case with the guarantee payment.

For earnings security insurance, the central government contributes funding for the minimum daily allowances and a 0.1% share of parental allowances, totalling EUR 85 to 90 million at the 2007 cost level. Total expenditure for earnings security insurance is estimated at slightly less than EUR 1.9 billion in 2007. The earnings security insurance contribution percentages are affected the most by daily allowances expenditure, where the compensation level is based on earnings just as insurance contributions now are. Thus, the contribution percentages are principally influenced by changes in the number of days for which compensation is paid. If it is considered that the sickness rate (number of days for which compensation is paid; compensation is paid by central government at the minimum level) is a non-cyclical structural phenomenon (assuming that it will first increase in the near future as the average age of the population rises and then decrease as the size of the working-age population begins to decline), and considering further what a small and stable contribution central government makes to occupational health care and marginally to parental daily allowances expenditure, it seems ill justified to exclude this portion of the sickness insurance expenditure from the spending limits.

For medical care insurance, central government funds compensation for medical care paid to EU Member States plus half of the medical care costs and the operating expenditure incurred. Medical care costs are determined on the basis of the current compensation code; they are made up of refunds on medicine (the largest item at EUR 1.2 billion), compensation for doctors' and dentists' fees, compensation for examinations and treatment prescribed by a doctor, compensation for travel costs, rehabilitation services and operating expenditure. The central government contribution to sickness insurance is estimated to total EUR 1.1 to 1.2 billion in 2007.

Current legislation and policy outlines dictate that the predominant item in sickness insurance benefits expenditure will continue to be refunds on medicine (currently 60% of all expenditure under this item). The spending limits decision sets a 5% limit in real terms (i.e. 6% to 7% in nominal terms) on the growth in refunds on medicine for the period 2007-2011. The actual average long-term growth rate is much higher. There are growth pressures in other sickness insurance benefits too.

As the funding is determined quite directly from costs and (after deduction of EU compensations which are covered wholly by central government) shared equally between central government and other funding providers, there is no case for excluding this item from the spending limits. The sickness insurance contribution percentages for wage earners, entrepreneurs and beneficiaries are flexible enough to generate the required matched funding. Cyclical fluctuations in this revenue is compensated for through changes in the contribution percentages so that the required funding is attained. The earlier argument that this expenditure is indirectly cyclical is no longer valid.

Statistical analysis

Because of the sickness insurance funding reform that came into force at the beginning of 2006, any examination of historical data regarding sickness insurance revenue items relevant to the central government contribution must be viewed with extreme reservation. For expenditure, a long-term perspective is easier to justify.

The first question that statistical analysis can be expected to illustrate is the cyclical sensitivity of central government budget appropriations related to sickness insurance. Sickness insurance expenditure in the budget has shown a strong positive correlation with overall production volumes, in terms of both amounts and annual change (correlation coefficient for amounts was 0.99 for 2000-2007 and 0.86 for 1991-2007; correlation coefficient for percentage change was 0.32 for 2000-2007 and 0.66 for 1991-2007). This evident pro-cyclical tendency would seem to disprove the hypothesis that these appropriations are automatic fiscal stabilizers as such.

The second question involves potential indirect cyclical sensitivity through insurance contributions. The amounts of both the insurance contributions and the central government contribution have as a rule been rising since the beginning of the 2000s, with a clear positive correlation (correlation coefficient 0.85). Up to 2005, the central government contribution increased more rapidly than the insurance contributions. However, with the reform that came into force in 2006, a clear increase was made to the insurance contributions, and as a result their revenue temporarily increased much more rapidly than the appropriation in the central government budget. The annual percentage changes show a negative correlation, but not too drastic (correlation coefficient was –0.15 for 2000-2007 and –0.24 for 1991-2007).

National pensions insurance and budget item 33.19.60

National pensions insurance expenditure (excluding survivor's pension benefits and front-veterans supplements) together with operating expenditure is estimated to reach EUR 3 billion in 2007. The number of recipients of the national pension will be declining slowly over the next few decades and more rapidly thereafter. Increases to its amount are discretionary, and a cost adjustment to the benefits based on the cost of living index is made annually. The cost-of-living classification of municipalities is meant to be abandoned in 2008, with national pension benefits in Class 2 municipalities being raised to the level of Class 1 municipalities. This will increase the benefits by a total of slightly over EUR 100 million. With the ageing of the population, there will be increased pressure in housing allowances and care allowances for pensioners. Under current legislation, no similar pressure is expected in other benefits (child increases, child care allowances, disability allowances). The most recent estimates show that under the current decisions, national pension benefits would increase by a total of slightly over EUR 200 million between 2007 and 2011.

The financing structure of national pensions insurance has changed substantially over the long term with the discontinuation of direct payment transfers of national pensions insurance contributions, local government contributions and VAT revenue. The remaining funding providers are the employers and central government (and to a minor extent the yields by the national pensions fund). The employer contributions are collected on the basis of wages paid, with staggered percentages: 0.901%, 3.101% or 4.001% for private employers depending on their depreciations and how those relate to wages paid, and 1.951% for public employers and parishes. In the current year, employer contributions are estimated to bring in EUR 1.1 billion, or about 36% of the national pensions insurance expenditure.

At present, the central government finances housing allowances for pensioners, child care allowances and disability allowances completely and, in principle, 40% of reduced national pensions, out of budget item 33.19.60. In the 2007 budget proposal, it was estimated that EUR 447 million is needed for benefits completely funded out of central government appropriations and EUR 841 million for the 40% central government contribution to reduced national pensions. However, the employer contributions referred to above are insufficient to cover the remaining 60% of reduced national pensions. The liquidity requirement of the national pensions fund (liquid assets must be at least 4% of annual overall expenditure at the end of the calendar year) will not be satisfied with these funding contributions. It is estimated that central government must pay an additional EUR 600 million as a ‘guarantee payment’ to ensure sufficient overall funding.

It is difficult to justify the exclusion of the national pensions item in the budget from the spending limits by claiming that it is cyclically sensitive. Benefits expenditure is largely determined by the age structure of the population and other structural factors (such as trends in employment pension security). With unchanging employer contribution percentages, the total revenue of employer contributions can show cyclical fluctuations through variation in wages paid, and this may be reflected in the central government contribution, specifically the guarantee payment. However, this effect is now smaller because employer contributions only account for slightly over one third of the overall funding. Compared with sickness insurance, especially medical care insurance, where the current automatic increases in refunds on medicine can easily increase expenditure, continuing to exclude national pensions insurance from the spending limits seems better justified. However, it should still be required that any changes in the its basis are included in the spending limits, as has been done in the past spending limits period with regard to increasing the amounts of benefits and to extending the coverage of benefits.

Statistical analysis

As noted in connection with sickness insurance, the national pensions insurance budget item shows a strong correlation with overall production in terms of amounts and, to a lesser extent, in terms of annual percentage changes (correlation coefficient for amounts was 0.90 for 2000-2007 and 0.83 for 1991-2007; correlation coefficient for percentage changes was 0.32 for 2000-2007 and 0.30 for 1991-2007). No immediate automatic-stabilizer effect can be perceived.

Instead, there is a clear negative correlation between the present funding items, the revenue of the employer contributions and the central government contribution in the 2000s, though not in the period 1991-2007 as a whole (correlation coefficient for amounts was –0.88 for 2000-2007 and 0.13 for 1991-2007; correlation coefficient for percentage changes was –0.78 for 2000-2007 and 0.21 for 1991-2007). A graphic representation of this trend confirms the observation; therefore, there is a case to be made for continuing to exclude this item from the spending limits because of the potential residual nature of the central government contribution.

The working group proposes that budget item 33.18.60, the central government contribution to expenditure under the Sickness Insurance Act, be included in the spending limits. The working group further proposes that budget item 33.19.60, the central government contribution to expenditure under the National Pensions Act, remain excluded from the spending limits, apart from changes to its basis.

3.3.2 Unemployment security expenditure

Under the 2003 spending limits decision, unemployment security expenditure was excluded from the spending limits because of its cyclical nature. The budget items excluded were the unemployment allowance under the Act on Income Security for the Unemployed (budget item 33.17.51) and labour market support (34.06.52), and two smaller items, the central government contribution to unemployment funds (33.17.50) and the central government contribution to switch-leave compensation (33.17.53).

Between 2000 and 2007, unemployment security expenditure has varied even though the number of unemployed persons has steadily fallen. The variance can probably be explained by a larger number of the unemployed participating in the new, more expensive activation measures, which increases the need for labour market support. Some activation measures are funded out of budget item 34.06.51, Job creation, training and special measures, which is included in the spending limits, but the rest of the expenditure comes out of the labour market support budget item (34.06.52), which is excluded from the spending limits. Increasing participation requirements and otherwise raising the activation rate should have and at the very least should now be ranked as a change in the basis of the payments, in which case the change would be included in the spending limits. The central government contribution to switch-leave compensation is a non-cyclical expenditure item, and as such should be included in the spending limits.

Unemployment security expenditure correlates with GDP in terms of both amounts (correlation coefficient 0.33) and percentage changes (correlation coefficient 0.44). However, the reduction in the number of the unemployed between 2001 and 2007 has decreased unemployment security expenditure (correlation coefficient 0.50), so there is still a case to be made for excluding unemployment security expenditure from the spending limits due to its continued existence as an automatic fiscal stabilizer.

The working group proposes that unemployment security expenditure, except for the central government contribution to switch-leave compensation, continues to be excluded from the spending limits due to its cyclical fluctuations. The central government contribution to switch-leave compensation should be included in the spending limits.

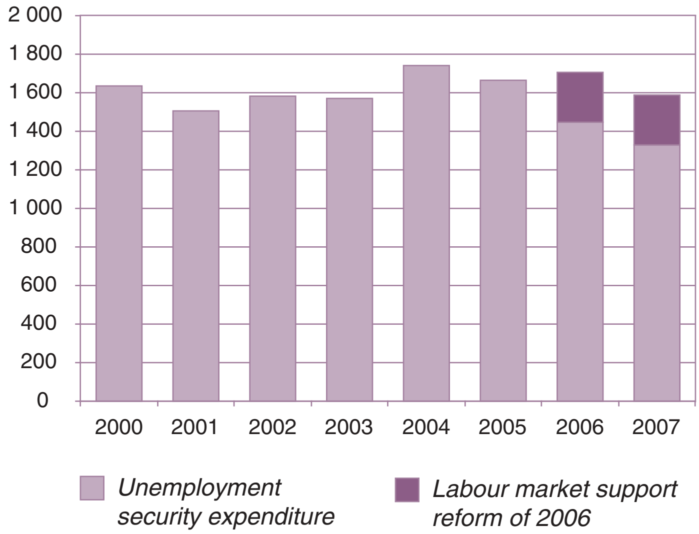
Decision-based changes to the basis of benefits, e.g. the amounts of daily allowances, the increased participation requirements and other measures to raise the activation rate, belong within the spending limits.

Table 5: ***Unemployed job seekers and the proportion taking part in active measures, 2000-2007***

	2000 Final	2001 Final	2002 Final	2003 Final	2004 Final	2005 Final	2006 Budgeted	2007 Budget
Unemployment, 1,000 persons (MoL)	321.0	302.0	294.0	289.0	288.4	275.3	255.0	245.0
activation degree*, %	24.0	24.2	23.8	24.6	24.7	25.0	26.7	28

* of broad unemployment. Estimated numbers, which usually have been about one percentage point higher than actual numbers.

Figure 2. ***Unemployment security expenditure adjusted for benefits improvements and the labour market support reform of 2006, at 2007 prices, EUR million***
(Price adjustment using the National Pensions Act index)

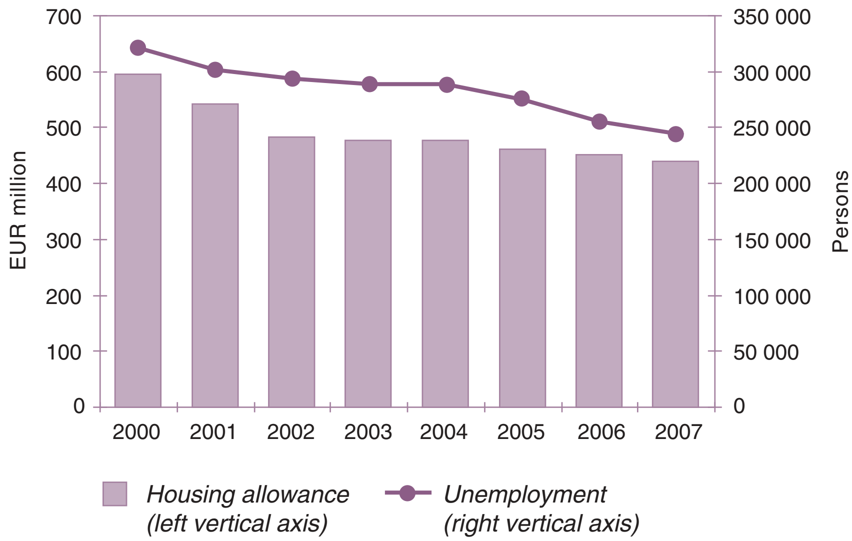


3.3.3 Housing allowance expenditure

Housing allowance expenditure has decreased between 2000 and 2007 together with the decrease in unemployment, although the rate of decrease has levelled off in recent years. Housing allowance expenditure clearly correlates with the number of unemployed persons (correlation coefficient 0.79 for amounts, 0.42 for percentage changes), because two-thirds of those receiving a housing allowance are unemployed. Therefore, housing allowance, being linked to unemployment, is a cyclical expenditure item and should be excluded from the spending limits.

The working group proposes that apart from changes to the basis of benefits, housing allowance expenditure should continue to be excluded from the spending limits due to its cyclical nature.

Figure 3. ***Prime adjustment according to the trend in the average housing costs of housing allowance recepients***
(Price adjustment using the National Pensions Act index)



3.3.4 Debt interest payments

Interest payable on the central government debt, like any on-budget expenditure, must be funded through annual central government revenue, new borrowing, realisation of receivables and/or decreasing the expenditure itself. From this viewpoint, the spending limits should include debt interest payments too. However, interest payments differ in nature from other on-budget expenditure items in many ways, and their inclusion in the spending limits must be carefully considered from a variety of aspects.

Debt interest payments are largely determined by how the balance of central government finances has developed in recent years and what funding decisions have been made; it depends only marginally on current balance and interest trends. This year's debt interest payments by the Finnish central government (2007 budget: EUR 2,348 million) still reflect a time when central government debt was high by domestic historical comparison, combined with the effect of the considerable reduction in the effective interest rate of the debt.

In analysing the case for including debt interest payments in the spending limits, we should first distinguish between the direct impact of interest payments at various points in the trade cycle on the basis of interest rates and the amount of debt on the one hand, and the relationship of interest payments to domestic cyclical trends on the other. In other words, we should examine whether interest payments plays a direct role as an automatic fiscal stabilizer or perhaps works pro-cyclically.

Secondly, we should estimate the indirect impact of interest payments on the flexibility of central government finances and on other expenditure: whether, in a situation where the spending limits or some other restrictions force expenditure under a given overall ceiling, externally determined interest expenditure (which depends on indebtedness history and current interest rates) at any given moment would help control other expenditure in a way justifiable in cyclical policy terms, i.e. to curb the growth of other expenditure in an upswing and to allow it flexibility in a downturn.

Uncertainty about the functioning of these mechanisms in the near future makes it difficult to answer these questions. The determination of interest rates in the euro zone as part of general economic trends, and any deviations between cyclical trends in Finland and in the rest of the euro zone, make it difficult to estimate which approach with regard to interest expenditure and the spending limits would be optimal to support the chosen fiscal policy. This is evident in the following discussion, which arrives at some conflicting conclusions.

Depending on the situation, debt interest payments could be more effective as an automatic fiscal stabilizer if included in the spending limits rather than excluded, and continuing to exclude interest payments from the spending limits is not necessarily justified in cyclical policy terms. Usually interest rates go up during an upswing, and interest expenditure included in the spending limits would curb the increase of other expenditure. By comparison, interest rates going down during a downturn would cause interest expenditure to give flexibility for other expenditure to grow. Net indebtedness during a downturn would have the opposite effect, increasing interest payments, and in such a case the inclusion of interest expenditure in the spending limits could exacerbate the downturn.

Interest rate changes that are independent of domestic factors may influence interest payments by hundreds of millions of euros over a few years. Compared with the size of the unallocated reserve in the spending limits, debt interest payments could be a rather unstable and unpredictable item. This would be especially apparent when interest rates fluctuate, and the euro market is currently showing signs of this. Attempts have been made to minimize the interest payments on the central government debt by moving towards short-term interest rates in debt structuring. The trade-off is that short-term interest rates have more variability, and this brings added uncertainty to estimating the amount of interest expenditure.

If debt interest payments were to be included in the spending limits, its instability should be taken into account in the scaling of the unallocated reserve. On the other hand, there are other items included in the spending limits that may vary by hundreds of millions of euros depending on the circumstances. The size of potential changes in an expenditure item or the exogenic nature of its determination are not considered acceptable grounds for excluding an expenditure item from the spending limits.

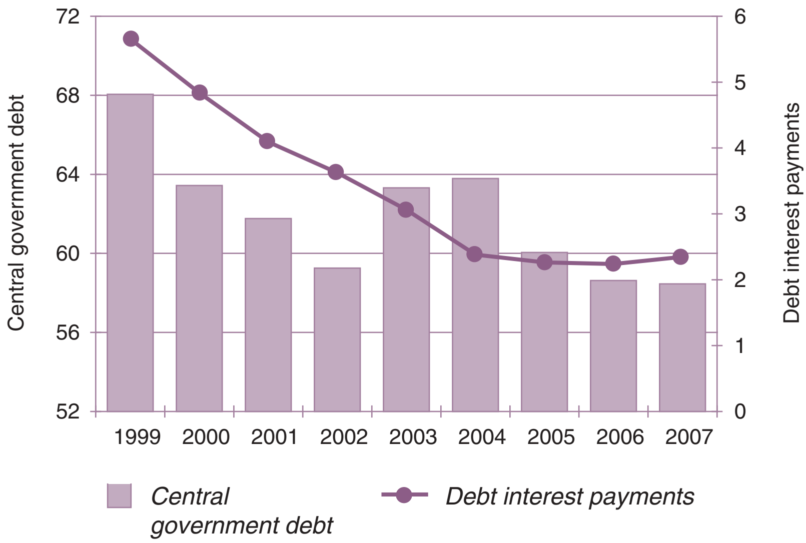
Including interest payments in the spending limits would encourage paying back of the central government debt, i.e. maintaining a surplus in central government finances. On the other hand, it would also serve as an incentive to sell off assets and to pay back the central government debt with the sales proceeds. However, the spending limits should not encourage the sale of assets as such.

The inclusion of debt interest payments in the spending limits would also reward good debt servicing, which in practice is the responsibility of the Treasury. On the other hand, debt servicing measures aim at achieving interest payments that are as low as possible over a long period, longer than a term of office. Therefore, it is not feasible to attempt to minimize interest payments in the short term. In some years, active debt servicing may lead to interest expenditure spikes which are expected to be offset by greater benefits in later years. Such spikes, if they occurred within the spending limits, might create pressures towards changing the debt servicing policy, even if that policy had been assessed as the most economical approach. In the case of strict spending limits, there might even be pressure towards changing the debt servicing policy so as to create momentary savings in interest payments at the expense of future years. This aspect is an argument in favour of excluding interest payments from the spending limits.

In light of the above, a case could be made for both the exclusion of debt interest payments from the spending limits and their inclusion. The arguments tend to go one way or the other, depending on the situation. In an uncertain environment, continuing the current practice seemed to be the best solution. It seems obvious that the risks for expenditure control and the foundation of fiscal policy would be greater if interest payments were included in the spending limits.

The working group considers that debt interest payments should continue to be excluded from the spending limits.

Figure 4: ***Central government debt and interest payments, EUR billion***



3.3.5 Compensations to other tax recipients for changes in the basis of central government taxation

It has been decided that expenditure to compensate other tax recipients (municipalities, parishes, the Social Insurance Institution) for revenue loss caused by changes in the basis of central government taxation will be excluded from the spending rules. The reason for this is to maintain neutrality in tax policy. The spending limits system is not intended to impose technical limitations on how tax cuts can be implemented.

The purpose of easing taxation on earnings is to ease the tax burden on labour, which has been achieved by changing the central government income-tax scale, increasing the work-related deduction, and increasing the earned income deduction in municipal taxation. The aim has been to focus these tax cuts on low-income and medium-income taxpayers, and until 2006 this was achieved by increasing the earned income deduction in municipal taxation. Increasing deductions in municipal taxation reduces the tax revenue of tax recipients other than the central government, and accordingly the municipalities have been compensated for this loss in tax revenue. Table 6 shows the changes in tax revenue caused by changes in the basis of income tax and how the municipalities have been compensated for these in 2004-2006. In earlier years, tax cuts were also implemented by lowering social security contributions, which in turn caused an increase in the transfers from on-budget entities to the Social Insurance Institution.

The Act on Restructuring Local Government and Services passed by Parliament in January 2007 contains provisions outlining the reform of the local government funding system and central government transfers to local government; its purpose is i.a. to strengthen the tax revenue base of the municipalities by transferring the impact of tax deductions to central government finances. The reform is meant to be put into practice as of the beginning of 2009. The reform will probably reduce the scope of paying compensation to municipalities for changes in central government taxation but will not necessarily completely eliminate it.

The working group proposes that any compensations to other tax recipients for central government tax changes continue to be excluded from the spending limits.

Table 6. ***Changes in tax revenue caused by changes in the tax base of municipal taxation and how municipalities have been compensated***

	Change in tax revenue, EUR million		**Change in central government transfers, EUR million**	
2004	-359	Earned income deduction increase EUR 343 million; work-related deduction increase EUR 13 million; changes to the income tax scale EUR 3 million.	359	Social welfare and health care service central government transfers increase by 3.25 percentage points, EUR 357 million; index-linked increase of transfers EUR 2 million.
2005	-121	Earned income deduction increase.	121	Reduction of percentage of municipal internal financing in the social welfare and health care central government transfers.
2006	-127	Daily allowance contribution deduction related to the sickness insurance reform EUR 90 million; earned income deduction in central government taxation EUR 7 million; and end of the forest tax transition period EUR 30 million.	128	Increasing the equalisation limit in equalisation of central government transfers by 0.5 percentage points; lowering the limit for equalisation deduction by 3 percentage points (these together come to EUR 98 million); and increasing the equalisation limit by 0.36 percentage points EUR 30 million.

3.3.6 Self-financing pass-through items

In the spending limits system, pass-through items such as expenditure corresponding fully to revenue from the European Union and expenditure corresponding to betting and lottery revenue and transferred earnings from the Slot Machine Association are excluded from the spending rules. This is because they are self-financing items which are statutory or similarly provided for, and their revenue does not come from taxes or fees. How these appropriations develop depends on how the corresponding revenue develops: if the revenue increases and the corresponding expenditure increases, this is not considered grounds for cutting other expenditure. Nor is there any fiscal policy need to attempt to limit the revenue gained from the EU or from gaming.

Expenditure corresponding to revenue from the European Union

Funding for ERDF and ESF projects consists of a direct contribution from the European Union and national matched funding. Both the EU funding and the national funding are paid to recipients through the central government budget and are recognized as central government expenditure. However, the EU funding is considered a pass-through item and as such excluded from the spending limits, whereas the national matched funding is included in the spending limits. In practice, if the EU funding increases, the national matched funding increases too.

The working group proposes that expenditure corresponding to revenue from the EU continue to be excluded from the spending limits.

Table 7*. **Deviations from spending limits in expenditure corresponding to revenue from the EU, EUR million***

	2000	2001	2002	2003	2004	2005	2006	2007
Expenditure corresponding to revenue from the EU, actual or budgeted	766	982	1,020	1,049	1,082	1,100	1,174	1,141
- in the estimate in the spending limits decision	913	1,009	1,060	1,084	1,133	1,187	1,223	1,112

Expenditure corresponding to betting and lottery revenue and transferred earnings of the Slot Machine Association

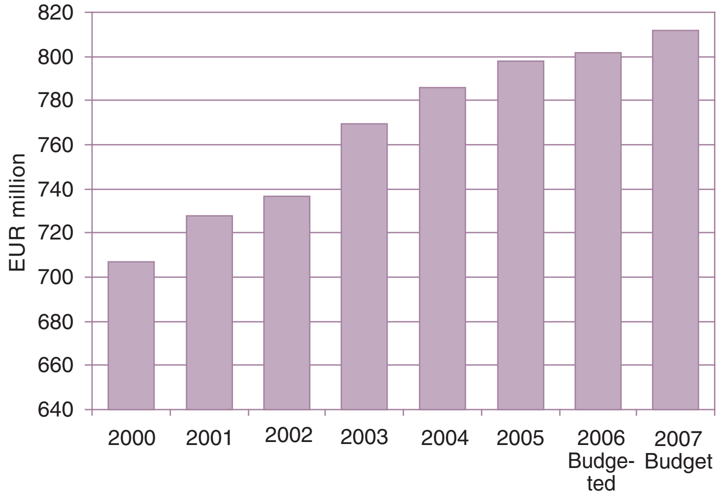
The funding for expenditure corresponding to betting and lottery revenue and transferred earnings of the Slot Machine Association consists of income from betting and gaming activities. The purposes for which this revenue may be used are provided for in the Lotteries Act (1047/2001), under which the proceeds from money lotteries, pools and betting are used to promote sports and physical education, science, the arts and youth work. Also, on the basis of the Lotteries Act the Government has given the Slot Machine Association the exclusive right to maintain slot machines, to operate casino games and to run casinos. The purpose of the licence-based operations of the Slot Machine Association is to raise funds for incorporated non-profit societies and foundations for promoting health and social welfare. Also, part of the revenue of the Slot Machine Association is designated for the use of the Treasury, for instance for the running costs of institutional care for war invalids and for the rehabilitation of front veterans.

The amount of gaming revenue available and the amount of transferred earnings depend on how lively gaming activities are. It has not been considered necessary from the fiscal policy viewpoint to limit the amount of revenue or the expenditure corresponding to it.

The working group proposes that expenditure corresponding to betting and lottery revenue and the transferred earnings of the Slot Machine Association continue to be excluded from the spending limits.

This expenditure does, however, have an impact on the scaling of fiscal policy, and therefore how the revenue is used should be monitored more closely. Also, preparations should be made for the eventual dismantling of the government monopoly on gaming and for the revenue of Veikkaus [the government betting and lottery company] and the Slot Machine Association not developing as predicted when the spending limits are drawn up. A decrease in this revenue would put pressure on the spending limits and might tend to displace other expenditure to make room for the expenditure that is currently covered by revenue from gaming.

Figure 5: ***Expenditure corresponding to revenue from betting and lottery and the transferred earnings of the Slot Machine Association, EUR million***



3.3.7 Financial investment expenditure

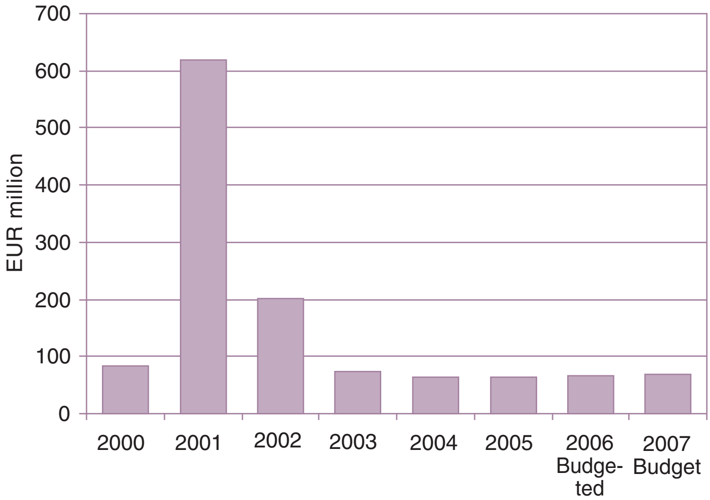
Financial investment expenditure consists mostly of one-off items and is part of the management of government property. It is excluded from the spending rules in the spending limits decision. Financial investment expenditure involves acquiring government property or converting government assets into a different form, and the assumption is that the asset value remains unchanged.

As a rule, fiscal investment expenditure is tantamount to saving or storing assets and not expenditure as such. Therefore, it is justified to exclude fiscal investment expenditure from the spending limits.

One of the growing items in the area of fiscal investment involves the capital loans granted by the Finnish Funding Agency for Technology and Innovation (TEKES), which include waiver authorisations. These authorisations amounted to EUR 10 million in 2005 and to EUR 20 million in the 2006 and 2007 budgets. Waived capital loans are tantamount to direct subsidies, and accordingly they should be handled like subsidies in the spending limits system. On the other hand, there are other revenue losses comparable to waived capital loans in central government finances, such as gratuitous transfers of property and capitalisation of corporate shares. The combined effect of these revenue losses is currently low, but the working group would like to draw attention to this point and note that if such procedures become more common, their inclusion in the spending rules should be considered.

The working group proposes that financial investment expenditure continue to be excluded from the spending limits.

Figure 6: ***Financial investments in nominal prices, EUR million***



3.4 Need for excluding other items from the spending limits

3.4.1 VAT expenditure

As of 2008, VAT expenditure included in the operating expenditure (items 01-28) and real investment expenditure (items 70-79) by ministries and government agencies will be budgeted separately by administrative branch under item 29. It is currently budgeted under item 19. Operating and investment expenditure paid under transfer expenditure items (30-69) must be budgeted inclusive of VAT, so the VAT expenditure for this expenditure is included in the appropriations. The 2007 budget contains a total of some EUR 905 million in VAT expenditure.

Since 2003, VAT expenditure has been budgeted under a separate item by administrative branch. It has been difficult to estimate this expenditure, although the accuracy of the estimates has improved year by year. What makes the estimation difficult is that the expenditure often arises towards the end of the year. Erroneous estimates — which at the worst have involved a single item under-budgeted by EUR 60 million — may lead to a misconception as to the size of the unallocated reserve. In fiscal policy terms, there is no case for including VAT expenditure in the spending limits, since it is paid to central government itself and is thus a zero-sum item. Excluding VAT expenditure from the spending limits would make the choice between in-house work and purchased services more neutral and make it easier to implement infrastructure projects with municipalities, for instance.

Transfer expenditure items containing pay, operating and investment expenditure, or ‘mixed items’, also contain VAT expenditure, and this would be technically very difficult to exclude from the spending limits, since the VAT expenditure is not itemized under these items. This would also lead to a large number of budget items existing partly inside and partly outside the spending limits, which would detract from the transparency of the system. Examples of such items are the national matched funding for ESF projects, water resources management projects and water supply engineering projects. The sums involved are relatively small, however, and for simplicity’s sake the VAT expenditure under these mixed items could continue to be included in the spending limits.

The working group proposes that VAT appropriations collected under separate items by administrative branch be excluded from the spending limits, since there is no fiscal policy case for including them as the expenditure is paid to central government itself. Excluding VAT expenditure would also make the choice between in-house work and purchased services more neutral.

3.4.2 Appropriations corresponding to external funding contributions

The working group has deliberated whether gross budgeting appropriations corresponding to external funding contributions should be excluded from the spending limits. Such appropriations exist for instance in transport projects where municipalities contribute some of the funding. It should be possible to receive any external funding offered for a project without requiring that the overall expenditure on the project should remain the same because of the spending limits. This would encourage the administrative branches to seek external funding actively. Essentially, the situation is the same as with EU funding.

This could be implemented so that only the central government contribution would be included in the spending limits, and the proportion of appropriations corresponding to external funding contributions would be excluded. This would only apply to major gross budgeting appropriations, so as to avoid jeopardizing the manageability of the system. The exclusion would naturally not apply to funding contributions that constitute a loan from the municipalities to central government.

The working group proposes that gross budgeting appropriations directly corresponding to external funding contributions received by central government could be excluded from the spending limits.

3.4.3 Expenditure with corresponding statutory revenue and pass-through items

The following expenditure items, which have a direct statutory revenue equivalent not deriving from taxation, are excluded from the spending limits (see section 3.3.6):

- expenditure corresponding to revenue from the EU; and
- expenditure corresponding to betting and lottery revenue and the transferred earnings of the Slot Machine Association.

The budget contains certain other expenditure items that have a direct statutory revenue equivalent. These include for instance the following, under the main title of the Ministry of Agriculture and Forestry:

- 30.40.25 obligation to manage fish stocks (riparian fishery fees);
- 30.40.41 compensation for damage caused by deer (deer hunting permit fees);
- 30.40.50 promotion of hunting and game management (game management fees);
- 30.40.51 promotion of the fishing industry (fishery fees);
- 30.40.52 Tenojoki fishing licence fees and lure fishing fees (Tenojoki fishing licence fees).

The working group deliberated whether these earmarked items should be excluded from the spending limits: in that case, if the appropriations were to change because the revenue estimates change, this would have no impact on the flexibility of the spending limits. The drawback here might be that the fees could be increased unnecessarily if this proved to be a way of obtaining extra appropriations without reference to the spending limits.

On the other hand, there are no grounds for excluding tax-based items from the spending limits. If the revenue consists of a tax, earmarking it for specific expenditure is problematic for fiscal policy, because it erodes the efficient focusing of revenue raised by the tax burden. Such revenue either restricts the flexibility of other taxation or alternatively increases the tax rate, which has a disincentive effect. Some items of expenditure cannot be treated in a more lax manner than others on the basis that they are funded from earmarked tax revenue rather than from tax revenue in general. For deer hunting permit fees, game management fees and fishery fees, the corresponding revenue is considered tax revenue.

Excluding earmarked expenditure from the spending limits would encourage the creation of new earmarked appropriations, contrary to the non-affectation principle,[10] which is also not desirable from the fiscal policy viewpoint. Therefore, it would be good to continue to include the items described here in the spending limits, particularly since they are relatively small and stable. Excluding them would detract from the transparency of the spending limits system.

However, it would be beneficial to include in the spending limits pass-through items which for technical reasons are handled through the central government budget. One example of these is the pensions paid on behalf of other pensions institutions (item 28.07.63), where the corresponding revenue item is Compensation for pensions paid on behalf of other pensions institutions (12.28.63). These two items are the same sum (about EUR 33 million in the 2007 budget). In the course of any given year, central government pays pensions on behalf of other pensions institutions under the 'Vilma' system. The other pensions institutions pay the same amount to central government as advance payments in the same year. This is a technical pass-through item, and there are no fiscal policy grounds for interfering with it.

For consistency, it would be good to exclude revenue from totalisator betting from the spending limits, just like betting and lottery revenue and the transferred earnings of the Slot Machine Association.

The working group proposes that technical pass-through items and totalisator betting revenue be excluded from the spending limits.

10 A budgeting principle whereby specific revenue must not be linked to specific expenditure.

3.4.4 Pay security

Central government pays the salaries of employees whose employers cannot pay them because of bankruptcy or other insolvency, under the pay security item (34.99.50). Central government then recovers part of this expenditure from employers and bankruptcy estates, and the rest (about 80%) is compensated for by the Unemployment Insurance Fund. The estimated interest revenue from pay security returns are retained by central government to cover the costs of the pay security system. The related revenue comes under items 12.34.70 (Pay security returns) and 12.34.99 (Other revenue in the administrative branch of the Ministry of Labour) (some of the interest revenue on pay security returns). In 2005, EUR 21 million was paid in pay security. Pay security is a cyclical expenditure item, since in a downturn the number of company bankruptcies increases and employer solvency declines. For this reason, it is proposed that pay security, like other cyclical expenditure items, be excluded from the spending limits.

The working group proposes that pay security (34.99.50), being a cyclical expenditure item, be excluded from the spending limits.

3.4.5 Social assistance

In the past electoral period, a new appropriation was created in the budget for the central government contribution to basic social assistance expenditure (33.32.38). This was enacted as of 1 January 2006 in connection with the labour market support reform. Central and local government now contribute equal shares to basic social assistance expenditure. This item is highly cyclical, since the number of people receiving social assistance depends to a great extent on the number of unemployed people. Being an automatic fiscal stabilizer, this appropriation should be excluded from the spending limits just like all other automatic fiscal stabilizers. However, expenditure arising from any increases to benefits must be included in the spending limits.

The working group proposes that the central government contribution to basic social assistance expenditure (33.32.28), being a cyclical expenditure item, be excluded from the spending limits. However, expenditure arising from any increases to benefits must be included in the spending limits.

3.4.6 Externally determined items

Certain substantial items of expenditure are beyond the control of decision-makers. Although in theory all expenditure can be affected, through the procedure for the enactment of constitutional legislation if nothing else, in practice some items are of such a nature that it is almost or nearly impossible to affect them. These include the EU membership fee, many international membership fees, some nationally funded EU expenditure, transfers to Åland and constitutionally enacted expenditure (e.g. benefits and pensions covered by basic security). The bulk of the operating expenditure of the key government agencies is also very difficult to influence. It has also been proposed that development cooperation expenditure constitutes such an item because of international commitments and that it should thus be excluded from the spending limits. Actually, the scaling of development cooperation expenditure is largely discretionary.

The working group has decided not to propose excluding any item of expenditure from the spending limits simply because it cannot be controlled or it can only be controlled to a limited extent.

If this criterion were accepted, it would precipitate a difficult classification task, and the spending limits would probably be much reduced. The working group considers that such expenditure should continue to be included in the spending limits, because ultimately they are funded out of tax revenue. Therefore, if they were to increase, they would affect the level of other discretionary expenditure within the limits of the chosen tax rate and other resource limitations.

It has also been proposed that major unstable statutory expenditure (e.g. the adjustment to the division of costs between central and local government) should be excluded from the spending limits. Managing expenditure like this and adapting to changes in it is crucial for the success of fiscal policy. Therefore items such as this absolutely cannot be excluded from the spending limits. The spending limits system must not be marginalized into a mechanism controlling small and stable discretionary expenditure items, because it would then have no fiscal policy significance.

3.5 Transport route construction expenditure in the spending limits

In connection with the Government Programme in spring 2003, an increase of EUR 25 million for infrastructure investments was agreed on, and no provision was entered for starting new projects in the 2004-2007 spending limits decision. Only the funding for projects already decided was taken into account, and thus the level of infrastructure investments in the spending limits decision remained fairly low.

After the spending limits decision was made, a ministerial working group led by the Minister of Transport and Communications was set up to work on a long-term approach to transport planning. Its report[11] contained a priority listing for major projects to be started and theme packages consisting of minor projects. There was also a ‘second basket’ of projects for the years 2008-2013, without priority ranking. During the term of office, the Government made several proposals for added expenditure above and beyond that decided in 2003. These were mostly based on the priority listing, and indeed this procedure has helped planning in the civil engineering sector. However, with a view to the spending limits this was problematic, as these transport infrastructure investments required cuts elsewhere and the use of revenue from sales of shares.

The shortcomings in transport infrastructure investments were due to the inadequate original scaling of investments as noted above but also to the uneven distribution of construction over time.

It is a problem in the present spending limits system that the investment funding rules it contains cannot establish a stable level of investment spanning several electoral periods. As the electoral period proceeds, the duration of the remaining binding spending limits period decreases, and in the final year of the period major projects are sometimes started on small investments scaled for that spending limits period. Authorisation procedures postpone the principal expenditure of such projects to the years after the current spending limits period.

The past four Governments have started major infrastructure investment projects as shown in Table 8. The Table indicates that cost estimates on project starts have increased substantially under the two last Governments.

11 Liikenneväyläpolitiikan linjauksia vuosille 2004-2013. Ministerityöryhmän mietintö. 7/2004 LVM. [Ministry of Transport and Communications]

Table 8. ***Cost estimates of new projects by Government*** (excluding VAT expenditure)

	Number of projects	**Cost estimate or contract authorisation** (EUR million)
Aho	32	1,012
Lipponen I	20	967
Lipponen II	20	1,576**
Vanhanen	21*	2,045**

* Parliament decision on 18 projects, funding provision for 3 further projects.

** The Muurla-Lohja life cycle project breaks down thus: Lipponen II EUR 279 million (original cost estimate) and Vanhanen EUR 421 million (increased cost estimate and additional financing costs from changing to PPP funding).

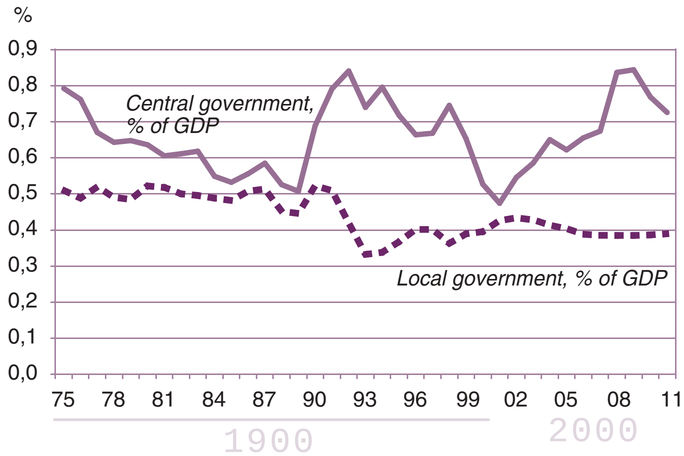
The rule on spending revenue from sales of shares is a random factor that may contribute to investment variance. Revenue from sales of shares was mainly used to fund infrastructure investments in the 2004-2007 spending limits period.

The Finance Committee referred to the aim of investment volume stability in a report (VaVM 4/2005, vp): "The Committee considers that resources should be scaled so as to enable transport investments to be made at an even pace throughout the term of office. There should also be no great variation in investment volume between electoral periods."

It has been difficult to achieve investment stability, as investment decisions have been taken on several occasions through the year. The volume and timing of investments has been uneven, partly because of random factors. In the long term, this will lead to inefficiency and increased costs. Stability of investment would translate into an increasingly long-term approach. On the other hand, there must be flexibility in fiscal policy to allow for changing circumstances. Therefore, it is also not justified to set investment levels in stone for many years to come; it must be possible to bring forward or push back project plans as needed.

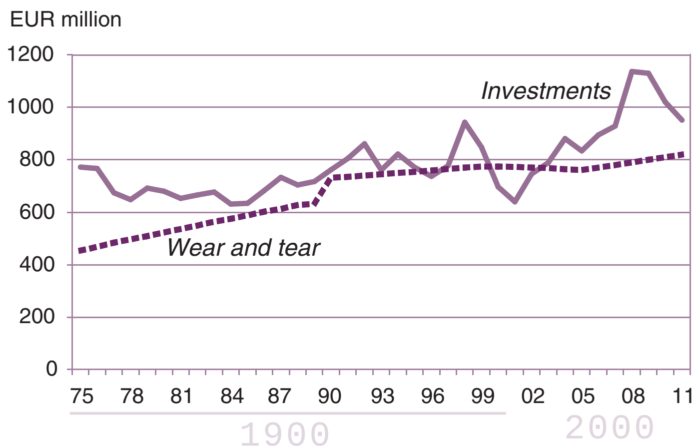
Stability in central government infrastructure investments would reduce current problems in resource allocation. The transport infrastructure projects that under current decisions will be implemented in 2008 and 2009 will overburden construction and equipment capacity. In the past electoral period, average expenditure on road and rail projects was EUR 197 million annually. The corresponding figure, based on decisions already taken, is much higher for 2008 and 2009 (EUR 460 million and EUR 521 million, respectively). The volumes set for 2010 and 2011 are also high but allow more scope for new project starts.

Figure 7. ***Central and local government civil engineering investments as a percentage of overall production, 1975–2011***



Source: Statistics Finland; 2006-2011 Ministry of Finance estimate

Figure 8. ***Central government civil engineering investments and wear and tear 1975-2011, EUR million***



Source: Statistics Finland; 2006-2011 Ministry of Finance estimate

A high capacity utilisation rate will lead to a rapid increase in road and rail construction production, probably followed by a rise in costs more rapid than anticipated. In a report published in June 2006, the business cycle group of the construction industry set up by the Ministry of Finance recommended that no new major project starts should be set for 2006 or 2007, because it was already known on the strength of decisions already taken that the capacity utilisation rate in certain fields in the industry would be high in 2007 and particularly in 2008. Yet several further major investments have been decided on since then. The currently ongoing projects show that there is a shortage of resources and excessive pressures towards increasing costs in construction projects calling for special expertise.

In national accounting terms, central government civil engineering investments comprised about 60% of all public civil engineering investments in 2005. The annual variation in these investments was much greater in central government than in local government. Central government investments decreased by about EUR 200 million between 1998 and 2001, after which the level of investment has increased rapidly. Decisions already taken dictate that growth will remain brisk during the current electoral period. What is essential now is to keep costs from rising unduly.

Central and local government civil engineering investments combined have over three decades almost consistently exceeded 1% of GDP (see Figure 7), except for a few years in the late 1980s and early 2000s. The prediction for 2006-2011 takes into account the transport route decisions already taken. Also, a further EUR 100 million per year is expected to be needed for new projects in 2009-2011.

In the near future, central government civil engineering investments as a percentage of GDP will be at record levels, achieved in past decades only in the deepest years of the depression. At that time, of course, the percentage increased because the GDP decreased. This time, the increase is due to substantially increased investments.

Table 9. ***Cost index of civil engineering works, 2000 = 100***

	2000	2001	2002	2003	2004	2005	2006
Index	100.0	103.0	104.7	107.0	110.8	116.5	123.1
Annual change, %		3.0	1.7	2.1	3.6	5.1	5.7

Source: Statistics Finland

Comparing central government civil engineering investments to calculated wear and tear (see Figure 8), we find that in the 1990s investments and wear and tear progressed in tandem but that in this decade investments will outstrip wear and tear. The central government civil engineering net stock in real terms was at the same level in 2005 as it was in 1990. However, in reading these figures we must note that in the capital stock statistics all infrastructure is assumed to undergo wear and tear at the same rate, so transport routes with minimal use are lumped together with heavily trafficked ones.

Table 9 shows how the annual growth in the cost index of civil engineering works has accelerated in recent years. This increase in costs is due to raw material prices and the prices of purchased services. Because of the robust demand for civil engineering, this cost trend is likely to continue, even though energy prices have at least temporarily fallen and the pressures towards increasing raw material prices are declining.

The spending limits system and transport route funding must be developed so as to avoid the above problems in the future.

Scaling investment appropriations in connection with the Government Programme

The appropriation provision for transport investments made in connection with the Government Programme in spring 2003 proved inadequate, and this was an important reason for the lively discussion on the relationship between investments and the spending limits system in the past electoral period. This problem could be resolved in connection with drawing up the Government Programme, which is when decisions on infrastructure projects should be made. When a Government takes office, it should make a comprehensive list of all projects due to be started or to which resources are to be committed through authorisations during the term of office, on the basis of a thorough overall survey of the infrastructure construction situation. The expenditure impacts of such projects can be estimated with sufficient accuracy for the term of office and for the years beyond.

A sufficiently large proportion of the spending limits should be allocated to transport infrastructure expenditure, with corresponding flexibility in other expenditure. In addition to transport route construction, basic road and track maintenance can also be scaled appropriately in relation to other needs through this process.

Excluding investments from the spending limits

An argument made for excluding transport route investments from the spending limits is that they have a significant impact on future economic growth potential. By this reasoning, what would be left included in the spending limits would be expenditure less important for the future development of society. If appropriations were to be classified on the basis of future growth potential, there are other candidates equally qualified for exclusion from the spending limits, for example, R&D and education (investments in human capital). Such a classification should be based on an evaluation of whether current or future benefits are more important, and how future benefits are to be assessed. Arguments in favour of shifting the burden onto future generations have a hollow ring, as future generations are already facing a considerable cost burden for instance because of the ageing of the population.

Investments are funded out of tax revenue like all other expenditure. The working group does not consider civil engineering investments important enough for fiscal policy in relation to other expenditure that it should be possible to allocate resources to them without reference to the spending rules.

THE GOLDEN RULE IN THE UNITED KINGDOM

Since 1997, the UK has observed the 'golden rule', which dictates that the Government can borrow money for investments but not for current expenditure. Current revenue and expenditure should on average balance out or show a surplus over the economic cycle, but the Government is allowed to incur debt in order to fund public net investments. Depreciations on investments are recognized as expenditure in the current budget. The net public debt is required to be maintained on a stable and cautious footing, which in the interpretation of the Treasury means less than 40% of GDP. After the introduction of this rule, public net investments remained at a low level for some years but have grown slightly in recent years.

The notion underlying the rule is that investment expenditure must be granted special dispensation so that current expenditure could not be increased at the expense of investment. Public investment is considered to boost economic growth and thereby to increase tax revenue; they thus pay themselves back at least in part. The rule is also considered to promote equality between generations, since investments are paid for by the future generations who also enjoy their benefits.

The golden rule has been criticized for allowing increases in expenditure, since investments are not covered by the spending rules. The golden rule also places strict requirements on the correct valuation of capital depreciation and return on investment. If a government deciding to introduce the golden rule has a high volume of public capital when the rule is introduced, depreciations will also be big, forming a large expenditure item in the budget.

Stability and planning in civil engineering investments in the long term

Central government should be able to undertake a methodical and even programme of construction in future years. Decisions on new project starts should be made so as to uphold a stable level of investments. If the level of investments is set for a four-year period, the level should be coordinated between electoral periods so as to avoid overheating when passing from one electoral period to the next.

Investment starts should not be thought of in terms of electoral periods, and indeed it might be justified to conceive of investment planning over a period longer than four years. However, a Government Programme cannot impose commitments on future Governments, so if a binding spending limits system were to be enacted for a longer period, it would have to be enshrined in law.

To improve the long-term approach, investment spending limits could function on a rolling basis so that the long-term instruction of the Government would be to implement infrastructure investment project starts at such a rate that their expenditure impact is stable from one year to the next. The following Government would then follow on from there. Investment levels could be calculated as an average for the past four years and the next four years. The spending limits would be determined in a rolling time frame, in which case extra funding decided by the current Government would be weighted towards the end of the term of office, but the average would in any case be calculated on the project starts of two different Governments.

However, a stable level of investments might cause problems in that projects are of different sizes and have construction stages of different lengths. At present, starting projects of different sizes has been possible as investments are included in the spending limits, and other expenditure has flexibly allowed room for expansion. Therefore, it would not be justified to place new investment projects in a new, even investment spending limits system.

Implementing a funding margin for project starts that is based on a rolling average is technically possible, but commitment to maintaining the level of investment is more difficult to manage, especially towards the end of a term of office. The old Government may not have the incentive to bequeath appropriations for new projects to the new Government, which would enable projects to be started on small investments, leaving the real costs to fall on following electoral periods. A rolling spending limits system would thus entail the risk of not enough funds being available for road and track maintenance in the next electoral period, for instance. A rolling spending limits system would also not avoid restricting the budget flexibility of future Governments if the level of investments remains constant.

A stable investment situation could be achieved by other means. The spending limits decision for each electoral period could contain a pre-determined sum for new authorisations and for payment appropriations. Thus, each Government would spend the same amount of money to complete projects started by its predecessors and a specific amount of money for initial financing of its own authorisation decisions. The authorisation ceiling concept could be improved in that life cycle projects could be treated equally to projects with construction-time financing. Life cycle projects could be divided into investment, maintenance and financing costs. This division would enable public-private-partnership (PPP) investments to be considered in almost the same way as projects with construction-time financing.

However, both the rolling spending limits system and the authorisation ceiling procedure would probably be too rigid, without generating sufficient added benefits.

Instead, the Government could immediately on taking office, for instance in the Government Programme, list all the projects it intends to start during its term. If a Government were exceptionally to decide on an additional project in the course of the term of office, it should take a careful look at projects decided on earlier, at the costs of other civil engineering, at the timing of projects, at the capacity situation in the industry and at price trends. This procedure would prevent sudden, random decisions from being made without reference to how the new project is related to other construction. Achieving a result feasible for the use of resources would be further helped if the Government were committed to a steady pace of infrastructure construction in the Government Programme.

In case a high capacity utilisation rate in civil engineering were to cause a rapid rise in costs, it would be advisable to agree in the Government Programme when and how to react to such a situation. A trend assessment in earth moving would enable the Government to decide on whether to postpone project starts and other infrastructure construction. Cost acceleration due to a high capacity utilisation rate in earth moving could serve as a justification for a Government decision to postpone project starts and other transport route construction.

It would enable a long-term approach in decision-making if there were a vision for a preliminary project plan spanning 10 to 15 years available during the Government Programme negotiations. This could be based on the report of the ministerial working group which deliberated the previous Government's transport policy outlines for 2004-2013. However, the Government need not comment on the long-term project list with regard to subsequent electoral periods, since allowing such comments binding significance would be tantamount to interfering with the selection of projects scheduled for future electoral periods.

The use of the spending limits system should primarily be applied to one Government term. Parliament and the Government should not become over-committed to infrastructure appropriations for the next electoral period. This is undesirable as it reduces the room for manoeuvre in fiscal policy. The matter can be influenced in conjunction with the Government Programme by making a commitment to a construction cost ceiling for expenditure incurred in future electoral periods due to current government's decision. This limitation would also cover projects that have been politically agreed on but not yet formally budgeted; once published, they are in practice binding upon following Governments. The limitation could be restricted to construction costs, so as to ensure equitable treatment for projects with construction-time funding and projects with secondary funding.

In a spending limits system spanning one electoral period, PPP projects (life cycle projects) have a clear advantage over projects with construction-time funding, since the former have a much lighter impact on the spending limits as the majority of their expenditure is actualized after the electoral period. On the other hand, the overall costs of PPP projects are much higher than those for projects with construction-time funding in the calculations, mainly because the builder's financing costs are included in the overall cost in secondary-funding projects. Nevertheless, it would be important to be able to estimate the sums for building commitments without their financing costs. The proposed limitation on expenditure determined for future electoral periods, combined with the spending limits for the current electoral period, would allow this.

By comparison, there seems to be no justification for moving to accrual-based cost accounting on projects, deviating from the budgeting principles. This would substantially improve the status of infrastructure projects with regard to other expenditure items. Such a change might, in the long term, skew the use of public resources towards civil engineering at the expense of other expenditure or increase the funding burden on the shrinking labour force in addition to the increasing burden already known.

The working group proposes that infrastructure construction expenditure continue to be included in the spending limits.

However, the working group proposes several changes to be made to the decision-making process concerning infrastructure construction. It would be advisable to decide the following at the beginning of the term of office, in the Government Programme or in connection with it:

- Civil engineering projects to be started or entered in the budget during the term of office, and the procedure for deciding on exceptional additional projects or major changes;
- Sufficient scaling for expenditure on basic road and track maintenance in the overall spending limits;
- Commitment to evenly paced civil engineering construction;
- Operating procedure in case of excessively rising costs;
- Maximum amount of construction costs imposed on future electoral periods by projects agreed to be started;

The working group considers it advisable that in making decisions in the Government Programme and during the electoral term an estimate of planned projects for a time period of 10 to 15 years and their cost estimates be available.

SWEDEN'S LONG-TERM INVESTMENT PLAN

In Sweden, long-term infrastructure plans for each electoral period have been drawn up for decades. The most recent one covers the years 2004 to 2015 and has a total cost estimate of SEK 381.5 billion. Parliament decides on the spending ceiling for the investment plan (10 to 12 years). After this, the national road and rail authorities[12] propose which projects can be implemented within the funding limits. The Government then decides on major projects on the basis of their proposals. The road and rail authorities decide on project timing and on minor projects on the basis of cost-benefit analyses. Minor projects are grouped into project packages.

The purpose of the plan is to prioritise transport projects. The plan includes cost estimates for new projects, basic road maintenance, basic track maintenance and financing. The investment plan is principally funded from on-budget entities. Lending within the central government finances is used if investment starts are brought forward. Any loans taken will not impact on the spending limits until the investments have been put into practice and payback on the loans begins. In road and rail projects, the loan period and thus the impact of lending costs on the budget is usually 20 years. Some 15% of project funding is covered with loans and the rest through normal appropriations. The loan financing for separate projects is approved by Parliament. The road and rail authorities often prefer loan funding, and thus more projects can be started and the planning environment is simpler and more stable.

The road and rail authorities have not only appropriations limits but also annual authorisation limits in the budget, just as in Finland. For example, in the 2007 budget, road maintenance appropriations by the road authority total SEK 16.8 billion, while the limit on authorisations for funding agreements signed in past years and to be signed during the budget year is SEK 59 billion. About 10% of the appropriations are allocated to covering the interest and instalments on investment projects funded with loans, 40% to investments, and 50% to use and maintenance. Track maintenance appropriations by the rail authority total SEK 13.3 billion and its limit on authorisations SEK 70 billion. Unused appropriations can be carried over to the following year in their entirety. The road and rail authorities are also allowed 10% credit against the following year's appropriations.

At the moment, the road and rail authorities and an institute for transport and communication matters[13] have been asked to draw up a new investment plan for the period 2010-2019. Normally, such a plan includes an overall cost estimate and a description of how transport policy goals are to be attained. After the plan is completed, the road and rail authorities will be asked to submit their proposals for investments within the limits of the funding decided by Parliament. Finally, the Government will decide on major projects. The challenge here is to prioritise maintenance and renovation in the plan so as to secure their funding, any new projects notwithstanding.

The investment plan system as it now stands is considered to work quite well. Its drawbacks include encouraging under-budgeting. Also, the plan makes commitments to long-term expenditure, and in a weak economy there may have to be compromise on these commitments. Moreover, any plan is by definition based on the baseline figures set by its predecessors.

The Government has been obliged to increase project starts in deviation from the plan to some extent. For example, new motorway and railway line investments were implemented as support measures in Trollhättan without reference to the plan limits. Projects were removed from the approved plan to make room for new projects. The plan may also change if the costs of the projects included in it increase beyond what was estimated. In principle, the exceeding of cost estimates should cause other projects to be removed from the plan, but in some cases extra funding for the plan has simply been added for cost reasons.

12 Vägverket [Swedish Road Administration] and Banverket [Swedish rail administration].

13 Statens institut för kommunikationsanalys. [Swedish Institute for Transport and Communications Analysis]

3.6 Spending limits and revenue from on-budget entities

3.6.1 Taxation

In spending limits systems abroad, there are examples of including revenue from on-budget entities in the spending limits system. For example, in the Netherlands both expenditure and revenue are agreed in the government negotiations. In Finland, the spending limits system does not control the development of revenue from on-budget entities, although revenue estimates obviously underlie the setting of the spending limits. Thus, the aim of balancing central government finances in the 2003-2007 term of office and the deficit limit of 2.75% implied underlying assumptions on revenue trends. The current spending limits system is considered to work well with regard to target-setting and the attainment of the desired surplus in central government finances.

If the achievement of the balance aim or staying under the deficit limit were to be endangered because of revenue trends being less favourable than anticipated or expenditure increasing more rapidly than anticipated, raising the tax rate or abandoning tax cuts might be easier than reducing overall expenditure in on-budget entities. In such a scenario, revenue framework might be relevant.

An estimate of future trends in both expenditure and revenue is made for the next four years at the beginning of the term of office. The purpose of this estimate is to anticipate how tax revenue will develop and eliminate the random factor in taxation. The expenditure outline is intended to reduce the risk of pursuing a pro-cyclical fiscal policy in case tax revenue is not sufficient to cover the expenditure in on-budget entities. If revenue trends were to be estimated with a similar system to spending limits, this might lead to undue rigidity. The present spending limits system works well.

The working group proposes that a system for revenue corresponding to the spending limits system should not be created. Revenue trends should be estimated in the spending limits decision as at present, and the decision can include comments on revenue. Once every four years, at the beginning of the term of office, the rules set on expenditure should be evaluated in the light of anticipated revenue trends.

REVENUE AND SPENDING RULES IN THE NETHERLANDS

In the Netherlands, the balance rule has led to revenue being monitored through the spending limits system too. Government negotiations include agreeing on limits on both revenue and expenditure. In the revenue frame upper and lower limits are set for the overall taxation during the government's term of office. Any deviations from these must be compensated for in taxation in future years. Taxation is monitored with an indicator agreed on in advance.

Since 1999, the budget has had an appended list of tax subsidies and their budget impacts; this list has included indirect taxation as of 2003. Budget rules allow the conversion of expenditure into tax subsidies and vice versa, in which case the revenue and expenditure limits are adjusted accordingly. The requirement is, however, that the target group and the amount of the subsidy remain the same. When new tax subsidies are proposed, an evaluation framework is used to justify why the tax subsidy would be better and more efficient than other forms of subsidy. The same framework is used to estimate the impact of existing tax subsidies over a period of at least five years. The purpose of this is to improve the monitoring of tax subsidies so that they would not be an easy option for funding additional expenditure without reference to the spending limits.

A civil service working group has proposed two macroeconomic indicators to be used for monitoring taxation, between which the future Government could choose depending on its viewpoint. The revenue indicator would reflect the impact of Government changes in taxation on the balance of public finances. This indicator would enable the Government to monitor the budget impacts of its tax policy. The revenue indicator would cover all decision-based changes but not cyclical tax revenue trends or technical accounting changes. The indicator should also include any measures as the result of which the tax rate will need to be increased in the near future, for instance in the next government's term of office.

The second proposed indicator, the tax burden indicator, would monitor taxation from the taxpayers' viewpoint. It would include all changes in taxation based on political decisions where these changes influence choices between consumption and savings, between work and leisure time, and between investment options.

The most important difference between these indicators is in how they reflect changes in the funding basis. If, for instance, sickness insurance contributions are lowered and the cover of the insurance is reduced — i.e. if citizens are required to take out additional private insurance policies — the revenue indicator would show that taxation is getting lighter, but the tax burden indicator would show that from the taxpayers' viewpoint the tax rate would remain the same.

Tax subsidies and their abuse

Subsidies granted through the tax system as a deduction, a tax exemption on certain income, or a lower tax rate, represent a deviation from the basic structure of taxation. The recipients of such subsidies are taxpayers. Tax subsidies amounted to EUR 9.4 billion in 2005. Most of this went towards social security, the largest individual items being the municipal pension income deduction, deduction of the statutory employee pensions insurance contribution, and tax-exempt child benefits.

In many countries with a spending ceiling system, there are indications of the spending rules being circumvented through tax subsidies. A system based on the controlling of expenditure includes a structural incentive towards using tax subsidies instead of expenditure subsidies, because tax subsidies do not burden the spending limits. As an example we might take a situation where a decision is taken to support certain individuals or businesses but the support amounts to such a large sum that it cannot be paid within the confines of the spending limits system. It can, however, be implemented as a tax subsidy, which does not cause the expenditure within the spending limits system to increase. Indeed, a spending limits system should be neutral with regard to technical implementation, meaning that it should not favour the use of tax subsidies over expenditure paid directly from appropriation items.

What could be considered problematic for tax policy is a situation where there is a general trend towards granting subsidies through the tax system to circumvent the spending limits. This may lead to an increase in the overall volume of indirect subsidies and to the tax system becoming unduly complicated, which increases costs and in most cases is counter-productive with regard to the productivity goals set. If subsidies decided for a specific target group were implemented as tax subsidies, the target group might unwittingly become much larger due to the technical nature of taxation, which would extend the subsidies to a much wider group than was intended. This, in turn, might lead to distortion of competition or similar impacts.

The reformed spending limits system has not yet generated examples of tax subsidies being used to circumvent the spending limits. However, the first spending limits period has shown that the risk does exist, because aspects of such circumvention have been discussed. The strictness of the spending limits has in some cases governed which method is chosen to implement which subsidies.

Discussions on how to draw the line between the spending limits system and taxation (appropriations and revenue) have been undertaken for at least the following subsidies during the term of Prime Minister Vanhanen’s Government:

- seamen’s income support (appropriation excluded from the spending limits)
- low-wage support (appropriation excluded from the spending limits)

- energy tax subsidy for agriculture and professional greenhouse cultivation (included in the spending limits)
- employment subsidy for individual entrepreneurs (included in the spending limits)

What the above forms of subsidy share is that they are implemented through the tax system, which is not always feasible with a view to the allocation of the subsidies and their administrative costs. The aim to avoid increasing expenditure has, to at least some extent, influenced the choice of how to implement these subsidies, although ultimately in all the above cases the subsidies are budgeted as appropriations. With the low-wage support and seamen's income support, a conscious exception was made to the spending limits system.

LOW-WAGE SUPPORT AND SEAMEN'S INCOME SUPPORT

Low-wage support was introduced in 2006. The support is implemented through the tax payment system so that while the employer deducts withholding tax from a qualifying employee's wages as normal, the employer retains a certain proportion of this withholding tax and does not pay it to the tax authority. The amount of this support was estimated at EUR 120 million, which could have led to the spending limits being exceeded. However, as the support was considered equivalent to a tax subsidy, it was treated less restrictively and excluded from the spending limits.

Support for certain passenger vessels (seamen's income support) was introduced at the beginning of 2005. This support is implemented by allowing employers not to pay to the tax authority the withholding tax deducted from the wages of seamen, or seamen's income. Other tax recipients are compensated for lost tax revenue out of central government funds after taxation is completed. However, in the 2005 budget there was no appropriation for this support, because the compensation to other tax payees for lost tax revenue did not fall due until 2006 when the taxation for 2005 was completed. The appropriation was considered expenditure to be excluded from the spending limits, as it is tantamount to compensating other tax recipients for tax cuts. The central government contribution to this support was erroneously budgeted under the item for income and wealth tax using net budgeting.

In connection with the preparation of low-wage support in summer 2005, it was discovered that the budgeting procedure for seamen's income support was erroneous. In the second supplementary budget proposal of 2005, an appropriation corresponding to the support to shipping companies was entered at an amount equal to the central government contribution to the support to shipping companies implemented in the year when the support was introduced. Conceptually, and largely in implementation too, low-wage support and seamen's income support are equivalent, since in both cases the recipient of the support is the employer, who under certain conditions can retain all or some of the withholding tax deducted from employees' wages and not pay them to the tax authority. The support has no effect on how employees are taxed. Other tax recipients are compensated for lost tax revenue out of central government funds.

These two forms of support have consciously been made exceptions to the spending limits system.

By definition, the above four subsidies are not tax subsidies, one of the criteria for which is that the recipient is a taxpayer. Instead, they are subsidies implemented through the tax system, with the recipient being someone other than a taxpayer, and the subsidies are budgeted as appropriations. They all involve a transfer of tax revenue (e.g. tax withholding) directly to a third party (e.g. the employer). One of the main principles concerning central government finances in the Constitution is the principle of completeness, whereby all central government revenue and expenditure must be included in the budget. If the central government raises tax revenue, it must be budgeted. If this money is to be used to subsidize employers, an appropriation must be budgeted for that.

The risk of increased use of tax subsidies will continue to exist in Finland and may even increase. This is due not only to the spending limits system, but the expenditure discipline imposed by the system may contribute to pressures to circumvent it.

In order to counter the abuse of tax subsidies, tax subsidy monitoring could be increased. This would argue in favour of including tax subsidies in the spending limits decision at least in some way. Tax subsidies involve many problems and risks which are administrative or more generally related to the structures of the economy. They increase the administrative burden on both the central government administration and the private sector, they reduce transparency, and like all public subsidies they may skew the structures of the economy.

In principle, the operating policy outlines of the spending limits system could be used to restrict to what extent tax subsidies could be changed from what they are in the first year of the spending limits period. This comparison would be performed in connection with the preparation of each piece of tax legislation and reported in the explanatory memorandum of the spending limits decision or in the General Strategy and Outlook part of the budget proposal and the financial statements.

The problem with including tax subsidies in the spending limits is that they are very complicated and uncertain to evaluate in advance and to monitor. Simplicity and transparency are the guiding features in good fiscal policy rules and the spending limits system. This is an argument in favour of avoiding complicated spending limits systems, revenue indicators or, on the other hand, tax burden indicators.

Although there are ways of including tax subsidies in the system, the working group considers that the manageability and simplicity of the spending limits system overrules this. Ultimately, the spending limits system exists for the purpose of overall control of expenditure, not for the allocation of expenditure. It would thus also not be logical to focus on limiting tax subsidies only on the revenue side, because that would mean focusing on how the tax burden is distributed, not on how high or low it is.

The working group proposes that in the next Government Programme or spending limits decision the Government would indicate a clear position with regard to the use of tax subsidies and declare that it will not use new tax subsidies to circumvent the spending limits system.

In the new spending limits system, low-wage support and seamen's income support should be included in the spending limits.

Tax subsidies can be used if they are better than direct support. In the Netherlands, for example, tax subsidy decisions are evaluated using a six-question framework. This arrangement would not work in Finland unless an external monitoring institute were founded as in the Netherlands. However, the principal means for supporting decision-making should be to enhance the monitoring of existing tax subsidies. This would support the balancing target, the functioning of the spending limits system and the monitoring of the resources used for organizing tax subsidies. The transparency of tax subsidies should also be increased; this could be done by developing reporting procedures. The feasibility of tax subsidies can be evaluated in more detail in connection with the preparation of legislation on them.

In order to enhance the monitoring of tax subsidies, the working group proposes that:

- the present calculation method for tax subsidies be further developed;
- changes in the level of tax subsidies be reported more clearly and more extensively in the financial statements than before and that reporting on tax subsidies be otherwise improved in other suitable contexts;
- tax subsidy policy be covered in the operational policy outlines in the spending limits decision if there is a particular need for it.

3.6.2 Allocation rule for revenue from sales of shares

In the spending limits decision taken by the Government of Prime Minister Jäätteenmäki in 2003, a rule regarding the use of exceptionally high revenue from sales of shares was introduced in Finland:

If the annual revenue from sales of shares exceeds EUR 500 million, the Government has agreed in addition to the Government Programme that a maximum of 10% of the excess can be used for discretionary one-off additional expenditure, mainly in infrastructure investments and in the promotion of R&D, without reference to the spending rules or the spending limits of the term of office.

THE RULE ON REVENUE FROM SALES OF SHARES IN THE NETHERLANDS

In the Netherlands, revenue from sales of shares is used towards paying off government debt, i.e. converting government assets into another form. The reduced debt management costs, i.e. savings in interest expenditure from which the corresponding dividend revenue loss has been deducted, are paid into a fund used for financing projects to improve infrastructure.

In the spending limits decision taken in spring 2006, the Government decided to increase the maximum percentage usable of the excess to 20%.

Fundamentally, there is no case for using revenue from sales of shares for additional expenditure. After all, selling shares simply means converting government assets to cash flow, and in order to keep net government assets at the same level, the entire revenue should be used to pay back the central government debt or transferred to the State Pension Fund. Selling shares also leads to a reduction in regular dividend revenue and represents the forfeiting of potential future appreciation on the value of the shares, so the whole revenue from sales of shares cannot be considered purely as income. The rule regarding the use of revenue from sales of shares was introduced at the suggestion of the working group developing the previous spending limits system because actual pressures towards using revenue from sales for additional expenditure were recognized. The rule made it possible to govern the extent of this phenomenon. In the past electoral period, revenue from sales has indeed served as a source of additional funding for infrastructure projects and R&D projects.

The one-off expenditure funded with revenue from sales of shares on the basis of the rule regarding the allocation of revenue from sales of shares should be calculated to include the entire costs of the project in question, not just its first-year impact. If a project is started with a small investment contribution funded out of the revenue from sales of shares, the rest of the project needs to be funded from within the spending limits by reducing other items of expenditure, unless additional revenue from sales of shares is obtained in future years. If the market realizes that the government is under pressure to sell off assets in order to fund investment projects already started, the price obtainable from the sale of those assets could decrease. Also, starting projects with a small investment contribution could tie down the next Government to substantial increases in expenditure in future years, which in turn might raise the spending limits level considerably.

The working group has considered whether the rule regarding the use of revenue from sales of shares should be extended to cover dividend revenue. Table 10 shows how revenue from sales of shares and from dividends has developed since 1995. The Rule 1 column shows how much of the revenue from sales of shares could have been used or has been used under the rule introduced in the 2003-2007 term of office. The Rule 2 column shows the same calculation with dividend revenue added. Revenue from dividends is more stable than revenue from sales of shares. The average amount annually available for one-off investment expenditure out of revenue from sales of shares has been EUR 91 million, or EUR 159 million if dividend revenue is included.

Table 10. ***One-off revenue and dividend revenue in on-budget entities, EUR million***

Year	Sales of shares (12.39.50)	Dividend revenue (13.03.01)	Rule 1	Rule 2
1995	226	146		
1996	649	257	15	41
1997	269	317		9
1998	1,875	509	137	188
1999	3,531	356	303	339
2000	2,012	911	151	242
2001	38	832		37
2002	1,300	675	80	147
2003	196	603		30
2004	2,134	821	163	245
2005	1,491	747	99	174
2006*	1,241	1,534	148	455
Total	**14,961**	**7,708**	**1,097**	**1,907**
Annual average	**1,247**	**642**	**91**	**159**

Rule 1: A maximum of 10% of the portion of revenue from sales of shares exceeding EUR 500 million can be used for one-off expenditure without reference to the spending rules or the spending limits system.

Rule 2: A maximum of 10% of the portion of revenue from sales of shares and dividends combined exceeding EUR 500 million can be used for one-off expenditure without reference to the spending rules or the spending limits system.

* The 20% rule was in force in 2006.

Sometimes the revenue from sales of shares on the one hand and from dividends on the other might be very similar in nature. In 2006, for example, a massive dividend was paid out from the government-owned company Kapiteeli before it was sold. Instead of paying out the dividend, the government could have sold the company at a higher price, generating more revenue from sales of shares and thus more money usable under the above rule for one-off investment expenditure. Also, a company can elect to purchase its own shares instead of paying out a dividend; from the point of view of the shareholder, this is tantamount to a dividend. In such a case, the purchase of own shares by the company increases the revenue from sales of shares even though it is more like a dividend by nature.

However, dividends are essentially a return on investment and cannot be equated with the selling off of assets. Interest revenue from cash investments and transferred earnings from government-owned enterprises are similar revenue items. Dividends are sensitive to cyclical fluctuations, and using them to fund increased expenditure during a strong economic upswing could permanently increase the level of expenditure and have a pro-cyclical impact.

The working group proposes that in the next electoral period a similar rule regarding exceptionally high revenue from sales of shares be established as was in force until 2006.

3.6.3 Extending the rule regarding the use of revenue from sales of shares to tax revenue

A rule similar to that regarding the use of revenue from sales of shares could be applied to tax revenue. An argument in its favour is that it would help rectify any errors in the prediction of revenue to match the spending limits; in other words, the Government could decide on a level of expenditure commensurate with actual revenue. Expenditure cuts would have to be made in the budget if the revenue estimate were too optimistic. It is not sensible to increase and decrease expenditure as revenue estimates change, if the overall aim in economic policy is to establish a stable level of expenditure and not to follow cyclical fluctuations, thereby strengthening them. The present system has worked well, and the spending limits have kept expenditure in check even though tax revenue has been higher than anticipated.

In recent years there have been negative experiences in using a rule regarding the use of revenue in the Netherlands, because the rule had a pro-cyclical effect through taxation. The rule, in use in the early 2000s, dictated how increased revenue estimates should be divided between paying off the central government debt and enacting tax cuts. By comparison, decreased revenue estimates were compensated for by increasing central government debt and raising the tax rate, in a pre-determined proportion. In the economic boom at the beginning of the millennium, tax revenue estimates increased and tax cuts were enacted, but as the economy flagged, revenue decreased substantially. The deficit in the central government finances exceeded the 3% limit specified in the Stability and Growth Pact, and the Government had to cut expenditure to reduce the deficit during an economic downturn. After this experience, the rule regarding the use of revenue was removed from the Government Programme in 2003.

The working group proposes that, as in the past electoral period, expenditure should not change if tax revenue deviates from that which was estimated.

3.7 External monitoring

3.7.1 Independent fiscal policy institutions

The role of fiscal policy institutions in eliminating the deficit tendency has been highlighted in international contexts (including the IMF, the Commission and the academic community). In the best cases, such institutions improve the efficiency of fiscal policy by exerting public pressure towards a disciplined and goal-oriented fiscal policy. There is at present no such institution in Finland.

In order to be functional, a fiscal policy institution should be:

- independent,
- impartial,
- comprehensive (analysing the key areas of fiscal policy broadly)
- future-oriented,
- committed to constant monitoring, and
- transparent; and
- it should have a high profile.

Scientific research has suggested, as an extreme case, transferring fiscal policy completely to an independent institution; this is not considered a realistic option. The duties of existing institutions can be broadly divided into three categories: drawing up predictions on the national economy, monitoring fiscal policy rules and targets, and issuing varying kinds of recommendations. Regardless of whether the proposals and analyses of the institutions are actually taken into account in the implementation of fiscal policy, these institutions play an important role in public debate and can thereby influence fiscal policy. They are seen to improve fiscal policy discipline, and they can also be useful in evaluating fiscal policy decisions that have an impact over a period longer than a single electoral period.

The public finances report published by the Commission of the European Communities in 2006 contains an extensive questionnaire on national fiscal policy institutions in EU Member States and an analysis based on responses to that questionnaire. The results show that Finland has no such institution. For example the Economic Council of Finland is not such an institution, because its work is confidential by nature and not public enough. Thirteen EU Member States had fiscal policy institutions at that time, and this number has not changed in recent years.

According to the study the stability programmes of various countries have a tendency to overestimate growth and thus to overestimate budget development too. (This has not been a problem in Finland.) In order to eliminate this tendency, the preparation of predictions can be outsourced to an independent institution. Even if the predictions of such an institution were not actually used in drawing up the budget, they would provide an important benchmark against which the government's predictions could be compared. An institution's calculations regarding the impact of various budget solutions are useful for fiscal policy discipline, and calculations also improve awareness of the impact of various budget solutions over a longer term. Estimates prepared by external institutions are used in the budget preparation in the Netherlands, Belgium and Austria among others.

Institutions that make assessments and recommendations monitor for example the attainment of fiscal policy goals. They play an important role in public debate, which may have the effect of sharpening economic policy and improving its quality. There are institutions that make fiscal policy recommendations in Belgium, Denmark, Sweden and the UK.

The IMF is also in favour of fiscal policy institutions and has concluded through its own research that the best-functioning such institutions are to be found in the Netherlands, Belgium, Denmark and Austria. The IMF has also proposed that the purview of inspection agencies should be extended towards that of fiscal policy institutions.

3.7.2 Institutions monitoring fiscal policy rules

The functioning and credibility of the spending limits system could be strengthened with external independent monitoring of its implementation. There is at present no national institution in Finland to monitor compliance with spending rules and to report on them. International institutions (the OECD, the IMF, credit rating agencies, etc.) can be considered to have this role to some extent, but their reporting is not detailed enough. At the moment, ex post facto monitoring on matters included in the Government Programme is conducted by the Prime Minister's Office and the National Audit Office and in the central government financial statements. The Government financial controller's function has certain monitoring responsibilities. However, at present the monitoring of the implementation of the spending limits rests almost entirely with the Ministry of Finance, which also prepares the spending limits decisions and budget proposals. There is a risk of self-serving here.

There are currently no formal sanctions for exceeding the spending limits; instead, sanctions can be seen in the form of eroded confidence and declining economic development. Political sanctions through the opposition in Parliament and through the media are also important. But for this mechanism to operate, absolutely correct information on how the spending limits are being realized must be available.

However, external evaluation is only useful if it is backed by solid expertise. Shortcomings in expertise would easily lead to erroneous statements, which would cause confusion, unfounded mistrust in the functioning of the spending limits system, and possibly even unnecessary measures. Attaining sufficient expertise would require a conscious study of central government finances down to the finest details. Keeping up to date with these matters outside the Ministry of Finance is a major challenge, even if the Ministry aims to publish all the necessary information.

The three institutions discussed below are considered to be good examples.

In Sweden, the National Institute of Economic Research monitors public finances in its quarterly publication *Konjunkturläget* [The Swedish Economy]. The Institute analyses the potential for attaining both the aim of a 2% surplus in general government finances and the aim of keeping below the spending ceiling. Regarding the latter, it monitors trends in the budgeting margin (spending ceiling less overall expenditure) for subsequent years. The Institute further observes how implementing measures on the expenditure side rather than on the revenue side would affect the spending ceiling. This considered the spending ceiling was exceeded in 2004-2006. The Institute notes that availability of information has never been a problem.

In Denmark, the Danish Economic Council analyses the attainment of fiscal policy objectives in its biannual publication. According to the report published in June 2006, the Government's recent target of 0.5% growth in public consumption expenditure in real terms will be exceeded. On the other hand, the target of a surplus of 1.5% to 2.5% in public finances will be attained by a wide margin, and thus the debt ratio will decrease.

The High Council of Finance (HCF) in Belgium is generally seen as an example of a good institution in its field. The HCF publishes two reports a year, one to analyse attainment of the objectives of the stability programme and the other to analyse the budget situation. The HCF also issues recommendations for fiscal policy objectives in the short and long term.

The Ministry of Finance should provide illustrative and transparent information in the explanations of the budget proposal, in the central government financial statements and in other contexts regarding compliance with and implementation of the spending limits, in order to improve the transparency of the spending limits system and its implementation. The working group also considers it advisable for the Ministry of Finance to increase its own publicity regarding the spending rules, as noted in section 3.1.1.

The working group supports the organizing of independent external evaluation of the implementation of the spending limits, provided that sufficient expertise is ensured. In the absence of external evaluation, the working group considers it advisable for the political leadership to make a conscious effort not to influence the technical evaluation of the implementation of the spending limits.

EXAMPLES OF EXTERNAL MONITORING INSTITUTIONS

In Sweden, Konjunkturinstitutet [National Institute of Economic Research] is a government agency under the Ministry of Finance, founded in 1937. It is an independent agency and is not governed by political principles in its analyses or research. The Institute makes predictions, analyses trends in the Swedish economy and the international economy and engages in related research. The Institute has about 60 employees.

In Denmark, Det Økonomiske Rådet [Danish Economic Council] is an independent institution financed out of public budget funds, founded in 1962. Its chairmen are three professors, and its members are 29 representatives of various parties: trade unions, employers' organisations, the central bank and the Government. The Council is assisted by a secretariat of 10 to 15 economists. The task of the Council is to monitor the Danish economy and to analyse long-term economic trends and the interaction of the environment and the economy. Another important task is to increase coordination between economic players in Denmark.

In Belgium, the High Council of Finance is made up of experts from various bodies in the scientific community, the central bank, the Government, the Flemish-language and French-language regions, and the Federal Planning Bureau. The Research Department of the Ministry of Finance serves as the Council's secretariat. The task of the Council is to analyse basic factors in the budget, the economy and fiscal policy and to propose changes to them. The Council has some 30 members, and the secretariat has 10 employees. The Council has two permanent departments, focusing on the need for public lending on the one hand and on taxation and social security contributions on the other. The Council also includes a working group on ageing. The plenary sessions of the Council are chaired by the Minister of Finance.

BIBLIOGRAPHY

Alesina, A., Hausmann, R., Hommes, R. and Stein, E. (1996): *Budget institutions and fiscal performance in Latin America*. NBER Working Paper. No. 5586.

Danninger, S. (2002): *A New Rule: "The Swiss Debt Brake"*. IMF Working Paper WP/02/18.

Det Økonomiske rådet (2006): *Konjunkturvurdering for år 2006*. [Danish Economic Council]

European Commission (2006): *Public finances in EMU*. Directorate-General for Economic and Financial Affairs.

Finansministeriet (2000): *Utvärdering och vidareutveckling av budgetprocessen*. SOU 2000:61 [Swedish Ministry of Finance]

Finansministeriet (2006): *Danmarks Konvergensprogram for 2006 sendt till EU*. [Danish Ministry of Finance]

Fischer, J. (2005): *Swedish budget rules: praise from Brussels, pressure at home*. ECFIN Country Focus volume 2, issue 4.

Heeringa, W. and Lindh, Y. (2001): *Dutch versus Swedish budgetary rules: A comparison*. Fiscal Rules, Bank of Italy workshop in Perugia, February 2001.

Hallerberg, M, Strauch, R and von Hagen, J. (2001): *The use and effectiveness of budgetary rules and norms in EU Member States*. Report prepared for the Dutch Ministry of Finance by the Institute of European Integration Studies. June 11.

Hallerberg, M., Strauch, R. and von Hagen, J. (2004): "Budgeting in Europe after Maastricht: Patterns of reform and their effectiveness." In *Estabilidad Presupuestaria y Gasto Público. Hacienda Pública Española*. Monografía 2004: 203–228.

Hallerberg, M. and von Hagen, J. (1999): "Electoral institutions, cabinet negotiations, and budget deficits in the European Union." In Poterba, J. M. and von Hagen, J. (eds.): *Fiscal institutions and fiscal performance*. National Bureau of Economic Research. London: The University of Chicago Press, Ltd.: 209–232.

Hjalmarsson, Å. and Lindh, Y. (2006): *Fiscal rules in Sweden*. Ministry of Finance.

Janssen, J. (2001): *New Zealand's Fiscal Policy Framework: Experience and Evolution*. Treasury Working Paper 01/25.

Konjunkturinstitutet: *Konjunkturläget* [The Swedish Economy], Augusti 2006. [National Institute of Economic Research, Sweden]

Kydland, F. E. and Prescott, E. C. (1977): "Rules rather than discretion: The inconsistency of optimal plans." *Journal of Political Economy* 85: 473–491.

Kydland, F. E. and Prescott, E. C. (1980): "Dynamic optimal taxation, rational expectations and optimal control." *Journal of Economic Dynamics and Control* 2: 79–91.

Liikenne- ja viestintäministeriö (2004): *Liikenneväyläpolitiikan linjauksia vuosille 2004–2013, Ministerityöryhmän mietintö 10.2.2004*. Liikenne- ja viestintäministeriön julkaisuja 7/2004. [Ministry of Transport and Communications]

Liikenne- ja viestintäministeriö (2006): *Liikenneväyläpäätösten pitkäjänteistäminen*. Liikenne- ja viestintäministeriön julkaisuja 18/2006.

Ministerie van Financiën (2004): *The budget rules*. *Budget Memorandum 2004*. [Ministry of Finance, the Netherlands]

Persson, T. and Svensson, L. E. O. (1989): "Why a stubborn conservative would run a deficit: Policy with time inconsistent preferences." *Quarterly Journal of Economics*: 325–346.

Rakennusalan suhdanneryhmä (2006): *Rakentaminen 2006, 1. väliraportti (21.6.2006), Kasvu jatkuu vahvana*. [Business cycle group of the construction industry]

Roubini, N. and Sachs, J. D. (1989): "Political and economic determinants of budget deficits in the industrial democracies." *European Economic Review* 33: 903–938.

Stein, E., Talvi, E. and Grisanti, A. (1999): "Institutional arrangements and fiscal performance: The Latin American experience." In Poterba, J. M. and and von Hagen, J. (eds.): *Fiscal institutions and fiscal performance*. National Bureau of Economic Research. London: The University of Chicago Press, Ltd.: 103–134.

The Study Group of the Budget Margin (2006): *Ageing and sustainability*.

Treasury (2003): *The New Zealand Fiscal Management Approach, An Explanation Of Recent Changes*.

Valtiovarainministeriö (2003): *Finanssipolitiikan sääntöjen ja kehysmenettelyn kehittäminen Suomessa*. Valtiovarainministeriön julkaisuja 3/2003. [Ministry of Finance]

Valtiovarainvaliokunnan mietintö 9/2003 vp: *Valtioneuvoston selonteko valtiontalouden kehyksistä vuosille 2004–2007.* [Finance Committee]

Valtiovarainvaliokunnan mietintö 3/2004 vp: *Valtioneuvoston selonteko valtiontalouden kehyksistä vuosille 2005–2008.*

Valtiovarainvaliokunnan mietintö 4/2005 vp: *Valtioneuvoston selonteko valtiontalouden kehyksistä vuosille 2006–2009.*

Valtiovarainvaliokunnan mietintö 4/2006 vp:, *Valtioneuvoston selonteko valtiontalouden kehyksistä vuosille 2007–2011*.

Valtiovarainvaliokunnan mietintö 39/2003 vp: *Hallituksen esitys valtion talousarvioksi vuodelle 2004, Hallituksen esitys vuoden 2004 talousarviota koskevan hallituksen esityksen (HE 55/2003 vp) täydentämisestä.*

Valtiovarainvaliokunnan mietintö 41/2004 vp: *Hallituksen esitys valtion talousarvioksi vuodelle 2005, Hallituksen esitys vuoden 2005 talousarviota koskevan hallituksen esityksen (HE 151/2004 vp) täydentämisestä.*

Valtiovarainvaliokunnan mietintö 45/2005 vp: *Hallituksen esitys valtion talousarvioksi vuodelle 2006, Hallituksen esitys vuoden 2006 talousarviota koskevan hallituksen esityksen (HE 119/2005 vp) täydentämisestä.*

Valtiovarainvaliokunnan mietintö 41/2006 vp: *Hallituksen esitys valtion talousarvioksi vuodelle 2007, Hallituksen esitys vuoden 2007 talousarviota koskevan hallituksen esityksen (HE 122/2006 vp) täydentämisestä.*

von Hagen, J. (1992): *Budgeting procedures and fiscal performance in the European Communities*. Economic Papers. No. 96. European Commission, October.

von Hagen, J. and Harden, I. (1994): *National budget processes and fiscal performance. Julkaisussa European Commission. Towards greater fiscal discipline*. European economy. Reports and studies. No. 3.

von Hagen, J. and Harden, I. (1996): *Budget processes and commitment to fiscal discipline*. IMF Working Paper WP/96/78.

Yläoutinen, S. (2005): *Development and functioning of fiscal frameworks in the Central and Eastern European countries*. Jyväskylä: University of Jyväskylä, Jyväskylä Studies in Business and Economics 42.

Material from the seminar organized by the Commission of the European Communities on 21 June 2006: *The role played by national fiscal rules and institutions in shaping budgetary outcomes*.

Appendix: INTERNATIONAL REVIEW OF FISCAL POLICY RULES

The spending limits system in the Netherlands

The Netherlands has been using a spending limits system since 1997. The OECD and the IMF consider the system exemplary. The budget balance objective is decided in government negotiations, following which the expenditure and revenue frameworks for the coming electoral period are agreed.

Spending limits

There are separate spending limits for public spending, social security (including unemployment benefits) and health care. This division is derived from the fact that social security and health care have separate funding systems. Any appropriations that are exceeded have to be compensated for within that sector, and the minister responsible for the area in which the excess occurred is responsible for proposing compensatory action.

The fixed-cost spending limits are converted to fair value using the consumer spending and gross capital formation price index. Until 2002, the cost adjustment was made using the GDP price index. The spending ceiling for the following year is adjusted using the price index and the predictions of the Centraal Planbureau (CPB),[14] and expenditure estimates are detailed in the autumn to match the most recent prediction of the CPB. No further cost adjustments are made to the following year's spending limits after the spring. The budget for the following year is principally negotiated in May, after which

14 In the Netherlands, the CPB — an independent government research institution — prepares the predictions on which the spending limits process and the budget process are based. It calculates the room for manoeuvre available for government negotiations, i.e. the surplus derived from current revenue and expenditure trends and the balance target that the Government can negotiate to use for tax cuts, increasing expenditure or improving the budget balance. The CPB also prepares constant revenue and expenditure predictions, monitors implementation of the spending limits and reports on the indicators of the central government finances.

the Minister of Finance sends the ministries the final budget sums for each administrative branch. On the basis of these, the ministries draft detailed item-specific budgets over the summer, and these are published in September. The fact that there is a period of several months between the budget negotiations and the publishing of the budget has led to the undesired result of unofficial budget negotiations continuing in August.

The spending limits cover expenditure and revenue other than tax revenue included on a net basis in the final amounts for each spending limits sector. However, the appropriations are not net appropriations. The public spending sector includes all expenditure and revenue other than tax revenue which do not belong to social security or health care. The revenue of and expenditure by certain funds are excluded from the spending limits. It has been proposed that interest expenditure be excluded from the spending limits so that a decrease in interest expenditure would not create pressure towards increasing other expenditure. The exclusion of cyclical unemployment and social security benefits and pay rises from the spending limits has also been considered, but for now they are included in order to avoid pressure towards increasing other expenditure.

The Netherlands has an unallocated reserve for unforeseen expenditure, but it is very small — only 0.25% of the total of the budget in 2002. A larger reserve has been mooted but never implemented. Expenditure under the spending limits is scaled according to a cautious growth prediction (1.75% for the coming years), which means in practice that expenditure can be increased, since the actual economic growth rate has been higher and social security expenditure has been lower than anticipated, creating flexibility within the spending limits. The Government is allowed to submit a supplementary budget to Parliament twice a year.

Appropriations can be carried over to the following year in order to avoid loose spending towards the end of the year. The transfer margin is defined separately for each administrative branch and constitutes about 1% of the total of the budget. Technical budget changes can increase or decrease the spending limits.

Revenue estimates

Revenue estimates are also agreed on in the government negotiations, defining the upper and lower limit for tax revenue during the term of office. Compensation must be made for any deviations. The level of taxation is monitored using an agreed indicator, which is used as an argument in political discussions.

The Netherlands previously had a rule on how to use revenue that turned out to be higher than anticipated. Depending on the size of the budget deficit, a certain percentage of excess revenue was used to pay off the central government debt and another percentage for tax cuts. Specific percentage rules were eventually abandoned, since they had a pro-cyclical effect. Tax revenue and social security contributions thus no longer have an impact on spending limits.

Since 1999, there has been a list of tax subsidies and their budget impacts appended to the budget. In 2003, a similar list was added for indirect taxation. The budgetary rules in the Netherlands allow expenditure to be converted into subsidies and vice versa, in which cases the spending limits and revenue estimates are adjusted accordingly. The requirement is that the target group and the amount of the subsidy remain the same.

When new tax subsidies are proposed, an evaluation grid is used to justify why the new subsidy would be better and more efficient than other kinds of subsidy. The purpose of this is to exert greater control over tax subsidies to prevent them from being an easy vehicle for increasing expenditure without reference to the spending limits.

Proposals for improvement

For the government negotiations following the general election in November 2006, a working group formed of high-ranking officials in ministries, the central bank and research institutions drafted a report with fiscal policy recommendations for the new Government. Among other things, the working group evaluated the spending limits system and made proposals for improvement.

Improvement proposals were needed, because in the early 2000s fiscal policy in the Netherlands did not work quite as it was supposed to. With the economic upswing in 2000, taxes were cut because of increased tax revenue, and the added flexibility in the spending limits caused by rapid economic growth was completely used up in new expenditure. Therefore, when the downturn came in 2003, the deficit in central government finances exceeded 3% of GDP, and expenditure cuts had to be made. Today, the budget is balanced again.

In the light of recent experiences, the civil servant working group proposed certain reforms to the system to reduce its pro-cyclical effects.

1. Exclude interest expenditure from the spending limits because of their cyclical nature.
2. Have the Government make a more binding agreement regarding how to treat appropriation shortfalls in unemployment expenditure, social security expenditure and the pay rise margin so that savings achieved in good times would not be used to finance additional expenditure.
3. Abandon the warning system which calls for automatic savings when the deficit in central government finances exceeds 2.5% of GDP. Savings should only kick in at the 3% limit, so as not to exacerbate the economic downturn through hasty expenditure cuts.

Fiscal policy rules in Sweden

Since 1997, Sweden has had the objective of generating a surplus in central government finances plus spending limits and, from 2000, the objective of balance in local government. The spending limits have been adhered to every year, albeit in some cases by working around the system, and the system is generally considered a good example of a spending limits system. The right-wing Government elected in autumn 2006 also considers the spending limits system important but intends to introduce certain reforms in spring 2007.

The structural surplus objective in central government finances is 2% of GDP. There is no standard formula for cyclical corrections, so the application of this surplus objective in determining the spending limits has not been very accurate. The Ministry of Finance, the National Institute of Economic Research and the central bank each calculate the cyclically adjusted surplus in different ways. To link the surplus objective more closely to the spending limits, *Ekonomistyrningsverket* [the Swedish National Financial Management Authority] has proposed that a surplus objective be set for the public administration.

Spending limits

The three-year appropriation spending limits are given at fair value and cover central government on-budget entities and public pension expenditure out of off-budget entities. The spending limits are considered politically binding, and every year a decision is made only for the year three years ahead (n+3), and the spending limits for the years before that are not changed. Parliament decides on the spending limits on submission from the Government, so both bodies are committed to them.

In practice, the setting of spending limits for the third year has often been postponed. For example, the spending limits for 2005 were not set until the 2004 budget, and the 2005 budget did not address the year 2007.

The spending limits process starts with an overall spending ceiling being set. In recent years, this has been defined as a certain percentage of the potential GDP given at fair value. However, the spending ceiling will not be raised if GDP grows faster than expected; vice versa. The new Government aims at bringing expenditure as a percentage of GDP down, so the percentages set are 32.1% for 2006 and 30.2% for 2009. After the spending ceiling is set, the spending limits for year n+1 are bindingly divided among 27 expenditure areas plus an unallocated reserve for undefined future expenditure. Interest expenditure is excluded from the spending limits.

The spending limits include a 12-year road and rail investment programme. This is to a minor extent funded using internal loans which distribute the costs over several years.

An unallocated reserve is left in the spending limits for automatic fiscal stabilisers, unforeseen expenditure and prediction errors. Because this reserve has proved to be too small in recent years, it has often been the case that it has been used for expenditure at an early date, leaving very little flexibility in the following year's budget. Creative accounting has been required to stay within the spending limits, including tax subsidies and postponing payments to the following year. The unallocated reserve has now been increased, being between 2% and 2.5% of the spending ceiling in 2007-2008. Government agencies can 'take out a loan' against overspending, meaning that the excess is deducted from next year's appropriations.

In 2000, a working group at the Swedish Ministry of Finance proposed that the unallocated reserve be divided into two components: a cyclical reserve to buffer cyclical expenditure, and a planning reserve for decision-based additional expenditure. This would prevent the entire reserve from being used for additional expenditure as can be done now. The proposal has not yet been implemented, but it has been taken up again and may be put into practice in the reform in spring 2007.

A calculation of tax subsidies has been given in the spring budget since 1996. Temporary tax subsidies have been used to circumvent the spending limits. For example, central government transfers to local government have been increased by levying less VAT on municipalities. It has been proposed that tax subsidies be included in the spending limits like other expenditure (Boije 2002) or, at the very least, that their use should be reported on more thoroughly (Boije and Fischer 2006). Table A1 shows that in most years tax subsidies exceed the unallocated reserve. In other words, if the tax subsidies had been entered as expenditure, the spending limits would have been exceeded.

Table A1. ***Spending limits, the unallocated reserve and tax subsidies, SEK billion***

	2004	2005	2006	2007	2008
Sum of spending limits expenditure	856	864	898	931	956
Spending limits	858	870	907	949	982
Unallocated reserve*	2	6	9	18	26
Tax subsidies	8	14	18	12	8

Source: National Institute of Economic Research, Sweden

* In 2004 and 2005, this refers to the unallocated reserve that remained unused, i.e. spending limits savings.

The Government that took office in 2006 had criticised the spending limits practices of previous governments while it was in opposition. The new Government may publish a spending limits system reform in the 2007 spring budget to increase gross budgeting and transparency. The new Government has abolished several tax subsidies and cut back on direct subsidies. This has led to a structural lowering of the spending ceiling. It is anticipated that tax subsidies will be cut further.

Fiscal policy monitoring

The implementation of the budget and adherence to spending limits is monitored particularly by the Swedish National Financial Management Authority and the National Institute of Economic Research, which are government agencies but independent bodies.

The National Financial Management Authority monitors the implementation of the budget of the current year monthly, and ex post facto annually. It prepares predictions and estimates risks in central government finances. It publishes annotated final accounts on the basis of which the Government drafts the financial statements.

The National Institute of Economic Research monitors the public finances in its quarterly publication *Konjunkturläget* [The Swedish Economy], analysing the chances of attaining the 2% surplus objective in public finances and of remaining under the spending ceiling. It also monitors the development of the unallocated reserve with a view to coming years and also considers what would have happened to the spending ceiling if certain measures had been undertaken on the expenditure side instead of the revenue side.

Fiscal policy rules and spending limits system in Denmark

Denmark has had a spending limits system in place since the 1960s, and it has been revised several times. The spending limits are not directly connected with fiscal policy rules, but they are set annually at a level matching the general economic policy objectives of the public sector, which are enshrined in the ‘2010 plan’. These objectives are:

- a structural surplus of 0.5% to 1.5% in public finances measured as a percentage of GDP by 2010 (objective set in 2001);
- increase of no more than 1% in public spending in real terms per annum in 2007-2010 (up from the previous objective of 0.5%);
- tax freeze (in place since 2001).

The budget process is begun in January when the Ministry of Finance presents a memorandum including the spending limits to the Government’s financial and cooperation ministerial committees. The memorandum also contains the operating policy targets of the Government and any savings to be implemented. Since the spending limits govern all public spending, the memorandum also includes the expected outcome of the negotiations to be undertaken between the Government and the municipalities and between regions in May and June. Following the Government decision, spending limits for the administrative sectors are specified in February, and budget proposals are invited. The spending limits are drawn up using the top-down method, meaning that spending limits are first set for administrative branches as a whole, and then the ministries allocate appropriations within their spending limits to their agencies and institutions, which in turn draw up their budget proposals based on their specific spending limits.

The spending limits are an internal tool used by the Government. They are not published or submitted to Parliament for approval.

The spending limits system consists of three main spending limits and two subordinate ones:

- the operating expenditure spending limits, including the subordinate spending limits for wages;
- the transfer spending limits, including the subordinate spending limits for central government transfers;
- the investment expenditure spending limits.

Interest expenditure on the central government debt, EU membership fees and assistance to families with children are excluded from the spending limits.

Each administrative branch is bound separately by the spending limits in the various categories. However, the spending limits are not binding upon statutory income transfers such as pensions and unemployment benefits, which are not up to the ministry to decide. For these income transfers, the spending limits represent an expenditure estimate for the current year. Each ministry has the right to reallocate appropriations within the decided spending limits, and ministries also have full control over the number of personnel they employ within the limits of the subordinate spending limits for wages. Expenditure that arises in the course of the year must in principle be funded within the spending limits, and any surplus accrued can be carried over to the following year.

The budget includes not only the budget itself for the next year but also an expenditure prediction for the following three years. These predictions are not binding spending limits, but they are used as a basis when preparing spending limits in the next year, taking operating policy decisions into account, before issuing the specific spending limits to the administrative branches. The spending limits for future years are always drawn up at the cost level of the year immediately following.

In June, central and local government agree on overall expenditure, tax rates and economic and political approaches. Central government transfers to local government are also decided at this point. The decisions are collective and as such binding on all municipalities and regions. However, they are not legally binding, and municipalities will not incur sanctions if they do not abide by them.

The Swiss debt brake

In Switzerland, a fiscal policy rule known as the 'debt brake' was approved by referendum in December 2001 and entered in the Constitution. This rule dictates that expenditure must not exceed revenue by more than the cyclical growth rate. Expenditure is dependent on revenue, corrected with a cyclical factor (*k-Faktor*). During an economic upswing, the budget will show a surplus, and during a downturn, the budget will show a deficit. The rule does not restrict taxation: tax rates can be raised to fund additional expenditure, and tax cuts can be enacted if expenditure is cut. Supplementary budgets are included in the spending ceiling. The purpose of the debt brake is to keep the central government debt at its current level so as to decrease its size measured as a percentage of GDP.

The rule is binding on both the Government and Parliament. The Parliament has budgetary authority within the confines of the spending ceiling. Under exceptional circumstances (a serious downturn, a natural disaster, etc.) the spending ceiling can be exceeded if both Government and Parliament take a majority decision to do so. If expenditure exceeds the spending ceiling, the excess is debited from the 'equalisation account' (*Ausgleichskonto*). Conversely, any surplus is credited to the same account. If the spending ceiling is erroneously set due to prediction errors on revenue estimates or economic growth, the difference is likewise debited from or credited to the equalisation account. The 'funds' in the equalisation account are bound by no rules; they can be used at Parliament's discretion over the following years. A negative balance in this account exceeding 6% of expenditure must be brought down to less than 6% within three years.

By law, the debt brake is only binding on the budget, but the Government has chosen to observe it also in the spending limits (*Finanzplan*), which are drawn up in connection with the budget for the next three years.

The forthcoming spending limits reform in Austria

The new Government is planning to introduce a new medium-term spending rule. The government negotiations were concluded in January 2007, but there is no detailed information on the introduction of this new rule.

The new spending rule is expected to set a spending ceiling for the next four years (on a rolling basis). The rule is statutory, and spending ceilings cannot be exceeded except in exceptional circumstances; this essentially means a threat to internal security. The spending limits decree will in future be enacted in spring, before 30 April, and the budget decree in the autumn, ten weeks before the beginning of the next budget year. The spending limits decree must include not only the spending ceilings but also an outline for a personnel plan with the maximum number of full-time civil servants.

At the top level, the spending rules consists of spending ceilings for five policy sectors, covering the entire federal budget:

1. Judicial matters and safety;
2. Labour, social welfare, health and family;
3. Education, science, art and culture;
4. Business, infrastructure and the environment;
5. Interests and cash reserve.

These policy sector spending ceilings are sub-divided into lower spending ceilings for individual units. The policy sector spending ceilings are binding for the next four years. Appropriations can be transferred within a policy sector with the approval of the Minister of Finance, as long as the spending ceiling is not exceeded. The lower-level spending ceilings are binding for one year and indicative for the following years. If a ministry manages to save money within the spending limits, the unused appropriations can be used in future years at its discretion without reference to the spending limits. Accordingly, the annual spending ceilings for the ministries must be set low enough that no great savings ensue; these could endanger compliance with the deficit limit.

The policy sector spending ceilings have fixed components and cyclical components. Expenditure which is cyclical or tied to specific revenue, especially unemployment benefits, pensions and income transfers to the states, is not tied to a fixed spending ceiling but instead has a flexible ceiling. This flexible ceiling must be derived from macroeconomic or otherwise suitable variables or be statutory, such as the income transfers to the states. The assumptions underlying the calculations must be reported in the spending limits memorandum. Appropriations that remain unused because of a flexible spending ceiling not being reached can be used for the same purpose in subsequent years. A fixed ceiling is set for all other expenditure. Thus, where a policy sector involves both fixed and variable expenditure, it has a flexible spending ceiling which cannot vary more than the cyclical expenditure it contains. However, savings in flexible expenditure cannot be used to increase expenditure under the fixed spending ceiling.

The sum of lower-level spending limits can be lower than the spending limits for that policy sector, in which case an unallocated reserve is created for the use of that sector in later spending limits decisions. Final accounts savings are carried over in an agency-specific reserve and can be used by that agency at its discretion in subsequent years. Exceptions to this rule include expenditure linked to specific revenue or to EU revenue, which of course can only be used for its original purpose. Savings in flexible-ceiling expenditure are also carried over in the reserve and used for their original purpose in following years.

The spending limits memorandum contains an estimate of revenue in the spending limits period. Additional revenue, which by law allows additional expenditure, is carried over in a reserve for subsequent years. Additional revenue from fee-based services can be used for additional expenditure in the same year, which is an incentive for agencies to accumulate extra revenue.

The Austrian Institute of Economic Research (WIFO) prepares the predictions on which the budget is based. The Government debt committee monitors the implementation of the budget.

Fiscal policy rules in New Zealand

The fiscal policy rules in New Zealand consist of general principles whose implementation is monitored through comprehensive reporting. Following their principles is promoted with a variety of tools selected by the Government. These can change from one electoral period to the next and can include debt targets, expenditure targets and spending limits budgeting.

The central government finances of New Zealand showed a deficit throughout the 1980s, which prompted a need for medium-term planning to curb the growth of the central government debt. Financial administration was reformed by converting agencies into public enterprises and by moving from cash-basis accounting to income and expenditure budgeting. Since the early 1990s, public finances in New Zealand have shown a surplus with cyclical adjustment. The OECD country report on New Zealand states that this is due to the Fiscal Responsibility Act[15] and strong political commitment.

The Fiscal Responsibility Act entered into force in 1994. It requires the Government to monitor five statutory principles and to make public evaluations of how its fiscal policy is observing these principles. Briefly, the five principles are:

1. Government debt will be reduced to a prudent level.
2. Once debt is reduced to a prudent level, the government will seek to maintain a balanced budget on average over the medium to long term.
3. The government will achieve and maintain a level of net worth that provides some buffer against unforeseen future factors.
4. The government will manage fiscal risks prudently.
5. The government will pursue policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

15 Fiscal Responsibility Act.

The decree does not define objectives (such as the level of the central government debt) in numerical terms; that is the job of the Government. Deviations from the principles are allowed if the Government publicly justifies these deviations and demonstrates how it intends to return to observing the principles.

Before issuing a budget, the Government must issue a budget policy report presenting long-term and short-term targets for central government expenditure, revenue, balance sheet, debt and net assets. The budget must also be accompanied by a fiscal policy strategy report with predictions on central government finances reaching at least ten years into the future. The budget is prepared using income and expenditure budgeting. Full costs must be shown for all measures, including depreciation and pension liabilities. Every four years, a long-term fiscal policy review (40 years) is published.

There is a flexible spending limits system for putting the fiscal policy principles into practice, and this can be changed from one electoral period to the next. It is not compulsory to use spending limits, and for instance the Government that took office in 1999 considered abandoning spending limits budgeting. It has been proposed that the spending limits system be institutionalised, but the flexibility of the system in its current unofficial guise is appreciated so much that this proposal has not been put into practice.

At the beginning of the 1999-2003 term of office, the expenditure level was frozen apart from index-linked appropriations. Any new expenditure to be taken up during the term of office was included in the fair-value spending limits. A cumulative numerical ceiling for the term of office restricted additional expenditure. In New Zealand, spending limits do not limit the appropriation impact of Government decisions beyond the term of office, which leads to expenditure creep in the next electoral period. The system has also been criticised for focusing on the appropriation impact of new measures instead of encouraging a critical look at existing expenditure.

Since 2003, spending limits have been of less importance, with the Government focusing on the operating balance sheet and debt trends. The purpose of reforms is to link fiscal policy better to long-term objectives and to simplify the rules on additional expenditure that have grown too complex.

PUBLICATIONS

MINISTRY OF FINANCE
Snellmaninkatu 1 A
P. O. Box 28, FI-00023 GOVERNMENT
FINLAND

Tel. +359 9 160 01
Fax +358 9 160 33123
www.vm.fi

5b/2007
FISCAL POLICY RULES
and the Reform of Spending Limits
in Finland

ISSN 1459-3394
ISBN 978-951-804-706-6 (pdf)