



**Presentation by Dr Tuomas Pöysti, Auditor General of Finland, in 2<sup>nd</sup> Working Session of the V Conference EUROSAI / OLAFCEFS, Lisbon, Portugal, 9<sup>th</sup> – 12<sup>th</sup> May 2007**

**SAIS CONTRIBUTION TO THE FISCAL SUSTAINABILITY OF SOCIAL SECTORS**

**1. Introduction**

In a parliamentary democracy the government shall prepare the necessary measures to attain, maintain and account on fiscal sustainability of public finances as a whole and of various social sectors. The legislative and budgetary authority (the Parliament) shall decide the necessary legislative and budgetary measures and exercise oversight on their implementation and on the quality of fiscal policy planning. Within this framework of responsibilities the Supreme Audit Institution has a role in assuring and promoting several aspects of the quality of public finances and fiscal sustainability of social sectors. I will discuss in this paper on the bases of the experiences and the Strategy for years 2007 – 2012 of National Audit Office of Finland (hereinafter the NAOF) *how Supreme Audit Institutions can contribute to the long-term fiscal sustainability of social policies*.<sup>1</sup>

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<sup>1</sup>In the current NAOF planning system the Auditor General has established a general strategy outlining principal orientations and general audit theme areas and audit themes for years 2007 – 2012, which is also the mandate period of the Auditor General elected by the Parliament. According to law the Auditor General adopts an annual Activity and Audit Plan defining individual audits to be performed during that year.

Fiscal sustainability is about whether the continuation of current policies in the books and given commitments will lead to an excessive debt accumulation. Long-term fiscal sustainability imposes an inter-temporal budget constraint. The current total liabilities of the a government, composed of the current public debt and the discounted value of all future public expenditure, should be covered by the discounted value of all future government revenue over an infinite time horizon. In other words, government should run sufficiently large primary surpluses to be able to cover future costs and pay off the interests of outstanding debt.<sup>2</sup> The sustainability measurement takes into account the recognised balance sheet liabilities and the implicit liabilities, the future expenditure arising from legal and political commitments. Fiscal sustainability of a specific sector can be discussed in terms of analysing the future financial pressures the continuation of the current policy creates and testing whether these pressures create an unreasonable adjustment need for other sectors and for government in general. A micro-level definition of fiscal sustainability requires that full economic costs of a sector can be covered and the necessary investments to infrastructure can be made at a rate needed to deliver necessary societal needs for well-fare and growth<sup>3</sup>.

Population aging creates a significant challenge in the European Union Member States and in many Latin American countries to the fiscal sustainability<sup>4</sup>. Climate change and other environmental changes pose also a risk to the fiscal sustainability. According to recent analyses the likely impact on economy and public finances will be of the same or even bigger scale than the population aging even though the dynamic effects of climate and other environmental changes are difficult to estimate<sup>5</sup>

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<sup>2</sup> On the analyses of the long-term sustainability of public finances in the European Union, see European Commission, Directorate-General for Economic and Financial Affairs, *The Long Term Sustainability of Public Finances in the European Union*, European Economy N:0 4/2006.

<sup>3</sup> This definition is modified from OECD Education Working Paper No 7, *On the Edge: Securing a Sustainable Future for Higher Education*, OECD EDU/WKP(2007)2, p. 27.

<sup>4</sup> See European Commission: *The Impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)*, European Economy, Special Report No 1/2006.

<sup>5</sup> Recent general analyses of the impacts of climate change is presented in the Inter-Governmental Panel on Climate Change (IPCC) Working Group II Fourth Assessment Report *Climate Change 2007, Summary for Policy Makers*, available at <http://www.ipcc.ch>. The UK Stern Review, commanded by the UK Chancellor of the Exchequer, provides a good point of departure to the assessment of the significance of the economics of climate change, see *Stern Review on the Economics of Climate Change*, available at [http://www.hm-treasury.gov.uk/independent\\_reviews](http://www.hm-treasury.gov.uk/independent_reviews).

According to European Commission Finland is a low risk Member State concerning aging-related risks to fiscal sustainability<sup>6</sup>. Finland's public sector was in 2006 in the position of net lending (surplus) of 3.8 % of GDP, central government surplus was 0,9 % of GDP and the public debt 39,1 % of the GDP<sup>7</sup>. Despite the good immediate term perspectives and financial position Finland has, according to the Ministry of Finance, a sustainability gap of 1 % GDP. Share of the age-related public expenditure is projected to increase 5,1 % from 25,6 % to 30,7 % of GDP between 2010 and 2050.<sup>8</sup> The evolution of pension expenditure depends on the willingness of the individuals to prolong their work careers and their physical and mental conditions to do so. The pressure on the health and welfare expenditure would diminish if the years during which aging population maintains their health and ability to live without long-term care would increase. The base line projection is that the employment rate in Finland would increase from current 68,9 % to 74,4 % in 2030. Educational system should then support efficiency life-long learning and change of profession during individual's work career. Improvement of the employment rate requires migration from regions with weak employment and growth perspective to centres and regions where there is demand for labour. To have right incentives in place to activate population is then important.

Fiscal sustainability is not a measure of economic efficiency of public spending. Successful response to the fiscal sustainability challenges of various social sectors requires, however, that:

- there is an awareness of the price and scale of the commitments included to current policies and systems individually and in total terms (*short and long-term fiscal transparency condition*).
- the incentives work well and support action which is supporting long-term fiscal sustainability (*incentives condition*).
- a sufficient control of expenditure exists (*expenditure control condition*). Here the efficiency of the allocation and use of resources can significantly reduce sustainability pressures (*efficiency condition*).

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<sup>6</sup> Communication from the Commission to the Council and the European Parliament, COM (2006) 574., The long-term sustainability of public finances in the EU.

<sup>7</sup>Preliminary figures of national accounts, Statistics Finland.

- political and budgetary institutions function with integrity and transparency and are able to allocate and use public resources in an efficient manner and are able to overcome the short term expenditure biases typical of political economy of public spending and resources allocation (*quality of institutions condition*)

Good expenditure discipline in short and long term perspective is a key issue in successful response to fiscal sustainability challenges. Expenditure rules limiting the maximum amount of expenditure have proven useful in practise. Finland has a good experience in the use of spending limits for a whole electoral period.<sup>9</sup> The efficiency improvements in allocation and use of resources are connected to the long-term sustainability. The efficiency improvements help to overcome aging-related and other expenditure pressures. Capacity of institutions to change legislation and allocation of the resources responding to the changing needs and priorities is a condition to the efficiency of allocation and use of resources which further links the governance and management issues to the sustainability agenda.<sup>10</sup>

Finland's experience shows also that wide transparency to the general public contributes to a good budgetary discipline and fiscal sustainability. In accordance with Finland's Openness in the Government Act budget proposals of the spending ministries are published on the internet after Minister of Finance has adopted his first position to the proposals and, thus, before the Government's budget negotiations.<sup>11</sup> Central Gov-

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<sup>8</sup> Ministry of Finance: Julkisen talouden liikkumavara (Room of Manoeuvre in Public Finances), Ministry of Finance Publications 4/2007.

<sup>9</sup> An expert group established by the Ministry of Finance has evaluated the fiscal policy rules and the needs of reform in the spending limits system applied in Finland on the basis of the evaluation of Finland's own experiences and fiscal policy challenges and taking into account experiences of selected other countries and viewpoints in theoretical literature, see Fiscal Policy Rules and the Reform of Spending Limits in Finland (original title Kehyksen puiteissa), Ministry of Finance Publications 5a/2007, an English translation of this report will be available in May at the Ministry of Finance www-site at <http://www.vm.fi>. Auditor General of Finland, Dr. Pöysti participated to the work of this expert group. The expert group's recommendations were all endorsed by the parties negotiating the new Government after 2007 general elections and the new Government of Matti Vanhanen will in the electoral period of 2007 – 2011 apply fiscal policy rule and spending limits system based essentially on working group's recommendations.

<sup>10</sup> Finnish Ministry of Finance expert group on the Fiscal Policy Rules recommended that allocation of resources between spending ministries should be regularly reviewed by the leaders of the Government coalition, in practise by the Prime Minister's Office and Ministry of Finance, see Finnish Ministry of Finance: Fiscal Policy Rules and the Reform of Spending Limits in Finland, cited above. This recommendation was taken in to the new Programme of Government of Matti Vanhanen's second Government, see Negotiation Result on the Programme of Government, 15.4.2007.

<sup>11</sup> The OECD secretariat also noticed the positive effect of the wide transparency of budget formulation process to budgetary discipline in its in evaluation of the Finland's budgeting system, see Budgeting in Finland: OECD Journal on Budgeting, Vol. 2, No. 2, 2003, pp. 275-310.

ernment financial accounting and performance information are accessible to everyone via a specific internet portal.<sup>12</sup> This portal service also provides during the fiscal year monthly use of budgetary accounts (how much a budget line has been used), balances of financial accounts, consolidated financial statements (revenue and expenditure, budget execution, balance sheet) of the government agencies and the same financial statements at a consolidated central government level. This wide openness helps the Ministry of Finance, research institutions, any civil society groups and the general public to keep pressure on sound and sustainable finances. Wide and easy access of the general public to performance and financial information, evaluation results and audit findings also enhances the effectiveness of the Supreme Audit Institutions reporting.<sup>13</sup>

### Supreme Audit Institutions' contribution

The Supreme Audit Institutions can contribute to the fiscal sustainability by:

- assuring that a true and fair view of the government's budget execution, revenue, expenditure and financial position is reported
- providing audit assurance on the adequacy and sufficiency of internal control and risk management belonging therein, in particular related to investment and management of funding reserved for the future pension expenditure
- assuring that there is a sound informational basis for policy making and policy assessment by audits aimed at further promoting fiscal transparency towards a wide transparency of the effectiveness and economic efficiency of the social policies.
- assuring and promoting the principles of sound financial management by performance audits

The most significant contribution to fiscal sustainability can be made by assuring that there are sufficient and reliable information on the short and long-term effectiveness and cost-efficiency of policy regimes and their implementation, on the incentives and disincentives included to the policy and the systems of implementation. Assuring information on the lacks of transparency leading to intentional or unintentional protection of non-efficient systems is also vital. The Supreme Audit Institutions can either directly

<sup>12</sup> See Government Internet Reporting Portal Netra at <http://www.netra.fi>

<sup>13</sup> In Finland the Government's Internet Reporting System Netra contains attached to the financial statements and performance reports and performance target documents links to the NAOF Audit Reports, see [www.netra.fi](http://www.netra.fi).

produce by their audits information on the lacks of efficiency and bad or less than optimal functioning of the incentives, or, they can assure and promote the quality of the government's effectiveness and efficiency assessments and reporting.

### Contribution by financial audit

Financial audit provides an assurance of the integrity and fairness of government's financial reporting and is an efficient tool to ensure integrity and fiscal transparency.<sup>14</sup> Indirect impact of financial audit is a creation of a culture of accountability and responsibility. A particular challenge for the financial audit is the treatment of implicit liabilities, government guarantees and the futures costs of policy commitments in the financial reporting. In most governmental accounting systems the discounted future expenditures are not recognised as liabilities in the financial statements or their annexes and, the economic policy-making tends to rely more on the information based on statistical national accounts.<sup>15</sup> The public-private partnerships, restructuring and securitisation of liabilities and receivables and other financing arrangements may be used to circumvent restrictions on direct expenditure. They may thereby be used in maintaining a level of expenditure which in the long run is not sustainable. For the Government of Finland enjoying very good sovereign credit ratings the financing costs in the public private partnerships tend to be considerably higher than the costs of direct government financing. The future costs of partnership may for many sectors and governments prove to be even troubling in the sustainability perspective. A particular attention should be paid to the comprehensiveness of the disclosure concerning liabilities related to the partnerships, government guarantees and to the implicit liabilities in the form of future costs of commitments. Management accounting systems should also provide sufficient information and basis for the analyses of economy and efficiency of public sector activities.<sup>16</sup>

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<sup>14</sup> See empirical analyses in IMF World Economic Outlook 2003.

<sup>15</sup> For example in Finland the fiscal sustainability analyses is conducted on the basis ESA95 conform national accounts and the projection methods developed in co-operation between European Commission and the Member States authorities.

<sup>16</sup> The scope of the annual NAOF financial audit covers the management accounting and reporting on the productivity, economy and amounts of services and goods delivered (output production).

### Contribution by performance audit

Fiscal sustainability risks are key economic risks to be addressed in the NAOF audits. In audit planning and audits the economic significance shall be assessed from the long-term costs and benefits perspective as well.<sup>17</sup> The performance audit analyses the whole chain of performance and activities related to a policy and each stage of the chain from the perspectives of effectiveness, efficiency and other components of economic expediency. NAOF performance audit seeks to systematically analyse the management of risks related to each stages of performance and activity chain and the functioning of the policy – impact -chain in its entirety.<sup>18</sup> Audits shall analyse effectiveness (the extent to which objectives have been achieved) and the cost-efficiency and cost-effectiveness in the form the input-output and input – outcomes ratios. Performance audit examines also the clarity and economic expediency of the definition of roles and responsibilities and the transparency of the costs and benefits in the short and long-term perspective.<sup>19</sup>

NAOF has conducted or commenced several audits directly relevant for the fiscal sustainability of various social sectors of which few examples can be cited here. Tax subventions or, *tax expenditure*, include several risks for the fiscal sustainability. Tax expenditure may reduce fiscal transparency and by there may be a poor channelling of the support to right beneficiaries. There is a risk of creation of incentives for non-efficient behaviour. All these risks were analysed in the NAOF audit on whether accountability requirements have been met in the Finnish system of tax subventions.<sup>20</sup> The audit examined the disclosure of the financial impacts of the tax subventions as a whole and, then looked into a behavioural effects of a particular tax subvention, tax deductions for

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<sup>17</sup>NAOF Strategy 2007 - 2012 and NAOF 2007 Activity and Audit Plan.

<sup>18</sup> The stages of the chain of performance are (1) recognition of the social needs, (2) establishment of policy and performance objectives (outcomes and outputs), (3) organisation of public activities and services and allocation of resources to it, (4) steering and management of public activities, (5) activities of public authorities and other public actors for the attainment of the objectives, (6) direct and indirect costs caused in steering and activities, (7) outputs and following direct and indirect impacts and outcomes, see draft Performance Audit Manual of NAOF.

<sup>19</sup> The NAOF Strategy states that even the considerations for inter-generational fairness and long-term perspective shall be taken into account in the analyses of economic significance and economic impacts.

<sup>20</sup> See NAOF Performance Audit Report 141/2007, available in Finnish Verotuet – tilivelvollisuuden toteutuminen. English translation of the Audit Report will be available in May via the NAOF www-site <http://www.vtv.fi>.

the fees of the voluntary pension insurances. Audit report discussed shortly the behavioural effects and allocation of the benefit of tax deductions of the interest rates of house loans. The NAOF ordered a theoretical survey of economic literature and econometric analyses from the Government Institute of Economic Research to complement audit material and to support analyses by NAOF own auditors.<sup>21</sup>

Health care is a high risk area for the fiscal sustainability. New legislation establishing guaranteed access to health care has been enacted in Finland in order to shorten queues to public health care and to give access on equal and fair terms. NAOF has commenced an audit of the guaranteed access to treatment –system and taken pressures on the fiscal sustainability explicitly as one of the economic risks to be addressed in the audit. The whole chain of steering and implementation will be analysed with quantitative and qualitative methods enabling to assess whether the objectives of the legislation have been attained, whether there has been unintentional behavioural consequences like reductions in preventive health care to cope with guaranteed access to treatment – requirements and other solutions, like poorly designed outsourcing, which are costly in the long run. According to NAOF audit experience, which concurs with observations from the theoretical and empirical economic literature and analyses, the long term costs and economic impacts and their appropriate assessment in financial management are a key and difficult issue in assuring fiscal sustainability of a particular sector.

### Steering system, fiscal policy and environmental audits

The Supreme Audit Institution can also have a look into the fiscal transparency as a whole and audit the adequacy of the accounting, reporting and evaluations systems. These audits can look particularly into the integrity, fairness and sufficiency of budget and legislative documentation for the economic significance of decisions.<sup>22</sup> For example, the quality of statistical national accounts has been and still is rather divergent

<sup>21</sup> See Government Institute of Economic Research Discussion Paper 408 (only available in Finnish) at <http://www.vatt.fi>. The idea was also to test and develop practises how an audit institution may complement its expertise by co-operating with an independent economic research institution.

<sup>22</sup> Finnish Parliament's Finance Committee has stated that financial decision-making at the Government and Parliament shall be based on information which gives a true and fair view of the targeted outcomes of the allocation of resources and of the consequences of decisions, including legislation with financial impacts, see VaVM 45/2006.

even in the European Union Member States. Depending on their powers, the Supreme Audit Institutions could audit the independence and the establishment quality management of statistical authorities and complement the quality assessments of national accounts by international institutions such as UN, IMF, OECD and, in the EU, particularly by EUROSTAT with audit observations of eventual circumventions or omissions affecting the fairness or comprehensiveness of reporting and additionally providing a guarantee to the independence and respect of the integrity of the statistical authorities.

Quality of the economic impact assessment is significant for the recognition of the vital issues for fiscal sustainability of particular social sectors.<sup>23</sup> The NAOF has recently conducted one general performance audit on the quality of national economic impact assessment of EU legislation<sup>24</sup> and, has looked into the issue in other audits, for example in the audit concerning tax subsidies. The quality of legislation and legislative impact assessment from good economic governance perspective has now been defined in as one of the strategic theme areas of the NAOF audits for 2007-2012.

NAOF will launch new series of steering and performance reporting system audit as a joint product of the financial and performance audit functions. The audit question will be whether budget documents in a selected administrative branch or other domain give sound informational basis for Parliament's decision-making and provide a true and fair view on the policy and performance objectives and impacts, whether the management accounting, internal control and risk management systems are adequate and sufficient and whether the evaluation system and financial and performance reporting as a whole give a comprehensively a true and fair view on finances, policy effectiveness and operational performance of government activities. Operational performance in the Finnish government context is defined to include productivity (efficiency) and economy of ac-

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<sup>23</sup> For a short overview of the functions of the economic impact assessment of legislation and the role of NAOF in the assurance of its quality, see the article by Auditor General Tuomas Pöysti in 2006 Annual Report of the Ministry of Trade and Industry Project for the Assessment of Regulatory Impacts for Business, available in English at the www-site of the Ministry of Trade and Industry at <http://www.ktm.fi> choose English, > Enterprises > Regulatory impact on business.

<sup>24</sup> See NAOF Performance Audit Report 122/2006, The National Decision Making of the Proposed New EU Legislative Acts, particularly from the perspective of economic impact assessment, only available in Finnish.

tivities.<sup>25</sup> A strategic theme area for NAOF audits is the informational foundations and functioning of the governance tools of fiscal policy. The NAOF will launch an audit of the functioning of the spending limits system and report annually, if necessary, on the reliability of the Government's fiscal reporting to Parliament including reporting on the respect of the spending limits. Purpose is to pre-empt pressures for purposive reporting by the Government and to pre-empt attempts to circumvent expenditure rules.<sup>26</sup>

The supreme audit institutions can also approach through environmental audit and combination of environmental audit to financial and performance audits contribute to the good governance of environmental changes. NAOF has defined environmental change and management of environmental risks to a strategic audit theme area.

## Conclusion

The Supreme Audit Institutions can make a good contribution to realisation of several of the conditions of fiscal sustainability. A well-designed programme of financial and performance audits can provide additional pressure in keeping the expenditure discipline both in short and long-term and help to overcome certain expenditure biases. Audits can increase efficiency of resources allocation and use of resources. To be effective in sustainability issues, the Supreme Audit Institutions should take a sufficiently long-term perspective. In reporting audit findings and recommendations should be put in a wider policy context which includes fiscal sustainability. Inclusion of the long-term fiscal sustainability perspective also often requires development of audit institutions expertise and skills towards economic analyses in national economic and econometric terms in the statistical system of national accounting.

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<sup>25</sup> Finland's performance management system and performance concepts are explained in the Ministry of Finance Performance Management Handbook, which is an integral translation of the performance management guide and best practises collection into English. Handbook is available at the Finnish Ministry of Finance www-site at <http://www.vm.fi>, >National finances > Performance.

<sup>26</sup> The Ministry of Finance report Fiscal Policy Rules and the Reform of Spending Limits emphasises the need for transparency and honesty in reporting on the observance of the spending limits. A good external review, if it is based on systematic follow-up of government finances and sufficient expertise, will reduce risks of purposive reporting, see Finnish Ministry of Finance: Fiscal Policy Rules, cited above.