

Chapter 7

The expenditure benchmark

7.1 Introduction

Fiscal governance across the EU features rules that were initially established through the Maastricht Treaty of 1992 and the SGP of 1997 (see Box 7.1). Following the onset of the economic and financial crisis in 2008, and the experience with the concrete implementation of the SGP, the Pact was subsequently amended. Significant changes were implemented through a package of legislation referred to as the ‘Six Pack’ of 2011 and another package of legislation termed the ‘Two Pack’ of 2013.⁵⁷ In particular, these legislative changes strengthened the ‘preventive arm’ of the Pact and enhanced surveillance and monitoring in the euro area.⁵⁸

A key objective for the launch of the ‘Six Pack’ and the ‘Two Pack’ was to encourage countries to pursue policies which lead to healthy public finances particularly in good economic times. An important development with the ‘Six Pack’ was the setting up of a new requirement, termed the ‘expenditure benchmark’, to supplement the other two fiscal rules which were previously in place, namely the ‘debt criterion’ and the ‘structural effort’ criterion (see Table 7.1). In terms of the expenditure benchmark, the expansion in adjusted expenditure must not exceed the growth in potential output unless any excess expenditure is fully matched by additional discretionary revenue measures.

Under the revised SGP, compliance with the preventive arm takes into account the three fiscal rules. Such rules complement each other and are meant to offer a more comprehensive and robust assessment of the suitability of a country’s current and planned fiscal policy towards the achievement and maintenance of the MTO.

⁵⁷ Links to the full set of relevant legislative texts is available in Annex 1 of the Vade Mecum on the Stability and Growth Pact, 2016 edition, European Economy Institutional Paper 21, published by the COM in March 2016. The publication is available on http://ec.europa.eu/economy_finance/publications/eeip/ip021_en.htm.

⁵⁸ Apart from the ‘preventive arm’, the SGP also features a ‘corrective arm’ which deals with the appropriate policy responses that a MS which is under the Excessive Deficit Procedure (EDP) must undertake to rectify its position when the fiscal deficit exceeds the 3% of GDP threshold.

Box 7.1: History of the SGP

- 1992 **Maastricht Treaty signed:** EU Member States sign the Maastricht Treaty, paving the way for the creation of the euro as the common currency of the EU. The Treaty limits government deficits to 3% of GDP and public debt levels to 60%, so as to enable countries to share a single currency.
- 1997 **Stability and Growth Pact:** EU Member States agree to strengthen the monitoring and coordination of national fiscal and economic policies to enforce the deficit and debt limits established by the Maastricht Treaty. The Stability and Growth Pact is born.
- 1998 **Preventive rules:** The SGP's preventive rules enter into force in respect of EU Member States whose budget deficit is less than 3% of GDP.
- 1999 **Corrective rules:** The SGP's corrective rules, also called the Excessive Deficit Procedure, enter into force in respect of EU Member States whose budget deficit exceeds 3% of GDP.
- 2005 **SGP amendment:** EU lawmakers amend the SGP to allow it to better consider individual national circumstances and to add more economic rationale to the rules that have to be complied with. Surveillance and coordination are strengthened. The excessive deficit procedure is clarified and made faster.
- 2011 **Six Pack:** The SGP is made more comprehensive and predictable with a major enhancement of the EU's economic governance rules through a collection of new laws, known as the 'Six Pack' consisting of five Council Regulations and one Directive. The monitoring of both budgetary and economic policies is organised under the European Semester and further details on the implementation of the SGP's rules are laid down in a 'Code of Conduct'.
- 2013 **Fiscal Compact:** The importance of the budgetary targets set by the SGP's preventive arm (the Medium-Term Objectives), are strengthened by a law known as the 'Fiscal Compact', which is part of an inter-governmental treaty known as the Treaty on Stability, Coordination and Governance (TSCG).
Two Pack: Adherence to the SGP is further strengthened by new laws, known as the 'Two Pack,' which reinforce economic coordination between Member States and introduce new monitoring tools. Further details on the implementation of the 'Two Pack' provisions are laid down in a 'Code of Conduct'.
- 2014 **SGP review:** A review of the 'Six Pack' and 'Two Pack' rules, which was called for in the legislation, determines that the legislation has contributed to the progress of fiscal consolidation in the EU. The review highlights some strengths as well as possible areas for improvement, which will be discussed with the European Parliament and Member States.
- 2015 **SGP Flexibility:** The Commission issues guidance on how it will apply the SGP rules to strengthen the link between structural reforms, investment and fiscal responsibility in support of jobs and growth.

Source: Based on http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm

Table 7.1: Fiscal rules under the SGP

| Rules | Focus |
|---------------------------------------|---|
| 1. Debt criterion | Scaling back of the debt-to-GDP ratio towards the 60% threshold according to a pre-defined timeline |
| 2. Structural effort criterion | Improvements in the structural budget balance, generally of at least 0.5% of GDP annually |
| 3. Expenditure benchmark | Country-specific limits on expenditure growth |

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

The expenditure benchmark acts as a guide to ensure that a country's policies are consistent with maintaining the fiscal balance stable at the MTO, when the latter has already been attained. On the other hand, in cases when the MTO has not been attained, as in Malta's case, the expenditure benchmark guides the adjustment towards the MTO. Indeed, the expenditure benchmark reinforces the pressure towards fiscal consolidation as it sets an upper limit, referred to as the 'reference rate' on the permissible annual growth in government expenditure. The desirable feature of the expenditure benchmark is the fact that it limits the possibility that revenue windfalls would be used to fund additional expenditures, rather than being used to achieve faster progress towards the MTO.

“Expenditure rules, in particular, have received increasing attention as they exhibit a number of features. In particular, they are directly aimed at addressing the expenditure pressures often at the origin of excessive deficits, they are transparent and generally easy to monitor, they fully accommodate revenue shortfalls resulting from adverse economic shocks (allowing for a stabilizing role of fiscal policy), and they are most directly related to the formulation of the annual budget, which sets legally binding appropriations, thus contributing to the rules' enforceability. Importantly, and unlike deficit caps, expenditure rules also help creating buffers in good times, when revenue windfalls can make spending pressures difficult to resist. These countercyclical properties also make expenditure rules particularly attractive for countries where estimates of the structural budget balance are challenging to obtain because the economic cycle is not well-defined (e.g., developing or transition economies and developed small open economies).”

Cordes et al (2015), *Expenditure Tools for Sound Fiscal Policy?*, IMF Working Paper 15/29.

Thus, the expenditure benchmark complements the other two rules which respectively focus on ensuring that debt levels are sustainable (debt rule) and that the pace of fiscal consolidation is sustained while being commensurate with the business cycle conditions in the country (structural effort criterion).

The framework for the expenditure benchmark is characterised by two main elements, the ‘reference rate’ and the ‘adjusted expenditure growth’. The reference rate acts as a ceiling, while the adjusted expenditure growth is derived from a new expenditure aggregate which is computed according to fixed guidelines. Both components necessitate a significant amount of macroeconomic and fiscal data, both historical as well as forecasts.

7.2 Components of the reference rate

The annual reference rate acts as a guide towards the permissible growth in yearly expenditure. Its estimation is based on two different components. These broadly relate to the country’s growth potential, and indirectly to the size of its public sector. The latter plays a role in the estimation of the magnitude of the necessary restraint on expenditure growth, which is implemented through the convergence margin (see Table 7.2).

Table 7.2: Components of the reference rate

| Input | Purpose |
|--|---|
| Medium-term rate of potential GDP growth | To offer guidance on the long-term average growth rate of the economy |
| Convergence margin | To slow down expenditure growth to below that in potential output in order to achieve convergence towards the MTO |

Source: *Vade Mecum on the Stability and Growth Pact, 2016 edition*

7.3 Methodology to calculate the medium-term rate of potential GDP growth

The applicable medium-term rate of potential GDP growth is set on a country-by-country basis. It is defined as an average over time and is expressed in terms of potential GDP growth rather than actual real GDP growth. This approach ensures that the application of the expenditure benchmark does not lead to the problem of pro-cyclicality. The latter describes a situation when an economic variable moves in the same direction as the economic cycle, thereby amplifying the economic cycle and thus contributing to more instability.⁵⁹

⁵⁹ The use of actual real GDP growth rates would result in a situation where above-trend actual growth would lead to a higher permissible growth rate while below-trend actual growth would lead to a lower permissible growth rate. Such situation would not lead to sound policy making.

The medium-term rate of potential GDP growth is calculated by a ten-year average of potential GDP, comprising five years of outturn data, the year underway, and four years of forward-looking data. The back data are provided by Eurostat, while the other figures build on the COM's forecasts. Figures for the years beyond the scope of the COM's forecasts are based on the commonly agreed methodology set out by the COM's Output Gap Working Group.⁶⁰

In the case of Malta, the medium-term rate of potential GDP growth used for the assessment of the 2015 budgetary figures was established at 1.8%, while that used for the assessment of the 2016 budgetary figures was established at 2.7% (see Table 7.3).

Table 7.3: Medium-term rate of potential GDP growth

| Assessment of budgetary figures for | Growth rate |
|-------------------------------------|-------------|
| 2015 | 1.8% |
| 2016 | 2.7% |

Source: Annex 4 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

The methodology prescribes that the medium-term rate of potential GDP growth applied in year [t] is set on the basis of the COM's spring forecast in [t-1]. This ensures that the results of the calculations are fully known to the country and can be used to prepare the necessary fiscal plans for compliance.

7.4 Methodology to calculate the convergence margin

The convergence margin is applicable only to countries which have not yet attained their MTO and thus need to undertake more ambitious fiscal restraint than those that have already achieved their MTO. The size of the convergence margin is related to the share of general government expenditure in GDP. The magnitude of the convergence margin is based on the assumption that any decrease in the public expenditure-to-GDP ratio would then translate into an exact proportional improvement of the structural balance. On this basis, larger public sectors would require less expenditure restraint, in percentage terms, to achieve the same tightening of the structural budget, when compared to countries having a smaller public sector.

The convergence margin for year [t] is set in spring [t-1] according to a prescribed methodology. Specifically, the computation utilises the size of the government primary expenditure (total expenditure net of interest payments) in nominal GDP. The figure comes from the same COM's forecast vintage on which the ten-year medium term potential GDP

⁶⁰ The MFIN is a member of this working group.

growth is centred. Specifically the formula used is $[C=50/P]$ where $[C]$ is the convergence margin and $[P]$ is the share of primary expenditure in GDP.⁶¹ In the case of Malta, the value of $[P]$ was approximately 38.5% in 2015 and 41.7% in 2016. This translates into a default convergence margin $[C]$ of 1.3% for 2015 and 1.2% for 2016.

However, since Malta's Country Specific Recommendations indicated a required improvement in the structural balance of 0.6% of GDP rather than 0.5% of GDP, the convergence margin needs to be recalibrated in order to be consistent with the recommended tightening in the structural balance. The recalibrated convergence margin multiplies the default convergence margin by the specific structural effort requirement (0.6% in the case of Malta), and dividing by the standard structural effort requirement of 0.5%. Accordingly the recalculated convergence margin for Malta for 2015 was established at 1.5%, while that for 2016 was established at 1.4% (see Table 7.4). Effectively, the convergence margin guides the necessary restraint which the country must undertake as long as it has not yet attained its MTO. Thereafter, once the MTO is attained, no convergence margin remains applicable.

Table 7.4: The recalibrated convergence margin*

| Assessment of budgetary figures for | Share of Primary expenditure in GDP [P] | Convergence Margin [C] | Ratio of required structural effort compared to standard structural effort | Recalibrated convergence margin |
|-------------------------------------|---|------------------------|--|---------------------------------|
| a | b | $c = 50 / b$ | $d = 0.6\% / 0.5\%$ | $e = c \times d$ |
| 2015 | 38.5% | 1.3% | 1.2 | 1.5% |
| 2016 | 41.7% | 1.2% | 1.2 | 1.4% |

*Figures may not add up due to rounding.

Source: Box 1.10 and Annex 4 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

7.5 Methodology to calculate the reference rate

In the case of Malta the reference rate is calculated by subtracting the convergence margin from the potential growth rate. A specific reference rate is calculated for each respective year (see Table 7.5).

Thus, the reference rate for 2015 was calculated at 0.3%, while that for 2016 was estimated at 1.3%. These growth rates define the expenditure limits for the year. The significant increase in the reference rate from 2015 to 2016 reflects the updated COM's forecasts which indicate

⁶¹ The figure 50 is related to the requirement of generating the necessary annual improvement in the structural balance.

a much higher medium-term potential growth rate. This follows the surge in investment spending and the positive labour market developments which were recently achieved.

Table 7.5: The reference rate

| Assessment of budgetary figures for | Potential growth rate | Convergence margin recalculated | Reference rate |
|-------------------------------------|-----------------------|---------------------------------|----------------|
| 2015 | 1.8% | 1.5% | 0.3% |
| 2016 | 2.7% | 1.4% | 1.3% |

Source: Annex 4 of the Vade Mecum on the Stability and Growth Pact, 2016 edition

7.6 Methodology to calculate the modified expenditure aggregate

The expenditure benchmark's reference rate does not apply to overall expenditure but rather to a modified aggregate. The latter takes into account a number of adjustments. The rationale for these adjustments is to focus on that element of expenditure which is more of a structural nature, and thus more indicative of the conduct of fiscal policy. In order to arrive at the modified expenditure aggregate, four main adjustments are carried out to the overall government expenditure (see Table 7.6).

Table 7.6: Adjustments to total government expenditure

| Adjustment | Rationale |
|---|--|
| Netting out of interest payments | To focus on expenditure which is totally within the government's control |
| Netting out of spending on EU programmes paid for by EU funds | To focus on expenditure which is paid out of tax revenues |
| Netting out of the cyclical elements of unemployment benefits | To focus on expenditure which is independent of cyclical conditions |
| Smoothing investment spending over four years | To avoid penalising peaks in investment spending |

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

Calculation of the modified expenditure aggregate thus requires information about: total expenditure; interest payments; EU-funded expenditure; the cyclical component of unemployment benefits; and a four-year time series of investment spending.⁶²

⁶² The calculation of the cyclical element of unemployment benefits further requires information about macroeconomic indicators such as the output gap conditions and the latter's impact on actual unemployment.

7.7 Methodology to convert nominal expenditure growth into real terms

Since the reference rate of the expenditure benchmark is established in real terms, the modified annual government expenditure growth rate needs to be converted into real terms to enable meaningful comparison. This is achieved by deflating the nominal government expenditure using a suitable deflator. The methodology specifically prescribes the use of the percentage change in the GDP deflator as the appropriate measure for inflation in this case. This choice is based on the need to use an indicator which is consistent with the workings used to derive potential output. Another advantage is the fact that the GDP deflator typically displays less volatility than other measures of inflation and is therefore more conducive to supporting transparent and stable policy-making. The particular GDP deflator vintages to be used are also prescribed according to a specific pattern (see Table 7.7).

Table 7.7: GDP deflators

| Budget and year of in year assessment | Year of ex post assessment | COM's deflators to use |
|---------------------------------------|----------------------------|---|
| 2015 | 2016 | Average of 2014 spring and autumn forecasts |
| 2016 | 2017 | Average of 2015 spring and autumn forecasts |

Source: Table 1.1 of the *Vade Mecum on the Stability and Growth Pact, 2016 edition*

When the COM assesses the fiscal plans for year [t] depicted in the USP or the DBP of the same year, the average GDP deflator from the Commission's spring forecast and that of autumn of the preceding year is used. The ex-post assessment of outturn data of year [t] which is undertaken in year [t+1] is then based on the average GDP deflator forecast for [t] taken from the COM's spring and autumn forecasts of [t-1].

7.8 Compliance with the expenditure benchmark

Countries that have exceeded their MTO do not need to be assessed for compliance with the expenditure benchmark, as long as the MTO is maintained. For the other countries (including Malta), compliance with the expenditure benchmark is ascertained by evaluating whether in each year the expenditure plans result in expenditure growth (converted into real terms) that satisfies the yearly reference rate.

Compliance with the expenditure benchmark in the country's USP or DBP is assessed against both the plans' own forecasts and those of the COM. The latter form the basis for the COM's risk assessment of the plans. With regard to the ex-post assessment of compliance, this is based on outturn data, with the exception of deflator values which follow the previous explained methodology.

If the country is compliant on an ex-ante basis, this means that if the plans turn out as forecast, the country would comply with the preventive arm of the SGP. On an ex-post basis, the assessment would conclude whether compliance has taken place in the previous year.

In order to ensure the predictability of the ex-post assessment's outcome and enable the country to take the appropriate measures in the forthcoming budget plan, the applicable convergence margin and the resulting reference rate are communicated in the spring of year [t-1] for year t and are kept fixed – unless the required structural adjustment is reset – for all the assessments (ex ante, in-year and ex post) of the budgetary figures of year [t]. This is based on the principle of the so-called ‘freezing’ of the requirements. The advantage of freezing requirements is that it allows for the limits to be known by the country ex-ante and hence the country is able to plan accordingly. The disadvantage of the freezing requirements is that they may not capture fully latest developments. This issue may be particularly relevant for countries like Malta which are experiencing rapid structural changes.

The purpose of aiming towards full compliance with the expenditure benchmark is to ensure that a country maintains its MTO or else closes the gap towards it (see Table 7.8). In particular, it ensures that benign fiscal revenue conditions do not translate into an expansion of the public sector through new expenditure initiatives but are rather channelled into faster progress towards the MTO.

Table 7.8: Link between compliance with the expenditure benchmark and the MTO

| Member State at MTO | Member State not at MTO |
|--|---|
| Net expenditure growth is in line with reference potential growth rate | Net expenditure growth is in line with a rate below the reference potential growth rate |
| The share of government expenditure as per cent of potential GDP remains constant (in the absence of revenue measures) | The share of government expenditure as per cent of potential GDP decreases (in the absence of revenue measures) |
| The structural balance is constant over time | The structural balance improves over time |
| The Member State remains at its MTO | The gap with the MTO closes over time |

Source: Vade Mecum on the Stability and Growth Pact, 2016 edition

7.9 The role of discretionary revenue measures

Irrespective of whether a country is at the MTO or not, compliance with the expenditure benchmark can also be achieved if any excess expenditure growth over the medium term potential growth rate is matched by discretionary revenue measures. The latter can take place principally via the introduction of new taxes or increases in tax rates.

Specifically, any excess expenditure growth over the medium-term reference is not counted as a breach of the benchmark if it is fully offset by revenue increases mandated by law. This provision is applicable to situations where country has revenue sources that are linked by law to certain expenditure items, so that when expenditure increases, the revenues automatically increase to fund that higher expenditure.⁶³ To date, in Malta there is no such framework of automatic revenue adjustment in place.

By factoring in the possibility of revenue measures within the expenditure benchmark calculations, the framework is flexible to accommodate a country's preferences in the area of public finances. The expenditure benchmark does not limit, or in any way determine, the size of government spending. It only requires that any 'excessive' expenditure growth is fully funded by equivalent discretionary revenue measures. Compliance with the expenditure benchmark is thus possible, independent of whether the political preferences in a country favour a large or small public sector.

7.10 Deviation from the expenditure benchmark

The assessment of the expenditure benchmark focuses on whether the growth rate of government expenditure, net of discretionary revenue measures, contributes to the appropriate adjustment towards the MTO, or whether it is in line with the medium-term rate of potential GDP growth for countries at their MTO. A deviation from the expenditure benchmark occurs when expenditure growth exceeds the reference rate. This is evaluated both on a yearly basis, as well as an average over a rolling two-year period.

Possible deviations fall under two categories, 'significant' or 'not significant'. The assessment of whether a deviation is significant is based on the following criteria: whether the deviation has a total impact on the government balance of at least 0.5% of GDP in a single year, or at least 0.25% of GDP per year when averaged over two consecutive years for a cumulative amount of at least 0.5% of GDP over two years.

In the case of Malta, the modified expenditure growth for 2015 was estimated by the COM at 1.4% thus exceeding the reference rate by 1.1% (see Table 7.9). On the other, the modified expenditure growth for 2016 was estimated by the COM at 0.5% and hence 0.6% below the limit. As a result, over a two-year average, the deviation was estimated at -0.3% indicating that modified expenditure growth has indeed exceeded the limit to an extent to be considered as 'significant'.

⁶³ A revenue (change) mandated by law is a change in a specific tax or contribution rate which is – in principle – triggered automatically (i.e. through a specific piece of pre-existing legislation) by a change in a well-specified and clearly linked expenditure category, with the intention of ensuring sufficient financing for this expenditure category. An example of this is the case where health and medical expenses are funded by a hypothecated tax which is automatically adjusted to cover these expenses when they increase (or decrease).

Table 7.9: Compliance with the expenditure benchmark (COM's assessment)

| Year | Reference Rate | Modified expenditure growth (deflated) | Yearly deviation | Two-year average deviation |
|------|----------------|--|------------------|----------------------------|
| 2015 | 0.3% | 1.4% | -1.1% | } -0.3% |
| 2016 | 1.3% | 0.7% | +0.6% | |

Source: Table 6 of the Commission Staff Working Document accompanying the analysis of the draft budgetary plans for Malta published on 16 November 2016. Figures may not add up due to rounding.

Deviations of expenditure developments are not considered significant if the country has over-achieved the MTO, after factoring in the possibility of significant revenue windfalls, and also as long as the budgetary plans laid out in the USP do not jeopardise that objective over the programme period. Similarly, the deviation may be left out of consideration when it results from an unusual event outside the country's control and which has a major impact on the financial position of the general government. It is also not considered significant in the case of a severe economic downturn for the euro area or the Union as a whole, provided that this does not endanger the fiscal sustainability in the medium-term.

In all other cases the conclusion depends on the 'overall assessment', which should include an in-depth analysis based both on the structural effort criterion as well as the expenditure benchmark. The risk of or the conclusion of an ex-post significant deviation requires at least one indicator to be in significant deviation. In case the country is considered to be in significant deviation on both indicators, this gives a strong presumption of a (risk of or observed) significant deviation, but an overall assessment is still needed before reaching such a conclusion. The overall assessment uses a certain element of judgement by putting everything into perspective. Indeed, there is no element of automaticity in the Regulation in reaching the conclusion of a significant deviation.

In the overall assessment, particularly when only one indicator points to a significant deviation, the COM analyses the factors which lead to the discrepancy between the two indicators. It informs the European Council about this analysis, explaining the discrepancy between both indicators and the reasons behind the conclusion of the overall assessment. The conclusion of the assessment of the country's plans considers whether the resulting change in the structural balance, including the analysis of the expenditure net of discretionary revenue measures, appears to be appropriate or whether a significant deviation from the adjustment path can be expected – either on a one year or on a two-year basis.

Where a conclusion of overall significant deviation is reached on an ex post basis on outturn data, this triggers a Significant Deviation Procedure (SDP), which starts with a COM's warning to the country in question and can lead to an interest-bearing deposit being required, for euro area countries, in the event that the significant deviation is not addressed appropriately.

7.11 Latest updates

At the Council meeting of the Economic and Financial Affairs (ECOFIN) which was held on 6 December 2016, reference was made to the expenditure benchmark (see Box 7.2). In particular an agreement has been reached at the European level whereby stronger focus on an expenditure-based indicator is envisaged for setting and assessing fiscal policies and outcomes. While this agreement could fine-tune some of the calculations referred to in this Chapter, there will not be any need for changes to the legislation underlying the SGP. The agreement follows from the Five Presidents Report which among other things has suggested the reduction in the complexity of the SGP framework.⁶⁴ The COM intends to publish the relevant details about the way in which the new agreement will take place in practice in the next edition of the Vade Mecum on the SGP.

Box 7.2: Outcome of the 3506th meeting of the Economic and Financial Affairs Council

Fiscal rules – Predictability and Transparency

The ECOFIN Council on 6 December 2016 endorsed an agreement concluded at the Economic and Financial Committee (EFC) aimed at improving the predictability and transparency of the EU's fiscal rulebook, the SGP.

On 29 November 2016, the EFC reached agreement on how to simplify the assessment of compliance with the SGP's rules. The agreement covers both the preventive and corrective arms of the Pact as relating to the assessment of Member States' fiscal policies and outcomes. No change to the legislation underlying the Pact is envisaged.

Stronger focus on an expenditure-based indicator is envisaged for setting and assessing fiscal policies, thereby aiming to reduce complexity in the fiscal surveillance framework.

The indicator involves setting an upper limit for the growth rate of government expenditure. This is considered an operational and easy-to-measure target that will guide Member States in the preparation and monitoring of their budgets. However, the structural balance indicator will still remain an essential part of the fiscal surveillance framework.

The SGP is based on articles 121 and 126 of the Treaty on the Functioning of the European Union and a treaty protocol on the excessive deficit procedure. Its rules were initially developed by a resolution and two regulations adopted by the Council in 1997.

Source: Based on www.consilium.europa.eu/en/meetings/ecofin/2016/12/st15205_en16_pdf

The information available to date indicates that under the corrective arm, the expenditure benchmark will in future be used as the operational indicator for determining compliance

⁶⁴ The Report can be downloaded from https://ec.europa.eu/commission/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en.

with the COM's recommendations made under the EDP.⁶⁵ In particular, the agreement stipulates that the expenditure benchmark will become the cornerstone of the COM's assessment of the Member States' compliance with the SGP. Accordingly, future EDP recommendations will be formulated also in terms of the expenditure benchmark. The expenditure benchmark will be the maximum allowable growth rate of government expenditure (net of any possible discretionary revenue measures) consistent with meeting the targets for the headline deficit and the change in the structural balance.

In the case of Member States who are in the preventive arm of the SGP and have not yet attained their MTOs, the adjustment requirements, which currently are set out by the Council only in terms of change in the structural balance, will be formulated ex-ante also in terms of the expenditure benchmark.

By establishing the use of the expenditure benchmark under both the preventive and corrective arms, the agreement will increase the overall consistency of the SGP. The COM's view is that the expenditure benchmark has the benefit of being easier to measure than the structural balance, as it is based on observable variables once the benchmark is set ex-ante. Another advantage is that the expenditure benchmark is directly connected to the evolution of non-cyclical expenditure, a policy lever which is directly under the control of government. Furthermore, the expenditure benchmark has the merit of being easier to communicate, both with the general public and with policy makers, as it essentially translates into an expenditure ceiling.

⁶⁵ Source: Report on Public Finances in EMU 2016, European Economy Institutional Paper 045, December 2016.