Council of the European Union

Brussels, 29 November 2016
(OR. en)

14814/16

LIMITE

ECOFIN 1107
UEM 399

COVER NOTE

From:	General Secretariat of the Council
To:	Permanent Representatives Committee/Council
Subject:	Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm (Opinion of the Economic and Financial Committee)

Delegations will find attached the opinion of the Economic and Financial Committee on Improving the predictability and transparency of the SGP: A stronger focus on the expenditure benchmark in the preventive arm.

ECONOMIC AND FINANCIAL COMMITTEE

THE SECRETARIAT

Brussels, 29 November 2016
ecfin.cef.cpe(2016)6489812

IMPROVING THE PREDICTABILITY AND TRANSPARENCY OF THE SGP:
A STRONGER FOCUS ON THE EXPENDITURE BENCHMARK IN THE PREVENTIVE ARM

(Opinion of the Economic and Financial Committee)

INTRODUCTION

The preventive arm of the SGP endeavours to ensure that fiscal policy is conducted so as to lead to healthy public finances over the short and longer term. It requires that Member States attain a country-specific medium-term budgetary objective (MTO) for their budgetary position after adjusting for the cyclical position of the economy. For Member States that are not at their MTO, an appropriate adjustment path towards it should be defined and adhered to. By setting a budgetary target in cyclically-adjusted terms the preventive arm aims to ensure that the underlying fiscal position of Member States is conducive to medium-term sustainability, while allowing for the free operation of automatic fiscal stabilisers. The country-specific MTOs are set taking into account their respective debt levels, the country-specific sustainability challenges posed by the costs of ageing population and the standard operation of automatic stabilisers. The adjustment paths are without prejudice to the requirement for Member States to reduce their government debt at a satisfactory pace, thereby contributing to the long-term sustainability of their public finances, in accordance with Article 126.2 of the Treaty on the functioning of the European Union and Article 2 of Regulation 1467/97.

1. THE ADJUSTMENT REQUIREMENTS

The working of the preventive arm is based on a two-pillar approach: the (change in the) structural balance and an analysis of the growth rate of an expenditure aggregate net of discretionary revenue measures. The expenditure aggregate is comprised of overall government expenditure net of interest payments, spending on EU programmes paid for by EU funds and the cyclical component of unemployment benefits, while investment spending (not matched by the EU funds) is smoothed over four years. When estimating the budgetary impact of a discretionary revenue measure, micro-level behavioural responses, including cautiously estimated tax compliance effects that are clearly attributable to well specified measures directly aiming at improving tax compliance, should also be factored in.

To remain at, or make adequate progress towards, their MTO, Member States shall ensure that annual government expenditure growth does not exceed a maximum allowable rate, known as the 'expenditure benchmark'. In particular, Member States at their MTO shall ensure that government expenditure grows at most in line with a medium-term rate of potential GDP growth – which is the rate which ensures adherence to the MTO over time[1] – unless any excess expenditure growth is matched by discretionary measures yielding additional revenues. Member States on the adjustment path to the MTO shall ensure that their expenditure grows at a rate

[1] Under the implicit assumption that, in the medium term, revenues grow proportionally in line with potential GDP.

below that medium-term rate of potential GDP growth – the difference in growth rates being the convergence margin – unless the excess growth in expenditure is matched by discretionary measures yielding additional revenues.

The expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is derived (as specified in Box 1) from the required improvement in the structural balance, so to be consistent with, and conducive to, the fulfilment of the required adjustment towards the MTO.

The country-specific adjustments requirements are set on an annual basis, as part of the Council's country-specific recommendations under the European Semester. Specifically, for Member States that have not yet attained their MTO, the recommendations indicate the required fiscal effort formulated in terms of the change in the structural balance and the expenditure benchmark. For Member States that are at their MTO, the expenditure benchmark does not reflect any required improvement in the structural balance but indicates the maximum growth rate of expenditure compatible with the Member State remaining at the MTO.

Box 1: Derivation of the expenditure benchmark

The expenditure benchmark provides guidance on how net expenditure should be set to maintain the structural balance at the MTO once it is attained or to fulfil the adjustment path defined as per the matrix of requirements[2] when a country is not at its MTO.

The expenditure benchmark is derived from a medium-term growth rate of potential output and a country-specific convergence margin.

Specifically, the expenditure benchmark L_t for year t is derived from the medium-term growth rate R_t by the deduction of a convergence margin C_t (all expressed in percentage points), as follows:

$$L_t = R_t - C_t$$

The medium-term growth rate is calculated over a 10-year window, on the basis of forward-looking projections and backward-looking estimates from the Commission's spring forecast of the preceding year. It is expressed in nominal terms using the increase in the GDP deflator for year t projected in that forecast. The medium-term growth rate is recalculated every year.

For Member States that have not yet attained their MTO, the convergence margin is calibrated to be consistent with the required improvement in the structural balance adj_t (expressed in

[2] Possibly adjusted for allowed deviations under 'flexibility' clauses, and capped at the level of the initial distance from the MTO.

percentage points). Its size depends on the share of government primary expenditure in GDP in the preceding year (P_{t-1}, expressed in percentage points). Thus, the convergence margin is given by:

$$C_t = \frac{adj_t}{P_{t-1}} \times 100$$

For Member States at their MTO, the convergence margin is by construction set to zero.

2. THE OVERALL ASSESSMENT

Sufficient progress towards the MTO shall be evaluated on the basis of an overall assessment with the structural balance as the reference, including an analysis of expenditure net of discretionary revenue measures, as per Article 5(1) of Council Regulation (EC) No 1466/97.

Compliance with the preventive arm requirements is evaluated notably on the basis of the structural balance and the expenditure benchmark, taking their respective strengths into account. The indication provided by the structural balance and the expenditure benchmark is always qualified through an overall assessment. This focuses on the possible sources of discrepancy between the two indicators and, on that basis, reaches a conclusion. The overall assessment can conclude that there is compliance with the requirements, or some deviation,[3] or a significant deviation, with the latter triggering a 'significant deviation procedure' if the conclusion is based on outturn data.

Both the structural balance and the expenditure benchmark have their respective strengths. These could be as follows.

The structural balance might dispense with the need to distinguish between discretionary and non-discretionary changes in revenues and quantifying individual measures. In addition, in some cases, the use of a single-year estimate of potential GDP growth, which underpins the calculation of the structural balance, could lead to a measure that appears more meaningful than the one provided by an estimate of medium-term potential GDP growth that includes some exceptionally high or low yearly estimates of potential GDP growth, as conventionally foreseen by the methodology.[4] Finally, a possible advantage of the structural balance is that it might provide an incentive for effective revenue administration.

[3] 'Some' deviation refers to any deviation which is not significant – for the purposes of Articles 6(3) and 10(3) of Council Regulation (EC) No 1466/97.

[4] For example, the large negative impact that the economic and financial crisis had on the estimates for potential GDP growth implies that, for a number of countries, the averaging formula can lead to an estimated 10-year potential growth rate that is much lower than estimates made for more recent and future years

The expenditure benchmark as a rule is more predictable in the sense that expenditure rules, in setting an upper limit for the growth rate of government expenditure, can serve as an operational target for the preparation of annual budgets and help monitor their in-year execution. Compliance with the expenditure benchmark is measurable ex post and, in general, is less affected by factors that lie outside government control, including abnormal responses of revenues to economic activity. In order to ensure transparency, the Commission and the Member States will provide a quantification of discretionary revenue measures incorporated in the estimation of the expenditure benchmark.

It is important that reliance on either indicator ensures consistency with the required path of adjustment and therefore ensures the achievement of the MTO.

Because of their nature, one-off measures have only a temporary effect and thus cannot lead to a sustained improvement in the government's fiscal position. One-off measures are excluded from the calculation of the structural balance. When assessing compliance with the expenditure benchmark, the impact of one-off measures is systemically corrected for in the context of the overall assessment: in particular, the removal of one-off expenditure measures is systematically taken into account in the overall assessment; similarly, any one-off revenue measures are systematically removed from the amount of discretionary revenue measures. Taking systematically account of such measures in the overall assessment ensures that the expenditure benchmark is consistent with the required improvement in the structural balance, in line with the spirit of Council Regulation (EC) No 1466/97. This is also consistent with the approach retained when assessing 'effective action' under the Excessive Deficit Procedure.

In addition, when assessing compliance with the expenditure benchmark, expenditure is measured excluding, in particular, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure (see Box 2). This is consistent with the methodology and assumptions underpinning the calculation of the structural balance, to the extent that expenditure on Union programmes is budget neutral (precisely because matched by Union funds revenue) and that non-discretionary changes in unemployment benefit expenditure are filtered out when removing the 'cyclical component' of the budget balance.

Box 2: Assessing ex post compliance with the expenditure benchmark

When assessing compliance with the expenditure benchmark, expenditure is measured excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed government gross fixed capital formation is smoothed over a 4-year period. In addition, any possible fiscal policy measures on the revenue side (including also revenue increases mandated by law) are netted out.

The net expenditure growth rate g_t for year t is computed as follows:

$$g_t = \frac{G_t - \Delta R_t - G_{t-1}}{G_{t-1}}$$

where G_t and ΔR_t are the expenditure aggregate and the estimated impact of revenue measures having an incremental (positive or negative) effect on revenues in year t.

In the context of the overall assessment, the net expenditure growth rate g_t is corrected for the effect of one-off measures OO_t (both on the expenditure and on the revenue side):

$$g_t^{corr} = g_t - \frac{OO_t}{G_{t-1}}$$

If the net expenditure growth rate corrected for one-off and measures g_t^{corr} is at or below the benchmark rate L_t, the country is compliant with the expenditure benchmark for year t. Otherwise it is not compliant with the expenditure benchmark. In the latter case, the excess growth over the benchmark is converted into a share of GDP, to judge whether the excess (if positive) is significant or not. If the figure exceeds 0.5% of GDP over 1 year, it is judged to be significant. If the figure exceeds 0.25% of GDP when averaged over 2 consecutive years, the deviation is judged significant over 2 years.

As defined in Articles 6(3) and 10(3) of Council Regulation (EC) No 1466/97, the assessment of whether a deviation from the requirements is significant includes, in particular, the following criteria, for Member States that have not yet attained their MTO:

i. When assessing the change in the structural balance, whether the deviation is at least 0.5% of GDP in a single year or at least 0.25% of GDP on average per year in 2 consecutive years;

ii. When assessing expenditure developments net of discretionary revenue measures, 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 on average per year in 2 consecutive years (see Box 2).

For a Member State that has not reached its MTO, the deviation will be considered significant if both:

i. The deviation of the structural balance from the appropriate adjustment path is at least 0.5% of GDP in one single year or at least 0.25% of GDP on average per year in two consecutive years; and

ii. An excess of the rate of growth of expenditure net of discretionary revenue measures over the appropriate adjustment path defined in relation to the reference medium-term rate of growth has had a negative impact on the government balance of at least 0.5 of a percentage point of GDP in one single year, or cumulatively in two consecutive years;

or if one of the two conditions (i) and (ii) is verified and the overall assessment evidences limited compliance also with respect to the other condition.

While the initial requirements for year *t* in terms of (the change in) the structural balance and the expenditure benchmark, set in the spring of year *t* -1, are kept unchanged throughout the successive assessments, the ex post assessment of compliance (in the spring of year *t* +1) shall take into account a possible worsening of the economic situation such that the Member State is found to have been in 'exceptionally bad' or 'very bad' times, as well as the achievement of the MTO, which is the cornerstone of the preventive arm.

In assessing compliance with the requirements and in line with Council Regulation (EC) No 1466/97, a deviation from the expenditure benchmark is in general left out of consideration if the Member State is found to have exceeded its MTO on the basis of the structural balance pillar. However, in line with Council Regulation (EC) No 1466/97, an assessment of compliance with the expenditure benchmark is performed in the specific situation where the Member State is found to have exceeded the MTO solely thanks to significant revenue windfalls. An assessment of compliance with the expenditure benchmark is also performed – over the 2-year average – when the country, having exceeded its MTO, has deviated from it in the next year.