Council of the
European Union

Brussels, 29 November 2016
(OR. en)

14813/16

LIMITE

ECOFIN 1106
UEM 398

**COVER NOTE**

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| From: | General Secretariat of the Council |
| To: | Permanent Representatives Committee/Council |
| Subject: | Improving the Assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology<br>(Opinion of the Economic and Financial Committee) |

Delegations will find attached the opinion of the Economic and Financial Committee on Improving the Assessment of effective action in the context of the excessive deficit procedure – A specification of the methodology.

**ECONOMIC AND FINANCIAL COMMITTEE**

THE SECRETARIAT

Brussels, 29 November 2016
ecfin.cef.cpe(2016)4275398

# IMPROVING THE ASSESSMENT OF EFFECTIVE ACTION IN THE CONTEXT OT THE EXCESSIVE DEFICIT PROCEDURE – A SPECIFICATION OF THE METHODOLOGY

(Opinion of the Economic and Financial Committee)

## INTRODUCTION

Once a Member State is subject to an Excessive Deficit Procedure (EDP) – the corrective arm of the Stability and Growth Pact (SGP) – the Commission regularly assesses whether it is acting in compliance with the Council recommendation under Article 126(7) TFEU or notice under Article 126(9).[1] That is, it regularly assesses whether 'effective action' has been taken. In particular, according to Council Regulation (EC) 1467/97, the Commission has to do so following the expiry of the deadline set by the Council for the Member State to take effective action.[2] Thereafter, the following assessments take place alongside the regular monitoring of budgetary developments.

The need to distinguish between fiscal consolidation actions and fiscal consolidation outcomes implies that a Member State can be found to be compliant with the EDP recommendation even if the headline deficit targets are not attained (consolidation outcome), provided that it is assessed to have taken sufficient measures (consolidation actions) to ensure adequate progress towards the correction of the excessive deficit situation, in the face of unexpected events with a significant impact on the public finances.[3] Accordingly, since the 2005 reform of the SGP, the change in the structural balance plays a central role in the fiscal surveillance framework, by approximating the extent of the consolidation actions implemented by the concerned Member State.

The use of the structural balance to assess fiscal effort is well known and widely used among experts. However, it suffers from its own weaknesses, mainly related to its endogenous relation with GDP which in turn may distort the estimations of governments' fiscal actions. In other words, the structural balance may be, and frequently is, affected by non-policy effects. The 2011 six-pack reform and subsequent non-legislative changes to the fiscal surveillance framework have sought to address the shortcomings of the structural balance approach. Namely, in the corrective arm of the Pact, the decision was made to take into account revisions affecting the estimates for potential output and the response of revenues to economic developments at the time of assessments. This was made through the so-called alpha and beta corrections. In addition, the structural balance approach has been complemented by a quantification of individual fiscal policy measures (essentially on the revenue side), which is known as the 'bottom-up approach' to fiscal effort.

These changes have allowed capturing better Member States' fiscal actions but have also led to increased complexity. Acknowledging that, the Commission Communication of 21 October 2015 on "*Steps towards Completing Economic and Monetary Union*"[4] identified a number of pathways towards improving the transparency and reducing the complexity of the current

[1] Hereinafter both referred to as 'the EDP recommendation'.
[2] Article 9(3) of Council Regulation (EC) 1467/97.
[3] Article 3(5) of Council Regulation (EC) 1467/97.
[4] COM(2015) 600 final (available at: https://ec.europa.eu/transparency/regdoc/rep/1/2015/EN/1-2015-600-EN-F1-1.PDF).

fiscal rules, among which exploring "*ways for increasing reliance on a single practical indicator of compliance*" with the SGP. For that matter, the Commission prepared a note[5] for the Alternates of the Economic and Financial Committee outlining an approach whereby the expenditure benchmark currently used in the preventive arm of the SGP, or a variant thereof, would gain greater prominence in the working of the Pact. The April 2016 informal Economic and Financial Affairs Council agreed that more work should be done on exploring the use of the expenditure benchmark in the EU's fiscal framework and to continue improving the common methodology for estimating the output gap. On this basis, the Commission's original note was complemented by an additional note[6] illustrating the suggested changes to the working of the corrective arm of the Pact and clarifying a number of issues that had been raised by Alternates. The Commission's notes were extensively discussed by the EFC between April and November 2016.

This document updates the Commission's original note reflecting the outcome of the discussions with respect to the corrective arm of the Pact. It presents the commonly agreed methodology for assessing effective action, as revised by the Economic and Financial Committee on 29 November 2016.

The document is structured as follows. Section 1 describes the terms in which the adjustment requirements are expressed under the EDP. Section 2 sets out the order of logical and procedural steps for assessing effective action, commonly designated as the 'EDP decision tree'. Section 3 focuses on the expenditure benchmark, which constitutes the main novelty in the assessment of effective action. Section 4 recalls the need for economic judgement in interpreting the outcome of the expenditure benchmark, which forms an integral part of the so-called 'careful analysis'. Finally, Section 5 addresses the specific case of multi-year EDP recommendations.

In order to increase transparency of the exercise, the Commission will supply EFC Alternates with all data, as well as the underlying calculations, needed to replicate the Commission's estimates of the structural balance, the expenditure benchmark and the debt-reduction benchmark for all concerned Member States for each vintage of the Commission's forecasts. These data will be made available on a dedicated website after the publication of the Commission's forecast, with access restricted to the EFC Alternates. These commitments should be seen in the context of the continuing efforts to develop further transparency on the sides of both the Commission and the Member States, and at a later stage consideration could be given to make this data available to the broader public.

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. This list will be updated with every forecast.In order to reduce

[5] "*Exploring ways for simplifying the assessment of compliance with the Stability and Growth Pact*", note for the Alternates of the Economic and Financial Committee, ref. Ares(2016)1480115 – 29/03/2016.

[6] "*Exploring ways for simplifying the assessment of compliance with the Stability and Growth Pact: Numerical examples*", note for the Alternates of the Economic and Financial Committee, ref. Ares(2016)2533344 – 01/06/2016.

complexity further and in line with the Commission Communication of 21 October 2015 and the mandate by the Council, the Commission services together with Alternates will in parallel examine the possibility of a stronger role of the expenditure benchmark in the preventive arm without prejudice to the structural budget balance indicator as established in Regulation (EC) No 1466/97.

## 1. THE EDP RECOMMENDATION

The EDP recommendation sets out annual targets for the headline deficit, with the final year target at or below 3% of GDP, "*consistent with a minimum annual improvement of at least 0.5% of GDP as a benchmark*"[7] in the structural balance. The EDP recommendation is also formulated in terms of the expenditure benchmark, that is, the maximum allowable growth rate of expenditure net of discretionary revenue measures consistent with, and conducive to, the fulfilment of the targets for the headline deficit and the underlying improvement in the structural balance. This ensures that, if fully complied with, the expenditure benchmark effectively leads to a timely correction of the excessive deficit (including compliance with the forward-looking component of the debt reduction benchmark), as long as macroeconomic developments and events that are outside government control remain in line with the 'EDP scenario', i.e. the set of assumptions underpinning the EDP recommendation. Therefore, the benchmark rates are simply those that come out from the EDP scenario. Concretely, they are the limits to the annual changes in government expenditure consistent with meeting the targets for the headline deficit and the change in the structural balance.

The expenditure benchmark is net of the possible fiscal policy (discretionary) measures assumed on the revenue side in the EDP scenario. It excludes the projected amounts of 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. Any possible one-off measures, whether on the expenditure or on the revenue side, are also excluded.

The expenditure benchmark set in the EDP recommendation is expressed in nominal terms for all the years covered by the EDP recommendation.

Annex 1 provides an example of how the EDP recommendation is formulated. Annex 2 provides a simplified numerical example of how the expenditure benchmark is determined.

[7] Articles 3(4) and 5(1) of Council Regulation (EC) 1467/97.

## 2. THE EDP DECISION TREE FOR ASSESSING EFFECTIVE ACTION

The EDP decision tree sets out the systematic sequencing for the implementation of the methodology for assessing effective action, which plays a central role in different phases of the EDP. The process, which is described in Graph 1, reads as follows.

If the Member State concerned is compliant with the headline deficit target and the underlying improvement in the structural balance, the procedure is held in abeyance. If the Member States fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, or both, a careful analysis of the reasons of the shortfall will be undertaken.[8] The careful analysis is, therefore, a centrepiece in the assessment of effective action.

The careful analysis first uses the expenditure benchmark to assess fiscal effort. All in all, the aim of the careful analysis is to provide an adequate estimation of the extent of policy actions, to evaluate whether the Member State concerned has delivered on its policy commitments as set in the EDP recommendation. If the expenditure benchmark is met, meaning that it shows an effort equal to or above what was recommended, there is a presumption that the Member State concerned has delivered on its policy commitments. If the expenditure benchmark is not met, there is a presumption the Member State has not delivered on its policy commitments.

The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In other words, the careful analysis evaluates whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. In sum, any conclusion needs to take into consideration the quantitative information from the expenditure benchmark together with other considerations – mostly of qualitative nature – that do not emerge from the benchmark itself. These considerations are typically related to the reasons that have caused the non-fulfilment of the expenditure benchmark and are directly linked to fiscal developments (see section 4 for details).

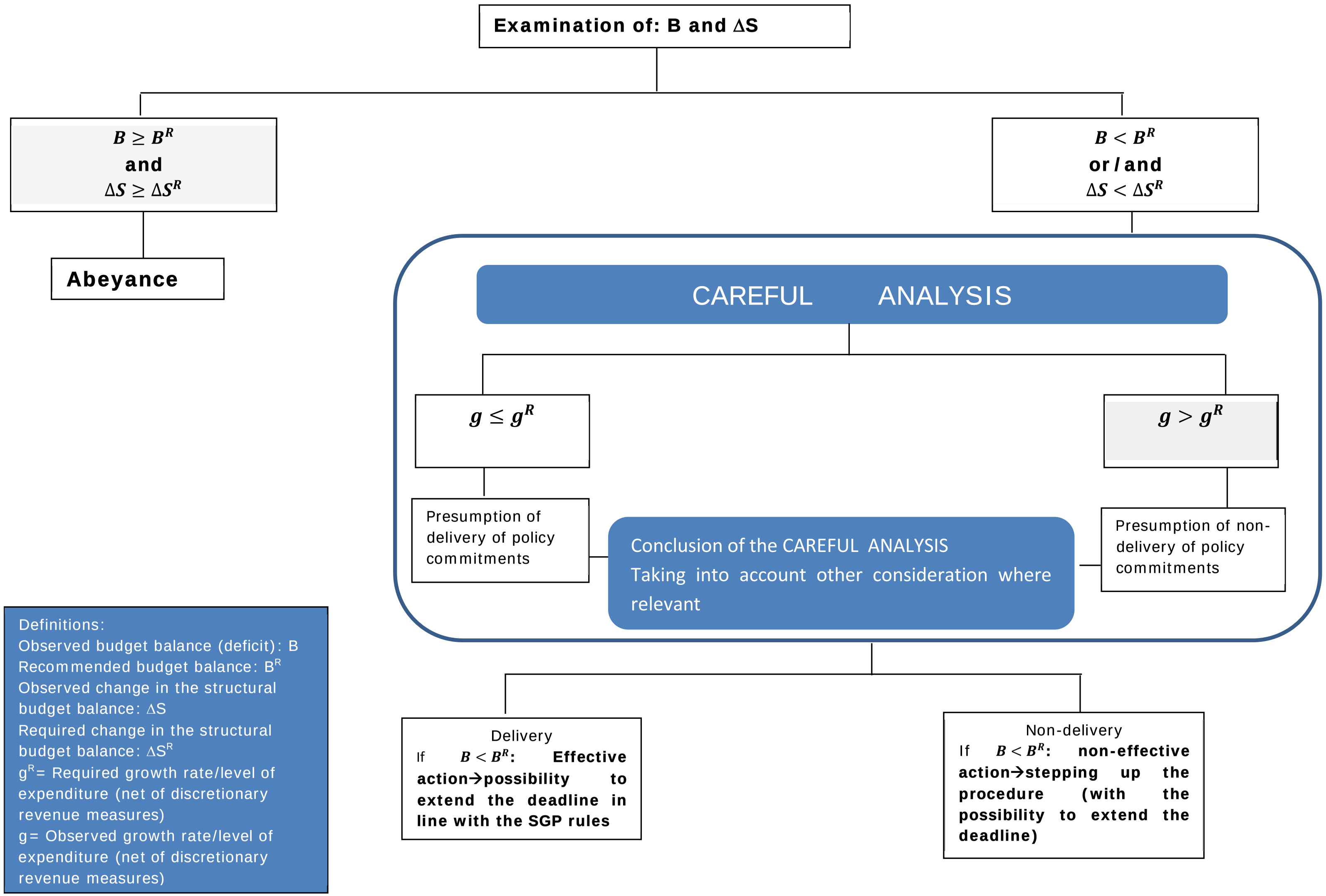
If the careful analysis concludes that the Member State concerned has delivered on its policy commitments, the assessment will conclude that effective action has been taken, with a possibility to extend the deadline, even if the headline deficit target has not been met. If the careful analysis concludes that policy commitments have not been delivered and that the headline deficit target is not met, the assessment will conclude on non-effective action and the procedure should be stepped up including by setting a new correction path (and possibly deadline) as appropriate.

It must be emphasized that if the intermediate headline deficit target has been met, the procedure will not be stepped up even if the policy commitments have not been delivered.

8 The Code of Conduct on the SGP states in this respect that: "*In case the observed budget balance proves to be lower than recommended or if the improvement of the cyclically-adjusted balance net of one-off and other temporary measures falls significantly short of the adjustment underlying the target, a careful analysis of the reasons of the shortfall will be made*".

However, it should be stressed that where the absence of a stepping-up of the procedure is taken based on in-year data, should the (notified) ex post data show that the intermediate headline deficit target was eventually not been met, the EDP can still be stepped up.

## Graph 1: The EDP decision tree for assessing effective action



## 3. THE CAREFUL ANALYSIS: THE EXPENDITURE BENCHMARK

As per the decision tree described in section 2, a careful analysis is warranted when the Member State concerned fails or it is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, or both. In order to determine the reasons of the shortfall and ultimately whether the country has delivered on the policy commitments laid down in the recommendation, the careful analysis first and foremost builds on the outcome of the expenditure benchmark.

The expenditure benchmark approach takes into account "*whether expenditure targets have been met and the planned discretionary measures on the revenue side have been implemented*", as indicated in the Code of Conduct on the SGP in that respect. Specifically, it focuses on aggregate expenditure developments and revenue-increasing (or decreasing) fiscal policy measures, that is, on what is more directly under the control of the government.

### 3.1. Concept

The expenditure benchmark approach aims at identifying the budgetary impact of individual fiscal policy measures. However, the different nature of public expenditures and revenues requires a separate treatment. While the total amount of revenues largely depends on exogenous factors, beyond the direct control of the government (e.g. changes in the tax bases – disposable income, overall consumption, production, etc. – or tax compliance), expenditures can be considered largely under the direct control of the government, except for a limited number of exogenously driven expenditure changes. As such, with few exceptions, nominal changes in government expenditure can be broadly considered as resulting from autonomous decisions by the government. This fundamental difference has obvious implications for the way the developments on the two sides of the budget balance are to be treated when assessing effective action.

Expenditure trends are influenced by active or explicit governmental decisions as well as by indirect ones, as governments can influence expenditures either through their action or their inaction.[9] Therefore, from the perspective of the expenditure benchmark approach, the required fiscal effort should be deemed achieved if annual expenditure growth has not exceeded the expenditure benchmark, that is, the maximum allowable growth rate of spending compatible with the fulfilment of the headline and structural deficit targets forecast at the time of adoption of the EDP recommendation. Any excess in annual expenditure growth over the expenditure benchmark should be funded by revenue-increasing fiscal policy measures.

[9] For example, not acting on future age-related spending is a policy decision that carries with it inherent fiscal sustainability risks.



### 3.2. Methodology

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 are netted out from the expenditure aggregate. Any possible one-off measures, whether on the expenditure or on the revenue side, are excluded from the calculation, too. 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 $\Delta R_t$ are the expenditure aggregate and the estimated impact of revenue measures having an incremental effect on revenues in year $t$, both net of one-off measures.

On the expenditure side, the change from the previous year ($G_t - G_{t-1}$) is used as a proxy of the measures – both explicit and implicit ones – that determined the expenditure outcome in year $t$. Therefore, expenditure slippages (or underspending) are taken into account along with the effects of expenditure-increasing or decreasing measures clearly identified as such.

On the revenue side, estimating the overall incremental effect of fiscal policy measures $\Delta R_t$ requires that the measures are defined and their budgetary impacts are quantified. For a government action to be considered as a discretionary revenue measure with a permanent effect, it should be: (*i*) an autonomous intervention by the government;[10] (*ii*) enacted or credibly announced in sufficient detail; and (*iii*) with a direct budgetary impact. On the contrary, commitments or targets (e.g. deficit targets, deficit rules) which are not underpinned by specific measures to achieve them should not be considered discretionary revenue measures.[11] 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. By contrast, the macroeconomic feedback loops, or 'second-round', effects that are material in relation to the whole economy should not be taken into account.[12]

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[10] In some specific cases, a government action triggered by an event beyond the direct control of the government can be also considered as a measure, e.g. exceptional events outside the control of government (like natural disasters), some court cases, rulings by international organisations, etc. However, often those events take the form of a one-off measure, in which case they would be excluded from the calculation of the expenditure benchmark.

[11] By contrast, conditional measures such as 'revenues mandated by law' can be taken into account if the condition is sufficiently operational and if the measures are specified in sufficient detail and adopted or at least credibly announced.

[12] These are the possible indirect, wider effect of a measure on the public finances that stem from its macroeconomic impact on the economy (size and composition of economic activity, employment, inflation). Only large measures, or packages of measures, are expected to generate this kind of effects. This convention

Overall, if the net expenditure growth rate $g_t$ is lower than, or equal to, the maximum allowable growth rate $g_t^R$ calculated following the methodology outlined in section 1, the expenditure benchmark is met and there is a presumption that the Member State has delivered on its policy commitments. If not, the expenditure benchmark is not met and there is a presumption that the Member State has not delivered on its policy commitments.

## 4. THE CAREFUL ANALYSIS: OTHER CONSIDERATIONS

The Commission uses qualitative economic judgement in making its final assessment where relevant, in particular of the outcome of the expenditure benchmark, as part of the careful analysis which the Commission uses to determine whether the Member State concerned has delivered or not on its policy commitments. In other words, the careful analysis evaluates whether the Member State concerned has put in place enough actions to comply with the EDP recommendation. The careful analysis should, as indicated in the Code of Conduct on the SGP, provide a qualified economic judgement of the outcome of the expenditure benchmark that will allow determining whether a Member State has put in place enough actions to comply with the EDP recommendation. It is, therefore, the final step in the assessment of effective action that aims at capturing any factor that is relevant to analyse fiscal effort beyond the expenditure benchmark indicator.

With the exclusion of interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure and nationally financed gross fixed capital formation smoothed over a 4-year period as well as the exclusion of one-off measures, the expenditure benchmark leaves aside the effects of temporary factors or factors that lie to a large extent beyond government control. Similarly, temporary overreaction of (non-discretionary) revenues to economic fluctuations is left out of consideration, since not affecting the expenditure benchmark. However, there might still be cases where the sole focus on the expenditure benchmark could lead to a biased conclusion.

In this sense, other considerations may be taken into account where relevant, including:

(*i*) Possible statistical revisions in data. National accounts are updated on a regular basis to take account of improvements in methods, data sources and classification changes. These may result in, sometimes significant, revisions to historical data. Large revisions most often lead to level shifts, with only small if any effects on annual changes. The expenditure benchmark is largely immune to such level shifts to the extent that it is formulated in terms of the growth rate of expenditure net of any revenue-increasing (or decreasing) fiscal policy measures. However, in the event of statistical revisions affecting significantly expenditure growth in a particular year, the implied impact on the fiscal effort as measured by the expenditure benchmark will be considered in the careful analysis. Eurostat closely monitors the list of public sector entities in the Member States and their calculation basis in the accounts (use of

fully concurs with the principles of estimating the budgetary effects of discretionary measures underpinning the Commission’s economic and budgetary forecasts.

actual accounts, trends, estimates, etc.). This safeguards against strategic changes in the delimitation of the general government sector for the years under assessment. Eurostat also pays close attention to the time and horizontal consistency of its guidance in order to preserve the reliability of the expenditure benchmark.

(*ii*) Unexpected dynamics in certain expenditure items driven by unusual events out of government control. In principle, any expenditure trend should be considered and internalized by governments when deciding their fiscal policy mix. Fiscal authorities cannot, however, be held accountable for unusual events with major unfavourable consequences for public finances that go beyond their control. Under the expenditure benchmark approach, this will be considered as an expenditure slippage, given that the formula systematically corrects for some exogenous expenditure items but not for other more specific ones. The careful analysis will allow differentiating such more specific expenditure developments from discretionary actions and/or predictable trends.

(*iii*) Unforeseen inflation developments. Inflation surprises can affect compliance with the expenditure benchmark, if they have a material impact on government spending. In such a case, a country may find it ‘easier’, or instead ‘more difficult’, to keep net expenditure growth in line with the allowable rate. The issue may be mostly of relevance for multi-year EDPs and in such cases should be considered in the assessment of the results.

(*iv*) Discretionary revenue measures. Any excess of spending growth over the allowable rate shall be funded by revenue-increasing fiscal policy measures in order to comply with the expenditure benchmark. The quantitative assessment of the yields/costs of fiscal measures plays a crucial role in assessing compliance with the benchmark. In some cases, however, it can be surrounded by a high degree of uncertainty, for example due to a lack of data or linked to the inevitable need to make assumptions. This is the case, for instance, of a wide package of measures, a tax shift, measures against tax avoidance or measures decided at sub-central levels or by state-owned enterprises.

All in all, the careful analysis will determine whether the Member State concerned has delivered or not on its policy commitments.

The report on action taken[13] by the Member State concerned will be an important piece of information for conducting the careful analysis. In particular, Member States are requested to include the targets for government revenues and expenditures as well as for the discretionary measures consistent with those targets. These measures should be described in detail so as to facilitate the assessment.

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[13] Articles 3(4a) and 5(1a) of Council Regulation (EC) 1467/97.

## 5. THE CUMULATIVE FISCAL EFFORT FOR MULTI-YEAR EDPS

A Member State is found compliant with the EDP recommendation if the annual headline target is met.[14] As a result, the EDP procedure would be held in abeyance even if the required annual fiscal effort is not delivered. This can generate an asymmetry in the way compliance with the EDP recommendation is assessed, as explained below.

This poses a particular challenge for multi-year EDPs. For example, one could consider a two-year EDP in which a Member State complies with the headline target without delivering the recommended annual fiscal effort in the first year, while it does not meet the headline target but delivers the annual fiscal effort recommended for the second year. An assessment of effective action that would take place in the second year would conclude that the Member State concerned has taken effective action if it focuses only on the (second) year under consideration. Therefore, it would pave the way for an extension of the deadline for correction without stepping up the procedure, in spite of the fact that the overall structural effort for both years as recommended in the EDP would not have been met, jeopardizing a durable correction of the excessive deficit. By the same token, a Member State that decides to frontload the necessary fiscal consolidation by delivering a fiscal effort above the recommended one in the first year and somewhat below in the following year, would be penalised in the assessment of effective action.

As it has been the case since 2014, the Commission will continue to examine whether the overall fiscal effort over the EDP correction period is delivered in order to balance – at least partially – the asymmetry in the assessment. This ensures that a Member State that meets its headline deficit target in the first year without delivering the recommended annual effort would only be found compliant with the recommendation in the second year if it delivers the cumulative fiscal effort of the first two years even if the headline target is not met. Analogously, by looking at the cumulative fiscal effort, Member States wishing to frontload the required adjustment would not be discouraged to do so.

All in all, Member States are thus better equipped to correct their excessive deficits in a lasting manner, i.e. having a deficit forecast not to exceed the 3% of GDP threshold over the horizon of the Commission's forecast. If the deficit reaches 3% of GDP at maximum in the final year of the EDP, but the durability of the correction is still not ensured, effective action will be assessed against the overall (cumulative) effort as a benchmark.

For Member States that do not meet the annual headline deficit target or the cumulative change in the structural balance, or neither of them, the assessment of the 'cumulative' expenditure benchmark will be considered in the careful analysis together with other considerations where relevant as described in section 3 and 4.

[14] This is consistent with the Code of Conduct on the SGP, which specifies that the EDP procedure shall be abrogated when the deficit is forecast to remain below 3% of GDP in a durable manner (irrespective of whether the fiscal effort has been delivered) and the forward-looking component of the debt reduction benchmark is respected. Recursively, if the intermediary headline deficit targets are fulfilled, the procedure should be held in abeyance.

From an operational perspective, this implies that compliance with the expenditure benchmark can be assessed in cumulative terms. This can be achieved by calculating the excess (positive or negative) of the growth rate of the net expenditure aggregate over the benchmark rate and converting it into national currency using the figure for the expenditure aggregate in the preceding year. Using the figure for nominal GDP, this difference of net expenditure growth relative to the benchmark rate can be expressed as a share of GDP and then easily calculated on a cumulative basis since the start of the EDP (or the first year of a revised EDP recommendation or EDP notice).

## Annex 1: Fiscal consolidation targets in the EDP recommendation

**EDP recommendations up to MONTH/YEAR**

| % of GDP | 20xx | 20yy | 20zz |
|---|---|---|---|
| Headline deficit | X% | Y% | Z% |
| Annual improvement in the structural balance | A% | B% | C% |
| Cumulative improvement in the structural balance | | B"%=(A+B)% | C"%=(A+B+C)% |

*Additional consolidation measures*

| % of GDP | 20xx | 20yy | 20zz |
|---|---|---|---|
| Additional consolidation measures | E% | F% | G% |

**EDP recommendations from MONTH/YEAR**

| % of GDP | 20xx | 20yy | 20zz |
|---|---|---|---|
| Headline deficit | X% | Y% | Z% |
| Annual improvement in the structural balance | A% | B% | C% |
| Cumulative improvement in the structural balance | | B"%=(A+B)% | C"%=(A+B+C)% |

*Expenditure benchmark*

| % change from previous year | 20xx | 20yy | 20zz |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Maximum allowable growth rate of expenditure[15] net of discretionary revenue measures (DRM) | K% | L% | M% |

*[**Option 2:** Expenditure benchmark (updated)]*

$$L^{"}\% = \frac{(1 + L\%) \times (1 + \pi_{20yy}^{COM\ SF\ 20xx}\%)}{(1 + \pi_{20yy}^{EDP}\%)} - 1$$

$$M^{"}\% = \frac{(1 + M\%) \times (1 + \pi_{20zz}^{COM\ SF\ 20yy}\%)}{(1 + \pi_{20zz}^{EDP}\%)} - 1$$

15 Government expenditure 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.

## Annex 2: Calculation of the expenditure benchmark: A simplified numerical example

**The EDP scenario**

| | | | **T** | **T+1** |
|---|---|---|---|---|
| Government expenditure | bn EUR | (1) | 50.0 | 52.0 |
| Government revenue | bn EUR | (2) | 46.0 | 48.8 |
| *Of which DRM* | *bn EUR* | *(2)'* | | *1* |
| Government balance | bn EUR | (3) = (2) – (1) | -4.0 | -3.2 |
| Nominal GDP | bn EUR | (4) | 100.0 | 104.0 |
| Government balance (*) | % of GDP | (5) = (3) / (4) x 100 | -4.0 | -3.0 |
| Output gap | % of pot. GDP | (6) | 0 | 0 |
| Structural balance | % of pot. GDP | (7) = (5) – ε x (6) | -4.0 | -3.0 |
| Change in structural balance (*) | % of pot. GDP | (7)' = $(7)_{T+1}$ – $(7)_{T}$ | | 1.0 |
| Expenditure growth | % change | (8) = 100 x [$(1)_{T+1}$ – $(1)_{T}$] / $(1)_{T}$ | | 4.0 |
| **Expenditure growth net of DRM**** | **% change** | **(9) = 100 x [($(1)_{T+1}$ – $(2)'_{T+1}$) – $(1)_{T}$] / $(1)_{T}$** | | **2.0** |

(*) Targets already mentioned in current EDPs.
(**) Targets to be added in future EDPs.

In the example, a Member State is recommended to bring its headline deficit from 4.0% of GDP in year T to 3.0% in year T+1. This is deemed consistent with the structural balance improving by 1.0% of GDP.[16] Government expenditure is forecast to increase by EUR 2 billion in year T+1, a 4% change from year T. At the same time, the Member State is assumed to implement revenue-increasing measures worth EUR 1 billion. In net terms, this means that government expenditure is assumed to increase by EUR 1 billion in year T+1, a 2% change from year T. In this example, the expenditure benchmark for year T+1, that is, the maximum allowable growth rate of net expenditure, is thus 2%. Note that the benchmark rate is the same if the adjustment is composed differently, for example exclusively based on expenditure cuts.

[16] For the sake of simplicity we assume that the output gap is 0 in both years.

In this case, government expenditure is projected to increase by EUR 1 billion in year T+1, a 2% change from year T, both in ‘gross’ and in ‘net’ terms.

In the example, the EDP recommendation will thus call on the Member State to bring their deficit at 3.0% of GDP in year T+1 and state that this is deemed consistent with the structural balance improving by 1.0% of GDP and government expenditure growing by no more than 2%, unless the excess is funded by revenue-increasing measures.

## Annex 3: Calculation of the ex post deviation from the expenditure benchmark in cumulative terms

**The outcome**

| | | | **T** | **T+1** | **T+2** |
|---|---|---|---|---|---|
| Government expenditure | bn EUR | (1) | 50.0 | 52.5 | 55.1 |
| Government revenue | bn EUR | (2) | 46.0 | 48.8 | 51.8 |
| *Of which DRM* | *bn EUR* | *(2)'* | | *1.0* | *1.0* |
| Government balance | bn EUR | (3) = (2) – (1) | -4.0 | -3.7 | -3.3 |
| Nominal GDP | bn EUR | (4) | 100.0 | 104.0 | 108.2 |
| Government balance | % of GDP | (5) = (3) / (4) x 100 | -4.0 | -3.5 | -3.1 |
| Output gap | % of pot. GDP | (6) | 0 | 0 | 0 |
| Structural balance | % of pot. GDP | (7) = (5) – ε x (6) | -4.0 | -3.5 | -3.1 |
| Change in structural balance | % of pot. GDP | (7)' = $(7)_{T+1}$ – $(7)_T$ | | 0.5 | 0.4 |
| Expenditure growth | % change | (8) = 100 x [$(1)_{T+1}$ – $(1)_T$] / $(1)_T$ | | 5.0 | 5.0 |
| Expenditure growth net of DRM | % change | (9) = 100 x [($(1)_{T+1}$ – $(2)'_{T+1}$) – $(1)_T$] / $(1)_T$ | | 3.0 | 3.1 |
| Expenditure growth net of DRM as per EDP recommendation | % change | (10) | | 2.0 | 2.0 |
| Deviation, if negative in excess over EDP target | bn EUR | (11) = [(10) - (9)] x $(1)_T$ / 100 | | -0.5 | -0.6 |
| **Deviation, if negative in excess over EDP target** | **% of GDP** | **(12) = (11) / (4) x 100** | | **-0.5** | **-0.5** |
| **Cumulated deviation, if negative in excess over EDP target** | **% of GDP** | **(13) = $(12)_{T+1}$ + $(12)_T$** | | **-0.5** | **-1.0** |

In the example, we consider a two-year EDP recommendation, with the Member State recommended to keep the growth rate of government expenditure net of discretionary revenue measures at or below 2% both in year T+1 and in year T+2.

Here we assume that the *actual* growth rate of government expenditure net of discretionary revenue measures is 3% in both years, that is, above the *recommended* growth rate of 2%. The excess over the requirement amounts to 0.5% of GDP in each year. In cumulative terms, the deviation therefore amounts to 0.5% of GDP in year T+1 and 1.0% of GDP in year T+2.