Box – Expenditure Benchmark

Expenditure Benchmark framework, rationale and objective.

Under the preventive arm, to which Portugal has been subject since 2017, Member-States must meet the medium-term fiscal objectives (MTO) within the time horizon of their stability programs. Progress towards the MTO is assessed annually by the Commission and the Council, on separate occasions from the *ex-ante* and *ex-post* standpoint. Such progress is the object of an overall assessment based on both the change in the structural balance and compliance with the expenditure benchmark.

The importance of the latter indicator has grown since the monitoring of the structural balance is not, by itself, sufficient to provide an accurate and overall picture of fiscal developments. On the other hand, failure to comply with fiscal targets has tended to be mainly a consequence of the expenditure dynamics, which depends more directly upon the discretionary acts of policy-makers unlike revenue where developments are largely driven by macroeconomic components (private consumption, employment, salaries and Gross Domestic Product).

In this context compliance with the expenditure benchmark is aimed at avoiding trends that lead to higher growth in expenditure as a percentage of GDP that is not suitably offset by policy measures on the revenue side. This rule does not restrict the level of public spending, rather it allows policy-makers to decide its scale, provided that the increase in expenditure resulting from their choices is accompanied by policy measures on the revenue side and not by taking advantage of windfall gains flowing from the economic climate. Thus, compliance with the expenditure benchmark takes into account a growth rate that is net of the effect of discretionary revenue measures and legally required revenue increases.

According to the European Commission, this indicator seeks to bypass the uncertainty about the structural balance and is intended to strengthen automatic stabilisation, guaranteeing a sustainable expenditure path that can cope with fluctuations in revenue when there are changes in the business cycle. At the same time, it favours the pursuing of countercyclical fiscal policies that provide for more robust public finance in the medium-term.

Calculating the indicators that assess the expenditure benchmark

Compliance with this rule is based on the modified aggregate expenditure calculation (net primary expenditure) and the benchmark calculation. The comparison of these two indicators determines whether there is compliance or non-compliance with the expenditure benchmark.

Modified *aggregate expenditure (primary expenditure net of discretionary revenue measures)*

The modified aggregate expenditure calculation, which takes total public expenditure as its starting point, is intended just to show the overall expenditure that tends to be within the policy-makers' control. Therefore, all expenditure that is not the result of discretionary Government action is excluded from total public expenditure, in particular:

- the cyclical component of unemployment benefit, since it depends on business cycle conditions;
- interest payments, which to a large extent are inherited from the past;
- expenditure relating to EU funds, since it is not financed by general government;

— public investment not financed by European funds in the year in progress and the three previous years, where only the average amount for those four years is considered so as to avoid the peaks and troughs relating to the public investment cycle.

This modified expenditure aggregate is then adjusted for discretionary revenue measures and legally required revenue increases. After making the aforementioned corrections modified aggregate expenditure (modified primary expenditure) is calculated in nominal terms, as is the corresponding growth rate.

Benchmark

This indicator, known as the benchmark, compares the modified aggregate expenditure (primary expenditure net of discretionary revenue measures). It is measured by the average growth in potential output for years t-5 to t+4 net of the convergence margin for countries that have still not reached the MTO in line with the required improvement in the structural balance (0.6% in Portugal's case).

To put it simply, the benchmark assumes growth in that expenditure aggregate in line with the average growth in potential output for countries that have already achieved their MTO and expenditure growth lower than the potential for countries converging towards their MTO.

It must be stressed that pursuant to articles 6(3) and 10(3) of Regulation 1466/97, those Member-States that have exceeded their MTO are no longer obliged to comply with the expenditure benchmark.

Assessing compliance with the expenditure benchmark

The assessment of compliance with the expenditure benchmark aims at determining whether the rate of growth in primary expenditure, net of discretionary revenue measures (the aforementioned modified aggregate expenditure) contributes to a suitable adjustment towards the MTO, or it is in line with the average growth in potential output for those countries that have already achieved their MTO.

Growth in primary expenditure, net of discretionary revenue measures, should be consistent with potential economic growth. Growth in that expenditure will depend upon the distance from the MTO, which reflects the effort required of each Member-Stare. Portugal has still not reached its MTO and so it is obliged to contain growth in that expenditure to a rate that is lower than potential GDP growth.

The outcome of this indicator is assessed on separate occasions, according to an *ex-ante* and *ex-post* standpoint. A significant divergence occurs if the indicator is greater than or equal to 0.5 p.p. of GDP in a single year or at least 0.25 p.p. on average in two consecutive years. Thus, from an *ex-ante* standpoint, when these levels are reached there is a "significant divergence risk", while under an *ex-post* assessment they can trigger a significant divergence procedure, if confirmed by the conclusions of the overall assessment.

Assessing the expenditure benchmark in the context of an overall assessment

In the context of an overall assessment, the additional correction to be made consists of excluding the one-off measures that affect the level of revenue and expenditure. That adjustment is taken into account within an overall assessment, together with an assessment of compliance with the fiscal effort measured in terms of the change in the structural balance.

Box 4 – "Expenditure Benchmark", initially published in the Report 13/2018, "Analysis of the Draft State Budget for 2019", from November 2018.