A clear cyclical pattern is visible, with increases in expenditure in the lead up to the crisis: a time characterised by strong, albeit unsustainable, growth. This was one of the factors leading to the introduction of the MTEF in 2011. Successive downward revisions of ceilings and ultimately lower outturns are seen following the crisis. Recently, the pattern of upward revisions to spending ceilings has returned. A continuation of such procyclical adjustments could undermine future public spending management. As noted in previous *Fiscal Assessment Reports* continuous upward revisions of ceilings reduce their credibility and contribute to the problem of a "soft budget constraint".[77] In turn, this can lead to further subsequent revisions in future. As discussed in Box I, the European Commission is seeking to strengthen medium-term fiscal sustainability in part through increased focus on the medium-term path of public expenditure.

Box I: The Medium-term Orientation of the Fiscal Framework

This box considers the possible implications of the proposed EU Council directive "laying down the provisions for strengthening fiscal responsibility and the medium-term budgetary orientation in the Member States" (European Commission, 2017d). The proposal seeks to support medium-term planning to a greater extent by improving the medium-term focus of the fiscal rules, in particular in relation to the growth path for expenditure.

The Council, along with other members of the Network of EU Independent Fiscal Institutions (IFIs), welcomed this proposed directive in a statement by the Network.[78] While the proposed role of IFIs in determining the adequacy of the medium-term requirements has yet to be clarified, the greater focus on fiscal sustainability and the medium-term path of expenditure is broadly seen as positive by the Council.

Medium-term Fiscal Framework

The proposed directive requires strengthening of the medium-term fiscal framework in domestic legislation, to support fiscal sustainability. The suggested approach aligns to the existing structural balance and Expenditure Benchmark rules:

(i) The MTO would be set to achieve a ratio of government debt to GDP not in excess of the reference value of 60 per cent.

(ii) A new medium-term growth path of government expenditure net of discretionary revenue measures consistent with the MTO or adjustment path towards it.

The second part shifts focus from incremental expenditure planning to a medium-term outlook.

Greater Focus on Medium-term Expenditure Growth

Presently, the fiscal rules involve setting expenditure limits annually through the Expenditure

[77] The soft budget constraint, as originally formulated (Kornai, 1992), posits that a budget constraint is soft where the decision maker in control of day-to-day expenditure anticipates that the constraint is likely to be relaxed *ex-post* if the original constraint is not met, notwithstanding any ex ante threats to impose a hard constraint. Where the budget-setting process is weak, this may further 'soften' the constraint as the manager – knowing plans are poorly set – has less of an incentive to adhere to them.

[78] http://www.euifis.eu/images/STATEMENT_FINAL.pdf

Benchmark. The permitted expenditure growth rate is set in the Spring of the previous year on the basis of the European Commission Spring Forecasts.[79] In contrast, the new proposal would set the path for government expenditure growth at the start of a new government's term. This would then apply for the entirety of the government's term. This path would be set so as to ensure that fiscal plans adhere to the MTO or converge towards it over the medium-term.

The proposed changes have two key potential advantages:

- A less incremental year-by-year approach to expenditure plans and a more medium-term emphasis.
- Preventing contribution to expenditure drift over time, a feature of the current rules.

Expenditure drift occurs under the current fiscal rules because any deviation in spending in one year is built into the base for determining the expenditure limit in the following year. In the event of a positive deviation in expenditure, the annual approach sees expenditure grow from the higher level of spending (the opposite could also be true if the expenditure outturn were temporarily lower than allowable spending, leading to expenditure growing from a lower base). Such deviations could lead to a drift in expenditure over time to unsustainable levels.

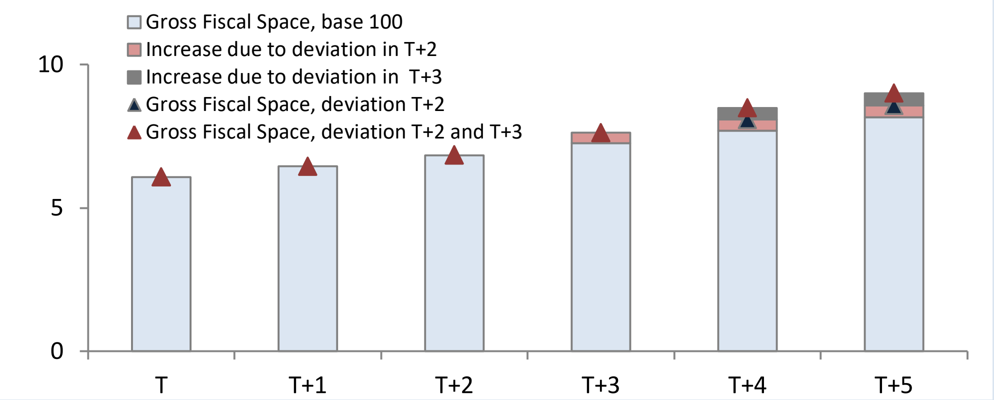
The proposed changes may eliminate this drift as the growth path of expenditure would be set at the outset of the government's term and actual expenditure could be assessed against this path. Any positive or negative deviation would need to be unwound the following year. This is important to avoid expenditure slippages being rewarded with higher spending in future years, and to avoid prudent policies whereby less is spent than allowed by the ceiling leading to permanently lower spending.

Illustration of How this Would Work

Figure I.1 provides an illustrative example of the possible impact of the proposed change. Assuming a new government is formed in period T and expenditure in T-1 was €100 billion. Given a reference rate of 4 per cent, a deflator of 2 per cent, and no convergence margin, the expenditure limit would be 6.1 per cent. Assuming this rate applies for the following five years, setting a medium-term path of expenditure for the term of the government would lead to gross fiscal space of €42.5 billion. This would be the case under the proposed rule changes.

Figure I.1: Illustrative scenario gross fiscal space under alternative spending paths

€ billion, change year-on-year



Sources: Internal IFAC calculations.
Notes: This scenario does not include any discretionary revenue measures.

However, if expenditure limits are reset annually, as under the rules presently in place, this path

[79] The real expenditure growth rate is set using a reference rate calculated using a forward- and backward- looking 10- year average of potential growth. Where a country is not at its MTO, a convergence margin is applied based on the required annual adjustment in the structural balance toward the MTO.

may change. If there was a deviation from allowable expenditure in T+2 by 5 per cent, leading to an outturn and new base of €125 billion for T+3, the gross fiscal space calculated for the period T to T+5 could be €43.7 billion. Furthermore, if there was a further deviation of 5 per cent in period T+3, the expenditure base for period T+4 would be €139.5 billion, and the gross fiscal space over the period T to T+5 would then increase to €44.5 billion. As such, deviations in expenditure from plans may lead to an increasing drift away from the original expenditure path.

Medium-term Budgetary Planning

The new approach under the proposed regulation could strengthen medium-term expenditure planning. As discussed above there are benefits in terms of fiscal sustainability as the new rules could ensure that deviations in expenditure are not built into the base. Furthermore, setting expenditure limits at the start of a government's term could allow for more certainty with regard to expenditure over the term. This could improve medium-term budgeting by providing more credible ceilings for expenditure hence avoiding the soft budget constraint (an issue discussed in previous Fiscal Assessment Reports for example see IFAC, 2017b, 2017d). Additionally, it could improve accountability under the rules as actual expenditure could be assessed against the planned expenditure path to identify deviations more accurately throughout the period.