- While the exact role of the expenditure benchmark is still somewhat unclear, the structural balance appears to take precedence over the expenditure benchmark in the assessment of progress towards the MTO. The differences in methodology between the MTO and the expenditure benchmark allow for a more thorough assessment of compliance with the rules and the particular factors that may lead to non-compliance. This may be especially important if the required MTO is not met. In this case, meeting the expenditure benchmark could help with compliance with EU requirements. There may also be differences between compliance with the expenditure benchmark and *ex post* compliance with MTO requirements if forecast errors or revisions in the structural balance mean that the MTO requirements are not met despite sufficient discipline in terms of spending.

BOX I: THE EU EXPENDITURE BENCHMARK

The assessment by the EU of progress towards the MTO uses the structural balance as a reference, but also includes an analysis of expenditure net of discretionary revenue measures. The expenditure benchmark is therefore not a "rule" in the same sense as other requirements but does need to be taken into consideration. It is considered by the European Commission to be a complementary indicator to the budgetary rule. Specifically, the expenditure benchmark is an important factor in the overall assessment of compliance with the preventive arm of the Stability and Growth Pact when a country is not at its MTO.[109]

The expenditure benchmark is also designed as a complementary measure to ensure countries stay at their MTOs by providing guidance about how expenditure should be set to fulfil the adjustment path condition and then maintain the structural budget balance at the MTO level thereafter. This is being applied in Ireland, where the expenditure benchmark is being used to inform the setting of the multi-year expenditure ceilings (see Chapter 2).

THE EXPENDITURE BENCHMARK

The expenditure benchmark essentially says that annual expenditure growth should not exceed the medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. If expenditure increases in a given year at the medium-term reference rate of potential GDP, the benchmark ensures that there is no change in the structural budget balance.

For countries that have not reached their MTOs, an additional convergence margin is set for the appropriate growth rate of expenditure that is below the medium-term rate of potential GDP growth, as well as requiring that any discretionary tax cuts are financed through lower

[109] For example, in their assessment of the German Stability Programme Update for 2013, the European Commission states that "the growth rate of Government expenditure, net of discretionary revenue measures, will exceed the reference medium-term rate of potential GDP growth in 2013. However, the expenditure benchmark is not binding given that it is intended to underpin the necessary adjustment towards the MTO (which Germany plans to continue to comply with). Moreover, the programme foresees that the growth rate of Government expenditure will again be below the reference rate in 2014".

spending or higher non-tax revenues or both.

Expenditure is measured excluding interest, cyclical unemployment benefit spending and Exchequer co-financing of EU programmes, and investment costs are smoothed over a four year period.

To Calculate The Benchmark

The medium-term rate of potential GDP growth is calculated over a 10-year window, incorporating estimates for the past 5 years of data, the current year and forecasts for the next 4 years from the European Commission. This will be re-calculated every three years.

The convergence margin is subtracted from the medium-term growth rate. It is set so that the structural budget balance improves by 0.5 per cent of GDP as required under the adjustment path condition of the MTO.[110] The margin is higher if the public sector is smaller because a larger proportional change in spending is needed to achieve a given improvement in the budget balance as a share of GDP. For Ireland, the expenditure benchmark would require General Government expenditure to decline by 0.7 per cent each year. This reflects a low medium-term rate of 0.6 per cent less a convergence margin of 1.4 per cent.

Implications Of The Benchmark

In principle, the expenditure benchmark is designed to achieve MTO-based requirements and therefore does not add additional constraints on policy, but rather shows what is needed to achieve requirements for the structural balance. It implies that real General Government expenditure will need to decline in nominal terms for some time. The scenarios shown in Chapter 4 develop the implications of the MTOs for expenditure more systematically.

There are, however, some cases where the expenditure benchmark and the MTO could give different signals:

- The expenditure benchmark excludes interest payments, while the MTOs are set in terms of the overall structural budget balance (including interest). This can lead to differences. For example if spending on interest payments falls as a share of GDP, the MTO could be achieved without meeting the expenditure benchmark.
- The expenditure benchmark uses a different (10 year average) measure of potential output than the assessment of progress towards the MTO in a given year, again creating possibilities of different signals. For example, the backward-looking element of the medium-term potential growth calculation in the expenditure rule could imply a weaker growth number than that used to derive the MTO and therefore the expenditure benchmark could require a more positive budget balance.
- The cyclical adjustment of the budget balance could be affected by measurement or forecasting errors, leading to a shortfall in the MTO despite compliance with the expenditure benchmark.
- The MTOs are set in structural terms and are net of one-off and other temporary

[110] It can be shown that, if revenues grow in line with potential nominal GDP and interest spending is constant as a share of GDP, the 0.5 percentage point adjustment can be achieved by a convergence margin of 50/(primary expenditure as a percentage of GDP).

measures. Such one-off adjustments are not applied to the calculation of the expenditure benchmark.

Given recent revisions to estimates of the output gap and potential output, the locking in of current expenditure benchmarks based on estimates in spring 2013 for three years may mean that expenditure growth is more constraining than necessary to fulfil the adjustment path conditions to the MTO than more up-to-date estimates would suggest.

Meeting the expenditure benchmark will not only be challenging during the adjustment to the MTO, but requires spending to be neutral with respect to the cycle thereafter. Given that the wage bill is a large share of Government spending, public sector wages may need to be decoupled from the cycle. This could be difficult to achieve. Alternatively, other forms of spending could be made more strongly counter-cyclical or discretionary tax increases could be made when the economy is growing faster than trend.

3.3 THE EU "TWO PACK"

The so-called "Two Pack" of new EU fiscal regulations came into force on 30 May 2013.[111] This section sets out the main features of these new rules and focuses specifically on the new endorsement function it adds to the Council's mandate.

The "Two Pack" largely deals with institutions and procedures to strengthen fiscal governance in the Euro Area and reduce fiscal and financial risks.

The main elements of this legislation are (EC, 2013b):

- All Euro Area countries will follow a common budgetary timeline with a draft Budget by 15 October and the Budget legislated by the end of the year. In Ireland, this has required moving the Budget process to earlier in the year. There is a new coordinated EU surveillance exercise in the autumn and new reporting requirements, allowing the Commission to submit an opinion on the draft budget.
- The macroeconomic forecasts underpinning the Budget and the Stability Programme Updates must either be made independently or endorsed by independent bodies. In Ireland, as discussed in Chapter 1, the Council has been assigned the role of endorsing the forecasts produced by the Department of Finance.

[111] Formally, (1) EU Regulation No 473/2013 on common provisions for monitoring and assessing draft budget plans and ensuring the correction of excessive deficit of the Member States in the Euro Area, and (2) Regulation No 472/2013 on the strengthening of economic and budgetary surveillance of Members States in the Euro Area experiencing or threatened with serious difficulties with respect to their financial stability.