

January 2018

Key messages:

- EU economies register solid growth rates, and the macroeconomic outlook remains positive
- Fiscal stance is estimated to turn pro-cyclical in several countries and some economies show signs of overheating
- The link between projected fiscal stance and available fiscal space (debt-to-GDP) is weaker in 2017 than in 2016
- There is a significant heterogeneity across EU countries in the extent of medium-term orientation in budgeting

Macroeconomic outlook

A large number of countries in the EU have registered a solid growth in their economy during 2017, and the outlook for 2018-19 remains favourable too.

Overall, the growth has been broad-based. While external demand remained a key driver of growth in a list of countries (Netherlands, Germany, Finland, Portugal as well as Cyprus and Malta), many economies have been witnessing a robust recovery in domestic demand, driven by growing employment figures and strong wage developments. A number of EU fiscal councils/IFIs report emerging labour shortages and wage developments being indicative of an overheating economy. EU funds supporting convergence among economies have played an important role in supporting investment in the recipient countries, and their effect is likely to intensify, as countries such as Lithuania and Bulgaria intensify their engagement in co-funded projects.

The outlook, however, continues to be affected by continued heightened uncertainty stemming from various global and regional sources. Political developments in the US and Europe remain high on the list of risks generally. Closer to home, the implications of Brexit specifically for the Irish economy or developments in Catalonia on Spain make the outlook of the two economies uncertain. High external debt levels are reported to be a source of risk in Portugal and Cyprus. In Greece, the interaction between macroeconomic developments and the fiscal stance remains a key source of concern.

Fiscal outlook

The positive general economic conditions are associated with a mixed outlook on the fiscal front. In a number of cases, IFIs highlight the likely pro-cyclicality of fiscal stance (Lithuania, Bulgaria, Estonia, Romania and Finland). The link between indebtedness and estimated change in the structural balance also weakens in 2017 relative to 2016. Countries with more fiscal space (measured, for simplicity and consistency, by the debt-to-GDP ratio) are envisaged to consolidate their budgets faster. Figures 2 and 3 that support these observations exclude data for Greece.

In addition to the factors affecting the overall macroeconomic outlook listed above, the IFIs highlight a diverse set of risks affecting the fiscal outlook specifically. These include policy uncertainty related to large-scale reforms in the tax system (Estonia), structural reforms on the spending side (Finland), envisaged and repeatedly delayed tax increases (Italy), the build-up of tax arrears stemming from weak economic performance (Greece), uncertainty surrounding the approval of the 2018 state budget (Spain), data revisions (Luxembourg) or changes in the sectoral classification of entities (Hungary).

Fiscal frameworks

There is significant heterogeneity in the approach to budgeting across EU countries. Broadly speaking, in one group, we have countries such as the Netherlands, the UK, Denmark or Germany where annual budgets follow a clearly set out medium-term target supported by a more or less binding procedural framework. On the other hand, several IFIs report of a lack of a sufficient medium-term orientation in budgeting that could generate confidence in achieving the fiscal targets (see below).

"The lack of a sound medium-term fiscal plan...is one of the main drawbacks of the...fiscal framework" AIReF, Spain

"[The UPB] judged the medium-term fiscal strategy of the Government as excessively blurred" UPB, Italy

"The fiscal framework is weak as it enabled worsening of targets repeatedly despite significant revenue windfalls" CBR, Slovakia

"...lack of medium-term oriented reforms" Fiscal Council, Slovenia

"...continuous deviation from both national and EU fiscal rules" Romanian Fiscal Council

"...disregarding current decisions' medium term implications...led to tax instability and to a pro-cyclical fiscal stance" Portuguese Public Finance Council

Figure 1: Distribution of GDP growth projections



Figure 2: Fiscal stance and the economic cycle

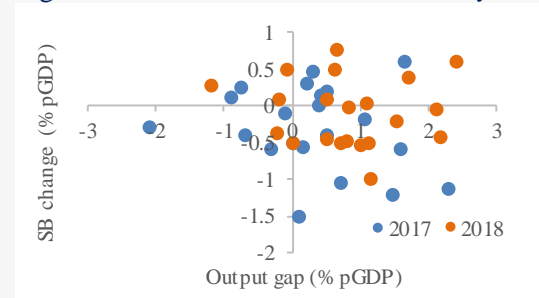


Figure 3: Fiscal space and fiscal stance

