COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.4.2004
SEC(2004) 487 final

REPORT FROM THE COMMISSION

United Kingdom

Report prepared in accordance with article 104(3) of the Treaty

1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration new data reported by the United Kingdom and validated by Eurostat in March 2004, the general government deficit reached 3.2% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value (Table 1). In addition, the estimated outturn data for financial year 2003-04 set out in the Budget Report on 17 March 2004 also show a deficit of 3.2% of GDP. This represents a significant slippage compared to the projection set out in the 2003 Budget of a general government deficit of 2.4% of GDP, largely resulting from lower than expected revenues, themselves a result of developments in the components of GDP that differed from the original projections. By 2004 and 2005, the deficit is expected to fall below 3% of GDP, to 2.8% of GDP and 2.6% of GDP respectively, according to the Commission Spring 2004 forecast under a no policy change assumption.

Table 1: General government deficit and debt ratios

(% of GDP)	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	0.1	1.1	3.9	0.7	-1.6	-3.2	-2.8	-2.6
General government debt	47.5	45.0	42.1	38.9	38.5	39.7	40.1	40.6

Source: Eurostat until 2003; Commission Spring 2004 forecasts for 2004 and 2005.

A general government deficit of greater than 3% of GDP provides prima facie evidence of the existence of an excessive deficit in the United Kingdom, as set out in the EC Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for the United Kingdom.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria [i.e. the ratio of the government deficit and of the government debt to GDP not exceeding the respective reference value], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. …"

This report, prepared by the Commission according to Article 104(3), assesses recent and current budgetary developments in the United Kingdom and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

Under Article 5 of the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the obligation under Article 104(1) of the Treaty to avoid excessive general government deficits does not apply to the United Kingdom unless it moves to the third stage of EMU. Instead, the UK is bound by the obligation under Article 116(4) (ex 109e(4)) of the Treaty "to endeavour to avoid excessive deficits" as long as it is in the second stage.

An Annex to Regulation No 1467/97 sets out that the reference period over which the UK public finances are assessed is the UK financial year, running from April to March. Because of this, the report refers throughout to both calendar year and financial year data. Financial year data are used by the UK authorities to assess and project the public finances, while Eurostat historical data and Commission forecasts are on a calendar year basis. However, the data are broadly similar, and the conclusions of this report are independent of whether a financial or calendar year basis is used.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

The UK economy slowed down quite substantially after reaching a peak of 3.7% GDP growth in 2000, with growth dropping back to 1.6% by 2002. Overall, however, the UK weathered the recent global slow-down relatively well compared with other EU countries. Growth began picking up in 2003, especially during the second half of the year, reaching 2.2% for the year as a whole. The three years of below-trend growth meant that, according to Commission services' calculations, a negative output gap of around ¾% of GDP had opened up in 2003.

Private consumption expenditure remained a significant driver of growth throughout the recent years. In 2003, it was affected by geopolitical concerns in the first quarter, reflected in consumer confidence indicators, but picked up strongly in the second half of the year. Fixed investment recovered over the course of 2003, while general government consumption also remained strong. The pickup in the global economy meant that the drag on growth from net exports slowed, with firm export growth notable in Q4. However, weakness in the sterling effective exchange rate during the first half of the year was largely reversed by the subsequent appreciation, thus removing a potential stimulus to growth in export volumes.

Despite the recent global slowdown, the UK labour market has remained strong, with high employment, and unemployment stable for the past few years at around 5%. However, an adjustment in the labour market appears to have taken place in average hours worked, which have declined in recent years. This may have contributed to the relatively subdued inflationary pressures. Indeed, CPI inflation remained comfortably below the Bank of England's 2% target[1] throughout 2003, within the permitted one-percentage-point symmetrical margin. Latest data show CPI at 1.3% in February 2004.

The Commission Spring forecast projects growth of 3.0% in 2004 and 2.8% in 2005, above the trend rate of around 2¾%[2], as UK export markets and business investment continue to recover. Strong household consumption and general government spending should continue to support growth, but to a lesser extent than of late.

---

1 In December 2003, the Government announced that the Bank of England would switch to a symmetric inflation target based on the harmonised index of consumer prices, known in the UK as CPI.

2 Commission services calculations.

Table 2 : Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	3.1	2.8	3.8	2.1	1.6	2.2	3.0	2.8
Contribution: Domestic demand	4.8	3.7	4.0	3.0	3.0	2.6	3.4	2.9
Change in stocks	0.1	0.2	-0.1	-0.2	-0.2	0.0	0.0	-0.1
External trade	-1.7	-1.0	-0.1	-0.6	-1.3	-0.3	-0.5	0.0
Unemployment rate (% of labour force)	6.2	5.9	5.4	5.0	5.1	5.0	5.0	5.0
Total economy nominal unit labour costs* (% change)	3.7	3.1	3.2	3.6	2.6	3.0	2.3	2.5
HICP (% change)	1.6	1.4	0.8	1.2	1.3	1.4	1.6	1.9

** Ratio of compensation per employee to real GDP per person employed.*
Source: Eurostat until 2003; Commission Spring 2004 forecasts for 2004 and 2005.

Inflation is projected to remain subdued in 2004 as a negative output gap, though closing, is expected to persist. Over the next two years, inflation is expected to rise towards the target.

3. THE SITUATION OF GOVERNMENT FINANCES

The deficit on the general government balance is estimated by the UK authorities to have been 3.2% of GDP in financial year 2003-04[3], against a background of substantial government spending to address historic under-funding and under-investment in public services. This result represents a marked deterioration in the public finances from the deficit of 2.4% (for 2003-04) that had been projected by the authorities in the 2003 Budget. The authorities forecast that the excess over the reference value is likely to be temporary, and that the deficit should decline to below 3% of GDP in 2004-05. A similar, though slightly less optimistic, assessment is given by the Commission Spring forecast on a calendar year basis. General government gross debt, at around 40% of GDP, remains well below the 60% of GDP reference value in forecasts by both the Commission and the authorities.

3.1. Recent budgetary developments

On a calendar year basis, the UK general government balance moved from a surplus of 1.1% of GDP in 1999, to a deficit of 3.2% in 2003. In part, the deterioration reflects a significant increase in public spending since 2000, and some cyclical impact from lower GDP growth than in the late 1990s. More recent, it also reflects unexpected weakness in tax receipts during 2003.

In total, the general government balance has deteriorated by 4.3 percentage points of GDP between 1999 and 2003. The surplus peaked in 2000 due to significant receipts from the sale of licences for use of the UMTS spectrum (£22.5 billion, ca. 2.3% of GDP), since which time the balance has deteriorated markedly. The public finances moved into deficit in 2002, to 1.6% of GDP, before a significant further deterioration in 2003 that has breached the 3% reference value.

[3] As set out in the 2004 Budget Report, released on 17 March 2004.

The cyclically adjusted deficit4 moved from a surplus of 0.8% of GDP in 1999, to a deficit of 2.8% in 2003, a cumulative deterioration of 3.6 percentage points, indicating that only a relatively small amount (0.7 percentage points) of the total deterioration in the public finances can be attributed to cyclical effects. This may, however, understate the true cyclical impact: in part due to the uncertainties inherent in estimating cyclically adjusted deficits; but, also due to disproportionately strong impacts on government revenues associated with declining profits in the financial services sector following the severe equity price falls in 2001 and 2002, reducing receipts from previously buoyant levels.[5]

However, the deterioration in the public finances has been largely structural, as a result of a sustained increase in current spending on public services, particularly health and education, and a desire to address historic under-investment in public services.

General government consumption has risen, from 18.4% of GDP in 1999 to 21.1% of GDP in 2003, as spending on front-line public services, on both human and physical resources, has increased. Over the same period, general government gross fixed capital formation has also risen from 1.1% of GDP in 1999 to 1.5% of GDP in 2003, and is projected to increase further under the government's plans.

The increase in government consumption and investment has been consistent with the UK's own fiscal rules; specifically, what the UK authorities refer to as the 'golden rule', which ensures that over the course of the economic cycle, the government borrows only to invest, and not to fund current expenditure.6 With its emphasis on the economic cycle as a whole, application of this rule effectively allows for deficits on the current budget in one part of the cycle to be offset against surpluses earned at other points in the same cycle. Since the authorities estimate that the current economic cycle runs from 1999-00 to 2005-06, the surpluses on the current budget achieved in the early years of the current cycle are being offset by the current run of deficits. Overall, however, the authorities maintain that the UK's 'golden rule' will be met, albeit with a declining margin.

Other factors have also contributed, however, to the deterioration in the public finances, most notably the expenditure related to the Iraq war, and measures to combat terrorism (ca. 0.3% of GDP).

---

[4] Commission services calculations.

[5] The Commission services calculation of cyclical adjustments relies on an estimate of the output gap. This approach has difficulty filtering out from the cyclically-adjusted balance changes due to composition effects, which may be temporary. This feature may help explain the marked computed deterioration in the cyclically-adjusted balance between 2002 and 2003, beyond the extra spending on the Iraq war, partially reversed in the following years.

[6] The rule refers to the public sector (i.e. also including public corporations), not 'general government'.

Table 3 : General government deficit and debt, GDP growth

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	3.1	2.8	3.8	2.1	1.6	2.2	3.0	2.8
General government balance*	0.1	1.1	3.9	0.7	-1.6	-3.2	-2.8	-2.6
Primary balance*	3.6	4.0	6.6	3.1	0.4	-1.2	-0.7	-0.5
Cyclically adjusted balance	-0.3	0.8	0.8	0.4	-1.4	-2.8	-2.5	-2.3
Total expenditures*	39.8	39.2	37.0	40.4	41.1	42.8	42.3	42.2
of which:								
General government final consumption	*17.9*	*18.4*	*18.7*	*19.2*	*20.1*	*21.1*	*21.0*	*21.2*
Consumption expenditure	*7.2*	*7.4*	*7.5*	*7.6*	*7.7*	*7.7*	*7.7*	*7.7*
Social transfers in kind	*10.7*	*11.0*	*11.2*	*11.7*	*12.4*	*13.4*	*13.3*	*13.4*
Social benefits other than in kind	*13.7*	*13.4*	*13.3*	*13.7*	*13.5*	*13.6*	*13.3*	*13.0*
Interest payments, general government	*3.5*	*2.9*	*2.7*	*2.4*	*2.0*	*2.0*	*2.0*	*2.1*
Gross fixed capital formation	*1.2*	*1.1*	*1.1*	*1.2*	*1.3*	*1.5*	*1.8*	*2.0*
*Other capital expenditure**	*0.6*	*0.6*	*-2.0*	*0.7*	*0.7*	*1.0*	*0.7*	*0.5*
Total revenues	39.9	40.3	40.8	41.1	39.5	39.6	39.5	39.6
of which:								
Current taxes on income and wealth	*16.3*	*16.2*	*16.7*	*16.8*	*15.6*	*15.2*	*15.2*	*15.4*
Taxes linked to imports and production	*13.2*	*13.6*	*13.6*	*13.4*	*13.5*	*13.5*	*13.4*	*13.3*
Social contributions received	*7.4*	*7.4*	*7.6*	*7.6*	*7.4*	*7.8*	*8.0*	*8.0*
Other current revenue	*2.6*	*2.7*	*2.5*	*2.7*	*2.4*	*2.3*	*2.2*	*2.3*
General government gross debt	47.6	45.0	42.1	38.9	38.5	39.9	40.1	40.6

** The figure for 2000 includes one-off proceeds of 2.3% of GDP (treated as negative expenditure) from the allocation of mobile phone licences (UMTS).*
Source: Eurostat until 2003; Commission Spring 2004 forecasts for 2004 and 2005.

3.2. *Budgetary developments in 2003-04*

The outturn for the general government balance is estimated[7] to have been a deficit of 3.2% in financial year 2003-04 - compared with a deficit of 2.4% projected in the 2003 Budget. This result, clearly worse than expected, appears to be due to developments in both revenues and spending that differed from the original projections.

On the revenue side, despite GDP growth being broadly in line with expectations, composition effects meant that growth in wages and salaries in the private sector in 2003 was lower than projected, reducing revenues from income tax and National Insurance Contributions (UK social security contributions). Specifically, Budget 2004 estimates that income tax receipts (gross of tax credits) will be some £3 billion (almost 0.3% of GDP) lower than had been estimated in Budget 2003, while social security contributions will be £2.2 billion (ca. 0.2% of GDP) lower. Corporation tax receipts are also £2 billion (ca. 0.2% of GDP) lower than expected, due to lower corporate profits – a continued legacy of the earlier turbulence in equity markets. In each case, these changes also reduce receipts in future years, insofar as they affect the base for the audited assumptions used in the latest public finance projections.

VAT revenues surprised on the upside however, despite lower than expected growth in consumers' expenditure. The authorities now believe that the reason for the better-than-expected outturn (£3.1 billion higher) is because previous forecasts had not reflected rising expenditure from the wider tax base other than consumers (only 70%

7 Estimate from Budget 2004, released on 17 March 2004.

of VAT receipts are accounted for by household consumption), while a government drive to combat VAT fraud may also be having an impact.

On the expenditure side, higher-than-expected general government current expenditure also contributed to the deficit in 2003-04, most notably the discretionary expenditure related to the Iraq war, and measures to combat terrorism (ca. 0.3% of GDP).

According to Commission estimates, the cyclically adjusted general government balance deteriorated significantly, moving from a deficit of 1.4% of GDP in 2002 to a deficit of 2.8% of GDP in 2003. This reflects, in part, the largely discretionary nature of the increase in government spending; however, due to the difficulties inherent in calculating cyclical adjustments, it is also likely to reflect some impact on government revenues, which may be temporary - such as lower corporation tax receipts from the financial services sector, and changes in average hours worked.

Table 4 : Successive targets for the 2003-04 general government deficit and estimated outcome

	Real GDP growth estimate (%) for 2003-04	General government balance (% GDP)
Targets for 2003-04		
2002 convergence programme (December ’02)	2.75	-2.2
Budget 2003 (April ’03)	2.25	-2.4
2003 convergence programme (December ’03)	2.25	-3.3
Estimated outcome		
Budget 2004 (March ’04)	2.75	-3.2

Note: The UK authorities base their public finance projections on a ‘cautious’ trend growth assumption that is one quarter of a percentage point lower than their ‘central’ view. The figures shown are from this ‘cautious’ case.

3.3. *Prospects for 2004-05 and 2005-06*

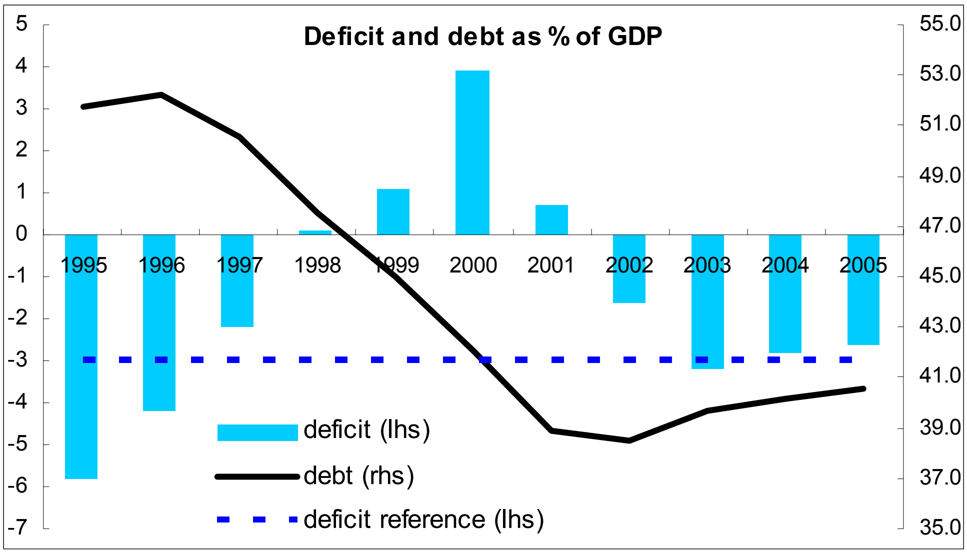
The public finances, as set out in Budget 2004, are expected to improve to show a deficit of 2.6% of GDP for financial year 2004-05. This compares, on a calendar year basis, to the Commission services Spring 2004 forecast of 2.8% of GDP for 2004. The difference largely reflects a more conservative estimate of the recovery in revenues, particularly in taxes on corporate incomes – despite forecasts for GDP growth broadly similar to the “cautious” forecasts used by the government to forecast the public finances.

Spending plans announced by the government in the 2002 Spending Review, which set the authorities’ overall expenditure plans for the three-year period 2003-04 to 2005-06, show that the rate of growth in public spending is programmed to slow over the next two years (see section 4.1). The Commission forecast assumes that the government’s spending plans will be broadly met in nominal terms. Both the authorities and the Commission therefore project a slowdown in the rate of growth of public spending going forward, in line with announced plans.

In 2005-06, Budget 2004 projects a further improvement in the general government deficit to 2.4% of GDP. This compares, on a calendar year basis, to the Commission Spring 2004 forecast for 2005 of a decline in the deficit to 2.6% of GDP, slightly less optimistic than the authorities. As well as differences in view over revenue growth, the difference also reflects a more optimistic growth projection for 2005 used by the

UK authorities. In particular, the "cautious" growth rate for GDP growth in financial year 2005-06 used by the government is 0.2 percentage points above that in the Commission forecast for 2005.

The cyclically-adjusted deficit is projected, according to Commission estimates, to narrow by 0.3 percentage points in 2004, from 2.8% of GDP to 2.5%, reflecting to a large extent the falling-away of expenditures associated with the Iraq War. In 2005, the cyclically adjusted deficit should fall further, to 2.3% of GDP.



3.4. *Recent debt developments and prospects*

General government gross debt in the UK has been on a broadly declining trend since the mid-1990s, falling from 52.2% of GDP in 1996 to 38.5% of GDP in 2002. This included a significant one-off impact from the sale of spectrum licences (UMTS) in 2000, which the authorities used to repay debt. Due to borrowing associated with the increase in public sector consumption and investment, however, gross debt rose to 39.7% of GDP in 2003.

On a financial year basis, general government debt is estimated to be 39.8% of GDP at the end of 2003-04, higher than the 39% projected in Budget 2003. The difference almost entirely reflects the impact of the higher than anticipated deficit, noted in the previous section, while gross debt interest payments are estimated to have been £0.4 billion (ca. 0.04% of GDP) higher than had been anticipated.

Looking forward, the gross debt to GDP ratio is projected, in the Commission Spring forecast, to increase to 40.1% in 2004 and 40.6% in 2005, remaining well below the 60% of GDP reference level throughout the projection period. Similar projections are set out in the official financial year projections by the authorities. Both the level of gross debt and gross debt interest payments, as a percentage of GDP, are presently amongst the lowest of the current EU Member States.

4. OTHER RELEVANT FACTORS

4.1. Medium term prospects

Budget 2004 updates the public finances projections released in the UK's December 2003 convergence programme update, and provides more detail on the growth in public spending that is planned for the period to 2007-08. The projections are based on spending plans announced in the 2002 Spending Review for the period to 2005-06; and, looking further forward, the overall spending increases set out in the Budget (and which will be announced in more detail in the summer 2004 Spending Review) for the period 2005-06 to 2007-08.

Over this period, growth in total spending, in nominal terms, is projected by the authorities to slow - from a rate of 9.5% in 2003-04, to between 6 and 6.5% in the period to 2005-06, before a further slowing to around 5.5% growth in the period 2005-06 to 2007-08.

On this basis, the general government balance is projected to steadily improve. According to the 2004 Budget projections, the deficit steadily declines from the estimated 3.2% of GDP deficit in FY 2003-04 to 2.0% in FY 2006-07. By FY 2008-09, the end of the official projections, the deficit is projected to have fallen to 1.6% of GDP. In cyclically-adjusted terms, the deficit is projected by the authorities to fall from 2.2% in FY 2005-06 onwards. However, a deficit of 1.6% of GDP is expected to exist even when the output gap has closed at the end of the projection period, in 2008-09, indicating that the UK will remain far from a position of "close to balance or in surplus". The general government gross debt ratio, meanwhile, is projected to rise to 42.1% of GDP by 2008-09.

4.2. Investment

Article 104(3) of the Treaty foresees that this report "shall also take into account whether the government deficit exceeds government investment expenditure".

Table 5 : General government fixed investment and deficit

(% of GDP)	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	0.1	1.1	3.9	0.7	-1.6	-3.2	-2.8	-2.6
General government gross investment	1.2	1.1	1.1	1.2	1.3	1.5	1.8	2.0

Source: Eurostat until 2003; Commission Spring 2004 forecasts for 2004 and 2005.

The UK authorities place great emphasis on the role of investment in public services in their expenditure plans, arguing that the UK needs to address a legacy of under-investment in public services. It is government policy to address that under-investment by increasing capital spending on public services. The increase in investment is reflected in the figures for general government gross investment which, according to Commission projections, will have increased from a low of 1.1% of GDP in 2000 to 1.5% in 2003, compared with an EU average of 2.3% of GDP in 2000 and 2.4% in 2003. However, as shown in Table 5, this can only account for a small part of the deterioration in the general government balance.

The increase in public investment is also consistent with earlier Broad Economic Policy Guidelines. However, the 2003-2005 Guidelines noted the need, reiterated in the Commission's assessment of the convergence programme update, for the UK to ensure that the public services associated with the increased spending are "delivered efficiently and with a view to ensuring cost-effectiveness".

4.3. Long-term sustainability of the public finances

An assessment of the long-term sustainability of the UK public finances was included in the Commission's assessment of the 2003 update of the UK's convergence programme. In summary, the assessment noted that on the basis of quantitative indicators[8] alone, risks of an unsustainable budgetary position in the long run cannot be ruled out. However, the low level of debt and the relatively low level of taxation give room to avoid undesired outcomes, since long term sustainability of public finances is constantly monitored and represents a key feature in the UK fiscal policy – the UK puts a good deal of effort in monitoring long term sustainability of public finances that should flag in advance possible risks. This gives room for manoeuvre to prevent the increase of the debt to GDP ratio and thus to intervene in time should unbalances emerge.

5. CONCLUSIONS

The general government deficit reached 3.2% of GDP in calendar year 2003, and is estimated to be the same for financial year 2003-04. This represents a significant deterioration in the general government balance of 4.3 percentage points of GDP, from a surplus of 1.1% of GDP in 1999.

Budgetary developments have recently been adversely affected by a modest negative output gap and composition effects in GDP growth (i.e. arising from developments in the components of GDP that differed from the original projections). The latter resulted in lower-than-expected receipts from taxes on corporate income and wages and salaries in 2003. Further, there was additional expenditure related to the Iraq war and measures to combat terrorism.

Overall, however, the deterioration in recent years in the deficit is largely explained by a sustained increase in public sector spending. This results from government policy aimed at addressing a legacy of under-spending, both capital and current, in public services, the bulk of which has taken the form of current consumption expenditure. The excess of the general government deficit over the 3% of GDP reference value therefore does not result, in the sense of the SGP, from an unusual event outside the control of the United Kingdom authorities, nor is it the result of a severe economic downturn.

Nonetheless, the deficit exceeded the 3% reference value only slightly, both in calendar year 2003 and financial year 2003-04; moreover, the Commission Spring forecast indicates that the excess over the reference value is likely to be temporary, as the general government deficit is expected to fall below 3% of GDP, to 2.8% in 2004, and to 2.6% in 2005. This would not, however, leave adequate margin against outturns exceeding the 3% of GDP reference value.

---

8 Based on a commonly agreed methodology by the Economic Policy Committee - See the Report "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003).

Further deficit reductions are targeted by the authorities in the medium-term, while maintaining plans to improve investment, and keep debt at a sustainable level. The general government gross-debt-to-GDP ratio is forecast in the Commission Spring forecast to rise only slightly, to reach 40.6% by 2005, remaining well below the 60% reference value and among the lowest of the current EU Member States.