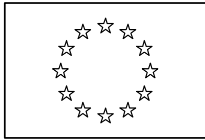

COMMISSION OF THE EUROPEAN COMMUNITIES

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REPORT FROM THE COMMISSION

United Kingdom

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

1. INTRODUCTION

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

Article 104 of the Treaty lays down an excessive deficit procedure (EDP) to ensure avoidance of excessive deficits or their prompt correction. The EDP is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure" as amended by Council Regulation (EC) No 1056/2005[1], which is part of the Stability and Growth Pact. While the provisions above apply to the UK in the same manner as to other countries not participating in the euro area, it should be recalled that 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, as long as it is in the second stage of EMU, the UK is committed under Article 116(4) of the Treaty "to endeavour to avoid excessive deficits"[2].

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "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".

In the period since the UK's previous EDP was abrogated in May 1998, the UK government recorded a deficit of 3.2% of GDP, i.e. over the Treaty reference level, already in financial year 2003/04. As a result the Commission initiated an EDP with the Article 104.3 report prepared in April 2004. However, since the then assessment was that the excess of the deficit over 3% of GDP was small and likely to be temporary, the deficit was not judged by the Economic and Financial Committee and the Commission to be excessive[3].

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1 OJ L 209, 2.8.1997 and OJ L 174, 7.7.2005 respectively. This report also takes into account the report "Improving the implementation of the Stability and Growth Pact", endorsed by the Council on 20 March 2005, available at http://europa.eu.int/comm/economy_finance/publications/sgp_en.htm.

2 http://europa.eu.int/eur-lex/en/treaties/selected/livre340.html

3 see: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/edp/edprep2004_uk.pdf August 2005 EDP notification, revised down from 3.3% of GDP.

According to the EDP data notified by the authorities in August 2005[4], the general government deficit in the United Kingdom reached 3.2% of GDP in the 2004/05 financial year[5] (running from April to March), thus exceeding the 3% of GDP reference value. In the March 2005 Budget the deficit had been projected to be 3.0%.

The general government gross debt ratio at the end of 2004/05 notified in August 2005 stood at 40.8% of GDP, clearly below the 60% of GDP reference value.

The figure for the 2004/05 financial year deficit provides *prima facie* evidence on the existence of an excessive deficit in the United Kingdom in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for the United Kingdom with the adoption of this report. Section 2 of the report examines the deficit criterion. Section 3 deals with the debt criterion. Section 4 deals with public investment and other relevant factors. The technical analysis underpinning the conclusions of the report is provided in a more detailed Commission staff working document, released in parallel[6]. Both documents take into account the Commission services' spring 2005 forecasts, released on 4 April, and the Commission services' evaluation of subsequent developments.

Table 1: General government deficit and debt [a]

	1999	2000	2001	2002	2003	2004	2005	2006
General government balance	1.1	3.8	0.7	-1.6	-3.3	-3.1	-3.0	-2.7
General government gross debt	44.9	41.9	38.7	38.2	39.7	41.5	41.9	42.5

	99/00	00/01	01/02	02/03	03/04	04/05	05/06
General government balance	1.6	3.8	-0.1	-2.2	-3.2	-3.2	-3.0
General government gross debt	42.9	39.8	37.8	37.6	39.5	40.8	42.0

Note:
[a] In percent of GDP.
Source: UK Office for National Statistics (ONS) and Commission services' spring 2005 forecasts (including previously unpublished data for financial year 2005/06).

This report refers 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 published 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.

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4 According to Council Regulation (EC) N° 3605/93, Member States have to report to the Commission their planned and actual government deficit and debt, twice a year.

5 The EDP applies to the United Kingdom on a UK financial year basis (annex to Regulation No 1467/97). Actual UK general government balance data reported here apply the Eurostat decision of 14 July 2000 on the allocation of UMTS receipts (in the UK case received during the second half of 2000). The UK has not generally applied this decision in domestic publication of its deficit data, which results in the balance on a Eurostat basis being approximately 0.1% points of GDP per annum lower than on a "UK" basis from 2001 and 2001/02 onwards; structural balances calculated by the Commission services reported here do not include such receipts; debt data are unaffected.

6 Technical document by the Commission services accompanying the report on United Kingdom prepared in accordance with Article 104(3) of the Treaty.

2. DEFICIT CRITERION

The general government deficit reached 3.2% of GDP in the 2004/05 financial year.

Though above the 3% of GDP Treaty reference value the 2004/05 deficit is close to it.

The excess over the 3% of GDP reference value is not exceptional. In particular:

- it does not result from an unusual event; and
- the growth performance accompanying the breach of the reference value in 2004/05 does not qualify as a severe economic downturn.[7] Indeed, over the period under consideration GDP growth - 3.2% in 2004 and 2.9% in financial year 2004/05 - has been above the potential rate, estimated at the time of the spring 2005 forecast at around 2¾%.

Table 2: Macroeconomic and budgetary developments [a]

	1999	2000	2001	2002	2003	2004	2005	2006
Real GDP (% change)	3.0	4.0	2.2	2.0	2.5	3.2	2.8	2.8
Potential GDP (% change)	3.1	3.0	3.0	2.9	2.9	2.7	2.7	2.8
Output gap (% of potential GDP)	0.3	1.3	0.6	-0.3	-0.7	-0.2	-0.1	-0.1
General government balance	1.1	3.8	0.7	-1.6	-3.3	-3.1	-3.0	-2.7
Primary balance	4.1	6.5	3.1	0.5	-1.3	-1.1	-1.0	-0.7
Government gross fixed capital formation	1.3	1.3	1.4	1.5	1.6	1.8	2.0	2.1
Cyclically-adjusted balance (CAB) [b]	1.0	0.8	0.5	-1.4	-3.0	-3.0	-2.9	-2.6
Cyclically-adjusted primary balance (CAPB) [b]	3.9	3.5	2.8	0.6	-0.9	-1.0	-0.8	-0.5

	99/00	00/01	01/02	02/03	03/04	04/05	05/06
Real GDP (% change)	3.4	3.6	2.0	2.1	2.8	2.9	2.7
General government balance	1.6	3.8	-0.1	-2.2	-3.2	-3.2	-3.0
Primary balance	4.3	6.6	2.2	-0.1	-1.2	-1.1	-0.9
Government gross fixed capital formation	1.2	1.3	1.5	1.6	1.6	1.9	2.0

Notes:
[a] In percent of GDP unless specified otherwise.
[b] Excluding UMTS receipts of 2.4% of GDP in 2000.
Source: UK Office for National Statistics (ONS) and Commission services, including spring 2005 forecasts with previously unpublished data for financial year 2005/06.

[7] Article 1 of Council Regulation (EC) No 1056/2005 sets out that a downturn should only be considered severe if there has been a negative annual GDP volume growth rate or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential. Neither of these conditions applies in the case of the UK.

As regards the temporariness of the excess over the 3% of GDP reference value, the following considerations apply: The Commission services spring 2005 forecast projected a deficit of 3.0% of GDP in 2005, declining to 2.7% in 2006; unpublished forecasts for financial years projected deficits of 3.0% in both 2004/05 and 2005/06. However, subsequent evaluation suggests that the macroeconomic projection on which these deficit figures were based is no longer tenable. Data available at the time the Commission's spring forecast was prepared showed UK economic growth slowing from the middle of 2004 onwards, but subsequent revised national accounts and other economic data[8] show that the slowdown has been much sharper than previously understood. Apart from the now slower GDP growth at aggregate level, recent growth performance to end-2004 also now appears to have been significantly more dependent on household expenditure, with the household saving ratio having dipped to a record low in 2004. In consequence the economy now seems more imbalanced than previously appreciated, with more subdued short-term prospects. The current central assessment is that GDP growth may be just over 2% in 2005 and possibly slightly higher in 2006, with household expenditure in particular weaker than expected in the spring; estimates for the financial years 2005/06 and 2006/07 are respectively very close to those for these calendar years.

As a result of this revised macroeconomic assessment and also taking into account recent developments in general government receipts and expenditures, on unchanged policies the deficit is expected to remain above the 3% reference value in 2005/06 (of the order of 3¼% of GDP) and also remain slightly above 3% in 2006/07.

The analysis above therefore suggests that the deficit criterion in the Treaty is not fulfilled.

3. Debt criterion

General government gross debt in the UK was on a broadly declining trend from the mid-1990s until relatively recently, falling from 52.2% of GDP in 1996 to 38.2% of GDP in 2002. This included a significant one-off impact from the sale of UMTS licences in 2000, which the authorities largely used to repay debt. From 2002, however, due to borrowing associated with the major increases in general government consumption and investment, the debt ratio has risen, to reach 41.5% at the end of 2004. Reflecting the usual first calendar quarter stronger receipts and thus overall balance, the general government gross debt ratio at the end of 2004/05 had dipped to 40.8% of GDP.

The Commission services' spring 2005 forecast projected the gross debt to GDP ratio to rise to 41.9% in 2005 and 42.5% in 2006, remaining well below the 60% of GDP reference level throughout the projection period. Similar levels are set out in the authorities' financial year projections.

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[8] UK quarterly national accounts released on 30 June made significant revisions to past data. As a result, growth appears to have been stronger than previously thought from 2002 to 2004, but markedly slower in the most recent quarters. First quarter growth in 2005 was first reported at 0.6% q-o-q (preliminary estimate), revised down to 0.5% (first full estimate), then further down to 0.4% in the June national accounts release. Q2 2005 quarterly growth as estimated by the ONS in August was 0.5%.

4. RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report “shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State”. These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97 as amended by Council Regulation (EC) No 1056/2005. This Regulation also specifies that “any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council” need to be given due consideration in the report.

In view of this, the following four subsections consider in turn (i) the medium-term economic position; (ii) the medium-term budgetary position (including public investment); (iii) other factors considered relevant by the Member State; and (iv) other factors considered relevant by the Commission.

4.1. Medium-term economic position

Cyclical conditions and potential growth. According to the Commission services’ spring forecast, the UK economy had virtually closed a negative output gap by 2004 and was expected to grow at close to an estimated potential rate of 2¾% per annum in the two years to 2006. The subsequent re-evaluation of recent developments and short-term prospects suggest a somewhat weaker current development of potential output (around 2½%), relative to which a small positive output gap in 2004 is expected to become negative in 2005 and slightly widen in 2006. Driving the development of actual output is weaker domestic demand.

Recent structural reforms. Notwithstanding a strong macroeconomic performance in recent years, the UK’s productivity levels continue to lag those of many other EU economies. While the gap in productivity levels relative to the EU15 average has been closing over a number of years, the UK’s GDP per hour worked was still estimated to be 5% below the EU15 average in 2003[9]. Reforms have focused on measures to improve competition, enterprise, innovation, skills, investment and public services’ productivity. Efforts to improve R&D have included the use of R&D tax credits and project-specific grants, while the government launched a Science and Innovation Investment Framework in July 2004, setting a target for combined public and private R&D expenditure to reach 2.5% of GDP by 2014 from 1.9% in 2004. Labour market reforms have included a number of measures to boost training and raise basic skills in the workforce and to encourage incapacity benefit claimants to return to work. While none of the reform efforts mentioned appears to have had a significant budgetary impact in the short term, their long-term impacts on growth (and thereby the budgetary position) are likely to be positive.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Following ongoing fiscal consolidation in the period 1997 to 1999, deficits in the public finances were transformed into surplus from 1999 to 2001 (with output gaps estimated to be positive over the whole period), though in terms of cyclically-adjusted balances the surpluses were somewhat lower. However, since 2000, the UK has significantly loosened its fiscal position by increasing

[9] Eurostat figure.

public expenditure. In 2004 the UK had an estimated structural deficit of 3% of GDP, representing a significant deterioration from the UK's structural surplus of almost 1% of GDP achieved in 2000[10] when the economy was clearly above potential. Similarly, the cyclically-adjusted primary balance is estimated to have progressively worsened by almost 5 percentage points between 2000 (when the balance was in strong surplus) and 2004. Fiscal loosening has been continuous since 2000, covering periods when the economy has been both above and below potential. The change in fiscal stance has taken the actual balance above the 3% Treaty reference value from the 2003/04 financial year. Similarly the medium-term objectives set in successive convergence programmes have demonstrated a shift from balance towards significant deficits even as the relevant programme horizons have been extended forward in the successive updates[11]. In the Commission's spring forecast, the structural deficit was expected to improve slightly over the next two years, with this remaining the current judgement**.**

Public investment. The ratio of general government gross fixed investment to GDP has risen gradually from around 1¼% at the turn of the decade to 1.5% in 2002, reaching 1.8% in 2004. This recent increase has occurred as the general government balance moved from initial surplus, in the four years up to 2001, to a deficit ratio of 1.6% in 2002 and over 3% in 2003 and 2004. The deficit ratio has therefore exceeded the government investment ratio from 2002 onwards. The deterioration in the structural deficit has also been well above the increase in the investment ratio. According to the Commission services' spring forecast, the deficit ratio will continue to exceed the investment ratio in 2005 and 2006 despite a further slight increase in the latter, while the revised deficit outlook is likely to increase the gap between the two ratios..

Quality of public finances. Primary general government expenditure has risen from around 37% of GDP in 1999 to a little over 41½% in 2004, reflecting the objective of redressing past underinvestment and the perceived inadequate provision of public services. Education and training and healthcare have been considered particular priorities. Expenditure on education and training has increased since 1998/99 from 4½% of GDP to around 5½% in 2004/05, while expenditure on healthcare has increased from 5½% to around 7% respectively.

Long-term sustainability of public finances. In its opinion of 8 March 2005 on the most recent UK convergence programme[12], the Council assessed the UK as being in a relatively favourable position with regard to the long-term sustainability of the public finances, despite the projected budgetary cost of an ageing population. Positive factors were the relatively low debt-to-GDP ratio and the strong emphasis placed in existing policies on long-term sustainability, while the UK's relatively low tax ratio would ease the accommodation of any imbalances that might arise in the longer term. However, higher age-related expenditures than officially foreseen could not be excluded. In particular, the possibility was referred to that insufficient provision of private pensions might have implications for the public finances. While the assessment of long-term sustainability of the public finances has not greatly

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10 Cyclically-adjusted balances have been calculated using the output gaps shown in table 2, i.e. taking account of revised outturn data but retaining the spring forecast of output growth in 2005 and 2006; the figure for 2000 excludes UMTS receipts. The indicators need to be treated with care, as factors such as composition effects and revenues stemming from the evolution of asset market prices may alter the estimated values. Nevertheless, there is no doubt that fiscal policy became expansionary after 2000.

11 From close to balance in the original 1998 UK convergence programme the medium-term objective has departed to a deficit of 1½% of GDP in the 2004 updated programme. The respective programme horizons were 2003/04 and 2009/10.

12 http://register.consilium.eu.int/pdf/en/05/st07/st07133.en05.pdf#page=2

changed since the adoption of the Council opinion, the initial position is now less favourable given a higher structural primary deficit than expected in that opinion. On the comprehensive issues of pension provision and adequacy, public debate within the United Kingdom is continuing, focused on the ongoing work of the officially appointed Pensions Commission which is expected to present policy options at the end of November 2005[13].

4.3. Other factors considered relevant by the UK authorities

In a letter of 27 July 2005, the United Kingdom authorities communicated some "other relevant factors" in accordance with Article 2(3) of Council Regulation (EC) No 1467/97 as amended by Council Regulation (EC) No 1056/2005. These were considerations relating to sustainability and debt, public investment, the timing of net payments to the EU and commitments to international aid and debt relief. The analysis above already covers the first two of the items put forward by the authorities, though alongside investment they mention that the composition of current expenditure in general has been redirected to growth-enhancing items.

As regards the first of the two remaining items, changes unexpected by the UK authorities in the timing of structural fund receipts raised the 2004-05 deficit by £800 million (0.07% of GDP) compared with the March 2005 Budget estimate, and is assumed to improve it by a similar amount in the current financial year.

Under the second item the authorities record that UK contributions to international aid and debt relief in 2004-05 were 0.36% of GNI. In 1997, such contributions were 0.26% of GNI, with the change representing a real increase of 140%.

4.4. Other factors considered relevant by the Commission

On the basis of the real GDP growth forecasts presented in recent years' UK Budget and pre-Budget reports, the UK authorities have a good record in the accuracy of their short-term forecasting. The government's budgetary forecasts have also been relatively good, and in their medium-term projection erring towards caution in their assumption for revenue growth that trend output growth will be a quarter of a percentage point below the authorities' neutral view. However, since 2002/03 such forecasts have persistently under-estimated the deterioration in the public finances. For financial year 2005/06, the March 2005 Budget projected a deficit of 2.7% of GDP. This now seems out of reach as the path of real and nominal output, and thus the revenue base, is falling significantly short of the authorities' underlying budgetary planning, a divergence likely to widen in financial year 2006/07.

Under the UK's public expenditure framework, overall three-year expenditure envelopes have hitherto been set every two years as part of the Budget process, with the last year of one expenditure period becoming the first year of the next[14]. Overall expenditure is then allocated between departments through a bidding process. A further important element is so-called End-Year Flexibility (EYF), which allows central government departments to carry forward unspent allocations from one financial year to the next. Together with the multi-year spending

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[13] The Pensions Commission has already published a first, analytical report on the adequacy of pension provision and saving: http://www.pensionscommission.org.uk/publications/2004/annrep/index.asp.

[14] The UK Treasury has recently indicated that it will move to holding the review process every three years, with the next taking place in 2007. Expenditure plans will still be set for three years, but the new timetable implies there will no longer be a "crossover" year for which the spending agreement can be reopened.

plans, the framework aims to reduce incentives to use up resources in wasteful bursts at year-end. Since the introduction of the current framework in 1998, departments have had a clear tendency to under-spend relative to plans and in this sense the system has been effective in preventing unplanned expenditure overruns. However, a counterpart is that the amount carried forward under EYF has increased from year to year, reaching around 1% of GDP, at the end of 2004/05. The implied possible call on the public finances by government departments reclaiming past under-expenditure is not included in the forward projections of the deficit. As previously noted in the technical assessment of the UK's 2004 convergence programme update, the existence of such large, unspent balances carries a negative risk to achieving future public finance projections. For general government expenditure these are based on the allocations made as part of the normal Budget and expenditure review processes, with no allowance for possible higher levels resulting from government departments using outstanding balances.

5. CONCLUSIONS

The provisions of Article 104 of the Treaty and of the SGP provide the basis for ensuring the conduct of sound and sustainable public finances. While such provisions apply to the UK in the same manner as to other countries not participating in the euro area, it should be recalled that as long as it is in the second stage of EMU, the obligation under the Treaty to avoid excessive general government deficits does not apply to the UK, which is only committed under Article 116(4) of the Treaty "to endeavour" to avoid excessive deficits.

The general government deficit in the United Kingdom reached 3.2% of GDP in financial year 2004/05, above but close to the 3% of GDP reference value. This is the second successive year of a deficit in excess of the reference value (in financial year 2003/04, the deficit was also 3.2% of GDP). Moreover, the most recent information suggests that on unchanged policies the deficit is expected to remain above the 3% reference value in 2005/06 (of the order of 3¼% of GDP) and also remain slightly above 3% in 2006/07. The excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. This suggests that the deficit criterion in the Treaty is not fulfilled.

The general government debt, at about 41% of GDP, is well below the 60% of GDP reference value. It is expected to remain around that value over the coming years. This means that the debt criterion of the Treaty is consistently fulfilled.

In line with the Treaty, this report has also examined "relevant factors", which, according to the Stability and Growth Pact, can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case seem to be relatively favourable.