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COMMISSION OPINION

on the existence of an excessive deficit in the United Kingdom

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GENERAL CONSIDERATIONS

1. Article 104 of the Treaty lays down an excessive deficit procedure (EDP) to ensure that Member States avoid excessive government deficits or that they correct such deficits when they occur. The EDP is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. However, while most provisions apply to the United Kingdom in the same manner as to other countries not participating in the euro area, point 5 of the Protocol on certain provisions relating to the United Kingdom states that 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 economic and monetary union[2]. Instead, while in the second stage of economic and monetary union, the United Kingdom is required pursuant to Article 116(4) of the Treaty "to endeavour to avoid excessive deficits". The EDP applies to the United Kingdom on a financial year basis (running from April to March).

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).

3. 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" as further clarified in Article 2(3) of the Regulation mentioned above. The 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

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[1] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5). Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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

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.

4. On the basis of the EDP data notified by the UK authorities in August 2005 together with an interim economic assessment prepared by the Commission services, the Commission adopted a report under Article 104(3) for the United Kingdom on 21 September 2005.

5. Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the report of the Commission on 30 September 2005.

6. Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. In order to reach a conclusion on whether an excessive deficit exists or may occur, the Commission considers that account should be taken of: (i) the conclusions of its report under Article 104(3), and (ii) the opinion of the Economic and Financial Committee on this report. On the basis of these elements, and taking into account the Commission services' autumn 2005 forecasts (published on 17 November 2005), the Commission has established a number of considerations for the United Kingdom.

CONSIDERATIONS CONCERNING THE UNITED KINGDOM

7. In the period since the United Kingdom's previous EDP was abrogated in May 1998, the general government balance moved from a comfortable surplus position in the late 1990s to a deficit of 3.2% of GDP in 2003/04[3,4], thereby exceeding the Treaty reference value for the first time since 1997. This development was equivalent to a change in the structural fiscal balance of around 4 percentage points of GDP in the period from 1999/00 to 2003/04. During these years the general government expenditure ratio increased from less than 40% to about 43% of GDP. In the same period, government gross fixed capital formation increased from 1.2% to 1.6% of GDP; the government gross debt ratio went down to 37.6% of GDP in 2002/03 and has been increasing since then. Such an evolution coupled with developments in interest rates led to interest payments having fallen from 2.9% to 2.0% of GDP in that period. As a consequence of the deficit for 2003/04 exceeding the reference level, the Commission initiated an excessive deficit procedure with the Article 104(3) report prepared in April 2004[5]. 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 to be excessive.

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3 August 2005 EDP notification, revised down from 3.3% of GDP. The United Kingdom August data were validated by Eurostat on 26 September 2005.

4 Actual UK general government balance data reported here apply the Eurostat decision of 14 July 2000 on the allocation of UMTS receipts. The UK has not generally applied this decision in domestic publication of its public finance data, which results in the net lending balance on a Eurostat basis being approximately 0.1 percentage point of GDP per annum lower than reported in UK national accounts from respectively 2001 and 2001/02 onwards.

5 See: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/edp/edprep2004_uk.pdf

8. In the 2004/05 financial year, according to the EDP data notified by the United Kingdom in August 2005, the general government deficit remained at 3.2% of GDP[6], again in excess of the 3% of GDP reference value. The reported deficit figure for the 2004/05 financial year deficit provided *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 therefore adopted a report on 21 September 2005 according to Article 104(3) of the Treaty assessing the fulfilment of the Treaty requirements concerning the deficit and the debt criteria[7]. The report considered that, although above the 3% of GDP Treaty reference value, the 2004/05 deficit was close to it. The excess over the 3% of GDP reference value was not exceptional. In particular, it did not result from an unusual event outside the control of the United Kingdom authorities, nor was it the result of a severe economic downturn. Growth of 3.2% in 2004 was estimated to have been above-potential as was growth in financial year 2004/05. The output gap in 2004 was estimated to be positive. As regards the issue of temporariness, the deficit was expected to persist above 3% throughout 2005/06 and 2006/07, based on an interim updated economic and budgetary outlook for the United Kingdom.

9. The Economic and Financial Committee issued its opinion in accordance with Article 104(4) on 30 September 2005, this opinion being consistent with the assessment made by the Commission in its report, and noting that the excessive deficit could not be considered temporary. The Committee nevertheless recommended that further steps under the EDP should await the finalisation of the Commission's autumn 2005 forecasts.

10. In the Commission services' autumn 2005 forecasts, assuming United Kingdom fiscal policy remains as announced, the deficit was expected to widen to just below 3½% of GDP in 2005/06 and to remain over 3% of GDP in 2006/07. These projections confirmed the Commission's assessment made in its report under Article 104(3) and the EFC opinion adopted under Article 104(4) that the deficit was expected to remain over 3% of GDP in 2005/06 and 2006/07 and was therefore not temporary. Based on these projections, the excess over the 3% of GDP reference value is confirmed as neither exceptional nor temporary, although the deficit is close to the reference value.

11. Subsequent to the Commission services' autumn forecasts, the United Kingdom announced fiscal measures in the Pre-Budget Report presented to Parliament on 5 December. In net terms, United Kingdom authorities' costings of these measures, compared with the baseline of announced policy (as taken into account in the autumn forecasts), represent an easing of policy by just below 0.1pp of GDP in the current financial year and a tightening of policy by 0.1pp of GDP in 2006/07. In the Pre-Budget Report, the UK authorities expect the deficit to be below 3% in 2006/07. Taking into consideration these measures, which are all structural, the Commission's assessment nevertheless remains that the deficit in 2006/07, is expected to exceed 3% of GDP, at 3.1% of GDP, and is therefore not temporary.

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6 However, the 2004/05 deficit outturn has been revised upwards since the August notification. The outturn consistent with that reported in the December 2005 Pre-Budget Report is 3.3% of GDP.

7 See http://www.ecfineuropa.cec/comm/economy_finance/about/activities/sgp/edp/com_rep_uk.pdf

12. In accordance with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these conditions can only be taken into account in the steps leading to the decision on the existence of an excess 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. In the case of the United Kingdom the double condition is not met. Therefore other relevant factors are not taken into account in this opinion. The analysis therefore indicates that the deficit criterion in the Treaty is not fulfilled.

13. In contrast, the general government debt ratio remains well below the 60% reference value (the August EDP data reporting a ratio of 40.8% of GDP in the 2004/05 financial year) although, given the scale of actual and projected primary deficits, on a rising trend. In the Commission's autumn forecasts the debt ratio is projected to reach around 44½% of GDP in 2007/08.

CONCLUSION

14. The monitoring of the budgetary situation in the United Kingdom and, in particular, the examination of compliance with the criteria laid down in Article 104(2) has led the Commission to prepare a report in accordance with Article 104(3) of the Treaty. The Commission, having taken into account its report, the opinion of the Economic and Financial Committee, the Commission services' autumn 2005 forecasts and the United Kingdom's December 2005 Pre-Budget Report, is of the opinion that an excessive deficit exists in the United Kingdom.