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COMMISSION OPINION

on the existence of an excessive deficit in the United Kingdom

(presented by the Commission)

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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, Article 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 shall, pursuant to Article 116(4) of the Treaty, "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 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.

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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://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12006E/PRO/25:EN:HTML

4. On the basis of the EDP data notified by the UK authorities in March 2008 and taking into account the Commission services' spring 2008 forecast, the Commission adopted a report under Article 104(3) for the United Kingdom on 11 June 2008.[3]

5. Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the report of the Commission on 25 June 2008.

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, the Commission has established a number of considerations for the United Kingdom.

CONSIDERATIONS CONCERNING THE UNITED KINGDOM

7. The United Kingdom undertook strong fiscal consolidation efforts during the late 1990s, which led to an improvement in the general government balance from a deficit of 3.8% of GDP in 1996/97 to a surplus of 1.3% in 1999/00. Gross government debt also declined from over 50% of GDP in 1996/97 to a low of 36.8% in 2002/03. Thereafter, the government adopted a looser fiscal stance, mainly as a result of an explicit policy objective to raise expenditure on public services. As a result, the general government balance moved from a surplus position in the late 1990s to a deficit of 3.2% of GDP in 2003/04 and 3.5% in 2004/05. With the output gap remaining positive throughout this period, this was equivalent to a deterioration of the structural balance by 4¾ percentage points of GDP[4] between 1999/2000 and 2004/05. During these years, the government expenditure-to-GDP ratio increased by about 4½ percentage points, to 43.2%, with government gross fixed capital formation rising from 1.3% of GDP to 1.8%. On 21 September 2005 the Commission initiated an EDP for the UK with the adoption of a report under Article 104.3 and on 24 January 2006 the Council decided that an excessive deficit existed in the United Kingdom. The budgetary position improved in 2005/06 and 2006/07, with the headline deficit in the latter year falling to 2.6% of GDP. On 12 September 2007, taking into account the 2006/07 deficit outturn and the spring 2007 forecast, the Commission adopted a recommendation for a Council decision abrogating the EDP against the UK. On 9 October 2007, ECOFIN decided to abrogate the EDP according to Article 104.12 of the Treaty.

8. Over the course of 2007/08 weak revenue growth, especially due to higher repayments of corporate tax overpaid in previous years and lower revenues from oil and gas extraction activity, led to a worsening of the UK's budgetary position. The 2007/08 deficit was estimated to have risen to 2.9% of GDP in both the Commission services’ spring 2008 forecast and in the data reported by the UK in March 2008.[5]

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[3] All EDP-related documents for the United Kingdom can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2

[4] Estimated by the Commission services, applying the common methodology on estimating output gaps.

[5] The data notified by the United Kingdom in March 2008 indicates a general government deficit of 2.8% of GDP in 2007/08. However, data for annual general government net borrowing as reported by the

Fiscal policy was estimated to be again pro-cyclical in 2007/08, with the structural deficit deteriorating by ¼% of GDP in a still favourable economic context[6].

9. According to the EDP data notified by the UK authorities in March 2008[7], the United Kingdom's general government deficit in 2008/09 was planned to reach 3.2% of GDP, thus exceeding the 3% of GDP reference value; this ratio was identical to that published in the United Kingdom's March 2008 budget, which also presented budgetary plans showing a general government deficit of 2.8% of GDP in 2009/10. A subsequent policy announcement on 13 May reduces personal income tax in 2008/09 by 0.2% of GDP, financed by additional borrowing. Other things being equal, this results in higher planned deficit and debt ratios than those in the notification, and also implies a structural deficit higher by 0.2% of GDP.[8] The figure for the 2008/09 deficit in the notification provides *prima facie* evidence of a planned excessive deficit in the United Kingdom in the sense of the Treaty and the Stability and Growth Pact, while the more recent policy announcement is to be considered additional evidence. The Commission therefore adopted a report on 11 June 2008 according to Article 104(3) of the Treaty assessing the fulfilment of the Treaty requirements concerning the deficit and the debt criteria.

10. The report considered that, although above the 3% of GDP Treaty reference value, the deficit planned for 2008/09, as notified in March 2008, 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. The Commission services' spring 2008 forecast projects UK growth to slow in 2008 and 2009 to annual rates below potential. Nevertheless, quarterly GDP growth is expected to remain positive and annual GDP growth to reach 1.7% in 2008 and 1.6% in 2009. As regards the issue of temporariness, the Commission services expect the deficit ratio in 2009/10 to remain above 3%, with the weak economic context feeding through into slower revenue growth. The government's statement on 13 May 2008 does not commit the government to extend to 2009/10 the same compensation offered in

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United Kingdom are increased by £1.0bn by the Commission services to ensure consistency of recording of UMTS licence proceeds. This increases the deficit ratio to 2.9% of GDP in 2007/08.

6 The provisional public sector finances' data for May 2008 published on 19 June 2008 and the national accounts' data published on 27 June 2008 imply a headline 2007/08 general government deficit on an EDP basis of 2.8% of GDP, 0.1 p.p. less than estimated in the 2008 Budget and in the 2008 spring forecast. The slightly better-than-expected outturn was primarily due to a downward revision to previously-published figures for central government current expenditure, which *ceteris paribus* also implies a lower structural deficit in 2007/08 by 0.1% of GDP. Under a no-policy-change assumption, the spring 2008 forecast assumes that the government will adhere to the non-cyclical primary expenditure plans announced in the 2008 budget, which were practically unchanged from those in the 2007 Comprehensive Spending Review. Lower departmental spending in 2007/08 would not pass through into the expenditure planned in 2008/09 and 2009/10, since the departmental spending limits for those years were established in the 2007 Comprehensive Spending Review. Indeed, under the End-year Flexibility (EYF) scheme, departments are allowed to carry forward under-spends on their departmental allocations from one year to the next.

7 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of the United Kingdom can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

8 In the UK government's income tax announcement published on 13 May 2008, the cost of the income tax reduction was stated to amount to £2.7bn in 2008/09, which is estimated by the Commission to be equivalent to 0.2% of GDP.

2008/09.[9] It nevertheless carries a significant risk for 2009/10 of a deficit overshoot, compared with the March 2008 budget plans, with a similar impact ceteris paribus on the spring forecast projection.

11. The general government debt ratio remains below the 60% reference value (the March EDP data reported a ratio of 43% of GDP[10] in the 2007/08 financial year), although projected to be on a rising trend up to 2009/10. The debt criterion in the Treaty is fulfilled.

12. In accordance with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "other relevant factors". According to the Stability and Growth Pact, these relevant factors 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. In this case the double condition is not met.

13. The Economic and Financial Committee issued its opinion in accordance with Article 104(4) on 25 June 2008; this opinion is consistent with the assessment made by the Commission in its report and confirms that the excess over the reference value cannot be considered exceptional and temporary.

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 and the opinion of the Economic and Financial Committee, is of the opinion that an excessive deficit exists in the United Kingdom.

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9 Further policy announcements are expected in the autumn 2008 Pre-Budget Report.

10 Using GDP adjusted for Financial Intermediation Services Indirectly Measured (FISIM).