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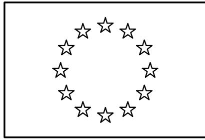

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.2009
SEC(2009) 1552 final

Recommendation for a

COUNCIL RECOMMENDATION TO THE UNITED KINGDOM

with a view to bringing an end to the situation of an excessive government deficit

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December 2008. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[1], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[2], which is part of the Stability and Growth Pact.

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

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1 See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release N° 103/2009.

2 OJ L 209, 2.8.1997, p. 6. 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, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

3 According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification

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

On 2 July 2008 the Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), addressed to the Council, in accordance with Article 104(5), its opinion that an excessive deficit existed in the United Kingdom.

Subsequently, acting upon a recommendation by the Commission, the Council decided on 8 July 2008 that an excessive deficit existed in the United Kingdom in accordance with Article 104(6), and, also on a recommendation by the Commission, it addressed recommendations to the United Kingdom in accordance with Article 104(7) with a view to bringing an end to the situation of an excessive government deficit by 2009/10. In its recommendations, the Council established a deadline of 8 January 2009 for effective action to be taken.

On 27 April 2009, acting upon a recommendation by the Commission that took into account the Commission services' January 2009 interim forecast, the Council decided that the UK had not taken action in response to the Council recommendation of 8 July 2008. In accordance with Article 104(7) and on a recommendation by the Commission, it addressed new recommendations to the United Kingdom with a view to bringing an end to the excessive government deficit situation by 2013/14. In its recommendations, the Council established the deadline of 27 October 2009 for the UK government to take effective action.

Regulation (EC) No 1467/97, Article 3(5), states that if effective action has been taken in compliance with a recommendation under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 104(7). To this end, the Commission has assessed recent macro-economic and budgetary developments as well as effective action taken by the United Kingdom.

3. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

According to Article 3(5) of Council Regulation (EC) No 1467/97, the occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the preceding Council recommendation, adopted on 27 April 2009.

The Commission services' January 2009 interim forecast, on which the Council recommendation of 27 April 2009 was based, had projected a contraction in real GDP by around 2.3% in 2009/10, following expected growth of 0.6% in the preceding year. The contraction envisaged in the January 2009 interim forecast was fully driven by falling domestic demand, especially due to declining fixed investment, a previously strong source of output growth that was expected to become increasingly constricted by the sharply tighter credit conditions to corporations and households as a consequence of the financial crisis. On

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of the UK can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables.

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

account of the contraction in tax-rich economic activity and the major stimulus package announced in November 2008, consistent with the EERP, that was part of the 2008 Pre-Budget Report, the Commission services' January 2009 interim forecast projected a surge in the government deficit from 5.7% of GDP in 2008/09 to 9.5% in 2009/10.

		2008/09	2009/10	2010/11	2011/12
Real GDP (% change)	COM January 2009	-0.6	-2.3	0.9	n.a.
	COM Autumn 2009	-1.3	-3.3	1.2	2.3
Nominal GDP (% change)	COM January 2009	1.5	-2.4	3.0	n.a.
	COM Autumn 2009	1.2	-2.0	3.1	4.2
General government balance (% of GDP)	COM January 2009	-5.7	-9.5	-9.2	n.a.
	COM Autumn 2009	-6.9	-13.0	-12.5	-10.7

Following the extraordinarily large contraction in the first quarter of 2009, which was the sharpest quarterly loss of GDP recorded in over fifty years and that primarily resulted from large reductions in fixed investment, the rate of output contraction in 2008/09 was double that forecast in January. This output fall and the larger-than-expected requests for delays in tax payments under a pre-existing business support scheme led to a sharp drop in government receipts in the final months of 2008/09. The undershoot in government revenue, coupled with an unanticipated one-off deficit-increasing rise in capital transfers by ¾% of GDP as a result of government financial sector interventions, led to a deficit outturn in 2008/09 of 1¼ pp. of GDP higher than originally forecast.

The Commission services' autumn 2009 forecast expects the contraction in real economic activity in 2009/10 to be 1 pp. deeper than envisaged in January 2009. The worsening in the macroeconomic prospects for 2009/10 is driven by the further deterioration in the outlook for domestic demand since the beginning of 2009 as a result of the strong reduction in inventories, highly restrictive credit conditions and a surge in spare capacity. By contrast, the autumn forecast projects in 2009/10 a smaller contraction in nominal GDP than forecast in the spring due to an upward revision in the consumer prices forecast, which mirrors the slower-than-expected moderation in inflation throughout the first eight months of 2009.

The autumn 2009 forecast revised the government deficit projection for 2009/10 upward to 13.0% of GDP, around 3½ pps. higher than had been projected in January 2009. Around two-fifths of the deficit overshoot in 2008/09, equivalent to around ½% of GDP, is expected to feed-through into a higher deficit in 2009/10. The standard budgetary elasticity with respect to UK output growth suggests an increase in the deficit ratio in 2009/10 of around ½ pp. as a result of the downward revision in real GDP growth, but the actual impact on the deficit of the deeper-than-expected contraction is estimated to be significantly greater. This is primarily due to the association of the recession with severe downturns in financial and housing markets, each of which had been hitherto major sources of revenue. The latest forecast also takes into account the additional stimulus measures that were announced in the Budget of 22 April 2009, but these contributed to an increase in the projected deficit for 2009/10 by only around ⅓% of GDP.

As regards the smaller contraction in the 2009/10 nominal GDP forecast in the autumn compared with January, although higher inflation cushions the contraction in the tax base for indirect tax revenue, its overall impact on public finances is estimated to be negative. Higher inflation increases interest payments on index-linked gilts, while, under current legislation,

the statutory indexation of means-tested benefits are also set to rise in line with the September increase in the Rossi index (Retail Prices Index less the elements representing housing costs).

The debt ratio should increase to around 72% of GDP in 2009/10, up from 65% in the January 2009 forecast, and will still be on a strongly rising trend in 2011/12, reaching almost 90% of GDP. Around three-fifths of the upward revision in the debt ratio in 2009/10 mirrors the deterioration in the primary deficit, while debt-increasing financial sector interventions are expected to raise the debt ratio by around 2½% of GDP more than had been expected in January 2009.

Overall, it can be concluded that, assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009, unexpected adverse economic events with major unfavourable effects for government finances have occurred in the United Kingdom.

4. ASSESSMENT OF EFFECTIVE ACTION TAKEN

According to Regulation (EC) No 1467/97 and the revised Code of Conduct[5] a Member State should be considered to have taken effective action if it has acted in compliance with the 104(7) recommendation. The Code of Conduct states that the assessment of effective action should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall should be made. In case of a multi-annual adjustment, the Code of Conduct specifies that the assessment should mainly focus on the measures taken in order to ensure an adequate fiscal adjustment in the year following the identification of the excessive deficit.

The Council in its recommendations under Article 104(7) of the Treaty of 27 April 2009, established a deadline of 27 October 2009 for the United Kingdom government to take effective action to limit the deterioration of the fiscal position in 2009/10 and to specify the measures that will be necessary to progress towards the correction of the excessive deficit, against the background of the economic outlook in the Commission services' January 2009 interim forecast.

On 22 April 2009 the United Kingdom government presented to Parliament its 2009 Budget. Due in major part to the strong negative fallout from the global financial crisis, the Budget presented a marked downward revision to the medium-term macroeconomic projections that had underpinned the January 2009 interim forecast. Whereas the latter had forecast annual contractions of around ½% and 2¼% in the financial years 2008/09 and 2009/10 respectively, the 2009 Budget made corresponding projections of contractions of 1% and 2¾%.

In the 2009 Budget the government confirmed it would continue to implement fiscal measures in 2009 in line with the European Economic Recovery Plan and, in the context of weaker-than-expected economic conditions and prospects, introduced further discretionary fiscal stimulus measures for 2009/10 of 0.4% of GDP. The new measures mainly consisted of tax

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[5] "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.

relief on business investment, a postponement of the inflation-linked increase in business property tax, higher expenditure on social benefits and housing, more funding for labour market support and a car scrappage scheme.

As regards the medium-term, in financial year 2010/11 the increase in January 2010 of the standard VAT rate to its pre-fiscal stimulus level will increase revenue by 0.6% of GDP, while a reduction in capital expenditure by 0.2% of GDP will compensate for the discretionary spending increase in 2008 and 2009. The UK authorities also target expenditure savings of 0.3% of GDP in 2010/11 through efficiency gains. Additional revenue from an increase in the income tax rate on high incomes and a rise in fuel duty rates is expected to be offset by a temporary increase in the budget allocation for employment schemes. In 2011/12, however, the higher revenue from the increase in the rates for income tax and fuel duty are expected to reduce the structural deficit ratio by 0.3 pp. of GDP.

The 2009 Budget also presented plans for more ambitious fiscal consolidation from 2011/12 onwards. Although departing from a significantly higher deficit in 2009/10, the measures announced in the 2009 budget imply a narrowing in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, averaging close to 1¼ pp. per annum between 2010/11 and 2013/14. This is around ¼% of GDP more per annum than in the 2008 update of the convergence programme and brings the medium-term reduction in the structural deficit in line with the Council recommendation on 27 April 2009 of an average annual fiscal effort clearly beyond 1% of GDP.

The increase in the planned pace of medium-term consolidation is driven by a sizeable reduction in planned spending growth throughout the period from April 2011 to March 2014. The revised spending plans imply in real terms a freeze in total spending between 2011/12 and 2013/14, compared to an average annual increase of 1.1% in the 2008 convergence programme. In nominal terms this implies an annual average reduction in the expenditure ratio by ½ pp. of GDP per annum compared to the baseline implied by the 2008 convergence programme, almost equally divided between current and investment spending.

On 29 October 2009 the UK authorities submitted a voluntary notification on the effective action taken in response to the Council recommendation of April 2009. The notification referred to the measures announced in the 2009 Budget and indicated that as a result of those measures the structural adjustment implied in the medium term is estimated to exceed that specified in the Council recommendation.

Overall, taking into account the action taken in line with the EERP and the economic developments and prospects compared to the outlook in the Commission services' January 2009 interim forecast, it can be concluded that the United Kingdom has taken effective action as required by the Council recommendation of 27 April 2009.

5. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

Since the United Kingdom authorities are considered to have taken effective action in compliance with the Council recommendations of 27 April 2009 under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in the United Kingdom, a revised deadline for the United Kingdom is justified.

Against this background, it is appropriate to consider a new deadline of 2014/15 at the latest for the correction of the excessive government deficit of the United Kingdom. This in particular takes into account the fact that given that the Commission services' autumn 2009 forecast projects a deficit in 2009/10 of 13.0% of GDP, the average annual structural adjustment that would be required to correct the excessive deficit situation if the deadline were maintained as 2013/14 would reach 2¼ pps. of GDP. A credible and sustainable adjustment path would nevertheless need to take into consideration the continued need to reduce the high primary deficit that carries risks to fiscal sustainability. The correction of the excessive deficit by 2014/15 would represent an average annual structural budgetary adjustment of 1¾ pps. of GDP between 2010/11 and 2014/15[6].

The 2009 Budget projections imply a narrowing in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, averaging close to 1¼ pps. per annum between 2010/11 and 2013/14. In 2010/11, the 2009 Budget projects a headline deficit of 12.0% of GDP and a reduction in the structural deficit by ½ pp. compared to the preceding year. The structural improvement reflects the government's policy announcements that in 2010 the temporary reduction in the standard VAT rate will be reversed and a reduction in capital expenditure will compensate for the spending increase in 2009.

Between 2011/12 and 2013/14, an increase in the revenue ratio by almost 1¾ pp. of GDP and a drop in the expenditure ratio by 4¾ pp. are expected to contribute to around one-fourth and three-fourths, respectively, of the target adjustment in the headline balance. In 2011/12, the increase in tax rates on income tax, social security contributions and duties are expected to account for around one-third of the structural adjustment envisaged for that year. No additional revenue-increasing discretionary measures have as yet been announced for subsequent years and the 2009 Budget's revenue growth projections in 2012/13 and 2013/14 imply an elasticity with respect to GDP that is consistent with the OECD ex-ante elasticity. On the expenditure side, the freeze in real government expenditure is estimated to account for two-thirds of the improvement in the structural balance in 2011/12 and for the entire planned structural consolidation in the subsequent two years. The 2009 Budget projections for

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[6] In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in the United Kingdom due consideration was given to the risk that the high government deficit could turn the debt position into an unsustainable one and that the government also assumed substantial contingent liabilities as a result of its financial sector interventions. In calculating the average annual adjustment, the 2011/12 deficit in the Commission services’ autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

expenditure between 2011/12 and 2013/14 are not yet backed by published departmental spending plans.

The Commission services' autumn 2009 forecast suggests that the budgetary projections presented by the UK authorities in the 2009 Budget programme are subject to downside risks, especially in 2011/12. The Commission services' autumn 2009 forecast projects a deficit in 2010/11 of 12½% of GDP and in 2011/12 of 10¾% of GDP, the latter around 1½ percentage points higher than projected in the 2009 Budget and primarily reflecting the Commission services' forecast of a significantly weaker recovery in economic activity in 2011/12. In order to achieve the correction of the excessive deficit by 2014/15 the government could have to step up the annual average consolidation effort currently planned between 2010/11 and 2013/14 by around ½ pp. of GDP, while ensuring an annual structural consolidation of 1¾ pp. of GDP in 2014/15.

As regards the long-term sustainability of public finances, the UK's budgetary position would pose challenges to sustainability, while the contribution to the sustainability imbalance from an ageing population is close to the EU average. Reducing the primary deficit would contribute to reducing the risk to the sustainability of public finances as defined by the Commission Communication[7] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[8] on 10 November 2009.

Government gross debt is projected by the UK authorities to increase from around 72% of GDP in 2009/10 to around 90% in 2013/14, primarily driven by the scale of the primary deficit. Once the economy recovers and financial sector conditions stabilise, the UK authorities could be expected to unwind, at least in part, the increase in debt due to financial sector interventions. In addition, the correction of the excessive deficit should contribute to a reduction in the debt ratio towards the 60% of GDP reference value.

In November 2008 the UK adopted a temporary fiscal operating rule: "*to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full*". The rule is apparently not applicable as long as the crisis persists. Once the UK economy emerges from the crisis, the rule will kick in, but it will impose only a relatively weak constraint in terms of minimum fiscal consolidation. A revised fiscal framework has to be credibly geared to delivering the needed consolidation, while ensuring that, after the excessive deficit has been corrected, budgetary consolidation is sustained.

Enhanced surveillance under the EDP, which seems necessary in view also of the relatively long period for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the United Kingdom convergence programme which will be prepared between 2009 and 2014 could usefully be devoted to this issue.

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[7] Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

[8] Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

Comparison of key macroeconomic and budgetary projections

		2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Real GDP (% change)	**COM Autumn 2009**	**2.5**	**-1.3**	**-3.3**	**1.2**	**2.3**	**n.a.**	**n.a.**
	2009 Budget	3.0	-1.0	-2¾	1¾	3¼	3¼	3¼
Output gap[1] (% of potential GDP)	**COM Autumn 2009[2]**	**2.3**	**0.3**	**-3.6**	**-3.4**	**-2.7**	**n.a.**	**n.a.**
	2009 Budget[3]	2.0	0.3	-4.2	-4.1	-2.7	-1.5	-0.2
General government balance (% of GDP)	**COM Autumn 2009**	**-2.8**	**-6.9**	**-13.0**	**-12.5**	**-10.7**	**n.a.**	**n.a.**
	2009 Budget	-2.8	-7.2	-12.7	-12.0	-9.3	-7.4	-5.9
Primary balance (% of GDP)	**COM Autumn 2009**	**-0.6**	**-4.7**	**-11.0**	**-9.4**	**-7.3**	**n.a.**	**n.a.**
	2009 Budget	-0.6	-5.0	-10.8	-9.0	n.a.	n.a.	n.a.
Cyclically-adjusted balance[1] (% of GDP)	**COM Autumn 2009**	**-3.8**	**-7.0**	**-11.5**	**-11.1**	**-9.6**	**n.a.**	**n.a.**
	2009 Budget	-3.8	-7.1	-10.9	-10.4	-8.2	-6.8	-5.9
Structural balance[4] (% of GDP)	**COM Autumn 2009**	**-3.8**	**-6.3**	**-11.5**	**-11.1**	**-9.6**	**n.a.**	**n.a.**
	2009 Budget	-3.8	-6.4	-10.9	-10.4	-8.2	-6.8	-5.9
Government gross debt (% of GDP)	**COM Autumn 2009**	**43.3**	**55.5**	**71.7**	**81.9**	**89.0**	**n.a.**	**n.a.**
	2009 Budget	43.2	55.2	71.9	82.1	87.2	89.9	90.7

Notes:

[1] Output gaps and cyclically-adjusted balances from the 2009 Budget as recalculated by the Commission services on the basis of the information in the 2009 Budget.
[2] Based on estimated potential growth of 1.9%, 1.4%, 0.8%, 0.8% and 1.2% respectively in the period 2007-2011.

[3] Based on estimated potential growth of 2.3% in 2007, 2.1% in 2008, 1.6% in 2009, 1.6% in 2010, 2.0% in 2011, 2.1% in 2012, 2.2% in 2013 and 2.2% in 2014.

[4] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are estimated at 0.7% of GDP for 2008/09 (deficit-increasing) according to the Commission services' autumn 2009 forecast.

Source:
2009 Budget; Commission services' autumn forecasts (COM); Commission services' calculations.

Recommendation for a

COUNCIL RECOMMENDATION TO THE UNITED KINGDOM

with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the recommendation from the Commission;

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) Pursuant to point 5 of the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the obligation in 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[9]. While in the second stage of economic and monetary union, the United Kingdom shall endeavour to avoid excessive deficits, pursuant to Article 116(4) of the Treaty.

(3) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) On 8 July 2008 the Council decided, in accordance with Article 104(6), that an excessive deficit exists in the United Kingdom and issued recommendations to correct the excessive deficit by financial year 2009/10 at the latest, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[10]. The Council also set a deadline of 8 January 2009 for effective action to be taken.

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9 OJ C 321 E, 29.12.2006, p. 299.

10 OJ L 209, 2.8.1997, p. 6.

(6) According to the provisions under Article 104(8) the Council decided on 27 April 2009 that in a context of progressively weakening economic conditions the United Kingdom had not taken action in response to the Council recommendation of 8 July 2008. In accordance with Article 104(7) and on a recommendation by the Commission, it addressed new recommendations to the United Kingdom with a view to bringing an end to the excessive government deficit situation by 2013/14. This implied an average annual fiscal effort of clearly beyond 1% of GDP over the period between 2010/11 and 2013/14. In these new recommendations, the Council established the deadline of 27 October 2009 for effective action to be taken.

(7) According to Article 3(5) of Council Regulation (EC) No 1467/97, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of Regulation (EC) No 1467/97, to adopt a revised recommendation under Article 104(7).

(8) The January 2009 interim forecast of the Commission services, on which the recommendation of 27 April 2009 was based, had projected a contraction in real GDP by around 2.3% in financial year 2009/10, following expected growth of 0.6% in 2008/09. The actual rate of output contraction in 2008/09, at -1.3%, was double that forecast in January, following the sharpest quarterly loss of GDP recorded in over fifty years in the first quarter of 2009. The latter contributed to a sharp drop in government receipts in the final months of 2008/09, which is expected to feed-through into a higher deficit in 2009/10 by around ½% of GDP. According to the Commission services' autumn 2009 forecast, the contraction in economic activity in 2009/10, at -3.3%, will be 1 pp. deeper than envisaged in January 2009, as a result of a further deterioration in the outlook for domestic demand, and the government deficit in 2009/10 will reach 13% of GDP. The impact of the deeper-than-expected contraction on the government deficit is estimated to be significantly more than what the standard budget elasticity with respect to the output gap would imply, primarily due to the association of the recession with severe downturns in financial and housing markets, each of which had been hitherto major sources of revenue. Although higher-than-expected inflation will cushion the contraction in the tax base for indirect tax revenues, its overall impact on public finances is estimated to be negative. In view of the above, unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred after adoption of the recommendation under Article 104(7).

(9) Consistent with the Council's recommendations under Art. 104(7) of 27 April 2009, the UK authorities confirmed the increase in 2010 in the standard VAT rate to its pre-fiscal stimulus level, which will increase revenue by 0.6% of GDP in 2010/11, while a reduction in capital expenditure by 0.2% of GDP in 2010/11 will compensate for the discretionary spending increase in 2008 and 2009. The UK authorities also target expenditure savings of 0.3% of GDP in 2010/11 through efficiency gains. Additional revenue from an increase in the income tax rate on high incomes and a rise in fuel duty rates is expected to be offset by a temporary increase in the budget allocation for employment schemes. The 2009 Budget, which was presented to parliament on 22 April, also included plans for more ambitious fiscal consolidation from 2011/12 onwards. Although departing from a significantly higher deficit in 2009/10 than in the

2008 update of the convergence programme as a result of the deeper-than-expected contraction, the measures announced in the 2009 Budget imply a narrowing in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, averaging close to 1¼ pp. per annum between 2010/11 and 2013/14. This is around ¼% of GDP more than in the 2008 programme and brings the medium-term reduction in the structural deficit in line with the Council recommendation on 27 April 2009 of an average annual fiscal effort clearly beyond 1% of GDP. The increase in the planned pace of medium-term consolidation is driven by a freeze in total government spending in real terms between 2011/12 and 2013/14. In view of the above, the United Kingdom authorities can be considered to have taken effective action.

(10) Since the United Kingdom authorities are considered to have taken effective action in compliance with the Council recommendations of 27 April 2009 under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in the United Kingdom, a revised deadline for the United Kingdom is justified.

(11) Against this background, it is appropriate to consider a new deadline of 2014/15 at the latest for the correction of the excessive government deficit of the United Kingdom. This in particular takes into account the fact that given that the Commission services' autumn 2009 forecast projects a deficit in 2009/10 of 13.0% of GDP, the average annual structural adjustment that would be required to correct the excessive deficit situation if the deadline were maintained as 2013/14 would reach 2¼ pps. of GDP. A credible and sustainable adjustment path would nevertheless need to take into consideration the continued need to reduce the high primary deficit that carries risks to fiscal sustainability. The correction of the excessive deficit by 2014/15 would represent an average annual structural budgetary adjustment of 1¾ pps. of GDP between 2010/11 and 2014/15[11].

(12) With the government's latest fiscal projections implying a reduction in the structural deficit by an annual average of close to 1¼ pp. between 2010/11 and 2013/14, the UK authorities could achieve the average annual structural budgetary adjustment implied by the 2014/15 deadline by increasing the planned consolidation effort between 2010/11 and 2013/14 by around ½ pp. of GDP, while ensuring that an annual structural consolidation of at least 1¾ pp. of GDP is also achieved in 2014/15. On the expenditure side, the planned freeze in real government expenditure, which is

[11] In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in the United Kingdom due consideration was given to the risk that the high government deficit could turn the debt position into an unsustainable one and that the government also assumed substantial contingent liabilities as a result of its financial sector interventions. In calculating the average annual adjustment, the 2011/12 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

estimated to account for two-thirds of the targeted improvement in the structural balance in 2011/12 and for the entire planned structural consolidation in the subsequent two years, is not yet backed by detailed departmental spending plans. The Commission services' autumn 2009 forecast suggests that the budgetary projections presented by the UK authorities in the 2009 Budget are subject to downside risks, especially in 2011/12. The Commission services' autumn 2009 forecast projects a deficit in 2010/11 of 12½% of GDP and in 2011/12 of 10¾% of GDP, the latter around 1½ percentage points higher than projected in the 2009 Budget and primarily reflecting the Commission services' forecast of a significantly weaker recovery in economic activity in 2011/12.

(13) As regards the long-term sustainability of public finances, the UK's budgetary position would pose challenges to sustainability, while the contribution to the sustainability imbalance stemming from an ageing population is close to the EU average. Reducing the primary deficit would contribute to reducing the risk to the sustainability of public finances as defined by the Commission Communication[12] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[13] on 10 November 2009.

(14) Government gross debt is projected by the UK authorities to increase from around 72% of GDP in 2009/10 to around 90% in 2013/14, chiefly driven by the scale of the primary deficit. Once the economy recovers and financial sector conditions stabilise, the UK authorities could be expected to unwind, at least in part, the increase in debt due to financial sector interventions, which in the 2009 Budget amounts to around 6% of GDP. The correction of the excessive deficit would contribute to a reduction in the debt ratio towards the 60% of GDP reference value, thereby improving the long-term sustainability of UK public finances.

(15) In November 2008 the UK adopted a temporary fiscal operating rule: "*to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full*". The rule is not intended to be applied as long as the crisis persists. Once the UK economy emerges from the crisis, the rule will begin to be applied, but given the scale of fiscal deterioration, will impose only a weak constraint in terms of minimum fiscal consolidation. The fiscal framework has to be credibly geared to delivering the needed consolidation, while ensuring that, after the excessive deficit has been corrected, underpins sustained budgetary consolidation.

(16) Enhanced surveillance under the EDP, which seems necessary also in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the United Kingdom convergence programme which will be prepared between 2009 and 2014 could usefully be devoted to this issue.

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12 Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

13 Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

(17) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

(18) In addition, in view of the importance of achieving a medium-term budgetary objective that provides an adequate safety margin against cyclical downturns and ensures convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, the UK should also ensure that budgetary consolidation is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

(1) Recognising that the United Kingdom's budgetary position in 2009/10 resulted from the implementation of measures amounting to around 1½% of GDP, which were an appropriate response to the European Economic Recovery Plan, and the free play of automatic stabilisers, the United Kingdom's authorities should put an end to the present excessive deficit situation by 2014/15.

(2) The United Kingdom authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the United Kingdom authorities should:

  (a) implement the fiscal measures in 2009/10 as planned in the 2009 Budget, avoiding further measures contributing to the deterioration of public finances, and start consolidation in 2010/11 in order to bring the deficit below the reference value by 2014/15;

  (b) to this end ensure an average annual structural budgetary adjustment of 1¾% of GDP between 2010/11 and 2014/15, which should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus;

  (c) further specify the additional measures that are necessary to achieve the correction of the excessive deficit by 2014/15 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected;

(3) In addition, the United Kingdom's authorities should seize any opportunity beyond the structural adjustment to accelerate the reduction of the gross debt ratio back towards the reference value.

(4) The United Kingdom should ensure that its revised fiscal framework limits the risks to the adjustment and, after the excessive deficit has been corrected, underpins sustained budgetary consolidation.

(5) The Council establishes the deadline of [2 June 2010] for the United Kingdom government to implement the fiscal measures as planned in the 2009 Budget and to outline the additional measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The United Kingdom authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes which will be prepared between 2009 and 2014.

Furthermore, the Council invites the United Kingdom's authorities to implement reforms with a view to raising potential GDP growth. This includes reforms conducive to enhancing the quality of public finances, in particular those consistent with achieving the expenditure efficiency savings identified by the Operational Efficiency Programme by 2013/14, as well as reforms that improve skill levels and raise productivity.

This recommendation is addressed to the United Kingdom of Great Britain and Northern Ireland.

Done at Brussels,

For the Council
The President