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Assessment of the action taken by the United Kingdom in response to the Council Recommendations of 2 December 2009 with a view to bringing an end to the situation of excessive government deficit

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

The vast majority of EU countries currently have general government deficits above the 3% of GDP reference value set in the Treaty on the Functioning of the European Union (TFEU). The origin of 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 brought 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. The Plan stipulated that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness. Finally, several countries took 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, although some of the costs of the government support could be recovered in the future.

In October 2009, capitalizing on the first signs of a recovery in sight, the European Council endorsed a fiscal exit strategy based on the following principles: (i) The exit strategy should be coordinated across countries in the framework of consistent implementation of the Stability and Growth Pact. (ii) There is a need for timely withdrawal of the fiscal stimulus. Provided that the Commission forecasts continue to indicate that the recovery is strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest. Specificities of country situations should be taken into account, and a number of countries need to consolidate before then. (iii) In view of the challenges, the planned pace of the fiscal consolidation should be ambitious, and will have to go well beyond the benchmark of 0.5% of GDP per annum in structural terms in most Member States. (iv) Important flanking policies to the fiscal exit will include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term fiscal sustainability, as emphasised by the SGP. In addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. These principles for fiscal exit have been put into operation in the recommendations issued in the context of the excessive deficit procedures as well as in the latest round of annual assessment of Stability and Convergence Programmes. The deadlines for correction and required structural efforts have been differentiated across Member States, taking into account country-specific circumstances.

The stimulus measures in the context of the EERP coupled with the measures taken to stabilise the financial sector have prevented an economic meltdown and laid the foundation for a recovery. The Commission services' spring 2010 forecast confirms the outlook of gradual recovery consistent with withdrawal of fiscal stimulus. Indicators point towards a self-sustaining recovery at the end of 2010 and into 2011. However, significant risks remain linked to the situation in financial markets and the potential negative feedback loop between sovereign debt evolution and the banking sector. The following assessment of action taken by the United Kingdom in response to the recommendations of 2 December 2009 takes place against the background outlined above.

2. EXCESSIVE DEFICIT PROCEDURE AND MOST RECENT RECOMMENDATIONS

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.

On 8 July 2008, the Council decided that an excessive deficit existed in the United Kingdom in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). The most recent Council Recommendation under Article 126(7) of the Treaty on the Functioning of the European Union (TFEU) was adopted on 2 December 2009[1].

The Council recommended the United Kingdom to put an end to the present excessive deficit situation by financial year 2014/15[2]. According to the Council Recommendation, 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 fiscal effort 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.

In addition, the United Kingdom authorities were recommended to seize opportunities beyond the fiscal effort, including from better economic conditions, to accelerate the reduction of the gross debt ratio back towards the reference value. 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.

The Council established 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 in some detail the consolidation strategy 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.

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[1] All EDP-related documents for the United Kingdom can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm.

[2] The UK financial year runs from April to March.

According to Regulation (EC) No 1467/97[3] and the revised Code of Conduct[4] a Member State should be considered to have taken effective action if it has acted in compliance with the Article 126(7) TFEU 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.

Following the general election of 6 May 2010, the new government quickly announced the intention to present an Emergency Budget, which was adopted on 22 June 2010. This assessment also takes the latter into account.

3. ASSESSMENT OF ACTION TAKEN

The Commission services' latest macroeconomic forecast, which was published on 5 May 2010, is broadly similar to the economic outlook envisaged in autumn 2009, on which the December 2009 Council recommendations were based. In financial year 2009/10 output contracted by ½ pp. more than had been expected in autumn 2009, in part due to a negative impact from poor weather in the first quarter of 2010. By contrast, in 2010/11 the spring 2010 forecast projects a stronger pick up in output. Real output growth in 2010/11 is expected to reach 1¾%, up by ½ pp. when compared to the autumn forecast, primarily reflecting prospects for positive growth in household consumption expenditure. An upward revision in the forecast for consumer price inflation further contributed to an increase in the projection for nominal GDP growth in 2010/11 by ¾ percentage point, although inflation is estimated to have a broadly neutral impact on public finances in the UK. The spring 2010 forecast confirmed the autumn 2009 projection of an expansion in real activity in 2011/12 of 2¼%.

The spring 2010 forecast projected a reduction in the government deficit from an estimated 12¼% of GDP in 2009/10 to 11½% in 2010/11. The reduction in the government deficit in 2010/11 was driven by discretionary measures amounting to around 1% of GDP. In particular, the increase in the standard VAT rate as from January 2010 to its pre-fiscal stimulus level was estimated to increase revenue in 2010/11 by 0.6% of GDP, while a reduction in capital expenditure by 0.2% of GDP would compensate for the forward shifting of planned public investment from 2010/11 to 2008/09 and 2009/10 to support the economy during the recession. The spring 2010 forecast also took into account planned expenditure efficiency savings of 0.3% of GDP in 2010/11, which had been announced in April 2009 and which primarily relate to health spending. It estimated that the structural budget deficit in 2010/11 would decline by only ¼% of GDP from 2009/10, inter alia reflecting low revenue elasticity as a result of continued weak activity in the financial and housing markets, each of which had hitherto been major sources of revenue.

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[3] OJ L 209, 2.8.1997, p. 6.

[4] "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 10 November 2009, available at: http://ec.europa.eu/economy_finance/sgp/deficit/legal_texts/index_en.htm.

Since the release of the spring 2010 forecast, a new initiative was taken on 17 May concerning the provision of independent forecasts in the UK, the UK government has published a significantly downwardly revised estimate of the government deficit outcome for 2009/10 on 21 May 2010, new measures reducing government expenditure were announced on 24 May and 17 June 2010, and an Emergency Budget was presented to parliament on 22 June.

Following the formation of a new coalition government after the general elections, the UK authorities announced on 17 May 2010 the establishment of a new Office for Budget Responsibility (OBR) that will "provide independent forecasts for public finances and the economy to inform fiscal policy decisions". The Chancellor has said that he will use the forecasts to inform the government's policy decisions. The OBR will also "assess the prospects for achieving the fiscal policy mandate, to be determined by the Chancellor".

On 24 May 2010 the government announced with immediate effect new spending cuts primarily consisting of lower budgets for several government departments and a freeze on civil service recruitment. These cuts in discretionary expenditure should reduce the deficit by 0.4% of GDP in the current financial year 2010/11, while in 2011/12 will compensate for the non-implementation of the increase in social security contribution rates that had been planned by the previous government. Also on 17 June, the government announced that, as part of a review of spending decisions taken by the previous government since 1 January 2010, it was cancelling a number of projects costing 0.1% of GDP and suspending projects, primarily related to defence and transport, which would have cost 0.6% of GDP over their lifetime.

According to the public finances data published on 18 June 2010, which were consistent with the data published by the UK statistical office on 21 May 2010, the government deficit in 2009/10 would amount to 11.3% of GDP. While this is some 1¾ percentage points of GDP less than had been projected in the autumn 2009 forecast and almost 1 pp. lower than estimated in the spring 2010 forecast[5], the deficit remains amongst the highest in the EU. In turn, the better-than-expected deficit outturn, which was due to the economic contraction having a weaker-than-expected negative impact on tax intakes, should feed-through into a lower deficit in 2010/11.

On 22 June 2010, the new government presented an "Emergency Budget". This announced substantial additional fiscal consolidation measures. The new measures are estimated by the OBR to reduce the government deficit by an additional 0.5% of GDP in the present financial year 2010/11, 1.0% of GDP in 2011/12, 1½% of GDP in 2012/13, and 2¼% of GDP by 2014/15. Taking into account the measures already announced in the March 2010 budget or earlier, which are estimated to total 4.0% of GDP by 2014/15, and the new measures announced in the June 2010 Budget, the OBR projects a reduction in the deficit from 11.3% of GDP in 2009/10 to 10¼% in 2010/11 and 7¾% in 2011/12. By 2014/15 - the deadline set for the UK in the December 2009 Council Recommendation - the deficit is projected by the OBR to reach 2¼% of GDP, compared to 4¼% of GDP based on policy as announced in the pre-election March 2010 Budget. The OBR considers the probability of this target being achieved is higher than 50%. The government debt ratio is plausibly projected by the OBR to peak at around 85% of GDP in 2012/13, before falling to almost 80% of GDP in 2015/16.

[5] The data were published subsequent to the publication on 22 April 2010 of government finance statistics. Thus, the latest deficit estimate for 2009/10 is based on data that have not yet been validated by Eurostat.

The new measures announced in the June 2010 Budget will contribute to an improvement in the estimated structural budget balance, as re-estimated using the commonly-agreed methodology, in 2010/11 by ¾% of GDP and between 2010/11 and 2014/15 by an annual average of around 1½% of GDP. This is slightly lower than recommended by the Council in December 2009 (1¾% of GDP) but is nevertheless appropriate given that the effort is being pursued from a significantly lower-than-expected budget deficit in 2009/10 (11.3% of GDP compared to 13.0% in the autumn 2009 forecast) and is therefore consistent with reducing the headline deficit to well-below the reference value by 2014/15.

Around three-quarters of the new fiscal tightening is planned to be achieved through a reduction in discretionary expenditure, including through a cut in departmental budgets - excluding those for health and overseas aid - of 25% in real terms on average over a four-year period, a two-year public sector pay freeze, and a reduction in welfare benefits. A Spending Review announced for 20 October 2010 will set out individual departmental spending limits for the whole term of the present parliament. The additional revenues will come mostly from an increase in the main VAT rate as from January 2011 from 17½% to 20%, raising government revenue by 0.2% of GDP in 2010/11 and by around 0.8% of GDP per annum thereafter. A new bank levy, to be introduced as from January 2011, will increase tax intakes by 0.1% of GDP in 2011/12. On the other hand, a relatively large increase in income tax personal allowances and reductions in employers' social security contributions will lower revenue by a total of 0.4% of GDP as from 2011/12. The government also announced reductions in the main rate of corporation tax and in the tax rate for small companies, which are expected to reduce receipts from taxes on corporate profits by 0.2% of GDP from 2012/13.

Compared with both the January 2010 convergence programme and the 2010 Budget of March 2010, the macroeconomic projections in the June 2010 Emergency Budget, which were independently produced by the new Office for Budget Responsibility, are significantly more in line with the Commission services' spring 2010 forecast for 2010/11 and 2011/12 and with current consensus estimates for the period between 2012 and 2014. However, output growth may be weaker than expected in the Budget, including possibly as a result of a stronger demand impact of the additional measures and from a weaker external environment, which would have second-round effects on public finances. In addition to the macroeconomic risks, the size of the planned spending cuts will be a challenge to implement, which if not achieved would reduce the likelihood of compliance with the Council recommendation in the absence of compensatory measures. Overall, while risks are substantial, at this stage the UK appears to be on track to achieve a deficit below 3% of GDP by the recommended deadline, with the planned deficit of 2¼% of GDP in 2014/15 providing a buffer against slippages.

In the June 2010 Budget, the UK authorities also announced a new fiscal "mandate": "to achieve cyclically-adjusted current (i.e. net of capital spending) balance by the end of the rolling, five-year forecast period". This is complemented by a target requiring a reduction in net debt as a percentage of GDP by 2015/16. With a clearly identifiable end point and less scope for manipulation, the new mandate is a clear improvement over the previous golden rule. Although the definitions of the fiscal targets are not directly comparable as the deficit target does not take explicit account of capital spending and the debt target refers to net - rather than gross - debt, the approach in the new mandate should contribute to greater consistency with the EU framework.

4. CONCLUSIONS

On current information it appears that the United Kingdom has taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council. In particular, the measures announced in the June 2010 Emergency Budget will further increase the size of fiscal consolidation in 2010/11 and also significantly strengthen the planned pace of deficit reduction over the medium-term.

As a result of the measures announced in the June 2010 Budget, the deficit in 2014/15 - the deadline set for the UK in the December 2009 Council Recommendation - is forecast by the OBR to fall to 2¼% of GDP. Output growth in these forecasts is significantly more in line with the Commission services forecast than previously. The planned pace of consolidation is driven by lower discretionary expenditure. The publication of the Spending Review on 20 October 2010, providing detailed departmental spending limits to back-up the overall spending targets for the entire term of the present parliament, will be another important step in the efforts of the authorities to restore sustainable public finances in the UK. The size of the planned spending cuts will be a challenge to implement, which, if not achieved, would reduce the likelihood of compliance with the Council recommendation in the absence of compensatory measures. The new Office of Budget Responsibility and the new fiscal mandate announced by the UK authorities should however contribute to improve the fiscal framework and limit the risks to the adjustment. Although the definitions of the fiscal targets are not directly comparable as the deficit target does not take explicit account of capital spending and the debt target refers to net - rather than gross - debt, the approach in the new mandate should contribute to greater consistency with the EU framework. Overall, while there are risks, at this stage the UK appears to be on track to achieve a deficit below 3% of GDP by the recommended deadline.

In view of the above assessment, the Commission considers that no further steps in the excessive deficit procedure of the United Kingdom are needed at present. The Commission will continue to closely monitor budgetary developments in the United Kingdom in accordance with the Treaty and the SGP.

Comparison of key macroeconomic and budgetary projections

		2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Real GDP (% change)	**June 2010 Budget**	**-1.4**	**-3.7**	**1.8**	**2.4**	**2.9**	**2.8**	**2.7**	**2.7**
	COM Spring 2010	-1.4	-3.7	1.7	2.2	-	-	-	-
	Jan 2010 CP	-1.3	-3.5	2.0	3.3	3.3	3.3	3.3	-
Output gap [1] (% of potential GDP)	**June 2010 Budget**	**-1.0**	**-4.1**	**-3.7**	**-3.5**	**-2.8**	**-2.3**	**-1.6**	**-0.9**
	COM Spring 2010	0.3	-4.0	-3.7	-2.8	-	-	-	-
	Jan 2010 CP	0.0	-4.6	-4.4	-2.8	-1.5	-0.4	0.5	-
General government balance[2] (% of GDP)	**June 2010 Budget**	**-6.8**	**-11.3**	**-10.2**	**-7.7**	**-5.7**	**-3.7**	**-2.3**	**-1.3**
	COM Spring 2010	-6.8	-12.2	-11.5	-9.4	-	-	-	-
	Jan 2010 CP	-6.9	-12.7	-12.1	-9.2	-7.4	-5.6	-4.7	-
Primary balance (% of GDP)	**June 2010 Budget**	**-4.7**	**-9.1**	**-7.3**	**-4.7**	**-2.5**	**-0.3**	**1.2**	**2.2**
	COM Spring 2010	-4.7	-10.0	-8.6	-6.4	-	-	-	-
	Jan 2010 CP	-4.7	-10.5	-9.1	-5.7	-3.7	-1.8	-0.9	-
Cyclically-adjusted balance[1] (% of GDP)	**June 2010 Budget**	**-6.4**	**-9.6**	**-8.6**	**-6.2**	**-4.5**	**-2.7**	**-1.6**	**-0.9**
	COM Spring 2010	-6.9	-10.5	-10.0	-8.2	-	-	-	-
	Jan 2010 CP	-6.9	-10.8	-10.3	-8.0	-6.8	-5.5	-4.9	-
Structural balance[3] (% of GDP)	**June 2010 Budget**	**-5.7**	**-9.3**	**-8.6**	**-6.2**	**-4.5**	**-2.7**	**-1.6**	**-0.9**
	COM Spring 2010	-6.2	-10.2	10.0	-8.2	-	-	-	-
	Jan 2010 CP	-6.2	-10.5	-10.3	-8.0	-6.8	-5.5	-4.9	-
Government gross debt (% of GDP)	**June 2010 Budget**	**55.8**	**71.2**	**78.9**	**83.6**	**85.5**	**84.9**	**83.1**	**80.4**
	COM Spring 2010	55.8	71.4	80.9	87.9	-	-	-	-
	Jan 2010 CP	55.5	72.9	82.1	88.0	90.9	91.6	91.2	-

Notes:

[1] Output gaps and cyclically-adjusted balances according to the programme/Budget as recalculated by Commission services on the basis of the information in the programme/Budget.

[2] General government deficit adjusted for UMTS receipts in line with Eurostat decision. Typically, this increases the deficit figure by 0.1 percentage point compared to the figure published in the official Budget documents.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source:

June 2010 Budget; Commission services' spring 2010 forecasts (COM); UK January 2010 Convergence Programme (CP); Commission services' calculations