COUNCIL OF
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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	COUNCIL RECOMMENDATION to the United Kingdom with a view to bringing an end to the situation of an excessive government deficit

COUNCIL RECOMMENDATION

of

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 on the Functioning of the European Union, and in particular Article 126(7) in conjunction with Article 126(13) thereof;

Having regard to the recommendation from the Commission;

Whereas:

(1) According to Article 126(1) of the Treaty on the Functioning of the European Union Member States shall avoid excessive government deficits.

(2) Pursuant to paragraph 4 of the Protocol (No 15) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the obligation in Article 126(1) of the Treaty on the Functioning of the European Union to avoid excessive general government deficits does not apply to the United Kingdom unless it adopts the euro[1]. Paragraph 5 of the Protocol provides that the United Kingdom shall endeavour to avoid an excessive government deficit.

(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.

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[1] OJ C 321 E, 29.12.2006, p. 299.

(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 excessive deficit procedure (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) of the Treaty establishing the European Community, 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 establishing the European Community and Article 3 of Council Regulation (EC) No 467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1]. The Council also set a deadline of 8 January 2009 for effective action to be taken.

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

(6) In accordance with the provisions of Article 104(8) of the Treaty establishing the European Community 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) of the Treaty establishing the European Community 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) Regulation (EC) No 1467/97 (which is part of the Stability and Growth Pact) establishes provisions for the implementation of Article 104 of the Treaty establishing the European Community, which has become Article 126 of the Treaty on the Functioning of the European Union. According to Article 3(5) of 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 126(7) of the Treaty on the Functioning of the European Union .

(8) The Council agreed on 20 October 2009 that, 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, that specificities of country situations should be taken into account, and that a number of countries need to consolidate before then.

(9) 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 50 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 percentage point 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 is projected to 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 direct and 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) of the Treaty establishing the European Community.

(10) Consistent with the Council's recommendations of 27 April 2009 under Article 104(7)of the Treaty establishing the European Community, the United Kingdom 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, which is the result of the bringing forward of planned public investment from 2010/11 to 2008/09 and 2009/10 to support the economy, will compensate for the discretionary spending increase in 2008 and 2009. The United Kingdom 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 percentage points 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 of 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 largely driven by constant total government spending in real terms between 2011/12 and 2013/14. In view of the above, and taking account of the European Economic Recovery Plan (EERP), the United Kingdom authorities can be considered to have taken effective action.

(11) 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) of the Treaty establishing the European Community 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.

(12) 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 fiscal effort that would be required to correct the excessive deficit situation if the deadline were maintained as 2013/14 would reach 2¼ percentage points 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 fiscal effort of 1¾ percentage points of GDP between 2010/11 and 2014/15[1].

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[1] In line with the initial recommendations under Article 104(7) of the Treaty establishing the European Community issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual fiscal effort is recommended. As in the initial recommendations the required fiscal effort should take into account 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, if not checked in a timely manner, 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 fiscal effort, the 2011/12 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total fiscal effort 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.

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

(14) As regards the long-term sustainability of public finances, the United Kingdom's budgetary position, if not checked in a timely manner, 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[1] on "Long-term sustainability of public finances for a recovering economy" and discussed by the ECOFIN Council[2] on 10 November 2009.

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

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

(15) Government gross debt is projected by the United Kingdom 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 United Kingdom authorities could be expected to unwind, at least in part, the increase in debt due to financial sector interventions, which, according to the classification decisions made by the United Kingdom Office for National Statistics, amounts to around 6 % of GDP. To aid transparency, the United Kingdom authorities have set out a provisional estimate that eventual losses on financial sector interventions may lie within a potential range from 1½ % of GDP to 3½ % of GDP, and has set policy on a forecast that incorporates the high end of this range. 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 the United Kingdom's public finances.

(16) In November 2008 the United Kingdom 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 United Kingdom 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. The government has announced its intention for a plan for fiscal consolidation to be set in legislation through a Fiscal Responsibility Act within the current Parliamentary session. The government is expected to set out more detail in the Pre-Budget Report on 9 December 2009.

(17) 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.

(18) 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.

(19) 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 United Kingdom 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 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 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;

(3) In addition, the United Kingdom authorities should 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.

(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 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.

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 2010 and 2014.

Furthermore, the Council invites the United Kingdom 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.

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

Done at Brussels,

For the Council
The President