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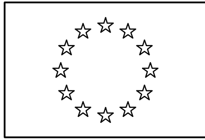

EUROPEAN COMMISSION

Brussels, 17.03.2010
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Recommendation for a

COUNCIL OPINION

on the updated convergence programme of the United Kingdom, 2009/10-2014/15

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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. The 2005 reform of the Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

In accordance with the Regulation, the Council delivered an opinion on the first convergence programme of the United Kingdom on 8 February 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of the United Kingdom, submitted on 28 January 2010, and has adopted a recommendation for a Council Opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");

(2) the conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy";

(3) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure);

(4) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council Opinion on the previous update of the convergence programme).

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[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of €170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions.

The Council agreed on the following principles of the fiscal exit strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) taking country-specific circumstances into account, timely withdrawal of fiscal stimulus was needed; provided that the Commission forecasts continued to indicate that the recovery was strengthening and becoming self-sustaining, fiscal consolidation in all EU Member States should start in 2011 at the latest; (iii) in view of the challenges, the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) important flanking policies to the fiscal exit would include strengthened national budgetary frameworks for underpinning the credibility of consolidation strategies and measures to support long-term

[2] Communication from the Commission to the European Council of 26 November 2008.

fiscal sustainability; in addition, structural reform efforts should be strengthened to enhance productivity and to support long-term investment. The Council agreed that these elements should be reflected in the stability and convergence programmes, to be transmitted by Member States to the Commission by the end of January 2010.

2.3. The excessive deficit procedure for the United Kingdom

On 8 July 2008 the Council adopted a decision stating that the United Kingdom had an excessive deficit in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). At the same time, the Council addressed a recommendation under Article 104(7) TEC specifying that the excessive deficit had to be corrected by 2009/10. On 27 April 2009, 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) TEC, it addressed new recommendations with a view to bringing an end to the excessive government deficit situation by 2013/14.

On 2 December 2009 the Council, following a recommendation by the Commission, considered that action had been taken in accordance with the recommendations, but unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the recommendation. In accordance with Article 126(7) of the Treaty on the functioning of the European Union (TFEU), the Council issued new recommendations to correct the deficit by 2014/15. The Council also recommended that: “(t)he 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; 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 were also asked to “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”.

2.4. The assessment in the Council Opinion on the previous update

In its opinion of 10 March 2009, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2008/09-2013/14, as follows. The Council considers "that the programme confirms a rapid deterioration in the United Kingdom's budgetary position, which has strained the sustainability of UK public finances. The probably significantly weaker-than-envisaged macro-economic context in the near term carries the risk of a higher government deficit throughout the programme period. After the expansionary fiscal measures in 2009/2010 the programme envisages sustained fiscal tightening from 2010/2011 onwards, but there are risks to the achievement of this consolidation. These reflect the possibility of an extension of the stimulus measures to 2010 in the absence of a significant economic recovery, weaker revenue elasticities, and risks to the achievement of spending targets. Taking into account the probability of a worse-than-expected deterioration in the UK's budgetary position in the near term and the heightened risks to fiscal sustainability, there is a need for a more ambitious consolidation effort in the medium term." In view of this assessment, the Council invited the United Kingdom to: "(i) implement the fiscal plans, including the stimulus measures in line with the EERP and within the framework of the SGP, while avoiding any further deterioration of public finances; (ii) implement a significant budgetary consolidation in 2010/2011 and beyond, and further specify measures underpinning the adjustment, to ensure that the deficit is rapidly brought below the reference value; (iii) set out how the fiscal framework will be applied in the future, consistent with an improvement of the long-term sustainability of its public finances".

Recommendation for a

COUNCIL OPINION

on the updated convergence programme of the United Kingdom, 2009/10-2014/15

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[3], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [22 April 2010] the Council examined the updated convergence programme of the United Kingdom, which covers the period 2009/10 to 2014/15.

(2) The economic and financial crisis, which began in 2007 after several years of strong growth, saw UK economic output fall cumulatively by around 6%, with only very subdued recovery starting to appear in the final quarter of 2009. The crisis was preceded and partly aggravated by a period of progressive increases in leverage of the household and financial sectors, such that a dependence on net capital inflows was large and persistent. In response to the unfolding crisis, the Bank of England responded with an aggressive programme of interest rate reductions, liquidity support for the banking sector and, from March 2009, quantitative easing. The government also intervened extensively to stabilise the financial system, including by major equity injections, deposit guarantees and the provision of liability insurance. In line with the EERP, the government implemented a sizeable fiscal stimulus, which in combination with the operation of automatic stabilisers and the effects on revenue of falls in asset prices contributed to a major deterioration in public finances. The weakening of the sustainability of UK public finances was aggravated by the fact that the primary balance was already in substantial structural deficit in the period leading up to the crisis, leading to the general government headline deficit soon going well above the 3% of GDP reference value as the crisis unfolded. Accordingly, the United Kingdom was made subject to an excessive deficit procedure on 8 July 2008 and on 2 December 2009 the Council issued the latest recommendations in accordance with Article 126(7) of the Treaty on the functioning of the European Union (TFEU) to correct the deficit by 2014/15. The main challenges for the UK economy over the

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

next years are to stabilise the public finances in the context of ongoing efforts by the household sector to reduce outstanding gearing; to achieve adequate levels of credit provision from a still fragile financial system, with many credit providers having reduced their lending capacity; and to underpin a shift of production towards greater tradeable output so as to permanently improve its external balance.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for the United Kingdom it is important to undertake reforms that improve skill levels and raise productivity.

(4) The programme contains two macroeconomic scenarios: a central scenario and a more cautious alternative scenario based on trend growth one quarter of a percentage point lower than the central view. The public finance projections are based on the alternative scenario, which is considered the reference scenario in the assessment of the updated programme. This scenario envisages a recovery in GDP growth to 2% in 2010/11 and to 3¼% per annum between 2011/12 and 2014/15. However, as a result of recent data now even this more cautious scenario, finalised in early December 2009, appears to be based on favourable growth assumptions, notably for the years 2010/11 and 2011/2012.[4] The projections for inflation appear realistic. The programme does not include explicit exchange rate forecasts, and assumes a positive contribution to GDP growth from net trade, the stock cycle and – from 2011 onwards – domestic demand, in particular fixed investment and household spending. These assumptions are broadly plausible. The net trade contribution is in line with Commission forecasts although the negative net trade contribution in the second half of 2009 weighs negatively on these projections. A potential slowdown in disposable income growth due inter alia to an insufficient labour market recovery and a further increase in the household savings ratio constitute two downside risks to household spending.

(5) The programme estimates the general government deficit in 2009/10 at 12.7% of GDP. The significant deterioration from a deficit of 6.8% of GDP in 2008/09 reflects to a large extent the impact of the crisis on government finances. The fall in the government revenue ratio and the increase in the expenditure ratio in 2009/10, adjusted for the denominator effect from the sharp drop in nominal GDP, are estimated to have contributed around 45% and 55% respectively of the deterioration in the government deficit. The impact of the contraction in economic activity on public finances was magnified by the association of the recession with severe downturns in the financial and housing markets, each of which had been hitherto major sources of revenue. In addition, around one-quarter of the increase in the deficit in 2009/10 was brought about by the stimulus measures totalling 1½% of

[4] The assessment notably takes into account the Commission Services' autumn 2009 forecast, but also other information that has become available since then.

GDP which the government adopted in line with the European Economic Recovery Plan (EERP). However, the rapid deterioration in public finances severely weakened the UK's capacity to pursue a looser fiscal stance without compromising budgetary sustainability and calls for a rapid improvement in the budgetary position. In line with the exit strategy advocated by the Council, and with a view to correcting the excessive deficit by 2014/15 and returning to a sustainable public finance position, substantial fiscal tightening needs to be implemented from 2010/11 onwards.

(6) The update projects a year-on-year decline in the general government deficit ratio in 2010/11 by 0.6 percentage point, to 12.1% of GDP. The modest improvement in the government deficit entirely reflects a planned increase in government revenue by 6½% in nominal terms, around one-third of which is due to the increase in the VAT rate to its pre-stimulus level implemented in January 2010. On the other hand, government expenditure is projected to continue growing at a high, albeit slower, pace: up by around 4½% nominal and 2¼% in real terms over the preceding year and leaving the expenditure-to-GDP ratio unchanged from the previous year. Overall, the discretionary measures that will come into force in 2010/11, including those announced in the 2008 Pre-Budget Report of November 2008 and in the 2009 Budget of April 2009, will reduce the government deficit by around 1.0% of GDP. The structural balance, defined as the cyclically-adjusted balance net of one-off and other temporary measures, in 2010/11 is estimated to improve by even less, at ¼% of GDP. The estimated improvement in the structural budget deficit is significantly lower than the net effect of the above-mentioned discretionary measures, reflecting continued composition effects depressing overall revenue elasticity.

(7) The update does not present a medium-term objective for the budgetary position that would bring public finances on a sustainable path[5]. This is not in line with the requirements of the Stability and Growth Pact. The programme's medium-term fiscal strategy is significantly less ambitious than recommended by the Council under Article 126(7) on 2 December 2009 and not in conformity with the recommendation to reduce the deficit to below 3% of GDP by 2014/15. In particular, the government deficit in 2014/15 - the deadline set in the Council recommendation for the UK to bring the deficit below 3% of GDP - is projected at 4.7% of GDP. The annual average improvement in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, between 2010/11 and 2014/15 is estimated at only 1.0% of GDP, ¾ pp. less than recommended by the Council in December 2009. Around 60% of the 7½ pps. reduction of the government deficit ratio between 2011/12 and 2014/15 is due to the planned tightening in expenditure growth. Government primary expenditure during these years is planned to increase by an annual average of around 1½%, which implies a reduction in real terms by an annual average of ¾%. Almost one-quarter of the drop in the expenditure ratio between 2011/12 and 2014/15 is due to a reduction in investment spending. Revenue-increasing discretionary measures, including as from April 2011 a planned increase in social security contribution rates and in the rates of tax on high incomes,

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[5] The country-specific MTOs should take into account three components: i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

account for around 10% of the forecast reduction in the budget deficit from 2011/12 onwards, while around 30% of the improvement in the headline deficit is due to the cyclical recovery envisaged in the programme.

(8) The budgetary outcomes could turn out worse than projected in the programme over the whole period. The markedly favourable macroeconomic context envisaged in the programme carries risks for the fiscal projections in the programme. The Commission services' autumn 2009 forecast projects weaker economic growth in 2010/11 and 2011/12, while according to the Commission services' assessment the UK's annual economic growth between 2012/13 and 2014/15 is unlikely to reach 3¼% per annum, as the programme assumes. Lower-than-expected economic growth from 2011/12 onwards would lead to an overshoot of the government deficit projected in the programme. Whilst the government's medium-term consolidation programme is largely driven by the assumption of considerable and unprecedented primary expenditure restraint, for the years between 2011/12 and 2014/15 this assumption is not backed by detailed departmental expenditure plans (which currently extend only to the end of the 2010/11 financial year). The absence of detailed departmental spending limits to back-up the programme's aggregate expenditure assumptions represents a further critical source of uncertainty on the programme's medium-term fiscal plan. The sharp slowdown in medium-term spending growth that is targeted in the update implies considerable efficiency challenges as well as extensive reprioritisation for the public sector. In general, there are considerable implementation challenges attached to the hitherto unprecedented degree of planned expenditure restraint which will need to be sustained over a prolonged period. The United Kingdom has also assumed substantial contingent liabilities as a result of its financial sector interventions. Under its *Asset Protection Scheme,* the government has agreed to insure banking sector assets amounting to almost 20% of GDP. While the extent to which the insured loans and investments are at risk of default is subject to high uncertainty, the scheme could result in a net cost for government, thereby reducing the pace of fiscal consolidation.

(9) Government gross debt is estimated at around 73% of GDP in 2009/10, up from 55½% in the preceding year. Around three-fifths of the increase in the debt ratio in 2009/10 reflects the high primary deficit, while a stock-flow adjustment as a result of government borrowing to finance the purchase of banking sector equity and lending to commercial financial institutions contributed to a rise in the debt ratio by almost 3¾ percentage points. The debt ratio is projected to increase by a further 18¼ pps. between 2010/11 and 2014/15. By the latter year, the programme projects a stabilisation in the debt ratio at around 91½% of GDP, as the contribution to the debt ratio of high nominal GDP growth is expected to offset the increase in government debt due to the primary balance, which is set to remain in deficit by the end of the programme period, and interest payments, which are expected to increase from 2¼% of GDP in 2009/10 to almost 4% in 2013/14. The debt ratio is also subject to a number of risks over the programme period. On the positive side, the successful sale of banking sector equity acquired as a result of the government's financial sector interventions could be used to reduce government debt. Negative risks to the debt ratio mainly stem from the likelihood of higher-than-projected deficits and from an adverse GDP denominator effect as a result of lower real economic growth; the impact of possibly higher borrowing costs, from global or domestic market influences, should be relatively contained, given the UK's long maturity structure, although would still be unhelpful.

(10) Whereas the long-term budgetary impact of ageing is close to the EU average, the budgetary position in 2009 as estimated in the programme constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Achieving primary surpluses in the medium term together with structural reforms would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report[6] as high. The gross debt ratio is above the Treaty reference value over the whole programme period. Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary strategy envisaged in the programme, taken at face value and with no further policy change, would not be enough to stabilise the debt-to-GDP ratio by 2020.

(11) The *Fiscal Responsibility Act* (FRA), which was approved by Parliament on 10 February 2010, has established a statutory fiscal plan for the UK authorities. The FRA sets out a *Fiscal Consolidation Plan* (FCP) requiring that the government *"halves public sector net borrowing as a share of GDP over four years from its forecast peak in 2009-10. The Government is setting a target, in secondary legislation enabled by the Bill, for borrowing to be 5.5 per cent of GDP or less in 2013-14"*. The FCP also requires the government to: "*reduce borrowing as a share of GDP in each and every year from 2009-10 to 2015-16, and ensure that public sector net debt is falling as a share of GDP in 2015-16*". More specific spending control is exercised through a system of multi-year "spending reviews", setting out overall spending envelopes and department-by-department limits for predictable expenditure ("departmental expenditure limits"). However, public spending has not always been sufficiently contained, with *total* expenditure outturns between 2002/03 and 2008/09 on average exceeding the original ceilings set out in the spending reviews. The *Fiscal Responsibility Act* also requires the government "*to provide an explanation* (to Parliament) *if the targets are missed*". To reduce the risk of missing the targets, a mechanism to assess their realism and a contingency plan - to be implemented if the underlying assumptions and macroeconomic forecasts prove inaccurate - would be useful. Overall, while the FRA is a step in the right direction, the consolidation plan set out in the Act is significantly less ambitious than in the Council recommendation under Article 126(7) on 2 December 2009 and it is not consistent with a reduction of the deficit to below the 3% of GDP reference value by 2014/15.

(12) The sharp increase in the government expenditure ratio since 2000 underlines the need to ensure efficiency and cost effectiveness of public spending in the UK. During the three-year period covered by the 2007 Comprehensive Spending Review (CSR) (i.e. between 2008/09 and 2010/11), the UK government has committed itself to achieving further value-for-money savings of an additional 2½% of GDP. Around one-fifth of the latter represent savings the government plans to deliver over the 2007 CSR period, following the findings of its one-year long Operational Efficiency Programme (OEP), which examined operational spending in the public sector and

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[6] In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

revealed scope for annual efficiency savings of 1% of GDP by 2013/14 compared to 2007/08. Measuring the success of these ambitious and well-conceived efficiency initiatives will be an important step in demonstrating that they indeed enhance the quality of public finances, as well as limiting the scale of public spending. In that respect, the announced plans for the National Audit Office to evaluate the 2007 CSR savings should be welcomed. Furthermore, the strong focus under the Public Value Programme on achieving efficiency savings in the public health sector of around ½% of GDP per year by 2012/13 appears particularly justified, given that, since 2000, spending on the UK National Health Service has increased sharply and productivity has fallen, notwithstanding improvements in health outcomes.

(13) Overall, in 2010/11 the budgetary strategy set out in the programme is broadly consistent with the Council recommendations under Art. 126(7), particularly the starting of consolidation in that year. However, from 2011/12 onwards, the budgetary strategy is not consistent with the Council recommendations under Art. 126(7). In particular, even taken at face value the government deficit in 2014/15 - the deadline set in the December 2009 recommendation for the UK to correct its excessive deficit situation - is projected clearly above the 3% of GDP reference value (4.7% of GDP) and is furthermore subject to downside risks mentioned above. Moreover, the measures announced, subsequent to the Council recommendation, in the 2009 Pre-Budget Report of 9 December 2009, implied over the period between 2010/11 and 2012/13 a small fiscal loosening relative to the fiscal plans in the 2009 Budget of April 2009, which is inconsistent with the Council's recommendation to "*avoid*(*ing*) *further measures contributing to the deterioration of public finances*". The annual average improvement in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, between 2010/11 and 2014/15 is estimated at 1.0% of GDP, ¾ pp. less than recommended by the Council in December 2009. Given debt projections presented in the programme and the risks mentioned above, the budgetary strategy is also not sufficient to bring the debt-to-GDP ratio back on a downward path.

(14) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has significant gaps in the provision of required and optional data[7]. In its recommendations under Article 126(7) of 2 December 2009 with a view to bringing the excessive deficit situation to an end, the Council also invited the United Kingdom to report on progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit in a separate chapter in the updates of the convergence programme. The United Kingdom did not comply with this recommendation.

The overall conclusion is that the fiscal strategy in the convergence programme is not sufficiently ambitious and needs to be significantly reinforced to be consistent with the Council recommendations under Article 126(7) TFEU of 2 December 2009. The combination of the operation of automatic stabilisers, falls in asset prices and the fiscal stimulus has provoked a major deterioration in UK public finances. However, budgetary sustainability was further weakened by the fact that UK deficits were at risk of breaching the 3% of GDP reference value already in the period leading up to the crisis. A restrictive fiscal policy in

[7] In particular, the lack of labour market data has significantly complicated the recalculation of output gaps according to the commonly agreed methodology.

2010/11 is appropriate. A credible timeframe for restoring public finances to a sustainable position requires substantial additional fiscal tightening measures beyond those currently planned. With the greater part of the projected reduction in the deficit in the medium term driven by the tight overall spending envelope between 2011/12 and 2014/15, the absence of detailed departmental spending limits to back up those expenditure targets is a source of uncertainty. The achievement of the consolidation forecast by the UK authorities is further clouded by the likelihood that the macroeconomic context could be less favourable than envisaged by the authorities, as well as the uncertainties relating to the banking sector loans and investments insured by government. Taking into account the Commission services' medium-term debt projections until 2020, indicating that the budgetary developments envisaged in the programme are not enough to stabilise debt in the medium term, and the considerable negative risks to the UK fiscal projections, a more ambitious consolidation plan for the near and medium-term is required. Achieving primary surpluses in the medium term would also contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as high in the United Kingdom.

In view of the above assessment and also in the light of the recommendation under Article 126(7) TFEU of 2 December 2009, the United Kingdom is invited to:

(i) avoid any further measures contributing to the deterioration of public finances in 2010/11 and in the event of weaker economic growth than foreseen in the programme contain the government deficit in 2010/11 to at most that forecast in the January 2010 programme in case risks related to the fact that the macroeconomic scenario of the programme is more favourable than the scenario underpinning the Article 126(7) Recommendation materialise;

(ii) target a more ambitious reduction of the government deficit to less than the 3% of GDP Treaty reference value by 2014/15 at the latest, including by strengthening the planned pace of fiscal effort from 2011/12 onwards, and seize any further opportunities, including from better-than-expected economic and market conditions, to accelerate the reduction of the gross debt ratio towards the 60% of GDP reference value, thereby also improving the long-term sustainability of public finances;

(iii) publish in 2010 the detailed departmental spending limits underlying the overall expenditure projections for at least the three-year period beyond 2010/11;

(iv) implement the expenditure efficiency savings identified in the Operational Efficiency Programme (OEP) and in other value for money initiatives;

The United Kingdom is also invited to improve compliance with the data requirements of the code of conduct.

The United Kingdom is also invited to submit in time for the assessment of the effective action under the Excessive Deficit Procedure an addendum to the programme to report on progress made in the implementation of the Council Recommendation under Article 126(7) of 2 December 2009 and to outline in some detail the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit. The Council reiterates its invitation that all subsequent updates should also provide a chapter with this information as long as a Member State remains subject to an excessive deficit procedure.

Overview of key macroeconomic and budgetary projections

		2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Real GDP (% change)	**CP Jan 2010**	**-1.3**	**-3.5**	**2.0**	**3.3**	**3.3**	**3.3**	**3.3**
	COM Nov 2009	0.6	-4.6	0.9	1.9	n.a.	n.a.	n.a.
	CP Dec 2008	*-0.3*	*-0.5*	*2.0*	*3.0*	*3.0*	*3.0*	*n.a.*
HICP inflation (%)	**CP Jan 2010**	**3.8**	**2.3**	**2.0**	**1.5**	**1.8**	**2.0**	**2.0**
	COM Nov 2009	3.6	2.0	1.4	1.6	n.a.	n.a.	n.a.
	CP Dec 2008	*3.8*	*1.0*	*2.0*	*2.0*	*2.0*	*2.0*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Jan 2010**	**0.0**	**-4.6**	**-4.4**	**-2.8**	**-1.5**	**-0.4**	**0.5**
	COM Nov 2009[2]	0.4	-3.7	-3.5	-2.7	n.a.	n.a.	n.a.
	CP Dec 2008	*-0.5*	*-2.4*	*-2.1*	*-1.2*	*-0.4*	*0.2*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)[3]	**CP Jan 2010**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
	COM Nov 2009	-1.4	-2.2	-1.4	-0.7	n.a.	n.a.	n.a.
	CP Dec 2008	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government revenue (% of GDP)	**CP Jan 2010**[4]	**36.6**	**34.8**	**35.4**	**36.7**	**37.1**	**37.2**	**37.1**
	COM Nov 2009	41.9	38.4	39.2	39.8	n.a.	n.a.	n.a.
	CP Dec 2008	*36.7*	*35.5*	*36.6*	*37.3*	*37.7*	*38.0*	*n.a.*
General government expenditure (% of GDP)	**CP Jan 2010**[4]	**43.4**	**47.4**	**47.4**	**45.8**	**44.2**	**42.7**	**41.5**
	COM Nov 2009	49.0	51.2	51.5	50.3	n.a.	n.a.	n.a.
	CP Dec 2008	*42.2*	*43.7*	*43.7*	*42.9*	*42.1*	*41.4*	*n.a.*
General government balance (% of GDP)	**CP Jan 2010**	**-6.9**	**-12.7**	**-12.1**	**-9.2**	**-7.4**	**-5.6**	**-4.7**
	COM Nov 2009	-6.9	-13.0	-12.5	-10.7	n.a.	n.a.	n.a.
	CP Dec 2008	*-5.5*	*-8.2*	*-7.1*	*-5.6*	*-4.4*	*-3.4*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2010**	**-4.7**	**-10.5**	**-9.1**	**-5.7**	**-3.7**	**-1.8**	**-0.9**
	COM Nov 2009	-4.8	-11.0	-9.6	-7.5	n.a.	n.a.	n.a.
	CP Dec 2008	*-3.4*	*-6.4*	*-4.5*	*-2.6*	*-1.4*	*-0.3*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Jan 2010**	**-6.9**	**-10.8**	**-10.3**	**-8.0**	**-6.8**	**-5.5**	**-4.9**
	COM Nov 2009	-7.1	-11.5	-11.0	-9.6	n.a.	n.a.	n.a.
	CP Dec 2008	*-5.3*	*-7.2*	*-6.2*	*-5.1*	*-4.2*	*-3.5*	*n.a.*
Structural balance[5] (% of GDP)	**CP Jan 2010**	**-6.2**	**-10.5**	**-10.3**	**-8.0**	**-6.8**	**-5.5**	**-4.9**
	COM Nov 2009	-6.3	-11.4	-11.0	-9.6	n.a.	n.a.	n.a.
	CP Dec 2008	*-5.3*	*-7.2*	*-6.2*	*-5.1*	*-4.2*	*-3.5*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2010**	**55.5**	**72.9**	**82.1**	**88.0**	**90.9**	**91.6**	**91.2**
	COM Nov 2009	55.5	71.7	81.9	89.0	n.a.	n.a.	n.a.
	CP Dec 2008	*52.9*	*60.5*	*65.1*	*67.5*	*68.6*	*68.5*	*n.a.*

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 1.5%, 0.8%, 0.8% and 1.1% respectively in the period 2008-2011.

[3] Data for calendar years.

[4] Data for revenue and expenditure are not provided in the UK programme on a harmonised ESA95 basis for the general government sector. The data in the table are based on Table 2.7 of the *supplementary material* of the 2009 Pre-Budget Report. For the years between 2011/12 and 2014/15, general government revenue and expenditure figures are inferred from projections for the public sector.

[5] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are estimated at 0.7% of GDP in 2008/09 and 0.3% of GDP in 2009/10 (deficit-increasing) on the basis of information in the most recent programme.

Source:

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations