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COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in the United Kingdom

(presented by the Commission)

EXPLANATORY MEMORANDUM

Article 104 of the Treaty lays down an excessive deficit procedure (EDP) to ensure that Member States avoid excessive government deficits or that they correct such deficits when they occur. The EDP is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. However, while most provisions apply to the United Kingdom in the same manner as to other countries not participating in the euro area, Article 5 of the Protocol on certain provisions relating to the United Kingdom states that the obligation under Article 104(1) of the Treaty to avoid excessive general government deficits does not apply to the United Kingdom unless it moves to the third stage of economic and monetary union[2]. Instead, while in the second stage of economic and monetary union, the United Kingdom shall, pursuant to Article 116(4) of the Treaty, "endeavour to avoid excessive deficits". The EDP applies to the United Kingdom on a financial year basis (running from April to March).

The United Kingdom undertook strong fiscal consolidation efforts during the late 1990s, which led to an improvement in the general government balance from a deficit of 3.8% of GDP in 1996/97 to a surplus of 1.3% in 1999/00. Gross government debt also declined from over 50% of GDP in 1996/97 to a low of 36.8% in 2002/03. Thereafter, the government adopted a looser fiscal stance, mainly as a result of an explicit policy objective to raise expenditure on public services. As a result, the general government balance moved from a surplus position in the late 1990s to a deficit of 3.2% of GDP in 2003/04 and 3.5% in 2004/05. With the output gap remaining positive throughout this period, this was equivalent to a deterioration of the structural balance by 4¾ percentage points of GDP[3] between 1999/00 and 2004/05. During these years, the government expenditure-to-GDP ratio increased by about 4½ percentage points, to 43.2%, with government gross fixed capital formation rising from 1.3% of GDP to 1.8%. On 21 September 2005 the Commission initiated an EDP for the UK with the adoption of a report under Article 104.3 and on 24 January 2006 the Council decided that an excessive deficit existed in the United Kingdom. The budgetary position improved in 2005/06 and 2006/07, with the headline deficit in the latter year falling to 2.6% of GDP. On 12 September 2007, taking into account the 2006/07 deficit outturn and the spring 2007 forecast, the Commission adopted a recommendation for a Council decision abrogating the EDP against the UK. On 9 October 2007, ECOFIN decided to abrogate the EDP according to Article 104.12 of the Treaty.

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

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5). Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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

3 Estimated by the Commission services, applying the common methodology on estimating output gaps.

the data reported by the UK in March 2008.[4] Fiscal policy was estimated to be again pro-cyclical in 2007/08, with the structural deficit deteriorating by ¼% of GDP in a still favourable economic context.[5]

According to the EDP data notified by the UK authorities in March 2008[6], the United Kingdom's general government deficit in 2008/09 was planned to reach 3.2% of GDP, thus exceeding the 3% of GDP reference value; this ratio was identical to that published in the United Kingdom's March 2008 budget. A subsequent policy announcement on 13 May reducing personal income tax in 2008/09, financed by additional borrowing, results in an increase in the planned deficit ratio by 0.2 percentage points[7] when compared to the notification, other things being equal. The figure for the 2008/09 deficit in the notification provides *prima facie* evidence of a planned excessive deficit in the United Kingdom in the sense of the Treaty and the Stability and Growth Pact, while the more recent policy announcement is to be considered additional evidence. The Commission therefore adopted a report on 11 June 2008 according to Article 104(3) of the Treaty assessing the fulfilment of the Treaty requirements concerning the deficit and the debt criteria.

The report considered that, although above the 3% of GDP Treaty reference value, the deficit planned for 2008/09, as notified in March 2008, was close to it. The excess over the 3% of GDP reference value was not exceptional. In particular, it did not result from an unusual event outside the control of the United Kingdom authorities, nor was it the result of a severe economic downturn. The Commission services' spring 2008 forecast projects UK growth to slow in 2008 and 2009 to annual rates below potential. Nevertheless, annual GDP growth is expected to reach 1.7% in 2008 and 1.6% in 2009. As regards the issue of temporariness, the Commission services expect the deficit ratio in 2009/10 to remain above 3%, with the weak economic context feeding through into slower revenue growth. The government's statement on 13 May 2008 does not commit the government to extend to 2009/10 the same compensation offered in 2008/09.[8] It nevertheless carries a risk for 2009/10 of a deficit

4 The data notified by the United Kingdom in March 2008 indicates a general government deficit of 2.8% of GDP in 2007/08. However, data for annual general government net borrowing as reported by the United Kingdom are increased by £1.0bn by the Commission services to ensure consistency of recording of UMTS licence proceeds. This increases the deficit ratio to 2.9% of GDP in 2007/08.

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

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

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

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

overshoot, compared with the March 2008 budget plans, with a similar impact ceteris paribus on the spring forecast projection.

The general government debt ratio remains well below the 60% reference value (the March EDP data reported a ratio of 43.0% of GDP[9] in the 2007/08 financial year), although projected to be on a rising trend up to 2009/10.

In accordance with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report all “other relevant factors”. According to the Stability and Growth Pact, these factors can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In this case the double condition is not met.

Therefore, the Commission's analysis implies that the deficit criterion in the Treaty is not fulfilled, whereas the debt criterion is met.

Article 104(4) of the Treaty states that “the Committee provided for in Article 114 [i.e. the Economic and Financial Committee] shall formulate an opinion on the report of the Commission”. The Committee issued its opinion on 25 June 2008; this opinion is consistent with the assessment made by the Commission in its report and confirms that the excess over the reference value cannot be considered exceptional or temporary.

The Commission, having taken into account its report and the opinion of the Economic and Financial Committee, is of the opinion that an excessive deficit exists in the United Kingdom. This opinion, adopted by the Commission on 2 July 2008, is herewith addressed to the Council, according to Article 104(5) of the Treaty. The Commission is recommending that the Council shall decide accordingly, in conformity with Article 104(6).

In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to the United Kingdom with a view to bringing the situation of an excessive deficit to an end, according to Article 104(7) of the Treaty. According to Council Regulation (EC) No 1467/97, the Council recommendation should “establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In the recommendation, the Council shall request that the Member State achieves a minimum annual improvement of 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”.

In the case of the United Kingdom, the overall assessment of the factors mentioned in the report under Article 104(3) does not suggest the existence of special circumstances warranting a departure from the standard deadline for correcting the deficit. While GDP growth is expected to slow in 2008 and 2009 relative to potential growth rates, thus leading to the emergence of a negative output gap, GDP growth is expected to remain positive throughout the spring forecast horizon at annual rates above 1.5% in 2008 and 2009. In order to reduce the headline deficit to below the 3% of GDP reference value in 2009/10, the UK authorities would have to achieve structural consolidation in 2009/10 of at least an annual improvement

[9] Using GDP adjusted for Financial Intermediation Services Indirectly Measured (FISIM).

of 0.5% of GDP expected under Article 3(4) of Regulation (EC) No 1467/97. A deadline for correction of an excessive deficit is to be set in accordance with the aforementioned Regulation, which envisages that the correction should be completed in the year following its identification. In the case of the United Kingdom, the identification took place in 2008 on the basis of a planned deficit in excess of the 3% of GDP reference value in 2008/09.

Accordingly, in the recommendation, the budgetary correction should be completed at the latest by financial year 2009/10.

United Kingdom: Macroeconomic and budgetary developments [a]

	2004/05	2005/06	2006/07	2007/08	2008/09		2009/10	
					COM	2008 Budget	COM	2008 Budget
Real GDP (% change) [b]	3.3	1.8	2.9	3.0	1.7	2.0	1.6	2½
Potential GDP (% change) [b,c]	2.7	2.7	2.8	2.7	2.4	2 ½	2.3	2 ½
Output gap (% of potential GDP) [b,c]	0.7	-0.1	0.0	0.4	-0.3	-0.6	-1.0	-0.6
General government balance	3.5	3.1	2.6	2.9	3.3	3.2	3.3	2.8
Primary balance	-1.4	-1.0	-0.4	-0.7	-1.1	-1.2	-1.2	-0.8
One-off and other temporary measures	-	0.3	-	-	-	-	-	-
Government gross fixed capital formation	1.8	0.6	1.8	1.9	2.0	2.0	1.9	2.0
Cyclically-adjusted balance [c,d]	-3.7	-3.0	-2.7	-3.0	-3.1	-2.9	-2.9	-2.6
Cyclically-adjusted primary balance	-1.7	-0.9	-0.6	-0.8	-0.9	-0.9	-0.8	-0.6
Structural balance [d,e]	-3.7	-3.3	-2.7	-3.0	-3.1	-2.9	-2.9	-2.6
Structural primary balance	-1.7	-1.2	-0.6	-0.8	-0.9	-0.9	-0.8	-0.6

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Data on a calendar-year basis. Numbers reported in 2004/05 column refer to the 2004 calendar year.

[c] Potential GDP growth, output gaps and cyclically-adjusted balances attributed to the 2008 budget are reported as recalculated by the Commission services on the basis of the information in the budget.

[d] The 2008 budget estimate of the cyclically-adjusted and structural balances in 2007/08 (as recalculated by the Commission services) is 2.8% of GDP.

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

Source: Eurostat and Commission services' spring 2008 forecasts.

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on the existence of an excessive deficit in the United Kingdom

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by the United Kingdom,

Whereas:

(1) Article 104 of the Treaty lays down an excessive deficit procedure (EDP) to ensure that Member States avoid excessive government deficits or that they correct such deficits when they occur.

(2) Pursuant to point 5 of the Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland, the obligation under Article 104(1) of the Treaty to avoid excessive general government deficits does not apply to the United Kingdom unless it moves to the third stage of economic and monetary union[10]. While in the second stage of economic and monetary union, the United Kingdom is required to 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 excessive deficit procedure under Article 104 of the Treaty, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[11], which is part of the Stability and Growth Pact, provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the excessive deficit procedure. Council Regulation (EC) No 3605/93[12] lays down detailed rules and definitions for the application of the provision of the said Protocol.

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

11 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

12 OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit exists in a Member State or may occur. Having taken into account its report in accordance with Article 104(3) of the Treaty and having regard to the opinion of the Economic and Financial Committee in accordance with Article 104(4), the Commission concluded that an excessive deficit exists in the United Kingdom. The Commission therefore addressed such an opinion to the Council in respect of the United Kingdom on 2 July 2008.

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of the United Kingdom, this overall assessment leads to the following conclusions.

(7) The United Kingdom undertook strong fiscal consolidation efforts during the late 1990s. Thereafter, the government adopted a looser fiscal stance, mainly as a result of an explicit policy objective to raise expenditure on public services. As a result, the general government balance moved from a surplus position in the late 1990s to a deficit of 3.2% of GDP in 2003/04 and 3.5% in 2004/05. With the output gap remaining positive throughout this period, this was equivalent to a deterioration of the structural balance by 4¾ percentage points of GDP[13] between 1999/00 and 2004/05. On 21 September 2005 the Commission initiated an EDP for the UK with the adoption of a report under Article 104.3 and on 24 January 2006 the Council decided that an excessive deficit existed in the United Kingdom. The budgetary position improved in 2005/06 and 2006/07, with the headline deficit in the latter year falling to 2.6% of GDP. On 12 September 2007, taking into account the 2006/07 deficit outturn and the spring 2007 forecast, the Commission adopted a recommendation for a Council decision abrogating the EDP against the UK. On 9 October 2007, ECOFIN decided to abrogate the EDP according to Article 104.12 of the Treaty.

(8) According to the EDP data notified by the UK authorities in March 2008, the United Kingdom's general government deficit in 2008/09 was planned to reach 3.2% of GDP, thus exceeding the 3% of GDP reference value; this ratio was identical to that published in the United Kingdom's March 2008 budget, which also presented budgetary plans showing a general government deficit of 2.8% of GDP in 2009/10. The deficit figure in the latter year is lower than the corresponding figure in the Commission services' spring forecast of 3.3% of GDP, mainly due to differences in expected GDP growth in 2009/10. Following the publication of the March 2008 budget, a policy announcement on 13 May reducing personal income tax in 2008/09, financed by additional borrowing, results in higher planned deficit and debt ratios than those in the notification. Other things being equal, this will lead to an increase in the 2008/09 deficit ratio forecast by the Commission services to around 3.5% of GDP.[14] Although above the 3% of GDP Treaty reference value, the deficit planned for 2008/09, as notified in March 2008, is close to it. The excess over the 3% of GDP reference value is not exceptional. In particular, it does not result from an unusual event outside the control of the United Kingdom authorities, nor is it the result of a

13 Estimated by the Commission services, applying the common methodology on estimating output gaps.

14 In the UK government's income tax announcement published on 13 May 2008, the cost of the income tax reduction was stated to amount to £2.7bn in 2008/09, which is estimated by the Commission to be equivalent to 0.2% of GDP. Adding this to the 2008/09 deficit figure from the Commission services'' spring forecast produces a deficit of 3.5% of GDP.

severe economic downturn. The Commission services' spring 2008 forecast projects UK growth to slow in 2008 and 2009 to annual rates below potential. Nevertheless, GDP growth is expected to reach 1.7% in 2008 and 1.6% in 2009. The excess over the 3% of GDP reference value is also considered not temporary, with the Commission services forecasting, on the basis of unchanged policies, a deficit ratio in 2009/10 still higher than 3% (at 3.3%). This indicates that the Treaty requirement concerning the deficit criterion is not fulfilled.

(9) The general government debt ratio remains well below the 60% reference value (the March EDP data reported a ratio of 43.0% of GDP[15] in the 2007/08 financial year), although projected to be on a rising trend up to 2009/10. In the Commission services' forecast, the debt ratio is projected to reach around 47½% of GDP in 2009/10.

(10) According to Article 2(4) of Regulation (EC) No 1467/97, "other relevant factors" can only be taken into account in the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. This double condition is not met. Therefore, other relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in the United Kingdom.

Article 2

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

Done at Brussels, […]

For the Council
The President
[…]

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[15] Using GDP adjusted for Financial Intermediation Services Indirectly Measured (FISIM).