COUNCIL OF THE EUROPEAN UNION

Brussels, 4 June 2012

10557/12

UEM 140
ECOFIN 475
SOC 458
COMPET 352
ENV 440
EDUC 149
RECH 201
ENER 227

COVER NOTE

from:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	1 June 2012
to:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
No Cion doc.:	COM(2012) 309 final
Subject:	Recommendation for a Council Recommendation on the United Kingdom's 2012 national reform programme and delivering a Council opinion on the United Kingdom's convergence programme for 2012-2017

Delegations will find attached Commission document COM(2012) 309 final.

Encl.: COM(2012) 309 final

EUROPEAN COMMISSION

Brussels, 30.5.2012
COM(2012) 309 final

Recommendation for a

COUNCIL RECOMMENDATION

on the United Kingdom's 2012 national reform programme

and delivering a Council opinion on the United Kingdom's convergence programme for 2012-2017

{SWD(2012) 309 final}

Recommendation for a

COUNCIL RECOMMENDATION

on the United Kingdom's 2012 national reform programme

and delivering a Council opinion on the United Kingdom's convergence programme for 2012-2017

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Articles 121(2) and 148(4) thereof,

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[1], and in particular Article 5(2) thereof,

Having regard to Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances[2], and in particular Article 6(1) thereof,

Having regard to the recommendation of the European Commission[3],

Having regard to the resolutions of the European Parliament[4],

Having regard to the conclusions of the European Council,

Having regard to the opinion of the Employment Committee,

After consulting the Economic and Financial Committee,

Whereas:

(1) On 26 March 2010, the European Council agreed to the European Commission's proposal to launch a new strategy for jobs and growth, Europe 2020, based on enhanced coordination of economic policies, which will focus on the key areas where action is needed to boost Europe's potential for sustainable growth and competitiveness.

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1 OJ L 209, 02.08.1997, p. 1
2 OJ L 306, 23.11.2011, p. 25
3 COM(2012)309 final
4 P7_TA(2012)0048 and P7_TA(2012)0047

(2) On 13 July 2010, the Council adopted a recommendation on the broad guidelines for the economic policies of the Member States and the Union (2010 to 2014) and, on 21 October 2010, adopted a decision on guidelines for the employment policies of the Member States[5], which together form the 'integrated guidelines'. Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

(3) On 12 July 2011, the Council adopted a recommendation on the United Kingdom's national reform programme for 2011 and delivered its opinion on the United Kingdom's updated convergence programme for 2011-2014.

(4) On 23 November 2011, the Commission adopted the second Annual Growth Survey, marking the start of the second European semester of ex-ante and integrated policy coordination, which is anchored in the Europe 2020 strategy. On 14 February 2012, the Commission, on the basis of Regulation (EU) 1176/2011, adopted the Alert Mechanism Report[6], in which it identified the United Kingdom as one of the Member States for which an in-depth review would be carried out.

(5) On 2 March 2012, the European Council endorsed the priorities for ensuring financial stability, fiscal consolidation and action to foster growth. It underscored the need to pursue differentiated, growth-friendly fiscal consolidation, to restore normal lending conditions to the economy, to promote growth and competitiveness, to tackle unemployment and the social consequences of the crisis, and to modernise public administration.

(6) On 30 April 2012, the United Kingdom submitted its convergence programme covering the period 2011-12 to 2016-17 and its national reform programme for 2012. In order to take account of their interlinkages, the two programmes have been assessed at the same time. The Commission has also assessed, in an in-depth review under Article 5 of Regulation (EU) No 1176/2011, whether the United Kingdom is affected by macroeconomic imbalances. The Commission concluded in its in-depth review[7] that the United Kingdom is experiencing an internal imbalance, although not excessive.

(7) Based on the assessment of the 2012 convergence programme pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections in the programme is plausible. The objective of the budgetary strategy outlined in the programme is to implement the necessary fiscal consolidation to achieve the government's fiscal targets on net debt and cyclically-adjusted current balance. The convergence programme does not include a medium-term objective (MTO) as foreseen by the Stability and Growth Pact. According to programme projections, the deadline to correct the excessive deficit set by the Council in its recommendation of 2 December 2010 is expected to be missed by one year. The government deficit in 2014/15, the deadline set by the Council, is

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5 Council Decision 2012/238/EU of 26 April 2012

6 COM(2012) 68 final

7 SWD(2012)161 final

estimated at 4.4% of GDP, implying, based on the (recalculated) structural deficit,[8] an average fiscal effort of 1.25% of GDP between 2010/11 and 2014/15 which is below the 1¾% effort set out in the Council recommendation under the Excessive Deficit Procedure. Although the government has not deviated from its fiscal consolidation strategy which initially, based on previous macroeconomic projections, appeared sufficient to comply with EDP targets, the fiscal performance and outlook have been affected by a deterioration of economic growth prospects. Revenue measures have been significantly front-loaded in the adjustment path of the fiscal consolidation. Almost 40% of the total annual fiscal consolidation planned for the 2010-11 to 2014-15 period has been achieved by the end of 2011-12, including 30% of the spending cuts and two-thirds of the net tax increases. The potential revenue contribution from an increased efficiency of the tax system, stemming from a review of the VAT rate structure, remains relatively underexploited. According to the convergence programme, the general government deficit is expected to be 8.3% of GDP in 2011-12, 5.9% in 2012-13, 6.0% of GDP in 2013-14, 4.4% of GDP in 2014-15, 2.9% of GDP in 2015-16 and 1.2% of GDP in 2016-17. These estimates are somewhat lower than those by Commission services, who in its 2012 spring forecast expect a deficit of 6.1% of GDP in 2012-13 (which would be 7.9% without an upcoming one-off pension fund transfer) and 6.5% of GDP in 2013-14. The differences stem from a lower growth forecast and amendments made by Eurostat to UK data. Some adjustments were made to the government's fiscal plans in the 2011 Autumn Statement to prioritise growth-enhancing expenditure, but public sector investment is still set to fall sharply by 2014-15. Government debt, forecast at 94.7% in 2013-14, is expected to peak in 2014-15.

(8) The run-up to the crisis saw the housing market overheat, with house price-to-income ratios reaching historic highs in the context of a growing housing supply shortage, leading to the accumulation of high levels of mortgage debt. According to the Commission's in-depth review, high household debt constitutes an internal imbalance in the United Kingdom's economy. Due to a high share of variable interest rate mortgages, household finances are vulnerable to interest rates rises, with a potentially destabilising knock-on effect on the economy as a whole via the financial sector. A sustained and significant fall in household debt is only likely if house prices fall relative to disposable income; however, if nominal house prices were to fall rapidly it would risk pushing many households into negative equity. Residential construction remains at record lows, due both to a restrictive planning system and cyclical weakness, and wider housing market activity is also still muted. In November 2011, the government published its housing strategy for England, which aims to facilitate an increase in residential construction, but significant uncertainty remains about the net impact of the new system on housing development. Also, the housing strategy did not mention the issue of property taxation, where the UK system combines a regressive recurring tax (council tax) with a progressive transaction tax (the Stamp Duty Land Tax - SDLT), which may play a role in cyclical developments in budget revenues and financial stability. Some adjustments were made to SDLT rates in the 2012 Budget, but only minor changes have been made in this field overall.

8 Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the programme, using the commonly agreed methodology.

(9) The UK has growing challenges of unemployment and labour market participation. Unemployment in the UK currently stands at 8.4%. Youth unemployment is much higher, at 22.2%, and more than 38% of the unemployed in the UK are under 25. 17.7% of young people (16-24 year olds) are not in employment, education or training. Private sector employment has been growing modestly, but not enough to offset reductions in public sector employment and the growth of the workforce. The UK has an oversupply of low-skilled workers, for whom demand is falling, and a shortage of workers with high-quality vocational and technical skills that are particularly needed by goods producing and exporting sectors in which the UK's performance is relatively weak. The main focus in vocational education and training (VET) policy is on basic skills and level 2 qualifications, while the economy increasingly demands more advanced VET qualifications. The UK also continues to have a relatively high number of adults with very poor basic literacy and numeracy skills, who are not well placed to benefit from vocational training. Early school-leaving has increased by 3.3 pp. since 2005 and is above the EU average at 14.9%; continued support for low-income families is crucial to prevent school drop-outs.

(10) The government has a welfare reform agenda to help more people get into work, while supporting the most vulnerable. The Universal Credit, which aims to simplify the benefit system, has not yet been implemented, but considerable risks remain that the positive impact of new policies on employment and incomes will be more than offset by declining amounts available for benefits, so poverty, particularly for families with children, risks increasing. Independent estimates forecast that in 2020-21 absolute child poverty will reach its highest level since 2001-02, and that the government will miss targets for reducing child poverty set down in the Child Poverty Act. Insufficient access to childcare, in particular for low earners, still causes significant problems and the government has not yet come up with adequate plans to tackle this challenge. Cuts to support for childcare also risk exacerbating the problem.

(11) Financing conditions remain tight, particularly for SMEs. Net lending to the corporate sector was negative in 2011, while survey evidence shows that a significant number of SMEs are credit constrained. Additionally, access to non-bank lending remains largely restricted to bigger firms, and competition in the banking industry is limited. Notwithstanding the steps taken by the authorities to improve the situation, the Breedon task force on alternative debt markets estimated a substantial ongoing financing gap over the next five years, especially for SMEs.

(12) The UK has a challenge to improve its energy and transport infrastructure, which is linked to laying the foundations for long-term growth and competitiveness, and to addressing the causes of the UK's lack of external competiveness in manufacturing sectors. The UK needs substantial investment to upgrade its electricity generation capacity, given the need to replace a large part of the existing generating capacity, which will close over the next decade, and the need to meet the renewable energy obligation and tighter carbon emissions standards. . The UK’s transport sector faces shortcomings in the capacity and quality of its networks, which could work against the government’s aim of rebalancing the UK economy towards investment and exports. As part of the government’s fiscal consolidation strategy, public sector net investment will fall sharply by 2014-15, which risks exacerbating existing pressures on transport infrastructure unless alternative funding sources can be secured.

(13) In the context of the European Semester, the Commission has carried out a comprehensive analysis of the United Kingdom's economic policy. It has assessed the convergence programme and national reform programme, and presented an in-depth review. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in the United Kingdom, but also their compliance with EU rules and guidance, given the need to reinforce the overall economic governance of the European Union by providing EU-level input into future national decisions. Its recommendations under the European Semester are reflected in recommendations (1) to (6) below.

(14) In the light of this assessment, the Council has examined the United Kingdom's convergence programme, and its opinion[9] is reflected in particular in recommendation (1) below.

(15) In the light of the results of the Commission's in-depth review under Article 5 of Regulation (EU) No 1176/2011 and this assessment, the Council has examined the United Kingdom's national reform programme for 2012 and the United Kingdom's convergence programme for 2012-17. Its recommendation under Article 6 of Regulation (EU) No 1176/2011 is reflected in particular in recommendations (2), (3) and (6) below,

HEREBY RECOMMENDS that the United Kingdom should take action within the period 2012-2013 to:

1. Fully implement the budgetary strategy for the financial year 2012/13 and reinforce the budgetary strategy for the financial year 2013/14 and beyond, supported by sufficiently specified measures, to ensure a timely correction of the excessive deficit in a sustainable manner and the achievement of the structural adjustment effort specified in the Council recommendations under the Excessive Deficit Procedure and to set the high public debt ratio on a sustained downward path. Prioritise growth-enhancing expenditure to avoid the risk that a further weakening of the medium-term outlook for growth will negatively impact on the long-term sustainability of public finances.

2. Address the destabilising impact of high and volatile house prices and high household debt by implementing a comprehensive housing reform programme to increase housing supply and alleviate problems of affordability and the need for state subsidy of housing. Pursue further reforms to the mortgage and rental markets, financial regulation and property taxation to prevent excessive volatility and distortions in the housing market.

3. Continue to improve the employability of young people, in particular those not in education, employment or training, including by using the Youth Contract. Ensure that apprenticeship schemes are taken up by more young people, have a sufficient focus on advanced and higher-level skills, and involve more small- and medium-sized businesses. Take measures to reduce the high proportion of young people leaving school with very poor basic skills.

9 Under Article 9(2) of Council Regulation (EC) No 1466/97.

4. Step up measures to facilitate the labour market integration of people from jobless households. Ensure that planned welfare reforms do not translate into increased child poverty. Fully implement measures aiming at facilitating access to childcare services.

5. Further improve the availability of bank and non-bank financing to the private sector, in particular to SMEs. Support competition within the banking sector, in particular through measures to reduce barriers to entry, increase transparency and facilitate switching between banks as recommended by the Independent Commission on Banking and explore ways to improve access to venture and risk capital and other forms of non-bank lending.

6. Pursue a long-term strategy for improving the capacity and quality of the UK's network infrastructure, including measures to address pressures in transport and energy networks by promoting more efficient and robust planning and decision-making processes, and harnessing appropriate public-private financing arrangements.

Done at Brussels,

For the Council
The President