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Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in the United Kingdom

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission,

Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (TFEU) 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 TFEU to avoid excessive general government deficits does not apply to the UK unless it adopts the euro. Paragraph 5 of the Protocol provides that the UK is to 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.

(4) On 8 July 2008 the Council decided, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit existed 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 TEC and Article 3 of Council Regulation (EC) No. 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1,2].

(5) In accordance with the provisions of Article 104(8) of the TEC, the Council decided on 27 April 2009 that the United Kingdom had not taken action in response to the Council recommendation of 8 July 2008. On 2 December 2009, the Council issued revised recommendations under Article 126(7) TFEU recommending that the United Kingdom should put an end to the excessive deficit situation by 2014-15. On 6 July 2010, the Commission concluded that based on the Commission 2010 spring forecast, the United Kingdom had taken effective action in compliance with the Council recommendation of 2 December 2009 and considered that no additional step in the excessive deficit procedure was therefore necessary at that point in time.

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

[2] All documents related to the excessive deficit procedure of the United Kingdom can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/uk_en.htm

(6) On [X June 2015], the Council established in accordance with Article 126(8) that the United Kingdom had not taken effective action over the period 2010-11 to 2014-15 in response to the Council Recommendation of 2 December 2009.

(7) In accordance with Article 126(7) of the TFEU and Article 3 of Council Regulation (EC) No. 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of an excessive deficit to an end within a given period. The recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit. Furthermore, in a recommendation to correct an excessive deficit, the Council should request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(8) The updated Commission 2015 spring forecast[3] projects an increase in real GDP of 2.4% in 2015-16 and 2.1% in 2016-17, following growth of 2.8% in 2014-15[4]. The main contributions to growth in both years stem from domestic demand. Private consumption is expected to pick up gradually over the forecast horizon as nominal wage growth accelerates and inflation remains low. Inflation has been declining rapidly from its peak of 5.2% in September 2011 to reach 0.1% in the first quarter of 2015. It is expected to increase to 1.1% in the final quarter of 2015 with an annual estimate of 0.4%, and further to 1.6% in 2016. Investment is projected to decline somewhat from 2014 but should remain relatively strong based on favourable credit conditions, healthy corporate profits and strong demand. The external sector is foreseen to continue to contribute negatively to growth but to a lesser degree as the outlook for the euro area, the UK's largest trading partner, improves. Employment has been strong and the unemployment rate is expected to fall to 5.4% in 2015 and further to 5.3% in 2016.

(9) The general government deficit has fallen from a peak of 10.9% of GDP in 2009-10 to 5.2% of GDP in 2014-15. The structural balance was reduced from 8.0% of GDP to 4.7% of GDP over the same period. The average annual improvement in the structural effort amounted to 0.7% between 2010-11 and 2014-15. When adjusted for the impact of revisions in potential output growth between the current forecast and that underlying the Council recommendations of 2 December 2009 as well as for the impact of revenue developments as compared to standard elasticities to GDP growth, the average annual adjusted structural effort over the period is estimated at 1.1% of GDP. The vast majority of measures for the consolidation plan were set out in the emergency budget in June 2010 amounting to 2.5% of GDP over the period 2010-11 to 2014-15. Just over one-quarter of these were taxation measures with spending cuts accounting for the remaining three-quarters. The remaining fiscal consolidation, of around 1% of GDP, was implemented via the two fiscal announcements prior to the June 2010 budget and the subsequent budgets and Autumn Statements until November 2014. There were some shifts between current and capital spending and the period of consolidation was extended until 2018-19.

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[3] GDP growth for the first quarter of 2015 was published after the finalisation of the Commission 2015 spring forecast, hence the current assessment of the effective action is based on an updated forecast.

[4] The published spring forecast presents only calendar-year figures. The values for financial years are calculated from the quarterly profile of the published forecast.

(10) General government gross debt increased from 42.7% of GDP in 2007-08 to 88.4% in 2014-15; continuously above the Treaty reference value since 2009-10. The dynamics of the primary deficit and financial sector interventions, which effectively nationalised two banks, have contributed to this debt increase. Based on the Commission's 2015 spring forecast, the debt-to-GDP ratio is projected to further increase marginally. At the same time off-balance sheet items related to the financial sector interventions could have a positive effect on the future debt development.

(11) As the headline deficit in 2014-15 amounted to 5.2% of GDP, the UK did not correct the excessive deficit by the deadline set in the Council recommendation of 2 December 2009. This was due to the lack of sufficient action, together with a much more unfavourable starting growth position where revisions downgraded GDP growth by 1.0 pps in 2008-09 to -2.3%. A revised recommendation for the UK under Article 126(7), setting a new deadline for the correction of the excessive deficit is justified, in line with the rules of the Stability and Growth Pact.

(12) Against the background of uncertainties regarding economic and budgetary developments, the budgetary target recommended for the final year of the correction period should be set at a level somewhat below the reference value of the Treaty in order to guarantee an effective and lasting achievement of the correction with the requested deadline.

(13) Granting the UK one additional year, which is the general rule according to Council Regulation (EC) No. 1467/97, would be overly demanding in the case of the UK, as it would imply an adjustment in the headline deficit of 2.2% of GDP. Such an adjustment in 2015-16 could significantly affect the recent pick-up of real wage growth and thereby have negative implications for growth. It would also require the implementation of additional measures over a very tight timetable. On the basis of the updated Commission 2015 spring forecast, such adjustment would have a significantly negative impact on economic growth. Therefore, it appears appropriate to extend the deadline of the UK to bring an end to its excessive deficit situation by two years.

(14) Granting two additional years for the correction of the excessive deficit would imply intermediate headline deficit targets of 4.1% of GDP in 2015-16 and 2.7% of GDP in 2016-17. The underlying improvement in the structural budget balance implied by these targets is 0.5% of GDP and 1.1% of GDP, respectively. The baseline scenario is the updated Commission 2015 spring forecast, which includes previously announced discretionary measures of 1.4% of GDP in 2015-16 and 2016-17, around three-quarters of which are expenditure cuts. This adjustment path provides a sufficient safety margin against the 3% of GDP deficit benchmark and is assumed to be the least detrimental to growth, while also allowing for the adherence to the minimum required annual structural improvement of 0.5% of GDP. To reach these targets, the UK needs to fully implement, in a timely manner, the measures announced up to and including the 2015 budget, with any modifications in relation to the current plans being fiscally-neutral; in that case, no further measures on top of those already announced will be needed,

HAS ADOPTED THIS RECOMMENDATION:

(1) The United Kingdom should put an end to the present excessive deficit situation by 2016-17 at the latest.

(2) The United Kingdom should reach a headline deficit of 4.1% of GDP in 2015-16 and 2.7% of GDP in 2016-17, which should be consistent with delivering an

improvement in the structural balance of 0.5% of GDP in 2015-16 and 1.1% of GDP in 2016-17, based on the updated Commission 2015 spring forecast.

(3) The United Kingdom should fully implement the consolidation measures incorporated into all budgets and Autumn Statements up to and including the 2015 budget to achieve the recommended structural effort, with any modifications being fiscally-neutral in relation to the current plans. The United Kingdom should further detail the expenditure cuts in the upcoming Spending Review. These are necessary to ensure the correction of the excessive deficit by 2016-17.

(4) The United Kingdom should accelerate the reduction of the headline deficit in 2015-16 and 2016-17 if economic, financial or budgetary conditions turn out better than currently expected. Budgetary consolidation measures should secure a lasting improvement in the general government structural balance in a growth-friendly manner. In particular, further cuts in capital expenditure should be avoided.

(5) The Council establishes the deadline of [15 October] 2015 for the United Kingdom to take effective action and, in accordance with Article 3(4a) of Council Regulation (EC) No. 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Furthermore, the UK authorities should (i) comply with the obligation to set out a medium term objective (MTO) as laid down in the Stability and Growth Pact and (ii) implement the planned reforms of increasing the state pension age in order to contribute towards strengthening the long-term sustainability of the public finances.

Finally, to ensure the success of the fiscal consolidation strategy, it will also be important to back the fiscal consolidation by comprehensive structural reforms, in line with the Council recommendations addressed to the United Kingdom in the context of the European Semester and in particular those related to the preventive arm of the Macroeconomic Imbalances Procedure.

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

Done at Brussels,

For the Council

The President