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Analysis of the budgetary situation in the United Kingdom

Accompanying the document

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Assessment of action taken by THE UNITED KINGDOM

in response to the Council Recommendation of 19 June 2015 with a view to bringing an end to the situation of excessive government deficit

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1. INTRODUCTION

This document assesses the United Kingdom's report on action taken which was submitted to the Council and the Commission on 15 October 2015 as foreseen in the Council recommendation of 19 June 2015 with a view to bringing an end to the excessive government deficit in the United Kingdom. It does so taking into account the Commission 2015 autumn forecast published on 5 November 2015.

The United Kingdom is currently subject to the corrective arm of the Stability and Growth Pact. The Council opened the Excessive Deficit Procedure for the UK on 8 July 2008 with an initial deadline in the financial year 2009-10. This deadline was extended to 2014-15 on 2 December 2009 based on the finding that effective action had been taken, but that unexpected adverse economic events with major unfavourable consequences for government finances had occurred. On 19 June 2015, the Council considered that no effective action had been taken and extended once again the deadline for the UK to bring an end to its excessive deficit situation to 2016-17. It also established a deadline of 15 October 2015 for the UK to take effective action and to report on the consolidation strategy, in accordance with Article 3(4a) of Regulation (EC) No 1467/97.

The Council recommendation of 19 June 2015 set budgetary targets both in nominal and in structural terms to be complied with every year over the adjustment period. Specifically, it was recommended that the headline deficit reach 4.1% of GDP in 2015-16 and 2.7% of GDP in 2016-17, which was considered consistent with delivering an improvement in the structural balance of 0.5% of GDP in 2015-16 and 1.1% in 2016-17. Based on the Commission's updated 2015 spring forecast, the Council did not require additional measures other than those already incorporated into all the UK government budgets and autumn statements up to and including the 2015 budget.

This document provides an assessment of the UK's budgetary strategy since the new Council recommendation of 19 June 2015. Section 2 presents the macroeconomic outlook and the main developments which took place since the publication of the Commission 2015 spring forecast on 5 May 2015. Section 3 presents the recent and planned budgetary developments. In particular, it provides an assessment of the budgetary strategy in the light of the information included in the report on action taken. Section 4 then assesses compliance with the Council recommendation of 19 June 2015, on the basis of the Commission's 2015 autumn forecast.

2. ECONOMIC DEVELOPMENTS AND OUTLOOK

The macroeconomic forecast underpinning the report on action taken has not been updated since the summer budget, published on 8 July 2015. The Economic and Fiscal Outlook (EFO) published, alongside the budget, by the Office for Budget Responsibility (OBR) forecasts economic growth to reach 2.4% in 2015. Growth is then projected to fall marginally to 2.3% in 2016 before picking back up to 2.4% in 2017. Growth is mainly driven by domestic demand with net exports detracting from growth each year. Inflation is estimated at 0.1% in 2015, rising to 1.1% in 2016 and further to 1.6% in 2017.

The macroeconomic scenario of the OBR appears plausible. The Commission autumn forecast projects slightly stronger GDP growth in 2015 and 2016, 2.5% and 2.4%, respectively and slightly lower GDP growth in 2017 at 2.2% than the OBR. In 2015 and 2016, the Commission scenario projects a somewhat less negative detraction from growth coming from net exports and in 2017, domestic demand is foreseen to be a little weaker. It should be noted that historical GDP data have been revised since the publication of the OBR's July EFO. Overall in 2014, GDP growth was revised down by 0.1 pp to 2.9% but the contributions from the components changed more. The main difference was that the contribution to growth from net exports was less negative after the revision (from -0.6 pp to -0.3 pp) and it was offset by the change in inventories being revised down by 0.3 pp to zero.

Table 1. Comparison of macroeconomic developments and forecasts

	2014	**2015**		**2016**	
	Outturn[1]	**COM**	**UK**	**COM**	**UK**
Real GDP (% change)	2.9	2.5	2.4	2.4	2.3
Private consumption (% change)	2.6	2.9	3.0	2.6	2.5
Gross fixed capital formation (% change)	7.5	4.9	5.6	5.9	5.6
Exports of goods and services (% change)	1.8	2.2	3.8	3.1	3.8
Imports of goods and services (% change)	2.8	3.0	5.1	4.0	4.6
Contributions to real GDP growth:					
- Final domestic demand	3.3	3.0	3.1	2.7	2.7
- Change in inventories	0.0	-0.1	-0.2	0.0	0.0
- Net exports	-0.3	-0.3	-0.5	-0.3	-0.4
Output gap	-0.7	-0.6	0.1	-0.4	0.5
Employment (% change)	2.3	1.7	1.6	1.0	1.0
Unemployment rate (%)	6.1	5.4	5.4	5.4	5.1
HICP inflation (%)	1.5	0.1	0.1	1.5	1.1
GDP deflator (% change)	1.7	1.3	1.1	1.7	1.6
Comp. of employees (per head, % change)	0.5	2.8	n.a.	3.3	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-5.2	-4.5	-5.0	-4.0	-3.9

Note:
[1]Based on data published on 30 September 2015

Source :
Commission 2015 autumn forecast (COM); UK's report on action taken - OBR EFO July 2015 (UK)

GDP growth in the first two quarters of 2015 were 0.4% and 0.7%, respectively. Domestic demand was the main source of growth in the first quarter but net exports detracted heavily (-0.6 pp) whereas in the second quarter, net exports were the main driver of growth (1.4 pp) with the change in inventories offsetting this stimulus (-1.5 pp). The first estimate of GDP growth in the third quarter is 0.5%. Despite a weakening in some forward-looking indicators of activity, such as the purchasing managers' indices and industrial production data, other indicators, such as retail sales, are more robust hence GDP growth is forecast at 0.7% in the final quarter of the year. The Commission 2015 autumn forecast for inflation is identical to that of the OBR for 2015 at 0.1% but higher in 2016 and 2017, where the Commission expects 1.5% and 1.7%, while the OBR foresees 1.1% and 1.6%, respectively.

The labour market remains robust with the employment rate at 73.6%, the highest rate since records began in 1971, in the 3-months to August 2015. The OBR forecast predicts the unemployment will continue to fall to 5.1% in 2016 before picking up to 5.2% in 2017. According to the Commission 2015 autumn forecast, the unemployment rate is likely to plateau in 2015 and 2016 at 5.4% before picking up marginally to 5.5% in 2017. The difference is linked to the output gap projections which sees the gap already closed in 2015 under the Commission forecast but only closing in 2018 under the OBR estimates.

3. BUDGETARY SITUATION AND UPDATED PROJECTIONS FOR THE PERIOD 2015-16 – 2016-17

The report on action taken confirms the budgetary strategy outlined in the summer budget which aims to correct the excessive deficit by 2016-17, the deadline set by the Council. Specifically, the OBR forecast the headline deficit at 4.0% of GDP in 2015-16 and 2.3% of GDP in 2016-17.

This section provides an update of the budgetary projections included in the Commission 2015 autumn forecast. It provides an assessment of measures announced in the July budget and the additional information included in the report on action taken and concludes with an analysis of the impacts of these developments on the government deficit in 2015-16 and 2016-17.

3.1. General government deficit developments in 2014-15

Eurostat published validated fiscal data on 20 October 2015 showing a general government deficit of 5.1% of GDP in 2014-15, 0.1 pp lower than at the time of the Council recommendation, but in line with the data in the OBR's forecast from July.

Real GDP growth for the financial year was revised upwards by 0.1 pp to 2.9% in 2014-15 in comparison with the outturn at the time of the Council recommendation. In nominal terms, GDP growth for 2014-15 increased by 4.4% compared to the 4.2% foreseen at the time of the Council recommendation. The OBR estimate real GDP growth at 3.0% and nominal GDP growth at 4.4% in 2014-15.

Outturn data for 2014-15 show that revenues are slightly higher than at the time of the Council recommendation, but slightly lower as a share of GDP; now 38.5% of GDP compared to 38.9% of GDP at the time of the recommendation. Lower VAT receipts were more than outweighed by higher income tax.

Total expenditure in 2014-15 has also been revised slightly up compared to the Council recommendation, but also lower as a share of GDP, i.e. from 44.1% of GDP to 43.6% of GDP. This was largely due to higher wage costs and social transfers, which were offset by much lower interest spending.

3.2. Assessment of the measures included in the report on action taken

The report on action taken submitted on 15 October 2015 does not include new measures since the budget of the new government, published on 8 July. However, it presents an overview of the measures that conform to the Council recommendation of 19 June 2015. Even though the recommendation did not require additional measures to bring the excessive deficit to below 3% of GDP, further measures were announced in the budget to decrease the deficit more decisively in 2016-17 with GBP 5 billion (0.25% of GDP) of welfare savings and GBP 1 billion (0.05% of GDP) of net tax increases. In line with the recommendation, the government will announce its Spending Review, which details departmental expenditure cuts, on 25 November 2015 and also set out its capital expenditure plans in this document.

The bulk of the improvement owing to the welfare savings in 2016-17 stem from a reduction in income thresholds in tax credits and work allowances in Universal Credit (GBP 2.9 billion) and an increase in the tax credits taper rate to 48% (GBP 1.5 billion). The main new tax measure presented in the budget is an increase in the insurance premium tax from 6% to 9.5%. This takes effect from 1 November 2015 hence part of this is attributable to 2015-16 and the remainder to 2016-17; GBP 0.5 billion and GBP 1 billion, respectively.

3.3. Updated budgetary projections

Taking into account the information included in the report on action taken, the Commission 2015 autumn forecast projects a general government deficit of 3.9% of GDP in 2015-16 and 2.4% of GDP in 2016-17, with an underlying improvement in the structural balance projected at 0.7% of GDP in 2015-16 and 1.3% in 2016-17. The difference between the baseline scenario underpinning the recommendation and the autumn forecast is mainly due to a revision to historical data, some small consolidation measures in 2015-16 and the extra consolidation of 0.3% of GDP in 2016-17.

3.4. Risk assessment

Risks to the budgetary outlook for 2015-16 and 2016-17, as projected in the Commission 2015 autumn forecast, appear balanced overall barring some implementation risks. While no major expenditure slippages are expected, economic performance is exposed to both positive and negative risks. On the one hand stronger-than-expected investment could imply higher growth, while on the other hand a strong domestic currrency could curtail exports more than expected.

The OBR's macroeconomic forecast laid out in the July EFO, which is close to the autumn forecast, remains plausible. The slightly lower estimate of growth in 2015 (2.4% compared to the Commission autumn forecast of 2.5%) stems from downwardly revised data from 2014 (3.0% compared to the revised 2.9%). The labour market estimates are somewhat more positive under the OBR projections, but both forecasts highlight a continuingly robust labour market (see Section 3.1).

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Based on the information submitted in the report on action taken along with the July Budget and the OBR's EFO, the Commission 2015 autumn forecast expects the headline deficit to reach 3.9% of GDP in 2015-16 and 2.4% of GDP in 2016-17 in line with the recommended targets. According to the report on action taken, the July Budget and OBR's EFO, the government's headline deficit is estimated at 4.0% of GDP in 2015-16 and 2.3% in 2016-17, thus below the general government deficit targets recommended by the Council.

The structural adjustment based on the Commission autumn forecast is also expected to reach the target recommended by the Council in both 2015-16 and 2016-17**.** The autumn forecast expects the structural balance to improve by 0.7% of GDP in 2015-16 and 1.3% in 2016-17, respecting the targets recommended by the Council of 0.5% and 1.1%, respectively.

Table 2. Comparison of budgetary projections

% of GDP	Headline budget balance		Adjustment in the structural balance	
	2015-16	2016-17	2015-16	2016-17
Commission 2015 autumn forecast	-3.9%	-2.4%	0.7%	1.3%
Report on action taken	-4.0%	-2.3%	*0.7%*	*1.5%*
Baseline scenario (updated 2015 spring forecast)*	-4.1%	-2.7%	0.5%	1.1%
EDP target	-4.1%	-2.7%	0.5%	1.1%

Notes:

*Scenario underpinning the Council Recommendation of 19 June 2015

Since the headline targets and the adjustment in the structural balance, set by the Council, are expected to be met in 2015-16 and 2016-17, a careful analysis of the fiscal effort is not necessary. Indeed, based on the agreed methodology, combined compliance with the nominal deficit target and the underlying improvement in the structural balance is sufficient to determine compliance with the EDP recommendation.

For information purposes and without considering them in the final assessment since both the headline targets and the adjustment in the structural balance are expected to be met, the calculations of the adjusted change of the structural balance (top-down approach) and the fiscal effort based on the bottom-up are included in Table 3 below. The fiscal effort, as measured by the bottom-up approach, is greater than zero as the summer budget introduced extra measures in both years. However, the impact of these measures is somewhat offset in the bottom-up measurement of fiscal effort by savings related to unemployment expenditure and interest payments.

Table 3. Assessment of the fiscal effort

% of GDP	Adjusted change in the structural balance		Bottom-up effort	
	2015-16	2016-17	2015-16	2016-17
Commission 2015 autumn forecast	0.4%	1.2%	0.1%	0.1%
EDP target	0.5%	1.1%	0.0%	0.0%

* Scenario underpinning the Council Recommendation of 19 June 2015

Box 1. Summary of the Council recommendation of 19 June 2015

On 19 June 2015, under Article 126(7) of the Treaty, the Council recommended the UK to correct its excessive deficit by 2016-17 at the latest.

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

(b) 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 Commission's updated 2015 spring forecast.

(c) 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.

(d) 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.

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

5. CONCLUSION

The report on action taken submitted by the United Kingdom on 19 October 2015 confirms the plan of the UK government to correct the excessive deficit by 2016-17, the deadline set by the Council, and provides details on the measures underpinning the budgetary strategy. Additional measures were not necessary to comply with the Council recommendation, however, extra measures were announced at the July budget, which are also included in the report on action taken.

Overall, based on the information available, the general government deficit is expected to reach 3.9% of GDP in 2015-16 and 2.4% in 2016-17, in line with the targets recommended by the Council on 19 June 2015. The improvement in the structural balance, as estimated by the Commission based on the autumn forecast of 0.7% of GDP in 2015-16 and 1.3% of GDP in 2016-17, also appears in line with the targets of 0.5% of GDP and 1.1% of GDP, respectively. Since the headline targets and the adjustment in the structural balance recommended by the Council are expected to be met in 2015-16 and 2016-17, a careful analysis of the fiscal effort is not necessary according to the agreed methodology to assess compliance with the EDP recommendation.The consolidation strategy pursued by the UK government focusses mainly on expenditure cuts over tax increases with the goal of having a budget surplus in 2019-20. The main risks to the budgetary strategy are on implementation but expenditure slippages are not expected. The upcoming Spending Review will detail the exact departmental expenditure limits within the already specified envelope. Commitment to the budgetary strategy is key to ensuring a durable correction of the excessive deficit.