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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission of the budgetary situation in the United Kingdom following the adoption of the Council Recommendation to the United Kingdom of 2 December 2009 with a view to bringing an end to the situation of an excessive government deficit

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

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

and

Recommendation for a

COUNCIL DECISION

establishing that no effective action has been taken by the United Kingdom in response to the Council Recommendation of 2 December 2009

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Analysis by the Commission of the budgetary situation in the United Kingdom following the adoption of the Council Recommendation to the United Kingdom of 2 December 2009 with a view to bringing an end to the situation of an excessive government deficit

1. INTRODUCTION

On 8 July 2008 the Council decided, in accordance with Article 104(6) of the Treaty establishing the European Community, 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 Treaty establishing the European Community and Article 3 of Council Regulation (EC) No. 467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure. The Council also set a deadline of 8 January 2009 for effective action to be taken.

In accordance with the provisions of Article 104(8) of the Treaty establishing the European Community, 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, recognising that the United Kingdom's budgetary position in 2009-10 resulted from the implementation of measures amounting to around 1½% of GDP, which were an appropriate response to the European Economic Recovery Plan and the free play of automatic stabilisers, the Council under Article 126(7) TFEU recommended that the UK authorities should put an end to the then present excessive deficit situation by 2014-15. This required additional measures to be specified to achieve an annual average fiscal effort of 1¾% of GDP between 2010-11 and 2014-15, which was also considered consistent with bringing the government debt ratio back on a declining path. In its recommendations, the Council established the deadline of 2 June 2010 for effective action to be taken. On 6 July 2010, the Commission concluded that based on the Commission's 2010 spring forecast, the United Kingdom had taken action representing adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

According to the Commission 2015 spring forecast published on 5 May 2015, the general government deficit is projected to reach 5.2 % of GDP in 2014-15. The headline deficit for 2014-15 is thus expected to remain well above the 3% of GDP reference value of the Treaty by the deadline for correction recommended by the Council on 2 December 2009. On the basis of the updated Commission 2015 spring forecast, this document provides an assessment of whether the United Kingdom has undertaken effective action towards the correction of its excessive general government deficit by the 2014-15 deadline, and suggests a new adjustment path that would durably bring the general government deficit below the 3% of GDP threshold. In particular, the document examines the budgetary developments since the Council recommendation of 2 December 2009.

2. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

The initial rebound in the UK following the global economic and financial crisis was more short-lived and it took longer for growth to become more firmly established than expected. Furthermore, growth in 2008-09 was revised down by 1 pp compared to earlier estimates. Initially, growth had been estimated at -1.3% in 2008-09 but this was revised to -2.3%. After

an initial spurt in growth in 2010-11 that subsequently petered out falling to 1.3% in 2011-12 and further to 0.6% in 2012-13, growth became more firmly established from 2013-14 at 2.1%. The updated Commssion 2015 spring forecast foresees growth rates of 2.8% in 2014-15, 2.4% in 2015-16 and 2.1% in 2016-17.

Inflation was exceptionally high following the crisis where it peaked at 5.2% in the year to September 2011. Part of the increases were due to a rise in the standard VAT rate from 17.5% to 20% in Janurary 2011 but also resulted from higher energy prices and generally higher import prices due to the depreciation of sterling. Since the peak, inflation has fallen to 0.1% in the first quarter of 2015 reflecting low oil prices, the currency appreciation and a squeeze on retailers' margins. Inflation is forecast at 0.4% in 2015 before rising to 1.6% in 2016.

After an initial increase in the unemployment rate[1] from 5.6% in 2008 to 7.6% in 2009 and further to 8.1% in 2011, the rate has come down relatively steadily since the final quarter of 2011 to reach 5.6% in the final quarter of 2014. The unemployment rate is expected to decline to 5.4% in 2015 and slightly further to 5.3% in 2016.

Private consumption declined strongly in 2008 and 2009 but gradually regained momentum thereafter and is forecast to increase by 2.6% in both 2015 and 2016, due to increased wage growth along with low inflation. Investment fell dramatically during the crisis years, notably declining by 14.4% in 2009 and recovering only marginally by 2012. It became stronger in 2013 and 2014, growing at rates of 3.4% and 7.8%, respectively. Investment is expected to continuing growing in 2015 and 2016 at an average of 5.5% annually owing to low borrowing costs, healthy profis and an increasingly resilient financial sector. Partly due to weaknesses in the euro area, the UK’s largest trading partner, net exports have not contributed positively to growth since 2011. This is expected to continue into 2015 and 2016, although with a declining negative effect as the demand from importing countries picks up.

Despite the ongoing fiscal consolidation, government consumption has only fallen in 2013 when it decreased by 0.3% however there was no growth in 2010 or 2011. Departmental spending has been cut significantly but the automatic stabilisers operating within Annually Managed Expenditure, along with a slight loosening of the fiscal plans in latter years, have meant that government consumption has not fallen by as much as initially expected. Its growth is expected to be positive but small in 2015 and to decline in 2016 as the fiscal consolidation intensifies.

[1] Eurostat definition.

Table 1: Comparison of macroeconomic developments and forecasts

	2009-10	2010-11		2011-12		2012-13	2013-14	2014-15
	outturn	outturn	COM AF2009	outturn	COM AF2009	outturn	outturn	estimate
Real GDP (% change)	-2.7	2.3	1.2	1.3	2.3	0.6	2.1	2.8
Contribution to real GDP growth								
Domestic demand	-3.2	1.6	0	0.6	1.6	1.0	2.1	3.2
Inventories	0.4	0.9	0.8	-0.2	0.4	0.2	0.4	-0.2
Net export	0.1	-0.3	0.4	0.9	0.3	-0.5	-0.5	-0.2
Employment (% change)	-1.7	0.9	-0.9	0.2	1.3	1.5	1.5	1.3
GDP deflator (% change)*	1.5	3.5	1.7	2.1	2.0	1.7	1.8	1.7
Output Gap (% of potential GDP)	-4.3	-3.4	-3.4	-3.0	-2.7	-3.0	-2.1	-0.8
Potential Output growth	0.8	0.9	0.8	0.9	1.2	0.9	1.1	1.3
Source: COM AF2009 - European Commission Autumn Forecast 2009								
**Calendar year*								

The general government deficit increased from 3.0% of GDP in 2007-08 to 6.8% in 2008-09, and peaked at 10.9% in 2009-10. This was largely brought about by a drop in revenues owing to the contraction in economic activity, stimulus measures announced by the government for 2009-10 and higher social security expenditure, combined with a rapidly falling growth rate. The Spending Review, published in October 2010, set out spending cuts until the end of 2014-15. The subsequent Spending Round, published in June 2013, detailed the spending cuts one further year to 2015-16. Along with these, the measures announced at the intervening Budgets and Autumn Statements between December 2009 and November 2014 have put the deficit on a downward trajectory. As a result, the deficit fell to 9.1% in 2010-11, 7.7% in 2011-12, 7.6% in 2012-13, 5.9% in 2013-14 and to 5.2% in 2014-15. The deficit figures were also improved by the dividend transfers from the Bank of England's Asset Purchase Facility (APF) to the general government accounts, which will affect several budgetary years until quantitative easing is unwound. The total transfer in 2012-13 was GBP 6.4 billion (0.4% of GDP). This was the maximum amount allowed to reduce the deficit under the "super-dividend" test based on the estimated "entrepreneurial income" of the Bank of England; the remaining transfers were classified as a financial transaction and therefore did not affect the deficit. Other transfers from the Bank of England that also affected the deficit in 2012-13 are the Special Liquidity Scheme (SLS)[2] of GBP 2.3 billion (0.1% of GDP) and the transfer from the Issues department of GBP 0.4 billion. Thus, the total transfer from the Bank of England in 2012-13 was GBP 9.1 billion (0.5% of GDP). The transfer from the APF amounted to GBP 12.2 billion (0.7% of GDP) in 2013-14 and to GBP 10.7 billion (0.6% of GDP) in 2014-15. These dividend transfers, though declining, are expected to continue to reduce the deficit until at least 2019-20[3].

According to the updated Commission 2015 spring forecast, the government deficit is expected to fall to 4.1% of GDP in 2015-16 and to 2.7% of GDP in 2016-17 on a no-policy-change basis. This implies an improvement in the structural balance of 0.5% of GDP and 1.1%, respectively.

Risks to the budgetary outlook appear balanced barring some implementation risks. While no major expenditure slippages are expected, economic performance is exposed to both positive

[2] The SLS was introduced in April 2008 to improve the liquidity position of the banking system by allowing banks and building societies to temporarily swap their high quality mortgage-backed and other securities for UK T-Bills for up to three years. The SLS officially closed on 30 January 2012 and was transferred to the government sector in 2012-13.

[3] Office for Budget Responsibility (OBR)

and negative risks. Low oil prices and a strong domestic currrency may place a larger-than-projected downward pressure on inflation and VAT revenues, along with lower revenues from the North Sea oil sector. However, the same factors are having positive implications for private consumption.

General government gross debt has been increasing continuously since 2002-03. The debt rate had been 42.7% of GDP at the outset of the crisis in 2007-08 but has more than doubled since then to reach 88.4% of GDP in 2014-15. Apart from the large deficit that has contributed to this increase, the financial sector interventions which effectively nationalised two banks, Bradford & Bingley and Northern Rock Asset Management, have also accounted for the increase in the debt ratio.

3. BUDGETARY IMPLEMENTATION OVER 2010-11 TO 2014-15

This section provides a detailed analysis of budgetary developments between 2010-11 and 2014-15. It notably discusses the main discretionary measures adopted on the revenue side and the implemented expenditure cuts.

Most of the budgetary consolidation path had already been set out at the beginning of the excessive deficit procedure, notably the 2009 Pre-budget report that was published following the Council recommendation along with a budget in March 2010, and a supplementary budget announced in June 2010, following the May elections. Along with increases in national insurance contributions in 2010-11 and 2011-12 of around GBP 8 billion announced in December 2009, the June 2010 budget contained consolidation measures totalling GBP 40 billion between 2010-11 and 2014-15, approximately three-quarters of which were spending cuts. The expenditure cuts focussed on non-cyclical current spending i.e. Departmental Expenditure Limits (DEL), mainly through public sector spending cuts and pay freezes, and changes to welfare benefits so as to curtail Annually Managed Expenditure (AME). Originally, public sector investment was planned to be reduced by 20% over the period to 2014-15 but this was later amended somewhat in order to maintain growth-enhancing expenditure. On the revenue side, the main measures announced were the introduction of a bank levy, incremental cuts in the main corporation tax rate with offsetting increases in the bank levy, increases in the personal income tax allowance, changes to pension entitlements and a range of tax avoidance measures.

Table 2: Composition of the budgetary adjustment

	2009-10	2010-11		2011-12		2012-13	2013-14	2014-15
% of GDP	outturn	outturn	COM AF2009	outturn	COM AF2009	outturn	outturn	estimate
Revenue	**38.6**	**39.1**	**39.2**	**39.0**	**39.8**	**39.0**	**39.4**	**38.9**
of which:								
Taxes on production & imports	11.5	12.3	11.9	12.7	12.2	12.7	12.9	13.0
Current taxes on income, wealth, etc.	14.9	15.1	15.1	14.8	15.5	14.3	14.1	14.0
Social contributions	8.2	7.9	8.4	7.9	8.4	7.9	7.9	7.7
Other (residual)	4.1	3.8	3.7	3.6	3.7	4.0	4.5	4.2
Expenditure	**49.5**	**48.2**	**51.5**	**46.7**	**50.3**	**46.6**	**45.2**	**44.1**
of which:								
Primary expenditure	47.3	45.2	48.8	43.6	47.3	43.7	42.3	41.4
of which:								
Compensation of employees	11.2	11.0	12.0	10.5	11.9	10.2	9.6	9.4
Intermediate consumption	12.5	12.0	13.8	11.5	13.6	11.3	11.6	11.2
Social payments	14.7	14.5	15.3	14.6	14.9	14.9	14.5	14.3
Subsidies	0.7	0.5	0.6	0.5	0.6	0.6	0.5	0.6
Gross fixed capital formation	3.4	3.2	2.4	2.9	1.9	2.7	2.7	2.8
Other (residual)	4.9	4.0	4.7	3.6	4.4	3.9	3.4	3.1
Interest expenditure	2.1	3.0	2.7	3.1	3.0	3.0	2.8	2.7
GG balance	**-10.9**	**-9.1**	**-12.5**	**-7.7**	**-10.7**	**-7.6**	**-5.8**	**-5.2**
Primary balance	-8.7	-6.1	-9.4	-4.5	-7.3	-4.7	-3.0	-2.5
One-off and other temporary measures (% of potential GDP)	-0.2	0.0	0.0	0.0	0.0	0.0	0.1	-0.1
Structural balance	-8.0	-7.0	-11.1	-5.9	-9.6	-5.9	-4.6	-4.7
Change in structural balance	-2.2	1.0	-0.4	1.1	-1.5	0.0	1.3	-0.1
Real GDP growth	**-2.7**	**2.3**	**1.2**	**1.3**	**2.3**	**0.6**	**2.1**	**2.8**
GDP deflator*	2.7	2.6	1.7	1.7	2.0	1.8	1.9	1.5
Nominal GDP	**-0.1**	**5.1**	**3.1**	**3.2**	**-**	**2.3**	**4.2**	**4.2**

Source: COM 2009 AF - European Commission Autumn Forecast 2009

** Calendar year for COM AF2009*

Note: Cyclically-adjusted balances excluding one-off and other temporary measures according to the programme as recalculated by the Commission on the basis of the information in the programme

3.1. Budgetary implementation in 2010-11

The main measures implemented in 2010-11 were an increase in the standard VAT rate from 17.5% to 20% from 4 January 2011, the introduction of a bank levy from January 2011 of 0.075%, which was subsequently increased to 0.078% in March, changes to national insurance contributions that raised revenue and the setting out of cuts to departmental spending. Revenues increased to 39.1% of GDP from 38.6% of GDP in the previous year. The deficit had fallen to 9.1% of GDP with the debt rate at 76.9%. The structural balance improved by 1.0 pps. The fiscal improvement was roughly half from tax increases and half from expenditure cuts.

3.2. Budgetary implementation in 2011-12

On the taxation side in 2011-12, the budgetary impact of a decrease in the corporation tax to 26% from was broadly offset by an increase in the bank levy to 0.088%, accompanied by an increase in the personal income tax allowance. On the expenditure side, cuts to departmental expenditure were implemented along with public sector pay freezes. As a result, expenditure as a share of GDP fell from 48.2% to 46.7% that year. The deficit was 7.7% of GDP, with the structural balance of 5.9% of GDP. This was a 1.1 pp improvement over the previous financial year. The debt ratio stood at 82.7% of GDP.

3.3. Budgetary implementation in 2012-13

Tax measures in 2012-13 were a continuation of those implemented in the previous year. The main corporate tax rate was reduced another 2 pps to 24%, the bank levy was raised to 0.130%, and the income tax allowance was raised again. Additional measures included an increase in charges from the North sea oil producers, a rise in the stamp duty land tax on homes worth more than GBP 2 million and the phasing out of child benefit for those on high incomes. On the expenditure side, the announced cuts to departmental expenditure limits were implemented. The deficit was 7.6% of GDP with the structural balance at 5.9% of GDP, which was unchanged from the previous year. The debt rate was 85.4%.

3.4. Budgetary implementation in 2013-14

In 2013-14, tighter departmental expenditure limits continued to be implemented, while revenues were impacted yet again by falling corporate tax rates, increases in the personal income tax allowance and a rising bank levy. Specifically, the income tax allowance rose to GBP 9,440, while the top rate of personal income tax on incomes over GBP 150,000 was reduced from 50% to 45%. The corporation tax rate was lowered to 23% and the bank levy raised to 0.156%. The deficit fell to 5.9% of GDP with the structural balance at 4.6% of GDP, which was an improvement of 1.3 pps over the previous year.

3.5. Budgetary implementation in 2014-15

The main measures on the revenue side undertaken again consisted of raising the income tax allowance (to GBP 10,000) and lowering the corporation tax rate (to 21%). This was accompanied by a number of measures including a reduction in employer national insurance contributions, a doubling in the annual investment allowance and higher R&D tax credits payable to loss making SMEs. Stamp duty land tax was restructured with the introduction of tiered system that increased the amount payable on high value properties. Expenditure as a share of GDP was reduced by more than 1 pp to 44.1%. The deficit stood at 5.2% of GDP with the structural balance at 4.7% of GDP; a deterioration of 0.1 pps compared to the previous financial year.

Table 3: Main budgetary measures	
Revenue	**Expenditure**
2010-11	
• Increase in VAT rate to 20% (+0.8% of GDP)	• Cuts in DEL and welfare spending (-0.3% of GDP)
2011-12	
• Corporation tax decrease to 26% (-0.03% of GDP) • Bank levy increase (+0.04% of GDP) • Increase in personal income tax allowance to GBP 7,475 (-0.2% of GDP) • Fuel duty changes (-0.1% of GDP) • North sea oil charge (+0.1% of GDP) • National insurance contribution changes (+0.2% of GDP) • Change to child tax credit (-0.7% of GDP)	• Cuts in DEL and welfare spending (-0.2% of GDP)
2012-13	
• Corporation tax decrease to 24% (-0.05% of GDP) • Bank levy increase (+0.02% of GDP) • Increase in personal income tax allowance to GBP 8,105 (-0.06 %) • Fuel duty changes (-0.1% of GDP) • National insurance contribution changes (+0.2% of GDP)	• Cuts in DEL and welfare spending (-0.8% of GDP)
2013-14	
• Corporation tax decrease to 23% (-0.02% of GDP) • Increase in personal income tax allowance to GBP 9,440 (-0.25%) • Bank levy increase (+0.02% of GDP)	• Cuts in DEL and welfare spending (-0.3% of GDP)
2014-15	
• Corporation tax decreases to 21% (-0.02% of GDP) • Increase in personal income tax allowance to GBP 10,000 (-0.06% of GDP) • Employment allowance (-0.07% of GDP) • Tax avoidance (+0.05% of GDP)	• Cuts in DEL and welfare spending (-0.3% of GDP)

Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue/expenditure increases as a consequence of this measure.

4. EFFECTIVE ACTION

4.1. Background information

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. It takes into account the economic and budgetary developments since the Council recommendation under article 126(7) of TFEU of 2 December 2009. The assessment starts by comparing the recommended fiscal effort in the Council recommendation with the apparent fiscal effort, as measured by the change in structural budget balance, and the adjusted structural effort. As the headline balance is not achieved, a careful analysis based on (i) the adjusted change of the structural balance (which takes into

account the impact of revisions in potential output growth compared to that underlying baseline scenario in the Council recommendation and the impact on revenue of revisions to the tax content of economic activity relative to what was assumed at the time of the recommendation) and (ii) an assessment of the discretionary consolidation measures undertaken by the authorities, is carried out. As the United Kingdom received its recommendation before the entry into force of the six-pack and the current methodology for assessing effective action, there are no annual targets for the headline balance and fiscal effort. Instead, it was specified that the UK should ensure an average annual fiscal effort of 1¾% of GDP between 2010-11 and 2014-15. Moreover, the agreed bottom-up methodology is not available as the amount of additional discretionary measures needed to achieve the targets was not specified in the recommendation. Instead, we have computed the cumulative size of the discretionary consolidation measures between 2010-11 and 2014-15.

4.2. Headline targets and adjustment in the structural balance

With the general government deficit at 5.2% of GDP in the financial year 2014-15, the UK has not corrected the deficit by the deadline set out in the Council recommendation. Headline deficits for the interim years were 9.1% of GDP in 2010-11, 7.7% of GDP in 2011-12; 7.6% of GDP in 2012-13 and 5.9% in 2013-14.

The structural deficit amounted to 7.0% of GDP in 2010-11, 5.9% in both 2011-12 and 2012-13, 4.6% in 2013-14 and 4.7% in 2014-15. Comparing the initial structural deficit of 8.0% with the structural balance of 4.7% in 2014-15, the apparent average annual average fiscal effort over the five year period 2010-11 to 2014-15, for which effective action is assesssed, is estimated at 0.7% of GDP, below the Council Recommendation of 1¾%.

Table 4: Change in the structural balance corrected for revisions in potential output gap and revenue windfalls/shortfalls

	2010-11	2011-12	2012-13	2013-14	2014-15
Change in structural balance (% of GDP) projected in the updated spring forecast 2015	1.0	1.1	0.0	1.3	-0.1
Uncorrected average change in structural balance up until:	-	1.1	0.7	0.9	0.7
Corrected average change in structural balance up until:	-	-	1.1	1.2	1.1

Source: Commission calculations based on updated Spring Forecast 2015

Correcting for differences in potential output and allowing for windfall gains and losses, the adjusted fiscal effort is 1.1%. This remains below the 1¾% fiscal effort specified in the Council Recommendation of 2 December 2009. The correction for revisions in potential growth since December 2009 have a small impact on the estimated improvement in the structural balance between 2010-11 and 2014-15. The forecast error, measured as the difference in average potential growth, was 0.2%. All other things being equal, an upward revision of potential growth increases the output gap and reduces the estimated structural deficit. Correcting for this development has, however, only a small impact of 0.1% over the assessment period. Compared to the baseline, the updated Commission 2015 spring forecast shows revenue shortfalls of 0.3% on average over 2010-11 to 2014-15. As the deficit is expected to remain above the 3% of GDP reference value in 2014-15, a new deadline for the correction of the excessive deficit has to be set.

The cumulative size of the discretionary consolidation measures between 2010-11 and 2014-2015, ignoring other factors such as budgetary drift, is estimated at some 3.5% of GDP. These consolidation measures focussed on cuts to non-cyclical current spending i.e. Departmental Expenditure Limits, namely public sector spending cuts and pay freezes, changes to welfare benefits so as to curtail Annually Managed Expenditure, and revenue increases via a VAT rate hike and the introduction of a bank levy. Counter-acting the latter, the main corporation tax rate was reduced incrementally, the personal income tax allowance was increased and fuel duty was cut.

On the basis of this assessment, the excessive deficit was not corrected by the 2014-15 deadline, due to a lack of sufficient fiscal action.

5. PROPOSED NEW ADJUSTMENT PATH

The United Kingdom did not correct its excessive deficit by the deadline established in the Council recommendation of 2 December 2009. It therefore appears necessary to extend the deadline for correction of the excessive deficit.

5.1 Baseline scenario

In order to define the effort required by the United Kingdom, the updated Commission 2015 spring forecast is used with the underlying budgetary projections for the government financial years 2015-16 and 2016-17. The government deficit is forecast to fall to 4.1% of GDP in 2015-16 and further to 2.7% of GDP in 2016-17. This implies an improvement in the structural balance of 0.5% of GDP in 2015-16 and 1.1% in 2016-17. The debt ratio is estimated to continue rising, though marginally, to 89.3% of GDP in 2016-17, above the 60% of GDP reference value of the Treaty. At the same time off-balance sheet items related to the financial sector interventions could have a positive effect on the future debt developments.

The baseline scenario takes into account all measures announced up to and including the 2015 budget, delivered in March, and assumes no further policy changes. New taxation measures include cuts to alcohol duty and a continuation of the freeze on fuel duty, an increase in the personal income tax allowance and tax cuts for the North Sea oil sector. These measures were offset by an increase in the bank levy from 0.156% to 0.21% and further measures to reduce tax evasion and avoidance.

On the spending side, a new ‘Help to Buy’ Individual Savings Account (ISA) was announced. The aim of the scheme is to encourage first-time buyers to save for a deposit for a home. The scheme will give a government bonus of 25% on top of the amount saved up to a maximum contribution of GBP 3,000, with minimal effect on the deficit. The main sources of the decline in the deficit in 2016-17 are previously announced measures cutting departmental spending and increases in social contributions from pension changes. On current plans, the implementation of announced measures amount to a total of 1.4% of GDP (0.8% of GDP in 2015-16 and 0.6% of GDP in 2016-17); approximately three-quarters of which are spending cuts.

5.2 Proposed extension of the deadline

The proposed deadline for correcting the excessive deficit situation notably takes into account the economic conditions together with other relevant factors. In particular, the implementation of announced reforms up to the 2015 budget is considered. The deadline for extension also takes into account the provisions of the Commission Communication of

13 January 2015 on "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact".

Building on this, different scenarios have been considered in order to assess the time needed for the United Kingdom to correct its excessive deficit. Nonetheless, the annual adjustment in the structural balance considered has to be at least equal to the minimum benchmark of 0.5% of GDP set by the Stability and Growth Pact.

An extension of the deadline by only one year would require new policy measures with significant impacts on macroeconomic performance, in particular through negative second-round effects on growth. In particular, such an adjustment in 2015-16 could significantly affect the recent pick-up of real wage growth and thereby have negative implications for growth. Such an option would have to be implemented under a very tight timetable. Given the size of the fiscal effort required to reduce the headline balance by more than 2.2 pps, the negative impact on GDP growth would be significant if the deadline was extended by one year.

Therefore, granting two additional years for the correction of the excessive deficit, in line with the pre-announced fiscal measures, would be appropriate as it would balance the ongoing fiscal consolidation with the need to ensure an adequate annual adjustment, thereby delivering a headline budget deficit of 2.7% of GDP in 2016-17. 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, keeping the economy close to potential while also allowing the minimum required annual structural improvement of 0.5% of GDP to be met.

The targets for the annual improvement in the structural budget balance take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on GDP growth. The path, which is identical to the baseline scenario as all the measures necessary for the deficit to fall below the 3% of GDP reference value in two years are already specified in previous fiscal announcements, follows the closing of the output gap profile and is therefore less procyclical than a simple frontloading of the measures. Accordingly, no additional fiscal effort is required of the UK in the financial years 2015-16 and 2016-17 on top of the implementation of the already announced measures of 1.4% of GDP included in the baseline scenario. Taking into account the second-round effects on economic growth of the consolidation measures needed, GDP growth would reach 2.4% in 2015-16 and 2.1% in 2016-17. This will allow the UK to return to sustainable position at the same pace as currently foreseen in the Convergence Programme.

Table 5: Forecast of key macroeconomic and budgetary variables under the baseline/EDP scenario

% of GDP	**2014-15**	**2015-16**	**2016-17**
Real GDP growth (%)	2.8	2.4	2.1
Potential GDP growth (%)	1.3	1.6	1.6
Structural balance	-4.7	-4.2	-3.2
General government balance	-5.2	-4.1	-2.7
p.m Output gap (% of potential output)	-0.8	0.2	0.8

Source: COM uSF 2015 - Commission updated Spring Forecast 2015

6. CONCLUSIONS

On current information, the average annual fiscal effort after correction for the effects of revised potential output growth and revenue developments is estimated at 1.1% of GDP betweem 2010-11 and 2014-15, using the updated Commission 2015 spring forecast. The calculated adjusted structural effort is below the required average annual fiscal effort of 1¾% of GDP over this period set in the Council recommendation. The cumulative size of discretionary measures is approximately 3.5% of GDP in this timeframe. The main measures were set out in the budget and spending review 2010, and the pre-budget report 2009, with subsequent alterations to the fiscal plans being mainly neutral and/or by extending the consolidation period. The recommended fiscal effort has thus not been achieved.

Furthermore, the United Kingdom's headline deficit has not fallen below the 3% of GDP reference value of the Treaty by the deadline year of 2014-15. Overall, this supports the conclusion that the response by the UK authorities to the Council recommendation according to Article 104(7) of the Treaty of 2 December 2009 has not been sufficient.

As the deficit is expected to remain well above the 3% of GDP reference value in 2014-15, a new deadline for the correction of the excessive deficit has to be set. An extension of the deadline by two years to 2016-17 appears appropriate. Such a deadline implies headline budget deficits of 4.1% of GDP in 2015-16 and 2.7% of GDP in 2016-17. The underlying improvement in the structural budget balance would be 0.5% of GDP in 2015-16 and 1.1% in 2016-17. To that end, measures adopted up to and including the 2015 budget have to be fully implemented.

Annex

Table A1: Adjustment of adjusted structural effort for the revision in potential growth – details of the calculation

	Potential GDP growth underlying the Council Recommendation (%)	Potential GDP growth at the time of assessment (%)	Forecast error (%)	Structural expenditure (% of potential GDP)	Correction coefficient α (% of nominal potential GDP)
	(1)	(2)	(3)=(1)-(2)	(4)	(5)=(3)*(4)/100
2014-15	1.4	1.2	0.2	47.0	0.1

Source: Commission calculations based on updated Spring Forecast 2015

Table A2: Adjustment of adjusted structural effort for the expected revenue windfalls/ shortfalls – details of the calculation

	Change in current revenues (yoy) (billions)	Discretionary current revenue measures (billions)	Nominal GDP growth assumptions (%)	Change in output gap	Current revenues in year t-1 (billions)	Revenue gap (billions)*	Nominal GDP	Correction coefficient β (% of nominal GDP)
	assessment	assessment	assessment	assessment	assessment		assessment	
	(1)	(2)	(3)	(4)	(5)	(6)=(1)-(2)-[(3)+(ε-1)*(4)/100]*(5)	(7)	(8)=100*(6)/(7)
2010-11	37.0	1.6	5.1%	1.6%	575.9	3.3	1576.5	0.2
2011-12	18.0	13.9	3.2%	0.4%	612.9	-16.0	1626.2	-1.0
2012-13	13.7	2.9	2.3%	-0.3%	631.0	-3.0	1663.1	-0.2
2013-14	31.4	2.1	4.2%	1.0%	644.6	0.2	1732.8	0.0
2014-15	21.2	-0.7	4.2%	1.4%	676.0	-9.7	1806.1	-0.5
*Revenue elasticity (ε): 1.31							Average	-0.3

Source: Commission calculations based on updated Spring Forecast 2015

Note: As the UK's Council Recommendation dates from 2009, the calculation of the beta adjustment is performed without reference to projected revenue windfalls/shortfalls at the time of the recommendation and is only based upon the departure of outturn revenues from that implied by nominal growth and a revenue elasticity

Table A3: Comparison of key macroeconomic and budgetary projections

		2014-15	2015-16	2016-17
Real GDP (% change)	COM uSF 2015	2.8	2.4	2.1
	CP 2015	2.6	2.4	2.3
Output Gap (% of potential GDP)	COM uSF 2015	-0.8	0.2	0.8
	CP 2015	-1.0	-0.2	0.1
GG balance (% of GDP)	COM uSF 2015	-5.2	-4.1	-2.7
	CP 2015	-5.2	-4.3	-2.2
Primary balance (% of GDP)	COM uSF 2015	-2.5	-1.5	-0.1
	CP 2015	-2.6	-1.8	0.5
Cyclically-adjusted balance (%GDP)*	COM uSF 2015	-4.7	-4.2	-3.2
	CP 2015	-5.1	-4.2	-2.3
Structural balance (%GDP)*	COM uSF 2015	-4.7	-4.2	-3.2
	CP 2015	-5.1	-4.2	-2.3
General government gross debt (%GDP)	COM uSF 2015	88.4	89.2	89.3
	CP 2015	88.4	88.8	88.7

Source: COM uSF 2015 - Commission updated Spring Forecast 2015; CP 2015 - Convergence Programme 2014-15

*Note: *Cyclically-adjusted balances excluding one-off and other temporary measures according to the programme as recalculated by Commission on the basis of the information in the programme*

Table A4: Forecast of key variables for the computation of the fiscal effort under the baseline scenario

			2014-15	2015-16	2016-17
Enters top-down	α	Structural expenditure (% of potential GDP)	43.8	43.0	42.0
		Potential GDP growth (%)	1.3	1.6	1.6
	β	Current revenue (national currency)	697.1	723.8	757.3
		Discretionary measures with impact on current revenue (national currency)	-0.7	1.9	4.2
		Nominal GDP growth (%)	4.2	4.1	4.1
		p.m Elasticity on current revenue	1.3	1.3	1.3
		p.m Output gap (% of potential output)	-2.1	-0.8	0.2
Enters bottom-up		Discretionary measures with impact on total revenue net of one-offs and other temporary measures (national currency)	-1.8	1.9	4.2
		Total expenditure net of one-offs and other temporary measures (national currency)	794.3	807.7	816.2
		Interest expenditure (national currency)	49.4	50.3	50.8
		Total unemployment (number '000s)*	1994.9	1774.8	1753.7
		Unemployment benefits (national currency)	4.5	4.0	3.9
		Investment expenditure matched by EU funds (national currency)	-	-	-

Source: Commission calculations based on updated Spring Forecast 2015

*Calendar year