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Recommendation for a

**COUNCIL RECOMMENDATION**

**on the National Reform Programme 2011 of the United Kingdom**

**and delivering a Council opinion**

**on the updated Convergence Programme of the United Kingdom, 2011-2014**

{SEC(2011) 736 final}

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## **COUNCIL RECOMMENDATION**

**on the National Reform Programme 2011 of the United Kingdom**

**and delivering a Council opinion**

**on the updated Convergence Programme of the United Kingdom, 2011-2014**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 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<sup>1</sup>, and in particular Article 9(3) thereof,

Having regard to the recommendation of the European Commission<sup>2</sup>,

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.
- (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<sup>3</sup>, which together form the "Integrated guidelines". Member States were invited to take the integrated guidelines into account in their national economic and employment policies.

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<sup>1</sup> OJ L 209, 2.8.1997, p. 1.

<sup>2</sup> OJ C , , p. .

<sup>3</sup> Maintained for 2011 by Council Decision 2011/308/EU of 19 May 2011.

- (3) On 12 January 2011, the Commission adopted the first Annual Growth Survey, marking the start of a new cycle of economic governance in the EU and the first European semester of ex-ante and integrated policy coordination, which is anchored in the Europe 2020 strategy.
- (4) On 25 March 2011, the European Council endorsed the priorities for fiscal consolidation and structural reform (in line with the Council's conclusions of 15 February and 7 March 2011 and further to the Commission's Annual Growth Survey). It underscored the need to give priority to restoring sound budgets and fiscal sustainability, reducing unemployment through labour market reforms and making new efforts to enhance growth. It requested Member States to translate these priorities into concrete measures to be included in their Stability or Convergence Programmes and National Reform Programmes.
- (5) On 28 April 2011, the United Kingdom submitted its updated 2011 Convergence Programme covering the period 2011-2014 and its 2011 National Reform Programme. In order to take account of interlinkages, the two programmes have been assessed at the same time.
- (6) The UK was particularly exposed to the international financial crisis because of its large, globally-integrated financial sector and high levels of household debt. GDP fell by 0.1% in 2008 and 4.9% in 2009. The UK government intervened massively to support the banking sector, and provided extraordinary additional liquidity to the whole sector. The government deficit rose by 8.5 percentage points in two years to 11.2% of GDP in 2009. Unemployment rose from 5.3% in 2007 to 7.6% in 2009. Quarterly growth returned in the fourth quarter of 2009 although output remains below its pre-crisis peak. The short-term outlook is for moderate growth driven by strong corporate investment and an exchange-rate driven rebound in net exports. However, growth will be held back by weak or negative growth in household and government consumption. Inflation is expected to remain well above the 2% official target during 2011, reflecting increases in value added tax and higher import and energy prices, before falling in 2012. High inflation is likely to erode real incomes as wage growth remains low. The main downside risks to the forecast are that the rebounds in corporate investment or net exports may not materialise and that persistent high inflation may prevent the use of monetary policy to offset lower government spending.
- (7) Based on the assessment of the updated convergence programme pursuant to Council Regulation (EC) No 1466/97, the Council is of the opinion that the macroeconomic scenario underpinning the budgetary projections is plausible except for 2012 when it is slightly too favourable. The programme does not include a Medium Term Objective (MTO) as foreseen by the code of conduct although it can be derived from targets therein. The objective of the budgetary strategy is to bring down the deficit from 9.9% in 2010-11 to 1.7% in 2015-16, mainly based on expenditure restraint. The programme plans to bring the deficit below the 3% reference value by 2014-15, the deadline set by the Council. Starting from a debt ratio of 78.7% in 2010-11, the budgetary projections in the programme foresee the debt ratio increasing to 87.2% by 2013-14 before beginning to fall slowly. The average annual fiscal effort over the period of 2010-11 to 2014-15 is 1.6%. This is slightly below that recommended by the Council in December 2009 (1.75% of GDP) but is nevertheless appropriate given that the effort is being pursued from a significantly lower-than-expected budget deficit in 2009-10 and is therefore consistent with reducing the headline deficit to below the reference value

by 2014-15. The UK appears to be at high risk with regard to the long-term sustainability of public finances. The long-term cost of ageing is above the EU average and the current budgetary position compounds the cost of ageing. Based on the current fiscal position, debt would increase to 128% of GDP by 2020. However, the full implementation of the programme would be enough to put debt on a downward path but would still be above 80% by 2020.

- (8) Implementing the proposed fiscal consolidation remains a major challenge. Ensuring no slippage from published spending plans will be vital to re-establishing a sustainable fiscal position. Subject to this, the historically low rates of public infrastructure investments, particularly as regards transport, mean that growth-enhancing expenditure should be prioritised. Ensuring sufficient primary surpluses over the medium-term, as already envisaged in the Programme, would improve the sustainability of public finances.
- (9) The UK's flexible labour market allowed it to cope reasonably well with the large contraction in GDP during the crisis. However, increases in unemployment were heavily concentrated on young people: between 2008 and 2010 youth unemployment increased from 15% to almost 20%. Poor labour market outcomes for young people are linked to more general and structural shortcomings in skills provision. The proportion of UK 18-24-year-olds who are early leavers from education and training, at 15.7%, is higher than the EU average of 14.4%. While the share of people aged 25-64 having attained high skill levels is particularly high in the UK, there are weaknesses at intermediate skills level, with the share of people in this group currently below the EU average. A further key challenge for the UK labour market is the significant proportion of children living in jobless households: at 17.5% this is the highest level in the EU, where the overall average is 10.2%. The problem is specifically acute for single parent households, reflecting poor financial incentives and lack of viable childcare options: over 32% of people with care responsibilities are inactive or work part-time due to lack of care services (this is 4 percentage points higher than the EU average).
- (10) The UK experienced a house price boom in the decade before the crisis. Prices fell sharply after the crisis hit but have since recovered partially and remain at historically high levels. Transaction levels collapsed and have remained very low. The house price boom contributed to the large increases in household indebtedness and unsustainable growth in household consumption in the pre-crisis decade. The collapse in housing transactions drove corresponding falls in receipts on housing transaction taxes, contributing to the worsening of the UK fiscal position. Weaknesses in the housing market also help explain the UK's high expenditure on housing benefits and high share of the population in state-subsidised housing. The UK has announced initial reforms to its planning system and to mortgage regulation. Reflecting the importance of this challenge to all sectors of the UK economy, there is a case to build on these measures to develop a more comprehensive package of reforms including in the mortgage market and property taxation to address these issues.
- (11) A recovery in private investment would be an essential component of the necessary rebalancing of the economy away from domestic consumption and help drive productivity gains. Surveys suggest that credit availability and cost is a significant constraint on investment and expansion plans in the private sector, notably for smaller firms reliant on bank financing. The annual rate of growth in lending to SMEs has

been negative since late 2009, with lending to small businesses contracting even more steeply. Moreover, whilst spreads over reference rates seem to have stabilised for medium-sized businesses, they have increased somewhat for small businesses. The UK has recently put in place a number of measures to improve SME access to finance including state sponsored investment vehicles and reaching an agreement with UK banks requiring them to increase their gross lending to SMEs. To develop a solution which can continue to work without regular government intervention, there is a case for further reform with the aim of improving competition in the banking sector and facilitating the development of markets for non-bank finance accessible to smaller firms.

- (12) The Commission has assessed the Convergence Programme and National Reform Programme<sup>4</sup>. It has taken into account not only their relevance for sustainable fiscal and socio-economic policy in the UK but also conformity 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. It considers that the programmes set out ambitious measures to reduce the deficit and encourages the government to proceed as planned. Further steps should also be taken to reform the housing market, reduce youth unemployment, early school leaving, address the situation of children living in workless households and improve credit availability to the private sector.
- (13) In light of this assessment, also taking into account the Council Recommendation under Article 126(7) of the Treaty on the Functioning of the European Union of 2 June 2010, the Council has examined the 2011 update of the Convergence Programme of the United Kingdom and its opinion<sup>5</sup> is reflected in particular in recommendation (1) and (2) below. Taking into account the European Council conclusions of 25 March 2011, the Council has examined the National Reform Programme of the United Kingdom,

HEREBY RECOMMENDS that the United Kingdom should take action within the period 2011-2012 to:

- (1) Implement the planned fiscal consolidation aiming at a deficit of 6.2% of GDP in 2012-13, ensuring no slippage from the ambitious spending reduction targets, thereby strengthening long-term sustainability; subject to this, prioritise growth-enhancing expenditure including research and innovation, and infrastructure investment.
- (2) Develop a programme of reform which addresses the destabilising impact of the house price cycle on public finances, the financial sector and the economy, with a view to alleviating problems of affordability and the need for state subsidy for housing. This should include reforms to the mortgage market, property taxation and the planning system.
- (3) Take steps to tackle youth unemployment by adopting a comprehensive strategy to reduce early school leaving, by the end of 2012. Address skill shortages by

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<sup>4</sup> SEC(2011) 736.

<sup>5</sup> Foreseen in Article 9(3) of Council Regulation (EC) No 1466/97.

increasing the numbers attaining intermediate skills, in line with labour market needs.

- (4) Take measures to reduce the high proportion of jobless households by increasing the supply of child care provision to facilitate single parents' and second earners' labour market participation.
- (5) Significantly improve the availability of bank and non-bank financing to the private sector and in particular to SMEs. Encourage competition within the banking sector and explore ways to improve access to non-bank financing such as venture and risk capital and publicly-issued debt.

Done at Brussels,

*For the Council*  
*The President*