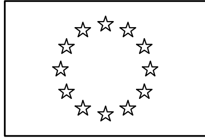

COMMISSION OF THE EUROPEAN COMMUNITIES

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Technical document by the Commission services accompanying the Report on the United Kingdom prepared in accordance with Article 104(3) of the Treaty

SEC(2005) 1144

1. INTRODUCTION

This working document is released in parallel with the Commission report on the United Kingdom according to Article 104(3) of the Treaty[1] and is meant to complement it by providing a more detailed analysis of relevant factors taken into account in the report. Specifically, Section 2 analyses in greater detail the medium-term economic position, while Section 3 does the same for the medium-term budgetary position (including public investment). The report ends by examining, in Section 4, other relevant factors put forward by the Member State and by the Commission.

2. MEDIUM-TERM ECONOMIC POSITION

2.1 Recent macroeconomic performance

Recent UK macroeconomic performance has been impressive in terms of growth, stability and labour market outturns (see Table 1), comparing well in all three respects with that of the euro area. Weaker aspects in the current decade have been very low rates of saving and business investment; the creation of vulnerabilities from very high growth of credit to the household sector, associated with fast-rising residential property prices, and both now reversing from unsustainable rates; and longer-term supply-side weaknesses manifested in relatively low productivity levels.

Table 1: Macroeconomic developments and outlook

	1999	2000	2001	2002	2003	2004	2005	2006
Real GDP (% change)	3.0	4.0	2.2	2.0	2.5	3.2	2.8	2.8
Contributions:								
- Domestic demand	*3.9*	*4.3*	*2.7*	*3.6*	*2.6*	*3.8*	*3.0*	*2.9*
- Change in inventories	*0.2*	*-0.1*	*0.1*	*-0.3*	*0.1*	*0.0*	*0.0*	*0.0*
- External trade	*-1.1*	*-0.1*	*-0.6*	*-1.2*	*-0.2*	*-0.6*	*-0.2*	*-0.1*
Employment [a] (% change)	1.3	1.1	0.8	0.7	0.9	0.9	0.4	0.5
Unemployment (% of labour force)	5.9	5.4	5.0	5.1	4.9	4.7	4.7	4.7
Nominal unit labour costs (% change)	3.0	3.0	3.5	2.6	3.2	1.8	2.3	2.7
HICP (% change)	1.3	0.8	1.2	1.3	1.4	1.3	1.7	2.0
External account [b] (% of GDP)	-2.6	-2.4	-2.1	-1.5	-1.4	-1.7	-2.1	-2.1
Euro area real GDP (% change)	2.8	3.5	1.6	0.9	0.6	2.0	1.6	2.1

Notes:
[a] Persons.
[b] Net lending/borrowing vis-à-vis the rest of the world.
Source: *Eurostat, UK Office for National Statistics (ONS) and Commission services' spring 2005 forecasts.*

The UK's current macroeconomic policy framework of an independent monetary policy is based on inflation targeting and a freely-floating exchange rate, combined with medium-term oriented fiscal policy. Operational independence was accorded to the Bank of England in 1997 and the current fiscal framework was instituted in 1998 (on the latter see below, Box 1). Up until and including the 1990-92 recession, UK macroeconomic performance had been relatively poor, marked particularly by real and nominal instability as well as low growth compared to the EU average. Thereafter, aided by the adoption of the new policy framework, performance increased markedly. Output growth recovered robustly from 1993 while consumer price inflation dropped to the 2-3% per annum range; for both variables instability

[1] SEC(2005) 1144 final

declined (for inflation, to very low levels). From a peak rate of 10% in 1993, unemployment fell steadily to reach 5% by 2001, with a further modest decline subsequently; employment growth has also been steady and sustained, averaging 1% in the eleven years to 2004, and with the employment rate rising to above the Lisbon target of 70%.

This macroeconomic success built on broad and deep supply-side reforms to capital, labour and product markets going back to the 1980s and further strengthened in the 1990s and subsequently. Wage bargaining is extensively decentralised while statutory employment protection has traditionally been limited (given the low base, there was little significant change to the latter during the 1990s). Product market regulation is also extremely light and according to the OECD's indicator this is consistently so across the domains of state control and barriers to enterprise and trade and investment, with the UK scoring overall ahead of all other OECD members[2]. Against these strengths, the UK still records a relatively low level of productivity, despite some recent closing of the gap, with its GDP per hour worked estimated to be about 5% below the EU15 average in 2003[3]. A number of reasons have been proposed to explain this: notably the UK's relatively low stock of physical capital, a shortfall in intermediate skills and low levels of R&D expenditure.

From 1993 to the turn of decade, the substantial output growth was achieved in a framework of progressive and rapid fiscal consolidation. The annual average improvement in the general government balance approached 1½ pp of GDP in the six years 1994-1999, with an initial substantial deficit turning to surplus. The corporate sector surplus declined (as firms expanded employment and stepped up investment), as did household saving (as confidence grew following the trauma of the early 1990s recession), with both sectors moving into deficit. The large negative output gap of around 3% in 1992 and 1993 closed within 5-6 years. From a demand-side perspective the growing strength of the economy in the 1990s, despite the withdrawal of fiscal support, was centred on the domestic private sector with rising private consumption pre-eminent, helped by a recovery of the depressed housing market from the second half of the decade. In the seven years to 1999, final domestic demand more than accounted for the growth in real GDP, with over two-thirds of this contribution coming from private consumption and just over a quarter from fixed investment. Government consumption growth was modest and net exports, after an initial fillip from the post-ERM depreciation, were a drag on growth, particularly after sterling strengthened significantly from 1996.

The period from 2000 has been marked by fast-growing demand and a widening of internal imbalances though, judged at the aggregate level, performance in terms of output growth and stability has continued to be very good. Helped by responsive monetary and fiscal policies within the UK macroeconomic framework, the economy has withstood global challenges well: first the peaking and fallout from the bursting of the global equity bubble and subsequently the acute volatility in oil prices. For the UK, although the first of these was important, given the corporate reliance on equity funding and, because of its impact on the wealth effect, the high stock market capitalisation relative to GDP, the bubble's bursting was tempered and subsequently probably more than offset up to 2004 by the positive demand effects from continued rapidly rising residential property prices. This offset has, however, come at a price. House price inflation, fuelled by fully liberalised mortgage funding and low nominal interest rates, averaged 13%[4] in the five years to 2004, but since late 2004 the

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[2] OECD Economics Department Working Paper 226, *Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation* (April 2000) and OECD Economics Department Working Paper 419, *Product Market Regulation in OECD Countries: 1998 to 2003* (February 2005).

[3] Eurostat figure.

[4] UK official data.

absolute level of prices has stagnated: this pattern has the hallmarks of over-shooting, though no sharp correction has yet been registered.

Very high rates of growth of secured and unsecured credit extended to the household sector, with debt-to-income ratios at record levels, have been accompanied by a continuing decline to record low rates of saving (4.2% of income in 2004). While overall household sector balance sheets appear strong, taking into account the rise in residential values and recovery in financial equity, and the labour market has continued to be robust, still there are reasons for concern. One is that the housing market almost certainly has to unwind, even if no more than stabilising in terms of nominal prices, undermining growth of household expenditure through confidence and wealth effects as well as directly reduced expenditure on housing-related durables. A second is that, in any case, household saving needs to rise, notably to address the prospect of levels of future pension provision widely evaluated as inadequate. The intensifying national policy debate on pension provision could of itself help to bring this about, which would be positive in the long term but potentially harmful to short-term demand prospects.

Table 2: Sources of potential output growth

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Potential GDP (% change) [a]	3.1	3.0	3.0	2.9	2.9	2.7	2.7	2.8
Contributions:								
- Labour	*0.7*	*0.8*	*0.8*	*0.7*	*0.8*	*0.5*	*0.4*	*0.5*
- Capital accumulation	*0.9*	*0.9*	*0.8*	*0.8*	*0.8*	*0.9*	*0.9*	*1.0*
- Total factor productivity	*1.4*	*1.4*	*1.3*	*1.3*	*1.3*	*1.3*	*1.4*	*1.4*
Output gap (% of potential GDP)	0.3	1.3	0.6	-0.3	-0.7	-0.2	-0.1	-0.1

Note:
[a] Based on the commonly agreed method for calculating potential output.
Source: ONS and Commission services, including spring 2005 forecasts.

Other major shifts in sectoral balances have been the move into significant deficit of the government sector (Section 3) with a falling household saving rate and government deficits reflected in a continuing external deficit (rest of the world surplus) and move into surplus of the corporate sector; the latter in part reflects a relatively low level of business investment that has been declining relative to GDP since 1998 to under 10% in the last two years. As in the 1990s, net exports have continued to be negative and their impact in terms of GDP growth has been persistently negative. Growth of demand has thus continued to be domestically led, with, however, a shift from 1999 onwards to an important contribution from government current and more recently capital expenditure in addition to the dominant role played by the private sector, especially private consumption expenditure.

Given the buoyant demand growth, output has also grown on a sustained basis, only slowing in recent quarters. The labour market has continued to be robust, with full employment effectively achieved. Potential output growth, according to the common methodology and based on the data underlying the spring forecast (see Table 2 below), has eased slightly from around 3% per annum at the turn of the decade to around 2¾%. Around half of the current rate represents increased inputs, chiefly of capital but with a high labour content; total factor productivity accounts around half, a rate of growth that has varied little in the past twenty years[5]. Applying this methodology to the spring forecast data, a situation of actual output

[5] The calculation of total factor productivity growth is derived by applying a Hodrick-Prescott filter, so is subject to a smoothing bias.

exceeding potential at the peak in 2000 had evolved to a marginal negative gap (essentially zero) by 2004 according to Commission services' spring 2005 forecast.

2.2 The short-term outlook

The short-term outlook now looks more subdued and more vulnerable than when assessed in the framework of the Commission services spring forecast. Part of the reassessment reflects taking into account new (and revised) national accounts and other economic data which now portray a much sharper slowdown starting in the second half of 2004 than previously thought; other new elements in the data portray a more worrying degree of internal imbalances, including low private and public saving, while uncertainty still hangs over the future of the housing market and its impact on the wider economy. Taking these factors into account, the Commission services spring forecast of 2.8% output growth this year is unlikely to be realised. Compared with expectations in the spring, the growth of output seems likely to be lower through the second half of this year and into 2006, though a return towards potential growth now estimated at around 2½% per annum still seems feasible.

After GDP growth of 0.4% in the first quarter of 2005 the second quarter estimate is of 0.5%, pulling the annual rate down to 1.8%. The manufacturing sector is in recession. Looking forward, elements affecting the short-term outlook, when compared with conditions actual or expected at the time of preparing the 2005 spring forecast (mid-March), are mixed. On the positive side monetary conditions have clearly eased, whereas the spring forecast assumed a degree of further tightening. The general re-evaluation of short-term prospects resulted in August in a first reversal of the tightening interest rate cycle initiated in November 2003, with the Bank of England reducing its policy rate by 25 bp to 4½%. Long rates for ten-year government bonds have eased by around 60 bp since mid-March. Although corporate bond yields have responded little, financing conditions and household wealth have been improved by a rise in equities of some 5%[6]. Sterling's nominal effective rate has eased by 1%[7], largely accounted for by the rise of the US dollar, against which sterling has weakened by approaching 7%. By contrast external developments have been clearly negative. Oil prices have risen and remained far in excess of expected levels: occasionally over USD 70 / bbl compared with a forecast 2005 average of USD 45 / bbl. As regards external demand, 2005 first-half growth in the euro area, the UK's chief trading partner, was weaker than forecast with only a mild acceleration expected for the third quarter.

Given this background, the Commission's spring forecast of 2.8% UK output growth in 2005 (and, a fortiori, the March 2005 Budget forecast of 3-3½%) is now clearly unlikely to be met. The prospects for the coming quarters seem likely to be of continuing sub-trend expansion. In addition, the composition of growth also seems likely to be tilted more towards net exports, and possibly investment, and less to household consumption than assumed in the spring. Such a composition may impact negatively on public revenues. The easing in monetary conditions which has already intervened, both of interest and exchange rates, is unlikely to have much significant impact until later in 2005 or even 2006, though some earlier impetus may come from the change in equity markets. The external environment, while improving, is doing so from a weaker position than expected in the spring, while the domestic economy appears subdued. On balance, an increase in real output of the order of 2% now appears cautiously realistic as a central estimate for both calendar 2005 and financial year 2005/06

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6 FT All-Share Index, price return.

7 Bank of England broad effective exchange rate (the Bank's narrower index yields a similar result).

(see Table 3). Given the positive monetary impulse, and continuing to assume unchanged fiscal policies, growth could be a little stronger in 2006 and 2006/07[8].

Taking this central view of the prospects for output growth having significantly weakened, the impact on the labour market, relative to the spring forecast, also needs to be considered. The spring forecast was based on an appreciation that the UK labour market in early 2005 was already quite tight, with only moderate scope for further increases in employment in the short term; consequently, recent higher rates of productivity growth were expected to be maintained, and the unemployment rate was expected to remain stable. Compared with this, changes as a result of the revised output prospects are unlikely to be dramatic, especially in the very short term given the normal lags, and recent labour market data so far do not contradict this. It does nevertheless now seem more probable that there will be slightly lower rates of employment growth and modest increases in the numbers economically inactive and unemployed. The unemployment rate may be around ¼ percentage point higher than expected in the spring, at around 5%.

This reassessment of short-term prospects, taking into account substantial data revisions for recent quarters, also impacts on the interpretation of the path and composition of potential output and the cyclical position. Applying the common methodology, potential growth now appears to have eased somewhat more significantly since the turn of the decade (Table 3). Currently it seems closer to 2½% rather than 2¾% per annum, with the modest deterioration compared with the spring assessment representing lower growth of total factor productivity. Relative to this lower potential output path, the sharp slowing of actual output now seems to imply a modest positive output gap in 2004 reversing during the course of 2005 and remaining modestly negative in 2006.

Table 3: Macroeconomic developments and outlook (revised central scenario)

	1999	2000	2001	2002	2003	2004	2005	2006
Real GDP (% change)	3.0	4.0	2.2	2.0	2.5	3.2	2.1	2.4
Potential GDP (% change) [a]	3.0	3.0	2.9	2.8	2.8	2.6	2.5	2.6
Output gap (% of potential GDP)	0.3	1.3	0.7	-0.1	-0.4	0.2	-0.2	-0.4

Notes:
[a] Based on the commonly agreed method for calculating potential output.
Source: ONS and Commission services

3. MEDIUM-TERM BUDGETARY POSITION

3.1. The deficit and the composition of revenue and expenditure

The UK general government balance has developed in two main phases over the last decade. The late 1990s saw significant fiscal consolidation with the deficit falling from 5.8% of GDP in 1995 to a surplus of 1.1% in 1999; the structural primary balance improved by 5.7 percentage points over the period. Higher revenues contributed, but most of the adjustment was on the expenditure side. Most of the subsequent deterioration of the balance also reflects a structural change: between 1999 and 2004 the general government balance deteriorated by 4.2 percentage points of GDP, fairly similar to the around 5 percentage points deterioration in

[8] For comparison, the UK Treasury's monthly survey of independent forecasters for August shows "new" GDP growth forecasts published in the preceding month (and thus all after the major national accounts revisions published on 30 June) average 2.1% for 2005 and 2.3% for 2006. See: http://www.hm-treasury.gov.uk/media/0CA/24/forecasts_ukeconomy_310805.pdf.

the cyclically-adjusted primary balance (Table 4). The actual surplus peaked in 2000, helped by receipts from the sale of UMTS licences, since which time the government has undertaken a sustained increase in the level of both current and investment expenditure. This, coinciding with slower growth and revenues, led public finances into deficit in 2002 and to exceed the 3% reference value in 2003/04 and 2004/05, though the debt ratio, while steadily increasing since 2002, has throughout remained relatively low.

Table 4: Budgetary developments and outlook [a]

	1999	2000	2001	2002	2003	2004	2005	2006
General government balance	1.1	3.8	0.7	-1.6	-3.3	-3.1	-3.0	-2.7
Primary balance	4.1	6.5	3.1	0.5	-1.3	-1.1	-1.0	-0.7
Total expenditure	39.9	37.7	40.8	41.7	43.4	43.7	44.0	44.1
of which:								
Government gross fixed capital formation	1.3	1.3	1.4	1.5	1.6	1.8	2.0	2.1
Interest expenditure	2.9	2.8	2.4	2.1	2.1	2.1	2.1	2.1
Total revenue	41.0	41.5	41.7	40.0	40.2	40.6	40.9	41.4
of which:								
Taxes and social security contributions	37.5	38.1	38.0	36.6	36.6	37.3	38.3	38.7
Cyclically-adjusted balance (CAB) [b]	1.0	0.8	0.5	-1.4	-3.0	-3.0	-2.9	-2.6
Cyclically-adjusted primary balance (CAPB) [b]	3.9	3.5	2.8	0.6	-0.9	-1.0	-0.8	-0.5
General government gross debt	44.9	41.9	38.7	38.2	39.7	41.5	41.9	42.5

	99/00	00/01	01/02	02/03	03/04	04/05	05/06
General government balance	1.6	3.8	-0.1	-2.2	-3.2	-3.2	-3.0
Primary balance	4.3	6.6	2.2	-0.1	-1.2	-1.1	-0.9
Government gross fixed capital formation	1.2	1.3	1.5	1.6	1.6	1.9	2.0
Interest expenditure	2.8	2.7	2.3	2.1	2.0	2.1	2.1
General government gross debt	42.9	39.8	37.8	37.6	39.5	40.8	42.0

Notes:
[a] In percent of GDP.
[b] Excluding UMTS receipts of 2.4% of GDP in 2000.
Source: *ONS and Commission services, including spring 2005 forecasts with previously unpublished data for 2005/06.*

As regards developments in the composition of revenues and expenditures, expenditure has risen from 39.9% of GDP in 1999[9] to 43.7% in 2004. While the overall level of expenditure remains slightly lower than observed during the early 1990s, the composition of expenditure has changed, helped by consolidation of the public finances. In particular, a reduction in gross debt has resulted in debt interest payments having fallen from 3.6% of GDP in 1995 to 2.1% in 2004, thus in turn allowing a greater share of total expenditure to be devoted to public services. This has also helped finance an increase in general government gross fixed capital formation since 1999 from 1.3% of GDP to 1.8% in 2004; the government intends to increase the ratio further in the coming years as it continues to address a perceived legacy of underinvestment in public infrastructure. From Figure 1, however, it is apparent that since 2002 the general government deficit has consistently exceeded general government gross fixed capital formation. Taking into account depreciation, the deficit has financed a relatively modest increase in the capital stock. Table 4 and Figure 2 show the impact on public finances of the substantial increase in government expenditure. Subsequent updates of the UK

[9] Expenditure figures for 2000, while lower, do not allow for an accurate comparison, since UMTS receipts were recorded in the national accounts as a negative expenditure.

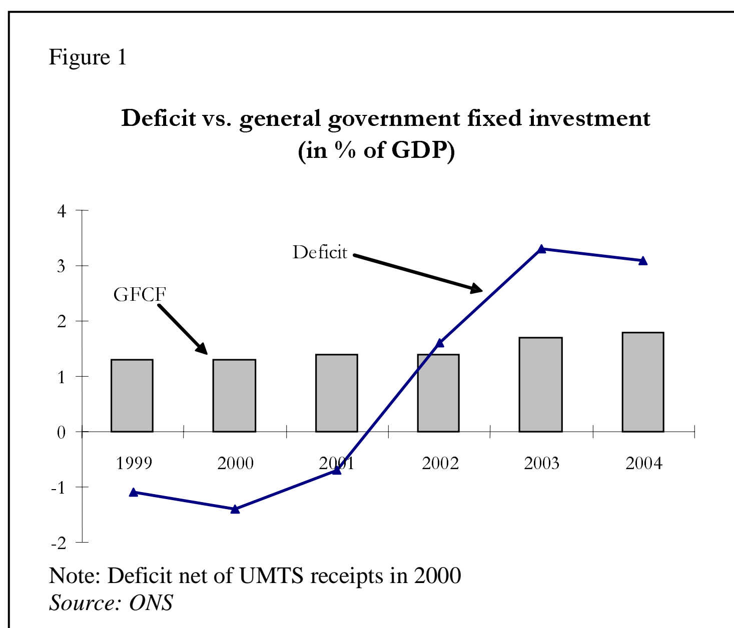

Figure 1

Deficit vs. general government fixed investment (in % of GDP)

Note: Deficit net of UMTS receipts in 2000
Source: ONS

convergence programme first presented in 1998 have shown a general worsening of the projected outturn at the end of the respective programme periods, even as successive updates have extended forward the programme horizons.

In 2003/04, the deficit breached the 3% of GDP reference value for the first time since the abrogation of the last UK excessive deficit in 1998. This was anticipated in the 2003 update of the UK convergence programme, implying a substantial revision of the authorities' expectations for the deficit by contrast with their earlier views.

At the time of the 2003/04 breach and as a reaction to it, the Commission prepared a report on the possible existence of an excessive deficit. However, the Commission and EFC concluded that since the breach of the reference value was small and likely to be temporary, an excessive deficit in the sense of the Treaty did not exist (see Box 1).

Coming to the most recent period, the subsequent update of the UK's convergence

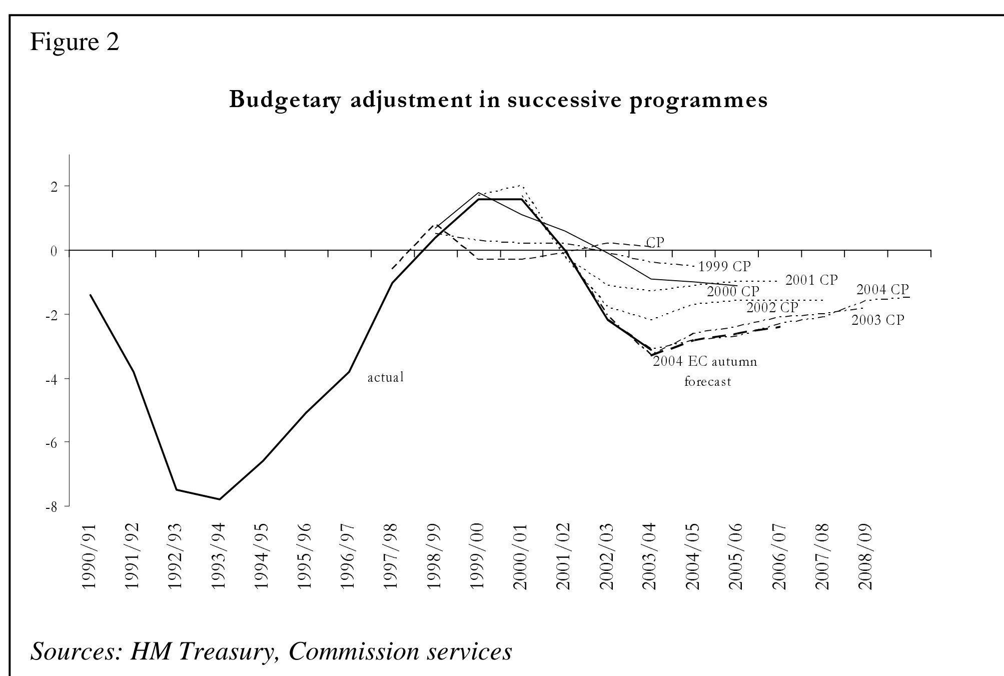

Figure 2

Budgetary adjustment in successive programmes

Sources: HM Treasury, Commission services

programme in 2004 revised upwards estimates of the 2004/05 deficit, for which the most recent official projection in the March 2005 Budget was of 3.0%[10]. However, the latest public finance outturn data indicates that the deficit actually reached 3.2% of GDP. Relative to the Budget projection, the deterioration results from both slightly higher expenditure and some relative weakness in revenues. Total current receipts are now estimated to have been slightly over 0.1% of GDP worse than was expected, though with significant variation among components: taxes on incomes and wealth were some 0.03% of GDP lower than expected, while taxes on production (principally VAT) were around 0.1% of GDP lower. This latter outturn is likely to reflect weaker household consumption, particularly towards the end of the year, than had previously been estimated. On the expenditure side, both net investment (UK definition[11]) and current expenditure were each around 0.04% of GDP higher than estimated in the Budget. Current expenditure's slight overspend appears to result from higher local authority expenditure, something difficult for the authorities to estimate accurately at the time of the Budget because of lack of data.

Box 1: The April 2004 EDP report

In financial year 2003/04, the UK breached the 3% of GDP reference value for general government net borrowing for the first time since the abrogation of its previous excessive deficit in 1998. On the basis of data estimating the deficit at 3.2% of GDP (3.3% once adjusted to reflect the Eurostat agreed basis of accounting for UMTS receipts) in calendar year 2003, and official estimates of a similar deficit in financial year 2003/04, the Commission initiated the Excessive Deficit Procedure against the UK in accordance with Article 104(3) of the Treaty.

The Commission report[12] noted that the principle reason for the deterioration in the deficit in recent years was the sustained increase in public sector expenditure that had been taking place for several years. The outturn represented a marked deterioration in the public finances from the deficit of 2.4% of GDP (for 2003-04) that had been projected by the authorities in the 2003 Budget; in this regard, the Commission's report also made clear that the deficit had been adversely affected by a modest negative output gap and some growth composition effects; despite GDP growth being broadly in line with expectations, growth in wages and salaries in the private sector in 2003 had been lower than projected, reducing revenues from income tax and social security contributions. Corporation tax receipts had also been depressed by low profitability, reflecting the impact of financial sector companies whose profits had been affected by turbulence in equity markets in the previous couple of years. Higher-than-expected general government current expenditure also contributed, most notably the discretionary expenditure related to the Iraq war, and measures to combat terrorism.

Both the UK authorities and the Commission foresaw that the excess over the reference value was likely to be temporary. The authorities forecast, in the March 2004 Budget, that the deficit would decline to below 3% of GDP already in 2004/05. A similar, though less optimistic, assessment was given by the Commission services' spring 2004 forecast on a calendar year basis – though the Commission report also noted the lack of an adequate margin against future outturns exceeding the 3% reference value. Following consultation of the Economic and Financial Committee, and on the basis of the report's analysis, the EFC and the Commission concluded that an excessive deficit did not exist at that time.

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10 March 2005 Budget. The figure has been adjusted to account for UMTS receipts on the Eurostat agreed basis.

11 A non-ESA aggregation of *public sector* net fixed investment, inventory formation and net capital receipts other than capital taxes (the latter being included in the public sector current account).

12 See: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/edp/edprep2004_uk.pdf.

The Commission services' spring 2005 forecast foresaw a modest improvement in the deficit to 3.0% of GDP in 2005 (and 3.0% also for financial year 2005/06, an unpublished projection), with a further improvement to 2.7% in 2006. However, subsequent evaluation suggests that the macroeconomic projection on which these deficit figures were based is no longer tenable. Recently published national accounts and other economic data show the economy having slowed more sharply than had previously been appreciated. Even assuming expenditure in line with the assumptions made for the spring forecast (the forecast assumes that the government's expenditure plans, already set for the period up to and including 2007/08, will be precisely met in nominal terms), weaker GDP growth can be expected to impact on revenues. Composition effects could also compound the negative impact on general government revenues as current slower growth largely reflects weaker domestic demand than forecast in the spring. A further risk to the public finances comes from the architecture of the government's departmental expenditure framework (discussed below in Section 4 and Box 3). As a result of the revised macroeconomic assessment and also taking into account recent developments in general government receipts and expenditures, on unchanged policies the deficit is expected to remain above the 3% reference value in 2005/06 (of the order of 3¼% of GDP) and also remain slightly above 3% in 2006/07[13].

The issue of the consistency between the UK's fiscal framework and that of the Community is explored in Box 2.

Box 2: The UK's fiscal rules and respect of the 3% of GDP reference value

The UK's fiscal policy framework is based on two fiscal policy rules for the *public* sector: the "golden rule", adherence to which ensures that over the course of the economic cycle, the government borrows only to finance net investment[14], and not to fund current expenditure; and the "sustainable investment rule", which aims to keep public sector *net* debt at "a stable and prudent level" (interpreted as below 40% of GDP). Within this framework, the authorities set an explicit objective of maintaining sound public finances.

With its emphasis on the economic cycle as a whole, application of the UK's golden rule allows for deficits on the current budget (current revenues minus current expenditure) to be offset against surpluses credited elsewhere in the cycle. A reassessment of the current cycle's duration was published by HM Treasury in July 2005[15]. Prior to this, the Treasury's provisional assessment had been that the current cycle began in 1999. In the reassessment, taking account of national account revisions, new market sector output data and new analysis of movements in the labour share of value-added, the authorities now estimate that the current economic cycle began in the first half of 1997. Under the golden rule this has effectively allowed increased surpluses on the current budget achieved in the early years of the current cycle to be offset against the current run of deficits. The surplus peaked in 2000/01, since when the balance has deteriorated markedly, leading to deficits since 2001/02 and a breaching of the 3% of GDP reference value in 2003/04 and in 2004/05 (see Figure 2).

[13] The UK Treasury's monthly survey of independent forecasters published in August indicates that "new" forecasts (those received in the preceding month) have an average forecast for the *public sector* deficit of £38.8 bn for 2005/06 and £38.4 bn for 2006/07. While there is no straightforward mapping of these forecasts to data comparable to the indications given above for the general government deficit, it is noteworthy that on average they seem to be based on a very similar real growth outlook to that of the Commission services (cf footnote 8); that in the 2004/05 financial year, there was no significant difference between general government and public sector deficits; and that these forecasts credit accruing UMTS licence receipts of £1.0 bn per annum excluded from calculation of the Treaty deficit. Expressing the average independent forecasters' deficit projections, after excluding such receipts, as a percentage of nominal GDP as currently foreseen by the Commission services yields deficits of 3.2% and 3.1% of GDP in 2005/06 and 2006/07 respectively.

[14] Cf. fn. 11.

[15] *Evidence on the UK economic cycle*, http://www.hm-treasury.gov.uk/media/2E6/A5/economic_cycles190705.pdf

Despite these recent outturns, the government maintains that the golden rule will be met over the current cycle, expected to be completed with a return to trend around the end of 2005.

For two reasons, this budgetary strategy is not necessarily consistent with achieving deficits below 3% of GDP as the results in 2003/04 and 2004/05 confirm. First, meeting the golden rule implies that, on average over the cycle, annual public sector net borrowing as a share of GDP will be no higher than average net investment as a share of GDP over the same period. This suggests that the likelihood of inconsistency in any one year is greater the higher is the level of net investment. The UK's budgetary strategy does not impose an explicit limit to the level of net borrowing, because it explicitly allows for borrowing to fund net investment.

The only implied limits to the level of net borrowing are those derived from the complementary "sustainable investment rule" which requires that over the medium to long term, deficit levels are de facto limited by the need to maintain net debt at "stable and prudent" levels, interpreted as below 40% of GDP. But given that the latest official public finance projections (in the March 2005 Budget) projected net debt to rise only modestly to around 37% of GDP by 2009/2010, the rules would still allow some further room for borrowing to finance net investment in the years ahead.

A second potential source of inconsistency is implied by the framing of the rules. In particular, the golden rule is framed over the course of the cycle, rather than on an annual basis; as already noted, the deficit can fluctuate widely from year to year, and it cannot be excluded that general government net borrowing will exceed the 3% of GDP reference value in one or more years of the cycle, while still meeting the golden rule (indeed, part of the rationale for framing the golden rule in this way was to protect investment expenditure from short-term budgetary pressures).

Actual fiscal performance since the introduction of the fiscal framework in 1997 has shown that the UK's fiscal rules have been consistent with observance of the 3% of GDP Treaty reference value in most years. However, more recent experience clearly illustrates the potential for inconsistency.

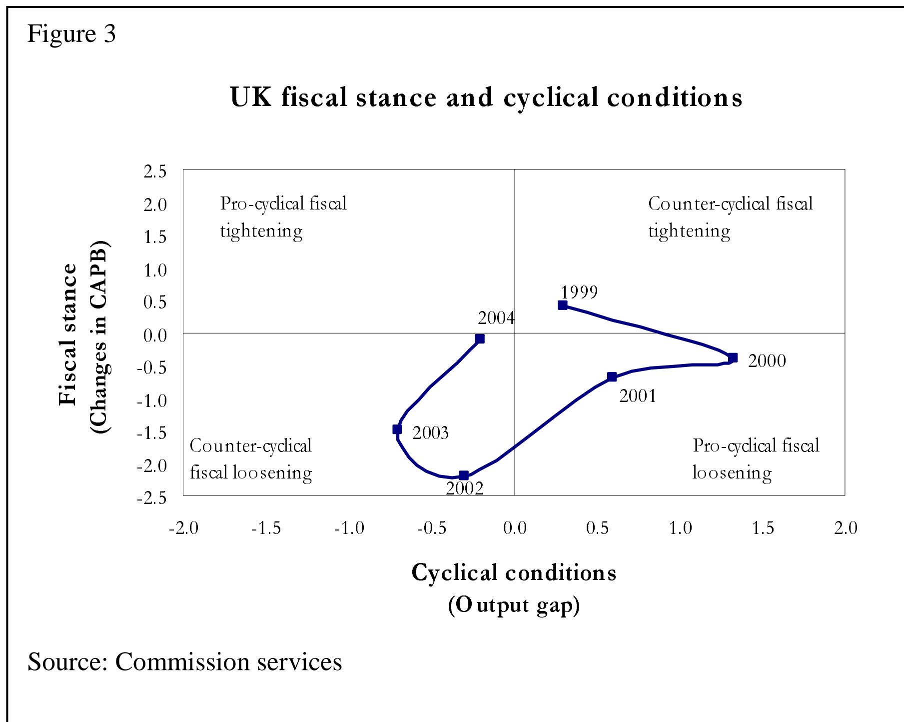
3.2. The structural deficit and fiscal consolidation efforts in good times

In 2004, the UK had an estimated deficit net of cyclical factors and one-off measures, of 3.0% of GDP. That represents a significant deterioration from the UK's structural surplus of 0.8% of GDP achieved in 2000[16]. In terms of the cyclically-adjusted primary balance the deterioration was also clear (from an estimated surplus of 3½% in 2000 to a deficit of 1% in 2004). In the Commission's spring forecast, the structural deficit was expected to improve slightly over the next two years. This remains the current judgement.

Since 2000, the UK has significantly loosened its fiscal position (net of both cyclical factors and one-off measures). Figure 3 shows the fiscal stance (proxied by the change in the cyclically-adjusted primary balance) in relation to the prevailing cyclical conditions (captured by the estimated output gap). Fiscal loosening has been continuous since 2000, covering periods when the economy has been both above and below potential.

[16] Cyclically-adjusted balances have been calculated using the output gaps shown in Table 2, i.e. taking account of revised outturn data but retaining the spring forecast of output growth in 2005 and 2006. The indicators need to be treated with care, as factors such as composition effects and revenues stemming from the evolution of asset market prices may alter the estimated values. Nevertheless, there is no doubt that fiscal policy became expansionary after 2000.

Figure 3



Source: Commission services

3.3. Quality of public finances

The UK government's determination to tackle what it views as past under-investment and under-provision in public services, within the framework of the UK's budgetary rules, helps explains why total general government expenditure has risen from just over 37% of GDP in 2000 to around 43½% in 2004. Education and training has been considered a particular priority, with such expenditure having increased since 1998/99 from 4½% of GDP to around 5½% in 2004/05, and planned to rise to roughly 6¾% of GDP by 2007/08. Another priority is healthcare; as a share of GDP, public expenditure on health has increased from 5½% in 1998/99 to around 7% in 2004/05; the share is planned to increase to 7¾% by 2007/08. In addition government measures to improve R&D performance could increase public sector R&D expenditure by just over 0.1% of GDP by 2014. In infrastructure, the government considers transport a priority problem, partly to be solved by increasing investment: capital investment in transport is set to rise in real terms by about 0.04% of GDP between 2004/05 and 2007/08.

Table 5. Total public expenditure on services by function as a percentage of GDP

	1998/99	2004/05	planned 2007/08
Social protection	13.2	13.8	-
Health	5.4	6.9	7.8
Education and training	4.6	5.6	6¾
Transport	1.0	1.5	-
Enterprise and economic development	0.4	0.6	0.6
Science and technology	0.1	0.2	0.2
Overseas development assistance	-	0.4	0.5

Source: HM Treasury Public Expenditure Statistical Analyses

2005

3.4. Long-term sustainability

General government gross debt in the UK has been on a broadly declining trend since the mid-1990s, falling from 52.2% of GDP in 1996 to 38.2% of GDP in 2002. This included a significant one-off impact from the sale of UMTS licences in 2000, which the authorities largely used to repay debt. Due to borrowing associated with the increase in expenditure, however, gross debt rose to 40.8% of GDP by the end of 2004-05[17]. The debt ratio, although projected to continue to rise modestly in the short term, is set to remain well under the Treaty reference value of 60% of GDP.[18] However, the ratio could rise more rapidly if the recent worsening trend of the cyclically-adjusted primary balance is not controlled.

The most recent Commission assessment of the UK's convergence programme update concluded that the UK "appears to be in a relatively favourable position with regard to the long-term sustainability of the public finances, despite the projected budgetary cost of an ageing population". Figure 4 shows the relatively favourable position of the UK inside the EU as regards the importance of the expected evolution to 2050 of public pension expenditure, though for other age-related expenditure items expected developments are more similar. As regards pensions, public finance risks may be posed in particular if provision of private pensions is recognised as insufficient. Long-term pension risks were identified in the First Report of the Pensions Commission, an independent body appointed by the government, which found that, given planned public provision, the current level of private pension provision is insufficient over the long run to maintain pension incomes relative to other income. A number of possible responses were identified by the Pensions Commission, including raising statutory retirement ages and options to increase levels of private saving. Policy options will be discussed further in the Second Report of the Commission, due to be published later this year. The government has indicated that any decision on firm proposals is likely to be taken over the course of the current parliament. Solutions to this problem would have public finance implications if they were to lead to higher public provision; however, this remains only one option among the several identified by the Pensions Commission. Moreover, adherence to the UK's fiscal rules would mean that any increase in pension expenditure would (on average over the cycle) need to be financed from current revenues, or reallocated expenditure, implying no increase in unfunded pension provision. It should also be noted that the UK's current relatively low tax ratio should ease the accommodation of any imbalances that may arise in the longer term.

The Commission assessment of the convergence programme noted a further challenge for the UK in the case of private defined-benefit pension schemes where the sponsoring firm becomes insolvent and there are insufficient assets in the scheme to meet schemes' liabilities. This challenge appears particularly relevant given estimates of a widespread shortfall in private pension scheme assets relative to their liabilities.[19] Since the assessment of the

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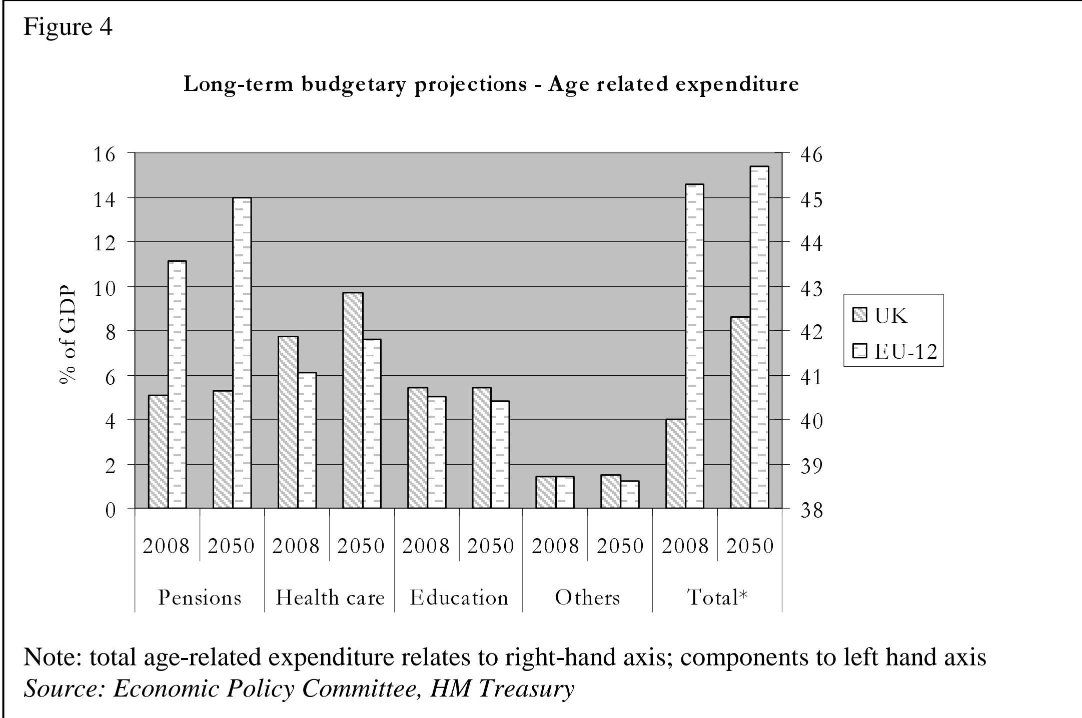
[17] August 2005 EDP return.

[18] It can also be noted that the UK government makes extensive use of Private Finance Initiatives (PFIs) as a means of undertaking investment with private capital. In essence, the private sector undertakes capital investment, which may include maintenance or construction of infrastructure, while the public sector leases the project, contracting to purchase services provided as result of the completed investment. As at the end of 2004, the total capital value of signed PFI contracts was recorded by HM Treasury to be around £48 billion.

[19] See, for example, "Accounting for Pensions, UK and Europe, Annual Survey 2005" by Lane, Clark and Peacock (Actuaries and Consultants). This survey estimates that the total deficit on defined benefit pension schemes operated by companies listed on the FTSE-100 Index was £37 billion (roughly 3% of GDP) as of July 2005; however, the report notes that this represented a fall from £42 billion as of July

convergence programme, the UK has introduced the Pension Protection Fund (PPF), designed to protect members of such schemes. The scheme is being financed by taking on the assets of pension schemes with insolvent employers, and through a levy on eligible defined benefit schemes. Specific provisions allowing the levy to be increased if the system faces resource pressures, help alleviate concerns regarding the scheme's ability to provide sufficient coverage and protection.

Figure 4



Note: total age-related expenditure relates to right-hand axis; components to left hand axis
Source: Economic Policy Committee, HM Treasury

4. OTHER FACTORS

In a letter of 27 July 2005, the United Kingdom authorities communicated some "other relevant factors" in accordance with Article 2(3) of Council Regulation (EC) No 1467/97 as amended by Council Regulation (EC) No 1056/2005. These were considerations relating to sustainability and debt, public investment, the timing of net payments to the EU and commitments to international aid and debt relief. Alongside investment they also mention that the composition of current expenditure in general has been redirected to growth-enhancing items. The analysis above already covers the first two of the items put forward by the authorities.

As regards the first of the two remaining items, changes unexpected by the UK authorities in the timing of structural fund receipts raised the 2004-05 deficit by £800 million (0.07% of GDP) compared with the March 2005 Budget estimate, and is assumed to improve it by a similar amount in the current financial year.

Under the second item the authorities record that UK contributions to international aid and debt relief in 2004-05 were 0.36% of GNI. The Commission notes that this is likely to rise as

2004, with companies having paid higher contributions to their pension schemes over the preceding year.

the UK Government implements its desire to increase international aid and debt relief to 0.7% of GNI by 2013.

Regarding the UK authorities' public finance projections, the authorities try to build caution into the projections by basing them on a forecast scenario in which trend output growth is a quarter percentage point lower than the rate used in their central macroeconomic forecast. Currently, the macroeconomic basis underlying the official public finance projections dates from the autumn 2004 Pre-Budget Report; these projections were not revised in the March 2004 Budget. However, more recently, the UK's short-term projections do not appear particularly cautious[20]. The GDP growth projection underlying the authorities' projections for financial year 2004/05 was 3¼%, whereas the outturn was actually 2.9%. The authorities' projections for 2005 are higher than the Commission's growth projections in its spring forecast and much higher than the Commission's current preliminary reassessment (see Table 3) based on the most recent available data.

In its February assessment of the UK's public finance projections (as represented by the December 2004 Convergence Programme update), the Commission already considered that UK GDP growth in 2005 risked being slower than forecast by the UK authorities. Developments since then have reinforced this concern. Only into the medium term was the trend growth assumption underlying the public finance projections assessed to be cautious[21].

For 2005/06, the UK authorities' GDP growth projection is 3% followed by 2½% for 2006/07 (and 2¼% per annum for subsequent financial years). The UK authorities' GDP growth projection for 2006 is now higher than the Commission's preliminary reassessment. The path of real and nominal output, and thus the revenue base (probably aggravated by composition effects), is thus falling significantly short of that underlying budgetary planning. This divergence is likely to widen in financial year 2006/07.

Apart from slower output growth than projected by the authorities, another risk to the public finances comes from the slower public expenditure growth projected by the authorities for 2006/07. Government departments may find it difficult to adjust to tighter budgets, and thus might make use of accumulated unspent balances (see Box 3).

Box 3: The public expenditure framework - limits and flexibility

The UK's public expenditure framework was put in place to address a number of perceived shortfalls in the management of public expenditure, *inter alia* to improve transparency, and develop a more forward-looking assessment of needs. Up until now, the foundation for this framework has been a biennial Spending Review process. The government formally set an overall expenditure agreement every two years as part of the Budget process. The agreement was actually set for a three-year period, but the last year became a "cross-over" year in which year three of one expenditure period became the first year of the next. In practice, that meant that the three year expenditure agreement reopened in year three: for example, the March 2002 Budget set the expenditure envelope for the financial years 2003/04, 2004/05 and 2005/06, while the spring 2004 Budget set the envelope for financial years 2005/06, 2006/07 and 2007/8.

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[20] The forecast for 2005, for example, is significantly above current consensus forecasts of around 2.1% GDP growth.

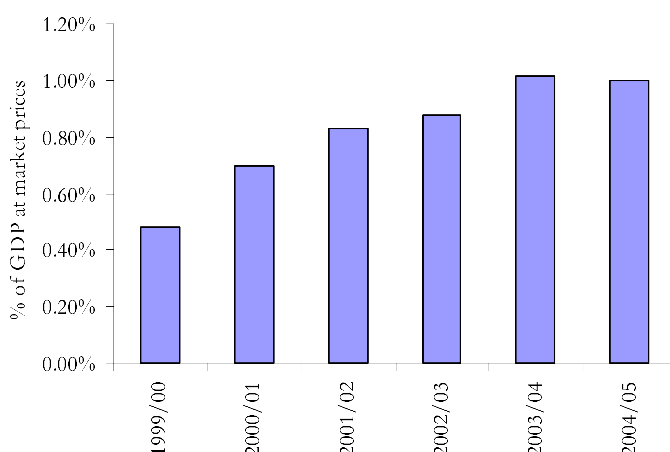
[21] See: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commass/uk/ass_uk20042005.pdf. This assessment was shared by the Council in its Opinion on the UK programme: see http://register.consilium.eu.int/pdf/en/05/st07/st07133.en05.pdf.

Now, however, the Treasury indicates that it will move to holding the Spending Review process every 3 years, with the next taking place in 2007. Expenditure plans will still be set for three years, but the new timetable implies there will no longer be a "crossover" year for which the expenditure agreement can be reopened. Within this framework, overall expenditure is then allocated between departments in the Spending Review (also biennial), as part of a process in which departments bid for available resources.

A further element of the UK's public expenditure framework is the End-Year Flexibility (EYF), which allows central government departments to carry forward under-spends on their Departmental Expenditure Limit (DEL) allocations from one year to the next. Together with the multi-year expenditure plans, the framework aims to reduce incentives to use up resources in wasteful bursts at year-end.

Since the introduction of the current expenditure framework, departments had a clear tendency to under-spend relative to plans (perhaps reflecting some short-term supply constraints); thus, the amount carried forward increased from year to year. As at the end of financial year 2003/04, available EYF was estimated to total £11.4 billion, equivalent to roughly 1% of GDP, comprising around £8.8 billion of unspent resource budget allocations (current expenditure), and £2.6 billion of capital budget allocations. Over the course of financial year 2004/05, accumulated EYF rose to an estimated £11.8 billion, indicating that in aggregate, DEL expenditure has once again been below planned expenditure. As a share of GDP, however, accumulated EYF fell slightly relative to last year.

Accumulated EYF as at year-end



<u>Source</u>: *HM Treasury Public Expenditure Outturn White Papers*

Within the overall under-spend, however, were differences between different types of expenditure. Evidence suggests that DEL overall expenditure on administration costs was slightly above plan, in spite of the authorities focus on administrative expense as part of wider efforts (beginning this year) to improve public sector efficiency. Overall capital expenditure outturns, in contrast, were some £0.5 billion (roughly 0.05% of GDP) lower than planned.

Differences also existed between departments. Some clearly drew on accumulated under-spends in financial year 2004/05, most notably the Department of Education and Skills (DfES) (resource expenditure some £0.5 billion above plans contributed to a total drawdown of previously unused EYF of around £0.6 billion). However, many others remained under-spent relative to their annual DEL allocation.

As previously noted in the technical assessment of the UK's 2004 convergence programme update[22], the existence of large, unspent balances carries some risk to the authorities' public finance projections. Projections for general government expenditure are based on the expenditure allocations made as part of the normal Budget and Spending Review processes; thus, the implied claim on the public finances by government departments reclaiming past under-expenditure is not included in the forward projections of the deficit. Nonetheless, the principle of End-Year Flexibility would so far appear to have had the intended effect of preventing end-year bursts of expenditure.

[22] See: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commwd/uk/com_uk20042005.pdf