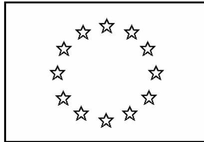

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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2003 UPDATE

OF THE CONVERGENCE PROGRAMME OF THE UNITED KINGDOM

(2002-03 TO 2008-09)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The UK authorities submitted the fifth and most recent updated convergence programme, covering the period 2002-03 to 2008-09[2] (hereinafter referred to as the update) on 10 December 2003.

The update incorporates the authorities' latest projections for the UK economy and public finances as published in tandem on 10 December 2003 in the 2003 Pre-Budget Report (PBR). The update largely complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes.

The strategy for public finances presented in the update is unchanged from the previous update and continues to be anchored by reference to observance of the UK's own fiscal rules[3], these being designed to ensure sound and sustainable public finances over the medium and long term while supporting monetary policy over the cycle. This strategy is thus located within an overall monetary and fiscal framework designed to deliver high and stable levels of growth and employment.

The economy in the recent downturn has proven highly resilient. Real GDP growth in 2003 is expected to be 2.1%, within the April 2003 Budget forecast range of 2-2½%, while unemployment has fallen to and remained around its structural level, employment growth has stayed positive and HICP inflation has been low. The projections reported in the update suggest a closing of a negative output gap, officially estimated to be around 1½% below trend in 2003, by 2006. GDP is expected to grow by 3 to 3½% in both 2004 and 2005, before falling back to an assumed trend rate of around 2¾% by early 2006 as slack in the economy is absorbed. The central estimate of trend growth is projected to decline to around 2½% per annum in the programme's two final years. A comparison with the Commission services autumn forecast, which extends only to 2005, shows broad similarities with the update's projections to this horizon, though growth in the update is higher in 2004 and 2005 with consequently a more rapid closing of the negative output gap than expected by the Commission. There are moreover certain country-specific risks to both the official and Commission projections, particularly the consequences on the household sector of any significant slowing of the rapid increase in recent years in residential property prices or more generally on household indebtedness if interest rates rose strongly, although overall, household net worth is currently strong.

The government's assessment announced in June 2003 that its tests for the UK's adoption of the single currency had not all been met implies that its monetary policy framework is unlikely to change in the near term. As part of this framework, an important development in December 2003 was the replacement of the former 2½% inflation target based on the annual increase in RPIX (retail price index excluding mortgage interest payments) by a new 2% target based on the annual increase in the HICP. The adoption of the new policy benchmark represents a move closer to that within the euro area, in terms of the ECB's May 2003 clarification of its definition of

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[1] This assessment has been carried out on the basis of information available as of 23.01.2004.

[2] The UK financial year runs from April to March.

[3] These are two: the 'golden rule', whereby over the economic cycle the public sector will only borrow to invest, and not to fund current expenditure; and the 'sustainable investment rule', whereby public sector net debt as a proportion of GDP will be held over the cycle at a stable and prudent level.

price stability of annual increases in the HICP over the medium term of close to but below 2%.

Given the monetary policy framework based on inflation targeting, the exchange rate is floating. The update contains no explicit assumptions on exchange rates. Following sterling's depreciation in early 2003, the exchange rate vis-à-vis the euro has stayed within a relatively narrow range, and current levels are now more in line with available estimates of equilibrium rates. Both policy and long-term interest rates have recently risen vis-à-vis those in the euro area, reflecting perceptions of a more advanced recovery cycle in the UK.

The update foresees a medium-term increase in the shares relative to GDP of both general government expenditure and revenue, designed to redress perceived under-provision of public services and past under-investment, while continuing to observe the UK's own fiscal rules and, in the opinion of the UK authorities, "a prudent interpretation of the Stability and Growth Pact" (SGP). Planned rates of growth of public expenditure are particularly marked for the targeted priority areas of health, education and public infrastructure. The update includes no major new policy measures to increase the revenue share (following an increase in social contribution rates in 2003) but projects this share to rise, reflecting contributions from a conventional cyclical response to output returning to trend, a partial correction of a particularly sharp recent fall in receipts, increased collection efficiency and normal fiscal drag.

For purposes of public finance projections, the UK authorities assume annual trend growth throughout the programme period to be a more cautious quarter-percentage-point lower than their central estimates. The resulting adjusted macro-economic scenario is closer to the Commission's autumn forecast, although projected growth still seems somewhat higher than forecast by the Commission in the short term. The projections for fiscal balances in the programme represent a significant downgrading compared with the previous update. The deterioration is most marked for the current financial year, from an expected deficit of 2.2% of GDP in the previous update to 3.3% in the December 2003 update. The projected deficits in the latest update are around 2½% of GDP in both 2004-05 and 2005-06, 2% in the following two financial years and 1¾% in 2008-09. The worsening of 1.1% points of GDP in 2003-04 compared with the previous update falls to 0.9% in 2004-05, 0.8% in 2005-06 and about ½% for the following two financial years. Almost all of this deterioration is structural, with the cyclically-adjusted deficit, as calculated in the programme, worsening by 0.9% point of GDP in 2003-04 and 0.7% in 2004-05. The deterioration in the public finances compared with the previous update is due, beyond a relatively limited part played by conventional cyclical influences, to a downgrading of expected revenue linked to composition effects of GDP growth and to some discretionary higher expenditure mainly linked to the Iraq war. In the short term these have not been offset, given UK fiscal policy's stabilisation role.

Looking ahead, during the programme period, the shortfall in receipts experienced in 2003-04 relative to plans is expected to be partly reversed autonomously. The update thus projects a cyclically adjusted deficit of 2½% of GDP in 2003/4, falling to around 2% of GDP per annum throughout the rest of the programme period. Commission estimates of the cyclically adjusted deficit show a similar downward path (though are slightly higher in the short term.)

The update foresees a slight increase in net and gross debt ratios. By the final programme year the primary deficit is virtually eliminated and the gross debt ratio stabilises at around 41½% of GDP. The modest debt ratios throughout the programme period are combined with the achievement of significant rates of government investment, with the general government net investment-to-GDP ratio rising from 1.1% in 2002-03 to 2.2% by 2005-06, compared to an EU average of 1.5% in 2002.

The resulting fiscal picture can be assessed both in terms of its value as a central projection and in terms of its conformity with the Community's fiscal framework. On the first, the main risk concerns the expected recovery in tax receipts from their recently depressed level. On the second, there is a clear risk of an excessive deficit, which may have already occurred in 2003. Further, the risk of a worse outcome for the public finances than projected in the programme is the more worrying since, even if the official projections were met, the cyclically adjusted deficits of around 2% of GDP throughout the programme period would not, in the Commission's view, ensure an adequate safety margin against a deficit breaching the 3% of GDP reference level with normal macro-economic fluctuations.

Long-term sustainability of public finances is constantly monitored by the UK authorities and represents a key commitment in the UK's fiscal policy. As outlined in the programme, ageing populations are expected to have a limited impact on public spending. The autonomous sharp increase in revenues into the medium term together with a decrease in longer-term non-age related expenditure will, in this view, put the UK on a sustainable path. However, the update itself shows that an inter-temporal budgetary gap cannot be excluded under certain interest rate assumptions. The Commission considers that, on the basis of the current and projected deficits, risks of imbalances in the long term cannot be ruled out. Quantitative indicators estimated by the Commission show an upward trend in the debt-to-GDP ratio. An additional element to be considered is that much of the financial sustainability of the pension system depends on the performance of private pension providers. If private provision produces significantly less than the anticipated coverage or level of pensions, the United Kingdom may face increased claims for means-tested benefits in the future. Nevertheless, the low level of debt and the relatively low level of taxation give room for manoeuvre.

The economic policies as reflected in the updated programme broadly comply with the 2003 Broad Economic Policy Guidelines, specifically those with budgetary implications. As noted above, the framing of the UK programme is centred on a major upgrade of public services, including a renewal and extension of infrastructure. The success of the programme in terms of the quality of public finances is contingent on being able to deliver the planned improvements and to do so in a cost-effective way. The UK authorities are well aware of the challenges, particularly given the worries that have been expressed that significantly higher levels of expenditure already being achieved are not yet being adequately matched in higher public sector output. Beyond the issues involved in adequately calibrating public sector output, it is difficult at present to assess whether the ambitious planned expenditure profiles sufficiently take into account the short term constraints on the supply side, including the managerial feasibility of rapidly extending and improving public sector provision.

1 INTRODUCTION

The fifth update of the convergence programme was submitted to the Commission on 10 December 2003. It is based on the Pre-Budget Report (PBR) published on the same day. The programme contains no new policy initiatives other than those described in the PBR. While the update largely conforms to the Code of Conduct for stability and convergence programmes[4] in its presentation of economic and fiscal policy and prospects, the presentation in the programme would have benefited from comparing changes to the previous update rather than to the Budget in April 2003. The programme could also have benefited from using the common methodology for cyclical adjustment.

Detailed macro-economic forecasts are presented to 2006. The policy framework defines clear policy objectives and allocates responsibility to give accountability. The fiscal objectives are framed in terms of the public sector (including public corporations) but projections, though for financial years only, are also made for the general government finances[5]. Outline projections are made for the period to 2008-09. The policies to secure sustainability of the finances in the longer term are presented, along with projections to 2051-52, to demonstrate that, in the authorities' view, the UK is well placed to meet the challenges of ageing populations. Indeed, "Sustainable Public Finances" is the title of the programme update.

Two particular features of the UK's approach are intended to provide a prudent anchor for the projections. First, a 'cautious' trend GDP growth estimate of 2½% to 2006-07 and 2¼% in 2007-08 and thereafter, underpins the public finance projections; these are a quarter percentage point per annum lower than the 2¾% neutral trend growth rate underpinning the central economic forecasts up to 2006. The caution is intended to guard against possible misjudgement of trend growth in the medium term. Secondly, the National Audit Office (NAO), a Parliamentary body independent of the government, audits a set of assumptions underlying the public finances[6] concerning, for example, trend growth, the development of VAT receipts and equity prices .

2 MACROECONOMIC DEVELOPMENT

2.1 Review of developments in 2003

Although the UK economy weathered the recent global slow-down impressively well, economic developments in 2003 still turned out significantly weaker than projected in the previous update. Overall, GDP growth is now estimated at 2% compared with a range of 2½% to 3% forecast a year earlier. The major demand difference, in terms of a contribution almost equivalent to the total shortfall in GDP, was the disappointing growth of fixed investment: whereas a strong recovery of up to 7% had been forecast, the estimated outturn is of growth only slightly better than that of overall GDP[7]. Other

[4] Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

[5] The update presents public finance data on a 'general government' basis only to 2005-06. Projections are provided for the wider definition of 'public sector', which includes public corporations, until 2008-09.

[6] See Box 4.1 on page 33 of the UK Convergence Programme Update, December 2003.

[7] Although it should be noted that the Office for National Statistics introduced far-reaching data revisions to the National Accounts in the autumn of 2003. These revisions provided new information on

main elements of domestic demand developed on an annual basis very close to the forecast in the previous update, with growth now estimated at 2½% for private consumption, 3¼% for government consumption and a neutral growth contribution from changes in inventories. Still robust growth of private consumption was fostered by continuing strong rises in residential property prices (up 15.6% during 2003[8]), while planned strong public consumption and investment expenditure growth also supported demand. Employment continued to grow, and unemployment fell further, reaching a rate of around 5% at year-end; labour productivity grew around 1½%, similar to the two previous years.

The ongoing weakness in the global economy in the first half of the year resulted in big downward revisions, compared to the previous update, to growth of both exports (down 5½ p.p.) and imports (down around 4½ p.p.). Nevertheless, these two effects were roughly balancing, so that the expected modest and continuing negative external contribution is now estimated to have been only slightly worse, at just over -½% of GDP.

Overall macroeconomic policy was strongly supportive of the UK's performance. The Commission's autumn forecast estimate is that the cyclically-adjusted primary balance eased by almost one percentage point between 2002 and 2003. Monetary conditions were eased by (a) a depreciation of the exchange rate early in the year in 2003; the nominal effective exchange rate is estimated to have been lower by some 4% between January and July, and (b) by two 25 bp cuts in policy rates, in February and July. The latter was reversed in November 2003, marking the UK's more advanced recovery cycle[9].

Inflation remained reasonably moderate in terms of both cost and price developments although inflation (RPIX measure) was higher than forecast a year earlier. Wage growth remained limited despite the strong labour market, with unit labour cost growth of around 3%. HICP inflation was 1.3% in the year to November 2003, while the RPIX rose 2¾% to the fourth quarter, compared with a forecast rise of 2¼%.

Household borrowing rose by 14 per cent in the year to the third quarter of 2003. This was driven mainly by a strong rise in mortgage lending, which accounts for over 80 per cent of the stock of household debt. In 2003Q2, the ratio of household debt to income reached a new peak of over 130%. Despite this, the ratio of household debt to total wealth has remained stable.

2.2 External economic assumptions

The 2003 update expects a rebound in global growth in 2004 that is largely in line with the Commission services autumn forecast. The slowdown in global growth at the end

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recent UK economic history, and resulted in some changes to the growth rates of the components of demand, giving a more balanced view of economic growth.

[8] UK All Properties Index (Q1 1993=100) in December 2003=270.6. In 2003Q4, the annual change of 15.5% was down from the annual change of 25.8% recorded in 2003Q1. Source: Nationwide Quarterly Review Winter 2003.

[9] For further discussion of monetary aspects, see Section 3 below.

of 2002 and into the first half of 2003 is believed to have been temporary, and growth prospects are considered good for most of the major economies.

The programme mentions both upside and downside risks to its growth projections; the update includes among the former the (positive) effect of a turnaround in the inventory cycle and a stronger-than-expected recovery in business investment. The latter include the negative effects of continued imbalances between the world's major economies which pose the risk of sudden, sharp movements in exchange rates. Downside risks also include greater balance sheet adjustment and the continued threat to activity and confidence from global terrorism.

Overall, the external economic assumptions are plausible and generally similar to the Commission's autumn forecasts.

2.3 Macroeconomic scenarios

Central scenario

As explained in the Section 1, the programme presents both a central or "neutral" economic scenario and a deliberately more cautious one, less articulated, directly used in the public finance projections. In the central scenario, as in the Commission autumn forecast, growth in 2004 is sustained by household and government expenditure, albeit with the latter slower than in 2003, together with a revival of investment expenditure and net exports. The recovery in business investment is stronger in the programme's projections than in the Commission autumn forecast, producing overall stronger GDP growth: GDP accelerates to centre on 3¼%, above trend, compared to 2.8% in the Commission forecasts[10]; household consumption growth is also slightly higher in the update. The update projects above-trend GDP growth to persist in 2005, centring on 3¼%. By 2006, growth falls back to trend, centring on 2¾%. This represents a more rapid closing of the negative output gap than expected by the Commission (see further discussion in section 2.4 below).

The inflation outlook to 2006 is for the newly-announced inflation target of 2% on the HICP measure[11] to be met and the Commission services forecast is consistent with this, though the update foresees a slightly faster return to the 2% level than in the Commission autumn forecast. Inflation developments are discussed in more detail in Section 3.

There are certain country-specific risks to the projections. The update accepts that household consumption growth would diminish as a result of slower house price inflation and consequent slower rises in households' wealth. UK consumers have also been accumulating relatively high levels of gross debt, which the update expects to reduce their appetite for continued net borrowing. These views are shared by the Commission. The possibility of a rapid adjustment to house prices represents a downside risk to both the update and the Commission forecasts. However, this effect may be tempered by the fact that, despite the recent build-up in gross debt, the

[10] The programme's forecasts are more optimistic than the average of 2.7% GDP growth projected by independent forecasters for 2004. The IMF (September) and OECD (January) are also forecasting GDP growth lower than the UK's official forecast, of 2.4% and 2.7% respectively.

[11] The HICP measure has now been officially named 'CPI' in the UK.

household sector's net worth position appears sound. Further, interest rates are not expected to rise rapidly, and mortgage interest payments remain low as a percentage of income. Households thus seem to be in a relatively strong position to face changes to their borrowing ability or cash flow requirements resulting from changes in house prices or interest rates.

Overall, the central macroeconomic assumptions in the programme seem credible, although in the short term, they embody a somewhat faster recovery than foreseen by the Commission and most outside forecasters.

Table 1 – Forecasts compared 2003-2006

% change on previous year	2003		2004		2005		2006
	COM[1]	CP 2003[2]	COM	CP 2003	COM	CP 2003	CP 2003
Real GDP growth	**2.0**	**2**	**2.8**	**3 to 3½**	**2.9**	**3 to 3½**	**2½ to 3**
Household consumption[3]	2.3	2½	2.2	2¼ to 2¾	2.3	2¼ to 2¾	2¼ to 2¾
General government consumption	3.6	3¼	2.1	2½	2.0	2½	2½
Fixed Investment	3.1	2¼	4.8	6 to 6½	4.8	5½ to 6	4 to 4¾
Exports of goods and services	-0.6	-1½	5.1	5¼ to 5¾	6.6	7 to 7½	6¼ to 6¾
Imports of goods and services	0.9	½	4.7	5¼ to 5¾	5.5	5¾ to 6¼	5¾ to 6¼
Balance of payments current account (% of GDP)	-2.3	-2¼	-2.2	-2½	-1.7	-2¼	-2¼
UK export markets	3.6	3¼	6.6	6¼	7.3	7¼	6¾
HICP	1.4	1½	1.5	1¾	1.6	2	2

[1] Commission Autumn 2003 Forecasts. These were finalised before the release of the Pre-Budget report on which the update is based.
[2] UK Convergence Programme update, December 2003
[3] Includes households and non-profit institutions serving households

"Cautious" scenario

The more cautious estimate of trend growth underlying the update's public finance projections, one-quarter percentage point below the UK authorities' central view and discussed in the following section, gives a lower path for actual GDP growth whereby growth rises from 2¼% in 2003-04 to 3¼% in 2004-05, falling back to 2¾% and 2½% in 2005-06 and 2006-07 and remaining at 2¼% growth for the rest of the projection period to 2008-09.

The cautious scenario is closer to the Commission's views in the autumn 2003 forecast, though projected growth in the short term still appears higher than forecast by the Commission. This scenario lacks some elements necessary to ensure a full analysis[12].

[12] Since it is the cautious scenario that underlies the public finances projections, the programme would have benefited from more details on the components of GDP growth in the cautious scenario up to 2008-09.

2.4 Potential growth and output gaps

The update's central estimate of trend growth is 2¾% a year to 2006, unchanged from the assumption in the previous update[13], and 2½% thereafter. This result is based within a growth accounting framework from a consideration of recent and projected developments in labour productivity, hours worked, the employment rate and the population of working age. Taken together with the programme's actual GDP growth projections, this yields a negative output gap of 1.4% in 2003-04 that closes to zero by 2006/07 (Annex Table 4).

The update's estimate of trend growth is not based on the production function methodology for calculating potential growth agreed between the Commission services and the Council. However, the Commission services have used, to the extent possible, the information in the programme's economic forecast to derive potential output growth rates and output gaps based on the commonly-agreed approach. These results are also compared with the Commission's own output gap projections based on the autumn 2003 forecast (Table 2).

Table 2 – Potential growth and output gaps

	2003 updated convergence programme UK authorities' calculations			2003 updated convergence programme Commission calculations[1]			Commission's autumn 2003 forecast Commission calculations[2]		
	GDP growth	Potential growth	Output gap	GDP growth	PF Potential growth	Output gap	GDP growth	PF Potential growth	Output gap
2002	1¾	2¾	-1.1	1.75	2.7	-0.4	1.7	2.7	-0.2
2003	2	2¾	-1.4	2.0	2.7	-1.0	2.0	2.7	-0.9
2004	3 - 3½	2¾	-0.7	3.25	2.7	-0.4	2.8	2.7	-0.7
2005	3 - 3½	2¾	-0.2	3.25	2.7	0.1	2.9	2.8	-0.6
2006	2½ - 3	2¾	0	2.75	2.7	0.1	2.9	2.8	-0.4
2007	-	2½	0	-	-	-	2.8	2.6	-0.2
2008	-	2½	0	-	-	-	2.7	2.5	0.0

[1] Based on programme data, applying the Commission's production function method for estimating potential growth.
[2] Calculated using the Commission's estimate of potential growth on the basis of the autumn 2003 forecast, including a technical assumption for the years 2006-2008.

The calculations indicate that the programme's central projection of potential growth rates of 2¾% falling from 2007 to 2½% are closely similar to Commission results based on the commonly-agreed methodology derived from the autumn forecast and to results obtained from applying the production function methodology using the economic assumptions underlying the programme.

As far as the output gap estimates are concerned, all calculations show the existence of an initial negative output gap which is estimated to close during the programme period. There are, however, differences in the levels of the output gap and the speed of its closure. The Commission calculation based on the commonly-agreed methodology using data taken from the update (middle section of the table) illustrates that the output gap would close around the year 2005. On the other hand, the estimate based on the autumn Commission forecast shows a slower closure of the output gap, due to slower growth in GDP.

[13] In 2003 the Office for National Statistics (ONS) made far-reaching data revisions to the National Accounts. The UK authorities suggest these revisions indicate a higher trend rate of output growth over the past few years of 2.9%. For the present, however, the central trend growth estimate has not been revised.

The analysis of the underlying budgetary position is made in section 4.4 below.

3 MONETARY POLICY

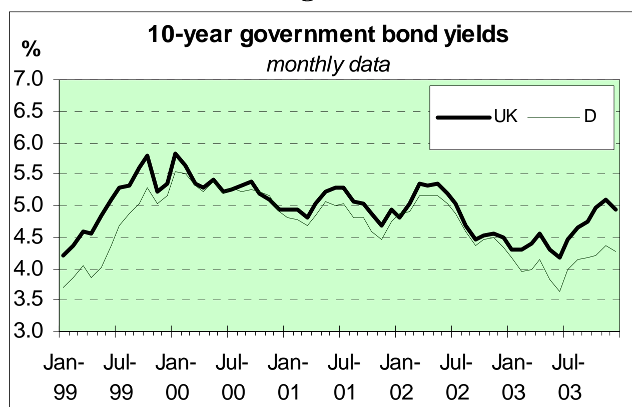
3.1 Inflation

Despite an unemployment rate at historically low levels of around 5%, UK inflation developments have remained benign. HICP inflation was 1.3% in December 2003 (RPIX: 2.8%). Domestic inflationary pressures have been subdued. Strong pay growth in the public sector has not yet been mirrored in the private sector. Strengthening economic activity is likely to lead to an acceleration in earnings growth, but a corresponding cyclical recovery in productivity should help to dampen the impact on unit labour costs. Imported inflationary pressures have also been muted. Although non-oil commodity prices have risen, oil prices are little changed, and sterling's earlier depreciation has not so far had a significant impact on import costs. The UK has been experiencing persistent deflation in the non-energy industrial goods component of the HICP, although this rose to -1.8% in September 2003, up from -4.1% in July 2000. The services component of HICP fell to 3.3% in September, down from 5% in December 2002, while processed food was at 1.6%. Processed food prices have been rising at 2% or below on an annualised basis since January 2002. Turning to the non-core components of the index, energy prices were at 2% in September, down from 6.2% in March; unprocessed food prices were at 3%, up from -3.2% in January.

3.2 Interest rate developments

The macroeconomic policy framework in the UK, with sound public finances and low and stable inflation, has continued to support low long-term bond yields. Over the past year, developments in British bond yields have been broadly in line with trends in international bond markets troughing in mid-year before rising significantly. For 2002 and 2003, the 10-year government bond yield in the UK was on average 4.9% and 4.6%, respectively.

Figure 1



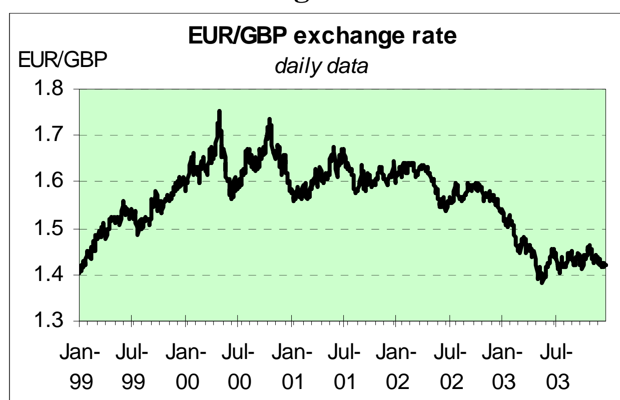
The 10-year government bond yield differential with respect to Germany rose from around 50 basis points in mid-2003 to around 65 basis points on average in December, reflecting increasing expectations of a recovery in the UK economy and higher short-term interest rates relative to the euro area.

At the short end of the yield curve, three-month interest rates have moved in line with policy rates. The interest rate differential between the UK three-month interest rate and that of the euro area was around 190 basis points at the end of December 2003.

3.3 Exchange rate developments

In 2002, the UK's nominal effective exchange rate index moved only within a narrow range and ended the year roughly unchanged from a year earlier. In the first quarter of 2003 the nominal effective exchange rate gradually moved lower, before stabilising at that lower level.

Figure 2



In bilateral terms, the British currency depreciated against the euro during much of the first half of 2003, reaching levels not seen since the beginning of 1999. In the second half of 2003, in spite of the greater rise in short-maturity money market interest rates in the UK than elsewhere during this period, sterling's value against the euro stayed within a narrow range of EUR 1.41 to 1.46 per GBP.

Some PPP measures and equilibrium exchange rate estimates suggested that sterling's value in 2002 against the euro was significantly "overvalued". As a result of sterling's depreciation against the euro in 2003, current levels are more in line with the values of estimates of the equilibrium exchange rate found in the literature.

On EMU, the government is of the view that exchange rate stability will be achieved on the basis of sound economic fundamentals, that is economic stability. Though there is some evidence to suggest that exchange rate volatility has declined in recent years, a reversal of such a trend remains a possibility. If it occurs, this may result in a less stable macro-economic path and government finances than those projected in the programme. In this context, ERM2 membership, once a judgement on the appropriate parity between the pound and the euro has been made, could add another pillar of stability to the sound and effective fiscal and monetary framework in place.

4 BUDGETARY TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES

4.1 Programme overview

The update foresees a medium-term increase in the shares relative to GDP of both general government expenditure and revenue, designed to redress perceived under-

provision of public services and past under-investment. UK policy aims to raise general government net investment as a percentage of GDP from its historically low values to levels more in line with those in the rest of the EU. The update projects an increase of around 1.1 percentage point between 2002-03 and 2005-06 in net general government investment, to reach 2.2% of GDP. Planned rates of growth of public expenditure are particularly marked for the targeted priority areas of health, education and public infrastructure.

The projections for fiscal balances in the programme represent a significant downgrading compared with the previous update (see Table 3[14]). The deterioration is most marked for the current financial year, from an expected deficit of 2.2% of GDP in the previous update to 3.3% in the December 2003 update. This would appear to breach the 3% of GDP Maastricht reference value in 2003-04. Indeed, the update projects net borrowing on a Maastricht basis to be higher throughout the projection period than in the last update. After 2003-04, the deficit gradually improves. The projected deficits in the latest update are around 2½% of GDP in both 2004-05 and 2005-06, 2% in the following two financial years and 1¾% in 2008-09. The deterioration of 1.1% points of GDP in 2003-04 compared with the previous update falls to 0.9% in 2004-05, 0.8% in 2005-06 and about ½% for the following two financial years. Almost all of this deterioration is structural, with the cyclically-adjusted deficit, as calculated in the programme, worsening by around 1%-point of GDP in 2003-04 and 0.7% in 2004-05. The deterioration in the public finances compared with the previous update is due, beyond a relatively limited part played by conventional cyclical influences, to an unanticipated downgrading of expected revenue linked to composition effects of GDP growth and to some discretionary higher expenditure mainly linked to the Iraq war.

There are no significant changes to the overall planned expenditures for the projection period compared with the previous update. The Commission considers the expenditure plans to be plausible.

The update also includes no major new policy measures to increase the revenue share (following an increase in social contribution rates in 2003) but projects this share to rise strongly, reflecting contributions from a conventional cyclical response to output returning to trend, a partial correction of a particularly sharp recent fall in receipts, increased collection efficiency and normal fiscal drag.

The shortfall in receipts experienced in 2003-04 relative to earlier plans is expected to be partly reversed autonomously. The programme projects a steady increase in general government total current receipts as a percentage of GDP from 37.7% in 2003-04 to 39.2% in 2005-06. This is an increase in the ratio of 1½ percentage points of GDP in just two years, and occurs despite the absence of any policy increase in tax rates. The largest contribution, of 0.7 percentage points by 2005-06, is expected to come from corporation taxes, as in particular financial company profits recover from their recent

[14] The update presents public finance data on a 'general government' basis only to 2005-06. Projections are provided for the wider definition of 'public sector', which includes public corporations, until 2008-09. The update would have benefited from including a detailed breakdown of general government data for the 'year X+3', i.e. 2006-07, for variables considered 'optional but highly desirable' in the Code of Conduct.

depressed levels[15]. The Commission considers this to be an optimistic projection, as it appears to imply that corporate taxes would recover to a ratio of GDP last experienced during the boom years of the late 1990's.

Table 3 – General government finances compared in the 2002 and 2003 updates

% of GDP	2002-03	2003-04	2004-05	2005-06	*Total change 2002-03 to 2005-06*
Current receipts					
2002 update	*38.0*	*38.9*	*39.6*	*40.0*	*2.0*
2003 update	*37.3*	*37.7*	*38.5*	*39.2*	*1.9*
Current expenditure					
2002 update	*37.5*	*38.3*	*38.3*	*38.6*	*1.1*
2003 update	*37.3*	*38.5*	*38.2*	*38.6*	*1.3*
Depreciation					
2002 update	*0.8*	*0.8*	*0.8*	*0.8*	*0.0*
2003 update	*0.9*	*0.9*	*0.9*	*0.9*	*0.0*
Surplus on current budget[16]					
2002 update	-0.3	-0.3	0.4	0.6	*0.9*
2003 update	-0.9	-1.6	-0.6	-0.3	*0.6*
Net investment					
2002 update	*1.5*	*1.9*	*2.1*	*2.2*	*0.7*
2003 update	*1.1*	*1.7*	*2.0*	*2.2*	*1.1*
Net interest payments					
2002 update	*1.0*	*1.0*	*1.0*	*1.0*	*0.0*
2003 update	*1.0*	*1.0*	*1.1*	*1.0*	*0.0*
Primary balance					
2002 update	-0.8	-1.2	-0.6	-0.6	*0.2*
2003 update	-1.1	-2.3	-1.5	-1.4	*-0.3*
Deficit (Treaty definition)					
2002 update	**1.8**	**2.2**	**1.7**	**1.6**	***-0.2***
2003 update	**2.1**	**3.3**	**2.6**	**2.4**	***0.3***
Cyclically-adjusted deficit (Treaty definition)					
2002 update	**1.1**	**1.4**	**1.3**	**1.5**	***0.4***
2003 update	**1.5**	**2.4**	**2.0**	**2.2**	***0.7***
Rise in deficit between updates	0.3	1.1	0.9	0.8	
Rise in cyclically-adjusted deficit between updates	0.4	1.0	0.7	0.7	

Source: UK Convergence Programme Updates 2002 and 2003

The update projects a cyclically adjusted deficit of 2½% of GDP in 2003/4, falling to around 2% of GDP per annum throughout the rest of the programme period. Commission estimates of the cyclically adjusted deficit show a similar downward path (though are slightly higher in the short term). Even if the projections are realised, the programme would not appear to be close to balance in the medium term, nor does it leave a sufficient safety margin to prevent further breaches of the 3% of GDP reference value over the projection period. Despite this, the UK authorities maintain that "the UK continues to meet a prudent interpretation of the Stability and Growth Pact."

[15] Tax revenues from direct taxes on companies and taxes on financial and capital transactions in the UK are more sensitive to movements in equity prices than in most other OECD countries (OECD Review of the United Kingdom, 2004). Since the equities boom in the late 1990's ended, tax receipts from the financial sector have been weak. As bonus payments to high-earners in the financial sector fell, tax receipts on wages and salaries were also adversely affected. Further, the fall in equities markets had knock-on effects on pension funds, so companies may have to increase contributions, which are tax deductible, to pension funds in order to reduce pension funding gaps. The Confederation of British Industry estimates that this may have reduced corporation tax revenue by 0.1 to 0.2 percentage points of GDP in 2003.

[16] Note that this measure of the surplus on the current budget is not the one used to assess compliance with the UK's 'golden rule'; the rule is based on the 'public sector', not 'general government'.

The update foresees a slight increase in net and gross debt ratios. By the final programme year the primary deficit is virtually eliminated and the gross debt ratio stabilises at around 41½% of GDP.

The update emphasises that the achievement of sustainable public finances is a pre-requisite to achieving long-term economic growth. To achieve this, the UK authorities have committed themselves to meeting two fiscal rules for the public sector[17]. The rules require them to keep a current budget surplus over the economic cycle and a low sustainable net debt level of under 40% of GDP (see Box 1). However, in the authorities' projections, the average annual surplus on the current budget is projected to remain in surplus by the equivalent of 0.2% of GDP over the economic cycle as a whole[18]. Given that public finances projections are subject to wide margins for error, 0.2% of GDP is sufficiently close to zero to imply the 'golden rule' is at risk of being breached.

Note also that the UK does not comply with Eurostat treatment of UMTS licences – it considers the UMTS licences as providing a stream of property income, rather than being a one-off source of revenue. Therefore, the update includes property income from UMTS licenses in its projections of current receipts. This implies that on average, the current receipts figures in each year are inflated by 0.1 p.p. of GDP. Correcting this implies adding 0.1 p.p. to the Treaty deficit in every year, so that in financial year 2003-04, the projected deficit reaches 3.4% of GDP, rather than the 3.3% in the update.

Box 1: The UK's Fiscal Framework

The UK's fiscal policy framework is based on five key principles set out in the government's 'Code for fiscal stability'. They are: transparency, stability, responsibility, fairness and efficiency. The UK's Code requires the government to state both its objectives and the rules through which fiscal policy will be operated. The fiscal policy objectives are:

- *over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and*
- *over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.*

To meet these objectives, the government has bound itself to two fiscal rules. The fiscal rules apply over the economic cycle (currently estimated to be running from 1999-2000 to 2005-06) and are:

- *The golden rule – that is, over the economic cycle, the public sector will only borrow to invest and not fund current spending and*
- *The sustainable investment rule – where public sector net debt as a proportion of GDP will be held, over the economic cycle, at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.*

The authorities stress that the fiscal rules are set over the cycle and thus help smooth out short-term variations in demand while maintaining longer-term sustainability of the public finances.
The two fiscal rules are at the core of the UK's fiscal policy.

4.2 Public finances in 2003-04

After a period of consolidation in the second half of the 1990's, the public finances have moved into deficit after 2001-02, reaching a deficit of 2.1% in 2002-03. The update estimates general government net borrowing on a Maastricht basis in the

[17] The rules refer to the public sector, not 'general government'.
[18] The authorities estimate that the current cycle is running from 1999-2000 to 2005-06.

financial year 2003-04 to be 3.3% of GDP. This is a significant upward revision to the 2.2% deficit projected for this financial year in the previous update. It is also significantly higher than the 2.4% deficit projected in the April 2003 Budget, the most recent official projection before the update.

The deficit projection for 2003-04 is also higher than the Commission services' autumn forecast of a deficit of 2.8% of GDP for the calendar year 2003. However, the difference is not large. A crude conversion into calendar year terms of the fiscal-year-based 2002-03 and 2003-04 data provided in the update would suggest a deficit projection of around 3.0% of GDP for the calendar year 2003.

The data in Table 3 shows the deterioration in the budget outlook for 2002-03 and 2003-04 between the programme updates. Much of the deterioration appears 'structural', in that for 2003-04, it is almost totally reflected in big rises in the cyclically adjusted deficit. Apart from increased discretionary expenditure associated with the war in Iraq, much of the large rises in actual and projected deficits since the 2002 budget have been unintended, due to an unexpected shortfall in revenues in 2003-04 [19]. The 2003 Budget indicated that shortfalls in financial company profits and the reduction in equity prices had already contributed to a little under 1% of GDP of the deterioration in the deficit in 2003-04 (and 2004-05). However, part of the shortfall has been offset by the fact that between the 2003 Budget and the update, equity prices actually rose by around 20 per cent, exceeding the official audited projections in the Budget. Thus, higher equity prices will increase receipts from stamp duty, capital taxes, and corporation tax from life assurance companies[20].

The update shows that an additional deterioration to the deficit projections was brought about by the fact that the growth in wages and salaries in 2003 was lower than projected, reducing revenues from income tax and National Insurance Contributions by around a third of a percentage point of GDP in 2003-04 and in future years. Lower than expected growth in consumers' expenditure had a negative impact on VAT and excise revenues. However, the authorities point out that despite this lower growth, VAT revenues in the first half of 2003-04 have been substantially *above* the levels projected in Budget 2003, partly reflecting, in their view, the caution built into the NAO audited assumptions used to forecast VAT revenues. Also, the government drive to combat VAT fraud may be having an impact.

On the *expenditure* side, the planned rises fixed in the 2002 Spending Review continue (see Box 2). Overall, expenditure is planned to rise substantially as a share of GDP, in 2003-04 - by 1.7 percentage points (of which 0.8 of a percentage point is accounted

[19] The details of the revenue shortfalls and expenditure changes in the update are given with reference to the 2003 Budget, but not the previous convergence programme. Indeed, it is not possible, on the basis of the information contained in the update, to obtain a detailed picture of the changes in the projections of receipts and expenditure that have taken place since the last update. As regards its analysis of developments in 2003-04, the update is therefore only partly in compliance with the requirement in the Code of Conduct that "annual updates of stability and convergence programmes should show how developments have compared with the programme objectives".

[20] Delays in the tax system mean that the authorities do not expect the full impact of higher equity prices and house prices to feed into capital tax receipts until 2004-05. This benefit is included in the update's projections as an extra benefit to public sector receipts of between 0.1 to 0.2 % of GDP per year from 2004-05 onwards. Going forward, the projections in the update are based on a resumption of the audited assumption, but from the higher starting point which equity prices had reached by 27 November 2003.

for by current expenditure and 0.6 percentage points is accounted for by net investment). However, there has been some slippage in the government's expenditure plans in recent years, mainly in net investment. In the last programme update, public sector net investment was projected to be 1.5% of GDP in 2002-03, yet the outturn reported in the 2003 update was 1.1%. Total current expenditures turned out to be 37.3% of GDP in 2002-03 but were projected to be 37.5% in the previous update. The possibility for end-year flexibility in the fiscal framework set up in the 2002 Comprehensive Spending Review allows for an underspend in one year to be offset by an overspend in another. While there is the possibility of some slippage to plans, these are likely to be offset by additional discretionary increases to expenditure that were made in 2003-04 which reflect the costs of the war in Iraq and other measures to combat international terrorism[21].

All in all, the deterioration in the deficit figure for 2003-04 has come in much larger than expected by the authorities (and to a certain extent the Commission services) during a period when the UK economy, in aggregate, has held up rather well in the face of the global economic slowdown. Although a negative output gap has opened, it would nevertheless seem to be insufficient to explain the 'unexpected' rise in the deficit. As developed above, the unanticipated rise in the deficit is due in large part to composition effects of GDP growth which affected receipts from wages and salaries, as well as the impact of the slowdown in the financial sector.

Box 2: The UK Government Spending Framework

At the heart of the UK's public expenditure framework are the three-year Departmental Expenditure Limits (DEL). These are set every two years in so-called Comprehensive Spending Reviews. The last Comprehensive Spending Review was in July 2002, and it covers spending to 2005-06. The next Spending Review is due in 2004, and will cover the period to 2007-08, with the last year of the previous Review being the first year of the next.

The system of three-year horizons allows government departments to draw on a stock of 'end-year flexibility'. Departments can carry forward resources not fully spent at the end of the year for use in future years. This has the benefit that spending can be more effectively planned; it also helps avoid inefficient year-end surges in departmental spending to 'use up' unspent budget money.

Expenditure items like social security benefits and debt interest payments are demand driven and too volatile to be planned in three-year cycles. These come under Annually Managed Expenditure (AME). The sum of DEL and AME is Total Managed Expenditure (TME), the broadest measure of total public expenditure.

The update reports that in 2003-04, total spending is planned to rise by 6.9 per cent in real terms over the year as a whole relative to 2002-03, with DEL spending rising by 7.3 per cent and AME spending rising by 6.4 per cent.

[21] £2½ billion (about 0.2% of GDP) in 2003-04 represents the carrying forward of the £2 billion unallocated special reserve into 2003-04 and the addition of a further £500 million. Overall, so far in 2003-04, government departments have chosen to draw down £2.5 billion of their end-year flexibility to add to their authorised spending limits. The update assumes that that the outturn for 2003-04 will equal total DEL plans and that, over the course of the year, departmental underspends will offset the drawdown of end-year flexibility.

Table 4 - General government expenditure and receipts (% of GDP)

	2002-03	2003-04	2004-05	2005-06
Current expenditure on goods and services	20.3	21.1	21.1	21.4
Net social benefits	12.2	12.4	12.4	12.3
Net current grants	2.2	2.1	1.9	2.0
Interest and dividends paid	2.0	2.0	2.1	2.1
Subsidies	0.6	0.8	0.7	0.7
AME Margin	0.0	0.0	0.0	0.0
Total current expenditure	**37.3**	**38.5**	**38.2**	**38.6**
Net investment	1.1	1.7	2.0	2.2
Total expenditure	**38.5**	**40.2**	**40.3**	**40.7**
Taxes on income and wealth	13.6	13.3	13.9	14.4
Taxes on production and imports	13.5	13.6	13.6	13.7
Other current taxes	1.9	1.9	2.0	2.0
Taxes on capital	0.2	0.2	0.2	0.2
Social contributions	6.0	6.7	6.7	6.7
Interest income	1.1	1.0	1.0	1.0
Other	1.1	1.0	1.0	1.0
Total current receipts	**37.3**	**37.7**	**38.5**	**39.2**

Source: UK Convergence Programme Update 2003

4.3 Public finances in 2004-05 and beyond

After 2003-04, the projected general government deficit falls to 2.6% in 2004-05 and 2.4% in 2005-06 as the adverse effects on revenue, a legacy of the recent slowdown in growth, fade. In subsequent years, the deficit remains at around 2% of GDP, falling to 1.8% of GDP by 2008-09. The improvement in the deficit after 2003-04 is based on a 'no policy change' assumption, and in particular rests upon a combination of reduced growth in planned expenditure and a strong autonomous rise in receipts over the projection period.

Expenditure plans for 2004-05 were laid down in the July 2002 Comprehensive Spending Review, which covers spending to 2005-06 (other than health-related expenditure, for which spending plans to 2007-08 were fixed in the 2002 Budget). A small amount is foreseen to cover continuing security commitments in Iraq and elsewhere. The discretionary changes for 2004-05 onwards also reflect other measures announced in the 2003 Pre-Budget Report, but their budgetary impact is small.

In the two years following 2003-04, the update expects an increase in total current *receipts* as a percentage of GDP of around 0.8 percentage points a year. Information provided directly to the Commission services by the UK authorities after the submission of the convergence programme reveals more detail about the recovery in receipts projected in the update. This is presented in Table 5 below, which contains estimates of the main drivers of the change in the level of the tax-GDP ratio by reference to 2003-04. The data supplied relates only to the period between 2004-05 and 2007-08, so it does not cover the full projection period in the update up to 2008-09.

Table 5 – Contributions to the change in the tax-GDP ratio since 2003-04

% of GDP	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Fiscal drag	0.1	0.2	0.2	0.3
Other income tax	0.2	0.3	0.4	0.4
Corporation tax	0.4	0.7	0.8	0.9
Capital taxes*	0.2	0.2	0.3	0.3
Other**	0.0	0.1	0.1	0.2
Total	**0.8**	**1.4**	**1.8**	**2.1**

*Note that this differs from 'Taxes on Capital' in Table 4, as that refers to inheritance tax only. Here the term 'capital taxes' includes stamp duties and capital gains tax.
**"Other" largely reflects increased council tax and VAT paid by the public sector which is refundable. As both these components score in public sector spending, they have no overall impact on government borrowing.
Source: HM Treasury

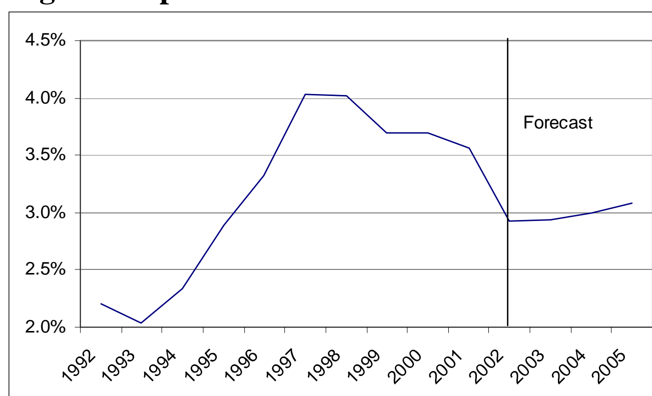
The table shows how important is the recovery of the financial company sector to the update's receipts projections. The recent period of equity market weakness meant tax receipts from the financial sector were unusually weak as financial corporation profitability declined. As financial company profits are expected to recover, so do corporation tax receipts. Also, bonuses to higher-rate tax payer financial sector employees increase, and tax receipts on these wages and salaries consequently increase. Together, these effects account for three-quarters of the increase in expected receipts between 2003-04 and 2004-05. By 2007-08, the recovery in corporation taxes by itself accounts for almost half the recovery in total current receipts.

Capital taxes are also expected to rise by more than GDP over the forecast period. This is mainly a result of continued above trend growth in house prices over the short term, and the lagged impact of the significant recovery of equity prices observed in 2003. 'Fiscal drag', the tendency of the tax-GDP ratio to rise over time as the economy grows, reflecting the progressive nature of the income tax system, is a very small contributor to the recovery in receipts in the short run, as is the "other" line.

The medium-term projections are subject to both upside and downside risks. On the upside, equity markets could rise faster than nominal GDP, thus exceeding the NAO audited assumption. On the downside, however, the Commission services estimate a lower current negative output gap and lower GDP growth, and do not project the output gap closing as quickly as in the update. If the UK's negative output gap is indeed smaller than estimated by the UK authorities, and if it fails to close as quickly as they project, then receipts may fall short of those projected.

A particular downside risk concerns the projected recovery of corporation taxes. The information provided by the UK authorities appears to be optimistic, although corporation tax receipts are notoriously difficult to predict. Data for recent years indicates that by 2002, as a proportion of GDP, corporation tax receipts had fallen around 1 percentage point from their peak in 1997 (see Fig. 3). However, the UK authorities appear to be expecting receipts from corporate taxes to recover by almost the same amount, as a proportion of GDP, by 2007-08. The problem here is that the end of the 1990's was an exceptionally buoyant period for corporate taxes – there may not be a return to those levels. The Commission's autumn forecast to 2005, for example, does not project as rapid a recovery in receipts. Overall, the kind of recovery in government receipts projected over the period 2003-04 and 2005-06 in the update may prove optimistic.

Fig. 3: Corporate taxes as a % of nominal GDP



Source: Commission Autumn 2003 Forecast

4.4 Cyclically-adjusted balances

The update includes projections of the cyclically adjusted general government balance based on the authorities' cautious 2½% trend growth assumption for public finance projections. These are shown in the Annex in Table 4.

In the update, the deterioration in the cyclically-adjusted deficits in 2003-04 is quite marked compared with the projections in the last update, and the cyclically adjusted measure deteriorates by almost a full percentage point between 2002-03 and 2003-04 to reach 2.4% of GDP. The update projects the cyclically adjusted deficit to remain at around 2% of GDP into the medium term. Table 6 reports the cyclically adjusted balance calculated by the Commission services, using potential output growth based on the production function approach using the economic assumptions from the central view and the unadjusted fiscal projections of both the programme and the Commission's own autumn 2003 forecasts. The cyclically adjusted budget deficits calculated by the Commission on the basis of the programme's assumptions rise between 2002 and 2003, and fall steadily thereafter, remaining very similar to those reported in the programme after 2006.

Table 6 – Budget balances: headline and cyclically-adjusted (% of GDP)

	2003 updated convergence programme[2]			Commission's autumn 2003 forecast	
	Budget balance	CAB (Programme)	CAB[1]	Budget balance	CAB
2002	-2.1	-1.5	-1.9	-1.5	-1.4
2003	-3.3	-2.4	-2.8	-2.8	-2.4
2004	-2.6	-2.0	-2.4	-2.7	-2.3
2005	-2.4	-2.2	-2.4	-2.4	-2.1
2006	-2.1	-2.1	-2.2	-	-
2007	-2.0	-2.0	-2.0	-	-
2008	-1.8	-1.8	-1.8	-	-

[1] Commission services calculations
[2] Public finance data in the update are based on financial years – 2002-03 to 2008-09

The methods used to estimate cyclically-adjusted balances have difficulty in filtering out from the cyclically-adjusted balance changes due to composition effects, which may be temporary, such as those related to the financial sector. This feature may help explain the marked computed deterioration in the cyclically-adjusted balance in 2003-04, beyond the extra spending on the Iraq war, partially reversed in the following years.

In any event, the update projects the cyclically-adjusted deficit to persist at around 2% of GDP into the medium term. This is not close to balance and does not appear to give a sufficient safety margin, throughout the projection period, against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

4.5 The debt ratio

The update projects rising general government gross debt relative to GDP, from 37.9% at the end of 2001-02 to around 41.5% in 2008-09. However, the general government gross debt ratio remains well below the 60% reference level throughout the projection period.

In net terms for the slightly wider public sector (that is, after accounting for short-term financial assets), debt was lower in 2001-02, at 30.2%. It is projected to rise throughout the projection period to reach 35.5% by 2008-09. It is this definition that the government uses to gauge compliance with its 'sustainable investment' rule to keep public sector net debt as a proportion of GDP below 40 per cent of GDP over the economic cycle. The sustainable investment rule is thus comfortably met.

The 2002 convergence programme update projected a small rise, to 39.1% by 2006-07, with most of this occurring between 2002-03 and 2003-04, with the ratio remaining stable thereafter. In the 2003 update, the deterioration is also front-loaded, with notable increases in all years between 2002-03 and 2005-06.

The difference in debt projections between the updates results from the larger deficits foreseen in the latest update. Table 7 compares the gross debt developments according to the previous update, the current update and the Commission's autumn forecast.

Table 7 – Gross debt, previous and current update

% of GDP	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Gross debt levels							
2002 update	37.9	38.8	38.9	38.9	39.1	39.2	-
2003 update	37.9	39.3	40.2	40.8	41.1	41.4	41.5
Commission autumn 2003 forecast[1]	38.5	39.6	41.0	-	-		-

[1] Calendar years 2002 to 2005
Source: UK Convergence Programme Update 2003 and Commission autumn 2003 forecast

4.6 Sensitivity analysis

The update indicates that short-term fluctuations in the economy can have significant impacts on the public finances. The update reports that over the past 25 years, the average absolute difference between year-ahead forecasts of net borrowing and

subsequent outturns has been a little over 1 per cent of GDP. The differences grow the longer the forecast horizon.

One reason for uncertainty, in the medium term, is the position of the economy in relation to its sustainable path. To illustrate this, an alternative projection in the update, called the 'cautious case', assumes trend output to be 1 percentage point lower in relation to actual output than the central case. The output gap that this implies lowers the cyclically-adjusted surplus on current budget by around ¾ p.p. of GDP a year. Projections on this basis would take the public finances, in cyclically adjusted terms, further away from the 'close to balance or surplus' medium-term requirement of the Stability and Growth Pact (by around ¾ percent of GDP a year).

Analysis made by the Commission suggests that a worsened growth outlook, by affecting potential growth, in the years to 2005-06 (of 0.5 percentage points lower GDP growth per year using the 2003 update as a baseline) would result in a cyclically-adjusted deficit almost a half-percentage point of GDP worse than in the central scenario. These calculations also suggest that even if economic growth were to be stronger than expected, a fiscal position of close to balance or in surplus in the medium-term would not be achieved.

5 THE QUALITY OF PUBLIC FINANCES

The update shows that the government has budgeted for a large increase in expenditure on public services and as a result of decisions taken in the 2002 Spending Review, public sector net investment is projected to rise steadily to 2.2% of GDP in 2008-09 from around 1.0% of GDP in 2002-03. One of the country-specific challenges identified in the 2003 Broad Economic Policy Guidelines was for the UK authorities to improve the quality and efficiency of public services. More specifically, the UK was recommended to 'ensure that the public services associated with the announced increases in public expenditure (including investment in the transport infrastructure) are delivered efficiently and with a view to ensuring cost-effectiveness'.

The UK government has recognised the need to accompany the increases in expenditure with reforms designed to ensure that these resources are used and allocated efficiently and effectively, that consumers receive high quality public services and that both consumers and taxpayers receive best value for money. The update suggests that the UK's fiscal rules remove an earlier bias against capital investment. The UK authorities have also introduced separate capital and resource budgeting for departments which have helped reverse the declining trend in public sector net investment. Further, the authorities underpin the approach to ensuring public spending is efficient and effective by: establishing clear, long-term goals expressed as desired outcomes; greater devolution of decision-making to local service providers, combined with effective governance structures; improved information about performance; and better incentives for service providers to meet users' needs (see Box 3).

Table 8 - Real/price split on General Government expenditure (% changes)

	Consumption expenditure (current prices)	Consumption expenditure (real)	Consumption expenditure implicit price deflator	Gross investment (current prices)	Gross investment (real)	Gross Investment implicit price deflator
1999	8.0	3.2	**4.7**	-5	-1.5	**-3.6**
2000	6.5	1.9	**4.9**	2.8	4.8	**-1.9**
2001	7.5	1.7	**5.7**	11.9	12.8	**-0.8**
2002	9.3	2.4	**6.8**	12.3	10.8	**1.4**

Source: European Commission

The government have certainly succeeded in increasing expenditure in money terms. It could be argued that the increases in general government consumption and investment expenditures in real terms (at 2.4% and 10.8% respectively in 2002) are a testimony to the beneficial impact of the government's efficiency drive. However, a note of caution is sounded by the fact that the rises in real current expenditure have been dwarfed by rises in implicit prices, so it may be questioned just how much is going into actual services provided. There has been a noticeable rise in the value of the public expenditure deflators in recent years. For example, the general government consumption deflator was estimated to be 6.8% in 2002, having risen from 4.7% in 1999 (see Table 8). On the investment side, there is less of a problem though it must be noted that, until recent quarters, the investment plans were being under-achieved. The implied general government investment price deflator has risen from –3.6% in 1999 to 1.4% in 2002. These developments could indicate the existence of short-term constraints on the supply side, including the managerial feasibility of rapidly extending and improving public sector provision. In other words, they may indicate the possibility that the rate of increase of planned expenditure has hit so-called 'speed limits' – indeed, these may prove to have been important in 2003-04 when the rise is very strong. There also remain problems of measurement of price rises in the public sector. There are clearly important issues involved in adequately calibrating public sector output and to distinguish the real from the nominal value component. The Office for National Statistics is closely involved with these issues (see Box 3).

Box 3: Achieving Effectiveness in Public Expenditure

To further address this issue, the Chancellor announced an Efficiency Review in his 2003 Budget speech. The Review seeks to maximise the effectiveness of investment going into public services by assessing measures to strengthen the transfer of best practice and support the devolution of funds to local bodies. A consultation process was launched in October 2003, with views sought by 21st November 2003. No conclusions on the effectiveness of this measure can therefore be drawn yet.

A well-established policy cornerstone for public expenditure reform is the use of Public Service Agreements (PSAs). These were first introduced in the 1998 Comprehensive Spending Review and are central to the Government's strategy for public service reform and improved delivery. PSAs set targets for the outcomes that each department is committed to achieving, so they form an integral part of the Government's public spending framework. Government departments now publish details of progress against their targets twice a year, in their Autumn and Spring departmental reports. As of April 2003, the government introduced an innovation in this area in the form of regular web-based reporting against all the new PSA targets, making all the latest performance information accessible to the public in a single place, the website of HM Treasury. The update describes how the 2004 Spending Review will determine new departmental spending plans for 2006-07 and 2007-08 and a new set of Public Service Agreements, but gives no further details.

On 4 December 2003, the National Statistician announced the Atkinson Review. The remit of the review is to advance methodologies for the measurement of government output, productivity and associated price indices in the context of the National Accounts. A preliminary report is expected by July 2004 and a final report by January 2005.

6 THE SUSTAINABILITY OF PUBLIC FINANCES

6.1 Quantitative indicators

The assessment of the sustainability of the UK's public finances is based on both quantitative and qualitative indicators. The quantitative indicators are run on the basis of a commonly agreed methodology by the Economic Policy Committee[22]. The purpose of the indicators is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear, and results of these quantitative indicators need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of "no policy change".

The quantitative indicators project debt and budget balance development according to two different scenarios, to take into account uncertainties over the medium term. The "programme" scenario is calculated on the following basis:

- Macroeconomic assumptions on GDP growth from 2009 onwards, interest rates and inflation are based on the agreed assumptions used in the EPC;

[22] See the Report "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003), available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

- The projections for age-related expenditures come from the programme. They include pensions, health care, education, and long term care up to 2052-2053. Also projections of other spending come from the programme: the projected decline reflects the assumption that most non-pension social benefits will rise in line with prices after 2007-2008, reducing their share of GDP.
- The projections for government revenues come from the programme up to 2005-2006, complemented with additional information up to 2008-2009 provided later by the British authorities. They are kept constant at that level for the projection period.
- The starting point for gross debt and the primary balance are the 2008-09 levels reported in the programme as "Treaty definition".

A "2003 position" scenario is based on the budgetary data for 2003 in the programme. Debt levels are extrapolated from 2009-10 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2008-09 remains the same as the 2003 level and no stock-flows operations take place.

Table below presents the debt and the budget balance development according to the two different scenarios. Overall, age-related expenditure is foreseen to increase by 2.3%, mainly due to health care development. This is partially offset by the decrease of other spending.

Table 9: Long-term sustainability analysis

Main assumptions - baseline scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Total age-related spending	19,6	19,8	20,2	21,4	21,9	21,9	2,3
Pensions	5,1	5,1	4,9	5,3	5,3	5,3	0,2
Health care	7,7	7,9	8,4	9,1	9,6	9,7	2,0
Long-term care	1,0	1,1	1,1	1,1	1,1	1,1	0,1
Education	5,4	5,4	5,3	5,5	5,4	5,4	0,0
Unemployment benefits*	0,41	0,41	0,41	0,40	0,41	0,40	-0,01
Total primary non age-related spending	20,4	20,4	19,9	20,1	19,9	19,5	-1,0
*Total revenues***	40,0						

* EPC projections

** constant

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	41,8	42,5	54,9	71,6	103,4	138,7	96,8
Net borrowing	-2,0	-2,3	-3,0	-5,2	-7,2	-8,8	-6,8
2003 scenario							
Gross debt	44,0	45,3	64,6	89,5	130,9	177,5	133,5
Net borrowing	-2,7	-3,0	-4,1	-6,8	-9,3	-11,5	-8,8

Sustainability gap	S1*	S2**
Programme scenario	2,2	2,4
2003 scenario	2,8	3,1

* S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. P.m. debt to GDP ratio at the end of the period: 8.1%

** S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

It is possible to verify whether the projected level of debt respects the Maastricht Treaty requirement to stay below 60% of GDP at all times. Failure to do so would *a priori* indicate that there may be a risk of budgetary imbalances emerging in light of ageing population and that measures may be required to place public finances on a more sustainable footing.

According to the quantitative indicators solely, risks of an unsustainable budgetary position in the long run cannot be ruled out for the UK. The debt-to-GDP ratio would show a significant increasing path: the relatively high deficit at the end of the programme and the foreseen increase in education and health care expenditure in the medium term as a consequence of the 2002 Spending Review lead to a primary deficit, pushing up debt levels and interest payments.

A sustainability gap therefore arises.

6.2 Additional qualitative features

As underlined in the EPC report on "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme"[23] (October 2003), several qualitative factors should be taken on board to

[23] Available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

avoid a mechanistic interpretation of the quantitative indicators. On the positive side, first UK puts a lot of effort in monitoring long term sustainability of public finances that should flag in advance possible risks. Second, some gains from the revenue side can be expected in the long run, in particular from pension income. In fact, while contributions to pension schemes are exempt from taxation, pension incomes are taxable. Third, the low level of debt and the relatively low level of taxation give room of manoeuvre to prevent the increase of the debt to GDP ratio and thus to intervene in time should unbalances emerge.

However, the UK programme assumes that non-age related expenditure will decline by more than 1% of GDP during the next 20 years and, after being constant for other 20 years, it will decline by an additional 0.4% of GDP. In total, non-age related expenditures are foreseen to be 1.7% of GDP lower at the end of the projection period than now. A more prudent assumption, where the level of these expenditures is kept constant as a share of GDP over the programme period, would lead to considerably worse results.

Also, the foreseen increase in revenues occurs in a no-policy change scenario (see section 4.3). Should this increase not fully materialize, higher risks of unbalances could emerge.

6.3 Overall assessment of sustainability

The Commission considers that, on the basis of the current policies, risks of imbalances in the long term cannot be ruled out for the UK. The quantitative indicators run by the Commission, although they should be treated with caution, would indicate that the debt to GDP ratio could increase significantly. The budgetary strategy outlined in the programme therefore appears not to be fully compatible with improving the sustainability of public finances. On the other hand, the update itself shows that an inter-temporal budgetary gap cannot be excluded under certain interest rate assumptions. Nevertheless, the low level of debt and the relatively low level of taxation give room to avoid undesired outcomes, since long term sustainability of public finances is constantly monitored and represents a key feature in the UK fiscal policy.

ANNEX 1

Summary tables derived from the 2003 updated convergence programme

Table 1. Growth and associated factors

	2002	2003	2004	2005	2006
GDP *growth* at *constant* market prices (7+8+9), 'central scenario'	1¾	2	3 - 3½	3 - 3½	2½ - 3
GDP *level* at *current* market prices	1044	1096	1158 to 1164	1222 to 1234	1287 to 1306
GDP deflator	3¼	3	2½	2½	2¾
RPIX	2½	2¾	2½	2½	2¾
Employment growth					
Labour productivity growth					
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	3½	2½	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
2. Government consumption expenditure	2½	3¼	2½	2½	2½
3. Gross fixed capital formation	1¾	2¼	6 to 6½	5½ to 6	4 to 4¾
4. Changes in inventories and net acquisition of valuables as a % of GDP	-¼	0	¼	0	0 to ¼
5. Exports of goods and services	-1	-1½	5¼ to 5¾	7 to 7½	6¼ to 6¾
6. Imports of goods and services	3¾	½	5¼ to 5¾	5¾ to 6¼	5¾ to 6¼
Contribution to GDP growth					
7. Final domestic demand (1+2+3)					
8. Change in inventories and net acquisition of valuables (=4)	-¼	0	¼	0	0 to ¼
9. External balance of goods and services (5-6)					
Basic assumptions					
Short-term interest rate (annual average)					
Long-term interest rate (annual average)					
USD/€exchange rate (annual average)					
(for non-euro countries) exchange rate vis-à-vis the €(annual average)					
World excluding EU, GDP growth					
EU-15 GDP growth					
Growth of relevant foreign markets	2	3 ¼	6¼	7¼	6¾
World import volumes, excluding EU					
Oil prices USD			24.9		

Table 2. General government budgetary developments

% of GDP	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Net lending by sub-sectors							
1. General government	2.1	3.3	2.6	2.4	2.1	2	1.8
2. Central government	2.3	3.4	2.6	2.5			
3. State government							
4. Local government	-0.2	-0.1	0.0	-0.1			
5. Social security funds							
General government							
6. Total current receipts	37.3	37.7	38.5	39.2			
7. Total current expenditures	37.3	38.5	38.2	38.6			
8. Budget balance	-2.1	-3.3	-2.6	-2.4			
9. Net interest payments	1.0	1.0	1.1	1.0			
10. Primary balance	-1.1	-2.3	-1.5	-1.4			
Components of revenues							
11. Taxes	29.1	29	29.8	30.5			
12. Social contributions	6	6.7	6.7	6.7			
13. Interest income	1.1	1	1	1			
14. Other	1.1	1	1	1			
15. Total receipts	37.3	37.7	38.5	39.2			
Components of expenditures							
16. Collective consumption (incl. social transf. in kind)	20.3	21.1	21.1	21.4			
17. Social transfers in kind							
18. Net current grants	14.4	14.5	14.3	14.3			
19. Interest payments	2	2	2.1	2.1			
20. Subsidies	0.6	0.8	0.7	0.7			
21. Gross fixed capital formation	1.2	1.7	2	2			
22. Other	-0.1	0	0.1	0.1			
23. Total expenditures	38.5	40.2	40.3	40.7			

Table 3. General government debt developments

% of GDP	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Gross debt level	37.9	39.3	40.2	40.8	41.1	41.4	41.5
Change in gross debt	0	1.4	0.9	0.6	0.3	0.3	0.1
Contributions to change in gross debt							
Primary balance	1.1	2.3	1.5	1.4			
Interest payments	1	1	1.1	1			
Nominal GDP growth	-1.8	-2.1	-2.3	-2.2			
Other factors influencing the debt ratio	-0.2	0.2	0.5	0.4			
Of which: Privatisation receipts							
p.m. implicit interest rate on debt	5.3	5.2	5.3	5.1			

Table 4. Cyclical developments

% of GDP	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
1. GDP growth at constant prices	1¾	2¼	3¼	2¾	2½	2¼	2¼
2. Actual balance	-2.1	-3.3	-2.6	-2.4	-2.1	-2.0	-1.8
3. Interest payments	1.0	1.0	1.1	1.0			
4. Potential GDP growth							
5. Output gap	-1.1	-1.4	-0.7	-0.2	0.0	0.0	0.0
6. Cyclical budgetary component	-0.6	-0.9	-0.6	-0.2	0.0	0.0	0.0
7. Cyclically-adjusted balance	-1.5	-2.4	-2.0	-2.2	-2.1	-2.0	-1.8
8. Cyclically-adjusted primary balance							

Table 5. Divergence from previous update

% of GDP	2002	2003	2004	2005	2006
GDP growth **previous update**	1½	2½ - 3	3 - 3½	2¾ - 3¼	
latest update	1¾	2	3 - 3½	3 - 3½	2½ - 3
Difference	¼	-½ - -1	0	¼ - ¾	-
Actual budget balance* **previous update**	-1.8	-2.2	-1.7	-1.6	-1.6
latest update	-2.1	-3.3	-2.6	-2.4	-2.1
Difference	-0.3	-1.1	-0.9	-0.8	-0.5
Gross debt levels* **previous update**	37.9	38.8	38.9	38.9	
latest update	37.9	39.3	40.2	40.8	41.1
Difference	0	0.5	1.3	1.9	-
* Fiscal Years 2002-03, 2003-04, 2004-05, 2005-06, 2006-07					

Table 6. Long-term sustainability of public finances

% of GDP	**2002-03**	**2012-13**	**2022-23**	**2032-33**	**2042-43**	**2052-53**
Total expenditure	38.9	40.5	39.9	41.8	41.7	41.3
Old age pensions	5	5.1	4.9	5.4	5.3	5.3
Health care	6.5	8.2	8.5	9.3	9.7	9.7
Education	5.1	5.5	5.3	5.5	5.4	5.4
Long-term care	0.9	1.1	1.1	1.1	1.1	1.1
Interest payments						
Total revenues						
of which: from pensions contributions						
National pension fund assets (if any)						
Assumptions						
Trend labour productivity growth		2	2	2	2	
Real GDP growth		2½	1¾	2	2	
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate						

Table 7. Basic assumptions from the Commission's 2003 autumn forecast

	2002	2003	2004	2005
Basic assumptions				
Short-term interest rate (annual average)	4.1	3.7	4.0	4.2
Long-term interest rate (annual average)	4.9	4.4	4.8	5.2
USD/€exchange rate (annual average)	0.95	1.13	1.16	1.15
(for non-euro countries) exchange rate vis-à-vis the €(annual average)	0.63	0.69	0.70	0.71
World excluding euro area, GDP growth	3.2	3.8	4.4	4.5
EU-15 GDP growth	1.1	0.8	2.0	2.4
Growth of relevant foreign markets	3.0	3.3	6.5	7.3
World import volumes, excluding euro area	-	5.8	7.9	8.4
Oil prices	25.0	28.3	25.6	24.1