



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.1.2004
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Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Article 9 of Council
Regulation (EC) No 1466/97 of 7 July 1997**

On the updated Convergence Programme of the United Kingdom, 2002-03 to 2008-09

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies¹, stipulated that countries not participating in the single currency were to submit convergence programmes to the Council and the Commission by 1 March 1999. In accordance with Article 9 of this Regulation, the Council had to examine each convergence programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, the updated convergence programmes, to be presented annually, may also be examined by the Council in accordance with the same procedures.

The United Kingdom's convergence programme covering the period 1997-98 to 2003-04 was submitted on 22 December 1998 and assessed by the Council on 8 February 1999² and updates were presented every following year.

The UK authorities submitted the fifth and most recent updated convergence programme, covering the period 2002-03 to 2008-09³ (hereinafter referred to as the update) on 10 December 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct⁴, the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies⁵. This evaluation warrants the following assessment:

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 rules⁶, 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.

¹ OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

² OJ C 68, 11.3.1999

³ The UK financial year runs from April to March.

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 COM(2002) 668 final, 27.11.2002.

⁶ 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.

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 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. A prudent budgetary position kept in the medium term would help avoid a risk of emerging budget imbalances in the context of ageing populations. However, there are still, in the light of the current and projected deficits, some risks of imbalances in the long term. Quantitative indicators estimated by the Commission show an upward trend in the debt-to-GDP ratio in the long run. 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.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the convergence programme update of the United Kingdom and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Article 9 of Council
Regulation (EC) No 1466/97 of 7 July 1997**

On the updated Convergence Programme of the United Kingdom, 2002-03 to 2008-09

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies⁷, and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [10 February 2004], the Council examined the United Kingdom's updated Convergence Programme, which covers the period financial years 2002-03 to 2008-09. The updated programme largely complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes.

The budgetary strategy underlying the update continues to be the maintenance of sustainable public finances as part of an integrated strategy for achieving high and stable economic growth. The projections set out in the update would increase, over the programme period, both the revenue and the expenditure ratios to GDP with a slight rise in the modest debt-to-GDP ratio. A significant programme of public investment is being implemented.

The programme draws a distinction between its central macroeconomic projection and the GDP growth rates used for public finance projections; for caution, the latter are set one quarter percentage point per annum lower. The update centrally projects real GDP growth to accelerate from an estimated 2% in 2003 to 3 to 3½% in 2004 and 2005. In 2006, the final year for which detailed macroeconomic projections are provided, growth falls back to trend at 2½ to 3% and the present negative output gap is expected to close. Underlying trend employment growth is estimated at 0.2% per annum. HICP inflation is forecast to rise gradually from 1½% in 2003 to 2%, the recently recalibrated inflation target, in 2006. The central macro-economic scenario is close to the Commission's evaluation and the slightly lower growth rates used for the public finance projections in the update even closer. However,

⁷ OJ L 209, 2.8.1997

projected growth in the latter is still somewhat higher than forecast by the Commission in the short term.

The update projects a general government deficit of 2.6% of GDP in 2004-05, compared to an expected deficit of 3.3% in 2003-04. For 2005-06, 2006-07, 2007-08 and 2008-09, the projections are for headline deficits of 2.4%, 2.1%, 2.0% and 1.8% of GDP respectively. In cyclically-adjusted terms, the update projects an improvement in the deficit between 2003-04 and 2004-05 of 0.4 percentage points to 2.0% of GDP. In the following years, the deficits amount to 2.2%, 2.1%, 2.0% and 1.8% of GDP. Commission calculations of the cyclically-adjusted changes, according to the commonly-agreed methodology, are similar. The gross debt ratio is projected to rise gradually, from 37.9% of GDP in 2002-03 to stabilise at 41.5% in 2008-09.

The budgetary stance in the programme is expected to breach the 3% of GDP deficit threshold on a financial year basis in 2003-04. If confirmed for a calendar year, this could constitute an excessive deficit. Looking ahead, the projection includes a strong increase in the revenue-to-GDP ratio. Despite an expected narrowing of the cyclically-adjusted deficit, in no year of the update period does it seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. Similarly, the budgetary projections in the update do not ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance or in surplus is achieved within the programme period. At the same time, however, it should be noted that the projected balances reflect to a significant extent the implementation of an intensive programme of public investment, bringing the general government net investment-to-GDP ratio up from 1.1% in 2002-03 to 2.2% in 2005-06, compared to an EU-average of 1.5% in 2002. Moreover the gross debt to GDP ratio is well below 60% of GDP over the programme period.

Long term sustainability of public finances is constantly monitored and represents a key commitment in the UK's fiscal policy. A prudent budgetary position kept in the medium term would help avoid a risk of emerging budget imbalances in the context of ageing populations. However, there are still, in the light of the current and projected deficits, some risks of imbalances in the long term. Indeed, quantitative indicators estimated by the Commission show an upward trend in the debt-to-GDP ratio in the long run. 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 2004 Budget and the 2004 Spending Review present opportunities to address the issues identified above.

In the 2003 Broad Economic Policy Guidelines, the UK authorities are 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 economic policies as reflected in the updated programme are broadly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications.