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DECEMBER 2004 UPDATE
OF THE CONVERGENCE PROGRAMME OF THE UNITED
KINGDOM
(2003/04-2009/10)
AN ASSESSMENT

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SUMMARY AND CONCLUSIONS¹

The UK authorities submitted the sixth update of their Convergence Programme (hereafter referred to as the update) on 17 December 2004, covering the period from financial year 2003/04 to 2009/10. The update incorporates the authorities' latest projections for the public finances as set out in the 2 December 2004 Pre-Budget Report (PBR). The programme partly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". Data relating to total expenditure and revenues are not provided on a harmonised ESA95 basis, while information is not provided using the standardised tables agreed by the code of conduct. The update also continues to treat the receipts from the sale of the UMTS spectrum as an annual income stream, rather than as the sale of an asset, and does not provide information on their importance to the public finance projections.

The central macroeconomic projection is of firm economic growth slowing to trend in 2006 and beyond. Some rebalancing of growth is expected, with domestic demand forecast to slow, while the recent negative drag on growth from net exports is forecast to be eliminated. On the basis of currently available information, the macroeconomic projections contained in the programme appear broadly plausible, notwithstanding risks of lower-than-expected growth in the short term. The forecast appears favourable in 2005, but is in line with the Commission services' forecast for 2006. Thereafter, the authorities forecast of trend growth in 2007 and beyond is slightly lower than the Commission services' latest estimates of potential growth.

It is nevertheless important to note that the UK authorities base their projections for the public finances on a forecast scenario in which trend output growth is a quarter-percentage point lower than the rate used in the central macroeconomic forecast. Even on this lower growth scenario, there is a risk in 2005 of GDP growth slower than that forecast; however, the medium-term assumption for trend output growth is likely to prove a cautious estimate.

Despite a strong labour market and a pickup in average earnings, HICP inflation remained subdued throughout 2004, generally well below the official 2% inflation target. In anticipation of emerging price pressures, the Bank of England raised its policy rate four times during the year, resulting in a cumulative rise in the repo rate since November 2003 of 125bp, to 4.75%. Sterling's effective exchange rate rose modestly in nominal terms over the first half of the year but subsequently fell back, and by the end of 2004 the index was little changed on its value at the start of the year; mirroring these developments, the bilateral exchange rate vis-à-vis the euro appreciated during the first half of 2004 before ending the year at a rate close to that of twelve months earlier. Over the past year, developments in UK bond yields were broadly in line with trends in international bond markets, while the differential on 10-year government bond yields relative to Germany rose from around 50bp at the beginning of 2004 to a peak of almost 100bp in mid-November, among other factors due to the higher spread between short-

¹ This technical analysis, which is based on information available up to 9 February 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 16 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Richard Salt (richard.salt@cec.eu.int) or John Sheehy (john.sheehy@cec.eu.int).

term interest rates in the UK and Germany and the changing relative growth outlook in the two countries.

The UK's fiscal policy framework is based on two domestic fiscal policy rules for the public sector as a whole: the "golden rule", which aims to ensure that, over the course of the economic cycle, the government borrows only to finance net investment, and not to fund current expenditure; and the "sustainable investment rule", which aims to keep public sector *net* debt at "a stable and prudent level" below 40% of GDP over the cycle. Within this framework, the updated programme projects a reduction in the deficit from 3.2% of GDP in financial year 2003/04 to below the 3% reference value in 2004/05 (the financial year being the reference period for assessing the UK's public finances under the Stability and Growth Pact). Thereafter the update projects a gradual reduction in the deficit over the medium term, but only to a level of 1.7% in 2008/09. The expenditure ratio continues to increase in line with the government's policy priorities, including a rise in net investment, but the expected increase in the revenue ratio would lead to an overall improvement in the general government balance. Deficit projections to 2006/07 have been revised upward relative to the previous update despite an essentially unchanged macroeconomic outlook, while maintained for 2007/08; consequently, the looser short-term stance is intended to be followed beyond 2005/06 by a sharper consolidation of the public finances than in the previous update.

Risks of a deficit higher than projected appear weighted towards the near term. In particular, the deficit in financial year 2004/05 might be in excess of 3% of GDP. In both the short and medium terms, risks are present due to the relatively optimistic forecast for growth in 2005 and the potential for a weaker-than-expected recovery in receipts, particularly of corporation tax. Especially in the period of slower projected expenditure growth from 2006/07, government departments may find it difficult to adjust to tighter budgets, and thus might make use of accumulated unspent balances. However, from 2006/07 these negative risks are countered by the relatively cautious macroeconomic projections.

In view of this risk assessment, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations at any point during the projection period. It is insufficient to ensure that the Stability and Growth Pact's medium-term objective of budgetary position close to balance is achieved by 2009/10. At the same time, however, it has to be noted that the debt ratio is relatively low and the projected balances are affected by the implementation of the above-mentioned significant programme of public investment.

The gross debt ratio is projected to rise modestly over the period covered by the update (largely as a result of deficits on the primary balance), peaking at below 43% of GDP in 2007/08, well under the Treaty reference value of 60% of GDP.

The programme reviews the government's structural reform programme since the previous update, providing information on reforms to labour, product and capital markets. It also outlines further measures to improve the quality of public finances through a major programme of enhancing public sector efficiency, consistent with the recommendation, included in the 2003-2005 BEPGs, for the UK authorities to ensure that public services accompanying the planned increase in spending "...are delivered efficiently and with a view to ensuring cost-effectiveness". The update also notes significant, ongoing efforts to improve the measurement of public sector output.

The UK appears to be in a relatively favourable position with regard to the long-term sustainability of the public finances. The relatively low debt-to-GDP ratio and the strong emphasis that the UK authorities have placed, in existing policies, on long-term sustainability of the public finances are positive in this regard. The strategy outlined in the programme is mainly based on achieving high and stable long-term economic growth with sound and sustainable public finances regarded as a prerequisite. While higher age-related expenditures cannot be excluded, as there is a possibility of insufficient provision of private pensions which might have implications for the UK public finances, the authorities are introducing the Pension Protection Fund (PPF), from April 2005, designed to protect members of private defined-benefit schemes where the sponsoring firm becomes insolvent and there are insufficient assets in the scheme to meet its liabilities. The effectiveness of the (PPF) has, however, yet to be tested. In addition, adherence to the UK's domestic fiscal rules would imply that any increase in public pension provision would (on average over the cycle) be financed from revenue or restructuring of expenditure. The UK's relatively low tax ratio should ease the accommodation of any imbalances that may arise in the longer term.

Overall, the economic policies outlined in the update are partly consistent with the country-specific recommendation on the public finances addressed to the UK in the 2004 update of the BEPGs, that the UK should improve the cyclically-adjusted position consistent with a budgetary position of close to balance or in surplus in the medium term. For 2004/05, evidence of significant progress remains unconfirmed in outturn data and there is a high degree of uncertainty over both expenditures and revenues, leaving the risk noted above of a deficit higher than 3% of GDP. Moreover, the planned slight expansionary stance in 2005/06 and the fiscal stance over the medium term are not in line with the recommendation in the BEPGs.

In view of the above, it would be appropriate for the United Kingdom to ensure that the deficit is below 3% of GDP in financial year 2004/05 in line with plans, and to take the necessary measures to ensure that a budgetary position close to balance or in surplus is achieved and maintained over the medium term.

Comparison of key macroeconomic and budgetary projections

1. Headline macroeconomic forecast		2004	2005	2006	2007	2008
Real GDP – headline forecast (% change)	CP 12/2004	3¼	3 to 3½	2½ to 3	2¼ to 2¾	n.a.
	COM	3.3	2.8	2.8	n.a.	n.a.
	<i>CP 12/2003</i>	<i>3 to 3½</i>	<i>3 to 3½</i>	<i>2½ to 3</i>	<i>n.a.</i>	<i>n.a.</i>
HICP inflation (%)	CP 12/2004	1¼	1¾	2	2	n.a.
	COM	1.4	1.9	2.0	n.a.	n.a.
	<i>CP 12/2003</i>	<i>1¾</i>	<i>2</i>	<i>2</i>	<i>n.a.</i>	<i>n.a.</i>
2. Macroeconomic forecast underlying the public finances		2004/05	2005/06	2006/07	2007/08	2008/09
Real GDP – public finances ² (% change)	CP 12/2004	3¼	3	2½	2¼	2¼
	COM ³	3.3	2.8	2.8	n.a.	n.a.
	<i>CP 12/2003</i>	<i>3¼</i>	<i>2¾</i>	<i>2½</i>	<i>2¼</i>	<i>2¼</i>
HICP inflation (%)	CP 12/2004	1¼	1¾	2	2	2
	COM ³	1.4	1.9	2.0	n.a.	n.a.
	<i>CP 12/2003</i>	<i>1¾</i>	<i>2</i>	<i>2</i>	<i>2</i>	<i>2</i>
General government balance ⁴ (% of GDP)	CP 12/2004	-2.9	-2.8	-2.3	-2.1	-1.7
	COM ³	-2.8	-2.6	-2.4	n.a.	n.a.
	<i>CP 12/2003</i>	<i>-2.7</i>	<i>-2.5</i>	<i>-2.2</i>	<i>-2.1</i>	<i>-1.9</i>
Primary balance ⁵ (% of GDP)	CP 12/2004	-0.8	-0.7	-0.2	-0.1	n.a.
	COM ³	-0.9	-0.6	-0.4	n.a.	n.a.
	<i>CP 12/2003</i>	<i>-0.5</i>	<i>-0.4</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
Cyclically-adjusted balance (% of GDP)	CP 12/2004 ¹	-2.8	-2.9	-2.3	-2.0	-1.6
	COM ³	-2.7	-2.4	-2.1	n.a.	n.a.
	<i>CP 12/2003</i> ¹	<i>-2.4</i>	<i>-2.4</i>	<i>-2.2</i>	<i>-2.0</i>	<i>-1.8</i>
Government gross debt (% of GDP)	CP 12/2004	40.9	41.8	42.4	42.8	42.8
	COM ³	40.4	40.9	41.2	n.a.	n.a.
	<i>CP 12/2003</i>	<i>40.2</i>	<i>40.8</i>	<i>41.1</i>	<i>41.4</i>	<i>41.5</i>
Note:						
¹ Commission services calculations on the basis of the information in the programme.						
² GDP forecast underlying the authorities' projections for the public finances; based on an estimate of trend growth one-quarter percentage point below the authorities' central view.						
³ Commission data are on a calendar year basis (for example, calendar year 2004 corresponds to financial year 2004/05).						
⁴ The UK authorities include, in their projections for the general government balance, annual receipts of around £1.0 billion from the sale of UMTS licences in 2000. Adjusting for this, to bring the projections onto an EDP basis, has the effect of subtracting around 0.1pp from the balance (i.e. increasing the deficit) in each year. All data shown in this table are given <u>after</u> this adjustment, made by the Commission services, to the data in the update.						
⁵ The authorities provide primary balances excluding net interest rather than only interest payments as done by the Commission. Figures shown are as recalculated by the Commission services, based on the data reported in Table 4.4 of the programme update.						
Sources:						
<i>Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>						

1. INTRODUCTION

The UK authorities submitted the sixth update of their Convergence Programme (hereafter referred to as the update) on 17 December 2004, covering the period from financial year² 2003/04 to 2009/10. The update incorporates the authorities' latest projections for the public finances as set out in the 2004 Pre-Budget Report (PBR), presented to Parliament on 2 December 2004.

The update partly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes:

- data for general government receipts and expenditures, while based on ESA95 components, use differing aggregation methods to the harmonised measure, making analysis of these variables difficult, and reducing the degree of comparability with other Member States;
- the update continues to treat the receipts from the sale of the UMTS spectrum as an annual income stream, rather than as the sale of an asset, and does not provide information on their importance;³ and
- more generally, information is not provided using the standardised tables agreed by the code of conduct.⁴ As such, these tables have been completed by the Commission services as far as possible.

2. MACROECONOMIC DEVELOPMENTS

The UK Convergence Programme is unusual in presenting a central macroeconomic projection, but deliberately for reasons of caution, basing the public finance projections on an alternative macroeconomic scenario embodying an assumption of lower trend growth. This section assesses both the central scenario and that used for the public finances.

The central projection is of firm economic growth slowing to trend in 2006 and beyond, as the output gap closes. Some rebalancing of growth is expected by the authorities, with

² The UK financial year runs from April to March.

³ It should be noted that figures for the general government balance have been adjusted in this assessment, in order to bring the projections onto a basis comparable with other Member States. Specifically, the UK authorities include, in their projections for the general government balance, annual receipts of around £1 billion (around 0.1% of GDP) from the sale of UMTS licences in 2000. Adjusting for this generally has the effect of subtracting 0.1pp from the balance (i.e. increasing the deficit) in each year – though since the annual receipts are slightly less than 0.1pp of GDP, the adjustments made may, in some cases, overstate the level of general government net borrowing due to rounding effects. However, since projections are only provided on a %-of-GDP basis for some years covered by the update, it is not always possible to provide more accurate estimates. Hereafter, data illustrated in this assessment have been adjusted, by the Commission services, to remove the UMTS receipts. This does not include those data in Annex 1, which are as reported in the programme update.

⁴ See Annex 1 for a full summary of data provided.

domestic demand forecast to slow over the forecast period, while the recent negative drag on growth from net exports is forecast to be eliminated.

Robust growth in 2004 is expected to continue in 2005 at 3 to 3½%, following estimated growth of 3¼% in 2004. Domestic demand growth, estimated at 4% in 2004, is expected to slow but remain above trend at 3 to 3½% in 2005. Household consumption should slow as a result of the slowing in house price growth and the impact of a cumulative 125bp monetary policy tightening that began in November 2003. Strong growth in fixed investment, on the other hand, is expected to provide a stronger contribution to output, while the drag on growth in recent years from net exports should be eliminated. In 2006, growth is expected to moderate further to 2½ to 3%, around the authorities' 2¾% estimate of trend, as domestic demand again moderates. Overall, the external economic assumptions in both 2005 and 2006, which lead to a zero contribution to growth from net trade in both years, are plausible and consistent with the Commission's autumn forecast.

The Commission services' autumn forecast for 2005 is for growth of 2.8%, with slightly weaker growth in investment and both household and government consumption than forecast by the authorities. Data released since the autumn forecast are broadly supportive of it. The general outlook for the main components of GDP growth in 2005 thus remains favourable, although risks of a more rapid slowing due to a marked downturn in the housing market cannot be ruled out, and, overall, the authorities' central case scenario appears on the optimistic side of the current forecast range in 2005. However, by 2006, the authorities' central forecast of 2¾% is in line with the Commission services' forecast of 2.8%, with a broadly similar composition of growth. Thereafter, the authorities' forecast of 2½% trend growth in 2007 and beyond is slightly lower than the Commission services' latest estimates of potential growth.

Consequently, the central macroeconomic projections contained in the programme appear broadly plausible, notwithstanding risks of lower-than-expected growth in the short term.

It is important to note, however, that the UK authorities base their projections for the public finances on a forecast scenario in which trend growth is a quarter-percentage point lower than in the central macroeconomic forecast. This alternative scenario is relatively cautious, although in 2005 it remains slightly above the Commission Services' autumn forecast (3% against 2.8%) and should not be considered as particularly cautious.⁵

In 2006 the UK authorities' forecast is for growth slightly below that of the Commission Services, with domestic demand growth similar. Over the medium term, the assumption of 2¼% trend output growth underlying the public finance forecasts is likely to prove a cautious estimate.

⁵ The forecast for 2005 is, for example, significantly above consensus forecasts of around 2.5% GDP growth.

Table 1: Comparison of macroeconomic developments and forecasts ¹

1. Headline macroeconomic forecast								
	2004		2005		2006		2007	2008
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3.3	3¼	2.8	3 to 3½	2.8	2½ to 3	2¼ to 2¾	n.a.
<i>Contributions (% points):</i>								
- Final domestic demand	3.9	4	2.7	3 to 3½	2.6	2½ to 3	2¼ to 2¾	n.a.
- Change in inventories	0.1	0	0.0	0	0.1	0 to ¼	0	n.a.
- External balance on g&s	-0.7	-¾	0.1	0	0.0	0	0	n.a.
Employment (% change)	0.7	n.a.	0.5	n.a.	0.5	n.a.	n.a.	n.a.
Unemployment rate (%)	4.9	n.a.	4.9	n.a.	4.9	n.a.	n.a.	n.a.
HICP inflation (%)	1.4	1¼	1.9	1¾	2.0	2	2	n.a.
GDP deflator (% change)	2.4	2¼	2.3	2½	2.1	2¾	2¾	n.a.
Current account (% of GDP)	-2.0	-2¼	-1.8	-2½	-1.9	-2½	-2½	n.a.
2. Macroeconomic forecast underlying the public finances								
	2004/05		2005/06		2006/07		2007/08	2008/09
	COM²	CP	COM²	CP	COM²	CP	CP	CP
Real GDP (% change)	3.3	3¼	2.8	3	2.8	2½	2¼	2¼
<i>Contributions (% points):</i>								
- Final domestic demand	3.9	4	2.7	3	2.6	2½	2¼	n.a.
- Change in inventories	0.1	0	0.0	0	0.1	0	0	n.a.
- External balance on g&s	-0.7	-¾	0.1	0	0.0	0	0	n.a.
HICP inflation (%)	1.4	1¼	1.9	1¾	2.0	2	2	2
GDP deflator (% change)	2.4	2¼	2.3	2½	2.1	2¾	2¾	2¾
Notes:								
¹ Table compares the authorities' forecast ranges with the Commission services autumn forecast. In each forecast year x, the macroeconomic forecast underlying the public finance projections in financial year x/x+1 is given by the lower bound of the forecast range. Hence, for example, the GDP growth forecast underlying the 2005/06 public finance projections is 3%, the lower bound of the 3 to 3½% range in calendar year 2005.								
² Commission services' forecast data are provided on a calendar year basis (for example, calendar year 2004 corresponds to financial year 2004/05).								
Sources:								
<i>Commission services autumn 2004 economic forecasts (COM); convergence programme update (CP).</i>								

On the basis of the data for the central scenario in the programme update, Table 2 presents Commission services' calculations of potential output according to the commonly agreed methodology, alongside estimates taken directly from the Commission services' autumn forecast. While estimates of potential output are broadly similar, both in terms of magnitude and composition, the most significant difference lies in the evolution of the output gap. The forecasts presented in the update suggest a slightly smaller negative output gap in 2004 than in the autumn forecast⁶, with firm growth leading to a small positive output gap in 2005. Given a forecast of below-potential growth from 2006 onwards, and a relatively benign evolution of the output gap, these estimates lend further support to the plausibility of the programme's central scenario, and

⁶ This assessment is based on Commission calculations applying the common methodology; the UK authorities' output gap estimates are negative and higher in absolute value.

to the assessment of the relative cautiousness of the macroeconomic assumptions underlying the programme's budgetary projections.

Table 2: Sources of potential output growth – central scenario ⁷

	2004		2005		2006		2007	2008
	COM	CP ³	COM	CP ³	COM	CP ³	CP ³	CP ³
Potential GDP growth ¹	2.8	2.8	2.9	2.9	3.0	2.9	2.7	2.6
<i>Contributions:</i>								
- Labour	0.5	0.4	0.5	0.4	0.6	0.4	0.2	0.1
- Capital accumulation	0.9	0.9	1.0	1.0	1.0	1.1	1.1	1.0
- TFP	1.3	1.4	1.3	1.4	1.3	1.4	1.4	1.4
Output gap ^{1,2}	-0.3	-0.2	-0.3	0.2	-0.5	0.0	-0.2	-0.3
Notes:								
¹ Based on the production function method for calculating potential output growth.								
² In percent of potential GDP.								
³ Commission services calculations on the basis of the information in the convergence programme update.								
Sources:								
<i>Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>								

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

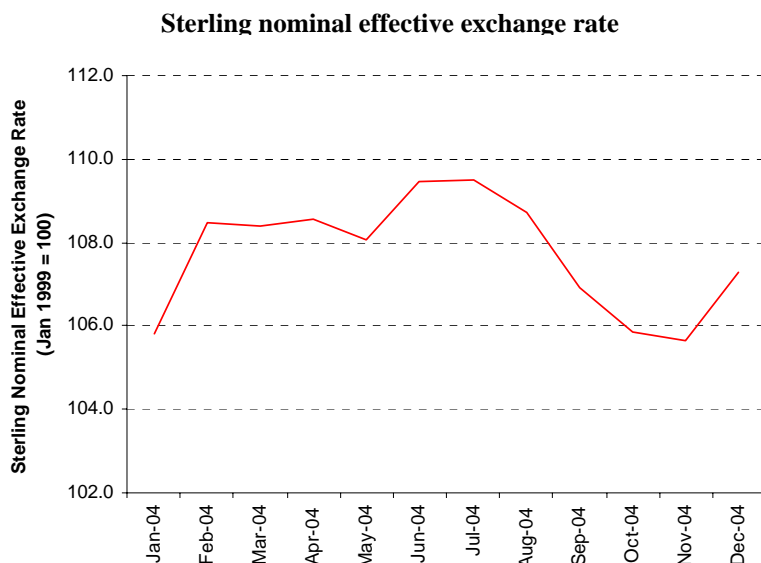
The monetary policy framework in the UK aims at delivering price stability over the medium term and, without prejudice to that objective, at supporting the government's economic policy, including its objectives for growth and employment. Price stability is defined by the official inflation target which, from 10 December 2003, has been specified in terms of the Harmonised Index of Consumer Prices (HICP) measure, referred to in the UK as the Consumer Prices Index (CPI). This is to achieve an inflation target of 2 per cent, as measured by the twelve-month increase in the HICP/CPI index.⁸ The move to an operational target based on the HICP increases cross-country comparability.

Despite a strong labour market and a pickup in average earnings, HICP inflation remained subdued throughout 2004, generally well below target. The index rose to 1.6% (its highest level since March 2003) over the first half of the year but subsequently fell back to just 1.1% in September. By December, HICP inflation had once again risen to 1.6%; producer prices have also begun to indicate emerging pressures, even excluding

⁷ It should be noted that the potential output estimates calculated from the programme update are based on the central-case macroeconomic scenario, rather than the more cautious scenario used to calculate the public finances. Under the UK's approach, the two yield the same output gap profile; however, it cannot be ruled out that output gap estimates would vary using the commonly agreed methodology. However, the programme update does not provide sufficient information for the purpose of estimating potential output from the macroeconomic scenario underlying the public finance forecasts according to the commonly agreed methodology.

⁸ Previously, the inflation target was specified in terms of the Retail Prices Index excluding mortgage interest payments (RPIX), with a target of 2.5 per cent, as measured by the twelve-month increase in the RPIX index.

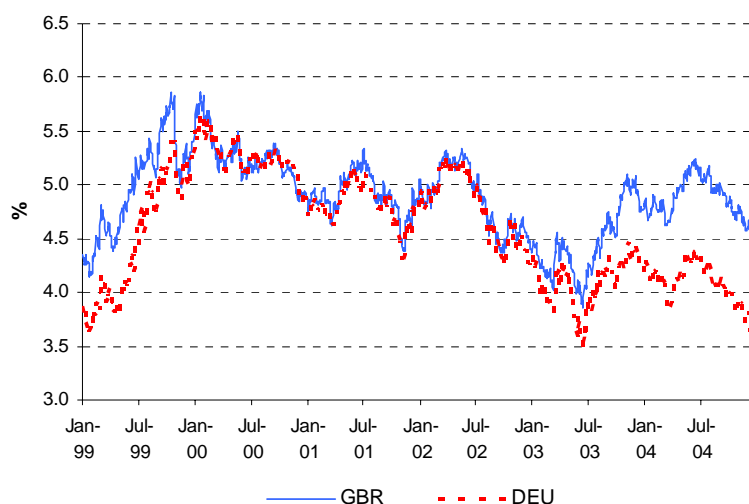
petroleum products.⁹ In anticipation of these pressures, the Bank of England raised its policy rate four times during the year to 4.75%, a cumulative rise in the repo rate of 125bp since November 2003.



The inflation targeting framework for monetary policy is combined with a free-floating exchange rate. Sterling rose in nominal effective terms by around 4 per cent from January to July 2004, but subsequently fell back and by the end of 2004, the index was only slightly above its value at the start of the year. In bilateral terms, sterling began the year trading at around £0.70 against the euro, but strengthened to below £0.66 by mid-April. This movement likely reflects a combination of factors, including changes in short-term interest rates and revisions to expectations about future interest rate movements. Between mid-April and early August, sterling traded in the narrow range of £0.66 to £0.68, but from early August began to depreciate against the euro, ending the year very close to where it had started at around £0.70. Again, this movement is likely to be due to a number of factors, including possible downward revisions to future interest rate expectations.

⁹ On the RPIX measure, inflation reached 2.5% in December 2004 (the previous target), while the broader RPI measure (which includes mortgage interest payments) reached 3.5%. Housing components excluded from the CPI largely explain the difference between the CPI and RPI measures, though differences in coverage, weighting and methodology all contribute.

10-year bond yields – UK and Germany



The macroeconomic policy framework in the UK continues to provide for low long-term bond yields. Over the past year, developments in UK bond yields have been broadly in line with trends in international bond markets. In 2004, the 10-year government bond yield in the UK was on average 4.9%, compared to 4.6% in 2003. The 10-year government bond differential with respect to Germany widened over the first half of the year from around 50 basis points, peaking at 96 basis points in mid-November. This reflects, among other factors, the higher spread between short-term interest rates in the UK and Germany, and the changing relative growth outlook in the two countries. At the short end of the yield curve, three-month interest rates moved in line with policy rates in 2004. The spread between UK and euro three-month interest rates stood at around 190 basis points at the start of the year but rose to around 275 basis points by the year-end.

4. BUDGETARY IMPLEMENTATION IN 2004/05

The update estimates general government net borrowing in financial year 2004/05 to be 2.9% of GDP. Recent data show that the deficit breached the 3% of GDP reference value in calendar year 2004, and is estimated to have reached 3.2% of GDP.¹⁰ However, it remains too early to draw firm conclusions on the final deficit outcome for financial year 2004/05, the reference period for assessing the UK's public finances under the EDP.¹¹

These developments reflect weaker than expected revenue outturns, despite firm GDP growth in 2004 in line with the authorities' previous forecasts. Estimates in the update for 2004/05 general government current receipts are 0.4pp (of GDP) lower than those set out in the previous update, largely reflecting weakness in the growth of corporation tax receipts relative to earlier forecasts. While this could be a largely structural effect, given robust growth in output and relatively strong corporate profitability, the authorities claim that at least some of this shortfall may reflect a previous underestimate of the backlog in unused losses accumulated by financial companies that have depressed taxable profits in

¹⁰ Commission services' estimate on the basis of public finance data released 21 January 2005.

¹¹ An Annex to Regulation No 1467/97 sets out that the reference period over which the UK public finances are assessed is the UK financial year, running from April to March.

the short term – a legacy of earlier turbulence in equity markets. This alternative interpretation would imply that some of the current weakness in corporate tax receipts is more cyclical than structural in nature. Other factors likely to affect revenue projections before the end of the financial year include some offsetting impact from higher oil prices (the UK remains a small net-exporter of oil).

Total expenditure, at 40.0% of GDP in 2004/05, is also forecast to be lower than in the previous update (40.3%). Data so far this year suggest, however, that risks of exceeding spending plans cannot be ruled out: current spending has been relatively strong through the first nine months of financial year 2004/05. Net investment, meanwhile, has also been revised down slightly since the previous update (by 0.1pp to 1.9% of GDP), and data suggest that for financial year 2004/05 as a whole investment will fall significantly short of target. While this would, all else equal, help counter any overrun on current spending, it also suggests that the quality of the public finances in 2004/05 gives some cause for concern.

5. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

5.1. Evolution of budgetary targets in successive programmes¹²

Relative to the 2002 update, higher deficits are expected throughout the projection period (Table 3). Since the 2003 update, the most marked revisions to budgetary targets are those in the short term. While the deficit outturn for 2003/04 is now estimated to have been 0.2pp lower than projected in the previous update, this still exceeded the 3% of GDP reference value, with budgetary developments adversely affected by GDP composition effects that depressed receipts; the projections for both 2004/05 and 2005/06 are for higher deficits. In 2004/05, as described above, projections of current revenues have been lowered, more than offsetting a downward revision to expenditure. The slower than previously expected recovery in revenues is also responsible for the higher deficit projected in 2005/06, despite a slightly stronger forecast for GDP growth.

Beyond 2005/06, the medium-term projections contained in the update would, if fulfilled, represent a slightly more rapid consolidation of the public finances than those in the previous update, with the general government balance projected to reach 1.7% of GDP in 2008/09. The adjustment profile is thus more ‘back-loaded’ than in the previous update.

Table 3: Evolution of budgetary targets in successive programmes

		2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
General government balance (% of GDP) ¹	CP Dec 2004	-3.2	-2.9	-2.8	-2.3	-2.1	-1.7
	CP Dec 2003	-3.4	-2.7	-2.5	-2.2	-2.1	-1.9
	<i>CP Dec 2002</i>	<i>-2.3</i>	<i>-1.8</i>	<i>-1.7</i>	<i>-1.7</i>	<i>-1.7</i>	<i>n/a</i>
General government expenditure ² (% of GDP)	CP Dec 2004	39.5	40.0	40.7	40.8	41.0	n/a
	CP Dec 2003	40.2	40.3	40.7	n/a	n/a	n/a
	<i>CP Dec 2002</i>	<i>40.3</i>	<i>40.4</i>	<i>40.8</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
General government revenues ² (% of GDP)	CP Dec 2004	37.4	38.1	39.0	39.5	40.0	n/a
	CP Dec 2003	37.7	38.5	39.2	n/a	n/a	n/a
	<i>CP Dec 2002</i>	<i>38.9</i>	<i>39.6</i>	<i>40.0</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>
Real GDP ³ (% change)	CP Dec 2004	2¾	3¼	3	2½	2¼	2¼
	CP Dec 2003	2¼	3¼	2¾	2½	2¼	2¼

¹² It should be noted that, under the UK’s fiscal framework (see section 5.2), the projections for the general government balance, or the path of adjustment, do not constitute “targets” for policy.

Notes:

¹ Data adjusted by Commission services to reflect the UK's treatment of UMTS receipts (see footnote 2).

² Data for general government expenditure are not provided by the UK on a harmonised ESA95 basis, and cannot be considered comparable to data for other Member States. The figures included in this chart relate to the UK series "Total expenditure" and "Total current receipts" taken from Table 4.4 of the programme update, which exclude some components of the ESA-95 harmonised definitions of total revenues and expenditure.

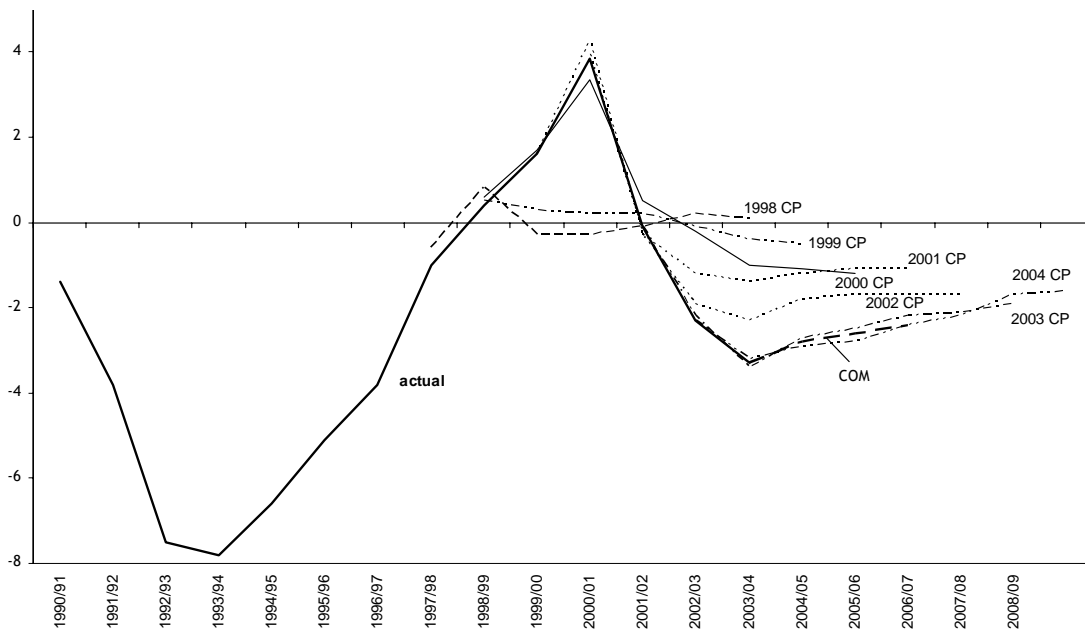
³ GDP projections underlying the public finance projections.

Sources:

Convergence programmes (CP)

Successive programme projections of the budgetary balance are shown in the graph below, which also illustrates that the authorities assume a slightly faster pace of deficit reduction in the short term than is projected in the Commission services' autumn forecast.

Figure 1: Moving targets in the UK Convergence Programme ^{1 2}
 General government balance as a per cent of GDP



¹ Commission services' forecasts are on a calendar year basis (data shown for financial year 2005/06 corresponds to the forecast for calendar year 2005).

² CP data adjusted by the Commission services to reflect the UK's treatment of UMTS receipts (see footnote 2).

Source: Commission services, HM Treasury, Convergence Programme and CP updates

5.2. Budgetary targets in the updated programme

The UK's fiscal policy framework is based on two domestic fiscal policy rules for the public sector: the "golden rule", which ensures that over the course of the economic cycle, the government borrows only to finance net investment, and not to fund current

expenditure;¹³ and the “sustainable investment rule”, which aims to keep public sector *net* debt at “a stable and prudent level” (below 40% of GDP over the cycle). Within this framework, the authorities set an explicit objective of maintaining sound public finances, but have undertaken, in recent years, substantial government spending to address historical under-funding and under-investment in public services.

There is little indication in the update of how policy has been set in the context of the EU’s fiscal policy framework; rather, the update sets out only how the authorities consider their public finance projections would be consistent with a revised Stability and Growth Pact as advocated by the UK.

With its emphasis on the economic cycle as a whole, application of the UK’s golden rule allows for deficits on the current budget to be offset against surpluses credited elsewhere in the cycle. Since the authorities estimate that the current economic cycle runs from 1999-00 to 2005-06, surpluses on the current budget achieved in the early years of the current cycle are being offset by the current run of deficits.¹⁴ The surplus peaked in 2000, since which time the balance has deteriorated markedly, leading to the deficit breaching the 3% of GDP reference value in 2003/04.¹⁵

The updated programme projects a reduction in the deficit to below the 3% of GDP reference value in 2004/05, the reference period for assessing the UK’s public finances under the Stability and Growth Pact. Thereafter the update projects a gradual reduction in the deficit over the medium term; whilst the level of public spending as a share of GDP continues to increase in line with the government’s policy priorities, the projected greater increase in the level of revenues as a per cent of GDP leads to an overall improvement in the general government balance.

As shown in Table 4, the update foresees the deficit on the budget balance to narrow from 2.9% of GDP in 2004/05 to 2.8% in 2005/06, but to decline at a slightly faster pace thereafter, to 2.1% in 2007/08. The update also sets out a projected deficit of 1.6% of GDP by 2009/10, though provides less detail on the underlying developments expected in the general government finances, making detailed analysis of this improvement more difficult. The time profile of the primary balance is broadly similar, with an improvement from -0.8% in 2004/05 to -0.1% by 2007/08 – thereby remaining in deficit, albeit by a small margin.

¹³ The rule refers to the public sector, not ‘general government’, i.e. including also public corporations.

¹⁴ The authorities forecast that the golden rule will be met, albeit with a declining margin. Other observers have reached different conclusions. Ex ante assessment of compliance with the golden rule is difficult, as it depends on a number of assumptions, such as the length of the business cycle, which are inherently subject to uncertainty.

¹⁵ On the basis of a report prepared by the Commission in accordance with Article 104(3) of the Treaty, the Economic and Financial Committee concluded that the excess of the deficit over the reference value did not, in the sense of the Treaty, constitute an excessive deficit. At the time of the report, the deficit was estimated for 2003/04 to have been 3.3% of GDP (approximately adjusted for UMTS receipts), but was expected to fall below 3% of GDP in 2004.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003/04	2004/05	2005/06	2006/07	2007/08	Change: 2007/08-2004/05
Total current receipts ¹	37.4	38.1	39.0	39.5	40.0	1.9
<i>of which:</i>						
- Taxes & social security contributions	35.1	35.7	36.7	37.2	37.7	2.0
- Other (residual)	2.3	2.4	2.3	2.3	2.3	-0.1
Total expenditure ¹	39.5	40.0	40.7	40.8	41.0	1.0
<i>of which:</i>						
- Primary expenditure	37.5	37.9	38.6	38.7	39.0	1.1
<i>Of which:</i>						
Gross fixed capital formation	1.6	1.9	2.2	2.3	2.4	0.5
Consumption	20.9	21.1	21.2	21.5	21.8	0.7
Transfers & subsidies	12.8	12.9	12.7	12.4	12.3	-0.6
Other (residual)	2.2	2.0	2.5	2.5	2.5	0.5
- Interest payments	2.0	2.1	2.1	2.1	2.0	-0.1
Budget balance	-3.2	-2.9	-2.8	-2.3	-2.1	0.9
Primary balance ²	-1.2	-0.8	-0.7	-0.2	-0.1	0.8
Notes:						
¹ Data for total revenues and expenditure are not presented by the UK on a harmonised ESA-95 basis, and therefore not directly comparable with other Member States. Data illustrated are UK series "total current receipts" and "total expenditure" drawn from Table 4.4 of the programme update. Other data presented are aggregates derived, by the Commission services on the basis of information provided by the UK authorities, to approximate (as nearly as possible) relevant ESA-95 definitions.						
² The UK authorities provide primary balances excluding net interest rather than only interest payments as done by the Commission. Figures shown are those recalculated by the Commission services', based on the reported budget balance. Figures included in the update are as follows: 2003/04 = -2%; 2004/05 = -1.8%; 2005/06 = -1.6%; 2006/07 = -1.1%; 2007/08 = -0.9%.						
<i>Sources:</i>						
<i>Convergence programme update; Commission services calculations</i>						

As the expenditure ratio increases during the period 2004/05 to 2007/08 by 1pp, with the growth in spending planned to slow from a relatively strong rate in 2005/06, the medium-term improvement in the deficit is attributable an assumed significant pickup in revenues, which are projected to increase from 38.1% of GDP in 2004/05 to 40.0% by 2007/08. Some plausible assumptions support the overall revenue increase of 1.9pp: fiscal drag is likely to contribute around 0.3pp over the period, as will other income tax receipts from higher wages (including an expected recovery in bonus payments) and higher interest income. VAT receipts are assumed to continue to decline as a percentage of the theoretical tax base (mainly consumer spending)¹⁶. Efforts are also being strengthened to reduce tax avoidance (announced in the 2004 Budget and Pre-Budget Report: see Box 2).

The principal downside risk concerns corporation tax receipts. As noted in Section 4, recent outturns have been weaker than forecast in the March 2004 Budget and the authorities suggest that this may reflect an overhang from the earlier cyclical downturn. From a relatively low base of 2.3% of GDP in 2003/04, the programme assumes a largely autonomous, cumulative 1.1pp rise in the contribution from corporation tax receipts to the current receipts-to-GDP ratio, reaching 3.4% by 2007/08 – back to the robust receipts of the late 1990s, and above the post-1990/91 average of 3.0% of GDP. Compared with this profile, while a significant recovery in receipts from their current levels is plausible, risks of shortfall relative to projections are significant.

¹⁶ The authorities' projections for VAT receipts are based on an assumption that the gap between theoretical and actual receipts will increase by 0.5 percentage points each year. This assumption has been audited by the National Audit Office (see: Audit of Assumptions for Budget 2004).

Expenditure projections carry risks in the face of slower planned growth in spending than in recent years. Overall, expenditure is projected to rise modestly as a share of GDP, from 40.0% in 2004/05 to 41.0% in 2007/08. Around half of the increase is accounted for by a projected increase in net investment, and just over half by an increase in current expenditure on goods and services (with some offset elsewhere). Since the introduction of the new UK spending framework in 1997, public sector spending outturns (i.e. including those of public corporations as well as general government) have tended to be within stated plans. However, looking forward, government departments will need to ensure that they adjust to tighter budgets in a period of slower expenditure growth, if plans are to be adhered to. In particular, under the UK's spending framework, where accumulated underspending of previous years remains available to departments, there appears to be a specific risk to remaining within spending plans from large currently unspent allocations, for which no specific provision appears to be made in the public finance projections¹⁷ (though departments would need to seek parliamentary approval if the drawdown of such allocations took spending over the planned level for the year); further detail is provided in Box 1 below.

Based on Commission services calculations according to the commonly agreed methodology (Table 5), the cyclically-adjusted balance shows no material improvement until 2006/07, when it is projected to fall to just above 2% of GDP. Indeed, the balance does not improve and even deteriorates slightly in 2005/06, reflecting a relatively strong annual increase in spending (both current and capital). This small loosening of the fiscal stance is also suggested by the authorities' own projections in the update, which also indicate a rise in the cyclically-adjusted deficit in 2005/06.

The downward adjustment in the deficit is relatively slow in the near term; thereafter, the cyclically-adjusted deficit is projected to fall to 1.5% of GDP by 2008/09, reflecting the back-loaded nature of the planned tightening in the fiscal stance.

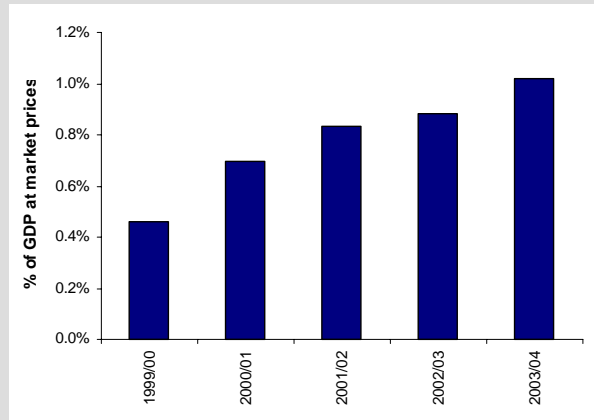
¹⁷ At the end of financial year 2003/04 such unspent allocations totalled over £11 billion (roughly 1% of GDP).

Box 1: Carry-forward of unspent budgets

The UK's public spending framework was put in place to address a number of perceived shortfalls in the management of public spending, *inter alia* to improve transparency, and develop a more forward-looking assessment of needs. A key element was the introduction of End-Year Flexibility (EYF), which allows central government departments to carry forward under-spends on their Departmental Expenditure Limit (DEL) allocations from one year to the next. Together with the fact that plans are now set over three years, the framework aims to reduce incentives for departments to use up resources at year-end.

In line with a recent tendency to under-spend relative to plans (perhaps reflecting some short-term supply constraints), the amount carried forward has increased from year to year. As at the end of financial year 2003-04, the carry-forward was estimated to total £11.4 billion, equivalent to roughly 1% of GDP, comprising around £8.8 billion of unspent resource budget allocations, and £2.6 billion of capital budget allocations. However, because projections for general government expenditure are based on the spending allocations made as part of the Spending Review, the implied claim on the public finances by government departments reclaiming past under-spending is not included in the forward projections.

Carry-forward of DEL under-spend in yr t to yr t+1



Source: Public Expenditure Outturn White Papers

Even as spending is set to slow, it would appear likely that any run-down will be gradual – not least because the accumulated EYF is spread across some 35 departmental groups. Nonetheless, the carry-forward may be drawn upon by some departments as they adjust to lower growth in spending. As a result, despite the recent record of spending within plans, some risk exists of higher spending in the medium term than currently planned.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)^{4 5}

	2003/04		2004/05		2005/06		2006/07		2007/08	2008/09	Change: 2008/09-2004/05
	COM	CP ¹	COM	CP ¹	COM	CP ¹	COM	CP ¹	CP ¹	CP ¹	CP ¹
Budget balance ²	-3.3	-3.2	-2.8	-2.9	-2.6	-2.8	-2.4	-2.3	-2.1	-1.7	1.2
Output gap ^{1,3}	-0.7	-0.7	-0.3	-0.2	-0.3	0.2	-0.5	0.0	-0.2	-0.3	-0.1
CAB ^{1,2}	-2.9	-2.9	-2.7	-2.8	-2.4	-2.9	-2.1	-2.3	-2.0	-1.6	1.2
CAPB ^{1,2,6}	-0.9	-0.9	-0.7	-0.7	-0.4	-0.8	-0.2	-0.2	-0.0	n/a	n/a

Notes:
¹Commission services calculations on the basis of the information in the convergence programme (CP). Calculations are made on the basis of data underlying the authorities' central macroeconomic forecast. Under the UK's approach, the two forecast scenarios yield the same output gap profile; it cannot be ruled out that output gap estimates would vary using the commonly agreed methodology. However, the programme update does not provide sufficient information for the purpose of estimating potential output from the macroeconomic scenario underlying the public finance forecasts according to the commonly agreed methodology.
²In percent of GDP.
³In percent of potential GDP.
⁴Data adjusted by the Commission services to reflect the UK's treatment of UMTS receipts (see footnote 2).
⁵Commission services autumn forecast data are on a calendar year basis (data shown for financial year 2003/04, for example, correspond to the forecast for calendar year 2003).
⁶Commission services' calculations of the primary balance based on interest payments, rather than net interest as provided in the programme update.

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations.

Overall, negative risks to the budgetary projections appear weighted towards the near term, particularly in financial year 2005/06. As set out in Section 2, the macroeconomic forecast in the update underlying the public finance projections for 2005/06 cannot be considered particularly cautious. Risks also remain from a weaker recovery than expected in receipts, particularly corporation tax.

Over the medium term, however, risks to the public finance projections look more balanced. There are risks of stronger public finance outturns due to better macroeconomic performance, given the authorities' use of more cautious growth projections. However, this is offset by downside risks associated with both revenue and spending projections. On the revenue side, risks to the authorities' projections for corporation tax receipts over the medium term cannot be ruled out, while on the spending side, central government departments will need to adjust to tighter budgets in a period of slowing expenditure growth.

Finally, the economic policies outlined in the update are partly consistent with the country-specific recommendation on the public finances addressed to the UK in the 2004 update of the BEPGs, namely that the UK was recommended to improve the cyclically-adjusted position to consolidate the public finances, consistent with a budgetary position of close to balance or in surplus in the medium term. So far in 2004/05, evidence of significant progress remains unconfirmed in outturn data and there is a high degree of uncertainty over both expenditures and revenues, leaving the risk noted above of a deficit higher than 3% of GDP. Moreover, in 2005/06 a planned slight expansionary stance is not in line with this recommendation. Over the medium term, the back-loaded but slightly stronger medium-term fiscal tightening than was envisaged in the previous update does not ensure that the Stability and Growth Pact's medium-term objective of a budgetary position close to balance or in surplus is achieved and maintained. The

projections contained in the update cannot moreover be considered as providing a sufficient safety margin against future breaches of the 3% of GDP reference value.¹⁸

Box 2: The 2004 Budget and Pre-Budget Report

The 2004 Budget was published on 17 March 2004; subsequently, the 2004 Pre-Budget Report (PBR – a more consultative document that precedes the publication of the 2005 Budget due in spring 2005) was published on 2 December, providing the updated macroeconomic forecasts and fiscal projections that form the basis for the convergence programme update.

Overall, announced measures in both the Budget and PBR have had relatively little impact on the near-term fiscal projections (combined, net additional spending amounts to around 0.1% of GDP in 2004/05). Significant spending measures during the year include a one-off payment to pensioners and an extension of public funding for childcare (both through tax credits and by making funds available to raise the quality of provision).

Two elements of the budgetary strategy are worth noting in particular:

- Both the Budget and PBR contained a significant focus on improving public sector efficiency, in particular that departments would achieve annual efficiency savings of 2.5% a year relative to department's 2004/05 baseline expenditure by 2007/08. These measures are discussed in more detail in Section 7. The programme update includes a brief summary of early progress against these targets; and
- The UK has introduced a range of measures to safeguard and increase tax revenues, including a disclosure requirement to counter the spread of schemes to avoid direct tax, a similar requirement on business to disclose use of VAT avoidance schemes, and a measure to ensure that companies and groups with profits chargeable to corporation tax are charged a minimum rate of 19 per cent on profits distributed to individuals. The impact of these measures offsets additional spending in other areas.

The Chancellor also used his Budget speech to announce that while the Government did not propose a new assessment of the economics of UK adoption of the euro; the Treasury will again review progress in the 2005 Budget.

5.3. Sensitivity analysis

The programme update does not include a sensitivity analysis on the basis requested in the code of conduct, namely an analysis based on different interest rate assumptions (nor, the optional analysis based on main extra-EU variables). Although the authorities base their projections for the public finances on an assumption of trend growth one quarter-percentage point below that in the central-case macroeconomic scenario, it is not possible to establish directly what the overall impact of lower (or higher) growth would be on key public finance aggregates.

¹⁸ To assess the size of the cyclical safety margin needed to withstand business cycle fluctuations without breaching the 3% of GDP reference value, a minimum benchmark can be estimated, defined as the difference between the reference value and the calculated cyclical safety margin. The minimum benchmark for the UK is estimated by the Commission services to be a deficit of 1.2% of GDP (source: Public Finance in EMU 2002).

The update includes a graphical analysis of developments on the UK's 'current budget' (current revenues minus current expenditure), based on a scenario in which trend output is assumed to be one percentage point lower in relation to actual output in the central macroeconomic scenario (in effect, that the output gap is one percentage point more positive). However, the principal value of this analysis lies in its usefulness for assessing the UK's own "golden rule"; a greater level of detail is necessary to enhance its usefulness in the context of assessing the projections contained in the update.

Commission services simulations¹⁹ of the CABs under the assumptions of (i) a sustained 0.5 percentage points deviation from the growth targets in the programme over the 2004/05-2007/08 period; (ii) trend output based on the HP-filter and (iii) no policy response, reveal that, by 2007/08, the CAB would be -2.8% of GDP, below the central scenario. Hence, in the case of persistently lower growth, additional measures of around 0.6 percentage points of GDP would be necessary to keep the public finances on the path targeted in the central scenario. In the event of persistently higher growth of the same magnitude, the CAB would reach -1.5% of GDP by 2007/08. These calculations also suggest that even if growth were this degree stronger than expected, a fiscal position of close to balance or in surplus would still not be achieved by 2007/08, and nor would a sufficient safety margin be provided against breach of the Treaty reference value.

6. EVOLUTION OF THE DEBT RATIO

The UK debt ratio is stable and, although projected to rise modestly over the projection period, is set to remain well under the Treaty reference value of 60% of GDP (Table 6).

The authorities' latest estimate for financial year 2004/05 is for general government gross debt to reach 40.9% of GDP – a small upward revision from the forecast outcome of 40.2% of GDP set out in the 2003 update. Thereafter, the debt ratio is projected to rise to 42.8% of GDP by 2007/08, largely as a result of deficits on the primary balance. Stock-flow adjustments are relatively small; however, they are the principal source of difference between the official projections and those set out in the Commission services' autumn forecast.

In line with usual practice, the UK authorities also project public sector net debt (i.e. allowing for the net accumulation of financial assets), which is projected to rise from 34.3% of GDP in 2004/05 to 36.2% of GDP in 2006/07.²⁰

¹⁹ Commission services' calculations based on the data series "Total Expenditure" as set out in Table 4.4 of the programme update. As noted in Section 1, these data do not correspond to the harmonised definition of Total Expenditure on an ESA95 basis; therefore some caution should be exercised in comparing the results of this simulation with those performed for other Member States.

²⁰ It is this definition that the government uses to gauge compliance with its 'sustainable investment rule', aimed at keeping net debt as a proportion of GDP below 40% of GDP over the economic cycle. On the basis of the projections in the update, the sustainable investment rule would be met comfortably.

Table 6: Debt dynamics

	average 2000-2003	2004/05		2005/06		2006/07		2007/08
	COM ¹	COM ¹	CP	COM ¹	CP	COM ¹	CP	CP
Government gross debt ratio	39.7	40.4	40.9	40.9	41.8	41.2	42.4	42.8
Change in debt ratio (1 = 2+3+4)	-1.3	0.7	1.1	0.5	0.9	0.3	0.6	0.4
<i>Contributions:</i>								
- Primary balance (2)	-2.2	0.9	0.8	0.6	0.7	0.4	0.2	0.1
- “Snow-ball” effect (3)	0.3	-0.2	0.0	-0.1	-0.1	0.0	0.0	0.0
- Interest expenditure	2.3	2.0	2.1	2.0	2.1	2.0	2.1	2.0
- Real GDP growth	-1.0	-1.2	-1.2	-1.1	-1.2	-1.1	-1.0	-0.9
- Inflation (GDP deflator)	-1.0	-0.9	-0.9	-0.9	-1.0	-0.9	-1.1	-1.1
- Stock-flow adjustment (4)	0.5	0.0	0.3	-0.1	0.3	-0.1	0.4	0.3
- Cash/accruals								
- Accumulation of financial assets								
- <i>asset</i> : Privatisation proceeds	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual								
Notes:								
The change in the gross debt ratio can be decomposed as follows:								
$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$								
where <i>t</i> is a time subscript; <i>D</i> , <i>PD</i> , <i>Y</i> and <i>SF</i> are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and <i>i</i> and <i>y</i> represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.								
¹ Commission services autumn forecast data are on a calendar year basis (for example, data shown for financial year 2003/04 correspond to the forecast for calendar year 2003)								
<i>Sources:</i>								
<i>Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations</i>								

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

Recent policy priorities in the UK have been aimed at addressing a legacy of under-investment and under-provision in public services – both in terms of current and capital spending. The 2003-2005 BEPGs included a recommendation for the UK authorities to ensure that the public services accompanying the planned increase in spending “...are delivered efficiently and with a view to ensuring cost-effectiveness”.

Consistent with this recommendation, the update notes that the 2004 Spending Review (which, in July 2004, set out detailed spending plans for the financial years 2005/06 to 2007/08) provided for government departments to achieve significant annual efficiency savings that are expected to reach £21.5 billion (roughly 0.2 per cent of GDP) by 2007/08.²¹ This includes real-term cuts in administrative costs for each government department, and a net reduction in civil service employment of 70,600 posts (roughly

²¹ It is important to note that the spending plans set out in the 2004 Spending Review – and the government’s fiscal rules - do not rely on the efficiency targets being met. The overall spending plans have been set consistent with the authorities’ view that the spending is affordable even without the efficiency savings. Instead, if the savings are achieved, the government intends to use all of the released resources for further provision of public services, leaving the overall level of expenditure unchanged.

13.5 per cent relative to an April 2004 complement of 524,580) by 2008. The success of the initiative will only become evident over the medium term, not least because some of the potential savings are difficult to assess independently ex ante. A system of targets and assessment has been set up to monitor the initiative, discussed in more detail in Box 3.²²

Box 3: Progress on efficiency

The government has set out a formal process for assessing departmental progress against the targets set in the 2004 Spending Review. Departmental reports setting out how performance will be measured have been scrutinised by the National Audit Office (NAO) and the Audit Commission, and are available on the internet. Government departments are also required to report publicly on progress against targets.

While some departments have not published disaggregated estimates of savings linked to particular efforts, the update nonetheless presents a summary of some of the principal efficiency savings that the authorities believe have already been achieved, including:

- The Department for Work and Pensions has achieved a reduction of over 6,000 posts (out of a target of 40,000 by March 2008); the department has also relocated 2,050 posts away from London, in an effort to further reduce costs; and
- the Department for Health has negotiated a new procurement deal for branded medicines estimated to yield annual savings of £370 million (roughly 0.03% of GDP); Further savings are expected on generic medicines that will increase annual savings to £1 billion (roughly 0.1% of GDP) from 2005/06.

Departments will be required to report formally on their progress against efficiency targets in their Departmental Reports, which are published in spring each year.

The update also sets out further measures taken to promote structural reform and flexibility in UK labour, product and capital markets since the previous update. These include measures to: ease the transition into work for those hitherto in receipt of incapacity benefits; increase housing market supply as a means of enhancing geographical labour mobility; provide additional training for low-skilled adults in work; simplify tax regimes for small businesses; and improve competition in public procurement.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of UK public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account different budgetary developments over the medium term. The “programme” scenario (baseline) assumes that the medium-term objective set up in the

²² In parallel, significant efforts are being made to improve the measurement of public sector output, with an independent review of these issues having been published in January 2005. More accurate measurement would complement the broader efforts to improve efficiency; in this regard, improved measures of health sector output have been adopted.

programme is actually achieved, while the “2004” scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme and additional information provided in the framework of the projection exercise conducted by the EPC, age-related expenditure is foreseen to increase by 3% of GDP between 2010 and 2050 (see Annex 2 for a breakdown of different age-related expenditures). Other social spending is projected to decrease by 1.8 percentage points of GDP, reflecting the assumption that most non-pension social benefits will rise in line with prices after 2009-10. This will considerably mitigate the impact of ageing on public finances. The gross debt ratio is projected to increase slightly over the coming decades and reach about 90% of GDP in 2050. However, if the plans for budgetary consolidation in the medium term do not materialise, the debt dynamics would become less favourable.²³

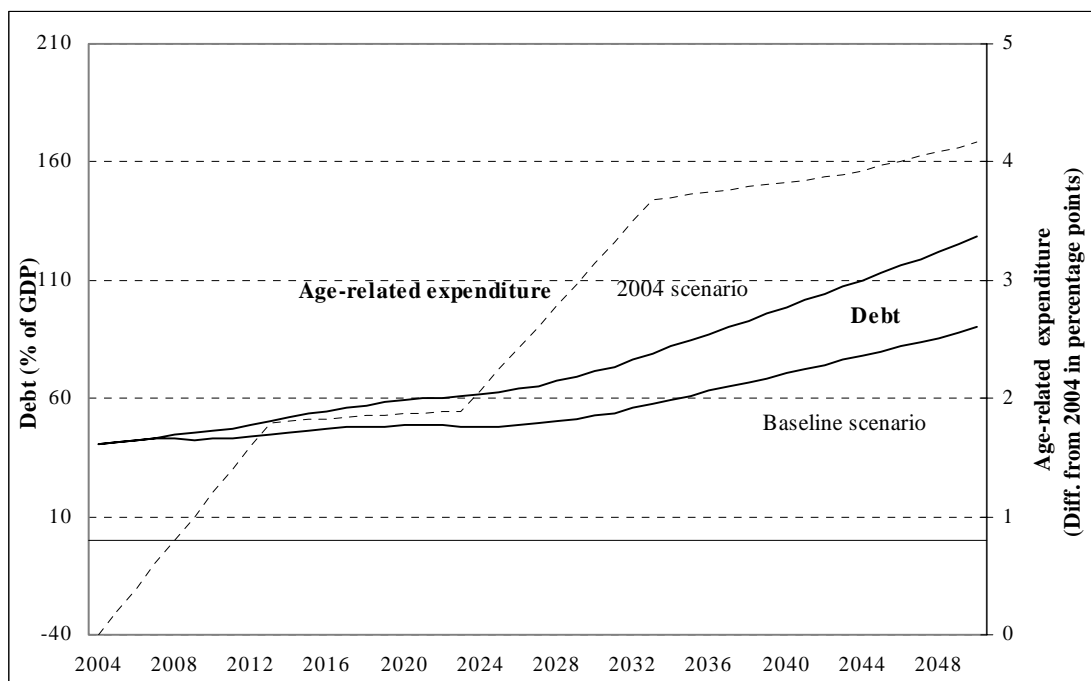
On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050).²⁴ S2 shows the gap between the current tax policies and those that would ensure respect of the inter-temporal budget constraint given the future impact of ageing on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to the latter, in order to tackle the cost of ageing entirely through a budgetary strategy, the UK should raise its tax ratio by at least 1.3 percentage points compared with the projected one at the end of the programme period. This would lead to a sustainable debt ratio of around 20% of GDP by the middle of the century.²⁵ In order to maintain a gross debt ratio below 60% of GDP in 2050, the tax ratio should be raised by at least 0.5 percentage points compared with the projected one in 2009/10. The budgetary effort over the first 5 years of projections (i.e. after the end of the programme period) to respect the inter-temporal budget constraint requires a primary surplus of around 1.3% of GDP on average, compared with -0.5% targeted for the last year of the programme period (measured in underlying terms).

²³ It should be recalled that, 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 likely outcomes and should not be taken at face value.

²⁴ The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible imbalances after the end of the projection period.

²⁵ The debt ratio of around 20% in 2050 according to the S2 indicator illustrates that the sustainability gap is higher in order to ensure a sustainable evolution of gross debt beyond 2050, compared with the S1 indicator, which illustrates that a lower budgetary strengthening is compatible with the 60% reference value in 2050.

Long-term sustainability: summary results



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	0.5	1.3	1.3
2004 scenario	1.2	2.7	2.1

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: 17.5 %

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP over the first five years of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

In interpreting these results, several factors must be taken into account. First, the rise in revenues as a per cent of GDP envisaged over the first 10 years of the long-term projections would appear entirely accounted for by developments in the medium-term period covered by the update (thereafter, receipts as a share of GDP remain constant); the update envisages a cumulative increase of 3 percentage points in *public sector* current receipts between 2003/04 and 2009/10. In parallel with the conclusions of Section 5.3 above, this improvement would appear to be based on a number of plausible assumptions regarding the growth of revenues, including the impact of fiscal drag and a number of efforts underway to deter tax avoidance. The principal downside risk concerns corporation tax receipts, where, for the reasons set out previously, some shortfall relative to projections cannot be ruled out – though towards the end of the projection period, this should be offset by the relatively cautious macroeconomic forecast. In addition, there are some risks to government spending if departments find it more difficult to adjust to tighter budgets in a period of slowing expenditure growth, which may worsen the medium-term budgetary outlook.

Second, long-term risks to pension provision have been identified by the First Report of the Pensions Commission (an independent body appointed by the government), which found that the current level of private pension provision is insufficient to maintain

pension incomes (relative to the rest of society) over the long run, given planned public provision. Solutions to this problem would have public finance implications, if they were to lead to higher public provision; however, this remains one option among several, and other options identified by the Pensions Commission include measures to increase private saving and/or raise retirement ages. Moreover, adherence to the UK's fiscal rules would mean that any increase in pensions spending would (on average over the cycle) need to be financed from current revenues, or reallocated spending, implying no increase in unfunded pension provision. The Pensions Commission's First Report should be seen in the context of the priority placed, by the authorities, on monitoring the long-term sustainability of the public finances.²⁶

Third, the existence of under-funded company pension schemes poses some risks. In an effort to deal with the specific risks associated with private occupational pension schemes, the government has established the Pension Protection Fund (PPF), to be introduced from April 2005. The (PPF) is designed to protect members of private defined-benefit schemes where the sponsoring firm becomes insolvent and there are insufficient assets in the scheme to meet its liabilities. However, the effectiveness of the (PPF) is unlikely to become clear until it is introduced. Long-term risks of increased liabilities cannot be excluded, as it is not clear what pressure the system will face, particularly with respect to initial demands. In addition, a succession of large claims could place considerable strain on such a fund; specific provisions allowing the levy to be increased if necessary nevertheless help alleviate this concern.

The UK appears to be in a relatively favourable position with regard to the long-term sustainability of the public finances, despite the projected budgetary cost of an ageing population. The relatively low debt-to-GDP ratio and the strong emphasis that the UK authorities have placed, in existing policies, on long-term sustainability of the public finances are positive in this regard. Higher age-related expenditures cannot be excluded, but the UK's relatively low tax ratio should ease the accommodation of any imbalances that may arise.

* * *

²⁶ A second report, due in autumn 2005, is to include policy recommendations.

Annex 1: Summary tables from the convergence programme update ²⁷

Table 1. Growth and associated factors²⁸

	ESA Code	2003	2004	2005	2006	2007
GDP growth at constant market prices (7+8+9)	B1g	2¼	3¼	3 to 3½	2½ to 3	2¼ to 2¾
GDP level at current market prices	B1g	1100	1161	1226 to 1231	1292 to 1303	1356 to 1376
GDP deflator		3	2¼	2½	2¾	2¾
HICP change		1½	1¼	1¾	2	2
Employment growth²⁹		0.2	0.2	0.2	0.2	0.2
Labour productivity growth ^{30 31}		2.25	2.25	2.25	2.25	2.25
Sources of growth: percentage changes at constant prices						
1. Private consumption expenditure	P3	2¼	3¼	2¼ to 2¾	2 to 2½	2 to 2½
2. Government consumption expenditure	P3	3½	4½	3	3	2½
3. Gross fixed capital formation	P51	2¼	6½	6¾ to 7¼	3¼ to 3¾	2¾ to 3¼
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52 + P53	0	0	0	0 to ¼	0
5. Exports of goods and services	P6	0	2¼	6½ to 7	6¼ to 6¾	6¼ to 6¾
6. Imports of goods and services	P7	1¼	4¾	6 to 6¼	5¼ to 5¾	5¼ to 5¾
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		2½	4	3 to 3½	2½ to 3	2¼ to 2¾
8. Change in inventories and net acquisition of valuables (=4)	P52 + P53	0	0	0	0 to ¼	0
9. External balance of goods and services (5-6)	B11	-¼	-¾	0	0	0

²⁷ Data reported as in the Convergence Programme update; public finance data are therefore *not* adjusted for the effect of UMTS receipts (see Section 1, and footnote 2, of the technical assessment).

²⁸ The forecast illustrated is the authorities' headline economic forecast; the GDP forecast underlying the authorities' projections for the public finances is set out in detail in Table 1 of Section 1. This is based on an estimate of trend growth one-quarter percentage point below the authorities' central view. In practice, this means that for each forecast year *x*, the macroeconomic forecast underlying the public finance projections in financial year *x/x+1* is given by the lower bound of the forecast range. Hence, for example, the GDP growth forecast underlying the 2005/06 public finance projections is 3%, the lower bound of the 3 to 3½% range in calendar year 2005.

²⁹ Data shown represent the authorities' estimate of trend growth in the employment rate, underlying the trend growth calculations, taken from the 2 December Pre-Budget Report. Explicit estimates of employment growth underlying the forecast are not presented in the update.

³⁰ Growth of GDP at market prices per person employed at constant prices.

³¹ Data shown represent the authorities' estimate of trend growth in output per hour worked, underlying the trend growth calculations, taken from the 2 December Pre-Budget Report. Explicit estimates of labour productivity growth underlying the forecast are not presented in the update.

Table 2. General government budgetary developments

% of GDP	ESA code	2003/04	2004/05	2005/06	2006/07	2007/08
Net lending (B9) by sub-sectors						
1. General government	S13	-3.1	-2.9	-2.7	-2.2	-2.0
2. Central government	S1311	-3.4	-3.0	-2.6	-2.5	
3. State government	S1312	n/a	n/a	n/a	n/a	n/a
4. Local government	S1313	0.2	0.2	-0.2	0.2	
5. Social security funds	S1314	n/a	n/a	n/a	n/a	n/a
General government (S13)						
6. Total receipts³²	ESA	37.4	38.1	39.0	39.5	40.0
7. Total expenditures³³	ESA	39.5	40.0	40.7	40.8	41.0
8. Budget balance	B9	3.1	2.9	2.7	2.2	2.0
9. Net interest payments		1.2	1.1	1.1	1.1	1.1
10. Primary balance³⁴		-2.0	-1.8	-1.6	-1.1	-0.9
Components of revenues						
11. Taxes	D2+D5	28.4	29.1	30.0	30.5	30.9
12. Social contributions ³⁵	D61	6.7	6.6	6.7	6.7	6.8
13. Interest income	D41	0.9	1.0	0.9	0.9	0.9
14. Other		1.4	1.4	1.4	1.4	1.4
15. Total receipts	ESA	37.4	38.1	39.0	39.5	40.0
Components of expenditures						
16. Collective consumption ³⁶	P32	20.9	21.1	21.2	21.5	21.8
17. Social transfers in kind	D63					
18. Social transfers other than in kind ³⁷	D62	12.1	12.4	12.2	11.9	11.8
19. Interest payments	D41	2.0	2.1	2.1	2.1	2.0
20. Subsidies	D3	0.7	0.5	0.5	0.5	0.5
21. Gross fixed capital formation ³⁸	P51	1.6	1.9	2.2	2.3	2.4
22. Other		2.2	2.0	2.5	2.5	2.5
23. Total expenditures	ESA	39.5	40.0	40.7	40.8	41.0

³² Data presented are according to the authorities' definition "total current receipts", which is not consistent with the harmonised ESA95 definition "total revenues".

³³ Data presented are according to the authorities' definition "total expenditure", which is not consistent with the harmonised ESA95 definition "total expenditure".

³⁴ Primary balance based on net interest payments (for consistency with UK public sector definition); interest payments given net of interest receipts.

³⁵ The authorities' definition of "social contributions" does not include pension contributions, and is therefore not consistent with the ESA95 definition.

³⁶ Data presented are according to the authorities' definition "current expenditure on goods and services", which aggregates the ESA95 definitions "collective consumption" and "social transfers in kind".

³⁷ Data presented are according to the authorities' definition of "net social benefits", which includes a deduction for pension contributions and is therefore not consistent with the ESA95 definition "social transfers other than in kind".

³⁸ The authorities' definition of "gross fixed capital investment" includes net acquisition of land, and is therefore not consistent with the ESA95 definition.

Table 3. General government debt developments

% of GDP	ESA code	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Gross debt level		39.5	40.9	41.8	42.4	42.8	42.8
Change in gross debt		1.8	1.3	1.0	0.5		
Contributions to change in gross debt							
Primary balance		2.0	1.8	1.6	1.1		
Interest payments ³⁹	D41	1.2	1.1	1.1	1.1		
Nominal GDP growth	B1g	-2.2	-2.2	-2.4	-2.2		
<i>Other factors influencing the debt ratio</i>		0.8	0.7	0.6	0.5		
<i>of which: privatisation receipts</i>		0.0	0.0	0.0	0.0		
<i>p.m. Implicit interest rate on debt</i>		5.1	5.0	4.9	4.9		

Table 4. Cyclical developments

% of GDP	ESA Code	2003/04	2004/05	2005/06	2006/07	2007/08
1. GDP growth at constant prices	B1g	2¼	3¼	3	2½	2¼
2. Actual balance	B9	-3.1	-2.8	-2.7	-2.2	-2.0
3. Interest payments ⁴⁰	D41	1.2	1.1	1.1	1.1	
4. Potential GDP growth ⁴¹		2¾	2¾	2¾	2¾	2½
5. Output gap		-1.4	-0.8	-0.1	0.0	0.0
6. Cyclical budgetary component ⁴²		-0.9	-0.6	-0.2	0.0	0.0
7. Cyclically-adjusted balance (2-6)		-2.2	-2.2	-2.5	-2.2	-2.0
8. Cyclically-adjusted primary balance (7-3) ⁴³		-1.0	-1.1	-1.4	-1.1	

³⁹ Primary balance based on net interest payments (for consistency with UK public sector definition); interest payments given net of interest receipts.

⁴⁰ Primary balance based on net interest payments (for consistency with UK public sector definition); interest payments given net of interest receipts.

⁴¹ The authorities estimates of potential growth are on a calendar year basis (for example, data shown for financial year 2003/04 correspond to the forecast for calendar year 2003)

⁴² Commission services' calculations based on data in the programme update.

⁴³ Commission services' calculation of primary balance based on total interest expenditure, rather than net interest payments as provided by the UK authorities.

Table 5. Divergence from previous update

% of GDP	ESA Code	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
GDP growth	B1g						
Previous update		2¼	3¼	2¾	2½	2¼	2¼
Latest update		2¼	3¼	3	2½	2¼	2¼
Difference		0	0	¼	0	0	0
Actual budget balance	B9						
Previous update		-3.3	-2.6	-2.4	-2.1	-2.0	-1.8
Latest update		-3.1	-2.8	-2.7	-2.2	-2.0	-1.6
Difference		0.2	-0.2	-0.3	-0.1	0.0	0.2
Gross debt levels							
Previous update		39.3	40.2	40.8	41.1	41.4	41.5
Latest update		39.5	40.9	41.8	42.4	42.8	42.8
Difference		0.2	0.7	1.0	1.3	1.4	1.3

Table 6. Long-term sustainability of public finances

% of GDP	2003/04	2013/14	2023/24	2033/34	2043/44	2053/54
	Pct. of GDP	Change compared to 2003				
Total expenditure	40.6	1.3	0.7	2.7	2.5	2.5
Old age pensions ²	6.5	0.4	0.6	1.3	1.1	1.3
Healthcare (including care for the elderly)	7.9	1.3	1.5	2.4	2.9	3.1
Interest payments						
Total revenues	36.7	2.7	1.9	3.1	3.3	3.3
<i>of which: from pensions contributions</i>						
	Percentage of GDP					
National pension fund assets (if any)						
Assumptions	Percentage change					
Labour productivity growth ¹		2	2	2	2	2
Real GDP growth		2	1¾	2	2	2
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate						
Notes:						
¹ Real GDP per employee growth.						
² Aggregate of state pensions and public service pensions.						

Table 0. Basic assumptions
(to be transmitted to the EFC and the Commission together with the SCP update)

	2003	2004	2005	2006	2007
Short-term interest rate (annual average)					
Long-term interest rate (annual average)					
USA: short-term interest rate (3-month money market)					
USA: long-term interest rate (10-year government bonds)					
USD/€ exchange rate (annual average)					
Nominal effective exchange rate (euro area)					
Nominal effective exchange rate (EU)					
(for non-euro countries) exchange rate vis-à-vis the € (annual average)					
World excluding EU, GDP growth					
US					
Japan					
G7	2¼	3½	3	2¾	2¾
EU-15 GDP growth					
Euro area	½	2	2	2¼	2¼
Growth of relevant foreign markets	3¾	8¾	8	7¼	6¾
World import volumes, excluding EU					
World import prices (goods, in USD)					
Oil prices (Brent, USD/barrel)					
Non-oil commodity prices (in USD)					

Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	2010	2020	2030	2040	2050	changes
<i>Total age-related spending</i>	21.3	22.0	23.3	23.9	24.3	3.0
Pensions	5.1	5.0	5.4	5.4	5.5	0.5
Health care	8.8	9.3	10.0	10.7	10.9	2.1
Education	5.3	5.2	5.2	5.2	5.2	-0.1
Unemployment benefits*	0.4	0.4	0.4	0.4	0.4	0.0
Public pension services	1.7	2.0	2.2	2.2	2.2	0.5
<i>Total primary non age-related spending</i>	18.6	17.8	17.4	17.2	16.8	-1.8
<i>Total revenues**</i>	40.2					

* EPC projections

** constant

Results (as % GDP)	2010	2020	2030	2040	2050	changes
Baseline scenario						
Gross debt	42.7	48.5	52.5	70.5	89.9	47.2
i + 0.5*	42.9	51.1	58.3	80.7	106.4	63.4
2004 scenario						
Gross debt	46.4	59.0	71.2	98.6	128.7	82.3
i + 0.5*	46.6	62.0	78.1	111.4	150.0	103.4

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.

