COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 16.2.2005
SEC(2005) 230 final

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of the United Kingdom, 2003/04-2009/10

(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 coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, had 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 assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The first convergence programme of the United Kingdom, covering the period 1997/98-2003/04, was submitted on 22 December 1998 and assessed by the Council on 8 February 1999. Updates were presented every following year. The UK submitted the most recent update of its convergence programme on 17 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies[3]. This evaluation warrants the following assessment:

– 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

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1 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 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.

3 COM(2002) 668, 27.11.2002.

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, due to the higher spread between short-term interest rates and to higher government net debt issuance in the UK compared to past years.

– 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 favourable 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, from April 2005, designed to protect members of private defined-benefit schemes that become insolvent. The effectiveness of this scheme 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 improve the cyclically-adjusted position to ensure that a budgetary position close to balance or in surplus is achieved and maintained over the medium term.

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

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of the United Kingdom, 2003/04-2009/10

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 coordination of economic policies[4], 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:

(1) On [8 March 2005] the Council examined the updated convergence programme of the United Kingdom, which covers the period 2003/04-2009/10. The programme complies partly 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 on a harmonised ESA95 basis, while information is not presented using the standardised tables agreed in 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 detail their importance to the public finance projections. Accordingly, the United Kingdom is invited to achieve compliance with the data requirements.

(2) The programme contains two different scenarios for the macroeconomic and budgetary projections: a 'headline' macroeconomic scenario; and a lower growth scenario based on an assumption of trend growth a quarter-percentage point weaker than in the central forecast; the latter underlies the public finance projections. The lower growth scenario is thus considered as the reference for assessing budgetary projections, and reflects broadly plausible assumptions. The scenario envisages real GDP growth in 2005 of 3%, only slightly lower than the growth of 3½% in 2004, before slowing to 2¼% by 2007/08. On the basis of currently available information,

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

there is a risk in 2005 of GDP growth slower than that forecast, as projected growth appears on the high side of the current forecasting range; however, over the medium term, the trend growth assumption underlying the public finance projections is likely to prove a cautious estimate. The programme's projections for inflation also appear realistic.

(3) The UK's fiscal policy framework is based on two domestic fiscal policy rules for the public sector: 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 an estimated 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 further 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, but the expected increase in the revenue ratio would, if realised, lead to an overall improvement in the general government balance. Within the overall level of expenditure, a significant programme of public investment is being implemented, which aims to lift general government *net* investment from 1.9% of GDP in 2004/05 to 2.4% in 2007/08. Relative to the 2003 update, deficit projections for both this financial year and next have been revised upwards; beyond 2005/06, however, the medium-term projections contained in the update represent a slightly more rapid consolidation of the public finances than those in the previous update.

(4) There is a clear risk that the budgetary outcome could be worse than projected in the programme in the short 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 favourable forecast for GDP 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. From 2006/07, however, these negative risks are countered by the relatively cautious macroeconomic projections.

(5) 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.

(6) The gross debt ratio is estimated to have reached 39.5% of GDP in 2003/04, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to increase modestly by less than two percentage points over the period to 2009/10.

(7) 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 as there is a possibility of insufficient provision of private pensions which might have implications for the public finances, but the authorities are introducing the Pension Protection Fund, from April 2005, to protect members of private defined-benefit schemes that become insolvent. These measures are welcome, though their effectiveness is yet to be tested. The UK's relatively low tax ratio should ease the accommodation of any imbalances that may arise in the longer term.

(8) The economic policies outlined in the programme 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 "in endeavouring to avoid the occurrence of an excessive deficit, 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". For 2004/05, there is a risk 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.

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In view of the above assessment, the Council is of the opinion that the United Kingdom should (i) ensure that the deficit is below 3% of GDP in financial year 2004/05 in line with plans, and (ii) improve the cyclically-adjusted position 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
	CP 12/2003	*3 to 3½*	*3 to 3½*	*2½ to 3*	*n/a*	*n/a*
HICP inflation (%)	**CP 12/2004**	**1¼**	**1¾**	**2**	**2**	**n/a**
	COM	1.4	1.9	2.0	n/a	n/a
	CP 12/2003	*1¾*	*2*	*2*	*n/a*	*n/a*
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
	CP 12/2003	*3¼*	*2¾*	*2½*	*2¼*	*2¼*
HICP inflation (%)	**CP 12/2004**	**1¼**	**1¾**	**2**	**2**	**2**
	COM [3]	1.4	1.9	2.0	n.a.	n.a.
	CP 12/2003	*1¾*	*2*	*2*	*2*	*2*
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.
	CP 12/2003	*-2.7*	*-2.5*	*-2.2*	*-2.1*	*-1.9*
Primary balance [5] (% of GDP)	**CP 12/2004**	**-0.9**	**-0.7**	**-0.2**	**-0.1**	**n.a.**
	COM [3]	-0.9	-0.6	-0.4	n.a.	n.a.
	CP 12/2003	*-0.5*	*-0.4*	*n.a.*	*n.a.*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP 12/2004**	**-2.8**	**-2.9**	**-2.3**	**-2.0**	**-1.6**
	COM [3]	-2.7	-2.4	-2.1	n.a.	n.a.
	CP 12/2003 [1]	*-2.4*	*-2.4*	*-2.2*	*-2.0*	*-1.8*
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.
	CP 12/2003	*40.2*	*40.8*	*41.1*	*41.4*	*41.5*

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 £1.4 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 after this adjustment, made by the Commission services, to the data in the update.

[5] The UK 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:
Convergence programme (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations