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DECEMBER 2005 UPDATE OF THE CONVERGENCE PROGRAMME OF THE UNITED KINGDOM

(2005/06-2010/11)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The United Kingdom authorities submitted the seventh update of their convergence programme on 14 December 2005[2], covering the period from financial year 2005/06 to 2010/11[3]. The programme deviates on some material points from the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[4].

In its opinion of 8 March 2005 on the previous update of the convergence programme, the Council invited the United Kingdom to ensure that the deficit was below 3% of GDP and to improve the cyclically-adjusted position to ensure that a budgetary position close to balance or in surplus was achieved over the medium term. On 24 January 2006, taking into consideration the information contained in the 2005 update of the convergence programme, the Council decided that the United Kingdom deficit was excessive. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit should be corrected by financial year 2006/07. Following the expiry of the six month period foreseen by the recommendation, the Commission is due to carry out an assessment of the progress made by the United Kingdom authorities towards the correction of the excessive deficit.

Over the last decade, United Kingdom macroeconomic performance has been impressive in terms of improved stability, growth, low inflation and labour market outturns. Annual real GDP growth averaged 3¼% in 1996-2000 and 2¼% in 2001-05. However, after a period of fiscal consolidation between 1996 and 2001, when the general government balance moved from a deficit of around 5% of GDP to a comfortable surplus, the United Kingdom has implemented a planned large increase of public expenditure including public investment, with the general government balance changing to a deficit of over 3%

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[1] This technical analysis, which is based on information available up to [XX February 2006], accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on [22 February 2006]. 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 Pietro Toigo (pietro.toigo@cec.eu.int) or John Sheehy (john.sheehy@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

[2] The UK is not subject to the 1 December deadline for submitting its convergence programme, as it has a different fiscal year to the other Member States. Instead, the code of conduct specifies that the UK should submit the programme "as close as possible to the publication of the autumn Pre-Budget Report" (PBR); the latter was presented to Parliament on 5 December 2005.

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

[4] In particular, the section on institutional features of the public finances is missing; the programme has gaps in the provision of compulsory data (for example, the forecast for employment, unemployment and compensation of employees and the breakdown of expenditure for the last year required are not provided), and does not provide all optional data. Data for general government expenditure and receipts, while based on ESA 95 components, use different aggregation methods from the harmonised measure. The update also continues to account receipts from the sale of UMTS licences as an annual income stream rather than the sale of an asset, contrary to the Eurostat decision of 14 July 2000 on the allocation of such receipts. A number of data gaps have been filled through bilateral discussions between the Commission services and UK officials.

of GDP by 2004. Gross debt declined from over 50% of GDP in 1996 to below 38% of GDP in 2002, but has been on a slowly growing path since then.

The macroeconomic scenario underlying the budgetary projections, assessed against currently available information, appears to be based on broadly plausible growth assumptions, though not without risks, for example linked to a slower than expected rise in household consumption expenditure. Economic growth picks up from 1¾% in 2005/06 to 3% in 2007/08, broadly in line with the Commission services' autumn 2005 forecast, and then dips to 2¾% in 2008/09. From 2009/10, annual growth is projected at 2¼%, which appears to be relatively cautious.

Surging oil prices in mid-2005 pushed HICP inflation sharply above the official 2% inflation target in the second half of the year; inflation eased back down towards 2% by the year-end as this impact waned. The programme expects inflation to dip below 2% in 2006 and then to remain at around the 2% target throughout the programme period, which appears realistic. In the course of 2005, both the nominal effective exchange rate and the EUR/GBP exchange rate have been relatively stable. Yield differentials between long-term government bonds in the United Kingdom and the euro area have declined and ten-year forward rates in the United Kingdom are only marginally above those in the euro area. The yield on index-linked long-term government bonds has fallen to a near-record low, partly driven by the regulatory regime for pension funds. Taking account of inflation prospects, the Bank of England reduced its policy rate by 25 basis points to 4½% on 4 August 2005 in a first reversal of the tightening interest rate cycle initiated in November 2003. The United Kingdom operates an inflation-targeting framework for monetary policy; the pound does not participate in ERM II and floats freely.

As regards budgetary implementation in 2005/06, the general government deficit is estimated at 3.4% of GDP in the Commission services' autumn 2005 forecast, against a projection of 2.8% of GDP set in the previous update of the convergence programme. The higher than expected deficit is due to lower than expected GDP growth, now estimated at 1¾% compared to 3% in the previous update, to base effects stemming from lower than expected outturns for tax receipts in 2004/05 and, to a lesser extent, to some slight discretionary easing.

The updated programme projects a reduction in the deficit from just above 3% of GDP in financial year 2005/06 to below the 3% reference value in 2006/07. Thereafter, the deficit is projected to decline to a level of 1.5% of GDP by 2010/11. The general government primary balance, estimated as a deficit of 1.0% of GDP in 2005/06, returns to balance in 2008/09 and reaches a surplus of 0.5% of GDP by 2010/11. The improvement in the nominal balance is mainly driven by a pick-up of revenues, partly due to the projected cyclical recovery of the economy, and partly to an increase in the tax to GDP ratio. The updated programme foresees a small discretionary fiscal tightening in 2006/07, and 2007/08 which is expected to be permanent. The expenditure ratio is projected to increase until 2007/08, driven by a planned increase in expenditure on public services and in public investment. *Net public sector* investment (including capital grants to the private sector) is planned to rise from 1.6% of GDP in 2004/05 to 2¼% of GDP by 2006/07, and then remain constant as a percentage of GDP. After 2007/08, current expenditure growth is planned to slow significantly. Thus by 2008/09 the deficit is projected to be entirely used to fund public investment. Compared with the 2004 update, the deficit projections for 2005/06 and 2006/07 have been revised upwards in line with economic developments, while over the medium term they converge to the profile in the previous update.

Calculated according to the commonly agreed methodology, the programme envisages an average annual improvement of the structural balance (i.e. in cyclically-adjusted terms and net of one-off and other temporary measures) of just above ¼ percentage points of GDP from an estimated structural deficit of just below 3% of GDP in 2005/06. This adjustment is front-loaded in 2006/07, when the excessive deficit is planned to be corrected and the negative output gap is at its widest, but slows thereafter, when the negative output gap narrows. A quantitative medium-term objective (MTO) for the structural balance of the general government is not specified. The programme refers to fiscal objectives under the domestic rules, which imply a medium-term path for the cyclically-adjusted deficit, consistent with stabilising the debt-to-GDP ratio at a low level and with keeping the current budget in balance or surplus on average over the economic cycle.

The budgetary outcome could be worse than projected in the programme, especially in the short term. The projected recovery of the tax to GDP ratio, and in particular of corporation tax revenues, presents risks, to the extent that it depends on an assumption of positive developments in the financial sector that continue into the next year and are not subsequently reversed. On the expenditure side, after the projected rise until 2007/08, the programme update projects a fall in the expenditure ratio after 2007/08 below the levels in 2005/06 that may be challenging. Given existing policy commitments, reducing the expenditure to GDP ratio implies significantly slower current expenditure growth, probably particularly marked in some areas. The comprehensive reassessment of public expenditure being planned in the 2007 Comprehensive Spending Review should help identify areas where public expenditure growth should be reduced. In 2009/10 and 2010/11 these negative risks may be partly offset, principally on the revenue side, by a projection for economic growth that seems to have a margin of caution.

With regard to the correction of the excessive deficit, the programme, which was published before the Council recommendation under Article 104(7), projects the deficit to drop below the reference value in 2006/07, while the Commission services estimated at the time of the Council recommendation, that, even after the discretionary measures announced in the December 2005 Pre-Budget Report, the deficit is likely to remain slightly above 3%. Progress towards the correction of the excessive deficit will be assessed by the Commission following the expiry of the six months deadline. On the basis of the minimum benchmark (estimated at a cyclically-adjusted deficit of just below 1½% of GDP), the budgetary strategy does not seem, except possibly at the very end of the programme period in 2010/11, to provide a sufficient safety margin against breaching, within normal macroeconomic fluctuations, the 3% of GDP reference value which the UK is under the obligation to endeavour to avoid. However, projected balances are affected by the implementation of the programme of public investment mentioned above. Following the planned correction of the excessive deficit in 2006/07, the projected structural adjustment slows, when the output gap, despite remaining negative, is set to narrow and developments in tax elasticities are relatively favourable. This suggests that the adjustment path could be strengthened.

The gross debt ratio, though remaining well below the Treaty reference value of 60% of GDP, is projected to slowly rise over the projection period, peaking at just below 45% of GDP in 2007/08 from a level of around 41% in 2004/05. Thereafter the debt ratio is expected to decline slightly.

With regard to the sustainability of public finances, in combination with an increase in the cost of ageing, the possibility of insufficient provision of private pensions increasing fiscal costs would put the United Kingdom at medium risk, unless changes are made to improve fiscal sustainability. Over the period until 2050, a contained rise in public pension expenditure is projected. However, higher age-related expenditure pressures cannot be excluded as there is a possibility of insufficient provision of private pensions. Pension policy is currently under review and the government's response to the November 2005 Pensions Commission report is expected in spring this year. The currently favourable debt position contributes to limit somewhat the budgetary impact of ageing populations; however, gross debt is projected to go above the 60% of GDP reference value during the projection period to 2050 if, compared to the structural budgetary position in 2005/06, no further budgetary consolidation takes place during the programme period. Improving the structural balance of government finances over the medium term would contribute to reducing risks to public finance sustainability.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. The current level of the government debt ratio is still relatively low but the deficit is excessive and remains to be corrected, with further consolidation required to stabilise the debt ratio. It is welcome that general pension provision is under review in order to ensure its accessibility, financial viability and social adequacy. Furthermore, the programme envisages measures to improve the quality of public finances, including a drive to improve effectiveness of public expenditure through better asset management, relocation of civil service positions and a reduction in public sector workforce headcount.

The National Reform Programme of the United Kingdom, submitted on 13 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: maintaining fiscal sustainability in the face of demographic challenges; promoting innovation and R&D; widening opportunities for the acquisition of skills; ensuring fairness through a modern and flexible welfare system; and increasing innovation and adaptability in the use of resources. The budgetary implications of the actions outlined in the National Reform Programme are fully reflected in the budgetary projections of the convergence programme. The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the National Reform Programme.

In view of the above assessment, the projected adjustment path is subject to risks. In the light of the recommendations under Article 104(7), and in order to address the risks to long-term sustainability, it would be appropriate for the United Kingdom to:

(i) ensure that the deficit is brought below 3% of GDP by 2006/07 in a credible and sustainable manner, and pursue budgetary consolidation thereafter, especially by implementing the projected reduction in expenditure growth after 2007/08;

(ii) attain a medium-term objective that ensures rapid progress towards sustainability, a prudent debt ratio well below 60% of GDP, and provides a sufficient safety margin against breaching the 3% of GDP deficit reference value, which the UK is under the obligation to endeavour to avoid, and allows room for budgetary manoeuvre, in particular taking into account the needs for public investment.

Comparison of key macroeconomic and budgetary projections

		2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Real GDP (% change)	**CP Dec 2005[1]**	**2¾**	**1¾**	**2¼**	**3**	**2¾**	**2¼**	**2¼**
	COM Nov 2005[2]	3.2	1.6	2.3	2.8	n.a.	n.a.	n.a.
	CP Dec 2004[1]	*3¼*	*3*	*2½*	*2¼*	*2¼*	*2¼*	*n.a.*
HICP inflation (%)	**CP Dec 2005[1]**	**1½**	**2¼**	**2**	**2**	**2**	**2**	**2**
	COM Nov 2005[2]	1.3	2.4	2.2	2.0	n.a.	n.a.	n.a.
	CP Dec 2004	*1¼*	*1¾*	*2*	*2*	*2*	2	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2005[3]**	**0.5**	**-0.5**	**-1.0**	**-0.8**	**-0.5**	**-0.6**	**-0.6**
	COM Nov 2005[4]	0.6	-0.5	-0.9	-0.8	n.a.	n.a.	n.a.
	CP Dec 2004[3]	*-0.2*	*0.2*	*0.0*	*-0.2*	*-0.3*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Dec 2005[5]**	**-3.3**	**-3.1**	**-2.8**	**-2.4**	**-1.9**	**-1.7**	**-1.5**
	COM Nov 2005[6]	-3.3	-3.4	-3.2	-3.0	n.a.	n.a.	n.a.
	CP Dec 2004[5]	*-2.9*	*-2.8*	*-2.3*	*-2.1*	*-1.7*	*-1.6*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2005[7]**	**-1.3**	**-1.0**	**-0.7**	**-0.3**	n.a.	n.a.	n.a.
	COM Nov 2005[2]	-1.5	-1.3	-1.1	-0.8	n.a.	n.a.	n.a.
	CP Dec 2004 [7]	*-0.8*	*-0.7*	*-0.2*	*-0.1*	*n.a*	*n.a.*	*n.a.*
Cyclically-adjusted balance = Structural balance[8,9] (% of GDP)	**CP Dec 2005[3,5]**	**-3.5**	**-2.9**	**-2.3**	**-2.1**	**-1.7**	**-1.5**	**-1.3**
	COM Nov 2005[4]	-3.5	-3.2	-2.9	-2.7	n.a.	n.a.	n.a.
	CP Dec 2004	*-2.8*	*-2.9*	*-2.3*	*-2.0*	*-1.6*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2005**	**40.9**	**43.3**	**44.4**	**44.8**	**44.7**	**44.6**	**44.4**
	COM Nov 2005	40.8	42.7	43.7	44.5	n.a.	n.a.	n.a.
	CP Dec 2004	*40.9*	*41.8*	*42.4*	*42.8*	*42.8*	*42.6*	*n.a.*

Notes:
1) GDP and inflation forecast underlying the authorities' projections for the public finances; derived from a scenario whereby trend growth is one-quarter percentage point higher.
2) Commission services' forecast is on a calendar year basis. According to first estimates, GDP growth was 1.8% in 2005. The Commission services' interim forecast of 22 February 2006 projects GDP growth of 2.4% in 2006.
3) Output gap calculations according to the commonly agreed methodology on the basis of data provided in the convergence programme. The output gap calculations are based on the data underlying the central trend growth scenario. Under the UK methodology, the two yield the same output gap profile.
4) Commission services calculation of output gap is on a calendar year basis.
5) Figures in the convergence programme adjusted for treatment of UMTS receipts. 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 to an EDP basis, has the effect of subtracting around 0.1 pp 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 programme.
6) Commission services' forecast is before discretionary measures announced in the December 2005 Pre-Budget Report and included in the convergence programme. Adding the net impact of the measures as estimated by the UK authorities, the Commission services' forecast would be a deficit at 3.4% of GDP in 2005/06, 3.1% in 2006/07 and 2.8% in 2007/08.
7) Data from the convergence programme adapted in line with a definition of the primary balance using gross rather than net interest payments.
8) Cyclically-adjusted balance (calculated according to the commonly agreed methodology) excluding one-offs and other temporary measures. The figures for cyclically adjusted and structural balances published in the programme, calculated according to the UK own methodology, and based on nominal balances not corrected for the treatment of UMTS receipts, are: -2.9% of GDP in 2004/05, -2.2% in 2005/06, -1.7% in 2006/07, -1.7% in 2007/08, -1.7% in 2008/09, -1.6% in 2009/10, -1.5% in 2010/11. .
9) There are no one-offs and temporary measures in the convergence programme projections and in the Commission services forecast.

Source: Convergence programme (CP), Commission services' calculations, Commission services' (COM) autumn 2005 forecast

1. INTRODUCTION

The UK authorities submitted the seventh update of their convergence programme on 14 December 2005. The UK is not subject to the usual 1 December deadline for submitting the convergence programme as it has a different fiscal year to the other Member States. The code of conduct specifies in place of the 1 December deadline that the submission of the UK programme should be "as close as possible to the publication of the autumn Pre-Budget Report" (PBR)[5]; the government presented the PBR to Parliament on 5 December 2005. The update covers the period from financial year 2005/06 to 2010/11[6], though many data are only partially available for years beyond 2007/08 (see below). According to the programme, it has been "subject to the usual UK Parliamentary scrutiny and approval under Section 5 of the European Communities (Amendment) Act 1993"[7].

The update deviates on some material points from the model structure and the data provision requirements specified in the new code of conduct for stability and convergence programmes.

Concerning the structure of the update, the section on institutional features of the public finances is missing. As for the provision of data, the update has significant gaps in the provision of compulsory data[8] and does not provide all optional data[9].

Data for general government expenditure and receipts, while based on ESA 95 components, use different aggregation methods from the harmonised measure. The programme update also continues the UK practice of accounting receipts from the sale of UMTS licences as an annual income stream rather than the sale of an asset, contrary to the Eurostat decision of 14 July 2000 on the allocation of such receipts. Consequently, in this assessment all relevant UK programme data have been adjusted to present data in this respect on a harmonised basis compliant with the Eurostat decision[10]. A number of

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[5] The Pre-Budget Report is presented to Parliament by the government annually in November or December. It is updates medium term economic and budgetary projections from the spring Budget and can be the occasion for some budgetary policy announcements, but it is more consultative in nature. In particular, the projections in the Pre-Budget Report have a status of interim forecast and do not represent necessarily government intentions. Alongside the PBR the UK also publishes long-term fiscal projections in the Long-Term Public Finances Report. The UK convergence report is based on the projections of the Pre-Budget Report.

[6] The financial year runs from April to March.

[7] This refers to the discussion and approval in Parliament by one of the House of Commons "standing committees on delegated legislation" (a sub-committee of MPs) of "the Government's Assessment as set out in the Pre-Budget Report 2005 for the purposes of Section 5 of the European Communities (Amendment) Act 1993". As this latter phrase suggests, there is no routine submission to and examination by a standing committee of the updated convergence programme itself (the only recorded exception to this practice being in 2003): debate is conducted on the basis of the PBR and not the update.

[8] The projections for employment, unemployment and compensation of employees are not provided, while the projections for general government interest payments and the breakdown of expenditure, including identification of general government fixed capital formation, are not provided beyond 2007/08 (and thus not for 2008/09, the third year ahead in terms of the code of conduct).

[9] Government consumption and investment deflator not provided. Hours worked not provided. Net lending by sub-sector not provided. Representation of general government expenditure by sector is not complete.

[10] The principal effect of this adjustment is, relative to deficit figures presented in the programme, to increase the deficit by reducing annual revenues by just over £1.0 billion (currently around 0.1% of GDP); as nominal GDP grows in the outer years of the projections, the difference as a share of GDP becomes less significant.

data gaps have been filled through bilateral discussions between the Commission services and UK officials.

The update does not define a quantitative medium-term objective (MTO) for the budgetary position as required by the code of conduct, but refers to medium-term objectives in terms of the domestic fiscal framework, which targets different fiscal aggregates from the structural deficit. An MTO in the sense of the pact cannot be inferred from the projections in the programme, which are based on the Pre-Budget Report projections, and do not, according to the update, necessarily represent an outcome sought by the government (i.e. the projections are not "targets"). Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

Over the last ten years, recent UK macroeconomic performance has been impressive in terms of stability, growth, low inflation and labour market outturns, comparing well in all these respects with the euro area. Annual real GDP growth averaged 3.2% in 1996-2000 and 2.3% in 2001-05. The UK's macroeconomic policy framework of an independent monetary policy targeting inflation combined with medium-term oriented fiscal policy has contributed to this performance. From a peak rate of 10% in 1993, unemployment fell steadily to reach 5% by 2001, with a further modest decline subsequently; employment growth has also been steady and sustained, averaging 1% in the eleven years to 2004, and with the employment rate rising to above the Lisbon target of 70%.

The preliminary estimate of growth in 2005, published after the programme, is 1.8%, a significant slowdown in economic activity compared with 2004 (3.2%), and mainly due to a marked weakening in private consumption growth. According to the programme, household consumption in 2005 was hampered by high oil prices eroding real incomes, by a housing market slowdown and by lower than expected nominal earnings growth.

For the programme period the update presents two macroeconomic scenarios: an articulated "central" scenario and a so-called "cautious" scenario based on an assumption of trend growth being one quarter of a percentage point lower than the central view; the public finance projections are based on the latter, hereafter termed the "reference" scenario (Table 1).

According to the central scenario, the authorities expect a slight re-balancing of composition of growth, with net trade ceasing to be a drag on growth from 2006 on. As the impact of oil prices fades and real disposable income growth recovers, household consumption growth is expected to pick up from 1¾% in 2005, to 2% and 2½% in 2006 and 2007 respectively. Business investment is also expected to rebound strongly, after subdued growth in 2005, to annual growth of 5% by 2007. As a result, GDP growth is expected to pick up to 2¼% in 2006 and 3% in 2007. Beyond 2007, the authorities project another year of above-trend growth as their estimate of the output gap closes[11]. Sustained growth at 3% might therefore be subject to a number of risks, especially related to slower private consumption growth and business investment. Such growth

[11]Estimated according to the UK's own methodology, the UK has a large negative output gap in 2005/06 of -1.4 percentage points and -1.5 percentage points in 2006/07. However, Commission services' estimates applying the common methodology to the same data yield a much smaller negative output gap of -0.5 in 2005/06 and -1.0 in 2006/07.

rates also exceed potential growth consistent with the Commission services' forecast, estimated at 2¾%. Cyclical conditions, as measured by the output gap calculated by Commission services on the basis of the programme, are projected to be unfavourable in 2006/07 but should improve over the programme period as the negative output gap narrows.

By comparison with the central scenario, the Commission services' autumn 2005 forecast projects a similar characterisation of the economic outlook, although the scale of the rebound is more moderate. The main difference is a stronger rebound in private consumption and business investment in the update, only partly offset by the contribution of trade: projected to be slightly negative in 2005 and zero in the following years; the Commission services project a small positive contribution to growth from trade. While the projections for real household income growth are broadly similar, stronger private consumption growth in the central scenario is at the expense of lower saving, which remains at 4½% of total household resources, compared with around 6% in the Commission services' projections.

Table 1: Comparison of macroeconomic developments and forecasts

1. Programme's central macroeconomic forecast								
	2005		**2006**		**2007**		**2008**	**2009**
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**	**CP**
Real GDP (% change)	1.6	1¾	2.3	2 to 2½	2.8	2¾ to 3¼	2¾ to 3¼	n.a.
Contributions:								
- Final domestic demand	1.8	2	2.2	2½	2.7	3	3	n.a.
- Change in inventories	-0.2	0	-0.1	0	0.0	0	0	n.a.
- External balance of g&s	0.0	-¼	0.2	0	0.1	0	0	n.a.
Output gap[1]	-0.5	-0.5	-0.9	-1.0	-0.8	-0.9	-0.5	-0.6
Employment (% change)	0.6	n.a.	0.4	n.a.	0.6	n.a.	n.a.	n.a.
Unemployment rate (%)	4.6	n.a.	4.9	n.a.	4.7	n.a.	n.a.	n.a.
Labour productivity growth (%)	1.0	n.a.	1.9	n.a.	2.2	n.a.	n.a.	n.a.
HICP inflation (%)	2.4	2¼	2.2	1¾	2.0	2	2	n.a.
GDP deflator (% change)	2.2	2½	2.6	2½	2.6	2½	2¾	n.a.
Compensation of employees (% change)	4.1	n.a.	4.5	n.a.	4.5	n.a.	n.a.	n.a.
External balance (% of GDP)	-2.1	-2¼	-1.9	-2½	-1.6	-2½	-2½	n.a.
2. Programme's macroeconomic forecast underlying public finances (reference forecast)								
	2005/06		**2006/07**		**2007/08**		**2008/09**	**2009/10**
	COM[2]	**CP**	**COM[2]**	**CP**	**COM[2]**	**CP**	**CP**	**CP**
Real GDP (% change)	1.6	1¾	2.3	2¼	2.8	3	2¾	2¼
HICP inflation (%)	2.4	2¼	2.2	2	2.0	2	2	2
GDP deflator (% change)	2.2	2½	2.6	2½	2.6	2¾	2¾	2¾

Note:
[1] In percent of potential GDP, with potential GDP growth as reported in Table 2 below.
[2] The Commission services' forecast data are provided on a calendar year basis (for example, calendar year 2005 corresponds to the column headed financial year 2005/06).

Source:
Commission services' autumn 2005 economic forecasts (COM); convergence programme update (CP)

The outlined reference scenario can be regarded as broadly in line as regards overall growth between 2005/06 and 2007/08 with the Commission services' autumn forecast[12], and the reference scenario can be considered broadly plausible in both the short and medium term. Among the main macroeconomic risks which could put this in question, the downside risk of a significant sharp correction to very high residential property prices seems to have eased over the past year, with a stabilisation and more recently some slight recovery in the housing market. Estimates suggesting a significant overvaluation of UK housing, and past UK experience of the impact of such corrections, nevertheless caution that the risk cannot be fully discounted[13].

[12]After 2008/09, in which year the update - employing the authorities' own methodology for calculating the output gap - estimates the output gap to close, the update's reference forecast projects output to grow at a trend rate of 2¼% per annum, which can be considered a cautious assumption.

[13]OECD (2005) Economic Outlook No.78, December. Some of these estimates were updated in *The Economist*, 8 December 2005, suggesting that in the third quarter of 2005 the degree of overvaluation in the UK was some 30%.

The programme does not include explicit projections for the paths of employment and unemployment[14]. The Commission services' autumn forecast assumes continuing resilience in the labour market, albeit with some increase in the unemployment rate. This observed resilience might indicate that the economy contains less slack than assumed in the programme, although the UK authorities argue that firms may have been hoarding labour in expectation of a short-lived slowdown of the economy.

Inflation in the programme is expected to fall below 2% in 2006 as the impact on inflation of higher energy prices wears off and because the economy will be operating below potential[15], exerting downward pressure on prices. After 2006, inflation is projected to remain at the 2% target. The Commission services' autumn forecast, although with a smaller negative output gap, projects a generally similar evolution of inflation, although its estimate of HICP inflation is higher in 2006.

As regards estimates of potential output growth, given the data limitations of the programme compared with the obligations in the code of conduct, the Commission services have used available information to calculate such estimates according to the commonly agreed methodology. The results can be considered more directly comparable with the programme's "central" rather than the reference scenario for the public finance projections because the detailed data necessary to perform the calculations are only available under the central scenario, although there is no particular reason to assume that factor inputs should vary between the two scenarios. Table 2 presents the results, alongside estimates up to 2007 consistent with the Commission services' autumn 2005 forecast. For this common period both estimates are very similar in the magnitude and composition of potential growth, indicating an annual rate of around 2¾% with some mild deceleration; the estimated driving forces are total factor productivity growth and sustained capital deepening. On this basis, the programme's reference scenario, with trend growth one-quarter percentage point lower than in the central scenario, offers reassurance that the downside risk of growth being lower than in the reference scenario is mitigated. A particular challenge nevertheless will be to achieve and sustain trend total factor productivity growth of the order of some 1-1½% per annum as implied in the programme[16]. After evidence earlier in the decade that some progress had been made in closing the UK's productivity gaps with other advanced economies, more recent productivity growth performance has been disappointing, with the possibility that it has deteriorated by more that could be explained by recent cyclical weakness alone[17].

Table 2: Sources of potential output growth - central scenario

[14]For the sole specific purpose of projecting certain public finances aggregates, the programme assumes a slight weakening of the labour market, with unemployment edging up 100,000 units by 2007. This assumption is based on a consensus forecast and is one of eleven independently audited by the National Audit Office. This is not necessarily the projection underlying the macroeconomic scenario.

[15]Significantly below potential, according to the UK authorities' estimates (see footnote 10).

[16]Given the presumption that factor inputs are essentially unchanged between the two scenarios, it is reasonable to assume that the lower rate of trend growth in the reference scenario essentially reflects a similarly lower level of total factor productivity growth.

[17]Hourly *labour* productivity growth in the year to the third quarter of 2005 was zero. The slowdown is more pronounced than during the previous period of cyclical weakness in 2001-02 when hourly labour productivity still grew at around 1% p.a.

	2005		2006		2007		2008	2009
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]	CP[2]
Potential GDP growth[1]	2.8	2.8	2.7	2.8	2.7	2.8	2.7	2.6
Contributions:								
- Labour	0.3	0.3	0.3	0.2	0.2	0.1	0.1	0.1
- Capital accumulation	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0
- TFP	1.5	1.6	1.5	1.6	1.5	1.6	1.6	1.6

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

The programme lacks an articulated discussion of sectoral balances, although there is a brief discussion of trade and the current account, drawing attention to possible recent data distortions, and limited sectoral balance projections are provided to 2008. It is nevertheless striking that the programme projects a continuing sizeable yet stable current account deficit of 2¼% to 2½% of GDP between 2006 and 2008. The net lending of the private sector is projected to diminish from a surplus of 1¾% of GDP in 2005 to ½% in 2006 and balance by 2008. Given the relative stability of the external current account (and a presumption of a small and relatively stable external capital account), the counterpart of the reduction in the general government deficit foreseen in the programme is almost entirely attributed to a reduction of the private sector surplus. It is not obvious why there is not expected to be some response in terms of a narrowing of the external deficit, though this could reflect the suggestion of some strengthening of business investment. In the event of the external deficit continuing broadly as forecast in the programme, with a sustained large recourse to external finance, the likelihood is that the current rate of national saving of around 15% of GDP, one of the lowest in the EU, might rise only modestly. This might in itself be a ground for supposing that fiscal consolidation has a larger role to play in ensuring a higher level of national saving and a more obviously sustainable external balance.

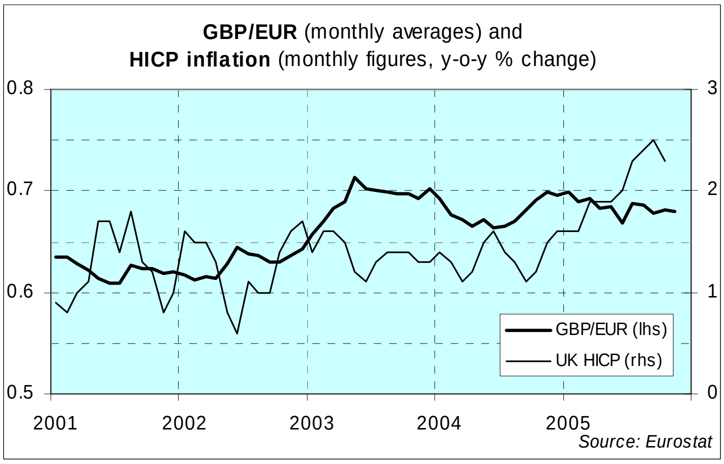
3. Medium-term monetary policy objectives and their relationship to price and exchange rate stability

The UK operates an inflation-targeting framework for monetary policy and the exchange rate of the pound sterling is a free float. Consequently, the pound does not participate in the ERM II, and the programme update makes no reference to future participation. The government believes that exchange rate stability can only be achieved on the basis of sound economic fundamentals. Thus, the exchange rate is considered as the outcome of, and not the target for, all other economic policies.

During the course of 2005, sterling's nominal effective exchange has been relatively stable (down just 1.2 points), as has been the bilateral exchange rate vis-à-vis the euro, trading between a band of 0.70 and 0.67 (based on monthly averages).

Surging oil prices in mid-2005 pushed HICP inflation sharply above the official 2% inflation target in the second half of the year; inflation eased back down towards 2% by the year-end as this impact waned. Taking account of inflation prospects, the Bank of England reduced its policy rate by 25 basis points to 4½% on 4 August 2005 in a first reversal of the tightening interest rate cycle initiated in November 2003.

The stability-oriented 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 in line with developments in major bond markets. In early December 2005, the long-term interest rate in the UK stood at 4.3 per cent, compared to 4.6 per cent in December 2004 (monthly average). The yield on index-linked long-term government bonds has fallen to a near-record low, partly driven by the regulatory regime for pension funds. The yield differential between conventional long-term government bonds in the UK and principal benchmarks in the euro area has declined from around +100 basis points in January 2005 to around 90 basis points in December 2005. As noted in the update, ten-year forward rates in the UK are only marginally above those in the euro area.



4. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous convergence programmes. It also discusses budgetary implementation in the financial year 2005/06. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

4.1. Targets in successive programmes and implementation in 2005/06

Relative to the 2004 update, the most marked revisions to the budgetary projections are in the short term. The deficit outturn in 2004/05 is now estimated to have been 0.4 percentage points of GDP higher than expected in the 2004 update, mostly due to lower than expected tax revenues (although growth was broadly as expected). Lower revenues in 2004/05 have a knock-on effect on the projections for subsequent years.

Table 3: Evolution of budgetary targets in successive programmes

		2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
General government balance (% of GDP)[1]	**CP Dec 2005**	**-3.3**	**-3.1**	**-2.8**	**-2.4**	**-1.9**	**-1.7**
	CP Dec 2004	-2.9	-2.8	-2.3	-2.1	-1.7	-1.6
	CP Dec 2003	*-2.7*	*-2.5*	*-2.2*	*-2.1*	*-1.9*	*n.a.*
	COM Nov 2005[2]	-3.3	-3.4	-3.2	-3.0	n.a.	n.a.
General government expenditure[3] (% of GDP)	**CP Dec 2005**	**41.1**	**42.2**	**42.6**	**42.5**	**42.1**	**42.0**
	CP Dec 2004	41.0	41.7	41.8	42.0	n/a	n/a
	CP Dec 2003	41.1	41.7	n/a	n/a	n/a	n/a
General government revenues[1, 3] (% of GDP)	**CP Dec 2005**	**37.8**	**39.0**	**39.8**	**40.1**	**40.2**	**40.3**
	CP Dec 2004	38.1	39.0	39.5	40.0	n.a.	n.a.
	CP Dec 2003	*38.5*	*39.2*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Real GDP[4] (% change)	**CP Dec 2005**	**2¾**	**1¾**	**2¼**	**3**	**2¾**	**2¼**
	CP Dec 2004	3¼	3	2 ½	2 ¼	2¼	2¼
	CP Dec 2003	*3¼*	*2 ¾*	*2¼*	*2¼*	*2¼*	*2¼*
	COM Nov 2005[5]	3.2	1.6	2.3	2.8	n.a.	n.a.

Notes.
[1] Data adjusted by Commission services to reflect the UK's treatment of UMTS receipts.

[2] Commission services' forecast made before the 2005 Pre-Budget Report (PBR). Adding the estimated impact of the new measures announced in the PBR, the Commission services' forecast would become 3.4% of GDP, 3.1% of GDP and 2.8% of GDP in 2005/06, 2006/07 and 2007/08 respectively.

[3] Data for general government expenditure are not provided by the UK on a harmonised ESA95 basis. The figures shown in the table 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. The projections from 2008-09 to 2010-11 assume that general government total expenditure and total revenues grow in line with the equivalent public sector projections in Table B9 of the Pre Budget Report. Prior to the Comprehensive Spending Review, which will take place in July 2007, there has been no allocation of expenditure between government sectors beyond 2007-08.

[4] GDP projections reported in the table are those underlying the public finance projections (cf. "reference scenario" in Table 1).

[5] Commission services' forecast for GDP growth is on a calendar year basis.

Source:
Convergence programmes (CP) and Commission services' autumn 2005 economic forecasts (COM)

Figure 1 below shows projections of the budget balances in successive convergence programmes. The figure highlights that since the 2001 convergence programme, budgetary outturns have turned out worse than expected. This is mainly due to shortfalls against projected tax revenues, while expenditure plans have been broadly on target (and in some cases have undershot targets, partially compensating for shortfalls in revenues).

As regards budgetary implementation in 2005/06, the wider than expected deficit is mainly due to lower than expected economic growth (1¾% rather than 3% previously projected), which accounts for lower tax revenues and slightly higher cyclical expenditure[18]. However, the deterioration of the budget balance is smaller than the

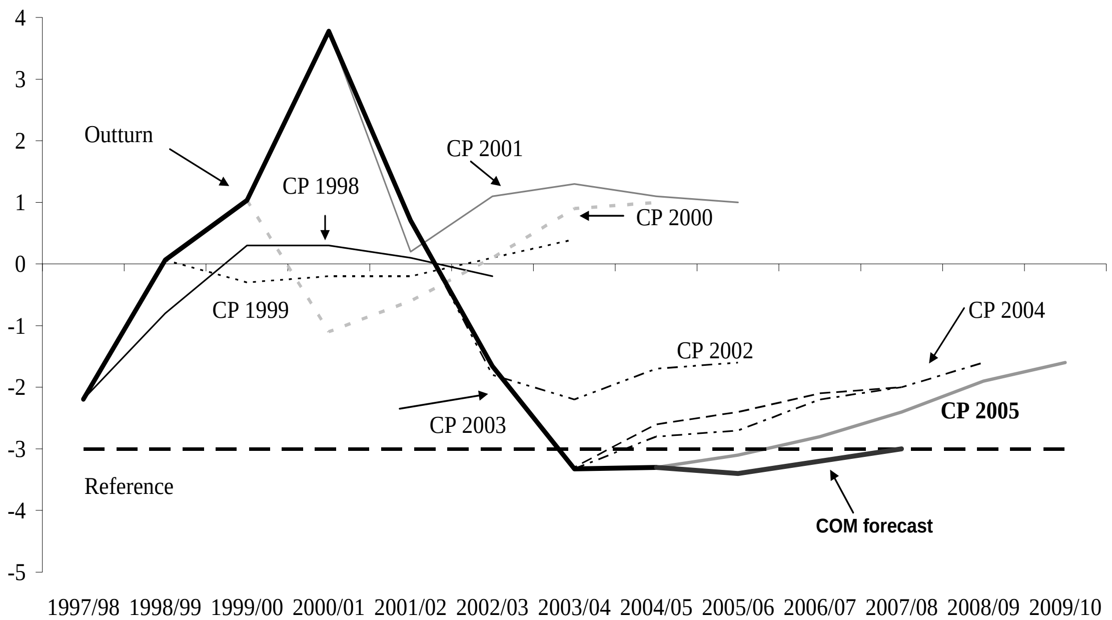
[18]Note that under its three year spending framework, in 2004 the UK government fixed expenditure plans in nominal terms for non-cyclical primary expenditure up to 2007/08. Therefore, a lower level of projected

downwards revision to the growth forecast would have suggested. This is because of an estimated recovery in the revenue-to-GDP ratio in 2005/06, broadly in line with observed outturns in the first three quarters of the financial year, which is expected to continue into 2006/07. Table 3 shows that the revenue ratio, starting from a lower level in 2004/05 than previously estimated, by 2006/07 exceeds the level projected in the 2004 update. This is partly explained by revenue-enhancing discretionary measures announced in the December 2005 Pre-Budget Report.

Because of the stronger expected recovery in the revenue ratio compared to the 2004 update, the profile of deficits in the current update tends to converge over the medium term to the profile projected in the previous update.

Compared with the 2004 update, the adjustment in the *nominal* balance is slightly less marked in 2006/07, reflecting a larger negative output gap.

Figure 1: General government balance projections in successive convergence programmes (% of GDP)



Source: Commission services' autumn 2005 forecast (COM) and successive convergence programmes

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GDP would translate in a higher expenditure ratio than explained by the increase in cyclically-sensitive expenditure in nominal terms, because of a "denominator effect".

Box 1: The excessive deficit procedure for the United Kingdom

On 24 January 2006, taking into consideration the Commission recommendation that included information contained in the 2005 update of the convergence programme, the Council decided that the United Kingdom was in excessive deficit. The Council addressed to the United Kingdom a recommendation that the excessive deficit should be corrected by the end of financial year 2006/07. This recommendation applied the standard deadline (set in the Stability and Growth Pact) for correction of the excessive deficit in the budgetary year following its identification, as the Council judged that special circumstances that might have merited a longer deadline did not exist, since the required adjustment was small and economic growth, although recently more subdued, was broadly satisfactory. The UK authorities were asked to take effective action by 24 July 2006, i.e. within the six-month period set in the Pact.

4.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The key objectives for fiscal policy in the convergence programme are to ensure long term sustainability, intergenerational fairness in terms of the burden of taxation and benefits of expenditure and, subject to this, to support monetary policy, in particular by allowing the automatic stabilisers to smooth the path of the economy.

These objectives are pursued by aiming to achieve two fiscal rules, defined for the public sector as a whole. The "golden rule" states that over the economic cycle the government should borrow only to invest (under the UK definition of net investment, that is net of depreciation and including capital grants), and the "sustainable investment rule" requires net debt to be maintained at low and sustainable levels (which for the current economic cycle the government interprets to at below 40% of GDP). Within this framework, fiscal policy in recent years has embraced a sustained increase in expenditure on public services, and especially a progressive increase in government investment as a share of GDP, from the comparatively low levels at the turn of the decade[19].

The convergence programme stresses the consistency of the UK domestic framework and the fiscal projections in the update of the convergence programme with the Stability and Growth Pact as interpreted by the UK authorities. There is, however, relatively little evidence that fiscal policy is set in the context of the EU's fiscal framework, in the sense that the latter serves as a significant guide to policy-setting both as regards medium-term objectives and intermediate constraints.

[19] Between 1995 and 2000, annual general government gross capital formation in the UK was on average 1.5% of GDP, against 3.0% in France and 1.9% in Germany.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	Change 2005/06-2010/11
Revenues[1]	**37.8**	**39.0**	**39.8**	**40.1**	**40.2**	**40.3**	**40.4**	**1.4**
of which:								
- Taxes & social contributions[2]	35.7	36.9	37.7	37.9	n.a.	n.a.	n.a.	n.a.
- Other (residual)	2.1	2.2	2.2	2.2	n.a.	n.a.	n.a.	n.a.
Expenditure[1]	**41.1**	**42.2**	**42.6**	**42.5**	**42.1**	**42.0**	**41.9**	**-0.3**
of which:								
- Primary expenditure	39.0	40.0	40.5	40.4	n.a.	n.a.	n.a.	n.a.
of which:								
Consumption	21.3	21.7	21.9	22.0	n.a.	n.a.	n.a.	n.a.
Transfers & subsidies	12.5	12.5	12.3	12.0	n.a.	n.a.	n.a.	n.a.
Gross fixed capital	1.8	2.2	2.3	2.4	n.a.	n.a.	n.a.	n.a.
formation	3.5	3.6	4.0	3.9	n.a.	n.a.	n.a.	n.a.
Other (residual) [3]	2.1	2.1	2.1	2.1	n.a.	n.a.	n.a.	n.a.
- Interest expenditure								
GG balance	**-3.4**	**- 3.1**	**- 2.8**	**- 2.4**	**- 1.9**	**- 1.7**	**-1.5**	**+1.6**
Primary balance[4]	**-1.3**	**- 1.0**	**- 0.7**	**- 0.3**	**0.1**	**0.4**	**0.5**	**+1.5**
One-off and other temporary measures	-	-	-	-	-	-	-	-
GGB excl. one-off	**-3.4**	**- 3.1**	**- 2.8**	**- 2.4**	**- 1.9**	**- 1.7**	**-1.5**	**+1.6**

<u>Notes:</u>

[1] Data for total revenues and expenditure are not presented by the UK on a harmonised ESA-95 basis. 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. Revenues are adjusted for the treatment of UMTS receipts. The projections for 2008-09 to 2010-11 assume that general government total expenditure and total revenues grow in line with the equivalent public sector projections in Table B9 of the Pre-Budget Report. Prior to the Comprehensive Spending Review, there has been no allocation of expenditure between government sectors beyond 2007-08.

[2] “Taxes and social contributions” include taxes on income and wealth, on production and exports, national insurance contribution and the category “other current taxes” in table 4.4 of the programme update. As elsewhere, data have been adjusted to remove annual UMTS receipts.

[3] Compared to the 2004 update, the category “other expenditure” is much higher, due to a re-classification of some elements of expenditure.

[4] The UK authorities provide primary balances on an ESA definition (i.e. excluding gross rather than net interest payments) only up to 2007/08. Figures shown afterwards are those recalculated by the Commission services, based on the reported budget balance and on the information inferred from discussions with the UK authorities.

<u>Source</u>:
<u>Convergence programme update; Commission services’ calculations</u>

Table 4 above shows the main components of the nominal adjustment planned in the updated convergence programme. The general government deficit is projected to improve by 1.6 percentage points of GDP over the programme horizon, from 3.1% of

GDP in 2005/06 to 1.5% of GDP in 2010/11. With interest payments projected to remain broadly stable over the projection period, the primary balance is projected to swing into surplus by 2008/09, from a deficit of 1.0% of GDP in 2005/06, and to reach a surplus of 0.5% of GDP in 2010/11. The adjustment in nominal terms is spread over the forecast period. The average pace of adjustment (in nominal terms) between 2005/06 and 2009/10 is slightly faster than in the previous update, while growth is projected to be somewhat weaker in the near term and slightly stronger in the medium term.

4.2.2. The composition of the budgetary adjustment in the programme

The improvement in the deficit discussed above is driven by three factors.

On the revenue side, part of the adjustment comes from an improvement of the cyclical condition of the economy, with growth projected to pick up from 1¾% in 2005/06 to 2¼% in 2006/07 and 3% in 2007/08 in the reference scenario. However, revenues are projected to pick up faster than GDP, with the revenue-to-GDP ratio increasing by 1.4 percentage points between 2005/06 and 2010/11 (and by 2.6 percentage points over the 2004/05 outturns).

The increase in the revenue to GDP ratio is particularly marked in 2006/07, when the ratio is projected to increase by around 0.8 percentage points (after rising by an estimated 1.2 percentage points in 2005/06). Considering that around 0.1% of GDP of the increase in the tax to GDP ratio is due to the advance in payment of corporation tax for oil companies (see Box 3)[20], the further increase in 2006/07 is even more marked.

Higher oil prices explain part of the substantial increase estimated for 2005/06, through the positive impact on the offshore corporation tax base (see Box 3 for a discussion of the effects of higher oil prices on the public finances). Outturns for the first three quarters of 2005/06 also suggest buoyant revenues from income tax and social security contributions. Part of the increase in 2006/07 is attributable to the new discretionary measures announced in the December 2005 Pre-Budget Report, described in Box 2, and in particular to the increase in taxation on oil companies (worth around 0.2% of GDP).

Other elements contributing to a medium-term rise in the revenue ratio are fiscal drag, which is likely to contribute around 0.6 percentage points to the overall rise in the revenue ratio between 2005/06 and 2010/11, in line with historical estimates, and a number of measures to counter tax avoidance and evasion announced in 2005 and earlier. By contrast, VAT receipts are expected to fall as a percentage of GDP, driven by an assumption of increasing share of tax avoidance[21].

Last but not least, the performance of non-oil corporation tax receipts is very strong in the short term. It accounts for 0.6 percentage points of the cumulated increase in 2005/06 and 2006/07, rising from an outturn of 2.6% of GDP in 2004/05 to 3.2% of GDP in 2006/07. This appears to be driven by an expected strong performance of the financial sector which is assumed to continue into 2006/07. A buoyant financial sector seems also to drive an increase in personal income tax in 2006/07, above what might be expected on

[20] The revenue gain in 2005/06 is offset by a temporary increase in spending, leaving the structural balance unchanged for the year.

[21] An assumption designed to build caution in the projections and audited by the National Audit Office, accountable to Parliament, although recent outturns for VAT suggest that the impact of VAT fraud has probably been on the rise.

the basis of an estimate of fiscal drag, presumably driven by an assumption fast earnings and bonuses growth for taxpayers who pay tax at higher rates than other sectors of the economy.

Box 2: The 2005 Budget and Pre-Budget Report.

The 2005 Budget was published on 16 March 2005; the 2005 Pre-Budget Report (PBR), a more consultative document, on 5 December. The PBR provides an updated macroeconomic forecast and fiscal projections that form the basis for the 2005 convergence programme update.

The net impact of the measures announced in the Budget and the PBR on the near-term fiscal projections is relatively small, and tend to offset each other. The net combined effect, compared to a no-policy change baseline, is a small loosening (about 0.05% GDP) in 2005/06, a small tightening of around 0.1% GDP in 2006/07 and tightening of around 0.2% in the following years. Significant expenditure measures during the year include a one-off payment to pensioners as well as extra funding for military operations in Iraq and other international obligations.

Two elements of the budgetary strategy are worth noting:

1. Oil prices, expected to persist at high levels in the medium term, brought about two different policy responses. On the one hand, there were a number of changes to the regime of taxation for oil companies. The Budget aligned the timing of payment of corporation tax with that of the petroleum revenue tax, advancing the deadline for payment. The Pre-Budget report then doubled the rate of the so-called "supplementary charge" on offshore companies, increasing offshore tax revenues by around 0.2% of GDP from 2006/07. On the other hand, as regards onshore revenues, the Budget froze the main rates of fuel duties, initially temporarily but then extended in the PBR until the 2006 Budget, for a total cost to the exchequer of about 0.05% of GDP a year.

2. A wide range of measures to counter tax avoidance and evasion were announced in both the Budget and the Pre-Budget Report, officially estimated to have a total impact of just above 0.1% of GDP. This continued a policy drive towards closing tax loopholes that started in 2002. It should be noted that the National Audit Office was asked to audit whether the assumptions underlying the estimated extra yield from anti-VAT avoidance measures implemented in 2002 were reasonable, but concluded that there still were insufficient data to draw a clear conclusion.

On the expenditure side, the update projects the ratio to drop by 0.3 percentage points over the programme period. The evolution of public expenditure can be divided in two distinct phases. Between 2005/06 and 2007/08, the period covered by the 2004 Spending Review, which fixes non-cyclical primary expenditure in nominal terms, the expenditure to GDP ratio is projected to increase from 42.2% to 42.5%. Two-thirds of this increase, or about 0.2 percentage points, is explained by an increase of gross fixed capital formation (a total increase of 0.6% percentage points over 2004/05 outturns), in line with the government's stated intention to increase the level of public investment as a share of GDP.

The expenditure ratio dips after 2007/08, declining to 41.9% of GDP by 2010/11. The projections over this period are driven by a top-down assumption that current expenditure will grow at an annual real rate of 1.9% and "net investment[22]" remains at around 2¼% of GDP. Thus the burden of the adjustment on the expenditure side would fall on current rather than on capital expenditure.

[22] A non-ESA concept broadly defined as gross capital formation minus depreciation plus capital grants to non-general government.

Box 3: The impact of high oil prices on UK public finances

The UK is an oil and gas producer with a continental shelf ("offshore") tax base. Higher oil prices directly impact on the public finances through higher profits for oil companies, boosting the corporation tax base. Revenues from the oil industry account for about two percent of total government tax revenues. The National Audit Office's audit of the oil prices assumption, published alongside the 2005 Pre-Budget Report, reports a UK Treasury estimate that a $1 increase in the oil prices would, other things being equal, increase revenues by about 0.02% of 2005/06 GDP a year. Compared to the 2005 Budget projections, oil prices in 2005 were USD15 per barrel higher. Moreover, in the 2005 Budget the government changed the regime for payment of offshore corporation tax, advancing required payments so as to result in a revenue windfall in 2005/06. At the time of the Budget, the Treasury estimated that this gain would be around £1bn (0.1% of GDP).

Therefore in the short term higher oil prices have a positive effect on the public finances. However, there are also **short-term offsetting effects**, such as an increase in inflation which increases the level of indexation of direct tax allowances and social benefits (which in the UK are statutorily indexed). Higher oil prices are also likely to reduce profit margins in the non-oil corporate sector, and thus reduce the tax base for non-oil corporation tax.

In the medium to long term, the key offsetting mechanism operates via the **negative impact of higher oil prices on potential supply**. As discussed by the Bank of England in its November 2005 Inflation Report, higher energy prices can impact on growth by reducing business investment, by eroding profitability of credit-constrained companies and by reducing returns on energy-using capital or, to the extent that higher energy prices feed into higher wage settlements, by increasing the level of unemployment consistent with stable inflation. Lower potential output would have a permanent negative effect on the tax base, offsetting the short-term positive impact of higher oil prices on the public finances. However, the Bank of England finds little evidence of these medium-term effects.

The UK Treasury concludes in the Pre-Budget Report that in the long term the impact of oil prices on the public finances is broadly neutral. However, higher oil prices did not appear to have induced a revision of the trend growth estimate compared to the previous update, so that from a forecasting perspective higher oil prices appear to have a positive net effect.

Barrell et al. (2005)[1] support the view of an overall positive impact of oil prices on the public finances. They simulate the impact of an oil shock on the economy, suggesting a total positive net effect on the public finances of around 0.5 percentage points of GDP after five years of the observed USD30 increase recorded over the past two years.

In evaluating the impact of oil prices, it is important to consider offsetting policy responses. An indirect effect of higher oil prices has been the decision taken in the 2005 Budget and extended in the December 2005 Pre-Budget Report not to implement the standing policy of indexing the main rates of fuel duty for the whole of 2005/06, costing £600m per year (about 0.05% of GDP).

[1] R. Barrel, A.Choy, S.Kirby and R. Riley (2005): "Prospects for the UK Economy", National Institute Review, N.194.

It is important to note that an implication of the December 2005 European Council agreement on the 2007-2013 financial perspectives, reached after the publication of the convergence programme, is that, compared to the plans in the updated programme, the UK will experience a small net revenue shortfall from 2009/10 onwards because of the agreed reduction in the UK rebate. The impact is geared to be progressive, negligible in 2007/08 and zero in 2008/09, but estimated by the UK Treasury at around £1bn (just below 0.1% of GDP) in 2009/10 and up to £1.9bn (just above 0.1% of GDP) in 2010/11. Achieving the budgetary projections set out in the convergence programme for 2009/10 onwards would therefore require an offsetting policy response in terms of a discretionary compensating increase in other revenues or a reduction in expenditure. However, the exact impact is still to be evaluated by the UK authorities and no revised fiscal forecast is expected before the 2006 budget, to be published in April/March. The present assessment takes into consideration the figures presented in the programme update, but notes where appropriate the possible main implications of the prospective reduction in net revenue in the latter part of the programme period.

4.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The update does not present an MTO in quantitative terms as meant in the Stability and Growth Pact. The convergence programme defines the UK medium-term objective in terms of the UK domestic fiscal framework, which targets different fiscal aggregates than the cyclically-adjusted deficit. However, the domestic fiscal framework implies a medium-term path for the cyclically-adjusted deficit, consistent with stabilising the debt-to-GDP ratio at a low level and with keeping the current budget in balance or surplus on average over the economic cycle. Nevertheless, a quantitative MTO cannot be inferred from the budgetary projections presented in the programme, as the programme states that the fiscal forecast, based on the Pre-Budget Report projections, does not necessarily represent an outcome sought by the government (i.e. the projections are not "targets"). According to the projections, and to the recalculation of the output gap according to the commonly agreed methodology, the structural balance would reach a deficit of just above 1¼% of GDP by the end of the programme period in 2010/11. Such a budgetary position would according to the programme stabilise debt at a low level (just below 45 % of GDP), but would not provide a sufficient safety margin against breaching the 3% of GDP reference value with normal macroeconomic fluctuations, except possibly at the very end of the programme horizon, as will be discussed below.

4.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

Table 5: Output gaps, cyclically-adjusted and structural balances

	2004/05		2005/06		2006/07		2007/08		2008/09	2009/10	2010/11	Change: 2011-2005
	COM	CP[1]	COM[2]	CP[1]	COM[2]	CP[1]	COM[2]	CP[1]	CP[1]	CP[1]	CP[1]	CP[1]
GG balance	-3.3	-3.3	-3.4	-3.1	-3.2	-2.8	-3.0	-2.4	-1.9	-1.7	-1.5	+1.6
One-offs	-	-	-	-	-	-	-	-	-	-	-	-
Output gap[3]	0.6	0.5	-0.5	-0.5	-0.9	-1	-0.8	- 0.8	-0.5	-0.6	-0.6	-
CAB[4]	-3.5	-3.5	-3.2	- 2.9	-2.8	-2.3	-2.6	-2.1	-1.7	-1.5	-1.3	+1.6
change in CAB			+0.3	+0.6	+0.4	+ 0.6	+0.2	+0.2	+0.4	+0.2	+0.2	-
CAPB[4]	-1.8	-1.9	-1.1	-0.8	-0.8	-0.2	-0.5	0	0.3	0.6	0.7	n.a.
Structural balance[5]	-3.5	-3.5	-3.2	- 2.9	-2.8	-2.3	2.6	-2.1	-1.7	-1.5	-1.3	+1.6
change in struct. bal.	-1.8	-1.9	+0.3	+0.6	+0.4	+0.6	+0.2	+0.3	+0.4	+0.2	+0.2	-
Struct. prim. bal.[6]			-1.1	-0.8	-0.6	-0.2	-0.5	0	+0.3	+0.3	+0.1	-

Notes:

[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission services on the basis of the information in the programme.

[2]Commission forecast for deficit is before Pre-Budget Report (PBR) discretionary measures. Adjusted for the discretionary measures, the Commission services' forecast would be -3.4, -3.1, and -2.8% of GDP in 2005/06, 2006/07 and 2007/08 respectively.

[3]In percent of potential GDP. Output gaps from the Commission services' forecast are on a calendar year basis. 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.

[4]CAPB = cyclically-adjusted primary balance. As seen above, deficit data in the Convergence programme are adjusted for the different treatment of UMTS receipts. The calculation of CAPB is on the basis of the definition of interest payments according to ESA (see footnote to table 4)

[5] CAB excluding one-off and other temporary measures.

[6] Structural primary balance = CAPB excluding one-off and other temporary measures.

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

Table 5 above shows the cyclically adjusted and structural balances based on Commission services' calculations on the basis of the commonly agreed methodology and the information in the programme. It shows that the structural balance would improve from a deficit of 2.9% of GDP in 2005/06 to 1½% of GDP in 2009/10 and just above 1¼% of GDP in 2010/11.

The structural balance is planned to improve on average by just above ¼ percentage point of GDP per year. The adjustment is front-loaded, with the structural balance improving by over ½ percentage point between 2005/06 and 2006/07. This improvement is to be achieved in the period with the largest negative output gap (at -1% of potential output in 2006/07). As mentioned above, this structural improvement is mostly coming from an estimated increase of the revenue to GDP ratio in part explained by new measures. Thereafter, the structural adjustment is rather small[23].

4.3.1. Appropriateness of the programme's medium-term objective

As stated above, the programme does not define a quantitative MTO that can unambiguously be inferred. Therefore, an assessment of its appropriateness in relation to the criteria laid down in the Stability and Growth Pact and the code of conduct cannot be made.

4.3.2. Risks attached to the budgetary targets

As seen above, the macroeconomic scenario underpinning the budgetary projections is broadly plausible, albeit subject to some downside risks mainly linked to lower household consumption growth[24].

A large part of the fiscal consolidation over the programme horizon is due to a significant increase in the tax-to-GDP ratio, for a given rate of economic growth, which is only partly originated by discretionary measures. The projected recovery in revenues estimated for 2005/06 is expected to continue in 2006/07, with an estimated rise of the revenue-to-GDP ratio by over 2 percentage points between 2004/05 and 2006/07, and carries a number of risks. While outturns for the first three quarters of 2005/06 support the view of an increase in the tax-to-GDP ratio, also helped by the beneficial effects of higher oil prices on public finances and the good performance of the financial sector, it is possible that the period of slower economic growth from mid-2004 will feed into the tax base with a lag, slowing revenue growth for a period to come. Moreover, there are signs that the particularly buoyant receipts of social security contributions (National Insurance Contributions in the UK system) in 2005/06 might be due to an increasing number of employees opting not to contract out of the Second State Pension System, and therefore not qualifying for a corresponding rebate on National Insurance Contributions[25]. If confirmed and sustained in the future, this trend might lead to higher revenues in the short term but higher pension liabilities in the longer term.

Table 6 analyses the differences in the tax forecast between the Commission services' autumn forecast and the projections in the convergence programme, focussing on total tax and its implicit elasticity to GDP. Note that the Commission services' forecast was completed before the announcement of discretionary measures in the December 2005

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[23]Note that the negative output gap at the end of the projection period in the Commission services' recalculations is due to the technical assumption that takes GDP growth rates published in the convergence programme as an exogenous input to the production function. However, this itself depends on the UK authorities' own-method estimate of the output gap, assumed to close in 2008/09, after which the economy grows at the potential rate. If the UK authorities had projected that the output gap were still negative in 2008/09, as in the Commission services' calculations, it is plausible that the convergence programme would have projected GDP growth in 2008 above potential (and to remain above potential until the output gap closed). Thus, also in the Commission services' recalculations it would be plausible to expect a gradually narrowing output gap, and thus the structural adjustment by the end of the period to be even smaller.

[24]Note however that the direct impact of slower consumption growth on indirect taxes is partly sheltered by an assumption of declining VAT revenues due to increasing avoidance – see footnote 16 above.

[25]The End of Year Fiscal Report, published alongside the Pre-Budget Report, reports lower than expected rebates on National Insurance Contributions in 2004/05 of about 0.05% of GDP.

Pre-Budget Report. The table shows that, while both forecasts estimate a sharp increase in the tax-to-GDP ratio in the current financial year, there is a crucial difference in the assumed increase in the tax-to-GDP ratio in 2006/07, even after taking into account the impact of the measures announced in the PBR, which are estimated to increase revenue by about 0.2 percentage points of GDP in 2006/07.

The split of the difference into an elasticity and composition component presented in the table needs to be taken with extreme caution as they represent only a broad approximation, due to data gaps that do not allow a full analysis of the tax forecast in the convergence programme. A high elasticity of taxes to GDP in the current year, both in the Commission services and in the convergence programme projections, reflects the fact that a significant part of UK revenues respond to asset prices cycles that are not necessarily correlated with the fluctuation of GDP around its trend. In particular, UK public finances are currently benefiting from high oil prices and a buoyant stock market.

Table 6: Assessment of tax projections

	2005/06		**2006/07**		**2007/08**		**p.m.: OECD[2]**
	COM	**CP**	**COM[3]**	**CP**	**COM 3**	**CP**	
Total taxes[1]							
Change in tax-to-GDP ratio	1.0	1.2	0.3	0.8	0.2	0.3	/
Difference	*0.2*		*0.5*		*0.1*		/
of which[4]: - elasticity component	*- 0.9*		*0.7*		*0.1*		/
- composition component	*1.3*		*-0.1*		*0.0*		/
p.m.: Observed elasticity to GDP	1.8	1.9	1.2	1.5	1.1	1.2	1.1

Notes:
[1] For the convergence programme, 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 drawn from Table 4.4 of the programme update, aggregates are 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. The definition of "taxes", including social contributions, is the one adopted in table 4.
[2] OECD ex-ante elasticity relative to GDP.
[3] Commission services' forecast made before the announcement of fiscal measures in the Pre-Budget Report, expected to add about 0.2 percentage point to the tax-GDP ratio from 2006/07.
[4]The decomposition is explained in Annex 4. Note that the convergence programme does not present a forecast for compensation of employees, which is necessary to calculate the split between the composition and the elasticity component. The Commission services have used their own estimation of compensation of employees based on the information on the programme, which is however only a broad approximation. Therefore, no conclusions can be drawn on the basis of the split between composition and elasticity components. .
Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

However, there is a risk to the convergence programme projections for corporation tax revenues, which is expected to rise by 1.1 percentage points from an outturn of 3.0% in 2004/05 to 4.1% in 2006/07. While the increase in corporation tax revenues from oil companies operating on the UK continental shelf is underpinned by a broadly plausible assumption for oil prices in the short tem[26], and by the impact of the discretionary

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[26]The assumption for oil prices is based on a consensus of independent forecasters and is audited by the National Audit Office.

increase of taxation on oil companies, the increase of 0.6 percentage points in revenues from the non-oil corporate sector over to years appears to be based on an assumption that profits from the financial sector, linked to the performance of the stock market, will continue to grow faster than the rest of the economy into 2006/07[27]. This assumption is likely to drive also part of the increase in the tax-to-GDP ratio for income tax in 2006/07, above what would be expected from normal fiscal drag. Given the relative volatility of the financial sector, this assumption has clear risks on the downside.

Overestimation of receipts from the non-oil corporate sector is a principal reason why since 2001 projections for the government balance in successive updates of the convergence programme have been under-achieved. As reported in successive End of Year Fiscal Reports, published alongside the Pre-Budget Report, one-year-ahead fiscal projections have overestimated non-oil corporation tax receipts on average by 0.3% of GDP between 2000/01 and 2004/05, a forecasting difference mostly explained by lower than expected financial company profits growth. Receipts from the financial sector tend to be linked to an asset prices cycle that is often only loosely correlated with the economic cycle, and is highly volatile. Therefore, even adjusting for cyclical output fluctuations, there is a risk of judging as a structural improvement an increase in revenues from the financial sector due to a temporary asset prices upswing. Thus the apparent dependence of the convergence programme projections on additional receipts from the financial sector is a risk to the projected structural improvement projected in Table 5.

A further risk concerns the projected profile of expenditure over the medium term. As seen above, over the period to 2007/08 (covered by the 2004 Spending Review), expenditure is projected to rise by 0.3 percent of GDP. Thereafter, the convergence programme projects a fall of the expenditure ratio of 0.6 percentage points by 2010/11. The UK government is, however, committed to a number of important policy initiatives to be pursued beyond 2007/08 (for example, the commitment to halve child poverty by 2010 on a challenging definition of poverty, or increasing overseas development assistance as a share of GDP), which will have expenditure implications. This implies a marked slowdown, or even cuts in real terms, in allocations for some other policy areas. Moreover, the burden of the adjustment is planned to fall on primary current expenditure, which tends to be harder to restrain than capital expenditure.

Slower expected expenditure growth after 2007/08 could induce Departments to draw down their unspent allocations accumulated from previous years. Under the UK expenditure framework, Departments can carry over to the following fiscal year unspent budgetary allocations. At the end of financial year 2004/05, unspent allocations totalled around £12bn[28] (roughly 1% of 2004/05 GDP), against which no specific budgetary provision seems to be made, as highlighted in the Commission assessment of the 2004 update of the convergence programme. While Parliamentary approval should still be sought if the drawdown of such allocations would take Departmental expenditure above

[27] Note that, while the UK convergence programme uses a published assumption, audited by the National Audit Office, for equity prices to grow in line with the economy, the assumption drives only a small fraction of the forecast for corporation tax revenues from the financial sector (namely receipts from life insurance companies).

[28] Public Expenditure Outturn White Paper 2004/05, HM Treasury (http://www.hm-treasury.gov.uk/media/301/26/Pub_Exp_Prov_outturn200705.pdf)

plans, unspent carryover might pose a further challenge to the planned expenditure restraint.

Therefore in the next round of expenditure allocations, to take place in the 2007 Comprehensive Spending Review, the UK authorities will need a strong commitment to achieving the projected expenditure restraint, and the ability of central government Departments to adjust to tighter budgets, and in some cases cope with cuts in real terms, in a period of slower expenditure growth. The decision to adopt a zero-baseline approach in the Comprehensive Spending Review should help to identify areas where expenditure can be reined in without compromising long-term growth prospects.

These risks of a higher than projected deficit are partly offset by two risks in the opposite direction.

First, the projections for economic growth underlying the public finances, while broadly in line with the Commission services' forecast up to 2007/08, after 2008/09 can be considered as having a margin of caution, subject however to the recovery in productivity growth discussed in section 2.

Second, budgetary outturns so far in 2005/06 suggest that non-cyclical expenditure might turn out lower than forecast in the December PBR, with a possibility of a carry-over effect into subsequent years. However, intra-year expenditure patterns are inherently volatile, and the convergence programme confirms that the UK authorities expect expenditure to pick up in the remainder of 2005/06 to achieve the planned level for the year as a whole. Moreover, unspent balances in 2005/06 might heighten the risk outlined above.

On balance, it appears that the risks of a worse than projected budgetary outcome dominates, especially in the short term.

4.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

– On 24 January 2006, having taken into account measures announced in the December 2005 PBR and accounted for in the projections in the 2005 update of the convergence programme, the Council decided that the UK was in excessive deficit and issued a recommendation to bring to an end the excessive deficit situation by 2006/07. The convergence programme projections suggest that the deficit will fall below the 3% of GDP reference value in 2006/07 (to a deficit of 2.8% of GDP). However, taking into account the risk assessment above, the Commission services' autumn forecast, even after incorporating the new measures, suggests that the deficit is likely to continue to exceed by a small amount the reference value (3.1% of GDP). Under the terms of the Council recommendation, the UK has a deadline for "taking effective action" expiring on 24 July 2006.

Taking into account the risk assessment above, the budgetary strategy, while consistent with stabilising debt at a low level towards the end of the programme period, does not build a sufficient safety margin against breaching the 3% of GDP reference value with normal macroeconomic fluctuations until possibly the very end of the programme period.

– According to the Commission services' re-calculations based on the commonly agreed methodology, the projections in the convergence programme shown in Table 5 suggest that the UK would reach the estimated minimum benchmark of a structural deficit of around 1½% of GDP only by 2009/10. While the estimation of the minimum benchmark necessary to maintain a safety margin against the 3% reference value is subject to uncertainty and should be carefully interpreted, especially in the light of the much increased macroeconomic stability of in the UK over the past decade, once the risk assessment is considered, the convergence programme projections does not seem to provide a sufficient safety margin against breaching the 3% reference value except possibly at the very end of the projection period, in 2010/11.

– Both the Commission services' autumn forecast and the convergence programme own estimates suggest a relatively large negative output gap in 2006/07, which is however estimated to narrow in subsequent years.

– Table 7 below considers whether other non-cyclical elements are relevant in assessing the overall economic prospects over the projection period. The table compares the tax elasticities implicit in the Commission services' forecast with the estimates of the OECD[29]. In line with observed outturns, the Commission services' forecast expects the elasticity of tax revenues to be more buoyant than could be expected on the basis of GDP growth in 2005/06 (not shown in table), because of high oil prices and a buoyant stock market; looking forwards, the table shows that from 2006/07 the tax-to-GDP elasticity is expected to return in line with the ex-ante estimates. This and consideration of a negative but closing output gap suggest that over the programme period the UK is facing an unfavourable but clearly improving economic environment, so that the overall outlook cannot be defined as "bad times" in the sense of the Stability and Growth Pact.

[29] The concept of "ex-ante" tax elasticity needs to be interpreted with some caution. This is particularly true for the UK, where the public finances are closely linked to movements in asset prices (housing and financial assets) and the prices of oil and gas.

Table 7: Assessment of tax elasticities

	2006/07		2007/08	
	COM (observed)	ex-ante[1]	COM[2] (observed)	ex-ante[1]
Total taxes Change in tax-to-GDP ratio	0.3	0.2	0.2	0.2
Difference	*0.1*		*0*	
of which[3]: - elasticity component	*0*		*- 0.2*	
- composition component	*0*		*0.1*	
p.m.: Elasticity to GDP	1.2	1.1	1.1	1.1

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

In the view of the considerations above, and taking into account the risks to revenue projections in the short term, the adjustment path could be accelerated in order to create a wider safety margin over the programme period. As seen in Table 5, the planned structural adjustment is front-loaded, while it slows down after 2007/08. Taking into account that 2006/07 is the year with the largest projected output gap (at around -1% of potential output), the UK authorities seem to recognise that a relatively small fiscal adjustment even in a period of below-trend activity would not impinge significantly on economic activity. However, after the excessive deficit is corrected in 2006/07, as the output gap is projected to narrow there would be an opportunity for a more prudent approach to fiscal planning, building further on the initial structural adjustment in order to create a wider safety margin against the 3% reference value.

The strategy for the general government balance outlined in the update is broadly consistent with the broad economic policy guidelines in the area of public finances (see Annex 3 for details). In particular, while the correction of the excessive deficit might not be achieved without additional action, the needed correction is estimated by the Commission services to be small, and the UK still has until 24 July 2006 to take effective action. Progress towards establishing a safety margin against breaching the reference value could be expected to be more rapid.

4.4. Sensitivity analysis

The programme does not include a sensitivity analysis on the basis requested in the code of conduct, applying different interest and exchange rate assumptions. While the authorities base their projections for public finances on assumptions on trend growth one quarter-percentage point lower than in the central-case macroeconomic scenario, it is not possible to establish directly what impact lower (higher) growth would have on the public finances.

The convergence programme includes a graphical analysis of the impact on the current budget surplus (on the UK's domestic definition) of a scenario where trend output is one percentage point lower than the central view (that is, the output gap is one percentage point less negative or more positive). However, the key usefulness of this analysis is in assessing the risks to the UK "Golden Rule" while a higher level of detail would be needed to enhance its usefulness to analyse the risks against the EU fiscal framework.

Commission services' simulations[30] of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005/06-2008/09 period; (ii) trend output based on the HP-filter[31] and (iii) no policy response (notably, the expenditure level is as in the central scenario[32]), suggest that, by 2008/09, the cyclically-adjusted balance would be 0.6 percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.6 percentage point of GDP in cyclically-adjusted terms would be necessary to keep the public finances on the path set out in the central scenario. On balance, the sensitivity analysis suggests that the convergence programme's projections are not particularly vulnerable to risks to the macroeconomic scenario. As seen above, the main downside risks to the projected public finances path do not come from lower than expected growth but rather from the assumed increase in the tax-to-GDP ratio for a given level of GDP growth.

5. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

5.1. Debt developments in the programme

The UK gross debt ratio is set to remain well under the reference value of 60% of GDP, despite being projected to be on a rising trend, as shown in Table 8.

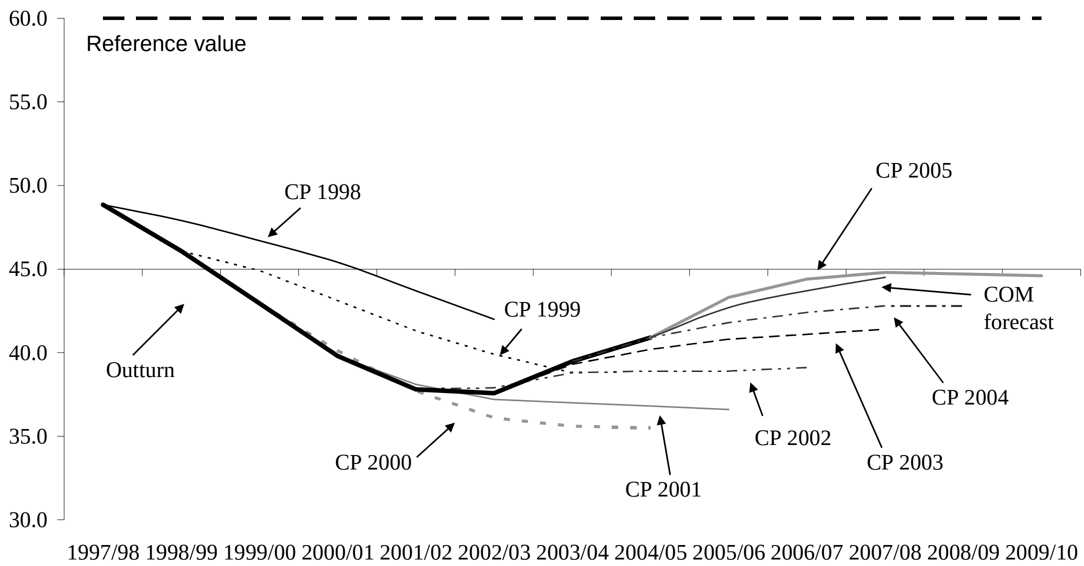
The authorities' latest estimate for financial year 2005/06 is for general government gross debt to reach 41.8% of GDP, an upward revision compared to the 2004 update, reflecting the upward revision to the deficit projections. Thereafter, the debt ratio is projected to rise to 44.8% of GDP by 2007/08, and then to decline slightly to 44.6% in 2009/10 and 44.4% in 2010/11 (not shown in the table).

[30]Commission services' calculations based on the data series "Total expenditure" as set out in Table 4.4 of the programme update. As noted above, these data have slight differences compared with the harmonised definition of total expenditure on an ESA95 basis.

[31]In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth using the agreed production function method.

[32]The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

Figure 2: Debt projections in successive convergence programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive convergence programmes

As in other convergence programmes, the UK authorities also project public sector net debt (i.e. allowing for the accumulation of financial assets), which is the fiscal aggregate against which the "Sustainable Investment Rule" is assessed in the domestic fiscal framework. Public sector net debt is projected to rise from an estimated 36.5% of GDP in 2005/06 to 38.2% of GDP in 2007/08, and then stabilise at that level thereafter. The projections in the convergence programme suggest that the constraint of the 40% *public sector net* debt ceiling might become binding should some of the negative risks to the deficit projections materialise.

As shown in Figure 2, since 2000/01 outturns for gross debt have tended to overshoot targets in successive convergence programmes, reflecting the overshoot of deficit targets seen in Figure 1 above.

Table 8: Debt dynamics

	average 2000 /2004	2005/06		2006/07		2007/08		2008/ 09	2009/ 10
	COM	COM[1]	CP	COM[1]	CP	COM[1]	CP	CP	CP
Government gross debt ratio	**39.1**	**42.7**	**43.3**	**43.7**	**44.4**	**44.5**	**44.8**	**44.7**	**44.6**
Change in debt ratio (1 = 2+3+4)	-0.4	1.9	2.4	1.0	1.1	0.8	0.4	-0.1	-0.1
Contributions:									
- **Primary balance**[2] (2)	**-1.2**	**-1.3**	**-1.0**	**-1.0**	**-0.7**	**-0.8**	**-0.3**	**0.1**	**0.4**
- **"Snow-ball" effect** (3)	**0.3**	**0.6**	**0.5**	**-0.1**	**0.1**	**0.0**	**-0.3**	**-0.3**	**-0.1**
- Interest expenditure	2.2	2.1	2.1	2.2	2.1	2.2	2.1	n.a.	n.a.
- Real GDP growth	-1.0	-0.7	-0.7	-1.0	-0.9	-1.2	-1.3	-1.2	-1.0
- Inflation (GDP deflator)	-0.9	-0.8	-1.0	-1.2	-1.0	-1.1	-1.2	-1.1	-1.2
- **Stock-flow adjustment** (4)	**0.5**	**0.0**	**1.0**	**0.0**	**0.3**	**0.0**	**0.4**	**0.3**	**0.4**
- Cash/accruals	0.0								
- Accumulation financial assets	0.4								
of which: Privatisation proceeds	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual adj.	0.1								

Notes:

[1]Commission services' forecast made before the discretionary measures were announced in the 2005 Pre-Budget Report

[2] The UK authorities provide primary balances on an ESA definition (i.e. excluding gross rather than net interest payments) only up to 2007/08. Figures shown afterwards are those recalculated by the Commission services, based on the reported budget balance and on the information inferred from discussions with the UK authorities.

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 t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Source:

Convergence programme update (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

Table 8 above shows that the pattern of primary deficits is the main driver of the rising debt ratio up to 2007/08. A large positive stock flow adjustment in 2005/06 also plays a part, raising the level of debt over what would be expected given the deficit pattern[33]. Interest expenditure remains stable at around 2% of GDP, kept low by the historically low long-term interest rates.

[33]On the basis of separate information provided by the UK authorities, this positive stock-flow adjustment in 2005/06 is due to a) the accumulation of non-liquid assets by central government, and especially student loans (about 0.3% of GDP) b) cash/accrual discrepancies between the measure of the EDP deficit and the measure of net cash requirement, mainly due to a change in the timing of receipts from the EU (just above 0.1% of GDP); and c) an assumption of accumulated liquid assets in local authorities' balance sheets that are not run down over the forecast period (an estimate was not provided by the UK authorities but can be presumed to be around 0.5% of GDP). The latter two reasons account for the particularly high stock-flow adjustment in 2005/06, above the historical average.

5.2. Assessment

The projected path for general government gross debt broadly reflects the Commission services' autumn forecast. The level of projected debt in the convergence programme is, however, higher than that projected by the Commission services despite higher primary deficits in the Commission services' projections. This is due to the positive stock-flow adjustment in the programme projections, which in 2005/06 is well above the historical average. Part of this stock-flow adjustment is due to an assumption of accumulation of liquid assets that seems to create a margin of caution in the debt projections, cushioning them at least in part from the risks to the deficit projections highlighted in section 4.3.2[34].

However, even in the worst-case scenario, the ample margin against the 60% reference value would ensure that the UK continues to meet the debt criterion in the Stability and Growth Pact over the period covered by the convergence programme.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

Measures taken by the UK authorities since the previous convergence programme with significant, persistent impacts in terms of the quality of public finances include, on the revenue side, continuing efforts to counter tax avoidance through closing tax loopholes or by preventing their exploitation (see Box 2 above). These efforts are expected to generate about an extra 0.1% of GDP in annual revenues. This is a multi-pronged approach which includes action to prevent companies creating capital losses to gain tax advantages or transferring assets abroad tax-free. Measures announced in the December 2005 PBR to increase taxation of North Sea oil should generate approximately an extra 0.2% of GDP annually from 2006/07, but already followed a change in the offshore oil tax regime introduced in the March 2005 Budget advancing the payment of tax due; the successive changes may therefore be at the cost of some questioning of the government's credentials for a stable tax regime and therefore of future investment, especially in the North Sea fields.

As for measures to improve the quality of public expenditure, the UK has already embarked on a significant series of important initiatives consistent with contributing to achieving outcomes in line with some of the broad economic policy guidelines in the area of public finances. Significant examples include measures to increase public sector efficiency and measures to improve public services. The convergence programme continues to put emphasis on the drive to improve the effectiveness of public spending through efficiency savings identified in the 2004 review of public sector efficiency ("Gershon Review"), to be achieved inter alia through a reduction in the civil service headcount. The December 2005 PBR announced progress in implementing the government's efficiency agenda, announcing, for example, a total reduction of 25,000 civil services jobs[35]. At the same time, health and education services are enjoying

[34] The current very low level of long-term yields could imply that there might be a risk to the deficit and debt projections coming from interest rate increases in the medium term. However, the not particularly low implicit interest rates on government debt reported in the programme suggest that this risk could be offset by the possibility of locking in currently low yields into a longer term debt structure.

[35]However, this figure discounts staff who have been taken on for additional functions after April 2004, and therefore do not represent a net workforce reduction. The National Audit Office has published an audit of progress in towards the Gershon targets in February 2006, noting good progress, but highlighting that

significant real increases in resources while at the same time being subject to an ambitious programme of reform designed to improve value for money.

Compared with this positive base, recent measures contribute only to a small amount to achieve outcomes in line with the broad economic policy guidelines in the area of public finances. Looking ahead, the government announced in July 2005 that it intends to conduct a second Comprehensive Spending Review (CSR), reporting in 2007 (the first such Review having been in 1997 at the start of the government's period of office[36]). As noted in Section 4, the CSR will take a "zero-baseline" approach (that is, will consider the appropriateness of overall expenditure allocations to Departments and not only requested changes relative to their baseline allocation), helping to assess comprehensively how well the government has achieved its stated objectives of concentrating more resources on those parts of the public sector most directly in contact with the public, improving the efficiency of public expenditure, and improving the accountability of public services. Departmental allocations are intended to be adjusted to reflect performance in implementing the government's priorities. It is clearly premature to anticipate the CSR outcome. One important policy area under review with implications for the quality of public finances is pensions, where current commitments on the structure of the public pension system, taken together with prospective private provision, are not guaranteed to ensure a socially adequate level of pensions in the longer term. It is therefore welcome that government proposals on possible reform are expected in spring this year.

The National Reform Programme of the United Kingdom, submitted on 13 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) maintaining fiscal sustainability in the face of demographic challenges; (ii) building an enterprising and flexible business sector; (iii) promoting innovation and R&D; (iv) widening opportunities for the acquisition of skills; (v) increasing innovation and adaptability in the use of resources; and (vi) ensuring fairness through a modern and flexible welfare state. The budgetary implications of the actions outlined in the National Reform Programme are fully reflected in the budgetary projections of the convergence programme. The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the National Reform Programme. The convergence programme outlines projections in which expenditure on education rises from 4.7% of GDP in 1996-97 to 5.6% in 2007/08 (although it already reached 5.5% in 2004/05) and then - on an assumption of unchanged policy beyond the medium term - remains roughly the same through to 2054/55; the cost of state pension provision increases from 5.0% of GDP in 2004/05 to 6.6% by 2054/55; and measures to improve the quality of public finances, including the drive to improve effectiveness of public expenditure through better asset management, relocation of civil service positions out of the more expensive South-East region, and - as mentioned above - the reduction in public sector workforce headcount identified in the 2004 Gershon Review. The convergence programme notes that the long-term projection of pension expenditure is

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this needs to be considered provisional and subject to further verification, due to a number of difficulties in measurement of efficiency. The NAO also stressed that the implementation of the Gershon review "remains a high risk programme".

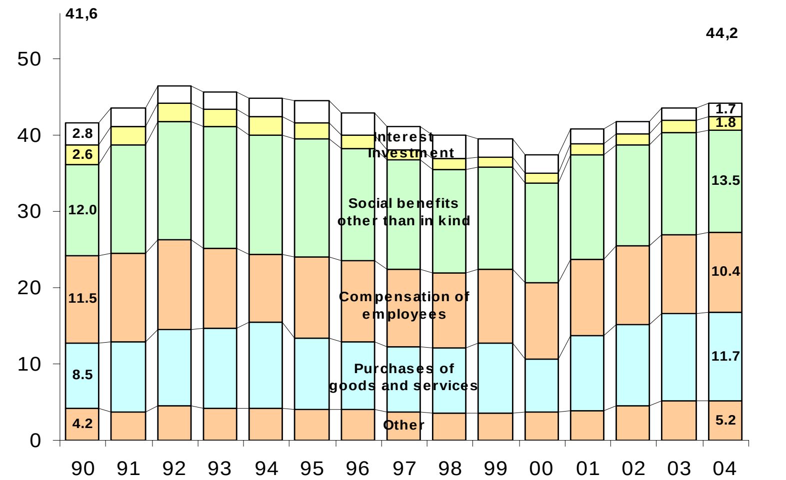
[36] Intermediate "regular" spending reviews have taken place in 2000, 2002 and 2004. The 2007 CSR overrides the schedule that would have seen a regular review in 2006 for the three-year period 2007-2010.

based on an upper estimate of the cost of the current system and does not represent a policy commitment.

Box 4: The level and composition of government expenditure in the United Kingdom since 1990

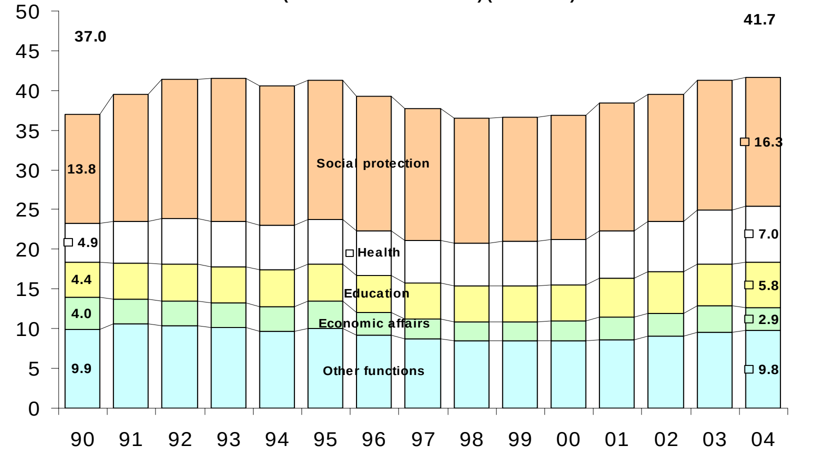
Over the last 15 years, UK government expenditure has grown moderately in real terms and has changed composition. Total government expenditure in 1990 amounted to 41.6% of GDP and by 2004 had grown by around 2½ percentage points to 44.2%. This evolution was not steady, however: growth was rapid in the early 1990s, prior to some steady and substantial retrenchment until 2000; since 2000 there has been a significant and relatively rapid expansion of the expenditure ratio (see Figure 3).

Figure 3 : The evolution of government expenditure (economic classification) (% of GDP)



Note: "Other" includes subsidies and other current and capital transfers.
Source: Commission services

The increase in primary government expenditure as a ratio of GDP has been almost 4 points over the entire period. The approximately 1% of GDP reduction in interest payments – due to lower debt and market interest rates – has been more than offset by increases in other expenditure categories. Public procurement, in particular, has grown significantly as a ratio of GDP. It is also of note that social benefits have grown as a ratio of GDP, despite unemployment at a near-record low, due to policies aimed at increasing labour market participation of low skilled workers. On the other hand, the decline of investment expenditure as a ratio of GDP over the last fifteen years helps explain why the government is so determined to expand public investment and reverse years of infrastructural neglect.



Note: "Other functions" include general services, defence, environment, culture, public order and housing.
Source : Commission services

The evolution of government expenditure can also be considered by looking at the functional classification of spending. Data in Figure 4 reveal that the increase by more than 4 percentage points of GDP in primary expenditure stemmed mainly from expenditure on social protection. This is the context for the government's current initiatives on welfare reform. Spending on health and education has also grown, in line with government objectives to significantly improve the quality of health and education services provided.

7. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of UK's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set out in the programme are actually achieved[37]. The "2005" scenario assumes that the structural primary balance[38] remains unchanged at the 2005/06 level throughout the programme period.

On the basis of information in the programme, age-related expenditure is foreseen to increase by 3.7 percentage points of GDP between 2010 and 2050, to which pension expenditure contributes the most, by almost 2 percentage points of GDP (see table A2 in Annex 5). The present analysis is based on the set of government expenditure items covered by the common projections carried out by the Economic Policy Committee (EPC)[39]. In addition to these expenditure items, the UK update includes a projected fall in

[37]The assessment does not therefore take into account any implications of the European Council agreement of December 2005 on EU financial perspectives which reduced the UK rebate towards the end of the programme period by around 0.1% of GDP, as referred to in Section 4; this is equivalent to an assumption that compensating changes to other revenues or to expenditure will be made to confirm the budgetary projections in the programme.

[38]The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out).

[39]Government expenditure on pension, healthcare, long-term care, education and unemployment benefits. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the

non-age related expenditure as a share of GDP. Moreover, for the first time the UK includes a projected rise in the revenue/GDP ratio.

The gross debt-to-GDP ratio is currently slightly above 40% of GDP, thus below the 60% of GDP reference value. In the '2005' scenario, it is projected to rise continuously over the projection period (until 2050) and breach 60% of GDP around 2020 while in the programme scenario it would go above 60% of GDP in 2030[40] (see Table A4 in Annex 5).

According to the S1 indicator, a sustainability gap of about 2¾% of GDP arises in the '2005' scenario. A lower gap, of about 1% of GDP would emerge in the 'programme' scenario, reflecting the consolidation of the public finances envisaged by the UK authorities over the programme period. However, S1 only takes into account changes in the primary balance up to 2050, which underestimates the cost of ageing.

A more demanding measure is the government's inter-temporal budget constraint, captured by the S2 indicator, according to which a sustainability gap of about 4½% of GDP emerges in the '2005' scenario. The initial budgetary position is not sufficiently strong to fully offset the future budgetary impact of ageing. In the 'programme' scenario the sustainability gap is reduced by some 1½ percentage points of GDP, indicating that a part of the budgetary challenge posed by ageing populations can be met by implementing the medium-term budgetary plans as set out in the convergence programme. This sustainability gap translates into a required primary balance (RPB) of about 3½% of GDP, significantly higher than the structural primary balance of about ¾% of GDP projected for the last year of the programme period.

Moreover, the sustainability gap, as measured by the S2 indicator, would increase by up to 0.2% GDP if the (budgetary or structural) adjustment were to be postponed by five years, highlighting that savings can be made over time if action is taken sooner rather than later (see table A3 in Annex 5).

Table 9: Sustainability indicators and the required primary balance

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projection period. The UK update does not include expenditure on unemployment benefits; however, the unemployment rate is projected to remain unchanged over the period 2010-2050, suggesting that there should be little change in expenditure on unemployment benefits as a share of GDP over this period. The update notes that spending on healthcare as a share of GDP will rise rapidly up to 2007/08, by about 1 percentage point, which was taken into account in the analysis.

[40]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 should not be seen as a forecast.

	Sustainability indicators and RPB								
	2005 Scenario					Programme scenario			
	S1	S2		RPB		S1	S2		RPB
Value (of which)	**2.6**	**4.4**		**3.5**		**1.0**	**2.8**		**3.4**
initial budgetary position	*1.3*	*1.3*				*-0.3*	*-0.3*		
debt requirement in 2050	*-0.3*	*:*				*-0.3*	*:*		
future changes in budgetary position	*1.6*	*3.1*				*1.6*	*3.1*		

Note: The S1 indicator measures the sustainability gap as the difference between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator measures the sustainability gap as the difference between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[41]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission (2005), European Economy, 'Public finances in EMU – 2005', Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

GDP growth in the programme is projected to be slightly lower than the EPC projections up to 2020 (by about ¼ percentage points) and from 2030 onwards higher, at 2% compared with 1.3% in the EPC projections. The unemployment rate in both sets of projections follows a similar pattern (see Table A1 in Annex 5). Overall, the underlying assumptions in the programme could therefore be on the optimistic side.

The update provides additional national long-term projections, according to which non-age-related expenditure as a share of GDP would fall by 0.5% of GDP between 2010 and 2050[42]. This is a less pronounced fall than projected in the previous update (-1.8% of GDP). Incorporating this national projection would reduce the S1 indicator by 0.4 % and the S2 indicator by 0.5% of GDP[43], suggesting lower sustainability challenges.

Moreover, as noted above, this update includes for the first time a projected rise in the revenue-to-GDP ratio (of 2.1% of GDP) between 2010 and 2050. Incorporating this national projection would reduce the S1 indicator by 1.1% and the S2 indicator by 1.8 % of GDP[44]. While the programme does not contain much detail on this projection, subsequent discussions with UK officials have clarified some aspects of this projection. The increase in the revenue-to-GDP ratio would mainly come from a projection of higher income tax[45], which results from an assumption that, for persons aged 70 and more, income tax receipts would rise in line with population changes. This would lead the tax

[41]The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age-related primary spending could be preferable and has the same impact.

[42]According to the update, the projected reduction in expenditure mainly comes from projected increases in 'other' consumption and capital spending (i.e. those unrelated to education, health and long-term care) being more than offset by projected relative falls in other spending items such as non-pension social transfers which, based on current policies, mainly increase in line with prices.

[43] The impact of these additional national long-term projections on the S1 and S2 sustainability indicator over the period 2010-2050 was calculated.

[44] See footnote 38.

[45] It would also be the result of a projected increase over the long-term in the inheritance tax/GDP ratio.

base for income tax to rise faster than GDP. To the extent that these additional revenues materialise, they would imply lower sustainability risks[46].

Higher age-related expenditures cannot be excluded as there are signs of insufficient provision of private pensions, linked to rising demographic costs that are leading to the closure particularly of the most generous occupational schemes. This might have implications for the public finances through greater enrolment in contributory state schemes and in greater recourse to means-tested pension and other benefits.

Initiatives like the introduction of the Pension Protection Fund in spring 2005, funded by risk-based levies charged on private pension schemes and aimed to protect members of private defined-benefit schemes if the sponsoring firm becomes insolvent, are attempts to tackle this issue, although it is early to assess the associated potential budgetary costs and whether the funding mechanism is appropriate in avoiding an increase in long-term implicit liabilities.

However, the UK pension arrangements, both public and private, are currently under comprehensive review. A key contribution to the debate has been the work of the government-appointed but independent Pensions Commission, which presented its final report in November 2005. In its report, the Pensions Commission found that pensions might be inadequate for an increasing number of persons over the coming decades (an issue that was also highlighted in assessments of previous convergence programme updates). It included a wide range of recommendations on the future of the UK pension system, which may serve as a basis for an upcoming white paper on pension reform expected to be issued in spring 2006. Box 5 briefly summarises some key recommendations of the Pensions Commission final report.

[46] It is possible that a similar reasoning can be applied also to other countries.

Box 5: The Pensions Commission proposals for pension system reform in the UK

The Pensions Commission (PC), a government-appointed body with a remit to make recommendations on the future of the UK pension system, published its final report in November 2005.

The PC found that, on current policies, an increasing number of pensioners might retire on incomes deemed to be inadequate, aggravated by significant inequalities for different employment and socio-demographic groups. The reasons identified are the modest generosity of state pensions, the falling rates of employers' contributions into private sector pension funds, shifts from defined benefit to defined contribution schemes, and some barriers to an increase in voluntary saving by the most disadvantaged sectors of the population that are inherent to the current system.

The key recommendations of the report are:

- to reduce means-testing in the provision of the state pension and transforming it into a flat rate, non-contributory system; effectively, this would mean a progressive phasing out of the means-tested Pension Credit, introduced in 2003 ;
- to increase the future generosity of the state pension by uprating basic pensions by earnings rather than prices while on the other hand raising the state pension age in line with longevity. At the same time, the current tenuous link between state pension and contributions would be severed, and entitlement would be on a universal, residence-based principle.
- to reform private pension provision by creating a **National Pension Savings Scheme** into which all employees are enrolled with a possibility to opt out. This is expected to increase enrolment rates given that, as suggested by behavioural studies, people are most likely to be members of a scheme if it represents a default option rather than if it requires an active choice.

Overall, the recommended reforms could considerably simplify the current pension system, and have the potential to increase private savings by overcoming some of the cost barriers and time inconsistency in some individual saving choices.

Judgement on the fiscal cost of the proposed reforms depends on the assumed baseline with which they are compared. Taking as a baseline the scenario underlying the projections for state pension expenditure that inform the assessment of long-term fiscal sustainability in Section 7, the cost of the PC proposal for future uprating of state pensions by earnings would only relatively modestly worsen the outlook for the UK, with spending on state pensions rising from the current level of around 6% of GDP to 7½-8% by 2050, broadly in line with the UK authorities' own projections on unchanged policy[1] (although as seen in section 6 the UK authorities projections represent the upper boundary of cost of the current system). This is chiefly because the extra cost of uprating the state pension by earnings would be offset by an increase in the state pension age.

[1] *The figure published by the Pensions Commission uses a different definition of spending in state pension, hence the difference in levels with the figures mentioned in section 6 above.*

7.1 Overall assessment.

With regard to the sustainability of public finances, the United Kingdom appears to be at medium risk on grounds of the projected budgetary costs of an ageing population. Over the period until 2050, a contained rise in public pension expenditure is projected. However, 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. Pension policy is currently under review and the government's response to the Pensions Commission report is expected in the spring. The currently favourable debt position contributes to limit somewhat the budgetary impact of ageing populations; however, gross debt is projected to go above the 60% of GDP reference value during the projection period to 2050 if, compared to the structural budgetary position in 2005/06, no further budgetary consolidation takes place during the programme period. Improving significantly the structural balance of government finances over the medium term would contribute to reducing risks to public finance sustainability

* * *

Annex 1: Summary tables from the convergence programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006 [1]	2007 [1]	2008 [1]
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g		3¼	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼
2. Nominal GDP	B1*g	1164	5¼	4¼	4½ to 5	5½ to 6	5¾ to 6¼
Components of real GDP [2]							
3. Private consumption expenditure [3]	P.3		3¾	1¾	1¾ to 2¼	2¼ to 2¾	2½ to 3
4. Government consumption expenditure	P.3		2½	1½	2	2½	2½
5. Gross fixed capital formation[4]	P.51		5	2¾	3¾ to 4¼	4¾ to 5¼	4¼ to 4¾
6. Changes in inventories and net acquisition of valuables (% of GDP) [5]	P.52 + P.53		0	0	0	0	0
7. Exports of goods and services	P.6		4	4¾	5 to 5½	5¼ to 5¾	5 to 5½
8. Imports of goods and services	P.7		6	4¾	4½ to 5	4¾ to 5¼	4¾ to 5¼
Contributions to real GDP growth [6,7]							
9. Final domestic demand [8]		-	3½	2	2½	3	3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0	0	0	0	0
11. External balance of goods and services	B.11	-	-¾	-¼	0	0	0

Notes (UK):
1) The economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent to the end of 2006 and 2½ per cent thereafter. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for the projecting the public finances, which is ¼ percentage point below the neutral assumption.
2) The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.
3) Household consumption under UK definition. Includes households and non-profit institutions serving households.
4) Fixed investment under UK definition
5) Change in inventories under UK definition. Contribution to GDP growth, percentage points
6) Components may not sum to total due to rounding and omission of private residential investment, transfer costs of land and existing buildings and the statistical discrepancy.
7) Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.
8) Equals sum of private consumption, business investment and government under UK definition.

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008
		level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			2	2½	2½	2½	2¾
2. Private consumption deflator		104	1¼	2¼	2	2¾	2¾
3. HICP*			1¼	2¼	1¾	2	2
4. Public consumption deflator							
5. Investment deflator							
6. Export price deflator (goods and services) **			-¾	1¾	1¼	¼	¼
7. Import price deflator (goods and services) **			-½	2¾	1¼	¾	½

Notes:
* Optional for Stability programmes (COM)
** Average value indices (UK)

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons [1]							
2. Employment, hours worked [2]							
3. Unemployment rate (%) [3]							
4. Labour productivity, persons [4]							
5. Labour productivity, hours worked [5]							
6. Compensation of employees	D.1						

Notes (COM):

1) Occupied population, domestic concept national accounts definition.

2) National accounts definition.

3) Harmonised definition, Eurostat; levels.

4) Real GDP per person employed.

5) Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world *	B.9					
of which: - Balance on goods and services		-3¼	-3¾	-3¾	-3½	-3½
- Balance of primary incomes and transfers		1¼	1½	1¼	1	1
- Capital account						
2. Net lending/borrowing of the private sector **	B.9/ EDP B.9	1½	1¾	½	¼	0
3. Net lending/borrowing of general government [1] *	B.9	-3.3	-3.0	-2.7	-2.3	-1.9
4. Statistical discrepancy						

Notes (UK):
* Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical with to GGNB calculated on a Maastricht definition.
**Mid-points of forecast ranges
Notes (COM):
1) Note that the figure for General Government balance published in the Convergence Programme and reported in this table does not take into account Eurostat decision on treatment of UMTS. Hence the difference with the figures recalculated by the Commission services.

Table 2. General government budgetary prospects

	ESA code	2004/05	2004/05	2005/06	2006/07	2007/08	2008/09
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government [1]*	S.13	-38.5	-3.3	-3.0	-2.7	-2.4	-1.9
2. Central government	S.1311	-37.0	3.1	2.9	2.7	2.3	
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	-1.4	0.1	0.1	0.0	0.0	
5. Social security funds	S.1314						
General government (S13)							
6. Total revenue	TR	445.1	37.8	39.1	39.9	40.2	
7. Total expenditure	TE[2]	483.6	41.1	42.2	42.6	42.5	
8. Net lending/borrowing [1]**	EDP B.9	-38.5	-3.3	-3.0	-2.7	-2.3	-1.9
9. Interest expenditure (incl. FISIM) ***	EDP D.41 incl. FISIM	24.4	2.1	2.1	2.1	2.1	
pm: 9a. FISIM							
10. Primary balance*****	[3]	14.1	-1.2	-0.9	-0.6	-0.3	
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		344.1	29.3	30.3	31.1	31.3	
11a. Taxes on production and imports	D.2	154.9	13.2	13.3	13.3	13.2	-
11b. Current taxes on income, wealth, etc	D.5	186.3	15.8	16.8	17.5	17.9	-
11c. Capital taxes	D.91	2.9	0.2	0.3	0.3	0.3	-
12. Social contributions	D.61	79.3	6.7	6.9	7.0	7.0	-
13. Property income [4]	D.4					-	-
14. Other (14=15-(11+12+13))						-	-
15=6. Total revenue [1]	TR	445.1	37.8	39.1	39.9	40.2	40.3
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) [5]							
Selected components of expenditure							
16. Collective consumption	P.32	250.8	21.3	21.7	22.0	22.1	
17. Total social transfers [4]	D.62 + D.63						
17a. Social transfers in kind [4]	P.31 =D.63						
17b. Social transfers other than in kind [4]	D.62						
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	24.4	2.1	2.1	2.1	2.1	
19. Subsidies	D.3	7.2	0.6	0.6	0.6	0.6	
20. Gross fixed capital formation	P.51	21.7	1.8	2.2	2.3	2.4	
21. Other (21=22-(16+17+18+19+20))							
22=7. Total expenditure	TE[6]	483.6	41.1	42.2	42.6	42.5	42.1
Pm: compensation of employees	D.1						

Notes (UK):
* Data on general government total revenue/ expenditure originally published in the CP in cash terms, but easily converted into percentages of GDP. F=The breakdown for revenue and expenditure published with the Convergence Programme is not consistent with ESA 95.
** Although this is based on the ESA95 definition of general government net borrowing (GGNB), the projections are identical with to GGNB calculated on a Maastricht definition.
*** GDP growth as used for public finance projections. FISM recorded as consumption not included.
****The UK authorities provide primary balances excluding net interest rather than gross interest payments as required under the code of conduct. Thus figures shown in thus table differ from those are those recalculated by the Commission services and reported in the main body of this assessment

Notes (COM):
1) Note that the figure for General Government balance published in the Convergence Programme and reported in this table does not take into account Eurostat decision on treatment of UMTS. Hence the

difference with the figures recalculated by the Commission services.
2) Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
3) The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).
4) Certain component of expenditure are presented with a level of detail sufficient to allow the analysis but are not presented according to the ESA definition, and thus cannot be considered as compliant with the code's format requirements.
5) Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

Table 3. General government expenditure by function

% of GDP		2004/05	2005/06	2006/07	2007/08	2008/09
1. Gross debt[1]*		40.9	43.3	44.4	44.8	44.7
**2. Change in gross debt ratio ** **		1.5	2.4	1.1	0.4	-0.1
Contributions to changes in gross debt						
3. Primary balance [2]		-1.2	-0.9	-0.6	-0.3	
4. Interest expenditure (incl. FISIM) [3]		2.1	2.1	2.1	2.1	
5. Stock-flow adjustment*[4]**		-1.7	-0.6	-1.6	-1.9	
of which: - Differences between cash and accruals [5]						
- Net accumulation of financial assets [6] *of which:* *- privatisation proceeds*						
- Valuation effects and other [7]						
p.m. implicit interest rate on debt [8] ******		5.5	5.4	5.1	5.0	
Other relevant variables						
6. Liquid financial assets[9]						
7. Net financial debt (7=1-6)						

Notes (UK):
*General government gross debt on a Maastricht basis
**General government gross debt measure on a Maastricht basis
***Change in gross debt ratio less primary balance less interest expenditure. This approach to calculate stock flow adjustment is different from the one adopted by the Commission – hence the difference with the figures in Table 6 in the main body of this assessment.
****Interest expenditure expressed as per cent of gross debt in previous year.

Notes (COM):

1) As defined in Regulation 3605/93 (not an ESA concept).

2) Cf. item 10 in Table 2.

3) Cf. item 9 in Table 2.

4) Note that stock flow adjustment is calculated by the UK authorities according to a different formula as the one used by the Commission services.

5) The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

6) Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

7) Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

8) Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

9) AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 4. General government debt developments

Table 4. General government debt developments

% of GDP		2004/05	2005/06	2006/07	2007/08	2008/09
1. Gross debt[1]*		40.9	43.3	44.4	44.8	44.7
**2. Change in gross debt ratio ** **		1.5	2.4	1.1	0.4	-0.1
Contributions to changes in gross debt						
3. Primary balance [2]		-1.2	-0.9	-0.6	-0.3	
4. Interest expenditure (incl. FISIM) [3]		2.1	2.1	2.1	2.1	
5. Stock-flow adjustment*[4]**		-1.7	-0.6	-1.6	-1.9	
of which: - Differences between cash and accruals [5]						
- Net accumulation of financial assets [6] *of which: - privatisation proceeds*						
- Valuation effects and other [7]						
p.m. implicit interest rate on debt [8] *****		5.5	5.4	5.1	5.0	
Other relevant variables						
6. Liquid financial assets[9]						
7. Net financial debt (7=1-6)						

Notes (UK):
*General government gross debt on a Maastricht basis
**General government gross debt measure on a Maastricht basis
***Change in gross debt ratio less primary balance less interest expenditure. This approach to calculate stock flow adjustment is different from the one adopted by the Commission – hence the difference with the figures in Table 6 in the main body of this assessment.
****Interest expenditure expressed as per cent of gross debt in previous year.

Notes (COM):

1) As defined in Regulation 3605/93 (not an ESA concept).

2) Cf. item 10 in Table 2.

3) Cf. item 9 in Table 2.

4) Note that stock flow adjustment is calculated by the UK authorities according to a different formula as the one used by the Commission services.

5) The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

6) Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

7) Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

8) Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

9) AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004/05	2005/06	2006/07	2007/08	2008/09
1. Real GDP growth (%) *		2¾	1¾	2¼	3	2¾
2. Net lending of general government [1]	EDP B.9	-3.3	-3.0	-2.7	-2.3	
3. Interest expenditure (incl. FISIM recorded as consumption)	EDP D.41 +FISIM	2.1	2.1	2.1	2.1	
4. Potential GDP growth (%) (1)						
contributions: - labour - capital - total factor productivity						
5. Output gap		-0.5	-1.4	-1.5	-0.7	-0.1
6. Cyclical budgetary component		0.4	0.8	1.0	0.6	0.2
7. Cyclically-adjusted balance (2-6)		-2.9	-2.2	-1.7	-1.7	-1.7
8. Cyclically-adjusted primary balance (7-3) **		0.4	-0.1	0.0	0.1	

Notes (UK):
*GDP growth is used for public finance projections
**General government net borrowing less interest paid less cyclical budgetary components
Notes (COM):

1) Note that the figure for General Government balance published in the Convergence Programme and reported in this table does not take into account Eurostat decision on treatment of UMTS. Hence the difference with the figures recalculated by the Commission services.

2) Note that the UK does publish a trend growth estimate in the Pre-Budget Report but this has not been reported in the Convergence Programme.

3) Note that the UK does not use the commonly agreed methodology in calculating output gaps and cyclically adjusted balances.

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	2004/05	2005/06	2006/07	2007/08	2008/09
Real GDP growth (%)						
Previous update		3¼	3	2½	2¼	2¼
Current update		2¾	1¾	2¼	3	2¾
Difference		-½	-1¼	-½	¾	½
General government net lending (% of GDP) [1]	EDP B.9					
Previous update		-3.1	-2.8	-2.7	-2.2	-2.0
Current update		-3.3	-3.0	-2.7	-2.3	-1.9
Difference		-0.2	-0.2	0.0	-0.1	0.1
General government gross debt (% of GDP)						
Previous update		40.9	41.8	42.4	42.8	42.8
Current update		40.9	43.3	44.4	44.8	44.7
Difference		0.0	1.5	2.0	2.0	1.9

Notes (COM):
1) Note that the figure for General Government balance published in the Convergence Programme and reported in this table does not take into account Eurostat decision on treatment of UMTS. Hence the difference with the figures recalculated by the Commission services.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2004-05	2014-15	2024-25	2034-35	2044-45	2054-55
Total expenditure [5]		**41.1**	**41.2**	**42.1**	**43.6**	**43.9**	**45.3**
Of which: age-related expenditures		**20.4**	**21.6**	**22.5**	**23.9**	**24.4**	**25.8**
Pension expenditure[1]		5.0	5.0	5.1	5.5	5.8	6.6
Social security pension							
Old-age and early pensions							
Other pensions (disability, survivors)							
Occupational pensions (if in general government)[2]		1.5	1.7	2.0	2.2	2.1	2.1
Health[3] care		8.4	9.5	10.0	10.8	11.2	11.7
Of which Long-term care [4]		1.2	1.3	1.4	1.6	1.7	1.9
Education expenditure [6]		5.5	5.4	5.4	5.4	5.3	5.4
Other age-related expenditures							
Interest expenditure							
Other spending		20.7	19.6	19.6	19.7	19.5	19.5
Total revenue		**37.3 ***	**39.7**	**40.4**	**41.3**	**41.5**	**41.9**
Of which: property income							
of which: from pensions contributions (or social contributions if appropriate)							
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government liabilities)							
Assumptions							
			2014-15 to 2023-25	**2024-25 to 2033-34**	**2034-35 to 2043-44**	**2044-45 to 2053-54**	
Labour productivity growth[7]			2	2	2	2	
Employment growth[8]	-	-	0	0	0	0	-
Real GDP growth			2	2	2	2	
Participation rate males (aged 20-64)							
Participation rates females (aged 20-64)							
Total participation rates (aged 20-64)							
Unemployment rate							
Population aged 65+ over total population							

Notes(UK):
1) Defined as the sum of basic state pension, incl. the State Second Pension, Minimum Income Guarantee and Pension Credit, Over 75 TV licences, and Christmas Bonus.
2) Public service pensions
3) Gross NHS spending
4) Excluding long-term care provided within the NHS which is accounted for Under Health.
5) Total spending incl. gross investment but excl. interests and dividends payments.
6) Excluding interest and dividends received.
7) Productivity growth is 1¾ per cent and 2¼ per cent in the low and high productivity scenarios respectively.
8) Employment provided in terms of rates of growth (not in levels)
Note (COM):
* Note that the figure for Total revenue published in the Convergence Programme and reported in this table does not take into account Eurostat decision on treatment of UMTS. Hence the difference with the figures recalculated by the Commission services.

Table 8. Basic assumptions This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	2004	2005	2006	2007	2008
Short-term interest rate [1] (annual average)					
Long-term interest rate (annual average)					
USD/€ exchange rate (annual average) (euro area and ERM II countries)					
Nominal effective exchange rate					
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)					
World GDP	5	4¼	4¼	4¼	4
World excluding EU, GDP growth					
G7*	2½	2¾	2¼	1¾	1¾
EU GDP growth					
Euro area	1¾	1½	1¾	2	2¼
Growth of relevant foreign markets **	9¼	6	7	6¾	6¼
World import volumes, excluding EU					
Oil prices, (Brent, USD/barrel) [2]			56		

Notes (UK):
* G7: US, Japan, Germany, France, UK, Italy and Canada
** UK exports markets: Other countries' imports of UK good and services weighted according to their importance in UK exports
Notes (COM):
1) If necessary, purely technical assumptions.
2) Assumption used in the public finances projections, but not necessarily in the macroeconomic scenario.

Note: some of the missing data has been subsequently provided by UK officials and thus has been considered in the main body of this assessment.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].	**n/a**		1 December deadline does not apply to the UK
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		Broadly consistent but section on institutional issues

Guidelines in the new code of conduct	Yes	No	Comments
			is missing.
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).		X	
The programme provides all compulsory information in these tables.		X	Employment, unemployment, wage inflation not provided. Detailed breakdown of general government expenditure not provided for the last year required. The split in central/local government finances is not provided. Some of the gaps have been filled through informal discussions with UK officials.
The programme provides all optional information in these tables.		X	Government consumption and investment deflator not provided. Hours worked not provided. Net lending by sub-sector not provided. The functional representation of expenditure is not complete.
The concepts used are in line with the European system of accounts (ESA).		X	Concepts are broadly in line but there are slight differences
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	Informal contact with UK officials however clarify that this has been the case.
b. Economic outlook			
Significant divergences between the national and the Commission services' economic forecasts are explained[2].	X		No significant divergence
The possible upside and downside risks to the economic	X		

Guidelines in the new code of conduct	Yes	No	Comments
outlook are brought out.			
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.		X	MTO not presented in quantitative terms
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.		X	
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary			

Guidelines in the new code of conduct	Yes	No	Comments
additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.			
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X		
– Member States should avoid pro-cyclical fiscal policies[2].			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].			X (deadline for taking effective action is 24 July 2006)
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.			X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the	X		

Integrated guidelines	Yes	No	Not applicable
composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public expenditure and the achievement of policy objectives and ensure the overall coherence of reform packages.			
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[47]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

.

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax

[47]Private and corporate income taxes are generally not provided, either in the programme or in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

elasticity[48]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon'_{T_i,B_i}\varepsilon'_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon'_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon'_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i \varepsilon_{T_tB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

[48]The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

Assessment of tax projections by major tax category

Note: the split between elasticity and composition component for the tax projections in the convergence programme is made on the basis of a broad approximation of compensation of employees that are not included in the convergence programme, and thus should not be considered particularly reliable.

	2005/06		2006/07		2007/08	p.m.:
	COM	**CP**	**COM[2]**	**CP**	**CP**	**OECD[1]**
Taxes on production and imports:						
Change in tax-to-GDP ratio	0.0	0.2	0	0.0	0.0	/
Difference	*0.2*		*0.1*		*/*	/
of which[3]: - elasticity component[4]	*0.4*		*0.0*		*/*	/
- composition component	*-0.2*		*0.1*		*/*	/
p.m.: Observed elasticity:						
- of taxes to tax base[4]	0.7	1.3	1.1	1.2	1.0	1
- of tax base[4] to GDP	1.4	1	0.8	0.8	0.9	1
Social contributions:						
Change in tax-to-GDP ratio	0.2	0.2	0.0	0.0	0.0	/
Difference	*0.0*		*0.0*	*0.0*	*/*	/
of which[3]: - elasticity component	*0.3*		*0.1*	*0.0*	*/*	/
- composition component	*-0.2*		*-0.1*	*0.0*	*/*	/
p.m.: Observed elasticity:						
- of taxes to tax base[5]	1.0	2.0	1.0	1.3	1.2	1.3
- of tax base[5] to GDP	1.6	1	0.9	0.8	0.9	0.7
Personal income tax[6]:						
Change in tax-to-GDP ratio	0.5	0.3	0.1	0.2	0.0	/
Difference	*-0.2*		*0.1*		*/*	/
of which[3]: - elasticity component	*0.4*		*0.3*		*/*	/
- composition component	*-0.4*		*-0.1*		*/*	/
p.m.: Observed elasticity:						
- of taxes to tax base[5]	1.3	1.8	1.3	1.7	1.1	1.7
- of tax base[5] to GDP						0.7
Corporate income tax[6]:						
Change in tax-to-GDP ratio	0.4	0.6	0.2	0.6	0.2	/
Difference	*0.2*		*0.4*		*0.0*	/
of which[3]: - elasticity component	*-0.4*		*0.3*		*-0.1*	/
- composition component	*2.0*		*0.1*		*0.0*	/
p.m.: Observed elasticity:						
- of taxes to tax base[7]	19.3	5.3	2.0	3.2	1.7	1.0
- of tax base[7] to GDP	0.2	1.1	1.1	1.3	1.1	1.3

Notes:
[1]OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Note: the convergence programme does not provide data for compensation of employees. For this analysis the Commission used a proxy. Thus the elasticity component of the UK projections should be considered with extreme caution.
Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth include non-oil corporation tax, corporation tax from oil companies, and petroleum revenues tax and North sea royalties
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Assessment of tax elasticities by major tax category

	2006/07		2007/08	
	COM [1] **(observed)**	**ex-ante**[2]	**COM**[2] **(observed)**	**ex-ante**[1]
Taxes on production and imports: Change in tax-to-GDP ratio	0	0	-0.1	0
Difference *of which*[3]*: - elasticity component* *- composition component*	*0* *- 0.1* *0.1*		*-0.1* *0* *-0.1*	
p.m.: Observed elasticity: - of taxes to tax base[4] - of tax base[4] to GDP	1.1 0.8	1 1	1 0.8	1 1
Social contributions: Change in tax-to-GDP ratio	0	0	0	0
Difference *of which*[3]*: - elasticity component* *- composition component*	0 *-0.1* *0.1*		0 *-0.1* *0.1*	
p.m.: Observed elasticity: - of taxes to tax base[5] - of tax base[5] to GDP	1 0.9	1.3 0.7	1 1	1.3 0.7
Personal income tax[6]**:** Change in tax-to-GDP ratio	0.1	0.1	0.2	0.1
Difference *of which*[3]*: - elasticity component* *- composition component*	*0* *-0.2* *0.1*		*0.1* *-0.1* *0.1*	
p.m.: Observed elasticity: - of taxes to tax base[5] - of tax base[5] to GDP	 1.6 0.9	 1.7 0.7	 1.6 1	 1.7 0.7
Corporate income tax[6]**:** Change in tax-to-GDP ratio	0.2	0.1	0.2	0.1
Difference *of which*[3]*: - elasticity component* *- composition component*	0.1 *0.1* *0.1*		0.1 *- 0.1* *0.1*	
p.m.: Observed elasticity: - of taxes to tax base[7] - of tax base[7] to GDP	 1.3 1.1	 1.1 1.7	 1.3 1.1	 1.1 1.7

Notes:
[1] Commission forecast does not incorporate subsequent discretionary measures announced in the PBR, worth around 0.2% of GDP from 2006/07.
Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2] On a no-policy change basis
[3] The decomposition is explained in the text above
[4] Tax base = private consumption expenditure
[5] Tax base = compensation of employees
[6] Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7] Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Annex 5: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	**SCP**	**EPC**	**SCP**	**EPC**	**SCP**	**EPC**	**SCP**
Labour productivity growth	**2.4**	**2.0**	**2.2**	**2.0**	**1.7**	**2.0**	**1.7**	**2.0**
Real GDP growth	**3.0**	**2.0**	**2.1**	**2.0**	**1.3**	**2.0**	**1.3**	**2.0**
Participation rate males (aged 15-64)	**82.7**	**n.a.**	**83.2**	**n.a.**	**82.6**	**n.a.**	**82.5**	**n.a.**
Participation rates females (aged 15-64)	**70.1**	**n.a.**	**72.5**	**n.a.**	**73.2**	**n.a.**	**74.0**	**n.a.**
Total participation rates (aged 15-64)	**76.4**	**n.a.**	**77.9**	**n.a.**	**77.9**	**n.a.**	**78.3**	**n.a.**
Unemployment rate	**4.6**	**5.0**	**4.6**	**5.0**	**4.6**	**5.0**	**4.6**	**5.0**
Population aged 65+ over total population* **	**16.6**	**28.3**	**19.5**	**33.0**	**22.9**	**40.2**	**26.5**	**44.8**

Note: * SCP shows the 65+ over 16-64 ratio, ** SCP shows 2014, 2024, 2034 and 2054, respectively.

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)		**2010**	**2020**	**2030**	**2040**	**2050**	**changes**	**Impact on S2**
Total age-related spending		21.5	22.1	23.3	24.2	25.2	3.7	3.1
Pensions		6.6	6.9	7.5	7.8	8.4	1.8	1.5
Health care		8.2	8.4	9.0	9.4	9.7	1.5	1.2
Long-term care		1.3	1.4	1.5	1.7	1.8	0.6	0.5
Education		5.4	5.4	5.4	5.3	5.4	-0.1	-0.1
Unemployment benefits		0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total primary non-age-related spending		18.4	18.4	18.4	18.4	18.4	0.0	0.0
Total revenues		40.6	40.6	40.6	40.6	40.6	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

	S1	**S2**
2005/06 scenario	**0.4**	**0.2**
Programme scenario	**0.2**	**0.1**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)		**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Programme scenario							
Gross debt		44.4	44.1	54.0	77.2	110.3	65.9
*Gross debt, i + 1**		*44.4*	*48.7*	*64.5*	*96.4*	*143.0*	*98.6*
*Gross debt, i - 1**		*44.4*	*39.9*	*45.3*	*62.4*	*86.9*	*42.5*
Adjusted gross debt		44.4	44.1	54.0	77.2	110.3	65.9
2005/06 Scenario							
Gross debt		47.0	62.7	90.1	132.5	186.7	139.7
*Gross debt, i + 1**		*47.0*	*68.2*	*104.5*	*161.1*	*237.3*	*190.3*
*Gross debt, i - 1**		*47.0*	*57.6*	*77.9*	*110.0*	*149.3*	*102.4*
Adjusted gross debt		47.0	62.7	90.1	132.5	186.7	139.7

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.