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**ECONOMIC ASSESSMENT  
OF THE CONVERGENCE PROGRAMME OF UNITED KINGDOM  
(UPDATE OF DECEMBER 2006)**

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The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. The most recent update of UK’s convergence programme was submitted on 18 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 6 February 2007. Comments should be sent to Pietro Toigo and Pilar Garcia Martinez ([pietro.toigo@ec.europa.eu](mailto:pietro.toigo@ec.europa.eu) or [pilar.garcia-martinez@ec.europa.eu](mailto:pilar.garcia-martinez@ec.europa.eu)). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted an assessment of the programme as well as a recommendation for a Council opinion on the programme on 13 February 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

**[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm)**

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## SUMMARY AND CONCLUSIONS<sup>1</sup>

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency such as the United Kingdom, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2006/07-2011/12<sup>2</sup> was submitted on 18 December 2006. Under the corrective arm of the Pact, on 24 January 2006, the Council decided that the United Kingdom was in excessive deficit and addressed a recommendation that the excessive deficit be corrected by financial year 2006/07.

The United Kingdom's economic performance over the past ten years has been strong, with relatively high rates of growth, low inflation and resilient labour markets that have weathered a number of economic shocks. Improved stability has been a particularly significant feature, with a flattening of cyclical fluctuations in output and with lower inflation volatility. Strong output growth has been mainly supported by robust household consumption, which has been matched by relatively low household saving. Despite flexibility in labour, capital and product markets being remarkable on most measures, some supply-side weaknesses have proved resistant to improvement. The relatively lacklustre productivity can be explained to some extent by comparatively high levels of employment, although lack of intermediate skills and underinvestment in infrastructure such as transport are likely also to play a role. Compared with the marked fiscal consolidation seen in the first part of the period, the public finances have significantly deteriorated from 2001 onwards, partly planned, reflecting the government's decision to address some of these issues through not fully funded increased expenditure on public services, but also due to shortfalls in planned revenues.

This background suggests three main challenges for fiscal policy in the United Kingdom. First, the fiscal stance remains loose. In order to consolidate while avoiding the disincentive effects associated with further increases in the tax burden, future growth of expenditure needs to be reined in to below that of potential output. Secondly, the long-term sustainability of the public finances needs to be ensured while at the same time delivering more adequate overall pension provision. Thirdly, the expansion of the public sector as a share of total output and employment, together with the increase in ratios to GDP of revenue and expenditure over the past five years increases the importance of ensuring the effectiveness and productivity of public expenditure in order to limit possible disincentive and distortionary effects on both revenue and expenditure sides.

The convergence programme contains two macroeconomic scenarios: a central scenario and an alternative scenario which is based on trend growth a quarter percentage point lower than in the central scenario. The projections for the public finances in the update of the convergence programme are based on the latter scenario, which is considered the reference scenario for this assessment. It envisages real GDP growth of 2¾% in 2006 and

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<sup>1</sup> The analysis takes into account (i) the Commission services' autumn 2006 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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

<sup>2</sup> The UK financial year runs from April to March.

2007, easing to 2½% on average over the rest of the programme period. Based on currently available information, this scenario appears to be based on plausible growth assumptions. The projections for inflation is expected to decline to 2% from 2007 on, but appears to be on the low side in the very short term, in the light of outturns published after the forecast in the convergence programme was finalised. Overall, the United Kingdom was judged to be neither in bad or good times.

For 2006/07, the general government deficit is estimated at 3.0% of GDP in the Commission services' autumn 2006 forecast. The current update of the convergence programme estimates a deficit of 2.8% of GDP for the same year, which implies recent trends, showing robust growth in revenues and slower growth in expenditure, being maintained in the remaining months of the financial year

The key objectives for fiscal policy as identified in the convergence programme update are to ensure long-term sustainability, intra- and intergenerational fairness and, subject to this, to support monetary policy, in particular by allowing the automatic stabilisers to smooth the path of the economy. The programme projects a reduction of the deficit below 3% of GDP by 2006/07 (2.8%) and to 1.4% of GDP by the end of the projection period in 2011/12. The primary balance is expected to return to balance by 2008/09 and to reach a small surplus by 2011/12. The budgetary adjustment over the projection period is equally distributed between revenues and expenditure. From 2007/08 the deficit is projected to be used entirely to fund public investment.

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is projected to improve from 2 ½ % of GDP in 2006/07 to about 1 ¼ % of GDP in the final programme year, 2011/12. This adjustment is more marked between 2006/07 and 2008/09 but slows thereafter. As in the 2005 update, a quantitative medium-term objective (MTO) for the structural balance is not specified. The programme refers to fiscal objectives under the domestic rules, which are consistent with stabilising the debt-to-GDP ratio at a relatively low level, but provides a safety margin with respect to the 3% of GDP general government deficit threshold only in certain circumstances.

The risks to the budgetary projections in the programme appear broadly balanced up to 2007/08 but the budgetary outcomes could be worse than projected in the programme thereafter, depending on the implementation of spending controls. While the UK authorities have pre-announced a reduction in the budgetary allocation for a number of smaller departments, the greatest part of the expenditure moderation from 2008/09 is not yet underpinned by specific measures but is subject to confirmation in the authorities' Comprehensive Spending Review, planned for July 2007. The record of active monitoring to enforce expenditure limits is positive.

In view of this risk assessment, the budgetary stance in the programme appears broadly consistent with a correction of the excessive deficit by 2006/07, as recommended by the Council. However, it provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations only around 2009/10, when the projections are subject to the outcome of the Comprehensive Spending Review. In the years following the correction of the excessive deficit, the pace of fiscal consolidation implied by the programme should thus be strengthened, especially towards the end of the projection period.

The long-term budgetary impact of ageing in the UK is close to the EU average, with pension expenditure showing a somewhat more limited increase than on average in the EU, in part as a result of the UK's historically relying relatively more on private pension

arrangements than have other EU countries. The proposed reforms to pension provision address the concern of potentially inadequate provision in the future, by strengthening the incentives for private savings for retirement and by increasing provision of public pensions, thus involving a slightly higher increase in public pension expenditure than previously projected; the reform also incorporates a planned gradual increase in the statutory state pension age. The initial budgetary position, though improved compared to 2005, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Consolidating the public finances by strengthening the budgetary position further than planned in the convergence programme would thus contribute to reducing risks to the sustainability of public finances. Overall, the UK appears to be at medium risk with regard to the sustainability of public finances.

The implementation report of the national reform programme of the United Kingdom, submitted on 16 October 2006, identifies as key priorities: maintaining fiscal sustainability in the face of demographic challenges; building an enterprising and flexible business sector, promoting innovation and R&D; widening opportunities for the acquisition of skills; increasing innovation and adaptability in the use of resources; and ensuring fairness through a modern and flexible welfare state. The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report<sup>3</sup>) showed that the United Kingdom is making good progress in the implementation of its national reform programme, particularly in micro-economic and employment policy. Against the background, the United Kingdom was recommended to take action in the areas of basic and intermediate skills. The convergence programme and the national reform programme are well integrated, with the convergence programme projections incorporating for example the financial impact of pension reform and reporting on measures to improve effectiveness of public expenditure.

The overall conclusion is that the updated convergence programme seems broadly consistent with a correction of the excessive deficit by the deadline set by the Council (financial year 2006/07), provided that current fiscal trends are confirmed in the last months of the current financial year. However, the estimated structural adjustment slows down considerably after 2009/10 and the achievement of the budgetary targets after 2007/08 is subject to the effective implementation of the projected expenditure restraint. In implementing these expenditure restraints, a continued focus on efficiency of public expenditure will be essential to achieve fiscal consolidation while continuing to fund expenditure on public services and investment in infrastructure. Finally, while the reforms to the pension system being implemented appear to address concerns on the adequacy of public pension provision, sustainability considerations recommend attention be paid to the further strengthening of long-term public finances.

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<sup>3</sup> Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery", 12.12.2006, COM(2006)816.

## Comparison of key macroeconomic and budgetary projections

		2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Real GDP (% change)	<b>CP Dec 2006<sup>1</sup></b>	<b>1 ¾</b>	<b>2 ¾</b>	<b>2 ¾</b>	<b>2 ½</b>	<b>2 ½</b>	<b>2 ½</b>	<b>2 ½</b>
	COM Nov 2006 <sup>2</sup>	1.9	2.7	2.6	2.4	n.a.	n.a.	n.a.
	<i>CP Dec 2005<sup>1</sup></i>	<i>1¾</i>	<i>2¼</i>	<i>3</i>	<i>2¾</i>	<i>2¼</i>	<i>2¼</i>	<i>n.a.</i>
HICP inflation (%)	<b>CP Dec 2006<sup>1</sup></b>	<b>2</b>	<b>2 ½</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>2</b>
	COM Nov 2006 <sup>2</sup>	2.1	2.4	2.2	2.0	n.a.	n.a.	n.a.
	<i>CP Dec 2005</i>	<i>2¼</i>	<i>2</i>	<i>2</i>	<i>2</i>	<i>2</i>	<i>2</i>	<i>n.a.</i>
Output gap (% of potential GDP)	<b>CP Dec 2006<sup>3</sup></b>	<b>-0.5</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.6</b>	<b>-0.5</b>	<b>-0.4</b>	<b>-0.3</b>
	COM Nov 2006 <sup>2,4</sup>	-0.3	-0.4	-0.5	-0.7	n.a.	n.a.	n.a.
	<i>CP Dec 2005<sup>3</sup></i>	<i>-0.5</i>	<i>-1.0</i>	<i>-0.8</i>	<i>-0.5</i>	<i>-0.6</i>	<i>-0.6</i>	<i>n.a.</i>
General govt. balance (% of GDP)	<b>CP Dec 2006<sup>5,6</sup></b>	<b>-2.9</b>	<b>-2.8</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.4</b>
	COM Nov 2006 <sup>6,7</sup>	-2.9	-3.0	-2.7	-2.5	n.a.	n.a.	n.a.
	<i>CP Dec 2005<sup>5</sup></i>	<i>-3.1</i>	<i>-2.8</i>	<i>-2.4</i>	<i>-1.9</i>	<i>-1.7</i>	<i>-1.5</i>	<i>n.a.</i>
Primary balance (% of GDP)	<b>CP Dec 2006<sup>8</sup></b>	<b>-0.8</b>	<b>-0.6</b>	<b>-0.2</b>	<b>0.1</b>	<b>0.3</b>	<b>0.5</b>	<b>0.7</b>
	COM Nov 2006	-0.9	-1.0	-0.6	-0.4	n.a.	n.a.	n.a.
	<i>CP Dec 2005<sup>8</sup></i>	<i>-1.0</i>	<i>-0.7</i>	<i>-0.3</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
Cyclically- adjusted balance (% of GDP)	<b>CP Dec 2006<sup>3,5</sup></b>	<b>-2.7</b>	<b>-2.5</b>	<b>-2.1</b>	<b>-1.7</b>	<b>-1.5</b>	<b>-1.4</b>	<b>-1.3</b>
	COM Nov 2006 <sup>4</sup>	-2.8	-2.8	-2.4	-2.2	n.a.	n.a.	n.a.
	<i>CP Dec 2005<sup>3</sup></i>	<i>-2.9</i>	<i>-2.3</i>	<i>-2.1</i>	<i>-1.7</i>	<i>-1.5</i>	<i>-1.3</i>	<i>n.a.</i>
Structural balance <sup>9</sup> (% of GDP)	<b>CP Dec 2006<sup>3,5</sup></b>	<b>-3.0</b>	<b>-2.5</b>	<b>-2.1</b>	<b>-1.7</b>	<b>-1.5</b>	<b>-1.4</b>	<b>-1.3</b>
	COM Nov 2006 <sup>4</sup>	-3.1	-2.8	-2.4	-2.2	n.a.	n.a.	n.a.
	<i>CP Dec 2005</i>	<i>-2.9</i>	<i>-2.3</i>	<i>-2.1</i>	<i>-1.7</i>	<i>-1.5</i>	<i>-1.3</i>	<i>n.a.</i>
Government gross debt (% of GDP)	<b>CP Dec 2006</b>	<b>42.7</b>	<b>43.7</b>	<b>44.1</b>	<b>44.2</b>	<b>44.2</b>	<b>44.0</b>	<b>43.6</b>
	COM Nov 2006	42.1	42.5	43.4	44.1	n.a.	n.a.	n.a.
	<i>CP Dec 2005</i>	<i>43.3</i>	<i>44.4</i>	<i>44.8</i>	<i>44.7</i>	<i>44.6</i>	<i>44.4</i>	<i>n.a.</i>



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.
- 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.
- 4) Output gaps based on potential growth estimates of 2.8% in 2006, 2.7% in 2007 and 2.6% in 2008.
- 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) Following discussions between Eurostat and the UK Office for National Statistics, it is likely that the write-off of the Nigerian debt, initially classified in the public corporation sector, will be reclassified as a general government transaction. This reclassification is estimated to have a one-off, deficit increasing effect of about 0.1% of GDP both in 2005/06 and in 2006/07.
- 7) Commission services' forecast is before discretionary measures announced in the December 2006 Pre-Budget Report and included in the convergence programme. In the absence of announced expenditure plans from 2008/09 onwards, the Commission services' autumn forecast formulates a technical assumption that expenditure remains constant as a percentage of GDP, while the convergence programme uses a working assumption implying a fall in the expenditure to GDP ratio.
- 8) Data from the convergence programme adapted in line with a definition of the primary balance using gross rather than net interest payments.
- 9) Cyclically-adjusted balance (calculated according to the commonly agreed methodology) excluding one-offs and other temporary measures. One-off and other temporary measures taken from the Commission services' autumn 2006 forecast and based on information provided by the Office for National Statistics (0.3% of GDP in 2005/06).

*Source: 2006 update of the UK Convergence Programme, Commission services' forecast*

## 1. INTRODUCTION

The United Kingdom authorities submitted the eighth update of the convergence programme on 18 December 2006<sup>4</sup>, covering the period from financial year 2006/07 to 2011/12<sup>5</sup> (though many data are only partially available for years beyond 2007/08 as discussed 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”<sup>6</sup>. The projections in the convergence programme update embody those published in the December 2006 Pre-Budget Report on which the programme is based. The budgetary projections in the Pre-Budget Report have a different status than those in the Budget (which is usually presented to Parliament in March/April) as they are an interim forecast update, and do not necessarily represent an outcome the government is seeking.

The update broadly follows the model structure specified in the new code of conduct for stability and convergence programmes<sup>7</sup>. However, the update has gaps both in the provision of compulsory data and in optional data. The lack of information on projections for employment, unemployment and compensation of employees have particularly hindered the Commission services' assessment of the convergence programme update<sup>8</sup>.

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 them on a

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<sup>4</sup> 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 6 December 2006.

<sup>5</sup> The UK financial year runs from April to March.

<sup>6</sup> This refers principally to the discussion and approval in Parliament by a House of Commons committee of MPs of “the Government’s Assessment as set out in the Pre-Budget Report 2006 for the purposes of Section 5 of the European Communities (Amendment) Act 1993”; a similar motion is taken in the upper house. The convergence programme itself is not formally presented to Parliament (unlike the Budget and Pre-Budget Report) nor directly scrutinised. The UK Parliament subjects to formal scrutiny Council Opinions on all stability and convergence programmes, with no special procedure for that on the UK programme. In its 2005/06 session, Parliament deferred clearance of the Council Opinion on the 2005 update of the UK programme, twice requesting the government to provide further information on the reasons for the Council's dissatisfaction on compliance with the data requirements set in the code of conduct (see also Box 1). Following a second government letter to the Committee on 29 November 2006, such clearance was finally given in the current Parliamentary session on 17 January 2007.

<sup>7</sup> While a separate section on institutional features is omitted, these are treated at length in a subsection.

<sup>8</sup> Moreover, the projections for the breakdown of expenditure, including identification of general government fixed capital formation, are not provided beyond 2007/08 (while the code of conduct requires a three years ahead forecast). The programme update contains projections for net public investment and for revenues on a public sector basis (i.e. including public corporations) over the whole projection period, which make it possible to formulate a broad assessment of the fiscal position.

harmonised basis compliant with the Eurostat decision<sup>9</sup>. Box 1 describes in more detail the impact of gaps in data provision on this assessment<sup>10</sup>.

### **Box 1: Compliance with data provision requirements in the Code of Conduct**

The United Kingdom enjoys a robust statistical framework, and the Office for National Statistics provides detailed and frequent publication of data outturns for a wide set of economic and fiscal variables. However, as noted in previous assessments, the United Kingdom convergence programme fails to comply with the requirements set out in the Code of Conduct when it comes to providing information on its projections. In particular, there are four areas of compulsory data provision where the UK programme is deficient:

- Forecast for macroeconomic variables such as employment, unemployment and wage inflation are not provided. These data are needed because, in order to ensure a consistent assessment across all 27 Member States, the Commission services use a common methodology, based on the production function approach, to estimate the cyclical position of the economy. This methodology was agreed by all Member States in the Economic Policy Committee, and requires as input the forecast for employment, unemployment and wage inflation.
- The breakdown of expenditure in its components is provided only up to 2007/08 (one year ahead). This reflects the nature of the UK budgetary framework, whereby detailed budgetary plans are set at fixed intervals in the Spending Review. Because the next spending review has been announced after a three year (rather than two year as in the past) interval from the previous one, the current update of the convergence programme, which is the last before the 2007 Comprehensive Spending Review, will have a particularly short horizon for expenditure plans. Lack of detailed plans make it more difficult for the Commission services to assess future spending risks and pressures, as highlighted in the assessment.
- The breakdown for projections of revenues is also provided only up to 2007/08 on a *general government basis*. However, the convergence programme provides a breakdown for revenue projections on a *public sector basis* (that is, covering not only general government as defined in ESA95, but also public enterprises that are market producers). This provides the Commission services with a reasonable approximation to assess the projections, although it formally represents lack of compliance with the Code of Conduct.
- Even for the years provided, the breakdown of projections for expenditure and revenues use different aggregation methods than the harmonised measure. This mean that the projections are less clearly comparable with the Commission services forecast, requiring a higher degree of approximation in the risk assessment.

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 (see also Section 4.2.3 below). As will be discussed in section 4.2.3, an MTO in the sense of the Stability and Growth Pact cannot be inferred from the projections in the programme. Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

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<sup>9</sup> The principal effect of this adjustment is, relative to 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.

<sup>10</sup> Some gaps been filled through bilateral discussions between the Commission services and UK officials.

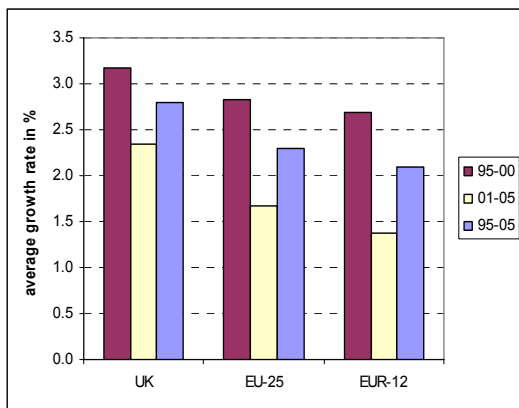
## 2. ECONOMIC TRENDS AND POLICY CHALLENGES

The section is in five parts. The first provides a brief overview of the UK macroeconomic performance in terms of growth and other major macro-variables. The second presents the results of a growth accounting exercise and tries to identify the main reasons for low or high average annual economic growth vis-à-vis the reference aggregate of the euro area. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. Based on the picture outlined in the first four parts, the fifth identifies major economic challenges with implications for public finances.

### 2.1. Economic performance

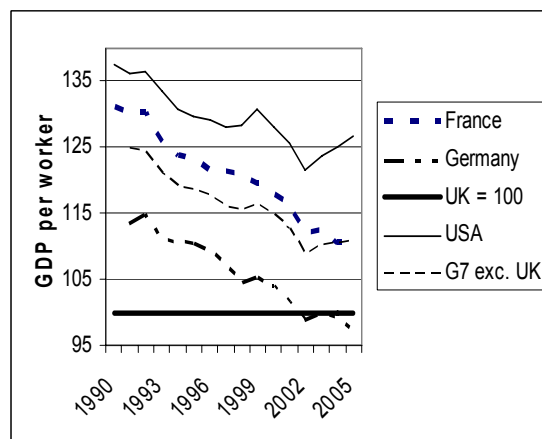
Over the ten years to 2005, macroeconomic performance was remarkably strong and stable (see Table 1 for an overview of key economic indicators). Annual real GDP growth averaged 2.8%, significantly higher than the 2.1% recorded in the euro area (see Figure 1). Domestic demand more than accounted for GDP growth, with the external contribution negative and the external account showing a deficit throughout the period. Unemployment declined from above 8% at the beginning of the period to below 5% in 2005. However, despite good framework conditions, some supply-side weaknesses remain, and productivity has been characterised by a weak evolution. Inflation remained low and relatively stable at 1.5% on average, although HICP inflation rebounded in 2005 mainly due to oil price increases. The public finances moved from a period of fiscal consolidation (1996-2001) to a period of significant loosening (2001-2005). The debt ratio remained relatively low, although the ten-year period saw a phase of debt reduction up to 2000 followed since then by an increase.

**Figure 1: Average GDP growth: UK vs. EU25 and the euro area**



*Source:*  
Commission services

**Figure 2: International comparison of productivity**



*Source:*  
Office for National Statistics, *International Comparison of Productivity, 2006*

Real GDP growth has been entirely driven by domestic demand, dominated by private consumption growth. Consumption has been boosted by the impact on real disposable income of a robust performance of the labour markets. A buoyant housing market (with

house prices increasing at an average annual rate of about 15% over the 96-05 period) has also supported consumer expenditure through both wealth and credit channels, the latter by facilitating higher household sector gearing at relatively low interest rates through the withdrawal of housing equity. Household debt has dramatically increased over recent years (its ratio to income having risen from around 100% in the 1995 to around 150% in 2005) driven by a rise in the proportion of households with a mortgage together with the rise in the median value of new mortgage lending relative to borrower's income. However, risks associated with affordability of debt seem to be at lower levels than in the earlier 1990s<sup>11</sup>, especially after taking into account the decrease in interest rates since the mid-1990s<sup>12</sup>.

Low household saving rates fell further from 2002; at the same time public savings turned negative. However, corporate saving, positively boosted by more difficult external financing conditions following the downturn in financial asset markets, more than offset the decline in household saving with a resulting increase in total private saving.

After relative strong growth over the 1995-2000 period, during the 2001-2005 period, business investment showed relatively sluggish growth despite the generally favourable background conditions (high profitability and low cost of capital and low relative cost of capital goods<sup>13</sup>)<sup>14</sup>.

External demand proved to be a drag on growth for most of the period, with the external balance as a whole averaging a deficit of 1.5% of GDP. Over the period 1995-2005 the balance of trade in goods showed an average deficit of 3.6% of GDP while trade in services generated a steady surplus. The income balance was consistently positive.

The labour market has performed strongly. The unemployment rate fell from about 8% in 1996 to below 5% in 2005. Employment rates have been relatively high compared to the EU average, at around 75%, with comparatively high rates of female participation. The marked expansion of the public sector contributed to support the labour market: of the 1.2 million new jobs created between 2000 and 2005, just below half were in public sector employment. Inactivity rates have also remained relatively stable; in the light of the steady increase in working age population, implying an increase in the number of people outside the labour force. The composition has, however, changed over time, with a decrease in female inactivity and an increase in male inactivity.

Labour market performance owes much to its structural underpinning. Wage bargaining is extensively decentralised and wage agreements are often renegotiated at firm level while statutory employment protection has traditionally been limited (given the low base, there

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<sup>11</sup> According to the Bank of England, the ratio of households' secured debt to income rose from around 75% in 1995 to around 115% in 2005, while unsecured debt increased from around 15% to around 23% respectively.

<sup>12</sup> See Salt, R. and Macdonald, J. (2004) UK household consumption (Part 1): built on a debt mountain?, Directorate-General for Economic and Financial Affairs, Country Focus, vol.1, issue 19.

<sup>13</sup> Explanations include a sizable investment overhang from the late 1990s and measurement issues such as an increase in investment in organisational restructuring and training that are not captured in the national accounts.

<sup>14</sup> More recently, large deficits in corporate pension funds might also have played a role in restraining investment, although survey evidence suggests that this would have a bigger impact on smaller companies which are more credit-constrained and it does not seem to have had a sizable aggregate effect (see Bank of England (2006) Inflation Report, August).

was little significant change to the latter during the 1990s). Nevertheless, building on an already liberalised foundation, a range of further reforms to the labour market were implemented from the late 1990s, aimed at promoting job search while making receipts of out-of-work benefits more contingent on labour market participation; these, matched with means-tested wage subsidies, are also credited with raising employment rates. Since its introduction in 1999, the National Minimum Wage has been kept at a relatively prudent level, and a lower rate for younger (and arguably less productive) workers has been adopted to minimise negative impact on employment<sup>15</sup>. Legislation aimed at easing part-time employment, associated with increased female participation, and encouraging flexible working should also have encouraged flexibility in the labour markets..

The structure of the labour market is one aspect of the economy's broader flexibility. The UK economy is among the most flexible, not only within the EU but globally. Broad and deep supply-side reforms to labour, capital, and product markets going back to the 1980s were further strengthened in the 1990s and subsequently. Product market regulation is extremely light and according to the OECD's indicator this is consistently so across the domains of state control and barriers to enterprise and trade and investment, with the UK scoring overall ahead of all other OECD members<sup>16</sup>. Level of competition are high and underpinned by a robust legal framework.

Despite the supply-side flexibility and strong macroeconomic performance, the UK economy has been characterised by a lower level of labour productivity compared to other EU economies and the USA (see Figure 2), although thanks to inter alia the comparatively high growth rate of TFP (shown in Figure 4) recent years has seen progress towards closing the gap relative to the larger EU economies. The productivity gap with France and to a lesser extent with Germany can be largely explained by the higher rates of employment in the UK, and thus the likely participation in the labour force of less-skilled workers, and by a relatively low stock of capital per worker due to subdued physical and human capital investment rates. The recent expansion in public sector employment, where productivity growth is traditionally lower, might also have contributed to the productivity gap. However, lower levels of intermediate skills in the UK, regardless of employment levels, remains an important explanatory factor. A significant part of the gap with the USA remains unexplained and is generally attributed to the US's superior levels of innovation and efficiency.

## **2.2. Anatomy of medium-term growth**

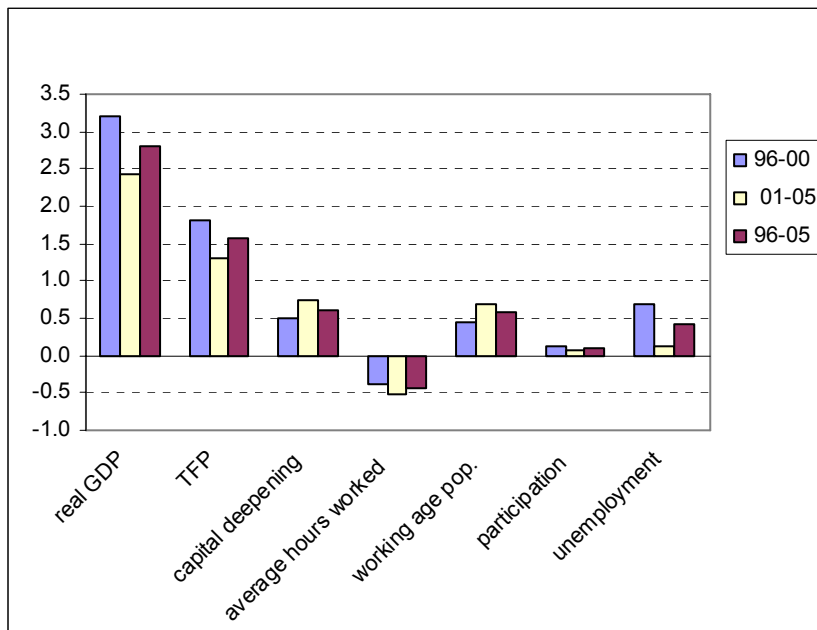
Within the framework of a traditional growth accounting exercise, this section dissects the sources of high or low average growth as well as possible differences in average economic growth vis-à-vis the euro area. The growth accounting exercise is carried out on the basis of a Cobb-Douglas production function, the results of which is shown in Figure 3 for real GDP over the 1996-2005 period. When comparing with the euro-area average, the UK positive real GDP growth rate differential is mainly explained by total factor productivity. The different trends of the employment components do not show a significant contribution to the UK real GDP growth nor to the growth differentials when compared with the euro area (see Figure 4).

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<sup>15</sup> Over the past two years however the minimum wage has risen significantly as a share of average earnings, reaching 41% of average hourly earnings, from 29% when it was introduced in 1999.

<sup>16</sup> OECD (2000) Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation Economics Department Working Paper 226 and OECD (2005) Product Market Regulation in OECD Countries: 1998 to 2003 , Economics Department Working Paper 419.

**Figure 3: Real GDP growth and its components**



Note:

Assuming a Cobb-Douglas-production function  $Y = A(L \cdot H)^\alpha K^{1-\alpha}$  where  $Y$  denotes the level of *GDP*,  $L$  employment,  $H$  the average hours worked per person employed,  $K$  the capital stock and  $\alpha$  the labour share in income, real GDP can be written as  $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left( \frac{K}{H \cdot L} \right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1-ur)$  where  $WP$  stands for working age population,  $PART$  denotes the participation ratio as a share of  $WP$  and  $ur$  the rate of unemployment. In terms of growth rates  $g$  this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression  $(g_K - g_L - g_H)$  is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source:

Commission services

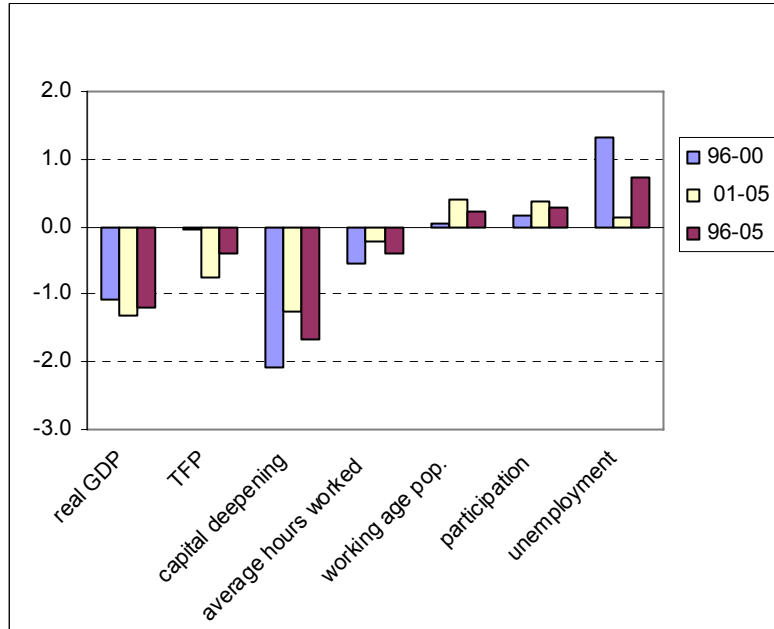
Faster TFP growth explains part of the progress in reducing the UK productivity gap. However, as shown in Figure 2, part of the UK productivity gap narrowing was more due to the weaker productivity record of the UK's main competitors than to the UK's own productivity outcomes which were rather feeble, in particular in those sectors with an important ICT capital share<sup>17</sup>. Measurement issues, especially for sectors such as ICT, could have played a role in reducing recorded UK productivity. The share in total output of the public sector (whose productivity is typically low) has risen. In the UK, incorporation of direct productivity measures together with a rapid increase in public sector resources has resulted in a less than proportional impact on outcomes and negative recorded public service productivity growth<sup>18</sup>.

<sup>17</sup> O'Mahony, M. and de Boer, W. (2002) Britain's relative productivity performance: Updates to 1999, National Institute of Economic and Social Research, March.

<sup>18</sup> By contrast, in other countries which have continued to rely on proxying public sector productivity growth by growth of inputs, an increase in public expenditure will result in proportional increases in productivity.

UK innovation performance looks rather poor by most standards (such as R&D intensity, patents, etc) which appears to be consistent with the fact that the UK economy is skewed towards services and industries where R&D intensity is lower.

**Figure 4: Real GDP growth and its components: Difference vis-à-vis euro area**



Note:

See note of Figure 3

Source:

Commission services

The production function approach underlying the commonly agreed method for the assessment of stability and convergence programmes can be written as:

(1)  $Y = A(L \cdot H)^\alpha K^{1-\alpha}$  where  $A$  is an index measuring the level of technology,  $L$  stands for labour,  $H$  for the average number of hours worked and  $K$  for the stock of capital. In terms of growth rates  $g$  the production function implies:

$$(2) g_Y = g_A + \alpha(g_L + g_H) + (1-\alpha)g_K \text{ or}$$

$$(3) [g_Y - (g_L + g_H)] = \left(\frac{1}{\alpha}\right)g_A + \left(\frac{1-\alpha}{\alpha}\right)(g_K - g_Y).$$

where  $g_Y$ ,  $g_L$ ,  $g_H$  and  $g_K$  are the (average) growth rates of output, the labour head count, average hours worked and capital respectively and  $\alpha$  is the share of labour in output.  $g_A$  measures that part of (average) growth that cannot be explained by either growth of labour or capital. This term is referred to as the growth rate of total factor productivity (TFP). The third equation states that there can be labour productivity growth (= the term on the left-hand side) even if TFP (growth) is zero, as long as the capital-output ratio increases. However, empirical estimates suggest capital has grown at a rate roughly equal to that of output, that is  $g_K - g_Y$  has been close to zero and the capital output ratio has remained broadly constant. Clearly,  $g_L$  can be decomposed into the growth rate of working age population, the rate of change of labour force participation and the rate of change of the unemployment rate.



Real GDP can be written as:

$$(4) \quad Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left( \frac{K}{H \cdot L} \right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1-ur)$$

where WP stands for working age population, PART denotes the participation ratio as a share of WP and ur the rate of unemployment. In terms of growth rates g this is:

$$(5) \quad g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression  $(g_K - g_L - g_H)$  is generally referred to as capital deepening, i.e. the increase in the capital labour ratio.

A detailed presentation of the production function approach can be found in [Denis, C. and D. Grenouilleau, K. Mc Morrow and W. Roeger \(2006\) Calculating potential growth rates and output gaps – A revised production function approach, Economic Paper No. 247.](#)

The UK has shown a higher participation rate when compared with the euro area. The negative contribution of the UK participation rate to real GDP growth differential which Figure 4 shows could be mainly explained by relatively larger recent improvements in the euro area. The UK participation rate has continued to increase, as shown in Figure 3, but at a lower speed than in the euro area, probably due to the difficulties of increasing the already high participation rate still further. Growth of the working age population has shown a larger positive contribution, when compared with the euro area, mainly due to high immigration. The UK has received significant flows of immigrants that have increased from 2004 onwards with the accession of ten new EU Member States<sup>19</sup>. The relative contribution of total hours worked has remained broadly flat, reflecting the trend in total hours worked, since the rise in the number of people in employment has coincided with a decline in the average hours worked.

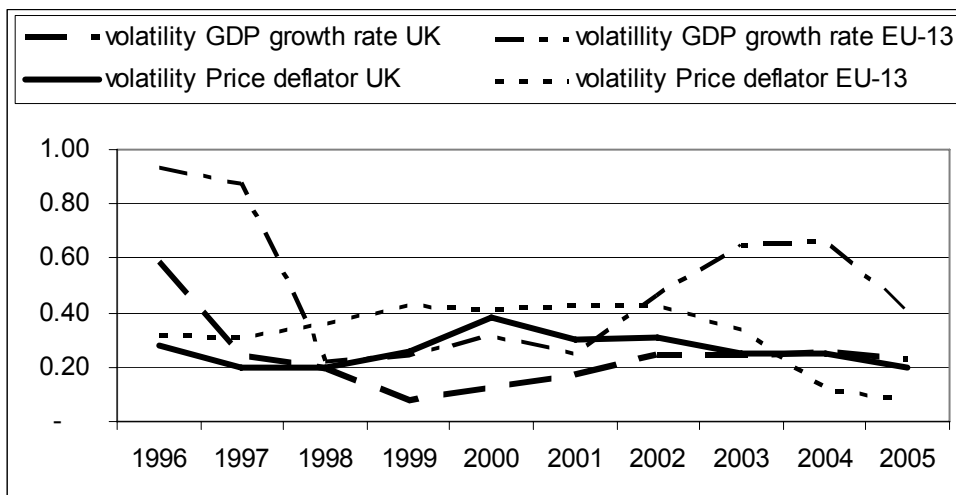
### 2.3. Macro-policies against the backdrop of the economic cycle

As well as growing relatively strongly on average, the UK economy has also proved remarkably stable, with volatility of GDP growth and particularly inflation significantly reduced in the period under consideration compared with earlier experience. Already for some time, the economic cycle in the UK appears to be more stable than in the euro area, with GDP remaining closer to potential, reflecting the decreased volatility of economic growth in the UK, as Figure 5 below shows.

#### Figure 5: Volatility of inflation and GDP

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<sup>19</sup> The UK, Sweden and Ireland were the only EU-15 countries which granted relatively unfettered access to their domestic labour markets to citizens of the newly acceded Member States in 2004. It is officially estimated that immigration in the UK amounted to 582,000 units (1% of the population) in 2004 of which 48,000 were from the recently acceded Member States (RAMS). This trend accelerated in 2005, with 588,000 immigrants into the UK, of which 74,000 were from the RAMS.



*Note:* volatility is measured as the coefficient of variation of rates of growth over a rolling 5 years period. Inflation is measured as the private consumption price deflator.

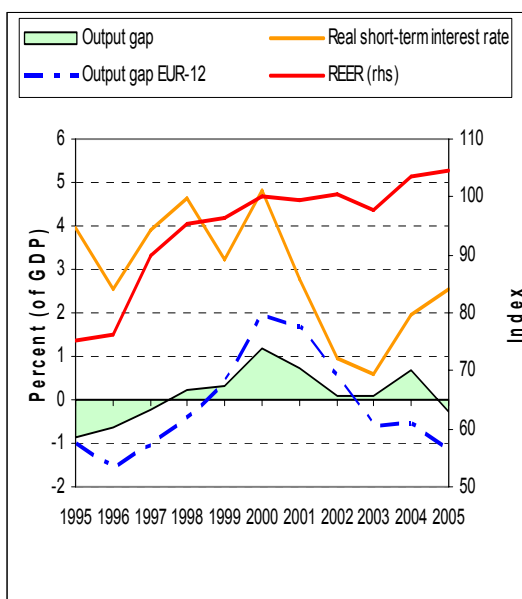
*Source:* Office for National Statistics and European Commission services

The reasons for a decreased macroeconomic volatility might be many, ranging from structural factors such as increased flexibility in the labour and product markets to institutional reforms that have facilitated macroeconomic management, such as a monetary policy framework that allows the Bank of England to stabilise the economy more actively and credibly<sup>20</sup>. It is important to note, however, that the United Kingdom has also seen over the same period significant financial and real asset price volatility. At one level this has complicated the task of macroeconomic management, although the sustained boom in the housing market helped support the economy during the global slowdown in 2001-02 and thus contributed to the output stability reported here.

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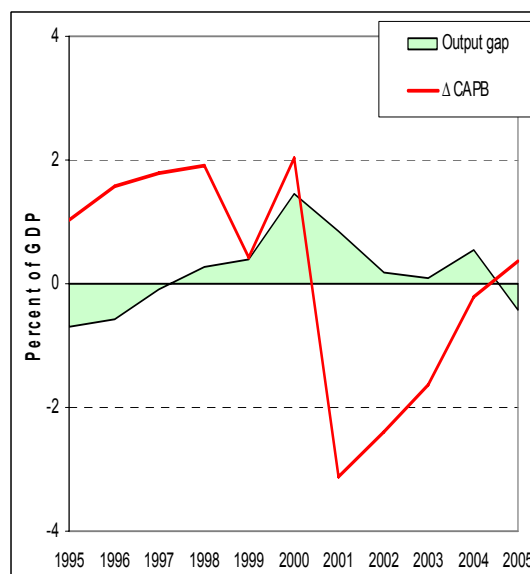
<sup>20</sup> Another important institutional reform implemented over the past ten years is the introduction of a new fiscal and budgetary framework, which alongside two numerical fiscal rules has introduced a set of transparency and reporting requirements (including an external audit of some of the budgetary projections), a longer time horizon for budgetary planning and a stronger focus on performance budgeting.

**Figure 6: Output gap and monetary conditions**



*Source:*  
Commission services

**Figure 7: Output gap and fiscal stance**



*Note:*  
ΔCAPB denotes the change in the cyclically-adjusted primary budget balance

*Source:*  
Commission services

Figure 6 assesses the UK cyclical position and the impact of monetary policy, by plotting the Commission services' estimate of the output gap for the UK and the euro area and real short-term interest rates. Monetary conditions eased significantly between 2000 and 2002 following the slowdown in economic growth, but progressively tightened from 2003 in response to a cyclical pick-up.

A number of structural characteristics of the UK economy, such as the large stock of variable-rate mortgages and the large ratio of financial wealth to GDP, might suggest that the UK economy could be more sensitive to interest rates than other member states, although developments such as shifts in UK and other European mortgage markets towards more similar product offer and take-up might reduce these differences over time.

Figure 7 plots the Commission services' estimate of the output gap with the change in the cyclically-adjusted primary balance, a measure of the fiscal stance.

In the UK macroeconomic framework, monetary policy is the chief instrument for stabilisation policy, while fiscal policy's objectives in this area are limited to supporting monetary policy through the free operation of the automatic stabilisers<sup>21</sup>.

<sup>21</sup> i.e. the UK fiscal authorities exert "Stackelberg leadership", with the Bank of England as the follower: see Bean, C.R. (1998) "Monetary Policy under EMU", Oxford Review of Economic Policy, 14(3). On stabilisation, "The Government's fiscal policy objectives are ... over the short term, supporting monetary policy, by allowing the automatic stabilizers to play their role in dampening variations in economic activity ... and where prudent and sensible, providing further support to monetary policy through changes in the fiscal stance" (HM Treasury). In addition to the objective on short-term

<b>Box 2: Monetary policy and exchange rate regimes of the United Kingdom</b>	
<i>18 October 1990</i>	UK joins Exchange Rate Mechanism (ERM) at DEM 2.95; short-term interest rates set by government.
<i>16 September 1992</i>	UK membership of the Exchange Rate Mechanism (ERM) suspended.
<i>8 October 1992</i>	Inflation targeting regime introduced; short-term interest rates remain subject to government control. First inflation target is 1-4% annual increase of Retail Price Index excluding mortgage interest payments (RPIX). Bank of England asked to assess inflation prospects every quarter in independent report. Targeted inflation to be in lower half of range by end of current Parliament (i.e. by 1997 at latest).
<i>14 June 1995</i>	Second inflation target: annual increase of 2.5% or less of RPIX.
<i>12 June 1997</i>	Introduction of new monetary policy framework <ul style="list-style-type: none"> <li>• Bank of England given operational independence in setting interest rates</li> <li>• Creation within the Bank of the nine-member Monetary Policy Committee, deciding interest rates by majority vote</li> <li>• Introduction of set of transparency and reporting requirements (especially to Parliament)</li> <li>• inflation target, set by government: a symmetrical target of 2.5% annual RPIX inflation.</li> </ul>
<i>10 December 2003</i>	Government redefines the inflation target: 2% annual increase in the HICP (called Consumer Prices Index, CPI).

Between 1995 and 1999, fiscal policy had a mildly counter-cyclical stance, with the fiscal stance being tightened as the negative output gap narrowed prior to the economy's moving above potential from 1998 on, as shown in Figure 7.

From 2000, judged against the Commission services' estimate of the output gap, fiscal policy appears to have had a pro-cyclical stance, with a loosening of the fiscal position when the economy was growing at or around potential with a relatively large positive output gap. However the significant expansion of expenditure that the government embarked on in 2002 helped support domestic demand in a period of world economic slowdown, maintaining economic growth at around potential. By 2004 the economy appears to have been growing above potential and the fiscal stance became more neutral.

The significant loosening of the fiscal stance seen between 2000 and 2002 was due to a combination of two factors.

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stabilisation, fiscal policy in the UK also pursues explicit medium-term objectives, namely to ensure sound public finances and to ensure intra- and inter-generational fairness.

First, since 2001 projections for revenues proved to be markedly optimistic compared to outturns, with corporation tax especially falling short of expectations. These shortfalls were linked to the sharp stock market downturn in 2001, which depressed financial sector profitability and thus the tax base. It appears plausible that traditional cyclical-adjustment methodologies might have overestimated the strength of the structural position of the UK public finances before 2001, as the stock market bubble in the late 1990s increased revenues by boosting the profitability of the financial sector and the incomes of higher-rate taxpayers (including through significant bonuses paid to financial employees).

Second, the government embarked in 2002 on a significant increase in public expenditure, as will be discussed in more detail in the next section.

The cyclically-adjusted primary balance continued to decline until 2004, even if the output gap was slightly positive, as the expenditure ratio rose faster than the revenue ratio. In 2005 the very steep increase in the revenue ratio, mainly due to strong growth of corporation tax receipts, meant that the change in the CAPB moved back into positive territory.

## **2.4 Public finances**

The development of the UK public finances over the past ten years can be divided into two different periods.

The first period, between 1995 and 2001, saw a marked fiscal consolidation, with a deficit of 4.0% of GDP in 1995-06 that swung into a surplus of 1.9% of GDP by 2000-01 (excluding the one-off impact of UMTS receipts). Correspondingly, gross debt declined from over 50% of GDP in 1995-06 to a low of 37% of GDP in 2002-03. The adjustment was mainly driven by a marked slowdown in expenditure growth, with the expenditure to GDP ratio falling by 5 percentage points over the six financial years from 1995-96. Current expenditure as a percentage of GDP dropped steadily between 1995-96 and 2001-02 by 2½ percentage points while capital expenditure (defined as gross capital formation) fell from 2.1% of GDP in 1995/96 to 1.4% of GDP in 2001/02. Part of the debt reduction was also financed by UMTS receipts, which in 2000 created a windfall gain for the Exchequer of over 2% of GDP. Last, interest rate payments, mirroring the decline in the stock of debt and a global decline in interest rates, were reduced from 3.5% of GDP at the beginning of the period to a low of 2.0% of GDP by 2002-03. At the same time, the late 1990s saw relative buoyancy in revenues, especially income and corporation tax, which together increased by 2 percentage points of GDP in the five years to 2001.

As regards the second period, the downward trend in public expenditure growth was reversed in 2002, when the government explicitly instated a policy objective to increase expenditure on public services, and especially to increase public investment from the relatively low levels seen in previous years. The 2002 Spending Review planned a discretionary increase of about 1½ percentage points of GDP for current expenditure and of 0.3 percentage points for capital expenditure over the levels in 2002/03 for the three years to 2005/06. The planned increase in the expenditure ratio was to be partly matched by a discretionary increase in revenues (mainly social contributions) implemented from 2003/04. At the time of the Spending Review, the UK authorities expected the impact of the tax and spending decisions to amount to a fiscal loosening of just above 1% of GDP in structural terms.

However, the planned increase in expenditure coincided with a fall in the revenue to GDP ratio, with total revenues falling from 39.7% of GDP in 2000-01 to 37.9% of GDP two

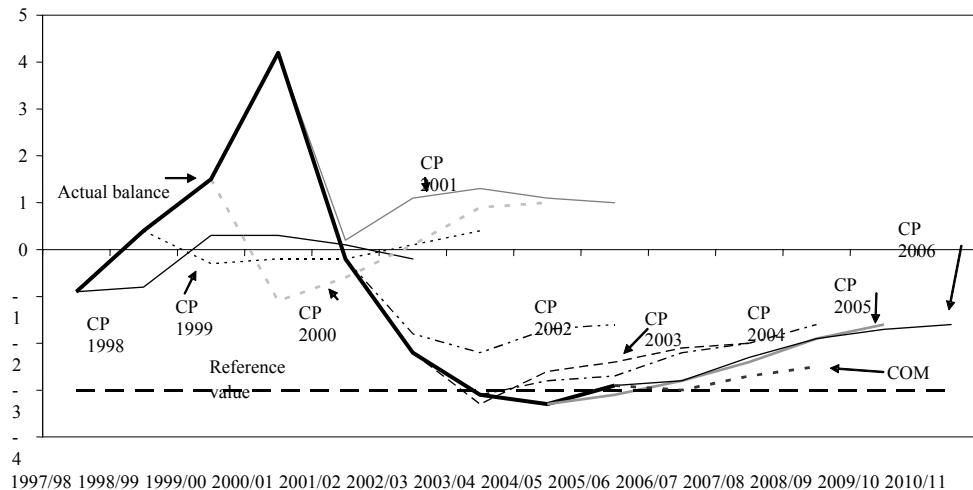
years later, just when the increases in expenditure took place. This fall was mainly driven by a reduction of receipts from taxes on income in the context of a slowdown in economic growth, albeit milder in the UK than in the wider international economy. Corporation tax receipts fell by nearly 1 percentage point of GDP between 2000/01 and 2003/04, partly reflecting the fall in the financial markets. However, the impact on the fiscal balances was attenuated by under-spending, with especially capital expenditure falling behind the planned increase. The deficit deteriorated significantly, exceeding 3% of GDP for the first time in 2003/04 and then in 2004/05, and remaining close to the Treaty reference value in 2005/06.

Overall, the past ten years have seen an increase in the expenditure ratio by just below two percentage points of GDP, matched by a slightly higher increase in the revenue ratio.

The substantial increase in public expenditure has put the focus on enhancing the efficiency and productivity of the public sector. On the one hand, the government commissioned in 2003 a review of the measurement of government output in the national accounts (the "Atkinson review"), with the aim of improving the quality of the statistical framework. On the other hand, the government also commissioned a report (the "Gershon report") to identify the scope to shift expenditure from non-priority areas (mainly procurement and administration) towards priority public services.

Looking at the past track record of the public finances projections over the past years, on average the forecast error is close to zero (around 0.2% of GDP) over the period from 1997/98 to 2005/06. However, the average over the past ten years hides two distinct trends, as Figure 8 shows.

**Figure 8: General government balance projections in successive stability programmes (% of GDP)**



*Source:*  
*Commission services and national convergence programmes*

Between 1998 and 2000, projections tended to be cautious, underestimating the size of future surpluses, in particular because revenue growth was underestimated. However, despite the fact that over this period the UK authorities' forecast for economic growth proved to be accurate (except for the year 2005, when the economy unexpectedly decelerated), from 2001 the convergence programme projections underestimated the size of deficits, on average by  $\frac{3}{4}$  percentage points in the one year ahead forecast.

## 2.5. Medium- and long-term policy challenges for public finances

The United Kingdom's economic performance over the past ten years has undoubtedly been impressive, with relatively high rates of growth, low inflation and resilient labour markets that have weathered significant economic shocks. Improved stability has been a particularly significant feature, with a flattening both of cyclical fluctuations in output and inflation volatility. Strong output growth has been mainly supported by robust household consumption, which has been matched by relatively low household saving. Despite flexibility in labour, capital and product markets being outstanding on most measures, some supply-side weaknesses have proved resistant to improvement. The relatively lacklustre productivity can be explained to some extent by comparatively high levels of employment, although lack of intermediate skills and underinvestment in infrastructure such as transport are likely also to play a role. Compared with the marked fiscal consolidation seen in the first part of the period, the public finances significantly deteriorated from 2001 onwards, partly planned, reflecting the government's decision to address some of these issues through not fully funded increased expenditure on public services, but also due to shortfalls in planned revenues.

This background suggests three main challenges for fiscal policy in the United Kingdom.

- **Fiscal consolidation:** the fiscal stance remains loose. In order to consolidate while avoiding the disincentive effects associated with further increases in the tax burden, growth of expenditure needs to be reined in to below that of potential output. The

forthcoming Comprehensive Spending Review will thus need to embody a significant reduction in expenditure growth compared with the growth seen over the past five years.

- Sustainability: the long-term sustainability of the public finances needs to be ensured while at the same time delivering more adequate overall pension provision (Section 5.2 discusses in more depth).
- Efficiency: the expansion of the public sector as a share of total output and employment, together with the increase in ratios to GDP of revenue and expenditure over the past five years increases the importance of ensuring the effectiveness and productivity of public expenditure in order to limit possible disincentive and distortionary effects on both revenue and expenditure sides.



**Table 1: Key economic indicators**

	United Kingdom						Euro area					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96-'05	'96-'00	'01-'05				'96-'05	'96-'00	'01-'05			
<b>Economic activity</b>												
Real GDP (% change)	2.8	3.2	2.4	2.7	3.3	1.9	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
<i>Domestic demand</i>	3.5	4.0	2.9	2.8	3.9	1.8	2.0	2.7	1.3	1.4	1.8	1.6
<i>Net exports</i>	-0.6	-0.8	-0.5	-0.1	-0.6	0.0	0.1	0.1	0.1	-0.7	0.2	-0.2
<b>Prices, costs and labour market</b>												
HICP inflation (% change)	1.5	1.6	1.4	1.4	1.3	2.1	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	1.7	1.9	1.5	1.7	2.2	0.9	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	0.2	0.2	0.2	0.0	-0.6	1.5	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	1.1	1.3	0.9	1.0	1.0	1.0	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	5.7	6.4	4.9	4.9	4.7	4.7	9.1	9.8	8.5	8.7	8.9	8.6
<b>Competitiveness and external position</b>												
Real effective exchange rate (% change) (1)	3.6	6.2	1.0	-2.8	5.7	1.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	-1.4	-2.5	-0.4	-1.5	-3.1	1.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-1.4	-1.2	-1.7	-1.2	-1.5	-2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Public finances (3)</b>												
General government balance (% of GDP)	-1.3	-0.2	-2.4	-3.1	-3.3	-2.9	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	42.0	45.0	38.9	38.6	39.9	42.1	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (4)	n.a.	n.a.	n.a.	-3.2	-3.5	-3.1	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
<b>Financial indicators (5)</b>												
Long term real interest rate (%) (6)	2.8	3.6	2.1	1.4	2.3	2.2	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (7)	77.3	67.5	87.0	87.0	93.4	98.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (8)	85.4	72.5	98.3	97.4	99.6	106.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

**Notes:** More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Public finances data for the UK are presented on a financial year basis, so that e.g. the heading "2005" correspond to the financial year 2005/06.

(4) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(5) Data available up to 2004.

(6) Using GDP deflator.

(7) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(8) Non-financial corporate sector debt, defined as loans and securities other than shares.

*Source: Commission services*

### **3. MACROECONOMIC OUTLOOK**

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, overall economic growth, the labour market, costs and prices, sectoral balances and potential output growth. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

#### **3.1. External assumptions**

The external assumptions on which the programme's macroeconomic scenario is based are broadly in line with the Commission services' autumn forecast, with robust world output growth, though moderating slightly through the forecast period. The average oil price assumption is \$60.30 a barrel in 2007, a slightly lower level than the Commission services' assumption. The programme does not include explicit assumptions for the nominal exchange rate of the UK pound to the euro nor for long-term interest rates over the projection period.

#### **3.2. Economic activity**

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 2).

According to the central scenario, real GDP is foreseen to grow at 2¾% in 2006, in the range 2¾ to 3¼% in 2007, and between 2½% and 3% in 2008 and constant afterwards. This represents an upgrade of the projections in the previous forecast, published in the 2006 Budget, reflecting a strengthening of the growth outlook in the medium term, and an upward revision of the estimate of trend growth, which the UK authorities attribute to the sharp increase in labour supply seen over the past two years. As seen in Table 2, the Commission's growth forecast for 2006 is 2.7% for 2006, 2.6% for 2007 and 2.4% in 2008, lower than the central scenario in the convergence programme update.

In the update the authorities expect a rebalancing of growth components, away from consumption towards investment and exports. Economic activity is driven by domestic demand while net trade is expected to cease being a drag on growth from 2007 on. In line with the Commission services' autumn forecast, private consumption growth is expected to remain relatively stable. The UK authorities anticipate a positive outlook for business investment supported by strong profitability and a low cost of capital. Annual growth in recorded exports and imports has been distorted by activity related to missing trader intra-community fraud (MTIC) which has significantly inflated measured goods trade. This has a significant effect on expected rates of growth in 2007 as the forecast abstracts from MTIC effects. The underlying momentum in export growth is expected to continue while, imports are expected to grow slightly less than exports in line with moderate rates of private consumption growth.

**Table 2: Comparison of macroeconomic developments and forecasts**

<b>1. Programme's central macroeconomic forecast</b>								
	2006		2007		2008		2009	2010
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.7	2¾	2.6	2¾ to 3¼	2.4	2½ to 3	2½ to 3	2½ to 3
Private consumption (% change)	2.3	2	2.3	2¼ to 2¾	2.2	2¼ to 2¾	2¼ to 2¾	n.a
Gross fixed capital formation (% change)	5.2	6	4.7	5¼ to 5¾	3.1	3¼ to 3¾	3¼ to 3¾	n.a
Exports of goods and services (% change)	17.8	11½	6.7	½ to 1	6.0	4¾ to 5¼	4½ to 5	n.a
Imports of goods and services (% change)	16.5	11	6.2	¼ to ½	5.5	4¼ to 4¾	4 to 4½	n.a
<i>Contributions:</i>								
- Final domestic demand	2.7	2¾	2.6	2¾ to 3	2.4	2¼ to 2¾	2¼ to 2¾	n.a
- Change in inventories	0.0	0	0.0	0	0.0	0	0	n.a
- Net exports	-0.2	-¼	0.0	0	0.0	0	0	n.a
Output gap <sup>1</sup>	-0.4	-0.6	-0.5	-0.6	-0.7	-0.6	-0.5	-0.4
Employment (% change)	0.8	n.a	0.8	n.a	0.5	n.a	n.a	n.a
Unemployment rate (%)	5.3	n.a	5.0	n.a	4.8	n.a	n.a	n.a
Labour productivity growth (%)	1.8	n.a	1.8	n.a	1.9	n.a	n.a	n.a
HICP inflation (%) <sup>3</sup>	2.4	2½	2.2	2	2.0	2	2	2
GDP deflator (% change)	2.6	2½	2.5	2¾	2.5	2¾	2¾	
Comp. of employees (per head, % change)	4.9	n.a	4.4	n.a	4.6	n.a	n.a	n.a
Real unit labour costs (% change)	0.4	n.a	0.0	n.a	0.2	n.a	n.a	n.a
External balance (% of GDP)	-2.5	-2½	-2.6	-2¾	-2.8	-2¾	-2¾	n.a
<b>2. Programme's macroeconomic forecast underlying public finances (reference forecast)</b>								
	2006/07		2007/08		2008/09		2009/10	2010/11
	COM <sup>2</sup>	CP	COM <sup>2</sup>	CP	COM <sup>2</sup>	CP	CP	CP
Real GDP (% change) <sup>3</sup>	2.7	2¾	2.6	2¾	2.4	2½	2½	2½
HICP inflation (%)	2.4	2½	2.2	2	2.0	2	2	2
GDP deflator (% change)	2.6	2¾	2.5	2¾	2.5	2¾	2¾	2¾
<i>Note:</i>								
<sup>1</sup> In percent of potential GDP, with potential GDP growth as reported in Table 4 below.								
<sup>2</sup> The Commission services' forecast data are provided on a calendar year basis (for example, calendar year 2006 corresponds to the column headed financial year 2006/07).								
<sup>3</sup> The Commission services forecast the average annual HICP. The convergence programme measures HICP (known in the UK as Consumer Price Index, CPI) as the 4 quarter percentage change over the same quarter of the previous year.								
<i>Source:</i>								
<i>Commission services' autumn 2006 economic forecasts (COM); convergence programme (CP)</i>								

The Commission services' autumn 2006 forecast projects a similar characterisation of the economic outlook to the central scenario, with two main differences. First, the central scenario assumes a slightly stronger rate of growth of private consumption at the expense of lower saving, which remains at 5¾% of total household resources, compared with 6.2% in 2007 and 7.0% in 2008 in the Commission services' projections. The UK authorities identify the possibility of larger increases in the saving ratio as a downside risk to the consumption forecast in the update, although they recognise that in the short term this could be offset by developments in the housing market which could support higher consumption growth. Second, the central scenario projects a stronger rebound of business investment than expected by the Commission services. Business investment has been revised up in comparison with the previous update; upside risks in 2007 and beyond

are pointed to by the UK authorities. Overall, according to the update, risks are broadly balanced.

The update of the convergence programme highlights the recent strength of house price inflation which the programs explains with supportive financing conditions related to developments in the bond market and the growth of fixed-rate mortgages. Looking further ahead, the update expects that house price inflation is likely to moderate due to future tighter financing conditions. Housing market fundamentals could have an impact in the moderation of growth in the medium term.

As mentioned, the public finances projections are based on a macroeconomic scenario that assumes trend growth  $\frac{1}{4}$  percentage point lower than in the central view. Between 2006/07 and 2008/09, the reference scenario can be regarded as broadly in line with the growth rate projected by the Commission services' autumn forecast. After 2008/09, the update's reference forecast projects output to grow at a trend rate of  $2\frac{1}{2}\%$  per annum.

**Table 3: Output gap estimates in successive Commission services' forecasts and Convergence programme updates (% of potential GDP)**

(% of potential GDP)	2006		2007		2008	
	COM	CP <sup>1</sup>	COM	CP <sup>1</sup>	COM	CP <sup>1</sup>
CP Dec. 2006		-0.6		-0.6		-0.6
Autumn 2006	-0.4		-0.5		-0.7	
Spring 2006	-0.7		-0.7			
CP Dec. 2005		-1.0		-0.8		-0.5
Autumn 2005	-0.9		-0.8			
Spring 2005	-0.3					
CP Dec. 2004		0.0		-0.2		-0.3

Note:  
<sup>1</sup>Commission services' calculations according to the commonly agreed method based on the information in the programme.

Source:  
*Commission services' forecasts, convergence programmes and Commission services*

Estimated according to the UK's own methodology, the output gap is expected to close early in 2007. However, the cyclical conditions implied by the programme, as measured by the output gap recalculated by the Commission services, appear to be slightly less favourable as a negative output gap remains constant until 2008 and narrows only towards the end of the programme.

### 3.3. Potential growth and its determinants

As regards estimates of potential output growth, given the limited data provision of the programme, the Commission services have used available information to calculate an estimate 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. Table 4 presents the results alongside estimates up to 2008 consistent with the Commission services' autumn 2006 forecast. For this common period both estimates are very similar in the magnitude and composition of the potential growth, indicating an annual rate of around  $2\frac{3}{4}\%$  with some mild deceleration. The estimates derived from the programme are slightly higher than those made on the basis of the Commission services' autumn 2006 forecast.

The UK authorities have increased by ¼% the central estimate of annual trend output growth in line with the upward revision of the projections for working-age population growth from 0.4% to 0.6% a year, based on a higher than expected contribution of net inward migration. The new working-age population growth projection does not make any allowance for possible additional migration from Bulgaria and Romania<sup>22</sup>. This upward revision offsets the downward effect of retirement of post-war baby-boom women<sup>23</sup>.

As for the composition, the estimated driving forces are total factor productivity and, by UK historical standards, a high rate of capital accumulation, while despite the demographic effects referred to, the contribution of labour is rather limited and is expected to diminish and turn negative towards the end of the programme period, in particular as growth in the working-age population slows.

**Table 4: Sources of potential output growth**

	2006		2007		2008		2009	2010
	COM	CP <sup>2</sup>	COM	CP <sup>2</sup>	COM	CP <sup>2</sup>	CP <sup>2</sup>	CP <sup>2</sup>
Potential GDP growth (%) <sup>1</sup>	2.8	2.9	2.8	2.9	2.6	2.8	2.7	2.6
<i>Contributions:</i>								
- Labour	0.3	0.3	0.2	0.2	0.0	0.1	0.0	-0.1
- Capital accumulation	1.0	1.0	1.0	1.0	1.0	1.1	1.1	1.1
- TFP	1.5	1.6	1.5	1.6	1.5	1.6	1.6	1.7
<i>Notes:</i>								
<sup>1</sup> Based on the production function method for calculating potential output growth.								
<sup>2</sup> Commission services' calculations on the basis of the information in the convergence programme (CP).								
<i>Source:</i>								
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations								

### 3.4. Labour market developments

The employment rate has recently held relatively steady during a period in which the labour force has been boosted by strong working-age population growth due to record net immigration, but also to an increase in labour market participation of older workers. Labour supply has been further boosted by a significant fall in the working-age inactivity rate corresponding to an increase in participation of older workers.

The programme does not include explicit projections for the paths of employment and unemployment<sup>24</sup>. Favourable supply-side conditions including the flexibility of the labour market, the boost to the labour supply experienced in 2006 and subdued growth in

<sup>22</sup> Inward migration to the UK from Bulgaria and Romania is subject to tighter restriction than the UK applied to the new Member States that acceded in 2004.

<sup>23</sup> The upward revision of estimated trend growth does not include the recent favourable evolution of productivity trends (which, measured in terms of output per worker, picked up to an annual rate of 2.3% in the third quarter of 2006). The UK authorities highlight that the favourable evolution shown by the current productivity data might be affected by cyclical factors, therefore the trend rate of productivity growth will only be reassessed once a distinct phase of the cycle has come to an end.

<sup>24</sup> For the sole specific purpose of projecting certain public finances aggregates, the programme assumes a slight weakening of the labour market, with unemployment rising slowly to 1.01 million in 2007-08 from recent levels of 0.96 million. 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 programme's macroeconomic scenario.

earnings and unit wage costs- are expected to support GDP growth in 2007 and beyond, leading to a reversal of the recent rise in unemployment. The Commission services' autumn forecast also assumes continuing resilience in the labour market, with some decreases in the unemployment rate in the medium term.

### **3.5. Costs and price developments**

According to the programme update, HICP inflation is forecast to return to the Bank of England's 2% target towards the end of 2007, as the impact of higher energy prices, particularly in items of domestic utility tariffs, and food prices are expected to unwind. HICP is projected to remain at the 2% target over the forecast period. The Commission services' autumn forecast, although with a smaller negative output gap, projects a generally similar evolution of inflation, with the difference of a slightly higher estimate than in the convergence programme update for 2006 as a whole, but a return to target by the end of 2007.

Despite current above target inflation, second-round effects have not so far materialised. Average earnings growth has remained subdued, although is expected to pick up moderately. During 2006, as growth strengthened and HICP inflation moved above target, the Monetary Policy Committee (MPC) of the Bank of England raised the official rate by 25 basis points in both in August and November, and again in January 2007 to 5.25%.

### **3.6. Sectoral balances**

The programme lacks an articulated discussion of sectoral balances, although there is a brief discussion of trade and the external balance, drawing attention to possible recent data distortions, and limited sectoral balance projections are provided to 2009. The programme projects a continuing sizeable yet relatively stable external deficit, from 2½% in 2006 to 2¾% of GDP from 2007 to 2009. The net lending of the private sector is projected to diminish from a surplus of ¼% of GDP in 2006 to a deficit of 1% in 2007 and 2008 and 1¼% of GDP in 2009. 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. The absence of projected response in terms of a narrowing of the external deficit could possibly reflect some assumed strengthening of business investment. Indeed, the Pre-Budget Report business investment forecast for 2006 has been revised up substantially compared with Budget 2006 and the UK authorities consider that there are still significant upside risks of higher business investment in 2007 and beyond. Nevertheless, in the event of the external deficit continuing broadly as forecast in the programme, with a sustained large recourse to external finance, the likely implication is that national saving remains low. 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.

### **3.7. Assessment**

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic 'good' or 'bad' times.

### 3.7.1. *Plausibility of the macroeconomic scenario*

The macroeconomic reference scenario underlying the programme envisages real GDP growth of 2¾% in 2006/07 and 3% in 2007/08, broadly in line with the Commission services' forecast; after 2007/08 the economy is projected to grow in line with a potential output estimate of 2½% a year, which appears to be plausible, in the light of the latest demographic developments and the significant increase in labour supply seen over the past two years.

Overall, the macroeconomic scenario in the programme seems to reflect plausible growth assumptions.

### 3.7.2. *Economic good vs. bad times*

While GDP growth is estimated to be relatively robust, between 2¾% and 2½% up to the Commission services' forecast horizon, the Commission services project a small negative output gap, slightly widening over the forecast period. Earnings growth has been relatively subdued and unemployment increased in the first half of 2006. The most recent data suggest that the labour market is firming up, while corporate profitability continues to be robust. Over the forecast period, earnings growth is expected to pick up moderately, employment to continue to grow and the unemployment rate to decline slightly. Thus, the outlook cannot be qualified neither "good nor bad times".

## 4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006/07 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

### 4.1. **Budgetary implementation in 2006**

The outturn for the general government deficit in 2005/06, at 2.9% of GDP turned out to be better than the 3.1% estimated in the previous update of the convergence programme. This is due to lower than planned expenditure in capital expenditure, and to a one-off statistical reclassification<sup>25</sup>. Revenues by contrast fell slightly short of the planned level, partly reflecting the risks to the projections highlighted in the assessment of the previous convergence programme update.

For the current financial year 2006/07, the projection of 2.8% for the headline deficit to GDP ratio in the 2006 update of the convergence programme are in line with those of the previous update. However, there are compositional differences, with higher than previously expected economic growth compensating lower expected elasticity of revenue to GDP. The expenditure to GDP ratio in 2006/07 is projected to be lower than expected

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<sup>25</sup> Following the restructuring of the nuclear energy sector, which led to the transfer to central government of assets held by a public corporation, the UK Office for National Statistics decided retrospectively to classify a transfer of liquid assets into central government as a deficit-reducing flow, worth about 0.3% of GDP in 2005/06.

in the 2005 update. This is mainly explained by lower than expected expenditure in 2005/06, discussed above. Data published after the close of the Commission services' forecast highlight relatively strong growth in revenues in 2006/07. However, central government<sup>26</sup> current expenditure, and especially in discretionary expenditure (i.e. current expenditure excluding social benefits and interest payments), which in the UK budgetary framework is subject to nominal ceilings, shows strong growth in the first half of the financial year. In-year data are partly distorted by changes in timing of some central government payments this financial year, and at the time of writing growth in expenditure appears to be clearly slowing in more recent months. Expenditure overruns in current expenditure might be compensated by capital expenditure coming in below plans, which would be consistent with past track record.

Compared to the projection in the Commission services' autumn forecast, the update projects a marginally better outcome for the general government deficit in 2006/07. The estimate in the convergence programme appears achievable, in view of recent strong outturns for corporation tax revenues,<sup>27</sup> provided that expenditure growth will continue to slow down towards the end of the year, reflecting the unwinding of timing effects.

At the time of preparing this assessment, it appears that following discussions between Eurostat and the Office for National Statistics both the outturn for 2005/06 and the estimate for 2006/07 could however be affected by a statistical reclassification which could ex-post increase the deficit in both years by about £1bn (just below 0.1% of GDP)<sup>28</sup>.

**Table 5: Evolution of budgetary targets in successive programmes**

		2005/ 06	2006/ 07	2007/ 08	2008/ 09	2009/ 10	2010/ 11	2011/ 12
General government balance (% of GDP) <sup>1</sup>	<b>CP Dec 2006</b>	<b>-2.9</b>	<b>-2.8</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.4</b>
	CP Dec 2005	-3.1	-2.8	-2.4	-1.9	-1.7	-1.5	n.a
	<i>CP Dec 2004</i>	<i>-2.8</i>	<i>-2.3</i>	<i>-2.1</i>	<i>-1.7</i>	<i>-1.6</i>	<i>n.a</i>	<i>n.a</i>
	COM Nov 2006 <sup>2</sup>	-2.9	-3.0	-2.7	-2.5	n.a	n.a	n.a

<sup>26</sup> In-year expenditure data for local government is not available.

<sup>27</sup> In particular, outturns published since the October cut-off date for the Commission autumn forecast.

<sup>28</sup> This refers to the possibility that the impact on the deficit of a write-off of Nigerian debt, which is currently classified in the private corporation sector, could be reclassified into general government, on the grounds that the Export Credit Guarantee Department (ECGD), which was the vehicle of the debt write-off and normally operates as a market entity, in this specific circumstance acted on behalf of general government.



General government expenditure <sup>3</sup> (% of GDP)	<b>CP Dec 2006</b>	<b>41.5</b>	<b>42.0</b>	<b>42.1</b>	<b>42.0</b>	<b>41.8</b>	<b>41.6</b>	<b>41.4</b>
	CP Dec 2005	42.2	42.6	42.5	42.1	42.0	41.9	n.a
	<i>CP Dec 2004</i>	<i>40.7</i>	<i>40.8</i>	<i>41.0</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>
	<i>COM Nov 2006</i>	<i>42.6</i>	<i>43.0</i>	<i>43.1</i>	<i>43.1</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>
General government revenues <sup>1, 3</sup> (% of GDP)	<b>CP Dec 2006</b>	<b>38.6</b>	<b>39.3</b>	<b>39.8</b>	<b>40.0</b>	<b>40.0</b>	<b>40.0</b>	<b>40.0</b>
	CP Dec 2005	39.0	39.8	40.1	40.2	40.3	40.4	n.a
	<i>CP Dec 2004</i>	<i>39.0</i>	<i>39.5</i>	<i>40.0</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>
	<i>COM Nov 2006</i>	<i>39.5</i>	<i>40.0</i>	<i>40.4</i>	<i>40.6</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>
Real GDP <sup>4</sup> (% change)	<b>CP Dec 2006</b>	<b>1 ¾</b>	<b>2 ¾</b>	<b>2 ¾</b>	<b>2 ½</b>	<b>2 ½</b>	<b>2 ½</b>	<b>2 ½</b>
	CP Dec 2005	1¾	2¼	3	2¾	2¼	2¼	n.a
	<i>CP Dec 2004</i>	<i>3¼</i>	<i>3</i>	<i>2½</i>	<i>2¼</i>	<i>2¼</i>	<i>n.a.</i>	<i>n.a</i>
	<i>COM Nov 2006</i> <sup>5</sup>	<i>1.9</i>	<i>2.7</i>	<i>2.6</i>	<i>2.4</i>	<i>n.a</i>	<i>n.a</i>	<i>n.a</i>

Notes.

<sup>1</sup> Data adjusted by Commission services to reflect the UK's treatment of UMTS receipts.

<sup>2</sup> Commission services' forecast made before the 2006 Pre-Budget Report (PBR). Adding the estimated impact of the new measures announced in the PBR, the Commission services' forecast would become 3.0% of GDP, 2.5% of GDP and 2.3% of GDP in 2006/07 and 2007/08 and 2008/09 respectively. In the absence of announced expenditure plans from 2008/09 onwards (see footnote 4 below), the Commission services' autumn forecast adopts a technical assumption that expenditure remains constant as a percentage of GDP, while the convergence programme uses a working assumption implying a fall in the expenditure to GDP ratio. The difference in the two assumptions accounts for about 0.2% difference in the deficit.

<sup>3</sup> 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 2011-12 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.

<sup>4</sup> GDP projections reported in the table are those underlying the public finance projections (cf. "reference scenario" in Table 2).

<sup>5</sup> Commission services' forecast for GDP growth is on a calendar year basis.

Source:

*Convergence programmes (CP) and Commission services' autumn 2006 economic forecasts (COM)*

## 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 as identified in the convergence programme update 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<sup>29</sup>. 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 gross capital formation 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 as below 40% of GDP)<sup>30</sup>.

The convergence programme stresses the UK authorities' belief in the consistency of the UK domestic framework and the fiscal projections in the update of the convergence programme with their interpretation of the Stability and Growth Pact. 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.

### **Box 3: The excessive deficit procedure for the United Kingdom**

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 24 January 2006, the Council decided that the United Kingdom was in excessive deficit in accordance with Article 104(6) and addressed a recommendation under Article 104(7) that the excessive deficit be corrected by financial year 2006/07 and that the authorities take effective action by 24 July 2006, i.e. within six months as specified in the Pact. On 20 September 2006, the Commission published a communication to the Council assessing the action taken by the United Kingdom. On the basis of then available information, the Commission judged that the United Kingdom appeared to be just on track to correct its excessive deficit, although this outcome was subject to large uncertainties and the structural adjustment appeared to fall short of the recommended 0.5 percent of GDP. On 10 October 2006 the Council endorsed the Commission view and concluded that no further steps were needed at that time.

Table 6 below shows the main components of the nominal adjustment projected in the updated convergence programme. Within the UK fiscal framework illustrated in the previous section, the UK authorities aim to reach a small surplus on the current budget by the end of the projection period (i.e. current revenues minus current expenditure including capital depreciation) while maintaining the ratio of net investment to GDP constant. This translates into a projected improvement in the general government deficit by 1.4 percentage points over the programme horizon, falling from 2.8% of GDP in 2006/07 to 1.4% of GDP in 2011/12. With interest payments projected to remain broadly constant as a percentage of GDP over the projection period, the primary balance is

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<sup>29</sup> The definition of "public sector" includes general government and public corporations. See Box 1.

<sup>30</sup> Compared with the 2005 update of the Convergence Programme, in the UK authorities have revised their estimate of the cyclical position of the economy, so that the economic cycle is now expected to close in early 2007 rather than in 2008 as previously estimated. This implies a different time horizon to assess compliance with the Golden Rule going forwards.

projected to swing into surplus by 2008/09, from a deficit of 0.6% of GDP in 2006/07, reaching a surplus of 0.7% of GDP in 2011/12.

The nominal adjustment is broadly in line with the projections in the 2005 update of the convergence programme, although in this year's update it is expected to take place against a more favourable short term macroeconomic outlook, and following a small discretionary tightening of the fiscal stance. The projected composition of the nominal adjustment is however different from the previous year when over the programme period a projected increase in the revenue to GDP ratio played the main role, while in the new update the adjustment is broadly equally spread between revenues and expenditure .

**Table 6: Composition of the budgetary adjustment**

(% of GDP)	2005/ 06	2006/0 7	2007/08	2008/09	2009/10	2010/11	2011/12	Change: 2011/12- 2006/07
<b>Revenues<sup>1</sup></b>	38.6	39.3	39.8	40.0	40.0	40.0	40.0	0.7
<i>of which:</i>								
- Taxes & social contributions <sup>2</sup>	37.0	37.5	37.9	n.a.	n.a.	n.a.	n.a.	-
- Other (residual)	1.7	1.8	2.0	n.a.	n.a.	n.a.	n.a.	-
<b>Expenditure<sup>1</sup></b>	41.5	42.0	42.1	42.0	41.8	41.6	41.4	-0.6
<i>of which:</i>								
- Primary expenditure	39.4	39.9	40.0	39.9	39.7	39.5	39.4	-
<i>of which:</i>								
Consumption	22.2	22.2	22.2	n.a.	n.a.	n.a.	n.a.	-
Transfers & subsidies	14.7	14.7	14.6	n.a.	n.a.	n.a.	n.a.	-
- Gross fixed capital formation	0.6	2.2	2.3	n.a.	n.a.	n.a.	n.a.	-
Other (residual) <sup>3</sup>	1.9	1.0	0.9	n.a.	n.a.	n.a.	n.a.	-
- Interest expenditure	2.1	2.1	2.1	2.1	2.1	2.1	2.0	-
<b>General government balance (GGB)</b>	<b>-2.9</b>	<b>-2.8</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.4</b>	<b>1.4</b>
<b>Primary balance<sup>4</sup></b>	<b>-0.8</b>	<b>-0.6</b>	<b>-0.2</b>	<b>0.1</b>	<b>0.3</b>	<b>0.5</b>	<b>0.7</b>	<b>1.3</b>
One-offs <sup>5</sup>	0.3	0.0	0.0	0.0	0.0	0.0	0.0	-
<b>GGB excl. one-offs</b>	<b>-3.2</b>	<b>-2.8</b>	<b>-2.5</b>	<b>-1.9</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.4</b>	<b>1.4</b>

Notes:

<sup>1</sup> 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 from 2008-09 to 2011-12 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.

<sup>2</sup> "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.

<sup>3</sup> Compared to the 2004 update, the category "other expenditure" is much higher, due to a re-classification of some elements of expenditure.

<sup>4</sup> 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.

<sup>5</sup> One-off and other temporary measures.

Source:

Commission services' autumn 2006 economic forecasts (COM); convergence programme update (CP); Commission services' calculations

#### 4.2.2. *The composition of the budgetary adjustment*

Table 6 shows that over the projection period the adjustment is equally shared between an increase in the revenue to GDP ratio and a drop in the expenditure ratio. The revenue adjustment takes place in the first years of the projection period, with an increase by 0.7 percentage points of GDP between 2006/07 and 2008/09. This is due to a combination of discretionary measures (an increase in indirect taxation on air transport and a set of anti avoidance measures), a projected increase in non-oil corporation tax, supported by expected strong corporate profitability, and fiscal drag. After 2008/09, the revenue to GDP ratio is expected to stabilise, with fiscal drag on direct personal taxation being broadly offset by a decline in indirect taxation as a percentage of GDP, based on an assumption of an increase of tax avoidance over time<sup>31</sup>.

On the contrary, the adjustment to the expenditure ratio is projected to take place after 2007/08, with a drop of about 0.6 percentage points by the end of the projection period. This reflects the aspiration of the UK authorities to implement a significant reduction in nominal expenditure growth in the forthcoming Comprehensive Spending Review, which will set plans for discretionary expenditure for the three financial years between 2008/09 and 2010/11. While the final settlement of the Comprehensive Spending Review will be announced only in July 2007, the UK authorities have confirmed their intention to reduce expenditure growth by using the March 2006 Budget and the December 2006 Pre-Budget Report to pre-announce expenditure reductions in real terms for a number of smaller Departments, which account for just above 10% of total discretionary expenditure. The reduction in expenditure growth is projected to fall entirely on current expenditure, which is assumed to grow at just below 2% in real terms in each year from 2008/09 on, with capital expenditure expected to be kept constant at around 2¼% of GDP throughout the projection period<sup>32</sup>, so that from 2008/09 the deficit is projected to be used entirely to fund public investment (under the definition of the UK convergence programme).

#### **Box 4: The 2006 budget and Pre-Budget Report**

The 2006 Budget was published on 22 March 2006; the 2006 Pre-Budget Report (PBR), a more consultative document, on 6 December. The PBR provides an updated macroeconomic forecast and fiscal projections that form the basis for the 2006 convergence programme update. While the 2006 Budget left the fiscal position broadly unchanged, the Pre-Budget report implements a small fiscal tightening of about 0.2% of GDP from financial year 2007/08. An increase in air passenger duties account for about half of this increase, while the other half reflects a combination of measures repealing some small corporate tax breaks and a set of measures aimed at tackling tax avoidance. The Pre-Budget Report also implements an increase in fuel duties in line with inflation; this is in line with stated government policy (and therefore does not yield revenues in the baseline projections), but reverts a previous trend whereby the government decided to postpone the planned fuel duty increase in the past two years in response to rising oil prices.

On the expenditure side, the Budget and Pre-Budget report pre-announced the expenditure settlement for some smaller departments, accounting for just above 10% of total discretionary expenditure, which will see their budget fall by 2.5% a year in real terms after 2007/08. This is a

<sup>31</sup> The assumption underlying the VAT projection in the programme is one of the 11 assumptions subject to external audit by the National Audit Office (accountable to Parliament).

<sup>32</sup> The update of the convergence programme provides a projection for gross fixed capital formation only up to 2007/08, but projects net investment (a non-ESA concept, including GFCF and capital grants net of depreciation) throughout the programme period.

step towards implementing the projected reduction in the expenditure to GDP ratio over the medium term, which should be completed in the 2007 Comprehensive Spending Review in July 2007.

**Table: Main measures in the 2006 Budget and Pre-Budget Report**

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> <li>○ Increase in air passenger duty (+0.1% of GDP)</li> <li>○ Tax base consolidation and anti-tax avoidance measures (+0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>○ Pre-announcement of expenditure settlement for smaller Departments ***.</li> </ul>

\* Estimated impact on general government revenues in financial year 2007/08.

\*\* Estimated impact on general government expenditure in financial year 2007/08.

\*\*\* Because the reduction in expenditure is already incorporated in the fiscal projections in the convergence programme update, these measures do not yield a direct saving for the Exchequer compared to the baseline.

Sources: Commission services and convergence programme.

#### 4.2.3. *The medium-term objective (MTO) and the structural adjustment*

The update does not present a medium-term objective (MTO) for the budgetary position 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. As a consequence, a range of paths for the structural deficit are consistent with the UK framework. The projected medium-term path for the cyclically-adjusted deficit is 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”).

#### **Box 5: The medium-term objective (MTO) for the budgetary position**

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific 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 MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct 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 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

Table 7 below 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 2.5% of GDP in 2006/07 to a deficit of 1½% of GDP in 2009/10 and to 1¼% of GDP in 2011/12. The budgetary position projected in the programme for 2011/12 would stabilise debt at a low level (just above 44% of GDP) and then bring it to a slightly declining path. However, the projected path for cyclically adjusted deficits leaves relatively little room for fiscal policy to deal with possible macroeconomic shocks. In particular, the estimated minimum benchmark – that is, the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value – calculated for the UK as a deficit of around 1½% of GDP, is projected to be reached only in 2009/10.

**Table 7: Output gaps and cyclically-adjusted and structural balances**

(% of GDP)	2005/06		2006/07		2007/08		2008/09		2009/ 10	2010/ 11	2011/ 12	Change: 2011/12- 2006/07
	COM	CP <sup>1</sup>	COM <sup>2</sup>	CP <sup>1</sup>	COM <sup>2</sup>	CP <sup>1</sup>	COM <sup>2</sup>	CP <sup>1</sup>	CP <sup>1</sup>	CP <sup>1</sup>	CP <sup>1</sup>	CP <sup>1</sup>
Gen. gov't balance	-2.9	-2.9	-3.0	-2.8	-2.7	-2.3	-2.5	-1.9	-1.7	-1.6	-1.4	<b>1.4</b>
One-offs <sup>2</sup>	0.3	-	-	-	-	-	-	-	-	-	-	-
Output gap <sup>3</sup>	-0.3	-0.5	-0.4	-0.6	-0.5	-0.6	-0.7	-0.6	-0.5	-0.4	-0.3	-
CAB <sup>4</sup>	-2.8	-2.7	-2.8	-2.5	-2.4	-2.1	-2.2	-1.7	-1.5	-1.4	-1.3	<b>1.2</b>
<i>change in CAB</i>			0.0	+0.2	+0.4	+0.4	+0.2	+0.4	+0.2	+0.1	+0.1	-
CAPB <sup>4</sup>	-0.7	-0.6	-0.8	-0.3	-0.5	0.0	-0.1	0.4	0.5	0.7	0.8	
Structural balance <sup>5</sup>	-3.1	-3.0	-2.8	-2.5	-2.4	-2.1	-2.2	-1.7	-1.5	-1.4	-1.3	<b>1.2</b>
<i>change in struct. bal.</i>			+0.3	+0.5	+0.4	+0.4	+0.2	+0.4	+0.2	+0.1	+0.1	-
Struct. prim. Balance <sup>6</sup>	-1.0	-0.9	-0.8	-0.3	-0.4	0.0	-0.1	0.4	0.5	0.7	0.8	<b>1.1</b>

Notes:

<sup>1</sup>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.

<sup>2</sup>Commission forecast for the deficit is before Pre-Budget Report (PBR) discretionary measures. Adjusted for the discretionary measures, the Commission services' forecast would be -3.0%, -2.5%, and -2.3% of GDP in 2006/07, 2007/08 and 2008 /09 respectively.

<sup>3</sup>In percent of potential GDP. Output gaps from the Commission services' forecast reported here 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.

<sup>4</sup>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 6). The CAB, CAPB and structural balance estimates in the Commission services' forecast is made on the basis of an estimate of the output gap on a financial year basis, based on a weighted average of the calendar year estimates.

<sup>5</sup>CAB excluding one-off and other temporary measures.

<sup>6</sup>Structural primary balance = CAPB excluding one-off and other temporary measures.

Source:

*Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations*

The planned structural adjustment is projected to average around ¼ percentage point of GDP per year. The adjustment is front-loaded, with the structural balance improving by about ¾ percentage points in the first two years between 2006/07 and 2008/09, corresponding to a mildly restrictive stance of fiscal policy<sup>33</sup>. As mentioned in section 4.2.2 above, in the short term the structural improvement is driven by an increase of the revenue ratio, supported by a set of discretionary measures and by continued strong profitability in the non-oil corporate sector. It needs to be noted however, that while under the commonly agreed methodology for cyclical adjustment, the increase in revenues appears to be structural, it might well be that part of it, e.g. from the financial sector, might be cyclical in nature, i.e. linked to an upswing in financial asset prices, which is not perfectly correlated with the economic cycle. From 2008/09, the structural improvement comes from a projected fall in the expenditure to GDP ratio.

After 2009/10 the structural adjustment slows considerably, even as the negative output gap continues to narrow.

### **4.3. Risk assessment**

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2008/09, table 8 compares the detailed

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<sup>33</sup> Note that the output gaps profile in the convergence programme differs from the profile as recalculated by the Commission services. In particular, the UK authorities expect the output gap to close in early 2007, and project the economy to grow at the potential rate thereafter. This also explains why the output gap remains negative at the end of the projection period in the Commission services' recalculations. This 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; if the UK authorities projected the output gap to be still negative in 2007/08, as in the Commission services' calculations, it is plausible that the convergence programme would have projected GDP growth in 2007 above potential until the output gap closed.

revenue and expenditure projections in the Commission services' autumn 2006 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

As the table suggests, the Commission services' forecast projects a higher deficit profile than does the updated convergence programme, with a wider deficit by about ½ percent of GDP by 2008/09. However, most of the difference can be explained by information having emerged following the publication of the Commission services' forecast and by a technical assumption, rather than by a substantially different view of the fiscal outlook. First, strong outturns for corporation tax receipts in 2006/07, published after the close of the Commission services' forecast, suggest a marginally better fiscal outlook, although current expenditure growth will need to continue to slow in order to meet budgetary targets in the current financial year (see also section 4.1 above). Second, after the publication of the Commission services' forecast, the Pre-Budget Report implemented a set of discretionary measures that together are estimated to increase revenues by 0.2% of GDP from 2007/08 (see box 4 above). Third, the Commission services' forecast assumes that total expenditure in 2008/09 remains constant as a percentage of GDP at the 2007/08 levels. This is a technical assumption that takes into account the fact that, as mentioned above while the UK authorities have expressed an ambition to significantly slow current expenditure growth from 2008/09, leading to a reduction of the expenditure to GDP ratio, firm expenditure plans are still to be confirmed. Should the Comprehensive Spending Review embody in full the reduction in expenditure growth projected in the programme, the fiscal position would improve by about 0.2% of GDP. Once these exogenous factors are taken into account, the fiscal projections in the update of the convergence programme would be significantly closer to the Commission services' projections.

**Table 8: Comparison of budgetary developments and projections**

(% of GDP)	2005/06		2006/07		2007/08		2008/09		2009/10	2010/11	2011/12
	CO M	CP	CO M	CP	CO M	CP	COM <sub>1</sub>	CP	CP	CP	CP
<b>Revenues<sup>2</sup></b>	<b>39.5</b>	<b>38.6</b>	<b>40.0</b>	<b>39.3</b>	<b>40.4</b>	<b>39.8</b>	<b>40.6</b>	<b>40.0</b>	<b>40.0</b>	<b>40.0</b>	<b>40.0</b>
<i>of which:</i>											
- Taxes & social contributions <sup>3</sup>	37.7	37.0	38.0	37.5	38.5	37.9	38.7	n.a.	n.a.	n.a.	n.a.
- Other (residual)	1.9	1.7	2.0	1.8	2.0	2.0	2.0	n.a.	n.a.	n.a.	n.a.
<b>Expenditure<sup>2</sup></b>	<b>42.6</b>	<b>41.5</b>	<b>43.0</b>	<b>42.0</b>	<b>43.1</b>	<b>42.1</b>	<b>43.1</b>	<b>42.0</b>	<b>41.8</b>	<b>41.6</b>	<b>41.4</b>
<i>of which:</i>											
- Primary expenditure	40.5	39.4	41.0	39.9	41.1	40.0	41.1	n.a.	n.a.	n.a.	n.a.
<i>of which:</i>											
Consumption	21.7	22.2	21.6	22.2	21.7	22.2	21.7	n.a.	n.a.	n.a.	n.a.
Transfers & subsidies	13.6	14.7	13.4	14.7	13.2	14.6	13.1	n.a.	n.a.	n.a.	n.a.
Gross fixed capital form.	1.9	0.6	2.2	2.2	2.4	2.3	2.4	n.a.	n.a.	n.a.	n.a.
Other (residual) <sup>4</sup>	4.1	1.9	4.2	1.0	4.3	0.9	4.3	n.a.	n.a.	n.a.	n.a.



- Interest expenditure	2.1	2.1	2.0	2.1	2.0	2.1	2.1	2.1	n.a	n.a	n.a
<b>General government balance (GGB)</b>	-2.9	-2.9	-3.0	-2.8	-2.7	-2.3	-2.5	-1.9	-1.7	-1.6	-1.4
<b>Primary balance<sup>5</sup></b>	-0.9	-0.8	-1.0	-0.6	-0.6	-0.2	-0.4	0.1	0.3	0.5	0.7
One-offs <sup>6</sup>	0.3	-	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>-3.2</b>	<b>-2.9</b>	<b>-3.0</b>	<b>-2.8</b>	<b>-2.7</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-1.9</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.4</b>

Notes:

<sup>1</sup>On a no-policy change basis.

<sup>2</sup>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. Moreover, the UK projections use an estimate of GDP which is not corrected for Financial Intermediation Services not Directly Measured (FISIM). For these reasons, the fiscal aggregates in the Convergence Programme and in the Commission services forecast are not directly comparable in levels but only in the yearly rate of change. The projections in the update of the convergence programme 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.

<sup>3</sup>"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.

<sup>4</sup>Compared to the 2004 update, the category "other expenditure" is much higher, due to a re-classification of some elements of expenditure.

<sup>5</sup>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.

<sup>6</sup>One-off and other temporary measures.

Source:

*Commission services' autumn 2006 economic forecasts (COM); convergence programme update (CP); Commission services' calculations*

As discussed in section 3.2, the macroeconomic scenario adopted to project the public finances in the update of the convergence programme is broadly in line with the Commission services' forecast up to 2008, and thereafter follows a projection for trend growth which is broadly plausible. The key uncertainty appears to be in estimating the cyclical position of the economy, in the view of the remarkable increase in labour supply that could further increase the growth potential of the economy.

About half of the projected fiscal consolidation is due to an increase in the tax-to-GDP ratio. This is supported by a specific set of discretionary measures implemented in the Pre-Budget Report, but is also explained by an increase in the ratio of non-oil corporation tax to GDP, which is expected to increase by 0.2 percentage points in 2007/08, continuing the increase seen in the current financial year.

Table 9 below analyses the differences in the tax forecast between the Commission services' autumn forecast and the convergence programme, focusing on total tax and its implicit elasticity to GDP. The split of the difference into an elasticity and composition component presented in the table needs to be taken with extreme caution as being only broadly indicative, due to data gaps that do not allow a full analysis of the tax forecast in the convergence programme. Part of the higher elasticity component in the convergence

programme is explained by discretionary measures announced in the December 2006 Pre-Budget Report, after the Commission services forecast was finalised. The comparison with the ex-ante OECD estimates highlights how both forecasts have a slightly higher elasticity of taxes to GDP over the next two years, reflecting past discretionary measures and buoyant corporation tax receipts. Overall, the table shows that up to 2008/09 the revenues projections in the programme are in line with the Commission services' autumn forecast. By 2008/09 both the convergence programme and the Commission services' forecast appear to converge to the ex-ante elasticities, which could be considered as further supporting the plausibility of the forecasts<sup>34</sup>.

**Table 9: Assessment of tax projections**

	2006/07			2007/08			2008/09		
	CP	COM	OECD <sup>3</sup>	CP	COM <sup>1</sup>	OECD <sup>3</sup>	CP	COM	OECD
Change in tax-to-GDP ratio (total taxes)	0.6	0.4	0.2	0.5	0.4	0.2	0.2	0.2	0.2
Difference (CP – COM)	0.2		/	0.1		/	0.0		/
<i>of which</i> <sup>2</sup> :									
- discretionary and elasticity component	0.8		/	0.7		/	0.0		/
- composition component	-0.5		/	-0.5		/	0.0		/
Difference (COM - OECD)	/	0.2		/	0.2		/	0.0	
<i>of which</i> <sup>2</sup> :									
- discretionary and elasticity component	/	0.2		/	0.3		/	0.0	
- composition component	/	0.0		/	0.0		/	0.0	
p.m.: Elasticity to GDP	1.3	1.2	1.1	1.2	1.2	1.1	1.1	1.1	1.1
<b>Notes:</b>									
<sup>1</sup> On a no-policy change basis.									
<sup>2</sup> The decomposition is explained in Annex 5.									
<sup>3</sup> Based on OECD ex-ante elasticity relative to GDP.									
<b>Source:</b>									
Commission services' autumn 2006 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)									

Looking at corporation tax, revenues from the oil-producing sector are projected to remain constant as a percentage of GDP, reflecting lower sterling oil prices offset by an increase in oil production in the short term. Non-oil corporation tax, which includes revenues from the financial sector, is projected to increase by about 0.2 percentage points of GDP into 2007/08 and then remain constant as a percentage of GDP thereafter. This component has historically been a relatively volatile item, and has been a source of large forecast differences in the past. For example, one-year-ahead fiscal projections have overestimated non-oil corporation tax receipts on average by 0.3% of GDP between 2000/01 and 2005/06, a difference which was mainly attributed to slower than expected financial sector profits growth. However, the current projections for corporation tax receipts appear more plausible than in the past, given the strong outturns registered in the

<sup>34</sup> This is because the ex-ante elasticity was estimated by the OECD with reference to the tax code in force in 2003. Since 2003, the UK has enacted a number of small discretionary measures that could have increased the ex-ante elasticity, such as an increase in taxation for oil companies, as well as measures aimed at consolidating the tax base and closing tax loopholes.

first half of the current year, and the continuing strong profitability across the economy. Moreover, a set of indicators, such as the number of merger and acquisitions, sectoral employment and rising equity prices suggest that it is plausible that the current favourable outlook should continue into the 2007/08 financial year, especially in the financial sector. Thus, while risks remain due to the intrinsic volatility of corporation tax receipts from the financial sector, the projections in the updated convergence programme appear to be a plausible central forecast.

On the expenditure side, the fiscal adjustment planned in the programme relies on a moderation in growth in current expenditure, leading to a drop in the expenditure to GDP ratio from 2008/09 on. As mentioned above, this reduction will need to be confirmed in the 2007 Comprehensive Spending Review, announced for July 2007. As highlighted in assessments of previous updates, these plans seem achievable but challenging, given that the need for infrastructure investment means that the entire correction is planned to fall on current expenditure. Moreover, the UK authorities have made a number of policy commitments (e.g. on reducing the number of children in poverty by 2010, or increasing expenditure on overseas development assistance as a percentage of GDP) which will have implications for the Comprehensive Spending Review. It also has to be noted that the convergence programme update projects the drop in the expenditure ratio to continue in 2011/12. However, the last year of the projection period does not fall within the Comprehensive Spending Review horizon, and thus plans for that year will not be confirmed until the next Spending Review<sup>35</sup>.

However, the UK authorities sent a signal on their intention to free up resources by using the 2006 Budget and Pre-Budget Report to pre-announce the spending settlement for some smaller departments, which will see their budgetary allocations fall in real terms from 2008/09 (see Box 4 above)<sup>36</sup>.

In sum, the fiscal projections appear broadly plausible up to 2007/08, although historical volatility of revenue items such as revenues from the financial and oil-producing sectors on which the UK fiscal system tends to be reliant, is relatively high. After 2008/09, achieving the projected path for the deficit will depend upon the UK authorities' confirming the projected reduction in the expenditure to GDP ratio in the forthcoming Spending Review, and subsequently using the existing monitoring mechanisms to enforce the expenditure ceilings.

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<sup>35</sup> Moreover, a risk that Departments carry over to future fiscal years unspent budgetary allocations was identified in the assessments of previous updates. At the end of financial year 2004/05, unspent allocations totalled around £12bn (roughly 1% of 2005/06 GDP), against which no specific budgetary provision seemed to be made, as highlighted in the assessment of previous updates of the convergence programme. However, Parliamentary approval should still be sought if the drawdown of such allocations would take Departmental expenditure above plans, and the UK authorities have a good track record in enforcing the annual expenditure ceilings.

<sup>36</sup> However, the significant reductions in HM Revenues and Customs' (the UK tax agency) budget could create a risk to the success of the anti-avoidance strategy, on which consolidation efforts have relied over the past four years. The UK authorities also used the Pre-Budget Report to pre-announce the capital budget to be spent on education, which will see a slight rise as a percentage of GDP over the CSR period.

#### 4.4. Assessment of the fiscal stance and budgetary strategy

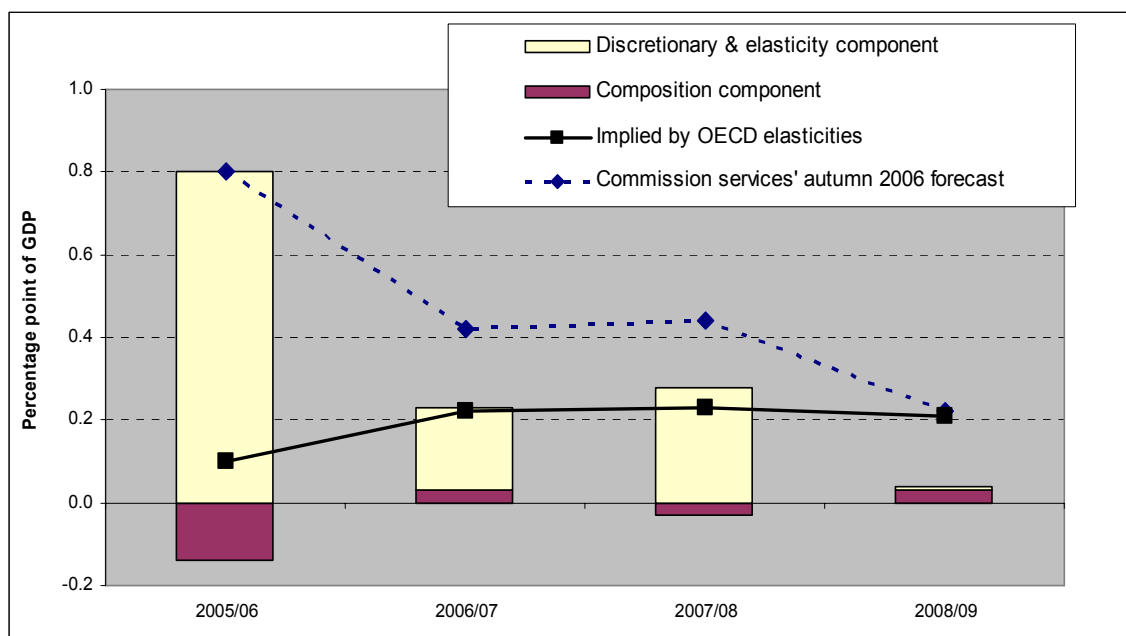
The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

**Table 10: Overview of compliance with the Stability and Growth Pact**

	<b>Based on programme<sup>3</sup> (with targets taken at face value)</b>	<b>Assessment (taking into account risks to targets)</b>
a. Consistency with correction of excessive deficit by 2006/07 deadline	Yes	Yes
b. Safety margin against breaching 3% of GDP deficit limit <sup>1</sup>	From 2009/10 onwards	From 2009/10 onwards if projected spending restraint implemented.
c. Achievement of the MTO	No MTO defined (only in terms of domestic framework)	No MTO defined (only in terms of domestic framework)
d. Adjustment towards MTO in line with the Pact <sup>2</sup> ?	should be strengthened, especially towards the end of the period	should be strengthened, especially towards the end of the period
<p>Notes:</p> <p><sup>1</sup>The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1½% of GDP for the United Kingdom). These benchmarks represent estimates and as such need to be interpreted with caution.</p> <p><sup>2</sup>The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.</p> <p><sup>3</sup>Targets in structural terms as recalculated by Commission services on the basis of information in the programme.</p> <p><u>Source:</u> <i>Commission services</i></p>		

The Commission services' assessment, taking into account risks to the budgetary targets, suggests that the United Kingdom is on track to correct its excessive deficit by financial year 2006/07, the deadline set by the Council. However, while the short-term fiscal outlook appears to have improved, uncertainties about the correction of the excessive deficit have not entirely dissipated. According to the Commission services' estimates at the time of their autumn forecast, the structural adjustment was expected to fall short of the 0.5% of GDP for 2006/07 required under the Pact (and specified in the Council recommendation on the correction of the excessive deficit). However, the slightly better outcome for 2006/07 projected in the update of the convergence programme appears to be achievable if expenditure overruns are avoided, possibly leading to a structural adjustment in line with the Council recommendation.

**Figure 9: Changes in the tax-to-GDP ratio:  
actual/projected changes vs. changes implied by OECD elasticity**



**Note:**

The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008/09, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

**Source:**

*Commission services*

A safety margin against exceeding the 3 percent reference value would be reached only in 2009/10, if the Comprehensive Spending Review is implemented as projected. As mentioned above, the updated programme does not define a quantitative MTO in the sense specified in the Pact, but refers to the UK's domestic fiscal rules, which target different fiscal aggregates than the cyclically-adjusted deficit. Because a quantitative MTO cannot be inferred from the budgetary projections presented in the programme, it is not possible to assess whether the MTO is achieved within the programme period.

As regards the pace of adjustment, the path for the structural balance projected in the convergence programme update is consistent with stabilising and slightly reducing the debt to GDP ratio. However, towards the end of the period the planned structural adjustment slows significantly and the achievement of the budgetary targets from 2008/09 is subject to implementation of the projected expenditure restraints. The negative output gap is estimated to narrow throughout the projection period, while

developments in the tax elasticities are expected to be relatively favourable. The adjustment could thus be strengthened, also in order to create room for manoeuvre for fiscal policy against possible macroeconomic uncertainties, both at the global level (e.g. through a sharp realignment of global imbalances hitting economic growth) or to the volatile elements of revenues, such as oil prices.

The United Kingdom authorities have made some progress towards fiscal consolidation, but mainly through a sharp increase in the tax to GDP ratio that has originated from buoyant corporation tax revenues from the oil-producing and financial sectors, and from some discretionary measures, mainly on the anti-avoidance side. This is highlighted in Figure 9 above, showing a relatively high elasticity of taxes to GDP in 2005/06. Overall, the tax to GDP ratio rose by over 1½ percentage points between 2002/03 and 2005/06. Given that the deficit remains close to the 3 percent reference value, and in order to avoid possible disincentive effect of a sharp increase in the tax burden, it is appropriate that the forthcoming fiscal consolidation relies on a gradual restraint of current expenditure in real terms to below the potential rate of growth of the economy.

## **5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY**

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.<sup>37</sup> The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the convergence programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

### **5.1. Recent debt developments and medium-term prospects**

#### *5.1.1. Debt projections in the programme*

The UK government gross debt ratio is set to remain well under the reference value of 60% of GDP, even if projected to be on a rising trend, as shown in Table 11.

The authorities' latest estimate for the current financial year 2006/07 is for general government gross debt to reach 43.7% of GDP, a downward revision compared to the 2005 update, reflecting the improved prospects for the deficit and more favourable outturns for the net cash requirement, the non-accrual flow measure that determines changes in the stock of debt. Thereafter, the debt ratio is projected to rise to 44.2% of GDP by 2008/09, and then to decline slightly to 44.0% in 2010/11 and 43.6% in 2011/12 (not shown in the table).

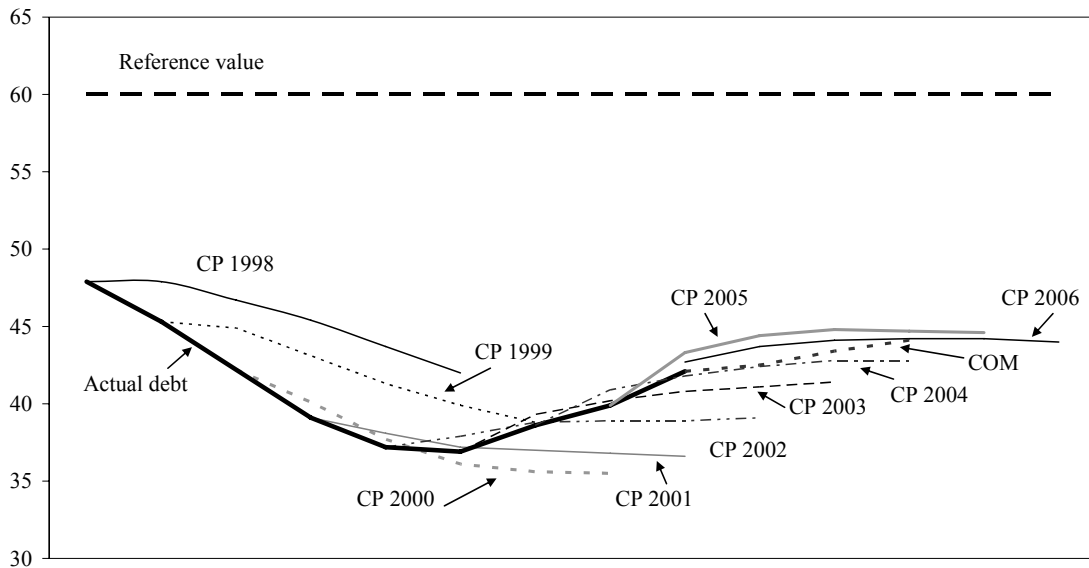
As in other previous convergence programmes, the UK authorities also project public sector net debt (i.e. allowing for the accumulation of financial assets), which is the fiscal

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<sup>37</sup> On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

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 37.5% of GDP in 2006/07 to 38.7% of GDP in 2009/10, 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 there be some slippages compared to the current projections.

**Figure 10: Debt projections in successive convergence programmes (% of GDP)**



**Source:** Commission services' autumn 2006 forecast (COM) and successive convergence programmes

Figure 10 compares the projections for general government gross debt in successive convergence programme with the outturns. The table shows that since 2000 outturns have tended on average to overshoot projections, reflecting the overshoot of deficit targets seen in section 2. However, in 2005 projections for debt have proved to be cautious, mainly due to a prudent assumption on accumulation of liquid assets leading to a positive stock flow adjustment, as noted in the assessment of last year's convergence programme.

**Table 11: Debt dynamics**

(% of GDP)	average 2000-04	2005/ 06	2006-07		2007-08		2008-09		2009-10	2010-11
			COM	CP	COM	CP	COM	CP	CP	CP
<b>Gross debt ratio<sup>1</sup></b>	<b>38.3</b>	<b>42.1</b>	<b>42.5</b>	<b>43.7</b>	<b>43.4</b>	<b>44.1</b>	<b>44.1</b>	<b>44.2</b>	<b>44.2</b>	<b>44.0</b>
Change in the ratio	-0.5	2.2	0.4	1.6	0.9	0.4	0.6	0.1	0.0	-0.2
<i>Contributions<sup>2</sup>:</i>										
<b>Primary balance</b>	<b>-1.2</b>	<b>0.9</b>	<b>1.0</b>	<b>0.6</b>	<b>0.6</b>	<b>0.2</b>	<b>0.4</b>	<b>-0.3</b>	<b>-0.5</b>	<b>-0.7</b>
<b>“Snow-ball” effect</b>	<b>0.3</b>	<b>0.5</b>	<b>-0.3</b>	<b>-0.1</b>	<b>0.0</b>	<b>-0.2</b>	<b>0.1</b>	<b>-0.1</b>	<b>-0.1</b>	<b>-0.1</b>
<i>Of which:</i>										
Interest expenditure	2.2	2.1	2.0	2.1	2.0	2.1	2.1	2.1	2.1	2.0
Growth effect	-1.1	-0.7	-1.1	-1.1	-1.0	-1.1	-1.0	-1.0	-1.1	-1.1
Inflation effect	-0.9	-0.9	-1.2	-0.4	-1.0	-1.2	-1.1	-1.1	-1.1	-1.1
<b>Stock-flow adjustment</b>	<b>0.5</b>	<b>0.8</b>	<b>-0.2</b>	<b>0.4</b>	<b>0.2</b>	<b>0.4</b>	<b>0.2</b>	<b>0.5</b>	<b>0.5</b>	<b>0.6</b>
<i>Of which:</i>										
Cash/accruals diff.	-0.1	-0.1	-	-	-	-	-	-	-	-
Acc. financial assets	0.5	0.9	-	-	-	-	-	-	-	-
<i>Privatisation</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Val. effect & residual	-0.9	-0.9	-	-	-	-	-	-	-	-
<b>Notes:</b>										
<sup>1</sup> End of period.										
<sup>2</sup> The change in the gross debt ratio can be decomposed as follows:										
$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$										
where <i>t</i> is a time subscript; <i>D</i> , <i>PD</i> , <i>Y</i> and <i>SF</i> are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and <i>i</i> and <i>y</i> represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the “snow-ball” effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.										
<i>Source:</i>										
Convergence programme update (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations										

Table 11 above shows that the pattern of primary deficits is the main driver of the rising debt ratio up to 2007/08. although a positive stock-flow adjustment, mainly reflecting loans to higher education students, also plays a role.

### 5.1.2. Assessment

The gross debt projections in the 2006 update of the convergence programme are broadly in line with the Commission services' autumn forecast. In terms of the drivers of debt, the Commission however projects a slightly higher primary deficit profile, which is however offset in the convergence programme projections by a larger positive stock-flow adjustment throughout the projection period.

In general, the debt projections appear balanced, and the ample margin against the 60% reference value should ensure that the UK continues to meet the debt criterion in the Stability and Growth Pact over the period covered by the convergence programme.



## 5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.<sup>38</sup>

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (see box 6), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006/07 through 2011/12, the final year of the convergence programme; it is called the “2006 scenario”. Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2011/12 provided in the convergence programme will be fully respected. This is the “programme scenario”. Debt and primary balance projections in this scenario start in 2012. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

### 5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections.<sup>39</sup> Non age-related primary expenditure and revenue are assumed to remain constant as a share of GDP.

**Table 12: Long-term age-related expenditure: main projections**

(% of GDP)	2004	2010	2020	2030	2040	2050	changes
<b>Total age-related spending</b>	19.6	19.4	19.9	21.8	22.9	23.6	4.0
Pensions	6.6	6.6	6.9	7.9	8.4	8.6	2.0
Healthcare	7.0	7.2	7.6	8.1	8.7	8.9	1.9
Long-term care	1.0	1.0	1.1	1.3	1.5	1.8	0.8
Education	4.6	4.2	4.0	4.1	4.0	4.0	-0.6
Unemployment benefits	0.4	0.3	0.3	0.3	0.3	0.3	0.0

*Source: Economic Policy Committee and Commission services.*

Note: the convergence programme includes long-term projections of the above-mentioned expenditure items which point to a slightly higher increase in age-related expenditure, see section 5.2.2.

<sup>38</sup> For a detailed analysis of long-term sustainability issues, see “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

<sup>39</sup> These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), “The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)”, European Economy, Special Report No 1 (hereinafter Ageing Report).

The projected increase in age-related spending in the UK is somewhat higher than the average of the EU; rising by 4% points of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be relatively limited in the UK, rising by 2.0% points.<sup>40</sup> This reflects the fact that the UK has historically relied relatively more on private pension arrangements (occupational and individual schemes) than most other EU Member States do. The increase in health-care expenditure is projected to be 1.9% points of GDP, slightly above the average in the EU. For long-term care, the projected increase of 0.8% points up to 2050, slightly above the average in the EU.

### Box 6– Sustainability indicators\*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden\*\*) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the:\*\*\* (i) **initial budgetary position (IBP)**; and, (ii) **long-term change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2012-2016) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

#### Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		Long-term changes in the primary balance
<b>S1***=</b>	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure <i>up to 2050</i>
<b>S2=</b>	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure <i>over an infinite horizon</i>

\* For a complete description of the sustainability indicators, see Annex I of the “The Long Term Sustainability of Public Finances – A report by the Commission services”, European Economy n°4/2006, published in October 2006.

\*\* Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

\*\*\* Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

<sup>40</sup> These projections do not take into account the recent proposals of the White Paper (see below Section 5.2.2 - Additional factors).

**Table 14: Sustainability indicators and the required primary balance**

	2006 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	2.6	4.2	3.8	1.4	3.0	3.7
<i>of which:</i>						
Initial budgetary position	0.8	1.0	-	-0.3	-0.2	-
Debt requirement in 2050	-0.2	-	-	-0.3	-	-
Future changes in budgetary position	2.0	3.2	-	2.0	3.2	-

*Source: Commission services.*

Table 14 shows the sustainability indicators for the two scenarios. In the “2006 scenario”, the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 2.6% of GDP. The sustainability gap (S2) which satisfies the intertemporal budget constraint would be 4.2% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are smaller in the present assessment, by about  $\frac{3}{4}$  p.p. of GDP. This is mainly due to a lower structural primary deficit, in 2006/07 (0.3% of GDP) compared with the structural primary deficit in 2005 estimated in spring 2006 (around 1.1% of GDP) that was used in the Sustainability Report.

The initial budgetary position constitutes a risk to the sustainability of public finances even before considering the long-term budgetary impact of ageing. The budgetary plans in the programme imply a strengthening of the structural balance, of 1.2 p.p. of GDP, between 2006/07 and 2011/12. If achieved, such a consolidation would reduce risks to long-term sustainability of public finances, reducing the S2 sustainability gap by about 1.2% of GDP (“programme scenario”). The difference between the initial budgetary position in the 2006 scenario and the programme scenario illustrates how the full respect of the convergence programme targets, will contribute to tackling the budgetary challenges raised by the demographic developments.

According to both sustainability gaps, the long-term budgetary impact of ageing is close to the EU average, thanks to the limited increase in pension expenditure over the long term.

The required primary balance (RPB) is around  $3\frac{3}{4}$ % of GDP, higher than the structural primary surplus of 0.8% of GDP in the last year of the programme's period.

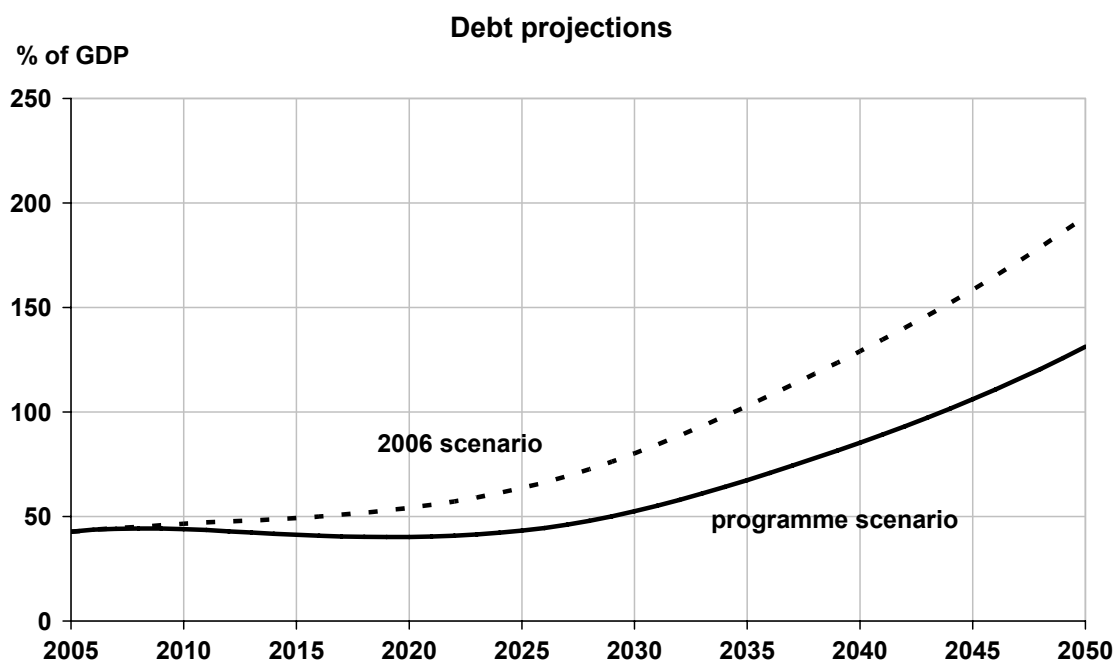
Moreover, the sustainability gap indicators would increase by up to 0.3 p.p. of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 11.

The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at 43.7% of GDP in 2006/07. According to the “2006 scenario”, the debt ratio is projected to start increasing in the 2010s as the impact of ageing takes hold and in the mid-2020s it will be higher than 60% of GDP. In the “programme scenario” the projected increase in the debt ratio will start somewhat later, since the budgetary position

in 2011/12 is stronger than in 2006/07, and the debt/GDP ratio would rise above the 60% of GDP threshold in the 2030s<sup>41</sup>.

**Figure 11: Long-term projections for the government debt ratio**



*Source: Commission's services*

### 5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to from where the main risks are likely to stem.

First, following the conclusions of the Pensions Commission,<sup>42</sup> the UK government published a White Paper<sup>43</sup> which outlines the proposed measures:

- (i) a reform of private pension provision, creating individual accounts into which most employers would be automatically enrolled (with an opt-out provision), funded by a combination of government, employee and employer contributions

<sup>41</sup> It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

<sup>42</sup> The Pensions Commission was set up by the UK Government in 2002, with a mandate to review the UK pension system and long-term saving incentives, and to make recommendations for reform. The Pensions Commission published its final report in April 2006 ('Implementing an integrated package of pensions reforms: The final report of the Pensions Commission', 2006).

<sup>43</sup> "Security in retirement: towards a new pensions system", Department for Work and Pensions and HM Treasury, May 2006

(ii) a reform of state pension provision, which simplifies the current arrangements, moving towards a flat rate system, and changes indexation from prices to earnings, thus increasing its generosity, and

(iii) a gradual increase in the state pension age, by one year every decade starting from 2024.

In November 2006 the UK government tabled a bill in Parliament implementing the reform of the state pension outlined in the White Paper. Indeed, the reform addresses the concerns of potentially inadequate pension provision in the future and should partly compensate for the decrease in the public benefit ratio projected in the Ageing Report (by about 20% between 2004 and 2050).

Overall, according to the 2006 update of the *'Long-term Public Finance Report'*, published by the UK's Treasury state pensions spending would be around 0.6 p.p. of GDP higher after 2030 than projected in the Ageing Report.<sup>44</sup>

Second, the update of the convergence programme presents long-term projections for the general government in a somewhat different macroeconomic and demographic framework than in the Ageing Report. As regards the expenditure items<sup>45</sup> covered by the Ageing Report, the update points to slightly higher increase in age-related expenditure (of around ½ points of GDP) over the long term, essentially due to slightly more dynamic health-care and education spending.

Third, the convergence programme projects a decrease in non age-related spending of slightly more than ½ point of GDP and an increase in revenue of around 2% points of GDP between the end of the programme period and 2050. The decrease in non age-related expenditure is mainly explained by the indexation to prices of social transfers other than pensions. The increase in the tax/GDP ratio does not seem to result from a specific feature of the tax system in the UK, but from an assumption that an increase in the number of pensioners will generate higher direct and indirect tax revenues over the *long-term*. In the update of the convergence programme, the estimation is carried out assuming that the average income of older people will evolve in line with productivity<sup>46</sup>

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<sup>44</sup> Box 5.3 (page 42) of the UK Treasury's Long-term Public Finance Report provides new projections for state pension in the macroeconomic and demographic framework of the Ageing working group. Those projections include the impact of the pension reform on nominal pension expenditure and on employment and GDP. On the scenario before the reform proposed by the UK government, state pension expenditure was projected to be 5.0% of GDP in 2010, 5.4% of GDP in 2030, 5.8% of GDP in 2040 and 6.1% of GDP in 2050. After the reform, state pension expenditure is estimated to be 5.0% of GDP in 2010, 5.9% of GDP in 2030, 6.6% of GDP in 2040 and 6.7% of GDP in 2050.

<sup>45</sup> Pensions, health-care, long-term care and education. No projections for unemployment benefits are available in the update of the convergence programme. Yet, in the Ageing report, unemployment benefits are projected to decrease marginally from 0.4% points of GDP to 0.3% of GDP; therefore this should only have limited impact on the comparison. The increase in pension expenditure ratio is the same in the Ageing report and in the UK convergence programme even though the latter includes the impact of the reforms proposed in the White Paper, as different underlying assumptions being used.

<sup>46</sup> The UK's Treasury uses a generational accounting framework to project most expenditure and revenue budgetary items. For a number of expenditure and revenue items, age-profiles – that is the way expenditure and revenue are distributed through the different age cohorts – are estimated. Most of these age profiles are indexed on productivity. In a few cases, they are indexed on prices, in line with current policies. In addition, some age-profiles are slightly modified to make them consistent with employment projections (as for income tax, see Chart 4.5 on page 33 in the UK's Long-term public finance report, December 2006, provided below). As a result, the evolution of expenditure and

and therefore that the total benefit ratio (including public and private pensions) would remain stable.<sup>47</sup> This estimation thus presupposes that contributions to *private* pensions will increase over the long-term, reverting the trend of declining contributions to private sector occupational pensions since the early 1980s. This suggests that tax revenues could even be reduced in the *medium-term* (i.e. contributions to private pension schemes could be tax deductible). Given the lack of projections on the future evolution of private pensions provision and contributions, it is not possible to assess the overall, net impact of changes in tax revenues over the long-term.

### 5.2.3. Assessment

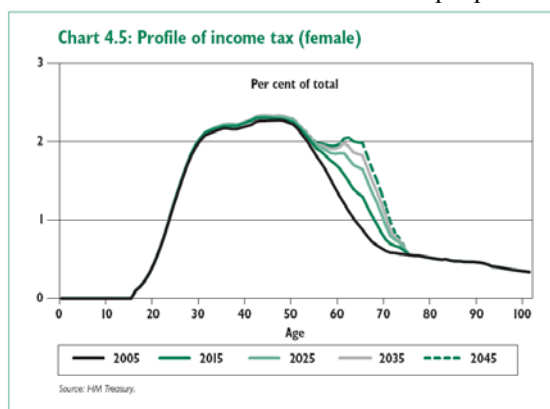
The long-term budgetary impact of ageing in the UK is close to the EU average, with pension expenditure showing a somewhat more limited increase than on average in the EU, in part as a result of the fact that the UK relies relatively more on private pension arrangements than do other EU countries. The currently proposed reforms, while addressing the concern of potentially inadequate provision of pensions in the future, could involve a slightly higher increase in expenditure than before.

The initial budgetary position, though improved compared to 2005, still constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Consolidating the public finances, as planned in the convergence programme, would contribute to reducing risks to the sustainability of public finances.

Overall, the UK appears to be at medium risk with regard to the sustainability of public finances.

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revenue results from the changes in the age structure of the population, the initial age-profile and the indexation. As can be seen from Chart 4.5, the implicit hypothesis behind those projections is that the relative income of older people compared to the working age population is constant or, put differently, that the total income of older people evolves in line with wages or productivity.



<sup>47</sup> The public benefit ratio should decrease by less than projected in the Ageing Report as a result of the pension reform. This would imply that the benefit ratio from private pensions would increase, or at least be maintained at its current level, so as to enable total pensions to increase proportionally with the projected change in the population structure of older people.

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

The significant increase in public expenditure implemented since 2002, with the specific purpose of improving the delivery of public services, has increased the focus on the issue of the effectiveness of public expenditure – in other terms, whether the increase in inputs in the public services led to an increase in outputs and, perhaps more relevantly, outcomes.

According to a measure based on the National Accounts, since 2000 government output in sectors such as health and education has increased less proportionally than inputs, leading to a decline in productivity. However, measuring public services output is complex, and national account measures could miss key aspects of public services delivery, such as quality improvement. In order to address these issues, the recent review of the measurement of government output and productivity made a number of recommendations<sup>48</sup>. Under the new experimental measurement techniques, the data would show a less sharp fall in productivity (in the case of health, productivity growth would between 1999 to 2005 have ranged between -0.5% and +0.2% a year, according to different measures of the inputs; measures of productivity in education range between 0% and a fall of 2% a year over the same period. Overall, these measures seem to be pointing to some falls in productivity, although it needs to be noted that productivity growth is not the only measure of public sector performance, and it might still be desirable to achieve an increase in public service outputs also at the cost of a fall in productivity, as further productivity growth might be difficult to achieve in some sectors.

The focus on public sector performance has also induced the UK authorities to undertake an exercise to improve the efficiency of the public sector in the delivering of public services. This initiative follows an investigation of how the operational efficiency of the public sector could be increased (the Gershon Report, published alongside the 2004 Spending Review). The report set a target of achieving annual efficiency gains of around £21bn by 2007/08. Departments and local authorities have reported annual efficiency gains of £13.3 billion by the end of September 2006; of these £5.5bn came from procurement, £2.4bn from "increasing productive time" and £1.5bn from improving the funding and regulation of Government activity.

The efficiency savings do not represent an overall fiscal tightening but a measure to increase the effectiveness of public expenditure. Gains do not revert to net savings for the Exchequer, but Departments and local authorities can retain achieved gains, re-directing them to priority areas within the same spending envelope.

Partly because there are no directly measurable net gains, progress in achieving the efficiency targets is intrinsically hard to evaluate, as the National Audit Office (NAO) reported in February<sup>49</sup>. While noting progress against the target, the report highlights a number of issues in measuring efficiencies achieved, due to time lags in data collection and Departments' abilities to measure changes in output quantity and quality as well as

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<sup>48</sup> See Atkinson T., "Atkinson review final report – Measurement of Government Output and Productivity for the National Accounts", January 2005. For a discussion of the implications of the Atkinson review's recommendations, see for example European Commission, "Public Finances in EMU", June 2006, p. 277-279.

<sup>49</sup> National Audit Office, "Progress in improving government efficiency", February 2006.

inputs. The December 2006 Pre-Budget Report announced that a framework for measuring and assess efficiency gains has now been put in place, in consultation with the NAO.

On the revenue side, the past five years have seen an increase in the tax burden, which has partly been achieved through fiscal drag and an increase in anti-avoidance measures, as well as some small ad-hoc tax increases. These have added to concerns, especially in the business community, at the increased complexity of the UK tax system. Combined with trends in other EU Member States towards reducing corporation tax rates, the UK has gone from having the fourth lowest corporate tax rate in the EU in 1999 to having the sixth highest among the EU-15 in 2006, raising some concerns also that these trends might have reduced the UK's attractiveness as a business location. However, a still relatively light overall regulatory burden remains an attractive feature of the UK economy.

As seen in Section 4, the forthcoming 2007 Comprehensive Spending Review (CSR) is projected to achieve a significant decrease in expenditure growth. The UK authorities have adopted a strategic approach to the 2007 CSR by commissioning a number of analytical studies and reviews aimed at identifying expenditure priorities. The CSR has been planned on a zero-baseline basis: that is, it will consider the appropriateness of overall expenditure allocations to Departments and not only requested changes relative to their baseline allocations. To support the CSR, the UK authorities are planning to develop Asset Management Strategies (AMS) for each department, which will set out the steps to maximise the value of their existing assets and will provide the foundations for future investment decisions. However, details of the proposal are not provided.

## **7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES**

The first implementation report on the UK National Reform Programme focuses on ensuring the achievement sustainable growth, high employment and a fair and inclusive society. The National Reform Programme presents a broad-based and relatively detailed strategy to reach this objective (see Section 5.2 on sustainability).

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 (see Box 6). It provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme. The budgetary implications of the actions outlined in the National Reform Programme are explicitly taken into account in the budgetary projections of the convergence programme.



**Box 7: The Commission assessment of the implementation report of the National Reform Programme**

The implementation report of the National Reform Programme of UK, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 16 October 2006. The Commission's assessment of this report, which was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The UK is making good progress in the implementation of its National Reform Program. The main challenges for the UK as described in the 2005-2008 National Reform Programme were: maintaining fiscal sustainability in the face of demographic challenges; building an enterprising and flexible business sector, promoting innovation and R&D; widening opportunities for the acquisition of skills; increasing innovation and adaptability in the use of resources; and ensuring fairness through a modern and flexible welfare state. Solid progress has been made in all policy areas, particularly in micro-economic and employment policy. In macro-economic policy, plans for fiscal consolidation and pension reform have been drawn up and still need to be implemented. The UK has made greater efforts to involve stakeholders.

The particularly strong points in the UK reform implementation are in encouraging entrepreneurship, promoting better regulation, and undertaking welfare reforms. Many other successful reforms have already taken place, such as energy market opening, increasing investment in transport infrastructure, and in introducing charging policies, for example the London road transport congestion charge. The UK has also undertaken innovative reforms to improve the quality of public expenditure that are still in the course of implementation.

The policy areas in the UK National Reform Programme where weaknesses need to be tackled most urgently are: improving skill levels compared with other economies; and tackling disadvantage and exclusion in the labour market. Against this background, it is recommended that the UK increase basic and intermediate skills, in order to raise productivity, and further improve employment prospects for the most disadvantaged.

In addition, it will be important for the UK over the period of the National Reform Programme to focus on: ensuring that the current proposals on pension reform are effectively implemented; progressively increasing housing supply to reduce house price pressures in the medium-term, without which there could be an effect on future growth prospects; implementing its science and innovation strategy, in the context of which an intermediate R&D target for 2010 should be set and measures should be taken to further strengthen investment incentives and to increase private sector engagement; and improving access to childcare.

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, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the convergence programme is broadly consistent with the broad economic policy guidelines.

**Table 16: Consistency with the broad economic policy guidelines**

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
<b>1. To secure economic stability</b>				
– 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 <sup>1</sup> .		X		
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .	X			
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .	X			
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.				X
<b>2. To safeguard economic and fiscal sustainability</b>				
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			
<b>3. To promote a growth- and employment-orientated and efficient allocation of resources</b>				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the 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 spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X			
<p><u>Notes:</u></p> <p><sup>1</sup>As further specified in the Stability and Growth Pact and the 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.</p> <p><sup>2</sup>As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.</p> <p><sup>3</sup>As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.</p> <p><u>Source:</u> Commission services</p>				

\* \* \*

## Annex 1: Glossary

**Automatic stabilisers** Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

**Broad economic policy guidelines (BEPGs)** Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

**Budget balance** The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also known as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance*, *structural balance* and *reference values*.

**Budget constraint** A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

**Budgetary sensitivity** The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance*, *structural balance* and *tax elasticity*.

**Code of conduct** Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

**Contingent liabilities** A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

**Convergence programme** Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme*, *code of conduct* and *medium-term objective*.

**Cyclically-adjusted balance** The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance*, *budgetary sensitivity* and *output gap*.

**Cyclically-adjusted primary balance** The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

**Debt dynamics** The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

**EDP notification** See *notification of deficit and debt*.

**ERM II** Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of  $\pm 15\%$  are defined.

**ESA95** European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

**Excessive deficit procedure (EDP)** A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

**Fiscal stance** A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

**Funded pension scheme** Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

**Government debt** See *public debt*.

**General government** The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

**Government net lending/borrowing** See *budget balance*.

**Implicit liabilities** Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

**Interest burden** *General government* interest expenditure on *government debt* as a share of GDP.

**Intertemporal budget constraint** A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

**Lisbon strategy** Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

**Long-term sustainability** A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

**Maturity structure of public debt** The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

**Medium-term objective (MTO)** According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific 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, and is defined in structural terms (see *structural balance*).

**Minimum benchmark** Estimated budgetary position (in *cyclically-adjusted* terms) that provides a “safety margin” that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

**National reform programme (NRP)** See *Lisbon strategy*.

**Notification of deficit and debt (EDP notification)** Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

**One-off and temporary measures** Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

**Output gap** The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary

pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

**Pay-as-you-go pension scheme (PAYG)** Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

**Primary balance** The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

**Pro-cyclical fiscal policy** A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

**Production function method** A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap*, *cyclically-adjusted balance*, *budgetary sensitivity*.

**Public debt (or government debt)** Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

**Public investment** The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

**Public-private partnerships (PPP)** Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

**Quality of public finances** A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

**Reference values for public deficit and debt** Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure*, *government debt* and *budget balance*.

**Sensitivity analysis** An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

**'Snow-ball' effect** The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

**Stability and Growth Pact (SGP)** Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

**Stability programme** Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme*, *code of conduct* and *medium-term objective*.

**Stock-flow adjustment (SFA)** The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics*.

**Structural balance** The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

**Structural primary balance** The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

**Tax elasticity** A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

## Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

**Table 1a. Macroeconomic prospects<sup>(1)</sup>**

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	(2,3,4) rate of change	(2,3,4) rate of change	(2,3,4) rate of change	(2,3,4) rate of change
<b>1. Real GDP</b>	B1*g		1¼	2¼	2¼ to 3¼	2½ to 3	2½ to 3
<b>2. Nominal GDP</b>	B1*g	1224¼	4	5¼	5¼ to 6	5¼ to 5¾	5¼ to 5¾

### Components of real GDP

<b>3. Private consumption expenditure (5)</b>	P.3		1½	2	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
<b>4. Government consumption expenditure</b>	P.3		2¾	2	2½	2½	2
<b>5. Gross fixed capital formation (6)</b>	P.5.1		2¾	6	5¼ to 5¾	3¼ to 3¾	3¼ to 3¾
<b>6. Changes in inventories and net acquisition of valuables (% of GDP) (7)</b>	P.5.2 + P.5.3		0	0	0	0	0
<b>7. Exports of goods and services (8)</b>	P.6		7	11½	½ to 1	4¾ to 5¼	4½ to 5
<b>8. Imports of goods and services (8)</b>	P.7		6½	11	¼ to ½	4¼ to 4¾	4 to 4½
Exports of goods and services (excluding MTIC)			4¼	6	5 to 5½	4¾ to 5¼	4½ to 5
Imports of goods and services (excluding MTIC)			4	6¼	4¼ to 4¾	4¼ to 4¾	4 to 4½

### Contributions to real GDP growth (9,10)

<b>9. Final domestic demand (11)</b>			¾	2½	2¼	2½	2½
<b>10. Changes in inventories and net acquisition of valuables</b>	P.5.2 + P.5.3		0	0	0	0	0
<b>11. External balance of goods and services</b>	B.11		0	-¼	0	0	0

#### Notes (UK):

(1) The forecast is consistent with output, income and expenditure data for the third quarter of 2006, released by the Office of National Statistics on 24 November 2006.

(2) All growth rates in tables throughout this annex are rounded to the nearest ¼ percentage point

(3) As in previous Budget and Pre-Budget reports, 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 2¼ per cent. 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.

(4) 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.

(5) Household consumption under UK definition. Includes households and non-profit institutions serving households.

(6) Fixed investment under UK definition

(7) Change in inventories under UK definition. Contribution to GDP growth, percentage points

(8) Figures up to and including 2007 are distorted by estimates of MTIC-related activity. Growth rates excluding MTIC are shown in subsequent lines of this table.

(9) Components may not sum to total due to rounding and omissions of private residential investment, transfer costs of land and existing buildings and the statistical discrepancy.

(10) Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.

(11) Equals sum of private consumption, business investment and government under UK definition.

**Table 1b. Price developments**

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>			2¼	2½	2¾	2¾	2¾
2. Private consumption deflator		105¼	3.0	2¼	2¾	2¾	2¾
<b>3. HICP*</b>			2¼	2½	2	2	2
4. Public consumption deflator							
5. Investment deflator							
<b>6. Export price deflator (goods and services)**</b>			1¼	2	2½	2¾	2¾
<b>7. Import price deflator (goods and services)**</b>			3¾	3	2¾	2¾	2¾

Notes:

\* Optional for stability programmes (COM)

\*\* Average value indices (UK)

**Table 1c. Labour market developments**

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons<sup>1</sup></b>							
2. Employment, hours worked <sup>2</sup>							
<b>3. Unemployment rate (%)<sup>3</sup></b>							
<b>4. Labour productivity, persons<sup>4</sup></b>							
5. Labour productivity, hours worked <sup>5</sup>							
<b>6. Compensation of employees</b>	D.1						

Notes:

<sup>1</sup>Occupied population, domestic concept national accounts definition.

<sup>2</sup>National accounts definition.

<sup>3</sup>Harmonised definition, Eurostat; levels.

<sup>4</sup>Real GDP per person employed.

<sup>5</sup>Real GDP per hour worked.

**Table 1d. Sectoral balances**

% of GDP	ESA Code	2005	2006	2007	2008	2009
<b>1. Net lending/borrowing vis-à-vis rest of the world *</b>	B.9					
<i>of which:</i>						
- Balance on goods and services		-3¾	-4¼	-4	-4	-4
- Balance of primary incomes and transfers		1½	1¾	1¼	1¼	1¼
- Capital account						
2. Net lending/borrowing of the private sector	B.9	1½	¼	-1	-1	-1¼
3. Net lending/borrowing of general government (1,2)*	EDP B.9	-2.8	-2.7	-2.2	-1.9	-1.7
<b>4. Statistical discrepancy</b>						

Notes:

(1) On financial year basis ("2005" corresponds to 2005/06)

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

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.



**Table 2. General government budgetary prospects**

	ESA code	2005/06	2005/06	2006/07	2007/08	2008/09	2009/10
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
<b>1. General government (1)*</b>	S.13	-35.2	-2.8	-2.7	-2.2	-1.9	-1.7
<b>2. Central government</b>	S.1311	-32.2	-2.6	-2.6	-2.2		
<b>3. State government</b>	S.1312	-	-	-	-	-	-
<b>4. Local government</b>	S.1313	-3.1	0.3	0.1	0.0		
<b>5. Social security funds</b>	S.1314						
<b>General government (S13)</b>							
<b>6. Total revenue</b>	TR	478.3	38.6	39.3	39.8	40.0	40.0
<b>7. Total expenditure</b>	TE (2)	513.6	41.5	42.0	42.1	42.0	41.8
<b>8. Net lending/borrowing (1)**</b>	EDP B.9	-35.2	-2.8	-2.7	-2.2	-1.9	-1.7
<b>9. Interest expenditure (incl. FISIM) ***</b>	EDP D.41 incl. FISIM	26.2	2.1	2.1	2.1	2.1	
<b>p.m.: 9a. FISIM</b>							
<b>10. Primary balance ****</b>	(3)		-0.7	-0.5	-0.1		
<b>11. Total taxes (11=11a+11b+11c)</b>		371.9	30.0	30.6	31.0		
<b>11a. Taxes on production and imports</b>	D.2	159.6	12.9	12.9	12.9	-	-
<b>11b. Current taxes on income, wealth, etc</b>	D.5	209.0	16.9	17.5	17.8	-	-
<b>11c. Capital taxes</b>	D.91	3.3	0.3	0.3	0.3	-	-
<b>12. Social contributions</b>	D.61	85.4	6.9	6.9	6.9	-	-
<b>13. Property income</b>	D.4					-	-
<b>14. Other (14=15-(11+12+13))</b>						-	-
<b>15=6. Total revenue</b>	TR	478.3	38.6	39.3	39.8	40.0	40.0
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) (4)</b>							
<b>16. Collective consumption</b>	P.32	274.6	22.2	22.2	22.2		
<b>17. Total social transfers</b>	D.62+D.63						
17a. Social transfers in kind	P.31=D.63						
17b. Social transfers other than in kind	D.62						
<b>18.=9. Interest expenditure (incl. FISIM)</b>	EDP D.41 incl. FISIM	26.2	2.1	2.1	2.1	2.1	
<b>19. Subsidies</b>	D.3	6.8	0.5	0.6	0.5		
<b>20. Gross fixed capital formation</b>	P.51	7.1	0.6	2.2	2.3		
<b>21. Other (21=22-(16+17+18+19+20))</b>							
<b>22=7. Total expenditure</b>	TE(2)	513.6	41.5	42.0	42.1	42.0	41.8
<b>p.m.: Compensation of employees</b>	D.1						

**Notes (COM):**

<sup>(1)</sup> 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.

<sup>(2)</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>(3)</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

<sup>(4)</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

**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 GGNB calculated on a Maastricht definition.

\*\*\* GDP growth as used for public finance projections. FISIM 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 this table differ from those are those recalculated by the Commission services and reported in the main body of this assessment.

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	Year 2004	Year 2009
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (=item 7=26 in Table 2)	TE <sup>1</sup>		

*Notes (COM):*  
1 Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 4. General government debt developments**

% of GDP		2005/06	2006/07	2007/08	2008/09	2009/10
<b>1. Gross debt<sup>1</sup> *</b>		42.7	43.7	44.1	44.2	44.2
<b>2. Change in gross debt ratio **</b>		2.2	0.9	0.4	0.1	0.0

**Contributions to changes in gross debt**

<b>3. Primary balance<sup>2</sup></b>		-0.7	-0.5	-0.1		
<b>4. Interest expenditure (incl. FISIM)<sup>3</sup></b>		2.1	2.1	2.1	2.1	
<b>5. Stock-flow adjustment ***</b>		1.0	0.5	0.5	0.4	0.4
<i>of which:</i>						
- Differences between cash and accruals <sup>4</sup>						
- Net accumulation of financial assets <sup>5</sup>						
<i>of which:</i>						
- privatisation proceeds						
- Valuation effects and other <sup>6</sup>						
<b>p.m.: implicit interest rate on debt<sup>7</sup> ****</b>		5.5	5.3	5.0		

**Other relevant variables**

6. Liquid financial assets <sup>8</sup>						
7. Net financial debt (7=1-6)						

*Notes (COM):*<sup>1</sup>As defined in Regulation 3605/93 (not an ESA concept).<sup>2</sup>Cf. Item 10 in Table 2.<sup>3</sup>Cf. Item 9 in Table 2.<sup>4</sup>The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.<sup>5</sup>Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.<sup>6</sup>Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.<sup>7</sup>Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.<sup>8</sup>AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).*Notes (UK):*

\*General government gross debt on a Maastricht basis (what do you mean by Maastricht basis?)

\*\*General government gross debt measure on a Maastricht basis

\*\*\*Change in gross debt ratio less general government net borrowing. This approach to calculate stock flow adjustment is different from the one adopted by the Commission – hence the difference with the figures in Table 12 in the main body of this assessment.

\*\*\*\*Interest expenditure expressed as per cent of gross debt in previous year.

**Table 5. Cyclical developments**

% of GDP	ESA Code	2005/06	2006/07	2007/08	2008/09	2009/10
<b>1. Real GDP growth (%) *</b>		2	2¼	2¾	2½	2½
<b>2. Net lending of general government (1)</b>	EDP B.9	-2.8	-2.7	-2.2	-1.9	-1.7
<b>3. Interest expenditure (incl. FISIM recorded as consumption)</b>	EDPD.41 incl. FISIM	2.1	2.1	2.1	2.1	
4. Potential GDP growth (%)						
contributions:						
- labour						
- capital						
- total factor productivity						
5. Output gap		-0.4	-0.2	0.0	0.0	0.0
6. Cyclical budgetary component		0.2	0.2	0.0	0.0	0.0
7. Cyclically-adjusted balance (2-6)		-2.6	-2.5	-2.2	-1.9	-1.7
8. Cyclically-adjusted primary balance (7-3) **		-0.5	-0.4	-0.1		
<i>Notes (COM):</i>						
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.						
<i>Notes (UK):</i>						
* GDP growth as used for public finance projections.						
** General government net borrowing less interest paid less cyclical budgetary component.						

**Table 6. Divergence from previous update**

	ESA Code	2005	2006	2007	2008	2009
<b>Real GDP growth (%)</b>						
<b>Previous update</b>		1¾	2¼	3	2¾	2¼
<b>Current update</b>		1¾	2¾	2¾	2½	2½
<b>Difference</b>		0.0	¼	-¼	-¼	¼
<b>General government net lending (% of GDP) (1)</b>	EDP B.9					
<b>Previous update</b>		-3.0	-2.7	-2.4	-1.9	-1.6
<b>Current update</b>		-2.8	-2.7	-2.2	-1.9	-1.7
<b>Difference</b>		0.2	0.0	0.2	0.0	-0.1
<b>General government gross debt (% of GDP)</b>						
<b>Previous update</b>		43.3	44.4	44.8	44.7	44.6
<b>Current update</b>		42.7	43.7	44.1	44.2	44.2
<b>Difference</b>		-0.6	-0.7	-0.7	-0.5	-0.4

*Notes (COM):*

<sup>(1)</sup> 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	2005-06	2015-16	2025-26	2035-36	2045-46	2055-56
Total expenditure		41.5					
Of which: age-related expenditures		20.8	21.0	22.3	24.3	24.8	25.8
Pension expenditure (1)		5.1	5.1	5.4	6.2	6.4	6.8
Social security pension							
Old-age and early pensions							
Other pensions (disability, survivors)							
Occupational pensions (if in general government)		1.5	1.8	1.9	2.0	1.9	2.0
Health care (2)		7.4	7.6	8.3	9.1	9.5	9.9
Long-term care ( <i>this was earlier included in health care</i> ) (3)		1.2	1.2	1.4	1.6	1.8	2
Education expenditure		5.5	5.3	5.3	5.3	5.2	5.2
Other age-related expenditures							
Interest expenditure							
Other spending		20.2	19.7	19.6	19.6	19.2	18.9
Total spending (4,5)		40.9	40.7	41.9	43.8	43.9	44.7
Total revenue *		38.6					
Of which: property income							
<i>of which: from pensions contributions (or social contributions if appropriate)</i>							
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government liabilities)							
<b>Assumptions</b>							
			2015-16 to 2024-25	2025-26 to 2034-35	2035-36 to 2044-45	2045-46 to 2054-55	
Labour productivity growth (6)			2	2	2	2	
Employment growth	-	-	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							
<i>Notes (UK):</i>							
(1) State pensions spending is defined as the sum of the basic State Pension, State Second Pension, Pension Credit, Winter Fuel Payments, over 75 TV licences, and Christmas Bonus.							
(2) Gross NHS spending.							
(3) Excl. long-term care provided within the NHS which is accounted for under Health							
(4) Total spending incl. gross investment but excl. interest and dividends paid.							
(5) Totals may not sum due to rounding.							
(6) Productivity growth is 1 ¾ per cent and 2¼ per cent in the low and high productivity scenarios respectively.							
<i>Notes (COM):</i>							
* 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**

	2004	2005	2006	2007	2008	2009
<b>Short-term interest rate * (annual average)</b>						
<b>Long-term interest rate (annual average)</b>						
<i>for countries in euro area or ERM II:</i> <b>USD/€ exchange rate (annual average)</b>		-	-	-	-	-
<b>Nominal effective exchange rate</b>						
<i>for countries not in euro area or ERM II:</i> <b>exchange rate vis-à-vis the € (annual average)</b>						
World GDP	4¾	4¾	5	4¾	4½	4½
<b>World excluding EU, GDP growth</b>						
G7, Real GDP (1)	3	2½	2¾	2¼	2½	2½
Consumer price inflation (2)	2½	2½	2½	2¼	2	2
<b>EU GDP growth</b>						
Euro area GDP	1¾	1½	2½	2	2¼	2¼
<b>Growth of relevant foreign markets</b>	10	5¾	7¾	6½	6¼	6¼
UK exports markets (3)						
<b>World import volumes, excluding EU</b>						
<b>Oil prices (Brent, USD/barrel)</b>						

Notes (UK):

(1): G7: US, Japan, Germany, France, UK, Italy and Canada

(2) Per cent, Q4

(3) Other countries' imports of UK goods and services weighted according to their importance in UK exports.

Notes (COM):

\*If necessary, purely technical assumptions.

### Annex 3: 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 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.

Guidelines in the code of conduct	Yes	No	Comments
<b>1. Submission of the programme</b>			
Programme was submitted not earlier than mid-October and not later than 1 December <sup>1</sup> .		X	UK not subject to 1 December deadline
<b>2. Model structure</b>			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		Broadly followed, with institutional features highlighted in a subsection rather than stand-alone section.
<b>3. Model tables (so-called data requirements)</b>			
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	
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).		X	Detailed breakdown of revenue and expenditure follow different Aggregation methods from ESA 95.
<b>4. Other information requirements</b>			
<i>a. Involvement of parliament</i>			
The programme mentions its status vis-à-vis the national parliament.	X		However, the programme itself is not formally presented to Parliament.
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	However, such Opinions (for all Member States) are regularly presented and subject to formal Parliamentary scrutiny.
<i>b. Economic outlook</i>			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.			Not applicable (not euro/ERM II country)
Significant divergences between the national and the Commission services’ economic forecasts are explained <sup>2</sup> .	X		
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	
<i>c. Monetary/exchange rate policy</i>			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate	X		

<b>Guidelines in the code of conduct</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
stability.			
<i>d. Budgetary strategy</i>			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.		X	However, no quantitative MTO is defined
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
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		Not applicable
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable (no major structural reform invoked)
<i>e. "Major structural reforms"</i>			
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 (no major structural reform invoked)
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
<i>f. Sensitivity analysis</i>			
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	Public finances are only stress-tested against a scenario in which trend growth turns out to be one percentage point lower than in the central case.
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable (see above)
<i>g. Broad economic policy guidelines</i>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
<i>h. Quality of public finances</i>			
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>i. Long-term sustainability</i>			
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 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.	X		

Guidelines in the code of conduct	Yes	No	Comments
<i>j. Other information (optional)</i>			
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		
<p><u>Notes:</u></p> <p><sup>1</sup>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.</p> <p><sup>2</sup>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.</p> <p><u>Source:</u> <i>Commission services</i></p>			



## Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

### United Kingdom - Key economic indicators

	Averages			2003	2004	2005
	1996–2005	1996–2000	2001–2005			
<b>Economic activity</b>						
Real GDP (% change)	2.8	3.2	2.4	2.7	3.3	1.9
Private consumption (% change)	3.4	4.1	2.8	2.9	3.4	1.4
Government consumption (% change)	2.3	1.6	3.1	3.5	3.2	2.8
Investment (% change)	4.7	6.3	3.1	0.4	6.0	2.7
Exports (% change)	5.1	6.6	3.5	1.7	4.9	7.1
Imports (% change)	7.0	9.2	4.9	2.0	6.6	6.5
Contributions to real GDP growth:						
<i>Domestic demand</i>	3.5	4.0	2.9	2.8	3.9	1.8
<i>Net exports</i>	-0.6	-0.8	-0.5	-0.1	-0.6	0.0
Output gap (% of potential GDP)	0.2	0.2	0.3	0.1	0.7	-0.3
<b>Prices and costs</b>						
HICP inflation (% change)	1.5	1.6	1.4	1.4	1.3	2.1
Unit labour costs (% change)	2.8	2.7	2.9	3.1	2.0	3.7
Labour productivity (% change)	1.7	1.9	1.5	1.7	2.2	0.9
Real unit labour costs (% change)	0.2	0.2	0.2	0.0	-0.6	1.5
Comparative price levels (EUR25=100)	108.5	106.6	110.3	106.2	108.9	108.8
<b>Labour market</b>						
Employment (% change)	1.1	1.3	0.9	1.0	1.0	1.0
Employment (% of working age population)	71.3	70.6	72.0	72.0	72.3	72.3
Unemployment rate (% of labour force)	5.7	6.4	4.9	4.9	4.7	4.7
NAIRU (% of labour force)	5.7	6.3	5.0	5.0	4.8	4.7
Participation rate (% of working age population)	75.5	75.4	75.7	75.7	75.8	75.9
Working age population (% change)	0.6	0.4	0.7	0.7	0.6	0.9
<b>Competitiveness and external position</b>						
Real effective exchange rate (% change) (1)	3.6	6.2	1.0	-2.8	5.7	1.4
Export performance (% change) (2)	-1.4	-2.5	-0.4	-1.5	-3.1	1.0
External balance of g & s (% of GDP)	-2.0	-0.9	-3.0	-2.7	-3.0	-3.7
External balance (% of GDP)	-1.4	-1.2	-1.7	-1.2	-1.5	-2.0
FDI inflow (% of GDP)	4.0	4.8	3.3	1.1	2.6	7.5
<b>Public finances (3)</b>						
Total expenditure (% of GDP)	40.9	39.5	42.3	42.4	43.2	41.5
Total revenue (% of GDP)	38.9	39.0	38.8	38.2	38.8	38.6
General government balance (% of GDP)	-1.3	-0.2	-2.4	-3.1	-3.3	-2.9
General government debt (% of GDP)	42.0	45.0	38.9	38.6	39.9	42.1
Structural budget balance (% of GDP) (4)	n.a.	n.a.	n.a.	-3.2	-3.5	-3.1
<b>Financial indicators (5)</b>						
Short term real interest rate (%) (6)	2.8	3.8	1.8	0.6	2.0	2.5
Long term real interest rate (%) (6)	2.8	3.6	2.1	1.4	2.3	2.2
Household debt (% change) (7)	9.5	7.2	11.9	13.0	13.0	9.3
Corporate sector debt (% change) (8)	10.9	12.5	9.3	5.8	8.0	11.1
Household debt (% of GDP) (7)	77.0	67.4	86.5	86.6	92.4	97.0
Corporate sector debt (% of GDP) (8)	85.3	72.8	97.9	96.9	98.8	105.5

Notes:

- (1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (= EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.
- (2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.
- (3) Public finances data for the UK are presented on a financial year basis, so that e.g. the heading "2005" correspond to the financial year 2005/06.
- (4) Cyclically-adjusted budget balance net of one-off and other temporary measures.
- (5) Data available up to 2004.
- (6) Using GDP deflator.
- (7) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.
- (8) Non-financial corporate sector debt, defined as loans and securities other than shares.

*Source: Commission services*

## Euro area - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 – 2005			
<b>Economic activity</b>						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption (% change)	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption (% change)	1.7	1.7	1.7	1.8	1.2	1.4
Investment (% change)	2.6	4.3	1.0	1.0	2.2	2.5
Exports (% change)	5.8	8.1	3.5	1.1	6.8	4.3
Imports (% change)	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth:						
<i>Domestic demand</i>	2.0	2.7	1.3	1.4	1.8	1.6
<i>Net exports</i>	0.1	0.1	0.1	-0.7	0.2	-0.2
Output gap (% of potential GDP)	-0.1	-0.1	0.0	-0.6	-0.5	-1.1
<b>Prices and costs</b>						
HICP inflation (% change)	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs (% change)	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity (% change)	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	n.a.	n.a.	102.1	103.0	102.7	102.3
<b>Labour market</b>						
Employment (% change)	1.2	1.5	0.9	0.7	0.7	0.8
Employment (% of working age population)	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate (% of labour force)	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU (% of labour force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate (% of working age population)	69.9	68.5	71.2	71.4	71.7	71.8
Working age population (% change)	0.3	0.2	0.4	0.5	0.5	0.5
<b>Competitiveness and external position</b>						
Real effective exchange rate (% change) (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s (% of GDP)	1.9	1.7	2.0	2.1	2.1	1.5
External balance (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI inflow (% of GDP)	2.4	2.5	2.2	1.9	1.1	n.a.
<b>Public finances</b>						
Total expenditure (% of GDP)	48.2	48.7	47.7	48.2	47.6	47.6
Total revenue (% of GDP)	45.8	46.5	45.1	45.1	44.8	45.1
General government balance (% of GDP)	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
<b>Financial indicators (4)</b>						
Short term real interest rate (%) (5)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (%) (5)	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% change) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% change) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

### Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

- (2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.
- (3) Cyclically-adjusted budget balance net of one-off and other temporary measures.
- (4) Data available up to 2004.
- (5) Using GDP deflator.
- (6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.
- (7) Non-financial corporate sector debt, defined as loans and securities other than shares.

*Source: Commission services*

## Annex 5: Assessment of tax projections

Table 12 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)<sup>50</sup>.

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  $\varepsilon_{T_i, B_i}$  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  $\varepsilon_{T_i, B_i}$  is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity<sup>51</sup>. By contrast, if  $\varepsilon_{T_i, B_i}$  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:

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

<sup>50</sup>Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 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.

<sup>51</sup>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:  $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex\,ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex\,post} \frac{dB_i}{B_i}$ .

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

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

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  $\varepsilon = \sum_i w_i \varepsilon_{T_i, B_i} \varepsilon_{B_i, Y}$

with  $w_i$  the share of the  $i$ -th tax in the overall tax burden.

**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.

### Assessment of tax projections by major tax category

	2006/07			2007/08			2008/09		
	CP	COM	OECD	CP	COM	OECD <sup>1</sup>	CP	COM	OECD <sup>1</sup>
<b>Taxes on production and imports:</b>									
Change in tax-to-GDP ratio	0.0	-0.1	0.0	0.1	0.0	0.0	n.a.	0.0	0.0
<i>Difference CP – COM</i>	0.0		/	0.0		/	n.a.		/
<i>of which<sup>2</sup>:</i>									
- discretionary & elasticity component	0.1		/	0.1		/			/
- composition component	0.0		/	0		/			/
<i>Difference COM – OECD</i>	/	-0.1		/	0.0		/	0.0	
<i>of which<sup>2</sup>:</i>									
- discretionary & elasticity component	/	0.0		/	0.1		/	0.1	
- composition component	/	0.0		/	-0.1		/	-0.1	
p.m.: Elasticity									
- of taxes to tax base <sup>4</sup>	1.1	1.0	1.0	0.8	0.9	1.0	n.a.	1.2	1.0
- of tax base <sup>4</sup> to GDP	0.9	0.9	1.0	1.4	1.2	1.0	n.a.	0.9	1.0
<b>Social contributions:</b>									
Change in tax-to-GDP ratio	0.0	0.0		0.0	0.0		n.a.	0.0	
<i>Difference CP – COM</i>	0		/	0		/	n.a.		/
<i>of which<sup>2</sup>:</i>									
- discretionary & elasticity component	0		/	0		/	n.a.		/
- composition component	0		/	0		/	n.a.		/
<i>Difference COM – OECD</i>	/	0.0		/	0.1		/	0.1	
<i>of which<sup>2</sup>:</i>									
- discretionary & elasticity component	/	0.1		/	0.2		/	0.2	
- composition component	/	-0.1		/	-0.1		/	-0.1	
p.m.: Elasticity									
- of taxes to tax base <sup>5</sup>	1.2	1.0	1.3	1.4	1.1	1.3	n.a.	1.1	1.3
- of tax base <sup>5</sup> to GDP	0.8	0.9	0.7	0.8	1.1	0.7	n.a.	1.0	0.7
<b>Personal income tax<sup>6</sup>:</b>									
Change in tax-to-GDP ratio	0.3	0.1		0.1	0.2		0.1	0.1	
<i>Difference CP – COM</i>	0.2		/	0.1		/	n.a.		/
<i>of which<sup>2</sup>:</i>									

- discretionary & elasticity component	0.4		/	0.1	/	n.a.	/	
- composition component	-0.1		/	-0.1	/	n.a.	/	
Difference COM – OECD	/	0.0	/	0.1	/		0.0	
of which <sup>3</sup> :						/		
- discretionary & elasticity component	/	-0.2	/	-0.2	/		-0.2	
- composition component	/	0.3	/	0.2	/		0.3	
p.m.: Elasticity								
- of taxes to tax base <sup>5</sup>	1.8	1.3	1.7	1.5	1.3	1.7	n.a.	1.2
- of tax base <sup>5</sup> to GDP	0.9	0.8	0.7	0.8	1.9	0.7	n.a.	1.0
<b>Corporate income tax<sup>6</sup>:</b>								
Change in tax-to-GDP ratio	0.3	0.4	0.1	0.2	0.2	0.1	0.1	0.0
Difference CP – COM	-0.1		/	0	/		n.a.	/
of which <sup>3</sup> :								
- discretionary & elasticity component	-0.1		/	-0.1	/		n.a.	/
- composition component	0.1		/	0.1	/		n.a.	/
Difference COM – OECD	/	0.2	/	0.1	/		-0.1	
of which <sup>3</sup> :								
- discretionary & elasticity component	/	0.5	/	0.4	/		0.0	
- composition component	/	-0.1	/	-0.1	/		-0.2	
p.m.: Elasticity								
- of taxes to tax base <sup>7</sup>	2.2	2.4	1.0	1.6	2.2	1.0	n.a.	1.1
- of tax base <sup>7</sup> to GDP	1.2	1.1	1.7	1.3	0.9	1.7	n.a.	0.9
<b>Notes:</b>								
<sup>1</sup> Based on OECD ex-ante elasticity relative to GDP.								
<sup>2</sup> On a no-policy change basis.								
<sup>3</sup> The decomposition is explained in the text above.								
<sup>4</sup> Tax base = private consumption expenditure.								
<sup>5</sup> Tax base = compensation of employees.								
<sup>6</sup> 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.								
<sup>7</sup> Tax base = gross operating surplus.								
<b>Source:</b>								
Commission services' autumn 2006 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)								