COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.2.2007
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of United Kingdom, 2006/2007-2011/2012

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of the United Kingdom was submitted in December 1998. In accordance with the Regulation, the Council delivered an opinion on it on 8 February 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of the United Kingdom, submitted on 18 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme)

(4) the Commission's assessment of the October 2006 national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.1. Recent economic and budgetary performance

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.

2.2. The excessive deficit procedure for the United Kingdom

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% of GDP. On 10 October 2006 the Council endorsed the Commission's view and concluded that no further steps were needed at that time.

2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period from financial year 2005/06 to 2011/12[2]. The Council was of the opinion that “the projected adjustment path is subject to risks” and invited the United Kingdom, under Article 104(7), and in order to address the risks to long-term sustainability, to “ensure that the deficit is brought below 3% of GDP by 2006/07 in a credible and sustainable manner” and pursue budgetary consolidation thereafter, especially by implementing the projected reduction in expenditure growth after 2007/08” and “attain a medium-term objective that ensures rapid progress towards sustainability, a prudent debt ratio well below 60% of GDP, and provides a sufficient safety margin against breaching the 3% of GDP deficit reference value, which the UK is under the obligation to endeavour to avoid, and allows room for budgetary manoeuvre, in particular taking into account the needs for public investment”.

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

2.4. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of the United Kingdom, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 16 October 2006. The United Kingdom's national reform programme 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[3]) showed that the United Kingdom is making good progress in the implementation of its national reform programme. 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 United Kingdom has made greater efforts to involve stakeholders.

Against the background of strengths and weaknesses identified, the United Kingdom was recommended to take action in the areas of basic and intermediate skills.

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[3] Communication from the Commission to the Spring European Council, “Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery” - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

4 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

5 "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.

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On the updated convergence programme of United Kingdom, 2006/2007-2011/2012

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated convergence programme of the United Kingdom, which covers the period from financial year 2006/07 to financial year 2011/12[7].

(2) The 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 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, which is expected to decline from 2½% in 2006 to 2% from 2007 onwards, appear to be on the low side in the short term, in the light of more recently published outturns, but otherwise plausible.

(3) 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

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6 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

7 The UK financial year runs from April to March.

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

(4) 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, estimated as a deficit of 0.6% of GDP in 2005/06, is expected to return to balance by 2008/09 and to reach a surplus of 0.7% of GDP by 2011/12. The budgetary adjustment over the projection period is equally distributed between revenues and expenditure. The increase of the revenue ratio is expected to take place in the first two years of the projection period, partly driven by discretionary measures, while significant adjustment on the expenditure side is planned to take place from 2008/09, through a moderation in current expenditure growth. Public investment in the definition used in the convergence programme[8] is planned to stabilise at 2¼% of GDP from 2006/07 so that from 2007/08 the deficit is projected to be used entirely to fund public investment. The adjustment path is broadly in line with the one projected in the 2005 update, against a more favourable macroeconomic outlook in the short term.

(5) Calculated according to the commonly agreed methodology, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is projected to improve from 2½% of GDP in 2006/07 to about 1¼% 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 imply a medium-term path for the cyclically-adjusted deficit that is 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.

(6) 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. The projected increase in the tax to GDP ratio partly relies on relatively volatile factors such as profits from the financial and oil-producing sectors. However, relatively good prospects for revenues appear supported by recent economic developments, including strong profitability. From 2008/09 on however, achievement of the deficit path in the programme will depend on implementing the projected moderation in expenditure growth, and on active monitoring to enforce expenditure limits. 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

8 The definition of public investment in the UK convergence programme, which is not an ESA concept, covers all public sector investment (that is, public corporations as well as general government) and includes capital grants to the private sector net of depreciation.

2007, which will announce firm expenditure plans up to 2010/11. The record of active monitoring to enforce expenditure limits is positive.

(7) 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, when no significant further adjustment is projected despite a broadly supportive economic outlook.

(8) The gross debt ratio, which stood at 42.1% of GDP in 2005/06, though remaining well below the Treaty reference value of 60% of GDP, is projected to rise slowly over the projection period, peaking at just above 44% of GDP in 2008/09. Thereafter the ratio is expected to stabilise and then begin to decline at the end of the programme period.

(9) 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.

(10) The convergence programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. In addition it provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage the gradual implementation of the government's objectives to increase efficiency and value for money in public service provision, while the long-term public finance projections incorporate the estimated cost of the proposed pension reform.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has gaps in the required and optional data[9], which are more severe than in the previous update, as the time horizon over which expenditure plans are specified is shorter.

The overall conclusion is that the programme seems broadly consistent with a correction of the excessive deficit by the deadline set by the Council (financial year 2006/07). However, no significant further consolidation is envisaged 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 view of the above assessment, the United Kingdom is invited to pursue budgetary consolidation over the programme period, especially by implementing the projected reduction in expenditure growth after 2007/08, and to strengthen further its fiscal position in order to address the risks to long-term sustainability of the public finances.

The United Kingdom is also invited to comply with the data requirements of the code of conduct.

9 In particular, the data on projections for employment, unemployment, wage inflation and a detailed breakdown of revenue and expenditure projections on a general government basis after 2007/08 are not provided. Compared to the 2005 update, the horizon for the breakdown of expenditure on a general government basis is shorter in the current update, which is the last update before new detailed spending plans will be fixed in the July 2007 Comprehensive Spending Review.

Comparison of key macroeconomic and budgetary projections

		2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Real GDP (% change)	**CP Dec 2006[1]**	**1¾**	**2¾**	**2¾**	**2½**	**2½**	**2½**	**2½**
	COM Nov 2006[2]	1.9	2.7	2.6	2.4	n.a.	n.a.	n.a.
	CP Dec 2005[1]	*1¾*	*2¼*	*3*	*2¾*	*2¼*	*2¼*	*n.a.*
HICP inflation (%)	**CP Dec 2006[1]**	**2**	**2 ½**	**2**	**2**	**2**	**2**	**2**
	COM Nov 2006[2]	2.1	2.4	2.2	2.0	n.a.	n.a.	n.a.
	CP Dec 2005	*2¼*	*2*	*2*	*2*	*2*	*2*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2006[3]**	**-0.5**	**-0.6**	**-0.6**	**-0.6**	**-0.5**	**-0.4**	**-0.3**
	COM Nov 2006[2,4]	-0.3	-0.4	-0.5	-0.7	n.a.	n.a.	n.a.
	CP Dec 2005[3]	*-0.5*	*-1.0*	*-0.8*	*-0.5*	*-0.6*	*-0.6*	*n.a.*
General government balance (% of GDP)	**CP Dec 2006[5,6]**	**-2.9**	**-2.8**	**-2.3**	**-1.9**	**-1.7**	**-1.6**	**-1.4**
	COM Nov 2006[6,7]	-2.9	-3.0	-2.7	-2.5	n.a	n.a	n.a.
	CP Dec 2005[5]	*-3.1*	*-2.8*	*-2.4*	*-1.9*	*-1.7*	*-1.5*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2006[8]**	**-0.8**	**-0.6**	**-0.2**	**0.1**	**0.3**	**0.5**	**0.7**
	COM Nov 2006	-0.9	-1.0	-0.6	-0.4	n.a.	n.a.	n.a.
	CP Dec 2005[8]	*-1.0*	*-0.7*	*-0.3*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2006[3,5]**	**-2.7**	**-2.5**	**-2.1**	**-1.7**	**-1.5**	**-1.4**	**-1.3**
	COM Nov 2006[4]	-2.8	-2.8	-2.4	-2.2	n.a.	n.a.	n.a.
	CP Dec 2005[3]	*-2.9*	*-2.3*	*-2.1*	*-1.7*	*-1.5*	*-1.3*	*n.a.*
Structural balance[9] (% of GDP)	**CP Dec 2006[3,5]**	**-3.0**	**-2.5**	**-2.1**	**-1.7**	**-1.5**	**-1.4**	**-1.3**
	COM Nov 2006[4]	-3.1	-2.8	-2.4	-2.2	n.a.	n.a.	n.a.
	CP Dec 2005	*-2.9*	*-2.3*	*-2.1*	*-1.7*	*-1.5*	*-1.3*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2006**	**42.7**	**43.7**	**44.1**	**44.2**	**44.2**	**44.0**	**43.6**
	COM Nov 2006	42.1	42.5	43.4	44.1	n.a.	n.a.	n.a.
	CP Dec 2005	*43.3*	*44.4*	*44.8*	*44.7*	*44.6*	*44.4*	*n.a.*

Notes:

1) GDP and inflation forecast underlying the authorities' projections for the public finances; derived from a scenario whereby trend growth is one-quarter percentage point higher.
2) Commission services' forecast is on a calendar year basis.
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 cancellation of Nigerian debt will be reclassified in government accounts as deficit-increasing by 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 adopts a technical assumption that expenditure remains constant as a percentage of GDP, while the convergence programme adopts 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.