



EUROPEAN COMMISSION  
DIRECTORATE GENERAL  
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 6 February 2008  
ECFIN/G1/2008/REP 50238-EN

**UNITED KINGDOM: MACRO FISCAL ASSESSMENT**  
**AN ANALYSIS OF THE NOVEMBER 2007 UPDATE OF THE CONVERGENCE**  
**PROGRAMME**

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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 the UK’s convergence programme was submitted on 30 November 2007.

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 (DG ECFIN) of the European Commission, was finalised on 6 February 2008. Comments should be sent to Karl Scerri ([karl.scerri@ec.europa.eu](mailto:karl.scerri@ec.europa.eu)), Birgitte Bjornbak ([birgitte.bjornbak@ec.europa.eu](mailto:birgitte.bjornbak@ec.europa.eu)) and Robert Kuenzel ([robert.kuenzel@ec.europa.eu](mailto:robert.kuenzel@ec.europa.eu)). The main aim of the 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.

The analysis takes into account (i) the Commission services’ autumn 2007 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. Technical issues are explained in an accompanying “methodological paper” prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 12 February 2008.

\* \* \*

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

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 financial years 2007/08-2012/13, was submitted on 30 November 2007.

The UK economy has displayed robust and remarkably stable growth over the last ten years and in 2007 grew at a rate above potential, though with building imbalances including low household saving and a wider external deficit. Favourable growth conditions have, however, been accompanied by a serious deterioration in public finances in the current financial year, 2007/08. After a general government deficit in 2006/07 of 2.6% of GDP, the deficit is expected to reach around 3% of GDP in 2007/08 with substantial risks of a breach of the reference value.

Furthermore, the deterioration in economic prospects following the financial market turmoil and a weakening in the housing market in the second half of 2007 points towards a near-term economic slowdown, which is likely to constrain revenue growth. The recent reappraisal of the economy has moreover entrained a relatively rapid and very sharp exchange rate depreciation which raises inflationary pressures and thus may constrain the ability of the monetary authorities to respond to weaker conditions. Particular macroeconomic risks relate to a markedly more abrupt slowdown in housing market activity, which would dampen private consumption growth, and a larger-than-expected weakening in financial services growth and employment. Overall, the assessment of the current macroeconomic outlook reinforces the need for expenditure restraint, while further enhancing the efficiency and effectiveness of public spending, if the UK is to achieve an improvement in the fiscal balance.

The programme contains two macroeconomic scenarios: a central scenario and a more cautious alternative scenario based on trend growth one quarter of a percentage point lower than the central view. The public finances projections are based on the alternative scenario, which is designed to be more cautious than the central scenario. The programme's alternative scenario is considered the reference scenario in the assessment of the updated programme. This scenario envisages a slowdown in economic growth from 3.0% in 2007/08 to 2.0% in 2008/09, partly as a result of tighter credit conditions following the turmoil in financial markets. In 2009/10, the programme expects growth to gather pace again, rising to 2¾%. Assessed against currently available information<sup>1</sup>, including increasing prospects of a significant downturn in the housing market and protracted financial market difficulties, this scenario appears to be based on growth assumptions that are favourable until 2009/10 and plausible thereafter. The programme's projections for inflation in the short term also appear to be on the low side, primarily due to its assumption on oil prices next year. However, the near-term prospect of activity levels depressed relative to potential should lead to a subsequent moderation in inflation, which should preserve price stability.

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<sup>1</sup> This assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

For 2007/08, the general government deficit is estimated at 3.0% of GDP in the Commission services' autumn 2007 forecast, against a target of 2.3% of GDP set in the December 2006 update of the convergence programme. The structural deficit, defined as the cyclically-adjusted budget balance calculated according to the commonly agreed methodology, net of one-off and other temporary measures, will be significantly higher than in the previous financial year. The deterioration in the budgetary position has primarily resulted from lower than expected receipts from corporate taxation; though compared with the previous programme a deficit-increasing national accounts reclassification of around ¼% of GDP per annum should be noted. More recent information, including in-year data on central government revenues, implies a substantial risk that the deficit in 2007/08 will be higher than the reference value. The expected deterioration in the public finances is not in line with the pursuit of consolidation recommended in the Council opinion of 27 February 2007 on the previous update of the convergence programme.<sup>2</sup>

The update does not specify a quantitative medium-term objective (MTO) for the budgetary position. The programme presents projections on a no-policy-change basis and envisages a very gradual reduction in the general government deficit. In 2008/09, the deficit-to-GDP ratio is projected to be slightly lower than in the previous year. During the same year, the structural deficit is estimated to improve by about 0.3 percentage points. The primary deficit is expected to edge upwards as the rise in primary expenditure is only partly offset by a drop in interest payments. Subsequently, the programme forecasts a reduction in the headline deficit by ½ p.p. in 2009/10 and by an average of ¼ p.p. per annum during the following three financial years. The primary balance is expected to improve from a deficit of 0.9% of GDP in 2008/09 to balance in 2010/11. Over the programme period, an increase in the revenue-to-GDP ratio and a drop in the expenditure ratio are expected to contribute around three-fifths and two-fifths of the adjustment respectively. The increase in the revenue ratio is evenly spread through the programme period, with fiscal drag on personal income taxation and, to a lesser extent, already announced measures contributing to higher revenues. On the expenditure side, the spending envelope set out in the 2007 Comprehensive Spending Review (CSR) implies a significant drop in annual average expenditure growth between 2008/09 and 2010/11 when compared to the annual average during the preceding 10 years. However, in 2008/09, total expenditure is still expected to grow more rapidly than nominal GDP, contributing to an increase in the deficit ratio. Compared with the previous programme, though partly reflecting the national accounts reclassification referred to above, the new update projects a significantly worse budgetary position throughout the programme period. The 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 until 2010/11.

The budgetary outcomes could be worse than projected in the programme. In particular, a deficit overrun in 2007/08 arising from the revenue side could extend also into a higher deficit in 2008/09, especially if largely representing lower tax revenues as a result of the downturn in financial sector activity, while tax-rich expenditures, especially household consumption, could also be particularly depressed by an extended period of housing market adjustment. Given the considerable risks attending macroeconomic performance in 2008, the convergence programme's assumption that in 2009/10 the UK economy will swiftly recover to potential growth is optimistic and thus carries a risk that the deficit

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<sup>2</sup> OJ C 72, 29.3.2007, p. 20.

will be higher than projected. Meanwhile, the sharp slowdown in expenditure growth that is targeted in the latest CSR is accompanied by objectives for considerable efficiency gains in the provision of public services, which, if not achieved, could trigger pressures for higher expenditure than set out in the CSR. The projections for 2011/12 and 2012/13, subsequent to the forthcoming CSR period, assume continued moderate growth in expenditure but are not backed by detailed departmental spending plans. Another critical negative risk to the projections arises from the government's assumption in recent months of substantial financial sector contingent liabilities.

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure the limited consolidation foreseen in the programme. There is a substantial risk that the reference value will be breached in the near term and a deficit level that provides a safety margin against breaching the 3% of GDP deficit threshold with normal economic fluctuations (estimated at 1.5% of GDP) is unlikely to be achieved within the programme period. The pace of fiscal consolidation is insufficient and should be strengthened significantly.

The United Kingdom appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing 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 2007 reforms, addressing the concern of potentially inadequate future pension provision, are likely to involve a somewhat higher increase in age-related expenditure. The budgetary position in 2007 as estimated in the programme, which is significantly worse than the starting position of the previous programme, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Achieving high primary surpluses would contribute to reducing risks to the sustainability of public finances.

The UK government's actions taken to improve the quality of public spending constitutes a welcome systematic approach to enhancing public sector efficiency. However, it is too early to conclusively judge whether the measures introduced in the 2007 CSR will lead to a real improvement in the efficiency and effectiveness of public spending, as this depends both on the degree of implementation as well as the ability to ascertain the quality of public services over time. It will therefore be essential for the UK to meet both spending and efficiency targets set out in the CSR 2007 as well as to continue the work on output and quality measurement.

The United Kingdom's national reform programme identifies as key challenges/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 in its December 2007 Strategic Report on the renewed Lisbon strategy for growth and jobs is that the UK has made significant progress in implementing its national reform programme over 2005-2007. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that the United Kingdom is to give the highest priority to the challenges in the areas of skills and employment opportunities for the most disadvantaged. In addition, the United Kingdom should also focus on the areas of housing supply and R&D and innovation.

The convergence programme appears to be consistent with the September 2007 implementation report of the national reform programme. In particular, both programmes integrate the 2007 Comprehensive Spending Review, including the gradual implementation of the government's objectives to increase efficiency and value for money in public service provision. The direct budgetary implications of important reform elements highlighted in the implementation report of the national reform programme, including the increase in the value and coverage of the state-pension as well as recent initiatives taken to increase housing supply, promote R&D and innovation and raise the skill levels in the workforce, have been taken into account in the budgetary projections of the convergence programme.

The overall conclusion is that the programme confirms a significant deterioration in the United Kingdom's budgetary position that, coupled with a probably weaker macroeconomic context than envisaged, carries a substantial risk of breaching the 3% of GDP deficit reference value in the near term. While the programme envisages some modest fiscal tightening from 2008/09 through a progressive increase in the tax burden and a reduction in previously rapid growth in current expenditure, there are risks to the achievement of this consolidation. These primarily stem from the deterioration in macroeconomic prospects, uncertainties concerning the government's ability to meet its spending targets, and the assumption by the government of substantial and accumulating contingent liabilities in the financial sector. Moreover, the projected speed of consolidation is itself unambitious, with the debt ratio increasing until 2010/11, before falling slightly in the two remaining programme years. The long-term sustainability of UK public finances has deteriorated when compared to the previous programme, mainly due to the deterioration of the starting position, although the United Kingdom remains at medium risk.



## Comparison of key macroeconomic and budgetary projections

		2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Real GDP (% change)	<b>CP Nov 2007<sup>1</sup></b>	<b>3.0</b>	<b>3.0</b>	<b>2.0</b>	<b>2¾</b>	<b>2½</b>	<b>2½</b>	<b>2½</b>
	COM Nov 2007	3.0	3.0	2.0	2.5	n.a.	n.a.	n.a.
	<i>CP Dec 2006<sup>1</sup></i>	<i>2¾</i>	<i>2¾</i>	<i>2½</i>	<i>2½</i>	<i>2½</i>	<i>2½</i>	<i>n.a.</i>
HICP inflation (%)	<b>CP Nov 2007<sup>1</sup></b>	<b>2½</b>	<b>2¼</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>	<b>2.0</b>
	COM Nov 2007 <sup>2</sup>	2.3	2.4	2.2	2.0	n.a.	n.a.	n.a.
	<i>CP Dec 2006<sup>1</sup></i>	<i>2½</i>	<i>2.0</i>	<i>2.0</i>	<i>2.0</i>	<i>2.0</i>	<i>2.0</i>	<i>n.a.</i>
Output gap <sup>3</sup> (% of potential GDP)	<b>CP Nov 2007<sup>1</sup></b>	<b>-0.1</b>	<b>0.0</b>	<b>-0.5</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.3</b>
	COM Nov 2007 <sup>2,4</sup>	-0.3	-0.1	-0.4	-0.6	n.a.	n.a.	n.a.
	<i>CP Dec 2006<sup>1</sup></i>	<i>-0.6</i>	<i>-0.6</i>	<i>-0.6</i>	<i>-0.5</i>	<i>-0.4</i>	<i>-0.3</i>	<i>n.a.</i>
General government balance <sup>5</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-2.6</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.6</b>
	COM Nov 2007	-2.6	-3.0	-3.0	-2.7	n.a.	n.a.	n.a.
	<i>CP Dec 2006</i>	<i>-2.8</i>	<i>-2.3</i>	<i>-1.9</i>	<i>-1.7</i>	<i>-1.6</i>	<i>-1.4</i>	<i>n.a.</i>
Primary balance <sup>5</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-0.4</b>	<b>-0.8</b>	<b>-0.9</b>	<b>-0.3</b>	<b>0.0</b>	<b>0.3</b>	<b>0.5</b>
	COM Nov 2007	-0.5	-1.0	-1.0	-0.7	n.a.	n.a.	n.a.
	<i>CP Dec 2006</i>	<i>-0.6</i>	<i>-0.2</i>	<i>0.1</i>	<i>0.3</i>	<i>0.5</i>	<i>0.7</i>	<i>n.a.</i>
Cyclically-adjusted balance <sup>3,5</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-2.5</b>	<b>-3.0</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.6</b>	<b>-1.5</b>
	COM Nov 2007	-2.5	-2.9	-2.8	-2.4	n.a.	n.a.	n.a.
	<i>CP Dec 2006</i>	<i>-2.5</i>	<i>-2.1</i>	<i>-1.7</i>	<i>-1.5</i>	<i>-1.4</i>	<i>-1.3</i>	<i>n.a.</i>
Structural balance <sup>6</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-2.5</b>	<b>-3.0</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.6</b>	<b>-1.5</b>
	COM Nov 2007	-2.5	-2.9	-2.8	-2.4	n.a.	n.a.	n.a.
	<i>CP Dec 2006</i>	<i>-2.5</i>	<i>-2.1</i>	<i>-1.7</i>	<i>-1.5</i>	<i>-1.4</i>	<i>-1.3</i>	<i>n.a.</i>
Government gross debt <sup>7</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>43.4</b>	<b>43.9</b>	<b>44.8</b>	<b>45.1</b>	<b>45.3</b>	<b>45.2</b>	<b>44.9</b>
	COM Nov 2007	42.6	43.3	44.5	45.2	n.a.	n.a.	n.a.
	<i>CP Dec 2006</i>	<i>43.7</i>	<i>44.1</i>	<i>44.2</i>	<i>44.2</i>	<i>44.0</i>	<i>43.6</i>	<i>n.a.</i>

Notes:

<sup>1</sup> Economic assumptions underlying the authorities' projections for public finances. The economic assumptions are based on a scenario which assumes that trend growth is one-quarter percentage point lower than the government's neutral view.

<sup>2</sup> On a calendar-year basis. Numbers reported in 2006/07 column refer to the 2006 calendar year.

<sup>3</sup> Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

<sup>4</sup> Based on estimated potential growth of 2.9%, 2.8%, 2.6% and 2.6% respectively in the period 2006-2009.

<sup>5</sup> Figures for the primary balance in the convergence programmes adjusted to use gross rather than net interest payments.

<sup>6</sup> Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures during the programme period.

<sup>7</sup> Figures in the Convergence Programme derived using GDP excluding the FISIM adjustment, which raises the debt ratio by about 0.8 percentage points when compared to the Commission services' autumn 2007 forecast.

Source:

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

## 1. INTRODUCTION

The 2007 update of the United Kingdom's convergence programme was submitted to the European Commission on 30 November 2007. It covers the period from financial year 2007/08 to 2012/13<sup>3</sup>, although many data are not available for years beyond 2007/08. 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 (see Box 1). The projections in the convergence programme update are entirely based on those published in the October 2007 Pre-Budget Report, on which the programme heavily draws. 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.

### **Box 1: Recent developments in United Kingdom parliamentary involvement in the preventive arm of the Stability and Growth Pact**

The 2005 reforms to the Stability and Growth Pact emphasised the desirability of greater national parliamentary involvement in the Pact's operation, and as part of this the revised code of conduct enjoins updated programmes to declare whether the Council's Opinion on the programme's previous update has been presented to the national parliament. Despite this, UK programmes have not to date given such information, although as part of regular scrutiny procedures undertaken by the United Kingdom Parliament all such Council Opinions (not solely those on the UK's own programme) are regularly examined.

The Commission services' Technical Assessment of the previous UK programme update presented existing UK parliamentary scrutiny procedures (in particular regarding scrutiny of the Council's comments in its 2005 Opinion on the UK programme's lack of data compliance with the code of conduct).<sup>4</sup> During its 2006-07 session the scrutiny procedure was, for the first time, taken a significant stage further, when the Council's Opinions on the UK (and other) programmes were referred for formal debate to the (lower) House of Commons European Standing Committee. This debate, which took place in July 2007, focused more closely on the UK's fiscal performance vis-à-vis the Community's fiscal framework rather than the UK's own fiscal rules.<sup>5</sup> It remains to be seen whether such debates become a regular or occasional feature of parliamentary business. See also Annex 1 (iii).

This assessment is further structured as follows. Section 2 discusses the key challenges for public finances in the United Kingdom, with a particular focus on the quality of public finances. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the financial year 2007/08 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the

<sup>3</sup> The UK financial year runs from April to March.

<sup>4</sup> See Technical Assessment of previous update, footnote 6 ([http://ec.europa.eu/economy\\_finance/about/activities/sgp/country/commwd/uk/com\\_uk20062007.pdf](http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/uk/com_uk20062007.pdf)). This discussion clarifies that the United Kingdom convergence programme itself is not formally presented to Parliament (unlike the domestic Budget and Pre-Budget Report) nor directly scrutinised.

<sup>5</sup> <http://www.publications.parliament.uk/pa/cm200607/cmgeneral/euro/070716/70716s01.htm>

budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

## **2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON PUBLIC EXPENDITURE AND EFFICIENCY CHALLENGES – CONTAINING PUBLIC SPENDING WHILE IMPROVING PUBLIC SERVICES**

### **2.1. Introduction**

In recent years macroeconomic performance in the United Kingdom has been strong with relatively high rates of growth, low and stable inflation and low unemployment. The UK economy is among the most flexible within the EU and the OECD.<sup>6</sup> 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. However, despite the good overall economic and regulatory framework conditions, the UK economy has for several years been lagging behind other EU economies and the USA in terms of labour productivity. This is largely due to historical underinvestment in physical capital, a shortfall in intermediate skills among its workforce and, on average, a poor record of innovative performance.<sup>7</sup> Moreover, in recent years public finances in the UK have significantly deteriorated. Since 2001, general government expenditure has grown faster than revenues in relation to GDP, reflecting to a large extent the government's objective to substantially improve public services. As a result the deficit exceeded the 3% reference value from 2003/04 to 2005/06, and it looks to remain at the reference value in financial year<sup>8</sup> 2007/08 and 2008/09.

One of the main challenges for fiscal policy highlighted in last year's assessment of the UK convergence programme was the need for the UK to curb the growth in expenditure while avoiding the disincentive effects associated with further increases in the tax burden. In the light of the even weaker current fiscal position this challenge is now more

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<sup>6</sup> However, in some specific areas the UK regulates relatively heavily and may also unnecessarily "gold plate" EU regulation. Furthermore, in recent years, other countries appear to have reduced the burden of their regulatory regimes faster than the UK. ECFIN Country Focus (2006): Regulation in the UK: is it getting too heavy?

[http://ec.europa.eu/economy\\_finance/publications/publication1322\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication1322_en.pdf)

<sup>7</sup> ECFIN Country Focus (2004): What next for productivity in the UK?

[http://ec.europa.eu/economy\\_finance/publications/publication1413\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication1413_en.pdf)

The OECD also mentions restrictive planning regulations as well as tax complexities and "red tape" as barriers to the UK's productivity growth. OECD (2007): Economic Survey of the United Kingdom.

<http://www.oecd.org/dataoecd/49/34/39384976.pdf>

<sup>8</sup> The remainder of this assessment will refer to financial years in the format 200x/y.

serious. UK fiscal policy should therefore ensure that overall public spending is contained over the programme period. In this context, further advancing the efficiency and effectiveness of overall public spending will be essential so as to ensure value for money and release resources for key priorities. At the same time, expenditure decisions should continue to take into account the UK's productivity challenge and the need to address inhibiting factors such as low intermediate skill levels. The 2007 Comprehensive Spending Review, which sets public spending and priorities for 2008/09 to 2010/11, is the UK's latest response to these challenges.

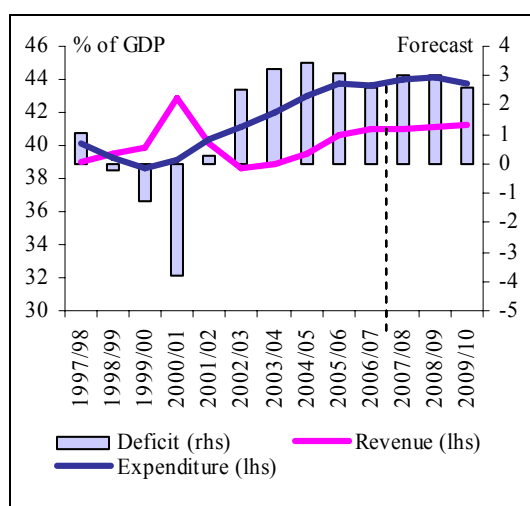
This section is in four parts. The first part provides an overview of trends in the level and composition of public expenditure and revenue. The second part presents the main elements of the UK public spending framework. The third part analyses and discusses the scope for improving the efficiency and effectiveness of public service provision in the UK education sector. The fourth part concludes.

## 2.2. Public finances

### 2.2.1. The overall picture

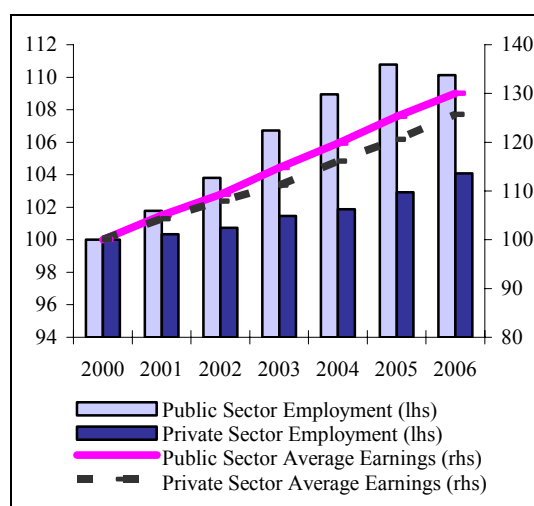
Since 2001 there has been a marked deterioration of UK public finances, with a general government surplus of 3.8% of GDP in 2000/01 (1.5% of GDP if excluding one-off UMTS receipts) turning into a deficit of 3.5% of GDP in 2004/05. The deficit was brought down to 2.6% of GDP in 2006/07, but is expected to rebound in 2007/08 and to remain close to the Treaty reference value until at least 2009/10 (Figure 1).

**Figure 1: UK general government expenditure, revenue and deficit 1997/98 to 2009/10 (% of GDP)**



Source: Eurostat and Commission Services

**Figure 2: Public and private sector employment and average earnings (index, 2000=100)**



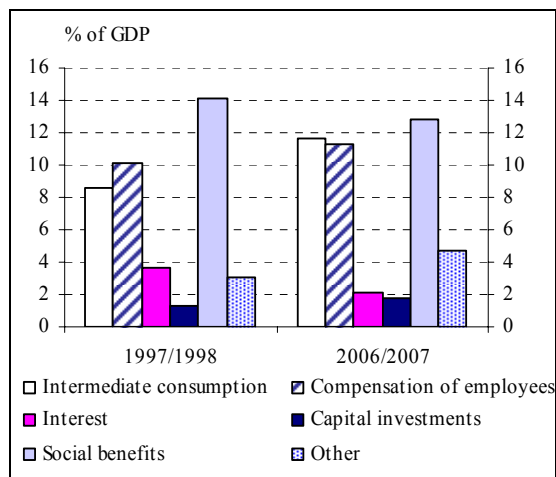
Source: UK Office of National Statistics

In recent years the ratio of general government expenditure to GDP has risen by more than 5 percentage points from 39% in 1999/00 to 44% in 2006/07. In comparison the EU average was around 47% in both 1999 and 2006. Underpinning this rise is the government's 2002 policy of increasing expenditure on public services, with a particular focus on increasing public investment from the relatively low levels seen in previous years. However, until 2006/07 the expenditure increase was mainly driven by higher intermediate consumption and compensation of employees (accounting for around half of general government expenditure), although public sector net investment since 2001/02

increased substantially as a share of Total Managed Expenditure<sup>9</sup> from 2.6% in 2001/02 to 4.6% in 2006/07. This translates into average public investment growth of around 15% per year in real terms (compared to 4% on average for current expenditure growth). At the same time there has been a reduction in interest payments, mirroring the decline in the stock of debt and a global decline in interest rates (Figure 3).

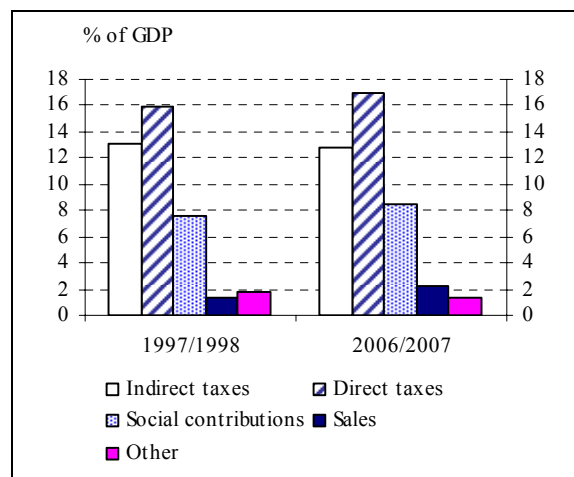
The increase in expenditure as a share of GDP has been partly matched by an increase in revenues, mainly due to higher direct taxes, social contributions and sales (Figure 4). The UK's general tax burden<sup>10</sup> fell considerably between 2001 and 2003, when economic growth was sluggish, but has since risen again to previous levels. A similar trend has been observed more widely in the EU, albeit less pronounced. The UK's tax burden is still below the EU average. However, over the last 6 years, the UK's tax burden increased by 0.5% of GDP to around 38% of GDP in 2006, whereas the EU average decreased by 0.7% of GDP to around 41% of GDP over the same period.

**Figure 3: Composition of UK general government expenditure in 1997/98 and 2006/07 (% of GDP)**



Note: Others include subsidies, other current expenditure and capital transfers payable.  
Source: Eurostat

**Figure 4: Composition of UK general government revenue in 1997/98 and 2006/07 (% of GDP)**



Note: Others include capital taxes, capital revenue and other current revenue.  
Source: Eurostat

The growth of public sector expenditure since 2001 helped stabilise the UK economy during the global downturn, with public sector employment growth between 2001 and 2005 accounting for half of all new jobs created in this period. Both public sector employment and earnings growth rates outpaced those of the private sector between 2000 and 2005 (Figure 2). In 2006 public employment growth sharply turned negative, reflecting the headcount reductions in central government departments as part of the

<sup>9</sup> Total Managed Expenditure (TME) is the national measure of total public sector expenditure and a key element of the government's fiscal framework. TME comprises expenditure by the entire public sector – namely the central government, local authorities and public corporations. TME consists of public sector current expenditure, public sector net investment and public sector depreciation. It differs from general government expenditure by including spending by public non-financial corporations, such as the formerly nationalised utilities, but excludes financial transactions.

<sup>10</sup> The tax burden is defined as the ratio of direct taxes, indirect taxes (including those paid to the EU budget) and social contributions over GDP. For further details on the development in tax rates and tax elasticities in the UK see the European Commission (2007): Public finances in EMU – 2007.

[http://ec.europa.eu/economy\\_finance/publications/publication338\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication338_en.pdf)

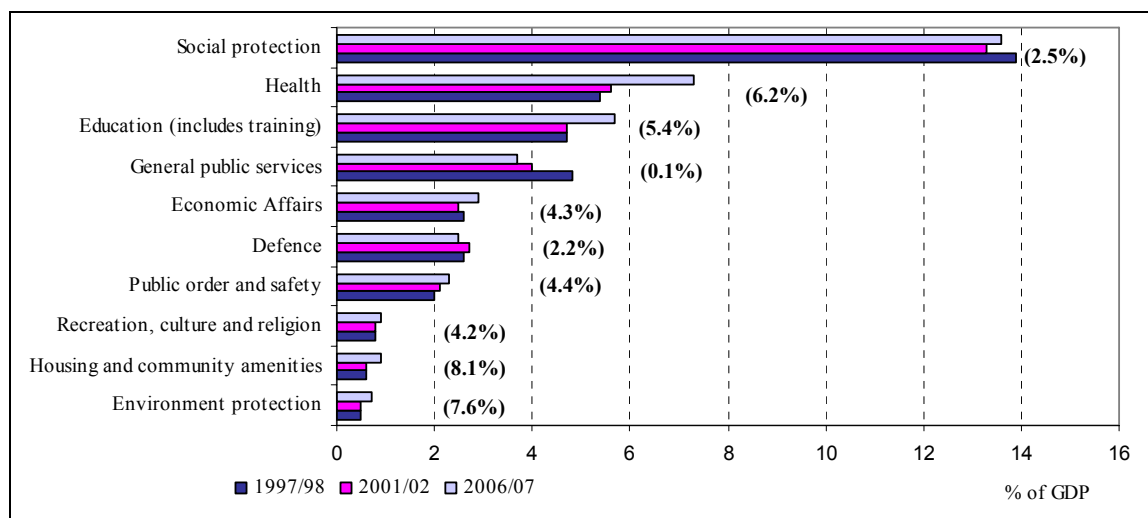
government's efficiency programme (see section 2.3). While in terms of the relative size of the public sector the UK's starting point was relatively low compared to most other European countries, further large increases in the public expenditure to GDP ratio would risk jeopardizing sound and sustainable fiscal policy. Furthermore, continued public dissaving may also crowd out private sector investment. It will therefore be essential for the UK to contain overall public spending, prioritizing those areas that can contribute to enhancing productivity and growth.

### 2.2.2. Public expenditure by function

Social protection is the function of public sector spending absorbing the most resources. In 2006/07 it accounted for 34% of Total Managed Expenditure and almost 14% of GDP. The next largest functions in terms of government spending are health and education, amounting to around 7% and 6% of GDP respectively (corresponding to 18% and 14% of Total Managed Expenditure) (Figure 5). A similar overall ranking can be found in most other European countries.

In 2006/07 total spending by central government accounted for around three-quarters of Total Managed Expenditure (equivalent to 30% of GDP), whereas total local authority spending<sup>11</sup> represented about one quarter (11% of GDP). As both central and local government play a key role in funding and providing welfare services, controlling public spending and putting a greater emphasis on improving delivery therefore needs to involve all levels of public administration.

**Figure 5: Public Sector spending by function, 1997/98, 2001/02 and 2006/07 and average annual real growth from 1997/98 to 2006/07 (in brackets)**



*Note:* Functional categories are based on the UN Classification of the Functions of Government (COFOG), the international standard.

*Source:* PESA 2007, HM Treasury

Since 1997/98, public sector spending on key public services such as health and education has increased substantially. With average annual real growth rates of 5% and 6% respectively, these areas have grown much faster than both total public spending and

<sup>11</sup> The main areas of expenditure by local authorities are education, social services, environment, fire and rescue service, housing, parks and recreation, planning, transport, roads and highways and waste disposal and collection.

national income (Figure 5). Over the last 6 years, public health and education expenditure have increased by 1.3 and 0.6 percentage point of GDP respectively. This expansion has partly been at the expense of growth in other spending areas, as expenditures on general public service, defence and social protection have fallen as a share of GDP over this period.

The changing composition of public sector spending underlines the UK's stated aim to ensure that scarce public resources are redirected towards budgetary items that are central to citizen's welfare and/or conducive to economic growth. The importance of human capital formation for economic growth and productivity supports the UK's focus on increasing resources for education and training. However, higher spending does not necessarily result in better education outcomes, as this depends very much on the degree of efficiency in the system (see section 2.4).

### 2.3. The budgeting framework

Since the early 1990s the UK's budgeting framework has gradually developed so as to take a more strategic approach to the planning of public spending, focusing in particular on public sector performance and public management practices. The efforts to modernise the public administration have been pushed forward to a great extent by the need to meet the growing demands by tax-payers for better public services at lower costs. The UK authorities have thus undertaken a series of reforms to enhance the efficiency of public services provision, putting the UK at the forefront of applying performance-based budgeting techniques, including the linking of spending to performance targets.<sup>12</sup> In this context, especially the *Spending Reviews* (the periodic reviews determining the three-year expenditure decisions) and the *Gershon Review* (an independent review of public sector efficiency) have been of great importance. The framework has been described by the OECD as a top-down approach, where an overall binding expenditure ceiling is set by the Treasury on the basis of macro-economic assumptions, the medium-term fiscal management target and strategic policy priorities, prior to receiving government ministries' individual funding bids. The more detailed resource allocation decisions are then made by individual ministries within the departmental expenditure ceilings granted by the Treasury.<sup>13</sup>

#### 2.3.1. The Spending Reviews

The Comprehensive Spending Review (CSR) framework introduced in 1998 is one of the main elements of the UK's budgeting approach. Each review sets three-year Departmental Expenditure Limits, accounting for about 60% of Total Managed Expenditure. CSRs separate public sector spending into capital and current budgets, and further comprise Public Service Agreements (PSAs) which set out the objectives of each department, including performance targets and measures of activity.<sup>14</sup> The framework

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<sup>12</sup> OECD (2007): Improving public sector efficiency: Challenges and Opportunities.

<sup>13</sup> OECD (2007): Performance budgeting in OECD countries.

<http://siteresources.worldbank.org/EXTFINANCIALMGMT/Resources/313217-1196229169083/4441154-1196275288288/4444688-1196378494429/PerformanceBudgetinginOECDCountries.pdf>

<sup>14</sup> The rest – the Annually Managed Expenditure (AME) – covers the demand driven spending that is more difficult to plan for, including for example social security payments, and is subject to annual

has evolved through successive spending reviews<sup>15</sup>, the latest being the 2007 Comprehensive Spending Review published in October 2007. In the series of reviews there has been an increasing focus on key outcomes and the PSA targets have been revised and reduced in numbers.

The CSR and Public Sector Agreements targets are potentially valuable tools for enhancing public sector efficiency and so help release resources for key policy priorities. They allow departments to plan their spending over a longer time horizon, reduce the risk of growth-enhancing capital investment being squeezed out by short term spending and increase incentives to manage the public asset base more effectively. However, several challenges to the existing public spending framework remain, including how to ensure better coordination between different levels of government and how to define appropriate and measurable performance targets and set outcome-focused objectives (see Box 2). Furthermore, PSA targets do not automatically guarantee better value for money, as this depends very much on the behaviour of public service providers and the incentives they face.

#### **Box 2: The 2005 Atkinson Review**

In December 2003 the UK announced a year-long review of the measurement of UK government output and productivity, to be undertaken by economist Sir Tony Atkinson.<sup>16</sup> The final report was published in January 2005 and highlights past advances made in moving from an 'input = output' convention to the direct volume measurement of government output, which now covers around two-thirds of general government final consumption. At the heart of the Atkinson Review lie nine suggested principles, to be adopted in the UK's efforts to improve the measurement of government output, productivity and associated price indices in the context of national accounts. Amongst these are that government output should be measured following a procedure analogous to that for market output, and that measured output should be adjusted for changes in quality. It notably also suggests allowing for complementarities between public and private output to be taken into account, so that the value of certain kinds of public output may rise with national income levels (e.g. protection of property rights). The UK Centre for the Measurement of Government Activity was set up in 2005 within the Office for National Statistics (ONS) in order to develop output measurement methods further, and since produces articles on public services productivity. It has recently published its strategy on how to incorporate quality adjustments in output measurement, in which education and healthcare quality is given particular attention. Key proposals include the more refined use of pupils' secondary education results and further work to measure health gain and illness prevention as part of healthcare output.

#### *2.3.2. The Gershon Review: An appraisal of public sector efficiency*

The 2004 Spending Review set out the government's ambition to implement the recommendations of an independent review of public sector efficiency (the *Gershon*

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review as part of the Budget process. Institute for Fiscal Studies (2004): A survey of public spending in the UK.

[http://www.ifs.org.uk/publications.php?publication\\_id=1791](http://www.ifs.org.uk/publications.php?publication_id=1791)

<sup>15</sup> Comprehensive Spending Review 1998 (April 1999 to March 2002), 2000 (April 2001 to March 2004) 2002 (April 2003 to March 2006) 2004 (April 2005 to March 2008) and 2007 (April 2008 to March 2011). [http://www.hm-treasury.gov.uk/spending\\_review/spend\\_csr07/spend\\_csr07\\_index.cfm](http://www.hm-treasury.gov.uk/spending_review/spend_csr07/spend_csr07_index.cfm)

<sup>16</sup> For a more in-depth overview of the Atkinson Report see the European Commission (2006): Public Finances in EMU 2006.

[http://ec.europa.eu/economy\\_finance/publications/publication423\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication423_en.pdf)



*Review*, produced under Sir Peter Gershon) with the aim of improving value for money in the public sector. The Gershon Review examined all public sector expenditure and identified scope for significant efficiency gains to be made in five broad areas – procurement, corporate services, transactions, productive time and policy, funding and regulatory systems. In that way the report aimed to free up resources which could then be employed in 'priority' public services such as health and education. Departments were each set individual targets for generating efficiency savings as part of the cross government Efficiency Programme, and a central government agency, the Office of Government Commerce (an independent office of the Treasury) was made responsible for monitoring departments so as to ensure delivery of the savings. The Efficiency Programme targets efficiency gains of £21.5 billion a year (roughly 2% of GDP) by 2007/08 so as to improve public services, and envisages the reduction of civil service employment by 70,600 posts (roughly 13.5% of the April 2004 total of 523,580) by 2008.<sup>17</sup> This "input-oriented" approach is supposed to complement the existing focus by Public Service Agreements on outputs/results.

According to the National Audit Office, government figures from September 2006 indicate that departments had achieved £13.3 billion of the targeted efficiency gains (corresponding to around 60%) and 45,551 of the targeted reduction in employment (corresponding to around 65%).<sup>18</sup> However, these figures have been questioned by the Committee of Public Accounts, which argued that *"of the £13.3 billion efficiency gains now reported: £3.5 billion fairly represent efficiencies made; £6.7 billion represent efficiency but carry some measurement issues and uncertainties; and £3.1 billion may represent efficiency, but the measures used either do not yet demonstrate it or the reported gains may be substantially incorrect."*<sup>19</sup> This illustrates that it is not yet clear whether the efficiency programme has indeed been able to release resources for key priorities by improving efficiency or whether it has inadvertently been made a cost-saving exercise compromising public services quality and/or output. For the initiative to ultimately become a success the challenge will be to ensure that efficiency gains take the form of long-term improvements and not just one-off savings.

Indeed, the need to secure these efficiency gains arguably becomes greater from 2008 onwards. For some of the largest UK public spending items, such as healthcare and education, the 2007 CSR for 2008/09 to 2010/11 heralds a period of relatively modest funding increases compared to the large rises in the last two CSR periods. The rapid expansion of healthcare and education services witnessed over the past years will thus not be able to continue unless increases in efficiency and productivity make up for the slower growth in spending.<sup>20</sup> By way of example, the following section examines the case of education spending in more detail because of its potentially growth-enhancing

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<sup>17</sup> For further details on the Gershon Review see the European Commission (2005): Public finances in EMU 2005.

[http://ec.europa.eu/economy\\_finance/publications/publication421\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication421_en.pdf)

<sup>18</sup> National Audit Office (2007): Value for Money Report.

<sup>19</sup> House of Commons, Committee of Public Accounts (2007): The Efficiency Programme: A Second Review of Progress Forty – eighth Report of Session 2006–07 Report.

<sup>20</sup> Efficiency is here defined as *technical* (i.e. productive) efficiency, and denotes the ratio of output produced with a given level of inputs relative to the highest achievable output level. All maximally efficient output levels constitute the production frontier, which can show diminishing returns. Productivity, on the other hand, measures the ratio of total output to total inputs used in production.

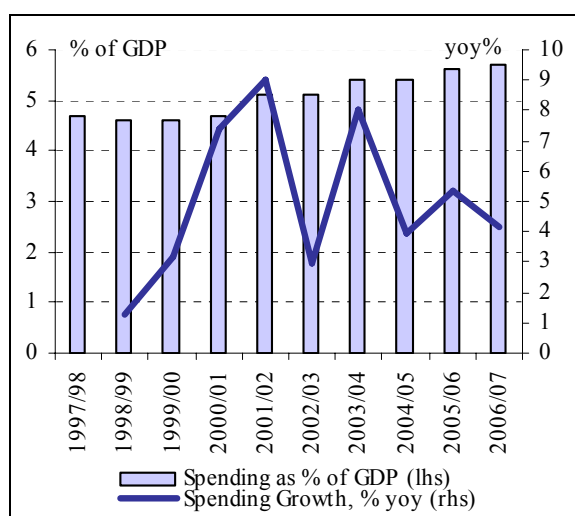
impact on human capital formation and its importance in closing the UK's productivity gap.

## 2.4. Spotlight issue: education

Education in the UK is the third largest public spending function after social protection and healthcare. All levels of UK education are predominantly financed by public means, although the funding share of the public sector decreases with the level of education. Total public spending on UK education in real terms has grown substantially since 1999 (Figure 6). Annual spending increases between 1998/09 and 2006/07 have helped increase education spending by more than a full percentage point of GDP since 1998/09. Sizeable increases in resources for education have benefited both capital and current expenditure, with capital spending on the construction of new facilities and large increases in staff numbers accounting for much of the extra spending.

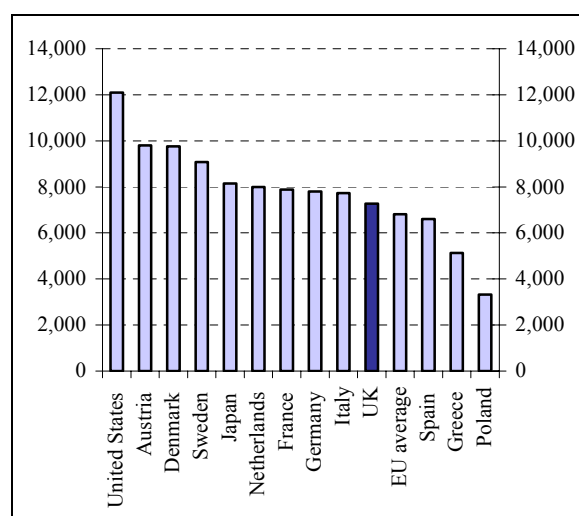
Looking ahead at the 2007 CSR education budget for 2008/09 to 2010/11, it seems that the spending boom will all but come to an end, with the average annual growth rate of education spending falling by almost half to 2.8% in real terms. This will be sufficient to keep the share of education spending approximately constant at its current level of 5.7% of GDP. These lower spending increases need not compromise the quality and output of the public education system, but in order to reap the greatest possible benefit the additional resources will need to be spent in a targeted way that ensures value for money.

**Figure 6: Public expenditure on education and training (% of GDP and % annual real changes)**



Source: PESA 2007, HM Treasury

**Figure 7: Total education spending per student in 2004 (public + private), in US\$ at PPS**



Note: EU average only includes OECD members

Source: OECD

### 2.4.1. International comparison of education performance

In an international comparison of total public and private education spending per pupil, large public spending increases have brought the UK to just over the OECD and EU average (Figure 7). The UK performs slightly better than the EU average on a number of structural indicators, such as the relative number of science graduates and upper secondary attainment rates amongst people aged 20-24. This overall picture has not

changed much since 1998. According to the OECD's 2006 PISA study results<sup>21</sup>, UK students at the age of 15 perform above-average in science and have an above-average level of top performers. The comparative strength of the UK education system in the field of science is however not mirrored in reading and mathematics performances, where in the 2006 PISA study the UK performs no better than the OECD average. Furthermore, considering the wider age range of 15-24, the UK shows lower overall participation rates in education than the EU average, particularly for those aged 16-18. And while labour market returns to tertiary education are amongst the highest of all OECD countries, the employment and earnings prospects for those who have not completed upper secondary education are significantly worse than for the OECD average, indicating a two-tier labour market. In addition, the number of 16-18 year olds who are not in education, training or employment increased by 15% since 1997 to 1.24 million in 2006. Of 15 OECD countries (14 of them EU members), the UK has the third highest share of young people in this category. Reducing the number of inactive youngsters remains a significant challenge for the UK education system, not least due to the individual and social costs related to this type of social exclusion.<sup>22</sup> Improvements in the quality of education and increased training opportunities should therefore form a key part in the overall strategy to improve UK education and skill levels.

#### 2.4.2. *Output measurement and productivity in UK education*

In September 2007 the UK's Office of National Statistics (ONS) published productivity figures for the public education sector, incorporating a quality adjustment for education output based on changes in average student point scores at the lower secondary school qualification level.<sup>23</sup> Dividing quality-adjusted education output by education inputs then gives an estimate of education productivity for the period 1996-2006. Education inputs are captured as the sum of public education expenditure on labour inputs and goods and services, adjusted for inflation through expenditure-specific cost deflators, while education output is measured as a cost-weighted index of pupil attendance rates and student numbers across all school types.

The quality adjustment for education output, which infers a steady rise in schooling quality from the observed increase in pupils' average qualification grades since 1995, is pivotal for the pattern of estimated productivity changes. The quality-adjusted figures show that education productivity was broadly stable over the period 1996-2006, when increases in average student performance matched the increase in resources. However, estimates based on quality-unadjusted education output show a distinct deterioration of education productivity, with an annual average reduction in productivity of between -1.7% and -1.9%. In any case, the robust growth in education funding therefore has not been accompanied by an *increase* in public education productivity, at least not during the period scrutinised. A partial explanation for this lies within the notion of education productivity itself, which tends to fall in times of large funding increases, as education output (i.e. student numbers) is partly determined by longer-term demographic factors

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<sup>21</sup> OECD (2007): PISA 2006: Science competencies for tomorrow's world.  
[http://www.oecd.org/document/2/0,3343,en\\_32252351\\_32236191\\_39718850\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/2/0,3343,en_32252351_32236191_39718850_1_1_1_1,00.html)

<sup>22</sup> The Princes Trust (2007): The Cost of Exclusion: Counting the cost of youth disadvantage in the UK.  
<http://www.princes-trust.org.uk/main%20site%20v2/downloads/Cost%20of%20Exclusion%20apr07.pdf>

<sup>23</sup> Office of National Statistics (2007): Public Service Productivity: Education; Paper 1, September 2007  
[http://www.statistics.gov.uk/articles/nojournal/Education\\_productivity\\_2007\\_main.pdf](http://www.statistics.gov.uk/articles/nojournal/Education_productivity_2007_main.pdf)

and will typically show lower year-to-year variance than resource inputs. In times of rising resource inputs and constant output, productivity improvements can then only result from a more-than-proportionate increase in the quality of education, i.e. in pupils' average qualification grade.

In light of the large difference that the quality adjustment for education makes for measured education productivity, one needs to assess whether the quality adjustment is plausible. The ONS therefore compares the quality index against a range of other education indicators, and concludes that the results are mixed. Supporting the inferred increase in education quality, there is evidence that the average performance of pupils of comparable ability has increased over the period in question, but it is unclear whether this is a result of better teaching and learning performance or whether it indicates that examination standards have fallen, or both. Furthermore, average class sizes have decreased slightly since the late 1990s, which should improve education quality. In contrast, official teaching quality assessment shows that teaching quality improved in the late 1990s but has remained stable since, suggesting that education quality has remained broadly constant. Finally, the number of students with conduct disorders has increased, thus indicating some adverse developments in schooling quality. But while quality measurement methods may still be at an early stage, they are valuable for assessing what the qualitative returns are to education spending.

In summary, given the slowdown of education spending growth in the future and the government's aim to further improve the education system, potentially quality-enhancing measures such as the recruitment of more and better-qualified teachers will become increasingly hard to fund. However, in light of the mixed evidence on schooling quality, the impact on education output and quality is more difficult to predict, partly also because previous increases in staffing and equipment may only show up with a lag in the coming years.

## **2.5. Conclusions**

The UK is faced with strong pressures on delivering higher quality public services at lower costs. During the last few years expenditure growth has outpaced revenue growth resulting in a general government deficit close to the 3% of GDP reference value. Controlling expenditure and further enhancing the efficiency and effectiveness of public spending is therefore crucial. The UK already has a good basis for modernising its public administration and budgeting framework, but further work on output and quality measurement as well as a strengthened focus on creating an incentive structure for public service providers that reinforces the "value for money" approach is needed. This will be particularly important for areas such as education, where potential growth and productivity benefits from improving educational outcomes are high, but in which a marked funding slowdown over the coming CSR period will constrain progress unless it is accompanied by quality- and efficiency-enhancing measures.

## **3. MACROECONOMIC OUTLOOK**

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether and when good or bad economic times in the sense of the Stability and Growth Pact prevail.

The programme presents two macroeconomic scenarios: a fully-fledged central scenario and a “cautious” scenario, which is based on trend<sup>24</sup> growth one quarter of percentage point lower than in the central scenario. All public finances projections in the programme are based on the cautious scenario, which is therefore considered here the reference scenario. However, due to the lack of detailed information about macroeconomic aggregates other than GDP in the reference scenario, a full assessment of the plausibility of the macroeconomic scenario can only be made by also taking into account the additional information from the central scenario as well. This appears to be in the spirit of the programme, which states that in the reference scenario the economy is expected to follow the path described in the central scenario, with the main difference between the two scenarios being the lower GDP growth forecast in the reference scenario.

### **3.1. Economic activity**

The central scenario of the UK programme expects real GDP to grow at a rate of 3% in 2007, thereby continuing on the relatively strong expansion path of 2006. In 2008, however, growth is forecast to slow to between 2% and 2½% before rising to between 2½% and 3% in 2009 and 2010. Against the background of the expected temporary slowdown in 2008, only domestic demand makes a positive contribution to growth throughout the programme period.

Based on robust private consumption growth in the first half of 2007, private consumption is expected to expand by 3% in 2007, in line with overall GDP. The disruption in financial markets witnessed since July 2007 is however expected to slow domestic demand growth in the short term via a negative impact on business and consumer spending. In addition, successive increases in the Bank of England’s main interest rate between August 2006 to July 2007 are expected to dampen private consumption growth in 2008, and, despite an interest rate cut in December 2007, are unlikely to be fully reversed in 2008. Thereafter, private consumption growth increases again, broadly in line with that of overall GDP for the remainder of the programme period. Due to the higher cost of capital, fixed investment growth is forecast to slow to around 3½% from 2008 on. The programme further envisages consumption by general government to maintain stable growth, although slowing slightly from 2009 onwards. Finally, the growth contribution of net exports, which was marginally negative in 2006 and is expected to remain so in 2007, is predicted to turn neutral from 2008 onwards, as export growth outstrips that of imports.<sup>25</sup>

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<sup>24</sup> The reference to "trend", rather than "potential" growth reflects the programme’s reliance on the UK’s domestic methodology for abstracting from cyclical factors, rather than the common methodology agreed between the Member States and the Commission.

<sup>25</sup> The external outlook behind the programme’s ‘central’ macroeconomic scenario is broadly in line with that in the Commission services’ autumn 2007 forecast. The ‘programme’s assumption for oil prices is lower than that in the Commission services’ 2007 autumn forecast (see section 3.2). The programme provides no explicit path for sterling exchange rates or interest rates.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2007		2008		2009		2010	2011
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3.1	3	2.2	2 - 2½	2.5	2½ - 3	2½ - 3	n.a.
Private consumption (% change)	3.0	3	2.1	1¾ - 2¼	2.2	2¼ - 2¾	2¼ - 2¾	n.a.
Gross fixed capital formation (% change)	5.3	5¾	2.9	3¼ - 3¾	4.8	3¼ - 3¾	3¼ - 3¾	n.a.
Exports of goods and services (% change)	6.1	3¾	5.5	4½ - 5	5.8	4¾ - 5¼	4¾ - 5¼	n.a.
Imports of goods and services (% change)	6.2	3¾	5.2	3¾ - 4¼	5.8	4 - 4½	4 - 4½	n.a.
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	3.3	3 - 3½	2.3	2¼ - 2½	2.6	2¼ - 2¾	2½ - 2¾	n.a.
- Change in inventories	0.0	0	0.0	0	0.0	0	0	n.a.
- Net exports	-0.2	-¼	-0.1	0	-0.2	0	0	n.a.
Output gap <sup>1</sup>	-0.1	0.0	-0.4	-0.5	-0.6	-0.3	-0.4	-0.3
Employment (% change)	0.5	n.a.	0.4	n.a.	0.6	n.a.	n.a.	n.a.
Unemployment rate (%)	5.3	n.a.	5.4	n.a.	5.3	n.a.	n.a.	n.a.
Labour productivity (% change)	2.6	n.a.	1.8	n.a.	1.9	n.a.	n.a.	n.a.
HICP inflation (%)	2.4	2	2.2	2	2.0	2	2	n.a.
GDP deflator (% change)	3.1	3¾	2.1	2¾	2.3	2¾	2¾	n.a.
Comp. of employees (per head, % change)	4.3	n.a.	4.5	n.a.	4.3	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.9	n.a.	-3.3	n.a.	-3.4	n.a.	n.a.	n.a.
<b>2. Programme's macroeconomic forecast underlying public finances (reference forecast)</b>								
	2007/08		2008/09		2009/10		2010/11	2011/12
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3	3	2	2	2.5	2¾	2½	2½
HICP inflation (%) <sup>2,3</sup>	2.4	2¼	2.2	2	2.0	2	2	2
GDP deflator (% change) <sup>3</sup>	3.1	3¾	2.1	2¾	2.3	2¾	2¾	2¾
<i>Note:</i>								
<sup>1</sup> In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.								
<sup>2</sup> The Commission services forecast the average annual HICP. The Convergence programme measures HICP, whereas the convergence programme measures HICP as the 4 quarter percentage change in the Consumer Price index (CPI) over the same quarter of the previous year.								
<sup>3</sup> Commission forecast figures for HICP inflation and GDP deflator refer to calendar years.								
<i>Source :</i>								
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)								

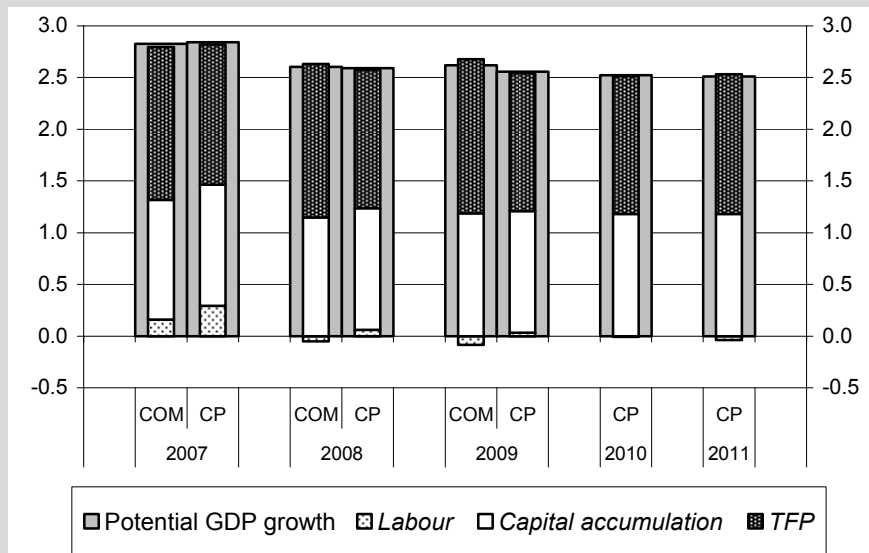
Overall, the economic outlook described in the central scenario is in line with the Commission services' autumn 2007 forecast with respect to the composition of GDP growth. Both the autumn forecast and the programme expect growth to slow significantly in 2008 due to weaker private consumption and investment growth, partly as a result of tighter credit conditions. Two main differences between the forecasts should however be noted. First, following the slowdown in 2008, the UK programme expects a swift recovery in 2009 due to rebounding private consumption growth. By contrast, the Commission services' autumn 2007 forecast expects a more moderate economic recovery in 2009, driven by reinvigorated fixed investment but with private consumption remaining relatively subdued on account of a moderation in housing market activity and associated wealth effects. Second, the UK programme projections appear to be somewhat optimistic regarding the improvement in the GDP contribution of net exports, which turn neutral from 2008 onwards due to an increase in export growth and broadly unchanged import growth relative to 2007. By contrast, the Commission services' autumn 2007 forecast expects net exports to continue their moderate drag on growth throughout the forecast period. Overall, and abstracting from the aforementioned differences of assessment, the programme's central scenario appears otherwise plausible in relation to the composition of GDP growth over the forecast horizon.

As mentioned above, the programme's public finances projections are based on the reference scenario. This shows annual economic growth of 3% in financial year 2007/08 and a slowdown to 2% in 2008/09, which broadly corresponds to the Commission services' autumn 2007 forecast. For 2009/10, economic growth is  $\frac{1}{4}$  p.p. higher than in the autumn 2007 forecast, suggesting that the reference scenario envisages the UK economy to rebound rather more quickly from conditions in the previous year. In 2010/11 the economy is projected to grow in line with the Commission service's estimate for potential output growth in 2009 of around 2½% per annum, which appears plausible.

However, the assessment of risks in the Commission services' autumn 2007 forecast was that these were tilted to the downside. By contrast, the UK programme's risk assessment views the risks to the upside and downside as balanced. More recent developments, both in the UK and internationally, subsequent to the October finalisation of the autumn 2007 forecast point to weaker short-term prospects than then expected. Quarterly GDP growth in the third quarter of 2007 was revised down by 0.1 percentage point to 0.7% relative to the preliminary estimate, on which the autumn forecast was based. And despite a recovery in the PMI index for manufacturing in November, the more significant PMI index for services has fallen sharply to its lowest level since May 2003. Finally, growth in producers' output and input prices increased sharply in October and November as a result of increases in fuel and food prices, which may additionally depress private consumption over the course of 2008 as producer prices feed through into higher retail prices. On balance, the main recent developments therefore imply that, relative to the Commission services' autumn 2007 forecast, the near-term outlook for growth has deteriorated. Accordingly, the reference forecast in the programme scenario should now be considered as optimistic in the near term.

### Box 3: Potential growth and its determinants

The Commission services have calculated estimates for potential growth and its determinants using the commonly agreed methodology based on information provided in the UK programme. The chart below presents these estimates and compares them with the estimates from the Commission services' autumn 2007 forecast. The information provided in the UK programme stem mainly from the reference scenario, although the data provided there are very limited and therefore require some interpolation in order for the recalculation of potential growth by the Commission services to be possible.<sup>26</sup>



As shown in the graph above, the recalculated potential growth estimates based on programme information are very similar to the Commission services' estimates. Potential GDP growth is estimated as 2.8% in 2007, and falls slightly in subsequent years to around 2.5% in both estimate series. Contributions to potential growth are also broadly equivalent in the two series, with TFP growth contributing most to potential GDP growth, accompanied by relatively stable capital rates of capital accumulation and a neutral contribution of labour from 2008 onwards. The overall estimates appear plausible in light of the UK's average growth rate in the past ten years, which was 2.8%.

Regarding the assessment of cyclical developments, the output gap as recalculated by the Commission services on the basis of data provided in the programme shows similar positions in 2007 and 2008 relative to the output gap estimates calculated in the Commission services' autumn 2007 forecast.<sup>27</sup> As Box 3 shows, both series employ almost identical estimates for potential growth, and hence any substantial divergence in output gap developments is mainly due to differences in forecast GDP. In both output gap series, the UK economy moves from a position of a zero or slightly positive output

<sup>26</sup> Data for unemployment and total earnings are based on the programme's assumptions underpinning the reference scenario, which are audited by the UK National Audit Office. Figures for total employment growth are based on the programme's latest estimates for components of trend growth.

<sup>27</sup> Output gap estimates recalculated by the Commission services on the basis of data provided in the programme based on the commonly agreed methodology use GDP forecast data from the reference scenario. They are made on a calendar year basis in order to ensure comparability with the Commission services' autumn 2007 forecast. For the purpose of calculating cyclically-adjusted fiscal balances, which the programme presents on a financial year basis, the recalculated output gaps from the programme are then again recalculated for financial years.



gap in 2007 to a significant negative output gap, resulting from the sharp slowdown in GDP growth to 2% in 2008. In 2009, the negative output gap based on programme data narrows again due to the swift rebounding of GDP growth to above-trend levels. By contrast, the autumn 2007 forecast expects growth in 2009 to reach 2.5%, thus remaining below potential and contributing to a further widening of the negative output gap. From 2010 onwards, the recalculated output gap on the basis of programme data remains virtually constant in negative territory.<sup>28</sup>

### **3.2. Labour market and cost and price developments**

The programme's forecast for levels of total unemployment shows a slight rise until 2009 and remains constant thereafter, at levels in line with the average unemployment level over the past six years. This broadly matches the Commission services' autumn 2007 forecast and is consistent with the re-emergence of a negative output gap in 2008. As the programme offers no numerical forecast for employment levels or employment rates, the labour content of growth cannot be fully assessed on the basis of the programme. The assumptions underpinning the programme's reference scenario however state that the share of labour income and profits in national income should remain broadly stable over the medium term.

The programme further presents an inflation trajectory for the period 2007-2013 that is broadly in line with that underpinning the Commission services' autumn 2007 forecast. The programme expects consumer price inflation of 2¼% in financial year 2007/08, falling to 2% thereafter. However, in light of more recent developments, notably a significant increase in energy prices in the final quarter of 2007, risks to the programme's inflation outlook must now be seen as tilted to the upside over the short term.. Specifically, the reference scenario's assumption for oil prices of 68US\$ per barrel in 2008 is somewhat lower than that in the Commission services' 2007 autumn forecast, which lies between \$75 and \$81. Pronounced increases in oil prices during October and November 2007 have brought prices to above \$90 per barrel, which therefore renders the programme's inflation outlook optimistic and shifts inflation risks firmly to the upside in the short term. If these risks were indeed to materialise, in the form of persistently high oil prices at levels around \$90, this would adversely affect both producer and consumer price inflation, thus depressing domestic demand further relative to the programme's reference scenario. However, the risk of higher inflation in the short term gives way to an expected moderation in inflation in the medium term as activity levels are depressed relative to potential.

No explicit forecasts for wages, earnings and productivity developments are included in the programme. As no unit labour cost or exchange rate forecast is presented in the programme, the plausibility of the programme's expected increase in export growth from 2008 onwards cannot be evaluated in relation to relative cost competitiveness.

### **3.3. Macroeconomic challenges**

For many years the UK economy has benefited from a stable macroeconomic environment of relatively low inflation and robust growth. Although both the 2007 update of the UK convergence programme and the Commission services' autumn 2007

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<sup>28</sup> The apparent change in the programme's output gap from -0.3% of GDP in 2009 to -0.4% of GDP in 2010 is numerically insignificant and results from rounding.

forecast expect a somewhat weaker period of growth to follow in 2008, this in itself is unlikely to jeopardise macroeconomic stability in the UK. However, two interrelated developments should be highlighted in the context of the anticipated turn to bad economic times in 2008, namely the financial market turbulence in the second half of 2007 and mounting indications of a possibly severe correction in the housing market as regards both price and levels.

Turning to the former, the UK's relatively large financial sector, which directly accounted for around 9% of gross value added in 2006,<sup>29</sup> exposes the UK economy to the impact of adverse developments in financial markets. These have been predominantly negative in the latter half of 2007 and are expected to remain so for 2008. The tightening of overall credit conditions since August 2007 and a weakening in financial market activity has dampened growth and employment prospects in the UK financial sector over the forecast horizon, with negative consequences for tax revenues strongly linked to financial services (particularly corporate and personal income tax). Furthermore, tighter lending conditions for loans to businesses and households will have a negative impact on fixed investment and private consumption activity, and thus pose the risk of substantial negative second-round effects on growth. Downside risks to the external account balance should also be noted, as a slowdown in financial services activity is likely to have a negative impact on both the UK's sizeable exports of financial and business services as well as on the UK's income account credits.

Secondly, an emerging housing market correction poses a separate macroeconomic challenge to growth over the medium term. The UK has witnessed strong increases in average house prices in recent years, with average property prices having risen by 179% over the ten years to November 2007.<sup>30</sup> As a result, debt-financed housing affordability is increasingly becoming stretched as mortgage repayments have risen steeply in relation to both disposable income and earnings, with the latter reaching a 16-year high in Q2 2007. Mortgage interest repayments have further been increased by the tighter lending environment over the course of 2007, caused by successive increases in the Bank of England's main interest rate as well as by some additional increases in mortgage spreads over Bank Rate. Furthermore, the availability of mortgage credit has also been restricted in recent months. In light of these trends, available data up to December 2007 showing falls in average house prices and a decline in new lending and housing turnover confirm a rapidly cooling housing market.

Weakening housing market activity is likely to have negative effects on private consumption growth over the forecast period as wealth effects from higher property prices weaken and turn negative. In addition, private consumption may also be weakened through a reduction in housing equity withdrawal, i.e. new lending mainly for consumption purposes secured on residential property. Lending of this kind has been an important source of financing for private consumption, amounting to 5.5% of net disposable income in 2006. Changes in housing equity withdrawal have tracked house price growth fairly closely since 2000.<sup>31</sup>

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<sup>29</sup> Source: UK Office of National Statistics; data series on experimental current price GVA by industry

<sup>30</sup> Halifax House Price Index, November 2007, <http://www.hbosplc.com/economy/housingresearch.asp>

<sup>31</sup> Source: Commission services' calculations based on data from Bank of England and Halifax Bank of Scotland Group

In line with these early indications of house prices and associated wealth effects moderating, it is likely that no further positive stimulus to private consumption will emanate from the housing market over the forecast horizon, and in the event of a substantial fall in house prices the effect on consumption growth will be negative. In this case private consumption growth is likely to moderate by more than expected over the forecast horizon, thus posing a further downside risk to GDP growth.

Furthermore, the UK economy has been marked in recent years by a number of imbalances that may, under certain circumstances, pose a downside risk to economic developments. These are a low household saving rate and a sizeable and widening current account deficit.

Concerning UK household saving, total household consumption expenditure has approximately equalled households' gross disposable income since 2004, implying that gross saving by households has been close to zero over the period. As of the final quarter of 2006, gross saving has turned negative. When factoring in the increase in households' net equity position in pension funds due to households' net contributions to such funds, the overall household saving ratio is still positive, but at 3.4% in the in the third quarter of 2007 it is nevertheless low compared to the ten-year average of 5.7%. In the event of an economic slowdown and, particularly, a downward correction in house prices, gross savings are likely to recover due to households taking a more precautionary stance vis-à-vis their financial situation (though their net wealth position may still deteriorate if asset prices fall), which is likely to aggravate such a slowdown and limit the strength of a subsequent recovery. If, however, a very low saving rate were to be sustained, this might pose a long-term sustainability challenge in relation to household indebtedness.

Regarding the latter, a marked deterioration in the UK's current account balance has taken place since 1997, when the current account, expressed as a percentage of GDP, was close to balance.<sup>32</sup> Despite some volatility in the evolution of the current account balance and its components, a significant deficit has emerged which widened from 1.3% GDP in 2003 to 3.9% GDP in 2006. Statistics for the third quarter of 2007 show that the deficit widened further in 2007, to an estimated 5.7% of GDP in the third quarter. The recent increases in the current account deficit have been driven by an erosion of the UK's income surplus as well as an increasing trade deficit. Continuing current account deficits would worsen the UK's net foreign asset position in the absence of countervailing valuation effects on the existing stock of domestic and foreign assets. The sizeable nominal exchange rate depreciation of around 9% in effective terms between July 2007 and January 2008 and the expected slowdown in UK domestic demand growth however suggest that a further deterioration in the trade and income balance is unlikely in the medium term. A permanent depreciation would also tend to improve the UK's net foreign asset position.

#### **Box 4: Good or bad economic times?**

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of

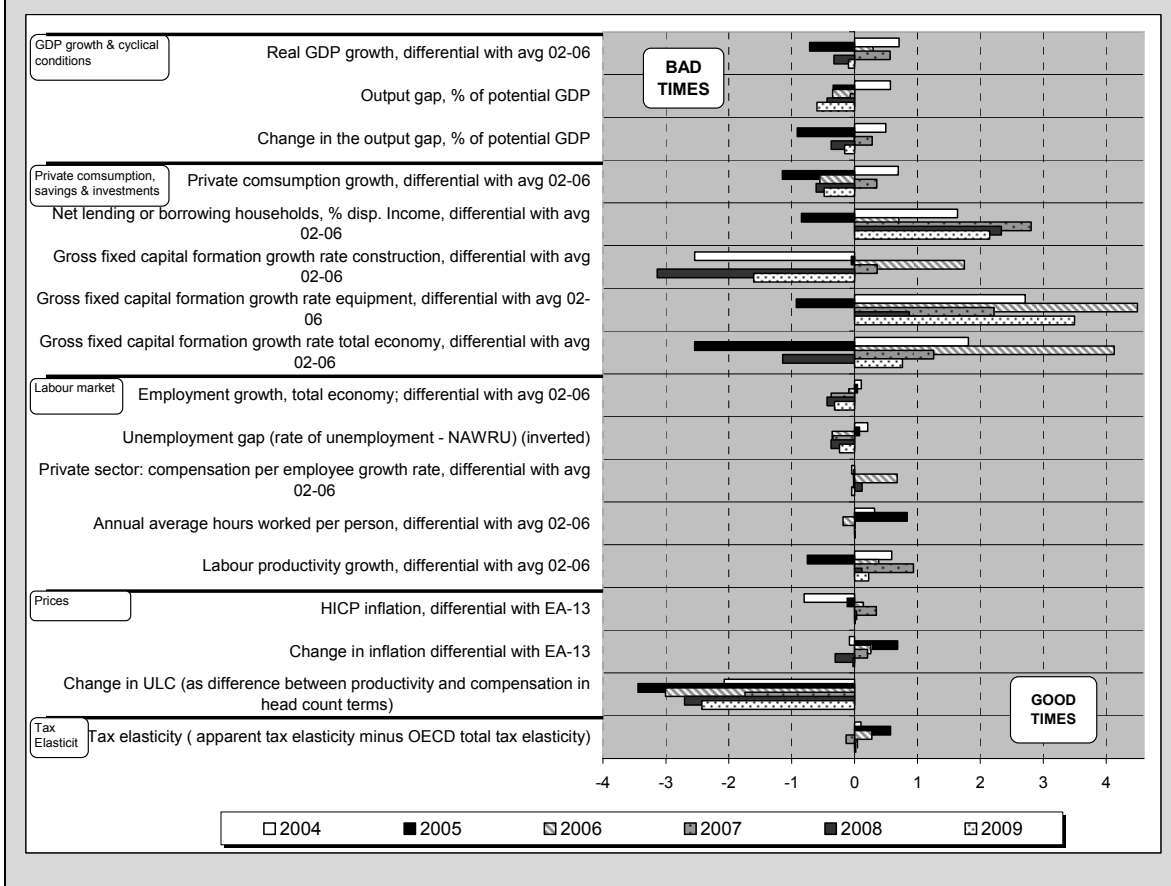
<sup>32</sup> This section will henceforth refer to the *current account* as designating the sum of the trade balance, income balance and current transfers balance. It is hence not synonymous with the *external balance*, which also includes the capital balance.

macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times taking into account tax elasticities in 2007, but will enter bad times in the subsequent year, with a return to neutral economic times thereafter.

For many indicators, observations for 2006 and 2007 tend to suggest relatively favourable economic conditions, whereas the expected downturn in 2008 stands out clearly as constituting 'bad times' and observations for 2009 tend to suggest relatively neutral economic conditions.

Overall, GDP growth and related indicators confirm the transition from good to bad to neutral times over the forecast period. Strong growth in private consumption and net household borrowing suggests good times, but in part also reflects the idiosyncrasies of the UK property market and an emerging housing market bubble. Labour market signals are somewhat less indicative, although prospects for employment and unemployment tend to suggest bad times, at least from 2006 onwards. Adverse developments in unit labour costs arguably provide the only unambiguous indication that the UK is in bad times, as the growth in earnings has not been matched by increases in labour productivity. Other things being equal, this bodes unfavourably for export competitiveness, future GDP growth and the large and widening external account deficit.

Finally, comparing the apparent tax elasticity in the Commission services' 2007 autumn forecast with the OECD ex-ante elasticity, the slightly positive reading until 2006 suggests that the tax system yielded more than implied by the OECD standard elasticities in these years, but the disappearing of the positive reading from 2007 onwards points to more neutral times ahead.



#### 4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme.

The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

#### **4.1. Budgetary implementation in 2007**

In the financial year 2006/07 ending in March 2007 the general government deficit fell from 3.1% of GDP in 2005/06 to 2.6% of GDP, 0.2 percentage points less than had been projected in the December 2006 update of the convergence programme. The improvement in the fiscal position to well below the deficit reference value occurred notwithstanding an unanticipated change in the statistical treatment of local government housing revenue that raised the deficit outturn in 2006/07 by 0.2 percentage points (and by 0.2/0.3pp in earlier years, see Box 5); this implies an underlying deficit out-performance relative to the projection in the previous update (of a deficit of 2.8% of GDP) of 0.4 percentage points. On the other hand, substantially higher-than-usual repayments of overpaid corporate taxation since April 2007 suggest that, perhaps particularly in 2006/07, such revenues could have been artificially boosted by overstated profits, though the extent of this offset is uncertain.

The improvement in the deficit in 2006/07 primarily reflected an increase in the revenue-to-GDP ratio by 0.4 percentage points, particularly as a result of strong year-on-year increases in revenues from employment income and corporate taxes on financial sector profits, although intakes from indirect taxation, which benefited from high growth in consumption expenditure and reduced Missing-Trader Intra-Community (MTIC) fraud, also grew buoyantly. Meanwhile, expenditure increased at a rate slightly less than nominal GDP growth, in part benefiting from some shortfall in planned capital expenditure.

The budgetary situation in the current financial year 2007/08 has unexpectedly and seriously deteriorated. The update estimates a deficit 3.0% of GDP, equal to that estimated in the Commission services autumn' forecast but 0.7 percentage points higher than projected in the previous update. The deterioration in the budgetary prospects for the present year primarily reflects a significant downward revision in revenue growth projections. The revenue-to-GDP ratio had been expected to increase by a ½ percentage point in the 2006 update, but in the latest programme is expected to remain unchanged from its level in the preceding year. In turn, developments on the revenue side are driven by lower than expected intakes from corporate taxation, primarily as a result of higher repayments, due to companies' having overpaid corporate tax in previous years, as well as to lower revenues from oil and gas extraction activity due to lower production and the appreciation of sterling against the dollar. Meanwhile, total expenditure is also forecast to grow at a faster pace than had been expected last year, such that the increase in the expenditure-to-GDP ratio is expected to be 0.2 percentage points higher than had been envisaged. This is partly due to a stronger effect of the national accounts' reclassification on expenditure this year, although interest expenditure should also be higher than anticipated as a result of the impact of the higher Retail Price Index (RPI) inflation on index-linked interest payments on government debt.

In-year public finances data for 2007/08 show that year-on-year growth in central government revenue during the first eight months of the year, at 5.0%, was less than the whole-year growth projection of 6.0% in the programme update. The in-year data on total expenditure growth were more consistent with the annual projection in the programme, although slower growth in investment expenditure partly compensated for a higher increase in current expenditure. The slower-than-expected revenue growth in the first eight months and the increased risks to revenue projections from a more fragile macroeconomic context in the second half of the present financial year, including the potential impact of the financial sector difficulties on income tax receipts from employee bonuses and salaries in January 2008, suggests a distinct possibility that the deficit outturn in 2007/08 could be worse than expected in the programme.

Compared to the deficit outturn in 2006/07, the abrupt deterioration in public finances during 2007/08 contrasts sharply with the Council opinion of 29 March 2007 on the previous update of the convergence programme, which had invited the United Kingdom to continue pursuing budgetary consolidation.

**Box 5: The impact of a revised statistical treatment of local government housing revenue**

In June 2007 the United Kingdom Office for National Statistics (ONS) announced a methodological revision in the national accounts treatment of local government revenues from the sales of social housing. The revision took into consideration that local authorities ring-fenced their housing activity, kept detailed housing revenue accounts, and sold houses at economically significant prices. This implied that local government housing units should be considered as public corporations or quasi-corporations and, as such, the distribution of local government housing surpluses recorded in the national accounts should be reclassified from the local government sector to outside the general government.

As the table below shows, the reclassification, which was applied backdated to 1997/98, led to an increase in the general government deficit by 0.2 percentage points in 2006/07, through the combined effects of foregone revenue from housing sales and an increase in the subsidy payments' component of expenditure.

<b>Impact on general government revenue, expenditure and deficit as a result of the reclassification of local government housing revenue</b>					
<i>% of GDP</i>	<b>2002/03</b>	<b>2003/04</b>	<b>2004/05</b>	<b>2005/06</b>	<b>2006/07</b>
Revenue	-0.3	-0.3	-0.2	-0.1	-0.1
Expenditure	0.0	0.0	0.1	0.1	0.1
General government balance	-0.3	-0.3	-0.3	-0.2	-0.2
<i>Sources</i> : Commission services, Office for National Statistics					

The updated programme refers to the reclassification as having a neutral impact on public finances, although statistically this applies only to the UK's own definition of 'public sector' finances at the aggregate net borrowing level (where increases in the government deficit are exactly offset by reduced public corporations' borrowing). The programme does not provide details on the impact of the reclassification on general government revenues, but estimates that the increase in expenditure as a result of reclassification is expected to reach 0.2 percentage points each year between 2007/08 and 2010/11.

Table 2 compares the 2007/08 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the

Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect.<sup>33</sup>

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

According to the table, the increase in the general government deficit in 2007/08 to 3.0% of GDP resulted from the combined effects of slower than expected revenue growth and a higher increase in expenditure. As explained in section 2.3, the budgetary framework in the United Kingdom provides for a nominal expenditure envelope covering a three-year period, with the overall spending envelope for a given year not subject to downward revision in the event of lower-than-budgeted expenditure in the preceding year. As a result, the improved outturn in 2006/07 is not expected to have had significant base effects on the budgetary position in 2007/08.

After adjusting for base effects and notwithstanding higher GDP growth when compared to the previous programme, the downward revision in revenue growth contributed to a worsening of the UK's budgetary position by about 0.4 percentage points, which, as explained above, was almost entirely due to lower-than-expected receipts from corporate taxation. After accounting for the effect of the higher GDP growth, a higher than expected increase in expenditure is estimated to have contributed to an increase in the deficit by about 0.4% of GDP. However, the notion that lower-than-planned expenditure growth in 2006/07 should have led to lower spending in 2007/08 would not seem consistent with the expenditure framework in the United Kingdom, including the three-year spending envelope and a scheme which allows departments to draw on previous years' unspent financial allocations. Excluding base effects from the expenditure side, would yield an expenditure growth effect (on the denominator) of 0.2% of GDP.

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<sup>33</sup> A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

**Table 2: Budgetary implementation in 2007/08**

	2006/07		2007/08	
	CP Dec 2006	CP Nov 2007	CP Dec 2006	CP Nov 2007
Revenue (% of GDP)	39.2	38.5	39.8	38.5
Expenditure (% of GDP)	42.0	41.2	42.1	41.5
Government balance (% of GDP)	-2.8	-2.6	-2.3	-3.0
Nominal GDP growth (%)			5.6	6.1
Nominal revenue growth (%)			7.2	6.1
Nominal expenditure growth (%)			5.8	6.9
<b>Revenue surprise compared to target (% of GDP)</b>				<b>-1.3</b>
<i>Of which</i> <sup>1</sup> : 1. Base effect				-0.7
2. GDP growth effect on the denominator				-0.2
3. Revenue growth effect				-0.4
<i>Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1</i> <sup>2</sup>				-0.6
<b>Expenditure surprise compared to target (% of GDP)</b>				<b>-0.6</b>
<i>Of which</i> <sup>1</sup> : 1. Base effect				-0.8
2. GDP growth effect on the denominator				-0.2
3. Expenditure growth effect				0.4
<b>Government balance surprise compared to target (% of GDP)</b>				<b>-0.7</b>
<i>Of which:</i> 1. Base effect				0.1
2. GDP growth effect on the denominator				0.0
3. Revenue / expenditure growth effect				-0.8
<u>Notes:</u>				
<sup>1</sup> A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive denominator effect indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.				
<sup>2</sup> Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.				
<u>Source:</u>				
Commission services				

## 4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

### 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.

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. Instead, its budgetary objectives are defined in terms of two domestic fiscal rules, which target different fiscal aggregates than the cyclically-adjusted deficit. The 'golden rule' states that over the economic cycle the public sector<sup>34</sup> should borrow only to invest (the UK's definition of

<sup>34</sup> The definition of 'public sector' includes general government and public corporations.



net investment refers to gross capital formation net of depreciation and including capital grants), while 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>35</sup> As a consequence, a range of paths for the structural deficit are consistent with the UK framework. 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').

**Table 3: Evolution of budgetary targets in successive programmes**

		2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
General government balance <sup>1</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-2.6</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.6</b>
	<i>CP Dec 2006</i>	-2.8	-2.3	-1.9	-1.7	-1.6	-1.4	<i>n.a.</i>
	COM Nov 2007	-2.6	-3.0	-3.0	-2.7	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
General government expenditure <sup>2</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>41.2</b>	<b>41.5</b>	<b>41.6</b>	<b>41.3</b>	<b>41.2</b>	<b>41.0</b>	<b>40.9</b>
	<i>CP Dec 2006</i>	42.0	42.1	42.0	41.8	41.6	41.4	<i>n.a.</i>
	COM Nov 2007	43.6	43.9	44.1	43.8	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
General government revenue <sup>1,2</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>38.5</b>	<b>38.5</b>	<b>38.7</b>	<b>38.9</b>	<b>39.1</b>	<b>39.2</b>	<b>39.4</b>
	<i>CP Dec 2006</i>	39.3	39.8	40.0	40.0	40.0	40.0	-
	COM Nov 2007	41.0	40.9	41.1	41.2	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
Structural balance <sup>3</sup> (% of GDP)	<b>CP Nov 2007</b>	<b>-2.5</b>	<b>-3.0</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.6</b>	<b>-1.5</b>
	<i>CP Dec 2006</i>	-2.5	-2.1	-1.7	-1.5	-1.4	-1.3	-
	COM Nov 2007	-2.5	-2.9	-2.8	-2.4	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
Real GDP <sup>4</sup> (% change)	<b>CP Nov 2007</b>	<b>3.0</b>	<b>3.0</b>	<b>2.0</b>	<b>2¼</b>	<b>2½</b>	<b>2½</b>	<b>2½</b>
	<i>CP Dec 2006</i>	2¾	2¾	2½	2½	2½	2½	<i>n.a.</i>
	COM Nov 2007	3.0	3.0	2.0	2.5	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>

Note:

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

<sup>2</sup>Data for general 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 ESA95 harmonised definitions of total revenues and expenditure. For 2011/12 and 2012/13, general government revenue and expenditure figures are extrapolated from public sector projections.

<sup>3</sup>Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are zero according to both the most recent programme and the Commission services' autumn forecast.

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

Source:

*Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)*

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 established taking into account 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.

With the domestic fiscal framework acting as an anchor to the government's fiscal targets, the UK authorities aim at having a small current budget deficit (current revenues less current expenditure including capital depreciation) in 2008/09 followed by a small but increasing current budget surplus between 2009/10 and 2012/13, while maintaining net investment at 2.2% of GDP or slightly higher. As shown in Table 3, this translates

<sup>35</sup> Compared with the 2006 update of the Convergence Programme, the UK authorities have revised their estimate of the cyclical position of the economy, so that the past economic cycle is now thought to have ended in the final quarter of 2006 rather than in early 2007 as previously estimated.

into a modest improvement in the deficit ratio of 1.4 percentage points during the next five years, to a deficit of 1.6% of GDP in 2012/13.

**Table 4: Composition of the budgetary adjustment**

(% of GDP)	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	Change: 2012/13- 2007/08
<b>Revenue<sup>1</sup></b>	<b>38.5</b>	<b>38.5</b>	<b>38.7</b>	<b>38.9</b>	<b>39.1</b>	<b>39.2</b>	<b>39.4</b>	<b>0.9</b>
<i>of which:</i>								
- Taxes on production and imports	12.8	12.8	12.9	12.8	12.8	n.a.	n.a.	-
- Current taxes on income, wealth, etc.	17.0	16.9	17.1	17.3	17.5	n.a.	n.a.	-
- Social contributions	8.5	8.5	8.5	8.6	8.6	n.a.	n.a.	-
<b>Expenditure<sup>1</sup></b>	<b>41.2</b>	<b>41.5</b>	<b>41.6</b>	<b>41.3</b>	<b>41.2</b>	<b>41.0</b>	<b>40.9</b>	<b>-0.6</b>
<i>of which:</i>								
- Primary expenditure	39.1	39.3	39.6	39.2	39.1	38.9	38.8	<b>-0.5</b>
<i>of which:</i>								
Compensation of employees and intermediate consumption	22.9	23.0	23.0	22.8	22.8	n.a.	n.a.	-
Social payments	12.9	12.8	12.8	12.6	n.a.	n.a.	n.a.	-
Subsidies	0.7	0.7	0.7	0.7	0.6	n.a.	n.a.	-
Gross fixed capital formation	1.8	1.9	2.1	2.1	2.1	n.a.	n.a.	-
- Interest expenditure	2.1	2.2	2.0	2.1	2.1	2.1	2.1	<b>-0.1</b>
<b>General government balance (GGB)</b>	<b>-2.6</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.6</b>	<b>1.4</b>
<b>Primary balance<sup>2</sup></b>	<b>-0.5</b>	<b>-0.8</b>	<b>-0.9</b>	<b>-0.3</b>	<b>0.0</b>	<b>0.3</b>	<b>0.5</b>	<b>1.3</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	<b>0.0</b>
<b>GGB excl. one-offs<sup>3</sup></b>	<b>-2.6</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.6</b>	<b>1.4</b>
Output gap <sup>4</sup>	-0.1	0.0	-0.5	-0.3	-0.4	-0.3	-0.3	<b>-0.3</b>
Cyclically-adjusted balance <sup>4</sup>	-2.5	-3.0	-2.7	-2.3	-1.9	-1.6	-1.5	<b>1.5</b>
<b>Structural balance<sup>5</sup></b>	<b>-2.5</b>	<b>-3.0</b>	<b>-2.7</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.6</b>	<b>-1.5</b>	<b>1.5</b>
<i>Change in structural balance</i>		<i>-0.5</i>	<i>0.3</i>	<i>0.4</i>	<i>0.4</i>	<i>0.3</i>	<i>0.1</i>	
Structural primary balance <sup>5</sup>	-0.4	-0.8	-0.7	-0.2	0.2	0.5	0.6	<b>1.4</b>
<i>Change in structural primary balance</i>		<i>-0.4</i>	<i>0.1</i>	<i>0.5</i>	<i>0.4</i>	<i>0.3</i>	<i>0.1</i>	
<b>Notes:</b>								
<sup>1</sup> Data for total revenues and expenditure are not presented by the UK on a harmonised ESA95 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 ESA95 definitions. Revenues are adjusted for the treatment of UMTS receipts. On a ESA95 basis, in 2006/07 revenue and expenditure were equivalent to 41.0% of GDP and 43.6% of GDP respectively.								
<sup>2</sup> The UK authorities provide primary balances on an ESA definition (i.e. excluding gross rather than net interest payments) only up to 2010-11. 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>3</sup> One-off and other temporary measures.								
<sup>4</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.								
<sup>5</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<i>Source:</i> Convergence programme; Commission services' calculations								

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

According to the latest update, in 2008/09 a small increase in the revenue-to-GDP ratio will be largely offset by an increase in expenditure, leaving the nominal deficit 0.1 p.p. less than in the previous year. The structural deficit in 2008/09, as re-calculated by the Commission services on the basis of the information in the programme according to the commonly agreed methodology, is estimated to improve by about 0.3 percentage points, underscoring the extent to which adverse economic conditions are expected to contribute to the weak budgetary position. However, as shown in Table 4, the increase in expenditure in 2008/09 is mitigated by a drop in interest payments by 0.2% of GDP, in part as a result of the redemption of government debt carrying a high coupon rate. As a result, the primary balance is expected to increase by 0.1% of GDP and the fiscal

consolidation effort, as measured by the change in the structural primary balance, is expected to be weak.

Subsequently, the programme forecasts a reduction in the nominal deficit by  $\frac{1}{2}$  p.p. of GDP in 2009/10 and by an average of  $\frac{1}{4}$  p.p. per annum during the following three financial years. The projected path for the cyclically-adjusted budget deficit to 2009/10 leaves very little room for fiscal policy to deal with a protracted slowdown in economic activity. With interest payments remaining constant as a percent of GDP, the primary balance is expected to improve from a deficit of 0.9% of GDP in 2008/09 to a surplus of 0.5% in 2012/13. The fiscal stance is expected to be only mildly restrictive between 2009/10 and 2012/13, with a structural improvement averaging around 0.3 percentage points each year. 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 2012/13.

Compared with the previous programme, the new update projects a significantly worse budgetary position throughout the programme period (Table 3). The deterioration in the budgetary projection for 2008/09, by 1.0 p.p. of GDP when compared to the previous update, is due to the combined effects of the base effect from the upward revision in the 2007/08 deficit and the downward revision to growth, particularly as a result of weaker prospects for the financial sector. In addition, the new update backloads the adjustment planned for 2008/09 in the 2006 update of the convergence programme to 2009/10, against a less favourable macroeconomic scenario in 2008/09.

Table 4 shows that over the programme period an increase in the revenue-to-GDP ratio and a drop in the expenditure ratio from 2009/10 onwards are expected to contribute to around three-fifths and two-fifths of the nominal adjustment, respectively. The revenue adjustment is evenly spread through the programme period, with the fiscal drag on personal income taxation and a combination of discretionary measures, including the reforms to the capital gains tax and the tax rule changes for non-domiciled residents, contributing to the increase in the ratio of direct taxation to GDP. The ratio of indirect taxation is expected to remain broadly stable throughout the programme period, as the increase in revenue from higher fuel duties and indirect taxation on air transport, are offset by the assumption of increased tax avoidance.<sup>36</sup>

On the expenditure side, the spending envelope set out in the 2007 Comprehensive Spending Review (CSR) implies an average increase in total expenditure of 2.1% per year in real terms between 2008/09 and 2010/11, down from an annual average of 4.0% in the preceding 10 years. Notwithstanding, a projected slowdown in nominal expenditure growth from 6.1% in 2007/08 to 4.9% in 2008/09, slower nominal GDP growth is expected to contribute to an increase in total expenditure by 0.1% of GDP in 2008/09, primarily on account of a step increase in gross fixed capital formation to 2.1% GDP.<sup>37</sup> With nominal GDP growth forecast to recover from 2009/10 onwards, the

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<sup>36</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, which is directly accountable to Parliament.

<sup>37</sup> The update of the convergence programme provides a projection for gross fixed capital formation (GFCF) up to 2010/11, but projects net investment (a non-ESA concept, including GFCF and capital grants net of depreciation) throughout the programme period.

expenditure tightening envisaged in the CSR should feed through into a drop in the expenditure ratio by 0.3 p.p. in 2009/10 and 0.1 p.p. in 2010/11, primarily due to lower spending on compensation of employees and intermediate consumption. The spending projections for 2011/12 and 2012/13, which are not backed by detailed spending plans, assume that total expenditure during this period will increase by an annual average of 2½% in real terms.

**Box 6 : The 2007 Budget and the 2007 Pre-Budget Report**

The 2007 Budget was published on the 21 March 2007, while the 2007 Pre-Budget Report (PBR), a more consultative document, was presented on the 9 October 2007. In the PBR, the government publishes updated macroeconomic and fiscal forecasts that form the basis of the 2007 update of the convergence programme. The 2007 Budget introduced important reforms in both personal and corporate taxation as from April 2008. These, however, are expected to have a neutral effect on the budgetary profile. In particular, increased revenues from the removal of the 10% starting rate of tax on employment income and the reduction in allowances for investment will largely finance reductions in the basic rate of personal income tax and in the main corporate tax rate.

The policy decisions announced in 2007 Pre-Budget Report are expected to have a neutral effect on the budget deficit 2008/09, but imply discretionary tightening equivalent to 0.1% of GDP as from 2009/10. In 2008/09, the loss in revenues as a result of changes in inheritance tax regulations should be largely compensated for by the introduction of a single capital gains tax rate of 18%, whereas in 2009/10 changes to the tax regime for non-domiciled UK residents will come into force.

On the expenditure side, the Budget 2007 set out an overall spending envelope for the 2007 Comprehensive Spending Review (CSR) period (i.e. 2008/09-2010/11), which allowed an average increase of 2% per year in real terms. When the 2007 CSR was published with the PBR on October 2007, the government announced an increase in projected investment expenditure in 2010/11, which raise the annual average real spending growth over the CSR period to 2.1%.

### Main measures in the 2007 Budget and the 2007 PBR

Revenue measures*	Expenditure measures**
<b>2008/09</b>	
<ul style="list-style-type: none"> <li>• Abolition of employment income tax starting rate (0.5% of GDP)</li> <li>• Reduction in basic income tax rate (-0.5% of GDP)</li> <li>• Reduced investment allowances (0.1% of GDP)</li> <li>• Reduction in main corporate tax rate (-0.1% of GDP)</li> <li>• Inheritance tax regulations (-0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Expenditure settlements for government departments</li> </ul>
<b>2009/10</b>	
<ul style="list-style-type: none"> <li>• Tax for non-domiciled UK residents (0.1% of GDP)</li> <li>• Capital gains tax reform (0.1% of GDP)</li> </ul>	
<small>* Estimated impact on general government revenues.  ** Estimated impact on general government expenditure.  Sources: Commission services, 2007 Budget, 2007 Pre-Budget Report and 2007 Comprehensive Spending Review.</small>	

### 4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009/10, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

As the table shows, when compared to the updated convergence programme, the Commission services' autumn 2007 forecast projects a similar budgetary position for 2007/08, but with slightly slower consolidation in the following two years, with a forecast deficit in 2009/10 that exceeds that in the programme by 0.3 percentage points. In structural terms, the consolidation envisaged in the Commission services' forecast in 2008/09 is 0.2 p.p. weaker than that in the update, in part due to the projection of a smoother path for interest expenditure, mirroring the persistent increase in government debt. In 2009/10 the Commission services forecast slower growth in revenue and a smaller drop in expenditure, in part as a result of a more negative output gap contributing to a smaller drop in social payments.

**Table 5: Comparison of budgetary developments and projections**

(% of GDP)	2006/07	2007/08		2008/09		2009/10		2010/11	2011/12	2012/13
	COM	COM	CP	COM	CP	COM <sup>1</sup>	CP	CP	CP	CP
<b>Revenue<sup>2</sup></b>	<b>41.0</b>	<b>40.9</b>	<b>38.5</b>	<b>41.1</b>	<b>38.7</b>	<b>41.2</b>	<b>38.9</b>	<b>39.1</b>	<b>39.2</b>	<b>39.4</b>
<i>of which:</i>										
- Taxes on production and imports	12.6	12.6	12.8	12.7	12.9	12.7	12.8	12.8	n.a.	n.a.
- Current taxes on income, wealth, etc.	16.6	16.6	16.9	16.8	17.1	17.0	17.3	17.5	n.a.	n.a.
- Social contributions	8.3	8.3	8.5	8.3	8.5	8.4	8.6	8.6	n.a.	n.a.
- Other (residual)	3.4	3.4	0.3	3.3	0.2	3.1	0.2	0.2	n.a.	n.a.
<b>Expenditure<sup>2</sup></b>	<b>43.6</b>	<b>43.9</b>	<b>41.5</b>	<b>44.1</b>	<b>41.6</b>	<b>43.8</b>	<b>41.3</b>	<b>41.2</b>	<b>41.0</b>	<b>40.9</b>
<i>of which:</i>										
- Primary expenditure	41.5	41.7	39.3	42.0	39.6	41.7	39.2	39.1	38.9	38.8
<i>of which:</i>										
Compensation of employees and intermediate consumption	22.5	22.6	23.0	22.7	23.0	22.5	22.8	22.8	n.a.	n.a.
Social payments	12.6	12.6	12.8	12.7	12.8	12.6	12.6	n.a.	n.a.	n.a.
Subsidies	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.6	n.a.	n.a.
Gross fixed capital formation	1.8	2.0	1.9	2.1	2.1	2.1	2.1	2.1	n.a.	n.a.
Other (residual)	4.0	3.9	n.a.	3.8	n.a.	3.8	n.a.	n.a.	n.a.	n.a.
- Interest expenditure	2.1	2.2	2.2	2.1	2.0	2.1	2.1	2.1	2.1	2.1
<b>General government balance (GGB)</b>	<b>-2.6</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.7</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.6</b>
<b>Primary balance<sup>3</sup></b>	<b>-0.5</b>	<b>-1.0</b>	<b>-0.8</b>	<b>-1.0</b>	<b>-0.9</b>	<b>-0.7</b>	<b>-0.3</b>	<b>0.0</b>	<b>0.3</b>	<b>0.5</b>
One-off and other temporary measures	0.0	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>-2.6</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-3.0</b>	<b>-2.9</b>	<b>-2.7</b>	<b>-2.4</b>	<b>-2.1</b>	<b>-1.8</b>	<b>-1.6</b>
Output gap <sup>4</sup>	-0.3	-0.1	0.0	-0.4	-0.5	-0.6	-0.3	-0.4	-0.3	-0.3
Cyclically-adjusted balance <sup>4</sup>	-2.5	-2.9	-3.0	-2.8	-2.7	-2.4	-2.3	-1.9	-1.6	-1.5
<b>Structural balance<sup>5</sup></b>	<b>-2.5</b>	<b>-2.9</b>	<b>-3.0</b>	<b>-2.8</b>	<b>-2.7</b>	<b>-2.4</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.6</b>	<b>-1.5</b>
<i>Change in structural balance</i>		<i>-0.4</i>	<i>-0.5</i>	<i>0.1</i>	<i>0.3</i>	<i>0.4</i>	<i>0.4</i>	<i>0.4</i>	<i>0.3</i>	<i>0.1</i>
Structural primary balance <sup>5</sup>	-0.4	-0.7	-0.8	-0.7	-0.7	-0.3	-0.2	0.2	0.5	0.6
<i>Change in structural primary balance</i>		<i>-0.3</i>	<i>-0.4</i>	<i>0.0</i>	<i>0.1</i>	<i>0.4</i>	<i>0.5</i>	<i>0.4</i>	<i>0.3</i>	<i>0.1</i>

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 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 relevant ESA95 definitions. Revenues are adjusted for the treatment of UMTS receipts. Moreover, the UK total revenue and expenditure 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 attributed to the update of the convergence programme for 2011/12 and 2012/13 are based on the assumption that general government total expenditure and revenues grow in line with the equivalent public sector projections in Table 4.2 of the convergence programme.

<sup>3</sup>The UK authorities provide primary balances on an ESA definition (i.e. excluding gross rather than net interest payments) only up to 2010/11. 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>4</sup>Output gap (in % of Potential GDP and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

<sup>5</sup>Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures

Source:  
Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

However, developments subsequent to the autumn forecast point to significant risks of a weaker than expected outturn in public finances. A deficit overrun in 2007/08, especially if largely representing a lower medium-term elasticity as a result of the downturn in financial sector activity, would feed through into a higher deficit in 2008/09. In 2009/10, the convergence programme's assumption that the UK economy will swiftly recover to potential growth is optimistic and also implies a risk that the deficit will be higher than projected in the update.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2008/09-2009/10 period; (ii) trend output based

on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the reference scenario), indicate that, by 2009/2010, the cyclically-adjusted balance could be 0.4 percentage points of GDP above the reference scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.4 percentage point of GDP would be necessary to keep the public finances on the path projected in the central scenario in the short run.

Table 6 below shows the differences in the tax projections in the Commission services' autumn forecast and those in the convergence programme. The split of the difference into an elasticity and composition component presented in the table needs to be interpreted with caution due to data gaps that do not allow a full analysis of the tax forecast in the convergence programme. Overall, the table suggests that the tax revenue projections in the convergence programme embody plausible assumptions about the tax intensity. For 2008/09, the Commission services' autumn forecast factored in a larger drop in the elasticity of personal income tax receipts with respect to compensation of employees, which would be consistent with a significant slowdown in bonus earnings by financial sector employees. On the other hand, in 2009/10, the convergence programme appears to be somewhat cautious in its assumption of a drop in the indirect taxes to GDP ratio, primarily because the increase in indirect taxes in the programme seems on the low side when compared to its projection of nominal growth in consumption expenditure.

**Table 6: Assessment of tax projections**

	2008/09			2009/10			2010/11
	CP	COM	OECD <sup>3</sup>	CP	COM <sup>1</sup>	OECD <sup>3</sup>	CP
Change in tax-to-GDP ratio (total taxes)	0.3	0.2	0.2	0.2	0.3	0.2	0.2
Difference (CP – COM)	0.1		/	-0.1		/	/
<i>of which</i> <sup>2</sup> :							
- discretionary and elasticity component	0.1		/	-0.1		/	/
- composition component	-0.1		/	0.0		/	/
Difference (COM - OECD)	/	0.1		/	0.0		/
<i>of which</i> <sup>2</sup> :							
- discretionary and elasticity component	/	-0.1		/	-0.1		/
- composition component	/	0.5		/	0.3		/
p.m.: Elasticity to GDP	1.2	1.2	1.1	1.1	1.1	1.1	1.1
<b>Notes:</b>							
<sup>1</sup> On a no-policy change basis.							
<sup>2</sup> 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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.							
<sup>3</sup> OECD ex-ante elasticity relative to GDP.							
<b>Source:</b>							
<i>Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).</i>							

A drop in the expenditure ratio accounts for a third of the forecast reduction in the deficit ratio during the three years to 2010/11 and two-fifths of the consolidation effort throughout the entire programme period. As a result, the consolidation effort depends to a significant extent on future government expenditure outturns not exceeding the total spending envelopes announced in the 2007 Comprehensive Spending Review. Table 7 shows that during the past six years total expenditure outturns exceeded the original

ceilings that had been established in previous Spending Reviews. Total expenditure outturns deviated from the original ceilings by an annual average of 1.7%. In addition, as explained in section 2, the sharp slowdown in expenditure growth that is targeted in the latest CSR implies considerable efficiency challenges for the public sector, which suggests a heightened risk of spending overruns relative to previous years. Past trends show that typically expenditure overruns are smaller in the first year of the spending review period, suggesting that the risks from higher than planned expenditure are relatively smaller for the update's deficit forecast for 2008/09 but higher for 2010/11. The programme's projections for 2011/12 and 2012/13, which are not backed by detailed discretionary spending plans, assume continued moderation in real expenditure growth and a further drop in the expenditure-to-GDP ratio.

**Table 7: Experience of expenditure envelopes**

(in £ billion)	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
<b>Total expenditure</b>						
Original envelope	415.4	439.6	481.5	511.4	549.3	580.0
Revised envelope		454.6		520.8		
Outcome	419.1	454.3	491.0	523.4	550.1	589.2
<i>Deviation (outcome minus ceiling; %)</i>	0.9	3.3	2.0	2.3	0.1	1.6
<i>Deviation (outcome minus revised ceiling; %)</i>		-0.1		0.5		
<b>Departmental expenditure limits</b>						
Original envelope	229.3	245.7	279.8	301.0	321.4	340.5
Revised envelope		263.5		301.9		
Outcome	240.6	266.0	282.5	302.9	320.4	344.6
<i>Deviation (outcome minus original ceiling; %)</i>	4.9	8.3	1.0	0.6	-0.3	1.2
<i>Deviation (outcome minus revised ceiling; %)</i>		0.9		0.3		
<i>Source:</i>						
<i>Successive convergence programmes</i>						

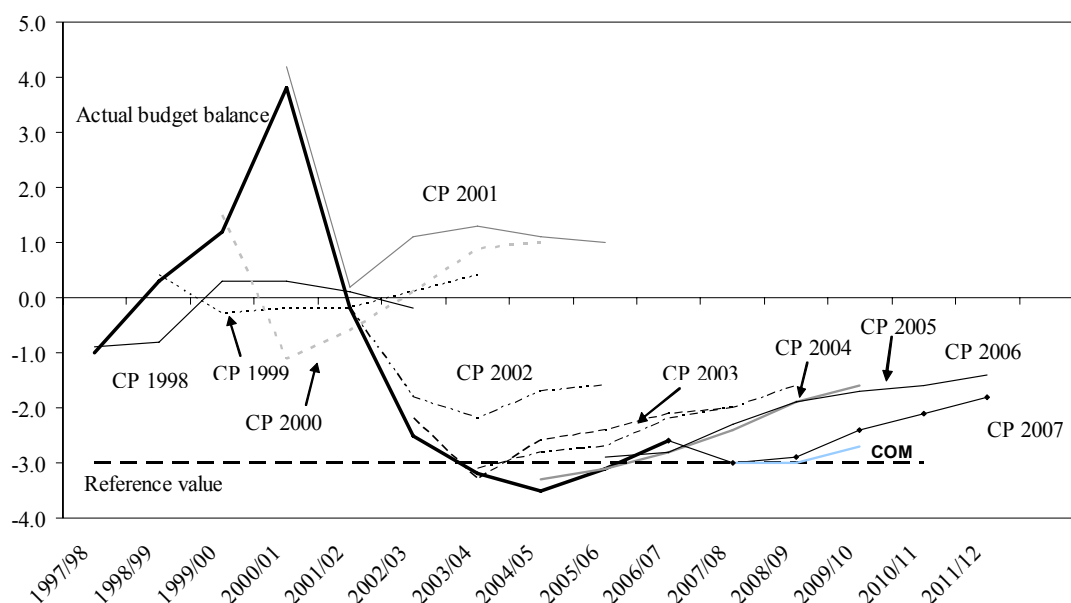
Another potential source of negative risk to the projections presented in the update arises from the government's assumption of substantial financial sector contingent liabilities in recent months. According to national accounts rules, contingent liabilities, including taxpayer guarantees on bank deposits, are recorded off-balance sheet, as long as they are not called. In total, the liquidity provided by the Bank of England to Northern Rock Bank and the deposits and other liabilities at Northern Rock guaranteed by government amounted in December 2007 to around 3½% of GDP, with the sum guaranteed continuing to augment. At this stage, while it is not possible to impute any exact impact on general government accounts from this source of risk for 2007/08 and beyond, the possibility that there will ultimately be some negative impact cannot be excluded. The update's projections are also subject to some negative risks due to possible changes in the accounting treatment of Public Private Partnerships (PPP), especially as from 2008/09 when the annual government accounts will start being prepared using International Financial Reporting Standards. At present, the total capital value of signed projects that are currently treated as off balance sheet are estimated at around 2.0% of GDP and tentative estimates suggest that changes in the accounting of PPPs could raise the annual general government deficit by up to ¼ percentage points of GDP.

Figure 8 compares the UK's budgetary projections in successive convergence programmes with the actual deficit outturns. The UK has a mixed track record in achieving its budgetary projections, with the deficit outturn significantly exceeding the one-year ahead forecast on three occasions during the past six years. Since 2001/02, on



average, the budgetary outturn was 0.3 percentage points worse than had been forecast in the previous convergence programme.

**Figure 8: Government balance projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes*

An overall assessment of the balance of risks indicates that the budgetary outcomes could be worse than targeted in the convergence programme throughout the entire programme period. The fragile macroeconomic context and the uncertainties concerning the government's ability to meet its spending plans pose a threat to the modest nominal adjustment path envisaged by the update.

#### **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 and, second, the final assessment also taking into account risks.

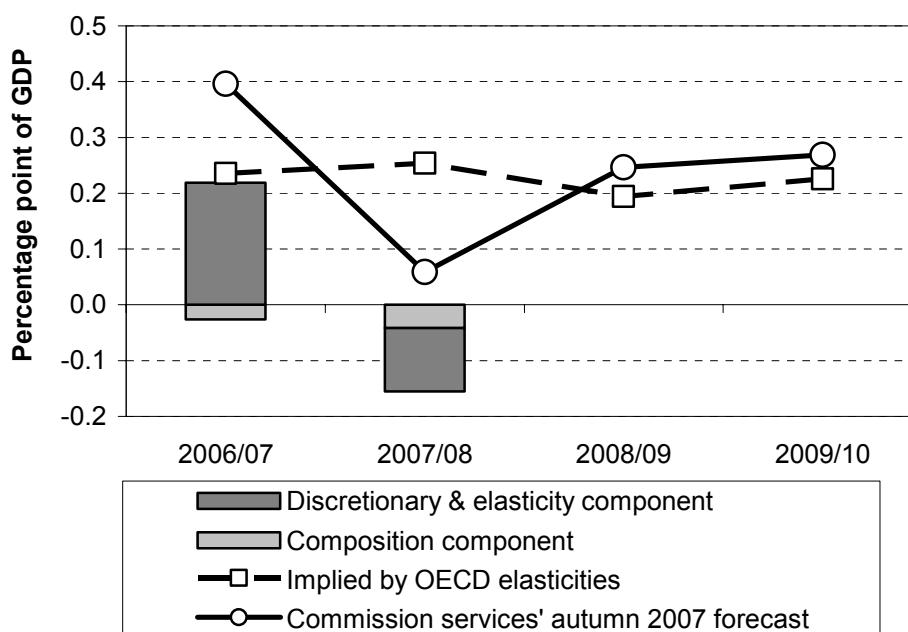
**Table 8: Overview of compliance with the Stability and Growth Pact**

	<b>Based on programme<sup>3</sup> (with the targets taken at face value)</b>	<b>Assessment (taking into account risks to the targets)</b>
a. Safety margin against breaching 3% of GDP deficit limit <sup>1</sup>	only in 2012/13	no
b. Achievement of the MTO	No MTO defined (only domestic fiscal rules)	Cannot be assessed
c. Adjustment towards MTO in line with the Pact <sup>2</sup> ?	(In the absence of an MTO, judged in relation only to annual improvements in the structural balance) is insufficient and should be strengthened significantly	(In the absence of an MTO, judged in relation only to annual improvements in the structural balance) is insufficient and should be strengthened significantly
<p><u>Notes:</u></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 the information in the programme.</p> <p><u>Source:</u> <i>Commission services</i></p>		

The programme confirms a significant deterioration in the United Kingdom's budgetary position. The Commission services' assessment highlights the substantial risk of a breaching of the 3% reference value in the near term. The negative risks to the achievement of the programme's budgetary projections primarily stem from the possibility that macroeconomic prospects will be weaker than projected, the significant efficiency gains in public services that will be required for the government to achieve its medium-term spending plans, and the financial sector contingent liabilities that have been recently assumed by the UK authorities.

The fiscal tightening envisaged in the programme from 2008/09 is driven by a progressive increase in the tax burden, and a sharp reduction in previously rapid growth in current expenditure. Figure 9 compares the changes in the tax ratios implied by Commission services' autumn 2007 forecast, which is underpinned by elasticities that are similar to those applied in the programme, with that implied by the OECD elasticity estimates. The comparison shows that the expected development in the tax burden is very much consistent with what the ex-ante elasticities would imply, underlining the absence of a significant effort to accelerate the pace of consolidation through new taxes or higher tax rates.

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



Note:

The solid line displays the change in the tax ratio in the Commission services' 2007 autumn forecast (for 2009, on a no-policy-change basis). The dashed 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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

Source:

*Commission services*

Since the programme does not provide for a quantitative MTO, its achievement throughout the programme period cannot be assessed. However, the projected speed of consolidation is itself unambitious and should be strengthened; in structural terms averaging only around 0.3 percentage points each year between 2009/10 and 2012/13. According to the programme the estimated minimum benchmark projected will be reached only in 2012/13. The Commission's assessment, taking into account the risks to the projections, is that the minimum benchmark is unlikely to be achieved by that year.

## 5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes 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

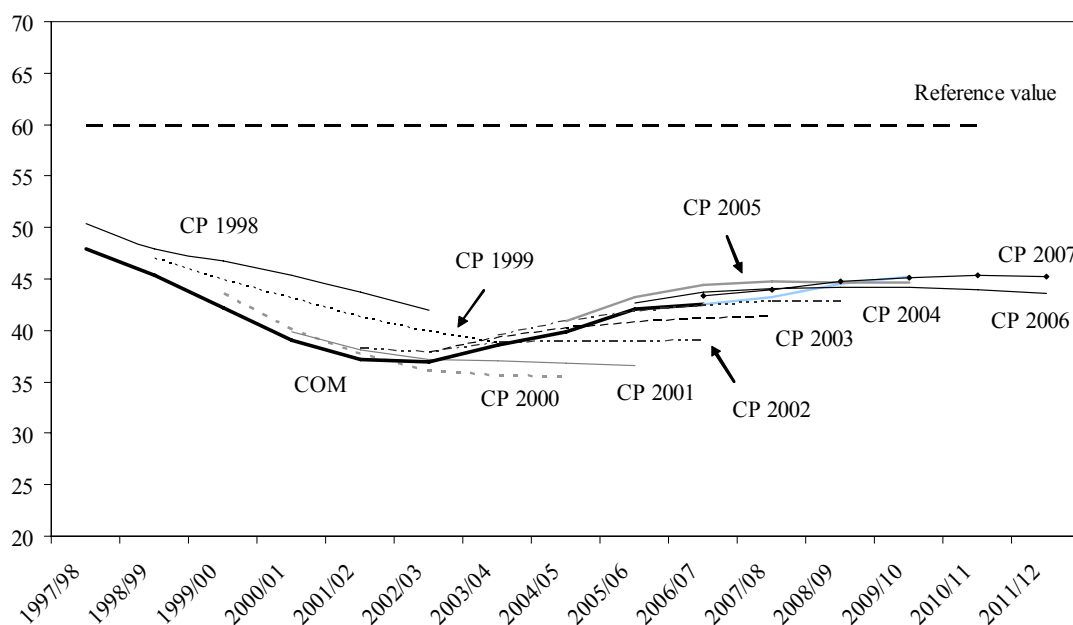
The UK government gross debt ratio is set to remain well under the reference value of 60% of GDP, even if projected to be on a rising trend, as shown in Table 9.

The authorities' latest estimate for the current financial year 2007/08 is for general government gross debt to reach 43.9% of GDP, a small downward revision from the forecast outcome of 41.1% of GDP set out in the 2006 update. Thereafter, the debt ratio is projected to rise to 45.3% of GDP by 2010/11, and then to decline slightly to 45.2% in 2011/12 and 44.9% in 2012/13, largely driven by the deficits on the primary balance. Stock-flow adjustments are relatively small.

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 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 37.6% of GDP in 2007/08 to 38.9% of GDP in 2010/11, and then decline slightly to 38.6% in 2012/13.

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 programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM) and successive convergence programmes*

**Table 9: Debt dynamics**

(% of GDP)	average 2002-05	2006/07	2007/08		2008/09		2009/10		2010/11	2011/12	2012/13
			COM	CP	COM	CP	COM	CP	CP	CP	CP
<b>Gross debt ratio</b> <sup>1,3</sup>	39.2	42.6	43.3	43.9	44.5	44.8	45.2	45.1	45.3	45.2	44.9
Change in the ratio	1.2	0.9	0.7	0.5	1.2	0.9	0.6	0.3	0.2	0.1	-0.4
<i>Contributions</i> <sup>2</sup> :											
<b>Primary balance</b>	1.1	0.5	1.0	0.8	0.9	0.8	0.7	0.3	0.0	-0.2	-0.3
<b>"Snow-ball" effect</b>	0.1	-0.2	-0.4	-0.4	0.3	0.1	-0.1	-0.2	-0.1	-0.1	-0.2
<i>Of which:</i>											
Interest expenditure	2.0	2.1	2.0	2.2	2.0	2.1	2.0	2.1	2.1	2.0	1.9
Growth effect	-1.2	-1.2	-1.2	-1.2	-0.8	-0.8	-1.1	-1.2	-1.1	-1.0	-1.0
Inflation effect	-0.7	-1.1	-1.3	-1.3	-0.9	-1.2	-1.0	-1.2	-1.2	-1.1	-1.1
<b>Stock-flow adjustment</b>	0.1	0.6	0.1	0.0	0.0	0.0	0.0	0.2	0.3	0.4	0.4

Notes:

<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  $t$  is a time subscript;  $D$ ,  $PD$ ,  $Y$  and  $SF$  are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and  $i$  and  $y$  represent the average cost of debt and nominal GDP growth (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.

<sup>3</sup>The Government Gross debt ratio in the Convergence Programme is derived using GDP *excluding* the FISIM adjustment (Financial Intermediation Services not Directly Measured). This raises the debt ratio by around 0.8% of GDP when compared to the Commission services' autumn 2007 forecast. For this reason, the debt 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. At present, the concept of FISIM has not been fully implemented in the UK National Accounts, but the UK Office of National Statistics plans to amend the National Accounts to reflect changes to the treatment of FISIM at Blue Book 2008. However, for the purpose of deriving aggregate fiscal policy measures - mainly for the Excessive Deficit Procedure - the UK submit to Eurostat an estimate of FISIM.

*Source:**Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*

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 4.<sup>38</sup> Table 9 above shows that the pattern of primary deficits is the main driver of the rising debt ratio up to 2010/11.

### 5.1.2. Assessment

The gross debt projections in the 2007 update of the convergence programme are broadly in line with the Commission services' autumn forecast, although the Commission for each year projects the increase in the debt ratio to be higher, mainly due to differences in the primary deficit profiles.

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.

<sup>38</sup> 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.

However, outcomes could be worse than targeted, reflecting the assessment of the balance of risks to the deficit, with a particular risk attached to the recent assumption of large-scale financial sector contingent liabilities. Further risks relates to the future accounting treatment of Private Finance Initiative (PFI) projects.<sup>39</sup>

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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

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

Table 10 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 and property income received by general government according to an agreed methodology.<sup>40</sup> Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

**Table 10: Long-term age-related expenditure: main projections**

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2004-50
<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
Property income received	0.7	0.7	0.6	0.6	0.5	0.5	-0.2

*Source: Economic Policy Committee and Commission services*

The projected increase in age-related spending in the UK is somewhat higher than the average of the EU, rising by 4.0 p.p. 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 p.p. of GDP.<sup>41</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.<sup>42</sup> The increase in health-care expenditure is projected to be 1.9 p.p. of GDP, above the average in the EU. For long-term care, the projected increase of 0.8 p.p. up to 2050, slightly above the average in the EU.

<sup>39</sup> According to the convergence programme the annual accounts of government departments and other public sector bodies would be prepared using International Financial Reporting Standards (IFRS), adapted as necessary for the public sector, from 2008-09. According to the data released by the HM Treasury in October 2007, approximately 600 Private Finance Initiative (PFI) projects have been signed, with a total capital value of £56.9 billion (4.0% of GDP in 2007/08), of which around £30 billion (around 2% of GDP in 2007/08) are currently treated as off-balance-sheet. At this stage the implications of the changes to the accounting regime are unclear, but switching some of the current PFI projects that today are off-balance-sheet onto the government's books will increase the reported debt levels.

<sup>40</sup> See the accompanying "methodological paper" for a description of the property income projections.

<sup>41</sup> These projections do not take into account the recent pension reform (see below Section Additional factors).

<sup>42</sup> The long-term projections do not include the most recent reform (enacted in 2007), see also 'additional factors'.

**Table 11: Sustainability indicators and the required primary balance**

	2007 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	3.3	4.8	3.9	1.7	3.4	3.8
<i>of which:</i>						
Initial budgetary position (IBP)	1.5	1.6	-	0.0	0.1	-
Debt requirement in 2050 (DR)	-0.2	-	-	-0.3	-	-
Long-term change in the primary balance (LTC)	2.0	3.2	-	2.0	3.2	-

*Source: Commission services*

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 11 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 4.8% of GDP.<sup>43</sup> Compared with the results of the 2006/07 round of SCP assessment, the sustainability gap is higher in the present assessment by around ½ p.p. of GDP. This is mainly due to a lower estimated structural primary balance in 2007/08 (-0.8 % of GDP) compared with the structural primary balance in 2006/07 (-0.3 % of GDP).

The initial budgetary position is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing.

According to both sustainability gaps, the long-term budgetary impact of ageing is close to the average of the EU. The programme plans a structural primary budgetary consolidation of 1.4 p.p. of GDP between 2007/08 and 2012/13. If achieved, such a consolidation would appreciably reduce risks to the long-term sustainability of public finances by reducing the S2 sustainability gap to 3.4% of GDP in the programme scenario. The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the convergence programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is close to 4% of GDP, significantly higher than the structural primary balance of about 0.6% of GDP in the last year of the programme's period.

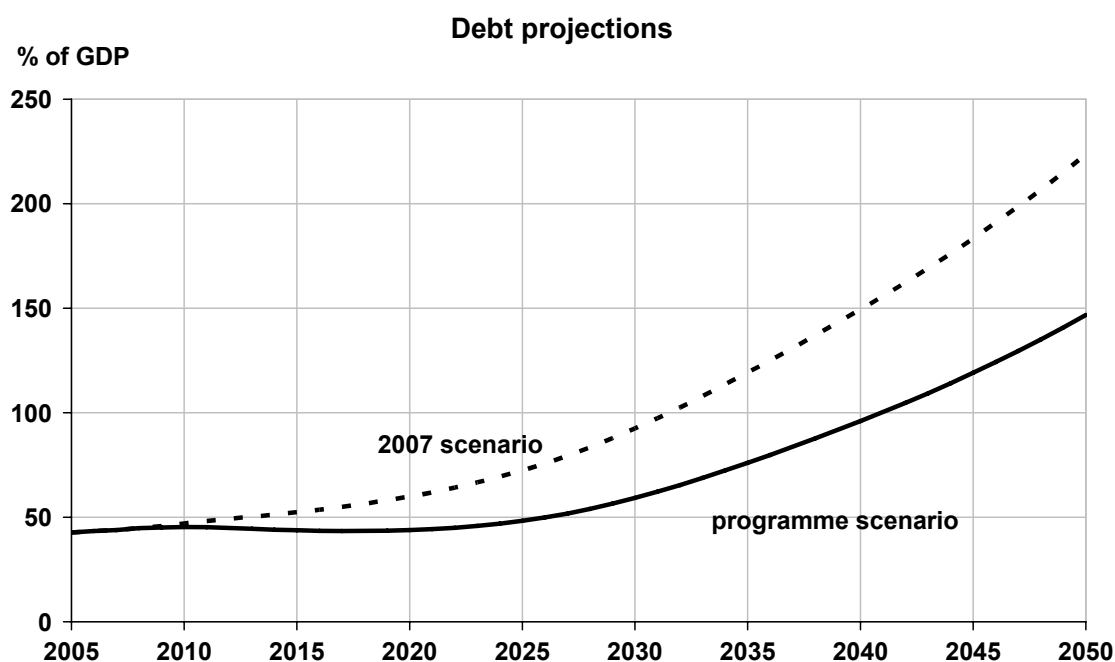
The sustainability gap indicators would increase by up to ½ % of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

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 the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 11. The gross debt ratio is currently

<sup>43</sup> The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 3.3% of GDP.

below the 60% of GDP reference value, estimated in the programme at close to 44% of GDP in the financial year 2007/08. According to the “2007 scenario”, the debt ratio is projected to increase throughout the projection period up to 2050, breaching the Treaty reference threshold by 2020. 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 by 2030.<sup>44</sup>

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



*Source: Commission services*

### 5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, following the conclusions of the Pensions Commission<sup>45</sup> and the first White Paper on Pension<sup>46</sup>, the Parliament has enacted (Pension Act, July 2007) the following measures:

<sup>44</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>45</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>46</sup> "Security in retirement: towards a new pensions system", Department for Work and Pensions and HM Treasury, May 2006



- (1) 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;
- (2) a gradual increase in the state pension age, by one year every decade starting from 2024;
- (3) 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>47</sup>

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>48</sup> The reform addresses the concerns of potentially inadequate pension provision in the future as it should (i) partly compensate for the decrease in the public benefit ratio projected in the Ageing Report (by about 20% between 2004 and 2050) and (ii) improve the coverage of private pensions.

Second, the 2007/08 convergence programme refers<sup>49</sup> to two additional trends over the next 50 years which, according to the UK authorities, would reduce the sustainability risks:

- a decrease in non-age related expenditure by more than half a point of GDP, notably due to the indexation to prices of non-pension transfers, which is assumed to be maintained over the long run;
- a significant increase in tax revenue of around 2 p.p. of GDP. As mentioned in the assessment of last year UK convergence programme, it is not possible to assess this change in particular given the lack of projections on the evolution of private pensions and the related contributions.<sup>50</sup>

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<sup>47</sup> In December 2006, the government published a second White Paper, which proposed that all eligible employees would be automatically enrolled into either a Personal Account or an employer-sponsored scheme, with a minimum contribution of 8% of salary. Employees would contribute to a minimum of 4%, matched by a minimum 3% employer contribution and around 1% in the form of normal tax relief from the State. Further legislation setting out a framework for Personal Accounts is to be enacted in a second pension Bill announced by the Government on July 2007 as part of its draft legislative programme.

<sup>48</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>49</sup> The 2007 update of the UK convergence programme provide no long-term budgetary projections but refers to the projections of the 2006 update of the '*Long-term public finances report*'.

<sup>50</sup> 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 2006 update of the convergence programme, the estimation is carried out assuming that the average income of older people will evolve in line with productivity and therefore that the total benefit ratio (including public and private

### 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 other EU countries do. The 2007 reform, while addressing the concern of potentially inadequate provision of pensions in the future, is likely to involve a somewhat higher increase in age-related expenditure.

The initial budgetary position, which has deteriorated compared to 2006/07, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Achieving high primary surpluses 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.

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

Improving public sector performance so as to ensure value for money and release resources for key priorities has been high on the UK's agenda for several years. As discussed in section 2, with the even weaker current fiscal position meeting the challenge of curbing the growth in expenditure and further enhancing the efficiency and effectiveness of public spending has become more important.

The UK multi-annual budgetary framework (including the spending reviews) together with the Public Service Agreements (PSAs) and the 2004 Efficiency Programme (The Gershon Review) are important elements that have underpinned the UK's effort to enhance public sector performance, including by allowing departments to plan their spending over a longer time horizon. Naturally, the Comprehensive Spending Review framework is also expected to contribute to controlling public expenditures. However, although the UK authorities describe departments' budgets to be "firm and fixed", the CSR overall spending envelope are not "set in stone". As illustrated in section 4, spending plans set out in previous spending reviews have in several cases been revised upwards, and in some cases substantially.

The 2007 Comprehensive Spending Review – announced together with the 2007 Pre Budget Report in October 2007 – sets departmental spending plans and priorities for the years 2008/09, 2009/10 and 2010/11. It has been developed through a number of analytical studies and reviews aimed at identifying expenditure priorities and has been planned on zero-baseline basis, that is considering the appropriateness of overall

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pensions) would remain stable. 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.

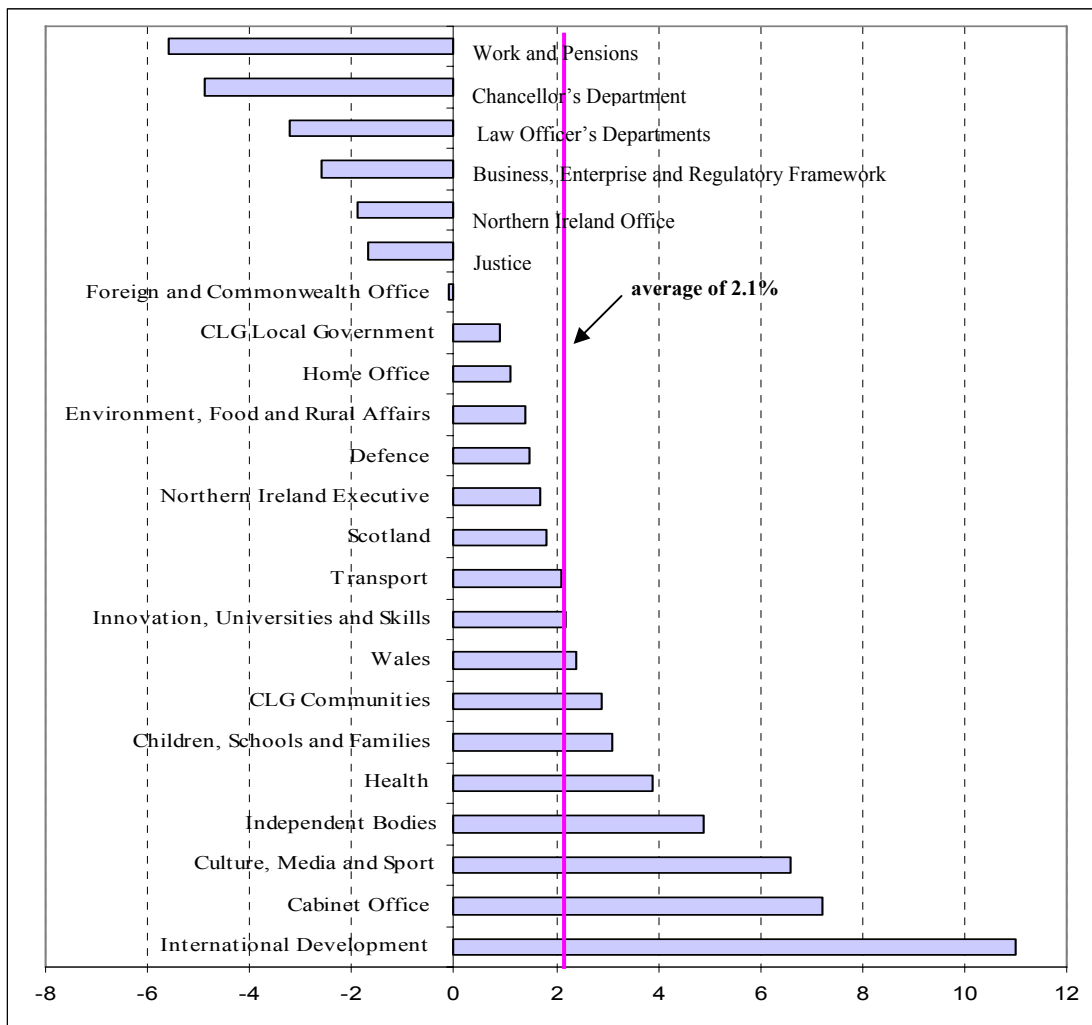
expenditure allocations to departments and not only requested changes relative to their baseline allocations.

The 2007 CSR is challenging as spending plans over the CSR period are tight in comparison with previous spending reviews with public expenditures expected to fall from 2009/2010 and taxes to rise as shares of national income. Total public spending is expected to increase by an average of 2.1% per year in real terms in the 2007 CSR period against an average of 4.0% for the spending reviews covering the period from April 1999 to March 2008.<sup>51</sup> The 2007 CSR seems to confirm the UK's continued effort to change the composition of public spending by further increasing the level of public sector net investment (from 2.1% of GDP in 2007/08 to 2¼ % of GDP by the end of the CSR period) and refocusing resources towards key long-term priorities such as education and health, although in the light of the overall lower spending envelope, at a much slower pace than seen in recent years ( Figure 12 and section 2).

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<sup>51</sup> The Institute for Fiscal Studies (2007): The 2007 Comprehensive Spending Review: A Challenging Spending Review? IFS Briefing Note No. 75.

**Figure 12: Departmental Expenditure Limits in the 2007 Comprehensive Spending Review, average annual real growth over the CSR period**



Source: 2007 Comprehensive Spending Review, HM Treasury

To support the departmental spending plans and enable the release of resources for priority areas, the UK government has also within the context of the 2007 CSR introduced a range of initiatives to further enhance the efficiency and effectiveness of public spending, including a value for money programme and a performance management framework.

Building on the 2004 efficiency programme approach, the new *value for money programme* aims at: 1) at least 3% efficiency savings per year over the CSR period across central and local government, releasing £30 billion by 2010/11<sup>52</sup> 2) 5% annual reductions in administration budgets across departments, releasing over £1,2 billion by 2010/11 and 3) the release of £30 billion from fixed asset disposals between 2004-5 and 2010-11. It should be noted that 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.

<sup>52</sup> In comparison the 2004 efficiency programme set a target of achieving annual efficiency gains of around £21bn by 2007/08.

The new efficiency programme demonstrates the authorities intentions to keep up the momentum of the UK's focus on value for money issues in the public sector, including by setting a more ambitious efficiency savings target and introducing a new monitoring and reporting framework. Enhanced commitment and ownership of departments as well as expected greater cooperation across organisations, common requirements for departments' reporting on progress and improved management of the public sector asset base should all contribute to increase the rate of success of the new programme, but as highlighted in section 2, it is still not clear to what extent the efficiency programmes will indeed be able to release resources for key priorities by improving efficiency and not just represent pure cost-savings, which will entail lower quantity output. Furthermore, the targets are intrinsically hard to evaluate. As regards the 2004 efficiency programme, the National Audit Office (NAO) noted in February 2007 that some good progress in addressing measurement issues and reaching the target has been made, although some projects have found it hard to demonstrate that quality of services has been maintained.<sup>53</sup>

The *new performance management framework* announced alongside the 2007 CSR introduces a set of 30 new cross-departmental Public Sector Agreements setting the government's priority outcomes for the 2007 CSR period. The PSAs describe the basket of national, outcome focused performance indicators that will be used to measure progress and each PSA is underpinned by a single Delivery Agreement shared across all contributing departments. Nationally set targets have been reserved for a small subset of PSA indicators. The new framework should contribute to greater flexibility for local communities in the provision of public services. New Cabinet committees have been established with the purpose of regularly monitoring progress and holding departments and programmes to account. The PSAs will also be complemented by a Service Transformation Agreement that should strengthen the cross-departmental commitment through a number of initiatives, including the rationalisation of government websites and improved management of information across government.

Overall, the UK government's actions taken to improve the quality of public spending is a systematic approach to enhance public sector efficiency. However, it is too early to judge whether the measures introduced in the 2007 CSR will actually lead to a real improvement in the efficiency and effectiveness of public spending, also compared to the 2004 efficiency programme. For the initiatives to ultimately become a success the challenge will be to ensure that the efficiency gains take the form of long term improvements and not just one-off savings. It will therefore be essential for the UK to meet both spending and efficiency targets set out in the CSR 2007 as well as to continue the work on output and quality measurement. Finally, the UK should strengthen the focus on creating the right incentive structure for public service providers that reinforces the "value for money" approach in all aspects of their business, not just those covered by efficiency projects.

On the revenue side, the past six 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.<sup>54</sup> These have added to concerns, especially in

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<sup>53</sup> National Audit Office (2007): *The Efficiency Programme: A Second Review of Progress*.

<sup>54</sup> For further information see the Commission services' technical assessment of the UK convergence programme 2005 and 2006.

the business community, at the increased complexity of the UK tax system.<sup>55</sup> The Budget 2007 announced a reform package to the business tax system, including a reduction in the main rate of corporation tax from 30 per cent to 28 percent. Since the previous convergence programme, the UK government has also continued the efforts to counter tax avoidance. Also as part of the 2007 Pre-Budget Report The government announced a proposed single rate of 18 per cent of the capital gains tax and announced the start of a programme of tax simplification, including three reviews<sup>56</sup>, in which the government in collaboration with business will evaluate how a range of tax policies could be simplified. As many of the proposals are in their preliminary stages it is too early to assess whether the actions foreseen on the revenue side will actually improve the quality of public finances and eventually lead to a simplification of the UK tax system.

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

The September 2007 implementation report on the UK National Reform Programme focuses on maintaining macroeconomic stability and ensuring long-term sustainability; raising productivity growth; providing employment opportunities for all; ensuring world-class public services; and addressing environmental challenges. The National Reform Programme presents a broad-based and relatively detailed strategy to reach this objective.

The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the implementation report of the National Reform Programme (see section 5.2 on sustainability and pensions reform; section 6 on quality of public finances and the Comprehensive Spending Review). The Implementation Report does not highlight the need for ensuring fiscal consolidation, but makes a reference to the convergence programme. It focuses mainly on the quality of public finances, pension reform and housing supply.

Both programmes integrate the 2007 Comprehensive Spending Review, including the gradual implementation of the government's objectives to increase efficiency and value for money in public service provision. The convergence programme provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme. The direct budgetary implications of important reform elements highlighted in the implementation report of the national reform programme, including the increase in the value and coverage of the state-pension as well as recent initiatives taken to increase housing supply, promote R&D and innovation and raise the skill levels in the workforce, have been taken into account in the budgetary projections of the convergence programme. However, the convergence programme does not contain a qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy, although it states explicitly that the convergence programme in the areas of sustainability of public finances and investment in public

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<sup>55</sup> CBI/MORI Survey (2006): UK Corporate Taxation and International Competitiveness; Ernst&Young (2007): Helping Britain Thrive.

<sup>56</sup> The reviews will cover the following three elements: 1) How to simplify VAT rules and administration in the UK and the EU 2) How anti-avoidance legislation can best meet the aims of simplicity and revenue protection 3) How to simplify the Corporation Tax (CT) rules for related companies.

services is consistent with the National Reform Programme and the 2007 implementation report.

Overall, the two programmes appears to be consistent.

**Box 7: The Commission assessment of the September 2007 implementation report of the national reform programme**

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the September 2007 implementation report of the United Kingdom's national reform programme<sup>57</sup> and is summarised as follows:

The United Kingdom's national reform programme identifies as key challenges/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 is that the UK has made significant progress in implementing its National Reform Programme over 2005-2007. Against the background of strengths and weaknesses identified, the Commission recommends that the United Kingdom is recommended to take action in the areas of skills and employment opportunities for the most disadvantaged. Against the background of progress made, the Commission recommends that the United Kingdom is encouraged to also focus on the areas of: housing supply and R&D and innovation.

The tables below provide an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations / points to watch, adopted by the Council in March 2007.

The budgetary strategy in the convergence programme is broadly consistent with the country-specific recommendation.

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<sup>57</sup> Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

**Table 12: Consistency with the broad economic policy guidelines (integrated guidelines)**

Broad economic policy guidelines (integrated 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>				

**Table 13: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)**

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
<b>1. Country-specific recommendations</b>				
– None				X
<b>2. Points to watch</b>				
– Ensure that the current proposals on pension reform are effectively implemented.	X			
<p><u>Source:</u> Commission services</p>				



## **Annex 1: Compliance with the code of conduct**

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

### **(i) Model structure**

The model structure of the programme as set out in Annex 1 of the code of conduct has been broadly followed. However, institutional features are highlighted in a subsection rather than a separate section.

### **(ii) Data requirements**

The programme does not adhere to the code of conduct in terms of compliance with data requirements. The programme has substantial gaps both in the provision of compulsory data and in optional data. The following compulsory sets of data have not been provided:

Government consumption and investment deflator in Table 1b (Price developments) have not been provided. 2006 levels of GDP deflator, export and import deflators are also not provided. Table 1c (Labour market developments) is entirely missing. Gaps exist for the capital account in Table 1d (Sectoral balances). The detailed breakdown of General Government budgetary prospects (Table 2) does not provide data for the tax burden and some of the selected components of expenditure. The representation of expenditure items by function has not been provided (Table 3: General Government expenditure by function). The General Government debt developments table (Table 4) has data gaps for stock-flow adjustment sub-components and financial debt. No data is provided on the long term sustainability of public finances (Table 7) and lack of data on basic assumptions (Table 8).

As for the optional data, the HICP inflation level for 2006 in Table 1b is not provided. There are some gaps for the later forecast years with respect to the statistical discrepancy in the sectoral balance (Table 1d) and the detailed breakdown of revenues (Table 2).

The complete lack of compulsory labour market data is particularly serious since the absence of such data greatly complicates the task of calculating the potential output in the programme using the commonly agreed methodology.

The detailed breakdown of expenditure and revenues does not follow the aggregation methods of ESA95. 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 harmonised basis compliant with the Eurostat decision.<sup>58</sup>

The tables on the following pages show the data presented in the November 2007 update of the UK convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

### **(iii) Other information requirements**

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

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<sup>58</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.

The CP...	Yes	No	Comments
<i>a. Involvement of parliament</i>			
... mentions status vis-à-vis national parliament.	X		However, the programme itself is not formally presented to Parliament.
... indicates whether Council opinion on previous programme has been presented to national parliament.		X	However, such Opinions (for all Member States) are regularly presented and subject to formal Parliamentary scrutiny (see also Box 1).
<i>b. Economic outlook</i>			
... (for euro area and ERM II Member States) uses “common external assumptions” on main extra-EU variables.			Not applicable
... explains significant divergences with Commission services’ forecasts <sup>1</sup> .		X	No significant differences to be explained. However, oil price assumptions are significantly lower than the Commission’s.
... bears out possible upside/downside risks to economic outlook.	X		
... analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.		X	
<i>c. Monetary/exchange rate policy</i>			
... (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		No explicit exchange rate forecast presented
<i>d. Budgetary strategy</i>			
... presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.		X	No quantitative MTO is defined
... (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
... (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
... backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
... specifies state of implementation of measures.	X		
<i>e. “Major structural reforms”</i>			
... (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible ‘major structural reforms’ over time.			Not applicable (no major structural reform undertaken)
... includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable (no major structural reform undertaken)
<i>f. Sensitivity analysis</i>			
... includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.		X	Public finances are only stress-tested against a scenario of trend growth one percentage point lower than in the central case.

<b>The CP...</b>	<b>Yes</b>	<b>No</b>	<b>Comments</b>
... (in case of “major structural reforms”) analyses how changes in assumptions would affect budget and potential growth.			Not applicable (see above)
<i>g. Broad economic policy guidelines</i>			
... provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
<i>h. Quality of public finances</i>			
... describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
<i>i. Long-term sustainability</i>			
... outlines strategies to ensure sustainability.	X		
... includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).		X	No updated information provided
<i>j. Other information (optional)</i>			
... includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		
<p><u>Notes:</u> SCP = stability/convergence programme; CP = convergence programme  <sup>1</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>  Commission services</p>			

Table 1a. Macroeconomic prospects (central scenario\*)

	ESA Code	2006	2006	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	<i>n.a.</i>	2¾	3	2 - 2½	2½ - 3	2½ - 3	<i>n.a.</i>	<i>n.a.</i>
<b>2. Nominal GDP</b>	B1*g	1302	5½	6½	5 - 5½	5¼ - 5¾	5¼ - 5¾	<i>n.a.</i>	<i>n.a.</i>
<b>Components of real GDP</b>									
<b>3. Private consumption expenditure</b>	P.3	<i>n.a.</i>	2	3	1¾ - 2¼	2¼ - 2¾	2¼ - 2¾	<i>n.a.</i>	<i>n.a.</i>
<b>4. Government consumption expenditure</b>	P.3	<i>n.a.</i>	2	2½	2½	2	2	<i>n.a.</i>	<i>n.a.</i>
<b>5. Gross fixed capital formation</b>	P.51	<i>n.a.</i>	8¼	5¼	3¼ - 3¾	3¼ - 3¾	3¼ - 3¾	<i>n.a.</i>	<i>n.a.</i>
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	<i>n.a.</i>	-¼	0	-¼ - 0	0 - ¼	0	<i>n.a.</i>	<i>n.a.</i>
<b>7. Exports of goods and services</b>	P.6	<i>n.a.</i>	7	3¼	4½ - 5	4¾ - 5¼	4¾ - 5¼	<i>n.a.</i>	<i>n.a.</i>
<b>8. Imports of goods and services</b>	P.7	<i>n.a.</i>	6¾	3¾	3¾ - 4¼	4 - 4½	4 - 4½	<i>n.a.</i>	<i>n.a.</i>
<b>Contributions to real GDP growth</b>									
<b>9. Final domestic demand</b>		-	3¼	3 - 3½	2¼ - 2½	2¼ - 2¾	2½ - 2¾	<i>n.a.</i>	<i>n.a.</i>
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	-¼	0	0	0	0	<i>n.a.</i>	<i>n.a.</i>
<b>11. External balance of goods and services</b>	B.11	-	-¼	-¼	0	0	0	<i>n.a.</i>	<i>n.a.</i>

\*The programme presents two macroeconomic scenarios: a fully-fledged central scenario and a "cautious" scenario, which is based on trend growth one quarter of percentage point lower than in the central scenario. All public finances projections in the programme are based on the cautious scenario, which is therefore considered here the reference scenario.

Table 1b. Price developments (central scenario)

	ESA Code	2006	2006	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>		<i>n.a.</i>	2½	3¼	2¾	2¾	2¾	2¾	2¾
<b>2. Private consumption deflator</b>		106¾	2½	2½	2¾	2¾	2¾	<i>n.a.</i>	<i>n.a.</i>
<b>3. HICP<sup>12</sup></b>		<i>n.a.</i>	2½	2¼	2	2	2	2	2
<b>4. Public consumption deflator</b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>5. Investment deflator</b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>6. Export price deflator (goods and services)</b>		<i>n.a.</i>	2½	1½	½	1¼	2	<i>n.a.</i>	<i>n.a.</i>
<b>7. Import price deflator (goods and services)</b>		<i>n.a.</i>	2½	0	½	1½	2¼	<i>n.a.</i>	<i>n.a.</i>

<sup>1</sup> Optional for stability programmes.

<sup>2</sup> On a financial-year basis (2006 refers to the 2006/07 financial year).

**Table 1c. Labour market developments**

	ESA Code	2006	2006	2007	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons<sup>1</sup></b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
2. Employment, hours worked <sup>2</sup>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>3. Unemployment rate (%)<sup>3</sup></b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>4. Labour productivity, persons<sup>4</sup></b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
5. Labour productivity, hours worked <sup>5</sup>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>6. Compensation of employees</b>	D.1	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<b>7. Compensation per employee</b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	optional	optional	optional	optional	optional

<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 (central scenario)**

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011	2012
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
<i>of which :</i>								
- Balance on goods and services		-3¼	-3¼	-3	-3	-3	<i>n.a.</i>	<i>n.a.</i>
- Balance of primary incomes and transfers		½	½	¼	¼	¼	<i>n.a.</i>	<i>n.a.</i>
- Capital account		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>
2. Net lending/borrowing of the private sector	B.9	-¾	¼	-¼	-½	-¾	<i>n.a.</i>	<i>n.a.</i>
3. Net lending/borrowing of general government <sup>1</sup>	EDP B.9	-2.6	-2.9	-2.8	-2.4	-2.1	-1.8	-1.6
<b>4. Statistical discrepancy</b>		<i>n.a.</i>	optional	optional	optional	optional	optional	optional

<sup>1</sup> On a financial-year basis. Number reported in 2006 refers to the 2006/07 financial year.

Table 2. General government budgetary prospects

	ESA Code	2006/07	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>									
1. General government	S.13	-34.2	-2.6	-2.9	-2.8	-2.4	-2.1	-1.8	-1.6
2. Central government	S.1311	-32.5	-2.5	-2.7	-2.5	-2.1	-1.8	n.a.	n.a.
3. State government	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	-1.7	-0.1	-0.2	-0.2	-0.3	-0.3	n.a.	n.a.
5. Social security funds	S.1314	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>General government (S13)</b>									
6. Total revenue	TR	510.4	38.6	38.6	38.8	39.0	39.2	n.a.	n.a.
7. Total expenditure	TE <sup>1</sup>	544.5	41.2	41.5	41.6	41.3	41.2	n.a.	n.a.
8. Net lending/borrowing	EDP B.9	-34.2	-2.6	-2.9	-2.8	-2.4	-2.1	-1.8	-1.6
9. Interest expenditure	EDP D.41	28.1	2.1	2.2	2.0	2.1	2.1	n.a.	n.a.
10. Primary balance <sup>2</sup>		n.a.	-0.4	-0.8	-0.8	-0.3	0.0	n.a.	n.a.
11. One-off and other temporary measures <sup>3</sup>		0	0.0	0.0	0.0	0.0	0.0	n.a.	n.a.
<b>Selected components of revenue</b>									
12. Total taxes (12=12a+12b+12c)		398	30.1	30.0	30.2	30.4	30.5	n.a.	n.a.
12a. Taxes on production and imports	D.2	169.9	12.8	12.8	12.9	12.8	12.8	optional	optional
12b. Current taxes on income, wealth, etc	D.5	224.5	17.0	16.9	17.1	17.3	17.5	optional	optional
12c. Capital taxes	D.91	3.6	0.3	0.3	0.2	0.2	0.2	optional	optional
13. Social contributions	D.61	90.9	6.9	6.8	6.9	7.0	7.0	optional	optional
14. Property income	D.4	n.a.	n.a.	n.a.	n.a.	optional	optional	optional	optional
15. Other <sup>4</sup>		n.a.	n.a.	n.a.	n.a.	optional	optional	optional	optional
16=6. Total revenue	TR	510.4	38.6	38.6	38.8	39.0	39.2	n.a.	n.a.
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) <sup>5</sup>			n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Selected components of expenditure</b>									
17. Compensation of employees + intermediate consumption	D.1+P.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
17a. Compensation of employees	D.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
17b. Intermediate consumption	P.2	-	-	-	-	-	-	-	-
18. Social payments (18=18a+18b)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
18b. Social transfers other than in kind	D.62	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
19=9. Interest expenditure	EDP D.41	28.1	2.1	2.2	2.0	2.1	2.1	n.a.	n.a.
20. Subsidies	D.3	8.7	0.7	0.7	0.7	0.7	0.6	n.a.	n.a.
21. Gross fixed capital formation	P.51	23.7	1.8	1.9	2.1	2.1	2.1	n.a.	n.a.
22. Other <sup>6</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
23=7. Total expenditure	TE <sup>1</sup>	544.5	41.2	43.0	46.2	48.4	50.8	n.a.	n.a.
p.m.: Government consumption (nominal)	P.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

<sup>1</sup>Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

<sup>2</sup>The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

<sup>3</sup>A plus sign means deficit-reducing one-off measures.

<sup>4</sup>P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

<sup>5</sup>Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

<sup>6</sup>D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

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

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE <sup>1</sup>	n.a.	n.a.

<sup>1</sup>Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 4. General government debt developments**

% of GDP	ESA Code	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<b>1. Gross debt<sup>1</sup></b>		43.4	43.9	44.8	45.1	45.3	45.2	44.9
<b>2. Change in gross debt ratio</b>		0.9	0.4	0.9	0.3	0.2	-0.1	-0.2
<b>Contributions to changes in gross debt</b>								
<b>3. Primary balance<sup>2</sup></b>		-0.4	-0.8	-0.8	-0.3	0.0	n.a.	n.a.
<b>4. Interest expenditure<sup>3</sup></b>	EDP D.41	2.1	2.2	2.0	2.1	2.1	n.a.	n.a.
<b>5. Stock-flow adjustment</b>		0.7	0.0	0.1	0.3	0.3	n.a.	n.a.
<i>of which:</i>								
- Differences between cash and accruals <sup>4</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets <sup>5</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>of which:</i>								
- privatisation proceeds		-	-	-	-	-	-	-
- Valuation effects and other <sup>6</sup>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>p.m.: Implicit interest rate on debt<sup>7</sup></b>		5.3	5.4	4.8	4.8	4.8	n.a.	n.a.
<b>Other relevant variables</b>								
<b>6. Liquid financial assets<sup>8</sup></b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>7. Net financial debt (7=1-6)</b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

<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 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).

**Table 5. Cyclical developments**

% of GDP	ESA Code	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<b>1. Real GDP growth (%)</b>		3	3	2	2¼	2½	2½	2½
<b>2. Net lending of general government</b>	EDP B.9	-2.6	-2.9	-2.8	-2.4	-2.1	-1.8	-1.6
<b>3. Interest expenditure</b>	EDP D.41	2.1	2.2	2.0	2.1	2.1	n.a.	n.a.
<b>4. One-off and other temporary measures<sup>1</sup></b>		0.0	0.0	0.0	0.0	0.0	n.a.	n.a.
<b>5. Potential GDP growth (%)</b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
contributions:								
- labour		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>6. Output gap</b>		-0.1	0.2	-0.3	0.0	0.0	0.0	-
<b>7. Cyclical budgetary component</b>		0.1	-0.1	0.1	0.1	0.0	n.a.	n.a.
<b>8. Cyclically-adjusted balance (2 - 7)</b>		-2.4	-3.0	-2.7	-2.3	-2.1	-1.8	-1.6
<b>9. Cyclically-adjusted primary balance (8 + 3)</b>		0.3	0.8	0.7	0.2	0.0	n.a.	n.a.
<b>10. Structural balance (8 - 4)</b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

<sup>1</sup>A plus sign means deficit-reducing one-off measures.

**Table 6. Divergence from previous update**

	ESA Code	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
<b>Real GDP growth (%)</b>								
<b>Previous update</b>		2¼	2¼	2½	2½	2½	2½	n.a.
<b>Current update</b>		3	3	2	2¼	2½	2½	2½
<b>Difference</b>		¼	¼	-½	¼	0	0	n.a.
<b>General government net lending (% of GDP)</b>	EDP B.9							
<b>Previous update</b>		-2.7	-2.2	-1.9	-1.7	-1.5	-1.3	n.a.
<b>Current update</b>		-2.6	-2.9	-2.8	-2.4	-2.1	-1.8	-1.6
<b>Difference</b>		0.1	-0.7	-0.9	-0.7	-0.6	-0.5	n.a.
<b>General government gross debt (% of GDP)</b>								
<b>Previous update</b>		43.7	44.1	44.2	44.2	44.0	43.6	n.a.
<b>Current update</b>		43.4	43.9	44.8	45.1	45.3	45.2	44.9
<b>Difference</b>		-0.3	-0.2	0.6	0.9	1.3	1.6	n.a.



**Table 7. Long-term sustainability of public finances**

% of GDP	2000/01	2006/07	2010/11	2020/21	2030/31	2050/51
Total expenditure	n.a.	41.2	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other pensions (disability, survivors)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term care ( <i>this was earlier included in the</i>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	n.a.	38.6	n.a.	n.a.	n.a.	n.a.
Of which: property income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Of which</i> : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Of which</i> : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Assumptions</b>						
Labour productivity growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Real GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate males (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rates females (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total participation rates (aged 20-64)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Population aged 65+ over total population	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

**Table 8. Basic assumptions**

	2006	2007	2008	2009	2010	2011	2012
<b>Short-term interest rate<sup>1</sup> (annual average)</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Long-term interest rate (annual average)</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>USD/€ exchange rate (annual average) (euro area and ERM II countries)</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Nominal effective exchange rate</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>World excluding EU, GDP growth</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>EU GDP growth</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Growth of relevant foreign markets</b>	10	7¼	7¼	7¼	7¼	n.a.	n.a.
<b>World import volumes, excluding EU</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Oil prices (Brent, USD/barrel)</b>	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

<sup>1</sup>If necessary, purely technical assumptions.



## Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of the United Kingdom. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

**Table: Key economic indicators**

	United Kingdom						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
<b>Economic activity</b>												
Real GDP (% change)	2.8	3.2	2.5	1.8	2.8	3.1	2.1	2.7	1.4	1.5	2.8	2.6
<i>Contributions to real GDP growth:</i>												
<i>Domestic demand</i>	3.5	4.0	2.9	1.7	3.1	3.4	2.0	2.7	1.3	1.7	2.6	2.4
<i>Net exports</i>	-0.6	-0.8	-0.5	0.1	-0.2	-0.2	0.1	0.0	0.1	-0.1	0.2	0.2
Real GDP per capita (PPS; EU27 = 100)	119	118	120	120	120	120	113	114	112	110	110	109
Real GDP per capita (% change)	2.5	2.9	2.0	1.2	2.3	2.6	1.6	2.5	0.8	0.9	2.3	2.2
<b>Prices, costs and labour market</b>												
HICP inflation (%)	1.5	1.6	1.5	2.1	2.3	2.4	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	1.7	1.9	1.5	0.9	2.0	2.6	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	0.2	0.2	0.1	1.1	0.3	-1.4	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	1.1	1.3	0.9	0.9	0.8	0.5	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	5.7	6.4	4.9	4.8	5.3	5.3	9.1	9.8	8.5	8.9	8.3	7.3
<b>Competitiveness and external position</b>												
Real effective exchange rate (% change)	3.4	6.0	0.8	0.8	2.5	1.8	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change) <sup>1</sup>	-1.3	-2.5	-0.2	2.1	3.0	0.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.4	-1.1	-1.7	-2.3	-3.1	-2.9	0.8	0.9	0.7	0.3	0.0	0.1
<b>Public finances</b>												
General government balance (% of GDP)	-1.3	-0.4	-2.3	-3.3	-2.7	-2.8	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	42.7	46.3	39.2	42.1	43.2	43.6	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP) <sup>2</sup>	n.a.	n.a.	-3.4	-3.2	-2.8	-2.7	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
<b>Financial indicators</b>												
Short-term real interest rate (%) <sup>3</sup>	2.8	3.8	1.8	2.4	2.2	2.8	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%) <sup>3</sup>	2.8	3.6	2.1	2.1	1.7	1.9	n.a.	n.a.	1.9	1.5	1.9	2.1
<b>Notes:</b>												
<sup>1</sup> Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.												
<sup>2</sup> Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.												
<sup>3</sup> Using GDP deflator.												
<b>Source:</b>												
Commission services												

