COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 23.1.2008
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of the United Kingdom, 2007/08-2012/13

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

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

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission examined the most recent update of the convergence programme of the United Kingdom, submitted on 30 November 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

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

(2) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies;

(3) the Commission's assessment of the September 2007 implementation report of the national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006/07-2011/12, as follows. "The Council considers that the programme seems broadly consistent with a correction of the excessive deficit by the deadline set by the Council (financial year 2006/07). The Council invites the UK to continue consolidation after 2009/10. The achievement of the budgetary targets after 2007/08 is subject to the effective implementation of the projected expenditure restraint". In view of its assessment, the Council invited the United Kingdom to "pursue budgetary consolidation over the programme period, especially by implementing the projected reduction in expenditure growth after 2007/08, and to strengthen further its fiscal position in order to address the risks to long-term sustainability of the public finances". In preparing its programmes, the Council also invited the United Kingdom to improve compliance with the data requirements of the code of conduct.

2.2. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[2]. In the area of budgetary policies, the United Kingdom was encouraged to "ensure that the current proposals on pension reform are effectively implemented".

2.3. 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 United Kingdom's national reform programme[3]. This can be 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 and the evidence on progress made, the Commission recommended that the United Kingdom is recommended to giving 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.

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2 OJ L 92, 3.4.2007, p. 23.

3 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)", COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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

5 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated convergence programme of the United Kingdom, 2007/08-2012/13

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [12 February 2008] the Council examined the updated convergence programme of the United Kingdom, which covers the period from financial year 2007/08 to financial year 2012/13[7].

(2) The United Kingdom 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 and reinforces the need for expenditure restraint if the UK is to achieve an improvement in the fiscal balance. 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

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

7 The UK financial year runs from April to March.

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.

(3) The programme contains two macroeconomic scenarios: a central scenario and an 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 alternative scenario, which takes into consideration the impact of the turmoil in financial markets as of September, 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[8], 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.

(4) 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 should be noted of around ¼% of GDP per annum. 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[9].

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8 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.

9 OJ C 72, 29.3.2007, p. 20.

(5) 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.

(6) 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 a deeper and more prolonged 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 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.

(7) 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.

(8) 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.

(9) 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.

(10) The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines in the area of budgetary policies issued in the context of the Lisbon strategy.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme continues to have substantial gaps in the required and optional data[10], with no evidence of improvement in response to the Council's previous invitation in this regard.

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[10] In particular, the data on projections for employment, unemployment, wage inflation and a detailed breakdown of general government revenue and expenditure on a harmonised ESA 95 basis are not provided.

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.

In view of the above assessment, the United Kingdom is invited to:

(i) implement measures necessary to substantially improve the budgetary position in the near term, especially in 2008/09;

(ii) strengthen the pace of fiscal consolidation throughout the programme period, which would also address the increased risks to the long-term sustainability of the public finances.

The United Kingdom is again invited to improve compliance with the data requirements of the code of conduct.

Comparison of key macroeconomic and budgetary projections

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

Notes:

[1] 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.

[2] On a calendar-year basis. Numbers reported in 2006/07 column refer to the 2006 calendar year.

[3] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[4] Based on estimated potential growth of 2.9%, 2.8%, 2.6% and 2.6% respectively in the period 2006-2009.

[5] Figures for the primary balance in the convergence programmes adjusted to use gross rather than net interest payments.

[6] Cyclically-adjusted balance excluding one-off and other temporary measures. There are no one-off and other temporary measures during the programme period.

[7] Figures in the convergence programmes 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.