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**UNITED KINGDOM: MACRO FISCAL ASSESSMENT**  
**AN ANALYSIS OF THE JANUARY 2010 UPDATE OF THE CONVERGENCE**  
**PROGRAMME**

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 United Kingdom's convergence programme was submitted on 28 January 2010.

The attached technical analysis of the programme prepared by the staff and under the responsibility of the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 17 March 2010. Comments should be sent to Karl Scerri ([Karl.Scerri@ec.europa.eu](mailto:Karl.Scerri@ec.europa.eu)), Thomas Springbett ([Thomas.Springbett@ec.europa.eu](mailto:Thomas.Springbett@ec.europa.eu)), Adriana Reut ([Adriana.Reut@ec.europa.eu](mailto:Adriana.Reut@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 2009 forecast, as well as the updated GDP and HICP inflation forecasts presented in the February 2010 interim 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 10 November 2009) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

Based on this analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 17 March 2010. The ECOFIN Council expected to discuss the opinion on the programmes on 16 April 2010.

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

[http://ec.europa.eu/economy\\_finance/sgp/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/index_en.htm)

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## 1. INTRODUCTION

This document assesses the January 2010 update of the United Kingdom's convergence programme, which was submitted on 28 January 2010 and covers the financial years 2009/10 to 2014/15. The programme builds on the 2009 Pre-Budget Report, which was published on 9 December 2009. The programme was approved by the government and, as part of UK parliamentary scrutiny, was and presented to both Houses of the UK national parliament for a debate and subsequently received parliamentary approval.

This assessment is structured as follows. Section 2 discusses the key challenges for the economy and public finances in the United Kingdom. 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<sup>1</sup>. Section 4 analyses budgetary implementation in the financial year 2009/10<sup>2</sup>, as well as the budgetary plans for 2010/11 and the medium-term budgetary strategy. It also assesses risks attached to the budgetary targets. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses institutional features of public finances. Finally, Section 7 concludes with an overall assessment of the programme. The annex provides a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme.

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<sup>1</sup> This assessment uses the Commission services' 2009 autumn forecast, as published on 3 November 2009, as a benchmark. However, more recent information that has become available has also been taken into account to assess the risks to the programme scenarios, including the updated GDP growth and HICP inflation forecast for 2010 that was published by the Commission on 25 February 2010.

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

**Table 1. Comparison of key macroeconomic and budgetary projections**

		2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
Real GDP (% change)	<b>CP Jan 2010</b>	<b>-1.3</b>	<b>-3.5</b>	<b>2.0</b>	<b>3.3</b>	<b>3.3</b>	<b>3.3</b>	<b>3.3</b>
	COM Nov 2009	0.6	-4.6	0.9	1.9	n.a.	n.a.	n.a.
	CP Dec 2008	-0.3	-0.5	2.0	3.0	3.0	3.0	n.a.
HICP inflation (%)	<b>CP Jan 2010</b>	<b>3.8</b>	<b>2.3</b>	<b>2.0</b>	<b>1.5</b>	<b>1.8</b>	<b>2.0</b>	<b>2.0</b>
	COM Nov 2009	3.6	2.0	1.4	1.6	n.a.	n.a.	n.a.
	CP Dec 2008	3.8	1.0	2.0	2.0	2.0	2.0	n.a.
Output gap <sup>1</sup> (% of potential GDP)	<b>CP Jan 2010</b>	<b>0.0</b>	<b>-4.6</b>	<b>-4.4</b>	<b>-2.8</b>	<b>-1.5</b>	<b>-0.4</b>	<b>0.5</b>
	COM Nov 2009 <sup>2</sup>	0.4	-3.7	-3.5	-2.7	n.a.	n.a.	n.a.
	CP Dec 2008	-0.5	-2.4	-2.1	-1.2	-0.4	0.2	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP) <sup>3</sup>	<b>CP Jan 2010</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>	<b>n.a.</b>
	COM Nov 2009	-1.4	-2.2	-1.4	-0.7	n.a.	n.a.	n.a.
	CP Dec 2008	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
General government revenue (% of GDP)	<b>CP Jan 2010<sup>4</sup></b>	<b>36.6</b>	<b>34.8</b>	<b>35.4</b>	<b>36.7</b>	<b>37.1</b>	<b>37.2</b>	<b>37.1</b>
	COM Nov 2009	41.9	38.4	39.2	39.8	n.a.	n.a.	n.a.
	CP Dec 2008	36.7	35.5	36.6	37.3	37.7	38.0	n.a.
General government expenditure (% of GDP)	<b>CP Jan 2010<sup>4</sup></b>	<b>43.4</b>	<b>47.4</b>	<b>47.4</b>	<b>45.8</b>	<b>44.2</b>	<b>42.7</b>	<b>41.5</b>
	COM Nov 2009	49.0	51.2	51.5	50.3	n.a.	n.a.	n.a.
	CP Dec 2008	42.2	43.7	43.7	42.9	42.1	41.4	n.a.
General government balance (% of GDP)	<b>CP Jan 2010</b>	<b>-6.9</b>	<b>-12.7</b>	<b>-12.1</b>	<b>-9.2</b>	<b>-7.4</b>	<b>-5.6</b>	<b>-4.7</b>
	COM Nov 2009	-6.9	-13.0	-12.5	-10.7	n.a.	n.a.	n.a.
	CP Dec 2008	-5.5	-8.2	-7.1	-5.6	-4.4	-3.4	n.a.
Primary balance (% of GDP)	<b>CP Jan 2010</b>	<b>-4.7</b>	<b>-10.5</b>	<b>-9.1</b>	<b>-5.7</b>	<b>-3.7</b>	<b>-1.8</b>	<b>-0.9</b>
	COM Nov 2009	-4.8	-11.0	-9.6	-7.5	n.a.	n.a.	n.a.
	CP Dec 2008	-3.4	-6.4	-4.5	-2.6	-1.4	-0.3	n.a.
Cyclically-adjusted balance <sup>1</sup> (% of GDP)	<b>CP Jan 2010</b>	<b>-6.9</b>	<b>-10.8</b>	<b>-10.3</b>	<b>-8.0</b>	<b>-6.8</b>	<b>-5.5</b>	<b>-4.9</b>
	COM Nov 2009	-7.1	-11.5	-11.0	-9.6	n.a.	n.a.	n.a.
	CP Dec 2008	-5.3	-7.2	-6.2	-5.1	-4.2	-3.5	n.a.
Structural balance <sup>5</sup> (% of GDP)	<b>CP Jan 2010</b>	<b>-6.2</b>	<b>-10.5</b>	<b>-10.3</b>	<b>-8.0</b>	<b>-6.8</b>	<b>-5.5</b>	<b>-4.9</b>
	COM Nov 2009	-6.3	-11.4	-11.0	-9.6	n.a.	n.a.	n.a.
	CP Dec 2008	-5.3	-7.2	-6.2	-5.1	-4.2	-3.5	n.a.
Government gross debt (% of GDP)	<b>CP Jan 2010</b>	<b>55.5</b>	<b>72.9</b>	<b>82.1</b>	<b>88.0</b>	<b>90.9</b>	<b>91.6</b>	<b>91.2</b>
	COM Nov 2009	55.5	71.7	81.9	89.0	n.a.	n.a.	n.a.
	CP Dec 2008	52.9	60.5	65.1	67.5	68.6	68.5	n.a.

**Notes:**

<sup>1</sup> Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

<sup>2</sup> Based on estimated potential growth of 1.5%, 0.8%, 0.8% and 1.1% respectively in the period 2008-2011.

<sup>3</sup> Data for calendar years.

<sup>4</sup> Data for revenue and expenditure are not provided in the UK programme on a harmonised ESA95 basis for the general government sector. The data in the table are based on Table 2.7 of the *supplementary material* of the 2009 Pre-Budget Report. For the years between 2011/12 and 2014/15, general government revenue and expenditure figures are inferred from projections for the public sector.

<sup>5</sup> Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are estimated at 0.7% of GDP in 2008/09 and 0.3% of GDP in 2009/10 (deficit-increasing) on the basis of information in the most recent programme.

**Source:**  
Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations

## 2. KEY CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

This section describes recent economic and budgetary developments for the United Kingdom, which form the background against which the current programme assessment should be viewed, and outlines the key challenges to be addressed by future economic policies.

Between late 2007 and 2009 the UK suffered the worst economic and financial crisis in its post-war history. The crisis, although global in its scope and foreign in its trigger, was preceded and partly aggravated by a period of strong growth of UK economic output and leverage of most sectors of the economy, notably the household and external sector. In response to the unfolding crisis the UK authorities responded with an aggressive programme of interest rate reductions, support for the financial sector and quantitative easing. As part of the latter, the Government authorised the Bank of England to buy

assets financed by the creation of central bank reserves to add further monetary stimulus after it cut its policy (repo) rate to 0.5% in March 2009. By 11 February 2010, the Bank had purchased £200 billion worth of assets (£198 billion of which were gilts), in line with the planned total.

The government further introduced support measures for the financial sector that included provision of new equity capital for banks, partially insuring banks' losses on some assets and compensating depositors in failed banks and building societies. Furthermore, a fiscal stimulus was implemented, composed chiefly of a temporary cut in the main rate of value added tax (VAT) from 17.5% to 15% which was in place between December 2008 and end 2009 as well as a reallocation of public capital investment from 2010/11 to 2009/10.

The combination of the severity of the recession, its impact on previously tax-rich income and expenditure, the operation of the automatic stabilisers and the discretionary fiscal stimulus resulted in a major deterioration in the fiscal balance. The United Kingdom is currently subject to an excessive deficit procedure. This followed a Council decision of 8 July 2008 confirming the existence of an excessive deficit in the United Kingdom. On 30 November 2009, the Council extended the previously set deadline for correction of the excessive deficit by one year to 2014/15, recognising that the United Kingdom's budgetary position in 2009/10 resulted from the implementation of stimulus measures amounting to around 1½% of GDP, which were an appropriate response to the European Economic Recovery Plan, and the free play of automatic stabilisers. The United Kingdom's fiscal situation is discussed further in Chapter 4 and the EDP in [Box 1].

The United Kingdom experienced a sharp correction in residential and commercial property prices in 2007 and 2008, which depressed construction activity and tax revenues from stamp duty. Prices continued falling for the first four months of 2009 but subsequently recovered somewhat to end 2009 up around 3.5% on the year.<sup>3</sup> After depreciating 27% on a trade-weighted basis between July 2007 and January 2009, Sterling stabilised in 2009, appreciating around 4% over the year.<sup>4</sup> However, the UK's terms of trade have yet to register any significant change in the relative prices of exports and imports from the pre-depreciation levels of mid-2007, as UK exporters appear to have markedly increased their sterling profit margins. Net trade contributed positively to growth in 2008 and 2009 as weak domestic demand depressed imports significantly, compensating falling export volumes caused by weak demand in the UK's main export markets. However, in Q3 and Q4, the contribution from net exports appears to have turned negative, as imports rebounded more sharply than exports, probably linked to a recovery in fixed domestic investment.

The United Kingdom economy therefore faces a number of important challenges. The greatest of these is achieving the urgently required fiscal consolidation fast enough to avoid further compromising sustainability while avoiding cutting off the still very fragile recovery. Similar challenges are present in the consumer sector; consumer spending and borrowing moved along a precarious path in the decade leading to the economic and financial crisis, and as a result the household saving ratio fell to zero by early 2008. Another challenge facing the UK economy is to achieve adequate levels of credit provision from a still fragile financial system, with many credit providers having reduced their lending capacity. A sustained adjustment to households' balance sheets is necessary

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<sup>3</sup> This estimate is an average of the Halifax and Nationwide Building Society indices.

<sup>4</sup> Source: Bank of England data and Commission services calculations.

but could prove problematic for economic growth in the transition as neither Government spending nor fixed investment are likely to act as particularly strong demand drivers of growth. This probably sustained weakness in domestic demand in turn underlines the importance for the economy of a rebalancing of production towards greater production of tradable output so as to permanently improve its external balance.

### 3. MACROECONOMIC OUTLOOK

Against the background of the current macroeconomic situation and the main policy challenges set out in the previous section, this section makes an assessment of the plausibility of the macroeconomic scenario underpinning the public finance projections of the programme.

The programme presents two sets of economic forecast figures: a fully-fledged central scenario in calendar years and a scenario underpinning the public finances projections, which is on a financial year basis and which assumes trend growth<sup>5</sup> one quarter of a percentage point lower than in the central scenario. The latter scenario is considered the reference scenario for the purpose of the assessment at hand. 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.

After a record annual contraction of 4¾% in 2009, the programme projects growth in 2010 and 2011 of 1% and 3¾% respectively. This compares to projections in the Commission services' autumn 2009 forecast of 0.9% and 1.9%, which its February 2010 interim forecast revised down slightly to an annual growth rate of 0.6% in 2010, due mainly to a weaker-than-expected final quarter of 2009. The UK programme's strong growth in 2011 is assumed to result from the absorption of spare capacity, with the demand coming from strong growth in fixed capital formation, household consumption and net exports, partially offset by falling government expenditure. In current economic conditions, any forecast is subject to significant uncertainty, but the balance of risks to these projections, particularly for 2011, appears to be on the downside, in view of the following considerations.

On the demand side, private consumption is unlikely to exert a significant pull on GDP growth during the recovery phase, as the labour market is expected to stagnate and nominal earnings growth slows. The United Kingdom's 2009 Pre-Budget Report forecasts the savings ratio to peak at 8% in 2010 before falling back, averaging 7.3% in the three-year period to 2012. Historically, UK recessions have tended to be followed by sharp rebounds in the household saving ratio to around 10% of disposable income, but from a much higher starting point.<sup>6</sup> Disposable income growth will be the principal determinant of the extent to which the household sector can choose to increase the rate of consolidation further (i.e. by raising the saving ratio), to choose to spend additional income, or a mixture of the two. As both the programme and the Commission services' autumn forecast expect no improvement in the labour market in the medium term,

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<sup>5</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, which is used instead of the common methodology agreed between the Member States and the Commission.

<sup>6</sup> In order for the latest saving rate of around 8% (Q3 2009) to be sustained over the forecast horizon, households may have to reduce their aggregate real consumption further downward, as part of the saving rate rise appears to be related to statistical factors not relating to 'core' disposable income and household spending growth, and is not borne out by Q3 2009 flow-of-funds data.

prospects for disposable income growth and thus growth of private consumption expenditure appear limited.

A further downside risk could come from lower business investment due to lower business sector confidence or a lack of improvement in the availability of affordable business finance. Credit conditions surveys by the Bank of England suggest that overall corporate credit availability has stabilised or improved somewhat over 2009, after rapid falls in 2008. Spreads over LIBOR on corporate lending continued to widen over the first three quarters of the year before falling back slightly in Q4. As a result, it appears unlikely that the corporate credit tightening observed during the financial crisis has been reversed to an adequate extent for investment to rebound significantly. The Commission services' autumn forecast projections for gross fixed capital formation are around 2 percentage point lower than the UK programme's for both 2010 and 2011, and reflect an expectation that investment intentions will remain low for the medium term, along with current and prospective capacity utilisation.

Uncertainty is perhaps greatest around the external outlook. Net trade contributed positively to growth in 2008 and 2009, because of a more rapid contraction in imports than exports driven in part by sterling's depreciation. However, this growth contribution appears to have been negative in both Q3 and Q4 2009. While the Commission services autumn forecasts and the UK convergence programme both forecast contributions of around ½ p.p. from net exports for 2010 and 11, recent data weigh negatively on these projections, partly also due to the insufficient UK terms of trade response. The programme does not include explicit exchange rate forecasts, but the assumed contribution to growth from exports implies that no major appreciation of the exchange rate is foreseen.

On the supply side, the biggest uncertainty is in the measurement of spare capacity. The Convergence Programme assumes a phased reduction in potential output of 5% of GDP between mid-2007 and mid-2010, which is equivalent to significantly lower trend growth rates over the corresponding period. After this, the programme assumes a return to trend growth in potential output of 2¾% in the central case and 2½% in the scenario used for the fiscal projections. As shown in Table 2, the output gaps as recalculated by Commission services based on the information in the programme, following the commonly agreed methodology are consistently larger than those in the Commission services autumn forecast. In all, the recalculated output gaps imply potential growth ½ p.p. higher than the Commission services autumn forecasts for all programme years, driven by higher assumed labour growth. The difference between the output gaps narrows by 2011 as the higher real growth projections in the programme counteract the Commission services' lower projections for potential growth. Potential output estimates are subject to particular uncertainty during periods of turbulence, but these disparities do imply that there are both supply- and demand-side risks to the UK's achieving the ambitious rebound forecast in the programme.



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

	2009		2010		2011		2012	2013	2014
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	-4.6	-4¾	0.9	1 to 1½	1.9	3¼ to 3¾	3¼ to 3¾	n.a.	n.a.
Private consumption (% change)	-3.3	-3	-0.3	0 to ½	1.5	2¾ to 3¼	2¾ to 3¼	n.a.	n.a.
Gross fixed capital formation (% change)	-15.9	-14¾	-3.8	-2 to -	3.0	4¼ to 4¾	8½ to 9	n.a.	n.a.
Exports of goods and services (% change)	-11.5	-10¾	1.8	2 to 2½	4.6	4½ to 5	5 to 5½	n.a.	n.a.
Imports of goods and services (% change)	-13.7	-12½	0.1	½ to 1	3.0	1¾ to 2¼	2¾ to 3¼	n.a.	n.a.
<i>Contributions to real GDP growth:</i>									
- Final domestic demand	-4.3	-4	-0.4	¼	1.0	2½	3	n.a.	n.a.
- Change in inventories	-1.2	-1¼	0.8	¾	0.5	½	0	n.a.	n.a.
- Net exports	1.0	¾	0.4	½	0.4	½	½	n.a.	n.a.
Output gap <sup>1</sup>	-3.7	-4.6	-3.7	-4.8	-2.9	-3.2	-1.7	-0.6	0.3
Employment (% change)	-2.0	n.a.	-0.9	n.a.	1.3	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%)	7.8	n.a.	8.7	n.a.	8.0	n.a.	n.a.	n.a.	n.a.
Labour productivity (% change)	-2.6	n.a.	1.8	n.a.	0.5	n.a.	n.a.	n.a.	n.a.
HICP inflation (%)	2.0	2	1.4	1¾	1.6	1½	2	n.a.	n.a.
GDP deflator (% change)	1.1	1½	1.7	2¾	2.0	1½	2¼	n.a.	n.a.
Comp. of employees (per head, % change)	1.2	n.a.	1.2		2.3				
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.2	n.a.	-1.4	n.a.	-0.7	n.a.	n.a.	n.a.	n.a.
<u>Note:</u>									
<sup>1</sup> In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.									
<u>Source:</u>									
Commission services' autumn 2009 forecasts (COM); Convergence programme (CP)									

#### 4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first three parts discuss the budgetary implementation in the year 2009, the budgetary plans for 2010 and the medium-term budgetary strategy in the programme. The final part analyses the risks attached to the budgetary targets.

##### 4.1. Budgetary implementation in 2009

In the financial year 2008/09 the general government deficit increased to almost 7.0% of GDP, 1½ percentage points higher than had been projected in the December 2008 update of the convergence programme. Following the extraordinarily large contraction in the first quarter of 2009, which was the sharpest quarterly loss of GDP recorded in over fifty years, the rate of output contraction in 2008/09 reached 1¼%. This output fall and the larger-than-expected requests for delays in tax payments under a business support scheme led to a sharp drop in government receipts in the final months of 2008/09. The undershoot in government revenue, coupled with an unanticipated one-off deficit-increasing rise in capital transfers by ¾% of GDP as a result of government financial sector interventions, led to a deficit outturn in 2008/09 of 1½ pp. of GDP higher than originally forecast. The budgetary situation in the financial year 2009/10 has continued to seriously deteriorate. The update estimates a deficit of 12.7% of GDP, ¼ pp. less than estimated in the Commission services' autumn 2009 forecast but 4½ pps. higher than projected in the previous update.

Table 3 compares the projected outcome for the general government balance, revenue and expenditure (as a percentage of GDP) in 2009/10 as presented in the new convergence programme with the targets from the previous update of the programme. Differences between outcome and targets (excluding the impact of an unanticipated GDP developments which may have affected the ratio, referred to as the 'denominator effect')

are decomposed in the impact of a different starting position (i.e. the outcome of 2008 may also have been different from what was anticipated in the previous programme update) and the impact of differences in the revenue/expenditure growth rate from the planned growth rates<sup>7</sup>.

The overshoot in the government deficit primarily reflects the effect of the deeper-than-expected recession on revenue and cyclical expenditure. Both the government revenue and expenditure ratios in 2009/10, adjusted for the effect of the sharp drop in nominal GDP, are estimated to be around 1¾% of GDP less than projected in the 2008 update. Around one half of the deficit overshoot in 2008/09, equivalent to around ¾% of GDP, is expected to feed-through into a higher deficit in 2009/10. As shown in Table 3, the deficit overshoot in 2008/09 takes the form of a higher-than-projected increase in the expenditure ratio, although this is entirely due to the denominator effect from lower nominal GDP in 2008/09, which leads to an increase in both the revenue and expenditure ratios by around ¾% of GDP. As mentioned above, the non-one-off component of the deficit overshoot in 2008/09 is due to a sharp drop in tax intakes.

With GDP in 2009/10 expected to contract by 3½%, compared to the December 2009 programme forecast of a contraction of only ½%, the standard budgetary elasticity with respect to UK output growth suggests an increase in the deficit ratio in 2009/10 by around 1¼ pps. as a result of the downward revision in the official real GDP growth projections. However, the actual impact of the deeper-than-expected contraction is estimated to be higher than what the standard budget elasticity with respect to the output gap would imply. This is primarily due to the association of the recession with severe downturns in financial and housing markets, each of which had been hitherto major sources of revenue. The budgetary forecast in the January 2010 update also takes into account the additional stimulus measures that were announced in the 2009 Budget of 22 April 2009, which contributed to an increase in the projected deficit for 2009/10 by around ½% of GDP. The latter was almost equally divided between revenue and expenditure measures, and primarily consisted of higher tax relief on business investment, a deferral in the inflation up-rating of the rate of the tax payable on business property, additional expenditure on military operations, and additional funding for labour market support schemes.

Turning to the contributors of the slower-than-expected revenue growth in 2009/10, income tax and social security contributions are estimated to contribute almost 1% of GDP to the revenue ratio undershoot in 2009/10 compared to the December 2008 convergence programme, reflecting the weakness in the overall labour market and the sharp drop in financial sector bonuses. The deeper-than-expected contraction in taxation on corporate profits is estimated to further reduce government intakes by 0.4% of GDP, including as a result of higher losses in the banking sector. Revenues from financial sector corporation tax in 2009/10 are estimated at just two-fifths of their level in 2007/08. By contrast, the loss in government revenue, relative to the 2008 update projections, from the contraction in Value Added Tax receipts in 2009/10 amounted to just 0.1% of GDP, as the reduction in the VAT rate, the car scrappage scheme and low interest rates had a stronger-than-expected impact on durable goods spending.

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<sup>7</sup> Mathematically, the difference in the revenue ratio in Table 3 can be expressed as:

$$\rho^o - \rho^p = \underbrace{\frac{1+r^p}{1+g^p} \Delta \rho_{-1}}_{\text{Base effect}} + \underbrace{\frac{\rho_{-1}^o}{(1+g^o)(1+g^p)} \Delta r}_{\text{Revenue growth effect}} - \underbrace{\frac{\rho_{-1}^o}{(1+g^o)(1+g^p)} \Delta g}_{\text{Denominator effect}} + \underbrace{\frac{\rho_{-1}^o (r^o g^p - r^p g^o)}{(1+g^o)(1+g^p)}}_{\text{Residual}}$$

where r is the growth rate of revenue and g is the growth rate of GDP. The subscript -1 refers to the previous year's value. Superscripts o and p refer to the outcome and the planned value respectively. Similar for the expenditure ratio.

On the expenditure side, government current expenditure was almost 1.0% of GDP higher than projected in the December 2008 update. Around three-fourths of the unforeseen increase in current expenditure was due to higher outlays on cyclically-sensitive (annually managed) expenditure. The rest of the increase in current spending was primarily due to additional expenditure on military operations, as announced in the 2009 Budget of 22 April 2009. Capital expenditure was 0.6% of GDP higher than planned in the 2008 convergence programme, including as a result of one-off capital grants of 0.3% of GDP due to the acquisition of banking sector equity at above market price.

**Table 3: Budgetary implementation in 2009/10**

	2008/09		2009/10	
	Planned	Outcome	Planned	Estimate
	CP Dec 2008	CP Jan 2010	CP Dec 2008	CP Jan 2010
Government balance (% of GDP)	-5.5	-6.9	-8.2	-12.7
Difference compared to target <sup>1</sup>	-1.4		-4.5	
<b>Difference excluding denominator effect <sup>1,2</sup></b>			<b>-4.3</b>	
<i>Of which</i> : due to a different starting position end 2008/09 <sup>3</sup>			-0.8	
due to different revenue / expenditure growth in 2009/10			-3.3	
p.m. Residual <sup>3</sup>			-0.2	
<i>p.m. Nominal GDP growth (planned and outcome)</i>			1.2	-1.8
Revenue (% of GDP)	36.7	36.6	35.5	34.8
Revenue surprise compared to target <sup>1</sup>	-0.1		-0.7	
<b>Revenue surprise excluding denominator effect <sup>1,2</sup></b>			<b>-1.8</b>	
<i>Of which</i> : due to a different starting position end 2008/09 <sup>3</sup>			-0.1	
due to different revenue growth in 2009/10			-1.7	
p.m. Residual <sup>4</sup>			0.0	
<i>p.m. Revenue growth rate (planned and outcome)</i>			-2.1	-6.6
Expenditure (% of GDP)	42.2	43.5	43.7	47.5
Expenditure surprise compared to target <sup>1</sup>	-1.3		-3.8	
<b>Expenditure surprise excluding denominator effect <sup>1,2</sup></b>			<b>-2.5</b>	
<i>Of which</i> : due to different starting position end 2008/09 <sup>3</sup>			-0.7	
due to different expenditure growth rate in 2009/10			-1.6	
p.m. Residual <sup>4</sup>			-0.2	
<i>p.m. Expenditure growth rate (planned and outcome)</i>			4.8	7.2
<b>Notes:</b>				
<sup>1</sup> A positive number implies that the outcome was better (in terms of government balance) than planned.				
<sup>2</sup> The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue and expenditure separately, on the balance they usually largely cancel against each other.				
<sup>3</sup> The part of the revenue/expenditure surprise that is due to the different starting position at end 2008/09 is net of one-off transactions in 2008/09. The latter consist of capital grants of 0.7% of GDP related to financial-sector interventions.				
<sup>4</sup> The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.				
<i>Source: Commission services</i>				

**Box 1: The excessive deficit procedure (EDP) for the United Kingdom**

On 8 July 2008 the Council adopted a decision stating that the United Kingdom had an excessive deficit in accordance with Article 104(6) of the Treaty establishing the European Community (TEC). At the same time, the Council addressed a recommendation under Article 104(7) TEC specifying that the excessive deficit had to be corrected by 2009/10. On 27 April 2009, the Council decided that the UK had not taken action in response to the Council recommendation of 8 July 2008. In accordance with Article 104(7) TEC, it addressed new recommendations with a view to bringing an end to the excessive government deficit situation by 2013/14.

On 2 December 2009 the Council, following a recommendation by the Commission, considered that action had been taken in accordance with the recommendations, but unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the recommendation. In accordance with Article 126(7) of the Treaty on the functioning of the European Union (TFEU), the Council issued new recommendations to correct the deficit by 2014/15. In particular, the United Kingdom was recommended to start consolidation in 2010/11, to ensure an average annual fiscal effort of 1¾% of GDP between 2010/11 and 2014/15, and to report on the progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes which will be prepared between 2010 and 2014.

#### **4.2. The programme's budgetary strategy for 2010**

The latest update projects a drop in the general government deficit ratio in 2010/11 by 0.6 percentage point, to 12.1% of GDP. The modest improvement in the government deficit entirely reflects an increase in government revenue by 6½% in nominal terms, around one-third of which is due to the increase in the VAT rate to its pre-stimulus level. On the other hand, government expenditure is projected to continue growing at a high, albeit slower, rate, up by around 4½%, or 2¼% in real terms, over the preceding year and leaving the expenditure-to-GDP ratio unchanged from the previous year.

The programme's budgetary projections take into account the discretionary measures announced by the UK authorities up to the 2009 Pre-Budget Report (PBR) of 9 December 2009, which was announced shortly after the Council recommendation under Article 126(7) of 2 December 2009. In the PBR, the UK authorities announced for 2010/11 an increase in discretionary spending on military operations by 0.2% of GDP. Overall, however, the discretionary measures that will come into force in 2010/11, including those announced in the 2008 Pre-budget Report of November 2008 and in the 2009 Budget of 22 April 2009, will *everything else constant* reduce the government deficit by around 1.0% of GDP.

The main discretionary measures for financial year 2010/11 are shown in Table 4. The increase in January 2010 of the standard VAT rate to its pre-fiscal stimulus level is forecast to increase revenue by 0.7% of GDP, while an increase in the income tax rate on high incomes is expected to raise intakes from taxation revenues by 0.1% of GDP. On the expenditure side, the discretionary measures announced by the UK authorities for 2010/11 are expected to have a largely neutral effect on the government deficit. The government targets efficiency savings of 0.3% of GDP, including through improvements in the utilisation of National Health Service real estate and changes in the working practices of the police force. In addition, the front-loading of capital expenditure to 2008 and 2009 will reduce investment spending in 2010/11 by 0.2% of GDP. These expenditure-reducing measures will, however, be largely offset by higher military spending, an increase in the budget allocation for employment support schemes, and the inflation up-rating of social benefits.

Total government revenue net of the higher intakes from discretionary measures is estimated to grow by 4.3%. Over three-fifths of this increase reflects higher intakes from tax on income and, especially, corporate profits. The latter are expected to grow by 10% over their level in 2009/10, equivalent to ½% of GDP, as a result of higher profitability, including a 10% increase in financial sector profits. Almost 70% of the increase in government expenditure is due to higher interest payments, primarily reflecting the underlying surge in government debt, and social security benefits. The planned growth in current departmental (largely non-cyclical) expenditure, at 3.3%, is around half that in 2009/10, whereas departmental capital expenditure is expected to fall by 0.3% of GDP due to the above-mentioned front-loading of investment spending.

The estimates of the cyclically-adjusted and structural budget balances, as measured by the Commission services on the basis of the information in the programme and according to the commonly agreed methodology, need to be interpreted with caution. With the negative output gap in 2010/11 expected to remain practically unchanged compared to the previous year, the structural government deficit in 2010/11 is estimated to improve by ¼% of GDP, mirroring the improvement in the headline deficit net of the one-off deficit-increasing transaction in 2009/10<sup>8</sup>. The improvement in the estimated structural budget deficit is significantly lower than the net effect of the above-mentioned discretionary measures, reflecting, as in the previous year, an effect from tax elasticities due to the fact that the scale of economic activities yielding high tax revenues, especially those in the financial and housing sectors, remains well below historical levels.

The start of fiscal consolidation in 2010/11 is consistent with the Council recommendation of December 2009, but the fiscal effort, as measured on the basis of the individual measures announced by the UK authorities, is well below the recommended average annual fiscal effort of 1¾% of GDP between 2010/11 and 2014/15. Moreover, the discretionary measures announced subsequent to the Council recommendation of 9 December 2009 have actually contributed to a slight worsening of the UK's expected fiscal position in 2010/11.

**Table 4. Main budgetary measures for 2010/11**

Revenue measures <sup>1</sup>	Expenditure measures <sup>2</sup>
<p>Increase in VAT rate to pre-stimulus level (0.7% of GDP)</p> <p>Increase in income tax rate and restriction of personal allowances (0.1% of GDP)</p>	<p>Efficiency savings (-0.3% of GDP)</p> <p>Capital expenditure brought forward to 2009/10 (-0.2% of GDP)</p> <p>Housing spending package brought forward to 2009/10 (-0.1% of GDP)</p> <p>Defence budget (0.2% of GDP)</p> <p>Employment support (0.1% of GDP)</p> <p>Benefits uprating and other social expenditure (0.1% of GDP)</p>
<p><u>Notes:</u></p> <p><sup>1</sup> Estimated impact on general government revenue</p> <p><sup>2</sup> Estimated impact on general government expenditure</p> <p><i>Sources: January 2010 Convergence Programme, Budget 2009 and December 2008 Convergence Programme</i></p>	

<sup>8</sup> Whereas the programme itself estimates a reduction in the negative output gap from -6.4% in 2009/10 to -5.3% in 2010/11, the recalculated output gap, which is measured by the Commission services on the basis of the information in the programme and according to the commonly agreed methodology, remains in 2010/11 practically unchanged from the previous year at -4½%. Using the formula "cyclically-adjusted net borrowing = net borrowing + 0.50 \* output gap in the current fiscal year + 0.20 \* output gap in previous fiscal year", as compared to the formula used by the Commission services of "cyclically-adjusted net borrowing = net borrowing + 0.42 \* output gap in the current fiscal year", the programme estimates an improvement in the cyclically-adjusted budget balance by 0.9% of GDP.

### 4.3. 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.

The update does not present a medium-term objective for the budgetary position as defined in the Code of Conduct. The update refers to the statutory fiscal plan laid out in the *Fiscal Responsibility Act (FRA)*, which was announced on 9 December 2009 alongside the Pre-Budget Report and which was approved by Parliament on 10 February 2010. The FRA sets out a *Fiscal Consolidation Plan (FCP)* requiring that the government "*halves public sector net borrowing as a share of GDP over four years from its forecast peak in 2009-10. The Government is setting a target, in secondary legislation enabled by the Bill, for borrowing to be 5.5 per cent of GDP or less in 2013-14*". The FCP also requires the government to: "*reduce borrowing as a share of GDP in each and every year from 2009-10 to 2015-16, and ensure that public sector net debt is falling as a share of GDP in 2015-16*".

The medium-term budgetary projections in the programme reflect the consolidation plan envisaged in the FRA, which is significantly less ambitious than recommended by the Council under Article 126(7) in December 2009. The discretionary measures announced subsequent to the Council recommendation of 2 December 2009, particularly as a result of the increase in discretionary government expenditure that was announced in the 2009 Pre-Budget Report of 9 December 2009 relative to the spending plans announced in the 2009 Budget of April 2009, implied a net fiscal loosening in 2011/12 by 0.3% of GDP and in 2012/13 by 0.1% of GDP. The government deficit in 2014/15 - the deadline set in the December 2009 recommendation for the UK to correct its excessive deficit situation - is projected at 4.7% of GDP. The annual average improvement in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, between 2010/11 and 2014/15 is estimated at only 1.0% of GDP,  $\frac{3}{4}$  pp. less than recommended by the Council in December 2009.

#### **Box 2: The medium-term objective (MTO) for the United Kingdom**

As noted in the Code of Conduct<sup>9</sup>, the MTO aims to (a) provide a safety margin with respect to the 3% of GDP deficit limit; (b) ensure rapid progress towards fiscal sustainability; and (c) allow room for budgetary manoeuvre, in particular taking into account the needs for public investment. The MTO is defined in cyclically adjusted terms, net of one-off and other temporary measures. On 7 July 2009, the ECOFIN Council took note of a new methodology for setting MTOs, ensuring that implicit liabilities (costs related to ageing populations, in particular projected healthcare and pension expenditure) are also accounted for.

Specifically, the country-specific MTOs should take into account three components: (i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; (ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and (iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure. This implies a partial frontloading of the budgetary cost of ageing irrespective of the current level of debt. In addition to these criteria, MTOs should provide a

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<sup>9</sup> "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 on 10 November 2009, available at: [http://ec.europa.eu/economy\\_finance/sgp/legal\\_texts/index\\_en.htm](http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm)

safety margin with respect to the 3% of GDP deficit reference value and, for euro area and ERM II Member States, in any case not exceed a deficit of 1% of GDP.

Contrary to the requirements of the Pact, the United Kingdom has not defined an MTO as defined in the Code of Conduct.

**Table 5: Composition of the budgetary adjustment**

(% of GDP)	2008/09	2009/10		2010/11		2011/12		2012/13	2013/14	2014/15	Change: 2009/10- 2014/15
	COM	COM	CP	COM	CP	COM <sup>1</sup>	CP	CP	CP	CP	CP
<b>Revenue<sup>2</sup></b>	<b>41.9</b>	<b>38.4</b>	<b>34.8</b>	<b>39.2</b>	<b>35.4</b>	<b>39.8</b>	<b>36.7</b>	<b>37.1</b>	<b>37.2</b>	<b>37.1</b>	<b>2.3</b>
<i>of which:</i>											
- Taxes on production and imports	11.7	11.3	11.8	11.9	12.2	12.2	n.a.	n.a.	n.a.	n.a.	n.a.
- Current taxes on income, wealth, etc.	16.4	15.0	14.5	14.9	15.0	15.3	n.a.	n.a.	n.a.	n.a.	n.a.
- Social contributions	8.4	8.5	6.8	8.4	6.6	8.4	n.a.	n.a.	n.a.	n.a.	n.a.
- Other (residual)	5.5	3.7	1.7	3.9	1.6	3.9	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Expenditure<sup>2</sup></b>	<b>49.0</b>	<b>51.2</b>	<b>47.4</b>	<b>51.5</b>	<b>47.4</b>	<b>50.3</b>	<b>45.8</b>	<b>44.2</b>	<b>42.7</b>	<b>41.5</b>	<b>-5.9</b>
<i>of which:</i>											
- Primary expenditure	46.8	49.4	45.2	48.8	44.4	47.3	42.3	40.5	38.9	37.7	-7.5
<i>of which:</i>											
Compensation of employees and intermediate consumption	23.8	25.9	23.8	25.8	23.9	25.5	n.a.	n.a.	n.a.	n.a.	n.a.
Social payments	13.6	15.3	13.3	15.3	13.2	14.9	n.a.	n.a.	n.a.	n.a.	n.a.
Subsidies	0.6	0.7	0.7	0.6	0.6	0.6	n.a.	n.a.	n.a.	n.a.	n.a.
Gross fixed capital formation	2.4	2.7	2.8	2.4	2.4	1.9	n.a.	n.a.	n.a.	n.a.	n.a.
Other (residual)	6.4	4.8	4.6	4.7	4.3	4.4	n.a.	n.a.	n.a.	n.a.	n.a.
- Interest expenditure	2.2	1.8	2.2	2.7	3.0	3.0	3.5	3.7	3.8	3.8	1.6
<b>General government balance (GGB)</b>	<b>-6.9</b>	<b>-13.0</b>	<b>-12.7</b>	<b>-12.5</b>	<b>-12.1</b>	<b>-10.7</b>	<b>-9.2</b>	<b>-7.4</b>	<b>-5.6</b>	<b>-4.7</b>	<b>8.0</b>
<b>Primary balance</b>	<b>-4.8</b>	<b>-11.0</b>	<b>-10.5</b>	<b>-9.6</b>	<b>-9.1</b>	<b>-7.5</b>	<b>-5.7</b>	<b>-3.7</b>	<b>-1.8</b>	<b>-0.9</b>	<b>9.7</b>
One-off and other temporary measures	-0.7	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs<sup>3</sup></b>	<b>-6.2</b>	<b>-12.7</b>	<b>-12.7</b>	<b>-12.5</b>	<b>-12.1</b>	<b>-10.7</b>	<b>-9.2</b>	<b>-7.4</b>	<b>-5.6</b>	<b>-4.7</b>	<b>8.0</b>
Output gap <sup>4</sup>	0.4	-3.7	-4.6	-3.5	-4.4	-2.7	-2.8	-1.5	-0.4	0.5	5.1
Cyclically-adjusted balance <sup>2</sup>	-7.1	-11.5	-10.8	-11.0	-10.3	-9.6	-8.0	-6.8	-5.5	-4.9	5.9
<b>Structural balance<sup>5</sup></b>	<b>-6.3</b>	<b>-11.4</b>	<b>-10.5</b>	<b>-11.0</b>	<b>-10.3</b>	<b>-9.6</b>	<b>-8.0</b>	<b>-6.8</b>	<b>-5.5</b>	<b>-4.9</b>	<b>5.6</b>
<i>Change in structural balance</i>		<i>-5.1</i>	<i>-4.2</i>	<i>0.4</i>	<i>0.2</i>	<i>1.4</i>	<i>2.3</i>	<i>1.2</i>	<i>1.3</i>	<i>0.6</i>	
Structural primary balance <sup>5</sup>	-4.0	-9.5	-8.3	-8.3	-7.3	-6.6	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Change in structural primary balance</i>		<i>-5.5</i>	<i>-4.3</i>	<i>1.2</i>	<i>1.0</i>	<i>1.7</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	

**Notes:**

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

<sup>2</sup>Data for total revenue and expenditure are not presented by the UK on a harmonised ESA95 basis. Data illustrated are UK series drawn from Table 2.7 of the 2009 Pre-Budget Report. Other data presented are aggregates derived by the Commission services on the basis of information provided by the UK authorities. Revenue data are adjusted for the treatment of UMTS receipts. For the years between 2011/12 and 2014/15, general government revenue and expenditure figures are extrapolated from public sector projections.

<sup>3</sup>One-off and other temporary measures.

<sup>4</sup>Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme 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 2009 forecasts (COM); Commission services' calculations

Table 5 shows that the nominal government deficit is forecast to drop from 12.1% of GDP in 2010/11 to 4.7% of GDP in 2014/15, with almost two-thirds of the medium-term consolidation projected to take place in 2011/12 and 2012/13. The forecast reduction in the government deficit between 2011/12 and 2014/15 is driven by the planned tightening in expenditure growth during those years. The drop in the expenditure ratio is expected to contribute to around four-fifths of the target adjustment in the nominal balance. While revenue growth is forecast to accelerate to an average of 7% per annum during the four-year period ending 2014/15, government expenditure during those years is planned to increase by an annual average of only 2½%. The latter implies in real terms a freeze in government spending at 2010/11 level and is equivalent to half the rate of nominal

expenditure growth between 2007/08 and 2010/11 of 5% per annum. If nominal expenditure had been planned to continue increasing by its annual average of 5% between 2007/08 and 2010/11, the forecast deficit in 2014/15 would have *everything else constant* remained at 9.0% of GDP. Almost one-quarter of the almost 6 pps. drop in the expenditure ratio between 2011/12 and 2014/ is due to a reduction in government investment spending.

In 2011/12, the government deficit is forecast to drop by almost 3 pps. from the previous year, while the structural deficit ratio is estimated to improve by 2¼ pps. The planned increase in social security contribution rates is expected to raise revenue by 0.4% of GDP, while an increase in the rates of tax on high incomes is expected to yield an additional 0.2% of GDP. Current expenditure is planned to grow by 3% in 2011/12, or 1½% in real terms, while investment spending is planned to be reduced by ¾% of GDP. In 2012/13 and beyond, no new major tax-increasing discretionary measures are planned to come into effect.

#### **4.4. Risk assessment**

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2009 forecast, which are derived under a no-policy change scenario, with those in the updated programme, which are available up to financial-year 2010/11. However, although the assessment uses the Commission services' forecast as a benchmark, it also takes explicitly into account all available information about more recent developments.

The Commission services' autumn 2009 forecast had projected for 2009/10 a deficit of ¼% of GDP higher than in the updated convergence programme. The public finances data for the first ten months of the financial-year 2010/11 indicate that the programme's estimate for the deficit in 2009/10 is likely to be achieved. In 2010/11, the Commission services' autumn 2009 forecast projected an expansion in real economic activity by 1¼%, while the Commission services' February 2010 interim forecast implies that growth in 2010/11 is likely to be closer to 1%. In turn, a weaker recovery in 2010/11, relative to the 2% increase in GDP projected in the latest update, carries the risk of a reduction in the improvement in the headline deficit that is envisaged in the programme in 2010/11 by around ⅓ pp. of GDP.

Commission services calculations on the contributors to the reduction of the government deficit by 7½ pps. of GDP between 2011/12 and 2014/15 indicate that: around 60% of the programme's projected consolidation in the medium-term reflects the planned sharp reduction in expenditure growth from an annual average of around 5.0% between 2007/08 and 2010/11; around 30% is due to the recovery in economic conditions (as measured by the change in the output gap); while revenue-increasing discretionary measures account for the remaining 10% of the forecast reduction in the deficit ratio. With the government's medium-term consolidation programme driven by the overall spending envelope published by the UK authorities for the years between 2011/12 and 2014/15, the absence of detailed departmental spending limits to back-up the programme's expenditure assumptions represents a source of uncertainty on the programme's medium-term fiscal plan. The sharp slowdown in medium-term spending growth that is targeted in the update implies considerable efficiency challenges for the public sector, which suggests a heightened risk of spending overruns, as well as extensive reprioritisation for the public sector. In general, there are considerable



implementation challenges attached to the hitherto unprecedented degree of planned expenditure restraint which will need to be sustained over a prolonged period.

In addition, the macroeconomic context envisaged in the programme between 2011/12 and 2014/15 also appears markedly favourable. The programme's fiscal projections are based on the assumption of real economic growth of 3¼% per annum between 2011/12 and 2014/15. The Commission services' autumn 2009 forecast projects growth in 2011/12 of 2¼%. Commission services' calculations, based on estimates of the potential growth rate and on an estimate for the cyclical component that would lead to a linear closure of the output gap from 2011 to 2015, suggest that the UK's annual economic growth between 2012 and 2015 is unlikely to reach the level projected by the Treasury. According to the Treasury's publication of independent forecasts in February 2010<sup>10</sup>, independent forecasters project economic growth between 2012 and 2014 to reach an average of 2½% per annum. Estimates based on the standard budget elasticity with respect to the output gap imply that the lower economic growth would lead to a cumulative overshoot in 2014/15 of the government deficit projected in the updated programme by 1¼% of GDP.

The projections imply a revenue elasticity with respect to GDP that, except in 2011/12, is broadly consistent with the *ex-ante* elasticity. In 2011/12, the increase in government revenue, adjusted for the additional receipts as a result of discretionary measures, is significantly stronger than that justified by the *ex-ante* elasticity with respect to GDP. This appears to reflect the programme's projection of a strong resumption in the growth of tax-rich economic activities during that year, especially private consumption expenditure and transactions in the financial sector, which the programme assumes will record another 10% increase in profits during that year. A revenue elasticity closer to the *ex-ante* elasticity would imply a reduction in revenue in 2011/12 by around ¼% of GDP.

The United Kingdom has assumed substantial contingent liabilities as a result of its financial sector interventions. In particular, under its *Asset Protection Scheme*, the government has agreed to insure banking sector assets amounting to almost 20% of GDP. The commercial bank participating in the scheme will have to absorb the first £60 billion (4.0% of GDP) of any eventual losses incurred on the insured assets, with the Treasury compensating the bank for any losses in excess of that amount. According to the Treasury's assessment, any losses should not exceed £60 billion. However, the extent to which the insured loans and investments are at risk of default is subject to high uncertainty and the scheme could potentially result in a net cost for government.

The impact of possibly higher borrowing costs, from global or domestic market influences, should be relatively contained, given the UK's long maturity structure, although it would still be unhelpful.

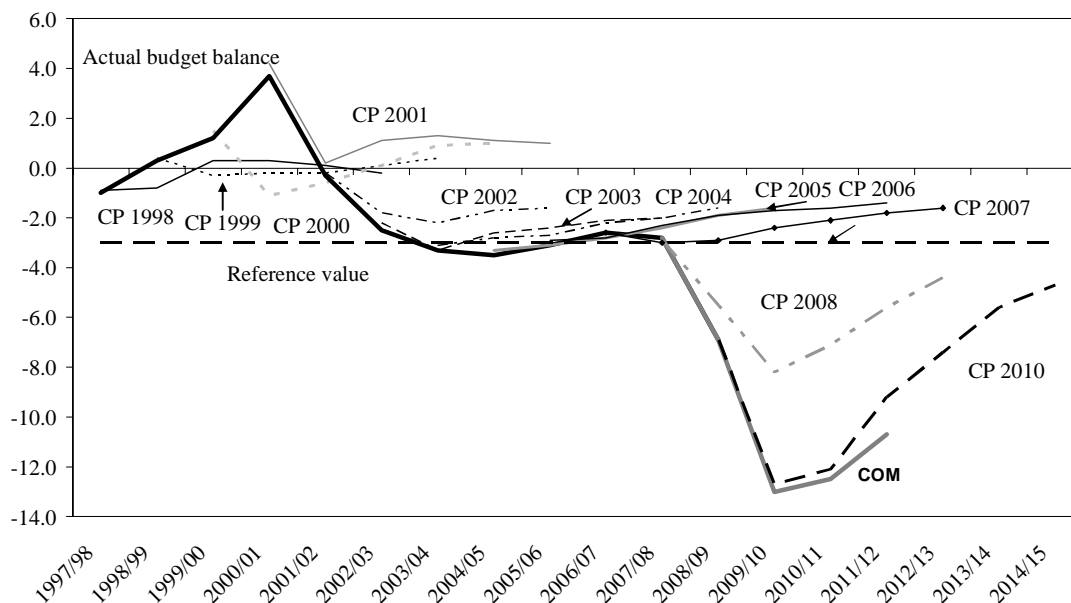
Figure 1 compares the UK's budgetary projections in successive convergence programmes with the actual deficit outturns. Since 2003/04, the deficit outturn did not exceed the one-year ahead forecast only on one occasion. Overall, over the past six financial years the deficit outturn exceeded the one-year ahead forecast by an annual average of around 1½ percentage points.

An overall assessment of the balance of risks indicates that the budgetary projections are subject to downside risks.

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<sup>10</sup> <http://www.hm-treasury.gov.uk/d/201002forecomp.pdf>

**Figure 1: Government balance projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2009 forecast (COM) and successive convergence programmes*

## 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

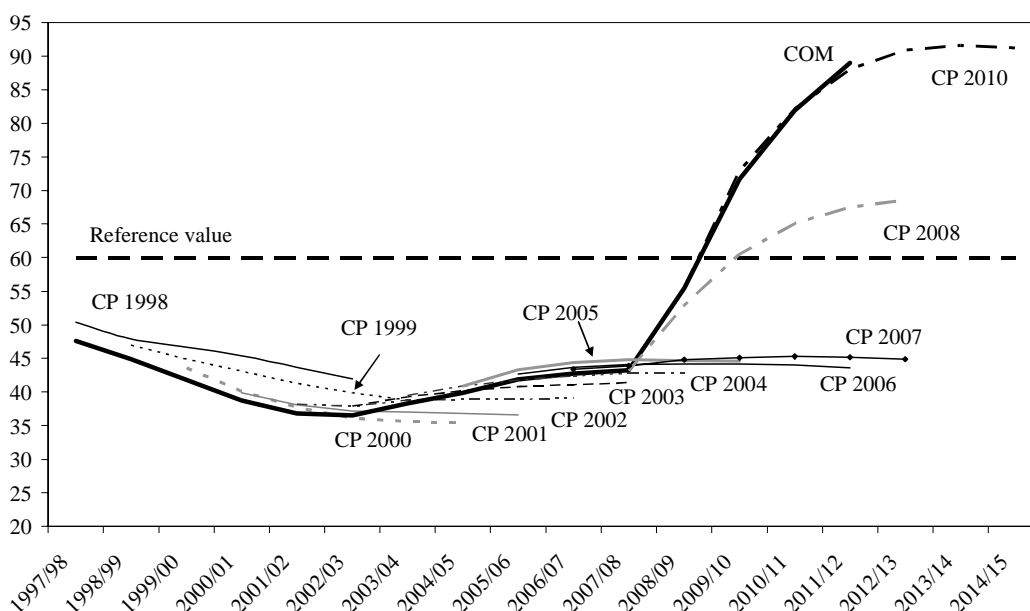
In the financial year 2008/09, the UK government gross debt ratio was 55.5% of GDP, 2½ percentage points more than had been projected in the December 2008 update of the convergence programme. The programme update estimates a gross debt ratio of 72.9% of GDP in 2009/10, 1¼ pp. more than estimated in the Commission services' autumn forecast and 20 pps. higher than had been projected in the December 2008 programme. The government gross debt ratio is projected to increase sharply over the programme period and to remain well above the reference value of 60% of GDP from 2009/10 onwards, as shown in Table 6. The debt ratio is forecast to increase to a peak of almost 92% in 2013/14.

Around three-fifths of the 17½ pps. increase in the debt ratio in 2009/10 reflects the high primary deficit, while the contribution from the stock-flow adjustment of almost 3¾ pps. reflects government borrowing to finance the purchase of banking sector equity and lending to commercial financial institutions. The Commission services' autumn 2009 forecast estimates a slightly lower increase in debt ratio in 2009/10 than in the convergence programme, as the Commission services' projection of a higher primary deficit is offset by the programme's estimate of higher interest payments and a greater stock-flow adjustment.

Between 2010/2011 and 2014/15, the pace of increase in the debt ratio diminishes gradually, in line with the improvement in the primary balance. By 2013/14, the programme projects a stabilisation in the debt ratio at slightly over 90% of GDP. In particular, the contribution of the high nominal GDP growth to debt ratio is expected to reach 5¼ pps. per annum by 2013/14, leading to a stabilisation of the debt ratio notwithstanding the fact that the primary balance is set to remain in deficit by the end of the programme period and interest payments are expected to surge from 2¼% of GDP in 2009/10 to almost 4% in 2013/14.

The convergence programme also projects the public sector net debt ratio, which records most financial liabilities issued by the public sector less its holdings of liquid financial assets, such as bank deposits. Public sector net debt<sup>11</sup> is expected to increase over the programme period from 55½% of GDP to around 65% of GDP in 2010/11, and further to 78% of GDP in 2014/15.

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



*Source: Commission services' autumn 2009 forecast (COM) and successive convergence programmes*

<sup>11</sup> Excluding temporary effects of financial interventions.

**Table 6: Debt dynamics**

(% of GDP)	average 2003-07	20008/ 09	2009/10		2010/11		2011/12		2012/13	2013/14	2014/15
			COM	CP	COM	CP	COM	CP	CP	CP	CP
<b>Gross debt ratio</b> <sup>1</sup>	<b>41.2</b>	<b>55.5</b>	<b>71.7</b>	<b>72.9</b>	<b>81.9</b>	<b>82.1</b>	<b>89.0</b>	<b>88.0</b>	<b>90.9</b>	<b>91.6</b>	<b>91.2</b>
Change in the ratio	1.3	12.2	16.1	17.4	10.2	9.2	7.1	5.9	2.9	0.7	-0.4
<i>Contributions</i> <sup>2</sup> :											
<b>1. Primary balance</b>	<b>1.0</b>	<b>4.8</b>	<b>11.2</b>	<b>10.4</b>	<b>9.8</b>	<b>9.0</b>	<b>7.6</b>	<b>5.6</b>	<b>3.6</b>	<b>1.8</b>	<b>0.7</b>
<b>2. "Snow-ball" effect</b>	<b>0.0</b>	<b>1.6</b>	<b>3.0</b>	<b>3.2</b>	<b>0.6</b>	<b>-0.1</b>	<b>-0.4</b>	<b>-0.3</b>	<b>-1.1</b>	<b>-1.2</b>	<b>-1.3</b>
<i>Of which:</i>											
Interest expenditure	2.1	2.2	1.8	2.2	2.7	3.0	3.0	3.5	3.7	3.9	3.9
Growth effect	-1.6	0.5	1.9	2.0	-0.8	-1.4	-1.8	-2.5	-2.7	-2.8	-2.8
Inflation effect	-0.5	-1.1	-0.6	-1.0	-1.3	-1.7	-1.6	-1.3	-2.1	-2.4	-2.4
<b>3. Stock-flow adjustment</b>	<b>0.3</b>	<b>5.8</b>	<b>1.9</b>	<b>3.7</b>	<b>-0.2</b>	<b>0.3</b>	<b>-0.1</b>	<b>0.6</b>	<b>0.5</b>	<b>0.2</b>	<b>0.3</b>

Notes:  
<sup>1</sup>End of period.  
<sup>2</sup>The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.  
Source:  
Convergence programme (CP); Commission services' autumn 2009 forecast (COM); Commission services' calculations.

The government gross debt is subject to a number of risks over the programme period, mainly stemming from higher-than-targeted deficits (see Section 4.3), and from lower-than-projected real growth (see Section 3). In particular, there is a risk that contingent liabilities assumed by the government, such as those resulting from its asset protection scheme, could eventually lead to an increase in government debt. However, the extent to which contingent liabilities may be called remains uncertain.

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

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

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2009 according to an agreed methodology<sup>12</sup>.

Table 7 shows that the projected increase in age-related spending is rising by 4.8% of GDP between 2010 and 2060, close to the EU average. Sustainability indicators for two scenarios are presented in Table 8. Assuming that the structural primary balance remained at its 2009 level except for the impact of age-related expenditure, the sustainability gap (S2)<sup>13</sup> would amount to 13.3% of GDP; about 5.7% of GDP more than in last year's assessment, which is mainly due to a higher estimated structural primary balance in the starting year, additionally the age-related expenditure increase slightly more in the new projections. This starting budgetary position would not be sufficient 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.

<sup>12</sup> Economic Policy Committee and the European Commission (2009), '2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-60)', *European Economy* No. 2/2009. European Commission (2009), 'Sustainability Report 2009', *European Economy* No. 9/2009. European Commission (2008), 'Public finances in EMU – 2008', *European Economy* No. 4/2008..

<sup>13</sup> The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

While the "2009 scenario" already reflects the weakening of the budgetary position in response to the current economic crisis, the "programme scenario", which is based on the end-of-programme structural primary balance, shows a smaller gap. If the budgetary consolidation planned in the programme was achieved, risks to long-term sustainability of public finances would be mitigated.

Based on the assumptions used for the calculation of the sustainability indicators, Figure 3 displays the projected debt/GDP ratio over the long-term.

Based on the assumptions presented in COM autumn 2009 forecast publication<sup>14</sup>, Figure 4 shows projected medium-term trajectory of the debt/GDP ratio.

**Table 7: Long-term age-related expenditure: main projections**

(% of GDP)	2007	2010	2020	2030	2040	2060	Change 2010- 60
<b>Total age-related spending</b>	<b>18.9</b>	<b>19.2</b>	<b>19.8</b>	<b>21.1</b>	<b>22.1</b>	<b>24.0</b>	<b>4.8</b>
- Pensions	6.6	6.7	6.9	7.6	8.0	9.3	2.5
- Healthcare	7.5	7.6	8.0	8.4	8.9	9.4	1.8
- Long-term care	0.8	0.8	0.9	1.0	1.1	1.3	0.5
- Education and unemployment benefits	4.1	4.0	4.0	4.1	4.0	4.0	0.0
<b>Property income received</b>	<b>0.7</b>	<b>0.7</b>	<b>0.5</b>	<b>0.5</b>	<b>0.4</b>	<b>0.4</b>	<b>-0.3</b>

*Source: Economic Policy Committee and Commission services.*

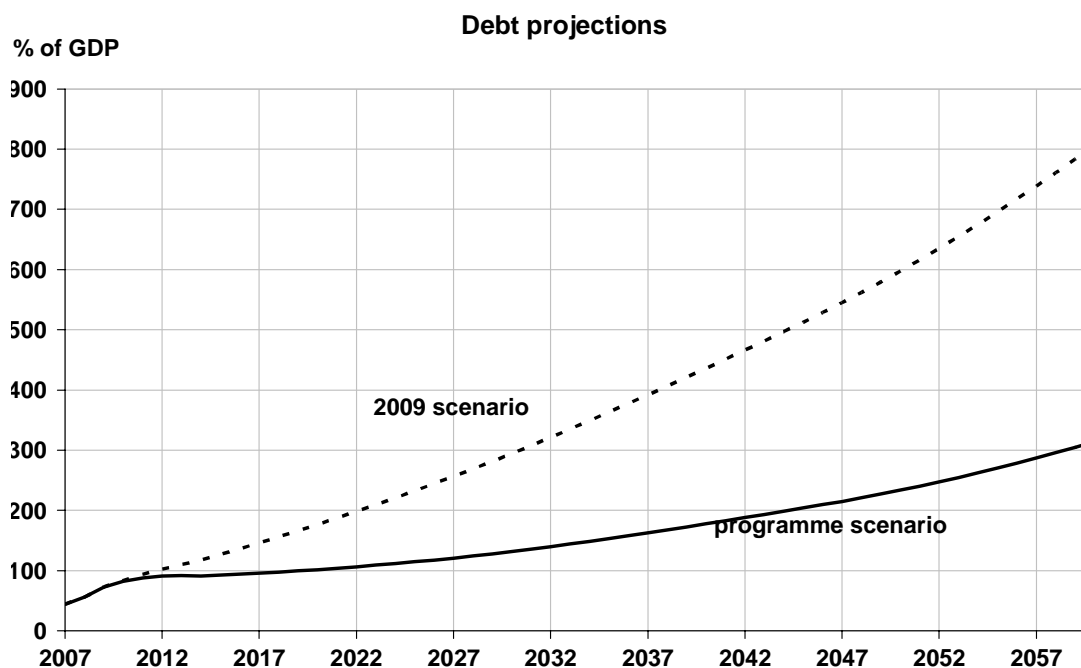
**Table 8: Sustainability indicators and the required primary balance**

	2009 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	12.8	13.5	4.9	4.4	5.5	4.6
<i>of which:</i>						
Initial budgetary position (IBP)	9.7	9.9	-	1.7	1.9	-
Debt requirement in 2060 (DR)	1.0	-	-	0.5	-	-
Long-term change in the primary balance (LTC)	2.1	3.6	-	2.1	3.6	-

*Source: Commission services.*

<sup>14</sup> Section 3.5 in European Commission (2009), 'European Economic Forecast – autumn 2009', European Economy No. 10/2009

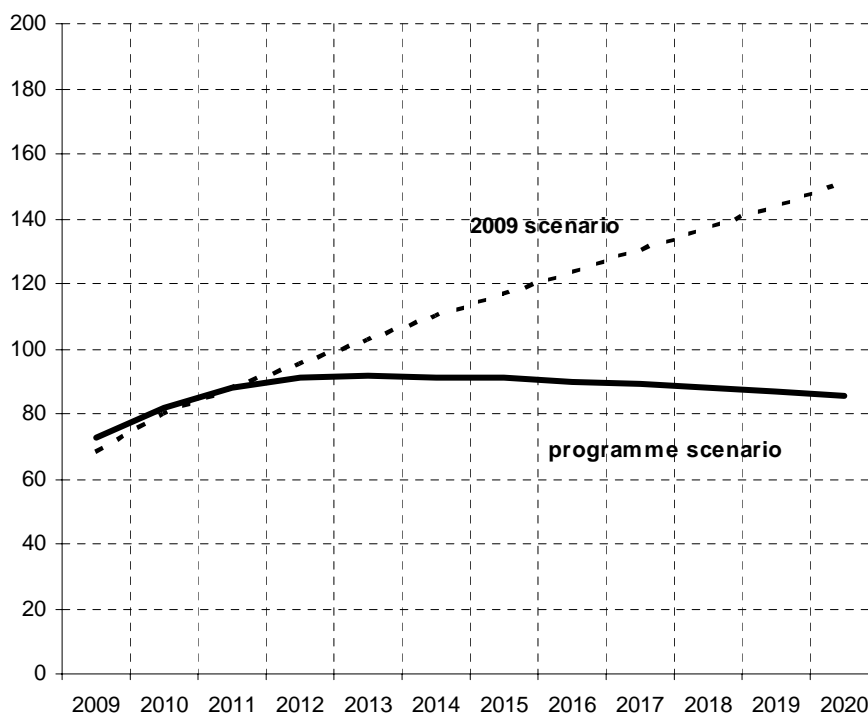
**Figure 3: Long-term projections for the government debt ratio**



*Note:* 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.

*Source:* Commission services.

**Figure 4: Medium-term projections for the government debt ratio**



*Source:* Commission services

### 5.2.2. Assessment

Illustrative debt projections until 2020 show that the budgetary development envisaged in the programme is enough to stabilise debt in the medium term. The '2009 scenario' that is based on the budgetary situation of 2009 shows however that debt would be increasing to over 150% of GDP by 2020 if the policy measures described in the programme would not be implemented.

Whereas the long-term budgetary impact of ageing is close to the EU average, the budgetary position in 2009 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. Moreover, the gross debt ratio is above the Treaty reference value. Achieving primary surpluses in the medium term would contribute to reducing risks to the sustainability of public finances.

## 6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES

### 6.1. Fiscal framework

The United Kingdom's fiscal framework has been substantially amended in response to the economic and financial crisis. Until the 2008 Pre-Budget Report, the United Kingdom had operated two fiscal rules: the first requiring the current budget (total spending minus investment spending and total revenues) to be in balance or surplus over the course of an economic cycle and the second requiring that debt be kept at a "stable and prudent" level, then defined as a 40% of GDP cap on net debt. While well grounded in theory, the effectiveness of this framework in practice is questionable. The leeway afforded to the Treasury to redefine the start and end dates of the economic cycle limited its effectiveness as a check on excessive deficits. The fact that the UK ran a deficit of 2.8% of GDP and a primary deficit of 1.0% in the financial year 2007/08, the most recent output peak, suggests strongly that this framework was not effective in preventing pro-cyclical fiscal policy in the upswing.

In response to the economic and financial crisis, at the 2008 Pre-Budget Report the United Kingdom replaced this framework with a *"temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full."*

As discussed in section 4.3, the United Kingdom subsequently replaced this temporary rule with the *Fiscal Responsibility Act (FRA)*, which was approved by Parliament on 10 February 2010. The FRA sets numerical targets for debt and deficit reductions up to the financial year 2015/16. The Treasury must report to Parliament on its compliance with these targets at every Budget and Pre-Budget Report and explain any failure to meet them. It must also set new targets or other fiscal rules once the period covered by the current targets has expired.

More specific spending control continues to be exercised through a system of multi-year "spending reviews". These set overall spending envelopes and department-by-department limits for predictable expenditure ("departmental expenditure limits") linked to performance targets ("public service agreements" and "departmental strategic objectives"). The most recent spending review was published in 2007 and covers the three financial years ending 2010/11. The United Kingdom has not yet announced when it will publish a spending review for the following period. More unpredictable

expenditure – principally social security and interest payments – is managed on an annual basis. Despite the existence of envelopes and limits, public spending has not always been sufficiently contained over the last years, with *total* expenditure outturns between 2002/03 and 2008/09 on average exceeding the original ceilings set out in the spending reviews.

The key strength of the FRA is that it sets unambiguous numerical targets with no subjective judgement being required to assess compliance. The framework at least exerts some pressure on the Treasury to meet the targets unless it is confident that Parliament will accept its justification for a failure to do so. To reduce the risk of missing the targets established in the FRA, a mechanism to assess their realism and a contingency plan - to be implemented if the underlying assumptions and macroeconomic forecasts prove inaccurate - would be useful. Overall, while the FRA is a step in the right direction, the consolidation plan set out in the Act is significantly less ambitious than in the Council recommendation under Article 126(7) on 2 December 2009 and it is not consistent with a reduction of the deficit to below the 3% of GDP reference value by 2014/15.

## **6.2. Quality of public finances**

The programme dedicated a chapter to the quality of public finances and therein provides a concise summary of past and current UK public sector efficiency initiatives, as well as of detailed spending initiatives by policy area. This section will assess the overall impact of UK measures adopted so far and foreseen over the programme's horizon.

The sharp increase in the government expenditure ratio since 2000 underlines the need to ensure efficiency and cost effectiveness of public spending in the UK. The Spending Review framework has provided the UK government with the opportunity to plan and implement medium-term improvements in public sector cost efficiency. Starting with the 2004 Spending Review, which covered the three financial years from 2005/6 to 2007/8 and set out a large public sector efficiency programme presented in the 2004 Gershon Report, departments reported to have achieved cost savings of £26.5bn, thus exceeding the target of £21.5bn. However, the UK's National Audit Office (NAO), in its second interim assessment of the Gershon Programme, found that by 2006 almost half of the £13.3bn of efficiency savings reported up to that point by departments had been measured with error, as almost a quarter of the efficiencies were assessed to be “substantially incorrect” or yet to have occurred. No final report on the final outcome of the Gershon programme was made by the NAO, so that it is difficult to independently verify the extent to which the reported costs savings fairly represent efficiencies that did not adversely affect the quantity or quality of public sector output.

The 2007 Comprehensive Spending Review (CSR) covers the subsequent three financial years up to and including 2010/11, and over this period the Government has committed itself to achieving further value-for-money savings of an additional £35bn, of which the 2009 Pre-Budget Report claimed £8.5bn had already been achieved by departments in the first year (or, for some departments, the first year-and-a-half of the 2007 CSR period). Around £6bn of these £35bn represent savings the government plans to deliver over the 2007 CSR period, following the findings of its one-year long Operational Efficiency Programme (OEP). This programme examined operational spending in the public sector and revealed scope for £15 billion of annual efficiency savings by 2013/14 compared to the 2007/08, based on changes to back office and IT managements, collaborative procurement and changes in public sector asset allocation and management. Furthermore, the 2008 Budget launched a Public Value Programme (PVP) that aimed to



identify further savings options for all major areas of public spending, most of which are expected to only accrue in the upcoming CSR period from 2011/12 onwards.

Measuring the success of these ambitious and well-conceived efficiency initiatives will be an important step in demonstrating that they indeed enhance the quality of public finances, rather than just limiting the scale of public spending. In that respect, the announced plans for the National Audit Office to evaluate the 2007 CSR savings should be welcomed. Furthermore, the strong focus under the Public Value Programme on achieving savings in the public health sector of around £10bn per year by 2012/13 appears justified, given that since 2000, spending on the UK National Health Service has increased sharply (real average annual expenditure growth of 10% in the period 2000 to 2007). Although health outcomes have improved, all available indicators (e.g. OECD 2009 Economic Review of the UK) suggest that the productivity of health care provision has fallen.<sup>15</sup> Over the period 2001 to 2006, productivity in the NHS is estimated by the Office of National Statistics to have declined by -1 to -2.5% annually.

## **7. OVERALL ASSESSMENT**

Taking into account risks attached to the budgetary targets discussed above, this section assesses the appropriateness of the fiscal strategy in relation to the Council Recommendations under Article 126(7) of 2 December 2009 with a view to correcting the excessive deficit and the budgetary objectives of the Stability and Growth Pact, against the background of the current economic situation, the debt and long-term sustainability position of the country, and the institutional features of its public finances.

The combination of the operation of automatic stabilisers, falls in asset prices and the fiscal stimulus has provoked a major deterioration in UK public finances. However, budgetary sustainability was further weakened by the fact that UK fiscal deficits were at risk of breaching the 3% reference value already in the period leading up to the crisis. The measures announced, subsequent to the Council recommendation, particularly those in the 2009 Pre-Budget Report of 9 December 2009, implied over the period between 2010/11 and 2012/13 a small fiscal loosening relative to the fiscal plans in the 2009 Budget of April 2009. A restrictive fiscal policy in 2010/11 is appropriate. However, a credible timeframe for restoring public finances to a sustainable position requires substantial additional fiscal tightening measures. The annual average improvement in the structural deficit, as recalculated by the Commission services using the commonly-agreed methodology, between 2010/11 and 2014/15 is estimated at only 1.0% of GDP,  $\frac{3}{4}$  pp. less than recommended by the Council in December 2009. The government deficit in 2014/15 - the deadline set in the December 2009 recommendation for the UK to correct its excessive deficit situation - is projected on a no-policy-change assumption to remain at 4.7% of GDP and it is subject to downside risks.

With the greater part of the projected reduction in the deficit in the medium-term driven by the tight overall spending envelope between 2011/12 and 2014/15, the absence of detailed departmental spending limits to back up those expenditure targets casts a source of uncertainty on the implementation of the UK's fiscal strategy. The achievement of the limited consolidation forecast by the UK authorities is clouded by the likelihood that the macroeconomic context will be less favourable than envisaged by the authorities, as well

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<sup>15</sup> [http://www.oecd.org/document/1/0,3343,en\\_33873108\\_33873870\\_43133249\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/1/0,3343,en_33873108_33873870_43133249_1_1_1_1,00.html)

as the uncertainties related to the banking sector loans and investments insured by government.

Overall the budgetary strategy is not consistent with the Council recommendations under Article 126(7) TFEU of 2 December 2009. The budgetary strategy may also not be sufficient to bring debt back on a downward path. Taking into account the considerable negative risks to the UK fiscal projections and the fact that the debt ratio is expected to exceed 90% of GDP by 2012/13, a more ambitious consolidation plan for the near and medium-term is required.

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## **ANNEX. COMPLIANCE WITH THE FORMAT AND CONTENT REQUIREMENTS FOR STABILITY AND CONVERGENCE PROGRAMMES**

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); It also assesses to what extent the United Kingdom followed up on the Council's recommendation to report on progress made in the correction of the excessive deficit, in a separate chapter of the programme.

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

The 2010 update of the United Kingdom's convergence programme substantially follows the model structure of the table of contents as set out in Annex 1 of the Code of Conduct. While ordering and structure of individual chapters in the programme partly differ from the model structure, almost all sub-sections required by the code of conduct appear in the programme. The only exception to this is the programme's lack of an equivalent of the model structure's chapter 4, which presents sensitivity analysis and a comparison with the previous update.

### **(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:

In table 1a (Macroeconomic prospects), 2008 levels of real GDP and its components are missing, although these are readily and publicly available. More significant is the absence of public consumption and investment deflators for the entire programme period from table 1b (Price developments). 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 some tax revenue components and some of 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. Insufficient detail is provided on potential growth components, but the programme does present a decomposition of the drivers of trend growth, which however does not fully corresponding to the components required in Table 5. No data is provided on the long term sustainability of public finances (Table 7) and there is a substantial lack of data on basic assumptions (Table 8).

As for the provision of optional data, there are 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 ESA95 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>16</sup>

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<sup>16</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 tables on the following pages show the data presented in the January 2010 update of the 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.

**(iv) Separate chapter on progress made in the correction of the excessive deficit**

In its recommendations under Article 126(7) of 2 December 2009 with a view to bringing the excessive deficit situation to an end, the Council also invited the United Kingdom to report on progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit in a separate chapter in the updates of the convergence programmes. The United Kingdom did not comply with this recommendation, in the sense that the programme does not include a chapter that is explicitly dedicated to the UK's response to the Council recommendation of December 2009. However, its chapter on fiscal policy outlines its fiscal strategy for consolidation over the programme period, while the Council recommendations under the ongoing excessive deficit procedure are acknowledged in the programme's introductory chapter.

**(iii) Other information requirements**

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

\* \* \*

The SCP...	Yes	No	Comments
<i>a. Involvement of parliament</i>			
... mentions status vis-à-vis national parliament.	X		
... indicates whether Council opinion on previous programme has been presented to national parliament.		X	
<i>b. Economic outlook</i>			
... (for euro area and ERM II Member States) uses “common external assumptions” on main extra-EU variables.			Not applicable (n.a.)
... explains significant divergences with Commission services' forecasts <sup>1</sup> .		X	
... 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		
<i>d. Budgetary strategy</i>			
... presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		No MTO specified
... (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			n.a.
... (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		Detailed departmental spending plans not provided
... 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.	X		Only reports structural reform measures taken in 2009 National Reform Programme
... includes quantitative cost-benefit analysis of short-term costs and		X	

The SCP...	Yes	No	Comments
long-term benefits of reforms.			
<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	
... (in case of “major structural reforms”) analyses how changes in assumptions would affect budget and potential growth.		X	
<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		EU Member States' age-related expenditure is shown, based on 2009 Ageing Report
<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>Notes: 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>Source:  Commission services</p>			

## Tables from Annex 2 of the code of conduct

Table 1a. Macroeconomic prospects

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1* <sub>g</sub>	<i>n.a.</i>	½	-4¾	1 to 1½	3¼ to 3¾	3¼ to 3¾
<b>2. Nominal GDP</b>	B1* <sub>g</sub>	1448	3½	-3¼	3¾ to 4¼	5 to 5½	5½ to 6
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	<i>n.a.</i>	1	-3	0 to ½	2¾ to 3¼	2¾ to 3¼
<b>4. Government consumption expenditure</b>	P.3	<i>n.a.</i>	2½	2	1¼	-1½	-2
<b>5. Gross fixed capital formation</b>	P.51	<i>n.a.</i>	-3¼	-14¼	-2 to -1½	4¼ to 4¾	8½ to 9
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	<i>n.a.</i>	-½	-1¼	¾	½	0
<b>7. Exports of goods and services</b>	P.6	<i>n.a.</i>	1	-10¾	2 to 2½	4½ to 5	5 to 5½
<b>8. Imports of goods and services</b>	P.7	<i>n.a.</i>	-¾	-12½	½ to 1	1¾ to 2¼	2¾ to 3¼
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>		-	½	-4	¼	2½	3
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	-½	-1¼	¾	½	0
<b>11. External balance of goods and services</b>	B.11	-	½	¾	½	½	½

Table 1b. Price developments

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>		<i>n.a.</i>	3	1½	2¾	1½	2¼
<b>2. Private consumption deflator</b>		109½	2¾	1¾	2	2	2½
<b>3. HICP<sup>1</sup></b>		<i>n.a.</i>	4	2	1¾	1½	2
4. Public consumption deflator		<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. Investment deflator		<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>	12¾	2	¼	¾	1¾
<b>7. Import price deflator (goods and services)</b>		<i>n.a.</i>	11¼	3½	1¾	2¼	2¼

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

**Table 1c. Labour market developments**

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	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>
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>
<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>
<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>
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>
<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>
<b>7. Compensation per employee</b>		<i>n.a.</i>	<i>n.a.</i>	<i>n.a.</i>	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**

% of GDP	ESA Code	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>of which:</i>						
- Balance on goods and services		-2½	-2¼	-2¼	-2	-1½
- Balance of primary incomes and transfers		1	0	¼	0	-¼
- Capital account		<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	3½	8¾	11¼	8	6
3. Net lending/borrowing of general government	EDP B.9	-6.9	-12.6	-12.0	-9.1	-7.3
<b>4. Statistical discrepancy</b>		<i>n.a.</i>	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2008/09	2008/09	2009/10	2010/11	2011/12	2012/13
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
<b>Net lending (EDP B.9) by sub-sector</b>							
<b>1. General government</b>	S.13	-97.8	-6.9	-12.6	-12.0	-9.1	-7.3
<b>2. Central government</b>	S.1311	-93.4	6.5	12.1	11.7	n.a.	n.a.
<b>3. State government</b>	S.1312	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>4. Local government</b>	S.1313	-4.4	-0.3	-0.5	-0.3	n.a.	n.a.
<b>5. Social security funds</b>	S.1314	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>General government (S13)</b>							
<b>6. Total revenue</b>	TR	525.1	36.6	34.8	35.4	n.a.	n.a.
<b>7. Total expenditure</b>	TE <sup>1</sup>	622.9	43.4	47.4	47.4	n.a.	n.a.
<b>8. Net lending/borrowing</b>	EDP B.9	-97.8	-6.9	-12.6	-12.0	-9.1	-7.3
<b>9. Interest expenditure</b>	EDP D.41	31.0	2.2	2.2	3.0	n.a.	n.a.
<b>10. Primary balance<sup>2</sup></b>		n.a.	-4.7	-10.4	-9.0	-5.6	-3.6
<b>11. One-off and other temporary measures<sup>3</sup></b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Selected components of revenue</b>							
<b>12. Total taxes (12=12a+12b+12c)</b>		404.7	28.2	26.5	27.3	n.a.	n.a.
<b>12a. Taxes on production and imports</b>	D.2	167.7	11.7	11.8	12.2	optional	optional
<b>12b. Current taxes on income, wealth, etc</b>	D.5	234.1	16.3	14.5	15.0	optional	optional
<b>12c. Capital taxes</b>	D.91	2.9	0.2	0.2	0.2	optional	optional
<b>13. Social contributions</b>	D.61	96.9	6.8	6.8	6.6	optional	optional
<b>14. Property income</b>	D.4	n.a.	n.a.	n.a.	n.a.	optional	optional
<b>15. Other<sup>4</sup></b>		n.a.	n.a.	n.a.	n.a.	optional	optional
<b>16=6. Total revenue</b>	TR	525.1	36.6	34.8	35.4	n.a.	n.a.
<b>p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)<sup>5</sup></b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Selected components of expenditure</b>							
<b>17. Compensation of employees + intermediate consumption</b>	D.1+P.2	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.
17b. Intermediate consumption	P.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>18. Social payments (18=18a+18b)</b>		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.
18b. Social transfers other than in kind	D.62	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>19=9. Interest expenditure</b>	EDP D.41	31.0	2.2	2.2	3.0	n.a.	n.a.
<b>20. Subsidies</b>	D.3	9.1	0.6	0.7	0.6	n.a.	n.a.
<b>21. Gross fixed capital formation</b>	P.51	33.5	2.3	2.8	2.4	n.a.	n.a.
<b>22. Other<sup>6</sup></b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>23=7. Total expenditure</b>	TE <sup>1</sup>	622.9	43.4	47.4	47.4	n.a.	n.a.
<b>p.m.: Government consumption (nominal)</b>	P.3	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+D.4 (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	2007	2012
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	2008/09	2009/10	2010/11	2011/12	2012/13
<b>1. Gross debt<sup>1</sup></b>		55.5	72.9	82.1	88.0	90.9
<b>2. Change in gross debt ratio</b>		12.2	17.3	9.3	5.8	2.9
<b>Contributions to changes in gross debt</b>						
<b>3. Primary balance<sup>2</sup></b>		-4.7	-10.4	-9.0	-5.6	-3.6
<b>4. Interest expenditure<sup>3</sup></b>	EDP D.41	2.2	2.2	3.0	n.a.	n.a.
<b>5. Stock-flow adjustment</b>		5.9	3.7	0.4	0.6	0.5
<i>of which:</i>						
- Differences between cash and accruals <sup>4</sup>		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.
<i>of which:</i>						
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other <sup>6</sup>		n.a.	n.a.	n.a.	n.a.	n.a.
<b>p.m.: Implicit interest rate on debt<sup>7</sup></b>		5.1	3.9	4.4	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.
<b>7. Net financial debt (7=1-6)</b>		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	2008/09	2009/10	2010/11	2011/12	2012/13
<b>1. Real GDP growth (%)</b>		-1¼	-3½	2	3¼	3¼
<b>2. Net lending of general government</b>	EDP B.9	-6.9	-12.6	-12.0	-9.1	-7.3
<b>3. Interest expenditure</b>	EDP D.41	2.2	2.2	3.0	n.a.	n.a.
<b>4. One-off and other temporary measures<sup>1</sup></b>		n.a.	n.a.	n.a.	n.a.	n.a.
5. Potential GDP growth (%)		n.a.	n.a.	n.a.	n.a.	n.a.
contributions:						
- labour		n.a.	n.a.	n.a.	n.a.	n.a.
- capital		n.a.	n.a.	n.a.	n.a.	n.a.
- total factor productivity		n.a.	n.a.	n.a.	n.a.	n.a.
6. Output gap		-2.0	-6.4	-5.3	-4.3	-3.4
7. Cyclical budgetary component		-1.0	-3.6	-3.9	-3.2	-2.6
8. Cyclically-adjusted balance (2 - 7)		-5.9	-9.0	-8.1	-5.9	-4.7
9. Cyclically-adjusted primary balance (8 + 3)		-3.7	-6.8	-5.0	-2.4	-1.0
10. Structural balance (8 - 4)		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	2008/09	2009/10	2010/11	2011/12	2012/13
<b>Real GDP growth (%)</b>						
<b>Previous update</b>		-¼	-½	2	3	3
<b>Current update</b>		-1¼	-3½	2	3¼	3¼
<b>Difference</b>		-1	-3	0	¼	¼
<b>General government net lending (% of GDP)</b>	EDP B.9					
<b>Previous update</b>		-5.4	-8.1	-7.0	-5.6	-4.4
<b>Current update</b>		-6.9	-12.6	-12.0	-9.1	-7.3
<b>Difference</b>		-1.5	-4.5	-5.0	-3.5	-2.9
<b>General government gross debt (% of GDP)</b>						
<b>Previous update</b>		52.9	60.5	65.1	67.5	68.6
<b>Current update</b>		55.5	72.9	82.1	88.0	90.9
<b>Difference</b>		2.6	12.4	17.0	20.5	22.3

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

% of GDP	2000/01	2005/6	2010/11	2020/21	2030/31	2050/51
Total expenditure	n.a.	n.a.	47.4	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 health care</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.	n.a.	35.4	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**

	2008	2009	2010	2011	2012
Short-term interest rate <sup>1</sup> (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	n.a.	n.a.	n.a.	n.a.	n.a.
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.
EU GDP growth	n.a.	n.a.	n.a.	n.a.	n.a.
Growth of relevant foreign markets	3	-12¼	2½	5½	7¼
World import volumes, excluding EU	n.a.	n.a.	n.a.	n.a.	n.a.
Oil prices (Brent, USD/barrel)	n.a.	n.a.	72.7	73.8	75.3

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