COUNCIL OPINION

of 14 March 2006

on the updated convergence programme of the United Kingdom, 2005/2006-2010/2011

(2006/C 82/13)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 14 March 2006 the Council examined the updated convergence programme of the United Kingdom, covering the period 2005/06 to 2010/11.

(2) Over the last decade, the United Kingdom macroeconomic performance has been impressive in terms of improved stability, growth, low inflation and labour market outturns. Annual real GDP growth averaged 3,25 % in 1996-2000 and 2,25 % in 2001-05. However, after a period of fiscal consolidation between 1996 and 2001, when the general government balance moved from a deficit of around 5 % of GDP to a comfortable surplus, the United Kingdom has implemented a planned large increase of public expenditure including public investment, with the general government balance changing to a deficit of over 3 % of GDP by 2004. Gross debt declined from over 50 % of GDP in 1996 to below 38 % of GDP in 2002, but has been on a slowly growing path since then.

(3) In its opinion of 8 March 2005 on the previous update of the convergence programme, the Council invited the United Kingdom to ensure that the deficit was below 3 % of GDP and to improve the cyclically-adjusted position to ensure that a budgetary position close to balance or in surplus was achieved over the medium term. On 24 January 2006, taking into consideration the information contained in the 2005 update of the convergence programme, the Council decided that the United Kingdom deficit was excessive. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit should be corrected by financial year 2006/07 [2]. Following the expiry of the six-month period foreseen by the recommendation, the Commission is due to carry out an assessment of the progress made by the United Kingdom authorities towards the correction of the excessive deficit.

(4) As regards budgetary implementation in 2005/06, the general government deficit is estimated at 3,4 % of GDP in the Commission services' autumn 2005 forecast, against a projection of 2,8 % of GDP set in the previous update of the convergence programme. The higher than expected deficit is due to lower than expected GDP growth, now estimated at 1,75 % compared to 3 % in the previous update, to base effects stemming from lower than expected outturns for tax receipts in 2004/05 and, to a lesser extent, to some slight discretionary easing.

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

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

(5) The programme broadly follows the model structure, but deviates on some material points from the data provision requirements for stability and convergence programmes specified in the new code of conduct ([1]).

(6) The macroeconomic scenario underlying the budgetary projections envisages real GDP growth to pick up from 1,75 % in 2005/06 to 3 % in 2007/08, and then to dip to 2,75 % in 2008/09 and 2,25 % thereafter. Assessed against currently available information, this scenario appears to be based on broadly plausible growth assumptions with a margin of caution toward the end of the projection horizon. The programme's projections for inflation appear realistic.

(7) The updated programme projects a reduction in the deficit from just above 3 % of GDP in financial year 2005/06 to below the 3 % reference value in 2006/07. Thereafter, the deficit is projected to decline to a level of 1,5 % of GDP by 2010/11. The general government primary balance, estimated as a deficit of 1,0 % of GDP in 2005/06, returns to balance in 2008/09 and reaches a surplus of 0,5 % of GDP by 2010/11. The improvement in the nominal balance is mainly driven by a pick-up of revenues, partly due to the projected cyclical recovery of the economy, and partly to an increase in the tax to GDP ratio. The updated programme foresees a small discretionary fiscal tightening in 2006/07 and 2007/08 which is expected to be permanent. The expenditure ratio is projected to increase until 2007/08, driven by a planned increase in expenditure on public services and in public investment. *Net public sector* investment (including capital grants to the private sector) is planned to rise from 1,6 % of GDP in 2004/05 to 2¼ % of GDP by 2006/07, and then remain constant as a percentage of GDP. After 2007/08, current expenditure growth is planned to slow significantly. Thus by 2008/09 the deficit is projected to be entirely used to fund public investment. Compared with the 2004 update, the deficit projections for 2005/06 and 2006/07 have been revised upwards in line with economic developments, while over the medium term they converge to the profile in the previous update.

(8) Calculated according to the commonly agreed methodology, the programme envisages an average annual improvement of the structural balance (i.e. in cyclically-adjusted terms and net of one-off and other temporary measures) of just above 0,25 percentage points of GDP from an estimated structural deficit of just below 3 % of GDP in 2005/06. This adjustment is front-loaded in 2006/07, when the excessive deficit is planned to be corrected and the negative output gap is at its widest, but slows thereafter, when the negative output gap narrows. A quantitative medium-term objective (MTO) for the structural balance of the general government is not specified. The programme refers to fiscal objectives under the domestic rules, which imply a medium-term path for the cyclically-adjusted deficit, consistent with stabilising the debt-to-GDP ratio at a low level and with keeping the current budget in balance or surplus on average over the economic cycle.

(9) The budgetary outcome could be worse than projected in the programme, especially in the short term. The projected recovery of the tax to GDP ratio, and in particular of corporation tax revenues, presents risks, to the extent that it depends on an assumption of positive developments in the financial sector that continue into the next year and are not subsequently reversed. On the expenditure side, after the projected rise until 2007/08, the programme update projects a fall in the expenditure ratio after 2007/08 below the levels in 2005/06 that may be challenging. Given existing policy

([1]) In particular, the section on institutional features of the public finances is missing. The programme has gaps in the provision of compulsory data (for example, the forecasts for employment, unemployment and compensation of employees, and the breakdown of expenditure for the last year required are not provided), and does not provide all optional data. Data for general government expenditure and receipts, while based on ESA 95 components, use different aggregation methods from the harmonised measure. The programme update also continues the UK practice of accounting receipts from the sale of UMTS licences as an annual income stream rather than the sale of an asset, contrary to the Eurostat decision of 14 July 2000 on the allocation of such receipts. A number of data gaps have been filled through bilateral discussions between the Commission services and UK officials.

commitments, reducing the expenditure to GDP ratio implies significantly slower current expenditure growth, probably particularly marked in some areas. The comprehensive reassessment of public expenditure being planned in the 2007 Comprehensive Spending Review should help identify areas where public expenditure growth should be reduced. In 2009/10 and 2010/11 these negative risks may be partly offset, principally on the revenue side, by a projection for economic growth that seems to have a margin of caution.

(10) With regard to the correction of the excessive deficit, the programme, which was published before the Council recommendation under Article 104(7), projects the deficit to drop below the reference value in 2006/07, while the Commission services estimated at the time of the Council recommendation that, even after the discretionary measures announced in the December 2005 Pre-Budget Report, the deficit is likely to remain slightly above 3 %. Progress towards the correction of the excessive deficit will be assessed by the Commission following the expiry of the six months deadline. On the basis of the minimum benchmark (estimated at a cyclically-adjusted deficit of just below 1,5 % of GDP), the budgetary strategy does not seem, except possibly at the very end of the programme period in 2010/11, to provide a sufficient safety margin against breaching, within normal macroeconomic fluctuations, the 3 % of GDP reference value which the UK is under the obligation to endeavour to avoid. However, projected balances are affected by the implementation of the programme of public investment mentioned above. Following the planned correction of the excessive deficit in 2006/07, the projected structural adjustment slows, when the output gap, despite remaining negative, is set to narrow and developments in tax elasticities are relatively favourable. This suggests that the adjustment path could be strengthened.

(11) The gross debt ratio, though remaining well below the Treaty reference value of 60 % of GDP, is projected to slowly rise over the projection period, peaking at just below 45 % of GDP in 2007/08 from a level of around 41 % in 2004/05. Thereafter the debt ratio is expected to decline slightly.

(12) With regard to the sustainability of public finances, in combination with an increase in the cost of ageing, the possibility of insufficient provision of private pensions increasing fiscal costs would put the United Kingdom at medium risk, unless changes are made to improve fiscal sustainability. Over the period until 2050, a contained rise in public pension expenditure is projected. However, higher age-related expenditure pressures cannot be excluded as there is a possibility of insufficient provision of private pensions. Pension policy is currently under review and the government's response to the November 2005 Pensions Commission report is expected in spring this year. The currently favourable debt position contributes to limit somewhat the budgetary impact of ageing populations; however, gross debt is projected to go above the 60 % of GDP reference value during the projection period to 2050 if, compared to the structural budgetary position in 2005/06, no further budgetary consolidation takes place during the programme period. Improving the structural balance of government finances over the medium term would contribute to reducing risks to public finance sustainability ([1]).

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. The current level of the government debt ratio is still relatively low but the deficit is excessive and remains to be corrected, with further consolidation required to stabilise the debt ratio. It is welcome that general pension provision is under review in order to ensure its accessibility, financial viability and social adequacy. Furthermore, the programme envisages measures to improve the quality of public finances, including a drive to improve effectiveness of public expenditure through better asset management, relocation of civil service positions and a reduction in public sector workforce headcount.

([1]) Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

(14) The National Reform Programme of the United Kingdom, submitted on 13 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: maintaining fiscal sustainability in the face of demographic challenges; promoting innovation and R&D; widening opportunities for the acquisition of skills; ensuring fairness through a modern and flexible welfare system; and increasing innovation and adaptability in the use of resources. The budgetary implications of the actions outlined in the National Reform Programme are fully reflected in the budgetary projections of the convergence programme. The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the National Reform Programme.

In view of the above assessment, the Council notes that the projected adjustment path is subject to risks. In the light of the recommendations under Article 104(7), and in order to address the risks to long-term sustainability, the Council invites the United Kingdom to:

(i) ensure that the deficit is brought below 3 % of GDP by 2006/07 in a credible and sustainable manner, and pursue budgetary consolidation thereafter, especially by implementing the projected reduction in expenditure growth after 2007/08;

(ii) attain a medium-term objective that ensures rapid progress towards sustainability and a prudent debt ratio well below 60 % of GDP, provides a sufficient safety margin against breaching the 3 % of GDP deficit reference value which the UK is under the obligation to endeavour to avoid, and allows room for budgetary manoeuvre, in particular taking into account the need for public investment.

Comparison of key macroeconomic and budgetary projections

		2004/05	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**
Real GDP (% change)	**CP Dec 2005** (1)	**2,75**	**1,75**	**2,25**	**3**	**2,75**	**2,25**	**2,25**
	COM Nov 2005 (2)	3,2	1,6	2,3	2,8	n.a.	n.a.	n.a.
	CP Dec 2004 (1)	*3,25*	*3*	*2,50*	*2,25*	*2,25*	*2,25*	*n.a.*
HICP inflation (%)	**CP Dec 2005** (1)	**1,25**	**2,25**	**2**	**2**	**2**	**2**	**2**
	COM Nov 2005 (2)	1,3	2,4	2,2	2,0	n.a.	n.a.	n.a.
	CP Dec 2004	*1,25*	*1,75*	*2*	*2*	*2*	*2*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2005** (3)	**0,5**	**– 0,5**	**– 1,0**	**– 0,8**	**– 0,5**	**– 0,6**	**– 0,6**
	COM Nov 2005 (4)	0,6	– 0,5	– 0,9	– 0,8	n.a.	n.a.	n.a.
	CP Dec 2004 (3)	*– 0,2*	*0,2*	*0,0*	*– 0,2*	*– 0,3*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Dec 2005** (5)	**– 3,3**	**– 3,1**	**– 2,8**	**– 2,4**	**– 1,9**	**– 1,7**	**– 1,5**
	COM Nov 2005 (6)	– 3,3	– 3,4	– 3,2	– 3,0	n.a.	n.a.	n.a.
	CP Dec 2004 (5)	*– 2,9*	*– 2,8*	*– 2,3*	*– 2,1*	*– 1,7*	*– 1,6*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2005** (7)	**– 1,3**	**– 1,0**	**– 0,7**	**– 0,3**	**0,1**	**0,4**	**0,5**
	COM Nov 2005 (2)	– 1,5	– 1,3	– 1,1	– 0,8	n.a.	n.a.	n.a.
	CP Dec 2004 (7)	*– 0,8*	*– 0,7*	*– 0,2*	*– 0,1*	*n.a*	*n.a.*	*n.a.*

		2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Cyclically-adjusted balance = Structural balance (8) (9) (% of GDP)	**CP Dec 2005** (3) (5)	**– 3,5**	**– 2,9**	**– 2,3**	**– 2,1**	**– 1,7**	**– 1,5**	**– 1,3**
	COM Nov 2005 (4)	– 3,4	– 3,2	– 2,9	– 2,7	n.a.	n.a.	n.a.
	CP Dec 2004	*– 2,8*	*– 2,9*	*– 2,3*	*– 2,0*	*– 1,6*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2005**	**40,9**	**43,3**	**44,4**	**44,8**	**44,7**	**44,6**	**44,4**
	COM Nov 2005	40,8	42,7	43,7	44,5	n.a.	n.a.	n.a.
	CP Dec 2004	*40,9*	*41,8*	*42,4*	*42,8*	*42,8*	*42,6*	*n.a.*

Notes:

(1) GDP and inflation forecast underlying the authorities' projections for the public finances; derived from a scenario whereby trend growth is one-quarter percentage point higher.

(2) Commission services' forecast is on a calendar year basis. According to first estimates, growth was 1.8% in 2005. The Commission services' interim forecast of 22 February 2006 projects growth of 2.4% in 2006.

(3) Output gap calculations according to the commonly agreed methodology on the basis of data provided in the convergence programme. The output gap calculations are based on the data underlying the central trend growth scenario. Under the UK methodology, the two yield the same output gap profile.

(4) Commission services' calculation of output gap is on a calendar year basis.

(5) Figures in the convergence programme adjusted for treatment of UMTS receipts. The UK authorities include, in their projections for the general government balance, annual receipts of around £1.0 billion from the sale of UMTS licences in 2000. Adjusting for this, to bring the projections onto to an EDP basis, has the effect of subtracting around 0.1 pp from the balance (i.e. increasing the deficit) in each year. All data shown in this table are given after this adjustment, made by the Commission services, to the data in the programme.

(6) Commission services' forecast is before discretionary measures announced in the December 2005 Pre-Budget Report and included in the convergence programme. Adding the net impact of the measures as estimated by the UK authorities, the Commission services' forecast would be a deficit at 3.4% of GDP in 2005/06, 3.1% in 2006/07 and 2.8% in 2007/08.

(7) Data from the convergence programme adapted in line with a definition of the primary balance using gross rather than net interest payments.

(8) Cyclically-adjusted balance (calculated according to the commonly agreed methodology) excluding one-offs and other temporary measures. The figures for cyclically adjusted and structural balances published in the programme, calculated according to the UK's own methodology, and based on nominal balances not corrected for the treatment of UMTS receipts, are: -2.9% of GDP in 2004/05, -2.2% in 2005/06, -1.7% in 2006/07, -1.7% in 2007/08, -1.7% in 2008/09, -1.6% in 2009/10, -1.5% in 2010/11.

(9) There are no one-offs and temporary measures in the convergence programme projections and in the Commission services' forecast.

Source:

Convergence programme (CP), Commission services' calculations, Commission services' (COM) autumn 2005 forecast.