

COUNCIL OPINION
of 12 February 2008
on the updated convergence programme of the United Kingdom, 2007/2008-2012/2013
(2008/C 49/07)

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 12 February 2008, the Council examined the updated convergence programme of the United Kingdom, which covers the period from financial year 2007/2008 to financial year 2012/2013 ⁽²⁾.
- (2) The United Kingdom economy has displayed robust and remarkably stable growth over the last ten years and in 2007 grew at a rate above potential, though with building imbalances including low household saving and a wider external deficit. Favourable growth conditions have, however, been accompanied by a deterioration in the general government deficit in the current financial year, 2007/2008. After a general government deficit in 2006/2007 of 2,6 % of GDP, the deficit is envisaged in the programme to reach around 3 % of GDP in 2007/2008, with no margin to the reference value.

Furthermore, there are risks of a further deterioration in economic prospects following the financial market turmoil and a weakening in the housing market in the second half of 2007. This points towards a near-term economic slowdown. Looking ahead, this could constrain revenue growth, reinforcing the need for expenditure restraint if the United Kingdom is to achieve an improvement in the fiscal balance. The recent relatively rapid exchange rate depreciation could also raise inflationary pressures. Particular macroeconomic risks relate to a markedly more abrupt slowdown in housing market activity, which could dampen private consumption growth, and a larger-than-expected weakening in financial services growth and employment.

- (3) The programme contains two macroeconomic scenarios: a central scenario and an alternative scenario based on trend growth one quarter of a percentage point lower than the central view. The public finances projections are based on the alternative scenario, which is designed to be more cautious than the central scenario. Both scenarios assume some feed-through to tighter credit conditions as a result of recent financial market disruption. The alternative scenarios considered the reference scenario in the assessment of the updated programme. This scenario envisages a slowdown in economic growth from 3,0 % in 2007/2008 to 2,0 % in 2008/2009. In 2009/2010, the programme expects growth to gather pace again, rising to 2,75 %. Assessed against currently available information ⁽³⁾, including increasing prospects of a significant downturn in the housing market and protracted financial market difficulties, this scenario appears to be based on growth assumptions that are favourable until 2009/2010 and plausible thereafter. The programme's projections for inflation in

⁽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://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

⁽²⁾ The UK financial year runs from April to March.

⁽³⁾ This assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

the short term also appear to be on the low side, primarily due to its assumption on oil prices next year. However, the near-term prospect of activity levels depressed relative to potential should lead to a subsequent moderation in inflation, which should preserve price stability.

- (4) For 2007/2008, the general government deficit is estimated at 3,0 % of GDP in the Commission services' autumn 2007 forecast, against an estimate of 2,3 % of GDP set in the previous update of the convergence programme. The structural deficit, defined as the cyclically-adjusted budget balance calculated according to the commonly agreed methodology, net of one-off and other temporary measures, will be higher by 0,5 % of GDP than in the previous financial year. The deterioration in the budgetary position has primarily resulted from lower than expected receipts from corporate taxation; though compared with the previous programme a deficit-increasing national accounts reclassification should be noted of around 0,25 % of GDP per annum. More recent information, including in-year data on central government revenues, implies a clear risk that the deficit will be higher in 2007/2008, thus exceeding the reference value. In this context, the expected deterioration in the public finances is not in line with the pursuit of consolidation recommended in the Council opinion of 27 February 2007 on the previous update of the convergence programme ⁽¹⁾.
- (5) The update does not specify a quantitative medium-term objective (MTO) for the budgetary position. The programme presents projections on a no-policy-change basis and envisages a gradual reduction in the general government deficit. In 2008/2009, the deficit-to-GDP *ratio* is projected to be slightly lower than in the previous year. During the same year, the structural deficit is estimated to improve by about 0,3 percentage points. The primary deficit is expected to edge upwards as the rise in primary expenditure is only partly offset by a drop in interest payments. Subsequently, the programme forecasts a reduction in the general government deficit by 0,5 p.p. in 2009/2010 and by an average of 0,25 p.p. per annum during the following three financial years. The primary balance is expected to improve from a deficit of 0,9 % of GDP in 2008/2009 to balance in 2010/2011. Over the programme period, an increase in the revenue-to-GDP *ratio* and a drop in the expenditure *ratio* are expected to contribute around three-fifths and two-fifths of the adjustment, respectively. The increase in the revenue *ratio* is evenly spread through the programme period, with fiscal drag on personal income taxation and, to a lesser extent, already announced measures contributing to higher revenues.

On the expenditure side, the spending envelope set out in the 2007 Comprehensive Spending Review (CSR) implies a significant drop in annual average expenditure growth between 2008/2009 and 2010/2011 when compared to the annual average during the preceding 10 years. Departments have already made good progress against efficiency targets in the SR04 period (ending 2007/2008) and have set out publicly a summary of proposed savings for the CSR period. However, in 2008/2009, total expenditure is still expected to grow more rapidly than nominal GDP, contributing to an increase in the deficit *ratio*. Compared with the previous programme, though partly reflecting the national accounts reclassification referred to above, the new update projects a weaker budgetary outlook, particularly in the early years of the programme period. The gross debt *ratio* is set to remain well under the reference value of 60 % of GDP, even if projected to be on a rising trend until 2010/2011.

- (6) The budgetary outcomes could be worse than projected in the programme, especially due to lower tax revenues and the possible materialisation of liabilities as a result of a deeper and more prolonged downturn in financial sector activity. Tax-rich expenditures, especially household consumption, could also be particularly depressed by an extended period of housing market adjustment. A deficit overrun in 2007/2008 arising from the revenue side could extend also into a higher deficit in 2008/2009. Given the risks attending macroeconomic performance in 2008, the convergence programme's assumption that in 2009/10 the UK economy will swiftly recover to potential growth appears optimistic and thus carries a risk that the deficit will be higher than projected. Meanwhile, the sharp slowdown in expenditure growth that is targeted in the latest CSR is accompanied by objectives for considerable efficiency gains in the provision of public services, which, if not achieved, could trigger pressures for higher expenditure than set out in the CSR. The projections for 2011/2012 and 2012/2013, subsequent to the forthcoming CSR period, assume continued moderate growth in expenditure but are beyond the detailed departmental spending plans set up for the preceding years.

⁽¹⁾ OJ C 72, 29.3.2007, p. 20.

- (7) In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure the limited consolidation foreseen in the programme. There is a clear risk that the deficit will be higher in the near term, thus breaching the reference value. A deficit level that provides a safety margin against breaching the 3 % of GDP deficit threshold with normal economic fluctuations (estimated at 1,5 % of GDP) is unlikely to be achieved within the programme period. The pace of fiscal consolidation should be strengthened over the programme period.
- (8) The United Kingdom appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is close to the EU average, with pension expenditure showing a somewhat more limited increase than on average in the EU, in part as a result of the fact that the United Kingdom relies relatively more on private pension arrangements than do other EU countries. The 2007 reforms, addressing the concern of potentially inadequate future pension provision, are likely to involve a somewhat higher increase in age-related expenditure. The budgetary position in 2007 as estimated in the programme, which is significantly worse than the starting position of the previous programme, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Achieving high primary surpluses would contribute to reducing risks to the sustainability of public finances.
- (9) The convergence programme appears to be consistent with the September 2007 implementation report of the national reform programme. In particular, both programmes integrate the 2007 Comprehensive Spending Review, including the gradual implementation of the government's objectives to increase efficiency and value for money in public service provision. The direct budgetary implications of important reform elements highlighted in the implementation report of the national reform programme, including the increase in the value and coverage of the State-pension as well as recent initiatives taken to increase housing supply, promote R&D and innovation and raise the skill levels in the workforce, have been taken into account in the budgetary projections of the convergence programme.
- (10) The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines in the area of budgetary policies issued in the context of the Lisbon strategy.
- (11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme continues to have substantial gaps in the required and optional data ⁽¹⁾, with no evidence of improvement in response to the Council's previous invitation in this regard.

The overall conclusion is that the programme confirms a significant deterioration in the United Kingdom's budgetary position that, coupled with a probably weaker macroeconomic context than envisaged, carries a clear risk that general government deficit will breach the 3 % of GDP deficit reference value in the near term. While the programme envisages some fiscal tightening from 2008/2009 through a progressive increase in tax revenues and a reduction in previously rapid growth in current expenditure, there are risks to the achievement of this consolidation. These primarily stem from the deterioration in macroeconomic prospects and risks to the achievements of spending targets. The projected speed of consolidation is itself unambitious. The debt *ratio* remains significantly below the 60 per cent of GDP reference value, increasing slightly before falling from 2010/2011 onwards only. The long-term sustainability of United Kingdom public finances has deteriorated when compared to the previous programme, mainly due to the deterioration of the starting position, although the United Kingdom remains at medium risk.

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

- (i) implement measures necessary for the deficit not to exceed the reference value of 3 per cent of GDP;
- (ii) strengthen the pace of fiscal improvement over the programme period, which would also address the increased risks to the long-term sustainability of the public finances.

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

⁽¹⁾ In particular, the data on projections for employment, unemployment, wage inflation and a detailed breakdown of general government revenue and expenditure on a harmonised ESA 95 basis are not provided.

Comparison of key macroeconomic and budgetary projections

		2006/ 2007	2007/ 2008	2008/ 2009	2009/ 2010	2010/ 2011	2011/ 2012	2012/ 2013
Real GDP (% change)	CP Nov 2007 ⁽¹⁾	3	3	2	2,75	2,5	2,5	2,5
	COM Nov 2007	3	3	2	2,5	n.a.	n.a.	n.a.
	CP Dec 2006 ⁽¹⁾	2,75	2,75	2,5	2,5	2,5	2,5	n.a.
HICP inflation (%)	CP Nov 2007 ⁽¹⁾	2,5	2,25	2	2	2	2	2
	COM Nov 2007 ⁽²⁾	2,3	2,4	2,2	2	n.a.	n.a.	n.a.
	CP Dec 2006 ⁽¹⁾	2,5	2	2	2	2	2	n.a.
Output gap ⁽³⁾ (% of potential GDP)	CP Nov 2007 ⁽¹⁾	- 0,1	0	- 0,5	- 0,3	- 0,4	- 0,4	- 0,3
	COM Nov 2007 ⁽³⁾ ⁽⁴⁾	- 0,3	- 0,1	- 0,4	- 0,6	n.a.	n.a.	n.a.
	CP Dec 2006 ⁽¹⁾	- 0,6	- 0,6	- 0,6	- 0,5	- 0,4	- 0,3	n.a.
General government balance ⁽⁵⁾ (% of GDP)	CP Nov 2007	- 2,6	- 3	- 2,9	- 2,4	- 2,1	- 1,8	- 1,6
	COM Nov 2007	- 2,6	- 3	- 3	- 2,7	n.a.	n.a.	n.a.
	CP Dec 2006	- 2,8	- 2,3	- 1,9	- 1,7	- 1,6	- 1,4	n.a.
Primary balance ⁽⁵⁾ (% of GDP)	CP Nov 2007	- 0,4	- 0,8	- 0,9	- 0,3	0	0,3	0,5
	COM Nov 2007	- 0,5	- 1	- 1	- 0,7	n.a.	n.a.	n.a.
	CP Dec 2006	- 0,6	- 0,2	0,1	0,3	0,5	0,7	n.a.
Cyclically-adjusted balance ⁽³⁾ ⁽⁵⁾ (% of GDP)	CP Nov 2007	- 2,5	- 3	- 2,7	- 2,3	- 1,9	- 1,6	- 1,5
	COM Nov 2007	- 2,5	- 2,9	- 2,8	- 2,4	n.a.	n.a.	n.a.
	CP Dec 2006	- 2,5	- 2,1	- 1,7	- 1,5	- 1,4	- 1,3	n.a.
Structural balance ⁽⁶⁾ (% of GDP)	CP Nov 2007	- 2,5	- 3	- 2,7	- 2,3	- 1,9	- 1,6	- 1,5
	COM Nov 2007	- 2,5	- 2,9	- 2,8	- 2,4	n.a.	n.a.	n.a.
	CP Dec 2006	- 2,5	- 2,1	- 1,7	- 1,5	- 1,4	- 1,3	n.a.
Government gross debt ⁽⁷⁾ (% of GDP)	CP Nov 2007	43,4	43,9	44,8	45,1	45,3	45,2	44,9
	COM Nov 2007	42,6	43,3	44,5	45,2	n.a.	n.a.	n.a.
	CP Dec 2006	43,7	44,1	44,2	44,2	44	43,6	n.a.

Notes:

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

(2) On a calendar-year basis. Numbers reported in 2006/2007 column refer to the 2006 calendar year.

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

(4) Based on estimated potential growth of 2,9 %, 2,8 %, 2,6 % and 2,6 % respectively in the period 2006-2009.

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

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

(7) Figures in the convergence programmes derived using GDP excluding the FISIM adjustment, which raises the debt ratio by about 0,8 percentage points when compared to the Commission services' autumn 2007 forecast.

Sources:

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