



EUROPEAN COMMISSION
Directorate-General
Economic and Financial Affairs

Brussels, 27 May 2015

**Assessment of the 2015 Convergence Programme for
UNITED KINGDOM**

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION.....	3
2. MACROECONOMIC OUTLOOK.....	3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS.....	5
3.1. Deficit developments in 2014	5
3.2. Projection for 2015 and medium-term strategy.....	5
3.3. Debt developments.....	8
3.4. Risk assessment.....	10
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT	12
5. LONG-TERM SUSTAINABILITY	15
6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES.....	17
6.1. Fiscal framework	17
6.2. Quality of public finances.....	17
7. CONCLUSIONS.....	18
ANNEX.....	18

1. INTRODUCTION

This document assesses United Kingdom's April 2014-15 Convergence Programme (hereafter called Convergence Programme), which was submitted to the Commission on 26 March 2015 and covers the period 2014-15 to 2019-20. It was approved by the government and presented to the national parliament for a debate without a vote. The parliament is, however, required to approve the government's assessment of the UK's medium-term economic and budgetary position, which forms the basis of the Convergence Programme. The content of the UK Convergence Programme is based on Budget 2015 and Autumn Statement 2014, combined with the Office for Budget Responsibility's 2015 Economic and fiscal outlook and 2014 Fiscal sustainability report.

The UK is currently subject to the corrective arm of the Stability and Growth Pact. The Council opened the Excessive Deficit Procedure for the UK on 2 December 2009. The UK's recommendation is to correct the excessive deficit by 2014-15. This has not been achieved within the set deadline. A new recommendation of the Commission of 13 May 2015 proposes to the Council a two-year extension of the deficit correction period by 2016-17 at the latest. The year following the correction of the excessive deficit, the UK will be subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. As the debt ratio in 2014-15 is estimated at 88.4% of GDP, exceeding the 60% of GDP reference value, in the three years following the correction of the excessive deficit, the UK will also be subject to the transitional arrangements as regards compliance with the debt criterion, during which time it should ensure sufficient progress toward compliance.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence Programme. Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

The UK economy grew by 2.8% in 2014, according to the latest estimate. The macroeconomic scenario in the Convergence Programme projects a slight weakening in economic growth to 2.5% in 2015 and 2.3% in 2016, which is in line with the Commission 2015 spring forecast of 2.6% and 2.4%.

Private consumption is set to be the major growth driver in the programme, growing at 2.6% and 2.7% in 2015 and 2016, respectively. Investment is expected to increase by 4.3% and 6.2% over the two years owing to low borrowing costs, healthy profits and an increasingly resilient financial sector. This is similar to the Commission spring forecast with domestic demand being the main driver of growth.

Net trade is forecast to detract from growth, amidst an acceleration in both exports and imports in 2015 and 2016. The programme foresees a substantial acceleration in export volumes in 2015 as compared to a more subdued performance in the Commission forecast. However, this is balanced with stronger import growth such that, overall, net exports are projected to have a similar impact to growth in both the programme and the Commission forecast. Nevertheless, given the strong appreciation of sterling, there are some downward risks to this part of the programme assumptions.

The output gaps as recalculated by the Commission based on the information in the programme suggest that the economy is expected to be close to its potential over the forecast horizon.¹ The output gap is expected to be closed in 2015 and the economy is set to perform slightly above its potential over the medium-term horizon.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018	2019
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	2.8	2.6	2.6	2.5	2.4	2.3	2.3	2.3	2.4
Private consumption (% change)	2.5	2.0	2.6	2.6	2.6	2.7	2.5	2.3	2.2
Gross fixed capital formation (% change)	7.8	6.8	5.6	4.3	5.5	6.2	5.6	5.7	4.4
Exports of goods and services (% change)	0.6	0.4	1.7	3.9	2.9	4.0	4.5	4.4	4.3
Imports of goods and services (% change)	2.2	1.8	2.7	4.0	3.2	4.8	4.6	4.6	4.4
<i>Contributions to real GDP growth:</i>									
- Final domestic demand	3.2	2.7	2.8	2.5	2.6	2.7	2.5	2.5	2.5
- Change in inventories	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.5	-0.5	-0.3	-0.1	-0.1	-0.4	-0.2	-0.2	-0.2
Output gap ¹	-1.0	-0.9	0.0	-0.2	0.7	0.1	0.3	0.3	0.3
Employment (% change)	2.3	2.3	1.2	1.4	0.8	0.8	0.5	0.5	0.5
Unemployment rate (%)	6.1	6.2	5.4	5.3	5.3	5.2	5.3	5.3	5.3
Labour productivity (% change)	0.5	0.3	1.3	1.1	1.6	1.5	1.9	1.9	1.8
HICP inflation (%)	1.5	1.5	0.4	0.2	1.6	1.2	1.7	1.9	2.0
GDP deflator (% change)	1.7	1.8	1.5	1.6	1.7	1.1	1.5	1.9	2.5
Comp. of employees (per head, % change)	1.5	0.9	2.4	2.8	2.8	3.3	3.5	3.7	4.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)*	-5.4	-5.3	-4.8	-4.1	-4.0	-3.0	-2.6	-2.5	n.a.
<u>Note:</u>									
¹ In percent of potential GDP, with potential GDP growth recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.									
*CP data in financial years, starting in the first year of the heading									
<u>Source:</u>									
Commission 2015 spring forecast (COM); Convergence Programme (CP).									

¹ There are no important differences between the programme's recalculated output gaps and the output gaps as presented in the programme itself. The recalculation figures show a closure of the output gap in 2015 as opposed to 2016 in the programme but the margin of deviation is small. Both the recalculated and programme numbers show a positive output gap of 0.3% in 2017 and 2018.

The macroeconomic scenario underpinning the programme's budgetary projections is plausible and broadly consistent with the Commission 2015 spring forecast. The contribution of domestic demand to growth is similar to the Commission expectations and risks to both consumption and investment projections appear broadly balanced.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2014-15

According to the programme, the general government deficit is expected to have fallen to 5.2% of GDP in 2014-15 from 5.9% of GDP in 2013-14, 0.2 pp above the 5.0% of GDP projection in the previous Convergence Programme. Both revenue and expenditure ratios turned out higher than the projections in the previous year's Convergence Programme. The higher revenues are explained by higher receipts from current taxes on income and wealth, along with higher social contributions. In the case of expenditure, the difference is explained by higher primary expenditure, namely capital spending. There is no material impact of unscheduled one-off measures in 2014-15. This is identical to the Commission 2015 spring forecast estimate.

3.2. Projection for 2015-16 and medium-term strategy

The projection for 2015-16

The budgetary forecast in the Convergence Programme is -4.3% of GDP in 2015-16; 0.3 pp higher than the deficit in the previous Convergence Programme. This is largely due to higher capital spending, a slightly lower nominal growth rate and the higher rate from the previous period. The Commission forecasts the headline balance at -4.1% of GDP in 2015-16. This small difference relates to higher nominal GDP growth in the Commission forecast.

The structural balance is estimated at -4.2% of GDP in 2015-16 in the Commission spring forecast. The structural balance, according to the programme as recalculated by the Commission using the commonly agreed methodology, is identical in 2015-16 at -4.2% although the output gaps differ by 0.2 pp, with the output gap fully closed in 2015 under the Commission estimates.

The measures underpinning the 2015-16 forecast in the Convergence Programme include actions to reduce tax avoidance and evasion, an increase in the bank levy to 0.21%, a reduction in the main corporate tax rate to 20% and an increase in the personal income tax allowance to GBP 10,600. In 2015-16, departmental spending will also be cut. All measures have been specified although the details of the department spending cuts will be outlined in the next Spending Review.

The medium-term strategy

The forecast from the Convergence Programme is a deficit of 2.2% of GDP in 2016-17; 0.2 pp lower than the deficit in the previous year's programme. This is primarily due to increased revenues and lower expenditure, largely owing to lower interest expenditure, although capital spending is now larger than foreseen one year earlier. The Commission

forecasts the headline balance at -2.7% of GDP in 2016-17. A small part of the higher deficit of 0.5 pp is explained by a lower growth forecast. In addition, the Commission projects that government consumption will rise more than projected by the programme, given upward revisions in the past, and lower GDP growth in 2016-17.

The Commission spring forecast estimates the structural balance at -3.2% of GDP in 2016-17. According to the programme, the recalculated structural balance is much smaller at -2.3%. The difference between the two of 0.5 pp. is explained by the difference in the nominal balance. The remainder stems from a substantially higher potential growth underlying the convergence programme compared with the Commission spring forecast. While the convergence programme sees the output gap for 2016-17 change by only 0.3 pp, the Commission projects it to move up by 0.7 pp in spite of a lower growth. Consequently, the difference in the structural balance is higher than that of the nominal balance.

The aim of the Convergence Programme, as set out in the updated Charter for Budget Responsibility in December 2014, is to balance the cyclically-adjusted current budget (excluding investment spending) by the end of the third year of a five-year forecast period, currently ending in 2019-20. This is the so-called fiscal mandate. There is also a supplementary target for public sector net debt to fall as a share of GDP in 2016-17. The Office for Budget Responsibility forecasts that the government will meet both the fiscal mandate and the supplementary debt target, with the latter being reached one year earlier in 2015-16.

The Convergence Programme does not plan to bring the deficit below the 3% of GDP reference value by the 2014-15 deadline set by the Council². It also does not include a medium-term objective (MTO) as foreseen by the Stability and Growth Pact. At the same time, the mandate for fiscal policy, introduced in April 2011 and updated in 2014, is a step forward towards compliance with the Stability and Growth Pact objectives, as it is designed to bring the fiscal position close to balance over the medium term in 2018-19.

The time profile of the budgetary adjustment is gradual, bringing the headline deficit from 4.3% of GDP in 2015-16 to a surplus of 0.1% in 2019-20. The current programme budgetary forecasts are not significantly different from the forecast in the previous programme. The deficit is forecast at a slightly higher level in 2015-16 but at slightly lower rates in the years thereafter. The previous programme envisaged a balancing of the books by 2018-19, but some small loosening of the fiscal constraints was announced such that the surplus is now forecast one year later in 2019-20. The forecast change in the structural balance is greater than the 0.5% benchmark every year.

The envisaged consolidation is sufficiently supported by measures in the programme and does not rely on unspecified measures. As the revenue share of GDP is forecast to stay constant around 36% of GDP, the adjustment is expected to be driven by lower expenditures, going down from almost 40% of GDP in 2015-16 to 36% of GDP in 2018-19. Both primary expenditures and social expenditures are expected to decline as a share of GDP, while gross fixed capital formation will remain broadly constant.

² In April 2015, the UK has notified to Eurostat fiscal data for the calendar year 2014, thus implying that the 2014/15 financial year data (the relevant data for implementation of the EDP) are reported as planned (by including only three quarters of validated outcome data).

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014-15	2015-16		2016-17		2017-18	2018-19	2019-20	Change: 2014-15 - 2019-20
	COM	COM	CP	COM	CP	CP	CP	CP	CP
Revenue	38.9	38.8	35.5	39.0	36.1	36.0	36.0	36.0	-2.9
<i>of which:</i>									
- Taxes on production and imports	13.0	13.2	12.7	13.5	12.6	12.5	12.5	12.5	-0.5
- Current taxes on income, wealth, etc.	14.0	13.8	11.7	13.7	12.0	12.1	12.2	12.3	-1.7
- Social contributions	7.7	7.7	6.0	7.7	6.4	6.4	6.4	6.4	-1.3
- Other (residual)	4.2	4.1	5.1	4.2	5.1	5.0	4.9	4.8	0.6
Expenditure	44.1	43.0	39.9	41.7	38.3	36.9	36.0	35.9	-8.2
<i>of which:</i>									
- Primary expenditure	41.4	40.3	37.4	39.1	35.7	34.1	33.3	33.3	-8.1
<i>of which:</i>									
Compensation of employees	9.4	9.1	n.a.	8.8	n.a.	n.a.	n.a.	n.a.	n.a.
Intermediate consumption	11.2	10.9	n.a.	10.6	n.a.	n.a.	n.a.	n.a.	n.a.
Social payments	14.3	13.9	12.3	13.4	12.0	11.8	11.6	11.3	-3.0
Subsidies	0.6	0.5	0.7	0.5	0.7	0.7	0.8	0.8	0.2
Gross fixed capital formation	2.8	2.8	2.5	2.8	2.5	2.4	2.4	2.4	-0.4
Other (residual)	3.1	3.1	3.0	3.0	2.6	2.5	2.5	2.5	-0.6
- Interest expenditure	2.7	2.7	2.5	2.6	2.6	2.8	2.7	2.6	-0.1
General government balance (GGB)	-5.2	-4.1	-4.3	-2.7	-2.2	-0.8	0.0	0.1	5.3
Primary balance	-2.5	-1.5	-1.8	-0.1	0.5	1.9	2.7	2.7	5.2
One-off and other temporary measures	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	-5.1	-4.1	-4.3	-2.7	-2.2	-0.8	0.0	0.1	5.2
Output gap ¹	-1.0	0.0	-0.2	0.7	0.1	0.3	0.3	0.3	1.3
Cyclically-adjusted balance ¹	-4.8	-4.2	-4.2	-3.2	-2.3	-1.0	-0.2	-0.1	4.7
Structural balance (SB)²	-4.7	-4.2	-4.2	-3.2	-2.3	-1.0	-0.2	n.a.	n.a.
Structural primary balance ²	-2.0	-1.6	-1.7	-0.6	0.3	1.8	2.5	n.a.	n.a.
<i>Notes:</i>									
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology (In calendar year)									
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures									
<i>Source:</i>									
Convergence Programme (CP); Commission 2015 spring forecast (COM); Commission calculations.									

Measures underpinning the programme

The measures underpinning the Convergence Programme include a continuation of measures implemented in the past including further departmental spending cuts, an increase in the bank levy, a further reduction in the corporate tax rate, an increase in the personal allowance, increased national insurance contributions owing to the end of contracting out of pensions, duty cuts, lower taxation on savings and measures to curtail tax avoidance and evasion. The estimates of the measures' budgetary impact are plausible.

Main budgetary measures

Revenue	Expenditure
2014-15	
<ul style="list-style-type: none"> • Corporation tax decrease to 21% (-0.02% of GDP) • Increase in personal income tax allowance to GBP 10,000 (-0.06% of GDP) • Employment allowance (-0.07% of GDP) • Tax avoidance (+0.05% of GDP) 	<ul style="list-style-type: none"> • Cuts in DEL and welfare spending (-0.3% of GDP)
2015-16	
<ul style="list-style-type: none"> • Bank Levy increase to 0.21% (+0.04% of GDP) • Corporation tax decrease to 20% (-0.02% of GDP) • Increase in personal income tax allowance to GBP 10,600 (-0.1% of GDP) • Corporation tax: restriction of losses (+0.04% of GDP) 	<ul style="list-style-type: none"> • Cuts in DEL and welfare spending (-0.4% of GDP)
2016-17	
<ul style="list-style-type: none"> • Increase in personal income tax allowance to GBP 10,800 (-0.05% of GDP) • Savings tax allowance & ISA flexibility (-0.05% of GDP) • Introduction of single tier pension (+0.3% of GDP) 	<ul style="list-style-type: none"> • Cuts in DEL and welfare spending (-0.4% of GDP)
2017-18	
<ul style="list-style-type: none"> • Increase in personal income tax allowance to GBP 11,000 (-0.03% of GDP) 	
<p>Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.3. Debt developments

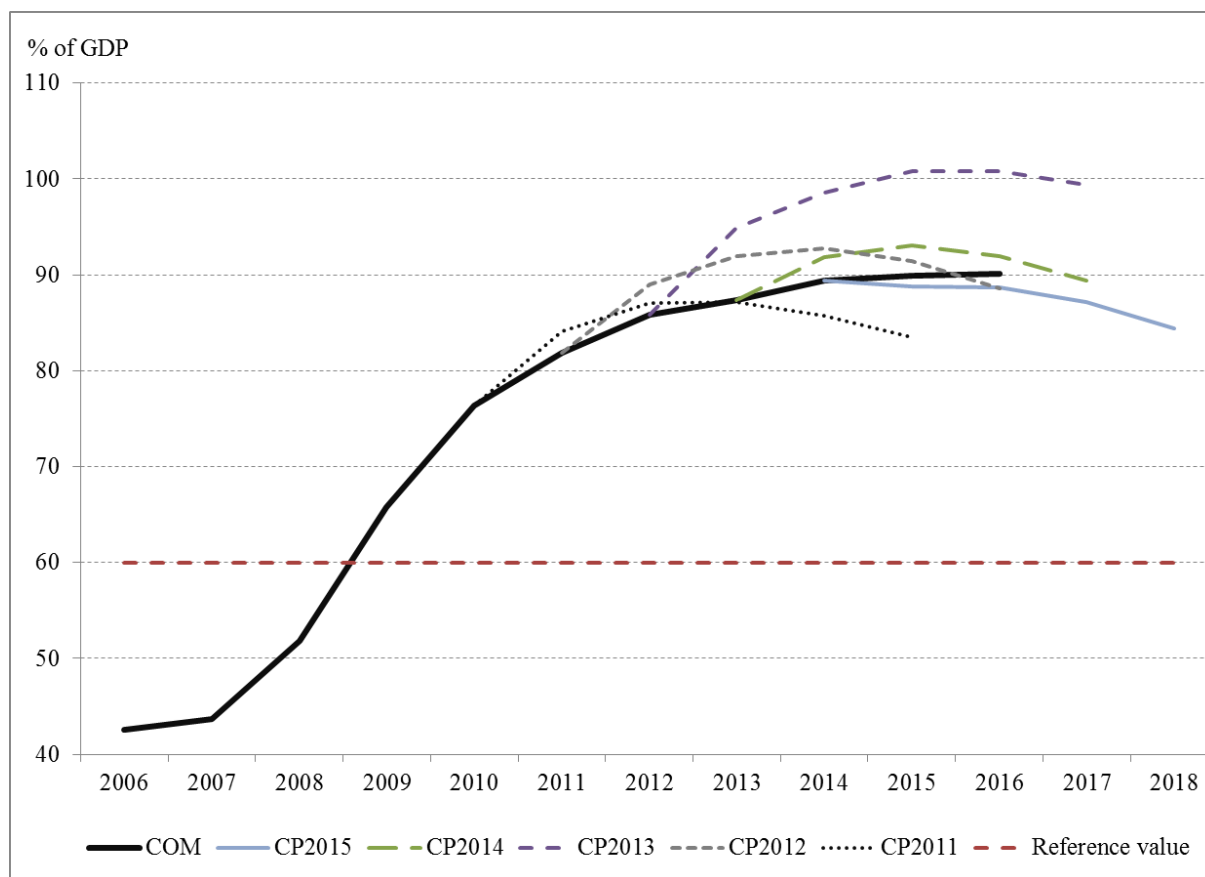
According to the Convergence Programme, the general government debt ratio is expected to peak at 88.8% of GDP in 2015-16 and to fall continuously thereafter, though only by 0.1 pp between 2015-16 and 2016-17. The Commission 2015 spring forecast envisages a small increase in the debt ratio of 0.1 pp to 89.3% of GDP in 2016-17, which is the final year of the forecast projections.

Overall, the debt dynamics between the programme and the spring forecast are similar with differences explained by the primary balance and also the effect of inflation in 2016-17. The UK has a national target for public sector net debt to be falling as a percentage of GDP in 2016-17. This will be achieved one year early in 2015-16 according to the forecast in the Convergence Programme but not according to the Commission spring forecast.

Table 3: Debt developments

(% of GDP)	Average 2009-10 - 2013-14	2014-15	2015-16		2016-17		2017-18	2018-19	2019-20
			COM	CP	COM	CP	CP	CP	CP
Gross debt ratio¹	80.9	88.4	89.2	88.8	89.3	88.7	87.1	84.4	81.4
Change in the ratio	6.6	0.6	0.8	0.4	0.1	-0.1	-1.6	-2.7	-3.0
<i>Contributions²:</i>									
1. Primary balance	5.4	2.5	1.5	1.8	0.1	-0.5	-1.9	-2.7	-2.7
2. "Snow-ball" effect	0.6	-0.8	-0.9	-0.9	-0.9	-0.3	-0.5	-0.9	-1.4
<i>Of which:</i>									
Interest expenditure	2.8	2.7	2.7	2.5	2.6	2.7	2.7	2.7	2.6
Growth effect	-0.7	-2.4	-2.2	-2.1	-1.8	-2.0	-2.0	-1.9	-1.9
Inflation effect	-1.5	-1.2	-1.4	-1.3	-1.7	-1.0	-1.3	-1.6	-2.0
3. Stock-flow adjustment	0.6	-1.0	0.2	-0.4	0.9	0.7	0.8	0.9	1.1
<i>Of which:</i>									
Cash/accruals diff.									
Acc. financial assets									
<i>Privatisation</i>									
Val. effect & residual									
Notes:									
¹ End of period.									
² 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:									
Commission 2015 spring forecast (COM); Convergence Programme (CP), Commission calculations.									

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



Source: Commission 2015 spring forecast, Convergence Programmes

3.4. Risk assessment

Deficit developments

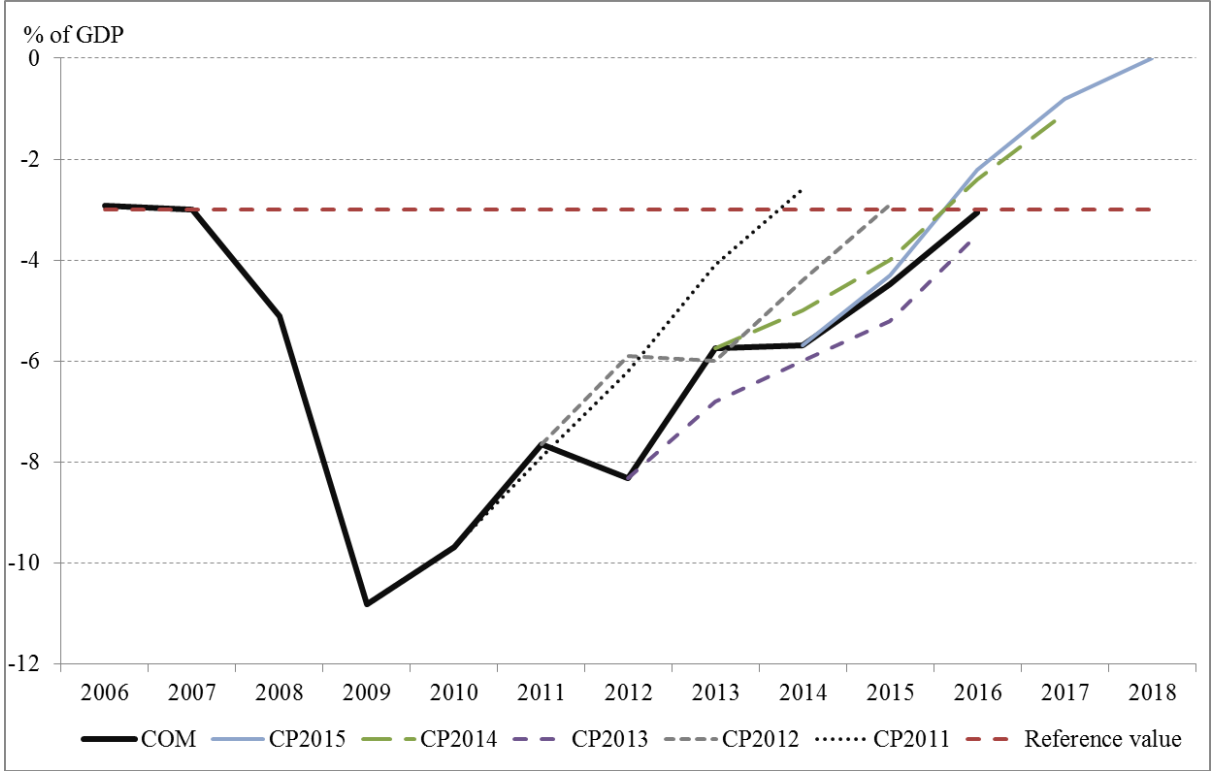
The programme envisages a cutting of the headline government deficit from 5.2% of GDP in 2014-15 to 4.3% in 2015-16 and 2.2% in 2016-17; the underlying economic assumptions are facing broadly balanced risks. The Commission 2015 spring forecast, which takes into account measures specified in the 2015 budget and assumes no policy change thereafter, projects a deficit of 4.1% in 2015-16 and 2.7% in 2016-17. This implies that the programme's fiscal forecast is on the cautious side for 2015-16, but more optimistic for 2016-17. The deviation in the programme projections is largely due to a higher GDP growth rate in 2016-17 along with lower government consumption than in the Commission forecast.

A risk therefore seems to stem from the policy implementation side. The historical lack of achievement of deficit targets underlines the importance of the government's steadfast commitment to delivery of the fiscal strategy.

Furthermore, lower primary expenditure is envisaged. Low oil prices and a strong domestic currency may place a larger-than-expected downward pressure on inflation and VAT revenues. On the other hand, the same factors present positive implications for domestic demand, in particular private consumption. However, the Commission 2015 country report,

released on 25 February 2015, revealed a policy challenge stemming from the analysis of macroeconomic imbalances in relation to the housing sector. Although the risks associated with high household indebtedness and rising house prices have fallen, the supply of housing does not match the increasing demand in the medium term.

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast, Convergence Programmes

Debt developments

The programme projection for government debt is broadly consistent with the Commission 2015 spring forecast. The aforementioned risks to deficit developments are likely to have a low impact on the debt forecast. Although the UK appears to face high debt sustainability risks in the medium and long run, the projection risks for the programme period appear low and there are even some positive possibilities related to the disposal of government shares in the financial sector. Indeed, off-balance sheet items may have a positive effect on future debt ratios. Financial sector interventions, in particular the effective nationalisation of two banks, Bradford & Bingley and Northern Rock Asset Management, have had upward implications in the past but risks of further debt-increasing transactions appear low. The government commitment to sell off shares acquired during the past financial interventions could result in off-balance sheet revenues, which would reduce the government debt issuing needs.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

According to the Commission 2015 spring forecast published on 5 May 2015, the general government deficit is projected to reach 5.2% of GDP in 2014-15. The headline deficit for 2014-15 is thus expected to remain above the 3% of GDP reference value of the Treaty by the deadline for correction of the excessive deficit.

In 2015-16, according to the Convergence Programme, the nominal deficit is expected to be above the 3% of GDP reference value and will fall below it in 2016-17.

Government debt is expected to remain significantly above 60% of GDP in 2016-17, both according the Convergence Programme and the Commission's spring forecast.

Box 1. Council recommendations addressed to the United Kingdom

- On 2 December 2009, the Council recommended The United Kingdom under Art. 126(7) of the Treaty to correct its excessive deficit by 2014-15. To this end, the United Kingdom authorities should: (a) implement the fiscal measures in 2009-10 as planned in the 2009 Budget, avoiding further measures contributing to the deterioration of public finances, and start consolidation in 2010-11 in order to bring the deficit below the reference value by 2014-15; (b) to this end ensure an average annual fiscal effort of 1¾% of GDP between 2010-11 and 2014-15, which should also contribute to bringing the government gross debt ratio back on a declining path that approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus; and (c) further specify the additional measures that are necessary to achieve the correction of the excessive deficit by 2014-15, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.
- On 16 June 2014, the Council recommended that the United Kingdom: (a) reinforce the budgetary strategy, endeavouring to correct the excessive deficit in a sustainable manner in line with the Council recommendation under the Excessive Deficit Procedure; (b) pursue a differentiated, growth-friendly approach to fiscal tightening by prioritising capital expenditure and (c) to assist with fiscal consolidation, consideration should be given to raising revenues through broadening the tax base.
- On 13 May 2015, the Commission recommended to the Council that the United Kingdom should: (a) put an end to the present excessive deficit situation by 2016-17 at the latest; (b) reach a headline deficit of 4.1% of GDP in 2015-16 and 2.7% of GDP in 2016-17, which should be consistent with delivering an improvement in the structural balance of 0.5% of GDP in 2015-16 and 1.1% of GDP in 2016-17, based on the updated Commission 2015 spring forecast; and (c) fully implement the consolidation measures incorporated into all budgets and Autumn Statements up to and including the 2015 budget to achieve the recommended structural effort, with any modifications being fiscally-neutral in relation to the current plans. The United Kingdom should further detail the expenditure cuts in the upcoming Spending Review. These are necessary to ensure the correction of the excessive deficit by 2016-17.

Comparing the initial structural deficit of 7.0% in 2010-11 with the estimate of 4.7% in 2014-15, the unadjusted annual average change in the structural balance over the five year period for which effective action is assessed, is estimated at 0.7% of GDP. This is below the Council Recommendation of 1¾%. Correcting for differences in potential output and allowing for windfall gains and losses, the adjusted fiscal effort is 1.1%. This is also below the 1¾% fiscal effort specified in the Council Recommendation of 2 December 2009.³

On 13 May 2015, the Commission adopted a recommendation for the Council to set a new EDP deadline of 2016-17 with a view to bringing the excessive deficit below the 3% of GDP reference value. The planned adjustment path in the programme is sufficient to achieve the proposed new deadline, the intermediate headline targets and the recommended fiscal effort.

According to the Convergence Programme, the headline budget deficit is forecast to reach 4.3% of GDP in 2015-16 and 2.2% in 2016-17, compared to 4.1% and 2.7% in the Commission spring forecast. According to the latter, this implies an improvement in the structural balance of 0.5% of GDP and 1.1%, respectively. To reach the new recommendation's deficit targets, the UK needs to fully implement these measures in a timely manner, with any modifications in relation to the current plans being fiscally-neutral; in that case, no further measures on top of those already announced will be needed.

³ For a detailed analysis, see Commission Staff Working Document relating to the EDP assessment

Table 4: Compliance with the requirements of the corrective arm

(% of GDP)	2014-15	2015-16		2016-17	
	COM	CP	COM	CP	COM
Headline balance					
Headline budget balance	-5.2	-4.3	-4.1	-2.2	-2.7
EDP requirement on the budget balance	-	-4.1		-2.7	
Fiscal effort - change in the structural balance					
Change in the structural balance ¹	-0.1	1.1	0.5	1.9	1.1
Cumulative change ²	-	1.1	0.5	3.0	1.6
Required change from the EDP recommendation	-	0.5		1.1	
Cumulative required change from the EDP recommendation	-	0.5		1.6	
Fiscal effort - adjusted change in the structural balance					
Adjusted change in the structural balance ³	-	-	0.5	-	1.1
of which:					
<i>correction due to change in potential GDP estimation (α)</i>	-	-	-	-	-
<i>correction due to revenue windfalls/shortfalls (β)</i>	-	-	-	-	-
Cumulative adjusted change ²	-	-	-	-	-
Required change from the EDP recommendation	-	0.5		1.1	
Cumulative required change from the EDP recommendation	-	0.5		1.6	
Fiscal effort - calculated on the basis of measures (bottom-up approach)					
Fiscal effort (bottom-up) ⁴	-	-	-	-	-
Cumulative fiscal effort (bottom-up) ²	-	-	-	-	-
Requirement from the EDP recommendation	-	0.0		0.0	
Cumulative requirement from the EDP recommendation	-	0.0		0.0	
Notes:					
¹ Structural balance = cyclically-adjusted government balance excluding one-off measures. Structural balance based on programme is recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology. Change compared to t-1.					
² Cumulative change: since 2014-15.					
³ Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations.					
⁴ The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.					
<i>Source :</i>					
<i>Convergence Programme (CP); Commission 2015 spring forecast (COM); Commission calculations.</i>					

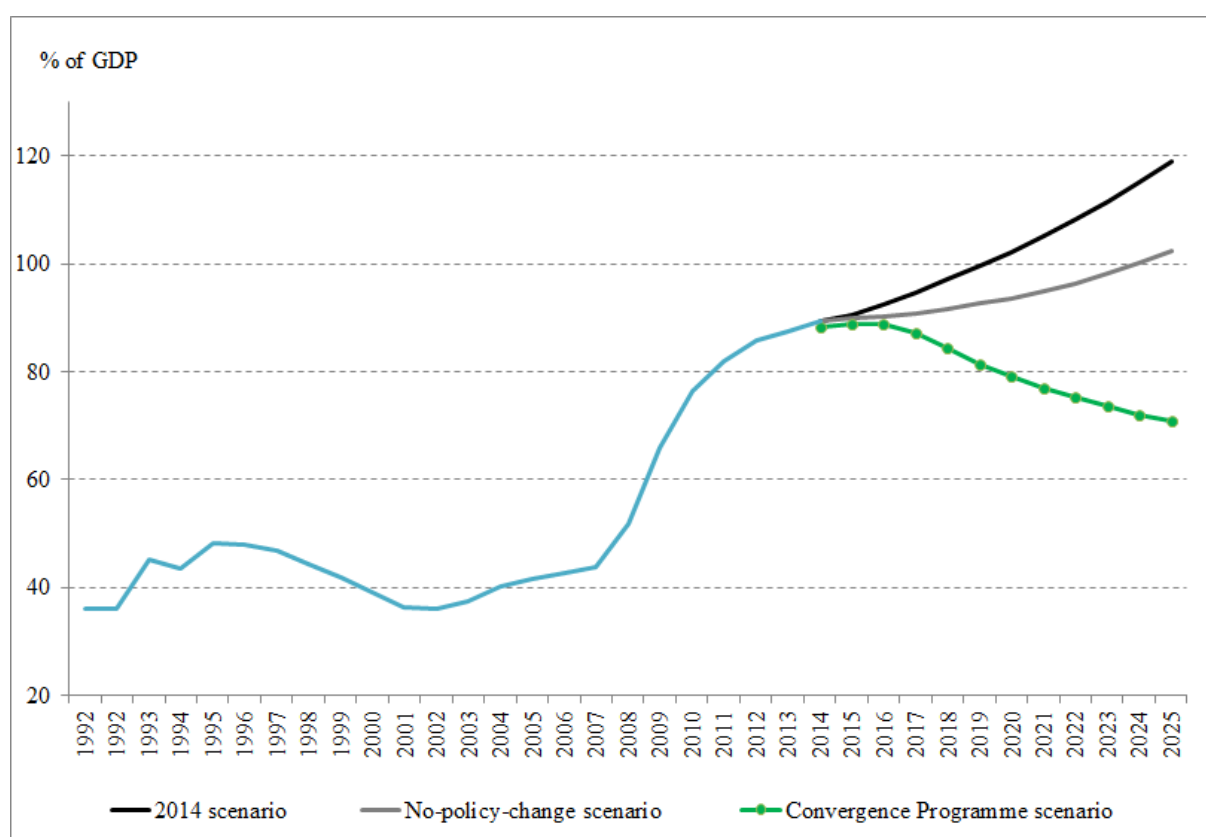
5. LONG-TERM SUSTAINABILITY

Government debt stood at 89.4% of GDP in 2014. It is expected to rise to 102.4% in 2025, remaining well above the 60% of GDP Treaty threshold, driven by the level of the structural primary balance in 2016 (at -0.9% of GDP), which is assumed constant under the no-policy change baseline scenario, as well as the projected costs of ageing. However, as shown in figure 3, the full implementation of the programme would put debt on a decreasing path, reaching 70.7% of GDP by 2025, although remaining above the 60% of GDP reference value in 2025. The United Kingdom appears to face low fiscal sustainability risks in the short-term.

Table 5: Sustainability indicators

	United-Kingdom			European Union		
	2014 scenario	No-policy-change scenario	Convergence Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	5.8	4.2	0.8	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	3.4	1.8	-1.4	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	2.3	2.4	2.2	1.0	1.1	1.1
<i>of which:</i>						
pensions	0.9	1.0	0.9	0.0	0.1	0.1
healthcare	1.1	1.0	0.9	0.8	0.7	0.6
long-term care	0.3	0.3	0.3	0.7	0.7	0.6
others	0.1	0.1	0.1	-0.4	-0.3	-0.2
S1**	6.3	4.7	0.6	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	3.8	1.7	-2.1	-0.4	-0.3	-1.6
Debt requirement (DR)	1.8	2.2	1.9	1.7	1.9	1.8
Long-term cost of ageing (CoA)	0.7	0.9	0.8	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.38	:		:		
<i>Fiscal subindex</i>	0.34	:		:		
<i>Financial-competitiveness subindex</i>	0.40	:		:		
Debt as % of GDP (2014)	89.4			88.6		
Age-related expenditure as % of GDP (2014)	21.7			25.6		
<i>Source: Commission calculations, Convergence Programme 2014-15</i>						
<i>Notes:</i> The '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'Convergence Programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.						
* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: (i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and (ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and (iii) if it is greater than 6, it is assigned high risk.						
** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring the debt ratio to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 pp of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 pp of GDP per year is necessary), it is assigned high risk.						
*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indices, thresholds are at 0.35 and 0.45, respectively.						

Figure 3: Gross debt projections (% of GDP)



Source: Commission 2015 spring forecast; Convergence Programme; Commission calculations

The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report⁴ published on 12 May. It therefore updates the assessment made in the Country Report⁵ published on 26 February. The medium-term sustainability gap, showing the upfront adjustment effort required to bring the government debt ratio down to 60% of GDP by 2030, is at 4.7% of GDP, primarily related to the high level of government debt (90.1% of GDP in 2016), the structural primary balance in 2016 (-0.9% of GDP) and the projected ageing costs (contributing with 0.9 pp. of GDP until 2030), indicating high risks. In the long-term, the United Kingdom appears to face medium fiscal sustainability risks, primarily related to the projected ageing costs (contributing with 2.4 pp. of GDP) over the very long run and the structural primary balance in 2016. The long-term sustainability gap, which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, is at 4.2% of GDP.

Given the level of fiscal sustainability risks in the medium and long term, it is appropriate for the United Kingdom to continue to implement measures that reduce risks to fiscal sustainability, including by further containing age-related expenditure growth.

⁴ The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)

⁵ Country Report United Kingdom 2015 – COM(2015)85

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES⁶

6.1. Fiscal framework

The macroeconomic forecast has been prepared by an independent body, the Office for Budget Responsibility (OBR), which is tasked with producing official economic and fiscal forecasts, and with assessing the government's performance relative to its fiscal policy framework. The current Charter, from December 2014, was updated twice since 2011. The fiscal mandate is an aim to achieve a cyclically-adjusted current balance by the end of the third year of the rolling, 5-year forecast period and the supplementary aim is for public sector net debt as a percentage of GDP to be falling in 2016-17; one year later than in the original Charter. There is also an assessment of the welfare cap defined in the Charter. In its March 2015 assessment, the OBR concluded that all three targets were on course to be met, including the supplementary debt target which would now be falling in 2015-16; one year earlier than the current target but in line with the initial target date. This is mainly due to the planned sales of financial assets.

The UK's fiscal framework is generally sound and benefits from well-established domestic good practice. However, the UK does not set an explicit medium-term objective (MTO) as recommended by the code of conduct of the Stability and Growth Pact (SGP) and the Stability and Convergence Programmes (SCP). Furthermore, the UK authorities follow different definitions of national debt and deficit targets from those in the Maastricht Treaty. The national deficit target refers to the cyclically-adjusted current account balance, excluding financial interventions, whereas the excessive deficit procedure (EDP) deficit is defined as general government net borrowing, including investment expenditure and interest. The national authorities' debt target is public sector net debt excluding financial interventions. This is defined in net terms and includes the debt of non-financial public corporations but excludes that of public sector banking groups. The EDP definition refers to general government gross debt thereby excluding both the debt of non-financial public corporations and public sector banks.

6.2. Quality of public finances

The quality of public finances was analysed in the Country Report 2015.⁷ In terms of public investment, the Convergence Programme forecasts growth in general government fixed capital formation to decrease from 2.6% of GDP in 2014-15 to 2.4% of GDP in 2017-18 and to stabilise thereafter. The UK plans to invest GBP 100 billion of public money in infrastructure "to 2020 and beyond" and expects the private sector to provide financing for three/four times as much as the government investment to fund the National Infrastructure Plan.

⁶ This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence programme

⁷ Country Report United Kingdom 2015 – COM(2015)85

7. CONCLUSIONS

Progress was limited in relation to the EDP recommendation of 2 December 2009. In 2014-15, the United Kingdom achieved a headline deficit of 5.2% of GDP, above the target under the EDP. Both the unadjusted and adjusted (top-down) annual average fiscal effort amounting at 0.7% of GDP and 1.1% of GDP, respectively, fall short of the 1¾% of GDP target adjustment stipulated in the Council recommendation of 2 December 2009.

The United Kingdom does not plan to correct its excessive deficit by the 2014-15 deadline set by the Council. However, it plans to correct the excessive deficit by the new 2016-17 deadline recommended by the Commission to the Council on 13 May 2015. Based on the Commission 2015 spring forecast, the headline deficit is expected to decrease to 4.1% of GDP in 2015-16 and further to 2.7% of GDP in 2016-17. These headline deficit projections as well as the estimated improvement in the structural balance of 0.5% in 2015-16 and 1.1% in 2016-17 are in line with the Commission's recommendation for a Council recommendation of 13 May 2015.

Annex

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	3.1	3.0	0.3	0.7	1.7	2.8	2.6	2.4
Output gap ¹	n.a	n.a	n.a	-3.1	-2.5	-1.0	0.0	0.7
HICP (annual % change)	1.3	1.7	3.2	2.8	2.6	1.5	0.4	1.6
Domestic demand (annual % change) ²	3.9	3.1	-0.1	1.4	1.8	3.3	2.8	2.5
Unemployment rate (% of labour force) ³	5.8	5.0	6.9	7.9	7.6	6.1	5.4	5.3
Gross fixed capital formation (% of GDP)	19.0	18.2	16.9	16.2	16.5	17.2	17.5	18.0
Gross national saving (% of GDP)	18.1	16.7	14.3	12.8	12.5	12.2	13.2	14.4
General Government (% of GDP)*								
Net lending (+) or net borrowing (-)	0.2	-3.1	-7.5	-7.6	-5.9	-5.2	-4.1	-2.7
Gross debt	37.6	39.0	65.7	85.4	87.8	88.4	89.2	89.3
Net financial assets	-25.8	-22.4	-41.9	-62.2	-61.6	n.a	n.a	n.a
Total revenue	38.7	38.9	39.7	39.0	39.4	38.9	38.8	39.0
Total expenditure	38.5	42.1	47.1	46.6	45.2	44.1	43.0	41.7
<i>of which: Interest</i>	2.8	2.0	2.5	3.0	2.8	2.7	2.7	2.6
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-5.2	1.3	3.1	3.1	0.9	0.0	0.5	0.3
Net financial assets; non-financial corporations	-164.3	-123.6	-121.0	-123.7	-126.6	n.a	n.a	n.a
Net financial assets; financial corporations	-47.9	-30.7	-7.2	-7.9	-8.3	n.a	n.a	n.a
Gross capital formation	13.0	10.6	9.4	9.5	10.0	10.4	10.3	10.5
Gross operating surplus	22.9	21.9	22.0	21.6	21.8	21.9	23.0	23.1
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	2.9	0.0	1.5	1.5	-0.1	-0.7	-0.9	-1.3
Net financial assets	225.0	165.6	164.8	179.3	194.7	n.a	n.a	n.a
Gross wages and salaries	44.7	44.2	43.3	41.9	41.7	41.5	41.3	41.1
Net property income	13.3	10.5	9.7	8.6	8.5	8.4	8.7	8.8
Current transfers received	21.0	20.7	22.1	23.8	23.3	21.9	21.7	21.3
Gross saving	7.5	5.6	5.8	5.6	4.5	4.1	4.1	3.9
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-1.5	-1.8	-2.7	-3.7	-4.4	-5.4	-4.8	-4.0
Net financial assets	13.4	11.3	6.1	15.6	2.8	n.a	n.a	n.a
Net exports of goods and services	-1.2	-2.6	-2.3	-2.1	-2.0	-1.9	-1.3	-1.3
Net primary income from the rest of the world	0.5	1.6	0.7	-0.3	-0.9	-2.2	-2.4	-2.1
Net capital transactions	0.0	0.0	0.0	0.1	0.0	0.0	0.1	0.1
Tradable sector	43.8	39.4	36.3	35.2	35.0	34.4	n.a	n.a
Non tradable sector	45.4	50.2	53.6	53.9	54.0	54.6	n.a	n.a
<i>of which: Building and construction sector</i>	5.2	6.1	5.7	5.4	5.4	5.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	111.3	117.3	105.7	102.7	101.0	107.7	113.5	113.9
Terms of trade goods and services (index, 2000=100)	99.0	101.8	99.1	99.2	99.5	100.9	103.8	104.1
Market performance of exports (index, 2000=100)	108.3	104.3	100.7	101.1	100.7	97.1	94.6	92.2
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
*General Government: Data in financial years, starting in the first year of the heading.								
Source:								
AMECO data, Commission 2015 spring forecast								