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Assessment of the 2017-18 Convergence Programme for the United Kingdom

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

This document assesses the 2017-18 Convergence Programme for the United Kingdom (hereafter called the Convergence Programme), which was submitted to the Commission on 30 April 2018 and covers the period 2017-18 to 2022-23. It was approved by the government and presented to the national parliament for a debate without a vote. The parliament was, however, required to approve the government's assessment of the United Kingdom's medium-term economic and budgetary position, which forms the basis of the Convergence Programme. The content of the Convergence Programme is based on the 2018 Spring Budget, published by HM Treasury, along with the Office for Budget Responsibility's (OBR) March 2018 Economic and Fiscal Outlook.

The United Kingdom is currently subject to the preventive arm of the the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its Medium-Term Budgetary Objective (MTO). As the debt ratio was 86.7% of GDP in 2016-17 (the year in which the United Kingdom corrected its excessive deficit), exceeding the 60% of GDP reference value, the United Kingdom is also subject to the debt reduction transitional arrangements as regards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit (transitional debt rule). In this period, it should ensure sufficient progress towards compliance with the debt reduction benchmark. After the three-year period of the debt reduction transitional arrangements, Member States are expected to comply with the debt reduction benchmark.

This document complements the Country Report published on 7 March 2018 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 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Convergence Programme. In particular, it includes an overview on the medium-term budgetary plans, an assessment of the measures underpinning the Convergence Programme and a risk analysis of the budgetary plans based on the Commission forecast. Section 4 assesses compliance with the rules of the SGP, 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. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The United Kingdom's economy grew by 1.8% in 2017, a marginal slowdown compared to growth of 1.9% in 2016 (see Table 1) and below the forecast included in the 2016-17 Convergence Programme (2%). The macroeconomic scenario for the United Kingdom set out in the Convergence Programme is predicated on a further slowdown in growth to 1.5% in 2018 and 1.3% in 2019, with growth in both years now expected to be weaker than the forecast contained in the 2016-17 Convergence Programme (1.6% in 2018 and 1.7% in 2019). The contribution of domestic demand to economic growth is expected to be subdued over this period, with moderate nominal wage growth and slower employment growth continuing to restrict consumers' spending power, in spite of gradually easing inflation. Net exports are expected to contribute positively to growth in 2018 and 2019, as in 2017, reflecting the continued impact of the significant depreciation of GBP in 2016 and the strength of external relative to domestic demand.

The United Kingdom is at a mature position in its economic cycle. The output gap (as recalculated by the Commission based on the information in the Convergence Programme, following the commonly agreed methodology) has been slightly positive since 2015 and is projected to fall gradually to around zero in 2020 and 2021. This is broadly in line with the output gap calculated on the basis of the Commission 2018 spring forecast.

The Convergence Programme contains plausible macroeconomic assumptions. In 2018 economic growth is projected to be 1.5%, the same as in the Commission 2018 spring forecast. Growth in 2019 is projected at 1.3% in the Convergence Programme, slightly above the Commission's forecast of 1.2%. The underlying trend of weak domestic demand over the forecast horizon is a feature of both the Convergence Programme and the Commission projections. Both forecasts also anticipate a positive contribution from net exports in 2018 and 2019. The expected labour market outcomes are also similar, with both the Commission and the Convergence Programme projecting a low and stable unemployment rate, but a slower pace of employment growth than has been seen in recent years. The projected growth rate of compensation of employees is however slightly weaker in the Convergence Programme. Both forecast project that inflation will ease to just below 2% in 2019. The Commission forecast for the output gap in 2018 and 2019 is the same as the one recalculated based on information in the Convergence Programme.

Given the ongoing negotiations over the terms of the United Kingdom’s withdrawal from the EU, the projections for 2019 in the Commission 2018 spring forecast are based on a purely technical assumption of status quo in terms of trading relations between the EU27 and the United Kingdom. This is for forecasting purposes only and has no bearing on the talks underway in the context of the Article 50 process. The Convergence Programme notes that the OBR has not attempted to predict the precise outcome of negotiations with the EU. Instead, it has made broad assumptions, including that the United Kingdom leaves the EU in March 2019, the negotiation of new trading arrangements with the EU and others slows the pace of United Kingdom import and export growth over a 10-year period, and that the United Kingdom adopts a tighter migration regime following departure from the EU than that currently in place.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	1.8	1.7	1.5	1.5	1.2	1.3	1.3	1.4
Private consumption (% change)	1.7	1.7	1.2	0.9	1.2	0.9	1.1	1.4
Gross fixed capital formation (% change)	4.0	3.9	2.1	1.8	1.1	1.5	2.4	1.9
Exports of goods and services (% change)	5.7	5.0	3.6	3.3	2.9	2.0	0.3	-0.1
Imports of goods and services (% change)	3.2	3.5	2.7	1.5	2.2	1.0	0.2	0.0
Contributions to real GDP growth:								
- Final domestic demand	1.8	1.9	1.3	1.1	1.1	1.0	1.3	1.4
- Change in inventories	-0.4	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.6	0.3	0.2	0.5	0.2	0.3	0.0	0.0
Output gap[1]	0.8	0.8	0.7	0.7	0.4	0.4	0.1	-0.1
Employment (% change)	1.0	1.0	0.5	0.6	0.4	0.4	0.4	0.3
Unemployment rate (%)	4.4	4.4	4.4	4.4	4.6	4.5	4.6	4.6
Labour productivity (% change)	0.7	0.7	1.0	0.9	0.8	0.8	0.9	1.0
HICP inflation (%)	2.7	2.7	2.5	2.4	1.9	1.8	1.9	2.0
GDP deflator (% change)	2.0	2.1	2.0	1.5	1.6	1.6	1.6	1.7
Comp. of employees (per head, % change)	2.9	3.0	2.9	2.5	2.9	2.7	2.6	2.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-4.1	-4.9	-3.6	-4.3	-3.2	-3.9	-3.7	-3.7

Note:

[1] In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017-18 AND 2018-19

According to the Convergence Programme and preliminary data from the Office for National Statistic (ONS) published on 24 April 2018[1], the general government deficit is expected to have fallen from 2.4% of GDP in 2016-17 to 2.2% of GDP in 2017-18 (see Table 2). The latter figure is 0.6 percentage point below the projection contained in the 2016-17 Convergence Programme, although it is only 0.2 percentage point below the projection published by the OBR at the time of the 2017 Autumn Budget (November 2017). At 36.4% of GDP, the revenue ratio in 2017-18 is expected to have been in line with the projection contained in the 2016-17 Convergence Programme. In contrast, the expenditure ratio (38.7% of GDP) is expected to have been somewhat lower than in the 2016-17 Convergence Programme (39.3% of GDP), despite a significant increase in interest expenditure due to higher coupon payments on inflation-linked bonds following a rapid increase in the retail

[1] Due to the timing of the United Kingdom's fiscal year, notified outturn data cannot be validated by Eurostat until the autumn of the following calendar year.

price index (RPI). These positive fiscal outcomes been have partly driven by higher nominal GDP in 2017, compared to the forecast contained in the 2016-17 Convergence Programme, following some significant data revisions by the ONS. At the same time, expenditure has been markedly lower-than-expected in nominal terms, once again emphasising the UK authorities' focus on expenditure-based fiscal consolidation.

According to the Convergence Programme, the deficit is projected to fall to 1.8% of GDP in 2018-19, 0.1 percentage point lower than the deficit anticipated in the 2016-17 Convergence Programme. This is due to two largely offsetting effects. On the one hand, the significantly lower-than-expected 2017-18 general government deficit has reduced the expected 2018-19 deficit via a base effect. On the other hand, the Chancellor of the Exchequer announced a number of expenditure-increasing discretionary measures in his 2017 Autumn Budget (see Section 3.3), thus slowing the expected pace of fiscal consolidation in the coming years. Nevertheless, the Convergence Programme incorporates a further fall in the expenditure ratio in 2018-19, to 38.5% of GDP. The Commission also forecasts the headline deficit to fall to 1.8% of GDP in 2018-19, again driven by a further fall in the expenditure-to-GDP ratio. The structural balance (the cyclically-adjusted balance net of one-off measures), recalculated by the Commission according to the commonly agreed methodology, is projected to be -2.2% of GDP in 2018-19, in line with the Commission forecast.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The main goal of the Convergence Programme's medium-term budgetary strategy is to meet the United Kingdom's national fiscal objective, which is to "return the public finances to balance at the earliest possible date in the next Parliament". There is some ambiguity as to the period that this objective refers to (see Section 6). The fiscal objective is complemented by three supplementary targets, namely: 1) to achieve a structural deficit below 2% by 2020-21; 2) that public sector net debt falls as a percentage of GDP by 2020-21; and 3) that total spending on a selection of welfare benefits (excluding the state pension and the most cyclical benefits) be below a target nominal level (i.e. a "welfare cap") by 2021-22. The Convergence Programme does not define an MTO, which is not in line with the legislation. For the purpose of assessing compliance with the preventive arm, the Commission uses the minimum MTO allowable under the agreed methodology (-0.8% of GDP).

The budgetary forecasts in the Convergence Programme are projections under a no-policy-change assumption. This assumes that the government's existing fiscal plans are implemented in full, including reductions to the budgets of some government departments and to working age social transfers, as set out in the multi-year Spending Review published in November 2015. The time profile of the budgetary adjustment envisaged in the Convergence Programme is gradual, with the headline deficit falling from 1.8% of GDP in 2018-19 to 1.4% of GDP in 2021-22. The forecast improvement in the recalculated structural balance is on average below the preventive arm requirement of 0.6% of GDP per annum, at just 0.3% of GDP per annum between 2017-18 and 2021-22. According to the Convergence Programme, the headline deficit in 2019-20 is projected to be 1.7% of GDP and the recalculated structural deficit to be 1.9%. The Commission also forecasts a headline deficit of 1.7% of GDP in 2019-20 and a slightly lower structural deficit of 1.8%. While these headline figures are similar, the Commission forecasts a higher revenue ratio (38.8% vs. 36.6% of GDP) and a higher expenditure ratio (40.4% of GDP vs. 38.3% of GDP) in 2019-20, although this is largely due to differences in accounting treatment. The deficit projections over the next two years are, overall, sufficiently supported by measures.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017-18		2018-19		2019-20		2020-21	2021-22	Change: 2017-18 to 2021-22
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Revenue	**38.8**	**36.4**	**38.8**	**36.7**	**38.8**	**36.6**	**36.5**	**36.2**	**0.0**
of which:									0.0
- Taxes on production and imports	12.9	13.0	12.9	13.1	12.9	13.1	13.1	13.0	-0.1
- Current taxes on income, wealth, etc.	14.0	12.0	14.0	12.1	14.1	12.1	12.1	12.1	0.1
- Social contributions	7.8	6.4	7.8	6.5	7.8	6.5	6.5	6.5	0.0
- Other (residual)	4.1	5.0	4.0	5.1	4.0	5.0	4.9	4.7	-0.1
Expenditure	**41.0**	**38.7**	**40.6**	**38.5**	**40.4**	**38.3**	**38.0**	**37.7**	**-1.2**
of which:									0.0
- Primary expenditure	38.3	36.0	38.1	35.9	37.9	35.9	35.7	35.3	-0.8
of which:									0.0
Compensation of employees	9.0	n.a.	8.9	n.a.	8.8	n.a.	n.a.	n.a.	n.a.
Intermediate consumption	7.9	n.a.	7.8	n.a.	7.6	n.a.	n.a.	n.a.	n.a.
Social payments	15.4	11.5	15.3	11.5	15.3	11.3	11.2	11.2	-0.3
Subsidies	0.8	0.9	0.8	1.0	0.8	1.0	1.1	1.1	0.1
Gross fixed capital formation	2.6	2.6	2.7	2.5	2.8	2.7	2.9	2.8	0.2
Other (residual)	2.6	3.8	2.6	4.0	2.6	4.4	4.6	4.5	0.7
- Interest expenditure	2.7	2.7	2.5	2.6	2.5	2.4	2.3	2.3	-0.4
General government balance (GGB)	**-2.2**	**-2.2**	**-1.8**	**-1.8**	**-1.7**	**-1.7**	**-1.5**	**-1.4**	**1.3**
Primary balance	**0.5**	**0.4**	**0.7**	**0.8**	**0.8**	**0.8**	**0.8**	**0.9**	**0.9**
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-2.2**	**-2.2**	**-1.8**	**-1.8**	**-1.7**	**-1.7**	**-1.5**	**-1.4**	**1.3**
Output gap[1]	0.8	0.8	0.7	0.7	0.4	0.4	0.1	-0.1	-1.0
Cyclically-adjusted balance[1]	-2.6	-2.7	-2.2	-2.2	-1.8	-1.9	-1.6	-1.4	1.8
Structural balance[2]	**-2.6**	**-2.7**	**-2.2**	**-2.2**	**-1.8**	**-1.9**	**-1.6**	**-1.4**	**1.8**
Structural primary balance[2]	0.1	0.0	0.3	0.4	0.7	0.5	0.8	0.9	1.4

Notes*:*

[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.

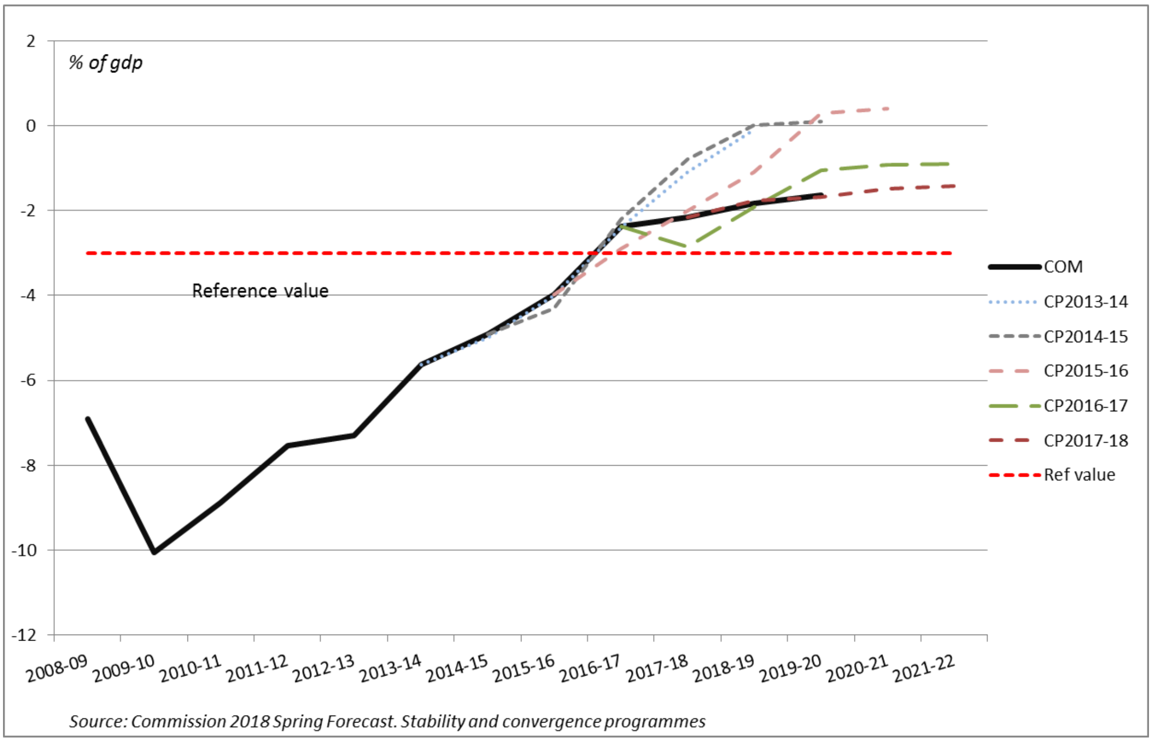
[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence Programme (CP); Commission 2018 spring forecasts (COM); Commission calculations.

Figure 1 highlights variation in the projected path of the general government balance in the Convergence Programmes published in recent years. Overall, projections of the general government balance have tended to deteriorate over time. There were, however, improvements in the near-term outlook in the two most recent Convergence Programmes, due largely to data revisions and better-than-expected fiscal outturn data. There was a particularly large deterioration in the forecast of the general government balance between the 2015-16 and 2016-17 Convergence Programmes, reflecting the adoption of less stringent fiscal rules by the government in the Autumn 2017 Budget. There has been a further decrease in the projections of the general government balance in the 2017-18 Convergence Programme, reflecting the additional expenditure measures and the overall slower pace of fiscal consolidation announced in the Autumn 2017 Budget (see Section 3.1).

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



3.3. MEASURES UNDERPINNING THE PROGRAMME

As discussed above, the projected improvement in the fiscal balance set out in the Convergence Programme is mainly driven by a decline in the expenditure ratio, with the revenue ratio expected to remain broadly steady. This highlights the UK authorities' ongoing efforts to reduce its headline government deficit and meets its domestic fiscal targets through expenditure-based fiscal consolidation.

The envisaged adjustment path is in general sufficiently supported by measures in the Convergence Programme. The fiscal adjustment is driven mainly by progressive reductions in the budgets of government departments and in working age social transfers, as set out in the multi-year Spending Review published in November 2015. The table below sets out further measures announced since the publication of the 2016-17 Convergence Programme. These mainly relate to measures announced in the Autumn 2017 Budget[2], in which the government announced a number of expenditure-increasing measures, mainly in the areas of health and social care in the coming years. In contrast, the Autumn 2017 Budget contained relatively few new revenue measures. The Convergence Programme presents plausible estimates of the measures' budgetary impact, based on costings produced by the OBR. However, for measures aimed at reducing revenue losses due to tax avoidance, only half of the impact estimated in the Convergence Programme is reflected in the Commission 2018 spring forecast due to the high level of uncertainty associated with such measures. There is no significant impact of planned one-off measures in any of the years covered by the Convergence Programme.

[2] The United Kingdom changed its budget calendar as of 2017, with the main budgetary announcement now taking place in the autumn and complemented by an update the following spring. As such, there were two budgetary announcements in 2017.

Main budgetary measures

Revenue	Expenditure
2017-18	
	• Social care: additional funding (+0.1% of GDP)
2018-19	
	• NHS: additional resources (+0.1% of GDP) • Domestic spending: preparing for EU exit (+0.1% of GDP)
2019-20	
• Capital Gains Tax payment window reduction: delay to April 2020 (-0.1% of GDP)	• Adjustments to departmental expenditure limit spending (+0.1%)
Note: The budgetary impact in the table is the impact reported in the Convergence Programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure. Only measures with an impact of at least 0.1% of GDP are included.	

3.4. DEBT DEVELOPMENTS

According to the Convergence Programme, the government debt-to-GDP ratio is expected to remain at around the same level as in 2017-18 (85.5%) for the next two years before declining over the remainder of the forecast horizon to stand at 84.8% in 2021-22 (see Table 3). Over this period, the forecast reduction in the ratio is mainly driven by a positive primary balance, although this is largely offset by the effect of the projected stock-flow adjustment. The primary balance first turned mildly positive in 2016-17 (0.1% of GDP) and is expected to stand at around 0.8% of GDP over the forecast period of the Convergence Programme. This is broadly in line with the Commission 2018 spring forecast. In both the Convergence Programme and the Commission 2018 spring forecast, interest expenditure is expected to put upward pressure on the debt ratio in the coming years, while both inflation and economic growth are expected to exert downward pressure. The Commission forecasts a slightly lower debt-to-GDP ratio in 2019-20 than the Convergence Programme, despite an estimated higher ratio in 2017-18, largely due to differences in the projected stock-flow adjustment and slightly higher nominal GDP growth.

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017-18		2018-19		2019-20		2020-21	2021-22
		COM	CP	COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**85.9**	**86.7**	**85.5**	**85.5**	**85.4**	**84.3**	**85.3**	**84.9**	**84.8**
Change in the ratio	0.9	0.0	-1.1	-1.2	-0.2	-1.2	0.0	-0.4	-0.2
Contributions [2] *:*									
1. Primary balance	**2.2**	**-0.5**	**-0.4**	**-0.7**	**-0.8**	**-0.8**	**-0.8**	**-0.8**	**-0.9**
2. "Snow-ball" effect	**-0.5**	**-0.1**	**-0.5**	**-0.3**	**0.0**	**-0.1**	**0.1**	**-0.1**	**-0.2**
Of which:									
Interest expenditure	2.6	2.7	2.7	2.5	2.6	2.5	2.4	2.3	2.3
Growth effect	-1.8	-1.4	-1.4	-1.3	-1.3	-1.0	-1.0	-1.1	-1.1
Inflation effect	-1.3	-1.5	-1.7	-1.6	-1.3	-1.6	-1.3	-1.4	-1.4
3. Stock-flow adjustment	**-0.8**	**0.7**	**-0.1**	**-0.2**	**0.6**	**-0.2**	**0.6**	**0.6**	**0.9**
Of which:									
Cash/accruals diff.									
Acc. financial assets									
Privatisation									
Val. effect & residual									

Notes:

[1] End of period.

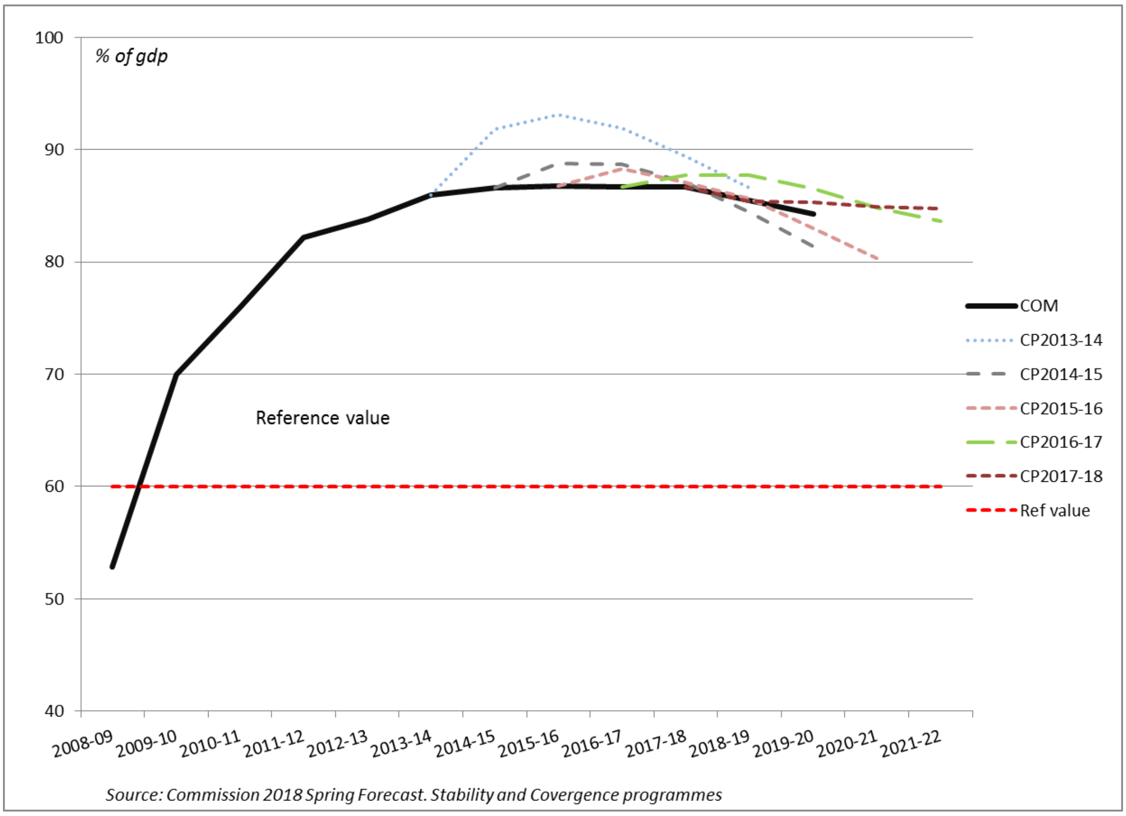
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2018 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Figure 2 shows that government debt projections have generally been revised up since the publication of the 2013-14 Convergence Programme. There was a particularly large revision between the 2015-16 and 2016-17 Convergence Programmes, reflecting the less stringent fiscal targets set out by the government in the Autumn 2016 Budget. Debt projections have remained broadly stable between the 2016-17 and 2017-18 Convergence Programmes, although the debt-to-GDP ratio is now expected to be slightly higher in the outer year of the forecast.

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



3.5. RISK ASSESSMENT

There are a number of risks to the moderate path of deficit reduction set out in the Convergence Programme. Firstly, medium-term growth projections for the United Kingdom are currently subject to a particularly high degree of uncertainty, in the context of its ongoing withdrawal from the EU, and there are downside risks to the macroeconomic scenario contained in the Convergence Programme (see Section 2). The realisation of these risks would likely depress revenue growth, trigger automatic stabilisers on the expenditure side, and put downward pressure on the general government balance.

Secondly, there has been growing pressure on a variety of public services in recent years and the government has responded by exploiting the fiscal space that exists vis-à-vis domestic fiscal targets (see Section 6) and increasing planned expenditure in a number of areas, such as health care. Indeed, the Chancellor of the Exchequer has signalled the possibility of further expenditure measures being announced in the Autumn 2018 Budget. Furthermore, public-sector wage settlements in recent months have breached the "pay cap" that the UK authorities have operated for a number of years. These settlements could signal that the projections for public sector wage growth contained in the Convergence Programme are not realistic, particularly in the context of increased labour market tightness. The potential of these pressures to lead to additional spending commitments pose a risk to the ability of the UK authorities to deliver the planned pace of fiscal consolidation.

The tax projections contained in the Convergence Programme are broadly plausible, although a number of measures that are expected to have an impact in the coming years relate to increased revenues from combatting tax evasion and avoidance. Given the uncertainty associated with such measures, this represents a further risk to the forecast of the general government deficit.

There have been no new control mechanisms put in place to manage public expenditure. The United Kingdom has a good track record in controlling expenditure, with departmental expenditure limits (DELs), which account for the bulk of discretionary expenditure, fixed and set three years in advance. The Convergence Programme reflects multi-year plans for progressive reductions to expenditure set out in the 2015 Spending Review. At the same time, as discussed above, there may be increased upward pressure on DELs in the coming years and, indeed, these have been increased in recent budgetary announcements (see Section 3.3). A new spending review is expected to be launched later this year and could give rise to an increase in planned DELs.

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

Box 1. Council Recommendations addressed to the United Kingdom

On 11 July 2017, the Council addressed recommendations to the United Kingdom in the context of the European Semester. In particular, in the area of public finances the Council recommended to the United Kingdom to "pursue its fiscal policy in line with the requirements of the preventive arm of Stability and Growth Pact, which translates into a substantial fiscal effort for 2018".

The Council noted that "in the light of its fiscal situation and notably of its debt level, the United Kingdom is expected to further adjust towards an appropriate medium-term budgetary objective. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal growth rate of net primary government expenditure which does not exceed 1.8%. It would correspond to an annual structural adjustment of 0.6% of GDP. (…) As recalled in the Commission Communication accompanying these country-specific recommendations, the future assessment will need to take due account of the goal to achieve a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of the United Kingdom’s public finances."

4.1. Compliance with the debt criterion

The government debt ratio is expected to remain above 60% of GDP across the forecast periods of both the Convergence Programme and the Commission 2018 spring forecast. Therefore, following the abrogation of the excessive deficit procedure (EDP) in 2016-17, the United Kingdom is subject to the Minimum Linear Structural Adjustment (MLSA) during the three year transition period.

According to the Commission 2018 spring forecast, the structural adjustment in 2017-18 (0.1% of GDP) is expected to have been lower than the required MLSA (0.4% of GDP). However, the United Kingdom is projected to have complied with the transitional debt rule in 2017-18 as a result of the allowed annual deviation of 0.25%. In 2018-19 and 2019-20, the structural adjustment (0.4% of GDP in both years) is also expected to be lower than the required MLSA (0.5% and 0.6% of GDP, respectively). However, in both years, the United Kingdom is expected to comply with the transitional debt rule as a result of the allowed annual deviation of 0.25%. According to data from the Convergence Programme, the United

Kingdom is not expected to comply with the transitional debt rule during all three of the years of the transition period.

Overall, the United Kingdom is in a transition period and is making sufficient progress towards compliance with the debt criterion in 2018-19 and 2019-20.

Table 5. Compliance with the debt criterion

	2017-18		2018-19		2019-20	
	CP	**COM**	**CP**	**COM**	**CP**	**COM**
Gross debt ratio	**85.5**	**86.7**	**85.4**	**85.5**	**85.3**	**84.3**
Gap to the debt benchmark [1,2]						
Structural adjustment [3]	0.1	0.1	0.5	0.4	0.3	0.4
To be compared to:						
Required adjustment [4]	0.7	0.4	1.0	0.5	1.7	0.6

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining annual structural adjustment over the transition period which ensures that - if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (S/CP) budgetary projections for the previous years are achieved.

Source :
Commission 2018 spring forecast (COM); Convergence Programme (CP), Commission calculations.

4.2. Adjustment towards the MTO

The United Kingdom became subject to the preventive arm of the SGP in 2017-18, following the abrogation of the EDP in 2016-17. In 2017-18, the United Kingdom was required to reduce government expenditure (net of discretionary revenue measures and one-offs) by at least 0.1% in real terms, corresponding to a structural adjustment of 0.6% of GDP towards the minimum MTO. According to the Convergence Programme and preliminary data from the ONS, net government expenditure is expected to have grown by 0.4% in real terms in 2017-18, exceeding the expenditure benchmark and pointing to a risk of some deviation from the required adjustment (see Table 6). The structural balance improved by 0.1% of GDP, also pointing to a risk of some deviation from the required adjustment. This calls for an overall assessment. The improvement in the structural balance is negatively affected by a temporary increase in interest payments in 2017-18 (see Section 3). This suggests that the expenditure benchmark pillar is a better indicator of the fiscal effort in 2017-18. As the growth of net government expenditure is expected to have exceeded the applicable expenditure benchmark, there is a risk of some deviation from the required adjustment in 2017-18.

In 2018-19, the United Kingdom is required to have a growth rate of net government expenditure of no more than 1.8% in nominal terms[3], corresponding to a structural adjustment of 0.6% of GDP. According to the Convergence Programme, net public expenditure is expected to grow by 2.3% in 2018-19, exceeding the expenditure benchmark and pointing to a risk of some deviation from the required adjustment. The recalculated structural balance is expected to improve by 0.5% of GDP, below the required adjustment and also pointing to a risk of some deviation from the required adjustment. Based on two-year averages, the expenditure benchmark pillar points to a risk of some deviation while the structural benchmark pillar points to a risk of significant deviation from the required benchmarks. This calls for an overall assessment. The two pillars point to a comparable one-year deviation from the requirements. However, over two years, the structural balance pillar is distorted by the large and temporary increase in interest payments in 2017-18, suggesting that the expenditure benchmark pillar is a better indicator of the fiscal effort over this period. Based on the Convergence Programme and the conclusions of the overall assessment, the growth of net government expenditure in 2018-19 is, therefore, expected to exceed the applicable expenditure benchmark, giving rise to a risk of some deviation from the required adjustment.

Based on the Commission 2018 spring forecast, net government expenditure is expected to grow by 2.3% in nominal terms in 2018-19, while the structural benchmark is expected to improve by 0.4% of GDP. Both pillars, therefore, point to a risk of some deviation from the required adjustment. Based the two-year average, the expenditure benchmark pillar points to a risk of some deviation and the structural benchmark pillar points to a risk of significant deviation. This calls for an overall assessment. The deviations on both pillars are similar in magnitude to those based on the Convergence Programme, with the change in the structural balance also affected by the increase in interest payments in 2017-18. Based on the Commission 2018 spring forecast and the conclusions of the overall assessment, the growth of net government expenditure in 2018-19 is, therefore, expected to exceed the applicable expenditure benchmark, giving rise to a risk of some deviation from the required adjustment.

In 2019-20, the United Kingdom is required to have a growth rate of net expenditure of no more than 1.6% in nominal terms, corresponding to a structural adjustment of 0.6% of GDP. According to the Convergence Programme, net public expenditure is expected to grow by 0.8%, pointing to compliance with the requirement. The recalculated structural balance is expected to improve by 0.3% of GDP, below the required adjustment and pointing to a risk of some deviation. Based on the two-year averages, the expenditure benchmark pillar points to compliance while the structural benchmark pillar points to a risk of some deviation. This calls for an overall assessment. The change in the recalculated structural balance is negatively affected by revenue shortfalls in 2019-20, suggesting that the expenditure benchmark is a better indicator of the fiscal effort in 2019-20 on both the one-year and two-year averages. Based on the Convergence Programme and the conclusions of the overall assessment, the growth of net government expenditure in 2018-19 is, therefore, expected to be lower than the applicable expenditure benchmark, in compliance with the required adjustment.

Based on the Commission 2018 spring forecast, net government expenditure is expected to grow by 1% in nominal terms in 2019-20, while the structural benchmark is expected to improve by 0.4% of GDP. The one-year (and two-year) growth of net expenditures is, therefore, expected to be lower than the expenditure benchmark, pointing to compliance with

[3] As part of the agreement on the EFC Opinion on "*Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm*", which was adopted by the Economic and Financial Committee on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

the requirement. In contrast, the one-year and two-year improvements in the structural benchmark point to a risk of some deviation from the requirements. This calls for an overall assessment. As with the recalculated structural balance, the improvement in the structural balance is negatively affected by revenue shortfalls in 2019-20, suggesting that the expenditure benchmark better reflects the fiscal effort. Based on the Commission 2018 spring forecast and the conclusions of the overall assessment, the growth of net government expenditure in 2018-19 is, therefore, expected to be lower than the applicable expenditure benchmark, in compliance with the required adjustment.

In conclusion, based on outturn data and the Commission 2018 spring forecast, the ex-post assessment suggests some deviation from the adjustment path towards the minimum MTO in 2017-18. According to both the Commission 2018 spring forecast and the Convergence Programme, and following an overall assessment, some deviation from the adjustment path towards the minimum MTO is also expected in 2018-19, putting at risk compliance with the requirements of the preventive arm of the Pact. The adjustment path towards the minimum MTO seems to be appropriate and compliant with the requirements of the preventive arm of the Pact in 2019-20, according to both the Commission 2018 spring forecast and the Convergence Programme.

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)	2017-18	2018-19		2019-20	
Initial position[1]					
Medium-term objective (MTO)	-0.8	-0.8		-0.8	
Structural balance[2] (COM)	-2.6	-2.2		-1.8	
Structural balance based on freezing (COM)	-2.9	-2.2		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6	0.6		0.6	
Required adjustment corrected[5]	0.6	0.6		0.6	
Change in structural balance[6]	0.9	0.5	0.4	0.3	0.4
One-year deviation from the required adjustment [7]	-0.5	-0.1	-0.2	-0.3	-0.2
Two-year average deviation from the required adjustment [7]	*n.a. in EDP in 2016-17*	-0.3	-0.3	-0.2	-0.2
Expenditure benchmark pillar					
Applicable reference rate[8]	-0.1	1.8		1.6	
One-year deviation adjusted for one-offs[9]	-0.2	-0.3	-0.2	0.3	0.2
Two-year deviation adjusted for one-offs[9]	*n.a. in EDP in 2016-17*	-0.2	-0.2	0.0	0.0
PER MEMORIAM: One-year deviation [10]	-0.2	-0.3	-0.2	0.3	0.2
PER MEMORIAM: Two-year average deviation [10]	*n.a. in EDP in 2016-17*	-0.2	-0.2	0.0	0.0

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

[10] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence Programme (CP); Commission 2018 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

The United Kingdom does not appear to face fiscal sustainability risks in the short run.[4] Nonetheless, there are some indications that medium- to long-term fiscal sustainability poses potential challenges.

Based on the Commission 2018 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, which stood at 87.7% of GDP in 2017, is expected to decrease to 81.2% of GDP in 2028, thus remaining above the 60% of GDP Treaty threshold. Over this horizon, the debt-to-GDP ratio is expected to have peaked in 2017. Sensitivity analysis shows higher risks.[5] Overall, this highlights the high risks to debt sustainability facing the United Kingdom in the medium term. The full implementation of the Convergence Programme would put debt on a clearly decreasing path by 2028, although remaining above the 60% of GDP reference value in 2028.

The medium-term fiscal sustainability risk indicator S1[6] is at 2.1 percentage points of GDP, pointing to a medium level of risk to fiscal sustainability in the medium term. This is primarily related to the current high level of government debt (contributing 1.9 percentage points of GDP) and projected ageing costs (0.6 percentage point of GDP). The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at 1.8 percentage points of GDP, leading to similar medium-term risks. Overall, given the high risks to debt sustainability, fiscal sustainability risks over the medium-term are high. Fully implementing the fiscal plans in the Convergence Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 3.5 % of GDP. In the long term, the United Kingdom therefore appears to face medium fiscal sustainability risks, primarily related to projected ageing costs, which contribute 3.2 percentage points of GDP. Full implementation of the Convergence Programme would put the S2 indicator at 2.8 percentage points of GDP, leading to a similar level of long-term risk.[7]

[4] This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.
[5] Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).
[6] See the note to Table 5 for a definition of the indicator.
[7] The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 5: Sustainability Indicators

Time horizon	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	**LOW risk**			
S0 indicator [1]	0.4			
Fiscal subindex	0.3	LOW risk		
Financial & competitiveness subindex	0.4	LOW risk		
Medium Term	**HIGH risk**			
DSA [2]	HIGH risk			
S1 indicator [3]	2.1	MEDIUM risk	1.8	MEDIUM risk
of which				
Initial Budgetary Position	-0.4		-1.2	
Debt Requirement	1.9		2.4	
Cost of Ageing	0.6		0.6	
of which				
Pensions	0.2		0.2	
Health-care	0.2		0.2	
Long-term care	0.2		0.1	
Other	0.0		0.0	
Long Term	**MEDIUM risk**		**MEDIUM risk**	
S2 indicator [4]	3.5		2.8	
of which				
Initial Budgetary Position	0.3		-0.4	
Cost of Ageing	3.2		3.2	
of which				
Pensions	1.3		1.3	
Health-care	1.1		1.0	
Long-term care	1.0		0.9	
Other	-0.1		-0.1	

Source: Commission services; 2018 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2018 forecast covering until 2019 included. The 'stability/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 2018 Ageing Report.

[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.

[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.

[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.

* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.

6. FISCAL FRAMEWORK

The government's headline fiscal objective, as contained in the *Charter for Budget Responsibility,* is to "return the public finances to balance at the earliest possible date in the next Parliament".[8] As discussed in Section 3.2, there is some ambiguity over the time period that the fiscal objective refers to. It was initially announced in the 2016 Autumn Statement and was expected to refer to the period 2020 to 2015. However, with the government having held an election in June 2017, this objective could now refer to the period 2017-2022. The objective is complemented by three supplementary targets, namely that: 1) the structural deficit be below 2% by 2020-21; 2) public sector net debt falls as a percentage of GDP by 2020-21; and 3) total spending on a selection of welfare benefits (excluding the state pension and the most cyclical benefits) be below a target nominal level (i.e. a "welfare cap") by 2021-22.

The macroeconomic forecasts underpinning the Convergence Programme have been prepared by the OBR, which is also required by the *Charter for Budget Responsibility* to judge whether the government has a greater than 50 per cent chance of meting its fiscal targets under current policy. The most recent OBR assessment, included in its March 2018 Economic and Fiscal Outlook, shows that all three of the fiscal targets are expected to be met. Given the ambiguity over the time period that the headline fiscal objective refers to, the OBR assesses this under two scenarios: firstly, that it refers to the period 2020 to 2025; and, secondly, that it refers to the period 2017 to 2022. As the OBR's forecast horizon only extends to 2022-23, it cannot assess the government's performance against this objective in the first scenario. However, it states that meeting this objective "appears challenging", particularly in light of projected population ageing and other non-demographic pressures on health spending. In the second scenario, the government is not expected to meet the objective, with the budget deficit projected to stand at 0.9% of GDP in 2022-23.

Based on the information provided in the Convergence Programme, the forecast fiscal performance in the United Kingdom appears to broadly comply with the requirements of the applicable national numerical fiscal rules.

7. SUMMARY

In 2017-18, the United Kingdom did not achieve its MTO. An improvement of the structural balance of 0.1% of GDP, which is lower than the required adjustment towards the MTO, was recorded. Furthermore, the growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by 0.2% of GDP. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the minimum MTO.

The United Kingdom plans a growth rate of government expenditure, net of discretionary revenue measures and one offs, that is higher than the applicable expenditure benchmark rate

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[8] The United Kingdom authorities follow different definitions of national debt and deficit targets from those in the Maastricht Treaty. PSNB, the national deficit target, refers to the cyclically-adjusted current budget balance, excluding financial interventions, whereas the EDP deficit is defined as general government net borrowing, including investment expenditure and interest. PSND, the national debt target, excludes financial interventions. It 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.

in 2018-19 but lower than the applicable expenditure benchmark in 2019-20. The United Kingdom also plans an improvement of the structural balance of 0.5% of GDP in 2018-19 and 0.3% of GDP in 2019-20, both lower than the required adjustment path towards the minimum MTO. According to both the Commission 2018 spring forecast and the Convergence Programme, and following an overall assessment, there is a risk of some deviation from the required adjustment in 2018-19, while the United Kingdom is expected to be compliant with the requirements of the preventive arm in 2019-20. While the United Kingdom is expected to comply with the transitional debt rule according to the Commission 2018 spring forecast, it is not expected to comply based on data from the Convergence Programme.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	2.9	0.6	1.9	2.3	1.9	1.8	1.5	1.2
Output gap [1]	0.9	0.2	-2.6	0.2	0.6	0.8	0.7	0.4
HICP (annual % change)	1.2	2.5	2.9	0.0	0.7	2.7	2.5	1.9
Domestic demand (annual % change) [2]	3.3	0.3	2.2	2.4	2.2	1.4	1.3	1.1
Unemployment rate (% of labour force) [3]	5.0	5.7	7.5	5.3	4.8	4.4	4.4	4.6
Gross fixed capital formation (% of GDP)	17.2	16.8	15.7	16.6	16.5	16.9	16.9	16.8
Gross national saving (% of GDP)	15.5	13.4	11.8	11.8	11.6	13.2	13.7	14.0
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**n.a**	**n.a**	**n.a**	**n.a**	**-2.4**	**-2.2**	**-1.8**	**-1.7**
Gross debt	**36.1**	**47.3**	**82.9**	**88.2**	**88.2**	**87.7**	**86.3**	**85.3**
Net financial assets	**-29.2**	**-37.1**	**-70.8**	**-82.4**	**-90.9**	**-87.7**	**n.a**	**n.a**
Total revenue	36.6	38.4	38.3	38.2	38.9	38.8	38.8	38.8
Total expenditure	36.1	41.4	42.3	39.8	41.3	41.0	40.6	40.4
of which: Interest	2.0	2.1	2.8	2.4	2.5	2.7	2.5	2.5
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-3.5**	**-1.0**	**-0.5**	**-4.0**	**-3.3**	**-1.5**	**-0.9**	**-1.1**
Net financial assets; non-financial corporations	**-165.1**	**-157.7**	**-157.6**	**-150.0**	**-155.4**	**-158.3**	**n.a**	**n.a**
Net financial assets; financial corporations	**-9.5**	**4.9**	**2.1**	**-6.6**	**6.1**	**-0.2**	**n.a**	**n.a**
Gross capital formation	11.8	10.2	9.7	10.4	10.1	10.0	10.0	9.8
Gross operating surplus	20.0	21.4	21.3	21.5	21.3	21.3	22.3	22.3
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.8**	**2.3**	**3.5**	**3.0**	**1.0**	**-0.6**	**-0.6**	**-0.2**
Net financial assets	**204.5**	**185.1**	**208.4**	**220.6**	**235.8**	**233.4**	**n.a**	**n.a**
Gross wages and salaries	43.2	42.3	41.5	41.0	40.9	40.8	40.8	41.0
Net property income	11.1	10.6	10.3	11.2	10.3	9.6	9.5	9.4
Current transfers received	20.8	21.8	24.1	22.8	22.1	21.6	21.5	21.4
Gross saving	6.5	6.1	6.8	6.6	5.0	3.6	3.4	3.8
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-2.2**	**-3.5**	**-4.3**	**-5.3**	**-5.9**	**-4.1**	**-3.6**	**-3.2**
Net financial assets	**-0.6**	**5.2**	**18.4**	**18.8**	**4.9**	**13.2**	**n.a**	**n.a**
Net exports of goods and services	-2.4	-2.5	-2.0	-1.7	-2.1	-1.4	-0.9	-0.4
Net primary income from the rest of the world	1.0	-0.1	-0.9	-2.3	-2.6	-1.6	-1.6	-1.6
Net capital transactions	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Tradable sector	38.5	35.3	34.7	34.6	34.8	35.5	n.a	n.a
Non tradable sector	51.4	55.0	54.8	54.6	54.3	53.7	n.a	n.a
of which: Building and construction sector	5.5	5.8	5.2	5.4	5.5	5.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	114.8	113.9	101.6	113.8	102.5	98.1	102.0	103.1
Terms of trade goods and services (index, 2000=100)	100.1	99.7	100.7	104.3	105.8	106.0	107.0	107.9
Market performance of exports (index, 2000=100)	106.0	104.3	100.4	98.2	96.0	98.2	96.7	95.1

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 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.

Source :
AMECO data, Commission 2018 spring forecast