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**Assessment of the 2018-19 Convergence Programme for  
the United Kingdom**

*(Note prepared by DG ECFIN staff)*

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## **EXECUTIVE SUMMARY**

The United Kingdom is subject to the preventive arm of the Stability and Growth Pact (SGP). Since the United Kingdom's public debt is above the 60% of GDP reference value of the Treaty, it also needs to ensure sufficient progress towards compliance with the debt reduction benchmark.

According to the Commission 2019 spring forecast, the United Kingdom's GDP growth is expected to remain subdued at 1.3% in both 2019 and 2020, down from 1.4% in 2018. Domestic demand growth is expected to be modest. Business investment growth is projected to be relatively weak in 2019, but public investment is set to increase significantly. In 2020, domestic demand growth is expected to remain subdued, with the contribution of net exports picking up slightly. The Convergence Programme contains plausible macroeconomic assumptions and is broadly in line with the Commission 2019 spring forecast.

The United Kingdom has been gradually adjusting to the medium-term budgetary objective (MTO). After several years of improvements in the general budget balance, including from -2.1% of GDP in 2017-18 to -1.2% of GDP in 2018-19, the general government balance is expected to deteriorate to -1.4% of GDP in 2019-20, according to the Convergence Programme. In 2020-21, the balance is expected to improve to -1.1% of GDP. The recalculated structural balance<sup>1</sup> is expected to be -1.6% in 2019-20 and -1.1% in 2020-21. There are several negative risks to the United Kingdom's public finance outlook, including the uncertainty surrounding its ongoing withdrawal from the EU, pressures to increase public spending and changes to the way student loans are accounted for in public finances.

According to the Commission 2019 spring forecast, the United Kingdom will be at risk of significant deviation from the requirements of the SGP in both 2019-20 and 2020-21. Compliance with the transitional debt rule is ensured in 2018-19. The United Kingdom is also projected to comply with the transitional debt rule in 2019-20, as a result of the allowed deviation of 0.25% of GDP. In 2020-21, the United Kingdom is projected to comply with the debt reduction benchmark.

### **1. INTRODUCTION**

On 24 April 2019, the United Kingdom submitted its 2018-19 Convergence Programme (hereafter called the Convergence Programme), covering the period 2018-19 to 2023-24. The government approved the programme and it was submitted to the 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 largely based on the 2018 Autumn Budget and the 2019 Spring Statement, published by HM Treasury, along with the Office for Budget Responsibility's (OBR) March 2019 Economic and Fiscal Outlook.

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<sup>1</sup> Recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology.

The United Kingdom is currently subject to the preventive arm of the SGP and should ensure sufficient progress towards its MTO. As the debt ratio was 86.4% 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 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 transition period, as of 2020-21, the United Kingdom is expected to comply with the debt reduction benchmark.

This document complements the Country Report published on 27 February 2019 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 2019 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 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**

Given the ongoing ratification process of the Withdrawal Agreement in the United Kingdom the Commission's forecasts for 2019 and 2020 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 future negotiations between the EU and the United Kingdom. The Convergence Programme notes that the OBR did not attempt to predict the precise outcome of negotiations with the EU. Instead, it made broad assumptions, including that the United Kingdom would leave the EU by March 2019 and that there would be a transition period until December 2020<sup>2</sup>.

The United Kingdom's economy grew by 1.4% in 2018, down from 1.8% in 2017 and 0.1 percentage point below the forecast for 2018 in the 2017-18 Convergence Programme. According to the Convergence Programme, GDP growth is expected to slow further to 1.2% in 2019 before increasing to 1.4% in 2020. These projections represent marginal revisions from the 2017-18 Convergence Programme, which forecast growth of 1.3% in both years. In 2019, the domestic demand contribution to growth is expected to be subdued, with both private consumption and investment growth projected to be relatively weak, despite support from expansionary fiscal measures in 2019-20. In 2019 a build-up of inventories is expected to be offset by a negative net exports' contribution to growth. This reflects the fact the Convergence Programme projected significant stockpiling in the first quarter of the year as firms were expected to mitigate against any effects in the event of the UK leaving the EU without a deal ('no-deal') in March. The net effect on GDP growth from this stockpiling was assumed to be minimal because much of the additional stocks were expected to be imported. In 2020 domestic demand growth is projected to pick up somewhat as private consumption

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<sup>2</sup> The Convergence Programme projections were taken from the OBR's most recent Economic and Fiscal Outlook, which was published on 13 March 2019.

growth increases in line with projected real disposable income growth<sup>3</sup>, investment growth accelerates modestly, while net exports contribute less negatively to growth.

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 from 2018 to 2019 and then further to around zero in 2020 and 2021. The Commission 2019 spring forecast for the output gap in 2019 and 2020 is higher than the one recalculated based on information in the Convergence Programme.

**Table 1: Comparison of macroeconomic developments and forecasts**

|  | 2018 |      | 2019 |      | 2020 |      | 2021 | 2022 |
|--|------|------|------|------|------|------|------|------|
|  | COM  | CP   | COM  | CP   | COM  | CP   | CP   | CP   |
| Real GDP (% change)  | 1.4  | 1.4  | 1.3  | 1.2  | 1.3  | 1.4  | 1.6  | 1.6  |
| Private consumption (% change)                                   | 1.7  | 1.7  | 1.8  | 1.1  | 1.7  | 1.5  | 1.6  | 1.6  |
| Gross fixed capital formation (% change)                         | 0.2  | 0.0  | -0.2 | 0.6  | 0.8  | 1.8  | 1.9  | 1.9  |
| Exports of goods and services (% change)                         | 0.1  | 0.2  | 2.3  | 1.4  | 2.5  | 1.7  | 0.2  | -0.3 |
| Imports of goods and services (% change)                         | 0.7  | 0.8  | 2.9  | 3.0  | 2.5  | 2.1  | 0.6  | 0.0  |
| <i>Contributions to real GDP growth:</i>                         |      |      |      |      |      |      |      |      |
| - Final domestic demand  | 1.2  | 1.2  | 1.5  | 1.2  | 1.4  | 1.6  | 1.7  | 1.7  |
| - Change in inventories  | 0.4  | 0.4  | 0.0  | 0.4  | 0.0  | 0.0  | 0.0  | 0.0  |
| - Net exports  | -0.2 | -0.2 | -0.3 | -0.5 | 0.0  | -0.2 | -0.1 | -0.1 |
| Output gap <sup>1</sup>  | 0.8  | 0.9  | 0.5  | 0.3  | 0.3  | 0.0  | 0.0  | 0.0  |
| Employment (% change)  | 1.2  | 1.2  | 0.8  | 0.4  | 0.8  | 0.5  | 0.5  | 0.4  |
| Unemployment rate (%)  | 4.0  | 4.1  | 4.1  | 4.1  | 4.2  | 4.1  | 4.1  | 4.0  |
| Labour productivity (% change)                                   | 0.2  | 0.2  | 0.5  | 0.8  | 0.5  | 1.0  | 1.1  | 1.2  |
| HICP inflation (%)   | 2.5  | 2.5  | 2.0  | 2.1  | 2.1  | 1.9  | 2.0  | 2.0  |
| GDP deflator (% change)  | 1.9  | 1.7  | 1.9  | 2.0  | 2.0  | 1.8  | 1.9  | 2.0  |
| Comp. of employees (per head, % change)                          | 2.7  | 2.6  | 3.1  | 3.7  | 3.2  | 3.3  | 3.2  | 3.2  |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | -4.0 | -4.8 | -3.8 | -5.1 | -3.5 | -5.2 | -5.0 | -4.9 |

Note:

<sup>1</sup>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 2019 spring forecast (COM); Convergence Programme (CP).*

The Convergence Programme contains plausible macroeconomic assumptions. In 2019, GDP is expected to grow by 1.2%, 0.1 percentage points below the Commission 2019 spring forecast. Within this, the Convergence Programme projects a weaker contribution from domestic demand but a larger contribution from inventories compared to the Commission's forecast. In 2020, the Convergence Programme projects growth to be 1.4%, marginally above the Commission's forecast of 1.3%. Compared to the Commission's forecast for 2020, the

<sup>3</sup> In 2019, a freeze in most working-age benefits and tax credits weighs on real disposable income growth, which unwinds in 2020.

Convergence Programme forecasts a slightly higher contribution to growth from domestic demand but a more negative contribution from net exports. The expected labour market outcomes are similar in the Convergence Programme and Commission's forecast, with both expecting a slowing in the pace of employment growth to result in a stable but low unemployment rate. However, compared to the Commission's forecast, the projected growth rate of compensation of employees per head is stronger in the Convergence Programme in 2019, which largely reflects a steeper (year-on-year) drop in the projected employment growth rate, but pay growth is similar in 2020. In 2019, the Convergence Programme forecasts inflation of 2.1%, 0.1 percentage points above the Commission's forecast, and projects inflation to ease to 1.9% in 2020, compared to a slight pick-up to 2.1% in the Commission's forecast.

### **3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS**

#### **3.1. Deficit developments in 2018-19 and 2019-20**

According to the Convergence Programme, the general government deficit is expected to have fallen from 2.1% of GDP in 2017-18 to 1.2% of GDP in 2018-19. This is 0.6 percentage points lower than the deficit that was expected for 2018-19 in the 2017-2018 Convergence Programme (1.8%), but only 0.1 percentage points below the projection published by the OBR at the time of the 2018 Autumn Budget (October 2018). At 37% of GDP, the revenue ratio in 2018-19 is expected to have been 0.3 percentage points higher than the projection contained in the 2017-18 Convergence Programme (36.7%), and the expenditure ratio (38.2% of GDP) is expected to have been 0.3 percentage points lower than expected in the 2017-18 Convergence Programme (38.5% of GDP). These positive fiscal outcomes have been mainly driven by higher-than-expected revenues, in particular income tax receipts, and lower interest expenditure due to lower payments on inflation-linked bonds following a sharper-than-expected fall in the retail price index measure of inflation.

According to the Convergence Programme, the deficit is projected to rise to 1.4% of GDP in 2019-20, 0.3 percentage points lower than the deficit anticipated in the 2017-18 Convergence Programme (1.7%), but only 0.1 percentage points lower than the deficit expected in the projection published by the OBR at the time of the 2018 Autumn Budget (October 2018). These reductions in the expected deficit reflect an increase in revenues that was not expected a year ago. The projected 2019-20 revenue ratio is now 36.8% of GDP, 0.2 percentage points higher than expected in the 2017-18 Convergence Programme. The expenditure ratio is expected to increase slightly in 2019-20 (38.3%), reflecting higher interest expenditure and the impact of some additional spending and other policy decisions included in the 2018 Autumn Budget.

#### **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 over the time period that the fiscal objective refers to, but the OBR now assumes it to relate to the mid-2020s, or 2025-26. 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 2022-23 (see section 6). The fiscal targets have broadly remained the same from last year's Convergence report. The Convergence Programme does not define an MTO, which is not in line with the legislation. The United Kingdom's minimum MTO as calculated by the European Commission is -0.75% of GDP for 2018-19 and 2019-20, and -0.5% of GDP for 2020-21.

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. The projections are overall sufficiently supported by measures. After a projected increase in the expenditure-to-GDP ratio in 2019-20, the United Kingdom authorities continue on a path of gradual expenditure-based fiscal consolidation over the medium term. In all years, the Commission forecast has a higher revenue ratio and a higher expenditure ratio than the Convergence Programme, which is largely due to differences in accounting treatment.

**Table 2: Composition of the budgetary adjustment**

| (% of GDP)                               | 2018-19     |             | 2019-20     |             | 2020-21     |             | 2021-22     | 2022-23     | Change: 2018-19 |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-----------------|
|  | COM         | CP          | COM         | CP          | COM         | CP          | CP          | CP          | CP              |
| <b>Revenue</b>                           | <b>39.3</b> | <b>37.0</b> | <b>39.5</b> | <b>36.8</b> | <b>39.8</b> | <b>36.9</b> | <b>36.7</b> | <b>37.0</b> | <b>-2.3</b>     |
| <i>of which:</i>                         |             |             |             |             |             |             |             |             |                 |
| - Taxes on production and imports        | 13.0        | 13.2        | 13.1        | 13.2        | 13.2        | 13.1        | 13.1        | 13.1        | 0.1             |
| - Current taxes on income, wealth, etc.  | 14.3        | 12.3        | 14.5        | 12.1        | 14.6        | 12.3        | 12.3        | 12.4        | -1.9            |
| - Social contributions                   | 7.9         | 6.5         | 7.9         | 6.5         | 7.9         | 6.6         | 6.6         | 6.6         | -1.3            |
| - Other (residual)                       | 4.0         | 5.0         | 4.0         | 5.0         | 4.0         | 4.9         | 4.7         | 4.9         | 0.9             |
| <b>Expenditure</b>                       | <b>40.6</b> | <b>38.2</b> | <b>40.9</b> | <b>38.3</b> | <b>40.9</b> | <b>38.0</b> | <b>37.8</b> | <b>37.7</b> | <b>-2.9</b>     |
| <i>of which:</i>                         |             |             |             |             |             |             |             |             |                 |
| - Primary expenditure                    | 38.2        | 35.9        | 38.6        | 35.9        | 38.6        | 35.8        | 35.7        | 35.6        | -2.6            |
| <i>of which:</i>                         |             |             |             |             |             |             |             |             |                 |
| Compensation of employees+Intermediate   |             |             |             |             |             |             |             |             |                 |
| <i>Compensation of employees</i>         | 8.9         | n.a.        | 9.0         | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        | n.a.            |
| <i>Intermediate consumption</i>          | 7.9         | n.a.        | 8.2         | n.a.        | 8.2         | n.a.        | n.a.        | n.a.        | n.a.            |
| Social payments                          | 15.2        | 11.3        | 15.1        | 11.0        | 15.0        | 10.8        | 10.8        | 10.9        | -4.3            |
| Subsidies                                | 0.8         | 1.0         | 0.8         | 1.0         | 0.8         | 1.0         | 1.0         | 1.0         | 0.2             |
| Gross fixed capital formation            | 2.7         | 2.7         | 2.8         | 2.7         | 2.9         | 2.7         | 2.8         | 2.7         | 0.0             |
| Other (residual)                         | 2.7         | 3.9         | 2.6         | 4.0         | 11.7        | 4.3         | 4.1         | 4.0         | 1.3             |
| - Interest expenditure                   | 2.3         | 2.3         | 2.4         | 2.4         | 2.3         | 2.2         | 2.1         | 2.1         | -0.2            |
| <b>General government balance (GGB)</b>  | <b>-1.3</b> | <b>-1.2</b> | <b>-1.5</b> | <b>-1.4</b> | <b>-1.2</b> | <b>-1.1</b> | <b>-1.1</b> | <b>-0.7</b> | <b>0.6</b>      |
| <b>Primary balance</b>                   | <b>1.0</b>  | <b>1.1</b>  | <b>0.9</b>  | <b>0.9</b>  | <b>1.1</b>  | <b>1.1</b>  | <b>1.0</b>  | <b>1.3</b>  | <b>0.3</b>      |
| One-off and other temporary              | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0         | 0.0             |
| <b>GGB excl. one-offs</b>                | <b>-1.3</b> | <b>-1.2</b> | <b>-1.5</b> | <b>-1.4</b> | <b>-1.2</b> | <b>-1.1</b> | <b>-1.1</b> | <b>-0.7</b> | <b>0.6</b>      |
| Output gap <sup>1</sup>                  | 0.8         | 0.9         | 0.5         | 0.3         | 0.3         | 0.0         | 0.0         | 0.0         | -0.8            |
| Cyclically-adjusted balance <sup>1</sup> | -1.7        | -1.7        | -1.7        | -1.6        | -1.3        | -1.1        | -1.1        | -0.7        | 1.0             |
| <b>Structural balance<sup>2</sup></b>    | <b>-1.7</b> | <b>-1.7</b> | <b>-1.7</b> | <b>-1.6</b> | <b>-1.3</b> | <b>-1.1</b> | <b>-1.1</b> | <b>-0.7</b> | <b>1.0</b>      |
| Structural primary balance <sup>2</sup>  | 0.6         | 0.6         | 0.6         | 0.8         | 1.0         | 1.1         | 1.0         | 1.4         | <b>0.8</b>      |

Notes:

<sup>1</sup>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.

<sup>2</sup>Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

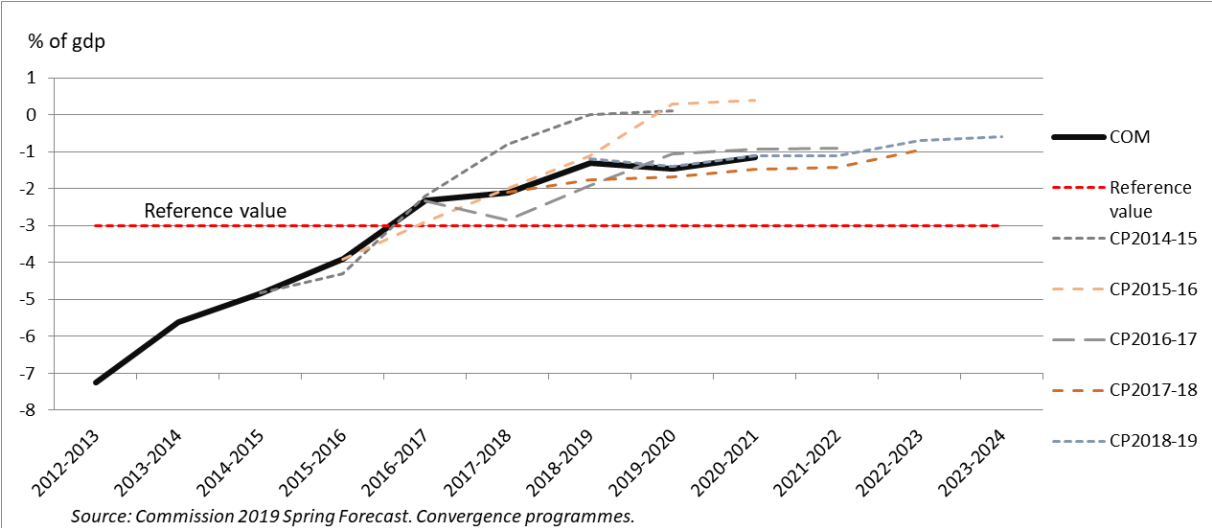
Source:

Convergence Programme (CP); Commission 2019 spring forecasts (COM); Commission calculations.

The structural balance as provided in the Convergence Programme is less negative than the structural balance recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology. While the structural balance originally included in the Convergence Programme is -1.3% of GDP in 2018-19, the recalculated structural balance is -1.7% of GDP due to a more positive output gap used for the recalculation. In 2019-20, the structural balance as provided in the Convergence Programme slightly deteriorates to -1.4% of GDP, whereas the recalculated rate is at -1.6% of GDP. For 2020-21, both improve and are close to -1.0% of GDP.

Figure 1 below shows the government balance projections in successive Convergence Programmes. Overall, projections of the general government balance in a given year have tended to deteriorate over time, though the current Convergence Programme reverses this trend with slight positive revisions. A particularly large deterioration in the forecast of the general government balance can be observed between the 2015-16 and 2016-17 Convergence Programmes, reflecting in particular changes to expected GDP and revenue growth. The current 2018-19 Convergence Programme forecasts an improved general budget balance in comparison to the 2017-18 Convergence Programme. This is mainly driven by a projected long-term improvement in tax receipts and lower spending on debt interest.

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



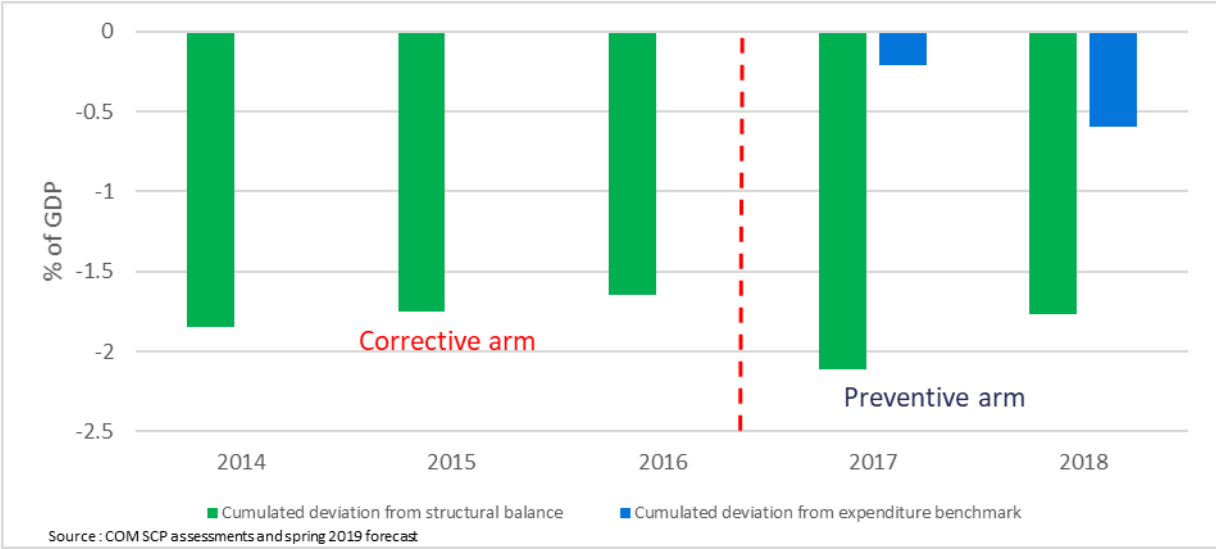
Over the last five years, the United Kingdom’s cumulative deviations from the structural requirements of the SGP remained negative (see Figure 2 below), due primarily to a large one-year shortfall of 1.85% of GDP from the required targets in 2014-15. This was followed by an overachievement of the structural targets by 0.1% of GDP in both 2015-16 and 2016-17. By 2016-17, the cumulative deviation from the required structural adjustment was therefore 1.65% of GDP.

Since the correction of the excessive deficit in 2016-17, the United Kingdom has been subject to the preventive arm of the SGP and has been recommended to ensure an annual structural adjustment of 0.6% of GDP towards the MTO in both 2017-18 and 2018-19. In 2017-18, the structural adjustment fell short by 0.45% of GDP, thus increasing the cumulative deviation from the required structural adjustment to 2.1% of GDP. In 2018-19 the structural balance improved by 0.9% of GDP, above the required adjustment. This therefore lowered the cumulative deviation from the required adjustment by 0.3 percentage points to 1.8% of GDP.



For the period during which the United Kingdom was subject to the corrective arm of the SGP (up to and including 2016-17), the deviation of the expenditure benchmark is not assessed. When the United Kingdom entered the preventive arm in 2017-18, the growth rate of expenditure led to a deviation from the requirements of the SGP of 0.2% of GDP for 2018-19. For 2018-19, an additional deviation of 0.4% of GDP is projected, giving a cumulative deviation of 0.6% of GDP.

**Figure 2: Cumulative deviations of the preceding five years from the upper limit for net growth of government expenditure and from structural effort requirements (in % of GDP)**



**3.3. Measures underpinning the programme**

The Convergence Programme presents a detailed list of policy measures both on the spending and revenue side. The table below sets out the most significant measures (above 0.1% of GDP) announced since the publication of the 2017-18 Convergence Programme. These mainly relate to measures published in the 2018 Autumn Budget, which included a number of deficit-increasing spending and tax measures. In particular, it increased spending for the National Health Service in England, and introduced changes to the personal income tax allowance. The changes to the public service pensions and the reduction of the corporation tax were both introduced in previous fiscal events.

The Convergence Programme presents plausible estimates of the measures' budgetary impact, based on costings produced by the OBR. As such, there are limited differences between the Commission's estimates and those in the Convergence Programme. However, for measures aimed at reducing revenue losses due to tax avoidance, the Commission only reflects half of the impact in the spring forecast, due to the high level of uncertainty associated with such measures. There is no impact of planned one-off measures in any of the years covered by the Convergence Programme.

### Main budgetary measures included in the Programme

| Revenue  | Expenditure   |
|--|---|
| <b>2018-19</b>   |   |
| •  | •   |
| <b>2019-20</b>   |   |
| <ul style="list-style-type: none"> <li>• Personal tax allowance and higher rate threshold (-0.1% of GDP)</li> </ul>  | <ul style="list-style-type: none"> <li>• NHS: additional funding (0.4% of GDP)</li> <li>• Public Service Pensions: update to discount rate (- 0.1% of GDP)</li> </ul> |
| <b>2020-21</b>   |   |
| <ul style="list-style-type: none"> <li>• Corporation tax: reduce to 17% in April 2020 (-0.1% of GDP)</li> </ul>  | <ul style="list-style-type: none"> <li>• NHS: additional funding (0.2% of GDP)</li> </ul>   |
| <p><u>Note:</u> The table refers to the main measures included in the 2018-19 Convergence Programme that have an incremental budgetary impact over the programme period. 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> |   |

#### 3.4. Debt developments

According to the Convergence Programme, the government debt-to-GDP ratio is expected to be stable at 85.5% of GDP in 2018-19, before falling to 83.8% of GDP in 2019-20 and 82.9% of GDP in 2020-21. By the end of the forecast horizon, in 2022-23, it is expected to be at 81.1%. The projections for 2019-20 and 2020-21 are in line with the Commission 2019 spring forecast. According to the Convergence Programme, the forecast reduction in the debt-to-GDP ratio is mainly driven by a positive primary balance, which is broadly around 1.0% of GDP over the forecast period. In 2019-20 and 2020-21 this is in line with the Commission forecast. In both the Convergence Programme and the Commission 2019 spring forecast, interest expenditure is expected to put upward pressure on the debt ratio in the coming years, although this is expected to be more than offset by the downward pressure from inflation and economic growth. With the exception of 2019-20, the stock-flow adjustment is expected to put upward pressure on the debt ratio.

**Table 3: Debt developments**

| (% of GDP)                          | Average     | 2018-19     |             | 2019-20     |             | 2020-21     |             | 2021-22     | 2022-23     |
|-------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
|                                     | 2013-2017   | COM         | CP          | COM         | CP          | COM         | CP          | CP          | CP          |
| <b>Gross debt ratio<sup>1</sup></b> | <b>86.0</b> | <b>85.4</b> | <b>85.5</b> | <b>83.8</b> | <b>83.8</b> | <b>82.7</b> | <b>82.9</b> | <b>82.2</b> | <b>81.1</b> |
| Change in the ratio                 | 0.4         | 0.0         | 0.0         | -1.6        | -1.6        | -1.1        | -0.9        | -0.7        | -1.1        |
| <i>Contributions<sup>2</sup>:</i>   |             |             |             |             |             |             |             |             |             |
| <b>1. Primary balance</b>           | <b>-0.6</b> | <b>-1.0</b> | <b>-1.1</b> | <b>-0.9</b> | <b>-0.9</b> | <b>-1.1</b> | <b>-1.1</b> | <b>-1.0</b> | <b>-1.3</b> |
| <b>2. “Snow-ball” effect</b>        | <b>-0.6</b> | <b>-0.6</b> | <b>-0.6</b> | <b>-0.2</b> | <b>-0.3</b> | <b>-0.2</b> | <b>-0.5</b> | <b>-0.8</b> | <b>-0.8</b> |
| <i>Of which:</i>                    |             |             |             |             |             |             |             |             |             |
| Interest expenditure                | 2.7         | 2.3         | 2.3         | 2.4         | 2.4         | 2.3         | 2.2         | 2.1         | 2.1         |
| Growth effect                       | -1.8        | -1.2        | -1.2        | -1.0        | -1.0        | -0.9        | -1.1        | -1.3        | -1.3        |
| Inflation effect                    | -1.4        | -1.7        | -1.7        | -1.6        | -1.6        | -1.6        | -1.5        | -1.6        | -1.6        |
| <b>3. Stock-flow adjustment</b>     | <b>-0.2</b> | <b>1.6</b>  | <b>1.6</b>  | <b>-0.5</b> | <b>-0.3</b> | <b>0.3</b>  | <b>0.7</b>  | <b>1.1</b>  | <b>1.1</b>  |
| <i>Of which:</i>                    |             |             |             |             |             |             |             |             |             |
| Cash/accruals diff.                 |             |             |             |             |             |             |             |             |             |
| Acc. financial assets               |             |             |             |             |             |             |             |             |             |
| <i>Privatisation</i>                |             |             |             |             |             |             |             |             |             |
| Val. effect & residual              |             |             |             |             |             |             |             |             |             |

Notes:

<sup>1</sup> End of period.

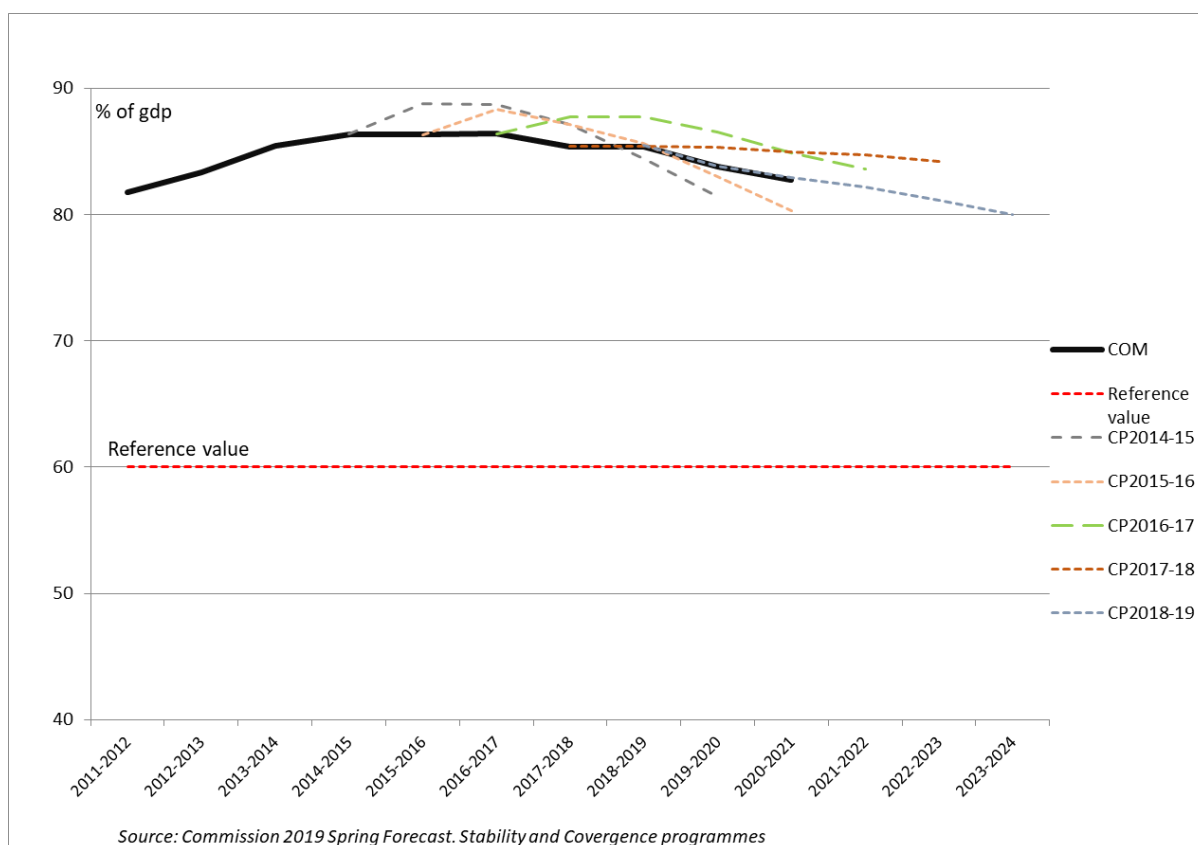
<sup>2</sup> The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial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

Source :

*Commission 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.*

Figure 2 below shows the government debt projections in successive Convergence Programmes. In the earlier Convergence Programmes, projections of government debt were generally revised up. A particular large upward revision can be observed between the 2015-16 and 2016-17 Convergence Programmes, reflecting expected lower GDP growth and expected slower deficit reduction. In contrast, in the latest Convergence Programme (2018-2019) debt projections were revised down, mainly reflecting the improvement in the general government balance.

**Figure 3: Government debt projections in successive programmes (% of GDP)**



### 3.5. Risk assessment

There are a number of risks to the economic and fiscal outlook in the Convergence Programme. Firstly, growth projections for the United Kingdom are currently subject to a 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. 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. 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 on health care in the 2018 Autumn Budget. The Chancellor of the Exchequer has signalled the possibility of further expenditure measures being announced in the 2019 Autumn Budget and in the upcoming Spending Review<sup>4</sup>.

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

<sup>4</sup> The UK government had previously announced that there would be a multi-year Spending Review in 2019, but due to uncertainties around the UK's withdrawal from the EU no final decision has yet been taken regarding the specific timeframe nor scope.

expenditure limits (DELS), which account for the bulk of discretionary expenditure, fixed and set three years in advance. However, as discussed above, there may be increased upward pressure on DELs in the coming years. The Spending Review that is due to be completed in autumn 2019 could give rise to an increase in planned DELs.

Lastly, the Office for National Statistics (ONS) has announced a change to the way student loans are treated in public sector finances and national accounts. The change, which the ONS plans to implement in autumn 2019, is expected to lead to a significant increase of the UK outturn headline deficit for previous years as well as for future projections (e.g. for 2018-19, an increase of 0.5% of GDP is expected). This might impact the assessment of the United Kingdom’s fiscal policy for both past and future years. A full assessment will only be possible once the ONS has implemented the changes in autumn 2019<sup>5</sup>.

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

**Box 1. Council Recommendations addressed to the United Kingdom**

*On 13 July 2018, 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 “ensure that the nominal growth rate of net primary government expenditure does not exceed 1.6% in 2019-2020, corresponding to an annual structural adjustment of 0.6% of GDP”.*

**4.1. Compliance with the debt criterion**

The government debt ratio of the United Kingdom is expected to remain above 60% of GDP across the forecast periods of both the Convergence Programme and the Commission 2019 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, until 2019-20. In 2020-21, the United Kingdom is subject to the debt reduction benchmark.

According to Convergence Programme, the recalculated change in the structural balance is projected to have been compliant with the transitional debt rule in 2018-19. The required adjustment is 0.8% of GDP and the (recalculated) structural adjustment amounts to 1.0% of GDP. In 2019-20, the required adjustment is 0.6% of GDP, but the (recalculated) structural adjustment is only 0.1% of GDP. Therefore, the United Kingdom is not projected to be compliant in 2019-20.

According to the Commission 2019 spring forecast, the structural adjustment in 2018-19 was 0.9% of GDP, and therefore exceeds the required adjustment of 0.6% of GDP. The United Kingdom is therefore projected to comply with the transitional debt rule in 2018-19. In 2019-20, the structural adjustment (0.0% of GDP) is expected to be lower than the required MLSA

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<sup>5</sup> For more information on the changes, see ONS announcement on student loans: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/articles/newtreatmentofstudentloansinthepublicsectorfinancesandnationalaccounts/2018-12-17>

(0.2% of GDP). However, the United Kingdom is projected to comply with the transitional debt rule as a result of the allowed annual deviation of 0.25% of GDP.

**Table 4. Compliance with the debt criterion**

|  | 2018-19     |             | 2019-20     |             | 2020-21     |             |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
|  | CP          | COM         | CP          | COM         | CP          | COM         |
| Gross debt ratio                         | <b>85.5</b> | <b>85.4</b> | <b>83.8</b> | <b>83.8</b> | <b>82.9</b> | <b>82.7</b> |
| Gap to the debt benchmark <sup>1,2</sup> |             |             |             |             | 0.3         | -0.4        |
| Structural adjustment <sup>3</sup>       | 1.0         | 0.9         | 0.1         | 0.0         |             |             |
| <i>To be compared to:</i>                |             |             |             |             |             |             |
| Required adjustment <sup>4</sup>         | 0.8         | 0.6         | 0.6         | 0.2         |             |             |

Notes:

<sup>1</sup> Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

<sup>2</sup> 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.

<sup>3</sup> Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

<sup>4</sup> 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 2019 spring forecast (COM); Convergence Programme (CP), Commission calculations.*

In 2020-21, the United Kingdom is subject to the debt reduction benchmark. According to the Convergence Programme, with a gap to the debt reduction benchmark of 0.3% of GDP, the United Kingdom is projected not to be compliant with the requirements. According to the Commission 2019 spring forecast the United Kingdom is projected to comply with the debt reduction benchmark in 2020-21 with a margin of 0.4% of GDP.

Overall, the United Kingdom is in a transition period until 2019-20 and is making sufficient progress towards compliance with the transitional debt rule in 2019-20. The debt reduction benchmark is expected to be met in 2020-21.

## 4.2. Compliance with the MTO or the required adjustment path 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 2018-2019, the United Kingdom was required to have a nominal growth rate of net primary government expenditure which did not exceed 1.8%, corresponding to an annual structural adjustment of 0.6% of GDP.

Based on outturn data and the Commission forecast, in 2018-19, over one year the expenditure benchmark<sup>6</sup> points to some deviation from the required adjustment, while the structural balance pillar points to compliance. Over two years, the expenditure benchmark points to a significant deviation, while the structural balance points to some deviation. This calls for an overall assessment. The structural balance pillar in 2018-19 is positively impacted by a fall in interest expenditure, due to reduced payments on index-linked gilts in 2018-19 following a sharper than expected fall in the retail price index, as well as revenue windfalls. This suggests that the expenditure benchmark more accurately reflects the fiscal effort in 2018-19. However, the persistence of estimated revenue windfalls in recent years gives rise to some uncertainty over the extent to which they should be included in normal government revenues. Due to this uncertainty and the closeness of the deviation on the expenditure benchmark to some deviation from the adjustment path towards the MTO over two years, it is considered that there was some deviation from the expenditure benchmark in 2018-19 and in 2017-18/2018-19 taken together. Overall, this leads to an assessment of some deviation from the requirements of the preventive arm in 2018-19.

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, the growth of nominal primary government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed the applicable expenditure benchmark, leading to a deviation of 0.4% of GDP. This points to a risk of some deviation from the requirements of the SGP. The structural benchmark pillar points to a risk of significant deviation, with a shortfall of 0.5% of GDP from the required adjustment. Over two years, the expenditure benchmark pillar points to a significant deviation from the requirements of the SGP, while the structural balance pillar points to some deviation. This requires an overall assessment. The change in the recalculated structural balance over one year is influenced by windfalls. The deviation on the structural balance over two years is positively affected by the 2018-19 figures, which themselves reflect interest savings. The expenditure benchmark is therefore considered to give a more accurate picture of the actual fiscal effort over two years, thus pointing to a significant deviation over two years. Overall the assessment according to the Convergence Programme therefore points to a risk of significant deviation.

According to the Commission 2019 spring forecast, in 2019-20, the expenditure benchmark and the structural balance pillar both point to a risk of significant deviation from the required adjustment. This is related to large planned increases in current expenditure. Over two years, the expenditure benchmark pillar also points to a risk of significant deviation, while the

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<sup>6</sup> 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.

structural balance pillar points to a risk of some deviation. This calls for an overall assessment. As discussed above, the structural balance in 2018-19 is positively impacted by reduced interest payments and revenue windfalls. The expenditure benchmark pillar is, therefore, considered to give a more accurate picture of the actual fiscal effort over two years. Overall, therefore, the assessment points to a risk of significant deviation from the requirements of the preventive arm in 2019-20.


In 2020-21, the United Kingdom is required to ensure that the nominal growth rate of net primary government expenditure does not exceed 1.9%, corresponding to an annual structural adjustment of 0.6% of GDP. While the minimum MTO for the United Kingdom in 2018-19 and 2019-20 was -0.75% of GDP, it was raised to -0.5% of GDP for 2020-21. According to the Convergence Programme, net public expenditure is expected to grow by 2.7% in 2020-21, thus pointing to some deviation from the recommended adjustment path towards the MTO in 2019-20. The change in the structural balance (-0.1%) is also below the required adjustment and points to some deviation in 2020-21. Based on two-year averages, both the expenditure benchmark pillar and the structural balance pillar point to significant deviation. This calls for an overall assessment. The assessment over two years reflects the risk of a significant deviation from both pillars in 2019-20, related to large planned expenditure increases by the United Kingdom's authorities. Based on the Convergence Programme, therefore, the overall assessment points to a risk of significant deviation from the requirements of the preventive arm in 2020-21.

According to the Commission 2019 spring forecast, net government expenditure is expected to grow by 3.2% in nominal terms in 2020-21, falling short by 0.5% of GDP of the required adjustment, thus pointing to a risk of some deviation. The structural benchmark is expected to improve by 0.4% of GDP, 0.2% below the required adjustment, thus pointing to a risk of some deviation from the required adjustment. Over two years, both the expenditure benchmark pillar and the structural balance pillar point to a risk of significant deviation. This calls for an overall assessment. The assessment over two years reflects the risk of a significant deviation from both pillars in 2019-20, related to large planned expenditure increases by the United Kingdom's authorities. The overall assessment, therefore, points to a risk of significant deviation from the requirements of the preventive arm in 2020-21.

In conclusion, based on outturn data and the Commission 2019 spring forecast, the ex-post assessment suggests some deviation from the adjustment path towards the minimum MTO in 2018-19. According to the both the Convergence Programme and the Commission 2019 spring forecast and following an overall assessment, a risk of significant deviation from the adjustment path towards the MTO is currently expected in both 2019-20 and 2020-21.



**Table 5: Compliance with the requirements under the preventive arm**

| (% of GDP)   | 2018-19               | 2019-20                      | 2020-21                      |   |                              |
|--|-----------------------|------------------------------|------------------------------|---|------------------------------|
| <b>Background budgetary indicators<sup>1</sup></b>   |                       |                              |                              |   |                              |
| Medium-term objective (MTO)  | -0.8                  | -0.8                         | -0.5                         |   |                              |
| Structural balance <sup>2</sup> (COM)  | -1.7                  | -1.7                         | -1.3                         |   |                              |
| <b>Setting the required adjustment to the MTO</b>  |                       |                              |                              |   |                              |
| Structural balance based on freezing (COM)   | -1.7                  | -1.7                         | -                            |   |                              |
| Position vis-a-vis the MTO <sup>3</sup>  | Not at MTO            | Not at MTO                   | Not at MTO                   |   |                              |
| Required adjustment <sup>4</sup>   | 0.6                   | 0.6                          | 0.6                          |   |                              |
| Required adjustment corrected <sup>5</sup>   | 0.6                   | 0.6                          | 0.6                          |   |                              |
| Corresponding expenditure benchmark <sup>6</sup>   | 1.8                   | 1.6                          | 1.9                          |   |                              |
| <b>Compliance with the required adjustment to the MTO</b>  |                       |                              |                              |   |                              |
|  | COM                   | CP                           | COM                          | CP  | COM                          |
| <b>Structural balance pillar</b>   |                       |                              |                              |   |                              |
| Change in structural balance <sup>7</sup>  | 0.9                   | 0.1                          | 0.0                          | 0.5   | 0.4                          |
| One-year deviation from the required adjustment <sup>8</sup>   | 0.3                   | -0.5                         | -0.6                         | -0.1  | -0.2                         |
| Two-year average deviation from the required adjustment <sup>8</sup>   | -0.1                  | -0.1                         | -0.1                         | -0.3  | -0.4                         |
| <b>Expenditure benchmark pillar</b>  |                       |                              |                              |   |                              |
| Net public expenditure annual growth corrected for one-offs <sup>9</sup>   | 2.8                   | 2.7                          | 3.1                          | 2.7   | 3.2                          |
| One-year deviation adjusted for one-offs <sup>10</sup>   | -0.4                  | -0.4                         | -0.6                         | -0.3  | -0.5                         |
| Two-year deviation adjusted for one-offs <sup>10</sup>   | -0.3                  | -0.4                         | -0.5                         | -0.3  | -0.5                         |
| <b>Finding of the overall assessment</b>   | <b>some deviation</b> | <b>significant deviation</b> | <b>significant deviation</b> | <b>significant deviation</b>  | <b>significant deviation</b> |
| <b>Legend</b>  |                       |                              |                              |   |                              |
| 'Compliance' - the recommended structural adjustment or a higher adjustment is being observed.   |                       |                              |                              |  |                              |
| 'Some deviation' - a deviation from the recommended structural adjustment is being observed, but it is below the threshold for a significant deviation.  |                       |                              |                              |   |                              |
| 'Significant deviation' - a deviation which has reached or breached the threshold for a significant deviation (i.e. 0.5% of GDP over one year, 0.25% of GDP over two years on average).  |                       |                              |                              |   |                              |
| <b>Notes</b>   |                       |                              |                              |   |                              |
| <sup>1</sup> 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.   |                       |                              |                              |   |                              |
| <sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.   |                       |                              |                              |   |                              |
| <sup>3</sup> Based on the relevant structural balance at year t-1.   |                       |                              |                              |   |                              |
| <sup>4</sup> 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.).   |                       |                              |                              |   |                              |
| <sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.   |                       |                              |                              |   |                              |
| <sup>6</sup> 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.   |                       |                              |                              |   |                              |
| <sup>7</sup> Change in the structural balance compared to year t-1. Ex post assessment (for 20XX-1) is carried out on the basis of Commission 20XX spring forecast.  |                       |                              |                              |   |                              |
| <sup>8</sup> The difference of the change in the structural balance and the corrected required adjustment.   |                       |                              |                              |   |                              |
| <sup>9</sup> Net public expenditure annual growth (in %) corrected for discretionary revenue measures, revenue measures mandated by law and one-offs (nominal)   |                       |                              |                              |   |                              |
| <sup>10</sup> 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. |                       |                              |                              |   |                              |
| <b>Source:</b><br>Convergence Programme (CP); Commission 2019 spring forecast (COM); Commission calculations.  |                       |                              |                              |   |                              |

## 5. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

The United Kingdom does not appear to face fiscal sustainability risks in the short run.<sup>7</sup>

Based on Commission 2019 spring forecast and a no-fiscal policy change scenario beyond the forecast horizon, government debt, projected at 85.1% of GDP in calendar year 2019, is expected to decrease to 78% in 2029, thus remaining above the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to reach its highest level in 2019 and then to decline steadily. Sensitivity analysis shows higher risks, notably due to the scenario assuming a primary balance reverting to its historical average.<sup>8</sup> Overall, this highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the Convergence Programme would put debt on a decreasing path by 2029, although remaining above the 60% of GDP reference value in 2029.

The medium-term fiscal sustainability risk indicator S1<sup>9</sup> is at 1.8 percentage points of GDP, primarily related to the high level of government debt. This indicator thus signals medium risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at 1.1 percentage points of GDP. Based on the debt sustainability analysis and the S1 indicator, overall medium-term fiscal sustainability risks are, therefore, high. While fully implementing the fiscal plans in the Convergence Programme would slightly decrease those risks, they would nonetheless remain high.

The long-term fiscal sustainability risk indicator S2 is at 3.3 percentage points of GDP. In the long term, the United Kingdom therefore appears to face medium fiscal sustainability risks, entirely related to the projected ageing costs. Full implementation of the Convergence programme would put the S2 indicator at 2.6 percentage points of GDP, leading to a similar long-term risk.<sup>10</sup> The debt sustainability analysis discussed above points to high risks so that, overall, long-term fiscal sustainability risks are assessed as high for the United Kingdom<sup>11</sup>.

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<sup>7</sup> This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 6 for a definition of the indicator.

<sup>8</sup> Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Fiscal Sustainability Report 2018 for more details).

<sup>9</sup> See the note to Table 6 for a definition of the indicator.

<sup>10</sup> The projected costs of ageing that are used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the projections of the 2018 Ageing Report.

<sup>11</sup> As mentioned above, in autumn 2019 the ONS will change the way student loans are treated in public statistics. This will lead to an increase in the headline deficit, and might also affect the assessment of the medium- and long-term debt sustainability analysis and fiscal risks. It is only possible to fully assess the impact when the ONS publishes the updated numbers in autumn 2019.

**Table 6: Debt sustainability analysis and sustainability indicators**

**Table 5. Fiscal Sustainability Assessment  
United-Kingdom**

| <i>Time horizon</i>                  |                            | <b>Commission Scenario</b> |             | <b>Stability / Convergence Programme Scenario</b> |             |  |
|--------------------------------------|----------------------------|----------------------------|-------------|---|-------------|--|
| <b>Short-term</b>                    |                            | <b>LOW risk</b>            |             |   |             |  |
| <b>S0 indicator</b> <sup>[1]</sup>   |                            | 0.4                        |             |   |             |  |
| Fiscal subindex                      |                            | 0.3                        | LOW risk    |   |             |  |
| Financial & competitiveness subindex |                            | 0.4                        | LOW risk    |   |             |  |
| <b>Medium-term</b>                   |                            | <b>HIGH risk</b>           |             |   |             |  |
| <b>DSA</b> <sup>[2]</sup>            |                            | HIGH risk                  |             |   |             |  |
| <b>S1 indicator</b> <sup>[3]</sup>   |                            | 1.8                        | MEDIUM risk | 1.1   | MEDIUM risk |  |
| of which                             | Initial Budgetary Position | -0.8                       |             | -1.5  |             |  |
|                                      | Debt Requirement           | 1.9                        |             | 2.0   |             |  |
|                                      | Cost of Ageing             | 0.7                        |             | 0.5   |             |  |
|                                      | of which                   | Pensions                   | 0.3         |   | 0.2         |  |
|                                      |                            | Health care                | 0.2         |   | 0.2         |  |
|                                      |                            | Long-term care             | 0.2         |   | 0.1         |  |
| Other                                |                            | 0.0                        |             | 0.0   |             |  |
| <b>Long-term</b>                     |                            | <b>HIGH risk</b>           |             |   |             |  |
| <b>DSA</b> <sup>[2]</sup>            |                            | HIGH risk                  |             |   |             |  |
| <b>S2 indicator</b> <sup>[4]</sup>   |                            | 3.3                        | MEDIUM risk | 2.6   | MEDIUM risk |  |
| of which                             | Initial Budgetary Position | 0.0                        |             | -0.5  |             |  |
|                                      | Cost of Ageing             | 3.3                        |             | 3.1   |             |  |
|                                      | of which                   | Pensions                   | 1.3         |   | 1.2         |  |
|                                      |                            | Health care                | 1.1         |   | 1.0         |  |
|                                      |                            | Long-term care             | 1.0         |   | 0.9         |  |
|                                      |                            | Other                      | -0.1        |   | -0.1        |  |

Source: Commission services; 2019 stability/convergence programme.

Note: the 'Commission' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2019 forecast until 2020. 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-indices, 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 2033. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2021 for Commission 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 2018.

## 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'.<sup>12</sup> There is some ambiguity over the time period that the fiscal objective refers to, but the OBR now assumes it to be in the mid-2020s, or 2025-26. 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 2022-23.

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 meeting its fiscal targets under current policy. The most recent OBR assessment, included in its March 2019 Economic and Fiscal Outlook, shows that all three of the supplementary fiscal targets are expected to be met. As the OBR's forecast horizon only extends to 2023-24, it cannot assess the government's performance against the headline fiscal objective of having a balanced budget in 2025-26. It states that meeting this objective 'appears challenging', particularly in light of projected population ageing as well as the change in the accounting method for student loans. However, the OBR also acknowledges that the recent positive developments in the public finances increased the likelihood of the objective being met, with a 40 per cent chance of balancing the budget in 2023-24.

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 2018-19, the United Kingdom is not expected to have achieved the MTO. An improvement of the structural balance of 0.9% of GDP, which is 0.3 percentage points higher than the required adjustment of 0.6% of GDP towards the MTO, was recorded. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures, exceeded the applicable expenditure benchmark rate by 0.4% of GDP. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the MTO.

According to the Convergence Programme, the United Kingdom is at risk of significant deviation from the requirements of the SGP in both 2019-20 and 2020-21. The Commission 2019 spring forecast confirms this assessment, projecting a risk of significant deviation.

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<sup>12</sup> 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.

Based on the Commission Forecast, the United Kingdom complied with the transitional debt rule in 2018-19. The United Kingdom is also projected to comply with the transitional debt rule in 2019-20, as a result of the allowed deviation of 0.25% of GDP. In 2020-21, the United Kingdom is projected to comply with the debt reduction benchmark.

## 8. ANNEXES

**Table I. Macroeconomic indicators**

|   | 2001-2005     | 2006-2010     | 2011-2015     | 2016          | 2017          | 2018          | 2019        | 2020        |
|---|---------------|---------------|---------------|---------------|---------------|---------------|-------------|-------------|
| <b>Core indicators</b>                                  |               |               |               |               |               |               |             |             |
| GDP growth rate   | 2.8           | 0.4           | 2.1           | 1.8           | 1.8           | 1.4           | 1.3         | 1.3         |
| Output gap <sup>1</sup>                                 | n.a           | n.a           | n.a           | n.a           | 1.0           | 0.8           | 0.5         | 0.3         |
| HICP (annual % change)                                  | 1.5           | 2.7           | 2.3           | 0.7           | 2.7           | 2.5           | 2.0         | 2.1         |
| Domestic demand (annual % change) <sup>2</sup>          | 3.2           | 0.3           | 2.1           | 2.4           | 1.4           | 1.6           | 1.5         | 1.3         |
| Unemployment rate (% of labour force) <sup>3</sup>      | 4.9           | 6.3           | 7.0           | 4.8           | 4.4           | 4.0           | 4.1         | 4.2         |
| Gross fixed capital formation (% of GDP)                | 17.3          | 16.7          | 16.1          | 16.8          | 17.1          | 17.0          | 16.6        | 16.4        |
| Gross national saving (% of GDP)                        | 15.6          | 13.2          | 12.4          | 12.0          | 13.8          | 13.3          | 13.1        | 13.1        |
| <b>General Government (% of GDP)</b>                    |               |               |               |               |               |               |             |             |
| <b>Net lending (+) or net borrowing (-)</b>             | <b>n.a</b>    | <b>n.a</b>    | <b>n.a</b>    | <b>n.a</b>    | <b>-2.1</b>   | <b>-1.3</b>   | <b>-1.5</b> | <b>-1.2</b> |
| <b>Gross debt</b>                                       | <b>n.a</b>    | <b>75.6</b>   | <b>84.6</b>   | <b>86.4</b>   | <b>85.4</b>   | <b>85.4</b>   | <b>83.8</b> | <b>82.7</b> |
| <b>Net financial assets</b>                             | <b>-27.0</b>  | <b>-39.1</b>  | <b>-72.4</b>  | <b>-87.9</b>  | <b>-84.5</b>  | <b>-80.7</b>  | <b>n.a</b>  | <b>n.a</b>  |
| Total revenue   | n.a           | n.a           | n.a           | n.a           | 39.0          | 39.3          | 39.5        | 39.8        |
| Total expenditure                                       | n.a           | n.a           | n.a           | n.a           | 41.1          | 40.6          | 40.9        | 40.9        |
| <i>of which: Interest</i>                               | n.a           | n.a           | n.a           | n.a           | 2.7           | 2.3           | 2.4         | 2.3         |
| <b>Corporations (% of GDP)</b>                          |               |               |               |               |               |               |             |             |
| <b>Net lending (+) or net borrowing (-)</b>             | <b>-2.2</b>   | <b>-0.5</b>   | <b>-1.2</b>   | <b>-3.2</b>   | <b>-0.8</b>   | <b>-2.0</b>   | <b>-1.3</b> | <b>-1.0</b> |
| <b>Net financial assets; non-financial corporations</b> | <b>-161.7</b> | <b>-157.1</b> | <b>-161.5</b> | <b>-160.4</b> | <b>-161.8</b> | <b>-147.5</b> | <b>n.a</b>  | <b>n.a</b>  |
| <b>Net financial assets; financial corporations</b>     | <b>-7.1</b>   | <b>5.5</b>    | <b>-1.8</b>   | <b>6.8</b>    | <b>2.9</b>    | <b>-5.5</b>   | <b>n.a</b>  | <b>n.a</b>  |
| Gross capital formation                                 | 11.7          | 10.0          | 10.1          | 10.5          | 10.2          | 10.2          | 9.7         | 9.2         |
| Gross operating surplus                                 | 20.5          | 21.8          | 21.9          | 21.9          | 21.9          | 21.2          | 21.6        | 21.5        |
| <b>Households and NPISH (% of GDP)</b>                  |               |               |               |               |               |               |             |             |
| <b>Net lending (+) or net borrowing (-)</b>             | <b>2.2</b>    | <b>3.0</b>    | <b>3.1</b>    | <b>0.9</b>    | <b>-1.2</b>   | <b>-1.0</b>   | <b>-1.2</b> | <b>-1.4</b> |
| <b>Net financial assets</b>                             | <b>195.6</b>  | <b>184.9</b>  | <b>215.7</b>  | <b>239.1</b>  | <b>235.4</b>  | <b>227.0</b>  | <b>n.a</b>  | <b>n.a</b>  |
| Gross wages and salaries                                | 42.8          | 42.2          | 40.9          | 40.5          | 40.4          | 40.9          | 41.3        | 41.6        |
| Net property income                                     | 10.6          | 10.6          | 10.3          | 10.3          | 9.8           | 10.0          | 9.8         | 9.8         |
| Current transfers received                              | 20.7          | 22.4          | 23.6          | 22.0          | 21.6          | 21.5          | 21.4        | 21.3        |
| Gross saving  | 6.1           | 6.5           | 6.4           | 4.7           | 2.9           | 3.1           | 2.9         | 2.9         |
| <b>Rest of the world (% of GDP)</b>                     |               |               |               |               |               |               |             |             |
| <b>Net lending (+) or net borrowing (-)</b>             | <b>-2.2</b>   | <b>-3.6</b>   | <b>-4.2</b>   | <b>-5.3</b>   | <b>-3.4</b>   | <b>-4.0</b>   | <b>-3.8</b> | <b>-3.5</b> |
| <b>Net financial assets</b>                             | <b>0.4</b>    | <b>6.2</b>    | <b>20.5</b>   | <b>2.9</b>    | <b>8.5</b>    | <b>7.2</b>    | <b>n.a</b>  | <b>n.a</b>  |
| Net exports of goods and services                       | -2.5          | -2.2          | -1.5          | -1.6          | -1.2          | -1.5          | -1.4        | -1.1        |
| Net primary income from the rest of the world           | 1.1           | -0.4          | -1.4          | -2.5          | -1.2          | -1.3          | -1.2        | -1.2        |
| Net capital transactions                                | 0.0           | 0.0           | -0.1          | -0.1          | -0.1          | -0.1          | -0.1        | -0.1        |
| Tradable sector   | 37.9          | 35.2          | 34.6          | 34.3          | 34.6          | 35.0          | n.a         | n.a         |
| Non tradable sector                                     | 52.1          | 55.1          | 54.7          | 54.9          | 54.5          | 54.1          | n.a         | n.a         |
| <i>of which: Building and construction sector</i>       | 5.7           | 5.6           | 5.2           | 5.3           | 5.5           | 5.4           | n.a         | n.a         |
| Real effective exchange rate (index, 2000=100)          | 115.9         | 110.5         | 104.4         | 102.5         | 98.0          | 100.1         | 101.9       | 102.9       |
| Terms of trade goods and services (index, 2000=100)     | 100.3         | 99.0          | 100.1         | 104.6         | 104.1         | 103.7         | 104.7       | 105.7       |
| Market performance of exports (index, 2000=100)         | 105.8         | 103.2         | 101.1         | 95.1          | 97.3          | 94.6          | 94.1        | 93.4        |

**Notes:**

<sup>1</sup> The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.

<sup>2</sup> The indicator on domestic demand includes stocks.

<sup>3</sup> 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 2019 spring forecast*

### **Mandatory variables not included in the Convergence Programme**

The Convergence Programme did not provide a number of mandatory variables. The most relevant of these are the variables “compensation of employees”, “intermediate consumption” and “total expenditure at unchanged policies”. Not included mandatory variables do not impede the Commission’s ability to assess the Convergence Programme on the basis of the Programme’s assumptions.