EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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Assessment of the 2015-16 Convergence Programme for the United Kingdom

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION

This document assesses the 2015-16 Convergence Programme for the United Kingdom (hereafter called Convergence Programme), which was submitted to the Commission on 24 March 2016 and covers the period 2015-16 to 2020-21. It was approved by the government and presented to the national parliament for a debate without a vote. The parliament is, however, required to approve the government's assessment of the 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 2016 Budget and the 2015 Autumn Statement, published by HM Treasury, combined with the Office for Budget Responsibility's (OBR) 2016 Economic and Fiscal Outlook and 2015 Fiscal Sustainability Report.

The United Kingdom is currently subject to the corrective arm of the Stability and Growth Pact. The Council opened the Excessive Deficit Procedure (EDP) for the United Kingdom on 2 December 2009. The initial deadline to correct the excessive deficit was 2014-15. On 19 June 2015, the Council decided that the UK had not taken effective action in compliance with the Council's recommendations and issued a revised recommendation granting two additional years for the correction of the excessive deficit. The United Kingdom is therefore recommended to correct the excessive deficit by 2016-17. The year following the correction of the excessive deficit, the United Kingdom will be subject to the preventive arm of the Pact and should ensure sufficient progress towards the minimum medium-term objective (MTO). As the debt ratio in 2016-17 is expected to exceed the 60% of GDP reference value, the United Kingdom will also be subject to the transitional arrangements as regards compliance with the debt criterion during the three years following the correction of the excessive deficit, during which it should ensure sufficient progress towards compliance.

This document complements the Country Report published on 26 February 2016 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 2016 spring forecast, published on 3 May 2016. Section 3 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 Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The United Kingdom's economy grew by 2.3% in 2015 after growth peaked in 2014 at 2.9%. The macroeconomic scenario for the United Kingdom set out in the Convergence Programme is predicated on a slight moderation in growth to 2.0% in 2016 and 2.2% in 2017 as the economy has reached potential. Domestic demand is set to continue to play a crucial role in driving growth in the context of a robust labour market, inflation rising gently from the low levels of 2015, and a historically large current account deficit. By contrast, net exports are projected to detract 0.4 pps from growth in 2016 and 0.1 pps in 2017. Therefore, growth is projected to remain somewhat unbalanced.

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) closed in 2015 and is projected to become mildly positive. This will curb the ability of demand to continue to grow more quickly than potential.

The Convergence Programme contains plausible macroeconomic assumptions, although the growth forecast in the Convergence Programme is slightly higher than that of the Commission. For instance the Convergence Programme expects growth of 2.0% and 2.2% in 2016-17 and 2017-18, while the Commission forecast 1.8% and 1.9%, respectively. The Commission forecast was published later and hence reflected a recent softening in leading and partial indicators of activity. The underlying trend of strong, although easing, domestic demand growth in 2016 and 2017 is the same in the Convergence Programme and Commission projections. Both forecasts also see net exports being a significant drag on growth in 2016, less so in 2017. The projected outlook for inflation and the labour market is very similar. The Commission forecast for the output gap is consistently slightly higher than the one recalculated on the basis of the Convergence Programme.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	2.3	2.2	1.8	2.0	1.9	2.2	2.1	2.1
Private consumption (% change)	2.7	2.9	2.4	2.4	2.1	2.2	2.1	2.0
Gross fixed capital formation (% change)	4.1	4.2	3.8	2.9	3.8	4.5	4.1	4.0
Exports of goods and services (% change)	5.1	5.0	2.5	2.5	2.8	3.3	3.3	3.4
Imports of goods and services (% change)	6.3	6.2	4.0	3.5	3.0	3.3	3.3	3.3
Contributions to real GDP growth:								
- Final domestic demand	2.7	3.2	2.3	2.1	2.1	2.3	2.2	2.1
- Change in inventories	-0.1	-0.4	0.1	0.2	-0.1	0.0	0.0	0.0
- Net exports	-0.5	-0.5	-0.5	-0.4	-0.1	-0.1	-0.1	-0.1
Output gap [1]	0.2	0.0	0.3	0.2	0.5	0.2	0.3	0.1
Employment (% change)	1.5	1.5	1.0	1.2	0.9	0.6	0.4	0.4
Unemployment rate (%)	5.3	5.4	5.0	5.0	4.9	5.0	5.2	5.1
Labour productivity (% change)	0.8	0.7	0.7	0.8	1.1	1.6	1.7	1.7
HICP inflation (%)	0.0	0.0	0.8	0.7	1.6	1.6	2.0	2.1
GDP deflator (% change)	0.3	0.3	1.7	1.1	2.1	1.9	2.0	1.9
Comp. of employees (per head, % change)	1.5	2.1	3.3	2.1	3.5	3.8	3.6	3.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-5.2	-4.3	-5.0	-4.0	-4.5	-3.8	-3.7	-3.5

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 2016 spring forecast (COM); Convergence Programme (CP).

3. Recent and planned budgetary developments

3.1. Deficit developments in year 2015-16

According to the Convergence Programme, the general government deficit was expected to have fallen from 5.0% of GDP in 2014-15 to 3.9% of GDP in 2015-16. This is 0.4 pps below the 4.3% of GDP projection for 2015-16 in the previous Convergence Programme. Since the Convergence Programme was submitted, the first estimate of the fiscal outturn for 2015-16 has been published. This first estimate suggests that the 2015-16 deficit was 4.0% of GDP and it is reflected in the Commission 2016 spring forecast. At 36.0% of GDP in 2015-16, revenues are higher than projected in the previous Convergence Programme (35.5%). In the same year, the expenditure ratio, at 39.9% of GDP, is in line with the projections in the previous Convergence Programme. The higher revenues are explained by a marginally better-than expected yield from taxes on production and imports (13.0% against a 12.7% forecast from the previous year), and on income and wealth (11.8% against 11.7%). On the expenditure side, Gross Fixed Capital Formation is expected to have been slightly smaller (2.4% vs 2.5%), and current expenditures slightly larger (19.2% vs 18.9%), than forecast in the previous Convergence Programme. There is no material impact of unscheduled one-off measures in 2015-16.

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 mandate, which is to achieve a surplus on public sector net borrowing (PSNB) by the end of the fiscal year 2019-20. This is supplemented by a target to reduce public sector net debt (PSND) as a percentage of GDP in each year until 2019-20 (see Section 6 below). According to the Convergence Programme, the deficit is projected at 2.9% of GDP in 2016-17. This is 0.7 pps higher than the 2016-17 deficit anticipated in the previous Convergence Programme. This is partly due to a decrease in the forecast nominal growth rate in 2016 from 3.5% to 3.1% since the previous programme. The Convergence Programme plans that by the 2016-17 deadline set by the Council the headline deficit will be brought to 2.9% of GDP, below the Treaty reference value but above the recommended 2.7% of GDP target. The Commission also forecasts the headline deficit at 2.9% of GDP in 2016-17. The programme does not define a medium-term budgetary objective (MTO). The Stability and Growth Pact requires all Member States to define an MTO in their stability or convergence programme.

The budgetary forecasts in the Convergence Programme are projections under a no-policy-change assumption. The forecast of a 2.9% headline deficit for 2016-17 is predicated on the basis that no additional consolidation is going to be needed to bring the deficit below the 3% of GDP reference value by the 2016-17 deadline. 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 -3.0% of GDP in 2016-17. In the Commission forecast, at -3.2% of GDP, the projected structural balance is slightly more negative, reflecting a small difference in the output gap forecast.

The time profile of the budgetary adjustment envisaged in the Convergence Programme is gradual, bringing the headline deficit from 3.9% of GDP in 2015-16 to a surplus of 0.3% in 2019-20. The forecast improvement in the recalculated structural balance is at least equal to the current preventive arm requirement of 0.6% in each year. According to the Convergence Programme, the headline deficit is forecast at 2.0% of GDP in 2017-18 and the recalculated structural deficit at 2.1%. The Commission forecasts a headline deficit of 2.2% of GDP in 2017-18 and a structural deficit of 2.5%. In the Budget 2016 the government announced measures that increase the 2017-18 deficit by 0.4% compared to the plans set out in the 2015 Autumn Statement.

Table 2: Composition of the budgetary adjustment[1]

(% of GDP)	2015-16		2016-17		2017-18		Change 15-16 to 17-18
	COM	CP	COM	CP	COM	CP	CP
Revenue	**39.1**	**36.0**	**39.6**	**36.7**	**39.5**	**36.7**	**0.7**
of which:							
- Taxes on production and imports	12.9	13.0	12.9	13.1	12.7	13.1	0.1
- Current taxes on income, wealth, etc.	14.1	11.8	14.5	12.0	14.7	11.9	0.1
- Social contributions	7.9	6.1	8.0	6.5	8.0	6.6	0.5
- Other (residual)	4.2	5.1	4.1	5.1	4.0	5.1	0.0
Expenditure	**43.0**	**39.9**	**42.5**	**39.5**	**41.7**	**38.6**	**-1.3**
of which:							
- Primary expenditure	40.7	37.4	40.2	37.0	39.4	36.0	-1.4
of which:							
Compensation of employees	9.2	n.a.	8.9	n.a.	8.8	n.a.	n.a.
Intermediate consumption	11.1	n.a.	11.0	n.a.	10.9	n.a.	n.a.
Social payments	13.9	12.3	13.6	12.0	13.2	11.6	-0.7
Subsidies	0.6	0.7	0.6	0.8	0.6	0.8	0.1
Gross fixed capital formation	2.7	2.4	2.6	2.5	2.6	2.5	0.1
Other (residual)	3.2	2.8	3.5	2.9	3.2	2.7	-0.1
- Interest expenditure	2.3	2.5	2.3	2.5	2.2	2.6	0.1
General government balance (GGB)	**-4.0**	**-3.9**	**-2.9**	**-2.9**	**-2.2**	**-2.0**	**1.9**
Primary balance	**-1.6**	**-1.4**	**-0.7**	**-0.4**	**0.1**	**0.6**	**2.0**
One-off and other temporary	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-4.0**	**-3.9**	**-2.9**	**-2.9**	**-2.2**	**-2.0**	**1.9**
Output gap[1]	0.2	0.0	0.3	0.2	0.5	0.2	0.3
Cyclically-adjusted balance[1]	-4.1	-3.9	-3.2	-3.0	-2.5	-2.1	1.8
Structural balance[2]	**-4.1**	**-3.9**	**-3.2**	**-3.0**	**-2.5**	**-2.1**	**1.8**
Structural primary balance[2]	-2.2	-1.6	-1.8	-0.5	-0.9	0.5	2.1

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.

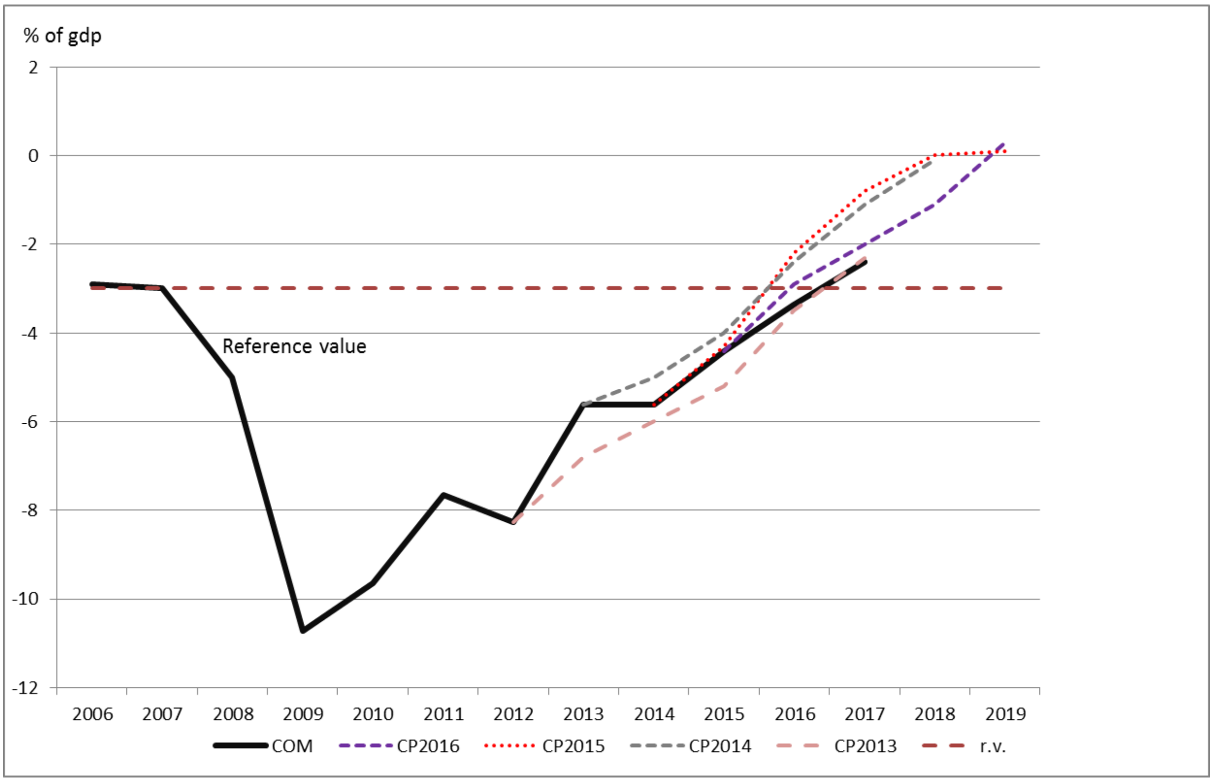
[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures. NB: the aggregates for revenues and expenditure of the CP and COM are not directly comparable because of accounting differences

Source :
Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

[1] The gap of around 3 pps between the two sets of revenue and expenditure ratios is due to differences in accounting treatment.

Figure 1 shows that between the 2012-13 and 2013-14 Convergence Programmes there was a significant positive revision to the fiscal outlook. In the subsequent Convergence Programmes the government balance projections for the period up to 2015-16 fluctuated slightly but proved to be not very different from the outturn. However, for 2016-17 onwards the deficit forecasts have been progressively revised upwards. Compared to the previous Convergence Programme the pace of future deficit reduction is therefore slightly slower, with a balanced budget in nominal terms being achieved in 2019-20 rather than 2018-19 as previously envisaged. This mainly reflects a modest downward revision to projected growth, with a weakened outlook for actual and potential growth, and a modest relaxation in the rate of improvement in the structural balance.

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



Source: Commission 2016 spring forecast; Convergence programmes

3.3. Measures underpinning the programme

The projected improvement in the fiscal balance underpinning the Convergence Programme is mainly driven by a steady decline in expenditure from 39.9% of GDP in 2015-16 to 37.8% of GDP in 2018-19. Revenues are expected to increase from 36.0% of GDP in 2015-16 to 36.7% in 2016-17, then remain stable in 2017-18 and 2018-19.

The envisaged structural 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. There is no significant planned impact of one-off measures in any of the years covered by the Convergence Programme. The Convergence Programme presents plausible estimates of the measures' budgetary impact. However, for the measures aimed at tackling disguised remuneration schemes and overseas trader evasion of VAT, only half of the impact estimated in the Convergence Programme is reflected in the Commission 2016 spring forecast because of their high uncertainty. In addition, GBP 3.5 billion (0.2% of GDP) of cuts in departmental spending in 2019-20 are not yet spelled out in sufficient detail. After the adoption of the Budget for 2016 and the publication of the Convergence Programme, the United Kingdom authorities decided not to proceed with expenditure savings on Personal Independence Payments which would have reduced the deficit by GBP 580 million (0.03% of GDP) in 2017-18 and GBP 1 190 million (0.06%) of GDP in 2018-19. This measure has currently not been replaced with specific alternatives cuts to public spending and was therefore not reflected in the Commission 2016 spring forecast.

Main budgetary measures (expressed as a % of GDP)

Revenue	Expenditure
2015-16	
• Increase in personal income tax allowance to GBP 10,600 (-0.1%)	• Cuts in Departmental Expenditure Limits (DEL) and welfare spending (-0.4%)
2016-17	
2017-18	
• Corporation tax: defer by two years bringing forward payment for large groups (-0.3%) • Increase in personal income tax allowance to GBP 11,500 and higher rate threshold to GBP 45,000 (-0.1%) • Corporation tax increase (+0.1%)	
2018-19	
• Corporation tax: defer by two years bringing forward payment for large groups (+0.1%)	
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure. 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 have peaked in 2015-16 at 88.9% before declining to 88.3% of GDP in 2016-17, and decreasing gradually to 83% in 2019-20. The Commission 2016 spring forecast projects a slight fall in the debt ratio to 87.9% in 2016-17 and 87.7% in 2017-18, which is the final year of the forecast (table 3[2]). The debt dynamics in the Convergence Programme and the Commission forecast are marginally different in the two years, but in both cases the debt ratio is relatively stable. In the later years, the programme expects the debt ratio to fall more decisively due to ongoing improvements in the primary balance.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015-16	2016-17		2017-18		2018-19	2019-20
		COM	COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**83.7**	**88.0**	**87.9**	**88.3**	**87.7**	**87.1**	**85.6**	**83.0**
Change in the ratio	3.2	0.6	-0.1	0.3	-0.2	-1.2	-1.5	-2.6
Contributions[2]:								
1. Primary balance	**4.2**	**1.6**	**0.7**	**0.4**	**-0.1**	**-0.6**	**-1.5**	**-2.8**
2. "Snow-ball" effect	**-0.2**	**0.0**	**-1.2**	**-0.1**	**-0.7**	**-0.8**	**-0.8**	**-0.8**
Of which:								
Interest expenditure	2.9	2.3	2.3	2.5	2.2	2.6	2.6	2.5
Growth effect	-1.6	-1.9	-1.8	-1.7	-1.3	-1.9	-1.8	-1.7
Inflation effect	-1.5	-0.4	-1.6	-0.9	-1.7	-1.6	-1.6	-1.5
3. Stock-flow adjustment	**-0.7**	**-1.1**	**0.4**	**0.1**	**0.6**	**0.3**	**0.8**	**1.0**
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:

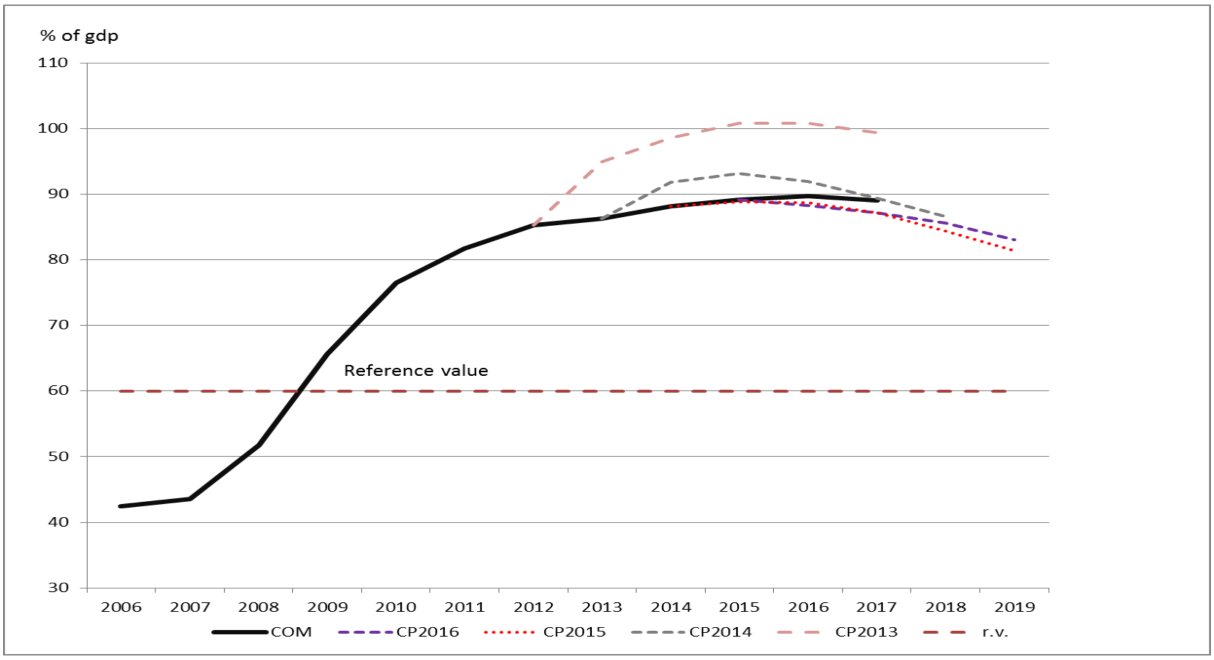
Commission 2016 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Figure 2 shows that government debt projections were revised down somewhat between the 2012-13 and 2014-15 Convergence Programmes. This was largely due to falls in the cost of government borrowing. Compared to the previous Convergence Programme, there are only

[2] In Table 3 the annual changes for financial year 2016-17 for both the Commission forecast and the Convergence Programme are calculated with respect to the Commission 2016 spring forecast as a starting point since it was published on 3 May and therefore is based on more recent debt data than the Convergence Programme.

slight revisions to projected government debt. The Commission forecasts a slightly higher trajectory for debt than the Convergence Programme, due to marginally weaker growth and slower fiscal consolidation. Financial sector interventions had upward implications on debt levels following the financial crisis. Disposals of these government holdings could result in non-deficit impacting revenues in the future.

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



Source: Commission 2016 spring forecast; Convergence Programmes

3.5. Risk assessment

A risk to the achievement of the path of deficit reduction set out in the Convergence Programme relates to economic growth which, as discussed in Section 2, is higher in the Convergence Programme in 2016 and 2017 than in the Commission 2016 spring forecast. A further risk relates to wage growth, which has been sluggish since the economic and financial crisis. If wage growth stays low, rather than picking up as forecast, personal income tax receipts could be weaker. Conversely, a faster rise in inflation than projected could be reflected in higher debt interest payments and those aspects of government expenditure that are indexed to inflation (in particular many welfare payments). At the same time departmental spending limits are set in nominal terms so lower-than-expected inflation would raise real departmental spending.

The tax projections in the programme are broadly plausible although a number of recent measures relate to increased revenues from combatting tax evasion and avoidance. Given the uncertainty in revenues raised from such measures, this represents a further risk to the fiscal objectives in the Convergence Programme.

There have been no new control mechanisms put in place to manage public expenditure. However, the United Kingdom has a good track record in controlling expenditure. Departmental budgets, which account for the bulk of discretionary expenditure, are fixed and set three years in advance. Welfare payments, especially unemployment-related benefits, are more cyclical. The Convergence Programme reflects multi-year plans for progressive reductions to expenditure set out in the Spending Review and Autumn Statement in

November 2015. These plans rely heavily on achieving savings from greater public sector efficiency, which may not fully materialise.

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

Box 1. Council recommendations addressed to the United Kingdom

– On 19 June 2015, the Council recommended the United Kingdom under Art. 126(7) of the Treaty to correct its excessive deficit by 2016-17. To this end, the United Kingdom should "reach a headline deficit of 4.1 % of GDP in 2015-2016 and 2.7 % of GDP in 2016-2017, which should be consistent with delivering an improvement in the structural balance of 0.5 % of GDP in 2015-2016 and 1.1 % of GDP in 2016-2017, based on the Commission's updated 2015 spring forecast".

– On 14 July 2015, the Council also 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 effective action under the excessive deficit procedure and endeavour to correct the excessive deficit in a durable manner by 2016-17, in particular by prioritising capital expenditure.

4.1. Compliance with EDP recommendations (in EDP years)

According to the Convergence Programme, the headline deficit will be brought below the 3% of GDP reference value by the recommended deadline, to 2.9% of GDP in 2016-17.

Based on the Commission 2016 spring forecast, the general government deficit was 4.0% of GDP in 2015-16, below the 4.1% headline target recommended by the Council. The Commission forecast implies an improvement in the structural balance of 0.6% of GDP in 2015-16, slightly higher than recommended.

In 2016-17, according to the Commission 2016 spring forecast, the deficit is expected to stand at 2.9% of GDP. This is below the 3% of GDP reference value but above the 2.7% of GDP recommended. The projected improvement in the structural balance is 0.9% of GDP, compared to the 1.1% of GDP target adjustment recommended by the Council. As the United Kingdom is expected to be compliant with the 3% deficit reference value but not with the improvement in the structural balance in 2016-17, a careful analysis is needed.

Using the same potential growth as the one estimated at the time of the Council recommendation of 19 June 2015, and correcting for revenue windfalls/shortfalls, the adjusted improvement in the structural balance in 2016-17 is 0.8% of GDP, which is 0.3 pp of GDP below the 1.1% of GDP recommended by the Council. The correction is due to higher potential growth and higher revenue windfalls than in the baseline. The bottom-up assessment of the additional fiscal effort achieved in 2016-17 would amount to -0.5% of GDP, which is 0.5 pp of GDP below the 0% recommended by the Council. The shortfall on the fiscal effort on the bottom-up approach is linked to a higher forecast for expenditure growth in 2016-17 than when the recommendation was issued. There are consequently some risks of not delivering the recommended fiscal effort.

Table 4: Compliance with the requirements of the corrective arm

(% of GDP)	2014-15	2015-16		2016-17	
	COM	CP	COM	CP	COM
Headline balance					
Headline budget balance	-5.0	-3.9	-4.0	-2.9	-2.9
EDP requirement on the budget balance		-4.1		-2.7	
Fiscal effort - change in the structural balance					
Change in the structural balance[1]	0.6	0.6	0.6	0.9	0.9
Cumulative change[2]		0.6	0.6	1.5	1.5
Required change from the EDP recommendation		0.5		1.1	
Cumulative required change from the EDP recommendation		0.5		1.6	
Fiscal effort - adjusted change in the structural balance					
Adjusted change in the structural balance[3]		-	0.0	-	0.8
of which: *correction due to change in potential GDP estimation (α)*		-	0.0	-	-0.1
correction due to revenue windfalls/shortfalls (β)		-	0.5	-	0.1
Cumulative adjusted change [2]		-	0.0	-	0.8
Required change from the EDP recommendation		0.5		1.1	
Cumulative required change from the EDP recommendation		0.5		1.6	
Fiscal effort - calculated on the basis of measures (bottom-up approach)					
Fiscal effort (bottom-up)[4]		-	-0.3	-	-0.5
Cumulative fiscal effort (bottom-up)[2]		-	-0.3	-	-0.8
Requirement from the EDP recommendation		0.0		0.0	
Cumulative requirement from the EDP recommendation		0.0		0.0	

Notes

[1]Structural balance = cyclically-adjusted government balance excluding one-off measures. Structural balance based on programme is recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology. Change compared to *t-1* .

[2] Cumulated since the latest EDP recommendation.

3 Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations.

[4]The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.

Source :

Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

4.2. Compliance with the debt criterion

If the EDP is abrogated in 2016-17, as government debt is expected to be significantly above 60% of GDP according to both the Convergence Programme and the Commission 2016 spring forecast, the United Kingdom will have to comply with the Minimum Linear Structural Adjustment (MLSA) during the three-year transition period following the abrogation[3].

The structural adjustment in the Commission forecast for 2017-18, at 0.7% of GDP, is consistent with the estimated MLSA requirement. Because of missing data required to compute the forward-looking benchmark, it has not been possible to recalculate the MLSA based on the assumptions in the Convergence Programme.

Table 5: Compliance with the debt criterion

	2017-18	
	CP	**COM**
Gross debt ratio	**87.1**	**87.7**
Gap to the debt benchmark [1,2]		
Structural adjustment [3]		0.7
To be compared to:		
Required adjustment [4]		0.7

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 2016 spring forecast (COM); Convergence Programme (CP), Commission calculations.

[3] Following the abrogation of the EDP, the UK would be subject to the preventive arm of the SGP and, as the debt ratio exceeds 60% of GDP, it should ensure sufficient progress towards compliance with the debt criterion during a three-year transition period. Over this period, the structural balance is expected to adjust in a way that ensures that the debt reduction benchmark is met at the end of the transition period. This adjustment is known as the Minimum Linear Structural Adjustment (MLSA).

4.3. Adjustment towards the MTO

If the EDP is abrogated based on the 2016-17 outturn budgetary data validated by Eurostat, the United Kingdom would be subject to the preventive arm in 2017-18. In 2017-18, the recalculated structural balance is projected to improve by 0.9% of GDP, more than the 0.6% of GDP current recommended adjustment towards the minimum MTO (a structural balance of -0.75% of GDP)[4]. Based on the Commission 2016 spring forecast, the structural balance will improve by 0.7% of GDP in 2017-18, again more than the 0.6% of GDP recommended adjustment towards the minimum MTO. The forecast improvement in the structural balance in the Convergence Programme exceeds the current recommended adjustment in every year of the programme.

In 2017-18, the recalculated Convergence Programme forecast projects the United Kingdom to comply with the expenditure benchmark with a margin of 0.2% of GDP. According to the Commission forecast the growth rate of United Kingdom government expenditure, net of discretionary revenue measures, is expected to comply with the expenditure benchmark reference rate of -0.1% with a margin of 0.1% of GDP in structural terms. Therefore, both indicators point to compliance with the recommended adjustment path towards the minimum MTO in 2017-18.

[4] While Member States set their MTOs in their Stability and Convergence Programmes, the Commission estimates a minimum MTO according to a commonly agreed methodology, taking into account a safety margin with respect to the 3% of GDP deficit limit, along with the need to ensure debt sustainability or rapid progress towards sustainability. See http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip021_en.pdf.

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)		2016-17		2017-18	
Initial position[1]					
Medium-term objective (MTO)		-1.3		-0.8	
Structural balance[2] (COM)		-3.2		-2.5	
Structural balance based on freezing (COM)		-3.6		-	
Position vis-a -vis the MTO[3]				Not at MTO	
(% of GDP)				**2017**	
				CP	**COM**
Structural balance pillar					
Required adjustment[4]				0.6	
Required adjustment corrected[5]				0.6	
Change in structural balance[6]				0.9	0.7
One-year deviation from the required adjustment [7]				0.3	0.1
Two-year average deviation from the required adjustment [7]				0.1	0.0
Expenditure benchmark pillar					
Applicable reference rate[8]				-0.1	
One-year deviation [9]				0.2	0.1
Two-year average deviation [9]				n.a. (in EDP in 2016-17)	
Conclusion					
Conclusion over one year				Compliance	Compliance

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

[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:

[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 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 2016 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

The United Kingdom does not appear to face fiscal sustainability risks in the short run. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges[5].

Based on the Commission forecast and a no-fiscal policy change scenario beyond the range of this forecast, government debt, at 89.2% of GDP in 2015, is expected to increase to 94.4% of GDP in 2026, thus remaining well above the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to level off in 2016 before resuming a rising trend through to 2026. This highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the Convergence Programme would nonetheless put debt on a decreasing path by 2026, although remaining slightly above the 60% of GDP reference value in 2026.

The medium-term fiscal sustainability risk indicator S1 is at 3.8 pps of GDP. This is primarily related to the high level of government debt (2.3 pps of GDP), and secondarily to the projected ageing costs (0.8 pps of GDP) and the unfavourable initial budgetary position (0.6 pps of GDP). This indicates high risks in the medium term. The full implementation of the fiscal consolidation plans in the Convergence Programme would put the sustainability risk indicator S1 at -0.5 pps of GDP, leading to much lower medium-term risk.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 3.6 pps. of GDP. In the long-term, the United Kingdom therefore faces medium fiscal sustainability risks. This is primarily related to the projected costs of ageing (2.4 pps of GDP (in particular, pensions (1 pp of GDP) and healthcare costs (1 pp of GDP)) and the initial budgetary position (1.2 pps of GDP). Full implementation of the Convergence Programme would nonetheless put the S2 indicator at -0.1 pps of GDP, leading to a lower long-term risk.

5 This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in Table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

Table 7: Sustainability indicators

Time horizon	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	**LOW risk**			
S0 indicator [1]	0.3			
Fiscal subindex (2015)	0.4	HIGH risk		
Financial & competitiveness subindex (2015)	0.3	LOW risk		
Medium Term	**HIGH risk**			
DSA [2]	HIGH risk			
S1 indicator [3]	3.8	HIGH risk	-0.5	LOW risk
of which				
IBP	0.6		-3.4	
Debt Requirement	2.3		2.1	
CoA	0.8		0.8	
Long Term	**MEDIUM risk**		**LOW risk**	
S2 indicator [4]	3.6		-0.1	
of which				
IBP	1.2		-2.2	
CoA	2.4		2.2	
of which				
Pensions	1.0		1.0	
HC	1.0		0.9	
LTC	0.3		0.3	
Other	0.1		0.0	

Source: Commission services; 2016 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 2016 forecast until 2017. 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 2015 Ageing Report.

[1] The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

[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. See Fiscal Sustainability Report 2015.

[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

[4] The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

6. FISCAL FRAMEWORK

The government's fiscal mandate, the main national numerical rule as specified in the Charter for Budget Responsibility, is "*a target for a surplus on public sector net borrowing (PSNB) by the end of 2019-20*". Once a headline surplus has been achieved, the government will target a surplus on PSNB in each subsequent year. According to the Convergence Programme, in 2015-16 PSNB is expected to have fallen to 3.8% of GDP, from 5.0% in 2014-15.

The macroeconomic forecasts underpinning the Convergence Programme have been prepared by the OBR. The OBR forecasts that under its current fiscal policy plans the government is on course to meet its fiscal mandate, with PSNB improving from a deficit of 2.9% of GDP in 2016-17 to a surplus of 0.5% of GDP in 2019-20. However, "*on the basis of past forecast errors*" the OBR judge that there is a 45% probability that the budget will be in deficit rather than surplus in 2019-20. This could be due to worse-than-expected economic developments or errors in the forecast of the "*prospects for receipts or spending for a given state of the economy*". Until 2019-20, the mandate for fiscal policy is "*supplemented by a target for public sector net debt (PSND) as a percentage of GDP to be falling in each year*". According to the Convergence Programme, PSND, however, is expected to have increased from 83.3% to 83.7% of GDP in 2015-16. Thereafter, the projected path for the debt ratio shows a continuous decline to 77.2% in 2019-20[6].

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

7. CONCLUSIONS

In 2015-16 the United Kingdom achieved a headline deficit of 4.0% of GDP, below the 4.1% target under the EDP. The improvement in the structural balance (0.6% of GDP) was slightly above the 0.5% target adjustment recommended by the Council on 19 June 2015.

The United Kingdom plans to correct its excessive deficit by the 2016-17 deadline set by the Council. Based on the Commission 2016 spring forecast, the headline deficit is expected to decrease to 2.9% of GDP in 2016-17. This is below the 3% threshold but above the target of 2.7% under the EDP. In 2016-17, the fiscal effort projected to be delivered is lower than recommended, on the basis of both the top-down and bottom-up methods. There are thus some risks of not delivering the recommended fiscal effort.

If the EDP is abrogated based on the 2016-17 outturn budgetary data validated by Eurostat, the United Kingdom would be subject to the preventive arm in 2017-18. The Commission forecasts the headline deficit at 2.2% of GDP in 2017-18. According to the Commission forecast the structural balance improves as recommended to achieve sufficient progress towards the minimum MTO. The growth rate of the United Kingdom's government expenditure, net of discretionary revenue measures, is expected to comply with the expenditure benchmark reference rate of -0.1% with a margin of 0.1% of GDP in structural

[6] 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.

terms. Therefore, both indicators point to compliance with the recommended adjustment path towards the minimum MTO in 2017-18.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	3.1	2.8	0.0	2.2	2.9	2.3	1.8	1.9
Output gap [1]	0.6	1.3	-3.0	-2.0	-0.6	0.2	0.3	0.5
HICP (annual % change)	1.2	1.9	3.3	2.6	1.5	0.0	0.8	1.6
Domestic demand (annual % change) [2]	4.0	3.0	-0.4	2.6	3.2	2.6	2.3	2.0
Unemployment rate (% of labour force) [3]	5.5	5.0	7.4	7.6	6.1	5.3	5.0	4.9
Gross fixed capital formation (% of GDP)	19.1	18.3	16.4	16.2	16.8	17.3	17.6	17.8
Gross national saving (% of GDP)	17.8	16.8	13.5	12.4	12.4	12.6	13.1	13.7
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**0.0**	**-3.3**	**-8.3**	**-5.6**	**-5.6**	**-4.4**	**-3.4**	**-2.4**
Gross debt	**39.3**	**41.0**	**72.2**	**86.2**	**88.2**	**89.2**	**89.7**	**89.1**
Net financial assets	**-31.3**	**-32.1**	**-57.7**	**-69.8**	**-81.1**	**-80.8**	**n.a**	**n.a**
Total revenue	38.6	39.1	39.5	39.3	38.3	38.8	39.2	39.6
Total expenditure	38.6	42.4	47.7	45.0	43.9	43.2	42.6	42.0
of which: Interest	2.6	2.0	2.6	2.9	2.7	2.3	2.3	2.2
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.6**	**1.9**	**3.0**	**1.4**	**1.2**	**1.2**	**1.0**	**0.9**
Net financial assets; non-financial corporations	**-186.1**	**-158.4**	**-149.0**	**-151.1**	**-167.1**	**-149.9**	**n.a**	**n.a**
Net financial assets; financial corporations	**-37.1**	**-17.6**	**0.6**	**0.4**	**-4.4**	**-4.2**	**n.a**	**n.a**
Gross capital formation	12.8	10.4	8.8	9.5	9.7	9.5	9.7	9.6
Gross operating surplus	22.1	22.2	21.4	22.0	22.6	22.1	22.5	22.9
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**2.3**	**-0.5**	**2.4**	**-0.2**	**-1.2**	**-2.2**	**-2.5**	**-2.9**
Net financial assets	**240.7**	**197.6**	**196.7**	**206.5**	**228.8**	**231.3**	**n.a**	**n.a**
Gross wages and salaries	45.3	43.9	43.0	41.0	40.3	40.9	41.0	41.1
Net property income	12.8	10.3	9.7	8.6	8.8	8.1	8.9	9.7
Current transfers received	21.1	20.8	23.2	23.1	22.0	22.1	21.7	21.4
Gross saving	7.1	5.2	6.4	4.4	3.7	2.9	2.8	2.6
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.9**	**-2.0**	**-2.9**	**-4.5**	**-5.1**	**-5.2**	**-5.0**	**-4.5**
Net financial assets	**14.0**	**10.7**	**9.9**	**14.5**	**24.2**	**3.9**	**n.a**	**n.a**
Net exports of goods and services	-2.0	-2.7	-2.4	-2.0	-1.9	-2.0	-2.0	-1.8
Net primary income from the rest of the world	0.9	1.7	0.7	-1.0	-1.8	-1.9	-1.6	-1.4
Net capital transactions	0.0	0.0	0.0	0.0	0.0	-0.1	-0.2	-0.2
Tradable sector	42.6	38.3	36.0	36.0	35.5	35.2	n.a	n.a
Non tradable sector	46.6	51.3	53.8	53.2	53.6	53.9	n.a	n.a
of which: Building and construction sector	5.6	6.2	5.5	5.2	5.5	5.7	n.a	n.a
Real effective exchange rate (index, 2000=100)	112.6	118.7	100.8	99.3	104.1	111.3	103.4	103.3
Terms of trade goods and services (index, 2000=100)	99.8	101.6	98.8	101.4	102.5	103.3	104.8	105.9
Market performance of exports (index, 2000=100)	108.2	105.0	101.8	101.0	97.7	97.1	95.2	93.1

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 2016 spring forecast