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accompanying the

REPORT FROM THE COMMISSION

United Kingdom

Prepared in accordance with Article 104(3) of the Treaty

{SEC(2008) 2014 final}

1. INTRODUCTION

This working document is released in parallel with the Commission report on the United Kingdom according to Article 104(3) of the Treaty[1] and complements it by providing a more detailed analysis of relevant factors taken into account in the report. Specifically, Section 2 analyses in greater detail the medium-term economic position, while Section 3 does the same for the medium-term budgetary position (including public investment). Section 4 examines the other relevant factors put forward by the Member State and Section 5 other factors considered relevant by the Commission.

2. MEDIUM-TERM ECONOMIC POSITION

2.1. Medium-term economic developments

The UK economy has shown strong GDP growth over the last decade, with an average annual rate of 2.8% since 1998. GDP growth was also fairly stable, dipping below 2% only once, in 2005. Since 2005, growth has again been strong, reaching 2.9% and 3.0% in 2006 and 2007 respectively. Over the past 10 years UK GDP growth has been entirely driven by domestic demand, with private consumption making the largest contribution. The past decade saw private consumption outpacing GDP by around 0.5% points each year, thus providing a sizeable boost to growth. Meanwhile, net external demand has exerted a persistent drag since 1998. Over the same period, UK potential growth is estimated to have averaged 2¾% per year, so the UK has achieved steady growth broadly in line with potential. Taking as a cyclical starting position a small positive output gap in 1998, the gap remained in slightly positive territory up to 2007. It appears that the amplitude of the business cycle over the past ten years was significantly lower compared to the 1980s and the first half of the 1990s, periods during which GDP growth tended to oscillate rather sharply.

The more recent period of high and stable GDP growth has taken place under a new macroeconomic policy framework, marked by the introduction of an inflation targeting regime in 1992 and the granting of independence to the Bank of England in 1997. The new framework has helped to achieve generally low and stable inflation over the past ten years, during which CPI inflation averaged 1.6% per year. However, rapid increases in global energy and commodity prices had a marked upward impact on UK inflation in 2006 and 2007, and in March 2007 UK CPI inflation surpassed 3% for the first time since Bank of England independence. CPI inflation fell back to an average of 2.3% in 2007, but continued global inflationary pressures have pushed CPI inflation up from 2.2% in January 2008 to 3.0% in April 2008. The upward inflation trend is likely to continue throughout the year, as high producer price inflation, driven by higher input costs resulting from energy and food price rises and the sterling depreciation, feeds through into consumer prices.

The UK labour market has performed very well over the last decade. Employment growth has been steady and sustained, averaging 1% per year since 1998. Over the past decade the employment rate has consistently exceeded the 70% Lisbon target, increasing from to 70.5% in 1998 to 71.3% in 2007. The unemployment rate is relatively low compared to the euro area, and has averaged 5% over the past five years. This good performance is in part due to the flexibility of the UK labour market, which is marked by largely decentralised wage bargaining and relatively limited statutory employment protection.[2] Furthermore, broad and

[1] Treaty Establishing the European Community, Article 104

[2] See OECD (2004): *Employment Outlook 2004*

deep supply-side labour market reforms going back to the 1980s were further strengthened in the 1990s. Moreover, the UK economy has experienced a positive labour supply shock over the past five years due to an increase in net inward migration, which significantly raised the working age population and boosted employment growth. This increase in the labour supply is also reflected in the stronger contribution which employment has made to potential GDP growth over the past decade compared to previous periods, and this has helped to offset the trend decline in hours worked per employee.

Despite a generally positive economic performance, a number of imbalances have built up during the past decade. These weaker aspects of the UK economy include the low rate of household saving. The household saving rate declined from 7% in 1998 to under 3% in 2007, and was even negative if one disregards transfers to pension funds. This gross dissaving by households has been accompanied by very high growth of borrowing by the household sector, of which secured borrowing accounts for around 85%. Expressed as a percentage of gross disposable income, household borrowing doubled from 7% in 1998 to 14% in 2007. Much of this has contributed to rapidly increasing property prices. Facilitated by fully liberalised mortgage lending and low nominal interest rates, house price inflation averaged 12% per year over the ten years to 2007, and even reached 20% per year between 2002 and 2004.[3] As a result, the average house price has nearly tripled over the past decade. This rapid appreciation poses a particular risk to economic growth and households' balance sheets if it were to unwind rapidly. Further imbalances are evident in an increasing current external deficit, resulting mainly from a pronounced rise in the trade deficit for goods and services, which has widened steadily since 1998. Standing at 4.2% of GDP in 2007, the current external deficit so far has been largely financed by a surplus on the UK's financial account.

Finally, some longer-term weaknesses of aggregate supply remain manifest in relatively low productivity levels. Despite some closing of the productivity gap over the past decade, the UK's GDP per hour worked in 2006 was 4% below the euro area average. A number of reasons have been proposed to explain this: notably the UK’s relatively low stock of physical capital, a shortfall in intermediate skills and comparatively low levels of R&D expenditure.

2.2. Recent macroeconomic performance

Overall, economic growth in 2007 continued in the strong vein of the previous year to reach 3.0%. However, from the onset of the credit crisis in July 2007 growth slowed gradually to a quarterly rate of 0.4% in the first quarter of 2008, nearly half the average growth rate achieved in the first half of 2007. From the start of the credit crisis, financial institutions' lending behaviour turned increasingly precautionary as the size and distribution of balance sheet losses linked in part to mortgage-backed securities remained uncertain. As a result, financial market conditions were tense through the second part of 2007, during which credit conditions tightened and liquidity problems in the banking sector persisted. Risk premia on interbank, corporate and household lending increased appreciably, and still remained elevated during the first half of 2008. As a result, successive base rate cuts by the Bank of England from 5.75% in July 2007 to 5.0% in April 2008 have not fully translated into a commensurate fall in effective interest rates faced by private and corporate borrowers.

Since September 2007, the Bank of England has sought to ease liquidity problems in the interbank market through a number of channels, including additional auctions of short-dated

[3] Source: Nationwide and Halifax House Price Indices

funds and widening acceptable collateral. In April 2008, the Bank of England announced the details of its "Special Liquidity Scheme", whereby the UK government issues bonds to the Bank of England, which will then offer these to eligible financial institutions in a swap operation. The scheme is to remain open for six months from April 2008, and accepts a relatively broad range of collateral, including AAA-rated credit card debt and UK and European mortgage debt. While setting no definite limit on the total value of bond swaps, initial take-up of the swap facility is estimated by the Bank at around £50bn (around half the value of net lending to individuals secured on dwellings during the 12-month period to March 2008). Overall, the general borrowing environment has nevertheless remained restrictive since the beginning of the credit crisis, with evidence of secured and unsecured lending spreads widening further in April 2008 and LIBOR spreads remaining relatively high. Furthermore, national accounts data for the fourth quarter 2007 and preliminary data for the subsequent quarter show a marked slowing in business and financial services activity.

While the labour market in the second half of 2007 showed robust employment growth and falling numbers of unemployed workers, latest data show that the slowdown has begun to depress the labour market. In the first quarter of 2008, a quarterly rise in unemployment of 14,000 was recorded, and employment grew by a comparatively moderate 117,000. Earnings growth increased to an annual rate of 4.7% in March, thus bringing average earnings growth (including bonuses) to 4.0%.

The residential property market has cooled appreciably since September 2007, partly due to concerns over housing affordability, a deteriorating economic outlook and the successive tightening of mortgage lending terms, including the almost complete closing by lenders of sub-prime mortgage facilities. Annual house price inflation fell from an average of 11% observed in the months of January through August 2007 to -5% in May 2008.[4] This has already brought average house prices down by 7% from their peak in mid-2007, and further falls are expected. Similarly, turnover in the housing market has slowed significantly, with the number of property transactions having fallen by 25% between the third quarter 2007 and the first quarter 2008.

Significant movements in the pound sterling's bilateral exchange rates have also taken place since July 2007, with a fall of 15% against the euro in the eight months to April 2008 being the most significant given the UK's strong trade integration with the euro area. Overall, the pound's nominal effective exchange rate weakened by 12% over the same period. Macroeconomic repercussions of this depreciation are not yet evident with regard to changes in external trade, although the improved export competitiveness can be expected to strengthen the UK's weak net exports balance so as to make a positive growth contribution over the medium term. However, the weaker exchange rate has raised inflationary pressures, and output prices rose in April by 7.5% year-on-year, with input prices up by 23.3%, although this is in part also due to recent increases in global energy and food prices. The more recent portion of the pound’s depreciation can be expected to raise import prices further over the year and, depending on the ability of retailers to absorb these in their margins, may partly feed through to consumer prices. At the same time, inflationary pressures are compounded by rising inflationary expectations by households, as evidenced in surveys having recorded inflation expectations edging up over the past six months to around 3¾% one year ahead.[5]

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[4] Average of Nationwide and Halifax house price indices
[5] Source: Bank of England and Citigroup/YouGov

2.3. Economic prospects

The Commission services' 2008 spring forecast, published on 28 April, forms the basis for the following assessment of the UK's short- to medium-term growth prospects. Incoming data available subsequent to the forecast cut-off date of 15 April have broadly confirmed the projections, though skewing the balance of risks up the forecast horizon further to the downside (as regards real activity) and upside (as regards inflation). GDP growth in the first quarter of 2008 is officially estimated at 0.4%, in line with the 2008 spring forecast. Further news relates to the housing market, where month-on-month falls in average house prices continued to be observed in April. Furthermore, PMI readings for April came in very low, especially for the service sector, which accounts for around 75% of UK GVA. Both manufacturing and services PMI levels have fallen well below their three-year average. Overall, the analysis presented in the spring forecast therefore continues to reflect the UK's current economic outlook. Overall, this sees developments in the housing market and the financial sector as dampening growth in the medium term. Domestic demand is likely to slow significantly, driven by moderation in both private consumption and gross fixed capital formation. However, the significant depreciation of the pound's nominal effective exchange rate since August 2007 is likely to improve the price competitiveness of UK exports, while at the same time aggravating inflationary risks.

A marked slowing of private consumption is expected in 2008, driven by more restrictive borrowing conditions, a downward correction in house prices and a squeeze on real incomes due to rising inflation, with only a limited recovery in 2009. The Bank of England's April 2008 credit conditions survey showed that conditions for all types of lending to households and corporations tightened in the first quarter and were expected to be restricted further in the second quarter. Expected falls in net housing equity will also weaken the collateral value of housing for secured borrowing, thus compounding the ongoing tightening of credit conditions. As a consequence, household spending growth will slow on account of lower secured and unsecured borrowing. Whilst moderate earnings growth would tend to support private consumption, in the current inflationary environment its positive effect on consumer spending is likely to be offset by marked increases in consumer prices and living expenses, leaving consumption growth weak in volume terms. In 2009, upward wage pressures from higher CPI and RPI inflation will be countered by increased labour market slack, as employment growth slows to almost zero over the forecast horizon and unemployment rises appreciably. The UK government's fiscal package announced on 13 May 2008, which increases the tax-free allowance of basic-rate taxpayers (i.e. those earning less than around £40,000 per year) by £600 during for the financial year 2008/9, amounts to a deficit-funded transfer to households worth £2.7bn, equivalent to around 0.3% of gross disposable household income. Depending on the propensity of households to spend this windfall, private consumption growth may rise slightly but is unlikely substantively to alter overall GDP growth prospects. Inflationary effects of this demand stimulus would then be commensurate to household's marginal propensity to spend.

Investment is also set to moderate in 2008 on account of tighter lending conditions and the consequences of the housing market correction on residential investment. Together with a weaker business climate, these factors will dampen business investment in 2008, though it should return to more robust levels in 2009 due to improved prospects. Government consumption will provide a moderate stimulus in 2008, notwithstanding the fact that the 2008 budget confirms a relatively tight expenditure envelope over the forecast horizon. The growth contribution of net external demand is expected to turn sharply positive from 2008. This is driven by a slowdown in imports in line with a moderation of domestic demand growth and the weaker exchange rate, while the pound's depreciation will support a recovery in exports that more than offsets the effects of subdued growth in key markets such as the euro area and US.[6]

Table 1: Macroeconomic developments and outlook

	Average 1995-1998	1999	2003	2004	2005	2006	2007	2008	2009
Real GDP (% change)	3.0	3.0	2.8	3.3	1.8	2.9	3.0	1.7	1.6
Contributions:									
-Domestic demand	3.4	4.1	2.8	3.8	1.8	3.0	3.5	1.7	1.3
-Change in inventories	0.0	0.2	0.1	0.1	-0.1	0.0	0.4	-0.2	0.0
-External trade	-0.4	-1.2	-0.1	-0.6	0.1	-0.1	-0.6	0.3	0.3
Employment [a] (%change)	1.3	1.4	1.0	1.0	1.0	0.9	0.7	0.1	0.0
Unemployment (% of labour force)	7.3	5.9	4.9	4.7	4.8	5.4	5.3	5.6	5.9
Nominal unit labour costs (%change)	2.2	2.8	3.0	2.0	3.5	2.9	1.5	2.6	2.8
HICP (% change)	2.2	1.3	1.4	1.3	2.1	2.3	2.3	2.8	2.2
External Balance [b] (% of GDP)	-0.7	-2.4	-1.3	-1.6	-2.5	-3.9	-4.2	-3.2	-3.2
Euro area real GDP (% change)	2.3	2.9	0.8	2.1	1.6	2.8	2.6	1.7	1.5

Notes:
[a] Ful-time equivalents
[b] Current external balance, in % of GDP
Source: Eurostat and Commission services' spring 2008 forecasts

Overall, growth in the UK economy is expected to slow to just below 1¾% in 2008, with a substantial carryover effect from the previous year masking a more significant slowdown, with in-year growth slowing to around 1% by year-end. In 2009, the gradual recovery in domestic demand through the year will lift in-year growth above 2% by year-end, but with no large carryover effect from 2008 annual growth will be limited to around 1½%. By contrast, the GDP growth projections in the UK's latest budget, published in March 2008, differ notably from those in the Commission services' spring 2008 forecast. The UK's official GDP forecast appears somewhat optimistic by virtue of significantly higher forecast growth figures in financial years 2008/09 and 2009/10 compared to the spring 2008 forecast. While the latter expects growth of 1.4% and 1.8% in 2008/09 and 2009/10 respectively, the UK's 2008 budget factors in growth of 1 ¾% and 2 ½% in these years. Underpinning this divergence of views is a somewhat different assessment of the outlook for domestic demand. While the UK's 2008 budget expects "sluggish or flat house price growth in 2008", the spring forecast expects substantially weaker housing market performance.[7] Indeed, nominal house prices have already fallen by 7% since mid-2007, and current indicators point towards a further weakening. A weaker housing market would tend to depress both residential investment and private consumption, and so the weaker spring 2008 GDP forecast would appear warranted in terms of the recent deterioration in housing market prospects in terms of turnover and price developments. Furthermore, differences in the assessment of future credit conditions are also likely to contribute to differences in overall growth forecasts. The Commission services' spring 2008 forecast is also more cautious than the UK's budget forecast regarding the speed of reversion to normal credit market conditions, including for secured and unsecured household borrowing, which the spring forecast expects to last into 2009.

This 2008 spring forecast scenario is subject to predominantly downside risks relating to the length and severity of financial market problems, which remain highly uncertain but are

[6] The projections for export and import volumes exclude the impact of Missing Trader Intra-Community (MTIC) fraud on trade figures.
[7] HM Treasury (2008): Budget 2008, Chapter B, p.161

crucial in view of the relatively high contribution of the financial sector to the UK's GDP. Over the forecast period employment growth is expected to slow to near-zero as a result of the moderation in activity. The supply of labour is also projected to increase at a slower pace, reflecting reduced immigration, and as a result of slowing activity the unemployment rate is set to increase. Slowing labour supply growth and a moderation in fixed capital formation will have a dampening impact on potential growth in the medium term. Given the above GDP growth forecasts, the economy is expected to move into negative output gap territory in 2008 and further so in 2009.

Table 2: Sources of potential output growth

	Average '95 - '98	1999	2003	2004	2005	2006	2007	2008	2009
Potential GDP (% change)	2.7	3.0	2.7	2.7	2.7	2.8	2.7	2.4	2.3
Contributions:									
- Labour	0.3	0.4	0.3	0.3	0.3	0.3	0.1	-0.1	-0.2
- Capital accumulation	0.7	0.9	0.9	0.9	0.9	1.1	1.2	1.1	1.1
- Total factor productivity	1.7	1.6	1.5	1.4	1.4	1.4	1.4	1.4	1.4
Output gap (% of potential GDP)	-0.1	0.4	0.1	0.7	-0.1	0.0	0.4	-0.3	-1.0

Note:
[a]Based on the commonly agreed method for calculating potential output

Source: Eurostat and Commission services' spring 2008 forecast

3. MEDIUM-TERM BUDGETARY POSITION

According to the United Kingdom's March 2008 EDP notification, the 2007/08[8] general government deficit is estimated at 2.9% of GDP[9], up from 2.6% in 2006/07; in the notification the UK authorities confirmed their projection of a 2008/09 deficit of 3.2% of GDP[10]. The Commission services' spring 20008 forecast projects a deficit in 2009/10 that will remain in breach of the Treaty reference value of 3% of GDP.

3.1. Budgetary developments until 2007/08

The United Kingdom undertook remarkable fiscal consolidation efforts during the late 1990s. The general government balance swung from a deficit of 3.8% of GDP in 1996/97 to a surplus of 1.3% by 1999/00, while gross government debt declined from over 50% of GDP in 1996/97 to a low of 36.8% in 2002/03. Although higher revenues, especially from income and corporation tax, contributed to the adjustment, the greater part of the consolidation was driven by a marked slowdown in expenditure growth.

Thereafter, the government adopted a looser fiscal stance, mainly as a result of an explicit policy objective to raise expenditure on public services. As a result, the general government balance moved from a surplus position in the late 1990s to a deficit of 3.2% of GDP in 2003/04. With output gaps estimated to be positive over this period, this was equivalent to a deterioration of the structural balance of 4¼ percentage points of GDP[11] between 1999/00 and 2003/04. During these years, the government expenditure-to-GDP ratio increased by about 3½

[8] The UK financial year runs from April to March.

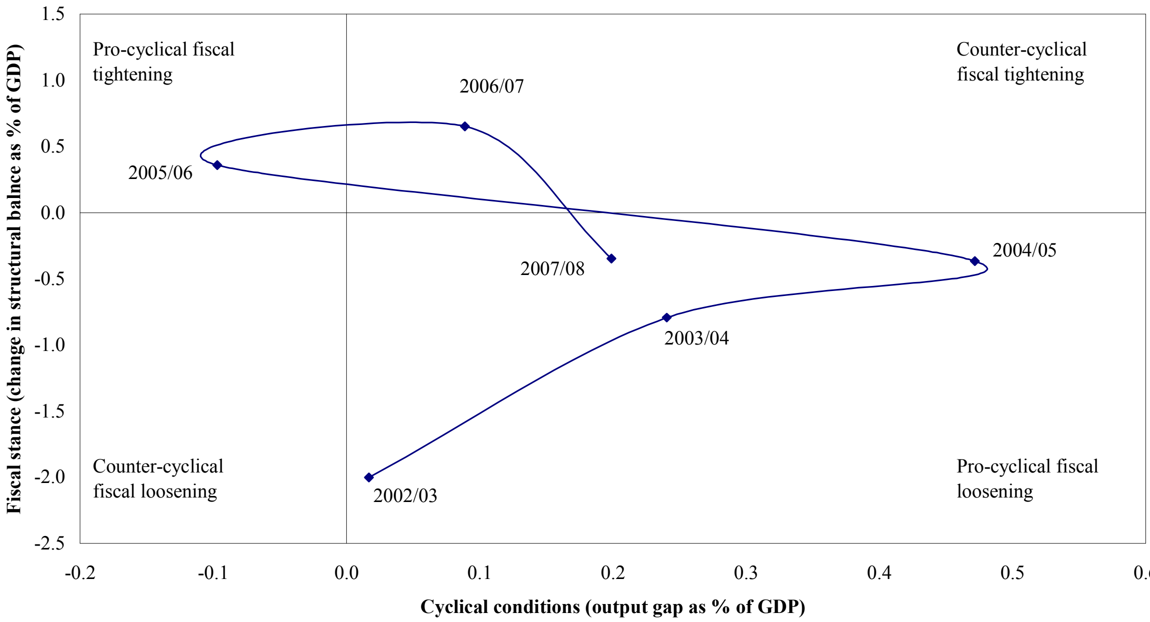
[9] In this document, all data quoted from the EDP notification and the convergence programmes have been adjusted to exclude receipts from the sale of UMTS licenses from the government's annual revenue flow, in line with Eurostat decision of 14 July 2000. This adjustment increases the deficit figures submitted by the UK authorities by just over £1.0 billion (0.07% of GDP in 2007/08).

[10] For the purpose of the EDP notification, the outturn data were submitted by the Office for National Statistics, whereas the forecast data have been notified by HM Treasury.

[11] Estimated by the Commission services, applying the common methodology on estimating output gaps.

percentage points, to 42.2%, with government gross fixed capital formation rising from 1.3% of GDP to 1.6%. At the same time, the ratio of government revenue to GDP fell by 1.0 percentage point, to 38.9%, mainly due to reduced growth of intakes from personal income taxes as a result of slower economic growth and a drop in taxes on financial sector corporate profits, down by ½ percentage points of GDP in 2002/03, following the burst of the dot-com bubble. As shown in Figure 1, fiscal policy in the UK remained pro-cyclical in 2004/05, with the headline deficit rising further to 3.5% of GDP[12] while the economy continued to expand at a rate above potential. Compared to the previous year, the structural balance is estimated to have deteriorated by 0.4 percentage points of GDP.

Figure 1: UK fiscal stance and cyclical conditions



Source: Commission services

Notwithstanding a slowdown in GDP growth, in 2005/06 the deficit fell to 3.1% of GDP. The consolidation, however, partly reflected a one-off imputed transaction that reduced the deficit by 0.3% of GDP[13]; in structural terms, the consolidation is nevertheless estimated to have been equivalent to 0.4 p.p. of GDP. In 2006/07, the headline deficit fell to 2.6% of GDP and the structural deficit was reduced by ½ percentage point of GDP over the previous year. The fiscal consolidation between 2005/06 and 2006/07 was driven by strong growth in taxes on corporate profits, which accounted for four-fifths of the increase in the revenue ratio during this period. In turn, taxes on financial sector profits, boosted by strong equity market performance and mergers and acquisition (M&A) activity, accounted for a third of the increase in corporate taxation during the two years.

Box 1: The Previous Excessive Deficit Procedure for the United Kingdom

[12] The March 2008 notification confirmed a deficit for 2004/05 of 3.5% of GDP, whereas the Council decision that the United Kingdom was in excessive deficit was based on a deficit estimate for 2004/05 of 3.2% of GDP. The upward revision in the deficit figure mainly reflects the reclassification of proceeds on disposals of social housing from revenue to disposal of equity.

[13] Following the restructuring of the nuclear energy sector, which led to the transfer to central government of assets held by a public corporation, the United Kingdom's Office for National Statistics decided to record an imputed transaction, valued at 0.3% of GDP in 2005/06, to central government as a deficit-reducing flow.

In financial year 2003/04, the UK general government deficit breached the 3% of GDP Treaty reference value for the first time since the abrogation of its previous excessive deficit procedure (EDP) in 1998. As a consequence, the Commission initiated the EDP in April 2004, with the adoption of the report foreseen by Article 104.3. With the deficit for 2003/04 estimated at 3.2% of GDP and against expectations that the excessive deficit would revert to below the threshold level in the following year, the Commission and the Economic and Financial Committee concluded that the United Kingdom could not be considered to be in an excessive deficit situation as defined in the Treaty. [a]

Following the August 2005 EDP notification, which reported a deficit of 3.2% of GDP in 2004/05, on 21 September 2005 the Commission initiated the EDP for the UK with the adoption of a report under Article 104.3. On 24 January 2006, the Council decided, on a recommendation from the Commission, that the United Kingdom was in excessive deficit according to Article 104.6.[b] At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104.7 to the UK with a view to bringing the situation of an excessive government deficit to an end by 2006/07 at the latest.

On the 12 September 2007, the Commission adopted a recommendation for a Council decision abrogating the EDP against the UK. The Commission's assessment was based on the 2006/07 deficit outturn, which was below the Treaty reference value, the spring 2007 forecast and the trends in public finances for 2007/08. While the effects of the emerging financial market turmoil on the budgetary situation were taken into account, forecast developments as a whole indicated that the UK deficit would remain below the 3% reference value throughout the forecast period. On the 9 October 2007, ECOFIN decided to abrogate the EDP according to Article 104.12 of the Treaty.

[a] All EDP-related documents for the United Kingdom can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2

[b] OJ L 51, 22.2.2006, p. 14.

Fiscal policy was again pro-cyclical in 2007/08, when the budgetary situation deteriorated notwithstanding favourable economic conditions. The deficit is estimated to have risen to 2.9% of GDP in both the Commission services' spring 2008 forecast and in the data reported by the UK in March 2008[14]. This exceeded the projection in the 2006 convergence programme by 0.6 percentage points, though compared with the programme a deficit-increasing national accounts reclassification of around ¼% of GDP per annum should be noted[15]. The increase in the deficit was due to sluggish revenue growth, with the revenue-to-GDP ratio estimated to have fallen by ½ percentage points. In turn, developments on the revenue side were driven by lower than expected intakes from corporate taxation, primarily as

[14] The provisional public sector finances' data for April 2008, which were published on the 21 May 2008, imply a headline 2007/08 general government deficit on an EDP-basis of 2.7% of GDP, 0.2 p.p. less than estimated in the 2008 Budget and in the spring forecast. The better-than-expected outturn was primarily due to a downward revision to previously-published figures for central government current expenditure, which *ceteris paribus* also implies a lower structural deficit in 2007/08 by 0.2% of GDP. Under a no-policy-change assumption, the spring 2008 forecast assumes that the government will adhere to the non-cyclical primary expenditure plans announced in the 2008 budget, which were practically unchanged from those in the 2007 Comprehensive Spending Review. Lower departmental spending in 2007/08 would not pass-through into the expenditure planned in 2008/09 and 2009/10, since the departmental spending limits for those years were established in the 2007 Comprehensive Spending Review. Indeed under the End-year Flexibility (EYF) scheme, departments are allowed to carry forward under-spends on their departmental allocations from one year to the next.

[15] This refers to the reclassification, from the local government sector to outside the general government, of local government revenues from the sales of social housing. The reclassification, retropolated since 1997/98, led to an increase in the general government deficit in 2006/07, through the combined effects of foregone revenue from housing sales and an increase in the subsidy payments' component of expenditure.

a result of higher repayments, due to companies' having overpaid corporate tax in previous years, as well as to lower revenues from oil and gas extraction activity due to lower production and rises in operating costs. The substantially higher-than-usual repayments of overpaid corporate taxation in 2007/08 suggest that, perhaps particularly in 2006/07, such revenues could have been artificially boosted by overstated profits, though the extent of this effect is uncertain. According to the Commission services' spring 2008 forecast, as a result of the pro-cyclical fiscal loosening in 2007/08, the structural deficit is estimated to have increased by ¼% of GDP.

Table 3: Budgetary developments and outlook [a]

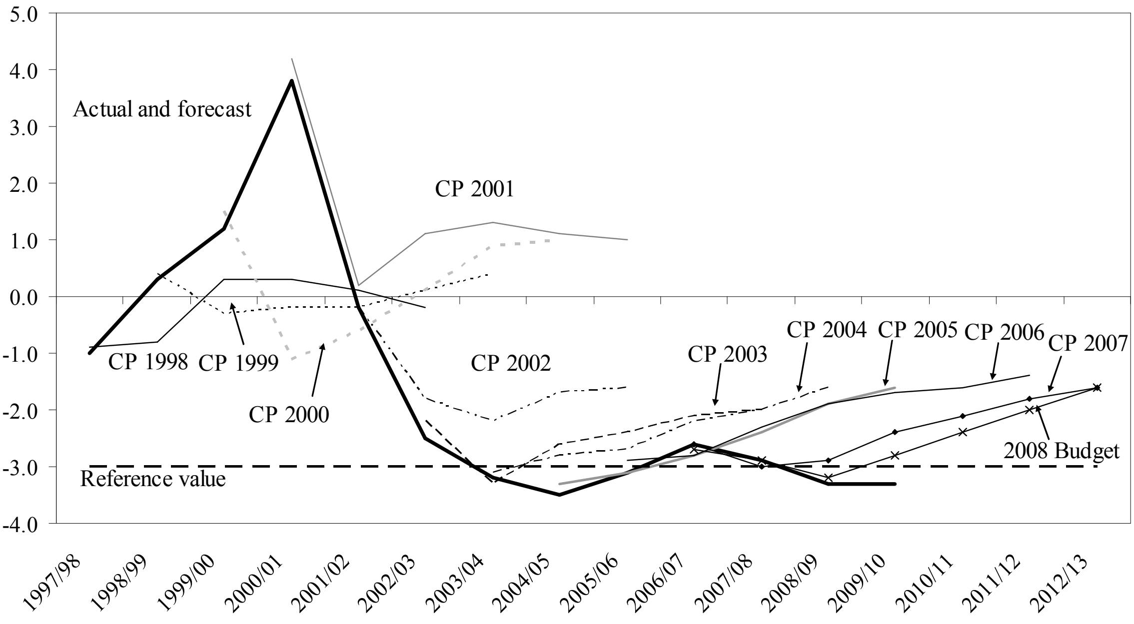
	1999/00	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
General government balance	1.3	-3.2	-3.5	-3.1	-2.6	-2.9	-3.3	-3.3
Primary balance	4.1	-1.2	-1.4	-1.0	-0.4	-0.7	-1.1	-1.2
One-off and other temporary measures	-	-	-	0.3	-	-	-	-
Total expenditure	38.6	42.2	43.2	44.1	43.9	43.6	44.2	44.1
of which:								
Government gross fixed capital formation	*1.3*	*1.6*	*1.8*	*0.6*	*1.8*	*1.9*	*2.0*	*1.9*
Interest expenditure	*2.7*	*2.0*	*2.0*	*2.1*	*2.1*	*2.2*	*2.2*	*2.1*
Total revenue	39.9	38.9	39.7	41.0	41.2	40.7	40.8	40.8
of which:								
Taxes and social security contributions	*37.1*	*36.0*	*36.6*	*37.6*	*37.9*	*37.4*	*37.6*	*37.8*
Cyclically-adjusted balance	1.0	-3.3	-3.7	-3.0	-2.7	-3.0	-3.1	-2.9
Cyclically-adjusted primary balance	3.7	-1.3	-1.7	-0.9	-0.6	-0.8	-0.9	-0.8

Notes:
[a] In percent of GDP.
[b] Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: Eurostat and Commission services' spring 2008 forecasts.

Looking at the track record of the UK authorities' fiscal projections over the past ten years, on average the forecast error was close to zero (on average the actual outturn was 0.3% of GDP worse than the one-year-ahead forecast in the programme[16]) over the period from 1998/99 to 2007/08. However, the average over the past ten years hides two distinct trends, as Figure 1 shows. Between 1999/00 and 2001/02, projections tended to be cautious, generally underestimating the size of future surpluses, typically because revenue growth was understated. By contrast, from 2002/03 onward, in spite of relatively accurate forecasts for economic growth (except in 2005, when the economy decelerated), the convergence programme projections underestimated the size of deficit ratios, on average by 1 percentage point in the forecast for the subsequent year.

[16] Excluding forecast error as a result of deficit-reducing revenues from UMTS sales in 2000/01.

Figure 2: General government balance projections in successive convergence programmes (% of GDP)



Source : Commission services' spring 2008 forecast, 2008 Budget and successive convergence programmes

Box 2: The UK's fiscal rules and respect of the 3% of GDP reference value

The UK's fiscal policy framework is based on two fiscal policy rules for the *public* sector: the "golden rule", adherence to which ensures that over the course of the economic cycle, the government borrows only to finance *net* investment [a], and not to fund current expenditure; and the "sustainable investment rule", which aims to keep public sector *net* debt (i.e. net of financial assets) at "a stable and prudent level". Within this framework, the authorities set an explicit objective of maintaining sound public finances.

With its emphasis on the economic cycle as a whole, application of the UK's golden rule allows for deficits on the current budget (current revenues minus current expenditure) to be offset against surpluses credited elsewhere in the cycle. The government's judgement is that a new economic cycle began in the first half of 1997, but there is still uncertainty on whether or not that cycle was completed in the second half of 2006. The golden rule combined with the current dating of the cycle has thus effectively allowed the deficits on the public sector current budget between 2002/03 and 2007/08 to be offset against the surpluses posted between 1998/99 and 2001/02. As a result, despite the recent scale of deficit outturns, the government maintains that it continues to meet the golden rule.

The budgetary strategy consistent with the 'golden rule' does not ensure deficits below 3% of GDP, as confirmed by the results in 2003/04, 2004/05 and 2005/06, as well as those in prospect for 2008/09 and 2009/10[b]. The golden rule is framed over the course of the cycle, rather than on an annual basis; as already noted, the deficit can fluctuate widely from year to year, and it cannot be excluded that general government net borrowing will exceed the 3% of GDP reference value in one or more years of the cycle, while still meeting the golden rule (indeed, part of the rationale for framing the golden rule in this way was to protect investment expenditure from short-term budgetary pressures). With the UK authorities targeting an average net investment-to-GDP ratio of around 2¼% of GDP over the next five years, a small deficit on the current budget would translate into a net borrowing approaching 3% of GDP.

The degree of constraint imposed by the 'sustainable investment' rule on the UK's deficit depends on the government's interpretation of "low and sustainable" debt levels. The 'sustainable investment' rule is interpreted as requiring net debt to remain below 40% of GDP in every financial year. With net debt well below that level over the past ten years, the 'sustainable investment' rule has not appeared an important constraint to the government's budgetary decisions during the past decade. On the other hand, with the 2008 budget forecasting an increase in net debt to 39.8% of GDP in 2010/11, the 'sustainable investment' would soon become binding should there be some slippages from the current medium-term projections.

[a] Gross investment (net of asset sales) less depreciation.
[b] Since 2002/03, the UK budget balance has remained persistently well above the estimated minimum benchmark (the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value), which for the UK is estimated as a deficit of around 1½% of GDP.

3.2. Short-term prospects

The UK authorities' latest fiscal projections were published in the 2008 Budget Report on the 12 March 2008. According to the 2008 Budget, the general government deficit in 2008/09 will rise to 3.2% of GDP, up by 0.3 percentage points when compared to the convergence programme submitted in November 2007. The upward revision to the 2008/09 deficit forecast was entirely due to a reduction in revenue projections, primarily reflecting the view that the volume of property transactions and the level of equity prices will both be lower than had been assumed in the programme. A reduction in expected property transactions (relative to what had been assumed in the programme), contributed to a downward revision in the official forecast for receipts from stamp duties and capital taxes, although the official projections do not assume a fall in house prices in 2008 and 2009. Meanwhile, lower-than-expected equity prices (down by almost 15% when compared to the assumption in the programme) are expected to reduce intakes from stamp duty on share transactions and from corporation tax.

The Commission services' spring 2008 forecast also projects a deterioration in the budgetary position in 2008/09. The deficit for the current financial year was projected to reach 3.3% of GDP, with the economic slowdown feeding through slower revenue growth. Weaker employment earnings and reduced corporate profitability were expected to constrain receipts from income taxation, while lower housing market activity was set to dampen intakes from stamp duties. Indirect tax revenues were forecast to grow at a lower rate than in 2007/08 due to lower household spending and an increase in the share of expenditure on food, which is not subject to the standard VAT rate. The spring 2008 forecast took into account all discretionary measures announced by 15 April (the forecast cut-off date), including those announced in the 2008 Budget. Those measures were expected to have an essentially neutral effect on public finances. The increased revenues from the removal of the 10% starting rate of tax on employment income and the reduction in allowances for investment were expected to finance reductions in the basic rate of personal income tax and in the main corporate tax rate. On the expenditure side, the envelope set in the government's 2007 Comprehensive Spending Review for the three years beginning in April 2008 envisages a deceleration in non-cyclical primary expenditure, which the spring 2008 forecast assumes will be adhered to, but which also implies a greater risk of spending overruns relative to previous years.

In 2009/10, the Commission services had forecast the deficit to remain at 3.3% of GDP, ½ percentage point higher than the 2009/10 deficit projected in the 2008 Budget. The latter was mainly due to differences in revenue growth projections as a result of the weaker economic context underpinning the spring 2008 forecast. In particular, the Commission services expected a more protracted economic slowdown relative to the 2008 Budget, with the spring 2008 forecast projecting real GDP growth well below potential and contributing to a further widening of the negative output gap. On the expenditure side, the Commission services forecast assumes that the government will adhere to the 2009/10 non-cyclical primary expenditure plans announced in the budget, which were practically unchanged from those in the 2007 CSR (and assumed in the convergence programme). However, the Commission services' higher inflation forecast for the third quarter of 2008 implies upward pressure on index-linked social benefits in 2009/10. In structural terms, the deficit was forecast to decrease by ¼% of GDP, reflecting the combined effects of discretionary measures, including the higher taxes on alcohol and motor vehicles introduced in the 2008 Budget, and continued slower growth in government expenditure.

Commission services' simulations of the budget balance assuming (i) different real GDP growth scenarios for 2009/10; (ii) trend output based on the HP-filter and (iii) no policy response from the UK authorities (notably, the expenditure level is as in the spring forecast) indicate that for the 2009/10 deficit to fall to the Treaty reference value, real GDP in 2009/10 would have to grow at a rate not less than 2¼-2½%. The latter is well above the spring forecast, the May 2008 update of the Consensus Forecasts for 2009 (1.7%), and the average of independent forecasts (1.6%) as published by the Treasury in May 2008[17].

The Commission's spring 2008 fiscal projections (and the 2008 Budget Report) pre-dated the government's statement on the 23 April 2008 that it now envisaged elements of compensation to some of those negatively affected by the removal from April 2008 of the 10% starting rate of income tax (one of the measures announced in the March 2007 budget). The government subsequently announced on 13 May 2008 that for financial year 2008/09 the compensation would be provided through an increase in individual personal tax allowances and that this measure would be financed through additional borrowing[18]. As a result, the Commission services now expect the headline deficit in 2008/09 to reach 3.5% of GDP, 0.2 percentage points higher than the annual deficit level forecast by the Commission services in spring 2008. The compensation plans also imply that the structural deficit in 2008/09 is now expected to deteriorate by 0.3 percentage points of GDP, to 3.3% of GDP. The government also announced that for future years it aims to "*continue the same level of support for those on lower incomes*"[19]. The announcement does not commit the government to extend to 2009/10 the fully debt-financed compensation offered in 2008/09 (thus opening the possibility of offsetting tax and expenditure measures[20]). It nevertheless carries a significant risk for 2009/10 of a deficit overshoot, compared with the March 2008 budget plans, with a similar impact ceteris paribus on the spring forecast projection.

3.3. The quality of public finances

[17] The Consensus Forecasts and the Treasury's *comparison of independent forecasts* do not publish growth projections for financial year 2009/10. However, the Commission services estimate that, given whole-year and quarterly growth projections for 2009, quarter-on-quarter growth in the first quarter of 2010 would have to reach around 2% - compared to an average of 0.7% since 2000 - for an annual growth rate in 2009/10 of 2¼%.

[18] See statement by the Chancellor of the Exchequer: http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/statement/Speech_statement_130508.cfm

[19] See paragraph 35 of the statement by the Chancellor.

[20] Further policy announcements are expected in the autumn 2008 Pre-Budget Report.

In recent years the ratio of general government expenditure to GDP has risen by more than 5 percentage points from 39% in 1999/00 to 44% in 2006/07. In comparison the EU average was around 47% in both 1999 and 2006. Underpinning this rise is the government's 2002 policy of increasing expenditure on public services, with a particular focus on increasing public investment from the relatively low levels seen in previous years. However, until 2006/07 the expenditure increase was mainly driven by higher intermediate consumption and compensation of employees (accounting for around half of general government expenditure), although public sector net investment since 2001/02 increased substantially as a share of Total Managed Expenditure[21] from 2.6% in 2001/02 to 4.6% in 2006/07. This translates into average public investment growth of around 15% per year in real terms (compared to 4% on average for current expenditure growth).

The 2007 Comprehensive Spending Review (CSR) – announced together with the 2007 Pre Budget Report in October 2007 – set departmental spending plans and priorities for the years 2008/09, 2009/10 and 2010/11. The spending plans over the 2007 CSR period are tight in comparison with the three preceding spending reviews. Total public spending is expected to increase by an average of 2.1% per year in real terms in the 2007 CSR period, against an average of 4.0% for the spending reviews covering the period from April 1999 to March 2008. The 2007 CSR seems to confirm the UK's continued effort to change the composition of public spending by further increasing the level of public sector net investment (from 2.1% of GDP in 2007/08 to 2¼% of GDP by the end of the CSR period) and refocusing resources towards budgetary items that are central to citizen's' welfare and/or conducive to economic growth such as education and health, although in the light of the overall lower spending envelope, at a much slower pace than seen in recent years. However, the outturn of higher spending in growth-enhancing areas such as education depends very much on the degree of efficiency in the system.

Table 4: Total public expenditure on services by function as a percentage of GDP

	1997/98	2001/02	2006/2007	Estimated 2007/08	Planned 2010/11
Social protection	13.8	13.6	13.4	13.3	-
Health [a]	5.4	5.9	7.1	7.3	7.8
Education [a]	4.7	5.1	5.5	5.6	5.6
Economic affairs	2.6	2.7	2.9	2.9	-
Other functions [b]	10.8	9.8	10.7	10.8	-

Note:
[a] Measured consistently with international definitions from the UN classifications of the functions of government (COFOG). Actual outcomes are subject to spending decisions by local authorities and devolved administrations.
[b] Includes "general public services", "defence", "environmental protection", "recreation, culture and religion", "public order and safety" and "housing and community amenities" and "EU transactions".
Source: *HM Treasury, Public Expenditure Statistical Analyses 2008, the March 2008 Financial Statement and Budget Report and the 2007 Comprehensive Spending Review.*

The annual real increase in public sector spending on health and education between 1997/98 to 2006/07 was 5% and 6% respectively. In 2007/08, public health and education expenditure are estimated at 7.3% and 5.6% of GDP respectively, rising from 5.9% and 5.1% of GDP in 2001/02. Whereas health spending is currently planned to grow further to 7.8% of GDP in

[21] Total Managed Expenditure (TME) is the national measure of total public sector expenditure and a key element of the government's fiscal framework. TME comprises expenditure by the entire public sector – namely the central government, local authorities and public corporations. TME consists of public sector current expenditure, public sector net investment and public sector depreciation. It differs from general government expenditure by including spending by public non-financial corporations, such as the formerly nationalised utilities, but excludes financial transactions.

2010/11, the share of education spending to national income is planned to remain stable over the CSR 2007 period. As part of its Science and Innovation Investment Framework 2004-2014, the government set a target to increase the UK's R&D intensity (public and private investment) to 2.5% of GDP by 2014.[22] In 2005, The UK spent £21.8 billion or 1.76 per cent of GDP on R&D (0.58% of GDP financed by government). Total public R&D spending as percentage of GDP fell from 0.72% in 1997/98 to 0.67% in 2005/06. According to the 2007 CSR, the UK science spending is expected to remain stable over the next three years at around 0.4% of GDP.

To support the departmental spending plans and enable the release of resources for priority areas, the government has also within the context of the 2007 CSR introduced a range of initiatives to further enhance the efficiency and effectiveness of public spending, including a value for money programme and a performance management framework.[23] The former aims at minimum 3% efficiency savings per year over the CSR period across central and local government, releasing £30 billion by 2010/11. It is still too early to judge whether the introduced measures will actually lead to a real improvement in the efficiency and effectiveness of public spending. There is a risk that some of the declared efficiency gains could represent pure cost-savings, entailing lower public service output. Furthermore, the targets are intrinsically hard to evaluate.

3.4. Government debt and long-term sustainability

The UK's general government gross debt ratio is set to remain under the reference value of 60% of GDP, even if projected to be on a rising trend up to 2009/10. The spring 2008 forecast estimates that gross debt at end-2007/08 rose to 43.2% of GDP and forecasts a further increase in the debt ratio to 47½% of GDP by 2009/10. The acceleration in the accumulation of government debt is in part due to the deterioration in the primary balance. However, in 2008/09 the forecast 3-percentage point rise in the debt ratio also reflects the denominator-effect from lower growth in real GDP and the GDP deflator, as well as a stock-flow adjustment of almost 1.0% of GDP due to the expected replacement of the Bank of England's loan to Northern Rock with government financing.

The 2008 Budget Report includes projections for public sector net debt (i.e. gross debt net of financial assets), which is the fiscal aggregate against which the "Sustainable Investment Rule" is assessed in the domestic fiscal framework (see Box 2). Public sector net debt is projected to rise from an estimated 37.1% of GDP in 2007/08 to 39.8% of GDP in 2010/11, and then decline slightly to 39.3% in 2012/13. The projections in the 2008 Budget imply that the constraint of the 40% *public sector net* debt ceiling might become binding should there be some slippages compared to the current projections.

Table 5: Debt dynamics [a]

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Government gross debt ratio	39.7	41.7	42.5	43.0	46.2	47.5
Change in debt ratio [b] (1 = 2+3+4)	1.1	2.1	0.8	0.6	3.0	1.3

22 HM Treasury and Department for Innovation, Universities and Skills (2007): Science and Innovation Investment Framework 2004-2014: Annual Report 2007. http://www.berr.gov.uk/files/file40538.pdf

23 For further information see Commission (2007): United Kingdom: Macro Fiscal Assessment. http://ec.europa.eu/economy_finance/publications/publication11832_en.pdf

Contributions:						
• Primary balance (2)	1.5	1.0	0.5	0.6	1.2	1.2
• "Snowball" effect (3)	0.1	0.4	-0.3	-0.3	1.0	0.1
of which:						
Interest expenditure	*2.0*	*2.1*	*2.1*	*2.2*	*2.2*	*2.1*
Real GDP growth	*-1.3*	*-0.7*	*-1.2*	*-1.2*	*-0.6*	*-0.8*
Inflation (GDP deflator)	*-0.7*	*-1.0*	*-1.2*	*-1.3*	*-0.6*	*-1.2*
• Stock-flow adjustment (4)	-0.4	0.7	0.6	0.3	0.9	0.0

Notes:
[a] In percent of GDP.
[b] The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.
Source: Eurostat and Commission services' spring 2008 forecasts.

The United Kingdom appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is close to the EU average, with public pension expenditure showing a somewhat more limited increase than on average in the EU, in part as a result of the fact that the UK relies relatively more on private pension arrangements than do other EU countries. The 2007 reforms, addressing the concern of potentially inadequate future pension provision, are likely to involve a somewhat higher increase in age-related expenditure. The budgetary position in 2007, which is significantly worse than the starting position of the previous programme, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Achieving high primary surpluses would contribute to reducing risks to the sustainability of public finances.

Based on the long-term budgetary projections provided in the Ageing Report and the UK's 2008 Budget Report, sustainability indicators can be calculated. Table 6 shows the sustainability indicators for two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is maintained and the programme scenario assumes that the plans outlined in the Budget Report are fully attained.

Table 6: Sustainability indicators and the required primary balance

	2007 scenario			**Budget report scenario**		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	3.3	4.9	3.9	2.3	3.9	3.9
of which:						
Initial budgetary position (IBP)	1.5	1.6	-	0.5	0.7	-
Debt requirement in 2050 (DR)	-0.3	-	-	-0.3	-	-
Long-term change in the primary balance (LTC)	2.0	3.2	-	2.0	3.2	-

Source: Commission services.

The "2007 scenario", in which it is assumed that the structural primary balance in 2007 was maintained, showed that the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 4.9% of GDP.[24] The Budget Report plans a structural primary budgetary consolidation of one percentage point of GDP between 2007/08 and 2012/13. If the "Budget

24 The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 3.3% of GDP.

Report scenario" was achieved, such a consolidation would appreciably reduce the S2 sustainability gap to 3.9% of GDP. In both scenarios, the initial budgetary position is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing. The long-term budgetary impact of ageing is close to the average of the EU. Since the budgetary adjustment planned in the 2008 Budget Report is less than that sketched in the November 2007 update of the convergence programme,[25] the sustainability gaps in the Budget Report scenario have widened compared with the convergence programme scenario. While the structural primary balance according to the 2008 Budget Report would amount to 0.1% of GDP, the primary balance required to stabilise the debt ratio and to finance the cost of ageing would amount to a surplus of 3.9% of GDP.

In addition to the common long-term projections, the 2007 reform to the state pension (changing pension indexation from prices to earnings), which makes the system more generous while increasing the statutory retirement age, tends to increase long-term pension expenditure.

Indeed, the 2008 edition of the *'Long-term Public Finance Report'* projects a somewhat larger increase in age-related spending between 2007/08 and 2047/48 in all its scenarios than the common projections. It also provides sustainability gap calculations, which – though not fully comparable to the above approach – are of similar magnitude as the S2 indicators of the "Budget Report scenario" above.[26]

4. OTHER FACTORS PUT FORWARD BY THE MEMBER STATE

In a letter of 20 May 2008, the authorities of the United Kingdom listed some relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97. The authorities noted that public finance projections contained in Budget 2008 were based on cautious, independently audited assumptions, an approach designed to build additional contingency into the headline fiscal numbers and to protect against unexpected events. The forecasts incorporate negative impacts and downward revisions in a range of areas including tax revenues from the financial sector, and from the property market. The authorities note that the increase in the deficit projected in Budget 2008 reflects the operation of the automatic stabilisers as well as non-discretionary factors, in the short term, resulting from exceptional disruption in global financial markets. The letter notes that UK forecasts indicate that the UK fiscal deficit will fall below the 3% reference value in 2009/10, highlighting the exceptional temporary nature of the excess over the 3% reference value. The authorities also highlight: debt levels well below the reference level, which in their view allow flexibility for sustained investment in public services; commitments made to improve efficiency and value for money in public spending; spending plans which allow for improvements in public services; significant commitments to implement the Lisbon Strategy for Jobs and Growth including on science spending, the Technology Programme and higher education teaching; and planned spending on Official Development Assistance (ODA).The analysis presented above covers

[25] Section 5.2 of European Commission DG ECFIN, "United Kingdom: Macro Fiscal Assessment, an analysis of the November 2007 update of the convergence programme", ECFIN/G1/2008/REP 50238-EN, available at: http://ec.europa.eu/economy_finance/publications/publication11832_en.pdf

[26] In particular, in contrast to the common projections, which assume a no-policy change scenario, the non-age-related revenues and expenditures are not kept constant as a share of GDP over time. See Chapter 4 in: HM Treasury, "Long-term public finance report: an analysis of fiscal sustainability", available at: http://www.hm-treasury.gov.uk/media/A/E/bud08_longterm_586.pdf

the items put forward by the authorities, except the observation by the authorities on the UK's international aid commitments. Under the latter item, the authorities record the UK's programme to increase its international development contributions, particularly in the context of the EU's collective commitment to provide an average of 0.56% of Gross National Income as Official Development Assistance by 2010. The UK plans to reach that level in 2010/11.

In 2005 and 2006, the ratio of the UK's net Official Development Assistance (ODA) to Gross National Income (GNI) stood at 0.47% and 0.51% respectively[27]. The ODA figures for those two years included the debt relief given to Nigeria which was agreed by the Paris Club group of creditors. In 2007 ODA fell to 0.36% of GNI, reflecting the lower levels of debt relief.

5. OTHER FACTORS CONSIDERED RELEVANT BY THE COMMISSION

Risk of expenditure overruns

The Commission services' spring 2008 forecast assumes that the non-cyclical primary expenditure plans that were announced as part of the 2007 Comprehensive Spending Review will be adhered to. During the six years between 2002/03 and 2007/08, annual *total* expenditure outturns have exceeded the *original* total spending envelopes that had been established in previous Spending Reviews. Total expenditure outturns deviated from the original ceilings by an annual average of 1.7%. In addition, as explained in section 3.3, the sharp slowdown in expenditure growth that is targeted in the latest CSR implies considerable control and efficiency challenges for the public sector, which suggests a heightened risk of spending overruns relative to previous years. Past trends show that typically expenditure overruns are smaller in the first year of the spending review period, suggesting that the risks from higher than planned expenditure are relatively smaller for the deficit forecast for 2008/09 but higher for 2009/10 and 2010/11. The 2008 Budget projections for 2011/12 and 2012/13, which are not backed by detailed discretionary spending plans, assume continued moderation in real expenditure growth and a further drop in the expenditure-to-GDP ratio.

Nationalisation of and Bank of England's loan to Northern Rock bank

The nationalisation on 22 February 2008 of Northern Rock bank, which had been facing severe liquidity problems since September 2007 as a result of the financial market credit squeeze, did not have any direct effect on the general government accounts for the time being. The UK's statistical office classifies Northern Rock in the public corporate sector, but it is not within the general government, the sector that is relevant for SGP purposes. However, it is not yet fully clear whether the Bank of England's loan to the bank, which stood at £24.1 billion or 1.7% of GDP at end-March 2008, should have already been reported as government debt, on the basis that the loan was granted on behalf of the State and with State guarantee. This issue is currently being discussed between the UK's Office for National Statistics and Eurostat. Meanwhile, the Bank of England's liquidity support and the Treasury's guarantees to the bank's other creditors (about £30 billion or 2.0% of GDP) are a contingent liability and, as such, do not show up in the government finance figures. A partial or full call of these contingent liabilities, if it ever happened, would be recorded as a debt assumption, with a corresponding increase in the deficit ratio (accounted for through a capital transfer) at the time of call.

[27] Annex 1, 2008 Annual Report, Department for International Development. http://www.dfid.gov.uk/pubs/files/departmental-report/2008/Annexes-bcov.pdf

Accounting treatment of Public Private Partnership contracts

The accounting treatment of some Public Private Partnership contracts is subject to an ongoing discussion between Eurostat and the ONS[28]. According to data released in March 2008, the total capital value of signed Private Finance Initiative (PFI) projects amounts to 4.0% of GDP in 2007/08, of which almost 2.5 percentage points are currently treated as off-balance-sheet. The Commission is aware that the UK authorities aim to adopt the International Financial Reporting Standards for the preparation of the annual financial statements of government departments and other public bodies from 2009/10. This move could see some of the current Private Finance Initiative (PFI) projects that are off-balance-sheet reclassified onto the public sector's books. Reclassifications would not necessarily adversely affect the general government accounts. Nevertheless, it remains possible that the changes in the accounting treatment could lead to a small increase in the general government deficit estimate, depending *inter alia* on the share of off-balance sheet PPPs that would end up on the general government accounts.

Council opinion on the 2007 convergence programme

In its opinion on the most recent update of the convergence programme, the Council concluded that the programme confirmed a significant deterioration in the United Kingdom's budgetary position that, coupled with a probably weaker macroeconomic context than envisaged, carried a clear risk that general government deficit would breach the 3% of GDP deficit reference value in the near term. The Council therefore invited the United Kingdom to implement measures necessary for the deficit not to exceed the reference value of 3% of GDP.

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28 See section 6.6 of the report on Eurostat's latest EDP visit to the UK: http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_DS_GFS/PGE_DS_GFS_9/FINDINGS%20FROM%20THE%20MISSION%20TO%20THE%20UK%20ON%2025-26%20JANUARY%202007_WEBSITE.PDF