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Assessment of the 2011 national reform programme and convergence programme for the UNITED KINGDOM

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

on the National Reform Programme 2011 of the United Kingdom and delivering a Council Opinion on the updated convergence programme of the United Kingdom, 2011-2014

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1. INTRODUCTION

The UK economy was severely hit by the crisis with GDP falling and the government deficit widening rapidly in 2008 and 2009. The recovery has begun but more slowly than after previous recessions. Responding to these developments called for significant change in the UK economy, both in the public and private sectors. The National Reform Programme (NRP) and Convergence Programme (CP) submitted to the Commission on 28 April set out a programme of reforms aiming to help the UK economy adapt to this new environment, through a large fiscal consolidation accompanied by significant supply-side reform.

2. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

2.1 RECENT ECONOMIC DEVELOPMENTS

In the decade before the crisis, UK annual GDP growth averaged 2.9%, peaking at 3.9% in 2000. Unemployment fell from its peak of 10.4% in 1993 to 5.3% in 2007. However, this strong growth performance masked emerging imbalances, in particular: (i) a greater-than-average reliance on household consumption growth to propel GDP leading, to a rising current account deficit[1]; (ii) a large increase in household debt linked to the housing boom and a falling savings rate; and (iii) a fiscal position which, although within Treaty reference values, was flattered by large cyclical revenues.

UK GDP contracted by 0.1% in 2008 and 4.9% in 2009. In 2009 domestic demand fell 5.5% with household consumption, private investment and stock building all declining sharply. Unemployment rose from 5.3% in 2007 to 7.6% in 2009. The trigger for this contraction was the international financial crisis to which the UK was particularly exposed because of its large, globally-integrated financial sector and high levels of household debt. The government deficit rose by 8.5 pp. in two years to 11.2% of GDP in 2009. This sharp increase was driven mainly by a sudden drop off in tax revenues, particularly from property transactions taxes and corporate taxes on the financial sector. Quarterly growth returned in the final quarter of 2009 and was maintained for the first three quarters of 2010. GDP contracted by 0.5% in the final quarter of 2010 as bad weather held back construction and transport in particular. According to the first estimate, this contraction was only just recovered in the first quarter of 2011.

The crisis triggered serious liquidity and solvency problems for UK banks. The UK government intervened decisively to support the sector, nationalising Northern Rock, taking large equity stakes in Royal Bank of Scotland and Lloyds Banking Group and providing extraordinary additional liquidity to the whole sector. The Bank of England also implemented very loose monetary policy, reducing the main policy rate to 0.5% and engaging in a £200bn (14% of GDP) programme of quantitative easing. Banking solvency ratios have recovered sharply from their crisis lows, assisted significantly by government support. As well as the problems in the financial sector, another factor which exacerbated the UK's economic crisis was the housing market. Nominal house prices doubled between 2000 and 2007. While the UK's strict planning laws prevented this price increase from causing a construction boom it did help drive a large increase in household debt as first time buyers took on more debt to buy houses and some owners borrowed more against their increased housing equity.

In the external sector, UK net exports deteriorated steadily throughout the pre-crisis decade with a surplus in (mainly financial) services more than offset by a large and growing deficit in goods. This decline appears to have been due partly to strong domestic consumption and partly to the persistent strength of sterling, driven somewhat by the UK's high interest rates. In

[1] Whereas domestic consumption accounted for half of euro area growth in the pre-crisis decade, in the UK it was three-quarters.

2008 and 2009, sterling depreciated 25% as interest rate differentials with the rest of the world evaporated and investments in the UK banking sector became less attractive. Sterling subsequently rebounded about 10% but remains well below pre-crisis levels. However, this has not yet driven a substantial improvement in UK net exports. The depreciation caused high imported inflation which, along with rising global energy prices and the increasing VAT rate, helped push inflation well above the official target of 2%.

2.2 OUTLOOK

The outlook for the short term indicates slow but steady growth. GDP is forecast to grow 1.7% in 2011 and 2.1% in 2012. The main drivers of this growth are expected to be strong corporate investment, with firms starting to spend more of their growing cash-pile and recoup some of 2009's dramatic fall in investment spending, and an exchange-rate driven rebound in net exports.[2] However, growth will be held back by the fiscal squeeze and weak private consumption growth.

Unemployment should remain stable at around 8% with private sector employment growth likely to be sufficient to offset job losses in the public sector.[3] However, there is uncertainty as to the degree to which firms will need to recruit - the twin crisis phenomena of labour hoarding and forced shifts from full-time to part-time working are still unwinding. The main downside risks to the forecast are that the rebounds in corporate investment and/or net exports may not materialise and that persistent high inflation may prevent the Bank of England from using monetary policy to offset the effect of the fiscal consolidation.[4] This high inflation is also likely to erode real incomes as wage growth remains low.

The longer-term outlook for the UK is relatively positive. According to Commission services' estimates, potential growth between 2012 and 2020 will average 1.9%, compared to 1.6% for the EU. The main medium-term threats to this positive outlook are persistently low investment and the risk of new incidents of economic instability. The investment share in GDP was well below the EU average throughout the pre-crisis decade and fell even further behind after the onset of the crisis. On the threat of new incidents of economic instability, recent macroeconomic disturbances in the UK have tended to happen alongside problems in the financial sector and sudden falls in house prices. As such, reforms in these areas could strengthen the UK's medium-term economic outlook.

3. MONITORING, PROCEDURAL ISSUES AND GOVERNANCE

The policy content of the UK National Reform Programme (NRP) and Convergence Programme (CP) is drawn from previous announcements and publications, mainly the March 2011 Budget and the October 2010 Spending Review as well as various other policy papers covering specific aspects. As such, while public comments were invited on the draft NRP via the Treasury's website and stakeholder engagement events were held in Scotland and Wales, there is no evidence of significant stakeholder input in the development of the NRP itself. Some of the initiatives described were subject to separate public consultation but the NRP

[2] During 2010, net exports subtracted around 1 pp. from growth as imports rebounded quicker than exports. However, this trend should reverse as new entrants exploit higher profit margins in export businesses and consumers substitute away from imported goods.

[3] Because of the public sector's small share in total employment, only relatively weak private sector growth would be required to offset the 400,000 expected public sector cuts.

[4] The macroeconomic outlook for the UK is covered in more detail in the Commission Spring Forecast 2011, available at http://ec.europa.eu/economy_finance/eu/forecasts/index_en.htm

does not give examples of ways in which policies may have been adapted to reflect stakeholder input.

Both documents have been approved by the UK Parliament following debates in the relevant select committees[5]. Prior to this, the House of Lords EU Scrutiny Committee held an evidence session on Europe 2020 and the NRP. The House of Commons EU Scrutiny Committee debated the Europe 2020 integrated guidelines and the Annual Growth Survey. In Scotland, Wales and Northern Ireland, the NRP and the policy measures included were debated by the devolved assemblies. The Scottish Government also submitted a separate NRP to set out in more detail their policy strategy.

The NRP does not contain the national targets foreseen under the Europe2020 framework, except for the target on renewable energies, in line with Directive 2009/28/EC. Instead it describes indicators of performance in areas connected to the Europe2020 headline targets and records their current level. As regards social inclusion, the NRP refers only to the existing numerical targets of the Child Poverty Act 2010. The lack of quantitative targets makes it difficult to assess reforms, in particular whether policy efforts are adequate and whether the speed of their implementation is sufficient.

4. POLICY CHALLENGES AND ASSESSMENT OF POLICY AGENDA

4.1 Challenges[6]

Consolidation of the public finances is the most pressing policy challenge for the UK in the context of output levels significantly lower than pre-crisis expectations. While the UK entered the crisis with low government debt, the high deficit will soon take debt above the EU average. The crisis revealed the unsustainable nature of some pre-crisis tax revenues, particularly from financial sector corporation tax and property transactions.

A second broad challenge for the UK is to ensure financial stability and avoid the formation of new bubbles. While the triggers of the crisis were global, two factors which exacerbated the situation in the UK were the large, globally-integrated and highly-leveraged financial sector and the overheating housing market. In the financial sector a particular failing, not unique to the UK, was a lack of oversight of prudential risks building up across the system as a whole rather than in any one individual institution. An example was UK banks' excessive reliance on short-term funding. There were also failures in individual firm supervision. Reducing the risk of such failures in the future is thus a key challenge for the UK.

As house prices rose rapidly in the pre-crisis decade, so households took on more debt and economic growth became more focused on domestic consumption. The increase in household debt certainly appears connected to rising house prices since the majority of the increase was in the form of mortgages. The link between house prices and the UK's domestic consumption boom is less certain. It could be that both were caused mainly by strong consumer confidence and easy access to credit. However, it does not seem credible to assume no causal link at all from house prices to consumption growth, with wealth effects almost certain to have contributed both to reinforcing consumer confidence and (through increased collateral availability) to more access to cheap credit. The unwinding of these phenomena damaged the UK economy. The sharp fall in household consumption in 2009 was the main contributor to that year's GDP contraction. The sudden drop-off in housing transactions and prices cost the

[5] The House of Commons scrutinised the Convergence Programme on 27 April. The House of Lords scrutinised both the Convergence Programme and National Reform Programme on 13 May.
[6] The UK did not sign the Euro Pact Plus for Competitiveness endorsed on 25 March 2011.

government a significant amount in lost revenue. House price falls – and concerns they could fall much further – increased market concerns about the soundness of UK banks' mortgage books, exacerbating the climate of extreme uncertainty which led to the drying up of short-term funding markets for banks.

As regards rebalancing away from domestic consumption, given weak domestic demand prospects outside corporate investment, a rebound in corporate investment and net exports would be an important support to demand. Corporate investment appears to be held back by poor credit availability as banks' reduced risk appetite has made them less willing to lend to business, particularly SMEs. Regarding net exports, one possible constraint is the availability of export finance. Feedback from firms suggests that banks have restricted their offer in this market since the crisis. While the UK Export Credit Guarantee Department does provide some state-financed options in this area, it works for the most part with larger firms.

In the labour market, while total unemployment increased less than might have been expected during the crisis given the large fall in GDP, youth unemployment increased disproportionately. Between Q4 2009 and Q4 2010, unemployment of more than 2 years among the 18-24 age category increased by 43.4% compared to 37.2% for the working-age population as a whole. The 16-24 year old age group accounted for 56% of the total decline in employment between the peak in Q2 2008 and trough in Q1 2010 despite representing only 15% of total employees in 2008. This emphasised longstanding issues in the UK of youth unemployment and early school leaving.

A challenge to the UK is its low private sector fixed investment; facilitating higher investment should increase potential growth. In the decade to 2007, private sector fixed capital formation averaged 15.6% of GDP in the UK compared to 17.8% in the EU. However, the UK picture worsened during the crisis with an unprecedented drop off in investment bringing the ratio down to 11.9% in 2009 compared to 16.2% in the EU. The UK's relatively large service sector only partly explains its low historical investment record. As well as the structural benefits, stronger investment could also provide support to domestic demand with household and government consumption likely to remain weak over the medium term.

Research and Innovation (R&I) intensity in the UK has been relatively stagnant over the last decade, first falling until 2004 and then recovering to 1.87% in 2009. Over the same period, public and especially private R&I investments lagged behind the EU and the United States. R&I intensity is now below the EU average. These lower values can be justified to some extent by the nature of the economic structure of the UK; when adjusting for the sectoral mix, the UK investment intensity gap is for instance only 0.25 pp. of GDP as compared with Germany and 0.5 pp. as compared with France. There is nevertheless a case for structural change towards a more sustainable and knowledge-intensive economy in order to preserve future growth and competitiveness. In the context of current weakness in some parts of the labour market, a major challenge is to create jobs in more R&I- and knowledge-intensive sectors.

4.2 Assessment of the policy agenda

4.2.1 Macroeconomic Policies

Public finances

The fiscal mandate of the new government is to balance the cyclically-adjusted current budget by the end of a rolling, five-year period, currently 2015-16. The government also has a supplementary target for public sector net debt (PSND) as a percentage of GDP to be falling at a fixed date of 2015-16. Another innovation is the Office for Budgetary Responsibility (OBR), which produces the official forecast underlying annual budgets. It must also judge whether, based on the announced policies, the chances of the government meeting the fiscal mandate and debt sustainability rule are greater than 50%. The OBR has assessed that there is currently a greater than 50% chance that these targets will be achieved.

The UK does not set an explicit medium term objective (MTO), but the new fiscal framework is a step towards compliance with the Stability and Convergence Programmes (SCP) code of conduct since it sets a target designed to bring the fiscal position close to balance over the medium term. Although the fiscal mandate is measured in terms of the deficit excluding investment expenditure, an implied target for the overall cyclically-adjusted deficit can be calculated from the programme figures.

The programme is based on a growth forecast of 1.7% in 2011 and 2.5% in 2012 (with inflation at 4.2% and 2.5%). While the growth assumption for 2011 is in line with the latest Commission forecast, for 2012 it is based on slightly more favourable growth assumptions. The programme's higher growth forecast in 2012 comes from higher private consumption and investment.

Potential GDP growth is estimated in the programme at 2.35% in both 2011-12 and 2012-13 then 2.29% followed by 2.1% in 2013-14 and 2014-15, respectively. These estimates are much larger than those of the Commission whereby potential growth only reaches 1.8% in 2014 and 2.0% thereafter. The output gap as recalculated by the Commission services based on the information in the programme, following the commonly agreed methodology, is expected to close in 2015, whereas the programme foresees closure only in 2017-18. There are also differences concerning the starting point, as the current output gap estimated by the Commission is -5.2% whereas the programme estimates -3.4%; but the latter is equivalent to -5.2% under the agreed methodology.

Two alternative scenarios are also analysed in the programme to test the robustness of the central scenario. The first is of persistent inflation where current high inflation leads to higher inflation expectations and subsequent wage settlements, ultimately leading to a rise in interest rates by the Bank of England. In this case, GDP for 2011 remains at 1.7% but 2012 growth falls by 0.1 pp. Thereafter, the effect is much larger with GDP growth lower by 0.8 pp. and 0.9 pp. in 2013 and 2014, respectively. The inflation forecast rises in each of the subsequent years by 0.1 pp., 1.3 pp., 2.5 pp. and 2.0 pp. respectively in 2011, 2012, 2013 and 2014. The second scenario envisages a weak euro with sterling appreciating significantly and euro area demand weaker than in the central scenario. GDP growth is lower by 0.2 pp. in both the initial years, is identical for 2013 and increases by 0.1 pp. in 2014. Inflation is estimated at 3.7%, 1.0%, 1.2% and 1.8% for 2011, 2012, 2013 and 2014, respectively which is on average 0.75 pp. lower than the central scenario. The effect of the lower rate is felt in 2012.

The main risks to the budgetary targets stem from inflation. The forecast assumes that inflation will fall substantially when the January 2011 VAT rise and recent energy price rises drop out of the comparison. If inflation does not decline as expected, this will push up inflation expectations, and subsequently wage settlements and index-linked Annually Managed Expenditure (AME). Furthermore, monetary policy may have to tighten as a result curtailing already-weak consumption and investment. Other potential risks include higher unemployment, which would increase AME spending and reduce tax revenues. Further sluggish growth in exports with import demand holding steady is a further risk.

The forecast deficit for 2010-11 is 0.3 pp. lower than the June 2010 budget at 9.9% due to stronger-than-expected VAT and self-assessment receipts. The Commission forecasts a slightly lower deficit in 2010-11 (by 0.4 pp.). The deficit in the convergence programme is expected to decrease rapidly over the next years to 2.7% in 2014-15. This increased from 2.3% since the June 2010 budget, but should still be in line with the Excessive Deficit Procedure (EDP) commitment of less than 3% of GDP by 2014-15, albeit with a lower margin of error.[7]

The planned consolidation implies an average annual fiscal effort 1.6% of GDP each year between 2010-11 and 2014-15. This is slightly lower than recommended by the Council in December 2009 (1¾% of GDP) but is nevertheless appropriate given that the effort is being pursued from a significantly lower-than-expected budget deficit in 2009-10 and therefore appears consistent with reducing the headline deficit to below 3% of GDP before the 2014/15 deadline. The consolidation plans are relatively front-loaded, with a planned reduction in the cyclically-adjusted deficit of 3.8 pp. of GDP between 2009-10 and 2011-12.

Approximately three-quarters of the planned consolidation come from spending cuts (£ 95bn) with the remainder (£ 30bn) from tax increases. Spending cuts focus on both government consumption and investment though the latter is projected to be cut more sharply over the forecast period.

Public sector current expenditure over the programme period[8], (specifically AME), is higher than forecast in the June budget because of higher inflation and the index-linked nature of social benefits and some debt interest payments. Departmental Expenditure Limit (DEL) spending over the programme period has been reduced since the forecast in the June budget. Total government spending[9] is forecast to fall from 47.1% of GDP in 2010-11 to 41.0% of GDP by 2014-15. Public sector gross investment is estimated to fall by 1.5 pp. of GDP over the same period. DELs have been cut by an average of 19% over the four years to 2014-15, excluding the protected health and overseas aid budgets. When assessed against the projected rate of medium-term potential output growth, expenditure projections seem to ensure an appropriate adjustment path.

Given the scale of the UK's planned expenditure cuts, prioritising the most growth-enhancing aspects is important. UK public investment has been significantly below the EU average throughout recent history. This has been reflected in relatively poor UK infrastructure, particularly as regards transport. The gap closed significantly during the last decade. However, as part of the fiscal consolidation, public investment will suffer cuts in real terms of around 28% by 2014-15 compared to its 2010-11 level. While it was not realistic to avoid cutting investment given the need for such significant cuts in overall spending, persistently low government investment could constitute an obstacle to growth in the future. Thus, there appears a good case for attaching high priority to public investment, R&I and other forms of growth-enhancing expenditure in future spending rounds.

In general, the forecast for current receipts over the programme period is slightly lower than the June 2010 budget, with the exception of 2011-12 where receipts are 0.1 pp. higher. This is due to weaker-than-expected income tax revenue and social insurance contributions, along with, though to a lesser extent, lower corporation tax revenue because of the measures announced in the March 2011 budget. The measures, such as the bank levy, the levy on North

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[7] According to Eurostat, the debt and deficit figures should be adjusted for financial defeasance structures with respect to Bradford & Bingley and Northern Rock Asset Management. See: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-26042011-AP/EN/2-26042011-AP-EN.PDF

[8] Multi-annual limits for predictable spending in every department are specified in advance through "Departmental expenditure limits" (DELs) set in regular Spending Reviews. Non-discretionary expenditure is forecast but not capped in advance under the "Annually managed expenditure" (AME) system.

[9] Total managed expenditure (TME)

Sea oil and gas producers, stronger VAT receipts and the change in the indexation base from HICP to RPI are not sufficient to offset this decline.

Gross debt grew substantially at the start of the decade following continuously increasing expenditure in the previous years. The gross debt ratio for 2010-11 was 0.2 pp. lower than the June 2010 budget forecast of 78.9%. However the forecast debt ratios to 2015-16 are approximately 2.5 pp. higher for each year. This is due higher projected expenditure. The debt ratio is now expected to peak at 87.2% in 2013-14. The Commission predicts a marginally higher debt ratio than the programme of between 0.2 pp. and 0.6 pp. for 2011-12 and 2012-13 based on a higher deficit.

The UK is at high risk with regard to the long-term sustainability of public finances. The long-term cost of ageing is above the EU average and the current budgetary position compounds the cost of ageing. Based on the current fiscal position, debt would increase to 128% of GDP by 2020. However, the full implementation of the programme would be enough to put debt on a downward path but would still be above 80% by 2020. Ensuring sufficient primary surpluses over the medium-term, as already envisaged in the programme, would improve the sustainability of public finances.

Main budgetary measures (% of GDP)	
Revenue	**Expenditure**
2010-11	
• Increase in VAT rate to 20% (0.19% of GDP)	• Reduction in Departmental Expenditure Limits (DEL): June 2010 to March 2011 budgets (-1.05%)
2011-12	
• Increase in VAT rate to 20% (0.78% of GDP) • Bank Levy (0.12% of GDP) • North Sea Oil & Gas producers supplementary charge (0.12% of GDP) • Fuel duty reduction (-0.12% GDP)	• Reduction in Departmental Expenditure Limits (DEL): June 2010 to March 2011 budgets (-1.00%)
2012-13	
• Increase in VAT rate to 20% (0.77% of GDP) • Bank Levy (0.16% of GDP) • North Sea Oil & Gas producers supplementary charge (0.14% of GDP) • Fuel duty reduction (-0.10% GDP)	• Reduction in Departmental Expenditure Limits (DEL): June 2010 to March 2011 budgets (-0.77%)
2013-14	
• Increase in VAT rate to 20% (0.75% of GDP) • Bank Levy (0.15% of GDP) • North Sea Oil & Gas producers supplementary charge (0.12% of GDP) • Fuel duty reduction (-0.10% GDP)	• Reduction in Departmental Expenditure Limits (DEL): June 2010 to March 2011 budgets (-0.54%)
2014-15	
• Increase in VAT rate to 20% (0.74% of GDP) • Bank Levy (0.14% of GDP) • North Sea Oil & Gas producers supplementary charge (0.12% of GDP) • Fuel duty reduction (-0.12% GDP)	• Reduction in Departmental Expenditure Limits (DEL): June 2010 to March 2011 budgets (-0.37%)

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.

Financial sector

The UK has taken a number of steps to ensure financial stability and prevent the formation of new bubbles. In financial regulation, they are in the process of creating a new architecture. At the top of this will sit a new Financial Policy Committee (FPC), run by the Bank of England, with broad responsibility for maintaining financial stability and powers to intervene where it identifies risks. Currently the Financial Services Authority (FSA) regulates almost all financial firms, including banks, insurers and securities firms. Under the new framework, the FSA will be broken up. Responsibility for prudential supervision of banks and insurers will be transferred to a subsidiary of the Bank of England, to be known as the Prudential Regulatory Authority (PRA). The FSA's responsibilities for regulating securities markets and conduct of business in retail financial services will transfer to a new Financial Conduct Authority (FCA).

A key strength of this new framework is its strengthened mechanisms for identifying stability risks which cut across the whole of the banking or broader financial sector rather than being specific to any one institution (known as macro-prudential risks). The FPC will include the chief executives of the FCA and PRA which should help cooperation between the different parts of the system. A challenge in the new system will be ensuring that the improvements in the quality of individual firm supervision which were shown to be necessary during the crisis are delivered and maintained in spite of the organisational disruption, which the switch to the new framework is likely to generate. The UK has also established an Independent Commission on Banking to consider further reforms to promote financial stability and competition. The Commission will make its final recommendations by September 2011. This is discussed further in section 4.2.3.

Other macroeconomic issues

UK houses are expensive compared to average historical price/income ratios and their prices experience regular booms and busts. This has several downsides. First, house price swings have a big impact on household balance sheets. Second, banks providing mortgages are vulnerable to swings in the housing cycle, increasing its economic impact. Third, public finances are vulnerable to swings in housing tax revenues. Fourth, high house prices help drive the large share (around 25%) of the population living in state-subsidised accommodation and the high cost (around 1.5% of GDP) of housing benefit for poor households. The UK has announced some measures to address these issues. Regarding supply, there will be a new "presumption in favour of sustainable development" under which the default response to planning applications would be positive provided they meet conditions on sustainable development. This could be a positive step, although much will depend on the detailed conditions around sustainable development and the leeway afforded to planners to go against the default response and refuse applications. This is part of a broader reform of the planning system under which central targets for house building are being replaced by incentive payments to local authorities who regain full control of the planning decisions themselves. £200m has been budgeted for these incentive payments in 2011-12 with £250m set aside for future years. The UK will also take steps to facilitate the use of publicly-owned land for housing development and to ease the regulatory burden on house builders.

However, there is significant uncertainty over whether this new framework will in fact encourage house building. A UK Parliamentary report[10] noted that the figures for new house

[10] "Abolition of regional spatial strategies: a planning vacuum" Report of the House of Commons Communities and Local Government Committee, available at:

building contained in local authorities' plans were estimated to have fallen by 200,000 following the announcement of the abolition of central targets for planning and that the government had not presented any evidence that local authorities would achieve comparable rates of house building to those in the past. While the degree of reform in this area is high, it is not yet clear that the combined effect of the various measures will increase or even stabilise the rate of new house building.

Box 1: The UK housing market and its taxation

There are two main property taxes in the UK: council tax and stamp duty land tax (SDLT). Council tax is charged to occupiers of residential property.[11] Rates are set according to value bands, as shown in Table A with local authorities having limited discretion over the rates charged for properties in each band. SDLT is a transactions tax and rates depend on the value of the transaction. Capital gains tax is levied when properties are sold for a profit, but owner occupiers are exempt from capital gains tax on the property which they declare as their principal private residence. Property rental income is subject to income tax. The UK share of total revenues from property taxes is, at 12% in 2009, by far the highest in the EU. Around 80% of this is accounted for by council tax, which is mainly residency rather than ownership based and only loosely linked to property value.

Table A: UK property taxes

Council tax

Band	Value as at 1 April 1991	No. of properties in band in England at March 2009 (ml)	Charge in local authority setting English average band D rate in 2009-10
A	Up to £40,000	5.7	£943
B	£40,001 to £52,000	4.4	£1,100
C	£52,001 to £68,000	4.9	£1,257
D	£68,001 to £88,000	3.5	£1,414
E	£88,001 to £120,000	2.1	£1,728
F	£120,001 to £160,000	1.1	£2,042
G	£160,001 to £320,000	0.8	£2,357
H	More than £320,000	0.1	£2,828

Stamp duty land tax

Band (2010-11)	Rate
Up to £124,999	0%
£125,000 to £249,999	1%
£250,000 to £499,999	3%
£500,000 to £999,999	4%
More than £1,000,000	5%

Source: Mirrlees Review

Some aspects of these taxes have been criticised. In the case of Council tax, properties in the top band are at least eight times as valuable as those in the bottom band but pay only three times as much tax. Secondly, the valuations have not been updated since 1 April 1991. Thirdly, second homes, empty dwellings and single occupancy houses all receive discounts on the taxes due. This allows people to subsidise ownership of properties which might otherwise be sold (thereby alleviating supply constraints) under a different tax system. Finally, people on low incomes are eligible for council tax benefit to help with the cost of the tax. While this benefit has a clear social rationale, subjecting people to a tax and then requiring them to apply to receive help paying it creates a larger administrative burden than would simply taking them out of the scope of the tax. New government plans to devolve council tax benefit policy to local authorities could aggravate this problem by creating a multitude of different rules.

Because transaction volumes are more volatile than prices, SDLT revenue is particularly vulnerable to the economic cycle. Large falls in SDLT revenue contributed to the radical worsening of the UK fiscal position during the crisis. Second, because the whole price becomes liable to the higher rate when a threshold is crossed, there is a strong disincentive to price houses just above any threshold, distorting prices. Third, taxing transactions rather than ownership makes moving house more expensive, discouraging labour mobility and increasing frictional unemployment. Finally, discouraging transactions creates a barrier to houses being owned by people who value them most.

http://www.publications.parliament.uk/pa/cm201011/cmselect/cmcomloc/517/517.pdf

[11] There are some exceptions. Where a property is deemed a single dwelling but multiple tenants live as separate households within it, the owner is liable for the tax. Full-time students are exempted from the tax completely.

Regarding stability risks from the housing cycle, the FPC is likely to have powers to intervene to prevent dangerous asset price bubbles, including in the housing market. These powers could include the ability to increase capital charges for banks on mortgage lending, offering an option to cool the housing market in the event of a credit-fuelled overheating. The FSA's work to tighten mortgage conduct of business rules should reduce the problem of people obtaining mortgages which they cannot afford. Tighter credit availability should help contain some of the swings in housing demand by constraining households' ability to overspend on housing by assuming excessive debt.

The importance of mortgage availability in influencing house prices means that this issue merits continued attention including monitoring of the impact of new conduct of business standards and development by the FPC of appropriate policy instruments to rein in new mortgage lending if and when it starts to pose stability risks. A return to pre-crisis levels of availability of mortgages at high loan-to-value ratios and income multiples would be likely to result in increased house prices and increased household indebtedness while doing little to address the problems of access to home ownership which are ultimately driven by inadequate supply.

Despite the potential importance of taxation in influencing demand for housing, housing taxation remains largely unreformed with the exception of a helpful but small measure to eliminate a disincentive to landlords buying more than one apartment in the same block at once.

Box 1 describes the current UK property tax system. A single annual property tax based on current values could avoid many of the problems of the current regime. The regressivity of Council tax and perverse incentives of SDLT could be eliminated. A higher tax burden on more expensive properties would discourage speculative investment and hoarding, reducing pressure on housing supply and helping to discourage bubbles. Revenue from such an annually recurring value-based tax would be more stable than SDLT since prices are much less volatile than transaction volumes. A value-based tax could also help weaken the link between house price inflation and consumption since post-tax income would be supported by lower taxes during times of falling house prices and held back when house price inflation was high.

There would be difficulties in implementation, not least the determination of the current values of each property. However, it should be possible to move towards a value-based tax without requiring annual revaluation of every house. For example, infrequent and staggered house-by-house revaluations could be supplemented by interim revaluations based on average house price inflation by region. Particular provisions, including options to defer taxation until after a property is sold or bequeathed, could be envisaged for households whose wealth is made up almost entirely of housing equity and for whom an increase in property tax might have a disproportionate effect on disposable income. In the long run, the social benefits of a more equitable and efficient system should outweigh the social costs.

4.2.2 Labour market policies

Weak work incentives have been a long-running problem for the UK, with the main underlying issues being the high marginal withdrawal rates for those moving off benefits into low-paid jobs, administrative delays as Tax Credits and Housing Benefit are calculated and adjusted over weeks and sometimes months and the complexity of the benefits system which makes it hard for benefit recipients to assess how much benefit they would lose if they took a job. These issues can be particularly acute for single parents and second earners. The UK is one of the Member States where financial incentives to take up employment for second earners are lowest, taking into account the impact of childcare costs on the net income gain (OECD, 2011).

A further challenge in getting the unemployed back to work comes from the approximately 400,000 public sector job cuts required to implement the government's challenging fiscal consolidation. While private sector job creation in aggregate is likely to generate sufficient vacancies to accommodate those losing their jobs in the public sector, their skills may not be appropriate to the areas of the economy growing most quickly, notably manufacturing.

In order to support unemployed people finding work, the government has announced a new "work programme" which was introduced in April and replaces the array of existing programmes. The central idea is to simplify and improve the effectiveness of ALMP programmes. The new approach includes the expansion of work placements for young people aged 18-24 lasting up to eight weeks. There is an emphasis on contracting with private and voluntary providers to deliver customised support, with payments to the providers strongly geared to outcomes.

The UK has begun taking steps to improve incentives to work. In 2013, it will introduce the 'Universal Credit' which will replace most means-tested benefits and tax credits for working adults with a single benefit. As well as the direct benefits of simplification, the Universal Credit will be designed to deliver a single marginal withdrawal rate of 65%, to ensure that work pays for all benefit claimants. To make work more attractive for low earners, the government has announced an objective to exempt the first £ 10 000 of income from income tax. For 2011-12 this threshold is £ 7 475. In 2012-13 it will increase to £ 8 105.

Education and training

UK performance is better than the EU average on participation in early childhood education, on reducing the number low achievers in reading, maths and science, on completion of upper secondary education and in adult education. Rates of participation in Higher Education are currently good, but could be adversely affected by the introduction of tuition fees of up to £9,000 p.a. for degree courses in England. Problems in vocational education have prevented significant increases in medium level skills. According to a report of the Government's *'UK Commission for Employment and Skills*' (*UKCES*)[12], based on current trends the UK's relative international position is unlikely to improve between 2010 and 2020 and for low and intermediate level skills the UK is projected to remain ranked in the bottom half of the OECD countries.

While the share of people aged 25-64 having attained high skill levels is, at 33.4%, high in the UK (EU: 25.2%), in 2009, the share of adults having completed ISCED[13] level 3 education was low, at 41.2% compared to 46.8% on average for the EU. UK public spending on education as a percentage of GDP has grown since 2000 and is now above the EU average, but educational performance (as measured by PISA scores) remains static. The OECD[14] notes that insufficient supply of high-quality vocational programmes and tertiary education study places hamper human capital formation and growth.

[12] UK Commission for Employment and Skills, Ambition 2010 Report, August 2010.
[13] International Standard Classification of education. Level 3 is broadly equivalent to upper secondary education.
[14] OECD Economic Survey of the UK, March 2011.

The announced measures to promote skills should contribute to alleviating the bottlenecks identified. The increase in annual funding for adult apprenticeships will be up to £250m per year with sufficient funding in place for 75 000 more adults by 2014-15. Other measures such as student loans for advanced further education courses and Lifelong Learning Accounts may assist in combating this bottleneck. There will be a £2.5bn pupil premium fund to support the education of disadvantaged children and a new National Scholarship fund to support students from disadvantaged backgrounds, reaching £150m per year by 2014-15. The budget details, where available, specify a maximum limit being invested but no minimum. Thus, the level of ambition is high but more details on certain schemes are required to make a full assessment of the plans' effectiveness (for example on the extent to which employers will in fact provide the extra apprenticeship places for which funding is being made available, and on the new targeting mechanisms for support to students from disadvantaged backgrounds – see below).

The measures in the NRP were supplemented on 12 May by the publication of a document entitled "Supporting Youth Employment" which summarised the government's approach to this problem and announced some new measures. These included implementing the reforms to vocational education recommended by a recent independent review, requiring secondary schools to offer careers advice, providing apprenticeships for "up to 10,000" vulnerable young people and trialling new "sector-based academies" to train up to 50,000 young unemployed people to work in particular sectors. Given that these measures were not included in the NRP, it was not possible to conduct a full analysis of them. However, as with some of the rest of the package, while these are clearly all steps in the right direction, the numbers helped appear small relative to the size of the problem and there is a lack of evidence on whether the target numbers will be reached and of how much the new initiatives will be a genuine addition compared to current levels of support.

The proportion of UK 18-24 year-olds who are early leavers from education and training, at 15.7%, is higher than the EU average of 14.4% and much higher than the EU target of 10%. The problem is more acute for boys than girls. In England, the number of 16-24 year-olds not in education, employment or training was 938 000 in the final quarter of 2010, a record high. Furthermore, pupils' educational performance in the UK remains strongly related to parents' income and background.[15]

Plans to tackle early school leaving include raising the age for leaving compulsory education from 16 to 17 in 2013 and to 18 from 2015. A coordinated range of policy measures and investment has not yet been specified. Plans to make more money available for apprenticeships and create a new type of 'technical' school in 24 localities should make vocational education and training more accessible for young people. However, according to the National Institute of Economic and Social Research neither the expansion of apprenticeships nor the expansion of the work experience scheme are sufficient to address the scale of the youth unemployment problem.

Furthermore, some further reforms may exacerbate the problem of early school leaving in the UK. In England, the 'Education Maintenance Allowance' (EMA) - a payment of up to£30 per week to children from poorer families who remain in post-16 education - was closed to new applicants as of January 2011 and replaced with a smaller, more targeted bursary scheme; total funding was reduced from £560m to £180m. The government draws on research by the National Foundation for Education Research saying that 90% of students who receive EMA would still continue with their education without the payment. However, Institute for Fiscal Studies (IFS) research shows that the EMA has raised participation as well as boosting grades; the costs of providing the allowance are offset by the financial gains of getting young

[15] OECD Economic Survey of the UK, March 2011.

people into training. There remains a risk that this new policy will not be as effective as the EMA in tackling educational disadvantage, suggesting a case for specific short- and medium-term nationwide measures to drive greater progress.

Combat poverty and promote social inclusion

People in the UK face a higher risk of poverty than the EU average. In 2009, the at-risk-of-poverty rate stood at 17.3% against an EU average of 16.3%, but declined by 1.7 percentage points between 2005 and 2009. Severe Material Deprivation declined between 2005 and 2009 by 2 percentage points, and was much lower (3.3%) than the EU average (8.1%). The UK's Low Work Intensity rate is the highest in Europe. In 2009, 12.6% of the UK population aged 0 to 59 years lived in very low work intensity households compared to a 9% EU average.

A particular issue is the high rate of jobless households with children, the highest in Europe at 17.5% compared to the EU average of 10.2%. The lack of conditionality for single parents, who do not have to work until their youngest child reaches age 7, and the difficulty in accessing affordable childcare are significant issues. In the UK, over 32% of people (4 pp. above the EU average) with care responsibilities are inactive or work part-time due to lack of care services. 60% of Family Information Services across Britain said that parents had reported a lack of childcare in their area during the previous twelve months. Childcare costs have typically increased by more than the average wage (in particular, the cost of a childminder for a child aged two and over in Scotland increased by 8.3 per cent - almost four times as much as the average wage)[16]. In England, free childcare is only available for children aged 3 and 4 for fifteen hours a week. Different arrangements apply in Scotland and Wales.

Regarding work incentives for single parents, from 2012 the government intends to reduce from 7 to 5 years, the age for children above which single parents are obliged to seek work. However, this appears to be the only new measure targeted specifically at single parents. While childcare entitlements were increased in 2010, even at the new levels a lack of access to childcare risks being a barrier to work for many lone parents.

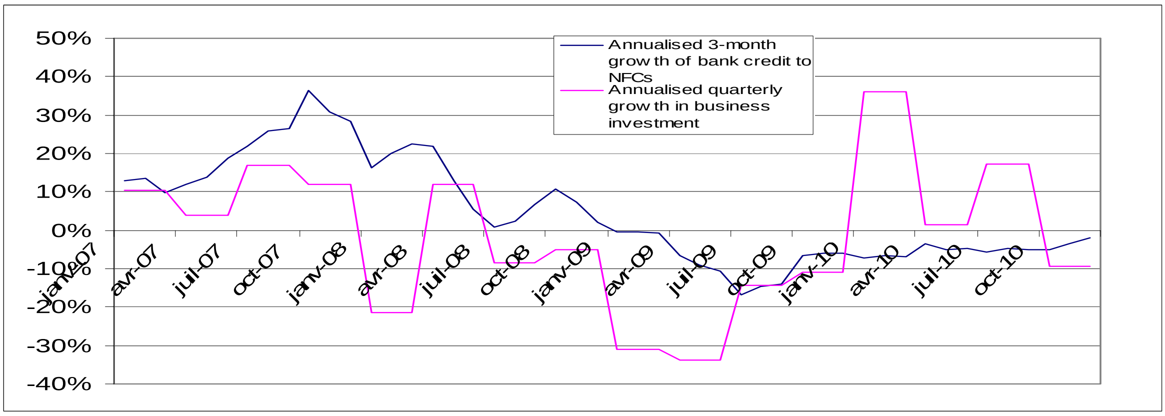
4.2.3 Growth-enhancing structural measures

The Business environment

The economic crisis has had long lasting effects on access to finance for SMEs, particularly for small firms. The UK banking sector was badly hit by the financial crisis and many banks still remain with substantial public shareholding and/or benefit from the UK government's asset protection scheme. Despite recent policy efforts, the Bank of England recently noted that credit conditions for small companies generally remain tight, both in terms of cost and availability and that lending to SMEs continued to contract in the second half of 2010.[17] Whilst spreads over reference rates seem to have stabilised for medium-sized businesses, they have increased somewhat for small businesses. As shown in Figure 1, the drop-off in investment was accompanied by a large fall in net lending to non-financial corporations. The causality in this relationship could run both ways. Business investment intentions were certainly scaled back as the crisis impaired demand prospects. This would have reduced credit demand. However, there is also evidence, especially from SMEs, that credit availability has become a significant issue since the crisis, in some cases holding back investment plans.

[16] Daycare Trust, Childcare costs 2011.
[17] Inflation Report, May 2011 and Trends in Lending, April 2011.

Figure 1: Credit growth and business investment



Source: AMECO

The UK government has introduced various policies aimed at improving credit availability. The highest profile was project Merlin, a deal negotiated between the UK government and HSBC, RBS, Lloyds and Barclays (plus Santander for the lending targets). Under Merlin, the four banks plus Santander agreed, subject to sufficient demand, to gross lending of £ 190bn (13% of GDP) to businesses in 2011, compared to £ 179bn loaned in 2010. Of this, £ 76bn (5% of GDP) will be made available to SMEs, compared to £ 66bn in 2010. The bonuses of bank chief executives will be linked to performance on this target. The higher gross lending will help support investment if it is achieved. However, previous lending targets agreed by banks since the crisis have not always been met. Furthermore, the terms and conditions of such lending are not included in the scope of the agreement. The agreement also included a £ 1bn contribution from the banks to the setting up of a £ 2.5bn Business Growth Fund for highly innovative SMEs with growth potential: investments of £ 2-10m per business will be made in return for an equity stake and a seat on the board.

In the longer term, the UK Banking Commission is compiling a report for the government on the future of the UK banking sector. The final report is due in September. One of the issues it will consider is the need to give businesses appropriate access to credit. It will consider a broad range of remedies, including splitting investment banking from retail banking. If the measures implemented as a result of the Banking Commission's report are successful in increasing competition within the banking sector, this could deliver a real improvement in credit availability. A lack of competition has also been identified as an issue in the retail banking sector.

Although the UK government has recognised and begun to tackle the issue of SME access to finance, the interventions are mainly short-term in nature with so far little evidence of progress in improving the effectiveness of the credit provision system in such a way that it can function well in the long-term without the need for regular government intervention. Possible avenues to delivering a more sustainable solution could include increasing competition in the banking sector and improving access to non-bank financing. Greater competition in the banking sector could help broaden the options of SME borrowers. Enhanced competition is one of the objectives being considered by the Banking Commission.

Improving firms' access to non-bank financing could help reduce the economy's exposure to changes in the banks' risk appetites. Possible avenues for exploration could include seeking to improve the availability of risk and venture capital, and making it easier for large and medium-sized firms to access public debt markets. An additional barrier to overcome in this area could be the reluctance, indicated by survey data, of SMEs to seek out non-bank financing.

The UK has also announced a series of planned cuts to the main rate of corporation tax which would reduce it from 28% to 23% by 2014-15. This should improve incentives to firms to invest by allowing them keep a larger share of profits.

Regarding export promotion, the government published a paper in February 2011, setting out its plans. The two key initiatives are an increase in the range and quantity of trade finance provided by the government and an increase in the focus of UK Trade and Investment (the government's trade promotion body) on emerging markets. These initiatives should provide necessary help to exporters.

Research and innovation

In a context where most UK Government Departments are facing significant expenditure cuts, the UK Government has announced a Settlement for Science and Research programme of £4.6n per year for the next four years (2011-2015). This is ring fenced across the four year period. However, where the budget has been held constant in nominal terms, science investment had been reduced in relative terms. Moreover, some departmental R&I spending had been reduced sharply (e.g. defence) and the innovation spending budget will also be reduced. As part of an overall decision regarding Europe 2020 targets, the UK has not set at this stage a national target for R&I intensity. Nevertheless, the UK overall policy framework is coherent and comprehensive. The UK has a multiannual strategy for enhancing the supply of R&I in its Science and Innovation Investment Framework (SIIF) 2004-2014 and a new Innovation Strategy is expected in 2011. The long-term reform measures are well complemented with short-term priorities, such as supporting higher investment levels and implementing R&I tax credits. The UK announced that it will target its support for business towards areas with high impact on growth and leverage additional private sector investment.[18]

Climate change and energy policies

The recent evolution of the greenhouse gas emissions does not appear in contradiction with the 2020 national target defined at the European level (-16% compared to 2005 levels) but as the economic crisis tends to have reduced emissions, caution is needed, especially in the road transportation sector given its weight in the national emissions and its current trend[19].

The government is presently preparing the roll-out of the "Green Deal", a finance mechanism which allows consumers to pay back the cost of energy efficiency improvements through their energy bills. It is designed to enable private firms to offer consumers energy efficiency improvements to their homes, community spaces and businesses at no upfront cost, and recoup payments through a charge in instalments on the energy bill. The programme should be monitored on regular basis and the funding realigned if necessary.

Under Directive 2009/28/EC on the promotion of the use of energy from renewable sources, the UK has committed to reach a target of 15% of renewable energy sources in final energy consumption and a 10% share of renewable energy in the transport sector by 2020. In 2010

[18] The Technology Strategy Board will become the Government’s prime channel to support business-led technology innovation and will be provided with additional funding of over £ 200m to establish a network of elite Technology and Innovation Centres.

[19] This assessment does not account for the announcements made on 17 May 2011 which contain proposals to cut the UK's emissions by 50% from 1990 levels by 2025.

the UK submitted its National Renewable Energy Action Plan which outlines the current and future measures to be used to follow the trajectory for developing renewable energy sources established in the Directive and sets sectoral targets. A step to implement this plan and complete the transposition of the Directive would be to clarify the support regime to be applied in both the heating and the electricity sectors which, together with the Electricity Market Reform, should ensure the creation of a stable regulatory environment that promotes the development of new markets in green goods and services. The UK may need further connections with both UCTE and NORDEL areas in mainland Europe, in order to allow increased transmission of renewable energy, mainly from the off-shore wind parks, in the North Sea Grid Project.

5. SUMMARY

The financial crisis created formidable challenges for the UK economy. The NRP and CP set out an ambitious programme of reform to address them. The planned fiscal consolidation will, if implemented as planned, deliver large improvements in the structural balance which would be sufficient, according to the official forecast in the CP, to reduce the UK's deficit below 3% of GDP before the EDP deadline of 2014/15. In the financial sector, the design of the new oversight framework clearly reflects lessons learned in the crisis and should represent a significant additional safeguard to stability. On credit availability, while the suite of interventions in the NRP should at least alleviate the problem in the short term, there is room for further progress in delivering a market framework which ensures good access to credit, ultimately also for SMEs without the need for regular government intervention. The housing market has been a longstanding source of problems in the UK. While a broad range of reforms is in train in this area some outcomes, particularly the volume of new house building, are subject to major uncertainty. There is also a lack of evidence of a strategy cutting across both the demand and supply sides of the UK's housing issues.

Another issue where further work appears to be warranted is on skills and the connected issue of unemployment, particularly among young people. In this area, the government has again set out a programme of reform, but some commitments lack specificity and efforts are insufficient in certain problem areas. The increase in unemployment since the crisis (especially youth unemployment), the upcoming public sector job cuts and the UK's longer-running problems with medium-level skills, persistent high rates of early school leaving, jobless households and the lack of affordable and flexible child care provision combine to make this an area where further progress is both necessary and potentially highly beneficial to the UK economy.

Table I. Macro economic indicators

	1995-1999	2000-2004	2005-2008	2009	2010	2011	2012
Core indicators							
GDP growth rate	3,3	2,8	1,9	-4,9	1,3	1,7	2,1
Output gap 1	0,7	1,9	1,8	-5,2	-5,2	-4,8	-4,1
HICP (annual % change)	2,0	1,2	2,6	2,2	3,3	4,1	2,4
Domestic demand (annual % change) 2	3,8	3,3	1,7	-5,5	2,4	0,4	0,7
Unemployment rate (% of labour force) 3	7,0	5,0	5,3	7,6	7,8	8,0	7,8
Gross fixed capital formation (% of GDP)	17,0	16,8	17,1	14,6	14,6	14,2	14,3
Gross national saving (% of GDP)	16,6	15,2	14,8	11,7	12,1	13,0	14,2
General Government (% of GDP)							
Net lending (+) or net borrowing (-)	**-2,3**	**-1,0**	**-3,5**	**-11,4**	**-10,4**	**-8,6**	**-7,0**
Gross debt	**48,5**	**39,2**	**46,2**	**69,6**	**80,0**	**84,2**	**87,9**
Net financial assets	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Total revenue	38,7	39,6	41,5	40,2	40,6	41,2	41,6
Total expenditure	41,0	40,6	44,9	51,6	51,0	49,8	48,6
of which: Interest	3,4	2,2	2,2	2,0	3,0	3,1	3,4
Corporations (% of GDP)							
Net lending (+) or net borrowing (-)	**-0,8**	**0,2**	**3,9**	**7,9**	**6,7**	**5,9**	**4,8**
Net financial assets; non-financial corporations	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Gross capital formation	12,0	11,0	10,4	7,4	8,9	9,0	9,4
Gross operating surplus	22,9	20,7	22,2	22,3	21,0	24,6	24,6
Households and NPISH (% of GDP)							
Net lending (+) or net borrowing (-)	**2,2**	**-1,1**	**-2,9**	**1,4**	**1,0**	**1,6**	**2,3**
Net financial assets	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	45,7	46,9	45,1	46,5	45,3	45,0	45,0
Net property income	10,8	8,8	8,0	8,4	7,8	7,7	7,6
Current transfers received	22,6	21,2	21,1	24,1	24,1	23,9	23,8
Gross saving	5,9	3,4	2,0	4,2	3,7	4,2	4,9
Rest of the world (% of GDP)							
Net lending (+) or net borrowing (-)	**-0,9**	**-1,9**	**-2,4**	**-1,5**	**-2,3**	**-1,0**	**0,1**
Net financial assets	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-0,3	-2,4	-3,1	-2,1	-3,3	-2,4	-0,2
Net primary income from the rest of the world	-0,2	0,9	1,3	1,4	2,0	2,7	1,7
Net capital transactions	0,1	0,1	0,2	0,2	0,2	0,2	0,2
Tradable sector	42,8	38,2	34,7	33,0	33,0	n.a	n.a
Non tradable sector	46,3	50,7	54,5	57,1	56,2	n.a	n.a
of which: Building and construction sector	4,5	5,1	5,7	5,6	5,5	n.a	n.a
Real effective exchange rate (index, 2000=100)	86,9	100,0	101,7	84,4	87,2	87,0	87,7
Terms of trade goods and services (index, 2000=100)	98,0	102,0	101,8	101,7	101,3	100,5	101,9
Market performance of exports (index, 2000=100)	111,4	100,1	96,8	96,3	92,2	95,0	96,1

Notes:

1 The output gap constitutes the gap between the actual and potential gross domestic product at 2000 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:

Commission services' spring 2011 forecast

Table II. Macro economic scenario for the budgetary projections

	2010		2011		2012		2013	2014	2015
	COM	CP	COM	CP	COM	CP	CP	CP	CP
Real GDP (% change)	1.3	1.3	1.7	1.7	2.1	2.5	2.9	2.9	2.8
Private consumption (% change)	0.5	0.8	0.3	0.6	0.8	1.3	1.8	2.1	2.2
Gross fixed capital formation (% change)	3.0	3.1	0.1	2.3	4.0	6.0	8.8	8.7	7.0
Exports of goods and services (% change)	5.3	5.8	8.9	7.9	7.5	6.5	6.2	5.7	5.6
Imports of goods and services (% change)	8.5	8.5	4.0	5.0	2.5	2.9	3.8	3.8	4.1
Contributions to real GDP growth:									
- Final domestic demand	1.1	1.2	0.4	0.9	0.9	1.5	2.2	2.3	2.3
- Change in inventories	1.4	1.3	0.0	0.2	-0.1	0.0	0.0	0.0	0.0
- Net exports	-1.1	-0.9	1.2	0.7	1.4	1.0	0.7	0.6	0.5
Output gap[1]	-5.2	-5.2	-4.8	-4.7	-4.1	-3.5	-1.9	-0.7	0.3
Employment (% change)	0.2	0.0	0.4	0.0	0.5	0.7	1.0	0.7	1.0
Unemployment rate (%)	7.8	7.9	8.0	8.2	7.8	8.1	7.6	7.0	6.4
Labour productivity (% change)	1.0	1.1	1.3	1.8	1.6	1.9	1.9	2.0	n.a.
HICP inflation (%)	3.3	3.3	4.1	4.2	2.4	2.5	2.0	2.0	2.0
GDP deflator (% change)	2.9	3.0	1.9	3.0	2.1	2.4	2.7	2.7	2.7
Comp. of employees (per head, % change)	3.2	2.6	2.8	1.4	4.0	2.4	3.8	4.3	4.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.3	-2.2	-1.0	-2.6	0.1	-2.0	-1.5	-1.1	n.a.

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

Commission services' spring 2011 forecasts (COM); Convergence programme (CP).

Table III. Budgetary adjustment

(% of GDP)	2010-11	2011-12		2012-13		2013-14	2014-15	2015-16	Change: 2011-12 2015-16
	COM	COM	CP	COM[1]	CP	CP	CP	CP	CP
Revenue[2]	**40.7**	**41.1**	**37.4**	**41.6**	**37.4**	**37.7**	**n.a.**	**n.a.**	**n.a.**
of which:									
- Taxes on production and imports	13.0	13.4	13.6	13.3	13.6	13.7	n.a.	n.a.	n.a.
- Current taxes on income, wealth, etc.	15.7	15.9	13.4	16.3	13.3	13.6	n.a.	n.a.	n.a.
- Social contributions	8.5	8.5	6.5	8.5	6.5	6.5	n.a.	n.a.	n.a.
- Other (residual)	3.5	3.5	3.9	3.4	4.0	4.0	n.a.	n.a.	n.a.
Expenditure	**50.2**	**49.3**	**45.4**	**48.1**	**43.8**	**42.0**	**n.a.**	**n.a.**	**n.a.**
of which:									
- Primary expenditure	47.3	46.2	42.3	44.6	40.6	38.6	n.a.	n.a.	n.a.
of which:									
Compensation of employees and intermediate consumption	24.6	24.3	22.7	23.3	21.8	20.9	n.a.	n.a.	n.a.
Social payments	15.2	15.0	13.2	14.8	12.9	12.3	n.a.	n.a.	n.a.
Subsidies	0.6	0.6	0.7	0.5	0.7	0.6	n.a.	n.a.	n.a.
Gross fixed capital formation	2.4	2.1	2.1	1.9	1.8	1.6	n.a.	n.a.	n.a.
Other (residual)	4.5	4.2	3.6	4.1	3.4	3.2	n.a.	n.a.	n.a.
- Interest expenditure	3.0	3.1	3.2	3.5	3.2	3.3	n.a.	n.a.	n.a.
General government balance (GGB)	**-9.5**	**-8.1**	**-8.0**	**-6.5**	**-6.3**	**-4.2**	**-2.7**	**-1.7**	**6.3**
Primary balance	**-6.6**	**-5.0**	**-4.8**	**-3.0**	**-3.2**	**-0.9**	**0.8**	**1.8**	**6.6**
One-off and other temporary measures	0.0	0.0	n.a.	0.0	n.a.	n.a.	n.a.	n.a.	n.a.
GGB excl. one-offs	**-9.5**	**-8.1**	**n.a.**	**-6.5**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
Output gap[3]	-5.1	-4.6	-4.4	-3.9	-3.1	-1.6	-0.5	0.5	4.9
Cyclically-adjusted balance[3]	-7.4	-6.2	-6.1	-4.9	-5.0	-3.5	-2.5	-1.9	4.2
Structural balance[4]	**-7.4**	**-6.2**	**-6.1**	**-4.9**	**-5.0**	**-3.5**	**-2.5**	**-1.9**	**4.2**
Change in structural balance		*1.2*	*1.3*	*1.3*	*1.1*	*1.5*	*1.0*	*0.6*	
Structural primary balance[4]	-4.4	-3.1	-2.9	-1.4	-1.8	-0.2	n.a.	n.a.	n.a.
Change in structural primary balance		*1.3*	*1.5*	*1.7*	*1.1*	*1.6*	*n.a.*	*n.a.*	

Notes:

[1]On a no-policy-change basis.

[2]Revenue data are adjusted for the treatment of UMTS receipts.

[3]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

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

Source :

Convergence programme (CP); Commission services' spring 2011 forecasts (COM); Commission services' calculations

Table IV. Debt dynamics

(% of GDP)	average 2005-06-09-10	2010 2010-11	2011 2011-12 COM	2011 2011-12 CP	2012 2012-13 COM	2012 2012-13 CP	2013 2013-14 CP	2014 2014-15 CP	2015 2015-16 CP
Gross debt ratio[1]	**51.1**	**78.2**	**84.4**	**78.7**	**87.7**	**84.1**	**87.0**	**87.2**	**85.7**
Change in the ratio	6.2	7.0	6.2	5.4	3.4	2.9	0.2	-1.5	-2.2
Contributions[2] *:*									
1. Primary balance	**3.2**	**6.6**	**5.0**	**4.8**	**3.0**	**3.2**	**0.9**	**-0.8**	**-1.8**
2. "Snow-ball" effect	**1.0**	**0.1**	**0.3**	**-0.4**	**0.0**	**-1.0**	**-1.3**	**-1.1**	**-1.0**
Of which:									
Interest expenditure	2.1	3.0	3.1	3.2	3.5	3.1	3.3	3.5	3.5
Growth effect	0.0	-1.2	-1.2	-1.4	-1.8	-2.2	-2.4	-2.4	-2.3
Inflation effect	-1.1	-1.7	-1.6	-2.2	-1.7	-1.9	-2.2	-2.2	-2.2
3. Stock-flow adjustment	**2.0**	**0.4**	**0.9**	**1.0**	**0.4**	**0.8**	**0.7**	**0.5**	**0.6**
Of which:									
Cash/accruals diff.	0.2	-0.1							
Acc. financial assets	1.8	2.5							
Privatisation	-0.1	0.0							
Val. effect & residual	-0.1	0.4							

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 :
Convergence programme (CP); Commission services' spring 2011 forecasts (COM); Commission services' calculations.

Table V. Long-term sustainability indicators

United-Kingdom	Baseline scenario (2010)			Programme scenario		
	S1		S2	S1		S2
Value	8.6		9.6	1.7		2.9
of which:						
Initial budgetary position (IBP)	5.8		6.1	-0.8		-0.6
Debt requirement in 2060 (DR)	0.7		-	0.4		-
Long-term change in the primary balance (LTC)	2.1		3.5	2.1		3.5
	2010	2015	2020	2010	2015	2020
Debt as % of GDP	78.7	99.3	127.9	78.7	83.5	80.8

Note: The 'baseline' scenario (2010) depicts the sustainability gap under the assumption that the 2010 budgetary position remains unchanged over the medium-term (until the end of the period covered by the programme). The 'programme' scenario depicts the sustainability gap under the assumption that the budgetary plans of the programme are fully implemented.

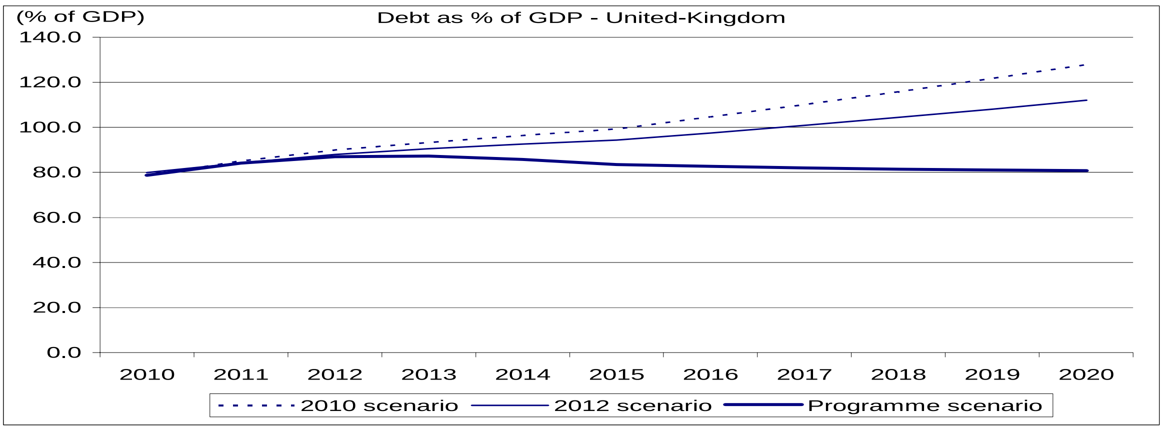


Figure: Medium-term debt projection

Source: Commission Services, Spring 2011 forecast and SCPs

Table VI. Financial market indicators

	2006	2007	2008	2009	2010
Total assets of the banking sector (% of GDP)	483.1	519.8	541.2	575.5	566.2
Share of assets of the five largest banks (% of total assets)	35.9	40.7	36.5	40.8	…
Foreign ownership of banking system (% of total assets)	71.3	54.5	51.1	51.5	…
Financial soundness indicators:					
- non-performing loans (% of total loans)	0.9	0.9	1.6	3.5	4.0
- capital adequacy ratio (%) [1]	12.9	12.6	12.9	14.8	15.9
- profitability - return on equity (%) [2]	8.9	6.2	-10.3	2.6	3.9
Private credit growth (annual % change)	10.9	14.5	-2.6	-9.2	7.2
Residential property prices (y-o-y % change) [3]	12.2	10.4	3.3	1.6	7.8
Exposure to countries receiving/repaying official financial assistance (% of GDP)[4]	6.6	8.0	9.4	9.8	8.4
Private debt (% of GDP)	152.6	156.4	150.4	213.7	198.7
Gross external debt (% of GDP)					
- Public	11.2	11.4	13.7	17.3	…
- Private	140.5	122.6	117.4	132.0	…
Long term interest rates spread versus Bund (basis points)*	61.2	84.3	51.7	13.7	62.1
Credit default swap spreads for sovereign securities (5-year)*	…	…	48.0	84.8	72.8

Notes:

[1] The capital adequacy ratio is defined as total capital devided by risk weigthed assets.

[2] Net income to equity ratio. After extraordinary items and taxes.

[3] Latest available in 2010. Data will be updated in end April or beginning of May.

[4] Covered countries are IE, EL, PT, RO, LV and HU.

* Measured in basis points.

Source :

Bank for International Settlements and Eurostat (exposure to macro-financially vulnerable countries), IMF (financial soundness indicators), Commission services (long-term interest rates), World Bank (gross external debt), Eurostat (residential property prices) and ECB (all other indicators).

Table VII. Labour market and social indicators

Labour market indicators	2005	2006	2007	2008	2009	2010
Employment rate (% of population aged 20 - 64)	75.2	75.2	75.2	75.2	73.9	73.6
Employment growth (% change from previous year)	1.3	1.1	0.7	0.3	-1.7	-0.7
Employment rate of women (% of female population aged 20 - 64)	68.5	68.6	68.4	68.8	68.2	67.9
Employment rate of men (% of male population aged 20 - 64)	82.0	82.0	82.2	81.8	79.6	79.3
Employment rate of older workers (% of population aged 55 - 64)	56.8	57.3	57.4	58.0	57.5	57.1
Part-time employment (% of total employment)	25.2	25.3	25.2	25.3	26.1	26.9
Fixed term employment (% of employees with a fixed term contract)	5.8	5.8	5.9	5.4	5.7	6.1
Unemployment rate[1] (% of labour force)	4.8	5.4	5.3	5.6	7.6	7.8
Long-term unemployment[2] (% of labour force)	1.0	1.2	1.3	1.4	1.9	2.5
Youth unemployment rate (% of youth labour force aged 15-24)	12.8	14.0	14.3	15.0	19.1	19.6
Youth NEET[3] rate (% of population aged 15-24)	8.4	8.5	11.9	12.1	13.3	:
Early leavers from education and training (% of pop. 18-24 with at most lower sec. educ. and not in further education or training)	11.6	11.3	16.6	17.0	15.7	:
Tertiary educational attainment (% of population 30-34 having successfully completed tertiary education)	34.6	36.5	38.5	39.7	41.5	:
Labour productivity per person employed (annual % change)	1.1	1.9	2.0	-0.8	-3.4	1.0
Hours worked per person employed (annual % change)	0.2	-0.3	0.1	-1.3	-0.4	-0.6
Labour productivity per hour worked (annual % change; constant prices)	0.9	2.2	1.9	0.5	-3.0	1.6
Compensation per employee (annual % change; constant prices)	1.2	1.8	2.0	-1.5	1.1	0.3
Nominal unit labour cost growth (annual % change)	2.5	2.6	3.0	2.3	6.1	2.1
Real unit labour cost growth (annual % change)	0.4	-0.4	0.0	-0.7	4.6	-0.8

Notes:

[1] According to ILO definition, age group 15-74)

[2] Share of persons in the labour force who have been unemployed for at least 12 months.

[3] NEET are persons that are neither in employment nor in any education or training.

Sources:

Comission services (EU Labour Force Survey and European National Accounts)

Table VII. Labour market and social indicators – continued

Expenditure on social protection benefits (% of GDP)	2004	2005	2006	2007	2008
Sickness/Health care	7.74	7.96	8.02	7.65	7.57
Invalidity	2.35	2.30	2.42	2.47	2.51
Old age and survivors	11.31	11.61	11.34	8.71	9.02
Family/Children	1.70	1.60	1.51	1.60	1.67
Unemployment	0.67	0.68	0.63	0.51	0.58
Housing and Social exclusion n.e.c.	1.62	1.63	1.62	1.37	1.39
Total	25.4	25.8	25.5	22.3	22.7
of which: Means tested benefits	4.11	3.99	3.94	3.59	3.63
Social inclusion indicators	**2005**	**2006**	**2007**	**2008**	**2009**
Risk-of-poverty or exclusion[1] (% of total population)	24.8	23.7	22.8	23.2	22.0
Risk-of-poverty or exclusion of children (% of people aged 0-17)	31.2	30.1	27.8	29.6	27.4
Risk-of-poverty or exclusion of elderly (% of people aged 65+)	25.9	27.4	28.8	28.5	23.1
At-Risk-of-Poverty rate[2] (% of total population)	19.0	19.0	18.9	18.7	17.3
Value of relative poverty threshold (single HH per year) - in PPS	10140	10584	11196	11124	10248
Severe Material Deprivation[3] (% of total population)	5.3	4.5	4.2	4.5	3.3
Share of people living in low work intensity households[4] (% of people aged 0-59 not student)	12.8	12.0	10.5	10.4	12.6
In-work at-risk-of poverty rate (% of persons employed)	8.1	7.7	7.9	8.0	6.4

Notes:

[1] People at-risk-of poverty or social exclusion (AROPE): individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

[2] At-risk-of poverty rate: share of people with an equivalised disposable income below 60% of the national equivalised median income.

[3] Share of people who experience at least 4 out of 9 deprivations: people cannot afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish, or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour tv, or ix) have a telephone

[4] People living in households with very low work intensity: Share of people aged 0-59 living in households where the adults work less than 20% of their total work-time potential during the previous 12 months.

Sources:

For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table VIII. Product market performance and policy indicators

Performance indicators	2001-2005	2006	2007	2008	2009	2010
Labour productivity[1] total economy (annual growth in %)	**1.5**	**2.0**	**2.1**	**-0.8**	**-3.2**	**1.2**
Labour productivity[1] in manufacturing (annual growth in %)	**4.4**	**4.4**	**2.5**	**1.9**	**-4.5**	n.a.
Labour productivity[1] in electricity, gas, water (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity[1] in the construction sector (annual growth in %) 5	**0.3**	**-0.5**	**0.6**	**-0.1**	**-3.9**	n.a.
Patent intensity in manufacturing[2] (patents of the EPO divided by gross value added of the sector)	**2.6**	**3.1**	**2.9**	n.a.	n.a.	n.a.
Policy indicators	**2.6**	**3.1**	**2.9**	**3.887**	**4.887**	**2010**
Enforcing contracts[3] (days)	**2.6**	**3.1**	**2.9**	**404**	**399**	**399**
Time to start a business[3] (days)	**2.6**	**3.1**	**2.9**	**13**	**13**	**13**
R&D expenditure (% of GDP)	**1.7**	**1.8**	**1.8**	**1.8**	**1.9**	n.a.
Tertiary educational attainment (% of 30-34 years old population)	**2.6**	**3.1**	**2.9**	**39.7**	**41.5**	n.a.
Total public expenditure on education (% of GDP)	**5.1**	**5.5**	**5.4**	n.a.	n.a.	n.a.
	2.6	**3.1**	**2.9**	**2008**	**2009**	**2010**
Product market regulation[4], Overall (Index; 0=not regulated; 6=most regulated)	**2.6**	**3.1**	**2.9**	**0.8**	n.a.	n.a.
Product market regulation[4], Retail (Index; 0=not regulated; 6=most regulated)	**2.6**	**3.1**	**2.9**	**2.0**	n.a.	n.a.
Product market regulation[4], Network Industries6 (Index; 0=not regulated; 6=most regulated)	**2.6**	**3.1**	**2.9**	**0.9***	n.a.	n.a.

Notes:

[1]Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.

[2]Patent data refer to applications designated to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.

[3] The methodologies, including the assumptions, of this indicator is presented in detail at the website http://www.doingbusiness.org/methodology.

[4] The methodologies of the Product market regulation indicators are presented in detail at the website http://www.oecd.org/document/1/0,3746,en_2649_34323_2367297_1_1_1_1,00.html. The latest available product market regulation indicators refer to 2003 and 2008, except for Network Industries.

[5]Nace Revision 2 definition.

6 Aggregate ETCR.

*figure for 2007.

Source :

Commission services, World Bank Doing Business (for enforcing contracts and time to start a business) and OECD (for the product market regulation indicators).