

## Appendix

### The economic policy strategy

Lately the economic progress has been stronger than formerly expected. On one side this has led to a faster increase in employment and an increase in general government budget surplus. On the other side both capacity and the balance of payments has been placed under pressure.

Therefore the Government has implemented – and announced – a string of initiatives to keep the economy on track and assuring that also the long-term targets for the Danish economy can be realised. The following *initiatives* are elaborated below:

1. The autumn 1997 adjustments of the economic policy.
2. The "Whitsun-package" (strengthening of private sector savings a.o.).
3. Agreements with local authorities (dampening of public expenditure a.o.).
4. The 1999 Budget proposal (general government retrenchments, reduction of company taxes a.o.).
5. Labour market reforms.

The latest turbulence in the financial markets and the pressure on the labour market creates the need to implement the planned tightening of the economic policy. In the current situation the Government will be prepared to adjust the economic policy if it is required by the economic development.

*The fixed exchange rate policy* is a central element in the macro economic policy. The main monetary policy task is to ensure a stable exchange rate. The monetary policy authorities have during periods of pressure against the Krone demonstrated a strong will to protect the exchange rate through interventions and interest rate increases

The fixed exchange rate policy has been determined in proportion to the other core countries in the EMS. As of 1999 the fixed exchange rate policy will be orientated towards the euro as a part of the ERM2 agreement. Due to the high degree of convergence in Danish economy, an agreement was reached at the informal ECOFIN meeting on 26 September 1998, establishing Denmark's participation in the ERM2 and the  $\pm 2.25$  per cent fluctuation band.

Despite the relatively high rate of growth the fixed exchange rate policy in

connection with the structural improvements of the labour market have kept the increase in consumer prices down to approximately 2 per cent. The continuation of the economic policy strategy is crucial to ensuring that future inflation is kept in line with the Danish inflationary target of approximately 2 per cent. During the past years the growth in domestic demand has been stronger than abroad and thus has caused a decline in the balance of payments surplus.

Since June of 1996 Danish economy has fulfilled all of the convergence criteria<sup>1</sup>. In 1997 once more a *general government budget* surplus was attained, and the surplus is expected to grow to 2½ per cent of GDP in 1999. This is an improvement of the general government budget balance equivalent to 5¼ per cent of GDP during the period 1994-1999. The general government gross public debt constituted approximately 64 per cent in 1997 and is expected to fall to approximately 59 per cent. In 1999 a further reduction to 56 per cent is expected.

It is a part of the Governments medium-term economic policy strategy to reduce the general government budget surplus to approximately 3¼ per cent in 2005 and to reduce debt to approximately 40 per cent of GDP<sup>2</sup>. This will be ensured through, among other things, a very dampened development in general government expenditure and a strengthening of the labour market policy with the aim of transferring more people from public support to employment.

A significant raise in the *labour force* is necessary in the years to come, if the targets for unemployment, employment, general government budget etc. are to be reached by the year 2005. The main task is to ensure the implementation of the necessary changes in the labour market policy, so that an adequate amount of qualified labour is available to help reach the established targets for growth and reduction of debt.

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1) Based on the reduction of the general government deficit and the marked fall in the gross debt ratio the ECOFIN council decided, that Denmark no longer had an excessive general government budget deficit

2) The objectives for the general government budget balance have been based on the new ENS95 standard, while the figures mentioned above have been based on the ENS79 standard which is more comparable. Calculated according to the ENS95 standard the general government budget surplus reached 0.2 per cent of GDP and the (EMU) gross debt constituted 60.8 per cent of GDP in 1997.

# **I. Economic policy initiatives**

## **1. Adjustments of the economic policy**

Aiming to achieve a moderate dampening of the economic growth, a row of initiatives to strengthen both private and public sector savings were adopted in the autumn of 1997. Here the primary element was the implementation of a temporary *pension savings payment* to the amount of 1 per cent of salary a.o. Moreover a row of public retrenchments were adopted along with a temporary increase of the stamp duty on supplementary property loans (intended to among other things reduce the loan-financed consumption and dampen activity in the construction sector). As a whole the package lead to a dampening of the 1998 growth of approximately ½ per cent of GDP. To ensure greater professional and geographic mobility and generally strengthen the flexibility of the labour market a string of labour market improvements were also implemented.

## **2. The Whitsun-package**

Important structural improvements of the tax system were adopted in the “Whitsun-package” in June 1998. At the same time these actions exert a dampening effect on demand and thereby counteract the risk of an overheating.

The tax adjustments of the “Whitsun-package” continue the line of the tax reforms of 1987 and 1993. The tax reform of 1993 will be fully implemented in 1998, and will be followed by the gradual implementation of the tax elements of the “Whitsun-package” during the years 1999-2002. It is expected that the announced reforms for the following years will dampen the real estate market and stimulate private sector savings. It is also expected, that these effects will be seen from the adoption of the reforms in the summer of 1998.

As a part of the “Whitsun-package” the temporary pension payment, which was introduced in the autumn of 1997, will be made permanent. In addition the “Whitsun-package” also contains the following elements:

*Work will be made more attractive* compared to passive support. This is attained by raising the income level at which the middle tax rate is applied. The tax value of interest deductions is gradually reduced from 40.4/46.4 per cent in 1998 to 32.4 per cent in 2002 (in an average municipality and assuming that municipal taxes remain unaltered). This makes it more expensive to finance consumption by loans etc. and thereby *strengthens the propensity to save* and the balance of payments. This change also means that

**Table B.1 Marginal income taxes (including labour market contribution).**

Per cent	1998	1999	2000	2001	2002
<b>Income (Dkr.):</b>					
34,130 - 151,087	45.2	45.3	44.9	44.2	43.5
151,088 - 185,870 <sup>1)</sup>	50.7	45.3	44.9	44.2	43.5
185,871 - 273,043	50.7	50.8	50.3	49.6	48.9
more than 273,043	62.0	63.3	63.3	63.3	62.6

Note: On average. Local - and therefore total income taxation - varies across regions. Income before payment of labour market contributions.

1) The basic allow. for coll. income tax, mean limit is increased during a period of four years.

the tax value of deductions is adjusted to that of other countries.

Furthermore the tax value of the *assessment deductions* is reduced (covering expenses related to union memberships, unemployment insurance, transportation a.o.)

In the *pension area* a 5 per cent tax on stock returns is implemented and bond revenue a.o will be subject to a fixed nominal tax of 26 per cent instead of the former tax based on real returns.

The basis of calculation for taxation on property will be changed and the effective value of *property taxes* increases slightly for future owners.

Several green taxes on for example oil, natural gas, coal, electricity and fuel are raised and the tax on low-sulphur diesel fuel is lowered. These initiatives will *reduce the strain on the environment* and contributes to the reaching the set environment targets.

By the “Whitsun-package” the Governments acts in accordance with the strategy presented in the former convergence programme, in which the tax system will be gradually changed to allow a decrease in income taxes. The tax reductions are primarily aimed at the lowest incomes. As seen in tableB.1, the higher incomes will experience a slight increase in marginal taxes<sup>3)</sup>, while the lower income groups will see a reduction of the marginal tax during the next years. By the year 2002 the largest reduction is reached for incomes between approximately DKK 151,000 and DKK 186,000, where the marginal tax will be 7 points lower than in 1998. This income level is above the maximum unemployment benefit level and therefore the tax adjustments increases the economic incentive to work.

The initiatives contained in the “Whitsun-package” alone contribute to a

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<sup>3)</sup> In municipalities with relatively low municipal taxes the marginal tax will be reduced also for the highest incomes.

**Table B.2 Fiscal effect etc.**

Per cent of GDP	1995	1996	1997	1998	1999
Expenditures . . . . .	0,3	0,9	0,4	0,3	0,2
Revenues . . . . .	-0,3	-0,3	-0,5	-0,4	-0,1
Fiscal effect . . . . .	0,0	0,6	-0,1	-0,1	0,1
Other items . . . . .	-	-	-0,0	-0,3	-0,6
Fiscal effekt etc. . . . .	0,0	0,6	-0,1	-0,4	-0,5

Source: Ministry of Finance (1998): “*Budgetoversigt 2, oktober 1998*”.

reduction of GDP by approximately 1 per cent in 1999. This counteracts the expansive effect caused primarily by the fall in interest rates and by the municipal budget excesses. Part of the effect on activity is caused by the effects on the propensity to save and is not included in the traditional budget effect.

### 3. Agreements with local authorities

In June 1998 the Government reached agreements with the local authorities about the municipal economy for the next four years and not as previously for only one year. The association of local authorities has joined in the Government target of keeping the annual real growth in the municipal service costs to less than 1 per cent. This leads to a significantly lower growth in municipal costs following an excessive increase over the past years.

The agreement with the counties only pertains to 1999. In both agreements with local authorities it is underlined, that the tighter cost control will place great demands on operations efficiency and on the ability to establish an order of priorities. There will be a special need to prioritise childcare, public schools and hospitals in the years to come.

In the agreements is recommended, that the local authorities do not raise the tax rates in 1999. The Government has underlined the desire to avoid further municipal tax raises by introducing a *State premium* of 25 per cent of the tax yield loss to local authorities lowering the tax rates.

Furthermore the *budget collaboration* between Government and the local authorities will be strengthened. In the future the parties will meet several times each year to continuously survey and ensure that cost development

and service ameliorations are kept at the desired level.

#### **4. The Budget Proposal**

In August the Government submitted the 1999 Budget Proposal. To realise the target of real unchanged operating costs, general government budget improvements of almost DKK 5 billion are proposed (equivalent of approximately 0.4 per cent of GDP). It is assumed that more than 1/3 of the general government cost reductions will be implemented in the area of transfer payments, as a part of the initiatives towards a strengthened effort on the labour market, as described below.

The *fiscal policy* was moderately tightened in 1997 and 1998 while a slightly expansive action is expected, see table B.2. The expansive effect will be more than counteracted by the dampening of the activity stemming from the elements to promote savings in the “Whitsun-package” and the effect on GDP stemming from the limitations induced on publicly subsidised construction and urban renewal. The collective effect on activity from the economic policy thus shows a tightening of approximately ½ per cent of GDP in both 1998 and 1999. It is estimated that, this will constitute a suitable degree of tightening to counteract the pressure on the labour market and to reach the targets of continued improvements of the general government budget balance, balance of payments a.o.

The “Whitsun-package” establish the major guidelines in the personal taxation for the years to come. There is, though, a continued need to reduce company taxes to ensure the competitiveness vis-à-vis especially the Nordic countries. In the Budget Proposal the Government therefore suggests that company tax be reduced from 32 to 34 per cent beginning in 1999. The Government recommends a further reduction to 30 per cent beginning in the year 2000, providing that the financing of this reduction can be found.

The development aid is kept at 1 per cent of national income, and on top of this comes the Danish aid to improvement of the global environment and prevention and relief of disasters totalling 0.3 per cent of national income.

#### **5. Labour market reforms**

The past years have seen a marked drop in unemployment from 12 per cent of the work force in 1994 to 6½ per cent today. Calculated by EU guidelines

unemployment today only amounts to 5 per cent of the work force.

So far it has been possible to maintain relatively moderate wage increases despite the large drop in unemployment. But especially for the building and construction sectors, wage increases have started to accelerate as a result of the high degree of capacity utilisation stemming from the strong economic upturn. Therefore the Government has dampened activity through economic tightenings, to ensure that the labour market can keep up and supply the necessary labour.

## **Boks B.1 Main elements in the labour market reform**

- The right and duty to activation is advanced. Activation of all unemployed people aged 25-59 within an unemployment period of 1 year. (To be implemented during a period of 2 years).
- The right and duty to activation for all *young* people is advanced. Activation of young people within an unemployment period of ½ year (ie. also young people with a qualifying education).
- The *unemployment benefit period* will be reduced from 5 to 4 years (to be implemented during a period of 2 years).
- The *50-54 year-old* will be subject to the same rules concerning the length of the unemployment benefit period.
- The target group for a *flexible effort* (the effort concerning persons subject to a higher risk of long term unemployment) is pointed out on more individual criteria, and the contact between the Public Employment Service (Arbejdsformidlingen) and the unemployed person is improved.
- The effort towards the weaker unemployed is improved. Integration of ethnic minorities in the labour market is improved.
- The efforts concerning *education* for the unemployed is more directed toward the needs of the labour market.
- The administration of *availability rules* has to be more efficient. The availability for reasonable work is advanced from 6 to 3 months.
- The calculation of unemployment benefits is brought up to date and simplified.

Furthermore initiatives will be implemented to ensure the desired long-term increase in labour supply<sup>4</sup>. A significant increase in the work force is needed, if the target for private employment etc. is to be met in the year 2005.

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<sup>4)</sup> A further description of the initiatives taken concerning the Danish labour market, is given in the report recently submitted to the Commission concerning the national agenda for employment. In the report especially the strengthened effort towards the youth it is pointed out as particularly successful.



Therefore a strengthened effort must be made to ensure that people with reduced capacity to work can be employed or maintain their connection to the labour market. Also a raise in the retirement age must be stimulated. On top of this, there will be reforms of the educational system so that young people are prompted to start their education at an earlier age, thus reducing the average duration of studies and minimising drop-outs.

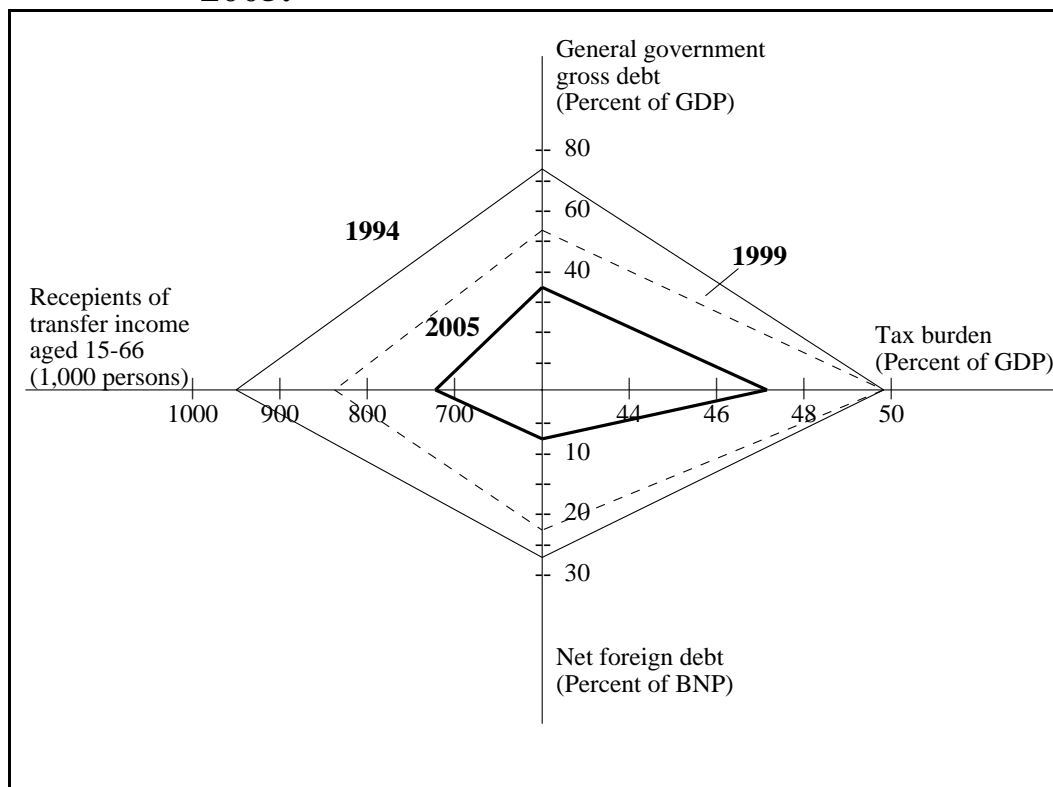
Following negotiations with the labour market parties, the Government has submitted proposals concerning a strengthening of the labour market policy, see box B.1. The reform will entail, among other things, that the unemployed will be activated at an earlier stage and that the proposals for activation will be more individual and result orientated. Furthermore a strengthened effort will be made towards the weaker unemployed. The 50-54 year-olds will be subject to the same rules concerning the length of the unemployment benefit period. As a part of the reform the unemployment benefit period will be reduced from 5 to 4 years, i.e. that the unemployment benefit period now constitutes 1 year and the active-period 3 years. The rules concerning availability are made more rigorous. The Government also wishes to modernise the calculation of unemployment benefits.

## **II. Long-term targets**

In August 1998 the Government performed a revision of the economic projection in the *Denmark 2005 plan*.

The pivotal point in the 2005 plan is the assumed successful reduction of the number of *transfer payment recipients* by approximately 15,000 persons. Without this reduction it will not be possible to reach the intended increase in employment nor the continued amelioration of the general government budget balance and in the tax system. Besides this, there is a need for further accession to the work force at an annual average of 30,000 persons. It has become more difficult to attain the supposed growth in employment because the cyclic unemployment has diminished due to the economic upturn. Therefore it is crucial, that decisions be made this autumn about further structural ameliorations in the labour market thus increasing the effective supply of

**Figur B.1 Net foreign debt, general government gross debt, tax burden and recipients of transfer in 1994, 1999 and 2005.**



labour.

The Government wishes to reduce *unemployment* to 5 per cent in 2005. This target seems to be perceptively within reach. But unemployment being below the present structural level it will not be an easy task. Thus it remains a considerable challenge to ensure, that the labour market has sufficient flexibility to make this low level of unemployment permanent.

The target to reduce *general government debts* to approximately 40 per cent of GDP could possibly be reached faster than formerly expected, see figure B.1. On the other hand the tax burden seems to be reduced slower the than estimated in the original 2005 targets. This is due to the expenditure level, where especially the municipal expenditure has increased more than expected. During the next years the real growth in general government expenditure is

assumed to be at an annual level of 1 per cent against 2-3 per cent during the past few years. This places considerable demands on cost management, and on the setting of a list of priorities for public services etc.

It is important that a significant amelioration of the general government budget balance is attained also in the years to come, thus creating a latitude to mitigate the demographic pressure on expenditure stemming from the future rise in the number of ageing citizens.

The relatively strong domestic demand is reflected in the fact that the assumed increases in the balance of payments surplus have not been attained. On the contrary, the balance of payments will show a deficit in 1998 and only a reach a balance in 1999. The balance of payments is expected to improve following the effects on the propensity to save contained in the “Whitsun-package”, thus gradually increasing the general government surplus to 2 per cent in the year 2005. As a consequence of the latest negative developments of the balance of payments the *foreign debt* will not be entirely paid back in the year 2005 but a few years later.

The changes in the areas of taxes and labour market are in the centre of the economic policy. But important tasks also remain in other areas:

In the *area of education* the target is to give qualifying education to a larger number of people while at the same time ensuring the quality of the education given.

- A good framework must be ensured for the *trades and industries*. The Government proposal of a reduction in company taxes will strengthen the competitiveness of the trades and industries. In addition to this comes the Government proposal to abolish the sales tax on stocks in 1999. This will improve both liquidity and the flow of capital to the companies. Moreover a strengthened effort in the areas of research and IT has been suggested, along with a string of initiatives which will ease the access to capital especially for the smaller or younger companies. Furthermore it is the target of the Government to lighten the burdens of administration for the trades and industries.
- To reach the targets in the *area of environment*, economic instruments in the form of green taxes, in for example the areas of energy and transport as well as on the use of pesticides in agriculture, are used. In connection with the 1999 Budget Proposal the environmental assessments of the Budget has

been elaborated. The assessments show that the high level of contributions to the environment is maintained, which contributes to reaching the targets of better water environment, lower CO<sub>2</sub>-discharge etc.