COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the Updated Convergence Programme of Denmark, 2001-2005

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries not participating in the single currency were to submit convergence programmes to the Council and the Commission by 1 March 1999. In accordance with Article 9 of this Regulation, the Council had to examine each convergence programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty, the Economic and Financial Committee. The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Denmark's convergence programme covering the period 1998-2005 was submitted on 30 October 1998 and assessed by the Council on 1 December 1998[2].

According to the Regulation, the updated convergence programmes, to be presented annually, may also be examined by the Council in accordance with the same procedures. The first annual update, covering the period 1999-2005, was submitted on 20 December 1999 and examined by the Council on 28 February 2000[3].

Denmark submitted the second updated convergence programme, covering the period 2000-2005, on 22 December 2000 and examined by the Council on 12 February 2001[4].

Denmark submitted the third and most recent updated convergence programme, covering the period 2001-2005, on 29 January 2001. It was delayed as a result of a new government coming into office in late November and its wish to include the new budget proposal for 2002 in the update. Apart from this delay the update conforms with the new Code of Conduct. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> In general the Danish economy is in good shape, and Denmark has continued to fulfil the convergence criteria on inflation, interest rate, exchange rate and public finances. Unemployment is low, inflation has come down to around 2% again and both public finances and the external account are in comfortable surplus. However, GDP growth in 2001 turned out somewhat lower than expected in the previous update, due to both lower international and domestic demand, especially with regard to fixed investment. Real GDP growth is, in the programme, expected to increase from 1¼% in 2001 to 1½% in 2002 and 2½% in 2003 and then level off to around 2% in 2004 and 2005. Inflation is expected to remain below 2% and unemployment to remain at a low level. The economic outlook is plausible and the developments are fairly in line with the Commission's 2001 Autumn forecasts.
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> Public finances are also expected to continue to be in good shape, even though the surplus for 2001 was lower than expected, mainly as a result of shortfalls on the revenue side, due to the downturn in the stock market. Surpluses are expected at the order of 2%

[1] OJ L209, 2.8.1997
[2] OJ C3, 6.1.1999
[3] OJ C98, 6.4.2000
[4] OJ C77, 9.3.2001

of GDP in 2002 and thereafter both in actual and cyclically adjusted terms and the general government debt is expected to be reduced to 35% of GDP by 2005. It can therefore be concluded that Denmark is expected to continue to fulfil comfortably the requirements of the Stability and Growth Pact of a fiscal position "close to balance or in surplus" and that the government accounts can withstand a normal cyclical downturn without breaching the 3% of GDP reference value. The surpluses are higher than in the Commission's Autumn forecast, due to more updated information on tax revenues and lower growth in expenditure, mainly due to the new budget proposal for 2002, and announced expenditure reductions for central government.

The update maintains the medium term strategy of the previous programme of keeping high surpluses on the public finances in order to prepare for the impact of ageing of the population, along with reduction in revenue and expenditure ratios. These goals are to be achieved by ensuring a stable macroeconomic environment on the basis of a fixed exchange rate within the ERMII, restraining real public consumption growth to 1% a year on average in the period 2002-2005 and by increasing labour participation rates. These aims have been strengthened by a "tax freeze" to stop the upward drift in the tax burden and to help curb the tendency for a rise in real expenditures compared with the budgets.

The revenue and expenditure ratios are expected to decline almost in parallel over the programme period by 1½ percentage points. The tax burden is set to decline slightly less. Thus, the strategy outlined for both the short and medium term is broadly in compliance with the BEPGs. However, given the comparatively high tax burden in Denmark, the programme could have been more ambitious in reducing it, as taxes on labour income are high. Though it is acknowledged this could not be achieved without further expenditure reductions relative to GDP than those revealed, given the need to avoid expansionary fiscal policy for an economy operating close to potential, while respecting the targeted surplus of 1½-2½% of GDP.

The main risks to the fulfilment of the medium term budgetary goals are a longer than expected slowdown of the economy, given the high sensitivity of the general government finances to the cycle in Denmark, and slippage in the expenditure control. Expenditure control has had a rather mixed record in recent years, as the target of restraining real public consumption yearly growth to 1% has frequently been overstepped. The need for expenditure control, especially in local government, is even more important now, that the "tax freeze" has been implemented, if high surpluses are to be assured. Furthermore, the redesign of the pension fund yield tax has led to increased volatility in revenues, due to a larger part of the revenues coming from yield on equities. A prolonged downturn in the stock market can therefore pose a risk to the high surpluses. On the other hand, windfall gains in the form of higher than expected revenues, should be reserved for reductions of the debt or tax burden, and not for increases in public expenditure.

Preparing for the ageing of the population has for some time been an important element in the Danish budgetary strategy. It is the main reason for having high surpluses on public finances till 2010 and for the focus on debt reduction. Sustainability calculations show that public finances are well equipped to handle the projected expenditure rises due to the ageing of the population and continue to be in compliance with the Stability and Growth Pact. These results are conditional on the realisation of the high surpluses. The projections also contain a continued high tax ratio between 2005 and 2050. While it is up to each Member State to determine its tax ratio, the projected level is high relative to those observed in other industrialised countries. In addition, the international mobility of production factors and thereby tax bases may increase in light of globalisation rendering it difficult for Denmark to maintain high tax revenues.

Increasing the labour force participation rate is an important assumption of the projections in the programme. A large part of this increase is likely to come from reforms already undertaken, where the full effect has not yet set in. It is, however, rightly acknowledged in the programme that further structural reforms are needed. These reforms are to focus on taxes on labour income and the functioning of the labour market. In this respect it is also important to ensure that the "tax freeze" does not prevent reductions of marginal taxes on income, as such reductions might help increase the labour supply.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the convergence programme update of Denmark and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the Updated Convergence Programme of Denmark, 2001-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[5], and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [... 2002] the Council examined Denmark's updated Convergence Programme, which covers the period 2001-2005. The macroeconomic scenario assumed in the updated Convergence Programme projects real GDP growth to increase from 1¼% in 2001 to 1½% in 2002 and 2½% in 2003 and then level off to around 2% in both 2004 and 2005. Inflation is expected to remain below 2% and unemployment to remain low. The Council notes that this economic scenario seems plausible and is in line with the Commission's 2001 Autumn forecast.

The Council notes with satisfaction that Denmark has continued to fulfil the convergence criteria on inflation, long term interest rate and on the exchange rate.

Regarding public finances, the Council notes, that while the outcome for the government surplus for 2001 was below expectations, mainly due to shortfall in revenue linked to the downturn in the stock market, a comfortable surplus was still achieved. The Council welcomes the maintenance of the objective of keeping surpluses between 1½-2½% of GDP over the programme period, during which the general government debt is expected to be reduced to 35% of GDP by 2005. As a result, Denmark continues to fulfil, comfortably, the requirement of the Stability and Growth Pact of a budgetary position of "close to balance or in surplus" over the entire period covered by the Programme. Denmark is also expected to be able to withstand a normal cyclical downturn without breaching the 3% of GDP deficit reference value.

[5] OJ L209, 2.8.1997

The budgetary consolidation strategy including a declining primary expenditure to GDP ratio and tax burden over the programme period outlined in the previous update of the Programme is upheld. The strategy has been further strengthened by the government's commitment to freeze all taxes and excise duties in order to put a halt to the upward drift in the tax burden. The Council welcomes this measure, while noting that it should not prevent reductions of marginal taxes on labour.

The Council notes that expenditure control has had a rather mixed record in recent years as the target of restraining real public consumption growth to 1% has frequently been overstepped. The need for expenditure control, especially in local government is even more important now that the decision to freeze taxes has been taken, if high general government surpluses are to be assured. The Council therefore calls on all levels of general government to make efforts to control expenditure such that the real increase in public consumption fulfils the target of an average annual growth of 1%. It also invites the Danish government to strengthen the institutional framework to avoid further slippage in the future, as already recommended in the Council Opinion last year[6].

The Council notes with satisfaction that the objective to substantially lower the ratio of gross debt to GDP enhances the sustainability of the public finances, thereby rendering the Danish economy in a good position to handle the projected expenditure rises due to the ageing of the population and still continue to be in compliance with the Stability and Growth Pact. However, it notes that these results are conditional on the continued realisation of the high surpluses. The projections also assume a continued high tax ratio to GDP between 2005 and 2050. The Council notes that such a high tax ratio to GDP may be difficult to achieve in a framework of increased mobility of production factors as a result of the globalisation.

Increase in the labour force participation rates in Denmark is an important assumption of the projections in the programme. A large part of this increase is likely to come from reforms already undertaken, where the full effect has not yet set in. Further structural reforms are, however, needed on the functioning of the labour market, while reductions in taxes on labour might help increase the labour supply. The Council therefore encourages the authorities to proceed with these measures, while of course maintaining adherence to the Stability and Growth Pact requirements.

[6] OJ C77, 9.3.2001