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, 2002-2010

(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. 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.

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].

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].The second annual update, covering the period 2000-2005, was submitted on 22 December 2000 and examined by the Council on 12 February 2001[4].The third annual update, covering the period 2001-2005, was submitted on 29 January 2002 and examined by the Council on 5 March 2002[5].

Denmark submitted the fourth and most recent updated convergence programme, covering the period 2002-2010, on 29 November 2002. A supplementary note was submitted to the Commission on 13 December 2002.The Commission services have carried out a technical evaluation of this updated programme, namely taking into account the Communication from the Commission to the Council of 27 November on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment:

> The programme is rich in information especially with regard to the amount of data provided for the analysis of medium- and long-term challenges of the Danish public finances and it broadly complies with the code of conduct. However, the programme is rather scarce on information regarding the budget for 2003. Two weeks after having submitted the updated programme the Danish authorities presented a supplementary note containing a revised short-term forecast (until the year 2004) and a short-term sensitivity analysis. However, the set of information contained in this supplementary note is not detailed enough to allow a comprehensive public finance assessment. Moreover the link of the new short term forecasts with the medium term projections of the programme – and therefore with the long-term analysis - is no longer straightforward as was the case in the initial scenario. The economic policies as reflected in the planned measures in the convergence programme update comply with the 2002 Broad Economic Policy Guidelines.

[1] OJ L209, 2.8.1997
[2] OJ C3, 6.1.1999
[3] OJ C98, 6.4.2000
[4] OJ C77, 9.3.2001
[5] OJ C64, 13.3.2002
[6] COM (2002) 668 final, 27.11.2002.

The 2002 updated Danish convergence programme covers the period 2002 to 2010. The public finance strategy presented is largely unchanged from previous years and continues to have a strong focus on ensuring sustainable public finances in the medium- and long-term. The foundation for the strategy continues to be both the maintenance of general government surpluses of the order of 1½-2½% of GDP on average towards 2010 and the tax freeze, which is also intended to help ensure expenditure control. In order to obtain the targets stipulated in the medium-term projection it is acknowledged in the programme that further labour market reforms are needed.

In general the Danish economy is in good shape and Denmark has continued to fulfil the convergence criteria on inflation, interest rate, exchange rate[7] and public finances. The economy has largely developed in 2002 as foreseen in the last update. The slowdown of economic growth in 2001 was estimated to result in GDP growth at 1.1%. The latest figure is 1.4%. For 2002 a small increase in GDP growth to 1.5% is expected which is in line with what was foreseen in the 2001 update. In 2003 and 2004 GDP growth is estimated at 1.8% and 2.1% in the supplementary note, driven solely by domestic demand. The growth profile and composition of the forecast are close to the Commission's forecast, but the overall GDP growth rates are slightly higher in the Commission's forecast at 2.1% and 2.4% in 2003 and 2004. This can largely be explained by the fact that the labour market situation has recently deteriorated as unemployment has begun to rise. This development is reflected in the supplementary note, but not in the Autumn Commission's forecast. From 2005 GDP growth is expected to average 1.8% as a technical projection.

Inflation is showing more resilience than expected which compared to last year's update has lead to an upward revision of the inflation forecast by more than ½ percentage point to 2.4% this year. This increase is mostly due to domestic factors as continued high wage increases in the service sector feeds into prices. The programme foresees wages growth to decelerate in 2003 and 2004, primarily due to the expected rise in unemployment which in turn is expected to gradually bring CPI inflation to levels below 2% from 2004 onwards. The Commission view is also for a deceleration of inflation but towards slightly higher levels.

Public finances in Denmark continue to remain healthy showing surpluses in the general government balance since 1997. Central government and social security sector are currently in surplus and local authorities are under the obligation to balance their revenue and expenditure. The outcome for 2001 at 2.8% of GDP was better than expected, but for a large part due to a delayed implementation of a technical change to a pension scheme. For 2002 to 2004 the supplementary note presents revised lower surpluses of 1.6, 1.9 and 2.4% of GDP, which is broadly in line with the Commission's estimates. For the rest of the period (2005-2010) the programme projects surpluses around 2% of GDP. The debt is expected to decrease from 44% of GDP in 2002 to 26% of GDP in 2010.

[7] In 2002 the reference value for the convergence criteria on inflation was 2.9% and Danish inflation stood at 2.4%. For the interest rate criteria the reference value was 6.9% compared to a figure for Denmark of 5.1%. With regard to the exchange rate Denmark has continued its membership of ERMII and the Danish *krone* has remained stable well within the narrow bands.

Both the Commission's and programme calculations of cyclically adjusted balances show continued surpluses in each year over the period and confirm that the public finances should remain sound. The underlying balance is expected to be in surplus - around 2% of GDP - over the programme period, and Denmark will therefore continue to comfortably fulfil the requirements of the Stability and Growth Pact.

Compared to last year's update the tax freeze has now been implemented for all levels of government, as recommended in the Broad Economic Policy Guidelines. The results of this implementation tentatively suggest that the tax freeze might also act as a mechanism of discipline in expenditure control, even though it is too early yet to make a full evaluation. Historically, expenditure control in Danish public finances has had a rather mixed record. It has so far proven difficult for the authorities to limit real growth rates of public consumption to their 1% target; and indeed from 2006 onwards the target becomes even stricter, at ½-¾%. Although it may appear that the tax freeze acted as a mechanism for discipline in expenditure control in 2002 as well as on the budget for 2003, the tighter target from 2006 may still prove to be quite a challenge.

The achievement of the medium term public finance targets hinges to a large extent on the realisation of some ambitious labour market goals which include increasing the labour force participation rates beyond their already high level. The achievement of these goals implies a need for further labour market reforms as labour market constraints continue to be the main challenge for the Danish economy. Compared to the previous update, a quantification has been made of the consequences for public finances if the reforms are not implemented. This is a welcomed innovation and it shows that the shortfall on the surplus risks being of the order of 1% of GDP. Given the possible severity of such a short-fall on the sustainability of public finances it is strange that the programme does not contain much information on the content of such reforms nor on a possible timetable of their implementation.

Recently there has been a downturn in the Danish labour market. Unemployment has begun to rise and employment is falling. These developments do not necessarily pose a threat to reaching the targets for labour market developments towards 2010, but such risks may emerge if the downturn is prolonged, in which case the projected level of budget surpluses might be at risk.

A reduction of taxes on labour income is announced in the programme – if the fiscal leeway can be found - but a final decision on a tax reform will not be taken until spring 2003. However, the reduction of taxes on labour income is planned to be of the order of ¼-½% of GDP which can only be considered of a small magnitude. If this reform is also intended to help alleviate the labour market constraints, the perceived effect can only be limited.

This year's update again presents substantial calculations on long-term sustainability of public finances and compared to last year's update, the calculations are augmented with sensitivity calculations. The attention given to public finance sustainability is welcome. The issue of long-term sustainability naturally hinges on the realisation of the medium-term targets, but should the medium term projection materialise, the calculations show that public finances in Denmark seem in a very good position to handle the impact of the ageing population, as large net assets are projected for both the government and pension funds. However, the implication of the calculations is a continued high tax burden compared with other industrialised countries.

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, 2002-2010

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[8], 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 [18 February 2003] the Council examined Denmark's updated Convergence Programme, which covers the period 2002-2010. The programme is rich in information especially with regards to the amount of data provided for the analysis of medium- and long-term challenges of the Danish public finances and broadly complies with the code of conduct. The economic policies as reflected in the planned measures in the convergence programme update comply with the 2002 Broad Economic Policy Guidelines.

The economy has largely developed as foreseen in the 2001 update. The slowdown of economic growth in 2001 was estimated to result in GDP growth at 1.1%. The latest figure is 1.4%. For 2002 a small increase in GDP growth to 1.5% is expected which is in line with what was foreseen in the previous update. In 2003 and 2004 GDP growth is estimated at 1.8% and 2.1% driven solely by domestic demand. The Council notes that the macroeconomic projection seem plausible and it is in line with the Commission's Autumn forecast.

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

The public finance strategy presented is largely unchanged from previous years and continues to have a strong focus on ensuring sustainable public finances in the medium- and long-term. The foundation for the strategy continues to be both the maintenance of general government surpluses at the order of 1½-2½% of GDP on average towards 2010 and the tax freeze, which is also intended to help ensure expenditure control. In order to obtain the budgetary targets

[8] OJ L209, 2.8.1997

stipulated in the medium term projection it is acknowledged by the Danish government in the programme that further labour market reforms are needed. The Council welcomes that the tax freeze has so far been implemented for all levels of government - a development which is in line with the Broad Economic Policy Guidelines.

The Council notes with satisfaction that public finances in Denmark continue to remain healthy. The outcome for 2001 was better than expected. For 2002 to 2004 the update forecasts budget surpluses of 1.6, 1.9 and 2.4% of GDP, which is broadly in line with the Commission's estimates. For the rest of the period (2005-2010) the programme projects surpluses around 2% of GDP. The debt is expected to decrease from 44% of GDP in 2002 to 26% of GDP in 2010.

The Council notes that also in underlying terms public finances should remain sound over the projection period with surpluses of around 2% of GDP. Denmark will therefore continue to comply fully with the requirements of the Stability and Growth Pact.

The achievement of the medium term public finance targets hinges to a large extent on the realisation of some ambitious labour market goals which include increasing the labour force participation rates from their already high level. The Council notes that the programme acknowledges that to obtain these goals further labour market reforms are required. Compared to the previous update a quantification has been made of the consequences in the event that the reforms are not implemented. The Council welcomes this innovation and notes that a short-fall due to non-realisation of the labour market goals may have important implications for reaching the projected developments of public finances. Furthermore, if the current downturn in the labour market is prolonged it may also pose a risk to the projected surpluses. The Council therefore encourages the Danish authorities to proceed with these reforms with determination .

The Council considers that on the basis of current policies, public finances appear to be on a sustainable footing to meet the budgetary costs of ageing populations, benefiting from the running of budget surpluses, and a projected accumulation of large net assets in both pension funds and government.

The Council notes the intention of the Danish authorities to reduce the tax ratio by 2010, and considers that this can be achieved while at the same time ensuring the sustainability of public finances. However, the tax ratio in Denmark will remain high compared to other industrialised countries, and consideration could be given to further reductions, in a framework of sound public finances.