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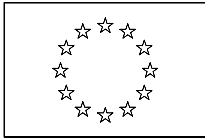

EUROPEAN COMMISSION

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Recommendation for a

COUNCIL OPINION

on the updated convergence programme of Denmark, 2009-2015

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

In accordance with the Regulation, the Council delivered an opinion on the first convergence programme of Denmark on 1 December 1998 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the Regulation foresees that these are assessed by the Commission and examined by the Committee mentioned above and, following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Denmark, submitted on 24 February 2010, and has adopted a recommendation for a Council Opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan");

(2) the conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy";

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council Opinion on the previous update of the convergence programme).

[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global crisis that hit financial markets and the world economy in 2008-2009, the European Commission called for a European Economic Recovery Plan (EERP)[2]. The plan proposed a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to €200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of €30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan called for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability (or room for manoeuvre) of government finances and competitive positions. In particular, for Member States with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008.

2.2. The conclusions of the Economic and Financial Affairs Council of 20 October 2009 on the "Exit strategy"

Following the halt of the sharp decline in economic activity and first signs of a recovery from the crisis, the stabilisation of financial markets and the improvement in confidence, the Council concluded on 20 October 2009 that, while in view of the fragility of the recovery it was not yet time to withdraw the support governments provided to the economy and the financial sector, preparing a coordinated strategy for exiting from the broad-based policies of stimulus was needed. Such a strategy should strike a balance between stabilisation and sustainability concerns, take into account the interaction between the different policy instruments, as well as the discussion at global level. Early design and communication of such a strategy would contribute to underpinning confidence in medium-term policies and anchor expectations. Beyond the withdrawal of the stimulus measures of the European Economic Recovery Plan, substantial fiscal consolidation was required in order to halt and eventually reverse the increase in debt and restore sound fiscal positions. Increasing the efficiency and effectiveness of public finances and the intensification of structural reform were desirable even in the short term as they would contribute to fostering potential output growth and debt reductions. The Council agreed on the following principles of the fiscal exist strategy: (i) the strategy should be coordinated across countries in the framework of a consistent implementation of the Stability and Growth Pact; (ii) timely withdrawal of fiscal stimulus was needed, taking country-specific circumstances into account; (iii) the pace of consolidation should be ambitious, in most countries going well beyond the benchmark of 0.5% of GDP per annum in structural terms; and (iv) the credibility of the strategy should be underpinned by measures to enhance the quality of public finances and ambitious structural reform efforts to raise employment and potential growth.

[2] Communication from the Commission to the European Council of 26 November 2008.

2.3. The assessment in the Council Opinion on the previous update

In its opinion of 10 March 2009, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2008-2015, as follows: "at the current juncture and given the comfortable fiscal position, the overall fiscal stance is considered adequate in view of the discretionary fiscal expansion of around 1 percentage point of GDP in 2009 and in view of the relatively strong automatic stabilisers. The programme foresees a reduction in the general government surplus by around 3 percentage points of GDP in 2009 and about 1¼ percentage point further in 2010. The programme's growth assumptions are favourable. The fiscal policy aims to continue to achieve the MTO, being consistent with the objective of long-term sustainability throughout the programme period, thus maintaining a sufficient safety margin to the reference value. Following a period of high budgetary surpluses, benefitting from a relatively strong fiscal framework, general government gross debt has declined to a low level. In view of this assessment, the Council invited Denmark to: "(i) Implement the fiscal plans for 2009, including the stimulus measures; in line with the EERP and within the framework of the Stability and Growth pact; (ii) identify the required structural reform measures; notably aiming at strengthening labour supply, in order to achieve budgetary targets in the outer years".

Recommendation for a

COUNCIL OPINION

on the updated convergence programme of Denmark, 2009-2015

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union,

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 coordination of economic policies[3], 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:

(1) On [22 April 2010] the Council examined the updated convergence programme of Denmark, which covers the period 2009 to 2015.

(2) The economic crisis hit the Danish economy hard in 2009, pushing Denmark into its deepest recession since the end of the Second World War. Denmark entered the crisis from a relatively comfortable position after a period of sustained strong growth with substantial surpluses in the current account and government finances and low public debt. The downturn began in 2008 when the housing bubble burst and was aggravated by falling exports, reflecting the collapse in world trade and declining investment on the back of receding final demand and tighter financing conditions. Despite disposable incomes still rising, private consumption weakened significantly, as the bleak economic outlook, falling real estate prices and rising unemployment affected consumer confidence. In response to the sharp fall in output, the Danish authorities adopted several large fiscal stimulus measures in line with the European Economic Recovery Plan (EERP) comprising tax cuts, investment projects and raising public consumption expenditures. On top of the fiscal support to economic activity, two bank rescue packages were adopted, providing guarantees and capital injections. These measures are expected to turn a comfortable budget surplus in 2008 into a deficit as from 2009 that is set to exceed the 3%-of-GDP reference value of the Stability and Growth Pact between 2010 and 2012. Public debt, while moving up in parallel, is still expected to remain below the 60%-of-GDP reference value. The exchange rate has been stabile throughout 2009 and the interest rate spread vis-à-vis the ECB has come down substantially. In order to ensure a sustainable development of public finances, a key challenge will be to ensure continued reform to increase labour supply. Another

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/sgp/index_en.htm.

challenge for the Danish authorities will be to ensure that the scaling back of stimulus measures takes place in a timely manner once the recovery is self-sustaining.

(3) Although much of the observed decline in actual GDP in the context of the crisis is cyclical, growth in potential output will resume from a lower starting point. In addition, the crisis may also affect potential growth in the medium term through lower investment, constraints in credit availability and increasing structural unemployment. Moreover, the impact of the economic crisis will coincide with the negative effects of demographic ageing on potential output and the sustainability of public finances. Against this background it will be essential to accelerate the pace of structural reforms with the aim of supporting potential growth. In particular, for Denmark it is important to undertake reforms in the areas of the labour market and early retirement benefits in order to increase labour supply.

(4) The macroeconomic reference scenario underlying the programme envisages that real GDP growth, after a setback of -4.3% in 2009, will resume to 1.3% in 2010, accelerating to an average rate of 2.2% over the rest of the programme period. Assessed against currently available information[4], this scenario appears to be based on plausible growth assumptions until 2011 and favourable ones thereafter. There are differences between the programme and the Commission services' 2009 autumn forecast in terms of the composition of growth. The programme assumes that the recovery will be driven by domestic demand, primarily by private consumption from 2010 and followed by gross fixed capital formation as from 2011, with public consumption growth levelling off from 2011 onwards and the external contribution turning slightly negative. The Commission services' 2009 autumn forecast assumes the recovery to be driven by both private consumption and net exports. The programme's projections for inflation and employment appear realistic. The macro-economic scenario is deemed consistent with the Danish fixed exchange rate policy.

(5) The programme estimates the general government deficit in 2009 at 2.9% of GDP. The massive swing from a surplus of 3.4% of GDP in 2008 reflects to a large extent the impact of the crisis on government finances, but was also brought about by stimulus measures amounting to 2.2% of GDP which the government adopted in line with the European Economic Recovery Plan (EERP). The deterioration was mainly driven by an increase in expenditure due to the working of automatic stabilisers, although the government's stimulus measures also included significant tax cuts. According to the programme, fiscal policy is planned to remain supportive in 2010 before turning restrictive in the outer years of the programme. In view of Denmark's relatively favourable starting situation the continued fiscal expansion in 2010 is appropriate and in keeping with the EERP. In order to return to a sustainable public finance position, the programme assumes fiscal consolidation to begin from 2011 and states that the measures needed to this effect will be specified later.

(6) The programme plans for the general government deficit to widen to 5.3% of GDP in 2010 caused by both a decreasing revenue ratio and an increasing expenditure ratio. The decreasing revenue ratio reflects the coming into force of the 2010 tax reform while the increasing expenditure share of GDP reflects the working of automatic stabilisers and additional government stimulus measures. Stimulus measures and tax

4 The assessment notably takes into account the Commission services' autumn 2009 forecast, but also other information that has become available since then.

cuts are expected to amount to 1.3% of GDP, while volatile elements reported in the programme, including revenue from North Sea oil extraction and subsidies to Greenland and the Faroe Islands amount to -1.7% of GDP in 2010[5]. The structural balance, i.e. cyclically-adjusted balance recalculated by the Commission services using the commonly agreed methodology, is set to worsen by 2.5 p.p. confirming a markedly expansionary fiscal stance. The difference compared to the size of the stimulus measures and tax cuts is mainly explained by revenue shortfalls.

(7) The goals of the programme's medium-term budgetary strategy are a structurally balanced budget by 2015, a long term sustainability indicator[6] of minimum zero and an improvement of the structural balance by a total of 1½% of GDP from 2010 to 2013. The programme expects the headline and primary deficits to gradually narrow from 2011 onwards, with the primary balance set to turn positive from 2013 and the headline balance reaching zero in 2015. The corresponding path of the structural balance recalculated according to the commonly agreed methodology on the basis of the information in the programme, indicates that the fiscal policy stance is somewhat expansionary in 2015 by -0.4% of GDP, which is slightly below the goal set out in the programme. Apart from assuming zero real growth in public consumption expenditures from 2011 to 2013 and rule out tax increases, the envisaged consolidation is based on yet unspecified measures, but the programme states that consolidation is to be based on expenditure restraint. The programme update sets the medium-term objective (MTO) for the budgetary position at a structurally balanced budget. In view of the new methodology[7] and given the most recent projections and current debt levels, the MTO more than adequately reflects the objectives of the Pact.

(8) While the budgetary projections in the programme appear plausible for 2010, the outturn for 2011 and beyond could be worse than projected. The revenue projections in the update remain realistic but subject to downside risks and the planned consolidation on the expenditure side is not underpinned by measures. In addition, the macroeconomic scenario underlying the budgetary projections assumes strong growth in private consumption and restraint on public consumption. Given the track record of expenditure frequently exceeding targets, the assumed zero real growth in public consumption expenditures between 2011 and 2013 appears optimistic. The financial sector appears stable, but the financial rescue measures enacted during the crisis have increased the government's risk exposure to the sector.

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[5] The programme update considers that for these volatile sources of revenue and expenditure, deviations from a structural level are 'temporary or one-off measures'. Apart from a capital transfer of 0.3% of GDP in 2010 stemming from a reform of the pension yield taxation, these measures do not qualify as one-offs according to the Commission Services' definition. Using the Commission Services' definition of one-offs, the structural balance would be -2.5% of GDP in 2010 and equal to the cyclically-adjusted balance in the remaining years of the programme period.

[6] The Danish long term sustainability indicator is comparable to the S2 indicator used by the Commission services.

[7] The country-specific MTOs should take into account three components: i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure.

(9) Government gross debt is estimated at 38.5% of GDP in 2009 and is set to increase to 48.3% in 2012 before declining to 45.0% of GDP in 2015. This is largely driven by the rapid increase in the deficit and the fall in GDP in 2009. In view of the negative risks to the budgetary targets, the debt ratio could rise more than projected in the programme. However, the net financial position of the general government is positive at the beginning of the programme period but will turn slightly negative during the programme period. The gross debt ratio is projected to remain below the 60%-of-GDP reference value stipulated by the Stability and Growth Pact.

(10) The long-term budgetary impact of ageing is clearly lower than the EU average. The budgetary position in 2009, as estimated in the programme, contributes to the reduction of gross debt. Ensuring high primary surpluses over the medium term would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report[8] as low. Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary development envisaged in the programme would be more than enough to stabilise the debt-to-GDP ratio by 2020.

(11) As reflected by its budgetary track record, Denmark has benefited from a relatively strong fiscal framework, notable for its wide coverage and the transparency and visibility of its fiscal rules. General government consumption expenditure has, however, been prone to exceeding targets. Recent initiatives involving economic sanctions could enhance incentives for municipalities to adhere to agreed targets. Since 2002 the Danish tax policy has been centred on the tax-freeze, whereby no indirect or direct taxes can be raised. The tax-freeze can as such be seen as an instrument to control public expenditures. The strict observance of the tax-freeze renders major tax reforms difficult and it locks in certain inefficiencies in the tax structure, especially in relation to real-estate taxation.

(12) As one of the main long-term challenges for the Danish economy is to increase labour supply, the government has initiated measures to strengthen work incentives and discourage absentees. In 2009, prompted by the global economic crisis and within the limits of the tax freeze, a tax reform was passed effective from 2010, which significantly lowers the tax burden on labour. The different elements of the tax reform will gradually be implemented in the period from 2010 to 2019. In the short term revenue losses are estimated at around 1% of GDP, but the financing elements and the hoped-for incentives to labour supply should render the reform fully financed in the long run.

(13) Overall, the strategy to maintain supportive fiscal policies also in 2010 can be considered in line with the EERP. Following the negative effects of the economic crisis, the general government deficit is projected to breach the 3%-of-GDP reference value in 2010, 2011 and 2012. However, in view of the risks to the budgetary

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[8] In the Council conclusions from 10 November 2009 on sustainability of public finances "the Council calls on Member States to focus attention to sustainability-oriented strategies in their upcoming stability and convergence programmes" and further "invites the Commission, together with the Economic Policy Committee and the Economic and Financial Committee, to further develop methodologies for assessing the long-term sustainability of public finances in time for the next Sustainability report", which is foreseen in 2012.

projections in the outer years of the programme, the planned return to a balanced budget may not be achieved and the planned correction of the structural budget balance of 1½% by 2013 may not be reached. The projected fiscal stance, as measured by the change in structural balance, indicate that fiscal consolidation takes hold from 2011, albeit at a moderate pace falling short of the 0.5% of GDP benchmark. The programme mentions that consolidation will take place on the expenditure side, but this is not backed up by specific consolidation measures. Therefore, the budgetary strategy would need to be reinforced to be in line with the requirements of the Pact. Moreover, whereas the programme targets the achievement of the structural balance by 2015, the structural balance, as recalculated by the Commission services' using the commonly agreed method, is projected to be slightly negative by -0.4% in 2015, and is subject to the same risks as mentioned above.

(14) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[9].

The overall conclusion is that that the severe economic crisis has substantially affected public finances. The programme's projections, based on current policies, indicate that the general government deficit will exceed the 3%-of-GDP reference value from 2010 to 2012. Whereas the projected consolidation path foresees that the MTO of a structurally balanced budget would be reached by the end of the programme period in 2015, the structural balance, as recalculated by the Commission services' using the commonly agreed method, is projected to be slightly negative. Taking also account of the downside risks attached to these projections, it would be desirable that the government specifies the consolidation measures to be taken.

In view of the above assessment Denmark is invited to:

(i) reinforce efforts ensuring that the planned breach of the 3%-of-GDP reference value would remain contained and to

(ii) specify the measures to underpin fiscal consolidation for the MTO to be reached by 2015 as planned.

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9 In particular, the data on detailed categories of stock-low adjustments are not provided, which has made the effect of making the assessment objectively more difficult.

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012	2013	2014	2015
Real GDP (% change)	**CP Feb 2010**	**-0.9**	**-4.3**	**1.3**	**1.6**	**2.0**	**2.3**	**2.6**	**2.6**
	COM Nov 2009	-1.2	-4.5	1.5	1.8	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*0.2*	*-0.2*	*0.7*	*1.9*	*1.7*	*1.6*	*1.6*	*1.6*
HICP inflation (%)	**CP Feb 2010**	**3.6**	**0.8**	**2.1**	**1.5**	**2.3**	**2.1**	**1.9**	**1.9**
	COM Nov 2009	3.6	1.1	1.5	1.8	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*3.6*	*1.3*	*2.1*	*1.4*	*1.8*	*1.9*	*1.9*	*1.8*
Output gap[1] (% of potential GDP)	**CP Feb 2010**	**0.3**	**-4.5**	**-3.9**	**-3.1**	**-2.0**	**-0.9**	**0.1**	**0.7**
	COM Nov 2009[2]	-0.1	-5.1	-4.1	-3.2	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*0.0*	*-1.4*	*-1.8*	*-1.2*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Feb 2010**	**2.2**	**2.9**	**2.4**	**2.4**	**2.6**	**2.9**	**3.2**	**3.5**
	COM Nov 2009	2.2	2.0	0.5	1.0	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*1.7*	*1.8*	*2.3*	*2.6*	*2.6*	*2.4*	*2.1*	*1.8*
General government revenue (% of GDP)	**CP Feb 2010**	**54.3**	**53.3**	**52.4**	**52.4**	**51.8**	**51.8**	**51.9**	**52.0**
	COM Nov 2009	55.3	53.9	52.8	53.0	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*53.2*	*51.2*	*51.5*	*52.1*	*51.8*	*51.7*	*51.6*	*51.5*
General government expenditure (% of GDP)	**CP Feb 2010**	**50.9**	**56.3**	**57.7**	**56.5**	**54.9**	**53.6**	**52.8**	**52.0**
	COM Nov 2009	51.9	55.9	57.6	56.4	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*50.2*	*51.2*	*52.8*	*51.8*	*51.7*	*51.6*	*51.6*	*51.6*
General government balance (% of GDP)	**CP Feb 2010**	**3.4**	**-2.9**	**-5.3**	**-4.1**	**-3.1**	**-1.8**	**-0.8**	**0.0**
	COM Nov 2009	3.4	-2.0	-4.8	-3.4	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*3.0*	*0.0*	*-1.2*	*0.3*	*0.1*	*0.1*	*0.0*	*-0.1*
Primary balance (% of GDP)	**CP Feb 2010**	**4.8**	**-1.3**	**-3.7**	**-2.3**	**-1.2**	**0.3**	**1.3**	**2.1**
	COM Nov 2009	4.8	-0.5	-3.3	-1.9	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*-4.2*	*-1.5*	*-0.2*	*-1.6*	*-1.3*	*-1.2*	*-0.9*	*-0.7*
Cyclically-adjusted balance[1] (% of GDP)	**CP Feb 2010**	**3.2**	**0.0**	**-2.8**	**-2.1**	**-1.7**	**-1.1**	**-0.8**	**-0.4**
	COM Nov 2009	3.4	1.3	-2.1	-1.3	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*3.0*	*0.9*	*0.0*	*1.1*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**CP Feb 2010**	**3.2**	**1.4**	**-1.1**	**-1.0**	**-0.8**	**-0.3**	**-0.5**	**-0.4**
	COM Nov 2009	3.4	1.4	-1.5	-1.3	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*4.0*	*2.6*	*1.7*	*1.3*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Feb 2010**	**33.4**	**38.5**	**41.8**	**46.2**	**48.3**	**48.1**	**46.1**	**45.0**
	COM Nov 2009	33.5	33.7	35.3	35.2	n.a.	n.a.	n.a.	n.a.
	CP Oct 2008	*30.3*	*27.9*	*26.3*	*25.4*	*24.6*	*23.8*	*23.2*	*22.6*

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 1.4%, 0.6%, 0.5% and 0.9% respectively in the period 2008-2011.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 1.4% of GDP in 2009, 1.7% in 2010, 1.1% in 2011, 0.9% in 2012, 0.8% in 2013 and 0.0% in 2015; all deficit-reducing according to the most recent programme and 0.1% of GDP in 2009 and 0.6% in 2010; all deficit-reducing according to the Commission services' autumn 2009 forecast. Due to differencees in methodology, the one-offs reported in the programme does not qualify as one-offs according to the Commission Services' definition. Using this definition, the one-offs would be 0.3%-of-GDP deficit reducing in 2010 and zero in the remaining years.

Source:

Convergence programme (CP); Commission services' autumn 2009 forecasts (COM); Commission services' calculations.