COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.1.2004
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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, 2003-2010**

(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] and updates were presented every following year.

Denmark submitted the fifth and most recent updated convergence programme, covering the period 2003-2010, on 28 November 2003. The Commission services have carried out a technical evaluation of this updated programme taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

The programme is rich in information especially with regard to the 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[5]. The strategy for public finances presented is largely unchanged and continues to 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 until 2010, and the tax freeze, which also is intended to help ensure public expenditure control. Tax reductions on labour income, to be implemented in 2004, aim at enhancing labour supply. Moreover, a series of labour market initiatives have been implemented.

Overall, the Danish economy is in good shape. However, as for the rest of the EU Member States, the economy has developed less favourably in 2003 than foreseen in the updated programme. After the robust GDP growth in 2002, growth slowed markedly in 2003. In 2004 and 2005, GDP growth is estimated to be just above 2%. The growth picture of the

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1 OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C3, 6.1.1999.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002.

5 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

programme forecast for the coming years is close to the Commission's. For 2003, however, the Commission services (and recently also the Danish authorities) forecast a markedly lower growth[6].

Inflation has come down in Denmark in 2003, to around 2%. This development is mainly due to lower increases in energy prices. Price increases in the services sector is part of the reason why inflation has been slightly above the euro area average. Wage increases in Denmark have been higher than in the euro area, but due to higher productivity growth the effects on price inflation have been limited. .The CP 2003 foresees inflation to decline further in the next years, due to slack in the labour market as well as to falling import prices and lower excise duties. Overall, the inflation forecast is similar to the Commission's.

Public finances in Denmark remain sound, showing surpluses in the general government balance since 1997. Central government and social security sector are currently in surplus. For the coming years, the updated programme foresees general government surpluses of between 1¼% and 1¾% until 2005. This is broadly in line with the Commission's estimates. For the rest of the projection period, surpluses of around 2% of GDP are projected. Both the Commission's and programme calculations of cyclically adjusted balances show continued surpluses over the period and confirm that public finances should remain sound. The government debt is expected to fall from 45.5% of GDP in 2002 to reach 27½ % in 2010.

Local authorities are under the obligation to balance revenue and expenditure. The tax freeze is a key mechanism for enforcing expenditure control, as local governments are severely restricted in access to raising capital via loans. In 2002, the tax freeze apparently did not fully constrain local government spending, as there were some spending overruns. As the largest share of public consumption is the responsibility of local governments, their adherence to the agreements with the central government, including the tax freeze, is therefore crucial for the achievement of the overall target for public consumption. The target for the growth of real public consumption is tightened in the updated programme. From 2005 onwards it is set at ½%, an ambitious target in the light of past trends. Overall, compliance with the tax freeze as well as with budget agreements between local and central government seems to have improved since 2002, but it is not established that the present instruments can deliver on the targets for public consumption growth in 2003 and thereafter. Historically, expenditure control in Danish public finances has had a mixed record. Reaching these targets is a recommendation to Denmark in the 2003 Broad Economic Policy Guidelines.

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[7]. The already implemented measures, including the tax reform, should increase employment. It is acknowledged in the programme that in addition to realising the labour supply effect of already adopted reforms, additional measures need to be implemented. The direction of these reforms is, however, not spelled out in the programme. Moreover, the recent slowdown has been accompanied by deterioration on the labour market. This development does not necessarily pose a threat to reaching the medium-term targets for the labour market, but actual employment needs to increase additionally in order to also eliminate the cyclical part of the current unemployment.

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6 On 11 December, the Ministry of Finance released a revised forecast, with GDP growth in 2003 at 0.4%, which is closer to the Commission's forecast.

7 The overall employment rate in Denmark was 76% in 2002. The employment rate for older workers (aged 55-64) in the same year was 58%.

The Danish authorities intend to reduce the tax ratio in the programme period, while ensuring the sustainability of public finances. However, as stated in the Council Opinion on the 2002 update of Denmark's Convergence Programme, the tax ratio in Denmark will remain high compared to other industrialised countries.

The programme presents calculations on long-term sustainability of public finances, including sensitivity analyses. The quantifications of the consequences for public finances of no further reforms are illustrative. Given the potential impact of such a shortfall on the sustainability of public finances, the programme would have benefited from more information about future direction of reform. The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The strategy is comprehensive and includes measures to run down debt, by maintaining a surplus over the programme period and use additional revenues induced by the North Sea agreement for faster debt reduction. If the medium term projection materialises as spelled out in the programme, the large net assets projected for both the government and pension funds would put Denmark's public finances in a good position to handle the impact of the ageing population.

The economic policies as reflected in the updated programme broadly comply with the 2003 Broad Economic Policy Guidelines, which recommended the Danish authorities to: continue to make work pay by increasing incentives to join the labour force; ensure expenditure control at all levels of government; step up efforts to enforce competition in sectors where competition is inadequate; and continue efforts to increase the efficiency of the public sector.

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, 2003-2010**

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 20 January 2004, the Council examined Denmark's updated Convergence Programme, which covers the period 2003-2010. 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 on the content and format of Stability and Convergence Programmes.

The strategy for public finances presented is largely unchanged and continues to 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 also is intended to help ensure public expenditure control. Tax reductions on labour income are to be implemented in 2004, aiming at enhancing labour supply. Moreover, a series of labour market initiatives have been implemented. However, additional measures to raise labour supply are necessary, as acknowledged in the programme.

The update projects GDP growth to accelerate from an estimated 1.4% to above 2% in 2004 and 2005. The growth picture of the programme forecast for 2004 and 2005 is realistic and it is close to the Commission's. For 2003, the Commission services (and recently the Danish authorities) forecast a markedly lower growth.

Public finances in Denmark continue to remain sound. For 2003 to 2005 the programme update forecasts budget surpluses of 1¼% of GDP to 1¾% of GDP, which is broadly in line

[8] OJ L 209, 2.8.1997.

with the Commission's estimates. For the rest of the period the programme projects surpluses just below 2% of GDP. Also in underlying terms public finances should remain sound over the projection period. The debt is expected to decrease from 45.5% of GDP in 2002 to 27½ % of GDP in 2010. Denmark will therefore continue to comply fully with the requirements of the Stability and Growth Pact.

The budgetary stance should provide a safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. Under plausible macro-economic and budgetary assumptions, the medium-term objective of a budgetary position of close to balance or in surplus should be maintained over the programme period.

The achievement of the medium term public finance targets hinges to a large extent on the realisation of a set of ambitious labour market goals, which include increasing the labour force participation rates from their already high level. The updated programme acknowledges that further labour market reforms are required in order to obtain these goals. A non-realisation of the labour market objectives may have important implications for the projected developments of public finances. The programme would therefore have benefited from more information about future direction of reform.

The Danish authorities intend to reduce the tax ratio in the programme period, while ensuring the sustainability of public finances. However, as stated in the Council Opinion on the 2002 update of Denmark's Convergence Programme, "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".

On the basis of current policies and the medium term projections in the updated programme, the large net assets projected for both the government and pension funds would put Denmark's public finances in a good position to handle the impact of the ageing population.

The 2003 Broad Economic Policy Guidelines included recommendations to the Danish authorities to continue to make work pay by increasing incentives to join the labour force; and to ensure expenditure control at all levels of government. The economic policies as reflected in the updated convergence programme are broadly consistent with the 2003 Broad Economic Policy Guidelines.