COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Denmark, 2004-2010

(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 coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, had 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 assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The first convergence programme of Denmark, covering the period 1998-2005 was submitted on 30 October 1998 and assessed by the Council on 1 December 1998. Updates were presented every following year. Denmark submitted the most recent update of its convergence programme on 29 November 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the broad economic policy guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies[3], endorsed by the Council. This evaluation is as follows:

- The 2004 update of the Danish convergence programme was adopted by the government on 29 November 2004 and submitted to the Commission the same day. The update was sent to the Danish Parliament for information. The present update, covering the period up to 2010, is the sixth update of the Convergence Programme submitted in October 1998. The updated programme fully complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes"[4].

- In the update, GDP growth rates of 2.2% and 2.5% are foreseen for 2004 and 2005, as domestic demand, in particular private consumption, rebounds after the slowdown in 2003. For 2006, GDP growth is set markedly lower. The labour market has so far improved only modestly but is expected to recover in the coming years. Overall, on the basis of currently available information, the macroeconomic scenario underlying the update seems relatively cautious and is broadly in line with the Commission services' evaluation including the autumn 2004 forecast. However, for 2006 and the following years the growth assumptions

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1 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 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.

3 COM(2002) 668 final, 27.11.2002.

4 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, document EFC/ECFIN/404/01-REV 1 of 27.6.2001 endorsed by the ECOFIN Council of 10.7.2001.

appear cautious and slightly below the Commission services' estimations of the potential growth rate in the medium term.

– Inflation decelerated in late 2003 due to falling import and energy prices and annual inflation was subdued in most of 2004. Towards the end of the year inflation rose somewhat as the reduction of excise duties on several items in late 2003 fell out of the year-on-year comparison and energy prices increased; average inflation in 2004 was 1.2%. There have not been any severe tensions affecting the exchange rate of the *krone*. Deviations in the exchange rate from the central parity have been much narrower than the official margin and the short-term interest rate differential to the euro area has continued to be low. This reflects a strong confidence in the macroeconomic policy framework in Denmark, which also continues to provide for low long-term bond yields. Over the past year, developments in Danish bond yields have been in line with trends in major bond markets.

– The medium-term budgetary framework includes a target range of general government surpluses of 1½-2½% of GDP up to 2010 and a limit on yearly real public consumption growth of 0.5% from 2005 onwards; expenditure control is reinforced through the so-called tax freeze. Both the central government sub-sector and the pension funds are expected to show stable surpluses in the programme period. Local governments are projected to balance their budgets, as required by law. The updated programme foresees surpluses of 1.2% in 2004, 2.0% in 2005 and 1.6 % of GDP in 2006. The surplus reaches 2.0% of GDP in 2010. Both expenditure and revenue ratios are on a gradually declining trend over the projection period. Adjusting for the estimated impact of the cycle using the common methodology, the cyclically-adjusted budget balance is in comfortable surplus throughout the projection period. The projected general government surplus targets are close to the 2003 update. Differences in the near term are due to revised assumptions about GDP growth as well as to the effects of recent policy measures, including the March 2004 fiscal package, which frontloaded the tax reform adopted in 2003. From 2007 the projected surpluses are slightly lower than in the previous update, due to revised demographic assumptions that have contributed to lowering the long-term fiscal requirements. Overall, the current update thus broadly confirms the strategy of the previous update against a similar macroeconomic scenario.

– The risks to the budgetary projections are fairly balanced, though to some extent weighted towards an outcome better than projected in the first years of the programme. Over a number of years, Denmark has posted solid general government budget surpluses. This held also in 2003, when the surplus was 1.0% of GDP in spite of GDP growth of only 0.5%. A GDP growth rate closer to trend in 2006, higher than expected, should strengthen public finances in that year in relation to the programme scenario. In addition, higher oil prices than assumed in the update could also improve public finances as Denmark is a net oil exporter. The composition of GDP growth in the coming years, largely based on domestic demand, should cater for sustained revenues and thus support a favourable development of public finances. Over the medium term, downside risks to the projections include any failure to restrain public expenditure to targeted growth, in particular at local government level, or to reach the medium-term targets of higher employment. In view of this risk assessment, the budgetary stance in the programmes is sufficient to maintain a medium-term budgetary position of "close to balance or in surplus" as required by the Stability and Growth Pact throughout the programme period. It also provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

- The gross debt ratio stood at 44.7% of GDP in 2003 and is projected to reach 28¾% of GDP in 2010 in the update. The main contributions to the fall in the debt ratio come from positive primary balances and the impact of nominal GDP growth.

- The 2004 update reviews the government's structural reform programme which focuses on increasing employment and strengthening competition. In recent years a range of measures have been taken. The recent tax reform, fully implemented in 2004, aims to mitigate the negative impact of high taxation on labour supply, including the number of hours worked. Even after the reform, however, the top marginal tax rate remains among the highest in the EU and still applies to a relatively large share of full-time workers. The objective of the earned-income tax credit introduced as a part of the tax reform is to increase incentives to enter or stay in the labour market, primarily for low-wage-earners. The medium-term fiscal projections assume increases in employment through future reforms, recognised as necessary by the Danish authorities but which remain unspecified. With the mid-point of the programme's time-frame to 2010 approaching, the picture is therefore mixed in this regard.

- Denmark appears to be in a favourable position with regard to the long-term sustainability of its public finances, despite significant projected budgetary costs of an ageing population. The budgetary strategy outlined in the programme, mainly based on further debt consolidation through continued budgetary surpluses, should result in a sustainable position over time. However, achieving continued tight expenditure control and a considerable rise in employment on which the strategy also relies may prove challenging.

- Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances.

On the basis of this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated convergence programme of Denmark and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Denmark, 2004-2010

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 coordination 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:

(1) On [15 February] 2005 the Council examined the updated convergence programme of Denmark, which covers the period 2004 to 2010. The programme fully complies with the data requirements of the "code of conduct on the content and format of stability and convergence programmes".

(2) The macroeconomic scenario underlying the programme envisages real GDP growth firming from 2.2% in 2004 to 2.5% in 2005 and an average 1.7% in 2006-10. On the basis of currently available information, this scenario seems to reflect relatively cautious growth assumptions. The programme's projections for inflation appear realistic.

(3) The medium-term budgetary framework includes a target range of general government surpluses of 1½-2½% of GDP up to 2010 and a limit on yearly real public consumption growth of 0.5% from 2005 onwards; expenditure control is reinforced through the so-called tax freeze. Both the central government sub-sector and the pension funds are expected to show stable surpluses in the programme period. Local governments are projected to balance their budgets, as required by law. The updated programme foresees surpluses of 1.2% in 2004, 2.0% in 2005 and 1.6 % of GDP in

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

2006. The surplus reaches 2.0% of GDP in 2010. Both expenditure and revenue ratios are on a gradually declining trend over the projection period. Adjusting for the estimated impact of the cycle using the common methodology, the cyclically-adjusted budget balance is in comfortable surplus throughout the projection period. The projected general government surplus targets are close to the 2003 update. Differences in the near term are due to revised assumptions about GDP growth as well as to the effects of recent policy measures, including the March 2004 fiscal package, which frontloaded the tax reform adopted in 2003. From 2007 the projected surpluses are slightly lower than in the previous update, due to revised demographic assumptions that have contributed to lowering the long-term fiscal requirements. Overall, the current update thus broadly confirms the strategy of the previous update against a similar macroeconomic scenario.

(4) The risks to the budgetary projections are fairly balanced, though to some extent weighted towards an outcome better than projected in the first years of the programme. Over a number of years, Denmark has posted solid general government budget surpluses. This held also in 2003, when the surplus was 1.0% of GDP in spite of a GDP growth of only 0.5%. A GDP growth rate closer to trend in 2006, higher than expected, should strengthen public finances in that year in relation to the programme scenario. In addition, higher oil prices than assumed in the update could also improve public finances as Denmark is a net oil exporter. The composition of GDP growth in the coming years, largely based on domestic demand, should cater for sustained revenues and thus support a favourable development of public finances. Over the medium term, downside risks to the projections include any failure to restrain public expenditure to targeted growth, in particular at local government level, or to reach the medium-term targets of higher employment.

(5) In view of this risk assessment, the budgetary stance in the programmes is sufficient to maintain a medium-term budgetary position of "close to balance or in surplus" as required by the Stability and Growth Pact throughout the programme period. It also provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

(6) The gross debt ratio stood at 44.7% of GDP in 2003 and is projected in the update to reach 28¾% of GDP in 2010. The main contributions to the fall in the debt ratio come from positive primary balances and the impact of nominal GDP growth.

(7) Denmark appears to be in a favourable position with regard to the long-term sustainability of public finances, despite significant projected budgetary costs of an ageing population. The budgetary strategy outlined in the programme, mainly based on further debt consolidation through continued budgetary surpluses, should result in a sustainable position over time. However, achieving continued tight expenditure control and a considerable rise in employment on which the strategy also relies may prove challenging.

(8) Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2010
Real GDP (% change)	**CP Nov 2004**	**2.2**	**2.5**	**1.3**	**1.9**	**1.8**
	COM Oct 2004	2.3	2.4	2.0	n.a.	n.a.
	CP Nov 2003	*2.3*	*2.2*	*1.9*	*1.7*	*1.7*
HICP inflation (%)	**CP Nov 2004**	**1.2**	**1.7**	**1.6**	**1.7**	**1.6**
	COM Oct 2004	1.1	1.9	1.6	n.a.	n.a.
	CP Nov 2003	*1.8*	*1.7*	*1.7*	*1.7*	*1.7*
General government balance (% of GDP)	**CP Nov 2004**	**1.2**	**2.0**	**1.6**	**1.7**	**2.0**
	COM Oct 2004[2]	2.0	2.6	2.8	n.a.	n.a.
	CP Nov 2003	*1.3*	*1.8*	*1.9*	*2.1*	*2.1*
Primary balance (% of GDP)	**CP Nov 2004[3]**	**4.3**	**4.8**	**4.5**	**4.6**	**4.4**
	COM Oct 2004	4.4	4.9	4.9	n.a.	n.a.
	CP Nov 2003	*2.3*	*2.7*	*2.6*	*2.3*	*2.3*
Cyclically-adjusted balance (% of GDP)	**CP Nov 2004[1]**	**1.7**	**2.0**	**2.0**	**2.0**	**2.3**
	COM Oct 2004	2.6	2.9	3.0	n.a.	n.a.
	CP Nov 2003[1]	*1.1*	*1.5*	*1.7*	*1.9*	*2.1*
Government gross debt (% of GDP)	**CP Nov 2004**	**42.3**	**39.4**	**37.4**	**35.3**	**28.8**
	COM Oct 2004	41.5	37.5	34.2	n.a.	n.a.
	CP Nov 2003	*41.2*	*38.7*	*36.4*	*27.5*	*27.5*

Notes:

[1] Commission services calculations on the basis of the information in the programme

[2] In the September 2004 EDP notification, Denmark presented figures for general government balance and gross debt where the ATP fund was reclassified outside of the government sector, which lowered the general government surplus by around 1 p.p. of GDP. On this basis, the Commission services' autumn 2004 forecast also excluded the ATP surplus. In this assessment, the Commission services' figures for general government balance and gross debt have been recalculated so as to include the ATP fund, as is the case in the programme update. The Commission services figures for general government balance and government debt are therefore not the same as in the autumn forecast.

[3] The updated programme presents primary balances excluding net interest expenditure and not gross interest expenditure which otherwise is conventional; this table presents primary balances excluding gross interest expenditure.

Sources:
Updated Convergence Programme, November 2003 and November 2004 (CP); Commission services autumn 2004 economic forecasts (COM; see note 2 above); Commission services calculations