COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 19.2.2008
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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, 2007-2010**

(presented by the Commission)

# 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 acknowledged its usefulness in anchoring fiscal discipline but 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. The first convergence programme of Denmark was submitted in October 1998. In accordance with the Regulation, the Council delivered an opinion on it 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 and if necessary 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 21 December 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

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

(1) 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),

(2) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies, and

(3) the Commission's assessment of the October 2007 implementation report of the national reform programme.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

### 2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 February 2007, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2006-2010, as follows: *"The Council considers that the medium-term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact"*.

### 2.2. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[2]. Denmark was not recommended to take particular action in the area of budgetary policies.

### 2.3. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which included an assessment of the October 2007 implementation report of Denmark's national reform programme[3]. This can be summarised as follows.

Denmark's national reform programme identified as key challenges: ensuring fiscal sustainability; improving competition in certain sectors; enhancing public sector efficiency; developing the knowledge society; securing environmental sustainability and energy; encouraging entrepreneurship; and increasing labour supply.

The Commission's assessment was that Denmark has been making very good progress in implementing its national reform programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Denmark should focus on the areas of: enhancing energy interconnection; increasing labour supply; and achieving education targets.

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[2] OJ L 92, 3.4.2007, p. 23.

[3] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)" - COM(2007) 803, 11.12.2007.

**Box: Main points covered by the assessment**

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[4] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[5] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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# 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, 2007-2010**

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[6], 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 [4 March 2008] the Council examined the updated convergence programme of Denmark, which covers the period 2007 to 2010[7] and gives further indications of developments towards 2015.

(2) In recent years, the Danish economy has been characterised by strong real GDP growth, sizeable employment gains, high capacity utilisation, low inflation and a stable exchange rate within the ERMII. Over the past year, however, capacity constraints have started to inhibit economic activity, and signs of increasing price and wage inflation have appeared. While the external balance still shows a surplus, the implication of mounting cost pressures and labour shortages for competitiveness is of rising concern. Public finances remain strong with sustained general government surpluses and a continued reduction of debt. The key challenge for fiscal policy at the current juncture is to maintain a prudent fiscal stance so as to avoid contributing to further labour market pressure. Ensuring that spending limits are adhered to represents an additional challenge, particularly in times of buoyant revenue, but is nevertheless important given the government's ambitions for ensuring fiscal sustainability.

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6 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

7 The update was submitted more than 3 weeks beyond the 1 December deadline set in the code of conduct in view of the formation of a new government following the November general elections.

(3) The programme envisages that the Danish economy is at the peak of its business cycle and is now facing a period of more moderate growth. Therefore, real GDP growth is expected to slow down from 2% in 2007 to 1% on average over the rest of the programme period. Assessed against currently available information[8], this scenario appears to be based on plausible growth assumptions in 2008 and cautious assumptions thereafter due to the underlying assumption in the update of a large positive output gap (calculated using a national methodology)[9] closing towards 2011. The programme's projections for wage and price inflation appear to be on the low side, particularly for 2009, in view of domestic wage pressures as well as global trends. However, price stability should be preserved throughout the programme period.

(4) For 2007, the general government surplus is estimated at 4.0% of GDP in the Commission services' autumn 2007 forecast, against a target of 2.8% of GDP set in the previous update of the convergence programme. This over-performance reflects a significant positive base effect from 2006 due to stronger-than-expected employment growth and higher revenue from oil- and gas- related activities in the North Sea than anticipated. The current programme anticipates a surplus at 3.8% of GDP, but in light of more recent information[10], revenue is likely to be higher than expected by ½ percentage point of GDP, and thus the surplus is likely to be revised upwards accordingly (to about 4½% of GDP).

(5) Guided by the general objective of ensuring fiscal sustainability, the main goal of the budgetary strategy is to maintain high, although rapidly declining surpluses (from 3.8% of GDP in 2007 to 3.0% in 2008 and further to 1.2% in 2010[11]) against the background of weakening cyclical conditions. The medium-term objective (MTO) for the budgetary position is revised upwards[12] by ¼ percentage point of GDP to a structural surplus (i.e. cyclically adjusted surpluses net of one-off and other temporary measures) of between ¾% and 1¾% of GDP. The MTO will be overachieved throughout the programme period. The path for the headline surplus is broadly similar to the previous update, although starting from a higher surplus, against a broadly comparable macroeconomic background. The strategy relies on the continued application of the tax freeze[13] and expenditure restraint and envisages some tax cuts. The expenditure restraint is targeted through annual limits for real public consumption expenditure growth (becoming increasingly tight from 1¾% in 2008 to 1% in 2009-2010), and a cap on nominal public consumption expenditure at 26½% of cyclically-adjusted GDP towards 2015. The structural balance calculated according to the commonly agreed methodology is foreseen to remain broadly unchanged at 3½% in

[8] The assessment takes notably into account the Commission services' autumn 2007 forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

[9] Using the national methodology, different from the commonly agreed methodology, leads to higher output gaps (due to a lower estimate of potential growth).

[10] The *Budget Outlook* accompanying the draft budget bill presented on 5 February 2008.

[11] In the forecast accompanying the new draft budget bill for 2008, published by the Danish Ministry of Finance on 5 February 2008, surpluses are revised upwards to 4.4% of GDP in 2007, 3.7% in 2008 and 2.7% in 2009.

[12] This is due to the assumed continued suspension beyond 2008 of the "special pension contribution", which previously generated an income tax deduction for private pension savings in the order of ¼ % of GDP. It is therefore planned to increase the MTO by the resulting increase in tax revenue.

[13] The tax freeze implies that from 2002 onwards, neither direct nor indirect tax rates can be raised, whether defined in nominal or percentage terms.

2007-2008 and to drop to 2½% in 2009-2010[14]. The programme indicates lower surpluses towards 2015, as the effects of ageing are expected to set in and revenue sources in the North Sea are foreseen to subside.

(6) The budgetary outcomes could be better than projected in the programme, particularly in view of the better-than-expected outcome for 2007 as indicated at the presentation of the 2008 draft budget bill on 5 February 2008. The good track record of sizable surpluses, often being revised upwards due to positive revenue surprises, and the cautious macro-economic outlook from 2009 outweigh the risk relating to the somewhat weaker performance in adhering to government consumption expenditure growth limits.

(7) In view of this risk assessment, the budgetary stance in the programme allows meeting the MTO by a wide margin throughout the programme period, as envisaged in the programme. The fiscal policy stance implied by the programme is broadly in line with the Stability and Growth Pact throughout the period.

(8) Denmark appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is lower than on average in the EU, notably thanks to the pension reform included in the Welfare Agreement[15]. Moreover, the budgetary position in 2007 as estimated in the programme, with a large structural surplus, contributes to the reduction of gross debt. Maintaining high primary surpluses over the medium term will further limit any risks to the sustainability of public finances.

(9) The convergence programme seems to be consistent with the October 2007 implementation report of the national reform programme. Both the programme and the implementation report are based on the economic strategy "Towards new goals – Denmark 2015", presented by the government in August 2007. Public finance effects of major reform measures such as the envisaged energy strategy and the so-called "Quality Fund" for investments in public services (mainly healthcare, child care and care for the elderly) are explicitly taken into account.

(10) 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[16].

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14 Differences in the definition of one-offs and temporary measures imply that estimates for the structural balance are not readily comparable with the Commission services' projections.

15 The "Agreement on Future Prosperity, Welfare and Investments in the Future", concluded by the government in June 2006, raises the standard retirement age from 65 to 67 years and the early retirement age from 60 to 62 years over the next 20 years. From 2025 age limits will be indexed to changes in life expectancy.

16 However, total revenue and total expenditure figures and some subcomponents do not correspond to the harmonised definitions. The specifications of the stock-flow adjustments are missing among the optional data.

The overall conclusion is that the programme aims at maintaining a sound budgetary position fully respecting the MTO throughout the period, while adhering to the long-term objective of fiscal sustainability. Foreseeing high, albeit rapidly declining, surpluses over the programme period, the budgetary targets appear to be on the cautious side, in view of the better-than-expected 2007 outcome and the most recent projections. The risk to long-term sustainability is assessed to be low. For the present, the most important policy challenge is to address labour shortages and looming cost pressures through a mix of structural and macroeconomic policies. Further measures need to be identified and implemented to stimulate labour supply. Meanwhile, the fiscal stance should be considered carefully so as to avoid pro-cyclicality. Therefore, containing public consumption expenditure growth, as foreseen in the programme, remains of high priority.

## Comparison of key macroeconomic and budgetary projections

| | | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| Real GDP (% change) | **CP Dec 2007** | **3.5** | **2.0** | **1.3** | **1.1** | **0.5** |
| | COM Nov 2007 | 3.5 | 1.9 | 1.3 | 1.4 | n.a. |
| | *CP Dec 2006* | *2.7* | *2.0* | *0.7* | *0.7* | *0.6* |
| HICP inflation (%) | **CP Dec 2007** | **1.9** | **1.7** | **2.4** | **1.6** | **1.9** |
| | COM Nov 2007 | 1.9 | 1.7 | 2.4 | 2.4 | n.a. |
| | *CP Dec 2006* | *2.0* | *1.8* | *1.7* | *1.8* | *1.7* |
| Output gap[1] (% of potential GDP) | **CP Dec 2007** | **1.2** | **1.0** | **0.3** | **-0.4** | **-1.5** |
| | COM Nov 2007[2] | 1.1 | 0.7 | -0.2 | -0.9 | n.a. |
| | *CP Dec 2006* | *0.9* | *0.9* | *-0.3* | *-1.3* | *-2.3* |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | **CP Dec 2007** | **2.4** | **1.7** | **1.3** | **1.9** | **2.2** |
| | COM Nov 2007 | 2.4 | 1.2 | 0.7 | 0.6 | n.a. |
| | *CP Dec 2006* | *1.6* | *1.7* | *1.3* | *1.2* | *1.3* |
| General government balance (% of GDP) | **CP Dec 2007** | **4.6** | **3.8** | **3.0** | **2.0** | **1.2** |
| | COM Nov 2007 | 4.6 | 4.0 | 3.0 | 2.5 | n.a. |
| | *CP Dec 2006* | *3.1* | *2.8* | *2.5* | *1.8* | *1.2* |
| Primary balance (% of GDP) | **CP Dec 2007** | **6.2** | **5.2** | **4.2** | **3.0** | **2.1** |
| | COM Nov 2007 | 6.2 | 5.3 | 4.3 | 3.6 | n.a. |
| | *CP Dec 2006* | *4.7* | *4.3* | *3.3* | *2.5* | *1.8* |
| Cyclically-adjusted balance[1] (% of GDP) | **CP Dec 2007** | **3.8** | **3.1** | **2.8** | **2.3** | **2.2** |
| | COM Nov 2007 | 3.9 | 3.6 | 3.2 | 3.0 | n.a. |
| | *CP Dec 2006* | *2.5* | *2.2* | *2.7* | *2.6* | *2.7* |
| Structural balance[3] (% of GDP) | **CP Dec 2007** | **2.7** | **3.5** | **3.4** | **2.5** | **2.5** |
| | COM Nov 2007 | 3.6 | 3.2 | 3.4 | 3.0 | n.a. |
| | *CP Dec 2006* | *2.2* | *1.9* | *2.7* | *2.6* | *2.7* |
| Government gross debt (% of GDP) | **CP Dec 2007** | **30.1** | **25.6** | **21.6** | **19.2** | **18.6** |
| | COM Nov 2007 | 30.3 | 25.0 | 20.9 | 17.5 | n.a. |
| | *CP Dec 2006* | *29.8* | *25.8* | *22.7* | *20.5* | *19.0* |

Notes:

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

[2] Based on estimated potential growth of 2.2%, 2.3%, 2.2% and 2.0% respectively in the period 2006-2009.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 1.1% of GDP in 2006 (surplus-increasing) and 0.4%, 0.6%, 0.2% and 0.3% of GDP respectively in the period 2007-2010 (all surplus-reducing) according to the most recent programme and 0.3% of GDP in both 2006 and 2007 (surplus-increasing) and 0.2% in 2008 (surplus-reducing) in the Commission services' autumn forecast. However, the programme uses a different definition of a one-off measure, as the temporary variations in revenue identified in the programme are not considered as one-offs by the Commission services.

*Source:*

*Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*