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DENMARK: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Denmark's convergence programme was submitted on 21 December 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 3 March 2008. Comments should be sent to Lotte Taylor (Lotte.Taylor@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services' autumn 2007 forecast, (ii) the code of conduct ("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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 19 February 2008. The ECOFIN Council adopted its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Denmark, has to submit a convergence programme and annual updates thereof. The most recent Danish programme update was submitted on 21 December 2007 based on the government's economic 2015-plan presented in August 2007. For the purpose of this macro-fiscal assessment, the programme covers the period 2007-2010 in detail and gives further indications towards 2015.

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. In this context, it is important to ensure that spending limits are adhered to, particularly in times of buoyant revenue, also in view of the government's ambitions for ensuring fiscal sustainability.

As reported in the programme, the Danish economy is presently around the peak of its business cycle and appears to be facing a period of more moderate growth. 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, 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) 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 is foreseen to be preserved throughout the programme period. Denmark is considered to be in economic "good times" in 2008, turning neutral in 2009.

On 5 February 2008, the government presented a new draft budget bill with an accompanying forecast, updating the projections presented in the programme. The forecast confirms the outlook of growth moderation and revises inflation estimates upwards in line with global trends.

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[1], revenue is likely to be higher than expected by ½ percentage

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

point of GDP, and thus the surplus is likely to be revised upwards accordingly (to about 4½% of GDP).

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) against the background of weakening cyclical conditions. The medium-term objective (MTO) for the budgetary position is revised upwards 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 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 2007-2008 and to drop to 2½% in 2009-2010. On the back of reforms enhancing long-term sustainability, 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.

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.

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.

Gross debt has been reduced significantly in recent years, and 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. 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.

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.

Based on Denmark's October 2007 implementation report, the Commission assessed in its Strategic Report[2] that Denmark has been making very good progress in implementing its national reform programme over the 2005-2007 period. 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.

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.

[2] 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.

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

1. INTRODUCTION

The Danish 2007 update of the convergence programme was submitted on 21 December 2007.[3] The late submission was due to recent elections held on 13 November 2007. The new update covers the period 2007-2010 in full and gives further indications towards 2015. For the period 2011-2014, however, the programme does not provide the full set of data. As a result, this assessment focuses on the period 2007-2010. The updated programme was sent to the Danish parliament for information.[4] The update is based on the same economic projections as the Government's draft Budget Bill for 2008 presented in August 2007. The draft bill was withdrawn in view of the elections. A new draft budget bill was presented on 5 February 2008, and negotiations on this basis are ongoing.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Denmark, with a particular focus on public consumption expenditure growth in view of the tax freeze. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON PUBLIC CONSUMPTION EXPENDITURE GROWTH IN VIEW OF THE TAX FREEZE

Public finances in Denmark are among the strongest in the EU. In recent years Denmark has recorded successive general government surpluses of well above 4% of GDP per year. The sizable budget surpluses are to a large extent due to strong economic and employment growth, as well as recent windfall revenues from the tax on pension fund returns and from the oil and gas activities in the North Sea.

The positive development in public finances has been supported by a well-designed fiscal strategy pursuing the twin objectives of stability in the short- and medium-term and sustainability in the long-term.

On the revenue side, there is strong political commitment to the *tax freeze*, introduced in 2002, which keeps unchanged all direct and indirect tax rates, whether expressed as a

[3] The English version was submitted on 17 January 2008.

[4] The convergence programme update serves as the main tool for reporting on the development in relation to the fiscal strategy.

percentage or in nominal terms (cf. Section 2.2). In the absence of cyclical and temporary factors, the tax freeze would imply a decreasing tax burden, and would – for a given deficit target – indirectly constitute a constraint on expenditure. However, in the present situation, high revenues imply that the constraint is not binding.

On the expenditure side, ambitious targets have been set for limiting growth in public consumption expenditure. Challenges remain in ensuring that the targets are achieved. In this regard regional and local governments play an important role, as they are responsible for a large share of public consumption and have wide-ranging powers. The annual budget agreement, negotiated by the central government and the associations of regional and local governments, appears inadequate as an institutional arrangement for ensuring that growth limits are respected. The difficulties in limiting public expenditure also reflect differing objectives and means. Central government fiscal policy is focused on fiscal stability and sustainability, but at the same time policy initiatives launched centrally generate expectations for services provided at local government level. Local governments tend therefore to focus more on short-term policy objectives, and are less concerned about long-term aspects. While such difficulties are common to most economies, the local governments' high degree of fiscal autonomy makes the challenge of aligning interests particularly important for Denmark.

Tight policies are particularly needed at the current juncture, because the labour market remains tight, capacity utilisation is high, and wage inflation is picking up.

2.1. Sound public finances overall

Both in a historical perspective and in comparison to other EU Member States, Danish public finances are sound, reflected in sustained surpluses and rapid reduction of debt levels. Local government borrowing is limited by legislation. In recent years, buoyant revenues from oil- and gas-related activities and from the tax on pension fund returns have contributed substantially to budget surpluses. In view of the volatility of such sources of revenue, it is widely recognised that the current strength of the public finances is to a significant extent transitory.

Figure 1: Net lending and debt

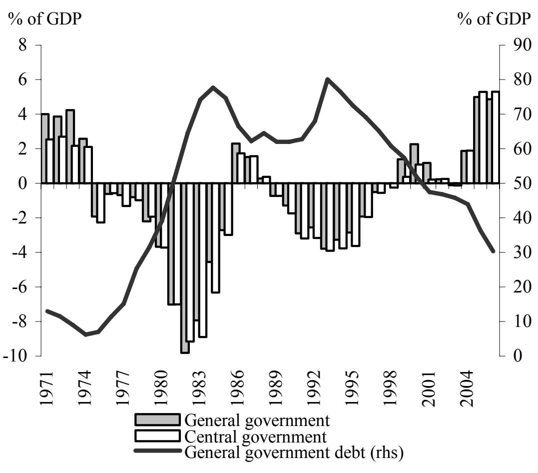
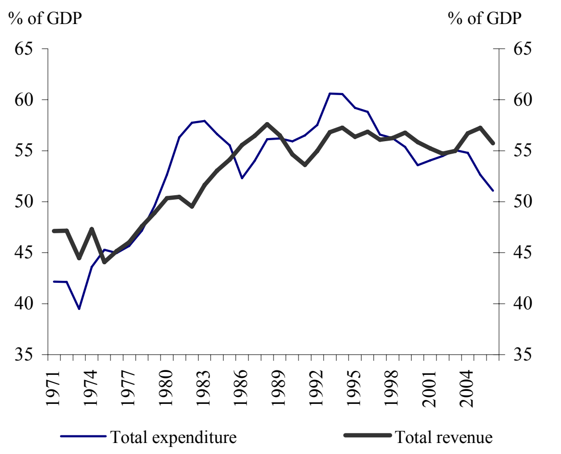


Figure 2: Revenue and expenditure ratios



Sources: Statistics Denmark, European Commission, Ameco

During the expansion of the public sector in the 1970's and 1980's total revenue and expenditure ratios soared from around 45% of GDP to levels above 55% of GDP. After peaking in 1992 at over 60% of GDP, the total expenditure ratio has fallen every year except in the most recent slow-down 2000-2003. During the recent upswing, public finances have benefited from lower unemployment and lower interest payments (due to lower interest rates and debt levels), reducing total expenditure to 51% of GDP. This is the lowest level since 1979, yet significantly higher than the EU-27 average of 45% in 2006. On the revenue side, the level has been relatively more stable yet high, around 56% of GDP, since the beginning of the 1990's (EU-27 averaging 46%).

The Danish economy is characterised by strong automatic stabilisers, and the budgetary sensitivity is the highest in the EU concerning both revenues and expenditure.[5] This holds true on the expenditure side, in particular, where low GDP growth has coincided with an increasing expenditure ratio. Analysis by the Danish Economic Council suggests that Danish fiscal policy has generally played a moderately stabilising role with only few instances of pro-cyclicality.[6] More recently, however, the chairmanship of the Council is clearly emphasising the need to tighten fiscal policy to avoid pro-cyclicality.[7]

2.2. The revenue side is subject to constraints

2.2.1. The tax freeze

While recognising the low level of debt and efforts made to prepare for the ageing of the population, the high tax burden leaves Denmark with limited room for manoeuvre to increase taxes, should imbalances require it in the future. With strict adherence to the tax freeze, this possibility is *de facto* eliminated.

The tax freeze is not enshrined in legislation; it stems from a clear pledge made by the government as it came to power in November 2001. With effect from 2002 no direct and indirect tax rates, whether expressed as a percentage or in nominal terms, can be raised. Specifically, the taxation of residential housing is capped in nominal terms. The tax freeze has become the fundamental principle of the government’s tax policy, with very limited possibilities for deviation. If changes are unavoidable, e.g. due to a court ruling, or desirable for environmental reasons, amendments can be made provided that revenue effects are neutralised.

The interpretation and enforcement of the tax freeze has been strict, and it has implied a gradual erosion of tax bases defined in nominal terms in particular. During the boom in the housing market, consumption possibilities increased considerably; through realised, untaxed capital gains and through widespread credit access by new financial products enabling equity release. As a consequence of the tax freeze, the automatic stabilising effect of taxation, previously taking its share of higher residential property value, has been absent.

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[5] European Commission, Directorate-General for Economic and Financial Affairs (2006) *Public Finances in EMU 2006*

[6] De Økonomiske Råd (2007) *Dansk Økonomi forår 2007*

[7] Sørensen, P. B. et al. (2007) "Ansvarlig økonomisk politik efterlyses" *Berlingske Tidende,* 11 December

2.2.2. *Fiscal powers at various levels of government*

There are three administrative levels in Denmark: central, regional and local. Since the reform in the beginning of 2007 the local level counts 98 municipalities. Five regions replaced the 13 counties at the regional level. The reform was accompanied by adjustments of financing and equalisation systems.

In comparison with local governments in other Member States, Danish municipalities enjoy a high level of autonomy reflected in particular in the power to tax income, property and corporate income. Taxation is thus the primary source of revenue for local governments. Since the reform, the regions no longer have tax powers. The revenue side of local and regional government budgets is described in Box 1.

Box 1: Local and regional government finance

The *regions* are financed primarily by a state block grant, but with a 20% element of co-financing from municipalities. For the *municipalities*, tax revenue amounts to more than half their total revenue, the remaining being composed mainly of operating and capital revenue (from charges, sales), reimbursements and general subsidies (block grant) from the state. An equalisation system is in place to correct in part for differences in demography and social structure. Furthermore, a mechanism named "the principle of extended total balance" is applied, ensuring that sector ministries become financially responsible for decisions with financial implications for the local government sector.

In principle, municipalities are subject to a balanced budget constraint on a cash basis, but on a National Accounts basis this may allow some net lending or borrowing. By law, the minister responsible for interior affairs is empowered to determine the credit conditions of local and regional governments. In general terms, loans can only be obtained for certain investments, certain energy saving measures and expenditure related to social housing. In some cases, particularly for sale-and-lease-back arrangements, the minister is empowered to approve and determine rules for depositing the revenue obtained by the sale.

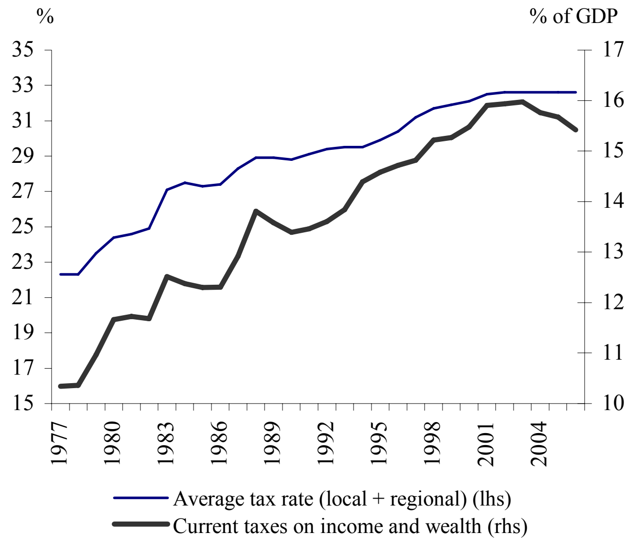
Income taxes are collected by the central government. Municipalities can opt for a state-guaranteed formula determining tax revenue, grants and equalisation payments, or for being self-budgeting. When opting for the former, payments are made in preliminary instalments based on the projected revenue, population etc. at the time of the budget agreement. When opting for the latter, preliminary instalments are determined on a similar basis, but the differences to revenue received are corrected for three years after, being treated as a loan with interest in the meantime. Whereas the state-guaranteed formula is fixed in the budget agreement, typically in June, municipalities are free to choose either option until adopting their budgets in October. Insofar as prospects improve in the meantime - indicating that the state-guaranteed revenue level can be exceeded - there is an incentive to opt for self-budgeting to maximise revenue. This has been the case in recent years in particular, where the vast majority has opted for self-budgeting. Two mechanisms ensure that incentives to speculate in the systems are limited: Firstly, the effect of the equalisation system implies that municipalities only end up with less than ¼ of any surplus revenue, and, secondly, the interest rates applied until correction are asymmetric and high in the event of a negative correction.

The average tax rate composed of local and regional income tax has increased steadily between the 1970's and 2002, and has since levelled off in accordance with the tax freeze (Figure 3). The total local and regional revenue from current taxes on income and wealth (including residential property tax) has increased correspondingly, but in recent years less rapidly than GDP. This reflects partly the effect of the tax freeze, capping the revenue from residential property tax[8], and partly that GDP growth has been driven by more external factors such as shipping and the gas and oil activities in the North Sea rather than factors increasing the income tax base.

Since the Danish central government introduced the tax freeze in 2002, it has been applied to local and regional government taxes via the budget agreement. To enforce it, a sanction mechanism was outlined implying penalties in the event that the aggregate tax rate were to be increased. The penalties envisaged included cutting the block grant or withholding deposited funds. As yet, no such sanctions have been enforced. In order to ensure that the tax freeze is respected from the point of view of the tax payers, the government committed politically to neutralise any aggregate tax increases by reducing the central government base tax correspondingly. The new draft budget bill presented on 5 February 2008 includes such a proposal to be implemented in 2009.

In 2006 and 2007, during the extensive reform of municipalities and counties, agreement was reached to freeze the tax rates in the individual municipalities and counties/regions. With the budget agreement for 2008, municipalities were once again free to set tax rates, provided that total revenue would increase by a maximum of ¾ billion DKK (0.04% of GDP). It appears from the most recent aggregation of local budgets that this limit will be exceeded by more than ½ billion DKK. Nonetheless, sanctions will not be enforced on this basis; the issue has been referred to the budget negotiations in the spring of 2008.

Figure 3: Local and regional tax revenue and rates



<u>Source</u>: Statistics Denmark

Following normalisation of cyclical and temporary factors, the tax freeze will result in a continued fall in the total revenue ratio. The implication hereof is mounting pressure to restrain government expenditure.

[8] Local governments are compensated for this effect via the state block grant.

2.3. Sustaining expenditure restraint

Public consumption accounts for about half of total general government expenditure in Denmark, corresponding to around one quarter of GDP. Social transfers fluctuate at around one third of GDP, depending on economic activity. Public investments amount to less than 2% of GDP. Following the rapid reduction in debt, interest expenditure has also abated to a level of around 2% of GDP. The recent drop in the expenditure ratio (cf. Figure 2) reflects mainly cyclical factors affecting social transfers and – although to a lesser extent - that public consumption expenditure is growing less rapidly than GDP.

Public consumption expenditure is highly decentralised, with local and regional governments managing expenditure amounting to nearly 20% of GDP[9]. The central government share has been reduced over time, from 9 % of GDP in 1971 to 7% in 2006, initially reflecting that local and regional government tasks and responsibilities have been extended. More recently, improved practices at the central government level, e.g. measures concerning public procurement, are likely to contribute to limiting central government expenditure growth.

Figure 4: Final consumption expenditure by sector

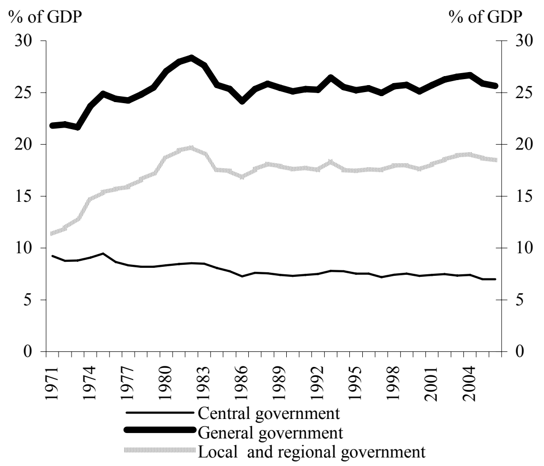
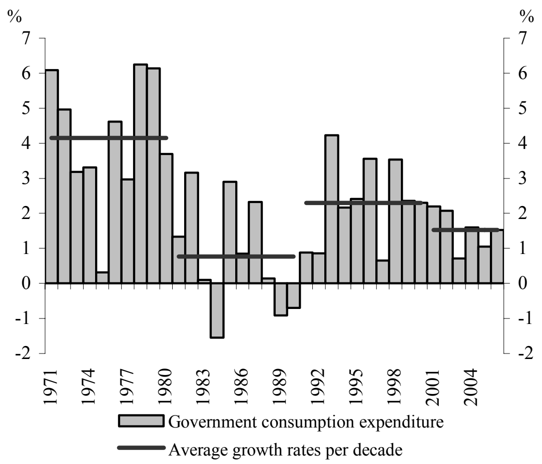


Figure 5: Government consumption expenditure, real annual growth



Source: Statistics Denmark

Real annual growth rates for government consumption expenditure have generally declined over the last decade. In view of the tax freeze and the prospects of increasing ageing-related expenditure, it is important that this development is sustained. Ambitious targets have been set accordingly, aiming at limiting public consumption expenditure growth to ensure sustainability. However, these targets have rarely been met. The following Section outlines the policy framework and institutional settings to shed light on the factors driving expenditure growth.

[9] Municipal tasks comprise child care, primary schooling, care for the elderly, cultural activities, granting certain social benefits, integration of refugees and immigrants, certain aspects of active labour market policies, public utilities, environmental measures and emergency services. Regions are responsible for health care, operation of social and special education institutions, and regional development.

2.4. Policy framework and institutional settings

2.4.1. General government

Since 1997, successive governments have been pursuing a similar approach, adopting medium-term macro-economic plans serving as a framework for fiscal policy, within which the budgetary framework is determined.

In the terminology of previous European Commission analysis[10] the Danish medium-term budgetary framework (MTBF) falls in the category of periodical, fixed frameworks, where medium-term targets are set once and for all for a definite time period, and where targets are not systematically updated during the period.

The most recent medium-term fiscal plan, "Towards new goals – Denmark 2015", was presented in August 2007 updating the previous plan for the period until 2010. Within the overall objective of fiscal stability and sustainability, the plan identifies key medium-term targets corresponding to a macro-economic scenario compatible with the objective of long-term sustainability.

The fiscal policy framework contains the following main elements:

- Budgetary element: target values for general government budget: Structural surpluses of ¾-1¾ % of GDP in 2008-2010, balance as a minimum in 2011-2015.[11]
- Revenue element: the tax freeze is maintained until 2015.
- Expenditure element: public expenditure policy aimed at fiscal sustainability expressed as a specific expenditure ratio as a point of orientation (26½% of GDP), determining limits to real annual public expenditure growth largely in line with projected real GDP growth.[12]

Compared with the previous plan, budgetary targets are largely unchanged until 2010. The less ambitious targets for the subsequent period reflect the beginning effects of the ageing of the population and subsiding revenue from oil and gas extraction in the North Sea. The revenue element is unchanged as the tax freeze is assumed retained until 2015.

The expenditure element has been elaborated, linking expenditure growth to a level of public service provision relative to GDP rather than simply constraining the growth to a specific rate. The cost-effectiveness or quality of public consumption expenditure is not included in the expenditure rule, but partly addressed elsewhere in the 2015-plan. In accordance with the plan, a "Quality Reform" package was presented, proposing a wide range of measures (see Section 6). The implementation thereof will be negotiated in 2008, at which point a strong focus on cost-effectiveness will be important to curb expenditure growth.

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[10] European Commission, Directorate-General for Economic and Financial Affairs (2007) *Public Finances in EMU - 2007,* European Economy No. 3

[11] It is not specified in the plan whether the targets are to be met on average or whether they are applicable each year.

[12] The plan allows for annual real public expenditure growth of 1¾% in 2008, 1% in 2009-2012 and ¾% in 2013-2015 (see Figure 7).

In addition to the three main elements, the fiscal plan emphasises the importance of a coordinating element, namely the agreement-based balanced budget constraint for the local and regional government level.

2.4.2. Fiscal relations with local and regional government

In order to coordinate macroeconomic policy and the decentralised provision of public services, an institutionalised system of cooperation has been established resulting in annual budget agreements. The first agreement was applicable for the year 1980, and the system of agreements has been relatively stable since 1990. The main elements of the annual budget agreement concern recommendations for the setting of tax rates, and the terms for other types of financing and liquidity constraints. Furthermore the agreements typically contain recommendations for priorities and special focus areas as well as horizontal issues.

The agreements are entered by the central government on the one side and the associations for local and regional authorities on the other. The agreements are not legally binding and the parties are only partly empowered to ensure their enforcement. The government, which is often a minority coalition, can commit to executing certain tasks e.g. issuing certain regulations – but cannot ex ante commit on behalf of the parliament to adopting e.g. financing elements. Similarly, the associations have no powers to commit to financing obligations for the individual municipality or region, and therefore agree only to recommendations.

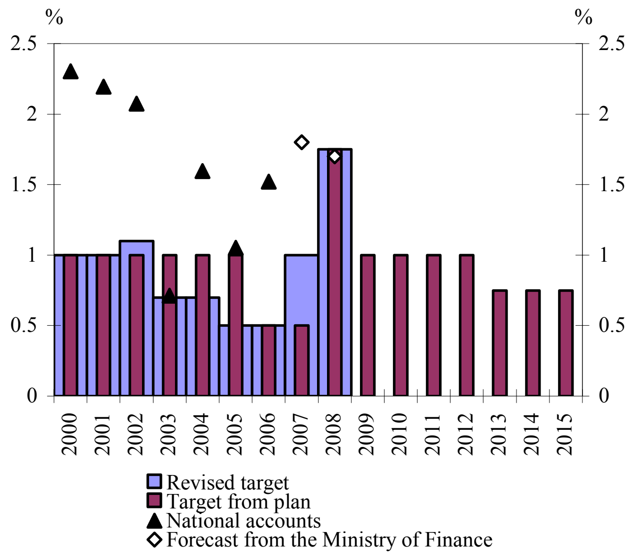
The two associations – Local Government Denmark (LGDK) and Danish Regions - have gained strong positions based on long experience in preparing and conducting negotiations on the annual budget agreement with the government. As municipalities and regions employ nearly ¼ of the labour force, they also play an important role as employers' associations in negotiations with the trade unions.

The instruments available to central government for controlling local and regional government consumption expenditure thus centre on the block grant, rules for the setting of taxes and credit and liquidity constraints.

2.4.3. Strengths and weaknesses

The recent plan reiterates the ambitious medium-term objective (MTO) for the period until 2010. The revenue rule – the tax freeze - has been effectively enforced at the central government level, and has served as a political commitment easily assessed by the public. The strict adherence to the rule may, however, entail some risks of pro-cyclical developments in public finances, as seems to be the case with the recently adopted lowering of income taxes.

Figure 6: Government consumption expenditure, real annual growth



<u>Note:</u> *Revised target from August the preceding year.*
<u>Sources:</u> *Ministry of Finance*

As depicted in Figure 6, the expenditure growth limits have been exceeded more often than not. The targets determined in the 2015-plan are less ambitious than previous targets, although still aiming at constraining expenditure growth compared to historical averages. In addition to the growth limits, a new target has been identified: Expenditure is to remain within a maximum share of GDP[13]. The somewhat weak track record in meeting the targets to limit expenditure growth indicates a downside risk to public finances, which is relevant in assessing the long-term sustainability aspects of the plan.

The European Commission has conducted several studies on the design and implementation of fiscal rules in general and expenditure rules in particular. In general terms, the analyses suggest that ambitious rules contribute to expenditure control, and that consolidations are more likely to be expenditure based in countries with stronger rules such as Denmark alongside the Netherlands, Austria, Finland, Sweden and the UK. [14]

In institutional terms, the Danish MTBF is well-regarded. Assessed against criteria evaluating the quality of institutions for medium-term budgetary planning, Denmark ranks among the highest along with Sweden, Austria and Finland.[15] This reflects its comprehensive nature, its connection to the preparation of the annual budget, the involvement of the national Parliament, and the existence of coordination, monitoring and enforcement mechanisms and procedures. The weaker institutional aspects relate to

[13] In the 2015 plan, the maximum share is specified as 26½% of cyclically-adjusted GDP.

[14] European Commission, Directorate-General for Economic and Financial Affairs (2005) *Public Finances in EMU - 2005,* European Economy No. 3

[15] European Commission, Directorate-General for Economic and Financial Affairs (2007) *Public Finances in EMU - 2007,* European Economy No. 3

monitoring and sanctions in the event of non-compliance, of which there are none specified.

Monitoring the fiscal rules in force is one task of the Danish Economic Council. It is an advisory body that publishes forecasts for the Danish economy and economic analyses and recommendations related notably to fiscal policy issues, covering the functioning of the public sector, the tax system, fiscal sustainability, and the appropriate fiscal stance in the prevailing cyclical conditions.[16] Whereas the chairmanship of the Council issues recommendations with the view to improve compliance with the fiscal rules, it has no authority to ensure that its recommendations are followed, and it is not involved in the budgetary process. The influence on decision-making procedures is thus mainly achieved through visibility in the media spurring public debate. In the most recent autumn report, the chairmen of the Economic Council note that the main follow-up to the implementation of the government's fiscal plan is presently done in the annual convergence programme, where results are assessed and targets revised. This leads to a recommendation that the follow-up be enhanced, suggesting annual reporting to the parliament on the status for attaining economic medium-term objectives. [17]

As an outcome of a budget procedure, Danish government finances are subject to sources of uncertainty before, during, and after a budget period. When drawing up the budget, estimates are particularly uncertain with regard to specific sources of revenue that are difficult to forecast. Due to their volatility, cautious estimates are applied. Such revenue volatility is generally confined to the central government level.

Monitoring during the budget period and over the period covered by a MTBF is complicated by uncertainties relating to statistics. Danish statistics for government finances (net lending and debt) are characterised by frequent and substantial revisions.[18] In drawing up targets such as the government consumption expenditure-to-GDP ratio and expenditure growth, revisions might imply that targets, previously considered met, need to be reassessed as exceeded.

In relation to suggesting enhanced monitoring, the chairmen of the Economic Council recently recommended defining additional target shares of GDP for e.g. public investment, direct and indirect tax revenue.[19] As the targets are determined as shares of *"GDP corrected for cyclical and other temporary factors"*, any assessment is complicated by uncertainty relating both to the statistics and to the definition and measurement of cyclical and temporary factors. Furthermore, such targets do not take demographic effects into account.

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[16] As described in European Commission, Directorate-General for Economic and Financial Affairs (2006) *Public Finances in EMU - 2006,* European Economy No. 3. Subsequently the Economic Council has merged with the Environmental Economic Council, an advisory body on environmental economics issues, together constituting the Economic Councils.

[17] De Økonomiske Råd (2007) *Dansk økonomi, efterår 2007*

[18] Gordo Mora, Luis and Joao Nogueira Martins (2007) How reliable are the statistics for the Stability and Growth Pact?, European Commission, DG ECFIN, European Economy Economic Papers Number 273

[19] Det Økonomiske Råd (2006) *Dansk økonomi, efterår 2006*, proposal presented again in De Økonomiske Råd (2007) *Dansk økonomi, efterår 2007*

Notwithstanding the difficulties in ensuring transparency in assessing cyclical and other temporary factors, target *share*s may be more easily understood than nominal or real growth rates and expenditure levels, and may therefore be useful tools for conveying economic arguments to the public. In the preparation of the welfare reform agreement in 2006, the rationale for reform was successfully explained outlining the sustainability challenge and the fundamental question of fair distribution across generations. At a time when net debt has been eliminated and cyclical factors and windfall revenue generate sizable surpluses, it is a considerable challenge, but nevertheless necessary, to explain that the same rationale requires restrictions on government consumption expenditure growth.

With regard to the interplay with the local and regional levels, expansionary pressure originates from all stages of the budget process. At the outset, the target growth rate is determined by the fiscal strategy of the government (the MTBF). It is, however, likely to be exceeded already in the proposal for negotiation presented by the government to the local and regional representatives, taking existing initiatives, trends, incentives and negotiating powers into account.[20] During negotiations moral hazard prevails due to asymmetric information with regard to realised as well as potential efficiency gains. Moreover, the incentives are such that the budget increases are required in order for local and regional negotiators to maintain the backing of their members. During the execution of the agreement, there is risk of free-riding behaviour, particularly in view of the non-binding nature of the agreement. There is a risk that the local level free-rides on expenditure restraint shown by the central level, but also more recently among municipalities in setting tax rates, because the tax freeze is imposed on the aggregate level. Meanwhile, the weak track record with regard to imposing sanctions is likely to have been taken into account at the earlier stages, weakening central government negotiation powers.

The common pool resource problem at the local government level is aggravated by the fact that the parties are inadequately empowered to ensure that an agreement is respected. In situations with a coalition minority government, political disagreements are generally reflected at the local government level, making it difficult for the central government to get local government representatives from opposition parties to contribute to meeting targets.

Making the budget agreements more credible is necessary to reach the objective of fiscal sustainability. To this end, a range of initiatives will be considered in the run up to the negotiations of the budget agreement for 2009. Within the present system, the commitment of the parties could be strengthened *ex ante*, and the specification and enforcement of sanctions *ex post* could be enhanced. Alternatively, fundamental changes could be made to the system. One option involves more centralised intervention, possibly requiring direct negotiations between the central government and individual municipalities or groups thereof. Another option, proposed by the chairmen of the Danish Economic Council, is to introduce tradable expenditure permits.[21] The central government would determine the overall spending limit, on the basis of which municipalities are granted an expenditure permit. Municipalities wishing to increase taxes to cover increased expenditure, would only be allowed to do so, if they could

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[20] Lotz, J. (2001) "Rette rammer for det kommunale selvstyre?" *AKF nyt*, vol. 4, pp. 7-11

[21] De Økonomiske Råd (2007) *Dansk økonomi, efterår 2007*

obtain a permit from a municipality willing to reduce taxes correspondingly, and targeted sanctions could be applied in the event of overspending.

Finally, it is a weakness of the annual budget agreements that there is no systematic link or reference to the targets of the MTBF. Local governments have no direct ownership in the strategy and therefore no commitment to medium- and long-term ambitions. Although municipalities are obliged to elaborate multi-annual perspectives in their budgets, the agreement itself is generally focused on one year only, establishing the conditions and requirements for ensuring budget balance. While this may be sufficient to address stability issues, it fails to consider sustainability effects. Recalling that local and regional government expenditure amounts to nearly 20% of GDP, including notably health care and care for the elderly, factoring in the expected impact of demographic changes is central to ensuring overall fiscal sustainability.

2.5. Conclusion

Given the fixed exchange rate regime, rendering active monetary policy unavailable as instrument, fiscal policy must take on the crucial role of stabilising the economy, remaining tight in good times and resisting the pressure for increased public expenditure. At present, public finances are showing high surpluses and rapid reduction of debt. On the revenue side, the tax freeze is limiting the room for manoeuvre, which over time will imply a falling ratio of revenue-to-GDP. In addition, the looming pressure from the ageing of the population makes it increasingly important to focus on the expenditure side. In this regard, local and regional governments play a powerful role.

At the level of general government, the Danish budgetary framework is generally strong in institutional terms. It could, however, be strengthened further by addressing monitoring and follow-up, taking the impact of frequently revised statistics into account. More importantly, the failure to respect the limits for consumption expenditure growth needs to be addressed. The system of annual budget agreements between central and local governments is weakened by asymmetric information, generating moral hazard, and the parties are inadequately empowered to ensure that the agreements are adhered to.

In view of the significant share of public expenditure covered by the agreement, any over-spending at the local and regional level leaves the overall targets for public consumption expenditure growth in peril. As these targets are one of the cornerstones in the strategy for sustainable public finances, permanent or re-occurring over-spending constitutes a major challenge. The expected strengthening of the focus on the quality, efficiency and cost-effectiveness of public finances could reinforce the efforts made to curb public expenditure growth.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes macroeconomic vulnerabilities and how they are expected to develop according to the programme.

3.1. Economic activity

The Danish economy has passed the peak of its business-cycle and is now facing a period of more moderate growth. The macroeconomic outlook assumes a marked slow-down vis-à-vis the average growth performance of the past decade.

Based on the August Economic Survey, the 2007 update foresees real GDP growth of 2% in 2007 and 1¼% in 2008. This is consistent with the 2006 update and corresponds well with the GDP growth prospects in the Commission services' autumn 2007 forecast (Table 1).[22] The main driving force towards the end of the recent upswing, gross fixed capital formation (housing construction in particular), is losing momentum, resulting in a moderation of GDP growth. Exports are weakened reflecting binding capacity constraints. Private consumption growth is slowing down somewhat in view of higher interest rates and stagnating or falling house prices.

From 2009, the programme's real GDP growth profile is largely determined by the technical assumption of a large, positive output gap – calculated on the basis of a national methodology - closing rapidly towards 2011. The output gap estimate is different from the Commission services' output gap estimate applying the commonly agreed methodology, as explained in Box 2. As a consequence the development in the real GDP growth rate differs, with the Commission services' autumn forecast being just under 1½% for 2009 while the programme foresees subdued growth of just over 1% in 2009 and ½% in 2010. [23] Subsequently, growth is projected to pick up gradually, starting with just over 1% in 2011, towards a level of about 1¾% in 2015.

In the update, the assumption of a gradual normalisation of cyclical conditions is foreseen to affect gross fixed capital formation in particular. More specifically, the private sector investment-to-GDP ratio is assumed to fall from 22% in 2007-08 to below 20% in 2011 onwards; a level seen prior to the housing boom and current capacity constraints.

[22] The external outlook behind the macroeconomic scenario is broadly in line with that of the Commission services' autumn 2007 forecast for 2007-08. As the update is based on projections from August 2007, certain assumptions follow those of the Commission services' spring 2007 forecast. According to the sensitivity analysis reported in an annex to the programme, the difference in assumptions – concerning the oil price and interest rates in particular - gives rise to only marginal changes in GDP growth, public finances and other variables for 2007-08. For 2009, the external assumptions differ, in particular assuming a lower World (excluding EU) GDP growth, higher interest rates and a lower price of oil.

[23] In the Danish official forecast published on 5 February 2008 in the Economic Survey accompanying the new draft budget bill, the real GDP growth projections are adjusted only marginally to 1.9% in 2007, 1.4% in 2008 and 1.0% in 2009.

Table 1: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2015
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	1.9	2.0	1.3	1.3	1.4	1.1	0.5	1.7
Private consumption (% change)	2.1	2.2	1.9	1.5	1.8	1.2	1.1	1.8
Gross fixed capital formation (% change)	4.5	3.0	0.8	0.6	1.1	-2.3	-2.6	2.7
Exports of goods and services (% change)	3.9	4.9	3.9	3.0	3.5	3.5	3.6	3.9
Imports of goods and services (% change)	5.3	5.7	4.8	3.5	3.8	2.2	3.3	4.0
Contributions to real GDP growth:								
- Final domestic demand	2.5	2.2	1.5	1.3	1.5	0.3	0.2	1.6
- Change in inventories	0.0	0.0	0.1	0.2	0.0	0.0	0.0	0.0
- Net exports	-0.6	-0.2	-0.3	-0.2	-0.1	0.7	0.3	0.1
Output gap[1]	0.7	1.0	-0.2	0.3	-0.9	-0.4	-1.5	n.a.
Employment (% change)	2.0	1.7	0.1	0.0	-0.3	-0.5	-0.8	-0.1
Unemployment rate (%)	3.0	3.3	2.7	3.1	2.7	3.2	3.6	4.0
Labour productivity (% change)	-0.1	0.3	1.2	1.3	1.6	1.5	1.3	1.7
HICP inflation (%)	1.7	1.7	2.4	2.4	2.4	1.6	1.9	1.5
GDP deflator (% change)	2.3	2.0	2.9	2.7	2.9	2.2	2.7	2.0
Comp. of employees (per head, % change)	4.2	4.3	4.5	3.8	4.5	3.6	3.8	3.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.2	1.7	0.7	1.3	0.6	1.9	2.2	1.4

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source:

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

The slow-down in investment activity combined with a dampening of private consumption implies that the growth contribution of final domestic demand is reduced significantly in 2009-10, before picking up and returning towards 2015 to a level broadly corresponding to the potential growth rate assumed in the update. The contribution of net exports is negative in the 2007-08 period, upon which slower growing imports imply a significant positive growth contribution from net exports in 2009. This development also hinges on the specification of the rapidly closing output gap towards 2011. The assumed strong correction in final domestic demand in 2009-10 implies a shift from tax-rich to tax-poor components of GDP.

In view of looming inflationary pressure and deteriorating competitiveness, and on the basis of more recent trade data, the development foreseen in the programme for net lending vis-à-vis the rest of the world does not appear plausible.

Box 2: Calculation of potential growth and output gaps

Member States have agreed on a common methodology for the calculation of potential growth and output gaps using the production function approach as reference method.[24] The Commission follows this agreement and applies the approach in the budgetary surveillance process, including the assessment of convergence and stability programmes. The estimation of potential growth and the output gap for Denmark follows therefore the same approach as for other Member States.

The Commission services' estimates for potential growth in Denmark over the programme period

[24] Described in Denis, C., D Grenouilleau, K. McMorrow and W. Röger (2006) Calculating potential growth rates and output gaps – A revised production function approach, European Commission, DG ECFIN, European Economy Economic Papers Number 247

are significantly higher than those presented in the programme. The difference stems mainly from the estimated contribution from labour components in 2007 and the general level of the contributions from Total Factor Productivity (TFP) throughout the programme period. Notwithstanding differences in definitions, methods and data, the underlying *development* in the estimated structural level of unemployment (as measured by the NAIRU) is similar, pointing towards a reduction of more than ¾ pp for the 2006-09 period.

The level difference in potential output growth leads to different estimates for the output gap. On the basis of the Commission services' autumn 2007 forecast, the positive output gap has been falling since 2006, and is estimated to become negative in 2008, continuing the fall in 2009. On the basis of similar growth prospects at the outset, but by applying a different, national methodology, the programme reports a high positive output gap in 2006, increasing further in 2007, before declining from the 2008 level towards zero in 2011 as specified in the underlying technical assumptions.

Both the specification of the dynamics of the NAIRU and the estimation of TFP are issues which receive special attention in the Output Gap Working Group. While particular specifications are normally inconsequential for the overall calculation of potential growth, the cyclical and structural circumstances suggest a relatively high sensitivity of the Commission services' calculations for Denmark to methodological adjustments. For the purposes of the present assessment, the output gaps calculated by the Commission services following the agreed common methodology remain the point of departure for assessing cyclical conditions. Nonetheless, uncertainties stemming from frequent and significant data revisions imply that such estimates must be interpreted with caution.

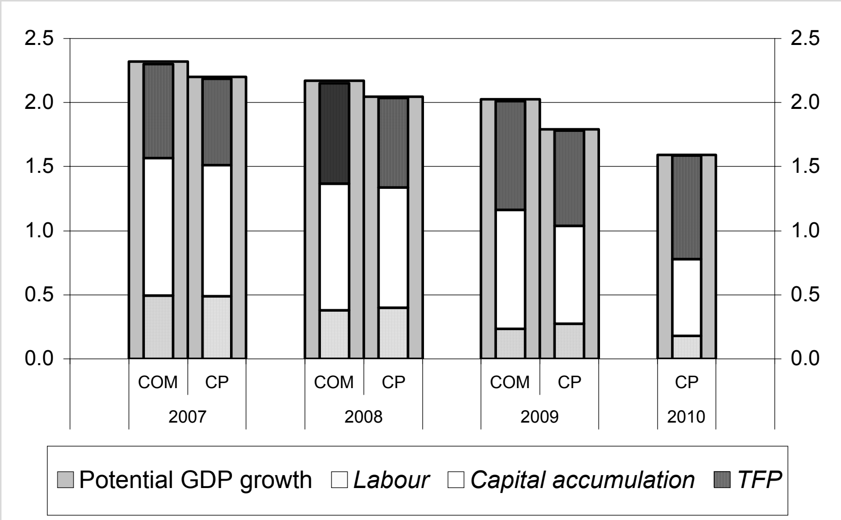
Based on the technical assumptions for the projections from 2009 onwards, the programme foresees a slight increase in potential GDP growth rates over the programme period. Averaging 1½%, the level is significantly lower than the Commission services' estimates for the 2007-2009 period.

Box 3: Potential growth and its determinants

The Commission services' recalculations, using the commonly agreed methodology based on the information provided in the programme, suggest that potential growth is slowing down towards 2010. Approaching 1½%, the assumed potential growth rate is significantly lower than trend growth over the past decade (see Annex 2)

In the beginning of the period, the fall is mainly due to a declining contribution from labour, following a period of rapidly declining unemployment. Towards the end of the period, the programme indicates a lower contribution from capital accumulation dragging potential growth. This is driven by a sizable fall in investment activity in 2009 and 2010, bringing the private investment-to-GDP ratio down to a level seen prior to the recent housing boom.

Potential growth and its determinants



Cyclical conditions are foreseen to develop negatively over the programme period. This is illustrated by the output gap, recalculated by the Commission services on the basis of the data provided in the programme using the commonly agreed method, which is positive in 2007, diminishing in 2008, and going negative in 2009. Compared to the Commission services' 2007 autumn forecast, the change of sign is postponed by a year due to a lower estimated growth in potential output, stemming from lower contributions from TFP and capital accumulation to potential growth.[25] Given the divergences in the estimation of potential growth, as outlined in Box 2, and noting that output gap estimates have been somewhat unstable, caution is warranted in the interpretation of cyclical conditions, and additional indicators merit attention as in Box 4.

The overall assessment is that the programme's macroeconomic assumptions are plausible until 2008 and cautious thereafter.

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[25] Output gap estimates derived on the basis of the autumn forecast using a HP filter also point to a reversal of the sign of the output gap in 2009 rather than in 2008.

3.2. Labour market and cost and price developments

The Danish labour market has shown a remarkable improvement in recent years. Unemployment has reached historically low levels and according to the programme employment will peak in 2008. Based on the technical assumptions of the programme, employment is foreseen to decline from 2009 onwards. Furthermore, average working hours are expected to decline somewhat in 2009 (reflecting wider access to paternity leave determined in collective wage agreements), which breaks the increasing trend since the 1990s.

Labour productivity growth has been rather moderate in recent years, but is foreseen to pick up over the programme period. Revised national accounts data for the period 2004-2006, published 21 December 2007, show a more positive development than what the programme and the Commission services' autumn 2007 forecast have been based on.

Although the estimates in the programme of the structural level of unemployment differ from those of the Commission services (due to differences in both data and method), there are two common conclusions. Firstly, the structural unemployment rate is foreseen to fall over the programme period. Secondly, the starting point is that the actual unemployment is lower than the structural level in 2007.

In terms of structural policy, the technical assumptions behind the projections implement the labour market related requirements for ensuring that the fiscal framework meets the objective of fiscal sustainability. These include, in particular, increasing structural (un-subsidised) employment by 20,000 persons and maintaining hours worked at the present level towards 2015 (implying a 1.8% increase in average hours worked, primarily due to demographic factors). Past reforms are also expected to continue to contribute positively to the level of structural employment. Meanwhile, the programme indicates that demographic effects and the neutralisation of cyclical factors are expected to result in a net reduction in actual employment by 2015 corresponding to 2/3 of the progress in the 2005-07 period.

In view of the tight labour market, wage pressures have been mounting. Negotiations in 2007 led to higher wage increases than is expected in the euro area and among trading partners, resulting in a loss in wage competitiveness. The combination of high wage growth, the weaker US dollar, capacity constraints and labour shortages results in a loss of market shares. Public sector wage negotiations are on-going (to be concluded in the early spring). Depending on the outcome and any further lags in the pick-up of wage growth, the programme may not fully capture the looming cost pressure stemming from the tight labour market.

Inflation is expected to pick up in 2008, in line with global and European trends, albeit from a low level. The projections for 2009-10 are determined subject to cyclical conditions reverting to normal, implying an implausibly low level for 2009, driven by the assumptions of modest wage growth and low import price inflation.[26] Meanwhile, a more rapid increase in the public sector deflator pushes the GDP-deflator upwards. Looking forward to 2015, conditioned by a normalisation of cyclical conditions, the update foresees the return to low-inflation regime with HICP inflation at 1½%.

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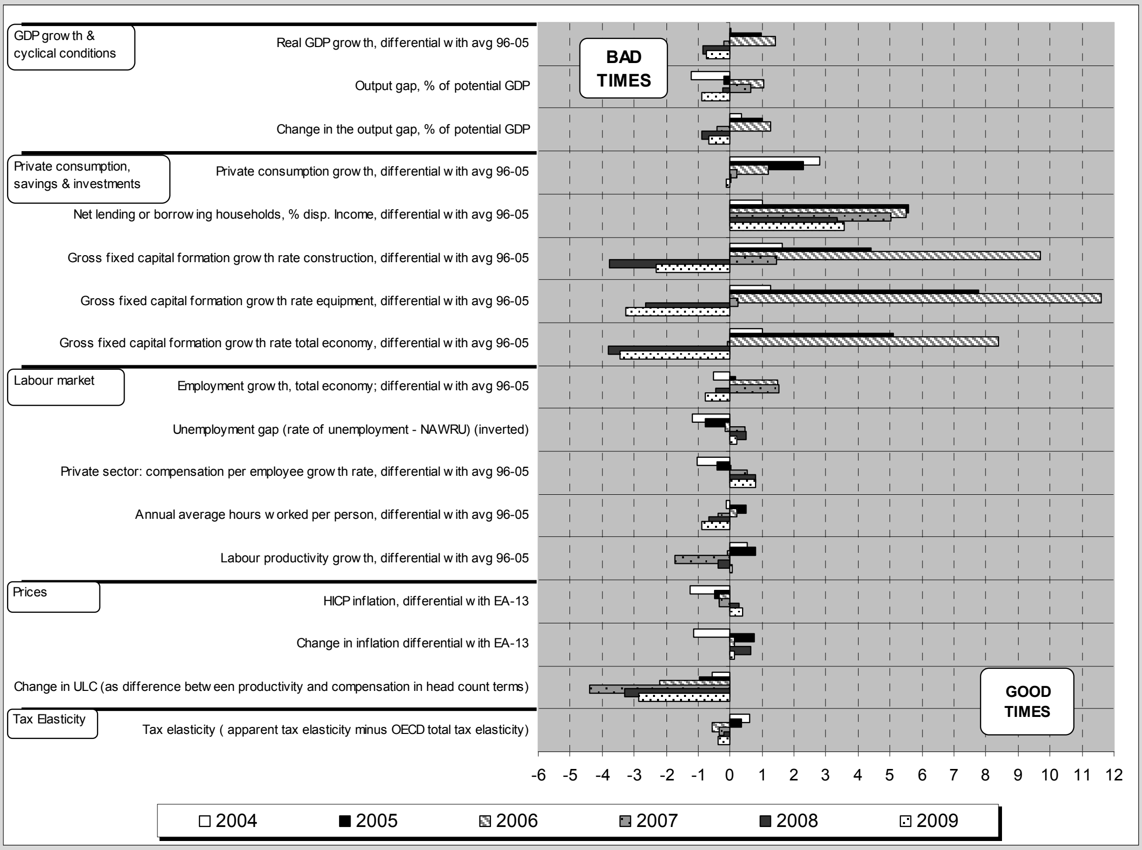
[26] In the more recent Economic Survey, published on 5 February 2008, HICP inflation is revised upwards to 2.7% in 2008 and 2.4% in 2009.

Box 4: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times in 2007-2008, gradually becoming neutral in 2009.

While GDP growth rates are lower than previously, and the output gap is developing negatively, other indicators supports this assessment: Employment is high, the unemployment rate has reached a historically low level, capacity utilisation remains at a high. As reasoned in Box 2, the calculated output gap may be sensitive to methodological specifications, and the output gap calculated using a HP filter suggests a positive gap in 2008 as well. The estimate in the programme is significantly more positive, as is the output gap estimated by OECD.

Good versus bad times



4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Due to the fact that reported figures for total revenue and total expenditure (and certain subcomponents) deviate from the harmonised approach[27], these cannot be compared with the Commission services' autumn 2007 forecast, although it would have been desirable, as it appears more plausible in light of the most recent information. Hence Table 2 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with those of the present update. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[28]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.
- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

[27] See Commission Regulation (EC) No 1500/2000.

[28] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

Table 2: Budgetary implementation in 2007

	2006		2007	
	Planned CP Dec 2006	Outcome CP Dec 2007	Planned CP Dec 2006	Outcome CP Dec 2007
Revenue (% of GDP)[3]	53.5	54.7	52.7	53.4
Expenditure (% of GDP)[3]	50.4	50.1	49.8	49.6
Government balance (% of GDP)	3.1	4.6	2.8	3.8
Nominal GDP growth (%)			4.3	4.0
Nominal revenue growth (%)			2.7	1.5
Nominal expenditure growth (%)			3.1	3.0
Revenue surprise compared to target (% of GDP)			**0.7**	
Of which [1]: 1. Base effect			1.2	
2. GDP growth effect on the denominator			0.2	
3. Revenue growth effect			-0.6	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1 [2]			*-0.5*	
Expenditure surprise compared to target (% of GDP)			**-0.2**	
Of which [1]: 1. Base effect			-0.3	
2. GDP growth effect on the denominator			0.1	
3. Expenditure growth effect			0.0	
Government balance surprise compared to target (% of GDP)			**1.0**	
Of which: 1. Base effect			1.5	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			-0.6	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive denominator effect indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

[3]The programme data for expenditure and revenue differs from the data reported to Eurostat, following the harmonised approach (cf. Commission Regulation No. 1500/2000), on which the Commission services' forecast is based.The difference relates primarily to the treatment of public sales of goods and services and of the consumption of fixed capital. The balance is, however, unaffected.

Source:
Commission services

For 2007, the update foresees a surplus for the general government balance of 3.8% of GDP (see Table 2), whereas the Commission services' autumn forecast is slightly higher. More recent information indicates that employment growth has exceeded expectations, which may again contribute positively to the budget, but this is not yet reflected in data on budgetary implementation. The 2006 convergence programme target was significantly lower, at 2.8% of GDP. [29]

The difference between the targets of the present and the previous programme is mainly due to a higher than anticipated surplus in 2006 (base effect)[30], driven by high revenues – due to the strong employment growth and energy exploitation in the North Sea. However, this effect is partly offset by a lower revenue growth rate in 2007 than previously targeted. Overall, the difference thus stems from a reassessment of the

[29] In the February Economic Survey the surplus is revised to 4.4% of GDP for 2007, largely due to higher tax revenue in view of more favourable cyclical conditions.

[30] As noted in the programme, Statistics Denmark published data in November 2007 revising the surplus for 2006 up to 4.9% of GDP, mainly due to higher-than-expected revenue from corporate tax.

cyclical conditions, reflected in an estimated higher output gap (derived according to the national methodology) but also a prudent approach to estimating revenue growth in view of the tax freeze. Furthermore, large expected revenues from oil- and gas-related activities in the North Sea are expected to be more than outweighed by the lower expected revenue from the tax on pension fund returns.

As noted in the programme, Statistics Denmark published revised figures for 2004-06 in November 2007, revising the government surplus upwards to 4.9% of GDP in 2006. The main upward revisions concern the revenue from corporate tax and labour market contributions, only partly outweighed by reductions in the revenue from taxes on personal income and pension funds returns as well as higher public consumption expenditure. These revisions would tend to amplify the effects in Table 2.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

4.2.1. The main goal of the programme's budgetary strategy

As explained in the introduction, the programme covers the period 2007-10, with indications for the period towards 2015 The programme is based on the projections underlying the medium-term fiscal strategy "Towards new goals – Denmark 2015", outlined above in Section 2. For 2007-08, the point of departure is the forecast underlying the draft budget bill, which was presented in August 2007, but subsequently withdrawn due to general elections in November 2007. The effects of the agreement on tax cuts reached shortly before the elections are also taken into account (described in Section 6).

Within the overarching objective of ensuring fiscal sustainability, the 2007 update aims at maintaining high surpluses that overachieve the medium-term objective (MTO) for the budgetary position. The programme presents a slightly revised MTO - structural surpluses of ¾-1¾% of GDP compared to the previous programme, which defined the MTO as structural surpluses of ½-1½% of GDP over 2007-2010 period.[31] The difference of ¼ percentage point reflects a technical revision and is due to the assumption that the currently *temporarily* suspended "special pension contribution" is suspended indefinitely. Contributions would be income tax deductible, and reintroduction would therefore reduce revenue by about ¼% of GDP in the short and medium term, while being largely neutral in terms of long-term fiscal sustainability as pension payments would be taxable. The suspension was foreseen to expire in 2008 and was not included in the MTO of the previous programme (see Box 5 for further details).[32]

[31] For the 2011-15 period, subsequent to the assumed normalisation of cyclical conditions, the programme indicates lower surpluses, as the effects of ageing are expected to set in and revenue sources in the North Sea are foreseen to subside. The objective from the 2015-plan is to maintain a structural surplus or balance as a minimum.

[32] In the Commission services' autumn 2007 forecast the suspension of the "special pension contribution" is included in "one off and temporary measures" for 2008, while assumed reintroduced in 2009, cf. Box 5. This implies a relative improvement in the structural balance in 2009. However, other one off and temporary measures have opposite effects in 2008.

The strategy relies on the continued application of the tax freeze and expenditure restraint. Public consumption expenditure is subject to real annual growth limits of 1¾% in 2008 and 1% in 2009-10. For 2008, this is higher than in the previous update, which assumed annual growth rates of 1% over the entire period. Furthermore, a cap is imposed on nominal public consumption expenditure as a share of cyclically-adjusted GDP, following the national methodology.

In nominal terms, the programme foresees sustained surpluses with a decreasing trend over the programme period following the assumed normalisation of cyclical conditions derived by applying the national methodology. Compared with the 2006 update, estimates have been revised upwards by 1 percentage point, ½ percentage point and ¼ percentage point over the 2007-09 period.[33] For 2008-09, this is largely explained by a slightly more favourable macroeconomic outlook due to the technical assumption of a normalisation of cyclical conditions by 2011 rather than 2010 (as assumed in the previous update). The tax cuts agreed in September 2007, entering into force in 2008-09, (see Box 8 in Section 6) only partly counterbalances the effects of a stronger cyclical position.

On the basis of the Commission services' calculations of the output gap, the cyclically-adjusted balance is seen to deteriorate over the programme period from 3% of GDP surplus in 2007 to 2¼% in 2010. The profile differs from that of the previous programme, where the cyclical factors implied an improvement from 2.2% of GDP in 2007 to a stable level just above 2½% towards 2010. This reflects the more favourable point of departure as well as the extended period assumed for normalisation of cyclical conditions.

Differences in the definition of one-off and temporary factors in the programme and the Commission services' autumn 2007 forecast imply that estimates for the structural balance are not readily comparable (see Box 5).

[33] The Danish forecast published 5 February 2008 foresees general government surpluses of 3.7% and 2.7% of GDP in 2008 and 2009, respectively. The upward revision by ¾ percentage point is explained by stronger-than-expected cyclical conditions and higher energy prices.

Table 3: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010
General government balance (% of GDP)	**CP Dec 2007**	**4.6**	**3.8**	**3.0**	**2.0**	**1.2**
	CP Dec 2006	*3.1*	*2.8*	*2.5*	*1.8*	*1.2*
	COM Nov 2007	4.6	4.0	3.0	2.5	n.a.
General government expenditure[2] (% of GDP)	**CP Dec 2007**	**50.1**	**49.6**	**49.8**	**50.0**	**50.5**
	CP Dec 2006	*50.4*	*49.8*	*49.7*	*50.0*	*50.6*
	COM Nov 2007	51.1	50.8	51.4	51.2	n.a.
General government revenue[2] (% of GDP)	**CP Dec 2007**	**54.7**	**53.4**	**52.9**	**52.0**	**51.7**
	CP Dec 2006	*53.5*	*52.7*	*52.1*	*51.8*	*51.7*
	COM Nov 2007	55.7	54.8	54.5	53.6	n.a.
Structural balance[1] (% of GDP)	**CP Dec 2007**	**2.7**	**3.5**	**3.4**	**2.5**	**2.5**
	CP Dec 2006	*2.2*	*1.9*	*2.7*	*2.6*	*2.7*
	COM Nov 2007	3.6	3.2	3.4	3.0	n.a.
Real GDP (% change)	**CP Dec 2007**	**3.5**	**2.0**	**1.3**	**1.1**	**0.5**
	CP Dec 2006	*2.7*	*2.0*	*0.7*	*0.7*	*0.6*
	COM Nov 2007	3.5	1.9	1.3	1.4	n.a.

Note:

[1]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.

[2]The programme data for expenditure and revenue differs from the data reported to Eurostat, following the harmonised approach (cf. Commission Regulation No. 1500/2000), on which the Commission services' forecast is based.The difference relates primarily to the treatment of public sales of goods and services and of the consumption of fixed capital. The balance is, however, unaffected.

Source :

Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)

Box 5: One-off and temporary measures

The MTO is defined in structural terms, i.e. adjusted for cyclical developments and excluding one-off and other temporary measures (i.e. "measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position", according to the revised Code of Conduct). The identification one-off measures by the Commission services is guided by the specifications in *Public Finances in EMU 2006.*[34]

One-off and temporary measures [2]

(% of GDP)	2006		2007		2008		2009		2010
	CP	COM	CP	COM	CP	COM	CP	COM	CP
Special Pension suspension		0.3		0.3		0.3			
Pension reform compensation						-0.5			
Corporate tax[1]	0.4		0.0		0.1		0.0		0.0
Tax on pension fund returns[1]	-0.1		-0.5		-0.3		-0.2		-0.2
Net interest payments[1]	0.1		0.1		0.1		0.0		0.0
Revenue from the North Sea[1]	0.5		0.3		0.0		0.0		0.0

[34] European Commission, Directorate-General for Economic and Financial Affairs (2006) *Public Finances in EMU - 2006,* European Economy No. 3

Other special items[1]	0.2		-0.2		-0.5		-0.1		0.0
Total	1.1	0.3	-0.4	0.3	-0.6	-0.2	-0.2	0.0	-0.2

[1] Specified as temporary variations in certain types of revenue.
[2] A positive (negative) figure denotes a surplus-increasing (surplus-decreasing) one-off.

Revenue from the North Sea includes hydro carbon tax, corporate taxes from corporations liable to carbon tax payments, excise tax on oil pipelines and profit sharing. The trend level is estimated as a 7 year moving average of actual and projected revenue, corresponding to 1.3-1.5% of GDP in 2005-07. For the tax on pension fund returns, the trend level is estimated at about 0.8-1.0% of GDP in 2005-07. Variations in "Other special items" include variations in net current and capital transfers, e.g. contributions to the EU, foreign aid expenditures, block grants to the Faroe Islands and Greenland, purchases and sales of land and rights.

Thus, in the programme, a significantly wider range of factors is considered to be one-off and other temporary measures and hence for deriving the structural balance. In previous programmes (and in the Commission services' autumn 2007 forecast), the suspension of contributions to the Special Pension scheme was considered a temporary measure. Formally, the suspension has been agreed upon for the period 2004-08. However, as the programme suggests an amendment of the MTO corresponding to an indefinite suspension of the contribution, the temporary nature of the suspension is removed and going forward the Commission services will amend their assessment of one-offs accordingly.

The listed items identified in the programme do not meet the specifications applied by the Commission services. However, in the tables presented in this assessment, structural balances according to the programme are derived on the basis of the information given in the programme for one-off and temporary measures. As a consequence, structural balance figures are not readily comparable, and should therefore be interpreted with caution, taking differences into account.

The table below summarises the effect of different definitions of one-off and temporary measures. While emphasising that the assessment relies on the commonly agreed methodology for calculating cyclically-adjusted balances, the table also includes the data provided in the programme as a result of applying a national methodology. The differences in methodology are commented upon in Box 2.

Structural balance

(% of GDP)	2006	2007	2008	2009	2010
Cyclically-adjusted balance[1]	3.8	3.1	2.8	2.3	2.2
Structural balance:					
- one-offs as in programme	2.7	3.5	3.4	2.5	2.5
- one-offs as in AFC	3.5	2.8	3.0	2.3	2.2
- one-offs as in AFC, without suspension of special pension scheme	3.8	3.1	3.2	2.3	2.2
Reported in the programme applying national methodology:					
Cyclically-adjusted balance	*3.5*	*1.3*	*0.8*	*0.6*	*0.5*
Structural balance	*2.4*	*1.7*	*1.5*	*0.9*	*0.8*

[1] As recalculated by the Commission services on the basis of the information in the programme following the commonly agreed methodology.

The time profile in Table 3 and Table 4 is to a large extent dictated by the assumption of a normalisation of cyclical conditions, resulting *inter alia* in higher unemployment, towards 2011. Adjustments in cyclically sensitive categories imply that the revenue-to-GDP ratio falls by 1¾ percentage points while the expenditure-to-GDP ratio increases by 1 percentage point over the programme period.

Given the considerable uncertainty of estimates and diverging methodologies, cyclically-adjusted and structural balances need to be interpreted with caution (cf. Boxes 5 and 6).[35]

Measured by the change in the structural balance, the planned fiscal policy effort implies a weakening towards the end of the programme period, but the structural balance remains well above the MTO throughout the programme period. By the same measurement, the fiscal stance is foreseen to have been tightened in 2007, remain neutral in 2008, be expansionary in 2009 and stay neutral in 2010. However, the expected increase in the structural surplus in 2007, stems from the "one-off and temporary measures" taken at face value from the programme, rather than the development in the cyclically-adjusted balance (see Box 5). If considering only the measures included in the Commission services' autumn 2007 forecast, and removing the correction for the suspension of the special pension contribution, the fiscal stance for 2007 is expansionary, and thus pro-cyclical,, which is also the conclusion reached in the programme. According to calculations reported in the programme, the estimated fiscal policy impact on economic activity is foreseen to be mildly expansionary by ¼% of GDP in 2008.[36]

Compared with the previous programme, the 2007 update frontloads the planned path against a broadly unchanged macroeconomic scenario.

[35] In the programme the cyclical component contributes negatively to the cyclically-adjusted balanced over the entire period. This is only the case until 2008 according to the Commission services' calculations, after which the contribution is positive as the output-gap turns negative in 2009-10.

[36] The February 2008 draft budget bill is assessed to have a slightly less expansionary effect according to the Danish Ministry of Finance, representing a stimulus of 0.2% of GDP (compared to 0.3% of GDP in the August .2007 draft).

Table 4: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
Revenue	**54.7**	**53.4**	**52.9**	**52.0**	**51.7**	**-1.7**
of which:						
- Taxes on production and imports	18.0	17.7	17.5	17.1	16.8	**-0.9**
- Current taxes on income, wealth, etc.	29.7	29.1	29.0	28.4	28.3	**-0.8**
- Social contributions	1.0	1.0	1.0	1.0	1.0	**0.0**
- Other (residual)	6.0	5.6	5.4	5.5	5.6	**0.0**
Expenditure	**50.1**	**49.6**	**49.8**	**50.0**	**50.5**	**0.9**
of which:						
- Primary expenditure	48.5	48.2	48.6	49.0	49.6	**1.4**
of which:						
Compensation of employees	16.9	16.8	16.7	16.8	16.9	**0.1**
Intermediate consumption	8.5	8.8	9.1	9.2	9.3	**0.5**
Social payments	17.0	16.6	16.7	16.9	17.3	**0.7**
Subsidies	2.2	2.3	2.3	2.4	2.4	**0.1**
Gross fixed capital formation	1.9	1.7	1.7	1.8	1.8	**0.1**
Other (residual)	2.0	2.0	2.2	1.8	1.8	**-0.2**
- Interest expenditure	1.6	1.4	1.2	1.0	0.9	**-0.5**
General government balance (GGB)	**4.6**	**3.8**	**3.0**	**2.0**	**1.2**	**-2.6**
Primary balance	**6.2**	**5.2**	**4.2**	**3.0**	**2.1**	**-3.1**
One-off and other temporary measures	1.1	-0.4	-0.6	-0.2	-0.3	**0.1**
GGB excl. one-offs	**3.5**	**4.2**	**3.6**	**2.2**	**1.5**	**-2.7**
Output gap[1]	1.2	1.0	0.3	-0.4	-1.5	**-2.5**
Cyclically-adjusted balance[1]	3.8	3.1	2.8	2.3	2.2	**-1.0**
Structural balance[2]	**2.7**	**3.5**	**3.4**	**2.5**	**2.5**	**-1.1**
Change in structural balance		*0.8*	*-0.1*	*-1.0*	*0.0*	
Structural primary balance[2]	4.3	4.9	4.6	3.5	3.4	**-1.6**
Change in structural primary balance		*0.6*	*-0.3*	*-1.2*	*-0.1*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

[3]The programme data for expenditure and revenue differs from the data reported to Eurostat, following the harmonised approach (cf Commission Regulation No. 1500/2000), on which the Commission services' forecast is based.The difference relates primarily to the treatment of public sales of goods and services and of the consumption of fixed capital. The balance is, however, unaffected.

Source:

Convergence programme; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

Three aspects determine the evolution in the programme of overall revenues and expenditure as a percentage of GDP. Firstly, the technical assumptions concerning the cyclical conditions, whereby automatic stabilisers come into play reducing revenue and increasing expenditure. Secondly, the rules of the fiscal framework implying a continuation of the tax freeze, limits on real annual growth in public consumption expenditure and a cap on the public consumption expenditure-to-GDP ratio. Thirdly, the broad measures outlined in the programme, notably the agreed tax cuts and the proposed quality reform initiatives (all outlined in Section 6).

All three aspects point in the direction of lower revenue-to-GDP ratios, with the biggest adjustment taking place in 2009 when cyclical conditions are assumed to worsen, the second half of the agreed tax cuts are implemented and the various revenue sources are capped by the tax freeze.

Similarly, the expenditure-to-GDP ratio is driven by the cyclical conditions increasing social payments and the launch of quality reform initiatives and the fiscal framework allows for increasing public consumption expenditure, particularly in 2008. The latter is mainly reflected in an increasing percentage of GDP for intermediate consumption, while the share for compensation of employees is foreseen to remain broadly unchanged.

Given the currently inconclusive budget situation, as outlined in Box 7, the programme contains all available information about the measures envisaged in the projections.

Box 7: The budget for 2008

A draft budget for 2008 was presented on 21 August 2007. Following elections on 13 November 2007 the government presented a new draft budget bill on 5 February 2008. It is expected to be adopted by parliament in April 2008, and in the meantime a temporary appropriation bill is applied. The programme is based on the August draft budget bill, and the February draft budget bill is considered to be beyond the scope of this assessment.[37]

In the August draft budget, the expectation for the general government balance in 2008 is a surplus in the range 3-4% of GDP. In 2008 real growth in public consumption expenditure and investments is foreseen at 1.7% and 5.2% respectively. The main measures focus on the quality of public services, the services provided at the local and regional level (e.g. health care, child care, care for the elderly) and globalisation. In total, the new expenditure measures amount to 10.8 billion DKK (0.6% of GDP).

On the revenue side, it has been agreed to abolish the labour market fund and substitute the foreseen adjustment of the labour market contribution by a package of adjustments of taxes and transfers, see Box 8 in Section 6.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Lower taxes net of higher transfers (-0.2% of GDP)	o Quality enhancing initiatives in the public sector (0.1% of GDP) o Health care initiatives (0.1% of GDP), as in the agreement on the regional budgets for 2008 o Initiatives concerning care for children, the elderly, social services etc. (0.1% of GDP) , as in the agreement on the economy of the municipalities for 2008 o Globalisation initiatives, concerning research, education, innovation and entrepreneurship (0.1% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.

Sources: Commission services and the Danish Ministry of Finance.

4.3. Risk assessment

This Section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme. The comparison is complicated by the fact that some reported figures do not correspond to the harmonised definitions in ESA95 with subsequent amendments.

[37] In view of the tight labour market, the February draft budget bill for 2008 contains measures to alleviate labour shortages, a 1% compulsory savings measure applied to central government and proposals to postpone certain infrastructure projects.

Table 5: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	CP	COM	CP	COM[1]	CP	CP
Revenue[4]	**55.7**	**54.8**	**53.4**	**54.5**	**52.9**	**53.6**	**52.0**	**51.7**
of which:								
- Taxes on production and imports	17.7	17.5	17.7	17.4	17.5	17.2	17.1	16.8
- Current taxes on income, wealth, etc.	29.7	29.3	29.1	29.1	29.0	28.6	28.4	28.3
- Social contributions	1.9	1.9	1.0	1.9	1.0	1.9	1.0	1.0
- Other (residual)	6.3	6.1	5.6	6.1	5.4	6.0	5.5	5.6
Expenditure[4]	**51.1**	**50.7**	**49.6**	**51.3**	**49.8**	**51.1**	**50.0**	**50.5**
of which:								
- Primary expenditure	49.3	49.3	48.2	50.0	48.6	49.9	49.0	49.6
of which:								
Compensation of employees	16.9	16.9	16.8	17.0	16.7	17.1	16.8	16.9
Intermediate consumption	8.5	8.9	8.8	9.3	9.1	9.5	9.2	9.3
Social payments	16.7	16.3	16.6	16.1	16.7	16.1	16.9	17.3
Subsidies	2.2	2.3	2.3	2.2	2.3	2.2	2.4	2.4
Gross fixed capital formation	1.9	1.7	1.7	1.8	1.7	1.8	1.8	1.8
Other (residual)	3.1	3.2	2.0	3.6	2.2	3.2	1.8	1.8
- Interest expenditure	1.7	1.5	1.4	1.3	1.2	1.2	1.0	0.9
General government balance (GGB)	**4.6**	**4.0**	**3.8**	**3.0**	**3.0**	**2.5**	**2.0**	**1.2**
Primary balance	**6.2**	**5.3**	**5.2**	**4.3**	**4.2**	**3.6**	**3.0**	**2.1**
One-off and other temporary measures	0.3	0.3	-0.4	-0.2	-0.6	0.0	-0.2	-0.3
GGB excl. one-offs	**4.3**	**3.7**	**4.2**	**3.2**	**3.6**	**2.5**	**2.2**	**1.5**
Output gap[2]	1.1	0.7	1.0	-0.2	0.3	-0.9	-0.4	-1.5
Cyclically-adjusted balance[2]	3.9	3.6	3.1	3.2	2.8	3.0	2.3	2.2
Structural balance[3]	**3.6**	**3.2**	**3.5**	**3.4**	**3.4**	**3.0**	**2.5**	**2.5**
Change in structural balance		*-0.4*	*0.8*	*0.1*	*-0.1*	*-0.3*	*-1.0*	*0.0*
Structural primary balance[3]	5.2	4.6	4.9	4.6	4.6	4.1	3.5	3.4
Change in structural primary balance		*-0.6*	*0.6*	*0.0*	*-0.3*	*-0.5*	*-1.2*	*-0.1*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

[4]The programme data for expenditure and revenue differs from the data reported to Eurostat, following the harmonised approach (cf Commission Regulation No. 1500/2000), on which the Commission services' forecast is based.The difference relates primarily to the treatment of public sales of goods and services and of the consumption of fixed capital. The balance is, however, unaffected.

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

As the macroeconomic assumptions in the programme are considered plausible until 2008 and cautious thereafter (cf. Section 3.1), the growth rate and the composition of growth are broadly similar at the outset. Towards the end of the programme period, the cautious outlook - driven by the technical assumption of a strong deterioration in cyclical conditions towards 2011 - is reflected in weak domestic demand, and caution appears to characterise the revenue estimates correspondingly. On the expenditure side, the cyclical factors explain most of the discrepancy in the comparison of projections.

Assessing the structural balance is complicated due to the difference in the definition of one-off and other temporary measures as explained in Box 5. Based on the information in the programme, the Commission services' considerations of such measures and the commonly agreed methodology to estimating cyclically-adjusted balances, the structural balance is estimated to remain broadly unchanged in 2008.[38]

As the Danish public finances are markedly sensitive to changes in the interest rate, the update includes a sensitivity analysis focusing on short-term effects of a permanent increase in foreign and domestic interest rates of 1 percentage point along the entire yield curve. It is estimated to reduce annual real GDP by ¼% in 2008 and 1½% in 2009-10 and to lead to a deterioration of the general government balance by ¾% of GDP in 2008 and around 1% of GDP in 2009-10. The deterioration is primarily due to the effect on the revenue from tax on pension fund returns. There is no suggestion that such a scenario is considered to be realistic, but illustrates well the significant sensitivity. The programme also illustrates how higher interest rates in fact strengthen public finances in the long run.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point negative deviation from the real GDP growth projections in the programme over the 2007-2010 period; (ii) trend output based on the HP-filter, and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2010 the cyclically-adjusted balance would be ¾ percentage point of GDP below the target in the programme. Hence, in the case of persistently lower real growth, additional measures of around ¾ percentage point of GDP would be necessary to keep the public finances on the path targeted in the programme.

As indicated in Section 4.2.2 above, the programme provide all available information about planned measures given the current uncertainties concerning the budget for 2008. Leaving aside the divergence in the definition of one-off and other temporary measures (Box 5), the planned reliance on discretionary one-off measures (as considered by the Commission services) is negligible.

Table 6: Assessment of tax projections

	2008			2009			2010
	CP	COM	OECD[3]	CP	COM[1]	OECD[3]	CP
Change in tax-to-GDP ratio (total taxes)	-0.3	-0.4	0.0	-1.0	-0.8	0.0	-0.4
Difference (CP – COM)	0.1		/	-0.3		/	/
of which [2] :							
- discretionary and elasticity component	*0.2*		/	*-0.6*		/	/
- composition component	*-0.1*		/	*0.0*		/	/
Difference (COM - OECD)	/	-0.4		/	-0.8		/
of which [2] :							
- discretionary and elasticity component	/	*-0.7*		/	*-0.9*		/
- composition component	/	*0.6*		/	*0.4*		/
p.m.: Elasticity to GDP	0.8	0.8	1.0	0.3	0.6	1.0	0.7

Notes:

[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

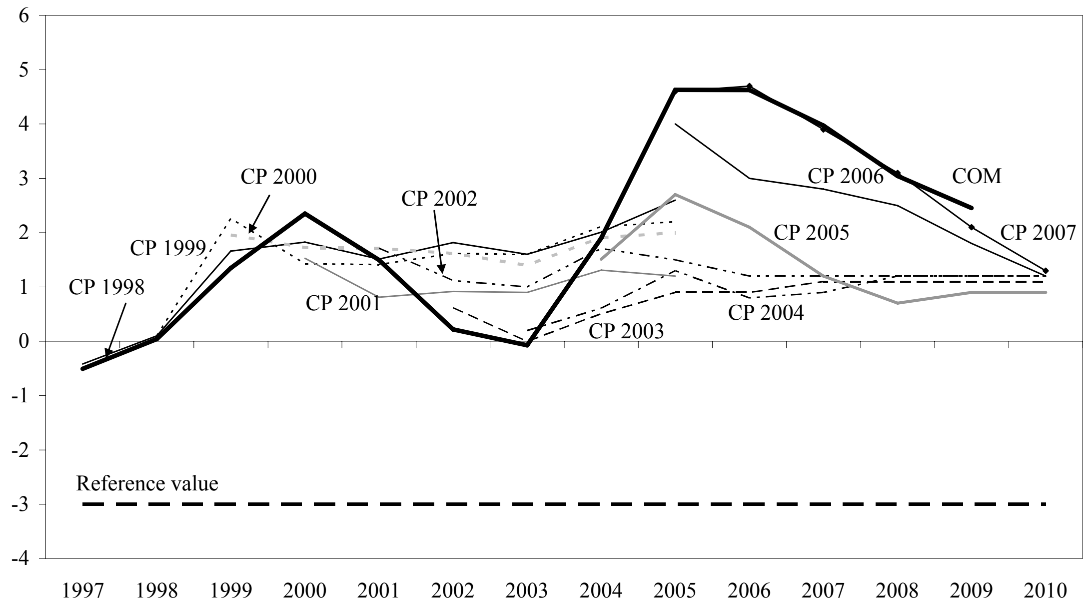
Source:
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

The tax revenue projections of the programme appear to be based on cautious assumptions about the tax intensity of economic activity. As outlined in Table 6, the tax-to-GDP ratio is foreseen to fall more than would be suggested on the basis of OECD's ex-ante elasticities. This is true for 2009, in particular, reflecting the further reduction of personal income tax as well as a cautious estimate for the link between personal income taxes and the wage sum. The elasticity for indirect taxes is also lower than suggested by OECD ex-ante values, which reflects mainly the cautious outlook for domestic demand and implicitly the effect of the tax freeze.

As discussed in Section 2, the track record with regard to achieving targets for government consumption expenditure restraint is rather poor. While recognising that targets may be ambitious, given cyclical conditions and expectations generated in good times with high surpluses, recurrent overspending poses a downside risk to the budgetary strategy.

Nevertheless, the overall track record is good when it comes to respecting budgetary targets, as illustrated in Figure 7 and Table 3. In recent years, respecting the targets has been facilitated by strong revenue overshoots.

Figure 7 Government balance projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

Overall, the risks to the budgetary projections in the programme indicate that outcomes could be better than targeted in the programme from 2009. Bearing in mind that the inflation outlook for 2009 appears less plausible in the programme, the risk that the outcome of on-going public sector wage negotiations may be underestimated, the poor track record in adhering to targets, and local and regional elections scheduled for November 2009, public consumption expenditure projections may be on the low side. This is likely to be more than outweighed by upside risks due to the cautious macroeconomic outlook, particularly in view of the good overall track record with sizable surpluses often being revised upwards due to positive revenue surprises.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Table 7: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	broadly in line	broadly in line

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around ½ % of GDP for Denmark). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

Based on the programme, and subsequent recalculations by the Commission services, Denmark clearly satisfies the requirement of keeping a safety margin against breaching the 3% of GDP deficit limit, and is also seen to (over-)achieve the MTO throughout the programme period. This conclusion does not change when risks are taken into account.

Both before and after taking risks into account, the fiscal stance is assessed to remain broadly in line with the Pact, avoiding pro-cyclical policies when good times can be expected.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

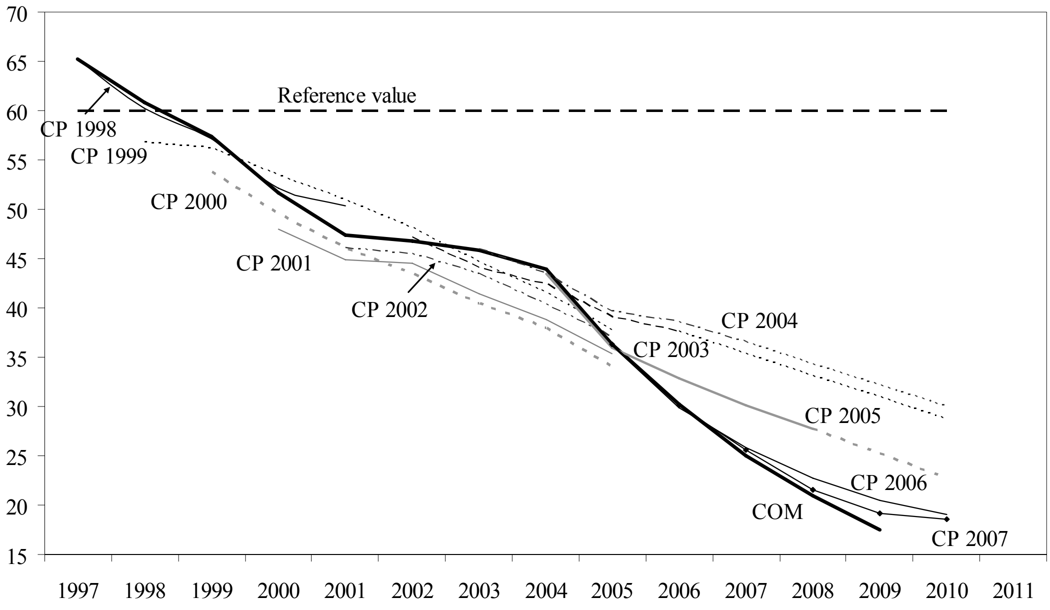
This Section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

Denmark has successfully pursued a debt-reducing strategy, as can be seen in Figure 8 and Table 8. Since 1999, the gross debt ratio has been well under the Treaty reference level, and it is foreseen in the programme to fall further, albeit at a slower pace. The programme projects a fall in the consolidated gross debt from 30.1% of GDP in 2006 to 18.6% of GDP. The Commission services' autumn 2007 forecast projects a more rapid reduction, reflecting the more favourable macro-economic and budgetary outlook. The programme furthermore indicates that the gross debt is projected to fall to 15.5% of GDP in 2015, implying a total reduction of 14.6 percentage points of GDP over the 2006-15 period.

Figure 8: Debt projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2007 forecast (COM) and successive convergence programmes

Referring to the strong focus on fiscal sustainability, the programme highlights the relevance of the level of public net debt, taking public sector financial assets into account. General government financial assets amounted to 33% of GDP in 2006. According to the programme, the public net debt is expected to turn into a net asset position in 2007 and projected to be maintained at around 5-10% of GDP towards 2015.

Table 8: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**43.2**	**30.3**	**25.0**	**25.6**	**20.9**	**21.6**	**17.5**	**19.2**	**18.6**
Change in the ratio	-2.8	-6.0	-5.3	-4.7	-4.1	-4.0	-3.4	-2.4	-0.6
Contributions [2] *:*									
Primary balance	**-4.1**	**-6.2**	**-5.3**	**-5.2**	**-4.3**	**-4.2**	**-3.6**	**-3.0**	**-2.1**
"Snow-ball" effect	**0.8**	**-0.4**	**0.1**	**0.2**	**0.2**	**0.2**	**0.3**	**0.3**	**0.3**
Of which:									
Interest expenditure	2.5	1.6	1.3	1.4	1.2	1.2	1.1	1.0	0.9
Growth effect	-0.6	-1.2	-0.6	-0.6	-0.3	-0.3	-0.3	-0.2	-0.1
Inflation effect	-1.0	-0.8	-0.7	-0.6	-0.7	-0.7	-0.6	-0.5	-0.5
Stock-flow adjustment	**0.6**	**0.6**	**0.0**	**0.3**	**-0.1**	**0.0**	**-0.1**	**0.3**	**1.2**
Of which:									
Cash/accruals diff.	0.1	0.6		n.a.		n.a.		n.a.	n.a.
Acc. financial assets	0.5	0.1		n.a.		n.a.		n.a.	n.a.
Privatisation	*0.0*	*0.0*		*n.a.*		*n.a.*		*n.a.*	*n.a.*
Val. effect & residual	-0.1	-0.1		n.a.		n.a.		n.a.	n.a.

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

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

Government ownership of enterprises has been reduced and is planned to be reduced further. Revenue arising from sales of (shares of) government-owned enterprises has been used to bring down public debt. Most recently, in August 2007, the government sold its stake in Scandlines. Reducing the stake in DONG Energy has received parliamentary approval. Further ahead, there are privatisation plans for TV2 Denmark, DSB and an obligation to reduce the ownership in Post Danmark. The programme is not explicit about public finance effects of such plans over the programme period.

While the privatisation policy tends to reduce general government financial assets, this tendency might be reversed in the pursuit of a different policy objective, namely ensuring a well-functioning domestic capital market. As the gross debt-to-GDP ratio falls below 25%, it becomes relevant to reconsider the debt strategy. Rather than eliminating outstanding debt, it may be considered appropriate to continue issuing government bonds – given the costs linked to a subsequent re-entry on the market – and increase general government financial assets instead. One option is simply to conceive a strategy for converting general government budget surpluses into general government financial assets; another is to establish a fund to sustain fiscal discipline.

In December 2007, the central bank (Nationalbanken) published a strategy for managing central government debt. In view of the low debt ratio, no euro loans are taken up, and it is foreseen to phase out T-bills during the course of 2008. On the basis of the budgetary outlook in the 2015-plan, Nationalbanken foresees an average gross financing requirement of DKK 30 billion (1.8% of GDP) over the 2008-15 period. During the years ahead, the intention is to concentrate on issuing 10-year bonds, opening a new series every second year. As the debt is reduced, it is likely that the Social Pension Fund (DSP) will need to use its possibility of placing a larger share of its assets in other listed bonds than government bonds. However, the strategy does not address the issue of increasing government financial assets.

5.1.2. Assessment

The main difference between the projections of the programme and those of the Commission services' autumn 2007 forecast stems from the projected primary balance for 2007 and 2009. In addition, projected stock-flow adjustments is foreseen to contribute differently. Stock-flow adjustments are not specified in the programme, but summarised as financial transactions including bond emission losses, re-lending to state guaranteed entities, revenue from reallocation of state assets and government bonds owned by the pension fund ATP.

As budgetary outcomes are likely to be better than foreseen in the programme, the reduction of debt is also likely to be more rapid than projected.

5.2. Long-term debt projections and the sustainability of public finances

This Section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 9 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology. [39] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 9: Long-term age-related expenditure: main projections

(% of GDP)	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**Change up to 50**
Total age-related spending	26.8	27.0	28.1	28.5	29.1	28.2	1.4
- Pensions	9.5	10.1	10.9	11.0	11.1	10.2	0.7
- Healthcare	6.9	7.0	7.4	7.7	7.8	7.9	1.0
- Long-term care	1.1	1.1	1.2	1.6	1.9	2.1	1.0
- Education	7.8	7.5	7.4	6.9	7.1	6.9	-0.9
- Unemployment benefits	1.5	1.2	1.2	1.2	1.2	1.2	-0.3
Property income received	2.2	1.9	1.7	1.4	1.1	0.9	-1.3

Source: Economic Policy Committee and Commission services.

[39] See the accompanying "methodological paper" for a description of the property income projections.

Denmark has implemented a pension reform in 2006 and new projections of age-related expenditure have been endorsed by the EPC in January 2008.[40] This reform has significantly reduced the increase in age-related expenditure by around 3½ percentage points of GDP between 2004 and 2050. The impact of the 2006 pension reform, as validated by the EPC, is included in the baseline calculations.

The projected increase in age-related spending in Denmark is below the average of the EU, rising by 1.4 percentage points of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be below the EU average, rising by 0.7 percentage point of GDP. The increase in health-care expenditure is projected to be 1.0 percentage point of GDP, lower than on average in the EU. For long-term care, the projected increase of 1.0 percentage point of GDP up to 2050 is above the average in the EU. Property income received by the general government should decrease over the long-term by 1.3 percentage points of GDP, one of the largest decreases in the EU, notably as a result of the depletion of natural resources.

Table 10: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	-3.7	-2.6	1.7	-2.1	-1.1	1.8
of which:						
Initial budgetary position (IBP)	-4.3	-3.9	-	-2.7	-2.4	-
Debt requirement in 2050 (DR)	-0.9	-	-	-0.8	-	-
Long-term change in the primary balance (LTC)	1.4	1.3	-	1.4	1.3	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 10 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period, i.e. up to 2010, and the programme scenario assumes that the programme's budgetary plans are fully attained.

In the “2007 scenario”, the sustainability gap (S2) which satisfies the intertemporal budget constraint would be -2.6% of GDP.[41] The sustainability gap is significantly lower, from positive to negative, than in last year assessment by around 3 percentage points of GDP. The pension reform has considerably reduced the sustainability gap, by around 2.7 percentage points of GDP. Moreover, the structural primary balance in 2007 is higher by 1.1 percentage points of GDP (at 4.9 percentage points of GDP) than in 2006 as measured in last year's assessment. This improvement was partly offset by the inclusion of property income projections in the sustainability indicator, which has increased substantially the sustainability gap by around 0.8 percentage point of GDP.[42]

The initial strong budgetary position with a structural primary balance of 4.9% of GDP contributes strongly to the reduction of gross debt and the accumulation of financial

[40] See EPC opinion of 11 January, CEFCPE01/2007/REP/55607.

[41] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be -3.7% of GDP.

[42] Property income development used to be considered as a qualitative factor in previous rounds of assessment.

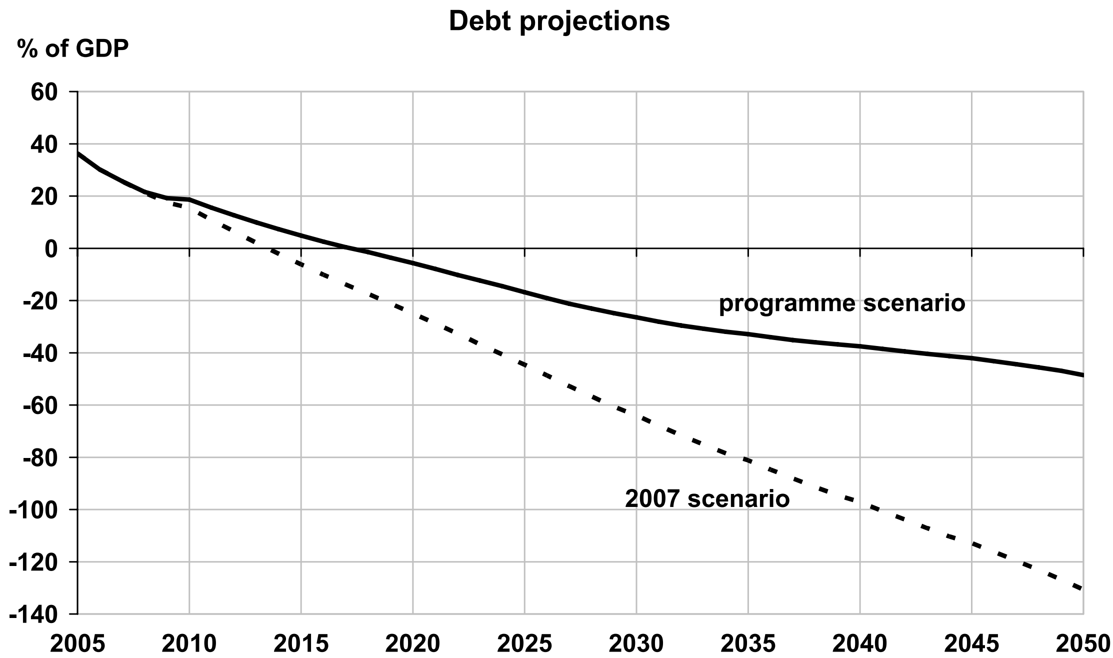
assets. According to both sustainability gaps, the long-term budgetary impact of ageing is limited.

The estimated reduction in the primary balance over the programme period of around 1.5 percentage points of GDP has a negative impact on the sustainability gap; however, a sustainability gap does not emerge in the programme scenario either.

The required primary balance (RPB) over the five years after the programme period (2011-2015) is of around 1¾% of GDP, below to the structural primary balance of about 3.4% of GDP in the last year of the programme period.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8. The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at 25.6% of GDP in 2007. In both the "2007 scenario" and the "programme scenario", the debt ratio is projected to remain below the 60% threshold over the projection period.

Figure 9: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, according to the convergence programme, revenues related to the net pension payouts (taxes on pensions) are projected to increase by 0.9 percentage point of GDP over the period from 2010 up to 2050. This is due to the increase of pensions, notably private occupational pensions, which are taxable in contrast to contributions to pension schemes which are tax-exempt. Taking this into account would reduce the sustainability gap further by around 0.7 percentage point of GDP.

Second, Denmark has one of the highest levels of taxation in the EU, suggesting that there is limited room for manoeuvre to meet expenditure increases by adjusting the budget on the revenue side.

5.2.3. Assessment

Denmark appears to be at low risk with regard to the sustainability of public finances.

The long-term budgetary impact of ageing in Denmark is lower than on average in the EU, notably thanks to the pension reform included in the Welfare Agreement.

Moreover, the budgetary position in 2007 as estimated in the programme, with a large structural surplus, contributes significantly to offsetting the long-term budgetary impact of ageing. Maintaining high primary surpluses over the medium term will contribute to limiting risks to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The convergence programme update is based on the new fiscal plan "Towards new goals - Denmark 2015", which focuses on sustainable public finances, higher employment, the quality of public services and climate and energy strategies. The budgetary elements of the plan are outlined in Section 2.4.1. The plan relies on two specific structural reform requirements for employment and hours worked to ensure fiscal sustainability. New initiatives are required to strengthen ordinary non-subsidised employment by about 0.7% and to maintain hours worked at or above the present level, counterbalancing demographic effects. Furthermore, it is a prerequisite that recent reforms, notably the welfare reform outlined in the assessment of the 2006 update, generate the estimated employment gains.

Two initiatives were presented in accordance with the plan in August 2007: a package of tax adjustments (Box 8) and the quality reform package (Box 9). As announced in the 2015-plan and in the new government platform of November 2007, structural and labour market reform issues are also addressed by establishing a labour market commission (to present recommendations to achieve the employment gains required for ensuring fiscal sustainability) and a tax commission (to consider tax reforms for lowering income taxation including marginal tax rates, while respecting the tax freeze, distributional concerns, and energy and climate policies). In view of the current tight labour market situation, a job-plan has been presented with proposals to increase labour supply (in the short term), some of which may prove to be costly (e.g. a tax relief for 64-year-old full-time workers).

Box 8: Tax adjustments agreed in September 2007

In Denmark, tax policy centres on the tax freeze as described in Section 2.2. In so far as public finances improve beyond what is required to ensure fiscal sustainability, the government gives priority to reducing the taxation of wage income. While the tax adjustments agreed in September 2007 are well in line with this policy, the argument behind was rather the strict enforcement of the tax freeze.

The labour market contribution of 8% of gross personal income was previously determined on the basis of the balance of a notional fund, establishing a link between contributions and labour market related expenditure such as unemployment benefits. Following rapid employment growth, a surplus built up in the fund, and the rules thus required the contribution rate to be reduced to eliminate the surplus in the notional fund. In this way, the labour market fund constituted a pro-cyclical mechanism, which has not been considered in previous programmes. According to the present update, maintaining the mechanism in place would reduce the sustainability indicator[43] by 0.2 pp. of GDP.

Abolishing the adjustment mechanism prior to the reduction of the contribution was considered to be violating the tax freeze, so alternative tax adjustments were proposed to compensate for keeping the contribution unchanged.

In September 2007 it was agreed to increase the in-work tax allowance and raise the middle tax bracket to coincide with the top tax bracket, while committing to adjusting the middle and top tax brackets to keep the number of tax payers concerned at or below the 2007 level. Adjustments were also agreed to ensure compensation of those receiving social transfers. In addition to the "financing" from maintaining the labour market contribution rate unchanged, it was agreed to let energy taxes increase with an assumed rate of inflation.

In total, income taxation is reduced by some 0.6% of GDP over the 2008-09 period. In this sense, it should be noted that the net effect is pro-cyclical. In view of the tight labour market, the timing and specification of the adjustments may not generate the optimum employment gains.

Box 9: The quality reform package

The quality reform package was launched with a view to accommodating mounting expectations to and demand for public services at a time when demographic effects imply declining revenue and increasing public expenditure. The package entails a wide range of initiatives, which are proposed to be allocated DKK 10 billion (0.6% of GDP) over a four year period. Moreover, a quality fund for public investments in new hospital structure, schools, and day care facilities is to be established, allocating DKK 50 billion over a ten year period.

The proposals address a variety of issues, summarised under the headings: "users at the centre"; "attractive work environment and good management"; "innovation, local governing and streamlined administration"; and "improved nursing and caring".

The proposals have yet to be negotiated, adopted and implemented. In this process, it will be essential to focus on proposals, which will foster cost efficient use of inputs and improve the effectiveness of government expenditure in achieving the desired outcomes.

[43] The reported sustainability indicator corresponds to the S2 indicator, showing the hypothetical fiscal adjustment needed today to ensure the financing of future increases in public net obligations, including the interest burden on current net debt.

The programme highlights two issues relating to institutional features. Firstly, following the reform at local and regional government level (see Section 2.2), a goal has been set to improve administration to reallocate resources to the provision of services to citizens averaging DKK 1 billion per year in the 2009-13 period. A plan for achieving this goal is to be presented in 2008. Secondly, the framework for budget negotiations between local, regional and central government will be reconsidered. Proposals will be presented in the first half of 2008 addressing the problems of adhering to overall spending limits and of enforcing the tax freeze at local government level (see Sections 2.4 and 2.5).

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The updated convergence programme in line with the national reform programme (NRP) and with the October 2007 implementation report of the NRP (the assessment of which is summarised in Box 10). It reiterates the key challenge of ensuring long-term fiscal sustainability by maintaining sound public finances and sustaining a high level of structural employment. Some references are made to implementation report of the NRP, and the descriptions of measures appear to concur, e.g. the proposed “quality reform package” (see Box 9). Both the convergence programme and the October 2007 implementation report are based on the 2015-plan (see Section 6), which enhances coherence in the assessment of the impact on public finances. The programme therefore implicitly provides a qualitative assessment of the overall impact of the NRP within the medium term fiscal strategy.

The programme includes systematic information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the NRP. The budgetary projections in the programme also appears to take into account the public finance implications of the reforms outlined in the implementation report of the NRP.

Overall, the implementation report of the NRP and the convergence programme seem to be integrated.

Box 10: 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 . 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.

The table below provides an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs, in particular the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The programme contains no explicit reference to the broad economic policy guidelines or any assessment of consistency, but the objectives of the fiscal plan, on which the programme is based, are largely concurrent with the guidelines.

Table 11: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].	X			
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.				X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X			
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X			

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The table of content of the programme adheres to the code of conduct, and the model structure broadly follows the model structure in Annex 1 of the code of conduct.

(ii) Data requirements

The update provides all compulsory data. However, there are discrepancies between the convergence programme and the Commission services in the definition of one-off and temporary measures (Tables 2 and 5), as outlined in Box 5.

The following optional data are missing: General government expenditure by function, year x+3 (Table 3); Specifications of the stock-flow adjustment (Table 4); Cyclically-adjusted balance/primary balance (Table 5).

Furthermore, the data reported for Total expenditure and Total revenue (Table 2) does not correspond to the harmonised definition. Differences are detected in the subcomponents social contributions and "other".

The tables on the following pages show the data presented in the December 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.	X		
b. Economic outlook			
… (for euro area and ERM II Member States) uses “common external assumptions” on main extra-EU variables.		X	The programme is based on projections predating the autumn forecast. A sensitivity analysis is carried out on the deviations for 2007-2008.
… explains significant divergences with Commission services’ forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with	X		

The SCP…	Yes	No	Comments
respect to budgetary targets endorsed by Council.			
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).			Not applicable
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.	X		
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		Except for different exchange rate assumptions
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		Reporting own projections and outlining difference to AWG projections.
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme; AWG = Ageing Working Group

[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	*1431.9*	3.5	2.0	1.3	1.1	0.5
2. Nominal GDP	B1*g	*1642.2*	5.8	4.0	4.0	3.3	3.2
Components of real GDP							
3. Private consumption expenditure	P.3	*711.2*	3.1	2.2	1.5	1.2	1.1
4. Government consumption expenditure	P.3	*356*	1.5	1.8	1.7	1.0	1.0
5. Gross fixed capital formation	P.51	*339*	13.0	3.0	0.6	-2.3	-2.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*10.5*	0.4	0.0	0.2	0.0	0.0
7. Exports of goods and services	P.6	*774.1*	10.1	4.9	3.0	3.5	3.6
8. Imports of goods and services	P.7	*765.3*	14.4	5.7	3.5	2.2	3.3
Contributions to real GDP growth							
9. Final domestic demand		-	4.6	2.2	1.3	0.3	0.2
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.4	0.0	0.2	0.0	0.0
11. External balance of goods and services	B.11	-	-1.4	-0.2	-0.2	0.7	0.3

Table 1b. Price developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator		*114.7*	2.2	2.0	2.7	2.2	2.7
2. Private consumption deflator		*111.6*	2.1	1.7	2.6	2.0	2.1
3. HICP		*101.8*	1.9	1.7	2.4	1.6	1.9
4. Public consumption deflator		*117.9*	3.0	2.6	2.8	2.8	3.0
5. Investment deflator		*108.7*	2.8	3.3	2.8	1.8	3.2
6. Export price deflator (goods and services)		*110.2*	2.3	1.7	1.3	0.7	1.0
7. Import price deflator (goods and services)		*105.1*	2.9	2.2	1.4	0.6	0.6

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*2780.5*	2.0	1.7	0.0	-0.5	-0.8
2. Employment, hours worked[2]		*4470.8*	2.7	2.0	-0.6	-0.7	-0.8
3. Unemployment rate (%)[3]		*3.9*	3.9	3.3	3.1	3.2	3.6
4. Labour productivity, persons[4]		*515*	1.5	0.3	1.3	1.5	1.3
5. Labour productivity, hours worked[5]		*320.3*	0.8	0.0	2.0	1.8	1.3
6. Compensation of employees[6]	D.1	*864*	5.6	6.0	3.8	3.2	3.0
7. Compensation per employee[7]		*332.2*	3.7	4.3	3.8	3.6	3.8

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

[6]Based on current prices, i.e. growth rates are in nominal terms.

[7]Calculated as compensation per employed wage earner.

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	2.4	1.7	1.3	1.9	2.2
of which :						
- Balance on goods and services		3.0	2.4	2.1	2.9	3.3
- Balance of primary incomes and transfers		-0.6	-0.7	-0.8	-1.0	-1.1
- Capital account		0.0	0.0	0.0	0.0	0.0
2. Net lending/borrowing of the private sector	B.9	-2.2	-2.2	-1.8	-0.2	0.9
3. Net lending/borrowing of general government[1]	EDP B.9	4.7	3.9	3.1	2.1	1.3
4. Statistical discrepancy		0.0	optional	optional	optional	optional

1Public balance (net lending) is based on national accounts, not EDP.

Table 2. General government budgetary prospects

	ESA Code	2006 Level	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*75.9*	4.6	3.8	3.0	2.0	1.2
2. Central government	S.1311	*82.5*	5.0	3.8	3.0	2.0	1.2
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-7.2*	-0.4	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	*0.6*	0.0	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue [7]	TR	*898.5*	54.7	53.4	52.9	52.0	51.7
7. Total expenditure [7]	TE[1]	*822.7*	50.1	49.6	49.8	50.0	50.5
8. Net lending/borrowing	EDP B.9	*75.9*	4.6	3.8	3.0	2.0	1.2
9. Interest expenditure	EDP D.41	*26.4*	1.6	1.4	1.2	1.0	0.9
10. Primary balance[2]		*102.3*	6.2	5.2	4.2	3.0	2.1
11. One-off and other temporary measures[3]		*n.a.*	1.1	-0.4	-0.6	-0.2	-0.3
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*786.7*	47.9	47.0	46.6	45.7	45.3
12a. Taxes on production and imports	D.2	*295*	18.0	17.7	17.5	17.1	16.8
12b. Current taxes on income, wealth, etc	D.5	*488.3*	29.7	29.1	29.0	28.4	28.3
12c. Capital taxes	D.91	*3.5*	0.2	0.2	0.2	0.2	0.2
13. Social contributions[8]	D.61	*17*	1.0	1.0	1.0	1.0	1.0
14. Property income	D.4	*31.3*	1.9	1.8	1.8	1.7	1.7
15. Other [4]		*63.5*	3.9	3.5	3.4	3.5	3.6
16=6. Total revenue [7]	TR	*898.5*	54.7	53.4	52.9	52.0	51.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			48.9	48.0	47.7	46.7	46.4
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*417.7*	25.4	25.6	25.7	26.0	26.2
17a. Compensation of employees	D.1	*277.6*	16.9	16.8	16.7	16.8	16.9
17b. Intermediate consumption	P.2	*140.1*	8.5	8.8	9.1	9.2	9.3
18. Social payments (18=18a+18b)		*278.6*	17.0	16.6	16.7	16.9	17.3
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*23.6*	1.4	1.4	1.5	1.5	1.5
18b. Social transfers other than in kind	D.62	*255*	15.5	15.2	15.2	15.4	15.8
19=9. Interest expenditure	EDP D.41	*26.4*	1.6	1.4	1.2	1.0	0.9
20. Subsidies	D.3	*35.8*	2.2	2.3	2.3	2.4	2.4
21. Gross fixed capital formation	P.51	*29.7*	1.9	1.7	1.7	1.8	1.8
22. Other[6]		*34.3*	2.0	2.0	2.2	1.8	1.8
23=7. Total expenditure [7]	TE[1]	*822.7*	50.1	49.6	49.8	50.0	50.5
p.m.: Government consumption (nominal)	P.3	*419.6*	25.6	25.6	25.8	25.9	26.1

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

[3]A plus sign means surplus-increasing one-off measures. The figures reported in the programme include temporary variations in revenues from pension yield taxation, North Sea activitites, net interest, corporate taxes and other special items.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Defined as the sum of taxes on production and imports (incl. those collected by the EU), current taxes on income, wealth etc., and capital taxes and compulsory social contributions.

[6]The programme notes that Statistics Denmark does not publish figures for all the subgroups (P.11+P.12+P.131+D.39+D.7+D.9(other than D.91), D.6311, D.63121, D.63131, D.29+D.4 (other than D.41)+D.5+D.7+D.9+P.52+P.53+K.2+D.8), and no estimates are composed for these single components in the projections.

[7] The programme data for total expenditure and total revenue differs from the data reported to Eurostat, following the harmonised approach (cf Commission Regulation No. 1500/2000), on which the Commission services' forecast is based.The difference relates primarily to the treatment of public sales of goods and services and of the consumption of fixed capital. The balance is, however, unaffected. Furthermore, total revenue is excl. central government revenues from sale of UMTS-licenses.

[8]Excluding voluntary and imputed social contributions

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	6.5	n.a.
2. Defence	2	1.6	n.a.
3. Public order and safety	3	1.0	n.a.
4. Economic affairs	4	3.8	n.a.
5. Environmental protection	5	0.5	n.a.
6. Housing and community amenities	6	0.7	n.a.
7. Health	7	6.7	n.a.
8. Recreation, culture and religion	8	1.6	n.a.
9. Education	9	7.8	n.a.
10. Social protection	10	21.5	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	51.6	n.a.

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		30.1	25.6	21.6	19.2	18.6
2. Change in gross debt ratio		-6.2	-4.5	-4.0	-2.4	-0.6
Contributions to changes in gross debt						
3. Primary balance[2]		-6.2	-5.2	-4.2	-3.0	-2.1
4. Interest expenditure[3]	EDP D.41	1.6	1.4	1.2	1.0	0.9
5. Stock-flow adjustment		0.4	0.5	0.0	0.3	1.2
of which:						
- Differences between cash and accruals[4]		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		n.a.	n.a.	n.a.	n.a.	n.a.
of which:						
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other[6]		n.a.	n.a.	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		4.7	4.8	4.9	4.8	4.7
Other relevant variables						
6. Liquid financial assets[8]		4.1	4.5	4.3	n.a.	n.a.
7. Net financial debt (7=1-6)		2.7	-1.2	-4.3	-6.5	-7.6

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	**2006**	**2007**	**2008**	**2009**	**2010**
1. Real GDP growth (%)		3.5	2.0	1.3	1.1	0.5
2. Net lending of general government	EDP B.9	4.6	3.8	3.0	2.0	1.2
3. Interest expenditure	EDP D.41	1.6	1.4	1.2	1.0	0.9
4. One-off and other temporary measures[1]		1.1	-0.4	-0.6	-0.2	-0.3
5. Potential GDP growth (%)		2.3	1.6	1.6	1.5	1.4
contributions:						
- labour		0.5	0.1	0.2	0.2	0.1
- capital		0.9	1.0	0.9	0.8	0.9
- total factor productivity		0.9	0.5	0.5	0.4	0.4
6. Output gap		1.8	2.1	1.8	1.4	0.5
7. Cyclical budgetary component[2]		1.1	2.5	2.2	1.4	0.7
8. Cyclically-adjusted balance (2 - 7)[3]		3.5	1.3	0.8	0.6	0.5
9. Cyclically-adjusted primary balance (8 + 3)[3]		5.1	2.7	2.0	1.6	1.4
10. Structural balance (8 - 4)[4]		2.4	1.7	1.5	0.9	0.8

[1]A plus sign means surplus-increasing one-off measures. The figures reported in the programme include temporary variations in revenues from pension yield taxation, North Sea activitites, net interest, corporate taxes and other special items.

[2]The calculation of the cyclical component is based on the national methodology using the employment gap.

[3]Not reported, but derived by the Commission services

[4]The structural balance is calculated using a national methodology

Table 6. Divergence from previous update

	ESA Code	**2006**	**2007**	**2008**	**2009**	**2010**
Real GDP growth (%)						
Previous update		2.7	2.0	0.7	0.7	0.6
Current update		3.5	2.0	1.3	1.1	0.5
Difference		0.8	0.0	0.6	0.4	-0.1
General government net lending (% of GDP)	EDP B.9					
Previous update		3.1	2.8	2.5	1.8	1.2
Current update		4.6	3.8	3.0	2.0	1.2
Difference		1.5	1.0	0.5	0.2	0.0
General government gross debt (% of GDP)						
Previous update		29.9	25.8	22.7	20.4	18.9
Current update		30.1	25.6	21.6	19.2	18.6
Difference		0.2	-0.2	-1.1	-1.2	0.3

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	53.0	51.7	50.4	51.0	51.5	52.5
Of which: age-related expenditures	33.6	34.6	34.1	35.3	35.5	35.7
Pension expenditure	9.1	9.3	9.6	10.4	10.0	9.5
Social security pension	9.1	9.3	9.6	10.4	10.0	9.5
Old-age and early pensions	6.9	7.2	7.6	8.4	7.8	7.3
Other pensions (disability, survivors)	2.2	2.1	2.0	2.0	2.2	2.1
Occupational pensions (if in general government)	0.0	0.0	0.0	0.0	0.0	0.0
Health care	6.0	6.4	6.5	6.9	7.4	7.7
Long-term care *(this was earlier included in the health care)*	1.0	1.1	1.2	1.3	1.6	1.8
Education expenditure	5.6	5.9	6.0	5.8	5.5	5.7
Other age-related expenditures	11.9	11.9	10.8	10.9	11.0	11.0
Interest expenditure	4.3	2.6	1.3	0.8	1.0	2.0
Total revenue	55.3	56.3	51.7	50.6	49.6	49.7
Of which: property income[1]	1.9	1.5	1.5	1.2	0.7	0.5
Of which : from pensions contributions (or social contributions if appropriate)	-0.7	-1.1	-1.1	-1.0	-1.0	-0.2
Pension reserve fund assets	115.9	138.3	147.9	176.4	203.2	226.0
Of which : consolidated public pension fund assets (assets other than government liabilities)[2]	1.1	0.1	0.1	0.1	0.0	0.0
Assumptions						
Labour productivity growth	3.8	1.8	1.6	1.6	1.4	1.5
Real GDP growth[3]	3.5	3.1	0.5	2.1	3.3	2.7
Participation rate males (aged 20-64)	85.5	85.6	86.1	86.9	89.3	90.1
Participation rates females (aged 20-64)	76.2	76.5	76.7	78.0	80.8	82.3
Total participation rates (aged 20-64)	80.9	81.1	81.4	82.5	85.1	86.2
Unemployment rate	5.2	5.5	4.0	3.9	3.9	3.9
Population aged 65+ over total population	791.0	818.0	916.0	1137.0	1315.0	1437.0

[1] Includes public revenues from interest income and dividends.

[2]Public funds assets is adjusted downward by almost DKK 300 billion (20 per cent of GDP) in 2005 due to the changed classification of the ATP fund due to the revision of national accounts.

[3]In some years after 2025 GDP growth is effected by the regulation of early- and old age person ages in line with longevity

Table 8. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate (annual average)	3.2	4.4	4.8	4.8	5.0
Long-term interest rate (annual average)	3.8	4.4	4.8	4.9	5.1
USD/€ exchange rate (annual average) (euro area and ERM II countries)	125.40	135.10	137.20	137.20	137.20
Nominal effective exchange rate	101.6	103.0	103.2	103.2	103.2
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	5.8	5.3	5.4	4.5	4.5
EU GDP growth	3.0	2.9	2.7	2.4	2.4
Growth of relevant foreign markets	7.3	6.9	6.6	4.5	4.5
World import volumes, excluding EU	8.8	7.7	8.0	7.5	7.5
Oil prices (Brent, USD/barrel)	64.9	70.0	68.0	65.5	63.0

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Denmark. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

Table: Key economic indicators

	Denmark						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.1	2.9	1.3	3.1	3.5	1.9	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*2.2*	*2.6*	*1.9*	*4.1*	*4.9*	*2.5*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*-0.1*	*0.3*	*-0.6*	*-1.0*	*-1.4*	*-0.6*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	131	133	128	129	129	128	113	114	112	110	110	109
Real GDP per capita (% change)	1.7	2.4	1.0	2.8	3.2	1.7	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	1.9	2.0	1.9	1.7	1.9	1.7	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	1.6	1.8	1.3	2.4	1.5	-0.1	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	0.0	0.0	0.0	-2.2	0.0	2.0	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	0.5	1.0	0.0	0.7	2.0	2.0	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	5.1	5.2	5.0	4.8	3.9	3.0	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	0.4	-1.4	2.3	-0.8	1.2	3.7	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	-0.8	-0.9	-0.8	0.6	1.5	-2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.1	1.1	3.2	3.7	2.4	1.2	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	0.9	0.3	1.6	4.6	4.6	4.0	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	52.5	60.9	44.1	36.3	30.3	25.0	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	2.6	4.5	3.6	3.2	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	1.4	2.1	0.7	-0.9	0.9	2.0	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	2.9	3.7	2.1	0.2	1.6	2.0	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source :
Commission services