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Danish Fiscal Policy in 2009 in view of the European Economic Recovery Plan (Addendum to Denmark's Convergence Programme 2008)

1. Introduction and conclusion

This note constitutes an addendum to Denmark's Convergence Programme 2008 focusing on Danish fiscal policy for 2009 in view of the European Economic Recovery Plan (EERP).

Denmark's adopted fiscal policies imply a discretionary expansion of almost 1 per cent of GDP – within the Danish medium-term framework consistent with long-term sustainability – which is hereby notified as the Danish government's fiscal policy stimulus measures in relation to the EERP responding to the economic and financial crisis.

Given a fiscal policy in line with the EERP and the overall requirement of sustainability, the need for fiscal policy to support the fixed exchange rate policy, and the challenges of an economy still operating above potential, the Danish macro policy management focuses in particular on ensuring the stability of financial markets.

2. Significant deterioration of public finances in 2009

The outlook points to a significant deterioration in public finances on the back of the cyclical slowdown, declining revenue from special factors, and a substantial easing of fiscal policies.

The *general government balance*, recording surpluses of up to 5 per cent of GDP in 2005-2007, is estimated to display a surplus of 3 per cent of GDP in 2008 before deteriorating to a roughly balanced position in 2009 and a deficit of 1.2 per cent of GDP in 2010. The actual balance will thus decline by more than 50 billion DKK, corresponding to 3 per cent of GDP, in 2009.

The *structural balance*, i.e. the actual balance corrected for effects from the cycle and special factors according to Danish methodology, is estimated at 2.3 and 1.1 per cent of GDP in 2008 and 2009 respectively, implying a deterioration of around 1.2 per cent of GDP in 2009. Applying EU methodology, the structural balance will deteriorate by 1.6 per cent of GDP in 2009 according to the Commission's November 2008 forecasts, most likely heading towards a larger deterioration in the upcoming January 2009 forecasts.

3. Discretionary fiscal expansion in 2009

Fiscal policies imply a discretionary expansion of around 16 billion DKK in 2009, corresponding to close to 1 per cent of GDP, as measured – bottom-up – by the direct budgetary impact (the sum of estimated effects on all individual revenue and expenditure items). This is in line with an estimated contribution from fiscal policies to the deterioration of the structural balance of close to 1 percentage point.

Active fiscal policy is estimated to yield a stimulus to GDP growth of around 0.4 percentage points, as measured by the first-year fiscal effect, taking into account the direct budgetary impact on all budgetary items and fiscal multipliers.

Active fiscal policies thus provide a significant stabilisation effect on top of the effects from automatic stabilisers from the cyclical rise in expenditures for unemployment benefits and fall in tax receipts, that are relatively large in Denmark and have the desirable property of a time profile matching the cycle, while avoiding a lasting deterioration of public finances.

Out of the total reduction of the actual balance amounting to 3 per cent of GDP – of which the structural deterioration mainly due to fiscal policy accounts for a little more than 1 per cent of GDP and lower net revenue from special factors (especially revenue from North Sea activities) accounts for less than 1 per cent of GDP – automatic stabilisers would account for a deterioration of public finances by more than 1 per cent of GDP.

The discretionary fiscal expansion in 2009 mainly consists of a reduction of taxation by around $\frac{1}{2}$ per cent of GDP, mainly reflecting the 2007 tax agreement, and an increase in expenditure of also around $\frac{1}{2}$ per cent of GDP, including an increase in public consumption. The suspension of payments to the Special Pensions scheme has no economic activity impact since this is unchanged as compared to the previous year.

The tax reform was adopted in 2007, while overall fiscal policy, including the final fiscal stance was set in the 2009 budget adopted in December 2008. Details of fiscal policy for 2009 are provided in the Convergence Programme 2008.

Fiscal policy is designed by deciding on a subset of independent budgetary measures, but calibrated as a whole within a framework of expenditure targets, and the overall fiscal stance is set according to the cyclical situation, the medium-term framework and long-term fiscal sustainability. The effective final fiscal policy was practically and politically adopted with the final parliamentary vote on the fiscal bill in December 2008.

Due to fiscal policy as well as wage increases and a substantial drop in inflation, households' real disposable income is expected to rise by up to 4 per cent in 2009.

4. Fiscal policy in 2009 and the overall framework aiming at long-term sustainability

The fiscal policy stimulus measures for 2009 are consistent with the Danish medium-term framework aiming at long-term sustainability, i.e. the 2015 Plan. The Plan's central targets are 1) long-term sustainable fiscal policies, 2) a structural balance with surpluses of $\frac{3}{4}$ - $1\frac{3}{4}$ through 2010 and thereafter at least a balanced position through 2015 (the Danish medium-term objective, MTO), 3) real public consumption growth of 1 per cent per year on average in 2008-2015, and 4) public consumption expenditure of no more than $26\frac{1}{2}$ per cent of GDP in 2015, as a benchmark.

The fiscal stimulus measures, reducing the structural balance by close to 1 percentage point to a level slightly above 1 per cent in 2009 and slightly below 1 percentage point in 2010, imply that the structural balance is in line with but at the lower range of the target interval in the 2015 Plan. Given an estimated sustainability indicator of -0.1 per cent of GDP, fiscal policies are only roughly consistent with the overall requirement of long-term sustainability, taking into account the requirement of structural reforms increasing employment by 20.000 and countering the tendency to declining working hours towards 2015.

5. Fiscal policy and challenges for the Danish economy

The fiscal policy expansion is relatively large in the light of the specific situation of the Danish economy and the fixed exchange rate policy.

The Danish labour market is still operating above its potential with an unemployment rate well below its structural level just starting to rise slightly, and pressure on wages and competitiveness. Further fiscal easing may exert undue pressure on macro balances and lead to a higher medium-term level of unemployment than currently projected.

Fiscal policy should support the credibility of the fixed exchange rate policy by ensuring sustainability and by contributing to an inflation rate in line with the euro area, thus providing for a reduction of the monetary policy interest rate spread, which during the crisis has widened significantly to 1.75 percentage points, currently 1.25 percentage points. Lower interest rates should support financial markets and housing markets under stress.

Danish macro policy management now in particular focuses on ensuring the stability of financial markets, following up on a number of measures already adopted.

The government has indicated that further temporary fiscal measures targeted at structural improvements would be considered dependent on economic developments.