Fiscal Consolidation Agreement – English Summary

In May 2010 the Danish government and the Danish People's Party agreed on measures to consolidate public finances towards 2013. With the Agreement, concrete initiatives have been decided to meet the recommendation from the EU to bring the deficit below 3 percent of GDP no later than 2013 and to improve the structural budget balance by 1½ per cent of GDP during 2011-2013. The agreement also delivers approximately 85 per cent of the required improvement in public finanses to ensure structural balance by 2015.

By specifying the budget improvements that were targeted in the Danish Convergence Programme 2009, the Fiscal Consolidation Agreement provides clarity on the concrete measures that will be implemented to meet the EU recommendation. It thus underpins confidence in Danish fiscal policy and lowers the risks of renewed financial turbulence pushing up interest rates.

The agreement also includes a labour market reform that reduces the duration of the unemployment benefit period. Overall the initiatives in the agreement are expected to increase employment by approximately 0.4 percent (some 10,000 persons) in the longer run.

The key challenges for fiscal policy

The Danish economy is gradually picking up pace and the sharp decline in employment following the global financial crisis has come to an end. Although growth prospects are still uncertain, partly reflecting developments in European debt markets since April, the near-term outlook is supported by a stabilisation of the housing market while consumer and business confidence are back at or above normal levels. Moreover, the moderate recovery of the international economy in particular in the northern part of Europe lends support to Danish exports.

It is expected that production will increase by 1.4 per cent in 2010 and 1.8 per cent in 2011. Growth this year is supported by the unusually expansionary fiscal policy in 2009 and 2010 as well as the large reduction in interest rates. Next year, growth is expected to become more self-sustained with continued growth in private consumption, rising exports and renewed investment growth.

Fiscal policy this year and last year was eased more than in other EU countries. Public investment is projected to increase by some 40 per cent in total in 2009 and 2010 and public consumption has risen more than planned in 2009. A fully financed tax reform is also implemented this year. The tax reform will initially strengthen household incomes. At the same time the large drop in interest rates helps to enhance real disposable incomes and support the housing market. Total household real disposable incomes are expected to rise by about 6 per cent this year mainly due to lower taxes and falling interest expenditures.

In the wake of the crisis and the substantial fiscal easing to support activity, the key challenge for economic policy is to consolidate fiscal policy and restore fiscal balance. The public finance deficit is expected to constitute just over 4½ per cent of GDP in 2010.

Delaying fiscal consolidation would both increase the required consolidation and expose the economy to unnecessary risks.

Firstly, large government deficits and rising debt could undermine financial markets' confidence in Danish public finances and push interest rates up, which can weaken both housing markets and employment and add further to the public debt-burden.

Secondly, Denmark would be at risk of being exposed to pressure on the Danish currency – as was the case in the autumn of 2008.

Thirdly, when public debt increases, interest payments will take up a larger share of public spending thus crowding out other expenditures.

Denmark is now in the Stability and Growth Pact procedure for Excessive Deficits and received a recommendation from the ECOFIN Council in July to strengthen public finances from 2011 to 2013. The recommendation implies that the structural budget balance should be improved by 1½ per cent of GDP during 2011-2013, requiring new measures for a total of DKK 24 bn.[1] An average annual tightening of ½ per cent GDP is the minimum requirement under the Pact.

The government and the Danish People's Party agree that it is necessary to start the consolidation of the public economy in 2011. The agreement implies a structural strengthening of general government finances of DKK 22 bn towards 2013 and a further DKK 2 bn by 2015.

The effect of the agreement on economic activity in 2011 is assessed to be broadly neutral relative to the policy stance assumed in the Convergence Programme. Most initiatives have effect only after 2011 and the agreement helps to keep interest rates low. Seen in conjunction with the delayed (multi-annual) effects of fiscal easing in 2009 and 2010 and lower interest rates, the agreement supports a continued moderate recovery.

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[1] The EU recommendation to strengthen the structural balance by 1½ per cent of GDP corresponds to an improvement of about DKK 27 bn. Some 5 bn. of this improvement are estimated to be realized through earlier initiatives, including the phasing-in of the financing initiatives in the 2009-tax reform, *cf. boks 1.2 p. 24 in Convergence programme 2009*). Hence, the structural balance must be strengthened by some 22 bn. by 2013 – through new initiatives – in order to comply with the EU recommendation (cf. *box 4.2 p. 95 in Convergence Programme 2009* as amended with the 2010 service check of the tax reform). The Fiscal Consolidation Agreement strengthens the structural balance by the required 22 bn. kr. The Agreement contains initiatives amounting to 24½ bn. kr., which after indirect effects on VAT revenues etc. strenghten the structural balance by 22 bn. kr.

Concrete initiatives

The main elements of the agreement to rebalance public finances are:

- Public consumption growth (in real terms) will be kept at bay in 2011-2013. Relative to previous spending plans, this entails a budget improvement of DKK 10½ bn.

- Enhanced mechanisms to ensure that actual spending does not exceed budgeted spending in local governments taking effect as of 2011. The mechanisms imply that the block grant can be reduced by up to DKK 3 bn. if the actual or budgeted spending increases more than agreed with the government. Moreover, sanctions are tightened with respect to municipalities that raise taxation if and when the local government in the aggregate exceed the agreement on local government taxes.

- Within the spending level, the agreement includes a switch in spending priorities for a total of DKK 10 bn. The current large budget for welfare services in the municipalities is kept unchanged at 2010-budget levels in real terms. In the central government a general savings of ministries' operating costs of ½ per cent per year in 2011-2013 is implemented.

- In addition, a series of targeted central government savings are implemented, including certain education activities and culture. Also, development aid is kept at 2010 nominal levels and child benefits are reduced. These savings are redirected notably towards health, education and initiatives for vulnerable groups.

- The automatic adjustment (wage indexation) of the thresholds for income taxes, etc., is suspended in 2011-2013. It includes the basic income tax allowance, the income threshold for top-bracket tax and a number of other thresholds in the tax system. The suspension is neutral for the income distribution and provides revenue of approximately DKK 6½ bn in 2013.

- The planned increase in the income threshold for top-bracket tax in 2011 agreed in the Spring Package 2.0 is deferred for three years until 2014. This results in gross revenue of around DKK 2 bn per year.

- The duration of the unemployment benefit period is reduced from 4 to 2 years. The experience from similar reforms through the 1990s is that a shortening of the benefit period increases search activity among the unemployed. The proposal will be fully effective in 2013 when labor shortages may begin to resurface in the light of demographic trends.

- Harmonisation of requirements for previous employment to be eligible for unemployment benefits. The proposal is linked with an agreement for reinforced preventive efforts against long term unemployment, which among other things include job-oriented training and workplace training activities.

- An annual ceiling of DKK 3,000 on tax deductions of union fees and limitations on tax deductions of certain employer contributions. It will, inter alia, strengthen the incentive to reduce union costs and hence union fee member payments. The immediate revenue is estimated at about DKK 1½ bn.

Fiscal sustainability and a balanced public economy

The Fiscal Consolidation Agreement is a significant step towards achieving the fiscal targets towards 2015:

- The key objective is to achieve structural balance in 2015. This requires new initiatives for about DKK 31 bn. (given certain assumptions on the types of measures enacted and the associated revenue loss from lower private disposable incomes and spending).

- As a step towards structural balance by 2015, to comply with the recommendation from the EU to strengthen the structural balance by ½ per cent of GDP on average per year in 2011-2013. This requires initiatives of DKK 24 bn compared to previous fiscal plans (given an associated revenue loss of some DKK 2 bn. from lower private consumption).

- Increase labour supply.

The agreement contains initiatives for slightly more than DKK 24 bn. in 2013, see Table 1.

Tabel 1. Fiscal Consolidation Agreement

DKK, bn	Compliance with the EU recommendation in 2013	Balanced structural budget in 2015
Lower public consumption growth in 2011-2103	**10½**	**10½**
Taxes	**10¼**	**8¼**
- Suspension of § 20 regulation in 2011-2013	6½	6½
- Postponement of the agreed increase in top tax threshold in 2011 for three years	2	-
- Limitations of tax deduction of union fees and employer contributions	1½	1½
Other initiatives (including parts of UIB reform[1])	**3¾**	**7¼**
Total initiatives	**24¾**	**26**
Required consolidation initiatives	24	31
Remaining requirement	-	5
Memorandum items		
- Shortening the period for UIB from 4 to 2 years	1¾	1¾
- Employment effects of UIB reform	-	2½

1 Some of the budget improvement from shortening the unemployment benefit period is in the form of reduced public consumption spending for active labour market policies.

At the same time the agreement contributes ro raising employment in the longer term by some 10,000 persons, primarily because of the reduction of the benefit period. This means that public finances overall are strengthened through initiatives for approximately DKK 26 bn. in 2015 – with DKK 5 bn remaining before the target of structural balance in 2015 is reached. This autumn the government will present proposals to reform disability pensions and faster study completion, which contribute towards reaching the target of structural balance by 2015.

Effects on economic activity

Fiscal policy in the years 2009-2011 is estimated to have a broadly neutral impact on demand growth in 2011 (measured by the multi-annual fiscal effect), even if the planned fiscal policy in 2011 in itself has a negative effect on activity, estimated at ½ per cent of GDP (at given interest rates). This should be seen in light of delayed positive effects on demand into 2011 from the expansionary measures in 2009 and especially in 2010.

The negative first year effect from fiscal policy in 2011 (of -½ per cent of GDP) primarily reflects a gradual normalisation of the level for public investments following the significant, planned growth in 2009 and 2010, while planned real growth in public consumption is set at 0.6 per cent (primarily as part of the Fiscal Consolidation Agreement) compared to zero growth in May.

The negative effect on activity from fiscal policy in 2011 (the so called fiscal effect) is marginally lower than estimated in May. The new elements in the Fiscal Consolidation Agreement strengthen public finances by 0.2 per cent of GDP in 2011 compared to the May estimate, but does not affect the fiscal effect, because the increase in public consumption under the agreement is financed among others by savings on public transfers with smaller first-year effects on activity.

The agreement implies real growth in government consumption of around ½ per cent in 2011, ¼ per cent in 2012 and approximately -¼ per cent in 2013. The spending reduction in 2013 should be seen in light of reduced outlays for active labour market schemes when the unemployment benefit period is shortened.