



LONG TERM FISCAL SUSTAINABILITY: A DANISH AND NORDIC SUCCESS STORY?

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by

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AGENDA

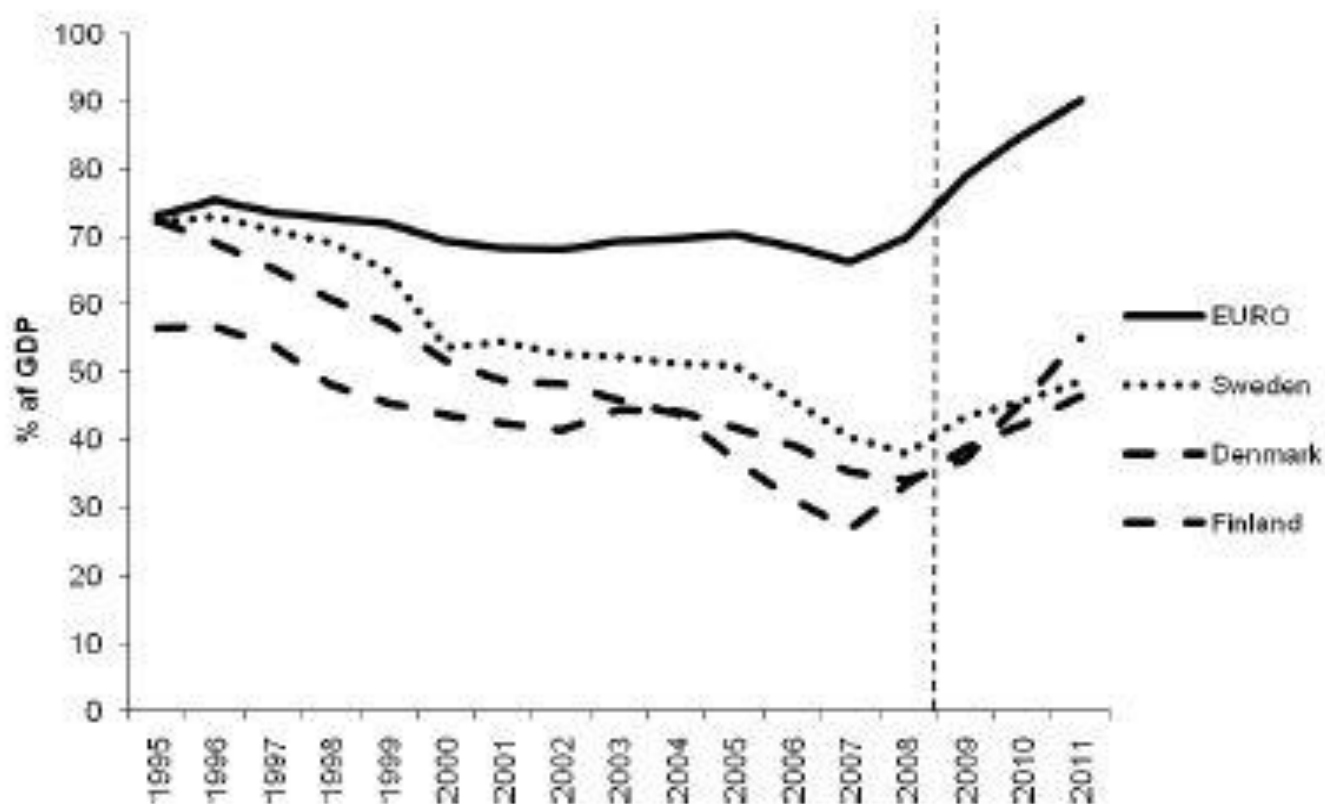
- The Nordic public finances in international perspective
- The Danish medium term fiscal strategy
- Recent structural reforms in Denmark
- The economic policy programme of the new Danish government
- Special features of the Danish public finances



THE NORDIC PUBLIC FINANCES IN INTERNATIONAL PERSPECTIVE



PUBLIC DEBT (Maastricht definition)



Source: Torben M. Andersen (2010), based on OECD data.



CURRENT FISCAL SITUATION IN SELECTED EU COUNTRIES

	Budget deficit (2010)	Public EMU debt (2007)	Public EMU debt (2010)	Output gap (2010)	Structural budget balance (2010)	Expected change in structural balance (2011)	Required change in structural balance
	----- Percent of GDP -----						
Germany	3.3	64.9	83.2	-3.0	-2.0	0.0	1.5 (2011-13)
France	7.0	63.9	81.7	-3.6	-5.1	1.3	4.0 (2010-13)
Spain	9.2	36.1	60.1	-5.6	-7.8	2.2	6.0 (2010-13)
Italy	4.6	103.6	119.0	-4.7	-3.5	0.5	1.5 (2010-12)
Portugal	9.1	68.3	93.0	-2.4	-	-	5.0 (2010-13)
Ireland	32.4	25.0	96.2	-9.0	-10.0	1.7	9.5 (2011-15)
Greece	10.5	105.4	142.8	-6.1	-	-	10 (2009-14)
UK	10.4	44.5	80.0	-5.0	-8.9	1.5	7.0 (2010-14)
Denmark	2.8	27.5	43.6	-5.6	-1.7	0.6	1.5 (2011-13)

Source: The Danish Economic Council.

FROM MAASTRICHT DEBT TO NET PUBLIC DEBT



Maastricht debt

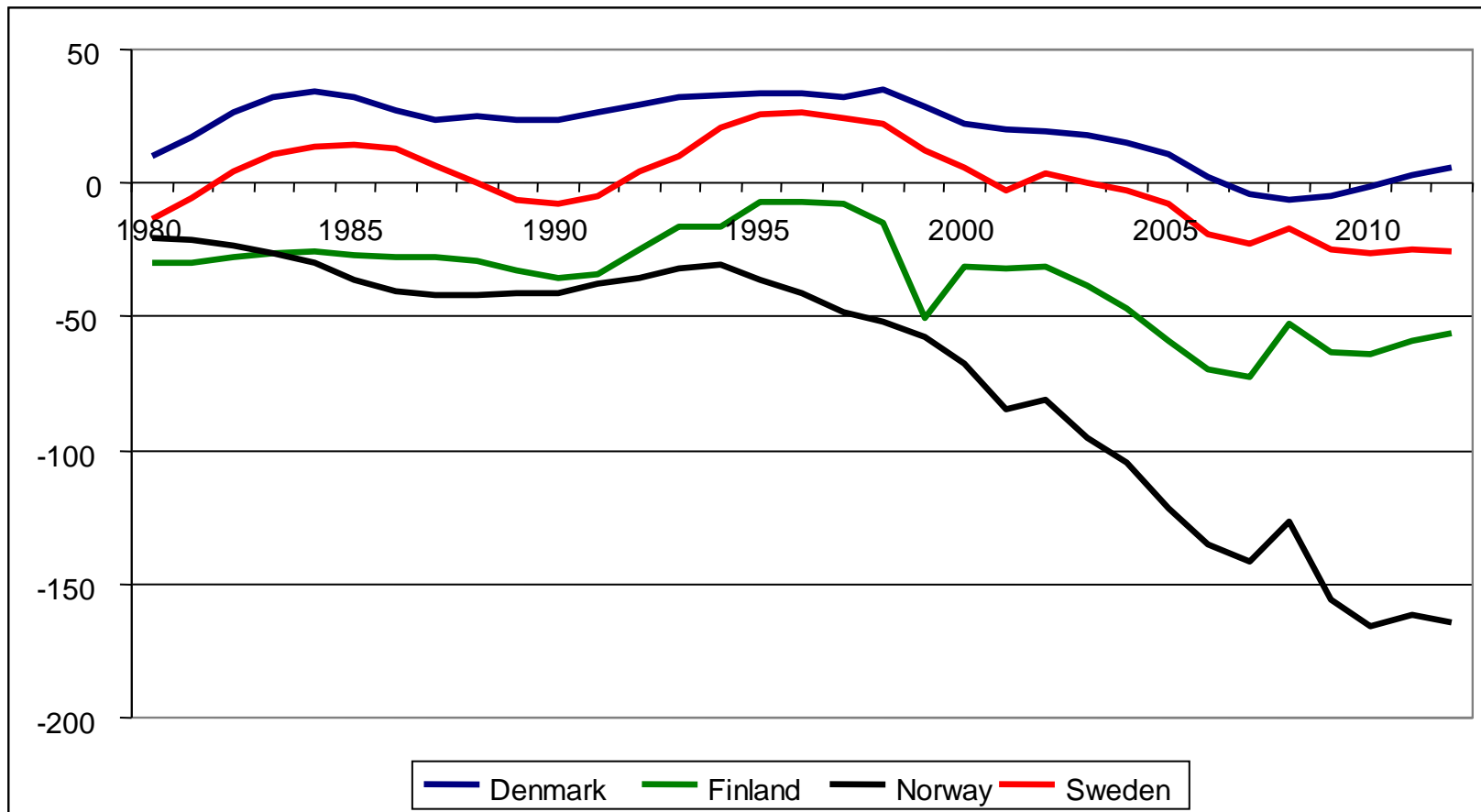
- government deposits in the central bank
- private bond holdings of government-owned entities
- government loans to private sector entities
- government ownership shares in state-owned enterprises
- government capital shares in private banks
- other government net financial assets

= Net public debt in national accounts

(Note: no real assets included)



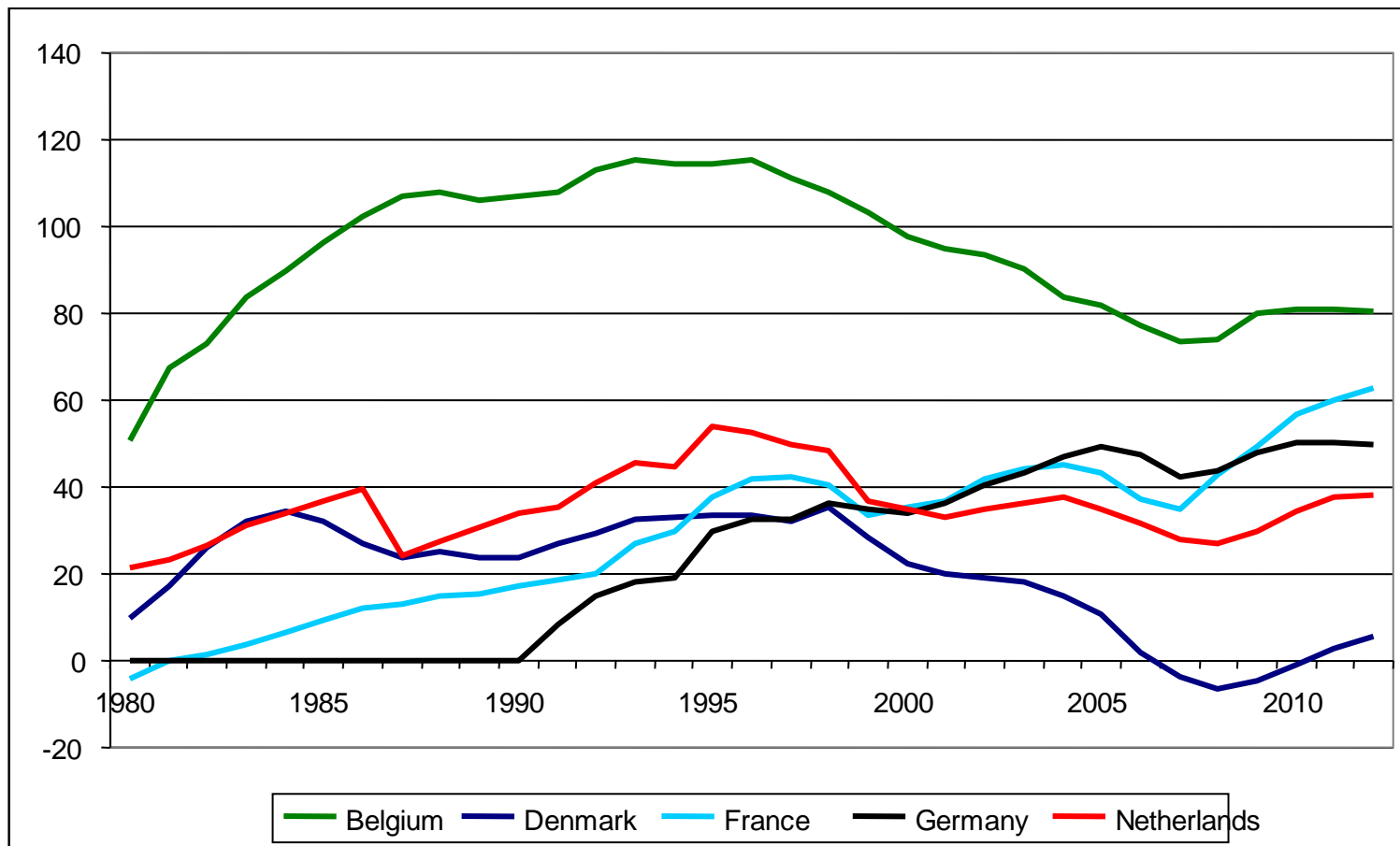
NET PUBLIC DEBT IN THE NORDIC COUNTRIES (percent of GDP)



Source: The Danish Economic Council.



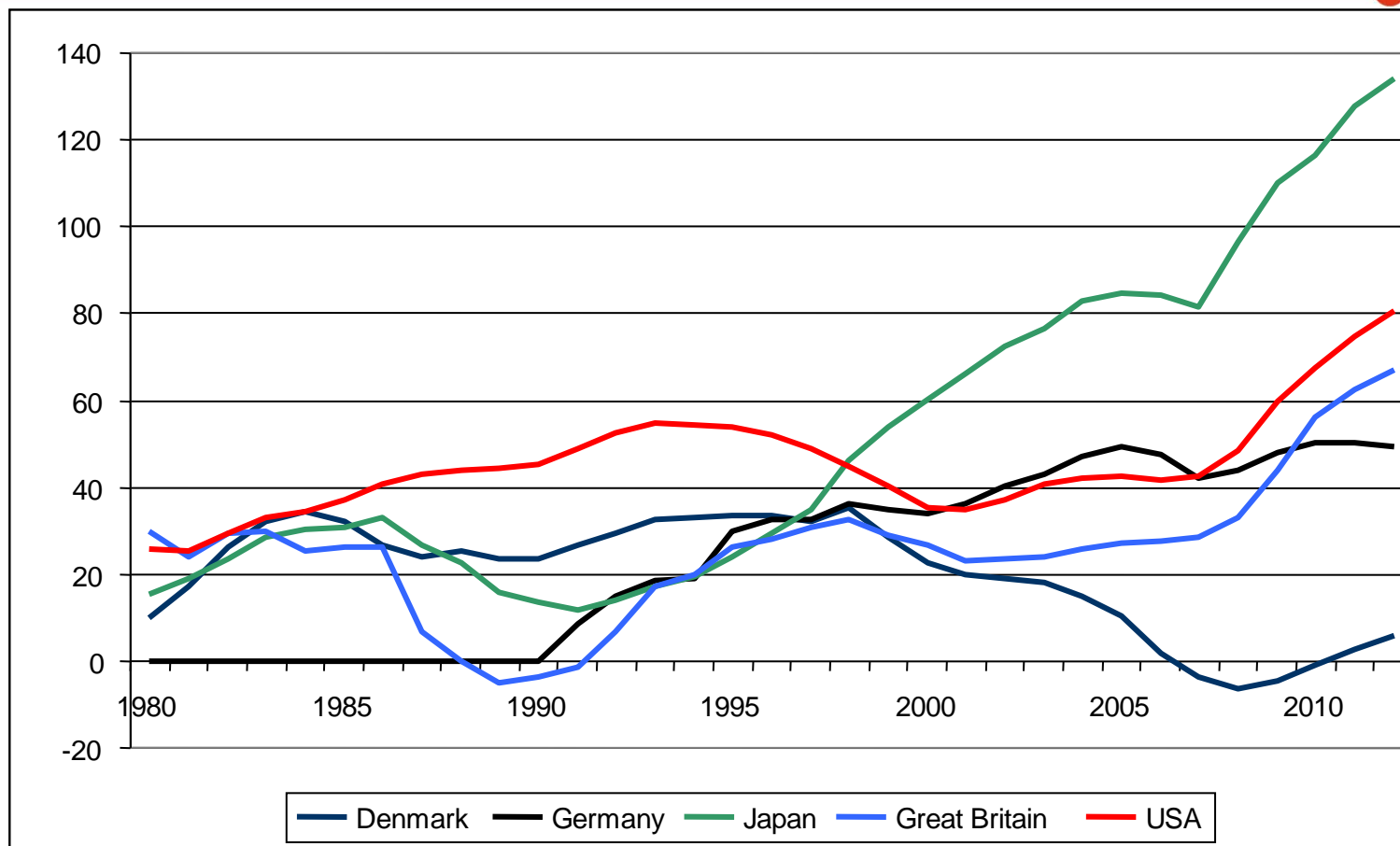
NET PUBLIC DEBT IN SELECTED EU COUNTRIES (percent of GDP)



Source: The Danish Economic Council.



NET PUBLIC DEBT IN SELECTED OECD COUNTRIES (percent of GDP)



Source: The Danish Economic Council.

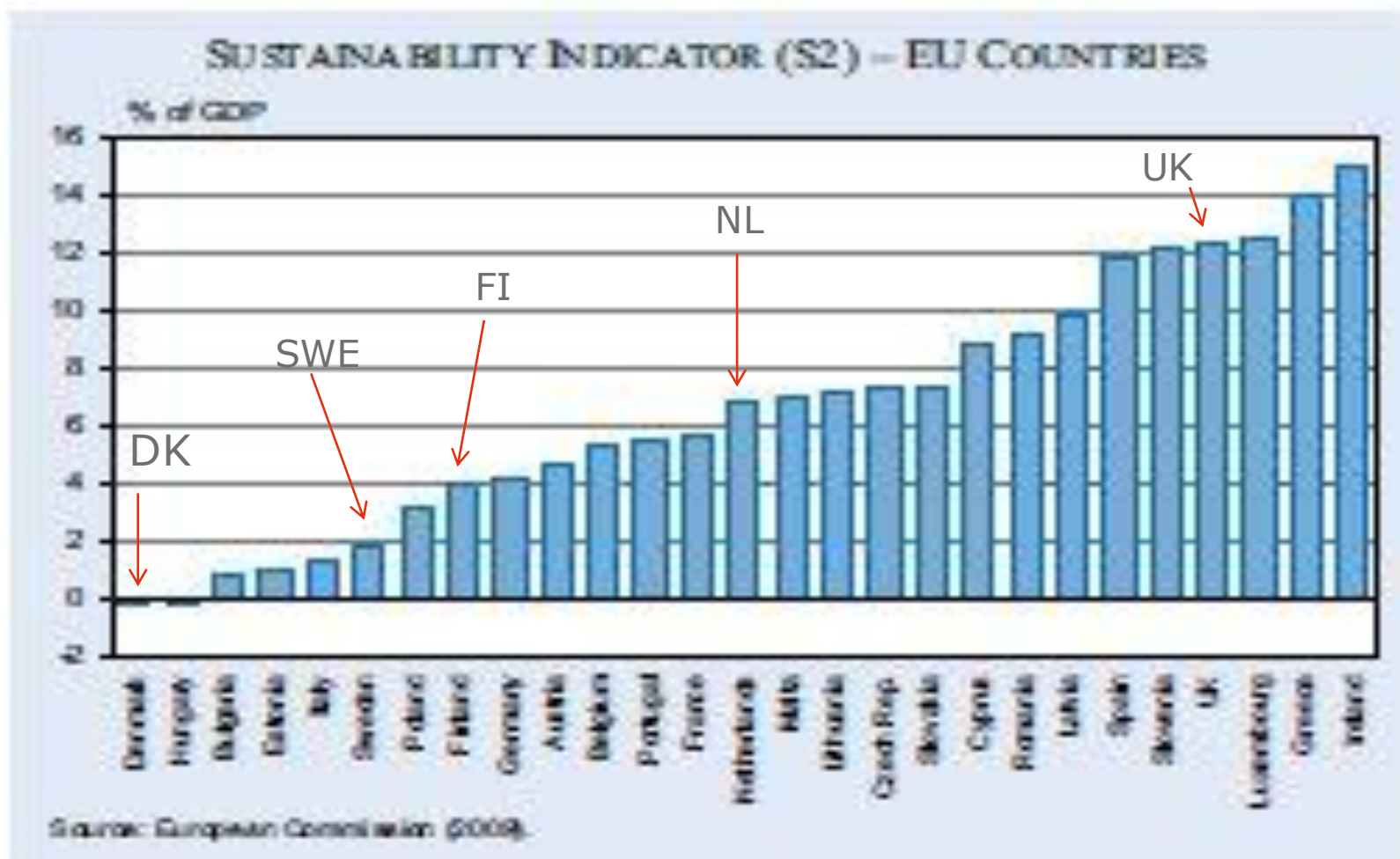


DEFINING FISCAL SUSTAINABILITY

- Fiscal policy is **sustainable** if projected future tax revenues and public expenditures do not imply an increase in the ratio of public debt to GDP, given the current policy rules
- The indicator of (the lack of) fiscal sustainability measures the permanent improvement of the structural primary budget balance needed to avoid an increase in the ratio of public debt to GDP.



FISCAL SUSTAINABILITY IN THE EU, 2009

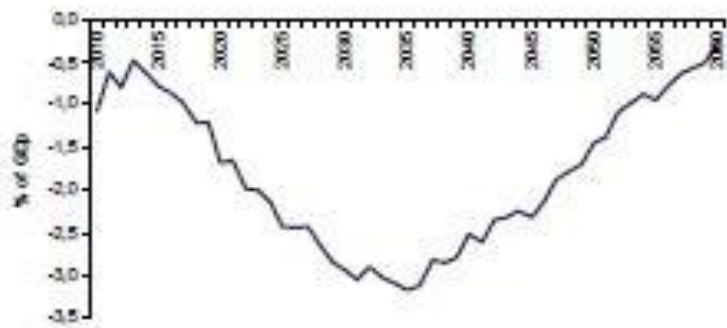


Note: The columns indicate the permanent improvement of the structural primary budget balance (in percent of GDP) needed to ensure fiscal sustainability. Source: European Commission.

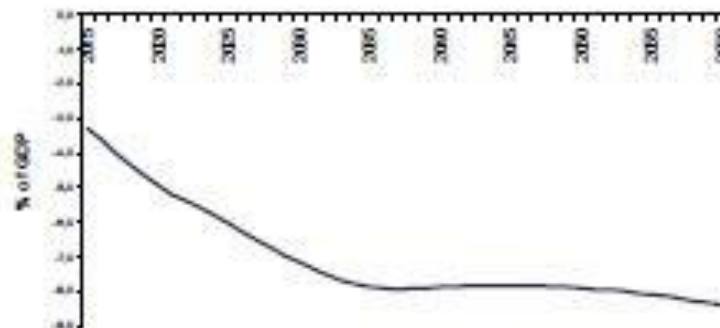


PROJECTED PRIMARY BUDGET BALANCES IN THE NORDIC COUNTRIES, 2010-2060

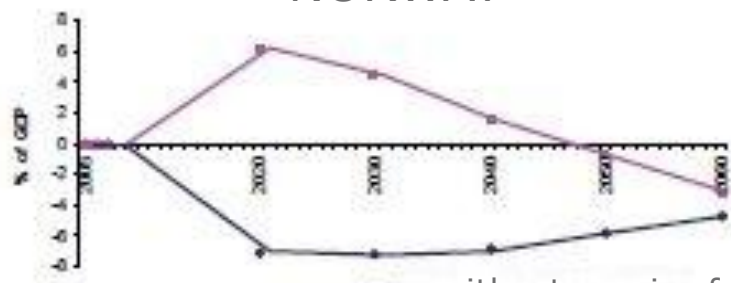
DENMARK



FINLAND



NORWAY



— without pension fund
— with pension fund

SWEDEN



THE CURRENT FISCAL SITUATION IN THE NORDIC COUNTRIES: SUMMING UP



- In contrast to the euro zone, the Nordic countries were able to consolidate their public budgets in the years before the financial crisis
- The current levels of net public debt are lower in the Nordic countries than in the rest of the EU and the OECD
- In the light of demographic change, the Nordic public finances are not quite sustainable, but the sustainability problems are relatively small by international standards



THE DANISH MEDIUM TERM FISCAL POLICY STRATEGY



BACKGROUND: THE EARLY FISCAL PLANS

- The **2005 plan** launched in 1998: Targets for net public debt and net foreign debt
- The **2010 plan** launched in 2001: Targets for net public debt and the structural budget balance to be achieved through structural reforms and low public spending growth
- Due to a booming economy in the years before the financial crisis, the 2010 goal of eliminating the net public debt was attained already in 2007 even though public spending growth exceeded the targets



DIAGNOSIS UNDERLYING THE EARLY MEDIUM TERM FISCAL STRATEGIES

- The sustainability problem was deemed to arise from a long-lasting but still *temporary* deterioration of the primary budget balance as the large cohorts of baby-boom generations retired and were replaced by smaller cohorts
- Based on developments up until the turn of the century, the increase in expected lifetimes in Denmark was assumed to be limited
- Against this background, the early fiscal plans followed a **savings strategy** aimed at building up net public assets which could be run down during the (temporary) period with relatively small cohorts in the labour market



THE CHALLENGE TO THE EARLY FISCAL STRATEGIES

- **Report from the Welfare Committee (2005):** The future deterioration of the government budget is *permanent* due to the increase in expected lifetimes. Hence a savings strategy is insufficient to solve the sustainability problem
- **Policy response:** The Welfare Agreement of 2006
 - Gradual 2-year increase in the early retirement age and the ordinary retirement age from 2019 to 2022
 - From 2025: Indexation of both retirement ages every 5 years corresponding to the increase in the expected remaining lifetime for a sixty-year old person.

THE STRATEGY UNDERLYING THE 2015 PLAN



- **The 2015-plan** (launched in 2007)
 - Continued fiscal consolidation through modest spending growth and structural reform up until 2015 (element of savings strategy)
 - The long-term financing problem due to the increase in expected lifetimes claimed to be solved through the Welfare Reform of 2006

With the combination of these elements, fiscal sustainability expected to be achieved by 2015



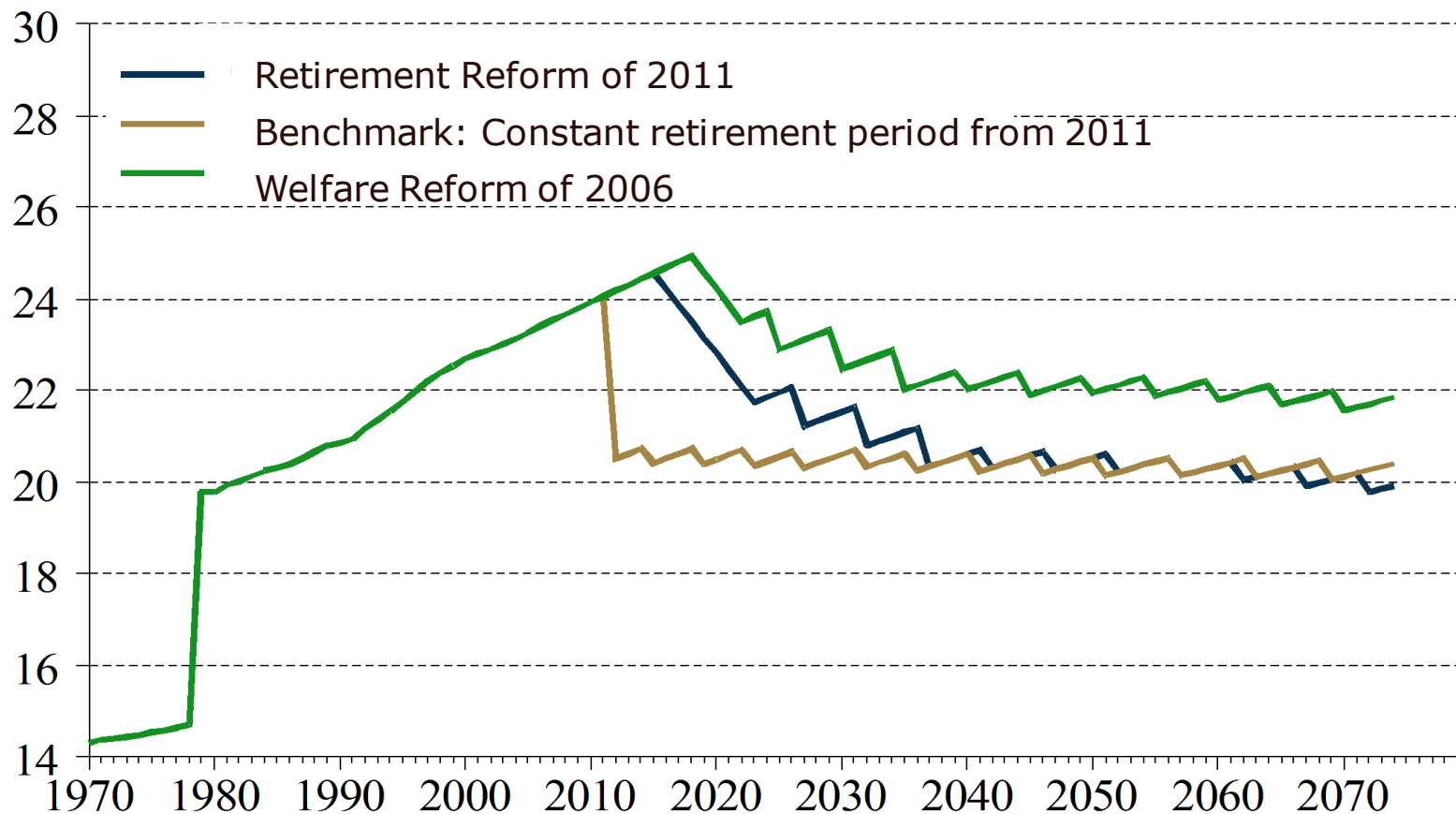
THE CRISIS AND THE POLICY RESPONSE SO FAR

- The 2008-2009 crisis caused a sharp increase in public debt due to automatic stabilizers and active fiscal stimulus → threat to the 2015 consolidation strategy
- **Policy responses**
 - *Tax Reform* phased in from 2010. Cuts in marginal tax rates, fully financed in the long run, projected to improve structural employment and the structural budget balance
 - *Consolidation Package* agreed in spring 2011: 1) Spending cuts, 2) Postponement of planned income tax cuts, 3) Duration of unemployment benefits cut in half
 - *Retirement Reform* agreed in spring 2011: 1) Increase in early retirement age moved forward to 2014, 2) Duration of early retirement benefits reduced from 5 to 3 years, 3) Tougher means-testing of early retirement benefits



EFFECTS OF RETIREMENT REFORMS: EXPECTED NUMBER OF YEARS IN RETIREMENT

Years in retirement



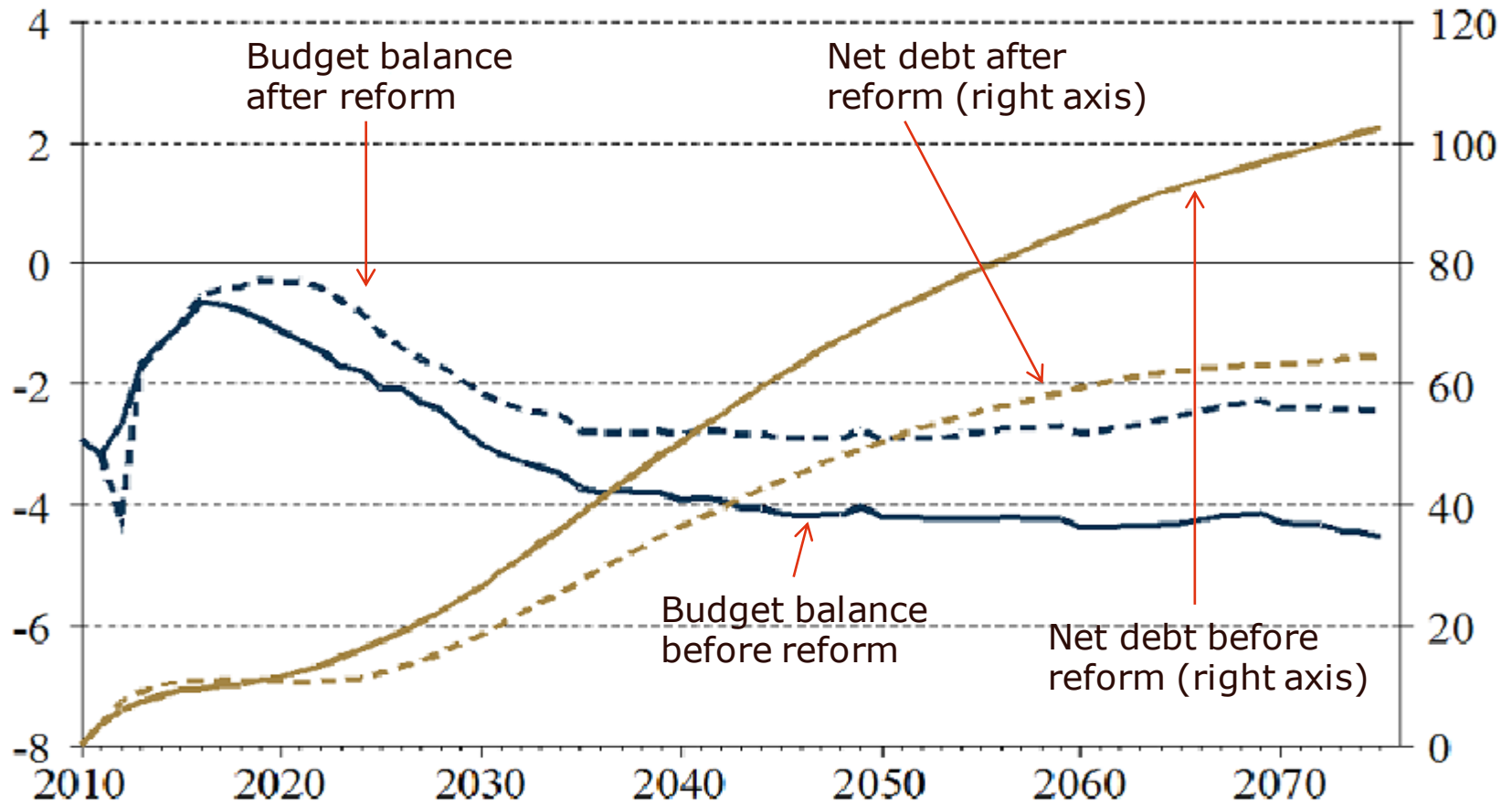
Source: The Danish Economic Council.



PROJECTED FISCAL EFFECTS OF THE RETIREMENT REFORM OF 2011

Percent of GDP

Percent of GDP



Source: The Danish Economic Council.



DANISH FISCAL THINKING AS OF 2011

By now there is broad consensus among policy makers and independent Danish economists that

- Long-run fiscal sustainability is a *minimum* requirement that does not guarantee credibility
- A *credible* fiscal strategy must ensure that the structural budget deficit and net public debt remain below conservative limits



DANISH FISCAL THINKING AS OF 2011 (CT'ND)

- Within a *medium term* horizon structural budget balance must be achieved through a combination of structural reform and constrained public spending growth (savings strategy)
- In the *long term* the demographic challenge must be handled via recurrent adjustments (adjustment strategy reflected in 2006 Welfare Reform and 2011 Retirement Reform)

FISCAL STATUS AFTER REFORMS AGREED UP UNTIL THE SUMMER OF 2011



Target: Zero structural budget balance by 2020 →

Required improvement of structural budget balance **before** 2011 reforms: **47 billion DKK (2.9% of GDP)**, assuming that the annual growth rate of real public consumption is kept at roughly 0% in 2011-13 and at 0.8% from 2014

Improvements of structural balance due to

- Consolidation package (incl. reform of unemployment insurance): 24 billion DKK
- Retirement reform: 18 billion DKK
- Cuts in defense spending from 2015: 2 billion DKK

Remaining gap (closed by reforms agreed under previous government but not supported by current government): 3 billion DKK



THE ECONOMIC POLICY PROGRAMME OF THE NEW DANISH GOVERNMENT



KEY ECONOMIC POLICY OBJECTIVES AND TARGETS IN THE NEW GOVERNMENT PROGRAMME

Goals and targets:

- Positive (or at least zero) structural budget balance by 2020
- The indicator of fiscal sustainability must always be positive
- The 1.5 percentage point improvement of the structural budget balance during 2011-13 requested under the EU Stability and Growth Pact must be achieved
- The level of public debt must be kept well below the limit set by the Stability and Growth Pact



KEY ECONOMIC POLICY OBJECTIVES AND TARGETS IN THE NEW GOVERNMENT PROGRAMME

Goals and targets (continued):

- Structural employment must be increased by about 55,000 persons up until 2020 (beyond the level achieved through the reforms already agreed) to finance targeted increases in public spending
- The trend rate of productivity growth must be raised
- Danish wage competitiveness must be improved
- Investment in education and research must be increased
- The poverty rate must be reduced and a fair distribution of income must be maintained



THE ECONOMIC POLICY PROGRAMME OF THE NEW GOVERNMENT: INSTRUMENTS

Long term structural policies:

- Retirement reform and unemployment benefit reform agreed under previous government to be maintained
- Tripartite negotiations with social partners to secure an increase in labour supply (target for increase in structural employment: 20,000 persons)
- A fully financed (green) tax reform that lowers marginal tax rates on labour income
- Reforms of active labour market policies, disability and education benefits, integration and immigration policies etc.



THE ECONOMIC POLICY PROGRAMME OF THE NEW GOVERNMENT: INSTRUMENTS

Short term stabilization policy

- 10 billion DKK (roughly 0.5% of GDP) fiscal stimulus package in 2012, mainly by bringing public investment forward (to be offset by lower public investment after 2012)

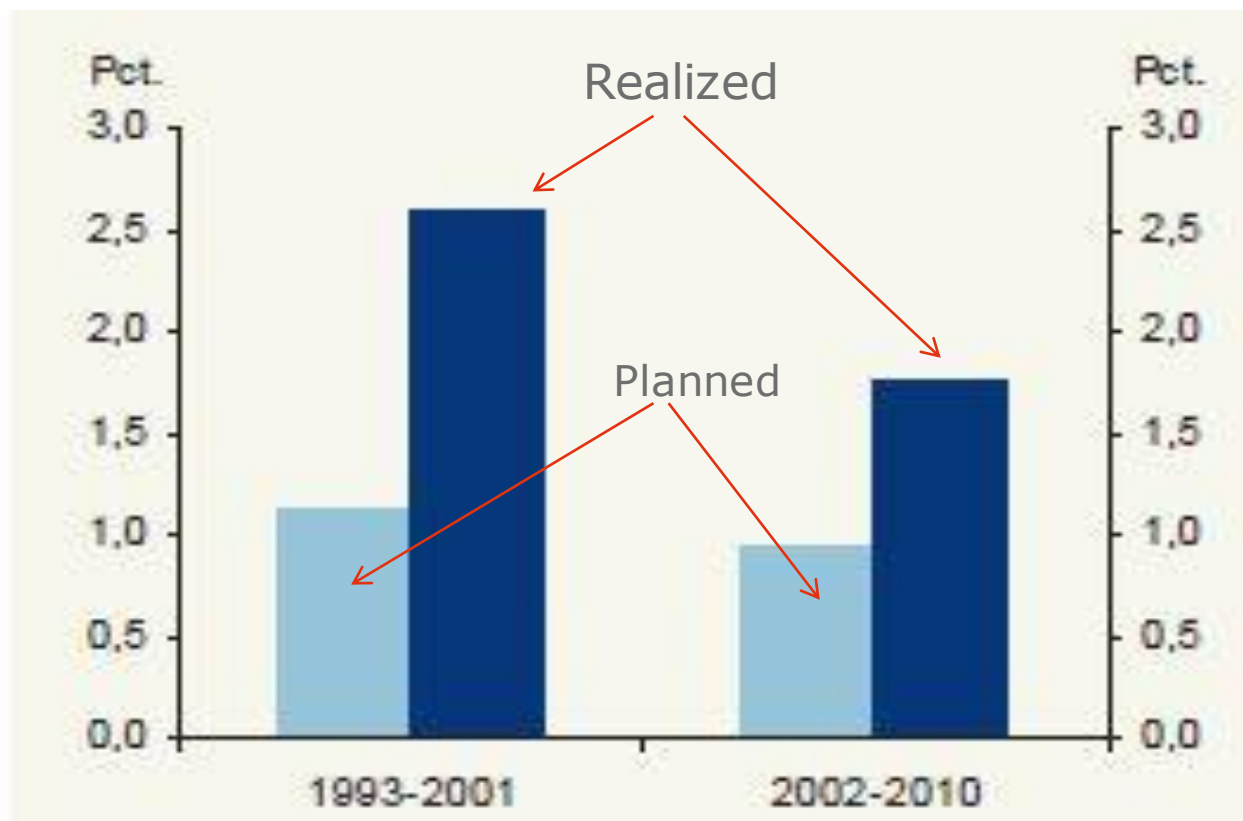
Other short term measures:

- 5 billion DKK increase in net public revenue in 2012-2013, mainly through increase in "sin" taxes and reduction of certain business subsidies
- Revenue to be used to finance targeted increases in public spending and cuts in certain taxes (budget neutrality)



THE PROBLEM OF SPENDING CONTROL

Annual growth in real public consumption



Source: Danish Ministry of Finance



POLICY RESPONSE: A NEW BILL ON PUBLIC EXPENDITURE CONTROL

The new government plans to follow up on the previous government's proposal to introduce a new **bill on public expenditure control**. Expected elements:

- Targets for budget balance and public debt
- 4-year (rolling) nominal spending ceilings for all levels of government (spending on unemployment benefits and certain other cyclical expenditure exempted)
- Tougher budget control procedures and sanctions against central government institutions and local governments if they violate their budgets (repayment, lowering of next year's budget etc.)
- The Danish Economic Council will monitor adherence to announced expenditure policy and fiscal policy



A NEW FISCAL POLICY PRINCIPLE

The new Danish government has announced a new

precautionary principle for fiscal policy:

- No new public spending to be legislated until the financing has been secured



SOME SPECIAL FEATURES OF THE DANISH PUBLIC FINANCES

SPECIAL FEATURES OF THE DANISH PUBLIC FINANCES



The **long term** perspective:

- Revenue from energy taxes and taxes on oil and gas production in the North Sea set for a secular decline

but

- Net revenue from taxes on private (occupational) pensions will increase as the population ages and the Danish funded occupational pension schemes mature

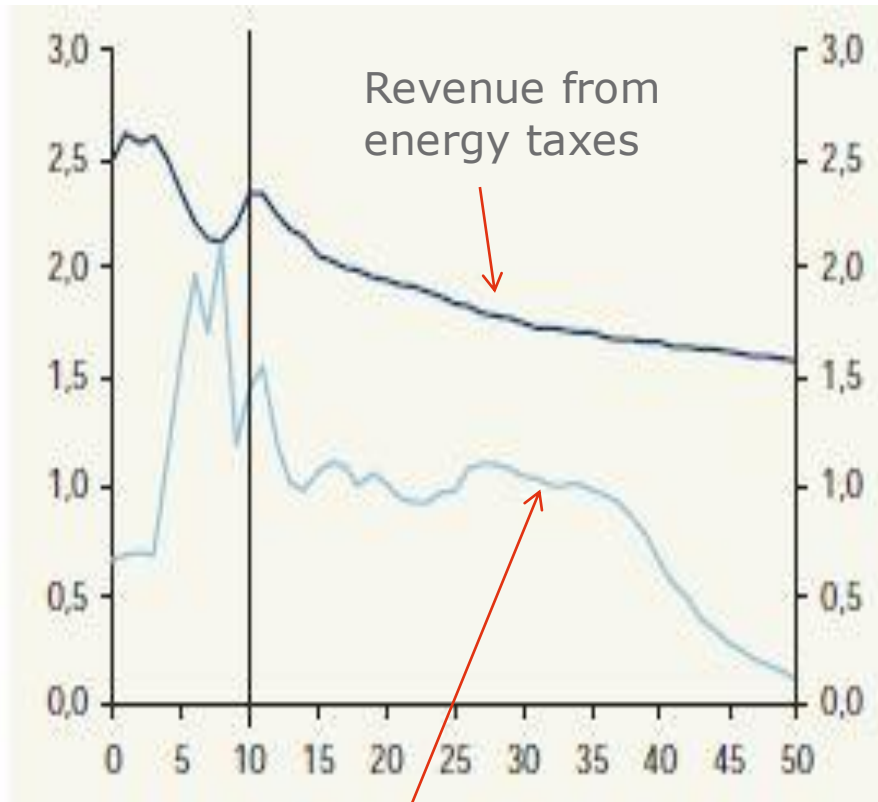


REVENUE FROM ENERGY TAXES AND TAXES ON PRIVATE PENSIONS

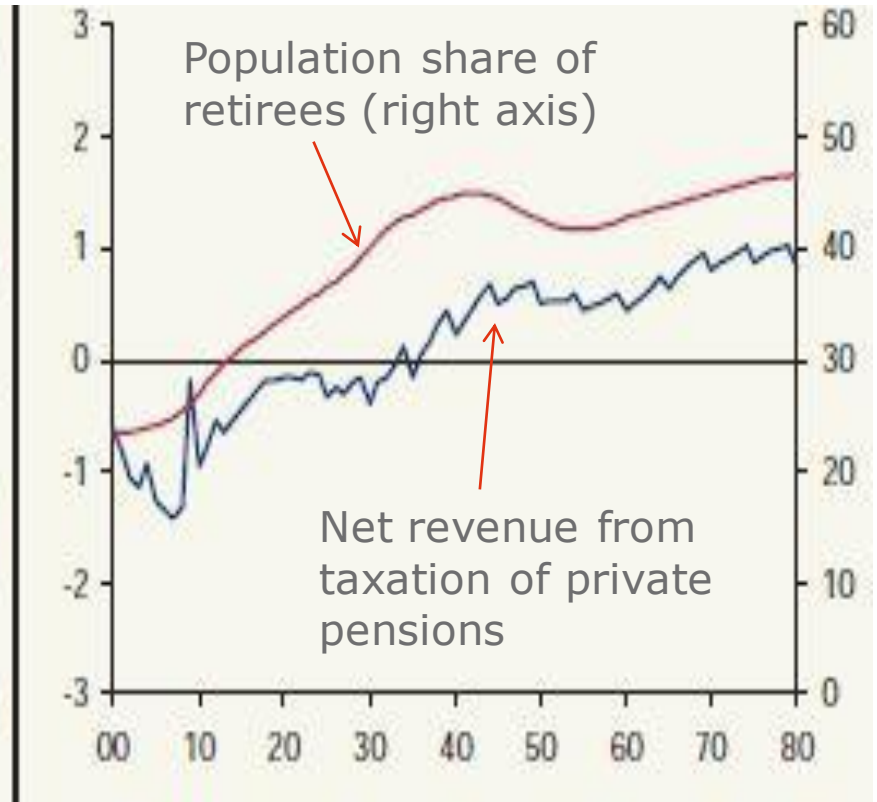
% of GDP

% of GDP

Share (%)



Revenue from North Sea activities



SPECIAL FEATURES OF THE DANISH PUBLIC FINANCES



The **long term** perspective (ct'd):

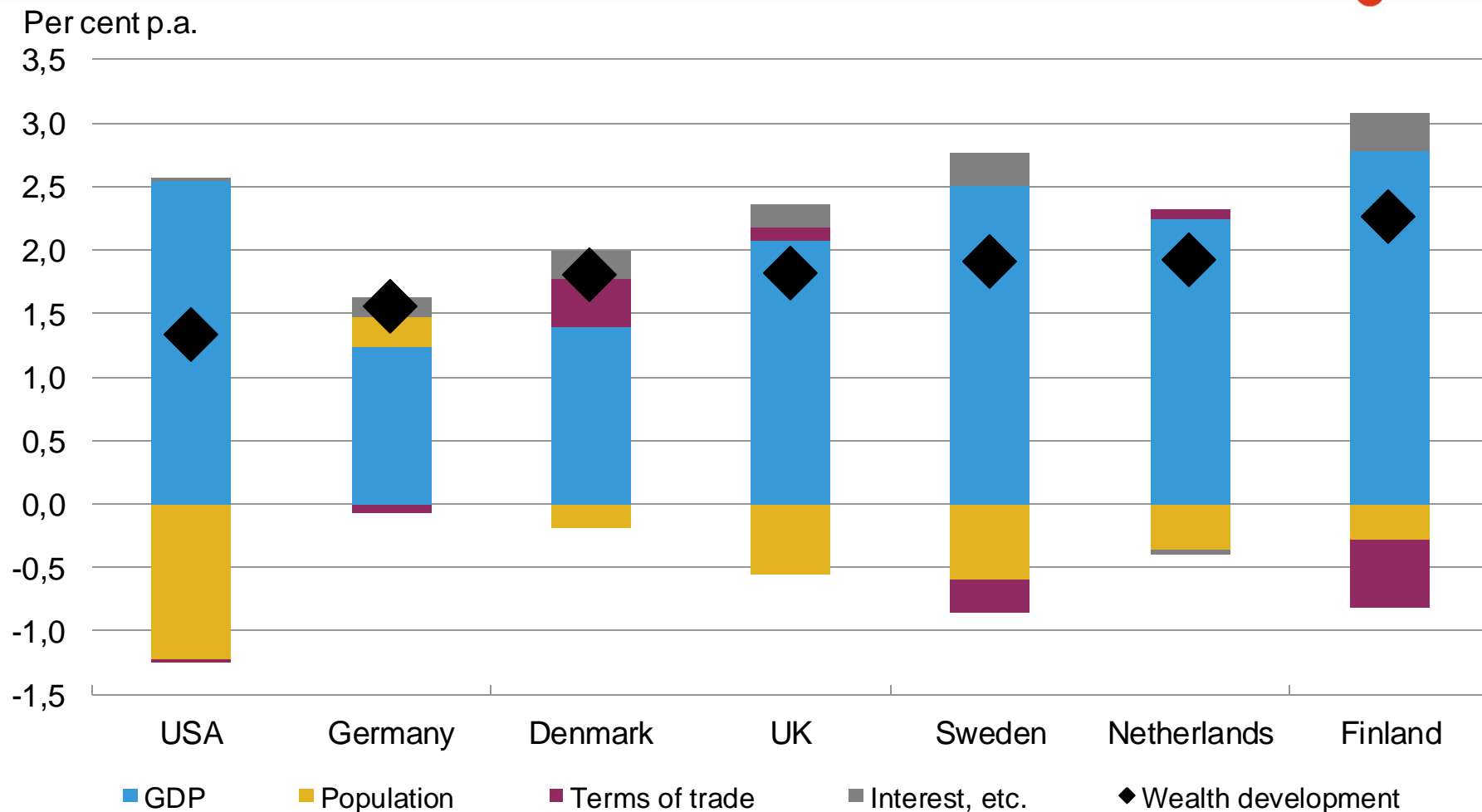
- The Danish public finances are insensitive to changes in the trend growth rate of productivity

Reason: Public sector wage rates, benefit rates and tax brackets etc. are all indexed to private sector wage rates

Implication: Weak Danish productivity performance poses no threat to the sustainability of public finances



AVERAGE ANNUAL GROWTH IN REAL INCOME PER CAPITA, 1995-2010



Source: The Danish Central Bank.

SPECIAL FEATURES OF THE DANISH PUBLIC FINANCES (CT'ND)



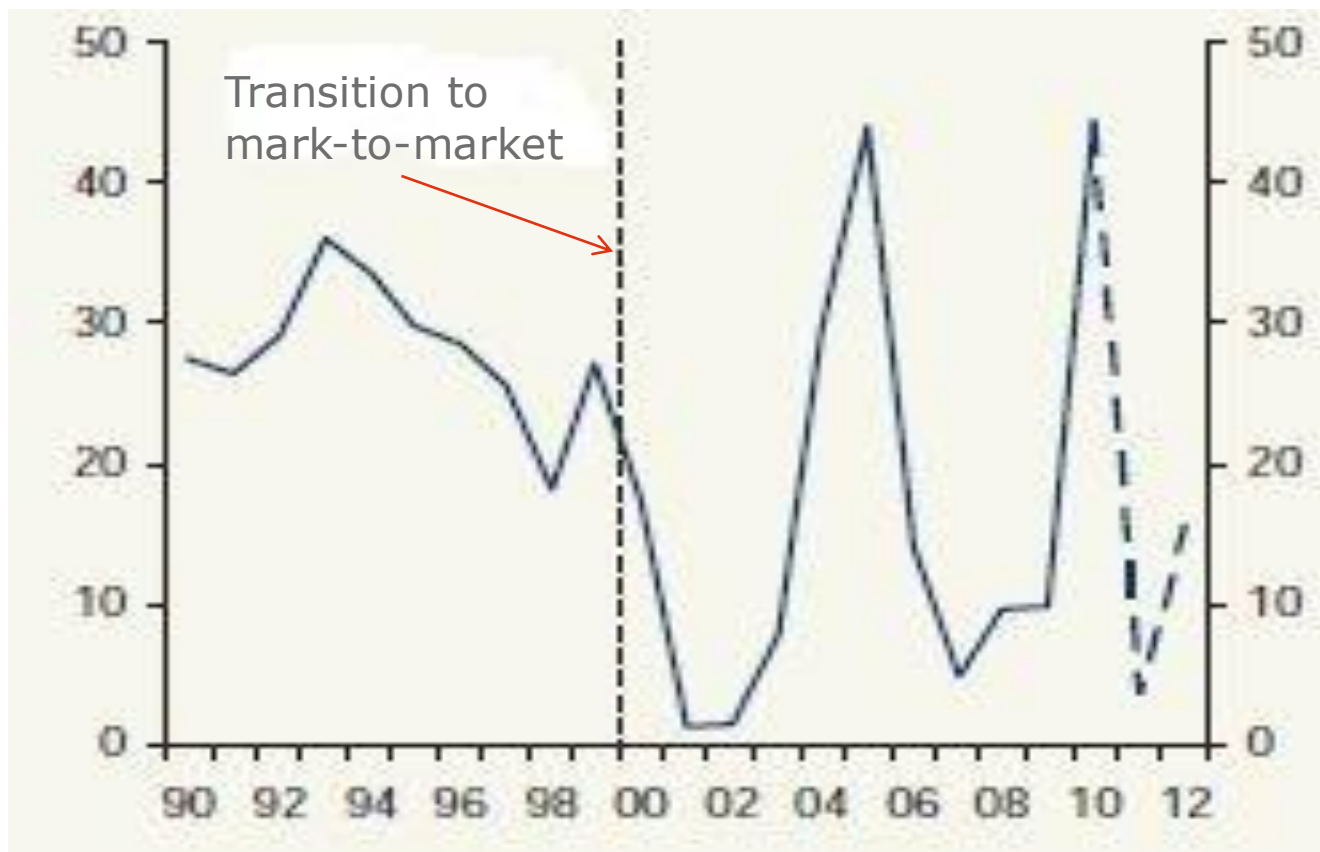
The **short term** perspective:

- Revenues from the tax on the return to pension savings and from taxes on North Sea activities are extremely volatile
- Roughly 20% of the recent increase in Danish Maastricht public debt is offset by a substantial increase in foreign exchange reserves
- A major part of the expected increase in the 2012 budget deficit (from 3.8% of GDP in 2011 to 4.6% of GDP in 2012) is due to a **one-off** repayment of contributions to the early retirement scheme as a consequence of the retirement reform



REVENUE FROM THE TAX ON THE RETURN TO PENSION SAVINGS

Billion DKK (2011 level)



Source: Danish Ministry of Finance.

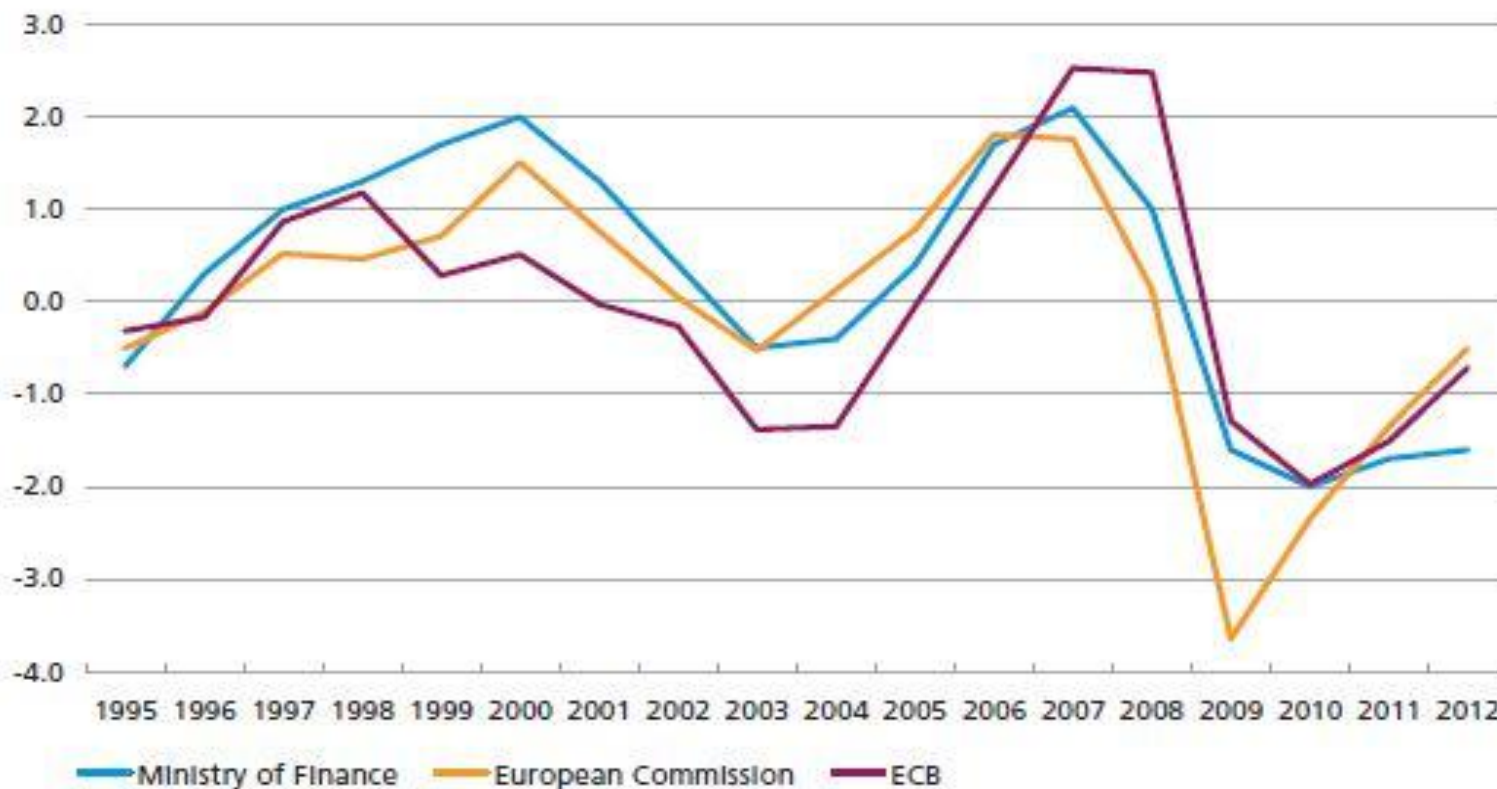


ESTIMATING THE STRUCTURAL BUDGET BALANCE: THE IMPORTANCE OF TEMPORARY FACTORS

THE CYCLICAL COMPONENT OF THE GOVERNMENT BUDGET BALANCE

Chart 9

Per cent of GDP



Source: The Danish Central Bank.



MAIN CONCLUSIONS

- The Nordic countries were early starters in implementing medium term fiscal strategies and managed to consolidate their public budget before the crisis
- The outlook for fiscal sustainability is better in Denmark than elsewhere in Europe
- The crisis has hurt the Danish public finances, but policy makers have responded by agreeing on important structural reforms of the labour market and the tax system
- Despite the recent change of government, there is a high degree of continuity in Danish economic policy with a strong emphasis on fiscal responsibility and structural reform