

THE COUNCIL OF ECONOMIC ADVISERS

# ECONOMIC REPORT

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SPRING 2010

MARCH 8<sup>TH</sup> 2010

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# CONTENTS

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PART 1	SUMMARY, RECOMMENDATIONS AND REPORT ON ECONOMIC TRENDS .....	5
1.	SUMMARY AND RECOMMENDATIONS.....	6
2.	ECONOMIC ASSESSMENT .....	9
2.1	The faroese economic situation.....	9
2.2	Global outlook .....	10
2.3	Economic outlook.....	11
2.4	The different sectors of the economy.....	13
PART 2	ANALYSIS AND DISCUSSIONS OF FISCAL POLICY .....	23
3.	THE CURRENT STATE OF FISCAL POLICY AND HISTORICAL DEVELOPMENTS .....	24
4.	FISCAL POLICY FRAMEWORK.....	28
4.1	Considerations with regard to the economy .....	28
5.	FISCAL CONSOLIDATION – PAST EXPERIENCES .....	31
5.1	The main conclusions of the study.....	32
6.	TAXES AND ECONOMIC GROWTH.....	33
6.1	Income, corporate and property taxes .....	33
6.2	Consumption tax.....	34
6.3	All businesses and institutions should be VAT registered .....	35
6.4	Domestic transport of persons should be subject to VAT .....	35
6.5	Rentals of real property should be subject to VAT .....	36
6.6	All VAT exemptions for the fishing industry should be cancelled.....	36
PART 3	MEASURES TO IMPROVE FISCAL POLICY.....	38
7.	RECOMMENDATIONS FOR FISCAL POLICY IN THE COMING YEARS.....	39
7.1	Example of a decisive plan of action .....	40
8.	IMPROVEMENTS TO FINANCIAL MANAGEMENT.....	43
8.1	Fiscal policy framework .....	43
8.2	Ministries and institutions must set target goals and measure achievements ....	46
8.3	Prioritising public activities and projects.....	46
8.4	Coordination between government and municipalities.....	47
9.	NECESSARY MEASURES .....	49
9.1	Some structural measures .....	49
9.2	SOME MEASURE WITH REGARDS TO EXPENDITURES .....	52

APPENDIX A: FISCAL POLICY RULES .....	53
LITTERATURE.....	54

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## THE COUNCIL OF ECONOMIC ADVISERS

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The Council of Economic Advisers hereby publishes its spring 2010 report on economic trends. Pursuant to Faroese Parliamentary Act No 50 of 11th May 2009 on the Council of Economic Advisers, the Faroese Council of Economic Advisers twice a year publishes economic reports – one in spring and one in the fall.

The members of the Council of Economic Advisers are elected for a term of three years and six months starting from 1 July 2009. The Council is assigned to monitor the Faroese economy and to deliver independent economic advice and reports on economic trends. As prescribed in the Act on the Council of Economic Advisers, the Council will publish two economic reports per annum.

The writing of the reports by the new Council has been handed over to the Faroese Governmental Bank to execute.

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PART 1

SUMMARY, RECOMMENDATIONS AND REPORT  
ON ECONOMIC TRENDS

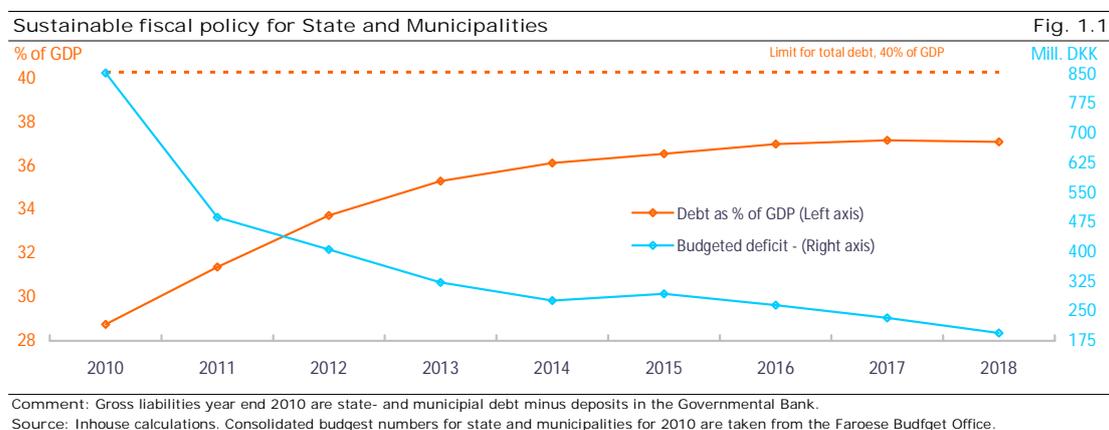
## 1. SUMMARY AND RECOMMENDATIONS

Indications of economic growth The latest figures on the Faroese economy, wage payments, unemployment and on VAT-revenues do not give any clear indications of growth in the Faroese economy. However, indications are that consumption may rise slightly as it is still below average. Car sales have gone up substantially in the first months of 2010. This could indicate that households will increase consumption in the near future.

Unemployment rose sharply The rate of unemployment rose sharply in the 4<sup>th</sup> quarter of 2009 and is now at a 6 percent<sup>1</sup> average for the whole country. Local figures are higher; app. 8 percent in Suðuroy and in the Northern Islands. Indications are that household consumption is still below average. The decline in consumption, which started in the fall of 2008, has stopped and consumption now seems to have stabilized at a low level.

Faroese economy is sound The Faroese economy is not in a bad state, when considering the balance of payments and the level of debt in the different sectors of the economy. On the other hand, the rise in unemployment and the public budget deficit constitute challenges that surely need to be addressed.

Decisive plans needed to address deficit The Faroese Treasury's revenues have gone down substantially due to e.g. government tax cuts, a reduction in block subsidies from the Danish State as well as on account of the current economic crisis. Budget deficit was just above DKK 330 million in 2008 and app. DKK 700 million in 2009. According to the 2010 budget, the deficit will reach app. DKK 800 million. Figure 1.1 shows an illustration of how the Faroese economy through decisive measures can be put back on the right track.



In the figure above government and municipal expenditures are increased 2 percent annually up to 2015 and from then on by 3 percent annually. In order to boost economic growth, measures worth just under DKK 300 million are implemented up to 2013 (i.e. 2.1 percent of GDP). The aim is to limit Government and municipal debt at 40 percent of GDP and to decrease Government and municipal budget deficits to 2 percent of GDP by 2015.

<sup>1</sup> Indications are that the rate of unemployment is closer to 8 percent, based figures from the Faroese Employment Office on the number of claims to unemployment benefits.

Deficit larger than in neighbouring countries When we add government budgets, the municipal budgets and the expected results from the social funds (i.e. the Faroese Employment Office, ALS, and the Labour Market Supplemental Pension Fund, AMEG), we find that the total public sector deficit is DKK 900 million in 2010, i.e. just above 7 percent of GDP.<sup>2</sup> This is higher than in the neighbouring countries, excluding Iceland. In Denmark, Sweden and Finland public sector deficits are expected to be in the range of 3 to 5.4 percent of GDP.<sup>3</sup>

Certain measures are necessary There is scope in the economy for the public sector to present a certain deficit over a couple of years, but if proper measures are not put into place it will become increasingly difficult to correct the situation. A sustainable government fiscal policy is the prerequisite for steady economic growth.<sup>4</sup> It is recommended that with the 2011 budget and onwards, substantial measures are undertaken to balance public sector revenues and expenditures.

Measures need to address both revenues and expenditures Experiences from OECD countries<sup>5</sup> clearly indicate that in the coming years measures need to be implemented in order to increase public revenues from direct and indirect taxes as well as measures to reduce public expenditure. In order to form a sustainable fiscal policy, measures are needed both on the revenue and expenditure side. Some measures can be implemented at short notice, while others are lengthier to implement due to the degree of prior analysis needed.

Taxes and economic growth OECD studies have sought to assess the effects different methods of taxation have on economic growth.<sup>6</sup> These studies indicate that corporate taxes have the most negative influence on economic growth. Income taxes come second, and consumption taxes third. Finally, we have property and real estate taxes, which exert the least influence on economic growth. This should be kept in mind in the coming years, as efforts are made to structure the Faroese public revenue base in a more sound way.

The financial sector and economic shocks Fiscal policies do not seem to have been effective at evening out economic fluctuations that stem from changes in the lending operations of the financial and banking sector. It is necessary to develop measures that can support fiscal policy. The Ministry of Finance is recommended to assemble a group of experts to investigate this possibility.

Align public budgets and long term goals It is crucial to ensure adequate coordination of government and municipal budgets. This must also be achieved with regards to the short and long term operation and investment plans of government and municipalities. Parliament and government must seek to facilitate coordination in such a way that the municipalities and the Faroese Treasury stick to the accepted fiscal policy, which has the

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<sup>2</sup> The latest estimates by the Faroese Governmental Bank put GDP at DKK 12,650 million in 2010.

<sup>3</sup> Source: OECD Economic Outlook No. 86.

<sup>4</sup> In order for the Government's fiscal policy to be sustainable, the Government must be able to take care of its obligations and pay interest and instalments on outstanding debt with its current direct and indirect tax policy and expenditure policy.

<sup>5</sup> Cf. [17] and chapter 5 of this report.

<sup>6</sup> Cf. [25].

aim of curbing economic fluctuations. Such a coordination and alignment can be achieved - the prerequisites should already be in place with the new Parliamentary Act on Appropriation, Executive Order on Accounting Procedures, and Executive Order on Municipal Accounting Procedures as well as a uniform public accounting system and shared IT infrastructure. Recommendations are to investigate whether it is possible to continue to strengthen the fiscal policy rules, e.g. in ways similar to New Zealand.

Assess utility of public sector activities Performing cost-benefit analyses should become an integral procedure in all public investment projects as well as all large public sector operations, projects and activities in general. Cost-benefit analyses can also be used to describe the societal utility of e.g. grants, subsidies and other public activities. In addition to aiding assessment of the net societal gains of public investments, cost-benefit analyses can also take into account special considerations such as regional policies, redistributive policies or other such considerations. Regional and redistributive considerations are crucial to many public investments and public activities in general. In such cases the cost-benefit analyses can be adjusted to take such considerations into account.

Ministries and institutions must set goals and measure performance Following the intent of the Executive Order on Accounting Procedures; we recommend that the guidance principles of listing goals and achievements should be used more extensively to measure the productivity and production of services by the public sector. The knowledge gained can be used to compare productivity and production with previously set goals and to improve the efficiency and quality of public services; and thereby optimize the use of public productive assets. If this instrument is used in the proper manner, it could increase transparency with regards to the production of public sector services and clarify the division of responsibilities within the public sector.

Continually improve efficiency as well as rationalize public sector Following more extensive studies, plans should be made with regards to how the public sector is most appropriately and rationally managed – both in terms of services, supply and costs.

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## 2. ECONOMIC ASSESSMENT

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Similarly to what has happened globally, the Faroese economy experienced a downturn in the fall of 2008 as the international financial crisis turned into an economic crisis, and directly affected production in nearly all economies.

### 2.1 THE FAROESE ECONOMIC SITUATION

The financial crisis affected the Faroese financial sector directly as financing costs of Faroese banks increased considerably due to higher interest rates on borrowings from other financial institutions and due expenses for bank bailouts. Overall, it seems as though the world of finance has weathered the storm and the worst winds have died down; yet, permanent changes are to be expected, such as stricter rules on capital requirements in the financial sector.

The financial crisis – and subsequent economic crisis – also affected households, as they reduced consumption and increased their savings. This is a result of increasingly uncertain future outlooks, a drop in the value and equity of real properties and worse credit facilities for consumer loans and investments compared to previous years. This also affected the revenues of the Faroese Treasury, which experienced comparatively large budget deficits in 2008 and 2009 – and expectations are of similar budget deficits this year and in 2011.

In addition, a combination of external blows and structural difficulties have meant that industry production, in particular local production, has gone down dramatically these last 2-3 years and is now historically low. Fish prices are low and this puts a strain on operations, and while oil prices are lower than in 2008, they are still high compared to previous years. The conditions for growth in fish stocks in Faroese waters have been below average these past years. Structural problems such as excess industry capacity and too high fishing pressure on stocks surrounding the Faroe Islands, contribute to the fact that profitability in the domestic fishing industry is not at the same level as it could have been with lower fishing pressure and better fish stock management.

In general, the Faroese economy is quite sound. In 2006, the Faroe Islands had net assets abroad worth DKK 3.7 billion, according to Statistics Faroe Islands. Estimates in this report indicate that ever since there has been a surplus on the total balance of payments. Therefore one might conclude that the Faroese balance towards foreign countries is very acceptable. Faroese households seem to be quite well off in global comparison. By the end of 2008, the net liabilities of the Government, municipalities and social funds were in total modest. Financial institutions and households own the majority of the net assets in foreign countries.

Currently, one of the biggest challenges in the Faroese economy is in the administration of the country and municipalities, which are running large deficits, and the administration of the fishing industry, where companies are experiencing significant problems in operations due to reduced catches, low selling prices and high oil prices.

Ensuring long-term economic growth could also be said to pose a challenge; partly on account of the fact that private sector investments have for many years only constituted a modest percentage of GDP, but also because excess capacity in the fishing industry makes it hard to turn a profit and to ensure future industry growth.

## 2.2 GLOBAL OUTLOOK

A small economy like the Faroese, where imports and exports constitute a large part of the economy, is very much affected by global economic trends and especially developments in those countries with which we trade goods and services. The Faroese economy is particularly affected by external developments when it comes to the price of imported goods and exported products, but also the households and their propensity to spend and save are affected by foreign economic trends. Global economic trends will therefore be significant in determining when productivity again will increase in the Faroese economy.

Following the downswing from around mid 2007 to mid 2009 – with a real reduction in the global economy of 1 percent in 2009 – estimates from acclaimed international organizations now point to the fact that most economies should soon start to experience economic growth. Total growth for 2010 and 2011 is expected to be app. 4 percent, in real terms.

Recent projections by the OECD indicate that the lost grounds in terms of growth, however, will at the earliest be regained in 2013. For the OECD member countries the reduction was in real terms 4 percent. Growth is furthermore expected to be relatively low in 2010 and 2011. Estimates by other international organizations indicate that it will take years before the global economy reached its previous levels. Yet, estimates differ on how long this will take. Table 2.1 shows the latest economic growth outlook from the IMF.

Real annual GDP-growth in %, 2008-2011	TABLE 2.1			
	2008	2009	2010	2011
World Economy	3,0	-0,8	3,9	4,3
USA	0,4	-2,5	2,7	2,4
Germany	1,2	-4,8	1,5	1,9
Great Britain	0,5	-4,8	1,3	2,7
Euro-zone	0,6	-3,9	1,0	1,6

Comment: 2010 and 2011 are IMF forecasts

Source: IMF World Economic Outlook Update, January 26, 2010

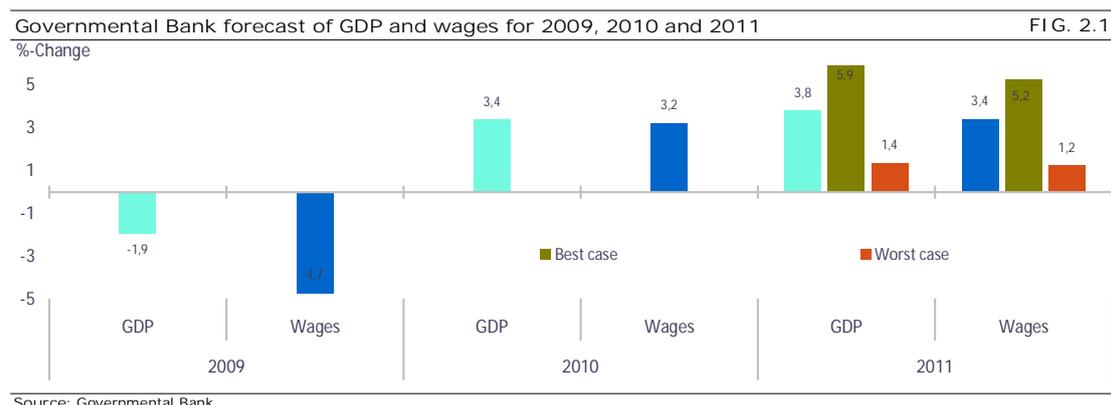
The table points to a growth in the global economy as a whole, primarily driven by growth in Asia and, in addition, the massive stimulation of the US economy seems to have had an effect.

Loan-funded spending, which was very apparent before the crisis, has all but disappeared – also on the Faroes – and people are now starting to save up. It is especially countries where property prices dropped and consequently equity was reduced that have experience an increase in savings and a decrease in private consumption. Seeing as private consumption has a great effect on the overall economy, this may imply lower economic growth over the next couple of years. Several governments have made efforts to boost demand for goods and services by increasing government spending with different stimulus packages. These measures are time limited and it is not clear what effect a drop in public expenditure will have on economic developments.

## 2.3 ECONOMIC OUTLOOK

### 2.3.1 GDP projections

There are indications of a fall in GDP in current prices by app. 3 percent in 2009, and projections point to an increase of app. 3 percent in 2010. If prices increase by 2 percent, it would mean that the Faroese economy grew in real terms, albeit a small growth. Thus, the economic downturn seems to have passed its peak and while indicators point in different directions, our estimate is that we will see economic growth already this year.



Private consumption, which grew considerably from 2004 to 2007, was unusually high in 2007 and by autumn the same year it was slowing down, i.e. before the global financial crisis was full blown. Since then consumption has dropped significantly and rapidly. Imports for direct household consumption fell significantly in 2009 and consumption relative to disposable income has probably not been this low since 1998, i.e. at a time when the effects of the Faroese economic crisis of the 1990ies were still being felt. It is difficult to estimate whether consumption has reached its lowest level under the current economic conditions. However, according to our assessment it is not likely that consumption will go further down. Surveys concerning people's economic outlooks for 2010 show that the households now are less pessimistic than they were 6 months ago and key indicators point in the same direction, e.g. the VAT-revenue to wage-payments ratio (see figure 2.2). Consumption is expected to increase on aggregate in 2010 and 2011.

Key indicators	TABLE 2.2									
<i>Annual nominal change</i>	2003	2004	2005	2006	2007	2008	2009	2010	2011	
GDP	-2,2	3,2	3,1	12,9	5,8	0,5	-1,9	3,4	3,8	
Private consumption	4,1	8,1	9,1	9,5	10,2	-8,4	-8,5	3,9	4,0	
Public consumption	5,4	6,2	5,2	3,6	8,2	10,8	1,5	3,1	1,4	
Private investments	61,8	-62,4	68,8	-2,7	2,1	-17,8	-23,7	10,8	17,6	
Public investments	1,9	16,5	-7,7	15,5	12,7	7,2	-0,8	1,4	2,5	
Exports	-6,8	-4,3	4,6	12,0	4,3	5,6	-6,0	2,0	4,0	

Source: Governmental Bank

Public consumption is easier to estimate, especially since the Faroese Budget bill for 2010 was presented and municipal budgets have been set. It seems widely accepted that the expenditure limit must be kept and based on known government and municipal plans, public consumption is estimated to increase app. 3 percent in 2010 – of which, the government increases consumption by 4 percent and the municipalities by 1 percent. The

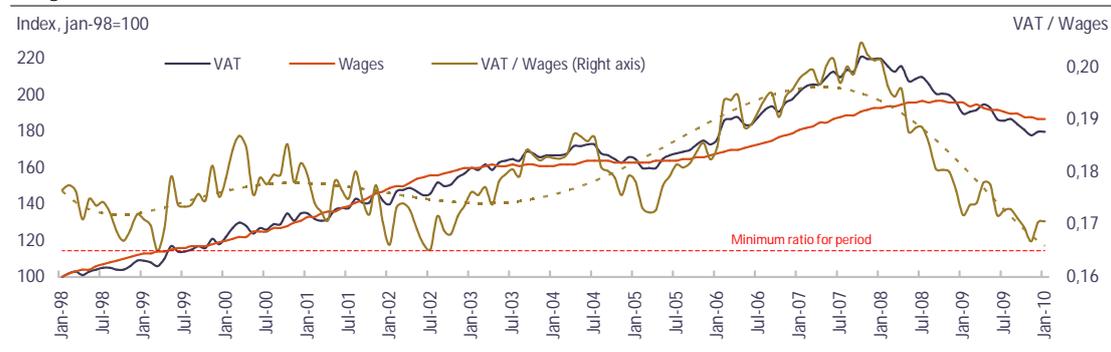
assumptions used in the projections for 2011 put the growth in total public consumption at 1.5 percent.

Private investments have fluctuated quite significantly during the past years and are more difficult to predict. Access to financing, the interest rate level and the bleak economic outlook of businesses influences the willingness of private companies to invest. It is estimated that private investments decreased significantly in both 2008 and 2009, but an increase is expected in 2010 and 2011.

Public investments decreased by app. 1 percent in 2009 and will grow between 1 percent and 2 percent in 2010 – municipalities seem to invest less, while the government increases its investments. The growth in total public investments is expected to be app. 2.5 percent in 2011.

Total exports of goods and services fell by 6 percent in 2009 and while it is difficult to assess exports in general, export value is not expected to decrease further given current outlooks. Exports are expected to increase by 2 per cent in 2010 and 4 percent in 2011.

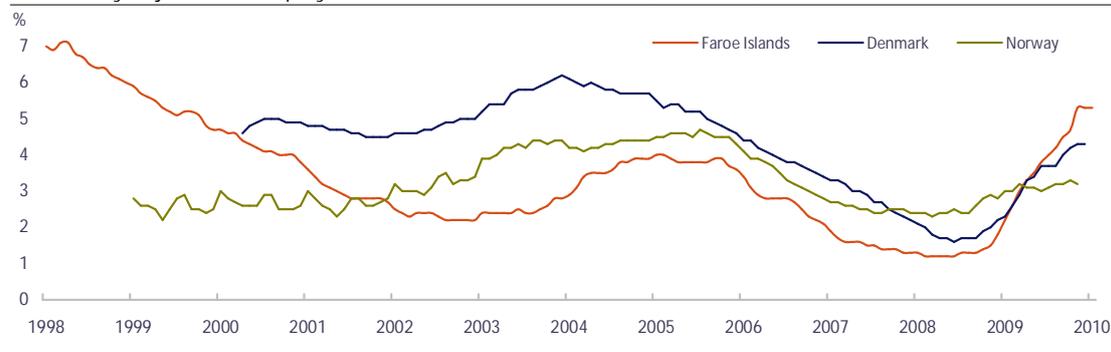
Wages and VAT-revenues, Jan-98 to Jan-09 FIG. 2.2



### 2.3.2 Economic developments and projections

Payment of wages, which with some reservations can be interpreted as a measure for the overall production in the economy, have been on the decline since February 2009, as measured in continuous annual sums. The latest figures are from January this year and show an annual change of -4.5 percent. Apart for certain minor industries only public services and the fish farming industry experienced an increase in wage payments.

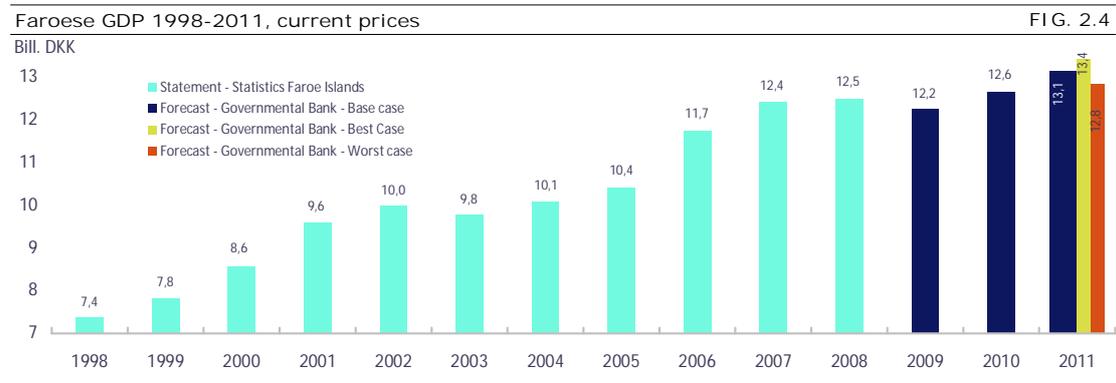
Seasonally adjusted unemployment as % of workforce, Jan-98 to Jan-10 FIG. 2.3



The unemployment rate has continued to rise during 2009 and at the end of January 2010 was measured at 5.6 percent. With a 3 per cent growth in GDP in current prices and perhaps a 1 per cent growth in real terms, it is not unlikely to see a certain reluctance of companies to hire new personnel. Therefore, the unemployment rate may increase further to app. 6-7 percent on average in 2010.

Increases in unemployment can be traced in most sectors, excluding the fish farming industry, the financial sector and the public sector. Following changes to legislation in 2009, the Faroese Employment Office (ALS) has significantly increased the size of all grants to unemployed persons. This may well be keeping emigration down, coupled with the fact that neighbouring country are also experiencing rising unemployment, and therefore may also contribute to a slightly higher rate of unemployment. On the other hand, the increases in unemployment benefits should mean that the reduction in the level of income due to unemployment should be less. Less emigration, which increases the number of persons in the system, and the higher individual grant rates both act in ways so as to counter the reduction in consumption.

In our view, the main reasons for the increase in domestic demand are the sizeable Treasury deficit, coupled with positive developments in the fish farming industry and improved outlooks in the fishing industry. The increase in unemployment benefits is expected to cause households to stop reducing their spending and possibly induce household to increase demand. These circumstances should to a certain degree hold back further growth in unemployment – which contributes to the estimates of an average yearly unemployment rate of app. 6-7 percent for 2010, i.e. a bit higher than in 2009.



## 2.4 THE DIFFERENT SECTORS OF THE ECONOMY

This section of the report will deal with the different sectors of the economy that are important to the overall developments and future prospects.

### 2.4.1 The public sector

The Government Up to 2008 the Faroese Government has had a stimulating effect on the economy by means of tax reductions and a significant rise in public spending – even during the times of economic growth. The enormous increase in public expenditure in 2008 has meant that the Government has directly stimulated business activity in 2008 and has counteracted a decline in business activity.

In 2009, the activities of the government were less stimulating, due to the fact that public expenditures (especially the purchase of goods and services) are reduced in the 2009 Budget compared to the 2008 accounts, while the deficit increases due to declining revenues.

In 2010 the Treasury's deficit is expected to be just below DKK 800 million. This can also be traced in the total growth of the economy, which is considerably stimulated by the deficit. The budget deficits in 2008 and 2009 were on average DKK 650 million. Particularly revenues from VAT and other charges have declined substantially since 2007.

Public pay-roll expenses have increased in 2009 and 2010 and this growth in expenses is greater than the increase in tax revenues; despite cuts in income tax and taxes on capital gains.

In the draft Budget for 2010, the Faroese Government plans for a deficit of DKK 778 million. Public expenditure on institutions will increase by app. 1 per cent, likewise grants for households, and investments will increase a little bit more, while revenues will decrease.

The Municipalities There are bound to be differences in the municipalities' abilities to meet their operational and investments objectives in the years to come. Tórshavn municipality will probably not be hit hard by the reduction in tax receipts, while other municipalities might experience a reduced tax base. Tórshavn municipality is also not burdened by debt in the same way as other municipalities and is therefore in the position to initiate a number of large projects, which may have a stimulating effect on the economy.

According to preliminary figures from the budgets, the municipalities' net expenditures (revenue and investment expenditures minus all the non-tax receipts) will be app. DKK 1,370 million and tax receipts will be app. DKK 1,280 million in 2010. This should result in a deficit of just above DKK 90 million.

The municipalities combined have most likely had a slight curbing to almost neutral influence on the economic trends in 2010 and possibly even more curbing in 2011. This is particularly true when Tórshavn municipality is left out. The financial situation in the majority of municipalities more or less forces them to tighten expenditures in order to lessen the deficit.

In these past few years, the municipalities have increased their revenue and investment expenditures, while they now reduce investments during the current recession.

Due to the different financial situations and debt burdens of the municipalities, it is a great challenge to create regulations, which will consider both the Government's overall needs as well as the needs of the individual municipalities.

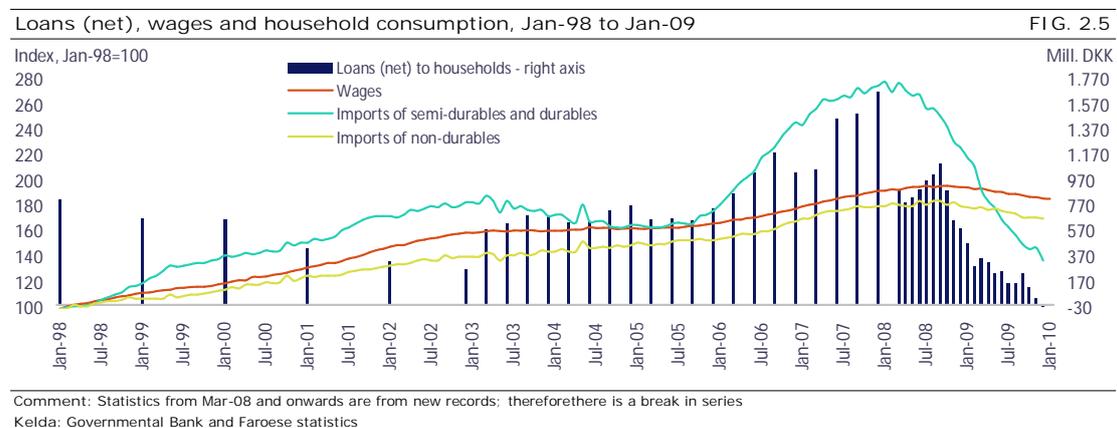
The Social funds The social funds, i.e. the Faroese Employment Office (ALS) and the Faroese Labour Market Supplemental Pension Fund (AMEG), will be able to stick to their

planned activities in 2010 and 2011. Especially ALS will most likely be able to stimulate the economy during the next two years. The ALS fund is in good condition to deal with the surge in unemployment. Yet, substantial changes have happened within a short period of time, and therefore it is difficult to offer any further indications or estimates of the condition of ALS other than estimates of expected payouts in the coming years.

Based on the amendments to the act concerning unemployment insurance and unemployment services, it is expected that ALS will increase their benefit payouts. Payments amounted to app. DKK 155 million in 2009, including payments to the wage supplement scheme for fish processing plants. Outgoing payments are expected to reach app. DKK 250 million in 2010, which is about twice the size of ingoing payments. This will strengthen the spending power of the unemployed and at the same time lessen the fear of losing one's job. This will probably influence households to increase their savings to a lesser degree than they otherwise would.

#### 2.4.2 Households

Different factors have had a negative impact on households in 2008 and 2009. Real property prices peaked in the autumn of 2007 and have since gone down. Together with increased borrowings, the fall in prices resulted in a drop in equity of app. DKK 4 billion or 20 per cent, although equity is still comparatively high. Shares owned by the Faroese people (of which households most likely own a small part) have depreciated by a total of 68 percent in market value (app. DKK 4 billion) during the same period of time. Uncertainties concerning the global economic outlook and our own fishing industry are still many. Moreover, the financial institutions have become more cautious with regards to lending operations.



All these factors combined make it possible to understand why households have become more cautious and reduced spending as well as increased savings. All these negative factors are not likely to be permanent. Property prices will hardly improve any time soon, yet equity value is still excellent. Many listed Faroese businesses are financially sound, in spite of low market values. There are indications that the market value again might increase a bit. The interest rate level or the costs of finance of the households has decreased in 2009, yet, it is uncertain what will happen to the interest rate in 2010.

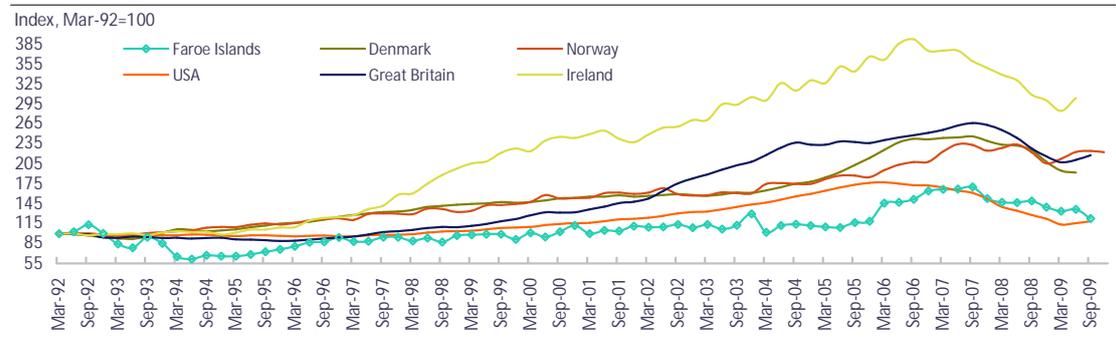
As seen in the VAT/wages ratio in figure 2.2, the households have lowered their spending from the autumn of 2007 to the summer of 2009. What can also be seen is that this decline in consumer spending corresponds to the increase from 2005 to 2007. According to the developments in figure 2.5 households have decreased their consumption of both durable and semi-durable consumer goods in 2008 and 2009, while at the same time reducing net borrowing. The development in non-durable consumer goods seems to follow developments in earnings. Borrowings have been at a standstill since October 2008, while household deposits in banks have increased. This indicates that it is the households themselves that have taken initiatives towards lowering spending, rather than it being the lack of access to financing, which has prevented a growth in spending.

Surveys concerning public expectations made by The Faroese Ministry of Finance point to the fact that, developments in household expectations correspond well to the developments in spending, as shown above. Therefore it is not meaningless to stress that the pessimistic outlook of households seems to lessen in recent surveys.

In global comparison, Faroese households are generally doing quite well. Property values appreciated significantly from 2005 to 2007 and later decreased in value. Property value does not seem to have been as overestimated on the Faroes as in other countries (see figure 2.6) and therefore does not seem set to decrease much further. Household debt is far less on the Faroe Islands (75 per cent of GDP) than e.g. in Denmark (111 per cent of GDP).

In conclusion, there is some reason to believe that households will be content with a level of consumption, which is no lower than the current level.

Real house prices in different countries, Mar-92 to Dec-09 FIG. 2.6



Source: Statistics Faroe Islands, Eik Bank, OECD, Standard & Poor's, Central Statistics Office Ireland, Statistisk Sentralbyrå, Danish Statistics

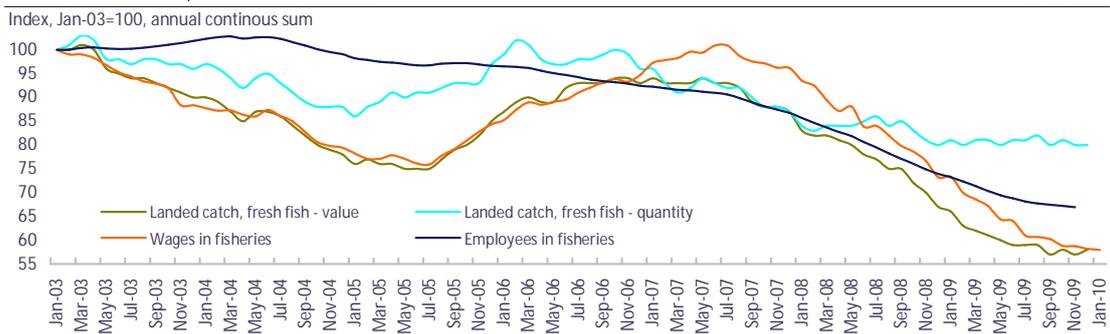
### 2.4.3 The resource industries

The resource industries are categorized into four subgroups, which all operate under different conditions at different times. The subgroups are: demersal fishing in Faroese waters, demersal fishing in distant fishing grounds, pelagic fishing and fish farming.

Two of these groups – demersal fishing in Faroese waters and pelagic fishing – are currently in difficulties, because of outside blows and due to situations of a more structural nature. On the other hand, demersal fishing in distant fishing grounds and fish farming are currently making good and steady contributions to the Faroese economy.

Trens in fisheries, Jan-03 to Feb-09

FIG. 2.7



Source: Statistics Faroe Islands

Demersal fishing in Faroese waters The operations of the long line fishing fleet, door trawlers and pair trawlers fishing off the Faroe Islands are currently burdened by low fish prices coupled with poor catches, while in the preceding years it was especially high energy costs and poor catches that affected the operations.

Figure 2.7 shows that catches have declined for many years, both in terms of quantity and value. There seem to be indication of a small change in conditions. It is still too early to assess the effects this could have, but on the whole prospects seem to be positive for the demersal fishing in Faroese waters. At the very least, prospects have now improved slightly.

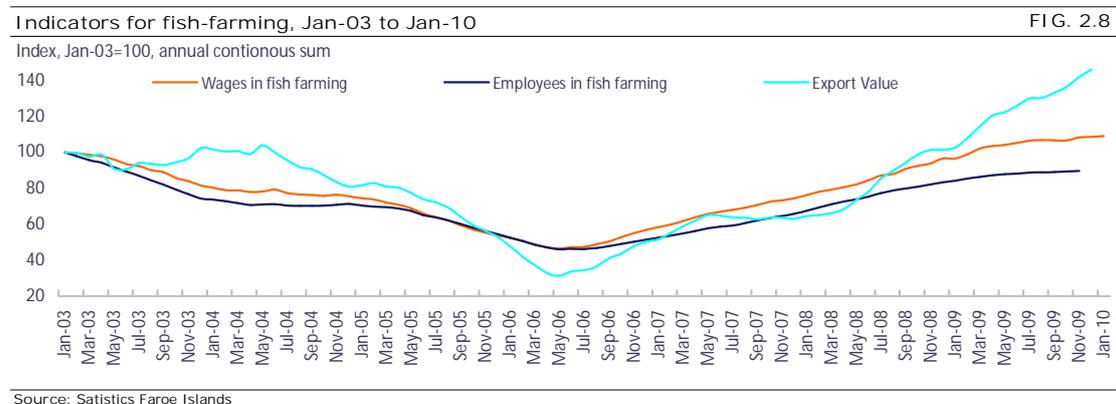
Demersal fishing in distant fishing grounds Currently, this part of the fishing industry contributes to the Faroese economy consistently and well, as indicated above. According to ICES, fishing for cod and haddock in the Barents Sea seems to be at a sustainable level and outlooks are that this will continue to be the case in the near future. Production is expected to improve in 2010 compared with the two preceding years. Low fish prices have burdened operations for one or two years, while on the other hand, oil prices have decreased and improved profitability. There are signs indicating that fish prices are on the rise again, although the increase comes from a low level.

Pelagic fishing F Pelagic fish production has decreased significantly, especially due to the fact that the blue whiting quota was heavily reduced in 2009 and was set to decrease by 8.5 percent in 2010 according to the new fisheries agreement between the coastal states. Another difficulty facing the pelagic fishing industry is of a structural kind – as many years of excessive fishing has depleted the blue whiting stock to such an extent that it became necessary to slash quotas dramatically in order to protect the stocks.

Management of pelagic fish stocks can be somewhat difficult, due to the migratory nature of the stocks. This makes it difficult for countries to agree on a joint and enforceable fisheries policy over a longer period of time. Thus, the combined efforts of the involved countries means that fishing often is too intense compared with scientific advice.

The blue whiting quota was heavily reduced in 2009 (by 53 per cent) and a further 8.5 percent in 2010. Quotas for Northernly Sea herring will decrease in 2010 (10 percent reduction). With regards to the mackerel fisheries, quotas increased just above 33 percent in 2010, but prospects for the 2010 fisheries are uncertain. Perhaps it will be possible to

add more value to these resources in the future. The capelin is an important part of pelagic fishing, however, it is difficult to say anything for certain about outlooks and stock volume is also expected to fluctuate.



The fish farming industry The positive trends in the fish farming industry continue and, at the very least, we can conclude that since the summer of 2006 developments have only gone one way. The value of exports, in particular, has gone up and this reinforces the perception that the industry is close to reaching maximum capacity levels. Further growth may be difficult to ensure, yet, at the same time it is the fish farming industry that is driving Faroese economic growth in 2010 and 2011. Outlooks for the fish farming industry are on the whole quite good, particularly with regards to price as supply of salmon is on the decline due to the state of the Chilean industry.

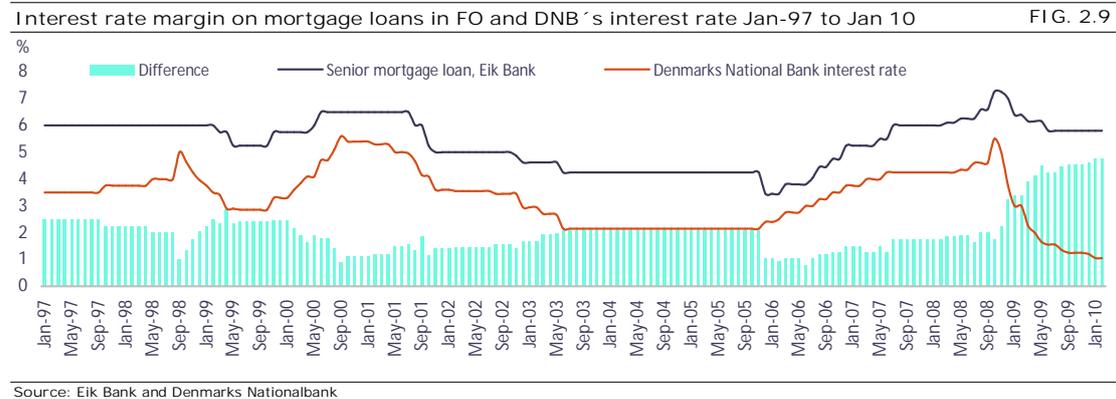
Harvests of farmed fish will go down slightly in 2010 compared with 2009. The reduction in quantity is app. 20 percent and export value is not expected to increase in 2010. Harvesting is likely to rise again in 2011 and 2012 as is the value of exports. Efforts have been directed at increasing production and tests made to see whether capacity can be expanded, e.g. through farming in less sheltered areas. This could potentially expand industry capacity, yet it is far from certain, given the current levels of knowledge.

Summing up the resource industries On the whole there are signs that, at best, production will stay at current level or go slightly up during the next year or two, compared with 2008 and 2009. Low fish prices and high fuel prices burdened operations in 2008 and 2009. Oil prices are significantly lower than in 2008, and fish prices have increased substantially in late 2009 and early 2010. Therefore, the prospects for the fishing industry have improved a lot, comparatively, if only prices keep their levels.

#### 2.4.4 The financial sector

Interest rate levels have of lately been record low in our neighbouring countries. Central banks around the world have cut short-term interest rates considerably and so far there has been no sign of an increase in 2010. Lending rates of Faroese banks have been somewhat higher than what we find on comparable loans in e.g. Denmark. This has had such an effect that the majority of the Faroese home loans are now mortgage financed. This sort of financial arrangement ensures a profit to the Faroese banks through administrative charges and improves liquidity, which can be used to pay off debt to other

banks or to extend lending operations. The Danish Government's *Bank Packages* have reduced uncertainties and improved the position of Faroese banks. The banks currently have a net debt of DKK 4.1 billion to foreign financial institutions. Refinancing the debt is not expected to be difficult the first coming years, partly because of the banks' ability to obtain state guarantees through the *Bank Packages*.



The size of the accounts of the Faroese banks has been nearly unchanged in total from March 2008 to December 2009. Lending operations have decreased by app. DKK 1 billion, while bonds and other assets have increased by DKK 2 billion. On the liabilities side, deposits have increased by DKK 500 million, issued debt instruments have increased by DKK 2.5 billion and debt to foreign financial institutions has decreased by DKK 1.7 billion. Bank lending has decreased, on account of home loans being refinanced to mortgage loans.

Therefore, it seems that access to financing might not be any obstacle in financing the investments and operations of the business sector and households in the next couple of years.

#### 2.4.5 Other industries

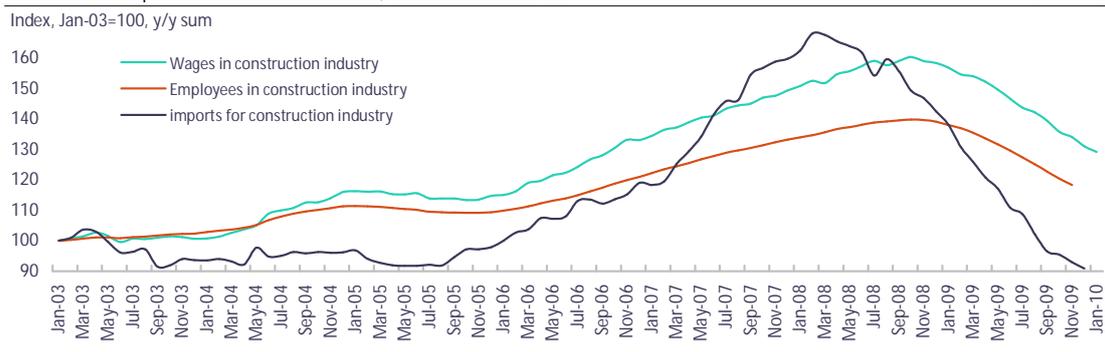
These are manufacturing and service industries, which are not mentioned above, but combined account for a large part of the total added value in the Faroese economy.

The fish processing industry Changes have recently taken place in the fish processing industry and the number of processing plants has been reduced in order to boost the profitability of operations. There seems to be a great deal of uncertainty with regards to this sector of the industry, as both access to financing and the difficulties in securing raw materials for production still appears to limit production – although condition seem to have improved compared to 2008.

In general, it is quite difficult to make estimates for the remainder of 2010 and 2011; however, indications are that a restructuring of production should be beneficial in the long run.

Trend developments in construction, Jan-03 to Jan-10

FIG. 2.10



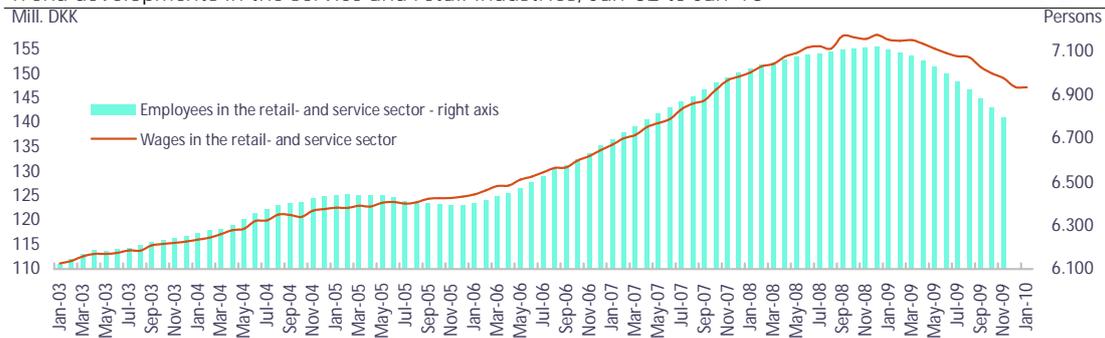
Source: Statistics Faroe Islands

The construction industry Not much has changed in the construction industry since the previous report was published. Expectations seem to have improved compared with the latest Trade Barometer. The dramatic changes in conditions, compared with previous years, are still being felt. The levels of public investments in projects will to a great degree determine development in the construction industry. Several projects have already been announced, e.g. the extension of the air strip at Vágur Airport, and Tórshavn municipality also plans to initiate a number of large construction projects.

Project management has not been satisfactory in the construction industry in recent years. So much work has been available that smaller businesses have taken large projects upon themselves. This has resulted in poor administration and low efficiency in the industry. The efficiency in the industry might improve in the years ahead, if construction companies increase in size and develop the necessary managerial skills. A consolidation is expected in the industry, as competition from foreign construction companies continues to increase.

Trend developments in the service and retail industries, Jan-02 to Jan-10

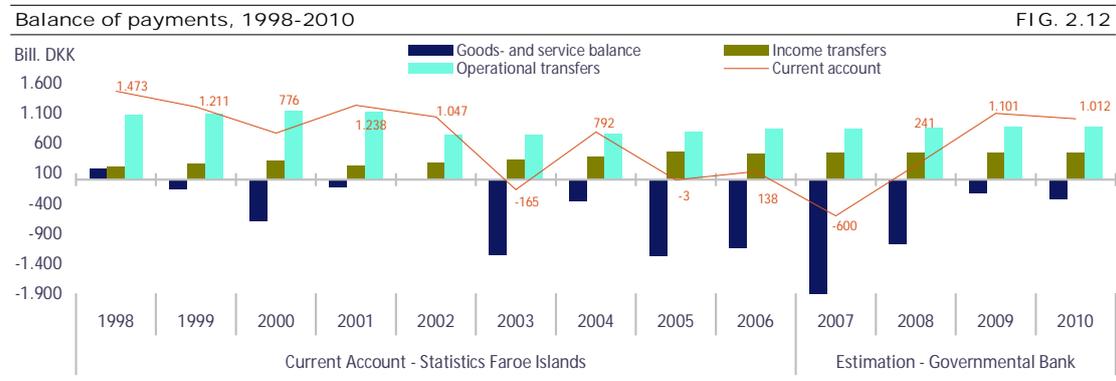
FIG. 2.11



Source: Statistics Faroe Islands

Trade and service industries The reductions in private consumption have had significant effects on the trade and service industries. Consumption fell dramatically in 2008 and 2009, following years of very high levels of consumption and this still affects the industries. Indications are that inventories will not be reduced further and investments might go up slightly, however, not to the same levels as a few years ago.

The trade barometer made by the Ministry of Finance indicates that prospects are not as dim as they were earlier. This supports the general assessment that the economy as a whole is at a turning point; yet, it is difficult to assess exactly when real change is likely to occur.

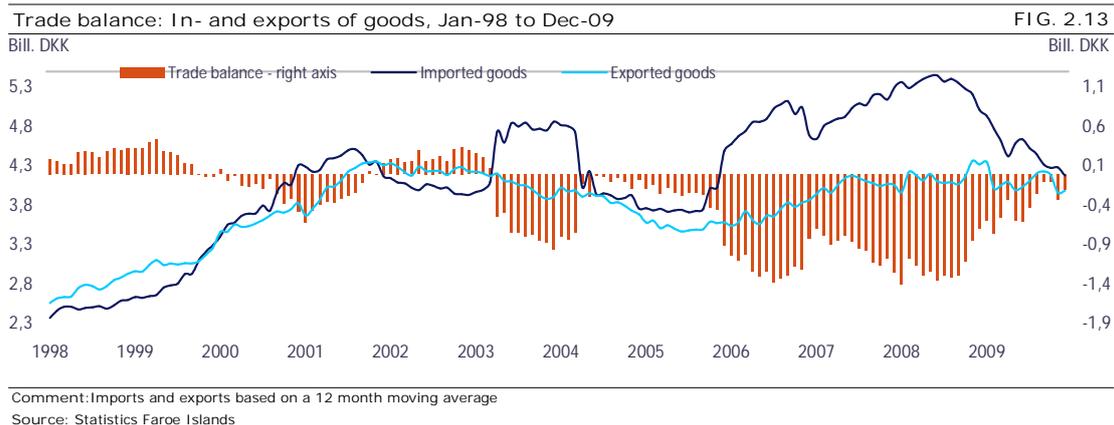


#### 2.4.6 The balance of payments

The balance of payments includes the balance of trade, trade of services and transfers to and from abroad. The uncertainty is considerable regarding the statistics about the Faroese balance of payments, and the newest figures are from 2006. The figures are therefore to be read with some reservations.

According to figures from Statistics Faroe Islands, the surplus on the balance of payments was substantial on average in the years 1998 to 2006, see Figure 2.12. The figures for 2003 and 2005 are greatly affected by the fact that two large ships were imported those two years, while 2006 is influenced by the fact that credit-funded spending really accelerated that year. There was a huge increase in imported goods that same year, both in terms of durable and semi-durable consumer goods as well as in materials for the construction industry, which resulted in a large deficit on the balance of payments.

In 2007, the deficit on the balance of trade nearly reached DKK 1.5 billion, which is the largest ever recorded on the Faroe Islands. The deficit on the balance of trade was app. DKK 700 million in 2008. The surplus on the 2008 balance of payments was most likely at the same level as it was in 2006. The surplus in 2009 will probably be a bit higher, judging by the development in imports and exports – seeing as imports has decreased more than exports, see figure 6.



The surplus in 2010 is probably lower, but only slightly. Trade in goods and services is nearly in balance, but has in total risen slightly compared to 2009. Fluctuations have been quite extraordinary with regards to the balance of trade in goods and services, particularly since 2007. This is partly due to the presence of imports of large ships in certain years; however, private sector imports have also declined substantially in the last two years – and figures indicate that this reduction is sustained. It is, nonetheless, not likely that this will be the trends for a longer period of time.

In other words, judging by the statistics, there is a surplus on the balance of payments, even though the public sector is currently experiencing huge deficits. Given that the statistics on the balance of payment are reliable, it means that the private sector combined, i.e. the industries and households, has huge surpluses and is increasing its savings significantly. In spite of great uncertainties, figures have been put on the trade operations of the balance of payments for the years 2007 to 2010, cf. figure 2.12.

PART 2  
ANALYSIS AND DISCUSSIONS OF FISCAL  
POLICY

### 3. THE CURRENT STATE OF FISCAL POLICY AND HISTORICAL DEVELOPMENTS

This chapter establishes that the Faroese fiscal policy has primarily been pro-cyclical in the last 30 years. Fiscal policy coordination between government and municipalities has been very limited, which otherwise could have strengthened the use of fiscal policy as an instrument to ensure stable economic growth. The fiscal policy instrument, however, does not seem to have been able to limit the fluctuations created by the lending operations of the financial sector.

Different kinds of revenues and expenditures exert varied influences on economic growth and, accordingly, also on the government's revenue base. Cost-benefit analyses have so far been used for public investments in transportation, but could also be used to assess other public expenditures and revenues.

Pro-cyclical fiscal policy In table 3.1, we find examples of periods with upswing fluctuation from the financial sector. The table shows that the banks in the early 1980ies initiated a substantial growth in credit facilities. By year-end 1989 the amount of borrowings had increased nearly five times compared with borrowings at year-end 1980.

Credit growth and fiscal policy 1980-1989, mill. DKK				TABLE 3.1
Year	Growth in domestic lending by Faroese Financial inst.	Operational- and investment expences growth	New state guarnatees	GDP
1981	263	169	52	2.946
1982	509	159	444	3.452
1983	466	189	221	4.196
1984	728	358	197	4.551
1985	814	158	257	5.099
1986	1.200	31	566	5.837
1987	1.894	160	239	6.372
1988	998	988	354	6.882
1989	766	382	225	6.023

Comment: Monthly bank balances; yearbook from state representative and state budgets 1980-89.

Source: Faroese Budget Office, Finance Ministry and Statistics Faroe Islands

... in 80ies The Faroese authorities made few efforts to solve the challenges of economic fluctuations in the 80ies, which were manifested through large deficits on the balance of payments and a shortage in the domestic labour force. In 1986-87 efforts were made to reduce domestic demand by imposing duties on e.g. oil. Also there was a certain level of control of government and state expenditure. These measures, however, had little curbing effect on the increasing levels of demand, which was satisfied through the growth in bank credits. The Faroese government did, however, also counteract its own attempts to curb demand by issuing a steady stream of new government warrants on private loans.

As indicated in table 3.1, the fiscal policy was on the whole pro-cyclical throughout the 80ies; the result was a perpetual deficit on the balance of payments and a deficit of domestic labour supply relative to demand.

...in the 90ies The fiscal policy was also pro-cyclical in the 90ies, but now the cycles had turned. As financial institutions grew more cautious with regards to lending policies,

government and municipalities raised taxes and cut expenditures. This was manifested through large and perpetual surpluses on the balance of payments and a surplus in the supply of labour relative to demand.

...and in the 00s Table 3.2 indicates that history repeats itself in the period from 2000 and onwards. Financial institutions engaged in a large expansion of credits while the government cut taxes and increased public expenditures. It is not likely that public authorities through fiscal policies could have counteracted the effect of the growth in credit in e.g. the years 2006 and 2007, where borrowings increased DKK 2.4 billion and DKK 5.1 billion, respectively. On the other hand, no such efforts were ever attempted – quite the contrary.

Credit growth and fiscal policy 2000-2009, mill. DKK				TABLE 3.2
Year	Growth in domestic lending by Faroese Financial inst.	Operational- and investment expences growth	New state guarnatees	GDP
2001	865	310	156	9.586
2002	653	221	359	9.995
2003	440	-39	101	9.780
2004	100	-44	135	10.091
2005	740	26	70	10.398
2006	2.414	435	260	11.738
2007	5.102	317	381	12.412
2008	353	-39	389	12.474
2009	-197	-274	-125	12.235

Source: Faroese Budget Office, Finance Ministry and Statistics Faroe Islands

**Fiscal policy improvements** The economic upswing of the 80ies and the economic crisis of the early 90ies forced Parliament and Government to realise the need to strengthen certain institutions and schemes relating to economic policy. Examples of such improvements include:

- The constitutional statute law – which gave rise to substantially more transparent and stricter rules on sound public financial management
- The social funds (ALS and AMEG) – which act as automatic stabilisers
- The legal framework concerning the Governmental Bank, which resulted in the establishment of a public currency reserve (which has primarily been placed outside the Faroes); in addition, this framework has meant that the government and the Governmental Bank now have better time to prepare the lending operations of the Treasury
- The improved accounting and managerial accounting system of the Ministry of Finance and Gjaldstovan, which ensured better transparency and a far sounder basis for managing public appropriation and expenditures than the old system, which was used up to 1996. A similar system was in 2010 implemented in the municipal sector, and thus forms a strong technological foundation for further fiscal policy coordination between government and municipalities.

- The new system of appropriation, which most likely will lead to tighter financial control of public institutions. The new appropriation system contains more rigorous rules and procedure for the budgeting process, in addition to regulations demanding that the government also prepares detailed budgets many years ahead.

**Fiscal policy coordination between government and municipalities** The municipal sector has in the last 15 years accounted for between 11 and 13 percent of the economy, as measured by the proportion of municipal tax revenues to the gross domestic product. It should therefore be natural to attempt a further coordination of government and municipal budgets as this follows from the fiscal policy goal of seeking to even out economic fluctuations. This has not happened yet, however, some measures have been attempted. Table 3.3 shows the trends in municipal expenditures and revenues.

Investment coordination discontinued in 2005 In the period 1998 to 2005 efforts were made to coordinate government and municipal demand by way of managing municipal investments. In 2005 the government abandoned its plans to coordinate the investment demands of government and municipalities. This was not very fortunate. It would have been more prudent to devote further resources to the efforts of achieving such an effective coordination.

Municipal income- and expenses								TABLE 3.3	
<i>Mill. DKK</i>	2000	2001	2002	2003	2004	2005	2006	2007	2008
Net operations and investments	704	703	860	968	1.128	1.080	1.264	1.478	1.708
Growth in %-points	25	0	22	13	17	-4	17	17	16
Tax revenue	1.024	1.089	1.150	1.143	1.167	1.219	1.361	1.493	1.452
Growth in %-points	9	6	6	-1	2	4	12	10	-3

Source: Statistics Faroe Islands

As already mentioned, the rules on appropriation as well as IT-systems have now been improved, which should entail more sound data material to coordinate government and municipal revenues and expenditures.

**The effects of fiscal policy** Fiscal policy is said to be expansionary if public expenditures are larger than revenues, and contractionary if the reverse is true. This is a tentative, yet insufficient, definition – as also the composition of public revenues and expenditure influences demand and economic growth. A more thorough description of the effect of a given fiscal policy should therefore also take into account the different classes of revenue and expenditure.

Different political goals are linked to the varied classes of public revenues and expenditures. This could be policies with regards to education, health, elderly care and other such issues. The effects on demand from expenditure and revenues from all of the areas combined are in effect what we term the fiscal policy (or the fiscal policy effect).

**Structural measures** Changes made to revenue and expenditures in the abovementioned policy areas are also commonly divided into structural and non-structural measures. Structural measures can be seen as changes to market conditions, which fundamentally affect the behaviour market participants.

An example of a structural measure could be e.g. that the public sector reduces its revenue through income tax cuts and instead acquires the same amount of revenues by the selling of fishing rights or licences – in such a way that the price can adjust to supply and demand for such rights. We can imagine that the reduction on income taxes in the first years will fully be balanced by the increased revenues for sales of rights to natural resource. Eventually, it is likely that such changes would bring about economic growth; and thus also increased public revenues. This is due to the fact that reduced income taxes increase the supply of labour and the market-based pricing of fishing rights should lead to lower levels of capital being committed to unnecessary fishing capacity.

It is probably correct to assume, that all the different items on the public budgets in one way or the other have a structural effect on the economy and economic growth. Different classes of revenue and expenditures have varied effects on the propensity to consume and productive capacity.

**Cost-benefit analyses** In the efforts to implement a process of public consolidation it is necessary to investigate the effects that different revenue or expenditure measures have on economic growth. If at all possible, the measures (both revenue and expenditure) should be assessed through cost-benefit analyses. This would reveal which of the measures have the most positive effect on economic growth.

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## 4. FISCAL POLICY FRAMEWORK

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This section briefly describes the ways in which fiscal policy rules can support government and public sector in pursuing a sound and sustainable fiscal policy. This section also describes the material considerations to make when implementing such rules.<sup>7</sup>

Possible steps to be taken Rules regarding Faroese fiscal policy have improved these last years, e.g. on account of the Parliamentary Act on Appropriation, the new Executive Order on Accounting Procedures, and the Executive Order on Municipal Accounting Procedures. These important improvements should provide the basis for a more coherent fiscal policy with tighter coordination of government and municipal budgets. Steps should continuously be taken to ensure further progress. For example, there are no requirements that:

- Government and municipal budgets are coordinated some years a head with regards to the expenditure and investment frame
- Public revenues and expenditures must balance over a certain period of time
- Unexpected or windfall income should fully or partly be placed in government trust funds or, alternatively, used to reduce public debt
- The political system develops clear goals on the maximum allowable level of public debt over a suitable period of time

Most developed countries have put in place fiscal policy rules.<sup>8</sup> In recent years the Faroese fiscal policy rules have been improved. These improvements should provide the basis for a more coherent fiscal policy where government and municipal budgets are coordinated.

Preconditions for fiscal policy rules There are several considerations to be made when a country implements such policy frameworks. Fiscal policy rules must be adjusted to the particular economy and flexible enough to take into consideration the state of the economy at a given point in time, e.g. when faced with unexpected blows to the economy. Furthermore, certain restriction must be built into the rules if they are to have any effect on the pursued fiscal policy. If such rules are to function properly, they must be simple and easy to understand. In addition, it is important that the municipal sector is also bound by these rules, and in most cases it seems prudent to include rules that ensure that unexpected or windfall revenues are placed in a government trust fund or are used to reduce debt.

### 4.1 CONSIDERATIONS WITH REGARD TO THE ECONOMY

The purpose of implementing fiscal policy rules is to bring about stable economic growth thorough the reigning in of public debt. Fiscal policy rules have two primary objectives:

- Ensure a sustainable and credible fiscal policy in the long term

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<sup>7</sup> This chapter summarizes the conclusions in [1], [17], [25] and [27].

<sup>8</sup> Appendix A includes an overview of the fiscal policy rules of several countries.

- Ensure fiscal policy scope and enhance the ability to withstand shocks and moderate cyclical fluctuations (i.e. to ensure short term economic stabilisation).

Fiscal policy rules usually include two primary constraints:

- Rules on public sector budgeting<sup>9</sup>
- Rules on public sector expenditure levels

No fiscal policy framework fits all countries. Rules must be modified to fit the particular economy and take into account how well the economy is capable of dealing with different economic shocks as well as take into account the preconditions to implement such rules (e.g. institutional, historical or cultural preconditions).

The Faroese economy is small, open and dependant on natural resources to a very large degree. The economy is therefore relatively susceptible to blows, e.g. to fluctuation in fisheries and in export prices. Potential fiscal policy rules for the Faroes should therefore be relatively flexible so as to allow fiscal policy to be used as a counter-cyclical tool and to withstand economic shocks.

#### 4.1.1 Rules must be clear and easily understood

Fiscal policy rules must be transparent, simple and easy to administer and understand. This makes it easier to control whether pursued fiscal policies are consistent with the rules and guiding principles. Furthermore, it become more likely that the political system can be held accountable for pursued fiscal policies – and brought to blame when policy does not conform to the rules.<sup>10</sup>

#### 4.1.1 Coordinate public budgets

If such rules are to affect the fiscal policies of the entire public sector it is crucial that they also apply to municipalities. Expenditure budget frames for longer periods of time must also include the economy of the municipalities. This is irrespective of decisions to transfer further areas of responsibility to the municipalities.<sup>11</sup>

#### 4.1.3 Consequences of failing to uphold rules

Most countries that have had good experiences with such rules also have in-built procedures, which increase the 'political price' of following fiscal policies that are not in line with guiding principles of the fiscal policy framework. This may be in the form of requirements to provide objective information to the public on future plans and goals and on the expected outcome of implementation, information on budget projections for some years ahead, or other similar procedures.

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<sup>9</sup> For example, EU's Stabilisation and Growth Pact has a ceiling on fiscal deficits at 3 percent of GDP

<sup>10</sup> For example, in New Zealand the Financial Responsibility Act of 1994 sets out guiding principles for responsible public management of fiscal policy.

<sup>11</sup> Appendix B includes an overview of different systems of municipal sector governance.

#### 4.1.4 Government trust funds or procedures to deal with unexpected revenue

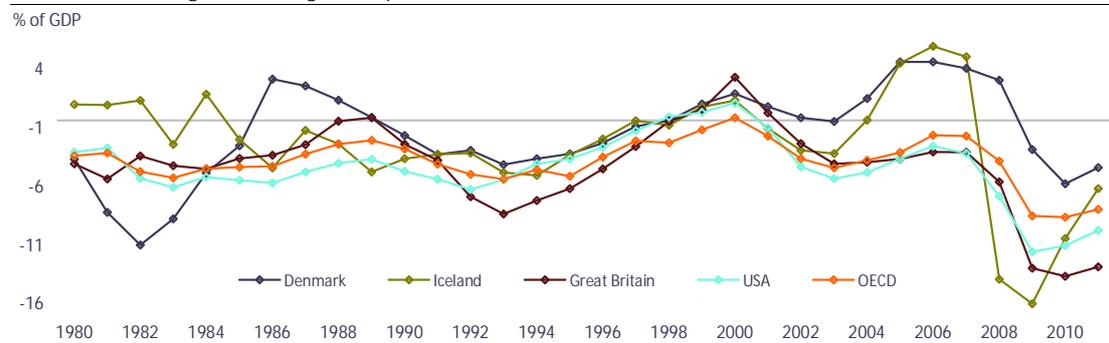
Many countries that are exposed to fluctuations in import and export prices (e.g. Norway and Mexico) have had good experiences with government trust funds to deal with unexpected and windfall revenues. One purpose of these funds is to ensure that future generations will benefit from natural resources, which e.g. provide revenues for only a limited period of time. Such funds could also contribute to the public sector increasing its savings in good years and, thus, pursues a fiscal policy that counteracts cyclical fluctuation in the economy.

## 5. FISCAL CONSOLIDATION – PAST EXPERIENCES

Most countries are faced with large public deficits. The main reason is undoubtedly the global economic crisis. But even prior to the downswing it was apparent that the revenue and expenditure policies of most Western countries were not sustainable in the medium term, e.g. due to demographic changes and rising health care expenditures.

Most western governments are therefore faced with the challenge of improving the balance between public revenues and expenditures these coming years. Figure 5.1 shows the trends in total public surpluses of selected countries in the years 1980-2011. The figure reveals that currently public sector deficits are large in most countries, in certain cases in excess of 10 percent of annual GDP.

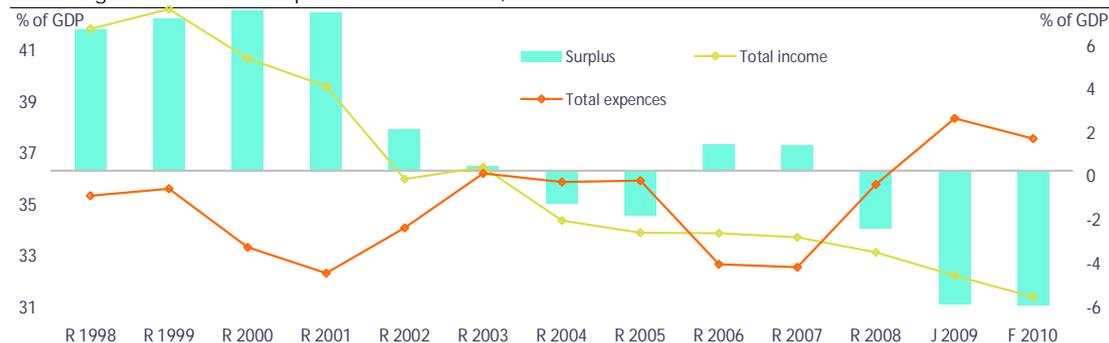
Public net lending/borrowing as %-points of GDP, 1980-2011 FIG. 5.1



Comment: The public sector is central gov. and municipalities plus public funds etc. The numbers for the years 2009-2011 are forecasts.  
Source: OECD

Most studies indicate a aggregate public deficit, even when adjustments are made to take into account the current economic conditions.<sup>12</sup> This is also the case with regards to the Faroese economy, cf. figure 5.2.

Central gov. income and expenses as % of GDP, 1998-2010 FIG. 5.2



Comment: The figure only shows central government results and must not be confused with FIG. 5.1  
Source: Finance Ministry, Faroese Statistics and the Governmental Bank

<sup>12</sup> Cf. also [8].

Most Western countries will in the coming years be forced to enact measures to consolidate the public sector in order to improve the sustainability of the pursued revenue and expenditure policy, i.e. they must achieve a better balance of revenues and expenditures in the public sector. This can only be achieved by way of increasing revenues from direct and indirect tax and/or by reducing public expenditure (e.g. by increasing the age of retirement). Furthermore, it would be interesting to assess the experiences of other western countries that have gone through periods of public sector consolidations. An OECD study from 2007 describes the experiences OECD countries have had with periods of public sector consolidations.<sup>13</sup> The study includes 85 different periods of public sector consolidation from 24 OECD member countries. The following section briefly describes some of the conclusions of the study.

## 5.1 THE MAIN CONCLUSIONS OF THE STUDY

The main conclusions of the OECD study are:<sup>14</sup>

- Large public sector imbalances and higher interest rate levels increase the possibility that countries engage in a process of consolidating the public sector. Change was most substantial in countries with the greatest initial imbalances.
- Consolidating measures that focus on reductions in public expenditure have a more significant and longer lasting impact than other measures.
- Countries that have set up fiscal rules with embedded expenditure targets and public budgeting requirements have achieved better results from fiscal consolidations than other countries.

OECD experiences from period of fiscal consolidation thus indicate, that it is most prudent to put in force a set of fiscal policy rules that can facilitate, and retain over time, the improvements made to balance public revenue and expenditure.

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<sup>13</sup> Cf. [17] for a further description of the statistical basis of the study.

<sup>14</sup> Cf. also [17].

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## 6. TAXES AND ECONOMIC GROWTH

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In general, recommendations are to increase to use methods of taxation, which do not distort the choices of individuals and firms on work and productive activities. If decisions in this regard are made purely for reasons of taxation instead of growth purposes, taxation may well constrain economic growth.

### 6.1 INCOME, CORPORATE AND PROPERTY TAXES

#### 6.1.1 Income tax

**Tax and behaviour** Changes in taxes have two distinct effects; a revenue effect and a redistributive effect. Lower taxes increase disposable income and the cost of leisure. Increases in disposable income expand consumption options – also with regards to leisure. Lowering taxes means that individuals are able to work less (i.e. consume more leisure) and retain the same level income, post tax. Raising taxes, on the other hand, reduces disposable income and the cost of leisure. Individuals must therefore work more hours in order to keep the same level of disposable income.

**Marginal tax** A too high marginal tax rate is detrimental to economic productivity. The adverse effects on productivity of an excessive marginal tax rate can e.g. be due to stifling effects on entrepreneurship.

#### 6.1.2 Corporate tax

Corporate tax and economic growth studies show that elevated levels of corporate tax can be harmful, and compared with other taxes; corporate tax is found to exert the most negative influence on economic growth.<sup>15</sup> Faroese corporate taxes are lower than in neighbouring countries, and it is therefore uncertain whether the effects of increasing the Faroese corporate tax rate will be significant with regards to growth.

*OECD observes that elevated corporate taxes have a relatively more negative effect on economic growth than all other taxes*

#### 6.1.3 Property taxes

**Real estate taxes** *Taxes on real property, residential taxes and the like are seen to be the least distorting form taxation there is. The reason is that real estate tax does not influence the choices people make with regards to e.g. working (as opposed to an income tax).* This sort of tax is also locally confined and levied on an inelastic good, as it is difficult to move to other countries where real property taxes are lower.

**Financial asset taxes** Financial asset taxes have certain distorting effects as they influence people's propensity to accumulate savings. The danger is that excessive financial asset taxes may induce people to transfer such assets to tax heavens. Most OECD countries therefore have exemptions with regards to financial asset taxation, e.g.

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<sup>15</sup> Cf. [26].

retirement savings are not taxed as a financial asset. This means that decision with regards to savings can be based on tax considerations instead of growth considerations.

**Inheritance and gift taxes** Inheritance and gift taxes are not deemed to exert significant negative effects on economic growth. Gift taxes are often levied to prevent the gratuitous transfer of wealth in an attempt to avoid inheritance taxes.

**Financial and capital transaction taxes** Taxes on financial and capital transactions, on the other hand, do have a relatively direct effect on the choices of households and individuals – and therefore may also influence economic growth. For example, if tax is levied on transactions regarding the sale of residential housing this may lead to more rigid patterns of settlement as people will be dissuaded to resettle, even in cases where employment opportunities are better in a new location.

## 6.2 CONSUMPTION TAX

**Consumption tax** Consumption taxes are very rarely progressive, most often they are proportional; and thus do not affect the propensity to save as much as income taxes – and they probably have the same effect on labour supply as do proportional taxes. The most commonly levied consumption tax is the value added tax (VAT).

**Special consumption taxes** In order to reduce societal imbalances many OECD countries use special consumption taxes. In some countries basic necessities are exempted for VAT. It is our opinion, that such a system is not very beneficial; as it can be shown, that direct grants to disadvantaged households are better at targeting such imbalances and also improve economic efficiency. The reason for this is that well-off households will consume relatively more of goods that are lower taxed. Therefore, these households will be better off by consumption taxes that disadvantaged households.

*OECD recommends the use of a consumption tax with uniform rates for all goods and services. Room should be left for excises on e.g. tobacco and alcohol as well as for environment affecting taxes – however, this should not be affected through the consumption tax.*

**Value added tax** Value added tax is a consumption tax levied on the value added to goods and services at the point of sales.

The system of value added tax has some clear benefits. Primarily, the system is to a large degree self-regulating. VAT evasion can occur, as it can in all similar systems; however, compared with a sales tax the likelihood of evasion is far less. Estimates are that a sales tax exceeding 10 percent will lead to excessive evasion and fraudulent behaviour.<sup>16</sup>

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<sup>16</sup> Cf. [28].

Another characteristic of the VAT system is that it has two distinct boundaries; one boundary towards the surround world (i.e. geographical borders) and the other boundary towards households. VAT must be pay on all imports of goods and services, while all exports are exempt of VAT. As these boundaries become more unambiguous and translucent, the system itself becomes more orderly and pure.

In international comparison the Faroese VAT system is relatively pure, applying a uniform rate of 25 percent with only few exceptions. But these few special cases are unfortunate and muddle the system unnecessarily. Faroese legislation on VAT could be greatly improved if:

- 1) Domestic transport of persons should not be a VAT exempt activity
- 2) Rentals of real property should be subject to VAT
- 3) All VAT exemptions for the fishing industry should be abolished

### 6.3 ALL BUSINESSES AND INSTITUTIONS SHOULD BE VAT REGISTERED

In an effort to create a more pure VAT system with clear boundaries, it is imperative that all purchases are subject to VAT. The current VAT system grants exemption to certain parts of industry, e.g. the transport and fishing industries as well as to financial institutions and dentists. The basic principle must be that all businesses and institutions should be VAT registered.

### 6.4 DOMESTIC TRANSPORT OF PERSONS SHOULD BE SUBJECT TO VAT

The Faroese Parliamentary Act on Value Added Tax (paragraph 2, section 2.f) lists domestic transport of individuals and motor vehicles by the Strandfaraskipum Landsins (public transport services) to be exempt of value added tax. Economic theory states that all industries should be subject to the same conditions<sup>17</sup>, and this should naturally also be the case for the entire transport sector. This would affect transport by bus, taxi and other means of transportation of persons. Furthermore, VAT should be levied on all public transport services (i.e. those of the Strandfaraskipum Landsins).

Such a change would mean that the transport sector became a more natural and self-regulating part of the combined VAT system. It is also from a socioeconomic point of view quite hard to justify that the transport of individuals should be granted special treatment compared with other service industries. Taxi transportation is also exempt of VAT in Denmark; however, this does not in itself justify a similar exemption in the Faroese system.

Such a change would increase the Treasury's revenues, while bus and taxi fares would undoubtedly rise as a consequence. For the providers of transport services to individuals

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<sup>17</sup> This report also recommends increasing corporate taxes in the fishing industry, and this may seem at odds with the statement that all industries should be subject to the same conditions. Yet, this increase in corporate tax should rather be seen as a tax on natural resource extraction – where the aim to a larger extent is to induce sustainable fisheries, profitable operations and to ensure that the industry pays for access to natural resources.

there are also benefits to being VAT registered and paying VAT, as VAT on all purchases can be reclaimed.

## 6.5 RENTALS OF REAL PROPERTY SHOULD BE SUBJECT TO VAT

In paragraph 2, section 3.h of the abovementioned act it is stated that rental, leasing and administration of real property is a service that is VAT exempt. There is not distinction between commercial and private rentals and this muddles the system of VAT with regards to issues of real property. It is recommended that commercial rentals become subject to VAT, while private rentals remain exempt – so as to make the boundary towards households more clear.

If a private individual lets an apartment or house, this individual has already paid VAT on all material, furniture and labour costs<sup>18</sup> without having been able to reclaim anything. In this case, the VAT boundary is quite clear and no VAT should be charged on the rent. If the leaser is a business or self-employed person, on the other hand, the situation is quite different; as investments made for commercial purposes qualify for VAT reclaims on all purchases connected to the investment.

Under current legislation all property rentals are exempt of VAT and investors and buyers are not able to reclaim VAT on purchases and investment tied to the real property. Therefore, all commercial activities on the rental market should be subject to VAT.

## 6.6 ALL VAT EXEMPTIONS FOR THE FISHING INDUSTRY SHOULD BE CANCELLED

The Faroese fishing industry is by and large VAT registered, as both ships and processing plants have to be registered. However, the commercial fishing fleet is VAT exempt with regards to nearly all duties (cf. paragraph 12, section 1f of the Act on VAT).

But these exceptions contribute to a discord in the system. Furthermore, the responsibility of determining, which sales should include VAT and which should not, is placed on the supplier to the fishing industry. An adjustment of the system would in itself not have any economic consequences, as nearly all fish produce is exported, and thus VAT exempt.

There could be issues with regards to liquidity as the flow of money would be somewhat altered. For export companies this may have disruptive effects in the short term, as the raw materials they purchase would become subject to VAT. These VAT payments would now pass through the Treasury before they could be reclaimed. Conversely, the fishing fleet would experience a short term increase in liquidity as sales now become subject to VAT. This issue of liquidity, however, should not be difficult to solve as VAT accounts (administered by TAKS) can be settled as often as once a week.

Yet, such an adjustment would mean that the public authorities assume greater risks; as businesses and ships that have outstanding VAT payments can go bankrupt and leave the Treasury with a loss in revenue.

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<sup>18</sup> It is possible to reclaim VAT on labour costs, however, this system is currently in the process of being revoked.

The aggregate effect of such measure would be close to neutral, perhaps leaning slightly towards an increase in revenue, as the adjustments may capture some transactions that are hidden under the current regime.

On a whole, the adjustments described above would make the Faroese VAT system significantly more orderly and pure and make the boundaries towards private household and the surrounding world clearer.

## PART 3

### MEASSURES TO IMPROVE FISCAL POLICY

## 7. RECOMMENDATIONS FOR FISCAL POLICY IN THE COMING YEARS

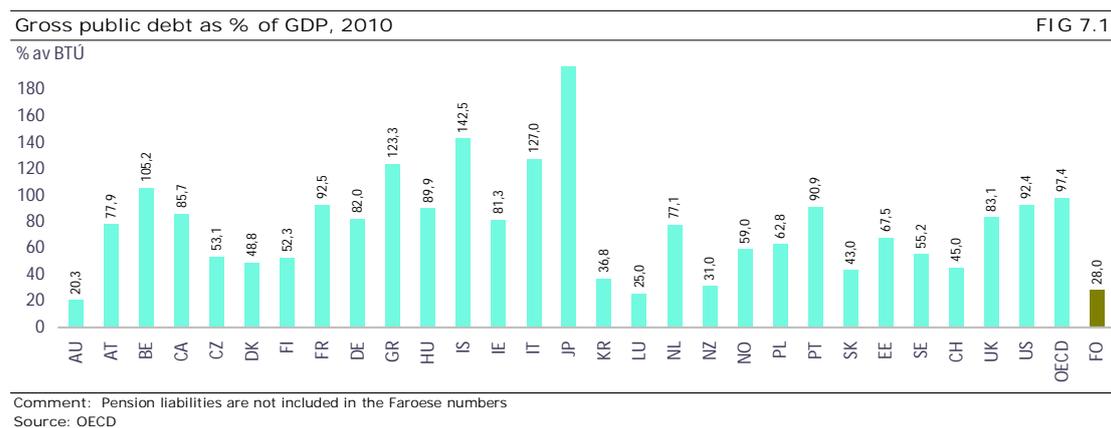
Faroese society has embraced the Scandinavian model of the welfare state. Hardly anybody expresses a desire for a decline in the level of public service provisions, not even now when the public sector is under severe pressure. It is likely that certain changes must be made in the Faroese economy if reductions in public expenditures are to be avoided in the coming years. Therefore, the Council of Economic Advisers will in this report make recommendations with regards to measures that could support economic growth and, consequently, secure a continued high level of public service provision.

It is recommended that the fiscal policy for 2011, as was the case in 2010, continues to focus on boosting domestic demand and in this way keeping the level of unemployment down. The total deficit of Treasury and municipalities is substantial, app. DKK 850-900 million in 2010; yet, it is the view of the Council of Economic Advisers that there is fiscal policy scope for public deficits some years ahead.

However, large public deficits cannot be sustained for many years and it is therefore suggested, that a structured plans is put in place to balance public revenues and expenditure. Proposals for such a plan are discussed below, cf. table 7.1, 7.2 and figure 7.2.

The Council of Economic Advisers highlighted in its 2009 autumn report that the public sector should strive to have relatively low levels of debt. This improves the economy's ability to withstand unexpected blows to supply or demand as it increases the fiscal policy scope as well as the government's credit ratings, all else equal.

Public sector debt is actually relatively small, app. 28 percent of GDP in 2010.<sup>19</sup> Figure 7.1 compares the gross public debt of the Faroes with other countries.



The Council of Economic Advisers therefore observes that it should not be necessary to enforce instant and drastic measures, which would lead to e.g. direct cuts in the total expenditure frame or to higher pay-roll taxes. There is occasion to implement the

<sup>19</sup> The concept of debt here and in the example refers to *gross debt*.

necessary measure for reducing public deficits while at the same time promoting economic growth.

Yet, this depends on the implementation of sound measures that can boost economic growth, as is explained in the section below. If measures to enhance productivity are not put in action it will to an increasing degree be necessary to make cuts in public expenditure or to increase taxes.

## 7.1 EXAMPLE OF A DECISIVE PLAN OF ACTION

This example provides an understanding of when and to what degree measures must be implemented in order to achieve a balance in public operations over a given period of time. The purpose is to reach a sustainable fiscal policy in the medium term, so as to avoid more harsh measures and cuts later on.

If there is strong political support to implement such a plan, it would increase the confidence in Faroese economy of households, creditors and rating agencies.

The example is based on two overarching goals; that public debt does not go above a certain percentage of GDP and that public deficit (as a percentage of GDP) goes down after a certain period of time. Fiscal policy is commonly referred to a sustainable, if public debt does not constitute an increasing proportion of the total economy over time. Therefore, the example examines debt as a percentage of GDP. Government and municipalities are treated collectively in the example.

In this example, government and municipal expenditure frames increase by 2 percent annually up to 2015, and after this, the growth in expenditure frame is 3 percent per year. As there are expectations of significant increases in social and health care expenditures due to demographic changes – as well as the usual increases in prices – the limit of a 2 percent total growth means that it will be necessary to make cuts on other areas.

Two overarching goals of the government and municipalities should be reached by 2015.

*Goal 1: The combined debts of government and municipalities should not exceed 40 percent of GDP.*

*Goal 2: The combined operations and investment deficit of government and municipalities should by 2015 have decreased to 2 percent of GDP.*

The measures taken to reduce the deficit should also remove impediments to economic growth. Table 7.1 and 7.2 contain examples of developments the coming years, with and without policy measures. Figure 7.2 then shows the developments in public deficit and public debt, with and without measures.

Currently, the deficit is just above 7 percent of GDP. According to the example and the chosen annual GDP growth, a deficit of 2 percent of GDP would roughly equal a deficit of DKK 300 million in 2015.

**Economic growth** The pivotal assumption in this plan relates to economic growth. Estimates are that economic growth in the coming 2-3 years will be app. 2 percent in constant prices and 4 percent in current prices. But it is possible that growth will subsequently decline unless measures to boost productivity are put into action. This can be seen in table 7.1 and 7.2, where a fiscal policy without significant measures results in declining economic growth from 2015 and onwards. If the assumption of a nominal growth in GDP of 4 percent is to hold for the period from 2015 and onwards, the measures implemented must also advance economic growth. Instead of raising pay-roll taxes efforts should focus on e.g. abolishing certain subsidy schemes that disrupt industry adjustments and distort market mechanisms.

**Expenditures** Another important assumption for the plan to succeed is that the combined expenditures of government and municipalities do not increase by more than 2 percent annually in the coming years. After 2015, the growth in the expenditure frame is fixed at 3 percent per year.

**Measures** In order to get the public economy back on the right tracks the Council of Economic Advisors recommends that measures are implemented, which should lead to new revenues and reductions in expenditures worth app. DKK 300 million in total for the years 2011, 2012 and 2013. The policy measures constitute roughly a third of the current deficit, i.e. just above 2 percent of GDP. The recommended measures have certain common characteristics in that they do not impede productivity and economic growth – rather the opposite.

	Expences inc. interest payments	Interest payments Mill. DKK	Tax revenue	Danish State subsidy	Deficit	Deficit as % of GDP	Debt as % of GDP
2010	6.499	89	4.990	656	853	6,7	28,5
2011	6.656	118	5.315	656	685	5,2	32,6
2012	6.844	175	5.528	656	660	4,8	36,3
2013	7.045	243	5.749	656	641	4,5	39,6
2014	7.259	321	5.979	656	624	4,2	42,4
2015	7.554	408	6.218	656	680	4,4	44,8
2016	7.809	448	6.404	656	749	4,7	47,8
2017	8.074	492	6.596	656	822	5,0	51,0
2018	8.350	541	6.794	656	900	5,4	54,4

Source: Inhouse calculations. Consolidated budget numbers for Central Gov and Municipalities are from the National Budget Office

Tables 7.1 and 7.2 describe the developments in the Faroese economy with and without effective policy measures. Table 7.2 shows that given an annual economic growth of 4 percent in current prices, it should be possible to reduce the deficit of government and municipalities to 3.7 percent in 2011 through the implementation of measures of just below DKK 200 million.

Fiscal policy situation for Central Gov and municipalities with measures TABLE 7.2

	Deficit	Measures needed	Measures as % of GSP	Accumulated measures	Accumulated measures as % of GDP	Deficit with measures	Deficit with measures as % of GSP	Debt as % of GDP
2010	853	0	0,0	0	0,0	853	6,7	28
2011	488	197	1,5	197	1,5	488	3,7	31
2012	406	49	0,3	246	1,8	406	3,0	33
2013	322	53	0,3	299	2,1	322	2,3	35
2014	277	12	0,0	311	2,1	277	1,9	36
2015	294	12	0,0	323	2,1	294	1,9	36
2016	265	13	0,0	336	2,1	265	1,7	37
2017	233	13	0,0	350	2,1	233	1,4	37
2018	195	14	0,0	364	2,1	195	1,1	37

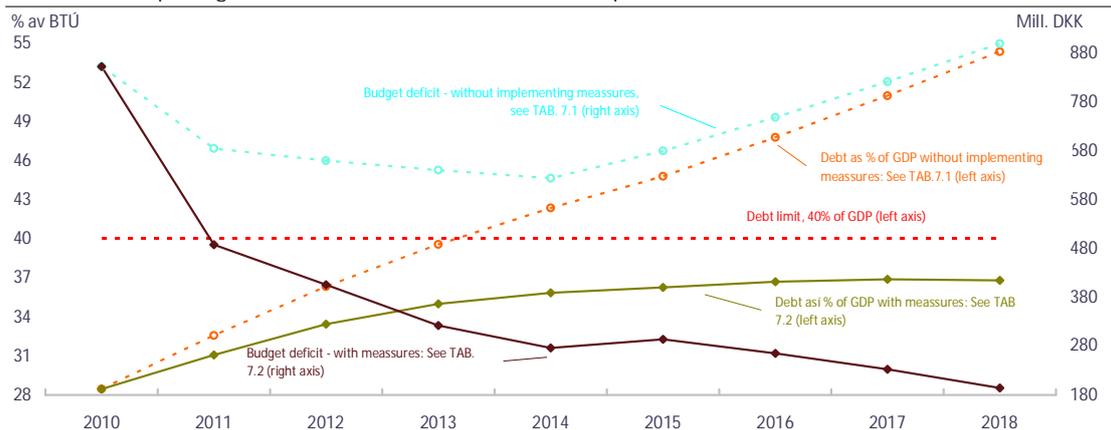
Source: Inhouse calculations. Consolidated budget numbers for Central Gov and Municipalities are from the National Budget Office

In order to reach the abovementioned goals, it will be necessary to instigate measures that constitute 2.1 percent of GDP in total up to 2013. The degree to which these measures are focused either on the revenues or expenditures of the public sector is, in the end, a political decision. The Council of Economic Advisers recommends, however, that these measures are directed at both revenues and expenditures.

The example in figure 7.2 assumes that the most substantial adjustments are made in 2011. After this the necessary measures are smaller, however, this assumes that the measures also increase productivity. Unless such measures are put into action, debt will increase in proportion to the economy; and thus, additional and more drastic measure will be needed to curb the growth in debt. If assessments are that a public debt of 40 percent of GDP is to great, then more policy measures must be put into action to make the debt decrease.

Figure 7.2 shows the developments in public debt and deficit, with and without the measures suggested in tables 7.1 and 7.2.

2 scenarios depicting deficits and debt for Gov. and municipal. as % of GDP FIG 7.2



Comment: Bruttoskuld við árslok 2010 er hér roknað sum skuldin hjá landi og kommunum, frádrágin innlán í landsbankanum.

Source: Inhouse calculations. Consolidated budget numbers for government and municipalities are from the National Budget Office

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## 8. IMPROVMENTS TO FINANCIAL MANAGEMENT

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The public sector has a limited amount of economic goods to use for public services, grants, projects etc. Accordingly, it is important to prioritise when decisions are made on public operations and activities. It is also very important to analyse all public operations in general so as to assess the quality, efficiency and transparency in public service provisions. Sound financial management must be ensured as well as compliance between political intent and the duties performed by the public sector.

The guidance tools, systems and procedure discussed in this section are the public fiscal policy rules, the guiding principles of target goals and achievement measurement and cost-benefit analyses.

The purpose of these tools is to ensure optimal public use of economic goods; that structured, long term plans and goals are made for all public activities; and in general, that the public sector exerts the most beneficial influence on the economy as is possible.

### 8.1 FISCAL POLICY FRAMEWORK

In chapter 4 the fiscal policy rules were briefly described as concepts and as instruments to execute a sound and sustainable fiscal policy. The sustainability of a fiscal policy is very important as it is a precondition for smooth and steady economic growth.

The Faroese economy is small, open and very dependent on natural resources as well as on trade in goods and services with other countries. Therefore is important that the public sector continuously strives to create fiscal scope in order to withstand shocks to the economy.<sup>20</sup>

Improvements have these last years been made on the Faroes due to the Parliamentary Act on Appropriation, the new Executive Order on Accounting Procedures, and the Executive Order on Municipal Accounting Procedures. But there are still no rules relating to the public fiscal policy itself. What is lacking is e.g.:

- that long term budgets are made for the operations and investments of the government and municipalities
- that an government trust fund is established
- that the political system sets up long term targets for public debt levels
- It is possible to learn from other countries' experiences in this regard, discuss the possibilities of modifying their frameworks to our own circumstances, and implementing it on the Faroes. One example is New

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<sup>20</sup> The public sector can ensure fiscal scope by in general pursuing sound fiscal, structural and industrial policies. This entails e.g. having an acceptable level of debt; pursuing a fiscal policy that is sustainable in the medium term; to pursuing structural and industry policies that stimulate high economic growth, sufficient supply of labour, and unburdened by subsidies of any kind; ensures free competition on as many market as possible; and engages in free trade with other countries, etc.

Zealand, where much work has gone into these efforts and the outcome has so far been good.

### 8.1.1 Experience from New Zealand

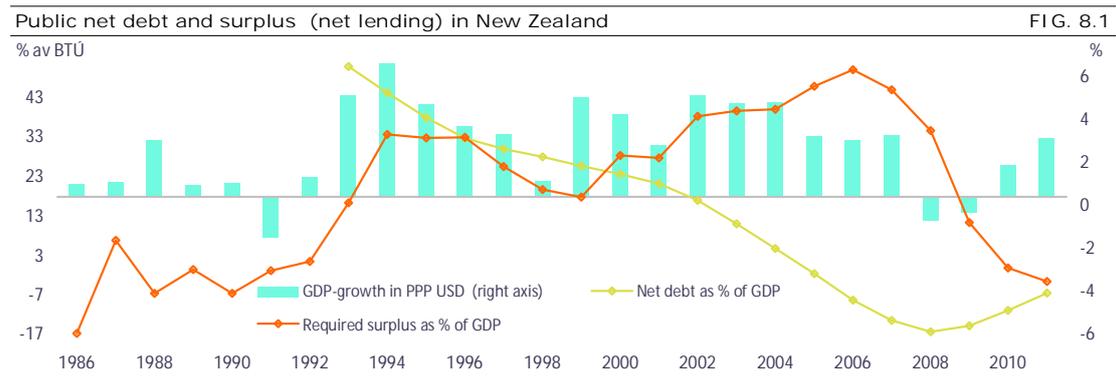
New Zealand was the first jurisdiction in the world to put in place legislation on sound public management of fiscal policy (1994) and have so far had good experiences with the fiscal policy rules.<sup>21</sup> New Zealand has by most accounts some of the most advanced legislation on fiscal policy rules, The Public Finance Act (1989).<sup>22</sup> This framework has been continuously improved since work first began in the 1980ies.

Following a prolonged economic crisis in the 1970ies several structural and economic reforms were made. The New Zealand economy was characterised by barriers to trade, reduced competition in most markets and by public market interferences e.g. through subsidies. The crisis of the 1970ies was primarily due to the UK's entry into the EC in 1973. This severed the close trade relations between the countries and the New Zealand economy was also affected by the two oil crises of the 1970ies.

The reforms in New Zealand included e.g.:

- to liberalise the economy through far-reaching free trade agreements with other countries
- to liberalise as many markets as possible
- to restrict public interference with markets
- to improve financial management in the public sector

In New Zealand the standards of living in the early 1980ies was among the lowest in the developed world, while the standard of living is now comparable to that of Southern European countries.



<sup>21</sup> Cf. [17]

<sup>22</sup> For more information on New Zealand's fiscal policy rules, please follow the link below: [http://www.legislation.govt.nz/act/public/1989/0044/latest/DLM160809.html?search=ts\\_act\\_public+finance\\_resel&p=1&sr=1](http://www.legislation.govt.nz/act/public/1989/0044/latest/DLM160809.html?search=ts_act_public+finance_resel&p=1&sr=1).

Figure 8.1 tracks developments in total net debt and public sector surplus in New Zealand in the period 1986-2011. The figure indicates that in the last years there has been sound public sector management in New Zealand.

The fiscal policy framework in New Zealand contains many sensible provisions. The government must pursue a fiscal policy that is in concord with certain guiding principles on sound fiscal policy management. The guiding principles are that:

- Efforts are made to keep public debt at an acceptable level, which ensures that the public sector is resilient to economic shock in the future
- When debt has reached suitable levels, public revenues and expenditures must balance over an appropriate period of time
- Public financial risks must be managed in a prudent manner
- The fiscal policy must take into account the uncertainties that are intrinsic to all estimates on future developments and tax revenue estimates.

The government can, however, deviate from the guidelines on the conditions that:

- Deviations are only of a temporary nature
- The government announces:
  - the reasons for deviating from guidelines
  - the government's plans to bring the fiscal policy back in line with guidelines on sound fiscal policy management
  - the expected period of time it will take before the fiscal policy again is in concord with the abovementioned guidelines

In addition, there are provisions stating that the government should have tangible short and long term goals with regards to total public revenues and expenditures as well as containing strict requirements to issue objective and regular information to the general public on the pursued fiscal policy and of its effects.

The fiscal policy rules in New Zealand stipulate that government should once a year issue a report in which the maximum allowable level of net public debt is specified. Net public debt must currently not exceed 40 percent of GDP. Furthermore, in the same report the government should announce short and long term plans and goals for public revenues and expenditure as well as the effects of such plans. In addition, there are several requirements to regularly provide information to the general public.

New Zealand's fiscal policy rules have been structured to take into account the nature of the economy. New Zealand's economy is somewhat similar to the Faroese economy in that it is relatively small, open and highly dependent on trade in goods and services with other countries. This necessitates that the fiscal policy rules have a certain degree of inherent flexibility, as it will allow the fiscal policy to withstand unexpected shocks to the economy.

The inherent flexibility in the fiscal policy rules means that government can temporarily deviate from the guiding principles, provided that a tangible plan is presented on how the fiscal policy again can be brought in concord with the guiding principles.

*Recommendations are to investigate whether it is possible to continue to strengthen the Faroese fiscal policy rules, e.g. in ways similar to New Zealand*

## 8.2 MINISTRIES AND INSTITUTIONS MUST SET TARGET GOALS AND MEASURE ACHIEVEMENTS

Executive Order on Account Procedure (paragraph 7) states, that government ministries and associated institutions must have implemented the management guidelines on target goals and achievement measurement by January 1<sup>st</sup> 2010.

It is required that ministries on a yearly basis lay down general goals for the institutions within their areas of responsibility. The institutions must develop goals and performance requirements to optimise the use of available resources, based on the general goals of the ministry. The institutions must see to that the target goals and performance requirements are met and also provide adequate information for informed decision-making, as this would ensure that disparities between target goals and achievements are prevented, made apparent and can be corrected in time.

This instrument can contribute to transparency with regards to how an institution utilizes its given resources (i.e. productivity). It can also ensure that the institution uses available resources for grants and services that are in real demand, and thereby engaging activities that offer the highest societal utility (i.e. efficiency).

*It is recommended that the guiding principles of target goals and performance measurements are implemented according to the provisions in the Executive Order on Accounting Procedures*

## 8.3 PRIORTISING PUBLIC ACTIVITIES AND PROJECTS

Before a decision to initiate a public project is taken, it is crucial to rigorously assess the socioeconomic consequences and to develop a solid basis on which the decision can be made. The aim is to provide the best possible and objective foundation for political prioritisation of public activities.

The public sector must justify the use of tax-payer money on a particular action or project in relation to net societal gains of all possible opportunities, including the opportunity of refraining from using tax-payer money on a given project. The projects and activities which offer the highest net gains to society should be first priority.

To this end, a cost-benefit analysis can be a useful tool. Cost-benefit analyses can take into account special considerations such as regional or redistributive policies or other

similar considerations. Regional and redistributive considerations are crucial to many public investments and activities in general. In such cases the cost-benefit analyses can be adjusted to take such considerations into account.

The method of all cost-benefit analyses is in short; that the total costs of a public service, project or activity is compared with the societal benefits of the project. Costs as well as benefits are calculated in present values.

Historically, cost-benefits analyses have primarily been use in the public sector to assess investments in the transportation infrastructure.<sup>23</sup> They can also be used to assess the gains to society of other kinds of public investments, activities and project (e.g. investments in education, research, health and social care).

*It is recommended that relevant tools such as cost-benefits analyses are used to prioritise public activities, investment and responsibilities*

## 8.4 COORDINATION BETWEEN GOVERNMENT AND MUNICIPALITIES

A lack of effective coordination of government and municipal budgets has in the last years made it unnecessarily difficult for the political system to pursue an appropriate fiscal policy. Indications are that the municipalities have had a pro-cyclical effect in the last decades, yet, less so than the government. In recent years, the municipalities have made substantial investments and service upgrades in child care and elderly care services as well as investments in other areas. Now on the contrary, they are forced to reduce spending in order to get their debts below the maximum threshold of one tax assessment. Given the current economic situation this is unfortunate, particularly for unemployment and economic activities in general.

### 8.4.1 Public sector expenditure and investment frame

Improved alignment of government and municipal budgets to the long term expenditure and revenue frames are likely to lessen the problem. A new municipal structure with larger units and transparent division of responsibilities between government and municipalities may well be a prerequisite for better financial management in municipalities.

### 8.4.2 Division of public service provisions between government and municipalities

In the process of ensuring more transparent division of responsibilities between government and municipalities, a possibility that has been discussed is to delegate to the municipalities responsibility of the public schools, elder care and perhaps the areas linked to child and youth services. A precondition for this is a new municipal structure with fewer and larger municipalities and improved municipal administration.

The Council of Economic Advisors supports the idea of fewer and larger municipalities and the consequent strengthening of municipal administration.

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<sup>23</sup> Landsverk (Government Engineering Office) has made cost-benefit analyses of planned investments up to 2020, cf. [29].

The question of delegating responsibility of the abovementioned areas to municipalities is, however, another issue. An issue that requires careful considerations on the costs as well as with regards to the level of public service on offer in the different municipalities.

There are pros and cons associated with delegating responsibility of public service and activities (herein public schools, elder care and the area of child and youth services) to the municipalities.

The pros are that each individual municipality has the possibility of adjusting its level of service to the needs and desires of its residents. Another benefit may be that competition arises between municipalities with regards to providing public services in the most efficient and effective way possible.

On the other hand, there are also disadvantages of delegating responsibility to municipalities. Most public service provisions are subject to significant economies of scale. Government can therefore provide more efficient management and administration of public services to citizens. In addition, it is easier for the government to coordinate public services across municipal borders. Ideally, this should mean that the government is able to deliver the same public service cheaper and more efficiently than municipalities.

Another disadvantage of further municipal delegation is that municipalities are very heterogeneous with regards to finances, revenue base and the levels of debt. It is therefore plausible that the quality of public services provided in different parts of the country will not be the same – unless some system is put in action which can even out differences in the revenue base of Faroese municipalities to a greater extent than at present.

It would be unfortunate if in future there were great difference in the levels of public service and that this primarily depended on the geographical choice of residence. This could mean that certain areas of the country would attract even more people of working age, resulting in further difference in the level of public services provided.

It is also questionable, given the size of the Faroese municipalities, whether all of the municipalities will be able to provide citizens with an adequate level of service with regards to public schools, elder care and to child and youth social services. For example, it is doubtful if municipalities will be able to develop the necessary professional competences needed to provide adequate services in relation to remedial instructions, special needs institutions etc. – despite having larger municipalities under a new municipal structure.

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## 9. NECESSARY MEASURES

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Through the years there have been a number of investigations, reports and proposals on how to improve public services and the activities of the public sector. Many of them have been shelved or proven too difficult to carry through the necessary political processes.

Table 9.1 contains an overview of some the measures discussed in this chapter.

Possible measures that can be taken	TABLE 9.1
<i>Some structural reforms</i>	<i>Estimated revenue</i>
Transitional scheme ensuring revenue for fishingrights	40 Mill. DKK.
Abolishment of subsidies in the fishing industry	80 - 90 Mill. DKK.
Pension reform - heiger retirement age	15 Mill. DKK
Abolishmnet of the oil-subsidy	30 - 40 Mill. DKK
Property Tax on Housing	40 - 50 Mill. DKK
Changes in VAT	20 - 30 Mill. DKK
<i>Measures regarding expences</i>	
Mergers and rationalizing in health services	
Rationalizing public services	
Mergers and rationalizing in education	
Group to study rationalizing the public sector	

Some of these measures could probably be implemented within a short period of time as the relevant knowledge and analyses are at hand, while other measures will need more extensive specialist and political deliberations.

### 9.1 SOME STRUCTURAL MEASURES

Tax on natural resources in the fish farming industry The Faroese governments presented mid-2009 the draft expenditure frame for 2010 (commonly referred to a the St. Olaf's Wake Package) wherein it was suggested to levy a tax on natural resources in the fish farming industry. The Council of Economic Advisers supports this idea and also recommends levying similar taxes in the fishing industry so that all resource-based industries are subject to the same conditions.

Tax on natural resources in the fishing industry It is essential to ensure sustainable fisheries as well as a fishing industry that is profitable and unburdened by subsidies. Many attempts have been made to address the issue, e.g. in spring 2000 the Council of Economic Advisers drew up a proposal on a market for trading fishing rights (*days of fishing*). This would be a sound, long term solution. The Council of Economic Advisers this time recommends putting in place a system that allows for adjustments over time as it is hardly possible to levy a genuine resource tax instantaneously. Two such methods of adjustment are proposed:

- 1) Corporate tax in the fishing industry is increased over a certain period of time. The Faroese fleet is at present not turning a profit and higher corporate taxes would therefore have little effect under current conditions. When catches again increase and ships start to turn a profit, there will be

pressure on the system and a market-based system for buying and selling days of fishing should be easier to implement.

- 2) Taxes are levied on the value landed catches. This method would immediately ensure revenues to the Treasury while at the same time facilitating the necessary adjustment in the fishing fleet.

A system of adjustment could be composed of a combination of 1) and 2). Conservative estimates are that this would provide an additional DKK 40 million to the Faroese Treasury.

**Abolish subsidies in the fishing industry** The subsidies to the fishing industry distort the market mechanisms in the Faroese industry. It is crucial that we see change in this area. The subsidy schemes not only distort choices with regards to capital, investment and labour – but also cause the industry to maintain an unreasonably high pressure on fish stocks.

Recommendations are of a gradually lowering of subsidies to the fishing industry. In addition to saving public money, such changes facilitate the movement of labour into more efficient industries and the likelihood of achieving sustainable fisheries is increased. The systems of income-guarantees and tax reduction to fishermen in total constitute annual subsidies to the fishing industry in excess of DKK 90 million. In addition, the authorities support the industry by granting free access to natural resources as well as paying for inspections and other such service, which other industries would normally have to pay for (e.g. the financial sector or the fish farming industry).

If the subsidy schemes are abolished in the next three years this would greatly increase the possibility of improve profitability in the fishing industry. Granted, if these measures are to be effective, they will immediately have consequence in the Faroese fishing industry as a whole and particularly in areas highly dependent on fisheries. The government must therefore consider regional policy measure in order to moderate these effects and encourage new business initiatives.

**Reform of early retirement system** A group of experts appointed by the Ministry of Finance issued a report in 2009 recommending significant reforms to the system of early retirement. One recommendation was to increase the age of retirement by ½ year ever 5 years until the retirement age is at 71 years. Also recommended is to deduct more in the public pension as pensioners earn money in addition to the pension. A minor increase in the age of retirement would have significant influence on public expenditure. It is recommended that the new system of pensions, which was part of the St. Olaf's Wake Package, is implemented as initially planned.

Recommendations are to increase the age of retirement by ½ year from January 2011. This would result in an annual reduction in expenditure of DKK 15 million in 2011 and onwards. Every time the retirement age is increased additional savings are made.

**Duties on oil** Recommendations are to abolish all exemptions granted to industry with regards to paying duties on oil. Also recommended is that the special duty on fuel oil be included in the calculations of VAT payables. Currently the special duty on fuel oil is not included in the amount liable to VAT. This contributes to a muddling of the VAT system in addition to reducing government revenues. The amendments would mean that the entire fishing fleet as well as all

other companies would pay a duty on oil. This would increase government revenues. Furthermore, the duty on oil is also an environmental tax and can reduce fishing intensity, which currently is too high.

It is estimated that the amendment will bring in app. DKK 50 million to Treasury annually, at current levels of oil consumption.

Road taxes converted into duties on petrol and diesel Such a system would ensure that road taxes were directly linked to the amount of time spent on the roads, i.e. cars that are driven frequently and thus cause more wear and tear to roads will pay more. This system would also trim down administration as well as make foreign cars pay for the wear and tear that they cause to Faroese roads.<sup>24</sup>

The price of diesel too low on the Faroes The Faroese price of diesel is amount the lowest in Europe. Recommendations are to increase the duty on diesel so as to achieve a better match between prices on the Faroes and in neighbouring countries.

Property taxes on residential homes Efforts are being made to expand the tax base and to a larger degree utilise methods of taxation that do not distort the decisions of individuals and businesses. Property tax on residential housing has several benefits; e.g. it would scatter residential and settlement patterns slightly across the country and improve the utilisation of the total accommodations in the country.

A prerequisite for property tax on residential homes is a public system of housing valuation.<sup>25</sup> If the property tax is fixed at 0.25 percent of the residential value, this would bring in app. DKK 55 million to Treasury (rough estimate).

Changes to VAT While the Faroese system of VAT in many respects is well functioning, certain improvements are necessary. A system that confers the same conditions to all industries is not only easier to administer, but is also augments general economic growth. Instead of functioning as a subsidy scheme, the VAT system should rather function as a method of taxation. This is more thoroughly discussed in section 6.2 of this report.

The Ministry of Finance wrote up a report in 2004<sup>26</sup> where it is recommended that excises and the VAT system are reassessed in order to make them more comprehensible and use-friendly. Parts of these recommendations have been put in action.

It is recommended that the exceptions in the Parliamentary Act on VAT are re-examined with a view to abolish them. This would simplify the system and make it easier to administer as well as reduce the risk of faulty VAT statements.

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<sup>24</sup> Cf. [12]

<sup>25</sup> Regardless of the introduction of tax on residential homes, it will be necessary with a public registry of housing, e.g. for housing and planning purposes.

<sup>26</sup> Cf. [12]

## 9.2 SOME MEASURE WITH REGARDS TO EXPENDITURES

Expert group on rationalising the public sector There has been no systematic process of rationalising and increasing efficiency of the entire public sector. Procedures have so far been somewhat fortuitous and while examinations of parts of the public sector have been made, in most cases, they have not led to any significant outcome.

Continuous improvements to efficiency and rationalisation of the public sector should become an embedded part of the responsibilities of the civil service. An expert group set up by the Office of the Prime Minister and the Ministry of Finance should be established on a permanent basis – with the primary task of performing continuous assessments of policy measures to improve efficiency in the public sector and of the socioeconomic consequences of such measures. This is so as to ensure that all policy measures, which affect the production of public services, are given an appropriate professional assessment (cost-benefit) prior to implementation, i.e. determining whether measures raise efficiency. In addition, the expert group should continuously provide information to the political system on possible measure to increase efficiency and rationalisations in the public sector.

The largest single expenditure accounts on the budget are that of health services, social services and education. In 2008 a budget examination was made for the Faroese Health Service and in 2009 a similar examination was made for the Faroese Social Service.

An examination of the educational services should commence and focus on determining the proper structure and administration of the area as well as discuss how money is most efficiently spent.

Based on these and other more thorough assessments, plans should be made on how these three areas are optimally administered, both in terms of service, products and price.

User-fees on certain public services should also be considered. Partial user-fees are already in place for many public services, e.g. on child care, visits to the dentist, different forms of medication and parts of the transportation infrastructure. User-fees could be a sensible way of ensuring that public services are not rendered in cases where there is no sufficient need as well as being an instrument to control the demand for public services.

## APPENDIX A: FISCAL POLICY RULES

### Main fiscal rules currently applied in OECD countries

Country	Date and name	Characteristics of the set of rules			
		Budget target	Expenditure target	Rule to deal with windfall revenues	Golden rule
Australia	Charter of Budget Honesty (1998)	yes	no	no	no
Austria	Stability and Growth Pact (1997) Domestic Stability Pact (2000)	yes	no	no	no
Belgium	Stability and Growth Pact (1997) National budget rule (2000)	yes	no	yes	no
Canada	Debt repayment plan (1998)	yes	no	yes	no
Czech republic	Stability and Growth Pact (2004) Law on budgetary rules (2004)	yes	yes	no	no
Denmark	Medium term fiscal strategy (1998)	yes	yes	no	no
Finland	Stability and Growth Pact (1997) Spending limits (1991, revised in	yes	yes	no	no
France	Stability and Growth Pact (1997) Central government expenditure	yes	yes	Since 2006	no
Germany	Stability and Growth Pact (1997) Domestic Stability Pact (2002)	yes	yes	no	yes
Greece	Stability and Growth Pact (1997)	yes	no	no	no
Hungary	Stability and Growth Pact (2004)	yes	no	no	no
Ireland	Stability and Growth Pact (1997)	yes	no	no	no
Italy	Stability and Growth Pact (1997) Nominal ceiling on expenditure	yes	yes	no	no
Japan	Cabinet decision on the Medium term fiscal perspective (2002)	yes	yes	no	no
Luxembourg	Stability and Growth Pact (1997) Coalition agreement on expenditure ceiling (1999, 2004)	yes	no	no	no
Mexico	Budget and fiscal responsibility law (2006)	yes	no	yes	no
Netherlands	Stability and Growth Pact (1997) Coalition agreement on multiyear expenditure targets (1994, revised	yes	yes	yes	no
New Zealand	Fiscal responsibility act (1994)	yes	yes	no	no
Norway	Fiscal Stability guidelines (2001)	yes	no	yes	no
Poland	Stability and Growth Pact (2004) Act on Public Finance (1999)	yes	no	no	no
Portugal	Stability and Growth Pact (1997)	yes	no	no	no
Slovak Republic	Stability and Growth Pact (2004)	yes	no	no	no
Spain	Stability and Growth Pact (1997) Fiscal Stability Law (2001, revised	yes	no	no	no
Sweden	Fiscal budget act (1996, revised in 1999)	yes	yes	no	no
Switzerland	Debt containment rule (2001, but in force since 2003)	yes	yes	yes	no
United Kingdom	Code for fiscal stability (1998)	yes	no	no	yes

Source: OECD calculations.

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