

THE COUNCIL OF ECONOMIC ADVISERS

ECONOMIC REPORT

AUTUMN 2009

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THE COUNCIL OF ECONOMIC ADVISERS

The Faroese Council of Economic Advisers hereby publishes its report on economic trends, which, as prescribed in Act No 50 of 11th May 2009 on the Council of Economic Advisers, is to be published on the 1 September 2009. Due to the fact that the newly appointed Council did not come into place until 1 July 2009, this report is published later than usual.

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 the 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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1. SUMMARY AND RECOMMENDATIONS

The recession is turning around There are indications that the recession, which started in the autumn of 2008, will soon come to an end. The unemployment rate constitutes app. 4 per cent of the total workforce. Although the recession seems to have come to an end, it still is too early to say whether economic growth has returned.

The Faroese economy is overall sound The Faroese economy is in good condition, despite the challenges, which lie ahead in the coming years. The debt is relatively low in all the sectors in the economy, the unemployment rate is low and statistics indicate a surplus on the balance of payments.

...yet the Treasury's deficit is too large The Treasury's revenues declined considerably during the fourth quarter in 2008 and have been reduced again this year, especially because consumer spending is lower than last year. The Treasury's deficit totaled app. DKK 330 million in 2008 and is expected to total near DKK 800 million this year. According to the Budget for 2010, the total deficit will amount to app. DKK 770 million next year.

When considering the 4 per cent unemployment rate, the deficit is quite large for the Treasury. One must also bear in mind, that the deficit accumulated in 2008-2010 will be settled by the Treasury's surpluses in the future, and that the interest expenses of the Treasury will increase over the next couple of years.

Necessary with measures Still, it is necessary to implement measures, which will even out the imbalance in the pursued revenue- and expenditure policy, in order for the fiscal policy to become sustainable again. Low debt levels insure the public sector can run a certain deficit over a couple of years, but if proper measures are not put into place, the more difficult it becomes to correct the situation. A prerequisite for steady economic growth is that the Government's fiscal policy is sustainable.¹

Two main situations to be taken into account We recommend that the economic and fiscal policy for the next years will be based upon two considerations. Firstly, the fiscal policy must take into account the current recession and the fact that it is uncertain how long the recession will continue in the Faroese economy and globally. Secondly, over the next couple of years, the fiscal policy must take into account the importance of making the fiscal policy sustainable over a mid-long period.

¹ 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.

Structural imbalances Significant parts of the public sector's deficit in 2008-2010 are structural and therefore more due to incorrect fiscal policy in recent years rather than the recession. Measures, which are put into place in the years to come, in order to improve the structural imbalances in the public revenue and expenditure policy, need not necessarily to have the purpose of eliminating the entire public deficit. A part of the deficit will diminish naturally when the economy and spending again will accelerate. Therefore, the measures should target the structural part of the deficit.

...demand quick changes we recommend that the process of balancing public revenue and expenditure again must commence as soon as possible, while the Government still has scope for it in its fiscal policy. By doing so, one may avoid that the Government will have to implement stronger measures later. If there will be a need for extensive adjustments later on, in order to balance out the public revenue and expenditure, one might run the risk of several people emigrating.

A determined and binding plan It is crucial that a determined and binding plan is made, in order for the fiscal policy to become sustainable after a mid-long period.

Also important, is the need for the political system to set clear and distinct targets to accord the revenue and expenditure of the Treasury in the years ahead, improve the credibility of these plans and let the general public know that clear plans have been made to reduce the deficit. This will make the plans more binding and improve the probability of the plans' success.²

Necessary to achieve balance By increasing public revenue and reducing public expenditure and investments, a balance between public revenue and expenditure can be achieved. As part of the adjustment to balance out the public revenue and expenditure once more, one needs to examine the revenue basis, current expenditure and investments. This will make the plans easier to implement politically and will increase the sentiment of all parts of the society sharing the load of the adjustments.

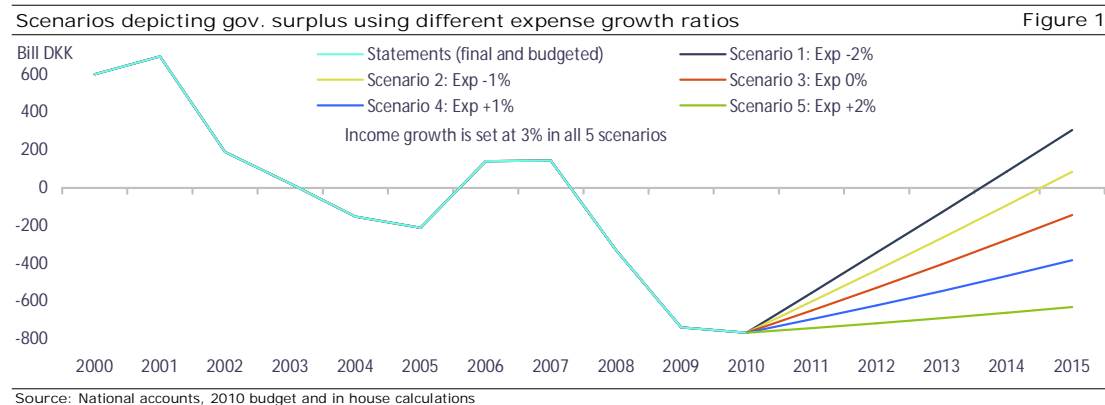
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In order to highlight the importance of creating balance, figure 1 illustrates five simple examples of possible developments in revenue and expenditure of the Treasury until 2015. All five illustrations are based on an annual revenue growth of 3 per cent combined with five different changes in expenditure. The figure shows that despite a 3 per cent growth in revenue, the total expenditure must decrease all the respective years in order to create balance. The figure also shows that if the political system is willing to commit to annually decrease expenditure by 2 per cent, there is a possibility of creating balance and reaching budget surplus in 2014 with a total of DKK 1.4 billion more debt from 2010 to 2014. On the other hand, if there is an increase in expenditure over the next few years by e.g. 2 per cent and a revenue growth of 3 per cent, then the debt of the Treasury will increase by more than DKK 4 billion from 2010 to 2015, while the deficit of the Treasury will not decrease considerably.

Announce upcoming measures early It is important that the public authorities give a clear announcement of which parts of the public revenue will increase, as well as which parts of the public expenditure and investments are to be cut down. This should be implemented in a large-scale, comprehensive long-term plan, rather than by using separate ad-hoc measures.

There is the possibility of temporarily increasing the tax-income with the purpose of repairing the public structure and operation, thus making it possible to reduce the tax-

³ See [15].

burden receipts again at a later stage. There are clear indications that the public sector is in need of repair, when considering its large growth in the preceding years. If the public sector grows too extensively, there is the risk of a distorting effect on the private sector's activities and investments. The effect of this scenario will be reduced economic growth in the medium-, too long run.

It is crucial that the fiscal policy from now on be adjusted according to the fluctuations in the Faroese economy, which are relatively large, meaning a fluctuating income base. Therefore, the public sector's expenditure level should not increase every time cyclical or non-recurrent revenues go to the public sector. These types of revenues might suddenly disappear due to economic fluctuations, which has been the case these last proceeding years.

Measures In order to form a sustainable fiscal policy, measures are needed both on the revenue and expenditure side. Some measures can be implemented within a short notice, while others measures are lengthier to implement due to the degree of analysis needed beforehand.

Increase revenue There is a need for examining how the tax base can be enlarged in the coming years. Compared to Denmark, the majority of the Faroese tax receipts stems from income tax and VAT, and tax receipts in total are more linked to economic trends. Case in point, the Faroese corporate tax is lower, there is no real property tax and the revenue from environmental taxes percentagewise only equals to half of the Danish green tax revenue.

Cut expenditure Compared with the Faroese economic trends, the public current expenditure has increased far too much these recent years.

If the public sector is examined closely, it will no doubt become clear that it is possible to run the public sector more wisely. Another possibility is to decrease public expenditure by making public funds and subsidies more dependent on the financial situation of the individual recipient, thus providing funds and subsidies mainly to those who need them.

New user fees Finally, it is possible to increase public revenue by putting into force partial user fees for public services. Partial user fees are already in force for several public services, e.g. childcare, dental treatments, various medications and parts of the transportation system.

User fees can be a sensible way of ensuring that public services will not be provided in cases where the need is not present, and can also be used to control the demand for

public services. In order to improve the public structure considerably, user charges will probably become necessary.

2. ECONOMIC TRENDS

This section of the report will describe the economic trends based on the different indications about the economy. Furthermore, the future outlook for the next one or two years will be assessed and which factors will be decisive for future developments.

Similar to many other economies, the Faroese economy has experienced a recession, subsequent to the global financial crisis becoming an economic crisis in the autumn of 2008, which had an impact on productivity in practically every economy worldwide.

Various foreign financial blows to the Faroese economy during the last couple of years have had an impact. Moreover, various circumstances of a more structural character have resulted in relatively large deficits in the public sector from 2008 to 2010.

A combination of the foreign financial impacts and structural circumstances have additionally resulted in a drop in productivity in the fishing industry – especially domestically – during the past two or three years and is at a historic low. All these circumstances combined affected the economy, which now is experiencing an economic recession. Still, there are indications that the recession might turn around soon.

Lately, the most severe blow to the Faroese economy has been the global financial crisis. The crisis affected the Faroese financial sector directly, since the financing cost for Faroese banks increased considerably because of a higher interest rate on borrowing from other financial institutions and expenses for bank bailouts. Overall, it seems as though the world of finance has weathered the storm, now the worse is over, although permanent changes are to be expected, e.g. stricter capital requirements for financial businesses.

Lastly, the global financial crisis affected the household behavior. Consumers spent less and saved more. This is the result of future outlooks becoming more and more uncertain, the value and equity of real properties dropping and worse credit facilities for consumer loans and investments compared to previous years. Consequently, this has affected the Treasury's revenue, which will experience budget deficits from 2008 to 2010.

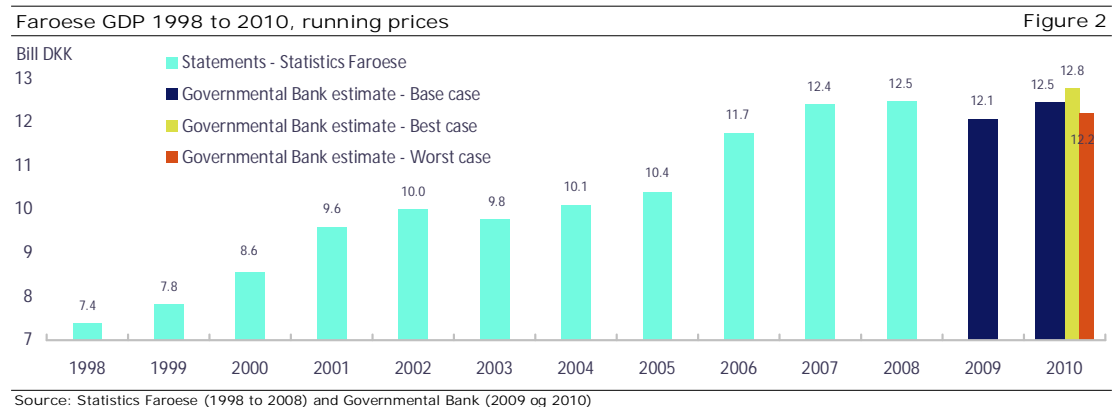
There have also been some financial blows to the Faroese fishing industry. Fish prices are low and this makes operations difficult, and although oil prices are lower than in 2008, they are still higher compared to previous years. The conditions of growth for the fish stocks in home waters have been below average these past years. Structural problems, e.g. excess capacity and the massive fishing pressure on the fish 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 administration.

2.1 MOST RECENT ECONOMIC TRENDS

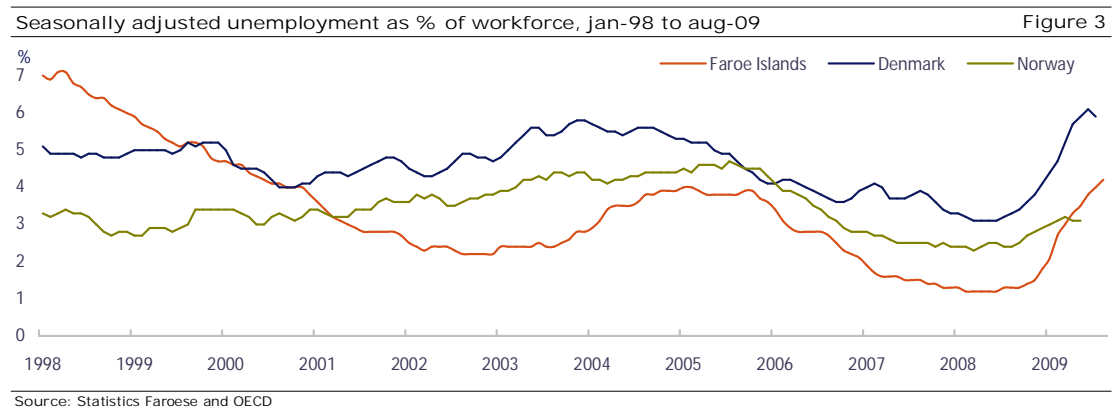
According to provisional figures from Statistics Faroe Islands, the GDP in current prices grew by 0.5 per cent in 2008. Part of the growth in GDP in current prices yet stems from an increase in prices of all goods and services. With inflation corresponding to the consumer price index, 6.3 per cent from mid-2007 to mid-2008, the GDP in real terms –

which in the fields of economics is called “production” – has fallen more than 5 per cent in 2008. The Governmental Bank’s projection of the GDP in current prices is shown in figure 2.

The Faroese unemployment rate is still low, see figure 3, and lower unemployment only appears in few countries. In addition, figures from the Faroese Employment Office (ALS) and Statistics Faroe Islands suggest that unemployment rates are evenly low across the country. The unemployment rate in the Northern Islands seems to be higher than in the rest of the country, app. 7.5 per cent. This is probably because of the fact that the fishing industry in the area has experienced a severe setback. The economy is therefore still close to its limit of productivity.



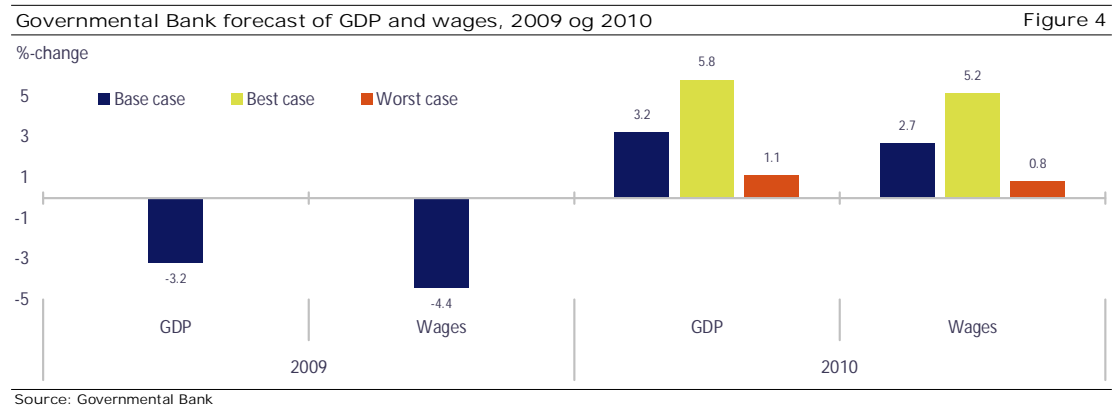
There are many suggestions that the decline in productivity continued well into 2009. Payment of wages, which with some reservations can be interpreted as a measure for the overall productivity in the economy, have e.g. been declining since the autumn of 2008, see figure 3.



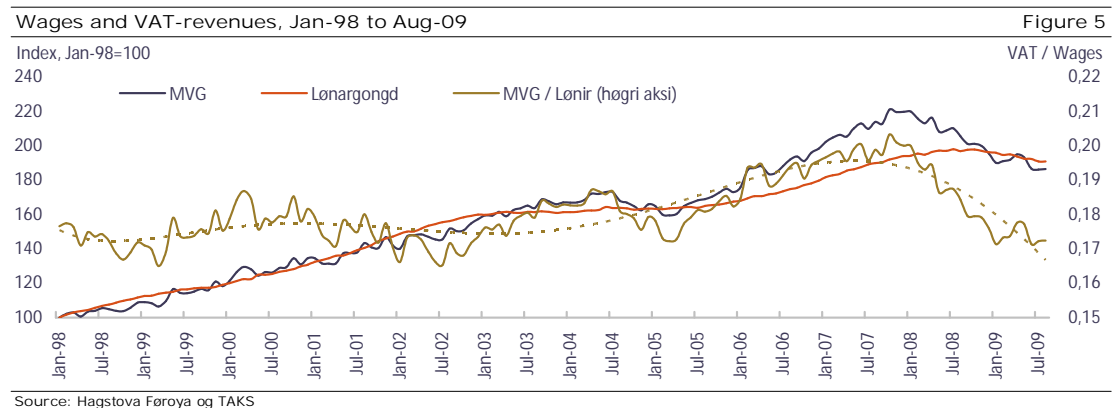
Nevertheless, there are signs of the recession ebbing away, although it is still too early to say with certainty if there is any actual economic growth. Also, it is too early to say if there will be a further decline in productivity, before it increases again. The unemployment rate has risen steadily for the last couple of years, although there are signs of the increase ebbing away later this year and well into 2010, similar to the decrease in the VAT-

revenue/payment of wages ratio, which is also ebbing away, see figure 5. These are signs of the recession coming to an end.

The Governmental Bank's projections of the national accounts indicate that the GDP in current prices might drop by 3 per cent in 2009 and increase by 3 per cent in 2010. In a worst case scenario, it can be expected that the GDP in current prices will increase by app. 1 per cent in 2010, while at best it may end up at 6 per cent. The projections are shown in figure 4.



One of the reasons for last year's recession was that the households reduced their spending and increased their savings. There are signs of this trend being on the decline and of the savings reaching a level, which the households find adequate. In 2009, the VAT-revenues/wages ratio (seen in figure 5) seems to be at an all time low for the last 10 to 15 years. Still, it is too early to say with certainty if the ratio might decrease further, yet the households are overall doing fine, although some are affected by the recession. Surveys concerning people's outlooks, show that in 2009, the households are less pessimistic when it comes to the economic outlook. Therefore, it might be expected that they will not decrease their spending any further.



2.2 THE SURROUNDING WORLD

A small economy like the Faroese, where imports and exports constitute a large part of the economy, is very much affected by economic trends in the surrounding world and

especially in the countries with which we trade goods and services. The Faroese economy is particularly affected by the surrounding world when it comes to the price of imported goods and exported products, but also the households and their tendency to spend and save are affected by the foreign economic trends. The economic trends in the surrounding world will therefore be significant in determining when productivity will become increasing again in the Faroese economy.

According to assessments made by the IMF, ECB and the World Bank, it is still not clear when we will experience global economic growth. Some economists predict that the global economy will experience growth later this year, while others predict that global economic growth will not occur until 2010 or later. Table 2 shows the latest economic growth outlook from the IMF.

At best, it is a possibility that consumers and households already this year will again grow confident in the pursued fiscal policy and that no more losses and write-offs will appear in the financial sector. In that case, there is a possibility that the economies will experience growth already this year.

Real GDP growth relative to previous year in %-points	TABLE 2			
	2007	2008	2009	2010
World economy	5.1	3.1	-1.4	2.5
USA	2.0	1.1	-2.6	0.8
Germany	2.5	1.3	-6.2	-0.6
Great Britain	2.6	0.7	-4.2	0.2
Euro-zone	2.7	0.8	-4.8	-0.3

Comment: 2009 and 2010 IMF estimates

Source: IMF World Economic Outlook Update, July 8, 2009

On the other hand, there is also the possibility that the western governments will have to take extra steps the next coming year or two in order to strengthen the capital base of the financial sector, so that he is capable of handling additional unexpected losses and write-offs; especially if share prices and real property prices drop even further over the next one or two years. In that case, the financial sector will become more cautious in granting loans and credits, and access to financing will most likely worsen. This can be expected to curb the economy and it will probably be a long time before household's trust in fiscal policy is restored.

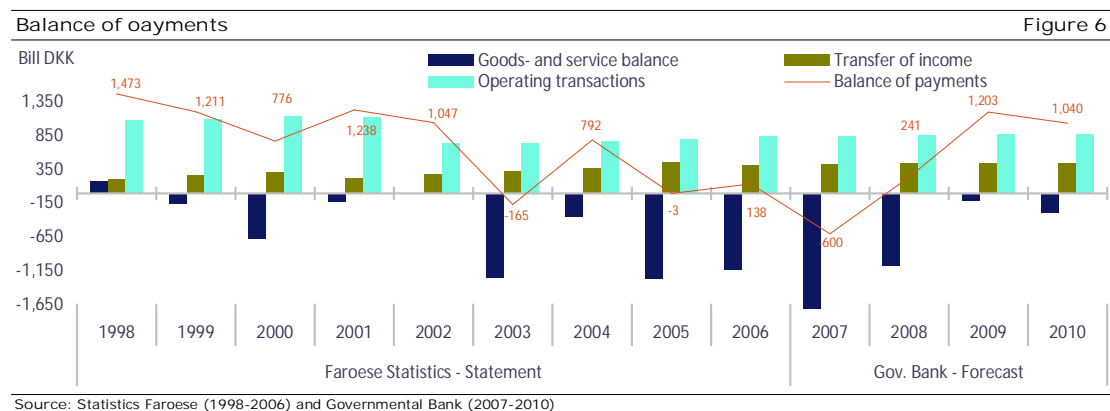
Spending funded by loans, which was very apparent before the crisis, has almost disappeared; also amongst the Faroese people and many people are now starting to save up. It is especially countries, where the property prices have dropped and consequently reduced the equity, which experience an increase in savings and decrease in private consumption. Seeing as private consumption has a great affect on the overall economy, this might imply lower economic growth for the next couple of years. In several countries, there have been efforts made by the governments in order to boost the demand for goods and services, by increasing government spending with different stimulus packages. These efforts are time limited, so it is not clear what the economic developments will be like, following a decline in public expenditure once more.

Forecasts of the economic growth must be read with the reservation that it is difficult to predict when the global economy will actually turn around. This is especially true during the current financial crisis. Furthermore, the uncertainty in forecasts based upon experiences from other financial crisis is substantial, because the current financial crisis is unlike any other in many cases. E.g. the business structure is different, the public sector is larger in most countries, household and business debt has risen in some of the bigger countries, the level of income has risen globally and the trade of goods and services has increased internationally.

2.3 THE BALANCE OF PAYMENTS

In addition to including the balance of trade, the balance of payments includes trade of services and the transfer (of payments) to and from abroad. The uncertainty is considerable regarding the statistics about the Faroese balance of payments, and the newest statement is from 2006. The figures are therefore to be read with some reservations.

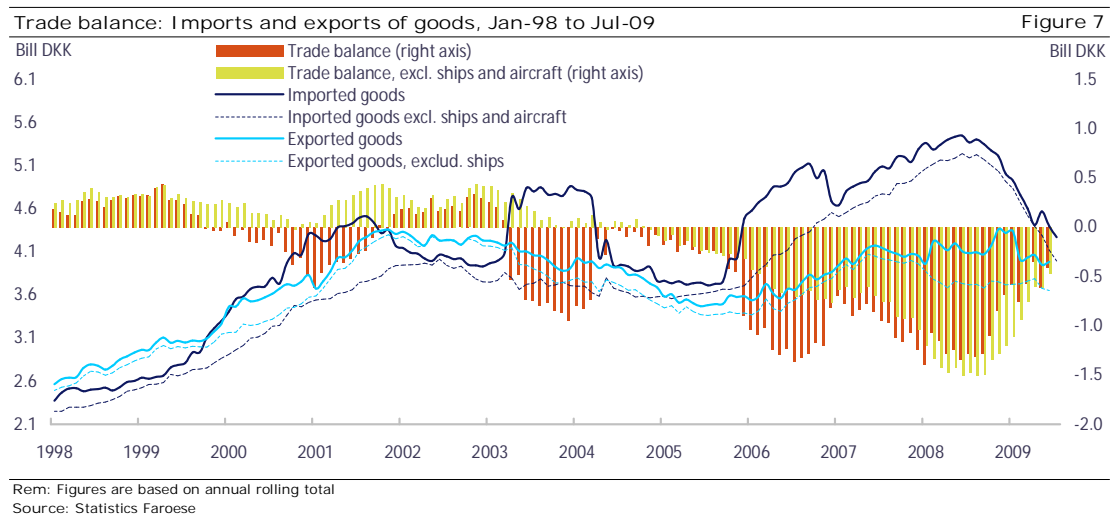
According to the statements from Statistics Faroe Islands, the surplus on the balance of payments was on average substantial in the years 1998 to 2006, see figure 4. The figures for 2003 and 2005 are greatly affected by the fact that two large ships were imported those two years, while 2006 is influenced by the fact that spending funded by credit really accelerated that year. There was a huge increase in imported goods, both durable and semi-durable consumer goods, and in materials for the building industry that same year, which resulted in a large deficit on the balance of payments.



Judging by the balance of trade, the deficit on the balance of payments in 2007 was most likely at the same level or higher than the deficit in 2003. In 2007, the deficit on the balance of trade reached DKK 1.5 billion, which is the largest ever recorded in the Faroe Islands. The deficit on the balance of trade was app. DKK 700 million in 2008. The surplus on the balance of payments was most likely at the same level in 2008 as it was in 2006. The surplus in 2009 will probably be a bit higher, judging by the development in imports and exports so far this year, seeing as imports has decreased more than exports, see figure 6.

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, the industries and households, has huge surpluses and is increasing its savings. The Governmental Bank has, in spite of great uncertainty, put figures on the trade operations of the balance of payments for the years 2007 to 2010, which can be seen in figure 6.



2.4 THE PUBLIC SECTOR

The public sector includes the Government (the Treasury), the municipalities and social funds. Moreover, public corporations (e.g. the Alcohol Monopoly of the Faroe Islands, the National Pharmacy Service and Faroese Energy (SEV)) and public limited companies (e.g. Faroese Telecom and Vagar Airport) are part of the total public sector.

One of the biggest economic policy challenges is to balance the revenues and spending in the public sector, in order to assure structural budget surpluses in the coming years for the Government. This is necessary partly due to demographic changes. This will in particular be a challenge for the Treasury and the municipalities.

2.4.1 The Government

Over the past few years, the Faroese Government has been working towards stimulating the economy by the means of tax reductions and of a significant rise in public spending, even during the economic growth. The enormous increase in public revenue 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 activity of the government is less stimulating, due to the fact that public revenue 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.

The Treasury's deficit was app. DKK 330 million in 2008. In 2009, the deficit, which includes new revenue assessments and supplementary appropriation, is expected to be app. DKK 800 million. The Treasury might have a challenging year in 2010. Corporate tax receipts in 2010 will be considerably lower than in 2009, because it will be calculated on the basis of the accounts of 2009. Especially corporate tax receipts from the banks will be significantly lower in the following year. Moreover, the public payroll costs will increase according to pay agreements, as well as public expenditure for eldercare is expected to increase in 2010. Lastly, it is unexpected that revenues in indirect taxes will return to the same level as in 2006 to 2008 in the coming years.

In the draft Budget for 2010, the Faroese Government contemplates a DKK 767 million deficit. Public revenue expenditure for institutions will increase by app. 1 per cent, likewise grants for households, and investments will increase a little bit more, while revenues will decrease.

2.4.3 The municipalities

There will be differences in the municipalities' abilities to meet their operational and investment objectives in the years to come. Tórshavn municipality will probably not be hit hard by the reducing tax receipts, while other municipalities might experience a reduced tax base.

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 1,450 million and tax receipts will be app. DKK 1,370 million in 2009.

The municipalities combined have most likely had a slight curbing to almost neutral influence on the economic trends in 2009 and possibly even more curbing in 2010, because they, due to the financial situation, more or less have 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 administrative needs and the needs of the individual municipalities.

2.4.4 The social funds

The social funds, the Faroese Employment Office (ALS) and AMEG (Labour Market Supplemental Pension Fund), will be able to stick to their planned activities in 2009 and 2010. Especially ALS will most likely be able to stimulate the economy during the next two years.

Based on the amendments to the act concerning unemployment insurance and employment service, it is expected that ALS will increase their benefits from app. DKK 50 million in 2008 to app. DKK 137 million in 2009. This will strengthen the spending power of the unemployed and at the same time lessen the fear of becoming unemployed. This will probably influence the households, so that they will increase their savings less than they otherwise would.

In conclusion, it can be said that the social funds are able to stick to their planned activities in 2009 and 2010, while the municipalities combined will have a hard time maintaining the current activities in 2009 and 2010. Therefore, the public sector in total has a difficult time in having the necessary positive effect on the recession, due to the lack of good administration the previous years.

2.5 THE HOUSEHOLDS

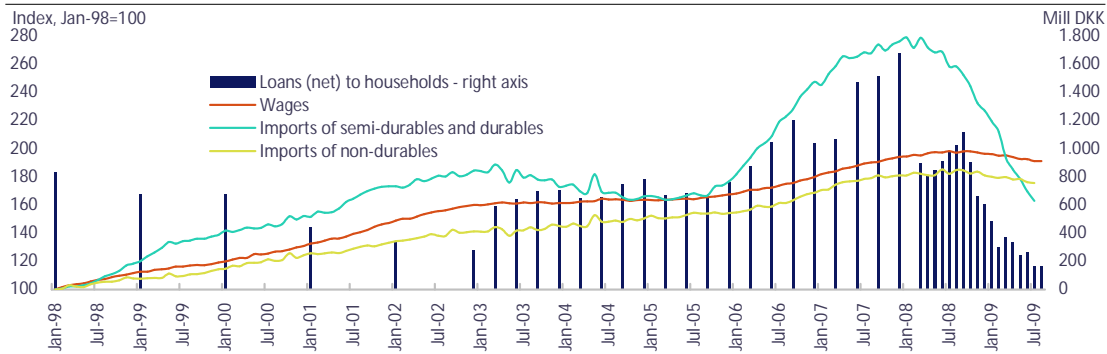
Different factors have had a negative impact on the households in 2008 and 2009. Real property prices peaked in the autumn of 2007 and have dropped since then, see figure 8 and F-58 in the appendix. Together with increased borrowing, the drop in prices has resulted in a drop in equity of app. DKK 4 billion or 20 per cent, although the equity is still high. Shares owned by the Faroese people, most likely of whom the households own a smaller part, have depreciated by a total of 68 per cent 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 in increasing lending operations.

All these factors combined make it possible to understand why the households have become more cautious and reduced their spending and increased their savings. All these negative factors will hardly be permanent. Property prices will hardly improve any time soon, yet the equity is still excellent. Many of the Faroese listed businesses are financially sound, in spite of the low market value. There are indications that the market value again might increase a bit. The interest rate level or the financing cost of the households has

decreased so far in 2009. More uncertain is what will happen to the interest rate for the rest of year and in 2010.

As seen in the VAT/wages ratio in figure 5, the households have lowered their spending from the autumn of 2007 to the summer of 2009. What also can be seen is that the decline in consumer spending corresponds to the increase from 2005 to 2007. According to the developments in figure 8, the households have decreased their consumption of both durable and semi-durable consumer goods in 2008 and 2009, while at the same time reducing new borrowing. The development in non-durable consumer goods seems more likely to follow the development in earnings.

Loans (net), wages and household consumption, Jan-98 to Aug-09 Figure 8



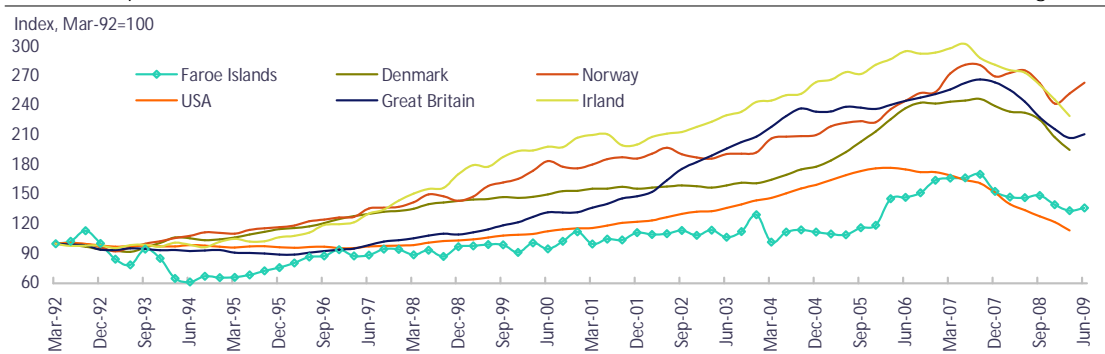
Rem: There is a break in the series from Mar-08
Source: Governmental Bank and Statistics Faroe Islands

Developments in household expectations correspond well to the developments in spending, as shown above. Therefore it is not entirely pointless to stress that the household's pessimistic outlook seems to lessen in the recent survey.

Compared globally, the Faroese households generally are doing well. Property values appreciated significantly from 2005 to 2007 and later decreased in value. This does not seem have to been as overestimated as in other countries (see figure 19) and thus do not seem to be in further need of decreasing. The households' debt is far less in 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 the households will be safe with a level of consumption, which is no lower than the current level.

Real house prices in different countries Figure 9



Source: Hagstova Føroya, Eik Banki, OECD, Standard & Poor's, Central Statistics Office Ireland, Statistisk Sentralbyrå, Danmarks Statistik

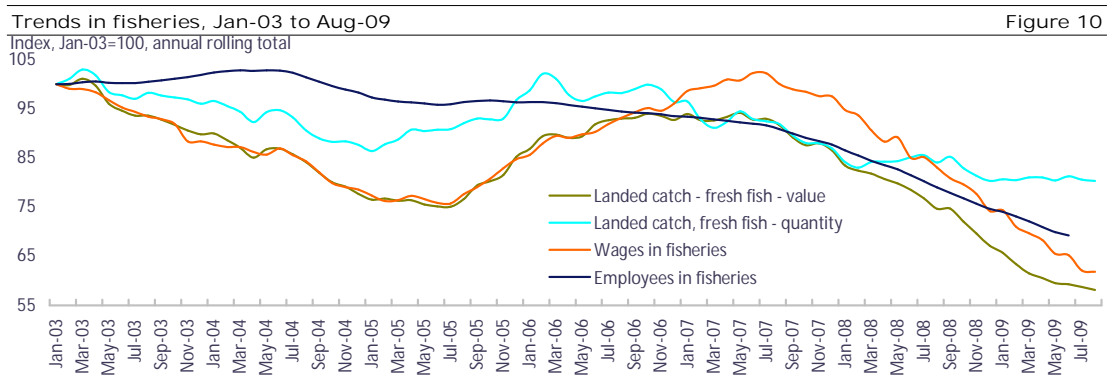
2.6 THE RESOURCE INDUSTRIES

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.

2.6.1 Demersal fishing in Faroese waters

Operations for the long line fishing fleet - trawl door and pair trawlers fishing off the Faroe Islands – are burdened by low fish prices alongside poor fishing operations, while in the preceding years it especially were high energy costs and poor fishing operations that affected the operations.



Cod and haddock fishing have for a long time been poor. Figure 10 shows how much fishing operations have fallen during these last couple of years. This is a structural problem, due to the fishing intensity around the Faroe Islands being too high for so long and therefore the fish stocks are being too severely worn out. Moreover, growth conditions for the fish stocks have been poor these preceding years.

2.6.2 Demersal fishing in distant fishing grounds

Currently, this part of the fish processing industry, as seen above, contributes to the Faroese economy consistently and well. According to ICES, fishing for cod and haddock in the Barents Sea seems to be at a sustainable level and outlooks are continuous for the future. Production is expected to be at the same level in 2009 as in 2008 and prospects are that the quota will increase in 2010. Low fish prices have burdened operations for one or two years, while on the other hand, oil prices have decreased and improved operations. There are signs indicating that fish prices are on the rise again, even though the increase is from a low level.

2.6.3 Pelagic fishing

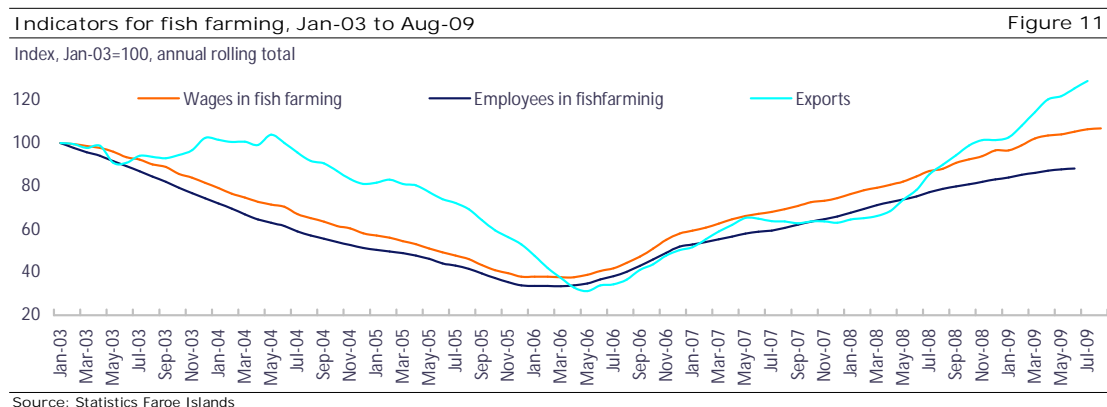
Pelagic fishing production has decreased significantly, especially due to the fact that the blue whiting quota was heavily reduced in 2009 and probably will continue so in 2010. Another difficulty facing pelagic fishing is of a structural kind, with the blue whiting stock for many being so worn out that it is necessary to slash quotas dramatically in order to protect the stocks.

Administering the pelagic fish stock can be somewhat difficult, because the stock journeys far across the ocean compared to other fish stocks. This makes it difficult for countries to agree about a joint and valid fisheries policy over a longer period. This leads to the countries' fishing becoming too intense compared to biological advice.

The blue whiting quota was heavily reduced in 2009 (by 53 per cent) and is expected to reduce further in 2010. In contrast, the quotas for northerly sea herring and mackerel increased by respectively 8 and 33 percent in 2009, and maybe it will be possible to add more value to this resource in the future. The capelin is an important part of pelagic fishing, yet there are some difficulties in assessing the prospects and the stocks volume is expected to shrink.

2.6.4 Fish farming

The Faroese fish farming industry produces near its maximum capacity and now totals a third of Faroese exports. The trend in fish farming is shown in figure 11. During the first seven months this year, exports in farmed fish exceeded the export of demersal fish in value. The industry expects that fish farm harvesting in 2009 will be app. at the same level as in 2008 or higher. Likewise, there are indications that the harvesting in 2010 will remain at the same level, although these predictions are uncertain. The price of farmed fish has been declining these last couple of months and approaching the production cost . The price of farmed salmon has been good for quite some time now, and will probably be able to remain at the same level, e.g. because of the impact the ILA virus has on fish farming in Chile. Still, Norwegian salmon exporters have increased their supply considerably lately and this will no doubt force the price even lower.



Summing up the resource industries

In conclusion, there are signs that at best the production will stay at the same level or higher during the next one or two years compared to 2008 and so far this year. Low fish prices are currently burdening operations, but it remains unclear how long they will stay so low. Oil prices are still lower on average than in 2008, but have increased this year. Currently, it remains uncertain whether they will increase much further or decrease again shortly.

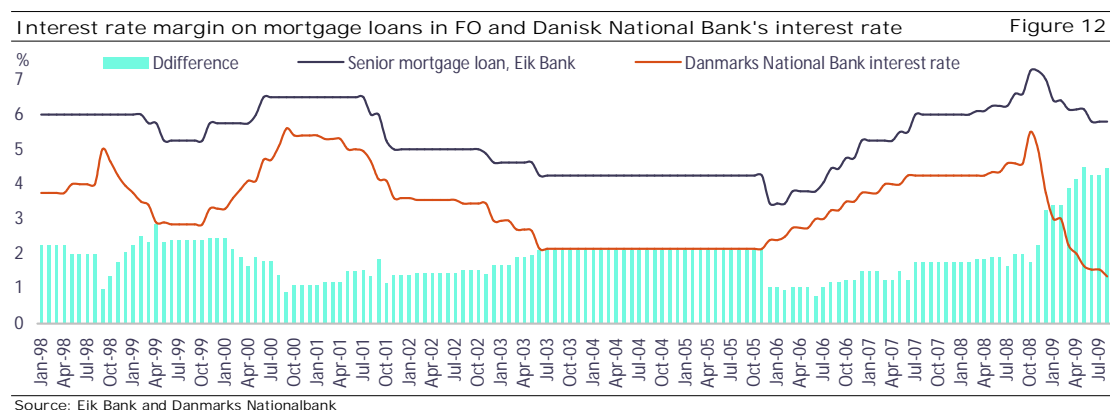
2.7 THE FINANCIAL SECTOR

The interest rate level will be very important for the economic trend in the near future. Central banks around the world have cut short-term interest rates considerably last year or so. More important for the economic trend are the banks' lending rates and the terms of credit under which the industry and households are able to borrow to finance their consumption and investments.

There are many indications that the Faroese banks' investment spending has increased last years or e.g. due to bank bailouts and high inter-bank rates. Furthermore, there are more losses and provisions on loans then before, although losses in the Faroe Island are less than in e.g. Denmark. That is why the banks have increased the deposit and lending rates margin. The banks' lending rates on mortgage loans have not been cut as much as the interest rates of the central banks (see figure 12). There are also indications that lending rates for businesses have increased lately.

The size of the accounts the Faroese banks has been nearly unchanged in total from March 2008 to August 2009. Also seen is the fact that 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 increase 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 for example has decreased, because of home loans being refinanced to mortgage loans.

The Faroese banks still owe DKK 5.3 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 receive public security through bank bailouts. It will also be possible for homeowners, in the extent in which it pays off, to refinance home loans from the banks with mortgage loans.



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

2.8 OTHER INDUSTRIES

These are manufacturing and service industries, which are not mentioned above, but they combined represent a large part of the total growth in the Faroese economy.

2.8.1 The fish processing industry

The setback in fishing operations does affect the fish processing industry and therefore it is expected that the setback in the fish processing industry, which has been present for quite some time, will continue for the remainder of 2009. The trade barometer made by the Faroese Ministry of Finance indicates that especially the availability of raw materials and access to financing reduces productivity at the moment.

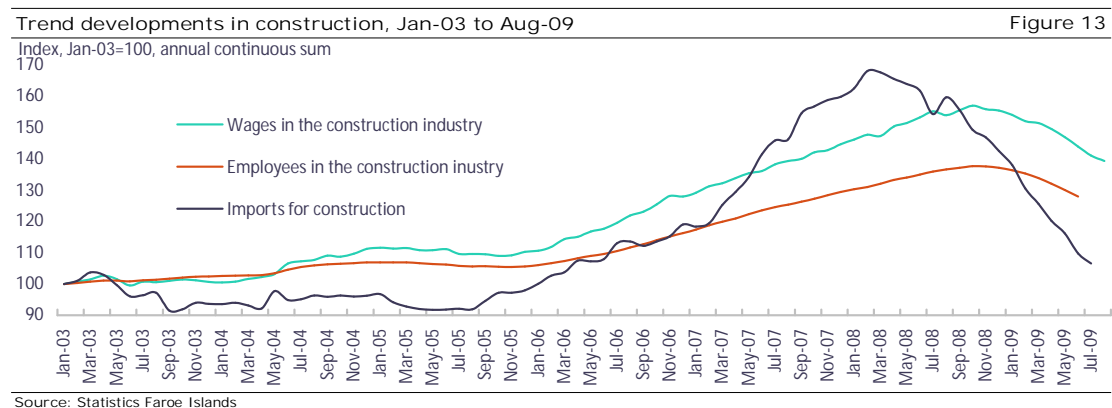
Processing pelagic fish into fishmeal and feed will possibly also experience a setback, because the fishing for blue whiting is worse in 2009 and probably in 2010 as well.

2.8.2 The building industry

Conditions for the building industry have changed a lot over the recent year or so. Earlier, limited production was due to a lack of workforce, but now the lack of demand and worse access to financing reduce the industry's production. The trade barometer made by the Ministry of Finance indicates that the industry is pessimistic about future prospects, yet the pessimism might calm down.

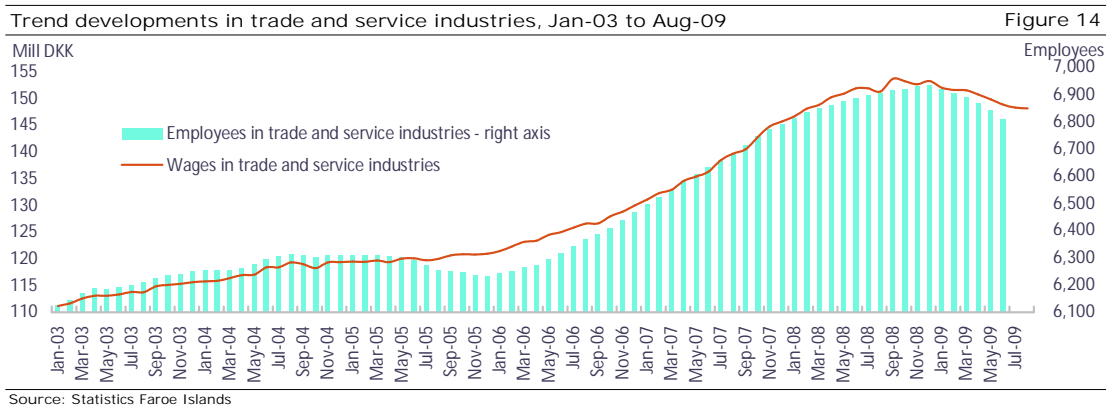
Large public projects are in the works this year and others might follow in 2010. This should create jobs for large businesses in the industry and the trade barometer indicates that the building industry has secured itself work for app. the next three consecutive quarters. Yet some Faroese businesses might experience difficulties facing foreign competition, when bidding on large projects, and this is expected to put some pressure on the businesses. There is a chance of building businesses becoming fewer and therefore larger in the future, due to indications e.g. that building businesses might go bankrupt under current conditions.

The administration of projects in the building industry has not been satisfactory in recent years. So much work has been available that smaller businesses have taken upon themselves large projects. This has resulted in poor administration and low efficiency in the industry. The efficiency in the industry might improve in the years ahead, if building businesses grow larger with the necessary managerial skills.



2.8.3 Trade and service industries

These industries are very connected to domestic demand. Therefore, it is expected that these industries will experience a certain decline due to less total demand in 2009 compared to 2008, while a stabilisation might occur in 2010. According to the trade barometer, the trade industry is pessimistic about the outlooks, and does not seem to see any improvement on the horizon. This could indicate that many businesses have heavy operations and an increased wish for investments cannot be expected in the near future.



3. THE CURRENT SITUATION AND CHALLENGES

The economic upswing in 2006 and 2007 and the Government's role The analysis of the economic trends in the previous section shows that e.g. the economic upswing in 2006 and 2007 (with a total growth in GDP of 19.4 per cent in current prices) was unusually large. Besides the fact that the fish farming industry recovered during these years, the growth mainly stemmed from improved credit terms and financing opportunities for the industries and households provided by Faroese banks and financial institutions. This led to e.g. a huge increase in consumer spending as well as significant growth in the building industry. Yet while these market-driven influences were at play during this period, the public sector significantly increased expenditure and investments.

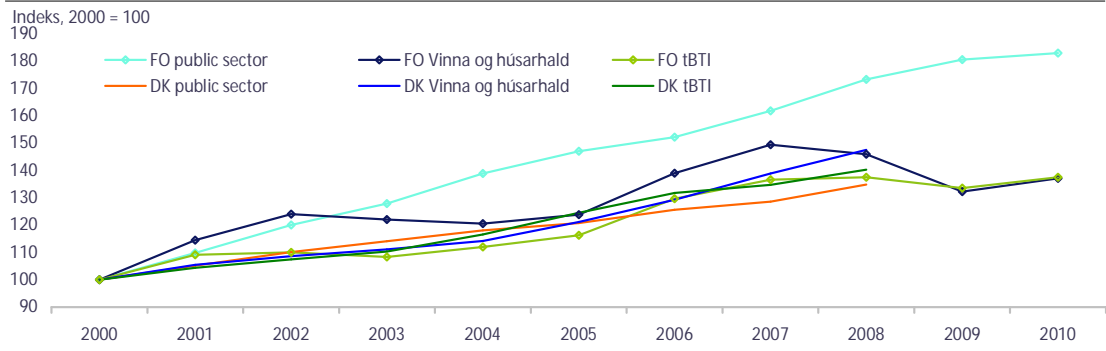
The recession The global economic and financial crisis is the main reason for the Faroese economy experiencing a real recession in 2008 and 2009, yet the direct impact of the crisis on the Faroese financial sector and overall economy has not been as severe compared to almost every other western economy. Therefore, the recession has to be viewed as a natural adjustment of some unusual temporary, market-driven circumstances in the economic upswing in 2006 and 2007. Among these adjustments are e.g. the conditions for the financial institutions have changed, the pressure on the building industry has been reduced and the growth in the fish farming industry has been limited and has now reached its capacity limit. Furthermore, the households' consumer behaviour seems to be at a normal level, although possibly lower than usual, and even with a rising unemployment rate during times of adjusting, a high level of unemployment is not expected. The balance of trade is almost level and a large surplus the balance of payments can undoubtedly be expected.

...and the Government's role During the recession in 2008 and 2009, the public sector has been working continuously stimulating, yet less stimulating compared to the economic upswing in 2006 and 2007. The Treasury, with a budget deficit of nearly DKK 800 million in 2010, also contributes to keeping the wheels of the economy going.

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Current challenges Still, for the Treasury this will mean that the total budget deficit for 2008, 2009 and 2010 will reach almost DKK 2 billion and compared to other countries, the key figures show an unfortunate development for the public sector.

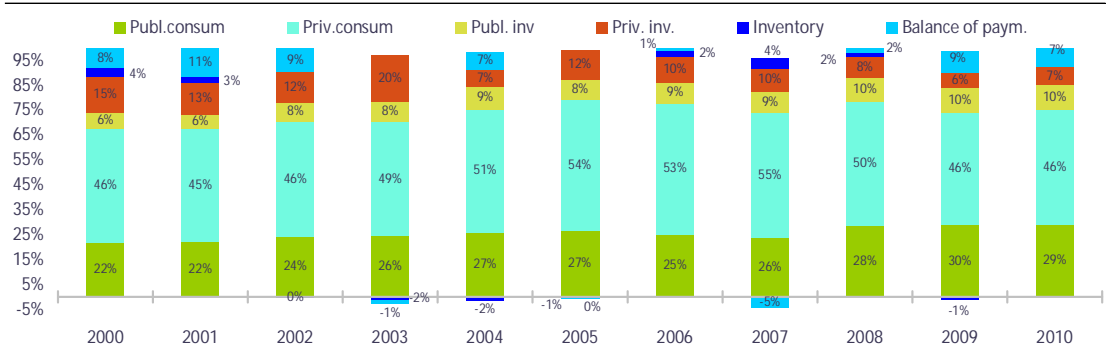
Index showing growth in public and private wages Figure 15



Source: Statistics Faroe Islands (FO for 1998-2006), Governmental Bank (FO for 2007-2010) og Danish Statistics

A comparison with Danish trends from 2000 to 2010 gives a clear indication of a development within the Faroese public sector, which demands particular attention and analysis (see figure 15⁴). The figure shows that since 2000, the payment of wages in the public sector has increased app. 80 per cent. At the same time, the wages for other producing activities follow the development in the available GNP on the Faroe Islands and in Denmark. Compared to the development in Denmark, there is a clear incoherence between the development of the Faroese public payroll costs and a large part of the tax base, which is necessary in order to finance the growth.

Disp GNI by consump. and invest. (= national invest. + baklance of payments) Figure 16



Source: Statistics Faroe Islands (Statements 1998 to 2006) and Governmental Bank (estimate 2007 to 2010)

Figure 16 shows the development in expenditure and gross savings, and here the indication is fairly clear: The public sector has grown relatively large from 2000 to 2010⁵, at the same time as private investments have become a relatively smaller part of the available GNP in recent years.

⁴ The Council has not had the time or power to perform a comprehensive analysis of the public sector, yet allows itself to stick to the overall indications.

⁵ The development can partly be due to the adjustment of pay rates in the public sector following the economic crisis in the 1990s, although the same argument can be used about other producing activities. Therefore, the adjustment of pay rates is not assessed to be a significant part of the development in the public sector.

Therefore, the question remains whether the increased Faroese Treasury's debt of nearly DKK 2 billion is the result of the global financial and economic crisis or/and the result of a unsuccessful pursued fiscal policy during recent years.

The answer is undoubtedly a combination of both, but for the Treasury the challenge is now to create a better coherence between revenue and expenditure, thus making the fiscal policy sustainable.

4. GUIDING PRINCIPLES FOR FISCAL POLICY

The Council has previously analyzed fiscal policy⁶ and will in this report not include a long discussion from a theoretical point of view, but rather to briefly describe the main considerations, which must be taken into account when the political system is to make decisions within fiscal policy.

4.1 THE FISCAL POLICY MUST BE SUSTAINABLE

One prerequisite for continuous economic growth is the Government pursuing a sustainable fiscal policy.

Obligations By the Government pursuing a sustainable fiscal policy, it entails that the Government is able over a mid-long period and with current direct and indirect tax and expenditure policies to meet its obligations and pay interest and installments on outstanding debt.

Civic confidence If the households begin to deem the public expenditure to be larger than the revenue, over a mid-long period, they might lose confidence in the pursued tax and expenditure policies. One way for the households to prepare themselves for changes in tax burden or an increase in financing cost for the public sector in the future is to increase their savings.

The guiding principle for the fiscal policy ought to be balancing public revenue and expenditure over a long term of years, thus making the current tax and expenditure policies sustainable

A “symmetrical” fiscal policy One crucial prerequisite for pursuing a discretionary fiscal policy is the political possibility of pursuing a curbing fiscal policy during periods of economic growth. This has been proven difficult to follow both on the Faroe Islands and globally during recent years. On the contrary, the opposite has occurred; the pursued fiscal policy has boosted the economy with reduction of taxation and huge increase in expenditure, while in the mean time, other conditions not influenced by fiscal policy have also boosted the economic growth.

The recommendation is therefore to pursue a “symmetrical” fiscal policy, i.e. the fiscal policy has to have an equally calming effect on the demand in periods of economic growth, and it must have a boosting effect on the demand in periods of recession.

⁶ See [5].

Which fiscal policy instruments does the political system have? The political system is able to use the public revenue and expenditure decisions as a fiscal policy instrument. If the Government is to pursue a discretionary fiscal policy, it has to do so by changing revenue, current expenditure, revenue grants or public investments.

Public expenditure However, public expenditure must not be used as an instrument to control fluctuating economic conditions. If, for example, public expenditure was increased during times of recession in order to boost the economy with demand from the public sector, then it would be very difficult to decrease public expenditure in times of economic upswing. This is a violation of the abovementioned guiding principles, which point out that the fiscal policy has to be "symmetrical" during recessions and economic upswings.

The level of public expenditure (the institution's operation) must not be fixed only considering the situation in a specific fiscal year. Public expenditure should remain continuous and fixed for a longer term of years considering the public revenue level, and in keeping with the type of welfare society we wish for and can afford.

Therefore, changes in public expenditure have a tendency to become permanent and thereby are unfit to use as an active fiscal policy instrument.

Public expenditure, i.e. the public current expenditure, should not be used as a fiscal policy instrument, due to the fact that changes often become permanent in the economy. Instead, public investments or tax receipts should be used as fiscal policy instruments, but only in special cases and under supervised circumstances

Public tax receipts and public services expenditure In some cases, it is possible to use tax receipts together with public revenue grants as an effective fiscal policy instrument. In coherence with the guiding principle of "symmetrical" fiscal policy, this will still require the use of tax increase in periods of economic upswing. Experiences from the Faroe Islands and other countries show that this is very difficult to put into effect politically.

Expediting investments can be used in some cases When public investments are used as a political instrument, it is important that this includes expediting *planned* public investments, i.e. that the Government by itself tightens demand later, because there will

not be so many public investments to be made left at that time. This requires that the Government has a clear long-term plan for all public investments.⁷

Our recommendation is that public investments should be prioritized with regards to the capacity of the future economy and considering which investments produce the highest public yield over a longer term of years

Fiscal policy measures of a non-durable type In coherence with the abovementioned guiding principles, it is important that fiscal policy measures used to control economic conditions are of non-durable type, i.e. that the Government curbs demand in periods of economic upswing as well as boosts demand in periods of recession.

4.2 DISCRETIONARY FISCAL POLICY ONLY IN SPECIAL CASES

Automatic equalizers The Government's fiscal policy should as far as possible be restricted in order to let automatic equalizers ("automatic stabilisers") boost the economy in periods of recession and curb the economy in periods of progress. The automatic equalization involves that for instance unemployment benefits automatically increase during recessions and that tax receipts decrease automatically. The opposite occurs in periods of economic upswing.

Uncertain basis of decision-making Statistics on the Faroese economy and every other economy are of such a type that it is very difficult to fine-tune the economy with discretionary fiscal policy. The statistics are delayed compared to the real trends and often they are not so accurate. Therefore, it is impossible to know with certainty to what extent the Government should either boost or curb the economy.

Discretionary fiscal policy should only be used in special cases, where there is little or no doubt about the indications given by economic statistics

The political process and delay Furthermore, fiscal policy has a lagged effect because firstly, political consensus must be reached about which measures should be taken. Secondly, these measures must be agreed upon and put into motion, before they finally can have an affect on the economy. Therefore, there is the risk of discretionary fiscal policy doing actual harm and have the opposite effect than planned. Parts of the economy can easily be over-stimulated, causing the pay level to rise in the whole economy, competitiveness to worsen and adds more pressure on the balance of trade and payments.

⁷ See also section 6.2 about prioritizing investments.

Blows to the supply and demand Economies can be hit by blows to the demand and supply. In the cases where recession is due to blows to the demand, it can be wise for the Government in some cases to boost the economy with public demand.

Boosting the economy with public demand in the cases where there have been blows to the supply in the economy is not wise.⁸ This will result in a rise in prices, capacity pressure, worsening competitiveness and pressure on the balance of trade and payments. Negative blows to the supply have the effect that the economy's production capacity will lessen with the resources available.

Therefore, it is not wise in all cases for the Government to boost the economy with fiscal policy, even though the economy produces below the so-called capacity limit.

We recommend that the Government should refrain from pursuing discretionary fiscal policy

Under any circumstances, the following requirements must be met, before it is wise to consider using discretionary fiscal policy:

- There must be available capacity in the economy, e.g. available labour, i.e. discretionary fiscal policy is not sensible to pursue during periods of very low unemployment
- Discretionary fiscal policy must be non-permanent, i.e. fiscal policy should be "symmetrical"
- There must be no uncertainties surrounding the indications the statistics provide. For example, it is only sensible to pursue an discretionary fiscal policy if it is certain that the blows to the economy have affected the demand in the economy

Having economic and political scope is a key prerequisite for pursuing an discretionary fiscal policy.

4.3 WORKING TOWARDS ECONOMIC AND POLITICAL SCOPE

The political system should ensure that there is a necessary scope in the economy for any given policy, which is planned to pursue. Economic scope could be:

⁸ For example, high oil prices are a negative blow to the supply for the Faroese economy, because the industry's production cost increases due to high oil prices.

- Scope for real economy, which implies productivity corresponding to labour and capacity utilisation
- Scope for finance and investments, which imply balancing revenues and expenditures gradually and financing necessary deficit by borrowing with favourable terms

In order to make sustainable fiscal policy work, the political system must consider how the economic scope is affected as time goes by. This applies to the scope for real economics for the economy as a whole, and to the financial and investment scope for the public authorities.

Revenue policy and parts of the expenditure policy (especially revenue grants) could and should also be used to influence the real economic scope and the scope for finance of the Government.

The investment policy should be adjusted to the scope, which the policy otherwise has created. Experiences from other economies⁹ show that when there is a need for tightening the fiscal policy, investments are reduced. Therefore, it is crucial to create scope for required investments and to have a timetable for the investments.

In the Faroese case, it is also important that it is a very small resource economy with great fluctuations.

Faroese public borrowing capacity (credit rating) is more easily influenced than in larger countries. Therefore, it is crucial to have clear and reliable plans in order to create the necessary scope in the economy and for the public authorities

⁹ See [12, p. 26].

5. THE GOVERNMENT'S FISCAL POLICY

This section of the report will focus on the pursued fiscal policy of the Government. An estimation of how much of the public deficit stems from pursuing the wrong policy in recent years or stems from the recession will be made.

5.1 IS THE PURSUED FISCAL POLICY SUSTAINABLE?

The public fiscal policy has boosted the economy during the latest economic upswing. The increase in current expenditure has been considerable following the economic crisis in the 1990's. Still, the Treasury's revenue has not increased as much and decreased in 2008 and 2009.

Tables 2 and 3 show some key figures from the Treasury's annual accounts in recent years. The tables show that the Treasury's deficit in 2010 is app. DKK 770 million and is equal to app. 20 per cent of the revenue.

<i>%-distribution and mill DKK (net)</i>	2007		2008		2009		2010	
Income Tax	43%	1791	44%	1829	44%	1696	43%	1688
VAT	41%	1722	39%	1629	40%	1539	40%	1569
Miscellaneous	1%	45	1%	44	1%	25	1%	25
Dansish State grant	15%	632	15%	635	16%	635	16%	635
Total	100%	4.190	100%	4.137	100%	3.895	100%	3.917

Comment: 2009 numbers are grants. 2010 numbers are from 2010 budget
Source: Finance Industry

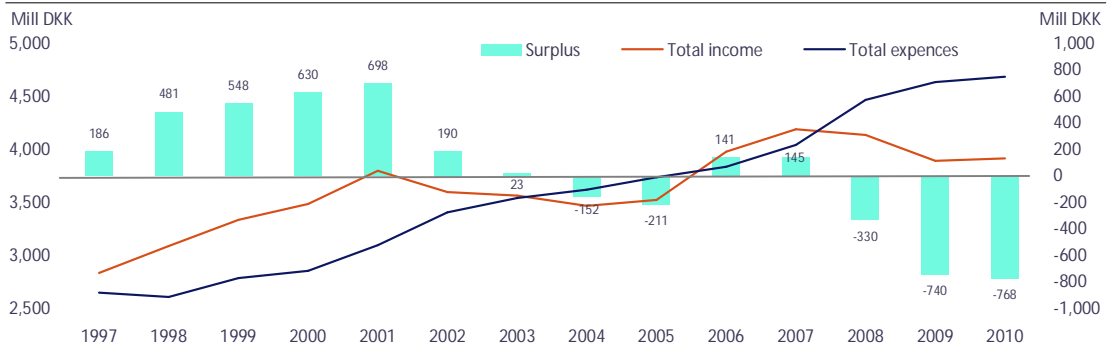
Figures 17 and 19 show the trend in revenue and expenditure of the Treasury in recent years. The figures show the huge increase in expenditure, while revenue has not increased correspondingly.

<i>%-distribution and mill DKK (net)</i>	2007		2008		2009		2010	
Operating expences	93%	3.767	95%	4.251	95%	4.404	92%	4.326
Invstments	7%	292	5%	232	5%	227	7%	317
Interest payments	0%	-14	0%	-16	0%	4	1%	42
Total	100%	4.045	100%	4.467	100%	4.635	100%	4.685
Surplus		145		-330		-740		-768

Comment: 2009 numbers are grants. 2010 numbers are from 2010 budget
Source: Finance Industry

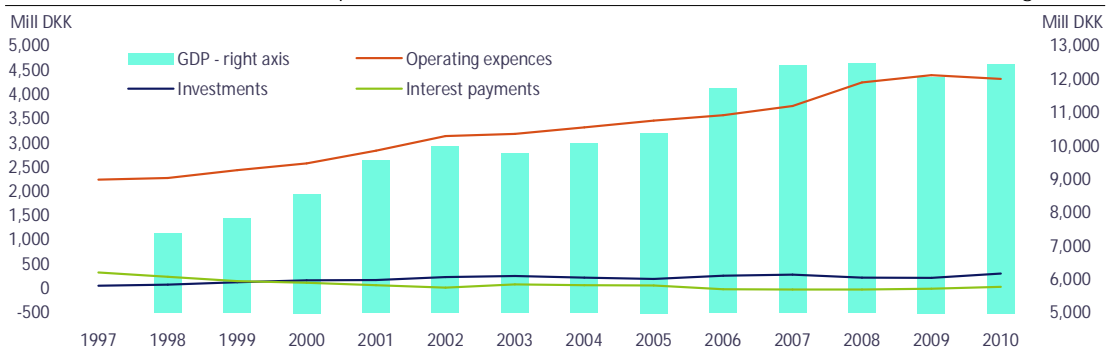
The increase in public expenditure must be seen in the light of that the Faroese economy has experienced a long and continuous economic boom since the crisis in the 1990's.

Central government's incomes, expences and surplus, 1997–2010 Figure 17



Rem: 2009 og 2010 are budgeted numbers
Source: Mynistry of Finance

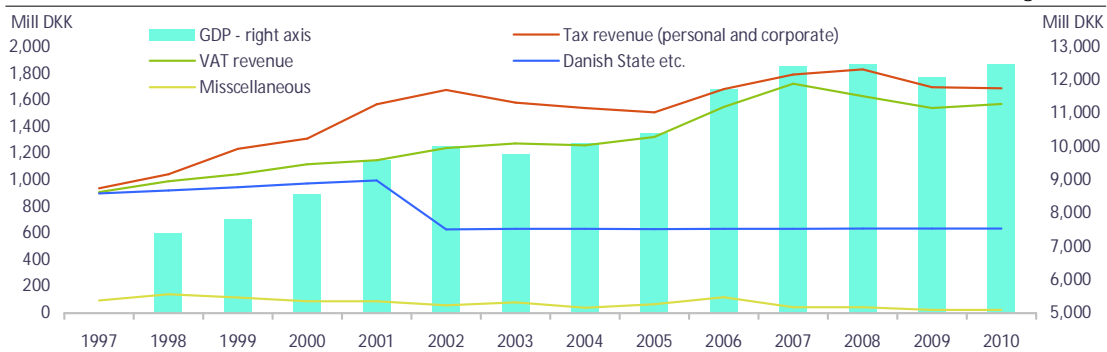
Selected Central Government expences, 1997–2010 Figure 18



Source: National Accounts and 2010 budget

Furthermore, there have been reductions of taxation, which have increased the households' disposable income and made the economic upswing bigger than it otherwise would have been. The reductions of taxation can be seen in figure 21, which shows that the Faroese Government tax, personal tax, has practically not increased since 2002, despite a huge growth in GDP. Reductions of taxation from 2004 to 2008 were considerable, almost DKK 100 million annually. Concretely, the reductions of taxation meant that changes were made on the level of the Faroese Government tax in such a way, making the tax bracket limits higher and the rate of taxation on different tax brackets was continuously decreased during 2004 to 2008.

Selected Central Government income sources, 1997–2010 Figure 19



Source: National accounts and 2010 budget

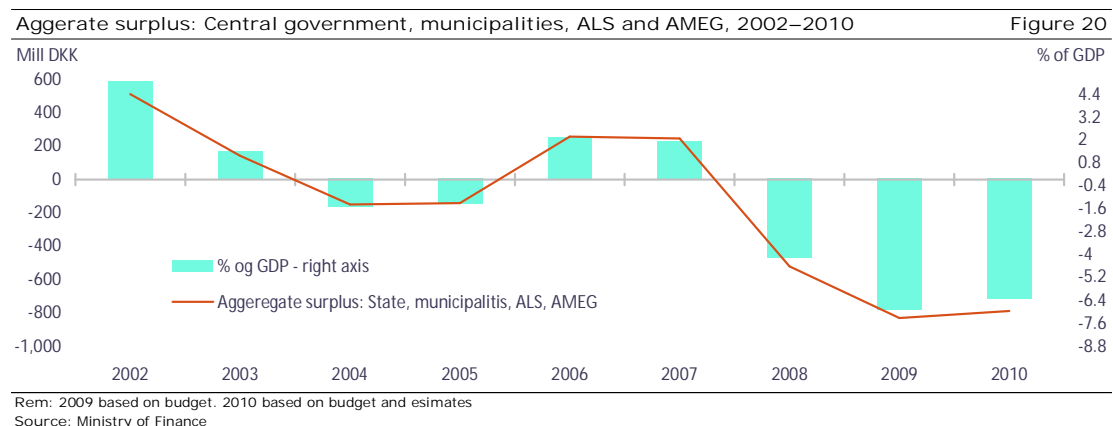
Payments received by AMEG (Labor Market Supplemental Pension Fund) were increased from 0.75 per cent to 1.75 per cent of the taxable income from 2005 to 2008. Payments made by AMEG also increased, thus the net impact of this on the economy was not significant. Concretely, the payments received by AMEG increased from app. DKK 100 million to app. DKK 240 million from 2005 to 2008, but the payments made increased from app. DKK 60 million to app. DKK 160 million during the same period.

The reductions of taxation were significantly greater and had a more boosting affect on the economy. The payments received by the Maternity Leave Fund also increased from app. DKK 30 million in 2005 to app. DKK 80 million in 2006. This increase is also insignificant considering the boost from the reductions of taxation from 2004 to 2008.

The reductions of taxation from 2004 to 2008 decreased the Treasury's revenue and consequently led to the Treasury having a smaller savings to withstand a change in economic trends. When public revenue is cut by reductions of taxation and by decreasing transfer income from Denmark, public expenditure must be adjusted to this new situation. This has not been done during recent years.

5.1.1 Indications of structural deficit

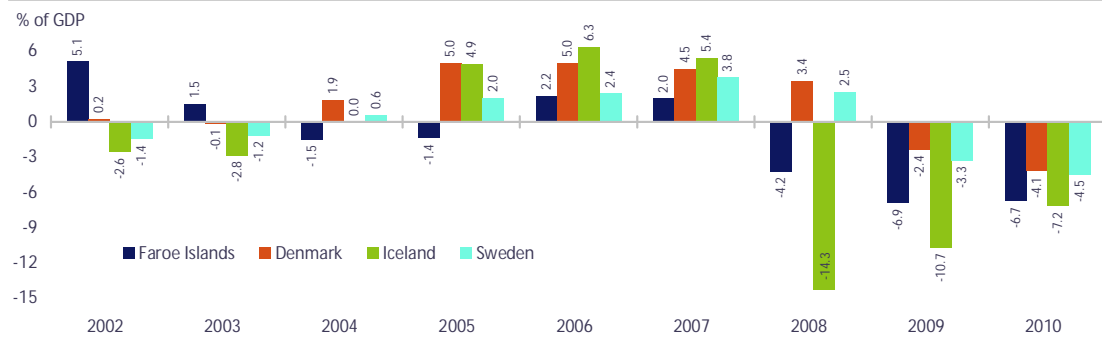
Cyclical deficit Figure 20 shows the public sector's surplus on the Faroe Islands. A part of the public deficit stems from the recession. This is the cyclical deficit, or what is due to the fact that households and the industry pay less direct and indirect taxes currently than before, because of the less activity in economy. The other part of the deficit is of a structural type and stems from the public tax receipts being on average too low compared to the expenditure.



Non-permanent revenue gone Figure 21 below shows (along with figure 16) that the growth in the Treasury's revenue in recent years stems from indirect taxes revenues, which now have been reduced significantly. The growth in indirect tax revenue from 2006 to 2007 is to be assessed as non-permanent revenue from credit funded expenditure growth in the two years. It is highly unlikely that this source of revenue will be durable in

the future. Furthermore, many non-recurrent revenues have gone to the Treasury due to the fact that many public corporations have been privatized in recent years.

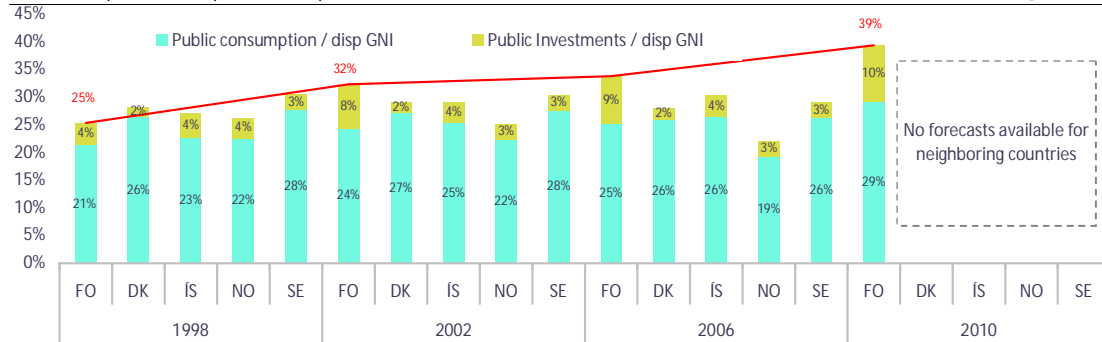
Public surplus as % of GDP, different countries, 2002–2010 Figure 21



Rem: 2009 and 2010 are estimates
Source: OECD Economic Outlook No 85 database

Growth in public expenditure The indication of a structural deficit is mainly based on different statistics on the trend in expenditure and revenue basis for the period 1998 and onwards, and compared to the surplus in the public sector¹⁰. Section 3 showed that e.g. the public payroll costs since 2000 have increased by app. 80 per cent, while the general pay, i.e. all the other payroll costs, which are not part of the public sector, have risen by app. 35 per cent. Figure 22 shows all of the public expenditure, i.e. public spending and investments on the Faroe Islands compared with its neighboring countries. According to these statistics, the total public expenditure compared to the available GNP has increased from a cautious basis compared to neighboring countries, from app. 25 per cent in 1998 to 34 per cent in 2006 (statistics from 2006 are prepared national accounts figures). An assessment of the public expenditure since 2006 shows that it has increased by 39 per cent of available GNP in 2010. In short, this implies that the cost of providing public services on the Faroe Islands has more than doubled and the revenue basis, which partly funds this growth, is relatively weakened.

Public expenses as part of disp GNI Figure 22



Rem: No disp GNI forecasts are available for neighbouring countries for 2010
Source: Statistics Faroe Islands (Statements 1998, 2002 and 2006), Governmental Bank (2010 estimate) and OECD for neighboring countries

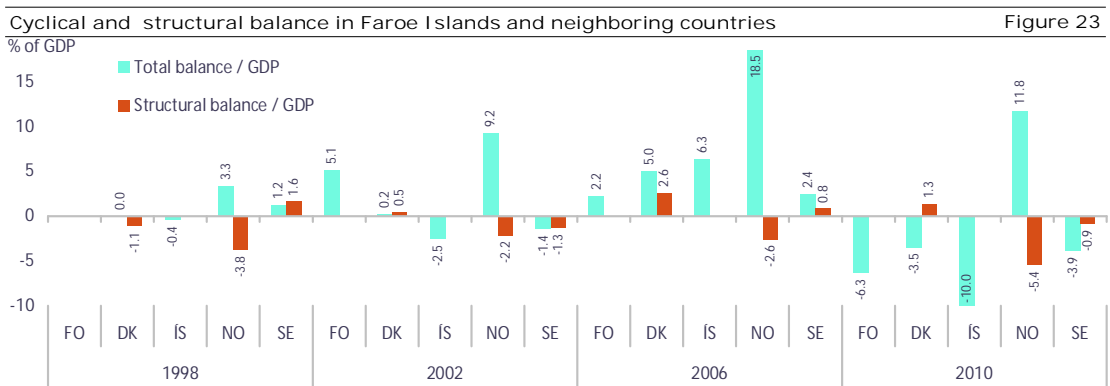
¹⁰ The statistics are from the national accounts statement from Statistics Faroe Islands, which do not go further back than 1998.

The revenue basis is weakened Revenue basis is basically the total revenue, which the Faroese economy is able to receive from domestic production and other transfers between the Faroe Islands and foreign countries, i.e. the available GNP. In concrete terms, the main part of the revenue of the public sector comes from personal and corporate tax along with VAT. The Government has with its reductions of taxation from 2004 to 2008 weakened the revenue basis more than it otherwise would have been.

Structural result In developed countries, fiscal policy measurement is set, which illustrates the condition of the public sector, where recession or economic boom is taken into consideration. Terms used in this connection are: structural result, structural surplus or structural deficit of the public sector (also known as structural balance). The result of the public sector, which is illustrated with this measurement, is a good way to determine whether fiscal policy measures should be commence or not.

Norway has a structural deficit Seen in figure 23 is for example Norway, which has experienced a large budget surplus in 2006, equal to 18.5 per cent of GDP. With this result, one might be inclined to assume that Norway had no need to adjust the public sector compared to the overall economy. Yet, when this accounting result is cyclically cleaned, the result has turned into a deficit equal to 2.6 per cent of GDP in 2006. The structural deficit for next year is estimated at 5.4 per cent of GDP. These structural results show that Norway will face huge challenges concerning its fiscal policy.

...meanwhile, Denmark has a structural surplus Figure 23 shows that the Danish public sector in 2010 will have an accounting deficit equal to 3.5 per cent of GDP. This deficit not only stems from the cyclical situation but also from planned measures by the Danish Government, which aim to increase activity in the country. At the same time, it can also be seen that a structural surplus is still expected in the public sector equal to 1.3 per cent of GDP. This structural surplus in 2010 is a sign of the Danish fiscal policy being sustainable; because the deficit will be gone when the economy has turned around.



Rem: No structural balance available for Iceland and Aroe Islands, that show structural surplus
 Source: Statistics Faroe Islands (Statements 1998, 2002 and 2006), Governmental Bank (2010 estimate) and IMF for neighboring countries

Possible example for the structural result of the Faroe Islands As abovementioned, statistics from the Faroe Islands regarding structural results are not available. We can still make an educated guess towards assessing the structural result for 2006 based on the ratio between accounting results and structural results of our neighbouring countries. In Norway, this ratio is app. 22-percentage points and in Denmark the ratio is 2.5-percentage points. We choose to calculate with a 3-percentage point ratio for the Faroe Islands in 2006. Then there is a structural deficit of 1 per cent of GDP in 2006.

In addition, we can also loosely estimate that reductions of taxation and a large increase in expenditure from 2007 to 2009 have increased the structural deficit. Consequently, a deficit around 3 per cent of GDP in 2010 can possibly be expected.

If this is corresponding to the reality – which we cannot know until accurate study has been made – a structural deficit equal to app. DKK 350 million can be expected. In other words, according to this the political system has to tighten its fiscal policy corresponding to this amount.

There are indications that the Government's pursued fiscal policy has inbuilt imbalances, which lead to structural deficit

5.1.2 The tax burden

The political decision as to the level of the tax burden in a country is in reality simple. The decision should be based on choosing a suitable level of service in the public sector, i.e. a suitable size of the public sector as a part of the whole economy, GDP, and fixing the tax burden at a level which insures that public revenue and expenditure break even over a long term of years.

In case there is a political decision to have a lower tax burden on the Faroe Islands than in its neighbouring countries, one of the consequences is that the public level of service will also be lower than in neighbouring countries, due to the public sector not being able to finance a level of service as high as in other neighbouring countries. On the other hand, if there is a decision to keep about the same public level of service on the Faroe Islands as in neighbouring countries, the Government will have to maintain the same tax and indirect tax receipts level as in the neighbouring countries.

Tax burden					Table 4
% av GDP	2004	2005	2006	2007	2008
Iceland	38%	41%	42%	not avail.	not avail.
Denmark	50%	52%	50%	49%	49%
Norway	43%	44%	44%	44%	42%
Sweden	48%	49%	49%	48%	47%
Finland	43%	44%	43%	not avail.	not avail.
Faroe Islands	45%	45%	47%	not avail.	not avail.

Source: Statistics Faroe Islands, OECD, Danish Statistics

Table 4 shows the tax burden on the Faroe Islands and in the neighboring countries based on the national accounts. Table 4 shows that the tax burden on the Faroe Islands can be compared to the tax burden in most neighboring countries, although it being slightly lower than in Denmark and Sweden.

Reading table 4, there is some need for reservation concerning different circumstances. There is no unambiguous method to measure tax burden; therefore there is a difference in the statements based on the method of statement used. The tax system varies from country to country and this affects the tax receipts in the countries. Therefore, comparing tax burden in different countries calls for caution. The tax burden is for example affected by how many tax deductions there are in the tax system, whether the public benefits are low and tax-free or high yet taxable¹¹.

There are indications that the tax burden on the Faroe Islands is lower compared to Denmark and Sweden, but higher compared to Norway and Finland

5.2 A SPECIAL CASE?

As shown in section 4.2, we recommend not to pursue a discretionary fiscal policy, except in special cases, and the prerequisites are shown which need to be present. In order to answer the question of whether the current state of the Faroese economy is a special case, it is necessary to look at the economic situation compared to long-term indicators, while at the same time considering the economy position compared to the past years and in the years ahead respectively.

The above-mentioned assessment of the economic trends indicates that the Faroese economy overall is sound. According to Statistics Faroe Islands the Faroese net worth was DKK 3.7 billion in 2006 and there are indications that the Faroe Islands has had a surplus on the balance of payments since then. The economic position compared to foreign

¹¹ The measure for tax burden in table 4 and other reservations are more clarified in [20, section 7.2] and [7].

countries must therefore be said to be satisfactory. The Faroese households seem to be fairly well off compared internationally and the net liabilities of the Government and municipalities were in total minor at year-end of 2008. Financial institutions and businesses stand for the greater part of net assets in foreign countries. Parts of the activities in the resource industries are experiencing operational difficulties. The building industry is experiencing severe setbacks. The trade and service industries have felt the affect of greater caution among the industries and households. With an unemployment rate of app. 4 per cent of the available labor force, the economy is still close to its maximum capacity. The conclusion is that although the Faroese economy still is affected by the global financial and economic crisis, the outlooks show overall more stabile conditions in 2010. The biggest problem is the management of the country and municipalities.

The Faroese economy has largely been in a state of exception during the economic upswing in 2005, 2006 and 2007, and despite a real recession in 2008 and 2009, there are indications of stabile economic conditions in 2010

During recent years, the Government has had a boosting effect on the Faroese economy and this will continue according to the Budget for 2010.

Bearing in mind the current economic situation and public deficit on the Faroe Islands, we do not recommend pursuing a boosting fiscal policy resulting in a larger public deficit. Fiscal scope for pursuing a more boosting fiscal policy is hardly present. The public deficit must be seen in the light of the fact that the costs must be paid back later with budget surpluses in the future.

The international financial markets have been through a long period, where governments have easily been able to finance their deficit at a reasonable cost. Yet it is still not certain whether this situation will continue from now on.

One of the consequences of the economic crisis could be that the difference between the financing cost in countries with acceptable and less acceptable credit rating will increase in the years ahead compared to recent years. Therefore, one might expect that from now on it will become increasingly more costly to finance public deficit for the countries, which do not have an exceptionally good credit rating.

According to the Budget for 2010, the Treasury's net interest expenses are expected to amount to app. DKK 42 million in the coming year. This figure will increase during the next

couple of years due to the anticipated deficit in 2010. Assessments made by IMF indicate for instance that net interests expenses for Governments in industrialized countries will be app. 4 per cent of GDP on average in 2014¹².

An example of calculation If the Treasury has a deficit of app. DKK 2 billion in the years 2008 to 2010, then this will result in the Treasury's borrowing increasing and the Treasury will therefore gain more interest expenses because of this debt, which will be financed by tax receipts. If we envisage that the financing cost of the Treasury is 4 per cent per annum, the interest expenses of DKK 2 billion in borrowing will amount to app. DKK 80 million per annum¹³. On the Faroe Islands, there are app. 28,000 people in the labour force. Every working Faroese must therefore pay app. DKK 2,860 extra per annum in taxes just to finance the interest expenses of DKK 2 billion in borrowing by the Treasury¹⁴.

5.3 IS THERE ROOM FOR MANUVRE?

In the sense the deficit is structural and hence will not disappear by itself when the economy picks up, it is important to begin the process of strengthening the pursued tax and expenditure policy as quickly as possible, while the Government has the scope for fiscal political decisions, in order to minimize the Treasury's burden of debt to deal with in the future. Also one must keep in mind that the Treasury's expenditure for elderly causes will increase in the next couple of years due to demographical changes in the composition of the population. For example, projections made by a working group, set up by the Faroese Ministry of Finance, show that expenditure for the health services and social benefits for the elderly calculated in fixed 2009-prices will increase by app. DKK 20 million before 2015 without any renewal of the early retirement benefit scheme. Therefore, the public deficit will increase by app. DKK 200 million before 2015 in case no measures are put into motion regarding the early retirement benefit scheme – other things being equal¹⁵.

¹² See [6].

¹³ DKK 2 billion in borrowing is not unimaginable, when considering the Treasury's deficit in the years 2008 to 2010.

¹⁴ See also example in [15].

¹⁵ See also [11].

5.3.1 The main consideration regarding the public rating

Decisive of the credit rating Decisive of the Government's credit rating is the ability of the Treasury to meet its obligations towards the creditors over a mid-long period and thereby also the sustainability of the pursued tax and expenditure policy.

The public credit rating of a small economy like the Faroese will probably worsen quicker due to the debt increasing considerably more compared to larger countries. This is because the Faroese economy is relatively more sensible to outside blows, has more fluctuations and cannot bear the same burden of debt as a larger economy, which has lesser fluctuations and can better stand outside blows¹⁶.

The public net debt According to table 5, the Treasury is expected to still have more assets than liabilities, i.e. net assets, in the years 2008 to 2010. At the turn of the year 2008/2009, the net asset was app. DKK 1.7 billion. The Treasury's net asset will be nearly DKK 1 billion at the end of 2009 and with the expected budget deficit in 2010, the net asset is expected to reach nearly DKK 200 million. The Treasury has early retirement benefit obligations in the future to public servants, who are not included in table 5.

In addition to the Treasury's net debt, the net debts of the Faroese Treasury include the debt of the municipalities of app. DKK 1 billion, future early retirement benefit obligations, public net assets in funds, in addition to net assets in public and local authority corporations.

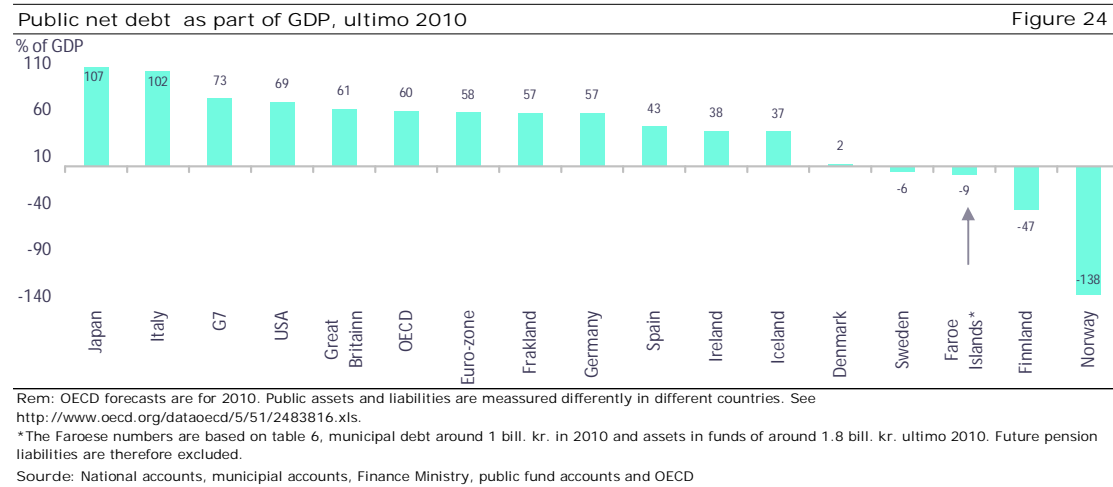
The public net debt on the Faroe Islands is low compared to most other developed countries. Figure 24 shows all of the public sector's net debts in selected countries and must not be compared to net assets shown in table 5.

Net debt and credit rating There is no definite or direct link between public net debts and the public credit rating. Case in point, the US, Great Britain, Denmark, Norway and Japan all have a good credit rating even though the public net debts are different. On the other hand, Iceland and Ireland have a lower credit rating even though their net debts are not among the largest in the world.

The public credit rating therefore depends on other factors than public net debts in total, e.g. net debts in connection with the resistant against outside blows, fluctuations in the economy, financial management, revenue level, the ability to collect direct and indirect

¹⁶ See also [10].

taxes individually, industry structure, industry diversity, openness of the trade policy, etc.¹⁷



Central Government liabilities, assets and balance net assets, 22006-2010 TABLE 5

	2006	2007	2008	2009	2010
Gross liabilities	3.316	3.379	3.590	3.865	4.911
Danish state	500	500	500	500	500
Bond loans	2.225	2.160	2.119	2.694	3.740
Other liabilities	592	719	971	671	671
Gross assets	3.959	5.194	5.282	4.857	5.133
Governmental Bank	1093	2.467	2.158	1.733	2.009
Other	818	959	841	841	841
Financial assets	2.048	1.767	2.283	2.283	2.283
Net assets	643	1.815	1.692	992	222
Net assets excl. Financial assets	-1.405	48	-591	-1.291	-2.061

Comments: 2009 and 2010 are preliminary numbers
 Kelda: Landsbanki Føroya

Scope and credit rating The guiding principle that the Faroese Government should always strive for fiscal scope is therefore closely linked to the regard of the credit rating of the public sector/the Treasury. The question is mainly how many years can the Treasury and the public sector tolerate a comparatively significant deficit, before the credit rating of the Government will worsen and the cost of financing future deficit therefore will increase.

Still, it can be stated that as long as the Treasury runs with a deficit, its scope will lessen. Furthermore, as long as there is a deficit the interest expenditure will increase. At the same time, it is clear that among other things public expenditure will increase over the next couple of years due to demographical changes. This emphasizes the importance of as soon as possible to come with a clear scheme for long-term balance, because the longer the wait, the bigger the risk of implementing harsh measures and cuts later on.

¹⁷ See also [1], [21] and [2].

The uncertainty about whether the public deficit on the Faroe Islands is cyclical or structural should not be used as grounds for postponing measures for balancing the public revenue and expenditure again. The uncertainty and lack of accurate knowledge about how the deficit is structural should rather hurry up the process of starting this development. Therefore, the Faroese Council of Economic Advisers recommends that balancing public revenue and expenditure must begin as soon as possible, while there is fiscal policy scope in order to avoid harsher adjustments in public revenue and expenditure later on.

It is important for the credit rating and the sustainability of the fiscal policy that a determined and binding scheme is made on how to achieve balance on the public revenue and expenditure. Also important is that there is a strong political consensus for the schemes. This will help the credibility of the schemes and the likelihood of them succeeding.

6. FISCAL POLICY MEASURES

6.1 EXTEND THE REVENUE BASE

The years 2008 and 2009 have shown how much the Treasury's revenue can fluctuate in times of recessions. Case in point, the Treasury's direct and indirect tax receipts will decrease by app. 4 per cent in 2009 compared to 2008, according to the Budget estimates. Meanwhile, the Danish Ministry of Finance expects direct and indirect tax receipts of the Danish Treasury to decrease by app. 2 per cent in 2009 compared to the previous year.¹⁸ This is despite of reductions in taxation in Denmark and a reversed reduction in taxation on the Faroe Islands in 2009.

Considering the fluctuations in the direct and indirect tax receipts of the Treasury, it will be wise to expand the public revenue base on the Faroe Islands. This would lead to a smaller part of the revenue stemming from payroll and expenditure taxes and doubtlessly stabilize the Treasury's revenue. In practice, there are several ways to widen the revenue base, e.g. the tax base can be widened.

Relatively narrow tax base The Faroese tax base is similar to the tax base in neighboring countries, although not as wide. Real property tax does not exist on the Faroe Islands and more environmental taxes are in the neighboring countries. Furthermore, a large part of the tax receipts on the Faroe Islands stems from payroll and expenditure taxes. Table 6 shows the division of tax receipts in Denmark and the Faroe Islands in 2007, divided into some main types of taxes.

The table shows that the main parts of the tax receipts on the Faroe Islands stem from the main sources of tax receipts; payroll tax and VAT. Therefore, it may be more logical to widen the tax base with other tax sources.

Distribution of taxes as %-points of total tax revenue	TABLE 6	
	Faroe Islands	Denmark
Corporate tax	5,1	7,4
Income tax*	48,7	39,1
Registration fee	2,7	2,9
VAT	26,6	21,3
Real estate tax	0,0	3,7
Other taxes	16,7	25,6
Total	100,0	100,0

Comment: State and municipalities

Source: Danish Statistics, Governmental Bank

¹⁸ See [13].

The corporate tax on the Faroe Islands is lower, there is no taxation on property, car taxes are lower and some environmental taxes do not exist as in Denmark. Environmental taxes amounted to 9.5 per cent of all public tax receipts in Denmark in 2007¹⁹. The fuel oil tax, the environmental tax on lubricating oil, road taxes, car taxes and travel taxes can possibly, with some reservation, be classified as environmental taxes. These taxes in total amounted to app. 5.4 per cent of the public direct and indirect tax receipts on the Faroe Islands in 2008.

By gaining tax receipts from other tax sources than payroll taxes and VAT, the Government's tax receipts will become more steady as well as the tax system will become more socially fair and will promote solidarity. Furthermore, it will be possible to have lower taxation on earned income, thus affecting the people's wish to work as little as possible.

The marginal income tax The highest marginal tax rate was 60.47 per cent²⁰ on the Faroe Islands in the municipalities with the highest tax rate (23.5 per cent) in 2009. In Tórshavn Municipality (with 19.75 per cent in local taxes), the highest marginal tax rate is 56.72 per cent. This is almost at the same level as in our neighboring countries, except in Iceland, see table 7. The local income tax on the Faroe Islands is on average 20.78 per cent; in these municipalities the highest marginal tax rate is 57.75 per cent²¹

Highest marginal tax rate: Different countries, 2008								TABLE 7
DK	FO	SE	FI	NO	IS	USA	UK	
63,0	60,5	56,4	55,6	47,8	34,3	43,2	41,0	

Comment: The Faroese number is from the 2009 taxtable
Source: OECD and TAKS

Raising the marginal income tax significantly is hardly sensible. There is the risk of this affecting the people's wish to work and live on the islands.

A lack of user fees User fees or part user fees on public services is also a way of increasing public revenue. There are already several examples of such user fees, e.g. on childcare, dental care, different medicines and parts of the public transport system. One of the advantages of user fees is that they can contribute to ensuring that some public services will not be let down in cases, where they are not needed. User fees can also be used as a management tool to control the demand for public services. User fees systems ought to be united, in order for the Government to provide financial support to citizens in financial turmoil; those who really need help. User fees are probably necessary if there is to be any improvement of the public structure.

¹⁹ See [8, pp. 140-141].

²⁰ 33 per cent in national taxes + 23.5 per cent in local taxes + 1.75 per cent to AMEG + 0.62 per cent to the Maternity Leave Fund + 1 per cent to ALS.

²¹ The Government has planned to raise the tax on income higher than DKK 400,000 from 33 per cent to 35 per cent. If this will proceed as planned, 2 percentage points have to be added to the above-mentioned figures.

6.2 PRIORITIZING INVESTMENTS

The Council of Economic Advisers recommends prioritizing investments rationally in the years ahead. All large public investments²² should be organized in a long-term framework (see also section 6.3), which there is a general political consensus about. Public investments in public transport, healthcare, education and social services should be prioritized according to the future economic performance.

Business investments Businesses seem to prioritize their investments according to their operating profit, in order for the investments to strengthen the operations of the business in the future. Therefore, the challenge for the Government is to create the framework making it possible for business investments to also yield a social profit and economic growth.

Basic requirements The requirements for public investments are more complex than for businesses. Three considerations reappear in specialist literature²³ concerning prioritizing tax funded investments:

1. The allocation principle²⁴
2. Distribution
3. Cyclical policy

Allocation principle is in the mentioned literature the most important because it has the biggest importance for welfare and growth. Large and widespread public investment plans seem not to exclusively provide crucial supplement to welfare and growth. Consequently, it is very important that every single investment plan is meticulously analyzed, assessed and prioritized before put into motion.

Distribution is taken care of by the tax system, revenue grants and public services. Public investments can be seen as a part of this equal distribution, because public services are provided to the citizens by these means.

Cyclical policy considerations can hardly be the main basis for pursuing public investments. On the contrary, the necessary scope with available manpower and capacity should be a cyclical policy consideration when planning public investments. Experiences²⁵ show that public investments not always have worked efficiently in controlling cyclical

²² Public investments made by: The Government, municipalities, funds, public corporations and joint local-authority enterprises.

²³ See [12, pp. 7-41].

²⁴ Term used within the field of economics to describe the allocation and effective use of scarce resources.

²⁵ See [12, p. 13].

fluctuations. Although, there are examples where public investments have been used as a part of a cyclical balancing policy with good results.

Necessary to be taken into account Society is constantly presented with new challenges, which also should influence for example public investments. Hence, it is a very immense challenge and task to handle public investments for the political system. We recommend that every public investment and investment prioritizing take into account among other things these questions:

- Demographical changes occur, the population becomes proportionally older, and the number of people financing the public operation is comparatively lower. How will this affect investments in public social and health service?
- Globalization changes the prerequisites for commerce and trade. How will this affect investments in the infrastructure and the transportation of people and goods?
- There is a need for educated young people on the Faroe Islands in order to strengthen the country's productivity. How will this affect investments in service offers, research etc.?
- The environment continues to demand more innovative solutions and the price of energy increases by the day. How will this issue affect public investments?
- The municipalities gain a growing number of public duties, making the issue of prioritizing investments more manifold and complicated. How will this affect the organizing of priorities?

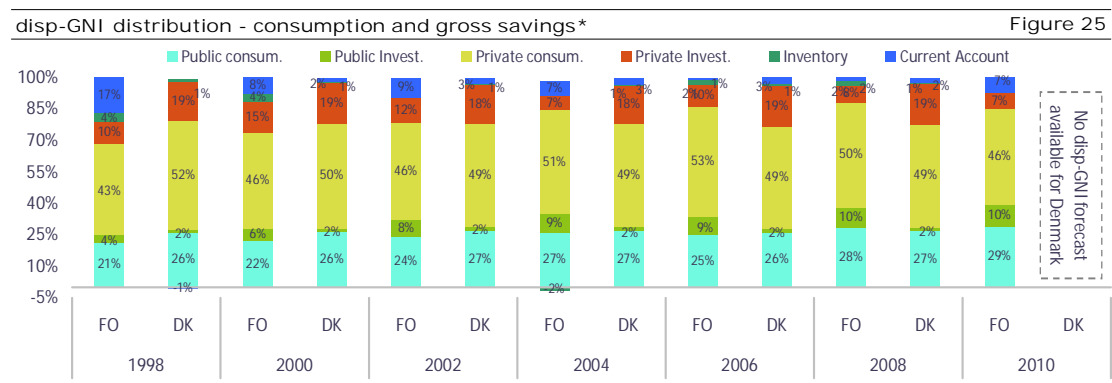
Rules for investment projects The Government should therefore lay down clear rules concerning the process which every single project should go through, in order to assess all the considerations which must be considered. In addition, the Government should prepare frameworks with clear encouragements and demands for projects of the municipalities and public corporations in order to commence the projects.

Some important work in prioritizing investments has already been done. In 2006, the Faroese Ministry of Trade and Industry published "Samferðsluætlan 2008-2020"²⁶ (a publication concerning plans in communications), where all the communications schemes are clarified and valued by social gain. These types of valuations should form an integral part of the process of all public investment projects – for investments in communications, as seen here, and for investments in education, research, health, social service etc.

²⁶ See [27].

Investments and scope As mentioned above²⁷, the investment policy should be adjusted according to the scope of the policy, which it has created. There are clear indications²⁸ that part of the public deficit is structural. If this is true, then there has not been created enough scope for public investments, and the investments should be decreased or the revenue increased.

Public investments are relatively large Public investments on the Faroe Islands²⁹ constitute a much larger part of the available GNP than e.g. in Denmark, as shown in figure 25. Therefore, it is very important to evaluate the social advantages of these large public investments as to decide whether to increase public revenue, in order to create more scope for the vital investments, or to lessen investments, which are not beneficial enough.



6.3 FINANCIAL MANGEMENT OF COUNTRY AND MUNICIPALITIES

Lack of coordination regarding budgets One of the issues surrounding fiscal policy is the lack of coordination regarding the budgets between different parts of the public sector. This issue does not lessen by the fact that more and bigger duties are moved from the country to being the municipalities' responsibility. The same applies to social tasks, which e.g. joint local-authority enterprises and public corporations deal with.

Some cooperation in fiscal policy between Government and municipalities has been attempted previously by fixing a capital budget for the Government and municipalities combined, which suited the future economic outlook for the Faroese economy. It is hard to say whether this system worked completely according to plan, among other things because there were no clear rules for which expenditures were to be seen as investments

²⁷ See section 4.3.

²⁸ See section 5.1.1.

²⁹ The Faroese national accounts are prepared differently from other countries when it comes to the division of public operations and investments, due to the inclusion of the maintenance of public roads and harbours in investments. Faroese investments are therefore too large to be used in comparisons.

or not. The investment cooperation fell through a couple of years ago, and the situation since then has been marked by that the fiscal political influence by the municipalities' budgets has had a stimulating effect, while at the same time also being true of the Government's Budget – all this during periods of economic boom, which would advocate that the demand from the public funds combined would have a calming effect.

Possible breakthroughs Some improvements seem to have occurred, which might lead to the fiscal policy reaching a higher level over the next couple of years.

1) A new appropriation system That the new appropriation system impels the political system to fix the overall expenditure and revenue level of the Treasury already in April for the next fiscal year has to be seen as an improvement. This is prescribed in section 8 of the Act No 42 of 4th May 2009 on the Faroese appropriation system. According to this section, the Faroese Government is obliged by the Faroese Parliament to henceforth present a Budget Statement, which corresponds with the framework agreed upon by the Parliament.

This new system will for the first time be put to the test in connection with the Budget for 2010. The Government has presented a Budget Statement for 2010, which corresponds to the parliamentary resolution in the matter for discussion by the Parliament no 8/2009. Thus, it has been possible for the Parliament to obligate the Government to uphold a certain discipline with its fiscal policy. Now it is up to the Parliament to prove that a parallel discipline exists within the Parliament. This will be possible if the Parliament does not – without there being a very pressing macroeconomic condition annulling this – change the framework, which the Parliament itself has agreed upon to apply to the Budget for 2010.

2) Executive order concerning the drafting of the municipalities' accounts Secondly, another good example of progress is the executive order no 89 from 15 October 2008 concerning the drafting of the accounts of the municipalities. This executive order prescribes that the municipalities must prepare their budgets and accounts following the same leisti, which applies to public institutes, which are included in the Appropriation Act. In the event that the executive order is enforced, large statistical issues concerning the economy of the municipalities will be eliminated. With this enforced, it is possible to establish a strong figure basis over the next couple of years, which will make it possible to coordinate the influence from Government and municipalities on the aggregate demand in the Faroese economy.

Despite these improvements – which hopefully will be successful this year and following years – it is necessary with more measures in order to truly reform the fiscal policy.

In this connection we recommend that the public authorities in cooperation with the municipalities try to develop a system, which entails taking care of the framework for revenue and expenditure for both the Government and municipalities in good time in the year before the next fiscal year. It is necessary that such a framework takes into account the fiscal policy goals, which will last some years into the future.

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