English Summary

Chapter I: Assessment of the Short-Term Economic Trends in the Faroes, Spring 2017.

The unusual development in the Faroese economy over the last few years and the lack of official statements of the national economy stated in both current-price and constant-price GDP have made it difficult to generate accurate short-term analytical projections about the growth in GDP in current year prices and how to explain it. In this semi-annual review, the growth in GDP in current year prices for 2014, 2015 and 2017 is projected somewhat higher than in the last report, and growth for 2016 somewhat lower.

	2014	2015	2016	2017	2018
Estimated GDP growth in current prices:	6,4%	8,0%	7,8%	6,9%	4,4%

The parts of this report on the short-term economic outlook are organized according to the demand side (expense side) of the country's GDP. Overall aggregate demands for goods and services are based on two driving forces: domestic demand for consumption and investment, and net foreign demand for exports. (i.e. export minus import).

The most current official account of the national economy (GDP) is for the year 2013. Statistics Faroe Islands, the Governmental Bank of the Faroe Islands and the Economic Council have jointly estimated GDP and GDP growth in current prices for 2014-2018. Minor changes have been made in assumptions which the estimation are based on for the years 2014-2017. For instance, extra heed is paid to significant changes in the price of oil and to the size of service export.

While consumption has been the most stable aspect of domestic demand, investment has been the most fluctuating. Public sector investment in the Faroes, as part of overall domestic demand, has traditionally correlated positively with the economic cycles. The case is the same for public (government) consumption. This pattern is detrimental to long-term economic development and its consequences may, to all appearances, be repeated, given that investment plans for municipalities and especially the central government are extensive for 2017-20.

For some time now, the Faroes has had a greater trade surplus than ever before. One reason for this is improved terms of trade in foreign trade, derived from an increase in farmed salmon prices and lower oil prices. Also, greater quantities in pelagic fisheries has influenced the result.

Economic indicators for the last half a year suggest a marked upswing in the economy characterised by low unemployment, high employment, positive net migration, housing shortage in the urban centre, and economic growth. Prospects show a small surplus in national fiscal accounts in 2016 and 2017. The Economic Council estimates that had circumstances otherwise been normal, national fiscal accounts should already have shown a large surplus at the beginning of this ascending business cycle. One obstacle to this has been changes in age distribution, and this obstacle will increase in size in coming years. As noted in previous reports, the use of the revenue generated by pre-taxing of pension savings to pay for tax cuts created a skewed picture of the true long-term economic sustainability.

Chapter II: Income distribution

The logical principle for remuneration of the factors of production (labour force, real and fiscal capital and natural resource capital) is that remuneration should, at any one time, be given in accordance to the contribution of the factors of production to the economic productivity (value-added per work-hour). Knowledge of and certainty pertaining to the aforementioned contribution of each factor of production is evidently incomplete or partial. However, the employers' estimate of this contribution remains decisive. Conditions of supply and demand with regard to the factors of production may counteract the aforementioned correlations.

A popular theory ascertains that the economic and social system has the innate ability to generate returns to capital faster than the economic growth, a consequence of which is the inability of wage payments to labour to follow suit. This might be true - it has been the case in the Faroe Islands ever since the financial crisis.

Between 2014-2016 wages payed to employees in Faroese businesses have increased significantly, but profits to capital have grown even faster – wages have not managed to follow suit. The ratio between profits and wages has increased from 30% in 2008 to an estimated 80% in 2016. The big change since 2008 is caused by the large earnings gained in the pelagic and sea farming industries, which have, by and large, mostly gone to capital owners.

Faroese after-tax pension savings amounted to 45% of GDP in 2015. The business capital of a country is normally expected to represent around 300% of GDP. Based on these figures, we can roughly expect Faroese salary earners, through pension savings, to own a value corresponding to around 1/6 of the country's business capital. If we look to Denmark for comparison, it is estimated that Danish pension savings after tax came to 150% of GDP in 2015, equalling around half of the business capital at 300% of GDP. Danish pension savings are therefore 3 times larger than Faroese pension savings in relation to GDP. This raises important questions of equality and inequality, especially when comparing future Faroese pensioners to the future pensioners of neighbouring countries.

According to the Gini index, income in the Faroe Islands is more equally distributed than in neighbouring countries, but inequality has increased from 2009-2012. The income quintile share ratio (S80/S20) also indicates that income distribution in the Faroe Islands is very equal compared to Nordic countries, but it is also the case that inequality in the Faroe Islands has been rising from 2009-2013.

The percentage of the population at risk of poverty in the Faroe Islands is and has been small when compared to other Nordic countries, but in this variable the Faroe Islands have also done less well from 2009 to 2014. The Faroe Islands are also faring better than the other Nordic countries with regards to the poverty gap index.

Chapter III is a report on sustainable fiscal policy

It was in spring 2015 that the Economic Council presented consequential calculations regarding the long-term fiscal sustainability of the Faroe Islands. Two years later - in spring 2017 - the political system has introduced no major reforms affecting public sector income and expenditure matters. Updating the aforementioned consequential calculations has therefore not been relevant; nothing decisive seems to have changed regarding fiscal sustainability.

We can consequently ascertain that poor financial sustainability in the public sector is going to be a challenge for the coming 20-25 years. The uncertainty lies in whether or not something will be done to meet these challenges at the political front.

Via Statistics Faroe Islands, the Economic Council has put forward a stochastic population projection, where the net-immigration in the past few years is included in the calculations. This, however, does not affect conclusions reached on the issue of fiscal sustainability as presented in the economic report from spring 2015. In relation to a previously uneven age and sex distribution, high net-immigration for a few years (during a boom) does not have a significant beneficial impact on the fiscal sustainability issue. The new population projection shows that significant changes in age distribution will have a serious and detrimental effect on municipalities outside of Tórshavn.

The sustainability problem is identified as an expanding gap between future public income and expenditure. The graph that shows a growing public financial deficit, i.e. a growing gap between income and expenditure of the public sector for the next 20-25 years, resembles a *ramp*. The ramp-pattern indicates that the situation will gradually worsen if nothing is done. The corresponding graph for Denmark has a pattern that looks like a *hammock*. The hammock-pattern shows that the fiscal balance for the Danish public sector (total income minus total expenditure in % of GDP) will decrease and/or be in negative growth during the years 2024-2040, followed by significant growth after 2040.

The Faroese ramp means that the further into the future we go, the more money is needed to keep the public sector running. Through the taxing of pensions at the time of disbursement (i.e. by post-taxation), money would be available when it is needed the most. Through the taxing of pensions at the time of contribution (i.e. by pre-taxation), money is available to the public sector for use when it is comparatively least needed. Pre-taxation did not finance any tax-cut either; it was unfinanced.

It is usually expected that productivity growth in the business sector is associated with a proportional growth in real income of employees and of public service workers as well. The fiscal sustainability calculations by the Economic Council are based on this assumption. Productivity growth in private sector companies consequently generates a foundation for increased tax revenue; though, on the other hand, this also leads to a corresponding increase of operating expenses in the public sector. Only inasmuch as productivity growth, after a business sector adjustment, leads to increased employment (i.e. creates new tax-paying workplaces especially in the private sector) does it contribute to better financial sustainability.

The current sustainability challenge faced by the Faroe Islands means it is even more important to discontinue the use of policies that correlate positively with the business cycles. This also holds true where the wish for a self-reliant national economy is concerned.