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THE FAROESE ECONOMY

Labour market squeezed by very low unemployment



Large-scale immigration has prolonged the upswing

Demand has risen strongly during the upswing since 2014, and the good employment opportunities have led to considerable immigration of labour. Unemployment is now very low, and there is a risk that this may lead to overheating of the economy.



Stability-oriented fiscal policy is essential for the Faroese economy

Historically, the Faroese economy has fluctuated strongly, partly on account of its strong dependence on exports of fish. The central government can increase the stability of the economy by pursuing countercyclical fiscal policies, e.g. via coordinated management of public sector spending and investment in the Faroe Islands.



More old people will put government finances under pressure

The ageing of the population in the coming decades means that in the long term tax revenue will not be able to match government expenditure if the service level remains unchanged. This can be addressed now by increasing the supply of labour or tightening fiscal policy.

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Strong economic growth in the last six years

The Faroese economy has picked up in the last six years. The strongest underlying drivers are substantial price increases for farmed salmon and larger catches of especially mackerel and herring. These two factors have boosted incomes and led to higher private and public sector demand.

Employment has risen notably, which has pushed down unemployment. The need for labour has increasingly been met via high net immigration, which has prolonged the economic upswing. However, the many new inhabitants have put the housing market under pressure, especially in and around Tórshavn.

Growth in employment continued in the 1st half of 2019, see Chart 1. Unemployment has fallen to just above 1 per cent of the labour force, which is the same low level as immediately before the financial crisis in 2008. During the current upswing, fiscal policy has also contributed to growth and hence to increasing labour market pressures.

Wage growth has accelerated as spare resources in the economy have shrunk, see Chart 2. All the same, wage growth remains moderate and lower than during the most recent boom. The low wage growth should be seen in the light of an expanded labour force and subdued consumer price inflation. The combination of a labour market under pressure and very low unemployment increases the risk that the economy overheats.

Consumers are optimistic and have seen their purchasing power improve substantially during the upswing. Since 2013, real wages have increased by almost 20 per cent. Business confidence indicators are generally high, except in the construction sector, where order books are not as full as they have been. Búskaparráðið, the Economic Council for the Faroe Islands, expects the Faroese economy to continue to grow throughout 2019 on account of increased exports and domestic demand, especially from households.¹

Facts about the Faroe Islands

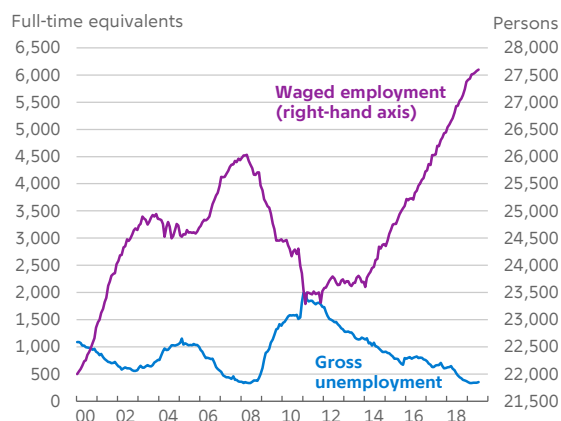
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|--|---------------|
| Population (August 2019) | 52,122 |
| Gross domestic product, GDP (2018, kr. billion) ¹ | 19.3 |
| per capita ² (kr. 1,000) | 369.5 |
| Currency | Danish kroner |

Source: Hagstova Føroya, Statistics Denmark and own calculations.

1. GDP is an estimate from Hagstova Føroya and Búskaparráðið.
2. By comparison, GDP per capita in Denmark was kr. 384,000 in 2018.

High growth in employment is pushing down unemployment

Chart 1



Note: Seasonally adjusted figures for unemployed people and wage earners.

Source: Hagstova Føroya.

¹ See Búskaparráðið, Búskaparfrágreiðingar (report of the Economic Council for the Faroe Islands – in Faroese only), autumn 2019 ([link](#)).

So far, consumers have shown more restraint than during the last upswing, and the consumption ratio is somewhat lower than 10 years ago. The banks' lending has increased, but at a slower pace than the gross domestic product, GDP. This means that the upswing is more robust than on previous occasions, e.g. in the period leading up to the financial crisis. Consequently, the economy is more resilient to a cyclical reversal.

A global slowdown will have an impact on the Faroese economy

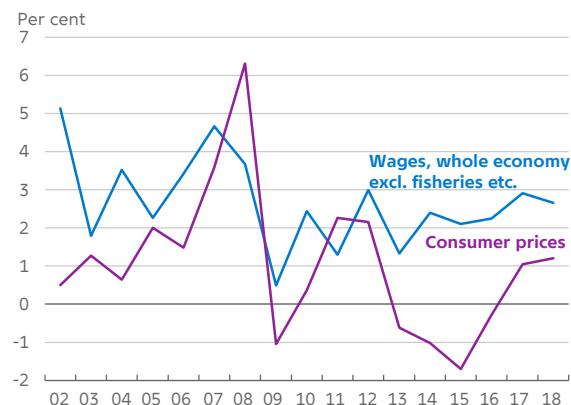
There are indications that the Faroese economy will be less favoured by global demand in the coming years. In their most recent forecasts, the IMF and the OECD expect growth in the global GDP to decline. The lower growth rates should be viewed in the light of factors such as a fall in industrial output in a number of large countries. This is to some extent attributable to increased uncertainty on account of the trade conflict, primarily between the USA and China, and other political uncertainty as regards the future trade relationship between the EU and the UK. A number of indicators point to a high risk of a global economic slowdown within the next two years.² This increases the downside risks in the Faroese economy.

Like Denmark, the Faroe Islands is a small, open economy that is heavily dependent on foreign trade. Although the Faroese economy differs significantly from e.g. Denmark's, the business cycles of the two economies have to a large extent been synchronised, see Chart 3. So a global economic downturn can be expected to rub off on the Faroese economy.

The slowdown in many countries has not yet had an impact on the Faroese labour market, which reflects the strong dependence of the Faroe Islands on exports of fish. Catches of fish and salmon farming in the aquaculture sector are practically unaffected by international economic fluctuations. However, exports are sensitive to foreign shocks from changes in the prices of exported goods and services relative to import prices, i.e. the terms of trade. In fact, the decline in the value of exports over the last year is attributable to lower prices for salmon in particular. Whether this reflects an international economic slowdown is uncertain. World market prices for e.g.

Moderate wage growth outside the fisheries sector despite low unemployment

Chart 2

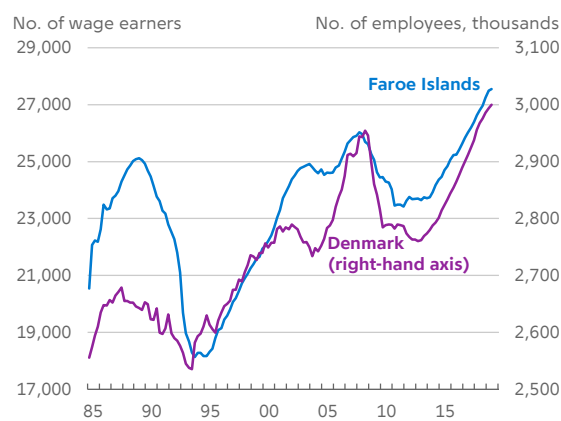


Note: Wage growth calculated as an implied wage index based on wage disbursements and number of wage earners. Fisheries and other resource industries have not been included as wages in fisheries are closely linked to earnings on the vessels. Hence, remuneration in fisheries includes a kind of profit-sharing, which does not provide a true view of general wage pressures in the Faroe Islands as a result of e.g. labour shortages.

Source: Hagstova Føroya and own calculations.

Historically, the Faroese and Danish economies have moved in tandem

Chart 3



Note: The scales for Denmark and the Faroe Islands are different, and the fluctuations for the Faroe Islands are thus relatively larger than for Denmark.

Source: Statistics Denmark and Hagstova Føroya.

² See Deanie Marie Haugaard Jensen and Rasmus Mose Jensen, Heightened risk of a global recession, *Danmarks Nationalbank Analysis*, No. 16, August 2019.

salmon are also highly sensitive to aquaculture developments in other countries.

Fiscal policy should ease pressures in the labour market

The slightly weaker export growth and a rising risk of an international economic slowdown do not mean that the Faroese economy is in need of fiscal policy stimulus. Given the strong capacity pressures in the economy, a flattening of labour market growth would be natural.

The Faroese government can help to ease immediate pressures by ensuring tighter fiscal policy in 2020. That will dampen demand and thus reduce labour market pressures. Tightening can be achieved by showing restraint as regards current expenditure and new building and construction projects, both centrally and locally. In September, the Faroese government tabled a Finance Bill for 2020 based on technical projections. The Faroese government's political priorities still remain to be seen as an election to the Løgting (parliament) was held on 31 August.

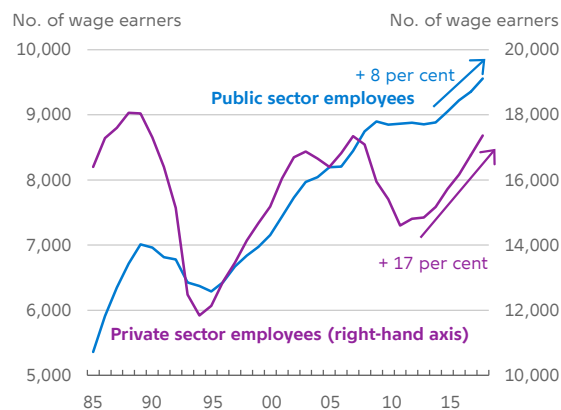
So far, fiscal policy has increased pressures in the labour market

So far, the increased tax revenue resulting from the strong economic growth has been converted into higher public sector spending. The relationship between activity levels in the private and public sectors is clearly reflected in employment. Employment in the public sector has risen substantially during the upswing as private sector employment has risen, see Chart 4.

Besides increasing current expenditure, the public sector has launched numerous building and construction projects, such as schools, hospitals and infrastructure. This has increased pressures in the

The public sector has amplified the upswing

Chart 4



Note: The arrows indicate the rise in the number of wage earners from 2013 to 2018.

Source: Hagstova Føroya.

construction sector, which is already highly cyclical. So, overall, fiscal policy has stimulated the Faroese economy in a period with capacity pressures.

The fact that public sector consumption and investments contribute to amplifying labour market pressures during a Faroese boom period is not a new phenomenon. Búskaparráðið's calculations have shown that fiscal policy has historically amplified fluctuations in the Faroese economy, i.e. it has been procyclical.³

The framework for local government finances should be reformed

Many public sector services are provided by the 29 municipalities in the Faroe Islands. Services are financed via e.g. taxation of household incomes and the local business sector, as no block grant is received from the central government, see Box 1. A considerable share of the increase in public sector employment since 2013 has taken place at the local level.⁴

³ See Búskaparráðið, Búskaparfrágreiðingar (report of the Economic Council for the Faroe Islands – in Faroese only), autumn 2015 ([link](#)).

⁴ Hagstova Føroya's 'municipalities, etc.' category does not include most of the area elder care, as such services are often undertaken by cross-municipal bodies. It has been taken into account that transfer of elder care had an impact on the number of people employed by Tórshavn municipality at the turn of the year 2015/16.

Local authorities have free reins to increase current and capital expenditure

Box 1

Among other things, local authorities provide services such as childcare and elder care, as well as the physical facilities for schools.¹

Unlike in Denmark, the framework for local government spending growth is not laid down in annual budget negotiations between central and local government. Nor is there an arrangement between the local authorities whereby funds are channelled into municipalities with special demographic challenges, e.g. because there are many old people requiring care. Local government is primarily financed via income taxes paid by local residents, and 30 per cent of central government revenue from corporation taxes is transferred to local authorities.

In addition, the central government transfers income from the taxation of pension contributions, whereby municipalities with a larger number of old people receive more per capita than other municipalities. Furthermore, the central government reimburses local government for loss of tax revenue from local residents who do not pay tax in the Faroe Islands because they work and pay taxes abroad.

The opportunities for local authorities to raise debt have been capped, but this is typically of no relevance in an economic upswing.

1. Teaching in schools is the responsibility of the central government.

The current framework for local government finances amplifies the procyclicality of the local government consumption and investment pattern. For example, local authorities may not save up for later years, but must use any budgeted surplus to reduce taxes, increase expenditure or invest. The framework for local government finances impedes the Faroese government's possibilities of conducting stability-oriented fiscal policy.

It would be appropriate to reform the fiscal policy framework. This can be done by changing the governance of the municipalities and laying down the central and local government budgets in binding agreements. Such a reform could contribute to stabilising economic developments in future. The Faroese economy is in itself characterised by substantial fluctuations on account of its strong dependence on fish, see Box 2. This underscores the importance of stability-oriented economic policies.

Immigration has prolonged the upswing

Employment has risen by 16 per cent since the beginning of 2013, mainly in the construction sector and the public sector. Part of the rise in employment in construction is attributable to the many large public sector building and construction

Strong dependence on fish makes the economy vulnerable

Box 2

The Faroese economy is a small and open food-exporting economy, concentrated on fish products. Fisheries and aquaculture account for one sixth of total gross value added and practically all exports of goods. This means that activities in the Faroe Islands are sensitive to changes in fish stocks and prices. Both fluctuate considerably over time, but not necessarily in the same direction for the various branches of fisheries and species. Earnings are spread across different branches of fisheries, which to some extent helps to reduce the vulnerability of the economy overall. Furthermore, the Faroe Islands have concluded a number of agreements with other countries, giving Faroese vessels the right to fish in the waters of those countries.¹ Such agreements may reduce the dependence on fish stocks in Faroese waters, thereby making the economy less vulnerable to fluctuations in these stocks. Nevertheless, the overall picture is that the economy will fluctuate strongly from time to time. A decline in fisheries may also, via direct and indirect effects, entail losses in the banking sector and further amplify real economic fluctuations.

1. See Box 1 in Sune Malthe-Thagaard, Boom and labour market pressure, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 17, September 2017.

projects, e.g. schools, port enlargements and tunnel construction. However, the increase in construction employment has come to a halt as the number of orders within the sector has declined according to the business indicator of Hagstova Føroya, Statistics Faroe Islands.

Growth in employment had pushed unemployment down to a mere 1.2 per cent in July. This is equivalent to the level at the peak of the boom leading up to the financial crisis and indicates that the labour market is very tight. The low level of unemployment is a challenge to firms, which are to a large extent stating that shortage of labour is an impediment to production.

The good employment opportunities in recent years have increased the labour force via immigration, see Chart 5. Increased immigration, especially of Faroese people living abroad, is a well-known phenomenon when the Faroese economy is booming. Conversely, many Faroese people move abroad when the economy deteriorates. However, the last year has also seen considerable immigration from Eastern Europe in particular.

Fish exports have peaked for now

Exports have risen sharply during the upswing, driven by a combination of favourable conditions in aquaculture and fisheries. Growth in exports reached a peak in 2017. During 2018 and in the 1st half of 2019, the value of exports has been more or less flat due to subsiding prices in the world market for both aquaculture and fisheries.

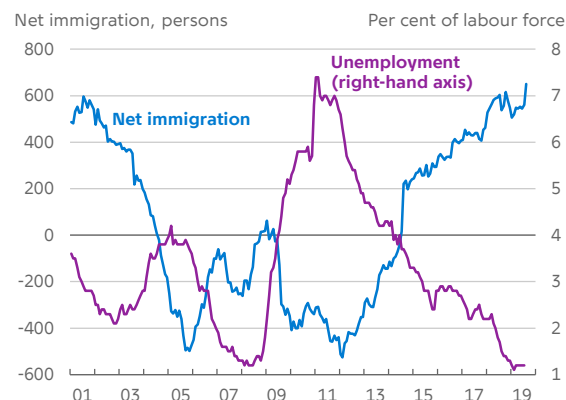
Lower prices for farmed salmon

In recent years, the aquaculture sector has been able to sell salmon at very high prices, and as a result their export value has doubled since 2012. Since early 2018, aquaculture exports have declined slightly due to lower world market prices and a slight downward trend in the volumes of slaughtered salmon, see Chart 6.

At present, aquaculture output capacity in the fjords has reached the biological limit that is compatible with preventing the outbreak of disease, etc. In other countries with extensive aquaculture, output is regularly disrupted by disease or algae blooms.

Much of the need for labour is covered via immigration

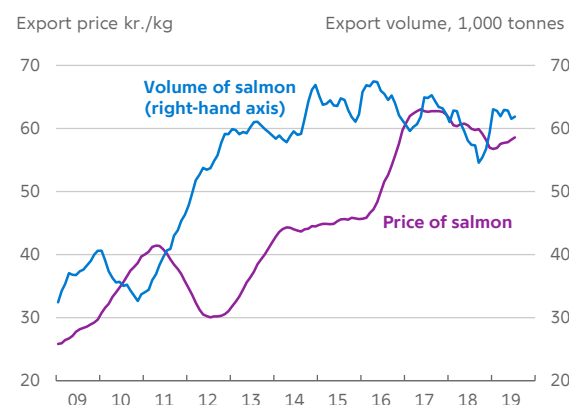
Chart 5



Note: Moving 12-month sum for net immigration.
Source: Hagstova Føroya.

The export value of salmon has fallen, mainly due to lower prices

Chart 6



Note: The export value is a moving 12-month sum, while the price is a 12-month average.
Source: Hagstova Føroya.

Outbreaks of disease among the salmon have previously constituted a problem for Faroese aquaculture. Most recently, the disease infectious salmon anaemia was discovered during a routine inspection of a production site. The necessary steps were taken and a clinical outbreak was prevented. This incident underscores the importance of good veterinarian standards and inspections of the predominant Faroese export industry.⁵

The largest Faroese aquaculture enterprise, Bakkafrøst, is currently investing heavily with a view to increasing output, e.g. via onshore facilities. Increased onshore production reduces the risk of disruptions due to the outbreak of diseases such as salmon lice.⁶

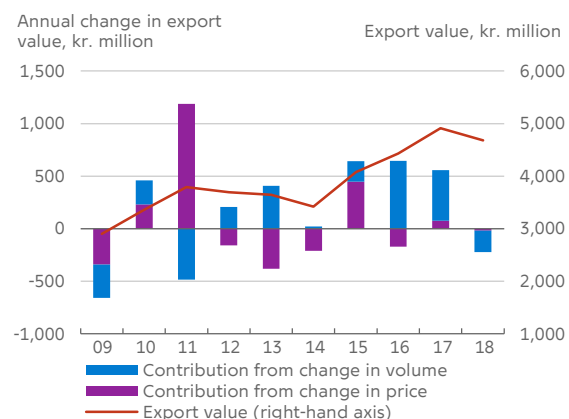
Catches of fish have declined a little since 2018

The fisheries sector has benefited from large catches, for which sales prices have also been higher in the last couple of years, see Chart 7. This positive trend has mainly been driven by fishing for mackerel and herring, known as pelagic species. On the other hand, traditional fishing for demersal species such as cod, haddock and saithe has been under pressure in recent years due to smaller catches and low prices.⁷ Earnings in the fisheries sector have generally been supported by relatively low oil prices since 2015. In 2018, exports of fish declined slightly.

The outlook points to catches of pelagic species generally remaining stable in 2020. However, for a number of years fishing for herring and blue whiting have exceeded the recommendations of the marine biologists in the International Council for the Exploration of the Sea, ICES, which may destabilise stocks in the longer term.⁸ As regards demersal species, especially cod and haddock stocks are improving, which may increase future catches for that part of the fishing fleet.⁹

After some years with strong growth, fisheries declined a little in 2018

Chart 7



Note: Annual changes in exports are broken down by changes in price and volume and are approximative. Fish exports, excluding salmon.

Source: Hagstova Føroya.

Strong dependence on fish exports makes the Faroese economy vulnerable

The Faroese economy's dependence on developments in fish exports makes it vulnerable. Recent years' growth in fish exports has taken place mainly in the Russian market. This reflects improved market access after Russia introduced a trade embargo on food from the EU and a number of other countries in response to those countries' sanctions against Russia. The Faroe Islands are not part of the EU and consequently not subject to the embargo.

Faroese access to the Russian market has led to higher sales prices than in a situation where EU member states would also be able to sell food to Russia. As a result, Faroese exports are potentially vulnerable to

⁵ See High Commissioner of the Faroe Islands, *Beretning* (report – in Danish only), 2019 ([link](#)).

⁶ See Bakkafrøst, *Interim report Q2 2019 and H1 2019* ([link](#)).

⁷ See High Commissioner of the Faroe Islands, *Beretning* (report – in Danish only), 2019 ([link](#)).

⁸ See International Council for the Exploration of the Sea, ICES Advice on fishing opportunities, catch, and effort (Northeast Atlantic and Arctic Ocean), (herring: [link](#); mackerel: [link](#); blue whiting: [link](#)).

⁹ See International Council for the Exploration of the Sea, ICES Advice on fishing opportunities, catch, and effort (Northeast Atlantic and Arctic Ocean), (cod: [link](#); haddock: [link](#)).

normalisation of trade relations between Russia and the EU. Overall, Faroese exports benefit from a greater geographical spread today than 15-20 years ago.

Thanks to strong growth in tourism, Faroese exports have become slightly more diversified in recent years. This can be seen from the number of airline passengers travelling to and from the Faroe Islands and from an increase in employment in the hotel and restaurant industry, see Chart 8.¹⁰

The number of overnight stays in hotels, youth hostels, etc. has risen by 40 per cent since 2013. Add to this letting of private homes via e.g. Airbnb and the derived effects on other industries. The increasing popularity of the Faroe Islands as a destination has boosted utilisation of hotel capacity. As a result, several new hotels are being built in Tórshavn and elsewhere. In the assessment of Hagstova Føroya, the share of gross value added attributable to tourism rose from 1.4 per cent in 2011 to 2.1 per cent in 2017.¹¹

Increased lending during the upswing

Since 2014, lending growth has been positive and exceeded GDP growth in 2017, see Chart 9. Lending growth may potentially soar within a few years, as seen in connection with the financial crisis, for example.¹²

For a number of years, GDP growth has exceeded the growth in lending. This indicates, inter alia, that business investments have been financed via savings, earnings or borrowing from foreign banks.

Lending to Faroese households constitutes more than half of the Faroese banks' lending in the Faroe Islands and mainly comprises bank loans for housing purposes. Since 2014, lending to households has increased

The Faroe Islands have become a more popular destination

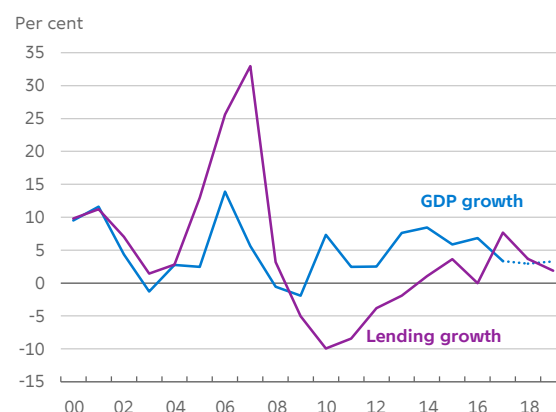
Chart 8



Source: Vága airport and Hagstova Føroya.

Growth in lending by Faroese banks rose during the upswing

Chart 9



Note: Data up to and including the 1st half of 2019. Preliminary GDP data for 2017-18. The 1st half of 2019 is an estimate of GDP growth in the 1st half. As far as possible, total lending has been adjusted for lending for non-resident customers.

Source: Búskaparráðið and reporting to the Danish Financial Supervisory Authority.

¹⁰ Part of the rise is also attributable to an increase in the Faroese population's travel activity and restaurant visits.

¹¹ See Hagstova Føroya, *Vitjandi ferðfólk, 2011 to 2018*, Búskapariskoyti, May 2018 ([link](#)).

¹² *Gongdin í bankageiranum*, Landsbanki Føroya (in Faroese only), May 2019 ([link](#)).

with around 3.8 per cent per year.¹³ In addition, the Faroese have increased their borrowing from Danish mortgage credit institutions since the end of 2017. At the end of the 1st half of 2019, mortgage loans constituted one quarter of total Faroese home financing. These loans are arranged by the Faroese banks.

Rising house prices may increase gross household debt

The increased lending to households should be seen in the light of the fact that house prices have increased considerably since 2014. The increase has occurred as household incomes have risen and interest rates have fallen. Prices have risen most steeply in the Tórshavn area and were 41 per cent higher in the 1st half of this year than in 2014, see Chart 10. Prices in and around Tórshavn have reached a level that fewer households are able and willing to pay. As a result, more people are moving to areas outside Tórshavn, which has led to rising house prices in the rest of the country. House prices may be a leading indicator of credit growth.¹⁴ Consequently, rising house prices may lead to higher growth in lending to households and hence higher gross debt.

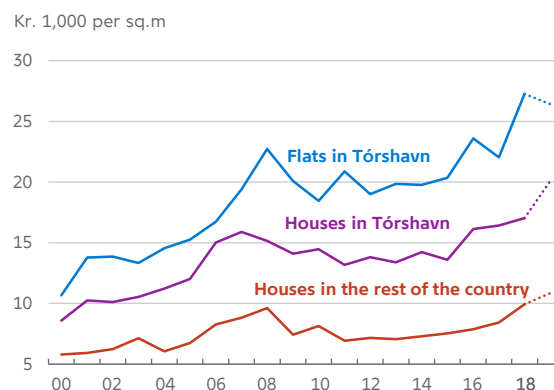
Nearly 92 per cent of household loans for housing purposes (bank loans and Danish mortgage loans combined) are at variable rates of interest. This means that high gross debt may have implications for financial stability if interest rates rise.

Large customer funding surplus may lead to easing of credit standards

On average, growth in lending by Faroese banks has been lower than growth in deposits. This has led to an increase in the banks' customer funding surplus¹⁵, which was kr. 5.8 billion at the end of the 1st half of

Increasing house prices in Tórshavn are spreading to the rest of the country

Chart 10



Note: 2019 comprises two quarters only, so the number of transactions is limited. For houses in the rest of the country, an average of the index for large and small towns, excluding Sandoy and Suðuroy, is shown.
Source: Hagstova Føroya and BankNordik.

2019, see Chart 11, and constituted 18 per cent of the banks' total assets. This development is attributable to factors such as consolidation among households and firms as a result of the economic upswing.

The low interest rate environment can put the banks' interest margins, and hence one of their sources of income, under pressure, so there is a risk that the large customer funding surplus may lead to easing credit standards in order to attract customers. Indeed, several banks point to fiercer competition as one of the reasons for their lower interest margins.¹⁶

¹³ Danmarks Nationalbank's statistics for banking and mortgage lending (balances).

¹⁴ See Oliver Grinderslev, Paul Lassenius Kramp, Anders Farver Kronborg and Jesper Pedersen, Financial cycles: What are they and what do they look like in Denmark?, *Danmarks Nationalbank Working Paper*, No. 115, June 2017.

¹⁵ The customer funding surplus is deposits in the Faroese banks less their lending. Deposits and lending are exclusive of counterparties that are central banks, banks, mortgage credit institutions or payment institutions, etc. The foreign branches of Faroese banks are included in the customer funding surplus. Furthermore, the customer funding surplus is also calculated adjusted for repos, so that repo deposits and loans are not included in the customer funding surplus. Series based on Danmarks Nationalbank's statistics for banking and mortgage lending (balances).

¹⁶ See *Annual report 2018*, BankNordik ([link](#)), *Ársrapport 2018*, Norðoya Sparikassi ([link](#)), *Ársfrásøgn 2018*, Betri Banki P/F ([link](#)).

The upswing has contributed to banks' high earnings despite low interest rates

The banks' return on equity has been above average since 2016, see Chart 12. This is primarily due to increased lending.

The average Common Equity Tier 1 ratio of the Faroese banks has risen by almost 4 percentage points since 2015. One of the reasons is that the capital buffer requirements for Faroese banks have increased. The capital conservation buffer and the systemic buffer have been phased in gradually since 2016 and 2018, respectively. In addition, the SIFI¹⁷ buffer has been phased in for the three systemically important banks since 2016. In March 2019, the Systemic Risk Council in Denmark decided to initiate an analysis of capital buffers in the Faroe Islands in collaboration with the Faroese Systemic Risk Council.¹⁸

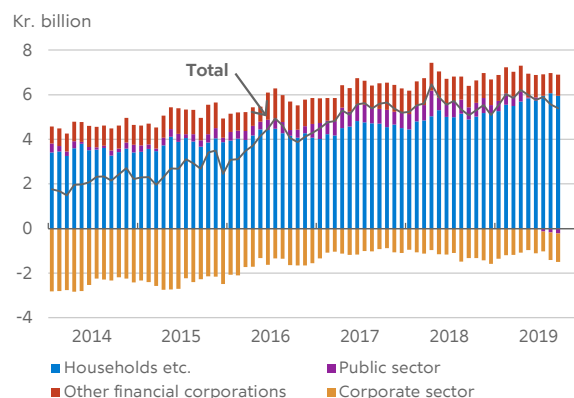
Public finances will be challenged in the coming decades

Like many other countries, the Faroe Islands are facing large challenges in terms of balancing government revenue and expenditure in the future. One of the reasons is that the number of people aged 70+ will almost double, to just over 11,000, by 2058, see Chart 13. More old people will increase expenditure for pensions and healthcare. At the same time, tax revenue will shrink because there will be fewer people of working age.

The public finances of the Faroe Islands are expected to be slightly more challenged than those of e.g. Denmark.¹⁹ This is, inter alia, because the population projections assume that net emigration will remain at the average level seen since 1985.²⁰ Although net immigration has been high in recent years, history

The customer funding surplus has increased since 2014

Chart 11

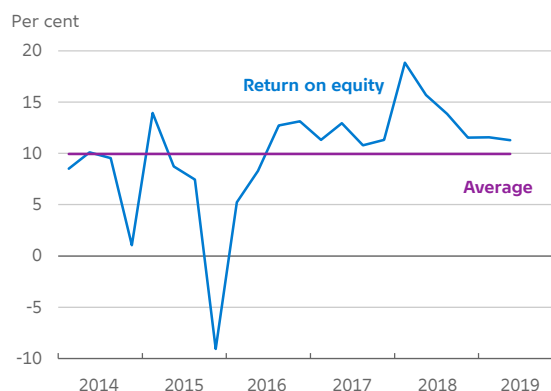


Note: Households including non-profit institutions serving households (NPISH). Other financial corporations are all financial corporations excluding central banks, banks, mortgage credit institutions and payments institutions, etc.

Source: Danmarks Nationalbank.

Return on equity has been above average since 2016

Chart 12



Note: Return on equity is the weighted average of the four Faroese banks over the period 1st quarter 2014-1st half 2019.

Source: Reporting to the Danish Financial Supervisory Authority.

¹⁷ Systemically important financial institution.

¹⁸ See the press release of the Systemic Risk Council, 26 March 2019 ([link](#)).

¹⁹ See Sune Malthe-Thagaard, Boom and labour market pressure, *Danmarks Nationalbank Analysis (The Faroese economy)*, No. 17, November 2018.

²⁰ See Búskaparráðið, *Búskaparfrágreiðingar* (report of the Economic Council for the Faroe Islands – in Faroese only), autumn 2019 ([link](#)).

shows that it can rapidly make way for net emigration when the economy goes into reverse, see Chart 14.

Obviously, projections of population figures several decades into the future are subject to uncertainty, especially when it comes to the fertility rate and net immigration, but nevertheless signs point to strong demographic headwinds for the Faroese economy. So unless the central government introduces extensive reforms, the government deficits are expected to increase steadily over the next 40 years.

In 2015, Búskaparráðið estimated that permanent fiscal tightening of 5 per cent of GDP will be required in order to ensure a long-term balance between expenditure and revenue, i.e. fiscal sustainability.²¹

Retirement reform contributes to fiscal sustainability

Although more people work after the age of 67 in the Faroe Islands than in many other countries, there is a considerable potential for increasing employment among those who have passed the current retirement age.

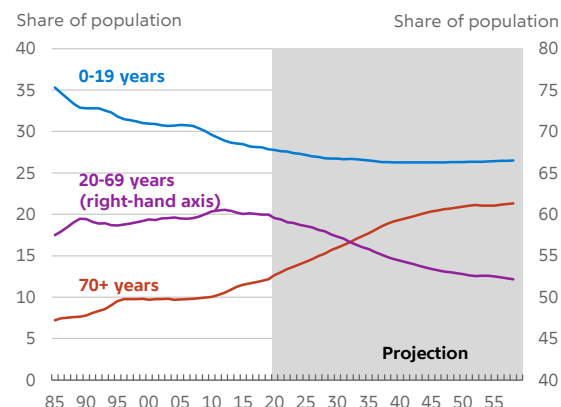
In 2018, the Løgting took an important step in that direction by increasing the retirement age by 1 year, to 68 years, in 2030. After that, the retirement age will to some extent mirror developments in life expectancy. According to Búskaparráðið estimates from 2015, an increase in the retirement age of that magnitude will solve only just under one quarter of the sustainability problem.²²

Reforms can ensure a balance between government revenue and expenditure

There is a need for further reforms to achieve a long-term balance between expenditure and revenue in the public sector. Both men and women already have a higher participation rate than in many other

Stronger demographic headwinds in the coming decades

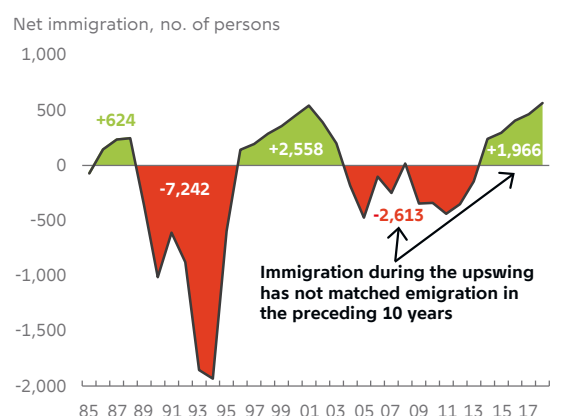
Chart 13



Source: Hagstova Føroya.

The many immigrants may rapidly leave again when the economy goes into reverse

Chart 14



Source: Hagstova Føroya.

²¹ See Búskaparráðið, Búskaparfrágreiðingar (report of the Economic Council for the Faroe Islands – in Faroese only), spring 2015 ([link](#)).

²² Búskaparráðið stated that an increase in the retirement age from 67 to 72 towards 2048 can improve sustainability by 1.9 per cent of GDP.

countries. So there is little potential for increasing employment among people of working age via reforms.

Basically, this leaves three types of reform that can help to balance government budgets in the long term: full indexation of the retirement age to match developments in life expectancy, higher taxes and lower expenditure for public sector services.

Higher retirement age can contribute further to fiscal sustainability

Under the current rules, the retirement age will be 70 years in 2050 if life expectancy continues to increase at the same pace as it has so far. By comparison, the retirement age in Denmark is expected to be 72 years.²³ One of the reasons for this difference is that a cap applies in the Faroe Islands, so that the retirement age cannot rise by more than six months every five years. The rise in life expectancy has been twice as high as that over the past 20 years. If this trend continues, the cap of the indexation rule means that the number of years in retirement will continue to grow.

Consequently, it is possible to achieve a greater contribution to solving the fiscal sustainability problems by introducing further reforms so that the retirement age e.g. mirrors developments in life expectancy one-to-one.

Reforms of the tax system can contribute to fiscal sustainability

Tax reforms may also contribute substantially to ensuring fiscal sustainability. For example, introduction of housing taxes and phasing-out of interest subsidies for housing loans could increase central government revenue, see Box 3. Such reforms would also increase the stability of the Faroese economy and dampen fluctuations in the Faroese housing market.

The Faroese government can also ensure that it gets a larger share of the “economic rent” from the Faroe Islands’ fish resources.

Examples of tax reforms

Box 3

The tax system can be adjusted in a number of areas, e.g.:

Introduction of a housing tax

Faroese homeowners pay neither land nor property taxes. The rising house prices make this a good time to introduce a tax on housing, which is a source of taxation that creates little distortion of household behaviour compared with other objects of taxation. At the same time, housing taxation is an automatic stabiliser that could support the stability of both the housing market and the Faroese economy if the tax payments are linked to housing market prices.

Phasing-out of interest subsidies

The central government pays a subsidy of 35 per cent of interest costs on housing loans. This subsidy cannot exceed kr. 100,000. The ceiling is binding on fully loan-financed houses of more than approximately kr. 10 million only. In other words, the central government subsidises debt financed house purchases, which buoys up house prices. The low interest rates mean that this is a good time to phase out the interest subsidies.

Neutral taxation of Faroese people working abroad

A large number of Faroese people live in the Faroe Islands but work abroad, attracted by higher wages and considerable tax deductibility. The Faroese government may reduce the amount deductible, thereby increasing tax revenue and countering the shortage of labour. This could ensure better consistency with the separation allowance costs actually associated with working abroad and maintaining their primary residence in the Faroe Islands.

Due to its relatively cheap access to fishing rights, the fisheries sector may generate higher profits than firms in an open and free market subject to similar risk.²⁴ Inexpensive access to fishing rights may also result in higher wages for employees on the fishing vessels concerned than for employees in other sectors when any risks and inconveniences associated with working on a ship are taken into account.

The low taxation of fish resources not only has an impact on the distribution of the economic rent be-

²³ See Ministry of Finance, *Reply to question no. 386 (Ord. part) of 6 June 2018 from the Finance Committee, asked at the request of Benny Engelbrecht (Soc. Dem.)*, 2 July 2018 (in Danish only) ([link](#)).

²⁴ This mechanism has long been known by fisheries economists, see e.g. Jens Warming, *Om grundrente af fiskegrunde* (on economic rent from fishing grounds – in Danish only), *Nationaløkonomisk Tidsskrift*, No. 49, pp. 499-505, 1911, and Jens Warming, *Aalegaardsretten* (the right to place eel weir – in Danish only), *Nationaløkonomisk Tidsskrift*, No. 69, pp. 151-162, 1931.

tween the sector and the central government. There is also a risk that high wages and earnings in fisheries bind more labour and capital in the sector than required. This may impede productivity in the sector and thus prosperity in the Faroe Islands.

The new government formed after the general election on 31 August stated in its Coalition Agreement that the 2017 fisheries reform needs to be amended, see Box 4. The proposed changes to the fisheries regulation was sent in public hearing in October.²⁵ The government wants the fishing quotas currently auctioned off to be converted into licences as the auctioned terms expire.

It is important that, as a minimum, proceeds to the central government from taxes on the shared resources do not shrink as a result of such a reform. Furthermore, there is still a potential for increasing central government revenue from fisheries. This may contribute to ensuring fiscal policy sustainability over the coming decades.

Sufficiently flexible fisheries legislation can help to improve the socioeconomic exploitation of the fish-

ing quotas and, for example, ensure that the sector reaps the full benefits of technological advances. Better utilisation of the quotas will stimulate productivity growth in the sector, e.g. by improving the use of fishing capacity, possibly via a reduction of the number of vessels.

Initial proposal from the Faroese government for amending the regulation of fisheries

Box 4

In December 2017, the Løgting agreed on a reform of the allocation of quotas whereby a limited share of the fishing quotas are auctioned off.¹ According to the Coalition Agreement, the new government wants to phase out the auctions so that these quotas can, once again, be allocated as licences with rolling 10-year terms of notice. The licences will be linked to the individual vessels again, and the government will seek to manage fisheries as individual fishing quotas. Flexibility of and incentives to allocate quotas to fewer vessels may ensure that the system does not impede productivity growth in the sector.²

1. See the descriptions of the 2017 reform in Danmarks Nationalbank's analyses of the Faroese economy from 2017 ([link](#)) and 2018 ([link](#)).
2. See e.g. Peder Andersen, Udnyttelse af naturressourcer: EU og fisk som eksempel (Utilisation of natural resources, taking EU and fish as an example – in Danish only), *Samfundsøkonomen*, No. 2, 2003.

25 See Uppskot til Løgtinglóg um sjófeingi (proposed new fishing act, in Faroese only) ([link](#)).

ABOUT ANALYSIS



As a consequence of Danmarks Nationalbank's role in society we conduct analyses of economic and financial conditions.

Analyses are published continuously and include e.g. assessments of the current cyclical position and the financial stability.

The analysis consists of a Danish and an English version. In case of doubt regarding the correctness of the translation the Danish version is considered to be binding.

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