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EUROPEAN COMMISSION

Brussels, 27.1.2011
SEC(2011) 115 final

COMMISSION STAFF WORKING PAPER

Analysis by the Commission services of the action taken

by Denmark

in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive government deficit

COM(2011) 22 final
SEC(2011) 113 final
SEC(2011) 114 final
SEC(2011) 116 final

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1. INTRODUCTION

The impact of the economic downturn and a discretionary fiscal stimulus triggered a deterioration of public finances in Denmark. The general government balance turned from a surplus of 3.2% of GDP in 2008 into a deficit of 2.7% of GDP in 2009, widening to an expected 5.5% of GDP in 2010 in the Commission services' spring forecast[1]. Against this background, on 13 July 2010, the Council decided that an excessive deficit existed and addressed recommendations to Denmark in accordance with Article 126(7) TFEU with a view to bringing an end to the situation of an excessive government deficit by 2013[2]. In its recommendations, the Council established a deadline of 13 January 2011 for effective action to be taken.

The Council recommended Denmark to bring the general government deficit below 3 % of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, Denmark should: (a) implement the fiscal measures in 2010 as envisaged in the latest update of the convergence programme and start consolidation in 2011 in order to bring the deficit below the reference value by 2013; (b) ensure an average annual fiscal effort of at least 0.5 % of GDP over the period 2011-2013; (c) specify and rigorously implement the measures that are necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

This paper examines the actions taken by Denmark to meet the above recommendations, in light of the economic and budgetary developments since the Council recommendations were issued on 13 July 2010. In particular, it examines the budgetary consequences between 2011 and 2013 of the 2011 budget and the consolidation measures presented by the government on 25 May 2010. The assessment takes into account the information on effective action taken provided by the Danish Ministry of Finance to the Commission on 13 January 2011.

2. ECONOMIC DEVELOPMENTS

After a sharp contraction of 5.2% in 2009 (compared to -4.1% for the euro area), the Danish economy has rebounded strongly, with real GDP growth expected to reach 2.3% in 2010 in the Commission services' autumn forecast (0.7 pp. higher than projected in spring). The current recovery has been driven mainly by domestic demand and a strong inventory rebound.

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1 In the spring forecast the 2009 deficit was projected at 2.8% of GDP.

2 All EDP-related documents for Denmark can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/denmark_en.htm

Government interventions to cushion the negative effect of the crisis on the labour market and on confidence contributed to the rather swift turnaround. In 2011 and 2012, real GDP growth is forecast to revert to a more moderate path, with annual rates of 1.9% and 1.8%, respectively.

In their latest economic update (December 2010), Denmark has also revised upwards their forecast compared to the 2010 convergence programme (submitted in February 2010). They now expect real GDP to grow by 2.0% in 2010. However, for 2011-12, the national authorities forecast GDP growth rates of around 1.6% per year, below what was projected in the 2010 convergence programme and slightly below the Commission services' autumn forecast. Hence, despite the upward revision for 2010, the national authorities maintain a cautious outlook for the whole 2010 - 2012 period.

Table 1: Comparison of macroeconomic developments and forecasts

	2009	2010			2011			2012		2013
	Outturn	COM SF10	COM AF10	CP10	COM SF10	COM AF10	CP10	COM AF10	CP10	CP10
Real GDP (% change)	-5.2	1.6	2.3	1.3	1.8	1.9	1.6	1.8	2.0	2.3
Contributions to real GDP growth										
Final domestic demand	-4.3	0.6	0.8	1.0	1.8	1.3	1.3	1.7	2.2	2.3
Changes in inventories	-2.0	0.8	1.2	0.6	0.1	0.5	0.3	0.0	0.2	0.2
Net exports	1.2	0.1	0.2	-0.3	-0.1	0.1	-0.1	0.1	-0.3	-0.2
Employment (% change)	-3.1	-1.9	-1.4	-2.5	-0.1	0.3	-0.1	0.3	0.3	0.4
GDP deflator (% change)	0.4	1.1	2.4	2.0	1.6	2.3	1.7	2.2	2.3	2.4

Source: COM SF10 - Commission services' spring 2010 forecast; COM AF10 - Commission services' autumn 2010 forecast, CP10 - Danish authorities' Convergence Programme (February 2010)

3. BUDGETARY PROJECTIONS FOR THE PERIOD 2011-2013

The recovery, which turned out stronger than anticipated in the spring forecast, is expected to have positive effects on Denmark's public finances. Expenditures are now expected to rise slightly less this year and the fall in government revenues is forecast to be less pronounced. In particular the better-than-expected performance of the labour market will help to cushion the deterioration of income tax receipts and reduce the cost of automatic stabilisers.

Over the period 2010-2013, the Commission services' forecasts and the 2010 Convergence Programme estimates for total government expenditures and revenues are similar. Both the Commission services and Danish authorities project a steady reduction of the budget deficit. The autumn forecast projects a deficit of 3.5% of GDP in 2012. Compared to the Convergence Programme, the projected budget deficits are slightly higher in the latest update of the Danish authorities' macroeconomic scenario, though, which is broadly in line with the Commission's autumn forecast[3]. These revisions do not derail the overall trajectory of deficit reduction.

[3] The Danish government's budget balance for 2010 is lower than the Commission services' 2010 autumn forecast primarily due to a temporary and unexpected boost of pension yield taxation revenues, which was not included in the Commission services' forecast. These revenues could consequently turn out lower in 2011 than foreseen in the Commission services' forecast.

Despite the projected improvement in Denmark's primary and nominal budget balance, the structural balance is estimated to deteriorate from -2.5% of GDP in 2010 to -3.0% of GDP by 2012 according to Commission services' calculations based on the commonly-agreed methodology. Denmark's potential growth rate over the period 2010 – 2013 is estimated to be only 0.4% per annum on average, which is unusually low and could point to uncertainties in the calculation of Danish potential output at the current juncture. As a result, the implied rapid narrowing of the output gap between 2010 and 2012 might overstate the cyclical component of the budgetary adjustment.

Table 2: Composition of the budgetary adjustment

	2009	2010						2011						2012				2013	
	Outturn	COM SF10		COM AF10		CP10		COM SF10		COM AF10		CP10		COM AF10		CP10		CP10	
	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP	yoy %-ch	% of GDP
Primary expenditure	56.5	4.0	57.1	3.9	56.1	-	56.1	1.4	55.9	2.3	55.0	-	54.8	2.4	54.2	-	53.0	-	51.5
Interest expenditure	1.8	6.0	2.1	4.0	1.8	-	1.6	7.0	2.2	8.0	1.9	-	1.7	8.0	1.9	-	1.9	-	2.1
Total expenditure	58.3	4.1	59.2	3.9	57.9	-	57.7	1.6	58.1	2.5	56.9	-	56.5	2.6	56.1	-	54.9	-	53.6
Current taxes on income and wealth	30.0	-6.6	27.4	-4.9	27.2	-	28.4	2.7	27.1	4.2	27.2	-	28.5	4.2	27.2	-	28.1	-	27.9
Taxes on production and imports	16.9	5.7	17.3	4.8	16.9	-	17.1	2.6	17.1	4.3	16.9	-	17.2	4.6	17.0	-	17.2	-	17.4
Total current taxes	46.9	-2.2	44.7	-1.4	44.1	-	45.7	2.7	44.2	4.2	44.1	-	45.9	4.4	44.2	-	45.5	-	45.5
Total revenues	55.6	-2.2	53.7	-1.3	52.8	-	52.4	2.5	53.3	4.2	52.6	-	52.4	4.3	52.6	-	51.8	-	51.8
Primary balance	-0.9		-3.4		-3.3		-3.7		-2.7		-2.4		-2.3		-1.5		-1.2		0.3
Budget balance	-2.7		-5.5		-5.1		-5.5		-4.9		-4.3		-4.2		-3.5		-3.2		-1.9
Structural budget balance	0.9		-2.7		-2.5		-1.7		-3.1		-2.9		-1.0		-3.0		-0.7		-0.2
Real GDP growth	*-5.2*	*1.6*		*2.3*		*1.3*		*1.8*		*1.9*		*1.6*		*1.8*		*2.0*		*2.3*	
GDP deflator	*0.4*	*1.1*		*2.4*		*2.0*		*1.6*		*2.3*		*1.7*		*2.2*		*2.3*		*2.4*	
Nominal GDP	*-4.8*	*2.7*		*4.7*		*3.3*		*3.4*		*4.2*		*3.3*		*4.0*		*4.4*		*4.7*	

Source: COM SF10 - Commission services' spring 2010 forecast; COM AF10 - Commission services' autumn 2010 forecast, CP10 - Danish authorities' February 2010 Convergence Programme (February 2010)

Due to the uncertainties in the calculation of potential output at the current juncture, the top-down assessment of effective action based on structural budget balances needs to be complemented by a bottom-up approach of measures adopted and enacted in Denmark. In May 2010 parliamentary support was secured for a set of additional consolidation measures to the already announced phasing-out of crisis-related expansionary measures. These consolidation measures include postponing previously planned tax cuts and temporarily suspending the automatic indexation of various tax thresholds (so-called "§20 regulation") until 2014, reforming and shortening the unemployment benefit period from four to two years and introducing a ceiling on deductions for trade union membership fees. In addition, government consumption growth is restrained between 2011 and 2013. The fiscal consolidation agreement foresees the achievement of a structural budget balance by 2015.

Table 3 presents an overview of these measures and an estimation of their impact on public finances: taken together, the measures are estimated to result in an average annual consolidation of about ½% of GDP over the period 2011 to 2013. The measures from the May consolidation package have already been introduced into law, as recommended by the Council. In addition, the budget for 2011 reconfirms the government's intention to contain government consumption growth. Amendments to the way municipalities are financed and their expenditures are controlled should help to reduce the risk of expenditure overruns. On top of the May fiscal consolidation agreement, earlier discretionary measures also contribute to the consolidation efforts over the period 2011-2013.

In addition to the measures already adopted by the Danish parliament and introduced into the 2011 budget, two further initiatives underway are likely to have budgetary implications in the coming years. First, a students' grant reform is currently being negotiated, which could result in a reduction in the duration of student grants. The reform would thus be expected to further reduce government spending, but in the absence of a clear agreement, it is difficult at present to quantify the effects on the government budget. Second, the government has proposed a phasing-out of the early retirement scheme by 2034 with an expected positive impact on long-term sustainability but with short-term budgetary costs. In particular, this reform might result in a significant one-off effect on the government budget balance in 2012. This one-off cost would not impact on the correction of the excessive deficit by 2013.

Table 3: Additional consolidation measures adopted by the Danish government in the May agreement

billion DKK	**cumulative**			**per year**		
Tax and labour market measures	2011	2012	2013	2011	2012	2013
Suspension of §20 regulation from 2011 to 2013	2.1	4.2	6.6	2.1	2.1	2.4
Postponement of tax brackets for three years	1.8	1.9	2.0	1.8	0.1	0.1
Unemployment benefit reform		0.3	1.7	0.0	0.3	1.4
Ceiling on deductions	0.9	1.6	1.6	0.9	0.7	0.0
Total savings on labour market and tax measures	4.8	8.0	11.9	4.8	3.2	3.9
Freeze on government expenditure growth	4.5	9.0	13.5	4.5	4.5	4.5
Financing of other measures [1]	*0.3*	*0.6*	*0.9*	*0.3*	*0.3*	*0.3*
Savings May consolidation agreement	9.0	16.4	24.5[2]	9.0	7.4	8.1
Savings May consolidation agreement (% of 2009 GDP)	0.5	1.0	1.5	0.5	0.4	0.5

Source: Danish Ministry of Finance, Budget Overview December 2010, appendix 2.1

[1] To fund other measures, the government expects to incur total supplementary expenses of DKK 0.9 bn over three years. In the absence of spending details, this amount is spread evenly over the three-year period.

[2] Due to indirect effects on - among others - VAT revenues, the structural balance is strengthened by DKK 22 billion.