EUROPEAN COMMISSION

Brussels, 12.5.2010
SEC(2010) 585 final

REPORT FROM THE COMMISSION

Denmark

Report prepared in accordance with Article 126(3) of the Treaty

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1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the budget balance as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn has brought about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan foresaw that the stimulus should be differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to prepare a report such as the present one whenever an actual or planned deficit of a Member State exceeds the 3% of GDP reference value. This report, which represents the first step in the "excessive deficit procedure" (EDP), analyses the reasons for the breach of the reference value with due regard to the economic background and all other relevant factors. The amendments to the Stability and Growth Pact in 2005 aimed specifically at ensuring that in particular the economic and budgetary background was fully taken into account in all steps in the EDP. This means for instance that, if an "excessive deficit" is deemed to exist, adequate consideration needs to be paid to the economic background and outlook when making recommendations on the pace of the correction. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

2. LEGAL BACKGROUND

This report, which assesses recent and current budgetary developments in Denmark and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government, is prepared according to Article 126(3) of the Treaty on the Functioning of the European Union (TFEU).

Article 126 TFEU includes the provisions for an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”[1], which is part of the Stability and Growth Pact. According to Article 126(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

According to data notified by the Danish authorities in April 2010[2], the general government deficit is planned to reach 5.4% of GDP in 2010, thus exceeding the 3% of GDP reference value, while general government gross debt would amount to 45.1% of GDP, below the 60% of GDP reference value, but higher than five years ago and on a rising trend.

Table 1: General government deficit and debt [a]

	2004	2005	2006	2007	2008	2009	2010		2011
							COM	DK	COM
General government balance	2.1	5.2	5.2	4.8	3.4	-2.7	-5.5	-5.4	-4.9
General government gross debt	44.5	37.1	32.1	27.4	34.2	41.6	46.0	45.1	49.5

Note:
[a] *In percent of GDP.*
Source: Eurostat, Commission services’ spring 2010 forecast, the April 2010 EDP notification.

The planned figure in the notification for the deficit in 2010 provides *prima facie* evidence on the existence of a planned excessive deficit in Denmark in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore decided to initiate the excessive deficit procedure for Denmark with the adoption of this report. Section 3 of the report examines the deficit criterion and section 4 deals with public investment and other relevant

[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of Stability and Convergence Programmes”, endorsed by the ECOFIN Council of 10 November 2009, available at http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm.

[2] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Denmark can be found at: http://epp.eurostat.ec.europa.eu/portal/government_finance_statistics/procedure/edp_notification_tables

factors. This report takes into account the Commission services' spring 2010 forecast, released on 5 May.

3. DEFICIT CRITERION

According to the April 2010 notification of the Danish authorities, the general government deficit is planned to reach 5.4% of GDP in 2010.

Well in excess of 3% of GDP, the planned deficit is not close to the Treaty reference value.

The planned excess over the 3% of GDP reference value can be regarded as exceptional. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. According to the Commission services' 2010 spring forecast, real GDP in Denmark is projected to recover at 1.6% in 2010 after the sharp contraction of 4.9% in 2009. The 2009 recession reflected the abrupt decline in private investment, consumption and foreign trade in the export-oriented manufacturing sector as a consequence of the financial crisis and the global slowdown, in particular the much lower growth prospects of the main trading partners (Germany, United Kingdom, Sweden and Norway). The deficit in 2010 is a consequence of both the economic downturn and the stimulus measures taken in line with the EERP by the Danish authorities.

The excess over the 3% of GDP reference value can not be regarded as temporary in the sense of the Treaty and the Stability and Growth Pact. The Commission services' spring 2010 forecast projects that, taking into account the measures adopted in the current year for the 2010 budget, the deficit would decline to 4.9% of GDP in 2011 on a no-policy change[3] basis. According to the February 2010 update to the convergence programme, the deficit is projected to decline to 4.1% of GDP in 2011 and to decline further in 2012 to 3.1% of GDP before reaching 1.8% of GDP in 2013, based partly on already implemented measures such as the financing elements of the 2010 tax reform and normalisation of public investments.

Table 2: Macroeconomic and budgetary developments [a]

	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP (% change)	2.3	2.4	3.4	1.7	-0.9	-4.9	1.6	1.8
Potential GDP (% change)	1.2	1.3	1.7	1.6	1.4	0.4	0.4	0.6
Output gap (% of potential GDP)	-0.3	0.8	2.5	2.6	0.2	-5.1	-3.9	-2.7
General government balance	2.1	5.2	5.2	4.8	3.4	-2.7	-5.5	-4.9
Primary balance	4.4	7.1	6.8	6.3	4.8	-0.7	-3.4	-2.7
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.0
Government gross fixed capital formation	1.9	1.8	1.9	1.9	1.8	2.1	2.4	1.9
Cyclically-adjusted balance	2.3	4.7	3.5	3.1	3.3	0.6	-3.0	-3.1
Cyclically-adjusted primary balance	4.6	6.5	5.2	4.7	4.7	2.6	-0.9	-1.0
Structural balance [b]	2.3	4.7	3.5	3.1	3.3	0.6	-2.7	-3.1
Structural primary balance	4.6	6.5	5.2	4.7	4.7	2.6	-0.6	-1.0

[3] The no-policy change forecast takes into account the (partial) withdrawal of measures of extraordinary nature linked to the crisis.

Notes:
[a] *In percent of GDP unless specified otherwise.*
[b] *Cyclically-adjusted balance excluding one-off and other temporary measures.*
Source: Eurostat, Commission services' spring 2010 forecast, the April 2010 EDP notification.

In sum, the planned deficit in 2010 is not close to the 3% of GDP reference value and although the excess over the reference value can be regarded as exceptional it is not temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled.

4. RELEVANT FACTORS

Article 126(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors including the medium-term economic and budgetary position of the Member State". These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that "any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council" need to be given due consideration.

In view of the above provisions, the following four subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position (including public investment); (3) other factors put forward by the Member State and (4) other factors considered relevant by the Commission.

4.1. Medium-term economic position

Cyclical conditions and potential growth. Prior to the current global crisis, Denmark had benefited from an extended period of rapid growth, building up a substantial surplus in the current account and in the government finances. This has allowed Denmark to implement a large discretionary fiscal stimulus amounting to about 3½% of GDP over 2009-2010 and to allow the full operation of automatic stabilisers, which to some extend has cushioned the effect of the crises on the domestic market. The Commission services' spring 2010 forecast projects a Danish GDP growth of 1.6% in 2010, driven by a rebound in private consumption and stockbuilding. In 2011, the moderate recovery is set to continue, with real GDP growth reaching 1.8%, as investments begin to pick up. The output gap turned strongly negative in 2009 and 2010. According to Commission services' calculations, potential output growth was below its long-run average of 2% in the last 3 years, and is projected to abate further to ¾% in 2010 and 2011, reflecting a decrease in labour contribution and lower capital accumulation as a result of a drop in investment.

Recent structural reforms. At a microeconomic policy level, Denmark's National Reform Programme 2008-2010 (NRP) outlines as a priority the strengthening of the educational system and the research and development environment. Cornerstones of the national reform programme are ambitious goals to have 95% of a youth cohort have an upper secondary education and 50% to have a tertiary education by 2015 and increasing spending R&D in the public sector to 1% of GDP. According to the 2009 NRP spending on public R&D would reach 1% of GDP in 2010 and with private spending at about 2% of GDP total spending on R&D stands at about 3% of GDP, which is in line with the Lisbon Strategy for Growth and Job's objective. The 2009 tax reform significantly lowered the tax burden on labour income and strengthened incentives to work and save. At the same time e.g. tax on energy consumption or excise duties were raised.

4.2. Medium-term budgetary position

Structural deficit and fiscal consolidation in good times. Between 2006-2008 Denmark was clearly in economic good times, as assessed in terms of strong GDP growth and a positive output gap. However, the structural balance worsened markedly by 2.7 pp in 2009 to 0.6% of GDP and is expected to deteriorate further to -2.7% of GDP in 2010. One-offs, according to the Commission services' estimates, amount to 0.2% of GDP deficit reducing in 2010 due to a capital transfer stemming from a reform of the pension yield taxation. The output gap turned negative in 2009 at -5.1% of GDP and is expected to improve to -3.9% in 2010, which suggest that Denmark is experiencing economic bad times in both 2009 and 2010. Denmark's medium-term objective (MTO) is to achieve a structurally balanced budget by 2015. The structural balance, as recalculated by the Commission services' using the commonly agreed method, is projected to be slightly negative by -0.4% in 2015. According to the Commission services' 2010 spring forecast, the structural deficit is expected to increase by 2.1 p.p. in 2010 and increase by 0.4 p.p. in 2011, suggesting that the fiscal stance is expansionary in 2010 and in 2011.

Public investment. Government investment (as a share of GDP) averaged slightly below 2 % of GDP from 2005 to 2009, increasing to just above 2% of GDP in 2009 and is expected to increase to about 2½% of GDP in 2010 on account of the fiscal stimulus measures taken. From 2011 government investments are expected to begin normalising as fiscal consolidation takes hold and gradually return to previous levels. The general government deficit is therefore expected to exceed total public investments in both 2010 and 2011. The structural budget balance according to the Commission services' 2010 spring forecast is expected to show a deficit of 2.7% of GDP in 2010 and 3.1% of GDP in 2011. Government investments are therefore not expected to exceed the structural budget balance in both 2010 and 2011.

Quality of public finances. General government expenditure fell from about 55% of GDP in 2000 to 50.9% in 2008. Driven by the measures in response to the economic and financial crisis and additional expenditure due to automatic stabilisers, the expenditure-to-GDP ratio is expected to increase by 6.8 percentage points to 57.7% of GDP in 2010. The February 2010 convergence programme acts as an update of the Danish macro-fiscal framework, the 2015 plan, and puts forward the fiscal requirements for long-term sustainability of public finances. According to the convergence programme, part from the financing elements of the 2010 tax reform and the normalisation of public investments, fiscal consolidation will take hold from 2011 through expenditure constraints while ruling out tax increases. The programme targets zero real growth in public consumption expenditure from 2011 to 2013.

Long-term sustainability of public finances. In its opinion of 26 April 2010 on the most recent convergence programme, the Council assessed the long-term sustainability of Denmark's public finances as follows. The long-term budgetary impact of ageing is clearly lower than the EU average. The budgetary position in 2009, as estimated in the programme, contributes to the reduction of gross debt. Ensuring high primary surpluses over the medium term would contribute to reducing the risks to the sustainability of public finances which were assessed in the Commission 2009 Sustainability Report as low.

4.3. Other factors put forward by the Member State

The authorities of Denmark have submitted a list of relevant factors according to Article 2(3) of Council Regulation (EC) No 1467/97. The list is replicated below.

The global financial crisis affected the Danish economy significantly. The fiscal balance is expected to deteriorate from a surplus of 3½ per cent of GDP in 2008 to a deficit of close to 5½ per cent of GDP in 2010. Close to 2/3 of the deterioration in public finances reflects the direct budgetary impact from the economic slowdown, notably the operation of automatic stabilisers, which are large in Denmark. A good 1/3 reflects expansionary fiscal measures of a total of 3.5 per cent of GDP in 2009 and 2010, including public investments and tax reform, in line with the EERP to cushion the effects of the crisis on economic activity and employment. The Danish economy is expected to recover gradually in 2011-2015.

Denmark has a strong track record of sound public finances, including consolidating public finances in good times. Fiscal surpluses amounted to 4.6 per cent of GDP on average in 2005-2008, with structural surpluses of 1.8 per cent of GDP on average during the same period. Denmark has a track record of largely countercyclical fiscal policy as measured by the fiscal effect. The key fiscal policy target is to achieve structural balance on public finances by 2015, which is Denmark's MTO. Balance in 2015 will halt debt accumulation and allow fiscal policy to fulfil the long-term requirement of fiscal sustainability. The planned improvement in the structural balance of 1½ per cent of GDP from deficit of around 1½ per cent of GDP in 2010 will bring the structural fiscal position close to balance in 2013. The planned structural improvement will thus be an important step on the way towards the primary objective of structural balance in 2015.

The concept of fiscal sustainability has been a key focus in fiscal planning since the 1990's and form the basis of the government's medium term plans. Besides consolidation, structural reforms contribute to sustainability. Thus, the welfare agreement of 2006 includes a major pension reform, which significantly supports long-term fiscal sustainability. The 2009 tax reform significantly lowers the tax burden on labour income and strengthens the incentives to work and save, while raising taxes on energy consumption, excise duties etc. The reform is fully financed over time in terms of direct revenue effects and strengthens public finances in the long run by 0.3 per cent of GDP. The Government will initiate the preparation of a comprehensive plan which will outline key structural and fiscal policy requirements towards 2020 aiming at maintaining the overall objective of long-term fiscal sustainability.

Apart from the deficit on public finances and rising unemployment, the Danish economy does not suffer from other imbalances. Denmark has a current account surplus estimated at 2.9 and 2.4 per cent of GDP in 2009 and 2010 respectively and low inflation. Even though gross public debt has risen due to the public finance effects of the crisis, it remains on a relatively low level and net debt – which includes all financial assets and liabilities of the general government – stood at a net asset position of 3.8 per cent of GDP in 2009. In a recent analysis the Commission has found that Denmark is among the Member States with the strongest fiscal framework. Expenditure rules, in combination with (structural) balance rules and revenue rules (tax freeze) have been effective in reconciling fiscal discipline and stabilisation. The long-term interest rate spread vis-à-vis Germany has remained on low levels and below most euro area member states. While the public sector retains risks on guarantees extended to the financial sector, including individual loan guarantees after the expiry of the current scheme covering all bank creditors, no loss events leading to the guarantees becoming effective have occurred so far. Currently it is expected that there may be a limited, one-off public sector surplus from the bank guarantee scheme.

4.4. *Other factors considered relevant by the Commission*

In its opinion on the most recent update of the convergence programme, the Council considered that the budgetary outcomes in the medium term could turn out worse than projected in the programme. While the risks in the short run are limited as the latest forward-looking indicators confirm a continuous recovery of consumer and business confidence, the budgetary outcome in the outer years may be worse than projected given the favourable growth assumptions underlying the budgetary projections. Given the track record of expenditure frequently exceeding targets, the assumed zero real growth in public consumption expenditures between 2011 and 2013 appears optimistic. In addition, although the financial sector appears stable, the rescue measures enacted during the crisis have increased the government's risk exposure to the sector. The Council therefore invited Denmark to reinforce efforts ensuring that the planned breach of the 3%-of-GDP reference value would remain contained as well as to swiftly correct the projected excess of the deficit over the reference value, and to specify the measures to underpin fiscal consolidation for the MTO to be reached by 2015 as planned.

5. CONCLUSIONS

The general government deficit in Denmark is notified to reach 5.4% of GDP in 2010, above and not close to the 3%-of-GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. However, it cannot be considered temporary. This suggests that the deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60%-of-GDP reference value. This suggests that the debt criterion in the Treaty is fulfilled.

In line with the Treaty, this report has also examined “relevant factors”, which, according to the Stability and Growth Pact - can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the twin condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. Considered on their own merit, the relevant factors in the current case seem to be relatively favourable.