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# Public Expenditure Management in Denmark

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## INTRODUCTION AND SUMMARY

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There is political agreement in the Folketing (Danish parliament) on a Budget Act. The Act will introduce 4-year rolling expenditure ceilings for the central government, regions and municipalities. The expenditure ceilings will comprise most public expenditure, including public consumption and transfers. Moreover, a balanced budget rule will be introduced as required by the Fiscal Compact.

New and improved instruments for managing public expenditure have been needed as growth in public consumption has exceeded the planned level repeatedly in the past nearly 20 years. This put additional pressure on the Danish economy during the boom period in 2005-08. In the longer term, the overruns imply that public finances will be ill-prepared for the future challenges, including an ageing population and a smaller working-age population. With the sovereign debt crisis, the financial markets are also increasingly focused on fiscal and expenditure policies.

The excess public consumption is to a large extent due to municipalities spending more money than agreed with the central government. For many years, the overruns had no consequences. However, in the period 2008-10, the Folketing in several steps tightened its sanctions against the municipalities if the total expenditure exceeded the agreed level. Combined with stricter requirements for the current financial management, the tightening seems to have had an effect. As a result, growth in public consumption was lower than planned in 2011. Hence, it is positive that the sanctions will be continued in connection with the new Budget Act and will be applicable to the regions as well.

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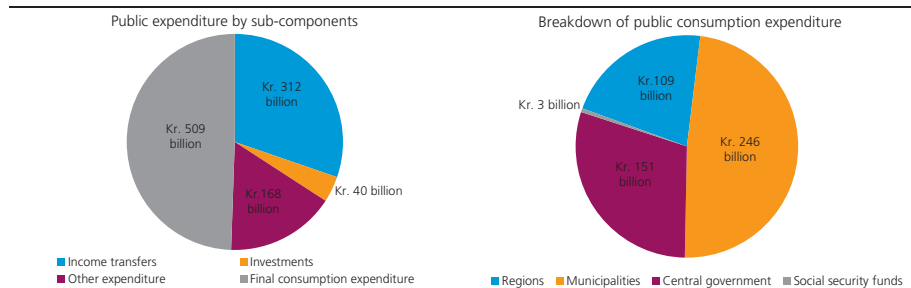
## DEVELOPMENT IN PUBLIC CONSUMPTION

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In 2011, public consumption was kr. 509 billion, corresponding to 28.5 per cent of the gross domestic product, GDP. Thus, it was equivalent to slightly less than half of public expenditure, which also comprises in-

# BREAKDOWN OF PUBLIC EXPENDITURE AND PUBLIC CONSUMPTION EXPENDITURE IN 2011

Chart 1



Source: Statistics Denmark.

come transfer payments, cf. Chart 1. In 2011, the municipalities accounted for almost half of public consumption, the regions for just over 20 per cent and the central government for nearly 30 per cent. The municipalities' share covers schools, day care and care for the elderly while the expenditure of the regions is largely related to healthcare. The central government's consumption covers expenditure for higher education, the armed forces, the police, central government administration, etc.

A key measure of public expenditure management in the medium-term plans, among others, has been growth in public consumption. Therefore, it is remarkable that growth has repeatedly been higher than planned for almost 20 years. On average, the annual overruns were 1.5 percentage points in the period 1993-99 and 1 percentage point in 2000-10, cf. Chart 2.

Overruns in a single year may be well-founded and have a limited effect on public finances, but if the overruns are repeated year after year, they may be of a structural nature. Moreover, repeated budget overruns will add up and become a real burden on public finances, which will be less prepared to cope with future challenges, including an ageing population.

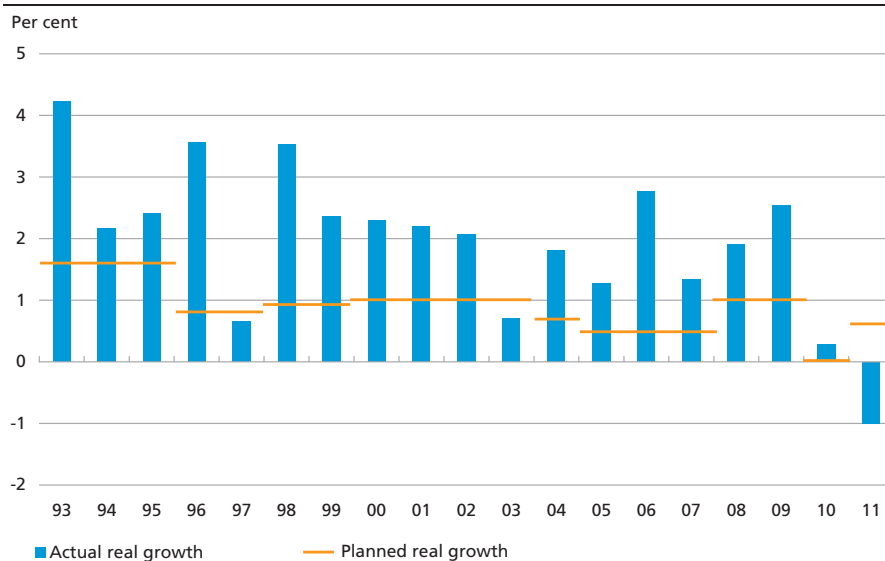
## The municipalities' budget overruns

A large proportion of the total budget overruns is related to municipalities. This should be seen in the context of municipalities accounting for approximately half of public consumption. Allowing for the fact that municipalities' expenditure has been impacted by tasks being added or taken away after the budgets have been laid, the municipalities exceeded their budgets in 10 out of 11 years in the period 2000-10, cf. Chart 3.

The municipalities' investments exceeded the budget every year in the period 2000-09. This is also the case if adjustments are made for add-

DEVELOPMENT IN PUBLIC CONSUMPTION EXPENDITURE

Chart 2

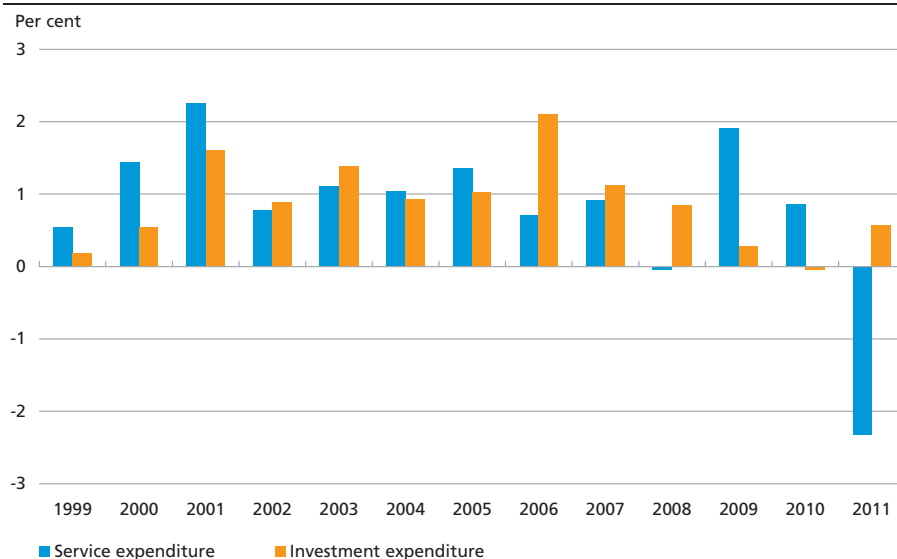


Note: Real growth in public consumption may be overestimated in the first half of the 1990s, cf. Sysser Davidsen and Nathalie Tuxen Hanus, *Analyse af det offentlige forbrug siden 1992* (Analysis of public consumption since 1992 – in Danish only), *Ministry of Finance Working Papers*, No. 1, 2001.

Source: Statistics Denmark, Ministry of Finance Budget Review 2004, 2005 plan, 2010 plan, 2015 plan, *Lavere skat på arbejdsindkomst* (Lower tax on income from employment – in Danish only) and Economic Survey, August 2010.

BUDGET OVERRUNS IN MUNICIPALITIES AS A SHARE OF TOTAL BUDGETED SERVICE AND INVESTMENT EXPENDITURE

Chart 3

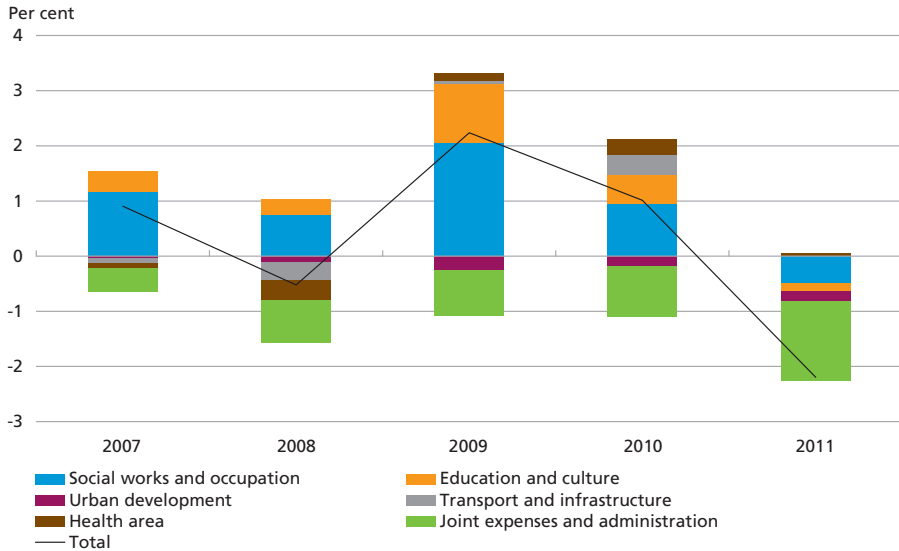


Note: Difference between budgeted and actual expenditure. The budgeted expenditure has been adjusted for developments in prices and wages as well as changes in tasks. The compilation only comprises municipalities under Local Government Denmark, i.e. up to 2006 the cities of Copenhagen and Frederiksberg were not included.

Source: Ministry of Finance and Ministry of Economic Affairs and the Interior.

BUDGET OVERRUNS IN MUNICIPALITIES FOR SERVICE EXPENDITURE  
BROKEN DOWN BY TASKS

Chart 4



Note: For 2007 and 2008, the budget and accounts have been adjusted for developments in prices and wages as well as additional tasks. This is not the case for 2009-11, where only limited adjustments have been made. The budget overruns are not fully compatible with those in Chart 3; here they are only viewed in relation to the budgeted service expenditure. The breakdown of service expenditure is in accordance with the breakdown made by Statistics Denmark which, however, does not include civil servant pensions relating to the supply area. Joint expenses and administration comprise political and administrative organisations, business development, tourism, pay pools, etc.

Source: Statistics Denmark, the former Ministry of the Interior and Health and the former Ministry of the Interior and Social Affairs.

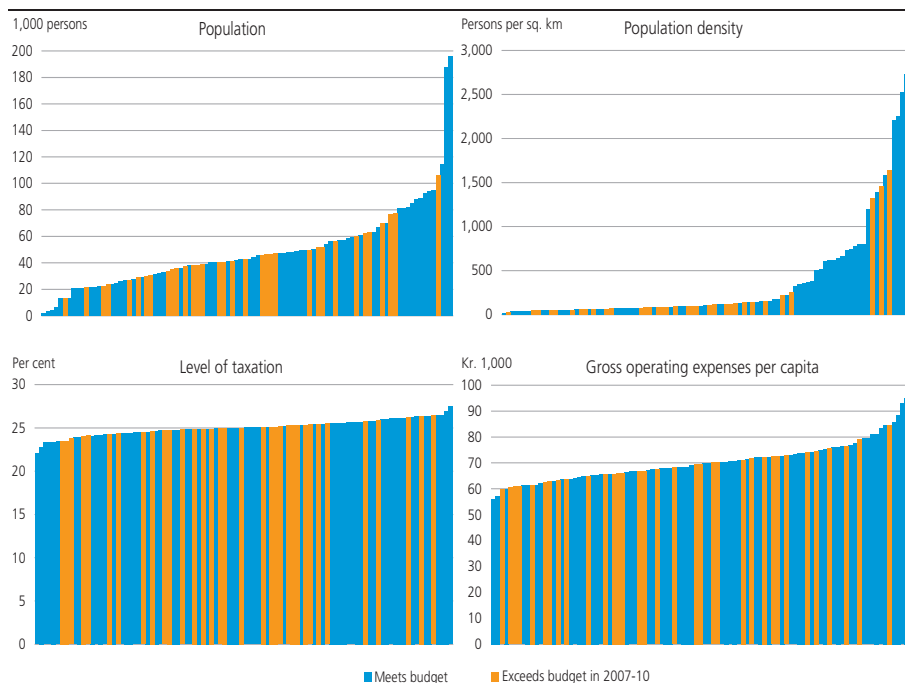
itional tasks. In other words, municipalities have not funded overruns of the consumption budget by spending less money on investments than budgeted. On the contrary, both items have contributed to higher expenditure than planned.

Until 2011, budget overruns in the municipalities largely reflected expenses for employment and social tasks, including care for the elderly and persons with special needs. Likewise, the budget overruns within education and culture have been of a permanent nature, cf. Chart 4. However, the total overrun has been lower because the expenditure for administration etc. has been systematically overbudgeted in recent years, indicating that budgeting has not reflected the actual priorities during the year. However, the required level of detail is lower for the budget than for the accounts, which makes it difficult to compare the two.

Apparently, the structural reform implemented with effect from 2007 has not had any effect on the budget overruns as they continued after the reform. Nor do the municipalities that repeatedly exceeded their budgets every year in the period 2007-10 seem to display any specific

## MUNICIPAL CHARACTERISTICS

Chart 5



Note: The budget overruns relate to net operating expenses. Adjustments have been made for large adjustments for additional tasks relating to service expenditure in 2008. The key ratios illustrating the municipal characteristics are from 2009. The charts illustrating population and population density do not include the two municipalities with the highest values. In both cases, the budget of the municipalities has been met. Gross operating expenses per capita cover the principal accounts 0-6, i.e. user- and tax-financed services.

Source: Statistics Denmark, the former Ministry of Social Welfare and the Ministry of Economic Affairs and the Interior.

characteristics. Hence, the municipalities that have exceeded their budgets are not overrepresented when grouped according to service expenditure, tax rate, population or population density, cf. Chart 5. But there are indications that the municipalities with the largest populations and highest population densities have been better at balancing their budgets. Moreover, it seems that municipalities with high service expenditure and resultant high tax rates have reached a level where expenditure is kept within the budget.

The planned local government expenditure is negotiated every year by Local Government Denmark and the central government, cf. Box 1. In the negotiations, the parties have to a large extent taken the actual and not the planned expenditure in the previous year as their point of reference. In practice, the budget overruns have therefore been accepted by both parties. This means that excess consumption in one year has not been offset by correspondingly lower consumption in another year. In consequence, the overruns have contributed to a permanently higher level of expenditure.

## EXPENDITURE MANAGEMENT IN THE MUNICIPALITIES

Box 1

Since the late 1970s, the government and Local Government Denmark have negotiated financial agreements which have been a key element in the management of local government expenditure. The framework agreement for local government finances for the coming calendar year is worked out during the negotiations. Typically, the parties agree on the overall level of service and investments while at the same time determining the framework for local taxes. The central government's block grant is calculated on the basis of the agreed expenditure.

In June, the government and Local Government Denmark agree on a framework for the overall local government finances. Subsequently, the individual municipalities draw up their preliminary budgets. If the agreed framework is subsequently exceeded, the municipalities have time to adjust their budgets in order for the national framework to be respected.

Once the individual municipalities have adopted their final budgets, the government assesses whether the agreement has been respected. If not, the government may ask the municipalities to reopen their budgets. On the other hand they can accept the overruns, possibly on the condition that they are dealt with in the following year's negotiations, as was the case in e.g. 2008.

The framework agreements concluded by the government and Local Government Denmark are not legally binding. This means that the system depends on mutual agreement that the framework must be respected. However, in 2008-10 the block grant was subject to statutory amendments; among other things, the government was empowered to reduce the grant if expenditure exceeded the agreed level.

### Incentives for municipalities to comply with agreements

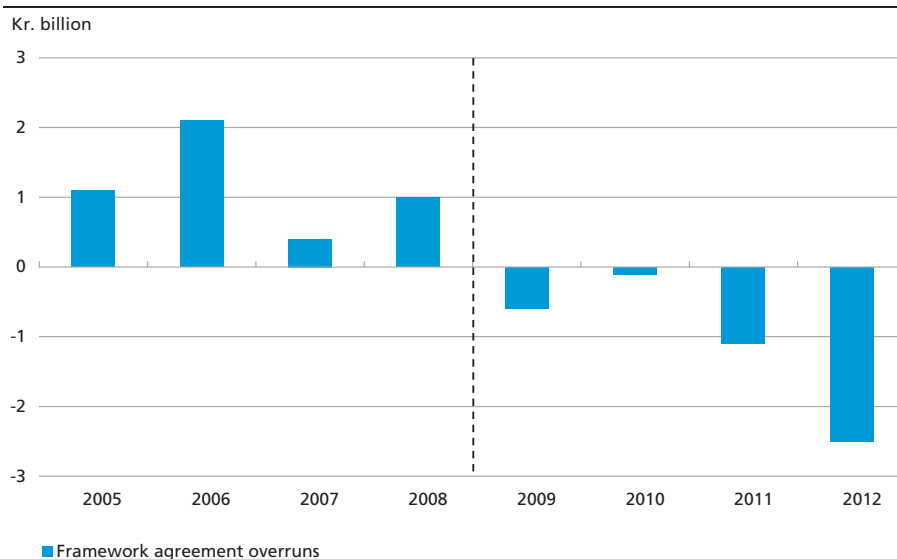
In the past few years, the sanctions on the municipalities have been tightened. As from the municipality budgeting for 2009, kr. 1 billion of the central government's block grant was made conditional on the municipalities' budgets staying within the agreed financial framework. The sanctions seem to have served their purpose as in each of the budgets for 2009-12 the municipalities have budgeted their expenditure lower than agreed, cf. Chart 6.

The sanction mechanisms were tightened further in 2010 in connection with the Fiscal Consolidation Agreement, in which very limited growth in real public consumption was a key element of the consolidation of government finances. Tight management of local government expenditure was therefore essential. Kr. 3 billion of the block grant was made conditional on the municipalities not exceeding the agreed level of service expenditure, both in the budgets and in the accounts. The conditional block grant also applied if the government wanted to impose a ceiling on investments in the financial agreements. This tightening applied from the financial agreement for 2011 and is still in force.

The conditional block grant implies that if the municipalities budget higher expenditure than set out in the framework agreement, a collect-

BUDGET OVERRUNS RELATIVE TO FRAMEWORK AGREEMENTS

Chart 6



Note: The agreed level of service expenditure has been adjusted relative to developments in prices and wages as well as additional tasks. The broken line indicates the introduction of the conditional block grant.

Source: The former Ministry of Social Welfare, the former Ministry of the Interior and Health and Local Government Denmark.

ive deduction will be made in the block grant. Once the local government accounts have been finalised in May, the government makes a preliminary assessment of whether the budgets have been respected. If not, the block grant will be reduced in the last three months of the year. The reduction will be 40 per cent on a collective basis and the remainder individually for the municipalities with budget overruns in order to induce the municipalities to comply with their budgets. The tightened sanction mechanisms combined with the political will to comply with the rules seem to have had an effect, given that the municipalities complied with the budgets in 2011, cf. Chart 3.

Moreover, financial management was tightened in connection with the implementation of the Fiscal Consolidation Agreement. The municipalities must prepare interim accounts for approval by the local councils in September. This will enable the municipalities to follow up on budget deviations during the year.

## BUDGET RULES

Over the years, budget rules have been introduced in connection with the management of public finances. However, as described above they have not – except in the past few years – been sufficient to ensure that growth in public consumption has developed as planned.

In this article, a budget rule is defined as a rule setting out conditions for the content of budget decisions<sup>1</sup>, such as a limit on public debt or on the general government budget deficit or specific rules for public sector revenue and expenditure. Basically, a rule cannot be deviated from. The alternative to a rule is targets that can be changed on an ongoing basis. They are more flexible than a rule but also widen the possibility of implementing decisions that may be optimal in the short term but are harmful in the longer term; for example a wish for an unfunded increase in public consumption which results in higher taxes or lower future public consumption.

One type of budget rule sets limits for key budget elements such as public debt or the government budget balance. In connection with the Stability and Growth Pact, Denmark has since 1999 committed itself to keep its government deficit below 3 per cent of GDP and its gross debt below 60 per cent of GDP.

The purpose of the rules has been to ensure a sound and sustainable development in public finances, and Danish fiscal policy has been planned in accordance with these rules. The Fiscal Consolidation Agreement from 2010 should be viewed against the fact that Denmark received an EU recommendation to reduce its deficit. The reason was that the European Commission at the time assessed that the deficit would exceed the reference value. So did several national and international institutions. However, this has still not been the case. Except in recent years, the 3-per-cent rule has not as such been a binding constraint, and the debt rule is still not, cf. Chart 7. In consequence, the rules set out in the Stability and Growth Pact have so far not required tight expenditure management.

Budget rules can also be linked to revenue or expenditure. If, for instance, restrictions are imposed on revenue and an active improvement of the budget balance is required, then expenditure will have to be reduced. The revenue rule may, therefore, act as an indirect tool for managing expenditure. The tax freeze introduced in 2002 and ultimately abolished in 2011 may be considered as such a rule. The tax freeze was not a binding restriction, though, as revenue rose sharply driven by strong cyclical trends. In most municipalities, the tax freeze was not a binding restriction either. With unchanged tax rates, the budgets allowed for operating profits. As a result, the tax freeze had no impact on the consumption of most municipalities as higher-than-budgeted consumption could be funded in this way.

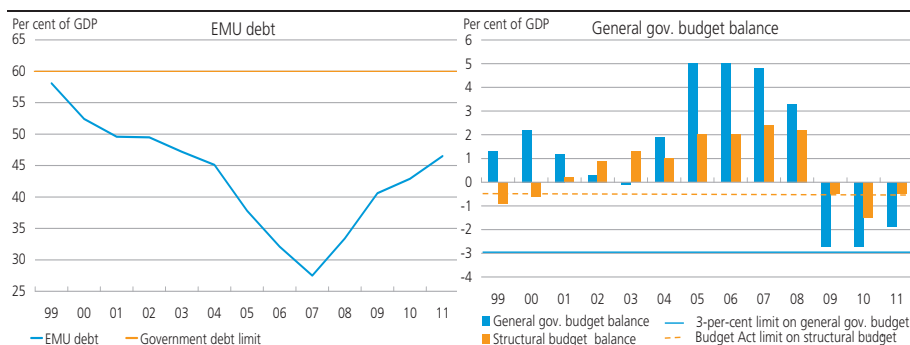
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<sup>1</sup> Alternatively, a budget rule can be defined more broadly: as the basic set of rules applying to the process of determining public expenditure and revenue.



## PUBLIC GROSS DEBT AND ACTUAL AND STRUCTURAL GOVERNMENT BUDGET BALANCE

Chart 7



Note: The structural government budget balance is based on calculations made by the Ministry of Finance. The maximum structural budget balance of -0.5 per cent of GDP is the balance requirement set out in the new Budget Act.

Source: Statistics Denmark and Ministry of Finance.

As an alternative to rules, targets in fiscal and expenditure policy may also be applied. Unlike rules, objectives are not binding but consultative. Since the first half of the 1980s, the Danish Ministry of Finance has applied targets; first in its Financial Reports and later in the medium-term plans for public finances. The financial agreements with the regions and municipalities have been based on these objectives.

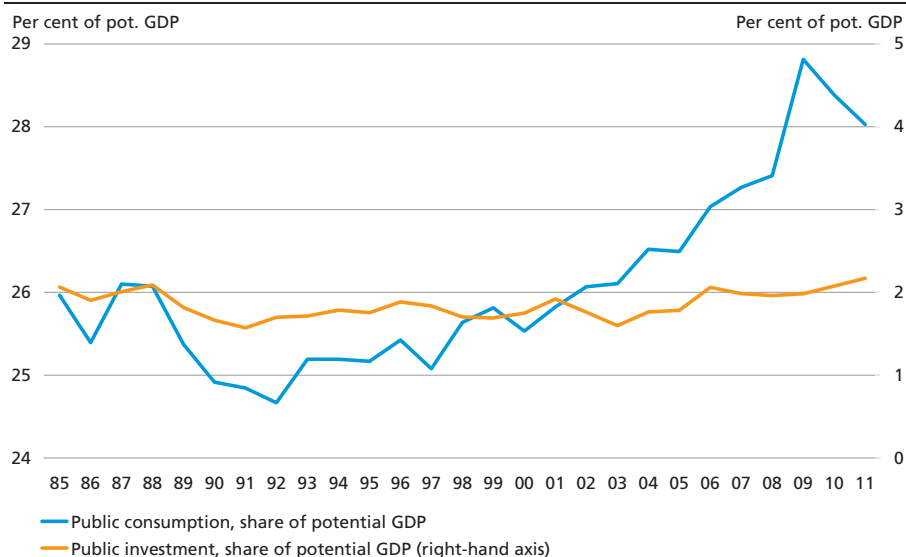
The first medium-term plan was introduced in 1997 and included targets until 2005. Since then other medium-term plans have followed, the 2020 plan from May 2012 being the most recent one. Every plan has contained targets for the actual or structural budget balance that adjust for the effect of cyclical fluctuations and other temporary factors affecting the budget. The targets of the 2020 plan are to ensure that the annual structural budget deficit does not exceed 0.5 per cent of GDP and to obtain balance in 2020. The planned growth in public consumption has been determined on the basis of these targets, among others. In practice, the medium-term objectives have served as an expenditure framework which could be departed from without any real consequences.

Since the millennium change the deviations from the plans have contributed to a steady rise in public consumption as a ratio of potential GDP<sup>1</sup>, cf. Chart 8. Potential GDP can be viewed as an indicator of the output which is to finance public consumption in the long term. With the growth targets for public consumption set out in the 2020 plan, public consumption will account for 27 per cent of GDP in 2020. This will require tight expenditure management in the years ahead. Unlike public consumption, government investment has been largely constant relative to potential GDP.

<sup>1</sup> Potential GDP is the underlying, cyclically adjusted GDP.

# NOMINAL PUBLIC CONSUMPTION AND INVESTMENT AS A SHARE OF NOMINAL POTENTIAL GDP

Chart 8



Source: Statistics Denmark and own calculations.

## BUDGET ACT

In the spring of 2012, a majority in the Folketing adopted a Budget Act to ensure more efficient management of public expenditure. The Act is expected to be fully implemented from 2014 and aims to ensure balance or surplus on the general government balance as well as appropriate expenditure management in the central government, regions and municipalities.

The balanced budget rule is a result of Denmark's participation in the Fiscal Compact. In practice, the rule imposes a limit of 0.5 per cent of GDP on the structural budget deficit. Among other things this limit has been determined on the basis of the debt level and the long-term economic outlook. The structural budget balance reflects the underlying position of public finances and influences the sustainability of fiscal policy. Managing fiscal policy on the basis of the structural budget balance will lead to an appropriate economic position in the long term.

The calculation of the structural budget balance is subject to some uncertainty, however, as significant adjustments may occur, cf. the article "Fiscal Policy in the EU – What Have We Learned from the Crisis?" in this Monetary Review. Based on the data available at a given time, the structural budget balance may be estimated at a level where the balanced budget rule requires tighter fiscal policy. But subsequent adjustments may prove that the fiscal tightening was unnecessary. If the

structural deficit is close to 0.5 per cent of GDP, the balanced budget rule will typically require more adjustments of fiscal policy than necessary. Also, there is a risk that the estimated structural budget balance does not include deterioration that is of a permanent nature. In consequence, the response of fiscal policy to such deterioration will be delayed.

As mentioned above, the medium-term plans have also contained targets for the budget balance. These objectives have been more ambitious than a structural deficit not exceeding 0.5 per cent of GDP. Although they were achieved, this did not result in tight government expenditure management, not even during the tax freeze period. One of the reasons was that revenue from North Sea production grew during that period.

### Expenditure ceilings

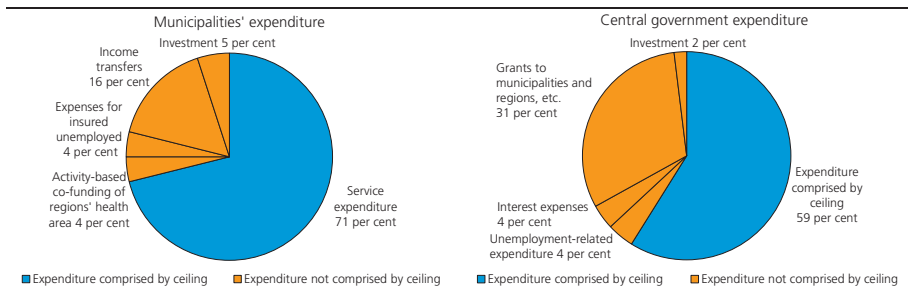
With the Budget Act, 4-year rolling ceilings on public expenditure will be introduced. This means that the Folketing will adopt maximum amounts for how large the expenditures comprised by the ceilings in the central government, regions and municipalities may be in the coming year and the next three years.

The expenditure ceilings will apply to public consumption but also to most central government transfer payments such as state retirement pension, early retirement benefits, student grants and housing benefits, cf. Chart 9. Unemployment-related expenditure, such as unemployment benefits and expenditure for employment measures, is not included as this is a very cyclical type of expenditure. This means that the automatic stabilisers still have an effect via this expenditure.

Although accounting for close to one third of government expenditure, transfer payments have not previously been a main focus area for public expenditure management. It can be difficult to manage current transfers as most of them are of a statutory nature. This means that the

EXPENDITURE COMPRISED BY CEILINGS

Figur 9



Anm.: 97 per cent of the regions expenditure is comprised by the expenditure ceilings as only investment is excluded.  
Kilde: Ministry of Finance.

rates are given beforehand and that citizens are entitled to benefits if they meet the requirements. Only by changing the law can this expenditure be changed.

Since transfers are comprised by the central government expenditure ceiling, the politicians will have to take action if the expenditure for a scheme is assessed to be permanently higher than expected. Either the expenditure for the scheme in question or the expenditure for other schemes will have to be reduced to ensure that the overall ceiling on transfers is not exceeded and to avoid a situation with permanently higher transfer expenditure.

Every expenditure ceiling imposed on the central government, regions and municipalities must be respected. Therefore, even if one sector spends less money than allowed, another sector cannot spend a correspondingly larger amount. The expenditure ceilings for regions and central government are split into two sub-ceilings, each of which must be respected. For example, the central government has a sub-ceiling on consumption and one on income transfers. Even if the transfer expenditure is below the ceiling and this scope is estimated to be of a temporary nature, it cannot be used to finance higher central government consumption. This will intensify the central government's focus on both consumption and transfers.

### **Sanctions**

The new expenditure ceilings are to be determined on the basis of the fiscal and expenditure policy targets set out in the medium-term plans. It is the task of the Danish Economic Council to assess whether the ceilings are aligned with the plans. In the most recent plan, real public consumption is allowed to grow by 0.8 per cent annually in the period 2014-20 and the expenditure ceilings must support this. Therefore, tight expenditure management is required.

Experience suggests that in order to be respected, the ceilings must be supported by sanctions. In the case of the municipalities, the sanction mechanisms will to a large extent remain unchanged, cf. above. Moreover, the budget act provides the individual municipalities with a stronger incentive to manage expenditure tightly by making an individual set-off, in full or in part, against the block grants for the municipalities that have caused the overall budget to exceed the agreed framework. The tightened rules also contribute to the individual local government budgeting low expenditure when drafting the budget and subsequently meeting the budget.

These sanctions will be extended to apply to the regions, whose conditional block grant is kr. 1 billion. Until now, no direct sanctions have

been imposed on the regions if they exceeded the financial agreement, so their situation will be significantly tightened.

In the case of the central government, budget overruns in one year must be offset by correspondingly lower expenditure in the following year, which prevents a permanent impact on the debt.

In order to improve the investment expenditure management in the municipalities and the regions, the Budget Act offers scope for a special conditional block grant concerning investments. Collective offsetting of up to kr. 1 billion may be effected in the case of municipalities and kr. 0.5 billion in the case of regions if their budgets exceed the framework agreement that the government may choose to conclude with them. This will strengthen investment expenditure management, an area in which repeated overruns have previously occurred, as in the case of consumption.

Once the accounts have been presented, the Danish Economic Council will assess whether government expenditure was actually kept below the ceilings. In this way, the final assessment is made by an independent body.