Chapter 1

Consolidating public finances

Denmark stands out as a country with sound public finances. Public debt and the deficit are relatively low. So is the foreseeable impact of ageing on public finances compared with many other OECD countries. Nevertheless, the very high level of public expenditures and hence, of taxes, as well as difficulties in controlling these expenditures, have negative effects on the economy and could threaten public finances in the longer run. Consolidating public finances would require addressing the core of the problem, which partly lies in the fiscal relations between levels of government. There is also room to increase the efficiency of public spending in some areas such as health and education.

Denmark's public finances are sound compared with many other OECD countries. The debt-to-GDP ratio increased during the economic and financial crisis, but remains well below the 60% EU ceiling. The fiscal deficit, close to 4% of GDP in 2011, is far below the EU and OECD averages. Going forward, the impact of ageing is expected to be limited, partly because the pension age has already been indexed to life expectancy. A Consolidation Agreement plan was introduced in 2010 and the newly elected government has announced it will comply with EU commitments under the Stability and Growth Pact.

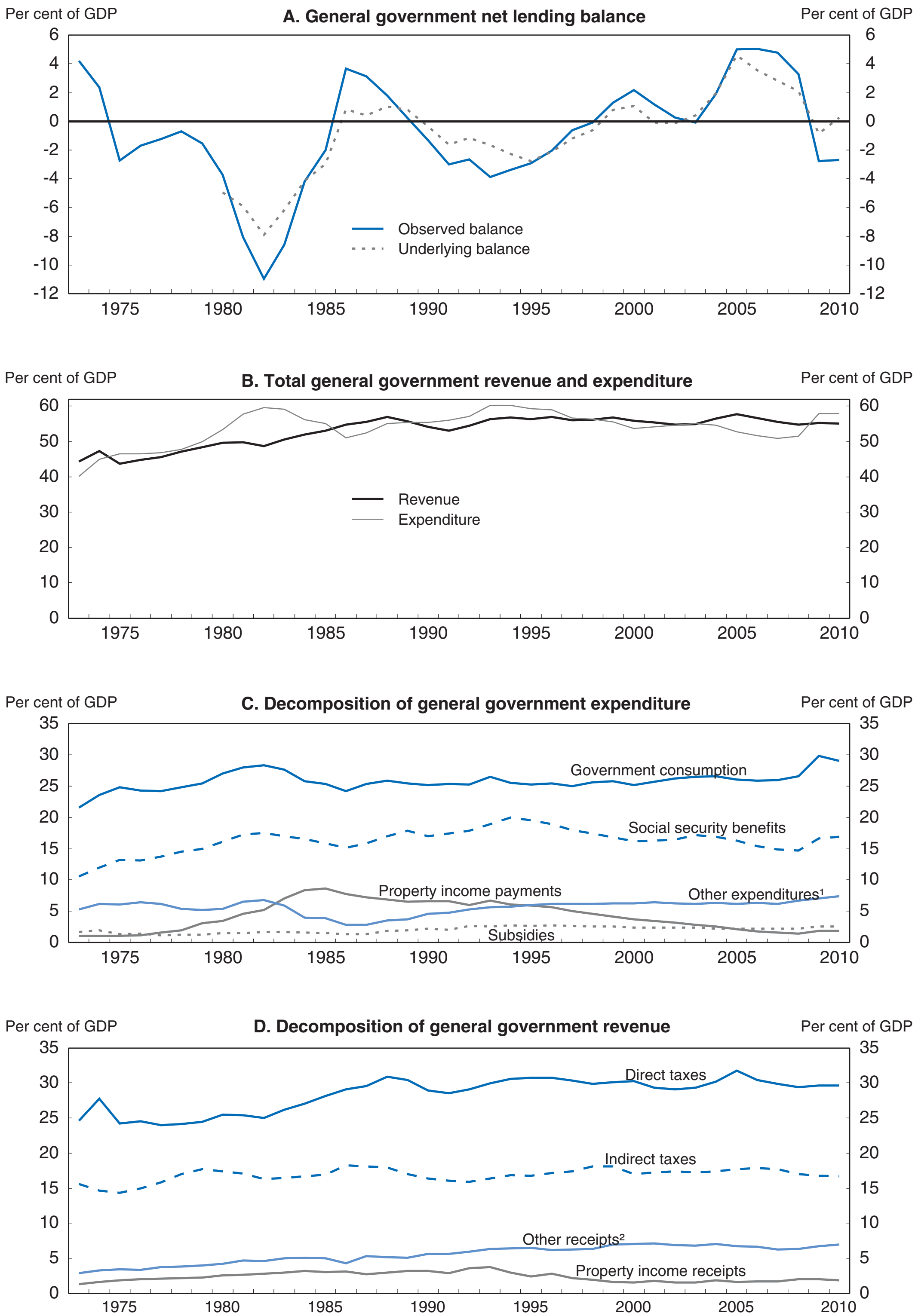
Nevertheless, Denmark faces a number of fiscal challenges. The global crisis led to an increase in government outlays, which are now the highest in the OECD as a share of GDP. This is not necessarily a problem *per se*, but it implies a heavy tax burden and past experience shows that Denmark has often failed to control public expenditures, including in times of strong economic growth. To finance these large expenditures, the tax burden has to be high – the highest among OECD countries. The large size of the public sector and high taxes, especially on labour, have negative effects for the economy, contributing to relatively weak productivity growth although the mix of expenditures can to some extent mitigate this negative effect (Cook *et al.*, 2011; Bassanini *et al.*, 2001).

Consolidating public finances in Denmark appears at first sight to require only moderate efforts: the deficit is not large, there are margins to reduce public expenditure at a relatively low social cost and there is some consensus for reducing at least some of these expenditures. However, past efforts to contain public expenditure have failed, suggesting that the problem does not stem from a lack of plans and targets but from weak implementation. This chapter sets out ways to consolidate public finances in Denmark by addressing the core of the problem, which mainly lies in the fiscal relations between levels of government. The chapter also discusses how to boost the efficiency of public spending and to improve the tax system. Reforms along these lines should help Denmark reduce the growth-inhibiting effects of high taxation.

Controlling public expenditure is a long-standing challenge

In many respects, Denmark's current public finance position compares favourably with most other OECD countries with a debt-to-GDP ratio below 50% and a general government deficit at less than 3% of GDP in 2010. This is largely because Denmark built up sizeable general government surpluses in the 2000s, following earlier spells of fiscal stress (Figure 1.1). The fiscal situation has deteriorated substantially during the current crisis, but as Denmark entered the crisis in a strong position, the budget deficit has remained moderate both compared to Denmark's past experience and to other OECD countries. The deterioration primarily reflected a large increase in public expenditure, due to both relatively large automatic stabilisers and discretionary measures, from already high levels. Indeed, Denmark failed to take advantage of buoyant economic times to bring spending down. Concomitantly, tax pressure remained very high, with ample revenues from North Sea oil and gas contributing to large budget surpluses.

Figure 1.1. **Public finance trends in Denmark**



1. Includes government investment, other current payments, capital transfers paid and other capital payments minus government consumption of fixed capital.
2. Includes social security contributions, other current receipts, capital tax and transfers receipts.

Source: OECD, *Economic Outlook Database*.

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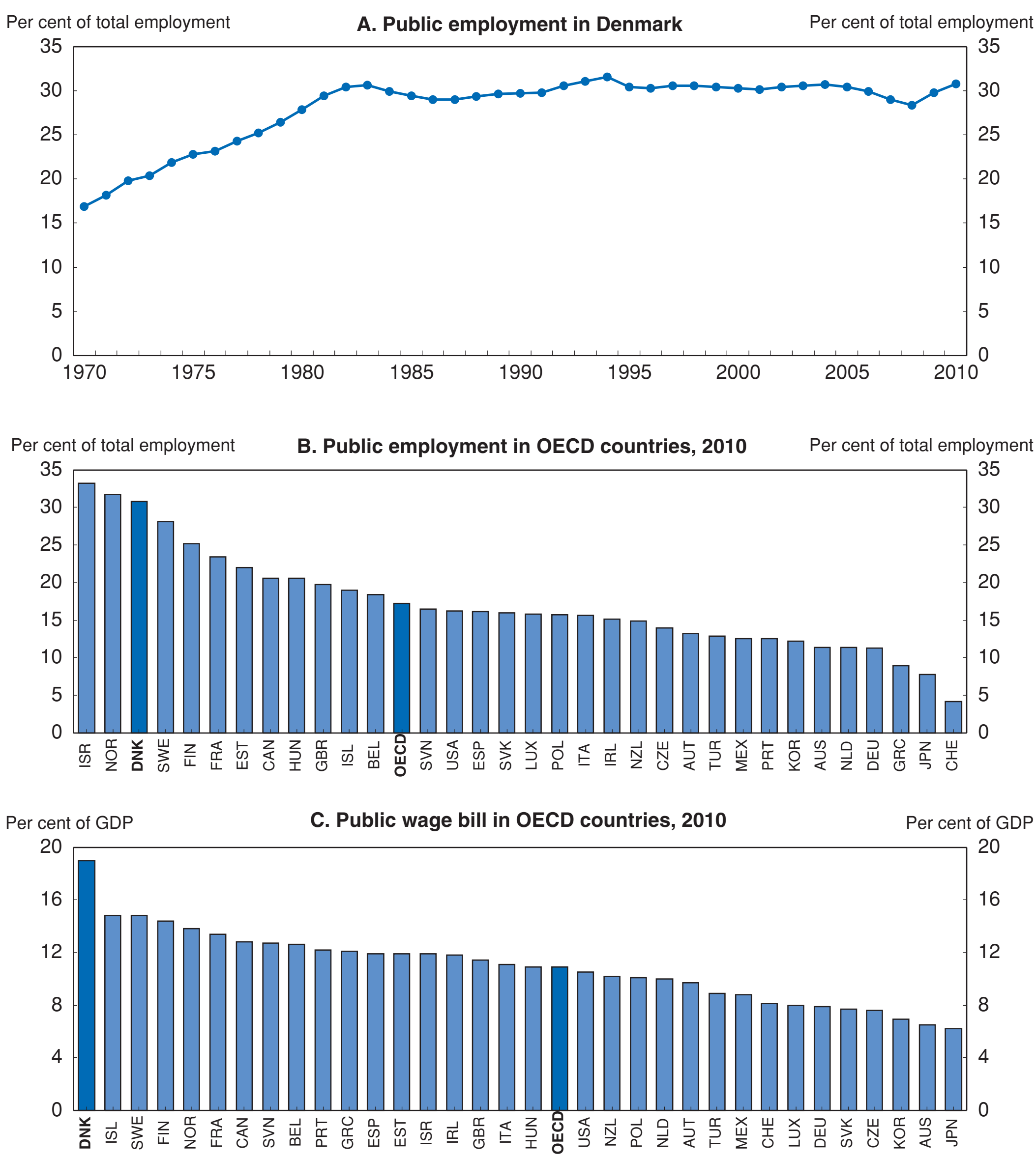
Government consumption accounts for the bulk of public expenditure, reflecting high public employment (Figure 1.2). The share of public employment has remained around 30% over the past three decades, one of the largest shares in the OECD, and public expenditure on wages (in relation to GDP) is the highest in the OECD.

Denmark's very high level of public expenditure reflects a generous welfare system that provides a broad range of services to the population, including education and health, has helped keep inequality in check and has ensured a high level of well-being (Figure 1.3). Social expenditures, in particular on incapacity, unemployment and health benefits, are

Figure 1.2. **Wages and employment in the public sector**



Source: OECD, *Economic Outlook Database.*

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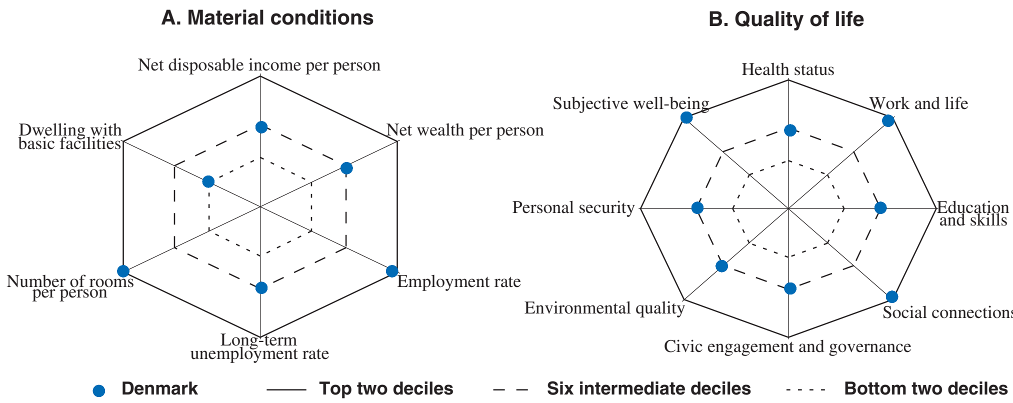
Figure 1.3. **Well-being indicators**[1]



1. The figure shows for each of the indicators that have been selected in the Compendium of OECD well-being indicators how Denmark ranks compared to other OECD countries. For example, Denmark is in the top two deciles for the employment rate, and in the bottom two deciles as regards dwellings with basic facilities.

Source: OECD (2011), *Compendium of OECD well-being indicators*.

StatLink http://dx.doi.org/10.1787/888932563134

high compared with other OECD countries, although once the impact of the tax system and of private benefits on social expenditure is accounted for, Denmark's net social spending ranks somewhat lower (Table 1.1, Adema and Ladaique, 2009). However, a high overall level of public expenditure can also have detrimental effects on the economy (Box 1.1).

Looking forward, Denmark will face additional public finance pressures. Spending related to population ageing and health care will rise, though less than in many other OECD countries (European Commission, 2009; IMF, 2010). Overall, population ageing is expected to be limited compared to other EU countries, but it is already well advanced, with the peak of the working-age population likely reached in 2009 and a marked ageing of the population expected for the next two decades. Furthermore, while Denmark has benefited from migration inflows at times when the unemployment rate was very low, immigration could be less important in future as neighbouring countries such as Germany and Sweden, also age. Revenues from North Sea petroleum, which amounted to 1.6% of GDP per year on average over 2004-09, are expected to decline sharply after 2040.

Some measures have been introduced to consolidate public finances and to limit public debt accumulation to prudent levels. The May 2010 Fiscal Consolidation Agreement, which included a plan to have zero growth in public consumption in real terms for 2011-13, was to improve the structural balance by 1.5% of GDP over this period. Furthermore, the adoption in December 2011 of the reform of the voluntary early retirement programmes significantly improves long-term public finances (see below). However, in its Budget Bill for 2012, the new government has announced some increases in public expenditures that would require raising taxes further to meet the EU commitment for 2013 (under the excessive deficit procedure) and its target to have a structural fiscal balance by 2020.

Better public expenditure control is called for to avoid the size of the public sector being too much of a drag on economic growth. Public expenditure rose markedly during the crisis and was around 58% of GDP in 2011. Just returning to the pre-crisis public expenditure-to-GDP ratio would necessitate a major adjustment in spending growth.

Table 1.1. **Social public expenditure in OECD countries**

Per cent of GDP in 2007

Countries	Old age	Incapacity	Health	Unemployment	ALMP[2]	Other	Total, gross basis	Total, net basis[3]
Australia	4.3	2.2	5.7	0.4	0.3	3.1	16.0	18.2
Austria	10.7	2.3	6.8	0.9	0.7	5.0	26.4	24.8
Belgium	7.1	2.3	7.3	3.1	1.2	5.3	26.3	26.2
Canada	3.8	0.9	7.0	0.6	0.3	4.3	16.9	19.4
Chile	4.5	0.7	3.7	0.0	0.3	1.4	10.6	
Czech Republic	6.9	2.3	5.8	0.6	0.3	2.9	18.8	19.2
Denmark	**7.3**	**4.4**	**6.5**	**1.9**	**1.3**	**4.7**	**26.1**	**23.9**
Estonia	5.2	1.8	4.0	0.1	0.1	1.8	13.0	
Finland	8.4	3.6	6.0	1.5	0.9	4.4	24.8	22.6
France	11.1	1.8	7.5	1.4	0.9	5.7	28.4	29.9
Germany	8.7	1.9	7.8	1.4	0.7	4.7	25.2	27.2
Greece	10.0	0.9	5.9	0.5	0.2	3.8	21.3	
Hungary	8.3	2.7	5.2	0.7	0.3	5.7	22.9	
Iceland	2.3	2.2	5.7	0.2	0.0	4.2	14.6	16.8
Ireland	3.1	1.8	5.8	1.0	0.6	4.0	16.3	16.8
Israel	4.3	2.9	4.3	0.3	0.1	3.6	15.5	
Italy	11.7	1.7	6.6	0.4	0.5	4.0	24.9	25.8
Japan	8.8	0.8	6.3	0.3	0.2	2.3	18.7	20.3
Korea	1.6	0.6	3.5	0.3	0.1	1.5	7.6	9.5
Luxembourg	4.8	2.7	6.4	0.9	0.5	5.3	20.6	19.1
Mexico	1.1	0.1	2.7	0.0	0.0	3.3	7.2	8.9
Netherlands	5.3	2.9	6.0	1.1	1.1	3.7	20.1	20.4
New Zealand	4.2	2.5	7.1	0.2	0.4	4.0	18.4	18.4
Norway	6.2	4.3	5.7	0.2	0.6	3.8	20.8	20.0
Poland	8.7	2.4	4.6	0.3	0.5	3.3	19.8	18.8
Portugal	9.2	2.1	6.6	1.0	0.5	3.1	22.5	23.6
Slovak Republic	5.4	1.5	5.2	0.4	0.2	3.0	15.7	16.0
Slovenia	8.2	2.1	5.6	0.4	0.2	3.8	20.3	
Spain	6.5	2.5	6.1	2.1	0.7	3.7	21.6	21.6
Sweden	9.0	5.0	6.6	0.7	1.1	4.9	27.3	26.0
Switzerland	6.3	3.0	5.6	0.6	0.6	2.4	18.5	
Turkey	5.0	0.1	4.1	0.0	0.0	1.3	10.5	11.3
United Kingdom	5.8	2.4	6.8	0.2	0.3	5.0	20.5	22.7
United States	5.3	1.3	7.2	0.3	0.1	2.0	16.2	18.9
OECD[1]	**6.4**	**2.1**	**5.8**	**0.7**	**0.5**	**3.7**	**19.2**	**20.2**

1. Weighted average of 34 countries.
2. Active labour market programmes.
3. Net publicly mandated social expenditure, which account for the effect of government intervention through the tax system on social spending. It includes: *i)* direct taxes and social security contributions on cash transfers, *ii)* indirect taxes on goods and services bought by benefit recipients and *iii)* tax breaks with a social purpose.

Source: OECD (2010), *Social Expenditure Database*, 1980-2007, Paris (*www.oecd.org/els/social/expenditure*).

Taking measures to better control public expenditure and to consolidate public finances in the longer term would leave room for short-term policy action, such as the fiscal stimulus presented by the new government. In fact, it would enhance its effectiveness in so far as Ricardian equivalence effects are less potent when the government is seen to have a better grip on public spending, so that firms and households anticipate that more spending today will be financed by less spending in good times rather than by higher taxes (Corsetti *et al.*, 2010).

Box 1.1. **Some links between the size of the public sector and productivity growth**

The large size of the public sector is the counterpart of the Danish welfare system that aims at providing free and wide access to education and health, at supporting those in need and at other objectives such as being a safe and clean country. This system has succeeded in providing the Danes with a high level of well-being in terms of material conditions and quality of life. However, a high level of public expenditures can also have some negative effects on the economy and act as a drag on productivity growth:

- High public expenditures require high taxes. While the design of the tax system can help limit economic distortions (Arnold *et al.*, 2011), the higher the burden of taxes, the more difficult it becomes to find a structure of taxes that limits distortions on labour and investment in particular. High marginal taxes on income discourage workers from taking more demanding and more productive jobs. High taxes can also be a barrier to attract productive workers or firms from other countries.
- The large size of the public sector may have led to some labour misallocation. The public sector employs a relatively large share of highly-educated workers (Danish Economic Council, 2010a). High marginal tax rates, better work conditions in the public sector and relatively moderate wage dispersion may have discouraged skilled workers from taking jobs with high productivity growth potential in the private sector. It can also be argued that, given high tax rates, students don't face strong incentives to undertake courses in more promising but also more demanding fields. The ensuing misallocation of skilled workers in the economy may partly explain the weak Danish productivity growth (OECD, 2009), especially in an era of globalisation that makes it even more important to develop highly skilled and innovative activities.
- The large size of the public sector also implies that some sectors of the economy are likely to be less open to competition. This is the case for instance of the health sector, in which the dominance of public sector provision can reduce incentives to innovate and to raise productivity.

Strengthening the fiscal framework at the central level

Denmark has been gradually formalising and strengthening its policy framework since the early 1990s. The EU deficit and debt norms and the requirement to provide a convergence programme were a first step. In 1997, the government published its first medium-term plan, *Denmark 2005*, which included fiscal targets and various labour market and social policy goals. Since then, the government has presented regular medium-term fiscal programmes with targets for the debt-to-GDP ratio, the structural budget balance and real public consumption growth, the latest one being the *2020 Fiscal Strategy* (released in early 2011). In addition, there is a long tradition of focusing on long-term issues, notably under the aegis of the Danish Economic Council and various commissions including the Growth Forum.

The current framework generally seems strong: it is transparent, looks at a medium-to-long-term horizon, and combines budget and expenditure rules that are generally found to be most effective for fiscal consolidation (Ayuso-i-Casala *et al.*, 2007; Guichard *et al.*, 2007). Nevertheless, fiscal outcomes have been mixed. The main targets covering the structural balance and long-term fiscal sustainability have generally been met. However, public consumption real growth targets have been systematically overshot, so that, by 2007, the share of public consumption in GDP was 3 percentage points above the target implied by the successive medium-term frameworks. The gaps between outcomes and targets suggest that the fiscal framework should be strengthened.

As past rules on government spending and debt failed to contain public expenditures, previous governments tried to act on the revenue side by introducing a so-called "tax freeze" in 2001. The freeze applied to both direct and indirect taxes (OECD, 2006). For taxes set in *ad valorem* terms, the rates could not be raised and for taxes set as nominal amounts, the latter could not be raised either. The tax on real property was initially based on a percentage of the assessed property value, but under the tax freeze, the valuation could not exceed the 2001 valuation plus 5%. The main advantages of the tax freeze were its simplicity and that it may have acted as a disciplining device. However, it failed to contain public expenditures, even though they might have grown faster in the absence of the tax freeze. The failure of the tax freeze partly comes from weaknesses of the instrument. A tax freeze may in fact hinder tax cuts insofar as governments may be reluctant to lower tax rates knowing that the tax freeze will make it difficult to raise them in the future. Another weakness of a tax freeze is that it may lock inefficiencies into the tax structure, by making it impossible to raise efficient taxes while leaving inefficient ones in place, even if the result is revenue neutral. For instance, it has led to low property taxes, which contributed to the housing market boom (see below). The Budget Bill for 2012 has effectively put an end to the tax freeze with increases in indirect taxes while the property value tax will continue to be frozen (Box 1.2).

Some features of the Danish political system may have contributed to the weak enforcement of fiscal rules. The election process, since it determines the extent to which policymakers will be held responsible for their actions, can play an important role in fiscal outcomes (von Hagen, 2002). The Danish election system rests on proportional representation, which tends to lead to higher levels of general public goods than plurality voting systems (Persson and Tabellini, 1999). This is because proportional representation weakens personal accountability, as voters can assess only the average performance of all candidates elected from the party list. Another important feature of the Danish system is that most governments have been coalition governments, which favours cross-party compromises on policies.

Against this backdrop, it is particularly important to have mechanisms that ensure enforcement of fiscal rules. A centralised and transparent budget process may help (von Hagen, 2002). Also, the probability of meeting fiscal rules is greater when they have a legal basis with no margin for adjusting the objectives, are monitored by independent authorities and by the media and include automatic correction and sanction mechanisms in case of non-compliance (European Commission, 2006 and Ayuso-i-Casals *et al.*, 2007).

The new government has recently proposed to introduce expenditure ceilings anchored into a law, one for each level of government (state, regions and municipalities), which is a step in the right direction and should help avoid fiscal slippages (Box 1.2). These expenditure ceilings should cover a medium-term horizon and include most public spending (not only public consumption) though perhaps excluding investment and cyclically-sensitive spending such as unemployment benefits. It is also important to have mechanisms to correct for deviations from the intended path. Prioritising public expenditures can help here by providing a basis for postponing or giving up some expenditures. In Sweden for instance, expenditures are ranked according to their costs and benefits and any increases are examined in relation to the fiscal space associated with the expenditure ceiling and the surplus target (Swedish Ministry of Finance, 2011). This can also help limit the risk that temporary increases in revenues lead to permanent increases in spending. Having public expenditure ceilings with strong enforcement mechanisms is particularly important for Denmark given its large and volatile revenues (from taxes on North Sea oil production and on pension fund earnings). Entrusting the Danish Economic Council more explicitly with the assessment of long-term fiscal sustainability and the fulfilment of expenditure ceilings and giving it broad access to the needed data would also help contain public expenditure growth.

Box 1.2. **Recent and proposed public finance measures**

Fiscal stimulus and new expenditures

The Budget Bill for 2012, unveiled by the new government on 3 November 2011, includes a fiscal stimulus package amounting to 1% of GDP in total (DKK 10 billion in 2012 and DKK 8 billion in 2013). It consists of investments in highways, schools, hospitals and energy efficiency, with 40% of them corresponding to the front-loading of public investments planned for 2014-20.

In addition, expenditure increases have been proposed in various areas, including the following ones:

- *Labour market*. The duration for receiving unemployment benefits, which had been cut from four to two years as part of the May 2010 Fiscal Consolidation Plan, is temporarily extended by six months for the unemployed who will have exhausted their unemployment benefits in the second half of 2012. The price ceiling on the six-week courses in which the unemployed can enrol – and which are paid for by public employment services – is abolished for low-skilled and vocationally educated workers. Recipients of social assistance will be able to take up to five weeks of holidays and continue to receive benefits.
- *Education*. The size of classes should not exceed 28 pupils on average in high schools. Funding is increased for vocational training. The proposal made by the previous government to reduce the duration of grants in tertiary education is withdrawn.
- *Health*. Funding is increased and user fees are reduced for some specific treatments and vaccination.
- *Poverty*. The rules for entitlement to social assistance are eased. In particular, the rule that used to require that spouses who both receive cash assistance and are able to work must have worked within the last 12 months, is abolished. The ceiling on the overall amount of social assistance and housing benefits that can be received is removed and the special low rates for new migrants are abolished. A job premium is tested in a two-year pilot scheme: recipients of social assistance who take a job earning more than DKK 15000 per month will receive a 4% tax-free premium. Case management is strengthened for the weakest recipients of social assistance.
- *Environment*. New spending concerns the development of buffer zones around water wells to reduce water pollution and measures to limit the use of dangerous chemicals.

Box 1.2. **Recent and proposed public finance measures** *(cont.)*

Taxation

A "fat tax" took effect on 1 October 2011, of DKK 16 (EUR 2.1) per kilogramme of saturated fat on any food that contains more than 2.3% thereof.

The Budget Bill for 2012 puts an end to the tax freeze, with increases in excise taxes, in taxes on soft drinks, chocolate and sweets, ice cream and air pollution (nitrogen oxides), the abolishment of tax exemptions for private health insurance and some other changes.

The new government has also announced a tax reform to raise labour supply (see below).

Fiscal targets

- Improvement of the structural budget balance by 1.5% of GDP over 2011-13, in line with the EU Stability and Growth Pact requirements.
- Structurally balanced public finances in 2020.
- Public debt below the EU threshold.

The new government has announced that a budget law will be proposed in Spring 2012 to introduce mandatory spending limits for the state, the municipalities and the regions.

These goals are to be achieved thanks to an increase in the labour supply by 135 000 persons by 2020 (about 4%) combined with a better management of public expenditure. The reforms of the unemployment benefit system as part of the May 2010 Fiscal Consolidation Plan and of the early retirement schemes are expected to raise the labour force by 80 000 persons. The remaining part of the increase (55 000) would be achieved through a tax reform and structural reforms yet to be specified as well as through negotiations with labour organisations.

Sub-central governments' public finances

The 2010 Fiscal Consolidation Agreement included measures to better control expenditures and taxes levied by municipalities:

- The possibility to cut the block grant by DKK 3 billion per year (or less than 0.2% of GDP) if actual or budgeted municipal expenditures increase more than agreed upon. 60% of the cut would apply to municipalities that do not comply with target and the rest to municipalities collectively.
- Increased sanctions, in the form of reduced grants, for the municipalities that increase taxes in a situation where the municipalities as a whole do not comply with the agreement on municipal taxation.
- Obligation to have political approval of the semi-annual accounts.
- Elements to improve the financial management and monitoring of hospitals by regions.

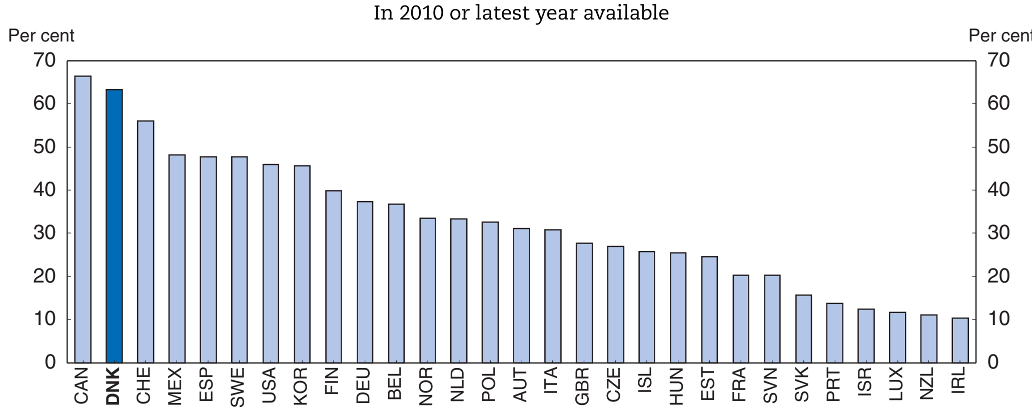
Strengthening the fiscal framework and enhancing self-governance at the sub-central levels

Efforts to contain municipalities' expenditures

Denmark is the OECD country with the second largest share of public expenditure at the local level (Figure 1.4). The increase in public spending observed at the general government level has been driven by sub-central levels, mainly municipalities, while spending from the central level has generally decreased (Figure 1.5). Even in 2004-06, when growth was very strong, spending at the local level as a share of GDP barely declined.

Figure 1.4. **Share of sub-central in total expenditure in OECD countries**[1]

In 2010 or latest year available

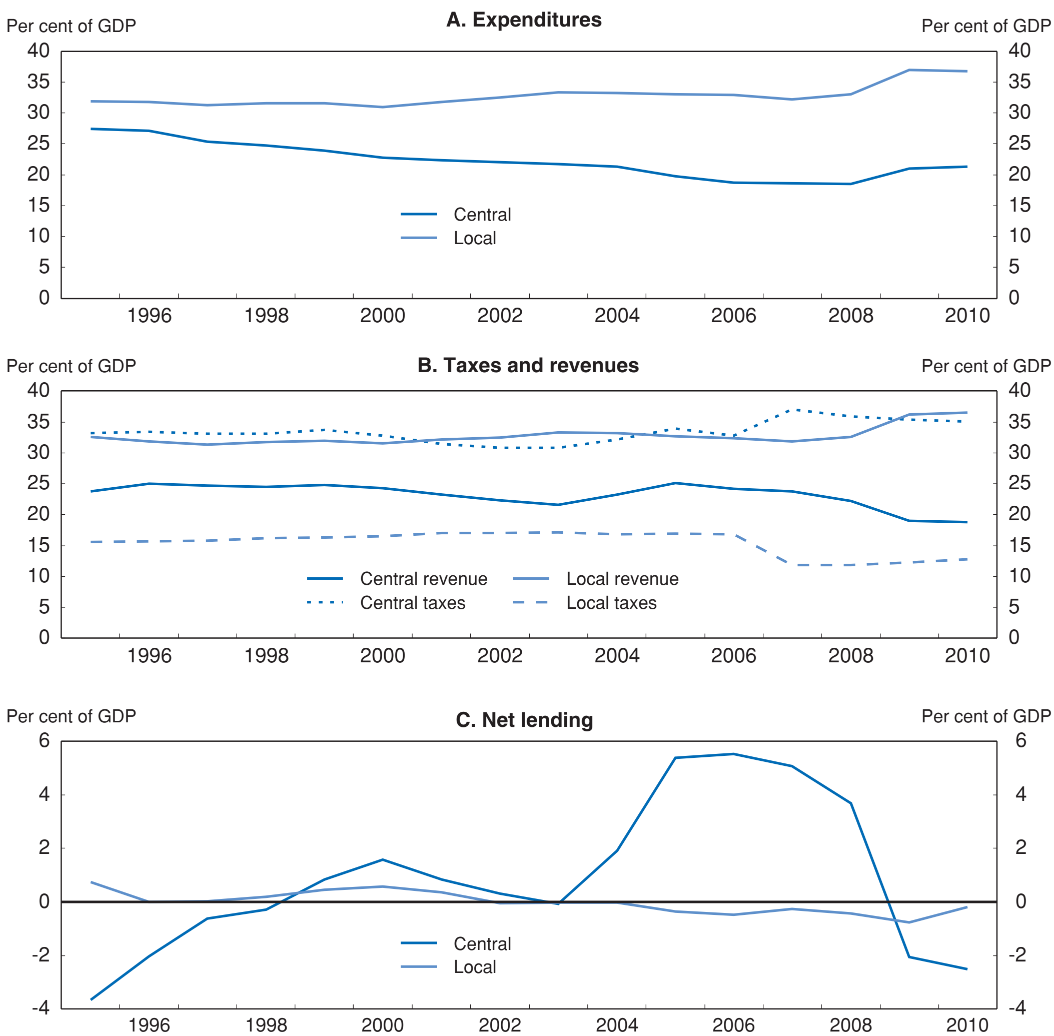


1. For Austria, Belgium, Canada, Germany, Mexico, Spain and Switzerland, "sub-central expenditures" include expenditures made at the state and local levels. For the United States, they show expenditures made at the state level.

Source: OECD, *Fiscal Decentralisation Database* (*www.oecd.org/ctp/federalism/stats*).

StatLink http://dx.doi.org/10.1787/888932563153

Figure 1.5. **Evolution of public finances at the central and local government levels**



Source: OECD, *Fiscal Decentralisation Database* (*www.oecd.org/ctp/federalism/stats*).

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The role of municipalities increased as a number of responsibilities were gradually decentralised, but expenditure increases went beyond what the government had been expecting. This occurred despite fiscal rules for municipalities, including a prohibition on borrowing and a balanced budget requirement (Sutherland *et al.*, 2005) as municipalities used other sources of revenue such as own land. Moreover, while spending ceilings are negotiated with the central government (see below), they have consistently been exceeded in the past two decades. In addition to these rules, the central government has made various attempts to control sub-central outlays. In 2003, as part of the "tax freeze" introduced in 2001, municipalities were henceforth forbidden from collectively raising the average tax rate, with hikes in individual municipalities' tax rate having to be offset by cuts in other municipalities. This contrasts with the previous situation, where local governments had the right to fix their own tax rates.

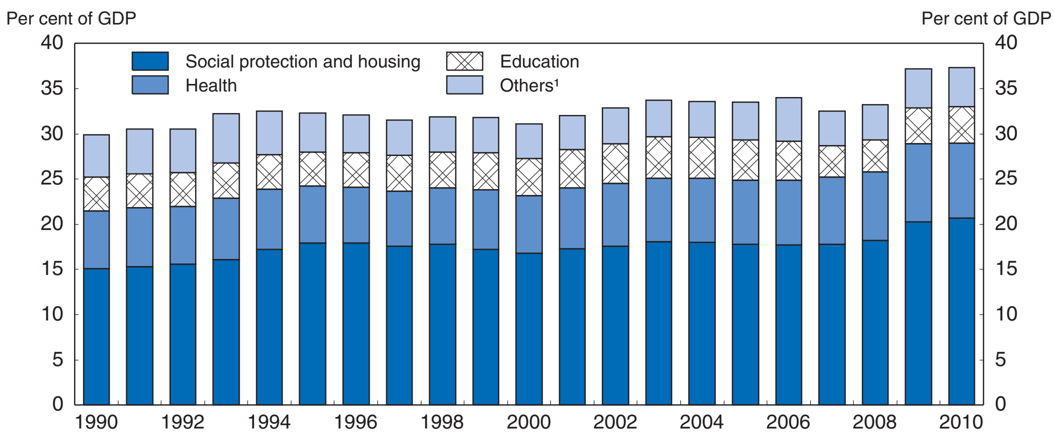
In 2007, a major institutional reform merged municipalities (reducing their number from 271 to 98), replaced the 13 counties by five regions, re-allocated tasks across levels of government, and changed financing and equalisation rules. The main objective was to adapt public service delivery to technological change and increasing demand (some small municipalities being unable to provide some social services). Nevertheless, the reform was also expected to contain expenditure by fostering economies of scale, though the government was recognised that such mergers might temporally push up expenditure (Ministry of Interior and Health, 2005). Municipalities have had to bear the costs of the mergers but were allowed to borrow to finance them and could keep the gains. For the moment, the reform has resulted in an increase in grants from the central government to finance services transferred to municipalities and regions (Blöchliger and Vammalle, 2012). For the reform to be cost-neutral, these additional costs will have to be compensated by future savings generated by the new set-up.

Reasons for the slippages in sub-central government budgets

The central government's failure to control local government finances, despite relatively stringent fiscal rules and various additional efforts reflect several factors, starting with the nature of local government spending. A large share thereof is on social protection policies and health, which have trended up (Figure 1.6). Social protection expenditures are politically sensitive, highly pro-cyclical and therefore difficult to control, especially at the local level. Fiscal pressures coming from population ageing have already started, with the share of people older than 65 on the rise. Furthermore, as productivity gains may be limited in some of these services (such as long-term care), employers may have to raise wages beyond productivity gains to attract workers, putting pressures on municipalities' expenditures. This factor may have played a role in Denmark, where unemployment fell significantly during the 15 years preceding the crisis, with some tight labour market spells. The 2007 local government reform might help contain the impact of rising costs in the health sector on local public expenditure, but its benefits will take time to materialise.

In Denmark, taxes accounted for 50% of total revenues of sub-central governments before the 2007 institutional reform and only 33% after the reform as tax revenues of regions have been replaced by grants (Figure 1.7). Taxes represent around 60% of municipalities' revenues, the remaining part primarily coming from grants. Financing through grants weakens the link between the costs of primarily services and taxes, creating an

Figure 1.6. **Local government expenditures by function in Denmark**



1. It corresponds to general public services; economic affairs; environment protection; defence; public order and safety; recreation, culture and religion.

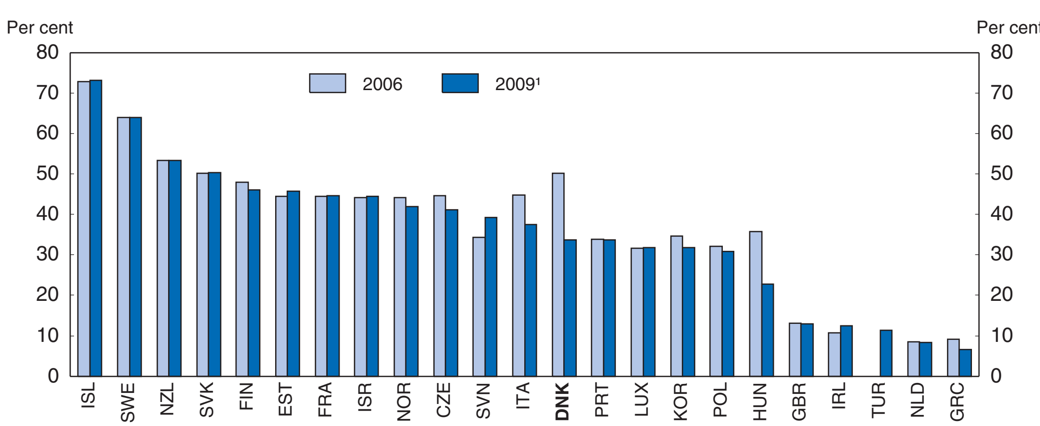
Source: OECD, *National Account Database*.

StatLink http://dx.doi.org/10.1787/888932563191

incentive at the local level to demand more services, even if the marginal benefit does not exceed the marginal cost and therefore leads to higher outlays and deficits (Hallerberg and Von Hagen, 1999; Careaga and Weingast, 2000; Blöchliger and Petzold, 2009). Grant systems may also cause sub-central governments to be less vigilant with their finances. Aware that the central government is helping them out, they increase their deficit, expecting to obtain higher grants in the next period. They then face a soft budget constraint and the growth of transfers from the central government becomes endogenous (Tanzi, 1995; Ter-Minassian, 1999). Indeed, grants were raised to finance overruns of spending. Nevertheless, since 1988, 29 municipalities have faced financial problems and have been subjected to special arrangements (Mau, 2011). These problems resulted from budget errors, non-compliance with borrowing regulations and overestimation of the tax base.

Figure 1.7. **Revenue composition of sub-central governments**

Share of local taxes in total revenues, consolidated account



1. Or latest year available.

Source: OECD, *Fiscal Decentralisation Database* (*www.oecd.org/ctp/federalism/stats*).

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Furthermore, some of the specificities of the Danish set-up increase the risks of having the second type mechanism at work, *i.e.* a soft-budget constraint with endogenous transfers. Local spending for the following year, grants, expected price and wage developments in the public sector, expected tax revenues and net borrowing are all negotiated between the central government and the local government association representing municipalities (called KL). This was supposed to create agreement between central and sub-central governments in which the former gets support for its policy and can influence local public expenditure and taxes, while municipalities have a say on the level of grants. However, in practice the system has generally failed to achieve its objectives. It has been in place for 31 years but the agreements were enforced only between 1983 and 1991, when local tax hikes beyond those agreed in negotiations were sanctioned by cuts in general grants (Lotz, 2010). As those sanctions were aggressive, they were thought to have ruined the negotiation system and were then abandoned until recently.

The negotiation process between the government and KL tends to soften municipalities' budget constraint for several reasons (Lotz, 2010):

- The agreement that sets a ceiling for local public expenditure and grants to municipalities is negotiated by KL, not directly by municipalities, and is not legally binding. Hence, individual municipalities do not feel strongly bound by the agreement and, in practice, ceilings have been systematically overshot. The national budget, which can include measures that affect local public finances, is adopted by Parliament after local budgets have been drawn up, which gives incentives to re-negotiate the agreement (Danish Economic Council, 2002). In recent years (2009 and 2010), municipalities have generally planned to have expenditures in line with the negotiated ceiling in their budgets but some slippages have been observed.
- The formula to set grants is very complex, as these grants are used to finance various policies that are mainly decided at the central level. This gives municipalities some leeway to try to negotiate higher grants.
- Once an agreement has been reached as a result of the negotiation process, it is presented to Parliament. In practice, Parliament has found itself obliged to accept the proposed agreement, because of the large costs and uncertainties of reopening the negotiations.

The tax freeze may also have weakened municipalities' budget constraint, contributing to a lack of control of local public expenditures. As taxes were frozen, municipalities have managed to find other sources of revenue, such as their own resources (land for instance) and higher grants. The tax freeze has put more pressure on the negotiation process between the government and KL as it became even more crucial to receive high grants since tax increases were constrained. It has also discouraged municipalities from cutting tax rates (and hence expenditure), as there was a risk of not being able to increase them again in the future. Following the tax freeze, few municipalities lowered their tax rates and the average tax rate remained broadly constant.[1] The government tried to remedy this problem by guaranteeing municipalities that, if they reduce their tax rates, they will be allowed to raise them again in the future without individual sanctions. Overall, the tax freeze has led to a situation where some municipalities benefiting from good demographic and economic conditions could have cut their tax rates, but dared not do so; while others with unfavourable conditions were in need of tax increases they were unable to make.

Finally, another feature of the Danish system is the disconnect between the large share of decentralised public expenditures and the real power of municipalities over them in areas where they are largely determined by regulations and standards set at the central level (Table 1.2). When municipalities have limited power over their budgets, they may tend to function as agencies funded and regulated by the state government rather than as independent policymakers, which might explain why they face difficulties in setting spending priorities or enforcing spending cuts. Furthermore, when local self-governance is weak, the central government is implicitly responsible for the quality of services provided at the local level, giving it a reason to intervene in the case of fiscal problems, which in turn generates expectations at the local level that fiscal problems will be solved by the central government. A pilot OECD survey has measured the "spending power" of local government for a group of countries, including Denmark, in four policy areas – child care, elderly care, education and public transports (Bach *et al.*, 2009). The indicator measures the extent to which services provided by sub-central governments are governed by rules and regulations set centrally. It shows that in the four areas under consideration, local authorities' spending powers are limited in Denmark.[2]

Table 1.2. **Allocation of social policy responsibilities between levels of government**

	State	Regions	Municipalities
Employment	Set the framework for ALMPs and the various steps for the unemployed		Responsibility for all unemployed
			Job centres
Social services	Set guidelines and rules on the levels of social benefits for receiving them	May provide highly specialised services to specific groups on behalf of municipalities	Total regulatory, supply and financing responsibility
	Counselling through the VISO organisation		Act as a purchaser of highly specialised services from regions or can supply the same services directly
Health care	Specialty planning	Hospitals	Preventive treatment, out-patient care and rehabilitation
	Set regulations on pharmaceuticals	Psychiatry	Home care
	Decide overall expenditures for regional health care	General practitioners and specialists	Treatment of alcohol and drug abuse
	Monitor quality and efficiency		
Education	Set goals and regulations for primary, secondary and tertiary education	Development projects for youth education	Public primary and lower secondary school
	Set regulations of self-governed institutions: upper secondary schools, centres for vocational training and education, centres for adult education, academies of professional higher education and universities	May provide highly specialised education on behalf of municipalities	Specialised education. Act as purchaser of highly specialised services from regions, or may supply the same services themselves
			Educational guidance

Source: Danish Ministry of Interior and Health, *The Local Government Reform* and OECD.

Solving the problem

The 2010 Fiscal Consolidation Agreement introduced measures to better control local government spending (Box 1.2). They included sanctions in the form of reduced grants if municipalities' expenditures increased more than the set targets or if tax rates were increased beyond what was agreed upon. It is too early to assess the efficiency of these sanctions, but up to now they seem to have successfully contained municipalities' expenditures. However, past experience shows that it is necessary to remain vigilant and to be ready to increase sanctions if slippages are observed.

Having a public expenditure ceiling for municipalities anchored in a law, as currently under discussion, would strengthen the status and credibility of these fiscal rules and sanctions. A major difficulty will be enforcing the newly introduced measures. The new fiscal framework is, in itself, more binding and less easy to circumvent, but its success will also depend on the political will to enforce it.

There is also a need to reinforce mechanisms that ensure that individual municipalities feel constrained by rules covering all municipalities. KL is already in charge of setting out a distribution of expenditure ceilings for municipalities consistent with the aggregate ceiling. However, as there is no legal status for these individual ceilings, municipalities can budget expenditures exceeding the ceiling. In this case, the current rules do not allow the government to impose individual sanctions but collective sanctions will be applied. The former government proposed to allow the government to impose individual sanctions in cases where budgeted expenditures are not consistent with the aggregate ceiling. It is important to implement this change. Furthermore, negotiations on the distribution of expenditure ceilings and grants should take place once the overall ceiling and budget for grants have been fixed. In Norway for instance, there is a two-stage budget procedure, whereby the overall budget for grants is determined before the distribution formula is negotiated among sub-central governments. The Economic Council has proposed to introduce a system of tradable municipal rights, limiting overall municipalities' expenditures to the number of "rights" (Danish Economic Council, 2010b). Under this system, each municipality would be allocated an individual expenditure right and would have to buy (sell) expenditure rights to increase spending above (below) its allocated rights. The system – analogous to what exists in Austria – would make municipalities internalise the cost of raising public expenditures but may be complicated to implement.

The envisaged spending ceilings should help prevent slippages. If they were to fail to contain local public expenditures, consideration should be given to better align municipalities' spending and revenue autonomy to prevent spending and taxes from rising beyond voters' choices. A well-functioning local democracy, where the impact of taxes on the local population is transparent and with some tax competition between municipalities, would prevent spending and taxes from increasing beyond voters' choices (Joumard and Kongsrud, 2003). Voters would vote for lower taxes when the cost of new services exceeds their benefits. Sweden, for instance, which is also a relatively decentralised country (albeit less so than Denmark), has managed to create a local democracy that functions well, and has helped to contain local government expenditures (Box 1.3). Hence, improving local self-governance is the key to preventing expenditure from rising permanently when taxes are hiked temporarily. This could be done by:

- Limiting the use of transfers. Transfers should be used for specific purposes (such as fiscal equalisation and in case of economic shocks), decided before the beginning of the budget year and should not be adjusted afterwards or at least only under very specific conditions. Transfers could be reduced to encourage municipalities to realise the economies of scale that the merging of municipalities in 2007 was supposed to generate and to raise the efficiency of their expenditures.
- Matching municipal autonomy in terms of taxes with real power on spending. Therefore, the sharing of responsibilities between the central government, regions and municipalities could be limited. This concerns specific areas such as health (see below).

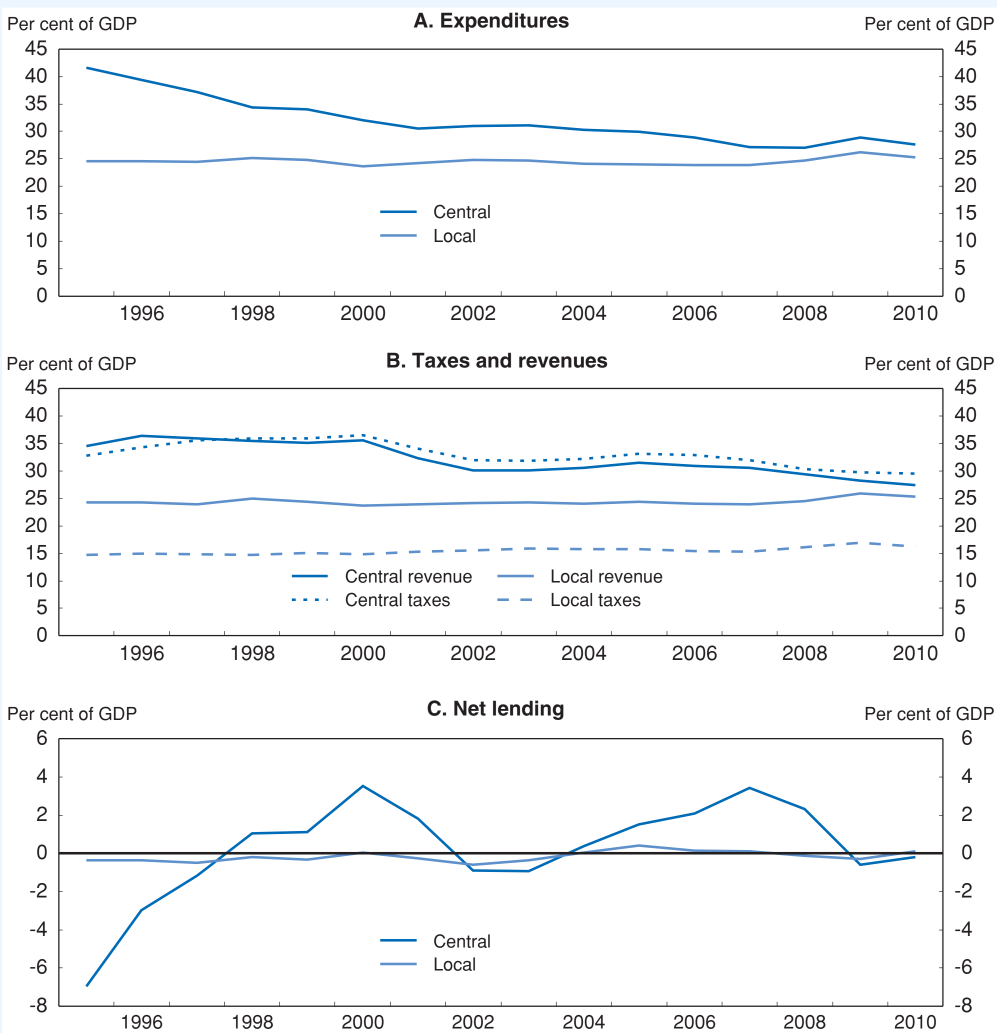
More generally, a cost-benefit analysis of standards and regulations imposed at the central level for decentralised policies should be carried out.

- Continuing efforts to provide more information (via websites) on services provided by municipalities, their quality, their costs and tax rates.

Box 1.3. **The Swedish policy framework for sub-central governments**

Sweden is also a highly decentralised country, with local governments being responsible for 45% of overall public-sector expenditures. Developments in Swedish local government finances have been very different from those in Denmark. The share of expenditures, revenues, and transfers from the centre have been constant as a share of GDP since 1990, apart from the increase in 2009 as a consequence of the global crisis (Figure 1.8).

Figure 1.8. **Developments in Swedish sub-national government finances**



Source: OECD, *Fiscal Decentralisation Database* (*www.oecd.org/ctp/federalism/stats*).

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Box 1.3. **The Swedish policy framework for sub-central governments** *(cont.)*

The fiscal framework for local governments is mainly based on a balanced-budget requirement which covers current expenditures while in Denmark, capital expenditures are also covered. Sweden's framework differs from Denmark's in several ways:

- The balanced budget requirement is strictly defined. Every year, local governments are required by law to define a budget and a financial plan for the next three years (including the budget year). If new expenditures are introduced during the current budget year, their funding has to be decided upon. A local government that reports a deficit *ex post* must adopt an action plan to return to a balanced budget within three years. The local government balanced-budget requirement is a minimum requirement. The Swedish Local Government Act stipulates that municipalities and county councils shall also take into account future costs, including those from ageing.
- The Swedish fiscal framework includes an expenditure ceiling covering transfers to local governments, but local public expenditures are not all covered by the ceiling.
- Any measures decided by the central government that directly affect the activities of the local governments should be financed by adjusting the state grant.
- Local governments are allowed to borrow to finance their capital expenditure. In principle, the market could exert pressures for fiscal discipline (Ter-Minassian,1999), especially when there is a strong commitment from the central government not to bail out sub-central governments, as is the case in Sweden. However, due to the right to levy taxes, the Swedish Constitution does not allow local governments to declare bankruptcy. A local government cannot decide to cease to exist and only Parliament can decide to merge local governments. In this case, the responsibility for assets and liabilities is transferred to another local government. In practice, market pressures may nonetheless have contributed to the healthy fiscal position of Swedish local governments, and thus to their high creditworthiness.
- Swedish municipalities have greater spending powers than their Danish counterparts. In Denmark, the central government has the ultimate responsibility for ensuring a sustainable development of public services, while the supremacy of the central government in this area is less clear in Sweden. Local self-governance is stronger in Sweden than in Denmark.

Overall, the Swedish framework has led to good outcomes, but it is criticised for contributing to a pro-cyclical policy at the local level. Since the municipalities and county councils are required to plan for balanced budgets each year and transfers are strictly limited, there is a risk that they tend to reduce expenditure when tax revenues fall. This happened during the recent crisis. The government has acknowledged this problem and recently appointed a committee to propose solutions. In particular, the committee will look into the case for a mandatory "rainy day" fund to which municipalities and county councils would be obliged to contribute in "good" years and from which they would receive payments in "bad" years.

A strong fiscal framework with multi-annual spending rules for general government, a system of credible sanctions and well functioning local governance could prevent expenditure from rising permanently when tax revenues increase temporarily, because of a cyclical upswing for instance. However, these changes may take time to deliver their effects and containing municipalities' expenditure may be harder to achieve in a recovery period when tax revenues will expand. Furthermore, in practice, several imperfections

– asymmetries of information between policymakers and voters, myopic behaviour on both sides, and policy pressures to continue temporary policies – create a bias in favour of more expenditure. For these reasons, some additional mechanisms should be considered:

- One option would be to define some margins under the expenditure rules, to be exhausted only in specific cases, as in Sweden. However, Sweden's experience shows that when and how these margins can be used needs to be clearly specified.[3]
- Denmark could also refine the "tax freeze" at the local level to ensure that it prevents revenues from rising too much in periods of economic booms. For instance, in the US state of Colorado, state government revenues are not allowed to grow faster than the sum of the growth rates of the regional consumer price index and state population (OECD, 2005). Revenues collected in excess of these limits must be returned to the taxpayers in the following fiscal year by any reasonable means, unless voters approve of the government keeping or spending these revenues. However, in the long run, this type of rule can create inefficiencies, as there is no clear rationale why government spending per capita should remain constant in real terms, and this formula may be inappropriate to tackle demographic changes. For a short period of time, however, this option could help to contain expenditure growth, especially in the context of an economic boom.

How to contain public expenditure

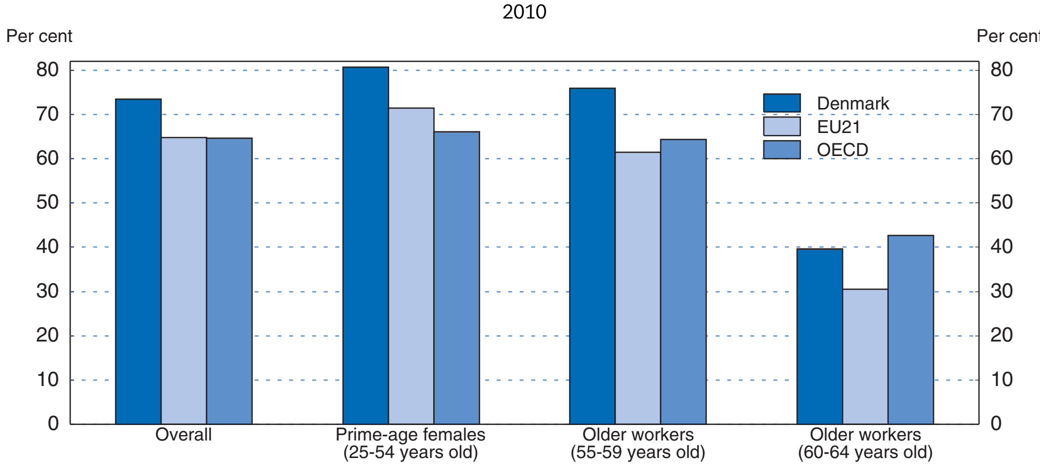
Strengthening the fiscal framework and rules to contain public expenditure would not necessarily harm the Danish welfare system. Indeed, the welfare system can become less costly and more efficient while continuing to stem inequality and poverty and to provide a high level of protection to individuals. This can be achieved through various channels, including reforms to boost labour supply and to improve value for money in the education and health systems.

Raising labour supply

The Danish labour market is characterised by high participation and employment rates, especially for 25 to 54 year-olds and for women generally. However, employment rates are relatively low for workers above 60 while quite high for workers aged 55-59 (Figure 1.9). Hours worked per worker are also relatively low. There is scope to boost labour

Figure 1.9. **Employment rates by age group**

2010



Source: OECD, *ELS Database.*

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utilisation, as aimed for by the government, which would lower public expenditure on programmes that support those outside the labour market and help improve fiscal sustainability. Policies to raise hours worked are discussed in the tax section below.

The employment rates of older workers are relatively low in Denmark, mainly on account of early retirement programmes (Box 1.4). In May 2011, the former government coalition signed an agreement with other parties to reform voluntary early retirement programmes (VERP), which was adopted by the Parliament in December 2011. The main measures imply raising the lowest retirement age (as the duration of VERP is shortened) and bringing forward (from 2019 to 2014) the rise in the retirement age. Estimates by the Danish Economic Council show that these reforms would substantially strengthen fiscal sustainability. Furthermore, by increasing the retirement age more rapidly than planned in

Box 1.4. **The early retirement issue in Denmark**

The issue

The voluntary early retirement scheme (VERP, "*Efterlønnen*") was introduced in 1979 at a time of high unemployment, especially amongst youth. Its purpose was to change the composition of the work force, with the idea that it would allow older people to retire in order for younger people to take their place. In fact, it led to a decrease in overall employment rates, as in many other OECD countries with similar policies.

In its current form, people who have paid their VERP contribution for 30 years and are members of an unemployment insurance fund are eligible to retire at age 60. People can benefit from the scheme until the age of 65, when the old-age pension starts.

Changes have been made over the years to the VERP in order to limit the size of the programme. In 1999 an incentive was given to postpone entrance into the VERP by two years (typically to the 62th year), by lowering the pension during the first two years. At the same time, the entry age of the old-age pension scheme was lowered from 67 to 65, which led to a decrease in the share of the working-age population on VERP after 2004 (Figure 1.10). The 2006 Welfare Agreement took a step further by raising the VERP retirement age by two years from 60 to 62, gradually from 2019 to 2022. The agreement also raised the age of the old-age pension scheme by two years from 65 to 67, gradually from 2024 to 2027 so that all generations can have five years on the VERP. Furthermore, the Welfare Agreement established a mechanism under which the retirement age is indexed on life expectancy at 60, starting in 2025. Changes will have to be announced 10 years in advance and a new decision will be made every five years.

While the Welfare Agreement took steps to postpone the retirement age, it has remained unchanged up to now and will remain so until 2019, even if life expectancy has increased. On some estimates, the expected length of retirement under the current system would rise to more than 24 years and then decrease (once the effects of the Welfare Agreement kick in) to stabilise around 22 years (Danish Economic Council, 2011).

May 2011 agreement on early retirement

In May 2011, the former government concluded an agreement with the Danish People's Party and the Danish Social-Liberal Party to further reform the system (these parties promised verbally to vote for the proposal after the elections):

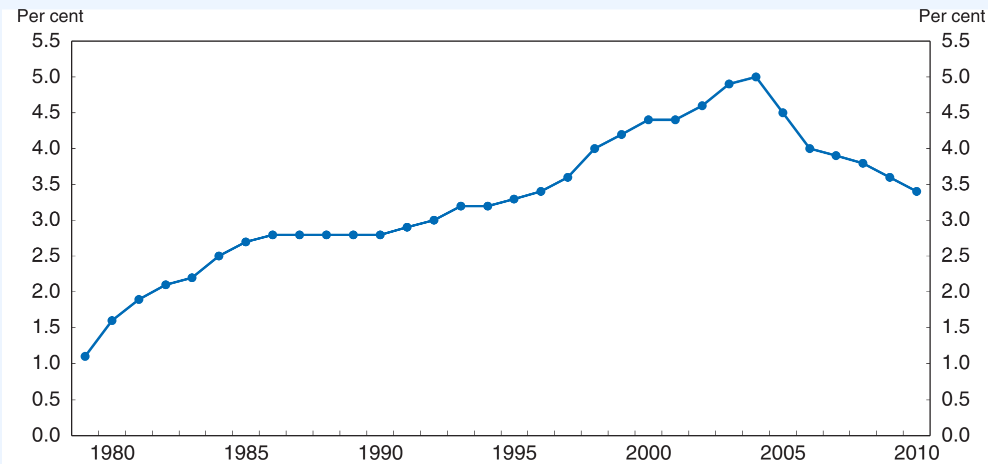
- The early retirement period is shortened from five to three years between 2018 and 2023 while the ordinary retirement age remains constant, implying an increase in the lowest retirement age, which will rise to 63 in 2020 and 64 in 2023.
- The increase in the early retirement age decided in the Welfare Agreement is moved forward by five years to 2014-17.

Box 1.4. **The early retirement issue in Denmark** *(cont.)*

- A new "senior" disability benefit scheme is introduced for those who have health problems linked to their work conditions and are within the five years of the eligibility to the old-age pension. The procedure to enter the scheme would be short (municipalities would have to decide within six months after the application).

According to the Ministry of Finance, the Agreement would increase employment by 1.8% and improve the structural balance by around 1% of GDP by 2020. The Danish Economic Council judges that the Agreement would improve fiscal sustainability and make for a more equal treatment between present and future generations.

Figure 1.10. **Share of the working-age population on voluntary early retirement programmes**



Source: Statistics Denmark.

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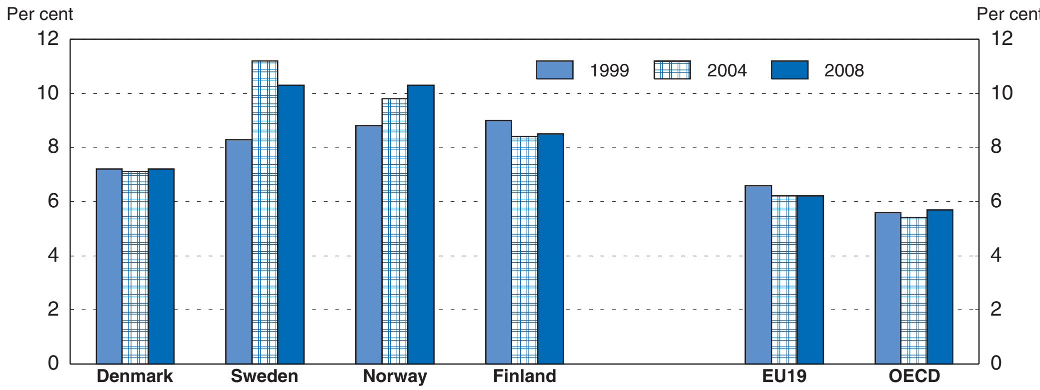
the 2006 Welfare Agreement, this reform implies a more equal treatment between present and future generations (Danish Economic Council, 2011). Hence, the decision by the new government to implement this reform is welcome.

However, the introduction of the new "senior" disability scheme and simplification of the access to disability benefit schemes proposed in the 2011 Agreement may partly offset such fiscal gains by expanding the already relatively high share of the working-age population receiving disability benefits (Figure 1.11). This share has exceeded the OECD average for decades, and may rise further as unemployment peaks tend to be followed by spikes in disability rates about two years later (OECD, 2010a). A rise in disability rates would push up already high social public expenditures (Table 1.1). Furthermore, the relatively large share of the working-age population receiving disability benefits is also a source of concern for equity reasons: a quarter of people with health problems or disability live in poverty (measured in relative terms), which is above the OECD average and far above the average for the general population (OECD, 2010b).

Bringing recipients of disability benefits with work capacity back to the job market is a challenge. The government should closely monitor VERP reform and its impact on the number of recipients. It should also persevere with efforts to improve the efficiency of

Figure 1.11. **Share of the working-age population receiving disability benefits**[1]

Percentage of the population aged 20-64



1. Disability benefits include benefits received from schemes to which beneficiaries have paid contributions (contributory), programmes financed by general taxation (non-contributory) and work injury schemes.

Source: OECD (2010), *Sickness, Disability and Work: Breaking the Barriers: A Synthesis of Findings across OECD Countries*, OECD, Paris.

StatLink http://dx.doi.org/10.1787/888932563286

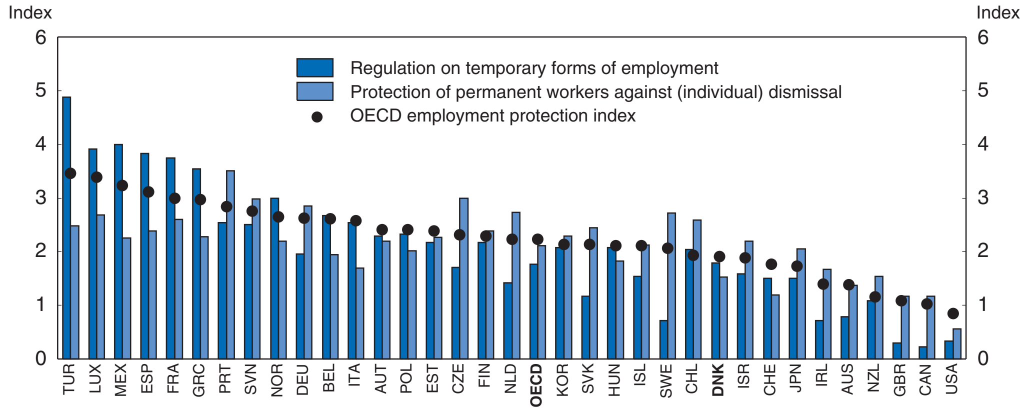
programmes to help the disabled with work capacity to find a job. The special disabled employment programme (*Fleksjob*) has led to an increase in the overall number of recipients of these programmes and therefore should be reconsidered, in particular by making it more targeted on individuals in need and less generous as the income can be higher than the previous wage. A plan to reform the special disabled employment programme following these lines was proposed in April 2011 but reforms have been postponed since then although the new government has announced a reform of the *Fleksjob* scheme (Danish Government, 2011). There is also a case for better integrating disability benefits with other policies to make work pay and helping the sick and disabled with sufficient ability to work to find ordinary employment (OECD, 2010b). The current responsibility structure, with municipalities being key players but not having the necessary powers could be improved. This reflects a larger issue of shared responsibilities between the central government and municipalities concerning labour market and social policies. While municipalities are in charge of job centres, various standards and procedures set at the central level have impeded the efficiency of those job centres. For instance, job centres could be given more responsibility with regard to medical decisions including by ensuring early involvement of municipal doctors and regular control of general practitioners' decisions (OECD, 2010b).

The shortening of the duration of unemployment benefits from four to two years as part of the May 2010 Fiscal Consolidation Agreement is also expected to raise labour supply although the new government has decided to postpone the implementation of this reform by six months. The Budget Bill for 2012 proposed some measures to ease the rules for entitlement to certain social benefits and to increase their generosity. It will be important to ensure that the potentially negative impact of these measures on labour supply is offset by other measures.

Denmark's flexicurity system will help ensure that efforts to raise labour supply translate into higher employment even though it may be tested by prolonged periods of low labour demand. It rests on three pillars: *i)* relatively flexible hiring and firing regulations (Figure 1.12); *ii)* a generous social safety net, and *iii)* strong and developed active labour market policies (ALMPs). Designing efficient ALMPs is particularly challenging. Evidence on the efficiency of these programmes is mixed with some studies finding them to be efficient

Figure 1.12. **Job protection in OECD countries**[1]

2008



1. OECD indicator for strictness of employment protection legislation. Index scale is 0 to 6, from least to most restrictive.

Source: OECD, *Employment Protection Database*.

StatLink http://dx.doi.org/10.1787/888932563305

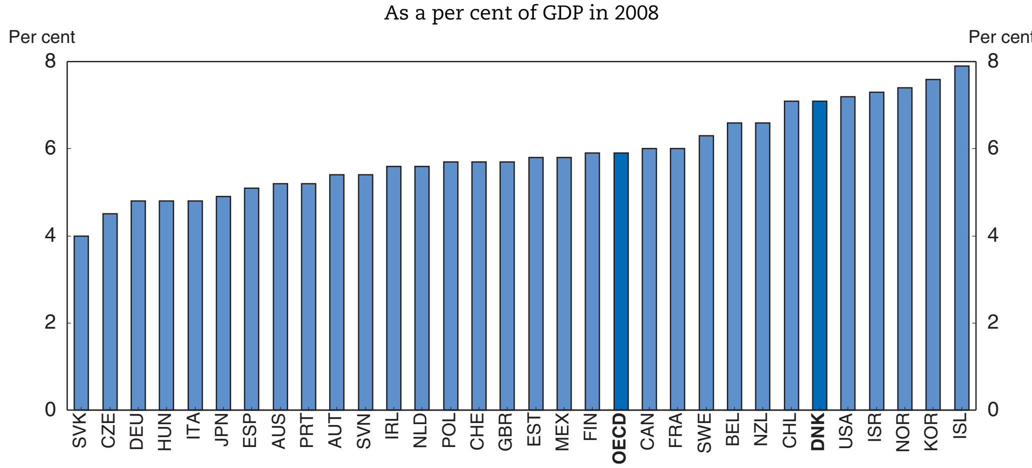
(Heinesen *et al.*, 2011) and others not (Munch and Skipper, 2005). However, according to Andersen and Svarer (2008), these programmes also have indirect effects as the activity requirement to receive unemployment benefits raises the incentives to look for a job and accept it before having been placed in one of these programmes (pre-programme effect). These effects are very strong, explaining the success of the Danish system.

Raising the efficiency of the education system

Various indicators suggest that education is an area where public spending efficiency can be raised. Denmark has relatively high outlays per student (Figure 1.13), yet, the performance of the education system is mixed. On the one hand, education attainment is high in Denmark and youth unemployment has not been a major problem (OECD, 2010c). On the other hand, PISA results are slightly above average for Danish students in general, and rather poor for immigrants. Furthermore, the share of youth with no upper secondary education is at the OECD average (Figure 1.14; OECD, 2009). Formal analysis of the efficiency

Figure 1.13. **Expenditure on educational institutions for all education levels**

As a per cent of GDP in 2008



Source: OECD (2011), *Education at a Glance 2011*, OECD, Paris.

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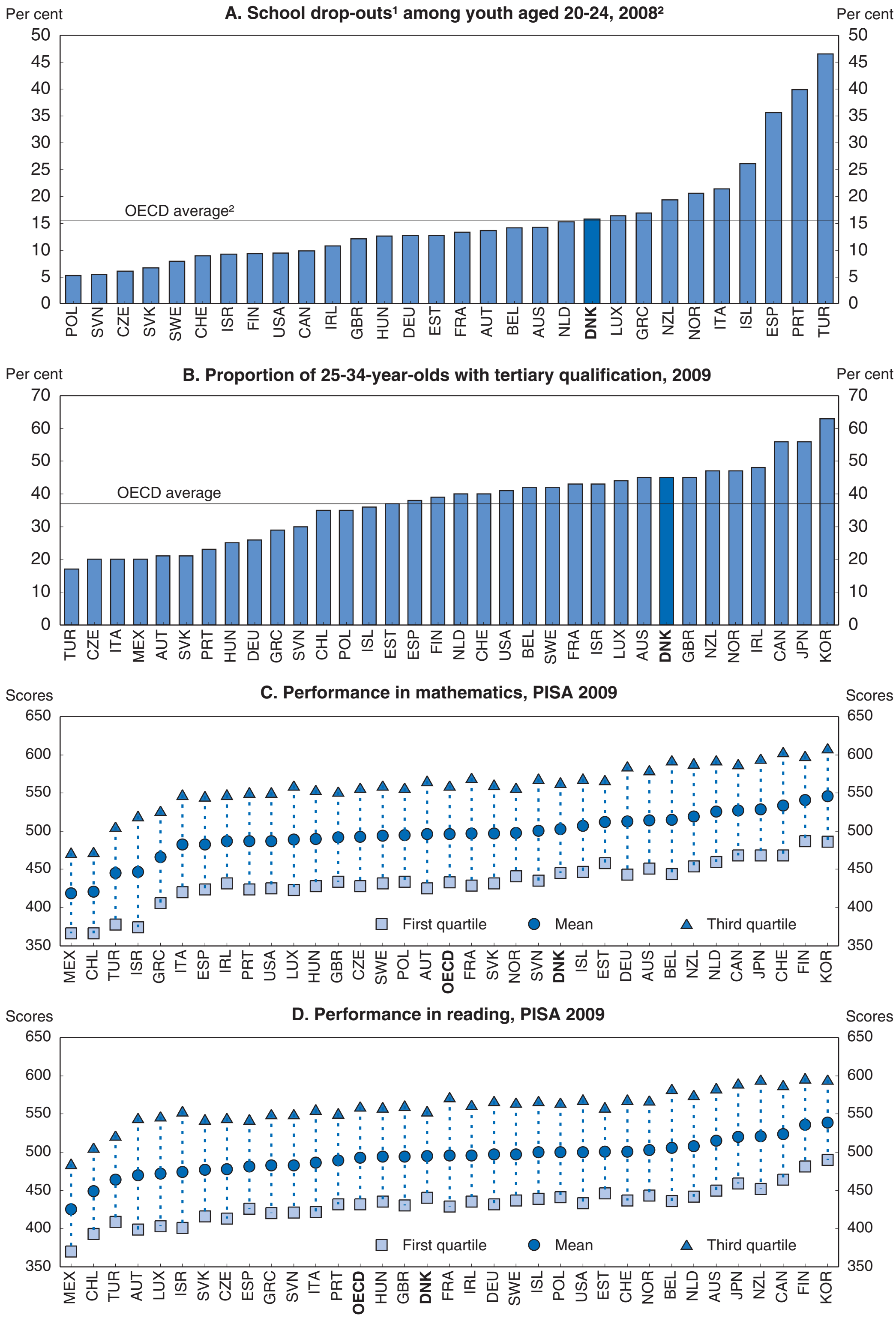
Figure 1.14. **Indicators of the performance of the education system**



1. No longer in education without International Standard Classification of Education upper secondary level (ISCED level 3).
2. 2006 for Australia. Unweighted average of countries shown.

Source: OECD (2010), *Jobs for Youth: Denmark 2010*, OECD, Paris; OECD (2011), *Education at a Glance 2011*, OECD, Paris; OECD (2010), *PISA 2009 Results: What Students Know and Can Do*, Volume I, OECD, Paris.

StatLink http://dx.doi.org/10.1787/888932563343

of public spending in primary and secondary education suggests that maintaining the same level of expenditure and moving towards best practice would lift performance substantially, or that moving towards best practice would help to achieve the same performance at a much lower cost (Sutherland *et al.*, 2007). Raising the performance of the education system would also help boost productivity growth (OECD, 2009; Danish Economic Council, 2010b). Better human capital lifts productivity in existing jobs and facilitates restructuring towards higher-value-added activities, entrepreneurship and R&D.

The previous *OECD Economic Survey* proposed a set of recommendations to raise human capital (OECD, 2009). One weakness it identified is the assessment and evaluation framework. As there is a high degree of school autonomy in Denmark and municipalities are responsible for the quality of compulsory education for public schools (and parent-elected boards for private schools), the evaluation and assessment framework plays a key role for central and local authorities to promote and monitor quality and focus on improvement. Evaluation gives incentives to both students and teachers to perform better, but to be more effective it should come with higher pay flexibility for teachers and school managers. Similar recommendations were made in the recent OECD *Review of Evaluation and Assessment in Danish Education* that calls for stepping up the implementation of newly introduced measures to monitor and evaluate quality in compulsory education (Shewbridge *et al.*, 2011). The implementation of these measures varies among schools and municipalities and there is a need to develop evaluation and assessment at all levels of compulsory education.

Another issue raised in the previous *Survey* is the relatively high rate of drop-outs. The education system leaves a number of youth behind and fails to target special individual problems. Recent findings suggest that the education system, like labour market policies, needs to be individualised to yield good outcomes. This is a dimension that Denmark has successfully introduced in its ALMPs but to a lesser extent in education, as opposed to Finland for instance (Box 1.5). The newly introduced compulsory tests of students would

Box 1.5. **The advantages of individualised service provision**

There has long been a focus on the need for social policies to be "active" rather than "passive". Recent analysis has shown that social policies have to shift away from insurance and move towards "skill-based risk mitigation" and individualised actions (Sabel *et al.*, 2010). This concerns in particular education and ALMPs.

There are several reasons for having individualised social services. First, new findings on learning show that individuals learn differently and learning problems need not be permanent, thus calling for an individualised pedagogical approach. Another reason is the awareness that risks faced by individuals can be structural (such as for instance the fall in demand for low-skilled workers) and require individuals to have the capacity to overcome these types of disruptions. A third reason is the increasing heterogeneity of populations.

Concerning the individualisation of service provision, Denmark is an interesting case with its ALMP system being highly individualised and successful, while its education system is not. The Finnish education system, which gives very good results (measured by PISA) is much more customised to individual needs than the Danish system. In particular, the Finnish system uses testing of pupils extensively and at an early stage. These tests are not being used for sanctions, but to detect learning problems. Another feature of the Finnish system is the large use of special education, with almost one third of pupils receiving special short-term instruction, mainly in standard classrooms.

help identify the weakest students earlier on. Furthermore, for schools to better adapt to the needs of all their students, both native and immigrant, there is a need to professionalise school leadership through better training and to improve the pedagogical skills and quality of teachers (Nusche *et al.*, 2010). Specific targeted initiatives to close the performance gap between Danish and immigrant students should be developed. For instance, the previous OECD *Economic Survey* recommended targeting the optional year following the nine years of compulsory education (the "10th form") on the weakest students and to review vocational education. Reducing the size of classes in high schools, which is already relatively low compared to other OECD countries, as proposed by the Budget Bill for 2012, tends to have only a limited impact on overall performance and to be costly (Nusche, 2009).

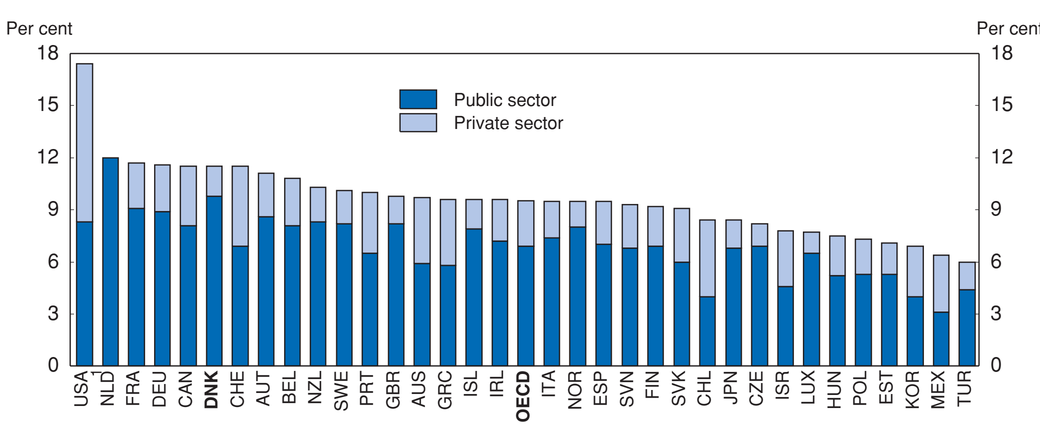
Concerning tertiary education, the main problems are that: *i)* students start tertiary education relatively late, reducing the supply of high-skilled labour (OECD, 2009); and *ii)* students tend to choose fields with relatively low business needs and weak productivity potential (Growth Forum, 2011). Gradually moving to a system that combines grants and loans in a way that encourages on-time completion – the duration of grants could be shortened – could help. Going even further, a system of tuition fees with income-contingent loans should be considered. Tuition fees would give universities more resources and/or free up public resources to be applied to other priorities in education or elsewhere. Furthermore, by creating a price signal, tuition fees would encourage students to take earnings prospects after graduation more into account when making study choices. However, care should be taken not to reduce overall incentives to take up education.

Raising the efficiency of health-care expenditures

Spending on health has increased strongly in recent years and Denmark is now one of the OECD countries with the highest spending on health, the bulk of which is public (Figure 1.15). However, in terms of health status, the country tends to underperform compared with similar countries and the OECD average (Table 1.3). Micro analysis that measures the effectiveness of health-care systems through cancer survival rates also points to weak outcomes for Denmark over 1995-2007 relative to other countries and, hence, scope for improvement (Coleman *et al.*, 2011).

Figure 1.15. **Expenditure on health in OECD countries**

As a per cent of GDP in 2009 or latest year



1. Total expenditure on health for the Netherlands, including both public and private sectors.

Source: OECD (2011), *Health Database*: Health Expenditure and Financing Account.

StatLink http://dx.doi.org/10.1787/888932563362

Table 1.3. **Health status indicators**

	Life expectancy at birth[1] 2009	Life expectancy at 65[1] Females, 2009	Life expectancy at 65[1] Males, 2009	Infant mortality[2] 2009	In-hospital case-fatality rates[3] 2007		
					Acute myocardial infarction	Ischemic stroke	Hemorragic stroke
Denmark	**79.0**	**19.5**	**16.8**	**3.1**	**2.9**	**3.1**	**16.7**
Finland	80.0	21.5	17.3	2.6	4.9	3.2	9.5
France	81.0	22.5	18.2	3.9			
Germany	80.3	20.8	17.6	3.5			
Norway	81.0	21.1	18.0	3.1	3.2	3.3	13.7
Sweden	81.4	21.0	18.2	2.5	2.9	3.9	12.8
OECD average	79.5	20.5	17.2	4.4	5.1	5.0	19.8
Best performing country	83.0	24.0	18.9	1.8	2.1	2.3	9.5
Worst performing country	73.8	15.9	13.7	14.7	8.1	9.0	30.3

1. Years.
2. Per 1 000 births.
3. Age-sex standardised rates within 30 days after admissions.

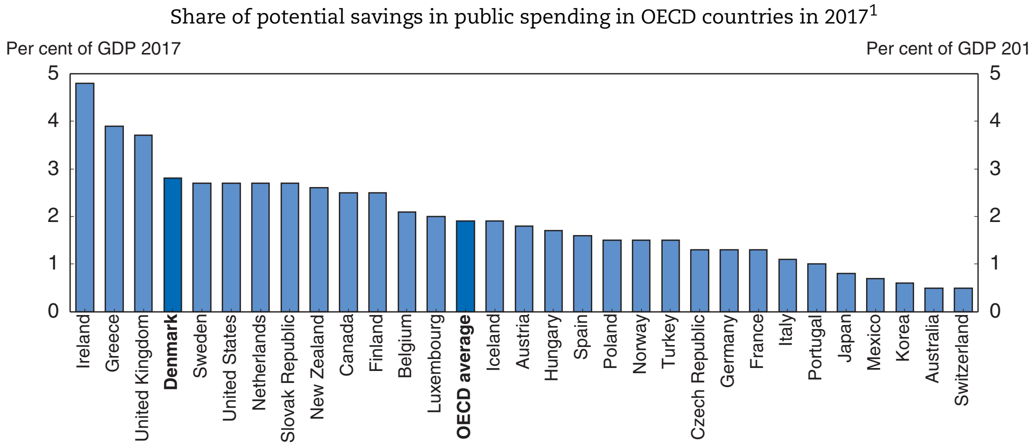
Source: OECD (2011), *Health at a Glance 2011*.

Lifestyle partly explains these health outcomes. Tobacco consumption has been very high in Denmark; more than half of adults smoked daily in the 1970s. While smoking has decreased significantly, the impact of past behaviour may contribute to current relatively low life expectancy. Alcohol consumption is also relatively high in Denmark and obesity has increased significantly. The new government has raised taxes on unhealthy food products and on tobacco (see Box 1.2 and below).

Nevertheless, even when the impact of lifestyle on life expectancy is taken into account, OECD analysis suggests that health outcomes could be better with the same level of spending on health or that these outcomes could be achieved at lower cost (Joumard *et al.*, 2010). The potential savings coming from an increase in the efficiency of the health care system are estimated at close to 3% of GDP for Denmark (Figure 1.16). Going forward, as expenditures on health are set to rise further and as they are mainly financed through taxes, it is crucial to exploit potential efficiency gains.

Figure 1.16. **Achieving efficiency gains in the health care sector**

Share of potential savings in public spending in OECD countries in 2017[1]



1. Potential savings represent the difference between a no-reform scenario and a scenario where countries would become as efficient as the best performing countries.

Source: Health Care Systems: Efficiency and Policy Settings, OECD, Paris, 2010.

StatLink http://dx.doi.org/10.1787/888932563381

The recently published OECD indicators on health care systems allow the features of the Danish health system and its performance to be compared with those of countries with similar health systems, *i.e.* systems based on a “command-and-control” approach, little private provision, no choice of providers, little incentive for providers to respond to demand and strict gatekeeping (Joumard *et al.*, 2010).

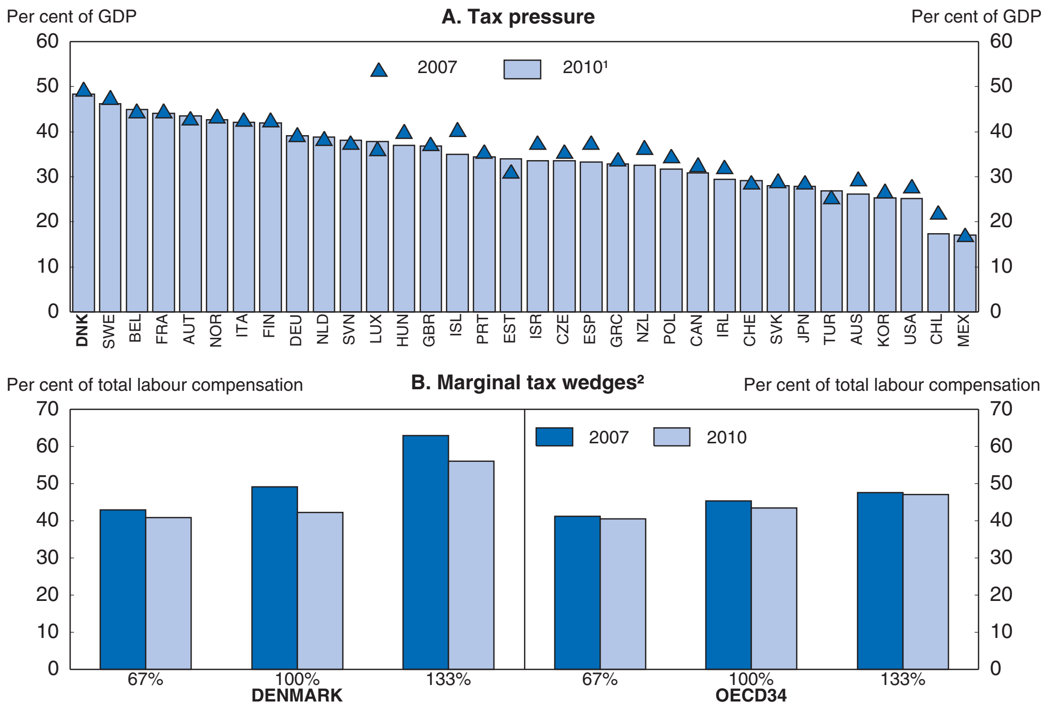
Denmark stands out as one of the OECD countries with the lowest degree of consistency in responsibility assignment across levels of governments. This is mainly because several levels of government are involved in key health care decisions, with regions being broadly in charge of hospitals and municipalities of out-patient care. However, the allocation of responsibilities is more complex than this broad picture suggests. For instance, regions negotiate tariffs and wages of practitioners and fix their number. Furthermore, while regions are in charge of hospitals, the Ministry of Health sets the payment methods for hospitals and the number of hospitals per region. Regions’ expenditures are mainly financed by a state block grant that amounts for 75% of their revenues. The involvement of several levels of government can lead to waste through duplication, lax control over spending when responsibilities overlap and insufficient exploitation of economies of scale (Joumard and Kongsrud, 2003). Furthermore, this allocation of responsibilities requires having an incentive system that ensures that each level of government does not try to transfer costs to the other level. For instance, under the current system, as regions cannot fully control costs, they have an incentive to ask for higher grants. Municipalities have limited incentives to develop preventive measures as they only partly bear hospital costs. Indeed, while they contribute 20% to the financing of hospitals, only half of this contribution depends on their use of regional services. The allocation of responsibilities and resources across different levels of government could thus be rationalised. Furthermore, funding should be refined further to give incentives to achieve good performance. In particular, remuneration of doctors and out-of-pocket payments are very low in Denmark. Another option would be to change the assignment of responsibilities, with either the regions or the central level being fully in charge of health issues. More detailed recommendations on health were made in an earlier *Economic Survey of Denmark* (OECD, 2008).

Revisiting the tax structure

Taxes on labour remain high compared with other OECD countries, despite a decrease in the tax and social security burden on labour over the past 11 years (OECD, 2009, 2011). This is not conducive to entrepreneurship and labour mobility and undermines Denmark’s attractiveness for skilled workers, thereby exerting a drag on productivity growth.

In particular, marginal tax rates on higher income are high (Figure 1.17). While this reflects a social choice for an equal society, it reduces hours worked, can be a barrier for workers to choose highly productive and demanding jobs, contributing to low productivity growth, and diminishes the attractiveness of higher education. The former government had decided to increase the income threshold from which the top tax rate applies in 2009, but postponed the increase to 2013 as part of its fiscal consolidation plan. When fiscal consolidation has been achieved and public expenditure is under control, marginal taxes on labour could be lowered further, by raising the tax threshold for the top personal income tax rate or cutting the marginal tax rate. The new government has announced a fully-financed tax reform, including a reduction in labour income taxation.

Figure 1.17. **Tax pressure and marginal tax wedges**



1. Or latest year available.
2. Evaluated at 67%, 100% and 133% of average earnings for a single person with no child.

Source: *OECD Analytical Database* and *OECD Tax Database*.

StatLink http://dx.doi.org/10.1787/888932563400

Reducing marginal taxes on higher income would have distributional effects and tend to raise income inequality, but this can be at least partly offset by raising taxes on property, which are low in Denmark. Indeed, property value taxes have been frozen in nominal terms since 2002. This can have distributional implications as higher-income households are more likely to be homeowners. In addition, low taxes on property value have adverse efficiency effects on housing and other markets by distorting the allocation of saving and investment (Andrews *et al.*, 2011). In particular, the property tax freeze arguably contributed to the housing market boom that destabilised the economy, adding to the problems Denmark faced during the global financial crisis (Danish National Bank, 2011).

More generally, there is room to extend the tax base by removing some tax expenditures, while lowering tax rates. Tax expenditures are relatively high in Denmark, at over 4% of total tax revenues in 2006 (OECD, 2010d), as a result of the Danish government's desire to alleviate the impact of high tax rates on some groups of the population and on some activities. However, the role and costs of these tax expenditures are not always transparent, partly because their costs, both in terms of lost revenues and administrative burden, and their effects are not fully reported by the Ministry of Finance (Danish National Audit Office, 2007).

A notable recent tax change is the increase in indirect taxes on unhealthy products (see Box 1.2). Such increases contribute to making room over the longer term for enhancing the efficiency of the tax structure by reducing taxes on income. Denmark is the first country[4] to introduce a "fat tax" on saturated fat, after pioneering strict regulations on the use of transfat (commonly used in industrially produced food) in 2004. The fat tax is meant to help address overweight and obesity problems, and thereby, to reduce the occurrence of cardiovascular diseases. While the share of the obese in the population is still relatively low from an international perspective, it has been on the rise over the past 15 years (Rockwool Foundation Research Unit, 2011). The effect of the fat tax on health status is unclear, however, as health depends on the overall diet, not only on fat intake, and on the overall nutrients contained in food. The proposal made in the Budget Bill for 2012 to raise taxes on other unhealthy products could help to improve the overall diet and thereby enhance the effect of the fat tax. The latter will have distributional impacts: *i)* in the short term, lower-income households will be particularly affected as food accounts for a larger share of their spending, especially in so far as the demand for these products is inelastic; *ii)* in the longer term, as these households are also those who are the most exposed to obesity problems, they may benefit from the tax, provided that they do not switch to products with higher detrimental effects on health. The effect of the tax on prices and consumption patterns will be central in this respect. Early observations suggest that the prices of some food products (such as butter) have risen by more than the amount of the new tax, possibly reflecting insufficient competition in the retail sector.[5] It will therefore be important to monitor and assess the impact of the fat tax in the near future.

Box 1.6. **Main recommendations to consolidate public finances**

Strengthening the fiscal framework at the central and sub-central levels

- Introduce expenditure ceilings at general government level covering most public spending (not only public consumption, though perhaps excluding investment and cyclically-sensitive spending such as unemployment benefits) at a medium-term horizon.
- Give the Economic Council more of a fiscal council role and to this end grant it access to the necessary information, including the detailed government accounts.
- Continue with the use of sanctions to contain local public expenditures and consider raising them further if slippages reappear.
- If the new sanctions and envisaged spending ceilings fail to contain local public spending, consider limiting the use of grants to sub-national governments to specific purposes and reducing the sharing of responsibilities between levels of government.

Measures on the expenditure side to contain public expenditure growth

- In the implementation of the 2011 reform of the early retirement scheme, make sure that the provision concerning the "new" senior disability scheme does not lead to an unwarranted increase in the number of recipients of these benefits.
- Improve work incentives and targeting of support for the sick and disabled with ability to work, while tightening eligibility conditions, and reassess entitlements regularly. In particular, the special disabled employment programme (*Fleksjob*) should be reconsidered. It should be better targeted, work ability should be regularly reassessed, and the wage subsidy should be lowered.
- Continue to improve and develop the evaluation and assessment framework for both students and school staff. Improve targeted initiatives for pupils most in need.
- Gradually move to a system that combines educational grants and loans in a way that encourages on-time completion.

Taxation

- Reduce marginal taxes on higher incomes, by raising the tax threshold or cutting the marginal tax rate, once fiscal consolidation has been achieved and public spending is better controlled. Increase property taxes by restoring the tax base once the housing market has recovered.

Notes

1. Over 1985-91, 80 of the 276 municipalities have reduced their tax rates while this number fell to eight over 2000-06 (Lotz, 2010). The average municipal tax rate increased by 1 percentage point over 1985-91, and by 0.2 percentage point over 2000-06.
2. Numerous binding regulations of ALMP programmes set at the central level have also weakened the efficiency of job centres (now run by municipalities).
3. In 1998-2000 when the Swedish economy was benefiting from strong growth, decreasing unemployment, low inflation and hence, less pressures on expenditures, expenditure margins were almost fully exhausted (Hansson Brusewitz and Lindh, 2008).
4. Taxes on unhealthy products also exist in Denmark as well as in the United States, for instance, where some states have introduced a tax on soft drinks.
5. "Supermarkets Using Tax Fat to Fatten Bottom Line", *Copenhagen Post*, 31 October 2011.

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