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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of Denmark, 2006

Summary

The Danish economy is performing very well, reaping the benefits of 25 years of well-managed economic reform. In 2005 growth picked up to 3%. Even though unemployment has declined to a historical low, inflation remains subdued and there are no signs yet of accelerating wages. The output gap has closed and growth is projected to stay above potential in the short term, with almost only the automatic fiscal stabilisers in place to slow a potentially overheating economy. Looking further ahead, a significant downward trend in labour supply is looming that will tend to reduce the potential growth rate. In the longer term, a declining workforce and ageing-related expenditure increases make the current public welfare system difficult to sustain. Although labour force participation is high, the number of hours worked is low, not least because of high marginal taxes. One area where reforms have not yet made enough progress is housing, which is overregulated and absorbs too many subsidies and tax expenditures.

Avoiding an overheating risk in the near future. The fixed exchange rate framework continues to serve Denmark well. However, in situations like the present one when the Danish economic cycle differs considerably from that in the euro area, other policy instruments need to show extra flexibility. Monetary conditions transmitted from the euro area via the fixed exchange rate regime will most likely remain too expansionary in the near future since the main drivers of the economy (investment, exports, consumption increases driven by rising housing wealth) continue to steam ahead. Measures are therefore needed to damp demand and boost supply. Fiscal policy must remain tight and structural reforms must go on. All sources for increasing labour supply should be tapped now – including reducing public employment by reaping efficiency gains from the municipality reform, cutting unemployment benefit duration and opening the labour market more effectively to job searchers from other parts of the EU.

This Policy Brief presents the assessment and recommendations of the 2006 OECD Economic Survey of Denmark. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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Raising labour supply to secure fiscal sustainability. The tight labour market provides a fertile environment for reforms to boost labour supply. The government's proposals to increase the age thresholds for early retirement by three years and the age pension by two years for citizens younger than 50 years today followed by an indexation of the retirement age to life expectancy are commendable and a major step to secure the sustainability of public finances. However, it would be preferable to phase out the voluntary early retirement scheme altogether and much will depend on how indexation will be implemented. The number of disability pensioners is high and continued effort to keep more of those with some remaining work capacity in employment is warranted. Furthermore, an updated medium term fiscal strategy should include timed, targeted and fully financed tax cuts which are much needed to make work pay better.

Enhancing human capital and using it better. Skill formation is not sufficiently effective for a high income country and it is urgent to address the culture of delaying tertiary studies. The government's proposal to reduce study grants for those delaying the start of tertiary studies by more than two years is welcome. For the longer term, a system should be developed whereby tuition costs and grants are subject to repayment after graduation, with such repayments creditable against income taxes. That could reduce the incentives to work short hours or to leave the country after graduation. It could also make the tertiary education sector more dynamic.

Reducing subsidies and tax expenditures for housing and easing regulation for the rental market. Denmark is well endowed with housing and its vast support programmes are not very well targeted. Tax concessions for housing should be given up and used to create room for reducing other, more distorting taxes. Regulation of rents should be phased out and the supply of new housing should be made more flexible. ■

Could strong growth lead to overheating?

The Danish economy is performing very well, reaping the benefits of 25 years of well-managed economic reform that have produced sound macroeconomic policies, a flexible labour market and a competition-friendly regulatory environment. Temporary factors such as revenue from oil exploration have also contributed to strong public finances. After some years of slow growth, the economy started to recover in late 2003, and accelerated to a GDP growth rate of 3% in 2005. Private consumption, exports and investment are all expanding. Consumer confidence is close to its highest level since records began three decades ago. Unemployment is historically low, and firms still expect to hire more people in most sectors of the economy. So far, wage inflation has been remarkably subdued, but that could change rapidly as labour shortages are now very clear in construction and seem likely to spread to other sectors.

While the Danish economy is in good shape, GDP growing much faster than its potential rate in 2005 and a closed output gap pose the immediate challenge to be vigilant in the face of an overheating risk. House prices have grown strongly and added about half a percentage point to consumption growth each year via wealth effects and mortgage equity withdrawal. With the recent acceleration of house price increases, private consumption and housing construction could have plenty of steam well into 2007. And neither world trade nor investment show signs of weakening. Wages seem set to rise somewhat faster than productivity next year, and experience from other small open economies shows that an overheating scenario can then set in very quickly. Monetary policy cannot be tightened autonomously because with the fixed exchange rate regime it is *de facto* set by the ECB, and it will most likely continue to add stimulus. In this context, policy makers must be very attentive to how the economy evolves, and stand ready to take swift measures to mitigate the risk of overheating. The following areas should receive particular attention:

- In general, automatic stabilisers function well and the cyclical response of the fiscal balance is the strongest among OECD countries, but recently the real estate tax has been frozen in nominal terms for each dwelling. Now only the smaller land tax follows increased valuations, putting only a weak check on the house price boom.
- Some oil exporting countries like Norway smooth their oil related revenues in funds, which establish a firewall between the economy and fluctuations in oil prices. Denmark does not have such a fund and keeps all oil-related revenues in the budget, leading to large swings in the budget balance. Such temporary revenues should be used to reduce public debt, as excessive public spending growth should be avoided not least in municipalities.
- The labour market is more flexible than in most OECD countries, but a number of factors still hinder adjustments. Administrative procedures for firms to employ foreigners from the new EU member states have been relaxed somewhat, but rules remain cumbersome. High marginal taxes on labour set in already from average incomes and reduce the incentive to work more hours when wages increase. Long duration of unemployment benefits, in particular for seniors, may reduce the intensity of job search.

What are the challenges further ahead?

Looking further ahead, ageing would reduce growth in GDP per capita to below 1% a year from an average 1¾ per cent during the two decades to 2005. Over the coming three decades, the labour force is projected to contract by 10%, if participation rates remain unchanged, bringing the economy into a regime quite different from the steady labour force growth of the recent decades. The number of children and over-65's will increase by a quarter relative to those in working age. Under current policies, the primary budget balance would deteriorate by 4% of GDP over the coming three decades. In this context three medium-term challenges need to be addressed to circumvent the slow-growth scenario:

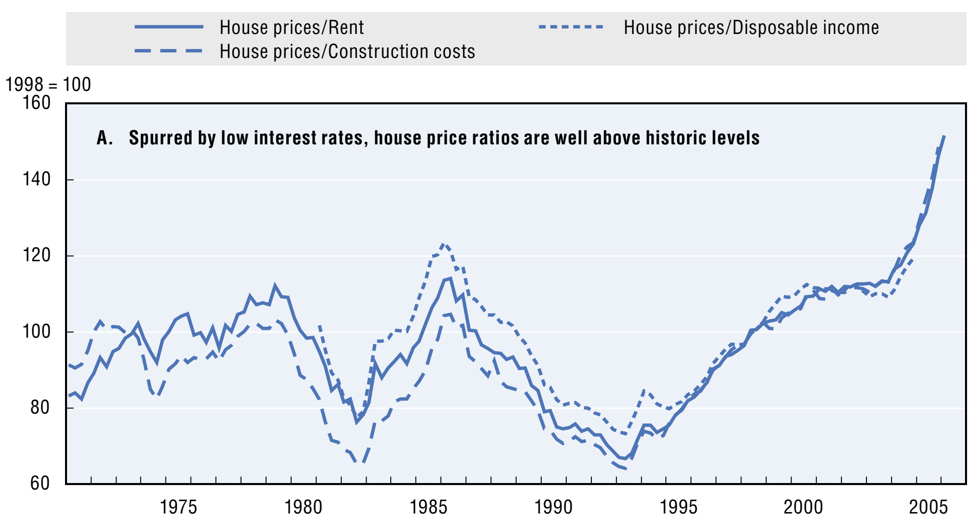
- It will be difficult to sustain today's welfare society unless there are profound reforms to raise labour supply. More people working gives an especially large fiscal gain in countries with high taxes and generous social benefits.
- To boost living standards, it is vital that Denmark continues reaping the full benefits of globalisation, with human capital and innovation being the key issues.
- Reforms are necessary also in areas that are sheltered from international competition, but where inefficiencies nevertheless put a drag on development, create unnecessary costs for public budgets and restrict mobility and flexibility. One such policy area is housing – the in-depth chapter topic in this *Survey* – which, despite some progress, still needs less subsidy and regulation.

Are interest rates too low for Denmark?

The fixed exchange rate regime which shadows the monetary policy stance of the European Central Bank continues to serve Denmark well. It is highly credible as indicated by only small fluctuations of the krone around its

Figure 1.

THE SPEED OF HOUSE PRICES INCREASES RAISES CONCERNS



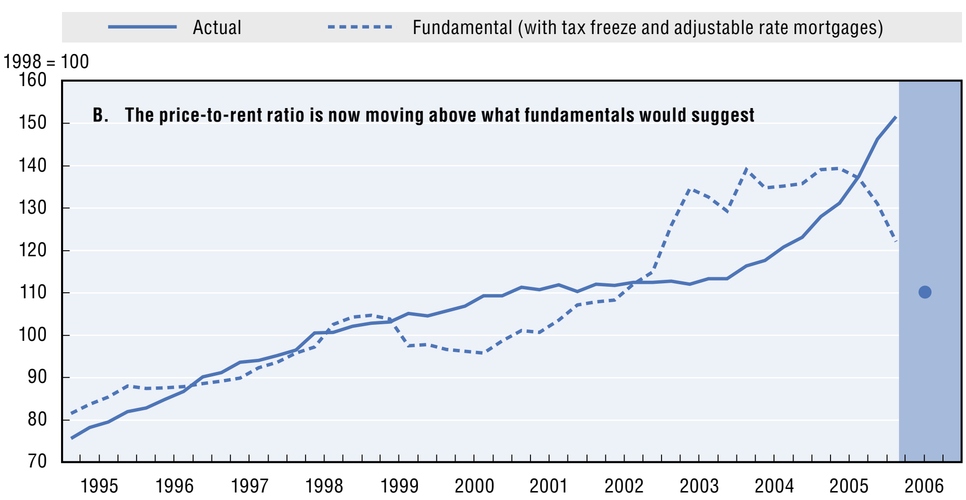
central parity *vis-à-vis* the euro and by a minimal interest-rate differential. One contributing factor has been that fiscal policy has held course so far, avoiding destabilising the economy. At the current juncture, with a strong boom in Denmark, and considerable slack in the euro area, ECB policy rates are well below the appropriate level for Denmark and are likely to remain so in the near future, adding stimulus that is not needed in the next couple of years. Moreover, over the recent decade, structural changes in the mortgage market have gradually changed how monetary policy functions. In particular, the transmission of short-term interest rates to the real economy has become stronger. This probably reflects the increased use of adjustable rate loans which have raised the exposure of households to changes in short-term interest rates, as well as mortgage equity withdrawal which has been facilitated by rising house prices in an environment of lower interest rates. The currently low level of interest rates is thus likely to have a larger effect on aggregate demand and economic activity than previously. Hence, an appropriate policy mix requires tighter fiscal policy and measures to increase the supply elasticity of the economy in order to balance the current excessive monetary stimulus.

What fiscal strategy to pursue?

Denmark has achieved much in terms of bringing down debt and recorded a budget surplus of almost 4% of GDP in 2005. General government net debt has been reduced to just 10% of GDP by the end of 2005, down from about 30% of GDP a decade ago, and will probably be eliminated by 2010. Removing old debt has provided a strong position for tackling the ageing challenge. Looking ahead, policy should focus on genuine reforms to extend working lives. *In an updated medium term fiscal strategy, it would be appropriate to aim for small budget surpluses, provided initiatives currently under way succeed in alleviating the longer-*

Figure 1. *(cont.)*

THE SPEED OF HOUSE PRICES INCREASES RAISES CONCERNS



Notes: Actual and fundamental house price-to-rent ratios have been set equal to 100 in the most recent year when the actual price-to-rent ratio was close to its 35-year-average. The dot shows what the fundamental price-to-rent ratio would be if interest rates increase by 1 percentage point from the end-of-2006Q1 level.

term budgetary pressures. This strategy needs to be implemented vigilantly. Room for tax cuts to make work pay better should then be created by further reforms. However, timing is important to avoid overheating the economy. Despite the present surplus there is no room for lax fiscal policy in the short run. The tax freeze has succeeded in ending the upward drift in municipal income tax rates, and it is important that municipal spending growth is kept modest to match this. ■

How can labour supply be raised quickly?

In addition to tight fiscal policy to damp excess demand, all options must be used to free labour supply rapidly, thereby increasing potential growth. The tight labour market provides a fertile environment for reforms to boost labour supply. In this regard, specific priorities are:

- First, to *reap the potential efficiency gains from the municipal mergers taking effect from 2007. Municipalities should reduce employment as much as possible*. This should give a welcome boost to labour supply for the private sector.
- Second, to *enhance job-search incentives by reducing the maximum unemployment benefit duration from 4 years to something like the 1-2 year duration in the other Nordic countries. Also, as proposed by the government, to abolish all exemptions in unemployment benefit rules and activation for people in their 50's.*
- Third, to *use foreign labour more intensively: removing barriers for skilled workers from abroad; speeding up the administrative procedures to issue residence and working permits for those from the new EU member states; and helping firms connect to unemployed workers in these countries as well as in other parts of the EU where there are skilled but unemployed workers*. Some improvements have recently been agreed in Parliament.

But increasing labour supply is not just a short-term priority. It is primarily a long term challenge, and the following paragraphs identify policies needed in this regard.

What if retirement age is raised?

Since 1960, the average number of years spent in retirement has increased by *half* to currently 19 and 23 years for men and women respectively. One cause is distortions to retirement decisions from large fiscal subsidies to early retirement. In fact, most of the reduction in labour market participation among seniors is due to expansion of the voluntary early retirement pension available for 60-64 year olds. It was introduced in 1979 to reduce unemployment, and to make early retirement possible for seniors worn out after many years of hard manual work; but today a typical recipient comes straight from employment and has no particular health problem. Moreover, cross-country experience has shown that while aggregate demand and unemployment can fluctuate temporarily, the number of jobs is mainly determined in the long run by how many are actively searching for work. The government's recent proposal to raise the starting age for the voluntary early retirement pension by three years (from 60 to 63) and the regular retirement age by two years (from 65 to 67) is therefore welcome. These changes would apply for citizens younger than 50 years today and, after being phased in from 2017 to 2025, it would be followed by indexation of the retirement age to life expectancy. Together with the other elements of the government's proposals for welfare reform, these measures would handle the demographic challenge to fiscal sustainability for many years into the future. But, given the uncertainties associated with demographic developments and other spending pressures, future governments will need to be ready to take necessary measures, including adjusting retirement age in line with a longevity indexation formula. Still, the preferred option should be to remove the early retirement scheme altogether, as proposed also by the Welfare Commission.

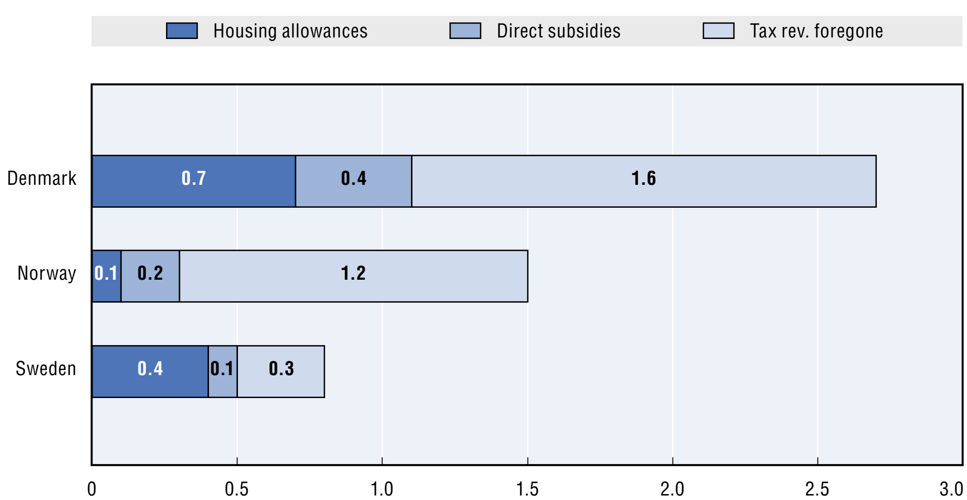
Could the boom feed through to those currently at the margin of the labour market?

For every ten people in employment, there is one receiving a permanent disability pension – almost twice the number of unemployed. Providing income for those who really cannot fend for themselves is a hallmark of a welfare society, although the number of benefit recipients appears to be high in international comparison. Measures have been taken to reduce the inflow, but *further attention should be given to how permanent disability status can be avoided for persons with remaining work capacity*. In this regard, there is a need to give social policy an even more active orientation, starting with prevention and early rehabilitation. Disability pensioners are to a large extent being excluded from an active work life and *more options to come back to work should be provided*. Permanent wage subsidies are available on so-called flexjobs, which are popular among workers, municipal social authorities and employers. *The scheme has been modified in 2006 but is still too generous and should be brought more in line with the level of related benefit programmes in order not to make expansion too expensive fiscally. Furthermore, flexjob arrangements should be reviewed on a regular basis and adjusted to changes in work ability and rehabilitation measures.*

Figure 2.

DIRECT AND INDIRECT SUBSIDIES FOR HOUSING IN NORDIC COUNTRIES

Per cent of GDP, 2005



Source: Submission from the Ministry of Social Affairs (Denmark); St.meld. nr. 1 (2005-2006) Nasjonalbudsjettet and St.prp. nr. 1 (2005-2006) Kommunal- og regionaldepartementet (Norway); Prop. 2005/06: 1 Budgetpropositionen for 2006 (Sweden).

The current upswing is also a unique chance for marginalised groups such as inactive migrants to get a foothold in the labour market. *One place to start is the large number of recipients of social assistance who are out of work, but are not registered as job seekers at the public employment service. The reform of the public sector should be used to align the efforts of the employment offices and the municipalities.* It is also important to ensure that those participating in activation are available for employment at short notice.

Is globalisation good for Denmark?

Today's living standards could hardly have been achieved without taking advantage of the gains from new technologies and specialisation deriving from the country's openness and the resulting international division of labour. To continue reaping the full benefits of openness, Denmark needs to reinvigorate its education system and develop greater interaction between universities and firms on R&D. Other policies such as labour and product market regulations are already more adjustment-friendly than in most OECD countries so that the key requirement is to look for ways to improve human capital and raise the supply of skilled labour. Business sector R&D has trended up since the mid 1990s, reaching 2% of GDP in 2004, and special subsidies or tax credits are not warranted. According to recent government proposals public R&D should reach 1% of GDP in 2010, with additional grants provided on a competitive basis.

Is the talent of all young people mobilised?

A key weakness is the surprisingly slow progress in human capital formation. Among the 25-34 year olds, only 86% have at least upper secondary education, compared with 89%, 91% and 95% in Finland, Sweden and Norway respectively. Despite large public investments in early childhood care and compulsory education, Denmark seems to have substantial difficulties mobilizing the talent of all young people, and a large share – including many second-generation migrants – seem to be lost during school, leaving with only limited literacy skills. Some steps are being taken now. The introduction of more frequent and systematic evaluation of student achievement will help identify learning problems at an earlier stage. Allowing teachers to specialise more will improve educational performance not least in subjects like science where Danish learning outcomes are among the poorest in the OECD. *Efforts to improve compulsory education should continue including by strengthening the educational content of the introductory year for six-year olds and targeting or abolishing the voluntary 10th form. More apprenticeships should be made available, possibly helped by increasing refunding for firms taking apprentices based on higher contributions from all employers.* The government and social partners have agreed to increase resources for the already high level of life long learning. ■

Are incentives to acquire and use human capital ensured?

High and progressive income taxation reduces the reward for studying, and weakens the incentive to choose subjects with promising job and earnings prospects. Despite both this and a narrow income distribution, private economic returns are boosted by full public coverage of tuition costs and generous grants for student living costs. Consequently, a comparatively high share of a youth cohort takes tertiary education, but the other side of the coin is a growing "culture of delay". With a typical starting age of 23 and prolonged study duration, too few years are left for reaping the fruits of the qualifications in the labour market. To counteract this, *the study grant should be adjusted to encourage young people not to postpone studies*, as proposed by the government. For the longer term, an arrangement whereby the costs of tuition and grants for living costs throughout tertiary education are treated as a loan to be repaid after graduation should be developed in order to improve the efficiency of educational choices and increase the responsiveness of universities to student needs. By granting tax deductions for repayment, the introduction of such loans can remedy the current adverse incentives for graduates to leave the country or work short hours, while not reducing the individual's economic return to education.

Is current labour, capital and housing taxation optimal?

Previous *Surveys* have noted that high marginal taxes hold down hours worked and may encourage "informal" work, especially in sectors like construction. Tax cuts introduced in 2004 targeting people with low and intermediate earnings were welcome, but the problem is remaining particularly pronounced for those with incomes at or just above average, where the top income tax rate cuts in, with the combination of social contributions plus income and consumption taxes creating a marginal tax rate above 70% for four in ten of the full-time employed. *The first priority for tax reform to increase labour supply should therefore be to raise the income threshold from where the top tax is paid*, considering that this would strengthen work incentives more, krone-for-krone, than tax reductions at the lower end of the income scale. It would also raise the average skill level of the labour supply, as people with intermediate qualifications would benefit most. Furthermore, disincentives for accumulating human capital would be reduced as the after-tax return to education would be higher.

Although the aim of the tax-freeze – putting an end to an upward spiral of public expenditures and revenues – can be fully shared, its narrow interpretation will become more and more problematic as it precludes meaningful restructuring of the tax system as a whole. *For instance, income taxation should be made less distorting by a revenue-neutral reform raising the real estate tax, while lowering the middle or top income tax rates*. This could improve incentives to work considerably while changing the income distribution only negligibly. It should be considered in connection with a wider reform of capital taxation, where effective tax rates on *real* return vary from 25% to 100% for two identical bonds, the one being held in a pension scheme, the other being held as a liquid investment. In particular the gap between 33% interest deductibility (which is large compared to other countries) and 15%

tax on pension returns seems to encourage tax planning. Sooner or later, tax reform will most likely be necessary to accommodate changes in mobility, financial markets and other factors. The current capping of the real estate tax for each home at the nominal level it had in 2001-02 cannot be an appropriate long run solution, as misalignment from neutrality gradually grows. ■

Could housing policies become more targeted and flexible?

Several reform measures have gradually liberalised the housing market but policies need further reform for two reasons: subsidies and tax expenditures are substantial and not well targeted, and excessive regulation on the rental market may impede labour-market mobility and encourage illegal side payments. Furthermore, supply should be made more responsive to demand in order to damp overshooting house prices. A wide-ranging reform is warranted, but gradual steps are also feasible and preferable to inaction.

In 2005, direct public subsidies for housing amounted to 1.1% of GDP, on top of which comes considerable indirect costs in the form of tax revenue foregone. That is much more than in neighbouring Sweden and also large compared to other OECD countries. These subsidies should be reduced, as housing availability is high by international comparison, and the distributional impact is not very well focused. Reform could proceed in a number of ways:

- *Increase the real estate tax for owner-occupied housing to make it neutral* vis-à-vis *the tax value of interest deductibility, preferably in connection with a wider reform of capital income taxation.*
- *Phase out tax exemption for co-operatives.*
- *End the tax subsidies for pension funds' investments in newly constructed private rental housing, as well as the tax exemption for pension funds' return on property bought earlier.*
- *Replace the general subsidies for housing associations with targeted support for those who are referred by municipal social authorities or in other ways are in clear need of public housing support. Increase the role of municipalities in the allocation of dwellings. From an overall fiscal perspective, the National Housing Construction Fund should be integrated with the central government budget.*
- *Reconsider the size and targeting of personal housing allowances to reduce the high marginal effective tax rates implied by their withdrawal. Reform the scheme by linking it to appropriate rents in a region instead of actually paid rents.*

A well-functioning rental market is important because it allows people to make undistorted choices both concerning housing and asset structure. The distributional outcome of the current rent regulation in the older part of the private rental sector and in social housing is not well targeted and it reduces mobility with adverse effects for the labour market. Measures should focus on rent liberalisation, full cost pricing and liberalisation of co-operative share prices:

- *Let rents in private rental housing be set freely on market terms by progressively scaling back rent regulation.*

- *Let tenants in social housing pay rents that better reflect differences in quality, location and demand.*
- *Remove price regulation for shares in housing co-operatives – as in Norway. Such a liberalisation generates capital gains, and the part that reflects identifiable public construction subsidies or urban renewal subsidies might be returned to the state and municipality.*

Currently, house prices are high relative to construction costs, making it attractive to build new dwellings. In most parts of the country where prices have been increasing, construction is growing rapidly. But this is happening to a lesser extent in the Copenhagen region. Quite some open farmland can be found within a 30-kilometre perimeter from the city centre, but a combination of tough zoning regulations, cumbersome administrative procedures and local reluctance means that the many smaller municipalities surrounding Copenhagen have not expanded fast enough to keep pace with increasing demand in the capital region as a whole. *Municipalities could be given more room for borrowing to finance infrastructure, schools and similar facilities when new land plots are issued for housing. Mechanisms like road pricing could allow infrastructure investment to be more closely linked to where the demand is and help avoiding congestion problems.*

For further information

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