

ENGLISH SUMMARY

This report from the chairmen of the Danish Economic Councils contains four chapters. Chapter I presents the outlook for the Danish economy, Chapter II deals with the public sector finances, Chapter III examines the Danish growth since the financial crisis, and Chapter IV discusses and analyzes the Danish taxation of residential property and land.

Chapter I: Economic Outlook

Since the autumn of 2015, the global economy has been characterised by increased uncertainty, and the international economic outlook for 2016 has deteriorated considerably. The unrest has been reflected in the financial markets by increased stock price volatility and lower yields on government bonds. In Europe, the sizeable influx of migrants and refugees and the possibility of Britain leaving the European Union have caused political uncertainty. Nonetheless, the uncertainty is not expected to derail the current, modest recovery of the global economy.

Growth prospects for the Danish economy are rather weak for 2016, mainly due to a fall in GDP in the second half of 2015. GDP is expected to grow slightly more than 1 per cent in 2016. In the subsequent years GDP is however expected to grow a little over 2 per cent annually, cf. Table A.

GDP growth during 2015 was driven primarily by growth in private consumption. This happened after several years with restrained consumption, which has contributed to restore household financial wealth. Along with increasing employment, growth in real wages as a result of very low inflation and prolonged low interest rates, this leads to an expectation of continued increase in consumption and thus growth in aggregate demand and production.

Table A Key figures of the short-term outlook for the Danish economy

	Current	Percentage change, volume				
	prices DKK bn.	2015	2016	2017	2018	2025 ^{a)}
Private consumption	951.8	2.1	2.0	2.3	2.3	2.3
Public sector consumption	519.7	0.6	1.1	0.4	0.9	1.0
Gross fixed capital formation	378.4	1.1	1.2	3.7	4.7	2.7
consisting of:						
Residential investment	74.2	-0.5	0.6	3.1	4.7	3.3
Business fixed investment	224.2	2.6	2.9	4.7	5.8	2.6
Public sector investment	73.6	-1.0	-3.8	1.1	0.9	2.0
Stockbuilding ^{b)}	9.7	-0.3	0.2	0.0	0.0	0.0
Total domestic demand	1 859.6	1.1	1.8	2.1	2.4	2.0
Exports of goods and services	1 057.8	-1.0	-0.5	2.8	4.2	4.7
Imports of goods and services	931.5	-1.4	0.7	3.1	4.7	5.3
GDP	1 985.8	1.2	1.1	2.0	2.3	1.8
Key indicators						
Consumer prices, percentage change ^{c)}		0.6	0.6	1.6	1.7	2.1
Unemployment, per cent ^{d)}		3.6	3.2	3.1	3.0	2.4
Current account, DKK bn.		139	120	112	108	125
Current account, per cent of GDP		7.0	6.0	5.4	5.0	4.4
General gov. budget balance, DKK bn.		-41	-43	-41	-23	11
General gov. budget balance, per cent of GDP		-2.1	-2.1	-2.0	-1.0	0.4
Hourly wage costs, percentage change		1.8	2.0	2.3	2.7	3.1
Terms of trade, percentage change		0.3	-0.9	-0.6	-0.1	0.0

a) The column shows projected average annual growth from 2018 to 2025 for all variables except for unemployment, the current account, and the general government balance. For these variables the column shows the projected values in 2025.

b) Contribution to GDP growth in percentage points.

c) Implicit private consumption deflator.

d) Percentage of total labour force. National definition.

Source: Statistics Denmark, National Accounts and own calculations.

Despite modest GDP growth rates in recent years, employment has increased by about 75 000 people since the end of 2012. The rise in employment has reduced unemployment, but is primarily generated by an increase in the labour force.

However, the decrease in the number of unemployed persons has accelerated the past six months and the number of unemployed excluding participants in active labour market programmes is currently just above 90 000 persons. The weak GDP growth and the significant increase in employment imply that productivity growth has been relatively weak in recent years.

This outlook presents a revised estimate of the structural labour force and hence of the production capacity in the Danish economy. The revision implies that the structural labour force is reduced by 41 000 people in 2015 and 32 000 people in 2016 due to a change in underlying assumptions of the calculations as well as incorporation of new historical data and a new population projection. With the new estimate, the actual labour force is currently around 30 000 persons below its structural level.

The revised estimate of the structural labour force implies that output gap is assessed to be -2 per cent in 2015 compared to -3½ per cent in the previous projection from February.

Given the projection for demand and production, output gap is expected to be almost unchanged from 2015 to 2016. A gradual normalization of the cyclical stance of the Danish economy is expected in subsequent years, where increasing domestic demand and growth in the Danish export markets are anticipated to contribute to growth in production and employment. The forecast of the international economy rests on the assumption that the recent negative signals will not turn into a significant decline in growth in the coming years.

Recent years' employment growth is expected to continue in the coming years, partly due to normalisation of the business cycle and partly due to a rise in structural employment. Employment is expected to increase by 230 000 persons from 2015 to 2025, of which about a quarter can be attributed to business cycle normalisation. The remainder reflects an increase in labour supply, caused by reforms adopted

during the past decade, in particular reforms that gradually increase the retirement age.

There are several risk factors that could affect the forecast of the Danish economy negatively. One is the considerable uncertainty regarding the forecast of the international economy. If global growth turns out to be lower than expected, it will have negative effects on exports in small open economies like Denmark. Another risk is that the progress in the domestic labour market will come to a halt, which will dampen domestic consumption. Also, there is a risk that the labour shortages will emerge causing large wage increases in some sectors. This is particularly dangerous if unsustainable wage increases spillover to sectors exposed to international competition.

Policy

With the government's current economic policy, including the agreement on expenditure ceilings until 2019, fiscal policy is expected to contribute negatively to economic activity in the coming years. Fiscal policy is presumed to reduce annual growth by $\frac{1}{4}$ to $\frac{1}{2}$ of a percentage point in the period 2016-19. This is in particular due to dampened growth in public consumption. The planned fiscal tightening is considered necessary for achieving a sound medium and long term development in public finances. Also, the tightening is considered to be fairly attuned to the expected cyclical recovery.

The Danish government has set for negotiations in parliament on a tax reform in the autumn of 2016. The government has announced that it will present a medium-term economic plan until 2025 which will clarify the available scope for tax reliefs. The chairmanship of the Danish Economic Councils advises the parliament to be cautious in passing unfinanced tax reductions as there is considerable uncertainty regarding public finances the coming years. However, this should not prevent fully financed tax reliefs. Whether tax cuts are financed by an increase in other taxes, structural reforms or reductions in public expenditures, these cuts should be fully itemised.

The government has recently proposed to reschedule the PSO tariff (Public Service Obligation), which is currently charged as an addition to the price of electricity and used to finance subsidies to renewable energy for domestic producers. The proposal was announced after the European Commission concluded that the current system conflicts with the treaty because it discriminates against foreign electricity producers. The government proposes that the expenses to renewable energy subsidies instead will be a part of the yearly public budget. The chairmanship finds it appropriate to include subsidies to renewable energy in the fiscal budget and proposes to finance the subsidies with a broad tax base.

There has been a significant increase in the number of asylum seekers since 2014, and it is likely that many non-western refugees will migrate to Denmark in the coming years. The Danish government has reduced social benefits to refugees and agreed with the labour market organisations that firms will be able to hire refugees in job training schemes at a pay considerably below minimum wage. This is favourable as some asylum seekers and refugees may not have the needed skills to obtain the minimum wage. In light of the low labour participation rate among people from non-western countries and the challenges this may cause in the coming years, it is positive that the government and the labour market organisations have made integration of refugees a part of the tripartite negotiations.

Chapter II: Public Finances

Danish fiscal policy is subject to the Budget Law, which has been in effect since 1 January 2014. The Budget Law imposes expenditure ceilings on the state, municipalities and regions, and sets a structural deficit limit of $\frac{1}{2}$ per cent of GDP. Fiscal policy is also subject to the constraints of the EU Stability and Growth pact, including the deficit limit of 3 per cent of GDP. In addition, Danish fiscal policy must be sustainable in the long run.

The Budget Law assigned the chairmanship of the Danish Economic Councils the role of “fiscal watchdog”. The

chairmanship is to evaluate the fulfilment of various fiscal policy objectives, including long term sustainability and whether fiscal policy complies with the Budget Law and other medium term budgetary restrictions. This includes assessing the expenditure ceilings.

It is the opinion of the chairmanship that the planned fiscal policy is generally in compliance with the fiscal policy rules, cf. Table B. However, there is a risk of non-compliance in certain areas.

One of the most important benchmarks in fiscal policy is the structural balance. The chairmanship estimates a structural deficit of 0.3 per cent of GDP in 2017, which is close to the limit of $\frac{1}{2}$ per cent mandated by the Budget Law. Therefore, even minor changes in the underlying conditions for this assessment may cause the deficit to breach the limit.

Based on the current outlook for the Danish economy, the budget deficit is expected to be 2.1 per cent of GDP in 2016 and 2.0 per cent of GDP in 2017. The budget balance is subject to significant uncertainty, and changes in assumptions regarding the evolution of the business cycle could still lead to a breach of the EU deficit limit of 3 per cent of GDP.

Table B Assessment of fiscal policy rules

Objective	Assessment
Fiscal sustainability	<ul style="list-style-type: none"> ● The overall assessment is that Danish fiscal policy is sustainable, cf. <i>Danish Economy, spring 2015</i>.
Medium-term developments of the budget balance	<p><i>Structural balance</i></p> <ul style="list-style-type: none"> ● Structural deficit close to deficit limit in 2017 ● Structural deficit within the ½ per cent deficit limit in the period 2018-25 ● Structural balance in 2020 <p><i>Budget balance</i></p> <ul style="list-style-type: none"> ● Deficit below 3 per cent of GDP in the period 2016-25 <p><i>Expenditure ceilings</i></p>
Compliance with expenditure ceilings in fiscal planning	<ul style="list-style-type: none"> ● The agreements with municipalities and regions as well as the budget for 2016 comply with the expenditure ceilings
Compliance with expenditure ceilings in accounts	<ul style="list-style-type: none"> ● The accounts for municipalities, regions and central government for 2015 comply with the budgets and expenditure ceilings

Note: Compliance with fiscal objectives is assessed based on the planned policy:

Red: It is assessed that a limit or an objective will not be met.

Yellow: It is assessed that a limit or an objective is close to not being met, and there is a risk of non-compliance

Green: It is assessed that a limit or an objective will be met.

Chapter III: Danish growth since the financial crisis

The Danish economy was hit hard by the financial crisis and in 2009 GDP decreased by 5 per cent. The setback was particularly severe because the Danish economy was overheated with soaring housing prices and an unemployment rate at historical lows in the years preceding the crisis.

The recovery since the crisis has been sluggish: From 2009 to 2014 Danish GDP per capita grew at only 0.3 per cent annually. This is very low compared to other EU and OECD countries. However, Danish growth rates have been comparatively low since at least 2000 so the weak growth might also be a structural phenomenon.

A decomposition of GDP growth in the period 2009-14 reveals that growth in hourly productivity is about as high as in other EU and OECD countries. However, this is specific to the period 2009-14 – growth in Danish productivity has been strikingly low in international comparisons at least since 2000.

The weak GDP growth is thus explained by weak growth in hourly employment in 2009-14. There is a sizeable contribution to the sluggish employment growth from a decrease in the labour force participation rate. This might reflect a combination of discouraged workers leaving the labor force in light of the economic slump and young people responding to political efforts to encourage education activity.

The chapter identifies the changes in the population's age distribution as one important structural reason why Danish growth has been comparatively low. Whereas the ratio of young people in the population has increased substantially in Denmark since 2009, it has decreased somewhat in most other EU and OECD countries. This is important because labour market participation and productivity differ significantly across age groups. It is estimated that the annual growth in Danish GDP in the period 2009-14 would have been 0,4 percentage points higher if the Danish age distribu-

tion had evolved as in the average of 26 countries in the EU and OECD all else being equal.

Contractionary fiscal policy is a potential demand-side explanation for the weak economic growth of the Danish economy. Following the expansion in 2009, the Danish fiscal policy has been somewhat contractionary in the period 2010-13 – as recommended by the European Commission. However, measured by the change in the structural primary deficit, the fiscal tightening was not stronger than in other countries. Actually, the opposite seems to be the case. Hence, it is unlikely that the fiscal tightening is an explanation of the comparatively low growth in the Danish economy – even though it was inappropriate for cyclical reasons.

The Danish fixed exchange rate policy vis-à-vis the euro is another potential demand explanation for weak growth. In order to defend the peg the Danish Central Bank raised its policy rate in the autumn of 2008 but only for a short while. From late 2009, Danish interest rates have been at the same level or even lower than in the euro area. Regarding the effective exchange rate, Denmark experienced an appreciation in 2008-09 but depreciation afterwards. Overall, compared to other countries neither the interest rate level nor the effective exchange rate seem to have hampered the Danish recovery. Thus, it appears unlikely that the recovery would have been much stronger had Denmark pursued an independent monetary policy.

The comparatively low growth in GDP per capita does not necessarily imply that growth in Danish income has been weak during the recent years. In addition to GDP, income depends among other things on terms of trade and net income from abroad. These factors have in fact compensated for the weak growth in GDP per capita to a large degree.

Denmark has for a number of years experienced a persistent improvement in terms of trade implying that consumption and investment possibilities grow faster than GDP. This improvement adds significantly to wealth growth as imports and exports represent more than 50 per cent of GDP, corre-

sponding to an additional GDP growth of 0.2 per cent annually in the period 2009-14. This is considerable and stands out in international comparisons.

Further, growth in Gross National Income (GNI) has out-paced GDP growth by 0.7 percentage points annually in the period 2009-14. The main reason is increasing capital income from the rapidly growing net foreign asset position. Danish net foreign assets have increased from 3 per cent of GDP in 2009 to 46 per cent of GDP in 2014. Cyclical weakness of domestic demand might contribute to this striking development, but it is highly likely that maturing of mandatory pension schemes have contributed to increase savings considerably.

Albeit GDP is a key economic indicator, the significance of changes in the age distribution, the improvement in terms of trade and the much faster growth in GNI emphasize that it is important to include other measures in an assessment of recent year's economic performance in Denmark. The need for improving the understanding of the persistent terms of trade improvement and increasing capital income from abroad is evident. If these developments do not continue the coming decades, higher productivity growth is needed if Denmark is to remain among the most prosperous countries in the world.

Chapter IV: Taxation of owner-occupied housing – Principles and experience

The most important taxes on owner-occupied housing in Denmark are property tax and land tax. It is due to the fact that they normally harm economy efficiency less than other taxes. Property tax is paid by homeowners and land tax is paid by all owners of land whether it is used for owner-occupied housing or other purposes. Property tax amounts to 1½ per cent and land tax on homeownership amounts to 2 per cent of total taxes. The two taxes play different roles and they are both important to ensure that the overall tax system function properly.

Since 2002, the property tax has been frozen, which has distorted the tax system. The tax freeze has locked in the property taxes in monetary terms and in line with the rising property prices, the real property rate has been eroded. The gain from the tax is unevenly distributed geographically, as it is homeowners in those parts of Denmark which experienced the strongest increase in house prices that have had the biggest gains.

Land tax and property tax generally have two remarkable features. Firstly, they are an example of a tax that in principle does not affect the economic activity because the overall supply of land is not affected by the tax size. This means that the tax on land from an economic efficiency perspective is one of the best forms of taxation.

Secondly, the land tax is expected to be capitalized in the land values. Sales prices for a plot reflect the value of the expected use of the land minus future tax payments. Therefore, the current owners effectively bear the entire burden of an increase in land tax in the form of lower land value. Future buyers of the land will thus be fully compensated for their tax payments in the form of correspondingly lower land tax. Conversely, the current owners earn all the benefits of a reduction in land tax in the form of an increase in the value of the land, while the future buyers actually are unaffected by the tax change.

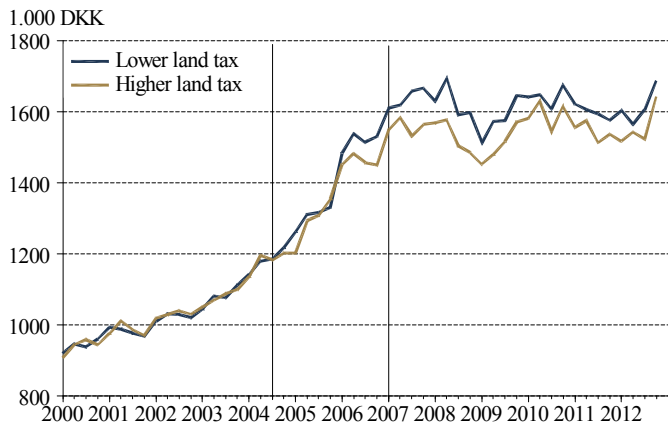
An empirical analysis in the chapter confirms that changes in land taxes are capitalized in housing prices. In 2007, 288 municipalities were merged into 99 municipalities. It resulted in an increase in the land tax in 139 areas and a decrease in 105 areas. Before the municipalities were merged citizens expected changes in land tax. The government decided in June 2004 to reduce the number of municipalities. In 2005 it was decided which municipalities should be merged and in autumn 2006, the new rates of land tax was determined. It is therefore likely that housing prices even before the merger was influenced by changes in land tax.

One can get an idea of whether the changes in land tax has affected property prices by comparing trends in property

prices for the areas that experienced a rise in land tax with the municipalities that experienced a decline in land tax. Before the end of 2004, the development of prices of single-family houses was broadly similar in the two groups referred to, cf. Figure A. From 2005 it is seen that prices rises less in areas where land tax is increased, than in areas where it is decreased.

An empirical analysis has been conducted to assess the effect of changes in land tax on the price of single-family houses. The analysis isolates the change in land tax as a result of the merger of municipalities from previous and subsequent changes in land tax resulting from the current adjustment or any policy decisions of the local council. The analysis also takes into account developments in other local conditions that could explain that prices of single-family homes in the two municipal groups develop differently. The results of the analysis suggest that changes in land tax are fully capitalized in the prices of single-family houses.

Figure A Prices for single-family houses



Source: Own calculations based on public registers.

In order to reduce the inefficiency loss of the tax system, it would be advantageous to give the land tax a larger role in the tax system in future. This will be the case especially if

increasing globalization will increase the pressure on other taxes such as taxation of labour or capital income. Simulations from a computable general equilibrium model in the chapter confirm that a shift from a labour income tax to a land tax results in a social efficiency gain. An increase in land taxation could be instituted in the form of a central-government land tax as a supplement to the present local-government tax.

Tax policy, however, is not only about efficiency, but also about distributional issues. The strong capitalization effects imply that changes in the taxation of property and in particular land should be phased in gradually.

An important element in an efficient and equitable tax structure is that persons with the same real income should be treated in the same way. This is often referred to as the principle of horizontal equity. It implies that the returns to owner-occupied dwellings should be taxed at the same level as income from other real or financial investment. This level is called the neutral tax on owner-occupied dwellings.

The size of the neutral tax on owner-occupied dwellings depends on the valuation of the returns to a representative dwelling, and the reference tax rate on capital income that is used as a bench-mark. It is difficult to measure the total returns directly, and other forms of capital income are taxed at various rates in the Danish tax system. However, a tax rate of 1.2 per cent on owner-occupied dwellings is considered a reasonable neutral rate.

The existing Danish nominal tax freeze has reduced the effective property tax on owner-occupied dwellings considerably; in 2014 the average effective tax rate was 0.6 per cent. This conflicts with the horizontal equity principle, and it contributes to an inefficient composition of investments and wealth. In the end, the result is too much consumption of bricks and too little consumption of other goods.

One way to gradually introduce a reasonable neutral rate on owner-occupied dwellings is to let the property value tax follow the prices on the housing market and gradually raises

the tax from 1.0 to 1.2 per cent and reduces the tax for the property with the highest values from 3.0 to 1.8 per cent.

Taxes on land and properties reduce the homeowners' disposable income and can cause liquidity problems, particularly if the tax payment increases faster than wage rate. A way to overcome this is to give an opportunity to postpone the tax payment on land and properties. This opportunity is already an option for retired people and can be extended to the rest of the homeowners.

Historically, the Danish assessment system on immovable properties has been considered in an international context quite well, but in the last few years a number of problems have been detected. A new system is under development and the aim is to take care of the detected problems. However, it is also important to stress that even the best assessment system will be unable to predict prices precisely.

An alternative to a higher property value tax is a capital gain tax on real estate. Capital gains are the profits that a homeowner realizes when he or she sells the property for a price that is higher than the purchase price. The tax value of the capital gain therefore depends on the time of sale and purchase and the locality of the property. Capital gains on real estate are therefore more or less random and a tax on capital gains reduces the randomness.