

De Økonomiske Råd
Formandskabet

DANISH ECONOMY SPRING 2018 SUMMARY AND RECOMMENDATIONS

SUMMARY AND RECOMMENDATIONS

Growth in the coming years is supported by earlier reforms that increase the size of the work force. The growing work force adds to what is expected to be only a moderate amount of pressure on the labour market.

The planned fiscal policy is relatively tight, and there is not room to ease it. The projection indicates weak growth in public expenditure over the coming years, which contributes to a gradual improvement in public finances towards 2025, when a small surplus is expected.

A longer-term projection underlines that fiscal policy is more than sustainable. Thus, public expenses can be permanently increased, or taxes can be permanently lowered, by 0.9 per cent of GDP, or approximately DKK 20 bn.

A chapter focuses on the Danish student grant and loan scheme. Compared to other Nordic countries, the scheme is generous and consists, to a larger degree, of grants rather than loans. The analysis indicates that restructuring the scheme from grants to loans would have limited effects on enrolment in higher education.

ENGLISH SUMMARY

This report from the Chairmanship of the Danish Economic Council consists of three chapters:

- Economic outlook and public finances
- Fiscal sustainability
- The design of the Danish student grant and loan scheme

Chapter I presents the outlook for the Danish economy and discusses the state of the public finances. Chapter II examines fiscal sustainability. Chapter III investigates the design of the Danish student grant and loan scheme.

CHAPTER I: ECONOMIC OUTLOOK AND PUBLIC FINANCES

Eight years of recession has ended. Employment has risen by nearly 180,000 people since 2013, and the present outlook projects further increases in employment during the coming years. GDP is projected to grow by around 2 per cent in 2018 and 2019, cf. table A. The increase in employment is supported by expansions of the structural workforce, especially as a consequence of increases in retirement ages. Additionally, it is assumed that the workforce will also increase due to immigration of foreign workers, which will expand the capacity of the Danish economy. Employment is projected to increase above the structural level in 2018, and the labour market will, to a larger extent, be characterized by a shortage of labour, rather than labour market slack.

Gradually, the increased pressure on the labour market is projected to lead to higher wage growth. Higher wage growth will tend to ease the pressure on the labour market as it will dampen export growth. The wage competitiveness of Danish firms is good, and, therefore, it is not considered a great problem if increased pressure on the labour market leads to higher wage growth.

The pressure on the labour market can increase rapidly if, for example, labour supply from immigration and foreign workers falls short of projections. Increased pressure on the labour market combined with unsustainable increases in house prices could lead to an overheating of the Danish economy, followed by a subsequent large drop in employment and house prices, i.e., a hard landing.

TABLE A KEY FIGURES OF THE OUTLOOK FOR THE DANISH ECONOMY

	2017	2018	2019	2020	2025^{a)}
	DKK bn.	Real growth rate, per cent.			
Private consumption	1,007	2.1	2.6	2.7	2.3
Public sector consumption	536	1.3	0.3	0.5	1.0
Gross fixed capital formation consisting of:	437	4.1	5.0	4.6	2.2
Residential investment	97	5.4	4.2	2.4	1.1
Business fixed investment	267	4.5	6.1	6.4	2.7
Public sector investment	74	1.1	1.4	0.3	1.5
Stockbuilding ^{b)}	13	0.1	-0.1	-0.1	0.0
Total domestic demand	1,994	2.4	2.5	2.4	1.9
Exports of goods and services	1,184	2.9	3.7	2.6	4.0
Imports of goods and services	1,033	4.2	4.2	3.6	4.1
GDP	2,145	1.8	2.3	2.0	2.0
Key indicators					
Consumer prices, percentage change ^{c)}	0.9	1.5	1.8	1.9	
Unemployment, per cent ^{d)}	2.9	2.7	2.6	2.9	
Current account, DKK bn.	146	138	121	137	
Current account, per cent of GDP	6.6	6.1	5.2	4.9	
General gov. budget balance, DKK bn.	-19	-11	-6	3	
General gov. budget balance, per cent of GDP	-0.9	-0.5	-0.2	0.1	
Hourly wage costs, percentage change	2.5	3.0	3.1	3.1	
Terms of trade, change in percentage points	-1	-1	-1	-0.5	
Employment gap, per cent ^{e)}	0.9	1.0	1.0	0.0	

a) The column shows projected average annual growth from 2021 to 2025 for all variables except unemployment, the current account, the general government balance and the output gap. For these variables the column shows the projected value in 2025.

b) Contribution to GDP growth in percentage points.

c) Implicit private deflator.

d) Percentage of total labour force. National definition.

e) Percentage of structural employment. National definition.

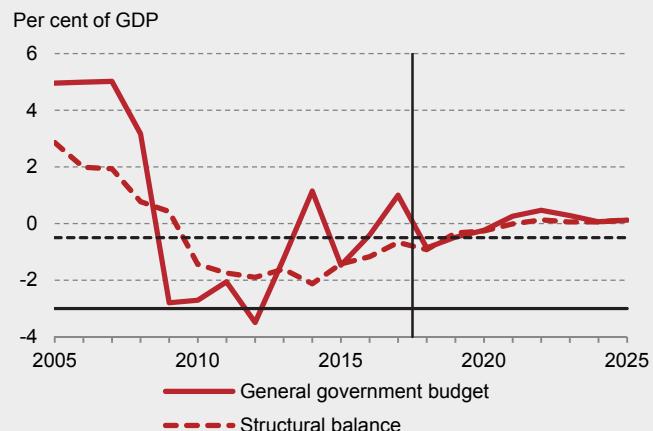
Source: Statistics Denmark, National Accounts and own calculations.

Public finances

It is the assessment of the Chairmanship that the planned fiscal policy from 2019 complies with the fiscal policy rules. There is a deficit in the structural balance of 0.9 per cent of GDP in 2018, cf. figure A. From then on, the structural balance gradually improves and becomes positive from 2022 onwards. The medium-term targets for the government's structural balance are, therefore, expected to be met.

FIGURE A BUDGET BALANCE, 2005-25

The structural balance gradually improves from the deficit in 2018.



Note: The solid line indicates the deficit limit of 3 per cent of GDP for the general government budget and the dashed line indicates the deficit limit of $\frac{1}{2}$ per cent of GDP for the structural balance.

Source: Statistics Denmark, ADAM's databank and own calculations.

The cyclical stance is approximately neutral, and, therefore, the general government budget balance is close to the structural balance. From 2021 until 2025 the general government budget balance is expected to be positive.

The Danish Ministry of Finance has a more positive assessment of the short run structural balance than is forecast in this report. One explanation for this is a deviation in the estimation of structural revenue from North Sea activities. Along with other corrections, this explains about half the difference between the present projection and

that of the Danish Ministry of Finance in 2018. In 2025 there are no major deviations in the assessments of the structural balance.

Policy

It is estimated that fiscal policy will reduce economic growth by 0.2 per cent of GDP in 2019. It is the assessment of the Chairmanship that fiscal policy should dampen economic activity in the current situation. Therefore, it is important that the planned tightening of the fiscal policy is implemented. This implies a relatively modest growth in government consumption expenditure in 2019. Tax cuts or increased government consumption expenditure should be fully financed in the current situation.

With the current outlook for increased pressure on the labour market, it may be a good time to implement structural reforms aimed at increasing the workforce. However, it is important to be aware that the extent to which general reforms can reduce the pressure that is already building in the labour market is limited. One possibility for increasing the labour supply is to ease foreign workers' access to the Danish labour market by reducing the Pay Limit Scheme's minimum amount, and exempting foreign workers from the top tax rate during their first 5 years in Denmark, as previously proposed by the Chairmanship.

The Budget Law is to be evaluated in the 2018-19 parliamentary year. Danish public finances are generally sustainable, and budgets for government consumption expenditure have complied with the Budget Law since its implementation in 2014. Additionally, fiscal policy is overly sustainable. From this perspective, it seems that the Budget Law is working. However, it is important that the fiscal policy framework supports an efficient public sector. To ensure this, the Chairmanship recommends strengthening the multiannual perspective of fiscal policy.

The Budget Law's fixed deficit limit of $\frac{1}{2}$ per cent of GDP contributes to fiscal discipline. However, the deficit limit supports a short-sighted focus, as the structural balance must comply with the deficit limit in each year. The deficit limit does not take account of periods with demographic headwinds or requirements for large public investments. Recently, the planning of economic policy has shifted towards putting more emphasis on the structural balance rather than fiscal sustainability. It is important to keep in mind that economic policy should also comply with sound long-run public finance objectives. Therefore, the

short- and medium-term objectives should be set in accordance with the long-run objectives, cf. Chapter II.

In April the Danish government launched a proposal for the future energy policy. It is positive that the policy proposes to reduce electricity taxes, as taxes on electricity are markedly higher than on other types of energy, compared to the associated CO₂-emissions. Lower taxes on electricity will also ease the process of electrification, which is required in order for Denmark to become a low-emission society. The proposal maintains the target for a share of renewable energy of at least 50 per cent by 2030. The Chairmanship has previously emphasized that setting intermediate targets for greenhouse gas emissions would be more appropriate than setting targets for the share of renewable energy. A thorough restructuring of the taxes on energy would, therefore, be desirable in order for taxes to better reflect energy-related emissions of CO₂ and other environmental externalities.

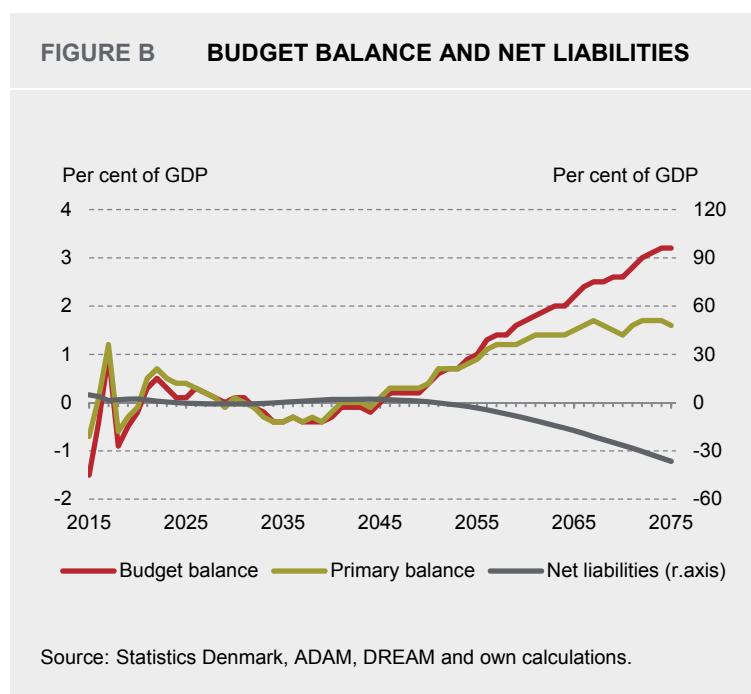
Given the target for renewable energy for 2030, it is positive that the energy policy proposes a restructuring of various renewable energy subsidies such that, to a greater extent, the subsidies are uniform and technologically neutral across different types of renewable energy. However, the policy also proposes an independent target for expansion of offshore wind. This implies that, when it comes to offshore wind, the proposal deviates from the technology neutrality principle. This entails a substantial risk that the economic cost of achieving the renewable energy target will be higher.

CHAPTER II: FISCAL SUSTAINABILITY

Chapter II presents a long-term projection for the Danish economy that builds on the medium-term projection to 2025 presented in Chapter I. The long-term projection focuses on public finances and is used to evaluate whether Danish fiscal policy is sustainable under assumptions made about, among other things, future demographic developments.

As seen in figure B, the budget is projected to improve over the years up to 2025, partly because of business cycle improvements and partly because of various policy measures. After 2025 the budget deteriorates for about 15 years and reaches a maximum deficit of 0.4 per cent of GDP around 2040. Subsequently, the budget improves again and becomes permanently positive around 2045. This is the so-called Danish fiscal “hammock problem”, named after the shape of the budget curve. The main reason for both the deterioration and the later

improvement is the succession of small and large generations in the labour market. The deterioration in the present projection is a bit worse than in the Danish Economic Council's 2017 projection. According to the present projection, net government liabilities are around 0 per cent of GDP until 2050, and turn into a net wealth position shortly thereafter.



According to the projection, Danish fiscal policy is overly sustainable. The sustainability indicator (S2) is 0.9 per cent of GDP (i.e. the primary budget can deteriorate permanently by 0.9 per cent without causing debt to explode in the long run). This is a deterioration of 0.1 percentage points of the S2 indicator compared to the Danish Economic Council's spring 2017 long-term projection. The main reasons for the deterioration are a worsened medium-term outlook and a change in rules for deposits in retirement savings.

However, there are a number of institutional arrangements that mean the official figures for debt and deficits do not fully reflect the underlying position of the public finances. An important arrangement is the substantial amount of deferred taxation of pensions. Calculations in

the chapter illustrate that the public balance would be permanently improved by more than 2 per cent of GDP if it included deferred taxes on pension assets.

An overly sustainable outlook implies that tax revenues are permanently larger than necessary to maintain public consumption expenditure at the desired level and ensure stable development in public debt. In the long run such a situation would clearly diminish the welfare of the population. It is to be expected that politicians will eventually ease economic policy relative to the conditions forecast in the projection. When and how this should happen is a political choice. However, it is relevant that the government and the Parliament should consider this question explicitly and present a clear argument for the long-run fiscal policy strategy. Thus, how decisions about intergenerational distribution and the appropriate degree of caution in the long-term planning are balanced would be made clear to the public. This is a prerequisite for an informed public debate on the overall political priorities.

The government's current medium-term plan includes a target for a balanced budget by 2025. This objective is essential for the so-called "fiscal space", which is the focal point of the political debate. However, there are no economic reasons for why a balanced budget, as such, should be an important objective. Previously, the objective of a balanced budget in the final year of the medium-term projection was motivated by the fact that this would ensure fiscal sustainability in the long run under the assumptions of the projections at the time. However, the situation has changed considerably, and today there is no clear connection between the medium-term objective and long-term sustainability. It would be more appropriate if the medium-term objectives were set in accordance with the long-term fiscal policy requirements in such a way that the medium-term objective for the budget balance implied that fiscal policy was just sustainable and debt was not exploding. If there is a political desire to reserve more funds for future purposes than necessary to ensure fiscal sustainability, it should be justified explicitly in the determination of the budget balance objective as part of the political priorities of the plan.

CHAPTER III: THE DESIGN OF THE DANISH STUDENT GRANT AND LOAN SCHEME IN HIGHER EDUCATION

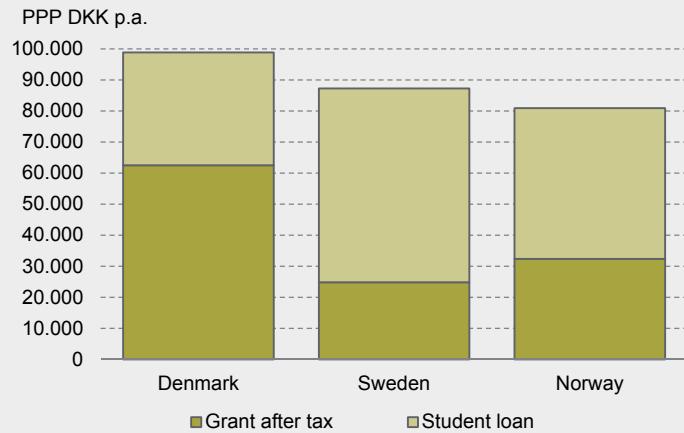
Chapter III analyzes how the propensity for young people to start and complete a higher education would change if the Danish student

grant and loan scheme (SU) were restructured such that a larger part consisted of loans rather than grants.

In Denmark education is supported through the provision of free education as well as through direct support to students in the form of SU. The total level of student support is somewhat higher in Denmark than in the other Nordic countries. More significantly however, Denmark differs from the other Nordic countries by having a larger share of student support in the form of grants rather than loans, cf. figure C.

FIGURE C STUDENT SUPPORT IN NORDIC COUNTRIES

Total student support is somewhat higher in Denmark than in Sweden and Norway. In Denmark, grants make up a markedly larger share of total student support than in Sweden and Norway



Note: The figure shows the maximum annual student support in 2015/16.

Source: Studiestøt i Norden (2017): Typiske maksimale støttebeløb i de nordiske lande 1983/84-2015/16.

Subsidizing education may be appropriate from an economic perspective for a number of reasons.

One reason for subsidizing education is that taxes on labour income reduce the private return to education below the social return. Thus, the choice of education is distorted such that people tend to choose a

too low educational level. This distortion can be mitigated by subsidizing education. A rather rough estimate based on the current tax rates implies that, in order to secure tax neutrality with regards to educational decisions, education for those who, as graduates, will not be liable to pay the top tax rate, should be subsidized by around 30 per cent. For those who will be liable to pay the top tax rate for their entire working lives, the education subsidy that ensures tax neutrality is around 50 per cent. It is estimated that higher education in Denmark is actually subsidized by around 60 per cent as a result of student grants and free education, among other things. These are rough estimates, but the differences are of a magnitude implying that, overall, the education subsidies are too high when considering the distortions that taxes impose on educational choice.

Another reason for subsidizing education is that there might exist market imperfections that tend to reduce investments in education to a suboptimally low level. It might, for instance, be difficult to obtain student loans using future income as collateral. This could lead to loss of talent in the absence of governmental intervention. Imperfect capital markets justify state-guaranteed loans to students.

Education is an investment that benefits each individual through higher productivity, and, thereby higher potential future income. This is not in itself an argument for subsidizing education (at least not above the level which compensates for distortionary taxation, as noted above). However, to the extent that higher education increases the productivity of other individuals or affects the welfare of others by others means e.g. by reducing crime, subsidizing education could be justified. The magnitude of these positive externalities is difficult to measure, but it does not seem likely that it is sufficiently large to compensate for the substantial discrepancy between the actual subsidy level and the level which secures tax neutrality.

Subsidizing higher education will often benefit those with the highest lifetime earnings. Hence, subsidizing education should not be justified by the desire to achieve an equal income distribution. Government subsidy of education is often justified by the desire to ensure equal opportunities for everybody, such that educational attainment is determined by ability and not by family background. This does not necessarily call for educational grants, but rather for ensuring the availability of student loans.

The estimations in the chapter and international evidence indicates that access to student grants or loans increases the enrolment in education, reduces dropout rates and shortens the time to gradu-

tion. However, it seems that the type of student support, i.e., grant or loan, only has a limited effect on student enrolment.

Therefore, a restructuring of the student income support system in order to reduce grants and increase student loans is not expected to have significant negative effects. Such a change would also reduce public expenditure and, since people with a higher education are among those with the highest lifetime earnings, there doesn't seem to be strong equity or efficiency reasons against such a restructuring.

Such a change in the subsidy system towards a higher share of loans rather than grants could be made partial by replacing grants with loans for students enrolled in a master's degree. There are a number of arguments for this. First, the uncertainty regarding the student's academic skills and ability to graduate would be substantially diminished when enrolling in the master's degree as the student has obtained experience during the bachelor's degree. Second, it must be expected that when enrolling in the master's degree, the student has better knowledge of the income opportunities and ability to repay within his or her own field of study. Third, students enrolled in a master's degree could expect to obtain an earned income in the upper end of the income distribution. In fact, the current subsidy contributes to an increase in inequality over a lifetime.

A restructuring of part of the education subsidy from grants to loans would diminish the difference between the size of the grant in Denmark compared to other countries within the EU or the European Economic Area (EEA). That would make it less attractive for students from other countries within the EU/EEA to study in Denmark on account of obtaining a "cheaper" education.

There are a number of issues which arise when considering such a restructuring of student support.

An important purpose of subsidizing education is to ensure that young people's possibility of obtaining an education is based on their abilities and preferences and not on their own or their parents' economic circumstances. Young people with parents in the lower end of the income distribution could be more reluctant to enrol in education. This might reflect, for instance, that young people from families without a tradition for obtaining higher education could be more cautious about incurring debt for the purpose of education. In principle, this may justify ensuring the cost of studying is lower for this group than for other groups of students. If a larger share of the student support is given through loans, it could be relevant to consider whether student

grants (for students living on their own) should be made dependent on the income of their parents. This would, however, be less relevant if the change in student support were restricted to students enrolled in a master's degree. Implementation of student grants dependent on parents' income implies an increase in the composite marginal tax rate of the parents or the student.

The rules for repayment of the student debt could be changed such that the yearly amount of repayment is made dependent on the borrower's income after graduation instead of being a fixed amount. This will be particularly relevant to consider if student loans are going to make up a larger part of student support. Such a change in the repayment rules could alleviate the issues in relation to some young people refraining from incurring debt for the purpose of undertaking higher education.

Whether or not the higher education support scheme is restructured, changes to the SU-loan conditions should be considered. The interest rate on SU-loans is 4 per cent during the time of enrolment, and equals the Danish central bank's discount rate plus or minus a supplement after graduation. The fixed interest rate implies that the size of the subsidy varies depending on when the student graduates. The interest rate on SU-loans should instead be linked to the interest rate on government bonds with a supplement deducted to reflect the desired level of the subsidy - before and after graduation.

Changes in the design of higher education support could also contribute to fulfilling the government's objective of shortening the average higher education enrolment duration. First, a part of the grant could be switched to a loan for students who do not complete the standard number of subjects within each study year. Second, there could be extra grants for students who complete more than the standard number of subjects per year, for example by taking courses during the summer. Finally, educational support paid after the standard specified time for completing a course of study could be changed from grants to loans.

