ENGLISH SUMMARY

This report from the chairmen of the Danish Economic Councils contains three chapters. Chapter I presents the outlook for the Danish economy, Chapter II deals with the public sector finances, and Chapter III examines public income support with special emphasis on social assistance.

Chapter I: Economic Outlook

The Danish economy has been expanding since mid-2013. The growth rates are not impressive but exceed the rates of structural growth somewhat. The moderate recovery has been sufficient to increase employment by 50,000 over the last two years. The cyclical upswing is expected to continue and the economy is expected to gain momentum over the coming years.

Growth prospects for the global economy have slightly deteriorated since the spring. Financial markets have been volatile, reflecting, among other things, the upcoming monetary policy tightening in the US and concerns that the Chinese economy may experience a sharp fall in growth rates. Nonetheless, the global economy currently benefits from low oil prices, accommodative monetary policy in the euro area, and the significant slowing down of fiscal tightening in both the US and the euro area. These factors are expected to feed through gradually and improve global growth in 2016.

In view of the modest outlook for the global economy in the near term Danish exports are expected to grow at a moderate pace in 2015. Domestic demand is expected to increase due to growth in private consumption but is dampened by weak business fixed investment. In 2016 both exports and domestic demand are forecast to gain momentum. Meanwhile, the projected fiscal policy is somewhat contractionary.

In view of these considerations, Danish GDP is expected to grow by just above 1½ per cent in 2015, just above 2 per

cent in 2016, and about 2¼ per cent in 2017. The negative output gap is forecast to narrow from just above 4½ per cent of structural GDP in 2014 to about 2 per cent in 2017, cf. Table A.

The public budget deficit is forecast to be about 3.2 per cent of GDP in both 2015 and 2016. This is slightly above the deficit limit set down in the EU Stability and Growth Pact. The budget deficit is expected to stay below the deficit limit in 2017. Danish public sector finances appear to be healthy in a medium- and long-term perspective. Thus the current deficits are not considered to be a serious problem. In view of these considerations, it is assessed that Denmark will most likely not be subjected to the excessive deficit procedure (EDP), as was the case in 2010.

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

	Current prices DKK bn. 2014	Percentage change, volume 2014	2015	2016	2017	2025[a)]
Private consumption	933.4	0.7	1.9	2.5	2.7	2.6
Public sector consumption	511.1	0.2	1.2	0.9	0.5	1.1
Gross fixed capital formation	359.1	4.3	0.3	5.1	6.8	3.8
consisting of:						
Residential investment	72.1	6.8	-1.6	3.7	4.8	3.6
Business fixed investment	209.4	1.7	2.2	7.5	10.1	4.5
Public sector investment	73.6	7.8	-0.7	-0.7	-1.6	1.5
Stockbuilding[b)]	15.2	0.4	-0.4	0.3	0.1	0.0
Total domestic demand	1,818.8	1.6	1.0	2.9	3.0	2.5
Exports of goods and services	1,031.1	2.6	0.1	3.3	4.6	4.7
Imports of goods and services	928.3	3.8	-1.3	5.1	6.1	5.4
GDP	1,921.5	1.1	1.6	2.1	2.3	2.1
Key indicators						
Consumer prices, percentage change[c)]		0.7	1.0	1.6	1.8	1.8
Unemployment, per cent[d)]		3.8	3.7	3.6	3.4	2.4
Current account, DKK bn.		121	124	121	115	104
Current account, per cent of GDP		6.3	6.3	5.9	5.4	3.5
General gov. budget balance, DKK bn.		35	-63	-65	-42	23
General gov. budget balance, per cent of GDP		1.8	-3.2	-3.2	-2.0	0.8
Hourly wage costs, percentage change		1.3	1.9	2.4	2.7	3.1
Terms of trade, percentage change		0.4	0.3	-0.3	-0.1	-0.1

a) The column shows projected average annual growth from 2017 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.

The current cyclical upswing in the Danish economy is expected to continue in the medium run and the output gap is expected to close shortly after 2020. The capital-labour

ratio is eroded by an expected significant increase in employment but reaches its trend level in 2025. The total increase in employment amounts to 250,000 between 2015 and 2025. This is mainly due to an expected increase in the labour force resulting from the various reforms of the Danish retirement system the past ten years.

Policy

The projected fiscal policy is estimated to place a drag on growth of about a ¼ of a percentage point in 2016 and about a ½ of a percentage point in 2017. It is assessed that the projected fiscal policy is reasonable in view of the cyclical upswing in the Danish economy and the restrictions imposed by deficit limits.

The newly elected Danish government intends to introduce a tax freeze. The tax freeze provides certainty regarding tax payments. However, it increases uncertainty for recipients and providers of public services, as fiscal tightening has to occur exclusively through reductions in expenditure. Moreover, the tax freeze prohibits socially beneficial revenue-neutral tax reforms. Further, the freeze on the property value tax implies that the housing market lacks a significant automatic stabilizer. Hence, the government's tax freeze policy is considered by the chairmanship of the Danish Economic Councils to be inappropriate.

The Danish government has announced a plan to relocate government jobs to remote areas. The plan could potentially contribute to a change in the geographical distribution of population and economic activity. However, there are no efficiency reasons for relocating jobs to remote areas and relocating may cause recruitment problems.

The Danish government has reintroduced "BoligJobordning", which is a scheme that allows homeowners to claim tax deductions for some of the labour expenses associated with home improvements and service work in households. The scheme is a selective industrial policy which is ill-founded in view of the current cyclical upswing with tentative signs of future labour shortages in the building and construction sector. Further,

there exists no evidence to suggest that possible reductions in undeclared work or do-it-yourself activities are sufficient to make the deduction scheme socially beneficial.

The European Commission has concluded that the Danish PSO tariff (Public Service Obligation) is in conflict with the Treaty because it discriminates against foreign electricity producers. The Danish PSO tariff is added to electricity bills and finances subsidies to renewable energy for domestic producers. The chairmanship of the Danish Economic Councils recommends replacing the PSO tariff with a broad-based income tax. This would increase economic efficiency and thus reduce the social costs of renewable energy subsidies.

The Danish government is planning to implement pension reforms that improve the incentives for people to save for their own retirement. The reforms will have a special attention on the residual group without pension schemes. A key issue is that a large group of people in the labour force face very high effective marginal tax rates as public transfers to pensioners are offset by own pension payments. The chairmanship has previously recommended modification of the offsetting rules and the introduction of mandatory pension schemes.

The Danish government intends to open negotiations in parliament regarding a reform of the unemployment insurance system in the autumn. The chairmanship of the Danish Economic Councils has previously emphasized that the main objective of the unemployment insurance system is to insure employed workers against income losses in the event that they become unemployed. However, the insurance feature of the Danish unemployment insurance system has been reduced by a prolonged decline in the unemployment benefit level relative to the wage level (the compensation rate).

However, it is possible to improve the insurance feature of the system without significantly increasing costs. The chairmanship has outlined a model where the benefit level is increased by 25 per cent for the first three months of the

unemployment spell for workers with a sufficiently good previous employment record. This would significantly increase the value of unemployment insurance for the majority of workers that rarely become unemployed without reducing employment incentives considerably.

Another possible way of improving the insurance property of the unemployment insurance system is to let the maximum unemployment benefit period depend on the state of the economy, such that the benefit period is higher during economic downturns when jobs are harder to find and shorter during economic expansions. It is possible to design the system such that the sustainability of public finances is unaffected.

Chapter II: Public Finances

Danish fiscal policy has been subject to the Budget Law since 1 January 2014. The Budget Law imposes expenditure ceilings on the state, municipalities and regions, and sets a structural deficit limit of ½ per cent of GDP. Fiscal policy is still subject to the constraints of the EU Stability and Growth Pact, including the deficit limit of 3 per cent of GDP.

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. However, there is a risk of non-compliance in certain areas.

One of the most important benchmarks of fiscal policy is the structural balance. The chairmanship estimates a structural surplus of around ¼ per cent of GDP in 2015 and

2016. The structural surplus reflects that the position of the public finances is fundamentally healthy. This estimate represents a significant deviation from the estimate of the government, which shows a structural deficit at or around the ½ per cent deficit limit in 2015 and 2016. The difference is explained by different estimates of the structural levels of employment.

Table A Assessment of fiscal policy rules

Objective	**Assessment**
Fiscal sustainability	● The overall assessment is that Danish fiscal policy is sustainable, cf. *Danish Economy, spring 2015.*
Medium-term developments of the budget balance	*Structural balance* ● Surplus from 2015-20 *Budget balance* ● -3.2 per cent of GDP in 2015 ● -3.2 per cent of GDP in 2016 ● Gradual improvement from 2017 towards 2020
Expenditure ceilings in compliance with fiscal policy objectives	No assessment, as the national budget has not yet been presented
Compliance with expenditure ceilings in fiscal planning	No assessment, as the national budget has not yet been presented
Compliance with expenditure ceilings in accounts	No assessment, as accounts for 2015 are not yet available

Note: The assessment of compliance with fiscal objectives is 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.

A significant point to note is the expectation of a budget deficit of slightly more than 3 per cent of GDP in both 2015 and 2016. This constitutes a minor breach of the EU deficit limit of 3 per cent of GDP.

Chapter III: Public income support with special attention to social assistance

Public income support has become a cornerstone of the Danish welfare state, and since 1960 the number of individuals of working age who are on public income support increased from 200,000 to 800,000 in 2014. Meanwhile employment has increased by a similar number, and there is no solid evidence that the number of recipients of income support has increased at the expense of employment.

The increase over the whole period from 1960 includes a very large increase in the number receiving income support up to the middle of the 1990s and a fall of nearly 200,000 over the latest 20 years. This fall has been mainly due to a number of reforms to the disadvantaged early retirement schemes, unemployment benefits, paid leave schemes and the old age retirement system.

In particular, the number of people on unemployment benefits and in the early retirement scheme has fallen, while the number on social assistance has been nearly constant compared to 1993-94. The number on social assistance fell during the years with high growth in employment up to the start of the great recession in 2007-08, but since then the number has increased to 150,000 full time persons again.

The number of individuals on public income support is expected to decline to approximately 700,000 by 2020. Half of the reduction can be attributed to a normalization of the business situation and lower unemployment, while the other half of the reduction is due to the structural effects of the reforms which have been adopted in recent years.

The public income support system is an important part of the universal welfare state. The system works as a safety net

in case of social or economic events that reduce income earning possibilities temporarily or permanently, such as unemployment or illness. It constitutes an insurance against a lapse in income, which increases the welfare of both the recipients who need the income support, and those who seldom or never utilize the scheme. As with any other insurance, the income support system redistributes from the lucky and advantaged to the unlucky and disadvantaged. The relatively generous income support system is also an important part of the flexicurity system, which is the foundation of a flexible and dynamic labour market with a low level of structural unemployment.

The design of the public income support system also affects the economic gain from becoming employed. If a person receiving public income support enters employment, then the income support is reduced or lapses. This lapse of the income support works as a tax and reduces the economic gain from entering employment. Thus the public income support system contributes to a lower effective labour supply.

Social assistance is a special part of the income support system and is targeted to persons without any type of income or wealth, and it is the welfare state's lowest safety net. The chapter analyses the economic incentives in the social assistance system to enter employment.

The calculations presented in the chapter show that the economic benefit of entering employment for individuals on social assistance is relatively low for parents, no matter whether they are single parents or married parents, and higher for those without dependent children. The primary reason is that social assistance is higher for parents than for those without dependent children, and parents lose a larger amount of social assistance when they enter employment. This effect is increased for low income families by the means-tested rent subsidy and the means-tested discount on day care institutions. Another group with a low economic incentive to enter employment is married couples who are both on social assistance. In general, recipients of social assistance have a lower gain in disposable income from

entering employment compared to other recipients if they receive means tested housing benefits and discounts on day-care payments.

The incentive or lack of incentive to enter employment for a benefit recipient is measured by the participation tax which is the total effects of direct and indirect taxes and lost income support, when those on income support enter employment. Empirical calculations illustrate that the participation tax is at least 90 percent for some parents on social assistance. A participation tax of 90 percent is equivalent to an increase in monthly disposable income of 2,500 DKK if the person on social assistance enters employment at an hourly wage of 130 DKK. Calculations show that 25,000 of those on social assistance aged over 30 years have a participation tax of at least 90 percent, and around 6,000 of these are ready to enter employment, while the rest need further qualifications.

Most of those who received social assistance and entered employment in the second quarter of 2014 earned an hourly wage above 110-120 DKK. A higher wage means that the gain in disposable income increases and the participation tax falls. As those with the poorest qualifications typically find employment at the lowest wages, they also have the highest participation taxes. Approximately 25 percent of those receiving social assistance find a job with an hourly wage below 130 DKK.

Even if high participation taxes tend to reduce labour market participation, there is no unique relationship between the two. In an international comparison, labour market participation is thus relatively high in Denmark, even though the Danish participation tax rate is among the very highest in the OECD. A high participation tax rate is typically the result of a comprehensive welfare state, which by itself can support labour market participation. Public child care or elderly care, for example, can increase the labour force.

During recent years there are several examples of reforms that have changed the rules for receiving public income support. The social assistance benefit reform of 2014 is one

of the latest examples. This reform has primarily reduced social assistance benefits for 25-29 year olds such that the benefits to job- or education-ready benefit recipients below 30 years are now substantially lower than the benefits to recipients aged 30 years and over. The exact reduction in benefits depends on several characteristics of the young benefit recipients. Generally, however, benefit reductions are largest for benefit recipients without children and benefit recipients living with their parents. On average the benefit reduction is around 45 per cent for 25-29 year old job- or education-ready benefit recipients. The reform does not reduce benefits to benefit recipients aged 30 years and over or benefit recipients below 30 years who are not assessed to be job- or education-ready.

Chapter III presents an analysis of the social assistance benefit reform. The analysis indicates that around 9 per cent of the social assistance benefit recipients aged between 25 and 29 years have left social assistance because of the reform. The majority of those leaving social assistance have started an education but some have also found employment. It is estimated that between 1,600 and 2,600 25-29 year olds have found employment due to the reform.

Generalising the results of the analysis of the behaviour of benefit recipients below 30 years to other age groups is difficult. Under several simplifying assumptions it is, however, estimated that employment could increase by between 3,000 and 5,000 if the benefit reductions in the social assistance benefit reform also applied to individuals aged 30 years and over. Compared to the size of the age groups, the estimated employment effect is smaller for individuals aged 30 years and over than for individuals under 30 years. The main reasons for the smaller effect for individuals aged 30 years and over are that a smaller proportion of the age group will experience a benefit reduction (because fewer are job-ready) and that the average benefit reduction for those experiencing a benefit reduction will be smaller. The method for calculating the potential employment effect of reducing benefits for individuals aged 30 years and over is somewhat crude. The calculation, however, illustrates that the potential for raising employment for social assistance benefit recipi-

ents aged 30 years and over through benefit reductions is limited, even when benefit reductions are substantial.

Lower benefits generally have two direct effects and a number of indirect effects. The first direct effect of lower benefits is a reduction in the affected individuals' income and welfare in the case of their labour market situation remaining unchanged. Consequently, income differences in the population will grow. The second direct effect of lower benefits is that public expenditure is reduced, contributing to improved sustainability of public finances

However, an additional important consequence of lower benefits is that individual behaviour is affected. The reason is that the economic gain from finding and maintaining employment increases for a given wage rate when benefits are reduced. As a consequence, employment tends to increase, and those individuals who find employment experience an increase in income.

Another indirect effect of lower benefits is that wage earners will experience downward pressure on the wage level. In practice, the level of unemployment insurance and social assistance benefits constitutes the lower bound for wages in the labour market. Therefore, if benefits are reduced, wages will tend to decrease at the lower end of the wage distribution. Consequently more low skilled individuals will find employment. Lower wages are, however, unfavourable for those who are employed at low wages and will tend to make the income distribution more uneven.

More fundamentally, an important consequence of lower benefits is that the insurance (or income safety net) function of the public income support scheme will be weakened. The weakened insurance function results in a welfare loss, even for individuals not directly affected by benefit reductions.

Whether it is desirable to achieve higher employment by lowering benefits is ultimately a political decision that needs to balance the desire for efficiency, distribution and insurance. Even if experience from recent reforms of the early retirement scheme, the unemployment insurance

scheme and the social assistance scheme shows that economic incentives are important, it is presumably difficult to increase employment markedly exclusively by lowering social assistance benefit rates. Complementary economic measures such as in-work tax credits or back to work bonuses would probably contribute to increasing employment, but the effect of these measures are not analysed in the chapter.