

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 provides a long-term projection for the Danish economy with emphasis on public sector finances, Chapter III discusses the European Banking Union, and Chapter IV examines the remote areas of Denmark.

Chapter I: Economic Outlook

The Danish economy grew by 1.1 per cent in 2014 following a strong performance in the second half of 2014. Further, according to the new figures from the major revision of the Danish national accounts in the autumn of 2014, the Danish economy grew steadily from mid-2013 to mid-2014. The growth performance is now consistent with the employment figures. Danish employment has increased by 30,000 persons since mid-2013.

It is expected that the recent growth in the Danish economy will continue, and increase, in the coming years. The growth will be driven by both domestic demand and exports.

The cyclical stance of the global economy is improving. The recovery of the US economy continues and is broad-based. Growth in the euro area is slowly gaining momentum with the area benefiting from low interest rates and the weak euro caused by the expansionary monetary policy. This suggests that major Danish export markets will experience improved performance in the coming years.

Growth in domestic demand will be driven mainly by private consumption and private sector investment. Meanwhile, the projected fiscal policy is contractionary, resulting in negative contributions to growth in the order of a $\frac{1}{4}$ of a percentage point in 2015 and in 2016.

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

	Current prices DKK bn.	Per cent of GDP	Percentage change, volume			
	2014	2014	2014	2015	2016	2020 ^{a)}
Private consumption	932	48.5	0.5	1.9	2.7	3.0
Public sector consumption	513	26.8	1.4	1.0	0.1	0.9
Gross fixed capital formation	359	18.7	4.0	4.0	10.1	7.4
consisting of:						
Residential investment	76	4.0	6.5	3.8	5.1	5.0
Business fixed investment	208	10.9	1.1	5.8	15.4	10.3
Public sector investment	75	3.9	8.6	-1.7	-0.4	-0.9
Stockbuilding ^{b)}	14	0.7	0.3	0.2	0.0	0.0
Total domestic demand	1,818	94.7	1.7	2.2	3.4	3.4
Exports of goods and services	1,030	53.7	2.6	3.3	4.8	4.9
Imports of goods and services	929	48.4	3.8	4.0	7.2	6.0
GDP	1,919	100.0	1.1	1.9	2.3	2.8
Key indicators						
Consumer prices, percentage change ^{c)}			0.7	0.6	2.0	2.3
Unemployment, per cent ^{d)}			3.8	3.7	3.3	2.6
Current account, DKK bn.			118.6	124.6	98.0	47.6
Current account, per cent of GDP			6.2	6.3	4.8	1.9
General gov. budget balance, DKK bn.			23.9	-40.8	-62.2	13.6
General gov. budget balance, per cent of GDP			1.2	-2.1	-3.0	0.5
Hourly wage costs, percentage change			1.3	1.8	2.5	2.9
Terms of trade, percentage change			0.4	0.8	-0.7	-0.3

a) The column shows projected average annual growth from 2016 to 2020 for all variables except for unemployment, the current account, and the general government balance. For these variables the column shows the projected values in 2020.

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.

In view of these considerations, Danish GDP is expected to grow by just below 2 per cent in 2015 and by about 2¼ per cent in 2016. The projected growth is sufficient to decrease the output gap by almost 2 percentage points from 2014 to 2016, cf. Table A.

Growth rates in the Danish economy are expected to increase towards 2020 and exceed the rates of structural growth. Consequently, employment is projected to increase by just over 200,000 between 2014 and 2020. Of this increase, roughly one half is cyclically induced. The other half is due to an increase in structural employment caused mainly by retirement reforms.

Policy

The planned fiscal policy is estimated to place a drag on growth of about a ¼ of a percentage point in 2015 and 2016. It is assessed that the planned fiscal policy is reasonable in view of the projected cyclical upswing in the Danish economy and the restrictions imposed by deficit limits.

As Danish fiscal policy is currently accommodative, it is appropriate to gradually tighten fiscal policy as a cyclical upswing is projected for the coming years. In addition, a budget deficit of 3 per cent of GDP is estimated for 2016. This is right on the deficit limit established in the Stability and Growth Pact. Further, the structural budget deficit, computed according to the method set down in the Budget Law, stands at ¼ per cent of structural GDP in both 2015 and 2016 – not much below the limit of ½ per cent in the Budget Law. According to computations in Chapter I, both deficit limits will probably be violated in the absence of fiscal tightening in 2015 and 2016.

The assessment is robust to modifications of the cyclical outlook for the Danish economy. If the cyclical upswing turns out to be stronger than expected, there is a risk of undue pressures on the labour market in the absence of fiscal tightening. On the other hand, a stronger fiscal contraction than planned may prevent the recovery of the Danish economy.

Interest rates have decreased significantly in recent years and stand at historical lows. According to the Danish Systemic Risk Council, the combination of low interest rates, low oil prices and the recent depreciation of the effective exchange rate could cause a build-up of systemic financial risks. Policy interventions to stabilise macroeconomic development may be necessary if these risks materialise in the Danish economy. However, it would be preferable to have sizeable automatic stabilisers rather than resorting to discretionary policy interventions. In this respect it is unfortunate that the tax freeze on property values prevents the property tax from stabilising the fluctuations in the housing markets and thus the broader economy.

A model for the abolition of the tax freeze on property values was suggested in *Danish Economy, autumn 2011*. This model could be implemented by increasing the property value tax rate to 1 per cent of the market value in 2016 or 2017. This corresponds to the rules that were in place before 2001. This would immediately increase the property owners' tax payment by roughly 50 percent, on average.

In order to avoid an immediate decline in property prices, owners could be compensated by a tax rebate that nullifies the increase in the property tax payments. The rebate could initially be kept fixed in nominal terms and subsequently be phased out over a number of years.

The model ensures that the effective property value tax on changes in property prices is 1 per cent of the change. Thus, the full benefit of increased stabilisation of property prices and the broader economy is reaped from the beginning, despite a gradual phasing in.

Significant increases in the level of interest rates are to be expected in the coming years. This will put downward pressure on housing prices – perhaps to such an extent that technical insolvency becomes prevalent. In *Danish Economy, autumn 2014* a loan-to-value limit on floating rate mortgages was proposed. Such a loan-to-value limit would further reduce the macroeconomic instability that could result from significant interest rate increases.

Chapter II: Public Finances

Danish fiscal policy has been subject to the Budget Law since 1 January 2014. The Budget Law imposes expenditure ceilings for the state, municipalities and regions, and sets a structural deficit limit of $\frac{1}{2}$ per cent of GDP. The fiscal policy is still subject to the demands 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 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, overall, the planned fiscal policy is in compliance with the fiscal policy rules. 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 around $\frac{1}{4}$ per cent of GDP in 2015 and 2016, which is below the limit of $\frac{1}{2}$ per cent mandated by the Budget Law. The structural balance is expected to improve over the coming years. The government has a stated goal of achieving balance or a surplus on the public balance by 2020. The chairmanship estimates that this goal will be achieved, and projects a surplus of $\frac{1}{2}$ per cent of GDP in 2020.

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
Medium-term developments of the budget balance	<p><i>Structural balance</i></p> <ul style="list-style-type: none"> ● Structural deficit of 0.3 per cent of GDP in 2015 and of 0.2 per cent of GDP in 2016. Structural balance or surplus in 2017-20 <p><i>Budget balance</i></p> <ul style="list-style-type: none"> ● -2.1 per cent of GDP in 2015 ● -3.0 per cent of GDP in 2016 ● Gradual improvement from 2017 towards a surplus of 0.5 per cent in 2020
Expenditure ceilings in compliance with fiscal policy objectives	<ul style="list-style-type: none"> ● Fully utilising expenditure ceilings in 2016-17 will result in a structural balance at the deficit limit ● Possible to utilise expenditure ceiling fully in 2018 within the constraints on the structural balance in the Budget Law
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 2015 comply with the expenditure ceilings
Compliance with expenditure ceilings in accounts	<ul style="list-style-type: none"> ● The accounts of the municipalities, regions and central government for 2014 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.

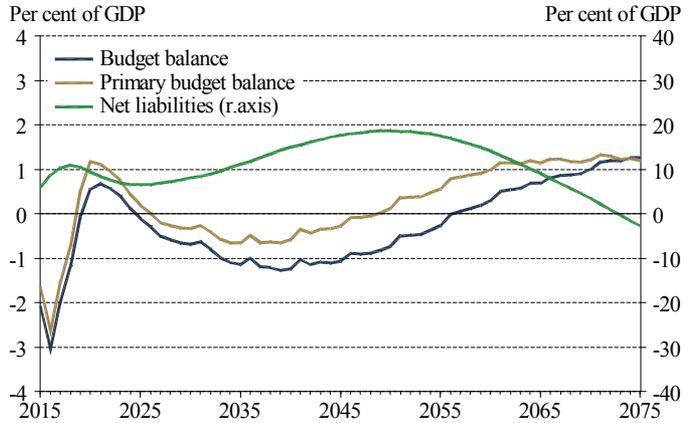
Based on the current outlook for the Danish economy, a budget deficit of 3 per cent of GDP is expected in 2016. Therefore, even minor changes in the underlying conditions for this assessment may cause the deficit to breach the EU deficit limit of 3 per cent of GDP.

The forecasted public expenses are judged to be at or below the adopted expenditure ceilings in 2015-18. If the ceilings were to be utilised fully, the structural deficit may exceed the Budget Law deficit limit of ½ per cent of GDP.

Long-term projection

The long-term projection of the Danish economy for the decades after 2020, focusing on public finances, illustrates trends caused by demographic changes, future age indexation of retirement benefits and projected changes in North Sea Oil revenues and tax revenues from pension savings. As seen in Figure A, the structural budget is projected to deteriorate for about 20 years after 2020. It reaches a maximal deficit of a little more than 1 per cent of GDP around 2040. Subsequently, the budget improves again and becomes positive after 2050. The main reason for both the deterioration and the later improvement is the succession of small and large generations in the labour market.

Figure A Budget balance and net liabilities



Source: Statistics Denmark, ADAM, DREAM and own calculations.

According to the projection, Danish fiscal policy is sustainable. The sustainability (S2) indicator is 0.3 per cent of GDP (i.e. the primary budget can deteriorate permanently by 0.3 per cent of GDP without causing debt to explode in the long run). Projected European Monetary Union (gross) government debt stays comfortably below the limit of 60 per cent of GDP stipulated in the EU Stability and Growth Pact. Moreover, there are very large implicit government assets in the form of deferred taxes on pension savings. Consequently, the projected deficit trend is not considered to be a real economic problem for Denmark. Denmark is obliged to adhere to the common EU rules, however, even though the way the present deficit rules are formulated may be unsatisfactory. From a Danish point of view, it would be preferable if the rules were changed, e.g. so that deferred pension taxes were taken into account when measuring debts, and their interest when measuring deficits.

Chapter III: Banking Union

The EU has established a banking union for the euro area with supranational supervisory and resolution authorities, including financial arrangements. The banking union is

underpinned by the common rules for the EU member states, known as the “Single Rules Book”. It is possible for non-euro member states, like Denmark, to participate in the banking union.

The financial integration of Denmark with the euro area implies potential benefits from a single supervisory and resolution authority that copes with international spill-overs and possible contagion during crises.

It is assessed that the main benefit from participating in the banking union lies with the insurance scheme of the Single Resolution Fund. Denmark has a large financial sector with institutions that would be difficult for the Danish government to handle unilaterally were they to become severely distressed. The benefits may appear moderate, as access to the funds is conditional on a prior bail-in of 8 per cent of total liabilities. However, in a worst-case scenario, the losses incurred by a distressed bank exceed this level – and it is in exactly such a scenario that insurance is of high value.

The Single Resolution fund is set to have subscribed capital of 55 billion euros financed by bank levies. The bank levies will be adjusted for the individual risk profiles of the banks. This adjustment protects safe banks from being net contributors to risky banks through the Single Resolution Fund. In an emergency case, the fund may borrow from external sources in order to extend its capacity. The fund will repay the loans through future bank levies. The EU member states have agreed to develop a “common backstop” to support the Single Resolution Fund in cases where loans cannot be obtained from private sources. At present, the exact design of the common backstop is unknown. Provided the only function of the common backstop will be to support the capacity of the Single Resolution Fund, the risks of participating in the common backstop are limited.

An additional advantage of Danish participation in the banking union is that the European Central Bank (ECB) may help to avoid any future decline in the quality of Danish financial supervision. As significant supervisory powers are transferred to the ECB, Denmark would be unable to

unilaterally relax financial supervision. This might be important if the lessons of the financial crisis of 2008 are forgotten in the future. Additionally, common supervisory standards within the banking union might promote competition.

The main disadvantage of participating in the banking union is that harmonisation of supervision and resolution approaches within the banking union might squeeze or rule out well-advised national approaches. An example could be the Danish practice of promoting transparency by the disclosure of inspections reports and individual capital requirements by the Danish financial supervisory agency.

Further, the structure of the Danish financial sector is distinctive due to the prevalence of specialised mortgage banks. The specialised mortgage system has many benefits, but in some respects it is at odds with the international financial supervisory and resolution standards designed for universal banking models. The supervisory and resolution approaches have to take account of the distinctive business model of the Danish mortgage banks.

Within the banking union, resolution tasks will be handled by the Single Resolution Authority. This agency is set to apply the new principle of bailing-in owners and creditors in large and systemically important banks. This might be a difficult task, especially as the procedures of The Single Resolution Authority appear cumbersome in some respects. This involves the risk that distressed banks will not be handled efficiently. However, there are clearly stated deadlines and the resolution is based on resolution schemes prepared in advance.

On balance, it is assessed that Danish participation in the EU banking union would involve a significant economic benefit. Largely, this is based on the expected benefits from participating in the insurance scheme of the Single Resolution Fund. In comparison, the disadvantages of participating in the banking union are modest. However, there are some important uncertainties involved: The common backstop for the Single Resolution Fund has not yet been defined, and

the exact consequences for the Danish mortgage system are unknown. The conclusion that Danish participation in the banking union is beneficial is conditional on these uncertainties being reasonably resolved.

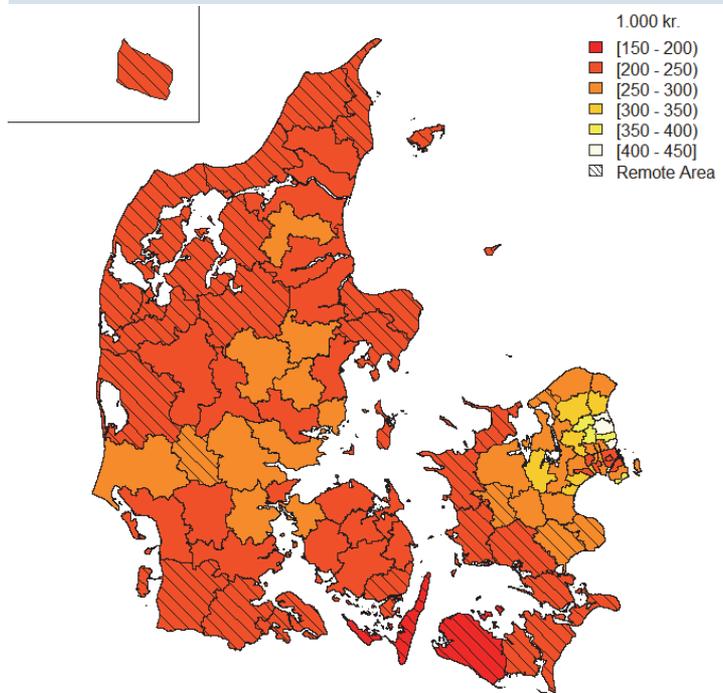
Chapter IV: Danish Remote Areas

Denmark constitutes a small geographic area compared to most other European countries, yet there are marked differences in economic development between geographic areas within the country. In this report a purely geographic criteria is used to define a Danish remote area as a municipality where the median citizen has to travel more than 30 minutes (by car) in order to reach a town with a population of at least 45,000 people. According to this definition, 35 of the 98 municipalities in Denmark are in remote areas. These 35 municipalities encompass around half of the country's total area, and are home to around 25 per cent of its population.

Earned income is low for the group of remote municipalities as a whole. Furthermore, population in the municipalities has declined in recent years, housing prices are low, and there are more empty houses than in the rest of the country. However, it should be noted that not all remote municipalities are characterized by low income, and that some large urban municipalities (defined as municipalities with a population above 45,000 people) have low earned income, see figure B.

On average, people in the remote areas are older than in the rest of the country. They also have a lower educational level and a lower labour market participation rate. However, conditional on the educational level and the age distribution, the participation rate is actually slightly higher in the remote areas than in the rest of the country. This indicates that it is the composition of the population in the remote areas, and not their behaviour, that differs from the rest of the country.

Figure B Earned income per employed person, 2012



Note: "Remote Area" refers to municipalities where the median citizen has to travel more than 30 minutes in order to get to town with more than 45,000 inhabitants.

The average earned income per employee is 12-13 per cent lower in the remote areas compared to large urban municipalities. This gap can be partly explained by differences in individual worker characteristics such as education, and partly by differences in business composition between municipalities. However, the analysis in the report shows that, even when these differences are taken into account, there is still a gap of around 8-9 per cent, which has been roughly constant for the last 20 years.

Population in the remote areas has been stable at around 1½ million people for several decades. Meanwhile, the total population of Denmark has increased. Hence, population in the remote areas has steadily declined relative to the rest of the country. In recent years, remote areas have also experi-

enced an absolute decline, in particular in areas where earned income is low. Since 2010, population in the remote areas has declined by 30,000 persons.

Housing prices are lower in the remote areas than in the rest of Denmark. In 2014, housing prices were, on average, 60 per cent lower in the remote areas than in large urban municipalities. This figure was only 40 per cent in 1995, illustrating that the housing price gap between urban municipalities and remote areas has increased over time. Also, the proportion of empty houses has increased more in the remote areas and is considerably higher than in the rest of the country.

The educational level in the remote areas is lower than in the rest of the country. A reasonable concern could be that young people in the remote areas achieve lower levels of education than their peers in other parts of the country due to limited educational opportunities. However, the analysis in the report shows that, conditional on the educational level of their parents, on average, children from remote areas do slightly better than children from other parts of the country. For instance, children of unskilled workers in the remote areas have a markedly lower probability of becoming unskilled workers themselves compared to children of unskilled workers in larger towns and cities. Also, a similar analysis shows that the intergenerational income mobility is roughly the same in the remote areas as in the rest of the country. Together, these analyses of educational and income mobility across generations suggest that the intergenerational mobility is fairly high in Denmark, and that children growing up in remote areas have the same opportunities in adulthood as children growing up in other parts of the country.

Economic theory provides two rationales for supporting certain areas economically (though they may be difficult to separate in practice): Income distribution and efficiency.

Income distribution is considerably more equal in Denmark than in most other countries. Taxes and transfers are the primary tools for redistributing income from people with

high incomes to people with low incomes. It seems difficult to justify that the redistribution of income on the individual level should contain a direct geographical dimension. Rather, taxes and transfers should redistribute income to households with a low income potential, regardless of where they live. In fact, such general redistribution implicitly favours remote areas as these areas have low participation rates and low earned income.

The distributional concern is also related to public services such as education and health. Basic principles of equality suggest that the level of public services adjusted for local tax rates should be roughly the same across the country. In Denmark, the system of inter-municipal equalization seeks to achieve this objective. The Danish Ministry for Economic Affairs and the Interior constructs a measure of the level of public services divided by the tax rate for each municipality. This measure indicates that the level of public service relative to the tax rate is slightly lower in the remote municipalities than in the rest of the country.

Economic support to remote areas might also be justified for other reasons than distributional concerns. First, there might be positive spill-over effects related to education, and thus reasons to ensure access to a wide range of education and training opportunities, as well as reasonable transport available in all parts of the country. Hence, not only distributional concerns but also efficiency considerations might speak in favour of ensuring that young people have access to a broad set of educational opportunities regardless of where they grow up. Such spill-over effects may justify specific economic support to educational institutions in remote areas as it might be more expensive to sustain such institutions in sparsely populated areas.

Second, the political debate concerning remote areas indicates that there might be a general social desire to ensure that the population in the remote areas doesn't decline further (or at least that the speed of the decline is reduced), and that a certain level of activity is maintained in the remote areas. If this concern is strong enough, it could justify support to remote areas in order to halt the population decline.

However, there are also reasons for reducing the existing support to remote areas, or at least not increasing it. One reason could be the possible gains from agglomeration, i.e. concentration of people and firms within areas. When firms are located close to each other, their employees might interact and generate positive spill-over effects, benefiting the entire society. Additionally, a large labour pool might encourage division of labour and thereby increase productivity and wealth. Thus, measures that seek to move economic activity from towns and cities to remote areas might entail substantial costs.

At the end of the day, it is a political judgment whether the reasons for supporting remote areas are stronger than the reasons not to. If they are, a related question is whether there exist effective measures for counteracting the decline in the remote areas.

One possible way of increasing the employment in remote areas is to move governmental jobs from the larger towns and cities to the remote areas. British experience suggests that this kind of measure has a positive effect on total employment in the remote areas, but only a limited effect on local employment in the private sector. The effect will probably be largest if the governmental bodies are able to hire the necessary workers locally. A decision to move governmental jobs should, under all circumstances, be based on a specific assessment of the costs and benefits.

Empty and dilapidated houses spoil remote areas, possibly entailing substantial negative externalities. Recent political measures intend to address these problems, but further measures might be necessary. The beneficiaries of these measures are the neighbours of the empty houses as well as the financial institutions with mortgages in these houses. Therefore, whether they should contribute to financing these measures in some way could be considered.

The Danish remote areas are faced with several challenges, and there are already several economic measures in place aimed at improving conditions in these areas. Even though

the arguments for economic support to the remote areas might be stronger than the counter-arguments, there is no easy way to assess whether the support should be increased from the current level. More support to remote areas could contribute to improved living standards and potentially counteract the population decline, yet it might simultaneously reduce aggregate productivity and income.