

De Økonomiske Råd 
Formandskabet

DANISH ECONOMY
AUTUMN 2023
SUMMARY AND
RECOMMENDATIONS

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Chapter I comments on current economic policy, including housing tax and meeting of the Climate Act's 2025 targets.

Chapter II presents a projection for the Danish economy, which shows signs of slowing down, although the labour market remains tight. Fiscal policy is assessed to be expansionary and should therefore be tightened for 2024.

Chapter III deals with long-term fiscal sustainability. The sustainability indicator is estimated to be 0.3 percent of GDP; therefore, fiscal policy is assessed to be sustainable.

Chapter IV analyses the effects of rent control on distribution and effectiveness. The results show that rent control is not well-targeted to low-income tenants and there is an efficiency loss for society that could be reduced if increases in rents were more in line with increases in the market rents.

Chapter V examines childhood health interventions and presents an analysis of childhood dental care, which finds no statistically significant long-term dynamic effects thereof.

SUMMARY AND RECOMMENDATIONS

This report by the Chairmanship of The Economic Councils contains five chapters.

- Current economic policy
- Economic outlook and public finances
- Fiscal sustainability
- Rent control of private rental dwellings
- Childhood health interventions

The assessments and recommendations in the report are solely those of the Chairmanship. Notes documenting the analyses along with the data are available at www.dors.dk (in Danish).

CHAPTER I, CURRENT ECONOMIC POLICY

This chapter provides a summary of the assessments and recommendations for economic policy, while the main conclusions about public finances and fiscal sustainability are presented in Chapters II and III below.

Higher pay for some public sector employees should be based on well-documented criteria for labour shortages

In September 2023, the Government invited the labour market organisations to negotiations with a view to improving pay and working conditions for some groups of public sector employees. This is justified by the fact that some public sector jobs either are, or are expected to, experience recruitment challenges. The goal of improving pay and working conditions for some may be appropriate if wages rise most for the groups where there is a shortage of labour. However, this should be based on well-documented criteria for how difficult it is to recruit labour.

Tax on owner-occupied housing is an appropriate part of the tax system

In 2024, the new rules for property taxation will come into force, and in September 2023, the preliminary assessments of the land and property values of all owner-occupied homes were published. Property taxation is an important and appropriate part of the Danish tax system. However, homes are not uniform goods, and the housing market is characterised by imperfect information, which is why there is no clear-cut objective market value. The assessed valuations should be consistent with the average market value for a home with the characteristics in question. An observed sale price that deviates from the average value does not necessarily reflect an error in the valuation. However, it is

important that the tax authorities continually work to improve the valuations so that the assessments are as precise as possible. To this end, appeals are an important source of information for the tax authorities and can improve the valuation process in the long term.

The 2025 emissions reduction target can be achieved by increasing the energy tax on fuel for transport

According to the Climate Act, total net greenhouse gas emissions are required to be reduced by at least 50 percent by 2025 compared to 1990 levels. The Climate Council has assessed that, under the currently adopted policy, it is unlikely that the target will be reached. Meeting the 2025 target can be achieved by increasing the energy tax on fuel for transport so that the total taxation of driving corresponds better to the externalities caused by congestion, accidents, noise and air pollution. Such a tax increase is likely to reduce the welfare loss from the current taxation of driving, even though it is targeted to a lesser extent at the externalities caused by driving than if the taxation were based on differentiated driving charges.

Unfortunate to move away from factoring in a tax distortion in cost-benefit analyses

With the publication of *Vejledning i samfundsøkonomiske konsekvensvurderinger* [Guidelines for economic cost-consequence analyses] in June 2023, the Ministry of Finance has adjusted the factor which takes into account the marginal cost of public funds down from 1.1 to 1.0. In doing so, the Ministry of Finance is moving away from traditional economic thought that publicly funded projects entail additional costs due to tax distortions. Since there is no consensus in the literature that it is appropriate to disregard tax distortions, the Chairmanship recommends that economic analyses be presented both with and without tax distortions.

CHAPTER II, ECONOMIC OUTLOOK AND PUBLIC FINANCES

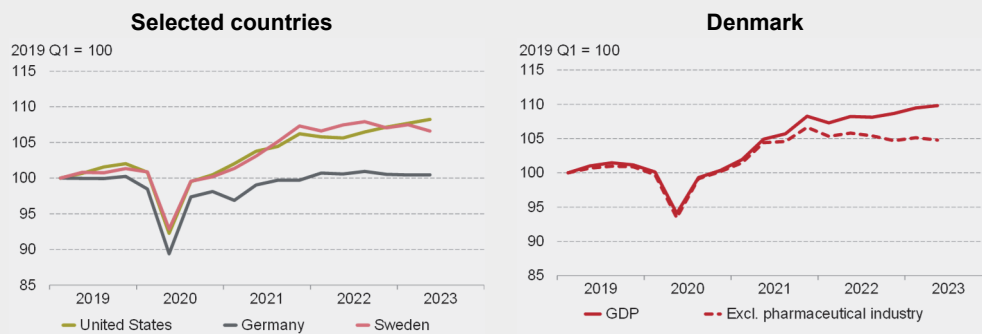
Chapter II contains an assessment of the current economic outlook and the evolution of public finances.

Signs of stagnation, but the labour market remains tight

The Danish and international economies are showing signs of slowing down following significant monetary policy tightening by central banks since the beginning of 2022. However, growth is still high in the US and Denmark, which for Denmark primarily is due to continued high growth in the pharmaceutical industry, see figure A. Employment has continued to increase over the summer and is currently estimated to be approximately 90,000 persons above the structural level, which corresponds to an employment gap of approximately 3 percent. Thus, according to this measure, the labour market remains tight.

FIGURE A GDP

GDP has stagnated in Germany and Sweden, while production continues to increase in Denmark and the US. The continued growth in Denmark is attributable to the pharmaceutical industry.



Notes.: The calculation of GDP excluding the pharmaceutical industry is based on a special data set from Statistics Denmark as well as on own calculations, see the background note (in Danish). The latest observation is for the second quarter of 2023.

Source: Macrobond, Statistics Denmark, Statbank Denmark and own calculations.

Fiscal policy and public finances

The difference in fiscal space estimates highlights uncertainty

Fiscal space (sometimes referred to as fiscal room for manoeuvre) is central in fiscal policy planning. According to the Ministry of Finance's latest calculations in August, the fiscal space is approximately 55 billion DKK. There are minor differences between the Chairmanship's and the Ministry of Finance's projection of tax revenue and public sector expenditure for the period up to 2030. Thus, based on the chapter's projection, the Chairmanship's estimate of the fiscal space is slightly higher, at approximately 64 billion DKK, see section 11.4 of the report (in Danish). The fiscal space may seem large, but must cover a number of things including increased defence spending and any positive real growth in government consumption expenditure over the period leading up to 2030.¹ Although the difference in fiscal space of approximately 9 billion DKK between the Ministry of Finance and the present projection may seem large, there is considerable uncertainty associated with the public finance projections and the estimates of the fiscal

1) The broad political agreements on increased defence spending and the so-called 'green fiscal space' will together require fiscal space of approximately 11 billion DKK. The estimates assume that government consumption expenditure follows a demographic and wealth trend over the period 2025-2030, which will require fiscal space of approximately 24 billion DKK.

space. When uncertainty is taken into account, the two estimates should be seen as almost coincident.

Forecast of economic activity indicates fiscal tightening needed

In assessing how tight or loose fiscal policy should be, the economic forecast for 2024 can be compared with the situation in 2019, which was a year with relatively normal economic conditions and no extraordinary fiscal measures. According to the current forecast, it is estimated that the employment gap will increase by approximately 1½ percentage points from 2019 to 2024, which indicates that fiscal policy should be tightened. The fiscal rule of thumb, which is described in *Danish Economy, Spring 2007* and Grinderslev and Smidt (2023), calls for a tightening of almost a ½ percent compared to 2019. However, there are other indications that the labour market pressure might be less than the estimated employment gap indicates, which points in the direction of slightly less tightening of fiscal policy.

Fiscal policy is assessed to be expansionary compared to 2019

The cumulative effects of fiscal policy are estimated to increase GDP by approximately 0.1 percent in 2024 compared to 2019. The estimate of the structural balance have worsened slightly between 2019 and 2024, even though there has been an underlying improvement resulting from an increase in structural employment of almost 150,000 people over the same period. Fiscal policy has thus been expansionary during the period.

Fiscal policy for 2024 should be tightened compared to what is planned

As stated above, the current economic forecast suggests that fiscal policy in 2024 should contribute to reducing the capacity pressure in the economy instead of increasing it. This is because the risk of a more abrupt and significant downturn increases with the size of imbalances in the economy and the tight labour market increases the search costs of hiring. A further reason that fiscal policy should not contribute to increasing demand in the economy is that the underlying price pressure is still significant, even though inflation is slowing.

CHAPTER III, FISCAL SUSTAINABILITY

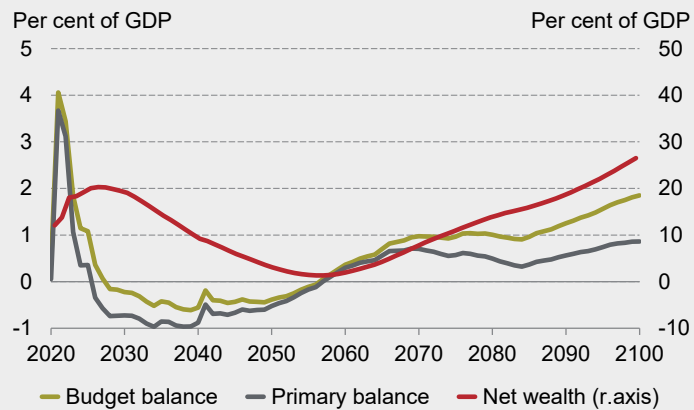
New long-term projection with a sustainability indicator of 0.3 percent of GDP

The long-term projection presented in Chapter III shows a deficit in the (structural) balance over the period 2030 to around 2050 of approximately a ½ percent of GDP, see Figure B. After that, the balance will be permanently improved. At the end of the century, under the assumptions made in the projection, the budget balance surplus will amount to just under 2 percent of GDP. The sustainability indicator is 0.3 percent of GDP, which is equivalent to being able to permanently raise public expenditure by approximately 9 billion DKK without raising taxes or,

conversely, lowering taxes by the same amount without reducing government spending. However, it is important to be aware that there is great uncertainty about many of the assumptions in the projection.

FIGURE B GOVERNMENT BUDGET BALANCE AND WEALTH

The figure shows the long-term projection of the government budget balance and net wealth given unchanged policy and a number of other assumptions.



Source: DREAM and own calculations.

Lower fiscal sustainability indicator and smaller long-term budget balance improvement than previously assumed

The fiscal sustainability indicator has deteriorated by 0.7 percent of GDP since the corresponding projection presented in *Danish Economy, Autumn 2022*. The single most important reason for this is that projected government consumption expenditure as a percentage of GDP has increased over the period leading up to 2030. Since there are also various other conditions that improve the balance over the coming decades, the budget balance profile up until 2040 is, however, relatively unchanged compared to previous years. The deterioration in sustainability thus comes primarily from a slower improvement in the government budget balance (relative to the 2022 projection) in the period after 2040.

The Government assumes far greater over-sustainability

The Government's latest long-term projection from August 2023 assumes a sustainability indicator of 1.5 percent of GDP. There is thus more than a percentage point difference between the Government's and the Chairmanship's assessments of sustainability. Such a large difference between the two institutions on this point has not been seen

since 2006. Two factors that together explain almost the entire difference between the sustainability indicators are that the Government expects a larger effect on employment from the assumed future increases in the state pension age than the Chairmanship, and the productivity growth projections also differ. Despite the Government's more optimistic indicator, it assumes a larger budget balance deficit than the Chairmanship over the next approximately 30 years, until the relationship reverses after 2050.

Should today's population fund more leisure for future generations?

The chapter highlights the consequences of changed assumptions in various areas, including the effects of the population choosing to trade some of the future increase in prosperity for more leisure time and correspondingly fewer annual working hours. Such a scenario may require the implementation of budget-improving initiatives in the form of tax increases or public sector savings if the state finances are to continue to be sustainable. An important question is whether today's politicians need to act now to further improve the budget in order to prepare for the possibility that the citizens of the future will want to prioritise leisure time to a higher degree. One could argue that it is not the current generation's responsibility to make budget improvements in order to finance a future generation's desire to work less. But this is a question of a purely political nature.

A decline in the labour force is hardly a distinct economic problem

There is currently a discussion about whether the decline in the workforce relative to the population as a result of demographic change over the next approximately 20 years is a distinct, important macroeconomic problem that requires economic policy changes, even though this is not necessarily a problem for the public finances. Apart from the issue of fiscal sustainability, it is difficult to point to actual market failures that suggest that the demographic shifts themselves create a particular need for government intervention. Therefore, a natural starting point is that the market mechanisms will ensure the creation of a new labour market equilibrium, where the demand for labour adapts to the supply. Specifically, this will involve an adjustment in wages, which is a matter for the employee and employer organisations.

CHAPTER IV, RENT CONTROL OF PRIVATE RENTAL DWELLINGS

Comprehensive rent control in the rental housing market

The home plays an important role in the lives of all Danes. Around 40 percent of all homes in Denmark are rented. Of this, approximately half is private rental housing, while the other half is public housing. In most private rental housing, there is extensive rent control, so the rent is typically lower than it would be without rent control. Chapter IV of the

report analyses the effects on distribution and the effectiveness of rent control in Denmark.

Rent control of the initial rent level in older private rental housing

The form of rent control depends on when the rental property was built. Thus, the level of the rent for private rental housing built up to 1991 is regulated. This comprises approximately 75 percent of private rental housing. For private rental housing built after 1991, the rent can be freely agreed upon between the tenant and the landlord when the lease is entered into.

Rules limits price increases in rent for all rental dwellings

In addition, for all private rental dwellings there are rules, which limits price increases during tenancy. For homes built after 1991, increases in rent are indexed with the so-called net price index

Distributional considerations argument for rent control

There are similar forms of rent control in many other countries, where rent control is often justified based on a desire to secure cheap rental housing for low-income households. However, rent control creates rationing, so homes are allocated using, for example, waiting lists, personal contacts and landlords' preferences. This does not guarantee that, largely, it is low-income households who have access to the cheap rent controlled dwellings.

Biggest rent reduction for the wealthy, highly educated and elderly

An analysis in the chapter shows that it is tenants with a high income, a university education and the elderly who gain the most from the rent control (largest rent reduction). Among tenants in older private rental housing, the average annual rent reduction is approximately DKK 12,000 for those with low and medium incomes and approximately DKK 25,000 for those with the highest incomes see Figure C.

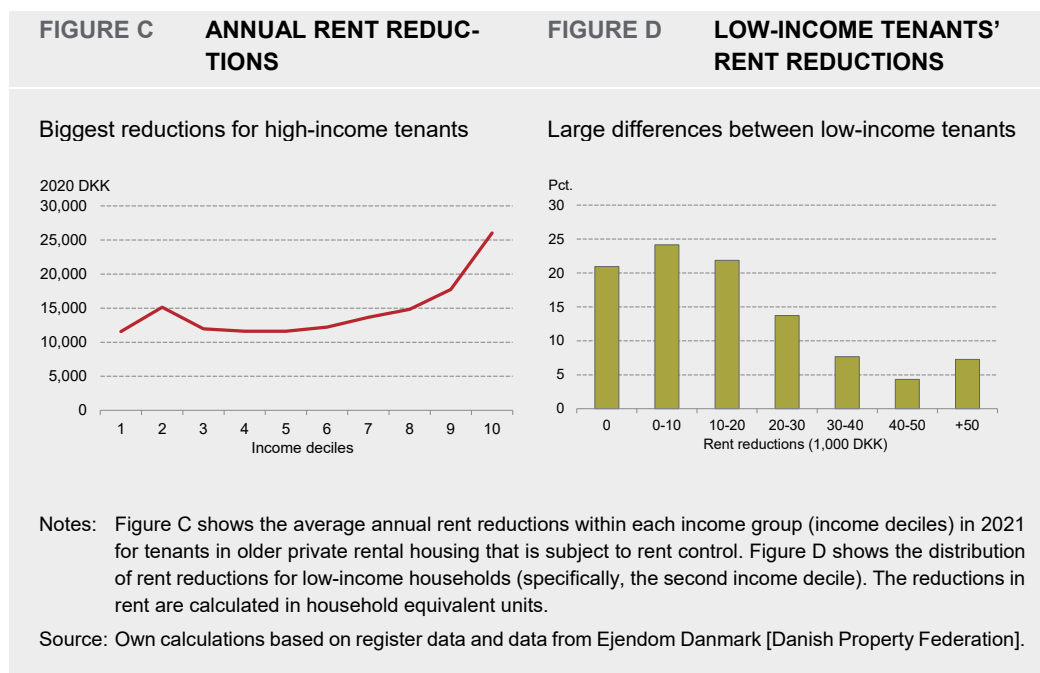
Large differences in rent reductions between tenants with the same income

The average annual rent reduction mask large differences between tenants on the same income level. Thus, just under 20 percent of low-income tenants do not obtain any rent reduction, while approximately 8 percent have annual rent reductions of more than DKK 50,000, see Figure D. There are corresponding differences in the rent reductions between tenants with medium and high incomes. In terms of benefiting tenants with low incomes, rent control are thus not very well targeted.

Poor match between housing and tenants in much of the rent controlled housing market

Rent control can lead to various types of efficiency losses. For older rental housing where the rent is below the market rate, the rent does not act as a mechanism for housing allocation. This results in a poorer match between the rental properties and the tenants' wishes. Analyses in the chapter find that there is a bad match of the order of 15 to 35 percent of the older private rental housing. A bad match exists, e.g., where households live in dwellings that are smaller or larger than they

would choose in the absence of rent control. This implies a loss of efficiency for society.



Lower mobility affects productivity

A number of previous studies referred to in the chapter show that people who live in cheap, rent controlled housing move less often and that they more often find jobs in the local area. Such lower workforce mobility is likely to result in lower productivity.

Rules for increasing rents prevent market power and provide certainty over future housing costs

Traditionally, economists have emphasised the negative effects of rent control. However, there are also efficiency gains from regulating rents. This applies, in particular, to rules for increasing rents over time once the lease has been entered into. These rules prevent landlords from raising rents excessively to take advantage of the fact that, over time, it may become increasingly expensive for existing tenants to move house, e.g., due to increasing attachment to the local area. Rules limiting rent increases also provide tenants with certainty over their future housing costs. In addition, in some municipalities there is a relatively high market concentration, which could have led to higher rents compared to municipalities with a low market concentration.

Loss of efficiency is smaller if the rent increases are more in line with increases in market rents

The increase in market rents has been higher than the increase in the net price index, which is used to regulate increases in these rents over time for private rental housing built after 1991. This means that the rents fall further and further below market rents the longer tenants stay, which leads to increasing efficiency losses over time. The efficiency loss would be reduced if the increases in rents over time more closely followed the changes in market rents. However, this would also mean higher rents, which could be a particular challenge for households with relatively low incomes. It is thus a political trade-off between loss of efficiency and distribution. If rent increases followed, at most, wage increases, which are typically higher than the net price index, a lower loss of efficiency would result, and at the same time, rent would not constitute an increasing share of the income of wage earners or transfer payment recipients.

CHAPTER V, CHILDHOOD HEALTH INTERVENTIONS

Previous reports have highlighted early interventions

The Chairmanship has previously described the importance of early interventions for children, see *Danish Economy, Spring 2021*. In Chapter V of the present report, the focus is on a specific form of such interventions – namely health interventions.

Health in childhood has far-reaching consequences

Early health interventions are important because children's health not only affects children's well-being, but can also affect health, level of education, labour market attachment and income as an adult.

Early public health interventions can reduce efficiency losses

Parents have a great deal of influence on the health of their children. Publicly funded measures make children's health less dependent on their family background. In this way, such measures can potentially increase, among other things, labour market attachment, and thereby reduce the loss of efficiency. At the same time, early public health interventions can reduce the inequality of opportunity between children.

New analysis does not demonstrate an effect of the right to free dental care for children

The chapter contributes to the relatively limited amount of Danish literature on the effect of early health interventions by examining the long-term effects of free dental care for school children. The long-term effects of childhood dental care are measured in terms of the use of dental care services, the use of health services, the probability of death, level of education, labour market attachment and income at ages 35, 40, 45, 50 and 55 years. The analysis does not find statistically significant effects of children's dental care on the selected variables.

Children's dental care is important for children's dental health

Odontological studies show that children's dental health improved significantly after the right to free dental care for children was introduced, see Schwarz (1985), Friis-Hasché (1994), Richard *et al.* (2022). The analysis in this chapter does not question this.

Effects earlier or later in life are possible

It is possible that there is no effect of childhood dental care in the age range that the analysis investigates but that there are effects later or earlier in life. It is not possible to analyse any effects that may appear beyond the age of 55. Conversely, it is also possible that no long-term effects of childhood dental care can be demonstrated because the effect does not extend beyond childhood. The individuals who did not receive dental care in their childhood may have received other interventions that enabled them to achieve the same outcome as individuals who received childhood dental care.

Great uncertainty, so effect cannot be rejected

However, it is also possible that there is actually an effect of childhood dental care on the selected age groups, but that it is not possible to demonstrate it statistically. There is great uncertainty in the results, which means that it cannot be rejected that the right to free dental care for children may even have had a large effect on all the measures.

Spillover effects can lead to underestimation

In addition, children who were not themselves covered by the free childhood dental care scheme may also have benefited from its introduction. For example, information about prevention is an essential part of children's dental care, and the information can easily be spread to people other than the target group. If so, the estimated effect of children's dental care would be a lower bound estimate.

Not a basis for taking effects into account

Thus, the analysis does not lead to the conclusion that long-term effects can be ruled out. On the other hand, the results show that there is currently no basis for taking into account indirect long-term dynamic effects when the net costs of children's dental care are calculated.

Dynamic effects can be difficult to detect

The analysis suggests that, even with a comprehensive amount of data and a suitable method, it can be difficult to demonstrate long-term effects of public interventions that makes it possible to take account of dynamic effects. Another challenge with universal schemes such as childhood dental care is that, although the effect may be small for the individual, the effect can potentially be large at the national level because so many are affected.

**More knowledge
needed for both
specific and general
assessment criteria**

As a supplement to studies that seek to map the dynamic effects of specific measures, further Danish research in the area is necessary to establish both theoretically and empirically based general rules of thumb about the dynamic effects of government consumption expenditure.

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