De Økonomiske Råd
Formandskabet

DANISH ECONOMY SPRING 2023

SUMMARY AND RECOMMENDATIONS

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Chapter I contains comments on a number of current economic policy initiatives proposed in the new Government's legislative program, including proposals for a number of tax changes and proposals in the area of education.

Chapter II presents a projection of the Danish Economy. A slowdown is expected the coming years due to low global growth, high inflation and high interest rates. Despite the prospect of a slowdown, fiscal policy should not stimulate demand in 2024; rather, it should do the opposite.

Chapter III presents a welfare indicator that estimates welfare in a theoretically consistent way based on consumption, life expectancy and leisure time. Geographical inequality differences are smaller measured by the welfare indicator rather than by income.

Chapter IV contains a review of the government departments' assessment criteria for the effect of changes in corporation taxation. The Chairmanship assesses that there are grounds for a number of changes in the assessment criteria, which, when taken into account, would reduce the degree of self-financing of a lower corporation tax.

SUMMARY AND RECOMMENDATIONS

This report by the Chairmanship of the Economic Councils contains four chapters:

- Current economic policy
- Economic outlook and public finances
- Wealth and welfare
- Effects of corporation tax.

CHAPTER I, CURRENT ECONOMIC POLICY

Chapter I summarises assessments and recommendations for economic policy. The report's main conclusions related to fiscal policy and public finances appear in Chapter II entitled Economic outlook and public finances.

Lower inheritance tax can reduce productivity and labour supply

In its legislative program, the Government has proposed a number of changes to the tax system. One of these proposals is to reduce the tax on business transfers within a family. Lower tax on business transfers will provide increased incentives for businesses to be transferred to the next generation. However, there is evidence that such a relaxation encourages family ownership to be maintained for tax reasons, which is expected to have a negative impact on productivity and, what's more, may reduce the aggregate labour supply.

Increased deductions for R&D expenditure require better grounds for decision making

Another proposal is to permanently increase the tax deduction for research and development expenditure. The Government has not presented evidence of positive effects from increasing the existing subsidisation of private businesses' research and development. The grounds for increasing the deduction should, therefore, be provided before any decision is made to increase the deduction permanently.

Top tax change is a trade-off between efficiency and distribution

The Government's legislative program also proposes a restructuring of the top tax bracket such that the marginal tax rate is lowered for some people who currently pay the top tax rate, while the marginal tax rate is raised for incomes over 2½ million DKK. The restructuring reflects a trade-off between efficiency and distribution. However, the distributional effect of increased taxes for the highest incomes is uncertain, as many in the high-income group can opt to receive some of their income paid in shares and thereby circumvent the tax increase. As a result, the revenue raised may also turn out to be lower than assumed.

Closing job centres should be based on evidence

Regarding the labour market, the Government's legislative program contains a proposal to close the job centres in their current form, and give private actors a greater role in the active labour market programs. Studies indicate that private actors are no better than the public sector at getting people with a weak labour market connection into jobs. Changes to the labour market measures should be based on an evaluation of the job centres' current performance compared to relevant alternatives.

Consider a gradual introduction of shorter Master's programmes

The Government has put forward several proposals in the area of education. In their green paper, 'Prepared for the Future I', the Government proposes to shorten up to half of the places in master's degree programs by three quarters of a study year and use the savings this entails to increase the quality of master's programs. The Chairmanship has previously recommended that the reform be introduced on a trial basis for a smaller number of masters places in order to investigate whether the reform will have the desired effect.

Shortening and restructuring of the student allowance [SU] is a good idea

In the Government's legislative program includes a proposal to shorten the period that the student allowance is paid to those in further education and improve the loan options available to students to enable completion of their studies. On the basis of recommendations to replace student allowances with student loans for the post-bachelor part of master's degree programs, see Danish Economy, spring 2018 and Productivity 2023 [*Dansk Økonomi, forår 2018* and *Produktivitet 2023*], the Chairmanship assesses that these proposals are appropriate.

Kilometre-based road pricing is positive, but rates are too low

In March 2023, a broad political agreement was reached on kilometre-based road pricing for heavy vehicles that implies increased taxation of heavy road transport. It is appropriate that taxation be increased and that the tax is kilometre-based. However, the rates are still significantly lower than the external costs; thus, the socio-economic benefits of this measure could be increased by raising the rates. The kilometre-based road price does not depend on CO_2 emissions, which are regulated in a more targeted way through fuel taxes.

Abolition of the Great Prayer Day public holiday is not expected to have a long-term labour supply effect

In February 2023, the Great Prayer Day public holiday was abolished with effect from 2024. The abolition does not directly affect economic incentives or the preferences of Danes for free time. A prerequisite for a lasting effect on the labour supply is that there is credible empirical evidence for such an effect. The Chairmanship does not consider that there is sufficient evidence for this.

CHAPTER II, ECONOMIC OUTLOOK AND PUBLIC FINANCES

Chapter II contains an assessment of the current economic situation and the development of public finances.

Surprisingly strong employment growth in 2022

Despite high inflation, considerable uncertainty and rising interest rates, the Danish economy has continued to experience growth in production and employment. Employment increased by around 60,000 during 2022, and even though reports by businesses of labour shortages have subsided, the pressure on the labour market is still considered to be significant. The growth in employment has continued into 2023, and employment is currently estimated to be approximately 3 percent higher than the estimated structural level.

The Danish and international economy have both fared better than expected

The development in employment and GDP have been a surprise on the upside, and both the Danish and international economy have so far proved more robust to high inflation and rising interest rates than expected. In the autumn, the expectation was that the world economy faced a period of low growth and significant downside risks. This expectation was based on the sharp rise in energy prices and inflation, which led to noticeable drops in purchasing power and rising interest rates both in Denmark and abroad. Furthermore, market expectations at the time were that energy prices would remain at a high level, and, especially in Europe, there was a real concern for energy supply shortages in the winter of 2022/23.

Continued expectation of economic slowdown, but now more subdued

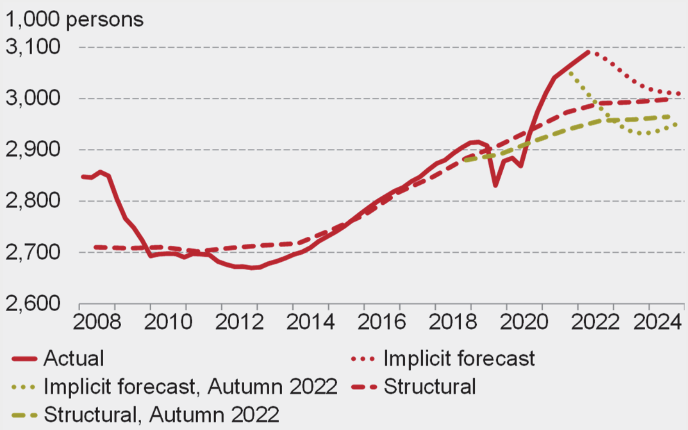
It is still expected that the Danish and international economy will face a slowdown, but the slowdown is now expected to be more subdued than previously expected. This can largely be attributed to the significant drop in energy prices – both in relation to the level in late summer 2022 and in relation to market expectations for the energy price level in 2023.

Employment is falling, but still above the structural level

It is now expected that, by 2025, employment in Denmark will have decreased by around 50,000 compared to the average level in 2022. This decrease is smaller and more gradual than expected in *Danish Economy, Autumn 2022*, see figure A. The decrease in employment combined with an increase in structural employment means that the pressure on the labour market, measured by the employment gap, will reduce from just over 3 percent in 2022 and 2023 to approximately 1½ percent in 2024, see table A.

FIGURE A **EMPLOYMENT**

The fall in employment is now expected to be smaller and more gradual than in the autumn forecast.



Notes: Structural employment has been adjusted upwards by approximately 30,000 compared to the autumn forecast, see section II.3.

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

High inflation driven by energy prices

Inflation peaked in the autumn at around 10 percent but has since fallen and was just over 5 percent in April. The rise in inflation until autumn was largely driven by rising energy and food prices, and until autumn, the domestic contribution to inflation was very limited and in periods directly negative. However, while energy prices have fallen, the domestic contribution to prices has increased, which is why inflation has remained relatively high. In the coming year, inflation is expected to be largely driven by domestic factors, including rising unit labour costs and rising unit profits. Inflation is expected to remain above 2 percent for the next couple of years and not fall below 2 percent until 2025.

TABLE A KEY FIGURES OF THE OUTLOOK FOR THE DANISH ECONOMY

	2022	2022	2023	2024	2030 a)
	DKK bn.	------ Real growth rate, per cent -------			
Private consumption	1,198	-2.3	0.1	2.0	3.7
Public sector consumption	615	-3.5	1.4	1.8	1.1
Gross fixed capital formation	652	8.6	-4.7	-3.4	1.0
consisting of:					
Public sector investment	87	-2.7	4.7	2.5	1.7
Residential investment	174	7.8	-8.0	-7.5	0.6
Business fixed investment	391	11.9	-5.3	-3.1	1.1
Stockbuilding[b)]	36	0.8	-0.5	0.0	0.0
Total domestic demand	2,501	1.0	-1.4	0.6	2.4
Exports of goods and services	1,939	8.6	1.3	2.2	2.7
Imports of goods and services	1,642	4.2	-2.3	1.7	4.9
GDP	2,798	3.8	1.0	1.0	1.2
Key indicators					
Consumer prices, percentage change[c)]		7.4	4.3	2.9	1.5
Unemployment, per cent[d)]		2.1	2.3	2.6	3.1
General gov. budget balance, DKK bn.		93	53	22	5
General gov. budget balance, per cent of GDP		3.3	1.8	0.8	0.1
Hourly wage costs, percentage change		3.5	5.0	5.8	3.4
Terms of trade, change in percentage points		-0.2	-1.6	-0.2	0.1
ECB deposit rate, per cent		0.1	3.3	3.3	0.5
Employment gap, per cent[e)]		3.1	3.2	1.6	0.0

a) The column shows projected average annual growth from 2024 to 2030 for all variables except unemployment, the general government balance, the ECB deposit rate and the employment gap. For these variables, the columns show the projected value in 2030.

b) Contribution to GDP growth in percentage points.

c) Implicit private consumption deflator.

d) Percentage of total labour force. National definition.

e) Percentage of structural employment. National definition.

Source: Statistics Denmark, ADAM's data bank, Macrobond, and own calculations.

Fiscal policy and public finances

The public finances are considered sound

The structural budget is projected to display a surplus in the coming years and, leading up towards 2030, only a slight weakening is expected such that, with the given assumptions, the budget is expected to be roughly balanced in 2030. At the same time, fiscal policy is assessed to be more than sustainable, see *Danish Economy, Autumn 2022*. Overall, the assessment of the Chairmanship is that the public finances are fundamentally sound. This is also illustrated by the fact that the Danish public finances are among the strongest in the EU, both in terms of balance and government debt.

Fiscal policy in 2023 is too loose

Measured in terms of the impact on economic activity, fiscal policy in 2023 is estimated to be fairly neutral compared to 2019 despite the fact that the pressure on the economy's capacity is now assessed to be markedly greater than in 2019. Thus, fiscal policy has not contributed to countering domestic inflationary pressures. In that light, the 2023 Finance Act, which was adopted in May, should have been tighter.

In 2024, fiscal policy should not increase demand pressures

The fiscal policy for 2024 will not be planned until the Finance Bill is announced in Parliament in August 2023. Under the assumptions given in the chapter, fiscal policy in 2024 is estimated to involve a slight easing. Seen in isolation, the expected slowdown in 2024 speaks in favour of a relaxation of fiscal policy, but several factors pull in the other direction. First, the domestic pressure on inflation is also expected to be considerable in 2024. Second, as mentioned, fiscal policy since 2019 has not reflected the developments that have taken place in the economic situation. As fiscal policy has not been tightened in line with the build-up of pressure on capacity, there is also no argument to relax it when the economic situation gradually normalises. Given the current economic outlook, the Chairmanship assesses that the arguments against fiscal easing suggest that fiscal policy in 2024 should not contribute to increasing demand pressures; rather, it should do the opposite.

CHAPTER III, WEALTH AND WELFARE

GDP measures economic output, not welfare

In a democracy such as Denmark's, it is crucial to measure the development of the population's wealth and welfare (also known as well-being). Per capita GDP is traditionally used for cross-country comparisons. However, GDP only measures economic output, and it is well known that GDP is not a suitable measure of welfare in a broader sense. An increase in working hours will mechanically increase GDP, but not necessarily welfare, as longer working hours lead to a loss of leisure time.

Analyses in the chapter contribute to the debate on measuring welfare

The way wealth is measured is relatively well established. However, in recent decades there has been a debate about whether the focus should be shifted from measuring economic production to focusing instead on measuring welfare. Welfare is a far more diverse concept than economic wealth measured by GDP or income. Economic wealth affects welfare, but is not in itself an indicator of welfare. Whether certain initiatives have opposite effects on wealth and welfare can be made clear using welfare indicators. Chapter III contributes to the debate by using a specific welfare indicator that calculates welfare in a theoretically consistent way based on expected consumption, life expectancy and leisure time.

An indicator of welfare

The chapter uses a welfare indicator developed by Jones and Klenow (2016). The welfare indicator seeks to measure the expected welfare over a lifetime. This approach assesses the expected lifetime welfare immediately before one is born, when one's actual life circumstances are unknown. The welfare indicator is affected by the level of consumption, the extent of leisure time, life expectancy and inequality in both consumption and leisure time.

Denmark ranks higher on welfare than on GDP

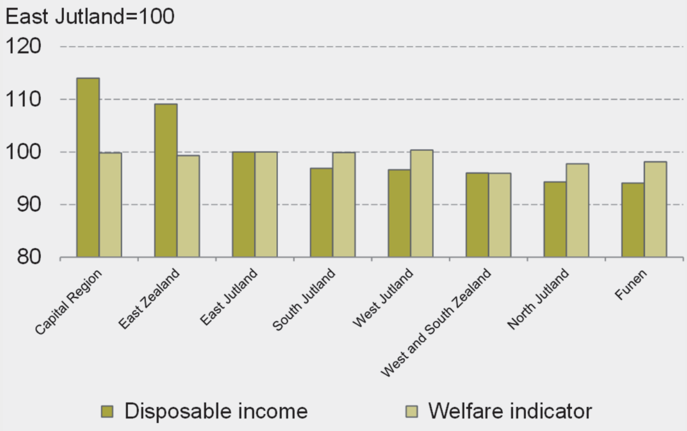
In the chapter, the estimates of the welfare indicator for 24 high-income OECD countries show that countries with high GDP per capita also typically have high welfare. However, the correlation is not perfect, and Denmark, for example, ranks higher among the 24 countries when measured by the welfare indicator rather than by GDP per capita. For example, Denmark has a lower GDP per capita compared to the United States, but, on the other hand, it has higher welfare. This reflects that the population in Denmark lives longer, works less and is more equal than in the USA. The American population, on the other hand, has higher consumption, which, in isolation, pulls in the direction of higher welfare.

Geographical income inequality

Calculated on the basis of average disposable income, there are marked differences between regions in Denmark. For example, disposable income is highest in the Capital Region, while in West Jutland it is a good 17 percentage points lower, see figure B.

FIGURE B WEALTH AND WELFARE ACROSS DENMARK

The geographical differences in disposable income are greater than the differences in the welfare indicator.



Notes: The figure shows disposable income and the welfare indicator based on individuals' place of birth. All scores are calculated relative to East Jutland in 2019.

Source: Author's calculations based on register data.

Less geographical welfare inequality

However, the geographical differences are smaller measured by the welfare indicator rather than by disposable income. Based on the welfare indicator, welfare in the Capital Region is no higher than in several other parts of the country, and, for example, the welfare score is higher in West Jutland than in the Capital Region. Thus, the results suggest that geographical inequality is overestimated when it is assessed solely on the basis of income differences rather than a broader measure of welfare, which includes several factors of importance for individuals' welfare.

No sign of increasing geographical welfare inequality

Over the period 2008-19, there was a trend towards increased inequality between the various regions of the country calculated on the basis of disposable income, see figure C. Using the welfare indicator, however, there is no sign of increasing inequality between the regions. It is thus decisive whether the assessment of the trend in geographical inequality across Denmark is made on the basis of disposable income or the welfare indicator.

FIGURE C GEOGRAPHICAL INEQUALITY IN DENMARK

There has been an increase in geographical inequality in disposable income, but not in the welfare indicator for the period 2008-19.

Notes: The figure shows standard deviations of disposable income and the welfare indicator in 2008 and 2019 based on individuals' place of birth. The standard deviations indicate how much the Danish regions deviate from the average.

Source: Author's calculations based on register data.

CHAPTER IV, EFFECTS OF CORPORATE TAX

The chapter evaluates the ministries' assessment criteria for corporation tax

Chapter IV evaluates the ministries' assessment criteria for the behavioural effects of changes in corporation tax. Corporation tax affects the economy through many and complex channels. The specific behavioural effects that the departments use as a basis for their assessment criteria are of crucial importance for how changes in corporation tax are ex ante assessed to affect public finances, the level of prosperity and the distribution of income.

The most important behavioural channels included, but adjustments are warranted

The Chairmanship finds that, overall, the ministries take into account the most important behavioural channels in response to changes in the corporate tax rate. It is thus the Chairmanship's assessment that is reasonable to assume that in response to a reduction in the corporation tax rate the behavioural effects will tend to reduce the total loss of tax revenue and that it is to expected that investments, labour supply and

GDP increase. However, the Chairmanship finds that the assessment criteria could more accurate if a number of adjustments were made.

Assumptions about distributional effects should be changed

First, it should be assumed that owners and employees bear the burden of corporation tax equally, as recent empirical studies indicate that this is the case. Among other things, this results in corporation tax acting as a progressive tax, contrary to the ministries' current assumption that it is distributionally neutral.

Overall, assessment criteria overestimate the degree of self-financing

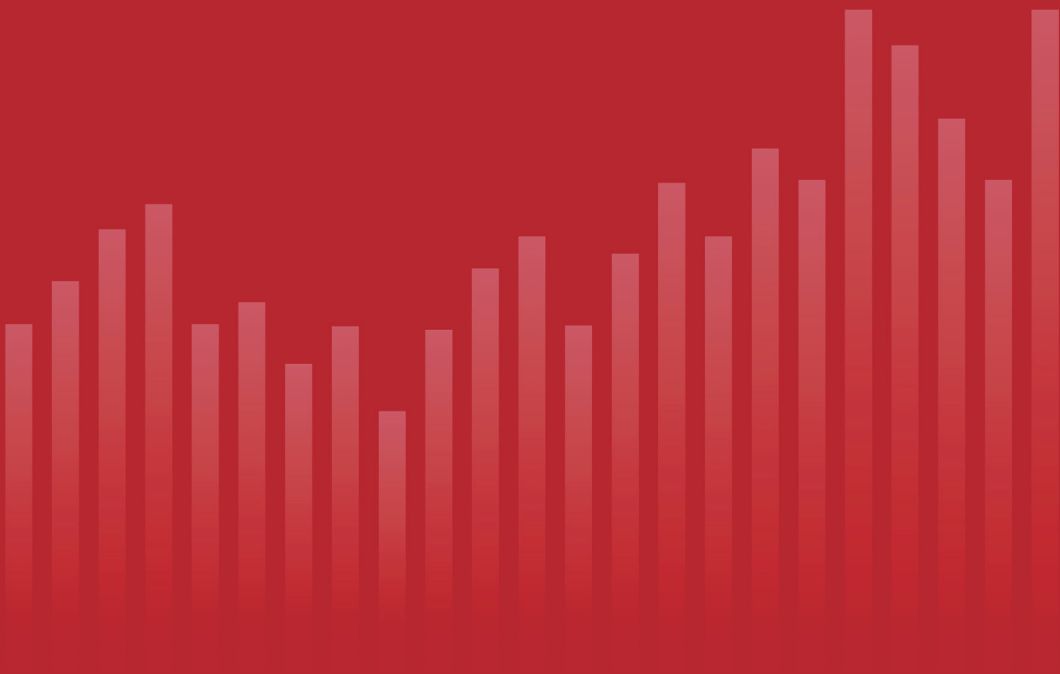
The changed assumption about who actually bears the tax burden is also important for the effect on the public finances of a reduced corporate tax rate, as, in isolation, it tends to reduce the total loss of tax revenue. Conversely, the Chairmanship points to two conditions that pull in the opposite direction. Estimates based on recent international studies indicate that the ministries' assessment criteria overestimate the effect on the public finances as a result of changes in the extent of international profit shifting. In addition, the departments include an effect on the public finances of higher private wages, which the Chairmanship does not consider to be substantiated. Overall, these adjustments imply that the degree of self-financing of a reduction in the corporation tax rate is overestimated by the ministries' assessment criteria.

Comprehensive documentation of assessment criteria is lacking, ...

The Chairmanship has pointed out several times that it is important that the ministries' assessment criteria comply with certain best-practice criteria, see, e.g., Danish Economy, autumn 2021 [*Dansk Økonomi, efterår 2021*]. One of these criteria is that there should be comprehensive and up-to-date documentation of the assessment criteria and the methods behind them. There is a lack of comprehensive and readily accessible documentation for the assessment criteria for changes in corporate taxation. Among other things, there is a lack of publicly available documentation of the key assumptions used in calculations that have a decisive impact on the estimated real economic consequences as well as on the consequences for public finances.

… and it is recommended that such documentation be published

The analyses in this chapter show, as mentioned above, that the departments' assessment criteria can paint an overly optimistic picture of the consequences for the public finances of reductions in corporation tax. This underlines the need for the assumptions used in the calculations to be as well documented as possible, so that there can be a public discussion of the specific assumptions. Therefore, it is recommended that comprehensive documentation of the assessment criteria be made public, and be continually updated.



Danish Economy, Spring 2023