

De Økonomiske Råd 
Formandskabet

DANISH ECONOMY
SPRING 2024
SUMMARY AND
RECOMMENDATIONS

SUMMARY AND RECOMMENDATIONS

Chapter I comments on current economic policy, including government support for businesses, public sector wage formation and climate policy.

Chapter II presents a projection of the Danish economy, where renewed growth is expected, along with continued high employment and pressure on the labour market. Fiscal policy is assessed to contribute to increasing demand and thereby supporting employment. A favourable economic outlook and an initially loose fiscal policy indicate that a tighter fiscal policy is appropriate.

Chapter III analyses effects on the labour supply of receiving an inheritance. The analysis finds that recipients of an inheritance reduce their labour supply. For this reason, it is recommended that the ministries take into account the labour supply effects of changes in estate taxes.

Chapter IV assesses the finance and taxation ministries' assessment criteria for participation effects of personal tax changes. Two studies that include Denmark indicate that the ministries underestimate the participation effect. However, the difference is within the confidence interval.

SUMMARY AND RECOMMENDATIONS

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

- Current economic policy
- Economic outlook and public finances
- Inheritance and labour supply
- Tax and labour force participation

Trends in the labour market are central to this report in several ways. Thus, Chapter I comments on the employment consequences of government support for businesses, public sector wage formation and the green transition. The economic outlook in Chapter II shows that employment is expected to remain high and above the structural level in the coming years. Chapter III analyses the labour supply effects of receiving an inheritance, and finally Chapter IV examines the impact of the tax system on labour force participation. The main conclusions for each of the chapters of the report are summarized below.

CHAPTER I, CURRENT ECONOMIC POLICY

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

Government support scheme for shipping should be reduced

The Expert Group for Future Business Support published its first report in February 2024. It recommends that the favourable tax arrangements for employees working on ships in the Danish International Ship Register (DIS scheme) be phased out. The Chairmanship agrees with the Expert Group's recommendation, as the scheme tends to reduce the productivity of these workers, as they will be retained in jobs with low productivity and pre-tax wages. Contrary to the Expert Group, it is the Chairmanship's assessment that the so-called tonnage tax should also be amended. The tonnage tax is a particularly low corporate tax on shipping companies. The low tonnage tax can lead to lower economy-wide productivity, as it encourages investment in the industry even when capital could earn a higher pre-tax return in other industries.

Public sector wage formation leads to misallocation of employment

In order to reduce staff shortages in some parts of the public sector, a tripartite agreement on wages and working conditions was concluded in December 2023. However, the agreement does not address the underlying trend towards uniform increases in wage rates for all public sector employees despite staff shortages in some parts of the public sector. In the absence of any changes in this policy, it must be expected that staff shortages will arise again in some parts of the public sector in the future.

Coastal protection should be financed by those who gain the benefits

In April 2024, a political agreement was reached on utilisation of some of the 'Green Fund'. This agreement has increased, by DKK 150 million, the pool of funds for which municipalities can apply for undertaking local coastal protection projects. However, as a basic principle, coastal protection projects that protect local assets should be financed by those who benefit from the projects. To address the increasing risk of storm surge, increased government funding is not required. The challenge can be addressed via new rules for *the storm surge scheme* (in Danish: stormflodsordningen) and coastal protection projects that ensure that property owners and municipalities have the right incentives when they make future decisions about building and coastal protection in risk areas.

The Expert Group's model 1 leads to the cheapest reductions

In February 2024, the Expert Group for Green Tax Reform presented models for how the non-energy-related greenhouse gas emissions in agriculture can be reduced. The Expert Group's model 1 includes a uniform tax on non-energy-related agricultural emissions of DKK 750 per tonne of CO₂e by 2030. This corresponds to the level of the energy-related emissions from agriculture, industry etc. that are not covered by the EU's quota system. As a starting point, uniform taxation ensures the cheapest reductions.

Historically conditioned compensation is significantly cheaper than models 2 and 3

In the Expert Group's models 2 and 3, farmers are compensated according to their current number of livestock and hectares of land. Thus, labour that would otherwise go to less climate-damaging occupations is retained in agriculture. This makes these models more expensive for society. If the compensation is instead based on the farm's emissions before the introduction of the tax, labour moves to other professions, and the additional costs of the same compensation to the farmers are significantly reduced.

CHAPTER II, ECONOMIC OUTLOOK AND PUBLIC FINANCES

Chapter II contains an assessment of the current economic situation and outlook as well as the evolution of public finances towards 2030.

Merchanting and processing make up an increasing share of the economy

An increasing share of Danish exports and value-added growth is made up of so-called merchanting and processing (M&P), where Danish-owned goods are exported from one foreign country to another without crossing the Danish border. M&P activities have increased significantly in recent years and are expected to make a significant contribution to growth in the next few years. It is estimated that M&P contributed almost 1½ percentage points to GDP growth in 2023, which is currently reported at 1.9 percent. This year the contribution from M&P is expected to be just over 1 percentage point. The development of the M&P activities thus has a major impact on exports and GDP growth in individual years, whereas the impact on the domestic economy is significantly smaller. This is particularly relevant when assessing pressure on the labour market in the Danish economy. This is due to the fact that the M&P activities are largely based on intangible capital and only to a limited extent on physical Danish production resources, see *Productivity, 2024*.

Outlook for continued high employment

After a certain moderation in demand in 2022-23 – partly as a result of high inflation and higher interest rates – demand is expected to pick up in the coming years. Fiscal policy is assessed to contribute to increasing demand. This supports employment, which is currently estimated to be approximately 3 percent above the estimated structural level. Employment is expected to remain high in the coming years, see Figure A. Next year, the employment gap is expected to be reduced slightly to approximately 2½ percent. This is a more positive assessment of the economic situation than presented in *Danish Economy, autumn 2023*, where the employment gap was estimated to be approximately 2¼ percent this year and approximately 1¼ percent next year. There is a degree of uncertainty in the estimated employment gap as it is challenging to determine exactly how much of the employment increase in recent years, which is permanent (structural) versus temporary (cyclical). For example, other labour market indicators suggest less pressure on the labour market than indicated by the estimated employment gap, and it is still unclear to what extent the influx of foreign labour is structural.

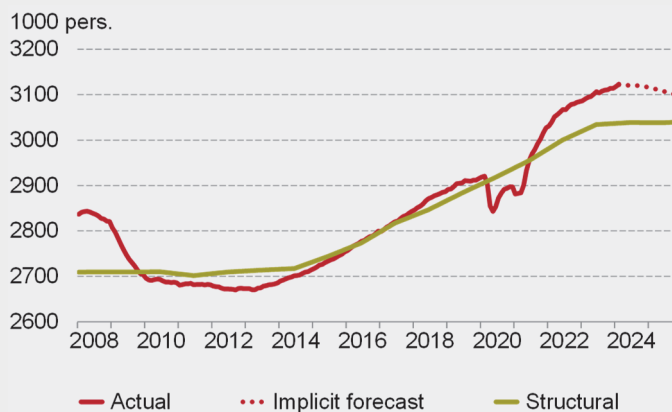
The economic outlook suggests that fiscal policy should be tightened

On the basis of the Finance Act proposal for 2024 and the agreed expenditure ceilings, the economic outlook presented in *Danish Economy, autumn 2023* was made under the assumption of a somewhat loose fiscal policy in 2024. Given the positive economic outlook mentioned above, the Chairmanship therefore recommended a tightening of fiscal policy, see *Danish Economy, autumn 2023*. Since then, fiscal policy has been relaxed further through increased defence spending. At the same time, the economic outlook is forecasted to be more pos-

itive. Both of these factors suggest that a tighter fiscal policy is appropriate given the economic outlook. However, it is challenging to quantify exactly how much fiscal policy should be tightened at this moment due to the uncertainty associated with the estimated pressure on the labour market. Nevertheless, there is sufficient certainty about the direction, namely a need for a tighter fiscal policy. When determining fiscal policy for 2025, the economic outlook dictates that the debate should place emphasis on achieving a smaller impact of fiscal policy on economic activity than assumed in the current assessment.

FIGURE A EMPLOYMENT

Employment is expected to remain high in the coming years, with an employment gap of almost 3 percent this year, which is expected to decline to approximately 2½ percent in 2025.



Notes: The figure shows monthly wage-earner employment adjusted to the national accounts annual figures for employment. The latest observation is February 2024. After that, an implicit monthly profile is shown, which is in line with the employment estimates at the annual level.

Source: Statistics Denmark, Statbank Denmark as well as the ADAM data bank, and own calculations.

CHAPTER III, INHERITANCE AND LABOUR SUPPLY

Inheritance affects the economy in a number of ways

Inheritance plays an important role in private wealth in Denmark and the changes in it over time. In addition, inheritance also has conse-

quences for a number of other significant economic factors. This applies to savings, labour supply, public finances (e.g., via the importance of inheritance for taxation) and the distribution of consumption opportunities in the population. Chapter III of the report analyses the effects of receiving an inheritance on distribution and the labour supply of heirs.

On average, approximately DKK 400,000 is inherited from the last parent – but big differences

The analyses of inheritance in chapter III uses register data on the wealth of the deceased to estimate the size of inheritances left to their heirs. The average age of people who lose their last parent was 58 in 2022. On average, according to the assumptions made in the estimates, each beneficiary receives an inheritance of approximately DKK 400,000. This masks large differences, where approximately 40 percent of people do not receive any inheritance at all, while the average inheritance is DKK 2½ million for the 10 percent who receive the largest inheritance. The geographical distribution of the size of inheritances reflects the concentration of wealth in the country, as both net wealth and estimated inheritance amounts are greatest in the capital, its surrounding regions and the other major cities. The average inheritance is greatest in Hørsholm Municipality (DKK 2,000,000) and least in Struer Municipality (DKK 180,000).

Analysis of effects of inheritance received in 2015-21 on labour supply

The chapter's main analysis examines the influence of inheritance on the employment rate and working hours of the children of the deceased over the period 2015-21. In order to isolate the effect of inheritance, the labour supply of the heirs in question is compared with the labour supply of persons who instead received an inheritance a few years later. The analysis examines both changes in the employment rate and in the number of working hours for those who are employed, see Figure B.

Employment and hours both fall by ½ percent in the first five years after receiving an inheritance

According to the analysis, in the five years following receipt of an inheritance, the employment rate falls by ½ percent on average for those who inherit. In addition, there is an independent effect of the same size on hours worked by those who remain in employment after receiving an inheritance. The results are considered to be a lower bound estimate, which is partly because the effects are likely to last longer than the five years covered by the analysis. In addition, it is likely that the expectation of receiving an inheritance could already reduce the labour supply of potential heirs in the years before they actually receive their inheritance (expectation effect).

FIGURE B EFFECT OF INHERITANCE ON EMPLOYMENT AND WORKING HOURS

Individuals who receive an inheritance reduce their average employment rate, just as those heirs who remain in employment reduce their average hours worked.



Notes: The figure indicates the change in the employment rate and hours worked hours by those who remain in employment in the years before and after receiving the inheritance for people who receive an inheritance in year 0.

Source: Own calculations using register data.

It is plausible that estate taxes increase the labour supply

In their analyses, the finance and taxation ministries currently include income effects on the labour supply through changes in income tax, but not through changes in estate taxes. The results in the chapter indicate, however, that it would be more correct to also factor in an effect on the labour supply of the latter. Since estate taxes reduce the available inheritance, a higher estate tax is expected to lead to an increase in labour supply via a reduction in the income effect that causes the initial decrease in labour supply following receipt of the inheritance. The direct employment effect that can be estimated from the chapter is somewhat lower than the effects that the ministries use as a basis for estimating the effect of changes in, for example, the personal allowance (tax free threshold). However, there are various uncertainties and shortcomings associated with the data and estimation design in the chapter that are considered to cause the estimated employment effect to be a lower bound estimate.

It is recommended that assessment criteria be introduced for the labour supply effect of estate taxes

Therefore, it is recommended that the ministries take into account an income effect of changes in estate taxes on the labour supply that, in terms of size, correspond to the effect that is already used for changes in the personal allowance, etc. This effect corresponds to an assumption that the labour supply increases by around 250 full-time equivalent persons with an increase in estate taxes corresponding to DKK 1 bil-

lion. Setting such assessment criteria is also consistent with the ministries' general consistency principle, where assessment criteria in one area are transferred directly to other areas if there are theoretical arguments that they should be treated in the same manner.

CHAPTER IV, TAXES AND LABOUR FORCE PARTICIPATION

The chapter assesses the participation effects of tax changes

As part of the Chairmanship's work is to assess the Danish ministries' ex ante assessment criteria of changes in economic policy, the chapter examines the assessment criteria for participation effects of personal tax changes. Up until now, the ministries have used a set of assessment criteria that had been in force since 2002, but in May 2024, the ministries have presented a new set of criteria for how participation effects will be included in analyses of the effects of personal tax changes.

Appropriate updates in the ministries' new assessment criteria

The Chairmanship generally considers that it is appropriate for the ministries to take into account participation effects for changes in the taxation of earned income, as there is empirical evidence for these effects. In addition, there are a number of appropriate changes in the ministries' updated assessment criteria, including a focus on effects on employment rather than unemployment. It is also positive that, in connection with the publication of the new assessment criteria, the underlying assumptions and the empirical bases have been thoroughly documented.

Two studies point to a larger behavioural response parameter than the ministries use, ...

In the updated assessment criteria, the ministries have decided to adjust the central behavioural response parameter upwards from approximately 0.1 to 0.15. This indicates how much the employment rate increases in percentage points when the net compensation rate is reduced by 1 percentage point. The ministries' choice of the size of the behavioural response parameter reflects an overall assessment of the international empirical tax and transfer literature. The Chairmanship focuses instead on two studies that have estimated participation effects for Denmark that can be converted into a behavioural response parameter of between 0.2 and 0.3.

... but difference is within confidence intervals

However, there is considerable uncertainty linked to the precise order of magnitude of the estimated effects, and the difference between the Chairmanship's and the ministries' behavioural response parameters is within the overlapping confidence intervals of the two studies.

