

## ENGLISH SUMMARY

### Chapter I: The Danish Economy

Over the past year and a half the Danish economy has been characterized by strong domestic demand. Private consumption has been growing fast, supported by a very strong housing market and improved labour market conditions. This year consumption is expected to grow by 4½ per cent, and growth is also expected to remain above trend in 2007. However, as it is expected that house prices will level out and that employment will stay more or less unchanged, growth in private consumption will gradually decline to more normal levels of around 2½ per cent in 2008-09. Investment has also been growing rapidly, as a result of strong rise in demand, low yields, and increasing difficulties in hiring qualified labour. Relatively high international growth rates have helped Danish exports, and Danish exporters even seem to have gained market shares despite facing higher wage increases than their competitors.

On the labour market, employment has increased and unemployment has fallen. Over the past year and a half, unemployment has decreased by 60,000 persons, lowering the unemployment rate by almost 2 percentage points. Currently, the unemployment rate is just above 4 per cent, which is well below the estimated structural level of unemployment. Given the prospects for continued strong demand, unemployment rates are expected to remain low in the forecast period up until 2009. The size of the labour force has not yet responded strongly to the current economic boom. Over the coming years a more pronounced impact on the labour supply is expected, but this will only just counteract the underlying demographic tendency towards a gradual drop in the size of the labour force. Hence, with both unemployment and the size of the labour force expected to stay more or less constant, the level of employment will remain largely unchanged. Until now, the restriction in labour supply has not given rise to any significant wage acceleration. However, the continued low level of

unemployment is expected to result in wage increases of around 4½ per cent in 2007-09.

The strong demand has caused imports to rise much faster than production, which has reduced the current account surplus. This tendency is expected to continue, such that the surplus on the current account will fall from 3½ per cent of GDP last year towards 1½ per cent in 2009. On the other hand, the high level of economic activity has improved public sector finances. The public sector budget surplus is expected to exceed 3 per cent of GDP throughout the forecast horizon.

On this basis, GDP is expected to grow by more than 3 per cent in 2006, which is slightly faster than in 2005. Over the coming years, lower growth rates are expected as a consequence of the supply-side constraints resulting from the tight labour market situation. GDP growth is therefore expected to be around 2 per cent in 2007, and just above 1½ per cent in 2008-09.

Table 1 Short-term outlook for the Danish economy

	Current	Per cent	Percentage change, volume				
	prices	of GDP					
	DKK bn.						
	2005	2005	2005	2006	2007	2008	2009
Private consumption	754.3	48.5	4.1	4.5	3.1	2.4	2.3
Public consumption	402.0	25.9	1.3	0.7	1.3	1.1	1.1
Gross fixed capital formation	324.1	20.9	9.4	11.4	4.2	2.5	2.1
consisting of:							
Residential investments	86.8	5.6	14.2	9.6	4.8	2.5	1.7
Business fixed investments	209.7	12.8	8.1	13.8	4.3	2.5	2.4
Public investments	27.6	1.8	4.4	2.0	2.0	2.0	2.0
Stockbuilding <sup>a)</sup>	1.2	0.1	-0.3	0.0	0.0	0.0	0.0
Total domestic demand	1,481.6	95.3	4.1	5.0	2.9	2.1	2.0
Exports of goods and services	753.5	48.5	8.5	11.9	4.6	3.5	3.5
Imports of goods and services	681.1	43.8	11.9	16.4	6.2	4.4	4.1
GDP	1,554.0	100.0	3.0	3.3	2.1	1.6	1.6
<b>Key indicators</b>							
Consumer prices, percentage change <sup>b)</sup>			2.0	2.3	1.8	2.1	2.2
Unemployment, per cent <sup>c)</sup>			5.5	4.3	4.0	4.1	4.1
Current account, DKK bn.			56.3	39.8	28.1	26.2	26.0
Current account, per cent of GDP			3.6	2.4	1.7	1.5	1.4
General government financial balance, DKK bn.			71.8	58.2	58.5	59.6	58.4
General government fin. balance, per cent of GDP			4.6	3.6	3.4	3.4	3.2
Hourly wage costs, percentage change			2.7	3.3	4.3	4.6	4.5
Terms of trade, percentage change			1.7	-0.6	0.3	0.4	0.4

a) The percentage changes are calculated as real changes in stockbuilding relative to real GDP in the previous year.

b) Implicit private consumption deflator.

c) Percentage of the total labour force. National definition.

Note: The DKK/USD exchange rate is taken as 6.00 in 2005, 5.96 in 2006, and 5.81 in 2007-09.

Sources: Statistics Denmark, *National Accounts* and own estimates.

## **Policy recommendations**

The forecast predicts a “soft landing” after several years of high demand growth and great strain on the labour market. So far increases in wage rates have been moderate; the strong growth in demand has to a large extent been covered by an increased level of imports, and foreign labour has contributed to an increase in the labour supply. Hence, there are many indications that the economy is considerably more capable of adjustment now than in, for example, the mid-eighties.

Nevertheless, the labour market is now so tight that it is not a question whether wage rates will accelerate, but rather to what extent and for how long. If wage acceleration leads to a rise in expected inflation, there is a great risk that higher wage increases will become a longer term phenomenon. In that case, the economy will most likely have to go through a long period of low growth with a relatively high level of unemployment in order to adjust wages and prices back to a sustainable level. Declining house prices would clearly deepen such a period of low growth.

In the current situation, with the risk of the economy overheating being considerable, fiscal policy should contribute to dampening economic activity. However, over the coming year fiscal policy is expected to be expansionary and thereby increases the risk of the economy becoming overheated. In a situation where the tax freeze (according to which the Government has committed itself not to raise any taxes) reduces the number of available instruments, expansionary fiscal policy is particularly inappropriate.

A tax reform whereby income tax is reduced and taxation of the imputed rent of owner-occupied houses is raised would in the current situation reduce the risk of the economy overheating. Lower income tax could increase the effective labour supply, and higher taxation on houses would reduce the tax subsidies of investment in owner-occupied homes. At the same time the tax system would become more robust to the effects of globalisation. In the long run such a tax

reform would improve public finances as a consequence of the derived positive effects on the labour supply.

Specifically, a revenue-neutral tax reform is recommended whereby the marginal tax on labour income is reduced by DKK 10 billion and the taxation of houses is increased by a similar amount. Such an increase in the taxation of houses does not even total the revenue loss caused by various preferential rules and the erosion caused by the tax freeze since 2001. The analysis in section I.7 of the report shows that the suggested tax reform would ease pressures on the labour market by the equivalent of 5-10,000 people, partly as a consequence of the increased labour supply and partly because the tax reform would dampen demand, at least in the short run.

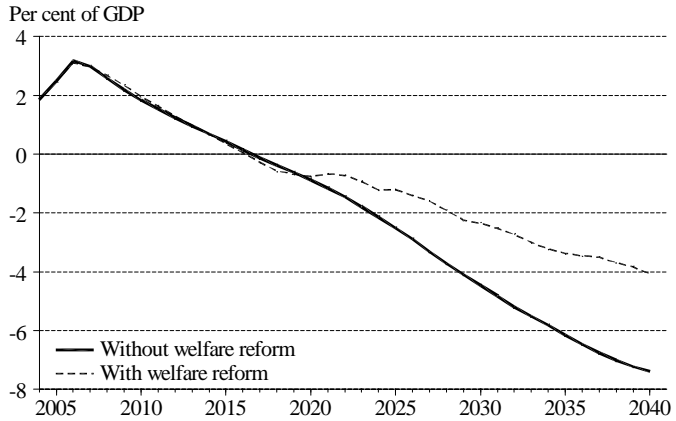
Obviously, this tax reform would violate the tax freeze. However, it is difficult to find other fiscal initiatives that have favourable structural effects, reduce the risk of overheating, and have limited distributive consequences at the same time.

If politicians are not willing to implement a tax reform, either because of the tax freeze or for some other reason, they face an unpleasant choice. One option would be to implement a traditional tightening of fiscal policy, which would not only affect the business cycle, but also bring about unintended side effects. Alternatively, they could choose not to tighten fiscal policy. In that case there would be a substantial risk that the economy would go through a period of overheating followed by a prolonged period with high unemployment and low growth. Since this risk is considered significant, it is recommended that a traditional fiscal tightening be put into effect, if it is chosen not to implement the suggested tax reform.

A welfare reform was introduced in Denmark in the summer which took a significant step in the direction of protecting public finances from the consequences of long term demographic developments. Even though the welfare reform contains a number of initiatives which will improve the public finances in the long run, the reform only solves

approximately half of the initial fiscal sustainability problem; see figure 1 and section I.8 of the report.

*Figure 1 Public fiscal balances with and without the reform*



Source: Section I.8.

The long-term projection of public finances presented in section I.8 is based on the assumption that the tax freeze will be abolished in 2011. Alternatively, if it is assumed that the “nominal principle” (meaning that taxes on housing and excise duties are fixed in nominal terms) of the tax freeze is continued until 2040, tax revenues will be eroded by inflation. This erosion would eliminate almost all of the improvement in the public finances resulting from the welfare reform. Another calculation shows that if there were additional growth in public consumption by only 0.15 percentage points per year until 2040, this would eliminate approximately half of the effects on public finances from the welfare reform. These alternative scenarios show that there is a considerable risk of a less favourable development in public finances than projected.

The projection shows that tax revenues and public expenditures in the period 2010-25 will be in balance on average, and that public debt in 2025 will be unchanged compared to

today. This shows that the deterioration of the public finances is a potential future phenomenon, not a present one. On this basis, it does not seem imperative at the present time to implement any further tightening of the public finances solely on the grounds of long-term sustainability. A scenario with a significant surplus for an extended period would mean that the public sector built up a credit balance of such a magnitude that it would be in conflict with the principle of equal treatment of the current generation compared to those coming.

Even though there is no need for immediate financial tightening on the grounds of long-term sustainability, the projection clearly shows that there will be a need for initiatives that improve the public finances at some point in the future. It will be natural for the main part of the adjustment to take place at a time beyond the immediate horizon of the welfare reform, which is around 2025.

However, in order to maintain a long-term focus in fiscal policy, it is appropriate to set up new goals for public finances. A new medium-term plan, to replace the current 2010 plan, should include goals that as a minimum aim at structural public finances being close to balance as we approach 2020 or 2025. Achieving such a goal would ensure that public debt is kept literally unchanged. This would not solve the long-term sustainability problem, but it would ensure that no new burdens were placed on future generations. A new medium-term plan should include the abolition of the tax freeze, so that excise duties and taxes on houses are not eroded further by inflation. In addition, the new plan should contain explicit targets for trends in public consumption. These targets should be stated for nominal public consumption relative to nominal GDP.

Currently, the overall growth rate in expenditures of local municipalities is controlled by a combination of the tax freeze (which keeps average tax rates constant across municipalities) and an agreement between the central government and the municipalities. The current system leaves the individual municipalities with limited flexibility. Given the repeated breaches of the medium-term goals for real growth

in public consumption, the system can only be described as a limited success. This is probably connected with ambiguity concerning sanctions and the difficulties of getting the sum of the budgets of the individual municipalities to match a centrally negotiated target.

A more flexible way of controlling total municipal expenditures and taxes would be to introduce tradable municipal “expenditure rights”. These expenditure rights could be allocated to individual municipalities each year on the basis of a centrally determined target. If an individual municipality wants to increase spending above its allocated rights, it will have to buy additional expenditure rights from other municipalities. Municipalities wanting to buy will have to increase taxes, while municipalities willing to sell expenditure rights must cut spending, but could in turn also cut taxes. The price of expenditure rights would in general reflect the tightness of the centrally determined target.

A system of tradable municipal expenditure rights would make it easier for individual municipalities to adjust the level of taxes and expenditures in accordance with local preferences. At the same time, the central government would maintain full control over total municipal expenditures (and average tax rates). It would also be easy to initiate sanctions against individual municipalities if the centrally determined target were violated, as it would be simple to identify municipalities exceeding their expenditure rights.

## **Chapter II: Poverty in Denmark**

One of the purposes of the welfare state is to fight poverty. Income transfers act as a public insurance against poverty, with transfers from the public purse being allocated to individuals or households who are unable to earn an acceptable income themselves. The chapter analyses economic poverty in Denmark.

In this chapter, a person is defined as being poor if his or her disposable income after income tax and public transfers is less than 50 per cent of the median income of the popula-



tion. This definition is commonly used in comparative analyses of poverty by the OECD and for the Luxembourg Income Study. Income is calculated using an equivalence scale for households of different sizes. The equivalence scale is based on the assumption that the maintenance costs to a household for a child are less than the costs for an adult, and that there are economies of scale.<sup>1</sup>

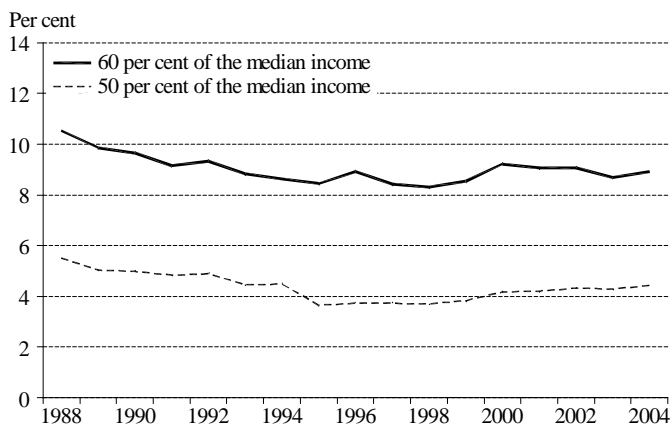
Persons aged 19 and above are included in the analysis if they are not enrolled in education, and if they have been registered as living in the country from the beginning of the calendar year. Others aged 19 or more are excluded from the analysis; this applies to adults enrolled in education, who are expected to receive a higher income later in life, and it applies to persons finishing a course of education during the current year. An important point is that a person is treated as head of a separate household if he or she is 19 years old and above and not living together with a partner at the same address.

The disposable income for a person on the poverty line in 2004 was DKK 75,000, and the real value of income at the poverty line had increased by 17 per cent from 1992 to 2004, while it was nearly constant from 1988 to 1992, when unemployment was increasing.

Calculations show that the proportion of the population living in poverty was relatively low at a level of 4.4 per cent in 2004, and that it was relatively stable for the previous 12 years (see figure 2). If poverty had instead been defined as 60 per cent of the median income, 8.9 percent of the population would have been defined as poor in 2004. The proportion of poor people in Denmark is low in nearly all international comparative studies of poverty.

1) The equivalence factor is  $F=(n_a + 0.6 \cdot n_c)^{0.8}$  where  $n_a$  is the number of adults and  $n_c$  is the number of children. The equivalence factor is based on analyses of the actual cost of living.

*Figure 2 Proportion of the population living in poverty 1988-2004*



Source: Section II.2.

In 2004, 165,000 persons were living in poverty. Poverty is relatively common among the young, persons living alone or with a large number of dependent children, immigrants, the self-employed, and people outside the labour force. Some of the young persons among the poor are living together with their parents, or they are foreign students or trainees.

In the chapter special attention is given to three groups of people who are often considered to be more at risk of living in poverty. These three groups are single parents, immigrants, and persons who are mentally ill. Single parents are more liable to be living in poverty than persons living alone without dependent children, but a single parent with one child usually leaves poverty relatively quickly, while single parents with more than one child usually remain poor for a longer period.

The proportion of persons living in poverty is above 10 per cent among immigrants from Western countries and above 20 per cent among immigrants from non-Western countries, while the share among ethnic Danes is less than 4 per cent. The proportion in poverty is especially high among those immigrants who have been in the country for only one to

three years, but the differences between people of different origins are remarkably large.

A separate analysis investigates poverty among persons who suffer from mental illness. We find large differences between persons with different diagnoses, and the incidence of poverty seems to be higher around the time when mental illness is diagnosed.

The welfare implications of living in poverty are much more severe if the person lives in poverty for several years compared to just a single year. More than half the people who experience poverty are only poor for one year. Their poverty may be due to exceptional circumstances such as divorce, childbirth or temporary income loss. For a year or two it is often possible to use savings, gifts from family and friends, or loans. As time spent in poverty increases, the level of living is affected more dramatically.

The duration of poverty is analyzed in a hazard rate model covering all spells of poverty starting from 1989 to 2003. Estimations show that hazard rates decrease during the time spent in poverty, and the probability of leaving poverty from the first to the second year is twice as great as the probability of leaving poverty from the fifth to the sixth year.

The duration of a spell of poverty is especially long for the unskilled, and for those who are outside the labour market or with only limited connection to it. Furthermore, the self-employed and immigrants experience longer spells of poverty as do persons living in Copenhagen. Finally, persons with a relatively large number of dependent children stay in poverty for a longer period than single parents with only one child or couples with up to three children.

Generational income mobility is examined. This is done by comparing earnings in 2002-04 for persons born in 1962-64 with their parent's earnings in 1980-82. Focus is placed on the lower tail of the earnings distribution. Hence, we use quantile regression to explore the effect of explanatory variables at different points in the conditional distribution of

the dependent variables. The analysis reveals that the effect of parents' earnings on the earnings of the offspring is modest. However, the effect on the lowest part of the income distribution is a little higher than the effect on average income. The probability of the children having zero earnings is quite sensitive to parents' earnings.

The prevention of poverty should start in early childhood. An important factor is to give children and young people personal skills and education that will be relevant on the labour market. Empirical findings support the theory that it is important to put in place pre-emptive measures aimed at socially vulnerable children. However, no comprehensive survey exists of which measures are effective in improving the prospects of socially vulnerable children. Therefore, a systematic quantitative evaluation of measures used to support socially vulnerable children is needed.

It is important that initiatives to improve qualifications for the weakest group of children come into effect early and continue in the elementary school. The problems are concentrated around young people leaving school without adequate qualifications to take a course of education at upper secondary and vocational training levels. The goal ought to be that almost everybody should be able to complete such a course of education.

Besides initiatives aiming at preventing poverty, there are two ways of reducing poverty. One is to increase income support to those who are below the poverty limit, while the second is to improve the probability of leaving poverty by becoming self-supporting.

Hardly any full-time workers are below the poverty line. Therefore it is important to create good employment possibilities for those who have the greatest risk of ending up in poverty. It is also important that there is a financial advantage to being employed. It is necessary that the level of public income transfers is balanced against the level of wages.

Social assistance can reduce the amount of poverty, but at the same time less strict rules and higher levels of compensation could reduce incentives to seek jobs. However, financial incentives only affect people who have a realistic chance of getting a job. Some people in poverty have such poor qualifications or health that they are unable to respond to financial incentives. A reduction of income transfers for these groups would only mean a reduction in income.

In Denmark, the level of social assistance is much lower for refugees, immigrants, and Danes returning to Denmark after more than a year abroad than it is for native Danes. However, it is very difficult for refugees to find a job, because of their lack of language abilities and of qualifications relevant for the Danish labour market. Financial incentives therefore have only very limited effects on this group. It is recommended that refugees receive social assistance at the same level as native Danes for three years. After this period their qualifications will be much better and their possibilities of becoming self-supporting will have improved considerably. Hence, from that point on they should be treated in the same way as immigrants and returning native Danes.

The average income for single parents is relatively low and the labour supply for this group is relative sensitive to changes in income. The financial gain from finding an unskilled job is very small for single parents receiving social assistance. Hence, it is recommended that an earned income tax credit specifically for single parents is introduced, since this improves the financial incentives to find a job for this group.

It is difficult for the people who are most exposed to poverty to find and hold a job. A strong attachment to the ordinary labour market is the best way to protect people from marginalization. It is possible within the collective agreements to employ workers on special terms, e.g. on lower wage rates or with reduced hours of work. However, this possibility is rarely used. In order to increase the use of employment on special terms, it is recommended that a temporary public subsidy be given to this type of employment. The specific terms should be negotiated locally. An

alternative is to prescribe a lower starting wage rate for new immigrants and persons on long-term social assistance for a defined limited period.

A wage subsidy to people on social assistance is also a means of creating a more firm attachment to the labour market for this group. It is recommended that recipients of social assistance with modest qualifications should be employed as quickly as possible with a wage subsidy.

If it is possible to integrate the poor into the labour market, poverty is reduced and labour supply increased. Hence, society gains from preventing and reducing poverty.