ENGLISH SUMMARY

Chapter I: The Danish Economy

The Danish economy has performed well in recent years, but the strong cyclical position is drawing to a close. The GDP growth rate declined to 1.8 per cent in 2007, and is expected to decline even further in 2008.

Several years of high growth and decreasing unemployment have led to accelerating wages, increasing inflation and declining balance of payment surpluses. The high growth rates have also resulted in a high level of GDP, which is estimated to be about 2.5 per cent above its structural level. Thus, further economic growth is currently limited by supply side constraints, and a normalization of the cyclical position of the economy will require some years of below average growth rates and increasing unemployment. Recent developments in international markets is also influencing the Danish economy, and the financial crisis, in conjunction with rising oil and food prices, is expected to result in a significant slowdown of demand growth.

The growth rate of private consumption has been high in recent years, but is expected to slow substantially in 2008. Consumer confidence has declined significantly, and house prices are expected to decline somewhat. However, other factors are supporting consumer demand: House prices are still high and tax cuts will increase disposable income in 2008 and 2009. The forecast increase in unemployment is expected to contribute to the slowdown in private consumption growth in the coming years. Increasing interest rates and the slowdown in demand are expected to contribute to slower capital formation over the next few years. The declining house prices are also expected to dampen housing investment and private consumption. Overall domestic demand is thus expected to slow.

Following recent developments in the global economy growth outside Denmark is also expected to slow down. US house prices have declined significantly, resulting in a financial crisis which is affecting the international economy. The financial crisis has led to increasing inter-bank interest rates and more restrictive credit conditions. Furthermore, the international economy is being subdued by increasing oil and food prices leading to increasing inflation and lower real income growth.

Growth in Denmark's export markets is expected to slow as a result of the international downturn. The strength of the Danish currency, combined with wage increases that have been higher than in other countries, is contributing to a decline in competitiveness and a loss of market share for Danish companies. These conditions are likely to lead to a significant reduction in export growth in the next few years. At the same time, imports are expected to grow faster than exports as there is insufficient capacity to satisfy the high demand. The overall balance of payments position is anticipated to worsen over the forecast period despite an expected slightly stronger increase in Danish export prices than import prices.

The unemployment rate in Denmark was at a record low of only 1.9 per cent in April 2008. The tight labour market is expected to result in wage increases of about 5 per cent, which will be significantly higher than those of close competitors to Denmark. Furthermore, increasing oil and food prices are putting upward pressure on consumer prices. Thus, inflation is expected to be almost 3 per cent this year and 2-2.5 per cent in the years to come.

Overall, the forecast presents a scenario of declining demand growth. The economic cycle is expected to slowly return to a more neutral position, though the baseline scenario is more uncertain than usual. Although unemployment is expected to increase, it will still be at low levels, and the tight labour market could still result in accelerating wages and higher inflation. The international downturn could also become more severe than anticipated, leading to slower growth rates than expected and a sharp increase in unemployment, which would reduce wage increases.

Besides the short-term forecasts, Chapter I of the Report also presents an analysis of unemployment insurance. The Danish unemployment insurance system provides unemployment benefits for four years. The exit rate out of unemployment is very high in the beginning of the unemployment period, and declines the longer a person has been unemployed. However, the exit rate increases significantly around the time that unemployment benefits run out – that is around four years. Three quarters of those who leave unemployment after four years find a job, provide for themselves by other means, or take up education or training.

Table 1 Short-term outlook for the Danish economy

	Current prices DKK bn. 2007	Per cent of GDP 2007	Percentage change, volume 2006	2007	2008	2009	2010
Private consumption	841.0	49.6	3.8	2.5	2.3	1.9	1.6
Public consumption	439.2	25.9	2.0	1.7	1.3	1.2	0.8
Gross fixed capital formation	389.3	22.9	14.0	6.2	1.4	0.0	-0.3
consisting of:							
Residential investments	118.6	7.0	12.2	4.5	-3.0	-3.8	-4.2
Business fixed investments	239.4	13.0	14.6	8.8	3.4	1.2	1.3
Public investments	31.3	1.8	16.5	-3.9	4.3	6.0	1.9
Stockbuilding [a)]	7.3	0.4	0.6	-0.4	0.0	0.0	0.0
Total domestic demand	1,676.8	98.9	6.0	2.7	1.8	1.3	0.9
Exports of goods and services	884.4	52.1	9.0	3.7	3.2	2.3	2.3
Imports of goods and services	864.9	51.0	14.1	5.6	4.1	3.2	2.9
GDP	1,696.2	100.0	3.9	1.8	1.3	0.8	0.7
Key indicators							
Consumer prices, percentage change [b)]			2.1	1.9	3.1	2.6	2.3
Unemployment, per cent [c)]			3.8	2.7	1.8	2.3	2.9
Current account, DKK bn.			44.1	18.8	14.9	7.1	6.1
Current account, per cent of GDP			2.7	1.1	0.8	0.4	0.3
General government financial balance, DKK bn.			79.9	75.6	68.9	56.5	42.3
General government fin. balance, per cent of GDP			4.9	4.5	3.9	3.1	2.2
Hourly wage costs, percentage change			3.1	3.8	4.9	5.0	4.4
Terms of trade, percentage change			-0.5	-1.4	0.5	0.1	0.5

a) The percentage changes are calculated as the real change in stock-building relative to 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 calculated as 5.44 in 2007, 4.85 in 2008 and 4.81 in 2009-10.

Source: Statistics Denmark, National Accounts and own estimates.

Policy recommendations

Fiscal policy has been rather expansive in recent years and has therefore contributed to the labour market tightening. The Danish government has also planned expansive fiscal policies in 2008 and 2009, putting further pressure on the scarce labour market resources. It is estimated that GDP will be 1.5 per cent above its structural level in 2009. Under normal circumstances such a high output gap would call for fiscal tightening, but in light of the extraordinarily high uncertainty of the forecasts, it is recommended that fiscal policy be almost neutral in 2009. This recommendation implies that fiscal policy should be tightened compared to the planned expansive policy.

Danish growth is restricted by the lack of capacity and foremost by the current shortfall of labour supply. It is possible to increase growth rates by increasing the effective labour supply, possibly by reducing unemployment spells or postponing retirement. The Danish unemployment insurance system is very generous, paying unemployment insurance benefits for up to four years. It is recommended that the eligibility period for receiving unemployment insurance benefits be reduced to two and a half years. The analysis presented in Chapter I of the Report shows that most people find a job within a year of becoming unemployed and only a few people are unemployed for more than two and a half years. After almost four years of unemployment the mobility out of unemployment rises significantly, indicating that the generous unemployment insurance benefits are affecting the incentives to leave unemployment. Most of the people who leave unemployment after four years find a job. It is estimated that a reduction in the Danish unemployment insurance benefit period from four to two and a half years would reduce structural unemployment by 15-20,000 persons.

The Danish Government is going to introduce a job plan scheme, which, it is estimated, will increase structural employment by about 7,000 persons.

The job plan includes a tax cut of DKK 100,000 for persons still working at the age of 64. This was recommended by the Chairmanship of the Danish Economic Council in *Danish Economy*, Spring 2007. Contrary to that recommendation of the Chairmanship, the job plan proposal includes an income ceiling so that persons earning more than DKK 550,000 will not get the tax cut. This induces a very high marginal tax rate on elderly persons earning wages above the ceiling. These workers will have strong incentives to reduce their labour supply in order to lower their wages below the ceiling and thus earn the right to the tax cut. The income ceiling reduces the dead-weight loss of the proposal, but it also hampers the positive effects on the labour supply. The Chairmanship recommends that the income ceiling be removed.

The job plan also includes provisions to increase recruitment of foreign workers. The existing job card and the green card schemes will be expanded, making it easier for foreign workers to obtain residency and work permits. The schemes could be expanded even more and in *Danish Economy*, Fall 2007, the chairmen recommended that the green card scheme be expanded to allow work permits for all highly-skilled workers and that the earnings floor of the job card scheme should be lowered from the proposed DKK 370,000 to DKK 250,000.

In recent years public sector spending has grown more than planned, and this growth has primarily taken place in the local government sector. Currently, the central government controls the overall growth rates of spending by the local government sector through annual agreements with Local Governments Denmark – the organisation that represents all of the local governments. The current system leaves the individual local governments with a high degree of flexibility, including control of the local tax rates. The local governments have repeatedly breached these agreements with the central government and have increased spending by more than agreed upon. This makes it difficult for the central government to effectively plan and execute both long and short run fiscal policies.

The agreements cover total local government expenditure and do not set an expenditure ceiling for individual local governments. The agreements are not legally binding and it has proved to be politically difficult for the central government to sanction the local governments when they breach the agreements. Therefore, the Danish Government will introduce a system that sanctions local governments if they breach the agreements. The central government pays annual grants to the local governments, and these grants will be reduced if total local government expenditure exceeds the agreed amount. The grants will also be reduced if the local governments raise taxes more than agreed upon.

A more flexible way of controlling total local government expenditure and taxation would be to introduce tradable local government "expenditure rights" as proposed by the Chairmanship in *Danish Economy*, Spring 2006. Such a system is preferable to the officially proposed system. In a system with tradable expenditure rights each local government is allocated an individual expenditure right. If an individual local government wants to increase spending above its allocated amount, it will have to buy additional expenditure rights from other local governments. The expenditure rights ensure that the central government can enforce sanctions on individual local governments if they breach their rights and thus the system increases the incentive for these governments to avoid overspending. At the same time the central government gains control over total local government spending and ensures a high degree of flexibility in individual local government spending.

Tradable local government "taxation rights" could be an alternative to tradable "expenditure rights". In a system with tradable taxation rights local governments are not allowed to increase taxes unless they buy taxation rights from a local government that is cutting taxes. In such a system, local government expenditure is indirectly controlled by the limits on local government income. Taxes are procyclical, though, and a system with tradable taxation rights is therefore unable to control local government spending in the short run. A system with tradable expenditure rights is preferable to taxation rights as it can control total local government expenditure in both the short and the long run.

With regard to the control of overall public expenditure it would be appropriate to draw up a long term plan for public investments. The Danish Infrastructure Commission has identified a number of future infrastructure investments that could be included in such a long term plan. It has also noted that there will be increasing congestion in the transport system. Analyses in *Danish Economy*, Spring 2006, suggest, however, that it is neither appropriate nor realistic to fully remove traffic congestion through infrastructure investments. Congestion is most effectively removed through a combination of infrastructure investments and some form of road pricing.

Chapter II: Savings

Chapter II of *Danish Economy* Spring 2008 presents analyses of the savings behaviour of households and the effect of the Danish tax and public welfare system on savings incentives and behaviour. Special focus is placed on retirement savings.

Total savings in Denmark have increased since the mid 1980s because the public sector has gone from having large deficits to having surpluses and thus has positive net savings. In addition, private savings have increased. The latter change was driven by tax reforms from the mid 1980s to the mid 1990s that increased the incentives to save. Savings in Denmark are now on a similar level to other comparable OECD countries. Since 2002, total household savings have shown a steep increase, which is caused by capital gains, increasing real estate prices and increasing pension contributions.

The development of the labour market pension system during the 1990s means that most employed people now save for retirement. The labour market pensions are mandatory for workers employed in a firm for which a collective pension scheme has been negotiated. When the system is fully matured, most prospective retired workers will have considerable net wealth and they will depend considerably less on public welfare benefits than retired workers of today. The system is mature when retired workers have had a full working life with labour market pension contributions.

Even though labour market pensions have become more widespread and contribution rates have increased, there are presently some groups that do not save for retirement. In particular, the unemployed and the self-employed and people permanently outside the labour force do not save in pension schemes.

People with high incomes and full-time workers are most likely to make pension contributions. They contribute a larger share of annual income than low income people and part time workers. Also, being an older worker increases the likelihood of a person saving for retirement. Being self-employed, living in rental accommodation, or working in a small firm reduces the likelihood of saving for retirement.

In 1988, highly educated workers had a considerably higher likelihood of saving for retirement than workers with a lower education. In 2005, the difference has almost levelled out, because the labour market pension schemes have become more widespread. The same applies to business sectors, where the earlier differences in the likelihood to save have also levelled out.

Chapter II of *Danish Economy* Spring 2008 also presents an analysis of how much the labour market pensions have increased total household savings. Future pensioners will, on average, have contributed to pension schemes for a larger part of their working lives than the pensioners of today. Thus, the future pensioners will, on average, be wealthier than pensioners of today. However, this is conditional on the assumption that the labour market pension contributions do not crowd out other savings. Crowding out occurs when pension savings make people reduce savings in other assets or increase borrowing.

Econometric estimations of household savings behaviour show that labour market pensions crowd out other savings by 15 to 20 per cent. For tenants, the crowding out effect is 20 per cent. For home owners the effect is less: about 15 per cent. This implies that for an average worker an extra DKK 100 in labour market pension contributions increases his total savings by between DKK 80 and DKK 85.

Since labour market pensions crowd out other savings only to a small extent, it is of interest to look at projections of future pension wealth, assuming unchanged savings behaviour for other forms of savings. The focus in this context is on replacement rates, which are defined as disposable income as a pensioner relative to the disposable income in the last year before retirement.

The analysis shows that for most groups in the labour market, future pension wealth will ensure replacement rates of about 100 per cent. Thus, most people in the future will be able to maintain their working life consumption level when they retire. In particular, low income groups will achieve replacement rates at this level, while high income groups will achieve replacement rates of about 80 per cent.

This conclusion is based on pension savings only. For many people, especially home owners with equity, the real replacements rates will be higher. Equity can be turned into consumption through reverse mortgages. For low income groups with equity, this increases the real replacement rates considerably above 100 per cent. For high income groups this increases the replacement rates to about 100 per cent or just over.

While it is positive that the future pensioners will be able to maintain a high standard of living, high replacement rates may give incentives for early retirement. This risk is big, since the replacement rates are reduced only to a small extent if a person retires three to five years before retirement age and receives an early retirement pension. For all groups in the analysis, the replacement rates are reduced by only three to five percentage points if the person retires early.

The reason that early retirement only affects replacement rates to a very small extent is that many pensioners face very high effective tax rates. The effective tax rates are implied by the combination of taxes and means-tested public welfare benefits.

The development of the savings-based pension system has only led to very small adjustments in the public old age pension system. The public pension system is designed to ensure that pensioners with no savings have a reasonable standard of living, while other public benefits are reduced for pensioners with supplementary income, such as payments from labour market pension schemes. Consequently, some individuals face effective marginal capital income taxes above 100 per cent on their capital income from pensions. The effective marginal tax on capital income is defined as the combined effect of the direct marginal tax on capital income and the marginal reduction in public welfare benefits.

The effective taxation on savings returns is calculated for five types of assets. The starting point for the calculations is a 60-year old person who makes an additional pension contribution. The calculations reveal large differences in the effective taxation of the five assets mainly because of big differences in the reductions in public welfare benefit payments. For one type of savings (owner-occupied dwellings), there is no reduction in public benefits. For other assets, public benefits are reduced based on the size of the savings returns, and finally for some assets, reductions in public benefits are based on both savings returns and wealth.

If savings on a standard bank account are used as pension savings, it implies a combined marginal taxation of the returns and a reduction in public welfare payments at about 60 per cent. For tenants, a reduction in the housing benefits for pensioners must be added.

The effective marginal taxation on the returns from a fixed-period or lifelong annuity can exceed the effective marginal taxation on the returns from a bank account if top bracket income tax is not paid at the time the savings are made.

The effective marginal taxation on the returns from a capital pension is about 40 per cent or lower. The main difference is in the reduction of public welfare benefits payments.

Savings in owner-occupied dwellings are taxed favourably. The effective marginal tax rate on capital income from housing savings is about 0 per cent. Public welfare benefits are not reduced in the case of positive capital income from housing savings. This applies both to low income and high income people.

The effective marginal taxes on capital income should be equal across different forms of savings, if there are no general welfare benefits from savings in specific assets or savings schemes relative to others. The analysis shows that the current Danish capital income tax system is far from achieving this. Individuals who pay the top-bracket marginal income tax rate and have a large net wealth can reduce their effective tax rate on capital income by up to 44 percentage points by redistributing assets from outside the pension system to a pension savings account. While arguments can be made in favour of a lower tax rate on pension savings accounts, a capital tax rate reduction of this magnitude invites tax arbitrage.

The Chairmanship of the Danish Economic Council recommends a limit on annual pension contributions of DKK 100,000 or up to 20 percent of gross earnings. To facilitate reasonable flexibility in building pension wealth for people with fluctuating earnings, the 20 per cent limit should be calculated on the basis of the average gross earnings during the latest three years.

This should be supplemented by an increase in the penalty imposed when cancelling a pension savings account before reaching the retirement age. Currently, pension savings accounts can be paid out before retirement by paying a one-off tax of 60 per cent of the deposit. However, since pension savings based on annuities and fixed-period annuities are all subject to effective marginal tax rates of about 59 per cent when paid out during retirement, this seems a small penalty given the potential gain from a reduced effective capital income tax rate.

Chapter II documents that the current labour market pension system, when fully matured, will ensure replacement rates for the majority of individuals of 100 per cent or more. This will happen around 2028. The income distribution among future pensioners will then resemble that of the working age population. Therefore, from a distributional point of view there will be no need for public policies targeted specifically at pensioners.

On this basis, it is recommended that the means-tested pension supplement, together with the supplementary pension benefit, be phased out in the period leading up to 2028. A removal of these means-tested transfers to pensioners will strengthen the incentives for some groups to save in pension savings accounts based on annuities late in working life. Home owners, with an income below the threshold for the top marginal income tax rate, will face effective marginal capital taxes between 20 per cent and 35 per cent when paying into pension savings accounts late in their working life. Thus, pension savings accounts appear to be more attractive than bank accounts.

Tenants with an income below the threshold for the top-bracket income tax rate presently face very high effective marginal capital income taxes on pension savings late in their working lives. In addition to reductions in the means-tested transfers, tenants are liable to reductions in special pensioner rent subsidies when their pension income is increased. A removal of the means-tested transfers to pensioners will lower the effective marginal capital income tax rate on life-long annuity-based pension savings accounts to between 50 and 70 per cent. This is lower than the effective marginal capital tax rate on a bank account.

In general the analysis in Chapter II has shown that the means-tested rent subsidies pensioners enjoy do not fit well with a savings-based pension system. They contribute to very high effective capital income tax rates on pension savings. In particular, this applies to lower income individuals who want to increase their pension savings in the years leading up to retirement. Therefore, there is a need to reform the system of rent subsidies for pensioners.

A reform of the rent subsidies for pensioners should be accompanied by a review of the effective taxation of owner-occupied dwellings. Our analysis shows that the marginal effective capital income tax rate on property wealth is far lower than other savings forms, in particular, pension savings accounts. Moreover, the marginal effective capital income tax rate on property wealth is close to zero. The recently established Tax Commission should look into this.

The removal of the means-tested pension supplement and the supplementary pension benefit will reduce the replacement rate for persons with only small pension deposits at retirement age. As a consequence, it is recommended to strengthen the savings based system for persons who are not included in the collective labour market agreements on defined contributions pension schemes.

It is recommended that persons on public income support (apart from persons with study grants, pensioners and persons on voluntary early retirement pensions) build up pension savings corresponding to 6 per cent of their income support or a minimum of DKK 750 per month. Of the 6 per cent, the government should pay 4 per cent and the individual 2 per cent. This initiative should be put into effect immediately, but only for persons born after 1961. That is, the same group that will be affected by the proposed abolition of the means-tested pension transfers.

For employed persons outside the collective agreement system, a mandatory contribution scheme of 6 per cent of gross earnings paid into annuities is recommended. The employer should pay 4 per cent and the employee 2 per cent. Any contributions paid into a pension savings account will count towards the 6 per cent. This will ensure that everyone in the workforce saves at least 6 per cent of gross earnings in a pension savings account. The mandatory contribution scheme should be put into effect from the beginning of 2009.

The recommendations could affect the incentives to seek employment for unemployed persons on public income support. The proposal entails two counteracting effects. On the one hand, the level of public income support increases because an additional 4 per cent is paid into a pension savings account. However, this increase is only available in the future. On the other hand the immediate disposable income decreases by 2 per cent due to the individuals' own contributions. Therefore, the combined effect on the incentives to seek employment is believed to be small.

As they stand, the recommendations will increase public expenditures from 2009, but the full effect of the removal of means-tested pension transfers will only be felt from 2028 onwards. However, in the long run the recommendations will generate a net public surplus and thus improve the sustainability of Danish fiscal policy. The extra revenue could be used to decrease taxes among low-paid wage earners, so as to improve the incentives for persons outside the labour market to seek employment.

The introduction of labour market pension schemes has led to an increase in pension savings. In the future, a large number of people approaching the official retirement age will have substantial pension wealth. This could potentially increase the number of people opting for the voluntary early retirement pension and thereby lower the effective retirement age.

The Chairmanship of the Danish Economic Council has previously argued for the abolition of the voluntary early retirement pension scheme. However, if this is politically infeasible it recommends that the present two-year rule be changed to a three-year rule. The two-year rule means that a person who has worked a minimum of 3,120 hours over the last two years is eligible to enter the voluntary early retirement pension scheme at the age of 62 and only have pension income from labour market pension schemes deducted in the payout from the early retirement pension. These rules give an incentive to enter at age 62 instead of age 60. A three-year rule would imply a working requirement of 4,680 hours in the last three years prior to turning 63.

The aim of any future pension system should be to encourage workers to remain in the workforce longer and to ensure that higher savings result in higher disposable income for retirees, regardless of the form of saving.