De Økonomiske Råd
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DANISH ECONOMY AUTUMN 2019
SUMMARY AND RECOMMENDATIONS

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Public finances are sound. The structural balance is projected to display small surpluses over the period 2020-25. Moreover, this period of small surpluses appears to extend to 2040. Furthermore, with a value of 1.8 per cent of GDP, the long-term fiscal sustainability indicator (HBI) indicates a sustainable trend in the public finances.

With expected growth of 1¼ per cent in 2020, there is a prospect of a slowdown in the Danish economy. However, given the strong starting point, there is no need to ease fiscal policy. Should the economic outlook deteriorate further, the assessment is that there will be room to react within the limits of the National Budget Act.

The fiscal framework supports the soundness of the public finances. The National Budget Act must be revised in the 2019/20 parliamentary year. This report discusses various aspects of The National Budget Act and spending management. Among other things, it is recommended that the National Budget Act be adjusted to allow for small and temporary overruns of the deficit level as is made possible by the Fiscal Compact. The report also discusses arguments for and against an easing of the deficit threshold.

ENGLISH SUMMARY

This report from the Chairmanship of the Danish Economic Council consists of four chapters:

- Economic outlook and public finances
- Fiscal sustainability
- The National Budget Act and the fiscal framework
- The costs of business cycle fluctuations

All four chapters touch on different aspects of fiscal policy. First, the main points related to fiscal policy, the fiscal framework and public finances are summarized. Then a brief summary of each chapter is given.

FISCAL POLICY AND PUBLIC FINANCES

Public finances are fundamentally sound, which the current fiscal framework has helped to support, cf. Chapters I, II and III. The structural balance is projected to display small surpluses over the period 2020-25, and the budget deficit limit of ½ per cent of GDP is, therefore, estimated to be complied with throughout the period. If the projection horizon is extended, the period of balance or small surpluses extends to around 2040. This reflects that the effects of demographic change, where a growing proportion of the population is outside the labour market, are offset by other factors, most importantly the gradual increases in the retirement age that follow from the 2006 welfare agreement and the 2011 retirement reform.

In the even longer run, surpluses in the public finances are increasing, and the fiscal sustainability is estimated to be 1.8 per cent of GDP. The projection for the public finances is based on a number of assumptions that become more and more uncertain the longer the projection period. Therefore, it is important to note that the positive sustainability indicator is essentially driven by a very positive development after 2040.

With the prospect of budget balance in the coming years, there will be a gap between the structural balance and the budget deficit limit, which will provide room for the government to react if the Danish economy is hit by a major setback. If necessary, this could be done, for example, by advancing planned public investment or by lowering particularly distortive taxes as part of a temporary underfunded tax reform.

Although slower growth is expected, the economic outlook does not justify an easing of fiscal policy. The expected slowdown is only moderate, and furthermore, employment is expected to be slightly above the estimated structural level in the coming years. Therefore, a roughly neutral fiscal policy is considered appropriate.

The need for an active fiscal policy is less in Denmark than in many other countries with a smaller public sector and fewer automatic stabilizers, cf. the discussion in Chapter IV. The welfare state and the automatic stabilizers act as insurance that reduces the individual welfare costs associated with business cycle fluctuations. This reduces the need for active stabilization policies. In any case, the benefits of stabilization must be weighed against the costs of pursuing an active fiscal policy. These considerations support the assessment that policy measures targeted towards stabilization are not needed in the current situation.

The positive assessment of public finances is underpinned by a target for balancing the public finances in 2025 and, following the announcements made by the new government, also in 2030. With the new target for 2030, a new medium-term plan is called for. A new plan will form the basis for assessing the scope for new priorities up to 2030, and the implications for the longer-term trajectory of the public finances will become clearer. A 2030 plan will also be an opportunity to present a statement on the overall framework for public investments. Such a statement should include an overview of agreed and planned investments, in order to clarify the possibilities for new decisions.

If the public finances are balanced in 2030, the long-term path of the budget balance is clearly sustainable. At the same time, the balance requirement in 2030 implies that a gap between the medium-term target and the budget deficit limit of ½ per cent of GDP can be expected. The gap between budget goals and the deficit limit provides some leeway to ease fiscal policy should the economy be hit by a major setback. At the same time the gap reduces the risk that fiscal policy may need to be tightened if the assumptions about the development of the public finances in the coming years are not fulfilled.

The new target for balance in 2030 implies a tightening compared to the long-term projection underlying the fiscal sustainability calculations made by the government in August. The need for tightening, which, based on this projection, amounts to about ½ per cent of GDP, implies that reforms or traditional fiscal austerity measures must be implemented. The necessary improvement of the public finances amounts to around DKK 10 billion.

The National Budget Act prescribes a deficit limit for the structural balance of ½ per cent of GDP. The deficit threshold is allowed to be 1 per cent of GDP according to the EU's regulatory framework, including the Fiscal Compact, which Denmark has chosen to join. There are arguments both for and against changing the deficit threshold. A lowering of the deficit threshold to 1 per cent of GDP would enable a medium-term balance target that is lower than just balancing the budget, without the gap between the target and the limit being too small. Thus, a lower limit would provide more policy options for dealing with the consequences of demographic change. At the same time, a lower limit would increase the room for maneuver in the economic policy. Conversely, a lower deficit limit risks reducing fiscal discipline, giving current politicians room to refrain from making decisions that may be necessary or appropriate for longer-term considerations, including those for future generations. Thus, there are both arguments for and against changing the lower limit.

An important discussion when considering any adjustment to the budget limit (within the limits of the Fiscal Compact) is the circumstances under which the limit can be exceeded and how it needs to be corrected if an overrun occurs. According to the Fiscal Compact and the National Budget Act, it is already possible to exceed the balance limit if the EU Commission considers that Denmark is affected by exceptional circumstances, for example a deep recession. If the deficit threshold is exceeded due to exceptional circumstances, the budget has to be brought back within the above limit with a speed that depends, among other things, on the prevailing economic conditions. The possibility of exceeding the limit for a period of time in exceptional circumstances reduces the need for an easing of the deficit threshold.

The Fiscal Compact allows for small and temporary overruns of the deficit threshold under normal circumstances. This possibility must be seen in the context of the considerable uncertainty associated with the calculation of the structural balance, and allowing small and temporary overruns reduces the risk of fiscal tightening due to chance. Specifically, the Fiscal Compact allows the deficit to exceed the threshold by up to ½ per cent of GDP in one year or ¼ per cent of GDP on average for two consecutive years.

The terms in the Fiscal Compact that cover the possibility for small and temporary overruns do not apply in Denmark. The National Budget Act stipulates that the deficit limit (in the absence of exceptional circumstances) must be strictly adhered to when the government presents its budget proposals. This strict implementation increases the risk of inappropriate fiscal policy tightening when the structural balance is close to the limit. Therefore, the Chairmanship recommends that the Danish Budget Act be amended on this point.

The current National Budget Act allows the deficit threshold to be exceeded following the presentation of the government's budget if the excess is due to changed estimates, but not if it is due to new, discretionary policy initiatives. In order to increase the credibility of the fiscal framework, a comprehensive overview of discretionary measures should be prepared and updated on a regular basis so that changes in the structural balance can be followed over time and discretionary measures can be separated from changed estimates and methods.

The National Budget Act is to be revised in 2019/20. A major focus in the forthcoming revision should be on simplification and increased transparency. Among other things, there is a call for greater transparency of the general reserves, which are currently part of the government's general expenditure ceiling. A review of the rules for adjusting the expenditure ceilings is also called for, (cf. the discussion in Chapter III), and how to avoid adverse effects of compliance with strict annual expenditure ceilings also needs to be discussed.

CHAPTER I: ECONOMIC OUTLOOK AND PUBLIC FINANCES

Uncertainty regarding the development in the global economy has increased. This increase makes consumers and businesses more cautious, which weakens demand and reduces growth prospects.

Interest rates on government bonds and other safe assets have declined since the mid-1980s, and the interest rates on government bonds are now negative in many European countries, including Denmark. Negative nominal interest rates are quite unusual and challenge the monetary policy options of central banks. The real interest rate, i.e., the nominal interest rate less expected inflation, is also negative in many countries. Historically, this is not unheard of, but it is unusual for it to occur at a time of low inflation. The return on capital in a broad sense has not decreased to the same extent as the interest rates on government bonds. This suggests that a significant portion of the decrease in the interest rates on government bonds must be explained by increasing demand for secure bonds in the wake of the financial and sovereign debt crisis.

TABLE A KEY FIGURES OF THE OUTLOOK FOR THE DANISH ECONOMY

	2018	2018	2019	2020	2025 a)
	DKK bn.	--------	Real growth rate, per cent.		---------
Private consumption	1,048	2.2	1.5	2.4	2.7
Public sector consumption	546	0.9	1.1	0.5	1.0
Gross fixed capital formation	499	6.5	-3.9	1.2	1.8
consisting of:					
Public sector investment	75	0.1	2.4	0.2	1.1
Residential investment	108	4.8	3.0	1.9	0.7
Business fixed investment	316	8.7	-7.7	1.2	2.3
Stockbuilding b)	19	0.2	-0.4	0.1	0.0
Total domestic demand	2,113	3.1	-0.3	1.7	2.0
Exports of goods and services	1,212	0.4	3.4	1.9	3.4
Imports of goods and services	1,101	3.3	-0.9	2.7	4.1
GDP	2,223	1.5	2.0	1.3	1.8
Key indicators					
Consumer prices, percentage change c)		0.9	1.0	1.3	1.2
Unemployment, per cent d)		2.9	2.9	3.0	2.8
Current account, DKK bn.		127	178	162	162
Current account, per cent of GDP		5.7	7.7	6.9	5.9
General gov. budget balance, DKK bn.		12	51	11	2
General gov. budget balance, per cent of GDP		0.6	2.2	0.5	0.1
Hourly wage costs, percentage change		2.3	2.4	2.7	2.8
Terms of trade, change in percentage points		-1.6	0.6	-0.7	0.0
10-year Danish government bond rate, per cent		0.5	-0.2	-0.4	1.5
Employment gap, per cent e)		0.4	0.8	0.6	0.0

a) The column shows projected average annual growth from 2020 to 2025 for all variables except unemployment, the current account, the general government balance, the 10-year Danish government bond rate and the output gap. For these variables the column shows the projected value in 2025.
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, National Accounts and own calculations.

The weakened global growth outlook has so far had only a limited impact on the Danish growth. This is particularly due to exports of goods performing surprisingly well in light of the high uncertainty and slowdown in the world economy. Danish growth is expected to slow from around 2 per cent in 2019 to just over 1¼ per cent in 2020. The more subdued growth is also expected to imply an easing of the labour market pressure. However, employment in 2020 is still estimated to be around 20,000 people above the estimated structural level, cf. Table A. The projection is based on already adopted policies. New measures that may follow in the wake of the change of government following the recent general election have not been included.

The new government has presented a paper (the so-called understanding paper) that outlines a number of areas in which it will undertake initiatives and adopt new policies. As mentioned above, the government has presented a new fiscal target for balance in 2030. The paper states that the government aims to raise funding for new policies of up to DKK 10 billion by 2025. The government aims to obtain part of the funding by increasing structural employment by more than suggested by the current rules. In recent decades higher structural employment trough labour market and retirement reforms has contributed significantly to strengthening public finances.

The new government has also set a target for national greenhouse gas emissions to be reduced by 70 per cent by 2030, compared to the 1990 level. This is an ambitious goal and achieving the target requires that the reduction rate more than doubles in relation to the reductions made from 2005 to 2018. A cost-effective target fulfillment should be based on uniform taxes on the emission of all greenhouse gases, combined with the cancellation of quotas as part of the so-called flexibility mechanism for meeting the non-quota sector reduction requirement.

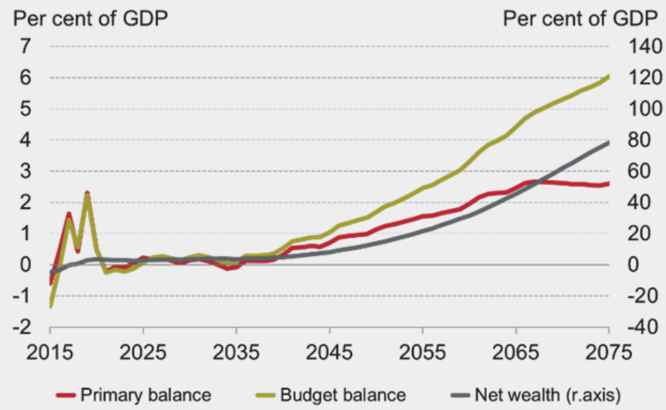
Lower emissions in Denmark reduce global emissions, but all else being equal, reductions in Denmark will increase emissions in other countries. The effect on global emissions is, therefore, less than the direct effect in Denmark. If the aim is to have a greater direct effect on global emissions, the focus of climate policy should not only be on reducing national emissions, but also on reductions in, for example, climate-damaging consumption or oil production in the North Sea. In light of this, it is appropriate to reconcile the upcoming climate law with new tenders in the North Sea.

CHAPTER II: FISCAL SUSTAINABILITY

Chapter II presents a long-term projection for the Danish economy building on the medium-term projection for 2025 presented in Chapter I. The long-term projection focuses on public finances and is used to evaluate whether Danish fiscal policy is sustainable under assumptions made about, among other things, future demographic changes.

As seen in Figure A, the budget, which should be interpreted as the structural budget, is very close to balance until around 2040, according to the assumptions of the projection.

FIGURE A **BUDGET BALANCE AND GOVERNMENT NET WEALTH**



Source: Statistics Denmark, ADAM, DREAM and own calculations.

Even though the period is marked by demographic headwinds as small generations succeed large ones in the labour market, various counteracting developments are forecast to take place. Higher projected retirement ages because of already instituted reforms, increasing tax revenues from larger savings-based pensions payments and increasing VAT revenues because of a projected increase in private consumption caused by increased wealth accumulation play important roles in this respect. After 2040 the budget surplus continually grows because of steadily increasing retirement ages, a reversal of the demographic trend toward larger labour market cohorts and eventually increasing interest income from rising government net wealth.

A number of institutional arrangements cause the official figures for deficits and debt to not fully reflect the underlying position of the public finances. One important arrangement is the substantial amount of deferred taxes on pensions. Calculations presented in the chapter illustrate that the government budget would be permanently improved by 2 to 3 per cent of GDP if the returns on pension wealth due to deferred taxes on pension assets were included.

According to the projection, Danish fiscal policy is overly sustainable, with a sustainability indicator (S2) of 1.8 per cent of GDP (i.e., the primary budget can deteriorate permanently by 1.8 per cent without causing debt to explode in the long run). This is a considerable increase of 0.9 percentage points in the S2 indicator compared to the Danish Economic Council's spring 2018 long-term projection. The main reasons for the increase are various updates in demographic and labour market data and higher disposable private income relative to GDP, which ultimately leads to higher consumption and income tax revenues.

An additional reason for the improved sustainability indicator is that new data and a new method have been implemented in accounting for the so-called "healthy ageing" effect when projecting future public health care costs. Since health care costs are relatively high among the elderly, the expected ageing of the population – which is partly caused by an increase in life expectancy – will tend to boost public health care costs. Healthy ageing, if present, implies that, as life expectancy increases, the elderly will live longer without major health problems, and, therefore, the high health care costs will appear at a later age. Consequently, the healthy ageing effect will dampen the expected future increases in public health care spending. The new method used to account for healthy ageing in the projection of future public health care costs has a somewhat larger cost-dampening effect than the previously used method, thereby improving fiscal sustainability.

In addition to the S2 indicator, the budget balance projected in the report is somewhat more positive than that of the government's latest long-term projection from August 2019. Having an S2 indicator of 1 per cent of GDP, the government also projects an overly sustainable fiscal policy, but the budget balance is less positive in all years. Two main differences are, first, the medium-term assumptions concerning government consumption and tax revenues and, second, an assumed smaller effect of healthy ageing in government calculations, which assume only an effect in health expenditure for the last three years before death instead of 10 years before death as suggested by the present analysis. Furthermore, the government projection assumes that part of the returns from government assets come in the form of capital gains instead of interest and dividend income. This assumption permanently aggravates the official budget position without affecting debt accumulation or sustainability.

CHAPTER III: THE NATIONAL BUDGET ACT AND THE FISCAL FRAMEWORK

An important objective of the current National Budget Act was to ensure that the fiscal objectives would be met; particularly in terms of public consumption, where expenditure ceilings combined with sanctions on municipalities and regions if they broke the ceilings have been important for compliance. As discussed in the first section of this summary, all fiscal policy objectives have been met since the adoption of the National Budget Act.

CHAPTER IV: THE COSTS OF BUSINESS CYCLE FLUCTUATIONS

The economy is recurrently hit by shocks causing fluctuations in output, employment, income, inflation and other macroeconomic variables around their long-run values. These fluctuations can be mitigated by economic policy. The extent to which it is appropriate to apply stabilization policies depends on the size of the social costs associated with business cycles and the effectiveness of the available policy tools. This chapter focuses on the first of these two subjects.

A central result in the literature concerning the social welfare costs of business cycles is Lucas' result, showing that these costs are very low. This primarily reflects that the observed fluctuations in aggregate private consumption are moderate.

There are, however, a number of reasons why the social costs of business cycles may be significantly larger than implied by Lucas' result. Among other things, recent economic research has documented that idiosyncratic shocks (i.e., shocks specific to each individual), that have long-lasting consequences for the earnings potential of individuals may lead to substantial welfare costs of fluctuations.

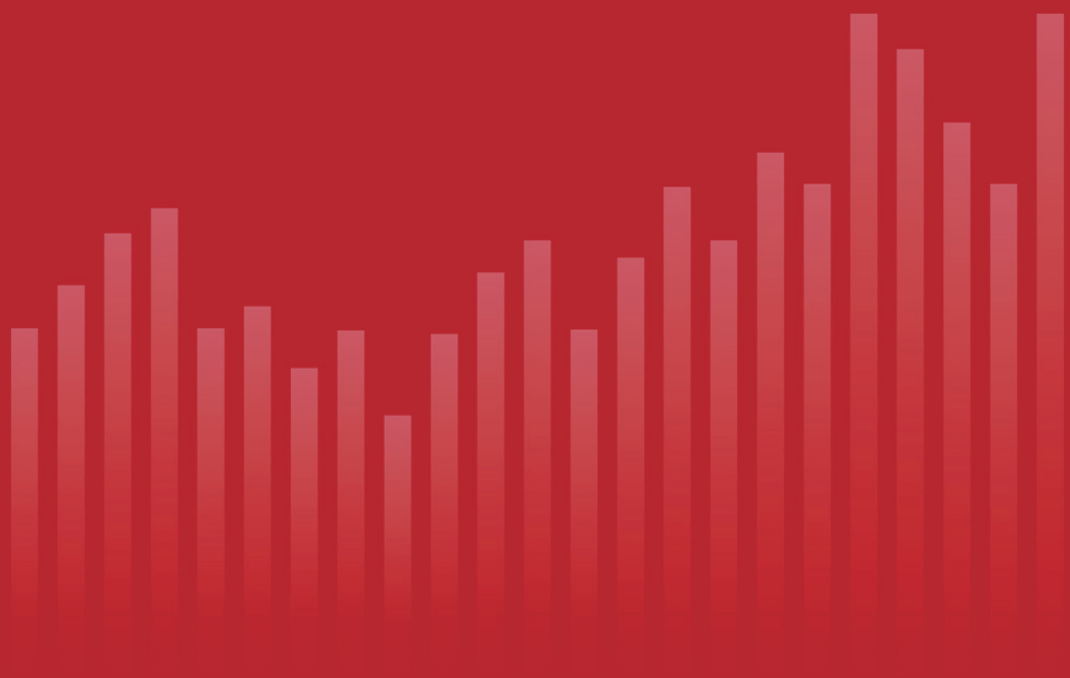
Similarly, distortions and frictions related to labour and goods markets may contribute to significant welfare costs, especially in relation to recessions. Furthermore, hysteresis, i.e., the possibility that a severe recession permanently reduces potential output, may contribute to the welfare costs of business cycles.

An analysis reveals which labour market groups are primarily exposed to cyclical fluctuations. For both the employment rate and earned income, the cyclical sensitivity is greatest for people up to their late 20s and for people aged 55 to 60. Also, the employment rate among non-Western immigrants and descendants is more affected by cyclical fluctuations than the employment rate among persons of Danish origin as well as Western immigrants and descendants.

The second analysis in the chapter explores whether there are indications of idiosyncratic shocks having long-lasting consequences for individual earnings. If so, earnings inequality within an age cohort should increase with age. The results in the chapter show that the tendency for inequality to increase with age is not as significant in Denmark as in the US and the UK. Inequality increases with age for earned income, i.e., income before public transfers and deduction of taxes. However, this is the case to a lesser extent when turning to disposable income, which is more closely related to consumption possibilities and, thereby, welfare.

The results indicate that the tax and public benefit system in Denmark contributes to neutralizing a significant part of the consequences of idiosyncratic shocks. This tendency is more pronounced in Denmark than in the US and the UK. However, the benefits of this insurance through the public budget should be weighed against the distortions that high taxes and generous public benefits generate.

Given the welfare costs of business cycles, it is relevant to consider the extent to which economic policy can be used to stabilize the economy. The chapter has not analyzed how effective different policy tools are in this respect. Thus, it is not possible to ascertain whether the public sector should pursue stabilization policies to a greater extent. Changes in taxes and public spending may, in themselves, introduce costs for citizens.



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