De Økonomiske Råd
Formandskabet

DANISH ECONOMY SPRING 2019
SUMMARY AND RECOMMENDATIONS

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Employment is estimated to be around ¾ per cent above the structural level, and this is forecasted to continue in the coming years. Economic policy should, therefore, dampen economic activity, and hence a somewhat contractionary fiscal policy in 2019 and 2020 is appropriate.

Taxation and capital income is particularly complicated because different types of capital income are taxed at different rates. Taxation distorts investment and saving decisions, and, therefore, it is important for economic prosperity. What's more, taxation of income from capital is an important source of redistribution.

The review of taxation of capital income in Chapter II leads to a number of recommendations, including a recommendation of a so-called ACE (an allowance for normal returns on new equity when calculating corporate taxes).

ENGLISH SUMMARY

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

- Economic outlook and public finances
- Capital income taxation

Chapter I presents the outlook for the Danish economy and discusses the state of the public finances. Chapter II examines the Danish capital income tax system.

CHAPTER I: ECONOMIC OUTLOOK AND PUBLIC FINANCES

The Danish economy has grown, on average, by almost 2 per cent annually for the past six years, and employment has increased by 240,000 persons since the beginning of 2013. Although growth slowed in 2018 due to temporary factors, it is expected to pick up again in 2019 with a forecast growth rate for the year of around 2 per cent, cf. table A.

The recent years' stable growth has led to a tightening of the labour market, and employment is projected to exceed the structural level by around ¾ per cent in 2019. The relatively tight labour market is expected to soften in the upcoming years as labour demand growth is expected to slow down while structural employment continues to grow. Structural employment is expected to increase by approximately 90,000 persons towards 2025, due, primarily, to the increasing average retirement age and continued immigration.

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	1,049	2.3	1.8	2.6	2.8
Public sector consumption	546	0.8	1.0	0.4	0.9
Gross fixed capital formation	492	5.1	-1.6	3.3	1.2
consisting of:					
Residential investment	75	0.0	4.5	1.4	1.0
Business fixed investment	108	4.8	3.7	1.5	0.9
Public sector investment	309	6.4	-4.8	4.4	1.4
Stockbuilding[b]	12	0.1	0.0	-0.1	0.0
Total domestic demand	2,100	2.6	0.8	2.0	2.0
Exports of goods and services	1,213	0.6	3.0	3.1	3.9
Imports of goods and services	1,094	2.7	0.8	3.9	4.3
GDP	2,218	1.4	2.0	1.7	1.8
Key indicators					
Consumer prices, percentage change[c]		0.9	1.1	1.7	1.9
Unemployment, per cent[d]		2.9	2.8	2.7	2.8
Current account, DKK bn.		136	165	160	164
Current account, per cent of GDP		6.1	7.2	6.7	5.8
General gov. budget balance, DKK bn.		11	9	-10	3
General gov. budget balance, per cent of GDP		0.5	0.4	-0.4	0.1
Hourly wage costs, percentage change		2.3	2.7	3.2	3.2
Terms of trade, change in percentage points		-2.1	0.7	-0.8	-0.3
Employment gap, per cent[e]		1.1	1.2	1.1	0.0

a) The column shows projected average annual growth from 2021 to 2025 for all variables except unemployment, the current account, the general government balance 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.

Public Finances

It is the assessment of the Chairmanship that the planned fiscal policy for 2020 complies with the fiscal rules. Based on the current outlook for the Danish economy, the budget surplus is expected to be 0.4 per cent of GDP in 2019, and a deficit of 0.4 per cent of GDP is expected in 2020, cf. figure A. The budget balance is affected by temporary circumstances, mainly due to volatile revenues from taxation of returns on pension savings.

FIGURE A BUDGET BALANCE, 2000-25

The budget balance surplus is expected to be around ½ per cent of GDP in 2019. This is mainly due to high revenue from taxation of returns on pension savings. Over the period up to 2025, the structural and budget balances are expected to be approximately balanced.

Note: The solid horizontal line indicates the deficit limit of 3 per cent of GDP for the general government budget balance, and the dashed horizontal line indicates the deficit limit of ½ per cent of GDP for the structural balance.
Source: Statistics Denmark, ADAM's databank and own calculations.

The structural balance has been improving since 2014, due, mainly to high growth in structural employment and low growth in public expenditure. The structural balance is expected to improve further, going from a small deficit of 0.3 per cent of GDP in 2019 towards parity in 2022.

Policy

The planned fiscal policy for 2019 and 2020 implies a moderate tightening of government expenditure, and thus, fiscal policy is set to dampen economic activity. This is appropriate given the tightening of the labour market. An improvement in the structural balance would give room for modest fiscal stimuli in the event of an economic setback.

The total expenditure of the municipalities exceeded the budgeted expenditure in both 2017 and 2018 due, primarily, to higher than expected investment costs. While it is difficult to manage the cost to investments, recurring budget overspends can lead to an erosion in budget credibility. Furthermore, it is important that public spending does not accelerate economic activity in an economy with a tight labour market.

Unlike public consumption, public investments are not subject to the 4-year budget ceilings. This is due to the difficulties associated with managing investment costs, and because it is important to have the possibility of using public investment as a tool to stimulate the economy. However, there is currently no clear overview of the approved and planned public investments, and a proper framework for determining the amount to be spent on public investments is lacking. The Chairmanship encourages the government to produce and maintain an up to date overview of public investments that includes an indication funds already allocated.

In early May 2019, the government announced a reform of the disability pension for older people with reduced work capacity. The reform intends to ease access to the so-called Senior Pension, a publicly funded scheme for people who have less than 7 years to go before they qualify for the age pension and whose work capacity is less than 15 hours per week. The government expects that 17,000 people will be enrolled in the new scheme with the majority coming from other government benefit schemes. Nevertheless, the new senior pension is expected to reduce overall labour supply marginally. The reform has not yet been passed by parliament, and the new government might change the reform.

CHAPTER II: CAPITAL INCOME TAXATION

Taxation of capital income is an important part of the Danish income tax system. The total annual revenue from tax on capital is around DKK 100 billion, or close to 10 per cent of total tax revenue, and capital taxes are important for investment and savings decisions of Danish households and firms and for the distribution of consumption possibilities.

The most important Danish taxes on capital income are corporate taxation, which yielded revenue of DKK 66 billion in 2017, taxation of returns to pension savings, with a revenue of DKK 17 billion, taxation of share dividends (revenue of 20 billion), taxation of the imputed income of owner-occupied dwellings (revenue of 14 billion), and taxation of personal capital income (mainly household interest income and payments), with a negative revenue of DKK 12 billion in 2017, because net interest payments are partly tax deductible.

Achieving an efficient and equitable capital income tax system is complex for several reasons. Capital income appears in many diverse forms and may be taxed at both corporate and personal levels. The distinction between capital and labour income is sometimes blurry, for example for income from small, owner-operated businesses. In contrast to labour income, capital income may also be negative. Certain types of capital income, corporate income in particular, are highly mobile internationally; therefore, international tax considerations are very important. Finally, capital income may consist of a normal risk-free return, a risk premium and, in certain cases, pure profit. The distinction between these components is important because taxation will typically affect behaviour towards them differently.

It is reasonable to question why capital income should be taxed differently from labour income and, indeed, until 1987, the Danish tax system did not distinguish between them. Nevertheless, there may be reasons of efficiency, as well as equality, to tax labour and capital income differently. If, for example, behavioural responses to taxation are more sensitive for capital income than for labour income, this could be a reason for taxing capital income less than labour income. Also, distributional considerations could play a role, as the two types of income are distributed very differently across the population.

Another important difference between labour income and capital income is the effect of inflation. With positive inflation, nominal capital income is partly a compensation for the diminished real value of invested capital. Accordingly, taxing labour and nominal capital income

at the same rate would imply a higher tax rate on real capital income than on labour income. In contrast, a neutral tax that taxes the two types of income equally would tax real capital income to compensate for inflation. Alternatively, capital income could be taxed at lower rates than labour income.

The average tax rate on capital income, measured as total tax revenue from capital income taxation as a share of total net capital income, is around 25 per cent. This is somewhat lower than the average tax rate on labour income. In Denmark, real effective marginal taxes on different types of income vary enormously, and the real marginal tax rates are very high for some types of capital incomes. Indeed, with an annual inflation rate of 1.75 per cent and the interest rate at 4 per cent, the real marginal tax rate for interest income is 66 per cent for tax payers below the top tax threshold, and 75 per cent for taxpayers above the threshold. In comparison, the average marginal tax rate is 42 and 56 per cent for labour income below and above the threshold. The real marginal rate for tax deductions for interest payments may be close to 60 per cent. Conversely, the real marginal tax rate on imputed income on owner-occupied dwellings may be as low as 8 per cent.

The distributional implications of the various personal capital income taxes are illustrated in table B. The table shows estimated changes in the Gini coefficient of equivalised disposable income for revenue-equivalent reductions in the various tax rates. Generally, taxable capital income is relatively concentrated among high-income tax payers. As a result, the Gini coefficient increases in all the tax experiments that reduce the tax rates for capital income. Compared to the bottom tax rate, which is relatively close to a proportional income tax, the capital income taxes on dividend income and imputed income from owner-occupied dwellings impact the Gini coefficient by a factor 13 and 25, respectively. For a reduction in the top tax rate on capital income, the Gini impact is around 60 times as high as the distributional impact of the bottom tax rate. By comparison, a revenue equivalent reduction in the top tax rate increases the Gini coefficient by 52 times that of the bottom tax rate.

TABLE B EFFECT ON THE GINI COEFFICIENT OF LOWER TAX RATES

The table shows the change in the Gini coefficient from tax rate changes corresponding to a direct revenue loss of DKK 100 million (excluding derived impacts on indirect taxes and other behavioural responses).

	Change in Gini coefficient	
	Absolute	Relative to bottom tax rate
Capital income taxes		
Top tax bracket, capital income	0.0060	60
Interest deduction (high rate)	0.0001	1
Interest deduction (low rate)	0.0023	23
Tax on dividend income, low rate	0.0025	25
Tax on dividend income, high rate	0.0061	61
Tax on owner-occupied dwellings, low rate	0.0013	13
Tax on owner-occupied dwellings, high rate	0.0062	62
Other taxes (for reference)		
Top tax rate	0.0052	52
Bottom tax rate	0.0001	1

Remark: The Gini coefficient for equivalised disposable income is 28.6. The table shows the resulting change in the coefficient for a hypothetical reduction in the relevant tax rate corresponding to a direct revenue loss of DKK 100 million. For deduction rates of interest expenditure, the table shows the result of an increase in deduction rates corresponding to a revenue loss of DKK 100 million.

Source: Own calculations on the Law Model.

Tax deductions for negative capital income (i.e. tax-deductible net interest payments) also have two brackets. The deduction rate for net interest expenditure up to a threshold of DKK 50,000 (DKK 100,000 for couples) is 33 per cent, while the rate is around 25 per cent for interest expenditure above the threshold. The bulk of all interest expenditure is deducted at the 33 per cent rate, and the distributional impact of increasing this rate is close to parity, as measured by the Gini coefficient. The low deduction rate of 25 per cent only applies to individuals and couples with very high interest expenditure. These are mainly homeowners with high disposable incomes and, accordingly, the income distribution becomes somewhat more unequal when raising the high deduction rate.

Empirical research has examined the impact of past changes to capital income taxation. Numerical elasticities in the range of 0.1-0.4 are reported. A recent paper analyses the effects of abolishing the former Danish wealth tax in 1989 and finds somewhat larger long-run elasticities of between ½ and 1 with respect to the net-of-tax rate. Optimal capital income tax rates should ideally take both equality (distributional) and efficiency effects into consideration. However, the first issue is fundamentally a matter of political preferences, and the large span of estimates of the behavioural effects makes it very difficult to pinpoint efficiency effects of various levels of capital income tax rates relative to the tax on labour income.

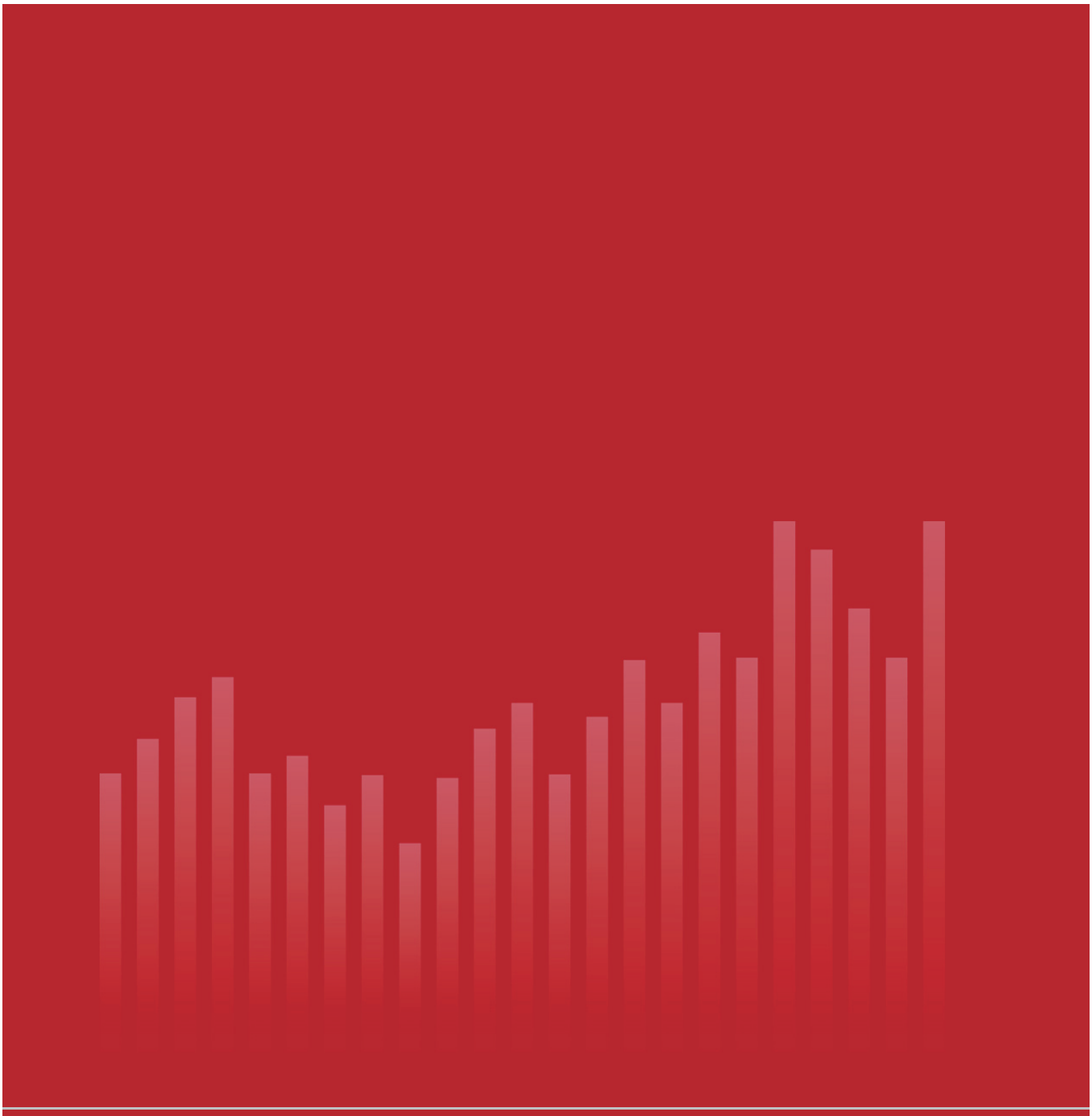
A special challenge when taxing capital and labour income at different rates is the treatment of owner-operators of, typically, small companies who are largely free to decide whether to pay company income to themselves as wage income, as dividends, or to leave it in the company with the potential to sell (part of) it as capital gains at a later date. Different tax treatments will affect the relative merits of these choices. In the present Danish tax system, the top tax rate on labour income and the combined corporate and top tax dividend income are, on average, approximately equal, thereby alleviating the problem. However, there is some geographical variations because of differences in municipal tax rates that affect labour income. The chapter presents analyses that find evidence of a clear correspondence between, on the one hand, the difference in tax rates on labour and corporate plus dividend incomes, and, on the other hand, the proportion of wage income of total income of owner-operators of small incorporated firms. The correspondence is compatible with the existence of tax-driven income shifting.

Corporate taxation distorts economic behaviour in several ways. Among other things, it may reduce investment in firms taxed in Denmark, stimulate international income shifting of multinational companies and reduce financial stability of firms to the extent that it exempts taxes on the normal returns to loan-financed investment. The corporate tax may also have a positive role, however, by taxing pure profits, and to the extent that it is levied on foreign owners of shares in Danish companies. Also, it plays an important role in alleviating the problem of taxation of owner-operators as mentioned above.

The introduction of an allowance for corporate equity (ACE) would, in principle, eliminate or alleviate several of the distortions in the taxation of corporations as it would exempt the normal returns to equity investment from taxation. In 2016 the former Danish government proposed the introduction of an ACE, but it was never passed by

parliament. An allowance that is only implemented for new investments would reduce the revenue loss, although it would be administratively more demanding.

It is recommended that the various kinds of personal capital income be treated more symmetrically. In particular, the tax rate on positive interest income should be reduced, as should the deduction rate for interest expenditure. The tax on owner-occupied dwellings should be increased. The possibility of taxing a larger part of income from shares at accrual rather than at realisation should be investigated, as should the possibility of including income from shares in the tax category of personal capital income in a narrow sense (i.e. mostly interest income). Finally, taxation of inheritances is generally less distortionary than ordinary capital income taxation. The favourable treatment of inherited family-owned firms should be abolished so that all types of inheritances are treated equally by the tax system.



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