De Økonomiske Råd
Formandskabet

DANISH ECONOMY SPRING 2022
SUMMARY AND RECOMMENDATIONS

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Chapter I contains a discussion of the tax deductions for interest payments, and comments on climate policy. The chapter also includes a follow-up on the Chairmanship's recommendations for the assessment criteria and ex-ante evaluations used by government ministries.

Chapter II presents a projection for the Danish economy. It also discusses “exceptional circumstances” in relation to the Budget Act as well as the economic activity effects of current fiscal policy in relation to the economic outlook.

Chapter III deals with regulation of housing market lending. The cost of tighter regulation should be weighed against the gains. It is concluded that not enough is known to say whether further regulation would be an advantage.

Finally, Chapter IV reviews the methods used by government ministries for assessing the impact of changes to the unemployment insurance benefit system. An important element in the assessments is the so-called inflow effect. It is concluded that the basis for calculating this effect is weak and that there is a need to rethink the assessment criteria.

SUMMARY AND RECOMMANDATIONS

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

- Current economic policy
- Economic outlook and public finances
- Regulation of housing market lending
- Inflow effects of changes to the unemployment benefit rules

CHAPTER I, CURRENT ECONOMIC POLICY

Chapter I summarises the Chairmanship's assessments of and recommendations for economic policy. The report's main conclusions related to fiscal policy, public finances and the Budget Act follow in Chapter II, entitled *Economic outlook and public finances*.

Lower tax deductions for interest payments will result in a more neutral tax system

An important principle in the tax system is the consideration of neutrality, i.e., uniform effective taxation of real income. The principle of neutrality applies both in relation to the taxation of earned income and the various forms of tax on capital income. The chapter points to several taxes on capital income that could be changed to achieve greater tax neutrality and reduce tax incentives that distort investment decisions. Specifically, it is assessed that a reduction in the tax deductions that can be claimed for interest payments would increase tax neutrality and, at the same time, provide revenue and reduce inequality. The chapter also includes an assessment of the 'tonnage tax' on shipping companies and taxation of the financial sector.

Non-uniform CO_2 tax makes climate policy more expensive …

The government's initiative for green tax reform contains a proposal for a CO_2 tax imposed on manufacturing and other industries. The proposal includes a lower tax for industries with mineralogical processes, including the cement industry, and it maintains certain energy taxes and subsidies. Therefore, the effective CO_2 taxation is not uniform across industries and applications, which makes climate policy significantly more expensive. The impact on selected industries is motivated, among other things, by the desire to limit the leakage due to Danish climate policy measures. The Chairmanship's assessment is, however, that the global climate effect is limited, partly due to high transport costs and high markups in the cement industry, and the Danish cement industry is more CO_2-intensive than other cement industries in the EU.

… and subsidies and other regulatory requirements create uncertainty

A CO_2 tax corresponding to the government's proposal reduces the uncertainty about future tax and quota payments for CO_2 emissions. Conversely, the subsidy funds announced and the unspecified requirements for climate adaptation in companies with mineralogical processes could increase uncertainty about future regulatory conditions for the green transition.

Revision of assessment criteria principles shows the need for improvements

The Chairmanship of the Economic Councils has been tasked with carrying out an ongoing review of the behavioural effects that are the basis for the Danish ministries' ex ante assessments of economic policy measures. A review of the ministries' assessments of measures in *A New Reform Package for the Danish Economy,* suggests that there is room for better compliance with the Chairmanship's recommendations for best practice for ex-ante assessments, including the introduction of quality declarations to make clear, to both decision-makers and the general public, the quality of the analyses that the assessments are based on. In the reform package, the so-called inflow effect constitutes a significant part of the behavioural effect in the ministries' assessments of the effect of the changes to the unemployment insurance benefit rules. However, the ministries' assessment criteria for the inflow effects are not considered to reflect the latest research knowledge, nor are they considered to constitute a reliable foundation for estimating inflow effects of changes in the unemployment insurance benefit rules, see also the summary of Chapter IV.

CHAPTER II, ECONOMIC OUTLOOK AND PUBLIC FINANCES

Chapter II contains an assessment of the current economic conditions and the outlook for public finances. The chapter also contains an assessment of whether fiscal policy is aligned with the state of the economy, as well as an assessment of compliance with the Budget Act.

High level of activity at the beginning of 2022

The Danish economy has experienced significant progress throughout 2021. At the beginning of 2022, the level of economic activity was high, and employment was approximately 3¾ per cent above the estimated structural level. Our main trade partners have also experienced significant progress through 2021, but employment growth in Denmark stands out by being particularly high.

A number of negative factors dampen the growth prospects

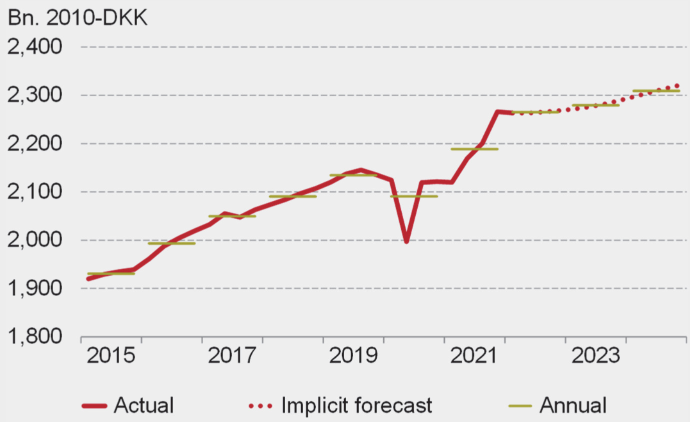
Even before Russia's invasion of Ukraine, energy prices began to rise, and interest rates rose as a result of expectations of monetary tightening. The negative factors are amplified by the invasion, and growth prospects are thus further dampened.

Prospect of stagnation in GDP for the rest of the year

A noticeable slowdown in the Danish economy is expected, with stagnation throughout the year and only weak growth in 2023, see Chart A. Despite the marked slowdown, GDP is expected to be, on average, approximately 3½ per cent higher this year than last year. This is due to the fact that there was significant progress through 2021, meaning that the level of activity at the beginning of 2022 was already significantly above the average for last year. The forecast implies some normalisation of economic activity, with the employment gap narrowing; however, activity is still expected to remain above the structural level. In 2023, the employment gap is expected to be approximately 1¾ per cent.

FIGURE A **IMPLICIT QUARTERLY FORECAST FOR GDP**

The forecast shows largely unchanged GDP through 2022, but the increase through 2021 means that annual GDP for 2022 is expected to be approximately 3½ per cent higher than the annual level for 2021.



Notes: The latest observation is the first quarter of 2022, which is based on Statistics Denmark's GDP indicator. The dotted red curve shows the implicit quarterly profile that is in line with annual growth rates.

Source: Statistics Denmark, Statistikbanken and own calculations.

TABEL A **KEY FIGURES OF THE OUTLOOK FOR THE DANISH ECONOMY**

	2021	2021	2022	2023	2030 a)
	DKK bn.	------ Real grow th rate, per cent. -------			
Private consumption	1,139	4.2	2.1	1.6	2.2
Public sector consumption	609	3.7	1.0	0.4	1.0
Gross fixed capital formation	560	5.6	0.5	-0.9	1.1
consisting of:					
Public sector investment	87	4.3	-3.9	7.0	1.4
Residential investment	140	6.1	0.6	-1.0	0.1
Business fixed investment	333	5.8	1.6	-2.8	1.4
Stockbuilding b)	22	0.3	0.0	-0.2	0.0
Total domestic demand	2,329	4.7	1.5	0.4	1.7
Exports of goods and services	1,487	7.8	5.8	2.5	1.9
Imports of goods and services	1,320	8.2	2.5	2.5	2.4
GDP	2,497	4.7	3.5	0.6	1.4
Key indicators					
Consumer prices, percentage change c)		2.1	4.9	2.5	1.9
Unemployment, per cent d)		3.1	1.9	2.4	3.1
General gov. budget balance, DKK bn.		59	17	-7	-7
General gov. budget balance, per cent of GDP		2.3	0.6	-0.3	-0.2
Hourly w age costs, percentage change		2.6	3.6	4.6	3.4
Terms of trade, change in percentage points		-0.2	-2.0	-2.1	0.3
10-year Danish government bond rate, per cent		0.0	1.1	1.5	1.1
Employment gap, per cent e)		1.6	3.6	1.8	0.0

a) The columns show projected average annual growth from 2023 to 2030 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 columns show the projected value in 2030.
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.

High wage increases in 2023, but no accelerating wage-price spiral

Inflation is estimated to be around 5 per cent in 2022, which is the highest level since the 1980s. Although inflation is expected to decline in 2023, and wage growth is expected to rise to 4½ per cent, overall, there is a prospect of stagnation in real wages over the years 2022 and 2023. Wage increases in subsequent years are expected to be slightly higher than normal, but this is not expected to spark an accelerating wage-price spiral. This is due to the fact that households' inflation expectations are assumed to be anchored in the longer term.

Significant downside risks

The economic outlook is associated with considerable uncertainty. The risks are mainly to the downside and have increased since the assessment in *Danish Economy, autumn 2021*. For the European economy, there is a significant risk associated with the war in Ukraine, including the risk of an interruption to gas supplies from Russia to Europe. For the international economy in a broader sense, there continues to be significant risk associated with the COVID-19 pandemic, including shutdowns in China that increase supply-chain disruptions. Added to this are the expected interest rate increases from both the European and US central banks, which risk weakening demand to an extent that the economies end up in a recession. The high inflation also risks increasing wage demands of employees in the medium term, and there is thus a risk that this sparks an accelerating wage-price spiral that could lead to a period of stagflation-like conditions, where inflation is high and growth is low.

Fiscal policy and public finances

Despite weak growth, fiscal policy should be tighter

The Budget Bill for 2022 entailed an easing of fiscal policy compared to 2019, when capacity pressure was less pronounced. Since then, several expansionary measures have been agreed, including in the form of more spending on vaccines and tests, compensation for higher energy prices and increased spending on Ukrainian refugees. The additional costs adopted are mainly unfunded. The already accommodative fiscal policy has thus been further eased, and overall, fiscal policy is estimated to increase economic activity in 2022 by approximately 1¼ per cent compared to 2019. Although the war in Ukraine and the rising inflation have a negative impact on growth, employment is still expected to remain high. Therefore, it is assessed that fiscal policy should be tighter than it currently appears to become.

Exceeding the structural balance limit this year is permitted, as it can be attributed to Covid-19

The structural deficit is estimated to be 0.6 per cent of GDP this year, and the deficit limit in the Budget Act is thus expected to be exceeded slightly. Management of COVID-19 at the beginning of the year is considered to be linked to an exceptional circumstance in the form of a public health crisis; therefore, it is considered that exceeding the deficit limit in 2022 for this reason can be attributed to an exceptional circumstance alone. This means that the exceeding of the deficit limit is not deemed to be in violation of the Budget Act.

On the other hand, compensation for higher heating bills is not considered to be justified as an exceptional circumstance

In order to be able to exclude expenditure from the deficit limit, the expenditure must be directly linked to the exceptional event, be significant and be temporary. The assessment of the Chairmanship is that increased expenditure on refugees, emergency aid and arms supplies to Ukraine is directly linked to the war in Ukraine, and can thus be exempted from the deficit limit due to exceptional circumstances. On the other hand, the Chairmanship considers that the compensation to households for higher heating costs is redistributive policy that is only indirectly linked to the war in Ukraine, and that such expenditure should, therefore, not be exempt from the deficit limit under the category of exceptional circumstances.

Good arguments for lowering the deficit limit

A majority in the Parliament has agreed on a national compromise on Danish security policy. The agreement states that defence expenditure is to be increased and that the deficit limit in the Budget Act is to be lowered to 1 per cent of GDP. Finally, it has been agreed that a 2030 plan aiming at a deficit on the structural balance of ½ per cent of GDP will be prepared. The Chairmanship has previously assessed that there are good arguments for lowering the Budget Act's deficit limit, see *Danish Economy, autumn 2021*. A lower deficit limit will, among other things, reduce the risk that an increase in public deficits due to demographic changes leads to a tightening of fiscal policy solely for the sake of complying with the deficit limit.

CHAPTER III, REGULATION OF HOUSING MARKET LENDING

Financial regulation has a long history

Regulation of the activities of commercial banks, savings banks and mortgage institutions has a long history in Denmark, which, not least, has been motivated by a number of financial crises dating back to the middle of the 19th century. The most recent in the series was the global financial crisis that started in 2007-08. Like the previous crises, this crisis gave rise to various measures to tighten financial regulations. Not least, the concept of macroprudential regulation has become much better known since the financial crisis due to the understanding that measures must not only focus on the health of the individual financial institution (which microprudential regulation concentrates on), but also look at the interaction between the individual institutions and thus the health of the overall financial system.

Studies confirm that macroprudential measures have an effect

Chapter III reviews the general economic principles and arguments for macroprudential regulation and descriptive statistics for the development of, among other things, housing-related lending and the most important rules in this area. This is followed by a review of the empirical literature on Danish and foreign data on the impact of macroprudential instruments targeted at borrowers in the owner-occupied housing market. The studies generally confirm that the examples of macroprudential measures examined have an effect on lending and house prices, but there are still many gaps in our knowledge of how large these effects are, not least when it comes to the size of the costs of regulation.

Limits market failures, but also involves costs

Regulation of the financial sector, including regulation of borrowing and requirements for banks' capital and liquidity, are important for limiting the risk of financial crises. However, there are also costs involved in regulating the sector's activities, because such regulation will limit the possibilities for households and businesses to exploit the capital markets to even out the differences between income and expenditure over time. Therefore, as far as possible, it is important to weigh the benefits and costs of each individual measure so that regulation in this area is neither more lenient nor stricter than what appears economically well-founded.

Not obvious that financial stability requires many different instruments

In addition to capital and liquidity requirements for credit institutions, there are a number of other instruments in the financial regulations that focus on loans to homeowners and buyers. These are, for example, deposit requirements and restrictions on the possibility of taking out interest-free loans. However, it is not obvious that further such restrictions on borrowing by individuals are needed if the sole purpose is to ensure financial stability. However, there may be other, independent economic reasons for enforcing such borrower-based restrictions. It may, for example, be a paternalistic desire to prevent short-sighted or ill-informed households from making decisions that are detrimental to their personal finances in the long run. Another reason may be a more general desire to stabilise the business cycle and thus house prices, which play a major role in general demand.

Clear motivation for specific initiatives is important

It is important that the justification for each existing and any future initiatives in the area is clearly stated. For example, calls for further restrictions on interest-only loans should be clearly justified on the basis of specific factors alone. This is the precondition for being able to make a rational assessment of the appropriateness of such measures.

Need for far more empirical research in the field

Proposals for changes in financial regulation should, in principle, be based on cost-benefit analyses that identify the expected costs and benefits. However, the empirical review in the chapter shows that there are still very large gaps in the collective knowledge about the effect of the various regulatory instruments, including limits on the debt-income ratio, restrictions on interest-only loans and deposit requirements. Therefore, it is difficult to carry out comprehensive and credible cost-benefit analyses in the area. Thus, there is a clear need for (much) more empirical research in the field in order to gain a better understanding of the significance of the various tools.

More focus on regulating business loans?

There are already many forms of regulation that are targeted at borrowers, for example, in the form of restrictions on the loan-to-value ratio. There is generally more focus on instruments targeted at households (homeowners) than instruments targeted at businesses. On the face of it, this may seem striking when one considers that business loans make up a significant proportion of total lending and that they have been the cause of several historical financial crises. If there is a need for further borrower-oriented regulation for reasons of financial stability, it may, therefore, be relevant to have a greater focus on the possibility and appropriateness of more targeted regulation of business borrowing.

INFLOW EFFECTS OF CHANGES IN UNEMPLOYMENT INSURANCE BENEFIT RULES

Focus on the inflow effect of changed unemployment benefit rules

Chapter IV makes an evaluation of the assessment criteria behind the ministries' ex ante assessments of changes to the unemployment insurance system. The chapter focuses on the so-called inflow effect, which indicates how much a change in the unemployment insurance benefit rules affects the inflow into the unemployment benefit system. The inflow effect can be of great importance for the overall effects of changed unemployment benefit rules, including for the changes to the unemployment benefit rules that are included in the reform measures in *A New Reform Package for the Danish Economy*. The reform package includes a lower rate of benefits and a shortened eligibility period for graduates, and a supplement for the first three months of the unemployment benefit period for people with a relatively strong employment history.

The inflow effect is evaluated for a change in benefit level and a change in the eligibility period

The amount of literature that sheds light on the magnitude of inflow effects of unemployment benefit rule changes is limited. However, it is possible to determine an order of magnitude of the change in the inflow to the unemployment benefits system that one would expect from a change in the unemployment benefit level or a change in the length of the unemployment benefits eligibility period. Therefore, the inflow effects that ministries apply to these two types of rule changes are compared with the magnitude of these effects found in the scientific literature.

The inflow effect is too large for benefit changes and too small for changes in the period of eligibility for unemployment benefits

For changes in the level of unemployment insurance benefits, the literature suggests that the ministries' underlying assumptions about the inflow effect are too high. Thus, for a general change in benefits, the assumptions used by the ministries result in an inflow effect that is significantly greater than recent studies suggest. Conversely, the literature suggests that the assumed inflow effect is too low when it comes to changes in the length of the unemployment benefit period. This is particularly pronounced if one considers changes that go beyond the first two-year unemployment benefit period. The literature finds that there are effects of changes in the unemployment benefit period after more than two years, however, by assumption, the effects are zero in the ministries' assessment criteria for changes after 1½ years into the unemployment benefit period.

The external validity of the inflow effects induced by the behavioural effects is weak

An accurate model should, moreover, be based on all mechanisms relevant to the area. The ministries' assessment criteria incorporate only one mechanism which generate inflow effects: employees in redundant positions and in temporary jobs are assumed to change their job-seeking behaviour in response to changes in the unemployment benefit system. At the same time, the empirical foundation for this mechanism is not convincing. The inflow effect concerns persons who are in employment but sit in redundant positions or are employed on a temporary basis, while the empirical foundation is derived from the behaviour of persons who have been unemployed for between six months and up to four years. This is an empirical foundation that is far removed from the context in which it is used.

The model omits several of the mechanisms that recent research finds relevant

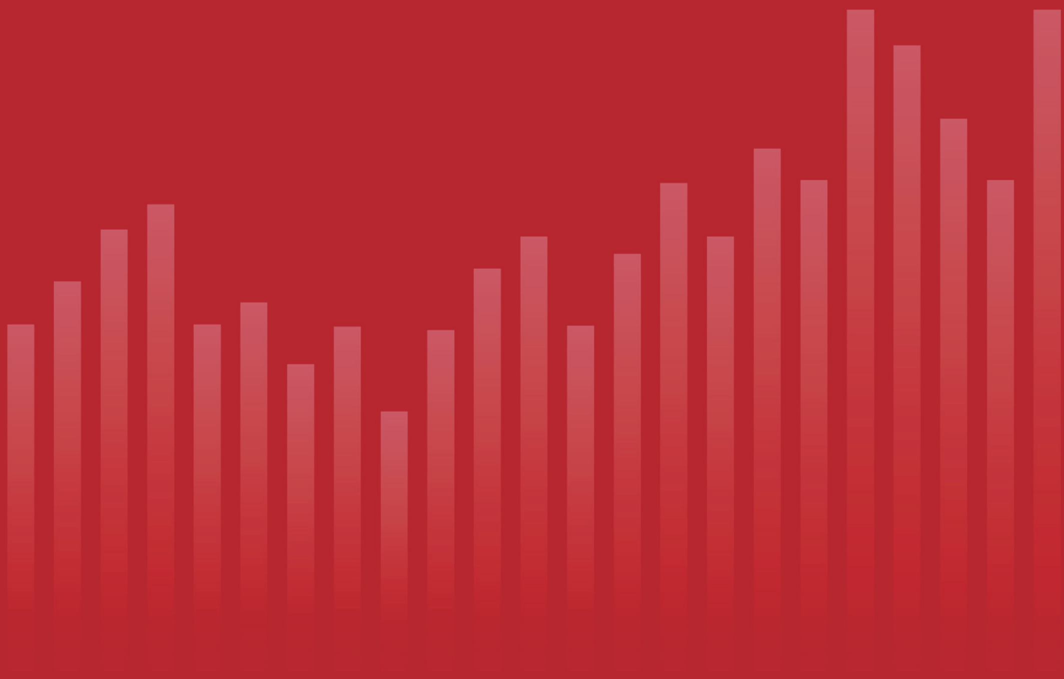
The fact that the ministries' results for the inflow effect do not agree with the results in the scientific literature must also be viewed in light of the fact that, the modelling framework used omits several of the mechanisms that the research literature finds are relevant to influencing inflow to unemployment. Among other things, changed unemployment benefit rules can have an impact on job creation and the job separation rate, i.e. how many people are laid off or quit their jobs.

An overall assessment can include several mechanisms

The omitted mechanisms can be taken into account by using a methodological approach that is based, to a greater extent, on studies of the aggregate consequences of changes in the unemployment benefit system. This would be in line with the findings in the recent literature, in which a number of recent studies focus on aggregate effects on employment and unemployment of changes in unemployment benefits. A more complete picture of the consequences would thus be obtained.

Need to rethink the assessment criteria

The discussion in Chapter IV does not enable an unequivocal conclusion about whether the overall effect on structural employment of the reform measures in *A New Reform Package for the Danish Economy* is overestimated or underestimated; however, the chapter points out that the individual elements are not very well assessed. The ministries' assessment criteria thus point in the direction of overestimating the negative effect on employment of the unemployment benefits supplement to be paid for the first three months to people with a relatively strong employment history. Conversely, they point in the direction of overestimating the positive employment effect due to the lower rate for unemployment benefits for graduates. And finally, they point in the direction of underestimating the positive employment effect due to the shortening of the unemployment benefit eligibility period for graduates. At the same time, the ex ante assessments concerning graduates are, to a large extent, based on ad hoc assumptions, which means that the effects must be characterised as being very uncertain. Overall, this exemplifies the need to rethink the assessment criteria in the area of unemployment benefits.



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