



Economic Survey of Denmark, 2000

Summary

Denmark managed the rare feat of a “soft-landing” in 1999, after a long and finally unsustainable period of strong growth. Now, real GDP is set to rise by around 2¼ per cent this year, and 2½ per cent the next, leaving output close to its potential level. Fiscal policy has had to play a major role in offsetting the expansionary effects of monetary policy, which turned out to be stronger than policy makers had expected. Closer convergence with the business cycle in the Euro area would alleviate the macro-economic policy challenges in the future, as would greater control over public spending. Although Denmark has achieved more progress on improving the budget balance than most OECD countries, there is no room for complacency: tax rates are too high, and ageing will soon add to spending pressures. Increased outsourcing and more reliance on user charges could help to restrain the growth of public consumption. Structural reforms undertaken over the past decade have led to higher trend growth rates, but more remains to be done. While Denmark has succeeded in reducing structural unemployment, it has made less progress on meeting its labour-supply objectives. Increased labour supply will be essential to assure long-term fiscal sustainability. There is still too little effective competition in many product markets, despite the best efforts of the Competition Authority, and the rental housing market continues to function rather poorly. There has been a laudable increase in the use of economic instruments in the area of environmental policy. But it should be possible to achieve environmental improvements more cost-effectively if greater use of cost-benefit analysis were made and policies were rationalised in some areas. In sum, while Denmark has made good progress on many fronts, further efforts to improve policies would help to secure a more prosperous future. ■

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This Policy Brief presents the assessment and recommendations of the 2000 OECD Economic Survey of Denmark. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

Can the economy maintain balanced growth?

The pace of activity in Denmark slowed in 1999. This followed a long period of very strong growth in domestic demand and the adoption of policy measures aimed at cooling the economy. Overall GDP growth was 1.6 per cent, with domestic spending remaining soft for most of the year, reflecting weak private consumption, falling fixed investment and a sharp adjustment in stocks. However, exports grew by 7 per cent, well ahead of market growth, benefiting in part from a lower effective exchange rate. Imports grew only slowly, so that the current account returned to a surplus of 1 per cent of GDP. Higher export growth offset weakness in domestic manufacturing orders and helped maintain industrial production growth. Capacity utilisation has fallen from its peak in early 1998 but started to rise again last spring, and business confidence has risen steadily from its trough at the end of 1998.

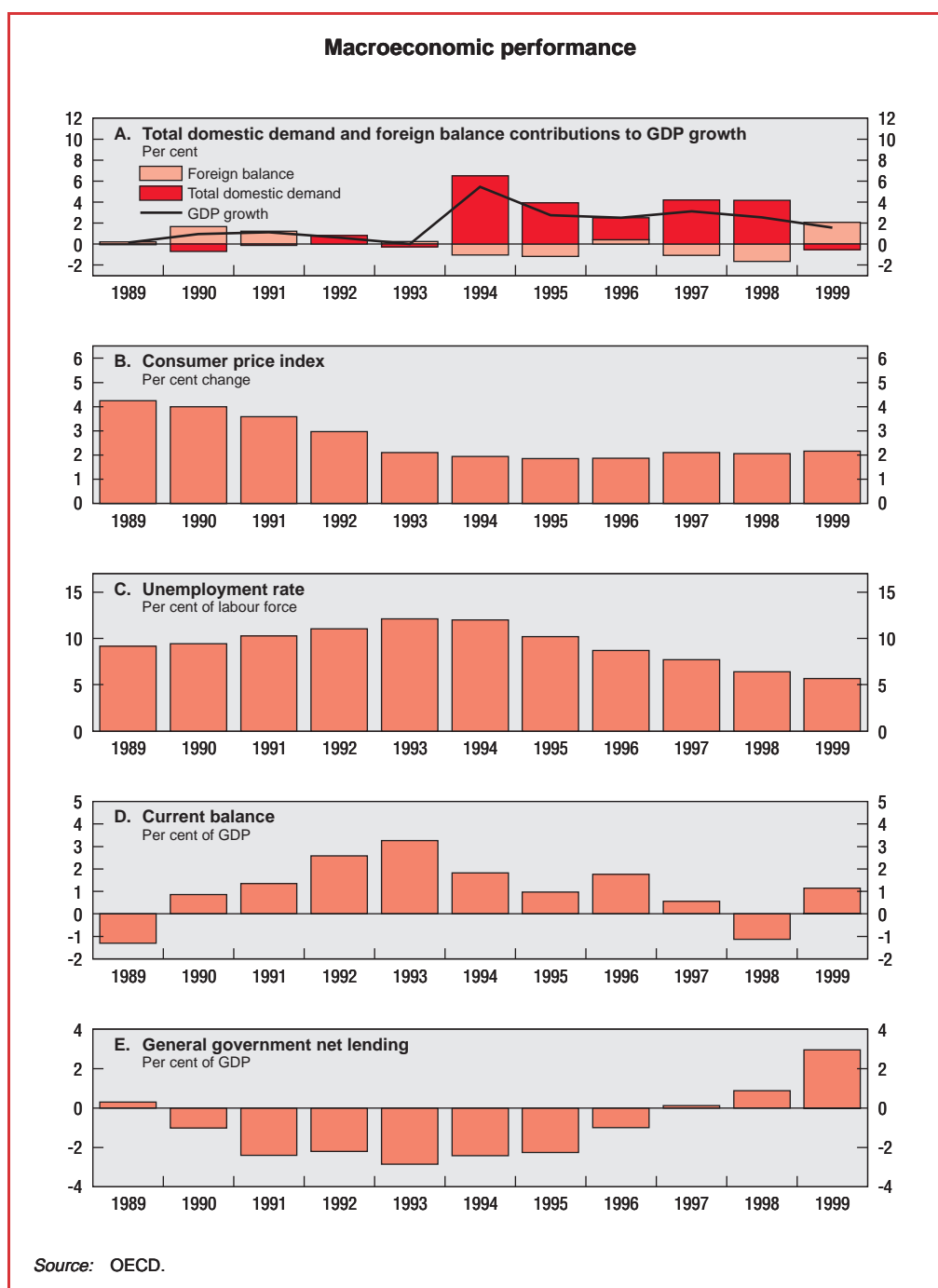
With output having moved above levels considered sustainable as the recovery matured, wage and price developments remained a concern in 1999. CPI inflation kept rising until very recently to over 3 per cent and Denmark breached the EMU inflation criterion in early 2000, although this is expected to be only temporary. In contrast, domestic market-determined inflation (abstracting from oil prices, imports, taxes and housing), which peaked in the first half of 1999 at 3.1 per cent, fell back to 2.7 per cent by the fourth quarter. Hourly earnings growth has moderated only slightly to 4 per cent. Employment growth has slowed, even though registered unemployment has continued to fall

to around 5¼ per cent of the labour force. Rather than signalling a further rise in labour market pressures, the persistent decline in measured unemployment may be sustainable, since it has coincided with continuing efforts to tighten the unemployment benefits regime. The recently concluded accord between the social partners suggests moderate wage growth can be expected in 2000, easing inflation risks. An important feature of the agreement was an increase in holidays, which is generally expected to reduce average working hours over the next three years, even if the costs thereof may be partially offset by increased working-time flexibility. The pact covers a four-year period, providing greater certainty to employers and a stable backdrop to bargaining at the enterprise level.

By the end of 1999, excess demand was more or less eliminated, and the danger of overheating had receded. Looking ahead, the economy is projected to expand at rates close to potential growth, at 2¼ per cent in 2000 and 2½ per cent in 2001. Exports may continue to benefit from increasingly buoyant activity in the rest of Europe, and domestic spending is projected to accelerate gradually as export-led growth feeds into higher employment and inflation eases, allowing real disposable incomes to recover. With no significant output gap expected in the short term, the risks are quite finely balanced between a renewal of inflationary pressures and a pick-up in unemployment. If wage settlements ultimately agreed at the plant level turn out higher than currently expected, possibly reflecting the recent strengthening in demand, this could be sufficient to set the economy back on a path of rising inflation, especially if labour supply

continues to shrink. On the other hand, if international developments lead to a larger increase in short-term interest rates and especially if these feed through into higher long-term mortgage rates, the economy might be pushed into a renewed slowdown. Managing to keep the economy on a reasonably steady growth path will be a challenge to policy makers, given the limited instruments available.

Monetary conditions play a major role in determining the short-term outlook for Denmark, but they are effectively determined by the economic situation in Europe as a whole. Expansionary monetary conditions, and the inability of fiscal policy to tighten enough to counteract them effectively, led to the overheating in 1997 and 1998. The appreciation of the effective exchange rate in 1998 helped to take some steam out of the economy. The economy has been out of step with the rest of Europe during the 1990s, producing sometimes inappropriate monetary conditions. However, the “soft landing” achieved in 1999, may help align the business cycle with that of the euro area in the future, reducing the risk of untimely monetary impulses. Denmark has a long-standing and highly credible policy of maintaining a fixed exchange rate. It is also committed to operating monetary policy in the framework of the Exchange Rate Mechanism, which ties the Danish currency to the euro and minimises risk premia over the longer term. Under these conditions, Denmark may be better off adopting the euro and thereby gaining the benefits of sharing a single currency with most of its main trading partners. However, the decision rests on the outcome of a referendum scheduled for September. ■



Are budget surpluses at risk?

With the effective exchange rate and interest rates largely beyond its ability to influence, fiscal policy is Denmark's main tool for macroeconomic stabilisation in the short run. A

budget surplus of 3 per cent of GDP was achieved in 1999, after several years of consolidation. The so-called "Whitsun" package, adopted in mid-1998 and being phased in up to 2002, contained measures oriented towards dampening activity in the short term and improving savings

incentives and resource allocation over the medium term. With no major policy changes in the budget for 2000, the surplus will be maintained, at least on a cyclically-adjusted basis, as long as the agreements with local governments are adhered to. However, as some other

OECD countries have found, maintaining a surplus can be difficult in the face of calls for tax cuts or additional spending, and such pressures may emerge in the negotiations over the budget for 2001. Nonetheless, these pressures should be resisted.

Public finance faces several medium-term challenges. The first is to continue to reduce the level of outstanding debt by at least maintaining the budget surplus. This would provide more room to manoeuvre if and when there is an economic shock, especially one that might affect Denmark to a greater extent than its EU partners. Maintaining the surplus would also help to prepare for the spending pressures of an ageing population that will begin to arise over the next few years. Second, the top marginal tax rate remains rather high and is paid by a growing number of taxpayers. More generally, high tax rates may discourage human capital investment and entrepreneurship and make short working hours and “do it yourself” activities more attractive. Efforts to reduce the distortions in the tax system have been made through reforms since 1994, although some further improvements in the efficiency of the tax system could be made. However, tax policy options may be constrained over the medium term by the need to respond to pressures on the overall tax base arising, *inter alia*, from the removal of restrictions on cross-border trade in 2004. In any case, the magnitude of the welfare state makes it difficult to reduce the overall tax burden without compromising public finances. With public expenditure at almost 55 per cent of GDP in 1999, and public consumption at more than 25 per cent of GDP, gaining better control over expenditure and enhancing the value for money in the public sector are key elements.

Tax reforms have improved private financial savings and lowered statutory tax rates. But because an increasing number of taxpayers find themselves in the top tax bracket and local government taxes have increased, the average effective marginal tax rate on labour income has declined only slightly. More than a third of full-time workers currently face a marginal rate of 62 per cent, and the proportion is likely to rise as a result of the 1999 tax reform. Since wages are relatively compressed, raising the threshold for the top tax rate could be achieved for relatively little revenue foregone while the impact in terms of strengthening work incentives could be significant. Furthermore, the large differences between the tax treatment of positive and negative net capital income, private share portfolios and pension saving schemes – which widened further with the latest tax reforms – tend to distort households’ portfolio choices. Some of these problems could be resolved by lowering the tax rate on positive net capital income. Although tax expenditures related to corporate taxation have been reduced in scope, depreciation rates higher than economic depreciation still reduce the effective tax rate and produce a bias in favour of capital-intensive industries. Broadening the corporate tax base by reducing depreciation allowances would provide room for reduction in statutory rates for all firms. ■

How can public expenditure control be strengthened?

Making room for even modest cuts in marginal tax rates without undermining the budget surplus will require restraint in and better control over spending. Real consumption expenditure by county and

municipal authorities has ratcheted up in recent years, having been repeatedly higher than initially provided for in the annual agreements with central government or in the budgets finally adopted, although the outcome for 1999 was in line with planned levels. The municipal budgets for 2000 reflect the annual agreement, so that one source of past slippage has been avoided this year. However, sustained progress in this area will require a clearer division of responsibilities between central and local governments. The increased tendency in recent years for central government to engage more directly in setting objectives for locally-provided services seems to be partly in conflict with the very decentralised governance structure of the Danish public sector. In addition, the large variation in unit costs of providing services across municipalities suggests scope for rationalisation of the present system through a combination of better co-operation between authorities, voluntary mergers or outsourcing. Although progress in altering existing arrangements has proved very difficult, it is important that rationalisation efforts be pursued.

More effort could be made to incorporate techniques for improving the allocation of resources within the public sector as well as the efficiency of their use. The general government share of total employment at 30 per cent, is higher in Denmark than in almost all other OECD countries, and the wage bill is a higher proportion of public consumption than elsewhere. Greater recourse to outsourcing, through tendering for the provision of publicly-funded goods and services, should therefore be considered. As in other countries, this could be achieved without compromising government objectives for service delivery and quality as long

as supply contracts are carefully designed. Tendering would also stimulate supplier innovation, ultimately providing better services at lower cost. Experience so far has been encouraging.

User charges for public services are not applied consistently and are mostly insignificant, with little effect on incentives. Experience from Denmark and elsewhere has shown that even relatively modest charges, if well-designed, can provide clearer signals about demand for public services and encourage more efficient use of resources. The free provision of many services by government has long been a feature of Danish society, and the utilisation of user charges for social services has actually diminished over the past decade. But it is well established that “free” services tend to be over-used, while the taxpayer foots the bill. A more consistent and widespread application of user charges could play an important role in achieving tighter control over public expenditures. An initial step would be to calculate and publish the full costs of providing each service so that the degree of subsidy is made transparent.

Denmark has achieved a considerable reduction in unemployment since 1994, and, while some of this improvement reflects the pickup in activity, structural policy reforms have played an important role. These reforms have concentrated on improving active labour market policies and tightening the eligibility criteria. However, it is doubtful whether these policies can do much more to reduce the structural unemployment rate, and they may even be put under some strain if unemployment edges back up. Further strengthening the eligibility criteria and stronger reliance on economic incentives should be considered. For example, calculating the unemploy-

ment benefit based on annual taxable income (rather than the last twelve weeks’ wages) could be one way to make the benefit digressive. Gradually reducing the high statutory replacement rate applying to most of the unemployed in line with the duration of the unemployment spell would encourage job search. Another initiative would be to remove the extended benefit rights that currently apply to the unemployed aged 55 to 59. These privileges, together with their link to early retirement benefit entitlement, prevent active labour market policies from working as effectively as they might for this age group. ■

What measures would raise labour supply?

Over the medium term, the government wants to increase labour supply to enhance productive capacity and help position the economy to deal with an ageing population. However, the objective looks unlikely to be attained on present policies. Average hours worked, already low by OECD standards, are falling further because of the high marginal tax rates and recently-agreed additions to standard holiday time. In contrast, Denmark has one of the highest participation rates in the OECD, even though almost everyone of working age outside the workforce is receiving a public benefit. But there are two particular weak spots in labour force participation – the withdrawal of older workers and the excess time spent in education. In general, reaching the government’s objectives may require a careful reassessment of the rules governing transfer schemes so that they do more to discourage take-up and promote a return to the labour market. The impact of the recent reform of the early retirement benefit

scheme should be monitored closely, and the changes should be strengthened if outcomes fall short of expectations. Within the announced framework for reform of the early retirement (disability) pension scheme, it is important to ensure that the benefit structure underpins rather than compromises the effort to improve job opportunities for people with less than full working capacity. In particular, the replacement rate for the least disabled group should not be increased. The sickness benefit could also be made less generous, by introducing a waiting period before benefits become available.

Progress has been made on improving performance and managing costs in the formal education system. Basic skills acquisition has been enhanced, and the dropout rate from upper secondary education has been reduced. The agreements reached in the 1999 wage bargaining round should lead to increased teaching hours and establish a link between teachers’ pay and performance. Nevertheless, more efforts are needed to reduce the excessively long time spent in education and the corresponding high average age of entry into the work force. Reducing the length of time over which students can receive state support would help. Initiatives to strengthen cost awareness and improve the incentive structure in the adult education system were agreed in 1999. In particular, the relevant public expenditures will henceforth remain unchanged in nominal terms, so that public financing will diminish over time, leaving employers and employees – the direct beneficiaries – to bear a greater share of the cost. But the list of courses for which public subsidies are made available should also be pruned to eliminate narrow, firm-specific programmes. ■

Could competition be strengthened further?

The housing market, which was reviewed in depth in the previous Survey, remains subject to a wide range of interventions and policies that have resulted in the misallocation of resources. Rent controls have discouraged maintenance and new investments in private housing, perversely adding to the stock of buildings qualifying for urban renewal subsidies. In a further negative twist, urban renewal is proving more costly on average than constructing new social housing. A two-pronged approach is in order: removing rent controls should be a high priority, and urban renewal policies need to incorporate stronger incentives for cost containment. Rent regulation in the social housing area also needs to be modified to eliminate unwarranted rent differentials within and across vintages. Furthermore, the social housing sector would benefit from granting increased property rights to tenants, provided social problems are not exacerbated, in order to encourage tenant responsibility. In addition, the housing associations are accumulating significant wealth, and it is unclear to whom it belongs or what should be done with it.

The vigour of competition in product markets has improved but remains weak in many sectors. The Competition Act has been strengthened, but merger control and limits on fines are two dimensions where it still falls short. The more active role being taken by the Competition Council in advocating intensified competition, even in matters where it has no direct authority, is welcome. Nevertheless, more could be done to ensure vibrant competition. It is important to remove remaining exemptions from the Act, such as co-

operative agreements in distribution, resale price maintenance for Danish publications, and pharmaceuticals. And practices that are exempt under the “necessary or direct consequence of public regulation” provision should be more tightly controlled. Most utilities are still heavily regulated. Reform is underway in the electricity sector, but further initiatives to reduce vertical integration are still needed. This industry should be carefully monitored to ensure effective competition. ■

How could environmental policies be made more cost-effective?

Environmental issues are a priority concern in Denmark. In some areas – notably greenhouse gas emissions and waste recycling – ambitious environmental targets have been adopted and a wide-ranging set of policies intended to achieve them has been developed. Most individual policies are carefully designed, partly to meet political, fiscal and distributional objectives. But it seems that some of the targets have been adopted without a full appreciation of the resulting costs or benefits, and the resulting structure sometimes appears rather complex. Progress in using economic instruments may be undermined by overlapping directives, special treatment or complicated exemptions that subvert the principal advantage of economic instruments – namely, ensuring that environmental externalities are internalised equally in all activities. Such special treatment both raises costs and reduces the likelihood of reaching the targets. More rigorous and systematic valuation of costs and benefits, where possible and even if subject to uncertainty, would provide a basis

for more transparent and consistent comparison with the many non-quantifiable costs and benefits.

Water is an example where different sectors currently face differing incentives to reduce polluting discharges. The targets for municipal water treatment and industrial discharges have been met, but at high cost, whereas discharges from agriculture have declined much less. The environmental component of current water charges and taxes could be used to equalise abatement costs, but major rebates are given to industrial users, and a completely separate system handles agricultural discharges. Although fines are imposed for “excess” fertiliser use (compared with a norm defined with respect to agricultural technology but with no reference to environmental costs), no incentives are given for reductions beyond the norm. Some farmers have even switched to more fertiliser-intensive types of wheat production to take advantage of special concessions in the Aquatic Action Plan II. A better approach would be to tax net nitrogen discharges from farms or to establish a tradable permits scheme. An offsetting and transitional generalised tax credit could be granted if there were concerns about the potential income effects on some farmers.

Denmark has a number of ambitious energy-related targets and appears willing to pay a considerable price to achieve them. Its laudable policy of “leading by example”, through which it hopes to induce other countries to adopt equally ambitious targets, results in relatively high costs, particularly in the case of CO₂ and other energy-related emissions. These costs should be made as transparent as possible so that the relative merits of various options to reach Kyoto commitments might be

clearer. The existence of a widely-varying set of tax rates, with lower rates for heavy energy users, means that overall costs – per tonne of Danish CO₂ emissions abated – are higher than would appear at first sight to be necessary. An alternative policy would imply higher taxation on energy-intensive industry (and lower taxation on households), with the likely result that some plants (though perhaps fewer than industry lobbyists might suggest) would close, and that some of their production – and CO₂ emissions – would migrate to countries with less stringent targets. The Danish authorities argue that such “carbon leakage” defeats the object of their programme, which is to have an impact on global emissions, not just those located in Denmark. If Danish credibility and influence as a leader in this field depends on other countries taking the same view on leakage, these added costs may be worthwhile. But in the context of the Kyoto Protocol, where all industrialised countries – including many to whom Danish emissions might “leak” – also have targets to meet, such an approach would certainly represent costly protection of particular industries. The Danish authorities recognise this and have stated that they will over time modify the system of differentiated CO₂ tax rates as the Kyoto Protocol comes into force. Consideration should be given to phasing the differentiation out entirely.

The authorities also recognise that the wind turbine programme has been expensive, although views differ on the value of the environmental benefits that have been obtained. In this and a number of other areas policy is already moving towards much more cost-effective ways of achieving environmental goals through increasing use of domestic cap-and-

trade schemes and emission taxation. It should be possible to increase the efficiency gains by integrating some of these, notably the green certificate system for wind turbines, the CO₂ trading system for electricity generators, and the CO₂ tax. This would allow the current sector-by-sector targets to be abandoned and the elimination of sector- and use-specific tax rates, as well as ensuring that the wind turbine programme is not used to protect and provide rents to an “infant” industry that, with a major presence in world markets, has now grown up. Danish concerns over leakage makes full integration of the various measures difficult.

Emissions are also an issue for transport. Transport policies may not currently provide the right incentives for reducing emissions. First, subsidies to public transport may be justified for social reasons (although procedures for allocating them are far from transparent), but they are often assumed to be good for the environment as well. In fact, the environmental advantages of public transport depend critically on passenger load factors. Economic efficiency and environmental effectiveness would be improved by ceasing to deliver subsidies through fuel tax exemptions and by ensuring that allocation of subsidies is based as much as possible on systematic and consistent cost-benefit analysis. Second, the current taxation of private cars and fuels is skewed. Most revenue is raised from a tax that discourages car ownership but where the relation to the emissions thereby generated is weak. It might appear desirable to switch taxation to fuel, but insofar as such a move results in a shift in fuel purchases across the border to Germany, its efficiency in terms of reducing overall emissions would be lowered, and tax revenues

would also be lost. As a consequence, costs to the nation would be high compared to environmental benefits.

Waste management is an area where Danish environmental policy appears to rely on a strong system of economic instruments in the form of differentiated waste taxes and charges. But government suggestions that cost-benefit analysis has been carried out are belied by the reliance, in practice, on national targets for the proportions of different types of waste to be recycled, incinerated or disposed of in landfill sites. Such a “waste hierarchy” approach is not necessarily cost-effective; hence further development of economic instruments should be considered. The system of taxes on individual containers and packaging products makes sense, provided they are set to reflect environmental costs, although there is inevitably a trade-off with administrative complexity. Ongoing monitoring or periodic review would help to establish the appropriate balance. However, the present regulations on re-use of glass bottles and the ban on metal cans as drink containers are believed to favour domestic producers and the EU Commission is contesting the regulations before the European Court. It would be best if they were revised to meet environmental objectives without harming trade and competition. ■

For further information

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- **Economic Outlook No. 67**, June 2000
A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

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Public Affairs and Communications Directorate.
They are published under the responsibility of the Secretary-General.

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