February 2005

Policy Brief

OECD

Economic Survey of Denmark, 2005

Summary

Denmark has been near the top of the OECD's income rankings for many years. It has the most equal income distribution among member countries, partly because of its comprehensive welfare state. Given an ageing population, the key economic challenge is to maintain growth in living standards while preserving the welfare system. To achieve this, Denmark will need to raise labour supply and productivity growth. If they do not improve from here, the growth rate of per capita GDP will be dragged down to just ½ per cent per annum within a couple of decades.

The government's approach, laid out in its 2010 Plan, is to target fiscal sustainability by boosting employment, restraining public spending growth (by freezing taxes) and paying down debt. Progress to date has fallen short of target, partly because of a cyclical downturn but also because new reforms are needed. Even if the Plan were achieved, however, it might not be enough. The Welfare Commission's analysis suggests the fiscal challenge is much greater. A debate may therefore be necessary about what are the core parts of the welfare system that should be retained in their current form. Otherwise, they may be crowded out by less important services that, by tradition rather than necessity, are publicly funded today.

New reforms are needed to achieve the government's labour supply target. The government's employment objectives are ambitious, but too little has been done about the three major labour supply holes: working hours, older workers and young people. Annual working hours are among the lowest in the OECD, and high income tax rates are a contributing factor. Eliminating the top marginal rate, or raising the threshold from which it applies, would lift work incentives and could – as part of a revenue-neutral package – help improve fiscal

This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of Denmark. The Economic and Development Review Committee, which is made up of the 30 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. The Committee discussed the draft on 29 November 2004.

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sustainability. An outright tax cut would, on the other hand, be likely to worsen fiscal sustainability. More generally, the social partners should recognise the tradeoff between more leisure and reduced finance for future public services whenever they try to bargain for fewer working hours. They should also help work towards reducing sickness absences, which are high by OECD standards. Second, the average retirement age could be increased by reforming the voluntary early retirement pension (*efterløn*) — for example, increasing contribution payments and the bonus for later retirement. The pension system as a whole could be made more robust if retirement ages were tied to expected lifespans. At the other end of the age spectrum, students should complete their studies more rapidly. To achieve this, tuition fees could be increased (backed by an income contingent loan scheme) and the profile of income support changed (more earlier, less later), and the one-year "paid holiday" for students should be abolished.

Productivity could be boosted through greater competition, especially in the public sector. The extent of efficiency improvements in the public sector will influence how much pruning of the welfare state may need to be done in the future. The government has been trying to open up the public sector to greater competition as a way of delivering these productivity gains, but progress has been slow. Various regulatory defects mean that municipalities (which deliver most public services) sometimes have too little incentive to contract out, and the private sector cannot compete on equal terms. Options include imposing an obligation to tender on local governments and tying some of their funding to progress on contracting out. The amalgamation of municipal governments (more than halving their number to around 100) should improve the quality of public services and make competition more feasible.

Productivity improvements are also needed in the business sector, as productivity growth over the past decade has been low. The priorities should be to continue deregulating network industries, boosting connections to international markets for electricity, and removing unnecessary restrictions in the construction, housing, distribution and professional services sectors. Competition law could be improved through a better leniency programme and a reduction of the domestic merger thresholds.

Education and innovation are part of the solution. Maintaining growth in living standards will require a more skilled workforce. The school system, however, is not performing as well as it could given the resources that it has. A stronger culture of evaluation would help; teachers' skills would be better used if they specialised more; gaps in their training should be plugged; and work practices should become more flexible.

Getting better results from the research budget would also be useful. One way is to shift further towards a contestable performance based funding mechanism and to tie funding to quality. The venture capital market would be boosted if tax rules were simplified and corporate restructuring procedures were eased. ■

What are the key challenges?

Measured by per capita incomes, Danish living standards have been in the top handful of OECD countries for several decades. Moreover, Denmark has paid great attention to its social goals such as income equality and environmental sustainability. Twenty years of comprehensive reforms have put the economy on a robust footing without any short-term macroeconomic imbalances. Hence, policymakers – and this Survey – have been able to focus mainly on the long-term issues rather than day-to-day cyclical pressures. Denmark's performance has been built on the foundation of a well-functioning job market, openness to trade and a comprehensive welfare system based on the principle of equal access to social services at minimal cost to the user. Retaining this social model is not impossible, but it will become harder as the population gets older. Some tough choices may have to be made. By 2040, a third of the adult population is expected to be older than 62, the age at which the typical Dane retires today. This will have two major impacts. First, a shrinking workforce will make it more difficult to keep output growing at the pace that has been the norm until now. All else equal, demographic effects will drag the growth rate of per capita GDP to around ½ per cent per annum within a couple of decades, although the decline in consumption growth should be cushioned to some extent as people draw down their savings. Second, an increase in the number of elderly people will raise the demand for health and welfare services, putting public finances under considerable strain. Faced with these pressures, the key challenge will be to maintain growth in living standards while preserving the welfare state. There are two main ways to go about this:

- *Lift labour supply*. More labour supply (per capita) obviously helps raise average incomes. But it also makes the welfare system more affordable by expanding the tax base and reducing income transfers.

- *Boost productivity growth*. Productivity is the key determinant of living standards in the long term. Moreover, the quantity of public services that Danes will be able to enjoy will very much depend on efficiency improvements in the public sector. ■

Is the welfare state sustainable?

With an ageing population, the welfare system will not be affordable without further policy reforms. Numerous studies have tried to estimate how large the impact of ageing on public finances will be. While they differ in the details, they all arrive at the same conclusion: the current welfare system will not be affordable unless further policy reforms are made. In all scenarios, including the government's, the required increase in the budget surplus — through some combination of lower spending, higher taxes and greater labour supply — is large: estimates range from 1.5 to 4 percentage points of GDP. The country therefore faces some difficult choices. First, raising income taxes would be costly, since higher marginal taxes would reduce average working hours from their already low level: indeed, high taxes have already driven down working hours by making work unattractive relative to leisure. Second, it would be hard to boost labour supply without cutting back on parts of the system itself. However, removing elements of the welfare state is difficult since it has broad public support. Third, there is a tradeoff between welfare services now and in the future. For example, there is sure to be demand for upgrading health care as new medicines and technologies are developed, and it is unrealistic to assume that patients will be asked to pay the full cost of these services. Today's workers therefore have the option to spend less on welfare now so as to leave more room for service improvements later on.

Paying down debt today is a prudent way of dealing with these pressures, partly because demographics are now favourable and partly because some degree of pre-funding is appropriate. However, fairness across generations needs to be considered when choosing the optimal pace of debt reduction. In health care for example, the impossibility of refusing care or relying on large out-of-pocket payments implies it would be equitable for today's workers to pre-save to cover the extra services they are sure to receive later in their lives. In contrast, it may not be fair to ask the present generation to save so that future generations, who will live longer, can spend a larger part of their lives receiving a public pension. In such cases, the pre-saving strategy should be supplemented with measures that reduce the cost pressures themselves.

It would therefore be useful to have a public debate about what are the core welfare services that should be provided with public funding and equal access. Currently the state delivers a variety of income transfers to the needy (such as the disabled) and the not-so-needy (tertiary students and healthy older workers, for example). It also funds a plethora of welfare services, ranging from the essential (such as emergency medical care) to the more peripheral (such as sport and leisure facilities). In the long term it may be hard to avoid shifting towards more market-based funding instruments, such as user charges and private insurance, for some of the lower-priority services.

The government's approach to sustainability has emphasised pre-funding as much as possible of the future rise in ageing-related spending. It has thus focussed on paying down debt and encouraging a greater supply of labour before the ageing problems begin to bite. Its 2010 Plan aims to secure fiscal sustainability by keeping the structural budget balance between 1½ and 2½ per cent of GDP on average until 2010. To achieve this, ambitious targets for employment and public consumption have been set (lifting the employment rate to the highest level in history and restraining real public consumption growth to 0.5 per cent per year until the end of the decade). While there has been some progress towards these goals, the so-called "window of opportunity" is shrinking fast and reaching the targets is becoming increasingly difficult. In structural terms, the surplus in 2004 is expected to be around 1¼ per cent of GDP, slightly below the target range, and it is likely to fall further unless public spending remains very restrained and future reforms succeed in substantially boosting labour supply.

There has been some success in reining in expenditure growth. This has been partly thanks to the tax freeze, applying to all levels of government, that was introduced in 2002. However, meeting the labour supply objective might be easier if the tax freeze were more flexible. Its main drawback is that it locks in certain inefficiencies in the tax structure. It would be better to allow revenue-neutral tax reform packages, which would create the opportunity to reduce marginal income taxes and shift towards other tax bases, thereby improving work incentives. The downside, however, is that a more flexible tax freeze would be less transparent. ■

How can labour supply be boosted?

Denmark will not be able to afford one of the world's most generous welfare systems unless it also has one of the highest labour supplies. While the employment rate is already impressive, annual working hours are among the lowest in the OECD. Total labour supply is therefore a little below average, and measures to raise working hours are needed. But there are also pockets where employment could be lifted at the margins, especially older workers, students and — to a lesser extent — immigrants. Many useful steps were taken in 2002's *More People in Work* package, but there is still more to be done. ■

Why are working hours so low?

The relatively low number of working hours per year has several facets: the normal workweek is short, vacation allowances are generous, and absences due to sickness and parental leave are extensive. Boosting average working hours by just 1½ hours a week would be enough to meet the sustainability objectives of the 2010 Plan.

- High marginal tax rates are a contributing factor. The highest statutory rate of 63 per cent applies from around the average wage, so nearly 40 per cent of fulltime employed people are in this bracket. Tax cuts in 2004 reduced *average* rates a little, but their main impact was to shift people from the middle to the lowest bracket, thereby reducing marginal tax rates for this group. However, flattening the tax scale by cutting the top tax rate or raising the threshold at which it applies would strengthen work incentives more, *krone*-for-*krone*, than tax cuts at the lower end of the scale. It would be best to do this as part of a revenue-neutral package (*e.g.* reducing progressive income taxes and raising proportional taxes such as indirect or property taxes) so that the long-term fiscal outlook is not worsened and the income distribution remains broadly in line with society's preferences. Tax cuts could also be paid for by lower expenditure.

- Sickness absence rates are low by Scandinavian standards but are above the European average. Changes were made in 2003 in order to reduce long-term absences. For example, municipalities now pay more of the cost of sickness benefits. But it would also help if medical assessments were obligatory for the receipt of public benefits (*i.e.* after the first two weeks), and short-term absences might be reduced if the first couple of days were unpaid or paid at a lower rate.

- The parental-leave scheme is one of the world's most generous, and became more so in 2002. Average leave duration is now 40 weeks. The government should consider whether it has reached the point where the costs outweigh the benefits and should avoid any changes that increase the use of the system. ■

How can later retirement be encouraged?

The voluntary early retirement pension (VERP) is an expensive programme that gives people a strong incentive to leave the workforce in their early sixties. The scheme was tweaked in 1999 to encourage people to delay retirement until 62, but the implicit tax on staying at work beyond age 60 remains substantial nonetheless. The best solution would be to abolish the VERP altogether, since people with genuine disabilities or reduced work capacity can be looked after under other programmes. This would bring the government a long way towards achieving fiscal sustainability and may even create room for tax cuts. However, if the first-best solution is not acceptable, then some second-best alternatives should be considered:

- Changing the VERP's rules so that workers must contribute for 40 years before becoming eligible for the full benefit. This would exclude most people with a university education, going some way towards returning the system to the group of blue-collar workers for whom it was originally intended (while recognising that keeping the scheme for people who leave education early reduces incentives to invest in human capital, especially for the elderly).

- Increasing the bonus for late retirement as the actuarial adjustment to the VERP is low by international standards. However, the impact on public finances of such a reform is uncertain. Since May 2004 there has been an actuarially fair adjustment if people postpone receiving their old-age pension beyond the age of 65. In principle this is a step in the right direction but will surely have a very limited impact when a clear incentive to retire before 65 is maintained.

- Progressively raising the contribution rate so it moves towards a fully-funded defined-contribution scheme. Going all the way would entail a quadrupling of the contribution rate over time.

In addition, the entry age for all parts of the pension system could be tied to life expectancy. This would make the system less costly in future, but more importantly it would make it more robust. In particular, it would help insulate the system from demographic surprises. Danish lifespans have been well below those in other Nordic countries, but they began to catch up remarkably quickly in the 1990s. If they rise by more than is currently projected, the long-term fiscal situation could be much worse. ■

Who else could increase their labour supply?

There is also room to increase labour supply among young people and improve equity in the process. A large proportion of youths are still studying in their late twenties because they start late (the median entry age is 23) and take a long time to finish. The entry age could be lowered by restricting the 10th form to only those who need it and by reducing social support for young people during the gap between high school and university. Study paths are drawn out because tuition is virtually free and income support is generous. The introduction of tuition fees, backed by an income-contingent loan scheme, would encourage students to finish faster, choose courses more relevant to their future careers and improve equity because the wealthier are more likely to go to university. However, Denmark cannot go too far down this road because the compressed wage distribution already reduces the private rate of return to higher education. Nonetheless, it does have *some* room to move, especially if it led to earlier entry into the professional workforce (as that would increase the payoff from getting a degree). Other options include cutting or changing the profile of student grants (more earlier, less later), offering loans rather than grants to people taking too long to finish and eliminating the option to take what amounts to a one-year paid holiday during their course.

The employment rate of immigrants falls well short of that of native Danes, largely because many migrants are low-skilled. Apart from the obvious language problems, these migrants face several barriers to integration. First, they find it hard to price themselves into a job because the minimum wage is high. To reduce this problem, the social partners should use their option to lower minimum wages for the unskilled. Second, they are crowded out of home-service jobs by skilled Danes who, because of high tax rates, prefer to do their own work at home. This is another reason why it would be useful to continue cutting income taxes so that highly educated workers do jobs commensurate with their skills. Third, generous income support lessens the incentive to find work. Since 2003, new immigrants and returning Danes have faced a seven-year qualifying period before receiving full benefits. This increases their work incentives, but a similar approach could be taken with all those who are eligible only for social assistance (cash benefits).

The second way to deal with the challenge of maintaining growth in living standards is to boost productivity growth and innovation. Although the level of productivity is near the top of the OECD rankings, Denmark's lead has been eroded to some extent. Growth in output per hour since the mid-1990s has been below the average of OECD countries, and a large part of the labour productivity growth that has occurred seems to have been driven by capital deepening. Maintaining its leading position requires boosting competition, improving the education system and removing barriers to entrepreneurship and innovation. These topics are dealt with next. ■

How can the public sector be made more efficient?

The extent of efficiency improvements in the public sector will influence how much pruning of the welfare state may need to be done in the future. Opening up to competition can be a powerful way of delivering these productivity gains. The government has been trying to encourage competition and free choice in many public-sector activities, but municipalities (who provide most public services) have been slow to adapt. There are several ways to encourage all levels of government to make greater use of markets and for private companies to get involved:

- *Remove unnecessary restrictions*. Contracting out is either banned or restricted to non-profit operators in some sectors or there are overly strict rules on staff qualifications and the way services should be delivered.

- *Level the playing field*. Inadequate accounting systems sometimes lead local governments to set prices below costs (*e.g.* because depreciation is ignored). Guidelines on measuring costs should be clarified and full-cost accounting implemented more quickly. VAT rules also need to be harmonised between the public and private sectors, and there are ongoing efforts to do so. Moreover, municipalities have easier access to subsidised labour on activation schemes, giving them an unfair advantage over private firms.

- *Boost obligations*. Under the government's "challenge right", private firms can bid for the right to produce certain public services. This policy has not proved successful, with few offers having been received. It should be supplemented with an obligation to tender (for certain services, above a reasonable threshold) and by a more widespread use of vouchers. Outsourcing might be encouraged if some portion of central government funding were used to reward municipalities that manage to lower their unit costs. It would also help if the "free choice" policy was expanded into new areas; the government has recently proposed to do so for childcare.
- *Continue the privatisation programme*. Central government has few stakes in commercial enterprises, and its ownership will soon halve with the sale of its natural gas and television companies. Local governments, however, retain major investments in utilities, partly because receipts from asset sales are partially taxed away by central government (although the rules were eased and clarified in 2003).

The proposed reform of local government structure in 2007 should help bring about more competition. The number of municipalities will be more than halved to around 100, while the health-care sector will be run by five regional authorities (down from 14). This may deliver some efficiency gains due to economies of scale. But the biggest benefit will probably come from better quality and management that is more professional. That in turn should boost the chances of competition and market mechanisms becoming more common in the public sector, since many municipalities are so small that private firms are not interested in servicing them, and the transaction costs of tendering can outweigh any cost savings. ■

How can competition be improved in the business sector?

Greater competition would also be useful in the business sector. Competition law has recently been modernised, fixing most of the problems highlighted in the OECD's *Regulatory Reform Review* that was published in 2000. It is now broadly in line with EU practices, and a clear "competition culture" is emerging. The main gap in the toolbox is the lack of an effective leniency programme, making it harder to bust cartels. A second problem is that merger control rules are too narrow. The dominance test was changed this year to be consistent with the EU's new rules, but the merger thresholds are much higher than in other similar-sized economies and should be reduced. The implementation of the law, however, is hampered by too many agencies being involved in the process. In particular, there is probably no need for two decision makers sitting between the Competition Authority and the courts. But if they are both to be kept, they should be reformed. The first of these bodies, the Competition Council, is too big and is not well suited to deal with merger decisions. The second, the Appeals Tribunal, should be strengthened, and it needs to explain its decisions better in order to add to the body of case law.

The state of competition in network industries varies across sectors. Progress has been good in telecommunications and to some extent in the electricity sector. But deregulation is in its infancy in gas markets and is almost nonexistent for the other networks.

- A reform package in 2004 addressed most of the remaining problems in *electricity*, but further steps would enhance competition even more. These include expanding capacity on the often congested links with neighbouring countries and making taxes *ad valorem* rather than a fixed amount so that competition has greater scope to drive down retail prices. A notable feature of the reform was an attempt to restructure "green" taxes so that environmental objectives might be achieved in less costly and more market-friendly ways. An equally rational approach to sustainable development should be taken in other areas, including water sanitation and waste management, where this goal is pursued in overly expensive ways.
- Prospects for competition in the *gas* sector look brighter now that the transmission network has been separated from the main producer (DONG). The government should go ahead with its plans to privatise DONG and should ensure there are no barriers to foreign suppliers entering the market.
- *Telecommunications* deregulation started early and has gone far. The main weakness is high broadband prices, possibly because users with a shared telephone and broadband connection pay twice at the margin to rent the raw copper. A change in price regulations would avoid this. The telecoms regulator is currently looking into the reasons for high broadband prices and possible solutions.

Turning to other sectors, competition is inadequate in the *construction* industry due to restrictions on who can do what work and because standards for building materials are not harmonised within EU countries. Prices are very high as a result. The markets for rental and co-operative *housing* are malfunctioning, and rent controls should be removed (with appropriate safeguards and a sensible phase-out period). There are better ways than rent controls to deal with the government's social concerns, such as accommodation benefits. Various restrictions in *professional and financial services*, including pension funds, could be loosened. Liberalisation of the *taxi market* is called for, as there is virtually no price or quality competition. The liberalisation of *shop opening hours* should also be completed. Finally, the "needs test" in the Planning Act should be abolished as it is particularly harmful to competition, and its main purpose, balancing environmental and competition goals, can be pursued in less damaging ways. ■

How can skills and innovation be improved?

Boosting productivity also involves lifting the skills of the workforce. The public school system, however, is not performing well. It is delivering mediocre results at great expense. It is also failing, by Nordic standards at least, in its goal of delivering equitable outcomes. Solutions are to: create more of a culture of evaluation of both students and schools, and push pupils harder to excel; identify students with special reading difficulties earlier; increase teaching hours; allow teachers to specialise more and plug the gaps in their training; shift resources from non-teaching to teaching staff; and make work practices more flexible.

After lagging for many years, most indicators point to a pickup in innovation (both discovery and diffusion). The weak spots, however, are insufficient commercialisation of research and minimal co-operation between the business and public sectors. Turning research into commercial products has been hampered in the past by meagre incentives and too much red tape. A reform in 2000 improved technology transfer, but research funding is still largely institution-based with little explicit link to quality. It would help if public financing moved further towards a contestable, performance-based allocation model. Private finance can also be difficult to find. The venture capital market is tiny, with banks providing the lion's share of business capital. Pension and insurance funds are reluctant to get involved because of complicated tax rules, although the government is trying to simplify them. Bankruptcy and corporate restructuring rules may also be holding back entrepreneurship and venture activity, as they make it harder to restructure or exit from a failing firm. Finding the optimum in this area is difficult, but Denmark's debt discharge rules in particular are much stricter than in most countries and have probably reached the point where they are hurting rather than helping entrepreneurship. ■

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- **Economic Outlook No. 76,** December 2004. More information about this publication can be found on the OECD's Web site at *www.oecd.org/eco/Economic_Outlook*.

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

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