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OVERVIEW

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BETTER POLICIES FOR BETTER LIVES

This Overview is extracted from the 2016 Economic Survey of Denmark. The Survey is published on the responsibility of the Economic and Development Review Committee (EDRC) of the OECD, which is charged with the examination of the economic situation of member countries.

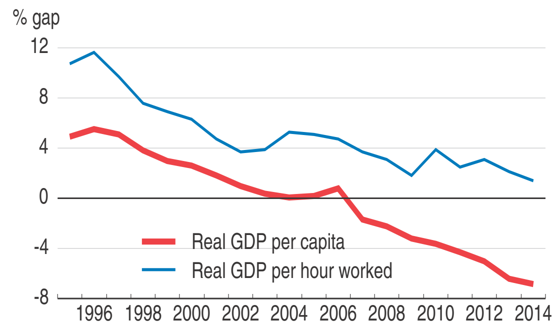
Executive summary

- *High living standards but slow growth*
- *New structural reforms to improve the balance between inclusiveness and work incentives needed*
- *Current monetary conditions call for more action in prudential policy*

High living standards but slow growth

Productivity and economic growth lag behind OECD best performers

Gap to the performance of upper half of OECD countries



Source: OECD, Going for Growth database.

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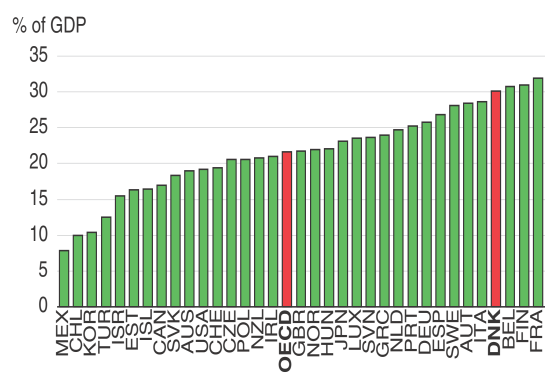
Danes enjoy high living standards and well-being, not the least because of the reform willingness of their governments. Yet, the economic recovery has been fragile and GDP per capita is still below its pre-crisis levels, although Gross National Income has received a boost from favourable term of trade developments. Investment has been subdued and North-Sea oil production has been a drag on growth. Sluggish productivity growth continues to be a challenge, undermining long-term growth prospects of an economy with an ageing population. In many areas such as domestic services and retail more competitive pressure and innovation would be a boon to growth. A number of reforms have been launched, but more can be done, for instance boosting competition in retail and pharmacies.

New structural reforms to improve the balance between inclusiveness and work incentives needed

Social spending is high



Source: OECD Social Expenditure database.

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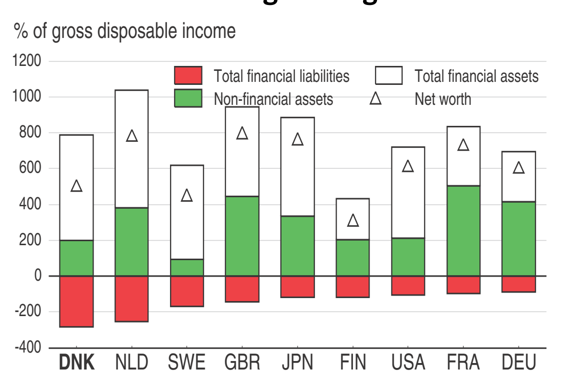
To enhance inclusive growth, barriers to work for some groups at the margin of the labour market need to be removed. The agreed extension of work lives will need to be accompanied by appropriate measures. The welfare system, though costly, provides generous support for those in need. Public finances are sustainable as long as labour force participation and work incentives remain high and the cost of welfare institutions can be held in check. To this end, generous benefits should be provided in a way which does not reduce work incentives and the effectiveness of integration measures for marginalised groups needs to be improved. On the expenditure side, cost pressures can be contained by further integration of welfare services and opening them to private suppliers.

Current monetary conditions call for more action in prudential policy

Households hold large balance sheets and their debt is among the highest in OECD



Source: OECD Analytical database.

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The current expansionary monetary conditions may lead to rising internal imbalances. Negative interest rates are contributing to the risk of building-up a new bubble in the housing market and may be encouraging excessive risk-taking by households and the financial sector. However, credit growth remains subdued. To mitigate future risks, macro-prudential tools should be extended across the whole country and tax policy of the property market needs to play its counter-cyclical role. Also, the debt-bias in favour of housing and credit should be lowered, in order to limit the vulnerability of households to rising interest rates.

MAIN FINDINGS	KEY RECOMMENDATIONS
Ensuring macroeconomic stability	
Monetary conditions are very accommodative and automatic stabilisers in the housing market cannot work fully.	Reform property taxation, including by decreasing mortgage interest rate deductibility and regularly updating valuations in order to establish neutrality across different asset classes.
High household debt poses vulnerabilities.	Encourage mortgage institutions to strengthen the use of debt-service-to-income ratios. Give consideration to extending some of the locally targeted "Best practices" introduced by the regulator for granting a mortgage in hotspot areas to the whole country.
Private rental market is underdeveloped.	Support a bigger private rental housing market by easing rent regulation while striking a balance between landlord and tenant protection.
Maintaining inclusive growth and sustaining the coverage and generosity of social institutions	
Inactivity and the number of social benefit recipients have increased. For some groups incentives to return to work or prolonging careers at older ages are low.	Reduce the effective taxation of returning to work by reforming benefits in order to make work pay. Allocate a permanent disability pension only to those with permanent incapacity to work regardless of age. Reduce disincentives and barriers to work at older ages originating from public and occupational pension design. Improve the quality and implementation of integration programmes for migrants. Monitor work requirements for social assistance recipients.
Social institutions are costly. In order to stay sustainable they need to become more efficient.	Use autonomy of local governments better for drawing lessons from the diversity of approaches in providing social services, which should also strengthen accountability for outcomes. Integrate welfare, prevention and rehabilitation services to improve provision of public services. Make general practitioners more responsible for the continuity of care. Encourage the private supply of welfare services to offer more choice while at the same time reaping efficiency gains.
Productivity growth has been slow.	The government should reintroduce overall quantitative targets for the effects of productivity measures on GDP. Further analysis of productivity enhancing measures should be carried out in some areas, while in others reforms could go further, notably in non-export oriented services and retail.

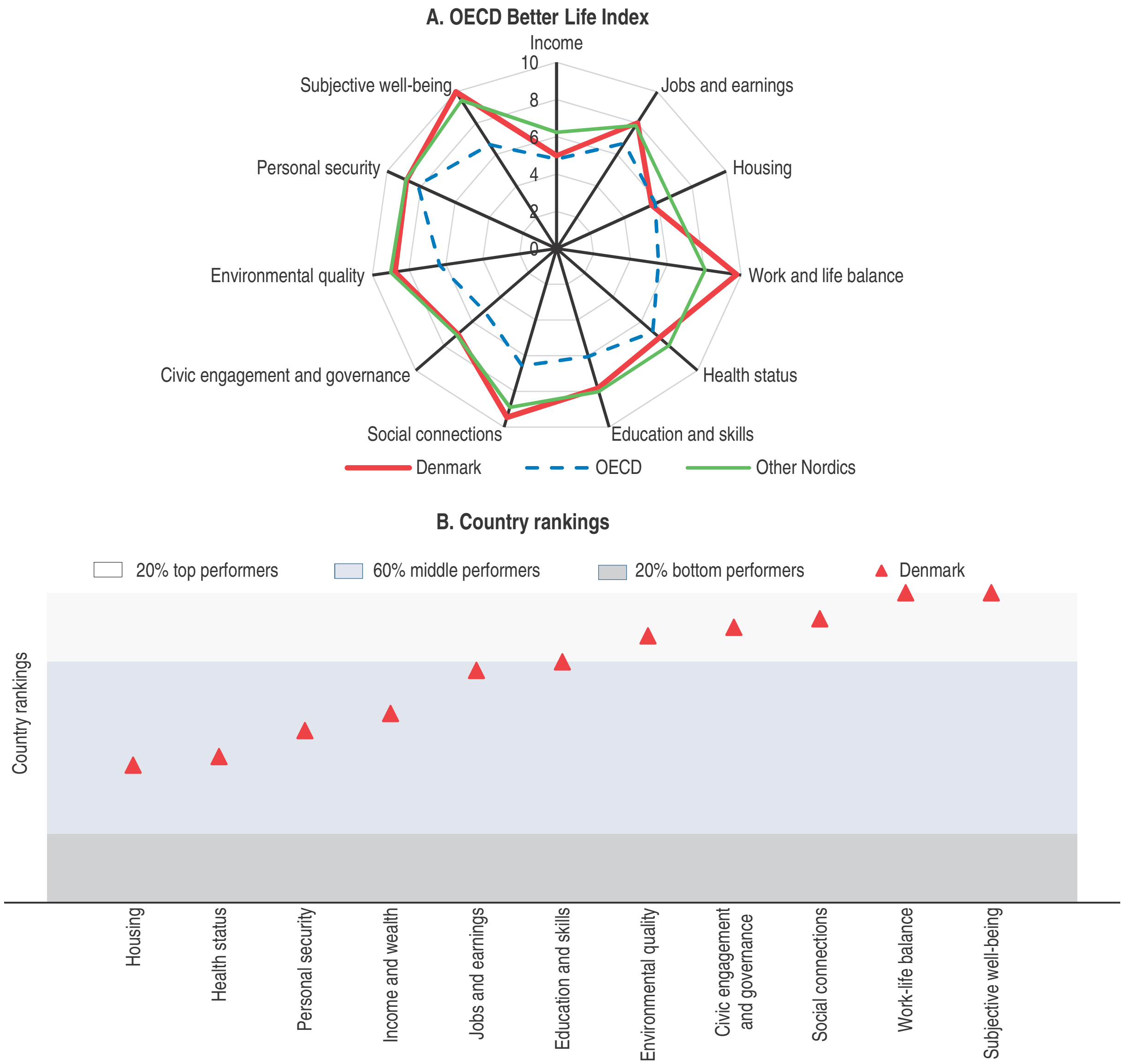
Assessment and recommendations

- *Economic prospects have improved recently*
- *Monetary conditions are very accommodative*
- *Fiscal policy is sustainable but could let automatic stabilisers work more freely*
- *Balancing inclusiveness, work incentives and sustainability in an ageing society*
- *Cost effective policies to manage environmental pressures*

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Denmark's population enjoys high material living standards, extensive social welfare, and scores highly on a number of dimensions of well-being (Figure 1). The economy is finally set to recover from a protracted recession, and households are enjoying private sector jobs growth and rising real incomes. Unemployment is low and the "Nordic Model", combining efficiency enhancing market forces, high quality public services, and an encompassing social net, is still working well.

Figure 1. **Denmark scores well in OECD's Better Life Index**



Source: OECD, Better Life Index 2015.

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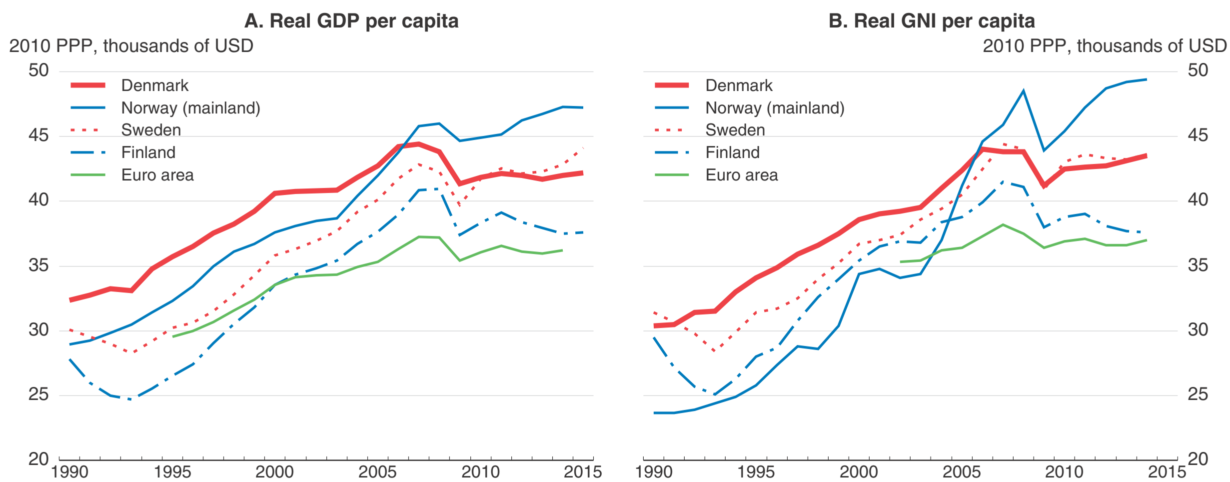
Yet, during the global recession the economy lost ground to other OECD countries, in particular its regional peers, measured by GDP per capita. By other measures, such as GNI that take into account income from abroad, it has done better (Figure 2). Furthermore persistent terms-of-trade gains also add to domestic incomes. Weak productivity growth, a major challenge prior to the recent downturn, continues to weigh on longer-term economic prospects, and current expansive monetary conditions contribute to the risk of internal imbalances building up, particularly via the housing market.

Figure 2. **GDP growth has been weak though other measures paint a better picture**



Source: OECD, National Accounts database.

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Against this backdrop, the main messages of this *Survey* are:

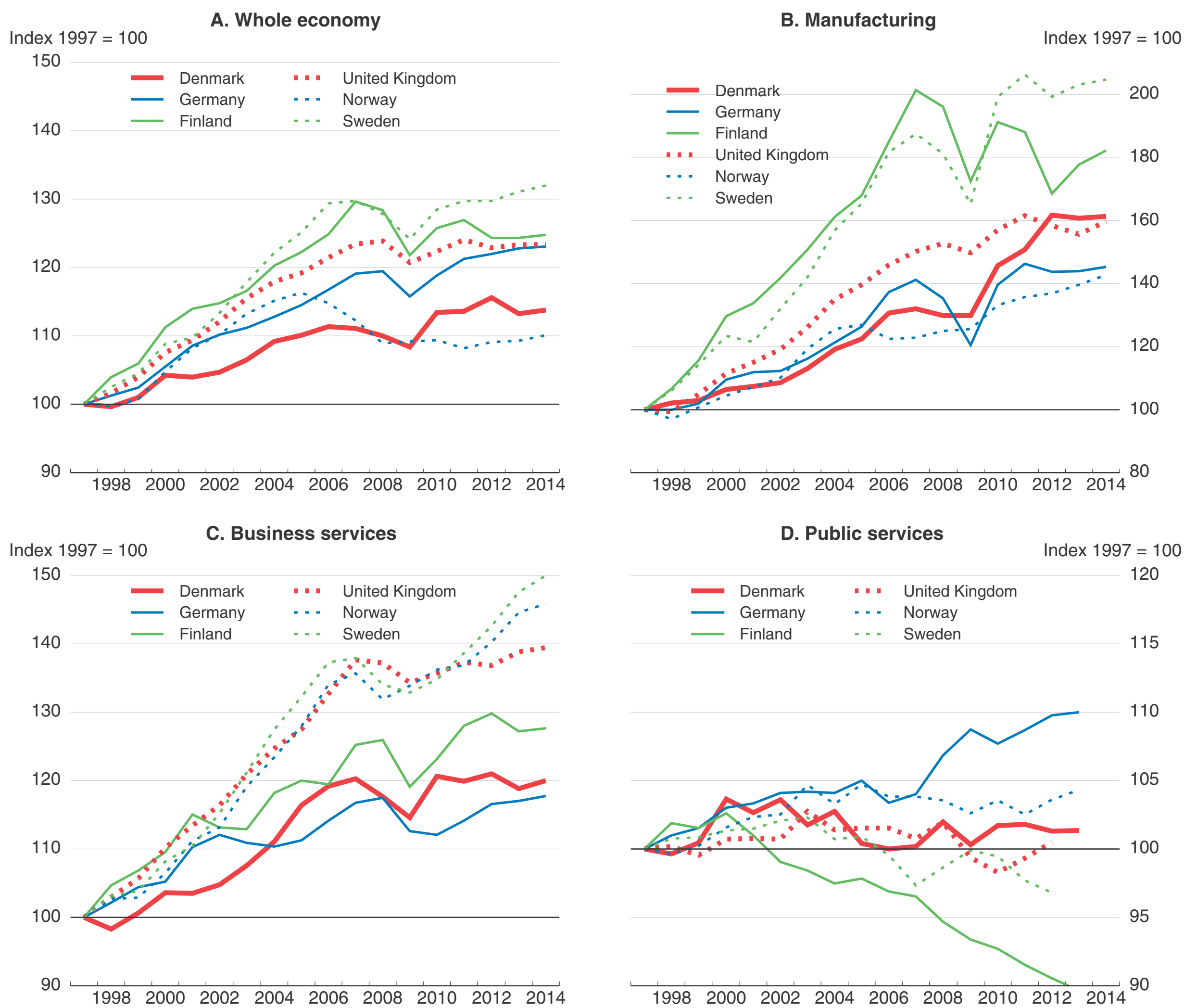
- *Mitigating risks of building-up internal imbalances*. Now that the economy has recovered further from a property price crash, and before imbalances reappear, it is time to put policies in place to bolster financial stability and stabilise the housing market. A prolonged period of low, and recently negative, interest rates has the potential to trigger another boom-bust cycle in an unchanged policy environment.
- *Safeguarding social welfare*. Social protection is high, but expensive. Removing obstacles to employment for all benefit recipients with some capacity for work would make growth more inclusive and improve long-term sustainability of the welfare system.

Despite a strong business environment, the Danish economy, and specifically business services, has suffered from weak labour productivity since the second half of the 1990s (Figure 3). The housing boom of the late 2000s contributed to a misallocation of resources in the economy, and it is likely that some of that misallocation continues given the large size of the financial sector and its wage premiums. The economy is not as well connected to global value chains as some comparable smaller open economies, and a relatively high level of investment in knowledge-based capital does not bring expected outcomes (OECD, 2014a). Denmark's potential growth was oscillating between 1-2% during the last economic upswing of the 2000s, and the financial crisis has in all likelihood weakened it. An estimate of the permanent medium-term loss to output is 2.6% in 2014 for Denmark (Ollivaud and Turner, 2014).

Continued increases in living standards and well-being hinge on reviving productivity and maintaining high employment. A number of measures to improve labour force participation have already been implemented with good results, particularly for older workers. Nevertheless, because of long lags involved, close monitoring and timely action are warranted.

Figure 3. **Lagging productivity growth**

Indices, different scales



Source: OECD, National Accounts database.

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Productivity has been on the policy agenda for some time. Following recommendations of a temporary productivity commission established in 2012, a series of "growth plans and packages" have been launched. These measures included a lowering of the corporate income tax; harmonisation with international standards; strengthening the independence of the Competition Council and Consumer Protection Authority; streamlining construction permit procedures and opening up the construction industry to more competition; removing entry barriers in various services such as real estate and maritime pilots. The most recent package, *Growth and Development Across Denmark*, launched in late 2015, contains over a hundred detailed measures. A key initiative is to lift some strict retail sector regulations, in particular rules concerning shop size and location contained in the Planning Act. The package also mandates an estimation of cost for business and impact on competition for all legislative proposals from now on.

Such measures are welcome and many of these have been identified in previous *Surveys* that looked at productivity issues in great length (Box 1). As planned, implementation and regular reporting on progress made on reform initiatives needs to continue. The previous government presented an overall quantitative target of how much productivity enhancing initiatives where to contribute to GDP growth towards 2020. The current government should reintroduce the use of overall quantitative targets for the effects of productivity measures on GDP. In some areas, further analysis has been agreed on and should be carried out (e.g. in network industries), while in others, reforms could go further (for instance in retail, liberal services, and pharmacies). A recent OECD review lists many specific recommendations to improve competition law (OECD, 2015a). Existing legislation could be screened with a focus on barriers to competition, for instance using *OECD's Competition Assessment Toolkit*.

Continued development of skills is key in ensuring future productivity growth. A reform of public primary and lower secondary education (*Folkeskole*) is being implemented, focusing on a longer and varied school day, including more and improved teaching; better professional development of teachers, pedagogical staff and school principals, and the simplification of rules and regulations. Also, a new unit analysing productivity issues and coordinating productivity and growth enhancing policy initiatives has been established at the Ministry of Finance, which is welcome.

Box 1. **Areas for reviving productivity growth**

Productivity issues have been analysed in great detail in previous Surveys (OECD, 2014a; 2009; 2006; 2005). These have identified a need to:

Reduce entry barriers in the economy notably for pharmacies, taxis and public transportation (OECD, 2005; 2009), by easing regulations on the size and placement of new suppliers (OECD, 2005; 2009).

Strengthen policies to promote innovation, for instance by moving towards a more balanced mix of project and institutional funding, by making sure that public funding is accessible to young and dynamic firms and by regular evaluation of effectiveness of public programmes in place (e.g. loan guarantee scheme, recent merger of innovation funding programmes) (OECD, 2014a).

Improve business angel investor training networks and enhance an entrepreneurial culture, including among women, via media and the educational system (OECD, 2014a).

Make a better use of skills, by strengthening the assessment framework of primary and secondary education, by including teacher and principal appraisal, making vocational education and training more attractive to students, raising the performance of adult learning programmes and the efficiency of active labour market policies (OECD, 2014a).

Economic prospects have improved recently

GDP growth has been weak in recent years (Table 1), and declining North Sea oil production continues to be a drag. Broad based job creation in the private sector and a decline in the unemployment rate since 2011, in spite of a meagre headline GDP performance, are helped by the overall supportive environment (Figure 4). Private consumption continues to be aided by a strong labour market, ultra-supportive monetary conditions, recovering housing wealth and low energy prices. Exports, which led the recovery in earlier years, have lost momentum during 2015, in part because of a slowdown in Europe and Asia. Nevertheless, the current account surplus as a share of GDP is one of the largest in the OECD.

Table 1. **Macroeconomic indicators and projection**

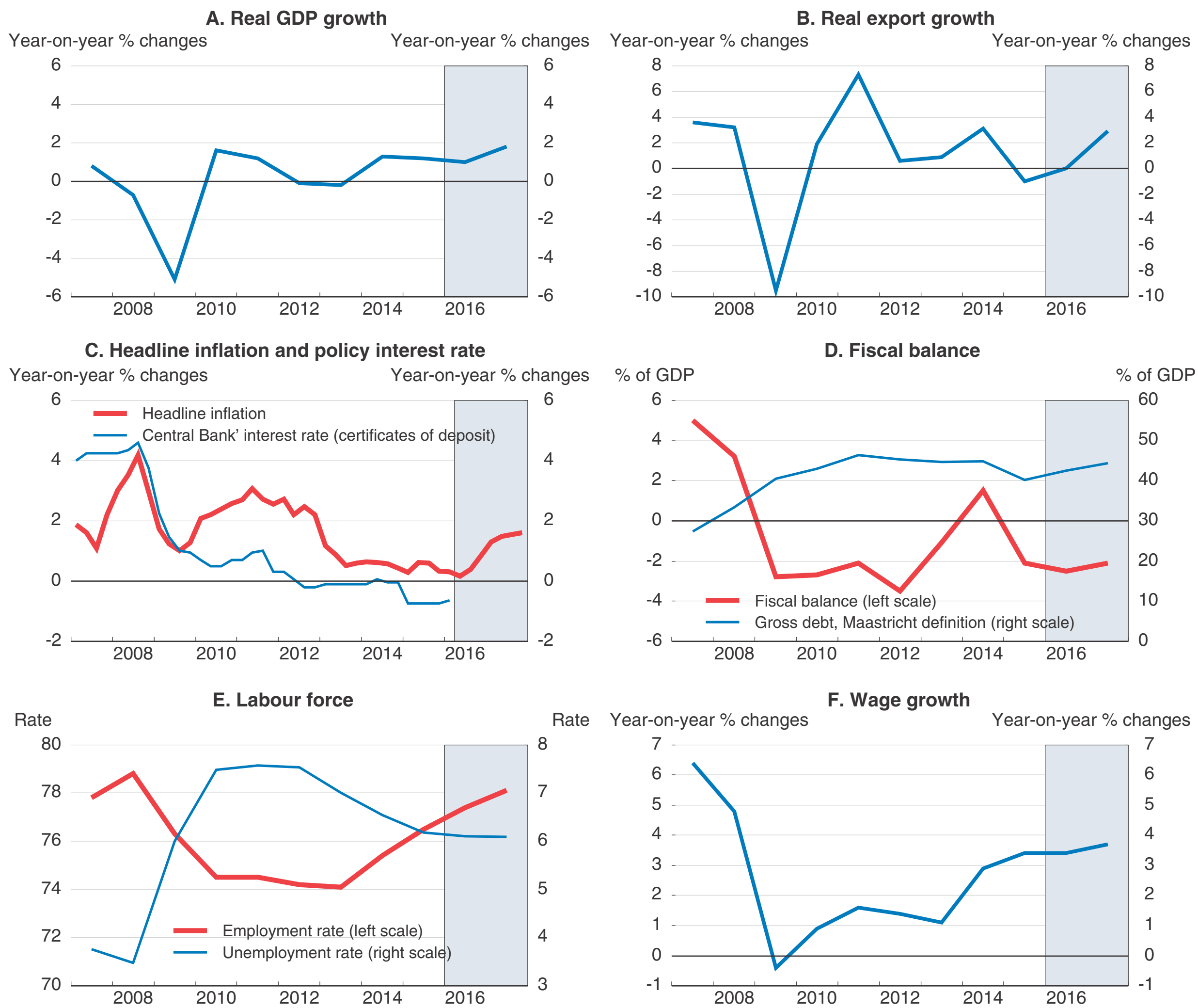
Annual percentage change unless specified otherwise, volumes at 2010 prices

	2012 billion DKK Current prices	2013	2014	2015	2016	2017
GDP	1 883	-0.2	1.3	1.2	1.0	1.8
Private consumption	909	-0.1	0.5	2.1	1.8	1.9
Government consumption	502	-0.7	0.2	0.6	0.3	0.6
Gross fixed capital formation	357	1.1	3.4	1.2	1.4	2.8
Of which: Housing	77	-1.1	3.1	-0.5	0.4	4.0
Business	210	2.4	2.1	2.6	2.3	3.4
Government	70	-0.4	7.4	-1.0	-0.1	-0.1
Final domestic demand	1 767	0.0	1.0	1.5	1.3	1.7
Stockbuilding[1]	13	-0.2	0.2	-0.3	0.2	0.0
Total domestic demand	1 780	-0.2	1.3	1.2	1.4	1.7
Exports of goods and services	1 009	0.9	3.1	-1.0	0.0	2.9
Imports of goods and services	906	1.1	3.3	-1.4	0.7	2.8
Net exports[1]	103	-0.1	0.1	0.1	-0.3	0.2
Other indicators (growth rates, unless specified):						
Potential GDP		0.6	0.7	0.8	0.8	0.8
Output gap[2]		-2.7	-2.1	-1.7	-1.5	-0.5
Employment		-0.0	1.0	1.4	1.2	0.9
Unemployment rate[3]		7.0	6.5	6.2	6.1	6.1
GDP deflator		1.4	0.8	1.0	1.1	1.6
Consumer price index		0.8	0.6	0.5	0.4	1.5
Core consumer price index (excluding food and energy)		1.2	0.9	1.3	1.0	1.4
Household saving ratio, gross[4]		1.2	-2.8	6.8	8.1	7.8
Current account balance[5]		7.1	7.7	7.0	7.1	7.2
General government fiscal balance[5]		-1.1	1.5	-2.1	-2.5	-2.1
General government gross debt[5] (Maastricht)		44.7	44.8	40.2	42.4	44.3
General government net debt[5]		4.0	4.9	5.5	7.8	9.6
Three-month money market rate, average		0.3	0.3	-0.1	-0.1	-0.1
Ten-year government bond yield, average		1.7	1.3	0.7	0.7	0.8

1. Contributions to changes in real GDP.
2. As a percentage of potential GDP.
3. As percentage of the labour force.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: OECD STEP 99 database.

Figure 4. **Recent macroeconomic developments**



Source: OECD STEP 99 database; Danmarks Nationalbank.

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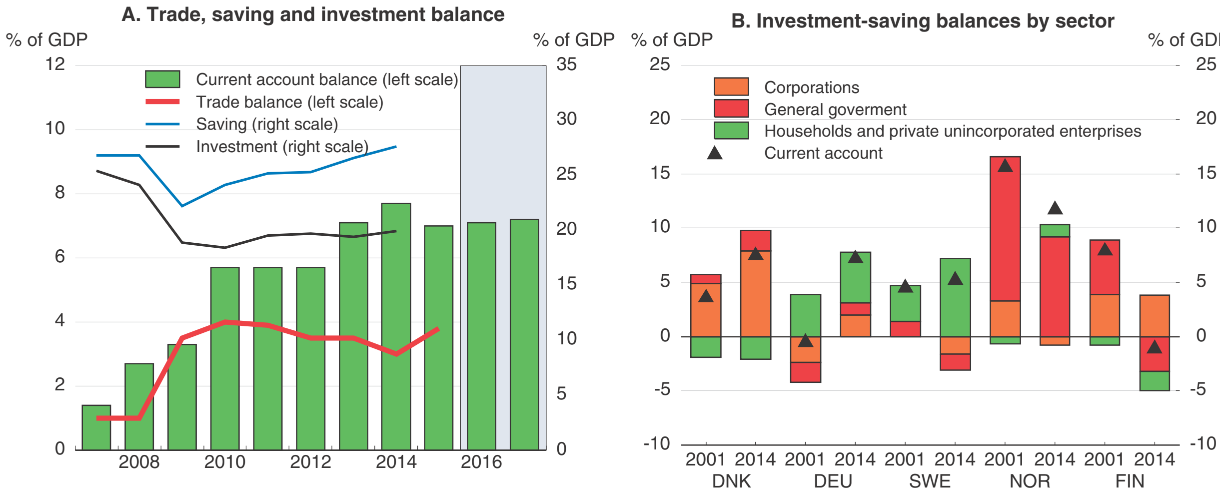
Economic growth is projected to be 1% in 2016 rising to just under 2% in 2017, when the economy will be close to full employment. Activity will be supported by a rise in investments and stronger world trade. Consumption is projected to pick up, but will be held back by the need for a further reduction in household debt. Given fiscal consolidation needs – of reducing the existing structural deficit to the target of at least balance by 2020 – growth of both public investment and consumption will be weak. Inflation is well below 1%, driven by falling energy prices and continued moderate wage growth. Nevertheless, core inflation started to edge up this year, albeit from a low level, and stood at 1% in 2015. The pick-up came from higher import prices, given the weak currency (Danmarks Nationalbank, 2015a). Inflation is projected to rise slightly towards the end of the projection period as the effects of falling oil prices fade and the labour market gradually tightens further.

The current account is hovering around an all-time high of 7-8% of GDP, with the balance for goods, services, and returns on investments contributing to the surplus (Figure 5). While to

Figure 5. **Current account at a historical high**



Source: OECD Economic Outlook database; OECD National Accounts database.

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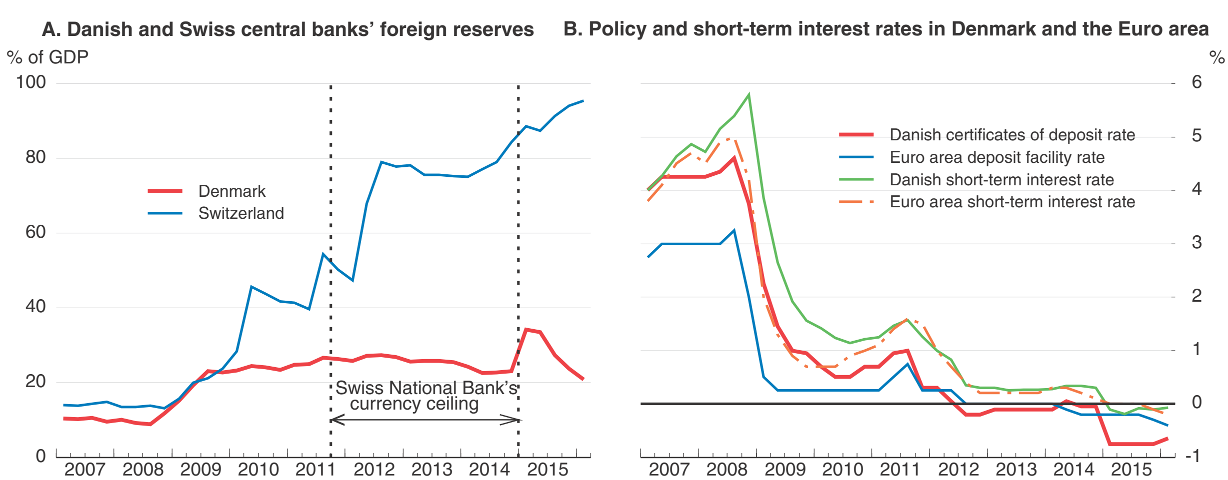
some extent this is a result of the cyclical position (due to low investment and consumption ratios), the underlying drivers are primarily linked to high gross private sector savings (largely in second pillar pensions) and positive returns on foreign assets. National estimates of the structural current account, i.e. when the output gap closes and consumption and investment normalise, is around 4-5% of GDP (Danmarks Nationalbank, 2015a).

Continued trade weakness linked to a slowdown in emerging markets, in particular in China, or disappointing growth in the euro area pose the main downside risks to exports. Financial market turbulence, be it global or regional, can have spill-over effects into the Danish economy, given the size and openness of the financial sector. Due to the safe haven status of the *krone*, there can be potentially substantial capital inflows, as experienced in early 2015, when the size of the central bank balance sheet exceeded 30% of GDP (Figure 6). On the

Figure 6. **Danish and Swiss central banks' foreign reserves**



Source: Danmarks Nationalbank; Swiss National Bank; European Central Bank.

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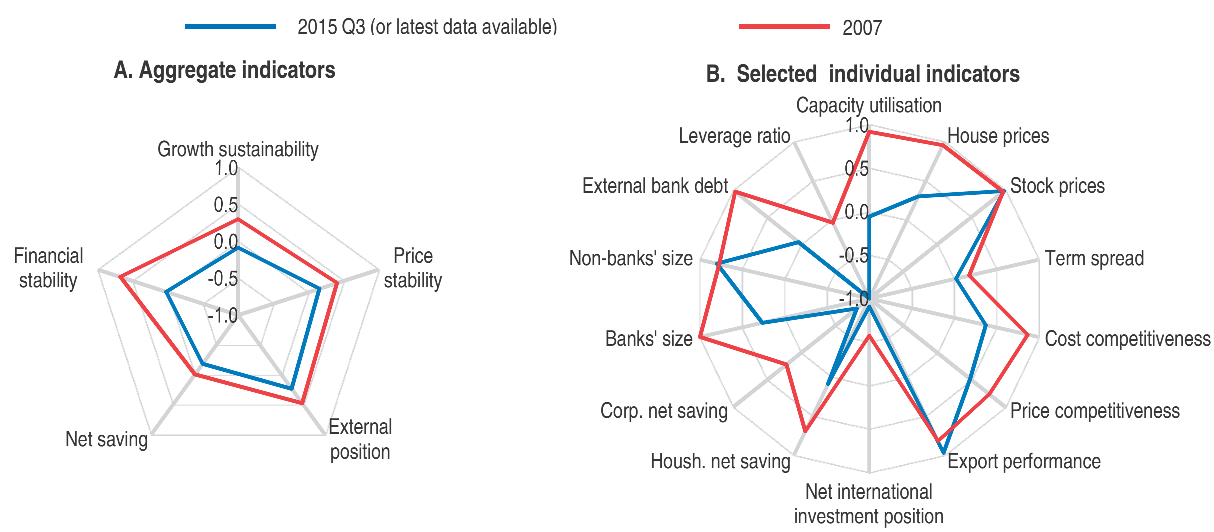
domestic side, stronger debt reduction among Danish households would weaken domestic demand in the short term, but would provide room for stronger consumption and investment later on. The very supportive monetary policy stance, and rising property prices, could boost domestic demand, but may also lead to another housing boom-bust cycle (Box 2). Indicators of macro-financial vulnerabilities have improved considerably since 2007 (Figure 7).

Box 2. **Shocks that might affect economic performance**

Vulnerability	Possible outcome
Decline of free movement of goods and labour in the EU	Denmark is a trading nation, and the EU is a destination for a large share of its exports, with Germany, the USA, the United Kingdom and Sweden being the most important trading partners. The imposition of any trade barriers would therefore have an impact. The reintroduction of identity checks at Schengen borders is already imposing an additional cost on cross-border activities.
Household indebtedness	Households are among the most indebted in the OECD, though they also hold very large pension assets. Most mortgages have variable interest rates, and interest-only periods are also common. Household exposure to rising interest rates, house-price fluctuations and losses in income are therefore of concern. A repeat of the 2005-08 housing cycle would again damage the economy.

Figure 7. **Potential macro-financial vulnerabilities have diminished**

Deviations of indicators from their real time long-term averages (0), with the highest deviations representing the greatest potential vulnerability (+1), and the lowest deviations representing the smallest potential vulnerability (-1)



Note: Each aggregate macro-financial vulnerability indicator is calculated by aggregating (simple average) normalised individual indicators. Growth sustainability includes: capacity utilisation of the manufacturing sector, total hours worked as a proportion of the working-age population (hours worked), difference between GDP growth and productivity growth (productivity gap), and an indicator combining the length and strength of expansion from the previous trough (growth duration). Price stability includes: the average of overall inflation and core inflation (consumer prices), the average of house prices-to-rent ratio and house prices-to-income ratio (house prices), stock market index for all Danish shares adjusted by nominal GDP (stock prices), and the difference between long-term and short-term government bond interest rates (term spread). External position includes: the average of unit labour cost (ULC) based real effective exchange rate (REER), and consumer price (CPI) based REER (cost competitiveness), relative prices of exported goods and services (price competitiveness), export performance and net international investment position (NIIP). Net saving includes: government, household and corporate net saving. Financial stability includes: banks' size as a percentage of GDP, non-banks' size as a percentage of GDP, external bank debt as percentage of GDP, and capital and reserves as a proportion of total liabilities (leverage ratio).

Source: OECD calculations based on OECD (2015), OECD Economic Outlook: Statistics and Projections (database), December and Thomson Reuters.

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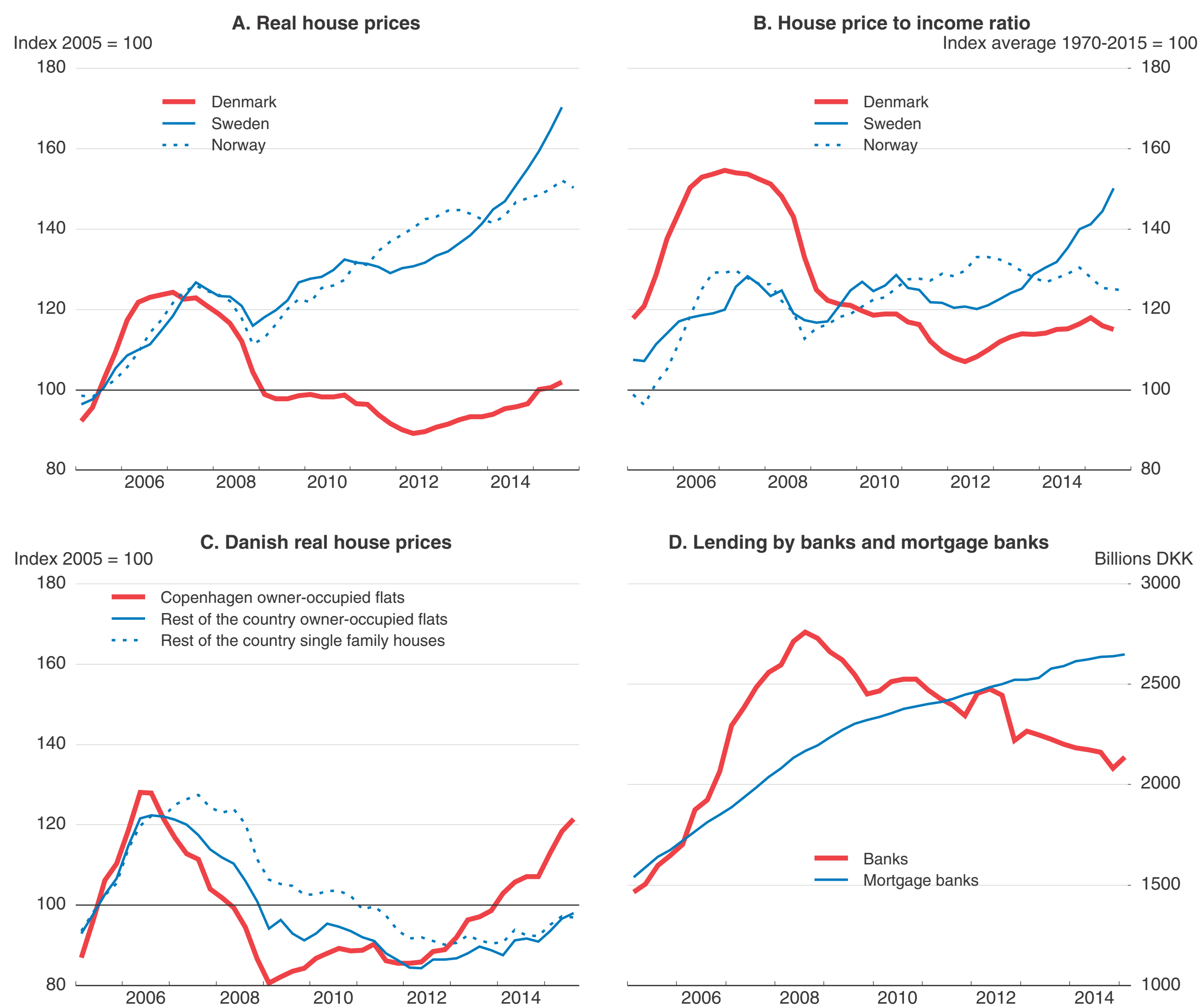
Monetary conditions are very accommodative

By and large, the monetary policy stance depends heavily on ECB's decisions and expectations of future developments of the euro area, since the Danish *krone* is pegged to the euro. Danish official interest rates have fallen below ECB rates to contain surges in demand for the *krone*. Supportive monetary policy in the euro area is expected to continue into 2017 and this may become too loose for the Danish economy, given the already currently small degree of slack in the labour market. Should monetary conditions become out of line with the Danish business cycle, other policies such as fiscal and macroprudential need to be stepped up. The economy is emerging from a housing boom-bust episode, during which the national average house prices fell by around 30% peak to trough, which amplified the effects of the global financial crisis (Danmarks Nationalbank, 2014). The housing market has now recovered, notwithstanding significant regional differences (Danmarks Nationalbank, 2015b). Indeed, owner-occupied flat and single family house prices in Copenhagen have been rising by around 10% a year since 2012 (Figure 8). As a result, while on aggregate house prices are

Figure 8. **Housing market is volatile and poses a risk**



Source: OECD Housing database; Statistics Denmark.

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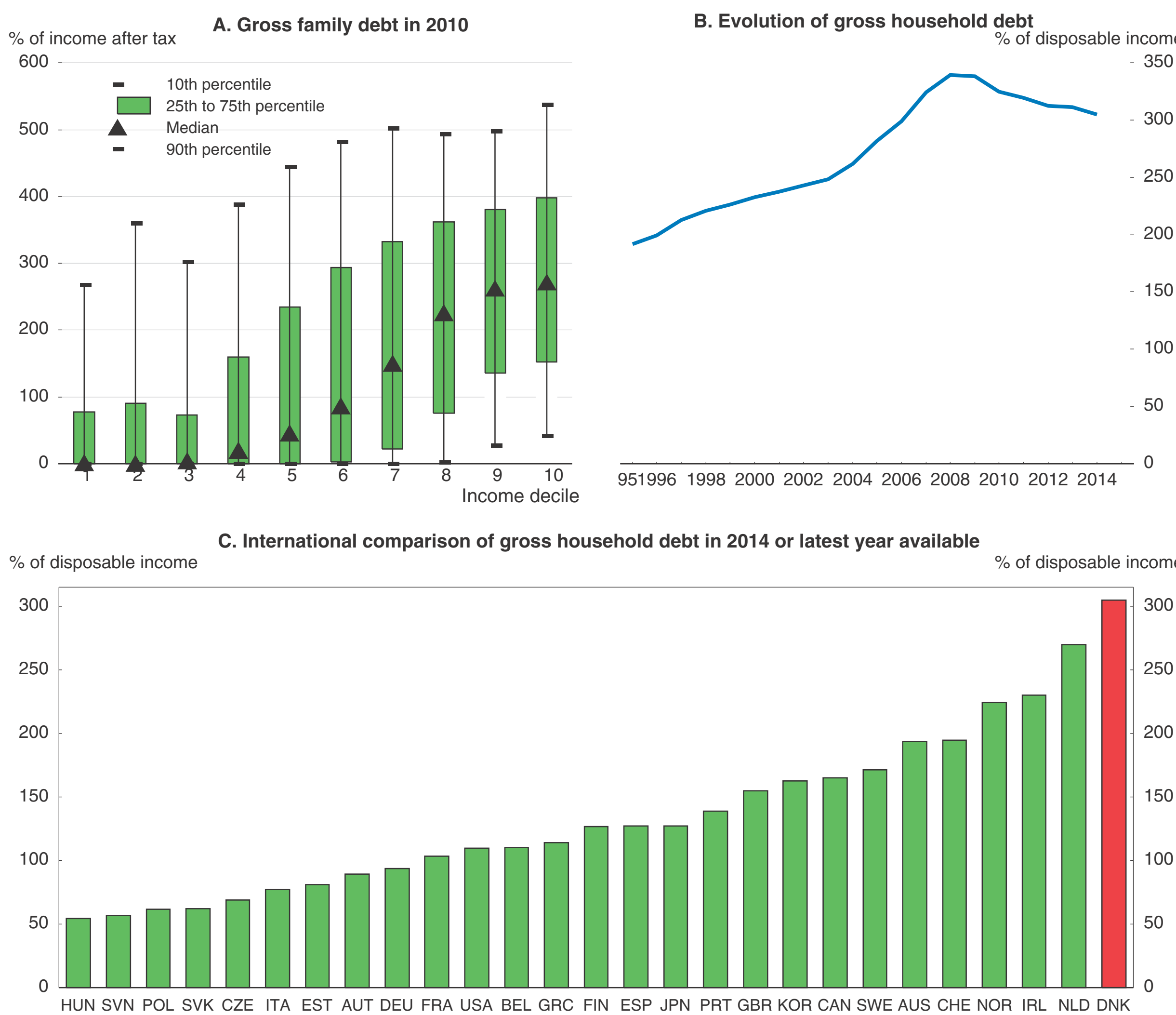
still well off their unsustainable peak, they seem set to continue to rise. The fact that the state of the housing market is currently robust means that now is an opportune time to put in place further measures to avoid a repeat of past boom and bust episodes.

Lending by mortgage credit institutions is strong, to a large extent replacing bank lending (see Figure 8, Panel D). Aggregate household debt stands at three times disposable income, one of the highest in the OECD, or 127% of GDP and the majority of it is in mortgages (Figure 9, Panel C). André (2016) shows that gross household debt rose markedly in most OECD countries since the mid-1990s and Denmark has been no exception. Danish households hold substantial assets too, notably in form of pension savings, but these are illiquid. A large share of debt is held by high-income households (Figure 9, Panel A), nevertheless, the most marked rise in debt over the past decade was among low-income households and the elderly (Andersen et al., 2012) exposing them to rate of return and interest rate risks. The mortgage debt structure has responded to these risks. While in the

Figure 9. **Household indebtedness is high and decreasing only marginally**



Source: Danmarks Nationalbank; OECD Analytical database.

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past, households traditionally held fixed-rate debt, at the end of 2014, two thirds of the outstanding loans had a variable rate, over a half a period of interest-only payments, and over 40% a combination of both (Kuchler, 2015). More recently mortgage holders have been gradually moving into less variable contract forms. However, the sensitivity of households to interest rate increases and house price developments remains substantial.

Some 5% of families with at least one mortgage had a total debt-service-to-income ratio (DSTIR) of 40% or more (Ministry of Business and Growth, 2016). As interest rates rise, households will experience rising debt servicing costs. Estimates of Andersen et al. (2015) and Danmarks Nationalbank (2015a) show that indebtedness of households would not pose a threat to the stability of the financial sector in a scenario of increased interest rates. However, there will be consequences for household consumption and wider macroeconomic prospects, if mortgage holders' incomes and purchasing power get squeezed.

The Systemic Risk Council (a body tasked with macro-prudential oversight, chaired by the central bank governor and reporting to the Minister of Business and Growth) sees possible risks from the current low interest rate environment, but does not at present judge it to be necessary to employ the counter-cyclical buffer, which is set at 0%, since the credit volume is low relative to GDP, and credit growth is below its long term trend (Systemic Risk Council, 2015). Sweden and Norway have raised their counter-cyclical buffers to between 1-2% and are scheduled to raise them further next year, but property prices in these countries are rising significantly faster than in Denmark.

Differentiated loan-to-value (LTV) ratios have been applied for some time (80% for residential properties, 70% for agricultural land, 60% for commercial properties and secondary residences and 40% for plots of land). However, although mortgage issuing banks respect the ratios, usually a regular bank loan covers part of the down-payment. A requirement for a down-payment of at least 5% of the house value has been in place since November 2015, as part of consumer protection legislation, though it can be disregarded in justified individual cases. The financial industry has been using a DSTIR check by ensuring that clients can afford an equivalent amortised mortgage with a 30-year fixed rate. Moreover, by regulation a mortgage bank's high LTV and deferred amortisation mortgages are now limited to 10% of its mortgage portfolio and credit policy regulations, such as requiring actual positive liquidity of commercial borrowers, have been tightened somewhat.

The Financial Supervision Authority has at the beginning of the year introduced "7 *best practices*" for granting owner-occupied mortgages in Copenhagen and Aarhus, which have seen the largest house price increases. These include for instance a recommendation that borrowers with high debt-to-income ratios above 5 should have positive net wealth even if property prices were to fall by 25%, and verifying that borrowers with two mortgaged properties can service the debt on both for a minimum of one year. Such sound practices for hotspot areas should be extended nationwide and modified where appropriate. Moreover, to protect households from taking on excessive leverage, in particular were house prices to boom again, the application of a DSTIR should be further strengthened and consideration should be given to impose specific limits. Also, general interest rate deductibility should be further curbed in order to ensure tax neutrality across different asset classes.

A number of policies exacerbate housing market volatility. Firstly, the property tax is fixed in nominal terms, which means that its effective rate is inversely related to house prices and to that extent fails to dampen house price fluctuations (see below and Figure 11). Secondly, the rental market is strictly regulated, notably in Copenhagen.

Historically, mortgage interest rate deductibility was significant, although it will fall – from currently 33% to 25% of interest expenses – in 2019 (for annual interest rate expenditures above EUR 6 700).

Some 20% of the housing stock is for private rent (Salvi Del Pero et al., 2016, *forthcoming*), but as noted in previous *Surveys,* rent increases are heavily regulated (OECD, 2006). There is flexibility for rent increases for dwellings built after 1991, but these represent only around a fifth of the private rental market. Rent flexibility could be increased for instance by allowing more scope for comparisons of flats when determining similar rents and lowering an investment threshold that the landlord needs to spend on upgrading the property to justify a rent rise.

Easing rent regulation, while striking a balance between landlord and tenant protection, would raise rents in the short term but stimulate more supply of rental dwellings. Experience from other countries confirms that development of a bigger private rental market needs a comprehensive reform package which includes rent regulation, tenant protection and fiscal neutrality (de Boer and Bitetti, 2014), while social concerns are best addressed via means-tested benefits. A large social housing sector is already available (about 20% of the housing stock) albeit with long waiting lists. A rental market commission should be set up, to look into the incentives for developing a bigger private rental market.

The financial sector is large

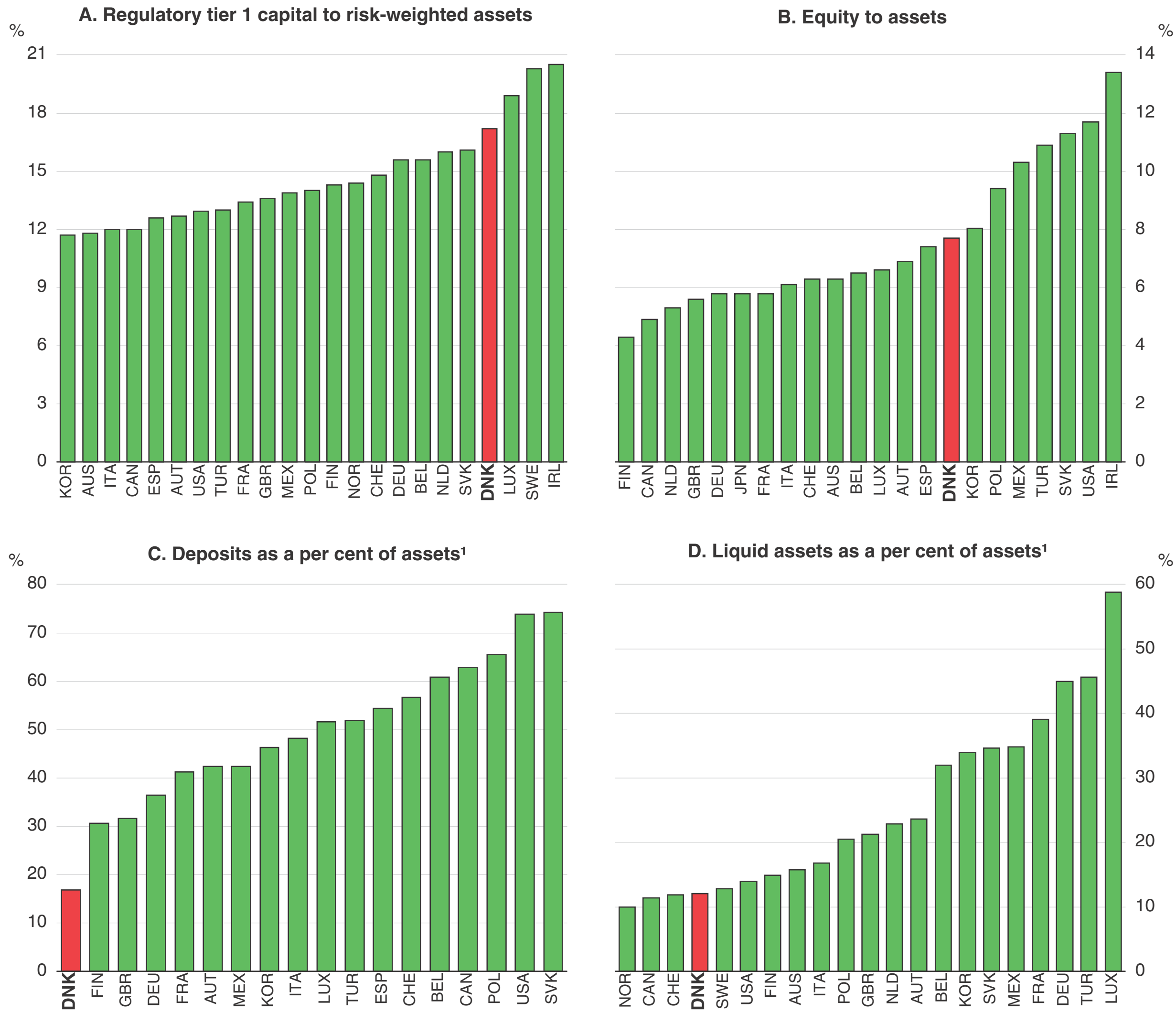
The Danish financial sector holds assets of over 500% of GDP and is highly interconnected. Two thirds of the assets are in the banking sector (Figure 10). Most of the sector has recovered from the global financial crisis and is well prepared for upcoming tightening of capital requirements, such as Basel III/ CRD IV (Danmarks Nationalbank, 2015b). There are six systemically important groups and the central bank carries out regular stress testing of the banking sector. The most recent vintage of these tests (Summer 2015) shows that all SIFIs have a considerable excess of capital adequacy in all test scenarios, while some non-systemic banks would have a small capital shortfall (0.3% of total risk weighted exposure) in the most severe scenario. Capitalisation of smaller banks is improving, though they continue to have elevated non-performing loans to agriculture. Nevertheless they should be able to fulfil tighter regulatory requirements (Danmarks Nationalbank, 2015b).

In response to the central bank's rate cut at the beginning of 2015, market rates plunged even further into negative territory. Yet, there hasn't been any major change in the earnings and risk appetite of banks as compared to recent years of low but marginally positive rates and only a small share of total deposits earns actually a negative interest rate (Danmarks Nationalbank, 2015a). The income from fees has been on the rise, compensating the lower net interest income. In the insurance and pensions sector, the very low interest rates are more of a challenge, in particular given that a majority of products carry guaranteed average rates of return. The insurance industry itself has been pushing towards non-guaranteed products, in particular during recent years, including in existing contracts.

The financial system is interconnected through mortgage bonds and this means that ensuring liquidity and health of this market is crucial (IMF, 2014). Mortgage bonds are issued by mortgage credit institutions to finance mortgage loans and their current stock is of a size of around 100% GDP. Some 80% of these are held by domestic investors, often

Figure 10. **The financial sector is well capitalised**

2015 or latest year available



1. A significant share of the financial sector is formed by the mortgage credit institutions that by design do not take deposits. This affects the DNK ranking in Panels C and D.

Source: IMF, Financial Soundness Indicators database.

StatLink http://dx.doi.org/10.1787/888933352317

banks, pension funds and the insurance sector, where they represent a significant asset share. On average, 40% of the assets of pension and insurance companies are invested in domestic bonds, the overwhelming majority of which are covered bonds. The Systemic Risk Council has commissioned an analysis into the issue of interconnectedness. Covered bonds are of high quality and liquidity, backed by a strong legal and regulatory framework, and earned considerable praise over the years (Campbell, 2012; IMF, 2014). Yet, the recent reliance on short-term bonds to finance floating rate loans has introduced a major maturity mismatch into the system (IMF, 2014). To reduce the risk of a failed re-financing case, legislation is now in place that automatically prolongs financing by a year in case of interest rate increases of more than 5 percentage points (OECD, 2014a). Also, banks are increasingly spreading out re-financing through the year. Still, wide-spread use of variable-rate mortgage bonds warrants close monitoring.

Fiscal policy is sustainable but could let automatic stabilisers work more freely

Fiscal policy played an important role in stabilising the economy in the downturn (see Figure 4, Panel D). With the economy picking up, it is expected to move to a more neutral stance, though the exact assessment of the cyclically adjusted fiscal position is clouded by uncertainty of estimates of the output gap since the crisis (Ollivaud and Turner, 2014). Continued very low interest rates in the euro area, and the peg of the *krone* to the euro, argue for a cautious fiscal stance.

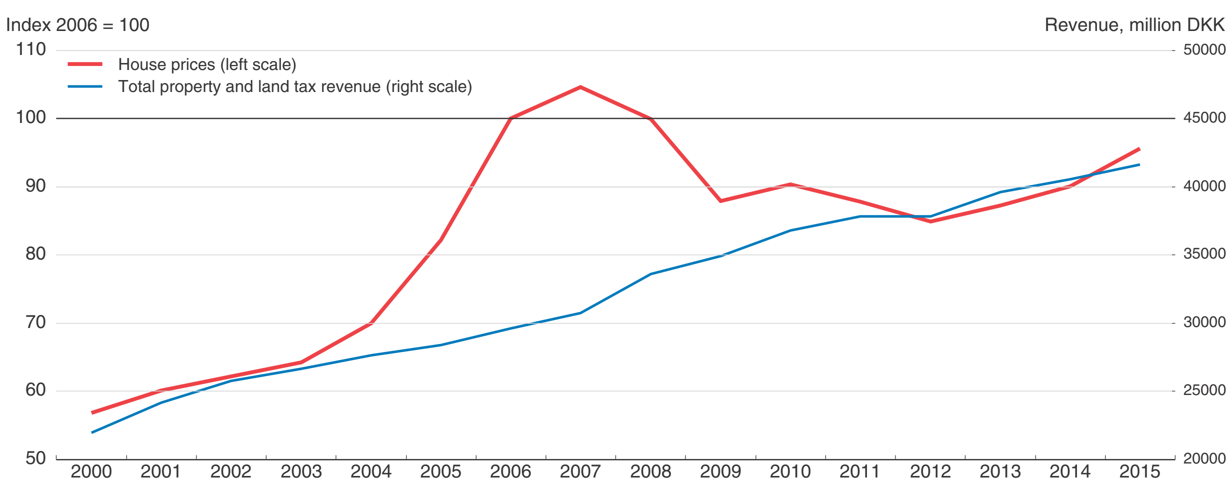
The 2016 budget maintains a broadly expansionary fiscal stance and according to national estimates fiscal policy is projected to gradually tighten towards balance in 2020 (Ministry of Finance, 2015), in line with the projected gradual closing of the output gap. Some taxes (NO_x tax, land tax, car-purchase tax) are being lowered or capped this year and spending priorities are on healthcare for the elderly and security. Additional expenditures to cover an increased in-flow of immigrants (estimated at around DKK 2 bn., or 0.1% GDP) are being met by decreasing overseas foreign aid and cuts in R&D spending. The actual fiscal balance is expected to remain within the 3% of GDP benchmark, and is supposed to be reduced gradually in coming years. In recent years, the fiscal balance has been influenced by large one offs, particularly revenue from a change in capital pension taxation.

Reducing mortgage and overall interest rate deductibility and restoring immovable property taxation would help to establish tax neutrality at higher effective rates and improve budgetary space, act as automatic stabiliser on the housing market, and help growth as property-based taxes tend to be less distortionary than other taxation (Arnold, 2008). Taxes on immovable residential and commercial property have been effectively capped since 2001 and the valuation of properties was updated on a two year cycle. Currently, the tax is collected on the basis on 2011 valuations and a new valuation system is planned for 2018.

A medium term target of a balanced budget (both headline and structural) by 2020 should be achieved given the projected continued upturn of the economy. Recently introduced expenditure ceilings on public consumption and non-cyclical transfers should ensure that

Figure 11. **Property taxation does not fluctuate with house prices**

Recurrent taxes on business and residential immovable property and land, and house price developments



Source: Statistics Denmark.

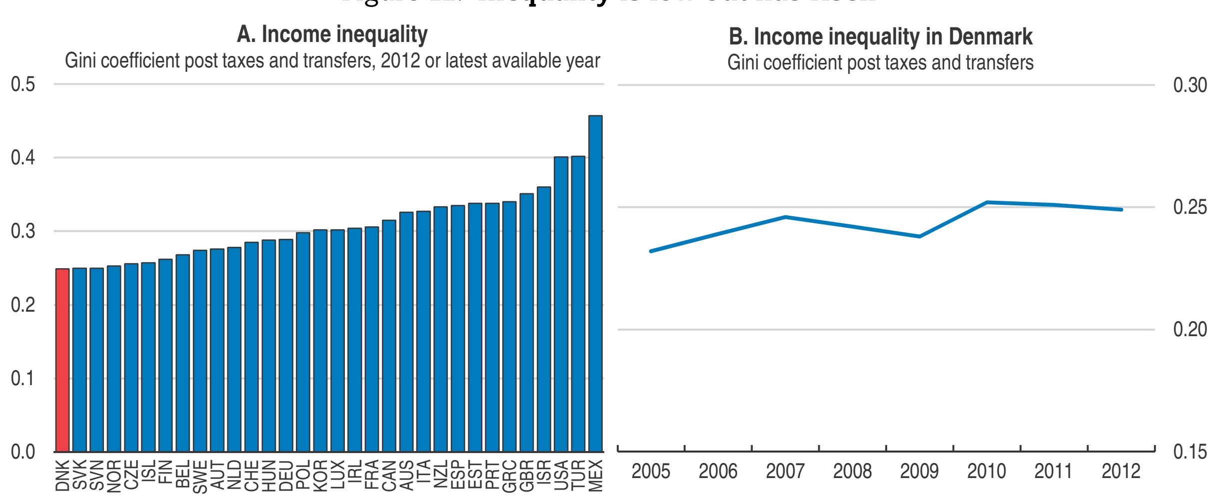
StatLink http://dx.doi.org/10.1787/888933352329

overall targets for fiscal policy are met. The ceilings are adopted by Parliament every four years and set legally binding limits for the expenditures in central government, municipalities and regions. General government debt stands at 40% of GDP, largely at the lower end of EU or OECD member countries. In the long term, public finances seem sustainable (OECD, 2014a, European Commission, 2015a). An occupational funded pensions system introduced back in the 1980s plays an important role in alleviating the fiscal burden of ageing and a number of structural reforms have been implemented to improve fiscal sustainability, such as increasing retirement age, limiting early retirement and inflows into disability benefits. Nevertheless, social spending remains elevated while the revenue base is weakening (see below). The following sections look at how to maintain growth inclusive by keeping labour force participation high and what can be done to increase the cost-effectiveness of social protection.

Balancing inclusiveness, work incentives and sustainability in an ageing society

Household income is distributed fairly equally in Denmark (Figure 12). The Gini coefficient is the lowest among OECD countries: 24.9 in 2012, well below the OECD average of 31.5. The share of population living on less than 50% of the median disposable income is only 6%, compared to the OECD average of 12%. Also, equality of opportunities, measured for instance as intergenerational social mobility, is good (Causa et al., 2009). Inclusiveness features high on the policy agenda, in part because inequality has grown in recent years. While GDP growth was shared equally across the income distribution during the period from the mid-1980s to mid-2000s, disposable incomes of the most vulnerable declined marginally in the period including the recent downturn, but continued to grow for those in the upper half of the distribution (Causa et al., 2016 *forthcoming*). This change can be attributed to a combination of: skills-biased technological change, which leads globally to wider wage dispersion (Braconier and Ruiz-Valenzuela, 2014); domestic reforms to enhance growth, which reduced the high degree of social protection somewhat; an increasing number of single-headed households (OECD, 2011) and higher capital income of the more affluent households (Ministry of Economic Affairs and the Interior, 2015).

Figure 12. **Inequality is low but has risen**

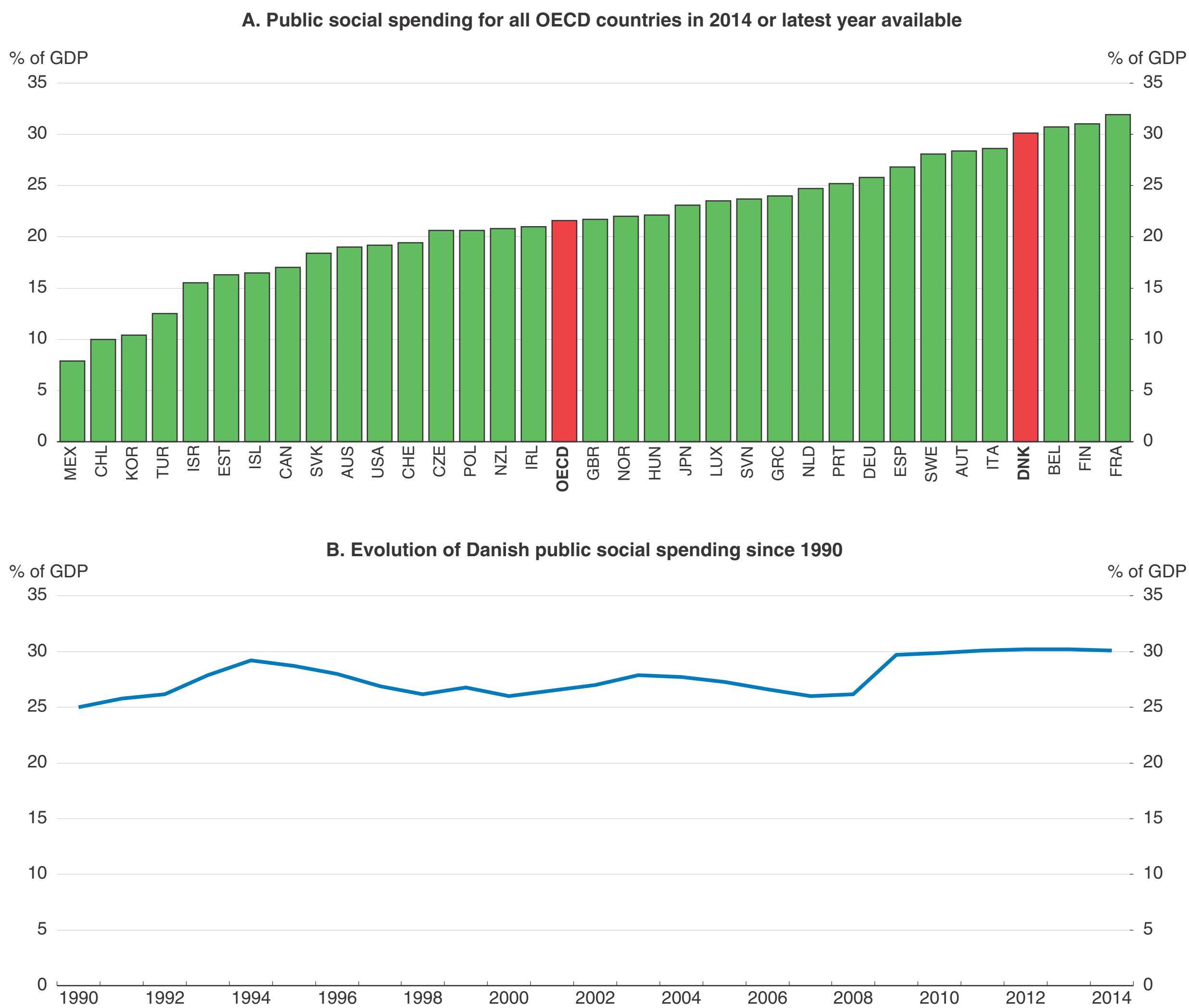


Note: The Gini coefficient is a common measure of income inequality that scores 0 when everybody has identical incomes and 1 when all the income goes to only one person. In Panel B, data prior to 2011 are based on a former income definition.
Source: OECD Income Distribution and Poverty database.

StatLink http://dx.doi.org/10.1787/888933352338

The cost of social institutions (i.e. pension, healthcare, unemployment and social assistance schemes) – among the highest in the OECD – remains elevated. Labour market participation – the core of the Danish *"flexicurity"* system (Box 3) – is high by international standards but has not risen With population ageing and a growing number of benefit recipients detached from the labour market, social institutions are coming under increasing strain (Figure 13). Furthermore, especially for vulnerable groups on the labour market well-being remains limited if based on benefits alone (Burton and Waddell, 2006). To increase economic potential and improve the sustainability of the system to support and increase the well-being of the population the authorities passed important reforms in recent years. Nevertheless, additional measures could widen the contribution base of the welfare system and improve the efficiency of public services in order to maintain the quantity and quality of services expected and requested by the population.

Figure 13. **Social spending is high and has increased**



Source: OECD Social Expenditure database.

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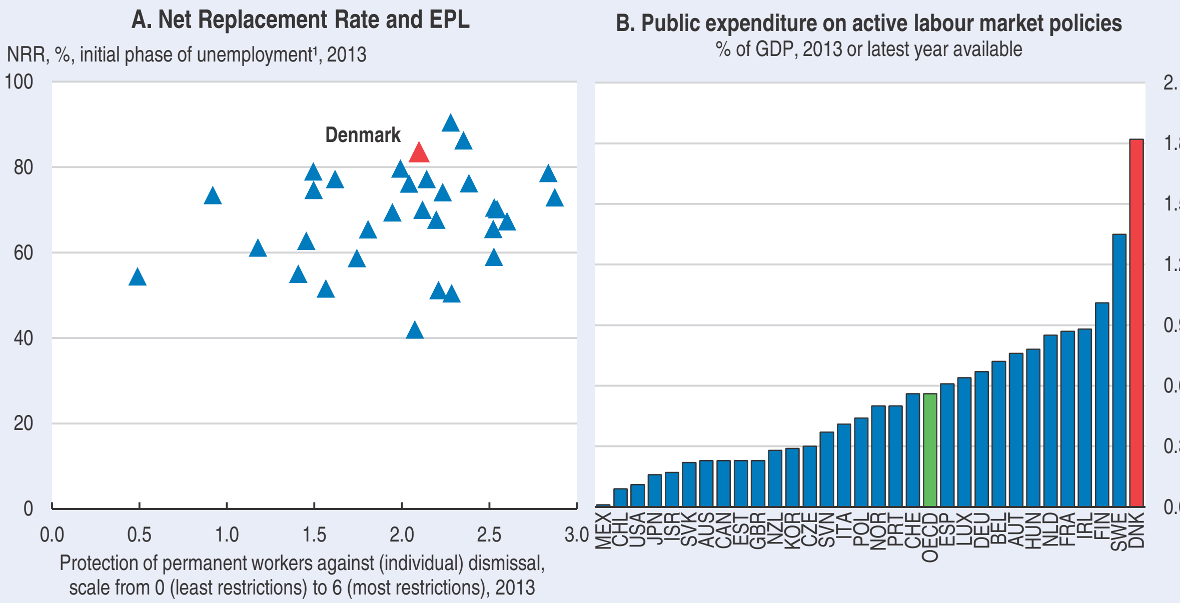
Box 3. The *flexicurity* labour market model

The Danish *flexicurity* model is characterised by three core elements: flexible rules for hiring and dismissals, generous replacement rates of unemployment insurance benefits (Figure 14, Panel A), and substantial spending on active labour market policies (Figure 14, Panel B). Furthermore, the labour market is largely organised by social partners, through broad based collective agreements (around 80% of the labour market is unionised). There is little national law on labour issues such as minimum wages, working hours and holidays as these are mainly covered by collective agreements. The term (*flexicurity*) was introduced in 1995 in relation to Dutch labour market reforms (Bekker and Wilthagen, 2008), but the decentralised planning of the labour market combined with a generous benefit system and flexibility in hiring and firing has a long history in Denmark.

Figure 14. The core elements of the *flexicurity* model



1. Simple average of the net replacement rates for the following households situations: single with no child and with two children at 67% and 100% of Average Wage (AW), one-earner married couple with no child and with two children at 67% of AW and 100% of AW. After tax and including unemployment and family benefits. Social assistance and other means-tested benefits are assumed to be available subject to relevant income conditions. Housing costs are assumed equal to 20% of AW.

Source: OECD/IAB Employment Protection database, 2013 update; OECD, Tax-Benefit Models; OECD database on Labour Market Programmes.

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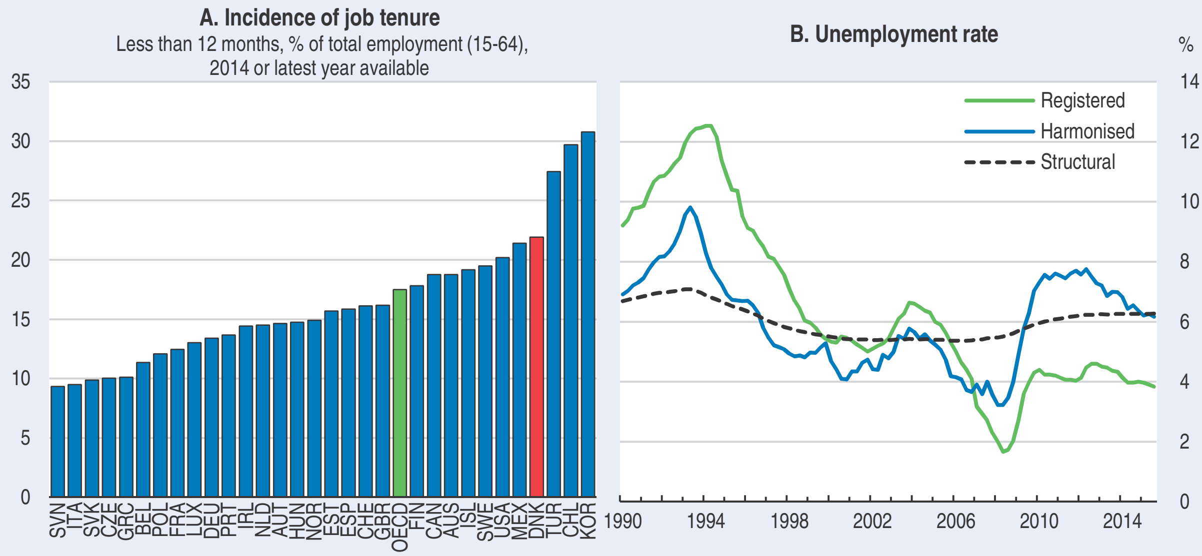
The *flexicurity* model in its current form was largely developed through the 1990s. A substantial decrease in the duration of unemployment benefits and a much stronger emphasis on active labour market policies was done to promote return to work through upskilling and to ensure that the unemployed are available to the labour market. Together with a prolonged economic boom, these adjustments are seen as a major driver of the decrease in structural, and actual unemployment since the mid-1990's, particularly in terms of register based unemployment (Figure 15, Panel B) (Unemployment Benefit Commission 2015).

The main advantage of *flexicurity* is that it limits the financial risk to both employers and employees. The high degree of flexibility allows companies to make quick adjustments to their work force in the different phases of the business cycle, and in hiring inexperienced youth. At the same time, the high unemployment replacement rate limits the risk for employees when taking up a new job, and allows for consumption smoothing in case of joblessness. This is a main driver behind the high rate of job turnover in the Danish labour market compared to other OECD countries (Figure 15, Panel A). Also, there seems to be a better matching between employers and employees, resulting in low skills mismatch.

Box 3. **The *flexicurity* labour market model** *(cont.)*

Figure 15. ***Flexicurity* supports high turnover rates and low structural unemployment**



Source: OECD Online Employment database: *www.oecd.org/employment/database*; OECD STEP 99 database; OECD Main Economic Indicators database.

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The *flexicurity* model has earned much praise, in part thanks to good performance in the two decades leading up to the global crisis. Early assessment of its performance during the downturn also points to robust outcomes (Eriksson, 2012). Unemployment rose quickly as a response to the crisis, more than doubling from mid-2008 to mid-2009, and reached almost 8% (harmonised) in 2012, and has been falling since then to the current 6% (Figure 15, Panel B). At the same time, there has been only. a small increase in structural unemployment in the wake of the downturn.

The Danish *flexicurity* system is nevertheless expensive. Both through the high replacement rate of unemployment benefits and the high level of spending on active labour market policies – the highest in the OECD.

Making growth more inclusive – eliminating barriers to work

As a result of past reforms (Box 4), incentives to work have been strengthened and the total number of benefit recipients has declined since 2010. However, the number of social assistance recipients (so-called cash benefit recipients) has increased after the duration of unemployment benefits was reduced, suggesting that a number of those no longer entitled to other benefits who were not able to find a job, fell into the social safety-net (Figure 16, Panel A). Bringing more benefit recipients back to work would improve their living standards and increase fiscal space. The recently introduced cap on cash benefits (except child allowances and housing benefits) aims at that. Like in most other OECD countries low-skilled workers, migrants and disabled persons encounter specific barriers to employment and are over-represented among long-term benefit recipients. When setting priorities, the assessment of the lifetime pattern of benefit recipients and their overall costs to the welfare system, should be formally implemented, as is done in New Zealand and published regularly (Taylor and Fry, 2013). The new reimbursement model (see Box 4) increases the municipalities' incentive to focus on the overall costs of benefit recipients.

Box 4. **Recent reforms of social institutions**

Unemployment insurance (UI) and cash benefits

- In 2016, a cap on the total amount of social benefits a household can receive has been introduced (depending on the number of children and the marital status). Furthermore, new eligibility criteria require at least seven years of within country residence in Denmark over past eight years, as well as 225 hours of work within a year. Benefit recipients that do not meet these conditions receive lower cash benefits.
- The cash benefits have been reduced to the level of the education grant for those under 30. Recipients under 30 who are not ready for education or employment can receive an activity supplement. In addition to the reduced benefits, education and employment efforts are initiated sooner; youth without qualification (40% of those receiving social assistance) has to undertake education; for those with education, activation measures, including longer vocational traineeships, are offered earlier and monitoring of job search is strengthened.
- The 2010 reform of the unemployment insurance benefit system reduced the maximum benefit duration from four to two years and increased the re-eligibility requirements for those expiring the full UI period. The 2015 revision of the reform allows an extension of the unemployment benefit from 2 years to a maximum of 3 years if the benefit recipient has worked sufficiently, which earns him/her additional eligibility (for a day of work, two days of benefit entitlements are acquired). The possibility of an extra year of benefits is largely financed by a reduction in the unemployment benefit level for graduates. Waiting days (without benefits) are introduced after periods, where the claimant has had high unemployment, but the waiting day can be avoided if the claimants meet a certain employment requirement. Temporary measures introduced in recent years for those who lost their benefits under the 2010 reform will be phased out by 2017.

Active labour market policies

- The 2014 reform of public employment strengthened screening of and individual services to job seekers. As of January 2016, a new model for the reimbursements of the municipalities from the central government covering part of municipal expenses for income transfers should give local authorities incentives to speed up return to work or education of benefit recipients. Reimbursements of municipalities will be determined by the length of the benefit period, rather than the type of benefit.

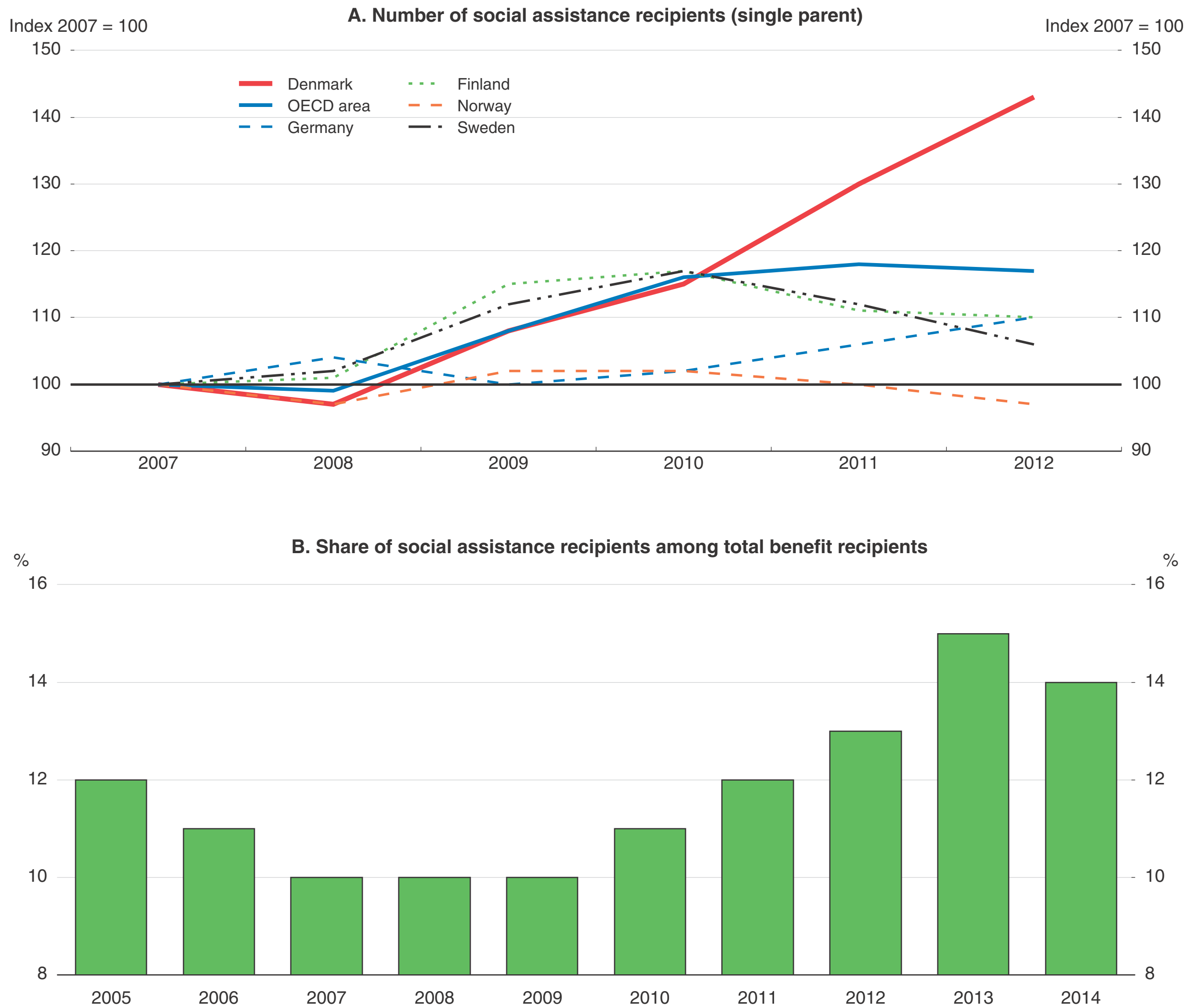
Disability and sickness benefits

- In 2013 a reform introduced a number of changes. Persons over the age of 40 must participate in at least one so called rehabilitation programme before being granted a disability benefit. The rehabilitation programme involves coordinated health, social and employment services and aims at strengthening the individual work capacity. Applicants under the age of 40 can by default not be granted disability benefit and must instead participate in one or more rehabilitation programmes. Exemptions are granted for persons with absolutely no chance of improving their work capacity. Also, 'flex jobs', i.e. subsidised jobs offered to people with reduced working capacity, have been made more targeted to those with low work capacity, more flexible in terms of time arrangement and granted for 5 years maximum (except for persons over 40, who may be allowed to have a permanent flex job).
- Since July 2014, the assessment of eligibility for a prolonged sickness leave takes place every 22 weeks (instead of 52 weeks). Depending on the assessment of work capacity and its development rehabilitation benefits (lower than sickness benefits) are allocated to those having difficulties to find a job after having exhausted their rights to the sickness benefit.

Pension

- The 2006 and 2011 pension reforms aim to gradually increase the statutory retirement age. In November 2015, the Parliament approved an increase of the statutory retirement age from currently 65 to 67 in 2022, and to 68 years in 2030. From then on, conditional on a vote of Parliament, the retirement age will be adjusted to life expectancy gains every five years (at most by one year) in order to limit the number of years in retirement to 14.5 years on average. The duration of voluntary early retirement programmes is also progressively shortened from five to three years with the minimum age being raised in line with the statutory retirement age.

Figure 16. **The number of social assistance recipients has risen since the crisis**



Source: OECD SOCR database; Danish Ministry of Finance.

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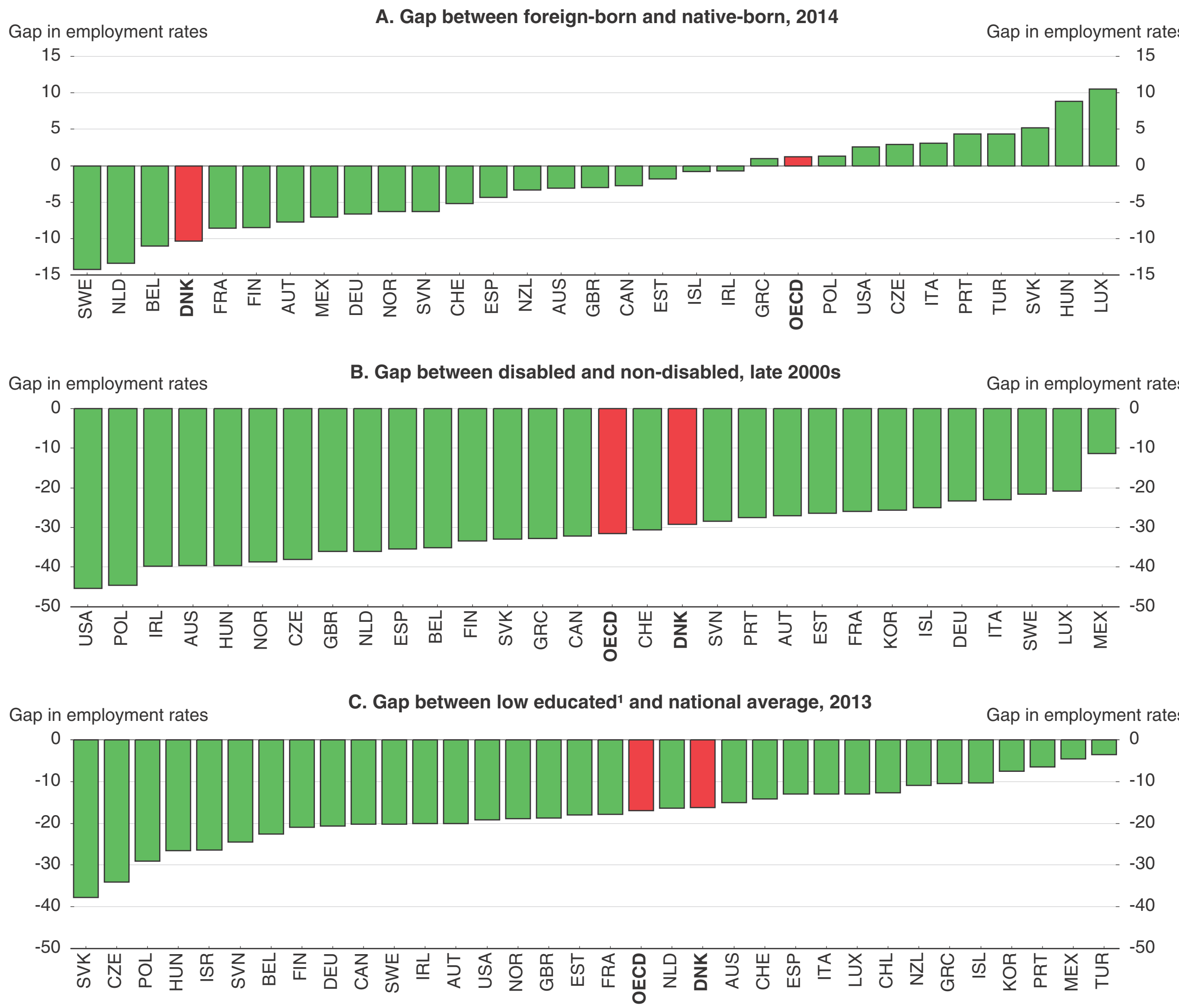
Balancing protection and work incentives for low-income earners

Finding a balance between high coverage, generosity of the welfare system and work incentives is challenging and the *flexicurity* system is a successful attempt to achieve this balance (see Box 3). Nevertheless, inactivity traps, resulting mainly from social assistance benefits and means-testing (of e.g. housing and child care subsidies), remain a major concern. The after tax income gain of taking up a low-paid or a part-time job is low. For instance, this results in marginal effective tax rate of 87% for those on social assistance and 84% average effective tax rate for a single parent when taking up a job paying 67% of the average wage that is the standard national level used, since it corresponds largely to the level of the common minimum wage. At half of the average wage the effective marginal tax rates are at around 100%.

Introducing in-work benefits targeted at low-paid workers and withdrawing benefits more gradually would make work more attractive, in particular for those who take up a

Figure 17. **Scope for increasing employment is particularly high among immigrants**

Gap in employment rate in percentage points



1. Low educated are those with less than upper secondary education.

Source: OECD *Employment Outlook 2015*; OECD (2010), Sickness, Disability and Work: Breaking the Barriers; Eurostat database; OECD (2015) *Education at a Glance*.

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low-paid job, by increasing the difference between the take-home pay and the alternative of social benefits. For instance, a plan of the previous government to introduce a monthly bonus (around EUR 225) for a restricted group of long-term unemployed would have benefited some of the most vulnerable. Reforms of in work benefits to make work pay have been introduced in recent years in Sweden and the United Kingdom. To reinforce weak incentives for job search, unemployment insurance benefits should be reduced gradually with the length of the unemployment spell (Immervoll, 2012). Reducing benefit levels can increase income inequality by disproportionately affecting those with more frequent and longer spells of unemployment (Causa et al., 2016, *forthcoming*). It can also decrease incentives for membership in the insurance scheme, which is voluntary, and thereby reduce coverage. Easing the requirements for benefit recipients to re-earn benefit rights, which was introduced in the 2015 reform, can mitigate these side effects, by making it more attractive to take up short term employment. Furthermore, the reforms have introduced recurrent days without benefits in case of unemployment for more than 4 months. The days without benefits will not take effect if the person has at least 20 days of full time employment in the preceding 4 months.

Another option is to reduce social assistance while providing top-up payments when working. This was done in Germany, where the *Hartz* reforms significantly lowered benefits, introduced top-up subsistence payments for those in low-paid jobs, and improved job placement services, (Huefner and Klein, 2012). Additional measures supporting income mobility, including upskilling programmes, would usefully supplement such reform by reducing the risk of poverty among those with low employability and avoiding that they become stuck in low-paid and precarious jobs (OECD, 2014b). Admittedly, Denmark already has one of the highest spending on active labour market policies. Past *Surveys* have pointed to the need to improve the efficiency of active labour market policies by ensuring that municipalities have the right financial incentives to motivate the unemployed to take up a job, and by increasing the quality of adult learning. The 2014 reform of public employment services and the new model for reimbursements to municipalities goes in this direction (see Box 4).

Promoting work and income security for disabled people

The share of the working age population receiving disability benefits is above the OECD average (6.5% of the working age population in 2012). Integration of the disabled into the labour market has not improved significantly since the early 2000s, and there is a substantial gap in the employment rate between people with and without disability, which is considerably higher than for instance in Sweden (see Figure 17, Panel B). Entitlement to permanent disability benefits has been restricted in order to better target recipients and to avoid inactivity traps, and new activation programmes involving multidisciplinary rehabilitation teams are being implemented (see Box 4). Inflows into the disability pension scheme have started to decrease as the reform is applied for new applicants. Scope for further adjustment includes removing the arbitrary age limit (of 40 years old) for granting a permanent disability and regularly reassessing eligibility for benefits. In addition, emphasis should be put on prevention of diseases and raising employers' awareness of disabled people's capacity to work.

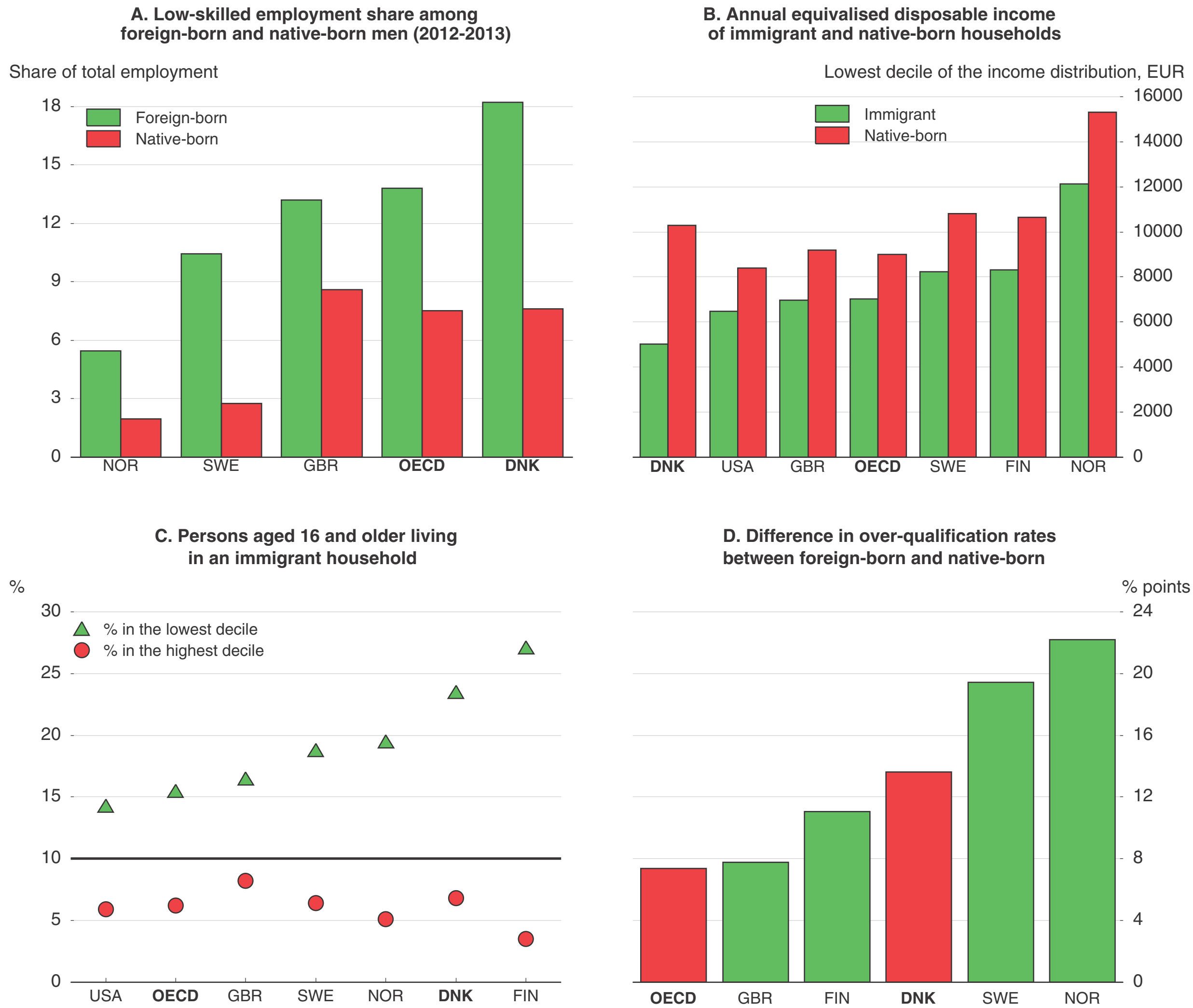
Strengthening integration of immigrants

Integration of immigrants is an issue in most OECD countries, and it is pronounced in Denmark (Figure 17 and 18). Immigrants have lower employment rates, a difference that has widened since the 2009 crisis, and income inequality between foreign born and natives is high by international standards. More worryingly, failure of integration tends to be transmitted to the next generation (Figure 19). Migrants encounter multiple barriers on the labour market. Among immigrants, refugees have greater difficulties to find employment. The total number of asylum applications roughly doubled between 2013 and 2014 and the refugee inflow has not weakened since, adding to the challenge of integration. In 2015 some 21 000 asylum seekers arrived in Denmark and some 10 900 were granted asylum – about 4 700 more than the year before.

Differences in education only partly explain differences in labour market performance (OECD, 2014c). High sectoral, collectively agreed, minimum wages can price lower-

Figure 18. **Inequality between foreign-born and native-born is high**

Selected OECD countries, 2012



Source: OECD Indicators of Immigrant Integration 2015.

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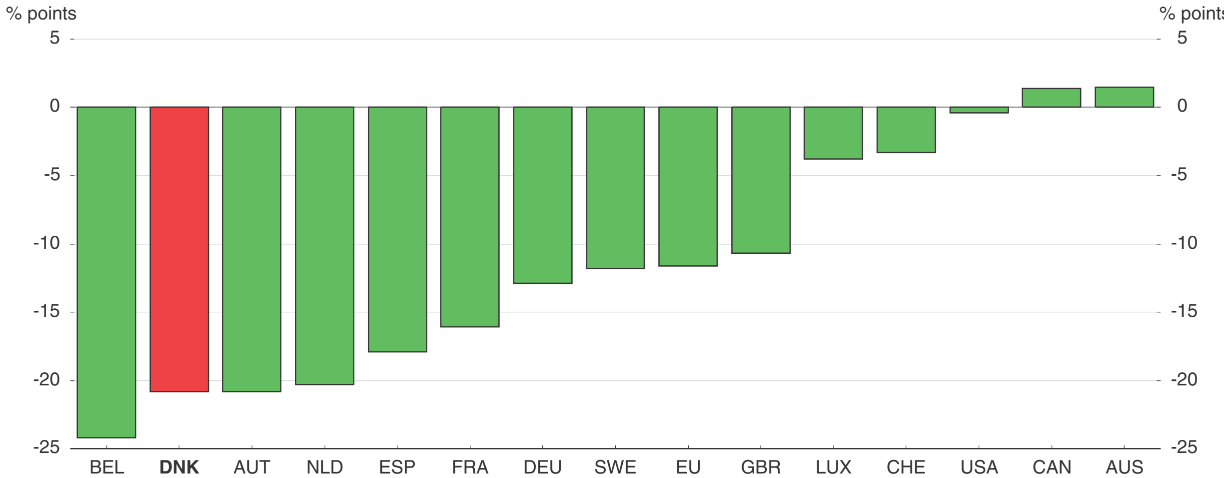
productivity immigrant workers out of formal employment. An introduction of a new two-year integration training programme focusing on upskilling and entry into the labour market seeks to counter this effect. Such a programme will allow companies to hire persons for up to two years at apprentice wages, which lies between 50 and 120 kroner per hour – significantly lower than the minimum wages determined by the social partners. The policy for spatial dispersion of migrants reduces geographical mobility and can be a barrier to employment. Furthermore, disincentives to work generated by the generous welfare system may be stronger for immigrants, as their average earnings prospects are initially much lower. Finally, differences in cultural human capital, lower access to networks, and ethnic discrimination can hamper integration.

Since the early 2000s, Denmark has implemented an array of innovative integration policies to address these complex issues, including language training, work placement and

Figure 19. **Substantial employment gap between native and foreign origin youth**

Difference in employment rates of native-born with foreign parents and native-born with native parents, 15-34 year olds not in education (2013)



Source: OECD Indicators of Immigrant Integration 2015.

StatLink http://dx.doi.org/10.1787/888933352403

wage subsidies (Liebig, 2007). Wage subsidies proved particularly effective in promoting integration as they compensated employers for the lack of country-specific human capital and poor language proficiency. Nevertheless, the implementation of the integration programmes has been incomplete and uneven across municipalities. For instance, only 45% of eligible immigrants participated in a work placement scheme and some 30% of those in language training did not pass the Danish language test (The Integration Barometer database and Expert Group on the Active Employment Effort, 2015).

Recently, social benefits for immigrants and those out of the country for seven out of the preceding eight years have been halved while maintaining other support measures, such as for housing and children (see Box 4). This measure was motivated by an aim to reduce the strain on public expenditures, increase the incentive to work among benefit recipients, and to act as a deterrent for further immigration (Ministry of Employment, 2015). A similar measure had been implemented between 2002 and 2012 (at the time called "the Start Help" programme), during which income transfers to the newly arrived refugee immigrants were decreased by about 35%. Independent evaluations showed that the likelihood of finding employment was small in the first two years, but after four and a half years the employment rate of those on the lower benefit was 12 percentage points higher, with a more pronounced impact on men, especially the young and single (Andersen et al., 2012). At the same time however, this measure increased poverty and induced local municipalities to pay supplementary allowances so that the families could make ends meet (Rosholm and Vejlin, 2010; Pedersen, 2013). The existing integration programme should focus more on labour market integration, in particular vocational traineeships, and be better monitored and implemented, including a stricter monitoring of the quality of language courses. A recent agreement by the social partners and the government aims at promoting on-the-job training, by both introducing a new integration training programme, and allowing for more flexibility in language training courses, in order to accommodate working hours and other work related circumstances.

Addressing the expenditure risks to the long-term sustainability of social institutions

The generous welfare system requires robust public finances. Around 2030, the public deficit is expected to exceed the national limit in the budget law (of structural deficit of 0.5% GDP) due to a transitory increase in public pension spending (the so-called "hammock" challenge), linked to the delayed pace of phasing-in the increases of retirement age. However, in the long run public finances seem sustainable and are in line with EU fiscal requirements (Danish Economic Council, 2015a; EC, 2012). This assessment is based on a number of assumptions, including eliminating the fiscal deficit by 2020, significantly higher labour market participation in response to structural reforms, and stable per capita public spending. Uncertainty regarding these assumptions is high, notably on future developments of labour force participation and healthcare costs.

As private pension schemes mature, public spending on pensions is projected to decline together with the share of pensioners relying on means-tested benefits (around 90% of individuals older than 65 in 2013). However, public pension spending could turn out higher than projected. Means-testing public pension reduces the effective return on savings for low wage workers, who might contribute less to the occupational pension plans than projected. Second, the tax on pension returns is higher than on returns from property investments. This can discourage pension savings among people who are not covered by collective agreements. Indeed, over the past five years, around 24% of those aged 30-59 (mainly self-employed and benefit recipients) were saving less than 5% of their income in pension schemes. As a result, their second pillar pension will be low, making them eligible for the first pillar public pension. Moreover, rates of return of defined contribution schemes are difficult to predict as they depend on market developments.

Participation in early retirement programmes, old-age unemployment, and reliance on public pensions could rise, resulting in additional costs to tax payers and a lower contribution base. The statutory retirement age is to be indexed to life expectancy gains (see Box 4). For this to happen, incentives to work longer need to be in place. Political pressures not to reduce the retirement period are likely to intensify in the future as the retirement age rises (reaching 70 by 2040), and even more so, if inequality in life expectancy continues to widen (Brønnum-Hansen and Baadsgaard, 2008). Also, work capacity of older workers might not fully adapt to longer working lives, in particular in demanding occupations.

Improving working opportunities for older workers should be a priority. Longer working lives have been promoted by earlier reforms reducing the generosity of voluntary early retirement schemes and unemployment benefits for those above fifty-five years old. These reforms have successfully translated into higher labour market participation. Recent pension reforms have already raised employment rates of older workers significantly (Figure 2.12). Other pathways to early retirement could, however, still be used (Halvorsen and Tägtström, 2013). Remaining regulatory barriers to employment of older workers should be removed and initiatives to adapt working environment to an ageing work force developed. A recent OECD (2015b) Review of *Ageing and Employment Policies in Denmark* includes a number of recommendations in this vein. In particular, offering flexible working hours and adapted work tasks, reducing seniority elements in wage setting, removing remaining mandatory retirement ages, and implementing programmes for early identification and prevention of work-related health issues are recommended.

Spending on healthcare and long-term care is difficult to project and control in many OECD countries, and Denmark is no exception. Future costs hinge widely on the health status of the elderly population, changes in relative prices of medical goods, and the capacity to achieve efficiency gains in healthcare and the provision of long-term care. The uncertainty of future healthcare spending is illustrated by a spectrum of projections in the OECD scenarios, varying from 2% to 5.9% of GDP by 2060, depending on assumptions (De la Maisonneuve and Oliveira-Martins, 2013). There is similar uncertainty about spending projections of long term care, which in the Danish case differ by a factor of five, from 0.6% of GDP in the OECD best-case scenario, to 3% in the European Commission worst-case scenario (Table 2).

Table 2. **Spending projections on health care and long term care**

Increase in percentage points of GDP by 2060

	OECD	Government	EC
Health care			
Average	-	0.0	+0.9
Best scenario	+2.0		+0.1
Worst scenario	+5.9		+3.1
Long-term care			
Average	-	+1.4	+2.0
Best scenario	+0.6		+1.9
Worst scenario	+1.0		+3.0

Source: De la Maisonneuve and Oliveira-Martins (2013), European Commission (2015), Danish Ministry of Finance.

Due to the large uncertainty that surrounds both health care and long term care projections, measures to improve efficiency are welcome. Disparities across local governments in terms of outcomes and efficiency suggest the scope for improvement is quite large (Medeiros and Schwierz, 2015; Heijink et al., 2015). Indeed, a number of welcome policy initiatives are under preparation and should be implemented:

- Stronger accountability for local government could stimulate efficiency gains in the provision of welfare and long-term care services. Improved quality monitoring in the primary and long-term care sectors would help to identify sources of local discrepancies and best practices.
- Integrating the delivery of healthcare, long-term care, and social services to allow for early identification of needs, improve information sharing between providers, avoid overlaps and duplication, and improve access to services (OECD, 2014d). To this end, mechanisms to reward the continuity of care should be developed, including publishing performance indicators for primary care, providing financial incentives and more responsibility on outcomes across the whole patient pathways to care providers. In such an approach, the GPs need to play a more active role and good performance needs to be recognised and rewarded.
- Stronger emphasis should be put on prevention activities and actions targeted to the most vulnerable. Low educated and low income earners are more exposed to unhealthy lifestyles and use less preventive services, not least because of their uneven geographical distribution (Ellins et al., 2014).

Other avenues for achieving efficiency gains could include:

- Continue limiting the use of grants to sub-national governments that are restricted to specific purposes, in order to maintain operational freedom and capacity to adjust spending priorities while making sure that appropriate output performance monitoring and minimum service delivery regulation remains in place.
- Removing barriers to competition that are likely to hamper efficiency gains in the public sector. Enforcement of competition law is limited since central or local governments can provide ad hoc exemptions from the application of the Competition Act (OECD, 2015a). Regulations of pharmacies, including restrictions on entry and ownership and controls on prices and profits, raise costs.
- Increasing co-payments from the current low level would limit overreliance on tax-financed public budget for the provision of healthcare and long-term care services. In Denmark, most health care is provided for free, except for some services such as pharmaceuticals, dental services and glasses. As a result, out-of-pocket payments (OPPs) account for around 13.7% of total health spending (vs 19.6% on average in the OECD). Extending co-payments in the healthcare sector should be considered: if kept low, they can raise revenue and limit overuse (Pisu, 2014). In the long-term care sector, municipalities have only limited freedom to charge for services delivered at home and non-health related expenses. Currently, OPPs account for 8.6% of total spending on long-term care, half of the OECD average.
- Developing tax instruments to limit health-damaging behavior should also be considered as it proves quite effective in improving health outcomes (Sassi et al., 2013). Denmark already imposes excise duties on unhealthy items such as alcohol, tobacco.

Cost effective policies to manage environmental pressures

Despite good environmental policies and many positive trends such as decoupling emissions and farm inputs from economic activity, there is scope for significant improvement in a number of environmental areas (OECD, 2007; European Environment Agency, 2015). Pressures on the environment come from manufacturing, agriculture, transport and energy. For instance, notwithstanding low private car ownership, around a fifth of the population is exposed to poor air quality, though much of the air pollution is said to originate outside the country's borders. Poor air quality is worrying given the high rate of cycling In Copenhagen, levels of PM_{10} and NO_2 exceeded the EU limit values on a number of occasions, and in 2011 air pollution caused estimated 3 200 premature deaths (WHO, 2013). Earlier plans for an introduction of a congestion tax in the capital, which is the most affected, have been replaced by a plan to decrease PM_{10} and NO_2 by other measures, which is expected to ensure compliance with EU limits. As shipping is an important industry in the Danish economy, Denmark should promote international initiatives to limit the environmental damage resulting from the lack of regulation in this area.

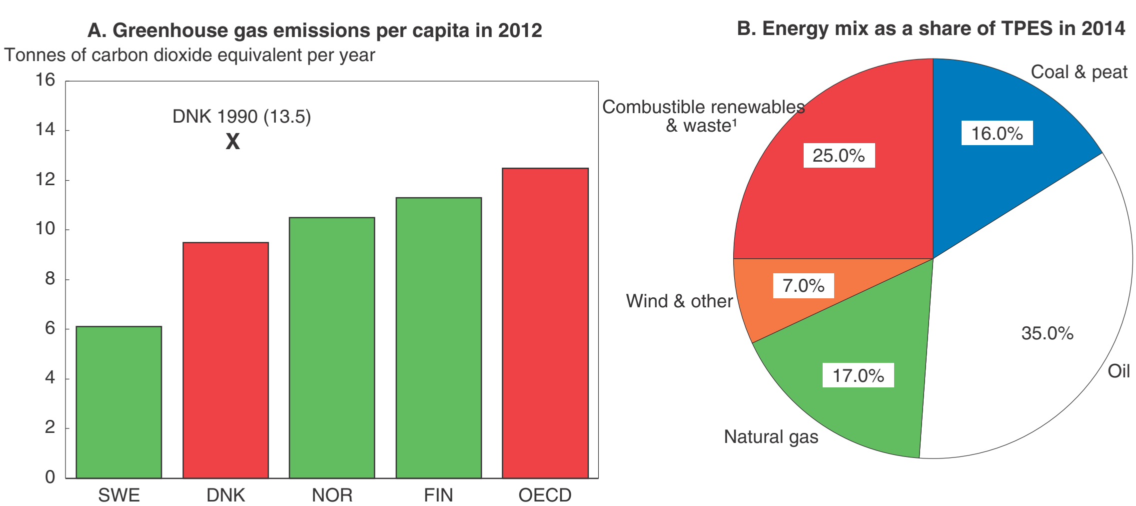
Agriculture occupies more than 60% of the land area, and pesticide use still exceeds national targets (European Environment Agency, 2015). The targets have been revised recently to decrease the pesticide load by 40% *vis-à-vis* 2011. A new differentiated pesticide tax based on the human health- and environmental properties of the pesticides was introduced in 2013 at the same time as a new indicator and target for the reduction in the pesticide-load on the environment and human health. Furthermore, an existing system of allowances for the use of nitrogen does not take into account differences in soil characteristics (Danish Economic

Council, 2015b), but a new regulation with improved targeting should be implemented from 2018 onwards together with other initiatives, such as creating of wetlands. Price increases resulted in a significant reduction in households' consumption of water; the same is not happening in agriculture. More generally, despite regulatory and monitoring measures in place, water quality in lakes and coastal areas can be an issue and only limited attention is paid to other contaminants such as heavy metals and toxic chemicals, or depleted maritime fish stock (European Environment Agency, 2015).

A generally sound, diverse, and in some cases innovative policy framework, that combines market-based instruments, regulations and subsidies is in place. Other instruments remain limited in scope, such as the full-cost recovery principle which is legally applied to municipal waste collection (OECD, 2007). Danish households produce one of the highest quantities of municipal waste per capita, but around 60% of it gets recycled (Figure 21) (European Environment Agency, 2015).

Denmark is in an ambitious transition to a fossil independent energy supply (without using nuclear power) by 2050 (Figure 20). Currently, the energy sector emits 37% of total greenhouse gas emissions. Renewables accounted for 28.5% of final energy consumption in 2014 and the current administration has pledged a commitment to the 2012 Energy Agreement that supports the development of various types on technologies leading to an expected wind energy share of 50% of electricity supply by 2020. The policy framework includes notable subsidies to specific technologies (wind, solar etc.), but also considerable taxes on energy (4% of GDP) and strict performance standards on energy efficiency and labelling in the housing sector. Based on the latest domestic projections, green-house gas emissions will be reduced by 40% vis-à-vis the 1990 levels and non-ETS greenhouse gas emissions will be reduced by 20% compared to 2005 levels (Danish Energy Agency, 2015). An Energy Commission has been established to provide input into political negotiations for a new energy agreement beyond 2020 and will report in 2017.

Figure 20. **Emissions are low and renewables play an important role**

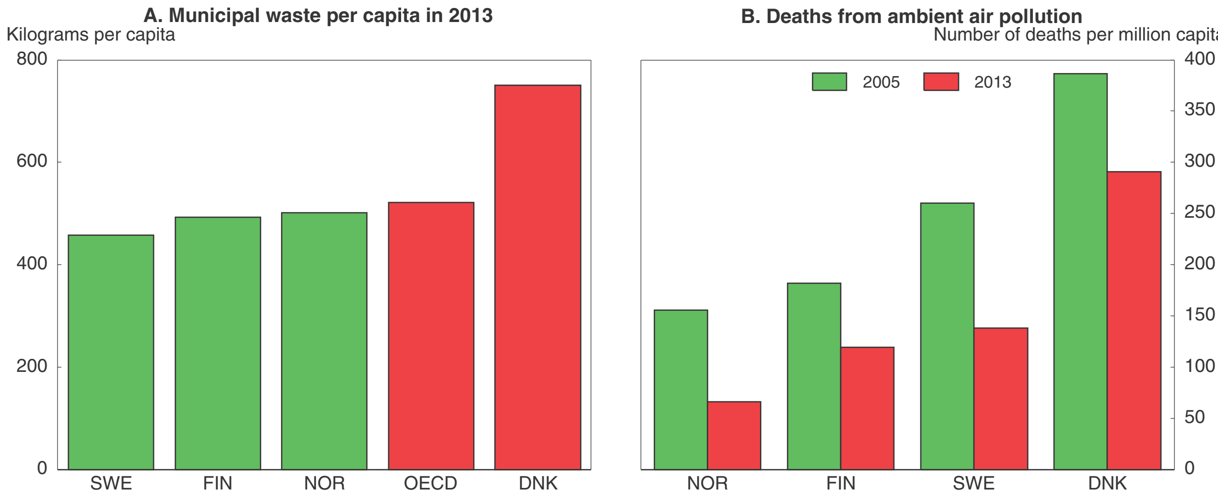


1. Includes non-renewable municipal waste, industrial waste, electricity trade and other sources of primary energy.

Source: OECD Environment Statistics database; IEA (2015), Energy Balances of OECD Countries.

StatLink http://dx.doi.org/10.1787/888933352418

Figure 21. **Other sustainability issues remain**



Source: OECD Environment Statistics database; OECD (2014), The cost of air pollution: Health impacts of road transport.

StatLink http://dx.doi.org/10.1787/888933352424

A number of initiatives addressing environmental issues are underway. A comprehensive strategy for energy savings was published in 2014. Measures to implement current EU minimum targets for waste management are in place (European Commission, 2015b). Furthermore, the strategy "Denmark without waste II" was introduced by the previous administration and is still applied.

The current government puts a strong emphasis on cost-effectiveness of measures to manage the environment sustainably. While in principle this is welcome, it remains to be seen how these issues will be addressed in practice. For instance, a decrease of the NO_x tax and a gradual phasing out of the break on the car purchase tax for electric vehicles from 2016 May generate adverse environmental consequences. Denmark has a very high car purchase tax of 150% (reduced from 180% in the 2016 budget bill). Deductions are given for energy efficiency, but should take the overall environmental performance into account. Introducing dynamically priced congestion charge in the most affected cities would reduce pollution, as well as make for a better use of infrastructure.

Other recent measures, such as retroactive tax deductions for improving energy efficiency of housing (the so-called *Housing Jobs scheme*), should be limited to credit-constrained households and not include other house-work such as cleaning and gardening services. Recent OECD evidence illustrates that home-owners and high-income households are more likely to invest in energy efficiency improvements anyway (Ameli and Brandt, 2014).

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ANNEX

Progress in structural reforms

This annex summarises recommendations made in previous Surveys and actions taken since the OECD Economic Survey on Denmark published in January 2014.

Fiscal policy

Recommendations	Action taken since January 2014
Closely implement the new fiscal framework and monitor its impact on municipalities' outlays.	The Budget Law is fully implemented for the central government, regions and municipalities.
In case of a weaker or postponed recovery, allow the automatic stabilisers to work. In the event of a faster recovery than the euro area one and a renewal of capital inflows, tighten the fiscal stance more than projected.	Fiscal policy, is primarily based on the structural balance and thus automatic stabilisers are as a rule allowed to work. In line with the projected gradual closing of the output gap the authorities envisage that fiscal policy will be gradually tightened in order to achieve the medium-term target of structural balance by 2020.
Further reduce marginal taxes on higher incomes.	No new measures taken. The budget bill for 2014 brought forward the increase in the employment tax allowance. The threshold for the higher marginal tax rate is gradually being increased as part of Tax Reform 2012.
Raise taxes on property once the recovery of the housing market is well under way.	No action taken.
Improve the structure of environmental taxes to raise their efficiency.	The registration tax on vehicles has been lowered (the highest tax rate for passenger cars and motorcycles decreased from 180 to 150%) in 2015. The tax on nitrogen oxides has been reduced from 2016 onwards.

Financial system

Recommendations	Action taken since January 2014
Create a new supervisory tool for mortgage banks, similar to the framework for banks which includes thresholds on the share of deferred-amortisation loans and refinancing needs.	*The supervisory diamond* will come into force in 2018/2020 and tighten the loan provision for deferred loans, high LTV ratios and refinancing needs.
Make sure that all banks, especially the largest ones, maintain a prudent leverage ratio, as a backstop to risk-weighted capital ratios.	A minimum leverage-ratio requirement taking into account particularly safe business models, like the mortgage credit institutions has been recommended by an expert group.
Encourage households with loan-to-value ratios above 80% and facing the beginning of amortisation payments for loans granted 10 years ago to start now to amortise their loans.	The authorities urged households to use the currently very low interest rates for higher amortisation.
Monitor the effectiveness of allocating the power to implement macroprudential policies to the government and if this set-up turns out to be ineffective, consider allocating it to the Financial Supervisory Authority or the Systemic Risk Council.	The Systemic Risk Board, established in 2013, will be evaluated in 2016.

Labour market

Recommendations	Action taken since January 2014
Closely monitor the implementation of the shortening of the unemployment insurance period and implement a quicker phasing-in if the labour market recovers rapidly.	An Unemployment Insurance Commission (*Dagpengekommissionen*) was in operation from June 2014 to October 2015. The government has largely followed the recommendations of the Commission. An evaluation of the shorter two-year unemployment period found it to have a positive impact on employment. Nevertheless, and despite strong labour market performance, an extension to three years of benefits will be introduced by 2017 under certain conditions.
Consider gradually reducing the unemployment benefit replacement rate over the benefit entitlement period.	Not recommended by the Unemployment Insurance Commission. A short waiting period has been introduced if benefit claimants fail to meet an employment requirement.
When implementing the reform of flexjob and disability programmes, make sure that the special disability scheme for older workers does not become a new pathway to early retirement.	Since January 1st 2014 only a total of 366 citizens have been granted a senior disability pension, due to tighter access criteria.
Move to regular entitlement assessment of disability pensions and limit the granting of permanent pensions for those above 40.	No action taken.
To better align funding with municipalities' responsibilities for labour market programmes, municipalities should receive proportionally less reimbursement for the costs of public benefits the longer a person is receiving benefits.	From the 1st of January 2016 municipalities' reimbursement for public benefits depend on the length of the benefit period alone: The first 4 weeks the municipality receives 80% reimbursement, from week 5 to 26, 40%, from week 27 to 52, 30%, and after 52 weeks the reimbursement is 20%.

Recommendations	Action taken since January 2014
Improve the efficiency of ALMPs, including by ensuring that municipalities face the right financial incentives to help the unemployed find a job.	See above. The reimbursement reform ensures incentives for municipalities to choose effective ALMPs.
More closely link wages to individual performance in the public sector	In 2015 a new collective agreement signed between the Ministry of Finance and its staff organization. The agreement introduces an asymmetric response to differences in private and public sector pay increases. Furthermore, the ministry is collecting and spreading examples of different systematic approaches to people performance management at the institutional level.
Assess the use and impact of non-compete clauses.	A political consensus was reached in the *Agreement on a growth package*, June 2014, to adjust the existing rules on employment clauses (non-competition clauses) in order to limit the use of clauses. Furthermore, a bill entering into force on 1 January 2016, introduces new rules for all employment clauses. Non-solicitation clauses are completely banned with a few exceptions. Also, the new rules on costumer or competition clauses limit the duration of these clauses. *Study of the use of employment clauses (non-competition clauses)* indicates that, among the selected sectors, 22% of companies use non-competition clauses, and 24% of the businesses use non-solicitation clauses. In total, the study indicates that about 1/3 of the companies use some kind of employment clause.

Integration of migrants

Recommendations	Action taken since January 2014
Maintain the spending on efficient programmes for the integration of immigrants. Continue efforts to raise the quality of Danish courses for immigrants.	An agreement between the social partners was reached in March 2016 on reforming the integration programme, focusing mainly on better labour market integration of refugees and immigrants.
Strengthen efforts needed to streamline immigration processing further to ensure that high-skilled workers can quickly and easily migrate to Denmark.	A new scheme to make it easier for companies and universities in Denmark to attract highly qualified labour from countries outside the EU/EEA has been in force from 2015 and will be evaluated in the first quarter of 2017.
Assess the Green Card programme to better understand its pros and cons and see how to make it evolve.	The Green Card scheme was tightened in 2015 with increased focus on educational levels in order to better support enterprises' need for highly qualified labour. The changes will be evaluated in the first quarter of 2017.
A broad strategy is needed to better integrate immigrants and the second generation in the education system, starting at compulsory level.	No specific action taken, though receiving increased policy focus.
Encourage private institutions to establish more international schools to cater for children of foreign workers living temporarily in Denmark.	No action taken.

Education and skills

Recommendations	Action taken since January 2014
Since pre-school class has been made compulsory, further strengthen its educational content to make it effectively the first year of primary education.	The teaching in the pre-school class is organised to ensure that the children gain competences within 6 proficiency areas and three compulsory themes
Introduce accreditation of teachers and introduce more wage flexibility.	No action taken.
Closely monitor the implementation and impact of the reform of compulsory education. Consider the introduction of university-based initial teacher-training programmes to enhance their attractiveness and improve career paths for teachers.	No action taken.
In the implementation of the reform, strengthen the assessment framework of primary and secondary education by including teacher and school principal appraisal. Give financial incentives, in the form of adjusted grants, to municipalities to achieve good outcomes.	No action taken.

Recommendations	Action taken since January 2014
When implementing the reform of vocational education and training (VET), make sure that VET becomes more attractive to students and more selective without increasing school failures among those who cannot enter VET. Develop VET programmes that offer pathways to tertiary education.	The reform should be fully implemented in 2016. The fulfilment of the specific objectives of the reform will be followed closely through ongoing monitoring, measurement, and evaluation of progress and results. Teaching of Danish is improved, and the students are ensured a minimum of 26 hours of teaching per week in the basic course from 2016, corresponding to almost 35 lessons per week. Furthermore, a new two-year combined youth education is established targeting persons under 25, who do not possess the qualifications for completing a vocational or general upper secondary education. In addition, further training for teachers is prioritised, and more measures are planned.
Raise the incentives to choose the right tertiary education programme by gradually introducing tuition fees.	Central regulation of student admission within select programmes with notable unemployment has been introduced, and increased transparency with comparable data about higher education programmes established.
Develop and publish indicators of the quality and performance of university programmes. Give the evaluation agency well identified tools to get tertiary institutions to improve.	As a part of the *Growth Package 2014*, indicators are published systemically, including regarding unemployment, income, entrepreneurship and completion rates and time. Further qualitative and quantitative data are being developed during in 2016.
Raise the performance of the adult learning system by continuing efforts to give educational institutions greater incentives to recognise prior learning and by increasing the quality control of courses.	With *Growth Plan DK* of 2013, the government allocated DKK 1 bn. in the period 2014-20 for more and better adult education and continuing training for unskilled and skilled labour. The goal is to upgrade the qualifications of semi-skilled workers, and to improve the level of education of skilled workers. As part of the VET-reform that came into force by August 2015, a new adult vocational training programme has been put in place, introducing as a starting point an assessment of adult's prior learning and work experience as a basis for a VET-programme. At the same time, the goal is to strengthen quality and flexibility in adult education and training.

Competition

Recommendations	Action taken since January 2014
Assess the impact of the regulations of professions and remove those that hamper competition and are not fully justified by other objectives.	In 2014, an inter-ministerial task force assessed the regulated professions in Denmark. As a result of this work, the public appointing schemes for translators and interpreters, among others, were abolished. In 2014, limited authorisations for the electricity, plumbing and sewage area were introduced, easing access to the market.
Increase competition for pharmacies, taxis, and public transportation.	No action taken.
Harmonise national standards that hinder foreign firm entry with international ones.	The use of international standards increased already in some areas for instance in the high voltage area and reviewed in other areas, like building and road construction.
Simplify the legislation on public procurement and increase the use of e-procurement to lower transaction costs and make the process more uniform.	The European Public Procurement Directive was implemented in 2016 in Danish law and e-procurement is expected to be mandatory in 2018.
Continue to open network industries, especially the rail passenger system, to competition.	No action taken.
Relax ownership regulations and zoning and size regulations for stores.	The government has recently presented plans to liberalise the current regulation of the retail sector easing restrictions on the size and location of grocery shops as well as shops selling durable goods (see Assessment and Recommendations).
Streamline the institutional set-up of the authorities in charge of competition.	Oversight by the Competition Board has been strengthened. The Board has been reduced in size from 18 members to 7 members. Furthermore, an advisory committee has been formed. The committee will advise the Competition Board on various competition-related areas.

Entrepreneurship and innovation

Recommendations	Action taken since January 2014
Entrepreneurship education programmes need to be designed in a way that incorporates practical work experience as an employee in order to improve students' understanding of running a business.	No action taken.
Evaluate the recent merger of different innovation funding programmes and if needed, consider further streamlining innovation policy instruments and funding programmes after a thorough evaluation of the system.	The recent reform of the innovation system will be evaluated no later than 2018. The government has initiated a review of the business development system, including the innovation system
To support young and dynamic firms, further extend carry-over provisions and cash refunds in R&D tax credit programmes or increase direct support.	No action taken.
Evaluate the effectiveness of the government loan guarantee schemes for SMEs in a unified and transparent manner and gradually withdraw those that are not economically efficient.	All schemes under the Danish Growth Fund are systematically evaluated every third year. The last evaluation was published in 2014. The relevance of different schemes is evaluated continuously.
Move towards a more balanced mix of project and institutional based research funding with the objective to increase the links between universities and industry.	In 2016 new compulsory targets will be added to the development contracts of the educational institutions. The target is added to improve stronger links between institutions and industry.
In the design of demand-side innovation policies, ensure sufficient competition and facilitate SME participation. Carefully evaluate these policies.	The new InnoBooster-programme is designed to facilitate innovation in SME's. The programme is run by the Danish Innovation Fund. The Danish strategy for intelligent public procurement, which was published in 2013 by the Ministry of Finance, has innovation and quality as one of the objectives.
Improve angel investor networks to increase the opportunities for early-stage financing of firms by continuing efforts to foster a more entrepreneurial culture and improving angel investor training networks.	A Business Angel Matching Facility under the Danish Growth Fund established in 2015 in order to match investment in Danish Businesses from Danish and foreign business angels.
Streamline the services provided by Business Development Centres and monitor closely their long-term effects.	In summer 2015 a new framework agreement for the Business Development Centres came into effect. The services provided by Business Development are further monitored in the yearly contracts with the Ministry for Business and Growth.
Further enhance the entrepreneurship culture, including amongst women, through the use of the media and the education system.	No action taken.
Consider developing an explicit internationalisation strategy for SMEs. Ensure that the new cluster strategy policies are tailored to the needs of different industries.	In 2016 a new cluster strategy will be presented. One focus of the strategy is the international involvement of the clusters in order to strengthen Danish SMEs' access to global knowledge networks and the EU's Horizon 2020 programme. The Ministry of Business and Growth will launch business strategies with industry representatives from areas where the Danish business sector has an international stronghold and competitiveness in 2016.

Climate change

Recommendations	Action taken since January 2014
Regularly reassess national targets in the light of international and technology developments. Adjust accordingly the share of GHG emission cuts to be achieved domestically by financing GHG emission cuts outside Denmark.	According to the latest projections from December 2015, the target to reduce non-ETS emissions by 20% in 2020 will be met domestically.
Ensure that policies towards renewable energy support least-cost abatement options and avoid supporting one technology in particular. Work at the EU level towards the introduction of a common strategy to help meet EU renewable targets at least cost.	Negotiations on a new energy agreement, going beyond 2020, will be initiated before the end of 2018. At the EU level, new Renewable Energy targets for 2030 were adopted in 2014. A governance system for the implementation of these goals is expected to be established from 2017 on.
Rationalise the Danish energy tax system to harmonise the implicit carbon price. In particular, raise tax rates on coal and diesel to reduce the gap with the implicit carbon price on petrol.	The Danish CO_2-tax is already partly harmonised based on the CO_2-content in the fuel. The total tax on fuels also includes an energy tax which is harmonised based on the energy content.
At the EU level, push for the adoption of a common policy to limit non-CO_2 emissions from agriculture.	Denmark pushes for the adoption of a Land-sector pillar (AFOLU-pillar) under which agriculture and LULUCF would receive a common reduction target from 2021.

Chapter summaries

Chapter 1. Macroeconomic and financial risks

The Danish financial sector is big and there is a high degree of inter-connectedness between banks, mortgage institutions and pension funds. At the same time, Danish households have large balance sheets and high levels of gross debt. Even though the high debt levels are matched by large assets, notably in form of pension savings, there are feedback loops with the housing market and households' balance sheets contributing to macroeconomic volatility. At the same time, the very low interest rate environment may contribute to the building up of risks, notably in the housing market. Given the on-going recovery of the housing market, it is an opportune time to eliminate the debt-bias in taxation, which would strengthen the automatic stabilisers of the fiscal system. In addition, further liberalising the private rental market would help create a more dynamic housing market overall and reduce the need to meet housing needs primarily with the owner occupancy segment.

Chapter 2. Getting the incentives right in an ageing society

The generous Danish welfare state relies on a high degree of labour force participation both for financing and in order to ensure social cohesion. This underlines the need for getting work incentives right and improve the employability of vulnerable groups of workers, in particular migrants. Many benefit recipients also face high marginal tax rates for returning to work, creating a barrier for inclusion. Likewise, as the population ages, the need for longer working lives becomes a central aim. In Denmark, much has been done to keep older workers in the labour market, but there is further scope for reducing barriers to work for this group, including through the design of the pension system. Cost pressures at social institutions could be addressed by better reaping the effects on municipal reform, more coordination between different service providers, and open the market for social services, for instance old age care, for private suppliers under a strict quality monitoring framework.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Denmark were reviewed by the Committee on 21 March 2016. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 14 April 2016.

The Secretariat's draft report was prepared for the Committee by Ms. Zuzana Smidova, Ms. Caroline Klein and Ms. Louise Aggerstrøm Hansen who was seconded from the Danish Ministry of Finance, under the supervision of Mr. Andreas Wörgötter. Research assistance was provided by Ms. Lutécia Daniel. Ms. Heloise Wickramanayake formatted and produced the layout. The previous Survey of Denmark was issued in January 2014.

Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at www.oecd.org/eco/surveys.

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2