ENGLISH SUMMARY

Chapter I: The Danish Economy

Five years of high growth rates in Denmark are ending. Growth is expected to fall to less than 1 per cent in 1999 and around 1½ per cent in 2000 and 2001 (see table 1). The slowdown is caused by a tightening of economic policy and poor export performance. The slower growth will lead to a temporary drop in employment in the private sector and to a slight increase in unemployment. However, public sector employment will increase, and in 2001 unemployment will be back at the present level, i.e. about 6 per cent of the labour force (national definition). Inflation will remain subdued, and the public surplus will continue. The current account will improve slightly owing to the lower growth rates, but will remain in deficit.

The outlook for the international economy is mixed, but is generally more positive than it was six months ago. The economies of countries in Asia and Latin America that were hit by the crises in those areas now seem to be improving, and the long-lasting upturn in the United States continues. On the other hand, Japan and the European countries seem to have weakened more than was previously expected. Yet the slowdown in Europe is expected to be only temporary. Growth rates within the EU are expected to be around 2 per cent in 1999 and to increase to 2½ per cent in 2000 and 2001.

The temporary slowdown in the economies of Denmark's trading partners will weaken Danish exports. However, the poor export performance, especially that in exports of manufactured goods, is also a result of deteriorating competitiveness due to higher wage increases in Denmark than abroad. Exchange rate movements, especially those occurring in 1998, have also contributed to the poorer competitiveness of Danish goods. As growth picks up abroad in 2000 and 2001, so will Danish exports. As a result of the low growth in domestic demand, Danish imports are expected to be reduced in 1999.

Domestic demand will be almost unchanged in 1999 and grow by some 1½ per cent in 2000 and 2001. In 1999 private consumption will be dampened both by an expected minor reduction in house prices and by tax increases. The higher taxes, and to some extent the reduction in house prices, are the results of a tightening of economic policy decided upon in the course of 1998. The aim of the policy measures, which include higher green taxes and a reduction in the tax deductibility of interest payments, was to slow the Danish economy. These policy measures, together with the slowdown in exports, are expected to keep down growth in private consumption, and to keep house prices at current levels in nominal terms. The general slowdown will reduce the level of new investment, which will also be negatively affected by the gradual completion of several large infrastructure projects. Investment is expected to pick up only slowly in the coming years.

Stock building was substantial in 1998. This was partly due to the poor export performance. Stocks are thus now thought to be too large and a big turnaround is expected, contributing a 1 percentage point drop in GDP growth. However, there is considerable uncertainty regarding likely changes in stock levels; the effect on growth could be either much larger or much smaller.

Employment in the private sector is expected to fall slightly during 1999, and a temporary increase in the number of people unemployed will result. However, the drop in private sector employment will only be moderate, as slow productivity growth is expected. Unemployment figures are expected to remain relatively stable, as increases in public sector employment will counteract reductions in private sector employment. Wage cost growth is expected to be around 4½ per cent per year during the forecast period. This is around 1 percentage point more than abroad.

Table 1: Short-term prospects for the Danish economy

	1998 Current prices DKK bn.[d]	1998 Per cent of GDP	Percentage change in volume terms 1998	1999	2000	2001
Private consumption	600.1	51.4	3.5	2.0	2.5	2.1
Public consumption	297.7	25.5	2.6	1.9	1.0	1.0
Gross fixed capital formation, of which:	242.6	20.8	6.1	-2.6	-0.2	1.1
Residential investments	50.1	4.3	3.7	-2.5	-0.1	-2.2
Fixed business investments	172.3	14.8	8.1	-3.4	-0.2	2.0
Public investments	20.3	1.7	-5.2	5.0	0.0	0.0
Stock building[a]	6.1	0.5	0.9	-1.0	0.0	0.0
Total domestic demand	1146.5	98.3	4.8	-0.1	1.5	1.6
Exports of goods and services	402.2	34.5	0.1	0.8	3.5	3.3
Imports of goods and services	382.0	32.7	4.7	-1.3	3.5	3.3
GDP	1166.6	100.0	2.9	0.7	1.6	1.7
Key indicators						
Consumer prices, percentage change[b]			1.7	2.1	2.4	2.3
Unemployment, per cent[c]			6.3	5.9	6.1	5.8
Current account, DKK bn.[d]			-15.9	-10.0	-5.2	-4.9
Current account, per cent of GDP			-1.4	-0.8	-0.4	-0.4
General government financial balance, DKK bn.[d]			8.6	26.6	20.8	23.4
Gen. government financial balance, per cent of GDP			0.7	2.2	1.7	1.8
Hourly wage costs, percentage change			4.4	4.4	4.5	4.5
Terms of trade, percentage change			0.4	-1.0	1.4	-0.0

a) The percentage changes are calculated as the real changes in stock building relative to real GDP in the previous year.
b) Implicit private consumption deflator.
c) Percentage of total labour force.
d) The DKK/USD exchange rate is taken as 6.78 in 1999 and 6.83 in the years 2000 and 2001.

Sources: Statistics Denmark, *National Accounts*, and own estimates.

The general government financial balance will improve despite the economic slowdown. The improvement partly reflects the fact that the supplementary pension scheme introduced in 1998 is being converted into an ordinary tax in 1999. The increased contributions to the supplementary pension scheme (1 per cent of wages) are exactly mirrored by increased future public sector obligations. Thus, the contributions and the future pension payments have the same present value. The increased pension contributions increase total savings, but will only improve the long-term public finances to the extent that the increased future pensions reduce the need for other public expenditures.

Policy Recommendations

The slowdown in the Danish economy and in particular in Danish exports is partly the result of slower growth, especially in Europe during 1998. However, the bad export performance is not solely due to slower growth abroad. The loss of market shares for Danish exporters of manufactured goods totals 10-15 per cent since 1993.

The loss of market shares can primarily be attributed to deteriorating competitiveness. Danish export prices have increased relative to those of competitors, and wage increases have been higher in Denmark than abroad. However, the loss of market shares should probably also be seen in the light of the gains in the early 1990s following the reunification of Germany. Another possible explanation of the loss of market shares is that high growth rates in domestic demand have diverted the attention of Danish producers, so that they have put too little effort into servicing their export markets. According to this hypothesis, the very slowdown of the Danish economy should increase exports. However, the hypothesis cannot be empirically verified, and therefore the lower growth in domestic demand is not expected to lead to a regaining of market shares during the coming years.

Reductions in taxes paid by businesses and cuts in indirect wage costs have been proposed as solutions to the substantial loss of market shares. However, several objections can be raised to making such reductions as a response to poor competitiveness. If indirect wage costs or taxes were reduced to counteract the effects of excessive wage increases, wage formation could be affected. The labour market parties would be able to agree on higher wage increases in the expectation that the government would subsequently “save” the country’s competitive position by lowering taxes or indirect wage costs. Furthermore, reductions in taxes which have been introduced in order to affect the behaviour of the firms, for example green taxes, would be doubly harmful, since the beneficial effects on the behaviour of companies brought about by these taxes would be reduced. Furthermore, it should be borne in mind that reductions would have to be paid for either by cuts in public spending or by new taxes. Both could very well be harmful to businesses. Finally, it should be noted that tax cuts would not automatically result in price cuts of a comparable size. Thus, reductions in taxes and indirect wage costs cannot be recommended as a means of improving competitiveness.

Competition in Denmark is less keen than in many other countries, and consequently prices are higher. This results in higher wages and poorer export performance. Greater competition would lead to welfare gains, lower unemployment and higher exports. Thus, in order to improve the competitiveness of Danish exporters, greater competition is clearly a favourable alternative to reductions in taxes and indirect wage costs. The Danish Competition Act was changed in 1998. It contained several elements intended to improve competition, but it is too early to evaluate the results quantitatively. Nevertheless, tighter control of mergers should in any case be introduced in order to prevent companies from bypassing the regulations by means of mergers.

Danish export performance will remain poor as long as Danish wage increases are higher than those of our competitors. Higher wage increases are only compatible with a fixed exchange rate policy if productivity also grows faster than in competing countries. The inflation target of the EMU is 0-2 per cent. If inflation is 1½ per cent in Euroland and productivity grows by 2 per cent, wage costs can increase by 3½ per cent. The present rate of Danish wage increases of 4½ per cent is therefore not sustainable.

The labour market reforms of the 1990s, with their emphasis on active labour market policies, have undoubtedly contributed to a reduction in the level of structural unemployment. In the years to come, these reforms will continue to help keep wage rates lower than would otherwise have been the case. However, the effects of the reforms are not sufficient to keep wage increases in line with those abroad. Labour market policy should ensure that training programs for the unemployed match the needs of the labour market. Continuing education should be paid for primarily by the employers and employees, as it is they who obtain the benefits of training in the form of higher productivity and higher wages. Publicly-financed continuing education should be reserved for those among the unemployed with the least skills and highest risks of being long-term unemployed, because training of these groups could reduce structural unemployment.

If structural unemployment is not further reduced, increases in the unemployment rate could prove inevitable. It is in times of increasing unemployment that labour market policy is really put to the test. The active labour market policy will prove harder and more expensive to maintain, and the current general support for the structural improvements accomplished over the last couple of years could vanish. However, it is very important that a period of moderate increases in unemployment rates does not lead to the loss of the improvements achieved.

There is no acute need for fiscal tightening. However, in the long run there is a need for higher total savings, i.e. the sum of public and private savings. Increased public savings now could reduce the future problems of generational distribution associated with an ageing population. With the present outlook for the Danish economy, a moderate fiscal tightening could safely take place in 2000. A fiscal tightening should serve other aims than just to increase total savings. For example, the environment would benefit from higher green taxes, and cuts in public spending or higher taxes on property relative to taxes on labour income could reduce the distortionary effects of the tax system.

Private savings could be encouraged by increasing the after-tax interest rate. The reduction in the tax deductibility of interest payments, which has been implemented from 1999, will reduce house prices and increase savings by making it more expensive to obtain loans. As the houseowners as a group is a net debtor, reductions in the taxation of interest payments would also improve public sector savings. Further reductions in the tax deductibility of interest payments could thus increase total savings, but would have to be coordinated with the taxation of other types of capital income.

Private savings are also affected by the tax rules concerning contributions to pension schemes, pension payments and interest payments accruing in the pension funds. The Danish tax system subsidises savings by lower taxation on interest payments on money invested in pension funds, and by allowing for deductibility of contributions to pension schemes. Recently, the generosity of the total pension system has been reduced by changes in the tax system and the rules for early retirement. These changes might have led to a reduction in pension savings. However, one should focus on total savings, and not on the separate parts of total savings. Presumably, a proportion of the foregone pension savings is being saved elsewhere. Moreover, some people are probably increasing their pension savings in order to keep their future pensions unchanged. On the whole, there should be no doubt that the recent changes in the tax system will increase total savings in Denmark.

Chapter II: The Ownership, Governance and Efficiency of Danish Firms

The governance and efficiency of a firm often depend on the owners and their degree of dedication. Thus, the ownership structure in Danish business has an impact on the governance and efficiency of Danish firms and, therefore, on the whole economy. Empirically, it is difficult to separate the ownership effect from other factors influencing the governance and efficiency of firms. Therefore, an evaluation of the ownership effect must to a large extent be theoretical.

The owners of a firm typically want the firm to maximize its financial return. Provided that other important considerations are not neglected, this objective may also be in society's interest, as firms aiming to maximize the owners' profit must always strive to use their resources as efficiently as possible. Society benefits from this by having a higher productivity level and standard of living. At the same time, firms may attract capital more easily, and this can lead to a higher level of investment, thus also influencing the future standard of living positively.

The social value of a high return on investment and a high return to owners depend critically on other important considerations. Public regulation and legislation are important parts of this. One example is that environmental legislation must be tight enough to ensure that environmental considerations are not neglected in an attempt to maximize the owners' profit. Another very important factor is the degree of competition in product markets. A number of empirical studies have shown that competition is too weak in several Danish industries. This lack of competition reduces the incentives for firms to produce efficiently. Firms that are not subject to sufficient competition can easily give their owners large profits. However, to the extent that this is due to high prices paid by the consumers rather than to high efficiency, this is not in the interests of society. Thus, there is every reason to strengthen competition in sectors where it is too weak.

Small firms seldom have serious governance problems, as the owners typically take part in the management of the firm. However, in many medium-sized and large firms there is a substantial separation of ownership and control. This may weaken the owners' influence and consequently reduce the efficiency of the firms, to the detriment of both the owners and society.

In limited companies in Denmark there is a dual board structure similar to the German system; in other words, there is a supervisory board and a management board. The management board is hired by the supervisory board and takes care of the firm's day-to-day operations. The supervisory board is appointed by the owners and deals primarily with long term issues. Moreover, the supervisory board must, on behalf of the owners, monitor the work of the management board. This two-tier structure no doubt helps to reduce governance problems in medium-sized and large Danish firms. However, it is not sufficient to eliminate such problems.

The largest proportion of turnover in most Danish industries is in limited companies, and most large Danish firms are organized as limited companies. The large limited companies in Denmark are characterized by concentrated ownership: i.e. the shareholders are relatively few in number and have relatively large holdings in the company. Among the 400 largest companies, 260 have a single dominant owner, i.e. the largest shareholder controls more than half the votes. In 312 of the 400 largest companies the two largest owners together control more than half the votes. In general, it is also the case that the large limited companies, along with a few large manufacturing cooperatives, have the most widespread ownership. One may therefore conclude that Danish firms overall are characterized by concentrated ownership.

Concentrated ownership is an advantage with regard to the governance of firms, as firms with concentrated ownership tend to have fewer problems with the separation of ownership and control than firms with widespread ownership. Large shareholders have a greater economic interest in the return of the firm and greater opportunities for exercising control than small shareholders. However, concentrated ownership is not without costs. First, it may be associated with serious conflicts between individual owners. Second, and more important from society's point of view, concentrated ownership implies less risk diversification. Lower risk diversification in turn increases firms' capital costs as the risk premium goes up.

Firms' capital costs also depend on the degree of investor protection and the obligations firms have to provide information. If investors are not sufficiently protected, or if they do not have access to sufficient information on the performance of the firms, then capital costs will increase, thereby reducing the level of investment. It is possible to protect minority shareholders better than is the case in Denmark today. One possibility is to allow the shareholders to mail their proxy votes to the general shareholders meeting; another is to strengthen the representation of minority shareholders on the supervisory board. The obligations of publicly listed firms to provide information are less extensive in Denmark than in, for example, Sweden, Norway, the United States and the United Kingdom. To increase the obligations to provide information, one might consider requiring companies to provide quarterly accounts. Furthermore, accounts could be made more informative by including, for example, information about management pay.

The concentrated ownership, which characterizes Danish firms, does not automatically ensure that owners are active, i.e. pressing for the maximization of their profit. In Denmark, some sizeable owner groups are either not strongly motivated to be active owners or are restricted from being so.

The most important group of owners of shares in Danish firms are the institutional investors, including insurance companies, pension funds, banks, mutual funds and public pension funds. The institutional investors manage large amounts of money, and a large proportion of these funds is invested in Danish shares, mostly in listed companies. Traditionally, the institutional investors in Denmark have been relatively passive, but there is evidence that they are becoming more active. As they are expected to acquire an increasing proportion of shares, it is important to discuss how they should act as owners in the future. One way to increase their focus on a high return on investments is to allow people to place compulsory pension contributions in whatever pension funds they prefer.

Danish institutional investors are not allowed to have a dominant position in any company. The reasons for this are firstly a fear that it could by too risky for an institutional investor to invest a large proportion of its funds in one project, and secondly that it is considered advantageous to maintain some distance between those offering capital and those who need capital. The idea behind this distance is to prevent a concentration of power, and also to prevent differences in access to capital between companies. On the other hand, it is a disadvantage that the institutional investors are not allowed to be active investors even though they own a large proportion of the shares. One has to balance the need for active investors against the risk of concentration of power and the need for a dispersion of investments.

Another important type of owner is the foundation. Firms owned or controlled by foundations employ around 15 per cent of the private sector employees in Denmark. One important reason for foundations being so important in Denmark is that they were almost exempt from taxation until 1987, and they are still taxed favourably. A foundation has no owner. It is managed by a board which is elected in accordance with its articles. The main purpose of the foundation may be to own and support a firm. As the foundation has no owner, there is a risk that the management of a firm owned by the foundation does not face any strong owner pressure, especially when the founder and his family are no longer on the board. One possible way for the firm to get a group of active owners might be to list the firm on the stock exchange. Several of the major Danish firms controlled by foundations are listed already. Although earnings in firms owned and controlled by foundations are at the same level as other Danish-owned firms, it might be an advantage for the future governance of these firms to list them.

The dominance of certain manufacturing cooperative firms is also remarkable. Most Danish cooperatives are small, but a number of these firms are very large and have a dominant role within their manufacturing sectors. This places heavy responsibilities on the internal controllers of the firms and on the competition council, because the pressure from the members of the cooperatives is weaker than it is in the smaller cooperatives. At present, two firms have such a dominant position and such a large number of owners that these factors might lead to governance problems. The owners have one vote each, but most of them will not be capable of analysing the firm's accounts, and there are no comparable competitors.

The state and the municipalities own or control a large number of firms. The difference between these firms and privately owned firms is that public employees do not have financial incentives to be active owners. This can lead to less efficient management and a low level of innovation. During the past 20 years, a number of publicly owned firms and institutions have become more independent and market-oriented. With several competitors, it is possible either to invite tenders for producing the goods or services or to privatise the publicly owned firms. Invitations to submit tenders have proved successful in increasing efficiency and reducing prices, e.g. in the field of public bus transport. If competitive markets cannot be established, monopolies have to be regulated so that both private and public firms produce as cheaply and efficiently as possible.

The essential problem for owners is whether the firm is managed in accordance with their intentions. This problem is the same for private and public owners. If the managers' salaries were dependant on the results of the firm, they might be more interested in being efficient. Less than 50 per cent of the managers have compensation schemes linking results and earnings. It would be an advantage both for companies and for society as a whole to compare the firm's results to those of comparable firms and to link earnings to the comparative result. All information on compensation schemes should be public. Shares and stock options as elements of compensation schemes may lead to inefficient incentive structures and cannot be recommended.

Chapter III: Eastern Europe, Reforms and EU

The economic changes in Central and Eastern Europe have been tremendous. The countries in the old Eastern bloc have widely sought to extend their cooperation with the West. Ten Central and Eastern European Countries (CEECs) have signed Association Agreements with the EU and will be admitted to the union when they meet certain economic and political requirements. Accession negotiations with the Czech Republic, Estonia, Hungary, Poland and Slovenia have already started, and at best these countries could join the union in 2002 or 2003. Latvia and the Slovak Republic have a good chance of starting their negotiations later this year, while Lithuania, Romania and Bulgaria will still have to wait for some time. The enlargement of the union is a great challenge to both the applicant countries and to the EU itself.

The transition has been painful for the CEECs. After ten years of reforms, only the best-performing countries have a standard of living corresponding to that which they had in 1989. The current standards of living in these countries lie between one fifth and one half of the EU average. The transition has caused a steep decline in production, as many state-owned firms closed without new private firms being created. Only as the necessary institutional reforms have been implemented have new firms been established. In recent years, most CEECs have experienced economic progress with positive growth rates and falling inflation. To a varying extent, however, the weakened recovery in the EU has affected the CEECs, and the recession in Russia has also hit some of the countries.

The Visegrad countries, which include Poland, the Czech Republic, Hungary and the Slovak Republic, have together with Estonia and Slovenia made the most progress in the reform process. In many respects these countries have achieved the standards required by well-functioning market economies. It is important for these countries to continue the process and make sure that the legal provisions already implemented are enforced.

Reforms in the financial sector are still needed, and the privatisation of banks has proceeded only slowly. Many banks are impeded by bad loans due to insufficient restructuring and lack of experience in commercial bank operation. In addition, banking supervision and surveillance are weak.

The approach to the EU means that CEECs have chosen not only to transform the organisation of their societies into market economies, but also to align their legislation with that of the EU. With the latest EU treaties, the legislative requirements for member countries have become substantial. Recognizing that it can be costly in the long term not to be members, the CEECs have been willing to incur the expenses necessary to implement the institutional changes required by the EU. The approach to the EU has already made it clear in what direction the CEECs are heading. Membership is viewed as a defence against arbitrary trade restrictions and tax changes. This reduces uncertainty, and consequently affects investment positively.

Accession to the EU requires full adherence to the treaties of the union, and the CEECs do not have any prospects of getting opt-out clauses or long transitional periods for any aspects of the membership. The legislative requirements are thus substantial, and the EU only grants limited aid to the CEECs in their preparation for accession.

The association agreements contain provisions for the lifting of trade barriers in the industrial sector, though only after a transitional period for sensitive products such as textiles. Only very limited reductions in trade restrictions for agricultural products have been agreed upon. Thus, the association agreements do not allow the CEECs to make use of their comparative advantages in certain areas.

The EU has started a reform of the common agricultural policy which will switch from price support to less distortionary income support. The passing of the budget for the next years, however, shows that the union is making only very slow progress in its reform process. Consequently, new member countries will be admitted during the continuing existence of a distortionary policy in an area where they can already compete to some extent under world market conditions. Agricultural support accounts for about half the EU budget. If new member countries were to be fully phased into the common agricultural policy on the same terms as the current members, the costs of this policy for the EU would increase substantially.

Direct agricultural support can to a large extent be regarded as social policy, and should therefore be a national matter rather than a matter for the EU. However, the EU should maintain a controlling function in order to avoid distortion of competition.

The EU does not plan to increase its budget. Therefore, a reallocation of the structural funds from the current recipients to the new member countries must take place. The standard of living in the ten applicant countries is a third of the EU average, and it is going to take many years before this income differential is eliminated. Assuming that the growth rate in the CEECs exceeds that of the EU by 2½ percentage points annually, it will take more than 30 years for the standard of living in the applicant countries to reach 75 percent of the EU average. Today, all members of the EU, including the wealthy countries, receive structural support. A reallocation of funds away from these countries will help speed up integration.

The existence of qualified labour is the basis for economic growth. Therefore, keeping well-qualified persons in the CEECs is very important. Transfers from the structural funds can limit labour migration and thus support economic development in the CEECs.

In the longer run, a high environmental standard in the CEECs is desirable. However, if new member countries have to fulfil all environmental requirements from the outset, it will probably delay their admission. Therefore, the EU should help pay for reductions in regional and global pollution, but with respect to local pollution it should be up to the countries themselves to decide upon the extent and speed of environmental improvement.

New member countries are subject to narrow limits with respect to economic policies. The intention is that the new member countries should eventually be able to introduce the Euro. Yet imposing such narrow limits is not advisable until all structural adjustments have been completed. The industrial structure in the CEECs differs from that of the present EU members, and economic shocks are likely to affect the two groups of countries differently. Under these circumstances, it is wise to have exchange rates that can move. The EU requires liberalisation of all capital flows before the introduction of the Euro. However, the CEECs cannot necessarily withstand large shifts in capital flows, due to their financial markets still being weak. Speculative pressure against their currencies might arise as a result of the CEECs having to maintain a fixed exchange rate *vis-à-vis* the Euro for a period before its introduction. To avoid speculative attacks, the European Central Bank (ECB) should be ready for unlimited intervention support. Otherwise, certain restrictions on capital flows should be allowed.

Following the dire economic situation at the beginning of the transitional period, several CEECs have experienced economic progress in recent years. EU membership can strengthen this progress. Accession is conditional on several costly legislative adjustments. To facilitate the enlargement of the union, the EU should allow long transitional periods. Experiences from advanced industrial countries show that the liberalisation of regulated sectors takes time. For example, exchange rate convertibility was not in place until 15-20 years after World War II, and the last restrictions on capital flows were lifted only in the early 1990s. Utilities and telecommunications are other examples of regulated areas which have been liberalised only recently.