

ENGLISH SUMMARY

Chapter I: The Danish Economy

Domestically as well as internationally there has been an economic slowdown in 2001. The domestic slowdown has not been caused solely by the lower growth rates abroad, but has also partly been a consequence of Danish economic policy. The aim of this policy has been to avoid the economy overheating after the boom in the late 1990s. Thus GDP growth rates are expected to be modest at 1 per cent in 2001 and 1¼ per cent in 2002, but will increase in 2003-04 to reach 2 per cent in the final year of the forecast. As a consequence of the modest growth rates at home and abroad, private sector employment is expected to fall by approximately 18,000 full-time posts in 2002, which together with a small increase in public sector employment and a small increase in the labour force means that the unemployment rate will increase to 5.8 per cent next year. This will be the first year since 1993 in which unemployment increases.

Domestic demand will be approximately constant from 2000 to 2001. The lack of growth can be attributed to two main causes. Firstly, gross fixed capital formation will, following a very high growth rate in 2000, decline in 2001, and secondly private consumption is expected to continue to grow by only about ¾ per cent in 2001 following the general slowdown in private consumption which started in 1999. In the coming years both consumption and investments will exhibit higher growth rates, giving rise to increasing growth rates in total domestic demand as well.

Table 1 Short-term prospects for the Danish economy

	Current prices	Per cent of GDP	Percentage change, volume				
	DKK bn. ^d	2000	2000	2001	2002	2003	2004
Private consumption	628.1	47.7	-0.1	0.8	1.3	2.0	2.2
Public consumption	325.9	24.8	1.0	1.7	1.2	1.2	1.2
Gross fixed capital formation	285.6	21.7	9.9	-3.6	-0.6	-0.4	2.1
consisting of:							
Residential investments	60.2	4.6	10.9	-15.9	1.5	-3.7	-0.2
Business fixed investments	202.9	15.4	10.2	-0.9	-1.4	0.1	2.7
Public investments	22.4	1.7	5.1	4.5	3.0	2.0	2.0
Stock building ^a	-1.5	-0.1	0.2	0.0	0.1	0.1	0.1
Total domestic demand	1,238.2	94.1	2.6	0.0	0.9	1.4	2.0
Exports of goods and services	565.7	43.0	11.6	4.4	1.2	4.2	4.1
Imports of goods and services	488.4	37.1	10.8	2.3	0.6	3.2	4.0
GDP	1,315.5	100.0	3.2	1.0	1.2	2.0	2.2
Key indicators							
Consumer prices, percentage change ^b			3.1	2.3	1.6	1.5	2.0
Unemployment, per cent ^d			5.3	5.1	5.8	5.6	5.2
Current account, DKK bn.			27.3	47.9	43.7	54.8	68.1
Current account, per cent of GDP			2.1	3.5	3.1	3.8	4.5
General government financial balance, DKK bn.			36.8	24.9	20.7	20.6	29.7
General government financial balance, per cent of GDP			2.8	1.8	1.5	1.4	1.9
Hourly wage costs, percentage change			3.5	4.4	3.8	3.4	4.0
Terms of trade, percentage change			0.4	0.9	-1.1	-0.4	0.6

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 the total labour force. National definition.

d) The DKK/USD exchange rate is taken as 8.11 in 2000, 8.33 in 2001, 7.78 in 2002, and 7.42 in 2003-04.

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

The global economy is at present subject to a slowdown in economic growth. In the United States and Western Europe growth rates are projected to be considerably lower this year than in 2000. In Japan, a fall in economic activity is expected. However, activity is expected to increase during the course of 2002. This is primarily due to the massive scale of the monetary and fiscal stimuli being implemented in the United States, which have led to interest rate reductions in Europe and Japan as well. The trade weighted average growth rate for Denmark's trading partners is expected to be 1½ per cent this year, increasing to about 1¾ per cent in 2001, and it will then stabilise at around 2½ per cent p.a. in 2003-04.

The terrorist attack on the United States on September 11th may lead to a number of economic effects. In the short term aggregate demand may be affected negatively through reductions in consumer and business confidence. However, it is expected that the huge stimulus given to the economy will contribute to supporting confidence, and will thereby cushion the negative impact on business conditions. In the long term productivity growth might be reduced if the greater uncertainty were to lead to a reduction in the international division of labour. However, it does not seem likely that this will be the case. On the contrary, there seem to be signs of an increasing will to co-operate internationally. Hence, long term trends in production, consumption and investment are not expected to be affected appreciably.

Danish exports and imports are projected to grow at 4½ per cent and 2¼ per cent respectively in 2001. These figures represent a sharp decline compared to the very high growth rates in 2000. Throughout the first half of 2001, Danish exports and imports continued to increase at a great rate, but growth is expected to slow down considerably in the second half of 2001 and the first half of 2002, reflecting the lower growth rates in both export markets and Danish domestic demand. As both the Danish and the international economies start growing again, exports are expected to grow at rates just above 4 per cent in 2003-04. A similar pattern is expected for imports.

Consumer price inflation will fall to 2¼ per cent in 2001 and will continue to decline in 2002-03. The predicted fall in inflation is caused by a combination of several factors. Firstly, import prices will rise very slowly in the light of the lower rate of growth in demand in international markets. An expected appreciation of the Danish krone caused by a change in the euro-dollar rate will contribute to this development. Secondly, wage increases are expected to be relatively small, given the low unemployment rate. This moderation in wage demands is probably a reflection of the labour market reforms implemented during the 1990s.

The government surplus is expected to decline from about 3 per cent of GDP in 2000 to 1½ per cent of GDP in 2001. An important cause of this fall will be the drop in revenue from taxation of returns on pension funds following the large drop in stock prices during this year. In the last two years of the forecast the government surplus is expected to increase again as growth rates increase.

During the decade 2000-10 the Danish population will be ageing, and immigrants will make up a larger and larger proportion of the total population. These demographic changes mean that the labour force will decline by approximately 40,000 persons if participation rates remain constant. The prospect of a reduction in the labour force led to reforms of the early retirement system in the late 1990s. These reforms, together with a better integration of immigrants into the labour market, are expected to lead to increased participation in the labour market corresponding to approximately 60,000 persons during 2000-10. Hence, a total increase in the labour force of about 20,000 persons is expected from 2000 to 2010. This predicted increase should be compared to the government's prediction of an increase in the labour force of 85,000 persons during the same period.

Policy Recommendations

The international economic slowdown has led to a very expansionary monetary and fiscal policy, especially in the United States. Whereas expansionary policies seem justified in the present circumstances, the correct dose may be difficult to calculate, and a counteracting contractionary policy may become necessary in 2002 or 2003. In the EMU, monetary policy has been eased less than in the United States. At the same time, the growth and stability pact limits the possibilities of some member countries for stabilization through fiscal expansion. It seems that it may be appropriate at some point to change the rules for fiscal policy in the EMU in the direction of rules which ensure a sustainable long-run fiscal policy without limiting the automatic stabilizers.

In Denmark, fiscal policy alone is expected to increase GDP growth by $\frac{1}{4}$ of a percentage point in 2001 and 2002. Given the projected economic situation, the present fiscal stance seems appropriate, and there is no need for further easing. If the situation becomes considerably worse than predicted in the present forecast, a need for a certain expansionary fiscal impulse to the economy may arise. However, in this case it would be very important that such measures should not aggravate bottle-necks on the public labour market, e.g. in the health sector. Fiscal easing in the form of tax changes should ameliorate the largest distortions in the present tax system.

The various problems on the Danish housing market have received much attention this year. The most important distortions are due to rent control, the large indirect subsidization of owner-occupied dwellings through incorrectly low taxation, and large direct and indirect subsidies to social and cooperative housing. There is a need for major reforms in the coming years to improve the functioning of the housing market. Unfortunately, negotiations on a housing package during the autumn seem to indicate a step in the wrong direction by extending public interference in the market. The suggested tax exemption for housing investments by pensions companies will aggravate existing distortions concerning taxation of capital income and give incentives to an inefficient composition of total private

investment.

The taxation of owner-occupied dwellings should be increased in coming years until it corresponds to the taxation of other kinds of savings and capital income. As a first step towards this long-term goal, the specially favourable tax treatment of people who bought their dwellings before July 1, 1998 should be abolished. At the same time, the favourable tax rules for owners aged 67 years or more should be phased out. Age in itself should not be a criterion for favourable tax treatment. Generally, a change in the tax system in the direction of a relatively larger weighting on taxation of land and real estate compared to labour is one of the most important principles in the attempt to create a more healthy tax system which can resist pressure from the process of internationalization.

During the autumn of 2001, a committee of civil servants recommended a reform of the tax on energy extraction in the North Sea. The main principle of the reform proposal is a replacement of the existing hydrocarbon tax, including a highly distortional 250 per cent investment allowance, by a neutral tax system on top of the ordinary company tax. A North Sea tax reform along these lines would be a clear improvement which could mean both a more effective tax structure and possibly a larger long-run revenue than the present system. It would be an advantage to combine a speedy change in the tax rules with an equally speedy clarification of the future terms of concession renewals through negotiations between the state and the main concessionist, DUC.

A major challenge to be faced during the coming years will be dealing with the changes in the labour force. In the period up until 2010, demographic changes alone will mean a reduction in the labour force, because more people will be above 60 years of age and because a larger proportion of the people of working age will have a non-Danish ethnic background. The latter factor can be empirically demonstrated to mean a lower labour market participation rate. Various measures have been taken to increase the retirement age of the population. The projection of the size of the labour force in this chapter suggests, however, that the total result of demographic changes

and various reforms will be a modest growth in the size of the labour force of around 20,000 people in the period 2000-10. If employment growth is to contribute to financing the larger future burden on the public finances resulting from there being more elderly people in the population, it is necessary to initiate further reforms which can increase the proportion of the population in work. In this respect an extension of maternity leave is a step in the wrong direction.

A special effort to increase the participation in the labour force of some groups may be warranted. An increase in the labour force participation of immigrants would make a noticeable contribution to the size of the labour force and would also promote integration into Danish society. However, efforts in this direction will require resources from both the public authorities and the labour market parties. The financial incentives for all groups to work instead of receiving transfers should be increased; this could be effected through the introduction of a general earned income tax credit.

The Danish retirement system still gives good opportunities for people to withdraw early from the labour market, even for people who have full ability to work and are in employment. It is important to distinguish between early withdrawal as a result of a desire for more spare time and early withdrawal as a result of reduced work capability. The social system should take care of people with reduced work capability, regardless of their age. The basic arrangement here is the disability pension scheme, on which people are enrolled on the basis of objective criteria. In contrast, people with full work capability who want early retirement should pay the full costs of this themselves. This principle is not realized in the present early retirement scheme, which can be described as a savings arrangement with a large public subsidy element. A revision of the existing early retirement scheme would consequently be beneficial. One step in this direction might be to abolish the opportunities for early retirement for people aged 60 or 61 years. Another possibility would be to make access to early retirement dependent on, say, 40 years of participation on the labour market, which would maintain the right to early retirement for people who entered the labour market at a comparatively early age. A third

possibility would be to make the possibility of early retirement flexible, but to make the annual pensions payments depend positively on retirement age for people who have full work capability.

Chapter II: Inequality and Redistribution of Incomes in Denmark

Issues concerning the distribution of incomes and, more broadly speaking, individual well-being have key significance for many political decisions in Denmark. Such issues are important for political, ethical, religious and economic reasons, and distributional issues can be discussed from any of these perspectives. Evaluating the relationship between the way incomes and individual well-being are distributed and the total welfare of the population is complicated. This is so even if one chooses a purely economic perspective as the basis for the evaluation. The chapter considers inequality and redistribution on the basis of the distribution of annual incomes and the distribution of lifetime incomes. Other analyses in the chapter consider the degree of social mobility and the lifetime incomes of people with the most common types of education in Denmark.

The effect on the distribution of income from reforms of the tax and transfer system is usually analysed using information concerning income distribution in a single year. This approach could lead to reforms that equalise the distribution of annual income, but unintentionally make the distribution of lifetime income less equal.

One element contributing to the inequality of incomes seen in a given single year stems from the fact that the level of income of an individual depends in part on the age of the individual. Students and retirees will have relatively low incomes in the distribution of annual income, but not necessarily a low lifetime income. There is a substantial difference in income inequality for the distribution of annual income and for the distribution of lifetime income. The inequality in lifetime

incomes is only half as great as that in annual incomes.

Analysis on the distribution of lifetime incomes shows a larger difference in the effects arising from public taxes and transfers than is seen in the distribution of annual income. Social welfare and social pensions are the most progressive transfers in a lifetime analysis, while social pensions have a relatively low effect on the annual income distribution. Student grants are very progressive when measured in the analysis of annual incomes, while student grants have an almost neutral effect on the distribution of lifetime incomes. The income tax in the highest tax bracket is still the most redistributive of taxes, but the effect on income distribution is somewhat less for lifetime incomes.

In the annual income distribution, 6.3 per cent of the Danish population have incomes below 50 per cent of the median. In a household with a single adult without children, 50 per cent of the median amounts to DKK 61,000. For a family with two adults and two children, 50 per cent of the median is DKK 155,000. Almost everyone experiences low income at some point during their lives, usually when studying. But very few experience low income throughout a large proportion of their lifetimes. Calculations show that only 0.3 per cent of the population experience low income for more than 40 per cent of their lives.

Compared to the United Kingdom, the United States, Germany and Italy, social mobility in incomes is high in Denmark, though not as high as in Sweden. Considering the distribution of incomes in different generations of the population, the highest incomes of one generation are not likely to fall within the same families as the highest incomes of another generation.

However, the propensity of children to choose a level of education which differs from their parents' level of education is relatively low. Children of unskilled workers have a higher probability of becoming unskilled workers themselves than children of people with other educational backgrounds. Whereas the proportion of children in the population as a whole who become unskilled workers is 32 per cent, the

corresponding proportion for children of unskilled workers is 40 per cent. Similarly, children of people with a postgraduate degree have a 37 per cent probability of taking such a degree themselves, compared to a corresponding probability of 6 per cent for the population as a whole. The relatively low social mobility in education may indicate that the abilities of the children of unskilled workers are not put to full use in the educational system. It is hard to judge whether the current level of social mobility in education is below the optimal level. Nevertheless, the differences in the educational attainments of children from different social backgrounds provide much food for thought.

Immigrants to Denmark from countries other than the Nordic countries, Western Europe and North America generally have less education than the rest of the Danish population. There is no evidence to support the view that the children of such immigrants receive less education than other Danes with similar social and economic backgrounds. However, there are great differences between the educational attainments of children of immigrants from different countries. The question of whether there is a need for a programme aimed at improving the educational attainment of specific groups of second generation immigrants should therefore be considered.

The Danish Economic Council calculates and analyses lifetime incomes associated with different types of education every fifth year. In individuals' wage and capital income alone, that is, excluding public transfers and income taxation, there are significant lifetime income differentials. Persons with the highest-income types of education have an average lifetime income about $3\frac{1}{3}$ times the lifetime income of persons with the lowest-income types of education. However, public sector income transfers and income taxes greatly reduce the differences in lifetime incomes, and so do income transfers and expenditure-sharing within households. Evaluating lifetime income differentials using an income measure which takes this redistribution into account shows that the lifetime income for people with the highest-income types of education is $1\frac{1}{2}$ times that of those with the lowest-income types of education. Thus, differences in average lifetime consumption possibilities for

people with different types of education in Denmark are relatively small.

The ranking of the various types of education with respect to the lifetime income associated with them has remained almost constant throughout the period 1988-98. People with postgraduate degrees in medicine, economics and management, engineering and law, and people with bachelor degrees in business economics, have the highest average lifetime incomes. Unskilled female workers, unskilled public employees, unskilled commercial and clerical employees, unskilled construction workers and nursery school teachers have the lowest average lifetime incomes.¹ The most notable recent change in the ranking of lifetime incomes is the drop in primary school teachers' lifetime income from being the thirteenth highest to being the nineteenth highest, out of the thirty one types of education dealt with in this chapter.

The chapter analyses the changes in inequality and redistribution resulting from changes in taxes and public transfers. A full assessment of the role of the public sector should also include considerations of the distortions caused by taxes and transfers. Previous reports have contained analyses of the distortions caused by different taxes. Those analyses are used together with the analyses of inequality and redistribution to give a comprehensive picture of the key elements of the Danish welfare model.

The design of the Danish tax and transfer system is analysed in the sections that follow. The most important question considered is whether the system could be changed so that the

- 1) Unskilled workers are grouped by trade union membership. An unskilled commercial and clerical worker, for example, is a person without a qualifying education who is a member of the Union of Commercial and Clerical Employees in Denmark. Similarly, female workers are defined as members of Women Workers Union, public employees are members of the Danish Trade Union of Public Employees, and construction workers are members of the Wood, Industry and Building Workers' Union in Denmark. Nursery school teachers have completed a short course of further education (3½ years) at an institute of social education and work in day care centres.

distribution of income becomes more equal while at the same time the costs associated with transfers and collecting taxes are reduced. Alternatively, and more realistically, there is a discussion of whether a better balance could be attained between equality and the costs of transfers and collecting taxes.

Analyses in this chapter demonstrate that several instruments have as almost their sole effects the redistribution of resources between people of different ages. Other elements of the welfare state reduce uncertainty concerning the living conditions of the individual, because taxes and public transfers can be thought of as an insurance mechanism. Some people have suggested the introduction of individual savings accounts for public services. In an individual savings accounts system, the individual saves money for his or her own use of public services. There have been very few attempts to introduce comprehensive systems of individual savings accounts, however, so experience is limited. The change in the way public services are financed in such a system reduces the tax burden and the distortions associated with it. The move towards less tax finance and more individual finance is also likely to decrease the demand for the public services in question. However, the change may lead to a more unequal distribution of incomes, because people with high incomes have little use for the public services covered by the individual savings accounts. Thus, high-income earners will not help to fund low-income earners' use of public services. Introducing the accounts will also lead to an erosion of the insurance function of the welfare state, which would harm the worst-off in society. Individual savings accounts can be justified for public services which substitute for personal savings, e.g. some services for old age pensioners. The accounts system is not advisable for services which have important insurance functions, such as health care. More information is needed in order to fully assess the desirability of a move towards a more comprehensive system of individual savings accounts.

However, elements of individual savings accounts can already be found in the Danish welfare state system for transfers that substitute for personal savings. For example, the 1999 reform

of the early retirement system introduced compulsory savings for early retirement.² Another example is the Danish Labour Market Supplementary Pensions Scheme (ATP). In this pensions scheme, an active labour market participant and his or her employer both contribute to fund the participant's pension.³ The contributions are put into a personal account.

It is possible to make changes in the tax-system that will give a more equal income distribution, and at the same time have a positive effect on the labour supply. It is suggested in the chapter that the income limit for the highest income tax bracket should be raised, and at the same time the tax rate should be raised. If this were done, ensuring at worst neutrality with regard to the effects on public budgets even without the dynamic effects stemming from a larger labour supply, the result would be a more equal income distribution. Furthermore, estimates published in *Danish Economy, Spring 2001* indicate that the changes would have a positive effect on labour supply. The proposed change in the tax structure would then result in higher GDP and at the same time contribute to a small amount of income inequality. The same effect would occur if the income limit and the percentage paid were raised for the medium income tax bracket level, but the positive effect would be a little less.

There is only one tax in the Danish tax system where payment partly depends on age. The payment of real estate tax is lower for people aged 65 years or more who have low incomes. There is no reasonable economic argument for this age distinction. If a progressive tax is required, the tax rebate should apply for everybody on comparable incomes. In general it cannot be recommended to have a progressive structure in the taxation of capital and real estate. Progressivity is handled more efficiently in the taxation of labour and transfer income, where it will apply automatically to the whole population.

- 2) The early retirement system allows people aged 60-64 to retire and receive public income transfers to compensate for the loss of income.
- 3) Contributions to ATP are also paid from some public income transfers.

The possibility of deducting a mileage allowance for travel to work results in a more unequal distribution of income. This is because people with high incomes generally receive the highest deduction relative to income. There are however economic arguments which support a mileage allowance deduction. The mileage allowance gives an incentive to job search, and at the same time a greater incentive to get a better paid job further away from the home address. It is often the case that only one person in a household will be able to get a job close to the home address, and in this situation the mileage allowance can result in greater mobility of the work force.

For the mileage allowance to be beneficial to society it is necessary that the positive effects on the economy should be greater than the negative effects. The deduction of the mileage allowance is concentrated at the high end of the income distribution, where there will always be a large difference between income when one is unemployed and income when in employment. For this part of the population the mileage allowance probably does not make any difference to the incentive to get a job, but only an extra incentive to get a better paid job even if it is further from home. In the long run, the mileage allowance gives an incentive to keep a job which is far from home. It is not at all obvious that the positive effects of the mileage allowance can justify a loss of taxation revenue amounting to DKK 3 billion and an increase in income inequality.

Trade union membership fees are tax deductible under the Danish tax system, as are firms' fees to employers' associations. The possibility of making such deductions has a neutral effect with respect to the distribution of income, and the total loss of taxation revenue totals DKK 3 billion. The deduction can only be economically reasonable if the organizations have a positive effect on the economy. The organizations can contribute to the development of a flexible labour market, including, for example, minimum standards. The collective bargaining system and prior warning of strikes may enhance labour market flexibility. Furthermore, trade unions enable a more transparent system of wage rates, thus ensuring that people with the same qualifications and experience are paid the

same wages. On the other hand, unions can use monopoly power to secure a wage for their members that does not correspond to productivity. Similarly, the employers' associations can exploit their market power if there are only a few firms in a particular line of business. It is not clear that these organizations have a positive effect on the economy as a whole, and it is therefore unclear whether the tax deduction should be continued.

The minimum wage can be used as an example of the positive and negative effects described above. The minimum wage can be seen as a way of ensuring that no one works for an unreasonably low salary. Furthermore, it gives both firms and individuals incentives to improve employees' qualifications. On the other hand, an increase in the minimum wage would result in a greater incentive for firms to replace workers with low qualifications by workers with higher qualifications.

The allocation of housing subsidies depends on the recipient's age, and on whether the applicant has retired early. The rules for those who have retired early and people above the age of 65 are more generous than the rules for younger members of the population. While housing subsidies to early retirees have a large impact on the distribution of income, this does not apply for housing subsidies to the elderly. There are no reasonable arguments for the distinction made between the young and the old. Housing subsidies should therefore be independent of age, and the allocation to the elderly should follow the same rules as for people below 65 years of age.

All families with children are entitled to child benefit. The amount received depends on the number and age of the children, and the benefit is not taxed. The child benefit loses a great deal of its effect on the income distribution when lifetime income is considered instead of annual income. Child benefit could be more effectively directed at the poor if the benefit was means tested. This would, however, reduce the incentive to earn more. Alternatively, the amount of child benefit could be raised, and at the same time be taxed. This could be done in such a way as to ensure that families with low income had the same after-tax benefit, and that only families with a high

marginal tax rate would lose. The only people whose marginal tax rates would rise would be families with incomes which were just below the limit for paying tax at the medium or upper levels. This reform would also make child benefits comparable to other social transfers, which are all taxed. The reform sketched above could also be considered for the child benefit to single parents.

Pensions to retirees consist of two different transfers; one of the transfers is means tested, and the other is not. The results documented in this report show a large difference between the effect on the income distribution of the means tested benefit and of the transfer which is not means tested. The difference is especially large in the context of lifetime income. If the means tested transfer were raised and the transfer which is not means tested were reduced by the same amount, the result would be a more equal distribution of income — both annual income and lifetime income. Public transfers will rise in the years to come because of the ageing of the population. A reform of this type would lower the financial pressure on the public sector, because payments made from private pensions will increase during the coming decades. The adjustment would result in a lower disposable income for persons with high private savings. But this group will have benefited from the favourable tax treatment of private pensions.

Student grants increase peoples' propensity to undertake education, because the amount of borrowing and the economic risks associated with undertaking education are reduced. A higher general level of education can lead to increased productivity and thereby increased national income and welfare.

Student grants redistribute annual earnings but not lifetime incomes. Indeed, student grants to people undertaking postgraduate education increase inequality in lifetime incomes.

A reform of the system of financial support for students is suggested. Currently a student can receive grants and loans for at most six years of further education. Instead, both grants and student loans should be offered to students during the first

three years of further education, just as under the current system. After the first three years of further education only augmented student loans should be offered. This reform would lead to a more equal distribution of lifetime incomes. The possibility of taking augmented student loans after the first three years would allow students to continue their studies without experiencing reduced standards of living, but they themselves would bear a greater share of the costs of their education. This would reinforce students' incentives to finish their education quickly. After three years of higher education, students from all social backgrounds would be likely to have the same chances of completing their education. Furthermore, as most courses which last more than three years lead to relatively high lifetime incomes, the proposed reform would not remove the strong incentives to undertake such courses.

Analyses in *Danish Economy, Spring 2001* indicate that emigration of highly educated Danes has not been a problem so far. The geographical mobility of highly educated people can, however, be expected to increase in the future. Hence, in the future, society's gains from financing higher education are likely to decrease, because more people will use their higher education abroad. This is a separate argument for increasing the amount of self-financing associated with taking a course of higher education.

Chapter III: Globalization and the Danish Labour Market

Free trade, foreign direct investments (FDI) and outsourcing increase overall wealth of nations but also have an impact on labour markets. Over the past three decades, labour market developments in most advanced economies have been characterized by either wider wage differentials or unskilled unemployment, and the connection to globalization seems to be obvious to many. The purpose of this chapter is to explain the ways in which globalization and economic integration affect the Danish labour market. It is important to emphasize that changes have taken place over a prolonged period and that

globalization should be considered more as a process which gradually leads to a more integrated world economy than as a sudden regime shift which has changed labour market structures fundamentally in the course of short time. However, labour market developments can lead to considerations related to the implementation of structural and distributional initiatives in order to offset possible tendencies towards increased inequality.

Denmark's trade with low wage countries, including China, is too limited in size to explain skill-biased labour demand in general. However, specific groups are affected by trade, in particular textile workers. Trade with the Central and Eastern European countries is also rather limited, although it has increased rapidly in the past decade. Denmark's trading partners, then, are mostly other advanced countries which are alike with respect to the level of income, the educational attainment of the labour force, the industrial structure, and a number of institutional factors. Almost 90 per cent of total trade is with other OECD countries.

Agricultural trade – particularly in the EU – is hampered by a number of restrictions which preclude developing countries and the Central and Eastern European countries from exploiting their comparative advantages. Accession to the EU of a number of Central and Eastern European countries will strengthen the pressure to liberalize the Common Agricultural Policy. Abolition of the current policies will obviously require adjustments in the agricultural sector and the food industry, and the relatively many unskilled employees in these sectors are likely to be affected. This should be weighed against the significant benefits from phasing out the distortionary support schemes, including gains that arise from trade with developing countries.

The Eastern Enlargement of the EU may create undesirable effects on labour markets in the present EU member countries, due to immigration from the Central and Eastern European candidate countries. Accession will mean that all barriers to labour mobility will be removed for the populations of these countries, and substantial differences in per capita income

between the candidate countries and the present member countries will give incentives for migration. Current immigrants to Denmark from the candidate countries have a relatively high formal education level, but they tend to find jobs that do not fully exploit their human capital. Therefore, possible adverse wage and employment effects for the low-skilled in Denmark can be countered if the skills of immigrants are better utilized.

Like other advanced economies, Denmark has experienced strong growth in FDI inflows and outflows over the past decade. Most foreign direct investments are placed in other advanced economies, and the sectoral distribution of inflows and outflows is similar. This symmetry points to limited direct consequences for the level of employment. A small proportion of the foreign direct investments are directed to low wage countries. These countries do not invest in advanced economies to the same extent. Thus, some jobs – presumably unskilled – may be lost on this account.

The internationalization of production also takes place through outsourcing, part of the production being subcontracted to firms abroad, e.g. to foreign affiliates. The analyses in the chapter indicate that outsourcing in Denmark is prevalent in the textile industry, which has lost many unskilled jobs.

An important aspect of globalization is technological advances, and the faster spread of these across countries. In particular, marked declines in costs of transport, communication and information have contributed to new possibilities for trade and production. More generally, technological advances have independent implications for labour market developments, because they are not necessarily neutral to all types of labour. Over the past decade, there are indications that skilled labour has benefited relatively more than unskilled from technological progress. Thus, technological progress may, like international trade, lead to increased inequality.

The increasing economic integration of European countries may also affect the labour market. These countries are fairly similar with respect to income levels, and the effects of

integration come primarily from increased product market competition and greater job mobility, which increases the elasticity of labour demand. A more elastic labour demand schedule weakens the position of the trade unions, and signs of such a development have already been seen. First, the unionization rate has declined in most industrialized countries in the 1980s and 1990s. This holds for Denmark and the other Nordic countries as well. Second, bargaining on the labour market is taking place at more decentralized levels. Third, the degree of job protection has fallen in most European countries.

Economic integration can have desirable labour market consequences if distortions caused by trade unions are reduced. Powerful unions sometimes succeed in negotiating wages and work conditions that are economically inappropriate. Insofar as economic integration renders trade unions less powerful in wage negotiations and reduces labour market distortions, these effects are welcome. However, unions help secure reasonable work conditions and they reduce the risks to the individual worker by negotiating pay schedules that tend to give equal pay to equally qualified workers. If the power and influence of unions are seriously reduced then some of their objectives must be achieved by government.

National labour market policies within the EU may be harder to sustain as a result of increased integration. This could be a problem if labour market rules and social standards have been implemented to protect specific groups on the labour market. In such a case, a certain degree of coordination of labour market policies in the EU might be preferred. In order to avoid possible costs associated with deviating labour market outcomes, Belgium and Sweden have already introduced “European wage norms” stipulating that wage increases should be in line with wage trends in other European countries.

Increased mobility of firms could alter the industrial structure in Europe because some firms tend to cluster in specific countries to exploit economies of scale. Such a trend towards increased specialisation of countries has been detectable in Europe since the 1980s, although there have been no dramatic changes. This could affect the demand for certain types of

labour. On the other hand, firms' choice of location also depends on the supply of production factors. For instance, firms that conduct research and development intensively are typically located in researcher-abundant countries. Therefore, a policy that enhances the supply of researchers in the work force could raise the probability of attracting such firms. However, even though the mobility of labour is relatively low in Europe today, increased public spending on education could lead to a "brain drain", as highly educated workers might have better wage and employment opportunities elsewhere. Furthermore, it is also necessary that areas where increased public spending on education is called for can be identified and defined.

Globalization definitely brings gains, and the possible distributional problems caused by globalization are best solved in ways other than by impeding progress. In that connection, it is important to ensure a sufficient level of general education for everyone and support continuing education and training for those with the lowest skills. In the short run, redistribution of incomes may be necessary to offset tendencies to wider wage differentials.