

## ENGLISH SUMMARY

### Chapter I: The Danish Economy

The Danish economy has experienced a period of strong demand with growth rates above 3 per cent over the past two years. However, during the second half of 2006 a slowdown in the growth rate began, mainly caused by a decline in private consumption. A number of indicators suggest that the slow growth in private consumption will continue in 2007, but growth in private consumption is expected to pick up again, stimulated by the accumulated capital gains on real estate resulting from several years of large increases in house prices. In the coming years demand is expected to remain at a relatively high level, and GDP is expected to rise at an annual rate of about 1½ per cent (see table 1). The relatively high growth rates in the Danish export markets over the past years – especially in Sweden and in Germany – are expected to decrease slightly.

Unemployment reached a very low level of 110,000 people at the end of 2006 and has since fallen to an even lower level below 4 per cent of the labour force. The current level of unemployment is estimated to be around 35,000 persons below the structural level of unemployment. Since demand is expected to remain at a relatively high level during the forecast period, unemployment is expected to remain low, with only a slight tendency to increase. The growth rate of nominal wages is expected to rise to about 4½ per cent during the forecast period (2007-09). The higher wage increases are a result of a tight labour market and the recent rounds of collective bargaining between employers and workers.

Consumer prices have increased by approximately 2 per cent per annum in recent years. Domestic costs are expected to increase at a slightly higher pace over the coming years as a result of higher wage increases. Inflation is thus expected to rise to 2¼ per cent by the end of the forecast period.

The large increase in employment over the past years continued in 2006, and at the beginning of 2007 employment was at a historically high level. At the same time the increase in hourly productivity has been very low. In 2006 the increase in hourly productivity was only  $\frac{3}{4}$  per cent, and in the present year it is expected to stagnate. It is expected that hourly productivity will then return to the recent historical trend of approximately  $1\frac{1}{2}$  per cent per year.

The large increase in labour input was possible due to a growing labour force based on the inflow of foreign labour and increasing average working hours. In the light of the economic upturn, the trend towards a growing labour force and increased working hours is expected to continue over the coming years, but at a slower pace.

The increase in demand has exceeded the increase in production. Consequently, the strong growth in demand has to a large extent been met by an increase in imports. In the coming years it is expected that growth in demand will continue to exceed Danish output growth, but as the growth in demand decreases, it is equally expected that the growth in imports will decrease.

However, since imports are expected to grow faster than exports, the current account surplus will fall from approximately DKK 40 billion in 2006 to approximately DKK 10 billion in 2009.

The scope for output growth in Denmark is constrained by the fact that the Danish economy is operating close to full capacity. The possibility of raising output via a lower rate of unemployment or through an increase in labour supply is considered to be limited. It will require new labour market policies, tax reform, or an increase in the inflow of foreign labour. Hence, a larger increase in demand than expected involves a risk of wage acceleration that is higher than assumed in this forecast. There is thus a risk that the current economic upturn might be followed by an extended period with low growth and increasing unemployment.

Table 1 Short-term outlook for the Danish economy

	Current	Per cent	Percentage change, volume				
	prices DKK bn.	of GDP	2005	2006	2007	2008	2009
Private consumption	796.0	48.6	4.2	3.4	1.8	2.4	2.5
Public consumption	418.3	25.5	1.1	1.2	1.5	1.1	1.1
Gross fixed capital formation	365.4	22.3	9.6	10.9	5.0	2.5	2.9
consisting of:							
Residential investments	104.7	6.4	16.7	8.1	7.1	1.9	2.6
Business fixed investments	230.5	13.3	7.7	13.4	5.3	3.1	3.3
Public investments	30.2	1.8	3.0	6.6	-4.0	2.0	2.0
Stockbuilding <sup>a)</sup>	10.3	0.6	-0.1	0.4	0.0	0.1	0.0
Total domestic demand	1,590.1	97.1	4.3	4.9	2.4	2.1	2.2
Exports of goods and services	849.4	51.9	7.3	9.6	6.3	3.7	3.4
Imports of goods and services	801.9	49.0	10.8	14.0	7.8	5.2	5.0
GDP	1,637.6	100.0	3.1	3.2	1.8	1.4	1.4
<b>Key indicators</b>							
Consumer prices, percentage change <sup>b)</sup>			2.2	2.1	2.0	2.0	2.2
Unemployment, per cent <sup>c)</sup>			5.5	4.3	3.6	3.8	3.9
Current account, DKK bn.			58.7	39.4	30.4	22.6	9.8
Current account, per cent of GDP			3.8	2.4	1.8	1.3	0.5
General government financial balance, DKK bn.			71.8	69.1	66.2	58.5	55.9
General government fin. balance, per cent of GDP			4.6	4.2	3.9	3.3	3.0
Hourly wage costs, percentage change			2.7	3.1	4.3	4.5	4.5
Terms of trade, percentage change			2.0	-0.5	0.4	0.3	0.2

a) The percentage changes are calculated as 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.

Note: The DKK/USD exchange rate is taken as 6.00 in 2005, 5.94 in 2006, 5.53 in 2007 and 5.48 in 2008-09.

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

## Policy recommendations

The shortage of labour implies a considerable short-run threat to the stability of the Danish economy. Hence, there is a need for policies that will quickly increase the supply of labour or reduce the structural unemployment rate. In chapter III a number of possible policy initiatives are presented which are estimated to reduce the structural unemployment level by about 35,000 people. These initiatives would not be fully effective in the short run, but they would contribute to eliminating some of the current pressure on the labour market. Import of labour would be another way to improve the labour market situation. The import of labour could be increased by an abolition of the restrictions on the free movement of labour from the new EU member states. Another possibility is to introduce a targeted earned income tax credit for employed persons aged 64 years (see chapter III).

During recent years, fiscal policy has contributed to the growth in demand. Over the coming years, the combination of the tax freeze (according to which the Government has committed itself not to raise any taxes) and a relatively high growth in public expenditures will stimulate economic activity, but to a smaller extent than in recent years. Accordingly, the current fiscal policy does not contribute to a reduction of the risk of economic overheating. If policies to increase the labour supply are not passed through parliament soon, there will be a need for a significant tightening of fiscal policy in 2008. In case no labour market reforms are implemented, it is recommended that fiscal policy is tightened in order to dampen GDP growth by  $\frac{1}{4}$  to  $\frac{1}{2}$  of a percentage point in 2008.

The Danish tax reform of 1994 introduced a new tax on all wage income and income from self-employment (the labour market contribution). The tax was earmarked to finance a range of specific national expenses related to the labour market, e.g. public expenses for unemployment benefit, the early retirement scheme, and the active labour market policies. By law, this tax must be reduced when the revenue exceeds the specified costs in the budget proposal for the

coming year announced by the Government in August. The present forecast estimates a budget surplus in 2008, which implies that the earmarked tax should be reduced from 8.0 to 7.8 per cent in 2008. This would produce a deterioration in the public finances of approximately DKK 2 billion. This tax reduction is clearly not appropriate in the current economic situation, and in general the earmarking of the labour market contribution will lead to a pro-cyclical fiscal policy. It is therefore recommended that the earmarking of the tax be abolished. In addition, it should be noted that a reduction in this specific tax is a far less effective way of stimulating labour supply than a reduction of marginal tax rates for specific groups or a rise in the earned income tax credit.

Over the coming years, the composition of the population will change. Cohorts of retirees will grow larger and the number of people in the working age group will diminish. The demographics will lead to a gradual but systematic tendency to a deterioration in the public sector budget over the coming years (see *Danish Economy, autumn 2006*). The demographic changes and the low growth in productivity imply that Danish GDP growth is likely to be significantly lower than in countries to which Denmark is normally compared.

On this basis, there is a need to look ahead and establish new objectives for medium- and long-term economic policy in the period up to 2020. The new plan should contain targets concerning labour force growth as well as targets for public expenditure and taxation policies. These targets should be continuously reassessed and supplemented as need be with specifications of the instruments to be used to achieve them.

The present medium-term plan sets goals for the real growth rates in public service expenditures. These goals should be replaced by a broader objective that includes growth rates for service expenditures as well as income transfers. Hence, the plan should involve targets for the ratio of public expenditure to GDP in current prices. On the revenue side, the tax freeze should be abolished, because it leads to a gradual erosion of the revenue from excise duties and real estate tax.

The new medium-term plan should include targets for labour force growth – both quantitative and qualitative. An increase in the effective labour force could take place through an increase in the number of people in the labour force, through higher average working hours, or through higher growth in productivity caused by increased research and education. Higher labour force growth would imply higher growth in income per capita, which would facilitate the maintenance of a continuing high level of welfare viewed in an international perspective. At the same time, higher employment could create additional ‘room for manoeuvre’ for fiscal policy, e.g. room to increase expenditure growth or scope for tax cuts. If such economic flexibility were used for tax cuts, a lowering of the marginal tax rate would probably be the instrument which would have the greatest effect on the effective labour supply.

A significant challenge over the coming years will be to restrain the growth in public expenditures. There are a number of reasons why the growth in the public expenditures will have a tendency to increase in the future. First of all, the demographics point in the direction of an increase in health care expenditures. Second, there is a tendency towards lower productivity growth in the services sector than in the economy in general. Products such as health care and education are typically produced by the public sector in Denmark. Third, it is quite possible that the demand for education and health care will increase faster than the demand for other types of goods and services. These pressures will tend to increase the tax burden unless there is a strong focus on public expenditure control and on efficiency in the public sector.

The Government is preparing a public sector reform aimed at increasing the quality of public sector production. The purpose of the reform is to raise the quality of public services without increasing public expenditures. There is no doubt that there is potential for increased efficiency in the public sector, e.g. by the use of benchmarking, outsourcing, and public-private partnerships (see *Danish Economy, spring 2004*). The recent administrative reforms of local

governments also provide possibilities for improvements in public sector efficiency.

It is a great challenge to continuously increase the quality of the public sector without increasing public expenditures. If the Government does not succeed in raising efficiency, the demand for improved quality can only be met by greater expenditure. Hence, if the reform efforts fail, this will constitute a threat to fiscal sustainability.

## **Chapter II: Business Cycles and Fiscal Policy**

The pace of the economy varies substantially over time. During expansions, demand for labour and capital is high, while it is somewhat lower during slowdowns. Fluctuations in economic activity affect the population in various respects, primarily in a negative way. Chapter II examines the extent to which fiscal policy can and should seek to dampen economic fluctuations.

Business cycles make it more difficult for people to find and retain employment in some periods than in others, thereby affecting wage earners directly. Periods of unemployment lead to losses of income. Long-lasting spells of unemployment may lead to depreciation of human capital among the unemployed and may keep some individuals permanently out of employment. Besides this, fluctuations cause uncertainty and complicate the investment and consumption decisions of households and firms. At the macroeconomic level, unemployment represents wasted resources and lost welfare.

One goal of stabilisation policy is to avoid major contractions in the economy and – if the economy already *is* in a recession – to make the adjustment path back to a normal activity level quicker and less painful. However, history also shows that periods of rapid expansion with very low levels of unemployment may trigger acceleration in wages and prices, leading to loss of competitiveness and ultimately dragging the economy into long-lasting contractions. Therefore, a stabilisation policy should not only stimulate demand

in bad times, but should also reduce the pace of the economy when capacity utilisation is too high.

The analyses indicate that it is possible to stabilise the economy to some extent by using fiscal policy. Specifically, the analyses lead to the following conclusions and recommendations:

- In the case of a positive output gap (defined as the percentage difference between actual and potential GDP) amounting to 1 per cent, fiscal policy should reduce GDP growth by around  $\frac{1}{4}$  of a percentage point. Similarly, the response to a negative output gap should be a positive growth contribution from fiscal policy of the same magnitude
- Such moderate fiscal responses may reduce fluctuations in employment and GDP by up to one third. On the other hand, a fiscal policy which is too aggressive might increase, rather than reduce, fluctuations
- In the event of indications that an economic imbalance is caused by temporary disturbances on the supply side, there should be no fiscal policy response
- Fine-tuning should be avoided: Fiscal policy should not be used to counteract modest imbalances characterised by output gaps of a magnitude of less than 1 per cent
- The gains from an active fiscal policy are limited for the following reasons:
  - Assessing the cyclical state of the economy is surrounded by uncertainty. There is a substantial risk that fiscal policy will react inappropriately, especially to small imbalances
  - An unintended side-effect of an active fiscal policy is that some ‘instruments’, e.g. tax rates or the number of people employed in the public sector, become more volatile.

These circumstances are the reason that only a cautionary response to fluctuations in the output gap is recommended.

Danish fiscal policy is planned with respect to the challenges implied by the ageing population. Fiscal policy affects long-term economic development, e.g. through the



tax structure. It also has an effect in the short run through the contribution to growth stemming from discretionary fiscal policy (changes in tax rates and benefits, or in public consumption) and from automatic stabilisers. The automatic stabilisers are large in Denmark, due to a progressive tax system and a relatively high level of unemployment benefits.

Danish fiscal policy over the last 25 years illustrates various examples of major actions aiming at stabilising short-term fluctuations in combination with changes in structural policies. The common feature of these actions is the combination of short-term stabilisation with changes in tax and labour market policies. Combining short-term stabilisation with actions that improve the long-run output potential is a desirable way of conducting economic policy. On this basis, fiscal policy in Denmark must be characterised as having been well-planned over the period.

The analyses use model simulations to illustrate the effects of active fiscal policy. Two different types of models are used to shed light upon the influence of price stickiness and differences in the formation of expectations among households and firms. On the one hand we have the Simulation Model of the Economic Council (SMEC), which is a traditional macro econometric model where demand is the short-run determinant of production. On the other hand we have a Dynamic Stochastic General Equilibrium model (DSGE) which was developed for the analyses. Within this model, households and firms plan consumption and investment based on expectations of future economic developments. Prices are sticky in this model, but less sticky than in SMEC, and production is to a larger extent determined by the supply of capital and labour rather than by demand.

The analyses assume that fiscal policy seeks to stabilise the output gap, which is a more reliable indicator of the true business cycle situation than is GDP growth. The reason is that if the economy reaches its capacity limit, the possibilities for further growth are reduced. This leads to lower growth rates, but does not mean that the economy is in a

recession and certainly does not mean that the economy should be stimulated through looser fiscal policy.

In both model frameworks, the analyses show that it is possible to use fiscal policy as a means of stabilising various macroeconomic key figures such as GDP, employment and prices when the economy is hit by demand shocks. A common feature of demand shocks is that they pull production and prices in the same direction, so no conflict exists between stabilisation of production and stabilisation of prices.

Fluctuations of output and employment caused by shocks to the supply side of the economy can in principle also be stabilised. However, the problem is that supply shocks alter the capacity limit of the economy. This means there is a risk of misperceiving a supply shock as a demand shock. For example, if an observed low growth rate is not caused by a negative demand shock, but instead is a consequence of a deterioration in potential output; fiscal policy should not be expansive. In such a case an expansive fiscal policy would be working against the necessary adjustment of the economy. Furthermore, an unpleasant side-effect might be a substantially increased level of public debt. Hence, if there are signs that an imbalance is caused by changed supply-side conditions, fiscal policy should not try to prevent the necessary adjustment of output.

It is not possible to recommend 'an optimal fiscal rule' on the basis of the analyses. The magnitude of the fiscal response to a given imbalance depends (among other things) upon the relative weight attached to stability in the general economy relative to stability in, for example, the number of people employed in the public sector, or public investments.

The greatest gains obtained by counteracting economic fluctuations are obtained when output is primarily determined by demand. On the other hand, gains are clearly smaller when production is supply-driven. All in all, the analyses suggest that a positive output gap of 1 per cent should be met by a negative fiscal growth contribution of around  $\frac{1}{4}$  of a percentage point, and vice versa.

In practice, the need for fiscal action is surrounded by uncertainty regarding the present as well as the future economic situation. This is so for many reasons. Firstly, relevant macroeconomic key figures such as GDP and employment are released with a time lag. Secondly, the numbers are often subject to substantial revisions. Furthermore, due to methodological issues, it is difficult to assess the exact size of the output gap. Because of this, robustness checks have been carried out to highlight the implications of misperceptions of the output gap. Naturally, misperceptions reduce the gains from active fiscal policy. Furthermore, if misperceptions are large and if the economic imbalance is small, an active policy responding to the estimated output gap runs the risk of stimulating the economy at a time when a fiscal tightening would have been appropriate.

In reality it is difficult to distinguish a demand shock from a supply shock, but the greater the size of a given imbalance, the easier the task becomes. By not responding to small imbalances, the risk of misidentifying a supply shock as a demand shock is reduced. Consequently, fiscal policy should not react to output gaps smaller than 1 per cent.

Politically, it is easier to loosen fiscal policy during slow-downs than it is to mobilise political support for fiscal tightening in good times. However, if fiscal policy actively aims at reducing fluctuations, it is indeed necessary to tighten policy during periods of expansion. If this symmetry is not ensured, an active fiscal policy will over time increase the level of public debt.

The analyses are based on the assumption that fiscal policy responds solely to the output gap, but in practice all relevant information on the current economic situation should be taken into account, e.g. figures on unemployment and the current account balance. Special attention should be paid to developments in wages and prices. For example, if the output gap is positive, but no inflationary pressure is present, it could be an indication that the output gap might have been misperceived, because the economy is being hit by a positive supply shock.

All in all, the analyses indicate that fiscal policy is able to contribute to reducing fluctuations in economic activity. However, the demographic challenges that Denmark faces underline the importance of having fiscal policy focused on medium- and long-term goals. In the short term, fiscal policy may reduce the volatility in the economy, but the long-run level of employment and welfare is determined by the long-term policies that shape economic structures and incentives. Consequently, short-term concerns should not compromise long-term objectives. Rather, short-term economic policy should be conducted within the framework of a plan that ensures long-run sustainability of public finances.

### **Chapter III: Danish Labour Market Policy since 2000**

The Danish labour market functions well, and unemployment is at its lowest in recent history. The employment rate is one of the highest within the OECD, but there is excess demand for labour, which raises new challenges for the functioning of the Danish labour market model, often called the ‘flexicurity’ model.

The flexicurity model is characterized by relatively generous unemployment benefit schemes, flexible employment contracts and an active labour market policy. Employees accept flexible employment contracts, since generous unemployment benefits provide an insurance against large income losses.

The labour market model was changed quite dramatically during the period from 1994-2000. The major changes were an expansion of the active labour market programmes (ALMP), a cut in the duration of unemployment benefits, and the introduction of a special programme aimed at reducing unemployment amongst the young. These changes were analysed in *Danish Economy, autumn 2002*. A substantial part of the drop in unemployment after 1994 resulted from these changes in labour market policy.

After 2000 the changes to labour market policy have continued as the demand for labour has increased, requiring further reductions in unemployment and a larger supply of labour. The major changes have included improved employment incentives for people on social assistance and more intensive advising and monitoring of the unemployed covered by unemployment insurance, with an increased emphasis on testing the availability for work. The use of ALMPs has been reduced, but the costs of the active labour market policy remain high.

Chapter III analyses and discusses central elements of the Danish flexicurity model, focusing on ALMPs, mandatory meetings and counselling, availability-for-work requirements and the unemployment benefit schemes. The chapter includes both new investigations and updates of previous analyses of ALMPs.

### **Instruments of Labour Market Policy**

The Danish labour market policy is a combination of relatively generous unemployment benefits available (if necessary) over long unemployment spells, flexible rules for hiring and firing, and an active labour market policy which includes strict checking of availability for work. This complex combination is often termed 'flexicurity', and this combination of instruments is unique within the OECD countries.

An important component of active labour market policy is the testing of availability for the labour market. Contact between the unemployed person and his or her case worker has been strengthened since 2000, and the unemployed have to write a CV for an internet job-bank and to attend a meeting with a case worker every three months. If an unemployed person does not show up for the meeting, this is reported to the unemployment insurance fund, and sanctions may be applied. These meetings are an important part of the administrative system aimed at checking up on the unemployed person and at the same time improving his or her awareness of job openings and job search skills.

The two most important characteristics of the so-called passive labour market policy are the level of compensation and the duration of unemployment benefit. The maximum level of compensation is 90 per cent of previous income, but the average level of compensation has fallen and is now around 50 per cent for the average worker. The maximum duration of unemployment benefit is four years, which is longer than in any other Nordic country. By this feature Danish labour market policy stands out from the policy in other OECD countries.

### **The Active Labour Market Policy**

The use of an Active Labour Market Policy is often motivated by the need to upgrade the skills of the unemployed in order to improve their opportunities for employment. However, the ALMPs also test whether the unemployed are actually available for work, so the prospect of participation in an ALMP can lead to an increased incentive to search for a job prior to the enrolment in the programme. This is referred to as the ‘motivation effect’ of ALMP.

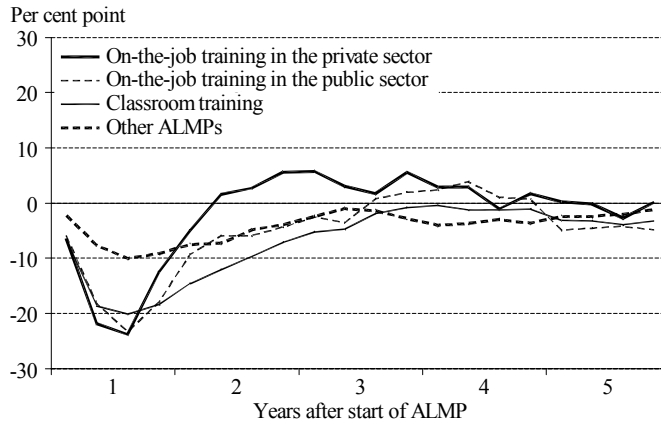
Analyses in this report indicate that the prospect of participation in an ALMP reduces the average unemployment duration by approximately one week prior to the programme start.

The analyses also show that some programmes have a negative effect on the probability of leaving unemployment after the start of the programme (see figure 1). These negative effects are often due to the locking-in effect; that is to say, while participating in active labour market programmes, the unemployed may reduce their efforts to find regular jobs. Furthermore, there is sometimes a negative post-programme effect which may arise if participation in a programme induces participants to raise their reservation wages and/or to narrow the range of jobs for which they search.

On-the-job training programmes in the private and public sectors are the only programmes that have a positive post-programme employment effect and a positive effect on

earnings. Classroom training and other programmes have a negative post-programme employment effect and a negative effect on earnings.

*Figure 1 Employment effects of ALMPs for those who were unemployed in the 1st week of 2001*



Source::Calculations based on register data

One result of note from this analysis is that a large proportion of the unemployed with a high level of education receive classroom training, but this type of ALMP has a negative effect on their employment rate and earnings in the subsequent years. However, after a few years of classroom training, an ALMP has a positive employment and earnings impact for the unemployed with only an elementary school education. A possible explanation is that classroom training as an ALMP for the highly educated is not sufficiently vocational.

Though the active labour market policy in Denmark appears to improve the job market qualifications for some groups of the unemployed, a comprehensive evaluation of the policy should also take the cost into account. In this report the economic value of ALMPs is calculated. The net economic cost of the policy is estimated to be around DKK three billion (see table 2). The results show a high deficit for classroom training, while on-the-job training in the private

and the public sectors contributes positively. The motivation effect also contributes positively. The net economic value of the motivation effect is about DKK two billion when transfers saved and higher levels of production are taken into account.

*Table 2 Net economic value of active labour market programmes for those unemployed in the first week of 2001*

<b>On-the-job training</b>		<b>Classroom training</b>	<b>Other ALMPs</b>	<b>Motivation effect</b>	<b>Total</b>
<b>Private sector</b>	<b>Public sector</b>				
----- DKK billions, 2005 level -----					
0.2	0.2	-4.9	-0.4	1.8	-3.0

Note: The analysis includes persons aged 18-50 years who were unemployed in the first week of 2001. The discount rate is assumed to be 3 per cent, while the marginal cost of public funds is assumed to be 20 per cent of the expenditure.

Source: Own calculations based on register data.

### **Intensified Effort – An Experiment**

A ‘natural experiment’ in labour market policy was carried out in two counties in Denmark during the winter of 2005-06. The treatment consisted of a substantial intensification of labour market policies involving information, early mandatory participation in job search assistance programmes, frequent meetings with employment officers, and full-time programme participation for at least three months for people who had not found a job within 18 weeks of becoming unemployed. The control group was treated according to the regular rules.

An analysis based on the experiment shows that after 18 weeks the treatment group had an exit rate from unemployment which was approximately eight percentage points higher than that of the control group. After 40 weeks the treatment group had an exit rate approximately three percentage points higher than that of the control group.



Despite the overall positive effects of the experiment, none of the specific treatments could be demonstrated to have a positive effect. A possible explanation is that the effects occurred because of the prospect of intensification of labour market policy programmes and not because of the specific treatments.

Taking the costs and benefits of the social experiment into account, an estimate of the socio-economic value of the intensification is about DKK 15,000 per person. The social gain from the experiment is estimated after 46 weeks, and thus does not include the long-term effects.

### **The Value of Meetings**

A more general analysis of the effects of meetings between the unemployed and the employment officers is also described in this report. There are four types of meetings.

A CV/basic registration is a meeting where the unemployed person meets with a case worker and prepares a CV. This type of meeting is estimated to have a small negative effect on the probability of getting a job.

Another type of meeting is a visitation meeting, where the case worker and the unemployed person discuss progress and job search strategies. This type of meeting has a positive effect on the employment rate before and after the meeting. The prospect of the meeting can motivate the unemployed person to get a job, which explains the positive effect before the meeting. The positive effect after the meeting may be due to more job opportunities arising for the unemployed person.

The third kind of meeting is an employment plan meeting where an action plan for getting back to work is formulated and where the labour market programmes are arranged. The employment plan meeting has large effects after the meeting on the employment rate. The positive effects result from a motivation effect of the ALMP.

Job assignment meetings and job interviews are the fourth kind of meeting. The case worker informs the unemployed person about a vacancy and decides whether he/she should apply for the job. This kind of meeting has a positive effect before the meeting. Again, this may reflect a motivation effect.

### **Unemployment and wages**

Unemployment was relatively low in 2000-02 and increased in 2003-04, but started falling again in 2005-06. The current level of unemployment is the lowest in 30 years. Nevertheless, wage increases have been low and stable, which is quite remarkable.

An analysis of the level of unemployment indicates that the actual level in 2007 is around 40,000 persons below the structural level of unemployment, which is defined as the sustainable level that is compatible with long term macro-economic balance. This finding suggests that the current situation may not be sustainable and that reforms are necessary

As illustrated by the current situation, the actual level of unemployment may fall below the structural level, but such an occurrence tends to generate higher wage increases and higher unemployment. Such a situation occurred in 1985-87, and it was followed by accelerating wages and macro-economic disequilibrium.

The fall in structural unemployment in Denmark is often ascribed to three different factors:

- The reform of the active labour market policy and increased economic incentives to find employment
- Globalisation of the markets for goods, capital and labour
- Further decentralization of the wage formation on the Danish labour market

The average unemployment benefit replacement ratio has fallen since 1990 from around 57 per cent of the average

salary wage rate to less than 50 per cent. At the same time the active labour market policy has been considerably strengthened. The analyses in the chapter show remarkable results, and the change in labour market policy beginning in 1994 has clearly affected wage formation.

Globalisation is not a new phenomenon, but trade in goods, services and capital does continue to increase, and even though it is difficult to estimate a direct effect of trade on wage convergence, it is plausible that globalisation has tended to discipline wage formation. One example is the closure of Danish plants and increased investment in the new EU member states.

Finally, wage dispersion has increased since 2000, partly as a result of a clear trend towards decentralization of wage bargaining. It is interesting that the increase in rates of employment has been greater within branches with decentralized wage formation.

### **Recommendations for Labour Market Policy**

Danish labour market policy has been successful in achieving a well-functioning labour market with a low level of unemployment. Nevertheless, there is scope for further improvement. The analyses show that some elements of the labour market policy are being implemented in an inefficient way, whereas other elements of the policy should be expanded. These recommendations do not change the general functioning of the labour market and the recommended policy is still within the 'flexicurity' framework.

The active labour market programmes have been a cornerstone of the labour market policy, but the policy needs to be revised, since the cost-benefit analysis of classroom training indicates a large deficit. The educational programmes should be more focused and targeted on those groups of the unemployed who can benefit from participation. Both the prospects for employment and expected income should be positively affected by participation. If it is impossible to achieve such positive effects, the use of the educational programmes should be reduced significantly.

The effect of the programmes could be improved if the case workers had tools for 'profiling' the unemployed. These tools would be based on statistical models of historical correlations between the characteristics of the unemployed, the demand for labour and the effects of the different programmes. It is recommended that such tools be developed and given higher priority.

The public effort to reduce unemployment must be further directed towards counselling, assisting in job search and testing availability for work. A recent experiment has documented the effects of an intensified and early effort. These practices should be implemented throughout the country, since the cost-benefit analysis of the experiment shows that the gains from the increase in employment clearly outweigh the increased cost of counselling.

The chairmen of the Economic Council also suggest that the duration of unemployment benefit should be limited to 2½ years. The welfare reform agreed upon by a parliamentary majority in 2006 kept the maximum unemployment benefit duration at four years and introduced full-time participation in ALMPs after 2½ years. However, the analyses of ALMPs have illustrated that this instrument is expensive and inefficient. Further analysis shows that the chances of leaving unemployment increases from two per cent to 10-12 per cent per week around the time of end of the benefit period. There seems to be a strong incentive effect from approaching the end of the benefit period. Moreover, even if the duration of unemployment benefits were shortened to 2½ years, the period during which unemployment insurance benefits could be collected would still be longer than in Sweden, Norway and Finland.

The total effect of the shortening of the benefit period, the early and intensified counselling and a reduction in educational ALMPs is estimated to be a reduction in the structural level of unemployment of 35,000 persons. This is roughly equivalent to the difference between the actual level of unemployment and the structural level of unemployment, the latter being estimated to be around 140,000 people in 2007.

Further action is needed if the estimated drop in the labour force due to demographic changes is not going to limit future growth. The chairmen have previously recommended that the post-employment wage (a comprehensive early retirement scheme) should be abolished, but they have noted that a far-reaching political agreement (*Velfærdsforliget*) has confirmed the political acceptance of the scheme. Against this background it is recommended that:

- All employed persons aged 64 years who have been employed since the age of 60 should be granted an earned income tax credit amounting to a maximum of DKK 100,000
- The limitation on free movement of labour from the new EU member states from East and Central European should be abolished
- To offset labour shortage in the public sector, the regulation of working hours for public sector employees should be carefully reviewed to remove any barriers that may prevent employees from working as many hours as they would like to.