# English Summary

The report contains two chapters; the first one gives an economic outlook for the Danish economy, and the second one presents an analysis of Danish labour market policy.

## Chapter I: Economic outlook

The economic situation in Europe is still dominated by a lack of confidence in the public finances of a number of countries and weak developments in demand and production. Initiatives from the ECB and the EU, in combination with the ongoing fiscal tightening and structural reforms in highly exposed countries, are expected to result in a gradual recovery in confidence in fiscal policy and future economic progress. However, the recovery of confidence is expected to be slow, and periods with renewed tensions may arise. The announcement from the ECB of an additional bond purchase programme has contributed to a reduction in Spanish and Italian government bond interest rates which has had a stabilizing effect on the financial markets. Spanish and Italian interest rates are still rather high, and restoring confidence crucially depends on these countries' ability to continue their fiscal consolidation.

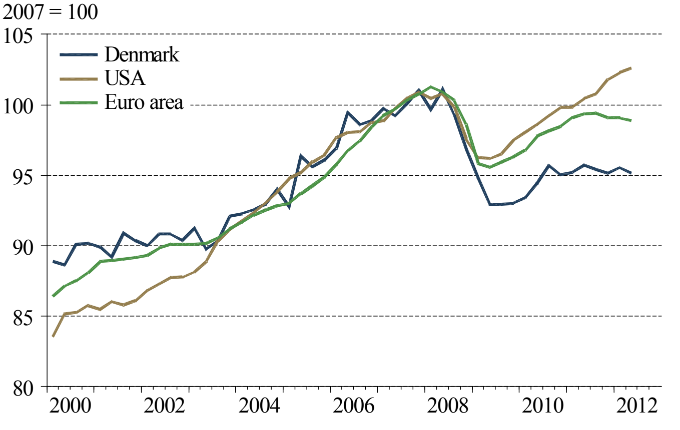
In 2010 the eurozone member states established a temporary rescue fund to assist member states in financial difficulty to obtain loans. The rescue fund programme is being replaced during 2012-13 by the permanent stability mechanism, ESM. Loans from ESM are explicitly contingent on fiscal tightening and reforms. It is crucial that loans are only provided on such conditions because in itself a loan weakens the individual country's incentive to pursue a responsible fiscal policy.

The ECB's new bond purchase programme, *Outright Market Transactions* (OMT), aims to reduce effective interest rates on highly indebted countries' government bonds. This will ease the funding burden in the exposed countries in the same manner as if they had been granted loans on favour-able interest rate terms. Basically, this reduces incentives to act fiscally responsibly. However, the ECB can only purchase government bonds from countries that are already in an ESM programme, and, thereby, subject to requirements of fiscal tightening and reforms. At the same time, under the new programme, the ECB can only buy short-term bonds. This implies that the country is only guaranteed assistance for a relatively short period, and if the country fails to meet the reform requirements, the ECB can stop the programme. The ECB will aim to neutralize the liquidity effect from such purchases so that monetary policy, in general, is unaffected.

A significant expansion of the ESM could have the same effect as the OMT and is, in principle, preferable, partly because the transparency of such a model is higher, and partly because the requirements for fiscal consolidation are expected to be stronger if the creditor directly sets the conditions. On the other hand, the possibility of unlimited intervention implies that the ECB can credibly keep interest rates down with relatively few funds placed in the ESM. The instrument in question is untraditional, but it is considered appropriate given the extent of the crisis, and given that both loans and bond purchases are contingent on a programme that sets requirements for reforms and fiscal consolidation.

The Danish economy remains stagnant. GDP has hardly grown for the past two years, cf. figure A. Early retirement contributions have been reimbursed to members of the scheme, but so far there has been no significant effect on private consumption, and in spite of public housing renovations that have been moved forward, and a temporary tax credit on expenses for home improvements, investments in dwellings remain at a low level.

*Figure A* *GDP*




Note: The latest observation is 2nd quarter 2012.

Source: Statistics Denmark and EcoWin.

It is estimated that, overall, fiscal policy will increase growth by ¼ of a percentage point in 2012, but conversely reduce growth by ¼ of a percentage point in 2013 and ½ a percentage point in 2014. The main expansionary measures are: reimbursement of early retirement contributions, which is expected to increase demand by DKK 10 billion over the remainder of 2012 and 2013; increased public investment in 2012; and an investment "window" that increases firms' basis for depreciation of certain investments made during the rest 2012 and 2013. The negative growth impact estimate in 2013 is particularly caused by cessation of the tax credits for private housing maintenance etc., less public investment, and increases in excise duties that follow from the 2009 tax reform. Apart from these elements, economic activity is stimulated by measures that do not affect public finances directly. These measures include public housing renovations, investments in wastewater plants and investments to reduce energy consumption.

Growth prospects for the near future are quite uncertain. The expansionary policy elements can lead to some improvements, and the private sector has accumulated a significant amount of savings, so there is a potential for growth. The forecast is also based on the assumption that economic stability is gradually restored in the European countries, cf. above. On this basis, progress is expected within the coming year, but it is difficult to forecast when – and to what extent – it will occur. In 2012 growth is expected to be around zero percent, followed by growth rates of around 1½-1¾ percent in 2013 and 2014, cf. table A.

Production remains well below the structural level, cf. figure B. The expected start of economic improvements is forecast to close the output gap gradually by 2018. Normalization of the economic situation is believed to manifest itself through strongly rising consumption and investment shares. Both shares are presently at very low levels, which, in combination with accumulated savings in the private sector, is expected to cause increases in the shares towards 2020. The increase in the consumption ratio is related to an expected increase in the financial wealth share, increased employment, and a larger share of the population that dissaves rather than saves, as demographic changes lead to more retirees.

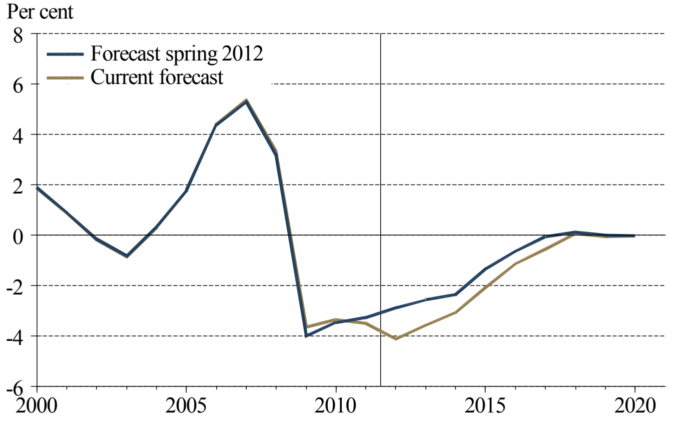
*Table A Key figures from the forecast for the Danish economy*

| | Current prices DKK bn. | Per cent of GDP | Percentage change, volume | | | | |
|---|---|---|---|---|---|---|---|
| | 2011 | 2011 | 2011 | 2012 | 2013 | 2014 | 2015 |
| Private consumption | 865.3 | 48.5 | -0.8 | 0.9 | 1.8 | 2.5 | 2.5 |
| Public sector consumption | 509.5 | 28.6 | -1.3 | 0.5 | 1.1 | 0.8 | 0.8 |
| Gross fixed capital formation | 308.4 | 17.3 | 0.7 | 1.9 | 4.6 | 1.4 | 3.0 |
| consisting of: | | | | | | | |
| Residential investment | 83.3 | 4.7 | 8.8 | -10.7 | 0.5 | 4.3 | 5.0 |
| Business fixed investment | 185.0 | 9.9 | -3.7 | 7.9 | 11.1 | 1.9 | 2.5 |
| Public sector investment | 40.1 | 2.3 | 5.2 | 5.5 | -9.8 | -6.5 | 1.8 |
| Stockbuilding[a)] | 2.8 | 0.2 | 0.3 | -0.2 | 0.4 | 0.1 | 0.0 |
| Total domestic demand | 1,686.0 | 94.6 | -0.4 | 0.8 | 2.8 | 1.9 | 2.1 |
| Exports of goods and services | 959.0 | 53.8 | 7.0 | 1.6 | 2.0 | 2.8 | 2.6 |
| Imports of goods and services | 862.5 | 48.4 | 5.2 | 2.9 | 4.3 | 3.2 | 2.2 |
| GDP | 1,782.5 | 100.0 | 0.8 | 0.2 | 1.6 | 1.8 | 2.3 |
| **Key indicators** | | | | | | | |
| Consumer prices, percentage change[b)] | | | 2.5 | 2.4 | 2.2 | 1.4 | 1.8 |
| Unemployment, per cent[c)] | | | 3.8 | 4.2 | 4.5 | 4.3 | 4.1 |
| Current account, DKK bn. | | | 118.2 | 99.3 | 65.2 | 56.8 | 60.3 |
| Current account, per cent of GDP | | | 6.6 | 5.5 | 3.5 | 2.9 | 3.0 |
| General government budget balance, DKK bn. | | | -34.5 | -77.3 | -37.2 | -26.3 | -20.9 |
| General government bud. balance, per cent of GDP | | | -1.9 | -4.3 | -2.0 | -1.4 | -1.0 |
| Hourly wage costs, percentage change | | | 2.3 | 1.8 | 1.8 | 2.0 | 2.8 |

a) The percentage changes are calculated as real change in stock building relative to GDP in the previous year.
b) Implicit private consumption deflator.
c) Percentage of the total labour force. National definition.

Source: Statistics Denmark, ADAM's databank and own calculations.

*Figure B* *Output gap*




Note: Output gap is the relative difference in percentage between structural and actual GDP.

Source: Statistics Denmark, ADAM's databank and own calculations.

Employment continues to decrease slowly and the modest growth prospects are expected to entail a small increase in unemployment over the next year. From January next year the maximum length of the unemployment benefit period will be reduced to two years, the government having postponed this measure for six months. A further temporary extension of the unemployment benefit period is not recommended. Repeated, discretionary delays will stimulate expectations that the benefit period will always be extended when a crisis persists. This weakens the individual's job search incentives. However, there are arguments in favour of introducing a business cycle dependent unemployment benefit period, but the dependence on the business cycle should be based on a set of rules rather than on discretion, in order to ensure the credibility of economic policies. For such a rule-based dependency to be neutral for the public finances, the benefit period should be shorter than two years in periods of economic boom.

The EU requirement for Denmark to improve public finances includes a recommendation to improve the structural government budget balance by 1½ percent of GDP from 2010 to 2013, so that the actual budget deficit is kept under

3 percent of GDP in 2013. Both targets are expected to be met given the assumptions on fiscal policy. Based solely on the persistent stagnation in Danish economic activity, the planned fiscal tightening next year is not appropriate. However, it is important to abide by the EU recommendation for the purpose of maintaining confidence in the public finances and so, on this basis, a relatively tight fiscal policy for the years 2011-13 is deemed necessary.

There is a risk that the weak economic situation could persist beyond 2013. At the same time the reformed early retirement system and other measures will begin to increase the labour force, particularly from 2014 onward. It is possible that the economic stagnation could persist in 2014, and in that case expansionary fiscal measures would be relevant. In itself this is an argument to hold back some of the potential fiscal stimulus until 2014 and the years thereafter. This also highlights the importance of solid public finances so that in the case of a lengthy recession there will be scope for an expansionary fiscal policy without conflicting with the given budget limits, whether these limits are set by the EU or by national legislation.

The investment window that allows increased tax deductions of a number of private business investments made during the second half of 2012 and all of 2013 reduces public revenue. Contrary to, e.g., a usual reduction of the corporate tax, this tax reduction is conditional on investments, which, other things equal, has a larger activity effect. Meanwhile, the scheme is temporary, which creates an incentive to bring investments forward. The isolated effect on investments through this measure is much larger than if the same amount had been spent on public investment. This is so because the cost of the investment net of the tax benefit is paid by private companies. On the other hand, the scheme favours not only investments that are brought forward in time, but also investments that would have been made even without the tax benefit. It is very difficult to estimate the extent to which investments are brought forward as a consequence of the tax benefit, and how large the effect on economic activity will be. The investment window includes investments in machines and vehicles, which often comprise a high import share, which in turn limits the effect on Danish production and employment. However, in total it is considered appropriate to channel part of the fiscal stimulus through private investments.

A tax reform was passed by the Danish Parliament this fall. The reform includes tax cuts consisting of an increase in the top tax bracket and a higher earned income tax credit. These tax cuts are mainly financed by higher excise duties, reduced regulation of income transfers in the period 2016-23, savings on Danish defence expenditure and estimated lower EU-contributions. The tax reform is not fully funded in the absence of behavioural effects. In the short run this is more pronounced (when the revenue resulting from the change in the taxation of capital income from pensions is not taken into consideration). This is both due to the time profile of tax cuts and the elements that finance the reform, but also due to the temporary higher deductibility of investments. The reform is expected to increase the GDP growth rate in 2013 by 0.1-0.2 percentage points and around ¼ of a percentage point when the temporary higher deductibility of investments is accounted for.

The tax reform is estimated to increase labour supply by more than 15,000 persons in the long run, according to calculations by the Danish Ministry of Finance. The behavioural effects of the increased labour supply correspond to a permanent improvement of public finances of DKK 3.4 billion. In total, the tax reform is expected to strengthen public finances by around DKK 2.7 billion each year when all effects are taken into consideration. However, the size of the behavioural effects and the speed at which they materialize are very uncertain. If the behavioural effects turn out to be weaker than expected, this may result in a lasting unfunded increase in public expenditure. However, the recently implemented Budget Law implies that the risk of a lasting unfunded increase in public expenditure is reduced. This is due to the fact that fiscal policy will be planned according to a limit on the size of public deficits with the use of expenditure ceilings according to the Budget Law.

The tax reform also specifies that several of the excise duties which are included in the nominal tax freeze will be discretionarily increased up to 2020, so that these duties will roughly keep up with inflation. It would be appropriate to have these duties indexed to inflation also after 2020.

The taxation of owner occupied dwellings is also included in the nominal tax freeze, implying ongoing tax cuts for homeowners. The tax reform specifies that the taxation of owner occupied dwellings and the deductibility of interest costs will not be changed before 2020, apart from the gradual reduction of the deductibility of interest payments following from the tax reform legislated in the Danish Parliament in spring 2009. A transition to indexation of the taxation of owner occupied dwellings would, however, be appropriate. It is recommended that a tax rate on owner occupied dwellings amounting to 1 percent of the current property value should be reintroduced. However, the tax increase should be complemented by a tax rebate which counteracts the immediate increase in taxes. The rebate could be sustained for a period and then gradually phased out over a number of years. This will ensure that the change in the taxation doesn't increase expenditure for homeowners in the short run. The proposal is more fully described in *Dansk Økonomi, forår 2011*.

The tax reform includes two measures that are targeted at families with children. The first element is the higher earned income tax credit for single parents, which is assessed to be an efficient way to stimulate labour supply. This is partly due to the fact that many single parents can obtain various grants which are reduced as the level of earned income increases. The high implicit tax rates reduce the economic incentive to work for a large part of this group. Also, empirical investigations indicate that the labour market participation of families with children, and, in particular, single parents, responds strongly to changes in tax incentives. Finally, the low employment rate of the affected group implies a low immediate loss in revenue.

The other element targeted at families with children is adjustment of the family allowance (a subsidy paid out to parents) according to the level of income. This implies a higher marginal tax rate for high-earning families with children compared to other high-earning families without children. However, efficiency considerations speak in favour of increasing taxes for all families in this income group, not only families with children.

The fact that the tax reform is underfinanced in the short run implies a structural deterioration in public finances in 2013, which would be in conflict with the EU-recommendation stating that the structural balance should be improved by 1½ percent of GDP from 2010 to 2013. In order to prevent a violation of the recommendation, the tax reform includes a change in the taxation of capital pensions such that the deductibility of contributions to new capital pensions is removed, while payment of pensions are not taxed later. Also, a tax rebate encourages the conversion of existing capital pensions to a new arrangement where the deferred tax payments will be paid up front. This change in the taxation of capital income from pensions is a “bookkeeping trick”, which relieves some of the constraints imposed by the EU-recommendation. Due to the “bookkeeping trick” it is possible to let fiscal policy stimulate the economy to a larger extent, which is advantageous taking the weak economic situation into consideration.

The government is projecting revenue from the change in the taxation of capital income from pensions amounting to DKK 10 billion in 2013. It is estimated that the change in the taxation of existing capital pensions will provide DKK 5 billion. However, it is very difficult to estimate the extent of the change of existing capital pensions. If most people choose to convert their existing capital pensions, this will imply that the extra revenue increases to around DKK 100 billion in 2013.

In principle, the change in the taxation of capital income from pensions does not affect long run fiscal sustainability. The primary public balance is improved in the short run but deteriorates in the long run. The total public balance (including net interest income) is, however, improved as far into the future as the eye can see. This is due to the fact that the change in taxation results in higher public net wealth and thus higher interest income. It is, however, an important assumption that the short-run improvement in public finances does not cause an increase in public spending or lower taxes. There is a risk that the short-run improvement may lead to a less disciplined fiscal policy, which would be an unfortunate side-effect of the change in the tax system. Thus, the medium-term target for the public budget balance should be adjusted accordingly. The magnitude of this adjustment can not be determined before the exact extent of the rearrangement of existing capital pensions is known in 2013.

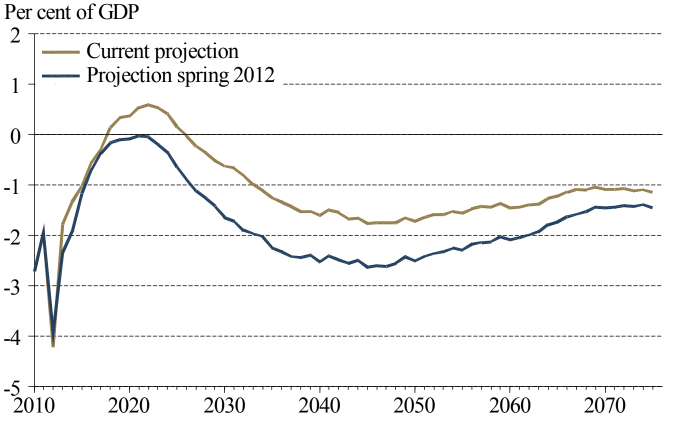
The present projection builds on the current fiscal policy and includes all reforms passed by parliament. The projection shows that, taking the goal of public budget balance in 2020 as given, there is room for a growth rate of real public consumption of around 0.9 percent each year (in the period 2014-20), which is estimated to be the "neutral" rate of growth taking the expected demographic development into account. The projection shows an expected public surplus of around DKK 7 billion in 2020. When abstracting from the revenue from the change in capital income taxation of pensions, the surplus will be reduced to around DKK 3 billion. Taking uncertainty into consideration this corresponds to roughly public budget balance in 2020.

If there is a political desire for higher public expenditure, this requires higher taxes or reforms that stimulate labour supply. This obviously is a political prioritization. However, some reforms may be beneficial under all circumstances. As an example it may be appropriate to review arrangements for people outside the labour force on a regular basis, to check whether the incentives to work can be improved.

In the government's 2020-Plan, from May 2012 further initiatives in the education area, amounting to DKK 2 billion, and initiatives to promote economic growth and employment, amounting to DKK 7 billion, are planned. However the revenue from tax reforms and several public savings turned out to be lower than expected. In addition, the tripartite negotiations between the government, labour unions and Danish employers' organizations did not lead to any results. Thus, there is a need for an updated fiscal plan towards 2020, which specifies the government's desired level of public expenditure and how that should be financed.

Public finances are estimated to be roughly sustainable in the sense that the ratio of public debt to GDP will be stabilized in the long run. In spite of this and the expected public surplus in 2020, it is expected that public finances for a number of years after 2020 will show structural deficits exceeding the limit of ½ a percent of GDP. In all years after 2035 it is expected that the public deficit will exceed 1 percent of GDP, see figure C. However, the entire time profile of the public balance in the time period 2020-75 is markedly improved when compared to the projections made in the spring.

*Figure C        Public budget balance*




Source: Statistics Denmark, ADAM's databank, DREAM and own calculations.

The improvement in the expected time profile of the public balance is reflected in the hammock-shaped deficit profile being elevated by just under 1 percent of GDP in the year where the deficit is expected to be highest (2045) compared to the projection in the spring. The improvement towards 2020 reflects various changes working in different directions. An important element which tends to improve public finances in 2020 is the change in the taxation of capital income from pensions. The improved public balance in 2020 also affects the trend after 2020 due to lower interest expenditures. The change in the taxation of capital income from pensions also affects the entire time profile, even though it is (almost) just an intertemporal rearrangement of public revenues.

The projection relies on a number of assumptions concerning, among other things, future developments in the labour force and economic policy. The projection assumes, for example, that the nominal tax freeze with respect to the taxation of owner occupied dwellings and a number of excise duties remain in place after 2020. If the alternative assumption - that the excise duties instead follow inflation - is adopted, fiscal sustainability improves by ½ a percent of GDP and the largest projected deficit would be reduced to around 1 percent of GDP. Even though a deficit of this magnitude is considerately above the ½ percent which the Budget Law stipulates, the challenges that fiscal policy face are assessed to be manageable.

The projection shows that, taking the underlying assumptions as given, there is no urgent need for reforms aimed at improving public finances. However, it is important to note that the assumptions may turn out to be wrong. As an example the labour force may grow at a different rate than expected and expenditures may increase more than planned. Thus, it is important to continue focusing on fiscal targets and to adjust policy if the development in public finances turns out worse than expected. The fact that fiscal policy is assessed to be sustainable in the long run does not in itself imply a high level of welfare. Reforms which aim at enhancing welfare and efficiency are as important and relevant as always.

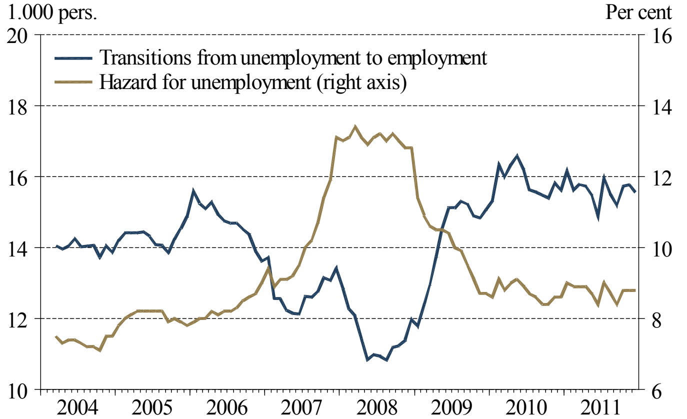
## Chapter II: Danish labour market policy

A high employment level is required to finance the Danish welfare state. By providing advice and motivation, and upgrading the skills of the unemployed workers, the active labour market policy plays a central role in achieving this. In 2012 the budgeted expenditure on the active labour market policy in Denmark was approximately DKK 16 billion, or almost 0.9 percent of GDP, which is significantly higher than other OECD countries. Therefore it is necessary to continually review the design of the active labour market policy to ensure that it is optimal and efficient.

The active labour market policy is part of the Danish labour market system. The system is characterized by flexible rules for hiring and firing workers combined with relatively high unemployment benefits. The active labour market policy aims to help and motivate the unemployed workers to find a job through skill upgrading, advice, sanctions and by testing the availability of the unemployed for work.

The labour market system contributes to the Danish labour market being very dynamic in an international context. Denmark has one of the highest job turnover rates among OECD countries. It is in line with the job turnover of U.S. and is significantly higher than in other Scandinavian countries. Even with a decline in employment there has been considerable job turnover in the most recent years, and despite the economic situation there has been a monthly transition from unemployment to employment of at least 11,000 persons, see Figure D. At the same time, the departure rate from unemployment to employment over the past few years has been at about the same level as for the period 2005-06, which are usually considered neutral or even boom years.

*Figure A From unemployment to work*




Note: The series are adjusted for seasonal fluctuations.

Source: Own calculations based on registry data.

**The Danish active labour market policy**

A vibrant labour market is important to ensure a well functioning economy where labour finds its best use based on personal qualifications and experience, while companies can find qualified workers. An active labour market policy can help increase and sustain a vibrant labour market.

In the Danish active labour market policy the unemployed have both a right and an obligation to participate in, e.g., skill-enhancing courses, subsidized jobs in private or public enterprises or corporate internships, and they are regularly called for meetings at the municipal job centres to give advice on job seeking, and to discuss job opportunities, etc. The active labour market policy is administered fully by the municipal job centres, but the state reimburses part of the municipals' expenses.

In the chapter, the effects of the active labour market policy on the Danish labour market are examined through a review of relevant studies from the literature, as well as two new studies. Both new studies differentiate the effects of the active labour market policy for the economic boom period prior to the economic-financial crisis in 2007/2008 and for the recessionary period afterwards.

In one of these studies, the effect of active labour market programmes on the unemployment duration of the individual unemployed is examined using registry data. The analysis is based on a duration model, using a timing-of-events approach, where the transition rate into employment is estimated simultaneously with the transition rate into an active labour market programme. The model estimates the negative effect during the programme, the locking-in effect, as well as the positive post-programme effect. The model does not identify the effect that arises when the unemployed workers find employment before participating in the programme due to the threat of entering a programme sometime in the future - the threat effect. The main data used to calculate the effects originates from a database containing weekly information about all government income transfers on an individual basis, unemployment benefits, pensions, social assistance etc. This is combined with socio-economic information about age, gender, education etc. from Statistics Denmark. The effects are measured both as the percentage change in the departure rate from unemployment to employment due to participation in active labour market programmes as well as the change in the expected residual duration of unemployment measured in weeks.

In order to test whether the effects of active labour market programmes on unemployed individuals are robust to possible crowding-out effects, an analysis of how active labour market programmes affect gross unemployment across municipalities is also carried. The increased job search due to the active labour market policy may lead to a congestion externality, as the increased job search by the unemployed individuals in a labour market programme reduces the chances of other unemployed individuals succeeding in their job search. The placement of the unemployed in subsidised jobs may, moreover, lead to the displacement of other workers. The effects of the active labour market policy on the gross unemployment level integrate both of these negative externalities.

The analysis of unemployment levels across municipalities suggests a positive effect of the active labour market programmes, even when controlling for characteristics of the individual municipalities and the educational composition of the unemployed. In particular, having a higher proportion of the unemployed in wage subsidy jobs in the private sector or in corporate internships reduces the level of unemployment compared to a situation where the unemployed are not participating in a programme, and this seems to apply both in an economic boom and a recession.

The duration model analysis suggests that corporate internships, as well as wage subsidy jobs in private enterprises, reduce individual unemployment durations in an economic boom, but not in a recession. This supports previous findings where subsidized employment in the private sector has shown positive effects on employment possibilities.

Frequent contacts with and meetings at the municipal job centres have come into focus as instruments to help unemployed workers into employment, as they can help clarify job opportunities for the unemployed and thereby increase their employment chances. Previous studies have found positive effects on the employment possibilities of the unemployed individual. The analysis of gross unemployment levels presented in the chapter indicates that an increased application of this instrument in the municipalities passes through to a lower gross unemployment level during a recession, while this instrument does not seem to have any effect on the unemployment level during a boom.

It has been advocated that during a recession the composition of the active labour market programmes should be changed to a greater use of skill-enhancing courses for the unemployed. During a recession, it is, however, difficult to identify which skills the future labour market will demand, and, therefore, it is hard to target educational and other active measures. It is difficult to analyse this topic empirically, but a number of results in the literature suggest that skill-enhancing courses during a recession are beneficial for some unemployed. However, the increased employment is not necessarily large enough to outweigh the high cost of skill-enhancing courses with long durations. A greater emphasis should, therefore, be put on short and targeted courses.

Overall, the studies indicate that active labour market programmes can have positive employment effects for the individual unemployed during an economic boom, but a lower post-program effect during a recession means that active labour market programmes lead to longer unemployment spells for the participants, see Table B. At an aggregate level, participation in subsidized employment in private enterprises generally lowers the unemployment level, while contact and meetings appear to be the most effective instrument during a recession.

Despite the fact that a number of programmes exhibit no or even negative effects on the transition to employment of unemployed individuals during the recession, the analysis of unemployment levels across municipalities suggests a positive overall effect of the active labour market policy. This suggests that the expectation of the programmes and thus the threat effect of the active labour market policy can play an important role.

*Table B* *Effects of active labour market programmes in boom and bust*

| | **Duration analysis for individual unemployed** | | | **Analysis of unemployment level** | | |
|---|---|---|---|---|---|---|
| | **Boom** | | **Recession** | **Boom** | | **Recession** |
| Wage subsidy in private enterprise | + | > | – | + | = | + |
| Wage subsidy in public enterprise | 0 | > | – | 0 | = | 0 |
| Counselling and courses | + | > | – | + | < | + |
| Corporate internship | + | > | – | + | = | + |
| Contact and meeting | * | * | * | 0 | < | + |

Notes: + : Positive, statistically significant effect, i.e. shortened unemployment spell for individual unemployed and reduced unemployment level in aggregate analysis.

– : Negative, statistically significant effect, i.e. longer unemployment spell for individual unemployed and higher unemployment level in aggregate analysis

.0 : the effect is not statistically significant.

* : Not examined in the relevant study.

<, =, > : Comparison of estimated effects in a boom and a recessionary period.

Source: Own calculations.

As the maximum unemployment benefit duration has been reduced from four to two years (introduced in 2010, see also below) there is an increased need to consider the design of the active labour market policy, as there is no longer room for programmes that have long durations. The negative lock-in-effect during the time in the programme has already been shown to dominate the positive post-programme effect in a number of cases, especially in a recession. The active labour market policies should, therefore, target counselling and meetings combined with relatively short programmes, such as corporate internships or short-term employment with a wage subsidy.

In recent decades an increasing number of studies have investigated the effects of the active labour market policies both in Denmark and in other European countries. In order to ensure effective active employment measures, it is important to learn from these experiences and to support further work on effect evaluations. Despite a growing number of studies, a better understanding of the effects of active labour market programmes on different types of unemployed workers is still needed. The chairmanship therefore supports the efforts that are put into making sure that the Danish active labour market policy is based on empirical evidence.

**Active labour market policy for the marginalized unemployed**

The active labour market policy has had different roles during the past two decades. In the 1990s the policy was aimed at reducing the high level of unemployment, whereas the policy during the last decade has been focused mainly on increasing the labour supply in the long run and on reducing the risk of an overheated economy by increasing labour supply in the short run. Thus, the main focus of the active labour market policy has been on unemployed workers with a strong attachment to the labour market.

The current recession carries a risk that marginalized unemployed workers, in particular, could lose their attachment to the labour market. This can lead to a decline of work experience, a loss of productive resources and have distributional consequences. Therefore, it is important to ensure that the active labour market policy is designed to maintain attachment to the labour market of the marginalized unemployed worker as well. This can reduce the long-term costs of government transfers and increase future tax revenues.

Previous Danish studies have indicated that programmes in the private sector, such as subsidized jobs or corporate internships, are beneficial to the marginalized unemployed. The study of the unemployment durations of unemployed individuals presented in the chapter confirms this and shows that, in a recession, it is corporate internships that particularly increase employment opportunities for the recipients of social assistance who are furthest away from ordinary employment.

**The municipal administration of the active labour market policy**

The active labour market policy is now administered by the 98 municipalities through job centres, while the state refunds a portion of the expenses for both disbursed benefits and the arrangement of active labour market programmes. This reimbursement is necessary to smooth the overall expenses across the business cycle, as municipalities are not allowed to finance their expenses by credits.

Administration of the active labour market policy for unemployed deemed ready for employment was originally handled by the state employment service. The current system of municipal job centres means that all the unemployed within a municipality can receive similar treatment. However, this creates a challenge to ensure that the implementation of the active labour market policy does not vary across municipalities more than the local conditions or the characteristics of the unemployed justify. The latest information about optimal labour market policy programmes must also be conveyed to all job centres.

Fourteen municipalities took over the responsibility for the active labour market policy in their districts in 2007, while the remaining municipalities gained this responsibility in 2009. By exploiting this differentiated introduction of the current system we can evaluate the municipal management of the active labour market policy compared to central government management through a difference-in-difference approach. However, no significant difference in the transition from unemployment to employment across the two groups was found. The analysis controls for municipal fixed-effects, yearly and monthly time indicators as well as the educational composition of the unemployed in the municipalities.

The current state reimbursement of municipal expenses for the active labour market policy entails higher reimbursements for the unemployed in active labour market programmes, and it restarts the reimbursement at 100 percent when an unemployed individual moves to another type of income transfer. This may lead to the unemployed being sent into active labour market programmes to optimize the reimbursement of expenses rather than to optimize the employment opportunities of the individual. The chairmanship therefore supports the initiative of the government to revise the system in order to make the state reimbursement dependent only on the time the unemployed individual is on public transfers. This increases the focus of the municipal job centres on the ultimate goal of the active labour market policy, i.e. to get the unemployed into employment.

**The recent reform of unemployment insurance**

In Denmark, unemployment insurance is not mandatory but requires active membership in an unemployment fund. An insured worker pays a quarterly contribution, but the system is not self-financing and relies, in most years, on a net contribution from the State. Unemployed workers not insured through this system may apply for fully tax-funded social assistance. The receipt of social assistance is, however, conditional on strict requirements to use up existing wealth and assets first, and is dependent on both own and spouses' income.

In 2010 a reform of the unemployment insurance scheme was enacted, shortening the maximum duration of unemployment insurance from four to two years, and increasing the required number of months in work to regain eligibility for unemployment insurance.

In the long run this reform will reduce the structural unemployment rate, as the shortened maximum duration of unemployment benefits will encourage the unemployed to search more for work. Overall, the reform is expected to increase structural employment by 13,000 persons in the long run and to improve public finances by 4½ billion DKK yearly. The increase in employment constitutes the net effect of a larger fall in the number of unemployment recipients as well as an increase in the number of unemployed on social assistance or being self-supporting. This latter effect may lead to a reduction in the labour force, as self-supporting citizen only have a right, but not a duty to look for work or to take part in labour market programmes.

Through the fall in the structural rate of unemployment and the increase in structural employment, the reform improves the efficiency of the economy. Experience suggests that many unemployed find work before the exhaustion of the maximum unemployment duration or shortly after, but this does not apply to all. The design and enactment of the reform is thus a political choice between increased efficiency of the economy and a more equal distribution of incomes between employed and unemployed citizens. However, an attempt to undo any part of the reform would have to be able to advise on other ways to improve the public finances, and may in themselves have adverse distributional consequences.

### Business Cycle Dependent Unemployment Insurance

The current Danish unemployment insurance system is independent of the business cycle situation. However, there is intuitively an increased need for unemployment insurance in a recessionary period when it is difficult to find work, while unemployment insurance is more distortionary in a boom period when there are sufficient opportunities for employment. The chairmanship therefore recommends a business cycle dependent unemployment insurance system, where the dependence is based on fixed rules instead of discretionary decisions. The consideration of a rule-based business cycle dependent unemployment system is partly motivated by the discretionary half-year extension of the maximum unemployment benefit duration announced in the summer of 2012, as well as by the political agreements reached in the second half of 2012 on intensified active labour market efforts aimed at the unemployed who risk exhausting their maximum unemployment insurance duration.

Studies show that business cycle dependent unemployment insurance, where e.g. the maximum duration of unemployment benefits is longer during a recession and shorter during a boom, can increase overall welfare and lead to a higher level of structural employment. A longer maximum unemployment duration in a slump will reduce the incentives for the unemployed to look for employment. However, the socio-economic loss from this increased distortionary effect is lower than the socio-economic gain from the correspondingly higher job search intensity during a boom, as there is a higher need for more workers during a boom.

A business cycle dependent unemployment insurance system will however also tend to increase the fluctuations over time in employment and unemployment. The better incentives to look for employment will decrease unemployment levels further during a boom, and lead to a lower inflationary pressure on wages during this period. A longer maximum unemployment duration during a slump will tend to increase unemployment levels and reduce the downward pressure on wages, which otherwise, through improved competitiveness, could contribute to increased demand. The increased counter-cyclical variation in the level of unemployment would also lead to a higher overall disbursement of unemployment benefits during a slump and vice-versa during a boom and thus increase the size of the automatic stabilizers in the economy.

In order to ensure that all workers and the unemployed have clear and accurate expectations about the future design of the unemployment insurance system, a business cycle dependent unemployment insurance system needs to be based on previously set rules that stipulate when, e.g., the maximum duration of unemployment benefits is increased or decreased. Discretionary decisions on this may lead to expectations of future changes that may or may not take place. This may lead the unemployed to abstain from an intensified job search towards the end of the maximum unemployment benefit duration, expecting another extension of the unemployment duration. Discretionary decisions on the business cycle dependence of the unemployment insurance system may also lead to an asymmetry in decisions, in the sense that the unemployment insurance system is not tightened as much during an economic upturn, as it is loosened during a downturn.

With predefined rules for a business cycle dependent unemployment insurance system, it would be known in advance in what situations the maximum duration of unemployment benefits would, for example, be extended. Even though the Danish economy experienced a serious downturn following the economic-financial crisis in 2007/2008, it is not certain that the current economic situation would prompt an extension of the maximum unemployment benefit duration in a properly designed system. The current gross unemployment level is on par with the unemployment level in the period 2005/2006, which is normally considered to have constituted a neutral business cycle situation. Likewise, the current number of job openings and the average duration of unemployment are also comparable to 2005/2006. A longer maximum duration of unemployment benefits therefore does not seem to be warranted in the current situation.