



**HOW CAN IT POSSIBLY FLY?
THE PARADOX OF A DYNAMIC LABOUR MARKET
IN A SCANDINAVIAN WELFARE STATE**

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Thanks for comments go to the editors and two anonymous reviewers.

Forthcoming in: *National Identity and a Variety of Capitalism: The Case of Denmark*, edited by John L. Campbell, John A. Hall and Ove K. Pedersen. Montreal: McGill University Press (2006).

CARMA Research paper 2005:2

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Aalborg 2005-09-09

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ISBN 87-89639-29-4

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1. The Danish job miracle¹

Over the past decade, Denmark has experienced a substantial rise in employment and a fairly dramatic decline in unemployment. From a maximum of 12.4 per cent in 1993, the rate of unemployment (national definition) gradually declined to 5.2 per cent in 2001, the lowest level since 1976. Figure 1 portrays this development against the background of the Danish post-war experience.



Figure 1: Total employment (left scale) and unemployment (right scale) in Denmark, 1948-2002. Source: Databanks of the macro-econometric model ADAM (Statistics Denmark)

As is evident from figure 1, the development from 1993 and onwards is characterized not only by a reduction in unemployment but also by a considerable increase in employment to its highest level ever. As a result, the employment rate increased to 76.2 percent, which as shown in figure 2 represents the top level among EU Member States. In the OECD area as a whole, the employment rate of Denmark is only surpassed by Norway and Switzerland.

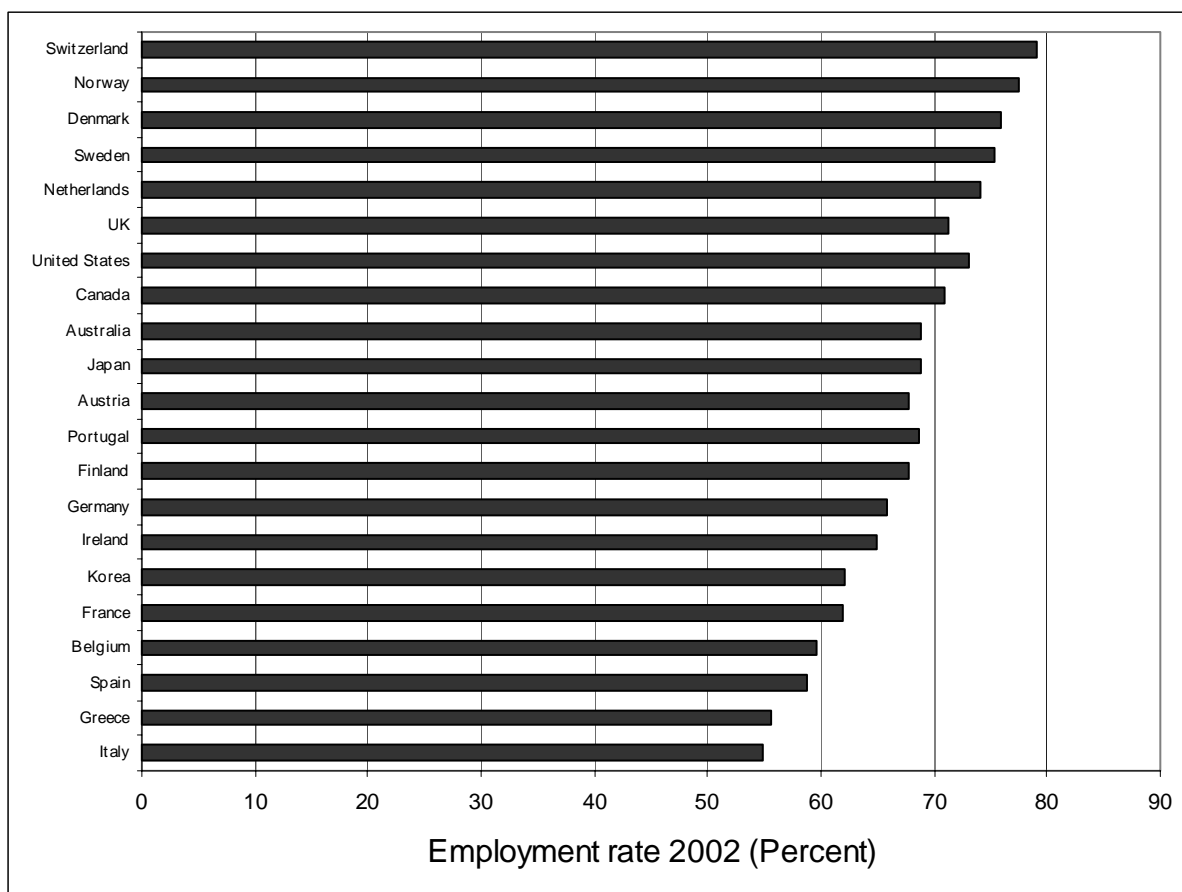


Figure 2: Employment rates (age group 15-64 years) of a number of OECD-countries, 2002. Source: OECD 2003, table B.

Table 1 takes a closer look at the main statistical indicators of labour market development in the recent period and also compares with the economic downturn from 1987 to 1993. During the whole period since 1987, the workforce has been almost constant. Thus the changes in open unemployment mainly reflect changes in total employment. The reduction in unemployment from 1993 to 2002 of just above 200,000 persons mirrors an increase in private employment of about 141,000 persons and in public employment of 68,000 persons. As shown in the last row, the employment rate increased during the 1990s and almost returned to the level of the mid-1980s. In this light, the Danish employment success in recent years is not just a reflection of surplus labour being transformed into participants in different labour market programmes or moved outside the workforce.

Table 1: Main statistical indicators for the Danish labour market, 1983-2002

Year	1987	1993	2002	Change 87-93 (1,000 p.)	Change 93-02 (1,000 p.)
Population, aged 15-64 years, 1,000 p.	3421	3495	3569	74	74
Workforce, 1,000 persons	2888	2880	2885	-8	5
Employment, 1,000 persons	2666	2531	2740	-135	209
Private sector employment, 1,000 p.	1901	1759	1900	-141	141
Public sector employment, 1,000 p.	765	771	840	6	68
Open unemployment, 1,000 p.	222	349	145	127	-204
Employment rate (employment as a share of adult population)	77.9	72.4	76.8	*	*

Source: Author's calculations based on the databanks of the macro-econometric model ADAM (Statistics Denmark)

Turning to the question of the level of unemployment, as opposed to the shifts in recent years, it is important to notice that the number of registered unemployed (labelled 'open unemployed' in table 1) to some degree underestimates the size of the labour reserve, because it does not include unemployed taking part in active labour market programmes, various leave schemes and the Voluntary Early Retirement Pay Scheme. This scheme, under certain conditions, allows both unemployed and employed to retire at the age of 60 years receiving a benefit, which is similar to unemployment benefits, until they qualify for old-age pension at the age of 65. The recipients of voluntary early retirement pay and the participants in active labour market programs are not included in the workforce, as it is normally defined.

Figure 3 present information on both open unemployment and 'gross unemployment', which includes not only the registered unemployed but also the unemployed that participate in various active labour market programmes, leave schemes and the Voluntary Early Retirement Pay Scheme. As can be seen from figure 3, total 'gross unemployment' fell from 600,000 persons in 1994 to about 434,000 persons in 2002. This is first of all the result of a strong decline in open unemployment.

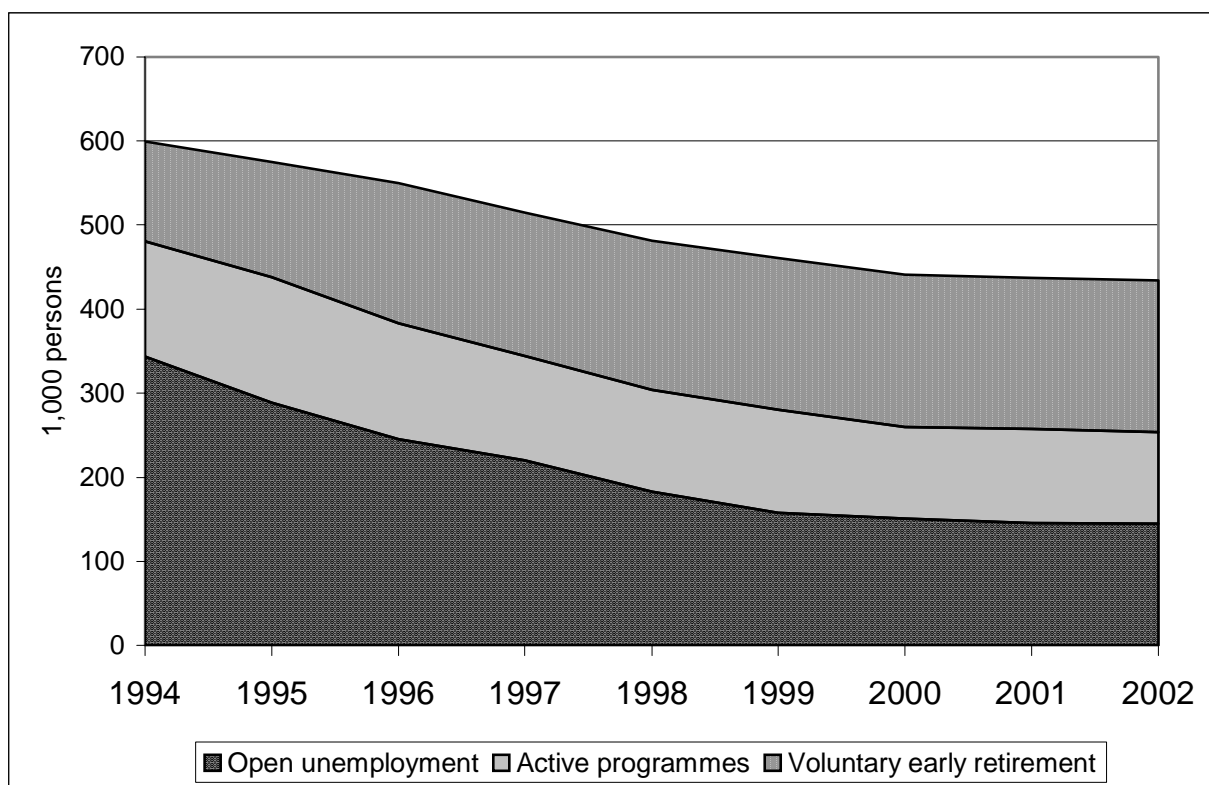


Figure 3: Open unemployment and gross unemployment, 1994-2002. Source: Databanks of Statistics Denmark.

Also the number of participants in active programmes fell during the upturn. Due to a steep increase in the number of recipients of voluntary early retirement pay, the total number of persons at the margin of the labour market did not fall as fast as the number of open unemployed. However, the main conclusion from figure 3 is that the reduction in open unemployment does not merely reflect a shift in the composition of persons at the margin of the labour market, but a genuine reduction in the labour reserve.

Finally, one could suspect that the positive employment performance to some extent could have been the outcome of a widening of the wage dispersion, which then allowed for the creation of new jobs at the lower end of the wage scale. The available statistical evidence shows that the relative yearly wage of low-wage workers fell slightly from 39 percent of the income of high-income earners in 1994 to 37 percent in 2002 (Dansk Arbejdsgiverforening 2003). However, the decline is only seen after 1999 and is thus more probably the outcome of the upturn in employment than its cause. Also, from 1994 to 2001, the Gini-coefficient, calculated on the basis of taxable incomes, increased a little from 0.36 to 0.37 (Danmarks Statistik 2003). Again, the increase is observed only at the very end of the period.

Summing up, the overall impression of the accomplishments of the Danish employment system in recent years is that of a genuine upturn, which reflects a strong increase in private and public employment. Furthermore, these results were obtained without deficits on the external balance of payments (except for 1998) and with rising surpluses for public budgets. Also, this remarkable improvement in the overall employment situation has been accomplished without any significant increase in wage-inflation. Finally, no sharp shifts are observed with respect to the wage or income distribution.

The international interest in the Danish experience

Not surprisingly, these favourable developments have caused international interest and made Denmark a member of the group of small successful European economies (Auer 2000; Auer & Casez 2003). To many international observers, Denmark seems to have created a unique combination of stable economic growth and social welfare since the mid-1990s, at a time when liberals were arguing that the classical Scandinavian model was becoming obsolete and was no longer able to face the demands of flexibility and structural change arising out of technological progress and the growing forces of international competition.

The term *flexicurity* is often used to characterize this successful combination of adaptability to a changing international environment and a solidaristic welfare system, which protects the citizens from the more brutal consequences of structural change. In recent years there has been a growing interest in the scientific study of various model of flexicurity characterized by different combination of forms of flexibility and security. In this broader perspective the Danish model can be seen as a specific variant, where a high level of mobility between firms (external numerical flexibility) is combined with income security. For an introduction to this new line of research, reference can be made to Wilthagen and Tros (2004). The success of the Danish model of *flexicurity* thus points to a 'third way' combining the flexibility of the labour market often ascribed to a liberal market economy with the social safety nets of the traditional Scandinavian welfare state.

However, reality is, as usual, more complex than the portraits of *model societies* found in international discussions of welfare state systems. The purpose of this chapter is therefore to present a brief, as well as critical analysis of the factors behind the Danish version of a 'flexicurity model'. Emphasis will be put on disentangling the various elements behind the apparent success of the Danish employment system by highlighting the following three aspects:

- The role of the macroeconomic expansion of the 1990s
- The long-term nexus between a high level of labour market flexibility and a generous system of economic support to the unemployed.
- The contributions of the reforms of Danish labour market policy since 1994.

Finally, the chapter takes a critical look at the future trends and challenges of the Danish version of flexicurity.

2. A good old-fashioned upturn!

A first factor to be noted is that the Danish upturn and the decline in unemployment since 1993 is not in itself an economic miracle, but a standard example of demand-driven growth. Figure 4 portrays the development in different components of aggregate demand since the early 1990s.

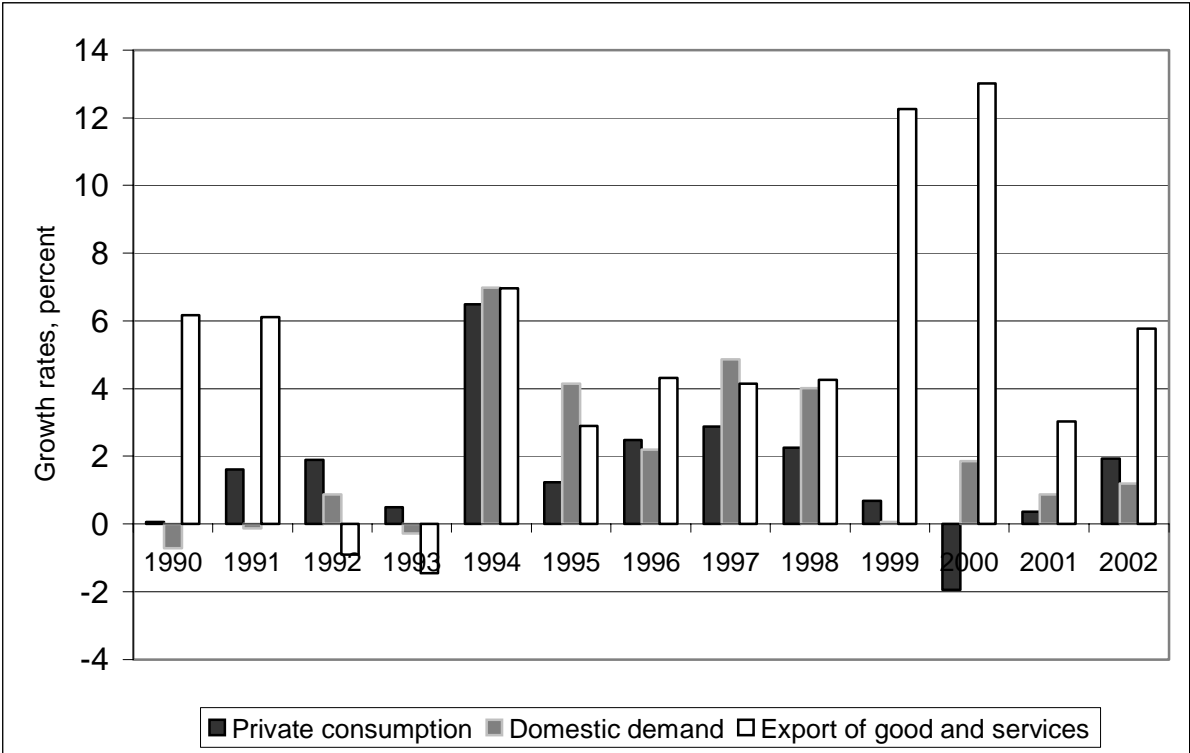


Figure 4: Real growth rates of components of aggregate demand in Denmark, 1990-2002. Source: Databanks of the macro-econometric model ADAM (Statistics Denmark)

The most notable observation from figure 4 is of course the steep rise in total domestic demand (especially private consumption) and in exports in 1994, both showing growth rates above 6 percent. This ‘kick-start’ of the economy was followed by four years of solid growth in both domestic demand and exports. Only in 1999 did the boom in domestic demand level out with export taking over as the main driving force.

There were several causal factors behind this remarkable development. Firstly, an expansion of fiscal policy was implemented by the Social Democratic government, which took office in January 1993. Then came falling international interest rates, rising prices of houses and a credit reform allowing home-owners to convert the fall in long-term interest rates into lower housing costs. Private demand was therefore strongly stimulated. In 1994 alone, private consumption grew by

almost 7 per cent in real terms. Investment in housing accelerated. The same happened, after a while, with private investment in general, all according to the standard economic textbook. Also, export developed positively due to a strong international competitiveness, which was among other factors the result of slow wage increases during the previous years and the fact that nominal wages during the upturn after 1994 were still remarkably stable.

3. The main research questions

The success of the Danish economy and labour market in recent years has stimulated ideas about the existence of a particular Danish model of the employment system. Due to the correspondence of the beginning of the upturn in 1994 and the implementation of a number of reforms of labour market policy, it is sometimes argued that the decline in unemployment can be directly attributed to the changes in labour market policy. However, as argued in the previous section, the decline in unemployment itself can be explained perfectly well within the framework of standard macro-economic analysis. The remarkable feature is therefore not the fall in unemployment as such, but the fact that this reduction took place without any outburst of wage inflation, cf. figure 5, which shows the Danish Phillips-curve since 1956. As seen, the Danish Phillips-curve can be subdivided into three distinct sub-periods. Both the first period from 1956 to the late 1960s and the second period from the early 1970s to the early 1990 are characterized by downward-sloping curves, while the third sub-period after 1993-94 shows an almost perfectly flat curve (Boje and Madsen 2003).

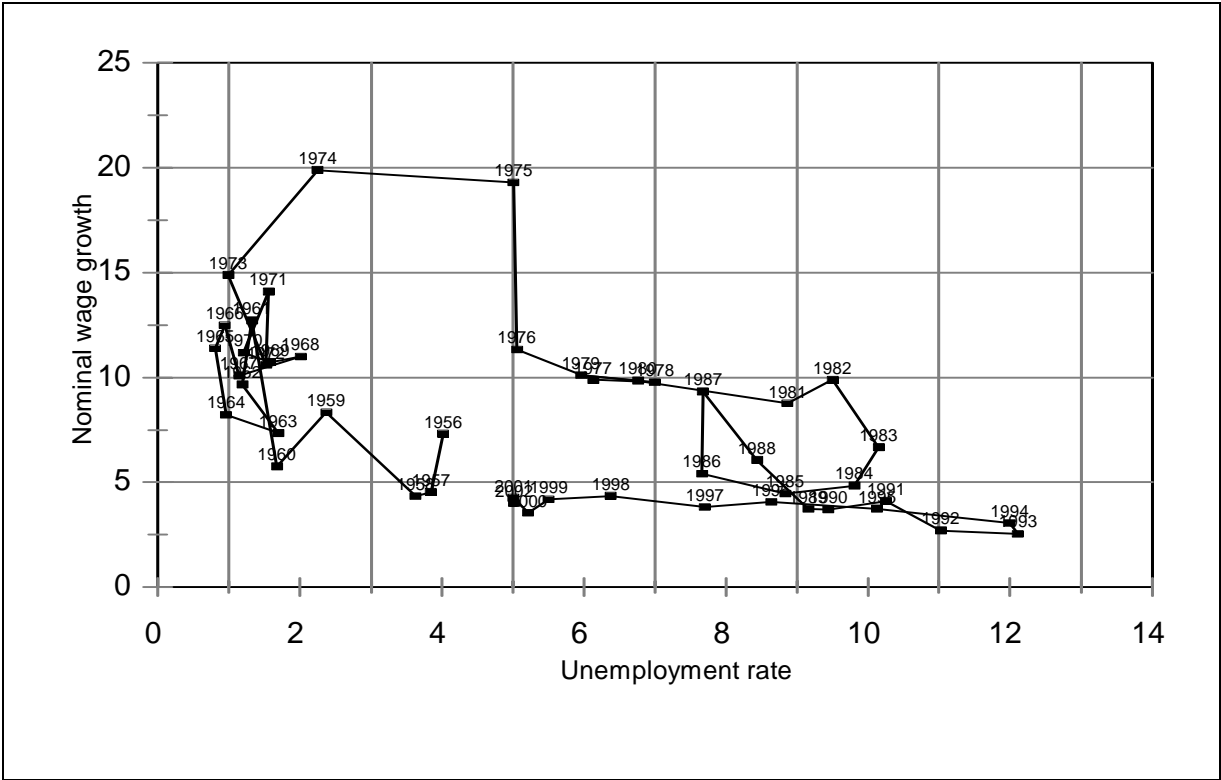


Figure 5: The Danish Phillips-curve 1956-2002. Source: Databanks of the macro-econometric model ADAM (Statistics Denmark)

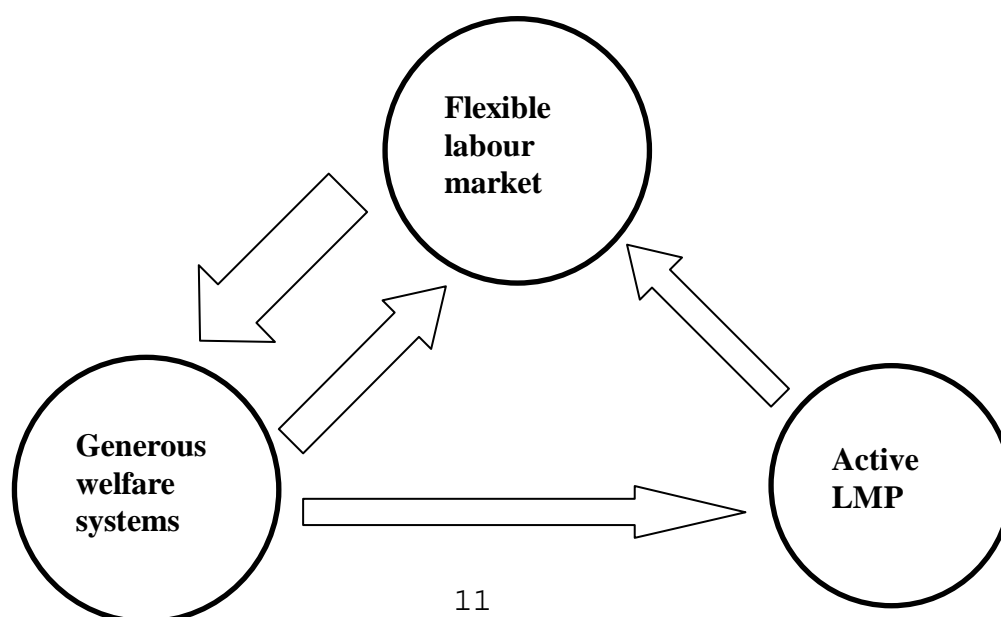
On this background, the developments of the Danish employment system lead to two different, but related, research questions. The first deals with the longer terms relative success of the Danish economy, which – as indicated in section 1 - has been able to sustain a high and rising level of employment during the post-war period leading to a level of the employment rate, which is among the highest found in the OECD-countries. The second question focuses on the more spectacular part of Danish employment history, which is the remarkable – and inflation-free - reduction in unemployment in recent years. In the remainder of this chapter both those questions will be dealt with in an attempt to disentangle the longer-term positive development of the Danish employment system from the noticeable success of the last decade.

4. The ‘golden triangle’ of the Danish employment system

The analysis will be carried forward applying a simple model of the Danish employment system, which has gained popularity in recent years. It takes the form of the so-called ‘golden triangle’ shown in figure 6 (adapted from Arbejdsministeriet 1999, figure 1.6). The model focuses on three elements of the Danish labour market and labour market policy:

- A flexible labour market with a high level of external numerical flexibility indicated by high levels of worker flows in and out of employment and unemployment
- A generous system of economic support for the unemployed
- Active labour market policies aimed a upgrading the skills of the unemployed, that are unable to return directly from unemployment to a new job

Figure 6: The ‘Golden Triangle’ of flexicurity



The arrows in the model symbolize flows of persons between different positions within work, welfare and active labour market programmes. The two arrows linking the flexible labour market and the generous welfare system indicates that large number of workers are affected by unemployment every year, but that most of them return to employment after a short spell of unemployment. Active labour market programmes assist those who do not quickly go back into employment, before re-entering a job.

The argument underlying the concept of the golden triangle is that the success of the Danish employment system is due to its unique combination of *flexibility* (measured by a high level of external numerical flexibility), *social security* (a generous system of social welfare and unemployment benefits) and *active labour market programmes*, all of which support the ongoing transformation of the economy. The golden triangle therefore depicts Denmark as a kind of *hybrid* employment system. Due to a non-restrictive employment protection legislation, which allows employers to dismiss workers with short notice, the Danish system has a level of flexibility, which is comparable to liberal labour markets like those of Canada, Ireland, United Kingdom and United States. At the same time, through its social security system and active labour market programmes, Denmark resembles the other Nordic welfare states in providing a tightly knit safety net for its citizens.

Concerning the historical background for the model, it should be seen not as the result of a well-defined grand scheme, but as the outcome of a long historical development. The high level of worker mobility supported by a low level of employment protection is a long-term feature of the Danish labour market. Actually, the employers' right to freely hire and dismiss their workers was accepted by the trade unions as a part of the so-called September Compromise between the social partners in 1899. Also, the present version of the system for economic support for the unemployed dates back to the last large reform of the unemployment benefit system in 1969. Finally, the present system of active labour market policy dates back to programmes introduced in 1979, which were given a large-scale overhaul in 1993-94.

The following sections 5 to 9 looks at each of the corners of the golden triangle, while section 10 in more detail returns to the issue of its historical origin.

5. Worker mobility

Compared to the net changes in employment, the underlying mobility of workers between jobs and the level of both job creation and job destruction are surprisingly high. A recent study concerning hires, separations, job creation and job destruction has found that, on average, the level of worker turnover during the period 1980-1995 was about 30 per cent, and in no year less than 25 per cent (Bingley et al. 2000). The level of job turnover (job creation and job destruction) is also much

higher than the level of yearly net changes in employment levels. The overall average of job turnover is around 12 per cent. Furthermore, the level of worker turnover is high for most categories of employees and not concentrated to a minor share of extremely mobile unskilled workers.

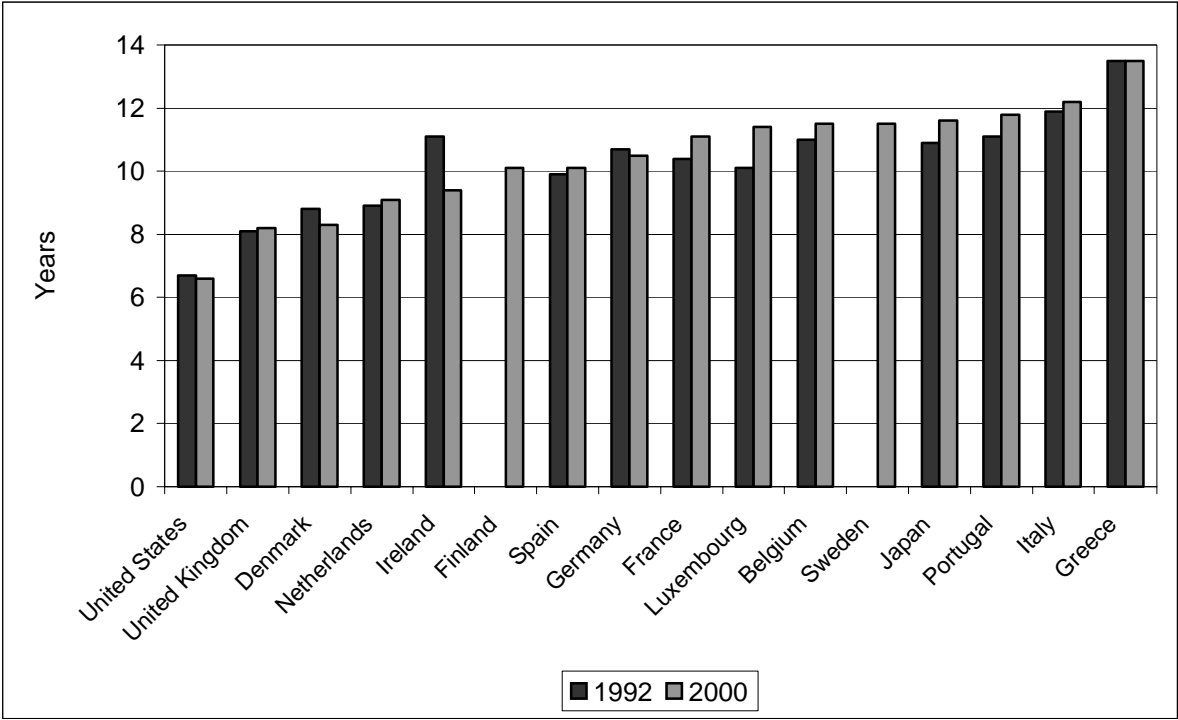


Figure 7: Average tenure (years) for employees in a number of OECD-countries. Source: Auer and Cazes 2003, table 2.1.

Another indicator of the high rate of mobility on the Danish labour market is provided by data on the average tenure of employees. Figure 7 shows the distribution of employees by average tenure in 1992 and 2000 in a number of OECD countries. Denmark is at the low end of the international scale in terms of average tenure, along with countries such as the United Kingdom and the United States. In contrast, other Nordic countries, such as Finland and Sweden, have significantly higher levels of average tenure. Sweden is actually at the top end of the rank, with Japan, Portugal, Italy and Greece. Moreover, it may be noted that the average levels of tenure, in both Denmark and in other countries, are fairly stable over time. The level of average tenure therefore appears to be an inherent structural characteristic of the employment system of each country. Finally, during the time span covered by the data, there are no signs of a general decline in the stability of the employment relationship in the countries covered by Figure 7. For the countries in the sample as a whole, average tenure actually increased a bit from 10.2 years to 10.4 years during the period covered by figure 7.

The composite index of labour mobility calculated by Eurostat based on its labour force survey gives a similar impression of a flexible Danish labour market. The index takes account of job rotation, inflows into employment following a period of unemployment, after leaving the education system and after having looked after a family. With EU-average at 100, the Danish score of 138 is the highest among the EU Member States (European Commission 2002, p. 10).

An important explanation for the high level of Danish worker mobility is the liberal regime of employment protection found in Denmark. A number of studies have compared the level of employment protection in Denmark to that of other countries. Figure 8 summarizes the results of an OECD study on employment protection legislation (OECD 1999, Chapter 2). As shown by the indicator of employment protection legislation, Denmark is ranked as having a low level of employment protection compared to most other industrialized countries, and much lower than the other Nordic countries, with which Denmark is commonly grouped. Although there may be differences between the formal level of employment protection and the actual enforcement of the legislation, the data still shows a surprising divergence between Denmark and the other Nordic welfare states.

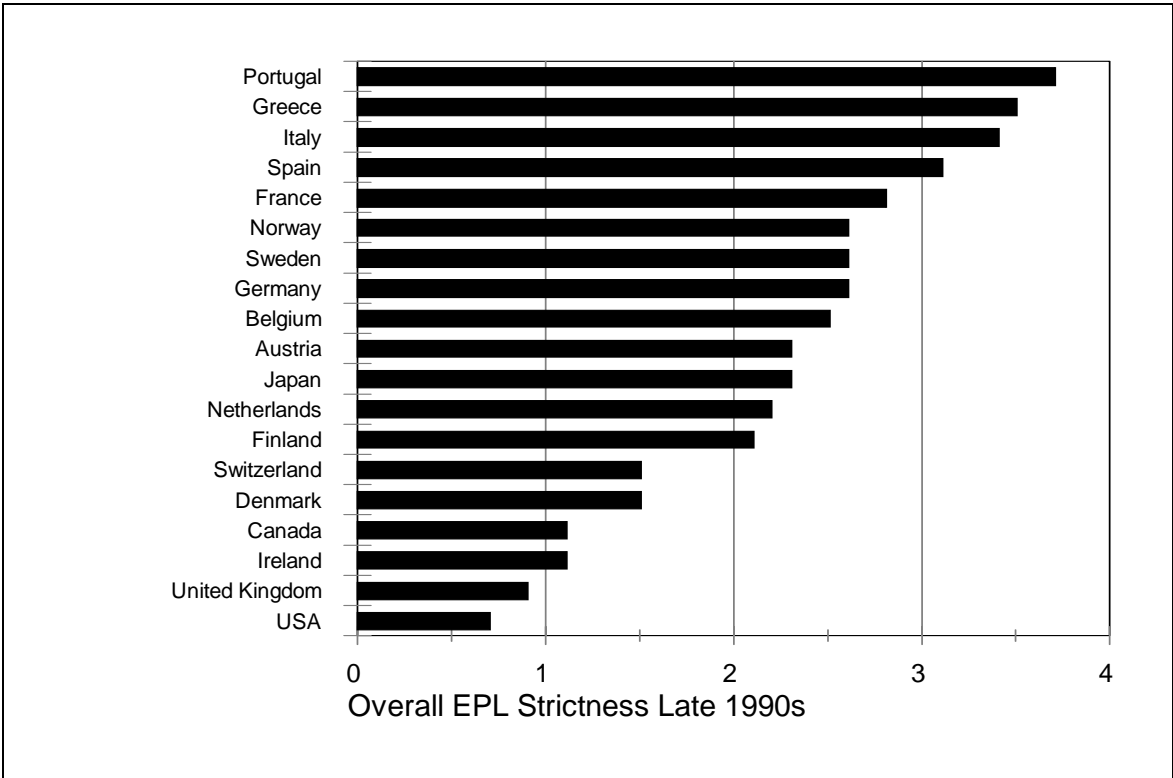


Figure 8: Overall strictness of employment protection legislation (EPL) in the late 1990s. Average indicator for regular contracts, temporary contracts and collective dismissals. Source OECD 1999, table 2.5.

It might be thought that this high level of job mobility and low level of employment protection would lead to a widespread feeling of insecurity among Danish employees. Paradoxically, this is not the case. In a survey conducted in 1996, the proportion of Danish workers *not* strongly agreeing with the statement ‘my job is secure’ was about 45 per cent, and therefore considerably lower than for all the other countries in the sample. This feeling of job security was found among all subgroups of workers (OECD 1997, Table 5.2). Although this may also reflect the positive situation on the Danish labour market at the time of the survey, there are no clear indications that Danish workers are reacting to the high level of numerical flexibility with a strong feeling of insecurity. Similar results have also been found in a more recent survey (Auer and Casez 2003, figure 1.1).

There are at least three explanations for this apparent paradox. One is the predominance of small and medium-sized enterprises (SMEs) in the Danish industrial structure, which implies that strong internal labour markets are less important than in other countries. It is easier to shift from one firm to another due to lower entry barriers at the enterprise level. Furthermore, the general improvement in the Danish labour market situation since 1994 may also have influenced the responses, although Danish registered unemployment in 1996 was still at the level of 8.9 percent of the labour force. But a final explanation is the relatively generous unemployment benefits paid to unemployed workers from the first day of unemployment and for a considerable period. This is the subject of the following section.

6. The Danish unemployment benefit system

The vast majority of unemployed persons who are members of an unemployment insurance fund receive unemployment benefits calculated at the rate of 90 per cent of their previous earned income, with a ceiling of 162,000 DKK (21,800 Euro) per year (2003). Unemployment benefits may be claimed from the first day of unemployment and for a maximum of four years, including periods of activation.

For low-income groups, this and other income-related benefits, combined with the effects of the rather high level of income tax, result in high net income replacement rates (OECD 2002). For an average production worker, for example, the replacement rate is around 70 per cent. For low-income groups, the net replacement rate is around 90 per cent, highest for single parents. This system puts Denmark in the top end of the EU Member States, when one compares the net replacement rates. Figure 9 shows the results from the comparison provided by OECD.

The minority of the unemployed, who are not members of an unemployment insurance fund (often labeled the ‘non-insured’ unemployed), will receive means-tested social security cash benefits, which for adult family supporters are at a level around 80 percent of normal unemployment benefits. The most important difference between unemployment benefits and social security cash benefits is thus the means testing. Furthermore, social security cash benefits will depend on the recipient’s family situation. Also, a special low level of cash benefits was introduced in 2002 for

newly arrived immigrants.

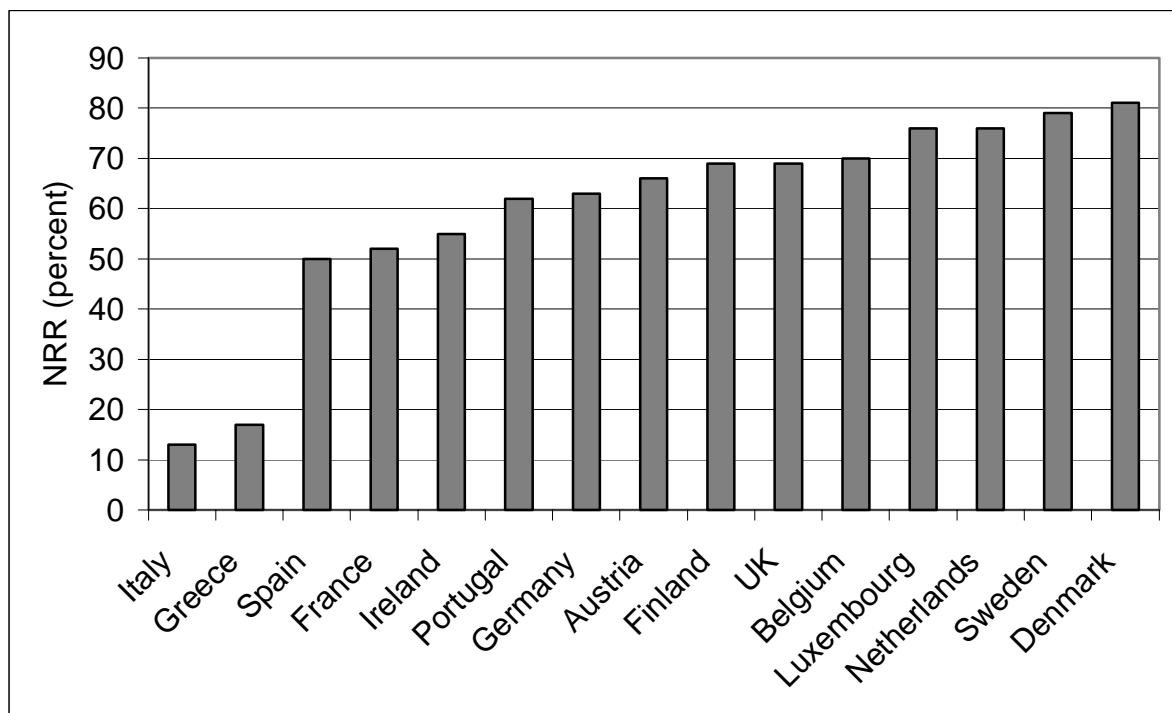


Figure 9: Average net replacement rates (NRR) for 60 months of unemployment for an average of different family types and income levels. Percent. Source OECD 2002, table 3.10

In the Danish labour market system, the potential disincentives caused by such high income replacement rates are addressed by requiring the unemployed to be actively seeking jobs and by offering mandatory activation after 12 months of unemployment for adults and 6 months of unemployment for young unemployed persons under the age of 25. Activation is therefore seen as fulfilling both a qualification and a motivation purpose.

7. Danish active labour market policy

Between 1979 and 1993, the main pillar of the active policies to address long-term unemployment was a programme combining job offers, training and support to the unemployed to help them start up in self-employment. However, this programme showed relatively poor results, with only a minority of the participants becoming employed on the open labour market. This factor, combined with a sharp new increase in unemployment between 1990 and 1993, increased the political pressure to find new measures to break the vicious circles of long-term unemployment. The result was a general labour market reform, which came into force in January 1994, having the following main characteristics:

- The introduction of a two-period benefit system, with an initial *passive* period of four years and a subsequent *activation* period of three years; during the passive period, an unemployed person receives benefits and is also eligible for 12 months of activation;

- A change in the assistance provided to individual long-term unemployed persons from a rule-based system to a system based on an assessment of the needs of the individual (with the introduction of *individual action plans* as an important instrument);
- The *decentralization of policy implementation* to regional tri-partite labour market councils, which are empowered to adjust programme design to fit local needs;
- The *abolition of the connection between participation in labour market measures and the unemployment benefit system*, with the effect that employment with a wage subsidy no longer would prolong the period for which the unemployed are eligible for unemployment benefits.
- The introduction of *three paid leave arrangements* for childcare, education and sabbatical leave to encourage job rotation by allowing employed (and unemployed) persons to take leave while receiving a benefit paid by the state and calculated as a fraction of unemployment benefit.²

Under the governments headed by the Social Democrats from 1994 to 2001, Danish labour market policy underwent a number of further reforms, having as their main effect a shortening of the maximum period for which the unemployed would receive benefits (the passive period). As noted above, this passive period was four years in 1994 (with an option of 12 months of activation during this period). In 1996, the passive period was reduced to two years. For young unskilled unemployed persons, the period was reduced to six months in 1996. It was subsequently decided in 1999 to further reduce the passive period to one year for adult unemployed persons. By the end of 2000, Denmark had therefore implemented the element of the European Union's employment guidelines, which call for early activation for both young and adult unemployed persons.

The Conservative-Liberal government in 2003 with broad political support introduced a new major reform of labour market policy, 'More people at work'. With respect to active measures, it had the following main elements:

- The number of individual programmes of active labour market policy was reduced from 32 different schemes to only 3 main types of instruments covering a) guidance, training and education, b) practical introduction to the enterprises and c) wage subsidies.
- Higher priority was given to early guidance and other forms of personal contact with the individual unemployed at least every 3 months. The demands on the unemployed for active job search and mobility were increased
- The whole administrative system for active labour market policy and benefits was modernised applying an extensive use of digital technologies.
- Other actors (private firms and organisations, including the unemployment insurance funds) were to become more involved in implementing active employment policies at all stages.
- All adult unemployed should still take part in an active program after 1 year of

unemployment. However, the exact extent of activation was now specified more vaguely than under the previous system, which had a rule stating that activation should be on a full-time basis (defined as 75 percent of the time in the ‘active period’).

- A long-term target of the reform goal was to fully integrate the two tiers of the present Danish system, which now handles insured and non-insured unemployed separately. Here an important step is to be taken in 2006, where joint job-centres located in the municipalities will take over the responsibility for both the insured and the non-insured unemployed.

Also as part of the reform, social security cash benefits for some groups (married couples and newly arrived immigrants) were reduced. However the vast majority of recipient of social benefits and of normal unemployment insurance benefits have not been affected by this element of the reform. Therefore the main impression of the reforms of labour market policy since the change in Government in 2001 is that the main policy profile is kept intact as a reflection of a broad political consensus about the merits of the style of labour market policy, which was developed during the second half of the 1990s.

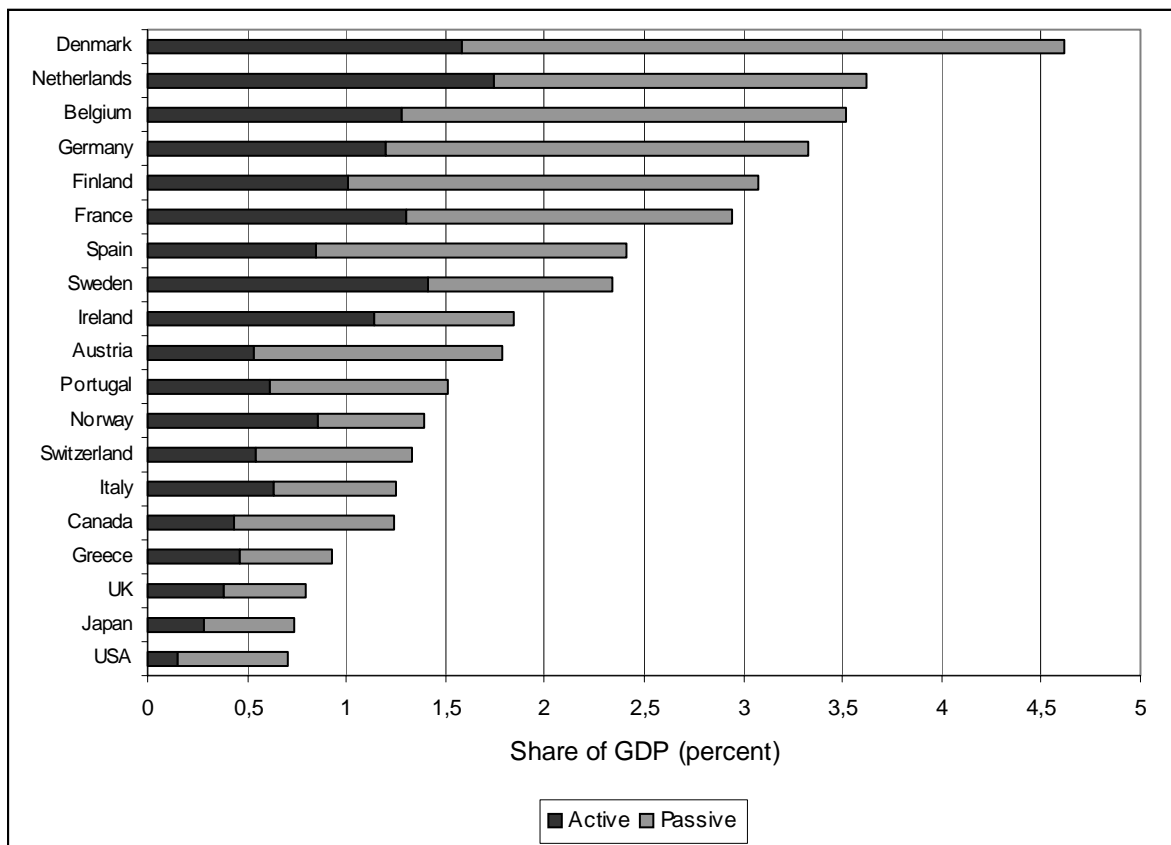


Figure 10: Expenditure on active and passive labour market policy, 2002 or latest year. Share of GDP. Source: OECD 2003.

The change in the profile of Danish labour market policy since the mid-1990s has placed Denmark in the upper range of OECD countries in terms of expenditure on both active and passive labour market policy measures. The data in figure 10 illustrate the high level in Denmark of total expenditure on active measures and passive benefits (unemployment benefits including early retirement for labour market reasons).³ Also when it comes to expenditure on active measures alone, Denmark is ranked high among the OECD-countries, only surpassed by the Netherlands.

8. Evaluations of active programmes

As in many other countries, the net effects of active labour market policy are disputed. One reason is that active programmes have both positive and negative effects on the future employment prospects of the individual participants:

- The *motivation effect* implies that an unemployed person seeks work more actively in the period immediately *before* she or he has to participate in a mandatory activation programme. The strength of the motivation effect is indicated by the change in the probability of leaving unemployment in the period immediately before the person is obliged to take part in an activation programme.
- The *'locking-in'-effect* means that job-search activities are reduced during the period that an individual takes part in a programme.
- The *training (or qualification) effect* stems from the rise in the level of qualifications during activation, which should improve the possibilities of finding a job for those who have participated in one of the active programmes.

In a study published in 2000, the Ministry of Labour presented some of the first results based on a new database, which it had developed (Ministry of Labour 2000). The database contains information on the labour market situation of all individuals, including their participation in labour market programmes and their contacts with the social security system.

First of all, the study revealed significant motivation effects, measured by an increased probability to take up employment in the period immediately before having to take part in mandatory activation programmes. Such effects have been confirmed by later studies (e.g. Geerdsen 2003; Rosholm and Svarer 2004) and play an increasing role for the proponents of active programmes. However, the specific dilemma posed by such observations should be borne in mind. If it is wished to increase the motivation effect, there may be a temptation to change the content of activation programmes in order to make them less attractive to participants. But this would also probably imply that the *quality* of the programmes themselves would be lowered in terms of their training content and other activities to improve the skills of the participants. As a result, the overall outcome might be less positive for those unemployed persons who are unable to find a job before entering activation.

Another potential effect for the individuals taking part in activation programmes is that they increase their chance of gaining employment due to the improvement in their qualifications and therefore their employability. In the study by the Ministry of Labour, the improvement in employability is measured by the reduction in the proportion of the year for which the persons concerned receive any form of transfer income (such as unemployment benefit, social assistance or sickness benefit). A reduction in this proportion is a reliable indicator of a genuine improvement in the employment situation of an individual, either because they have found ordinary employment or taken up some form of ordinary education.

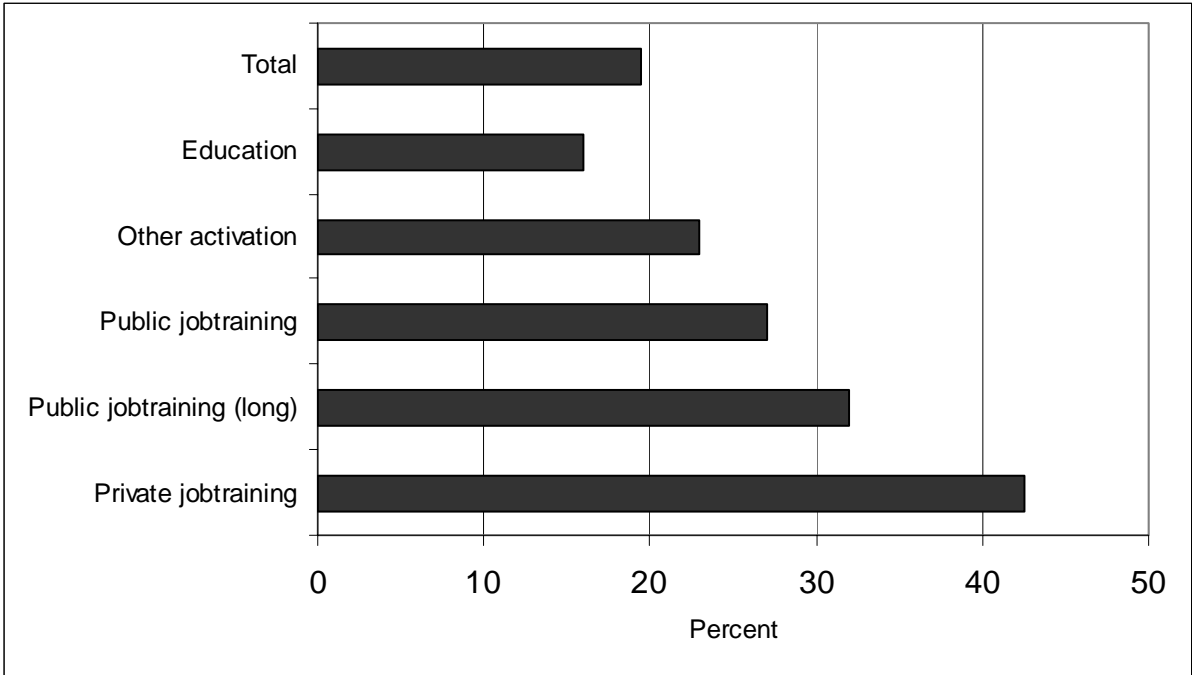


Figure 11: Increase in economic self-dependency after taking part in different programmes, averages for 1996-1998. Source: *Beskæftigelsesministeriet 2002, figure 9.*

Such qualification effects of the various types of labour market programmes are of considerable interest, cf. figure 11.⁴ In this respect, the largest improvement in the employment situation (measured by an increase in the economic self-dependency of the participant) is found for participants in private job training. For public job training and labour market education the effects are positive, but smaller. These findings are in line with international experience (Martin 2000).

Other studies have been more sceptical towards the positive net effects of active programmes, often pointing to the existence of significant locking-in effects. By example, the Chairmen of the Economic Council in their report from December 2002 ascribe about one third of the reduction in unemployment since 1993 to improved structural performance of the Danish labour market and attributes part hereof to improved labour market policy (Det økonomiske Råds formandskab 2002). However, the report gives a rather critical account of the majority of the instruments

applied within active labour market policy and especially points to significant locking-in effects of several measures. Only job training in private firms seems to have large positive net effects and to be cost-effective. Job-training in the public sector and many forms of education have dubious or negative net outcomes for the participants. On this background the Chairmen proposes improvements in the use of active measures (including giving higher priority to job search and private job-training).

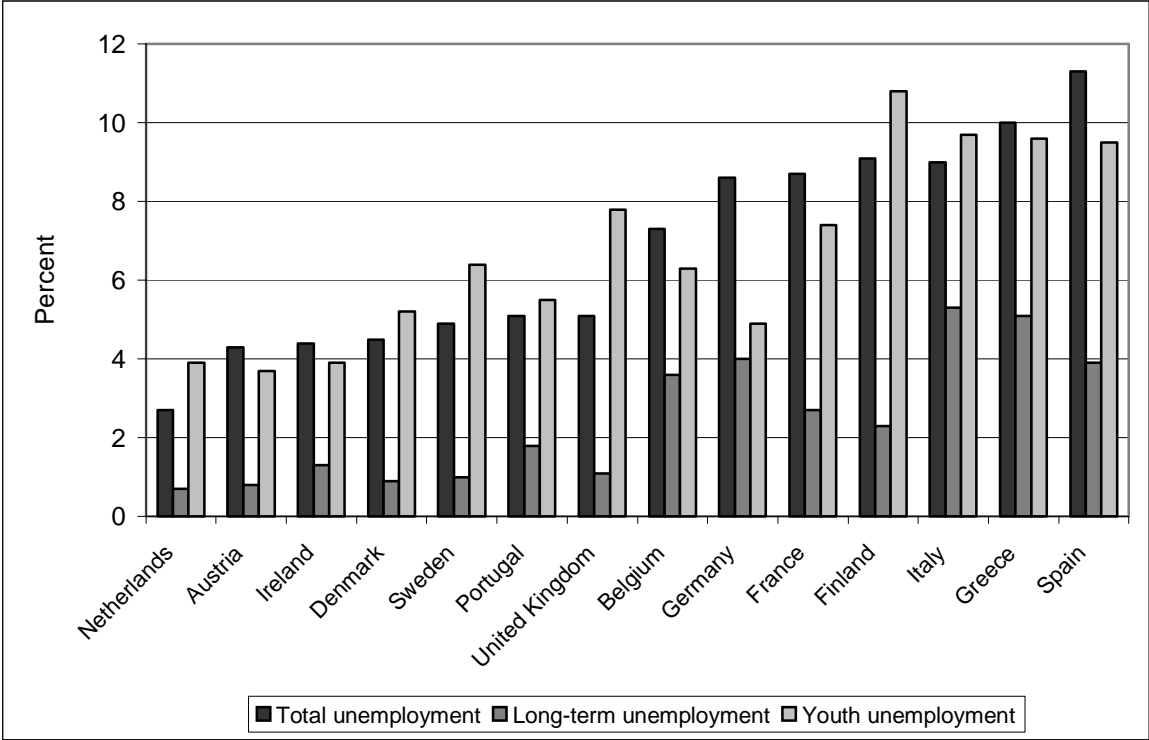


Figure 12: Total unemployment (unemployed as % of workforce), long-term unemployment (long-term unemployed as % of workforce) and youth unemployment (unemployed as % of age group) in a number of EU Member States. Source: European Commission 2003, statistical annex. The countries are ranked according to the sum of the three indicators.

Concerning international comparisons, it is difficult to assess the efficiency of Danish active labour market policy in a comparative perspective. Figure 12 gives some data on overall unemployment, long-term unemployment and youth unemployment for a number of European countries. As indicated by figure 12, Denmark is among the best performers among the European countries, when assessed by various aspects of unemployment. Also when measured by other indicators of labour market performance like life-long learning, gender pay gaps, employment rates of older workers etc. Denmark is among the top performers of the EU Member States.

9. Labour market reforms and the functioning of the labour market

The evaluation findings discussed above have focussed on the micro-level. However, the coincidence of the implementation of the labour market reforms and the dramatic fall in unemployment has of course stimulated discussions about the extent to which the inflation-free macro-economic upturn can be attributed to the shift in labour market policy in the 1990s. A lowering of the level of wage inflation for a given size of unemployment is taken as an indicator of greater flexibility in the functioning of the labour market. As noted above, the Danish Phillips curve has since 1994 become almost horizontal, indicating a steep fall in structural unemployment.

Of course, there could be a number of factors behind these developments. The changing attitudes of the social partners could be important. Thus, in 1987 the social partners issued a joint declaration stating that they would take the overall macro-economic performance into consideration and therefore negotiate wage increases below the international wage inflation in order to improve the competitiveness of the Danish industry. This declaration has since laid the foundation for the general wage negotiations. From a theoretical perspective this explanation can be supported by the concept of the 'negotiated economy', which sees Denmark as a prime example of a society, where a joint conception of the overall targets and constraints for macro-economic development has been established (Nielsen & Pedersen 1991).

Furthermore, Danish wage negotiations have to an increasing degree been decentralised to the level of the individual firms. Thus, in the collective agreements covering the major part of the private sector, only 15 percent of the agreements had centrally negotiated wage rates in 2000. In 1989, the share was 34 percent. The share of agreements, which mentions no wage rate at all increased during the same period from 4 to 20 percent (Dansk Arbejdsgiverforening 2003, table 8.10). According to the well know Calmfors-Driffill-hypothesis, this development could also explain slower wage growth (Calmfors and Driffill 1988).

Combining the conditions for wage negotiations at the central and de-central level, one could therefore point to a shift in the norms for wage negotiations, which implies both a recommendation of wage restraint from actors at the central level and a higher acceptance of the need to keep wages in line with (foreign) competitors at the firm level. Thus shifts in norms and in the organisation of wage formation overruled the potential inflationary effects of a large reduction in unemployment. Following the argument of Smith (1992) this points to the complexity of the forces that determine inflation and to the fragility of the traditional Phillips-curve.

In this context one must furthermore emphasize the lowering of the international level of inflation (including wage inflation) as an important factor behind the lower internal pressure for nominal

wage increases. In their report from December 2002, the Chairmen of the Economic Council presented a new model of Danish wage formation, which includes wage increases abroad as an important explanatory variable. The estimate for the influence of foreign wage growth implies that Danish nominal wages increase by almost 0.6 percent, when foreign wages increase by 1 percent (Det Økonomiske Råds Formandsskab 2002, pp. 155-6).

A final point worth taking into the argument concerning the lowering of nominal wage inflation is the difference between the development of nominal and real wages during the last decades, cf. figure 13. The main message is that stable growth in real wages of about 2 percent per year can be reached also at a moderate level of nominal wage growth, as indicated by the experience from the 1990s. The opposite lesson was learned during the years from 1977 to 1986, where increases in nominal wages of 5 to 12 percent resulted in increases in real wages around zero. An added factor during the period from 1994 and onwards was the further increase in private consumption made possible by the growth in prices of private homes and the easy access to cheap mortgage. Therefore the perception of the need to moderate nominal wage growth was strongly supported by the daily experience of the wage earners themselves – slow wage increases and rising living standards could easily go hand in hand.

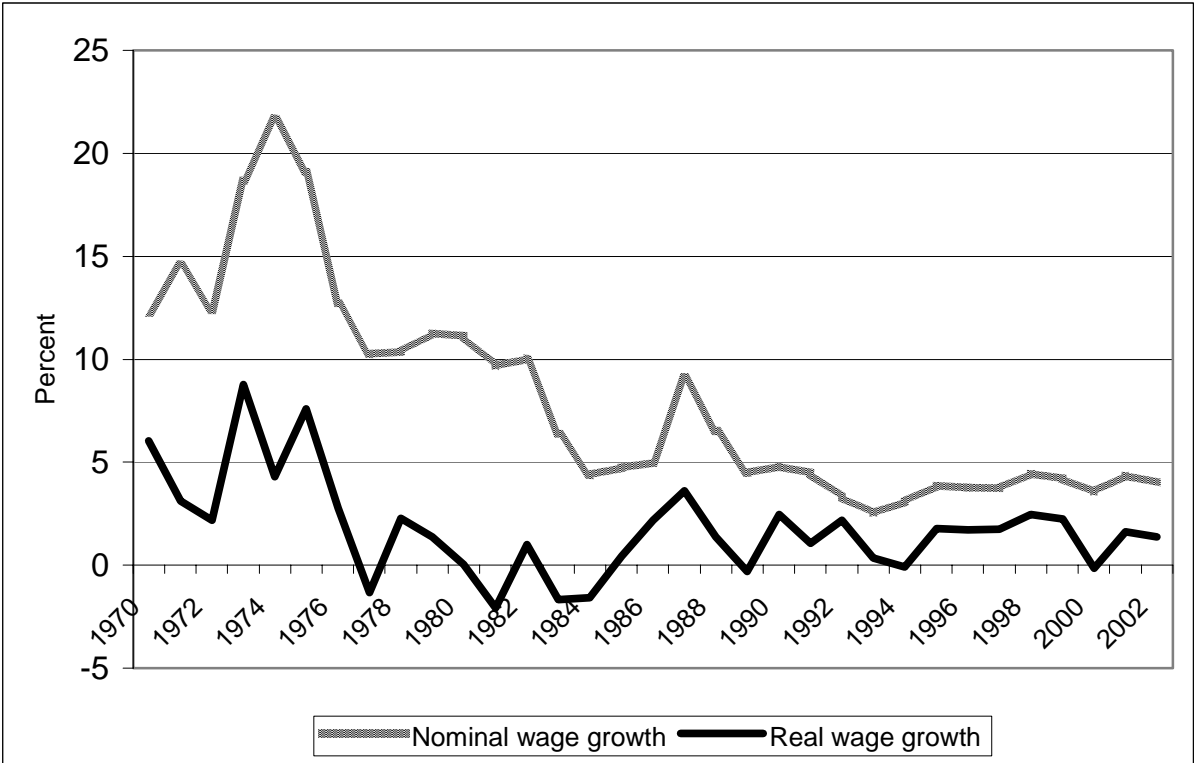


Figure 13: Growth in nominal and real hourly wages for workers in manufacturing industry, 1980-2002. Source: Databanks of the macro-econometric model ADAM (Statistics Denmark)

While one can therefore present a number of explanations for the shift in the unemployment-inflation nexus on the Danish labour market since the early 1990s, one can also point to evidence, which support the view that the *reforms of labour market policy* during the 1990s made a significant contribution to the improved functioning of the labour market. Thus the Chairmen of the Economic Council, who as indicated above are rather sceptical to the merits of active labour market programmes, nevertheless ascribe a little less than half of the reduction in unemployment since 1993 to improved structural performance of the Danish labour market and attributes a significant part hereof to the reforms of labour market policy, although they find it difficult to provide a more exact estimate. The Chairmen furthermore point to an increase in the share of unemployed that are actively looking for work and relate this to the shortenings of the period of passive benefits payments and the stricter demands to take part in activation (Det Økonomiske Råds Formandskab 2002, pp. 163-5 and 153).

A study from the Danish National Institute of Social Research in 1998 summed up the evidence from a large-scale evaluation programme studying the initial labour market reform of 1994 (Larsen and Langager 1998, pp. 34-36). Concerning the importance of the activation strategy, the analysis showed that:

- The employment goals specified in the individual action plans indicated that there was a *considerable planned mobility* among the unemployed.
- Labour market policy seemed to function effectively in that planned mobility among the unemployed was *larger* in those regions where the need for mobility was the highest (due to threats of bottlenecks)
- There were *significant positive employment effects* of both job training and education for unemployed.
- The *effective supply of labour among the insured unemployed seemed to have increased* from 1994 to 1997 probably due to the stricter demands made on the unemployed during the second phase of the reform (for instance in relation to the increased demands on the young unemployed).

Concerning the activities directed at the firms, there were indications that the reform has contributed to the absence of bottlenecks since 1994:

- There was a (weak) indication that *the quality of the services of the Public Employment Service to the firms has improved* since the reform when looking at the ability to fulfil the needs for qualified labour (though there were also examples of labour shortages in the short run).
- The introduction of new forms of placement services (in the form of ‘open’ self-service placements) had - together with the surveillance activities and regular contacts with employers - lead to *an increase in the transparency of the labour market* and thus

improved its function as a system to match demand for and supply of labour; the market share of the Public Employment Service however, was still rather low.

Thus, based on the positive evaluation findings for both the process and the effect of the labour market reforms, there is a well-based case for arguing that the change in Danish labour market policy in 1993-94 has made a separate contribution to the improved functionality of the Danish labour market in recent years. The absence of labour shortages and wage-pressure since 1994, in spite of the fall in unemployment and the strong growth in employment, indicate that the functioning of the labour market has improved.

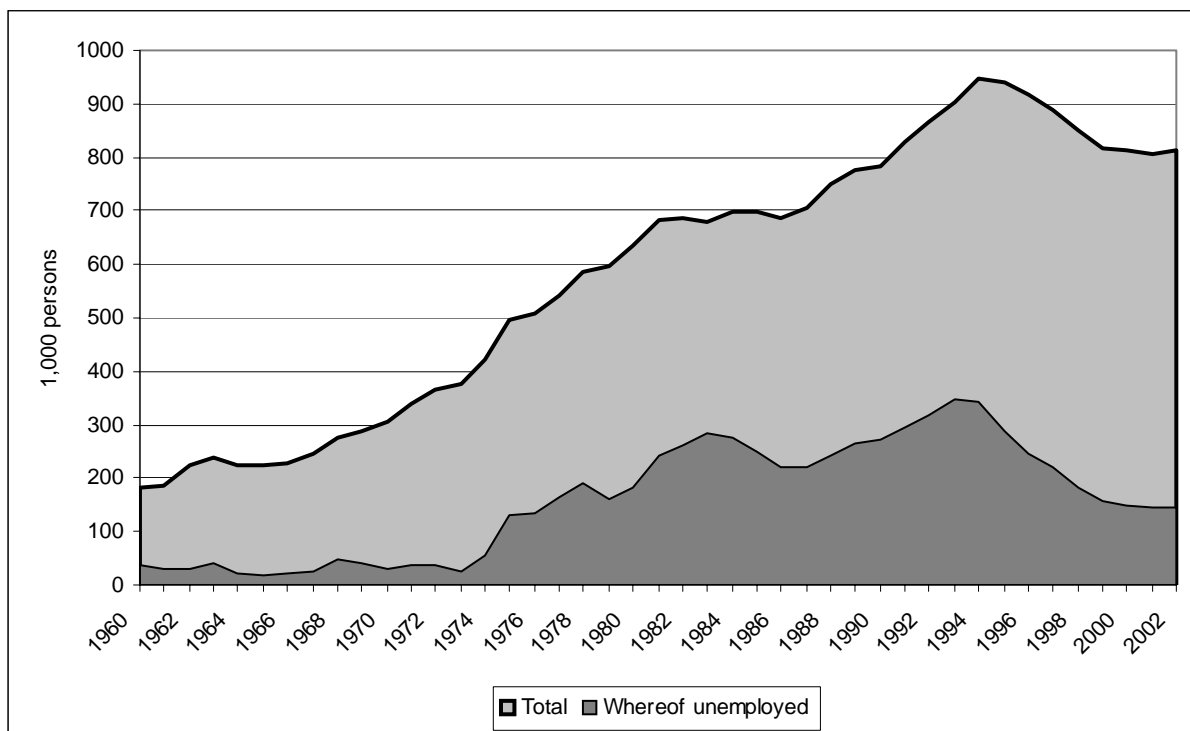


Figure 14: Number of adults aged 15-65 years and receiving transfer income 1960 to 2002. Full time equivalents. Source: Databank of ADAM (Statistics Denmark)

Also, as indicated in figure 14, the number of both unemployed and the total number of adult persons receiving transfer income has been falling since 1993. Besides the unemployed, the number of adult persons aged 15-65 years and receiving transfer income includes persons on sickness benefits, invalidity pension and voluntary early retirement schemes. The number of recipients of transfer income has been steadily rising since the early 1960s, but started falling in 1993. To what extent this is due to the labour market reforms, the economic upswing or to other of the above mentioned factors cannot be definitively determined on the basis of the available evidence. However, on the basis of the data in figure 14, it is hard to judge Danish labour market policy

during the 1990s as creating social exclusion or being in other ways destructive to the functioning of the labour market or the welfare state.

10. A small state phenomenon?

Given the interest in the Danish experience in recent years, it is appropriate to address the question of the background and uniqueness of the interplay between labour market flexibility, social security and active labour market policies that has been spelled out in detail in the previous sections.

As already indicated, the Danish ‘model of flexicurity’ is not the result of a well-defined grand scheme, but as the outcome of a long historical development. Thus, the high level of worker mobility supported by a low level of employment protection is a long-term feature of the Danish labour market. Already in the September Compromise between the social partners in 1899, the trade unions accepted the employers’ right to freely hire and dismiss their workers. Since then, a set of agreements and norms have developed, which put some restrictions of the practices of the employers with respect to dismissals. Thus, a revision of the General Agreement between the social partners in 1960 stated that dismissals should not be arbitrary and that suspected unfair dismissals could be assessed by a special tribunal (Kristensen 1997, chapter 10). However, as indicated by the indicators provided by the OECD, the Danish regime concerning dismissals still puts relative few restrictions on the employers (OECD 2004, chapter 2).

Similarly, the system for economic support for the unemployed is not of a recent date, but has its origin in unemployment insurance funds founded by the trade unions and regulated by law since 1907. The last large reform of the unemployment benefit system took place in 1969, where the state undertook the responsibility for financing the extra costs of unemployment benefits that were caused by increases in unemployment (the principle of financing ‘at the margin’). The members of the unemployment insurance funds would therefore only be obliged to pay a fixed membership contribution, independent of the actual level of unemployment. Furthermore, as shown by Kærgaard and Hansen (1994), the average compensation rate of unemployment benefits almost doubled during the late 1960s and 1970s. Data from the databank of the macro-econometric model ADAM indicate that the level of compensations then levelled out round 60 percent. During the 1990s the average rate of compensation has slowly fallen to around 50 percent. Finally, as described in detail above, the present system of active labour market policy dates back to programmes introduced in 1979, which were given a large-scale overhaul in 1993-94 and subsequent years.

A further observation can be made concerning the present foundation for this model. The relationship between the liberal regime of employment protection and the well-developed state-financed system of unemployment compensation is strongly supported by both trade unions and employers’ organisations. This support becomes manifest every time political proposals for

restrictions in the access to unemployment benefits are put forward. In such cases a strong alliance between trade unions and employer's organisations is formed, where the employer's organisations point to the risk of claims for better employment protection in case of deteriorations of the benefit system. An illustration of the strength of this alliance was given in August 2003, when the Minister of Employment, as part of the negotiations for the budget for 2004, put forward a proposal to reduce unemployment benefits by a number of reforms, including the introduction of a longer waiting period for high-income earners. Originally the aim for this and related proposals was to reduce public expenditures by around 100 million Euros. Immediately the proposals met strong resistance from the trade unions, especially in the construction sector. Longer terms of notice were called for, if the rules were changed. Then the employer's organisations moved in and supported the views of the trade unions referring to the lower flexibility that would be the outcome of cutbacks in the benefit-system. At first the protests lead to a reduction in the intended savings to around 20 million Euros, and in the end the Minister had to drop the proposal all together.

The third element in the triangle, active labour market policy, is also the outcome of a long tradition for interventions into the functioning of the labour market. When it comes to the settling of wage negotiations, the September Compromise in 1899 is often taken as the starting point, because this agreement between the social partners also laid the foundation for the state's role as mediator in collective agreements. In 1907 the first law on Unemployment Insurance Funds was passed and in 1913 a public employment service was established. In 1942 the Ministry of Labour was established as a separate ministry. Thus, labour market policy in Denmark has a long political legacy, although it only developed into a distinct policy area in the mid-1950 (Jørgensen & Larsen, 2002, pp.171-175). Being partly based on a system of private unemployment insurance funds affiliated with the trade unions and having traditionally a large number of tri-partite bodies responsible for labour market training and other institutions, Danish labour market policy is thus a prime example of the negotiated economy:

'The September Compromise provided the foundation for labour market regulation that emphasized negotiation early on, and organizational representation in government committees, boards and commissions has remained strong ever since. The state has learned to delegate authority to the labour market organizations, and they almost always assist in the design of initiatives. The organizations also have a strong sense of 'ownership' of the post-war labour market policy' (Jørgensen & Larsen, 2002, p. 171)

Also the reforms of labour market policy in the 1990s were the outcome of a compromise between the Government and the social partners, which was struck in the early 1990s in a special tri-partite committee (the Zeuthen Committee). The committee hammered out the foundation for the active and de-central profile of Danish labour market policy in the following years. The background for the Zeuthen-Committee was increasing dissatisfaction with the general design of labour market

policy, which had been the outcome of the last reform in 1979. Also, the dramatic rise in open unemployment in the early 1990s pushed the need for reform higher on the political agenda. Recent studies of the political processes behind the reform of labour market policy in 1993 and its successors have pointed to a number of factors behind this development (cf. the various contributions in Madsen & Pedersen 2003b):

- The changes in the discourse where active labour markets programmes were increasingly argued as an important instrument to lower structural employment and received support from both proponents of workfare-oriented and human-capital oriented strategies (cf. also Torfing 2004)
- The need of the newly elected government led by the Social Democrats to demonstrate its ability to ‘break the curve’ of unemployment
- The broad public support for reforms, including the various leave schemes.
- While the social partners had a dominant role during the work in the Zeuthen Committee, their function in the subsequent adjustments has been somewhat ambiguous. In some years, especially in 1998, they played an important part, while the Government took the lead in other situations, thus shifting between different political channels for decision making (cf. Winter 2003).

However most observers will agree that corporatist structures play an important role in explaining the development and robustness of the particular Danish version of ‘flexicurity’ (Mailand & Due 2003; Jørgensen & Larsen 2003). Furthermore, the above observations also fit well with Peter Katzenstein’s view on small state democratic corporatism in the sense that the Danish version of ‘flexicurity’ allows for flexible adaptation of the level and composition of employment to a changing international environment with ongoing shifts in the demand for goods and services (Katzenstein 1985). In a slightly different context, Auer (2000) has also pointed to the importance of strong corporatist governance as a factor of explanation for the success of a number of small European countries, including Denmark.

With reference to the literature on the Varieties of Capitalism (VOC), Denmark on the other hand provides an interesting case of a variety, which does not fit well with the idea of regimes clustering either around the liberal market economy (LME) or the coordinated market economy (CME) (Hall and Soskice 2001). From the VOC-perspective, Denmark would be seen as having an unstable configuration of institutions and being on the move in the direction of one of the two clusters. However, when looking at the historical background for the Danish model of flexicurity, the main notion is that of a model developed through a long time period and underpinned by stable institutions and class compromises.

Concerning the question of the relation between the longer-term traits of the Danish labour market and the specific developments of the 1990s, it is important to note that neither the flexibility-

security nexus nor a well-performing employment system (indicated by a high employment rate) is something new. To the contrary, and in spite of the difficult years of the first and the second oil crisis, the post-war economic and social history of Denmark must in most respects be seen as a successful transformation from an agrarian to a modern society, which has kept its place in the top league of nations based on most indicators of economic and social performance.

Table 2: An overview of the Danish system of 'flexicurity'

	Basic traits of the Danish system of 'flexicurity'	Specific developments in the 1990s
Political environment	<ul style="list-style-type: none"> • Strong corporatist structures • Implicit social contract concerning balance between security and flexibility 	<ul style="list-style-type: none"> • Broad political support for reforms of labour market policies • Acceptance by social partners of need for wage restraint • New government headed by the Social Democrats
Macroeconomic environment	<ul style="list-style-type: none"> • Changing international economic conditions • Active fiscal policy, but constrained by external balance 	<ul style="list-style-type: none"> • Strong internal demand • Favourable external balance • Lower level of international inflation
Employment situation	<ul style="list-style-type: none"> • High employment rate (around 75 percent) • Shifting levels of open unemployment • Rising share of persons receiving transfer income 	<ul style="list-style-type: none"> • Significant reduction in both open and gross unemployment • Reduction in structural unemployment
Worker mobility (external numerical flexibility)	<ul style="list-style-type: none"> • High by international standards 	<ul style="list-style-type: none"> • High by international standards
Employment protection	<ul style="list-style-type: none"> • Weak 	<ul style="list-style-type: none"> • Weak
Unemployment benefits	<ul style="list-style-type: none"> • Significant increase in compensation rate with reform in the late 1960s • Cash benefits for non-insured unemployed 	<ul style="list-style-type: none"> • Slow decline in compensation rate, but still high by international standards • Reduction in duration, especially for passive benefits
Active labour market policy	<ul style="list-style-type: none"> • High expenditures on LMP in general • Incremental policy adjustments since 1979 	<ul style="list-style-type: none"> • Decentralized • Individualized • Right and duty to early activation

Table 2 aims at summing up the basic traits and the more recent developments of the Danish model of flexicurity. The main points from table 2 is that the combination of high employment rates, weak employment protection and generous economic support for the unemployed has been a characteristic of the Danish employment system since the late 1960s. The added features during the 1990s were firstly a more favourable macro-economic environment, and secondly, a more ambitious labour market policy.

The interesting aspect of the most recent Danish development in the 1990s is therefore that Denmark has been able to keep its position as a successful economy at times, where the Nordic welfare states were criticised for being ill adapted to face the pressures from increased internationalisation. However, the present situation of the Danish employment system is not without strains and tensions. This is the subject of the following section.

11. Tensions in the Danish employment system

As noted in the introduction, the dramatic fall in open unemployment in Denmark since the mid-1990s has attracted the attention of international observers. In many respects, there are real grounds for this admiration. But on the other hand, it may be useful to take a closer look at some of the drawbacks and tensions in the Danish model of flexicurity. Returning to the concept of the golden triangle, a number of problems can be identified in the Danish employment system.

Large groups expelled from the labour market

Firstly, the highly dynamic nature of the labour market, involving a large number of shifts between jobs, also implies a continuous testing of the productivity of employees. One outcome of these ongoing selection processes is that some workers are being gradually expelled from the labour market if they fail to meet the productivity criteria set by employers. The few restrictions placed on employers with regard to lay-offs may of course add to the risk of exclusion from the labour market. There may also be many other, often inter-related, causes of marginalisation, such as health problems, lack of formal or informal skills, age or ethnic background.

Over the 40-year period from 1960 to 1999, the number of full-time persons receiving some form of transfer income increased from about 200,000 persons to over 800,000 persons equivalent to about one quarter of the adults aged 15-66 years. This number does not include persons covered by active labour market measures for the unemployed, who accounted for another 87,000 persons in 1999, or persons above the age of 67 receiving old-age pensions. One price paid for the high level of efficiency of the Danish labour market therefore appears to be that a large number of persons are being gradually excluded from the labour market and placed on transfer income.

However, the growth in the number of persons supported by transfer income has not been at the expense of the share of employed adults. Figure 15 shows the distribution of the adult population (aged 15-65 years) from 1960 to 2002 into the number of persons receiving some form of transfer income, the number of adults supported in the family and the employed (divided into public and private employment). During the last forty years, the share of adult Danes in employment has been around 75 percent. The rise in the share of adults receiving transfer income has therefore solely been reflected in a corresponding decline in the share of adults being supported in the family (mainly as married women).

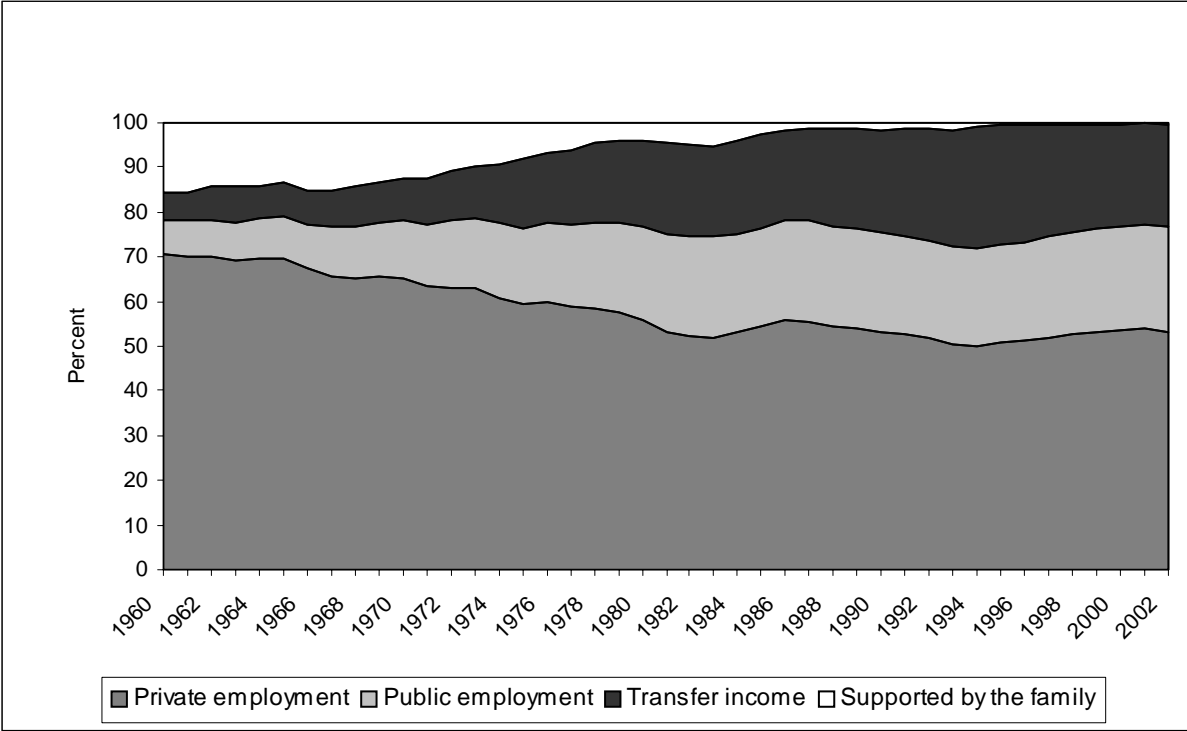


Figure 15: Denmark: Adult population (15-65 years) by source of income, full-time equivalents, 1960-2002. Source: Author's calculations based on ADAM's databank (Statistics Denmark)

Secondly, it should be noted that the high level of the population receiving transfer income is not a purely Danish phenomenon. All four Scandinavian countries experienced the growth in the share of inactive adults receiving transfer income up to the level of about 25 per cent in the late 1990s, indicating that the mechanisms involved cannot be attributed solely to special features of the dynamics of the Danish labour market, but also to more general aspects of the interplay between welfare states of the Scandinavian type, modern labour markets and the business cycle.

Unemployment benefits and poverty traps

Another debate related to the golden triangle has already been foreshadowed. The high replacement rates in the Danish unemployment benefit system increase the risk of financial disincentives, especially for low-income groups (Finansministeriet, 2001). While such effects are

theoretically plausible, they have been hard to verify empirically, at least as being important in their magnitude. Indeed, the general remedy has been to rely on early and intensive activation measures to counter problems related to the potential disincentives of the unemployment benefit system.

Problems of active labour market policy

Turning to the third corner of the golden triangle, some further critical points may be made to supplement the discussion of the micro-effects already touched upon. Thus, Danish labour market policy has been given a more active profile during a period of economic expansion. In the event of a change in the business cycle, the cost of maintaining the level of ambition to activate the unemployed at an early stage would lead to a sharp increase in public expenditure at a time when revenues would be falling due to the economic downturn. The political pressure to cut active programmes could therefore become overwhelming, and would be compounded by Denmark's *de facto* need to comply with EMU budget criteria.

And on the horizon...

Taking a longer-term perspective, a number of further problems may be identified which could increase the forces that are already causing a rise in the number of persons excluded from the Danish labour market. These include:

- The demographic changes over the coming decades, which imply a growth in the number of older workers, with higher risks of marginalisation.
- The rising share of immigrants in the Danish population, with the proportion of persons from non-European countries rising from about 4 per cent today to about 10 per cent in 2020.
- The increasing wage competition from low-wage countries, also within Europe, which will be strengthened in the event of the accession of a number of Eastern European countries to the European Union.

These challenges to the Danish model will place the need to reduce the upward trend in the numbers of persons left outside the golden triangle high on the Danish political agenda in coming years (Nordic Council of Ministers 2000).

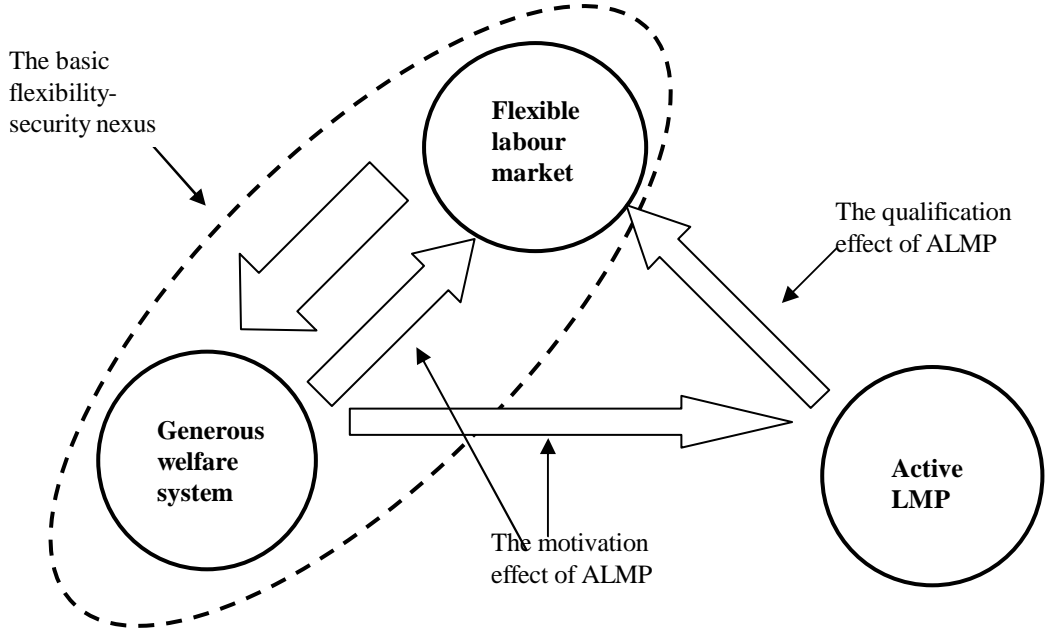
12. Conclusion: The feasibility of 'flexicurity' and the role of ALMP

The analysis of the Danish version of flexicurity can be summarized in three steps. Firstly, one can identify a high level of worker mobility (external numerical flexibility) as a structural characteristic of the Danish labour market. An important explaining factor for this situation is the liberal regime of employment protection found on the Danish labour market. Secondly, the high level of numerical flexibility is made acceptable for the trade unions and more broadly within the framework of the traditional value system of a Scandinavian type welfare state by the development of a state supported unemployment insurance system supplemented by cash benefits for the

uninsured unemployed. These two elements constitute the basic flexibility-security nexus. Thirdly during the 1990s, a more ambitious active labour market policy added stronger both motivation and qualification effects to stimulate the flows of workers between employment and unemployment.

Figure 16 sums up the argument applying a modified version of figure 6. The dotted eclipse indicates the basic flexibility-security nexus combining a high level of numerical external flexibility and a generous system of economic support for the unemployed. In this context the main role of active labour market policy is seen as supporting the flows from unemployment back to employment by creation motivation effects to all the unemployed in the target groups and by upgrading the skills of the unemployed actually taking part in the programmes.

Figure 16: The Danish model of 'flexicurity' revisited



Finally, the positive Danish experience during the 1990s illustrates the importance of the macro-economic environment. Labour market policies cannot generate ordinary jobs by themselves. Sufficient pressure from the demand side is a prerequisite. On the other hand, once the upturn is under way, active labour market policies play an important role in securing the supply of skilled labour and avoiding bottlenecks.

Thus the Danish experience points to the economic feasibility of a 'hybrid employment system' combining on the one hand the traditional virtues of a liberal labour market with few restrictions on the employment contract with - on the other hand - a reasonable level of economic protection

of the individual wage earner. The Danish model therefore fits the picture of a possible ‘trade-off’ between a very flexible employment relation and a social protection system combined with active labour market programmes, which defends the individuals from the potential costs of a low level of employment security. In this respect the model represent a genuine alternative to the common idea of making the firms more responsible for employment by developing a high level of individual employment protection at the company level.

However, one should remember that the Danish model of ‘flexicurity’ itself is the outcome of a long historical process involving a series of negotiations and compromises between the social partners, the evolution of the welfare state and – in recent years - a gradual development of a more active profile of labour market policy. The model is thus a prime example of the specific Danish version of the negotiated economy. Therefore it should be taken as a source of inspiration for new ideas about alternative configurations of flexible labour markets and economic security for the individual – not as a simple scheme, which is ready for immediate export.

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² For a detailed account of the introduction of the three leave schemes, see Compston and Madsen (2001). The schemes have later been integrated into other pieces of legislation (concerning maternity leave and adult education).

³ One should mention that expenses for the Danish Voluntary Early Retirement Pay is included in the figures for Danish passive expenditure and constitutes about 1.7 percent of GDP. However similar schemes or substitutes for them are found in other countries. It has therefore been chosen to present the aggregate figures for public expenditure on labour market programs

⁴ The estimated effects in figure 11 are based on an version of the so-called 'fixed-effect' method, which applies information about the labour market history of each participant to estimate the effects of participation on subsequent employment and unemployment. Each individual is therefore used as his or her own control-group. Space does not allow for a more elaborate presentation of the Danish debate on the relative sizes of the different effects of active programs and of further effects (like dead-weight and substitution effects) to be included in a full-fledged evaluation of active labour market programs.