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## The Danish Model

A European success story

■ The Danish Model is a reference for many other countries regarding the design of welfare policies. The basic characteristics of the Danish Model are:

- A fairly even distribution of qualifications, a high labour market participation by both men and women.
- An extensive redistribution through a progressive taxation system, paying for public services within education, child care, care of the elderly and health care.
- A uniquely small disparity in living standards compared with other countries.
- The rather heavy taxation – especially on private income and consumption – does not harm employment – on the contrary it stimulates competitiveness through investment in education, research and development, good infrastructure, etc. Low corporate taxes and only small mandatory social contributions from the employers.
- A public sector which in international comparison is highly effective and citizen-friendly. Corruption is practically non-existent.

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## 1 The triumphal progress of democracy

First a few facts on recent Danish history, its political structure and the business pattern.

Denmark is a small country with 5.5 million inhabitants and an area of 44,000 square kilometres. Since 1973 Denmark has been a member of what is now the European Union (EU). Denmark had a GDP per capita of 35,800 dollars in 2007. That made it the 11<sup>th</sup> richest country in the world measured in purchasing power parity – i.e. not translated into official rates of exchange, but with respect to how much can be bought with the money in specific countries.

The World Economic Forum's 2008 competitiveness index ranks Denmark in its Top Three worldwide. And the World Transparency Index ranks it as *the* world champion in non-corruption. Furthermore it should be noted that other international comparisons nominate the Danes as the happiest people in the world!

For a long time Danes have had no ambition to dominate other large and small countries. But they do believe that they can contribute good experience and sound ideas on how democracy and social relations can enrich a society.

Democracy came to Denmark at an early stage. Denmark's loss of territory and power – most recently the loss of Schleswig-Holstein to Germany in the 1864 war – made the country a small, homogeneous nation state with a distinct cultural, social and democratic development which explains a lot about the strength of Danish society.

Agriculture, which was long the principal industry in Denmark, was dominated by an independent and confident farming class, which organised a strong cooperative movement and gained political supremacy as of 1901. »Folk high schools« became a stronghold for the development of democratic attitudes and a national feeling founded in Christianity.

Rapid industrialisation towards the end of the 19<sup>th</sup> century increased growth in the cities and created strong trade unions as a counterweight to private capitalist power. From the beginning, the trade union movement and the Social Democrats were linked politically as well as organisationally. In Denmark, as well as in the other Nordic countries, the interaction between unions and the party became the key driving force in the development of a highly vital welfare model. Economic inequalities were evened out through tax-funded services within

education, health care, care of the elderly and children, and through a system of financial benefits in case of unemployment, illness, disability and old age.

Social Democrats originally had public ownership of the means of production on their political agenda. In reality, however, the Danish Model was never about abolishing capitalism but rather humanising it by insisting on a fundamental social structure that could provide more equal rights and strong security for the individual as opposed to the free play of market forces. The Danish Model is not the result of one big master plan. Creating social progress for ordinary people with lower incomes has been a long and gradual process – opposing and striking balances with employers and centre-right political parties.

Crucial for this development was the substantial political influence gained by the Social Democrats in collaboration with the small Social-Liberal Party at an early stage in the 20<sup>th</sup> century, so that it could set the agenda for social reform. Initially most Liberals and Conservatives were against it, but over time they adopted significant parts of it as it turned out to have huge popular appeal.

The Communists played a significant role on the Danish political scene for only a short period after the end of the German Occupation in 1945 – because of their role in the Resistance. But in 1959 a new left wing party – the Socialist People's Party – was established by former communists, breaking with Moscow. That party has established itself as a much stronger factor and one that was to be permanent. Nowadays there are few programmatic differences between Social Democrats and the Socialist People's Party.

Only for a few times and a period that totals three years (1967 and 1971-73) has a »socialist« parliamentary majority existed, which was enjoyed by the Social Democrats and the Socialist People's Party. These majorities did not give rise to any revival of old socialist anthems. However, in 1967 this majority managed to ensure the two most significant sources of income for the welfare society – taxation-at-source (or pay-as-you-earn-tax) and value added tax (VAT).

Between 1924, when the first Social Democratic government came into power, and 1982, the party was only outside the government for 12 years. Since 1982 a Social Democratic government has ruled for only 9 years, from January 1993 to November 2001. Nevertheless, during this time the Danish Model was renewed and the economic progress and rise in

employment experienced by Denmark was – in the European context – exceptionally strong.

## 2 The Danish Model: from crisis and war to the major welfare advances

Naturally, the Danish Model has developed in interaction with the vast changes in economic conditions. The first great challenge – and also the first huge leap forward – was »the Slump« and mass unemployment of the 1930s.

On the very same day that Hitler came to power in Germany in 1933, the Danish Social Democratic Prime Minister Stauning made a huge political settlement with the opposition Liberals. The deal addressed unemployment, consolidated agricultural earnings and laid the groundwork for a social reform that gave social welfare benefits to those in need as a right – not as alms.

During the 1930s Denmark pursued an economic policy involving huge public investments with the aim of creating jobs. This was in good conformity with the ground-breaking ideas of the great British economist Keynes, who said that the state must make capital injections and create employment during times of crisis. Although it is uncertain whether the decision-makers of the time actually knew of Keynes' theory, they took the right action nevertheless.

After the liberation in 1945, politicians decided to continue the work that had been interrupted by World War II. Society took a more active part in ensuring the return to full employment. People in Denmark were – along with everyone else in the Western world – experiencing how dramatic technological developments and the opening of the markets to the outside world resulted in huge changes in job opportunities and demanded new and different skills. From the 1950s the standard of living exploded. Family patterns underwent a revolution that Danes have still not seen the end of. But the fact is that Danes now live and work under totally different circumstances than they did a few decades ago.

Huge changes have happened at a record pace during the past 60 years. These economic and social changes have been generated in particular by two unique revolutions: very extensive migration from rural areas to urban areas and the entrance of women into the organised labour market.

In 1950, 545,000 people were earning a living from farming in Denmark. In 2008 this figure was

83,000. This development resulted in depopulation in the rural areas and huge investments in housing and infrastructure in the big cities. The few remaining people in the agricultural sector produce 14 times as much as in 1950. And then there were six times as many of them!

In 1950, 33% of the workforce was female. In 2008 it was 48%. The employment rate in 2008 was 80% for men and 74% for women. Just a few generations ago, the role of most married women was to take care of their children, the elderly and the sick within the family. Not particularly visibly. And without pay. Now the women of the new generations – also women with young children – are just as much a part of the labour market as their husbands.

But where did they go – all the people migrating from agriculture and from looking after their homes? In rough numbers, the changes are as follows: The agricultural sector has lost a workforce of 460,000 and the industrial sector has lost 170,000. The construction and civil engineering sector has grown by 60,000, the public service sector by 635,000 (!), and the private service sector by 655,000 employees since 1950.

From 1950-2008, Denmark's gross domestic product in real terms increased by 276%. It is difficult to quantify the specific factors, which caused this development. But let me stress a few points:

1. A solid general level of education with high-quality primary and lower secondary schooling which emphasised interaction with other people – development of social skills and development of the ability to improvise. Furthermore there are strong traditions in vocational training. Finally – as in other European countries – the proportion of each generation attaining higher education has increased dramatically: From 25% in 1980 to 47% in 2006!
2. Many small, adaptable, individually-owned companies account for the bulk of private employment. However, there is one single international giant – *A. P. Møller/Mærsk* – within shipping and oil and gas extraction, to mention but a few areas, which represents a substantial and increasing proportion of value creation and foreign exchange earnings in Denmark.
3. A very liberal industrial policy, where government has not come to the rescue of companies in trouble. Denmark does not have large, inflexible subsidy-requiring companies within mining and heavy industry. On the other hand, the public authorities have traditionally owned or con-

trolled fields such as telecommunications, electricity, water supply and public transport. Technological development, the demand for a competitive market and more rigorous EU competition requirements have led to the opening up of public transport for private competition – and the direct sale of the publicly owned shares in telecommunications. These are the most important examples in some of the traditionally owned public areas. The current philosophy is that protecting consumers from exploitation by private monopolies is handled better by increased cross-border competition and more effective national and European regulations than through public ownership.

4. The economic policy pursued has supported growth and changes in the private sector. Beginning from the 1950s tax legislation giving the companies very generous depreciation possibilities on all kinds of machinery made a crucial contribution to the renewal of the Danish industrial sector.

Furthermore, prioritisation of good service for all citizens, for instance within health care, has at an early stage created a domestic market which offered Danish industry the possibility of becoming market leader in valuable niches on the global market. This accounts for *NOVO*'s leading role when it comes to insulin and similar global positions for other Danish medical products. It is no coincidence that the late Chinese leader Deng Xiaoping had a highly sophisticated Danish hearing aid from *Oticon*. Or that another Danish company, *Danavox*, is mass producing a robust and inexpensive hearing aid for less-privileged consumers in China and other parts of the world.

Particularly in the 1990s, demand for a more environmentally sustainable energy supply resulted in the state sponsoring the development of windmill technology through preferential taxation and research and development funding. This laid the groundwork for a highly significant export success and positive contributions to employment – not least for unskilled workers in peripheral areas of Denmark with low employment. *Vestas* is the largest and increasingly international producer of windmills.

There certainly exists a much greater potential for interaction of this kind between public demand and funding for environmental or socially desirable development on the one hand and private industrial initiatives on the other. For

instance there should be strong focus on other types of renewable energy that contribute to reducing carbon emissions – aiming at ambitious, but necessary, climate goals.

5. As a small country with very extensive international trade, by the end of the 1950s Denmark was already a leader in lifting import restrictions and dealing with external competition. As a result major changes were required, but new export opportunities arose as well.

Entire industrial sectors disappeared at an early stage when Denmark pointed the way to the elimination of import restrictions – e.g. the conventional production of textiles and clothing.

6. Subsequently, efforts to encourage new forms of production which could enable decent salaries to be paid were initiated at an early stage. The union movement was a highly active participant in this and placed great emphasis on training in new technology and agreements on new incentive pay schemes. Rather high minimum wages in the collective agreements also played a significant part in the acceleration of the phased elimination of low-wage trades in Denmark. It was a deliberate tactic. And the development confirmed that supplementary training and education of the workforce and investments in production facilities could create very high employment regardless of the comparatively high minimum wages.

In other words, the relatively narrow wage differentials in Denmark are the result of collective bargaining supported and supplemented by a significant effort in the educational field resulting in a declining number of unskilled workers and a rise in the number of well-trained semi-skilled workers. The distribution of competencies is simply smaller in Denmark than in most other countries.

7. The agreements on terms of employment combined with the structure of the unemployment insurance system – the so-called flexicurity-model – have supported developments towards more and better paid jobs on the Danish labour market:

It has been part of the unwritten social agreement that the trade union movement would not insist on long periods of notice for workers. It has therefore been much easier for employers to hire and fire in line with fluctuating market conditions compared to employers in Germany and France – or even in neighbouring Sweden. When employers know that it is possi-

ble to get rid of manpower when market conditions change, they will not hesitate to hire new people during an upswing. For instance, Denmark has experienced faster and healthier progress than most European countries in private employment for almost 15 years since 1994.

However, another aspect of the social agreement is the unemployment insurance system, where the lowest paid workers from the first day of unemployment and for several years ahead are entitled to benefits equal to 90% of their current wage. There is a maximum amount – to the effect that coverage is significantly lower for the higher paid workers – for instance skilled metalworkers receive only around 60% of their usual net income in unemployment benefit.

The ideology behind the generous entitlement to benefits for low paid workers is that no one should be forced to give up their home because of unemployment. In turn, in order to be entitled to unemployment benefit, the claimant is required to be fully available for the labour market.

However, it is crucial to such an efficient system that labour market policies and economic policies in general are arranged in such a way that everyone who is affected by unemployment quickly moves on and receives supplementary skills, job training or a new job. This was not an option in the early 1990s, when the unemployment rate reached 12%. Thus, the main purpose of the intensification of the active labour market policy under the Social Democratic government in the 1990s was to offer terms that were so good that no unemployed people could turn them down, to enforce the availability requirement and to upgrade the qualifications of all the unemployed in order to gear them for new job opportunities.

The benefit rate is the same for unemployment insurance as for illness – and for maternity leave, which at present is up to one year long. The benefits during illness and maternity leave are obtained after a very short period of active employment, while entitlement to unemployment benefit requires 12 months of prior employment and 12 months membership of an unemployment insurance fund. If the requirements for unemployment insurance are not fulfilled, the applicant is only – and then only perhaps – entitled to a lower amount of cash according to the provisions on social welfare. This allowance depends on the situation of the household: the

income of any spouse and almost all net assets will reduce the cash benefit amount.

The Danish benefits system is funded as follows:

- the total benefit cost for illness and maternity leave as well as cash benefits and most of the cost for unemployment benefits is funded by means of ordinary tax (income tax, value added tax, etc.),
  - employees fund a small proportion of these costs through membership fees,
  - employers do not contribute to the financing of the unemployment insurance system.
8. Furthermore, Danish corporate tax is relatively low and the possibilities of depreciation deductions etc. are favourable. Recently the corporate tax rate has been reduced to 25%. Also from this point of view, it is attractive to run a business in Denmark. Moreover, there are practically no statutory employers' or company contributions to social insurance (nor to social pensions or voluntary early retirement pension schemes).

A predominant share of government expenditure on welfare is funded through taxes which are paid by the entire population according to income or consumption, and all groups are guaranteed almost all social rights. That is why both personal income tax and value added tax are high as is expenditure tax on cars, energy, beer, wine, alcohol, tobacco, etc.

There is a significant difference in the total level of taxation between Denmark and Germany – due partly to the extensive public financing of care for children and elderly people in Denmark. There is an even greater difference between Denmark on the one hand and Germany and France on the other concerning the tax *structure*: In Denmark personal income tax is high and contributions from employers low. In Germany and France large mandatory contributions for social costs are paid by the employers in addition to wages. Thus there has been room for larger wage increases in Denmark. But the state has taken back a much larger share of the wages in the form of direct income tax. The end result for the individual – the amount left for private consumption – is not particularly different in the three countries.

One of the fundamental differences is that the Danish system leaves the lowest paid workers with more money and the highest paid workers with a little less than in most other countries. However, the effective progressivity of

Danish income taxation is counterbalanced as the largest amount of the tax-free capital gains on residential property go to the highest income earners and they also get the largest share in tax-privileged pension schemes. But even so disposable incomes are distributed more evenly in Denmark than in most other countries in the world:

The needs of the citizens are not only higher material standards in their daily life – such as better clothes and food, a decent place to live, modern appliances, IT, holidays and experiences. The demands of citizens are just as much concerned with resources and quality when it comes to their children's schools and education, child-care provision, care for the elderly and health care.

When the funding for schools, education, care for the elderly, health care and the bulk of child care comes from taxes instead of individual payments, the distribution of disposable incomes will be more equal.

The most significant features of the Danish model are exactly this:

- Education is free. Even 85% of the costs of private schools are funded by the public authorities – offering an alternative choice to the public primary and lower secondary school. Vocational and higher education is free. Add to this the fact that Denmark has the most generous grant scheme for students – e.g. with no obligation to pay back. And by statute and agreement there are plenty of options of free supplementary training.
- For local child care – day nurseries, kindergartens and after-school care facilities – the share of the expenses paid by parents is typically less than a third of the total expenditure: families with more than one child and low-paid workers even less. Three-quarters of the total cost is tax funded. Financially, this has facilitated the entry of women into the labour market, which explains why 96% of children between 2 and 5 years are in some form of child care arrangement.
- Elderly citizens who have difficulty managing daily chores receive domestic assistance free of charge after an inspection by local authorities. Large grants reduce the rent on homes for the elderly who are not capable of taking care of themselves.

- Visits to doctors are free of charge, as is hospital care.

Few European countries have a matching welfare model. And in comparison with the USA, the differences are dramatic – not least regarding inequalities in income distribution. The reason is obvious: while citizens in Denmark with a low income only pay for welfare relative to income and spending, the situation is totally different in the USA. Wealthy Americans pay very little tax – even less now than they did before George W. Bush became president. In return, families have to save a fortune in order to get their children into good universities or pay for decent care for elderly family members. The family budget has to cover the full price for nurseries and private health insurance is necessary to receive proper medical treatment. User charges and private insurance, where premiums are paid according to the risk of illness or unemployment, are a much heavier burden on a tight family budget than on a large family one.

Professors John L. Campbell and Ove K. Pedersen from the Copenhagen Business School have analysed the differences between Denmark and the USA as follows: Real income per inhabitant, productivity, unemployment and inflation rate have roughly been at the same level since the second half of the 1990s. Denmark has had a large budget surplus and is bringing down debt, while the USA has developed a new large budget deficit and large indebtedness since the presidential change in 2001.

The UN's Human Development Index 2002 ranks Denmark and the USA on line – in the top group of the world. But the inequalities in the distribution of income are much larger in the USA than in Denmark: The Gini coefficient, which shows how large a part of the total income must be redistributed in order to obtain an even distribution of income, was 25% in Denmark and 40% in the USA in the middle of the 1990s. The share of the population with an income less than half of the median income is 9% in Denmark, whereas it is 21% in the USA (the median income is the income where half of the population is above and the other half is under). In the mid-nineties the share of the population between 16 and 65 years being functionally illiterate was 10% in Denmark and 21% in the USA. Taxes and social expenses constitute twice as big a share of the gross national product in Denmark as in the USA.



9. Through the past 40 years, most women have wanted to enter the labour market. And it is in fact the case that women participate in the labour market almost as extensively as men do. However, women still work part-time to a somewhat greater extent than men, women are still undertaking more domestic duties as regards children and they do not get as far in their careers as men. But the high female participation is both the reason for and the effect of the gigantic expansion of the role of the welfare society in child care, elderly care and health care. And while women used to be responsible for this care within the confines of the family, it is now mainly women who perform these tasks outside the family in day nurseries, hospitals, nursing homes, etc. – and at the same time are paid for their work

### 3 The interaction between the trade unions and the political system

As previously mentioned, the characteristic social structures created in Denmark in the 20<sup>th</sup> century are to a high degree the result of the strong organisation, mutual relationship and great political influence of the trade union movement and the Social Democrats.

There has been an efficient, but also highly pragmatic distribution of work between the trade unions and the political labour movement. The trade union movement was acknowledged as a negotiating party with the employers more than 100 years ago, and upon recommendation from both sides a no-strike agreement was concluded when collective agreements applied. That is why Denmark has rarely experienced »wildcat« strikes in periods covered by collective agreements. And almost all collective agreements have been renewed without conflict.

The trade union movement made real progress in securing better pay and improved working conditions in negotiations with the employers. But where collective agreements were unable to provide adequate possibilities, the political allies of the trade union movement took over. For instance, at an early stage legislation was passed in order to ensure a better working environment. The trade unions' own unemployment and health insurance system was replaced by legislation on systems to ensure risk sharing across job demarcations, so that insurance premiums are no higher for people employed in the most risky trades.

In a number of situations legislation was enacted in a way that enhanced improvements initially agreed upon in collective agreements so that all employees would benefit regardless of whether they were members of strong or weak unions or not unionised at all.

However, a distinctive feature of the Danish labour market has been the absence of important competing unions inside the same trades, and the extremely high density of union membership – only marginally exceeded by Sweden.

The long existing linkage between trade union membership and unemployment insurance has been a significant contributory factor to the high density of union membership. Most unemployment insurance is still politically and administratively linked to the trade unions and most wage earners still consider trade union membership and insurance as two sides of the same coin. But since the centre-right government came into power in 2001 it has deliberately weakened cohesion between trade unions and unemployment insurance via legislation and thus contributed to a decrease in trade union membership and in the share of the labour force covered by unemployment insurance.

The blue collar worker groups are in general all unionised in LO – the Danish Confederation of Trade Unions, which is the trade union movement that has historically been linked to the Social Democrats. Over the past 50 years two other strong confederations have gained strength – FTF (the Joint Council for Salaried Employees and Public Servants), which unites large groups of employees from the public service sector such as teachers, nurses, kindergarten employees and social educators as well as employees from the financial community, and AC (the Danish Confederation of Professional Associations), which unites academics from the public and the private sectors. As a main rule, clear demarcation lines exist for membership of the different unions and of the confederations. The confederations cooperate in negotiations with employers. They participate in a large number of public boards, councils and commissions alongside employer organisations, business organisations and public authorities and thus have influence on proposals for new employment legislation, etc.

It should be noted that on several occasions – not least from the 1960s to the 1980s – the trade union movement agreed on a number of so-called »income policy« packages. This can be described simply by saying that the unions accepted lower pay increases than market conditions could provide in

return for legislation on social improvements and economic policies that could stimulate employment. Naturally, such agreements were based on the strength and capacity of trade unions to deliver the agreed slow-down of wage levels *and* the government's ability to fulfil *its* promises in its economic policy.

From the end of the 1980s a new facet was added to the Danish Model. Until then the vast majority of blue collar workers' retirement provisions were mainly based on the relatively low tax-paid old-age pension scheme, which gives every citizen the same basic pension. On the other hand, the large and growing groups of public servants and salaried employees had collectively agreed and financed supplementary pension schemes to which employers and employees together contributed 10-15% of the payroll. It became clear to LO that this situation was unsustainable in the long run. A working class family in which both spouses had been in the labour market had no possibilities of maintaining their living standard during retirement without a supplementary pension scheme established through collective agreements. During the past 15-20 years, LO-leaders have succeeded in persuading their members to demand better pension schemes rather than the customary pay increases. Now it is normal for 10% of a typical worker's salary to be allocated to supplementary occupational retirement pension contributions.

The formation of the occupational pension scheme for blue collar workers has had a significant positive impact on the national economy. Savings have accumulated, and – along with very significant increases in earnings from oil and gas extraction activities in the North Sea – this contributed to a reversal from a chronic deficit in the balance of payments up to the 1980s to a very significant surplus from the 1990s onwards.

At the same time the low rise in the wages and salaries paid has helped to relieve government finances, because the statutory mechanism for regulating income transfer to parallel the development in the wages *paid* to the employed excludes compensation for the proportion set aside for labour market pension schemes. And in fact the level of the income transferred in the form of old-age pensions, unemployment and illness benefits etc. has risen somewhat more slowly than wage levels.

In the long term, government finances will benefit even more from the boom in pension savings as a significant proportion of the old-age pension scheme is only paid out to citizens with a very small

supplementary pension. And in future, the number of such citizens will decrease.

A growing share of pensions overall is now based on saving, and Denmark is not remotely experiencing the problems of financing its pension system which a large number of other western countries will in a few years. However, these countries face the same challenge, more or less.

Over the past decades, fortunately, average life expectancy has risen significantly. And there is reason to believe that this development will continue, supported by the fact that most elderly people are now healthier and more fit for work at an advanced age than in the past. At the same time, Denmark has developed retirement schemes in such a way that more people are entitled to and have the financial possibility of earlier retirement. Somewhat simplified, the picture in Denmark is this: in 1970 Danes typically retired at the age of 67 and lived to be 73. In 2006 they typically retire at the age of 62 and live to be 78.

The lowering of the retirement age is strongly linked with the formation of what was known as the early retirement benefit scheme in 1978. In simple terms, this enabled individuals that had had lifelong membership of the unemployment insurance system to stop being available for the labour market from the age of 60 and still receive an allowance corresponding to unemployment benefit until they retired on an old-age pension at the age of 67. The added expense was completely funded by regular taxes because the introduction of this new entitlement was not accompanied by an increase in membership fees.

In the original draft legislation on early retirement benefits, it was estimated that 35,000 people would gradually make use of the offer, most of them those who had been doing hard physical labour for 40-45 years. However, it turned out quite differently. In the late 1990s 180,000 persons took advantage of the early retirement benefit scheme, and even though the group of unskilled workers is larger than other groups, large groups with good pension schemes were using the early retirement benefit scheme as supplementary means of paying for early retirement. In 1998, this caused a majority of the Danish Parliament to adopt an adjustment of the scheme in order to limit government expenditure and the reduction of the workforce. All other things being equal, the workforce will decrease in the coming years as the baby boomers of the 1940s retire and the children of the small families of the 1980s enter the labour market.

The 1998 revision had four main points: a separate fee was imposed on those who wanted to subscribe to the early retirement benefit scheme – but only a fraction of the real expense of the scheme. If a person chooses to accept early retirement benefits before turning 62, the allowance will be reduced relative to other pension rights. If a person refrains completely from using the scheme, a substantial bonus is awarded at the age of 65. The retirement age in the old age pension scheme was lowered from 67 years to 65 years. This means that now there are 3 years instead of 7 years with early retirement benefits without deduction for other pension rights. The change must be seen in the context in which the rate of early retirement benefits rate is higher than the rate for old-age pensions and the fact that the vast majority retired *before* the official retirement age in the old-age pension system.

Any amendments of access to retirement is naturally highly politically sensitive. Furious reactions from, among many others, the trade unions contributed to the weakening of electoral support for the Social Democratic government. These reactions may have been the result of surprise and anger caused in particular by a number of previous denials by the prime minister of any plans to change the early retirement scheme.

In spite of the reactions to the 1998 reform further changes in the retirement schemes were actually decided upon already in 2006 in an agreement between the centre-right government and the social democratic opposition. Most importantly, the age at which one is allowed to join the early retirement scheme as well as receive an old-age pension will rise in step with the increase in average living age of the Danes – but not before 2019.

#### **4 After the oil crisis: Unemployment and devaluation strategies**

A short backward glance at the economic policy of the past decades might show which experiences were gained and which errors were – or were not – corrected regarding the Danish Model under the fluctuating economic and political conditions.

After years of steady growth, in 1973 Denmark, like the rest of the world, was affected by increasing unemployment as a consequence of the first oil crisis. During the initial years there was a great deal of uncertainty on how to react, and Denmark experienced the unpleasant combination of inflation

and stagnation – with a very high interest rate which only worsened the situation by killing off investments.

In Denmark these problems were exacerbated by the fact that the collective agreements had an automatic »cost-of-living adjustment«, which meant that large wage increases followed in the aftermath of increasing oil prices. In order to stem the ensuing erosion of competitiveness, the Danish government devalued the currency relative to its most important trading partners in the 1970s and early 1980s.

In any case, these devaluations briefly reinstated the competitiveness of the Danish economy. In 1979, the largest pre-emptive devaluation combined with a freeze of part of the agreed cost-of-living adjustment was implemented.

The problems associated with this policy were that the international markets would expect Denmark to repeat the devaluations at short intervals. As a result interest rates rose dramatically. And the employment rate declined even further when the second oil crisis erupted in 1980.

These problems wore out the Social Democratic minority government of the day. It was unable to get support to pursue an adequately coherent policy to stimulate employment and the government finances accumulated an immensely large deficit.

#### **5 1982-1993: From active reform course to another high unemployment rate**

This was the situation when a centre-right minority government came into power in the autumn of 1982 under the leadership of the Conservative Poul Schlüter. Schlüter succeeded in remaining at the helm for more than 10 years under changing centre-right coalitions.

Initially, the centre-right government was very proactive and managed to lay down lines which have lasted under changing governments ever since and furthermore have contributed to stability and the competitiveness of the Danish economy. The necessary switch from devaluation to a fixed rate policy was implemented in a credible manner and with full support from the Social Democratic opposition. Ever since then the Danish currency has been glued to a fixed exchange rate, initially with the German mark and later the Euro.

The adoption of the fixed rate policy was accompanied by an equally necessary final liquidation of the automatic cost-of-living adjustment of wage

levels. When the fixed rate policy had gained credibility and wage inflation was under control, an improved investment climate arose, due to a significant drop in the interest rate. This and a tentative international recovery rectified employment figures nicely from 1983-87.

The government also managed to stabilise its finances by means of a transitional determination of unemployment and sickness benefits and other income transfers in nominal terms – thus cancelling the automatic compensation for inflation.

Finally, the government managed to collect large amounts of money by reducing subsidies to local governments who then had to raise taxes.

But the most significant and permanent contribution to the stabilisation of government finances was the implementation of taxation of the current interest income and capital gains from pension funds and insurance companies which had up to then added a very high interest rate to the citizens' pension receivables. The Social Democratic government had unsuccessfully tried to find support from the centre-right to implement this taxation of the increase in value. Now it was proposed by a centre-right government and implemented with the support of the Social Democratic opposition!

The centre-right government in the 1980s was unable at the same time to exert control over the three deficits which had become chronic in the Danish economy since 1973: the job deficit, the budget deficit and the balance-of-payments deficit.

Up to 1987 the first two deficits were successfully reduced. A lot of new jobs were created which automatically contributed to stabilisation of the government budget. However, concurrently a substantial growth in consumer spending obstructed an early-stage export growth. In consequence, the balance of payments was dangerously weakened. As a result, from the summer of 1985 an agreement between the centre-right government and the Social Democrats and Social Liberals on a reform of the income tax rules took shape. First and foremost, this reform meant a very significant reduction in the deductible value of interest payments on residential property, which had hitherto benefited those with high incomes.

Up to then, people with high incomes had been able to offset 73% of their interest payments against taxes while inflation compensated for more than the rest. In other words, the section of the population best able to accumulate savings were being rewarded for having incurred debt. This was instrumental in increasing property prices during the

boom of the 1960s and the 1970s and once again during the economic upturn after 1983. The consequence was a growth in redistribution that benefited house owners who had been in the market for a long time and especially those with the most expensive houses. It facilitated taking up new loans on increasing property values. This was a recipe for an explosion in private consumption and a strain on the already chronic deficit in the balance of payments.

However, the fear of tax interventions among house owners made the subject political dynamite, which is why no changes were introduced before 1987. And then they had huge impact, mostly because the government – while it was panic-stricken over the balance of payments – did not wait to see what effect the intervention would have on the behaviour of the citizens. A supplementary intervention against consumer borrowing in the form of austerity measures (the so-called »kartoffelkur«) was introduced at the same time as the tax reform.

The result was a complete standstill in the real estate market during the years up to 1990 including a huge decline in prices, many compulsory sales and a drastic slowdown in private consumption. The balance of payments was stabilised. But the slowdown contributed strongly to yet another increase in unemployment and – in connection with that – a dramatic weakening of government finances.

In 1987, Denmark's international competitiveness again came under threat because of the accelerating wage increase. Nobody wanted to ruin the credibility of the fixed rate policy by adjusting competitiveness through a return to the pre-1983 policy. The solution was for the centre-right government in cooperation with the trade union movement and the Social Democrats to implement an abolition of basically all specific employer's contributions to social schemes, financing the reduction by a 2% increase in value added tax (a very similar proposal was implemented in Germany by the CDU/SPD-coalition government after the 2005 elections).

The improvement in competitiveness that resulted from this readjustment lasted in the years that followed. This was only partly due to the beginning of a rise in the unemployment rate so that market pressure on pay rates therefore decreased. In the long run it was of great importance that the trade union movement and the employers in cooperation with the centre-right government and the Social Democrats drafted a »social agreement« in

order to avoid pay increases of such a magnitude that Danish competitiveness would once again be weakened.

As mentioned earlier, at this time the trade union movement was in the process of developing occupational pensions in order to ensure that a significant part of the moderate wage increases went to savings and not consumer spending.

In the last years of the centre-right government's term in office in the early 1990s, it remained completely passive in relation to the soaring unemployment rate, frequently declaring that an external upturn was on its way: thus the Social Democrats and the trade union movement felt that the government was failing to stick to the renewed social agreement in not stimulating employment. The increase in unemployment became a vicious, self-perpetuating process and reached an all-time peak of 350,000 persons before the curve reversed in the summer of 1994.

## 6 The renewal of the Danish Model 1993-2001

The new Social Democratic government came into power in January 1993 and one crucial factor in this success was its promise to reverse this development quickly through national Danish political action.

The approach was as follows. The employment situation in 1993 dramatically emphasised that it was both necessary and possible to boost employment intensively in order to stimulate production and create more value and more equality – acknowledging that a high unemployment rate is the worst source of polarisation in society.

But the Social Democrats realised that it was just as necessary – and indeed much more difficult from a political point of view – to ensure that the economic stimulus would only be temporary. Economic policy would have to be tightened further when private demand started to increase.

In other words, the Social Democrats wanted to prove that precise cyclical management was possible. The centre-right government's argument for doing nothing to relieve unemployment was that it was impossible to control cyclical fluctuations and that they would adjust automatically with time!

The Social Democrats think, on the contrary, that this blind faith in market forces gives rise to unreasonably large losses, for individual citizens as well as for society as a whole. Unfortunately, unemployment goes up very quickly in times of crisis,

but it takes a great deal more and much longer to reverse the situation. That is why it is so important for governments to intervene vigorously to fight increasing unemployment. In the longer perspective it is much less costly than to wait and see.

It seems that the dispute about how to react to the global financial crisis is repeating itself in 2009. It is the opinion of Social Democrats that it *is* possible to a large extent to control cyclical movements but the timing must be extremely precise – and the political system must be capable of reacting swiftly enough to cyclical fluctuations. The main reasons why others attempting to lead a business cycle policy have failed have always been rooted in incomplete analyses of the problems and bad timing – or inadequate political action.

Social Democrats believe – and with pride – that they made the correct analysis, got the timing right all the way from 1993 to 2001 and were lucky to have the courage as well as the political opportunities to translate their intentions into practical political action.

But the aim of the Social Democrats was not merely to manage cyclical fluctuations. Just as important was the combination of macroeconomic policy with fundamental structural reforms of the labour market and the tax system so that a steady increase in the employment rate would not be curbed by bottleneck problems and new inflationary pressure. The policy implemented in 1993-2001 can be summed up as follows:

1. A labour market reform which was to restore rights and obligations for the unemployed. Large-scale investments in education and job training, but also the introduction of stricter rules – laying down that the unemployed should be fully available for the labour market. The period of entitlement to unemployment benefits was shortened, but not the size of the benefits apart from for one group: young people under 25 years with neither education nor training who were and who had been long-term unemployed were moved into a lower benefit category. However, these lower benefits were combined with the provision of proper training services. In the beginning, financially favourable terms were offered for leave for training or education and childcare but in step with the improvement in employment figures these terms were tightened by targeting leave for training or education. A temporary extension was also made of the possibilities of withdrawal from the labour market for long-term unemployed per-

- sons in their 50's but this was then withdrawn when employment opportunities improved significantly a few years later. In the autumn of 1998 – as already mentioned – changes were negotiated to the early retirement benefit scheme for people over the age of 60, in order to encourage later withdrawal from the labour market. It was a natural continuation of other attempts to expand the workforce in line with the increasing employment opportunities. This process provoked – unlike previous reforms – fierce criticism of the government and crippled it considerably in its further reform work.
2. A credit reform aimed at the residential property market which made it possible for home-owners to convert old burdensome high-interest loans into ones with lower interest and longer amortisation periods. This was decisive in order to hold up compulsory sales and stimulate the real estate market. For a short period this effort was further strengthened through a subsidy scheme for the repair and maintenance of private homes.
  3. A tax reform which started out with a net effect that was supposed to stimulate the economy became in the course of a few years a mere structural change with reduced income tax rates, a limitation of deductible allowances and the introduction of extra »green« taxes on energy and water consumption, which apart from the fiscal contribution were also meant to – and did – restrain consumption of scarce resources. The total tax collection was not meant to decline except during a short period of initial stimulus. But the collection of taxes following the reforms was carried out in a way that further encouraged increases in earned income and savings and discouraged too much environmentally unsustainable consumption. When Denmark faced great export prospects in 1998, which were, however, threatened by a heavily debt-funded growth in consumer spending, further changes in tax legislation were introduced in the form of new austerity measures – the so-called »Pinsepakke« – (meaning »Whitsun-package« as it was introduced around Whitsun). These involved a moderate increase in the taxation of property values and a further limitation of the value of interest payment deductibles. The purpose – and the effect – of the package was to weaken the dramatic growth rate in property prices and thereby limit debt-funded consumption as well. The restraints did not give rise to a permanent tax increase but formed the basis for income tax relief for people on low incomes. In 1993 the total tax burden was 48% of the gross national product and in 2001 – even before the last stage of »Pinsepakken's« tax reliefs had taken effect it was 48.6%.
  4. An active industrial, environmental and energy policy which developed – with help from the new indirect taxes and direct subsidies – renewable energy and in general a more sustainable production structure. Another experiment initiated involved offering subsidies for cleaning services in private homes.
  5. Public infrastructure investments were moved forward in order to contribute to improved competitive power (traffic, IT, etc.). The large combined bridge and tunnels between the Danish main islands and between Denmark and Sweden were completed during this period, and an entire new metro was built in Copenhagen.
  6. Acceptance of a somewhat higher rate of increase in public service expenditure – not least within training, education and research, child care, the health care sector and care of the elderly. Within training, education and research the investment was absolutely necessary in order to ensure future competitiveness. And the establishment of 200,000 extra places in kindergartens and nurseries within local authority child care was, for instance, a necessary response to the fact that even more parents with young children were working outside the home.
- The figures show that the political goals have been reached and even surpassed. The Social Democrats inherited an unemployment rate of 12% and reduced it to 5%. When the government had to step down after nine years, the unemployment figures had dropped from a peak number of 358,000 to 142,000 and jobs for 200,000 Danes had been created. Two-thirds of these new jobs were in private companies.
- The employment boost was much greater than in most other European countries. But the figures also comprise a dramatic renewal process as every year in the second half of the 1990's, 200,000 old jobs disappeared and 230,000 new jobs were created – and this in an employment market with a work force of only around 2,6 million employees! And many of the new jobs had better prospects, improved technology and a higher knowledge input than the disappearing jobs. The numbers give hope that European countries with the ability and will to implement structural changes on the employment market may come out as net winners as regards full

employment in spite of the fact that the global division of labour is changing dramatically and traditional jobs in this part of the world are being moved to China, South-East Asia, India, etc.

There is a very important observation to be made here: In January 1993, the best minds of the Ministry of Finance were of the opinion that Danish »structural unemployment« was 9%. This meant that you could not get below this level without causing the economy to break down due to the lack of qualified labour. With a strong focus on skill development and supplementary training – perhaps the single most important element of the new policy – the Social Democrats actually succeeded in bringing down structural unemployment to the same rate as the unemployment figures in the years up to 2001.

Improved employment figures improve equality and harmony in a society. And thus the Social Democratic government continued its improvement of the collective, tax-financed goods, and attempted to protect the tax system against tax evasion through loopholes and fraud. But the new boom in property prices and the major rise in share prices as an isolated factor pointed towards greater inequalities.

In the summer of 1998, Denmark found itself in an unusual situation with the members of LO rejecting a proposal for new collective agreements which union officials had negotiated and recommended. Therefore the government was forced to give legal backing to the rejected collective agreement proposals with the inclusion of a few changes. Public understanding of economic policy and the social agreement, which LO had been party to since 1987, was diminishing.

The fierce and partisan criticism by the opposition of »Pinsepakken« in 1998 – appealing especially to the self-interests of the home-owners – contributed to weakening support for the government. And the settlement on the early retirement benefit scheme that same autumn only made matters worse.

The criticism of the so-called »liberal« immigration laws – particularly organised family reunification from a number of Muslim countries (Turkey, Pakistan, Arab states) – and concern over the poor integration of immigrants from these countries became a decisive point of attack against the government.

Thus the scene was set for an election defeat for a government which had brought about the longest uninterrupted period of economic growth in Denmark since World War II.

## 7 Many people on transferred income

The decline in the unemployment figures was followed by a slightly smaller decline in the number of citizens receiving transferred income from the public authorities.

The very large number of citizens receiving transferred incomes often gives rise to misinterpretations of Danish reality in the Danish debate and in the eyes of other countries. The fact is that in all societies a large proportion of the population will be temporarily or permanently incapable of participating in the labour market. This proportion is no larger in Denmark than in other wealthy countries, but the Danish social system has changed during the last 40 years, meaning that these people are now supported by the public authorities instead of their families.

On average 8 out of 10 Danes between from the age of 18 to 62 are either working or studying. That is practically a world record. Therefore Denmark does not have several hundred thousand citizens who may eventually become part of the employment market if some new and different policy is introduced. There will always be some people on leave due to maternity or illness and in these cases favourable rules will apply. Some people will be temporarily between jobs without posing any real social problem. But they will be included in the statistics as unemployment benefits are payable from day one of unemployment. Many people are granted social retirement benefit because of physical or mental disorders. And of course many people have chosen early retirement as the early retirement benefit scheme has been so attractive.

A long-term change with follow-up action on long-term illness, better rehabilitation, a more successful senior employees' policy and the decided long-term increase in retirement age will some day contribute to a better and longer working life for more people.

It is a special challenge to improve the integration of immigrants. From 1993 to 2008, the proportion of immigrants and their descendants from non-Western countries rose from 2.8 to 6.4 per cent of the population, especially due to the inflow of refugees, family reunifications and a high birth rate within immigrant families. Where the employment rate for the Danish population is 79%, it is 59% for immigrants from non-western countries and 68% for their descendants.

With increasing employment, a growing proportion of the shrinking number of the unemployed

originate from outside Denmark. Many within this group lack adequate language skills and other qualifications. But many who have actually mastered the language and have the appropriate qualifications often encounter unjustifiable mistrust. The climate on the labour market is not totally unaffected by the frequently acerbic political discussions of problems linked to small groups of immigrants.

But the fundamental fact is that the active labour market policy has been crucial in gradually reducing structural unemployment from 9 per cent in the early 1990s to 3-4 per cent in 2009 – and with room for even further improvement down to 2 per cent.

In 2006 – at a point where registered unemployment was a little less than 5 per cent – the author predicted that 80,000 of those in receipt of transferred income might become employed within a fairly short period of time through a combination of especially favourable market conditions, extensive focus on active labour market initiatives such as supplementary training and the creation of more sheltered jobs for people with reduced working capabilities.

Interestingly, Denmark experienced a decrease in unemployment of precisely that magnitude from spring 2006 to late 2008, when the financial crisis broke out. It was the end of an extremely high growth period – internationally as well as domestically. This high growth was only made possible by mobilising the last reserves in the national labour market and inviting tens of thousands of workers from abroad, primarily in the construction sector from neighbouring Poland and the Baltic countries.

We now realize that this extreme boom – driven by private consumption and investment – depended on excessive borrowing based on the unsustainably high values of shares and fixed property, and it was not accompanied by sufficient investment in the labour force. But we did get an impression of how far we can bring down unemployment in times of very high growth with a revival of an active labour market policy.

## **8 »Freedom of choice« and »Tax-freeze«**

The general election in 2001 led to a centre-right minority government under the leadership of the Liberal leader Anders Fogh Rasmussen coming into power, and the elections in 2005 and 2007 did not change much in the balance of power between the

government and the opposition.

The government consists of Liberals and Conservatives, but in all major issues it depends for its majority on the support of the populist Danish People's Party. This party is based on xenophobic hostility to immigration. It appeals to right-wing nationalism and opposition to the EU. When it comes to economic policies the party offers loyal support to the centre-right government though with some further demands – not least as regards senior citizens.

The centre-right government and its supporters have created an image of themselves as those being able to slow down Muslim immigration, make cuts in welfare benefits for immigrants and pursue a tight law and order policy, while generally preserving the welfare model for the Danes – and at the same time freeze and even reduce taxes.

The government has benefited fully from the fundamental improvements of the economic structure and especially on the labour market that was initiated in the 1990s.

Unemployment increased somewhat in the government's first three years – from 5 to 6 per cent. But then it declined steeply to 2 per cent to be followed by a steady increase since the autumn of 2008. The figure could well pass the 5 per cent level again before the end of 2009.

Up until 2008 the government budget showed an overwhelming surplus as a combined result of a number of extraordinary events. A huge debt-funded private spending spree, good company earnings, a fall in interest rates, capital gains tax on pension schemes and high tax revenues from oil and gas extraction in the North Sea due to the extraordinarily high energy prices. The latter also contributed decisively to major surpluses in the balance of payments.

In 2009 a large budget deficit will re-emerge, which shows that the super-boom was very shaky and unsustainable. Public service expenditure – which is mainly borne at municipal or regional level – has been kept by the government within strict growth limits – even in the boom years.

Under the slogan of »Freedom of choice« the government has managed to cultivate private competition to the public services. This is expanding mainly in hospitals, because private competitors are being given very high rates of payment for surgical operations. In that way the government is encouraging the population to transfer tax money from the public system into private hospitals. This involves



a major risk that the middle class will in increasing numbers be turning their backs on the financially strapped public services – taking with them their money and support. The door has opened to a huge increase in private insurance and could dampen the willingness of this group to pay to maintain good public services for everyone – including the financially and socially weak groups – via their taxes.

In the upcoming crisis it is more obvious that the government has invested all too little in education, research and development in order to maintain Denmark's leading position in the global economy. With increasing unemployment, there is a strong need to reverse the cuts from recent years in active labour market measures. There is an urgent need for a much stronger educational component for the unskilled workers now being thrown into unemployment and whose traditional jobs will probably not return to Denmark in the future.

The crisis also puts the focus on the weaker position that many people are now in, because they were somehow lured into opting out of the unemployment insurance system and stopped being organized in the trade unions. The government's preference for the private sector – and its »freedom of choice« and a tax policy in line with this preference – explains the limitation of resources for important public services.

»The tax freeze« has been the major sales promotion idea from the centre-right government. Primarily it is a promise not to raise income tax rates and to freeze tax on the property value of private homes, which has hitherto followed the development in sales prices. This tax freeze has been supplemented with two minor reductions in income tax rates on middle and higher incomes in the election years 2005 and 2007.

In March 2009 – when the financial crisis struck – the government majority decided on a major reform of the tax system, which in the years up to the next election is heavily under-financed and offers major tax reductions to the upper ten percent. The theoretical basis for this tax reform is that lower marginal taxes for high-earners in the electorate will increase the labour supply and avoid a potential brain-drain from Denmark of people with higher education. The empirical evidence for this theory is limited in Denmark. Danes work hard already and most of the Danes that go abroad for education and work return home after some years.

While they decided to free up billions by under-financing the tax reform, the government parties rejected the alternative proposal from the opposi-

tion of introducing a large stimulus package of public investment in infrastructure, hospitals, schools, energy conservation and developing sustainable energy supplies. The opposition's proposal would create many more jobs for the same amount of money now spent on under-financing the tax reform. In a situation of deep crisis there is strong reluctance in private households to spend money from tax reductions, because many have lost their jobs, many more are afraid of losing theirs and the majority have incurred heavy losses in the values of pensions and homes.

Naturally, the tax freeze and tax reductions are attractive in themselves. But in 2005-2008 the government's tax policy combined with rising share prices, extremely low interest rates and new possibilities of amortisation-free loans in private homes has triggered the explosive rise in property values and a corresponding explosion in private consumption on borrowed money. These were the driving forces in the boom-bubble that burst in the autumn of 2008 in America and much of the rest of the world, including Denmark. In the boom, tax reductions contributed to the instability. In crisis they do not work effectively against rising unemployment!

Denmark is still one of the countries with the least inequality. But the overall result of 7-8 years of centre-right government is that inequalities have increased. Between the very few with even more exceptional income and wealth and the increasing number of the poor; between house-owners and tenants; between the well-established and the young, newly established on the housing market; between the big cities and the outer regions; between the employed and people on transferred income; between well established Danes and incoming new immigrants.

So the Danish model *does* face serious threats. The major challenges do not, however, come from the pressure of globalisation but a potential decline in support for the model among the electorate as a consequence of the centre-right policy.



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