

## FLEXICURITY IN DENMARK

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### Introduction

The key word in recent debates on labour market policy has been flexicurity. Is it possible to combine *security* for employees with *flexibility* for employers so as to ensure a well functioning labour market with low unemployment? Denmark has been highlighted as a flexicurity country which, via flexible hiring and firing rules as well as a generous social safety net, has balanced the two concerns in a way that has been conducive to labour market flexibility and low unemployment. Since the unemployment rate in Denmark has been below the European average for several years, many observers have readily concluded that the Danish system works and has positive results. Hence, it is often seen as a model for other countries.

Labour market developments in Denmark have indeed been impressive: in mid-2008 the unemployment rate was close to 1.5 percent (structural unemployment is assessed to be 3 to 3.5 percent). Unemployment has been reduced to a historically low level, and the debate has shifted from focusing on a “shortage of jobs” to a “shortage of hands”. This development has been achieved without significant cut-backs in welfare state provisions, including the social safety net, and employment growth has been consistent with distributional objectives. While business cycle factors have been important for reducing unemployment in Denmark, structural changes have also been important. The following focuses on characterizing Danish labour market policies and on explaining what accounts for the improvement in the labour market situation over the last 10–15 years.

The dramatic change from high and persistent unemployment to very low unemployment and the implied change in the perception of the Danish labour market are succinctly summarized by the following OECD quotes on Denmark:

“The malfunctioning of the labour market is at the core of the macroeconomic imbalances in the Danish Economy”, (OECD Economic Survey Denmark 1990, 57).

“... the flexible labour market, combined with active support for those losing jobs, makes a good starting point to benefit from globalisation”, (OECD Economic Survey Denmark 2008, 21).

How did this change come about? And what can other countries learn from this experience?

The Danish developments and experience offer interesting insights on how to strengthen labour market incentives under tight distributional constraints. Denmark has an extended welfare system with a tightly-knit social safety net and a high level of public service provisions, all of which are tax financed. Labour market policies and institutions are an integral part of the welfare state. The Danish welfare model is based on ambitious egalitarian objectives, and a strengthening of the incentive structure by general reductions in benefits that constitute the social safety net is not a possible policy avenue. Working poor is not a policy option in Denmark. At the same time, it is important to note that an extended, tax-financed welfare state presupposes that a large fraction of the population is in employment. Thus, for the model to be financially viable, the employment rate must be high. The reason is simple: when unable to support themselves, most people have an entitlement to some income support, and at the same time, their tax payments are lowered. It is therefore no surprise that Denmark (and the other Scandinavian countries) have a high labour force participation rate. To put it differently, the welfare model is employment focused. The critical and challenging issue is thus how to strike a balance between the social/distributional objectives and the need to maintain a high employ-



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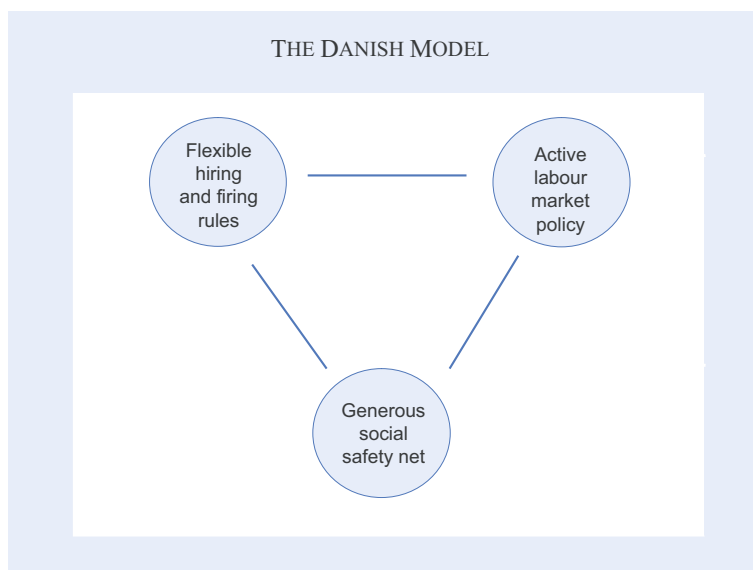
ment ratio. This balance was lost in the 1970s and 1990s, but the reform process since the mid-1990s has contributed to re-establishing it.

**The Danish case**

The short version of the Danish story is as follows: hiring and firing rules are rather flexible, and the unemployment insurance scheme is generous by international standards. However, this was also the case in the period from the mid-1970s to the early part of the 1990s, where Denmark was routinely listed as a crisis country with problems for almost any macro-economic indicator, including high and persistent unemployment (see the OECD quote above). Therefore, the *flex* and the *security* part of the Danish policy package cannot alone account for the drop in unemployment. This is not denying that these aspects have attractive implications, but they are no guarantee for a low and stable unemployment rate.

To account for the Danish experience, a series of reforms during the 1990s must be looked at. The

**Figure 1**



main thrust of these was a shift from a passive approach towards labour market policies to a more active focus on job search and employment. The policy tightened eligibility for unemployment benefits, shortened their duration and introduced workfare elements into unemployment insurance and social policies in general. The shift in policy and labour market performance should also be seen in view of macroeconomic developments, which contributed to an up-turn in economic activity and thus also to the political support for the changes. The term flexicuri-

**Table**

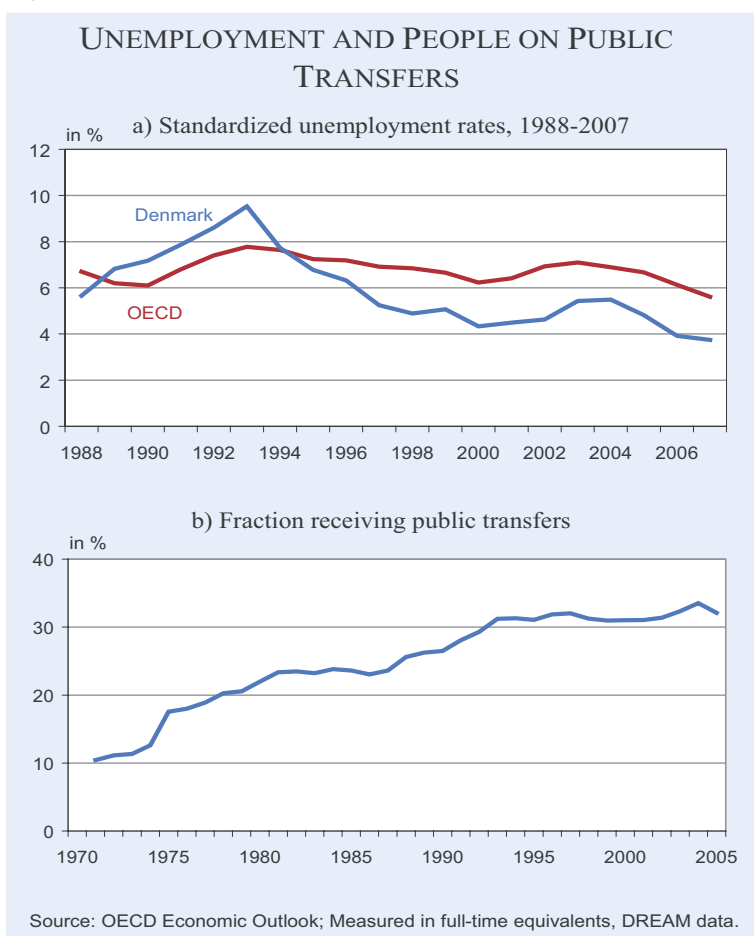
**Workfare requirements in the Danish social safety net 2007**

|                       | Eligibility  | Conditions   | Job search   | Activation requirements <sup>a)</sup>  |
|-----------------------|--|--|--|--|
| Unemployment benefits | Voluntary, contribution-based, tax subsidized  | Membership: relevant education or employment in the last 12 months.<br>Renewed benefit period: regular work in 6 of the last 36 months.<br>Duration: max 4 years | Mandatory registration in job centre (to be renewed weekly)<br>CV on jobnet<br>Individual job-plan/regular contact to job-centre<br>Active job search (monitored and sanctioned) | Age below 30: after 6 months<br>Age between 30 and 60: after 9 months<br>Age above 60: after 6 months<br>Repeated offers<br>After 2 ½ years full-time activation   |
| Social assistance     | Universal, but depends on age, and means tested for married couples based on family income | Mishap precluding self-support   | For recipients of social assistance whose main problem is assessed to be unemployment – the same requirements as for those receiving unemployment benefits                       | Age between 25 and 30 and no education: education offers after 6 months (alternatively lower benefits)<br>Age between 25 and 30: after 5 weeks an offer of 8 weeks' duration, after 13 weeks an offer of 18 months' duration<br>Above 30: after 9 months |

<sup>a)</sup> The actual activity and duration varies across the different groups.

Source: Andersen (2008).

Figure 2



ty is therefore in some sense a misnomer for the “Danish” model. When the model was based solely on flexibility and security, it did not perform well, and public transfers grew considerably. The unemployment rate reached 10 percent, and the fraction of the age group 15–66 receiving public transfers increased from about 10 percent in 1970 to 30 percent in the early 1990s. The social safety net thus

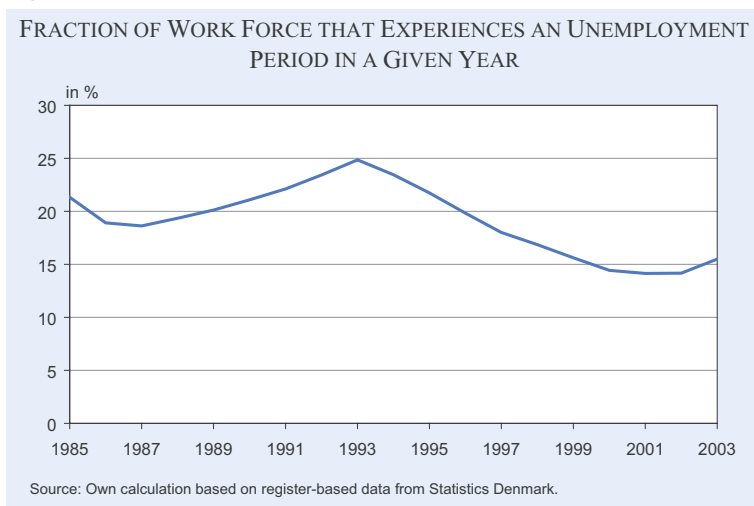
change, the passive period was effectively open-ended because benefits combined with occasional job training would ensure continued eligibility for benefits. After the reform, the benefit period became shorter and activation compulsory for claimants of benefits. Furthermore participation is no longer sufficient for fulfilling the employment criteria to remain eligible for unemployment insurance (UI) benefits, i.e., the

served to protect incomes but did not have an employment focus, which had dramatic consequences for public financing. The model began to function better when an additional element was added – active labour market policies – with a clear emphasis on job search and employment (Figure 1). Prior to the reforms, the welfare system was essentially a passive player between firms benefiting from flexibility and workers from income security. As is often the case in tripartite relations, the passive player is at a clear disadvantage. When a more active approach was taken in labour market policies, it became possible to strengthen employment while maintaining flexibility and income security.

The single most important change as a result of the reforms initiated in the mid-1990s is that participation in activation measures no longer qualifies for remaining eligible for benefits. Before this transition from UI benefits to social assistance (also associated with activation requirements) is a real option. The Table above gives a summary overview of the workfare requirements attached to the social safety net in Denmark as of 2007.

The reduction in the rate of unemployment in Denmark is impressive (Figure 2a), and it was mainly driven by an increase in employment. However, as illustrated in Figure 2b a large fraction of the population in the

Figure 3



age group 18–64 is still dependent on public transfers. While there has been some reduction in this share, it is still at a high level. Hence, while the unemployment problem has been solved, there is still a significant non-employment problem for a large share of the population.

The flexicurity feature of the Danish labour market is reflected in several indicators. A key characteristic is a large incidence of short-term unemployment, i.e., many are affected by unemployment within the year, but mostly only for a short period of time. In Figure 3, the fraction of the work force that experiences unemployment in a given year is depicted.

In 2003 the unemployment rate was about 4.5 percent, but about 15 percent of the work force was affected by unemployment within the year. So although the unemployment rate has fallen by more than 60 percent from 1993 to 2007, the number of people affected by unemployment has only dropped by around 35 percent in the same period; i.e., short spells of unemployment are not uncommon. This indicates that job tenure is relatively short in Denmark. However, surveys persistently show that employees in Denmark perceive a high degree of security (Parent-Thirion et al. 2007), suggesting that the Danish labour market is functioning well under the current business cycle conditions.

**Insurance versus incentives**

A generous social safety net including unemployment benefits and social assistance provides income insurance for workers. This has a direct welfare effect on risk-averse workers, but it may also be conducive to risk taking and thus labour market flexibility. However, any form of insurance raises problems of moral hazard and adverse selection. These incentive problems have been widely analysed in the literature, which has pointed to the detrimental effects of generous unemployment insurance for search incentives, etc. The political dilemma between insurance and incentives implies that countries with high unemployment insurance would have incentive problems in the labour market and thus

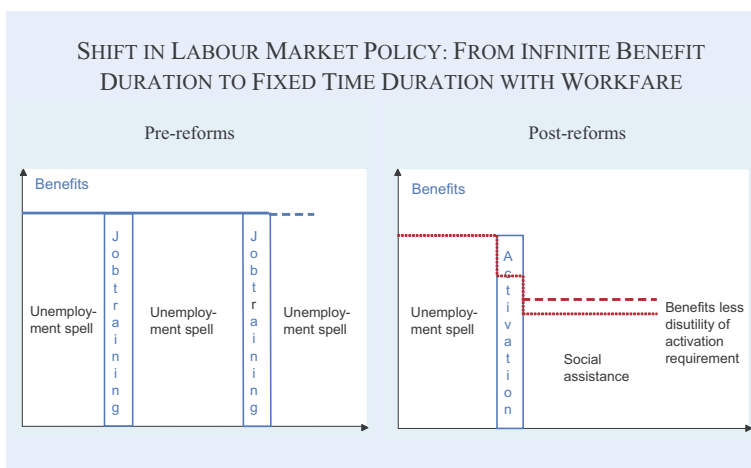
higher unemployment. The Danish experience does not confirm this view.

Active labour market policies broadly interpreted are important in reconciling insurance and incentives. Appropriately designed labour market policies can be used to strengthen job search incentives without reductions in benefit levels. The latter is not a real policy option in a country with strong distributional concerns.

Studies of active labour market policies have focused on the direct consequences of programme participation. Is there a programme effect which improves the subsequent chances of finding a job? While it is important to consider these direct effects, it is equally important to consider the indirect effects since they may have important implications for the moral hazard and adverse selection problems.

Associating some activity requirement with the entitlement to benefits after a specified duration of unemployment effectively amounts to having a benefit level which is duration dependent. The dependency is created because the benefit cannot be claimed passively. Work requirements strengthen incentives precisely in the same way a declining benefit profile does. This means that the effects of workfare elements should not be evaluated solely by the direct programme effect on the unemployed; the indirect effect on the unemployed in terms of increased job searching must also be taken into account. Figure 4 illustrates the effect on individual utility of a workfare requirement. Moreover, wage formation will also be affected since the workfare element reduces the outside options of the employed. A more detailed analysis of the effects of

**Figure 4**



workfare in terms of striking a balance between insurance and incentives in the labour market can be found in Andersen and Svarer (2008).

Workfare also has screening effects because it reduces the possibility of passively claiming benefits as an alternative to work. Individuals who have a strong preference for non-work alternatives (or engage in black sector activities) will not be able to finance these activities through the benefit system.

### Fine-tuning active labour market policies

The reduction in unemployment implies that active labour market policies have been adjusted over the years to take into account both the effects of policy shifts but also the changing composition of the stock of unemployed as a result of the reduction in the unemployment level.

Designing active labour market policies involves a number of concerns. Such activities are costly (direct costs of active labour market policies amount to 1.3 percent of GDP in Denmark), and the shift in the trade-off between incentives and insurance is thus not obtained for free. Two aspects are particularly important, namely timing and programme types.

The frontloading of workfare requirements will strengthen incentives the most, but it is also very costly, and it will entail a large deadweight loss from programme participation for many who are likely to find a job after a short unemployment spell. This is particularly so in a labour market with a high incidence of short-term unemployment periods. Hence, workfare requirement should be imposed after some duration of unemployment.

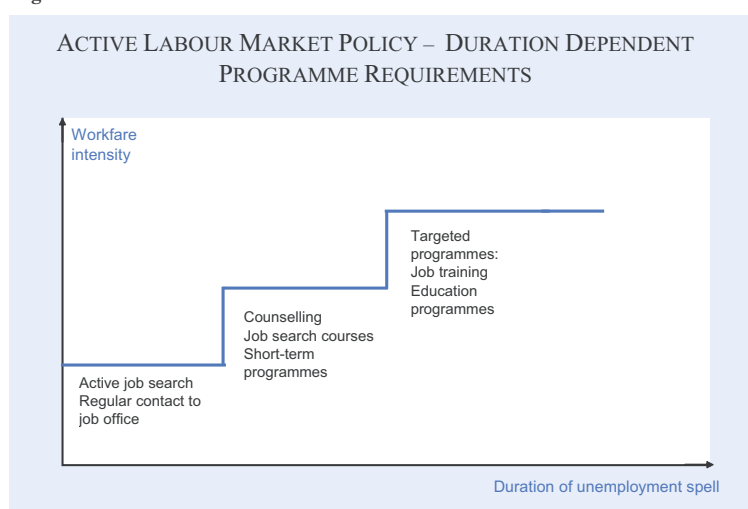
The group of unemployed is heterogeneous, spanning from those who have the qualifications and experience making them readily employable to those who lack these properties (e.g. due to long-term unemployment) and therefore find it very difficult to get a job. For the former group, help with job searching may be sufficient, while for the latter more specific programmes may be needed to

specifically address the constraints lowering their job finding rate. In some cases, it may be easy to identify these constraints (e.g., if the unemployed lack specific skills) while in others it may be more difficult and also depend on market conditions (qualifications become obsolete due to structural changes). In the latter case, avoidance of deadweight losses provides an argument for making workfare programmes duration dependent.

These considerations lead to an optimal profile for workfare requirements as illustrated in Figure 5, where the requirements run from general and relatively costless activities to specific and more costly activities, depending on the duration of the unemployment spell. The duration-dependent sequencing of workfare requirements works to minimize deadweight losses and programme costs while maintaining the incentive effects and addressing more specific programmes to groups for whom it may make a difference.

The selection or targeting of workfare programmes in individual cases may be strengthened by making both participation and the type of workfare programme dependent on some observational characteristics (e.g., extensive educational programmes only available to unemployed without formal education) or by distinguishing between different groups. The latter is done in the Danish social assistance scheme, where claimants are divided into five different groups depending on the extent to which they are assessed to be able to work, and the workfare requirements/programme content differ across the groups. A more sophisticated way of targeting programmes is via so-called profiling. Here statistical

Figure 5



programmes are used to select which programme (if any) is expected to have the largest effect in reducing the length of unemployment spells for a particular individual with given personal characteristics. The advantage of using statistical tools is that accumulated experience from all previous unemployment spells can be used. Currently, several countries including Germany, Switzerland and Sweden are considering introducing statistical targeting tools to assist programme selection (see, e.g., Staghoej et al. 2007).

### Business cycle dependence

A key question is to what extent active labour market policies should be business-cycle dependent. This applies at two levels. At the economic level, it may be argued that supply-oriented policies are more effective in a situation where there is an upward trend in the demand for labour. At the political level, it may be argued that it is easier to maintain support for active supply-oriented policies in a situation where unemployment is decreasing. Given current projections for global economic developments, it is therefore an open question as to how the flexicurity model in general and the active labour market policy in particular will work under less favourable business cycle circumstances. If unemployment rises significantly, there is a risk of an overload of activation policies which will either lead to a cost hike and thus a burden on public finances or a reduction in the efficiency of the programmes.

Another issue is how to adopt workfare policies to a situation with higher unemployment. Two responses are possible. One is to shift the different workfare stages to longer unemployment durations, that is, a horizontal shift of the steps in Figure 5. This is similar to an extension of the benefit period in periods with high unemployment as is done in the US and Canada. Another is to reconsider the specific types of activation policies to be used. At the current low level of unemployment, most of the long-term unemployed have some barriers significantly reducing job-finding rates. However, in a slump more “core” workers will be affected by unemployment and also experience longer duration than at present. For these groups, the primary problem is not lack of qualifications and experience per se, but rather to ensure that these do not depreciate too much due to unemployment. This may be countered by a high incidence of short-term activation programmes intended to keep the participants in close contact with the labour market.

### Conclusion

The significant reduction in unemployment on the Danish labour market since the mid-1990s is remarkable since it has been achieved without resorting to general benefit reductions. This shows that it is possible to improve incentives in the labour market without turning to benefit reductions. The pivotal elements are the activation policies and the shortening of the benefit period. These measures work both directly by shortening benefit duration and indirectly via the conditions arising from activation. However, these changes have not come without costs since the active labour market policies require considerable resources. In light of the expected downturn in the global and also in the Danish economy, it will be interesting to see whether the Danish flexicurity model will also perform well when unemployment increases.

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