Labor legislation: Denmark

Abstract

Every year, one of five Danes loses his or her job. But they don't lose their incomes. Unemployment benefits replace close to two-thirds of their earnings, and the government helps them find work. This combination of flexibility for employers and income security for workers is called "flexicurity." The arrangement has been in place since at least the 1970s, but it has evolved over time, principally in strengthening the active labor programs component. It seems to work well. Between 1995 and 2008, unemployment averaged 4.9 percent, compared with 8.5 percent the rest of the EU15. How does Denmark have both flexibility and security? First, employment laws have evolved from a system in which unemployment benefits were paid by labor and trade unions, not the government. Second, sensible adaptation: the arrangements were reformed in the 1990s after decades of high unemployment. Policies cut job protection, raised unemployment benefit coverage, and strengthened job search assistance. The OECD Employment Protection index for Denmark has fallen from 2.4 in 1983 to 1.5 in 2009. Unemployment insurance financed from contributions and taxes covers around 80 percent of the labor force. Benefits last up to four years, and replacement rates cannot exceed 90 percent of wages. After four years, recipients have to switch to social assistance, which means a reduction of between 20 and 40 percent of benefits. Active labor market programs like job search assistance and training nudge the unemployed back to work. The unemployment rate dropped from 10 percent in 1993 to 3.3 in 2008. The incidence of long-term unemployment—those without work for more than a year—fell from a third of the total to a tenth. Third, generous public spending: Denmark spent 4.5 percent of GDP on labor market programs in 2008, a good year. The Danes have flexicurity because of their history, and they can afford it because of participation rates of more than 80 percent. Others who want both flexibility and security should be mindful of this.

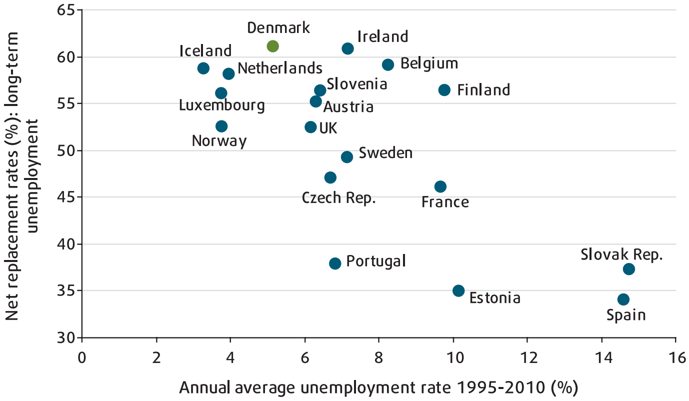
During the past three decades, the Danish labor market has gone through an impressive transition. In the 1980s, Denmark's unemployment rate reached nearly 9 percent, higher than the average for Western Europe (about 7 percent).[1] In the 1990s, unemployment stood at 8.5 percent, about the same as the Western European average. By the 2000s, unemployment was 4.3 percent, more than 2 percentage points below the average for Western Europe. The Danes were able to achieve all this while maintaining one of the most generous benefit systems in Europe. This note tries to explain how labor legislation contributed to this success.

Success in the labor market

Between 1995 and 2010, Danish unemployment rates averaged 5 percent, much smaller than in most of Europe (figure 55). The country has the second highest participation rate (80.7 percent) in Western Europe, after Switzerland (82.9 percent). At the same time, as of 2009, Danes enjoyed one of the most generous unemployment benefit systems in Europe. Despite high incomes for the jobless, Danes return to the workforce quicker than their OECD counterparts—the incidence of long-term unemployment in Denmark stood at 9.1 as opposed to the OECD weighted average of 23.5.[2]

Because of its low unemployment rate, income security for workers, and economic freedom for employers, the Danish approach to labor market legislation has been receiving a lot of attention in Europe. How did the legislation helped to boost the labor market performance?

Figure 55: Annual average unemployment rate in 1995–2010 and net replacement rate in 2009 for long-term unemployed (previous earnings equal to an average wage)[3]



Source: IMF WEO and OECD.

High rewards, low security

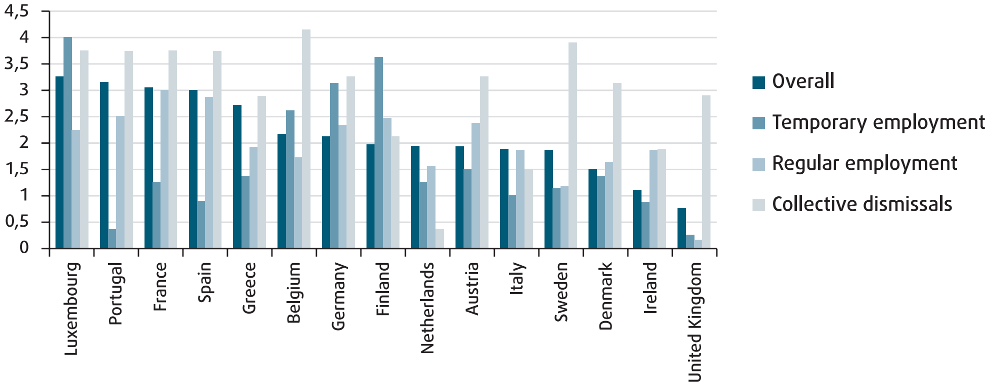
The Danish system is based on the concept of flexicurity, which combines high benefits for unemployed with the employers' right to hire and fire workers at relatively low costs. These two pillars of flexicurity are not new—they have been in place since the mid-1970s. In the 1980s, generous benefits and high unemployment strained public finances. Given relatively high transfers and a weak economy, the incentives for the jobless to enter employment were weak. This led to changes in the system.

The new approach, called the "Golden Triangle," combines the previous version of flexicurity with one additional component: active labor market policies. Broadly speaking, Denmark now provides stronger incentives for the unemployed to reenter employment. Benefits from unemployment insurance became available for a limited time and contingent on one's efforts to find a job. The unemployed have access to training programs as well as assistance in job search (e.g., the Individual Job Plan). In general, out of €13 billion devoted in 2010 to labor market policy, around 75 percent was spent on active instruments.

The second pillar, flexibility of firing and hiring, has remained practically unchanged over the past several decades. Although the OECD Employment Protection Legislation (EPL) overall index in Denmark decreased in the past 15 years, it was moderate even in the 1980s.[4] Currently, the Danish labor market is one of the most flexible in the EU (figure 56). Every year, one out of five Danes faces unemployment. Internal mobility rates are also high. Around 36 percent of Danes move within the country, the second highest ratio in the EU after Sweden (42 percent).

Danes change jobs frequently because they have a safety net to land on. In the Danish labor tradition, which derives from the "Gent system," unemployment benefits are paid by labor and trade unions rather than the government. Unemployment insurance is financed from members' contributions and taxes. It covers around 80 percent of labor force and the membership is voluntary. The benefits can be received for up to four years and cannot exceed 90 percent of wage over a previous year or regulatory cap (currently €2,173 per month).[5] The jobless can also benefit from social assistance, financed from taxes and administered by local municipalities. How much an unemployed gets depends on income levels in the past and family situation. For example, an unemployed single parent with two children earning two-thirds of the average wage has a net replacement rate of 90 percent, while the same parent with earnings of 150 percent of average wage receives a net replacement rate of 64 percent.[6]

Figure 56: Strictness of employment protection in the EU15: overall, regular employment, temporary employment, and collective dismissals, 2008



Source: OECD.

The flipside of flexicurity

Although flexicurity has been praised for keeping unemployment low in Denmark, some reservations need to be mentioned. Andersen and Svarer (2007) point out that despite a decrease in the official unemployment rate since the mid-1990s, the gap between gross unemployment (includes unemployed, people in activation, early retirees, etc.) and official statistics remains high. Further, it is difficult to assess how much flexicurity contributed to the improved performance of the labor market, since other factors like macroeconomic performance count as well. Bredgaard and Larsen (n.d.) underline that competitive labor markets may exclude certain groups of employees that fail to meet expectations of employers. Finally, spending a lot on active labor market police becomes less effective if there are not enough jobs to go around—a likely problem in a protracted recession.

Even if the reduced unemployment rates can be attributed to flexicurity, it came at a high cost. The National Labour Market Authority assesses the costs of the current model to around 4.5 percent of GDP. In 2008 Denmark spent 2.6 percent of GDP for labor market programs, in comparison to 2.2 percent in Finland, 2.3 in the Netherlands, and 1.5 in Sweden (the OECD average is 1.36 percent). And the cost may be even greater in times of crisis, when benefits need to be paid to a growing share of unemployed people.

Finally, the Danish model cannot be replicated easily, if at all. Flexicurity in Denmark was not implemented by a one-time legislative decision but evolved gradually over many years. Moderate government regulation works in Denmark because it has a long history of self-regulation by labor market partners that goes as far back as the introduction of September Compromise of 1899.[7]

Variants of flexicurity, however, offer models that other countries could consider. The Danish experience provides lessons on how to balance the growing fiscal burden of current social security models with the contestability needed for efficiency and growth. But those considering flexicurity should be clear about the distinction between the general notion of flexicurity and the particularities of the Danish labor market.

Sources

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- Bredgaard, Thomas, and Flemming Larsen. n.d. "Comparing Flexicurity in Denmark and Japan." Centre for Labour Market Research at Aalborg University, Denmark. Available at: www.epa.aau.dk/fileadmin/user_upload/conniek/Dansk/Research_papers/5-Comparing_Flexicurity_01.pdf.
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Notes

1 All rates are annual averages for respective decades. Western Europe includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Norway, Netherlands, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

2 The incidence of long-term unemployment (more than 12 months) as a share of total unemployment. Source: OECD.

3 Net replacement rate includes unemployment benefits, social assistance, and family and housing benefits in the 60th month of benefit receipt, all after tax. The computed values are averages of net replacement rates for six types of households earning an average wage: (1) single, no children; (2) married couple, one earner, no children; (3) married couple, two earners, no children; (4) single parent, two children; (5) married couple, one earner, two children; (6) married couple, two earners, two children. For married couples, the percentage of average wage relates to one spouse only; the second spouse is assumed to be "inactive" with no earnings in a one-earner couple and to have full-time earnings equal to 67 percent of average wage in a two-earner couple. Children are aged 4 and 6 and neither childcare benefits nor childcare costs are considered.

4 The higher the score, the stronger the protection of employment. The EPL rating in Denmark decreased from 2.4 in 1983 to 1.5 in 2009 as opposed to the OECD average of 1.94.

5 After four years of receiving unemployment benefits, an individual has to switch to social assistance. This usually means a reduction of income (according to Andersen and Svarer 2007 by 20-40 percent).

6 OECD estimates for initial phase of unemployment.

7 The September Compromise of 1899 established how to solve disputes between unions and employers associations.