

Denmark: An Exemplary Economic Policy?

In economic terms, Denmark has been one of Europe's most successful industrialised countries during the past decade. With comparatively high economic growth, it has achieved virtually full employment in recent years, and public finances have also developed favourably. International competitiveness is high, and the increase in consumer prices roughly corresponds to the euro zone average. In contrast to the United Kingdom, another country demonstrating above-average success in terms of economic and employment policy, Denmark – although not in the euro zone – is de facto linked to it in economic policy terms: since 1993, the rate of the Danish crown has been kept more or less constant against first the ecu, then the euro. Nevertheless, Denmark's cyclical development has not been synchronised with that of the euro zone, even if the country was unable to completely escape the dampening effects emanating from there. A specific policy mix and a tendentially anti-cyclical financial policy have contributed to this outcome.

Positive macro-economic development since 1994

As many other European countries, Denmark also suffered from cyclical downturn in 1992/93. Although this did not lead to recession, investment fell considerably and unemployment rose – to almost 10% in 1993. With a strong upturn in 1994, previous loss of growth could be rapidly offset – in contrast to the situation in western Europe. In the subsequent years, too, growth in Denmark was higher than the European average. The development moved in tandem in the late 1990s and in the western European 'boom year' of 2000. Since 2001, Denmark has again been less strongly affected by the more recent international stagnation than the euro zone (cf. table).

With by and large higher and also decidedly steadier economic growth, Denmark succeeded in reducing its unemployment rate considerably up to 2001 – from almost 10% to 4.3%. Although this rate has risen slightly since 2002, at currently 5.5% it is still much lower than the euro zone average of 9%. As in most other countries however, both the number of those in employment and the average working time has fallen in the past two years. From mid-2001 to mid-2003, the volume of work fell by 6%.

Until 1998, domestic and foreign demand developed at roughly the same speed (cf. figure 1). Here, the strong investment dynamism is particularly noticeable. In subsequent years, foreign demand became uncoupled from domestic developments; growth was sustained primarily by exports and high balance of payments surpluses were achieved. Despite the more favourable economic development in the time period observed, consumer price increases barely deviated from those in the euro zone. At around 2%, the increase in the harmonised consumer price index (HCPI) corresponded roughly to the targets of the European Central Bank (ECB) – although these are not binding on Denmark.

The generally strong economic growth means that the Danish government has been achieving budget surpluses since 1997 (cf. figure 2), although these have become noticeably smaller in the past two years in the course of the cyclical downturn. The general government rate of debt was reduced from 78% in 1993 to 43% in 2003 – while, in the euro zone, it rose from 67% to 70% during the same period.

Economic policy linkage to the euro zone

Given the existing world economic policy conditions, Denmark's generally positive economic development has been shaped by the well-coordinated behaviour of monetary and financial policy, as well as of wage and labour market policy.

Despite a predominantly pro-European attitude among the Danish population and Denmark's successful achievement of the Maastricht criteria in the run-up to the introduction of the euro, linking the country to the euro zone has until now been prevented, due to negative referenda outcomes (most recently in September 2000). Nevertheless, the exchange rate of the Danish crown against first the ecu, then the euro has been held more or less constant for a decade now. From an economic viewpoint, therefore, the decision not to introduce the euro is merely symbolic. For by tying its exchange rate to the euro zone, Denmark's monetary policy is closely linked with the ECB's monetary policy. The only difference is that, in contrast to the euro zone countries, Denmark has the option of giving up this status at any time.

The policy of a fixed exchange rate against the euro zone is determined by the regulations of the European Exchange Rate Mechanism (ERM II). Basically, this means that interest rates in Denmark do not differ substantially from those in the euro zone when inflationary trends are similar. Due to the – on balance – slightly higher rate of price increases and the linked inherent devaluation trends against the euro, short-term interest

Table
Economic Indicators, 1993 to 2004
Change on the previous year (%)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Denmark												
GDP, real	0.0	5.5	2.8	2.5	3.0	2.5	2.6	2.9	1.4	2.1	0.8	2.2
Domestic demand												
Private consumption	0.5	6.5	1.2	2.5	2.9	2.3	0.7	-1.9	0.4	1.9	1.3	2.5
Government consumption	4.1	3.0	2.1	3.4	0.8	3.1	2.0	1.1	2.1	2.1	1.1	2.5
Fixed capital formation	-4.0	7.6	11.6	4.0	10.9	10.1	1.5	8.6	1.9	0.3	3.0	2.3
Exports	-1.5	7.0	2.9	4.3	4.1	4.3	12.3	13.0	3.0	5.8	2.3	4.0
Imports	-2.7	12.3	7.3	3.5	10.0	8.9	5.5	11.3	1.9	4.2	1.8	4.0
Domestic labour force	-1.5	1.4	1.3	1.0	1.2	1.6	1.2	0.9	-0.3	-0.7	-0.8	0.3
Standardised unemployment rate (%)	9.6	7.7	6.8	6.3	5.3	4.9	4.8	4.4	4.3	4.5	5.5	5.2
Consumer prices (HICP)	0.9	1.8	2.1	2.1	1.9	1.3	2.1	2.7	2.3	2.4	2.0	2.3
Balance on current account (in billion DKK)	25.2	14.8	7.2	15.4	4.4	-10.2	21.2	19.0	40.7	34.8	37.0	38.5
Gross level of debt (as % of nominal GDP)	78.0	73.5	69.3	65.1	61.2	56.2	53.0	47.3	45.4	45.5	43.5	41.0
Financing surplus/deficit (as % of nominal GDP)	-2.9	-2.4	-2.3	-1.0	0.4	1.1	3.3	2.6	3.1	2.1	1.5	1.7
Germany												
GDP, real	-1.1	2.3	1.7	0.8	1.4	2.0	2.0	2.9	0.8	0.2	0.0	1.4
Domestic demand												
Private consumption	0.1	1.1	2.1	1.0	0.6	1.8	3.7	2.0	1.4	-1.0	-0.2	0.7
Government consumption	0.1	2.4	1.5	1.8	0.3	1.9	0.8	1.0	1.0	1.7	0.4	-0.3
Fixed capital formation	-4.4	4.0	-0.6	-0.8	0.6	3.0	4.1	2.7	-4.2	-6.7	-3.2	1.7
Exports	-5.5	7.6	5.7	5.1	11.2	7.0	5.5	13.7	5.6	3.4	1.4	4.4
Imports	-5.5	7.4	5.6	3.1	8.3	9.1	8.4	10.5	0.9	-1.7	1.6	3.1
Domestic labour force	-1.4	-0.2	0.2	-0.3	-0.2	1.1	1.2	1.8	0.4	-0.6	-1.2	-0.3
Standardised unemployment rate (%)	7.7	8.2	8.0	8.7	9.7	9.1	8.4	7.8	7.8	8.6	9.3	9.2
Consumer prices (HICP)	.	.	.	1.2	1.5	0.6	0.6	1.4	1.9	1.3	1.2	1.0
Balance on current account (in billion euro)	-11.8	-23.9	-19.8	-10.6	-8.1	-11.1	-23.4	-28.0	4.2	59.7	.	.
Gross level of debt (as % of nominal GDP)	46.9	49.3	57.0	59.8	61.0	60.9	61.2	60.2	59.5	60.8	64.3	66.2
Financing surplus/deficit (as % of nominal GDP)	-3.1	-2.4	-3.5	-3.4	-2.7	-2.2	-1.5	-1.2	-2.8	-3.5	-4.0	-3.4
Euro zone												
GDP, real	-0.8	2.4	2.2	1.4	2.3	2.9	2.8	3.5	3.4	0.9	0.4	1.7
Domestic demand												
Private consumption	-0.8	1.3	1.9	1.6	1.6	3.0	3.5	2.7	4.1	0.5	1.1	1.4
Government consumption	1.5	1.3	0.6	1.7	1.2	1.4	1.9	2.0	3.6	2.8	1.5	0.9
Fixed capital formation	-6.1	2.4	2.4	1.2	2.4	5.1	5.9	5.0	1.6	-2.8	-1.6	2.0
Exports	0.8	9.0	7.9	4.5	10.4	7.4	5.2	12.5	4.4	1.5	-0.2	3.5
Imports	-4.1	8.4	7.6	3.3	9.0	10.0	7.4	11.2	3.3	-0.3	0.8	3.1
Domestic labour force	-1.6	-0.3	0.7	0.5	0.8	2.0	1.8	2.2	1.4	0.5	-0.1	0.3
Standardised unemployment rate (%)	10.2	10.8	10.6	10.8	10.8	10.2	9.4	8.5	8.0	8.4	8.8	8.8
Consumer prices (HICP)	3.4	2.8	2.6	2.3	1.6	1.2	1.1	2.1	2.4	2.3	2.1	1.6
Balance on current account (in billion euro)	.	.	.	.	56.7	26.7	-23.8	-67.6	-14.5	67.0	.	.
Gross level of debt (as % of nominal GDP)	67.2	69.5	73.0	75.4	75.4	73.7	72.7	70.2	69.1	69.0	70.3	70.8
Financing surplus/deficit (as % of nominal GDP)	-5.7	-5.1	-5.1	-4.3	-2.6	-2.3	-1.3	-0.9	-1.6	-2.2	-2.8	-2.8

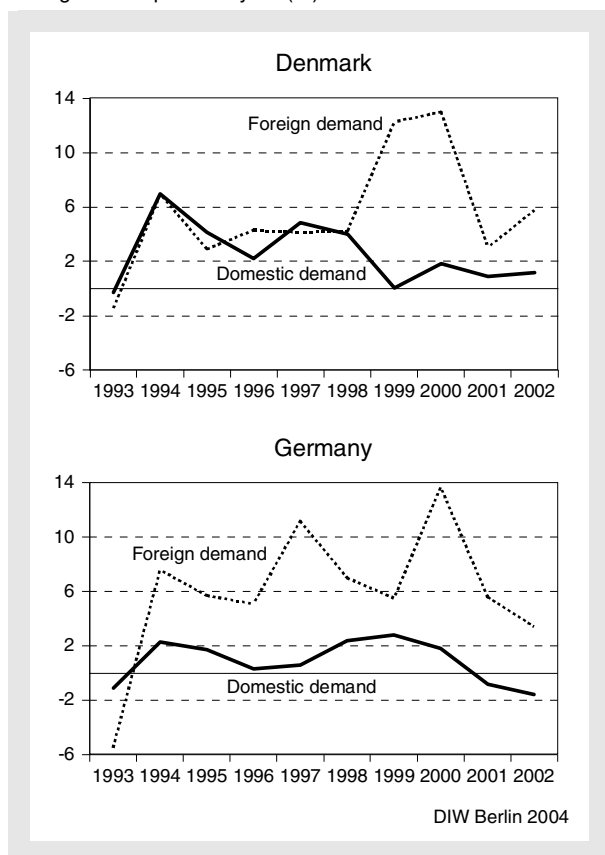
Sources: OECD; European Commission; ECB; 2003 and 2004: DIW Berlin estimates.

rates were, for the most part, slightly higher than those in the euro zone.¹ Since 2001, in contrast to previous

¹ Since 1 January 1999, Denmark has participated in the new Exchange Rate Mechanism (ERM II), which permits fluctuations against the euro within a bandwidth of only $\pm 2.25\%$. In actual fact, the fluctuations have been much lower.

years, longer-term real interest rates (nominal interest rates deflated by the GDP deflator) were also higher than those in the euro zone. Here, as there, monetary policy was on a decidedly expansionary course, however; the interest rate structure, i.e., the difference between short- and long-term interest rates, was consistently positive (cf. figure 3).

Figure 1
**Domestic and Foreign Demand
in Denmark and Germany, 1993 to 2002**
Change on the previous year (%)



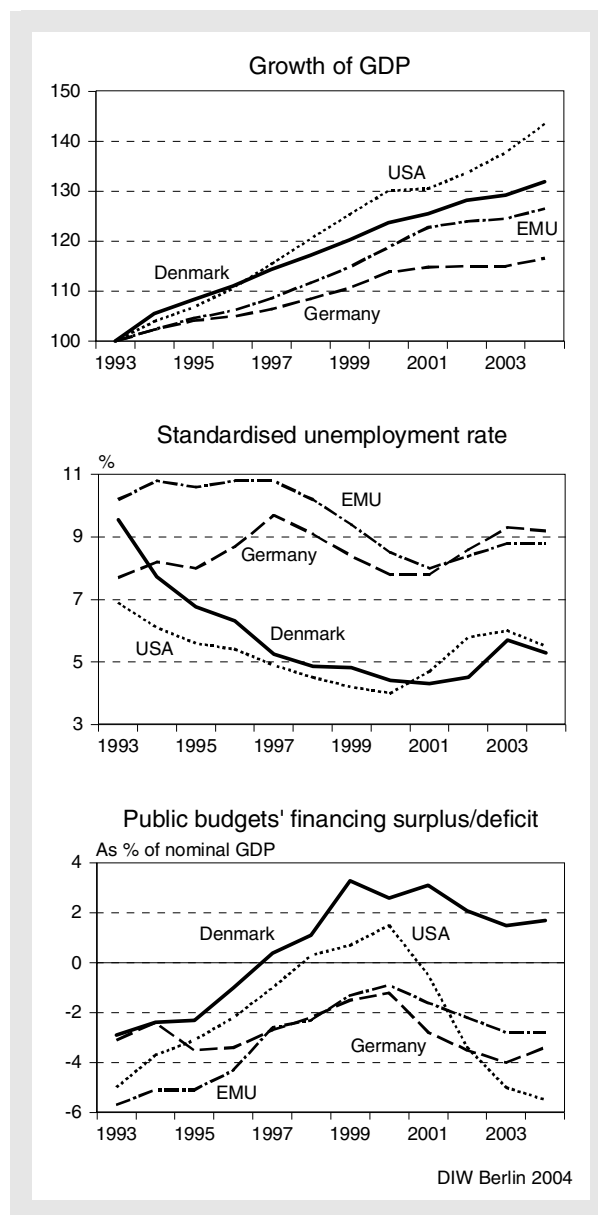
Sources: OECD; DIW Berlin calculations.

Anti-cyclical financial policy without deficit targets

While Denmark's monetary policy is, for the most part, tied to the ECB's monetary policy strategy, it continues to act autonomously with regard to financial policy. Nevertheless, Denmark is also obliged to present convergence programmes regularly within the framework of the Stability and Growth Pact.² Here, a special feature is important for an economic policy evaluation: the Danish social system is primarily financed by (indirect) taxes and only to a very small extent by labour-cost-related social security contributions. Denmark has recorded a surplus in its national budget since 1997, which implies that the country in fact fulfilled both the convergence criterion for a balanced budget and the Stability and

² In contrast to the euro zone countries' 'Stability Programmes,' non-euro zone countries provide 'convergence programmes.' The first such convergence programme was submitted in 1994.

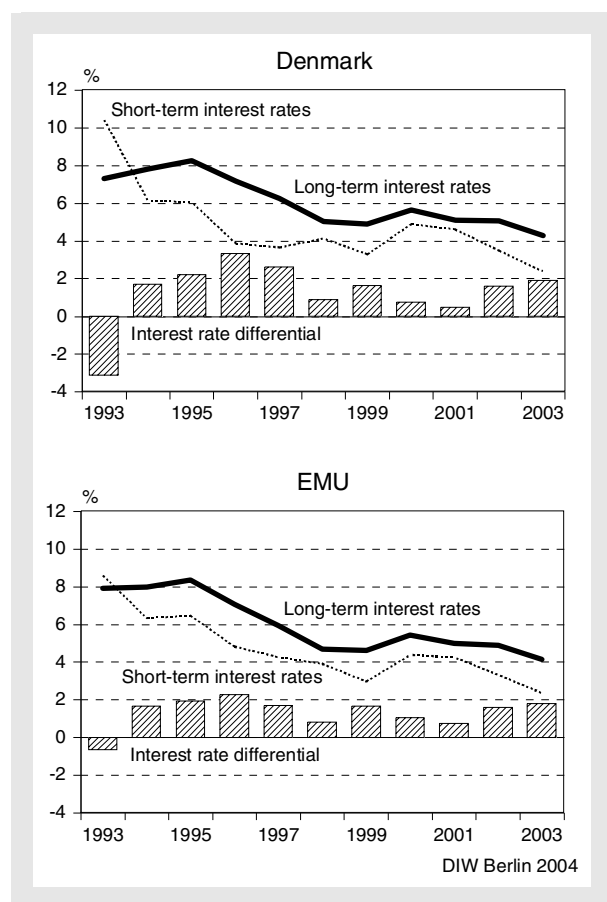
Figure 2
**Key Comparative Figures on Denmark's
Economic Development, 1993 to 2004**
1993 = 100



Sources: European Commission; OECD; 2003 and 2004: DIW Berlin estimates.

Growth Pact's medium-term goal of being 'close to balance or in surplus' – which was originally meant to be achieved by 2001 – quite some time ahead of schedule. With reference to future demographic problems and financial pressures, the Danish government had aimed for decisive budget surpluses in order to reduce government debt of over 60% in 1997 to about 40% by 2004 (cf. table). The rate of spending was to be reduced with a slightly falling rate of taxation.

Figure 3
Short- and Long-term Interest Rates
in Denmark and the EMU, 1993 to 2003¹



Source: OECD.

In fact, in the course of the strong boom of the late 1990s, budget surpluses of over 3% of nominal GDP were achieved at times – financial policy during this period was restrictive and therefore anti-cyclical. This was made possible above all by the rapidly improving situation on the labour market resulting from strong economic growth, and consequently falling transfer costs and higher tax revenue, but also by the widening of the basis of tax assessments, in which, for example, the deductibility of interest rate payments for private households was reduced.

June 1998 saw the adoption of the so-called 'Whitsun Package.' This stipulated the lowering of direct taxes and the simultaneous reduction of tax allowances (especially in housing construction) and therefore an increase in the share of indirect taxes; at the same time, the increase in public spending was to be restricted. As a result of these measures, in June 1999 consumer prices rose by about 0.5%,³ while economic growth – as intended by economic policy – was dampened by 0.5%.

Furthermore, low earners were to be motivated to work, since, by shifting the tax burden towards indirect taxes, tendentially, consumption was taxed more and the employment of labour less. On balance, the dampening in national demand was stronger than expected. Not only was the increase in government consumption halved in 2000; private consumption also fell by almost 2%, a consequence of the restrictions on tax breaks for the purchase of private real estate and of the stock market crash. This strongly affected demand for motor vehicles – further affected by higher ecology taxes and petrol prices, as well as fewer opportunities for tax deductions; at the same time, interest rates on savings accounts rose, thereby making saving more attractive.

As the unexpectedly strong downturn of the world economy became evident towards the end of 2001, financial policy loosened its restrictive course. In particular, a series of previously planned tax rises were suspended, and the effect of automatic stabilisers was authorised. Moreover, greater levels of spending were considered vital in the health and elderly care sectors. However, these were partly 'counter-financed' by cuts made elsewhere – such as, for example, in (comparatively still well-funded) development aid, in subsidies and in public-sector employment.

In addition to freezing tax rates,⁴ an upper limit was determined for certain taxes on rented property. Consequently, the yield from these taxes is rising more slowly than GDP. With this performance target for spending and income development, policy aims for a further reduction in the public-sector share in the longer term. At the same time, the debt level is set to fall to 24% by 2010 in relation to GDP; this implies high annual income surpluses.

The aim of this policy is to maintain the relatively high level of social security in Denmark, even with a falling number of persons in employment and an increasing number of elderly people. Moreover, structural, and especially labour market policy measures aim at widening the active labour force. By increasing the number of persons in employment and reducing the number unemployed, these measures are to strengthen both revenue and spending of the social security system.

In contrast to the Stability and Convergence Programmes of many EMU countries, Denmark did not set modestly – or downward revised – target levels and indicators for individual programmes. Rather, targets were frequently exceeded. Consolidation was conducted as part of an anti-cyclical strategy, in which, on the budget-

³ Cf. Ministry of Economic Affairs: 'Denmark's Convergence Programme'. Copenhagen, 1998, p.12).

⁴ Exceptions are permitted only in cases of 'external' obligations, the result, for example of changes in European Union regulations.

ary spending side, an increase – steady, yet also lower than average – was fixed, which in the medium term, at 1%, is below the increase of nominal productive capacity. An additional pressure to control spending is the result of the combination of constant tax rates with the aim of achieving a budget surplus of between 1.5% and 2.5% of GDP.

Wage policy: appropriate utilisation of distribution margin

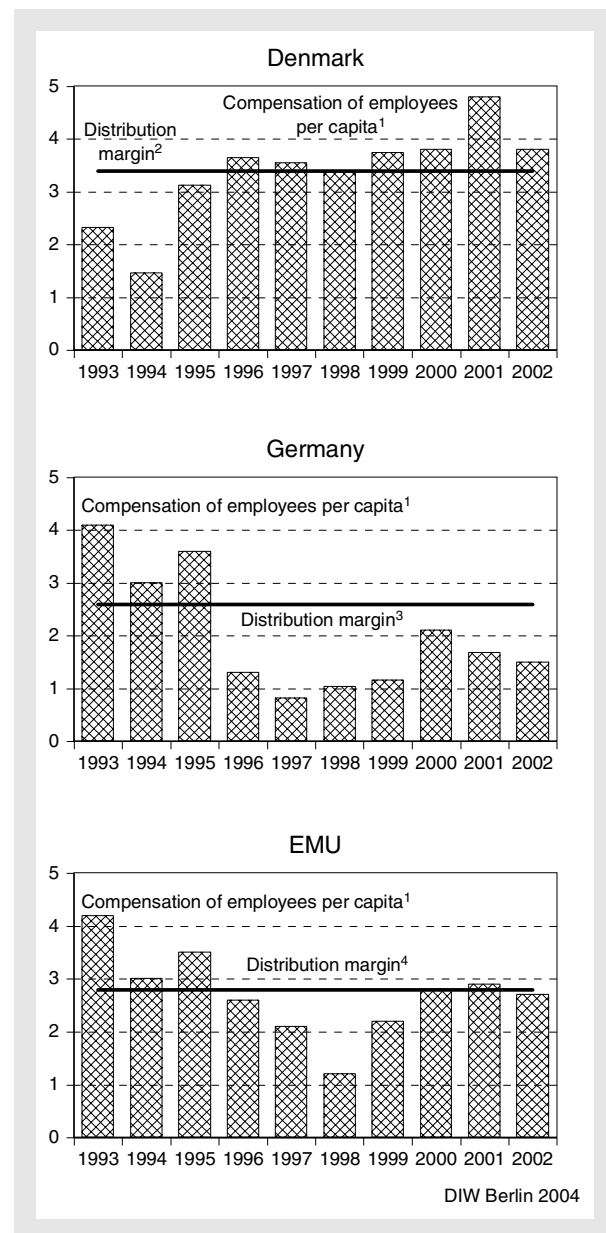
With noticeably higher capacity utilisation than in the euro zone, the rise in hourly labour costs in Denmark in the past years, at 4%, has been almost 1% higher than in the euro zone. Due to the institutional differences, administratively determined rises in wage costs by increasing social insurance contributions have virtually no role in Denmark compared with most other European countries. The increase in salaries per employee since 1995 has largely corresponded to the distribution margin, that is, the tolerated inflation rate plus the medium-term average improvement in labour productivity (cf. figure 4).⁵ Given the higher increase in productivity than in the euro zone and a similarly high national increase in unit labour costs, wage trends are therefore no area for concern. It is evident that the appropriate utilisation of the distribution margin – in contrast to Germany – has contributed to a more favourable long-term development of domestic demand. In the longer term, Denmark has achieved a high level of employment and a lower rate of unemployment without resorting to a strategy focused on wage restraint (i.e. not exploiting the distribution margin) as has been the case in Germany. Consequently, the wage ratio in Denmark has risen slightly in the past 10 years. Utilising the distribution margin has served the Danes well economically.

Labour market policy focused on increasing volume of work

Despite economic success, in Denmark, as in other European countries, possible obstacles to growth resulting from 'structural faults' are being discussed. In Denmark, the focus is less on a reduction in labour costs or specific labour market rigidities such as protection against unfair dismissal or the lack of labour motivation. Rather, for several years now the problem of demographic developments has taken centre stage. Here,

⁵ The target inflationary value was set at 1.5% – the same as for Germany or EMU in total. At 1.9%, Denmark's average rise in labour productivity was considerably higher than in Germany (1.1%).

Figure 4
Distribution Margin, 1993 to 2002



1 Change on the previous year (%). — 2 Inflation value (1.5%) plus average annual productivity improvement between 1993 and 2002 (1.9%). — 3 Inflation value (1.5%) plus average annual productivity improvement between 1993 and 2002 (1.1%). — 4 Inflation value (1.5%) plus average annual productivity improvement between 1993 and 2002 (1.3%).

Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

measures are being vigorously driven forward to permit the better utilisation of the anticipated lower labour potential as measured against the number of persons of working age.

A basic tenet of Denmark's labour market policy since the 1990s has been to be in accordance with both the right – and the obligation – to work. In an interna-

tional comparison, the originally highly favourable conditions in terms of the amount and duration of unemployment benefits paid were reduced.⁶ A number of early retirement measures were eliminated or reduced, and further reductions are being considered. As a countermove, considerable effort has been expended to make those in unemployment 'employable' through qualification and further training, to accelerate the increase in labour productivity in the long term, and to specifically support younger and foreign employees. The intention of these measures is to increase the active workforce by about 65 000 persons, or 2.5%, by 2010. In total, the number of employees – with a slight reduction in the average working time per employee – is set to increase by 3% and the measured volume of work in hours by 1.5%.⁷

To make better use of the labour force potential, a comprehensive reform of the education system was introduced in 2000. One of the distinguishing features of this reform, which affects the vocational training system in particular, is a high degree of flexibility in determining education and further training and also within individual training courses. In a comparison with Germany, it is interesting to note that initial professional training in Denmark fares considerably better and, furthermore, that costs for further training throughout professional life are decidedly more favourable.⁸ In the long term, the labour force potential will also increase as a result of the fact that school entry is being brought forward and the length of training periods is being tightened.

Economic policy: cyclically appropriate and structurally favourable

Denmark's cyclical recovery after 1993 has been due primarily to the appropriate utilisation of the distribution margins. Financial policy, too, has played a part, by initially permitting relatively high deficits and subsequently reducing these only gradually. In addition, labour market reforms were not just oriented around a widening of 'passive' incentives (such as reduced services and duration of unemployment insurance, or

increased demands in terms of geographical and professional mobility), but aimed first and foremost to provide all unemployed groups with appropriate professional opportunities, for example by supporting attainment of necessary additional qualifications and further training, thereby widening the labour force potential as much as possible. Over the entire period observed, economic growth was higher than the increase in productivity. With higher economic performance and a rapidly falling unemployment rate (until 2001) tax revenue rose while spending – especially spending linked to unemployment – fell.

The strategy of maintaining public spending increases at a low level even during longer periods of growth is particularly significant in the Danish 'model'. In contrast to the euro zone's Stability and Growth Pact, in Denmark the symmetry of financial policy action has been calculated along upturns and downturns: during longer growth periods, there is an automatic consolidation of public budgets.⁹ However, it also becomes evident that, precisely with a view to making structural reforms effective, it is useful to avoid a policy of restraint in periods of downturn or stagnation. Although labour market reforms can increase the growth potential in the long term, or assist in preventing price-hiking 'bottlenecks' during periods of boom, they cannot normally provide the initial spark for an upturn. Thus, it remains the economic policy achievement of Denmark – and other European countries (e.g., Finland and the United Kingdom) that have also been successful in employment policy – to have paid greater consideration to the anti-cyclical significance of financial policy than has been the case in many other EMU countries.

The successful short- and medium-term stabilisation of economic development permitted Denmark to set new priorities early on to overcome longer-term challenges. With regard to the problematic demographic trends (evident there as elsewhere) the focus is not on cutting services to the older generation, but rather on a greater utilisation of the growth potential, with an emphasis on raising the respective participation rates on the labour market and an improvement in the national level of qualifications. Against the backdrop of increased spending resulting from the ageing of the population, such a strategy is recommendable – since these costs can be completely or partially absorbed through higher participation in working life and greater productivity growth.

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⁶ The duration of unemployment benefits, which for typical recipients, with or without family, stood at between 76% and 87%, and were often only slightly less than net income, was reduced to four years – from previously seven to nine years (or, in some cases, an unlimited period). Cf. 'OECD Economic Survey: Denmark 2003/10'. Paris, 2003, p. 50.

⁷ This, however, assumes a fall in the unemployment rate to a mere 4.5% – a somewhat optimistic assumption.

⁸ Cf. Carroll Haag: 'Weiterbildung in kleinen und mittleren Betrieben – ein deutsch-dänischer Vergleich'. In: *MittAB*, no. 2/2003, p. 178.

⁹ The Danish consolidation strategy thus pursues a direction similar to the concept put forward by DIW Berlin for a re-orientation of the Stability Pact. Cf. (most recently) 'Economic Trends 2004/2005'. In: *DIW Economic Bulletin*, vol. 41, no. 1, January 2004.