



Economic Survey of Denmark, 2009

How can Denmark return to sustainable growth?

What more could be done to improve financial stability?

How can fiscal and labour market policies help achieve fiscal sustainability?

Why has Danish productivity slowed?

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Summary

The Danish economy has been suffering during the global crisis but beyond the projected cyclical recovery it will need to restore sustained robust growth. While the level of national income is high, the gap *vis-à-vis* the leading OECD countries has widened somewhat over the past decade. GDP gains have been driven primarily by rising labour utilisation, related to the evolution of the “flexicurity” model, with increases in both the share of the population in work and average hours worked. At the same time, however, productivity has been slowing down.

The Danish economy is currently enduring a rough ride, although less so than some of its neighbours. The effects of the global economic crisis, notably the collapse in world trade, and the impact of the downturn in the domestic property market have combined to produce the largest fall in GDP in over four decades. Monetary policy has eased and measures to relieve financial sector stress and loosen fiscal policy have been extensive:

- In the **financial sector**, government guarantees, capital injections and liquidity measures have supported the functioning of financial markets and boosted bank capital. Going forward, stress tests may help establish whether banks are sufficiently capitalised to absorb the losses that are yet to surface.
- The **fiscal** response has been vigorous, reflecting large automatic stabilisers and substantial discretionary measures, and at this point there is no need for additional fiscal stimulus. While the relaxation of the fiscal stance is designed to be temporary, further measures will be required to bring fiscal policy back on track with the longer-term targets.

This Policy Brief presents the assessment and recommendations of the 2009 OECD Economic Survey of Denmark. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee’s discussions, and issued under the responsibility of the Committee.

The depth of the recession is set to have adverse medium-term economic consequences – the first hard test of the “flexicurity” model. Rising unemployment may lead to higher structural unemployment, and falling investment will limit the contribution to growth from capital deepening. While labour demand is currently weak, the efforts to raise **labour supply** in the longer term will take on new significance. Such efforts now have to offset any medium-term impact of the crisis on labour supply, as well as meet the employment goals required to ensure sustainable public finances. The recent recommendations of Denmark’s Labour Market Commission focus on measures to raise labour supply that are broadly consistent with previous OECD *Surveys*. This *Survey* focuses on how to boost productivity:

- The **slowdown in labour productivity** is at least partly related to the rise in labour utilisation. While the policy frameworks influencing productivity are generally growth-friendly, there are opportunities to raise productivity over the medium term through action in such areas as research and development, innovation, entrepreneurship, product market regulation and taxation. The government is addressing most of these issues and recently launched a Growth Forum to explore how to improve potential growth beyond the crisis.
- Education is generally a strongpoint of the Danish economy, but the **contribution of human capital to productivity growth** can and should be raised. Key areas requiring attention are improving education outcomes in compulsory school, reducing the high dropout rate from upper secondary education and encouraging students to make the most of their capacities by moving more rapidly into and through tertiary education. ■

How can Denmark return to sustainable growth?

The Danish economy has not escaped the global financial and economic crisis. The deterioration in financial conditions and collapse of world trade, along with the ending of the property boom, have all hit Denmark hard, although GDP has not fallen as much as in some neighbouring countries. Unemployment is now on the rise, providing the first hard test of the “flexicurity” model, which to date has operated primarily in better times. With labour utilisation already high, though needing to improve further, the key here is boosting productivity, the Achilles heel of the Danish economy over the recent past. This will require maintaining the traditional strengths in the economy, described below, as well as pursuing an agenda focussed on productivity-enhancing reforms in education and the business sector.

Growth in Danish living standards has been underpinned by flexible labour and product markets, a strong social safety net and active policies to help the unemployed back into work. These measures have promoted gains in labour utilisation that have driven economic growth. Following the deep downturn of the early 1990s, structural unemployment has fallen, and labour force participation and average hours worked have risen. The employment rate is now amongst the highest in the OECD, although average hours worked are still relatively low. However, while labour utilisation has been growing, productivity has slowed. As a result, national income per capita has lost ground *vis-à-vis* the leading OECD economies.

High living standards have been achieved alongside a very equitable distribution of income, both within and between generations. A high degree of social mobility, measured by the extent to which parents’ educational attainment influences that of their children, is supported by a generally sound education system. Ongoing focus on improving educational attainment and outcomes can help maintain equity as well as boost the contribution of human capital to productivity growth, the current weak link in the economy.

In the short term, the Danish economy is in the midst of a challenging period. Danish financial markets have been under severe pressure, although they are returning to greater normality. The unique mortgage bond market has continued to function and while it has experienced some stress it has been much less affected by the sub-prime crisis than mortgage bond markets elsewhere. Banks’ earnings have deteriorated and loan losses have surged. Some 18 smaller institutions have been taken over or wound up. Sharp falls in equity prices, along with the downturn in the housing market, have led to a substantial deterioration in household wealth, although the net wealth-to-income ratio remains fairly high in a longer-term perspective. Tightening lending standards coupled with weakening demand for credit have led to slower growth in lending by financial institutions. If the measures already implemented to improve solvency and confidence in the financial sector turn out to be insufficient, credit conditions might become even tighter and act as a brake on economic activity. Interest rates spiked late in 2008 but have

retreated significantly since, in line with an easier monetary stance and improvement in financial markets.

Against this backdrop, the real economy is set to shrink in 2009 before recovering modestly in 2010. Private consumption will be restrained by diminished household wealth and rising unemployment, but supported by tax cuts, withdrawal of Special Pension Scheme savings and lower interest rates. Business investment will be held back by the scale of economic slack. While the drop in interest rates since last autumn may help stem the fall in house prices, residential investment is on course to decline further, a process that could be compounded by rising forced sales due to higher unemployment. With Denmark's export markets undergoing a major contraction, exports will be very weak. The recovery might also be slowed by the sizeable loss in competitiveness accumulated over the past few years due to strong wage growth and effective exchange rate appreciation. With the output gap widening considerably, inflationary pressure will diminish but unit labour costs and consumer prices may continue to rise more than in the euro area, further hurting competitiveness. Another risk relates to the mortgage debt taken on in recent years by some households, the burden of which might hold back consumption growth in the future.

The depth of the recession is likely to have adverse medium-term consequences for the Danish economy. Higher actual unemployment could lead to higher structural unemployment for quite some time, although less so than in many other OECD countries due to low long-term unemployment and strong active labour market programmes. Also, the depth of the downturn in investment means that the contribution to GDP growth from additions to the capital stock will be lower than normal for a few years. Furthermore, there could be effects from reduced investment in R&D. Since growth in potential employment is expected to be weak due to a reduction in the working-age population, this means that the growth potential of the economy will be subdued for a number of years. Taking into account these various effects, potential output growth is expected to decline from 1.7% on average over 2006-08 to 0.5% in 2009-10 and 1.1% in 2011-17. ■

What more could be done to improve financial stability?

Financial sector policy measures to deal with the crisis have been extensive. A key measure was the creation of a bailout fund by the government and the Danish banking sector that serves to guarantee all claims of unsecured creditors on participating banks. Only if the total loss were to exceed DKK 35 billion would this guarantee entail government payments. The government also established a new process for dealing with institutions whose capital falls below statutory minimum levels and offered capital injections to boost capital-adequacy ratios. In addition, the Central Bank has taken a number of initiatives to improve financial system liquidity. These measures are likely to significantly reduce the risk of widespread insolvency even under scenarios of great stress. However, if used to their fullest extent,

they imply that the government could end up as a significant owner of equity in some banks. Furthermore, the measures will probably only stem the slowdown in lending to some extent since demand for financing will be curtailed by the drop in investment and lower house prices while lending policies in any case become more cautious when growth prospects are weak. Detailed “bottom-up” stress tests, involving the financial institutions themselves, would help establish whether financial institutions are sufficiently capitalised to absorb the losses arising from impaired loans.

In the medium term, significant changes are likely to stem from international efforts to bolster financial system regulation. A specific issue for Denmark will be how to reduce the pro-cyclical capital requirements for the new type of mortgage bonds, which require extra capital when house prices are falling. The regulatory resources to supervise medium- and smaller-sized institutions have been increased and it will be important to ensure that they are adequate. ■

How can fiscal and labour market policies help achieve fiscal sustainability?

Denmark entered the recession with a strong fiscal position and a sound fiscal policy framework. Large budget surpluses in recent years have reduced debt – indeed, the government had a positive net asset position of about 5% of GDP in 2008. Fiscal targets are set according to a medium-term framework based on fiscal sustainability assessments. Therefore, discretionary policy measures are likely to be credible in the eyes of financial markets. Danish automatic stabilisers are the largest in the OECD, implying a smaller need for discretionary policy measures. Nevertheless, given the depth of the recession, significant discretionary measures have been taken. Tax cuts, which were decided well before the crisis, took effect in 2009. Public consumption will increase quite sharply. Government investment spending has been brought forward. A major tax reform package was legislated in early 2009, aimed at raising labour supply and reducing the government financing gap in the long run but providing demand stimulus in the short run. And release of funds from the compulsory private Special Pension Scheme has significantly eased households’ liquidity constraints. Signs of improvement in the economy and the substantial deterioration in the fiscal position already expected suggest that there is no need for additional fiscal stimulus, although with a highly uncertain environment it should not be completely ruled out. Looking ahead, discretionary measures will be required to bring the structural budget balance back in line with the government’s 2015 fiscal targets. Spelling out targets for the intervening years and identifying some specific consolidation measures would help.

With unemployment on the rise, the short-term focus of employment policies will need to be on maintaining job search efforts and keeping people attached to the labour market to prevent a rise in structural unemployment. With weak labour demand, unemployment spells will lengthen, so a larger proportion of the unemployed will end up participating in activation

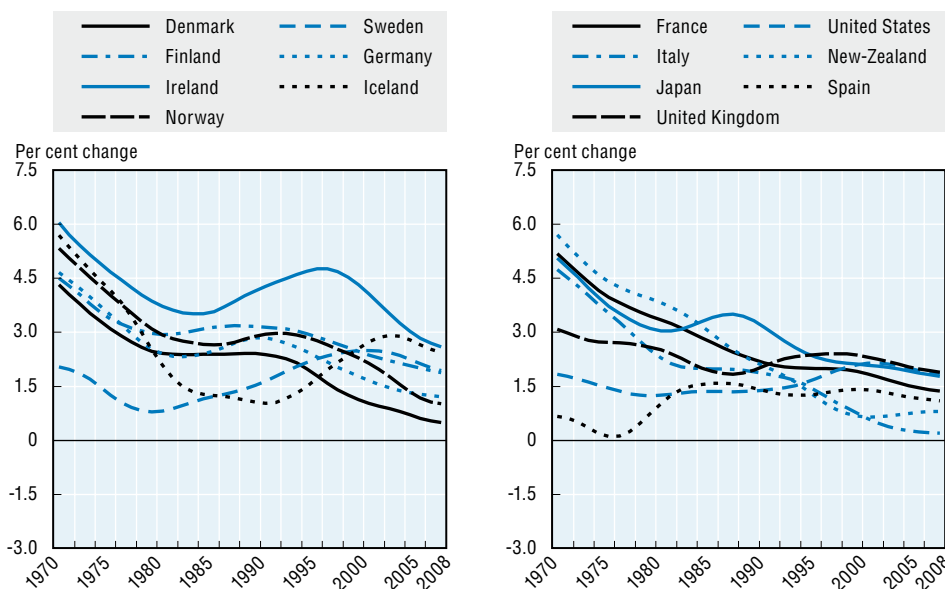
programmes. It is important that public sector job centres have sufficient resources to deal with the rise in unemployment. The decentralisation of all functions of the public sector job centres to local governments should be carefully monitored to ensure that effective services are delivered to an increasing pool of clients. At the same time, there is less risk of unemployed people missing out on a job because they reduce search effort due to the time commitments of participating in activation programmes. This calls for careful targeting of training programmes and job placements to steer the unemployed to those programmes that are most likely to be effective.

For the longer term, the recommendations of the Labour Market Commission will be more important now than ever – if structural unemployment rises in response to the crisis, the government’s long-term goals for fiscal sustainability will be even more difficult to achieve. As unemployment rises, it will be important to avoid policies that restrain labour supply, such as job-sharing measures that may be hard to reverse once labour demand picks up again. ■

Why has Danish productivity slowed?

Labour productivity, or GDP per hour worked, has decelerated markedly since the early 1990s. While this trend is also evident in a number of other OECD countries, productivity growth in Denmark is now lower than in many comparable countries. This has put a brake on the process of catching up to the GDP per capita levels of the leading economies. While some industries have bucked the trend, the slowdown is evident across much of the economy.

Figure 1.
LABOUR PRODUCTIVITY GROWTH IN DENMARK HAS SLOWED TO WELL BELOW THAT IN OTHER OECD COUNTRIES¹



1. The growth of GDP per hour worked has been smoothed using a HP filter (lambda = 100) and the series shown are the annual growth rates of the smoothed series.

Source: Statistics Denmark National Accounts, Tables NAT02 and NAT18 and OECD Productivity Database.

Furthermore, the large size of the public sector, where measured productivity growth is nil for statistical reasons, cannot explain the slowdown.

The slowdown in labour productivity has coincided with a trend rise in employment and, to a lesser extent, hours worked. These developments may be related. It takes time for the stock of capital to adjust to higher labour supply. In addition, newly-employed workers might have lower human capital than existing employees. The overall skill level of the Danish workforce has been growing more slowly over the past decade. Even highly-skilled people who have recently moved into the workforce may take time to attain the productivity levels of their colleagues. The slowdown in the contribution to growth from capital deepening seems consistent with a lagged adjustment to higher employment. However, these factors probably explain less than half of the observed slowdown in labour productivity growth.

The remaining portion of the productivity slowdown is harder to explain. This is particularly true since the policy factors that are thought to underpin strong productivity growth are generally sound in Denmark. Furthermore, policy changes have moved in the direction of higher productivity, rather than working against it. Still, the expected slowdown in potential output calls for renewed focus on policies to lift Denmark's productivity performance and ought to be a key focus of the government's recently launched Growth Forum. ■

Which policies can help reinvigorate productivity growth?

Measures can be and are being taken in a number of policy areas to boost productivity growth. The planned increases in infrastructure investment might add to potential growth in the medium term and, as they have been frontloaded, they will help pull the economy out of recession. The recent income tax reforms, which cut marginal tax rates for all income levels, should encourage greater efforts to develop human capital and might make it easier for Denmark to attract and retain talented foreign workers. It is important that these reforms are not reversed. More efficient processing of immigration applications could boost the pool of potential new entrepreneurs. In addition, targeting of entrepreneurship support should attempt to capture all high-growth-potential firms, regardless of their age. Entrepreneurship education needs continued attention, particularly in ensuring that students get experience in work as well as time to develop their own business ideas. Finally, while product market regulation is relatively liberal, further reforms could boost the economy's flexibility. OECD product market regulation indicators suggest the need for measures in licensing procedures, planning of retail outlets and access in the legal services industry.

Human capital is important to productivity performance for a number of reasons. In general, increasing skills can lead to restructuring of production towards activities with higher value added. The right training can boost the likelihood of success as an entrepreneur. Human capital is important for R&D, both in undertaking research but also in having the skills and knowledge

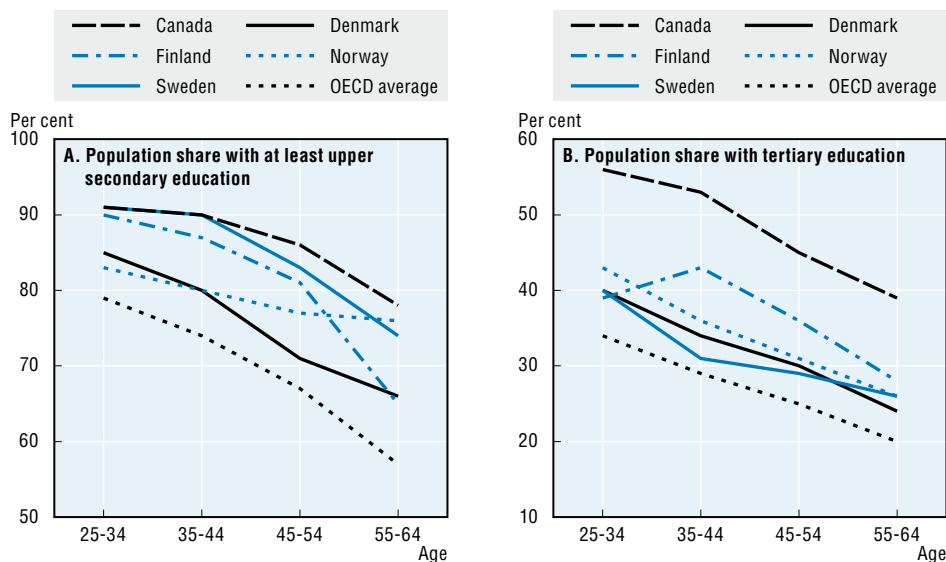
to implement new technologies and methods in the workplace. Moreover, higher-skilled workers might be more flexible and able to adapt more easily to new environments. ■

How does the educational system perform?

Human capital has traditionally been considered a strong point for the Danish economy, not least thanks to the quality of life-long learning. However, educational achievement studies have indicated that Danish education outcomes were not as good as generally perceived, or as could be expected given the considerable resources available. Also notable in international comparison are the high rates of dropout from upper secondary education, particularly for immigrant children, and the high average age of completion of tertiary education. The latter reflects primarily long gaps between completion of secondary school and entry into tertiary studies. In light of the results on educational attainment, a number of measures have been taken in recent years. These have focused on strengthening the education content of the earliest years in the formal school system, increasing reporting of individual education progress, promoting an evaluation culture, and boosting Danish language training for immigrants. Recent survey results indicate that children at age 10 or 11 have better skills today than five to 10 years ago.

The distribution of hourly wage earnings has narrowed over the past quarter of a century, due to relatively strong wage increases for low-income earners. Over time, education has become more important in determining individual

Figure 2.
EDUCATIONAL ATTAINMENT IS RELATIVELY HIGH IN DENMARK
In 2007¹



1. International comparisons are all based on the ISCED classification of educational programmes as applied in the OECD *Education at a Glance* publication. In ISCED, the concepts of upper secondary and tertiary education tend to be wider than the similar Danish concepts used in national statistics. Based on the national concepts underlying this figure, the share of 35-44 year-olds having completed secondary and tertiary education, respectively would be only 80% and 34% in 2007, i.e. lower than when based on the international comparable concepts.

Source: OECD (2009a), *Education at a Glance*.

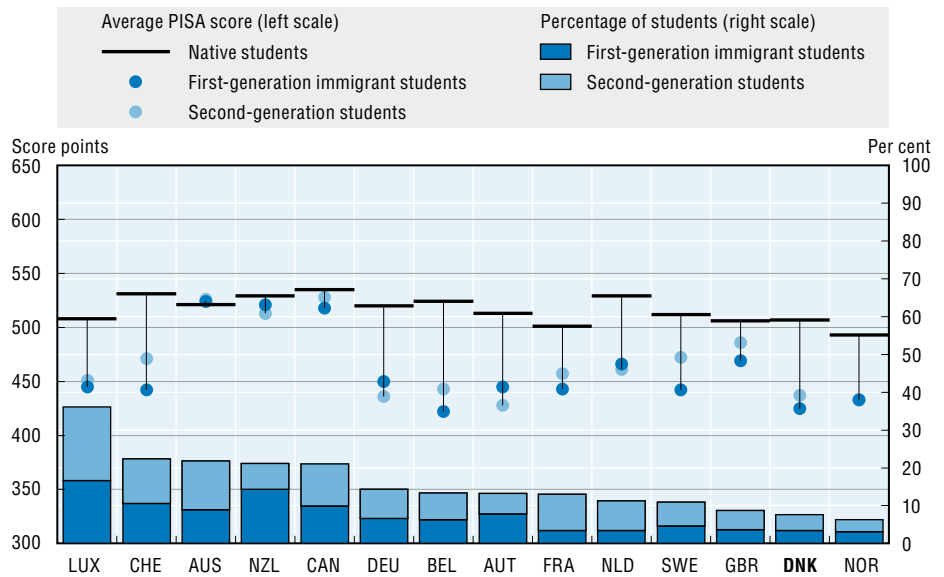
earnings, while age and experience are now less important. This suggests the need for a strong general level of education that can support a flexible and adaptive workforce. While the overall wage distribution narrowed in the 1980s and has not changed much since, relative wages have risen for the most highly educated. ■

How can pre-school and school performance be improved?

The pre-school class offered for six-year-olds before commencing formal primary school has now been made compulsory and the educational content of this year has been strengthened. In addition, language testing has been introduced at ages three and six to identify children who might require extra assistance with language development. However, there is still scope for improvement in early childhood learning. Recent reforms of the voluntary 10th form (for 16-year-olds) have strengthened its educational content and provided opportunities for students to try out vocational education pathways to help them make better career and study choices. Targeting the 10th form more carefully towards the weakest students would release resources that could be better employed elsewhere in the education system and may speed up entry into further studies. This can be expected to contribute to the trend decline in the share of students attending 10th form, which has fallen below half.

Additional training is being introduced for both teachers and school administrators to bolster education quality. Continued efforts are needed

Figure 3.
HOWEVER, LEARNING OUTCOMES FOR IMMIGRANT AND NATIVE STUDENTS ARE RATHER POOR
Average for reading, mathematics and science scales, PISA 2006¹



1. Only including countries with at least 3% of students in each category.

Source: OECD, PISA Results 2006.

to build a “culture of evaluation” and to strengthen school leadership. A long-term goal might be to use the outcomes of both educational quality reporting and compulsory national testing of students in carrying out the performance assessment of teaching and schools. The ensuing contestability might yield quality gains. There might also be scope for attracting and motivating high-performing teachers via more pay flexibility. This could be achieved through an accreditation scheme, where completion of professional education programmes could attract higher remuneration.

The number of youth dropping out from upper secondary education presents a major challenge to achieving the government’s ambitious goals for secondary school completion rates. Reviewing the diverse array of paths available in secondary education is necessary, particularly to ensure that vocational programmes provide a solid basis of education to allow graduates to retrain later in life if necessary. At the same time, introducing practical components earlier in vocational programmes could reduce dropouts by people who are less academically and more practically inclined. More information about labour market outcomes for recent graduates could also help youth make better study choices.

There is also a case for extending the special welfare benefit arrangements applying to people under 25 to all those aged less than 30. The youth regime applying to under-25 year-olds involves reduced unemployment insurance and social assistance benefits and stronger focus on education or activation. This approach has clearly reduced inactivity amongst young people. ■

How can more timely completion of tertiary studies be encouraged?

In the tertiary system, average completion times have fallen slightly over the current decade, but students are taking a long time to move from secondary to tertiary education, primarily owing to periods of work rather than being out of the labour force. As a result, the median age of students when they start tertiary education, at over 22 years, is the second-highest in the OECD. This generates significant foregone tax revenue, to the extent that swifter entry into, and completion of, tertiary education would lead to higher lifetime earnings. Measures are being introduced to encourage more timely completion, including making it easier to enter tertiary education if students move quickly from the secondary level and providing universities with more incentives to promote on-time completion. The recent tax reforms, which reduce high marginal tax rates, should raise the returns to education in the long term. However, the recent measure allowing students to earn more from work before losing some public grants might not encourage timely completion. Reducing the generosity of study grants, particularly if studies are prolonged, would encourage shorter study time.

In the long term, particularly if the overall tax burden on higher incomes continues to fall, a system of tuition fees for Danish and EU students, combined with income-contingent loans, might encourage quicker completion and help students make better study choices. This would encourage

competition, and therefore efficiency, among universities and give them more flexibility to design innovative courses and programmes to meet demand. Furthermore, moving towards general tuition charging would give universities better conditions to develop attractive offers for foreign students, at lower cost to public finances. ■

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Economic Outlook No. 85, June 2009.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2009 edition.

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