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The Danish labour market and
wage formation process

Preface

The term "Nordic model" is used in many contexts, including labour market systems and wage formation processes. This is the historical approach. In the 1990s, however, changes occurred. Nordic countries have nowadays increasingly country-specific characteristics. A very good example of this is the Danish labour market of today – the topic of the present paper.

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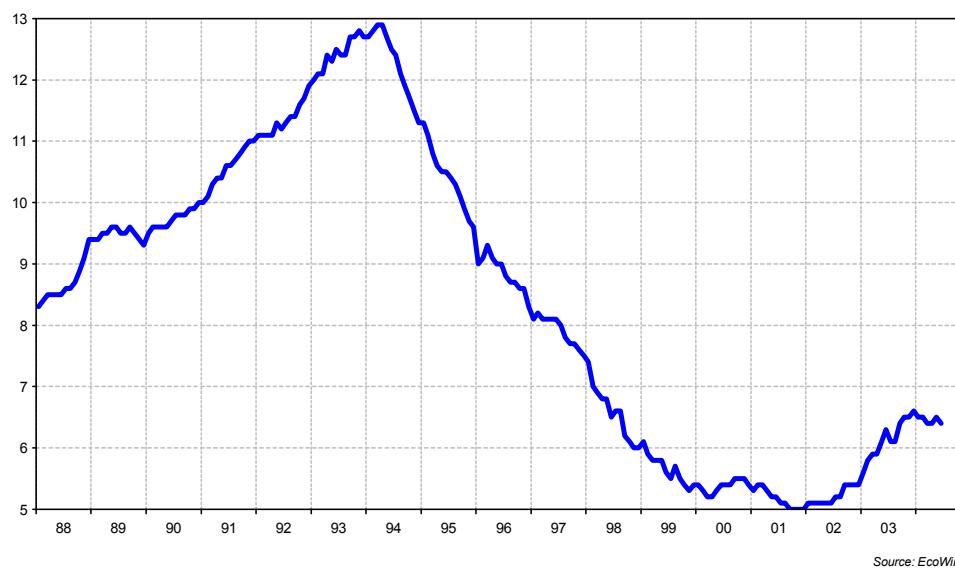
1. Historical background

Denmark has experienced a major historical change in its production structure. Employment within agriculture and industry has fallen substantially. In contrast, employment within private and public service has increased. Arbejderbevægelsens Erhversråd (2003, 46) predicts a continuous development in this direction in its forecast until 2010.

Labour market policy was not very active up to 1994. The focus was mainly on income maintenance for people being unemployed. During the 1970s and 1980s, unemployment benefit levels were very generous. Early retirement schemes were also attractive. Fiscal spending on active labour market measures was, however, limited. In the 1980s, the conservative government therefore launched a number of labour market initiatives. At the end of the 1980s, a couple of years after the introduction of policy initiatives, the number of individuals depending on support began to rise again because of weak economic growth (Holm 2001, 1-2).

At the beginning of 1990s, the unemployment rate was very high, more than 12 per cent in 1993 and 1994 (*Figure 1*).

Figure 1 **Unemployment in Denmark (percent)**



When the Social Democrats came into power in 1993, the emphasis shifted dramatically towards the creation of a more efficient labour market policy through active labour market training. Unemployment should no longer be accepted as one's destiny. Much more should be done to get unemployed Danes onto the labour market.

One important factor, which most likely has affected the functioning of the Danish labour market, is the successful conduct of the fixed exchange rate policy since 1982. In this respect Denmark differs from her Nordic neighbours. The absence of the opportunity to devalue the currency has probably contributed to reforms which have increased labour market flexibility.

2. The labour market system

2.1 Falling unemployment

During the first half of the 1990s, wage increases in Denmark were moderate compared to unified Germany but somewhat above wage increases, say, in France. The main reason for this was a general reduction in the Danish inflation rate since the 1980s. The rise in Danish prices was weaker than the development in wages. This implied - despite the low nominal wage increases - rises in real wages.

Between 1990 and 1994, the average annual nominal increase in wages in Denmark's business sector was 3.6 per cent according to OECD statistics. The average annual rises in real earnings were 1.1 per cent during the same period. The corresponding figures for the periods 1995-2000 and 2001-2005 are 3.5 and 3.2 per cent for nominal wages and 1.4 and 1.2 per cent for real wages.

It might be interesting to add that average GDP growth during these three periods was 1.6, 2.7 and 1.5 percent, respectively. Consequently, wage increases during, for instance, the second period were relatively dampened when considering growth compared to the early 1990s. However, wages seem to be rising somewhat too much in the period 2001-2005 compared to the moderate growth expected by OECD.

Table 1 Employment rate in Denmark

Av 1982-84	Av 1992-94	2002	2003	2004	2005
72.2.	73.7	76.6	75.8	75.8	76.1

The employment rates are calculated as the ratio of total employment to the population of working age. The working age population includes all persons between 15 to 64 years.

Source: OECD (2004, 234).

Since 1994, there has been a decline in unemployment in Denmark (*Figure 1*). This fall in the unemployment rate is, according to Danish experts, due to two developments: better growth in the Danish economy and more active labour market reforms. It is also worth mentioning that there has been an increase in the employment rate by approximately two percent during the past ten years (*Table 1*). The employment rate in Denmark is one of the highest among the OECD countries. Despite these improvements, it should be taken into account that the Danish labour force participation rate has more or less stagnated since 1994.

2.2 Institutional changes in the labour market

Labour market reforms were an important part of the Social Democratic government's economic programme when took office in 1994. The reforms were consequently continued in later years by governments with a different composition. The reforms aimed particularly at the creation of incentives for entering the labour market. Some important details are worth mentioning.

- *The criteria for receiving unemployment benefits became stricter.*

Being registered as unemployed and receiving benefits for unemployment have become clearly stricter in the past decade. For instance, a job has to be accepted no later than one year after having been registered as unemployed. Terms have become harder when calculating employment periods. For example, at least 52 weeks of employment are required within the last three years in order to qualify for unemployment benefits.

- *The availability and eligibility criteria have been tightened.*

Active labour market programmes (ALMP) can be seen as a more effective way of testing the actual availability of the unemployed to get back to work. Consequently, ALMP made it less attractive for unemployed people to get public benefits for unemployment. The possibility of renewing eligibility for unemployment benefits after participating in active labour market measures was cancelled. Until 1994 it was possible for unemployed people to renew entitlement through participation in particular labour market measures (Det Økonomiske Råd 2002, 4-7). However, losing eligibility does not mean that people being affected by this suffer from financial misery. They can still receive cash benefits as a last resort.

These reforms have been considered as major structural progress by many economists. The modification of the eligibility rules increases incentives for the unemployed to seek qualified assistance in order to get a job after the entitlement period runs out.

- *A distinction between different types of the unemployed was made.*

A new definition of unemployment was formulated, containing three different kinds of unemployment:

- individuals only in need of job seeking assistance
- individuals in need of new qualifications
- individuals with other problems than just unemployment.

The unemployment offices shall, on an individual level through personal interviews, determine what types of problems a particular unemployed individual faces. Together with the unemployed individual, the unemployment office then shall decide on the timing and the type of measures needed (Holm 2001, 2-3).

- *The definition of unemployment in terms of active labour market policy changed.*

Before the reforms that started in 1994, four years of unemployment were necessary in order to be covered by active labour market measures. The period of unemployment has been cut to one year (Holm 2001, 2). Obviously, this cut was intended to help the unemployed to faster receive necessary assistance and skills in order to find new jobs.

- *A reduction in the maximum unemployment benefit to four years from previously seven years.*

This change has to be regarded as a major step toward getting the long-term unemployed to seek a job more seriously.

One aspect of the Danish employment protection system that is unusual for the Nordic labour market scene is widely referred to as the Danish “*hiring and firing*” model. It resembles the American rather than the European system. The purpose of the model is to make the hiring and firing process as frictionless as possible. Some consequences of the model are worth mentioning:

- Its implementation has clearly resulted in an increasing flexibility on the Danish labour market and in the creation of more enterprises and jobs.
- Its existence has been accepted by the unions.
- "*Hiring and firing*" is based on agreements between social partners, not on legislation.
- Layoffs can take place any time, although most frequently a 3-month notice is applied.
- The employers do not need to justify their actions to any great extent.
- The model is being used in all sectors. It is important that it can be applied also to newly employed civil servants.
- Today, "*hiring and firing*" is not a controversial subject. It seems to have gained public support.

The "*hiring and firing*" model in Denmark has certainly resulted in weaker job protection. According to comparisons made by the OECD, individual job protection is only less applied in the USA, Great Britain and Switzerland. It is a fact that a lot of employees in Denmark lose their jobs each year. Despite uncertainty about keeping their jobs, Danes seem to feel rather secure in terms of employment. The OECD explains this security by referring to the fact that the unemployment benefits in Denmark are the most generous in the world. OECD has chosen the term "*flexicurity*" to describe the combination of flexibility and protection characterising the Danish labour market.

2.3 Some further characteristics of the Danish labour market

A typical feature of the Danish labour market is the view that social partners are in the best position to agree on wages and working conditions on their own. Government intervention is only required if the social partners are not able to solve problems in a responsible manner. The reason for this limited or theoretical governmental intervention option is the fundamental position that the social partners can – and should – make the wage agreements most effectively on individual enterprise levels.

Another interesting characteristic of the Danish labour market according to many Danish experts is its strong relationship to the growth performance of the economy. The negative development of, for instance, young people's participation in the labour market in 2002 and 2003 can be seen as a result of the weakening economy. However, this negative trend is expected to be slightly reversed in 2004 and 2005 as better economic conditions should affect employment in a more positive direction (Finansministeriet 2004, 103).

Notifications of sickness in Denmark amounted in 2003 to roughly 5 percent of the labour force being absent from work at any point of time. During the first two weeks of sickness – a period that includes almost 50 percent of the sickness periods – the employers are responsible for payments. The period in which workers are entitled to the sickness benefit is conceptually limited to 12 months. After that, the full costs of sickness benefits are under the responsibility of the municipalities. About 45 000 people were on sick leave for a period of 26 and 52 weeks in 2001. The corresponding number for sick leaves for more than one year was 15 000 (OECD 2003, 71).

2.4 Trade unions and employers' organisations

The Danish model is very much characterized by the eminent importance of agreements between the social partners and the limited number of legal acts that regulate the relationship between employers and employees. By tradition, the national wage agreements extend to more than one year.

As in other Nordic countries, the labour market in Denmark is highly organised. More than 80 per cent of all employees are members of a union. Between 1993 and 2003, union membership increased by 1.7 percent at a time when unions in many other countries were affected by declines in membership numbers (EIRO 2004, 3). It seems to be possible that this increase indicates public support of the labour market changes that have been taking place in Denmark during the past ten years.

The Danish central trade union, Landsorganisation i Danmark (LO) does not have the right to control the collective bargaining process of its affiliated unions. The situation is different on the employer side, where the central organisation, Dansk Arbejdsgiverforening (DA), has to approve collective agreements between affiliated branch-level federations and their respective trade unions.

In recent years, both trade unions and employer organisations have changed their organisational structures towards fewer but larger and more influential organisations.

For example, an important trade union for the manufacturing industry is the Centralorganisation af industriansatte (CO-industri), which today comprises 13 national branch-level federations. Issues such as national agreements and labour disputes affecting its members are of

great importance. During the past decade, CO-industri has increased its influence on the Danish labour market substantially.

3. Collective bargaining and wage agreements

The Danish wage formation process has clearly its own characteristics compared to other Nordic countries. This makes studies of the Danish experience particularly interesting.

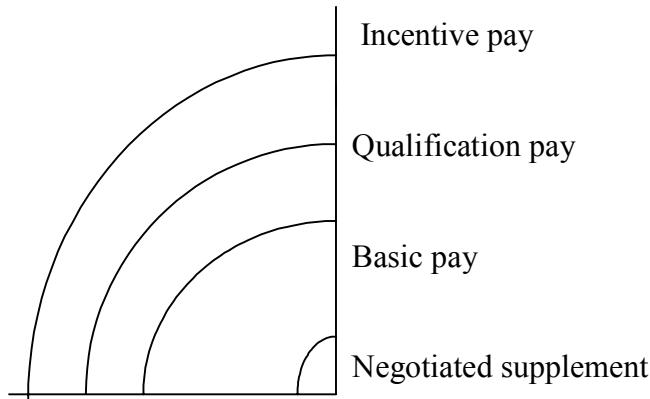
In theory – which sometimes is called the Danish model – wage agreements are the outcome of tripartite agreements between the social partners and the government. However, government intervention is usually avoided.

More recently, there has been a shift in the Danish labour market from centralised towards more decentralised wage bargaining processes and agreements. This transition from a centralised to a more decentralised labour market is the result of requirements on increasing flexibility and adjustment to local or corporate specific conditions due to international integration and technological changes (Andersen 1999, 1-2).

During the 1990s, a debate between the social partners about the impact of new technology on pay systems intensified. As a result, the parties at the central level developed a new pay system model called “*Pay system of the 1990s*”. It implied that a pay system could be adjusted to and implemented locally on the firm level.

The “pay system of the 1990s” consists of four elements (*Figure 2*). *Negotiated supplements* means that the central agreement regulates issues such as compensatory payments for inconvenient working hours, shift work, overtime etc. A significant part of earnings is the *basic pay*, which is fixed and the same for all employees. *Qualification pay* comprises nine factors, such as training, required skills, responsibility, flexibility, efficiency, etc. Not all nine factors are necessarily being used. It is more common on the firm level to apply two or three of these factors. The factors that are used depend to a large extent on the individual work and the employer (firm) as a whole. *Incentive pay* is the last part of the pay system model. Its objective is for the employees to work more efficiently and thereby increase the firms’ profitability (Nilsson and Olsson, pp. 95-96).

Figure 2 Pay system of the 1990s



Collective bargaining at the central level still includes different kinds of general frameworks. This should not give the impression of perfect harmony. Discussions between social partners can be very tough. It also can be added that wage and labour market agreements tend to have a number of renegotiating clauses.

LO and DA have a main agreement (Hovedaftalen). It entails, for instance, overriding rules for minimum wages, pension terms, sick pay, parental leave conduct etc. In 2004, a new deal on minimum wages was achieved (implying an increase from 88.40 to 95.15 DKK, that is from 11.89 to 12.79 EUR) within the forthcoming three years). Minimum wages cannot be considered as low by international standards.

The first finalization of collective agreements is usually in the metal industry. The public sector's adjustment to the private wage deal usually occurs with a lag of one year. However, this adjustment of the public sector is usually not done by 100 percent. The effectiveness of this system could be a topic for further research.

Historically, guidelines for wage increases in Denmark have been domestic price expectations and wage increases in Germany. During the period 1985-1997, the average rise in labour costs in the manufacturing industry was 4.6 percent in Denmark and 4.7 percent in Germany. The trade union for the manufacturing industry, CO-industri, aims to achieve wage increases which correspond to inflation and productivity growth. Agreements should aim at maintaining the good competitiveness of Danish industry (Nilsson and Olsson, 84-88).

An example of a collective agreement is the one proposed for the industrial sector during the first quarter of 2004. It should be observed that this wage deal has both a substantial central and a major local content.

The *central* part: This interesting new agreement extends over a period of three years. It includes, among other details, increases in pension contributions (from 9 to 10.8 percent), the extension of the period with full wages during maternity leave, and a yearly increase in the minimum hourly wage (DKK 2.25 each year; after three years the minimum hourly wage will be DKK 95.15). Furthermore, higher inconvenience bonuses, higher public-holiday payments and higher wages for apprentices are covered in the new agreement.

The *local* part: The new wage deal contains even more decentralization. An important consequence of the new agreement is the possibility of local negotiations between employers and employees about varying working hours and its individual and not only company-wise application.

The social partners assume that the centrally negotiated part of the new wage agreements increases costs for business enterprises by just below 1 per cent per annum, which seems to be bearable. Consequently, when adding up both central and local agreements, the National Bank and OECD expect some dampening of the relatively high rate of wage increases that have been taking place in Denmark for some years (Danmarks Nationalbank 2004, 16-17 and OECD 2004). However, the ultimate development in costs will depend on the final results of local negotiations in individual enterprises.

4. Wages and competitiveness

Since the mid-1990s, business enterprises' total wage costs in Denmark have been rising at a faster pace than in other competing countries, despite all the reforms. But it cannot be said how developments would have been without the improvements on the labour market. In any case, Denmark has enjoyed a lower unemployment rate and higher employment rate than most other EU countries.

Table 2 Compensation per employee in the business sector
% per annum

	1999	2000	2001	2002	2003	2004	2005	1999-2005
Denmark	3.0	3.7	3.4	1.8	3.9	3.5	3.4	3.2
Euro area	1.3	2.4	2.5	2.3	2.3	2.2	2.2	2.2
Germany	1.0	2.2	1.8	1.5	1.6	1.3	1.6	1.6
France	2.1	1.8	3.0	2.5	2.6	2.8	2.9	2.5
Finland	2.3	4.2	5.2	1.3	3.5	3.6	3.9	3.4
Sweden	0.9	7.6	4.5	2.2	2.0	2.8	4.0	3.4
United Kingdom	4.7	6.2	5.0	2.8	4.3	5.2	4.7	4.7
USA	4.5	6.8	2.6	2.1	3.0	4.3	4.8	4.0
Norway	6.2	4.7	6.3	5.7	4.3	3.8	4.2	5.0

Note: OECD defines the business sector as the total economy less the public sector.

Sources: OECD (2004)

The table above shows that wage compensation in previous years, with the exception of the year 2002, have been higher in Denmark than those in the euro area. A similar development in the euro area is to be expected according to the forecasts for 2004 and 2005. The present situation is different from the one of the end of the 1990s when the depreciating effective krone (DKK) could counteract the effect of high increases in Danish wages. This time, the stronger DKK limits the scope for local wage increases for competitive reasons. However, productivity is not considered in this part of the analysis.

When having a fixed exchange rate, relatively high rates of wage increases must be offset by a strong increase in productivity in order to not weaken competitiveness relative to foreign countries. In the second half of the 1990s, productivity development in Danish economy was weaker than in the euro area on average, although in the business sector productivity growth was somewhat higher than in the euro area during the same period (OECD 2004). At the same time, Danish wage compensation in the private sector rose faster. This led to an increase in the unit labour cost and a marked deterioration of Denmark's competitiveness relative to the euro area.

Table 3 Unit labour cost in the total economy
% growth per annum

	Average 1996-2000	Average 2001-2003
Denmark	2.0	2.6
Euro area	1.0	2.4

Compensation per employee divided by productivity per head. Labour productivity is defined as GDP in volume divided by total employment.

Source: European Commission

Starting in mid-2000, nominal wages in Denmark continued to rise faster than in the euro area. However, the situation had changed somewhat. Productivity increases for the whole economy strengthened, caused mainly by a weaker development in employment than in the years before (Danmarks Nationalbank 2004, 17). This increase in productivity was not high enough to offset the increase in the nominal wages. During the period 2001-2003, the increase in the unit labour cost in Denmark was higher than in the euro area. This clearly indicates a continuation of the loss in Denmark's competitiveness previously mentioned.

5. Advantages of the current wage formation and labour market system

Denmark is often considered to be a positive exception to inflexible European labour markets. Some important positive examples should be particularly mentioned.

- *Local wage bargaining and local decisions on certain labour market topics.*

Denmark is a country that has transferred a lot of wage and other labour-related matters to local social partners such as working time, telework and training. According to this year's industrial deal, the local parties may even renegotiate central agreements. Firm-specific realities are hence taken seriously.

- *Increased influence of local unions.*

The unions have extended their local power for some time already but a further considerable increase of local influence has occurred as a consequence of this year's industrial wage round.

- *More pressure on the unemployed to actively seek a job.*

Today the Danish unemployed have much stronger incentives to search for a job than a decade ago. This is one of the biggest changes on the Danish labour market, which obviously contributed to a declining unemployment rate.

- *"Hiring and firing".*

"Hiring and firing" processes are part of the Danish labour market, which certainly is positive from a flexibility point of view and in terms of the expansion and creation of small enterprises.

6. Remaining problems and future challenges

6.1 Problems

- *Still too many people not searching for jobs.*

There are still 900 000 people of the working population outside the regular labour market. Many experts claim that the economic incentives for seeking a job are still too weak, despite all the reforms so far. The pressure on the unemployed is relatively high. However, the average unemployment compensation for low-wage earners is still 90 per cent. For high-wage earners the replacement ratio is, however, considerably lower.

- *Still attractive early retirement conditions.*

In 1979, an early retirement benefit scheme was introduced for members of unemployment insurance funds between 60 and 66 years of age (Voluntary Early Retirement Benefit, VERB). Since that time, the number of people participating in the scheme increased steadily, causing many exits from the labour market. VERB does not link its early retirement scheme to reduced working ability. Today, VERB still exists, but other similar benefit schemes were abandoned or restricted as labour market conditions improved (OECD 2003).

There are Danish experts who still find the early retirement system in Denmark too attractive. This position is explained by the ongoing increase of recipients in previous years, which amounted to 177 000 people in 2003 (Arbejderbevægelsens Erhvervråd 2003, 38).

- *Lagging integration of immigrants.*

Many immigrants find it difficult to get a job in Denmark. It is especially hard for low-skilled foreigners to participate in the Danish labour market. The generous social benefits have caught many of these immigrants in a benefit trap. Furthermore, Denmark still has a problem of attracting high-skilled foreigners.

6.2 Reform plans and future challenges

- *Expanding the labour supply to ensure fiscal sustainability.*

With an aging population and the challenge of rising income transfers and expenditures for the elderly, fiscal sustainability and fiscal health will become increasingly important in the future. The government is therefore focusing on reducing public debt and increasing the labour supply in order to expand the tax base and to alleviate the burden of transfer payments (Arbejerbevægelsens Erhversråd 2003, 5-14).

- *Improvements in education, labour market entry and human capital formation.*

A significant proportion of Danish students have jobs while they are studying. These jobs in combination with studies delay entry into the labour market. Measures to increase the economic incentives for Danish students to start their tertiary studies earlier or to finish them more quickly would be desirable. Due to this relatively late entry into the labour market, adults in Denmark spend nowadays fewer years in the labour force than adults in many other OECD countries (OECD 2003, 51-53). Encouraging students to finish their studies at a younger age and spend more time in employment could be one of the solutions to expand the labour supply.

- *Further economic incentives to participate in the labour market.*

First, the OECD (2003) points out some interesting methods to increase economic incentives for the unemployed to more actively search for jobs and decrease the duration of unemployment. These include a reduction in the maximum duration (at present four years) of unemployment insurance, a gradual decline in benefits based on uninterrupted unemployment and implementing longer work requirements before being able to qualify for full unemployment insurance benefits.

Second, the government has adopted cuts in income taxes from 2004 to 2007. These tax cuts provide an earned income tax credit to all workers by raising the threshold for the intermediate tax rate once the full implementation of the agreed tax cuts is made. It is important to note that the top tax rate remains at a high of 63 percent and applies to almost 40 percent of full-time workers.

The purpose of the reduction in income taxes is to increase the incentives for people to join the workforce. The Danish economy is however, closing its output gap. Consequently, experts such as the “wise men” suggest a reduction in income taxes starting in 2004 only if it is financed by cuts in outlays or increases in other taxes (Det Økonomiske Råd, 2002).

Another step to increase participation in the labour market is the government’s “More People at Work” package announced in autumn 2002 which was passed by the parliament in 2003. The package entailed changes in different areas such as the harmonisation of schemes, a faster and more direct process towards employment, simple and active programmes, a special concentration on young people and people over 50, etc.

- *Increase in the effective retirement age.*

When the Voluntary Early Retirement Benefit (VERB) was reformed in 1999, Denmark lowered its age of entitlement from 67 to 65 years. Such a decline stands in contrast to the current discussion in many OECD countries. The average age of retirement from the labour market is close to 62 years, which is higher than in many other EU countries (Arbejderbevægelsens Erhversråd, 2003, 37). Erhversråd estimates that employment could be increased by 65 000 persons by getting people to work one extra year. The reform to VERB was designed to make it more attractive to postpone one’s withdrawal from the labour market. So far, the results seem to be encouraging. For example, the increasing labour market participation rate in 2003 among persons of 55-66 years of age is the result of reforms of various pension benefit systems.

- *Better integration of immigrants and more highly skilled foreigners in the Danish labour market.*

An important challenge for the Danish government is to improve the integration of immigrants, especially those from less developed countries. According to previous statements of the Minister of the Interior, active participation in the labour market is the most important

precondition for the successful integration of immigrants. This includes, for instance, good or improving education and a lack of discrimination. Denmark has so far had problems in attracting highly skilled foreigners. The reasons are not only formal barriers to entry and difficulties for foreigners to apply their skills - but also language barriers, compressed wages and high Danish taxes. Lots of improvements remain to be made in this area.

8. Conclusions

- During the 1990s, there has been a relatively large drop in unemployment on the Danish labour market, which can be attributed to the labour market reforms from 1994 but also to favourable growth conditions until the year 2000. The role of the fixed exchange rate should not be neglected either.
- Despite these encouraging signs, it should be recalled that no change in the labour force participation rate has occurred since the beginning of the 1990s. However, this rate is the highest of all the European OECD countries apart from Switzerland and Iceland. Some room for a further rise could probably be created if further reforms can be achieved. It also should be mentioned that Denmark still has a significant number of people that are outside the labour market.
- Obviously, labour market changes seem to have broad public and political support. Union membership has even increased somewhat since the start of the reforms in the mid-1990s.
- Denmark has a high – and increasing - degree of decentralisation in its wage formation process. Local agreements are important. This is a good precondition for adapting individual companies to international competition.
- With the labour market reforms starting in 1994, the previous “attractiveness” of being unemployed has been lowered substantially. The unemployed cannot, to the same extent as before, passively claim their rights to unemployment benefits. Incentives for job seeking have been strongly raised. This is a very important change.
- The "*hiring and firing*" combined with unemployment benefits add to labour market flexibility without risking security excessively.

- To summarize: Danish labour market experts agree that the country's wage formation now functions much better than in the past. However, domestic discussions are still going on as to how well the labour market and wage formation process really work. There is still room for improvement. Despite these obviously remaining shortages, Denmark clearly has the most flexible labour market conditions among the Nordic countries and deserves for this reason analytical attention.

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