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Distribution and labour market incentives in the welfare state – Danish experiences

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With comments by
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Distribution and labour market incentives in the welfare state – Danish experiences[°]

by

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Abstract

In recent years, Denmark has been successful in ensuring and maintaining a low unemployment rate. However, almost one third of the working-age population remains dependent on public transfers, a fact which poses questions on both social inclusion and financial pressures on the welfare state. In this paper, we consider more closely the interaction between the social safety net and the need and scope for maintaining a high employment rate in a welfare state of the Scandinavian type. The focus is on the basic dilemma between ambitious distributional goals on the one hand and work incentives on the other. The paper discusses policy issues related to minimizing welfare dependence that improve the transition from welfare to work. We consider these issues in a life cycle perspective considering entry into the labour market, maintenance of labour market contact, and exit from the labour market. Finally, we consider some recent reform proposals and initiatives in Denmark.

Keywords: Incentives to work, Social safety net, Distribution
JEL-codes: I3, J1

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1 Introduction

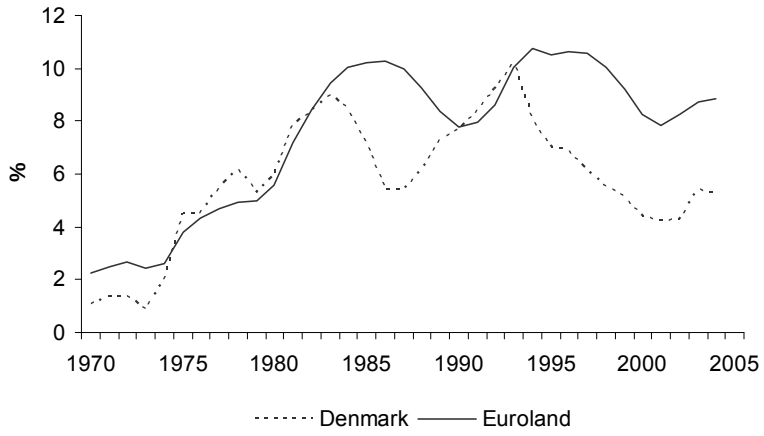
The Scandinavian welfare model, of which Denmark is an example, has very ambitious distributional objectives. This is reflected in an extended social safety net, pension schemes, and an unemployment compensation system that offers relatively generous benefit levels and duration periods in an international comparison. A further characteristic is that minimum wages in the labour market are relatively high, precluding working poor in accordance with distributional goals. This policy raises important challenges with respect to equal opportunities for jobs and social inclusion. There are problems associated with both maintaining incentives to work and the fact that a generous social safety net causes a high wage level hampering demand for less qualified labour. At the same time, it is essential for the financial viability of the welfare model that a large fraction of the population is in employment.

The economic performance in Denmark has recently attracted wide attention. After a long period with high and persistent unemployment, the unemployment rate has been low (4-5 percent) for a number of years and all standard macro indicators like growth, inflation, the current account, and the budget balance are favourable. Much of the international attention has centred on the interpretation of the Danish labour market as a flexicurity-model, which has shown how to combine extended social security with labour market flexibility conducive for employment. This tends to overlook the fact that the recent favourable performance of the Danish labour market can hardly be attributed to the flexicurity model per se since its main ingredients were also in place during the 1970s and 1980s with high and persistent unemployment rates. It seems more plausible that the change should be attributed to macroeconomic policies[1] and a radical shift in labour market policies through a sequence of supply oriented reforms, mainly during the 1990s. The reforms included a shortening of the unemployment benefit duration, stricter eligibility conditions for unemployment benefits and the introduction of workfare elements (see e.g. Andersen and Svarer 2007 a,b, for details).

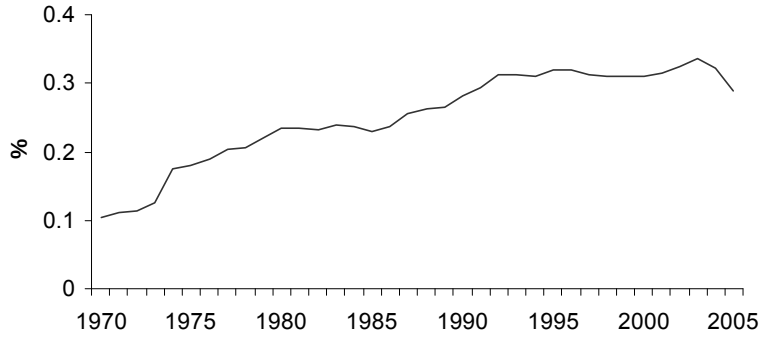
[1] The shift in macroeconomic policy originated in the early 1980s when a soft exchange rate policy and extensive fiscal activism were replaced with a fixed exchange rate policy and a more medium-term focused fiscal policy. This so-called “stability” oriented policy has been pursued since then. The decline in unemployment in the early 1990s can

Figure 1 Unemployment and recipients of income transfers

a) Unemployment rate: EU-15 and Denmark, 1970-2005



(b) Recipients of transfer income in the age group 15-66 years



Note: The number of recipients of income transfers is in full-time equivalents and excludes individuals receiving social security pension. Since 2004, the legal pension age has gradually been reduced from 67 years to 65 years. This accounts for part of the drop in the ratio of transfer income recipients to the population of working ages in 2005 and 2006.

Without depreciating the achievements of the labour market reforms, it is also part of the story that the share of the population in working age groups relying on one form of transfer income or another has not shown a similar decrease as the unemployment rate, cf. *Figure 1*. Almost one third of the age group 15-66 (the working population) is dependent on some form of public income transfer.[2] A rough decomposition into main

in part be attributed to an expansionary fiscal policy partly caused by the phasing in of a tax reform reducing the marginal tax on labour income and, among other things, reducing the tax value of interest rate deductibility.

[2] The figures only include transfers that substitute ordinary income. Individuals who receive supplementary income transfers like e.g. child care benefits or rent support are not included.

recipient groups reveals that in 2005, 4 percent of the working population receive unemployment compensation, 3 percent receive sickness pay or maternity leave pay, 6 percent receive educational grants, 5 percent are in early publicly financed retirement programmes, 4 percent receive social assistance including individuals in activation and rehabilitation programmes, and 7 percent are on disability pension.

The large fraction of the working population relying on income transfers – the transfer problem – is a severe problem for several reasons. First, while the large number of individuals in the schemes shows that the arrangements in the welfare state are used, it is not in itself a purpose of an extended welfare state to have a large number of people relying on transfers. The large fraction of people being dependent on transfers reveals that it has not been possible to achieve equal opportunities for all to find a job and become self-supporting and therefore, these numbers may indicate a marginalization problem. However, the gross numbers reported in *Figure 1b* give the upper bound to this problem since they also include arrangements which serve a welfare purpose, like extended maternity leave schemes or initiatives to improve long-term employment possibilities like education (study grants). Below, we return to a more detailed account of the transfer problem. Second, in an extended welfare state like the Danish one, the employment rate has significant public finance implications. A drop in employment of 1 percent would imply a deterioration of 0.8 percent in the public budget balance (relative to GDP) due to the combined effects of lower tax revenue and increasing expenditures on transfers.[3] Finally, it should be noted that the social arrangements and the social safety net are intimately related to key objectives, not least crucial distributional objectives in the welfare state. Hence, the policy dilemma is how to combine these objectives with a high employment rate.

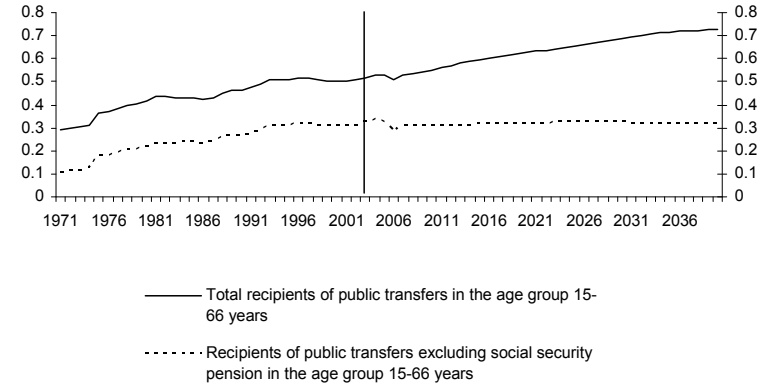
The "transfer" problem has attracted additional interest since demographic changes are causing a substantial trend increase in the dependency ratio, due to the effect of the baby-boom generation approaching retirement and the increase in longevity, cf. *Figure 2a*. A consequence of demographic developments is both that the labour force is

[3] The estimate is for Denmark and is based on the effects of a drop in private employment among people who are entitled to unemployment benefits. The estimate is calculated on the basis of analyses in the Danish Welfare Commission (2006).

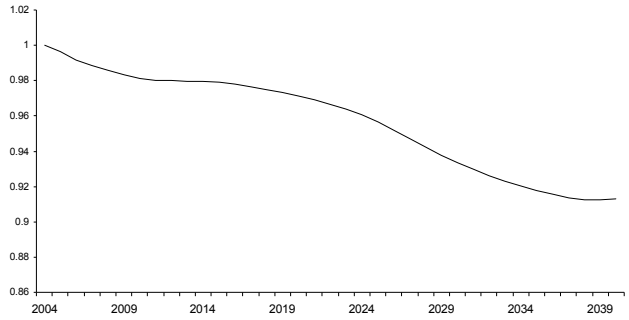
shrinking (*Figure 2b*) and that public finances worsen significantly (see e.g. Andersen and Pedersen 2006). These facts have intensified the focus on the question "can other groups be more integrated in the labour market?" to mitigate the twin problems of dwindling labour supply and deteriorating public finances.

Figure 2 Recipients of public transfers per individual in the age group 15̃66 years, including projections, and projection of demographic effects on the domestic labour force

(a) Dependency ratio



b) Demographic effect on domestic labour force



Note: The projection is based on the assumption that current rules remain unchanged.
Source: DREAM (2006).

In this paper, we analyse more closely the interaction between the social safety net and the need and scope for maintaining a high employment rate in a welfare state of the Scandinavian type. The focus is on the basic dilemma between distributional concerns and incentives and therefore, we mainly deal with the margins of labour market participation (the extensive margin). By implication, general issues related to labour market policies including taxation, education, training etc. are not addressed. We

consider the Danish experience which is interesting not only for its own sake, but also because it is pointing to some difficulties in policy choices, and to "what works, and what does not".

In Section 2, we start by clarifying some key elements of the social safety net in Denmark and the policy dilemmas it creates in terms of reconciling distributional concerns with a high employment rate. Some principle arguments essential for these issues are addressed in Section 3. We then consider the social-safety net in a life-time perspective, that is, entry into the labour market as young (Section 4), risk of marginalization for people in the work force (Section 5) and retirement (Section 6). In Section 7, we offer a brief overview of some of the proposals made by the Welfare Commission on how to address the "transfer problem" and maintain the key properties of the welfare system, and Section 8 outlines some recent policy initiatives in Denmark. Finally, Section 9 offers some concluding remarks.

2 The social safety net and the labour market

The labour market is pivotal for the Danish welfare model. This is so not only because the labour market sets the frame for availability and distribution of jobs and incomes, but also because a welfare model relying on a large public sector with a high level of taxation has the precondition that the employment rate is high. This is the case for three reasons: i) the financing of the welfare state is mainly via direct and indirect taxation of incomes generated in the labour market, ii) the social safety net implies that most individuals without an income in the labour market would be entitled to some form of transfer, and iii) a number of welfare services are taken care of by the public sector where labour is needed.

During the 1970s and 1980s, significant problems arose with respect to maintaining a high employment ratio. Unemployment was rising and became persistent at a high level. Labour market policies were mainly passive in their focus, aiming at income maintenance for unemployed as well as a reduction in labour supply via e.g. early

retirement[4]. This track was both socially and economically untenable. The employment focus was reinacted by a policy shift in the early part of the 1990s. Since then, the employment focus has been pursued in a sequence of partial reforms adding up to a very significant policy shift. These policy reforms strengthened the eligibility for unemployment benefits, shortened the benefit duration from 7 to 4 years, and excluded job training periods from the employment criteria that would allow individuals to remain eligible for unemployment benefits. A "right and duty" principle was launched stressing the right to a transfer income but, at the same time, a duty to try to become self-supporting. The "duty" part could be education or activation in the form of e.g. job-training (see below). Initially, the "right and duty" principle applied to the unemployment insurance system, but it was extended to the social safety net in general via the law on active social assistance from 1998. This policy shift can be interpreted as an attempt at re-establishing the employment focus of the welfare model, also cf. below.

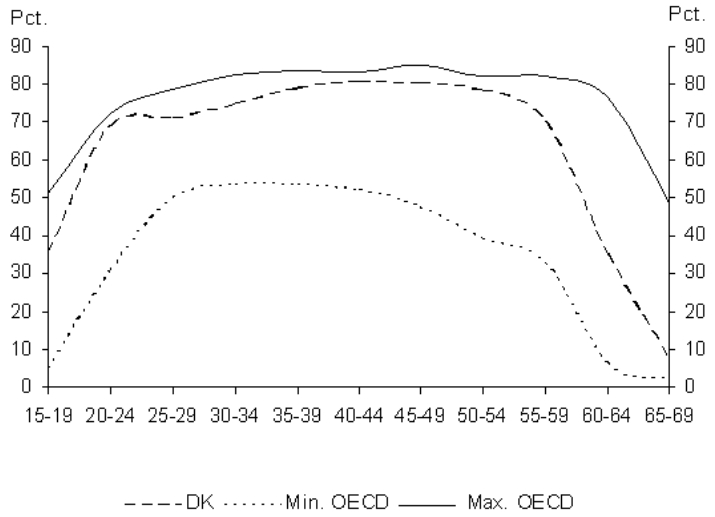
The employment orientation of the Scandinavian welfare model is reflected by the fact that labour force participation rates are high by international standards. *Figure 3* shows the age dependent labour force participation rates in Denmark and compares them to the max and min within OECD. It is seen that Denmark is close to the max for prime age groups.

It is often highlighted as a hallmark of the Scandinavian Welfare Model that it is universal and that labour has been decommodified (see e.g. Esping-Andersen 1990). There are reasons to qualify these defining characteristics. Universality is not equivalent to unconditionality. The social safety net in Denmark is universal in the sense that it is an individual entitlement (constitutional right, although recently with a more explicit entry criterion, see *Table 1* below), but it is not unconditional and therefore, it is remote from a basic income or demo grant system. With some nuances, it is a precondition that individuals of normal working ages are available for the labour market unless, via some screening, they have been found unfit for work or are eligible for voluntary retirement (in Danish "efterløn").

[4] In the early 1990s, a paid leave scheme was introduced based on the perception that unemployment was caused by an excessive labour supply relative to labour demand (lump of labour fallacy). However, this policy was quickly dismantled when unemployment dropped.

To see this more clearly, consider the main element of the social safety net, social assistance (in Danish "kontanthjælp")[5]. This scheme offers support to individuals having been exposed to a social event like unemployment, illness, divorce etc. The assistance is means tested on a family basis, that is, the income/wealth of the spouse is also of importance for the assistance offered. Moreover, the social assistance is dependent on a number of criteria including age and children. There is a possibility of individual supplements and recipients of social assistance will usually also be eligible for a housing subsidy (also means tested). Almost all transfers are gross income and thus, taxable income.

Figure 3 Age dependent labour force participation rates in Denmark and maximum and minimum values for OECD



Source: Danish Welfare Commission (2006).

[5] The system has been repeatedly changed over the years. The recent system builds on the law on active social assistance from 1998. It can be seen as an extension of the "Rights and duties" principle introduced in labour market policies, namely that the individual has a right to transfer but also a duty to try to become self-supporting. The latter is mainly tested via activation requirements. As discussed in Section 5, there are now activation requirements associated with social assistance.

Table 1 Income transfers in Denmark, selective schemes, individual entitlements in Euro, 2006

	Eligibility and financing	**Conditions**	**Gross amount per year, EUR**	**Number of recipients 2005 and share of the population 15-66 years**
Educational aid	Universal, available to individuals at least 18 years old, means tested	Enrolled and actively studying in an approved educational institution.	7,805€ Living with parents: 3,880€	222,000 or 6 percent
Unemployment benefits	Voluntary, contribution based, tax subsidized	Membership: relevant education or employment in 12 months Renewed benefit period: regular work in 6 out of the last 36 months	Maximum of i) 90 % of past wage, and ii) 22,340€	146,000 or 4 percent Including activation measures: 176,000 or 5 percent
Sickness and childcare benefits	Universal	Conditioned on employment prior to the receipt	22,340€	114,000 or 3 percent
Social assistance	Universal, depends on age and means tested for married based on family income	Social condition precluding self-support, living in DK in 7 out of the last 8 years	Single with child[a]: 17,974€ Above 25 years: 13,526€ Below 25 years: 8,717€ Below 25 years: 4,208€ and living with parents	87,000 or 2 percent Including activation measures: 133,000 or 4 percent
Start assistance	As social assistance. Not available for individuals with a residence permit based on family reunification (except to refugees)	Living in DK in less than 7 out of the last 8 years	8,717€	
Disability[b]	Visitation	Age group 18 to 65 and loss of work capability precluding self-support	Single: 22,351€ Couple: 18,997€	264,000 or 7 percent Including flexjobs[d]: 300,000 or 8 percent
Early retirement	Voluntary, contribution based, tax subsidized	Age group 60-65, membership of an UI-fund and contribution paid for at least 30 years	At age 60: 20,319€ At age 62: 22,340€	179,000 or 5 percent Including voluntary retirement for age-group 50-59 years[e] 185,000 or 5 percent
Social security pension[c]	Universal, depends on civil status, and supplements are means tested	From the age of 65, proportional reduction if residence in DK is less than 40 years since the age of 15	Single: 15,003€ Couple: 10.990€	700,000 or 19 percent

Notes: All transfers are taxable income. Amount calculated in euro according to central parity DKK-euro. a) in addition there is a child supplement of 4,342 euro, b) According to the rule applying for new entrants to the disability pension after 2002. c) Amounts are given as the base pension + supplements. d) Flexjobs require visitation, subsidized jobs with loss of work capacity. e) The intake to the voluntary early retirement scheme for the age group 50-59 years was stopped in 1996.
Source: Forsikringsoplysingen, Sociale Ydelser, Statistic Denmark, Registerbased Labour marked Statistics and own calculations.

The social assistance system is fairly complicated, reflecting an attempt to strike a balance between different objectives in the welfare state. This is illustrated by the following listing of some of the main conditions: (i) *Labour market availability criteria*: all recipients of social assistance are required to actively search for jobs and participate in so-called activation measures (see Section 5 below). (ii) *Time dependence*: after receiving assistance for more than six months, there is an upper cap on the sum of social assistance and supplements, for most people implying a reduction in the total assistance level. Special rules apply to young recipients, see Section 4. (iii) *Employment criteria*: For a married couple there is a work requirement of at least 300 hours of regular work within the last 2 years to qualify for assistance, and if this condition is not met, only one person receives social assistance. (iv) *Earned income credit*: In general, all income is deducted from the social assistance, but if the person receives a reduced assistance level, cf (ii), part of the work income is not deducted in the social assistance, so that the incentives to work are increased. (v) *Entry condition*: entitlement presupposes that the individual has been living in Denmark for 7 out of the past 8 years (or fulfils the conditions for eligibility according to EU rules), otherwise the person would only be entitled to social assistance at a lower level, the so-called "start assistance" (in Danish "starthjælp").

The main elements of the social safety net are briefly sketched in *Table 1* giving the conditions for receiving various benefits, their level and the use of the scheme. As is seen from the table, the social safety net in the Danish welfare system is highly conditional and labour market focused. Considering the population in the age group 15-66 in 2006 consisting of 3,688 thousand individuals, 2,805 thousand individuals (76 percent) are in the labour force, 1,125 thousand individuals (30 percent) are receiving transfers[6] and only 163 thousand individuals (4 percent) are outside these classifications. Hence, discussions of labour market participation should be seen from the perspective that this is essentially the default option given the way welfare

[6] Unemployed individuals, individuals in so-called flexjobs, and individuals on maternity leave and sickness benefits are included in both the labour force and the number of individuals receiving transfers. In addition, part of the group of individuals receiving disability pensions work in e.g. part time jobs and are therefore included in the labour force as well. Finally, the labour force includes individuals who are older than 66 years. For these reasons, the sum of

arrangements are structured. The key questions with respect to labour market incentives are thus i) the incentive for active job search, including reservation demands with respect to wage, job types, geographical location etc., ii) incentives and options for acquiring a labour market relevant education and training, and iii) the scope for leaving the labour force either via schemes available for individuals with reduced work capability (what are the criteria etc.) or via voluntary schemes like early retirement (see Section 6).

In policy debates in Denmark, distributional concerns play a key role. At a formal level, all transfers are indexed to wages (in Danish "satsreguleringsloven"). The rules are fairly complicated but they imply that transfers are indexed to the average wage developments in the labour market[7]. The Danish Economic Council (2006) has shown that the indexation of transfers over the period 1988-2004 is roughly equivalent to having transfers proportional to the median real income. Essentially, this rule thus ensures an unchanged distribution between those in and out of work[8]. Irrespective of the technicalities of the indexing formula, it is a condition in policy debates that strengthening labour market incentives via general reductions in benefit levels is not acceptable. This explains why the basic system of social assistance has developed into a very complicated system and attempts at improving incentives and screening have been introduced via other mechanisms, cf. above. We discuss some of these in detail below.

The social safety net can also be assessed by considering poverty. The poverty rate is low in international comparison, with only 4 percent of the population being below the poverty line defined at 50 percent of median income (an annual income level of about EUR 10,100 in 2004), and 9 percent below the poverty line defined by 60 percent of the median income, cf. Danish Economic Council (2006).[9] No full time employed individual is below the poverty line (no working poor) and individuals in basic welfare

individuals receiving public transfers and the labour force may exceed the number of individuals in the age group 15-66 years.

[7] The current indexing formula is from a law enacted in 1990 (revised in 2003) according to which all transfers are indexed on the basis of the annual wage two years earlier. If the increase is above 2 per cent, 0.3 per cent is transferred to a fund (satsreguleringspuljen) which can be used for initiatives aiming at improving the conditions for people on transfers.

[8] In policy debates, changes in various measures of inequality play an important role, even to the extent that attempts at fine-tuning the Gini coefficient are often proposed.

[9] Calculations based on equivalent income.

arrangements like disability pensions or ordinary pension would normally remain above the poverty line. The group with an income below the poverty line includes some young people in education, some self-employed and some individuals with only a marginal attachment to the labour market, including some immigrants. The transition out of poverty is large, with a hazard rate out of poverty of about 75 percent the first year. However, poverty is persistent for a small group of about 10 percent.

3 Incentives and distribution – principles and policy trade-offs

The design of the social safety net reflects basic distributional considerations. Given the political resistance to benefit reductions and the tight relation between benefit levels and wage developments, it is reasonable to interpret the political constraint as applying to the lowest income or consumption possibilities acceptable in society. The level of social benefits sets a floor for wage formation[10] on which the whole wage distribution stands. It is inevitable that some unemployment is implied by binding lower wage levels (minimum wages). This raises some issues on both the demand and supply side of the labour market.

On the demand side, the most obvious implication is that binding minimum wages reduce labour demand. A consequence of this is that groups with low qualifications tend to be in excess supply, i.e. their qualifications are too low relative to the minimum wage. This problem may be reinforced over time when benefits are indexed to the average wage developments. If productivity increases more for "high" skilled jobs than for "low" skilled jobs (skill-bias), it follows that the gap between wage demands and the distribution of qualifications at the lower end of the distribution worsens over time. There are two ways of mitigating these demand problems under the constraint that benefit levels cannot be changed, namely, wage subsidies or educational/training to increase qualifications and reduce the groups with few labour market relevant qualifications.

[10] In Denmark, minimum wages are negotiated in the labour market and thus not directly regulated politically.

Various issues arise on the supply side. One is the trade-off between insurance and incentives. The whole complex making up the social safety net can be seen as an implicit insurance arrangement pertaining to the risk associated with work capability, employment and wages/incomes. If agents are risk averse and private markets offer insufficient options for diversification of these risks, the social safety net may not only have a direct beneficial welfare effect, but also be conducive to a well-functioning labour market (see e.g. Acemoglu and Shimer 1999; Sinn 1995). It is a basic principle of insurance that temporary shocks can easily be diversified whereas permanent shocks cannot. Moreover, both moral hazard and adverse selection problems are present. Therefore, there is a difficult choice to be made between providing short-run insurance and incentives for active job search. Fredriksson and Holmlund (2006) list a number of reasons for why the optimal profile for unemployment insurance has a time profile where the support eventually decreases in duration. Short-run insurance is thereby combined with incentives. In Denmark, there is a time dependency via the following main steps: unemployment benefits, unemployment benefits with activation (after one year), social assistance (after 4 years) with activation, and reduced social assistance. Whether this profile is sharp enough, in particular the 4-year duration of unemployment benefits, can be discussed.

The social safety net also raises adverse selection problems since individual preferences, personal characteristics and abilities cannot be observed. Among those claiming assistance, there may thus be both some with low options for finding a job (low ability), and some who evaluate leisure highly or are very restrictive in their job ambitions (type of job, employer, wage, location etc.). To mitigate selection problems, the system includes various screening mechanisms including classification within the social assistance scheme and screening for disability pensions, flexjobs etc.

Both the moral hazard and adverse selection problem can be addressed by associating activation (workfare) with requirements to claim benefits (unemployment or social assistance) (see e.g. Besley and Coate 1992, 1995)[11]. First, consider the adverse selection mechanism. The activation requirement is both time consuming and may

[11] For the various effects of activation, see Section 5 below.

involve other inconveniences, and this tends to make benefits less attractive for groups with a high value of leisure or narrow job ambitions, since they may then either opt out of the labour market or accept available job offers. The moral hazard problem is also addressed (see e.g. Andersen and Svarer 2007b) since adding an activation requirement (activation) to the conditions for claiming benefits implies that there is a utility loss upon the transition from passive transfers to activation, which strengthens the incentives to search for jobs. In other words, there is a motivation or threat effect of such workfare elements which strengthens labour market incentives. In addition, there are several other effects of activations policies which we discuss in Section 5.

In assessing the incentives for the non-employed, there thus seems to be a choice between reducing benefit levels or associating activation requirements with the social safety net in the sense that they can both be used to strengthen incentives. If so, it may also be argued that they must be equivalent from a policy perspective since they basically work by making it less attractive to claim benefits (either by lowering the level of benefits or increasing the activation demands) and therefore, are equivalent in utility terms (see Besley and Coate 1992, 1995). However, the comparison between the two is not that simple. First, activation essentially works both to create a time profile and involve a stochastic penalty in the social safety net, and this has an anticipatory (threat or motivation) effect on incentives (see Andersen and Svarer 2007b), i.e. the two instruments are not necessarily equivalent even from a utility perspective. Second, from a political perspective, there is a significant difference between reducing benefits and imposing activation requirements, and the latter is much more acceptable than the former. This may reflect that the distributional concern is mainly associated with consumption possibilities[12], and that activation is a quid pro quo which can be interpreted in terms of reciprocity between the individual and society. Workfare can thus be interpreted as being justified by work norms, but also strengthening these by the implied sanctions if agents are not willing to offer some effort in return for receiving transfers. Finally, it should be mentioned that the direct public finance implications of

[12] One important reason being that income or consumption possibilities are interpersonally comparable, while utility is not.

the two instruments are obviously very different with the first leading to expenditure reductions and the latter to expenditure increases.

There are two important policy dilemmas here, however. The first is the screening paradox related to activation requirements and the like. To the extent that this policy works, the consequence may be that those actually ending up in activation are the groups with severe problems in terms of meeting the requirements to obtain a job at given wage levels (low ability groups), while the stronger groups have left the system. Hence, it may seem as if the policy does not work (those on activation do not get jobs) and activation accomplishes nothing but punishing weak groups. The other dilemma is that with a binding distributional constraint, it inevitably follows that labour demand falls short of labour supply and hence, it may seem pointless to focus so much on job search for these groups. This view is problematic for several reasons. First, even with unemployment, it does not follow that employment is invariant to changes on the supply side (more job search, changed wage setting), especially in a small and open economy. Second, there is a dynamic aspect to this since slack job search criteria may imply that labour supply eventually comes to constrain demand, in particular if human capital depreciates over time.

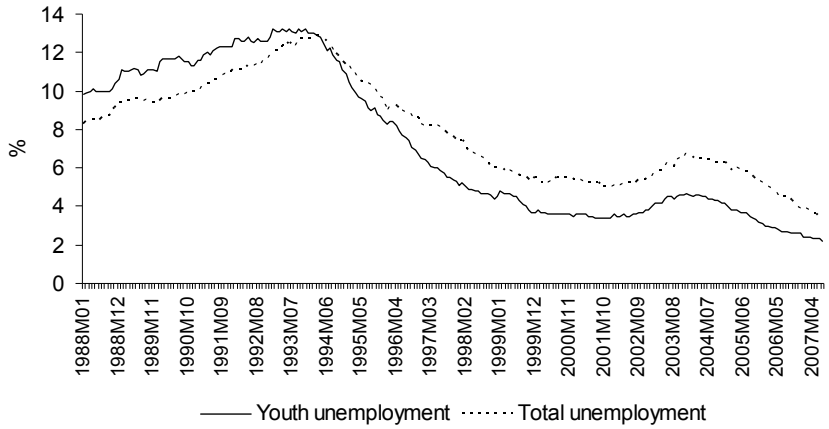
4 The young – entry to the labour market

Youth unemployment is a particular problem since insufficient attachment to the labour market in the youth may cause persistent unemployment and marginalization from the labour market. This is in particular the case since youth unemployment is often related to lack of education and labour market relevant qualifications. During the high unemployment period from the mid 1970s to the early 1990s, youth unemployment was higher than the general unemployment rate and therefore, the youth unemployment problem naturally attracted particular interest, cf. *Figure 4.*

In 1996, a youth unemployment programme was implemented and it has been extended since then. The basic idea of the programme was twofold, namely, to make periods on transfer short and strengthen the economic incentives to educate. These aspects were motivated by the fact that young people were to an increasing degree in

long-term positions where they were dependent on transfers (mainly social assistance) at the same time as the short-term economic incentive to undertake education was low (social assistance exceeded study grants). The youth unemployment programme addressed both of these problems. The programme introduced mandatory activation of all young unemployed below the age of 25 without a labour market relevant education after 6 months of unemployment. The activation could be an education programme with a duration of at least 18 months, possibly in the ordinary education system. At the same time, social assistance was lowered to about 50 percent of maximal unemployment benefits, which eliminated the gap between social assistance and the study grant. The programme was in a sequence of steps extended to include all young individuals and have mandatory activation no later than after 13 weeks. In 2003 the age group 25-29 years was also included under the scheme, although this group would not face a lower compensation.

Figure 4 Total and youth unemployment rate, January 1988-July 2007



Notes: The unemployment rate is in percentage of the labour force, and the numbers are seasonally adjusted. Note that the series has breaks after 1995.12 and 1999.12
Source: www.statistikbanken.dk.

The youth programme is thus an element of the shift from a passive to a more active oriented labour market and social policy launched during the 1990s (cf. Section 2) but, at the same time, it is a notable exception from the rule that benefit levels cannot be reduced. The latter is interesting from a political economy perspective since although there is a large political opposition against general benefit reductions, the reduction for

the young was accepted because it was considered an anomaly of the welfare system that young people entered life-long transfer dependency, attaining only marginal or no contact with the labour market.

The effect of the youth unemployment programme is remarkable when considering the drop in the youth unemployment rate relative to the general unemployment rate, cf. *Figure 4*. It should, however, be noted that this happened in a positive business cycle climate and the overall unemployment rate also fell significantly over the same period. To the extent that youth unemployment is more sensitive to the business cycle stance, this may partly explain the shift in the relation of youth unemployment to the overall unemployment rate.

There is, however, clear evidence that the programme had a significant effect on the behaviour of the youth. One indication is that once the programme was launched, it turned out that about 2/3 of the target group had left the group before the activation offer was given after 6 months. An empirical study by Jensen, Rosholm and Svarer (2003) finds that the programme had a clear positive effect on the transition rate into education, whereas the effect on transition into employment is more uncertain. However, since the low level of educational attainment of the group was part of the problem, the policy has contributed to mitigate this situation.

The entry of young people into the labour market is still not without problems, despite the fall in the youth unemployment rate. In an international comparison, Danish youth start education relatively late and also complete their education with significant delays. This means that the social return to public investment in education is significantly reduced. This is, however, a general problem which does not in particular refer to groups risking marginalization in the labour market. In that respect, it is more problematic that about 1/5 of a cohort of young still do not get any education beyond basic schooling (residual educational group). Although about 95 percent of a cohort enrol in an education, the drop out rate is large implying that only about 80 percent of a cohort complete a secondary education. This fraction has been roughly constant in recent years. In this educational residual group, one finds an overrepresentation of children with parents who are unskilled and/or immigrants from non-western countries. These problems should be seen in the perspective that Denmark is at the OECD top as

concerns public spending (relative to GDP) on education. Given the ambitious distributional goals and the skill-bias in labour demand, it follows that bringing cohorts into the labour market where 1 in 5 has no education beyond basic schooling is particularly worrisome. It is well-established that employment possibilities are strongly related to education and qualifications, and that the risk of marginalisation is significantly higher for low educated groups. Calculations show that the returns to society from ensuring that individuals from the educational residual group get a vocational training (the most realistic alternative) are very large mainly because this increases employment chances and correspondingly lowers the risk of persistent welfare dependence (Danish Welfare Commission 2006).

5 Work or welfare? – Risk of marginalisation

The fact that many individuals are living on public transfers from various welfare programmes can be seen as an indication that these programmes serve a purpose. However, it raises the question of whether policies are mainly in a defensive position "repairing" problems, rather than in a more active position minimizing the risk of problems arising. Extensive use of welfare programmes may indicate that the system is malfunctioning, implying that too many fail to become self-supporting and instead become dependent on transfers. This is, in itself, a potentially large social problem, but it also raises questions concerning the financial viability of the welfare state since a tax financed extended social safety net necessitates a high employment ratio, cf. Section 2.

It is well-established that social conditions may display strong persistency; hence, individuals who either do not enter the labour market with sufficient qualifications or become long-term unemployed face a large risk of marginalisation implying persistent welfare dependence.

Considering long-term dependence on transfers (leaving out disability pensions and early retirement), one finds that the group having been unemployed more than 80 percent of the time during the last three years and having actively been searching for a job is close to 50,000 individuals. This group has been reduced in recent years alongside the fall in unemployment. In addition, about 140,000 in the working age group have

been receiving transfers more than 80 percent of the time in the last 3 years, i.e. due to sickness, rehabilitation etc. In total almost 200,000 or about 5 percent of the age group 18-66 are thus more or less permanently on transfers (Danish Welfare Commission 2006), and the size of this group has not been reduced during the period with a sharp fall in unemployment. A large fraction of this group may later be eligible for disability pension or choose early retirement. Hence, there is a non-trivial problem of marginalisation in the labour market leading to persistent welfare dependence. Moreover, a large fraction of those on social assistance and long-term welfare have problems in addition to being without a job. This includes health and social problems and lack of work capability due to various other problems.

The gains from early intervention to prevent marginalisation are thus potentially large both socially and economically. An important element of early intervention is education and acquisition of relevant qualifications in youth; cf. the discussion in Section 4. For other age groups, it is important to ensure that spells of unemployment do not become too long, since long-term unemployment often leads to additional social problems and marginalisation in the labour market. The policy pursued in Denmark in the 1970s and 1980s overlooked these risks for a long period, and mainly had a passive focus on income maintenance. A paradoxical consequence of this passive focus may have been that it has increased marginalisation and therefore, in turn, welfare dependence. In the following, some of the reform initiatives with a more active focus are reviewed, and some remaining problems are discussed.

5.1 Economic incentives

The combination of an extended social safety net and high labour income taxation creates a dilemma concerning the economic incentives to work. Shifting from welfare to work will often involve a high composite tax rate when comparing labour income after tax to the previous social transfer after tax plus eventual supplements or subsidies lost when in employment or obtaining a higher income. *Table 2* gives an indication of the problem in terms of the difference in disposable income from shifting from welfare to work. For more than 10 percent of the population, the gain in disposable income from work is less than 270 EUR per month, and for almost 5 percent, it is less than 135 EUR per month (effectively implying a compensation for work which is less than 1 EUR per

working hour). In the group with a low difference in disposable income between work and welfare, one finds an overrepresentation of long-term unemployed and immigrants from low-income countries.

The same incentive problem can be illustrated by considering the average effective tax rate defined as the sum of the marginal tax and the marginal reduction of transfers. This is often called the participation tax rate for individuals outside the labour force. For low income groups, it is found to be around 80 percent with some dispersion (between 62 and 95 percent), and this is very high in an international comparison (see Immervoll *et al* 2004; Kleven and Kreiner 2006).

Table 2 Population distributed according to annual gain in disposable income per month from work, 2003

	Group size in 1000 people	Pct.
Less than 135 €	116	4.7
135-220 €	73	2.9
200-270 €	108	4.4
270-400 €	281	11.3
400-670 €	568	22.9
More than 670 €	1330	53.7
Total	2476	100.0

Notes: Difference in disposable income between work and unemployment, taking into account income taxation, housing subsidies, subsidies for childcare, pension contribution and transport costs. Data are from "Law model" 2003 and using 2006 rules.
Source: Danish Welfare Commission (2006).

An important issue is how actively the non-employed in the work force search for jobs. This is clearly difficult to assess quantitatively, but some attempts have been made via surveys. These surveys indicate that about 50 percent of the unemployed (unemployment spell of at least 5-6 weeks) are willing to start working immediately, and about 64 percent have applied for jobs within the last month, cf. Madsen *et al* (2007). However, in addition, some have restrictions on e.g. the type of job, its location and working hours. These numbers suggest that search intensity is on the low side.[13]

The welfare and tax systems thus produce a situation where the economic incentives to work are low and this may strengthen welfare dependence. This is an inevitable consequence of the tax financed extended social safety net. It is important to minimize the problem, however. One route is via an earned income tax rate which can lower the

[13] The figures also indicate that not all individuals receiving unemployment compensation in Denmark may actually fulfil the ILO criteria for being unemployed.

participation tax rate. The difficulty is to target such a scheme to avoid an excessive deadweight loss. An earned income tax credit (in Danish "beskæftigelsesfradraget") was introduced in 2004 in the form of a deduction in taxable income of 2.5 percent of wage income up to a maximum (EUR 965 in 2005).

A problem with the earned tax credit is that it gives the maximum deduction to high income groups for whom the participation decision is not an issue. However, phasing out the tax credit over some income interval would increase the composite marginal tax rate over the relevant income interval and hence, lower the participation tax but increase the marginal tax rate, i.e. a trade off between the extensive and intensive margin is involved here. Despite these problems, it has been found that an increase in the earned income tax credit can have a noticeable effect on labour supply via the participation effect, see Danish Economic Council (2004).

The above mentioned problem is a classical problem of targeting the measures to the relevant group, which in this case consists of people on welfare with a low economic incentive to work. On a small scale, a more direct targeting is attempted in the social assistance scheme via the cap on assistance, the reduction in assistance after 6 months combined with labour income being less than fully deducted in social assistance, cf. Section 2. However, these measures are minor and do not solve the problem of ensuring that sufficient incentives for labour market participation exist.

Do economic incentives work for groups with long-term marginalisation in the labour market? For some in this group, the problem is insufficient qualifications and therefore, they are constrained from the demand side and accordingly, strengthened supply incentives would not improve the job prospects. But this does not apply to all and there is evidence showing that economic incentives matter. Pedersen and Smith (2002) found that economic incentives in the form of the net compensation rate matter for search intensities and the risk of being unemployed. Le Marie and Scheuer (2006) evaluate the effects of economic incentives for labour market participation for groups with a weak labour market attachment (recipients of social assistance and home-working housewives). They also find economic incentives to play a role, and the elasticity of the participation probability with respect to the gain in disposable income from work is found to be 0.2-0.4. Empirical evidence thus suggests that there is a trade-

off between economic incentives and employment also for marginalized groups, but whether it is steep enough as compared to political preference is another issue.

Economic incentives must be expected to play the largest role in initial periods of unemployment, especially if human capital depreciates when out of work and if other social problems arise due to long-term unemployment.[14] This is an argument for having much focus on early intervention in policy initiatives.

Finally, it should be noted that small or even negative gains from labour force participation also have an endogenous element. The lower end of the wage distribution adapts to the level of social transfer, and to the extent that individuals are heterogeneous with respect to pecuniary and non-pecuniary costs of work, it follows that some may find it economically unattractive to work.

5.2 Non-economic incentives

Strengthening incentives by lowering benefits or via the tax side is both problematic and politically difficult. This raises the question of whether incentives can be strengthened by non-economic means. This includes measures to ensure job market availability and active job search. The right and duty principle first introduced in labour market policy (1994 and subsequent reforms) and later in social policy (1998) are steps in that direction. The main instrument here is activation, which is essentially a workfare element, that is, to remain eligible for transfers some activity requirement is imposed. This could be counselling and training/education, job-training or subsidized jobs. Approximately 44,000 recipients of social assistance participated in activation schemes in 2005. This corresponds to about 1/3 of the individuals receiving social assistance (i.e. recipients of social assistance are on activation schemes about 33 percent of the time). About 2/3 of the activation were in the form of counselling and training, and only 10 percent in job training. Activation “offers” have to be given no later than after 12 months of unemployment (before 13 weeks below the age of 30).

In principle, activation can have the following effects: i) a threat or motivation effect on unemployed individuals arising, since workfare makes claiming of transfers less

attractive and this induces people to search more actively for jobs and lower their reservation demands, ii) a screening effect in the sense of making it less attractive or feasible to claim benefits without wanting a job (high preference for leisure) or at the same time as they are working in the informal sector, iii) a wage effect by reducing the value of the outside option for employed workers if they become unemployed iv) a locking-in effect by reducing job-search while participating in the programme, and v) a post-programme effect to the extent that the activity improves the qualifications which increase the job prospects (although a negative effect is possible if the job search is narrowed to specific jobs related to the training).

Empirical evaluations of the effects of activation leave mixed results.[15] In general, the post-programme effects are only clearly positive in case of private job-training, while there is also evidence of locking in effects during participation (see, e.g., Danish Economic Council 2002, 2007; Rosdahl and Petersen 2006). There is some evidence of a threat or motivation effect.[16] Indirect evidence can be found from the fact that despite a substantial reduction in unemployment, wage developments have been stable, suggesting that the overall package of labour market and social policies in recent years has had an effect on wage setting.

These effects of workfare policies should, however, be seen relative to the expenses on active labour market policies. Denmark is the OECD country spending most on active labour market policies as a share of GDP. Hence, it is an open question whether the effects are worth the money. In recent years, there has been an increasing focus on this issue and therefore, attempts have been made to "fine-tune" the use of activation policies.

One example of this is the introduction of so-called match groups in 2004. The aim of this system is to identify individual capabilities and barriers to achieve a better targeting of the instruments. The match groups are 1) *immediate match* meaning that the

[14] Graversen and Tinggaard (2005) analyse whether the introduction of the cap on social assistance after 6 months, cf. Section 2, has increased the employment probabilities, and conclude that no such effect is present. This can be interpreted as showing that the groups involved are demand constrained in their job prospects.
[15] The effects of activation have mainly been analysed for insured unemployed, and to a lesser extent for people in the social assistance system. However, the qualitative findings tend to be the same for the two groups.

person has abilities and qualifications meeting the demands in the labour market, 2) *high match* for individuals with abilities and qualifications which to some degree meet the demands in the labour market, 3) *partial match* for individuals with abilities and qualifications which to a weak extent meet the demands in the labour market, 4) *poor match* for individuals with severe constraints in abilities and qualifications relative to the demands in the labour markets, and 5) *no match* for individuals with abilities and qualifications that give no chance of finding a job. About 60 percent of the recipients of social assistance are in match groups 4 and 5, indicating that a large fraction has significant difficulties in meeting the requirements in the labour market. Moreover, in targeting efforts to groups with a high risk of long-term unemployment, a profiling system is used, i.e. a statistical tool to aid case workers in identifying individuals with a high risk of being unemployed after 6 months; see Rosholm *et al* (2006).

Recipients in match groups 1 and 2 are required to sign up in job-centres as actively searching for jobs, and this also mostly applies for group 3. Activation requirements are also larger for this group, since they should have a new offer no later than 6 months after having ended the previous offer.

6 The old – retirement

Retirement from the labour market is a key question. For the individual, it involves issues like health, work-capability, pension etc, while for society, it is both a crucial factor for the overall employment ratio of importance for both labour markets and public finances and involves issues of inter-generational distribution and insurance. The latter is often summarized in the form of a social contract across generations, implying that the average person tends to benefit from the welfare schemes as young and old, and contribute to them while of working ages. This feature of the welfare state raises several issues of which the following focuses on two. The first relates to the balance over life between periods benefiting from the possibilities created by the welfare state and

[16] Danish Economic Council (2007) finds that the motivation effect is the largest positive effect on employment of the activation programme. A reduction in the average duration of unemployment spells of 3/4 of a week is estimated. See Andersen and Svarer (2007a) for evidence on the effects of workfare policies for the unemployed.

periods contributing to this, i.e. working life as a fraction of total length of life. This also involves an insurance element in the sense that those experiencing a significant or full depreciation of their working capabilities are offered possibilities of leaving the labour market (e.g. disability pension), while those being able to work should stay on longer in the labour market. Likewise the public pension scheme, which is a defined benefit scheme with a statutory pension age, has a life insurance property. The second relates to support as a retiree, that is, pensions but also access to health and old age care facilities supplied by the welfare state.

The retirement issue has come into focus due to changing demographics reflecting the joint effect of the retirement of the large post World War II generations and relatively large trend increases in longevity (especially for individuals over 65 years). As a consequence, the dependency ratio increases significantly, cf. *Figure 2a*, and public finances will deteriorate significantly for given welfare arrangements (see e.g. Andersen and Pedersen 2006). Increases in the dependency ratio have been seen previously, cf. *Figure 1b*. There are, however, several factors making the adjustment to the predicted increase in the dependency ratio more problematic. One is that the problem remains, even if only current welfare arrangements are to be financed, which in itself is a very conservative assumption. Second, while it has historically been feasible to expand the welfare state, it has primarily been financed by an increase in the tax burden (now approximately 50 percent) and an increased (female) labour force participation rate. Since both are high, it is not possible to re-apply the historical adjustment mechanism.

Retirement from the labour market may be involuntary or voluntary. The former arises in case the work capability is reduced to such an extent that continued work is considered infeasible. The main arrangement dealing with this problem in Denmark is the disability scheme, cf. *Table 1*, and access is based on screening. Voluntary retirement prior to the official statutory pension age is facilitated by the voluntary early retirement pension (VERP) (in Danish “efterløn”), which was initially introduced as a labour market measure but is now considered as a part of the “welfare package”. The effective retirement age is relatively low in Denmark, which is also seen from *Figure 3* where the labour force participation rate is found to be high in Denmark for age groups

into the late 50s, after which it drops to an average position. Even though the official pension age is 65, only 12 per cent of a cohort remain in employment until reaching this age. Direct exit from the labour force to retirement in the social security pension is therefore very limited. Incentives to increase the retirement age therefore tend to focus on VERP and the disability pension.

In principle, the consequences of increasing longevity can be addressed in two ways, namely, either by adjusting benefits to expected longevity or by raising the statutory retirement ages alongside increases in longevity. Interestingly, Sweden has adopted the first approach, while Denmark has chosen the second, cf. below. The Danish choice can be seen as a reflection of the political barrier associated with lowering benefit levels in the welfare system, and accordingly increasing longevity will have to be addressed by increasing the statutory ages for access to early retirement and public pensions.

In the following, we focus upon three key issues related to retirement, namely, disability pension, early retirement and the public pension scheme.

6.1 Disability pension

Disability pension is a core scheme of the welfare state and, as such, is not up for debate. However, in line with the increased employment focus of the social security system during the 1990s, the public disability pension was reformed in 1999. The general idea of the reform was to avoid that loss of some work capability led to complete exit from the labour market, that is, the system should be more flexible and use the work capability, even though it was reduced. Accordingly, the criteria for obtaining disability pension were changed to focus on the individual's remaining work ability. Disability pension is now granted only if work ability is expected to be permanently reduced so that the individual cannot be expected to maintain any subsidized job. Simultaneously, special subsidized jobs, so-called flexjobs, were introduced. The idea was to introduce a subsidy to compensate the employer for the loss in work ability in order to maintain a job. The subsidy is half or two-thirds of the salary, depending on the reduction in work ability. For individuals that are allowed a flexjob, a

system of rights comparable to the ordinary labour market has been introduced.[17] However, for individuals permitted to enter the flexjob system, the system of "rights" is not matched by "duties" like in the ordinary labour market. There is no limitation to the duration of unemployment compensation, no requirement for active flexjob search, and no activation measures.

The reform has not been able to significantly affect the annual admissions to the disability system while, at the same time, the number of individuals in the flexjob system has been increasing relatively fast. By 2005, a total of 45,000 individuals had been admitted into the flexjob system with 35,000 in a flexjob and 10,000 receiving unemployment compensation within the system. The Danish Ministry of Finance expects that the long-term equilibrium is approximately 75,000 individuals in the flexjob system. Overall, the reform has thus not been successful in reducing the number of individuals receiving transfer income, and it has contributed to increase subsidized employment.

6.2 Voluntary early retirement

VERP may be considered as one of the major exceptions to universalism of the Danish welfare state and also the main reason why labour market participation rates for individuals above 60 years are lower than in other Scandinavian countries (Danish Welfare Commission 2005). VERP is a membership and contribution based scheme, but it is highly subsidized. VERP was originally introduced in the early 1970's, with the dual aim of reducing labour supply (intended as a remedy for the high level of youth unemployment) and a retirement system for so-called worn-out elderly workers. However, no criteria for being worn-out were written into the legislation and the system developed into a general voluntary early retirement scheme.

VERP is available for the age groups 60-64 years. Pensions are contingent on absence of income from work. The pension payments are comparable to the maximum unemployment benefits and therefore significantly higher than the pensions in the social security pension system, cf. *Table 1*.

[17] If the individual becomes unemployed, he or she receives unemployment compensation at 91 percent of the maximum level of unemployment benefits. Similarly, a voluntary early retirement system comparable to VERP has

VERP has become very popular and therefore, it has turned out to be politically very difficult to change the scheme. However, a reform in 1999 aimed at postponing early retirement. The reform lowered the statutory public pension age from 67 years to 65 years. Given the increase in longevity, this may seem paradoxical, but the reform was motivated by an effort to reduce the duration of VERP from 7 to 5 years of pension which was cost saving.[18] The reform also introduced a means of testing the pension from VERP if the person retires before turning 62 years. The means testing is based on potential income from labour market pension schemes, implying that individuals with high labour market pensions have less incentives to use VERP in the first two potential years. This part of the reform has affected the retirement pattern so that an increasing number of individuals actually postpone retirement until the age of 62. This accounts for some of the reduction in the ratio of recipients of transfers to the total population in working ages that has been observed in recent years, cf. *Figure 2*. Since the system of contribution-defined labour market pension schemes has been extended to blue-collar workers in the private sector during the 1990's (see below), the effect of the means testing is expected to increase in the coming years.

VERP remains an attractive alternative to self financed retirement in a private pension scheme, since the overall contributions fall short of the value of the benefits, even in those cases where early retirement benefits are only claimed for three years (from 62 to 65).[19]

6.3 The pension system

The public pension scheme is basically a universal system, cf. *Table 1*. This pillar I of the pension system has been supplemented by a strong pillar II in the form of labour market pension schemes over the last 25 years. In addition, individual Pillar III schemes exist, and have been growing.

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been introduced.

[18] Although the social security pension is universal and VERP is not, the difference in pensions of the two systems is sufficiently large to compensate for the higher coverage of the social security pension. In addition, the reform implied that individuals on disability pension would shift to a lower benefit through the public pension scheme.

[19] However, this tends to reduce the tendency to retire earlier than the age of 62 (given current rules), since VERP can only be claimed if one fulfils the criteria for receiving unemployment benefits, and this puts some limitations on retirement before entering VERP.

During the 1990s, a fully funded pension system was gradually introduced for blue-collar workers as part of the wage package in labour market segments covered by agreements between the Danish Confederation of Employers (DA) and the Confederation of Danish Trade Unions (LO). Public employees and most privately employed white-collar workers were already covered by this type of funded pension systems. This extension of the funded pension system implies that the expected increase in total pension income per individual is higher than the expected growth in income per employee. The expected additional income growth implies that the average equivalent disposable income per pensioner relative to employed individuals in the age group 25-64 years increases from 2/3 to 3/4 (Danish Welfare Commission 2006), including the effects from the means testing of social security pension.

The build up of the labour market pension schemes is interesting, since they imply that a large support problem for elderly citizens is being taken care of and ensure that the gap between labour income and pension does not become too large. In the absence of these pension schemes, a larger burden would have rested with the public pension scheme. The labour market pension schemes are thus an important example of a welfare problem which has been addressed outside the public sector and since from an individual perspective, it is mandatory, the scheme fulfils the aim of ensuring that everyone obtains a satisfactory pension.

However, since labour market pensions are based on labour market income, it follows that groups with no or only a marginal labour market attachment will not have a significant supplementary pension (and since the pension schemes are in a build-up phase, this problem also applies to groups that have only been contributing to the scheme for a short period, or with low contribution rates). The group without a significant supplementary pension amounts to 1/3 of the current population of working age (Danish Welfare Commission 2006). This points out that the public scheme still has a significant role to play and also that the distributional profile among pensioners will become more unequal in the future.

Finally, it should be noted that although the labour market pensions contribute to solve a “support” problem, they may thus also reinforce self-financed early retirement, especially for those who find that they are forced to “over-save”. The phasing in of the

funded system may therefore imply an additional income/wealth effect in the retirement decision, and this in combination with changing preferences (third life phase) may imply that the underlying tendency towards early retirement is strengthened at the same time as the policy aim is to ensure later retirement alongside increases in longevity.

7 Policy recommendations

The future of the welfare state has been intensively debated in Denmark in recent years, focusing on challenges including demographic shifts and globalization. As a consequence, a Welfare Commission was appointed (2003) with a mandate to clarify the challenges and suggest remedies. The commission was an expert commission working independently, and it submitted its final report in 2006 (Danish Welfare Commission 2006). A guide line for the proposals made by the commission was to maintain the welfare system and accordingly, the focus was on ensuring the financial viability of the model by increasing (private) employment. The main alternatives of general tax increases or retrenchments of the welfare state were thereby ruled out.

The policy recommendations of the Danish Welfare Commission (DWC) include the following parts: i) earlier entry to the labour market, ii) increased incentives to education, iii) increased incentives to employment, iv) a gradual phasing out of the VERP v) a reform of the flex job system, vi) an indexation of the pensionable age of the social security to the expected increase in life expectancy.[20]

7.1 Earlier entry to the labour market

Given the high labour market participation rates for middle aged individuals, the potential for increasing the size of the labour force is most outspoken for younger and older age groups. One way of ensuring earlier entry to the labour market is to reduce the delays in the educational system. DWC proposes an earlier start in the schooling system by integrating the current pre-school class into the primary schooling system. In addition, DWC proposes that the resources of the currently optional tenth class of

[20] Proposals also include policy measures concerning the production and financing of welfare services. These are ignored in this presentation.

primary school are focused on the weakest 30 percent of the pupils. Finally, the DWC proposed the introduction of bonuses in the study grant system, both for early entry to tertiary education and early completion of the bachelor level. The bonuses are financed by the removal of the study grant for students in secondary schools.

7.2 More education

The large drop-out rate of Danish vocational training and the poor performance in PISA-tests suggest that there are problems in the educational system. To ensure the "right start", measures are to be focused on the primary schooling system and a particular challenge is to improve schooling for weaker pupils and bilingual pupils (descendants of immigrants). To deal with these problems, the DWC proposes the introduction of "all day schooling", where resources are allocated to homework assistance to weaker pupils. All day schooling replaces the current voluntary after-school system.

To increase the focus on education, DWC proposes an extension of the youth unemployment programme to individuals in the age group 25 years to 30 years, cf. Section 4. This increases the time period before young individuals may receive social assistance in excess of study grants. At the same time, activation measures are proposed to start after shorter unemployment spells than for older age groups.

In addition, the economic incentives for education are increased by removing the "middle income tax bracket" of Danish income taxation. The middle income tax bracket is a progressive tax element paid by the typical employee with a vocational training. The removal of this tax therefore increases the return on the investment in vocational training. Similarly, the income level to which the "top income tax level" applies is increased, which tends to increase the return on further education. The reduction in the progressivity of the labour income tax is financed through a gradual increase in housing taxation.

Finally, as an indirect effect, the return to education is increased by both the earlier entry to the labour market and the proposed postponement of the exit from the labour market through the increase in the retirement age (see below).

7.3 Increased incentives to employment

DWC proposes a reduction of the duration of unemployment benefits to 2.5 years and the introduction of a "base level benefit" for individuals who have lost the right to unemployment benefits. The base level benefit is equal to the current social assistance benefit but is not means tested against spouse income as is the case for social assistance. This gives an incentive for the individual to remain in the labour force and participate in activation programmes etc.

DWC also proposes to abandon the special rules for elderly in the unemployment benefit system. These rules currently imply that individuals aged above 55 may maintain the rights to unemployment benefits for a longer period than four years, and that labour market authorities may exclude this age group from activation measures.

DWC also proposes a significant extension of the earned income tax credit to increase the monetary gains from employment, especially for the low income group. The earned income tax credit is financed by part of the increase in the public budget that follows from postponing the retiring age.

7.4 Postponement of retirement age

The major effect on the public finances of the DWC proposals is due to the increases in the retirement age. The overall idea is that the part of the expected life time that the average individual spends working is the same, irrespective of the increase in longevity. To obtain this effect, DWC proposes that the pensionable age should increase at the same absolute rate as life expectancy. If retirement on social security pension were the only exit route from working, this rule would tend to imply that an increasing part of life is spent working. However, since exit to disability pension is also a possibility, the rule tends to ensure that working life constitutes a constant share of life expectancy for the average person.

In addition to the indexation of the statutory pension age to life expectancy, the DWC proposes a gradual closing down of VERP by increasing the entry age to VERP by three months more than the increase in life expectancy. The duration of the pension period in VERP will thereby gradually be reduced over time.

Finally, the DWC proposes that the flexjob system becomes a less economically attractive exit from the ordinary labour market, both for employers and employees. The

reason is that there is a risk that the flexjob system becomes a substitute for VERP and ordinary retirement in case of indexation of the retirement age.

7.5 Labour force and public finance effects of the DWC proposals

The basic idea of the indexation rule in the DWC proposals is to redress the expected increase in the dependency ratio and therefore, avoid the pressure on public finances from an increased number of recipients of public transfers, cf. *Figure 2.* The gradual removal of VERP and the positive labour supply and employment effects of the remaining proposals provide sufficient revenue to finance increased expenditures to public services over the lifecycle of an average individual, due to increased life expectancy. Therefore, the proposals are sufficient to maintain the current welfare arrangements in light of the ageing population (Danish Welfare Commission 2006).

However, it should also be stressed that the proposals of the DWC are not sufficient to finance increases in public expenditures to welfare services per individual that are higher than the general growth rate. Expenditure increases due to e.g. Baumol effects or an income elasticity above one therefore need to be financed by measures that come in addition to those mentioned above (for a further discussion, see e.g. Andersen and Pedersen 2006).

8 Policy reform

Following the report and the proposals of DWC, a major welfare reform was passed in the Danish Parliament in 2006. 90 percent of the seats in Parliament were behind the welfare reform. The reform focused on two issues: Postponement of retiring age and increased incentives for employment. In addition, the reform increased public spending on education and research and development. The reform package does not deal with all policy areas addressed by the welfare commission, neither does it follow the details of all proposals, but it follows the main thrust of the proposals made by DWC.

8.1 Incentives to employment

The duration of unemployment benefits is maintained at four years, but full time activation is introduced for individuals with an unemployment spell longer than 2.5

years. This is in line with the point made in Section 3, i.e. that there is a political reluctance to reduce income transfers and a higher willingness to use instruments that affect the amount of leisure of the recipients. Accordingly, activation is further fine-tuned to reach the target of making benefit dependence shorter.

The welfare reform follows the proposals of the DWC to abandon the special rules for elderly unemployed. However, since VERP is maintained as part of the pension system and pensions rights in VERP are conditioned on rights to unemployment benefits, elderly individuals who are about to lose the right to benefits are offered a job in the public sector, so that they keep their pensions rights in VERP.

8.2 Postponement of retirement

As compared to the proposals of DWC, the reform is less ambitious in three respects: First, the indexation of the retirement age is delayed until 2019, second VERP is maintained and integrated as a part of the pension system and finally, the indexation of the retirement age is linked to increases in the remaining life expectancy of a 65-year old individual, instead of the increase in life expectancy at birth (as is the case in DWC's proposal).

The reform implies that the earliest entry age into VERP is increased by 0.5 years in the period from 2019 to 2022, so that the earliest entry age is 62 years in 2022. Each birth cohort maintains a maximum period of 5 years with pension payment from VERP. Therefore, the pensionable age of the social security pension is increased by 0.5 each year in the period 2024 to 2028. In 2028, the pensionable age will therefore be back at the pre 2004 level of 67 years.

Indexation of the pensionable age is introduced from 2025 for the entry age to VERP and therefore, for the social security pension from 2030. The indexation increases the pensionable age by 0 years, 0.5 years, or 1 year, depending on the increase in remaining life expectancy of a 65 year old. Indexation is performed every five years. The indexation implies that the expected period as a pensioner – VERP plus social security pension – remains at approximately 19.5 years in the years where indexation is performed.

If implemented as stated, the reform stabilizes the number of social security pensioners from 2020-2025 and onwards. The delay implies that the stabilization

appears at a level of pensioners that is approximately 200,000 individuals (or 20-25 percent) higher than the current level.

In addition, the number of disability pensioners increases both due to the fact that indexation of the entry age of VERP and social pension implies an increase in the number of age groups that are potential recipients of disability pension and due to the fact that non-universal VERP is maintained.

The combined effect of the above mentioned three deviations from the proposals of the DWC implies that the increase in the labour force is both delayed and smaller than in case of the DWC proposals. In addition, the higher pension rate in VERP implies that the revenue effect is smaller than if VERP had been abandoned.

Put differently, the reform will ensure that total transfer incomes will not grow as a share of GDP but only from 2020 and onwards. Given the indexation of transfer income in Denmark, this implies that the welfare reform succeeds in maintaining a fixed ratio of income transfer recipients to the working population.

In case of the DWC proposals, there is a tendency that expenditures to transfer income grow at a rate slightly lower than general economic growth, due to the higher annual effect of the indexation scheme. Therefore, the proposal of the DWC implies that expenditures to welfare service may grow in excess of the general growth rate of the economy, without violating the intertemporal budget constraint of the public sector.

As mentioned, there are several reasons why one should expect public welfare services to increase at a higher rate than the general growth rate. First, increased life expectancy implies that a given individual receives public services in additional years in the future. If expenditures per individual at a given age increase by the general growth rate, this effect alone tends to increase the expenditure relative to production over time. In addition, one may mention both the Baumol effect that tends to imply that the relative cost of welfare services increases over time and that maintaining a given level of real welfare services relative to consumption will imply an increase in expenditures to welfare services relative to the general income. Finally, economic growth may imply that real welfare services increase faster than income, if income elasticity is above one, as is probably the case for a number of services, in particular health care.

Therefore, the welfare reform only solves part of the financing problem related to ageing. A tight fiscal policy that keeps the growth rate of welfare services in line with the general growth rate is needed in addition (see also DREAM 2006).

9 Conclusion

The Danish experience suggests that it is possible to maintain a high rate of employment and a low rate of unemployment and, at the same time, have high ambitions concerning income distribution. It is, however, necessary to introduce non economic incentives in the form of activation programmes for unemployed and similar programmes for individuals receiving social assistance in order to be able to avoid the long unemployment spells and a large exit from the labour force into social assistance and other forms of income transfers. If activation or other "duties" are not an option, the formal rules for eligibility to the various types of income transfer must be used to reduce growth in the number of recipients of the given income transfer.

In the case of social security, neither activation nor formal eligibility rules are an option and therefore, ageing tends to be a critical phenomenon for the universal welfare state with high income distributional aspirations, since the increased number of pensioners tends to increase expenditures and threaten the financial viability of the welfare system.

To avoid this problem, the Danish Welfare Commission proposed an indexation of the pensionable age to the increase in life expectancy. Given this rule, the financial viability of the welfare system may be maintained by compromising the distributional goals. A subsequent welfare reform goes a long way in the same direction but leaves a financial problem calling for either a slower growth of welfare services or a less than full indexation of income transfers.

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Comment by Oskar Nordström Skans[*°]

The paper discusses issues of fundamental political importance: Can a society with strong egalitarian preferences build and maintain a welfare state to provide insurance for its citizens *without* discouraging employment? Obviously, this is a difficult topic and in most cases, one will inevitably be faced with the need to compromise on either the level of insurance or the incentives to work.

The paper draws on recent Danish experiences which constitute an excellent starting ground, given how much recent interest the Danish "flexicurity" model has spurred in many European countries, including Sweden.[1] The interest in the Danish model is most likely generated by the remarkable drop in Danish unemployment numbers over the last decade and a half. As the paper clearly shows, however, this development cannot be attributed to the flexicurity model as such, since that model was in place also during the preceding period when Danish unemployment numbers were high, often above the EU-average, and always far above comparable Swedish statistics. Rather, the development appears to be a function of a strengthening of the incentives for unemployed to find jobs. From a Swedish perspective, many of these changes in incentives can hardly be viewed as controversial given that they meant tightening up a system which was extremely lax by Swedish standards. As an example, the duration of unemployment insurance (UI) was shortened from 7 to 4 years, whereas Swedish UI-duration has never exceeded 1 year.[2]

Unemployment, transfer dependency and employment

Interestingly, the paper shows that the drop in Danish unemployment numbers has not been accompanied by a similar drop in the overall dependency on transfers. Rather, transfer dependency has risen almost linearly from the early 1970s. This is a crucial observation which serves as the starting point for much of the analysis in the paper. It

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[°] In writing these comments I have benefited from discussions with Laura Hartman. I am of course solely responsible for all views, and possible errors, in the text.
[1] The term flexicurity comes from the idea that the Danish model combines flexibility in terms of labour market protection, with security through the various incentives schemes.
[2] Although, as discussed below, a renewal of the benefit period was possible after participation in an active labour market program during the 1990s.

shows how important it is to not just evaluate policies with regard to their importance for unemployment. Rather, we also need to know how they affect labour force participation and (ideally) hours worked.

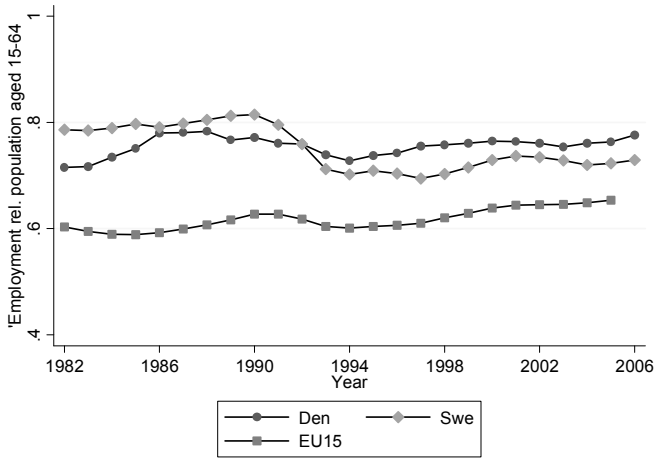
The insight that official unemployment numbers do not tell the full story hit the Swedish public debate in the campaign building up to the 2006 national election. The result was a major confusion over concepts, where various more "inclusive" definitions of "actual" unemployment were put to use. However, as nicely described by Holmlund (2005), the traditional definition of unemployment as the share of non-employed among those either working or actively looking for jobs, is a key statistic for understanding how the labour market works. It is an indicator of discrepancies between active supply and demand, and thus tells us something about the degree of market failure (broadly defined) at the labour market at each point in time. However, it does *not* inform us about the use of available resources in society. For this purpose, we need other statistics such as employment, or even better – hours of work, relative to the working age population. Andersen and Pedersen work along these lines and separately discuss unemployment and other forms of transfer dependencies.

Having said this, it is clear that transfer dependency is not the same as non-employment, and it is thus unfortunate that Andersen and Pedersen do not discuss the corresponding development of employment or working hours in Denmark. Is the raise in transfer dependency a result of people working less, or is it the case that those not working (or even those working) receive an increasing amount of transfers? A simple figure based on OECD statistics of employment relative to population (*Figure A. 1* below) suggests that the development of employment rates may be less worrisome than the transfer dependency numbers seem to suggest – in fact, the employment rates have not shown any signs of a trend fall since the early 1980s. The amount of work needed in order to be classified as employed according to these statistics is fairly low and the numbers do therefore not tell the full story. Nevertheless, the numbers do seem to suggest that the growth in transfer dependency may not be driven by a fall in employment, but rather by a growth in the subsidy rate at a given level of employment. Although, even if taken at face value, this result does not alter the budgetary impact of

the growth in transfer dependency, it does suggest a different interpretation of this time trend than the one presented in the paper.[3]

From a Swedish perspective, it is interesting to note, in the same figure, that the Swedish experience is less encouraging than the Danish; the recession in the early 1990s led to a dramatic drop in employment with only a minor bounce back towards the end of the 1990s despite falling unemployment numbers.[4] This suggests that the recent focus of the Swedish political debate on labour supply is well motivated – perhaps more so than in the Danish case.

Figure A. 1 Employment to population shares in Denmark, Sweden and EU15



Source: OECD databases.

The role of activation policies

The paper convincingly suggests that the rather extreme development in Danish unemployment rates was driven by a tightening of the UI compensation scheme (which previously was extremely generous in terms of duration) and an increased use of "activation" (or workfare) policies. One of the merits of the paper is that it makes a serious attempt to discuss such activation policies.

Activation policy is a topic of great importance also in the Swedish context. The active labour market policies which have been extensively used during a number of

[3] The discussion regarding the relationship between employment rates and budget balance in the introduction clearly gives the reader the impression that the increased use of transfers is a phenomenon driven by reduced employment.
[4] In fact, the development of the Finnish numbers very closely follows the Swedish statistics (although, always below), whereas the Norwegian series is closer to the Danish.

decades have increasingly taken the form of activation arrangements, whereas they started off as mainly "restructuring" devices.[5] During the crisis of the early 1990s, active programs could be used to renew UI benefits after the end of a one-year spell on benefits. This could be viewed as a system with never-ending benefits and reoccurring willingness-to-work tests through participation in active programs. During 2001 the system changed, programs no longer renewed benefits and the unemployed should instead enter a never-ending program when benefits expired. This followed the earlier example of youth policies which, starting in the mid 1990s, should provide all unemployed youths with program participation after 100 days of unemployment.[6] The names of the various activation components have changed over time but the basic principle, that unemployed should be hit by a program (which should never end) after a certain period of time, has remained.[7] In addition, social assistant recipients are subject to an increasing number of municipality-run programs which also often appear to take the form of activation measures. The scope for this was introduced through the Social Assistance Act of 1998.[8]

Thus, a discussion of the role of activation policies is certainly warranted from a Swedish perspective.[9] Unfortunately, the discussion regarding the incentive effects of activation policies relative to those of benefit cuts is not very enlightening. Contrary to the impression given in the text, it is obvious that both benefit structures and activation policies can be time dependent, have a stochastic element (sanctions), or be predictable. Furthermore, the "screening paradox", stating that the unemployed not in need of the incentives are the ones actually hit by them, equally applies to both types of policies.

The main difference between incentives in the form of lower benefits and incentives in the form of activation is in whether *income* or *leisure* is taxed for the long-term unemployed (assuming that activation policies or benefit reductions hit after a certain

[5] See Calmfors *et al* (2001) and references therein for a discussion of the evolution of Swedish active labour market policies.
[6] See e.g. Forslund and Skans (2006a,b).
[7] Presumably as a result of the "activation" idea, these programs have all had names including the word "Garanti" (Guarantee). For young workers: Ungdomsgarantin, Utvecklingsgarantin, Jobbgarantin (current) and for older long-term unemployed: Aktivitetsgarantin and Jobb- och Utvecklingsgarantin (current).
[8] Hjertner Thorén (2005).
[9] See Boone *et al* (2007) and references therein regarding the literature on how to design the optimal UI-benefit system.

period of unemployment). This distinction is mentioned but not explored in the paper. It should make a difference for the following reason: Imagine that there are two groups of unemployed, one which is unemployed due to low productivity or bad luck (involuntary unemployed), and the other due to a high value of leisure (voluntary unemployed). In this case, taxing leisure rather than income should hit the voluntary unemployed relatively harder than the involuntary since, by assumption, these individuals have a higher valuation of leisure. Intuitively, this suggests that the same effect on incentives for the voluntary unemployed would be found at a lower cost in terms of reduced utility for the involuntary unemployed.[10]

Although this reasoning seems to suggest that activation policies are always preferable to benefit cuts, it is important to note, as is nicely done in the paper, that activation is *costly*, whereas benefit cuts mean *savings*. Thus, all else equal, a system of high benefits and extensive activation policies is more expensive.

Interactions between different elements of the welfare state

A priori, it cannot be ruled out that the increase in dependencies of other benefit systems found in Denmark is a direct function of the tightening of incentives in the UI and welfare assistance systems. It is clear that increased incentives in one transfer system may move people to other systems rather than encourage them to go to work – Larsson (2006) and Larsson and Runeson (2007) convincingly show that changes in financial incentives in one system may, in a comprehensive welfare state, induce subjects to move into the wrong system. It is likely that such effects can arise due to benefit cuts or activation policies alike.

Although this may appear as a minor problem mainly of statistical (and budgetary) interest, it may become a real problem if the transfer systems are attached to different support systems. An unemployed worker who switches to sickness compensation (as in Larsson and Larsson and Runeson) for financial reasons is unlikely to be able to fully use the resources available to job seekers at the public employment service. Thus, a

[10] If the egalitarian preferences are, as (reasonably) postulated in the paper, over equality in consumption rather than utility, we are likely to prefer to provide insurance for the low productive rather than those with a high disutility of work.

financially induced switching between systems is likely to generate real effects if these resources are useful.

This line of reasoning appears to suggest that all systems should be neutral in terms of compensation and activation requirements.[11] Indeed, this appears to be the motivation behind the harmonisation between social assistance levels and study grants in Denmark discussed in the paper. However, although neutrality is a reasonable first principle, the role of externalities should also be accounted for. In the case of young workers and education, it is, for example, clear that education is much more expensive for society than passive benefits. Thus, neutrality of compensation must mean that positive effects of education (for society) that counteract these costs are expected.

Although it may seem obvious that education is more useful than unemployment, a word of caution is warranted: Is really more education always good, for all groups and under all conditions? Given that we, in general, are unwilling to accept that participation in labour market training programs is a good outcome in itself, the same criteria should hold for regular education. This means that the possible merits of education should be evaluated against the costs (e.g. in terms of lost job search) for the relevant group. In the worst case, these youths only hibernate in the education system and then exit into the labour market without having accumulated anything but lost time.[12]

The issue of education versus labour force participation for marginalized youths becomes even of more concern given the evaluation of Jensen *et al* (2003) which is reported to show that the main effect of the tightened incentives for youths in Denmark was in transitions into education rather than in transitions into employment. This is in contrast to Swedish evidence, presented in Forslund and Skans (2006a,b), and British evidence, summarized elsewhere in this volume (Brewer 2007), which suggests that youth incentive programs in these countries led to higher transitions also into employment. It is not clear why the Danish experience differs in this respect.

[11] See Larsson (2004) on a discussion regarding the harmonization of different benefit systems.
[12] In the evaluation literature, this is typically referred to as the "locking-in" effect; see e.g. Calmfors *et al* (2001).

Summary

Overall, the paper provides an interesting exposé over different questions that follow from the problem of combining a welfare state with economic incentives. Since the topic is so complex, however, the value of the paper is first and foremost in highlighting some essential questions which should be addressed for a welfare state to maintain a high level of employment. These questions, which should all be viewed as interesting topics for future research, include such fundamental issues as: What is the relationship between transfer dependencies and employment, and why has the transfer dependency increased even though employment has remained constant? What is the optimal policy design in terms of combining activation policies and economic incentives for different groups? How should we think about interactions between different transfer systems so that the incentives do not only induce workers to work when they can, but also encourage workers to be in the right system when not working? How do we design an incentive system for youths so that we get an appropriate mix of education and job search activities?

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