

## DENMARK: TOO GOOD TO BE TRUE?

### 4.1 Introduction

Denmark is known to some as the country of Lego and fairy tales, and for decades it was pinpointed as an example not to be followed. Unemployment was persistently high, the current account and the public budget displayed systematic deficits, there were frequent devaluations, and recurrent changes of government etc. In recent times, the picture has changed radically. There are frequent references to the Danish welfare model, the flexicurity model is highlighted as an example of a well-functioning labour market, the pension system is ranked as the best in the world,<sup>1</sup> and Danes are usually found to be among the happiest people in the world.<sup>2</sup>

In the case of Denmark one may also see a number of paradoxes. It is a small and open economy with one of the largest public sectors within the OECD, and yet Denmark’s economic performance indicators, like per-capita income and employment rates, are among the highest of all OECD countries. At the same time, income inequality is low. In discussions on monetary policy and exchange rate regimes, the option of a stable and credible unilateral exchange rate peg seems to be ruled out, and yet Denmark has successfully maintained such a regime. Denmark has a tradition for being highly open, and there is widespread support for EU-membership among its citizens. The country is a front-runner in the implementation of EU rules and regulations, and yet the euro has not been adopted and exemptions remain regarding military, police and judicial cooperation within the EU.

This chapter takes a closer look at the Danish case – is it too good to be true? The short answer is that Denmark has not worked miracles. Its performance is based on foundations laid years ago in response to an

unsustainable economic situation. In the 1980s policy-makers invested in the credibility of the fixed exchange rate policy and accepted the discipline that this required. Labour market reforms in the 1990s laid the foundation for the flexicurity model as it is currently known. Subsequently, a consolidation of public finances and concerns over the financial viability of the welfare model prompted reforms of welfare arrangements, including pension and retirement reforms. Among policymakers there is an understanding of the constraints faced by a small and open economy, and that the viability of the welfare model ultimately depends on maintaining a high employment level in the private sector.

Danish achievements are the result of hard political work. The policies applied in Denmark are not unique: their packing may differ, but the ingredients are familiar. Denmark’s achievements are a result of economic reforms, initially directed at overcoming the crisis and subsequently turned more forward-looking. If anything in these developments stands out, it is the political economy of establishing consensus across a broad political spectrum. This implies both support for reforms and that continuity and consistency have been maintained in economic policy, despite the fact that most governments have been minority governments (and usually coalitions among several parties) and that there have been frequent changes in government.

### 4.2 Public sector and economic performance

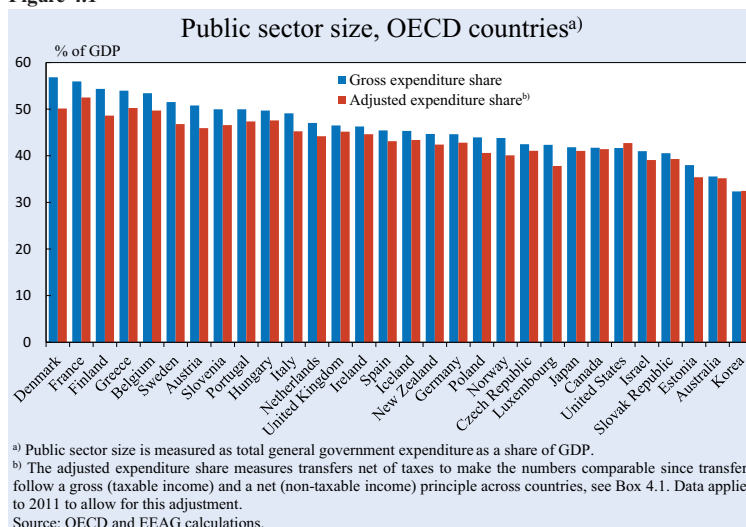
The key question asked by outside observers is: “How is it possible to reconcile Denmark’s relatively good economic performance with its large public sector and high tax rates?” Have fundamental trade-offs been avoided? How can this be explained?

International comparisons suffer from potential measurement issues both when comparing public sector sizes and GDP levels. Some of these problems are discussed in Box 4.1, but they do not fundamentally alter the point that Denmark has a relatively strong economic performance, measured in terms of per-cap-

<sup>1</sup> According to the Melbourne Mercer Global Pension Index, cf. Mercer (2015).

<sup>2</sup> Ranked 3 of 158 in the 2015 World Happiness Report 2015, cf. Helliwell et al. (2015).

Figure 4.1



tics of the Danish/Nordic welfare model. At the same time, Denmark aims to be one of the most affluent countries in the world.

The Danish lesson is not that incentives do not matter, or that there are no trade-offs. Micro-analyses of the incentive effects of taxes or unemployment benefits etc. do not put Denmark in a particular position.<sup>3</sup> Denmark, however, may stand out in terms of what has been done to flatten the trade-off, or counteract the effects of high taxes via the packaging of policies.

ita income, for instance, and that the public sector is large, cf. Figure 4.1.

The size of Denmark's public sector clearly reflects its political priorities. Equal opportunities, the eradication of poverty and low income inequality are important policy goals. Universal entitlement to education, health and the social safety net are thus defining characteris-

While there is a heavy burden on Denmark's large public sector, it is often overlooked that its private sector is among the most liberal in the OECD area. Markets can be distorted not only by taxes, but also by

<sup>3</sup> The system also includes a number of checks and balances, for instance individual identification numbers to ensure that all income is declared for taxation. This raises "Big Brother" issues. It is also the reason why the Nordic countries have such rich individualised data available for research!

#### Box 4.1

##### Measurement issues

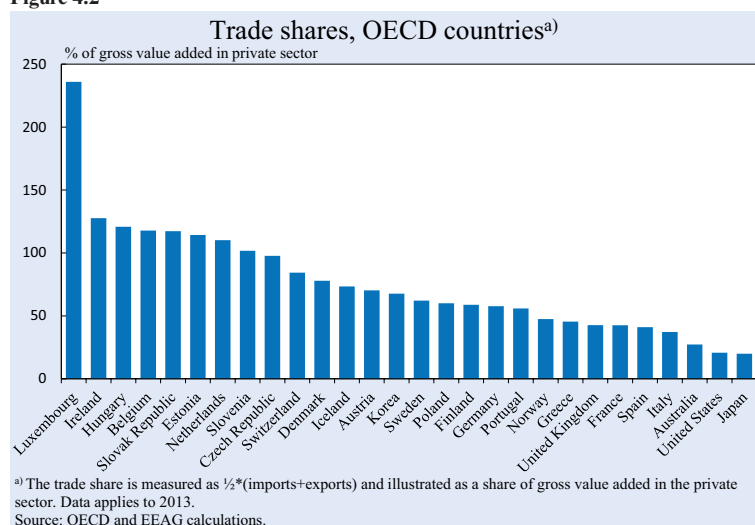
Cross-country comparisons of public sectors commonly use gross expenditure or revenue measures as a share of GDP, cf. Figure 4.1. This approach is problematic since it neglects important institutional differences; see Adema et al. (2011). Some countries pursue a gross principle where social transfers as a rule are taxable income, while others follow a net-principle whereby transfers are not taxable income. Obviously, recorded expenditure and tax revenues are larger under the gross principle for the same net transfers and thus net expenditure. Such differences must be taken into account in cross-country comparisons.

The OECD produces statistics for net and gross public social expenditure. In 2011 gross public social expenditure as a percent of GDP was 30.1 percent in Denmark, 27.2 percent in Sweden, 25.5 percent in Germany and 22.7 percent in the UK. Considering net expenditure narrows the differences considerably. The share was 23.4 percent in Denmark, 22.5 percent in Sweden, 23.7 percent in Germany and 21.4 percent in the UK. In short, the usual measurement approach exaggerates differences in the size of welfare arrangements and thus the size of the public sector. To illustrate the implications of public sector size, Figure 4.1 corrects the gross expenditure share by the difference between gross and net social expenditure. Measured in this way the public sector is still large in Denmark, but not that much larger than in many other countries (and not the largest within the OECD).

The public sector may influence international comparisons in other ways. GDP is a measure of value added created by market activities. Hence, if activities like day-care are shifted from the household sphere to the public sector, recorded GDP will increase. This implies that GDP measures for countries like Denmark, where the public sector to a larger extent has taken over care activities and the like, may have a higher recorded GDP level; see Sinn (2006). Correcting GDP measures for such public activities as old-age, incapacity and child care, GDP falls by 5–6 percent for Denmark and Sweden, but by only 0.8 percent for Italy, for example; see Andersen (2015a). However, the ranking of countries does not change significantly by such a correction, but the absolute differences do. This brings up the general problem that GDP is an imprecise measure of living standards and thus welfare, and that there are a number of institutional and cross-country differences influencing recorded GDP levels. As an example, Gordon (2006) argues that while the gap in GDP per capita between the USA and Europe is about 30 percent, it is reduced to 17 percent when account is taken of excess energy use, prison population, metropolitan dispersion and an inefficient medical care system. For a general discussion of GDP measures, see Stiglitz et al. (2009).

There are also reasons why GDP may be underestimated, especially in countries with a large public sector. Under traditional national accounting conventions, the output value of public activities is assessed from the input (cost) side, and therefore productivity growth is, by definition, zero. Over time this may lead to a systematic underestimation of GDP. To address this issue, the European Commission has decided that output indicators should be used to assess public production in national accounts. Applying this approach over the period 2005–12, Statistics Denmark (2014) reports the average annual productivity growth in the public sector to be 0.8 percent, and the level of GDP based on the traditional approach is therefore an underestimation.

Figure 4.2



rules and regulations, a lack of competition etc. Therefore, for international comparisons, all potential “distortions” should be taken into account. To mention just a few indicators in support of this, the OECD index of product market regulation for 2013 ranks Denmark as having the fifth lowest level of product market regulation (close to the level in the US).<sup>4</sup> The World Bank ranks Denmark number four (highest in Europe, and also above the US) in its 2015 version of the “Ease of Doing Business Index” including 189 countries,<sup>5</sup> and the World Economic Forum Global Competitiveness Index for 2014–15 has Denmark ranked 13 among 144 countries.<sup>6</sup>

The liberal private sector is intimately related to the fact that Denmark is a small and open economy. There are few large companies, but a large number of small and medium-sized enterprises, who are facing international competition in export and/or import markets. The trade share is high (see Figure 4.2), and the more broad KOF Globalization Index ranks Denmark as number seven out of 204 countries.<sup>7</sup> Maintaining competitiveness has thus been a continuous challenge. Interestingly, terms of trade have followed an upward trend, which may reflect an ability to innovate and move up the value added chain (Danish Economic Council, 2014). The current account has since the late 1980s displayed surpluses. There is a widespread understanding of the importance of remaining competitive to sustain high income and employment levels.

<sup>4</sup> See OECD, “Economy-wide Regulation,” *OECD Product Market Regulation Statistics* (database), last accessed on 31 December 2015.

<sup>5</sup> See World Bank (2015).

<sup>6</sup> See Sala-i-Martin et al. (2014).

<sup>7</sup> Cf. 2015 KOF Index of Globalization, [http://globalization.kof.ethz.ch/media/filer\\_public/2015/03/04/rankings\\_2015.pdf](http://globalization.kof.ethz.ch/media/filer_public/2015/03/04/rankings_2015.pdf), last accessed 31 December 2015.

Globalisation is not a new phenomenon. Denmark is not an example of “politics against markets” – if anything, it is an example of how to find a “third way” in striking a balance between markets and state.

Secondly, not only the size, but also the structure of the welfare state matters. The effects of taxes cannot be assessed without taking into account what they finance. Different expenditure types and taxes affect economic performance in dissimilar ways.

As an example, consider labour supply in cases where one may distinguish between passive expenditure reducing labour supply (such as early retirement) and active expenditure supporting labour supply (such as day care, education). Recent empirical work on the nexus between economic performance (economic growth) and the public sector shows that the composition of public expenditure and the mode of financing is more important than its sheer size. The distinction between active/productive and passive/non-productive expenditure is important, and the former may have positive effects on growth (see, for example, Gemmell et al., 2011, and Arnold et al., 2011). A relatively large share of public expenditure is of the “active” type in Denmark, and this helps to explain why economic performance has been relatively good, despite the large public sector, cf. Andersen (2015a). A similar distinction applies to transfers; they are not passive in the sense that they can be claimed unconditionally.<sup>8</sup> Various conditionalities – known as workfare or active labour market policies – are part of the system to balance concern for income security and active job search incentives. It is also a case in point that there are trade-offs, and these policies come at a cost. Denmark spends 1.8 percent of GDP (2013 data) on active labour market policies (direct expenditure on programmes and their administration, and expenditure on transfers come on top of this).<sup>9</sup> This is the highest level of expenditure among OECD countries, where the average is 0.6 percent of GDP.

<sup>8</sup> Entitlement to the basic social safety net is universal in the sense that it is not contribution-based. However, this is not tantamount to transfers being akin to a basic income scheme since various eligibility conditions apply.

<sup>9</sup> See OECD (2015), especially Table Q.

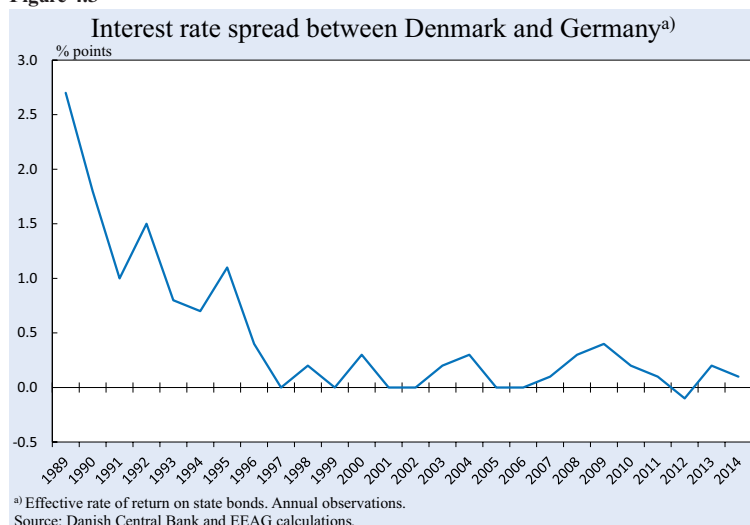
Finally, it is worth noting that the “active” approach may also contribute to reducing income inequality. It is thus notable that low income inequality in Denmark – and the other Nordic countries – can largely be attributed to an equal distribution of market incomes. Education and labour market policies create the basis for high employment and a relatively equal distribution of income. Low inequality is often attributed to taxes and transfers, and although they are important, the labour market outcomes constitute the foundation for the egalitarian outcomes.

### 4.3 Exchange rate policy

Economic policies in Denmark are continuously up to a market test since Denmark is one of the few countries where a unilateral fixed exchange rate is pursued. The Danish Krone is pegged to the euro, and the interest spread to the euro area is a metric of the credibility of the peg, and thus ultimately of economic policy.

During the 1970s and 1980s, when the economy suffered from various imbalances, the interest rate spread was high, and recurrent devaluations took place. Credibility was low, and economic policies were not consistent. A firmer fixed exchange regime was established in the 1980s, based on the premise that discrete devaluations were not a policy option, and the credibility of the peg should be ensured via fiscal policies (and structural reforms). The exchange rate was thus effectively pegged to the Deutsche Mark, and to the euro as of 1999. Denmark has adopted a narrow band for variations of the Danish Krone relative to the euro of  $\pm 2.25$  percent within the Exchange Rate Mechanism II, and this policy has attained a strong credibility.<sup>10</sup> The interest rate spread to the euro area is very small, and has occasionally even been negative,<sup>11</sup> cf. Figure 4.3. It is

Figure 4.3



worth noting that, over the same period, the situation changed from a scenario of systematic current account deficits and rising foreign debt (peaking at close to 50 percent of GDP in the late 1980s) to systematic surpluses and a net foreign asset position (of about 40 percent of GDP).

Since the Danish Krone is pegged to the euro, it is often difficult for outsiders to understand why Denmark does not join the EMU. The question is highly sensitive and the issue has become taboo in policy debates. In parliament, there is a clear majority for membership, but there is a political commitment that the issue should be decided in a referendum. A referendum has been held twice without obtaining support for membership,<sup>12</sup> and the political risk of calling a new referendum is therefore high. In recent polls the no-side has a clear majority, or over two thirds of votes.<sup>13</sup> There is hardly any public debate on the issue, and the positions are at a stalemate. Proponents of membership argue that since the fixed exchange rate policy is not being politically contested, Denmark might as well join to be present at the decision table, while its opponents argue that staying out has not been a problem, so why join.

bank was financing its operations by short-term foreign borrowing) and the central bank raised interest rates, but the markets calmed quickly. Interestingly, and unthinkable just a few years ago, the Danish Krone has also been under an appreciating pressure. This happened during the sovereign debt crisis in 2011–12, and more intensively in early 2015 when the Swiss central bank abandoned the “peg” vis-à-vis the euro and allowed the Swiss Franc to appreciate.

<sup>12</sup> The Maastricht Treaty was not approved by a referendum in 1992. In 1993 a referendum approved the so-called Edinburgh agreement allowing Denmark to opt out of not only the economic and monetary union, but also the parts dealing with cooperation in areas such as the military, the police and the judicial system, as well as union citizenship. A referendum in 2000 had 53.2 percent of the votes against EMU membership.

<sup>13</sup> In previous referenda, the majority of the no-side was lower at the referendum.

<sup>10</sup> The exchange rate has been very close to its parity. The parity is at 746.038 and daily exchange rates have been within the  $\pm 1$  percent band over the entire period from January 1999 to June 2015. Over the period of 2 January 1999 to 14 August 2015, the Danish Krone-euro exchange rate reached a peak of 747.17 and sank to a low of 742.32. The standard deviation over the period is 1.1.

<sup>11</sup> There have been occasional devaluation pressures on the Danish Krone. For instance, at the onset of the Great Recession, there was some capital outflow (mainly driven by the fact that a major Danish

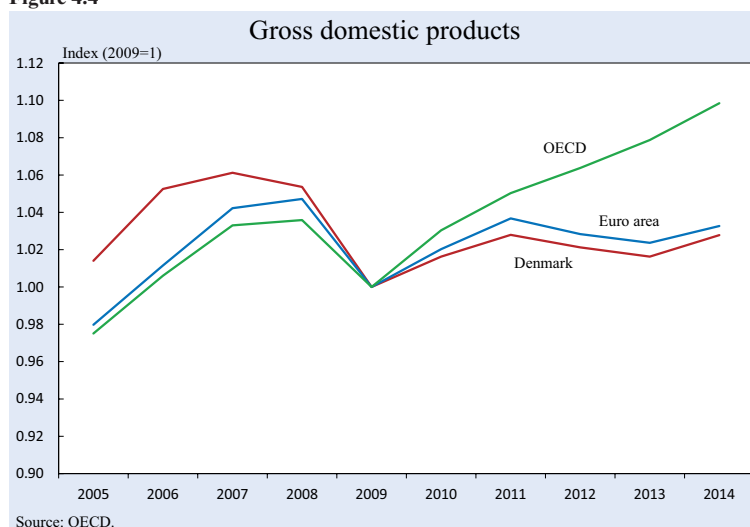
#### 4.4 Model resilience – effects of the Great Recession

Being a small and open economy, Denmark was severely affected by the Great Recession. No less than thirteen countries—including Denmark—experienced a drop in real GDP of 5 percent or more between 2008 and 2009.

Denmark has experienced a boom-bust pattern in the past, cf. Figure 4.4. Prior to the Great Recession, aggregate activity was at or above full capacity utilisation. There were several signs of over-heating, including very low unemployment (significantly below the structural level), accelerating wage increases, and a booming housing market. This development was largely driven by domestic demand. The economy was thus not on a sustainable path, and on the eve of the Great Recession there were already signs that economic activity was fading. The Great Recession accelerated this development. The combination of an already decelerating path and the Great Recession induced a steep decrease in GDP (see Figure 4.4) and employment. Unemployment increased by 2.5 percentage points between 2008 and 2009, and 4 percentage points between 2008 and 2010, almost double the increase for OECD countries on average, although unemployment remained below the OECD average. While the initial increase was larger than for euro and OECD countries, subsequent unemployment has been slightly declining, cf. Figure 4.5.

The financial crisis did not only have foreign causes, but also domestic roots related to a price bubble in the Danish housing market. The financial sector was severely affected by the crisis, and “bank packages” were introduced, but since they relied on bail-in mechanisms there have been no public bailouts of the financial sector. It is also noteworthy that, despite the large turnaround, not least in the housing market, there was no significant increase in household bankruptcies in Denmark. The boom-bust

Figure 4.4



pattern was thus in some respect similar to that seen in some Southern European countries (like Portugal and Spain), but with the important difference that Denmark's financial sector was more resilient and public finances were in a much better position to absorb the consequences of the downturn in economic activity.

The boom-bust pattern can partly be attributed to an excessively lean fiscal policy. The economy was booming with high growth in private consumption and investments, and fiscal policy was expansionary. However, policymakers were reluctant to tighten fiscal policy. When confronted with calls from several economists to tighten fiscal policy, the Danish prime minister stated that economists had to rewrite their textbooks if they did not appreciate how good the situation was. Subsequent developments confirmed that

Figure 4.5

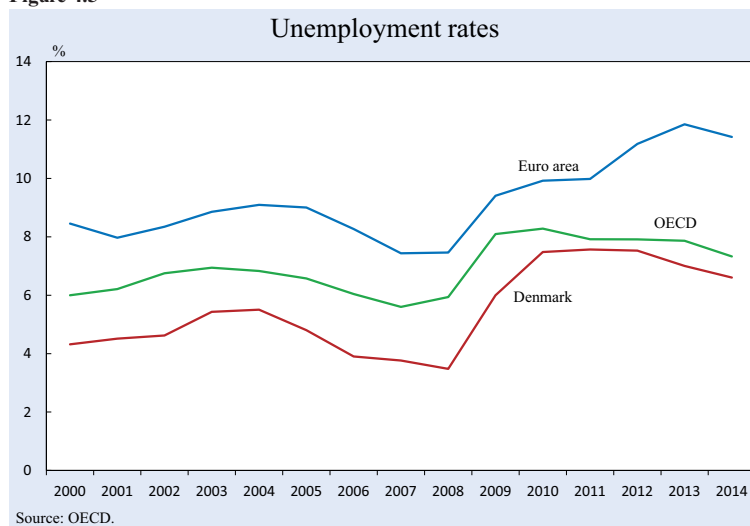
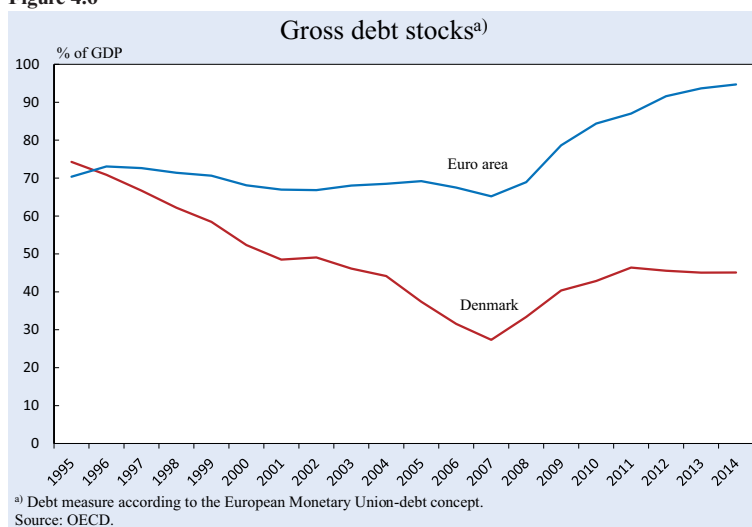




Figure 4.6



the textbooks were closer to the mark than the prime minister!

The destabilising effects of fiscal policy had two main sources: a tax freeze and high public expenditure growth. The liberal-conservative government introduced a so-called tax freeze with the intention of curbing public sector expenditure. The tax freeze meant that tax rates were not to increase, but for property taxes and some excise taxes the freeze was defined in terms of nominal tax payments.<sup>14</sup> In a situation with rapidly increasing house prices, this reduced effective tax rates which, in turn, contributed to further house price increases. At the same time, public consumption growth was high. The average annual growth rate for public expenditure was about 2 percent in the period prior to the Great Recession – primarily driven by increasing health expenditure – while the target was around 1 percent. Fiscal policy was thus clearly procyclical during this period.

After the onset of the Great Recession, fiscal policy was expansionary. Denmark is among the group of countries that pursued the most expansionary fiscal policy over the period 2009–10.<sup>15</sup> The presence of fiscal space allowed automatic stabilisers to work (the strongest within the OECD area) and left room for

<sup>14</sup> Property taxation has two parts: a property value tax to the state and a land tax (municipal property tax) to the municipalities. The state property value tax is 1 percent of the assessed housing value (3 percent of the value above some threshold, in 2015 3,040,000 Danish Krone). A so-called tax freeze implies that the housing value for most house owners remains at the 2002 valuation. The municipal property tax decided by the municipalities lies within the interval of 0.16 percent and 0.34 percent of the assessed land value. A temporary freeze of the land tax has been launched in 2016.

<sup>15</sup> According to Danish Ministry of Finance estimates, discretionary fiscal policy was expansionary over the years 2009–10 and mildly contractionary over the years 2011–14.

discretionary policies.<sup>16</sup> It is thus also part of the story that public finances were consolidated prior to the crisis, cf. Figure 4.6, which meant that there was some room for manoeuvre during the Great Recession.

Although Denmark is one of the European countries with the least problems assessed in terms of standard macroeconomic indicators, the crisis has proved very persistent. As illustrated in Figure 4.4, activity has essentially remained unchanged after a small improvement in 2010–11. Aggregate

demand has remained subdued, particularly due to domestic private consumption and investment, while net export has grown. The protracted reduction in private domestic demand may be related to debt consolidation, precautionary savings and pessimistic expectations driven by the boom-bust pattern. However, being a small and open economy, foreign demand remains of crucial importance.

#### 4.4.1 The labour market – the flexicurity model

Denmark's low unemployment, especially prior to the Great Recession, generated a great deal of hype surrounding the so-called flexicurity labour market model.<sup>17</sup>

The short version of the flexicurity model is as follows: hiring and firing rules are fairly flexible, and the unemployment insurance scheme is generous by international standards. However, this was also the case in the period from the mid-1970s to the early part of the 1990s, where Denmark was routinely listed as a crisis country with problems for almost any macroeconomic indicator, including high and persistent unemployment. Therefore, the *flex* and the *security* part of the Danish policy package cannot, in isolation, account for the performance of the Danish labour market. This is not denying the importance of these elements, but it points out that they are no guarantees of a low and stable unemployment rate. A series of reforms

<sup>16</sup> Denmark has been in the excessive deficit procedure due to deficits exceeding the 3 percent limit in 2010–14. Measured in terms of deficits, public debt etc., Denmark is one of the EU countries facing the smallest problems with public finances.

<sup>17</sup> This section partly builds on Andersen (2015b).

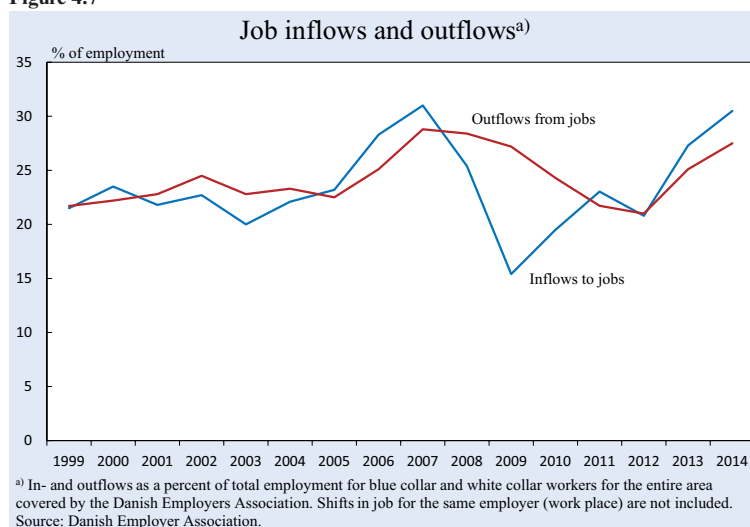
during the last half of the 1990s plays an important role in accounting for the Danish experience. The main thrust of these reforms was a shift from a passive focus on income protection to a more active focus on job search and employment. The policy tightened eligibility for unemployment benefits and shortened their duration,<sup>18</sup> as well as introducing workfare elements into unemployment insurance and social policies in general.

Since Denmark took a severe beating during the Great Recession, the flexicurity model has been put to a serious test. The model as such cannot prevent cycles, and the interesting question is whether the model can weather a significant downturn. Lax firing rules make it likely that employment will fall drastically when aggregate demand drops, and although the social safety net cushions incomes for unemployed, the financial viability of the model is at risk from a persistent decline in employment. A prolonged decline in employment will reduce tax revenues and increase social expenditure, and thus put public finances under strain.

A hallmark of the flexicurity model is a high level of job-turnover, implying that the unemployed (as well as the young entering the labour market) can find a job fairly easily; and that most unemployment spells are short. Can this characteristic survive a large drop in employment?

The answer to this question is given by Figure 4.7 showing inflow and outflow rates to and from jobs for a large part of the private labour market.<sup>19</sup> The effects of the Great Recession are clearly

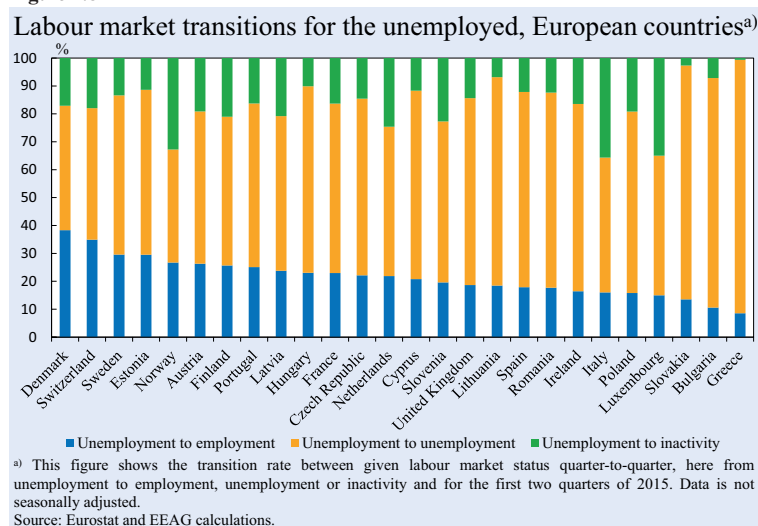
Figure 4.7



visible. Outflows from jobs increased and inflows into jobs declined. More striking is the fact that turnover levels recovered to the levels seen prior to the boom period, despite the overall level of activity remaining gloomy, cf. Figure 4.4. The turnover rates are high from a comparative perspective, and the transition rate from unemployment into employment is also high, cf. Figure 4.8.

Two additional facts are important: exit rates from unemployment are not significantly lower than during the boom years before the Great Recession, for example. Accordingly, most unemployment spells are short. The average duration of an unemployment spell among those on unemployment benefits was 17 weeks in 2014 (compared to about 13 weeks during the boom period). Importantly, exits from unemployment into employment are also back to normal levels.

Figure 4.8



<sup>18</sup> Benefit duration was further reduced from four to two years. A recent reform, following the work of the Unemployment Insurance Commission, has allowed for more flexible employment eligibility rules related to claiming benefits.

<sup>19</sup> A new statistic comprising the entire labour market shows the turnover rate at the same level and a rising trend in job-matches (inflows) from 2009 to 2014. This statistic is only available since 2009 and does not display the changes induced by the Great Recession.

The point of the evidence reported here is that although unemployment has increased, most unemployment spells are short (close to 50 percent of total unemployment is made up of spells of less than three months in 2013).<sup>20</sup> As a result of the high level of turnover in the labour market, youth and long-term unemployment are low by international comparison. High turnover rates thus effectively work as an implicit work sharing mechanism. Equal burden sharing is important from a distributional perspective, but it is also of structural importance. The alternative would be longer unemployment spells concentrated on a smaller group of individuals, more long-term unemployed and a corresponding depreciation of human and social capital. In short, high turnover rates reduce the negative structural implications of high unemployment.

One critical question concerning the flexicurity model is whether labour turnover is excessive. Short tenure may reduce the incentive of both firms and workers to invest in firm-specific human capital, causing lower productivity growth. It is not clear that this is a major problem. International comparisons indicate that human capital acquisition of employees is fairly high.<sup>21</sup> Empirical studies also show that the turnover is conducive to structural adjustments, which in turn improves productivity growth; see Parrotta and Pozzoli (2012).

Excessive temporary lay-offs may also follow, since employers indirectly obtain a subsidy when workers are compensated by unemployment insurance in case of temporary variations in the need for labour. Employers contribute to unemployment insurance financing by covering the first three days of an unemployment spell (if the employment relation has had a duration of at least three months), and this may fall short of the social costs of lay-offs; see Blanchard and Tirole (2003).

#### 4.4.2 Labour market policies

Activation policies are an integral part of the Danish labour market model. Policies in this area have been continuously revised in the light of experience, research and policy discussions. Most recently, the focus has been two-fold. Firstly, there is rising pressure on the young to obtain an education. This is reflected in a recent reform of the social assistance system. For indi-

viduals below the age of 30 (previously the critical age was 25) without a qualifying education, the social assistance level has been reduced so that it does not provide better compensation than study grants. To be eligible for support, it is mandatory for individuals to commence education, or participate in activation programmes.

Secondly, activation policies have been changed from a rather rigid scheme to a more flexible system directed towards labour market needs and an individual focus relying more on job-search/matching than programme participation, as well as incentives to ensure a quicker return to employment. In the first part of an unemployment spell (3 months for persons below age 30, 6 months for persons aged 30 to 49, and 3 months for persons above age 50), the main intervention consists of meetings and counselling to strengthen and target job-search, and further into the unemployment spell this is followed by programme participation (a right and a duty). All of the unemployed also have a right to participate in an education programme lasting up to six weeks (individually chosen from a short-list). The pendula thus swings from very rigid activation policies to more flexible policies, and since the policy shift is still under implementation, it is too early to assess how effectively it is working.

### 4.5 Future challenges

Complacency about past performance may blind, and it is crucial to consider how well prepared Denmark is in relation to future challenges including ageing and migration. How will they affect the model?

#### 4.5.1 Ageing and fiscal sustainability

The global ageing trend also affects Denmark, although the increase in the dependency ratio is to the lower side since fertility rates are comparatively high. The key driver behind ageing is the trend increase in longevity.

A changed age composition may put public finances on an unsustainable path, and this concern has been high on the policy agenda for some years.<sup>22</sup> A number

<sup>20</sup> For unemployed individuals entitled to unemployment insurance.

<sup>21</sup> The share of persons in the age group 24–70 years receiving life-long education is way above the EU average, according to Eurostat data.

<sup>22</sup> The core of the Danish pension system is a combination of tax-financed public pensions and labour market pensions. The latter is a funded defined contribution scheme, which is bargained between social partners (participation is thus mandatory for the individual).



of reforms have been enacted and they all share the common strategic aim of increasing labour supply and employment, which, in turn, improves public finances via lower expenditure on social benefits and higher tax revenue.

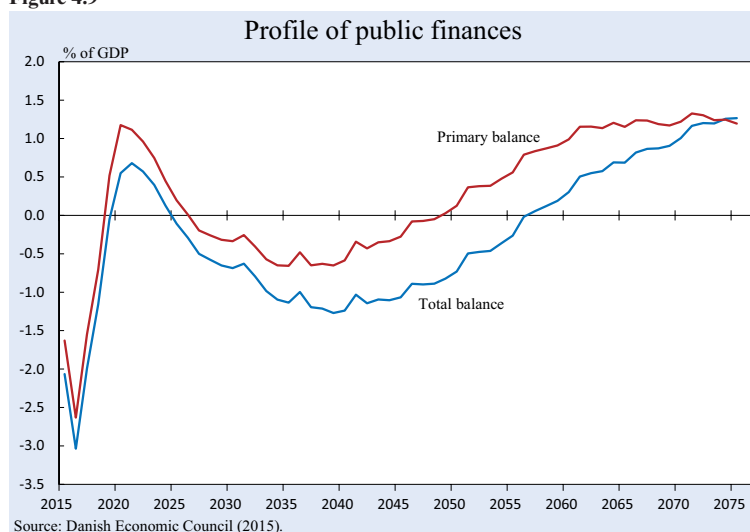
A pivotal element in these reforms has been increases in the statutory retirement/pension ages via reforms undertaken in 2006 (the welfare reform) and 2011 (the retirement reform). Both the early retirement age and the statutory pension age will increase in steps from currently 60 and 65 years to 62 and 67 years, respectively.<sup>23</sup> When these changes are phased in, statutory retirement ages will be indexed to the life expectancy at the age of 60 in order to target an expected pension period of 14.5 years (17.5 including early retirement). Currently, the expected pension periods are 18.5/23.5 years, so the reforms are quite ambitious from this perspective.

Moreover, all key social transfers constituting the social safety net (disability pensions, social assistance, unemployment insurance etc.) have been reformed to further increase the labour supply and employment.

The labour market implications of the reforms are rather large, leading to a projected increase of five percentage points in Denmark's labour force participation rate, which was already one of the highest in the OECD at the outset. The labour market challenge is to ensure that these increases in labour supply translate into employment.

The reform initiatives ensure that Danish public finances meet the criteria for fiscal sustainability (see Danish Ministry of Finance, 2015, and Danish Economic Council, 2015).<sup>24</sup> In that sense, the welfare system is robustly funded. The projected profile for public finances, taking into account both ageing and the reforms outlined above, is shown in Figure 4.9. Although the technical requirement for fiscal sustainability is satisfied, the profile for public finances is problematic since it involves a long string of years with deficits to be followed by surpluses in the distant

Figure 4.9



future. This implies that the public balance will be in conflict with the fiscal budget norm, stipulating that the structural budget deficit is not to exceed 0.5 percent of GDP. Moreover, the margin for coping with business cycle fluctuations within the 3 percent deficit limit will be small. The particular budget profile arises mainly because life expectancy has grown substantially since the reforms were agreed in 2011 (by about 1½ year for a person at the age of 60). Since the indexation mechanism linking retirement ages to longevity will not be operative until later, some cohorts gain a longer pension period than originally planned. In the long run the indexation formula for statutory pension ages is rather tough, since an expected pension period of 14.5 years implies that the share of life spent in the labour market increases when longevity goes up; hence, the long-term improvement in the budget. This latter feature may call into question the medium-run political sustainability of the indexation mechanism.

#### 4.5.2 Migration

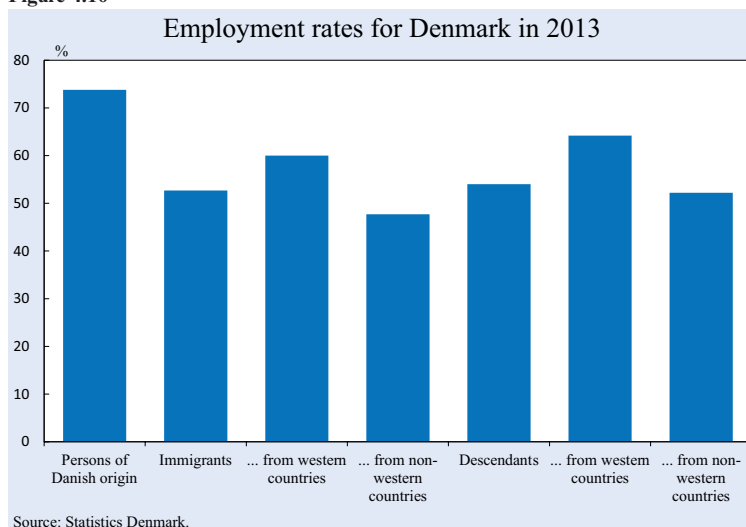
Migration is a particularly sensitive issue in Denmark. It is a predominant theme in public debates, and has been a major issue in parliamentary elections for a number of years. Denmark has traditionally been very open, and in other respects known for having rather liberal views on the way people live their lives. The recent asylum crisis has further attenuated the migration issue, and Denmark has opted out of participating in a common EU-solution to the problem.<sup>25</sup>

<sup>23</sup> The early retirement period is reduced from five to three years.

<sup>24</sup> Defined such that the present value of projected revenues is at least as large as the present value of projected expenditure, plus initial net-debt for the public sector.

<sup>25</sup> Measured relative to population size, Denmark received the fifth most asylum seekers in 2014 among EU countries. The relative position will be lower for 2015.

Figure 4.10



It is well-established that the implications of immigration for public finances are closely aligned with the employment rate of immigrants; see OECD (2013) and Hansen et al. (2015). The higher the employment rate, the larger the net contribution to public finances, and vice versa. This is no surprise since most of the jobless are entitled to some form of social transfer and the tax burden on earned income is high. In an extended welfare state, public finances are highly sensitive to the employment rate; see Andersen (2015a).

It is therefore impossible to generalise about how immigration affects public finances, and thus the financial viability of the welfare model, since this depends on the employment record of the group in question, cf. Figure 4.10. The labour market performance of immigrants varies significantly, making it difficult to generalise. But at an aggregate level, immigration from high-income countries (higher share of migrant workers, students, well-educated etc.) may improve public finances (be neutral), while immigration from low-income countries (more asylum seekers, family reunification, lower qualifications etc.) tends to negatively impact public finances.

The design of the welfare model in general may in itself be an impediment to labour market entry for some immigrants.<sup>26</sup> The Danish labour market is characterised by relatively high minimum wages and a compressed wage structure. Working in a poorly paid position is not an option. It is a consequence that there are

<sup>26</sup> Empirical evidence does not find strong support that welfare arrangements function as magnets attracting migrants; see Pedersen et al. (2008) and Giuletti et al. (2013). There is some indication of “welfare magnet” effects between the “old” and “new” EU member states (see De Giorgi and Pellizzari, 2013), but not more generally influencing EU migration flows; see Skupnik (2014).

relatively high qualification requirements for finding a job, and few low-skilled jobs.

In addition, the reference point for labour market participation is high for both men and women. By international comparison, the employment rate for various groups of immigrants is not particularly low in Denmark. However, employment gaps are large, reflecting generally high employment rates for natives (the welfare model is an “employment model”), especially for women. Lower labour market participation rates

may also reflect different cultures and norms for some immigrants with respect to gender roles, for example. This effect may be compounded by language barriers, problems related to recognising foreign education qualifications and possible discrimination in the labour market.

The policy debate on migration has been lively in Denmark, and various policy initiatives have been taken.

Firstly, immigration rules have been tightened. International conventions and EU-rules limit the room for manoeuvre in this respect, but Denmark has introduced tougher criteria for family unification.<sup>27</sup> For voluntary migrants from outside the EU, there are selection criteria that depend on qualifications, job opportunities etc. The latter follows an international trend and a “race to the top” to attract the best qualified labour; see for example Chaloff and Lemaître (2009).

Secondly, there have been several changes in the social safety net prompted by immigration issues. The welfare model builds on the principle of universality; that is, equal rights for all independent of past history (employment, tax payments etc.). This has not been changed for welfare services, but there have been changes for social transfers. However, the options are constrained, not least due to EU-rules. Since eligibility cannot be made directly dependent on nationality, screening is attempted via eligibility criteria in the social safety net.

<sup>27</sup> The so-called 24-years rule is much debated. It requires both spouses to be at least 24 years old. Additionally, the couple’s connection to Denmark must be stronger than to the country of origin, unless one spouse has lived in Denmark for more than 26 years.

The core element of the social safety net is the so-called social assistance, which provides a floor for economic support to all those unable to support themselves and their family. A residence principle for eligibility was introduced in 2002, implying that full social rights to social assistance are attained after residence in Denmark for 7 out of the last 8 years. In 2006 this was further strengthened by adding an employment criterion, stipulating that eligibility depends on having been in ordinary employment for an accumulated period of at least 2½ years within the last 8 years.<sup>28</sup> Individuals who do not fulfil these requirements are entitled to a different transfer (start aid/introduction benefit) equivalent to roughly half of the value of social assistance. Although, these conditions did not achieve a complete screening, since they also affected Danes returning after extended periods abroad, they did have the largest effect on groups of immigrants with a low employment rate and thus very likely to receive social assistance.

This scheme was extensively debated, not least because the employment effects of the benefit reductions were small. The above-mentioned rules were abolished by the Social Democratic government in 2012, but the newly elected Liberal government (2015) has reintroduced a similar scheme. The frequent changes in policies in this area reflect the sensitivity of the issue and different political standpoints on it, but the overall trend has been towards a tightening of the rules on both immigration and access to the social safety net.

A particularly controversial issue is the universal state child subsidy (*børnechecken*) to which all parents are eligible. This implies that a guest worker who leaves his family in his home country is still eligible to the subsidy, even if the children are not living in Denmark. To many this is a sign that the generosity of the Danish welfare model goes too far. In 2010 an eligibility condition was introduced, stipulating that full entitlement to the subsidy requires two years of residence in Denmark (the subsidy is reduced proportionally in case of a shorter residence period, starting with 25 percent of the subsidy after 6 months' residence). This rule applies to all immigrants, including those from EU countries. The EU court has twice (in 2011 and 2013) ruled this to be in conflict with EU rules. Since 2013 the scheme has been administered accord-

ing to EU rules, but the issue is being contested by policymakers.

Immigration, particularly by migrant workers, also directly affects labour markets. As for other “old” EU countries, there has been an upward trend in migrant workers. While this is an intentional consequence of EU-enlargement and the single market, there have been concerns about its labour market effects. Firstly, there have been problems in terms of ensuring compliance with labour market and tax rules. Secondly, many labour market issues in Denmark (like minimum wages, for example) are not regulated by law, but settled via collective wage bargaining. Among unions there is thus a concern that migrant workers undermine collective bargained outcomes and release “race-to-the-bottom” mechanisms.

#### 4.5.3 Welfare services – increasing demands

Denmark – and the other Nordic countries – stand out by virtue of the extensive public provision of welfare services like education, care and health. This has important implications for equal access (universality) and opportunities, but it also contributes to redistribution. Moreover, solutions offered by the welfare state are supposed to meet reasonable standards acceptable to most, and are not supposed to be of a lower standard only acceptable to those who cannot afford better quality private solutions.

The extensive provision of welfare services raises various challenges. Services may be exposed to both the Baumol cost disease (low productivity growth) and the Wagner effect (high income elasticity of demand), which creates an expenditure surge. This is most clearly seen in the area of health. Life sciences make ongoing progress offering new and better treatment, but this immediately translates into an expenditure pressure on public health expenditure.

The importance of the health area is reflected in a consensus across the political spectrum, irrespective of views on the size of the public sector, that health expenditure should increase. As mentioned above, the fiscal targets for expenditure growth in the early 2000s were violated primarily due to a public expenditure hike in health.

Education is a topic of lively debate in Denmark, which has the highest public education spending as a

<sup>28</sup> A further employment criterion was added to target couples, implying lower levels of social assistance (for those meeting the above-mentioned criterion) to couples with an insufficient employment record.

share of GDP among all OECD countries. Yet educational outcomes are mediocre, and there is a great deal of discussion over the achievements of the educational system in both qualitative and quantitative terms; see e.g. Bogetoft et al. (2015). In qualitative terms, Denmark does not score particularly high in the Pisa tests, for example. In quantitative terms, around 1/5 of a cohort still does not get any education beyond basic schooling (10 years). Moreover, there is also the problem of high turn-over (most youths embark on higher education, but drop-out rates are high) and low completion rates. A further issue is the choice of subject, and whether the consumption value of education dominates the investment value (relevance for the labour market), since education is publicly financed and study grants are relatively generous.

All levels of the educational system are currently undergoing reforms to address some of these challenges. Some of these reforms are still in the pipeline, and others are in the implementation phase, meaning that it is still too early to judge their success.

The large level of public consumption (and thus the high public employment level) raises important questions on productivity and efficiency in the public sector.<sup>29</sup> These issues are not new, but have been brought to the fore by the discussion of the financial sustainability of the welfare model. While reforms imply that the requirements for fiscal sustainability are met, this only ensures that it is possible to finance current standards. Financial scope for improvements needs to be found if they are to be realised. Since reforms have already considered most routes by which labour supply and employment can be increased, the need to prioritise will be sharper in the future. Pressures to increase expenditure in various areas require financing via tax increases, cuts in other areas, or improvements in efficiency and productivity. Most policymakers refrain from the first two, and the focus therefore switches to efficiency and productivity within the public sector.

It is much easier to agree in principle on the need for productivity and efficiency improvements in the public sector than to deliver such improvements. There are ongoing discussions on this. Explicit targets have been formulated, but there are obvious measurement problems in controlling whether these targets are met. Some recent changes to make public provision more

productive have been taken, a controversial example being a new “time agreement” for teachers. Outsourcing may be a solution in some areas, but more generally it is important to have a clear management structure for public institutions, so that their performance can be evaluated continuously and in a systematic way.

#### 4.6 Conclusion

Public debates often pronounce particular countries to be “super-models”, as is the case for Germany and Sweden, for example, and more recently for Denmark. Despite differences in country performances and lessons to be learned from cross-country benchmarking, such discussions easily become superficial, leading to a naïve “copy and paste” view. This neglects the complementarity between different policy instruments, the institutional structure and the political environment. History also documents that the “super-models” have their ups and downs, stressing that performance is shock dependent and various models/countries have different comparative advantages.

The relatively favourable performance of the Danish economy is not the result of a quick fix, but the outcome of a long string of reforms addressing structural problems and very explicitly taking into account the constraints faced by a small and open economy. The latter is immediately clear from the fixed exchange rate policy and the need to ensure that it is credible. This has passed a market test since the interest rate spread vis-à-vis the euro area has been very small for years, and even negative in some periods. The Danish case also shows that policy choices are possible even in an era of globalisation. Denmark’s public sector plays a larger role than in most other countries. The interesting lesson is how the welfare state has been designed so as to balance concerns over economic performance on the one hand, and the public provision of welfare services and the pursuit of egalitarian outcomes on the other. Two points are particularly important. Firstly, while the public sector is large, the private sector is very liberal in Denmark. The Danish model is thus not “politics against markets”. Secondly, welfare arrangements have a strong active focus on supporting labour market participation and human capital acquisition. Since the financial viability of the welfare model ultimately depends on maintaining a high employment level in the private sector, the conflict between welfare objectives and

<sup>29</sup> Productivity in this context refers to whether a given task is solved cost efficiently or with the highest possible quality for given costs, while efficiency refers to whether the right tasks are being addressed.

economic performance is not as stark as it may first appear.

Looking forward, the future holds both political and economic challenges for Denmark. On the political side, it is unclear whether Denmark is a fully-fledged member of the EU. Denmark's rejection of the euro and the exceptions to EU regulations that it has introduced on a number of other issues makes it unclear whether Denmark is in or out. Is it a tenable position to be a selective member? This question was revitalised by the referendum in December 2015 on whether Denmark should change its blanket opt-out on all EU justice and home affairs cooperation in favour of an opt-in model as adopted by the UK and Ireland. The outcome was a "no", further confirming Denmark's "side-lined" position on EU cooperation.

Looking to the future, migration is a particularly thorny issue for a country with extensive welfare arrangements. Even if welfare arrangements are not magnets attracting migrants, the financial viability of the welfare model rests on a high employment level. Egalitarian objectives imply high entry requirements in the form of qualifications to find jobs (to qualify for high minimum wages), as well as generous social transfers. This causes a very tight relation between the employment rate and how public finances are affected by immigration. Denmark thus faces a difficult trilemma of having to choose between extremely restrictive immigration rules (constrained by international treaties and EU rules), lowering minimum wages or differentiating between social rights. All three avenues challenge the basic objectives of the welfare state. To date Denmark has largely pursued the first and third avenues, but how far is it possible to proceed in these directions?

Ageing challenges fiscal sustainability. In the Danish case, the first test has been passed. A number of reforms, notably increases in pension ages, imply that the criterion for fiscal sustainability is met. The second test is to ensure that the reforms work out and deliver the anticipated effects. Policy discussions often focus on new initiatives to be taken; but it is equally important to ensure the effective implementation of already approved reforms and make them work. In the case of Denmark this is not a trivial point, since its economic policy strategy relies critically on substantial increases in labour supply and employment. This is not an impossible task, but not a trivial one either. Retirement ages are going to increase significantly, and although

this is motivated by increasing longevity and healthy ageing, there are still hurdles to pass. Does the design of the system provide the right economic incentives to support increases in the labour supply and employment? How can the level of qualification be maintained and developed to facilitate such increases?

The strategy of ensuring both high employment and an equal distribution of income depends critically on ensuring not only a high level, but also a reasonably equal distribution of qualifications. Despite the substantial resources devoted to education, guaranteeing "value for money" in education is a major challenge. A particularly severe problem is the large share of young cohorts who do not receive a labour market relevant education.

There are also challenges within the public sector. Since it is large, and not directly exposed to market forces, it is essential to maintain focus on efficiency and productivity within the sector. Public finances will be strained in the future, and room for improvement has to be found either via the reallocation of resources or improvements in efficiency and productivity.

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