

## ENGLISH SUMMARY

### Chapter I: The Danish Economy

The current upturn in the Danish economy will continue for the next couple of years, although with diminishing intensity. Accordingly, GDP growth in 2005 is expected to be around 2¼ per cent. This is a little less than GDP growth last year but somewhat more than normal. As a consequence, the unemployment rate will fall to approximately 5.5 percent of the labour force this year. Next year GDP growth will be slightly less than 2 per cent and in 2007 output will increase in accordance with trend growth, which will probably be around 1¾ per cent. The unemployment rate is expected to level off in 2007 at about 5.1 per cent of the labour supply.

As in 2004, the expected growth in the years to come will primarily be driven by domestic demand. Growth in exports is expected to be modest, partly because of the relatively slow growth in some of Denmark's export markets, in particular Germany, and partly due to an assumed depreciation of the dollar.

There are several uncertainties regarding the international economy. These uncertainties concern, for example, oil prices, interest rates, and the low rate of growth in Europe and Japan. A perhaps more important threat to the international economy comes from global imbalances. These imbalances arose as a result of the international upturn and show up most clearly as a twin deficit on the US current account and public budget. The imbalances are to some extent caused by the expansionary fiscal and monetary policies in the US in recent years, which have contributed to a large increase in private consumption. The Chinese currency has been kept low compared to the dollar, which has aggravated the American balance of trade. On the other hand, dollar purchases by the Chinese central bank have to some extent financed the American current account deficit.

A removal of the twin deficit will most likely result in decreasing growth rates in the USA or in a substantial drop in

the dollar value. Whether such a restoration will be gradual or sudden is, however, difficult to say. A major economic setback in the USA or a sudden drop in the dollar value will definitely affect economic developments in the rest of the world.

There is much uncertainty related to the development in Danish house prices, which have increased considerably during the last decade. A future price drop caused by, for example, a large rise in interest rates would negatively affect private consumption and consequently domestic demand. The market for dwellings has furthermore become more sensitive to interest rate changes in recent years. This has been caused by the large amount of outstanding loans issued with variable interest rates, which will mean greater interest payments if the interest rate increases. However, the newly issued debt instruments, which incorporate fixed ceilings on otherwise variable interest rates, reduce the sensitivity to large interest rate increases.

Private consumption in Denmark is expected to grow by approximately 4 per cent in 2005, and will be an important driving force behind a large growth in domestic demand. The increase in consumption is due to higher incomes and to a larger consumption ratio, resulting from less unemployment and rising house prices. Fixed business investments and residential investments also contribute to the large growth in domestic demand.

The significant growth in domestic demand in 2005 will induce a considerable increase in imports. Only a modest growth in exports is expected. The current account surplus will fall from about DKK 35 billion in 2004 to about DKK 25 billion this year. In 2006-07 the current account surplus is expected to be DKK 20-25 billion.

Employment only increased a little last year, even though GDP growth was almost 2½ per cent. Employment is projected to increase considerably in 2005, which is a result of the substantial economic growth last year and this year. Employment will also increase in 2006 but is expected to remain approximately unchanged in 2007.

The labour force is assumed to be more or less unchanged in the years of the forecast. Therefore, the increase in employment will reduce unemployment in 2005-07. This year unemployment is expected to drop by approximately 15,000 persons, reaching a level of about 5.3 per cent at the end of 2005. Afterwards the decrease in unemployment will be less. Unemployment is expected to be around 5.1 per cent of the labour force in 2007.

Consumer prices will increase by approximately  $1\frac{3}{4}$  per cent this year. An expected drop in the oil price and an increase in the value of the Danish kroner will result in increases in import prices being small. As consumer prices are affected by import prices, inflation will also be relatively small, even though wages are expected to grow by approximately  $3\frac{1}{2}$  per cent. In 2006-07 increases in import prices will again be small, meaning that inflation will remain low, although the Danish economy will come close to its potential.

Table 1 Short-term outlook for the Danish economy

	Current prices	Per cent of GDP	Percentage change, volume				
	DKK bn.						
	2004	2004	2003	2004	2005	2006	2007
Private consumption	695.3	48.1	0.9	4.3	3.8	2.4	2.2
Public consumption	385.6	26.7	1.0	0.7	0.7	0.7	0.7
Gross fixed capital formation	288.0	19.9	1.3	4.7	5.4	3.1	2.5
consisting of:							
Residential investments	72.6	5.0	11.2	10.8	7.9	3.1	2.0
Business fixed investments	190.3	13.2	-0.8	2.9	5.0	3.2	2.7
Public investments	25.1	1.7	-0.3	6.6	2.5	2.0	2.0
Stockbuilding (a)	3.6	0.3	-0.1	0.4	-0.2	0.0	0.0
Total domestic demand	1,372.6	94.9	0.9	3.9	3.1	2.1	1.9
Exports of goods and services	629.3	43.5	-1.6	4.0	3.2	3.1	3.2
Imports of goods and services	555.4	38.4	-1.4	7.4	5.2	3.8	3.7
GDP	1,446.5	100.0	0.7	2.4	2.2	1.8	1.7
<b>Key indicators</b>							
Consumer prices, percentage change (b)			1.8	1.1	1.7	1.6	1.4
Unemployment, per cent (c)			5.9	6.1	5.5	5.3	5.1
Current account, DKK bn.			46.1	35.8	27.3	22.7	21.6
Current account, per cent of GDP			3.3	2.5	1.8	1.5	1.3
General government financial balance, DKK bn.			14.6	33.7	35.9	34.0	34.4
General government fin. balance, per cent of GDP			1.0	2.3	2.4	2.2	2.1
Hourly wage costs, percentage change			4.2	3.0	3.6	3.7	3.6
Terms of trade, percentage change			2.2	0.1	0.1	-0.1	0.2

- a) The percentage changes are calculated as real changes in stock-building relative to real GDP in the previous year.
- b) Implicit private consumption deflator.
- c) Percentage of the total labour force. National definition.
- d) The DKK/USD exchange rate is taken as 6.58 in 2003, 5.99 in 2004, 5.67 in 2005, 5.41 in 2006 and 5.12 in 2007.

Sources: Statistics Denmark, *National Accounts* and own estimates.

## **Policy Recommendations**

The upturn in the Danish economy makes the coming years a favourable period for reforms. Reforms aimed at increasing the labour supply, e.g. through better integration of immigrants and later retirement, will be easier to implement when unemployment is low. Germany provides an example of how difficult it is to implement reforms in a situation with high unemployment.

In the coming years demographic changes will create increased pressure on public finances. This should be taken into account when drafting the economic policy for these years. The 2010 plan set up objectives for mid-term economic policy on this basis. It is a positive factor that the government's programme for the next four years includes a list of instruments that can be used to increase employment and reach the planned 2010 employment level. It is also good that the government has put forward a concrete plan to improve the integration and employability of immigrants. However, without new initiatives, it is unlikely that the objective of a permanent increase in employment of 60,000 persons compared to 2003 can be achieved.

Consequently, there is a need for further initiatives to improve employment. Moreover, it will be natural to look further ahead and set up new objectives for medium- and long-term economic policy up to, for example, 2015. By extending the time horizon, it will be possible to include the effects of reforms that will take a longer time to implement. The analyses in Chapters II-VI in this report look at new models for the structure of the welfare state. Reforms are needed, since the present version of the Danish welfare state will come under increasing pressure.

When working out a new plan other proposals could be taken into consideration as well, especially the recommendations by the Welfare Commission to be published by the end of this year. Inspiration can also be found in numerous reports about the pressure on the labour market, including those from The Commission for Future Growth ("Tænketanken Fremtidens Vækst") and the Globalisation Council ("Globaliseringsrådet"). Numbers of job losses due

to outsourcing are fairly small compared to the number of jobs that are created and destroyed each year, but nevertheless the consequences of globalization should receive due attention. In particular, it is relevant to consider shifts in labour demand, whether caused by globalization, technology, or other factors. In that connection it will be obvious to look at the conclusions reached by the Government Commission on Life Time Learning and Education.

The upturn in the Danish economy means that there is no conflict at present between short-term and long-term considerations in fiscal policy. In a situation where the economy is close to its capacity limit, fiscal policy should not contribute to increased activity. Large public surpluses should be sustained in order to reduce public debt. In the past, it has been difficult to fulfil the ambitious objectives for limited growth in public consumption. Challenges will be greater when municipalities with different levels of taxes and expenditures are merged in 2007, because there is a risk that municipalities with high expenditure levels will set the standards in the new municipalities.

The automatic changes in the public budget will in most circumstances be sufficient to dampen fluctuations in the business cycle. This is also assessed to be the case under the present economic outlook. Consequently, it is not relevant to reintroduce the mandatory savings scheme (SP), which was originally introduced to dampen private consumption and was suspended in 2004-05 in order to stimulate consumption. Suspension and reintroduction of the SP is a very uncertain way of regulating the business cycle. The effect hinges on the condition that mandatory savings either cannot or can only to a limited extent be offset by changes in other savings. Furthermore, there are the usual arguments against fine tuning. These reservations point to an abolition of the SP scheme unless there are strong arguments in favour of a scheme that can strengthen savings. However, it is difficult to see what role the SP scheme can play as a supplement to existing pension schemes.

If a fiscal instrument is needed to regulate the business cycle, a more obvious instrument would be to advance or

postpone public investments, especially in a situation where the tax freeze limits the number of instruments available. The effect on activity of changes in the public budget is more immediate, because demand is affected directly. It is, however, problematic to use public investment as an instrument to regulate the business cycle, because public investments serve structural purposes. It is advisable to have a detailed public plan identifying investments that are suitable to advance or postpone.

The high oil prices have been mentioned as a risk factor that can threaten the economic upturn, because high energy prices reduce purchasing power and increase production costs. However, high energy prices should not lead to decisions to lower energy taxes. Energy taxes reflect environmental damage, which is typically unaffected by higher energy prices. To the extent that the high energy prices are permanent, the appropriate reaction should be less energy consumption. A global reduction of energy taxes would give the OPEC countries an incentive to keep energy prices high, because they know that price will only have a limited effect on demand.

There is an increasing focus on research as a means of improving productivity and thus a means of ensuring a high level of wealth. The particular interest in applied research which can promote innovations and the use of research in production has led, through the establishment of The Danish Councils for Strategic Research (“Det Strategiske Forskningsråd”) and The High-Technology Foundation (“Højteknologifonden”), to a reorganisation of the Danish system for research grants. Both institutions serve the purpose of strengthening growth and employment through research and development cooperation between Danish firms and public research institutions. The targeting of public research grants to certain firms, groups of firms or sectors should be done with great caution, and should be weighed against the advantages of spending public research grants on basic research. It is risky to increase grants for applied research in private firms to the detriment of basic research at universities. In addition, it is very important to coordinate the activities of The Danish Councils for Strategic Research

and The High-Technology Foundation if both are to be maintained as independent institutions for public co-financing of private research.

In order to ensure that public co-financing of applied strategic research and development gives a high economic return to society and does not to a large extent replace private research and development, it is important that there is a high degree of private co-financing. If there is not, then there is a risk of providing selective subsidies to private firms. The less the research can be assumed to be available for other potential users, the higher the level of private co-financing should be. That is, the faster the research results are spread, and the larger the effects they have for other firms, the larger the level of public co-financing that can be justified.

Another key challenge in connection with public research grants is the selection of the priority areas with great potential. There are no certain ways of selecting these areas, and it is therefore necessary to have an active interaction between public research institutions and users of public strategic research, i.e. private firms. It is important that the selection of priority areas is based on heavy private sector co-financing in order to ensure that public research grants contribute to a real increase in total research. It is also necessary to select broad priority areas, and to ensure that results are made available to a large group of users. Finally, the quality of research should meet international standards. If these guidelines are not followed, public research grants should not be given. The value of publicly financed research should be measured by productivity increases in the economy as a whole, reflecting the spreading factor, and not more narrowly by considering the success of only one specific firm or sector with respect to employment or exports.

## **Chapter II: Income Benefits and the Welfare State**

The Danish welfare state is under pressure. The challenge comes from demographic changes and globalization. Demographic development necessitates an increase in pub-



lic spending as we approach the year 2040, because the number of recipients of income benefits will increase and the labour supply decrease. Increasing globalization will also put pressure on tax sources and will increase the cost of the high taxes.

In the last 40 years there has been a considerable increase in expenditure on income benefits for people aged between 16 and 64 years. This has been caused by an increase in the proportion of the population receiving income support and by an increase in the absolute number of people in that age group. The voluntary early retirement pension in particular has contributed to the increase in the number of income transfer recipients. Labour market policy contributed to the decrease in unemployment during the nineties, and has reduced the structural problems of the labour market. Further, there has been a decrease in the proportion of long-term unemployed. But the proportion of people in rehabilitation, on long-term sick leave and receiving long-term social assistance has been constant.

A central purpose for income support is to redistribute income between rich and poor. Income transfers contribute to a more equal distribution of yearly disposable income than market income provides. However, calculations in chapter II show that there are large differences between how much different income benefits contribute to the redistribution of income. For instance, pensions for the disabled contribute a great deal to the redistribution of income, while voluntary early retirement pensions hardly contribute to the redistribution of income at all.

In a lifetime income perspective, the redistribution of total income is considerably smaller than redistribution of annual income. This results from the fact that some income benefits are paid to people who have a low income only temporarily, but have a high a lifetime income. If tax-financed income benefits to the individual could take lifetime income as a starting point instead of annual income, it would be possible to lower taxes. In Chapter VI the possibility is discussed of partially basing redistribution of income upon lifetime income instead of yearly income.

One way to secure sustainable development of the Danish welfare state is to increase employment. An increase in employment could come from a reduction in the number of persons who receive income benefit. Because of this, it is appropriate to analyze the different benefit schemes and the interaction between them.

### **Chapter III: Active Social Policies and Disability Pension**

The number of people with limited attachment to the labour market has increased steadily over the last thirty years, and the boom period in the second half of the 1990s did not reduce this group of people. This is unfortunate, as a prolonged period of limited attachment to the labour market increases the risk of a permanent exit from the labour market through disability pension. In Chapter III, the Danish disability pension system and related benefit schemes are analysed.

Absence from work due to sickness is not in itself tantamount to having a fringe position in the labour market, but prolonged sickness absence increases the risk of withdrawal from the labour market with disability pension benefits. The total sickness absence is estimated at approximately 5 per cent of the labour force and thus is comparable to the general unemployment rate. Compared to other EU countries, short term sickness absence is high in Denmark, which may be related to the widespread system of giving full pay during sickness absence.

In recent years, public expenditures on sickness absence benefits have increased markedly. This has been partially caused by a change in law whereby public employers are now entitled to receive sickness benefits from the municipalities when their employees are absent for more than two weeks and receive full pay during sickness absence. This has had the effect of increasing the number of persons on benefit without changing total sickness absence. In the report it is estimated that approximately half of the increase in

the number of sickness benefit recipients in the official statistics is due to this “re-classification” of sickness absence in the public sector. The analysis furthermore shows that the number of sickness benefit recipients, measured relative to the labour force, is pro-cyclical.

The number of publicly subsidised jobs for people with limited work capacity, so called flexi-jobs, has increased markedly in recent years. To some extent this reflects a political priority of limiting entry into disability pensions by increasing the number of subsidised jobs. Since the late 1990s, this policy has resulted in a number of changes in the disability pension scheme and other benefit schemes. However, the number of flexi-jobs has increased more than the entry into disability pensions has decreased. A short-term increase in the total number of flexi-jobs and persons on disability pension benefits may be acceptable, to the extent that the increase in flexi-jobs attenuates the intake to disability pensions in the longer term. However, the bulk of the increase in the number flexi-jobs has occurred in age groups other than the age groups that have seen the largest reductions in disability pension intake, indicating that to a significant extent persons employed in flexi-jobs are individuals with only a low risk of exiting from the labour market through disability pensions. Furthermore, there is a risk that the flexi-job scheme will displace some regular employment.

After a reform in 1984 extended the disability pension program, the number of people on disability pension benefits increased steadily up until the mid-1990s. In more recent years there has been a small decline in the number of people on disability pensions. This may partly be related to the introduction of active social policies in 1998-99 and, more recently, to a reform in the disability pension scheme in 2003. In combination with the introduction of active social policies, the policy was implemented that disability pension benefits would only be granted to people who could not achieve attachment to the labour market through job subsidies or other measures. On the basis of data collected from a 10 per cent sample of the Danish population over the period 1996-2002, the chapter shows that entry into the disability

pension scheme decreased by more than 30 per cent after the 1998 reform. This should be contrasted with the increase in flexi-jobs and possible increases in take-up rates of other benefits after the reform. At present, it is not possible to evaluate the 2003 reform in detail. The rate of entry into disability pensions in 2004 is comparable to the rate of entry before the implementation of the reform, however, indicating a limited effect. The government expected the reform to decrease entry to disability pensions by approximately 3,000 a year and to increase the number of flexi-jobs by a similar magnitude.

The most prevalent entry-routes into disability pensions are social benefits and sickness absence benefits. Approximately three fourths of all persons entering disability pensions received such benefits prior to entering the disability pension system. Some 10 per cent did not receive any public income support.

In Denmark most workers receive full or close to full pay while absent due to sickness. This is set out in wage contracts between employers and wage earners. It is consequently difficult to strengthen financial incentives to employees to reduce sickness absence, for instance by stopping pay for the first couple of days of illness, as was suggested recently by the OECD in their survey of the Danish economy. Instead, sickness absence could be reduced by using administrative rules, including stricter requirements being placed on municipalities to follow up on illness. The Danish government has proposed new procedures for the monitoring of persons taking sickness absence and for follow-up practices. Part of the proposal is the suggestion that the mandatory doctor's certificate that is required from people taking sick leave under current law should be dispensed with. Swedish evidence shows that doctor's certificates have a positive effect on the exit rate from sickness absence benefit to employment. It may therefore be inappropriate to abandon this requirement. The implementation of the new rules needs to be followed closely.

One element of the Danish active social policies is the rehabilitation scheme. This provides income support to persons

with reduced work capacity, who are not otherwise able to provide for themselves. Income support may be given, for example, to complete a course of education, or as a job subsidy. The benefit level corresponds to the maximum benefit available under the unemployment insurance scheme. People on social benefits who are admitted to the rehabilitation scheme will therefore experience an increase in benefits. This may in some cases be appropriate, as it may motivate the individual to complete the rehabilitation course. However, it is not appropriate in general, and it should therefore be considered whether to lower the benefit level for this group of people when other considerations do not provide strong arguments against doing so.

Workplace injuries and repetitive strain injuries are significant causes of exits from the labour market through the disability pension scheme. Employers bear financial costs as a consequence of workplace injuries and repetitive strain injuries. These costs consist of losses in production, expenditures on temporary replacement employees, the obligation to pay an employee's wages for the first two weeks of sickness absence, and premiums for mandatory insurance policies for workplace injuries and repetitive strain injuries. However, employers do not cover the costs of medical treatment, sickness benefit after the first two weeks of sickness absence, and any disability pension benefits. Employers' marginal costs related to workplace injuries and repetitive strain injuries are therefore lower than the marginal social costs, a fact which may encourage irresponsible behaviour.

Consideration could therefore be given to increasing employers' financial incentives to reduce workplace injuries and repetitive strain injuries. Several options are available in this respect. Firstly, the premiums for the current workplace injury insurance schemes could be scaled so that each employer's premium is related to that employer's claims history, without increasing total premiums paid by employers. Secondly, employers could be obligated to pay a larger share of the social costs than they do today through their insurance premiums, including a proportion of the public expenditures on sickness and disability pension benefits.

Finally, fines related to violating working condition regulations could be increased.

However, there are a number of other considerations which mean that employers cannot be charged the full social costs, and that scaling of insurance premiums could not be implemented on a large scale. Firstly, employers might become more reluctant to hire people perceived as being at greater risk, and might also have an incentive to lay off older workers with a greater risk of repetitive strain injuries, if they knew they would be charged higher insurance premiums if there were more claims from their employees. It might also be difficult to relate general attrition to work for a particular employer, and employees might also have some responsibility in this regard. These considerations should be weighted against the desire to reduce workplace injuries and repetitive strain injuries.

## **Chapter IV: Voluntary Early Retirement Pension**

In 1979 a scheme for early retirement was introduced in Denmark. The aim was to make room on the labour market for the young unemployed, and at the same time to make it possible for older, less fit employees to retire. The scheme made it possible for employees between the ages of 60 and 66 to retire. The only requirement was membership of the ordinary unemployment benefit scheme. Several reforms have since been implemented to reduce participation in the scheme, but there are still 180,000 people, or 45 per cent of the relevant age group, on voluntary early retirement pensions (VERP), (“*efterløn*”). Chapter IV contains several analyses of the VERP scheme.

A comparison of the persons on VERP and the total population in the same age group shows that persons on VERP resemble the total population in most respects. Thus the highest level of education for persons on VERP is almost the same as for the total population. Similarly, health indicators for the people on VERP are much closer to those who are active in the labour market than to persons on disability

pension. The comparison shows one notable difference, namely that the unemployed have a higher likelihood of entering the VERP scheme than those in employment.

In the 1990s the transitional allowance scheme (“*overgangsydelse*”) was introduced and then abolished. This scheme was targeted at the long-term unemployed between the ages of 50 and 59. Since the scheme was closed down, the rate of employment has risen for this age group. This clearly supports the view that abolition of the VERP scheme would lead to higher levels of employment for the relevant age groups (and not to an increase in unemployment).

A 1999 reform of the VERP scheme increased the required period of membership of the unemployment benefit scheme to 25 years, introduced an explicit contribution to the VERP scheme, and made VERP less favourable for people with large supplementary pensions. On the basis of micro data studies of this reform, it is estimated that the average retirement age has increased by approximately 2 months. In addition, the introduction of the explicit VERP contribution has led many young people to stop paying this contribution. This effectively means that fewer will be eligible for VERP in the future. Despite these more long-term effects, it is estimated that well over 100,000 persons will be on the VERP scheme in 2030. This estimate does not take into account the fact that historically there has been a rising trend in the participation rates for VERP – probably due to a positive income effect.

Several possible reforms to the VERP scheme are analyzed in the chapter. The calculations of the effects of the reforms of the VERP scheme are based on the assumption that 10-15 per cent of the persons who would go on to VERP would be on disability pension (“*førtidspension*”) if the VERP-scheme was abolished. Even though such calculations are uncertain, it seems clear that drastic changes would be needed in order to have significant effects on labour supply and public finances.

An abolition of the VERP scheme would increase labour supply and improve public finances. This would make an

important contribution to achieving fiscal sustainability. In addition, the employment opportunities for persons just under 60 years of age would improve. One often-stated argument for the VERP is the consideration for employees who are no longer as fit and energetic as they were. However, the scheme is not specifically targeted at this group. Analyses in the report show that people currently on VERP enjoys much better health than people on disability pensions, and only slightly worse health than those in employment aged 60-64. Thus, the scheme should be regarded as a general welfare scheme subsidizing early retirement of generally fit employees.

Abolition of the VERP scheme would be most beneficial for the public finances if it were done soon. On the other hand, announcing the abolition some years in advance would make it possible for those affected to adjust.

If the VERP scheme is abolished, adjustments to the rules for other schemes related to the labour market and the social security system would be necessary. On one hand, the special rules for unemployed 55-59 year olds (longer maximal benefit period) would no longer be warranted. On the other hand, there could be reasons for adjusting the requirements for disability pension, but it is not obvious that this would be the case.

## **Chapter V: Insurance Income Support**

Public income benefits can be considered as public insurance arrangements redistributing wealth from more fortunate to less fortunate people. It is sometimes argued that it could be appropriate to use private insurance more widely. This could reduce public spending on income benefits. In Chapter V there is a discussion of the pros and cons of different insurance arrangements. The relationship between unemployment benefit and social assistance is also investigated, and an earlier proposal to create a uniform system for income compensation for unemployment is discussed.



The advantage of changing public insurances to private insurance schemes would be that private insurance takes into account the fact that people have different requirements and needs for insurance coverage. On the other hand, a proportion of the population would probably not be able to have proper insurance coverage. Therefore it would hardly be appropriate or distributionally acceptable to completely rely on private insurance or on a form of public insurance where premiums are calculated using only actuarial principles.

A system for income replacement must ensure that individuals will receive an acceptable income and at the same time take into account the fact that people have different insurance requirements. These goals can both be achieved with a compulsory basic insurance for everyone and an additional voluntary insurance for those who want a higher level of cover.

In Denmark, unemployed workers may obtain income support through the social benefits system or, if insured, through the public subsidised unemployment insurance system. All citizens are covered by means-tested social security benefit. This benefit is dependent on spouse's income and liquid assets, in contrast to unemployment insurance benefit, which is paid contingent only on the event covered by the insurance taking place, i.e., unemployment. Approximately 80 per cent of all 18-66-year-olds are insured against unemployment. This high rate may to some extent be explained by unemployment insurance being a prerequisite for eligibility to the popular voluntary early retirement scheme.

Means testing of social security benefit means that it is difficult to estimate the net benefits from unemployment insurance, as these depend on future spouse's income and are different for family breadwinners and non-breadwinners. Furthermore, means testing results in reduction in the incentives to search for work or take on extra work in cases where one or both spouses receive social security benefits, because any extra income earned by one spouse reduces the benefit received by the other spouse.

In Chapter V, a new system for income support in case of unemployment that eliminates these drawbacks of the current systems is discussed. The new system consists of a basic benefit, which all workers attached to the labour market are eligible for, and a voluntary insurance supplementary benefit. The definition of being attached to the labour market is that one must meet specific eligibility criteria, for example having been employed for one year within the three years in the period before unemployment, and accepting job offers and participating in active labour market programs as required by law. If a person has this status, he or she would be eligible for the basic benefit indefinitely, unless the person failed to satisfy the availability criteria. If that happened, means-tested social security benefits would be available. The amount of the regular benefit would correspond to the current level of social security benefit for single non-breadwinners. Unlike social security benefits, these regular benefits would not be means-tested. The regular benefit plus the voluntary insurance supplement could yield a total income support corresponding to the level received in the present unemployment insurance system.

The new system would have a number of benefits compared with the present system. Firstly, it would be more transparent, which could increase the possibility for an individual to optimize his or her choices. Secondly, the incentive to take up work would increase for a subset of the population. Finally, all employees would have access to income support in the event of unemployment, regardless of their spouse's income.

However, the new system might increase public expenditures and might decrease the incentives for job search for those of the unemployed who were not insured against unemployment and who were not eligible for social security benefits, due to a spouse's income. This provides an argument for reducing the overall compensation rate or for gradually reducing the compensation rate over the course of the unemployment spell for the voluntary unemployment insurance scheme. In conclusion, the new system would have a number of advantages compared with the current

system, but more analyses are required than are given in this report in order to design a system that balances each consideration.

## **Chapter VI: Mandatory Savings Accounts for Social Insurance**

An important goal for the welfare society is to redistribute a part of the income in the society. This is done, for instance, through income benefits. A significant part of income benefits is essentially a redistribution of income between different periods of the life cycle. Examples of this type of benefit are education support, support to families with children, and the voluntary early retirement scheme. Some of these benefits are given to people with relatively high lifetime incomes. Financing these benefits contributes to a high tax pressure. The relatively high level of compensation in the Danish transfer system also distorts the labour supply.

A possible reform of the tax and transfer system is outlined in the chapter. This could lower marginal taxes and reduce the amounts drawn on a number of income benefits that primarily redistribute income over the life cycle. The reform would increase total employment and income and at the same time maintain the social safety net. The reform is based on mandatory saving accounts.

Mandatory savings accounts mean that a part of the money paid in income taxes or labour market contributions is paid into individual accounts. When the owner of the account uses one of the income benefits that form part of the system, payments are withdrawn from the account. When retirement age is reached, any surplus would be paid as a supplement to the public pension. If the account has a negative balance at that time, it would be set to zero. The system would mean that a person who had a surplus in fact paid for his or her own income benefit, because the income benefit would be withdrawn from the account. This would discourage unnecessary withdrawals from the account. Extra payments into the account are not a tax, because extra payments to the account, including interest payments, are returned to the

owner of the account. The system would ensure liquidity support in the event of income losses, because the owner of the account would have the right to draw from the account even if it was in deficit.

In the chapter, a possible model is presented for a system of mandatory savings accounts for social insurance for Denmark. In the example, the system consists of education benefit, maternity benefit, child benefit, sickness benefit, unemployment benefit and social assistance for short-term spells of unemployment, and voluntary early retirement pension. These are included because calculations in Chapter II show that these benefits primarily redistribute income over the life cycle and not from the rich to the poor.

In the first part of the calculations, changes in behaviour caused by the implementation of mandatory saving accounts are taken into account. These calculations show that the gains from the accounts are first and foremost distributed to people with relatively high lifetime incomes. The total sum of surpluses for the accounts amounts to DKK 7 billion.

In the second part of the calculations possible changes in behaviour are illustrated. It is estimated that 60 per cent of people between 16 and 64 years of age would be affected. Making only modest assumptions, the calculations show that changes in behaviour could finance the surpluses. The changes in behaviour would create an increase in the labour supply and increase in the number of working hours for the employed. The calculations show an increase in employment by 30,000 persons.

In the calculations, a significant part of the effects from changes in behaviour stems from fewer people choosing to leave the labour force for the voluntary early pension scheme. In the report it is recommended that early retirement pension be abolished. Consequently, calculations are made which exclude early retirement pension. If voluntary early pension is not included in the system the calculations with the same moderate assumptions for the behaviour of the labour force show that only 60 per cent of the surpluses can be financed.

The calculations are associated with a significant amount of uncertainty concerning both the behavioural and the distributional effects of implementing mandatory savings accounts for social security. This uncertainty results, for example, from factors such as which benefits are included in the system and whether the citizens will regard payments to the account as savings and not as taxation. The size of the change in labour supply and the amount of withdrawals in social benefits also create uncertainty. However, the positive effects on employment and welfare seem to be rather significant. It is recommended that further investigations are made of mandatory savings accounts for social insurance.