The economics of welfare

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Question 1

Background: The voluntary early retirement scheme (VERS) was introduced in 1979, during a recession with high unemployment (12.4% in 1978 and 9.2% in 1979). The original aim of the scheme was offer unskilled laborers a possibility of early withdrawal from the labor market. But the scheme could only be introduced universally for all unemployment insured. The hope was that youth unemployment, which was above average, would be reduced with the introduction of VERS, while the overall unemployment rate would fall. Within some years the "take-up rate" raised to 50% of those aged 60-66 years later, 60-64.

For long periods, there has also been considerable pressure on the older employee to leave the labor market or a desire for an early withdrawal. It is expected that the exam paper contains a brief description of the VERS model today and the 2006 - reform's intent to change the VERS from 2019 onwards.

Prospects: In the period 1990-2010 there was an intense economic and political debate on the influence of future structural challenges on the welfare state policy design today. It is the strong interest in demographic analysis, combined with a new perspective on a long-term budgeting, which opened the eyes of economists on economic sustainability. Analyses by Kotlikoff and others of DREAM to the Welfare Commission 2003-05, revealed that most Western countries have a significant sustainability problem and a particular challenge in a stagnant or declining labor force. Denmark, located in the middle group of countries analyzed in the work of Kotlikofs and others, expect according The Economic Council recent reports sustainability a problem around 1.5% of GDP, with a shrinking workforce. Furthermore, the global crisis intensified deficits and indebtedness of the public sector, thereby worsening the long-term economic problems. Hence, the exam paper should include an analysis of the impact economically, socially and in public budgets.

Tools: As analytical tools can be used, The neoclassical labor supply theory (NC), or push, pull, jump, theory (PPJ). There may also be referred to Nicolas Barr's utility theory or generational accounting.

NC theory concerns the tradeoff between work and leisure. Substitution effect and income effect can, given the reservation wage (below which level no one will work), be used in the analysis of the withdrawal. At higher market wages is more likely that seniors selling their work. At higher alternative income (reservation wage) as pension, savings or VERS are more likely to retire early.

If there is an increasing focus on retirement plans, which are strictly actuarially controlled (occupational, deferred pension etc.) late withdrawal will be stimulated. If the retirement age in public schemes increases, the cost of leisure is raised, and more seniors tend to return to working.

The PPJ theory illustrates the many incentives behind the decision to remain in the workforce or retire. Push reflects the events or incentives that push seniors out of work. Pull-impact is all benefits and incentives that draw seniors into retirement. Finally Jump is the expression of the exogenous determinants that contribute to leap from employment to VERS or Pension.

The most far-reaching policy change for VERS is a complete and rapid removal, e.g. after a short warning. **The social consequences** can be extensive. During a recession, these policies would involve a risk of substantial unemployment among seniors and other groups.

When it also recalled that benefit period per. 1st July this year has been reduced to two years of unemployment, this implies a change in such a situation to the seniors after subsistence period is referred to their dependents or spouse maintenance, alternative without fortune (wealth less than DKK 10,000 for singles, 20,000 for married couples) cash when all other financial sources have been exhausted. A significant unemployment may lead to a wage pressure in the downward direction for a number of vulnerable groups. Nearly 15 to 20% of current early retirees are also assessed as being worn out (example: Welfare Commission) and must - late in their lives – go through a lengthy process for obtaining disability benefits. There will also be significant differences between educational groups. Skilled and unskilled workers and other groups with little education are typically former starters on the labor market, and have markedly lower life expectancy.

They will achieve relatively long periods of work and less time in retirement than groups with longer education. High-income groups with greater savings in pensions will experience that a delay of withdrawal increases the pension savings for higher pension payouts. Moreover, the next generation of young pension savers could adapt to the new situation. They will either experience a higher pension because of the actuarial impact of longer working, or they will reduce the level of savings to achieve the same expected income in retirement life as before the removal of VERS.

NC and the Keynesians tend to disagree on the employment opportunities for seniors. NC will emphasize the proportional relationship between the labor and employment, which in the long term will absorb the increased senior labor supply. Against this stands the view that a recession will always marginalize the weaker social groups, seniors will not be picked out for job interviews. On the other hand, there are now far less indication that the older employees were less productive than others.

The **macroeconomic consequences** are clear. The Welfare Accord of 2006 will be implemented from 2019 onwards, why workforce and growth is particularly affected in the next 8 years. A removal of VERS will increase the workforce and thereby economic growth. It can create substantial unemployment over at period of time, until the economy has adapted. It should also be considered if the situation can give rise to higher frictional unemployment. At the same time, the economy may eventually provide more growth on the basis of the greater labor supply. The long-term sustainability is likely to be greatly improved. It can also be expected that the development reduces retirement savings for younger groups who will have to reckon with more time at work and less time in retirement, which over time could be expected to adjust their savings accordingly.

The **public sector** will immediately experience substantial savings in the order of 16 billion DKK, on the other hand, perhaps low growth rates may increase spending in other social programs, unemployment, early retirement scheme flex etc. In the short term, it is expected that a rapid elimination of early retirement scheme will provide a large deficit because of the accumulated retirement contributions must be refunded. This will markedly increase the public debt, as a one-off effect. In the longer term, an increased output means more tax revenue and a way to balance the government budget.

An **acceleration of 2006**-settlement will in the long term, have a number of similar effects as a complete elimination, but the social impact, impact on government budgets and the economic effects especially 2011-2020 will in some areas differ.

In **social terms**, the early retirement scheme will imply later retirement to take place sooner, but adjustment for this will happen gradually so that seniors and managements of companies have a longer adjustment period. This can be important for HR functions in large enterprises and public sector so they can adapt jobs to the new seniors needs, but could imagine that some businesses and seniors choose part-or flex scheme as a useful transition to a new Danish "fleksseniority" model.

In the **macroeconomic area**, smooth transitions will imply that the labor force until late 2020 toward increases in the expected harmony with a possible transition from recession to a better economic climate.

For the **public budgets**. a smooth acceleration of the reform will imply that retirement system basically is retained, but reduced if necessary to 3 years. This means that the payment of retirement contributions can be postponed, unless the government maintains its proposal for a voluntary tax payment here and now to people who want to opt out of an already connection to the early retirement scheme.

Question 2

Within the EU system social reforms are not implemented on community level through directives or legislation, but through a soft method: OMC (Open Method of Coordination). The tools that are available for OMC's analysis reports are preparation of social indicators, comparisons of statistics, etc.

This leaves social policy in principle to the Member States' national policies, supplemented by EU consultations.

Basic principles of EU law rules for coordination of the migrant EU citizen to social security may eventually affect national policies. These principles apply not only to the 27 EU member countries also known as the EEA countries (Norway, Iceland and Liechtenstein) and Switzerland, also under certain conditions, have joined the agreement.

There are four basic principles of EU approx. 500 mil. residents concerning the social protection and equality for migrant workers.

1. The principle of equal treatment in employment of its citizens
2. Aggregation principle of rights
3. Exportability of rights
4. Pro rata temporis.

For an open economy like the Danish, it is important for companies and public organizations that they can attract qualified workers. In the years prior to 2008, Denmark has considerable inflow of labor from Sweden, Germany and Poland, etc. Most continental European countries subscribe to the social security earning principle. This faces the Danish model with a significant challenge. Despite immigration stop / changed immigrant policy from 2001, immigration to Denmark has accelerated. The public benefits for foreigners are dependent on their employment rate and of the regulations which largely involves benefits to their families and returning home.

This has prompted Danish politicians to consider the earning principle in a number of universal schemes to reduce transfers. So far, relatively few retirees have gone abroad after retirement, but this is expected to accelerate. However, few European migrants annually take up residence in another EU country, but this trend may accelerate. These conditions can put the Danish model under a long-term pressure, which over time may increase the importance of funded schemes (e.g. Occupational Pensions) or the vesting rules (e.g. fraction pension). This in light of that Denmark may again need inflow of labor from other EU countries in years to come.