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## Highlights in this issue:

- Denmark's population is ageing, while the immigrant population is projected to rise.
- Sustaining the generous welfare system requires low dependency ratios and high labour market participation.
- Better integration of immigrants could underpin fiscal sustainability.

## Immigrants in Denmark – improving integration to sustain the welfare state

By Ana Claudia Alfieri and Jens Matthiessen\*

### Summary

*Denmark is facing the challenge of an ageing population and the consequences of increasing immigration. The Danish universal welfare state, which includes a rather compressed wage structure and high welfare benefits, requires a broad tax base and a relatively low dependency ratio to be sustainable. However, the immigrant population is relatively low-skilled as a result of the migration policies in place and the fact that immigrants are attracted more by existing networks than by welfare-magnet effects. Immigrants therefore tend to be difficult to integrate in the labour market, making them more welfare-dependent than natives. Denmark's policy focus is consequently on raising the labour market participation of immigrants in order to help meet Denmark's long-term fiscal challenges.*

### Introduction

Like most European countries, Denmark is facing the challenge of an ageing population. The projected ageing is leading to a substantial increase in the number of retirees and to a shrinking working-age population, which constrains future labour supply and risks slowing down economic growth. Under the present welfare system, public expenditure will increase as the share of dependent persons grows. The funding of publicly financed goods and services in Denmark is universal, i.e. everybody contributes to the system by paying taxes. As the level of the transfers and the quality of the services are high, the system requires a broad tax base and a low dependency ratio to be sustainable.

Denmark's strategy in preparing for the effects of ageing is based on debt reduction, combined with measures increasing the labour supply by raising participation rates. With the room for manoeuvre limited, since the country already has one of the highest employment rates in the EU, a part of the challenge for the sustainability of public finances is to raise employment in segments of the population which tend to have lower employment rates (European Commission, 2004).

Some 8 per cent of the Danish population are immigrants. The overall employment rate of the immigrant population is similar to that elsewhere in Europe, at 51 per cent compared to 54 per cent in the EU-15. However, the labour market participation of non-Western immigrants is markedly lower than that of native Danes, and their welfare dependency thus higher. These two phenomena are closely intertwined and their effects will increasingly weigh on public finances as this group becomes a larger part of the working-age population. For Denmark, immigrants are thus a pocket of potential labour supply.

The purpose of this Country Focus is to look at Denmark's immigration in the context of the Danish welfare state and discuss some implications for fiscal

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sustainability. It will also analyse the factors which affect the integration of immigrants in the labour market and the policies which are being pursued to enhance participation.



## **Economics of immigration and the Danish welfare state**

Traditional economic theories of migration are somewhat analogous to traditional trade theory but within a human capital framework (Borjas, 2000). Their conclusion is that in a world with free labour mobility, people would migrate from countries with low wages to countries with higher wages to maximise the net present value of their expected lifetime income.

The skill composition  
of migrants depends  
on relative income  
distribution...

However, the self-selection and the skill composition of migrants will depend on the income distribution of the source country relative to the host country. High-skilled migrants will move to countries with greater wage dispersion (positive selection), while low-skilled migrants will try to reach countries with greater wage compression and significant income redistribution (negative selection). In particular, a country with unemployment insurance will attract those who assess their own risk of being unemployed higher than average, a phenomenon called the “welfare-magnet” effect in the literature (Borjas, 2000). However, it may also attract those with a high accumulation of human capital (the high-skilled), since it appears that migration entails a higher risk for them. The net welfare-magnet effect on the skill-endowment of the migrants will therefore not be clear-cut (Brücker et al., 2002).

... but the net  
welfare effect is  
ambiguous

Nevertheless, Denmark remains a prime example of a country where negative selection effects might occur. In the academic literature, the Danish welfare state is defined as a *universal* welfare state. This means that an extensive supply of publicly financed goods and welfare benefits is available for all residents, regardless of their role in the labour market. Redistribution is also very significant and happens *between* or *within* generations. This results in a very compressed wage structure and one of the most equal income distributions in the world, two features that would tend to attract low-skilled migrants.

### **Box 1: Immigration in Denmark**

Today, 8.4% of the population in Denmark are immigrants or their descendants. Of those, around 70% (5.9% of the total population) come from non-Western countries, while the rest come from the EU, the Nordic countries and other Western countries. Before 1960, immigrants to Denmark came from neighbouring countries and had similar skills and earning potential as native Danes. In the 1960s, immigration was dominated by low-skilled guest-workers with a nearly 100 per cent labour market participation rate. They came mainly from Turkey, Yugoslavia and Pakistan and arrived to satisfy the growing labour demand caused by the high economic growth of those years. With the first oil crisis in 1973 and the ensuing economic downturn and rising unemployment, this kind of immigration was banned by law, allowing only immigration from the other Nordic countries and from EU countries.

In the 1990s, the right of entry for the purpose of family reunification led to an influx of immigrants mainly from Turkey and Pakistan, while relatively large numbers of people from Iran, Iraq, Palestine, the former Yugoslavia and Somalia arrived as asylum-seekers. These cohorts were also low-skilled, and very few of them entered the labour market in spite of the fact that when an asylum-seeker is granted political refugee status in Denmark, he or she also obtains a permanent residence and work permit, with no administrative restrictions on getting a job.

From 1998 immigration policies have become more restrictive. The *de facto* refugee status has been abolished, so only asylum-seekers covered by the UN Refugee Convention rules obtain residence. The rules for family reunification have also become stricter, e.g. with the introduction of a minimum age for arriving spouses in order to avoid forced marriages. In addition to these stricter entrance rules, other measures creating incentives for immigrants to integrate in their new country have been put in place, and rules regarding the granting of a permanent residence permit and Danish citizenship have been tightened (Bauer et al., 2004). As a consequence, immigration from countries such as Turkey, Iraq and Somalia has fallen sharply. At the same time inflows from the EU-10, some ex-USSR countries and China are rising.

Migration is also  
determined by  
networks...

However, two other factors may influence the final skill composition of migrants. One is the effect of *imperfect information*. If migrants do not have complete information about labour market conditions in host countries and their advantages or disadvantages with respect to wages and/or welfare systems, they will rely on the information and support provided by friends or relatives who have already emigrated. This phenomenon is called the “network effect” (Pedersen et al., 2004). It implies that the skill composition of new cohorts of migrants will be heavily influenced by the skill composition of previous cohorts. This effect is very clear in

Denmark, where one of the main channels of immigration has been family reunification.

... and migration policies.

The other factor is the effect *migration policies* may have on selection processes. In the real world there is no such thing as free movement of labour. In the 1970s Denmark, like most European countries, put in place policies to sharply reduce immigration, mainly in order to protect its labour market. It seems that restricting migration mainly to the two channels of family reunification and political refuge, while limiting labour migration, tends to increase the proportion of low-skilled immigrants from less developed countries (Brücker et al., 2002).

Non-Western immigrants in Denmark are largely low-skilled

An analysis of the relative importance of the three effects shows that the composition of Denmark's immigrant population in Denmark has been determined mainly by the network and migration policy effects. If there is a welfare-magnet effect, it has been overshadowed by the two others (Pedersen et al., 2004). As a result, the foreign population in Denmark largely comprises people originating from less developed countries who hold less formal qualifications than natives (Constant et al., 2004), with the result, as we see in Table 1, that the labour market attachment of these immigrants differs substantially from that of the native Danes.

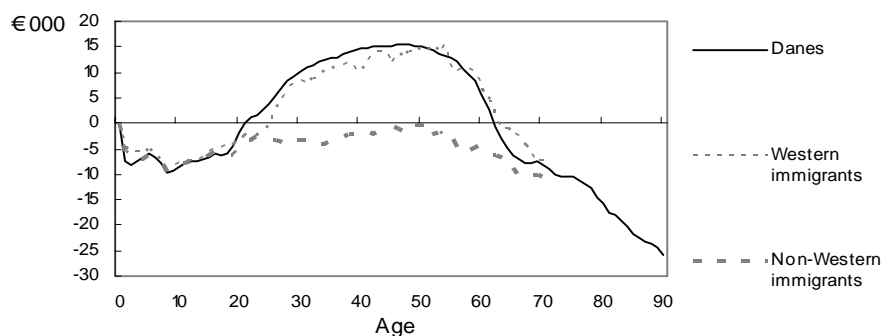
The universal welfare state is like a club with obligatory membership, acquired together with the residence permit. All members contribute by paying their taxes and benefit from the commonly financed goods or services. Thus the skill composition of immigrants and their ability to integrate successfully in the labour market are crucial to the sustainability of public finances, as we will see in the following section.

### Immigration and Denmark's public finances

The Danish welfare state requires the contribution of people of working age ...

As mentioned above, redistribution via the public sector plays an important role in the Danish welfare state. This redistribution happens through the tax and transfers system and via public consumption. Normally, adults of working age contribute to the financing of the system so that immigrants, who tend to be concentrated in this age bracket, should be net contributors. This was indeed the case in Denmark in the 1960s, but things look different now. Wadensjö and Gerdes (2004) focus on data from 1991 to 2000 to assess whether or not immigrants are net contributors to the public finances. Their results show that the net transfers from both Danes and first- and second-generation Western immigrants to the public sector are positive, while transfers from non-Western immigrants are negative (Chart 1). An even more troubling result is the fact that these transfers are also negative for the second generation, though to a lesser degree.

Chart 1: Net transfers to the public sector per person (3-year average) in 2000



... but the net transfers from immigrants to the public sector are negative for all age groups

Source: Wadensjö, Eskil and C. Gerdes, 2004a.

Note: The actual average values have been used for those aged 0-70 years. For those aged 71 and older the values for natives have been used for all three groups as there are so few observations for older immigrants.

The results also show that tax payments are significantly lower for first generation non-Western immigrants than for native Danes, transfer payments are significantly higher, and individual public consumption<sup>1</sup> is slightly lower across all age groups.

This can be explained by the age composition of the immigrants, their pattern of public consumption and, most of all, their participation in the labour market. The foreign population is younger than the native population as most immigrants arrive when they are young adults and their fertility rate is higher than that of natives. As a

consequence, they benefit from expenditure on young people – mainly in education – but they do not increase expenditure for old age. Their pattern of public consumption is somewhat different from that of natives, due mainly to the fact that non-Western immigrant women work more in non-market activities than native Danish women and do not use public day-care facilities to the same degree.

However, even though the pattern of public consumption is somewhat different, it by no means explains all of the differences in transfers. The main reason for the negative net transfer is in fact the low employment rates, which imply lower tax payments and higher transfer payments for immigrants than for Danes over their entire life span.

Schou (2005) examines the consequences of different immigration scenarios and concludes that if the current pattern of immigration from non-Western countries is maintained and if labour market, net transfers and public consumption features remain unchanged, public finances will become less sustainable in the long run. Immigration is not, therefore, a solution to the fiscal sustainability problem arising from ageing. Rather, better integration of existing and future immigrants may alleviate future financing difficulties. Projections from Statistic Denmark show that the immigrant population will grow from 8.4% of the total population at present to 14.4% in 2050 (3.2% from Western countries and 11.2% from non-Western countries). The immigrant population in the working-age group will grow proportionately and even beyond, since the immigrant population is younger than natives, so that in 2050 17% of the working-age population will be immigrants or descendants (3.8% from Western countries and 13.2% from non-Western countries). These projections make it even more necessary to successfully integrate immigrants into the labour market.

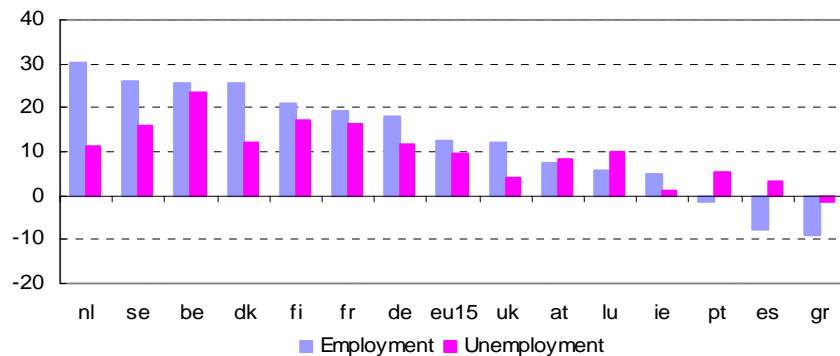
*Immigration does not solve the ageing problem in the long run*

### **Immigrants in the Danish labour market – obstacles and policies**

As seen in the previous section, the net transfers by non-Western immigrants to the public sector are negative, the main explanation for this being the weak labour market attachment of this group. The difference between the employment rate of natives and that of non-EU foreigners in Denmark is one of the highest in the EU (see Chart 2).

**Chart 2: Difference in employment and unemployment rates of natives vs. non-EU foreigners**

*There are large differences in employment rates between Danes and immigrants*



Source: Eurostat, Labour force survey data.

Note: The difference in the employment rate is the employment rate of natives minus that of foreigners. The difference in the unemployment rate is the unemployment rate of foreigners minus that of natives. Data for Italy not available.

This is mainly explained by the fact that Denmark has the highest employment rate in the EU, but the question remains of why so relatively few non-Western immigrants, particularly women, enter the Danish labour market compared to native Danes (Table 1).

Several factors explain the relatively weak links to the labour market of non-Western immigrants. The first is the high labour productivity in Denmark, which results in an overall high level of wages. In addition, the minimum wage is high. This makes labour market entry more difficult for low-skilled workers since it implies a limited demand for workers with low qualifications (and low productivity). The share of low-skill jobs in Denmark is low compared to other EU countries. This is true in particular for manufacturing, where production in some sectors, such as the textile industry,

*Integration of immigrants is made difficult by high productivity and compressed wages...*

*... as well as by weak financial incentives to take up work*

has largely left Denmark for low-wage countries, and for the services sector, where the high marginal taxes incite many people to reduce their own working hours and carry out household work themselves rather than buying the services on the market (OECD, 2005).

Another explaining factor are weak financial incentives to work. The high net replacement rates which apply to low-wage earners apply even more to immigrants, since the difference between the potential labour income and unemployment or social benefits is often low or even negative. Such benefit traps are often even more pronounced in the case of couples with children, a group where migrants are typically overrepresented.

For the future, the effects of immigration on fiscal sustainability will largely depend on the labour market attachment of descendants. Table 1 shows that participation and employment rates are markedly higher among descendants of non-Western origin than among the first generation of this group. However, it is difficult to say at this stage how valid these findings are, as there are still relatively few non-Western descendants and most of these are young. Most long-term projections therefore assume a labour market attachment among non-Western descendants which is higher than among immigrants but lower than for native Danes.

**Table 1: Labour market attachment among 16-64-year-old immigrants, descendants and Danes by origin and gender (January 2004)**

Immigrants	Western countries		Non-western countries	
	Men	Women	Men	Women
Participation rate	69	61	61	46
Employment rate	64	57	52	39
Unemployment rate	6	7	15	17
Descendants	Men	Women	Men	Women
	Participation rate	76	74	64
Employment rate	72	70	59	56
Unemployment rate	6	6	8	8
Danes	Danes		Men	Women
	Participation rate	83	78	-
Employment rate	79	74	-	-
Unemployment rate	5	5	-	-

Source: Ministry of Refugee, Immigration and Integration Affairs, 2005.

In view of these obstacles encountered by migrants on the labour market, the Danish government is pursuing activation and training policies, often combined with tighter requirements for receiving benefits. Since 1998, immigrants receiving social benefits are obliged to participate in an "introduction programme" that includes language courses and labour market training, and sets a lower level of social benefits than those received by natives. In the same vein, the recent "new chance for everyone" package stipulates that all young people leaving school must be offered relevant training or education and young people receiving cash assistance must enrol on a vocational course.

The policy approach is also intended to gradually strengthen financial incentives to take up a job. The 2003 tax reform introduced an earned income tax credit to improve work incentives by raising the gains from employment relative to benefits, in particular for low-wage earners, and thus induce higher employment (European Commission, 2004). The June 2005 measures reduce social benefits for a married couple unless at least one of the spouses has been employed for at least 300 hours within a period of two years, and extend the rules on labour market availability to recipients of social assistance not registered with the public employment service.

*Danish policy focuses both on strengthening skills and improving incentives to work*

## Conclusion

To meet the challenge of ageing in Denmark, an increase in labour supply will be needed. The overall employment rate is high, but certain groups are not sufficiently integrated in the labour market. Immigrants from non-Western countries are a group with a potential for higher employment rates and the fact that this group will grow as a share of the working age population over the next few decades makes integration imperative. With low participation rates, in particular for women, first- and second-generation immigrants as a whole have not been contributing to the sustainability of the welfare state. If present patterns of immigration continue, an increased inflow of immigrants will not solve Denmark's challenge, whereas integrating migrants better could help meet future financing challenges.



The development of descendants' employment rates will be a key factor determining labour market integration in the future.

Integration is made more difficult by the compressed wage structure in Denmark, by a relative lack of low-skill jobs and by the weak or negative financial incentives for people with low earning potential to take up a job. This has contributed to the substantial differences in the employment rates between non-Western immigrants and native Danes.

The strategy of the Danish government has centred on efforts to raise the participation rates of current migrants and their descendants. Current policy focuses both on enhancing education and skills and on making work pay by strengthening financial incentives to take up a job. This policy is in line with the EU's Lisbon strategy for growth and employment, and is outlined in the recent Danish National Reform Programme. The degree to which the employment rate of migrants and their descendants will approach that of native Danes will determine the extent to which better integration can contribute to meeting Denmark's long-term fiscal challenges.

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<sup>1</sup> Individual public consumption includes children's day-care, education, health and old-age care.

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