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INTERNATIONAL SOCIAL SECURITY ASSOCIATION

Crisis country case study

Denmark

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ISSA crisis case study: Denmark

Summary

In Q3 2008, Denmark officially became the first European country to enter recession following the collapse of the US subprime mortgage market. Unemployment more than doubled from 1.8 per cent in 2008 to 3.9 per cent in 2009, placing strain on a government budget that recorded a deficit of US-dollar (USD)9.7 billion equivalent to 3 per cent of GDP in 2009 – the first in over ten years of healthy fiscal surpluses.

The adverse financial impact (-17 per cent return) on pension funds in 2008 attracted innovative responses from the government such as the release of a 30-year inflation-indexed bond, targeted at helping domestic pension funds and insurance companies. In a counter-cyclical move, the Danish government also employed the use of automatic stabilizers where changes to activation, job search assistance, job-finding incentives, work experience and training programmes increased automatically as they were indexed to the unemployment rate.

Like many countries Denmark faced a genuine "either-or" dilemma: the need to address budgetary concerns and continue to contend with the current crisis, in particular a labour market crisis. However, comparatively very low pre- and post-crisis poverty and unemployment in Denmark is a testament to the country's consistent ability to cope well with severe downturns.

Social security institutions covered

The Ministry of Social Welfare (general supervision and national administration); local (municipal) governments (administer pensions, sickness and maternity benefits at the local level); the Social National Board of Industrial Injuries (*Arbejdsskadestyrelsen*) (handles workers' compensation claims); ATP: Labour Market Supplementary Pension Institution administers the ATP programme; SP: Labour Market Supplementary Pension Institution administers the SP programme.

Overview of the social security system

Based on the "flexicurity" model, the Danish social security system is unique in combining high benefit levels and activation services with light employment protection legislation. It has characteristics which typify the Scandinavian model where generous, universal and individualized benefits are funded mainly through the tax system, and affordable childcare and elderly care are widely available. However, the Danish model has evolved into a three-sided mix of: (1) flexibility in the labour market combined with (2) social security and (3) an active labour market policy with rights and obligations for the unemployed.

Denmark has a complex three-pillar pension system that is made up of a combination of flat-rate benefits, working-time based contribution benefits and earnings-based contribution benefits:

- A public pension which includes: (a) a flat-rate basic universal scheme (a PAYGO (pay-as-you go) pension that requires at least three years' residence between the ages of 15 and 65) and individual contribution records such as (b) a compulsory labour market supplementary pension (ATP); (c) a labour market supplementary pension for recipients of the disability pension (SAP); and (d) special pension savings (SP).
- Occupational pension schemes that cover about 80 per cent of the workforce for those covered by a collective agreement.
- Private pensions and tax-subsidized savings accessed from the age of 60. These are tax deductible contributions to individual pension schemes or contributions based on agreements with an employer (Organisation for Economic Co-operation and Development (OECD, 2005)).

Unemployment insurance is voluntary in Denmark and benefits represent 90 per cent of the average income, paid five days a week for a maximum of four years. To become eligible, individuals should be insured for at least 12 months.

With regard to sickness benefits, up to USD640¹ a week is paid based on the insured's hourly wage. Concerning maternity, a salaried woman must have worked for at least 120 hours during the 13 weeks immediately preceding prenatal leave.

Impact of the crisis

The economy and labour force

In Q3 2008, Denmark officially became the first European country to enter recession following the collapse of the US subprime mortgage market in 2007. Figures by Statistics Denmark (2010) show that the Danish economy contracted for four consecutive quarters (until Q3 2009) with GDP falling a total 7.3 per cent over the same period.

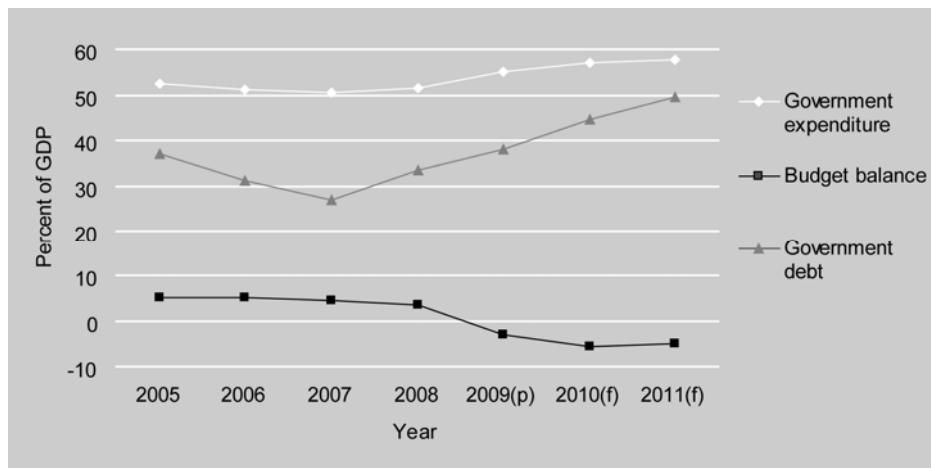
As a small open economy (exports and imports both account for around 50 per cent of GDP) Denmark was hit especially hard by the collapse of world trade while domestically the country is still undergoing a difficult adjustment following a consumer and housing boom between 2004 and 2007. A fiscal stimulus via tax cuts and higher public spending on hospitals, education and infrastructure is helping to support the economy but at a cost of lowering government revenue and raising the country's budget deficit.

According to Statistics Denmark, unemployment more than doubled from 1.8 per cent in 2008 to 3.9 per cent in 2009. Though this official level still remains considerably lower than European Union (EU) or OECD averages, the EU/OECD standardized unemployment measure puts Danish unemployment at a much higher 6.4 per cent Economist Intelligence Unit (EIU, 2010). The exact unemployment level and methodology vary yet the downward direction is clear and is forecasted to rise in 2010 and into 2011.

Rising unemployment rates will continue to place strain on a government budget that recorded a deficit of USD9.7 billion equivalent to 3 per cent of GDP in 2009 – the first in over ten years of healthy fiscal surpluses. As depicted in figure 1, the rapidly rising government debt is a real concern.

¹ Currency conversions in this study were made in March 2009.

Figure 1: Fiscal indicators, Denmark, 2005–2011



Note: (p) = provisional. (f) = forecasted.

Source: EIU (2010).

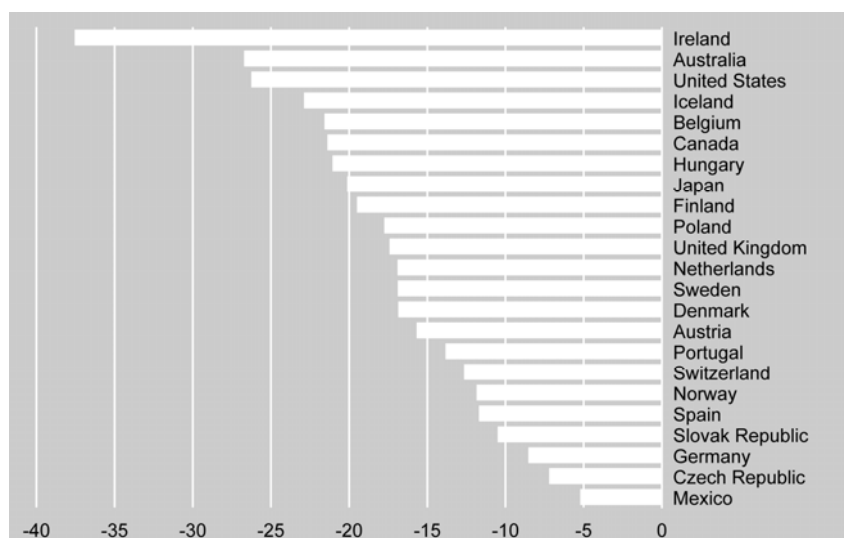
Greater government social expenditure can act as a counter-cyclical force and automatic stabilizer by boosting demand and promoting consumer confidence. Yet there is a large risk that such expansionary fiscal policy will face pressure for fiscal consolidation to cope with increased deficits and public debt. If so, this would result in social security spending cuts, consequently affecting beneficiaries and others via reducing aggregate demand.

The financial crisis tested the government's ability to trade off long-term sustainability and the counter-cyclical role of social security spending. With regard to pensions, the Danish government linked pension entitlements to the state of the pension system's finances by indexing the eligibility age to increases in life expectancy. When it was calculated that pension liabilities were likely to exceed assets, the automatic stabilizer for pensions was activated.

Investment performance

Figure 2 illustrates the adverse financial impact (-17 per cent return in Denmark) that the crisis had on pension funds in 2008 which activated the automatic stabilizer.

Figure 2: Real investment returns of pension funds, OECD countries, 2008 (%)



Source: OECD StatLink (<http://dx.doi.org/10.1787/635276166554>).

In 2008 the Danish government allowed the indexing of the social security eligibility age (Turner, 2009). In response to the ISSA survey, the Social National Board of Industrial Injuries stated that the eligibility age should be increased from 65 to 67.

Administrative capacity

Given Denmark's developed social protection system and recent responsiveness of its automatic stabilizers, the country's administrative capacity to protect people has not been affected. With low levels of poverty, the government's capacity to deal with the crisis was particularly strong. Denmark was able to afford greater organizational and fiscal manoeuvrability and expansion of social expenditures enabled the government to protect those most vulnerable and most affected by the downturn.

Responses to the crisis

Stabilizing the financial sector

Beyond the bank bail-outs in October 2008 and February 2009, the Danish government responded to the crisis in innovative ways to support other major financial players such as pension funds and insurance companies. In 2009, the Danish government released a 30-year inflation-indexed bond that was targeted at domestic pension funds and insurance companies (International Labour Organization (ILO, 2009a)). This move avoided the forced sale of mortgage bonds owned by pension funds in depressed markets. The OECD applauded the move for its ability to manage risks associated with the payout phase of pensions and annuities, and stabilize the mortgage bond market (Council of the European Commission, 2009).

Under the national recovery package, private households were allowed to withdraw savings from the Special Pension savings scheme during 2009, in the hope that it would increase private consumption and replace lost income for the unemployed. Through active fund management of its investment portfolio, the ATP (labour market supplementary pension fund), was particularly effective at proactively limiting financial losses and planning for future crises via scenario testing. Although the ATP scheme experienced a pre-tax market return of -3.2 per cent on its investment portfolio in 2008, this was comparatively much better than most developed countries. The ATP effectively hedged against interest rate and exchange rate risks, aggressively diversified investment portfolios and managed risks extensively. In 2008, the ATP gained 10.3 billion Euros (EUR) on interest-rate swaps, i.e. borrowing money to buy long-term bonds (Gosvig, 2009).

Labour market measures

Changes to activation, job search assistance, job-finding incentives, work experience and training programmes for the unemployed undertaken in response to the economic downturn increased automatically when they were indexed to the unemployment rate. The government focused efforts on work experience programmes combined with higher unemployment benefits for those most affected, i.e. long-term unemployed and young people. Some initiatives included:

- On 19 March 2009 more flexible rules for the work-sharing scheme came into force allowing companies to dismiss temporarily (for up to 26 weeks) employed persons with unemployment benefits. The use of work-sharing increased significantly as a means of avoiding redundancies as shown in table 1.

Table 1: Number of work-sharing cases reported to job centres, 2006–2009

2006	2007	2008	2009
33	27	213	500

Source: OECD (2009).

Work-sharing was arranged as either one week at work and one week on unemployment benefit, or a minimum of two days a week on benefits.

- In September 2009, a youth package was introduced aimed at combating the increase in youth unemployment and facilitating further education. This included work placement schemes (within a week of registering with a job centre) and reading and writing skill testing of young people with no formal qualifications etc.
- The right and duty to participate in an active labour market programme after three months of unemployment for all unemployed persons aged less than 30 years (previously it was six months).
- The unemployed received financial support for training during start-up in a new job to increase willingness of employers to hire workers who were not initially qualified.
- In January 2010, a political agreement was reached on establishing adult vocational training centres (VEU centres) targeting low-skilled adults and improving coordination with providers of general adult education.
- Increased funds for job centres to enable faster assistance from the employment services when enterprises announce lay-offs.
- Establishment of a national job alert system seeking to offer support as early as possible.
- Increased monitoring of labour market developments (e.g. number of announced redundancies, vacant jobs etc.), also on a regional level.
- Reorganization of the Public Employment Service under a single local management catering for both insured and uninsured unemployed and benefit receivers.
- Tightening of the rules for sickness leave (while giving sickness beneficiaries access to activation measures).

Improving income support

From 2010 widespread and significant income tax cuts were introduced. Marginal tax rate was reduced by 21 percentage points (from 63 to 42 per cent) for 10 per cent of the labour force. A "green cheque" to compensate households for higher green taxes and health-related excise duties has also recently been introduced.

Enhancing business support

From 2008 the government gave priority to purchasing from small businesses and granted direct subsidies or access to credit for firms hard hit by the downturn (e.g. car manufacturing,

small and medium-sized businesses). Further deferment of corporate tax payments and social security contributions – a policy it introduced in the wake of the crisis – has also continued.

Investing in social, educational and health services infrastructure

The Danish government's regional government is presently bringing forward investments in health infrastructure, i.e. USD6.4 billion, for five new major hospitals and at least 11 hospitals will undergo renovations. Municipalities have also launched plans for major renovations of schools and kindergartens. The 2010 financial agreement between the regions and the government included roughly USD133 billion for improved funding to the healthcare sector.

Lessons learned

First and foremost the economic downturn demonstrated that social assistance and unemployment benefit schemes work and can easily be ratcheted up automatically provided the appropriate institutional capacity is in place. Secondly, it highlighted the importance of having expansionary social security schemes in place prior to crises occurring, in order to be able to conjointly provide social security and activation services to the unemployed and others. Comparatively very low pre- and post-crisis poverty and unemployment in Denmark is a testament to this. It was also clear from the ISSA financial crisis survey that there was no need for more anti-poverty measures due to Denmark's existing universal welfare coverage.

However, less clear is the financial sustainability of Denmark's rising social expenditure. The current crisis has strained the finances of many social security systems and as stated by the survey respondents, the debate regarding pension schemes such as early retirement are ongoing. Whilst the crisis has revealed the fragility of pension systems reliant on financial capital markets it has also highlighted the relative effectiveness of innovative investment strategies.

The public ATP fund minimizes risks by managing pension liabilities in a separate portfolio to its highly diversified investment portfolio, and focusing on eliminating investment tail risks especially in equities and commodities. With efficient public regulation and supervision, and careful use of the more modern private sector investment techniques, Denmark's ATP retains a pension system with a high degree of long-term security and predictability for the individual (Gosvig, 2009). Lastly, and from a wider perspective, Denmark's experience underscores the need for an effective balance of risk (and return) sharing between individuals and the state, and between PAYGO (at risk from demographic changes such as Denmark's ageing population) and fully pre-funded schemes (at risk from unforeseen inflation).

Conclusion

Denmark experienced one of the longest slumps of any European country in 2008–9. Yet expansionary fiscal policies such as income tax cuts and increased spending on social and health services infrastructure were part of an exit strategy from the crisis that has revitalized the economy via the stimulation of aggregate demand and the support of social protection. And responses were not solely of a national, fiscal nature. As exemplified by the ATP public pension, social security institutions responded individually to the crisis in dynamic and innovative ways, diversifying aggressively not only to minimize losses but also take advantage of recovery when it arrives.

In a counter-cyclical move, the Danish government employed the use of automatic stabilizers to ensure social security programmes were maintained and extended to the most vulnerable

members of society. A plethora of active labour market policies were introduced and the extension of work-sharing schemes was welcomed by Danish firms. A recent OECD study also shows that Denmark tops the list of countries where most (62 per cent) of the country's future low-income earners will receive pensions at the level of 20–25 per cent of average earnings (the OECD average is 36 per cent) (OECD, 2009a).

Nevertheless, controversy still remains in policy circles over the long-run financial sustainability of such high levels of social security coverage given there is a borrowing limit and efficiency limit to the use of automatic stabilizers. Firstly, the Danish authorities are not alone in projecting a post-crisis outlook that exceeds the 3 per cent of GDP limit enshrined in the EU's Stability and Growth Pact. It seems that Denmark, like many countries, faces a genuine "either-or" dilemma: the need to address budgetary concerns and continue to contend with the current crisis, in particular a labour market crisis.

Secondly, the logic of simultaneous spending increases with tax cuts, i.e. taking money from a weak economy, is questionable (OECD, 2009b). Moreover, Denmark's recent attempts to stabilize the economy may in fact prove destabilizing due to the presence of time lags (ILO, 2009b). The introduction of generous income tax cuts at the start of 2010 – more than one and half years after Denmark entered a recession and six months into recovery – may be stimulating the economy at the wrong time. The problem of timing responses is further exacerbated when one considers the possibility that the current global recession could be double dipped.

Irrespective of this, however, Denmark's social security system is in fact designed to cope with severe downturns, e.g. ATP stress test their fund regularly and are reportedly secure. Thus the question is not so much whether Denmark's social security system can cope with crises but by what means it will.

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