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NORDIC ECONOMIC POLICY REVIEW

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2. The Nordic welfare model in an open European labor market[1]

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Abstract

Is it possible to sustain an ambitious and redistributive Nordic welfare state in a Europe with open borders? Drawing on longitudinal administrative records spanning four decades, we first present discouraging historical evidence showing that labor migrants from low-income source countries tend to have unstable employment careers with marked overrepresentation in welfare programs. This pattern extends to post-accession labor migrants from Eastern Europe, who quickly experience high rates of unemployment. The article discusses possible avenues for making the welfare state "migration robust". We argue that there are alternatives to reclosing borders and/or cutting down welfare state ambitions, and recommend policies based on strengthening of activity requirements in social insurance programs, raising minimum job standards, and substitution of work-oriented services for cash-based family allowances.

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2.1 Introduction

The recent enlargements of the EU Single Market represent new opportunities for growth and prosperity. The liberalized migration regime that followed allows workers to flow more easily toward their best potential use (Kahanec *et al*., 2014; see also Clemens, 2011 and Kennan, 2012). Improved labor mobility removes bottlenecks in production processes and facilitates dynamic cushioning of regional cyclical fluctuations. Left unhindered, the open-border policy is a powerful tool for raising and equalizing living standards across Europe, and thus for promoting economic and social cohesion. However, at least in the short and intermediate terms, the integrated labor market also presents some political and economic challenges. Large cross-country differences in labor productivity, wages, and social insurance standards may trigger migration flows that place pressure on present welfare state institutions (Sinn, 2002; Kvist, 2004). In particular, the fact that social insurance benefits in the Nordic countries by far exceed typical wages in most accession countries may distort migration flows and weaken labor migrants' incentives to remain in productive employment over the long haul. As we show below, prior empirical evidence points to a considerable risk that labor immigrants from low-income countries fail to establish lifecycle employment and earnings careers on par with natives, but instead exhibit high rates of premature labor market exit and welfare uptake.[2] Beyond their mere fiscal implications, such processes may well lead to economic marginalization of minority groups and, as discussed by Mollerstrom (this volume), reinforce any decline in popular support for redistribution linked to growing demographic heterogeneity as many natives will perceive it as less likely that they will be on the receiving end. This brings to the fore questions of how labor market institutions and social insurance systems should adapt in order to reap the full benefits – and avoid the perils – of an integrated European labor market.

[2] A large literature studies welfare uptake among immigrants and natives across Europe; see Nannestad (2004) for a review and Boeri (2010) and Barrett and Maitre (2013) for recent cross-country comparisons.

Based on Norwegian administrative register data, this paper first reexamines past experiences with labor immigration. Labor immigration benefits the welfare state in the short run through its immediate expansion of labor supply. But, the impacts on the fiscal sustainability of the welfare state also depend on the migrants' long-term integration in the labor market and their rate of return migration. Our brief review of prior studies, paired with new evidence on labor market outcomes of recent European labor migrants, indicates grounds for concern: Labor immigrants from countries with low economic development have more unstable employment patterns, and face a much higher probability of becoming reliant on social insurance transfers, than natives. We move on to discuss mechanisms that can explain these patterns, such as vulnerability to cyclical fluctuations; lack of language skills needed to adapt to new jobs/occupations in response to structural change; high effective replacement ratios in the social insurance system; and employer incentives to recruit low-skilled immigrant workers to jobs with low wages and poor working conditions. Finally, we discuss some policy options. We argue that a reintroduction of migration barriers is not the way to move forward. Instead we recommend policies aimed at making the Nordic welfare model more "migration robust": First, by establishing (or raising) minimum standards/wages in the labor market in order to prevent social dumping at the tax payers' expense, and, second, to make the social insurance system more participation oriented – essentially by substituting job offers and/or various forms of activation for pure cash transfers.

2.2 Experiences prior to the enlargements of the European labor market

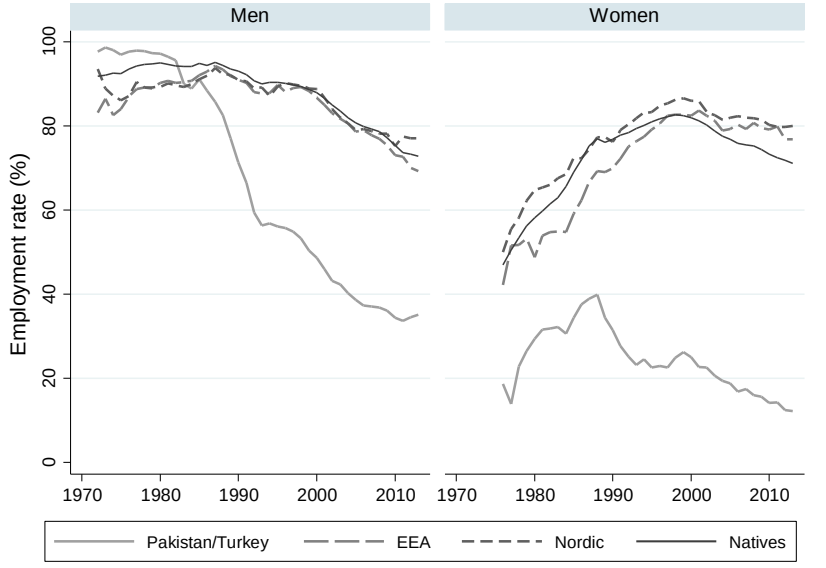
Between 1975 and 2004, work-based immigration to Norway from outside the Nordic region (the EEA area since 1994) was subject to strict regulations. Hence, in order to examine the long-term labor market performance of labor immigrants from low-income countries, we have to go back to the waves that arrived just prior to the 1975 legislation. Although this obviously raises questions about comparability with today's migrants and today's labor market institutions, the exercise has the ad-

vantage that it facilitates assessments of immigrant performance over four decades.

Bratsberg *et al*. (2010; 2014) have examined the lifecycle employment and earnings patterns of these early cohorts of labor migrants to Norway. Their analyses distinguish between immigrants from countries with similar earnings levels and living standards to those of Norway (i.e., Western Europe) and immigrants from countries with considerably lower earnings and living standards (e.g., Pakistan and Turkey). A key finding of these studies is that whereas labor immigrants from Western Europe had employment and earnings patterns similar to those of natives, the labor immigrants from low-income countries had a disproportional tendency to drop out of labor market after 10–15 years of employment.

The left-hand panel of Figure 1 summarizes and updates some of the main findings of the prior studies by showing the annual employment rates of male immigrants who entered Norway during the early 1970s, and then remained in the country until 2013. Similarly, the right-hand panel shows employment rates for female immigrants who entered during the late 1970s (with the delayed entry period explained by the fact that very few women from low-income countries arrived during the early 1970s; the majority of those from the late 1970s being spouses of the male cohorts of the early 1970s). Here, we distinguish between three different regions of origin that dominated labor-related migration to Norway during this period: i) Pakistan and Turkey, ii) the Nordic countries, and iii) the rest of Western Europe (denoted EEA in the figure). In addition, we show employment rates for a comparison group of natives, stratified to have the exact same age composition as the three immigrant groups put together. Since the age compositions of these groups were roughly the same (with the typical immigrant being 24–25 years of age at the time of arrival), we can compare the dynamic employment patterns directly. It is clear that lifecycle employment was *much* lower for labor immigrants from Pakistan and Turkey than for immigrants from Western Europe and natives. Employment levels tended to be high during the first years in Norway, but after around 10–15 years of residency, they started to drop precipitously. Immigrants from the Nordic countries and the rest of Europe, on the other hand, had employment patterns very similar to natives.

Figure 1: Annual employment rates 1972–2013, conditional on continued residency in Norway – Immigrants from the 1970s and native comparison groups

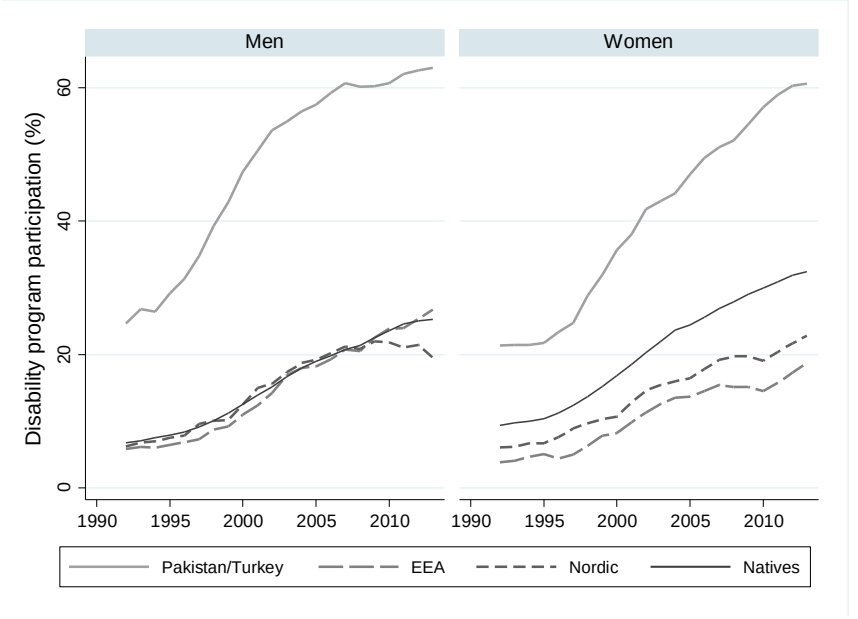


Note: Employment is defined as having annual labor or business earnings exceeding the base amount of the social insurance system (currently NOK 90,068). The figure shows annual averages for those aged 25–64. The "EEA" group consists of immigrants from the following countries (with sample share in parenthesis); The United Kingdom (47), Germany (14), France (12), the Netherlands (10), Spain (4), Switzerland (4), Italy (3), Austria (2), Belgium (2), Ireland (1), Portugal (1), Greece (1), and Luxembourg (0).

Figure 2 illustrates how the low employment rates among immigrants from Pakistan and Turkey translate into correspondingly high participation rates in disability insurance programs. These data are available from 1992 only, but we see that already at this point more than 20% of the Pakistani and Turkish immigrants who arrived 15–20 years earlier had become recipients of disability insurance benefits. By the end of our observation period, more than 60% of the labor migrants still in Norway, as well as their spouses, had become disability insurance claimants, compared to around 20% of the immigrants from high-income countries.

The reason why we focus on disability insurance benefits here, and not, say, unemployment benefits or social assistance, is that the disability program had already become the major social insurance program for the 1970s cohort of labor immigrants when the data series for social insurance transfers start in 1992. Likewise, the unemployment insurance register data are first available in 1989 and we are unable to study the dynamic transitions between employment, unemployment insurance, and disability program enrollment during the critical downturn of the late 1980s. Unemployment insurance was presumably an important income source for many of the immigrants during the slump, but since these benefits are subject to time limits (currently a maximum of two years) the welfare state had to find other ways to ensure lasting solutions for persons who persistently failed to find new employment. Existing empirical evidence (Rege *et al*., 2009; Bratsberg *et al*., 2013) shows that there is a large "grey area" between unemployment and disability insurance programs: Job loss raises the probability of becoming a disability insurance claimant considerably, and Bratsberg *et al*. (2013) argue that disability insurance is sometimes unemployment insurance in disguise. For the cohorts under study, the underlying data indeed show a strong correlation between unemployment and subsequent disability program enrollment: For the men who first entered disability in 1993, unemployment insurance rates in 1989 were twice those of men who did not enter disability insurance.

Figure 2: Disability program participation 1992–2013, conditional on continued residency in Norway. Immigrants from the 1970s and native comparison groups



Note: Figure entries are restricted to those aged 25–64.

Given that we examine a wave of immigrants who arrived during the 1970s, it is now possible to assess their patterns of employment and earnings over their whole potential working lives. On average, the male labor immigrants from Pakistan and Turkey were employed 61.9% of all years between the ages of 25 and 66. To put this number into perspective, we have computed the corresponding number for native men of the same birth cohorts, who were employed 85.5% of their potential working lives. Examining annual earnings instead, we find that the labor immigrants from Pakistan and Turkey on average earned 177,791 NOK per year (not conditional on employment, and inflated to 2012 currency), whereas the comparable group of native men earned 328,464 NOK. Hence, the labor immigrants' lifetime earnings were on average only 54% of those of native men of the same birth cohorts.

Moving on to the spouses of these labor immigrants, we find that the women were employed in only 21.9% of all years between the ages of 25 and 66, with average annual earnings as low as 43,737 NOK. By comparison, native females of the same birth cohorts were employed 68.0% of their potential working-life years, with average earnings equal to 176,772 NOK. Hence, the lifetime earnings of the cohort of immigrant women were only 25% of those of native-born women.

Lower lifetime earnings than natives do not necessarily indicate that immigrants represent a fiscal burden for the welfare state, however. In order to provide a broader assessment of the fiscal consequences of migration, one has to include contributions and expenditures over the complete lifecycle, taking into account that tax payers do not have to pay the costs of child care and education before immigrants arrive and that some immigrants will spend the last – and the most cost intensive in terms of health care – years of their life in their country of origin. Hence, the break-even point of direct taxes paid versus benefits received likely involves lower lifetime labor earnings for immigrants than for natives (Preston, 2014).

Nevertheless, it is of paramount importance to understand why the immigrants from Pakistan and Turkey performed so poorly in the Norwegian labor market over the long term. Unfortunately, we are not able to provide complete evidence-based answers to this question. We know that business cycle fluctuations played an important role, as many of the immigrants lost their foothold in the labor market around the major cyclical downturns in the early and late 1980s; see Bratsberg *et al*. (2010). A large fraction was originally recruited to declining (and, to some extent, dying) industries and they did not possess the human capital and language skills typically required by the new and growing industries. Thus, dependency on temporary social insurance became prevalent. Since social insurance benefits are more generous for persons with children and dependent spouses, many of the immigrants experienced that social insurance gave as high, and in some cases even higher, family income than fulltime work (Bratsberg *et al*., 2010). This situation might have undermined incentives to provide the effort required for regaining a foothold in the labor market, thereby transforming temporary insurances into permanent ones.

The presence of a relatively comprehensive social security net in Norway, combined with large differences in living standards between Norway and the source country, further weakened the incentives for return migration among the labor migrants from low-income countries, even in cases were new employment could not be found in Norway. This illustrates an important asymmetry in labor-motivated migration patterns between countries with very different levels of development: Whereas high labor demand during economic booms in the wealthy country will attract workers from poor countries, there is no reason to believe that a subsequent economic bust will set the migration flows in reverse. At this point, there is a significant difference between labor migration flows across countries with similar and countries with very different living standards. The discrepancy also shows up in our data: While as many as three in four of the 1970s immigrants from the Nordic and other Western European countries had left Norway by 2013, this was the case for only one in four of the Pakistani and Turkish immigrants – despite the latter group's *much* poorer performance in the Norwegian labor market.

For those who did stay in Norway, the long-term labor market performance of immigrants from the Nordic and other Western European countries is actually a completely different story: As Figures 1 and 2 showed, their lifecycle employment patterns are hardly distinguishable from those of natives, and for females, participation in disability insurance programs is even considerably lower than for similarly aged native women.

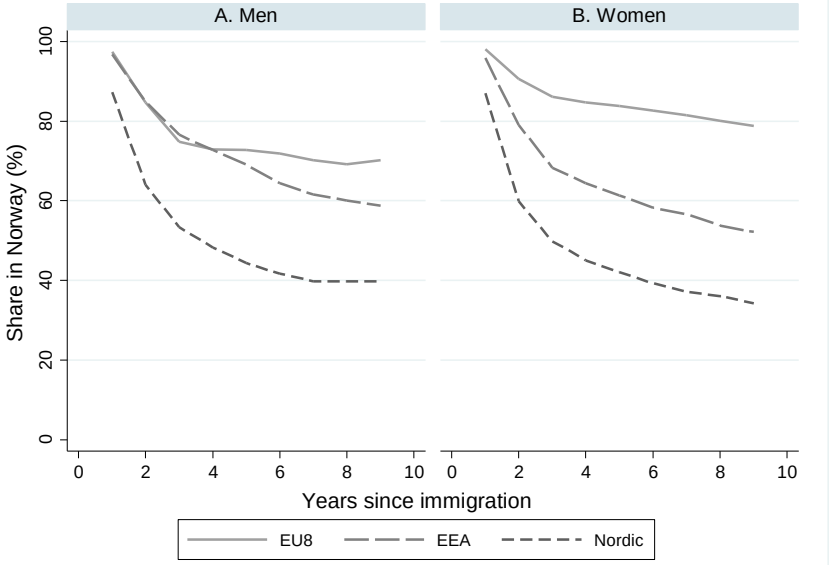
2.3 Experiences since the expansions of the European labor market

So, for the issue of how the new European flows of labor migrants will affect the long-term fiscal sustainability of the Nordic welfare states, a key question is whether the eastwards extensions of the European labor market will lead to migration flows and long-term employment patterns that resemble the 1970s experiences with migration from poor or from rich source countries. Geographical and cultural closeness suggest that past immigration from Europe is the most relevant

reference. However, since the new European labor market covers countries with large differences in economic development, and with very different labor market and social insurance institutions, the answer to the question is not obvious.

Given that the first eastwards extension of the European labor market took place only 11 years ago (in 2004), it is obviously too early to paint a complete picture of the lifecycle employment and earnings patterns of the new immigrants. What we can do, however, is to examine economic outcomes over a 10-year period after entry. To do this, we look at three groups of recent European immigrants to Norway: i) those from the nearby Nordic countries, ii) those from other countries in Western Europe (for simplicity denoted EEA), and iii) those from the 2004 accession countries in Eastern Europe (denoted EU8). Specifically, we examine immigrants from these regions who arrived in Norway between 2005 and 2008 and were 17 to 46 years of age at the time of entry. Figure 3 first shows how long these migrants stayed in Norway. While fewer than 40% of the Nordic immigrants remained in Norway 10 years after arrival, this was the case for 70–80% of the migrants from EU8, and around 50–60% of the migrants from other countries in Western Europe, depending on gender. In other words, the return migration patterns of the new immigrants from the accession countries in Eastern Europe are closer to those we saw among 1970s immigrants from low-income countries than from countries in Western Europe.

Figure 3: Share of immigrants residing in Norway, by years since entry and region of origin

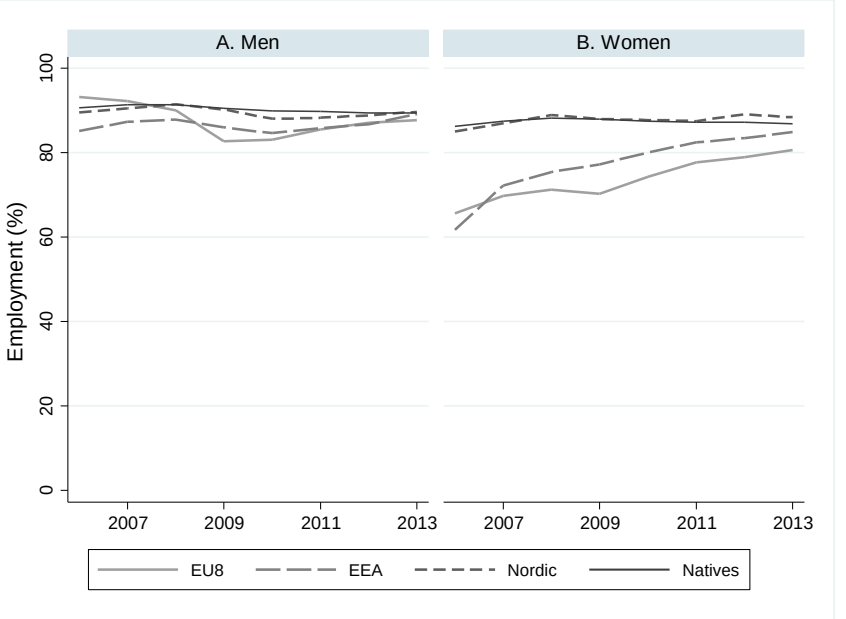


Note: Immigrant populations consist of 2005–2008 arrivals age 17–46 at entry. The EU8 group consists of immigrants from the following countries (with sample share in parenthesis); Poland (75), Lithuania (14), Slovakia (3), Latvia (3), Estonia (2), Hungary (1), Czech Republic (1), and Slovenia (0); and the "EEA" group of Germany (50), the United Kingdom (14), the Netherlands (10), France (9), Spain (4), Italy (4), Portugal (2), Austria (2), Switzerland (1), Belgium (1), Greece (1), Ireland (1), Liechtenstein (0), Luxembourg (0), Andorra (0), and San Marino (0).

Figure 4 displays, separately by gender, annual employment rates for each of the three immigrant groups. The employment figures are computed for persons aged 25 or more, conditional on continued residency in Norway (at the end of each calendar year), and also conditional on not being enrolled in education during the year. Again, we add a native comparison group with the same age composition as the various immigrant groups combined. (There is some variation in age across the three immigrant groups. To illustrate, among those in Norway at the end of 2010 the average age was 34.5 for the EU8 group, 35.7 for the EEA group, and 31.6 for those from the Nordic countries. When we reweight

the native data to reflect the age distribution of each immigrant group, we uncover however only minor differences from the overall native employment numbers displayed in Figure 4.) The figure shows that employment rates for Nordic immigrants again tend to be high and indistinguishable from those of natives. Male immigrants from Eastern Europe also had very high employment rates in 2007 and 2008, but their employment rates apparently took a serious blow during the financial crisis in 2009–2010. In 2013, however, their employment was almost back to native levels. Male immigrants from other Western European countries have consistently had employment rates somewhat below native levels. For female immigrants from both Western and Eastern Europe, we see patterns of relatively low employment rates the first years after immigration, followed by a gradual convergence toward native levels. The underlying data reveal that many of the female non-Nordic immigrants were admitted as family immigrants (44% of the EU8 women and 39% of the EEA women, compared to only 1% and 7% of the male groups). The data also reveal that the convergence of female employment rates over time foremost is attributable to strong employment growth for those who entered on a family visa. A second point to note here is that, while Figure 1 showed similar employment profiles for natives and the 1970s immigrants from both the Nordic countries and other countries in Western Europe, the recent data indicate some differences between these groups. In particular, the recent Western European immigrants from outside the Nordic countries exhibit lower return migration rates and lag somewhat behind the Nordic group in the labor market. Plausible explanations for these patterns relate to the stronger links between admission and job offers for labor immigrants from outside the Nordic countries during the 1970s, with a greater emphasis on skills considered to be needed in the Norwegian labor market, along with the much stronger economic growth in Norway compared to the United Kingdom and continental Europe between 1970 and 2010. Hence, it is probable that the 1970s' cohorts of immigrants from Western Europe were particularly favorably selected in terms of their job opportunities in Norway.

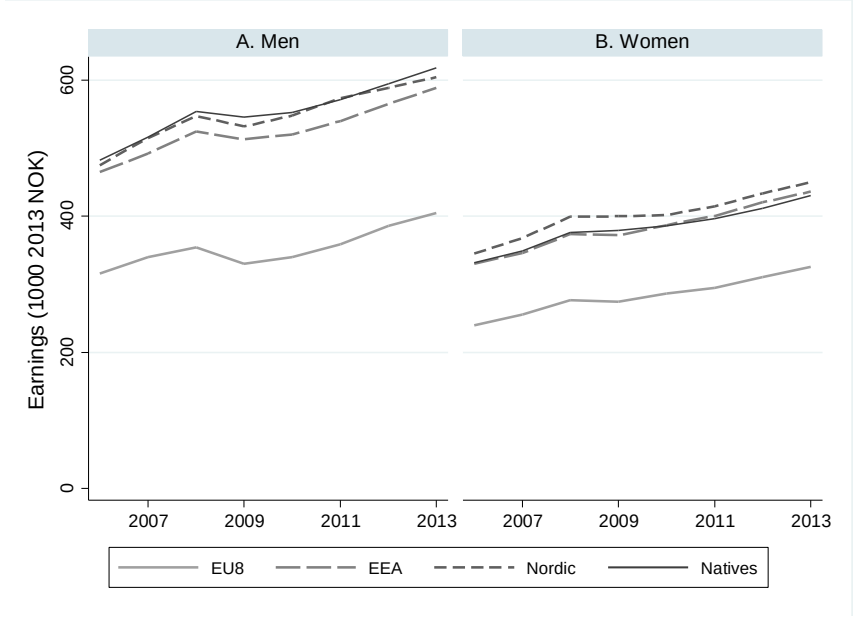
Figure 4: Employment rates 2006–2013, immigrants arriving in 2005–2008 and native comparison groups



Note: Employment is defined as having annual labor or business earnings exceeding the base amount of the social insurance system (in 2013 NOK 84,204). The data include persons at least 25 years of age, not enrolled in education, and with residency in Norway at the end of the calendar year.

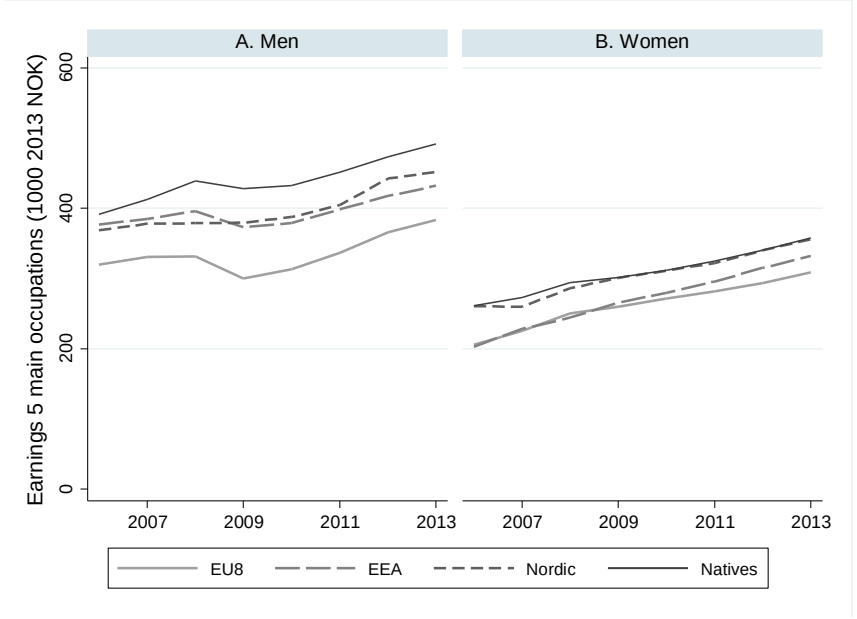
Figure 5 shows average annual earnings for those who were employed each year. It is clear that labor earnings tend to be much lower for Eastern European immigrants than for all the other groups. Moreover, the figure gives no indication of the assimilation effects typically found elsewhere in the literature, whereby immigrant earnings grow more rapidly than those of natives during the first years in the host country. Instead, the earnings gap between natives and EU8 immigrants remained constant over the eight-year period considered, with the 2013 earnings of male EU8 immigrants 34% below those of native men and the earnings of female EU8 immigrants 24% below those of native women.

Figure 5: Annual labor and business earnings 2007–2013, conditional on employment. Immigrants arriving in 2005–2008 and native comparison groups



One possible explanation for the relatively low earnings of EU8 immigrants is that they were recruited into occupations with particularly low wages. If we focus on immigrants and natives employed in the major immigrant occupations, the earnings gaps are reduced considerably; see Figure 6. The earnings differential between EU8 immigrants and natives remains significant, however, and again there is no indication of assimilation effects on immigrant earnings. When we compare natives and immigrants from accession countries who in 2008 worked in the five most common immigrant occupations, the earnings gap in 2013 stood at 22% for males and 13% for women.

Figure 6: Annual labor and business earnings 2007–2013, conditional on employment in one of the five main 2008 immigrant occupations



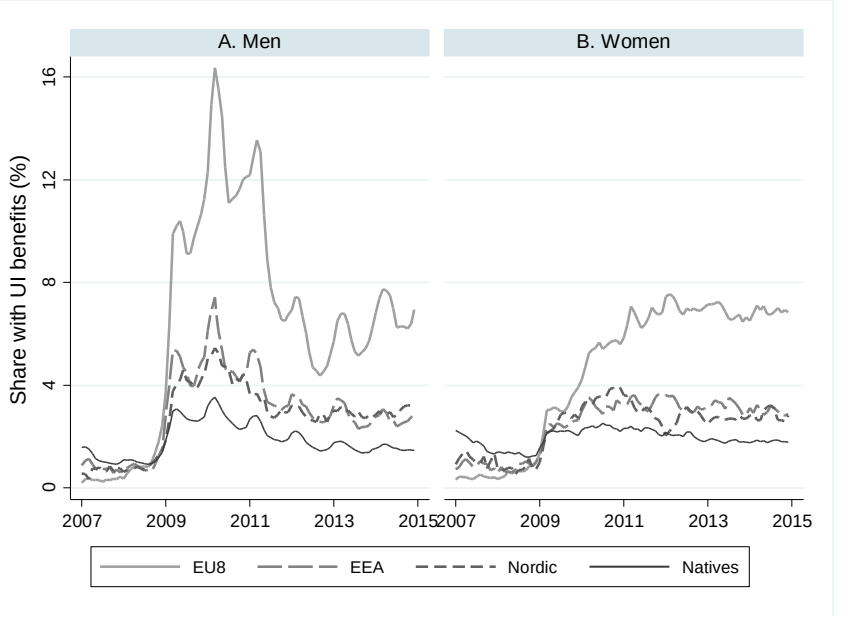
Note: The five main occupations and their employment share in the immigrant data are, for men, carpenter (11), clerical (10), construction laborer (6), cabinet maker (6), and brick layer (4), and, for women, cleaner (18), child care (6), sales (6), clerical (6), and waiter (5).

Even though most of the new Eastern European immigrants managed to maintain a foothold in the Norwegian labor market through the financial crisis, a relatively large fraction also claimed unemployment insurance (UI) benefits. Figure 7 shows the uptake of UI benefits month by month for immigrants still residing in Norway. For men, there was a huge spike in benefit claims around the financial crisis, starting late 2008, particularly for men from Eastern Europe. The EU8 claimant rates came back down around 2012, but have remained at much higher levels than those of other European immigrants and natives. And since 2012 they have again displayed an increasing pattern. For Eastern European women, we have seen a more monotonous increase in UI claimant rates after the financial crisis, albeit with slower

growth since 2012. Of particular concern is that the UI claimant rates of the EU8 group seem to have stabilized at very high levels when compared to natives. In fact, in December 2014 (the last entry in Figure 7) the UI claimant rate among men from accession countries who had immigrated to Norway in 2005–2008 was five times that of native men of the same age, and the claimant rate among women four times that of similarly aged native women.[3] Even immigrants from the Nordic and other Western European countries have had higher UI claimant rates than natives in the aftermath of the financial crisis, but at much lower levels than those of the EU8 immigrants.

[3] As with earnings (see Figures 5 and 6), immigrant-native differences in UI uptake are smaller when we consider workers in the same occupation. To illustrate, when we restrict the sample to those in the major immigrant occupations used in Figure 6, the January 2011 uptake rate among male EU8 immigrants was 2.8 times that of native men (14.8 vs. 5.2%) and the uptake rate of EU8 women twice that of native women (7.7 vs. 3.8%). Bratsberg *et al*. (2014) study overall UI uptake during the financial crisis and find that differences in age, tenure, industry and occupation account for 40% of the observed difference in uptake between immigrant men from Eastern Europe and native men and 60% of the observed difference in UI uptake among women.

Figure 7: Monthly unemployment insurance claimant rates 2007–2014, immigrants arriving in 2005–2008 and native comparison groups



Note: The data include persons at least 25 years of age who are not enrolled in education and with residency in Norway at the end of each calendar year.

2.4 Structural challenges

While it is too early to draw any firm conclusions regarding lifecycle employment in Norway, we do see some discouraging medium and long-term labor market performance patterns among the post-enlargement immigrants from lower-income countries in Europe. Why do we apparently fail to achieve full labor market integration on par with natives? We will focus here on three interrelated explanations.

The first is that immigrants often are recruited to jobs with low general skills requirements, and, in particular, to jobs where Norwegian language skills is not a key ingredient. These jobs are often temporary in nature and disproportionally found in cyclically sensitive industries

such as construction. And since most firms practice a last-in-first-out principle in case of downsizing, immigrant workers generally have a high risk of becoming unemployed. Once unemployed, the lack of general qualifications and language skills obviously become a serious handicap in attempts to find other types of work.

Second, those who become unemployed are in most cases entitled to unemployment insurance (UI). In principle, UI entitlements are fully transferable within Europe. Among labor immigrant in Norway, entitlement will in any case follow if their labor earnings during the prior calendar year exceeded 1.5 times the base amount of the social security system (in 2013, earnings above NOK 126,000 – or one third of the average earnings of male EU8 immigrants depicted in Figure 5). For workers from, say, Poland or Lithuania, Norwegian UI benefits will typically exceed earnings in the home country by an order of magnitude. In Table 1, we report average monthly UI benefits and wages in the home country, collected from the OECD Social and Welfare Statistics database (see columns I and II). These data show that typical Norwegian UI benefits are 7 to 15 times average UI benefits – and 4 to 5 times average wages – in Eastern Europe. Because the preceding section showed that Eastern European migrants earn less than natives and other migrants, we have also computed monthly UI benefits for those who actually claimed benefits in Norway in 2010 (see column III) as well as monthly pay among wage earners (column IV) and average monthly labor earnings for those employed during the year (column V). Although both benefits and wages of Eastern European migrants fall below those of the other groups considered, they remain much higher than UI benefits and wages at home. Hence, incentives for returning home to look for employment there are weak. A probable consequence is that many immigrants from accession countries remain registered as unemployed in Norway, despite being poorly qualified for new employment. For some of the unemployed, it will also be tempting to bring the insurance money back to the home country, where costs of living may be less than half of those in Norway, and thereby obtain a higher standard of living than what even a fulltime job could deliver in Norway. The rules of the UI program allow for such stays within the European labor market for a period of up to three months, but the absence of border controls be-

tween European countries obviously implies that it can be done to a much larger extent in practice.[4] Such opportunities may undermine incentives for active job search in Norway, and raise the reservation wage of the unemployed.

Table 1: Unemployment benefits and average earnings at home and in Norway, immigrants from the Baltic States, Poland, and the Nordic countries, 2010

	(I)	(II)	(III)	(IV)	(V)
	At home		In Norway		
	Monthly UI benefits	Monthly wage income if employed	Monthly UI benefits among claimants	Monthly pay, wage earners	Monthly earnings
Estonia	405	809	1,891	3,344	3,043
Latvia	411	684	1,686	3,282	3,200
Lithuania	188	561	1,579	3,224	3,091
Poland	223	754	1,689	3,353	3,134
Denmark	2,188	4,208	2,095	5,188	5,120
Finland	1,584	3,283	2,186	4,141	4,005
Iceland	1,547	2,793	1,900	4,599	4,429
Norway	2,948	4,916	1,929	4,491	4,500
Sweden	1,545	3,217	2,067	4,432	4,308

Note: Benefits and wages are converted to Euros using average exchange rate for 2010. Source of entries in columns (I) and (II) is OECD iLibrary, OECD Social and Welfare Statistics. Entries in columns (III)–(V) are authors' calculations based on the register data for the immigrant and native samples used in Figures 4 and 5.

Third, since European legislation implies that welfare state entitlements are transferred to the country of employment, a job in, say, Norway, not only grants membership in the Norwegian social insurance system, but also entails eligibility to various family allowances. For families with children, this entails that a job in Norway may be attractive even if the

[4] Although the higher costs of living in Norway will mitigate some of the cross-country differences uncovered in Table 1, the possibility of exporting benefits justifies comparisons without adjustments for purchasing power parity.

offered wage is extremely low. For example, the Norwegian cash-for-care subsidy for a one-year old child now amounts to NOK 6,000 per month, which adjusted to the 2010 wage levels and exchange rates used in Table 1 corresponds to EUR 629, or around 80% of average earnings in Poland. Such features give employers and prospective immigrant employees incentives to agree on very low wages and poor working conditions. While this can be a win-win situation for the employer and the immigrant worker – at least in the short run – it may stimulate the creation of poor jobs with high subsequent unemployment or disability risk and substantial (expected) costs for the welfare state.

2.5 A more robust welfare model

There is now an ongoing policy debate in several European countries about reestablishing elements of the previously existing migration barriers; either by making eligibility of economic transfers from a particular country conditional on past social security contributions to that same country (i.e., limit the transferability of eligibility), or by adjusting benefits with a country specific cost-of-living index when they are exported to another country. The latter would mean, for example, that Norwegian UI benefits paid out in Poland would be cut by more than one half compared to the current level.

Requiring a country-specific contribution period before benefits can be claimed may reduce some of the incentive distortions discussed in the previous section, particularly those related to creation and acceptance of very poor and short-lived jobs. However, this potential advantage must be balanced against the disadvantage of also reducing welfare-enhancing labor mobility within Europe. Further, introducing cost-of-living adjustments to social insurance payments appears to us to be a "dead end". Given that people can travel freely across Europe without notifying authorities of their whereabouts at each point in time, the scope for circumventing downwards cost adjustments appear almost limitless (unless draconian control measures are implemented).

In any case, we will argue that a strategy designed to strengthen the sustainability of the Nordic welfare model primarily must consist of pol-

icies aimed at making the welfare system *robust* to the existence of an open European labor market, and not of policies aimed at reversing it.
How can this be achieved in practice? One obvious policy option is to scale down on social insurance programs and thus make the welfare state less generous for everyone. Such a policy might trigger a "race to the bottom", as it seeks to ensure that a country's own welfare state provisions are not too generous relative to those in other countries. Thriftier social insurance would improve work incentives for natives as well as immigrants, and reduce migration distortions generated by cross-country differences in social insurance systems. However, the relatively generous social insurance programs in the Nordic countries are in place for a reason. They reflect voter preferences for a low-risk society with sound insurance arrangements in case of sickness, disability, or involuntary unemployment. They also reflect preferences for a relatively egalitarian society with little poverty. Viewed as a whole, the "Nordic model" has been successful in delivering economic growth and high standards of living for the vast majority of its citizens.

Is there an alternative way? We will argue that there is, but obviously not without its pros and cons. We will sketch a policy based on three pillars:

A first pillar consists of ensuring minimum standards in the labor market, including a minimum wage and possibly limitations on the use of temporary contracts. In the absence of such minimum standards, employers will have an incentive to recruit foreign workers with a high expected future income flow from the welfare state as such workers are willing to accept lower wages, ceteris paribus. This may result in an "adverse selection" of foreign workers (from a fiscal point of view), and also imply particularly high social insurance replacements among those who do arrive, as the progressive nature of social insurance entails that the replacement ratio declines with earnings. In a worst case scenario, firms could repeatedly recruit new immigrant workers to temporary and poorly paid jobs, based on the premise that their "real pay" would come from the welfare state. Hence, a benefit of minimum standards is that they may remove externalities arising from the fact that a job contract in, say, Norway, not only commits the employer, but also the Norwegian welfare

state, to future payments. Another benefit of minimum standards is that they will reduce average replacement ratios of welfare benefits.

A second pillar consists of transforming the social insurance system from being based on passivating and easily exportable cash transfers to being based on active participation. There is now ample empirical evidence showing that the moral hazard problems in social insurance can be considerably reduced by offering income *through active participation* rather than cash benefits only; see Røed (2012) for a recent overview and discussion of the literature. Participation-based social insurance further leads to more favorable selection by attracting persons who wish to work and contribute while deterring persons with low work-morale. In relation to longer term spells of both unemployment and sick leave/disability, active participation entails that social insurance payments to a larger extent become contingent on participation in job search, training, communal work, or vocational/medical rehabilitation programs. In particular, with active participation the design of temporary and permanent disability insurance programs will encourage and support the use of remaining (partial) work capacity, if necessary through the establishment of sheltered employment. A job offer is obviously also more place-bound than a cash transfer, and cannot readily be exported to a home country with lower costs of living.

The third pillar consists of transforming family allowances from being based on cash transfers to being based on the supply of free/affordable family-friendly and work-oriented services. For example, instead of offering (exportable) cash-for-care subsidies, the welfare state can offer high-quality child care directly.

Now, all of these policies also have some downsides. Higher minimum standards in the labor market distort the price-adjustment mechanism in the labor market and may raise unemployment among low-skilled workers. A more activity-oriented social insurance system may come with high administration costs and may require a large number of sheltered workplaces adapted for persons with reduced work capacity. Offering publicly provided childcare instead of cash transfers reduces the families' freedom of choice. Finding the optimal policy inevitably involves some tradeoffs. It is about balancing conflicting arguments. The point we wish to emphasize here is that policy makers actually have a

range of options. There are viable alternatives to the reintroduction of migration barriers and to benefit-cutting competition. We will also argue that the extension of the common European labor market to include countries with lower economic development implies, ceteris paribus, that the optimal balancing points shift toward higher employment standards and more place-bound social insurance and family support programs. Hence, if the policy was close to its optimum prior to the enlargements of the European labor market, it probably needs considerable adjustment now.

2.6 Conclusion

The recent enlargements of the European labor market represent a considerable challenge for welfare state economies. Provided that we wish to preserve the freedom of movement across European national borders, welfare state institutions in rich countries need to adapt. We have argued that business as usual is not a viable option, and that we either need to scale down on income insurance and family support programs (a race to the bottom), or make welfare state institutions more migration robust by i) raising minimum standards in the labor market, ii) making income insurance programs more participation oriented, and iii) substitute place-bound services like free childcare for exportable cash transfers in family support programs.

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