

Immigration policy and the Nordic welfare states

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Abstract: Immigration from an LDC to a DC is potentially advantageous for all parties. However, only under certain conditions will the potential be adequately realized and equitably distributed. In the Nordic welfare states the institutional setup, the refugee orientation, and the policies pursued creates an asymmetric situation where immigration confers a substantial welfare related benefit on the immigrant, but at significant costs to the natives. This is because under current conditions the welfare state promotes the adverse selection of immigrants and provides unusually small incentives to work. Two basic policy options are discussed: The erection of barriers and a change in the incentives. Both are found to have serious costs, but on balance a more market-oriented change in incentives is likely to be less problematic since it is more in keeping with the requirements of globalization.

Keywords: Immigration, welfare state

Jel: F22, J41, J70, O15

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The present analysis draws on the theoretical framework presented in Chand and Paldam (2004), Many comments to the first paper especially at seminars at Jena, Bruxelles and Göteborg Universities have been included in the present. We also build on Nannestad (2004) surveying the literature. Consequently references are kept at a minimum.

Immigrants to DCs flee poverty, persecution or both, and many are drawn to the Nordic welfare states with their generous social benefits. For many years the Nordic states have operated a policy of an immigration stop directed at economic migrants. In principle, it is quite difficult to gain access, see section VI. However, these criteria are difficult to administer. Despite setting up high barriers many economic migrants have gained entry. The public perception in the Nordic countries is that the pool has been increasing much faster than anticipated, and certainly in excess of absorptive capacities, making it difficult to integrate LDC immigrants.

All countries have a package of institutions, which influences the gains and losses from immigration. The Nordic package is an outlier, which appear to have two effects: It decreases the advantage of immigration for the world, and it redistributes the relative gains of the two parts. In large part this is attributable to the immigration not being market based in the sense of responding to the requirements of business. This is a marked change from the “golden 60s” when large numbers of guest workers were imported. While the welfare state ensures large gains for the immigrant, the economic advantage for the natives is low or negative. Key institutions of the Nordic welfare state, and the policies currently applied are thus inconsistent with large scale LDC immigration. This is reflected in the increasingly emotionally charged political economy of LDC immigration in the Nordic DCs.

The asymmetry of the gains from immigration has led to increased reliance on non-market rationing. These are undertaken by a large and growing bureaucracy, which bestows a valuable permit on the chosen few out of a large pool of potential immigrants. At the same time, to regulate the excess supply the Nordic countries are building higher and higher barriers involving cumbersome and costly regulations, surveillance, and entry procedures.

This is turning the Nordic countries into bigot anti-foreigner states, and it reduces their possibilities for reaping the full advantages of globalization. Already cases have appeared where firms in need of international staff, have decided to move elsewhere where institutions are more oriented to the market. Global competition is becoming sharper, and the production of goods and services are being increasingly outsourced. This puts pressure on the Nordic welfare states to adopt solutions that maintain competitiveness. Some of these will involve addressing immigration policies and institutions. The objective here would be to create a more attractive environment especially for the highly skilled labor that is increasingly to be found in the emerging economies. Given the small sizes of the Nordic welfare states and their heavy dependence on foreign transactions, closing boundaries is not a viable solution.

The background to the analysis is the stress that is increasingly experienced by the Nordic welfare states. These states are universally recognized as having had considerable

success in their striving toward the twin ideals of equality and solidarity, while at the same time ensuring adequate standards of efficiency and productivity. However, the stress is growing: One factor is the gradual slowing of growth, and sluggish job creation. Another is the demographic shift toward an aging population. A third stress factor is the problem associated with immigration from LDCs. Present institutions and practices have resulted in a process that contributes to immigrant welfare dependency, increased hostility to immigrants on the part of natives in the Nordic states, frustrated immigrants, and an unattractive environment for the global exchange of value creating labor.

A main purpose of our analysis is to study if an alternative to the building of barriers can lead to a superior outcome that would better realize the potential gains from immigration. We believe that it is possible to do so through a strategy that involves streamlining and reforming current practices, while shifting the orientation of the immigration program towards a more market-based model that encourages labor movements on a non-permanent basis.

Section I sets up the analytical framework, while section II presents what we shall refer to as the standard immigration case. Section III turns to the Nordic-type welfare state variant, and section IV considers selectivity and incentive effects. Section V deals with some additional consequences and costs. Section VI examines policy choices, while section VII concludes.

Table 1. Variables and curves analyzed

Curve	Definition (all variables consider one immigrant)	Depends upon
t, T	time from entry $t = 0$. The immigrant is absorbed at $t = T$	decision is made at $t = 0$
W	wage in DC: $w = ae^{at}$. For $t = 0$, $w = a$	Grow at constant real rate a
w_l	wage in LDC: $wL = \beta e^{bt}$. For $t = 0$, $w = \beta$	Grow at constant real rate b
$\lambda(T, \dots)$	absorption curve, labor income of immigrant is λw	t, ρ and other institutions of DC
$\rho(T, \dots)$	excess social subsidy to immigrant for $t < x$. Subsidy is ρw	t and institutions of DC
NPV	net present values for immigrant NPV_I and natives NPV_{DC}	calculated at time $t = 0$
NPV^*	potential net present values, if no absorption problems	$\lambda = 1$ and $\rho = 0$ for all t
S, D	benefit of increased human rights, costs of outsider status	We assume $S > D$
Q	costs to natives of increased social tensions	
Z	surplus to natives of immigrant product. Fraction of product	typical value $z \approx 0.25$
X	time of social break even, excess subsidy zero	Intersection of λ and ρ curves
L	loss of DC production due to slow absorption	λ -curve
R	excess transfer to immigrant, between $t = 0$ and T	λ -curve and ρ -curve

For easy comparison we use US \$ as the unit of account, but we have fixed it at 1\$ = 0.8 Euro.

Note: Excess is above the normal amount received by the native. Surplus is gain of the natives. While the labor market absorption takes place at T , the social sector absorption already occurs at x .

I. Analytical Framework: The large potential gains

The following analysis abstracts from the issue of genuine refugees and the benefits that they, the host countries, and the international community obtain from the process of recognizing and accepting refugees. The focus here is on the economic migrant, the incentives they face, and the procedures used in dealing with them, and their associated costs and benefits.³⁾

Two agents are considered: The immigrant (micro) who wishes to enter the labor market of the DC (macro), and the DC itself. The analysis begins at $t = 0$, when the immigrant legally enters DC. To simplify we assume that the country of the immigrant and the DC grow at equilibrium rates. The salary structure in country i is represented by the (factor) wage, w_i . It is calculated net of: (a) standard social benefits such as unemployment benefit at the average unemployment rate, pensions, etc., and (b) taxes and insurance contributions financing these benefits. The rest of his taxes finance his consumption of collective goods.

1.1 The operational concept of absorption and the difficult concept of integration

An immigrant is fully absorbed – he has turned insider – when he receives the going wage w . At that stage he receives the standard social benefits only, i.e., he has the same average rate of unemployment, as do natives, and retires at their average age of retirement, etc. When the immigrant is accepted into DC at time $t = 0$, he is initially unemployed. He begins work and starts earning a salary which rises over time until he becomes fully absorbed, at $t = T$. This process is described by a labor absorption function that is denoted here as λ that rises from 0 to 1. In this interval, the difference between w and λw measures the extent to which the immigrant has been absorbed.

Notice that in concentrating on the precise and operational labor market concept of absorption, the paper largely disregards the less precise cultural concept of integration, where the immigrant acquires the language and habits of the natives. However, the two concepts are related. Some integration is surely needed before an immigrant can be fully absorbed. This aspect can be included in the form of a cultural distance $\kappa(0)$ at time $t = 0$, which then falls to κ when/if the immigrant is so integrated that he resists further integration. No doubt κ is an important explanatory factor for λ , but its size will depend on attitudes towards immigrants and the institutions of the DC.

3. The first in a family to immigrate is mostly male, so we use the male gender. We use a simple overlapping generation framework, where the immigrant establishes a dynastic family and lives forever through succeeding generations.

I.2 Utility: Net present values of income flows and the micro-macro puzzle

The utility gain of the immigrant and the host has economic and non-economic parts. The economic part is taken to be a positive monotonic function of the net present values of the changes in the income flows calculated from the time of immigration $t = 0$.

For the immigrant the change in utility is $U = U(NPV_I, S, D)$, where NPV_I is the net present value of the changes in his income, as analyzed below. The other variables S and D are the potential increase in personal security in going from the LDC to DC, while D is the non-economic loss he experiences before he is absorbed – i.e. the costs of being an outsider and of having to give up elements of his native culture. We assume that $S > D$, so that S and D increase the utility of the immigrant.

For the DC natives the utility is $U = U(NPV_{DC}, Q)$, where NPV_{DC} is the net present value of two flows: (a) The surplus produced by the immigrant in excess of his salary, absenting any externalities. It is taken to be proportional to his salary λ by the factor z , which corresponds to the share of capital so that $z \approx 0.25$ and (b) the excess social expenditures paid to the immigrant till he is absorbed. The non-economic variable Q accounts for the social tensions created by the immigration. Q reduces the utility of the DC.

No attempt is made here to quantify the non-economic variables. They are further discussed in Chand and Paldam (2004).

While the benefits to the immigrant are individualized, they are not for the DC native. NPV_{DC} is divided between all natives in DC, but it is negligible for any one native. This creates a typical macro-micro puzzle: A native may want to forbid immigration, but still be in favor of allowing specific persons to enter, e.g., to work in his business or if a touching story is told in the media.

I.3 The potential gain to the immigrant, NPV_I^ , and the host country, NPV_{DC}^**

The maximum gain possible for both parties occurs when absorption takes place upon entry, so that $\lambda = 1$ from $t = 0$. The immigrant just shifts from the LDC-wage to the DC-wage. His gain is the net present value of the DC-wage minus the LDC-wage. Using the two formulas for the wages from table 1 and the standard expression for a perpetual annuity, we get:

$$(1) \quad NPV_I^* = NPV(w - w_L) = \int_0^{\infty} (w - w_L)e^{-rt} dt = \alpha \int_0^{\infty} e^{-(r-a)t} dt - \beta \int_0^{\infty} e^{-(r-b)t} dt =$$

$$\frac{\alpha}{r-a} - \frac{\beta}{r-b} \approx \frac{\alpha - \beta}{r-a} = \alpha \frac{1 - \beta/\alpha}{r-a}. \text{ The last two expressions hold if } a = b$$

Assuming that the LDC and DC growth rates are equal simplifies the analysis but it is likely to be true only for LDC groupings. However, where there are substantial differences e.g. between China and India with sustained annual growth rates of 7-10 percent on the one hand and the DC's growing at 1-2 percent, the analysis has to be qualified since the NPV 's could now move in the opposite direction.

The typical GDP per capita in PPP terms of our stylized DC and LDC suggests that β is ap 15% \pm 10% of α . The real rate of interest may approximate the rate of discount. Hence, r is at most 5%, and a and b are both around 2%. With these values $NPV_I^* \approx \alpha(1-0.15)/0.03 = 28\alpha$. Even for a low α such as \$25'000, NPV_I^* exceeds \$ 2/3 mill. NPV_I^* falls to half if r is high, say 8%, but it rises towards infinity if r falls to a . A rough estimate would therefore be:

$$(2) \quad NPV_I^* = \$ \frac{2}{3} \pm \frac{1}{3} \text{ mill}$$

The large size of NPV_I^* provides a strong inducement for economic migration. However, the immigrant faces 3 problems:

- (p1) He may fail to get through the barriers to entry, see section VI.
- (p2) He may have to pay commissions to agents to get through the barriers, see section VI.
- (p3) During the absorption period some of NPV_I^* is lost, see section II.

The potential gain for the DC is the net value of the surplus production of the immigrant. When $\lambda = 1$, there are no excess social expenditures incurred over and above those normal for natives. The potential value is thus:

$$(3) \quad NPV_{DC}^* = NPV(zw) = z \frac{\alpha}{r-a} = z(NPV_I^* + NPV(w_L)) \approx z \frac{\alpha}{\alpha-\beta} NPV_I^*$$

For the values of the parameters above this is about $0.3NPV_I^*$, which is still considerable.

The sum of NPV_I^* and NPV_{DC}^* according to the example here is roughly about \$ 1 mill. With such large potential gains for both parts it is no wonder that many observers think that the labor flows are highly beneficial for the world.⁴⁾

4. Many stories can be told where this has been the case, such as the large Finnish immigration to Sweden.

II. The standard case

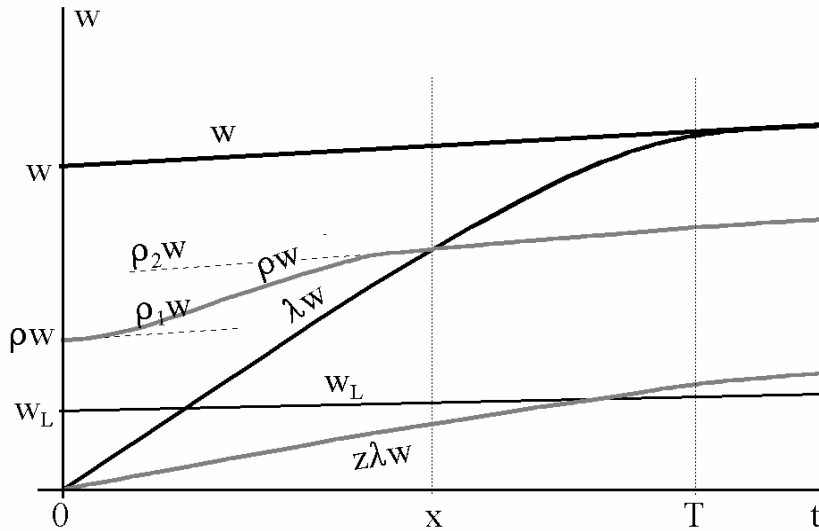
It is likely to takes some time, T , for the immigrant to be absorbed in the labor market. We assume that he starts without a job at $t = 0$, so the absorption curve, λ , starts at 0 and reaches w at T . We assume that the λ -curve is linear. However, as long as his income falls below a certain threshold, he is entitled to social support, ρ . The absorption function, $\lambda = \lambda(t...)$, refers to an average: Some immigrants may be absorbed right away, while others take much longer. It is less than the one for the native for at least two reasons: (a) The labor market participation rate is lower notably for women, and (b) the unemployment rate is higher. In addition we take λ to be a function of the institutional package in the DC that influences hiring practices.⁵

II.1 A slow absorption λ , and a social policy ρ

This case is drawn on Figure 1. The basic curves on Figure 1a show a loss $(1 - \lambda)$ to the immigrant, which accumulates to L . For the natives the loss is $z(1 - \lambda)$ that accumulates to zL . The immigrant receives an excess social transfer, ρ , which accumulates to R . It partly compensates the immigrant, but it is a cost to the native. The *NPV*-calculations thus change to:

- (4) $NPV_I = NPV_I^* - (L - R)$, where L and R are given in eqs. (6) and (7)
- (5) $NPV_{DC} = NPV_{DC}^* - (zL + R)$

Figure 1a. Standard case: Basic curves

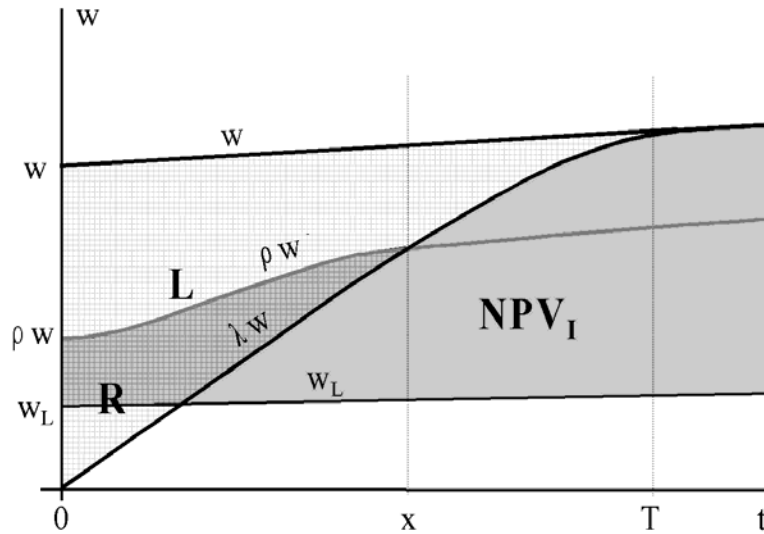


5. Chand and Paldam (2005) contains a set of simulations, for different absorption times and social support curves. We shall not repeat the calculations at present.

The subsidy, ρ , has two parts: A subsistence payment at the rate ρ_1 , and an insurance part that has to be saved up, so ρ rises from ρ_1 till the maximum ρ_2 , which is a certain fraction of w . The social policies of the individual DC determine the exact form of the ρ -curve. At the break-even point, x , the immigrant ceases to be a net recipient of subsidies. To simplify, assume that the subsidy received is the difference between the subsidy and income made, λ .

From casual observation and many studies from different countries we know that T is often large. It depends upon the institutions in the DC and the difference between the culture, education, etc. of the immigrants and the natives. The slowness of absorption gives rise to two deviations from the ideal “potential” case: A production loss L and a social redistribution R . The production loss L is the triangle between the w -line and the λ -curve – shown on figure 1b as the checkered area. The NPV is then approximated as:

Figure 1b. Standard case: NPV_I of immigrant



$$(6) \quad L = \int_0^T (1-\lambda)we^{-rt} dt = \int_0^T we^{-rt} dt - \int_0^T \lambda we^{-rt} dt \approx \frac{q}{2} \frac{\alpha}{r-a} = \frac{q}{2} NPV_I,$$

where q is the fraction of $NPV(w)$ between 0 and T .

The redistribution R from the natives to the immigrant is the area between the ρ -curve and the λ -curve from $t = 0$ to x . It is shown in figures 1b and c. The NPV is:

$$(7) \quad R = \int_0^x (\rho - \lambda)we^{-rt} dt = \alpha \int_0^x (\rho - \lambda)e^{-(r-a)t} dt = vL$$

As R compensates a part of L only, ν must be a positive fraction, $0 < \nu < 1$. If the curves look as drawn in figure 1c, $\nu \approx 1/3$, but we shall meet cases with larger ν 's below.

II.2 The NPV-calculation of the immigrant and the natives

The immigrant's income gain from being accepted in DC is drawn as the dark-shaded NPV_I in figure 1b – note that some NPV_I is checkered. The potential NPV_I^* is the area between the w -curve and the wL -curve. The gray area of NPV_I is somewhat smaller, due to the loss triangle caused by the slowness of absorption. The exact formula is:

$$(8) \quad NPV_I = \int_0^{\infty} (w - w_L) e^{-rt} dt - L + R = NPV_I^* - L + R, \text{ as in (4).}$$

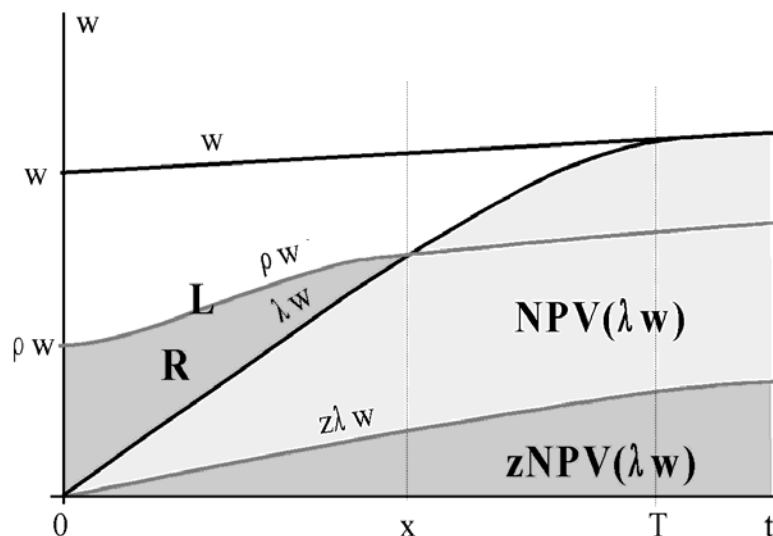
A reasonable order of magnitude to have in mind is: $NPV_I \approx 2/3 NPV_I^*$.

The corresponding calculation by the natives in the DC is shown on figure 1c. The net surplus to the natives is assumed proportional to w , by the factor z , assessed to be 0.25.

$$(9) \quad NPV_{DC} = z(NPV(w) - L) - R = NPV_{DC}^* - zL - R, \text{ as in (5).}$$

With a fast absorption and stingy social benefits NPV_{DC} is still positive, but with slow absorption and generous social support NPV_{DC} easily becomes negative.⁶⁾

Figure 1c. Standard case: NPV_{DC} of natives



6. In addition, most DC's pay reception and training costs to facilitate the absorption of the immigrant.

II.3 Some alternative cases of labor absorption and social policies

In Chand and Paldam (2004) we consider three – highly stylized – cases chosen to span the possibility space. (1) The Nordic-like case to be dealt with in section III. (2) A Dubai-like society of guest workers, where immigrants are allowed in only on contract to fill a vacant job. They pay a sponsor fee to the natives and the bulk of the taxes, but receive no social benefits except health care. Hence, $\lambda = 1$ for all t , ρ is almost zero, and NPV is close to NPV^* , though divided in such a way that the natives get a relatively large share. (3) A USA-like society of immigrants, where social security is low and largely insurance based, and the economic migrant has to obtain sponsorship and Department of Labor endorsement. Here, immigrants confront a steep λ -curve.

The result from applying the welfare calculus set out above for the assumed parameter values to these cases is shown in table 2. The cases are remarkably different and the Nordic-like case is by far the inferior one. Section III repeats the analysis of the Nordic case.

Table 2. Alternative Cases: Unit \$ 1 mio

	Potential	Dubai-like	USA-like	Nordic-like
Immigrant NPV_I	0.75	0.6	0.55	0.6
Natives NPV_{DC}	0.25	0.35	0.10	-0.2
World NPV	1	0.95	0.65	0.4

Note: Based on Chand and Paldam (2004).

III. A Nordic-like country with a tax-based welfare state

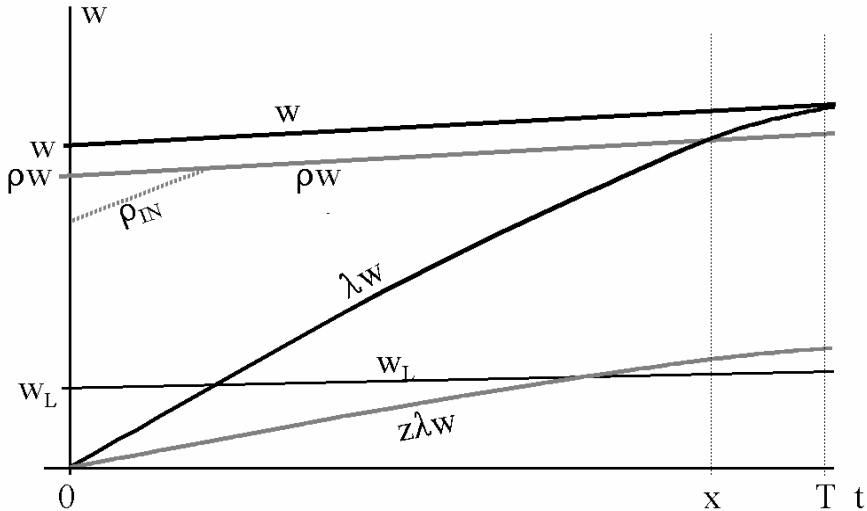
In a welfare state of the Nordic type, ρ is high and paid out of the general tax revenue. Once the immigrant is accepted, he is eligible for social benefits on a par with the natives. The benefits are given to equalize incomes, so they are highest at the low end of the income scale, where the immigrants are likely to be for some time.

III.1 The basic curves in the Nordic-like country

Figure 2a shows the basic curves in the Nordic-like case. The curves have the worst possible shapes as regards the interests of the natives: The ρ -curve is unusually high, with a social support level in the order of $0.8w$. The λ -curve is correspondingly low, with values of T in

excess of 40 years – estimates even suggests about 60 years. As a result the loss triangle, L , is unusually large, and the share of the loss compensated, v , is large too, so that the transfer, R , becomes very large as well.

Figure 2a. Nordic-like case: Basic curves



The high ρ -curve is due to a high general level of support for the needy, both in general and with respect to special expenditures such as rent, kindergarten, etc. It is well known that immigrant groups quickly develop a solid knowledge of their entitlements, even when the social legislation is complex. To partly offset the high path of the ρ -curve, Denmark has experimented with a special reduction in the subsidy for a new immigrant, ρ_{IN} . However, this has not been undertaken as yet in the other Nordic countries and will be disregarded below.

III.2 The two NPV-calculations for the Nordic-like country

Figure 2b shows an outcome that is slightly better for the immigrant than in the standard case (figure 1b) as NPV_I is approximately 85% of NPV_I^* . As to NPV_{DC} this now looks as in figure 2c. Both L and R are much larger than in the standard case, so it is obviously very difficult to reach positive values of NPV_{DC} . NPV_{DC} is always negative even for $T = 40$.

With a high T NPV_N becomes about $-0.25 NPV_I^*$. Finally, reception and training costs should be included. The amount is also unusually high as it includes language courses and the costs incurred by the state between the arrival of the prospective immigrant to the country and his actual admission. A ballpark estimate would be at least $0.05 NPV_I^*$, increasing the total costs to $-0.3 NPV_I^*$.

Figure 2b. Nordic-like case: NPV_I of immigrant

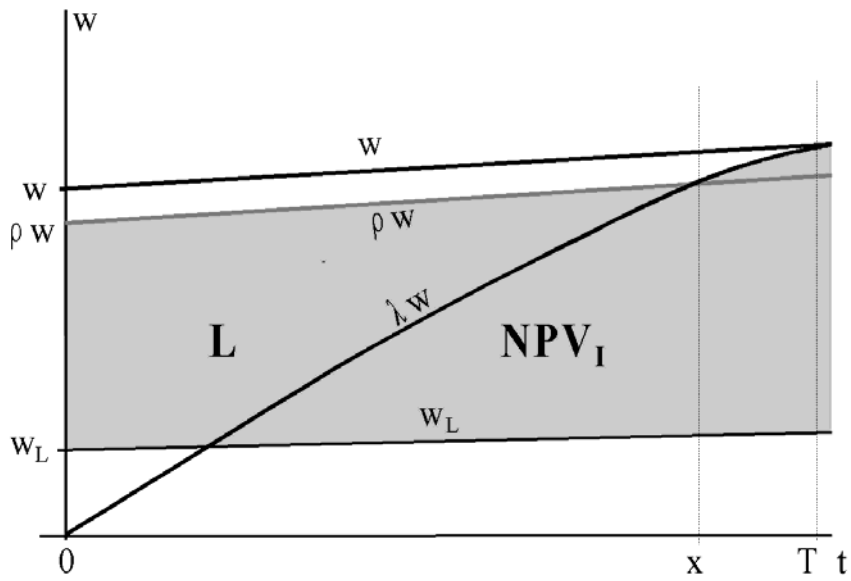
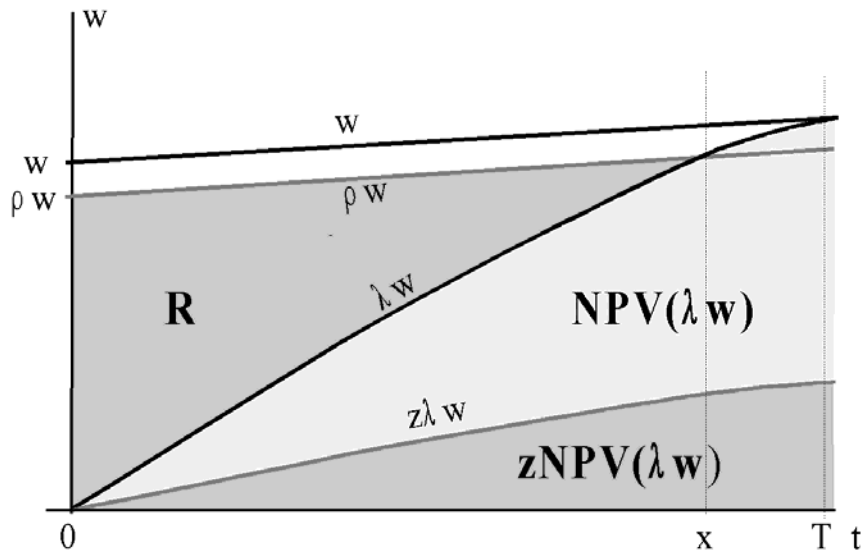


Figure 2c. Nordic-like case: NPV_N of natives



We thus conclude: Immigration under the present institutional setup is expensive for the natives in the Nordic-like case. No mutually advantageous deal can be made so long as the incentives flow only in one direction.

III.3 *The bureaucratic nature of the decision*

The decision to accept an immigrant under current procedures is thus in the nature of a favor bestowed on the immigrant. Bureaucrats, according to an increasingly complex set of laws that are not market-based, do this as an administrative act. They build on versions of the three criteria listed in table 3.

Table 3. Criteria for permitting immigration

Criterion	Bureaucratic rule	Formulation
1 Prosecution	a. UNHR share	“Well founded fear of prosecution”
	b. Asylum applicant	“Well founded fear of prosecution”
2 Family reunion	Family definition	Core family, and connection to country
3 Long stay	Temporary permit	Needed skills

Note: In addition some people always get accepted as immigrants without fulfilling the criteria.

The decision of the bureaucrat is based upon the legend of the immigrant. To be accepted he must demonstrate a well founded fear of persecution by the LDC authorities. His application is thus an accusation against the authorities of his country of origin, and it is not easy to get cooperation from the same authorities to control the legend. In addition the relation between authorities and people are different in DCs, where people in general trust authorities, and most LDCs, where people distrust authorities (see Paldam & Svendsen, 2001). Thus it can be checked by the DC bureaucrats to a limited extend only. This is well known by immigrants, so, with large gains at stake, moral hazard becomes a problem.⁷⁾

The large immigration bureaucracy that has been built in response has been given considerable discretionary power to assess legends. This leads to decisions, which are frequently cruel and often arbitrary. Hopeful immigrants are subjected to unbearably long waiting periods, while authorities seek information controlling claims, and lawyers haggle over inadequate evidence and hearsay. No wonder the atmosphere becomes strained and one of mutual suspicion, which erodes the attractiveness of the DC for higher level immigrants.⁸⁾

7. Even if parts of the legend can be tested it is normally expensive. This applies to DNA-tests that are sometimes used to test legends of persons claiming family links, with amazing results. Even claimed biological children are not always so.

8. Germany recently tried the experiment of attracting hi-tech workers from emerging economies such as India through a special visa issue but this has so far been a complete flop. See Geddes (2003).

IV. Selection and incentives

The Nordic case is distinctive because of the combination of an institutional setup associated with the welfare state and an LDC immigration policy that is oriented in favor of refugees. The resulting selection process and the incentive structure both influence the λ -curve.

IV.1 The selection/self-selection of immigrants

Selection works both on the demand and supply sides. DCs choose which immigrant to accept. Immigrants try harder to get into some countries than in to others.

The Nordic countries have for the past three decades prioritized immigrants who can prove that they have been persecuted. This means that immigrants may be traumatized and in need of treatment. Hence, there may be a negative relation between market value and this criterion of acceptance.

A mechanism that produces similar results operates on the supply side. Consider two types of immigrants: Type A has a high labor market value, while type B has a low labor market value. A-type immigrants will surely try to enter the countries where it is most easy to find work. They will be less interested in the level of social support, while B-type immigrants will have the reverse preference. Hence, countries with generous support systems and overly regulated labor markets – such as the Nordic welfare states – are likely to generate adverse selection of immigrants.

An additional reason for adverse selection is that labor markets in the Nordic countries use the local language, which can only be acquired through a large investment on the part of the immigrant. Considerable time may thus have to elapse before the immigrant can get a job. The best-educated immigrants are likely to know English, French or Spanish, but not Danish, Norwegian or Swedish. Hence, they will try much harder to get into a country where the labor market is more congenial and operates in the language they are accustomed to such as the USA, Dubai, France or Spain.

Note that the self-selection mechanism works both for the individual and for the group. Immigrants normally prefer to go to a country that has a group of people from the old country. This cuts transaction costs dramatically. We also note from the calculation of net present values that the type of LDC depending on their economic performance will influence the sorting mechanism. Those that are on a much faster growth curve will release potential

immigrants of either much lower skill levels or with social needs for whom the Nordic type welfare states are attractive options.

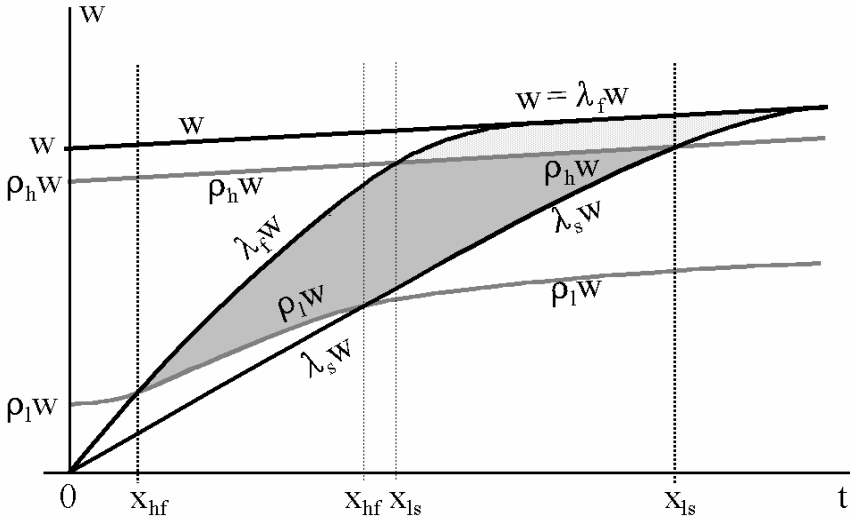
IV.2 Incentives at the low-end in the welfare state

A large literature deals with the incentive problems in the welfare state (see e.g. Andersen, 2004). Essentially the welfare states reduce marginal incentives to work and particularly at the low-end income levels. Many calculations show that such incomes increase little – sometimes not at all – if they get a low-end job.⁹⁾ Just as with natives, the welfare state’s incentives could lead to an unemployed immigrant on social support working a bit in the gray sector, helping an uncle, say, in his shop, thereby generating a more acceptable level income.¹⁰⁾

The social policies are summarized in the ρ -curve. It is determined by the organization of social security among the natives and the tradition for immigration into the country. Since the Nordic states generally apply the principle of nondiscrimination to social benefit access, the rules for the natives apply to the immigrants as well.

Figure 3. Incentives to immigrants: Alternative cases:

Absorption: λ_f is fast and λ_s is slow. Social security: ρ_h is high and ρ_l is low



9. In the Nordic countries taxes constitute 50% of GDP and are highly progressive – even unskilled workers pay high marginal taxes. In addition social benefits are income dependent. Therefore, the marginal net effect on incomes, when salaries rise, becomes small – sometimes even negative.

10. Immigrants appear to work more in the gray sector than natives for three reasons: (1) They have higher unemployment rates. (2) Relatively many immigrants are self employed in businesses that are so small as to be difficult to control by tax authorities. (3) Their “solidarity with the system” is relatively small. Note that all three factors are dynamic.

Figure 3 shows two ρ -curves and two λ -curves. The high ρ_h curve has no insurance part of the social payment, so the curve is parallel with and close to the w -line. The low ρ_l curve has a low basic social minimum payment, with the rest of social security insurance based. The immigrant starts with no contribution to the insurance fund, and it only increases as time passes. The two λ -curves are also extreme: λ_f is fast, so that immigrants are quickly absorbed, while λ_s indicate that immigrants are slowly absorbed. The four curves suggest three points.

(i) The differences between the curves have dramatic effects on the intersection point x and the areas L and R . In particular, and using our assumed parameter values, the amount of social support received by the immigrant could differ by some 20 times between the case where the curves are (ρ_l, λ_f) and (ρ_h, λ_s) . This will have large consequences for NPV_{DC} .

(ii) Incentives to work are different. Imagine, while keeping constant labor demand practices, that the λ -curve is influenced by effort. The λ_f -curve is then a high effort curve, and the λ_s -curve a low effort curve. The two areas marked with gray show the incentives to make an effort. If the ρ -curve is the high alternative, then the immigrant's loss if he makes a small effort is the light gray area, which is small. Consequently, the logic of the curves is that if the ρ -curve moves upward, the economic pressures on the immigrant to find work decrease, and the λ -curve hence moves down, and vice versa.

(iii) Immigrant benefits are less affected. Consider NPV_I in the (ρ_l, λ_f) -case and the (ρ_h, λ_s) -case. If incentive effects on λ are large, the seemingly brutal social policies may not cause large welfare losses. However, if incentive effects are small as illustrated by comparing the (ρ_h, λ_s) -case and the (ρ_l, λ_s) -case, welfare losses in the latter cases are large even for high discount rates.

The incentive effect and the adverse selection effect are difficult to distinguish in practice, but it is plausible that they reinforce each other.

V. Some additional costs and implications

The present section discusses some issues neglected in the analysis so far: (1) The market for agents. (2) The family multiplier of immigration. (3) The civil liberty problem. (4) The problems of solidarity and the receptivity of societies to immigration. (5) The limited job prospects. Their overall effect is to reinforce the perception that the gains from immigration, as it is presently practiced, are one-sided.

V.1 Barriers and the market for agents

The large amount of money involved, and the barriers to entry have generated a market for agents. Some are legal and some are illegal in the DCs.

Legal agents are lawyers, NGOs and politicians helping immigrants getting through the bureaucracy for humanitarian, political, economic and other reasons. Some politicians and journalists specialize in running individual human-interest cases, etc. Their activity builds upon the micro-macro paradox, and the low verifiability of legends.

Illegal agents perform two services: (i) They provide legends that tally to the rules of admission in the chosen DC. Most LDC-immigrants come from countries with high levels of corruption (see Paldam, 2001), with “bazaars” where many documents can be purchased. (ii) They organize unrecorded transport so that the immigrant turns up in the chosen DC without a legal exit from a country to which he can be sent back

The DCs increasingly criminalize such agents as “human traffickers”. Consequently, they are becoming more ruthless and well organized. These agents may or may not cheat the potential immigrants, but most try not to do anything criminal in the LDCs, so the DCs are finding it difficult to get much support from the LDCs authorities in prosecuting the agents.

It appears that the illegal agents often collect fees in the order of \$ 10'000 from an immigrant – immigration is not for the poor in the LDCs – or if collected on a deferred basis, the immigrant must have access to adequate benefits, etc. In addition, the legal process from when the immigrant enters the country until the decision is made, is likely to take half a year, in which period the immigrant loses, say, $\frac{1}{2}wL$. The implication is that the immigrant may have invested a considerable sum in the attempt to obtain entry. Frequently, his family – that is, his extended family, see next section – has invested in him.

Thanks to the large interests, the agents, the family networks etc., some immigrants manage to seep through the barriers. In order to reduce the seepage and especially to reduce the family multiplier (see below), a whole set of laws and administrative rules are being implemented in the Nordic-type societies. Some of the rules define the family as only a DC-type core family, which is deemed sufficiently close to allow immigration. Obviously, this creates further tensions between the groups.

V.2 The family multiplier: The extended family and the family obligation

So far we have considered the situation of one male immigrant. However, the story does not end here. Most immigrants come from countries that have not made the demographic transition, and where social security is very modest.

Hence, families are extended, and social security and care are a family obligation. This causes a set of attitudes where the solidarity within the extended family dominates attitudes toward the nation, the system, etc.¹¹⁾ The family member who emigrates still carries the obligation to the extended family, and it is further cemented by the investment the family has made in the immigrant by financing the fees for the agents, who have helped him to get in.

One way to get an extra family member in is by marriage, and it is hence a strong obligation that immigrants marry, say, a cousin from the old country as soon as he reaches the required age. Also, it is perhaps possible to get the immigrant's parents in, and then their other children and their spouses and the parents of the spouses, and so on. The more members the family manages to get in, the smaller the financial burdens, and the easier it is to keep traditions for one more generation.

It thus appears that each immigrant accepted will generate an additional immigration of μ (say 3-5) persons in the future. The total cost is thus not NPV_N , but μNPV_N .

V.3 The civil liberty problem

Many of the rules and regulations necessary to control immigration infringe upon the civil rights of the natives. Rules are appearing, for example recently in Denmark, which control the rights of ethnic natives to marry foreigners, and the right of people to cross borders in general. At the borders, cars with people who look "different" are stopped, etc. This all creates unpleasant images of a police state based on racist criteria, which most ethnic natives resist. In other words, it creates trade-offs between civil liberties on the one side, and economic costs and ethnic tensions on the other side. Difficult and highly politicized choices have to be made.

V.4 Solidarity and the receptivity of countries¹²⁾

Finally, it should be mentioned that a set of attitudes and values stand between the immigrant and his new country, and depresses the λ -curve. Immigrants are outsiders trying to break into the society of insiders. Some groups react to this challenge by making an extra effort, while others react with disdain and by turning inward to their own values.

The welfare state builds on solidarity and shared values, which in the final analysis are based upon some sort of expected reciprocity among insiders. People know that society will support them in case of need, and hence they are also willing to support others. This is

11. Some of the reasons for the tensions between the groups are precisely that the DC-societies have passed the demographic transition and have core families where both spouses work and the care for old and young is handled by institutions. Many immigrants do not want to be so integrated that this process affects their families. To this comes secularization, which many immigrants abhor.

12. This subsection discusses issues covered in more depth in Coleman & Wadensjö (1999), giving the historical perspective, and Nannestad (1999) analyzing recent data.

buttressed through a system of tax payments on a life-time basis. The welfare system is thus a mutual support system within a group that extends to all insiders. Subgroups of natives do exist, who for several generations need more support than others, but they are not so distinct that solidarity fails. Solidarity comes under pressures when conspicuous groups of immigrants are seen as sending strong signals that they do not want to belong. It is not religion, culture, dress code, language, but the totality of these differences that has turned into a problem in welfare states of the Nordic type.¹³⁾

The other side of this issue is the receptivity of the welfare state to immigrants. Many immigrants indicate that they experience a society that is closed to them – i.e. they are not taken as “normal folks”. They meet a social system that provides money and some social control, but real jobs are hard to get, as the labor market prefers insiders. It is safer and much nicer to stay within the group, and reject decadent native society.

So one gets into a vicious circle, where the market prefers insiders forcing the immigrants to remain outsiders, and thereby turning them even more into their own society, making them remain outsiders. One may even argue that the big social payments to the immigrants serve to give natives an excuse for the discrimination in the labor market. But this, of course, is a source of inefficiency. Immigrants represent potential assets that should be effectively utilized.

V.4 Competition for low-end jobs: Two possible outcomes

It appears that most immigrants are in the low-skill group that competes with unskilled natives for minimum wage jobs. A minimum wage typically creates excess unemployment at that rate. Immigration thus increases the competition for relatively scarce jobs. Natives and immigrants each have advantages in this competition:

(NA) Natives are insiders known by employers and recommended by each other. Immigrants are outsiders, often with language problems, who want to “break into” the labor market. Insiders have an advantage even if employers try not to discriminate.

(IA) Immigrants may be keener to work for three reasons: (1) They are more used to poor working conditions. (2) A self-selection mechanism may work, so that immigrants are more

13. In some parts of all Nordic countries one frequently sees families with women dressed in full chador, walking with a bunch of children, with whom they speak in their language. It makes natives ask themselves questions as: In what way do such families want to become part of “our” society? Will they bring up their children to become integrated? What is the nature of the solidarity by which the average native should subsidize the way they live? How much reciprocity can they expect from that family?

enterprising than natives.¹⁴⁾ (3) Incentives to work will be higher than for natives if the social benefits received include an insurance element so that new immigrants receive less in social benefits than natives.

Two outcomes may result: (i) NA dominates: Unemployment will be concentrated among immigrants. (ii) IA dominates: Immigrants replace natives, and unemployment is concentrated among natives.¹⁵⁾ Both outcomes may lead to social tensions: Outcome (i) means that immigrants are cut off from society, and they may develop anti-native attitudes. Outcome (ii) may cause anti-immigrant attitudes to spread among low-end natives. Both types of tension interact dynamically with the outcome to make it more extreme.

At bottom, the problem is one of inadequate jobs. This is a reflection of the fact that the demand for immigrants is not economically based. The issue then becomes one of the State having to undertake various job creating actions, which is an added burden.

VI. Policies: Unpalatable choices

The Nordic welfare states were created before mass immigration from LDCs became a real possibility and at a time when the Nordic were ethnically homogeneous. Various numbers have been calculated to show the size of immigration. The *problem* is the share of unabsorbed immigrants. It is often argued that the solution to the problem is policies that integrate the immigrants into the Nordic societies. Many policies have been made to that end, but they have not had a clear effect. At present we concentrate the discussion on the factors determining the size of the new entrants.

We shall first look at the numbers, which are surprisingly poorly known, and then turn to policy problem: How can the immigrant intake be switched from the more costly and thus less desirable refugee type to the more economically beneficial and thus desirable immigrant type with needed skills?

VI.1 Actual immigration: Small numbers, but cumulative

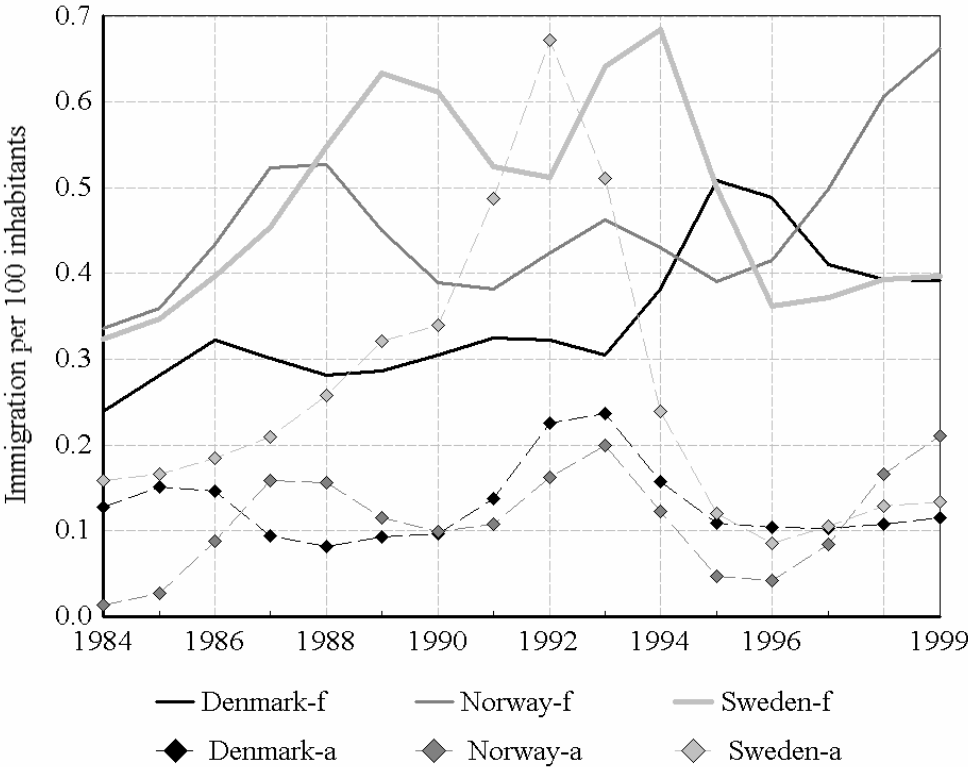
Figure 4 shows the data for the inflow of foreigners (f), and the number of asylum applicants (a) in per cent of the inhabitants to the three Nordic countries. The rate has been between 0.3

14. This assumption is contrary to the ones made in section IV.2, and thus it is more likely to apply in non-Nordic countries.

15. The solution (i) describes the Nordic outcome, while (ii) has more resemblance to the German outcome, see Sinn (2003).

and 0.4 per years since the mid 1960s. The LDC immigrants are roughly one-half of the flow, but while many of the immigrants from other DCs leave later, most of the LDC immigrants settle permanently. So the LDC-immigrants have slowly accumulated, and even when their fertility is slowly falling to the Nordic level it started at a higher level.

Figure 5. Inflows of foreigners (f) and asylum seekers (a) per 100 population



Note: “Country-f” is the flow of foreign born to the country, while “country-a” is the number of asylum seekers. The curves are smoothed a little by a MA(3) process with weights (0.25, 0.5, 0.25). Source: WDI (2003).

The share of the immigrant population is now in the range of 8-10% in all 3 countries. This group includes 2nd generation immigrants, but not 3rd generation. More than half – i.e. 5-7% – are LDC-immigrants. However, some in this group are fully absorbed. So the many estimated done ends with the conclusion that the problem of non-absorbed immigrants is a share somewhere between 3% and 5% of the population in all 3 countries. The excess costs to the natives are between 1½% to 2% of GDP.

No prediction we know of say that the pressures of immigration will decrease. The general pressures are likely to *increase* with rising globalization. Most projections are therefore

that the problem group will double or triple in the next quarter century, causing a similar rise in the costs, give present policies.

While the numbers of LDC immigrants are small in absolute terms, many natives do regard even these levels as problematic. The main reasons are four widespread perceptions: (1) Immigrants are coming in faster than the immigrant population is absorbed, so that the problem is increasing. (2) The number of potential immigrants is huge (see next section). (3) Many LDC immigrants evade the stop on economic immigration. (4) Immigrants have created parallel societies, which are very good at getting all social benefits they are entitled to and even more. It is difficult to know the extent to which these perceptions are justified, but surely such perceptions and emotions stimulate xenophobia and lead to a panzer mentality, with barricades that are constantly being increased.

VI.2 Potential immigration: Large numbers

One option would be to lower the barricades and encourage free immigration. The Nordic countries have populations of 5-9 million people each. Immigration is such a difficult issue, because its potential size is large relative to these populations:¹⁶⁾

Consider first the potential for economic immigration.¹⁷⁾ The World Bank classifies about 1/6th of the world population as living in DCs. Of the remaining 5 billion only about 1 has a standard of living above 25% of the average of the one in the DCs, and at least 2 billion are poor by any standards. Imagine that it was possible for these poor people to move to the DC world. It is hard to imagine that less than 5% would move over a 10 year period – that is between 100 and 200 million.

The numbers of political immigrants are potentially large as well. In 2003 about 2 billion people lived under political regimes which the NGO Freedom House characterized as having few or no democratic rights and civil liberties.¹⁸⁾ Even if only 5% of these people can truthfully claim a “well founded fear of persecution” (see table 3) it is still 100 million.

Most of these do not actually flee their country; but the UNHCR (2003) estimates that the refugee population (living in another LDC than their own) in 2003 is about 10 million, while 17 million are their “population of concern”. Obviously, the life of a refugee in a LDC is not very attractive, and many may recognize that it is preferable to stay, and keep a low

16. See UNHCR (2004), Hatton and Williamson (2004) and Paldam (2004) for data and interpretations.

17. A theoretical model of reference is the Harris-Todaro model, which deals with immigration from the countryside to the towns. The key point of the model is that the actual numbers of migrants is small relative to the potential numbers that may be “released” (even?) if conditions in the towns are good.

18. The NGO publish an annual report and the Gastil index of *democratic rights* and *civil liberties*. The 2 billion people mentioned are those who fall in the two worst of the 7 categories.

profile in their country of origin, especially when the hazards of the flight itself are added. It is well known that the great majority of these 10-17 million would like to get asylum in a DC.

Hence, the potential for immigration is large indeed. Our argument is that the refugee group increases with the chance of getting asylum, while there is a large potential migrants. Mechanisms are thus needed to restrain the flow, i.e. reducing it to a manageable trickle. The key policy choice adopted by many DCs – including the Nordic ones – is to handle the problem through raising barriers to entry of immigrants.

VI.3 Barriers to entry, changed incentives or contracts?

Logically three possible solutions appear possible:

(1) A continuation of the present system of building barriers. The immigration acceptance decision is here a huge favor bestowed upon the *chosen few*, by a bureaucracy according to legal principles, even when everybody knows that the choice is largely arbitrary and heavily politicized.¹⁹⁾

(2) Steering of the flow by changes in the economic costs of benefits of the two parts: That is, a reduction in the great economic advantage of the immigrant and a conversion of the disadvantage of the natives into an advantage.

(3) The gradual movement to a contract system, where it becomes more difficult to obtain citizenship and less difficult to get a temporary contract.

It is important to recognize that all three possibilities are *problematic*. There appear to be no nice fix for this problem. It is small at present, but if a solution is not found that is flexible and can work in the longer run, it is going to grow.

The Nordic countries are largely following the solution (1). The decision is taken by a bureaucracy according to a set of legal rules, which have been developed out in many legal details from the three criteria listed in table 3. Our argument above is that this solution poses problems for the participation of the countries in the globalization, which is the key to the wealth of the Nordic countries. In addition it gives welfare losses to convert the countries to bigot police states, and it is expensive to create large bureaucracies.

The possibility (2) attempts to reduce the pressure by reorienting incentives in accordance with standard economic theory. The main problem with this solution is that if it done in a more comprehensive way it will change the welfare state for the natives as well. The

19. Hatton and Williamson (2004) demonstrate that there is some correlation between the numbers accepted and major international political developments, such as wars and civil wars.

simplest way to do this would be to have a special tax on immigrants, moving part of their gain to the natives. This would involve reducing welfare benefits to the poor, which is against the principles of the welfare state.

The third approach is to base immigration on contracts of e.g. 2 years of duration. The key idea of this solution is to allow in more people on temporary contracts, and to give fewer citizenships.²⁰⁾ Two main types of contracts will be necessary. (i) *Guest worker* contracts, and (ii) *refugee* contracts. We imagine that the former should be much easier to obtain than the latter. All contracts should stipulate the conditions of termination in case it is not renewed, and that rule should be enforced. The contract should also stipulate all entitlements, and contain an arrangement where the immigrant saves to a ticket home. There should be a clear rule by which n contracts are necessary for obtaining citizenship. Immigrants should not be allowed to settle outside asylum centers without a contract. The conditions for having a guest worker contact renewed is that the immigrant has worked enough in the *official* economy, and an application from a firm. That is, an immigrant may work in his uncles firm, but he would have a strong interest in being registered as working there.

For political refugees the contract should stipulate the conditions in the homeland of the immigrant that would allow the refugee to return. It would be easy to stipulate special treatment periods for traumatized refugees in the contracts.

With a set of standard contracts with clear rules most of the bureaucracy will be unnecessary, and moved to the marketplace. Also, it will be obvious to the natives that the immigration is a mutually advantageous deal for everybody.

VI.4 What can we learn from Dubai and the USA?

Dubai is a small oasis of prosperity in a huge sea of more or less permanent refugees. It does not accept asylum seekers, but the whole economy builds on guest workers. Thus it follows two policies: (a) The harsher one of refusing admittance to refugees and not providing any benefits when in Dubai, but providing assistance if the refugee remains abroad; and (b) the less harsh one of encouraging economic migration at all skill levels, to the extent they are needed by the economy, which is largely a matter for the market to decide.

20. This would also be in conformity with WTO's objective of liberalizing labor flows under Gats (the general agreement on trade in services). Currently under its so-called "mode four" provision member states are required to facilitate access by business visitors. There is strong pressure, especially from the India led lobby, for extending it to temporary workers of all skill categories as part of the prospective WTO settlement. Parties to the present WTO agreement define "temporary" as ranging from three months to five years.

These policies shift the sorting mechanism in favor of economic migrants, but it also provides a set of incentives that even genuine refugees could avail of. Thus an able-bodied refugee could obtain a job in Dubai, take care of his family in a camp through remittances, and hope to ride out the time to eventual return to his country. The refugee could bring his family into Dubai, provided he can afford to do so, but as the family does not receive any benefits, he would have to earn enough to maintain them. If he cannot he loses his work permit and all are expelled. Knowing this the lower income refugee typically chooses to operate solo, and to put emphasis on earnings and remittances.

A separate element in the strategy of moving to a more desirable pattern of immigration that better accords with globalization is to create a new category of immigrant – the economic migrant. This should reduce some of the pressure for entry under the inappropriate refugee category, but it will have to be done carefully in the context of an appropriate restructuring of incentives so.

Here the U.S practice can be instructive. First, it would seem essential not to extend the full range of social benefits available, at any rate those of a non insurance type. Access to insurance based benefits would need to be earned. If access is to be made available to other benefits, these should be based on the time spent by the economic migrant in gainful employment and the taxes paid. Second, rather than rely on a bureaucracy to select the economic migrant, with all the problems that that entails, the primary decision should be deferred to firms, subject of course to overall scrutiny. Firms are surely in the best position to decide what their needs are and how to fill them.

In the present environment, unlike with the early post-war period when the demand was for unskilled workers, the firms would presumably seek highly skilled workers who would add substantially to economic product. Insofar as the firm chooses to hire abroad, they should take over the responsibility for providing various benefits, or pay a fee to the state to deliver such benefits. This is more easily affordable if the worker is highly skilled making a big contribution. Linking in this way the immigration decision to sponsorship by the firm ensures that the immigrant proceeds straight to the job at minimal cost to the state.

As in Dubai, the economic migrant should enter on a temporary visa, but in contrast to Dubai, there should be a possibility of moving to permanent residency status after a sufficient number of years have elapsed. This should preserve the intended temporary nature of the migration, but take account of possible permanent benefits.

As for the relatives of the migrant, there would be no need for the state to take over the cost of their upkeep. Such costs should be reflected in the emoluments paid by the firm to the

employee, and be borne by the employee, who should be free to decide whether to be accompanied by them or not. The likely result could be that fewer family members are brought in, given the high costs in maintaining them in a DC as compared to an LDC, with the migrant resorting more to remittances. Insofar as the family remains at home, the temporary nature of the migration is better assured – the migrant will want to return home after having made enough money. Not least, such a policy would better accord with the preferences of emerging economies. They get remittances while the migrant is abroad and more experienced and skilled human capital when they return.²¹⁾

VII. Some conclusions

The paper began by showing that the potential gain – measured as net present value – of being accepted into a Nordic type DC for our stylized LDC immigrant is of the order of \$ 2/3 mill. It was also demonstrated that there is a potential gain for the DC amounting to about half of that. So the potential total gain for the world could well be over \$ 1 mill. It is further demonstrated that the institutions of the DC provide a package that reduces the size of the total gain and redistributes it among the two parts, which is inconsistent with immigration.

The asymmetry of the economic results of immigration has at least five effects: (1) It generates large flows of hopeful immigrants. (2) It causes increasingly desperate DCs building barriers trying to stop the inflow. (3) It creates a thriving market for agents helping people to get through. It has proved difficult to stop people trying by all means – fair and foul – to seep through the barriers. (4) This has led to increasing bureaucratization and the imposition of restrictions that cut across the civil rights of natives and immigrants. (5) The more restrictive environment further hampers economically oriented immigration. Thus the recruitment of foreign workers whose skills are needed by Nordic based firms is thwarted eroding their competitive strengths.

We have argued that the pool of potential immigrants is large and likely to grow in the future, and the web of agents organizing travel and legends for potential immigrants is growing in size and sophistications. Thus the problem is likely to grow in the future.

Currently the political efforts in the Nordic countries seem to be concentrated on heightening and tightening the barriers. We have argued that the solution chosen work poorly, and that it will become even more burdensome in the future. It is consequently important to find a

21. In 2003, India, for example is estimated to have received some US\$ 18 billion in remittances, the bulk from the Gulf region.

new system that is flexible enough to handle the problems in the future. Most solutions would appear to demand rather drastic changes of the welfare state, such as a shift from a taxed-based system of social entitlements to an insurance based system.

However, one solution is possible without major changes in the welfare state. It is to base all immigration on temporary contracts. Citizenships should only be given after a number of contracts. Contracts should be of two types: (i) Guest worker contracts and (ii) refugee contracts, where the latter should be made very difficult to obtain. The contracts should stipulate all entitlements, as well as conditions of termination. As a renewal of the contacts will depend upon the amount of work the immigrants have done in the official part of the economy, this will change incentives, also it will lead to different selection process.

We fully recognize that this is a sweeping proposal, and we are well aware that many problems will have to solved, but we believe that this possibility should be explored much more seriously than it is at present.

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