

Economic Survey of the Netherlands, 2005

Summary

After five years of sluggishness, an economic recovery finally appears in the offing in the Netherlands. The financial imbalances that contributed to the downturn at the start of the decade have been corrected, thanks to well-tailored policies for the most part, and exports have already rebounded. The severity of the downturn – the output gap stands at –3% in 2005 – partly reflects an unusual succession of adverse shocks. Even so, other OECD economies have rebounded more quickly in similar conditions, suggesting an intrinsic difficulty to return to trend – a lack of resilience. The present *Survey* examines why the Netherlands lacks resilience and what could be done to avoid the recurrence of such difficulties. It also reviews how the re-emergence of large fiscal imbalances could be avoided, while making progress towards sustainability in a context of population ageing. As well, the *Survey* examines what could be done to raise trend growth through a combination of higher labour utilisation and stronger productivity growth.

Like several other European countries, the Dutch economy is slow to return to trend. Traditional re-equilibrating forces appear weak, notably the reaction of unit labour costs to slack, thus holding up these costs, eroding international competitiveness and limiting the extent to which inflation falls. One of the reasons for such behaviour of unit labour costs is that firms face obstacles to adjust employment to bring down these costs. To improve the economy's capacity to return to trend quickly, future reforms should further reduce the strictness of EPL.

This Policy Brief presents the assessment and recommendations of the 2005 OECD Economic Survey of The Netherlands. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

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Following the large deterioration in public finances over 2000-03, consolidation measures have successfully cut the budget deficit to 1.6% of GDP in 2005. Continued efforts at consolidation will be needed over the next few years so as to achieve a sustainable fiscal position. The present fiscal rule (ceilings on public spending over the legislature) is appropriate, but could be strengthened to avoid that cyclical and unexpected revenue windfalls are spent. The amount of tax expenditures and the practice of earmarking natural gas revenues to special projects will be reviewed.

The Netherlands has initiated a very substantial programme of reforms of its labour market and social security institutions, including health care. These reforms will shift people from social benefit dependence into employment and contribute to structural growth and budget consolidation. In the future, more needs to be done to reduce incentives for early retirement. This would entail monitoring access to publicly subsidised routes to early retirement and indexing the future official retirement age to life expectancy. To ease the trade-off between women's participation in the labour force and family responsibilities, marginal effective tax rates should be lowered further, possibly by reducing further the taper rate at which childcare subsidies are progressively withdrawn as household income rises.

The Netherlands has not experienced the surge in productivity growth observed outside the European Union, particularly in retail and financial services. To do so, it will be necessary to go further in removing barriers to competition in these key ICT-using service sectors and in further eliminating disincentives to entrepreneurship. Innovation activity (the subject of the in-depth chapter) will benefit from the reforms in framework conditions (*e.g.*, creating an attractive business climate) and tertiary education, as well as from the rationalisation of the various forms of government support to innovation, all of which will make the Netherlands more attractive for both domestic and inward R&D spending. ■

What are the economic challenges faced by the Netherlands?

After having stagnated during the past five years, the Dutch economy finally appears to have begun to recover. Substantial progress has been made towards correcting the financial imbalances that contributed to the downturn. Furthermore, major labour market,

social benefit and health care reforms are underway to enhance labour utilisation and labour productivity. At the same time, cost competitiveness is being gradually restored. Barring further international energy price spikes, the Dutch economy should grow above trend in 2006, turning the page on one of the worst periods of stagnation since the 1930s. Even so, the economy remains vulnerable in the face of adverse shocks.

- While several special factors have exacerbated the recent stagnation, the five years it has taken for the economy to begin to recover suggests a lack of resilience (Chapter 1).
- The prolonged downturn has taken its toll on public finances, necessitating substantial consolidation measures since 2003 to respect the Stability and Growth Pact, but more needs to be done to achieve a sustainable path (Chapter 2).
- There is scope to limit the amount of additional budget consolidation by implementing structural reforms that would further increase labour utilisation (Chapter 3) and productivity growth (Chapter 4).
- Enhancing the diffusion of innovation would also contribute to faster trend growth (Chapter 5). ■

Is a recovery unfolding?

Dutch economic growth has been weak since the start of the decade. A temporary rebound in economic activity unfolded in 2004, but was stalled by weak domestic and external demand, not least due to rising oil prices. After five years of below trend growth, the output gap has fallen from a peak of +4% in 2000 (compared with +2% for the euro area) to -3% in 2005 (-2% for the euro area), making this a very ample cycle by both historical and international comparison. The magnitude of the downturn is partly explained by the fact that a number of factors that boosted growth in the late 1990s – notably developments in housing and stock markets and in the euro-dollar exchange rate – have since contributed less (housing) or even dragged the economy down. In addition, the decline in capital market returns adversely affected pension funds, necessitating large increases in pension contribution rates to restore solvency. These increases are estimated to have reduced GDP by 2 percentage points. The impact of these factors was aggravated by a large loss of international cost competitiveness, even against other euro area countries.

Competitiveness is now improving and exports are once again stimulating the economy. The fiscal and pension fund financial imbalances have been largely corrected. Corporate earnings are growing fast, helping build up business capital formation. Real GDP accelerated sharply in the second quarter and unemployment declined slightly during the summer, after having stabilised during the first half of the year. Assuming that oil prices stabilise and that there is a pick up in other European economies, strengthening exports and domestic demand could well propel annual economic growth to above 2% in 2006. ■

How could increased labour-market flexibility foster macroeconomic resilience?

While special factors have undoubtedly exacerbated the recent downswing, the slow speed at which the economy is returning to trend suggests that re-equilibrating forces are weak. Empirical evidence presented in this *Survey* shows that inflation is slow to respond to cyclical conditions, especially in comparison with non-EU countries. This appears to be so because adjustment channels have operated weakly, notably the response of labour costs to cyclical downturns. As firms have difficulty adjusting their levels of employment owing to employment protection legislation (EPL) for regular contracts, which is strict by international comparison, labour productivity growth falls sharply during the initial stages of an economic downturn, holding up unit labour costs, and therefore eroding international competitiveness and limiting the extent to which inflation falls. Even though there is a reasonable degree of wage moderation when there is labour market slack, this occurs only after a significant lag. In the latest cycle, labour hoarding was unusually large because many employees recruited during the economic boom of the late 1990s had permanent contracts, employers had faced high hiring costs and they had initially anticipated a quick recovery. Also, labour costs were inflated by large increases in pension premiums. All of this suggests that the adjustment of unit labour costs has occurred only slowly in the face of economic slack, thus lengthening the period of stagnation required for market forces to operate. On the whole, the slowness of adjustment appears to result, for the most part, from the strictness of EPL on regular contracts, which increases employment adjustment costs.

The government has announced measures to ease EPL, which come into effect in October 2006, and the Social and Economic Council will advise on further reforms. The announced measures, lower the administrative costs of dismissals and increase flexibility for employers. Even so, EPL will remain strict by international comparison.

- The government should go further in easing EPL on regular contracts by reducing the procedural inconveniences for dismissing a worker and widening the circumstances in which a dismissal is justified. ■

How can public finances be put on a sustainable path in a context of population ageing?

After the sharp deterioration of public finances in 2002-03, consolidation measures have been implemented to cut the general government deficit. While the deficit has been reduced to 1.6% of GDP in 2005, fiscal consolidation has had an adverse impact on short-term economic growth. With hindsight, fiscal policy was too loose during the upswing, allowing a marked deterioration of the structural deficit that did not leave enough room for automatic stabilisers to work fully during the subsequent downturn while adhering to the Stability and Growth Pact.

After several years of consolidation, the structural deficit is likely to approach 0.5% of GDP in 2005. While this is an impressive achievement by EU standards, the evolution of public finances nonetheless raises a number of concerns. With economic growth projected to rise above trend and with large expected windfalls in natural gas revenues, the government has sought to restore part of the additional tax burden imposed on households in recent years and to invest in structural reforms, for example by increasing outlays for child care. As a result, the deficit is projected to rise to 1.8% of GDP in 2006, implying some deterioration in the structural deficit. This development shifts public finances further away from the sustainable path that was estimated by the authorities in 2000 to require a surplus of 1% of GDP, on what turned out to be optimistic assumptions, leaving a challenge for 2006 (using windfalls for further deficit reduction) and beyond. In the longer run a more ambitious fiscal strategy seems warranted.

- The opportunity of economic recovery should be used to undertake a new medium-term consolidation programme that moves public finances

towards a sustainable path – a level that will soon be re-estimated by the Netherlands Bureau for Economic Policy Analysis (CPB) – while at the same time strengthening medium-term growth prospects.

The fiscal framework has many merits, but the expenditure ceilings tend to be circumvented by recourse to tax expenditures. These tax expenditures should therefore be reviewed. The earmarking of natural gas revenues to special programmes should also be subject to close examination. It is vital that these revenues be used for capital expenditures, not current expenditures. This is in accordance with the operating rules of the fund (Fund for the improvement of the structure of the economy, FES) into which gas revenues are paid. Moreover, the authorities should ensure that investments made with these resources earn adequate rates of return, thereby enabling both current and future generations to profit fully and equitably from the natural resource rents. A study group is evaluating both the fiscal framework and the system of spending gas revenues via the FES and will report in 2006. This advice will be used by the next administration to determine the future of FES.

Achieving a sustainable medium-term path for public finances would be facilitated by increases in the retirement age. Rising life expectancy at retirement age is substantially increasing pension costs. At the same time, the health status of people at the official retirement age (65-years old) is now better than in the past – most people are healthy enough at this age to continue working.

- The government should consider indexing the future official retirement age to life expectancy and encourage social partners to make concomitant adjustments to the age at which (actuarially fair) early retirement can be taken in occupational pension schemes, so as to lessen the impact of rising life expectancy on pension costs and support potential growth. ■

What is being done to increase employment rates?

Budget consolidation will also benefit from the measures that have been implemented or are in the pipeline to shift people from dependence on social benefits into employment. Disability benefit recipients aged less than 50 are being re-tested for eligibility and incentives for the partially disabled to use their residual work capacity are being strengthened. The reform of social

assistance in 2004, which decentralised this programme to municipalities and gave them strong incentives to encourage the return to work of social assistance beneficiaries, also goes in the right direction. As well, the government plans to reform unemployment benefits (UB) by reducing maximum benefit duration from 5 years to 38 months, which nonetheless remains long by international comparison, and by making duration more dependent on the employment record and less on age. On the other hand, the government has introduced a new welfare-level benefit for older unemployed persons which, in contrast to social assistance, is not subject to an assets – means test for people aged 50 or over nor to a partner income test for people aged 60 or over. The scheme is subject to a sunset clause and will be evaluated in 2010.

- The impact of the reform of the UB-scheme on its use as an exit-route to early retirement should be closely monitored. Even after the reform, the maximum duration of the benefit is relatively long compared with other countries, where duration of 1-2 years is more usual.
- The plans to dispense older persons with care responsibilities from job search obligations may be a cost-effective way to address the increase in long-term care needs, but should be monitored to avoid abuse.

The Dutch authorities have reduced unemployment and poverty traps in recent years. A notable exception concerns sole earner households with children earning a modal income, as they gradually lose a tax credit when their income increases. The government has rightly decided to integrate the various tax credits for people with children in 2006 and progressively withdraw the tax credits from the modal income at a taper rate of 6%.

- The government should see whether further action is feasible to reduce unemployment traps by examining further the trade-off between increasing in-work benefits, so as to reduce remaining traps, against the adverse effects on labour supply further up the income scale.

The reforms to shift some people off social benefits and into employment should help to increase the employment rate for older workers (45%), which is below the OECD average (50%). In this regard, the recent reforms of disability benefits, unemployment benefits and social assistance are important. These changes complement the termination of tax subsidies for early retirement schemes from the beginning

of 2006. However, a new (tax-favoured) life-course-savings scheme offering opportunities to take leave that should help workers to cope with their family responsibilities and to invest in training, potentially prolonging working lives, can also be used as an individual early retirement scheme.

- The government should monitor the use of the new individual life-course-savings scheme and prevent it from becoming an alternative route to early retirement. ■

What can be done to increase working time, especially for women?

Even though employment rates are relatively high, labour utilisation is held back by the shortest annual working time in the OECD (1 357 hours in 2004). An important factor reducing average working time is the high proportion of women working part-time. Many women have chosen to work part-time because of the high cost of suitable childcare, school hours that are ill adapted to the needs of working parents (many schools send children home at lunchtime and on Wednesday afternoons) and the absence of affordable pre- and after-school facilities. A new Childcare Law was implemented in January 2005 that aims at making it easier for parents (in practice, mothers) to reconcile family responsibilities and work. The government pays a subsidy that on average amounts to of childcare costs. Employers are on average expected to pay a further one-third, with the remainder to be paid by parents. The government subsidies are means tested, which enables a larger subsidy to be paid at lower incomes out of a given budget but increases marginal effective tax rates at higher incomes. The government recently increased the budget for childcare subsidies by € 130 million to reduce the taper rate at which its subsidy is withdrawn as household income rises, making childcare more affordable for middle-income households. The employers' contribution to child care will be monitored in 2006. The government also rightly increased the budget for lunchtime and after-school care facilities by € 70 million, which appears to be particularly cost effective for increasing female working time. More could be done to increase working time by making it easier for parents with youngsters to reconcile family and work life.

- Notwithstanding the 2006 evaluation, the government should consider further reducing the taper rate for withdrawing childcare subsidies as household

income rises. The government is rightly considering increasing its support for "out-of-school hours care", so that mothers can work longer hours. Furthermore, schools should be required to make arrangements so that children are not sent home when teachers are absent.

- To increase incentives to work more hours, marginal effective tax rates should be reduced. Budget room for such reductions could be found by broadening the income tax base. An option could be to further limit tax deductions for mortgage interest payments on owner-occupied housing; the government already has taken some steps in this regard (for example, for owner-occupiers moving house, tax deductibility is limited to interest on that part of the mortgage that is equal to the home's purchase price less equity realised from the sale of the previous home).

The short duration of working time in the Netherlands, like in other European countries, can be explained partly by the activities of trade unions, which have tried to cushion employment losses through lower number of hours worked per employee. Now that the government has dropped the distinctions in regulations between overtime and normal working time on the one hand, and standard and agreed time on the other, in favour of a maximum duration of 48 hours per week averaged over a period of 13 weeks (as stipulated in the EU working time directive), only collective agreements stand in the way of extending working time if employers and employees find that mutually advantageous.

- Social partners should review the existing working time clauses in collective agreements, inasmuch as they reduce labour utilisation and lower income *per capita*, with a view to phasing out existing obstacles (notably, high overtime premiums) for individual employees wishing to work longer hours to earn more, doing so. ■

How could competition in product markets be increased to boost productivity growth?

Even though the level of Dutch productivity is high, its growth has trended down. This differs from the evolution in some other countries, such as the United States and Australia, where productivity growth has accelerated since the mid-1990s. Sluggish productivity growth is often associated with a lack of product market competition, as firms protected from

competitive pressures have less incentive to increase their efficiency. According to the product market regulation (PMR) indicator, the Netherlands occupies an intermediate position. However, it has relatively high barriers to entrepreneurship, reflecting complex, time-consuming and expensive procedures to obtain licences and permits. Moreover, personal costs of bankruptcy are high, which is likely to discourage entry and growth of firms. Against this backdrop, the authorities have embarked on a medium-term plan aimed at alleviating the burden of regulation. They are right to envisage reducing the personal costs of bankruptcy by offering the bankrupt individual a “clean slate” by way of discharge. They also rightly plan a simplification of the licence and permits system by introducing a “silence is consent” rule.

With respect to corporate governance, the government has decided to increase the power of shareholders. The practice of co-optation (in which existing members of the supervisory board select the new members) was abolished along with non-voting shares with the introduction of the new structural regime Co-optation and certification (trust offices that are on friendly terms with the management hold the shares and issue non-voting certificates) in the past have discouraged hostile takeovers.

In countries where productivity has accelerated in recent years, much of the increase has taken place in two key ICT-using service sectors – distribution and financial services. In the Netherlands, the development of large retail stores with a high use of ICT has been hindered by strict zoning regulations and regulation of shop opening hours, inhibiting the exploitation of economies of scale. The liberalisation of shop opening hours is to be evaluated next year. Municipalities have a large influence on the location of (large) outlets due to their responsibility in drawing up zoning plans but have weak incentives to authorise the establishment of such outlets and might be inclined to favour insiders. In the financial sector, the main barrier to greater use of ICT to raise productivity growth is the lack of integration of retail banking across Europe.

- The Netherlands should consider further liberalising shop opening hours, monitor the land-use policies of municipalities and give them greater incentives to authorise the entry of large outlets.
- To remove barriers to integration in retail financial services, the Dutch authorities and their European counterparts should fully implement the Financial

Services Action Plan and apply the four-level “Lamfalussy framework”. ■

How could reforms in framework conditions spur innovation activity?

Knowledge creation in the Netherlands is strong – scientific publications per capita are the sixth highest in the OECD and the citation impact is high – but innovation activity is only around the average for OECD countries according to the EIS Summary Innovation Index, undermining productivity growth. This combination of strong knowledge creation but only average innovation activity is characterised as the Dutch paradox. The authorities have started to address this weakness. They have established the “Innovation Platform” – a high-level group of government, business and academic leaders – in charge of formulating new policy initiatives. A number of reforms specific to innovation policy would help in this respect, as discussed below, but framework conditions could also make an important contribution to spurring innovation activity. The relatively limited number of enterprises undertaking non-technological innovations, process innovations, and introducing products that are new to the firm suggests that incentives to innovate are lacking. Increasing entrepreneurship and product market competition, and making social institutions more innovation friendly, would help to strengthen this aspect of innovation activity. While product market regulation limits competition and the entry rate of firms is average, there is much less experimentation than in the United States and fewer exits, undermining innovation activity. Moreover, surveys of social attitudes point to a culture that does not favour risk taking and the pursuit of excellence. The government is trying to change these attitudes through education programmes. Likewise, as noted, it is reforming bankruptcy law to reduce the personal costs of bankruptcy and increase the options for a quick re-start of non-fraudulent bankrupts. There are also other options that could be considered.

- Further easing strict EPL on regular contracts, as recommended above to enhance resilience, would also support innovation by facilitating work re-organisation, especially in industries implementing radical innovation.
- Similarly, lowering barriers to entrepreneurship, as recommended above to increase product market competition, would increase pressure to implement radical innovations. ■

What can be done to make the Netherlands more attractive for knowledge development?

One of the most important innovation indicators, business R&D intensity, is relatively weak in the Netherlands, at 1% of GDP compared with an OECD average of 1.5%. About 60% of the shortfall in the business R&D intensity relative to the OECD average is linked to the specialisation of the Dutch economy in R&D extensive sectors. The remaining 40% can be explained by a number of factors among which, low R&D inflows adjusted for the openness of the economy. A key factor in making the R&D climate more attractive is to increase the supply of scientists and engineers.

- The government has recently reformed immigration laws to facilitate entry of knowledge workers but should go further by introducing a points system, as in other countries.
- Dutch universities should also be encouraged to compete more aggressively for foreign science and engineering students.
- Work permit rules should be relaxed to make it easier for foreign students to stay in the Netherlands after graduation.

The government aims to strengthen linkages between public research organisations (PRO) (many of which are specifically designed to create knowledge and transfer it to firms) and firms in order to increase (domestic as well as inward) private R&D. In a recent initiative to strengthen such linkages, the government introduced a system of innovation vouchers that can be used by small and medium-sized enterprises to buy knowledge from (semi-) public knowledge institutes (enhancing demand driven research). The government has also rationalised its financial support for R&D activity, which used to be dispersed among a variety of agencies with different objectives, so as to improve co-ordination. Finally, government has introduced an arrangement (Regional Action and Attention for Knowledge) to strengthen the relationship between higher (vocational) education and SMEs.

- The government should continue to strengthen the linkages between firms and knowledge institutes to enhance the use of (scientific) knowledge in new products, processes and services thereby helping to solve the Dutch paradox of strong knowledge creation combined with low levels of commercialisation.

- Linkages between public knowledge institutes and private firms could be strengthened by making university funding partly dependent on performance in diffusion of knowledge to firms.
- Flexibility in university pay scales should be more widely used to increase incentives for researchers to co-operate with firms.

Another key innovation indicator that is relatively weak in the Netherlands is the proportion of the population with tertiary education, which is below the middle ranking of the OECD countries included in the EIS Summary Innovation Index. This ranking is likely to deteriorate as the extent to which the proportion of the population with such attainment in the younger age group (aged 25-34) exceeds that in the older age group (35-54) is less than in most other countries. Low attainment in the younger age group is largely explained by the absence of differentiation in the supply of tertiary education. While enrolment of students in tertiary A (mainly theoretical programmes preparing for research and high-skill professions) programmes is at about the OECD average, the absence of shorter (two or three years) tertiary vocational programmes explains low enrolment in vocational programmes and brings down total average enrolment. The low degree of differentiation in the supply of tertiary education is also evident from fixed tuition fees, relatively long duration of programmes and high barriers to entry for new suppliers of higher education. Therefore:

- The government should encourage universities to offer short (two-year) courses, as are available in most other countries.
- The authorities should differentiate tuition fees, as this will provide universities with an incentive to offer courses that are more attractive to students. Furthermore, the authorities should continue their experiments allowing more private education suppliers to compete for public education funds so as to enhance the quality and diversity of courses offered. ■

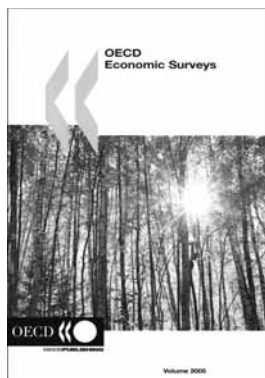
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