JANUARY 2008 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Economic Survey of the Netherlands, 2008

Summary

After a long stagnation during the first half of the decade, the Dutch economy has made a successful comeback. Growth has strengthened, unemployment has fallen back and the fiscal position has been brought into balance. Though the current recovery is partly cyclical, it is also built on a robust medium-term performance, which has helped to maintain living standards among the highest in the OECD.

Increases in labour utilisation have been the main source of growth, but the economy is now facing labour shortages, related to the greying of the population and the continued weak labour market participation of several groups. In addition, part-time work remains widespread and net migration flows have turned negative in recent years. If the policy setting remains unchanged, medium-term growth is likely to be impaired by insufficient labour resources and demographic ageing will be a burden for the public finances. While the previous *Economic Survey* focused on raising productivity growth, the present one focuses on the following challenges:

- **The ageing of population and its effects on fiscal sustainability.** Public spending on health care and pensions is projected to increase sharply in the next four decades, despite second pillar pension funds being well funded. These trends should improve thereafter, but not by enough to avoid a spiral of debt accumulation. Policy solutions to restore sustainability should focus on containing ageing-related costs, including a reform of the state pension scheme and later retirement. Additional measures should include an expansion of the funding base through increased labour participation and a certain degree of prefunding.
- **The need to increase labour-market participation further and lengthen working time.** Dutch participation rates are high, but there are a number of groups who remain less active on the labour market, notably lone parents, low-skilled women, partially disabled persons and inactive migrants. For

This Policy Brief presents the assessment and recommendations of the 2008 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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those people, reforms in the tax-and-benefit system are needed and activation strategies should be enhanced. Their job-search activities would also be facilitated by an easing of employment protection legislation, which currently reduces the fluidity of the labour market. For parents with young children, the provision of pre-school child care continues to be lacking despite recent progress, contributing to a high incidence of part-time work. Recent reforms requiring primary schools to offer before- and after-school care go in the right direction, but more could be done to facilitate full-time careers for mothers.

- **The scope for opening borders more widely to labour flows and to enhance the integration of immigrants into the labour market.** The Netherlands has tightened rules for non-work migration, partially reflecting the unsuccessful integration of non-OECD migrants into the labour market and their dependence on social benefits. As well, the entry of non-European workers is subject to a strict labour market test that hampers cross-border labour flows. To ease labour market shortages, it could be envisaged to open new entry routes, such as a skill-based visa system. In order to improve the prospects for a successful integration of the migrant population, the likely adverse impact of early streaming on the educational attainment of immigrants' children should be evaluated. ■

What are the main challenges to sustain growth?

After the stagnation in the first half of the decade, the Netherlands is once again in good shape. The pace of real GDP growth has strengthened since 2005, unemployment has fallen back to a low level and the fiscal position has been brought back into balance. Though the current recovery is partly cyclical, it is also built on an impressive underlying performance, which has helped to maintain income *per capita* among the highest in the OECD. While the Dutch economy displays a high level of productivity, the trend growth of productivity has been lower than in many other countries during the past decade, which may in part reflect the continued reliance on traditional industries. The government has taken measures to foster innovation, facilitate entrepreneurship and stimulate competition so as to spur productivity growth. These policy goals were discussed at length in the previous *Economic Survey* and are not addressed in detail here.

The present *Survey* focuses on labour utilisation, which has been the main source of growth in the past decade, but is likely to slow sharply with the greying of the Dutch population. Improving work incentives is therefore a key imperative. Although labour-market participation rates are high, there are several groups who continue to be less active. Labour utilisation is also being held back by the relatively short working week and the high incidence of part-time employment. In addition, net migration flows have turned negative, as fewer foreign migrants are entering the country and more natives are leaving it, a rare occurrence in a high-income nation. Accordingly, the following challenges are the central focus of this *Survey*:

- Addressing the effects of population ageing on the sustainability of the public finances (Chapter 2).
- Boosting the labour market involvement of under-participating groups, notably recipients of out–of–work benefits (Chapter 3).
- Helping parents reconcile work and family responsibilities, so as to facilitate fuller participation and promote female careers (Chapter 4).
- Improving immigration policy and the integration of immigrants (Chapter 5).

Real GDP growth quickened in 2006-07, reaching an average annual rate close to 3%, reflecting buoyant business investment and exports. The economy is projected to continue expanding slightly above trend in 2008, eliminating the slack in productive capacity and raising output above potential. At the same time, the unemployment rate is projected to decrease further and fall below the Secretariat's estimate of the structural unemployment rate (3½ per cent), indicating labour market tightness. As the job vacancy rate is already at an historical high, there is a risk that real wages will accelerate, repeating events at the turn of the century when labour costs reacted strongly to labour shortages, hurting competitiveness and corporate profitability. However, high uncertainty prevails in these short-term prospects, magnified by the financial market turbulence during the summer of 2007. Like other countries, the Netherlands is exposed to the prospect of a bank credit squeeze. Dutch households have highly-leveraged balance sheets, hold a large part of their assets in the form of housing and have a high marginal propensity to consume out of housing wealth. Even though OECD estimates suggest that the risk of a house price correction is not particularly high, there is evidence that house prices have diverged from fundamentals. A stagnation of house prices would imply a less dynamic growth of private consumption and a decline in house prices could exert a significant drag. ■

Should automatic stabilisers be allowed to play freely?

This high degree of uncertainty calls for a cautious fiscal policy stance. The government plans to achieve a budget surplus of 0.5% in 2008, reflecting cyclical increases in tax receipts and a rebound in natural gas revenues. The cyclically-adjusted balance is expected to become positive again and to gradually improve further over the cabinet term, which is a desirable development given the foreseeable increase in ageing-related spending. Fiscal policy needs to address both short-term downside risks and long-term ageing-related challenges. *In these circumstances, a sensible fiscal strategy would be to let automatic stabilisers operate freely, while keeping the structural balance on a medium-term path of consolidation, so as to progress towards sustainability.* Starting from the current fiscal position, the risk of running an excessive deficit is limited. Moreover, in case of unexpected adverse economic events, the revised Stability and Growth Pact allows some flexibility with respect to the 3% of GDP budget deficit reference value. ■

Should the fiscal framework be strengthened further?

In the Netherlands, the fiscal framework is an important tool of macroeconomic management. The framework comprises: *i)* a set of multi-annual expenditure ceilings established for the term of each coalition government; *ii)* a requirement that new tax measures are off-set by compensating revenue measures, so as to have a neutral impact on the budget balance; *iii)* a "signal value" of 2% of GDP for the budget deficit that, if exceeded, triggers fiscal consolidation measures; and *iv)* a medium-term goal of preparing the public finances for the effects of demographic ageing. This framework did not prevent the budget deficit from breaching the 3% Maastricht limit in 2003, which forced the government to put in place a strict consolidation package, with most of budget restraint unfolding during the period of output stagnation. Nor did the framework prevent the budget from turning expansionary in 2007, when the economy was running close to full capacity and overheating risks were looming large. This pro-cyclical pattern of fiscal policy has been a recurrent feature over the past decade. In order to address this issue, the government has strengthened the fiscal framework. The efficacy of the multi-annual spending ceiling has been improved by removing from its definition several items over which the government has no direct control, such as interest payments. *To improve budgetary control further, the government should consider excluding all counter-cyclical items from the expenditure ceilings, such as unemployment benefits. As well, including certain revenue items in the expenditure ceilings (such as dividends and central bank profit) is questionable, as this allows greater spending in good times.*

Significant deductions from income taxes are allowed, which represent a costly and growing form of government intervention. The level and purpose of these expenditures are not clearly established and contribute to higher marginal tax rates than otherwise would be necessary. *The reporting of tax expenditures should be improved, as was announced in the government's budget memorandum. Furthermore, their periodical assessment should be strengthened, so as to evaluate whether they achieve their purposes and whether they do so in a cost-effective manner, following the existing practice in some OECD countries. In addition, the government could consider including some of the tax expenditures under the expenditure ceilings when they are close substitutes to government spending.*

The Netherlands is better prepared than many other countries to cope with the challenge of ageing, thanks to its second pillar pension scheme. Recent health-care reforms also aim at containing the increase in health care spending. In addition, the government has decided to raise the structural budget surplus to 1% of GDP by 2011, so as to pre-fund some of the future expenditure burdens. This nonetheless leaves a fiscal sustainability gap. This gap has been revised upwards recently as a result of lower interest rates reducing future revenue streams (second pillar pension plans are mostly on a defined-benefit basis) revisions in life expectancy and delays in securing sustainability, only partially offset by government measures to increase participation. All in all, measures equivalent to more than 2% of GDP would be necessary to achieve sustainability. The government could run large surpluses for a long period of time to close this gap, but this would be hard to achieve for political economy reasons, as experienced in other countries. *Therefore, in addition to building up surpluses further after 2011, policy solutions to restore sustainability should address the core of the problem, namely to further control ageing-related costs, by cutting back public pension entitlements and by encouraging later retirement. Expanding the funding base through higher participation is also an important objective in this regard.* ■

How can the state pension system be made more sustainable?

Health care and first-pillar state pensions (AOW) are the two largest sources of ageing-related spending pressures. The health care insurance system has been subject to a comprehensive restructuring and the government plans to make further adjustments as needed. State pensions, by contrast, are largely unreformed. Under this (post-war Beveridgian) scheme, the government pays the same pensions to all residents having lived sufficiently long in the country, irrespective of past contributions. The age of eligibility to a state pension (65 years) has been kept unchanged since the establishment of the scheme in 1957, even though life expectancy has increased by more than 6 years. *Hence, although the current government has decided not to do so, eligibility to state pensions should be postponed in several pre-announced steps (for instance to 67 years) over a reasonable transition period and then be kept in line with developments in life expectancy.* Model simulations of increasing the pension age suggest that this would have favourable effects not only on fiscal sustainability but also on labour market participation. Moreover, first-pillar pensions are relatively high in relation to average income (about 31% of average earnings) in comparison to neighbouring countries (about 22% of average earnings) which makes the state pension a relatively costly scheme to combat old-age poverty (annual spending of 4½ per cent of GDP and rising). Indeed, simulations by the Secretariat suggest that lowering the level of first pillar pensions would have a favourable effect on labour participation and would improve public finances substantially, although this would score low in terms of equity as some people would be worse off. ■

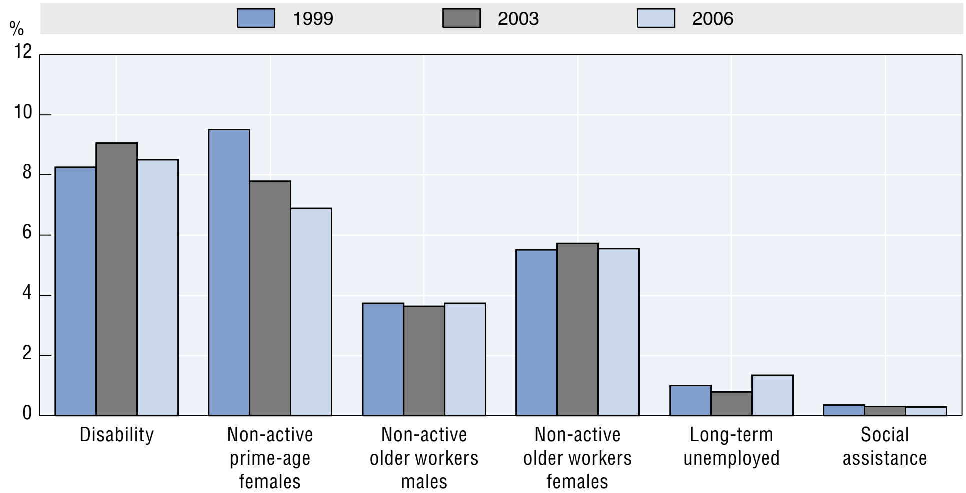
How to expand the effective labour supply?

Dutch governments have successfully sought to encourage labour market participation. Recent measures include the closing of early-retirement routes and greater emphasis on activating (long-term) unemployed, the partially disabled and social assistance recipients. Nonetheless, labour supply is still restrained by comprehensive social entitlements for those out of work, which benefit almost 17% of the working-age population. In addition, the tax-and-benefit system and labour-market policies continue to discourage participation of several groups and to incite working short hours.

Labour market participation of older workers remains low, although it has increased in recent years following the removal of tax incentives for early retirement and pre-pension schemes. The government plans to increase the work-related tax credit for workers older than 57 years. In addition, the government plans to introduce a new levy for pensioners who stopped working before the age of 65. However, this measure is only being phased in gradually and affects only people born after 1945 and with pension income above a certain threshold. *Thus, a more encompassing and rapid implementation of this measure would further strengthen incentives to participate.* Continued work is also discouraged by the possibility of using the unemployment benefit system in combination with generous severance payment as a transition into (early) retirement, indicating a need for reform in these areas (see below). Moreover,

Figure 1.

INACTIVITY RATES IN PERCENT OF WORKING AGE POPULATION



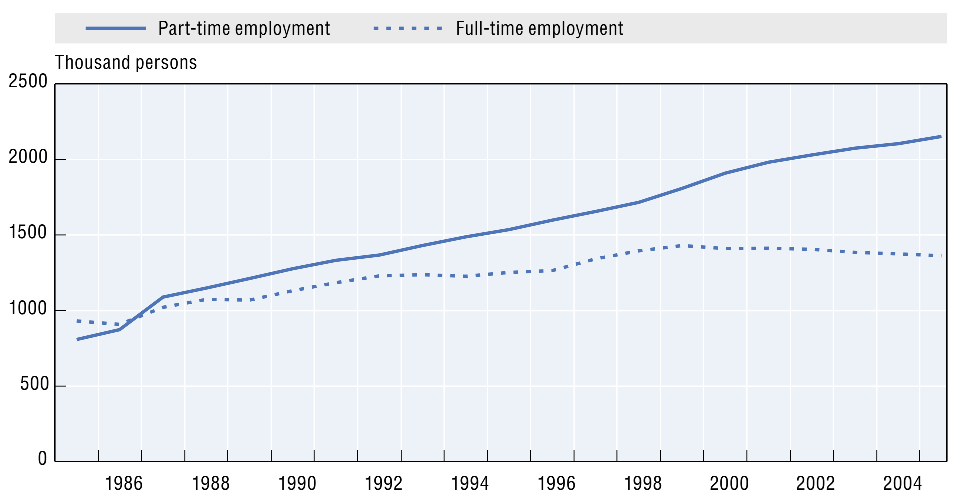
Source: OECD Labour Force Survey and Garcillo and Grubb (2006).

tax favoured saving schemes such as the life course scheme can be used for retiring early, pointing to *the need for phasing out such schemes*. In addition, firms that employ workers aged 65 and over must pay their wages during sickness absence (as for their other workers) for a period of up to two years, even though they cannot insure against this risk. Thus, to strengthen labour demand for older workers, *the government should consider easing the obligation on enterprises to pay wages during periods of sickness leave for workers older than 65 years. Such support should be provided socially.*

About two-thirds of Dutch working women opt for part-time jobs, bringing down the country's average working time to one of the lowest levels in the OECD. While individual preferences may play a role, international evidence strongly links the incidence of part-time work to taxation and childcare. In the Netherlands, full-time female participation is hampered by a high marginal effective tax burden on second earners, reflecting the withdrawal of social benefits conditioned on family income. *The government should continue to reduce the marginal effective tax rate faced by second earners by reducing further the rate at which housing and child benefits are tapering off. Moreover, certain work-related entitlements and tax credits could be conditioned on the number of hours worked, as in some other OECD countries*. Recent government decisions have stimulated the provision of childcare services and helped reduce their cost, making it easier for parents to work longer hours. But not all obstacles to the supply of childcare services have been removed. *The government should consider designating childcare as an essential facility in the zoning law in order to facilitate the deployment of services*. A new law requires schools to arrange the provision of care before and after school hours, by either supplying care themselves or by acting as a matchmaker between external providers and parents. *In addition, the government should require that schools take responsibility for the provision of childcare services during agreed opening hours, at least as providers of last resort. As well, school premises should be available to external childcare providers outside normal school hours*.

Figure 2.

FEMALE PART- AND FULL-TIME EMPLOYMENT



Source: OECD Labour Force Statistics.

The aggregate female participation rate is relatively high, but low-skilled married females tend to remain at the margin of the labour market. This group is often willing to work and the service sector has a strong demand for their labour, but the tax system discourages their participation. Each family member is taxed separately, independently of the income of other household members, making the tax system in principle neutral with respect to marriage. Nonetheless, the tax system contains elements based on joint taxation, in particular the right for non-working partners in single-earner couples to transfer their general tax credit (about € 2 000) to the primary earner. Such an element of joint taxation scores high in terms of equity, because it takes into account the fact that the family is the consumption unit and applies the progressivity of the tax system to family incomes. But it scores low in terms of efficiency because it discourages the labour market participation of the secondary earner. On balance, the government has decided to phase out the transferability of the tax credit (completing the individualisation of the tax system) starting in 2009, but over 15 years and with exemptions for mothers with children aged five and under and those born before 1972. Estimates by the Netherlands Bureau for Economic Policy Analysis indicate that the full phase-out would have a significant impact on female participation. To get this benefit at an early stage, *the transferability could be eliminated more rapidly and without exemptions.*

The number of social assistance recipients has declined over recent decades, but their share of the labour force remains high internationally. Various tools have been used to enhance job-search incentives and facilitate labour market reintegration. As well, activation has been well served by transferring the budgetary and implementation responsibilities of the social assistance scheme (WWB) to the municipalities and allowing them to use budget surpluses in this area for other purposes, thus providing strong incentives to monitor and activate benefit recipients. *To ensure continued success, existing availability for work requirements should be strictly enforced and the envisaged exemptions from these requirements should be reconsidered.*

Several reforms since the 1990s have reduced the inflow of new recipients into the disability benefit scheme, notably by introducing more restrictive entry requirements and expanding the sickness period paid by the employer from one to two years. Nevertheless, the number of disability benefit beneficiaries remains high internationally. A sensible strategy in these circumstances is to conduct regular assessments of work capacity and encourage individuals, when possible, to resume labour market participation. *In this respect, the government should reconsider its decision to apply lighter testing criteria to current beneficiaries in the age group 45 to 50.* Moreover, the reduction of inflows has been concentrated on the age group 25-45, with less progress achieved in partially reintegrating older and younger benefit recipients into the labour market. A worrying development is the increasing inflow (often for unspecified psychological disorders) of young people into the special *Wajong* scheme for young disabled, which offers limited reintegration services.

This creates a risk of excluding an increasing number of young people permanently from the labour market. *To avert this risk, those registering in the Wajong scheme should be requested to first apply for social assistance and receive disability benefits only as a top-up after some waiting period.* This would allow case managers in appropriate cases to apply the full range of activation measures associated with social assistance.

Although unemployment is low, the incidence of long-term unemployment is relatively high in comparison to countries with similarly low unemployment rates reflecting, among other factors, the generosity of unemployment benefits. The duration of unemployment benefits has been reduced from 5 years to a maximum of 38 months, which is a welcome move, but benefit duration remains long by international standards, especially for workers with long seniority. In combination with non-decreasing benefits, this is likely to dampen job-search incentives and create paths into early retirement. *Thus, the government should further reduce the duration of unemployment benefits. Alternatively, the replacement rate could be reduced with the length of the unemployment spell. As well, the use of sanctions penalising insufficient job-search activities could set in earlier.*

The incidence of long-term unemployment may be raised by strict employment protection legislation, which tends to reduce labour market fluidity and prolong unemployment spells for those at the margin of the labour market. A reform of the dismissal system is therefore under consideration. At present, layoffs can occur through two channels: employers can address their request to the individual employment service (CWI), but the procedure is bureaucratic, involves long notice periods and comes with unpredictable results; alternatively, employers can request a local court to dissolve the individual employment contract, which is faster but also more expensive, as firms face much higher severance pay obligations. *The system should be reformed to become simpler, more predictable and less time-consuming for both employers and workers; accordingly, the rules governing layoffs should be clearly specified in law, making dismissals a more predictable process, with appeal to local courts only possible as an ex-post option, in case one of the parties feels unfairly treated.* In addition, severance payments are currently quite costly by international comparison. Dismissed workers can be entitled to payments equivalent to one month of salary per year of service, which may result in costly redundancy costs for workers with long job tenure. This can also contribute to lower mobility incentives for workers concerned about losing severance pay rights. A funded severance payment system, like in Austria, could be used to preserve severance payment rights during job transfers, thus helping to increase the fluidity of the job market. Under the present system, workers see their severance pay rights increase to two months of salary for years worked after the age of 50. This is likely to be harmful to the hiring of older workers and therefore have the perverse effect of encouraging earlier retirement. *Hence, the accumulation of severance payment rights of older workers should be aligned with that of other workers.* ■

How can the economy benefit more from immigration?

Immigrants have traditionally made an important contribution to increasing the labour supply, as first-generation immigrants and their children constitute about 19% of the labour force. In recent years, however, the net flows of migration turned negative, as emigration increased while inward migration dropped, in part reflecting adverse cyclical developments. The drop in inward migration was partly caused by the tightening of age and income requirements for family-related migration and the introduction of language and cultural tests. Also, the introduction of the Alien Act of 2000, which considerably changed asylum policy, seems to have reduced inflows. On the other hand, entry procedures for high-skilled workers from outside the European Economic Area (EEA) have been simplified by abolishing the work permit requirement for employees with an income above € 45 000 (€ 33 600 for employees younger than 30 years). *To increase the attractiveness of the Netherlands for high-skilled migrants, the current scheme, which is largely demand-driven, should be supplemented by a supply-driven immigration system, under which workers with desired characteristics would be granted a work permit without the ex-ante requirement of holding a job contract.* The number of temporary work permits granted to workers from the countries that joined the EU in 2004, mainly for low-skilled employment, rose to almost 60 000 in 2006 (0.6% of the working-age population) under a sector-based transition arrangement. All remaining restrictions were abolished for this group in May 2007. People coming from Bulgaria and Romania remain subject to the strict labour market test applicable to all workers from outside the EEA. In many cases, this test entails a bureaucratic process to prove that no job seeker is available within the EEA. *If labour shortages persist, the government should consider implementing a transition scheme for Bulgaria and Romania similar to the earlier scheme for the other new EU member states. Furthermore, to allow a smoother adjustment of migration flows to labour market needs, the authorities should consider reducing the overall length and administrative complexity of the general labour market test.*

The contribution of immigrants to the economy depends on their labour market performance, which is significantly lagging behind that of natives, notably for immigrants of non-OECD origin. Several labour market institutions seem to pose barriers to immigrants as outsiders on the Dutch labour market. *Strict employment protection legislation for regular contracts hampers opportunities for outsiders, of which immigrants are an important group and should therefore also for this reason, be eased. Also administrative and regulatory burdens should be further reduced, as they can be particularly discouraging to immigrant entrepreneurship.* Two specific groups with lagging labour market performance are women who enter for family-formation or reunification reasons and former asylum seekers; *encouraging an early entry into the labour market seems particularly relevant for these groups.* Another problem behind the poor labour market integration is the educational attainment of immigrants, which lags behind that of natives. A negative factor in the Dutch educational system seems to be the early streaming taking place at the start in secondary education (age 12). *The authorities should postpone the age at which children are placed into different streams during secondary education. It is also important to* *introduce greater flexibility between streams thereafter, which would improve the educational performance of immigrants and facilitate their integration.* To enable immigrants to better reap economic opportunities, geographical and social mobility should be improved, *notably by changing regulations in the rental housing market that hamper mobility.* ■

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