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OVERVIEW



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Executive summary

Main findings
Key recommendations

Main findings

The Netherlands is gradually emerging from a protracted recession. The authorities have implemented, or are going to put in place, significant structural reforms in the labour market, health care and the pension system to ease the reallocation of resources and help the economy to recover. Significant fiscal consolidation has also been achieved and the budget deficit lowered to below 3% of GDP. However, the banking sector is large and remains vulnerable to high household indebtedness. Small and medium-sized enterprises (SMEs) face major credit constraints.

Fiscal policy. Fiscal policy has accomplished a major structural adjustment over the recent past and long-term fiscal sustainability has been strengthened by reducing ageing-related pressures on public budgets. The fiscal framework is robust, but Dutch commitments to the European Union have led to a suspension of automatic stabilisation on the revenue side, induced frequent revisions of consolidation plans and made fiscal policy pro-cyclical. A specific international tax issue is tax planning strategies of foreign multinational firms.

Banking sector and household debt. The Dutch banking sector is large compared to the size of the country and suffered major losses linked to troubled foreign assets early in the global downturn as well as remains vulnerable to domestic risks. Despite progress made to strengthen bank capital, regulatory ratios of total and Tier 1 capital to risk-weighted assets and unweighted measures of capital ratios (leverage ratios) are not comparatively strong on a Basel II basis. However, banks have already made progress to meet all Basel III standards. The amount of non-performing loans not covered by loan loss provisions is high in relation to bank capital. Banks' dependence on international capital markets is extensive while the volatility of risk premiums has increased since the beginning of the crisis. Banks are also highly exposed to the property market. Some structural reforms have been implemented to improve the housing market. Nominal house prices have dropped by 20% since their peak in early 2008 and around 40% of households with mortgage debt have negative home equity. Moreover, the majority of the mortgage portfolio is not amortized regularly and more than 50% is "interest-only" (the repayment of capital only occurs when the loan matures). Households have significant assets on average, but both their composition and distribution suggest that they might not be available to repay the full principal once it will fall due. Adequate procedures to resolve banks in case of a new crisis are a crucial component of a financial stability toolkit and major progress has been made, notably with the adoption of a bail-in law in mid-2012.

Small and medium-sized enterprises. SMEs play an important role in the Dutch economy but have been hit hard by the crisis. Dutch banks have been tightening credit conditions and few alternative sources of financing are available. At the same time, not all public guarantees for loans are being used. Restrictive labour regulations are another barrier for the development of dynamic SMEs and could also raise the incidence of last-resort self-employment. The authorities intend to increase the protection of employees on temporary contracts and simultaneously both reduce the protection of those on permanent contracts and restrict access to unemployment benefits. The number of SMEs engaging in collaboration on innovation is comparatively low. Tax policies could have encouraged the growth of self-employment. Regulatory barriers to entrepreneurship are low but the licence and permits system is stricter and some compliance costs are higher than in the best performing OECD countries.

Key recommendations

Fiscal policy

Return to the initial fiscal framework by adhering to medium-term spending ceilings while allowing automatic stabilisers to play fully on the revenue side.

Continue to actively participate in international negotiations about co-ordinated action to combat tax base erosion and profit shifting of multinational enterprises and, within this international context, take appropriate domestic measures to support such action.

Banking sector and household debt

Encourage banks to further increase their capital adequacy ratios by issuing equity and retaining earnings.

Phase in maximum Basel III standards on systemically important bank capital buffers and aim for strong leverage ratios for systemically important banks.

Once the housing market starts to recover durably, accelerate the reduction of mortgage interest relief to increase incentives for amortisation of mortgages and further lower the maximum loan-to-value ratio significantly below 100%.

Small and medium-sized enterprises

Continue to evaluate policy instruments supporting access to finance in the light of existing market inefficiencies faced by SMEs and, if needed, ensure broader access to those instruments and in particular public loan guarantees.

Allow public research institutes to take equity stakes in young business, broaden access to academic research and increase the share of direct innovation grants to SMEs.

Reduce the protection afforded to permanent employment contracts by capping and lowering severance pay and by simplifying individual dismissals, as planned.

Assessment and recommendations

Challenges facing the Netherlands

Ensuring a sustainable recovery

Improving fiscal policy

Making the banking sector more resilient

Promoting the development of efficient and dynamic SMEs

Challenges facing the Netherlands

The Netherlands is gradually emerging from a protracted double-dip recession and real gross domestic product (GDP) is about 3% below its first quarter 2008 peak. Pre-crisis growth was partly driven by banks' use of international capital markets to fund mortgage expansion. Rising house prices boosted household wealth and consumption, but the subsequent correction has exposed imbalances in the economy. Growth is improving but, due to deleveraging pressures, remains weak, which contributes to the persistence of a very high current account surplus of about 10% of GDP.

The authorities have implemented, or are going to put in place, significant structural reforms, in many instances consistent with OECD recommendations from past *Economic Surveys* and *Going for Growth* reports. Fiscal sustainability has been strengthened, notably with recent reforms of the pension system, health care and long-term care. Distortions in the housing market are expected to be reduced with the introduction of better targeting of social housing through rent increases depending on income and by lowering the property transfer tax. Since January 2013, new mortgages are eligible to interest tax deductibility only if they are regularly amortised. The functioning of the labour market is planned to be enhanced by diminishing segmentation, shortening the duration of unemployment benefits to two years, simplifying child benefits and improving the integration of the disabled. Product market regulation is the least restrictive in the OECD, which contributes to firms' creation, and several policies have been designed to stimulate innovation.

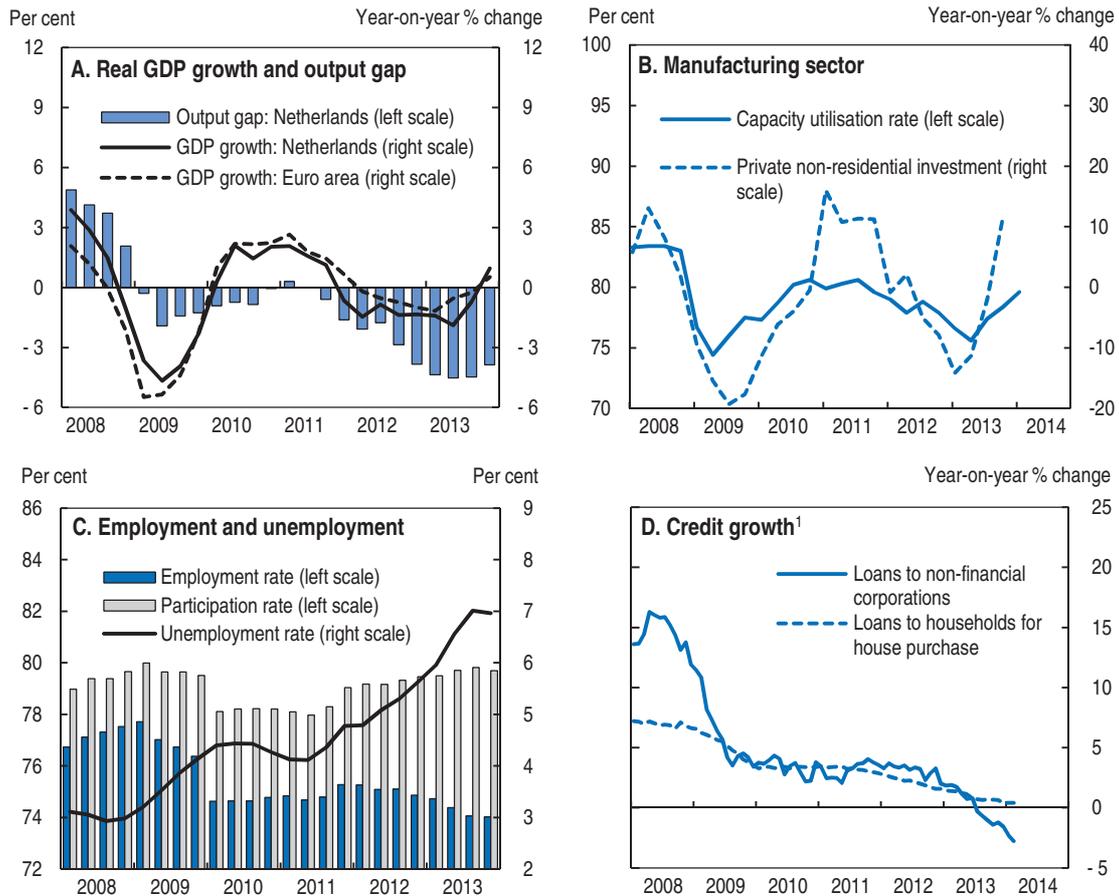
However, challenges remain to return to sustainable growth. Despite ongoing improvement following the financial crisis, the banking sector is still exposed to domestic property risks as falling house prices have put many households in a negative home equity position. Small and medium-sized enterprises (SMEs) face tight access to credit and have difficulties to grow. Structural reforms are needed to facilitate banks' and households' balance sheet restructuring (Chapter 1) and to enhance the dynamism of SMEs (Chapter 2).

Ensuring a sustainable recovery

Following a sharp downturn in 2009 and a short-lived recovery, faltering domestic demand has restrained GDP growth (Figure 1, Panel A). Reduced capacity utilisation rates in the manufacturing sector have held back business investment (Figure 1, Panel B); labour hoarding mitigated increases in the unemployment rate at an early stage to the crisis, but subsequently firms' restructuring efforts combined with difficulties to absorb increased labour supply pushed the unemployment rate to 7% in mid-2013 (Figure 1, Panel C); and credit growth has fallen to essentially zero for households and to negative territory for non-financial corporations (Figure 1, Panel D). Recently, GDP rose by 0.9% in the fourth quarter of 2013 partly driven by car purchases brought forward by businesses and households with

the introduction of new taxes in 2014, private sector confidence has improved supporting a turnaround in gross fixed investment, nominal house prices have stabilised 20% below their peak, and the unemployment rate has been broadly stable at around 7%.

Figure 1. **Key macroeconomic developments**



1. Data refer to loans granted by Dutch Monetary Financial Institutions (MFIs), including loans transferred by MFIs to special purpose vehicles (SPVs), and are adjusted for securitisations and breaks.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections, Main Economic Indicators and OECD Employment and Labour Market Statistics* (databases), April; Statistics Netherlands (2014), "Manufacturing and Energy", *Statline*, April and DNB (2014), "Domestic MFI-statistics", *Statistics DNB*, De Nederlandsche Bank, April.

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Amid sizeable fiscal consolidation, with net *ex ante* budget measures of 2% of GDP in 2014 and 1% of GDP in 2015 corresponding to a tightening in the underlying deficit of about 1% of GDP per year, GDP is likely to recover only gradually (Table 1). Private consumption is projected to fall in 2014, albeit at a moderating pace, and to stabilise in 2015, supported by increases in real incomes. Business investment is set to pick up further assuming that SMEs can obtain credit and that large firms draw on their ample savings. Export growth should also rise as global growth gains momentum, followed by a progressive increase in imports as the economy recovers. The unemployment rate is

projected to continue to creep up owing to further declines in employment, and then to stabilise by late-2014 and to gradually recede in 2015. Latest forecasts of the public employment service (UWV) point to job losses reaching almost 1% in 2014 and the number of unemployment benefit claimants rising by about 10%. Harmonized consumer price inflation has recently dropped to below 1% and is expected by the OECD to remain low owing to the substantial economic slack.

Table 1. Macroeconomic indicators and projections

Annual percentage change, volume (2005 prices)

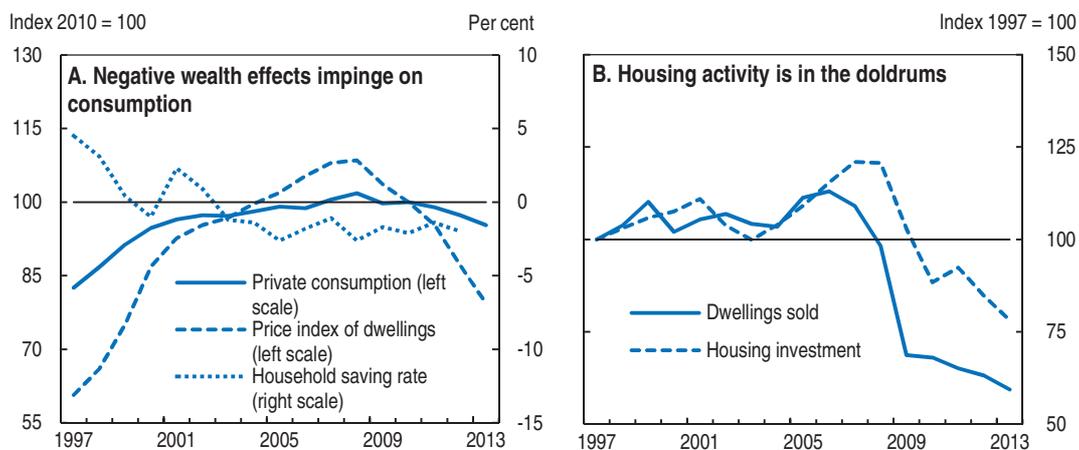
	2010 Current prices (million EUR)	2011	2012	2013	2014	2015
GDP	586 735	1.0	-1.3	-0.8	1.0	1.3
Private consumption	268 200	-1.1	-1.6	-2.1	-0.6	0.1
Government consumption	166 969	0.2	-0.7	-0.2	0.4	-0.2
Gross fixed capital formation	101 885	6.1	-4.0	-4.8	4.2	2.3
Housing	28 506	4.5	-8.2	-6.9	1.8	0.9
Business	52 042	12.3	-2.9	-4.3	7.2	3.7
Government	21 337	-7.0	-1.3	-3.5	-1.5	-0.1
Final domestic demand	537 054	0.7	-1.8	-2.0	0.6	0.4
Stockbuilding ¹	2 397	0.1	0.2	-0.3	0.0	0.0
Total domestic demand	539 451	0.8	-1.6	-2.4	0.6	0.4
Exports of goods and services	461 718	4.1	3.2	1.4	2.6	4.4
Imports of goods and services	414 434	4.2	3.3	-0.2	3.1	3.8
Net exports ¹	47 284	0.2	0.2	1.4	-0.1	0.9
Other indicators (growth rates, unless specified)						
Potential GDP	..	0.9	0.9	1.0	1.1	1.3
Output gap ²	..	-0.5	-2.6	-4.3	-4.4	-4.5
Employment	..	0.6	-0.2	-1.0	-0.7	0.5
Unemployment rate	..	4.3	5.2	6.6	7.6	7.6
GDP deflator	..	1.1	1.3	1.4	0.0	0.5
Harmonised consumer price index	..	2.5	2.8	2.6	0.5	0.8
Harmonised core consumer prices ³	..	1.7	2.2	2.5	0.7	0.7
Household saving ratio, net ⁴	..	4.9	4.1	5.1	6.0	6.2
Current account balance ⁵	..	9.1	9.5	10.4	8.9	9.8
General government financial balance ⁵	..	-4.3	-4.0	-2.4	-2.7	-2.0
Underlying general government financial balance ²	..	-3.7	-2.7	-0.9	0.0	0.7
Underlying general government primary balance ²	..	-2.3	-1.4	0.3	1.2	1.9
Gross government debt (Maastricht) ⁵	..	65.7	71.2	73.4	74.7	74.9
General government net debt ⁵	..	38.8	42.2	44.4	46.7	47.9
Three-month money market rate, average	..	1.4	0.6	0.2	0.1	0.0
Ten-year government bond yield, average	..	3.0	1.9	2.0	2.1	2.5

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. Excluding energy, food, alcohol and tobacco.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), April.

There are numerous downside risks. Households may not sustain their consumption as their voluntary saving rate, which excludes mandatory contributions to pension funds, is negative and could increase more than expected (Figure 2, Panel A). Declines in real income could reduce consumption further and the impact would be magnified by negative wealth effects should house prices continue to fall. While being rough indicators, notably because they are not adjusted for the user cost of housing, price-to-rent and price-to-income ratios are still above their long-term averages by respectively nearly 5% and 20% in the last quarter of 2013. Additional price falls would also further impinge on housing transactions and residential investment (Figure 2, Panel B). Unemployment could rise more, which could put pressure on house prices and on banks through higher foreclosures. The latter have so far been limited but are favoured by strong creditor rights and substantial negative home equity. Results of the asset quality review and the stress tests by the European Central Bank (ECB) could ease or impinge on banks' access to funding in wholesale markets. On the upside, a stronger-than-expected rebound in consumer confidence would foster growth and encourage investment. A recovery in world trade would also boost activity given the large trade openness of the economy.

Figure 2. **The housing market weighs on the economy**¹



1. Private consumption is measured in volume. Price index of dwellings is deflated by consumer prices. Both price index of dwellings and dwellings sold refer to purchase prices of all dwellings sold to private individuals. Household saving rate does not include mandatory contributions to pension funds.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), March; Statistics Netherlands (2014), "Construction and Housing", *Statline*, March and Netherlands Bureau for Economic Policy Analysis (2013), *Macro Economic Outlook (MEV) 2014*, September.

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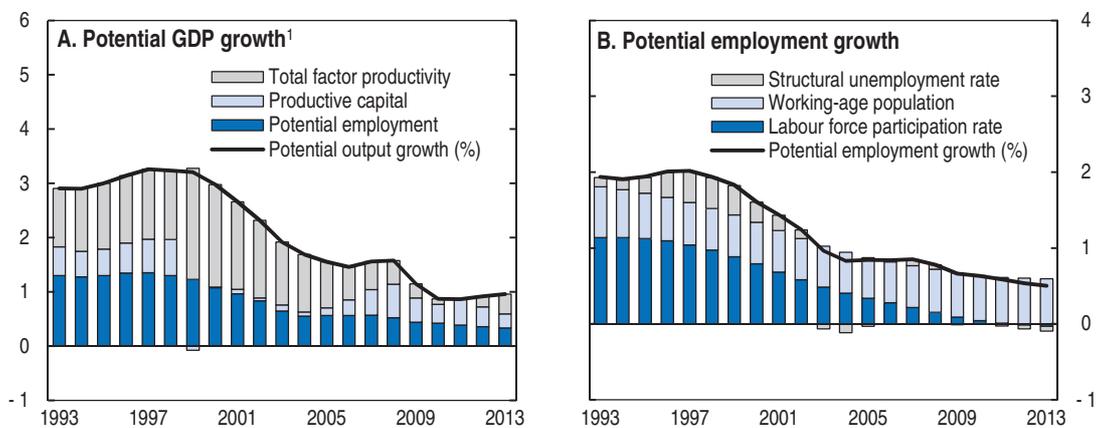
Sustaining high living standards

Potential output growth has been falling towards 1% (Figure 3). Total factor productivity (TFP) growth has slowed since the late 1990s, coming almost to a halt. The contribution of labour has also waned and population ageing will reduce it further. Productivity growth may recover somewhat (Johansson et al., 2013), but ensuring high total factor productivity gains will depend on implementing further structural policies. Reforms with rapid implementation towards the stances in best-performing OECD

countries would over the next ten years: i) raise TFP levels by around 3% when easing product market regulation in upstream sectors (typically network industries); ii) boost productivity levels by around 0.75% when reducing stringent labour regulations; and iii) increase employment rates by almost 1 percentage point when reducing labour tax wedges (Bouis and Duval, 2011). Overall, broad reforms of product and labour market regulations as well as benefit, tax and retirement systems would strengthen GDP per capita by 5% over a 10-year horizon.

Figure 3. **Potential growth has decelerated**

Potential output and employment growth with contributions, percentage points



1. Contributions to growth are calculated using a weight of 0.67 for potential employment and 0.33 for productive capital; total factor productivity is calculated as a residual. Productive capital excludes investment in housing, while potential employment abstracts from cyclical variations in the labour force and unemployment.

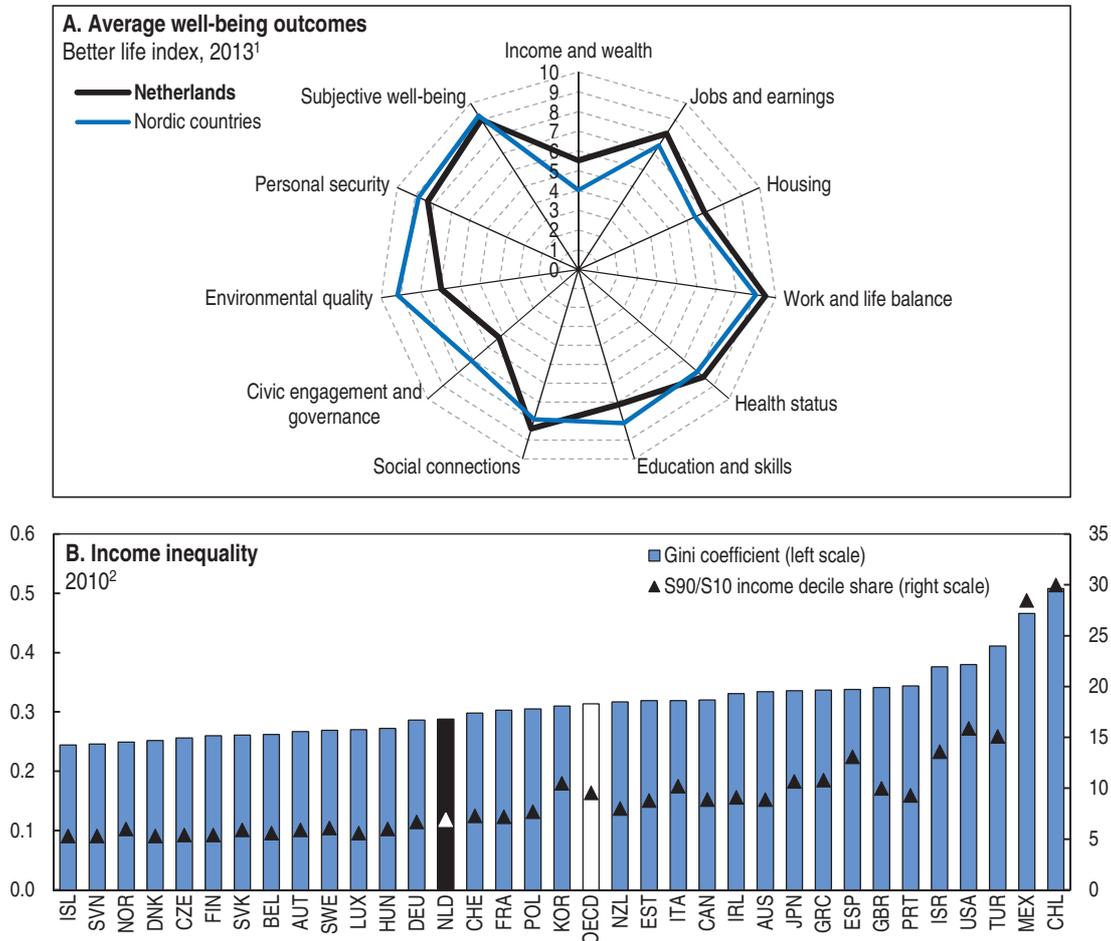
Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), April.

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The Netherlands scores high on well-being outcomes (Figure 4, Panel A), with significant GDP per capita, sizeable employment rates, high quality of the education system as captured by good Programme for International Student Assessment (PISA) scores and long life expectancy at birth. Income inequality is comparatively low (Figure 4, Panel B) and has fallen during the crisis (OECD, 2013b). Rises in relative income poverty have been limited despite a jump in the poverty rate of youth. The top 10% of Dutch households owns more than 60% of domestic net wealth, a high ratio among advanced economies (IMF, 2013c; Davies et al., 2012).

Although the Netherlands has always been vulnerable to flooding, the awareness of Dutch citizens about this risk is surprisingly low, reflecting high confidence in the extensive flood-protection systems (OECD, 2013c). Population and assets of Rotterdam and Amsterdam are exposed to significant coastal flooding (Figure 5), but both cities have the highest flood defence standards in the world (Hallegatte et al., 2013). Nevertheless, exposure is expected to rise owing to climate change, subsidence and, more importantly, urban development in flood-prone areas, which need to be further contained (Figure 5). In parallel, the level of taxes paid by firms and households to district water boards should

Figure 4. Social indicators are solid

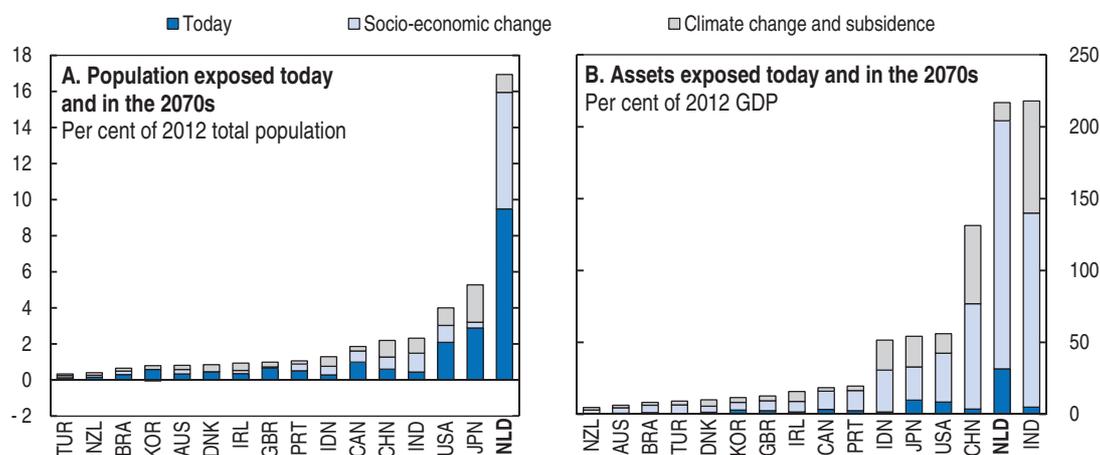


1. Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights and they range between 10 (best) and 0 (worst) performing country in the OECD. The aggregate for Nordic countries (i.e. Denmark, Finland, Norway and Sweden) is calculated as an unweighted average.
2. The Gini coefficient is based on disposable income, after taxes and transfers. The S90/S10 ratio is the share of income received by the top decile divided by the share of income of the bottom decile. 2009 instead of 2010 for Chile, Hungary, Ireland, Japan, New Zealand, Switzerland and Turkey.

Source: OECD (2013), OECD Better Life Index and OECD (2014), OECD Social and Welfare Statistics (database), March.

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fully ensure that liabilities linked to building in exposed areas correspond to additional costs of protection. Properly internalising the costs of protection would ring-fence the housing market from unexpected shocks and would therefore safeguard household assets and banks' collateral.

Figure 5. **Exposure of major coastal cities to flood risks¹**

1. Exposure refers to the population and assets that are threatened, taking no account of any flood defences or other adaptation. Socio-economic change refers to the scenario of current environmental situation with the 2070's economy and population. Climate change and subsidence refers to the scenario of future socio-economic situation with the 2070's climate change, natural subsidence/uplift and human-induced subsidence minus the impact of the scenario of socio-economic change.

Source: R.J. Nicholls et al. (2008), "Ranking Port Cities with High Exposure and Vulnerability to Climate Extremes: Exposure Estimates", *OECD Environment Working Papers*, No. 1, and OECD (2014), *OECD National Accounts Statistics and OECD Factbook Statistics* (databases), March.

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Improving fiscal policy

Fiscal policy has achieved a major adjustment

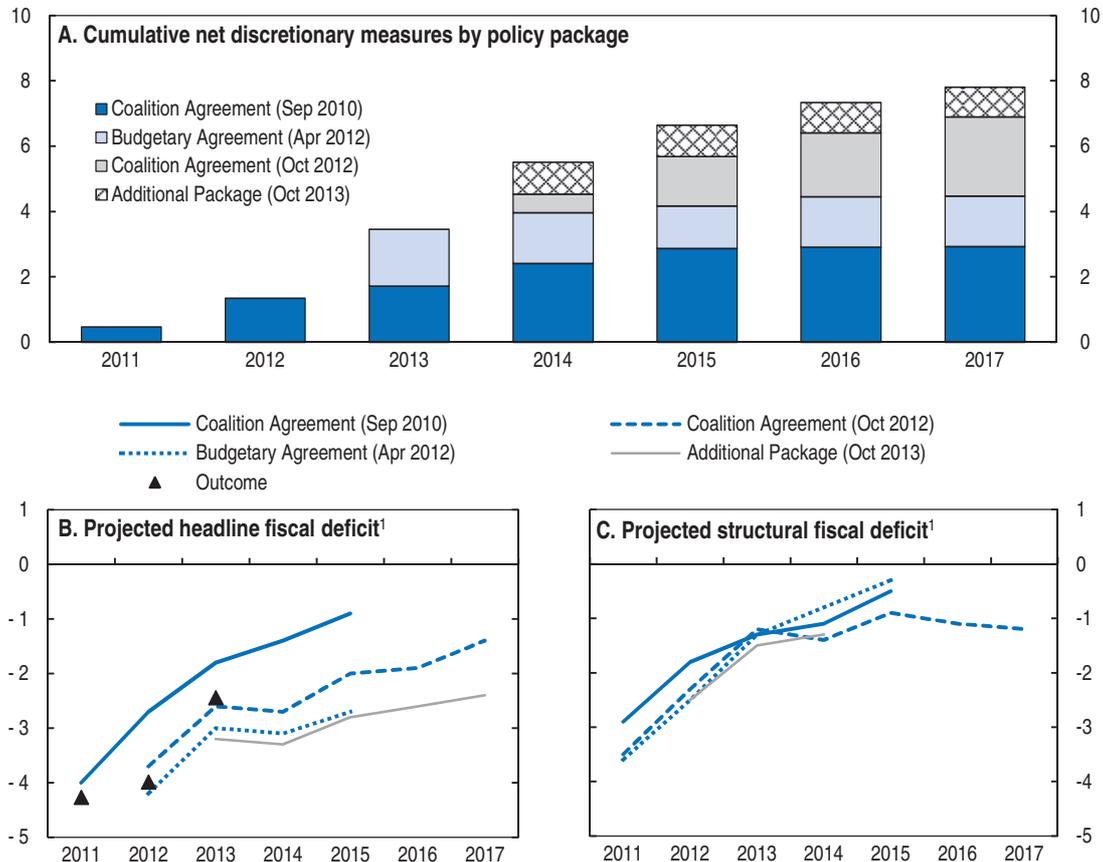
Strong public finances bolster macroeconomic stability and the authorities rapidly lowered the budget deficit to 3% of GDP to comply with the Stability and Growth Pact (SGP). Current consolidation plans aim to complete budget adjustment through an appropriate mix of spending growth restraints and revenues raises, and the cumulative net discretionary effort has been almost 8% of GDP between 2011 and 2017 (Figure 6, Panel A). The size of the effort has risen steadily as growth has weakened and budget deficits have widened more than envisaged (Figure 6, Panel B). The structural deficit, i.e. cyclically-adjusted fiscal balance net of one-offs, has been put firmly on a downward path (Figure 6, Panel C). As a result, the headline deficit was reduced from about 5.5% of GDP in 2009 to nearly 2.5% of GDP in 2013.

Returning to the initial fiscal framework

The Dutch fiscal framework is underpinned by a spending rule. Except for interest payments, expenditure items are subject to spending ceilings and every shortfall needs to be offset. This framework has been serving the Netherlands well for some time as it buttresses fiscal sustainability while leaving some flexibility to accommodate the economic cycle. However, automatic stabilisation on the revenue side has been suspended since 2011 in order to conform to the SGP, as legally mandated in the Netherlands in such cases. This has made fiscal policy pro-cyclical. As the budget deficit has been lowered to below 3% of GDP and is expected by the OECD (Table 1) and the Centraal Planbureau (CPB, 2014) to drop further in 2015, the authorities should return to their initial fiscal framework based on spending control and the work of automatic stabilisers on the revenue side.

Figure 6. **Fiscal consolidation has been sizeable**

Per cent of GDP



1. Fiscal deficit as projected at each policy package.

Source: Ministry of Finance and OECD (2014), OECD Economic Outlook: Statistics and Projections (database), April.

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Addressing growing ageing costs

The Netherlands has significantly improved long-term fiscal sustainability by mitigating ageing-related pressures on public budgets. Pension reforms have more than halved projected pension-related increases in public expenditure (European Commission, 2012a, b) and there are plans to accelerate the increase in the statutory retirement age to 67 by 2021 (instead of 2023 as initially planned). Total public health and long-term care spending is among the highest in the OECD and could rise significantly in the absence of policy actions (De la Maisonnette and Oliveira Martins, 2013; Van der Horst and van Erp, 2011). Exploiting efficiency gains could significantly mitigate spending increases in health care while sustaining gains in life expectancy (Hribernik and Kierzenkowski, 2013).

Important reforms have been implemented and are being considered by the authorities, often in line with the recommendations in a special chapter on health care and long-term care of the previous *Survey* (OECD, 2012; Schut et al., 2013). In health care, steps are taken to rationalize the basic health package, enhance the gate-keeping role of primary-care doctors, strengthen incentives for health insurers to develop cost-effective purchases of health services, lower spending on medicines as well as boost savings in the hospital sector. In long-term care, the focus is to expand home care and allow

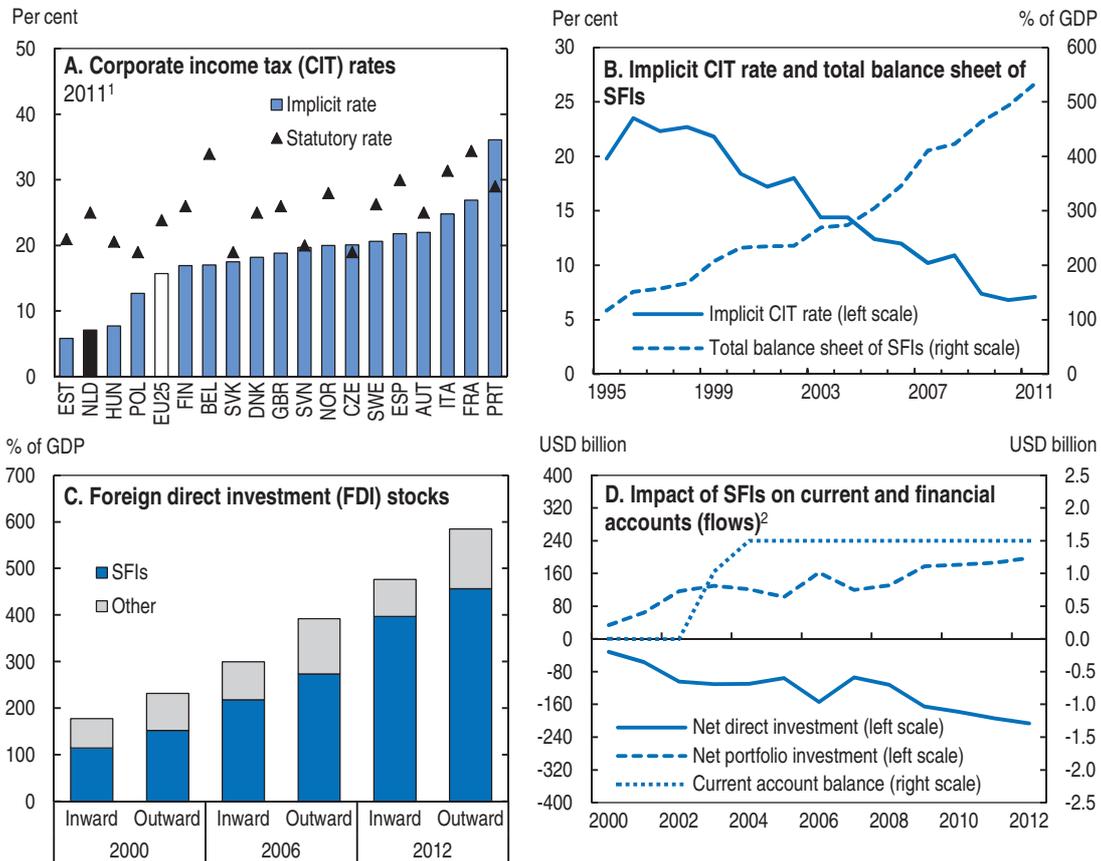
municipalities to play a more prominent role in the system, which is a step forward given their ability to generate cost-efficiency gains in home help with domestic activities. At the same time, those requiring intense care and rehabilitation would benefit from more cost-effective centralised institutional care, partly funded through greater involvement of health insurers and higher wealth-tested out-of-pocket payments.

Addressing tax planning strategies of multinationals

The Netherlands, among other countries, plays an important role in the business environment of multinational companies. It has a strong legal and financial infrastructure, has established an extensive network of bilateral taxation treaties and taxation information exchange agreements, and provides tax certainty with a system of “advance tax rulings”. The Netherlands is a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) which reviews the legal and regulatory framework and the actual implementation of the international standard for effective exchange of tax information so as to counter cross-border tax evasion. The Netherlands is seen as largely compliant by the Global Forum on its implementation of the standard (OECD, 2013d). Moreover, while being complex to estimate, the gap between the Dutch implicit and statutory tax rates on corporate income is high in international comparison (Figure 7, Panel A). In 2011, the former was only about 7% in 2011, against a 25% rate for the latter (Eurostat, 2013). A low implicit tax rate illustrates the importance of special financial institutions (SFIs) of multinational companies, with the Netherlands being home to more than 14 000 of them. The gap between the statutory and implicit tax rates can be linked to the importance of dividends and capital gains channelled through the Netherlands, both reflected in the production and income accounts of the national accounts. The absence of withholding taxes on interest and royalty income, and a “participation exemption” that exempts partially or fully intra-firm transfers of dividends and capital gains from the Dutch corporate income tax (CIT), contribute to make the Netherlands an attractive country from a tax perspective (European Commission, 2013a; Broos et al., 2012).

SFIs are directly or indirectly controlled by non-resident parent companies and many of them are special purpose entities, which are so-called letterbox companies, as they have no or few employees and have no or limited physical presence. The majority of the hundred biggest foreign firms in the world have one or more SFIs in the Netherlands (Broos et al., 2012). A steadily diminishing implicit corporate income tax rate has been driven by large and growing assets of SFIs (Figure 7, Panel B), whose gross inward and outward financial transaction flows were estimated at nearly EUR 9 000 billion (15 times Dutch GDP) in 2011. SFIs command a large stock of inward and outward foreign direct investments (FDIs) (Figure 7, Panel C), but net FDI outflows are essentially offset by net portfolio and other investment inflows, resulting in a small impact of SFIs on the current account balance as estimated by the Dutch central bank (De Nederlandsche Bank, DNB) (Figure 7, Panel D). The Netherlands seems to be used as a tax conduit for multinational firms, such as Google (IMF, 2013c), or for firms from the euro area periphery, such as Portugal (Fernandez et al., 2013). Business profits reported by majority-owned affiliates of US parent companies in a group of countries, including the Netherlands, are large and disconnected with their actual economic activity in terms of employment or investment (Keightley, 2013; Gravelle, 2013). Dutch companies may also use tax planning strategies by setting up SFIs

Figure 7. **Corporate income tax rate, foreign direct investment and special financial institutions (SFIs)**



1. Data for implicit rate refer to 2009 for Denmark and Spain and to 2008 for Portugal. The EU25 aggregate is calculated as an unweighted average and it covers European Union member countries except for Bulgaria, Croatia and Romania.
2. Cumulative net direct investment and net portfolio investment flows from 2000. Portfolio investment flows also include other investment flows.

Source: Eurostat and European Commission (2013), *Taxation Trends in the European Union*; De Nederlandsche Bank and OECD (2014), *Foreign Direct Investment (FDI) Statistics* (database), March.

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abroad, as the recent case of the national rail operator shows. Therefore, international co-operation in setting tax policies would also benefit the Netherlands.

Base erosion and profit shifting is a growing international issue (OECD, 2013e, f). Recent steps have aimed to reduce the extent of profit shifting, which is welcome. In 2009, the government introduced requirements for material business presence and the number of SFIs is estimated by the DNB to have fallen by almost 500 in 2012. The authorities also plan to renegotiate their tax treaties and exchange tax information with 23 least-developed countries so as to tame incentives for multinationals in those countries to operate tax planning strategies through the Netherlands. In order to minimize base erosion and profit shifting, the Netherlands is encouraged to examine how their own domestic laws contribute to this and to actively participate in international negotiations to ensure that tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid

by artificially shifting profits to low-tax jurisdictions. As a general principle, profits should be taxed where economic activities deriving the profits are performed and where value is created.

Key fiscal recommendations

Return to the initial fiscal framework by adhering to medium-term spending ceilings while allowing automatic stabilisers to play fully on the revenue side.

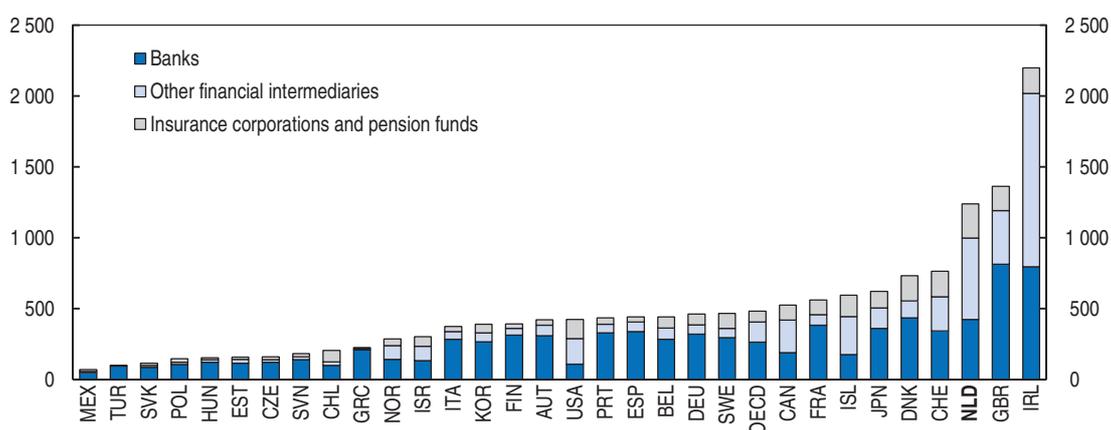
Continue to actively participate in international negotiations about co-ordinated action to combat tax base erosion and profit shifting of multinational enterprises and, within this international context, take appropriate domestic measures to support such action.

Making the banking sector more resilient

The Dutch banking sector is large compared to the size of the domestic economy (Figure 8) and the sector is dominated by three banks with cross-border linkages – ING, Rabobank and ABN AMRO. While important steps have been taken to make the sector more resilient, further efforts would help to head off worst-case scenarios triggered by future domestic or international shocks. A vulnerable, large and concentrated banking sector threatens the financing of the economy through lower credit availability and excessive risk aversion, endangers the taxpayer through bailouts and risks international financial stability through its large size.

Figure 8. **Assets of financial corporations**

Per cent of GDP, 2012¹



1. 2011 for Israel and Switzerland. 2009 for Mexico. Figures for banks for Germany, Ireland, Italy, Poland and United Kingdom also include central bank assets. Other financial intermediaries refer to financial corporations (except insurance corporations and pension funds) that raise funds on financial markets, but not in the form of deposits, and use them to acquire other kinds of financial assets. The OECD aggregate covers 31 countries. Non-consolidated data from financial balance sheets.

Source: OECD (2014), OECD National Accounts Statistics (database), March.

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Risks facing the banking sector

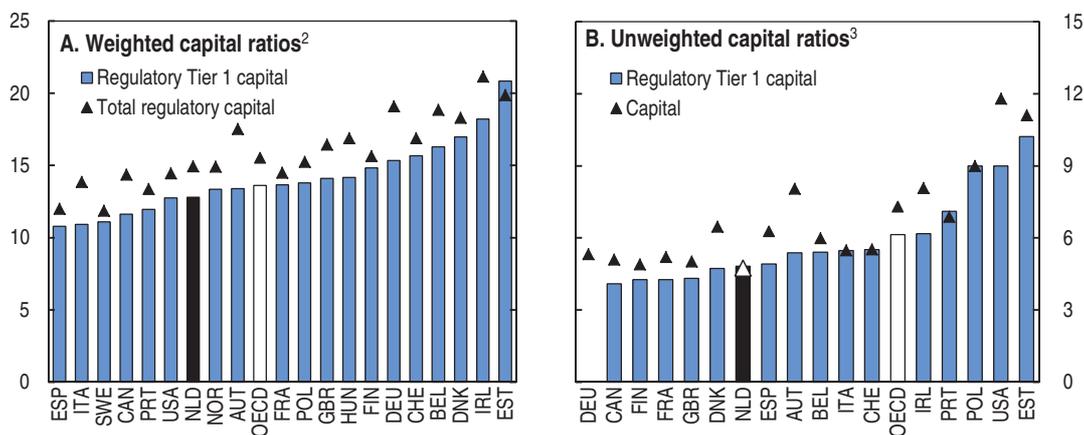
The Dutch financial sector incurred large losses linked to troubled foreign assets and suffered liquidity strains early in the global downturn, although domestic mortgage and

housing markets remained relatively stable (IMF, 2010; 2011). The government undertook a massive intervention to rescue the sector from collapse, as described in the 2010 Survey (OECD, 2010). The large international bank ABN AMRO has fallen under state ownership. The bailout of the financial sector increased gross public debt by around 15% of GDP, although two-thirds of the costs have now been recovered (IMF, 2013c). Contingent liabilities linked to the financial sector are expected to be scaled down to nearly 30% of GDP in 2014 (Ministry of Finance, 2013). A planned privatisation of ABN AMRO is a step in the right direction.

According to the DNB, Dutch banks are making significant progress in the implementation of Basel III standards that will come fully into force in 2019. For instance, they had a core Tier 1 ratio at 11.5% in the second half of 2012, although they still needed over 2% of GDP of net additional capital to meet all requirements (DNB, 2013a; 2014). Yet, international comparison can currently only be made on the Basel II basis and regulatory ratios of total and Tier 1 capital to risk-weighted assets are not particularly strong on this account (Figure 9, Panel A). Also, unweighted measures of capital ratios (or leverage ratios) are lower than in many OECD countries (Figure 9, Panel B). As well as asset composition driving a wedge between risk-adjusted and unadjusted capital positions, there is evidence of cross-country heterogeneity in banks' average risk weights driven by bank and supervisory practices, which could also lead to cross-bank heterogeneity within the same country (BIS, 2013a). In accordance with Basel II standards, banks are allowed by the regulator to develop internal models to determine risk-weighted assets.

Figure 9. **Capital ratios in the banking sector are comparatively low**

Per cent, third quarter of 2013¹



1. Or latest quarter available. 2012 for Switzerland. Regulatory capital compiled in accordance with the guidelines of Basel II (except for the United States where Basel I is applied). For France there is no information available on Basel standards. The banking sector covers banks and other deposit takers (units engaging in financial intermediation as a principal activity).

2. Capital to risk-weighted assets. The OECD aggregate covers 30 countries.

3. Capital to total assets that are not risk weighted. Capital is measured as total capital and reserves as reported in the sectoral balance sheet. The OECD aggregate covers 29 countries for regulatory Tier 1 capital and 26 for capital.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, March.

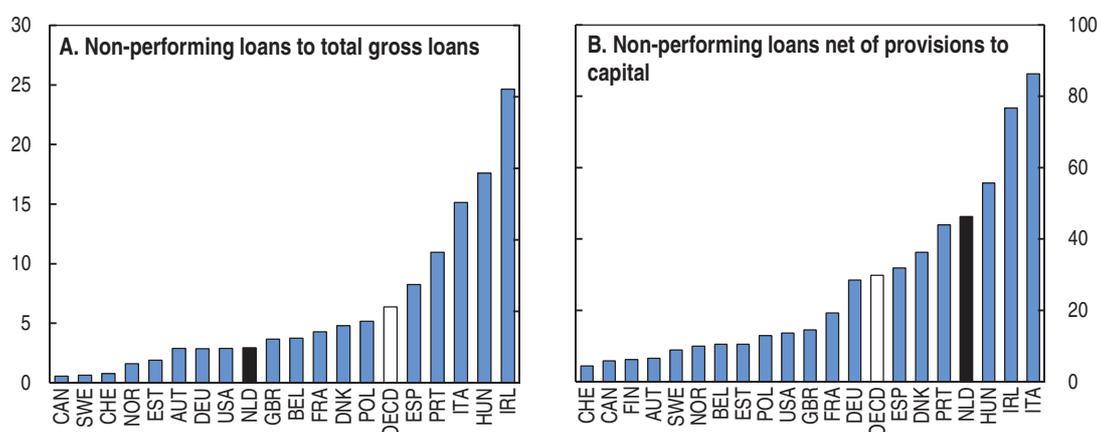
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Provisioning is consistent with current international accounting standards of the incurred loss model (IAS 39), which is not sufficiently forward looking about future impairments (Knot, 2013). The share of non-performing loans (NPLs) in total loans is low

(Figure 10, Panel A), but the amount of NPLs not covered by loan loss provisions is high in relation to bank capital (Figure 10, Panel B). This means, for example, that notwithstanding the value of the collateral linked to loans, banks' capital would be cut by half if current NPLs were fully written off. Coverage ratios, measuring loan loss provisions as a percentage of NPLs, have been flat at around 35% and are ten percentage points lower than the median of ratios in the euro area (ECB, 2013a). Furthermore, a low incidence of loans in arrears could be underestimated, notably because there is no uniform definition of NPLs. This is also an issue in other euro area countries which is being addressed by the European Banking Authority so as a new definition of NPLs is used in the asset quality review of the ECB.

Figure 10. **Financial buffers to absorb losses from non-performing loans are relatively weak**

Per cent, third quarter of 2013¹



1. Or latest quarter available. 2012 for Germany and Switzerland. The OECD aggregate covers 29 countries in Panel A and 30 in Panel B.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, March.

How to read this figure: Potential reduction of banks' capital to absorb losses assuming that all non-performing loans net of loan-loss provisions are written off.

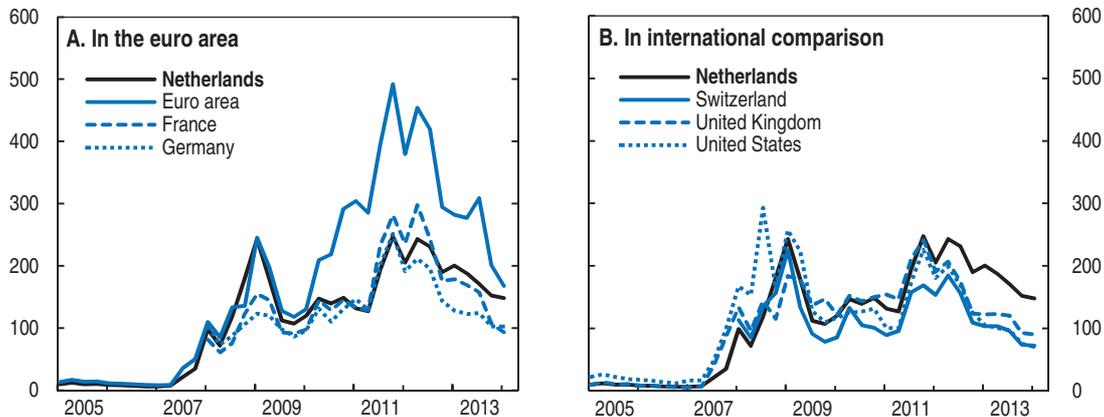
StatLink  <http://dx.doi.org/10.1787/888933029508>

Dutch banks continue to depend heavily on international capital markets to fund their assets. Risk-free interest rates have dropped, but risk premiums facing banks have increased and have become more volatile (Figure 11). The cost of funding does not seem high in international comparison, but the exposure of Dutch banks to refinancing risks is large as they combine among the highest loan-to-deposit ratios and levels of external bank debt in the OECD (Figure 12). In particular, short-term external liabilities amount to about 45% of GDP.

Banks' exposure to the property market is extensive. The overall bank exposure to the domestic and foreign commercial property market is respectively almost EUR 80 billion and EUR 20 billion (in total around 15% of GDP or 4% of banks' total assets). The SNS Reaal bank-insurer was nationalised in early 2013 due to high losses of SNS Bank linked to commercial real estate. Losses originating from mortgage loans have been low so far and NPLs barely exceed 1% of total lending volume. Mortgages amount to close to 30% of total banks' assets and are a major component of total household debt, which at close to 290% of gross disposable income and around 130% of GDP in 2012, is one of the highest in the

Figure 11. **Risk premiums on market funding have become more costly and volatile**

Credit default swap (CDS) spreads of banking sectors, basis points¹

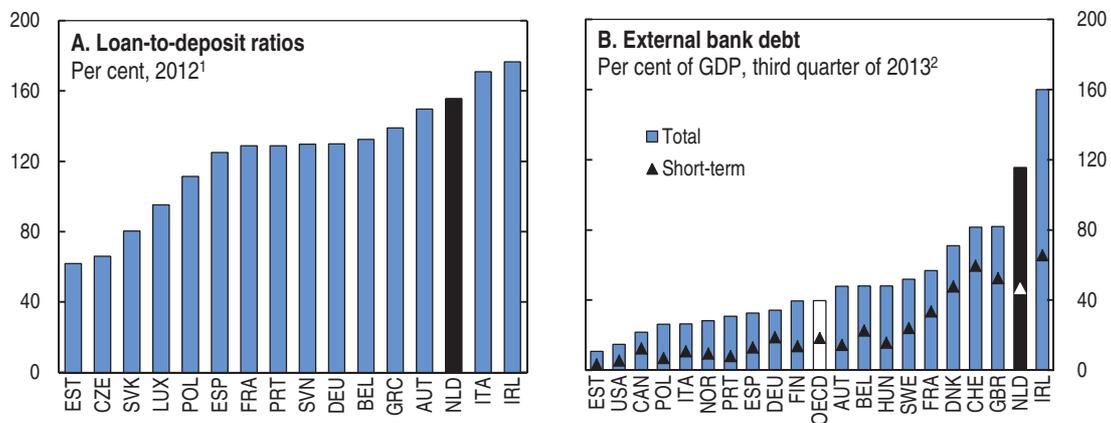


1. Five-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve. Quarterly data calculated as the unweighted average of end-of-month figures. Figures for the Netherlands are calculated as the unweighted average of CDS spreads of four banks: SNS Bank, ING Bank, Rabobank and ABN AMRO.

Source: Datastream.

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Figure 12. **Dependence on market funding remains high**



1. Ratio of loans and receivables including finance leases to total deposits other than from credit institutions. Data refer to domestic banking groups and stand-alone banks.

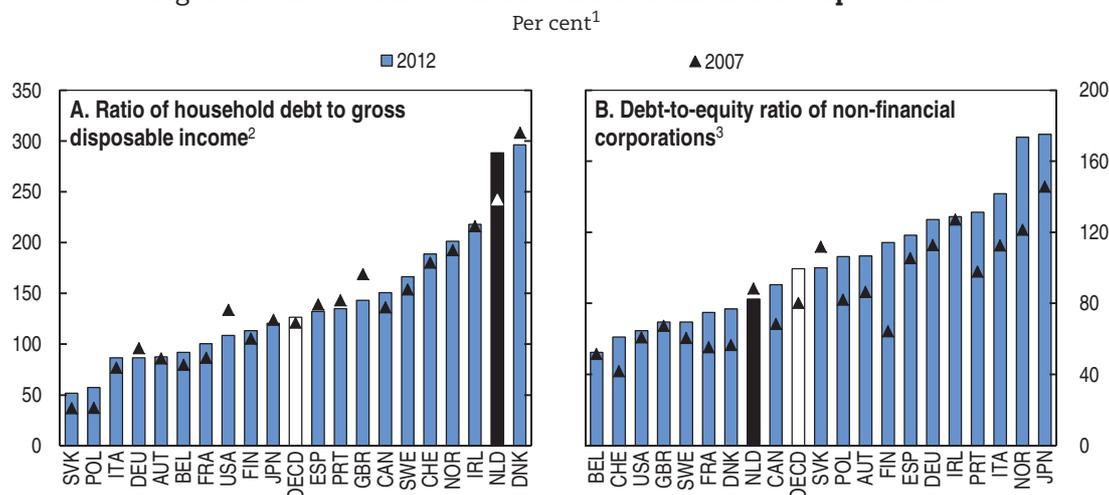
2. Total international debt liabilities and international debt liabilities with residual maturity below one year towards BIS reporting banks. The OECD aggregate excludes Luxembourg.

Source: ECB (2014), "Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, March and BIS (2014), "Consolidated Banking Statistics", *BIS Statistics*, Bank for International Settlements, March.

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OECD (Figure 13, Panel A). This contrasts with a more contained indebtedness of the non-financial corporate sector (Figure 13, Panel B).

Many borrowers have not started repaying the principal of their mortgages. More recently, redemptions have somewhat increased driven by lower interest rates on saving accounts, a cancellation of penalties for early repayments and tax incentives for intergenerational transfers of wealth used for house purposes. There are several types of mortgage products in the Netherlands. Around 35% of outstanding mortgages are 100% "interest-only" loans. They do not have any mechanism attached for the build-up of the

Figure 13. **Debt of households and non-financial corporations**

1. Debt is calculated as the sum of the following liability categories, whenever available/applicable: currency and deposits, securities other than shares, except financial derivatives, loans, insurance technical reserves and other accounts payable. Non-consolidated data from financial balance sheets.
2. Debt of households including non-profit institutions serving households. The OECD aggregate covers 29 countries. 2011 instead of 2012 for Japan and Switzerland. 2010 instead of 2012 for Canada.
3. Debt as a percentage of shares and other equity. This indicator measures the financial leverage or the extent to which activities are financed out of their own funds. The OECD aggregate covers 31 countries. 2011 instead of 2012 for Japan and Switzerland.

Source: OECD (2014), OECD National Accounts Statistics (database), March.

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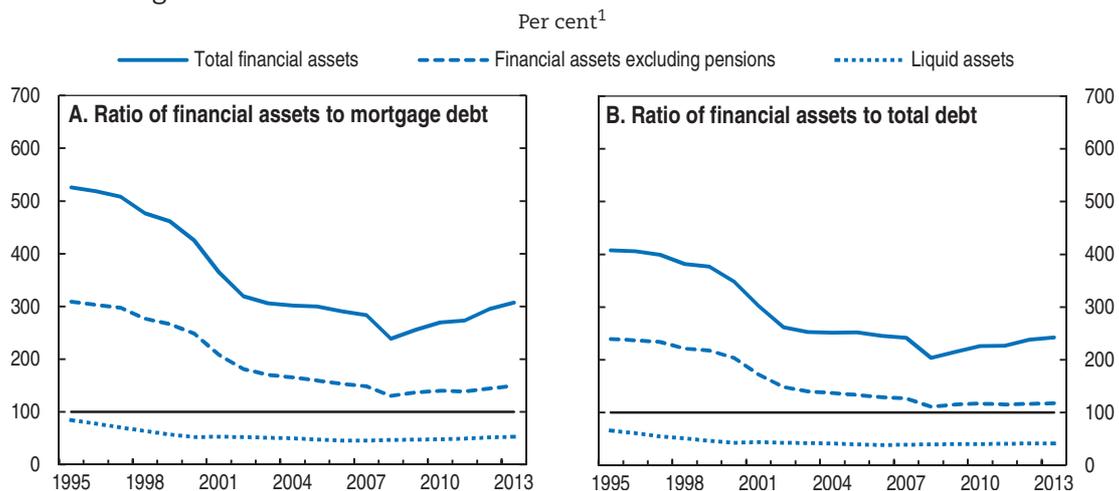
principal, which has to be repaid in full only at maturity once a deferment period has expired. Approximately 25% are savings-based mortgages that are linked to a savings account in a bank or an insurance company to accumulate the principal that needs to be redeemed at maturity, although there is some but no regular amortisation. Only 5% of mortgages are subject to regular (linear or annuity) amortisation. Finally, nearly 35% of outstanding mortgages combine two or more products, for instance they may have a 50% part linked to a savings account in a bank or an insurance company for the accumulation of the principal and a 50% part which is “interest-only”. Given the mortgage product mix, it is estimated by the DNB that around 55% of the overall loan portfolio is *de facto* “interest-only”, against less than 10% in the mid-1990s, and that the share of loans linked to a savings account with a lump sum repayment of the principal reached 30% in 2012. At the same time, the market share of regularly amortising mortgages fell from 50% to 15%.

Loans with deferred amortisation were engineered to maximise mortgage interest tax deductibility (available for a maximum of 30 years) by not amortising and requiring a lump-sum repayment of principal at maturity. According to the DNB, many households are not accumulating equity sufficiently to pay back their mortgage debt (DNB, 2012; IMF, 2011). This applies to interest-only and also to savings-based mortgages. Interest-only mortgages, also a concern in the Nordic countries (IMF, 2013b), blunt the amortising behaviour, may exploit borrowers’ short-sightedness and their gaps in financial literacy, and ultimately create macro-prudential risks. The share of maturing interest-only loans will begin to rise sharply from 2025, exposing banks to risks of default, even though risks are lower for older borrowers with high net wealth. Yet, the example of Denmark shows that a rising number of families can encounter difficulties in redeeming such loans (OECD, 2014).

Defaults have been limited so far. Lenders have full recourse, but strategic defaults (no payments despite financial ability to make them) cannot be ruled out if borrowers with negative home equity change their behaviour (IMF, 2013a). A large number of defaults could also occur if economic conditions deteriorate further. The unemployment rate has been rising, undermining the ability to service consumer debt. Of around 8.5 million borrowers recorded in the Dutch Credit Registration Office (BKR), close to 8.5% have recently been falling behind payment schedules by at least two months, and these difficulties could spread into mortgage debt (so far only about 1% have had difficulties in servicing their mortgages by three months or more). With falling house prices and maximum loan-to-value (LTV) ratios above 100% for new loans, nearly 40% of mortgage borrowers already have negative home equity (outstanding mortgage debt larger than the value of the home). Exposure to changes in interest rates is high. In 2008, around half of all mortgages had a remaining fixed interest period of four years or less reflecting the fact that around 70% of borrowers tended to fix the interest rate for a maximum period of 10 years (DNB, 2009). A hike in the policy rate by 300 basis points would increase the median debt service-to-net income ratio to nearly 25% and more than a fourth of households would face a ratio in excess of 40% (ECB, 2013b).

Households on average have assets that significantly exceed their liabilities, but both their composition and distribution reveal that they cannot easily be used to repay debt. First, the composition of assets has become more illiquid as the ratio of total financial assets (which exclude housing) to mortgage and total debt has dropped over time (Figure 14). When pensions and housing are excluded, assets exceed debt only marginally. Liquid assets to make an early repayment of debt or to offset potential increases in debt servicing costs are low.

Figure 14. **Household balance sheets have become more stretched**



1. Figures from 2011 onwards are provisional. Financial assets include savings and other deposits, shares and other equities, the net equity of households in the pension funds reserves of resident pension funds and life insurance companies as well as the net equity of households in the life insurance reserves of resident and non-resident pension funds and life insurance companies. Liquid assets refer to savings deposits and other deposits that are all the savings of individuals and deposits (in euros and foreign currency) at any resident and non-resident bank, which are not immediately transferable without restrictions.

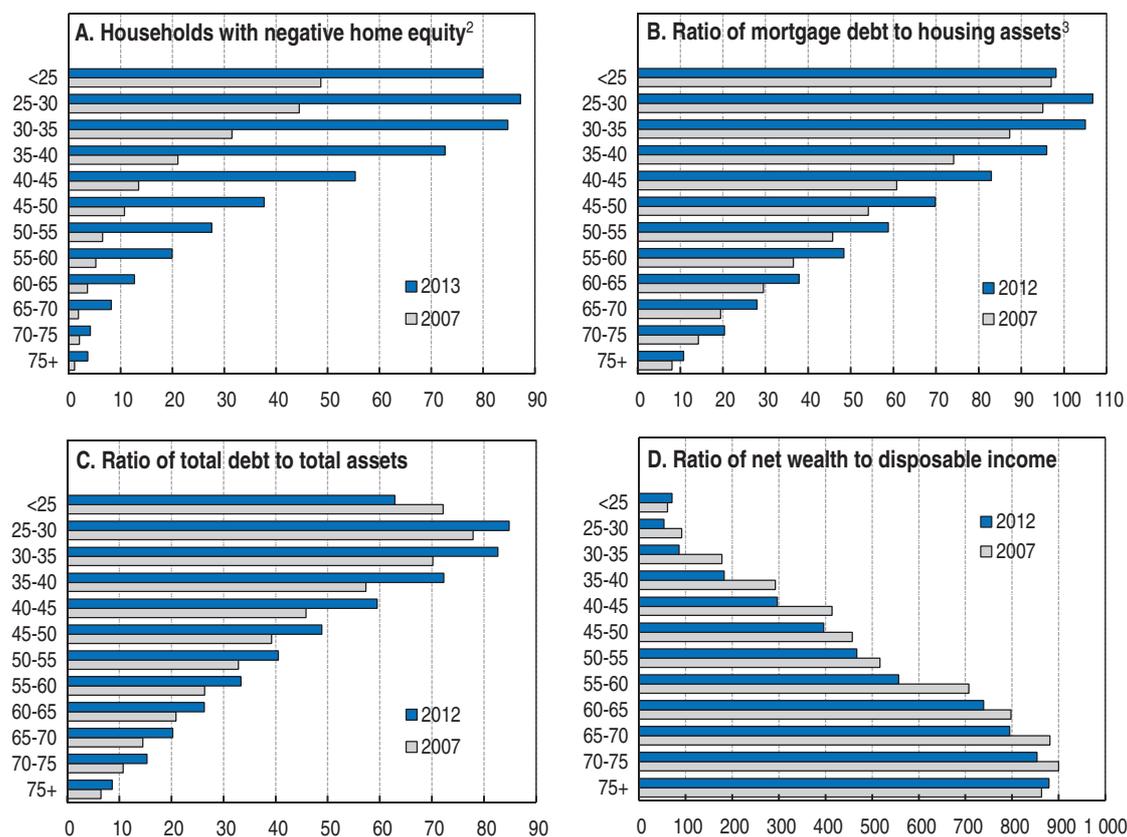
Source: Statistics Netherlands (2014), "Macroeconomics: Sector accounts", Statline, April.

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Second, the distribution of assets shows that young and prime-age households are particularly exposed to adverse developments in the housing market, as opposed to older borrowers, and risks have increased since the beginning of the crisis. Among home-owning households with a mortgage, the share of those aged below 40 with negative home equity was above 70% on 1 January 2013, and nominal house prices have been broadly flat since then (Figure 15, Panel A). For this group, the overall value of mortgage debt was almost equal or higher than the corresponding value of housing assets on 1 January 2012, latest data available, knowing that nominal house prices dropped by around 7% that year (Figure 15, Panel B). Total debt-to-assets ratios were high (Figure 15, Panel C) and net wealth as a share of disposable income was low (Figure 15, Panel D) for the young and the opposite was true for seniors (pension assets are disregarded in both cases as relevant data by age are unavailable).

Figure 15. **Risks are concentrated among young and prime-age households**

Per cent of households by age of the main breadwinner, data at 1 January¹



1. Assets include current and saving accounts, bonds and stocks, own-home, business assets and other possessions, but exclude pension assets as relevant data by age are unavailable. Figures from 2012 onwards are provisional.
2. Home-owning households with a mortgage.
3. Housing assets refer to property owned and used as a main residence. Mortgage debt is associated with home ownership and represents the value of the debt on which interest is payable.

Source: Statistics Netherlands (2014), "Income and Spending", Statline, March.

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Reducing refinancing risks

The Dutch government is considering setting up a National Mortgage Institute to securitise part of the mortgage debt and sell it to international and national institutional

investors, including Dutch pension funds. The objective is to increase banks' funding stability, lower banks' costs, and pass this advantage on to new borrowers and borrowers who renegotiate their interest rate. The government would take on no extra credit risk, as only mortgages covered by the public National Mortgage Guarantee (NHG) scheme (which insures against residual liabilities left after a sale of a property) would be eligible. While such an instrument would help reduce refinancing risks, it is important that the government's exposure to the NHG scheme (currently at 25% of GDP) remains contained and that pension funds' decisions remain prudent in terms of return, risk and investment diversification (also internationally).

Several other policies could also be considered. Higher amortisation of mortgages would narrow the gap between loans and deposits. Deferred-amortisation loans could be systematically linked to a bank account, but such a measure would need to be implemented progressively to prevent liquidity problems in insurance companies when households' stable assets are withdrawn. Further restructuring banks' balance sheets by rationalising non-core activities (loans represent only half of total assets) would also help to reduce their dependence on wholesale funding. To progressively shift the banks' funding model towards more stable sources, the government could consider raising the current tax on liabilities other than equity and deposits (KPMG, 2012). The small difference between the tax rates for liabilities for less and more than one year, respectively 0.044% and 0.022%, could also be increased.

Strengthening financial buffers

The authorities have launched an in-depth asset quality review of risks attached to commercial property loans. The aim is to ensure a realistic valuation of collateral in banks' books, greater scrutiny of banks' property models and higher provisions (DNB, 2013b). These are welcome steps. Banks' mortgage portfolios should receive the same degree of scrutiny as their commercial business. Regulatory authorities should continue to request banks to hold sufficient capital to make up for possible losses stemming from rising unemployment, the high share of households with negative home equity, sensitivity to interest rate shocks and low mortgage amortisation. New international accounting standards (IFRS 9) are not yet enforced, but banks may also choose to apply them as of now, notably the new impairment methodology based on the expected credit loss model. For instance, Danish banks have recently been asked to boost provisions for borrowers who are unable to start amortising their mortgages.

New Basel III regulation should improve both the quality and quantity of capital and will be phased in between 2014 and 2019. If the future counter-cyclical buffer were to be binding for the average Dutch bank in mid-2012, it would have amounted to 0.5% of risk-weighted assets (Bonner and Jongen, 2013), which could indicate little scope to support lending. Implementing a maximum Basel III counter-cyclical buffer of 2.5% of risk-weighted assets in good times would have required around 3.5% of GDP of additional capital in mid-2012. The systemically important bank capital buffer is planned by the authorities to be in the range of 1% to 3% of risk-weighted assets. Aiming for the upper bound would limit spillover effects and reduce the implicit guarantee of banks too big (or too interconnected) to fail.

Evidence by the OECD suggests that Tier 1 risk-weighted capital ratios do not reflect a distance to default of a bank, but leverage ratios do (Blundell-Wignall and Roulet, 2013). To be at a prudent distance from default with a leverage ratio of 5%, Dutch banks would need 4.5% of GDP of additional core Tier 1 capital (OECD, 2013a). The authorities' goal expressed in their "Banking vision paper" of a leverage ratio of at least 4% for systemically important

banks is commendable (Government of the Netherlands, 2013) and the Netherlands is the first euro area country doing it. Seeking a higher leverage ratio, as applied for the two biggest Swiss banks, could be considered given the size of the largest banks as this would provide a greater backstop against unexpected risks, further lower the cost of funding and create stronger incentives to recognise losses. Such a change would need to take into account the potential negative impact on lending in the short term and would need to be implemented progressively. Current discussions at the international level on the definition of the leverage ratio would need to be taken into account when defining its appropriate level.

Capital buffers should be raised by increasing the level of capital rather than by scaling back lending. Issuance of shares and increased retained earnings through lower dividend distribution and reduction of costs should bolster high-quality capital. In particular, there is scope to reduce salaries in the banking sector (DNB, 2013b). The government is considering introducing a limit on performance-related bonuses at 20% of salary which could favour financial stability by lowering risk-taking, but banks may compensate by raising salaries. Rabobank has announced a voluntary temporary freeze in pay and bonuses until 2015.

Containing household leverage when the housing market recovery is durable

Recent reforms have aimed to lower incentives to expand household leverage. Mortgage interest deductibility has been an important driver of the rise in household debt and tax breaks tended to be capitalised in house prices (Andrews et al., 2011). Since 2013, interest deductibility has been restricted to new mortgages with regular repayment of the principal within 30 years, which is a commendable measure. However, new borrowers can take a second interest-only loan to redeem up to 50% of the first loan (Van Leeuwen, 2013). The tax treatment of mortgage interest has been made less generous for both new and existing mortgages, but with a very gradual lowering of the tax relief from 52% to 38% between 2014 and 2042. The maximum value of a mortgage eligible for the NHG guarantee scheme has been reduced and will be diminished further and the maximum LTV ratio for new mortgages will be cut in steps from 106% in 2012 to 100% in 2018.

Reforms need to be deepened as soon as the housing market recovery is sustainable. To improve tax neutrality, the taxation of housing should be at a level consistent with the taxation of financial incomes (Andrews et al., 2011). The taxation of housing corresponds to the first-best policy as households benefit from mortgage interest deductibility and imputed rents are taxed. However, imputed rents are taxed at a maximum rate of only 0.7% of the economic value for dwellings below EUR 1 million. The fee to benefit from the NHG scheme should be adjusted for risk, for instance linked to the size of the LTV ratio. Further lowering the maximum LTV ratio significantly below 100% (most OECD countries have LTVs in the range of 70-80%) would limit the interest burden, decrease the incidence of negative home equity and reduce default rates. The latter noticeably increase for LTVs above 80% in the United States (Qi and Yang, 2009; White and Bauguess, 2013). Lower LTVs would also free up banks' capital and decrease their refinancing risks (SER, 2013). Alternatively, lower LTVs could be incentivised by the regulator by requiring banks to apply floor risk weights on new mortgages.

The Dutch rental sector is heavily skewed towards the public rental sector and developing the private rental market would give time to households to accumulate an adequate mortgage deposit. Recent reforms have initiated a welcome differentiation of rents depending on income in social housing (representing about 35% of the housing stock). They should be continued and would need to be coupled with tighter income

conditions for eligibility to ensure that social housing associations focus on providing affordable housing only for low-income households. In parallel, as assessed in a chapter on the housing market in the 2010 *Survey* (OECD, 2010; Høj, 2011), it is necessary to promote the development of the private rental market by progressively liberalising rents to create an alternative to homeownership and social housing. Ensuring a stronger role for a property's value in setting maximum rents, as currently planned, would be a step in the right direction. Additional far-reaching measures would include fully liberalising rents in new constructions and deregulating rents for new contracts in existing dwellings.

Additional measures are needed to lower household indebtedness in the medium term

Reforms need to be broadened to reduce the stock of household debt in the medium term. Regulatory authorities could prompt lenders to contact their borrowers holding interest-only mortgages and inform them about needed repayment of the loan at the end of the term as, for instance, in the United Kingdom (FCA, 2013). Well capitalised banks could be less willing to refinance borrowers with negative home equity who cannot repay their loan at maturity.

A more fundamental way to reduce household debt would be to more strongly incentivise amortising behaviour for existing mortgages once the housing market has recovered durably. In particular, this could be achieved by accelerating the reduction of the mortgage interest relief. Also, redemptions of loans with deferred amortisation should be closely monitored to prevent practices of “evergreening” by banks. Higher amortisation of existing mortgages would reduce banks' exposure to liquidity and solvency risks linked to the housing market, and improve consumer protection for vulnerable households. Concerns about the accumulation of illiquid and/or excessive net wealth by seniors are overstated. Assuming that underwriting standards remain solid, home equity could be extracted by developing home equity loans (repaid in regular instalments) and reverse mortgages (repaid from equity through the sale of the house).

For borrowers who would be unable to start paying the principal when they refinance their debt with a new loan, banks could propose another mortgage with regular amortisation and longer maturity, or otherwise it would be advisable that they raise their capital for expected losses or boost their loan loss provisions if borrowers are only able to pay the interest. Denmark has recently decided that debtors who have difficulties to begin amortising their mortgage with a LTV ratio of over 80% can convert it into a 30-years loan with amortisation; otherwise banks have to build higher provisions for borrowers only able to pay the interest on a new loan (OECD, 2014).

Balancing creditor and debtor rights would ease loan restructuring. Banks have priority among creditors and full recourse to the collateral and other borrower's assets, typically for three years and a maximum of five years, including claims on future income (Van Leeuwen and Bokeloh, 2012). Widespread repossessions could be socially and politically difficult to enforce in case of defaults, and would deepen banks' losses if large forced sales destabilise house prices. Also, lender-friendly foreclosure laws can weaken underwriting standards and have been found to be associated with a higher incidence of subprime originations in the United States (Curtis, 2013). On the other hand, the government is currently working on draft legislation to mitigate the debt burden of heirs linked to unexpected debts from inheritance, which could put high risks on creditors. Adjusting the personal insolvency regime by lowering the cost of restructuring for financially responsible debtors would ensure an orderly reduction of debt and support consumption, without jeopardising financial stability.

Improving bank resolution

Procedures to resolve banks are a crucial component of a financial stability toolkit, especially as this is a key instrument to avoid that “too big to fail” banks become “too big to save”, namely that the cost for the taxpayer for rescuing the banking sector becomes exorbitant (as happened in Iceland or Ireland in recent years). Major progress has been made to ensure an orderly resolution of financial enterprises with the adoption of the Act on Special Measures for Financial Corporations (Intervention Act) in mid-2012. The Intervention Act has laid the ground to bail-in shareholders and junior creditors of the bank-insurer conglomerate SNS Reaal in early 2013. Further progress is expected with the adoption of the Bank Recovery and Resolution Directive (BRRD), which is set to harmonise rules for the recapitalisation and orderly resolution of banks at the European Union (EU) level by January 2015. According to the BRRD, from 2016 onwards, there should be a clear ranking of creditors to bail-in, including senior unsecured bondholders who did not incur any losses in the case of SNS Reaal at the expense of the taxpayer. Moreover, total losses of private investors will have to amount to at least 8% of the bank’s balance sheet before drawing on a bank-financed *ex ante* domestic resolution fund (expected to reach the level of 1% of domestic covered deposits by 2025) and public funding. A recently agreed European single resolution fund of EUR 55 billion, to be built up over the next eight years, could also be used in periods of acute stress.

There is scope to enhance early intervention in bank supervision and secure a timely trigger of resolution procedures. Recently, a commission set up to evaluate the nationalisation of SNS Reaal has concluded to the absence of a timely and effective response to the growing problems of the conglomerate. In particular, the regulator was insufficiently informed about the risks taken by SNS Reaal before the crisis and there was little restructuring undertaken following government state aid attributed in late 2008. Therefore, there should be clear criteria and early-warning indicators when a resolution procedure needs to be launched. It is also important that the regulator specifies *ex ante* the measures to be taken in the event of a resolution procedure and the timing of their implementation, so as to reduce the risk of regulatory forbearance. Similarly, recovery and resolution plans (or “living wills”) for an orderly wind up of systemically important banks are needed and the authorities are working in this direction.

Deposits under EUR 100 000 are fully protected if a bank fails. According to the BRRD, deposits of natural persons and SMEs above EUR 100 000 will also benefit from a preferential treatment as they will not suffer from losses before all other unsecured creditors’ claims (shareholders, junior and senior bondholders, and depositors from large corporations) are absorbed. Two additional measures could be taken to further limit potential costs for the government, which ultimately guarantees deposits below EUR 100 000. First, the national deposit guarantee scheme should be funded *ex ante* by the banking sector. Such arrangement was delayed, but it is set to be introduced in the Netherlands in 2015.

Second, the amount of secured debt issued by banks, which is excluded from the scope of bail-in, should be closely monitored to ensure a high effectiveness of resolution procedures. Banks are increasing their secured funding, such as covered bonds, as a way to limit their funding costs. This form of debt insures the right of the creditor to payment against a certain share of banks’ assets pledged as collateral. This leads to asset encumbrance and a higher probability that resolution procedures would lead to losses of insured deposits, putting back the cost to the taxpayer. At around 15%, average asset

encumbrance of Dutch banks is lower than the European average of 25%, partly owing to prudential limits set by the DNB for the volume of covered bonds issued (DNB, 2013c). However, there are a number of challenges how such caps could be designed and the regulator could, in addition, consider linking capital requirements to the level of asset encumbrance as a way to ensure that the risk-sharing burden is not unduly tilted towards unsecured creditors (BIS, 2013b).

Recommendations to improve the resilience of banks

Key recommendations

Encourage banks to further increase their capital adequacy ratios by issuing equity and retaining earnings.

Phase in maximum Basel III standards on systemically important bank capital buffers and aim for strong leverage ratios for systemically important banks.

Once the housing market starts to recover durably, accelerate the reduction of mortgage interest relief to increase incentives for amortisation of mortgages and further lower the maximum loan-to-value ratio significantly below 100%.

Other recommendations

Continue to request banks to hold sufficient capital for expected losses.

Adopt a uniform definition of a non-performing loan across banks.

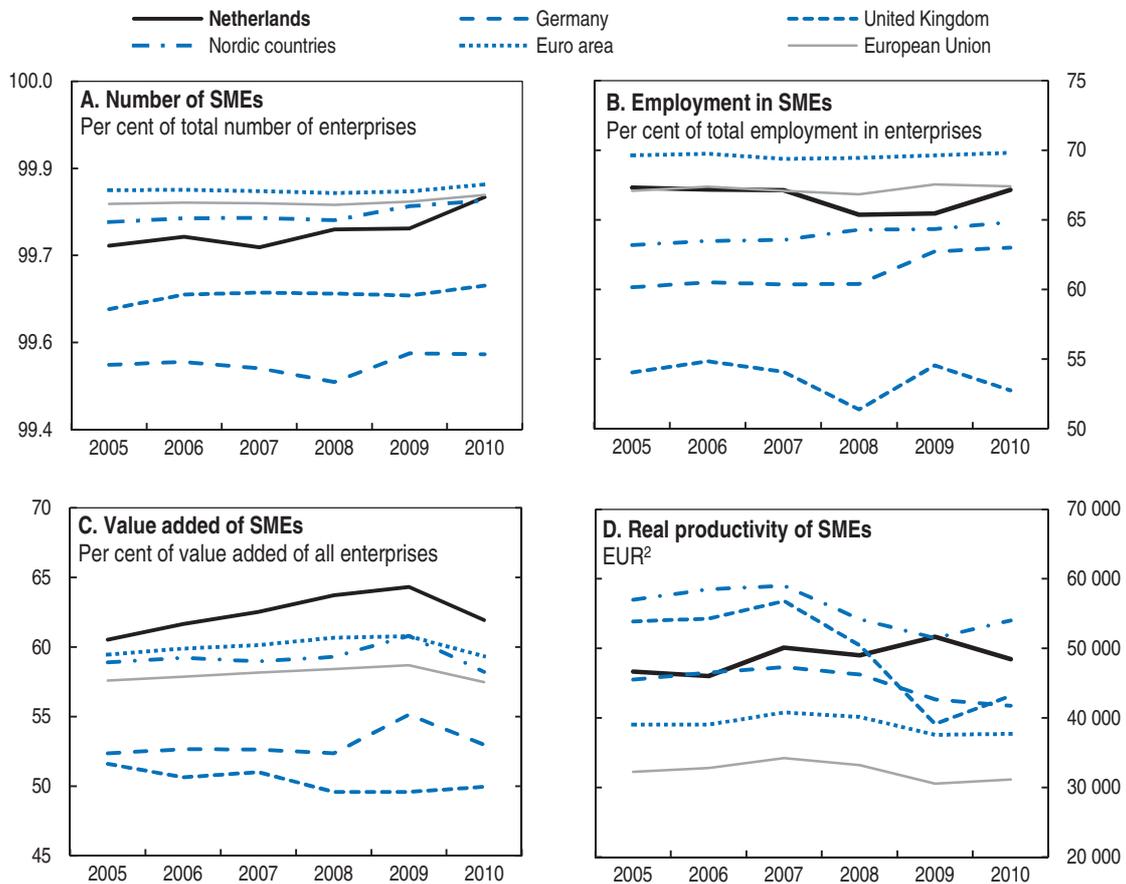
To reduce potential costs of resolutions for taxpayers and depositors, link capital requirements to the level of asset encumbrance. Also, build a domestic resolution fund and a deposit guarantee scheme both funded *ex ante* by banks as foreseen at the euro area level to create a banking union.

Continue to improve targeting of social housing to low-income households through means tested rent increases and ease rent regulations in the private rental market by increasing the role of property's value in setting maximum rents, freeing rents in new constructions and deregulating rents for new contracts in existing dwellings.

Promoting the development of efficient and dynamic SMEs

In Europe, SMEs are defined as firms with fewer than 250 employees. As elsewhere, they play an important role in the Dutch economy as they represent 99.7% of all enterprises, about the EU average (European Commission, 2013b). They also account for about a 65% share of total employment and a slightly smaller share in value added, and have a significantly higher level of labour productivity than the EU and euro area averages. In the run-up to the global downturn, and in its early stage, the SME sector fared well in comparison with other countries in terms of number of firms, employment and value added (Figure 16).

However, SMEs have been hit hard by the crisis. Corporate failures have increased briskly due to a difficult economic climate and weak domestic demand. Also, access to bank finance is difficult in particular for start-ups, high growth and innovative firms (OECD, 2013g). Moreover, there are around one million self-employed, three quarters of whom have no employees (so-called ZZP-ers in Dutch). The development of dynamic SMEs is hampered by labour-market impediments and there is scope to improve the quality of SMEs by better exploiting their innovation potential and reforming taxation. Also, women entrepreneurs could play a more prominent role in SME expansion. For instance, women

Figure 16. **Small and medium-sized enterprise (SME) sector indicators**¹

1. The data cover the “business economy” which includes mining and quarrying, industry, construction, trade and services. The aggregates for Nordic countries (i.e. Denmark, Finland and Sweden), Euro area (i.e. EA15) and European Union (i.e. EU27) are calculated as unweighted averages.
2. Real productivity is defined as real value added (in euros) per person employed. Value added of SMEs is deflated by GDP deflator.

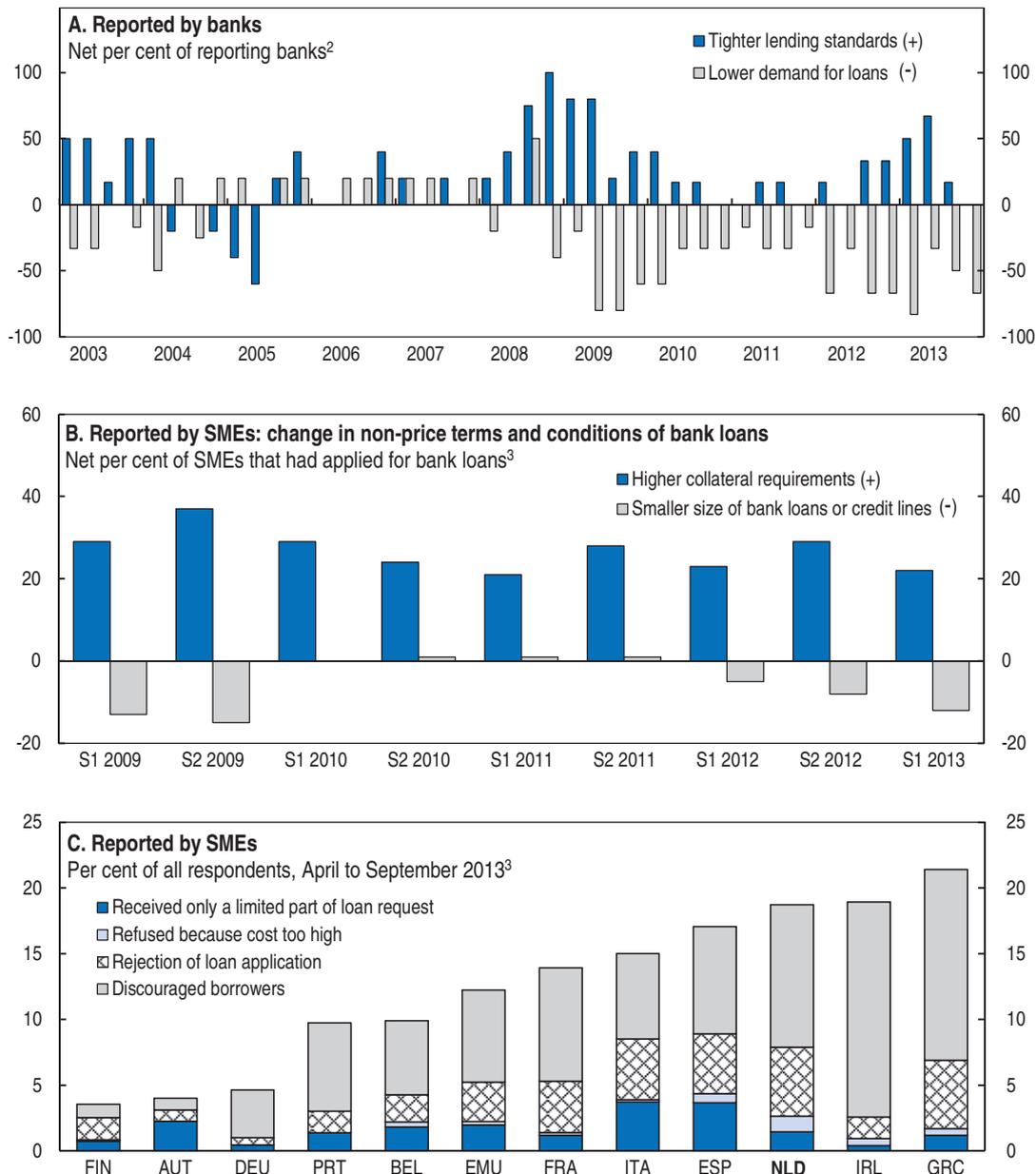
Source: European Commission (2014), *Annual Report on European SMEs 2012/2013* (database), DG Enterprise and Industry, January.

StatLink  <http://dx.doi.org/10.1787/888933029622>

are more represented in businesses with a lower turnover than men. However, women’s business creations appear to have been less affected by the crisis than those of men, which could partly be due to a higher propensity of the latter to enter sectors more affected by the crisis, such as construction or manufacturing (Piacentini, 2013).

Credit constraints facing SMEs are high

Dutch banks have been reporting reductions in loan demand since the beginning of the crisis, but they have also been rationing credit as lending standards have been tightened, mainly through stricter collateral requirements reported by SMEs (Figure 17, Panels A and B). In turn, tight credit standards have been weighing on business lending (Van der Veer and Hoerberichts, 2013). According to bank lending surveys, costs related to the capitalisation of banks have had a lower impact on lending conditions than poor industry, firm and economic outlook. Nearly 20% of all surveyed Dutch SMEs reported obstacles for receiving a bank loan around mid-2013, one of the highest ratios in the euro area (Figure 17, Panel C).

Figure 17. **Bank lending constraints for SMEs are high**¹

1. SME: Small and medium-sized enterprises. For Panels A and B, the values of net percentages may vary between +100% (e.g. all banks tighten their lending terms and conditions) and -100% (e.g. all banks ease their lending terms and conditions).

2. SMEs are defined as having a net annual turnover of less than or equal to EUR 50 million.

3. SMEs are defined as having 0-249 employees. First semester (S1) refers to the period between April and September. Second semester (S2) refers to the period between October and March. EMU: European Monetary Union.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", Statistical Data Warehouse, European Central Bank, March and DNB (2014), "Domestic MFI-statistics", Statistics DNB, De Nederlandsche Bank, March.

How to read Panels A and B: For Panel A, net percentage of banks reporting an increase (+) of lending standards and reporting increases (+) or decreases (-) in demand for loans. For Panel B, net percentage of SMEs reporting an increase (+) of collateral requirements and reporting increases (+) or decreases (-) in bank loans or credit lines over time.

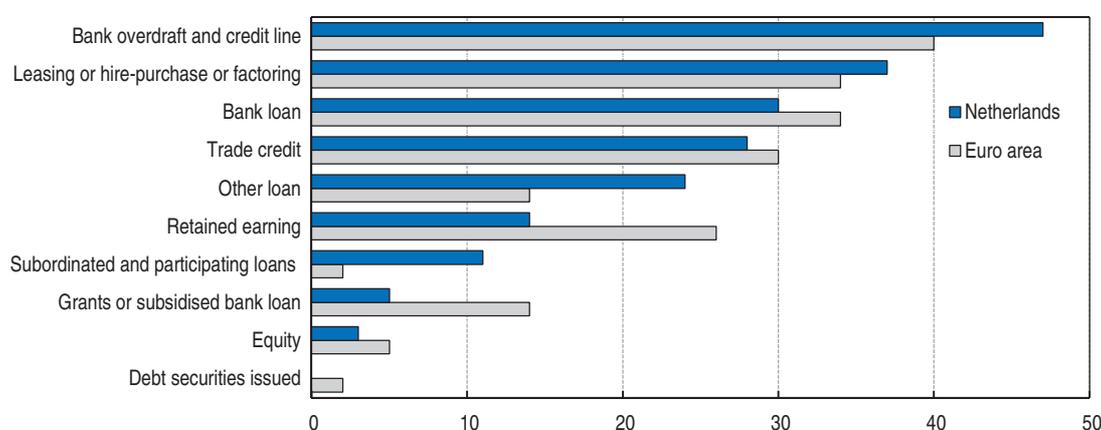
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Improving access to finance is critical

Ensuring adequate access to bank finance for viable SMEs is essential to support growth. Bank overdrafts, credit lines and bank loans are the most important sources of finance of Dutch SMEs (Figure 18). Even though bank lending is likely to remain a major financial channel, the authorities have undertaken commendable policy efforts to develop alternative sources of funding.

Figure 18. **Sources of external financing of SMEs**

Per cent of all respondents, April to September 2013¹



1. Figures refer to the following question: "Turning to the financing structure of your firm, to finance normal day-to-day business operations or more specific projects or investments, you can use internal funds and external financing. For each of the following sources of financing, could you please indicate whether you used them or not during the past six months?" Small and medium-sized enterprises (SMEs) are defined as having 0-249 employees. The category of subordinated and participating loans also includes preferred stocks and other similar instruments. The category of bank overdraft and credit line includes credit cards overdraft.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", Statistical Data Warehouse, European Central Bank, March.

StatLink  <http://dx.doi.org/10.1787/888933029660>

The government launched a number of programmes to ease access to finance during the crisis. These include higher guarantees to banks for lending to SMEs and start-ups with little or no collateral, and the possibility to delay the repayment of loans benefitting from state guarantees. Together with banks, the authorities started a microcredit institution, Qredits, in 2009. Public guarantees of equity stakes for venture capital investors and/or subordinated loans made by banks further eased small business finance. Other measures have aimed to stimulate direct public lending to new, fast-growing and innovative companies or to attract private investors (such as business angels) through public co-investments. More recently, public guarantees have been extended to non-bank institutions. The objective is to promote the development of credit unions or crowd funding, but also to entice pension funds and insurers into a planned SME financing fund and Netherlands Investment Institution. Steps to broaden access to finance are welcome and SME awareness about less used instruments could also be enhanced (OECD, 2013h).

SMEs face numerous market failures, which have become even more acute during the crisis, and the government has developed a range of instruments to overcome problems of access to finance. However, the type of projects eligible to state support could influence expected economic returns of public intervention. There is a trade-off between the levels of risk taken by the taxpayer and related potential economic benefits on the one hand, and

possible costs for the budget in case of failure on the other. The authorities should continue to evaluate policy instruments supporting access to finance while monitoring market inefficiencies faced by SMEs. Existing instruments should be adapted depending on results, but the government needs to avoid taking excessive risks. For instance, not all public guarantees for loans are being used in the Netherlands. If this reflects supply rather than demand problems and firms with strong economic potential are excluded from funding, then this would call for broadening access to guaranteed loans within well defined budget constraints. In parallel, to derive maximum efficiency and not to obstruct necessary restructuring of SMEs, the government should continue to seek high involvement of private sources of funding. Public money should leverage private money at different stages of firm growth, but only to offset well identified market failures.

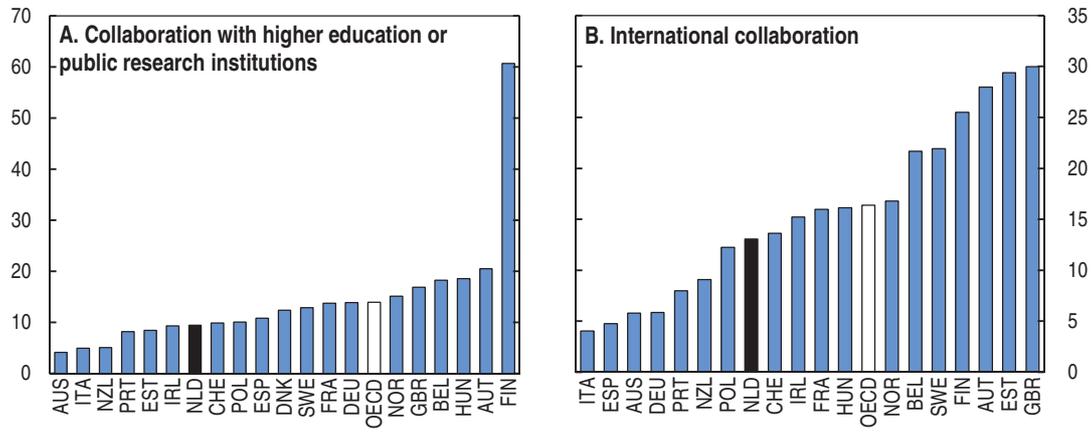
Fostering innovation

The Netherlands has launched an approach based on two complementary pillars to promote a healthy entrepreneurial system with innovation at its core. As discussed in a chapter on business-sector policies for the business sector to harvest the benefits of globalisation in the 2012 *Survey* and latest OECD Review of Innovation Policy (OECD, 2012; Gerritsen and Høj, 2013; OECD, 2013j), the aim is to enhance framework conditions for the entire business sector (the first pillar) and to develop sector specific policies to unleash research and development (R&D) and address bottlenecks hampering the growth of nine “top sectors” (the second pillar). R&D incentives for all firms are mainly available through indirect tax instruments, although direct support measures could be more suitable for young firms that may not have the upfront funds to start an innovative project (OECD, 2013i). There is a need to ensure that well established firms and industries within the “top sectors” do not effectively capture public support to the detriment of SMEs and emerging industries. The recent creation of knowledge and innovation contracts for “top sectors”, involving an easier access of SMEs to the “top sector” instruments through an SME innovation scheme (so-called MIT scheme), is a step forward. The approach in the composition and the number of “top sectors” could also be made more dynamic/flexible, both to promote the development of small businesses in the services sector or implementing non-technological innovation.

There is scope to further strengthen the collaboration of SMEs on innovation (Figure 19) and efforts are made in this direction by supporting the creation of networks and ecosystems. Empirical evidence suggests that small Dutch firms engaged in collaboration with public research institutions (PRIs) are more likely to expand their innovation potential (OECD, 2013j). PRIs can commercialise their research through licence fees, but it would be more affordable for young businesses if PRIs could also take equity stakes. Moreover, R&D spillovers could be bolstered by permitting students to own their inventions, encouraging free access to university inventions (in particular to unexploited patents), merging technology transfer offices into regional centres, and promoting PRIs’ funding schemes for faculty spin-offs and student start-ups (OECD, 2013k). More recently, the government has taken welcome steps to tackle the shortage of technicians with the adoption of a Technology Pact. This should raise the second-lowest share of graduates with a science or engineering degree in the OECD, reduce skills mismatches and enhance R&D spillovers benefitting SMEs.

Figure 19. **SMEs collaborating on innovation**

Per cent of product and/or process innovative firms, 2008-10¹



1. 2011 for Australia, 2006-08 for Ireland, 2009-10 for New Zealand and 2009-11 for Switzerland. SME: Small and medium-sized enterprises. The OECD aggregate covers 30 countries in Panel A and 28 in Panel B.

Source: OECD (2013), OECD Science, Technology and Industry Scoreboard 2013.

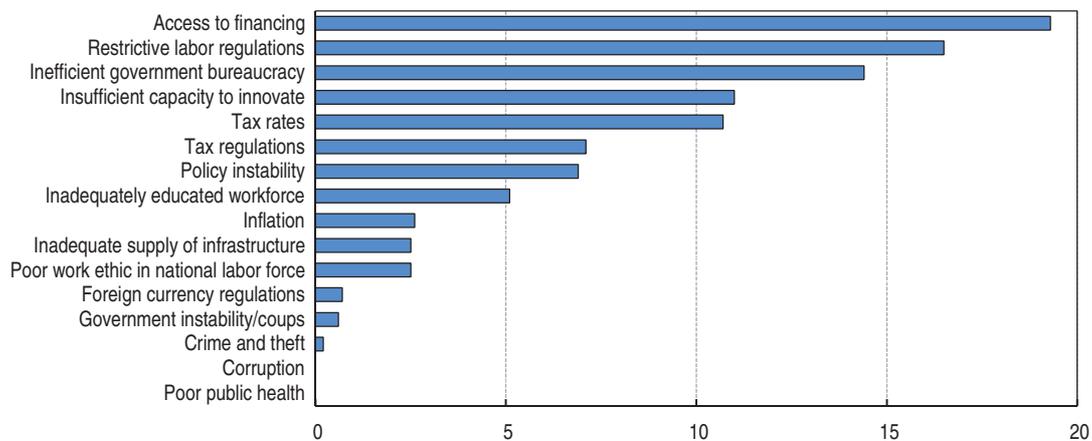
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Reforming labour market institutions

After access to finance, restrictive labour regulations are cited as the second most important barrier for doing business in the Netherlands (Figure 20). Lower employment protection legislation (EPL) promotes the development of high-performing SMEs by reducing the opportunity cost of starting an uncertain career as a business founder against a secure salaried job; could encourage a future firm to reach an optimal size (Van Stel et al., 2007; OECD, 2013); and it facilitates the reallocation of resources towards more productive uses and firms, which may enhance access of SMEs to the existing pool of skills and capital

Figure 20. **The most problematic factors for doing business**

Per cent of respondents, first half of 2013¹



1. From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: World Economic Forum (2013), *The Global Competitiveness Report 2013-2014*, Geneva.

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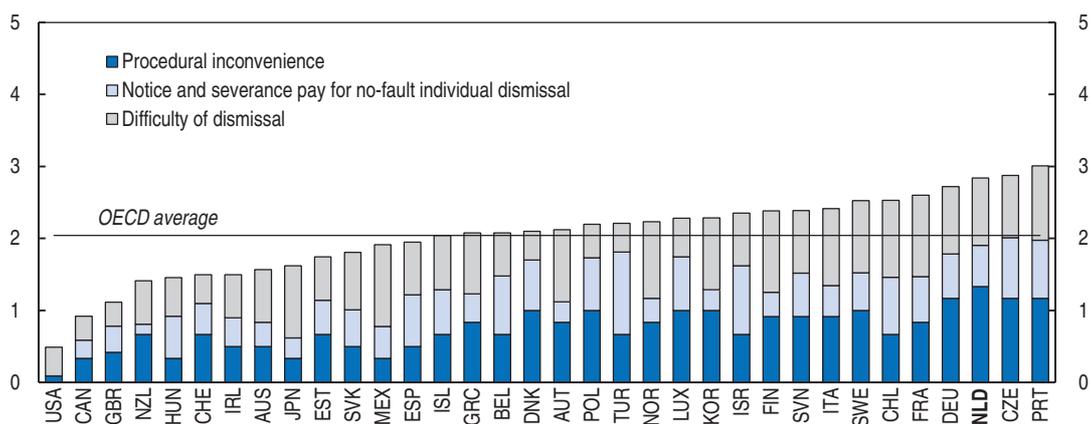
(Klapper et al., 2006; Martin and Scarpetta, 2012; OECD, 2009a, 2012, 2013m). As a result, adaptation to changes in technology or consumer demand is stronger (Bassanini et al., 2009) and the distribution of firms is more dynamic as risk taking and pressure on underperforming firms are higher (Bravo-Biosca et al., 2013). When the initial level of protection is high, positive effects of lower EPL are likely to outweigh its possible adverse effects on human capital investment or skill mismatches.

While self-employment can lead to a transition into salaried employment (CPB, 2011), tight labour regulations raise the incidence of last-resort self-employment for outsourcing purposes or owing to insufficient opportunities for salaried employment (Román et al., 2011, 2013). Stringent EPL also deters hiring decisions of self-employed with no personnel (Millán et al., 2013). Necessity-driven own-account self-employed have a lower entrepreneurial performance, run smaller firms and have weaker growth expectations for their businesses (Poschke, 2013). Yet, the share of necessity entrepreneurs appears to be relatively low and stable at about 10% in the Netherlands (De Vries et al., 2013).

Employment protection for regular contracts is extensive in the Netherlands (Figure 21). The authorities intend to increase the protection of employees on temporary contracts and to simultaneously reduce the protection of permanent contract. Plans to lower and cap severance payments and simplify dismissals would improve the labour market, as emphasised in the previous *Surveys* (OECD, 2006, 2008, 2010 and 2012), and would contribute to SME dynamism. Care is needed when reducing labour market segmentation by tightening the protection of temporary contracts as this may reduce needed flexibility for the development of SMEs, which on the other hand could also benefit from greater labour supply driven by unemployment benefit reforms. The overall impact of

Figure 21. **The strictness of employment protection legislation for permanent contracts is high**

Scale from 0 (least stringent) to 6 (most restrictive), 2013¹



1. Contribution of sub-components to the indicator for employment protection for regular workers against individual dismissal (EPR). The EPR incorporates three aspects of dismissal protection: i) procedural inconveniences that employers face when starting the dismissal process, such as notification and consultation requirements; ii) notice periods and severance pay, which typically vary by tenure of the employee; and iii) difficulty of dismissal, as determined by the circumstances in which it is possible to dismiss workers, as well as the repercussions for the employer if a dismissal is found to be unfair (such as compensation and reinstatement).

Source: OECD (2013), OECD Employment Outlook 2013.

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planned labour market reforms needs to be carefully evaluated and further action should be taken if needed. Employer-paid sickness leave of up to two years has sharpened firms' incentives to contain the growth of sickness leave and the number of disabled workers, but could constitute a barrier to growth and job creation of SMEs. The costs of disability and related uncertainty could be lowered by mutualising risks across SMEs, for example through a fund to which SMEs would contribute.

Reviewing the tax system

Self-employment plays an important role in the flexibility of the supply side and sustains entrepreneurial motivations. Tax policies have also encouraged the growth of self-employment (Van Es and van Vuuren, 2010). These include tax allowances for start-ups, the possibility for the unemployed to use welfare benefits to start a business and the opportunity for disabled workers to get an extra tax credit to become self-employed. The government had considered scaling back some tax reliefs, but these plans did not go through. Bringing social charges paid by self-employed to a level closer to the one levied on salaried workers (paid by both employers and employees) would help to ensure that self-employment is driven by genuine entrepreneurial motivation and would reduce incentives for tax arbitrage by employees and/or employers. The issue of levying pension and disability contributions on self-employed has recently been mentioned in the policy debate.

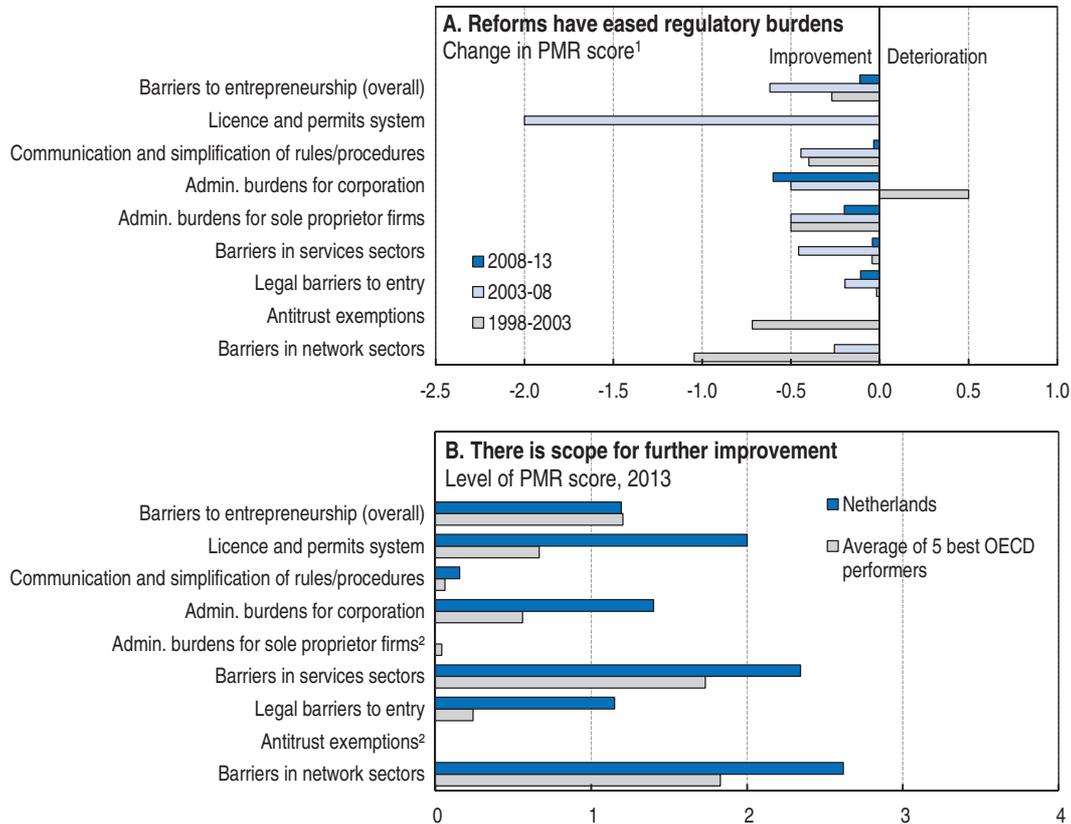
The current corporate income tax (CIT) system, with two rates at 20% and 25%, may act as a disincentive for SMEs below the tax threshold to grow. Also, a lower CIT rate for SMEs does not ensure that market failures are adequately targeted, as opposed to measures acting directly on the distortions themselves, such as grants or loan guarantees to address credit market imperfections or earned income tax credits to boost employment of low-skilled workers (IFS, 2010; Crawford and Freedman, 2010; OECD, 2009b; IMF, 2007). This would call for the adoption of a single CIT rate, but without increasing the tax burden on SMEs. In parallel, broadening the corporate income tax base would ensure a level playing field between smaller and bigger companies and hence increase the effective tax rate paid by the latter.

Lowering regulatory burdens

To lower administrative burdens, which involve comparatively higher costs for SMEs than for large firms, the government has launched a welcome rationalisation of its business support network. Barriers to entrepreneurship have fallen significantly over the last 15 years (Figure 22, Panel A), but there is scope for improvement compared to the average of five best OECD performers, in particular by easing access to licences and permits (Panel B). Licences could follow the principle that "silence is consent rule" and be issued automatically beyond administrative deadlines. Exit policies are efficient as they imply low time and cost to close a small business, but costs required to transfer property and enforce contracts could be lowered as they are comparatively higher than in other European countries (European Commission, 2013b). Enhancing access to public services through the internet would be an additional step forward.

Figure 22. **Product market regulation (PMR):
Barriers to entrepreneurship**

Index scale from 0 (least restrictive) to 6 (most restrictive)



1. There was no change in the PMR score for licence and permits system in 1998-2003 and 2008-13, nor for antitrust exemptions in 2003-08 and 2008-13, nor for barriers in network sectors in 2008-13.
2. For administrative burdens for sole proprietor firms the PMR score of the Netherlands is zero (i.e. least restrictive). For antitrust exemptions the PMR scores are zero.

Source: I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

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Recommendations to unleash SME dynamism

Key recommendations

Continue to evaluate policy instruments supporting access to finance in the light of existing market inefficiencies faced by SMEs and, if needed, ensure broader access to those instruments and in particular public loan guarantees.

Allow public research institutes to take equity stakes in young business, broaden access to academic research and increase the share of direct innovation grants to SMEs.

Reduce the protection afforded to permanent employment contracts by capping and lowering severance pay and by simplifying individual dismissals, as planned.

Recommendations to unleash SME dynamism (cont.)

Other recommendations

Consider converting the two-rate corporate income tax into a single rate tax system while not increasing the tax burden on SMEs and levelling the playing field between smaller and bigger companies by broadening the corporate income tax base.

Reduce the gap between social security contributions and coverage of own-account self-employed and employees and consider mutualising the costs of disability through a dedicated fund for SMEs.

Ease access to licences by issuing them automatically if they are not delivered by the end of the statutory response period and lower the administrative costs of enforcing contracts and transferring property.

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Chapter summaries

Chapter 1

Making the banking sector more resilient and reducing household debt

Dutch banks were put under heavy strains early in the global downturn and have comparatively weak financial buffers to cope with new shocks. Falling house prices have increased the share of households with negative home equity to nearly 35% for home-owning households and 40% for mortgage holders. Even though defaults have so far been limited, mortgage amortisation is low and risks are concentrated among younger borrowers who often do not have sufficient resources to cope with adverse shocks. Banks are very large relative to the size of the domestic economy, have sizeable cross-border exposures and rely significantly on wholesale funding. Resolution procedures should be strengthened to reduce the potential cost for the taxpayer and the regulator's tools available to reduce risks should be expanded. In particular, banks should set aside sufficient provisions for expected losses and problem loans, which requires some harmonisation of the definition of non-performing loans across banks. Higher capital buffers would bolster financial stability and help ensure access to market funding while lowering its cost. Welcome measures have been taken to encourage household deleveraging, but deeper and broader steps are needed to bolster financial stability and improve consumer protection when the housing market starts to recover durably and over the medium term. The stock of existing mortgages should be gradually converted into amortising mortgages, the cap on the loan-to-value ratio reduced significantly below 100% and housing subsidies to homeownership cut more decisively.

Chapter 2

Boosting the development of efficient SMEs

Entrepreneurship is an important driver of economic growth, job creation and competitiveness. However, the small and medium-sized enterprises (SME) sector has been severely affected by the crisis, with access to bank finance being particularly difficult. Various government-sponsored schemes have been introduced to ease credit conditions. Developing alternatives to bank lending options for SME finance is important but will take time. Restructuring banks' balance sheets is essential to step up bank lending to SMEs in the medium term. Beyond financing issues, boosting innovation would support productivity gains, and SME competitiveness and growth. Also, easing labour market regulation would further support SME development. A large share of small businesses consists of self-employed with no employees. The tax system should minimise distortions for the creation and expansion of businesses. Despite significant progress made in lowering barriers to entrepreneurship, there is scope to further reduce administrative burdens.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

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