# Assessment and recommendations

***Growth has slowed sharply and inflation has accelerated***

After several years of rapid economic expansion with relatively little inflationary pressure, the performance of the Dutch economy has deteriorated markedly since early 2000. Real GDP growth is expected to fall to around 1½ per cent in 2001, compared with nearly 4 per cent on average over the 1997-2000 period. The downturn appears to have been primarily due to external factors, as is typically the case in the Netherlands. But the way it gathered momentum early 2001 suggests that the abrupt slowdown of the US economy and the fall in global stock markets may have directly affected the Dutch economy through household and business confidence. These negative effects have more than offset the impact of the introduction at the beginning of the year of a major income tax reform, which included a shift from direct to indirect taxes and entailed a sizeable one-off boost to disposable income. As measured by the harmonised index of consumer prices (HICP), inflation started rising rapidly in 2000 and further accelerated at the beginning of 2001 due to the increase in the VAT rate and environmental taxes in the tax reform. HICP inflation seems to have passed its peak, but at 5.0 per cent (year-on-year) in October 2001, it still remained among the highest in the euro area, and also very high by Dutch standards. Core inflation (excluding food, energy, government levies and indirect taxes) has increased less strongly but it has nonetheless trended up to nearly 4 per cent in the course of 2001, reflecting the pass-through of rapidly rising labour costs.

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***The labour market is still very tight and growth in labour costs has picked up markedly***

The slowdown of the economy is still not fully reflected in labour market conditions. Owing to strong job creation, the unemployment rate has fallen to around 2 per cent. This is virtually the lowest rate in the OECD area and is well below the structural rate (NAIRU) estimated by the OECD Secretariat at some 4 per cent. With vacancies at a historically high level and shortages in many sectors of the labour market, the increase in contractual wages and compensation per employee has picked up markedly and the latter is expected to be of the order of 5 per cent in 2001. This is a disappointing departure from wage moderation, especially since wage claims seem to have largely disregarded not only the projected deceleration of the economy but also the increase in purchasing power brought about by the tax reform. As a result, in terms of unit labour costs, the competitive position *vis-à-vis* the euro area and all trading partners – which had admittedly reached unsustainably high levels – is expected to deteriorate markedly in 2001.

***The outlook is highly uncertain with growth projected to recover only slowly and wages expected to grow strongly***

Currently the outlook is rather gloomy and the high degree of uncertainty is reason for further worries. The driving force is likely to remain the international environment but the recent deterioration of competitiveness also plays a role. Under these conditions a central scenario would seem to entail a progressive stabilisation of the economy, followed by a hesitant recovery beginning only in the second half of 2002, lagging the pickup in other OECD economies and international trade. Real GDP growth is thus projected to rise moderately to around 2½ per cent in 2003, somewhat below potential growth. Hence, the positive output gap, which had prevailed for several years, is expected to be largely erased in 2001, and turn negative over the projection period. With one-off factors, such as the increase in indirect taxes and the impact of foot and mouth disease, out of the way and with lower oil prices, HICP inflation is likely to decrease significantly, and core inflation will also decline but more moderately. A slower pace of job creation and a rise in unemployment combined with lower profit margins can be expected to curb progressively the backward looking increase in wages and unit labour costs recorded in 2001. Nonetheless, the labour income share is likely to rise even further.

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***The current focus on the international situation should not divert attention from the domestic risk of excessive wage increases***

While at the moment the focus is on external risks and uncertainties, on the domestic side the recent departure from wage moderation is worrisome. Up to now, the increase in wages and labour costs *vis-à-vis* the euro area and, more recently, *vis-à-vis* all trading partners may have largely represented the normal adjustment process, entailing the reversal of earlier trends and a decrease in the Dutch competitive position to more sustainable levels. However, a lesser degree of wage restraint than incorporated in these projections could result in an overshooting of the adjustment process, entailing an excessive loss of competitiveness and an additional increase in unemployment. Given the rigidities in the Dutch labour market and social security system, this might again prove difficult to reverse.

***Automatic stabilisers can be allowed to work***

Since 1995, fiscal policy has been based on cautious growth assumptions for the medium term, with ceilings for the volume of public expenditure and a firewall between windfalls in revenues and expenditure. This policy has turned out to be very successful in turning a large budget deficit into a small surplus, mainly through exploiting large revenue windfalls, which were only partly distributed via tax measures aiming at increasing labour supply. From 1998 to 2001, the general government budget balance improved by 1.4 percentage points, moving to a surplus of 0.6 per cent of GDP, despite the economic slowdown, implying that the structural balance improved even more. A minor further improvement in the structural surplus can be expected on the basis of the budget for 2002, the last year the present cabinet will be in office, keeping fiscal policy on the track needed to pre-fund ageing related expenditure increases. During the next cabinet period, spending should continue to be kept in check but, given the improvement in the budget balance, expenditure ceilings can be based on trend growth with a smaller safety margin. This would open up the possibility of letting the automatic stabilisers work fully on the revenue side and reduce tensions between fixed expenditure ceilings on the one hand and large revenue windfalls on the other. Structural expenditure windfalls can continue to be used for necessary increases in spending. However, a smaller safety margin also calls for (larger) amounts to be reserved below the expenditure ceiling, in order to maintain

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both a smooth budgeting process as well as and the priorities set for the medium term in the coalition agreement.

***Population ageing requires pre-funding future expenditure increases,...***

Population ageing will reduce economic growth and increase resource transfers to the elderly. This will put pressure on the retirement-income- and healthcare insurance systems. The Netherlands is better placed than most OECD countries to meet these pressures because it has a large, funded occupational pension system. Even so, the government budget balance is projected to deteriorate when the baby boom generation passes into retirement. The government should adopt the policy of pre-funding these outlays that it is considering. This would entail maintaining a budget surplus of 1¼-1½ per cent of GDP over the next quarter century, by which time government debt would be eliminated. As demographic developments cause expenditures to rise from 2010 onwards, it would be preferable to do some front-loading of debt reduction over the coming decade. On this basis, a surplus of 1¼ to 1¾ per cent of GDP should be targeted in the next government period.

***... careful monitoring of capital market risks...***

One of the uncertainties surrounding the scale of advance funding required, both for the government and for pension funds, concerns capital market returns. The Netherlands Bureau for Economic Policy Analysis (CPB) made its projections on the basis of historical averages over the past century. However, it could be argued that population ageing may reduce returns for the baby boom generation. Lifecycle models of savings behaviour in an ageing society, when applied to the OECD area as a whole, would suggest that returns on accumulated savings for the current baby boom generation may be low relative to historical averages, because, in some sense, baby boomers are in a position of having to buy assets high and sell low. However the empirical support for such models remains relatively weak. Also other factors – especially diffusion of ICT – could well increase returns. While there is considerable uncertainty about the relative magnitudes of these effects, current asset prices do not appear to be compatible with historical rates of return. If current below-average returns were to be maintained, this would have significant implications for the amount of pre-funding required by pension

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funds and the government. For the time being, it is too early to conclude that future rates of return are unlikely to match historical rates. However, if it does become clear that this is likely to be so, action should be considered early, entailing increasing funding and/or reducing pension entitlements, amongst other things, so as to minimise the impact on labour costs and/or give people time to adjust to possible changes in pension entitlements.

***… and reforms to work longer and making older workers more attractive to employers***

Coping with population ageing also requires increasing labour force participation in general and of older persons in particular. With the first of the baby boom generation now entering their 50s, the returns from removing incentives for early retirement and barriers to working beyond the normal retirement age will be particularly high over the next two decades. To enhance the employment rate of older people, which is close to the low EU average, the phasing out of fiscal provisions favouring early retirement should be accelerated and pay-as-you-go early retirement schemes arranged by the social partners should be converted as fast as possible into actuarially neutral fully-funded pre-pension schemes. The government could accelerate this process directly, in its role as an employer, and indirectly, by refusing to extend clauses in collective agreements relating to such pay-as-you-go schemes to the rest of the respective industrial sector. In addition, the duration of unemployment and higher first-stage disability benefits for older persons should be brought more into line with those of the rest of the population. Government measures to increase demand for older workers, like cutting employers' social security contributions for them – with the size of the cuts possibly increasing with the age of the worker – may be acceptable as a second best policy only to the extent that inflexible seniority based wage scales cause a problem. To complement the measures to enhance longer working lives, older workers must become more attractive to employers. Ideally, this calls for wage scales being less dependent on seniority and greater scope for flexible employment contracts beyond the normal retirement age. To be acceptable, this would require modifying the close dependence of pension entitlements on the last wage that characterises most of the present defined benefit pension plans. In addition, older

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workers will need to make greater efforts to improve their productivity, notably through increased participation in job-related training, which again requires longer working lives increasing the expected period during which training investments can be amortised. These changes, together with the reforms to reduce incentives for early retirement would give a considerable boost to the employment of older workers.

***The income tax reform has reduced unemployment and poverty traps, but incentives to work need to be strengthened further…***

Quite aside from the longer-term importance of increasing participation of older age cohorts with a view towards the ageing of the population, improving the functioning of the labour market should remain a high short and medium term priority. In this respect the large pool of "inactives" – working-age benefit recipients not seeking a job – remains a weak point of the Netherlands economy. A sustained increase in the overall employment rate in full-time equivalents would also provide some offset to the reduction in the trend growth of per capita GDP that population ageing will cause. The personal income tax reform, which was introduced at the beginning of 2001, was a step in the right direction since it included a general tax credit for working persons (or earned income tax credit) with no phasing out income range. This, combined with other features of the reform, notably lower marginal tax rates, reduced both unemployment and poverty traps by lowering replacement rates, while not raising the tax wedge on labour further up the wage scale. There is, however, a trade-off between avoiding such distortions by not targeting, and the strength of the incentives that can be provided within given budget room. In particular, incentives to work, especially for older age groups and at the lower end of the labour market, need to be strengthened further.

***… and vigorous measures need to be taken to prevent working-age persons from leaving the labour force prematurely…***

A new and very detailed eligibility requirement system for screening new disability claimants aimed at reducing the inflow into this scheme is to be phased in progressively. However, given the many disappointments with past initiatives in this area, a more stringent approach may well be necessary. An independent commission appointed by the government (the Donner Commission) has recently made a number of suggestions centred around the idea of restricting the disability scheme to totally and permanently disabled

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persons, with permanently but only partially disabled persons being covered by a private employers' insurance. Another suggestion of the Commission is to require both employers and sick employees to take all the necessary measures to prevent, as much as possible, the latter from reaching the point of applying for a disability status. While the Donner Commission may not have provided a full and entirely viable answer to the problem of disability, some of its suggestions will no doubt be included in future policy initiatives. However, if the introduction of a private scheme for partially disabled persons is proposed, it will be important, especially if this new scheme is to be co-managed by the social partners, to prevent a relaxation of eligibility criteria and the topping-up of benefits with an administrative extension of these provisions to whole sectors – lest this scheme becomes the new route into the welfare system. (At the same time, the existing practice of topping-up benefits in the first year of sickness, which reduces incentives to work, should be discouraged.) Also measures have to be considered to avoid that the requirement that employers take all the necessary measures to prevent the transition of sick workers into the disability scheme is circumvented by hiring through temporary work agencies. Ideally, this loophole should be closed by requiring temporary work agencies, like normal employers, to take the necessary measures to enhance the reintegration of sick workers without, however, changing the nature of these agencies as suppliers of flexible labour.

***… but the real challenge is to return at least some of the inactives to the labour market***

Although the emphasis should be on stemming the flow into inactivity – especially through stricter eligibility criteria and more appropriate incentives – measures taken in this respect should be extended to the "stock aspect" of the inactivity problem, *i.e.* the return of at least some of the inactives to the labour force. This may seem a daunting task since a large proportion of these persons is over 50 and, having been away from the labour market for several years, their "employability" is probably rather low. Nonetheless, given that tensions in the labour market are expected to persist, despite the slowdown of the economy, and that the effects of population ageing are beginning to be felt, there could hardly be more favourable conditions for tackling the

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stock aspect of reintegration. The authorities have estimated at 375 000 the number of unemployed and partially disabled persons (some 5 per cent of the labour force) deemed capable of returning to the active labour force within one year, provided they are assisted by an appropriate reintegration programme. It would thus seem imperative to try a wide-ranging approach which, supported by specific programmes of counselling and retraining, would rely essentially on financial incentives but also on some penalties. As regards incentives, the government should consider correcting them through a major reduction in unemployment and poverty traps to be achieved by replacing various income-related subsidies which increase the purchasing power of inactives with a strengthening of the recently introduced earned income tax credit – a measure which would help correct both the stock and flow aspects of inactivity. Penalties could include reinstating normal job search requirements for unemployed 57½ and older and better enforcing these requirements also for certain categories of persons on social assistance, and introducing a re-examination process for all "disabled" already in the scheme.

***A number of other labour market measures needs to be implemented***

Other promising labour market measures already on the agenda of the authorities and which should be pursued vigorously include: increasing the role of private placement agencies in the activation process; beginning reintegration efforts already during the first year of sick leave before a person can apply for a disability status; creating adequate childcare facilities; and progressively reforming the educational and vocational system and introducing life-long learning programmes to improve the quality of the labour force and to minimise labour mismatches. Moreover, especially if labour market conditions were to ease somewhat, opportunities should not be missed to lower bottom pay scales towards the legal minimum wage, and to effectively use them as well as "opening clauses". But in the near future, given the pressing need to reduce the risk of overshooting wage adjustment, the authorities and the social partners should consider relying more on measures with an immediate impact, such as relaxing working time legislation and related provisions in collective wage agreements. Furthermore, measures to reduce the effective entry barriers for

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foreign workers with specific skills, in particular from countries outside the EU, should be considered.

***Increasing productivity growth is the key for long-term growth, and raising productivity would also ease the burden of population ageing***

As a result of population ageing, productivity growth is set to become by far the most important source of economic growth. Already in the coming cabinet period, economic growth will be more dependent on productivity growth than on employment growth. This makes fostering higher productivity growth the key to sustained improvement in living standards. Higher productivity will also make it easier to cope with population ageing in so far as it would facilitate de-coupling of government expenditure from GDP growth, as has occurred over the past two decades. Moreover, it could ease pressures on defined benefit pension schemes as it would increase contributions without necessarily raising pensions – boards of pension funds can decide partially or fully to suspend indexation (usually to wages) for a specific period of time if necessary. It will thus be important to continue to implement the comprehensive productivity growth strategy currently followed by the government– including the diffusion of ICT – based on a combination of actions aimed at strengthening economic and social fundamentals, improving the functioning of markets, fostering innovation, investing more in human capital and stimulating firm creation.

***Competition is key for the introduction of productivity increasing technologies…***

Nevertheless, the Netherlands has not experienced a "new economy" surge in productivity growth, in contrast to the United States, or within Europe, to Ireland or Finland: labour productivity growth in the Netherlands only recovered slightly in the late 1990s. Compared to the United States, this difference mainly reflects a much smaller increase in information and communication technology (ICT) capital intensity. Incentives to make such investments appear to have been weaker in the Netherlands because ICT prices are higher, product market competition is less intense and restrictive labour market legislation limits the scope for firms to reorganise to use ICT profitably. As discussed below, a range of product market reforms in the context of the Single Market programme is increasing competition and hence incentives to invest in ICT. However, these will need to be complemented by reforms to prohibit practices by ICT-hardware producers to segment markets if

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significant progress is to be made in reducing prices towards levels in the United States. In addition, it will be important to ensure that the recent reform opening the local loop of the telecommunications network to competition is effective, as this will have an important bearing on the costs of using ICT. Moreover, some easing in employment protection regulation could also make it easier for firms to re-organise their activities to take advantage of ICT.

***… requiring the implementation of reforms in the goods and services markets to be stepped up***

Structural reform, which has been one of the success stories of the Netherlands and an integral part of the Dutch model, seems to have lost momentum. However, to reap all possible synergies, corrective efforts in the labour market need to be accompanied by stepped-up policies to make the whole economy more efficient and dynamic. Rapid progress in tackling issues, which are important to the consumers and explaining the concrete benefits that can be expected from these measures, may impart a new momentum to the Market Forces Deregulation and Legislative Quality Project (MDW) which seems to suffer from reform fatigue. The phasing out of the Establishment Law looks like a promising initiative, since, according to a recent evaluation by the government, it is not an efficient and essential instrument in fostering the quality of entrepreneurship and, by setting minimum qualifications and other regulations for the creation of new enterprises, especially small ones, it acts as a barrier to entry with a potentially harmful restraint of competition. Other barriers to entry should also be dismantled, for instance by reforming the bankruptcy law, and reducing impediments for innovative entrepreneurs, such as lack of support during the start-up phase, lack of access to research facilities and limited venture capital. As regards network sectors, a lot remains to be done, for instance in the market for water services and in the energy sector, and other countries' experience has shown that, if carried out in an appropriate framework of supervision and regulation, liberalisation typically brings significant gains in efficiency, as well as lower prices. Hence, the government should confirm its intention of accelerating the liberalisation process in the electricity sector.

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***Transport infrastructure needs to be improved and used in a more efficient way***

The liberalisation process in the public transport sector has been especially slow and the current and prospective levels of congestion in rail and road traffic may increasingly become a threat to productivity and economic growth. Part of the answer lies in a more efficient use of the existing infrastructure. Hence, once appropriate regulatory and supervisory rules are in place, more market forces should be injected in the rail sector, and the authorities should convince public opinion to accept some forms of "road pricing". At the same time, additional investment in the infrastructure is urgently needed, particularly in the rail sector to improve commuting and domestic lines which, in recent years, have been somewhat neglected as a result of the concentration of investment in the high speed international rail line.

***Planned reforms in financial markets should be implemented rapidly***

In the context of rapidly-changing technologies, venture capital and the financial system in general may have an especially important role to play in the growth process by enhancing the emergence of new, innovative enterprises. Hence, it is essential to press ahead with several initiatives which are already in the pipeline and aim at strengthening financial markets by: making corporate governance more transparent with strengthened shareholders' rights; providing distressed firms with better instruments for restructuring via appropriate modifications to the bankruptcy law; and further developing venture capital. Moreover, the financial supervisory authorities should continue to closely monitor mortgage debt used to finance consumption which, given its rapid growth over the past few years, could have a destabilising impact on the financial system and the economy if there were a major downward correction in house prices.

***Further health sector reform is required, in particular to tackle the problem of waiting lists***

In the health sector, a full overhaul of the system is again in the forefront of public discussion, which may reflect a widespread desire to see a substantial improvement in the performance of the system, and notably a rapid correction of the problem of waiting lists. According to the authorities, there is a large consensus in the country to transform the present centralised and supply-driven system into a decentralised and demand-driven system. Although some major elements are still subject to political controversy, the

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general approach, as outlined in the plan recently submitted by the government to Parliament, looks promising and should be pursued vigorously, taking care to strike an appropriate balance between considerations of performance and efficiency and the principle of equity or equality of treatment which is especially important in the Netherlands. Meanwhile, the current gradual approach needs to be continued and accelerated. Specific areas where further progress is required include: an increase in the supply of medical staff (to be achieved mainly by removing obstacles to education, training and setting up practices); the definition of standard procedures and treatment in health care; the reliance on a therapy-based payment system for in-patients; and benchmarking health care institutions on a regular basis.

### *Summing up*

These are undoubtedly testing times for the Netherlands, with the economy moving away from sustained non-inflationary growth, which had been the hallmark of the Dutch model for nearly two decades. While the highly uncertain outlook is currently dominated by external considerations, domestic economic policy in co-operation with the social partners should be directed at preventing an overshooting of wage adjustment. Given the sound fiscal position, the automatic stabilisers can be allowed to work. To curb wage-price inflation as much as possible and pave the way for a much-needed return to wage moderation, the authorities need to do their utmost to step up structural reforms. In the labour market there is a pressing need to improve further incentives to work and strengthen reintegration efforts in order to: *i*) boost the participation rate of certain groups, such as benefit recipients, women and especially elderly people, *ii*) to lengthen working lives and hence *iii*) to raise the overall employment rate in full-time equivalents. Moreover, it is essential to create the right economic environment to boost productivity growth. Such reforms, together with the large amount of advance funding, would make the Netherlands better prepared to cope with the economic consequences of population ageing. It is essential for the Dutch authorities to back up these policies with a deepening of the reform process in product and financial markets in order to make the whole economy more competitive and dynamic, thereby steering the economy back to sustained non-inflationary growth.

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