

## **1 MAIN OUTLINES OF POLICY**

### **1.1 The Netherlands is working**

The Dutch economy is gathering momentum again. While 2005 was still a year of hopeful expectations, 2006 has provided tangible results. Economic growth will accelerate to 3<sup>1</sup>/<sub>4</sub>% this year, and should reach 3% next year. Wage moderation has improved the Dutch economy's competitive position again and is making a major contribution to the economic recovery. Employment is growing, unemployment is falling fast, the budget is tending towards balance, and purchasing power is increasing. In short, the Netherlands is working again. The long phase of the last economic downturn has come to an end.

Over the past years, the government has been committed – under the motto 'joining in, more work, fewer rules' – to strengthening the Dutch economy and making it more resilient. The implemented reforms were painful and sometimes triggered unrest. But the positive developments in 2006 have confirmed the administration in its view that the right choices have been made. Over the past economic cycle the Netherlands has performed above the euro zone average. The reforms have laid down a strong economic foundation, on which can be built in the coming years.

The government's main priorities in the 2007 budget are to further improve the economic structure, purchasing power, public safety and youth policy. All this within a framework of healthy public finances, now and in the future. The government aims to make enterprise and work more attractive by reducing taxes and social security contributions for businesses and citizens and by allocating additional funds to childcare. A broad and balanced package of purchasing power support will ensure that nearly all households will be around 1% or more better off. And the investments in public safety and youth policy will contribute to a safer and more favourable society for young people and future generations.

### **1.2 Economy back on track**

#### *Economy expanding*

The Dutch economy has left behind a long period of modest growth. At the time of the Budget Memorandum 2006 the omens were already good. It is now clear that they did not deceive us. Gross domestic product (GDP) will increase by a robust 3<sup>1</sup>/<sub>4</sub>% this year. And for the first time since 2003, employment is rising and unemployment is falling this year. For 2007 the Netherlands Bureau for Economic Policy Analysis (CPB) forecasts a GDP growth of 3%.

Revisions by Statistics Netherlands (CBS) also cast a more positive light on the recent past. It turns out that the economy did not actually contract in any year of the downturn, and that in 2004 and 2005 it performed better than the early figures suggested. The Budget Memorandum 2006 still assumed that GDP growth would average 1.1% per year between 2003 and 2006. It is now expected that the average growth rate will be 1.8% per year. The rapid recovery is even bringing the cumulative growth rate for the four years until 2006 close to trend-based growth. During this period the Dutch economy also expanded faster than the euro zone average.

The improving growth is a marked relief for citizens and businesses. Employees see their incomes increase, and job seekers find new opportunities for paid work. In the rich countries it is sometimes fashionable to question the importance of economic growth. But every economic downturn shows again that little or no growth exacts a high price, because many people are confronted with loss of income and greater uncertainty.

#### *Employment growing*

The economic recovery offers more people an opportunity to deploy their talents and energies on the labour market. According to forecasts by the CPB, the jobs total will increase by 260,000 in 2006 and 2007. And the number of unemployed is expected to fall by 140,000 over the same period. People who find another job or their first job will see a sharp rise in their income. People who move from benefit into paid work will experience a 15% increase in their purchasing power on average. So job finders are enjoying the juiciest fruit of the economic recovery, both from a social and a financial perspective.

#### *Purchasing power increasing again*

For other groups of citizens the recovery also manifests itself clearly in an improvement in living standards. Thanks to cuts in taxes and social security contributions and the introduction of the healthcare allowance, the incomes of 80% of the population – including the low income groups – will increase in 2006. Purchasing power will increase by 2% on average in 2006, one of the largest hikes in the last decade. The improving economy will bring a further boost in citizens' spending power in 2007. At 2% wage increases are expected to come out slightly higher than in previous years, and the pension funds will increase their payments more in line with wage trends. The lower EU contributions will also offer further scope for purchasing power support in 2007 (see section 1.4).

#### *Restored confidence*

The growth in employment and purchasing power are both the cause and the effect of revived confidence among consumers and businesses. Consumer confidence in the Netherlands rose sharply between June 2005 and June 2006, in fact more sharply than anywhere else in the European Union. Dutch consumers are more optimistic in particular about their chances of staying in work and about the future of the economy and their own finances.

### **1.3 Stronger out of the trough**

Citizens and business have gone through a difficult and uncertain period. But partly owing to the reform policies of the past years, the Dutch economy is now in better structural shape than three years ago.

#### *Sound public finances*

The public finances recovered quickly from the low point in 2003. For 2007 the budget balance is expected to come out at 0.2% of GDP. This would be a more favourable outcome than projected in the first Budget Memorandum prepared by the second Balkenende administration (see table 1.1.1). In this respect the Netherlands is performing significantly above the euro zone average, since most other member states still have substantial budget deficits. The reform policies have made a positive contribution to making the public finances sustainable. This is true in particular of the reforms in the social security system. The Netherlands has not passed on the bill for budgetary setbacks to future generations.

The foundation has thus been laid for sustainable public finances over the long term. The budget balance improved significantly between 2003 and 2007. As a result, next year's budget will show a small surplus. Because of the reforms of the past years, the budgetary gap compared to the sustainable balance has been reduced by 3½% of GDP. However, the CPB's recent study on ageing shows that a serious challenge still awaits the country in terms of reaching the sustainability of the public finances.

**Table 1.1.1: EMU balance, 2004 and 2007 (in % of GDP)**

	2004	2005	2006	2007
Budget Memorandum 2004	-2.3	-1.6	-0.9	-0.6
Budget Memorandum 2007	-1,8	-0.3	0.1	0.2

Euro zone average                      -2.8      -2.4      -2.4      -2.3

Source: Ministry of Finance, CPB, European Commission

### *New health insurance system*

The new health insurance system provides access to high-quality care for all. Pessimists warned that the introduction of the new system would push insurance premiums sharply upwards, erode purchasing power and undermine consumer confidence. This would harm the fragile economic recovery, it was claimed. Reality turned out rather more positively, however. The transition to the new system, including the payment of the healthcare allowance, proceeded without too many problems. The health insurance premiums have come out lower than expected, so that for many people the cost of their health insurance has actually fallen. This explains why the number of people who have a negative view of the new health insurance system has been declining steadily. It is true that the new system still has to prove itself over the longer term, but the first signs are positive and testify to a successful introduction. Furthermore, the government is also investing in improving care for the elderly. Between 2007 and 2011 additional outlays of more than EUR 400 million will be allocated to nursing homes to improve their management and productivity.

### *Stronger economic structure*

Over the past years, also in the years with low economic growth, the government worked hard to strengthen the structure of the Dutch economy. Substantial public investments in the road network, know-how and the environment went hand in hand with measures to ease bureaucracy and with far-reaching reforms of the social security system.

Since 2003 more than EUR 6 billion has been made available through the Economic Structure Enhancing Fund (FES) for investments in the knowledge economy, infrastructure, spatial development and sustainability. This is nearly twice as much as projected at the start of the second Balkenende administration. Specifically the money has been spent on intermediate vocational education (MBO), high-quality scientific research, mobility, air quality and sustainable energy, for instance. Private investment levels have also improved sharply since 2003. This will further boost productivity growth in the coming years.

Far-reaching reforms have been implemented in the social security system, such as the welfare benefit, occupational disability benefit, unemployment benefit and pension schemes. The stronger incentives to enter or stay in the labour market have reduced the level of benefit dependency. Thus the number of occupational disability benefit recipients has fallen from 980,000 in 2003 to an expected 860,000 in 2006, and a further fall is envisaged next year. A CPB study has shown that the new Work and Welfare Act (WWB) has led to a sharp fall in welfare benefit payments. Not least as a result of these developments, the number of people entering the labour market has increased between 2003 and 2006. The reforms will ensure a further decline in the number of benefit recipients in the coming years as well. This is a boon in both economic and social terms. In the coming years of economic upswing, the falling benefit dependency will create a broader tax base to help cope with the costs of the impending population ageing.

### *Improved public safety*

Public safety is at least as important an issue for citizens as the performance of the economy and the distribution of prosperity. Safety and prosperity are not unconnected. Generally speaking, economic stagnation goes hand in hand with higher crime rates and a greater sense of insecurity among the population. However, between 2003 and 2005 public safety actually improved. The number of victims of property crime and violent crime has declined by 10% since 2002, the prison cell shortage problem was overcome in late 2004, the efforts to deal with multiple offenders are proving successful, and citizens have a more positive perception of police performance. In 2002

around one third of the population did not feel safe at times. Since then this number has fallen to less than one quarter.

#### **1.4 Priorities for 2007: purchasing power, economic structure, public safety and youth policy**

In 2007, within the framework of sound public finances, this government will give priority to further improve the economic structure, purchasing power, public safety and youth policy.

##### *Increasing purchasing power and labour market participation*

The purchasing power trend for 2007 is positive across the board as a result of the improving economy and thanks to government measures. In 2007 taxes and social security contributions will be cut. This is possible as a result of the successful negotiations to reduce the Dutch contributions to the EU budget, which mean that the annual transfer to Brussels will be EUR 1 billion less in the future. This money can be used to lighten the tax bill of Dutch citizens and businesses.

Much of the cut in taxes and social security contributions for citizens will take place through the reduction in unemployment insurance contributions. The purchasing power of employees will also rise through an increase in the labour tax credit and a reduction in the rate of the first tax bracket. All these measures will ensure that work becomes more rewarding, especially at the bottom end of the labour market. A larger labour supply is also needed to prevent the labour market tightening up now that the economy is reviving.

Furthermore, a number of specific measures will be taken to support purchasing power. From 2007 an additional EUR 250 million will be made available annually for households with children. EUR 125 million of this will go towards reducing the parental contribution to childcare arrangements, and EUR 125 million towards increasing the child allowance. The employer contribution to childcare will also be made compulsory. These measures will support parents with young children. They will make it more attractive for them to continue working and developing their skills, also while they are looking after their children. The purchasing power of older people will be supported by raising the state pension supplement. Taken together, these measures constitute a broad and balanced package of purchasing power support, which will make average households nearly 1% or more better off in purchasing power terms.

Finally, the government will allocate just under EUR 100 million in additional spending on debt assistance. In this context the government will also take measures to prevent people from accumulating heavy debts, such as tighter advertising rules and curbs on excessive lending.

##### *Strengthening the economic structure*

In late 2005 the government published the policy paper "Working on Profit" ("Werken aan Winst"), which contained a package of measures intended to make enterprise and innovation in the Netherlands more attractive. The main stimulus for businesses in general and innovators in particular is the prospect of high net returns.

By cutting the corporation tax rate, the Netherlands is following an international trend. Although the rate is being cut in absolute terms, in an international comparative perspective this marks a necessary correction to maintain the Netherlands's strong position in this area. This correction is not only desirable to create and retain jobs in the Netherlands. A lower corporation tax rate also makes it less tempting for businesses to account for their Dutch profits in other jurisdictions.

The government will channel EUR 1.9 billion of the additional natural gas revenues through the Economic Structure Enhancing Fund (FES) into projects for spatial and economic development, education and innovation. An acceleration of infrastructure projects is an important element of

this. Investments will also be made in matching the outcomes of vocational education more closely to the demands of businesses, promoting research in the molecular medicine field, and making more efficient use of the main road network.

The economic structure will be further strengthened with an easing of the administrative burden for businesses. The government will take further measures to address the – justified – irritation by businesses with superfluous or unnecessarily complicated laws and regulations. These include simplifying health and safety at work regulations and introducing fixed times when changes to laws and regulations come into force. Furthermore, the separate demolition, building, exploitation, tree-felling and environmental permits will be replaced by a single “spatial permit” (omgevingsvergunning), and application processing times will be significantly shortened.

#### *Improving public safety*

The government wants to reinforce the trend towards greater safety. Resources will be made available for improving safety in the neighbourhood, through neighbourhood- and district-bound projects. The police budget will be increased with effect from 2007 and reapportioned, so that more account will be taken of the safety situations in the various regions. The government will also make additional resources available for the construction of a new secure unit for people detained under a hospital order (TBS), which will have 170 places.

#### *Investing in youth*

Investments in young people are the source of prosperity and safety in the future. Fortunately most youngsters are doing well at school and on the labour market. The trends are also favourable. Thus the number of early school leavers fell by 20% between 2002 and 2005, and youth unemployment fell from a peak of 13½% in 2004 to less than 10% this year. The number of early school leavers and the level of youth unemployment are still too high, however. It is therefore important to continue to invest in young people. That is why the compulsory school age will be raised to 18 years in 2007. And agreements have been made with the educational institutions and other stakeholders to reduce the number of early school leavers by another 10% this school year. If this target is met, there will be an additional 20,000 pupils in schools. Furthermore, more work experience places will be created (also another 20,000) and the move from pre-vocational secondary education (VMBO) to intermediate vocational education (MBO) will be made easier.

Besides additional outlays for education, the government will also invest in the whole youth and youth care chain. Thus more attention will be paid to “early warning systems” and parenting support for at-risk families, and another 350 places will be created in secure youth care units to receive and treat children with serious behavioural problems.

### **1.5 Confidence in the future**

In the past years, also when economic growth was low, the government worked hard to strengthen the Dutch economy and make it more sustainable. The government is convinced that its policies have been good for the Netherlands. The recent reforms have strengthened the foundations of the Dutch economy. The results of the reform policies are becoming visible, and will become more visible in the coming years. The policies pursued in 2007 will make further contributions to employment and purchasing power in the Netherlands. And the balanced budgetary situation will provide a sound basis for achieving sustainable public finances.

In the coming years international tensions, ageing, globalisation and technological advances will pose new challenges for the Netherlands. But thanks to the reforms, the Netherlands now finds itself in a strong starting position to face the future with confidence.

## 2 THE BASIS OF FINANCIAL AND ECONOMIC POLICIES

### 2.1 Introduction

The economic recovery is in full flow. The Netherlands is working again! The past years were not easy: unemployment rose, purchasing power lagged behind, and consumer and business confidence tumbled to their lowest levels since the early 1980s. Moreover, during this difficult period a number of far-reaching reforms were implemented. But all available figures show that better times are now upon us. The recovery is clearly visible on the labour market: in 2007 there are likely to be more jobs than in 2003, in fact more jobs than ever before.

The economic upswing brings higher employment and higher incomes. But a dynamic economy is crucial for a successful society for other reasons as well. Wealth is no guarantee of happiness, but for a range of reasons economic growth does constitute an important precondition. That is why the government has opted to promote economic dynamism and economic growth. And with considerable success, as is evident from the short- and medium-term outlook.

Government policy focusses on the the long term and is aimed at promoting efficiency and enabling citizens to develop and businesses to expand. These are deliberate choices. Choices will have to be made in the future as well, for instance in response to globalisation and ageing. But the experience of past years shows that it is possible to make the Netherlands stronger without having to give up key Dutch achievements.

### 2.2 An overview of the Dutch economy

#### *Economy gathering momentum*

The recovery of the Dutch economy has been gathering momentum roughly since the publication of the previous Budget Memorandum. Last year was still one of wait-and-see; after all, there had been false dawns before. But since the second half of 2005 all actual figures are moving sharply upwards, and by now the recovery is clearly visible in all areas of the economy. New figures from Statistics Netherlands (CBS) also show that the Dutch economy performed considerably better between 2003 and 2005 than was thought last year: growth during that period was actually more than  $\frac{1}{2}$  percentage point per year higher (on average) than was thought last year. At the low point of the downturn, growth was still positive. And the length of the economic downturn was also shorter than thought, two years instead of three. The forecasts for this year and next are very encouraging indeed. Unemployment in particular is falling fast<sup>1</sup>. This is good news for people who are still out of work at the moment. There is a risk that shortages will again develop in some parts of the labour market, which might choke off the recovery prematurely. This poses a constant challenge for the government and the social partners (i.e. employers' associations and trade unions).

#### *Broadly based growth*

The high oil price has not yet dampened international economic activity. World economic growth was very strong in 2004 and 2005 and is expected to remain on the high side over the coming period. Owing to the high pay increases up to 2002 inclusive, Dutch competitiveness had deteriorated considerably, so that the economy could not benefit optimally from the strong demand in the rest of the world. Even so, exports were still the main (almost the only) pillar of economic growth in the past years. This shows the importance of European integration and international stability for the Dutch economy. Exports will continue to play a major role this year and next, thanks in part to the gradual recovery in competitiveness (and also thanks to the wage restraint between 2003 and 2005). Exports are usually the main growth engine of the Dutch

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<sup>1</sup> For the forecasts for this year and next, see CPB, 2006, *Macro Economic Outlook 2007*.

economy in the early phase of an upswing. But by now private consumption and business investment are also reviving. This means that economic growth is now more broadly based. In 2006 and 2007 Dutch economic growth will again exceed the euro area average. This will more than make up for its lagging behind the average over the past years. Over the longer term (i.e. 15 years) the Dutch economy is also expanding well above the euroarea average.

**Box 2.2.1: Direct economic consequences of oil price hike still limited for now**

Oil prices have trebled since the turn of the century. However, in real terms (i.e. adjusted for inflation) the price records of the early 1980s have not yet been broken, and the dampening effect on economic growth has been relatively small thus far. There are several reasons for this. Firstly, oil prices have risen less suddenly than during the early 1980s. Secondly, most economies are far less sensitive to oil price hikes than during the early 1980s. (The oil price sensitivity of the Dutch economy has halved since the 1970s.) This is due to a more efficient use of oil and a decline in the relative importance of energy-intensive industries compared to the service sector. Thirdly, in contrast with the past, the current hike is due mainly to an increase in demand (sparked by the strong growth of the world economy, especially China and the United States) rather than to supply restrictions. And fourthly, credible monetary policies contribute to stable inflation expectations. As a result of these factors, there is only a small risk that the oil price hike will trigger a pay-price spiral.

The positive side of the current high oil and energy prices is that they will stimulate the development of alternative energy sources and will encourage users to be more careful with energy resources. After all, energy conservation yields more than during the 1990s, when prices were relatively low. At the same time producers are making record investments in exploration and refining capacity to keep up with demand. Technological advances enable oil companies to exploit existing oil fields more efficiently and to develop new fields. Let us quote an example from the past. In the mid 19th century there was great concern that whales would become extinct. This because whale oil was the most widely used energy source for lighting. When the price of a barrel of whale oil surged to a record level, the first oil well was struck. The actual and near extinction of some whale species was an ecological disaster, but the lights did not go out in the 19th century. The high prices ensured that alternative energy sources were tapped and developed<sup>2</sup>.

The expectation is that oil prices will remain high over the coming years. In the past period most of the available spare capacity has been used to meet the increased demand. Supply and demand are now closely matched, which means that a modest supply distortion can have a major price effect. Threats of terrorist attacks, the crisis in the Middle East and unrest in Africa and Latin America are responsible for a tight and unstable market at the moment. It is quite possible that persistent high oil prices will at some point start to have a greater dampening effect on economic growth. New technologies and alternative energy sources cannot be developed from one day to the next, and in the meantime the more expensive oil has to be paid for one way or another. Thus far, however, the high prices have had a surprisingly limited impact.

*Consumption and confidence*

Private consumption began to pick up again in the course of last year, and has been posting the strongest growth in years since the start of 2006. Consumption is supported by the employment growth and by the tax and social security contribution cuts. Over the past decade, average consumption growth exceeded the 2006 figure only in 2001 (largely as a result of the tax reform introduced that year). Household net total assets (total assets minus debts) are rising significantly again (by around EUR 90 billion in the first half of 2006). The consumption of durable consumer goods, such as electronic equipment, domestic appliances and furniture, has shown a definite upswing since the start of 2006. For 2007 private consumption is expected to increase at a similar pace.

The positive economic news is clearly reflected in consumer confidence, which has been firming steadily since September 2005. In fact, Dutch consumer confidence has been firming faster than in other EU member states. Consumers are more optimistic in particular about the current economic situation and the outlook for next year. Consumers' willingness-to-buy is also growing,

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<sup>2</sup> See Bardi, U., 2004, *Prices and Production over a Complete Hubbert Cycle: The Case of the American Whale Fisheries in the 19th Century*, University of Florence and Association for the Study of Peak Oil (ASPO).

albeit somewhat more slowly than the other indicators. This is not unusual in a recovery phase, as people do not want to count their chickens before they are hatched. Still, optimists have outnumbered pessimists in the Netherlands since June 2006. This is unusual, because over the longer term pessimists are invariably in a majority in the Netherlands, according to the CBS indicator<sup>3</sup>.

#### *More work and more people joining in*

The best and for many people most tangible result of the economic upswing is the turnaround on the labour market. During the last economic boom period, unemployment fell to an historical low (see figure 2.2.3). But as the downturn set in, unemployment surged, and the pain was felt mainly by the young, the ethnic minorities and the low-skilled. For them the recovery on the labour market is very good news indeed.

The employment figures look very good. Unemployment started to fall around September 2005, and since then seasonally adjusted unemployment has already declined by more than 80,000. According to the most recent CPB projections, unemployment will fall further, to an average of 345,000 in 2007 (equivalent to a more than 30% drop since the peak of 516,000 in early 2005). Everyone benefits from the improving labour market: youth unemployment is falling fast, but unemployment among the low-skilled and older people is also falling. The new jobs are concentrated in the market sector and in semipublic sectors such as the health service and the education system.

The labour supply is also developing positively. The labour market participation rates of women and older people continued to rise during the past period (despite the economic downturn). Another positive factor is that the number of benefit recipients is finally coming down. In 2007 there will be more work and more people will be joining in than in 2003. The lower unemployment and higher employment are largely due to the revival of economic activity, but the measures taken in the past years also help. Several analyses by the CPB provide evidence of the positive effect of the increase in the labour tax credit on labour market participation, and of the reforms of welfare and occupational disability benefit schemes on benefit dependency<sup>4</sup>. The abolition of the tax breaks on early retirement and pre-pension schemes is also contributing to a change in behaviour, and over the longer term this will raise the labour market participation rate among older people. All in all, then, many steps have been taken in the right direction. However, population ageing poses a permanent challenge in the area of labour market participation.

#### *Risk of a tight labour market*

During the last economic boom period, the Netherlands hit the limits of the labour supply. Every shopping street was full of "staff wanted" signs, and students who had not even graduated were tempted with bonuses and cars. The tight labour market led to high pay increases, which in turn caused a rapid deterioration in competitiveness. Even so, even at the top of the boom many people were still sitting at home receiving one social benefit or another and too many people with permanent employment contracts stayed in jobs where they were not as productive as they could be. Precisely now that the economy is performing better again, it is important not to forget the lessons from this period. Just as during the previous boom (which via a tight labour market ended in a prolonged economic downturn), the labour market is improving sharply at the moment, and there are already signs of overheating in some areas<sup>5</sup>. Moreover, over the longer term

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<sup>3</sup> This is also true for the German and US consumer confidence indicators, incidentally, so that it does not necessarily reveal anything about the Dutch national character. (In fact, over the longer term Dutch people are more optimistic than the average EU citizen.)

<sup>4</sup> See e.g. Ewijk, C. van et al., 2006, *Ageing and the Sustainability of Dutch Public Finances*, CPB Special Publication; 61; Mooi, R. de, 2006, *Reinventing the Welfare State*, CPB Special Publication 60; and Stegeman, H. and A. van Vuren, 2006, *Wet Werk en Bijstand: Een eerste kwantificering van effecten*, CPB Document 120.

<sup>5</sup> According to information from Nielsen Media Research, the number of job adverts in the first half of 2006 was 37% higher than in the corresponding period of 2005.

demographic trends such as dejuvenation and ageing will cause additional strains on the labour market. But history does not have to repeat itself. Firstly, the effective labour supply has increased further over the last few years, not least thanks to the reforms which have been implemented. Because the whole social security system now contains strong incentives to work, the economic recovery may well ensure that many people can make a permanent transition from benefit to paid work, which will relieve the pressure on the labour market. If the employers' associations and trade unions maintain their responsible attitude of the past years, they can also contribute to moderate pay trends, so that the upswing will not be slowed prematurely by excessive pay increases.

### *Mobility*

Labour market flexibility is not just about ensuring that people who are out of work can quickly find another job. At least as important is that people in work are actually in the right place. The Dutch labour market is relatively dynamic by international standards, and it is actually becoming more so<sup>6</sup>. Nevertheless, international comparisons also show that the mobility of Dutch workers on permanent contracts is still relatively limited, not least owing to the relatively strong dismissal protection legislation and sometimes generous collective labour agreement (CAO) terms and conditions which these workers enjoy<sup>7</sup>. The labour supply can be made more flexible by reviewing whether the overall package of rights and duties of employees and employers still meets the requirements of today's world. This poses a constant challenge for the social partners. The government has asked the Social and Economic Council (SER) to consider these issues in its recommendations on medium-term policy.

### *Businesses in good shape*

Despite the economic downturn, businesses have remained reasonably profitable over the past years (in contrast with previous recessions). By engaging in sometimes sweeping restructuring, Dutch businesses were able to adapt quite quickly to economic developments<sup>8</sup>. This relative flexibility – as well as policy effects – may provide an explanation for the remarkably strong recovery on the labour market over the last year or so. That is to say, because businesses had sorted themselves out, they were in a position to take on new staff at the first signs of an economic revival. Over the past years the government has invested heavily in further improving the business climate. The measures taken in this context also seem to be contributing to the rapid recovery in confidence. Indeed, in July 2006 businesses in the manufacturing sector were at their most upbeat since measurements began<sup>9</sup>.

### *Fewer rules*

The measures to ease the administrative burden for businesses are also helping to improve the business climate. Thus a single "spatial permit" (omgevingsvergunning) will be introduced in 2007, which will replace all the specific permits which businesses have to apply for if they want to extend the back of their premises, for instance. This approach has earned the Netherlands much praise internationally. Thus in its publication *Doing Business* the World Bank commends the Netherlands and advises developing countries to adopt a similar approach. And in a comparative study on bureaucracy the Organisation for Economic Cooperation and Development (OECD) highlights the Dutch method of reducing the administrative burden. And the European Commission has complimented the Netherlands in its latest review of progress on the Lisbon Agenda. In the meantime ever more EU member states are adopting or considering the Dutch method, which is based on quantifying administrative burdens on the basis of a standard cost model, and then setting quantitative reduction targets. Among those member states which have

<sup>6</sup> See Budget Memorandum 2006, p. 16.

<sup>7</sup> See CPB, *2006, Spring Forecast 2006*, and Bouman, M., 2006, *Hollandse overmoed*, Amsterdam: Uitgeverij Balans.

<sup>8</sup> See De Nederlandsche Bank (DNB), 2006, *Annual Report 2005*.

<sup>9</sup> Measurements started in 1985.

adopted the Dutch method are the United Kingdom, Denmark, Austria, Germany and the Czech Republic. The list of member states conducting trials with the method is even much longer.

*Outlook: steady economic growth*

The economic prospects for this year and next are encouraging indeed. For the subsequent years (2008-2011) the CPB projects a GDP growth rate of nearly 2% per year. This is reasonable, but certainly not spectacular<sup>10</sup>. The reform of the social security system also has a positive impact on the labour market participation rate in the CPB's projections<sup>11</sup>. Over the past years the greater participation has yielded a clear growth impulse, and the further increase in participation will make a positive contribution in the future as well. Even so, the positive impact of the labour supply on economic growth will be limited, because the ageing population will ensure that the total labour force will increase by less than in the past. But because the CPB does project an increase in labour productivity (to just above the average growth rate of the last 15 years), economic growth should reach a reasonable rate on balance.

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<sup>10</sup> CPB, 2006, *Het groeipotentieel van de Nederlandse economie tot 2011*, CPB Document 117.

<sup>11</sup> Vuuren, D. van and R. Euwals, 2006, *De structurele groei van het arbeidsaanbod op de middellange termijn*, CPB Memorandum 155.

## 2.3 The importance of a dynamic and flexible economy

### *Future growth mainly through higher productivity*

Economic growth arises from the deployment of more production factors (i.e. capital and labour) or through a better utilisation of those production factors (e.g. smarter working, innovation). In the decades after the Second World War the Netherlands was able to post strong growth by using additional capital and by adopting knowledge from more productive countries, “catching up” in other words. Since the 1980s the Netherlands has been one of the world’s most productive countries, so there is not much scope for catching up in that sense. A sharp rise in labour market participation in the 1990s was able to make another major contribution to economic growth. Indeed, thanks to the policies pursued, the participation rate is still rising (see section 2.2). But owing to population ageing, the additional deployment of labour will not be able to provide a growth impulse over the long term. Future growth will therefore have to come mainly from an increase in productivity. This requires a better utilisation and a higher quality of capital and labour. Knowledge and innovation will play essential roles in this respect. Work will have to be done more efficiently. Making the economy more dynamic is imperative in this context, which is why this has been one of the government’s main policy priorities in past years.

### *Preconditions for a dynamic society*

Each generation is preoccupied with the idea that natural resources are being exhausted and that all the best ideas have already been thought of. And hence each generation underestimates the potential for new ideas and applications<sup>12</sup>. Innovation is difficult to predict by definition, and therefore also difficult to manage. But the lesson of economic history since the Industrial Revolution is that innovation will take place as long as the conditions are conducive and as long as a society is sufficiently dynamic. Dynamism and flexibility are not just necessary, but actually inherent to a modern society. These insights were already elaborated in detail in the early decades of the last century by the Austrian economist Joseph Schumpeter<sup>13</sup>. They still apply in full today. Striving for progress is part of human nature, and is not a choice imposed from above. But it is up to government to create the right preconditions, so that all people have the opportunity to make the most of themselves, so that businesses have an incentive to produce and sell, and so that initiative and new ideas are rewarded.

#### **Box 2.3.1: More for your work**

One of the consequences of economic growth is that it provides more for your work. Thanks to technological advances, workers become more productive and they receive a higher remuneration for their work. At the same time most goods can be produced more cheaply (with less work, for instance). The upshot is that ever more originally “luxury” goods come within reach of ever more people. This point is also made by Schumpeter (writing in 1942): “The capitalist achievement does not typically consist in providing more silk stockings for queens, but in bringing them within the reach of factory girls”<sup>14</sup>. These benefits of economic growth become evident by looking at the number of hours which an average Dutch worker has to work to pay for certain products. A comparison of the outcomes for 1970 and 2006 shows the extent of economic progress over the last few decades.

The 1970 prices are taken from advertising brochures from that year. By dividing these prices by the average net pay in 1970, the “cost” of the product can be expressed in terms of the number of hours of work required to buy it. The same calculation was then made for 2006. The products in 2006 were selected to offer the best possible comparison with those from 1970, although strict comparisons are not always possible (because many products will be of better quality or have more features in 2006, for instance).

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<sup>12</sup> Romer, P.M., 2002, “Economic Growth”, in *The Concise Encyclopedia of Economics*, The Library of Economics and Liberty ([www.econlib.org](http://www.econlib.org)).

<sup>13</sup> His main work is Schumpeter, J., 1942, *Capitalism, Socialism and Democracy* (3rd ed., 1962, New York: Harper and Row).

<sup>14</sup> *Ibid.*, p. 67 (3rd ed.).

Nearly all products are more expensive in 2006 than in 1970. But the “price” expressed in hours worked reveals a very different picture. For instance, in 1970 workers had to work on average nearly 7.4 hours (almost a whole day) to pay for a down-filled pillow. These days they need to work less than 2 hours to buy this product. The rest of the day they can earn money for other things, or they can of course try out their new pillow at home ....

**Figure 2.3.1: Hours worked to pay for selected products, 1970 and 2006**

Package holiday to Lloret de Mar	68.4	34.9
Sofa (economy model)	59.0	24.4
Table fridge	37.2	15.0
Down-filled pillow	7.4	1.9
Hand-held mixer	6.0	1.8
Cutlery set	5.2	1.8
Sleeping bag (economy model)	4.4	1.9
Single inflatable bed	4.2	1.2
Men’s shirt	2.5	1.0
Quality ballpoint pen	1.6	0.3

Source: Advertising brochures from various department stores, internet shops, CPB, own research

The above list is only illustrative of course. For instance, it says nothing about housing costs and the costs of labour-intensive services such as healthcare. Housing costs have increased as a share of total spending, which means that workers now have to work longer for their home (although this is generally a better and larger home). But with regard to goods, it is true almost without exception that thanks to economic growth these now offer more value for money.

#### *Upward spiral*

Dynamism is not only crucial for sustained economic growth, it also has unmistakable positive side effects on a society. That is the crux of the argument by economist Benjamin Friedman in his book *The Moral Consequences of Economic Growth*<sup>15</sup>. On the basis of detailed historical research he concludes that economic dynamism and growth create more opportunities for all. What is more, dynamism and growth contribute to tolerance, social mobility, social policy, deregulation and more democratic decision making. When the economy is thriving, people tend to show more concern for the situation of the disadvantaged, and they tend to take more responsibility, have more personal freedom and have greater scope for participation. Economic growth thus also sets off an upward spiral: the improved prospects and the scope for initiative stimulate innovation, which in turn generates new growth. By contrast, lean economic times tend to lead to less tolerance, greater conservatism and greater introspection, and social and other innovations tend to be curbed or even reversed. As an example Friedman quotes the rise of extremist movements at times of economic stagnation.

#### *Money does not make happy, it seems*

Especially in rich countries – and especially when the economy is flourishing – it is sometimes fashionable to question the importance of economic growth<sup>16</sup>. Thus the British economist Richard Layard argues that people in the rich countries have not become any happier despite the economic growth since the 1950s<sup>17</sup>. One of the main reasons, he claims, is that people do not derive their happiness from absolute wealth, but from relative wealth. People compare themselves to the people around them, they push each other in an endless rat race, they are working ever harder to keep up with their neighbours. In the end no one becomes any happier from all this hard work. For that reason Layard concludes that the rat race should be diffused by

<sup>15</sup> Friedman, B.M., 2005, *The Moral Consequences of Economic Growth*, New York: Alfred A. Knopf.

<sup>16</sup> See e.g. the recent debate in the Netherlands in the *NRC Handelsblad*: first an article by Paul de Beer on 8 April 2006, then a response by Laurens Jan Brinkhorst on 15 April, an article by Cyrille Offermans on 27 May, the response by Piet Emmer on 24 June, responses by Offermans and De Beer on 1 July, and another response by Emmer on 8 July.

<sup>17</sup> Layard, P.R.G., 2005, *Happiness: Lessons from a New Science*, London: Penguin.

raising taxes, so that people are forced to enjoy their leisure time more. Layard's starting point is the individual's perception of happiness. People derive their happiness from all kinds of factors, such as love, hobbies, holidays, eating, relaxing, sex, religion or a goal scored by the Dutch football team. By no means all these factors relate directly to economic wealth. From this perspective, Layard has a point: money alone does not make happy.

#### *No prospects without a dynamic economy*

However, what is lacking in Layard's analysis are the positive consequences – the “external effects” – of the efforts of one individual on the prospects and opportunities of another. If businesses have no incentive to invest, workers will have fewer chances of a job. A benefit payment for one person is a tax payment for another. Workers who shirk on the job darken the outlook for their colleagues. A discovery by one driven scientist may bring a cure for many. Creativity, innovation and progress are the fruits of hard work. A society which discourages hard work and progress is exceedingly vulnerable. So Layard's recommendation to tax work more does not make sense. Instead, the Dutch government is committed to making the economy more dynamic.

#### **Box 2.3.2: Growth rate makes a big difference**

The importance of dynamism and growth are illustrated by the four long-term scenarios elaborated by the Netherlands Bureau for Economic Policy Analysis (CPB)<sup>18</sup>. Even in the least optimistic scenario – “regional communities”, with few institutional reforms, no trade liberalisation and a lack of competition – the Dutch economy will continue to expand over the coming decades, so that the Dutch people will become ever richer. But this rather undynamic scenario should not be welcomed. The average GDP growth per head in this scenario of around 0.7% is appreciably lower than what the Dutch have been used to, while unemployment will rise (to an average of 7.3%). A low growth rate is disastrous over the longer term in particular: because growth is exponential (i.e. growth on growth), small differences in the growth rate can have far-reaching consequences over the long term. This can be illustrated with a thought experiment. Let us assume that the Dutch economy had expanded according to the slow scenario since the 1950s. In that case the Netherlands would now have a living standard (i.e. GDP per head) below that of Estonia (and only just above that of countries such as Slovakia and Mexico)<sup>19</sup>. Moreover, the Netherlands would probably not have been a happy country. Over the last four years (2002-2005) average growth was actually higher than in the slow scenario, but this lean economic period was widely perceived as difficult and painful, with many people losing their jobs and most losing purchasing power. For these reasons the CPB's slow scenario is not an acceptable option for the government. Future generations also have a right to sound growth and a dynamic society.

#### *New certainties replacing old ones*

In the past years the government has invested heavily in improving the preconditions for a dynamic economic and society. This involved not only allocating more resources, through the Economic Structure Enhancing Fund (FES), for instance, but above all changing institutions. The measures that spring to mind here include those to improve the business climate, modernise the social security system, make the labour market more flexible (including facilitating the access of foreign knowledge workers), and make corporate governance more transparent. Where necessary the government has given new or innovative firms a helping hand by means of generic schemes, such as the tax break under the Research and Development Promotion Act (WBSO) and the reduced corporation tax rate on income from patents (under the “patent box”), or by means of specific schemes sponsored by the Ministry of Economic Affairs. The government has also invested more in education.

Policy aimed at making the economy more dynamic also means that old certainties disappear. Over the short term it may therefore seem that greater dynamism leads to greater insecurity. But

<sup>18</sup> Huizinga, F. and B. Smid, 2004, *Vier vergezichten op Nederland: productie, arbeid en sectorstructuur in vier scenario's tot 2040*, CPB Special Publication 55.

<sup>19</sup> Own calculation, on the basis of data from the Statistics Netherlands (CBS) and the International Monetary Fund (IMF).

modern society is like a bicycle: economy dynamism ensures that the wheels continue to turn, and as long as the wheels turn fast enough, the bicycle will remain stable. It is precisely the ability to change, the dynamism, that provides security. When a lack of dynamism depresses growth or even causes stagnation, society faces serious problems. For society as a whole, standing still (i.e. a lack of dynamism) means falling behind. Desperate efforts to maintain certain jobs in a certain sector may seem to enhance job security for a certain group of workers, but this will prove illusory. A lack of dynamism will lead to job losses in the longer term, and will therefore erode job security. The reform of the social security system may trigger unrest over the short term, certainly among those people who currently depend on benefit payments. That is why it is important to provide appropriate transitional arrangements (see section 2.4). But the reforms ensure that the system will be resilient and thus actually enhance its long-term stability.

## **2.4 Making choices**

In the past years the government has worked hard to further strengthen the Dutch economy. The economy has been made more dynamic, so that the outlook for the Netherlands has improved. This is good news for all Dutch people. At the same time, though, over the short term at least some measures have been painful for some groups of people. That is the inevitable consequence of making choices. After all, policy making always involves different interests, with the politicians having to weigh the various costs and benefits. On the basis of three classic tradeoffs we will illustrate the choices which the government has decided to make and what will be the consequences for the choice of making the Dutch economy more dynamic and strengthening its long-term growth potential.

### *2.4.1 Opting for the long term*

A well known tradeoff is that between the short term and the long term. Policy which is “good” or desirable over the short term is not necessarily so over the long or longer term. Investing in the future costs money in the short term, but it is hoped will yield more in the future. A lower official interest rate probably stimulates economic activity over the short term, but over the long term it will lead to higher inflation and greater instability. (This is why in nearly all countries responsibility for monetary policy has been devolved to an independent central bank, which will not be swayed by the issues of the day.) Policy makers always have to consider whether what is good over the short term will also be good for the long term, and vice versa.

The Budget Memorandum 2006 examined in detail the challenges arising from ageing, globalisation and technological advances. Although these are urgent issues which face the Netherlands already today, they are primarily long-term challenges which demand a long-term vision in policy terms. Government policy is therefore aimed primarily at the future: the modernisation of the social security system, the reform of the health insurance system, the strengthening of the public finances, the overhaul of immigration policy, housing policy, environmental policy, spatial policy, investments in physical infrastructure and in education and innovation. All these measures ensure that the Netherlands will be in better shape in the future. This in contrast to many other countries, which still have to start to address the long-term challenges.

### *Timing of the measures*

The reforms implemented by this government are good for the long term, but some have been painful over the short term. This pain was even more difficult to bear because some measures were carried out while the economy was struggling. Of course it is better to repair the roof when the sun is shining, rather than when it rains. But it is not wise to abandon the repair work as soon as the weather turns. Unfortunately it is very difficult to predict precisely when the economy will be in a cyclical upswing or downswing. Thus on the one hand the sharpness of the downturn in 2001-2002 was not predicted, but on the other hand it turns out that growth in 2003-2005 was around  $\frac{1}{2}$  percentage point higher per year than thought last year. When the second Balkenende

administration took office, it was clear that immediate action was required with a view to the long term. Waiting until the economic tide had turned favourably would have meant an indefinite delay and hence greater uncertainty. But it was clear that something had to be done. Delaying essential reforms means choosing the short term over the long term, and this is not the government's choice. Because the government took action immediately, the Netherlands can now benefit fully from the economic upswing. Now that the sun is shining again, the Dutch roof is in good repair. The Dutch economy is again expanding at above the euro zone average. The next government and its successors are now in a better position to make the Dutch house ageing-proof.

#### *Attention to short-term developments*

Opting for the long term does not mean that the government ignores short-term developments. Although purchasing power trends have been less than favourable in recent years, policies have been designed in such a way that the reforms have not widened income differentials (see section 2.4.2). More importantly, in part thanks to the measures taken, the labour market has been able to recover relatively quickly from the economic downturn. After all, over the long term, but certainly also over the short term, having a job is much more important for people's financial positions than a quarter of a percentage point more or less purchasing power (and much more important in terms of "happiness"). Furthermore, the formulation of transitional arrangements shows that the government cares about short-term effects and the social unrest which reforms can cause. (Examples are the transitional arrangements for older people drawing occupational disability benefit and unemployment benefit.) And when the tax breaks for the early retirement and pre-pension schemes were abolished, the government ensured that employers and employees had sufficient scope to agree transitional arrangements between themselves.

#### *The long term*

The government opts for the long term, without losing sight of the short term. Thanks to the measures taken, the Dutch economy is in better shape structurally. But this does not mean that this policy has now run its course. Choices between the short term and the long term will have to be made in the future as well. This is evident from the CPB's ageing study, for instance<sup>20</sup>. One of the conclusions of this study is that owing to the rising ageing costs, the public finances will be unsustainable under unchanged policies. Not least on the basis of these calculations, the Study Group on the Budget Margin, an official advisory group, has called for courageous choices during the next government's term of office<sup>21</sup>. Preventing the public finances from spiralling out of control will require a structural policy effort equivalent to around 3% of GDP. (This figure is based on calculations under certain assumptions about interest rate developments, for instance.) The Study Group suggests a combination of higher labour market participation, reform of the "ageing-related institutions" (i.e. state pensions and public healthcare), and "normal" cuts and savings to the government budget. Incidentally, in the past years a number of significant steps have already been taken towards making the public finances sustainable and able to cope with the strain of the ageing costs. Box 2.4.1 considers the importance of structural reforms for the sustainability of the public finances. Moreover, since the second Balkenende administration took office, cuts and savings have already brought about an improvement in the structural budget balance by over 2 percentage points. From this perspective, then, much has already been done during this government's term of office to enable the public finances – and hence the Dutch economy – to cope with population ageing.

#### **Box 2.4.1: Reforms good for older people's labour market participation and sustainable public finances**

In the past years the government has been strongly committed to a reform of social security. These reforms are aimed at raising the labour market participation rate of older people in particular. Examples are the

<sup>20</sup> Ewijk, C. van et al., 2006, *Ageing and the Sustainability of Dutch Public Finances*, CPB Special Publication 61; see also the other references in note 4.

<sup>21</sup> Study Group on the Budget Margin, 2006, *Twelfth Report: Ageing and Sustainability*, The Hague: SDU.

extension of the employer's obligation to pay sick employees, the tightening of the eligibility criteria under the Work and Welfare Act (WWB), the introduction of the Income according to Capacity for Work Act (WIA), the amendments to the Unemployment Insurance Act (WW), and the changes to the early retirement and pre-pension schemes. These reforms provide new incentives for both employers and employees to ensure that older workers will stay on the labour market for longer in the future.

The reforms also have positive effects on the sustainability of the public finances. Thus over the longer term the outlays on occupational disability and unemployment benefit payments will come out 2½ percentage points of GDP lower than assumed in 2000. By broadening the tax base for public services, the higher labour market participation rate will bring an additional improvement in sustainability equivalent to 1 percentage point of GDP. Taken together, the reforms implemented over the past years have improved the future sustainability of the public finances by 3½ percentage points.

#### 2.4.2 *Opting for incentives*

Policies aimed at achieving a more equal income distribution can undermine a country's economic performance<sup>22</sup>. The most striking example of this was the contrast between the capitalist United States and the communist Soviet Union. The wide income differentials in the United States acted as a strong incentive for people to work hard and to aspire to the "American dream". The upshot was a fast-growing and innovative economy (together with sometimes staggering income inequality). In the Soviet Union, equal distribution was the overriding priority, so that working hard was not or only barely rewarded (so that people were not stimulated to do their best or to invest in their knowledge and skills). In the Dutch context this tradeoff between equality and efficiency is reflected in particular in the debate on the "poverty trap" and the "unemployment trap". In part thanks to the income-dependent schemes (such as the rent allowance and the healthcare allowance), people on benefit may under certain circumstances be no better or only barely better off when they accept a paid job, and people on low pay are often no better off if they work more. The various measures aimed at income support thus discourage people from entering the labour market, which is bad for the Dutch economy. (It is worth noting, incidentally, that the poverty trap problem is more serious in the Nordic countries<sup>23</sup>.) Precisely because of the tradeoff between targeted income support and labour market participation incentives, it is difficult to close the poverty trap and the unemployment gap completely. The formulation of policy has to take account of this "dilemma between equality and efficiency", as the CPB's study *Reinventing the Welfare State* puts it. A high basic income for all would provide equality, but not an efficient means of redistribution. For in that situation large amounts of money would go to people who do not really need income support. And to achieve this, the government would have to increase the tax burden, which in turn would lead to serious distortions.

As mentioned in section 2.3, the government is opting for economic growth. But this choice does not have to be made at the expense of income equality, provided well designed incentives are in place. By international standards the Netherlands has a high degree of income equality, and surveys show that the Dutch people like it that way<sup>24</sup>. Although there is always a tradeoff up to a certain point, with carefully designed incentives it is possible to stimulate the economy without significantly widening income inequality or jeopardising income security. And that is what has been happening in recent years.

#### *Income distribution in an international context*

Redistribution by the government is effected through many instruments. The progressive tax system, coupled with the income-dependent allowances, is important. Thus a key feature of the new health insurance system is income solidarity, achieved through the healthcare allowance and the income-dependent contribution. According to a widely used measure of income inequality, the

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<sup>22</sup> A classic analysis is Okun, A.M., 1975, *Equality and Efficiency: The Big Tradeoff*, Washington: Brookings Institution.

<sup>23</sup> See Mooi, R. de, 2006, *Reinventing the Welfare State*, CPB Special Publication 60, p. 56.

<sup>24</sup> See e.g. the results of surveys conducted by 21 Minuten ([www.21minuten.nl](http://www.21minuten.nl)).

Gini coefficient<sup>25</sup>, income inequality in the Netherlands is comparable to that in United States at the level of gross incomes (i.e. before taxes and income transfers). But after taxes (and benefits, allowances and subsidies), income distribution in the Netherlands is far more balanced than in the United States<sup>26</sup>. The CPB has recently made a study of a broader measure of redistribution, taking into account the net profit of public spending on education, health and culture, and also taking into account the profit over a person's whole lifetime<sup>27</sup>. This shows, for instance, that the highly educated benefit relatively much from outlays on education and culture, while the lower educated in turn benefit more from public healthcare spending and the rent allowance<sup>28</sup>. The conclusion to draw from this is that the full range of public services leads to a considerable smoothing of income differentials in the Netherlands.

#### *Balanced income distribution*

The result of this redistribution is that income inequality in the Netherlands is very low by international standards. As measured by the Gini coefficient, the Netherlands has one of the most equal income distributions in the world<sup>29</sup>. What is more, a review of developments since 2003 suggests that income equality has narrowed further in the past few years. During this period households below the low income line have fared better than households above this line<sup>30</sup>. Over the slightly longer term (1999-2004) income inequality did not widen either, according to one study<sup>31</sup>. "Relative poverty" is also very low in the Netherlands by international standards. Eurostat uses incomes below 60% of the median income as a measure of relative poverty<sup>32</sup>. According to this criterion, relative poverty in the Netherlands stood at 12% in 2003 (the latest available figure), which was the same as in 1996 and one of the lowest in Europe. The number of households on low incomes<sup>33</sup> (based on benefit levels in 1979, adjusted for inflation) declined from 15.3% in 1993 to an estimated 9.7% in 2006.

In an international context the Netherlands also contributes towards achieving a more balanced income distribution between rich and poor. In August 2006 the Netherlands was proclaimed as the country which in relative terms makes the largest contribution to poverty alleviation across the world<sup>34</sup>.

The essential measures taken in the Netherlands to strengthen incentives have sometimes caused substantial income losses in individual cases. But they have not led to a general increase in inequality. In practice the Netherlands has thus found a good balance in the tradeoff between equality and efficiency, not least owing to a successful labour market participation policy.

#### *Work: the best medicine against inequality and for social integration*

The previous paragraphs concentrated on the redistribution of income. The focus on purchasing power is primarily a focus on the short term. But the most effective means of fighting income inequality over the long term is to raise labour market participation and reduce unemployment. To illustrate the point: people on benefit in 2004 saw their purchasing power increase by 0.2% that year, but people who moved from benefit into paid work saw their purchasing power increase by 15.1% on average that year<sup>35</sup>. These kinds of dynamic purchasing power effects are not visible in

<sup>25</sup> The Gini coefficient indicates the degree of equality or inequality of a particular distribution. With regard to income distribution the Gini coefficient shows to what extent the income is divided equally or unequally across the population.

<sup>26</sup> Mooi, R. de, 2006, *Reinventing the Welfare State*, CPB Special Publication 60, p. 49.

<sup>27</sup> Rele, H. ter, 2005, *Measuring Lifetime Distribution in Dutch Collective Arrangements*, CPB Document 79.

<sup>28</sup> Owing to the structure of the study, it was not sensible or possible to work with "high" and "low" incomes.

<sup>29</sup> See OECD, 2005, *Income Distribution and Poverty in OECD Countries in the Second Half of the 1990s*, OECD Social, Employment and Migration Working Paper 22.

<sup>30</sup> See Social and Cultural Planning Office (SCP), *Armoedemonitor 2005*, (Poverty Monitor) SCP Publicatie 2005/16.

<sup>31</sup> Irrgang, E. and M. Hoerberichts, 2006, "Inkomensongelijkheid in de eenentwintigste eeuw", in *Economisch Statistische Berichten*, no. 4483, 7 April 2006, pp. 152-154.

<sup>32</sup> It should be noted that by this measure, there would still be relative poverty even if everyone's income doubled.

<sup>33</sup> Social and Cultural Planning Office (SCP), *Armoedemonitor 2005*, SCP Publicatie 2005/16, p. 18.

<sup>34</sup> Center for Global Development (CGD), *Commitment to Development Index 2006*, www.cgdev.org.

<sup>35</sup> Source: CBS.

the “standard” purchasing power patterns, but they tend to have a much greater impact than small changes to the general purchasing power situation. Work not only helps to reduce social inequality (through the income derived from it), it also gives people an opportunity to display their talents and to integrate socially. As far as the stimulation of the labour supply and employment (and the reduction of benefit dependency) are concerned, the government sees no contradiction between equality and efficiency: higher employment is a win-win situation. The pay restraint over the past years, which has led to job creation, in this way also contributes to a more equal income distribution over the longer term.

In conclusion we can say the following. Making choices is always painful, but the choice for growth does not have to be made at the expense of a balanced income distribution. The Netherlands has shown that with carefully designed policies it is possible to pursue both goals at the same time. The CPB’s study on the future of the welfare state makes clear that further reforms will be required to respond to recent and future developments. But these reforms do not have to lead to an unacceptable increase in income inequality. If sensible choices are made, it is possible to maintain the Dutch combination of high prosperity and balanced income distribution.

#### **Box 2.4.2: Future labour market trends not necessarily bad for income equality**

Recently some quarters have been calling for attention to the labour market position of the low-skilled. They express the fear that the inequality on the labour market between rich and poor, between the high-skilled and the low-skilled, will increase in the future. It is certainly true that the labour market position of the low-skilled is generally worse than that of the high-skilled. This is also evident from the fact that, over the last few decades, unemployment among the low-skilled has been twice as high on average as among the high-skilled. And unemployment among the low-skilled is also more vulnerable to cyclical economic developments (when the economy is struggling, unemployment among the low-skilled rises faster because they often have only short-term employment contracts). However, over time the relative labour market position of the low-skilled has not deteriorated, and on closer study there are no convincing arguments why developments such as globalisation, technological advances or ageing as such should be bad for the low-skilled.

Many of the claims about the current and future problems of the low-skilled draw on the theory of “skill-biased technological change”. This theory states that technological change benefits the high-skilled, which means that demand for this group of workers will increase in relative terms. Consequently the low-skilled will lose their jobs more often, or will earn relatively less. The theory is appealing, because everyone can quote examples of lower-skilled workers who lost their jobs as a result of technological progress: a coffee machine replacing the coffee lady, a robot replacing an assembly line worker. Yet the figures do not provide any evidence for this theory. Despite the rapid technological changes, the relative labour market position of the low-skilled has not deteriorated over time. The main reason for this is that the average educational and training level of workers has risen. David Autor and others argue that it is the relative labour market position of semi-skilled workers which has deteriorated compared to both the low-skilled and the high-skilled<sup>36</sup>. The reason for this is that these workers perform a substantial amount of routine intellectual and physical work, which can easily be taken over by machines or computers. The same applies for the consequences of globalisation. Thanks to the internet, even intellectual work can now be traded more easily and more cheaply across the world. In the future the only work that cannot be traded internationally or cannot be replaced by machines will be the provision of personal services, such as in healthcare, home help, catering and the retail trade. And these are precisely the kinds of jobs which are open to the low-skilled<sup>37</sup>. And finally, it is important to realise that the category of “low-skilled” is changing: an average vocational student will be more adept at using a computer than most government ministers.

The higher unemployment rate among the low-skilled remains a problem. Another striking factor is that certain groups (especially non-western ethnic minorities) are overrepresented in the unemployment statistics. This problem requires constant attention from policy makers. All in all, however, there is no convincing reason why the relative labour market position of the low-skilled should lead to more inequality in the future. It is true, though, that the changing demand for skills (less routine work, more creativity, more

<sup>36</sup> See e.g. Autor, D.H., L.F. Katz and M.S. Kearney, 2005, *The Polarization of the US Labor Market*, NBER Working Paper, no. 11,986; Dew-Becker, I. and R.J. Gordon, 2005, *Where Did the Productivity Growth Go?: Inflation Dynamics and the Distribution of Income*, NBER Working Paper, no. 11,842; and for the Netherlands, e.g. Beer, P. de, 2006, “Kansen voor de onderkant”, in *Binnenlands Bestuur*, 10 March 2006, pp. 32-35.

<sup>37</sup> Blinder, A.S., 2005, *Fear of Offshoring*, CEPS Working Paper 119.

personal contact) will require additional attention from the education system in developing these qualities. This also applies to the low-skilled. The government then aims its policies at stimulating the overall labour market participation rate and job creation. This approach is ideal with regard to both equality and efficiency.

### 2.4.3 Opting for individual responsibility

The government wants to give citizens as much personal responsibility as possible. The reason for this is that it is convinced of both the limitations of public intervention and the significance of taking responsibility for people's self-development. The government cannot solve all the problems, it cannot make all the choices, it cannot eliminate all the risks. Nor should it want. It is often difficult or even impossible for the government to assess the real demand for a product or service<sup>38</sup>, and government interference discourages personal initiative and responsibility. It is therefore better to leave the choice to citizens wherever possible, and to leave the government to set the frameworks within which citizens can solve problems themselves or with others and do themselves justice.

International research shows that there is a very close correlation between liberalisation and privatisation on the one hand and economic growth on the other<sup>39</sup>. Taking responsibility is also good for economic growth, in other words. But taking responsibility is not an end in itself, nor does it mean that there is no role for government. The scope for taking responsibility is determined in part by the conditions which the government creates. In short, the literature distinguishes two possible purposes for government intervention. Firstly, government intervention is intended to increase efficiency (if no efficient outcome can be effected without government intervention); and secondly, government intervention is intended to redistribute wealth (if the distribution of wealth without government intervention is deemed politically undesirable). Government interference "from above" is sometimes desirable or necessary, but in some cases it can erode the personal responsibility of citizens. There is a tradeoff here as well.

The choice for responsibility is visible in many areas. Among the most striking examples are the health insurance system and the energy market. With the strengthening of competition in these sectors, providers are encouraged to operate more efficiently, so that consumers receive better value for money. Especially at the time of the introduction of the new health insurance system, there was criticism of its reliance on market forces and personal responsibility. Citizens were not keen on more choice and the uncertainty that would go with it, it was claimed. It was even predicted that citizens would collapse under the "choice stress"<sup>40</sup>. Since then it has become clear that these concerns were overly pessimistic (and overly paternalistic). During the introduction of the new health insurance system many people (acting individually or in groups) used their freedom to choose. Some 18% of people switched insurance company. This means that insurers will have to work hard to retain customers (not least through premium competition).

#### *Government sets the preconditions*

The government's choice for responsibility is not a blind choice for market discipline. In some ways the government plays a major role, for instance by creating the right conditions. Of course there are people who do not want to make a choice, and they are not obliged to. These people will simply remain insured with their current insurer or buy energy from their current provider. More generally, the government ensures that consumers do not lose out from freedom of choice, through "default options" (i.e. standard choices for people who do not choose), other major preconditions (such as the acceptance obligation in the health insurance system), and through regulation and supervision. This is how the new Consumer Authority will be able to take action against unfair trade practices in the future. Incidentally, it is worth noting that because some

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<sup>38</sup> See Teulings, C., L. Bovenberg and H. van Dalen, 2005, *De cirkel van goede intenties*, Amsterdam: University Press.

<sup>39</sup> For an overview of the literature, see Bouman, M., 2006, *Hollandse overmoed*, Amsterdam: Uitgeverij Balans.

<sup>40</sup> Hurenkamp, M. and M. Kremer (eds), 2005, *Vrijheid verplicht*, TSS Jaarboek 2005, Amsterdam: Van Gennep.

citizens exercise their freedom of choice, those citizens who do not actively make a choice also benefit from competitive premiums and charges.

The emphasis on personal responsibility is also clearly evident in the reforms of the social security system. Instead of deciding what people cannot do anymore, social security provision is increasingly based on what people still can do. (In this case, incidentally, responsibility is equally divided between employees, employers and the government.) In this way the social security system has become much more “activating” and makes greater demands on the initiative and responsibility of benefit recipients. After all, they no longer have a guarantee of state support, but are instead encouraged to shape their own lives. (For instance, unemployment benefit recipients are encouraged more than in the past to start their own businesses.) The state benefit schemes now offer a helping hand, which people accept to pull themselves up if necessary. The new social security system also makes greater demands on the sense of responsibility of employers. Under the Act on the Compulsory Payment of Salary during Sickness (WULBZ) employers are now obliged to pay at least 70% of a sick employee’s last pay for a period of up to two years. This gives employers an incentive to create good working conditions or to make serious reintegration efforts.

The choice for taking responsibility and against unnecessary government interference also plays a major role in reducing the administrative burden. This same is true for the management of the public and semipublic sectors, with ever more freedom being given to the professionals in the workplace. Instead of relying on patronising regulations from above, the government is increasingly concentrating on how to bring about the right outcomes.

The choice for taking responsibility applies not only to the relationship between government and citizens. The government and the other public authorities are also giving special attention to the best possible division of responsibilities between themselves. Ideally government intervention takes place at the lowest possible level, as close to citizens as possible. But this does not mean that all policy making can or should be decentralised. Under the subsidiarity principle, responsibility should be placed with the lowest possible tier of government, the level at which all relevant interests can be taken into account. Thus it can be left to the municipalities to devise solutions for the nuisance caused by loitering youngsters; this does not need a policy handed down from central government. By the same token, because environmental pollution often strays beyond national boundaries, it is logical that some aspects of environmental policy are formulated at EU level<sup>41</sup>.

A good example of the choice for more responsibility at municipal level is the Work and Welfare Act (WWB). The level of the welfare benefit payment is decided by central government. At the same time the new law makes optimum use of the advantages of implementing policies aimed at encouraging people to enter the labour market at local level, by means of a good financial model (centred on placing the macro risk with central government, an objective allocation of resources, and a strong incentive for the social security agencies). The key point is that the municipalities have financial responsibility in this area. Those who pay their own bills and do not pass on costs can have greater freedom to decide how to spend money and do not have to account for their expenditures. One result of this structure is that municipalities are focusing more on getting people into work instead of paying out welfare benefits. Together with close eligibility monitoring, this is bearing fruit: despite the economic downturn, the number of people on welfare benefit has not increased since 2004 and is now beginning to fall sharply. In a recent evaluation the CPB described the WWB as a success. It offers a good example of how to strike a balance between government intervention and personal responsibility.

## 2.5 Conclusion

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<sup>41</sup> See also the William of Orange Lecture, “Voortgaande decentralisatie geen automatisme” (“Ongoing decentralisation not a given”), delivered by the finance minister, Gerrit Zalm, on 28 May 2006; available at [www.minfin.nl](http://www.minfin.nl).

After several difficult years, the Dutch economy is steaming ahead again, and the prospects for this year and next are encouraging. Some optimism is certainly justified. Not least thanks to the political choices made in the past years, the Netherlands is in good shape. By international standards, the Netherlands still has high productivity, a high and sharply increased labour market participation rate, low unemployment, and equal income distribution. But now that the economy is performing well again is not the time to succumb to complacency. The previous economic boom ended with a historically long dip, and the past years were by no means easy. Over the longer term the Dutch economy still faces considerable challenges. Addressing these challenges means that clear choices have to be made in the future as well. Different objectives have to be weighed against each other, and making choices is always painful. That was also the case in the past period. Some of the reforms have been far-reaching, but at the same time the considered choices show that it is possible to make the Netherlands stronger without having to give up key Dutch achievements.

