Informatieblad

Budgetmemorandum 2006

Main outlines of policy

Contents

September 2005

1. Main outlines of policy

1.1 Improved outlook

The past few years have been difficult. Almost everyone has felt the economic downturn in their pocket. But by now the economic outlook has improved. Thanks to the measures taken in the past two years, the public finances are in better shape. There is scope in 2006 for cuts in taxes and social security contributions (worth more than EUR 2 billion), for outlays to support purchasing power, and for investments in knowledge, education, the environment and the physical infrastructure (via the Economic Structure Enhancing Fund, FES). At the same time the budget deficit will come out lower than projected in the previous Budget Memorandum: 1.8% of GDP instead of 2.1%.

The government has used the last two years to elaborate the reform agenda set out in the Global Agreement for Government Policy (i.e. the coalition agreement) and to turn it into legislation. The ongoing globalisation of the economy and the ageing of the population pose new challenges. By responding to these changes in time, the Netherlands will be able to address the problems they cause and also to exploit the opportunities they offer.

The reforms strengthen the structure and competitiveness of the Dutch economy. Doing nothing would mean people would soon wonder, with justification, why no decisive action had been taken. The government will therefore continue ‘full steam ahead’ with the implementation of the reform agenda. In 2006 the emphasis will be on carrying out the previously agreed measures.

1.2 Back on track

Economy picking up

The Dutch economy is expected to expand by 0.5% in 2005. Modest, but positive. And the underlying economic trends present a rather more encouraging picture. A number of important adjustment processes have been completed. The financial positions of households and pension funds have improved, labour cost increases have moderated, and corporate profitability has risen.

In 2006 the economy is expected to expand by 2.5%, the highest figure since 2000. This recovery is driven by higher exports. The improved profitability of Dutch businesses and higher business investment levels are also providing a positive impulse. Private consumption is rising, not least thanks to the government’s efforts to support purchasing power. Against this background, unemployment will fall in 2006 compared to 2005.

Public finances consolidated

The government took action quickly when the public finances had deteriorated unexpectedly at the start of its term of office. It took the measures in the realisation that the costs of ageing are already visible and are accelerating fast. The measures were sometimes painful and eroded consumer purchasing power. But they were necessary and they have been effective. In the meantime the EU Council of Ministers has stopped the excessive deficit procedure. And in its latest report the International Monetary Fund (IMF) has praised the Netherlands for its quick reaction to the budgetary problems. The Fund regards this as a sound basis for securing sustainable public finances, also over the longer term.

For 2006 the government has sought to strike a balance between consolidating the public finances, strengthening the economic structure, supporting purchasing power and facilitating an economic recovery. Now that the looming derailment of the public finances has been averted, no new round of austerity measures will be required. The previous measures provide scope for cuts in taxes and social security contributions and for outlays which support purchasing power. And all this within the financial frameworks of the Global Agreement for Government Policy. What is more, the government has adopted a package of investments to be financed by the Economic Structure Enhancing Fund (FES). The EMU balance should remain at the 2005 level. For all the years in this term of office the EMU deficit will come out lower than projected a year ago. Between 2003 and 2006 the structural budget balance will improve by an average of 0.5 percentage points of GDP per year.

Table 1.2.1 EMU balance, 2003-2006
In percent of GDP

	2003	2004	2005	2006
EMU balance, Budget Memorandum 2005	-3.2	-3.0	-2.6	-2.1
EMU balance, Budget Memorandum 2006	-3.2	-2.1	-1.8	-1.8

1.3 A helping hand

The difficult economic conditions of the past years have put almost everyone's purchasing power under pressure. Now that the government's financial position has improved, there is scope to support people's purchasing power. And because of the higher than previously expected inflation (due to the higher oil price and weaker euro), there is good reason to do so. The government's priorities in this respect are to protect vulnerable groups and to ease the burden on middle income earners with children, because the latter group's purchasing power has deteriorated sharply in the past years. The indexation of benefit payments to contractual pay increases will also be restored in 2006.

The government has allocated a total of EUR 2.5 billion to measures to support purchasing power. Box 1.3.1 gives an overview of these measures.

Box 1.3.1 Purchasing power support

The government has allocated more than EUR 2.5 billion to measures to support purchasing power in 2006, more than EUR 2.0 billion through cuts in taxes and social securities contributions and more than EUR 0.5 billion through additional outlays. The most salient measures are discussed below.

All taxpayers will benefit from an increase in the general tax credit by EUR 78. Employee contributions to the premium under the Unemployment Benefit Act (WW) will be reduced by more than 0.5 percentage points, with part-time workers even enjoying a slightly larger reduction. And the user element of the property tax will be abolished in 2006.

In 2006 the new health insurance system will be introduced. More than 6 million households will receive an income-dependent healthcare allowance to compensate them for the higher nominal health insurance premiums. This measure applies mainly to people currently insured under the Compulsory Health Insurance Act (ZFW). On balance most households will pay a maximum of 5% of their incomes on health.

The excise duties on petrol and other vehicle fossil fuels will remain unchanged in 2006, that is, they will not be raised in line with inflation as usual. Furthermore, the annual standing charge for domestic electricity users will be held at the 2005 level.

Because of the popularity of the renewable energy subsidy scheme, which is funded from the domestic user charge, this charge was in danger of nearly doubling from EUR 52 to EUR 100. This will be averted with a one-off contribution of EUR 350 million (see also section 1.4).
Some measures are aimed in particular at middle income earners with children. In the spring the government already decided to abolish tuition fees for students in secondary education and for 16- and 17-year-olds in secondary vocational education (MBO). Furthermore, from 2006 an additional EUR 200 million will be allocated to lunch-time and after-school care. This will make working more attractive and will also enable parents to combine working and caring more easily.

1.4 Investing in a stronger economy

The government will also make additional investments in further strengthening the structure of the Dutch economy. This will be done with resources from the Economic Structure Enhancing Fund (FES). The idea behind the FES has been summarised as ‘capital below ground for capital above ground’. Some 42.5% of natural gas revenues flow into the FES, and these revenues should then be used for projects and activities that will also benefit future generations.

Some EUR 2.3 billion has been earmarked for investments in knowledge, education and innovation, the environment and sustainability, and mobility, space, physical infrastructure and monuments (see box 1.4.1). This amount will be spent over a number of years, without making a permanent claim on the budget.

The government has also decided to allocate the subsidies for offshore wind farms to the FES. The amount involved is EUR 1 billion, which will be paid in instalments over the coming years. Together with the one-off contribution to the annual standing charge for domestic electricity users (see section 1.3), this will ensure that this charge will not be raised in the coming years.

Box 1.4.1 Economic Structure Enhancing Fund

The resources of the Economic Structure Enhancing Fund (FES) are not only used for investments in physical infrastructure, but also for investments that strengthen the structure of society in a broader sense. The allocated amounts are often spent over a number of years and have a finite character. This means that the FES does not finance any permanent expenditure.

FES allocations (in EUR millions)

Knowledge, education and innovation	1,060
Environment and sustainability	730
Mobility, space and monuments	340

Indexation	200
Total	2,330

Knowledge, education and innovation

In the vocational education sphere, the FES invests in training spaces through improved workplace simulations in pre-vocational secondary education (VMBO). This helps to reduce early school leaving and improves the flow into higher vocational education (MBO). In the MBO segment the FES invests in the updating of teaching materials, including information and communication technology and other equipment, and in improving teachers' knowledge of the business world. The FES also promotes the development of the 'community school', where schooling, childcare and other care tasks are combined on the same premises. This should also contribute to a higher labour market participation rate.

High-quality research requires a high-quality research infrastructure, such as laboratories and simulation spaces at universities and technological institutes. The government has allocated funds to stimulate the development of this relatively expensive infrastructure. The FES is also investing in projects and research groups of scientific excellence and with economic and social relevance. This creates a potential for cooperation with risk-bearing private parties, as in the case of the establishment of a leading institute for the development of new medical drugs.

These investments fit in with the European Union's Lisbon strategy, which aims to raise Europe's growth potential. Knowledge, education and innovation have been identified as essential in realising this ambition. The EU's Seventh Framework Programme (FP7), which is intended to generate investments in research, puts great emphasis on the need to promote innovation and cooperation between universities and businesses.

Environment and sustainability

The government has allocated funds for investment in the improvement of air quality, by stimulating the fitting of soot filters in vehicles, for instance. The subsidies are available for new and used passenger cars and lorries, as well as other means of transport such as inland ships. With the package of measures aimed at improving air quality and with the introduction of the Air Quality Act in 2006, the government is creating a healthier living environment and paving the way for spatial projects such as the construction of homes, roads, offices and industrial buildings.

Furthermore, through the FES the government is investing in a more sustainable energy household, in order to reduce the dependence on fossil fuels and to reduce emissions of greenhouse gases. Some EUR 250 million has been earmarked in connection with the decision making on the future of the Borssele nuclear power station, a process which should be finalised by the year end. The resources will be used for energy saving, clean fossil fuels (e.g. carbon dioxide storage) and renewable energy sources (including innovative biofuels). The intention is to double the climate change benefit – lower carbon dioxide emissions – of keeping Borssele open. As part of the decision-making process, the government is holding discussions with the energy companies on a substantial contribution from their side.

Mobility, space and monuments

The FES is investing around EUR 100 million to avoid future modifications to the railway facilities in the Zuidas district of Amsterdam, a new commercial centre in the south of the city. The government has also reserved EUR 100 million to introduce toll systems as a means of resolving traffic congestion.

Additional resources have also been allocated to deal with the backlog in the restoration of national monuments.

1.5 Full steam ahead

The government will continue with the implementation of the reform agenda set out in the Global Agreement for Government Policy. The reform agenda is a response to the globalisation of the economy and the ageing of the population. It aims to strengthen the structure and competitiveness of the Dutch economy through reforms of the social security system and early retirement schemes that promote labour market participation. It also aims to improve the sustainability of the public finances and healthcare costs, also over the longer term. This is the only way to maintain essential social services into the coming decades; passing the costs on to future generations is neither morally acceptable nor socially responsible.

More work

The government is stimulating the labour supply by reforming the social security system. The new Capacity to Work Act (WIA) will encourage workers who can still work to do so. Workers who are permanently and wholly unable to work will receive a full benefit. The introduction of the WIA completes the long process of reforming the Occupational Disability Insurance Act (WAO).

In 2006 the system of unemployment benefits will be reformed, in accordance with a unanimous recommendation by the Social and Economic Council (SER). The guiding principle of the new Unemployment Benefit Act (WW) is that the unemployed will be encouraged to find a job. The WW also includes provisions to counter its abuse as an exit route for older workers. The maximum period of entitlement to unemployment benefit will be reduced from five years to three years and two months. Against this, the benefit will be equivalent to 75% of the last-earned pay during the first two months and then 70% (compared to 70% from the start at the moment).

The tax break for early retirement will be abolished. Valuable knowledge and experience will thus be preserved in the labour market for longer. This measure will also broaden the tax base for the costs associated with population ageing.

Joining in

The government is working to integrate newcomers to the Netherlands. In 2006 the new integration system will be introduced. This system defines the rights and duties of new immigrants more clearly. All immigrants will have to learn Dutch and familiarise themselves with Dutch society. Any immigrant who fails to do so will not receive a permanent residence permit. In this context special attention will be paid to the integration of immigrant women, who play a crucial role in raising their children. Disadvantaged children will also benefit directly from investments in pre-school education.

High-quality healthcare must remain accessible for all. Healthcare costs are rising sharply, and are likely to continue to rise in the coming decades. The new health insurance system which will take effect in 2006 will abolish the division between the privately and publicly insured (with an insurance company and a health insurance fund respectively). In future every resident of the Netherlands will be compulsorily insured in the same way. Health insurance companies will be obliged to accept any insured person and will not be able to charge different premiums. No insurance premiums will have to be paid for children, and a healthcare allowance will be introduced for the less well off. Competition among health insurers will give them an incentive to insist on efficiency from health providers. And an efficient operation of the system should help to keep it affordable. The government has allocated additional resources to safeguard the quality of high care in nursing homes. And in the youth services sphere additional resources have been allocated to fund an increase in the number of care placements.

Fewer rules

The government and public services should continue to reflect on their roles in society. Citizens are increasingly better educated and more mature. The days when the government could decide paternalistically over the heads of citizens and professionals are gone.

The professionals in the education system, the teachers, must be able to concentrate on their core task, namely offering pupils and students a good education. Not all problems can be solved from The Hague. That is why educational institutions will be given more freedom to decide the content and structure of lessons and other provision. This means that many national regulations will be scrapped and that schools will be given greater responsibility for their budgets. But the government will continue to supervise the quality of schools.

Superfluous and excessively detailed laws and regulations frustrate citizens and businesses and hamper economic activity. That is why the government is addressing the issue of the administrative burden. The intention is to reduce ‘red tape’ for businesses by a quarter by 2007. Many measures will be implemented in 2006. Two specific examples are that small and medium-sized businesses will be allowed to coincide their commercial annual accounts and their accounts for tax purposes, and that the periodic motor vehicle test (APK) certificate will be digitised. Other measures will also be taken to reduce the administrative burden for individual citizens. Thus the provisional tax credit refund will be extended automatically, and the planning permission system will be simplified.

1.6 Confidence in the future

The government is halfway through its term of office. The last two years have been used to elaborate the reform agenda. In 2006 many of the planned measures will be carried out. But 2006 will not only be about implementing reforms; the structure of the economic will be strengthened in other ways as well, and the purchasing power of consumers will be supported. At the same time the government will safeguard the sustainability of the public finances.

The government is convinced that its policies are good for the Netherlands. The foundations of the Dutch economy and Dutch society have been and will be strengthened. The results of the policies are becoming visible and will become more so in the coming years. Thanks to the reforms the Netherlands.

2. The basis of financial and economic policies

2.1 Introduction

After ailing for a longer period, the Dutch economy seems likely to pick up again in 2006. Section 2.2 examines the current state of the economy and the reasons behind the volatile growth pattern of recent years. Underlying structural adjustment processes, together with the reforms set in motion, ensure that the economy is now in better shape than at the start of this government's term of office. A number of longer-term developments are discussed in section 2.3. This sets out how ageing, globalisation, greater prosperity, higher labour market participation and other factors contribute to a lasting change in the Dutch economy and Dutch society. The changing world calls for a changing government, and section 2.4 outlines what this means in practice. Similar developments have led to comparable reforms in other countries. Of course the Netherlands makes it own choices: it is precisely the implementation of the reform agenda that makes it possible to maintain the desired public services in the 21st century. Section 2.5, finally, shows not only that the short-term outlook is favourable, but also that – not least thanks to the reforms – the Netherlands can be confident about the future over the longer term as well. The course has been set. But prosperity does not increase of its own accord: it requires a constant proactive stance by both citizens and the government.

2.2 Overview of the Dutch economy

Economy awaiting the upturn

Some more patience is required. The growth forecasts for 2005 have been revised downwards compared to the Budget Memorandum 2005, and the Netherlands Bureau for Economic Policy Analysis (CPB) currently forecasts that gross domestic product (GDP) will increase by only 0.5%. This latest setback is largely due to external developments, such as the oil price hike and disappointing world trade volumes. Whereas previously 2005 was still regarded as a transition year, current perceptions suggest that in economic terms it will turn out to be a rather poor year on the whole. Everyone is affected by the disappointing economic performance. Purchasing power is likely to fall by 1.5% in 2005, and unemployment will rise for the fourth successive year.

Forecasts (and provisional actual figures) offer no guarantees

The reason for the downward revision in the growth forecast seems to be mostly behind us. Growth was particularly disappointing in the first quarter of 2005 (equivalent to a contraction of 0.5% on an annual basis). The outlook for the coming period is appreciably better. Statistics Netherlands (CBS) has already reported positive growth of 1.3% for the second quarter of 2005. All forecasting and research institutes expect the economy to recover next year, with the CPB now forecasting growth of 2.5%. This is a healthy upswing. Not a boom as in 1999 and 2000, but the worst seems to be behind us. It is true of course that economic recovery has been proclaimed before, but then failed to materialise. Forecasts are often wrong, and turning points in the economic cycle are particularly difficult to predict[1]. The CBS's actual figures should also be treated with some caution, given the recent quite substantial revisions of previous provisional figures. All this argues for a long-term vision of social and economic policies, rather than knee-jerk responses to actual or perceived short-term cyclical fluctuations.

Box 2.2.1 Sharp cyclical turnaround

According to the latest CPB estimates, GDP growth averaged 0.7% per year between 2001 and 2005. This constitutes the lowest five-year growth rate since the 1930s (equal with the early 1980s). Moreover, the turnaround was exceptionally sharp: in the previous five-year period (1996-2000) the Dutch economy posted very strong growth, 3.7% per year, far above the euro zone average. The subsequent trough was not very deep, but it was unusually long. Measured from the high point in the third quarter of 2000, the recession lasted 14 quarters (not including 2004). This made this the longest economic downswing since 1945.

What caused the sharp turnaround and the prolonged dip? Table 2.2.1 shows that most of the factors which pushed growth to very high levels between 1996 and 2000 either fell away during the subsequent period or even acted as brakes on growth. These figures hide a number of extreme exogenous shocks, such as first the information and communication technology boom and then the terrorist attacks of 11 September 2001, accounting scandals in the United States and Europe, the SARS outbreak, the Iraq war and – closer to home – the problems with the pension funds and the outbreak of fowl pest, for instance.

Table 2.2.1 Major differences between the upward and downward phase of the economic cycle

Average volume changes in percent per year (unless otherwise indicated)

	1996-2000	2001-2005
GDP	3.7	0.7
AEX stock market index (annual average)	27.3	-8.9 (to 2004)
House prices	12.9	4.5 (to 2004)
Pension contributions (in percentage points of payroll costs)	0.1	1.3
Labour supply (in persons)	1.9	0.6
Export market growth	7.5	4.2
Unit labour costs	0.7	1.6
Oil price (Brent, in USD, annual average)	11	13
Euro exchange rate (against USD)	-7.5	7.3
Price competitiveness	1.6	-2.7

N.B.: For 2005, the latest estimates have been used. In the case of the AEX and house prices it is not appropriate to make predictions for 2005 as a whole, but developments in the first half of 2005 suggest a more positive trend in the AEX.

Source: CPB

[1] This is a conclusion that the CPB itself came to in its study 'Trefzekerheid van CPB prognoses voor de jaren 1971-2003', CPB Document 77, 2005. Between 1971 and 2003 the average absolute prediction error for GDP growth for the following year was 1.3 percentage points. During the current economic cycle the average absolute prediction error has even been slightly higher, namely 1.5 percentage points for the period 1998-2003. It should be noted that other forecasting institutes have made similar prediction errors, but unlike the CPB they have generally not written about them.

How serious are sharp cyclical shocks for the Netherlands? Over the whole period between 1996 and 2005 the Dutch economy performed reasonably well, on balance around 5% (in cumulative GDP growth) better than the euro zone average. Although unemployment has nearly doubled since 2001, it is still appreciably lower than in the early 1990s, and in fact still barely half the EU average. It must also be said that relatively sharp shocks are not that surprising for a small open economy like the Dutch. From that perspective one might argue that there is no cause for concern; but it is too simplistic too look only at the cumulated growth figures. Wide and prolonged cyclical fluctuations lead to imbalances in the economy. These involve, for instance, significant changes in incomes and the social positions of individual citizens. Cyclical fluctuations also create uncertainty, and via risk premiums this can depress expenditure (including investment). And finally, prolonged cyclical fluctuations may have negative structural consequences, for instance because workers lose skills as a result of being out of work for a long time.

The sharp turnaround is largely attributable to exogenous shocks. Not much can be done about these of course. But the question is whether specific features of the Dutch economy may have aggravated the impact of these shocks. Broadly speaking, half of the turnaround can be attributed to faltering exports, in which the above-mentioned exogenous shocks played a major role. Most of these shocks also affected the other euro zone countries, and therefore cannot really explain the Netherlands's large growth differential with the euro zone. But because labour cost increases in the Netherlands outstripped those in the competitor countries more or less continuously from 1998, Dutch competitiveness was steadily eroded. This may explain why Dutch businesses were hit relatively hard by the slump in world trade in 2001 and 2002. The factor which broadly accounts for the other half of the turnaround is private consumption. The downswing in consumption was closely linked to relatively strong impact of ‘wealth effects' in the Netherlands: in the late 1990s households cashed in and consumed the substantial gains from shares and homes. Between 1995 and 2000 both the Dutch equity market and housing market were far more buoyant than in the euro zone as a whole. Research by the Netherlands central bank (De Nederlandsche Bank, DNB) confirms that the impact of ‘wealth effects' (by cashing in asset gains, for instance) is relatively strong in the Netherlands: positively so in the first instance, and negatively from 2001. The changes in the pension funds' assets coupled with pension contribution policies also contributed to the turnaround in private consumption. (Because of the Netherlands's unique funded pension system, the impact of the cyclical turnaround on pension contributions was also greater than in other countries).

The current long cyclical downswing has also drawn attention to several rather more structural problems in the Dutch economy. The rapid deterioration of competitiveness at the start of this decade was worrying, and was also due to a still insufficient flexibility on the labour market. In this context it is striking, for instance, that at the peak of the economic boom, when pay increases soared and competitiveness plummeted, more than 2 million people were still at home and in receipt of a state benefit. This realisation prompted the government to review the operation of the labour market and its relationship to the social security system. Section 2.3 considers the issue of publicly supported economic inactivity in greater detail.

Underlying developments reveal strength

Because predicting the exact turning points is so difficult, it is important to look beyond cyclical data to the underlying, more structural developments in the economy. Every recession carries the germ of the subsequent recovery. That this is the case this time as well is clear from both the latest cyclical figures and the underlying, partly structural, developments in several areas. One of the positive cyclical developments, for instance, is that the rise in unemployment seems to be coming to an end in the course of 2005. Many good things have happened in the underlying sphere in recent years. Although the reservoir of unused labour is still too large (see section 2.3), the labour market has certainly revealed a strong underlying dynamism over the past period. Pay restraint has already contributed to preventing a further erosion of competitiveness, businesses have used the past period to restructure and reorganise, and households have seen a gradual improvement in their financial positions. The reform agenda initiated by the government enhances the structural improvement in the Dutch economy's growth potential. These developments are examined in greater detail below.

A more dynamic labour market

Unemployment should top out this year at around 505,000. This figure is below last year's projection: the previous Budget Memorandum still assumed that unemployment would reach 550,000 this year. This 'windfall' is not only good news, however, because it is due in part to a smaller than expected growth in the labour supply. (This is due in turn to the 'discouraged worker effect': people see no point in looking for a job when the economy is struggling[2].) But there are certainly signs that the labour market has turned the corner. Unemployment has been nudging downwards over the last few months, fewer jobs are being lost, the number of job vacancies has been rising for six successive quarters, and the number of temporary employment hours has been increasing for some time already. In 2006 unemployment is expected to fall for the first time in five years (to 475,000).

Over the short term, then, the labour market seems to be improving. What is more, the distribution of jobs by industry also reveals a substantial underlying shift in the employment structure. Of course employment in the various industries is affected by economic conditions. But beyond that it is clear that the manufacturing sector, for instance, is experiencing a structural contraction, while employment in the service sector has expanded significantly[3]. This underlying dynamism is also evident from the data on gross flows on the labour market. Kock[4] shows that between 1991 and 1997 an average of 939,000 jobs were created per year (and 856,000 destroyed). This dynamism has increased since the mid 1980s. Few suitable internationally comparative data are available. But in one study Gómez-Salvador, Messina and Vallanti[5] constructed job flows in and out of businesses in the EU-15 countries on the basis of individual company data, and their calculations suggest that the Dutch labour market is relatively dynamic.

As mentioned elsewhere (chapter 1 and chapter 3), the government has taken a number of measures that will boost the labour supply and benefit the labour market. These include: the reform of the 'old' welfare system into the Work and Welfare Act (WWB), which provides more incentives to work; the reforms in the occupational disability schemes, which have already reduced the claim volume; the additional incentives (for both employers and employees) contained in the new Health Insurance Act; the removal of incentives for early retirement; the new Unemployment Act (WW), which includes more incentives to work; the new Childcare Act; and policies aimed at reducing the 'poverty trap' (such as a further increase in the labour tax credit in 2006). All these measures help to make the labour market more dynamic, so that it is well placed to respond to an economic upswing.

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[2] A possible positive effect of this 'discouraged worker effect' may be that school leavers decide to stay in education longer before entering the labour market.

[3] DNB, 'The Netherlands in the euro area', *Quarterly Bulletin,* June 2004, pp. 23-26.

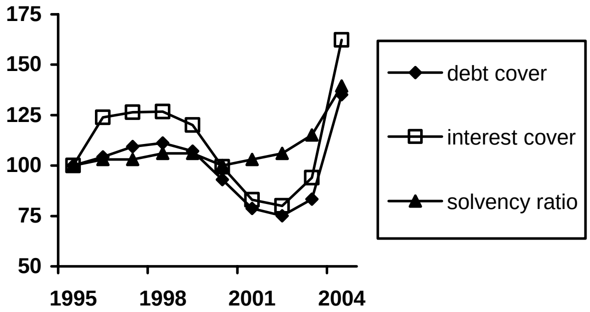
[4] Kock, U. 'Sociale uitkeringen en de stromen benadering van de arbeidsmarkt', *Tijdschrift voor Politieke Economie*, vol. 24(4), 2003, pp. 29-52.

[5] Gómez-Salvador, R., J. Messina and G. Vallanti, 'Gross jobs flows and institutions in Europe', *Labour Economics*, vol. 11(4), August 2004, pp. 469-485.

Improved competitive position and investment climate

The competitiveness of Dutch businesses has been under pressure in recent years. Between 2001 and 2003 competitiveness was eroded mainly as a result of excessive pay increases. The subsequent pay restraint negotiated under the Social Accord (between employers and trade unions) brought an improvement in competitiveness compared to the other euro zone countries as early as 2004. But competitiveness did not improve against all competitors, owing to the euro's appreciation (which made Dutch products more expensive in US dollars, for instance). Because labour costs will rise less in the Netherlands than among the competitor countries between 2004 and 2006, the foundation has been laid for an improvement in general Dutch competitiveness in 2005 and 2006. Dutch exporters will then also benefit from the expected upswing in world trade. Continuing pay restraint is an important prerequisite, however.
Manufacturers expect to invest 20% more this year than in 2004 (according to a CBS survey). The CPB has forecast only a modest increase in investment for 2005, but it expects a sharp rise in business investment next year. The CPB also expects business profits to continue their recovery next year. This is already evident in the latest official figures: non-financial enterprises increased their profits after taxation by EUR 7.0 billion in 2004, to EUR 60.8 billion. The added value generated by non-financial enterprises increased by 2.7% in 2004, double the 2003 figure.

Figure 2.2.1 Financial positions of businesses
Index figures, 1995 = 1000



Source: REACH (http://reach.bvdep.com)

As in the case of the labour market, the business world is also experiencing strong underlying structural activity. Figures for the period 1995-2003 show that the numbers of business starts and closures in the Netherlands are similar to those in other European countries (but slightly lower than in the United States). However, 2004 saw record levels of bankruptcies as well as start-ups, which points to greater dynamism. And DNB figures show that many businesses used the past period to sort out their finances[6] (see also figure 2.2.1).

A major spearhead of government policy is the improvement of the business climate. To that end the preparation of an overhaul of corporation tax was announced last year. And this spring the government sent the policy document 'Working on profit' ('Werken aan winst') to the House of Representatives. This document contains a package of tax measures to attract businesses to the Netherlands and to keep them here. The proposed further cut in the corporation tax rate and the broadening of the tax base will lead to a more competitive taxation of businesses. One of the measures

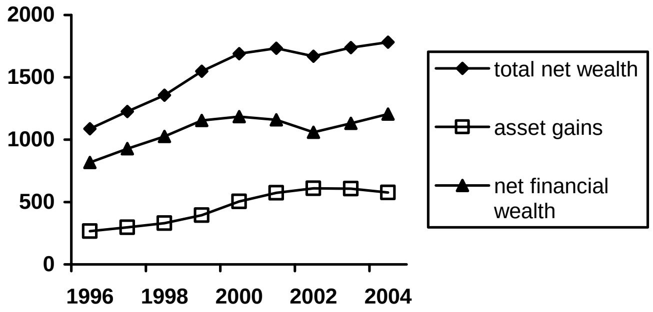
[6] This is also evident from the extension of loan terms, for instance; see DNB, *Quarterly Bulletin*, June 2005.

in the package is the abolition of capital transfer tax with effect from 1 January 2006. This makes it easier and cheaper for businesses to raise capital to conduct their activities. The government also proposes to cut the corporation tax rate again from next year, to a level of 29.6% (nearly 5 percentage points lower than at the beginning of the government's term of office). Other measures which will help to improve the business climate include support for new businesses, subsidies for research and development work, and of course the reduction of the administrative burden (see annex 9).

Recovery of household finances

Next year private consumption is expected to rise slightly, by 1%[7]. Purchasing power will also rise slightly (on average, that is; there are relatively large individual differences). Household incomes will develop more favourably in 2006 owing to the new jobs being created and the government's measures to support purchasing power (such as the reduction of the unemployment insurance premium and the increase in the general tax credit; see box 1.3.1 in chapter 1 for further details). Price increases will also remain within bounds next year (see box 2.2.2).

Figure 2.2.2 Household finances
In EUR billions



Source: DNB

As in the case of the labour market and in the business world, there are positive underlying developments to report for households as well. After the serious blow in 2000, the financial positions of households have improved in the past years (see figure 2.2.2). The housing market has entered calmer waters (although the moderate house price increases have still helped to boost household finances, as is also evident from 'asset gains' in figure 2.2.2. The AEX index has perked up, and the pension funds' finances have also improved. And finally, the government has also been able to improve its finances (for details, see chapter 4), which has created scope for targeted outlays, spending increases and burden relief.

Box 2.2.2 Inflation

Inflation in the Netherlands is exceedingly low at the moment. The consumer price index (CPI) rose by 1.2% in 2004, and inflation is likely to come out at a similar figure this year. This means that inflation is at its lowest level since 1989. In the subsequent period, until 2004, average inflation was consistently 2% or higher. Inflation is not only low by historical standards; price increases in the Netherlands are also low in comparison with other European countries. In 2004 Dutch inflation was well below the

[7] Adjusted for the statistical effects of the introduction of the new health insurance system.

European average, and in 2005 it will also be among the lowest in Europe.

The low inflation is due in part to the price war among the supermarket chains. Food prices fell by 3.5% in 2004 compared to the previous year, and this downward trend has continued in 2005. Another cause of the low inflation is the modest trend in pay rates. Together with the sharp rise in labour productivity in 2004, this led to a fall in unit labour costs. The euro has also been a major contributory factor to the low inflation. Because the euro has appreciated in the past years against the US dollar, products from outside the euro zone (which are often traded in dollars) have been relatively cheap. The record prices on the world markets for oil, coffee and cocoa have only had a limited upward effect on inflation in the Netherlands. The CPB's forecast for inflation next year is only 1% (although it should be noted that this figure is skewed downwards by the abolition of the user element of the property tax).

Although the official facts clearly show that inflation is low by historical standards, many people do not see it like that. Since 2002 many more people believe that prices have increased more than might be expected on the basis of the actual rate of inflation. Perceived inflation is thus higher than the actual rate. The CBS measures average inflation, so that there may be differences at individual level. But this cannot explain the wide discrepancy between measured and experienced inflation. After all, the complaint that everything has become much more expensive is articulated by all social groups. The CBS tracks around 80,000 prices every month and takes account of the weight of various goods and services in spending patterns. A possible explanation for the high perceived inflation may be the price hikes in recent years in products which are bought frequently (e.g. in supermarkets before the price war broke out or in restaurants and bars immediately after the introduction of euro notes and coins). Thus food and beverage prices rose by an average of 3.3% in 2002. But since then this price hike has been reversed (something which also applies to a large extent to the catering industry). By way of illustration, table 2.2.2 shows price comparisons of a range of everyday goods on 1 January 2001 and 15 July 2005[8]. This shows that many of these kinds of goods are actually cheaper than before the introduction of euro notes and coins. Of course this does not apply to all products. (The products mentioned here were picked at random, but it is of course possible to select a different basket of goods with higher price increases.) All in all, however, the CBS figures show that the supermarket price war has pushed food prices back to the levels of late 2001.

Table 2.2.2 Prices of supermarket goods

Product	Price		
	1 Jan 2001		15 Jul 2005
	NGL	EUR	EUR
plain crisps	2.38	1.08	0.86
coffee	3.79	1.72	1.74
orange juice	2.09	0.95	0.81
toilet roll	6.99	3.17	2.56
beer (crate)	19.48	8.84	8.55
coca-cola	2.49	1.13	0.92
white bread	2.69	1.22	1.19

Household appliances, mobile and other telephones and audio and video equipment have also fallen sharply in price over the last three years. But the fall in the prices of these goods has not yet brought perceived inflation in line with actual inflation. It seems that price rises have a greater impact on consumers' perceptions of inflation than price cuts. Another explanation for the perception that the cost of living has risen sharply may be that people spent more after prices were divided by 2.2 with the introduction of euro notes and cash. This gave the impression that many goods and services had become cheaper, so that people spent their money more easily. (This has been called the ‘money illusion’.) Recent research shows that people are willing to pay up to 60% more for certain services if their prices are expressed in euros rather than guilders (Beretty et al., *ESB*, 17 June 2005, vol. 90, no. 4463, p. 277). When Dutch consumers feel well off, but at the end of the month are left with less than expected, they quickly conclude that everything has become more expensive.

Resilience of the Dutch economy

Underlying developments indicate that the Dutch economy is currently in better shape (also in structural terms) than at the start of this government’s term of office. This impression is confirmed by the latest economic figures. However, the prolonged lean period has led to much unrest and dissatisfaction. Is the Dutch economy likely to experience relatively sharp shocks in the coming years as well? Not necessarily. For one thing, tax measures were introduced in both 2001 and 2004 which discouraged the consumption of house price gains. For another, new rules have been drawn up to monitor the pension funds’ funding levels and thus to mitigate the risks of stock market investments. And finally, it should be noted that the surges in house prices and share prices were exceptionally strong during the boom years (as were the subsequent slumps in the downward phase of the economic cycle).

2.3 Structural changes and challenges

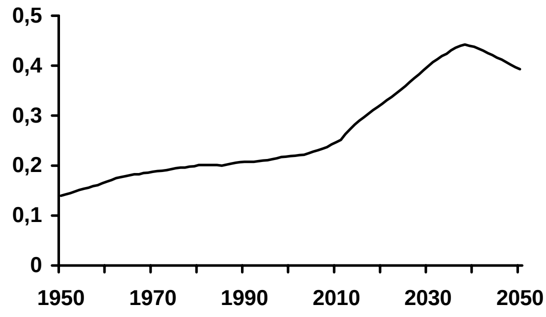
The Netherlands has experienced an unusual economic cycle in recent years, with high peaks and deep troughs. Over the short term these fluctuations have a major, but temporary, effect on the economic climate. At the same time a number of significant underlying structural developments are unfolding, which will have a permanent effect on the economy and society. This section examines three of these structural changes: population ageing, globalisation as a result of technological advances, and the changes in Dutch society.

Population ageing

Much has already been written about the challenges arising from the ageing of the Dutch population, not least in last year’s Budget Memorandum. The intention here is not to dwell on the issue at length, but to touch on several important aspects.

First the key figures. At the moment the Netherlands has around 2.3 million people aged 65 years or older. According to the CBS’s population projection, there will be more than 4 million elderly people by 2040. Over the same period the number of people aged 20-64 will fall slightly (from 10.0 million to 9.2 million), so that the number of over-65s will increase as a proportion of the labour force. Figure 2.3.1 shows the ratio between over-65s and the 15-64 age group (what has been called the ‘grey pressure’). This clearly shows how the composition of the Dutch population will change over the coming decades. There are two major reasons for this change: a higher life expectancy and a lower birth rate[9].

Figure 2.3.1 Grey pressure: the ratio between over-65s and 20-64-year-olds



Source: CBS

Policy implications

Population ageing is a given. That Dutch people are living longer and also staying healthier longer is of course good news. And that people can enjoy their retirements for longer is a boon for those in that position. What is more, they can enjoy their retirements in relative prosperity. In the future elderly people will on average be relatively better off, not only in comparison with elderly people today and in the past, but also in comparison with working people in the future (see below). Another positive factor for the Netherlands is that in comparison with many other countries it has saved relatively large amounts for old age provision (thanks to the unique funded pension system).

In short, population ageing as such is not a reason for panic. But it will require adjustments in government policy. As mentioned in the Budget Memorandum 2005, in 1960 workers worked an average of 50 years of their lives and enjoyed their pensions for 13 years. By 2002 workers worked an average of 40 years (with shorter working weeks) and enjoyed their pensions for 21 years[10]. The average period of retirement thus nearly doubled, while the average number of hours and years worked (during which workers can save for their old age, and during which they contribute to the financing of public services through their social security contributions, for instance) have fallen sharply. Clearly this situation is not tenable over the long term: eventually people will not be able to save enough during their shorter working lives to provide for themselves during their retirement.

Very broadly speaking, the solutions to this problem can be sought in two directions. The first option, if the aim is to maintain the same level of public and other services, is to work more, that is, for more people to work or for people to work longer hours or more years. As outlined below, the labour market participation rate is indeed rising, also among older people. The second option is to accept that state pensions will be reduced. The government does not want to force people to work longer. Of course they can still retire before the official retirement age. But in that case they will have to accept that the financial implications of that decision are theirs to bear. In short, society will no longer be able to contribute to early retirement. That is also why the government has restricted the tax incentives for early retirement and why pension schemes have been modified so that people who decide to work longer do not lose out (in the jargon, the schemes have been made ‘actuarially neutral’).

Globalisation

These days much is being written about the challenges of globalisation[11]. At times this seems like a new phenomenon, but it is not. The Dutch ‘Golden Century’ (i.e. 17th century), for instance, was also the result of globalisation. At that time successful innovations in the spheres of trade, logistics and finance sparked an explosion in international trade[12]. The same period also saw the emergence of the first multinational in the shape of the Dutch United East India Company (VOC). The years between 1950 and 1973 are also often characterised as a 'golden era'. Thanks to relative exchange rate stability under the Bretton Woods system and in part owing to the development of container transport, world trade – and hence the world economy as a whole – experienced strong growth at this time[13].

Since 1980 the world economy has expanded by an impressive 130%. But world trade expanded by a massive 300% over the same period. This makes clear that the importance of trade has increased again over the past decades, as it did between 1950 and 1973. This renewed trade explosion is attributed to rapidly falling transport costs and the emergence of new information and communication technologies. These technological developments are making the world ever smaller.

The Dutch economy is heavily dependent on trade. The value of exports amounts to around 65% of GDP. It is true that around half of these exports are re-exports (for instance, goods which are cleared through customs in Rotterdam and then immediately put on a train to Germany), but these exports also benefit the Dutch economy. Over the last decade exports accounted for nearly half of total economic growth. The benefits of imports are difficult to quantify, but the prosperity gain of being able to buy cheeses ripened in France, cars built in Japan, DVD players assembled in China, dresses sewn in Turkey and garden gnomes painted in Poland is huge. It is unthinkable that all these goods could be produced at the same low costs in the Netherlands. Thanks to international trade, in short, we doubtless get more choice and better value for money. That is why the government supports free trade and hence further trade liberalisation, including the removal of the remaining barriers within the European Union.

Emergence of Asian 'tigers' (and East European 'bears') good news

Recent studies of globalisation tend not to focus on the explosion in world trade, but much more on the economic emergence of China, India and the other Asian 'tigers'. (The also rapidly expanding new EU member states in Central and Eastern Europe – the 'bears' – are often unjustly ignored in this context.) These economies are certainly posting impressive growth rates. Over the last decade the Chinese economy has expanded by an average of 8.6% per year, and the Indian economy by 6.2% per year. According to some analyses, China will become the world's largest economy around 2040 (in dollar terms)[14].

The explosive growth in China, India and the other Asian 'tigers' and the Central and East European 'bears' means that overall prosperity is growing. That is to say, the 'cake' is getting larger, so that more people can have a larger slice of it. According to a World Bank estimate, the number of people in China forced to live on less than USD 1 per day declined by around 400 million between 1981 and 2002. The Netherlands can also benefit from the greater production and prosperity. The port of Rotterdam, for instance, is thriving on the transhipment of Chinese manufactured goods destined for the European market. In this way the booming Chinese economy also generates employment and growth in the Netherlands. Much of the wealth generated by the booming Chinese economy is spent on buying western (and hence also Dutch) goods and services. Dutch exports to Asia increased by 20% in 2004, to nearly EUR 18 billion, and this upward trend is continuing this year. And ever more Chinese tourists are visiting the Netherlands. Dutch exporters are also clearly benefiting from the EU enlargement in 2004: exports to the 10 new member states surged by 30% in the first eight months after their accession. And finally, consumers also benefit from the Chinese manufacturing boom, because the video recorders and DVD players produced there are becoming ever cheaper.

Relocation of jobs a challenge for the Dutch economy

One of the aspects of globalisation that is often highlighted is the relocation or outsourcing of business activities from the Netherlands to other countries. This is understandable, because as the business activities disappear abroad, so do jobs. As in other countries, jobs have been lost at Dutch businesses in recent years because of the relocation of production to the new EU member states or Asia, for instance. But on balance relocation need not be negative for Dutch employment and growth[15]. The relocation of labour can be regarded as a form of international trade, in which all countries can maximise the benefit from technological advances, so that workers can maximise their productivity worldwide. Over the longer term, the jobs lost abroad will be replaced by better jobs in the Netherlands (for instance, more knowledge-intensive jobs instead of production-line jobs[16]), and because of the growing demand from China and other countries the activities that generate these jobs will be able to expand further. But these jobs will not come about of their own accord; it may take some time before businesses are able to respond to the new situation. Certainly if their competitive positions have deteriorated at the same time, businesses may find it difficult to retain jobs. Relocation of jobs can in some cases be a sign that payroll costs have risen too fast in relation to productivity. Relocation may therefore have negative consequences for individual workers. Some businesses will relocate their production, while others will go bankrupt because they cannot compete with the low-wage countries. Relocation certainly leads to transitional unemployment over the short term, that is, when people lose their job and it takes a while before they find another one. This is a very troubled time for those affected. But the number of jobs that disappears through relocation is as nothing compared to the annual dynamism in the labour market. (Nearly 1 million jobs are created in the Netherlands every year; against this, a potential 21,000 jobs disappear abroad every year, according to hypothetical calculations by the CPB .) Relocation is an integral part of economic relations between countries and forms part of the constant change and renewal that lead to economic growth. There is no convincing economic argument for policies aimed at blocking the relocation of jobs. What government can do, however, and should do, is to help create an environment where people who lose their jobs can quickly find new (and better) jobs. This requires a flexible operation of the labour market, as well as an ‘activating’ social security system which contains strong incentives to work. Thanks to pay restraint, the Netherlands should be able to improve its competitiveness and prevent permanent job losses abroad owing to temporary cyclical fluctuations. Workers can benefit from technological advances and find new and better jobs when they have sufficient skills (‘smarter working’). Hence the importance of good education and life-long learning. And finally, there is a need for a social safety net for those people who still drop out.

Immigration and economy

After the relocation of jobs, the relocation of people – migration, in other words – is the final aspect of globalisation considered here. Immigration is not a new phenomenon either. The Netherlands’s rapid technological development during the Golden Century relied in no small measure on contributions by Flemish immigrants who had fled from Antwerp and other parts of the Southern Netherlands. Many entrepreneurs also migrated. When the VOC was founded in 1602, more than one-third of the invested capital was committed by immigrants from the Southern Netherlands[17]. A century later the arrival of many Huguenots (i.e. French Protestants) brought another impulse for the Dutch economy (and Dutch culture!). Although the overall migration flows to the Netherlands were relatively small in the 19th century, there was considerable intra-European labour mobility at that time. Every year tens of thousands German and Belgian seasonal workers came to the Netherlands to help with the harvests or with major infrastructural projects. And during the 20th century, there were two major waves of labour migration: German domestic servants immediately after the First

World War, and Turkish and Moroccan industrial workers in the 1970s. The arrival of large numbers of Indonesians (1945-1975) and Surinamese (1973-1990) also had a major impact on the Dutch economy and society.

Immigrants are important for an economy. The migrants who left for North America between 1850 and 1913 were decisive in the rise of the New World. Nearly 20% of employees in the US information and communication technology industry are first-generation immigrants. Foreign workers offering high added value can make a major contribution to an economy's innovative capacity and thus contribute to technological progress and job creation. The government's measures to facilitate the admission of highly skilled immigrants to the Netherlands should be seen in this context. (These measures were based on a recommendation by the Innovation Platform.)

Although immigration has contributed much to the Dutch economy and society over the centuries, this is not a matter of course[18]. The figures show that certain groups of immigrants to the Netherlands lag behind in several areas, not least because their integration is not proceeding smoothly enough. The next section looks at labour market participation and benefit dependence. And chapter 3 gives a detailed description of the new integration system and other measures in the immigration sphere, such as the tightening of rules concerning family reunification.

Changing society

The world is changing, and so is Dutch society. Recently a number of studies have been published which examine the social implications of 'de-pillarisation' ('ontzuiling', i.e. the fading of the segmentation of many aspects of Dutch public life along denominational and political lines), the broadening of cultural diversity, the increase in social and geographical mobility, and the emergence of new media[19]. Although the various analyses come to different conclusions, they do seem to reflect a widespread recognition that Dutch society has changed forever. These changes call for a different role for government, with a more tailored approach to the social security system and public services, for instance. It is not the intention here to conduct a detailed social study. Instead four developments with special relevance for economic policy making are singled out: the greater prosperity, the rising educational attainment, changes in labour market participation, and the high benefit dependency. Moreover, in several areas the special position of non-western immigrants still poses major challenges[20].

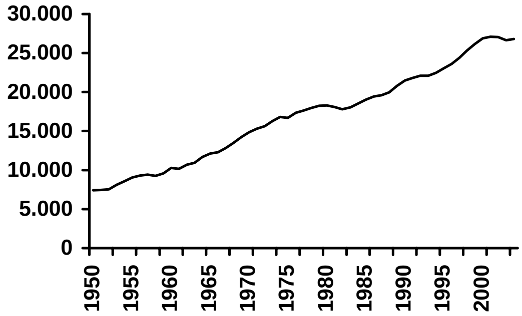
More prosperous

At a time when the economy is not performing that well, it is good to consider income trends over the longer term. It then becomes clear that the average Dutch person has become increasingly prosperous. Figure 2.3.2 shows that the average income per head of population (adjusted for inflation) has increased sharply over the last few decades. In the past many older people lived in relative poverty. This was the main reason for the introduction of the state old age pension in 1957. The percentage of older people who say that they are well off has increased appreciably in recent years[21]. In 1992 around 41% said that they were well off, but by 2003 this figure had risen to 55%, which means that older people have closed the gap with the rest of the population.

Figure 2.3.3. shows that the difference in income between the over-65s and under-65s has narrowed. This difference should narrow further in the coming years. At the moment already 85% of over-65s have a supplementary pension, and this figure is set to rise further in the coming decades (not least because ever more women have careers and hence supplementary pensions). In the future some older people will still have to live on the state pension, but they will become a shrinking minority. For ever more people the state pension is no longer the sole cushion against poverty, but rather an element in an old age provision for which they have largely saved

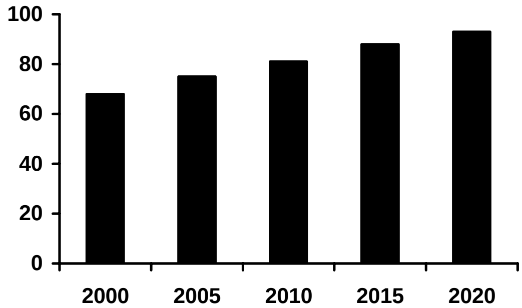
themselves. A major exception concerns non-western immigrants over the age of 65. Half of this group has not been able to build up a full state pension entitlement[22] or a supplementary welfare benefit. More generally, disposable incomes among non-western immigrant households are more than 20% lower than among indigenous households. This also applies to the younger generations of non-western immigrants and their descendants, which illustrates the integration problem.

Figure 2.3.2 GDP per head
In today's euros



Source: CBS

Figure 2.3.3 Average disposable incomes, over-65s/under-65s
In percent

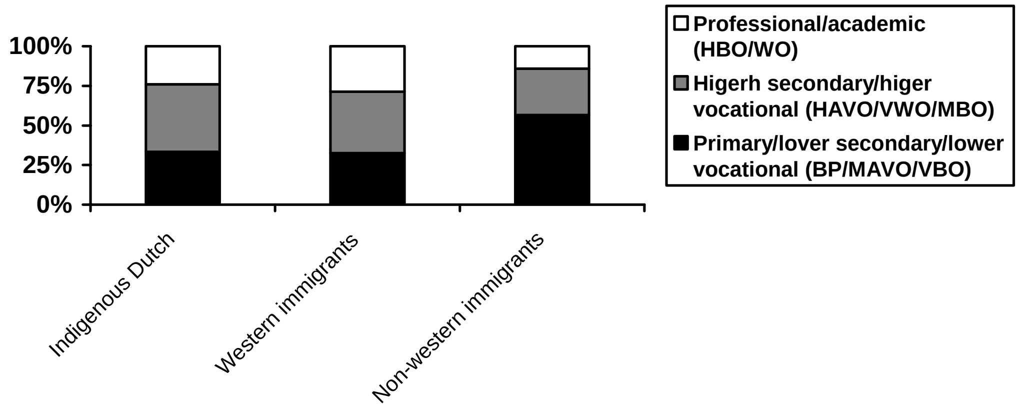


Source: Thio, V., 'De inkomenspositie van ouderen', Werkdocument 230, Ministry of Social Affairs and Employment, 2002.

Better educated

Between 1996 and 2003 the average educational attainment level of the Dutch population clearly improved. In 2003 a quarter of Dutch people aged between 25-64 years had completed an education to professional (HBO) level at least; the figure in 1996 had been just over 20%. The average education level of older workers is also gradually rising. This is largely due to a 'cohort effect', that is to say, every generation is better educated. The average education level of immigrants is still well below that of the indigenous population, with immigrants of Turkish and Moroccan descent in particular lagging far behind (with less than 10% attaining an HBO diploma or higher qualification). But a cohort effect is also evident among these groups, and since 1996 the education level has risen sharpest among Turks and Moroccans. Even so, the average lower education level of non-western immigrants remains a focus of attention. Owing to the above-mentioned effects of globalisation, the labour market position of the lower-educated and lower-skilled will come under further pressure (in favour of the higher-educated and higher-skilled). If the gap between immigrant and indigenous groups is not closed further, then immigrants will continue to stand on the sidelines of the labour market. This development would present a barrier to successful integration. This is unacceptable, which is why 'joining in' is one of the government's top priorities.

Figure 2.3.4 Educational attainment among 15-64-year-olds by origin



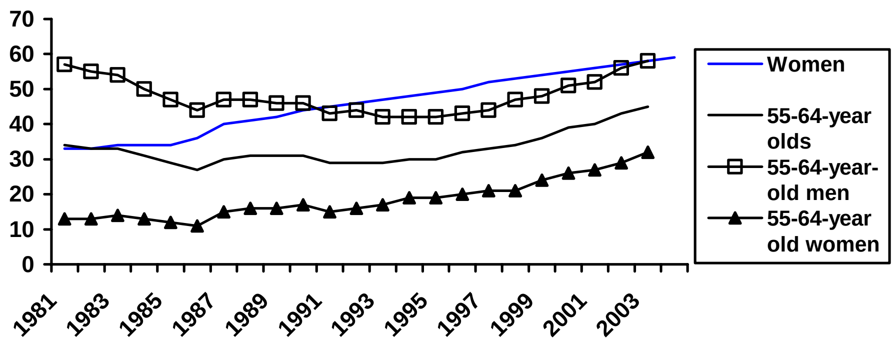
Source: CBS

More women ...

Fortunately, ever more people are joining in. Twenty-five years ago only 30% of women aged between 15-64 years held paid jobs; by 2004 this percentage had nearly doubled to 55%. And this trend is likely to continue in the coming years. The CPB forecasts that by 2010 between 60-63% of women will have joined the labour force.

The greater labour market participation among women also means that the number of households with a single breadwinner has declined rapidly. More than two-thirds of the country's 3.5 million couples have both partners in paid employment at the moment. The increase is greatest among parents with underage children. The higher participation rate of women also means that the economic independence of women has increased significantly.

Figure 2.3.5 Labour market participation rates of women and older workers
In percent



Source: CBS

... more older people ...

The labour market participation rate of older people (i.e. 55-64-year-olds) has increased steadily since 1995. (It had fallen in the early 1990s.) One of the reasons for this increase is that working conditions have improved steadily and that older workers have become healthier. Recent reforms of the early retirement and benefit schemes also play a role. Although the participation rates of both older men and older women has increased over the last 10 years, the participation rate of older women continues to lag far behind[23].

... and more immigrants in work

The labour market participation rate of non-western immigrants increased sharply between 1995 and 2001. During this period the gap with the indigenous population was nearly halved. Since 2001 there has been a slight fall, no doubt due to the economic downturn, which suggests that the labour market position of immigrants is much more vulnerable to cyclical fluctuations than that of the indigenous population. Because of a 'displacement' effect on the labour market, it is likely that during lean economic times the lowest-educated lose their jobs first. As mentioned, these are more likely to be immigrants (also because they are more often on temporary or short-term contracts). Discrimination is another possible explanation for the worse labour market position of non-western immigrants[24].

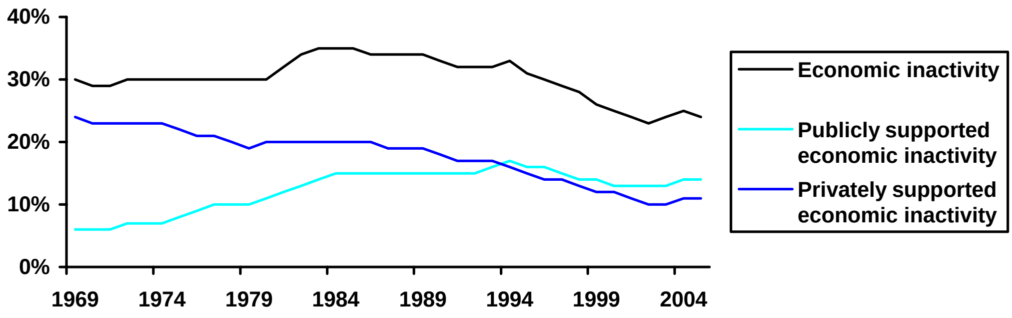
But the Netherlands remains Europe's leisure champion

The higher labour market participation rate of women, older people and immigrants has ensured that the utilisation of the total labour supply has improved again since its low point in 1984. Even so, measured in labour years, the total participation rate remains below the European average. (Moreover, measured in hours it is no higher than 50 years ago). There are two reasons for this. Firstly, part-time working has become much more popular. The major advantage of part-time working is that it allows people to combine paid work and caring tasks. But the downside is that the labour supply has increased by less than is desirable with a view to the future. To put it bluntly, the Netherlands remains the leisure champion of Europe. It is also an open question whether part-time working is invariably a deliberate choice, or whether in some cases it is a consequence of not being able to find a full-time job or the difficulty of combining work and childcare. That is why the government will make an additional EUR 200 million available for childcare from 2006. This additional outlay will make taking a job or working more hours more attractive and will thus give both parents the opportunity to combine working and caring in a balanced way.

The second reason for the relatively low utilisation of the labour supply is that the number of people staying at home at society's expense is still too high. Thanks to the above-mentioned developments, the number of economically inactive people has fallen from 35% to 25% of the potential labour force since 1984. But the number of people at home in receipt of a state benefit has remained broadly the same during this period (see figure 2.3.6). A striking feature is that the number of non-western immigrants on the sidelines is also above the average. Nearly 27% of the first-generation non-western immigrants aged between 15-64 years receive a benefit, which is more than twice as many as among the indigenous population. When adjusted for the different age structure, the benefit dependence among second-generation non-western immigrants is also appreciably greater than among the indigenous population.

Despite the higher labour market participation rate and the lower unemployment rate, and despite the fact that the social security system now contains more incentives to work, the level of publicly supported economic inactivity remains high. It is also true, however, that ever more people contribute to the economic base of our society (by entering the labour market or by working longer). What matters now is to reduce the publicly funded economic inactivity. This will not be easy, but it is imperative. 'Joining in' is the watchword!

Figure 2.3.6 Economic inactivity
In percent of the potential labour force



Sources: CBS, Ministry of Finance own calculations

2.4 Different world, different government!

People are changing. Society is changing. And the world is changing. Hence it is only logical to review the role of government as well. Over the last few decades confidence in government's ability to effect social change has waned. There is now a growing awareness of the limitations of public intervention. But at the same time citizens still make high demands of government. Broadly speaking, economic theory recognises two possible reasons for government intervention in the economic process: to raise efficiency (if the market cannot achieve an efficient outcome), or to redistribute resources[25]. Unfortunately government action does not always lead to the desired result. Markets may fail, but so can governments. Government failure may occur, for instance, because intervention in the market causes further disruptions, or because the government does not have sufficient information about the actual need for a particular product.

Furthermore, these days it is not only the benefits of government intervention that are taken into consideration, but also the costs. Government intervention often involves restricting citizens' freedom in some way (by imposing rules, for instance) or spending public funds raised through taxes. Other examples are the implementation costs of complying with certain directives, and the administrative costs associated with a certain licensing policy. Because of all these costs of public intervention, it is important to keep the role of government under constant review, to be cautious about allocating new tasks to government, and to identify both the benefits and the costs as much as possible. Less government is strong government. The government offers space, but it also sets the parameters and conducts effective supervision.

The reforms initiated by this government do not stand on their own. They form part of a change in thinking which has been unfolding for some time. This change is evident not only in the Netherlands, but also to a greater or lesser extent in all European countries. Table 2.4.1 – derived from an article by Aiginger on Europe, not specifically on the Netherlands – gives a schematic (and perhaps somewhat stark) overview of this development.

Table 2.4.1 Towards a new European model

Old	New
Trying to keep redundant employees in existing jobs	Helping workers to find new jobs, emphasis on employability
Paternalistic government	Reliance on personal responsibility, confidence in citizens and professionals
Social security geared to income protection	Social security geared to encouraging labour market participation
Supply-led healthcare	Output costing, more market forces, with significant guarantees
Standard compulsory pensions	Flexible pension arrangements
Strict labour and product regulation	Flexibility, self-regulation
Breadwinners with full-time jobs	Part-time and flexi-workers, flexible working hours
Compulsory reductions in working hours to tackle unemployment	Stimulation of the labour supply, reduction of excessive employment protection
Pushing the bill for ageing population into the future	Preparing institutions (and pension schemes) now, no writing of blank cheques
Early retirement	Longer working lives, actuarially neutral pension schemes, debate on flexible retirement age, leave schemes
Education - work - retirement	Life-long learning
National champions	Stricter competition policy, also at European level
Administration through rules and regulations	Reliance on incentives
Input management	Management by results, benchmarking
Inefficient public utilities	Lower prices through competition after privatisation
Rigid standard policy implementation	Policy competition, flexibility
Keynesian budgetary policy	Long-term sustainability of public finances
State support for ailing businesses	Tax breaks and other incentives for business start-ups
Stimulation of investments in physical capital	Stimulation of investments in knowledge

Based on Aiginger, K., 'Towards a new European model of a reformed welfare state: an alternative to the United States model', *Economic Survey of Europe*, United Nations, 2005, p. 113.

The Netherlands makes its own choices

A contemporary view of the role of government must fit in with the wishes of today's discerning citizens, an increasingly international society and the changes in the composition of the population. This is the reason for the reforms initiated by the government. As outlined in chapter 1, many of the reforms are being implemented more or less simultaneously. Opinion polls indicate that many people are overwhelmed by the ambition and pace of the reform agenda. It is important to recognise that all the reforms are taking place against the backdrop of the new role of government in the 21st century. What matters is to find new ways to solve old problems more effectively (with closer attention to benefits as well as costs). It is precisely because of the reforms that the public services desired by the Dutch people can be secured for the 21st century. The Dutch performances are often compared with those of the United States. That is understandable, because this country is ahead of the Netherlands in a number of areas, which means that Dutch policy makers have something to learn. But there are also areas where the United States is not the example to follow. A case in point is healthcare. While the United States spends 15%

of its GDP on health (one-and-a-half times more than the Netherlands), more than 10% of all American children are not covered by health insurance, nor are as many as 20% of people aged between 18-64 years. By contrast, the new Dutch health insurance system being introduced combines market elements (such as administration by competing private insurance companies) with strong social guarantees (such as the underwriting duty, the ban on premium differentiation, income solidarity through the healthcare allowance and a percentage contribution); and parents do not have to pay for their children's health insurance. This example illustrates that on the basis of an 'economic' analysis of the role of government it is possible to come to very different practical arrangements as a result of different preferences. Any fears of 'American conditions' in the new Dutch healthcare system are unfounded.

Government in the 21st century

Without aiming to be exhaustive, it is possible to give several examples to illustrate how the developments outlined in section 2.3, coupled with a critical analysis of the role of government, have brought about a shift from the old to the new model. A good example is the social security system. In the past social security was seen primarily as a safety net for people who had somehow lost out in the job or social stakes. Consequently the various institutions had above all a redistributive function. Because of the structural changes outlined in section 2.3 and because of the new view of the role of government, the Dutch social security system has become increasingly 'activating', that is, aimed at helping as many people as possible to get back 'in the saddle', as it were. This applies for the schemes under the new Unemployment Insurance Act (WW), the Work and Welfare Act (WWB) and the reformed occupational disability schemes. Compared to the past, all these schemes focus much more on the capabilities of benefit recipients and demand much more from them in terms of personal responsibility. In this respect the reforms fit in well with the outcomes of a large national opinion survey, '21 Minutes', in which a majority of the people expresses a desire for more flexibility on the labour market and opts for policies that encourage people to enter or re-enter the labour market (while providing support for those who need it)[26].

The administration of the social security system is also being overhauled. The best example is the Work and Welfare Act (WWB). In accordance with the principle of subsidiarity, responsibility for the implementation of the WWB has been devolved to the lowest appropriate tier of government, in this case the municipalities. The municipalities have considerable freedom of action and have financial incentives to operate the WWB scheme as efficiently as possible. What is more, since recently the municipalities' performances can be compared on the internet. This is a good example of policy competition and use of new media. Today's discerning citizens can now compare various municipal policies with each other at the touch of a button.

The government's intention to reduce the administrative burden for businesses is a good example of the greater attention paid to the costs of (in principle legitimate) government intervention. The administrative burden is too heavy and must be reduced. The government has already achieved significant results in its first two years, and is on track to meet its targets. The issue was also put at the top of the European agenda during the Netherlands's EU presidency. Following on from the successes in relieving the administrative burden for businesses, the government is now taking measures to reduce 'red tape' for individual citizens.

A final example concerns the government's efforts in the area of knowledge and innovation. Economic growth is generated by deploying additional production factors (e.g. labour, capital) or by deploying the existing production factors more efficiently and effectively. Because of the population ageing, the deployment of additional labour cannot provide a growth impulse over the longer term. And because of globalisation it is by no means certain that additional capital will necessarily be deployed in the Netherlands. That is why future growth will have to come mainly from 'smarter working' and new products. This explains the government's greater emphasis on knowledge and innovation. Economists agree that government has a task here. Knowledge and innovation are one of the few areas where the economic literature finds clear positive external effects. The public return on knowledge investments is higher than the private return, so that without government action, these investments would remain below the optimum from a social point of view. That is also why the government has decided to use a larger proportion of the additional natural gas revenues for investments in knowledge and innovation. This requires careful consideration, however, because as Cornet and van de Ven[27] have shown, knowledge investments are not inured from the risk of government failure. Thus there is a risk that projects executed or subsidised by the government will replace private projects (i.e. lack of additionality). And there is some doubt that the government can have sufficient information at its disposal to pick the best projects (rather than the best lobbyists). The government's innovation policy takes account of these risks. The 'knowledge vouchers' project launched last year, in which small and medium-sized businesses can buy knowledge from research institutions, is a good example of the simultaneous stimulation of knowledge transfer and investigation of the impact of government intervention (with sufficient attention to the risk of government failure, in other words). In the case of public investments in knowledge, the government also regularly asks for financial contributions from the involved private parties. This because contributions by the private sector are likely to maximise the economic benefits.

Across Europe

As mentioned, similar reforms are taking place across Europe. The process is unfolding somewhat faster in some countries than in others, and countries also concentrate on different aspects of the reform agenda. Clearly there are national differences, and there is scope for such differences. But it is important to recognise that – not least thanks to the Lisbon objectives – a similar process has been set in motion in all the EU member states. Because all countries face the same challenges, it is in any case only a question of time before they take action in all the necessary areas. And not a moment too soon, as is made abundantly clear by a recent OECD [28] study on the euro zone. The OECD stresses that further structural reforms are imperative in all EMU member states, in order to prevent the prosperity of euro zone citizens falling further behind the US's. The OECD is particularly critical of the strict employment protection legislation and describes the introduction of the services directive as crucial.

These days the 'Nordic model' is often cited as the way forward (see box). A deep financial crisis in the early 1990s triggered a wide range of reforms in the various Nordic countries, specifically Denmark, Finland and Sweden. Since then nearly all the elements of the new model set out in table 2.4.1 have been realised.

Box 2.4.1 The Nordic model

Recently the strong economic performances of Denmark, Finland and Sweden have attracted much attention. Despite their large public sectors, these countries have been posting growth rates above the EU average in recent years. The Nordic countries perform well on various rankings, such as the World Economic Forum's Global Competitiveness Index, the Economist Intelligence Unit's list of countries with the best investment climates, and the education tables of the Programme for International Student Assessment (PISA). But this should be kept in some perspective: in particular, income per head in the Nordic countries, as in many EU countries, is still 30% below that in the United States. But the encouraging performances of recent years do offer leads for a successful policy mix.

(1) A structural budget surplus

The Nordic countries use a strict budgetary framework, based on the objective of achieving structural budget surpluses in view of the impending population ageing. And these surpluses are actually achieved! In 2004 Sweden had a structural budget surplus of 1.7% of GDP, Finland one of 2.4% and Denmark even 3.4%. The regular budget surpluses in the Nordic countries help to underpin strong consumer confidence and high consumer spending. A structural budget surplus also means that attention can be focused on strengthening the economy, allowing the automatic stabilisers to operate, and creating the scope to cope with the budgetary implications of ageing.

(2) A flexible labour market through low employment protection

Denmark has a widely praised labour market policy, which has been dubbed ‘flexicurity’. It is characterised by low employment protection, generous social security benefits and strong incentives to work. As far as the level and duration of the social security provisions is concerned, there is no major difference with the Netherlands. There is however a major difference in the employment protection sphere. In Denmark it is very easy for employers to dismiss redundant staff. Because this is so simple, it is also easier for employers to take on new staff. Hence people have a better chance of finding a job. This aspect makes the Danish model socially responsible. The Danish labour market is very flexible and provides for an efficient allocation of labour. Incidentally, the ‘generosity’ of Denmark’s social security benefits should not be exaggerated. For lower incomes the Danish unemployment benefit is higher than in the Netherlands, but for higher incomes it is lower. As a percentage of the last-earned pay the average Danish benefit comes to 73%, compared to 77% in the Netherlands. The maximum period of entitlement to unemployment benefit is four years in Denmark, and three years and two months in the Netherlands.

(3) A well educated labour force and close cooperation between businesses and universities

The Nordic countries invest more in research and development and have a better educated population than the Netherlands. The number of youngsters leaving school without a basic qualification is far lower than in the Netherlands (although the overall educational attainment level is higher in the Netherlands). Cooperation between businesses and universities, a precursor to innovation, is particularly close in Finland. This has been achieved, incidentally, without the government introducing any special schemes. Most universities operate ‘scouting’ agencies which keep track of what researchers are working on. These agencies also act as knowledge brokers. They have contact persons in all the major businesses in the region, know what the problems are, and can also link research to topical issues raised by businesses.

(4) High labour market participation among women

The labour market participation rate of lower-educated women in particular is high in the Nordic countries. Measured in labour years, Sweden has the highest participation rate in this segment (65%), followed by Finland (62%) and Denmark (55%); the corresponding rate in the Netherlands is appreciably lower (47%). This is due to cultural differences, but also to the childcare system. However, childcare in the Nordic countries is not cheap, and it is important to weigh up the costs and benefits.

(5) Smaller government

The Nordic countries traditionally have large public sectors and consequently high tax and social security burdens. One cannot conclude from this that Dutch society could cope with higher taxes, however. It is true that Nordic levels of public spending are higher than in the Netherlands, but there is a strong trend towards smaller government. In Sweden the share of the public sector in the overall economy has

shrunk by 13% over the last decade. In Denmark the equivalent figure is 16%, and in Finland it is even close to 20%. The shrinking government has thus given these countries' economies another growth impulse.

Similar reforms are being undertaken in other EU member states. The Agenda 2010 programme in Germany, for instance, broadly addresses the same issues as the reform agenda in the Netherlands. And the Hartz-IV reforms have already increased the incentives to work. The entitlement to unemployment benefit has been reduced to one year (18 months for the over-55s). By way of comparison, the entitlement period in the Netherlands is shorter for younger claimants, but longer for claimants over the age of 35 or so. Germany has also abolished the continuation benefit, so that unemployment benefit recipients are transferred more quickly to welfare benefit (which is means-tested). Redundancy procedures for small businesses have been streamlined, and longer working hours have been introduced in some businesses (and industries). Germany has also addressed the implications of an ageing population. For that reason the early retirement scheme has been abolished, the ambition level for pension payments has been revised (and linked to life expectancy), and a rise in the retirement age is under consideration. Germany has also introduced major reforms in the healthcare system (although thus far these have not been as far-reaching as the Dutch reforms).

France recently implemented a major reform to its pension system. As part of this reform, public sector pension payments have been brought more in line with the less generous levels in the private sector. Early retirement has been made less attractive for all workers. Financial incentives have been introduced to encourage people to work longer. And from 2008 the retirement age will be linked to life expectancy. In the autumn of 2004 France also reformed its healthcare system. French people now have to make an appointment with a family doctor before they can go to a specialist. And they have to pay EUR 1 for a doctor's appointment. This payment constitutes a new source of income (albeit a small one) for the health service. However, it remains to be seen whether the various measures will actually reduce doctor visits and drug use. And finally, France has introduced several labour market reforms. Thus the law on the 35-hour working week has been made more flexible.

The Italian reform agenda seems rather less impressive at first glance, but Italy has also implemented a major reform of the pension system. The minimum retirement age will be raised in steps (from 57 years to 62 years), with a working life of 40 years the basis for full pension entitlement. (The Italian pension system thus remains one of the most generous in Europe.) Italy is also introducing incentives to work longer and to save for a pension. The Italian government has also introduced several labour market reforms over the last year. Thus the strict conditions governing part-time and temporary work have been relaxed.

While Italy is lagging behind somewhat in terms of reforms, the United Kingdom is ahead of the field. The British labour market is already very flexible by European standards, for instance. Even so, the government this year announced a five-year strategy centred on raising the participation rate to 80% of the labour force. Among the measures being taken are providing comprehensive childcare, allocating more resources to raise skill levels, and extending the financial incentives to work. The government has also announced measures to get as many occupationally disabled workers as possible back into the labour market. As in the Netherlands, the emphasis is on what people can still do (rather than what they cannot). The retirement age for women – which is currently lower than for men – is being raised. And the early retirement age for men and women is also being raised (albeit from a very low level of 50 years). The debate on further pension reforms is still in full flow.

It is not possible to consider developments in all EU member states. Suffice it to say that, on the basis of the above examples, it is clear that while the Netherlands's reform agenda may put it ahead of the field in some areas, our country certainly does not stand alone. There is no 'European model' as such, but the direction of the reforms is the same everywhere.

2.5 Conclusion

Late last year the CPB published four long-term scenarios for the Dutch economy[29]. The outcomes of this study have been interpreted in different ways. The optimistic reading is that the Dutch economy will continue to expand even in the most unfavourable scenario. Thus even at much lower growth rates, prosperity 30 years from now will still be greater than today. So why are we worried, why do we need all these reforms? The pessimistic reading is that in most scenarios future economic growth will lag behind what we have become used to in the past. In the past we achieved substantial economic growth, but our children and grandchildren will fare less well. And even if the predicted greater prosperity materialises, much of it will be 'swallowed' by the higher costs associated with the ageing population.

Long-term projections are of course surrounded with a large degree of uncertainty. The economic boom in the United States in the 1990s came as a complete surprise to most economists, as did the sharp decline of the Japanese economy during the same period. As mentioned in section 2.2, forecasting economic growth for just one year ahead is already exceedingly difficult. History is full of economists who have predicted the collapse of economic growth over the longer term. In practice the Dutch economy expanded (thanks to technological progress and trade) by more than 700% since the Second World War[30] (in terms of real GDP growth per head), which is more than during the preceding 1000 years. Then again, at the end of the last century there were economists who thought that the 'new economy' would bring an unprecedented era of high growth and low inflation. This prediction also proved false, as became painfully clear when the information and communication technology bubble burst in 2000.

The Dutch economy will continue to expand in the future. That is the good news. But structural economic growth never comes about of its own accord, it is always a consequence of changes and reforms. The CPB scenarios make clear that government policies matter. The reform agenda being implemented in the Netherlands and across Europe is a logical response to the challenges of the 21st century. Special attention for the role of government in the new millennium is justified in this context. The reforms are necessary to prepare the economy for the future, and they will ensure that, in the CPB's words, a 'robust growth in prosperity is a realistic prospect for the coming decades'. This year is likely to prove another difficult one in economic terms. Next year will be better. And thanks to the reforms, the Netherlands can be confident about its future in a changing world.

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