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Kingdom of the Netherlands—Netherlands: Selected Issues

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KINGDOM OF THE NETHERLANDS—NETHERLANDS

Selected Issues

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Approved by European I Department

May 23, 2002

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I. Medium-term Fiscal Policy Issues[1]

A. The Fiscal Framework

1. Over the past decade, the Netherlands has undergone a remarkable fiscal adjustment, with the deficit, the tax burden, and the expenditure to GDP ratio all falling significantly (Figure 1). The switch from a deficit-target-based to an expenditure-target-based fiscal framework in 1994 and commitments to two successive four-year fiscal plans have played an important role. The current multi-year framework expires this year, and the Study Group on the Budgetary Margin has produced recommendations for the coming government period. In brief, the Study group recommended maintaining the key elements of the current framework, while proposing some important refinements.

2. During the period 1983 to1994, Dutch fiscal policy was based on the operational target of the central government cash deficit. In practice, budget discussions set a time path for the reduction of this deficit and placed limits on the "collective burden" of taxes and social security contributions. Deficit reduction was therefore to be achieved through expenditure reduction. The use of an actual deficit target at times led to strongly pro-cyclical fiscal policy (Figures 2 and 3). For example, during the 1983-1994 period, changes in structural primary balance are negatively correlated with output gaps. This pattern was especially pronounced in the late 1980s and early 1990s: the structural primary deficit rose sharply in the boom years of 1989-90, but the balance improved by almost 2 percent of GDP in 1993, a year of virtual economic stagnation. Lower-than-expected economic growth led to substantial ad-hoc austerity measures, such as the supplementary budget in 1991, when the government was forced to cut spending and raise taxes.

3. This experience led in 1995 to the adoption of a framework emphasizing expenditure rules. During 1995-98, ceilings were set on spending for the central government, social security, and health care. The time path for expenditure was based on assumed real GDP growth of 2½ percent, based on the "cautious scenario" produced by the Netherlands Bureau of Economic Policy Analysis (CPB). As the actual rate of economic growth averaged 3½ percent, no spending cuts were needed and revenue windfalls funded additional tax and deficit cuts.

4. The 1998 Coalition Agreement continued the emphasis on multi-year expenditure ceilings and cautious growth assumptions. The principle of separation between spending and revenue management was entrenched. This meant that revenue windfalls could not be used to expand the expenditure ceilings, but instead had to be used for tax rate cuts or deficit reduction. Revenue targets under the framework were based again on the CPB's cautious scenario of 2½ percent growth, minus a substantial "safety margin" of ½ to ¾ percentage points of growth.

[1] Prepared by Jianping Zhou.

5. The use of this safety margin led to the presumption that revenues would tend to outperform the projections under the framework. Accordingly, rules were drawn up to govern the disposal of the "windfalls" (or, possibly, shortfalls). Since they would be only partly cyclical (the rest would be structural, in the sense that underlying growth would almost surely be higher than the CPB projection less the safety margin), in normal conditions half the "windfall" would go to deficit reduction and half would go to tax cuts.[2] This rule ensured that not all the "windfall" went to lower taxes, but it meant that the automatic stabilizers were not allowed full play and, thus, that fiscal policy still had a procyclical aspect. In fact, "windfalls" grew steadily during the four years of the coalition, reaching some €13.2 billion by 2002, although in practice most went to deficit reduction out of concern that tax cuts would aggravate demand pressures.

6. The key to the framework remained spending limits, fixed in real terms for the four-year government period.[3] Separate ceilings applied to the three categories of the central government, social security and the labor-market, and health care; overruns in a category were normally to be offset within that category. Some flexibility was built in, since the cabinet could shift resources across categories, and there was initially a small amount of room under the spending ceiling (about €1 billion in 1999) which was used up over the course of the government period. Each year, the real expenditure ceilings were converted into nominal ceilings using the projected GDP deflator, and these nominal ceilings were further adjusted according to updated projections at the time of the mid-year supplementary budget.

7. The new fiscal framework proposed by the Study Group on the Budgetary Margin would maintain the key elements of the current framework, including real expenditure ceilings, strict separation of spending and revenue decisions, and cautious growth assumptions. However, it would also involve changes to address the pro-cyclical tendency embedded in the current fiscal framework. Notably, the Study Group recommended reducing the safety margin to only ¼ percentage point. As this would largely remove the presumption of one-sided "windfalls," it also recommended full play of automatic stabilizers on the revenue side (rather than the 50-50 rule for allocating windfalls). However, it recommended re-examining the fiscal rules should the surplus rise above 3 percent of GDP or fall below zero.

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[2] If the deficit rose above ¾ percent of GDP, however, then 0.75 percent of the "windfall" would go to deficit reduction.

[3] The framework covered "net expenditure," which is total expenditure less non-tax revenue. Some expenditures, notably an infrastructure investment fund (financed in part with gas revenues and privatization proceeds), were not covered.

8. The Group also proposed using the expenditure deflator rather than the GDP deflator to translate the real expenditure ceilings into nominal spending for budget purposes. It argued that the expenditure deflator would be less affected by terms of trade shifts, and thus more stable. The practical effect of this change may be small, however, as the domestic demand deflator has in recent years been only marginally more stable than the GDP deflator (see table below).

Price Developments
(Percent change from previous year)

	GDP deflator	CPI	Expenditure deflator	Nominal Wages	Terms of trade
1995	1.8	2.0	1.7	1.2	0.9
1996	1.2	1.4	1.5	1.9	-0.7
1997	2.0	1.9	1.9	2.8	0.5
1998	1.7	1.8	1.7	3.2	0.2
1999	1.7	2.0	2.5	3.1	-1.2
2000	3.7	2.3	3.3	4.2	0.1
2001	4.7	5.1	4.5	4.0	0.7
2002	3.4	3.4	3.6	5.3	-0.1
Std. Dev.	1.24	1.21	1.10	1.31	0.71
Average 99-02	3.4	3.2	3.5	4.1	-0.1

B. Fiscal Strategies and Population Aging[4]

The estimated budgetary costs of aging

9. Compared to other EU countries, the Netherlands is well positioned to deal with population aging in the sense that its relatively balanced population structure implies a relatively small aging shock (see table below), its debt-GDP ratio is below the EU average, and the pension system is better diversified as it includes a large and well funded second pillar (see the Box 1). Nevertheless, population aging is projected to significantly increase public expenditures for pensions and health care. As a result, the CPB prepared a long-term fiscal strategy to ensure sustainability of the public finances over the next five decades.

10. According to the CPB, the Dutch old-age dependency ratio will rise from 22.1 percent in 2000 to 42.7 percent in 2025, then stabilize at around 40 percent by 2050.[5] The rising old age dependency ratio in the Netherlands is attributable to the expected rising

[4] This section draws on Van Ewijk, *et al.* (2000), which follows the Gokhale-Kotlikoff generational accounting methodology, applied to data available in the summer 2000.

[5] The old-age dependency ratio is defined as the number of people over 65 divided by those 20 to 64 years old.

life expectancy and a falling fertility rate.[6] The CPB projects that, as a result, public expenditures on pensions, health care, and disability could rise by 8¾ percentage points of GDP between now and 2040, and the share of these items in government spending could rise form 26 percent to 38 percent (see Table 1).

Old-Age Dependency Ratios		
	2000	2050
Italy	0.29	0.67
Spain	0.27	0.66
Greece	0.28	0.59
Austria	0.25	0.55
Germany	0.26	0.53
France	0.27	0.51
Belgium	0.28	0.50
Portugal	0.25	0.49
Finland	0.24	0.48
Sweden	0.30	0.46
U.K.	0.26	0.46
Ireland	0.19	0.44
Denmark	0.24	0.42
Luxembourg	0.23	0.42
Netherlands	**0.22**	**0.40**
EU-15	0.27	0.53

Source: OECD (2001), except for the Netherlands, which is from the CPB.

11. The taxation of private-sector pension income provides a substantial offset to these costs, and is projected by the CPB to raise additional revenue of 5.1 percent of GDP between now and 2040. This projection is based on the assumption of buoyant returns to investment of private pension funds, as has indeed been the case in the past 20 years (Iglesias and Palacios, 2001),[7] but if returns prove substantially lower, pension payouts and the tax revenue from them will also be less. However, given this projection, the fiscal costs net of the automatic tax benefits would rise by about 4 percent of GDP by 2040.

[6] By 2050 the life expectancy for males is expected to rise from its present level of 75.3 to 80 years, and for females from 80.0 to 83 years. An additional year of life expectancy would raise pension costs by an estimated ½ percent of GDP.

[7] For example, Algemeen Burgerlijk Pensioenfonds (ABP), the Dutch civil servants' pension fund, is one of the world's largest investment institutions., with total assets of more than €150 billion at end-1999. PGGM, the number two pension fund in the Netherlands, with total assets of €50 billion at end-1999, ranked 20th worldwide. Most of the top Dutch corporations—such as Shell and Philips—have their own pension funds.

Box 1. The Dutch Pension System

The pension system in the Netherlands has three pillars. The first is mandatory pay-as-you-go public pension schemes, with benefits indexed to the minimum wage. The second pillar includes occupational pension schemes which are mandatory for workers in the public sector and for vast majority of workers (more than 90 percent) in the private sector; they are mainly defined-benefit schemes. The third pillar is individual retirement provisions. Both the second and the third pillars are fully funded. The first pillar accounts for 50 percent of pension income, and the second and third pillars account for 40 and 10 percent, respectively.

The Netherlands (together with the UK) has by far the largest amount of private pension fund assets in EU countries (table). Assets of the Dutch occupational pension funds (a second-pillar scheme) amounted to 121 percent of GDP in 2001, and are expected to increase to nearly 200 percent of GDP by 2040. The financial position of these funds is thought to be sound (Verzekeringskamer, 2000).

Private Pension Fund Assets in Selected Industrial Countries

Country	Assets as percentage of GDP	Year
Netherlands	**121.0**	**2001**
Netherlands	**87.3**	**1996**
United States	86.4	1998
United Kingdom	83.7	1998
Australia	61.0	1996
Canada	47.7	1998
Ireland	45.0	1996
Japan	41.8	1996
Finland	40.8	1996
Sweden	32.6	1996
Denmark	23.9	1996
Luxembourg	19.7	1996
Greece	12.7	1996
Portugal	12.0	1998
Norway	7.3	1996
Germany	5.8	1996
Spain	5.7	1999
France	5.6	1996
Belgium	4.8	1997
Italy	3.2	1998
Austria	2.6	1998

Sources: OECD and CPB. Of these countries, only Australia, Denmark, Sweden, the United Kingdom, and the Netherlands have mandatory private pension schemes.

The proposed long-term fiscal strategy

12. In view of these costs, the CPB calculated a deficit path that would ensure long-term fiscal sustainability without increases in taxes or social security contributions. In brief, it

calls for reaching and maintaining a budget surplus of 1¼ to 1¾ percent of GDP, in order to eliminate the national debt by 2025, and then a return broadly to balance.

13. The methodology used in the study for analyzing the sustainability of public finance is based on the generational accounting framework established by Gokhale and Kotilikoff (Kotlikoff, 2001), and on ensuring that the government's intertemporal budget constraint is satisfied; that is, in present values, government revenues (T) are sufficient to cover expenditures (L), including liabilities associated with aging. Age-specific benefits from the government minus age-specific tax payments to the government are calculated for the base year, and extrapolated to estimate future revenues and expenditures.[8] If the intertemporal budget constraint were not satisfied, revenues would need to rise, the permanent adjustment required to close the gap being (where r is the interest rate and g the growth rate of GDP):

$$(r-g)\frac{L-T}{GDP}\ .$$

14. In addition, tax rates are held constant over time in order to minimize deadweight loss. The argument, laid out in Barro (1979), is that the distortionary cost of a tax rises more than proportionally with the tax rate, implying that the total distortion is minimized when the tax rate is constant. Note that this rule is not equivalent to equalizing the tax burden across generations.

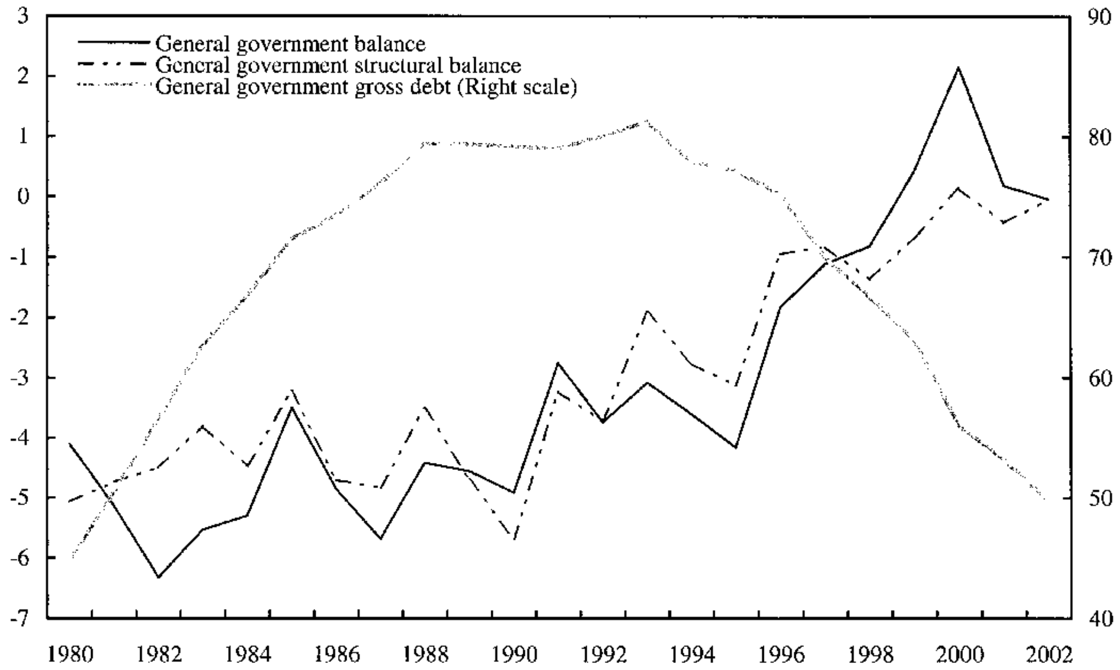
15. The CPB produced two scenarios to analyze the implications of aging for long-term fiscal sustainability (Table 1). The base case of unchanged policy is characterized by a gradual reduction in government debt during the period 2001-2020, followed by a gradual increase in debt during 2020-40, and a high and rising debt level by 2080. The second scenario—in which taxes are raised early in response to future population aging—is characterized by an initially rapidly declining debt stock, which remains broadly stable thereafter. Both scenarios have the same macroeconomic assumptions: the real interest rate (4 percent), the inflation rate (2 percent), and labor productivity growth (1¾ percent) are exogenous and constant; and age-specific wages are assumed to grow at the same rate as age-specific labor productivity.

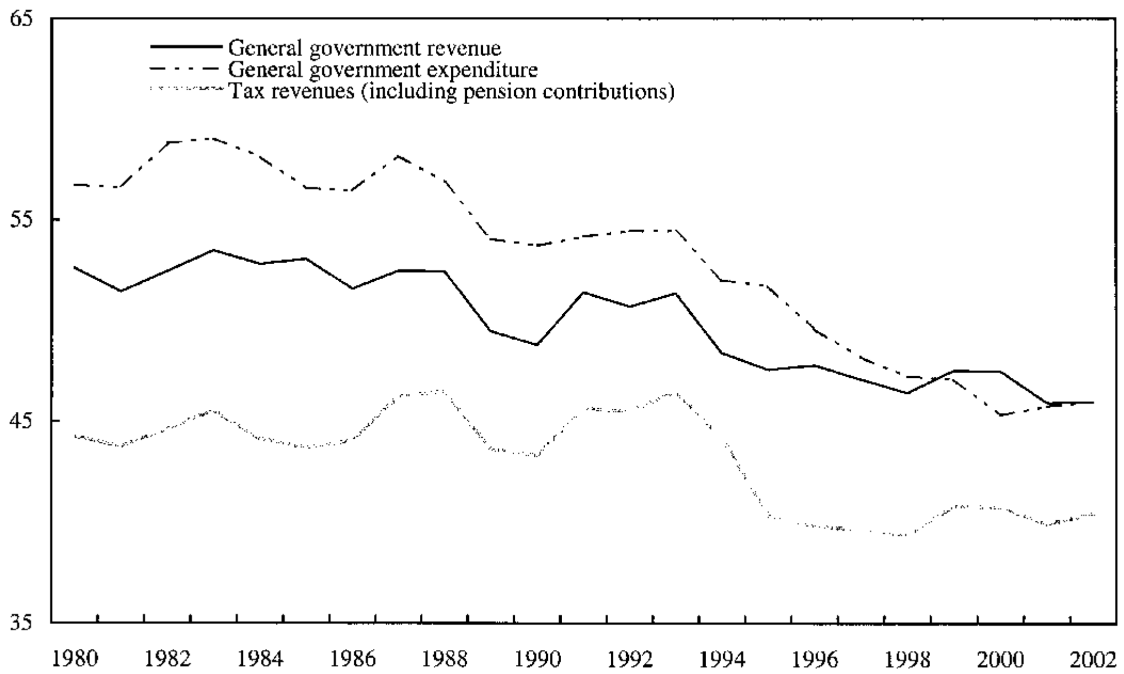
16. Two key results emerge from the analysis. First, even in the base case public finances appear sustainable at least over the next thirty years, and public debt is even reduced substantially during this period. But, after 2030 the budget deficit could exceed the Maastricht ceiling, the public finances become increasingly unsustainable as the fiscal costs of aging peak in 2040, and the debt path becomes explosive after 2040. Second, under the second scenario, implementation in the near future of a permanent increase in indirect taxes

[8] A typical age profile of benefits would show the percentage of population (the young and the old) that are the recipients of age-specific net benefits, as well as the percentage of population (middle-aged) that are net contributors.

of 0.7 percent of GDP (assuming a surplus of 0.9 percent of GDP in 2001) would raise the surplus to 1¼ - 1¾ percent of GDP, which is sufficient to ensure long-term fiscal sustainability. The national debt would be eliminated by 2025 and the budget nearly balanced in 2040, when population aging peaks.

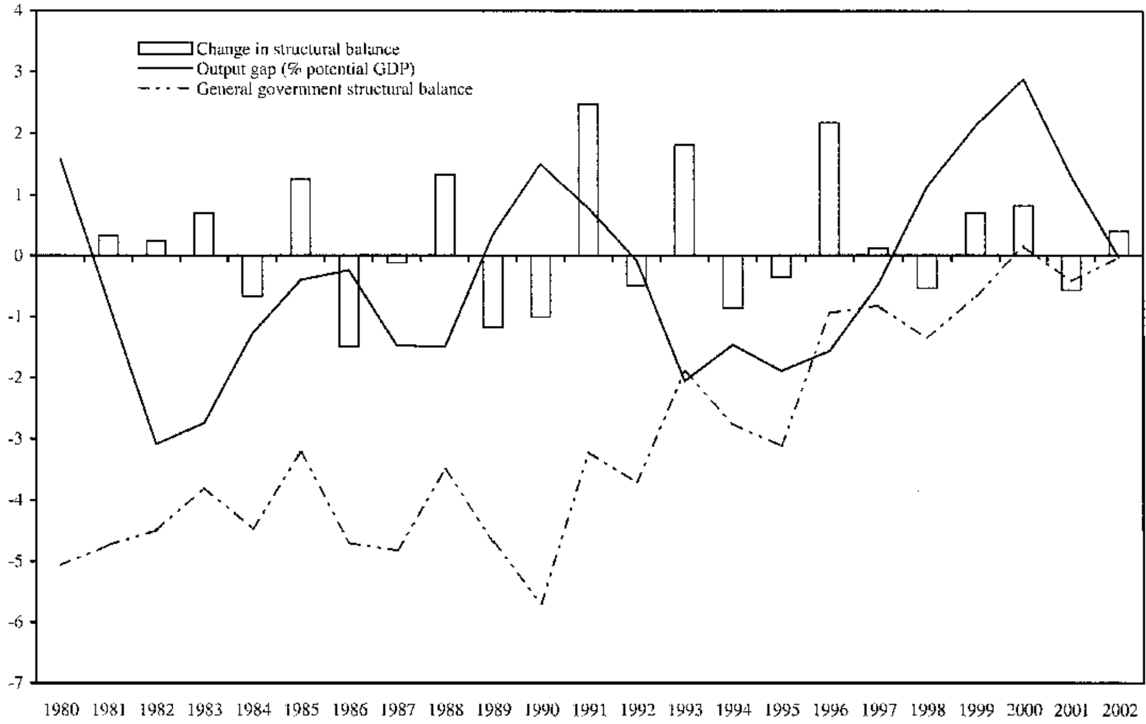
Figure 1. Netherlands: Fiscal Developments
(In Percent of GDP)





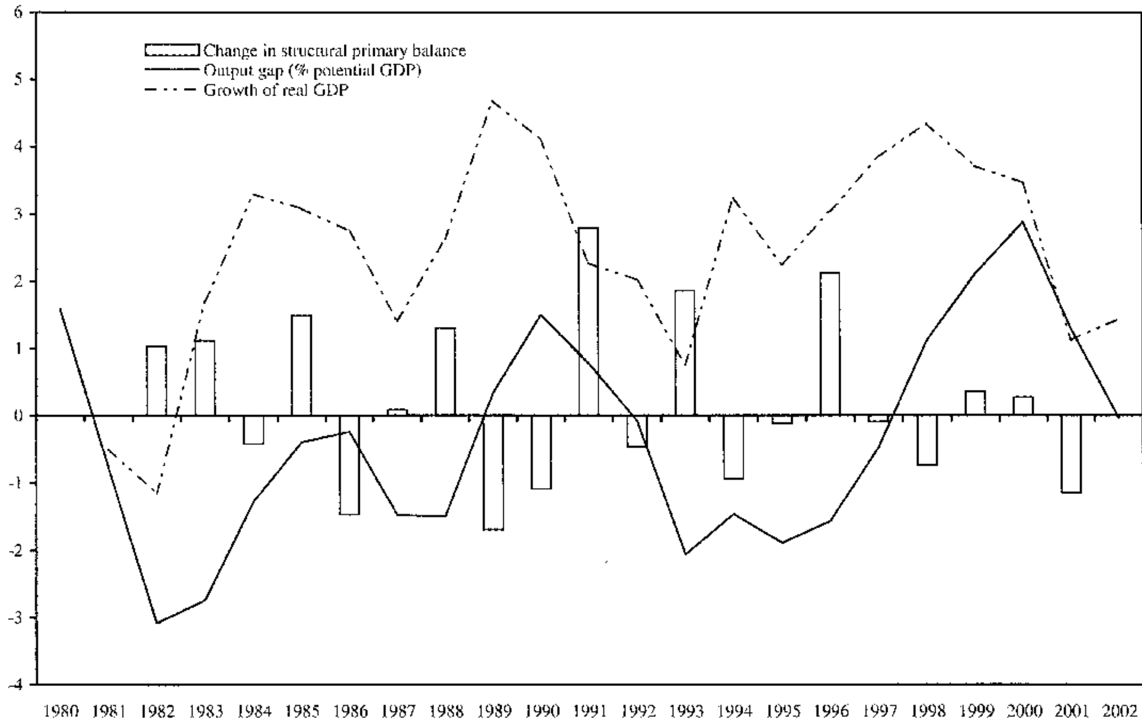
Source: IMF, WEO.

Figure 2. Netherlands: Evolution of the Structural Balance
(In Percent of GDP)



Source: IMF, WEO.

Figure 3. Netherlands: Change of the Structural Primary Balance
(In Percent of GDP)



Source: IMF, WEO.

Table 1. The Netherlands: Budget Projections Under Alterative Scenarios[1]
(As percent of GDP)

	2001	2010	2020	2040	2060	2080
			Base case scenario			
Revenues	45.8	46.5	47.7	50.2	49.8	49.6
Income tax + social security contributions	20.7	21.7	22.5	24.2	24.1	23.8
of which: from pension income	1.8	2.1	2.9	4.9	4.9	4.9
Corporate tax	3.6	3.2	3.2	3.2	3.2	3.2
Indirect tax & other	19.2	19.5	20.0	21.2	21.2	21.2
of which: from pension income	1.5	1.7	2.3	3.5	3.5	3.5
Revenue from asset (e.g. Gas)	2.3	2.1	2.0	1.6	1.3	1.4
Expenditure	44.9	46.3	48.1	53.5	55.1	58.6
Social security	10.9	12.4	13.9	15.9	15.3	15.5
Public pensions	4.7	5.4	6.8	9.0	8.3	8.5
Disability benefits	2.7	3.3	3.6	3.4	3.5	3.5
Unemployment benefits	1.5	1.7	1.6	1.6	1.6	1.6
Other	2.0	2.0	1.9	1.9	1.9	1.9
Health care	7.0	7.7	8.6	10.6	10.3	10.2
Education	4.4	4.6	4.4	4.6	4.5	4.6
Other primary expenditure	19.1	19.5	19.5	19.5	19.5	19.5
Interest payments	3.5	2.1	1.7	2.9	5.5	8.8
Budget balance (EMU definition)	0.9	0.2	-0.4	-3.3	-5.3	-9.0
Primary balance	4.4	2.3	1.3	-0.4	0.2	-0.2
Government debt (EMU definition)	54	36	28	51	98	157
			Adjustment scenario			
Revenues	46.5	47.2	48.4	50.9	50.5	50.3
Income tax + social security contributions	20.7	21.7	22.5	24.2	24.1	23.8
of which: from pension income	1.8	2.1	2.9	4.9	4.9	4.9
Corporate tax	3.6	3.2	3.2	3.2	3.2	3.2
Indirect tax & other	19.9	20.2	20.7	21.9	21.9	21.9
of which: from pension income	1.5	1.7	2.3	3.5	3.5	3.5
Revenue from asset (e.g. Gas)	2.3	2.1	2.0	1.6	1.3	1.4
Expenditure	44.9	45.9	47.2	51.0	50.4	50.4
Social security	10.9	12.4	13.9	15.9	15.3	15.5
Public pensions	4.7	5.4	6.8	9.0	8.3	8.5
Disability benefits	2.7	3.3	3.6	3.4	3.5	3.5
Unemployment benefits	1.5	1.7	1.6	1.6	1.6	1.6
Other	2.0	2.0	1.9	1.9	1.9	1.9
Health care	7.0	7.7	8.6	10.6	10.3	10.2
Education	4.4	4.6	4.4	4.6	4.5	4.6
Other primary expenditure	19.1	19.5	19.5	19.5	19.5	19.5
Interest payments	3.5	1.7	0.8	0.4	0.8	0.6
Budget balance (EMU definition)	1.6	1.3	1.2	-0.1	0.1	-0.1
Primary balance	5.1	3.0	2.0	0.3	0.9	0.5
Government debt (EMU definition)	54	28	12	8	13	10

Sources: CPB and the IMF staff estimates.

[1]Same macroeconomic assumptions applied to both scenarios.

II. Inactivity and Poverty Traps[9]

17. Inactivity and poverty traps are substantial in the Netherlands, particularly at the lower end of the earning scale. For example, in 2001, for one-earner families, transition from assistance to a minimum-wage job implied an 8 percent decline in net disposable income, and the "break-even wage" was 1⅓ minimum wage (Table 2). The main contributors to this situation are the rent subsidy from the central government (Box 2) and the income support policies of the municipalities (Box 3). Largely reflecting these programs, replacement rates have increased in recent years: between 1995 and 2001, the purchasing power of recipients of the social minimum benefit increased approximately twice as much as that of a modal household. Finally, Dutch replacement rates are also high by international standards (Table 3).

18. In addition, the marginal effective tax rate (METR)—the rate of benefit withdrawal as income rises plus the marginal tax rate (including employee social security contributions)—can exceed 100 percent for earnings between 100 and 140 percent of the minimum wage (Figure 4). The rent subsidy and municipal policies also contribute to the METR. Again, Dutch METRs are high by international comparison (Tables 4).[10]

19. Recent reports (the IBO report and the Poverty Trap Report) have analyzed these issues, and the Social Economic Council (SER) recently produced an opinion on the strategy to resolve the problems they create.

Box 2. The Rent Subsidy

Approximately one million households (32 percent of all renters) receive a rent subsidy. The amount of the subsidy depends on the difference between the actual rent and the so-called standard rent (or the renter's contribution), with the latter rising with the renter's income. Actual rent in excess of a threshold is only covered partially by the subsidy. The fact that the subsidy diminishes with income raises the METR by some 40 percentage points for multi-person households earning between 100 and 145 percent of the minimum wage, and 50 percentage points for one-person households earning between 80 and 100 percent of the minimum wage.

Expenditures on rent subsidies increased sharply in the second half of the nineties, primarily due to an increase in the per capita subsidy (rather than an expansion of the subsidy base). This development reflected in part a conscious policy to support purchasing power. However, it aggravated the poverty trap and created an inequality of treatment between subsidy recipients and others. Recently, some progress has been made on the latter front. The extra allowance for purchasing power was removed from the rent subsidy and replaced by an increase in the general tax credit. In July 2002, the child supplement, which is now linked to the receipt of a rent subsidy, will be replaced by a general child allowance for households with incomes below €25,500.

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[9] Prepared by Florence Jaumotte.

[10] The figures in Tables 3 and 4 include income-dependent benefits from the central government, but not from local governments. The latter are substantial in the Netherlands, resulting in an underestimation of replacement rates and METRs.

Box 3. Municipal Income Support

The law restricts municipal responsibility to supplementary support for specific cases for which the generic income policy of the central government is insufficient. However, in the mid-1990s the municipalities began to benefit from both more financial resources and wider policy room. In particular, municipal policy in this area broadened with the introduction of categorized income support, in which assistance is based on general criteria instead of individual circumstances. As a result, expenditures on municipal poverty policy almost tripled between 1995 and 1998, despite strong economic growth, rising incomes, and improved work opportunities. This increase in municipal expenditures reflected mostly the expansion of waivers and special assistance.

Municipalities can grant waivers from municipal and water authority levies to people with insufficient payment capacity and wealth. There is substantial latitude in the design of waiver policies, and they have proved very generous. Owing to their specific nature, the increase in METR these policies create varies, but is perhaps 20 percentage points in some income ranges. Municipalities are also responsible for special assistance, in circumstances where personal resources and the general assistance are insufficient to cover basic living expenses. In this case, the concern has been insufficient control by municipalities to ensure that the expenses claimed are necessary or actually incurred. In terms of the budget, special assistance is the largest municipal income-dependent policy, and also raises the METR over some income ranges by about 20 percentage points.

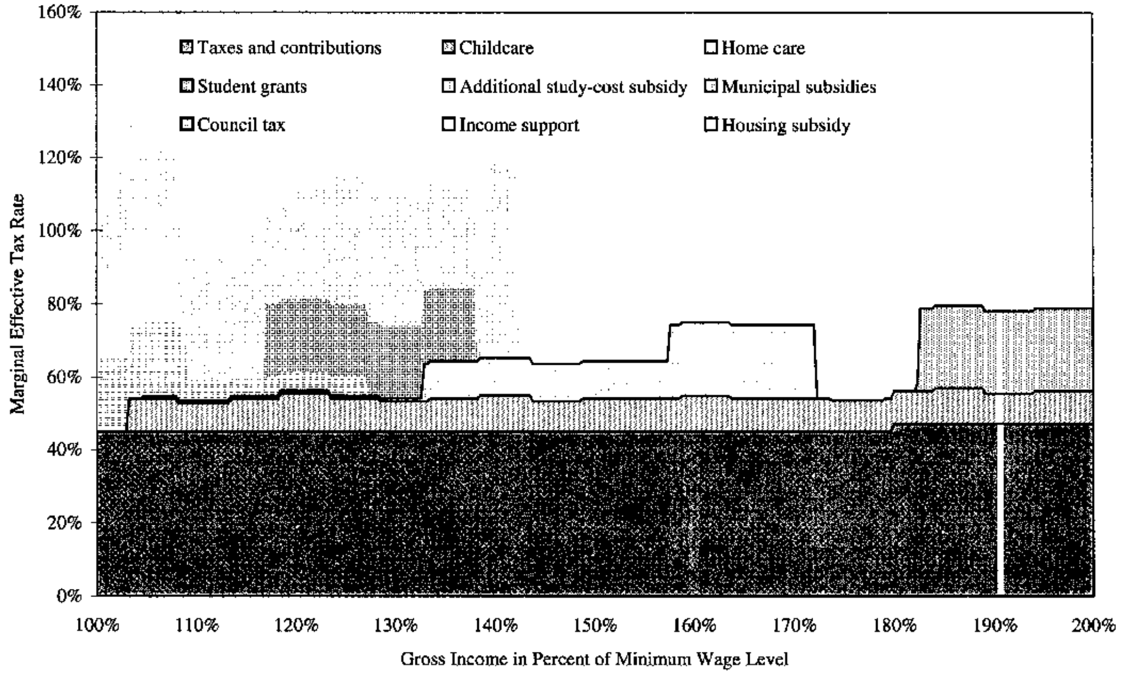
A. Income Support Policy

20. The SER proposed to reduce inactivity traps via four initiatives: recovering the central government's control over income support policy; increasing the transparency of this policy; cutting benefits; and reforming the labor tax credit.

21. The expanded municipal role in income support has tended to dilute the central government's role. Therefore, the SER proposes to recentralize those expenditures pertaining to generic income support, leaving municipalities with their original role of providing temporary support based only on special circumstances. Additionally, municipal control over transfers, to ensure that the expenses claimed by beneficiaries are necessary and take place, is to be strengthened.

22. The multitude of income-dependent benefits, many of which use different income and household concepts, have made the total effect of these policies opaque. Greater transparency, by rendering the scale and nature of the inactivity and poverty traps more obvious, might help to gather support for reform. Also, during the reform process, the implications of policy changes would be clearer and thus more easily analyzed. However, increased transparency would not in itself reduce the traps; indeed, it could initially increase them as more people become aware of their entitlements.

Figure 4. Netherlands: Marginal Effective Tax Rates (Single Earner Household with Three Children)
(In percent)



Source: National authorities.

23. As first steps, the SER recommended grouping programs to the maximum extent and harmonizing the concepts of income and households used to determine eligibility and benefits. Ultimately, they saw the various programs being brought into the tax system in the form of tax credits—that is, the programs would be fiscalized. Apart from increasing transparency, this reform could simplify the administration of benefits, although it may also require the tax authorities to collect more information, such as household size and income.

24. Actual reductions in inactivity and poverty traps would require that benefits be cut to increase the attractiveness of working versus inactivity, and that rates at which benefits are withdrawn be lowered (that is, the METR reduced) to encourage greater work effort. One way to implement the latter measure would be to extend existing benefits further up the income scale. This option was rejected by the SER because of its substantial budgetary costs, and because it would imply raising METRs at higher incomes. Regarding benefit cuts, the SER saw room to eliminate redundant and non-essential municipal programs. It recommended phasing these out gradually by, for example, freezing subsidy rates in nominal terms, or grandfathering existing beneficiaries. In any event, the SER recommended using tax credits to protect the purchasing power of those at the social minimum benefit.

25. The labor tax credit (LTC), introduced as part of the 2001 tax reform, served a double purpose: to cover employment-related costs (previously covered by fixed tax deduction) and to make work more attractive by reducing the effective replacement rate. However, the Dutch system, contrary to programs elsewhere, does not claw back benefits as earned income rises. This feature implies that some 85 percent of the benefits go to those at higher incomes who see no reduction in their METR. On the plus side, it means that the LTC lowers METRs at low incomes but does not raise them at higher ones (except to the extent that general tax rates have to be higher to pay for the LTC). CPB simulations show that there is a risk that introducing a benefit clawback could result in a fall in total hours worked and a shift from more-educated to less-educated workers.

26. The SER recommends limiting the LTC to employment-related expenses, and introducing an additional income-dependent program with a claw back at higher levels of income. The claw back would provide money to lower further the replacement rate or the METR at low earning levels, where the inactivity trap is greatest. With a view to limiting the increase in marginal burden at further up earning scale, the SER suggests reducing somewhat marginal tax rates for the middle and higher-income groups, using part of the resources freed by the claw back.

B. Reintegration Policy

27. The SER also calls for more effective labor-market reintegration to combat inactivity traps. This would involve on the one hand better tailoring reintegration efforts to individual needs, and on the other hand stronger financial incentives for municipalities to reduce welfare dependence and increase reintegration.

28. The SER has put forward several proposals to increase the effectiveness of reintegration efforts:

- A case management approach, involving individual brokering and monitoring and a bigger role for the private sector in reintegration. The SER proposes that the Center for Work and Income (a public-sector agency) initially attempt integration directly, but if this effort failed then municipalities (who would take over responsibility) would contract the services of a private reintegration firm. If this too failed, the private firm would report why, in part in order to inform further reintegration efforts by the municipalities themselves.

- Reintegration into regular jobs, rather than subsidized jobs. Experience suggests that subsidized jobs programs (ID and WIW) have not been efficient at moving people to regular work, and in many instances such jobs have come to exert unfair competition on the private sector. The SER therefore recommends regularizing those subsidized jobs that serve a socially useful purpose, and eliminating the rest. Municipalities would have the possibility of giving jobs to the long-term unemployed, but only after all other reintegration attempts had failed.

- Limiting employment subsidies (SPAK and VLW). The SPAK, which reduces employers' social security contributions, would be limited to four years, on the ground that this should be enough time to increase a worker's productivity to the point of being able to hold a regular job. The VLW subsidies, for long-term unemployed, mostly serve to finance ID and WIW jobs, and would therefore be eliminated.

- Schooling to help people reintegrate. The SER emphasizes specific training combined with work, which available evidence suggests is likely to be most effective. The employer would be compensated for the training part of the job, possibly using resources released by the elimination of VLW subsidies.

- Narrow exemptions from job search for benefit recipients, and apply controls and sanctions more strictly. At present, about two-thirds of benefit recipients are exempted from job search, either statutorily or *de facto*. Municipalities can grant exemptions to individuals for personal, medical or social reasons. Single parents with children below the age of five and workers over 57½ years old are automatically exempted. The effectiveness of reducing these exemptions would be greatly enhanced by stricter controls to ensure job-search obligations were being met and stiffer sanctions in the event they were not.

29. Municipalities administer welfare and reintegration policies, and the incentives they face in this regard are therefore critical. The SER proposes to stiffen incentives by extending the use of block grants by the central government to finance municipal welfare spending to 50 percent, from the current 25 percent. The system has already been changed from one in which the central government financed all municipal public assistance spending based on

municipalities' declaration of the number of recipients. Currently, it reimburses only 75 percent of actual assistance expenditures, with the remaining 25 percent coming from a predetermined budget provided to the municipality for this purpose—the so-called block grant. If assistance spending turns out lower than this, the municipality can use the rest for other purposes, but if it is higher, the municipality must make up the difference from other sources (though only up to the limit of 15 percent of the budget or €6.8 per inhabitant).

30. The amount of the block grant is based on national projections of assistance expenditures that take the macroeconomic situation (unemployment, inflation) into account. This amount is allocated among municipalities using 10 criteria which bear on the level of assistance expenditures, but which cannot be manipulated by the municipality. Currently, the allocation remains in part based on historical assistance expenditures, but for the large municipalities it should be fully based on these criteria by 2003.

31. From a budgetary perspective, block grants should give municipalities stronger incentives to discipline spending, as the alternative of matching funds implies a "subsidy" to spending. The theory and available empirical evidence on the use of block grants in financing welfare is summarized in Appendix I. Another advantage of block grants is that they increase municipalities' flexibility in budget allocation, which may enhance efficiency relative to central government control. There is the risk, of course, that municipal spending may fall below what the central government views as appropriate, perhaps due to a "race to the bottom" or just different priorities at the municipal or central level.

Table 2. Netherlands: Change in Net Disposable Income Following Transition From Assistance to Work

	Increase net wage	Loss of income-dependent Benefits			Job-related costs	Increase disposable Income	In percent of net income
		Loss rent subsidy	Loss waivers	Loss special assistance			
Single person to minimum wage							
1995	4905	-2240	-290	-570	-1020	780	5
2000	5360	-2680	-790	-2000	-1390	-1270	-7
2001	6810	-2760	-830	-2260	-1260	-330	-2
One-earner household to 130 percent minimum wage							
1995	5120	-1860	-840	-570	-1350	500	2
2000	5920	-2630	-1130	-2000	-1540	-1380	-5
2001	7550	-2660	-1190	-2260	-1750	-310	-1

Source: Poverty Trap Report (Dutch authorities).

Table 3. Netherlands: International Comparison of Net Replacement Rates for Four Types of Households, 1997 (Excluding municipal income support)

Income	0.6*APW[1]				1*APW[1]			
Household type	Single person	One-earner household w/o child	One-earner household with two children	Single person with two children	Single person	One-earner household w/o child	One-earner household with two children	Single person with two children
Netherlands	84	93	94	84	60	76	79	70
Germany	75	85	61	82	54	60	52	63
Belgium	61	88	79	85	46	67	63	69
Denmark	67	94	92	82	48	67	97	70
USA	10	18	61	51	7	12	48	41
UK	73	88	95	81	50	61	73	63

Source: OECD, *Benefits and work incentives*, Paris 1999.

[1] APW = average production worker. For the Netherlands, the minimum wage is about 60 percent of APW.

Table 4. Netherlands: International Comparison of Marginal Burdens, Excluding Municipal Income Support (2001 in parentheses)

Household type	Single person			One-earner household w/o child			One-earner household w/two children			Two-earner household w/ two children		
Income (as fraction of APW)[1]	0.6	1	1.5	0.6	1	1.5	0.6	1	1.5	0.6	1	1.5
Netherlands	121	52	49	103	40	49	103	40	49	-	41	49
	(121)	(44)	(41)	(103)	(43)	(42)	(103)	(43)	(42)	-	(43)	(44)
Germany	51	55	57	21	45	43	43	44	41	-	46	49
Belgium	54	56	56	54	52	56	54	52	56	-	51	54
Denmark	46	51	65	58	45	45	58	45	45	-	39	45
USA	30	30	43	30	30	30	51	51	30	-	45	25
UK	33	33	33	33	33	33	70	70	33	-	26	33
Sweden	40	37	52	40	37	52	60	57	52	-	55	36
Finland	43	49	54	43	49	54	75	49	54	-	36	45
Ireland	29	52	49	29	30	27	88	30	27	-	30	30
Italy	25	25	25	25	50	50	50	50	25	-	29	33

Source: NEI Arbeid en Onderwijs, *De armoedeval in perspectief*, Rotterdam 2001.
[1] APW = average production worker. For the Netherlands, the minimum wage is about 60 percent of APW.

Theory and Facts on Block Grants

Theory

32. Bradford and Oates (1971) show that matching-grant financing of lower levels of government will always lead to greater spending than block grants. They assume collective decisions are taken by simple majority rule, individuals' tax shares are fixed, and there is a single public good (standing here for municipal assistance). Each individual is assumed to have convex preferences defined over quantities of a private good and a public good, the relative price of the public good in terms of the private good is unity, and the budget constraint is AB (Figure 5).

33. Consider first an individual decision maker. The receipt of a matching grant would pivot his budget constraint outward about the point A to reflect what is now in effect a lower unit price of the public good. As a result, provision of the public good would rise to G_1, implying a grant of DE. If instead of a matching grant of DE, the state provided a lump-sum grant of the same amount, the budget constraint would shift out to FH but would not pivot (there would be no change in the relative price of the private and public good). Since FH is steeper than AC at point E, the individual would choose a point somewhere to the left of E (depending on the exact shape of the indifference curve tangent to FH). Thus, both grants have the same income effect, but the matching grant encourages greater spending on the public good.

34. Consider next the collective decision (Figure 6). With single-peaked individual preferences and simple majority voting, the equilibrium budget allocation is the median of the levels of the public good chosen by the individuals. Let point E denote the equilibrium budget under the matching grant. The examination of the individual decision shows that the median voter, in particular, would choose less public good if faced instead with a lump-sum grant. This does not show that the collective decision will be for less public good, because voters who preferred less public good than E under the matching grand (say, K) might prefer more if the municipality received a lump-sum grant of DE. Indeed, the lump-sum grant corresponding to the equilibrium budget (DE) is larger than the one they would have received under their most-preferred matching grant, inducing an income effect. However, the tangency of an indifference curve with the budget line under the lump-sum grant must always occur on a curve which is higher than that which passes through K, so the chosen point must lie to the left of E.

Empirical evidence

35. The empirical literature has focused on estimating price and income elasticities of benefits, the key parameters determining how much spending would decline if financing shifted from matching grants to lump-sum, or block, grants. These estimates are based on a

regression of benefit levels on state median income and on a price variable, usually constructed as the caseloads times one minus the matching rate.[11] Income elasticities are generally significantly positive and quite large (see Chernik, 1998). Prices elasticities—the more relevant variable, as they capture the substitution effect—tend to be negative as expected, although their size and statistical significance varies across studies. Ribar and Wilhem (1999) conclude from a survey of estimates that price elasticities are of the correct sign but weak in significance and relatively small in magnitude. Chernik (1998), after reviewing the evidence, and Baiker (2001), using a different estimation strategy, argue for larger elasticities.

36. The "waiver programs" under the U.S. welfare system that existed until 1996 provide evidence on the effect of block grants. A 1987 agreement allowed Wisconsin to retain federal dollars resulting from state-initiated welfare benefit cuts, introducing a block-grant aspect to welfare financing. Wiseman (1996) found Wisconsin responded to the block grants by tightening eligibility, although strong economy was also found to play a role in reducing the welfare caseload. The 1996 U.S. welfare reform converted the system from open-ended matching of federal with state funds to block grants, thereby in principle providing another "natural experiment."[12] However, it has not yet been possible to test the effects of block grants, because most states have found the block grant not binding (have not spent all of their block grants) due to the sharp fall in welfare cases since 1994.

37. In France, Dėpartement expenditures for children, the aged, and the disabled were converted from open-ended matching grants into block grants in the early 1980s. The block grants were accompanied by a transfer of taxing authority, with a view to exactly compensating the Dėpartments for additional spending responsibilities. The reform induced a sharp drop in the rate of growth of regional social welfare expenditures after 1983, and other spending categories grew faster. Rocaboy (1994), estimating demand equations for local public goods, concluded that this resulted from the switch to block grants, rather than a change in local decision-makers' preferences.

[11] There are a number of issues in using aggregate state median income to proxy the income of the median voter, and also whether median income itself identifies the median preference voter.

[12] The reform introduced several other major changes, such as the devolution of major program design elements to the individual states, the imposition of strict work requirements to qualify for federal aid, and lifetime limits on the number of benefit-years which can be paid out of federal funds.

Figure 5. Netherlands: The Current Labor Tax Credit
(Guilders, 2001)

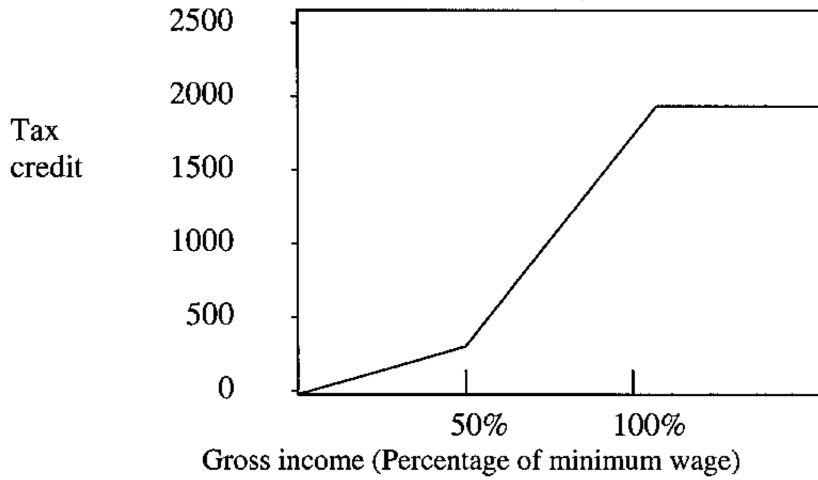


Figure 6. Netherlands: Individual Choice

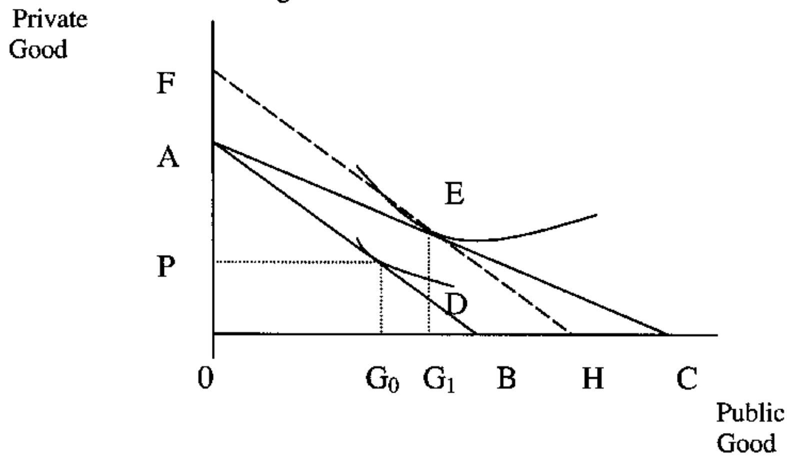
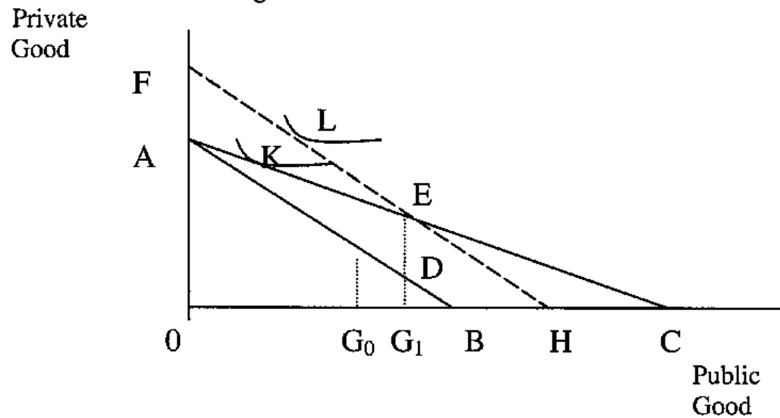


Figure 7. Netherlands: Collective Choice



III. Reform of the Disability Program[13]

38. While the share of workers receiving unemployment benefits in the Netherlands is one of the lowest in the OECD, the opposite is true of disability benefit recipients. The program has one million individuals, or about 13 percent of employment, and costs 4 percent of GDP (see table below). After stabilizing in the mid-1990s, the number of disabled has expanded again since 1997. A growing labor force and the increasing share of older workers and women (two groups over represented among the beneficiaries) are expected to push up the ranks of the disabled in the future.

39. There widespread agreement in the Netherlands that the disability program attracts people who do not really need social assistance and are capable of working. Although some disabled work part time, many do not, thus subtracting a valuable resource from the economy, an outcome particularly unwelcome given the persistent labor shortages of recent years.[14] In addition, the program represents a burden on employers and employees who finance it through social security contributions.

40. After a strong expansion in the 1970s and 1980s was tolerated and even welcomed as a way to reduce open unemployment, several attempts at reforming the disability system have taken place since 1987. These attempts, while yielding some success, failed to durably reduce the inflow into the program. The latest initiative to overhaul the disability program began in the spring of 2001, when a committee of experts (the Donner Commission) issued an advisory report to Parliament outlining a blueprint for reform. The Social and Economic Council (SER), an advisory body consisting mainly of representatives of employer and employee organizations, was then requested by Parliament to issue an opinion on the proposal. In March 2002, the members of the SER reached an agreement on a modified version of the Donner plan. Evaluations of the effects of the proposed reform on the size and cost of the disability program were performed by the Netherlands Bureau of Economic Policy Analysis (CPB), a government organization, and by NYFER, a private research center. The government expressed its opinion on the SER proposal in April 2002. The task of translating the SER plan into legislation will fall on the new government that will emerge after the May 2002 elections.

A. Characteristics of the Current System

41. Disability insurance in the Netherlands covers all employees as well as the unemployed. In contrast with other countries, there is no distinction between disabilities resulting from work-related injuries and other disabilities. An employee who becomes sick is covered by sickness insurance for the first year; if he does not recover, he can apply for

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[13] Prepared by Enrica Detragiache.

[14] About half of the partially disabled work at least part time. The partially disabled are 27 percent of the total disabled.

disability insurance. A medical examination is performed by a specialized physician, who in conjunction with an ergonomist determines the degree of disability based on the loss of working capacity. The latter is measured relative to a "generally acceptable" job for the skill level of the applicant. The beneficiary is re-examined every five years. Workers with a disability as low as 15 percent are eligible to receive benefits, and no minimum contribution period is necessary to qualify for the program.

Size of Disability Insurance Programs in Selected OECD Countries		
	Public expenditure on disability and sickness (Percent of GDP) Average 1995-98	Disability benefit-years as a percentage of full-time equivalent employment 1997
Japan	0.6	
Canada	1.0	
United States	1.4	7.9
France	1.7	10.8
Ireland	1.7	
Italy	1.8	
Greece	1.9	
Belgium	2.2	
Spain	2.4	9.7
Portugal	2.7	
Australia	2.8	
United Kingdom	2.9	9.5
New Zealand	2.9	
Germany	3.1	7.3
Denmark	3.1	9.5
Switzerland	3.3	
Austria	3.3	6.7
Luxembourg	3.3	
Finland	4.0	
Sweden	4.0	12.1
The Netherlands	4.4	11.1
Norway	5.1	

Sources: OECD, Netherlands Economic Institute.

42. The level of the benefit depends on the worker's wage and age at the time of disability, the degree of disability, and the statutory minimum wage. For example, a worker who is 45 years old and becomes fully disabled earns a benefit equal to 70 percent of his last wage (up to a statutory maximum) for the first 1½ years of disability. Thereafter, she earns 70 percent of the so-called "follow-up wage," computed as the weighted average of the minimum wage and the last earned wage, with weights 0.4 and 0.6 respectively. In contrast, if the same worker was only 50 percent disabled, she would earn 35 percent (i.e., 70 percent

of the degree of disability) of the last wage for the first 1½ years, and 35 percent of the follow-up wage thereafter. Workers who become disabled at a younger age receive lower benefits: for a fully disabled worker who joins the program at age 30, for instance, the benefit is 70 percent of the follow-up wage, and the latter is computed giving the last wage a weight of only 30 percent (rather than 40 percent as in the case of a 45 years old worker). Thus, replacement rates are higher for older workers and workers earning close to the minimum wage.

43. Collective agreements often top up the disability (and sickness) benefit for the first two years, often bringing it to 100 percent of the last earned wage. Thus, the first years of sickness and disability are particularly attractive financially.

44. During sickness both employers and employees have an obligation to work towards reintegration and rehabilitation. In 1998 the government introduced a system to differentiate the employers' disability contributions to penalize employers with high rates of disability among their workforce (PEMBA). This measure was intended to create financial incentives for firms to keep workers out of the program. A number of firms, however, took out insurance against the higher disability premia, thereby diluting the incentive.

B. The SER Reform Proposal

45. The new disability program proposed by the SER would be restricted to the permanently and fully disabled, i.e. individuals at least 80 percent disabled with no possibility of recovery within the subsequent five years. The disability is to be determined according to objective medical indicators, using standard prognoses established by the medical profession. For this category, the basis for the computation of the legal benefit would be the average indexed wage in the three years prior to disability, rather than the last earned wage, but the percentage rate would be raised from 70 percent to 75 percent. Topping up of the legal benefit in collective wage agreements still be permitted. The system of premium differentiation for employers (PEMBA) would be abolished.

46. A second important change would be the extension of the sick leave period from one to two years. In both years the employer would have to pay the employee 70 percent of the wage, and there would be a strong recommendation not to top up the benefit beyond this level in collective wage agreements in the second year. The obligation to work toward prevention and reintegration would remain, and the definition of a job deemed "adequate" for the employee in the second year would be broadened. If the employer's efforts to reintegrate the employee were judged insufficient, the social security agency would be able to extend the sick leave period as a sanction, until the employer satisfied his obligation.

47. For workers who are partially disabled, the new system would distinguish between those with a substantial work limitation (loss of earning capacity of at least 35 percent) and the others. The former would be entitled to a benefit from their employer, but only if they worked at least part time. The benefit would be calculated as under the current system, although the basis would be the average indexed wage over the three years prior to disability rather than the last earned wage, thus reducing the replacement rate somewhat. The employer

would be obliged to insure against this risk. The proposal does not specify whether this insurance should be private, or if the risk would be pooled at a national or sectoral level. Individuals with substantial work limitations who are unwillingly unemployed and the temporarily fully disabled would be entitled to unemployment benefits. When these expire, they could apply for general assistance. Importantly, the test for wealth and partner's income which is performed for standard assistance applicants would be waived for the partially or temporary disabled. Finally, people with substantial work limitations who did not want to work would no longer receive a benefit.

48. For the remaining category, workers with a disability of less than 35 percent, the SER proposal envisages no benefit, although work contracts could provide some compensation.

49. The reform blueprint also makes a number of suggestions to improve the medical examination. Given the difference of treatment between fully and partially disabled under the new system, the quality of the examination would become especially important. The main provisions in this area would be the following: (i) the person claiming disability would be responsible for providing the necessary medical information; (ii) a second independent examination would be required if the first examination diagnosed permanent and full disability; (iii) the competence of insurance physicians would be scrutinized and the quality of the services they provide would be improved, not least by making insurance medicine an academic discipline and resorting to specialists in the examination; (iv) the examination process would be randomly tested.

50. Importantly, the new system would only apply to new entrants, and the currently disabled would continue to receive benefits under existing rules.

C. The CPB Evaluation of the SER Proposal

51. Using its microeconometric model, the CPB simulated the effects of the SER reform proposal.[15] According to this analysis, the new system would strengthen financial incentives to reintegrate three groups of employees: the temporarily fully disabled, who would lose the contractual top-up of the legal minimum benefit in the first two years of disability (a decline in replacement rate of about 8 percent); individuals with substantial work limitations who do not want to work, who would lose disability benefits resulting in a decline of the replacement rate of 22 percent; and employees with a disability of less than 35 percent, who would also lose disability benefits, thus seeing their replacement rate fall by 15 percent. On the other hand, replacement rates would increase somewhat for the fully and permanently disabled and for people with substantial work limitations who work or are looking for work.

[15] The analysis makes the following assumptions with respect to the contractual top-ups of legal minimum benefits: a complement up to 100 percent of the last earned wage during the first year of sick leave, and one of up to 90 percent of the last earned wage during the first year of disability. The average degree of disability for people with substantial work limitations is assumed to be 52 percent.

52. The effect of the proposed reform on the average replacement rate would depend crucially on how much the new criterion that full disability also be permanent would reduce the inflow into full disability. This is because this group is by far the most numerous. If the new criterion reduces access to the disability program to 25 percent of the current inflow (the objective adopted by the SER), the average replacement rate would decrease by 1 percentage point. Under an alternative scenario in which inflow into disability is reduced only to 40 percent of the current inflow, the average replacement rate would increase by 2 percentage points.

53. With respect to the employers, according to the CPB the proposed reform would weaken incentives to prevent disability and seek reintegration, because the fraction of benefit payments subject to some extent of premium differentiation would decline from 73 percent under the current system to 54 percent under the new one. This results mostly from the elimination of PEMBA and from the fact that the benefit for the partially disabled who work would likely be financed sectorally or nationally. On the other hand, the extension of the sick leave period (on average by ½ year) would strengthen incentives somewhat.

54. Under the scenario in which the inflow of fully and permanently disabled drops to 25 percent of the currently fully disabled, the new structure of financial incentives for both employees and employers would result in total benefit payments remaining roughly unchanged, while benefit years would decrease by 10,000 and years spent working would increase by 8,000. Under the more pessimistic 40 percent scenario, total benefit payments would increase by €0.7 billion, the number of benefit-years would increase by 25,000, and the number of work-years would decrease by 18,000. Furthermore, if wage complements above the legal minimum were 2 percent higher than assumed in the simulation, total benefit payments would increase by €0.7 billion in the 25 percent inflow scenario and by €1.4 billion in the 40 percent one. Thus, according to the CPB, the proposed reform is more likely to lead to an increase in benefit payments than to a decrease.

55. The SER proposal also includes some non-financial incentives for reintegration, but their effects are difficult to quantify. First, the extension of the sick leave period to two years could increase the chances of reintegration by preserving the relationship between the employer and the employee for a longer period of time. Broadening the interpretation of "adequate work" for the disabled should also facilitate reintegration. Finally, the proposed reform would also lead to more frequent medical examinations, although the current shortage of examining physicians may prove an obstacle to implementation.

56. As noted above, much of the outcome of the reform depends on the application of the criterion of "permanent" full disability, which the SER report defines as "no chance of any recovery within the next five years." The CPB emphasizes how difficult it would be to make this criterion operational. Strictly speaking, at the time of entry into the program, almost every fully disabled has a possibility, albeit minimal, of recovery; thus under such a strict interpretation almost no one would be allowed into the disability program. Conversely, if physicians base their decision on the average duration of disability (currently 10 years), then

every fully disabled would enter. The use of a standardized list of probability of recovery may result in unfair decisions.

57. The CPB also expressed concern about having firms privately insure the wage top-ups for partially disabled who work. This would create incentives for employers or insurance companies to avoid the charges by not helping the worker find a job. In extreme cases, private insurers could persuade workers to resign in exchange for a financial compensation.

D. The NYFER Evaluation

58. The NYFER study relies on estimates made by physicians and medical experts and substantiated by natural experiments to evaluate the potential for reintegration of the various categories of disabled under the new system. In addition, the study assumes that the reform will introduce improvements in the medical diagnosis and follow-up which, studies have shown, will improve the likelihood of reintegration. The proposed extension of the sick leave period by one year is also assumed to improve the likelihood of reintegration, as it prolongs the employment relationship.

59. Psychological disorders, musculo-skeletal disorders, and unspecified pain account for about 90 percent of the inflow into disability. Medical experts evaluate that, under the new definition of disability as a full and permanent condition, entry into the program could be avoided in about 75 percent of these cases for people under the age of 55.[16] Based on these estimates, the NYFER assumes that the inflow into the new program could be limited to 37 percent of the current inflow, which is similar to the pessimistic CPB scenario. Of the remaining 63 percent, 43 percent would be fully reintegrated, while the rest (mostly the partially disabled) would receive a wage supplement or unemployment benefits. Under this scenario, in the long term the net saving in benefit payments could amount to €7.2 billion (1.8 percent of GDP). Savings would be smaller initially, since the new system would apply only to the new disabled. Additional expenditures may have to be incurred to improve the reintegration policy, both at the medical and at the labor market levels. On the other hand, society will gain from increased labor market participation and production.

60. The percentage of individuals who would be fully reintegrated is the main difference between with the NYFER and CPB evaluation. While the NYFER foresees a high rate of reintegration, thanks to the favorable effects of a more intense reintegration policy and better medical diagnosis and treatment, the CPB focuses mainly on the adverse change in financial incentives (the average replacement rate would rise), and predicts a low reintegration.

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[16] Under the SER proposal, access to disability on account of a psychological disorder would be limited to serious disorders such as schizophrenia. In addition, back pain, now a very common source of disability, presents a very high likelihood of recovery, and would therefore not be considered permanent.

E. The Government's Opinion

61. The government endorsed the basic recommendations of the SER with some key modifications.[17] First, for partially disabled workers who become involuntarily unemployed, the government recommends maintaining the test for partner's income to determine eligibility for general assistance once unemployment benefits expire. Otherwise, in many cases benefits would be more favorable than they are currently. The cabinet also expressed reservations about the SER proposal to finance privately the wage complements for the partially disabled who work. Besides creating incentives to keep the disabled unemployed, private insurance would also create a double examination process, one for the public insurance and the other for the private insurance.

62. The government also recommended that a first medical examination take place after the first year of sick leave, rather than at the end of the second year. This is because experience shows that about 25 percent of sick workers recover between the time they apply for disability and the medical examination, and the examination itself currently results in another 20 percent of applicants returning to work, suggesting that the examination is a useful deterrent to fraudulent claims. Those who are diagnosed permanently and fully disabled in the preliminary exam would enter disability immediately, while the others would be tested again at the end of the second year.

63. Concerning the system used to calculate the loss of earning power, the government recommended it be made more difficult for workers with low productivity (such as participants in subsidized work schemes) or high-skill workers to be declared fully disabled.

64. Finally, the government did not take a position on the proposal to increase the replacement ratio for the fully and permanently disabled and eliminate the system of experience-rating in employers' premia (PEMBA). A decision on these aspects of the proposal was left to the next government.

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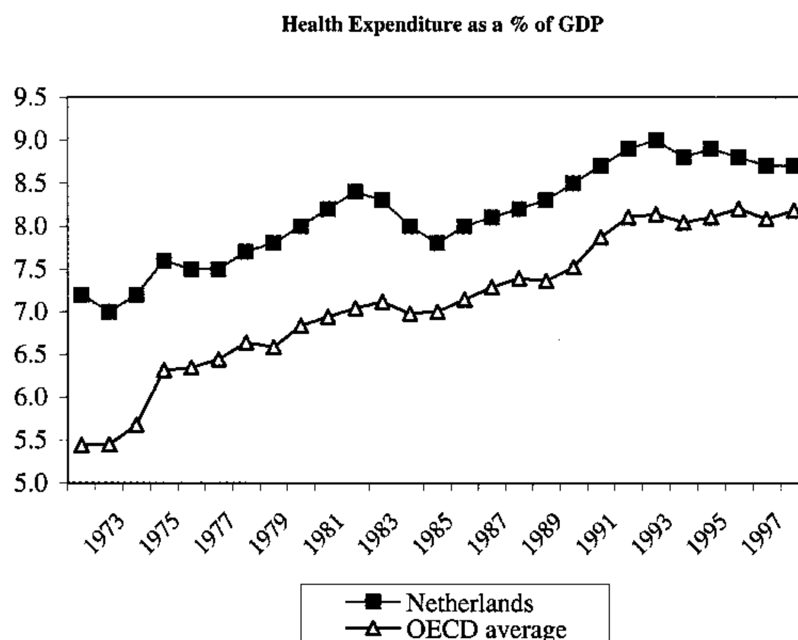
[17] As a step towards implementation, the government has asked the social security agency to draw up a list of permanent disabilities. Before that becomes available, the government recommends using a list of disabilities which are not permanent, such as stress, and lower back pain.

IV. Health Care Reform[18]

65. As in other advanced countries, in the Netherlands the health care system is a mixture of public and private.[19] Over the years government regulation, including widespread administrative and price controls over insurance and health care provision, has greatly reduced both the margin of manouver and the financial risks of private insurers and health care providers. Thus, the system is in many ways closer to a completely public one than official figures would suggest. At over 8 percent of GDP, total health care expenditure is somewhat higher than the OECD average (see figure below), but the gap has narrowed in recent years, as tight supply controls have held down spending growth.

Health Expenditure as a % of GDP



The health status of the population and other performance indicators in the Netherlands are good in international comparison.[20] There are, however, significant pressures in the system. In recent years, dissatisfaction among the public has been mounting because of long waiting

[18] Prepared by Enrica Detragiache.

[19] According to the OECD, "Health Care at a Glance, 2001," 68.6 percent of health care expenditure in the Netherlands was public in 1998, the 8th smallest share in the OECD.

[20] For a review of the Dutch health care system, see OECD, Economic Survey, 2000. Life expectancy in the Netherlands is above the OECD average, and so are indicators of health care inputs, such as physicians, nurses, and hospital beds per capita. Dutch men perform relatively better than women in international comparison, and younger people better than the old. Life expectancy at age 65 in the Netherlands is, however, below the OECD average.

lines, staff shortages, and perceived deteriorating quality of service. In addition, rapid technological advances and the challenges of population aging will likely require more flexibility and ability to adapt to new demands than the current system provides. Responding to these challenges, in July 2001 the government submitted to Parliament the outline of a reform project for the health care sector. The plan would introduce more market elements of private control and financial responsibility, while at the same time safeguarding universality of access and solidarity among participants of different risk and income levels. This plan might form the basis of a more specific proposal to be included in the agenda of the new government. The authorities envisage the introduction of the new system as a gradual process which will take several years to complete.

Characteristics of the current system

66. The current health system is quite complex, as it developed through the juxtaposition of new elements over time rather than through coherent design (see table below). Concerning the supply of health care services, hospitals are private non-profit organizations, and health care workers are not civil servants. However, the government sets price ceilings for most services, thereby controlling the system very tightly. These controls were introduced in the mid-eighties to keep costs low during a difficult economic situation. The years 1995-97 saw compression in health expenditures, and bottlenecks in various areas emerged since then.

67. On the insurance side, the first pillar (or compartment) of the system is basic mandatory insurance covering long-term hospital and nursing home care, and exceptional medical expenses (AWBZ). All residents are covered, and premia are means-tested but independent of individual risk. Expenditure in this first compartment amounted to €15.8 billion (about 4 percent of GDP) in 2001. The system is administered by sickness funds, usually non-profit mutual organizations.

68. For other health risks, private and social insurance coexist. About 65 percent of the population is covered by a public insurance scheme for low income individuals (ZFW). It is provided by sickness funds, which are also purchasers of health care services (as are, for instance, health maintenance organizations in the U.S.). Sickness funds cannot refuse to insure an applicant, and the package of care offered under the ZFW is standard. Individuals can change sickness fund once a year to seek better quality or lower price. Because funds are prohibited from charging risk-based premia, there is a system of transfers across funds (the risk-adjusted prospective payment, RACP) to ensure that funds with a poor risk pool are not penalized.[21]

[21] For each participant, the fund receives a payment equal to the RACP for the risk category of the participant minus a small amount. To cover the shortfall from the RACP, the fund must charge a flat premium. More cost-efficient funds can charge lower premia and, thus, attract more customers. In practice, differences in premia are small, and the insured rarely change sickness fund.

Table 5. Netherlands: The Dutch Health Care System

Type of service	Name of program	Category of beneficiary	Administrators	Type of premium Ss
Long-term care and exceptional expenses (first pillar)	AWBZ	All citizens; mandatory	Sickness funds; private insurers	Dependent on income but not on risk or insurer.
Basic care services (second pillar)	ZFW	Low-income citizens; mandatory for all eligible	Sickness funds	One part income-dependent and one part dependent on the sickness fund.
	WTZ	Elderly not eligible for ZFW; high risk individuals; mandatory for all eligible	Private insurers	Uniform for all participants.
	Other plans	All who are not eligible for ZFW and WTZ; mandatory.	Private insurers	Differ across insurers and risk classes
Supplementary care services (third pillar)		Voluntary	Private insurers and sickness funds	Differs across insurers and risk classes

Source: National Bureau of Economic Policy Research and Ministry of Health, Welfare, and Sport.

69. Individuals who do not qualify for the ZFW are covered by private insurance.[22] In the private system, insurance funds simply reimburse the costs incurred, and are not direct purchasers of health care. In addition, there is no obligation to accept all applicants. Higher-risk individuals and persons over 65 are placed in a separate risk pool (WTZ). Private insurance contracts are often group contracts negotiated by employers. Premia can and do vary substantially based on the extent of coverage, the risk profile of the insured, the employment category, and so on. Because there is no obligation of acceptance, higher risk people often have little prospect of switching insurer. Second pillar health care costs amounted to €19.7 (4.9 percent of GDP) in 2001.

70. The third pillar of the system consists of supplementary insurance, which covers procedures not insured under the second compartment. This compartment is entirely private and is relatively small (about 3 percent of total health expenditure).

[22] One drawback of the current system is that, as income fluctuates near the threshold to qualify for the ZFW, individuals lose and gain access to public insurance, with sizable consequences on net income.

The proposed reform[23]

71. The centerpiece of the reform is the introduction of a national health care system in the second compartment, ending the current distinction between private and public insurance. In the new system, insurance would be provided by private funds, which would also directly purchase medical services, as is currently the case with the ZFW. Funds would be obliged to accept all customers and offer a standard insurance package defined by law. However, within boundaries set by law, funds would also be allowed to offer alternative packages, which entail preferred provider obligations. Premia would be policy-specific but independent of the health status of the insured, and a transfer mechanism along the lines of the current RACP would compensate funds with worse risk pools.

72. Insurance funds would be allowed to enter into "preferred provider" arrangements with suppliers to secure lower charges for services performed. The purpose is to stimulate competition among both care providers and insurance funds. Various measures to facilitate entry and strengthen competition in the health care sector are also contemplated. Correspondingly, direct supply control would be reduced or eliminated. The government, however, would continue to monitor the provision of health care to ensure that quality standards are upheld and would preserve the option of imposing price control if costs grew excessively.

73. Once the new system is introduced in the second compartment, the first compartment would also be integrated, thus eliminating the often arbitrary distinction between the two types of health care.

[23] This section is based on "A Question of Demand. Outlines of the Reform of the Health Care System in the Netherlands," International Publication Series No. 14E, Ministry of Health, Welfare, and Sport, March 2002.

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