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CPB Newsletter

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CPB Netherlands Bureau for Economic Policy Analysis

Inspired by Mirrlees



Ruud de Mooij

Until recently, most accountants and lawyers working on fiscal matters didn't know James Mirrlees, the Scottish Nobel Laureate of 1996 who received the prize for his work on optimal income taxation. This has all changed now, however. Three years ago, Mirrlees was appointed as chair of the Tax Review Committee of the Institute for Fiscal Studies in London. With the aid of 71 of world's best public finance economists, Mirrlees collected the most up-to-date research results on taxation. Together with a small team, he is now drafting a new blueprint for the UK tax system, which is to be published soon. This *Mirrlees Review* is already legendary: the background papers are widely cited and discussed, other countries have installed similar tax committees, and Mirrlees has become a well-known name among all tax experts.

Mirrlees' Review gives a boost to the contribution of economists to the tax policy debate, which is traditionally dominated by tax lawyers and tax accountants. The latter tax experts usually find pragmatic solutions for all problems. As a consequence, tax systems have tended to evolve as uncontrollable organisms. The key role of economists is to offer a conceptual frame for guiding tax policy. The *Mirrlees Review* puts the fundamental debate on principles-based tax policy back on the agenda – and not only in the UK.

The *Mirrlees Review* also inspired the Dutch government to install a

Study Committee on Taxation, which is charged with offering a broad review of the Dutch tax system and proposing directions for reform with a horizon up to 2020. The committee will use input from various sources, including academic experts. This should offer a challenging opportunity for public finance economists. It complicates matters somewhat, however, that most scholars from Dutch universities have little interest in policy and lack the necessary knowledge about institutions. In fact, Public Finance as a field has become almost extinct at Dutch universities. That's a shame. A good tax policy debate needs contributions from economists as a complement to the precision of accountants and the eye for detail of tax lawyers. Moreover, economists miss out on the opportunity to become inspired by interesting conceptual questions. Two examples:

(i) Age-specific taxation: How should tax rates be varied over the life cycle of individuals: should tax rates on the elderly be reduced or should relatively high taxes be imposed on them?

(ii) Taxation and risk taking: The financial crisis has revealed problems with the asymmetric treatment between debt and equity. How can these distortions be resolved? Should the Netherlands continue to tax a presumptive rate of return on capital, leaving the risk premium untaxed?

The *Mirrlees Review* offers a source of inspiration for new theoretical and empirical research in public finance. Moreover, the issues are relevant for tax policy. I'm inspired by Mirrlees – how about you? □

Ruud de Mooij, head of sector Labour Market and Welfare State

CPB's short-term forecasts March/April 2010

- The Dutch economy is expected to grow by 1½% in 2010. For next year, a growth rate of 2% is foreseen.
- Economic growth returned in the third quarter of 2009. Nevertheless, the production level in 2011 will still be below its peak of early 2008.
- The estimated average unemployment rate in both 2010 and 2011 is 6½% of the labour force, or 500 000 people.
- Contractual wage growth in the market sector will be equal to inflation this and next year: 1¼% in 2010 and 1½% in 2011.
- The government budget deficit will be 6.3% GDP this year. The deficit falls to 4.9% GDP in 2011.

For the main economic indicators for the Dutch economy, see the back page or www.cpb.nl.



a) GDP volume growth rate compared to corresponding period in the previous year.

Recent Publications

DECEMBER 2009 - MARCH 2010

The following list provides an overview of recent CPB publications that have appeared in English between December 2009 and March 2010. All publications can be downloaded at www.cpb.nl. An English press release on these publications is sometimes available on the website.

CPB Documents

197. AIECE general report; report submitted at the general meeting of 5-6 November 2009

Wim Suyker, Jos Ebrecht, Douwe Kingma and Gerard van Welzenis, December 2009
jos.ebrecht@cpb.nl

198. Home, green home: A case study of inducing energy-efficient innovations in the Dutch building sector

Joelle Noailly, Svetlana Batrakova and Ruslan Lukach, January 2010
joelle.noailly@cpb.nl

200. Childcare subsidies revisited

Egbert Jongen, February 2010
egbert.jongen@cpb.nl

This analysis shows that existing childcare subsidies have promoted labour participation. However, at the current average subsidy rate of almost 80%, a further increase in the subsidy rate is a rather ineffective way to promote formal participation.

201. A Labour Market Extension for WorldScan: Modelling Labour Supply, Wage Bargaining and Unemployment in a CGE framework

Stefan Boeters and Nico van Leeuwen, March 2010
stefan.boeters@cpb.nl

CPB Discussion Papers

136. The impact of social capital on crime; evidence from the Netherlands

I. Semih Akçomak and Bas ter Weel, December 2009
bas.ter.weel@cpb.nl

137. Improving the energy efficiency of building; the impact of environmental policy on technological innovation

Joëlle Noailly, January 2010
joelle.noailly@cpb.nl

This paper investigates the impact of alternative environmental policy instruments on technological innovations aiming to improve energy efficiency in buildings. Estimates for seven European countries over the period 1989-2004 imply that a strengthening of 10% of the minimum insulation standards for walls would increase the likelihood to file additional patents by about 3%.

138. Systems of innovation

Luc Soete, Bart Verspagen and Bas ter Weel, February 2010
bas.ter.weel@cpb.nl

This paper provides a review of the literature on national innovation systems. The authors focus on the emergence of the concept of innovation systems and discuss how the notion filled a need for providing a broader basis for innovation policy.

139. The effect of education on smoking behaviour; new evidence from smoking durations of a sample of twins

Pierre Koning, Dinand Webink and Nicholas G. Martin, February 2010
pierre.koning@cpb.nl

140. Selective contracting and foreclosure in healthcare markets

Michiel Bijlsma, Jan Boone and Gijsbert Zwart, February 2010
gijsbert.zwart@cpb.nl

This paper provides an analysis of exclusive contracts between healthcare providers and insurers in a model in which some consumers choose to stay uninsured.

141. Identifying options for regulating the coordination of network investments with investments in distributed electricity generation

Eva Niesten, February 2010
eva.niesten@eui.eu

142. Supply of renewable energy sources and the cost of EU climate policy

Stefan Boeters, February 2010
stefan.boeters@cpb.nl

What are the excess costs of a separate 20% target for renewable energy as a part of the EU climate policy for 2020? This paper answers this question using a computable general equilibrium model, WorldScan. In the base case simulation, the costs of EU climate policy with the renewables target are 6% higher than those of a policy without this target.

143. Exports and productivity selection effects for Dutch firms

Henk Kox and Hugo Rojas-Ramagosa, March 2010
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This study presents recently available data on the micro-structure of Dutch exports and the relation between export participation and productivity at the firm- and establishment-level. Even after controlling for sector- and firm-specific characteristics, the authors find significant evidence that firms self-select into export participation. In general, only the most productive Dutch firms participate in exports and foreign direct investment.

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Top incomes grow faster, also in the Netherlands

Since the late nineties, wages earned by the 0.1% of the Dutch with the highest labour income have been growing faster than the average wage. The Netherlands is following in the footsteps of other countries for which this trend started earlier. Above-average pay growth for executives of large firms is mainly caused by the growth in firm size. Pay growth is strongest for executives of listed firms.

Top pay grows faster than average wages

Traditionally, the Dutch income distribution is perceived to change little over time. This perception no longer appears to be correct for the top of the income distribution. Until 1998, the share of the top 0.1% in the total wage bill was a stable 1.3%. Since then, this income share has steadily increased, reaching 2.0% in 2006.

The relatively fast growth of top incomes is not specifically Dutch. In other countries, top incomes have grown at above-average rates for longer periods. The income share of the top 0.1% in the United States and the United Kingdom has been growing since the end of the seventies. In Sweden, the top-income share started to grow at the end of the eighties. The income share of the top 0.1% remains relatively small in the Netherlands, partly because the Dutch top-income share growth is lagging other countries. In Germany, the top 0.1 receives about 4% of total income, while in the United States this is even more than 7%.

Rise in firm size is main cause of pay growth

CPB has tried to explain the rise in top incomes by analyzing the pay of executives of about 600 large, non-financial companies. Of these firms, 10% are listed on a stock exchange. Between 1999 and 2005, executive pay grew by 6% per year nominally, on average. In comparison, the wage of the median employee grew by approximately 3% per year. Inflation explains slightly more than half of the executive pay growth; the remainder is largely due to the enlargement of firms.

Earlier research has shown that executive pay is related to firm size. What matters here is the value of a firm's activities, rather than the number of its employees. When the size of a firm increases, then demand will grow for the most talented managers. The larger a firm is, the higher the amount will be that the owner of the firm is prepared to pay for a good manager. As the average size of firms increases, executive pay will grow.

In the Netherlands, value added per firm grew 3.5% per year nominally between 1999 and 2005. The average number of employees remained unchanged during this period. Globalisation offers an explanation for the growth of firm size. Stronger international competition forces firms to operate on a larger scale. The demand for the most talented managers will structurally rise be-

cause of this. The above-average growth in executive pay therefore seems to be a fundamental aspect of globalisation.

Listed companies pay more

There are remarkable differences between Dutch firms that are listed on a stock exchange and firms that are not listed. For instance, executive pay is about 25% to 50% higher for a listed company than it is for a comparable company that is not listed. The growth of executive pay at listed firms is almost 9% – much higher than the 6% annual growth for unlisted firms.

The difference in pay growth could be a consequence of a stronger rise in the demand for managers by listed firms. This, however, does not seem likely. Listed firms do not grow as fast as unlisted firms. Both value added and earnings hardly changed for listed firms during the period 1999 to 2005, while in the sample of all large firms value added and earnings grew by more than 3% annually. Inflation and increases in firm size can explain 5 %-points of the yearly 9% executive pay growth at listed firms. The remaining 4 %-points could not be explained. Otherwise, executive pay growth at listed firms hardly affects the wage bill share of the top 0.1%. □

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Main Economic Indicators for the Netherlands, 2008-2011

	2008	2009	2010	2011
	annual growth rates %			
International items				
Relevant world trade volume	1.6	- 12.7	7½	5½
Import price goods	4.5	- 7.5	1¾	0
Export price competitors	4.1	- 4.6	¼	½
Crude oil price (Brent, level in \$ per barrel)	96.9	61.5	76	76
Exchange rate (dollar per euro)	1.47	1.39	1.43	1.43
Long-term interest rate (level in %)	4.3	3.7	3¾	4¼
Demand and foreign trade (volume)				
Gross domestic product (GDP)	2.0	- 4.0	1½	2
Private consumption	1.3	- 2.4	½	½
Public demand	2.5	2.9	¾	½
Gross fixed investment, private non-residential	7.0	- 17.5	- 11¼	2
Exports of goods (non-energy)	1.0	- 9.6	8¼	5¼
of which domestically produced	- 1.6	- 10.9	6¾	3¼
re-exports	3.6	- 8.4	9½	7
Imports of goods	3.7	- 10.7	5¼	4½
Wages, prices and purchasing power				
Export price goods (excluding energy)	2.0	- 4.9	- ½	- ¼
Price competitiveness ^{a)}	0.0	1.7	0	0
Consumer price index (CPI)	2.5	1.2	1¼	1½
Contractual wages market sector	3.5	2.8	1¼	1½
Compensation per full-time employee market sector	3.6	2.7	2¼	2¾
Purchasing power	- 0.1	1.6	- ½	- ¼
Labour market				
Labour force (persons)	1.5	0.5	0	¼
Employment (persons > 12 hours/week)	2.1	- 0.5	- 1¾	½
Unemployment rate (level in % of labour force)	3.9	4.9	6½	6½
Unemployment (level in 1000 persons)	304	379	500	500
Market sector ^{b)}				
Production	2.1	- 5.1	2¼	2¼
Labour productivity	0.9	- 2.4	5¾	2
Employment (labour years)	1.2	- 2.8	- 3¼	0
Price gross value added	1.4	3.3	¾	¾
Real labour costs	2.2	- 0.6	1¾	2
	levels in %			
Labour share in enterprise income	79.0	81.1	77½	77
Profit share (of domestic production) ^{c)}	13.2	8.7	12½	13¼
Public sector				
General government financial balance (% GDP)	0.3	- 4.9	- 6.3	- 4.9
Gross debt general government (% GDP)	58.2	61.8	66.5	68.9
Taxes and social security contributions (% GDP)	39.1	38.1	37.9	38.4

^{a)} Export price competitors minus export price domestically produced goods.

^{b)} Private sector excluding health care, mining and quarrying, and real estate.

^{c)} Market sector excluding banking and insurance companies.