**CPB Newsletter** 2004 September **2**

CPB Netherlands Bureau for Economic Policy Analysis

# Longer working hours

Taco van Hoek

***Concerns about the country's competitive position, outsourcing of activities towards low-wage countries and the cost of ageing have recently led to a call for longer working hours by both employers and the government in the Netherlands. Could this do the trick?***

First, let's take a look at the development of the competitive position. After the strong performance of the Dutch economy during most of the 1990s, the labour market tightened and wages rose quickly. Price competitiveness deteriorated substantially as wages continued to rise. Once the world economy lost momentum, the Netherlands faced a sharp decline in production growth and a prolonged period of rising unemployment. Clearly, the problem is not that wage levels are structurally too high, but that wages adjust slowly because of a lack of flexibility in the wage-bargaining process. A structural increase in working hours will not address this issue and will in the short run only add to our unemployment problem.

Now let's turn to outsourcing of activities towards low-wage countries. Advanced economies with a highly educated work-force can easily be recognised by their high wage levels. In the long run, high wages reflect high productivity. Instigating longer working hours in order to compete with low-wage countries does not appear to be a very promising strategy. Why not profit from comparative advantages and import goods that are more cheaply produced elsewhere?

Finally, the problem of ageing. Longer working hours will raise the income of workers, at the expense of leisure. This is the trade-off. One could argue that workers are quite capable of making their own decisions. There are, however, certain externalities involved. You and I will gain if others decide to work more, but these others do not take our benefits into account. Longer working hours will enlarge the tax base and can in this way be helpful in dealing with the cost of ageing.

What does this mean for policy? The government cannot determine the working hours of employees. As income rises over time, rational individuals may well wish to substitute some of this extra income for leisure time. The government, however, can stimulate labour supply by other means. Lowering tax rates and reducing social security benefits will surely raise labour supply. Of course, such policies are not without costs, and measures that increase labour supply will always require some degree of sacrifice. Sad but true: there is still no 'free lunch' in economics.

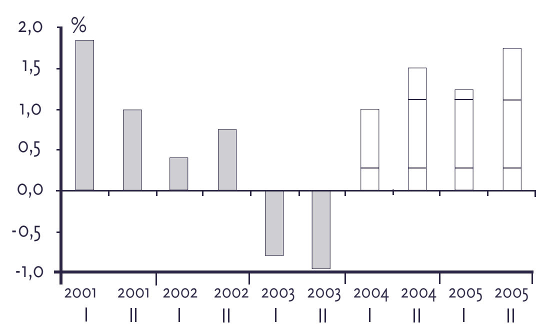
Taco van Hoek, CPB's deputy director

# CPB's short-term forecasts September 2004

- In 2004 GDP in the Netherlands is expected to rise by 1¼%, slowly accelarating to 1½ % next year.
- While exports are rising, consumption growth is stagnating, mainly because of unfavourable developments in purchasing power.
- Unemployment continues to rise steadily, to 7% of the working population in 2005.

See the back page for the main economic indicators for the Dutch economy, or www.cpb.nl for more information.

**Economic growth in the Netherlands, 2001-2005** [a)]




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

# Recent publications

JUNE – SEPTEMBER 2004

*The following list gives an overview of recent CPB-publications that have appeared between June and September 2004, ranked according to publication series. An abstract is included when studies are of particular relevance to the academic community or cover a topic interesting to international policymakers. The publications can be downloaded at www.cpb.nl. A press release on the publication is often also available from the website.*

## Forecasts

### *Macro Economic Outlook 2005 (only in Dutch)*

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The MEV 2005 describes the situation for the Dutch and international economy, and presents forecasts for the economic development in 2004 and 2005. Special topic in this MEV is 'Labour productivity and participation'. The accompanying press release provides an overview in English of these forecasts.

## CPB Discussion Papers

### *33. Do student loans improve accessibility to higher education and student performance? An impact study of the SOFES program in Mexico*

Erik Canton and Andreas Blom, July 2004
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### *34. Returns to university education; evidence from an institutional reform*

Dinand Webbink, July 2004
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In 1982, duration of university education in the Netherlands decreased from five to four years. This institutional reform is used to estimate the causal effect of one year of university education on wages in 1997. Wages of employees who enrolled just before or after the reform are compared using data from the Dutch Wage Structure Survey of 1997. We find that the fifth year of university education increased wages with 7 to 9 percent.

### *35. Does reducing student support affect educational choices and performance? Evidence from a Dutch reform*

Michèle Belot, Erik Canton and Dinand Webbink, July 2004
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This paper investigates the impact of student support on educational choice (university versus non-university) and student performance in higher education, using data from the Netherlands. This paper considers the 1996-reform, which reduced the duration of public support by one year and limited it to the nominal duration of the study program. We find that the reform drove 2.2% of the upper secondary school graduates from university to higher vocational education. We also find that performance improved after the reform. The probability of dropping out after 5 months fell from 2.2% to 0.6%, and university students completed 5% more courses.

### *36. A different approach to WTO negotiations in services*

Henk Kox and Arjan Lejour, July 2004
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International negotiations on the liberalisation of service trade are concentrated at non-tariff barriers (NTBs). Negotiations on lowering these obstacles are complicated because government regulations are seldom strictly oriented at keeping foreign firms out their domestic service markets. Some of them (e.g. quantity-based restrictions) are clearly at odds with WTO principles. We argue however that in most cases regulators primarily aimed at correcting domestic market failures, disregarding the potential repercussions for foreign providers of services. In negotiations this problem can be approached by introducing economic necessity tests, but that is a very long and tedious process. The authors propose a different negotiation approach based on lessons learned from WTO negotiations on agricultural support measures.

### *37. Estimating the impact of experience rating on the inflow into disability insurance in the Netherlands*

Pierre Koning, August 2004
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See the article in this Newsletter.

### *38. Auctioning incentive contracts: Application to welfare-to-work programs*

Sander Onderstal, August 2004
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## CPB Documents

### *60. Capacity to spare? A cost-benefit approach to optimal spare capacity in electricity production*

Mark Lijesen and Ben Vollaard, June 2004
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### *61. Private contributions for higher education: Using the direct benefit principle*

Erik Canton, Dinand Webbink and Michèle Belot, July 2004 (only in Dutch)
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# Experience rating in Disability Insurance

*In the Netherlands, the provision of Disability Insurance (DI or WAO, as it is called in Dutch) is mandatory and financed by pay-as-you-go contribution rates. The DI system is based on the remaining individual earnings capacity. This means that disability is measured as a percentage. In principle, the programme covers all workers against all income loss that results from medical problems, whether physical or mental, beyond the first year of illness.The public monopoly provision of DI makes the disability determination system rather susceptible to moral hazard. Public monopoly insurance has a record of minimising erroneous denials, at the cost of allowing more erroneous admissions. However, the most important moral hazard problem is caused by the generosity of the DI system and the lack of incentives to prevent an appeal on DI. As a result, a record-breaking 16% of the working population received DI benefits in the mid eighties. Since then, the appeal on DI has declined and has stabilised at about 13%.*

The Dutch, of course, are no less healthy than other Europeans. What explains their predicament? During the recession years, DI provided an 'elegant' way to get rid of redundant workers that was advantageous to both employers and employees. DI benefits are more generous than unemployment benefits. An individual employer that could shift the expenses to the general DI fund found the solution to be much easier and more pleasant than straightforward dismissals, leading to the expensive popularity of the *WAO* scheme.

Over the years, the Dutch DI programme has repeatedly been the subject of public debate. Various *WAO* reform plans have been introduced to improve incentives. To start with, the sickness benefit programme covering the first year of illness was (fully) privatised in 1996, making employers responsible for these costs. In 1998, employer incentives were further tweaked by the system of DI experience rating: the contribution of a firm to the DI scheme now depends on the number of their employees who have enrolled in the DI scheme. Finally, in 2002, the (potential) impact of incentives was extended further by a more stringent system of gate keeping: testing individual eligibility for DI.

The experience-rating system has met with substantial opposition from employers, who argued that they could not be held responsible for a large part of their DI costs. In 2003, the Dutch government responded to this uproar by abolishing the experience-rating system for employers with fewer than 25 employees. The major ingredient of the government's current reform proposal is the distinction between workers who are fully and permanently disabled, on the one hand, and partial and/or temporary disabled, on the other hand. Abolition of the experience rating is being considered for the 'full and permanent' programme, which offers more generous benefit conditions for workers—in contrast to the partial DI programme. As the 'full and permanent' programme will comprise an important part of the total DI costs, the overall experience-rating incentive will diminish substantially.

In his recent publication entitled 'Estimating the impact of experience rating on the inflow into disability insurance in the Netherlands', CPB researcher Pierre Koning examined the effectiveness of the experience-rating plan. The overall picture that emerges from his empirical analysis is that experience rating substantially impacts DI inflow, reducing it by 15%. More strikingly, Koning finds that employer decisions to increase preventative activities seem mainly a function of being aware of the experience-rating incentive. In the time period under consideration, employer awareness of the experience rating system was limited, regarding both the advantages (i.e. a gradual reduction in the premiums they pay, as long as there is no inflow into DI) and the disadvantages once the premium increases took effect. Notwithstanding the greater awareness of the negative consequences of a larger DI inflow (compared to the advantages of a smaller inflow), employers seem to have been triggered to increase their preventative activities only by experiencing (substantial) increases in their premium rates. This suggests that employers were not well informed about either the experience-rating system or the nature and size of the disability risk, or both.

Koning found similar and substantial experience-rating incentive effects for the inflow into partial- and full DI. Therefore, from the perspective of stimulating preventative activities, restricting the experience-rating incentive only to partial DI would not be effective, as it would increase the risk of a rising inflow into DI schemes.

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## Main Economic Indicators for the Netherlands, 2002-2005

| | 2002 | 2003 | 2004 | 2005[a] |
|---|---|---|---|---|
| | annual growth rates % | | | |
| **International items** | | | | |
| Relevant wordl trade volume | 2.2 | 4.3 | 7 ¼ | 6 ¾ |
| Import price goods | –1.7 | –1.2 | 2 | ¾ |
| Export price competitors | –3.3 | –4.8 | ¼ | ¾ |
| Crude oil price (Brent, level in $ per barrel) | 25.0 | 28.9 | 36 | 35 |
| Exchange rate (dollar per euro) | 0.94 | 1.13 | 1.21 | 1.20 |
| Unit labour costs competitors in manufacturing | –1.7 | –5.6 | –3 ¼ | 0 |
| **Wages and prices** | | | | |
| Contractual wages market sector | 3.5 | 2.7 | 1 ½ | ¾ |
| Compensation per employee market sector | 6.6 | 3.8 | 2 ¾ | ½ (1) |
| Unit labour costs in manufacturing | 4.5 | 3.4 | –1 ½ | –1 ¼ |
| Export price goods (excluding energy) | –1.0 | –0.6 | ¼ | 0 |
| Consumer price index (CPI) | 3.4 | 2.1 | 1 ¼ | 1 ¼ |
| Price domestic expenditure | 3.3 | 2.7 | 1 ¼ | 1 |
| **Demand and output (volume)** | | | | |
| Private consumption | 1.3 | –0.9 | ¼ | 0 |
| Gross fixed investment, private non-residential | –6.4 | –3.5 | 1 ¼ | ¾ |
| Private residential investment | –4.4 | –4.2 | 4 ½ | 4 ¾ |
| Exports of goods (non-energy) | 0.9 | 0.5 | 5 | 7 ½ |
| of which domestically produced | 1.8 | –0.8 | 2 ½ | 2 ¾ |
| re-exports | –0.3 | 2.2 | 8 | 13 ½ |
| Imports of goods | –0.2 | 1.0 | 4 | 5 ¾ |
| Production market sector [b] | –0.6 | –1.3 | 1 ¼ | 2 |
| Gross domestic product (GDP) | 0.6 | –0.9 | 1 ¼ | 1 ½ |
| **Labour market** | | | | |
| Employment (labour years) | –0.1 | –1.0 | –1 ¼ | ¼ (0) |
| Employment (persons working 12 hours or more) | –0.1 | –0.5 | –1 | ½ (¼) |
| Labour force (persons) | 0.6 | 0.8 | ½ | 1 ¼ (1) |
| Unemployment rate (lin thousands) | 302 | 396 | 495 | 550 |
| Unemployment rate (level in % of labour force) | 4.0 | 5.1 | 6 ½ | 7 |
| **Public sector** | | | | |
| General government financial balance (level in % of GDP) | –1.9 | –3.2 | – 2.9 | –2.6 |
| Gross debt general government (level in % of GDP) | 52.6 | 54.1 | 55.9 | 58.0 |
| Taxes and social security contributions (level in % of GDP) | 39.4 | 39.3 | 39.3 | 39.2 |
| **Miscellaneous items** | | | | |
| Purchasing power | 1.1 | –1.3 | 0 | – ¾ |
| Household disposable income | 4.3 | 0.8 | 1 ¾ | ½ |
| Labour productivity market sector [b] | 0.6 | 0.8 | 3 ½ | 1 ¾ (2 ¼) |
| Price gross value added market sector [b] | 3.9 | 2.3 | – ¼ | ¼ |
| Real labour costs market sector [b] | 2.5 | 1.4 | 3 | – ¼ |
| Labour share in enterprise income (level in %) | 85.3 | 86.9 | 87 | 86 ¼ |
| Export surplus (level in % of GDP) | 5.1 | 5.0 | 5 | 5 ½ |
| Long-term interest rate (level in %) | 4.9 | 4.1 | 4 ¼ | 4 ¾ |
| Short-term interest rate (level in %) | 3.3 | 2.3 | 2 | 2 ¼ |

[a] *Figures between brackets have been adjusted for statistical effects related to institutional reforms in sickness and dissability insurance.*

[b] *Excluding mining and quarrying and real estate activities.*