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SM/82/244
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

February ?, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Netherlands - Staff Report for the 1982 Article IV Consultation

The following corrections have been made in SM/82/244 (12/30/82):

Page 7, para. 1: Delete last sentence.

para. 2, line 5: for "1 percentage point a year"
read "1 per cent of national income a year"

Page 11, para. 4: Delete last sentence.

Corrected pages are attached.

Att: (2)

Other Distribution:
Department Heads

The authorities were convinced that the past diversion of resources to the public sector had been detrimental to the growth and employment potential of the economy. They also felt that the support of private consumption through public transfers had not helped to bring about an upturn of investment. The structural situation had deteriorated so much that there was no scope for a successful implementation of anticyclical measures. Indeed, it had become almost impossible to separate structural from cyclical factors, except perhaps in relation to the construction sector. The external surplus reflected largely the fall [illegible] restic demand, particularly in investment demand, and stimulat[illegible] mestic demand would, in the end, put upward pressure on capital [illegible] put in jeopardy the recent recovery of profitability. The [illegible] was judged to have been very limited, and clearly insufficient to support an early upturn in the growth of productive capacity. Under unchanged policies, even an average growth rate of GDP of 2-3 per cent per year could not prevent unemployment from rising nor substantially reduce the budget deficit. Accordingly, only structural policies could bring the economy back to a sustainable growth path and the associated continued weakness of activity in 1983 would have to be accepted.

## 1. Fiscal policy

The policy of restoring order to the public finances rested on two elements: (i) stabilization and reduction of the collective burden in order to give the private sector more room to respond to market stimuli, and (ii) a steady reduction of the public sector borrowing requirement (PSBR) by about 1 per cent of national income a year over the 1983-86 period. The reduction in the PSBR should allow a decline in the very high current level of interest charges. Recent studies had indicated that a 1 percentage point cut in the ratio of the PSBR to national income could result in a 1 percentage point cut in long-term interest rates. This would benefit the capital position of enterprises, bring about an improvement in profitability, and, thereby, in productive investment.

Fiscal policy in 1981 and 1982 had also sought to contain the public sector deficit, indeed to reduce it in specified proportions to national income. At the same time, however, it intended to provide some support to domestic economic activity and to increase the resources available to the enterprise sector, through investment-oriented tax relief measures, labor market programs, and a rise in public residential construction to help offset the steep fall in private residential construction. However, this approach was continually frustrated by exogenous developments that resulted in expenditure overruns and shortfalls in revenues. Accordingly, the past two years have been characterized by virtually continuous ad hoc attempts to adjust budget plans to actual economic developments in order to close the large gap between originally planned and projected deficits, resulting in frequently announced budget cuts. These cuts are made from multiyear expenditure estimates, that assumed relatively high growth rates for the economy as well as for real public expenditures. Therefore, they are reductions from projected increases rather than cuts from actual levels.

Because of the failure to implement even these "cuts" fully and because revenue projections were too optimistic, the deficits continued to widen and the Government abandoned its medium-term aim to reduce, or at least stabilize, the tax burden. Accordingly, indirect taxes were increased and the Government reduced its subsidization of the social insurance funds, which in turn necessitated further increases in premia. Despite a widespread acceptance that a return to sustained economic growth requires vigorous restraint of incomes and public expenditures, especially of social security transfers, there has been considerable political conflict regarding its implementation. Time and again, the policies that sought to achieve the budget targets proved to be too difficult to realize. The political tensions associated with the various proposed programs explain in part why an increasing lack of control over public expenditures has emerged. In addition, revenue shortfalls reflect not only lower-than-projected income flows, but also, increasingly, delays in tax payments. Accordingly, the 1983 budget proposals need to deal with an inherited revenue shortfall from the 1982 budget of f. 8.8 billion coupled with an f. 3.3 billion excess of expenditures over intial appropriations as part of the proposed cuts were not carried out while increased outlays were incurred for unemployment and interest payments.

In drafting the 1983 budget, every effort was made to base it on a realistic economic projection, nevertheless, it already appears that the activity forecasts have been too optimistic. As it is, the budget proposals imply a public sector deficit of 10.8 per cent of net national income in 1983. This deficit arises even though the proposals project expenditure cuts and tax increases of some f. 13 billion from an unchanged policy baseline. These measures include freezes of public sector salaries and of social insurance benefits. The latter together with a further increase in social security contributions, will allow a reduction in state subsidies to the social security funds of f. 5.3 billion. In addition, income tax brackets will not be adjusted fully for inflation, and specific expenditure reductions amounting to some f. 3 billion will be implemented.

The authorities recognize, however, that the full achievement of the 1983 budget goals also would be difficult. Although the Government has been able to call off a projected price and wage freeze because the social partners came to an agreement about wage moderation, this by no means implies that a consensus on the measures included in the budget proposals has been forged.

### 3. Incomes policies

Wage restraint is a fundamental element of the Government's policy in order both to improve the profitability of enterprises and to restore the competitive position of the export sector. In principle, the Government seeks to influence wage formation by issuing guidelines for the negotiation of wages at the national level. However, time and again the social partners could not reach agreements acceptable to the Government. Consequently, government interference in wage and price formation has almost become the norm.

In 1980-81 and through 1982 the Government imposed a statutory incomes policy. This policy has been based on controlling nominal wage developments by partial deindexation, by limiting fringe benefits, in particular vacation allowances, and by restraining real wage improvements as contracted in collective labor agreements. In 1981 the average wage bill in enterprises increased by only 4 per cent and public sector wages were stabilized at about their 1980 levels. For 1982, the Government hoped to limit wage increases in the private sector to 6.5 per cent.

These policies, particularly as they were instituted against a background of rising unemployment, significantly reduced the growth of nominal wages. But the authorities felt that they also had led to a substantial reduction in income differentials and a severe compression of disposable incomes toward the bottom of the income scale. A study by the Central Planning Bureau, comparing trends in Germany and the Netherlands, concluded that the flattening of the income distribution led to relatively higher wage increases in the labor-intensive sectors in the Netherlands. Moreover, the lack of wage differentiation was seen as one of the factors accounting for the rigidities in the labor market that, inter alia, contributes to the rise in unemployment. The Government, in formulating its wage policy for 1983, intended to discontinue the statutory wage policy for the private sector, while freezing public sector wages at their 1982 levels. The freeing of private sector wage formation, however, was dependent upon the voluntary moderation of wage settlements.

The Government maintains a detailed system of price controls which, however, are implemented rather flexibly. According to the authorities, the impact of the controls on profitability is very limited and competition rather than price controls accounts for what appears to be a shortfall in the recovery of profit margins compared to what could have been expected from the reduction in cost pressures because of the moderation in labor costs and in import prices.

The wage restraint has resulted in some decrease in the wage share in 1982. However, the room created for a rise in profits by wage moderation has been taken up largely by increases in social security taxes and in interest costs. Although some worried about the beneficial effects of wage and price moderation being eroded by a continuous appreciation of the guilder, the authorities took the view that the strength of the guilder within the EMS was an essential element in the control of inflation and was also the most effective way to bring about a sustainable reduction of interest rates.

## 4. Industrial policy

The transfer of resources to enterprises under the Investment Law Scheme (WIR) is at the center of Dutch industrial policy. This instrument is considered superior to a general corporate income tax cut for three reasons. first, investment premiums can be paid to all enterprises, including new entities, which in their early stages of operation have a weak or negative profit performance, second, the use of WIR financial incentives is clearly linked to the realization of investment projects within the Netherlands, and third, the investment premiums are payable for investment by unincorporated businesses, which could not benefit from corporate tax cuts. The authorities considered the frequent changes in WIR premiums a weak point of the scheme, because it had created an atmosphere of uncertainty.

The authorities were also aware of the fact that regulations with respect to environmental issues and other regulatory procedures had a negative impact on investment activities and that inflexibility of hiring and firing procedures did not contribute to a favorable response to market stimuli.

## 5. Development assistance

The policy of the Netherlands is to appropriate budgetary resources equal to about 1.2 per cent of GNP for development assistance. This figure is expected to be achieved in 1982, and, for 1983, despite the severe budgetary constraints, the same percentage of GNP has been allocated.

# IV. Staff Appraisal

In recent years, the Netherlands has achieved remarkable successes in moderating the growth of nominal wages and in keeping price developments in hand. Therefore, the authorities have a considerably lesser problem in dealing with the effects of ingrained inflationary expectations than do a number of other countries. These developments also have led to a partial restoration of the competitive position of the Dutch economy in international markets. As a result, some gain in market shares abroad and at home has been obtained despite falling world demand and even greater weakness of demand for the industrial goods the Netherlands produces.

However, relatively low inflation appears to have been bought at a very high price. The progressive redistribution of incomes of the past