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CPB Newsletter

2006 December

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CPB Netherlands Bureau for Economic Policy Analysis

Playing with uncertainty



George Gelauff

Uncertainty is inevitable. Drafting this column on November 16, I am still uncertain as to the election results. The only certainty I have at this moment is that you will read this piece after the elections, and will then know the outcome of the Dutch elections of November 22.

It is a Dutch tradition that political parties ask CPB to analyse their electoral platform. How can we be sure about the economic consequences of the platforms? I realize, of course, that we are never really sure: we merely try to restrict uncertainty. How? By speaking with political parties to get a thorough insight into the contents of their proposals. By confronting the models we use with reality. By continuously questioning whether we are able to understand the results of our computations.

We know much, but there is also much that we do not know. We cannot, for example, pinpoint the extent of economic growth that occurs when the government spends an additional euro on infrastructure. This uncertainty applies to most types of government expenditure. CPB has made a step forward, however, concerning education and innovation: a number of proposals have been identified as either beneficial or negative for welfare. Even so, also in these fields a considerable set of proposals remains about which we are uncertain. Economic policy only partly escapes uncertainty.

Sometimes we can prepare ourselves for it. We then include a margin of caution or try to deal with it in another way.

Science develops further and further, but does that make life more certain? The more you know, the more you know the things you still do not know. From nuclear energy to cloning, the uncertainties of the social consequences of scientific discoveries seem to increase. A more dynamic economy reduces job security for many employees. In the newspaper I read a statement of the British historian Tony Judt: 'globalization creates enormous uncertainties, and we have to realize that we enter an age of fear'. In contrast, not long before that I attended the Tinbergen lecture delivered by the Indian economist Jagdish Bhagwati, currently at Columbia University. As a true cosmopolitan he praised globalization: it offers opportunities for development and reduces social deprivation in developing countries.

It's impossible to imagine life today without uncertainty. Wouldn't it be better to look for ways to deal with it? The South African writer Antjie Krog thinks a romantic irony of uncertainty should guide our lives. Then you are 'oriented at a confusing quest for answers', 'aware of the relateness of every point of view' and you explore 'the unlimited series of contradictions'. Although it sounds somewhat poetic (for some, perhaps, hazy), there may be something to it. In that case, we play with uncertainty — and uncertainty involves not only threats but also opportunities. □

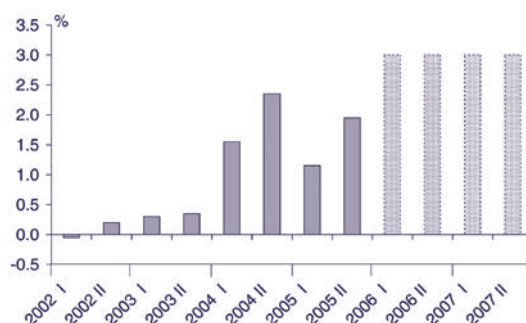
George Gelauff, deputy director

CPB's short-term forecasts December 2006

- Dutch GDP is expected to accelerate to a robust and stable 3% growth rate in 2006 and 2007.
- Domestic expenditures (private consumption, investment and government expenditures) and exports will contribute equally to economic growth in 2006 and 2007.
- Employment growth is expected to accelerate to 1¼% this year, stabilizing next year. The unemployment rate will fall sharply, to 4¾% on average in 2007.
- Wage growth is increasing slightly, but is still moderate. Inflation is smoothing down to 1% in 2006 and 2007.
- The government EMU-balance will be around equilibrium in both forecasting years.

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

Economic growth in the Netherlands, 2002-2007^{a)}



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

Recent Publications

SEPTEMBER 2006 – DECEMBER 2006

The following list provides an overview of recent CPB publications that have appeared in English between September and December 2006. All publications can be downloaded at www.cpb.nl. A press release on the publication is often also available from the website.

CPB Documents

126. Report AIECE Working Group on Foreign Trade, Autumn 2006

Gerard van Welzenis,
November 2006
gerard.van.welzenis@cpb.nl

Annual production growth in the world economy has exceeded 4½% for four consecutive years and is expected to continue to do so in 2007. However, growth next year will be lower than in 2006. This is by far the strongest run since the early seventies, and is above all due to the staggering performance of the emerging markets. World trade growth over the past four years has averaged 8½% and is forecast to fall back only slightly to 7½% in 2007, still above the potential rate of growth.

132. Innovation Policy: Europe or the Member States?

Albert van der Horst, Arjan Lejour and Bas Straathof,
November 2006
albert.van.der.horst@cpb.nl

Taking the subsidiarity principle as a starting point, this report discusses the economic rationale of a European innovation policy. Explorative empirical analysis suggests that public R&D and public funding of private R&D are subject to economies of scale and external effects. This is an argument in favour of a European innovation policy, although the heterogeneity in social eco-

nomic objectives on public R&D spending between Member States, for example, calls for national government involvement.

133. Assessing subsidiarity

Sjef Ederveen, George Gelauff and Jacques Pelkmans,
November 2006
george.gelauff@cpb.nl

This paper discusses the assessment of subsidiarity in the European Union from a broad fiscal federalism perspective. It incorporates recent insights from political economy analyses of fiscal federalism to arrive at a list of issues that need to be taken into account when considering whether or not concrete policies should be centralised in the European Union.

135. Employment protection legislation: Lessons from theoretical and empirical studies for the Dutch case

Anja Deelen, Egbert Jongen and Sabine Visser,
November 2006
egbert.jongen@cpb.nl

See the article on page 3 of this issue.

CPB Discussion Papers

71. The impact of competition on productive efficiency in European railways

Gertjan Driessen, Mark Lijesen and Machiel Mulder,
September 2006
mark.lijesen@cpb.nl

This paper empirically explores the relationship between competition design and productive efficiency in the railway industry. The results suggest that competitive tendering improves productive efficiency, which is in line with both economic intuition as well as expectations on the design of competition. Another finding is that free entry lowers productive efficiency. A possible explanation for this result is that free entry may prevent railway operators from reaping economies of density. Finally, more autonomy of management is found to lower productive efficiency. Most of the incumbent railway companies are state owned and do not face any competitive pressure. As a consequence, increased independence without sufficient competition and adequate regulation may deteriorate incentives for productive efficiency.

72. EU accession and income growth: An empirical approach

Arjan Lejour, Vladimir Solanic and Paul Tang,
October 2006
arjan.lejour@cpb.nl

The dynamic effects of EU membership are crucial for the new member states seeking to catch up with the average income level in the

old member states. To gauge the dynamic effects, this paper follows a two-step procedure in which a gravity equation for bilateral trade shows the trade effect of EU membership and a growth regression yields the income effect of trade. Shared EU membership is found to increase trade between two member states by about 34%. EU membership may contribute to trade by inducing countries to improve the quality of their institutions. Trade increases by another 22% if institutions improve, yielding a total trade increase of 56%. Improved openness increases income by 37.5% according to the paper's estimates. Adding a small direct effect of improved institutions on income, the total income effect of EU membership is 39% for the ten new members. This implies that EU membership, or its effect on trade and institutions, could lead to large economic gains for the new member states, but does not bring them economically on par with the old member states.

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CPB Newsletter is a publication of CPB Netherlands Bureau for Economic Policy Analysis
P.O. Box 80510
2508 GM The Hague
The Netherlands
T +31 70 3383380
F +31 70 3383350
I www.cpb.nl
E redactie@cpb.nl

Editorial board:

Kees Folmer
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Print: Koninklijke De Swart
Design: Maarten Balyon
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Employment protection and the case for reform

Employment protection reform is a hot topic, in the Netherlands and abroad. Two CPB studies explore reform options and their implications.

In 'Employment Protection Legislation: Lessons from Theoretical and Empirical Studies for the Dutch Case' CPB exploits insights from the literature on employment protection to infer some reform options for the Dutch case. In 'Exploring the Ambiguous Impact of Employment Protection on Employment and Productivity,' we construct a formal model to study the impact of different types of employment protection, and simulate some reforms in a calibrated version for the Dutch labour market.

The case for reform to boost aggregate employment and productivity is not very strong. The literature review in the first paper allows us to conclude that the average impact of employment protection across empirical studies on employment is negative but small, and not significantly different from zero. Furthermore, the findings on the impact of employment protection on productivity are mixed. The available evidence therefore does not point to a convincing case for reform to raise aggregate employment and productivity, though we should point out that the case is not closed, as most of the 'evidence' comes from cross-country studies that suffer from a number of serious limitations.

The lack of clarity on aggregate performance does not mean that a case cannot be made for reform. First, there is a case for reducing employment protection for permanent contracts based on equity grounds. This will increase the flows between employment and unemployment, thereby redistributing the chances for regular employment over insiders and outsiders. Additional gains may arise from less insider power in the wage bargain and reduced skill losses due to shorter unemployment durations. These points are particularly relevant for the Netherlands, where the flows between employment and unemployment are very low, and insider power is high. Furthermore, a number of trends work against high employment protection. Rising income levels and higher female participation rates have reduced the need for insurance against the risk of being laid off. Furthermore, the large inflow of females and immigrants on the labour market, globalization and the increasing importance of reallocation for productivity growth may all increase the need for flexibility.

Second, a case can be made for reducing system costs. When it comes to 'procedural inconveniences' related to dismissal, the Netherlands ranks 'number 1', according to the OECD. A recent reform will hopefully reduce these costs in the Netherlands. However, one of the upsides of these costly procedures is that it reduces the inflow into unemployment insurance. One way to keep this benefit of employment protection but to reduce the heavy involve-

ment of third parties in the separation decision is to introduce a system of 'experience rating', where unemployment insurance premiums rise with the number of workers that are laid off.

Third, in the current system in the Netherlands, the level of employment protection is mainly determined by the wage, age and tenure of the worker. The system is thus unlikely to capture the full spectrum of heterogeneity in the pros and cons of employment protection across different groups of workers and sectors. One option, then, is to give workers and firms more freedom to set the level of employment protection in individual and collective employment contracts.



In 'Exploring the Ambiguous Impact of Employment Protection on Employment and Productivity', one of our key points is that lumping together different types of employment protection into one indicator, such as the popular OECD indicator, may be a poor empirical strategy. Indeed, the impact of e.g. firing costs, firing taxes and severance pay can be quite different, the latter being a transfer to the government and the worker respectively. Furthermore, we show that the 'tenure profile' of employment protection is important for its impact. 'Flat' employment protection, popular in theoretical work, has more pronounced effects than 'rising' employment protection, popular in practice, for the same spending on employment protection in both cases.

Finally, most research raises more questions than it answers, and this is no exception. In the near future we hope to take up the issue of how employment protection interacts with other labour-market institutions, particularly for older workers, and what we can learn from Dutch firm-level data about the impact of employment protection on productivity. □

More information: egbert.jongen@cpb.nl

Main Economic Indicators for the Netherlands, 2004-2007

	2004	2005 ^{a)}	2006 ^{a)}	2007
	annual growth rates			
International items				
Relevant world trade volume	7.7	5.3	8	6¼
Import price goods	0.6	3.3	4	-½
Export price competitors	0.2	1.6	2	1
Crude oil price (Brent, level in dollars per barrel)	38.2	54.4	65	60
Exchange rate (dollar per euro)	1.24	1.24	1.25	1.25
Unit labour costs competitors in manufacturing	-4.7	0.5	-1¼	-¾
Demand and output (volume)				
Gross domestic product (GDP, economic growth)	2.0	1.5	3	3
Private consumption	0.6	0.7	-1 (2¼)	2¼
Gross fixed investment, private non-residential	-2.2	3.1	4¼	5
Private residential investment	6.5	5.3	6½	4¾
Exports of goods (non-energy)	9.8	6.8	8	7¼
of which domestically produced	6.5	1.9	4	3½
re-exports	13.6	12.4	12¼	11¼
Imports of goods	8.8	6.0	8¼	7¼
Production market sector ^{b)}	2.2	2.3	3½	3¼
Prices and wages				
Consumer price index (CPI)	1.2	1.7	1	1¼
Price domestic expenditure	1.1	1.7	1½	1¾
Export price goods (excluding energy)	-0.5	0.6	¾	0
Price competitiveness	-0.2	-1.4	¼	½
Contractual wages market sector	1.5	0.8	1¾	2¼
Compensation per employee market sector	3.9	1.3 (1.7)	1¼ (1¾)	2½
Unit labour costs in manufacturing	-1.5	-0.8	-2¾	-1¼
Labour market				
Unemployment rate (level in % of labour force)	6.5	6.5	5½	4¾
Unemployment (x 1000)	479	483	415	360
Employment (labour years)	-1.4	-0.3 (-0.6)	1¼ (1)	1¼
Active labour force (persons)	-1.2	0.0 (-0.3)	2 (1¾)	1¾
Labour force (persons)	0.0	0.0 (-0.2)	1 (¾)	1
Public sector				
General government financial balance (level in % of GDP)	-1.8	-0.3	0.1	-0.2
Gross debt general government (level in % of GDP)	52.6	52.7	51.2	49.8
Taxes and social security contributions (level in % of GDP)	37.7	38.2	40.0 (38.5)	39.4
Miscellaneous items				
Purchasing power	0.1	-1.7	2	1½
Individual savings rate (in % of disposable income)	-1.6	-2.8	-3¼	-3
Labour productivity market sector ^{b)}	4.5	2.9 (3.1)	2 (2¼)	2¼
Price gross value added market sector ^{b)}	-0.3	-0.1	-2	1½
Real labour costs market sector ^{b)}	4.2	1.4 (1.7)	3½ (3¾)	1
Labour share in enterprise income (level in %)	80.1	79.0	80¼	79¼
Export surplus (level in % of GDP)	7.2	7.7	7¾	7½
Long-term interest rate (level in %)	4.1	3.4	3¾	4

^{a)} Figures between brackets have been adjusted for changes in funding schemes caused by institutional reforms in sickness, disability insurance and healthcare. For more information see <http://www.cpb.nl/eng/pub/cepmev/explanation.pdf>.

^{b)} Excluding mining and quarrying and real estate activities.