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# CPB Newsletter

2006 April

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CPB Netherlands Bureau for Economic Policy Analysis

## Regulation and benefit-cost analysis



Taco van Hoek

*Environmental policies rely heavily on regulation. The good news is that, more often than in the past, the government determines the targets, but leaves it to the market to choose the appropriate measures to reach these targets. This is good news because such a market-based approach is generally more cost-effective than 'command and control measures'. There is, however, also bad news. This applies*

*to the rules itself. Rules exist for many environmental and safety issues, but very little is known about the effects of these rules. For instance, NO-x emissions in the Netherlands are to be reduced by 40% between 2000 and 2010. But why by 40%? Why not by 20% or 60%?*

The answer to the above mentioned questions is political by nature, but it would make sense to have at least some information about the benefits and costs of (various levels of stringency of) the rule.

Lack of insights into the effects of regulatory standards can have serious consequences. Air pollution abatement rules for the Netherlands which were recently determined at the European level, cannot be achieved by even the most drastic national policy efforts. The national noise abatement rules with respect to Amsterdam Airport, on the other hand, have been ineffective in recent

years. Technological developments throughout the years have reduced noise emissions too far below the required standards.

The main problem of virtually all of these rules is that there is very little information available on benefits and costs. In theory, it is possible to determine the socially optimal level of intervention. This is the intervention level at which marginal benefits equal marginal costs. Admittedly, such research involves complex valuation issues, requires a lot of time and may not be feasible in some cases. Short-cuts will then have to be considered. An interesting example is provided by the special US-guideline on regulation and benefit-cost analysis. This guideline prescribes that at least three different levels of stringency - one higher and one lower than proposed - should be assessed.

I am convinced that systematic economic research with respect to environmental regulation will reveal opportunities to increase environmental quality at relatively low costs or vice versa substantially reduce costs at little expense in terms of the environment. Dynamic analysis is important in this respect. Costs of environmental rules can often be strongly reduced if somewhat more adaptation time is given to the private sector. In a situation of strong autonomous technological change, timely adjustment of regulation is important in order to prevent regulation from becoming obsolete. Benefit-cost analysis can clarify such issues and contribute to a more efficient regulatory system with potentially large societal gains.

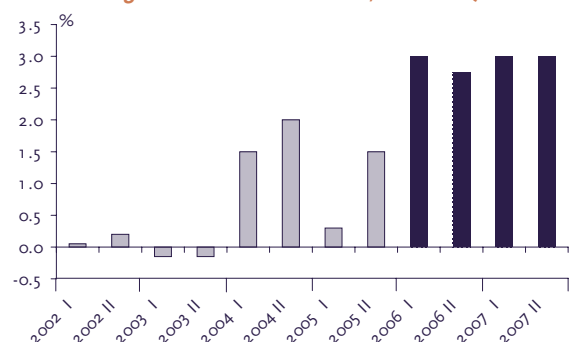
Taco van Hoek, deputy director

## CPB's short term forecasts March/April 2006

- Dutch GDP is expected to accelerate to 2¾% in 2006 and to 3% in 2007.
- Exports will benefit from a favourable international economic climate and an improvement of competitiveness.
- For the first time since 2001, domestic expenditures (private consumption, investment and government expenditures) will contribute to economic growth as well.
- Employment growth is expected to accelerate this year and the next. The unemployment rate will fall by ½%-point each year, to 5% on average in 2007.
- Inflation and wage growth continue to be low in 2006 and 2007.

See the back page for the main economic indicators for the Dutch economy, or [www.cpb.nl](http://www.cpb.nl) for more information.

Economic growth in the Netherlands, 2002-2007<sup>a)</sup>



<sup>a)</sup> GDP volume growth rate compared to corresponding period in the previous year.

## Recent publications

DECEMBER 2005 – MARCH 2006

The following list gives an overview of recent CPB publications that have appeared in English between December 2005 and March 2006. All publications can be downloaded at [www.cpb.nl](http://www.cpb.nl). A press release on the publication is often also available from the website.

### Forecasts

#### Central Economic Plan 2006

[johan.verbruggen@cpb.nl](mailto:johan.verbruggen@cpb.nl)

### Special Publications

#### Reinventing the welfare state

Ruud de Mooij, March 2006

[ruud.de.mooij@cpb.nl](mailto:ruud.de.mooij@cpb.nl)

See the article on page 3.

#### Ageing and the Sustainability of Dutch Public Finances

Casper van Ewijk, Nick Draper, Harry ter Rele and Ed Westerhout, March 2006

[ed.westerhout@cpb.nl](mailto:ed.westerhout@cpb.nl)

The ageing of the population jeopardises the sustainability of public finances in the Netherlands. The increase in expenditure on public pensions and health and long-term care will outweigh the increase in tax revenues. Budgetary reforms are therefore necessary in order to avoid future generations from having to raise taxes or economise on public expenditure.

### CPB Documents

#### 101. Europe's financial perspectives in perspective

George Gelauff, Herman Stolwijk and Paul Veenendaal, November 2005

[paul.veenendaal@cpb.nl](mailto:paul.veenendaal@cpb.nl)

#### 102. Do market failures hamper the perspectives of broadband?

Machiel van Dijk, Bert Minne, Machiel Mulder, Joost Poort and Henry van der Wiel, De-

ember 2005

[machiel.van.dijk@cpb.nl](mailto:machiel.van.dijk@cpb.nl)

#### 104. Five Lisbon highlights: The economic impact of reaching these targets

Arjan Lejour and George Gelauff, January 2006

[arjan.lejour@cpb.nl](mailto:arjan.lejour@cpb.nl)

#### 105. Athena: A multi-sector model of the Dutch economy

CPB, January 2006

[bert.smid@cpb.nl](mailto:bert.smid@cpb.nl)

#### 108. The trade-induced effects of the Services Directive and the country of origin principle

Roland de Bruijn, Henk Kox and Arjan Lejour, February 2006

[henk.kox@cpb.nl](mailto:henk.kox@cpb.nl)

#### 110. Government involvement in liberalised gas markets

Machiel Mulder and Gijsbert Zwart, February 2006

[gijsbert.zwart@cpb.nl](mailto:gijsbert.zwart@cpb.nl)

#### 111. WorldScan: a Model for International Economic Policy Analysis

Arjan Lejour, Paul Veenendaal, Gerard Verweij and Nico van Leeuwen, February 2006

[arjan.lejour@cpb.nl](mailto:arjan.lejour@cpb.nl)

### CPB Discussion Papers

#### 51. What explains the variation in estimates of labour supply elasticities?

Michiel Evers, Ruud de Mooij and Daniël van Vuuren, December 2005

[ruud.de.mooij@cpb.nl](mailto:ruud.de.mooij@cpb.nl)

#### 52. Early retirement behaviour in the Netherlands

Rob Euwals, Daniel van Vuuren and Ronald Wolthoff, December 2005

[rob.euwals@cpb.nl](mailto:rob.euwals@cpb.nl)

#### 53. Testing Consumers' Asymmetric Reaction to Wealth Changes

Mauro Mastrogiacomo, January 2006

[mauro.mastrogiacomo@cpb.nl](mailto:mauro.mastrogiacomo@cpb.nl)

#### 54. Solving large scale normalised rational expectations models

Olaf van 't Veer, January 2006

[olaf.van.'t.veer@cpb.nl](mailto:olaf.van.'t.veer@cpb.nl)

#### 55. Models and methods for economic policy; 60 years of evolution at CPB

Henk Don and Johan Verbruggen, January 2006

[johan.verbruggen@cpb.nl](mailto:johan.verbruggen@cpb.nl)

#### 56. Consumer price sensitivity in health insurance

Februari 2006

[marc.pomp@cpb.nl](mailto:marc.pomp@cpb.nl)

#### 57. Compensation of regional unemployment in housing markets

Wouter Vermeulen and Jos van Ommeren, February 2006

[wouter.vermeulen@cpb.nl](mailto:wouter.vermeulen@cpb.nl)

#### 58. Do innovation vouchers help SMEs to cross the bridge towards science?

Maarten Cornet, Björn Vroomen and Marc van der Steeg, February 2006

[maarten.cornet@cpb.nl](mailto:maarten.cornet@cpb.nl)

#### 59. Income Incentives to Labour Participation and Home Production

Mauro Mastrogiacomo and Nicole Voskuilen-Bosch, March 2006

[mauro.mastrogiacomo@cpb.nl](mailto:mauro.mastrogiacomo@cpb.nl)

#### 60. Team incentives in public organisations

Jana Vyrastekova, Sander Onderstal and Pierre Koning, March 2006

[pierre.koning@cpb.nl](mailto:pierre.koning@cpb.nl)

#### 61. Health plan pricing behaviour and managed competition

Rudy Douven and Erik Schut, March 2006

[rudy.douven@cpb.nl](mailto:rudy.douven@cpb.nl)

#### 62. Optimal safety standards for dike ring areas

Carel Eijgenraam, March 2006

[carel.eijgenraam@cpb.nl](mailto:carel.eijgenraam@cpb.nl)

#### 63. Households' Response to Wealth Changes: Do Gains or Losses make a Difference?

Robert Paul Berben, Kerstin Bernoth and Mauro Mastrogiacomo, February 2006

[mauro.mastrogiacomo@cpb.nl](mailto:mauro.mastrogiacomo@cpb.nl)

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## Reinventing the welfare state

Suppose you are asked to design a new architecture of the welfare state. From scratch. And fit for the 21st century. How would it look like? Would it contain a flat tax and a basic income? Would it contain subsidies for parental leave or child care? And would the government facilitate life-long learning?

To answer these questions, we went back to the fundamentals. Why do we have a welfare state? What are its key functions? We came up with three R's: *Redistribution* of income between people, *Risk* and insurance, and *Reallocation* of income over the life cycle. Subsequently, we wondered what would be an optimal set of instruments to fulfil these tasks. And what can the future of the Dutch welfare state look like? These issues are explored in the CPB study '*Reinventing the Welfare State*'.

With respect to *redistribution*, we meet the inevitable trade-off between equity and distortions on the labour market. How can we strike a balance between these two? We conclude that the balance is not optimised by a simple structure of a negative income tax with a flat rate. A basic income is simply too expensive and causes too large distortions in labour supply. More targeted forms of redistribution are more efficient. Yet, they cause distortions at the bottom of the labour market. High minimum wages and compressed wage structures reinforce these distortions. Targeted measures like an earned income tax credit or tax relief for employers are able to mitigate such distortions, although they create distortions elsewhere. Using tags for income support and adopting compulsory activation strategies would enhance the equity-efficiency trade-off.

To deal with labour-market *risks*, we meet another inevitable trade-off: between insurance and moral hazard. Full insurance is not

optimal as it creates excessive inflows into insurance schemes and too small outflows. Therefore, some risk should be borne privately. Yet, an individual saving account cannot fully substitute for insurance. To successfully combat moral hazard, an optimal insurance contract should contain tight eligibility criteria, tough monitoring and sanctioning policies and an administration with proper incentives and exclusive responsibility. A good contract is especially important if the insurance scheme is generous. Therefore, unemployment insurance would be complemented by a firing tax to reduce excessive inflows. Active labour-market policies would help raising exit rates out of social insurances, especially compulsory workfare that is backed by sanctions.

To facilitate income *reallocation* over the life cycle, the government should strike a balance between public smoothing and private smoothing via the capital market. Regarding life-cycle decisions, we conclude that there is little value added from government intervention in adult learning. More important is to eliminate saving subsidies that distort the choice between investment in financial and human capital, and which encourage early retirement. Distortions in the labour supply of women with children can be mitigated by individualising income taxes, maintaining tax progression, and providing subsidies for labour complements like childcare.

In many respects, our new architecture does not differ fundamentally from today's welfare states in Europe, although labour-market performance may be improved through subtle reforms. Hence, there is no need for revolution. Still, future trends like ageing and skill-biased technological change put a strain on current welfare states. Therefore, raising labour-market participation is a high priority for Europe. This requires better incentives, which come at a cost of equality, insurance or commitment: no gain, no

pain. Governments thus need to reconsider the dilemmas that are inherent in welfare-state design and face these difficult choices.

As economists, we have little to say about choosing between one social priority against another. Our value added is that we can assess and quantify the costs and benefits of various institutions. This is what '*Reinventing the Welfare State*' does. So, if you are asked to design a new architecture of the welfare state, please be invited to read the study. Be prepared!

More information: [ruud.de.mooij@cpb.nl](mailto:ruud.de.mooij@cpb.nl)



## Main Economic Indicators for the Netherlands, 2004-2007

	2004	2005 <sup>a)</sup>	2006 <sup>a)</sup>	2007
	annual growth rates			
<b>International items</b>				
Relevant world trade volume	7.3	5.4	6½	7
Import price goods	0.6	3.5	3½	- 1
Export price competitors	0.3	1.1	2½	0
Crude oil price (Brent, level in dollars per barrel)	38.2	54.4	60	55
Exchange rate (dollar per euro)	1.24	1.24	1.20	1.20
Unit labour costs competitors in manufacturing	- 4.4	0.1	- ¼	- ¾
<b>Demand and output (volume)</b>				
Gross domestic product (GDP, economic growth)	1.7	0.9	2¾	3
Private consumption	0.0	0.3	- 2 (1¼)	1¼
Gross fixed investment, private non-residential	3.3	0.3	8	5
Private residential investment	6.4	5.7	4¾	3¾
Exports of goods (non-energy)	9.4	6.3	8¼	9¼
of which domestically produced	1.2	2.3	4	4¼
re-exports	20.1	10.9	13	14½
Imports of goods	9.0	5.6	8	8¾
Production market sector <sup>b)</sup>	1.9	1.4	3¾	4
<b>Prices and wages</b>				
Consumer price index (CPI)	1.2	1.7	1¼	1¼
Price domestic expenditure	1.4	1.6	1½	1¼
Export price goods (excluding energy)	- 0.7	0.3	1¼	- ½
Price competitiveness	- 0.8	- 1.0	1	¼
Contractual wages market sector	1.5	0.8	1½	1¾
Compensation per employee market sector	3.5	1.5 (1.9)	¾ (1)	1¾
Unit labour costs in manufacturing	- 1.4	0.3	- 3½	- 2
<b>Labour market</b>				
Unemployment rate (level in % of labour force)	6.5	6.5	6	5
Unemployment (x 1000)	479	483	445	370
Employment (labour years)	- 1.6	- 0.5 (- 0.8)	1¼ (1)	1¾
Employed labour force (persons)	- 1.2	0.0 (- 0.3)	1½ (1¼)	2
Labour force (persons)	0.0	0.0 (- 0.2)	¾ (½)	1
<b>Public sector</b>				
General government financial balance (level in % of GDP)	- 2.1	- 0.6	- 0.9	- 0.4
Gross debt general government (level in % of GDP)	52.5	51.8	51.1	49.5
Taxes and social security contributions (level in % of GDP)	37.8	39.6 (38.8)	39.4 (37,8)	39.5
<b>Miscellaneous items</b>				
Purchasing power	- 0.4	- 1.7	1¼	1
Individual savings rate (in % of disposable income)	- 2.1	- 4.3	- 3½	- 2¾
Labour productivity market sector <sup>b)</sup>	4.3	2.1 (2.4)	2¾ (3)	2
Price gross value added market sector <sup>b)</sup>	- 0.3	- 0.3	- 1	1
Real labour costs market sector <sup>b)</sup>	3.8	1.8 (2.1)	1¾ (2)	¾
Labour share in enterprise income (level in %) <sup>b)</sup>	80.0	79.7	79	77¾
Export surplus (level in % of GDP)	7.3	7.7	7½	7¾
Long-term interest rate (level in %)	4.1	3.4	3¾	4

<sup>a)</sup> 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/cepmev/explanation.html>.

<sup>b)</sup> Excluding mining and quarrying and real estate activities.