CPB Netherlands Bureau for Economic Policy Analysis

Macro Economic Outlook 2015

MEV 2015, translation of chapter 1

1 Summary

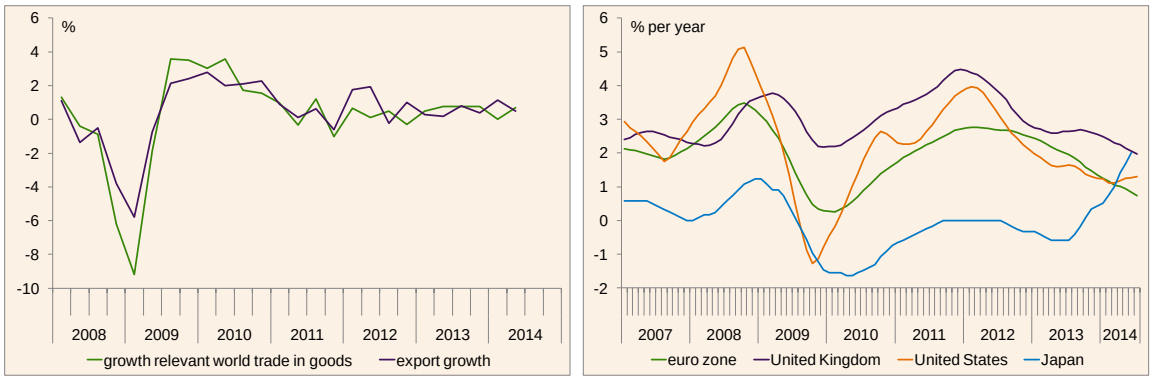
The geopolitical tensions in some parts of the world pose a risk to the global economy. The growth of the global economy and world trade is picking up in fits and starts. Expectations are attenuated by disappointing realisations and the consequences of tensions around the Ukraine and Russia. For this year, an increase of 2½% in relevant world trade is projected, and for next year this will be 4½%. The Dutch economy will grow by ¾% this year and by 1¼% in 2015. Growth is driven by exports, but investments are also increasing and, for next year, household consumption is projected to go up again. Unemployment is expected to decline, slightly, to 6¾% in 2015. Inflation will remain low, with 1% this year and 1¼% in 2015. This year is the first year in which median purchasing power increases (1½%), following four years of decline. Next year, median household purchasing power will improve by ½%. The government deficit in 2014 will be 2.6% of GDP, decreasing to 2.2% next year. This decrease, on balance, is mainly due to deficit-reducing measures, particularly in health care and public administration. The government debt is projected to increase in 2015 to 70.2% of GDP.

1.1 Summary and introduction

Careful recovery of the global economy, low inflation, geopolitical risks

The geopolitical tensions that exist in some parts of the world pose a risk to the global economy. In case of no further escalation, the global economy is projected to improve in fits and starts. Global GDP growth, 3¼% this year, is slightly higher than in 2013. Leading indicators point to a careful recovery of the global economy, and, for next year, an increase of 3¾% in global GDP is projected. Of the developed economies, growth is particularly high in the United Kingdom and the United States, hesitantly followed by the euro zone. In Japan and China economic growth is slowing down. Furthermore, the increase in world trade is also moving in fits and starts. World trade expectations are attenuated by disappointing realisations and by the consequences of the tensions around the Ukraine and Russia. Growth is slightly lower than last year, and with 2½% still considerably below the multi-annual average. This is particularly the result of the slight growth in world trade volumes in the first half of this year. Incidental and country-specific factors have plaid a role in this (e.g. extreme weather events in the United States and a mild winter in Germany). Projections include a recovery of world trade over the course of the year, followed by an increase of 5½% in 2015. This also applies to relevant world trade (i.e. imports by the most relevant trading partners for the Netherlands). World trade is projected to increase by 2½% this year, and for next year to come to the multi-annual average of 4½%.

Figure 1.1 Relevant world trade and exports (left), continuing decline in inflation (right))



Dutch exports are closely related to developments in relevant world trade (Figure 1.1, left), although deviations over a few quarters are not uncommon (e.g. the second quarter of 2010 and the first half of 2012). This phenomenon can also be seen to emerge in the first quarter of this year; despite disappointing relevant world trade, Dutch exports are growing slightly, again. This growth in exports is projected to continue over the coming 18 months, in line with the increasing growth in world trade.

The euro zone economy will grow by 1% this year and by 1½% next year. In Germany, growth is above average in both years, whereas in France, Italy and the Netherlands it is below average. Exports and investments are driving this growth, supported by expansionary monetary policy. Consumer spending remains weak, partly due to high levels of

unemployment and declining capital positions. In many countries in the euro zone, budgetary policies continue to be restrictive, in order to comply with EU budgetary regulations. Inflation in the euro zone continues to decrease (Figure 1.1, right) and will also be low next year. In response, the ECB announced more measures in September, including the lowering of interest rates and the purchase of *Asset Backed Securities*. More expansionary monetary policy, to date, has not led to an increase in inflation, but it has increased the value of financial assets and real estate in a number of countries. Positive signs are the slight increase in the provision of credit to businesses and households and the depreciation of the euro since last March. Depreciation contributes to price increases in the euro zone.

Financial market sentiment has continued to improve. A strong decrease could be seen with respect to CDS spreads, the volatility of share prices and risk premiums that countries such as Spain, Portugal and Greece are paying on their government loans vis-a-vis the German interest rate. This decrease in risk premiums, compared to the situation in Germany, is the result of the 'whatever it takes' statement by Draghi in July 2012 (in which he indicated that he intended to keep the euro zone in tact, no matter the cost), and the improvement of current accounts of the euro zone's problem countries. At this moment, however, the spreads are so low that it is questionable if they are a realistic reflection of the risk.

Geopolitical tensions pose an increasing risk to the recovery of global economic growth. The text box on the following page provides an indication of the impact on the Dutch economy caused by a further escalation of the conflict around Eastern Ukraine. Persisting lower inflation in the euro zone also poses a risk; particularly because this leads to debt deflation – an increase in the real financial burden of debtors.[1] Another downward risk would be a further slowing down of economic growth in China and other emerging economies. Under an inadequate policy response, as described in the Central Economic Plan 2014, a disappointing outcome of the *Comprehensive Assessments* (CAs) of European banks this autumn could also pose a downward risk. An upward risk would be presented by a positive outcome or adequate response to the CAs, or an unexpectedly rapid economic upturn in the United States, the United Kingdom, the euro zone and Japan.

Dutch economy: turning point for consumption

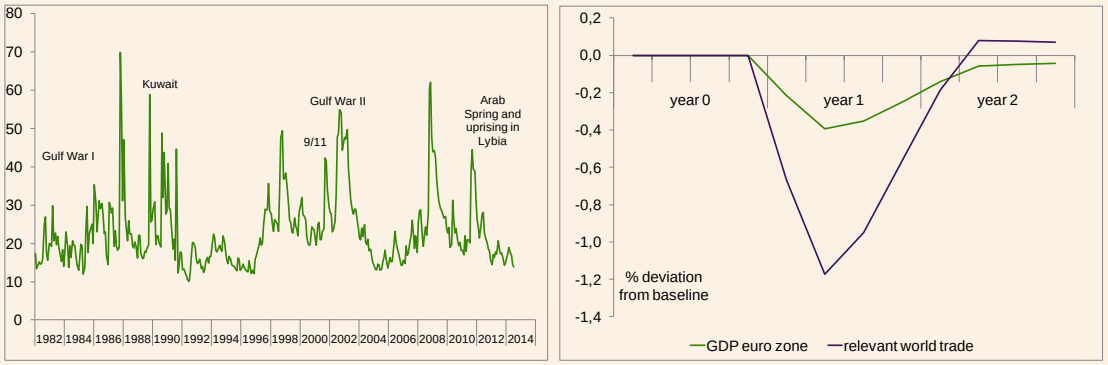
Under the influence of a careful recovery of global and European economies, the Dutch economy will increase by ¾% this year and by 1¼% in 2015. During the first quarter of this year, the economy contracted; particularly due to the incidental factors of the mild winter and the reverberating effect of the fiscally driven increase in investments in company vehicles in the last quarter of the previous year. In the second quarter of this year, the economy was seen to grow again by 0.5%. Considering the average over these quarters results in an underlying growth of ¼% per quarter. This growth is expected to continue over the remainder of the projection period.

[1] See also the text box on pages 30 and 31 of the *Central Economic Plan 2014* (in Dutch) (link).

Varying uncertainties under a further escalation of the Ukraine conflict

In cases of serious armed conflict, strong increases in share market fluctuations worldwide also show increases in uncertainty. Confidence of investors, businesses and consumers decreases. Businesses are postponing their investments and consumers are spending less. This results in a decrease in the GDP of Western countries and in global trade relevant to the Netherlands. The figure shows the volatility on the share market of Frankfurt as an indication of the uncertainty in Europe under armed conflict in the past (left). The right-hand figure presents the response in the euro zone's GDP and relevant world trade, under an uncertainty impulse that could occur in case of further escalation of the Ukrainian conflict. Events considered include an invasion of the Ukraine by Russian troops. Furthermore, trade sanctions on both sides could temporarily reduce Western exports to Russia by 20% (against 3% today, for the EU).

DAX volatility in relation to armed invasions (left), and the response of euro zone GDP and world trade (relevant to the Netherlands) to the uncertainty impulse in the subsequent two years (right)



The assumed uncertainty impulse and trade restrictions, together, could cause a decrease in Dutch GDP of ½% in the year following the first month of escalation. A less serious escalation would cause a ¼% reduction in Dutch GDP over the same period. Under both scenarios, the effects would largely disappear again after that first year.

Consequences for the Netherlands of increasing macroeconomic uncertainty and/or trade restrictions caused by an escalation of the Ukrainian situation (deviations from the baseline, in ppt)

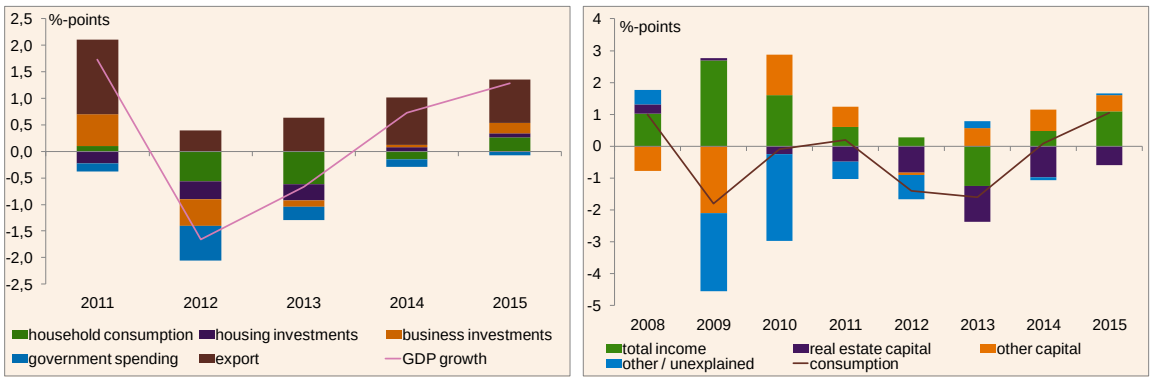
	Moderate uncertainty / trade restrictions		High uncertainty / trade restrictions	
	Year 1	Year 2	Year 1	Year 2
Volume relevant world trade (excluding energy)	-0.6	0.0	-1.2	0.0
Competitor prices (excluding energy)	0.0	-0.1	-0.1	-0.3
Gross Domestic Product (market prices)	-0.3	0.0	-0.5	-0.1
Household consumption	-0.1	-0.1	-0.3	-0.2
Investments total (including stocks)	-0.9	-0.3	-1.9	-0.7
of which business investments	-1.6	0.1	-3.2	0.2
of which housing investments	-0.3	0.0	-0.6	0.0
Export of goods and services	-0.4	0.0	-0.9	0.0
Import of goods and services	-0.5	-0.1	-1.0	-0.2
Employment (labour years)	-0.1	-0.1	-0.2	-0.3
Unemployment percentage (in % of GDP)	0.1	0.1	0.1	0.2
Contractual wages private sector	-0.1	-0.3	-0.2	-0.6
Consumer Price Index (CPI)	0.0	-0.1	-0.1	-0.2
EMU government balance (% of GDP)	-0.1	-0.1	-0.2	-0.2
EMU debt (% of GDP)	0.3	0.3	0.6	0.6

A detailed description of these variants can be found in the CPB background document *Onzekerheidsvarianten bij verdere escalatie Oekraïne-conflict* [Uncertainty variants under further escalation of the Ukraine conflict (in Dutch)], 20 August 2014 (link).

This year, this growth will continue to be driven by exports and investments, with household consumption next year also contributing to GDP growth (Figure 1.2, left).

Starting this year, disposable income will again positively contribute to consumption (Figure 1.2, right). This year more so than the next, real disposable income will increase, as will the development in median purchasing power. In 2014, labour income again contributes to disposable income. Increases in other income, such as interest and dividend payments, will partly be consumed, but will particularly contribute to an increase in savings.
The negative impact of decreasing house prices over the last years and related asset losses have a delayed reducing effect on consumption levels in both this year and next year. However, the size of this impact is expected to decrease, compared to previous years.

Figure 1.2 Contribution of consumption (a) will become positive (left) and income growth will carry consumption growth (right)



(a) Contribution of government spending to GDP growth concerns only direct spending effects of government consumption and investment expenditures. The impact of other government spending, including income transfers and subsidies, may contribute to growth via household and business spending. This also applies to taxation.

Disposable income also is expected to develop more favourably than in the preceding years, because average pension premiums will decrease both this year and the next, particularly as a result of cutting back pension-related tax benefits (the so-called Witteveenkader). The maximum annual pension build-up for this year will be reduced from 2.25% to 2.15% (average wage) and in 2015 to 1.875% (average wage). At that time, also the tax deductibility of pension premiums will be limited for incomes over 100,000 euros. Although the implementation of the revised Dutch FTK regulation (*Financieel Toetsingskader*) will have an upward impact on premium payments in 2015, on balance, a decrease in the premium level is projected. Chapter 1.2 elaborates on the future revision of the pension system.

The higher disposable income will not be consumed fully, but will also lead to additional savings. The individual savings share is projected to rise substantially in this year, stabilising in 2015. One of the factors here is the fact that over a million homeowners are 'underwater'. These households save a relatively large share of their income in order to reduce their negative equity.[2] The losses they incurred over the past years will not be recovered swiftly, assuming that house prices are unlikely to rise in the near future. The housing market is

[2] See Chapter 6 of Gelauff G. and D. Lanser, A. van der Horst and A. Elbourne (2014), *Roads to Recovery*, (link).

slowly recovering, as a result of the careful economic recovery. For now, house prices are assumed to stay in line with inflation.

Table 1.1 Main economic indicators for the Netherlands, 2011–2015

	2011	2012	2013	2014	2015
	mutations per year in %				
International economy					
Relevant world trade	4.0	0.7	1.7	2½	4½
Competitor prices	6.3	4.1	-2.1	-1	1
Oil price (Brent, USD per barrel)	111.3	111.7	108.7	108	107
Euro exchange rate (USD per euro)	1.39	1.28	1.33	1.36	1.35
Long-term interest in the Netherlands (in %)	3.0	1.9	2.0	1.7	1.8
Volume GDP and spending					
Gross Domestic Product (GDP, economic growth)	1.7	-1.7	-0.7	¾	1¼
Household consumption	0.2	-1.4	-1.6	0	1
Government spending	-0.2	-1.6	-0.2	-¾	0
Investments (including stocks)	3.5	-5.8	-4.9	2¾	3¼
Export of goods and services	4.4	3.2	2.0	3¼	3¾
Import of goods and services	3.5	2.8	0.8	3	3¾
Prices, wages and purchasing power					
Price level Gross Domestic Product	0.1	1.3	1.0	½	1¼
Export prices domestically produced goods (a)	4.7	1.8	-0.2	-¾	¾
Import price levels	8.1	3.4	-1.5	-1¾	¾
National Consumer Price Index (CPI)	2.3	2.5	2.5	1	1¼
Contractual wage level private sector	1.4	1.6	1.2	1¼	1½
Purchasing power, static, median all households	-1.1	-2.1	-1.4	1½	½
Labour market					
Labour force	0.0	1.5	0.8	-½	¼
Working population	0.0	0.6	-0.7	-¾	½
Unemployed labour force (in thousand persons)	389	469	600	620	605
Unemployed labour force (in % of the labour force)	4.4	5.3	6.7	7	6¾
Market sector (b)					
Production	2.7	-1.9	-0.9	1½	1½
Labour productivity, in labour years	2.1	-1.3	0.6	2	1¼
Employment, in labour years	0.6	-0.6	-1.5	-½	¼
Wage rate (c)	2.8	2.3	2.6	3	1¼
Labour income share (in %) (c)	77.5	79.5	81.4	81¾	81
Other					
Individual saving share (in % disposable income) (c,d)	0.5	0.0	0.6	2¼	2¼
Balance current account (in % of GDP)	7.1	8.8	8.5	8½	8¾
	% of GDP				
Public sector					
EMU balance	-4.3	-4.0	-2.3	-2.6	-2.2
EMU debt (end of year)	61.3	66.5	68.6	69.7	70.2
Taxes and social security contributions (in % of GDP)	35.9	36.3	37.2	38.1	37.7

(a) Excluding energy.
(b) Businesses, excluding health care, mineral mining and the real estate sector.
(c) The wage rates in the market sector, labour income share, as well as the individual saving share for 2014 and 2015 have an upward distortion due to the measure to limit the use of a so-called Stamrecht bv (severance pay insurance fund). Severance pay packages are paid out directly to those involved, instead of first having to be entered into such an insurance fund. Since the revision, severance pay packages are booked as a social burden for employers. The measure leads to a one-time accounting increase in the social burden for 2014, which in turn has an upward impact on wage-rate developments of over 0.5 ppt in the market sector.
(d) Level; disposable family income includes public saving.

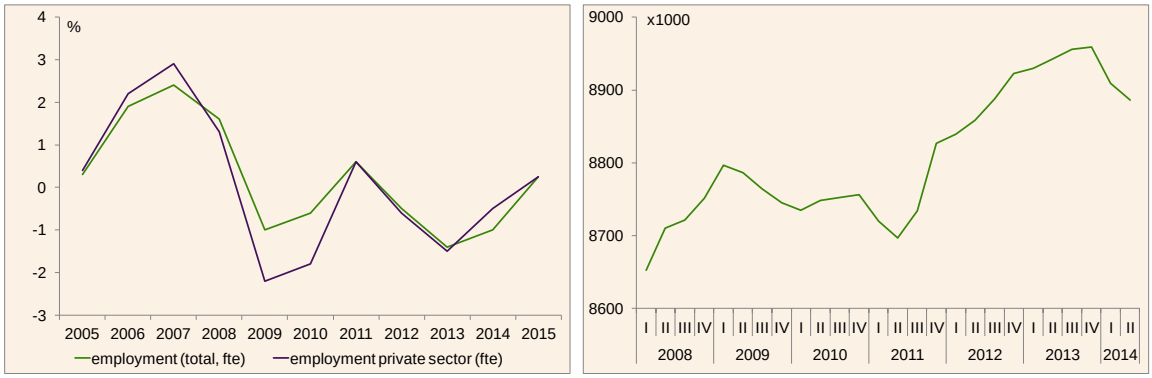
Similar to GDP and consumption, business investments over the past quarters also show an erratic development. There was a strong increase in the fourth quarter of 2013, particularly because investments in business vehicles were pushed up in anticipation of upcoming adjustments to tax policy. In the first half of this year, the echoes of this impact were visible in lower investments. Apart from these incidents, there is an underlying moderate growth in investments. Business investments (excluding those in housing) are projected to increase in 2014 and 2015 by 2½% and 5½%, respectively, due to low interest rates, a recovering economy and the related increase in capacity utilisation. Industrial capacity utilisation, over the past quarters, already increased to over 80%. In addition, producer confidence increased strongly, over the last five quarters. Because of the careful recovery of the housing market, housing investments will also grow again in 2014 and 2015, following a number of years of strong decline.

Labour market has also reached a turning point

The economic turning point can now also be seen on the labour market. Unemployment seems to have reached its peak and has since decreased by 44,000 people. It is expected to stabilise during the rest of this year and next year. Employment and labour supply are projected to increase slightly over the remainder of the projection period. As a result, unemployment is projected to stay more or less constant.

The modest increase in employment is the result of recovering production levels in the market sector. This turning point in employment in the market sector is confirmed by various indicators, such as an increase in the number of job vacancies and the number of businesses that say they are looking to expand their staff numbers. Measured over the full year, employment will decline this year, but next year it will turn into a modest increase (Figure 1.3, left). This also applies to the development of total employment (in employment years), which this year will lag behind market developments because of government and health-care spending cuts.

Figure 1.3 Turning point for employment (left); declining labour force (right)



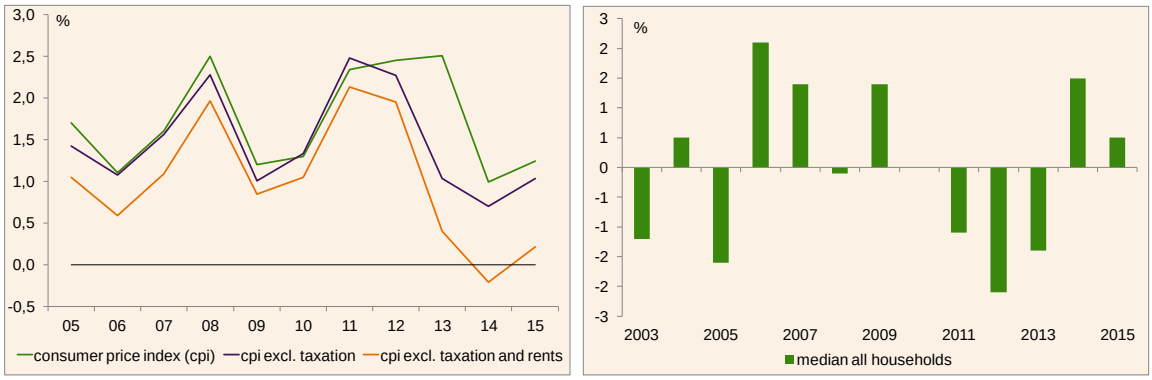
Because of the continuing decline in employment over the past years, job opportunities were limited. Up to the end of last year, however, there was an increase in labour supply. This has since reversed: in the first half of 2014 the labour force decreased considerably (Figure 1.3, right). The timing of this turning point is remarkable, because the economy has begun to

recover. People between the ages of 45 and 60, in particular, have withdrawn from the labour market. In addition, the labour supply of young people is declining, for example, because they stay in school longer, or stop looking for a secondary job. Discouragement is expected to remain a factor during the rest of this year and next year, but not in current volumes. The structural increase in labour participation will regain the upper hand, causing the labour supply, on balance, to increase again slightly next year.

No turning point yet for inflation, but purchasing power will improve

Inflation will be low this year and the next, not only in the Netherlands, but everywhere in the euro zone. Inflation (CPI) will be 1% this year and for the following year 1¼% is projected. For the Netherlands, internationally harmonised inflation (HICP), with ½% and 1% respectively, will even lag a little behind the euro zone average. When Dutch inflation is corrected for policy, such as the VAT increase of 2012–2013 and the rent increases, it is more or less equal zero, since 2013 (Figure 1.4, left). For next year, inflation is projected to stabilise, due to the careful economic recovery and a further increase in rent prices.

Figure 1.4 Inflation low (left) and purchasing power development positive again (right)



Contract wage developments, of 1¼% this year and 1½% next year, in the market sector will be moderate, as a result of low inflation and high unemployment levels. Incidental wage developments are also low in the market sector. Next year, the social burden will decline for employers; in particular due to the restrictions on fiscal deductions related to pension build-up for incomes of over 100,000 euros. The real wage rate in the market sector (contract wages, incidental wages and social burden), on average, is projected to increase by less than labour productivity, for this year and the next. This causes the labour income share to decline slightly, following strong increases over the 2011–2013 period.

Real wages will increase both this year and the next, by ¼%, as the contract wage increases in both years will be larger than inflation. For the first time since 2009, purchasing power will improve this year, by 1½% (Figure 1.4 right). Everyone will benefit from the tax rate reduction in the first tax bracket and the increase in general tax deduction. The working population, in particular, will benefit (+2%). They also benefit from an increased earned income tax deductions and lower pension fund premiums. Pensioners will experience limited indexation of their supplementary pension and in some cases will even face reductions. The nominal health premium in 2014 is over 100 euros less than it was in 2013, which has been

favourable for households that receive no health-care insurance subsidy. Increases in purchasing power are reduced by freezing the bracket boundaries, restrictions on general tax deductions and decrease of the earned income tax deduction for high incomes. The income freeze is unfavourable for public servants, but they have the advantage of lower government pension (ABP) premiums.

Median household purchasing power is projected to increase by ¼% next year. The rise in nominal health insurance premium, the increase in the reduction percentage for health insurance subsidies and the increase in the tax rate for the first tax bracket all have a negative effect. On the other side, there is the increase in general tax deduction and earned income tax deduction, and the raised reduction limit of this deduction. In addition, in 2015, the number of child regulations will be reduced to four. Furthermore, for single parents there will be an increase in the child-related budget and the maximum for this budget will also be increased. The purchasing power impact of these adjustments, on balance, is negative, except for single parents on low to middle incomes because they receive an increase in child-related budget.

Improvement in government finances due to a decrease in public spending

The government deficit is projected to increase from 2.3% in 2013 to 2.6% this year, and to decrease to 2.2% in 2015. The underlying decrease in the deficit by 2015, from 2013 levels, is greater because in 2013 the deficit was temporarily reduced due to unusual factors (revenues from the telecom auction corrected for SNS, 0.4% of GDP). In 2014, revenues from gas sales will decrease because of a lowering of the production maximum. The tax and premium burden share this year will increase due to policy. Spending cuts put pressure on public spending; this year, the expenditure share will decrease slightly and for next year by 0.9% of GDP. Despite the decrease in this share during three consecutive years, expenditures in 2015 will still be over 2% (of GDP) higher than before the 2008 crisis. Uncertainty about the projections for government finances is larger than usual. This is true for revenues related to the temporary reduction in the tax rate in Box 2 of the income tax, revenues from the severance pay insurance measure, restrictions on the pension-related tax benefits (Witteveenkader), and developments in health-care expenditure.

The structural balance, corrected for the economic situation as well as incidents, for both this year and the next, will be -0.7%. The government debt is projected to increase further over the projection period. Revision of the National Accounts leads to a downward adjustment of the debt of 4.5% of GDP, and will have a limited downward effect on the government deficit.

Seeing that last year's deficit stayed below 3% of GDP and that it is expected to remain on this level, the Excessive Deficit Procedure for the Netherlands has been terminated. The budgetary regulations of the preventative arm of the Stability and Growth Pact, therefore, have now become relevant.

1.2 Analysis

'as, between dream and deed, there are laws and practical objections'[3]

Interventions in the pension system will take place in 2014 and 2015, in the form of restrictions on pension-related tax benefits (*Witteveenkader*) and implementation of the revised FTK regulation (*Financieel Toetsingskader*). In addition, Cabinet has started a broad societal discussion on further reform of the pension system. However, implementing such reform appears difficult. Three factors play a role here; to begin with, proper preparation increases the chance of success.[4] Such preparation anticipates on legal and technical execution issues, thus limiting the risk of reform failure during its implementation. Secondly, an analysis of the winners and losers is needed. Reforms take time to yield a profit. Generally speaking, the losers often can be identified relatively early on, and they therefore begin to make a great deal of noise and are able to exert influence.[5] Thirdly, developing a fair transitional phase is therefore important, in which losers are partly or fully compensated. Especially for reforms that threaten the implicitly or explicitly acquired rights, it can be difficult to construct a transitional regulation that distributes the negative impacts over time and affected groups.

The pension system is particularly a subject for which progress is determined by political-economic issues, and where transitional problems can prove serious obstacles. The Dutch old-age pension system has gone through a fair amount of change. In practice, a number of different transitional regulations were chosen. For example, for the abolition of the VUT (Dutch early retirement benefit), a transitional measure was to exclude people born before 1950. Later generations were not fully compensated and the increase in the retirement age (General Old Age Pensions Act (AOW)) was implemented in phases. The restrictions on the pension build-up rate for the so-called Witteveenkader (pension-related tax benefits) were implemented without transitional regulation. The transition towards realistic pension contracts, in practice, met with difficult transitional issues. An important element in the discussion about a fundamental reorganisation of the pension system is the average pension premium, because of the redistribution and the resulting brake on labour mobility. The abolition of the average pension premium, however, comes with large transitional problems. Below, these problems are put into perspective, and the winners and losers of alternative transitions are identified.

Common system

Under the system of the average pension premium, everyone pays the same amount in premium and has the same pension build-up (in % of pension-providing wage). This system leads to redistribution, because it ignores the differences in investment horizons between

[3] Elsschot, W., 1910, Het Huwelijk [The Marriage (in Dutch)].
[4] OESO, 2009, The political economy of reform, Lessons from pensions, product markets and labour markets in ten OECD countries (link), and Gruner, H.P., 2013, The political economy of structural reform and fiscal consolidation revisited, European Economy Economic Papers 487 (link).
[5] This may lead to the so-called *status quo bias*. For example, see Fernandez R. and D. Rodrik, 1991, Resistance to reform: status quo bias in the presence of individual-specific uncertainty, *American Economic Review*, vol. 81 no. 5 (link).

young and old, as well as differences in life expectancy. Because of this difference in investment horizons, the premium for young people should be lower than for those who are older, or the build-up rate should be higher. Because of the differences in life expectancy, premiums for lower educated men with on average low life expectancy should be lower than for higher educated women with generally a higher life expectancy. The average pension premium leads to redistribution among participants; in particular in cases of partial build-up, such as at a switch to self-employment. This may put a brake on labour mobility. Because premium and build-up of rights do not match, any implementation of freedom of choice under the current system is difficult.

Alternatives

There are various alternatives for eliminating the redistribution between young and old, as is caused by the common system.[6] Possible alternatives are:

1) Progressive premiums, with an average build-up and a premium that increases with the age of the participant.
2) Degressive build-up, with an average premium and a build-up that decreases with the age of the participant.
3) Indexation of pension yields, with a higher or more secure indexation in exchange for a lower initial build-up.
4) Individual accounts, in which the built-up capital equals the amount paid in premiums and the net yield.

Under degressive build-up, indexation of pension yields, and individual accounts, the premium stays at a constant percentage of pension-providing wage, for people of all ages. Under a transition towards progressive premiums, the wage profiles are expected to become even steeper with age. Pension premiums are partly covered by employers, which means that progressive premiums under current labour market institutes, in the short term are unfavourable for the labour market position of older employees. Below, focus is on the impacts of redistribution of the implementation of a degressive pension build-up. The line of reasoning is similar to that for indexation of pension yields and for individual accounts.

Redistribution, which is created because the pension build-up does not take differences in life expectancy into account, is more difficult to solve. It is becomes smaller as the group of participants who share the longevity risk is more homogenous, but forming such homogenous groups could prove difficult, in practice. A more indirect approach would be that of using the positive coherence between income and life expectancy. There are pension schemes in which low-income earners, through a lower franchise, have more pension entitlements without having to pay additional premiums (there are different franchises for premiums and build-up). There are also pension funds that have separate regulations for higher and lower incomes, in order to prevent mutual cross-subsidies.

[6] Further investigation should indicate whether, after abolition of the common system, sufficient elements of solidarity remain within the pension system to continue the compulsory participation in private sector pension schemes according to European law.

Transition costs

Under the common system, part of the premiums paid by young people are used for the pension build-up of older people. When these young people are old themselves, they will hopefully benefit from the premiums paid by new young people. Because of this system, the average investment horizon is shortened. This reduces the yield on investments and raises pension premiums. In the switch to degressive build-up, the subsidy flow of young people to the elderly is terminated. Investment yields are used for the benefit of the investing generations themselves. A large amount of capital is accumulated early in life, so that people can fully benefit from the investment horizon. With the abolition of the average pension premium, the additional amount in premium necessary because of the shortened investment horizon is terminated. Transition costs equal the net constant value of the terminated additional premium, which over time would come to 8% of the annual premium, and the transition costs would be around 100 billion euros in pension rights.[7]

Transition impacts under abolition of the common system would be substantial, but probably smaller than those for the abolition of the early retirement scheme (VUT). The transition-financed VUT regulations were tightened from the mid 1990s onwards, and with it 10% or more of the pension build-up was transferred to capital funding. A number of pension funds were able to finance the transition from their capital buffers; on average, this meant an improvement in their financial position. Transition costs thus were less visible for employees than if premiums would be raised or expected pension payments lowered.

Compensation

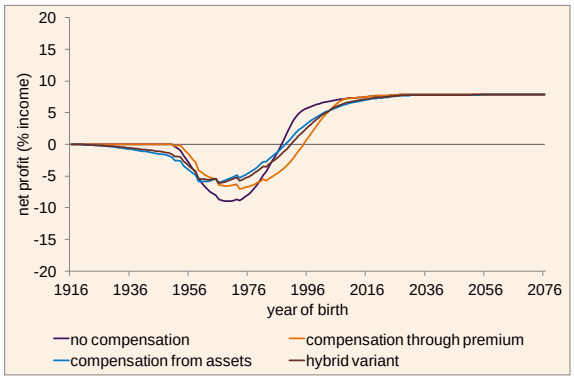
Under a transition towards degressive build-up, the working population of today misses a certain amount in pension build-up, as they have not had a degressive – higher – build-up in the earlier years of their careers, but rather have been co-financing the pension payments to older generations. Transition impacts are largest for middle-aged employees, who are halfway their careers. If the common system were to be terminated in 2015, this would apply roughly to generations born between 1960 and 1980. The generation effects under a transition towards degressive build-up are shown in Figure 1.5 on the left (see the line of no compensation). Generation effects are measured according to mutations in net benefit, the balance of payments and premiums. For determining the generation effects, lower pension premiums are assumed to lead to higher wages, keeping wage costs on balance at the same level. The financial pain caused by the transition could be spread out more by compensating employees for the loss of subsidised pension build-up during the second half of their careers. This compensation could be financed from a temporary increase in premium or by lowering indexation.

[7] The amount in premium decrease is sensitive to assumptions on interest rates and age structure of the pension fund. See Lever, M., J. Bonenkamp and R. Cox, 2014, Doorsneesystematiek in pensioenen onder druk? [Average pension premium under pressure? (in Dutch)], CPB Policy Brief 2014/1, (link).

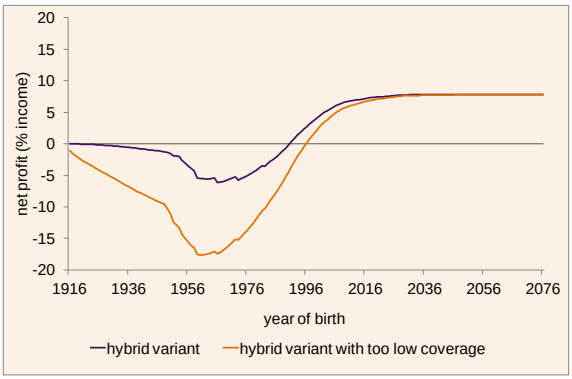
Completely financing the transition costs from premium payments would lead to substantial or long-term higher premiums. Financing the transition partly from premium payments is very possible, also because abolition of the average pension premium offers the opportunity to lower premiums. Additional opportunities to do so exist in certain sectors, due to the termination of premiums for transition regulations regarding the Dutch law on the adjustment of fiscal rules on early retirement (*Wet aanpassing fiscale behandeling VUT/Prepensioen*) and the introduction of the life-course regulation (*Levensloopregeling (VPL)*). Financing by using the coverage ratio would lead to less indexation in the future, but would spread the transition effects over many generations. A combination of measures (hybrid variant) could also be an option: no full compensation for loss of rights, temporary higher premiums, and financing the remainder from the coverage ratio. A runtime of 15 years for an increase in premiums would be comparable to that of the VPL transition. An increase of 8% on premiums within a new pension system would correspond with the effects of extending the investment horizon under abolition of the average pension premium, so that on balance premiums will not go up from their current levels. The generation effects of abolition of the average pension premium are less severe than those related to a too low coverage ratio, which would especially lead to incomplete indexation. These effects could be particularly severe for certain generations due to cumulation (see Figure 1.5, right), but in practice this will vary per pension fund. Please note that purchasing power effects are substantially smaller than those on gross supplementary pensions, because the transition will have no impact on state pensions (AOW) and because taxation and premiums are progressive.

Figure 1.5 Generation effects in the transition towards degressive increase

Effects under various ways of compensation



Hybrid variant with and without the effect of a too low cover ratio



The Dutch pension system was constructed shortly after World War II. Since those days, the Netherlands and the Dutch labour market have changed, considerably. Labour mobility has increased, both between sectors and between paid employment and self-employment. The pension system must accommodate these changes, and abolition of the average pension premium would contribute to that. The costs involved in the transition towards a new system are high, but must be put into perspective. The impact of the abolition of the VPL was comparable in size and the consequences of too low coverage, on average, were more serious. The effects must also be weighted against the benefits of the abolition of the average

pension premium; less redistribution from young to old premium payers, less of a brake on labour mobility and lower premiums in the long term, due to the fact that deposits have more time to return a profit. This means the system is more efficient and better equipped for the changing labour market. Moreover, terminating redistribution, as currently connected to the average pension premium, would ease the transition towards a future-resilient pension contract. Thus, a view on a sustainable pension system is created.

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P.O. Box 80510 | 2508 GM The Hague
+31 (070) 3383 380 | info@cpb.nl

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