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Challenges for the Dutch welfare state[1]

Ruud A. de Mooij

CPB Netherlands Bureau for Economic Policy Analysis

Abstract

The Dutch welfare state is under pressure. Ageing makes public finances unsustainable and globalisation tends to worsens the position of low-skilled workers. At the same time, welfare state institutions seem insufficiently adapted to changed socio-cultural circumstances and cause inactivity among elderly workers, women and social benefit recipients. To prepare for the future and maintain social cohesion, the Dutch government aims to raise the quantity and quality of employment. This paper explores how welfare state reform can contribute to these goals, thereby taking into account the key functions that the welfare state fulfils in terms of equality, security and smoothing. We quantify the effects of various reforms on the labour market and the income distribution by using an applied general equilibrium model for the Netherlands. The paper further develops three comprehensive welfare state reforms for the Netherlands and assesses its implications.

[1] This paper is based on the study Reinventing the Welfare State published in De Mooij (2006). This version is prepared for the Euroframe EFN Report.

1 Introduction

European welfare states are under pressure. Developed during the post-war period and expanded in the 1960s and 1970s, welfare states have brought substantial achievements for European citizens: they improved income security, mitigated poverty and enabled a broad access of people to services like education and health care. In this way, welfare states have facilitated the development of European economies, *e.g.* by investment in human capital and by creating social and political stability. Indeed, it is widely believed that welfare states not only serve social objectives, but also have a productive function for the economy.

However, European welfare states tend to become unsustainable in the future, both in financial terms and in terms of social legitimacy. Indeed, public expenditures will rise in light of ageing while globalisation makes it more difficult to finance them due to increasing mobility of tax bases. At the same time, welfare state institutions have poorly adapted to recent changes in socio-economic conditions, such as heterogeneous preferences, a better educated work force, and rising female participation rates. Moreover, welfare states create sustained inactivity among benefit recipients, elderly workers, low-skilled people and women. Therefore, countries can no longer afford these high rates of inactivity in combination with generous public welfare state provisions. European Union governments are therefore thinking about 'reinventing their welfare states'. This paper aims to contribute to this debate, with a special focus on the Netherlands.

The paper is organises as follows. Section 2 discusses the experience of the past 25 years of welfare state reform in the Netherlands and explains the need for further reform. Section 3 considers the key trade-offs in welfare state design. It is used to identify promising options for the future. Section 4 uses these insights for an analysis of three comprehensive welfare state reforms in the Netherlands. Section 5 concludes.

2 A tale from a small country

25 years of welfare state reform

The current Dutch welfare state has been largely founded in the post-war period when many social expenditure programs were introduced. During the sixties and seventies of the twentieth century, welfare state expenditures expanded rapidly. When the Dutch economy was hit by severe shocks in the seventies, however, generous benefits in combination with lax administrative controls caused an inflow of redundant workers in social security schemes with open-ended benefits, such as the disability scheme. When the second oil crisis hit the economy at the end of the seventies, the Dutch economy was caught in a vicious circle of declining employment and rising claims on the welfare state. In the beginning of the eighties, the Dutch economy had arrived in dire straights. Table 1 illustrates this: the state spent more than 60% of GDP and taxation and social security contributions accounted for about half of GDP. The

unemployment rate contained two digits and for every ten employed persons there were nine persons on social benefits. The need for drastic measures thus became increasingly apparent.

Table 1 Dutch public finance and labour-market performance in 1982 and 2007

	1982	2007
Public finances (in % of GDP)		
Public expenditure	62	44
Overall tax burden	49	39
Public budget deficit	6	0
Labour-market performance		
Participation rate (in % of labour force)	59	73
Unemployment rate (in % of labour force)	10	4
Ratio inactive / active	0.9	0.5

Source, Central Economic Plan of CPB (2007)

The Dutch government took decisive steps in 1982. It broke the link between wages in the public sector and social benefits to wages in the private sector. Thus, public sector wages and benefits lagged behind wage growth in the private sector. Statutory social benefits were cut from 80% to 70% of gross wages. The minimum wage, to which the minimum social benefits are linked, was frozen in nominal terms. This reduced the minimum wage from 61% of the median wage in 1980 to 47% in 2000.

It took some time before cuts in social expenditures reversed the vicious circle of rising inactivity. The ratio of social security claimants to those employed stayed roughly constant between the mid eighties and the mid nineties. Only by then could the number of social security recipients be stabilised and started the ratio of social benefits to employment to fall. Cutting benefits had not been sufficient to reduce the number of benefit recipients, in part because supplementary arrangements negotiated in collective labour agreements offset some of the cuts in disability and sickness benefits. Moreover, social partners had introduced generous early retirement schemes which reduced the effective retirement age of elderly workers.

During the nineties, the cuts in social benefits were complemented by institutional reforms. For instance, eligibility criteria for social benefits were tightened. In 1993, the legal definition of the appropriate job was widened in the disability scheme. At the same time, the government reduced the discretion of decentralised administrations by issuing specific criteria for determining disability and residual earning power. For existing claimants, a program of reassessment was started in 1994. The focus in the nineties was more on microeconomic incentives and screening to avoid moral hazard, rather than on cutting benefit levels. Since the beginning of the nineties, the government also started to reduce the tax burden. In 1990, it reformed the income tax, thereby cutting marginal tax rates and broadening the tax base. During the nineties, the tax burden was reduced to support the process of wage moderation. Moreover,

by targeting tax cuts at low labour incomes, the government aimed at reducing the replacement rate at the bottom of the wage scale, thereby stimulating low-skilled employment. In the late nineties, social security was reformed even more fundamentally. Sickness insurance was privatised and competition in disability insurance was introduced to achieve efficiency gains in the implementation and administration of the insurance. Competition also meant that employers can no longer shift the costs of their behaviour unto a collective pool. During the eighties and nineties, the Netherlands experienced a considerable employment growth and a substantial decline in the unemployment rate. Most of the growth came from part-time work. Also flexible contracts through temporary work agencies rose substantially in the 1990s. Employers increasingly used flexible contracts to avoid employment protection, to screen new employees, and to meet their need for flexibility. Recent reforms have further sharpened the criteria to enter disability insurance, shortened the maximum unemployment benefit duration and reduced the incentives for early retirement.

Current performance of the Netherlands

Where did 25 years of welfare state reform bring the Netherlands? Table 1 shows that the performance of Dutch public finances and labour-market performance improved considerably in 2007. The size of the public sector became much smaller and the overall tax burden fell by about 10% of GDP. Labour-market performance improved, which is clear from the large rise in the participation rate, lower unemployment and a reduction in the ratio of inactivity.

Today, the performance of the Dutch labour market is favourable, also compared to the rest of Europe. This is shown in Table 2. We see that, compared to the average in the EU-15, the Netherlands performs well in terms of participation and unemployment. For these indicators, performance is similar to that in the United States, except for the participation of people between 55 and 64, and for the share of long-term unemployment, where the Netherlands is more European than American. Priority in the Netherlands is therefore given to raising the participation rate of elderly and improving the position of low-skilled workers on the labour-market. The Netherlands performs relatively poor on the number of hours worked compared to both the United States and the rest of the European Union. This is especially due to the high share of part-time employment, i.e. jobs of less than 30 hours per week. For women, this share is 60% which is twice as large as in the European Union and more than three times that in the United States. Hence, there seems ample scope for raising female labour supply in the Netherlands in terms of hours worked. The bottom row of Table 2 shows occupancy in social benefit schemes as a percentage of the working age population. It includes unemployment insurance, social assistance, sickness benefits and disability insurance. We observe that the number of benefit recipients is higher than in the United States and also higher than elsewhere in Europe, especially due to high coverage in disability insurance.

Table 2	Labour-market performance of the Netherlands compared to EU-15 and the US, figures for 2004		
	The Netherlands	EU-15	US
Employment rate in % population 15-64	73	65	71
men	80	73	77
women	66	57	65
age 55-64	45	42	60
lower than secondary education	59	57	58
Share of part-time employment	35	13	17
men	15	7	8
women	60	31	19
Annual hours worked per employee	1357	1578	1824
Unemployment rate	4.6	8.0	5.5
share long-term unemployed	33	42	13
Benefit recipient rate[a]	16	14	11

[a] Figures for benefit recipient rate refer to 1999 and contain only 10 countries for the EU (excluding Finland, Luxembourg, Italy, Greece and Portugal). Source, OECD 2003 and OECD Employment Outlook 2005

The need for further reform

While the Netherlands today performs relatively well, the discussion on future welfare state reform remains high on the policy agenda. The reason is that trends trigger a need for further reform. First, public expenditures on pensions and health care will rise in light of ageing. At the same time, globalisation makes it more difficult to finance these extra public transfers due to increasing mobility of tax bases. This renders current welfare states financially unsustainable. Moreover, it causes tensions among a growing share of elderly people relying on public transfers and a shrinking share of workers paying for it via taxes. Second, international economic integration and skill-biased technological change may deteriorate the position of low skilled workers on the Dutch labour market. This causes tensions within the working generation, namely between low skilled workers who suffer and high skilled workers who benefit from economic integration and technological change. Third, welfare state institutions seem to have poorly adapted to recent changes in socio-cultural circumstances, such as individualisation, a growing heterogeneity in life courses, a better educated work force and rising female participation rates. This undermines the social legitimacy of current welfare state institutions. Finally, the welfare state creates sustained inactivity among a number of groups, such as social benefit recipients, elderly workers, low-skilled people, and women. Like in other countries in Europe, the Dutch government now thinks about ‘reinventing the welfare state’. Thereby, a key policy objective is to raise employment in both quantity and quality. The government thus aims to broaden the tax base, which is necessary to maintain the basis for social cohesion in the future.

3 Design of an efficient welfare state

Usually, the term welfare state is used as a catchall for public institutions that are related to the income and expenditures of people over their life cycle. This includes programs for pensions, disability, survivor and unemployment insurance, medical expenditures and perhaps even education. In this paper, we structure the discussion along three functions of the welfare state, all starting with an R, namely *Redistribution*, *Risk and insurance*, and *Reallocation over the life cycle*. For each of these three R's of the welfare state, the paper demonstrates the key trade-offs and explores opportunities to improve combinations between them through efficiency enhancing reforms.

R1: Redistribution between people

People differ in their talent or abilities. The welfare state aims to reduce inequality between these people by means of redistribution. This creates, however, several labour-market distortions, such as lower labour supply, less training and higher unemployment. This trade-off between equity and efficiency applies to various institutions such as the progressive tax-benefit system, benefits in kind, indirect taxes, subsidies and wage compressing institutions. The economic literature arrives at a number of conclusions regarding the efficient design of the redistributive system (see also De Mooij, 2007).

Universal income support, such as a basic income, does not seem an optimal form of redistribution. It is expensive and raises marginal tax rates across the board, thereby causing large distortions in labour supply. Targeting support to families with low incomes would be more efficient. This creates, however, distortions at the bottom of the labour market due to the poverty trap. It reduces the gains from targeting. Designing an optimal redistributive system therefore requires careful consideration of the distortions at both the participation margin and the intensive margin of labour supply.

In-work benefits have the advantage of reducing the benefit replacement rate, without hurting the income of benefit recipients. It leads to a lower rate of involuntary unemployment, especially for the unskilled. In-work benefits can also be targeted to the low skilled, which would enhance its effectiveness to reduce involuntary unemployment. However, by phasing out benefits among middle income groups, targeted relief is particularly distortionary for the intensive margin of labour supply.

In-work tax relief can also be targeted on female workers who feature relatively large labour supply elasticities, e.g. compared to male breadwinners. Moreover, subsidies on complements of female labour, such as childcare expenditures, are typically desirable features of an optimal tax-benefit system as they mitigate distortions at the intensive margin of labour supply. Also an individualised income tax system yields better labour market incentives than a system that takes the family as the tax unit, especially for females. Individualising social benefits is less

attractive, however, since it will raise marginal tax rates at the participation margin of secondary earners.

Redistribution is also achieved through wage compressing institutions, e.g. due to trade union behaviour. However, this raises unemployment among the low-skilled. Lower minimum wages or less wage compression will relax this problem, but this raises inequality. Society may alternatively shift from wage compressing institutions towards fiscal redistribution or provide tax relief for employers hiring low-skilled employees.

Since reforms in the redistributive system have social costs, complementary instruments may be considered to escape the inevitable trade-offs in redistribution. For instance, modern welfare states increasingly rely on the integration of vulnerable people in the labour market by combining the carrot of positive financial incentives with the stick of punitive work mandates.

R2: Risk and insurance

Risk against disability or unemployment is dealt with by social insurance. In designing a social insurance contract, society aims to minimise the adverse implications for the labour market caused by moral hazard. We find that less generous social insurance, e.g. through lower levels of unemployment and disability benefits, shorter unemployment benefit duration, or substitution towards individual saving accounts, can help reducing unemployment rates and raising labour-market participation by combating moral hazard. It yields, however, less insurance. Hence, there is a trade-off between insurance gains and incentives to fight moral hazard. Savings may be more appropriate than insurance in the case of small risks and large moral hazard, e.g. for small unemployment spells. For larger risks, however, insurance is typically more efficient than savings.

For a given level of insurance, the key policy challenge is to minimise moral hazard. The government may use stringent job search requirements and mandatory obligations to raise the exit from social insurances. An efficient administration should engage in tight monitoring and claim assessment and invest in activation of benefit claimants. In delegating administrative tasks to decentralised units, the government should care about both the risk of selection by competing administrations, and proper incentives for administrators to fight moral hazard. Irrespective of the choice between a public monopoly and competing administrations, the exclusivity requirement should always be fulfilled.

Insurance can be supplemented by active labour-market policies in order to raise exit from the insurance. Yet, whereas harsh measures like sanctions and mandatory workfare tend to significantly increase outflows from the insurance, empirical evidence provides mixed evidence on the effectiveness of more lenient forms of active labour-market policies. Lock-in effects and reduced search activities seem to render some forms of active labour-market policies even counterproductive in raising employment in the market sector. Still, active labour-market policies may be a social imperative, rather than a way to increase employment in the open

market. Moreover, some types of active labour-market policy, such as job-search assistance and vouchers for the long-term unemployed, yield more positive effects.

Employment protection and firing taxes may be efficient to reduce moral hazard in inflows into unemployment insurance. Moreover, it encourages commitment and thus stimulates employment durations and investment in firm-specific human capital. However, employment protection also creates a social cost by increasing unemployment duration and hampering innovation. It hurts especially the labour market position of youngsters, women and immigrants. Financial incentives, e.g. via experience rating in unemployment insurance, tend to be more efficient than administrative procedures to reduce excessive job separations.

R3: Reallocation of the life cycle

The welfare state plays a role in consumption smoothing over the life cycle. Capital-market imperfections, impatience and distortions associated with redistribution and insurance may provide a rationale for this. European governments are indeed substantially involved in reallocating income over the life cycle: estimates suggest that between 60 and 80% of the welfare state actually concerns intrapersonal reallocation of income over the life cycle, rather than redistribution between the life-time rich and poor. An alternative for collective smoothing via the welfare state would be mandatory or subsidised individual saving schemes. While these schemes may reduce the overall tax burden compared to collective smoothing via transfers, they may bring along other distortions. Hence, the government faces a dilemma. It applies to areas of life-long learning, the combination of work and family care, and early retirement.

Life-long learning is a vital pillar for our welfare state. While investment by the government seems important in initial education, the value added of government intervention is less clear in adult learning. Some subsidies may help to alleviate training distortions imposed by progressive taxes and generous social insurance provisions. The argument for large-scale public investment in on-the-job training is weak though.

Facilities for the combination of work and care for children seems important for combining high female participation and high fertility, although it is not clear whether externalities from children are actually positive or negative. Female participation may benefit from increased labour-market flexibility and child-care facilities. Subsidies for parental leave may support fertility, but typically come at the expense of labour market participation in terms of hours worked.

A number of distortions in retirement decisions have recently been removed in the Netherlands. Indeed, the system has been reformed towards a more actuarially neutral system for early retirement. Still problematic for the participation of elderly is, however, the rigidity of the labour market. Indeed, the combination of fixed wage contracts with seniority wages, employment protection and mandatory retirement hampers the mobility of older workers and increases unemployment durations. Moving towards a more flexible labour market can increase

employment, improve allocative efficiency and allow for more flexible retirement patterns. It calls, however, for a breakdown of the implicit contract.

Quantifying reform in the Netherlands

For a selection of welfare state reforms in the Netherlands, we have used an applied general equilibrium, model to make a quantitative assessment of their impact on the labour market and the income distribution (see Graafland et al., 2001, for more details about the model). Figures 1 to 3 summarise these findings. Figure 1 presents various policies that reduce the amount of redistribution and insurance, e.g. by cutting social benefits or tax credits. In particular, we present a reduction in welfare benefits (WB), unemployment benefits (UB), disability benefits (DB), the tax credit for non-participating partners in couples (PC), and two forms of child support, across-the-board child benefits (CB) and a targeted child credit (CC). In the figure the size of each shocks is ¼ billion euro, where savings for the government budget are used to cut income tax rates by 0.1%-point. The figure shows the positive labour-market effects of less redistribution/insurance. We see that benefit reductions typically raise the incentives for labour supply by allowing for lower marginal tax rates (left panel). This is particularly effective if marginal tax rates are reduced for secondary earners, who are relatively elastic in their labour supply, or for income groups that are densely populated. If benefits are targeted to the unemployed or partially disabled, lower benefit levels also reduce the structural unemployment rate because of a fall in the replacement rate (right panel). Benefits that are not related to the labour market position of households exert very small effects on equilibrium unemployment.

Figure 1 Simulated effects of lower social benefits or credits on labour supply and unemployment[a]

[a] All simulations are normalised at a budgetary effect of ¼ billion euro. The revenues are used to cut income tax rates. The simulations are: WB: reduction in welfare benefits; UB: reduction in unemployment benefits; DB: reduction in disability benefits; PC: reduction in the tax credit for non-participating partners; CB: reduction in general child benefits; CC: reduction in the targeted child credit. Effects on labour supply are in relative changes; effects on unemployment in absolute changes.

Figure 2 shows the implications of a variety of tax credits and subsidies in the Netherlands. Two credits aim to reduce the tax burden for low labour incomes (WC1 and WC2) or subsidize low-skilled employment of the employer (ETR). Two forms of active labour market policy

involve public sector jobs (ALMP1) and subsidies for the long-term unemployed (ALMP2). The last two policies focus on reducing tax distortions for female workers: the combination tax credit for two-worker families with children (CC) and child-care subsidies (CS). The amount of credit or subsidy is ¼ billion euro, the revenue of which is raised by an increase in income tax rates by 0.1%-point. The right panel of Figure 2 shows that tax credits targeted at low incomes are effective to reduce the unemployment rate among the low skilled. By raising marginal tax rates for higher incomes, however, the left panel reveals that they reduce labour supply. Hence, there is a trade-off between policies that aim to cut low skilled unemployment and policies that foster labour supply. The effects of these targeted credits on overall employment are therefore small. Only vouchers for the long-term unemployed tend to escape this trade-off since they are not conditional on income, but well targeted on the unemployed. Hence, the deadweight loss of this instrument is relatively small. The scope for using vouchers is limited though. The left panel of Figure 2 reveals that childcare subsidies are most effective in encouraging labour supply as they mitigate tax distortions at the margin of employment by secondary earners. The scope for using this instrument is limited since the overall size of the childcare sector is less than 0.5% of GDP in the Netherlands.

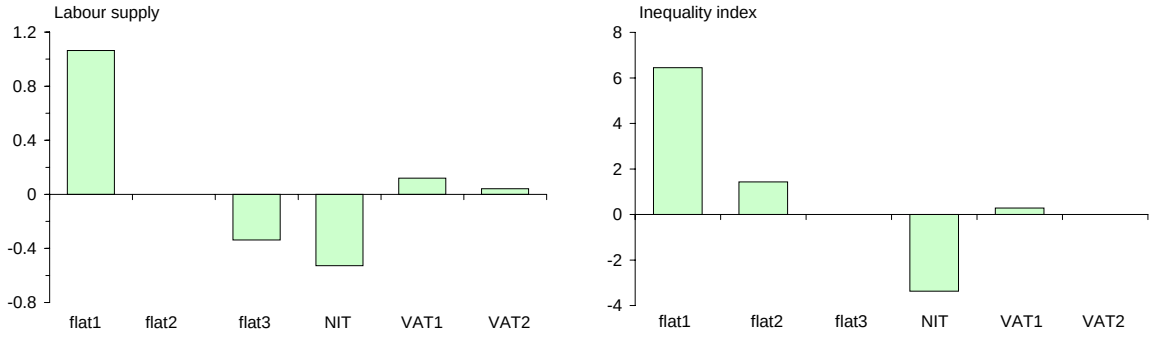
Figure 2 **Simulated effects of higher credits and subsidies on labour supply and low skilled unemployment**[a]

[a] All simulations are normalised at a budgetary cost of ¼ billion euro. It is financed by higher income tax rates. The simulations are: WC1: general earned income tax credit; WC2: targeted earned income tax credit; ETR: employer tax relief; ALM1: relief jobs for the low skilled in the public sector; ALM2: vouchers for the long-term unemployed; CC: combination credit for working couples with children. CS: childcare subsidies that reduce the parental price. Effects on labour supply are in relative changes; effects on low-skilled unemployment in absolute changes.

Figure 3 shows the impact of budgetary neutral shifts in the structure of the tax-benefit system. It includes three proposals for a flat tax (flat123), a basic income (NIT), and two alternative shifts from income taxes towards value added taxes (VAT12). The figure shows that policies that raise inequality, as measured by our aggregate inequality index (the Theil coefficient), come along with an increase in labour supply. This holds for one version of the flat tax and for one version of the shift from income taxes towards value added taxes. If inequality does not

change by the reforms, we observe no increase in labour supply. In fact, a flat tax that leaves overall inequality unaffected actually reduces labour supply since it raises the marginal tax on part time jobs that are occupied by elastic female workers. A basic income reduces aggregate inequality but is most distortionary in terms of labour supply. The simulations thus clearly reveal the trade-off between an equitable income distribution and labour supply incentives.

Figure 3 Simulated effects of budgetary neutral shifts in the tax system on labour supply and inequality[a]

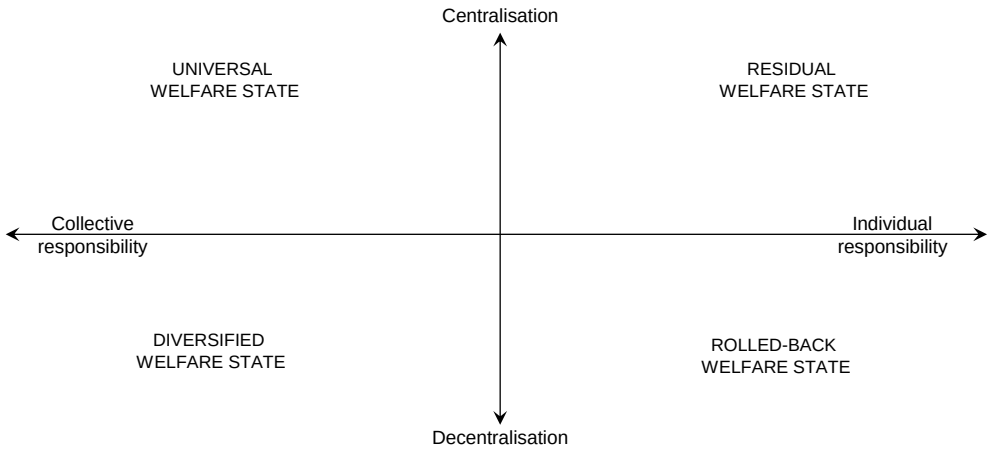


[a] The inequality index reflects the Theil coefficient of the entire income distribution, based on individual incomes. The simulations are: Flat1: replacement of the current income tax structure by a flat tax of 37,5%; Flat2: replacement of the current income tax structure by a flat tax of 42% and an increase in the general tax credit by 1 100 euro; Flat3: replacement of the current income tax structure by a flat tax of 43,5% and an increase in the general tax credit by 1 400 euro; NIT: introduction of a negative income tax or basic income; VAT1: shift of 2.5 billion euro from income taxes towards value added taxes; VAT2: shift of 2.5 billion euro from income taxes towards value added taxes whereby the general tax credit is increased as well. Effects on labour supply and the Theil coefficient are in relative changes.

4 Comprehensive welfare state reform along three lines

This section develops three directions of comprehensive welfare state reform in the Netherlands. The directions differ in two key dimensions: social preferences and division of powers. First, social preferences for redistribution, insurance and commitment are not independent. Indeed, societies that assign a high value to redistribution usually also assign a high value to insurance. We therefore merge the fundamental trade-offs regarding the three R's of the welfare state and obtain a broadly defined trade-off on a one-dimensional scale. We refer to this trade off as collective versus individual responsibility. It is illustrated by the horizontal axis in Figure 4. The left-hand side of the figure reflects a society that features strong preferences for solidarity and collective responsibilities. The right hand side reflects a society that features a strong preference for individual responsibility and incentives.

Figure 4 Design of the welfare state



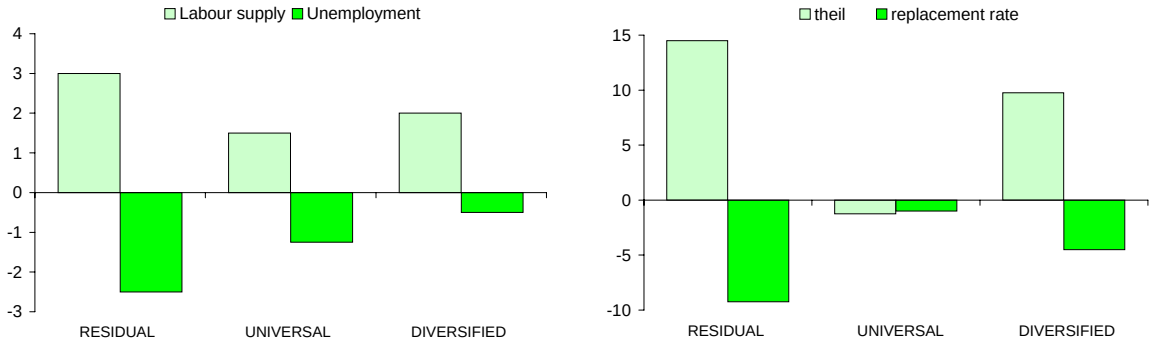
The second dimension is the organisation of the three functions of the welfare state. Institutions can be organised at more centralised or at more decentralised levels. The vertical axis in Figure 4 illustrates this choice between *centralisation* and *decentralisation* of responsibilities.[2] Decentralisation means that a number of smaller collective groups obtain discretion to organise solidarity, insurance and smoothing in decentralised groups. It can, for instance, be organised by local governments, sector trade unions, professional interest groups, or companies. This distinction does not so much refer to the *administration* of welfare state functions – which should in any case be delegated to the most efficient level of organisation, independent of preferences – but rather to the division of *powers* between centralised and decentralised units. For instance, either central or decentralised organisations can be made responsible for setting rules and regulations, contract design, premium rates and the like. On the one hand, decentralisation of powers is attractive to the extent that it can do better justice to differences in preferences and circumstances between people or clubs. Moreover, decentralised decision making may yield more efficient policies due to competition induced by either exit opportunities of group members or benchmarking (leading to yardstick competition). The bottom of Figure 4 reflects a welfare state that emphasises the decentralisation of powers. On the other hand, centralisation has potential advantages as well. It can reap scale economies in the presence of high fixed costs or information sharing gains (*e.g.* in tax collection or social insurance administration). Centralisation also reduces exit opportunities, thus avoiding adverse selection and reducing spillover effects of decentralised policies. Moreover, centralisation is desirable if people prefer nation-wide solidarity. The upper side of Figure 4 reflects welfare states characterised by a large degree of centralisation.

[2] The principle of subsidiarity endorsed by the European Union suggests that decentralisation is preferable, unless centralisation has clear benefits. It is used to divide responsibilities between the member states and the union.

By combining the two key dimensions of Figure 4, we obtain four possible models for the welfare state. As we ignore the lower right quadrant, we focus on three of them. First, the upper-left quadrant in Figure 4 reflects a welfare state that assigns a high value to collective responsibility and that organises decision making on a centralised level. It is dubbed the UNIVERSAL WELFARE STATE. Second, the lower-left quadrant represents a welfare state that assigns a high value to collective responsibility, but decision making is organised on a decentralised level, either regionally or by profession or industry. The welfare state thus allows for more differentiation among clubs and is dubbed the DIVERSIFIED WELFARE STATE. The two quadrants on the right of Figure 4 represent less generous welfare states with more focus on individual responsibility. In the RESIDUAL WELFARE STATE at the upper-right part of Figure 4, solidarity with the most vulnerable groups is organised on the state level.[3]

The current Dutch welfare state may best be characterised on the left hand side of Figure 4, somewhere between the UNIVERSAL WELFARE STATE and the DIVERSIFIED WELFARE STATE. Past reforms, however, also contain elements of the RESIDUAL WELFARE STATE, i.e. reforms that emphasise individual responsibility. It raises the question where the Dutch welfare state will or should be heading towards. We elaborate on this issue in more detail by exploring concrete comprehensive reform packages in Dutch institutions along the lines of each welfare state philosophy of Figure 4. It renders the discussion about alternative welfare states concrete. The packages serve as an illustration of how a certain welfare state reform affects Dutch labour market performance and the income distribution. The reform packages have been simulated with our applied general equilibrium model, the results of which are summarised in Figure 5.

Figure 5 **Simulated effects of comprehensive reform directions on labour market performance and social cohesion indicators**[a]



[a] The inequality index reflects the Theil coefficient of working singles. Effects on labour supply and the Theil coefficient are in relative changes. Effects on replacement rate and unemployment rate are in absolute changes.

[3] The welfare states are reminiscent to the typologies of Esping Andersen (1990), which is based on an empirical approach. By starting from trade-offs, our approach emphasises more the different principles underlying welfare state design than outcomes.

Residual welfare state

The RESIDUAL WELFARE STATE is characterised by a more flexible labour market and more emphasis on private responsibility. The government retreats in provisions for people with middle and high incomes. They increasingly rely on individual responsibility. Solidarity with vulnerable groups is maintained via targeted income support measures. Reforms in the RESIDUAL WELFARE STATE include lower social benefits, a lower minimum wage, the introduction of a flat tax of 27% and a replacement of employment protection by experience rating in unemployment insurance. The life cycle saving account partly replaces insurance and subsidy schemes, e.g. for unemployment risk, care, adult education and early retirement.

The RESIDUAL WELFARE STATE improves labour market performance by raising the incentives for labour supply, a better integration of entrants into the labour market, and reduced wage costs for low skilled workers. Model simulations suggest a rise in employment of 6¼%. The female participation rate increases by 9%. Low-skilled unemployment falls by 8¼%-point.

The RESIDUAL WELFARE STATE fits best in an individualised, heterogeneous society. Inequality and insecurity become more important, but a safety net is maintained for the most vulnerable groups. The RESIDUAL WELFARE STATE is relatively robust for shocks in immigration, economic integration and technological change. A potential problem is that sustained poverty occurs for a small group of low-skilled people that is unable to escape the poverty trap.

Universal welfare state

The UNIVERSAL WELFARE STATE is characterised by a combination of more flexibility on the labour market and generous social provisions with a uniform character. To avoid moral hazard and high rates of inactivity, it is combined with intensive and mandatory activation and public expenditures that are complementary to labour.

Reforms in the UNIVERSAL WELFARE STATE contain a further individualisation of the tax system, public childcare support, tight eligibility criteria in social insurance, an abolishment of privileges for elderly outside the labour market and intensified activation strategies with strict monitoring backed by sanctions. The welfare state tends to become bigger, but additional expenditures are geared towards labour participation.

We find that the UNIVERSAL WELFARE STATE improves labour market performance. The female participation rate increases by 14½% while elderly participation rises as well. The low skilled are better integrated due to subsidy schemes. Simulations suggest that employment rises by 3% in the long term, especially due to higher female labour supply. The unemployment rate among the low skilled falls by 4¼%.

The UNIVERSAL WELFARE STATE fits with a relatively homogeneous society with a well-educated labour force and a high priority to emancipation of women. Solidarity and security are maintained at a cost in terms of privacy, less choice, fewer privileges for elderly, and less commitment in labour relations. The welfare state remains vulnerable for the financial implications of ageing, however. Moreover, the UNIVERSAL WELFARE STATE is less robust for shocks in low-skilled immigration and skill-biased technical change.

Diversified welfare state

The DIVERSIFIED WELFARE STATE emphasises commitment, long-term relations and decentralised solidarity in small collective groups. This substitutes for state responsibilities in social insurance and redistribution. Collective groups reap the benefits from economies of scale and provide a variety of social provisions. These differ between clubs. The government ensures a safety net and aims to integrate low-skilled workers in the labour market via subsidies.

Reforms of the DIVERSIFIED WELFARE STATE include less tax progression, selective reductions in social insurance provisions and a government role to subsidise low-skilled employment. Wage compression in communities aims to mitigate rising inequality. Exclusive responsibility for social insurances at the decentralised level provides incentives for administrations to combat moral hazard through activation. This also applies to elderly, which increases the effective retirement age. Mobility is hampered between groups to reduce exit opportunities and to maintain social provisions within communities. Employment protection remains important.

We find that the DIVERSIFIED WELFARE STATE improves labour market performance, especially due to more labour supply of men. The low skilled face better job-finding probabilities due to subsidy schemes. Simulations suggest an overall rise in employment of 2½%. The unemployment rate of the low-skilled falls by 1¾%. These effects are smaller than for other welfare states while inequality increases.

The DIVERSIFIED WELFARE STATE fits in a world in which long-term relationships and internal flexibility within collective groups provide a good basis for investment in knowledge and innovation. A problem is that limited mobility and tight employment protection hamper adjustments in the economy, e.g. to global shocks. Moreover, it hampers the integration of immigrants, females and school leavers in the labour market. The DIVERSIFIED WELFARE STATE is therefore relatively vulnerable for shocks in globalisation and immigration.

5 Conclusions

We conclude that there exist several opportunities for reform in the Dutch welfare state that may help raising the quantity and quality of labour supply. Yet, there is no gain without pain.

Indeed, society needs to make choices. Which reform direction is most feasible or desirable for the Netherlands depends on social preferences and future developments in our society.

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