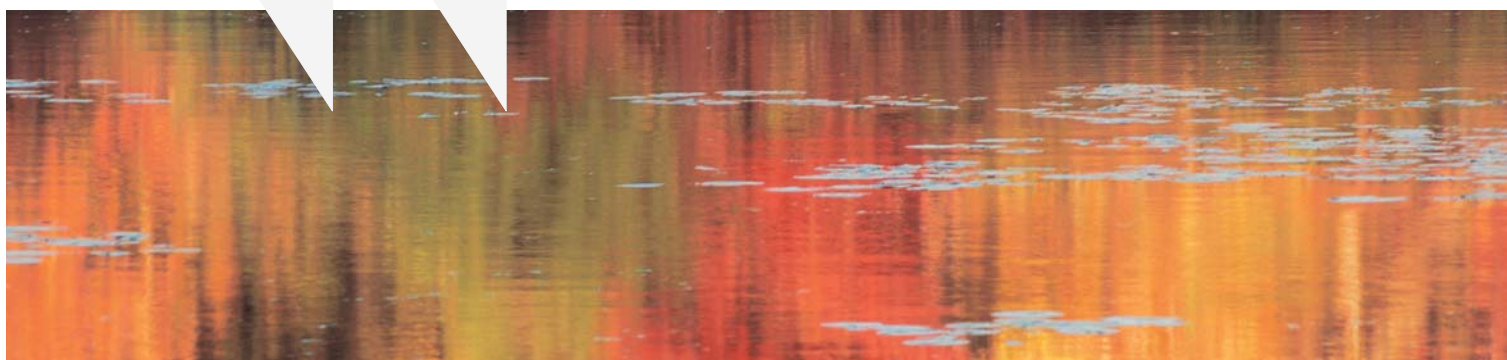




OECD Economic Surveys: Netherlands, June 2010

OVERVIEW



Summary

The global crisis led the Netherlands into deep recession, despite a decisive government intervention to support the financial sector and a timely fiscal stimulus. The increase in unemployment was surprisingly limited, reflecting, among other factors, a severe pre-crisis overheating of the labour market. Growth recommenced in mid-2009. Looking ahead, the recovery is expected to gather pace relatively slowly. In this context, the main challenges for the government coming in after the June 2010 general election are to exit from stimulus policies and to boost potential growth in an ageing society.

The planned fiscal consolidation is a step in the right direction to secure fiscal sustainability. Fiscal policy is appropriately supporting weak 2010 economic activity. In the following years, the recovery should be sufficiently strong to allow consolidation that is at least as sizeable as laid out in the Stability Programme. Fiscal consolidation should be combined with structural reforms to boost employment and participation rates.

The financial crisis and increased longevity are threatening the solvency of the second-pillar pension system. The fall in the funding ratios of the pension funds for the second time in this decade required the widespread implementation of recovery plans, mostly relying on suspending indexation of pensions and accrued pension rights. In the longer term, only longer working lives in combination with a mix of higher contribution rates and lower real pensions and pension rights can secure promised pension replacement rates. To avoid abrupt recovery measures in the future, regulation should be less sensitive to short-term developments, for example by using more stable discount rates. In addition, there is a need to improve corporate governance and make investment strategies more transparent.

For several decades road traffic has increased faster than the expansion of the road network, leading to widespread congestion. *As a result, the Dutch spend a large amount of time commuting by international comparison and the share of road transport in CO2 emissions has increased markedly. The proposed nation-wide road pricing scheme is an innovative and forward-looking measure to enhance the efficiency of road transport. An important element in any road pricing scheme is the inclusion of congestion charges, which would further harvest its benefits. To provide alternatives to travellers, the adopted scheme should be accompanied by more efficient provision and use of public transport services and the promotion of different working patterns.*

The housing market is characterised by numerous rigidities, which may hamper geographical labour mobility. The rental segment is characterised by rigid rent control and an internationally large social housing sector. The below-market rents combined with eligibility checks only at entry have led to low tenant turnover and only 40% of the social dwellings being occupied by households with low incomes. In the owner-occupied segment, mobility is reduced by a high transaction tax and prices are pushed up by a generous tax treatment of mortgages and a rigid supply which is related to strict land use policies. These issues point to the need for a fundamental change of housing policies combined with rethinking land use regulation.

Assessment and recommendations

The economy is slowly exiting from the global crisis

Growth came to an abrupt halt in mid-2008 as the economy was hit by the global crisis, although the increase in the unemployment rate was smaller than anticipated. The economy exited recession in mid-2009, as the effects of the fiscal stimulus, easier monetary policy, improved financial conditions and an emerging recovery in world trade began to revive activity. Given the expected slowdown in household incomes, the fall in real and financial wealth of households and the need for rebuilding profits, it is likely that the domestic economy will remain sluggish in the short-term.

A substantial part of the explanation for the lower-than-expected increase in unemployment relates to firms' desire to keep qualified workers after experiencing widespread labour shortages before the crisis. The government also supported labour hoarding by introducing a reduced work time programme which subsidises firms with falling activity levels to maintain their employment. The programme appears to be well designed with a large number of checks and balances to enhance its efficiency, including rules to ensure that only companies with large falls in activity can apply. Moreover, if the workers are fired after enrolment in the programme, the employer has to repay the financial support. More traditional factors, such as strict employment protection legislation for permanent workers, also explain the degree of labour hoarding.

The government reacted swiftly to save the financial sector and stimulate the economy

The Dutch financial sector was strongly affected by the global crisis. The government responded with decisive action to save the financial sector by intervening with liquidity measures as well as nationalising a large part of the sector. In total, the cost of government interventions came to about 14% of GDP, although almost half of the total amount of financial interventions has subsequently been repaid. In addition, guarantees worth 2½ times that amount have been made available. Furthermore, banks are encouraged to provide credits to business through expansion of guarantee facilities. The government does not intend to have a long-term involvement in the financial sector. Thus, the next step for the government coming in after the June 2010 general election is to formulate and implement exit strategies. The government also supported economic growth through a substantial fiscal stimulus package. Total discretionary measures amounted to about 1 ½ per cent of GDP. The stimulus package aimed at reducing taxes (*e.g.* tax relief for companies), increasing public investment and sustaining employment. In addition, the unemployment insurance premiums were lowered, amounting to a stimulus of almost 1 per cent of GDP over the two years. The fiscal deficit exceeded 5% of GDP in 2009 and is expected to widen to above 6% of GDP in 2010.

The fiscal stimulus should be removed as soon as the recovery gains strength

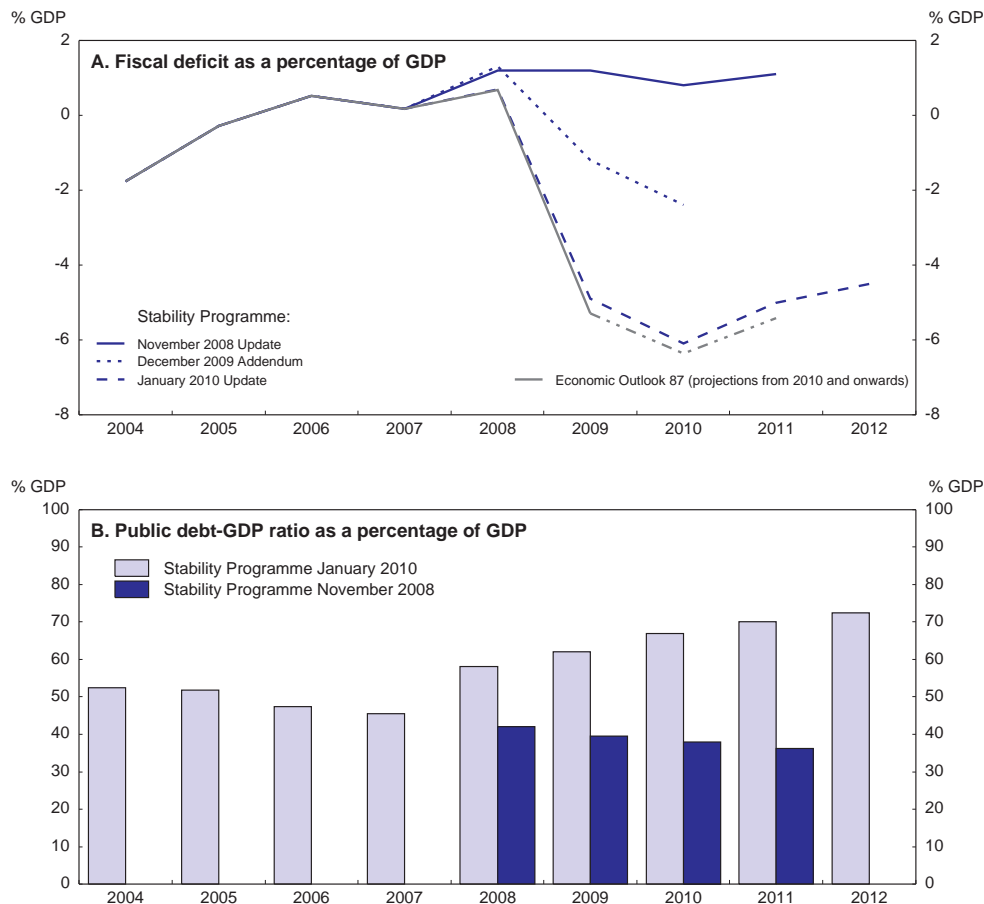
An appropriate growth-dependent fiscal consolidation plan has been adopted to remove the structural deficit of around 4% of GDP. According to the plan, fiscal policy will appropriately support the economy in 2010 and start consolidating by at least 0.5% of GDP per year in 2011 (if projected growth is higher than 0.5%). The consolidation will start by withdrawing the stimulus and reducing public administration costs. Raising the retirement

age in the state pension system, cuts in health care and higher property taxes have also been proposed, but will only yield effect in the longer term. Moreover, 20 committees proposed on 1 April 2010 substantial spending cuts and another committee has suggested measures to make the tax system more efficient. It is welcome that the government has already prepared the ground work for substantial consolidation. *The government should pursue its consolidation plans by using the committees' proposals to specify more concrete measures. Moreover, if economic growth surprises on the upside, the government should be ready to implement more consolidation.*

In the longer term fiscal sustainability should be secured

Public finance sustainability has deteriorated following the crisis. Consolidation should primarily aim at curbing growth in public spending. A particular challenge in this respect is to restrict growth in ageing-related spending, such as health and pensions. With respect to the latter, the government should pursue the plans to increase the official retirement age by two years to 67 years – an important measure to (partially) address the fiscal sustainability. However, more front-loading of this measure would have stronger effects on fiscal sustainability and reduce early retirement incentives in the transition phase. Moreover, life expectancy is likely to increase further, so the retirement age will also need to be adjusted in the future. A structurally more solid solution would thus be to *link the official retirement age to developments in life expectancy.*

Figure 1. **Public finances have deteriorated**



Source: OECD Economic Outlook 87 database and Stability Programmes for the Netherlands.

Labour utilisation remains low

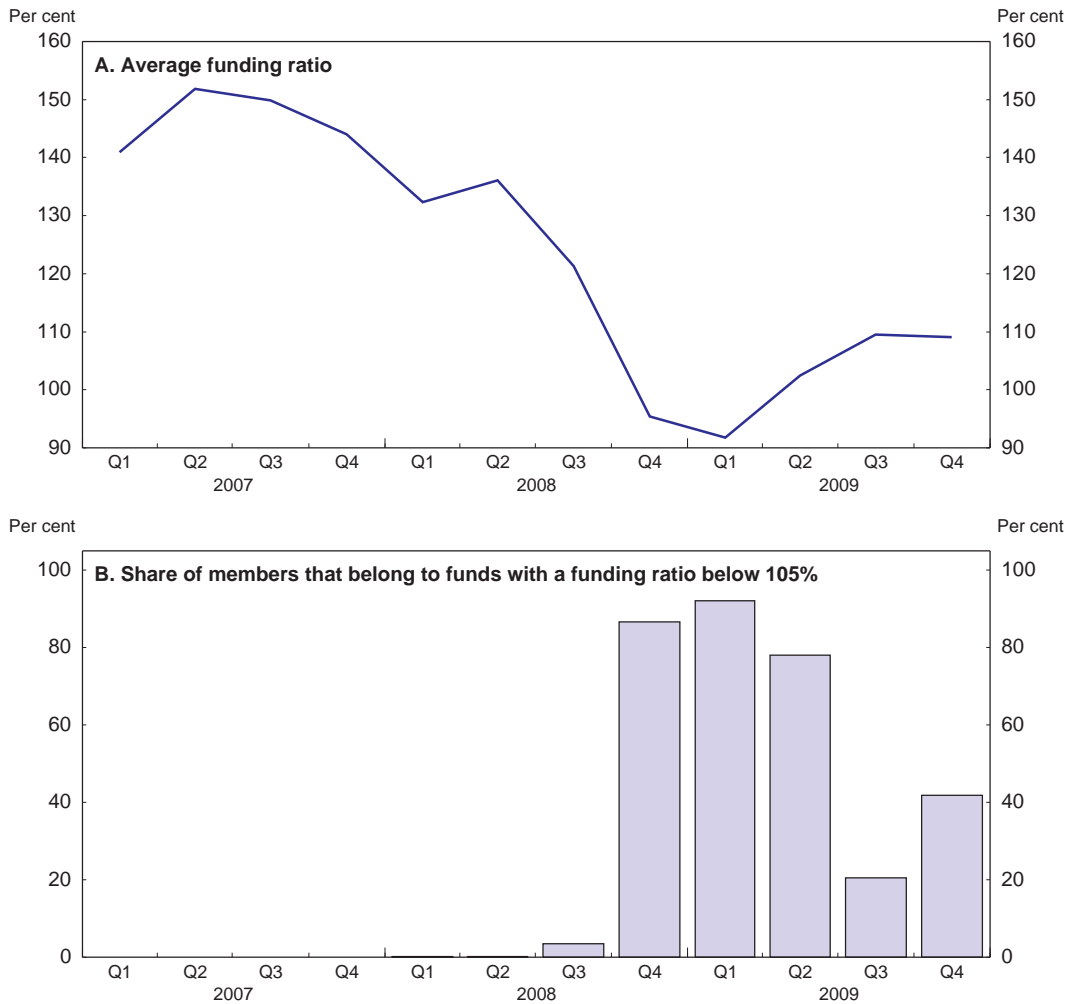
Labour utilisation remains relatively low in the Netherlands, reflecting relatively high participation combined with low hours worked, despite a strengthening of activation policies over the past couple of years. Recently adopted measures aim at lengthening working careers by offering wage subsidies for hiring older workers. In addition, older workers are encouraged to continue to work through tax incentives. Younger people (less than 27 years) are no longer eligible for passive income support, but are encouraged to work or study. A similar measure has been put in place for the young partially disabled to stem the high inflow into the special disability programme for young people. *To reduce the stock of the young disabled, they should be subject to the same controls and activation measures as new applicants.* In addition, there has been an emphasis on providing more and better targeted services to job-seekers. These efforts follow the OECD recommendation on creating effective activation policies. Their efficiency could be further improved by *making activation policies more counter-cyclical*, by making the resources devoted to activation policies proportional to the number of unemployed. Moreover, as highlighted in the previous Survey, there is a need to increase the hours worked by females.

There are two areas of labour market policy where progress should be made in order to boost the employment content of the economic recovery. The efforts to reform the strict employment protection of workers with permanent contracts have come to nought. *The government should renew its efforts to make the judicial part of the system more predictable and generally lower the cost of firing to enhance the job creation capacity of the projected upswing.* Moreover, unemployment benefits continue to be generous and have long maximum duration (38 months). *Reform of the system should include three dimensions: the long duration should be reduced; the initial generosity should be maintained, but should decline over time to create dynamic search incentives; and the high upper ceiling for benefits should be reduced to sharpen search incentives for high wage workers.* A particular issue in this respect is that older workers can use a combination of severance pay and unemployment benefits as a pathway into early retirement. This often leaves older unemployed, who have accumulated substantial severance pay rights, financially better off than if they continued to work. *Thus, benefit periods and severance payments should be truncated for older workers, preferably as a function of the work life remaining before becoming eligible for state pension.*

The pension system has been hard hit by the financial crisis and increasing longevity

The financial crisis threatened the solvency of many pension funds, which have the largest asset accumulation (relative to GDP) in the OECD. A more structural problem is increasing longevity. Thus, if unresolved the solvency crisis could potentially threaten pension promises and fiscal sustainability in case of bail-outs. As equity collapsed, the value of pension assets fell from a level well above that of GDP to below it in 2009, putting many funds' solvency under pressure. In addition, the turbulence on the interbank market meant that the swap yield curve began to gyrate along a declining trend. As the interbank swap yields are used as the discount rates, this fall in interest rates boosted the present value of liabilities. Combined with the fall in assets, this led in many cases the pension funds' nominal funding ratios (the share of assets over the discounted value of future liabilities) to fall below the legal minimum of 105% from a pre-crisis level of more than 140% on average. In response, the funds had to implement recovery plans, which were mostly based on suspending indexation of pensions and accrued pension rights. In addition, the period within which the funds had to restore their funding rates was extended from three to five years as it was recognised that not all of the turbulence could be attributed to a fundamental shift in the pricing of financial market products.

Figure 2. **The average funding ratio and share of funds with a funding ratio below the legal minimum**



Source: Dutch National Bank.

Current recovery plans will only restore funding ratios to their minimum legal levels

As equity markets recovered during 2009, a number of funds have seen a return of their nominal funding ratios to above the legal minimum. However, in most cases the ratios remain well below the level (125%) where indexation can be reinstated, or the level (145%) that allow funds to make up for past suspension of indexation. OECD simulations (carried out for this survey) show that with current measures in place (based on a set of conservative assumptions concerning future rates of returns) funding ratios will continue to increase within the 5 year recovery period, so that by the end of the period most funds will reach the legal minimum funding ratio. However, there will be little subsequent improvements, implying that in the absence of a strong rally in equity markets, most funds will not be able to honour their internationally generous pension promises. This highlights the conflict between providing a high level of benefits and a high degree of certainty.

Based on OECD calculations, restoring funding rates so pension funds can honour their pension promises would require that the working life of their members are extended by four years or that the contribution rates are raised by some 4½ percentage points. Alternatively, future indexation can be secured by reducing the real value of accrued pension rights by one-third. These options have different impacts on the macroeconomic development and on intergenerational equity. *Thus, to balance intergenerational considerations while minimising potential macroeconomic costs, the recovery plans should include requiring members to work an additional two years and introducing a mix of lower indexation and higher contribution rates.* The additional two years would realign the retirement age with the proposed changes in the state pension system – a feature that should be preserved in the future.

Regulation could be less focussed on short-term developments

The assessment of the long-term health of pension funds is tied to short-term financial market developments. For example, the choice of using the interbank swap yields (to abide by the “fair-value” accounting standards) as the discount rates implies that the net present value of the funds’ long-term liabilities has to be adjusted almost on a daily basis. One option would be to allow funds to use less volatile rates, as in other countries. This could be a fixed discount rate (as previously used in the Netherlands and still in used in the United Kingdom and the United States) or a moving average of historical interest rates. *A more structurally solid measure, however, is to use the rate on a long-term high grade investment bond such as corporate AA- bonds. However, if the markets for corporate bonds are considered too volatile, the long-term government bond rate should be used as the discount rate.* To reflect the higher market rates, a historical average of the spread between corporate and government bonds could be added. Such a discount rate would perhaps not fully reflect pension funds’ expected returns – a critique also applicable to the current discount rate – but would capture changes in market sentiments without exhibiting excessive volatility. *The standard recovery period of three years comes across as rather short, and at least the exceptional extension should become permanent to allow funds greater flexibility in restoring their funding rates.* Finally, the repetition of large losses within a decade could indicate that stronger risk control could also be helpful.

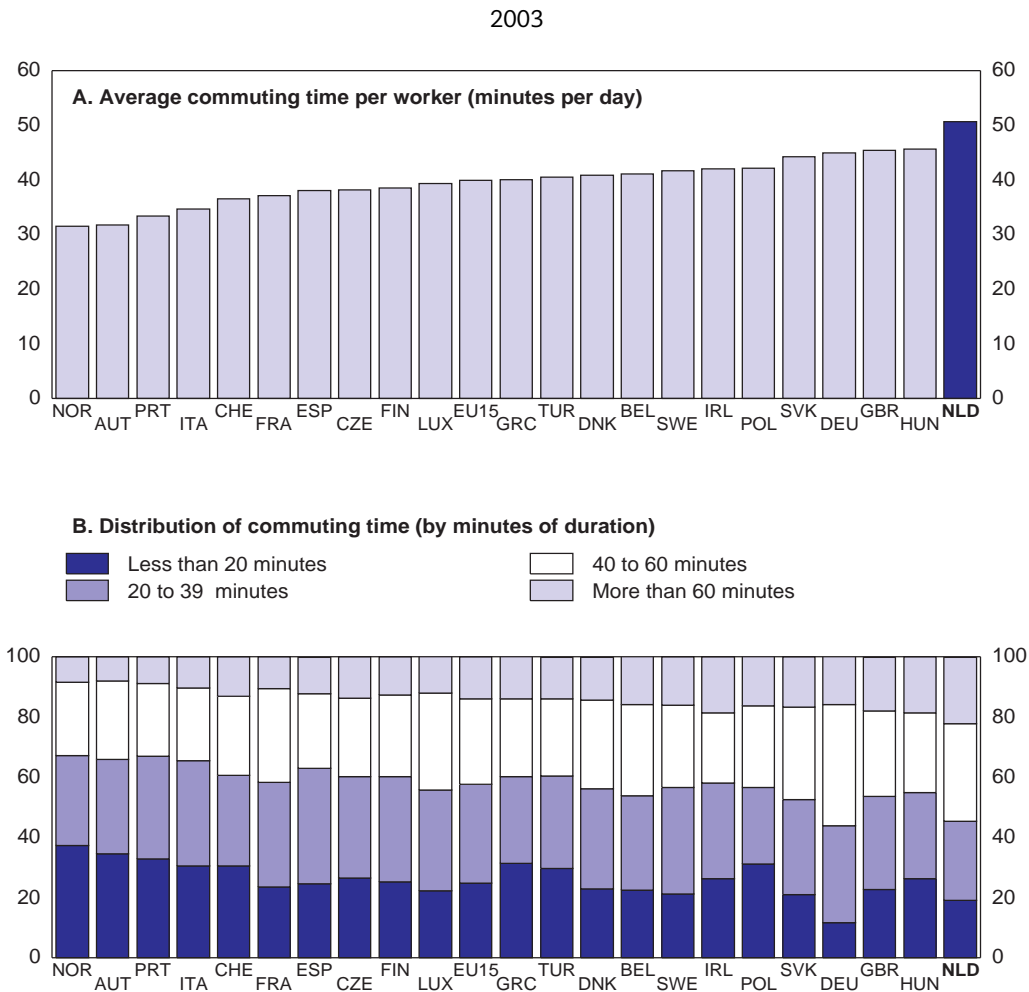
Pension transfer decisions should be made easier

All members of pension funds have a legal right to transfer their accrued pension rights (but not indexation promises) to another fund when changing jobs. However, because pension promises are contingent on indexation, it is difficult to make a rational decision on the benefit of transferring. The main issue is that members have to compare the type and quality of indexation (which is often linked to the offered accrual rate of pension rights). A further complication is that indexation is conditional on the financial health of the pension funds, implying that members also have to compare investment strategies, etc. Only the most financially literate members are able to make such complicated comparison. The lack of transparency may even make risk-averse workers hesitant to change jobs. Moreover, older workers may refrain from becoming self-employed as there is no pension fund for self-employed and most of the accrued pension rights are accumulated relatively late in peoples’ careers due to the important seniority based element in wages. *This problem can be solved by allowing self-employed to stay (longer) with their previous pension funds and pay the full (employer and employee) contributions.* In addition, corporate governance issues should be addressed to ensure that the risk profile of the investment portfolio reflects the desired risk strategy and the members’ age structure. In this respect it should be considered to *allow members of persistently under-funded or -performing funds to change funds*, although this would require that the associated transfer of pension rights reflects the financial situation of the fund concerned.

Road congestion has become a major problem

The average commuting time in the Netherlands is longer than in other European countries and commuters also spend more time in congestion. This can partly be explained by the fact that the Netherlands is a densely populated country, where much of the population is concentrated in the so-called Randstad area. The rigid housing market plays some role in explaining the large amount of commuting, indicating that more than just transport policies are required to solve these problems. Road infrastructure also contributes to the problems, as the Dutch highway system is more constrained in terms of capacity than in other OECD countries. Moreover, the secondary road network tends to be less developed than in other countries. The problem is expected to grow further with long-term projections indicating a 50% increase in traffic over the period 2000-20. On current trends, this expansion is likely to materialise soon after 2020.

Figure 3. **Commuting times are longer than in other countries**



Source: European Working Conditions Survey (2005).

Congestion can be addressed through more infrastructure and managing demand through improved incentives

In the long-term, infrastructure expansion could ease congestion problems. However, strict zoning and planning regulation make it difficult to find land and lengthy to obtain planning permission. *Thus, to facilitate the expansion of the infrastructure, strict zoning and planning regulation should be eased.* In the short-to-medium term, a more promising reform avenue is to improve the efficiency of infrastructure. Recognising this, a pioneering road pricing scheme covering (nearly) all vehicles and roads in the country has been presented to parliament. Under the scheme, users will pay for each kilometer driven plus potentially a surcharge in bottleneck areas. *The government should pursue the implementation of the innovative and forward-looking road pricing system as it is a powerful instrument to reduce congestion and to pursue environmental objectives.*

Road pricing should address negative externalities

The scheme, as envisaged, sets prices so that revenues from the scheme are no higher than the revenues lost by the planned elimination of the current vehicle taxes. So, for example, trucks will be charged less per kilometer than car while motorcycles are excluded. Thus, the relative road prices will not reflect the external costs of different vehicles. A number of adjustments should be considered to capture all negative external effects. *The possibility in the scheme for implementing congestion charges should be employed rapidly to reduce congestion - a key problem the plan is meant to address. To ease congestion from freight transport, road prices for trucks should set to discourage road haulage during rush hours. Further refinements could include more price differentiation according to vehicle class to better reflect road maintenance and social costs, such as noise and road safety, including extending charges to motorcycles. Such changes may violate the revenue neutrality of the initial implementation. If revenue neutrality is to be preserved, it should be done through the adjustment of other taxes, for example on income or consumption.*

If implementation of a road price system is delayed, the government should rely on alternative price measures

Other options could also be considered if the implementation of a fully-fledged road pricing scheme takes longer than expected. To address the congestion in and around the main cities, *a relatively fast, low-cost solution could be to implement a congestion charge system* in these areas. Such a solution would address a considerable part of the congestion problems, though it would not have the same environmental benefits as a fully fledged road pricing scheme. *The negative environmental effects of road transport could be addressed through a higher reliance on taxation of transport fuels.* In this context the tax on diesel fuels is lower than that on gasoline despite its higher carbon content and other polluting emissions. Thus, *taxation of diesel should be increased.*

Commuters should have more alternatives

In order to secure the maximum benefits from the road pricing scheme, it is important that commuters can adjust their travel. This can be achieved through the promotion of alternative working patterns and a more efficient provision and use of public transport. Currently, public transport is considered to be working at full capacity during rush hours. Hence, the supply of such services should be better aligned with changes in demand. *This can be achieved by opening up more for competition and giving private providers of public*

transport greater possibilities to open new (bus) routes. To ensure that commuters take informed decisions, prices in public transportation should reflect the cost of provision and subsidies should be transparent and clearly defined, notably to reflect the positive externalities of having public transportation (e.g. reduction in congestion, improvements in accessibility, and increased mobility).

Housing is characterised by a large and rigid social housing sector

Renting is composed of a social housing sector which is large by international comparison (about 35% of the total housing stock) and a small declining private rental segment. The rigidity of the rental sector arises from strict rent regulation and only 10% of all rentals are unregulated. Moreover, entry into the social housing sector is subject to means testing, which is not repeated afterwards. As a result, only 40% of the social dwellings are occupied by households with low incomes, *i.e.* eligible for housing allowance. Turnover is low because moving apartments, even within the housing association, is considered as a new entry and thus potentially leads to large rent increases. In addition, rental contracts are open-ended. As a result, tenants tend not to adjust their consumption of housing to changes in family and income situations.

Creating a more flexible rental sector is necessary and requires for political economy reasons a well-designed transition path, including a gradual reduction in the extent of rent regulation. *A first and easily implementable measure is to introduce free rent setting in all new rental construction.* Such a measure would also attract institutional investors, such as pension funds, boosting the supply of rentals. Next, *rental contract should have time limits to ensure that rents are periodically adjusted to reflect market conditions.* Such measures increase the flexibility of the rental market only over long time periods. A more rapid measure would be *to restrict the role of social housing associations to focus on their core activity of providing social housing to those eligible and move other parts of the social housing sector into the private rental sector with free rent setting. This would require the extension of means testing to tenants in social housing and faster rent adjustments in the part of the rental sector that is destined to be liberalised.* Moreover, the scope for a private rental market should be enhanced by gradually lowering the maximum allowed rent in social housing. Rent liberalisation may lead to large windfall capital gains for some social housing associations. Given that the capital of the social housing associations has been build up over time through large direct and indirect subsidies from the government, then *excessive capital gains arising from free rent setting or sale of dwellings should be transferred to the government.* A corollary of introducing free rent setting in a larger part of the rental sector is that *the government should increasingly rely on housing allowances to pursue its social objectives* – a measure that, contrary to rent control, does not hinder mobility.

Housing taxation should be based on ownership rather than purchase

The inflexibility in the owner-occupied segment arises from high transaction costs and rigid zoning and planning regulations which impede the housing supply from adjusting to price signals. This results in welfare loss and reduced labour mobility. *To bolster the flexibility of owner-occupied housing, the transaction tax should be abolished while taxation of ownership should be increased. The latter would ideally take the form of higher taxes on imputed rents. However, many countries have had difficulties in effectively implementing such a tax, so instead reducing the value of mortgage interest deductibility and increasing property taxes could be considered.* In all cases, a key element to effective reform is to ensure that the tax base is calculated using current market prices.

Land management should be reconsidered

Lowering housing subsidies will reduce the tensions in the housing market. In addition, land management policies should be rethought to achieve a more flexible housing supply. The supply restrictions on housing are, to a large extent, an issue of preserving the “green heart” of the Netherlands in the middle of the densely populated Randstad quadrangle, where two-thirds of the area is devoted to (mostly) agriculture and (to a smaller extent) water management, providing a “lung” for this metropolitan area. There is scope to develop more housing in the green heart, but permission is seldom given. Earlier Surveys have recommended *easing zoning laws for new developments*. Nevertheless, in densely populated areas it is important to preserve recreational areas, a function not necessarily provided by agriculture. *Thus, a balanced development of the green heart would include both more housing and new forests and nature parks*. Planning, however, cannot be a standalone measure, and *municipalities should benefit more from new developments, for example in terms of greater tax revenues*.

Chapter summaries

Chapter 1. Securing fiscal sustainability and boosting potential growth after the crisis

The economy contracted sharply during the crisis but began to recover slowly from mid-2009. Unemployment rose by less than might have been expected, partly as the labour market was more overheated prior to the crisis than realised at the time. Strict employment protection legislation and the government's continued focus on active labour market policies also played a role. In this context, the most pressing challenge for the near future is to prevent the cyclical increase in unemployment from becoming structural. As in other OECD countries, the upturn is still supported by exceptional fiscal and monetary stimulus. The fiscal policy response was generally well designed, but as a result the deficit widened significantly and fiscal sustainability deteriorated. As economic growth strengthens, the government coming in after the June 2010 elections will be confronted with the task of consolidating public finances without putting the recovery at risk. The most crucial longer-term challenges are to secure fiscal sustainability and raise potential growth.

Chapter 2. Making the pension system less vulnerable to financial crises

The Dutch occupational pension system has been successful in securing high asset accumulation to fund generous pension promises. However, for the second time in this decade the pension system has been affected by a financial crisis and many pension funds' assets fell below levels needed to meet regulatory requirements. Insufficient funding raises solvency issues, which could eventually lead to large fiscal costs in case of bail-outs. In response to the crisis, most funds were required by the regulator to draw up recovery plans to restore their funding over five years. This has raised concerns that the adjustment required by the regulator is unnecessarily sharp, with possibly adverse macroeconomic implications. On the other hand, OECD simulations indicate that under current policies, it is unlikely that funding rates will be secured that enable the funds over the long term to fulfil their promises of a replacement rate of up to 80% of average wages. This raises the challenge of implementing parametric changes that secure pension benefits without large detrimental effects on intergenerational equity and growth. Occupational pensions are transferable, which enhances labour market mobility. But it is often very difficult for workers to assess how one pension scheme compares to another, posing practical barriers to mobility that should be eased.

Chapter 3. The transport system can contribute to better economic and environmental outcomes

Congestion has become a burden for the Dutch economy. Commuters and businesses are suffering from the time lost in traffic and the unreliability of travel time. Expanding infrastructure can potentially solve such problems, albeit only in the long term and at a high cost. Thus short to medium-term solutions will have to be oriented at improvements in the use of existing infrastructure, more efficient public transport and better demand management. In this light the previous government had decided to introduce an innovative country-wide road pricing scheme. This scheme aims to make users pay for road usage and

can bring about significant benefits in terms of lower congestion and less pollution. The full benefits of road pricing can be reaped by adjusting the prices to encourage more efficient economic and environmental outcomes. If the implementation of a fully-fledged road price system is delayed or aborted, the government should rely on alternative measures such as fuel taxation and congestion charges to obtain similar outcomes. Reforms to the transport system, including public transport, together with the housing market reforms proposed in the subsequent chapter should reduce the economic and environmental burden of transport, thereby improving prospects for sustainable long-term growth.

Chapter 4. Improving the flexibility of the housing market to enhance labour mobility

The housing market figures among the main determinants of labour mobility, as households seldom make employment and housing decisions independently of each other. This interdependence is likely to strengthen as the cost of commuting increases, due to worsening road congestion or measures that would raise fuel prices, for example to counter global warming. The Dutch housing market is more rigid than in many other OECD countries, as the result of numerous government interventions. Boosting labour mobility by easing rigidities would improve labour resource utilisation, which will be especially important as the labour force contracts with ageing. The rental sector could be made more attractive and flexible by dismantling strict rent regulation and rigid allocation mechanisms in the social housing sector. Lowering tax incentives to homeowners would improve the allocation of scarce capital and reduce house prices. Easing strict land-use and zoning regulation would increase the supply of all types of housing, reducing prices and allowing the housing stock to adjust better to residents' needs.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of the Netherlands were reviewed by the Committee on 22 April 2010. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 6 May 2010.

The Secretariat's draft report was prepared for the Committee by Jens Høj and Tomasz Koźluk under the supervision of Pierre Beynet. Statistical research was provided by Sylvie Foucher-Hantala. The survey also benefited from external consultancy work.

The previous Survey of the Netherlands was issued in January 2008.

Further information

For further information regarding this overview, please contact:

Mr. Pierre Beynet, e-mail: pierre.beynet@oecd.org; tel.: +33 1 45 24 96 35; or
Mr. Jens Høj, e-mail: jens-christian.hoj@oecd.org; tel.: +33 1 45 24 90 80; or
Mr. Tomasz Koźluk, e-mail: tomasz.kozluk@oecd.org; tel.: +33 1 45 24 90 77

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