OECD Economic Surveys
NETHERLANDS

APRIL 2014

OECD Economic Surveys: Netherlands 2014

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Please cite this publication as:
OECD (2014), *OECD Economic Surveys: Netherlands* 2014, OECD Publishing.
http://dx.doi.org/10.1787/eco_surveys-nld-2014-en

ISBN 978-92-64-20690-8 (print)
ISBN 978-92-64-20691-5 (PDF)

Series: OECD Economic Surveys
ISSN 0376-6438 (print)
ISSN 1609-7513 (online)

OECD Economic Surveys: Netherlands
ISSN 1995-3305 (print)
ISSN 1999-0367 (online)

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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 Netherlands were reviewed by the Committee on 6 March 2014. 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 27 March 2014.

The Secretariat's draft report was prepared for the Committee by Rafał Kierzenkowski under the supervision of Pierre Beynet. Research assistance was provided by Gabor Fulop. Chapter 1 benefited from external consultancy work done by Olena Havrylchyk. Chapter 2 benefited from the co-operation of Jochebed Kastaneer, seconded from the Netherlands Ministry of Economic Affairs.

The previous Survey of Netherlands *was issued in June 2012.*

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Basic statistics of the Netherlands, 2012

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	16.8		Population density per km²	403.9	(34.3)
Under 15 (%)	17.2	(18.4)	Life expectancy (years, 2011)	81.3	(80.0)
Over 65 (%)	16.5	(15.3)	Men	79.4	(77.3)
Foreign-born (%, 2011)	11.4		Women	83.1	(82.8)
Latest 5-year average growth (%)	0.5	(0.5)	Latest general election	September 2012	

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	771.0		Primary sector	1.7	(2.5)
In current prices (billion EUR)	599.7		Industry including construction	24.3	(27.3)
Latest 5-year average real growth (%)	-0.2	(0.6)	Services	74.0	(69.9)
Per capita, PPP (thousand USD)	43.3	(37.2)			

GENERAL GOVERNMENT
Per cent of GDP

Expenditure	50.4	(43.0)	Gross financial debt	82.7	(108.0)
Revenue	46.4	(36.9)	Net financial debt	42.2	(68.1)

EXTERNAL ACCOUNTS

Exchange rate (EUR per USD)	0.8		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.8		Machinery and transport equipment	25.2	
In per cent of GDP			Chemicals and related products, n.e.s.	15.8	
Exports of goods and services	88.0	(53.8)	Mineral fuels, lubricants and related materials	14.4	
Imports of goods and services	79.6	(50.4)	Main imports (% of total merchandise imports)		
Current account balance	9.4	(-0.5)	Machinery and transport equipment	26.7	
Net international investment position	47.1		Mineral fuels, lubricants and related materials	23.0	
			Chemicals and related products, n.e.s.	11.7	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year-olds	75.1	(65.0)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	5.3	(7.9)
Men	79.8	(73.1)	Youth (age 15-24)	9.5	(16.2)
Women	70.4	(57.0)	Long-term unemployed (1 year and over)	1.7	(2.7)
Participation rate (%) for 15-64 year-olds	79.3	(70.9)	Tertiary educational attainment 25-64 year-olds (%, 2011)	32.0	(31.5)
Average hours worked per year	1 381	(1 766)	Gross domestic expenditure on R&D (% of GDP)	2.2	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe)	4.7	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2011)	10.4	(10.0)
Renewables (%)	4.3	(8.5)	Water abstractions per capita (1 000 m^3, 2010)	0.6	
Fine particulate matter concentration (urban, PM_{10}, µg/m^3, 2010)	30.0	(20.1)	Municipal waste per capita (tonnes)	0.5	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2010)	0.288	(0.304)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2010)	7.5	(10.9)	Reading	511	(497)
Public and private spending (% of GDP)			Mathematics	523	(494)
Health care (2011)	11.9	(9.5)	Science	522	(501)
Pensions (2009)	6.0	(8.7)	Share of women in parliament (%, December 2013)	37.8	(26.2)
Education (primary, secondary, post sec non tertiary, 2010)	4.1	(4.0)	Net official development assistance (% of GNI)	0.7	(0.4)

Better life index: *http://www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exists for at least 29 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

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Executive summary

Main findings
Key recommendations

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Main findings

The Netherlands is gradually emerging from a protracted recession. The authorities have implemented, or are going to put in place, significant structural reforms in the labour market, health care and the pension system to ease the reallocation of resources and help the economy to recover. Significant fiscal consolidation has also been achieved and the budget deficit lowered to below 3% of GDP. However, the banking sector is large and remains vulnerable to high household indebtedness. Small and medium-sized enterprises (SMEs) face major credit constraints.

Fiscal policy. Fiscal policy has accomplished a major structural adjustment over the recent past and long-term fiscal sustainability has been strengthened by reducing ageing-related pressures on public budgets. The fiscal framework is robust, but Dutch commitments to the European Union have led to a suspension of automatic stabilisation on the revenue side, induced frequent revisions of consolidation plans and made fiscal policy pro-cyclical. A specific international tax issue is tax planning strategies of foreign multinational firms.

Banking sector and household debt. The Dutch banking sector is large compared to the size of the country and suffered major losses linked to troubled foreign assets early in the global downturn as well as remains vulnerable to domestic risks. Despite progress made to strengthen bank capital, regulatory ratios of total and Tier 1 capital to risk-weighted assets and unweighted measures of capital ratios (leverage ratios) are not comparatively strong on a Basel II basis. However, banks have already made progress to meet all Basel III standards. The amount of non-performing loans not covered by loan loss provisions is high in relation to bank capital. Banks' dependence on international capital markets is extensive while the volatility of risk premiums has increased since the beginning of the crisis. Banks are also highly exposed to the property market. Some structural reforms have been implemented to improve the housing market. Nominal house prices have dropped by 20% since their peak in early 2008 and around 40% of households with mortgage debt have negative home equity. Moreover, the majority of the mortgage portfolio is not amortized regularly and more than 50% is "interest-only" (the repayment of capital only occurs when the loan matures). Households have significant assets on average, but both their composition and distribution suggest that they might not be available to repay the full principal once it will fall due. Adequate procedures to resolve banks in case of a new crisis are a crucial component of a financial stability toolkit and major progress has been made, notably with the adoption of a bail-in law in mid-2012.

Small and medium-sized enterprises. SMEs play an important role in the Dutch economy but have been hit hard by the crisis. Dutch banks have been tightening credit conditions and few alternative sources of financing are available. At the same time, not all public guarantees for loans are being used. Restrictive labour regulations are another barrier for the development of dynamic SMEs and could also raise the incidence of last-resort self-employment. The authorities intend to increase the protection of employees on temporary contracts and simultaneously both reduce the protection of those on permanent contracts and restrict access to unemployment benefits. The number of SMEs engaging in collaboration on innovation is comparatively low. Tax policies could have encouraged the growth of self-employment. Regulatory barriers to entrepreneurship are low but the licence and permits system is stricter and some compliance costs are higher than in the best performing OECD countries.

Key recommendations

Fiscal policy

Return to the initial fiscal framework by adhering to medium-term spending ceilings while allowing automatic stabilisers to play fully on the revenue side.

Continue to actively participate in international negotiations about co-ordinated action to combat tax base erosion and profit shifting of multinational enterprises and, within this international context, take appropriate domestic measures to support such action.

Banking sector and household debt

Encourage banks to further increase their capital adequacy ratios by issuing equity and retaining earnings.

Phase in maximum Basel III standards on systemically important bank capital buffers and aim for strong leverage ratios for systemically important banks.

Once the housing market starts to recover durably, accelerate the reduction of mortgage interest relief to increase incentives for amortisation of mortgages and further lower the maximum loan-to-value ratio significantly below 100%.

Small and medium-sized enterprises

Continue to evaluate policy instruments supporting access to finance in the light of existing market inefficiencies faced by SMEs and, if needed, ensure broader access to those instruments and in particular public loan guarantees.

Allow public research institutes to take equity stakes in young business, broaden access to academic research and increase the share of direct innovation grants to SMEs.

Reduce the protection afforded to permanent employment contracts by capping and lowering severance pay and by simplifying individual dismissals, as planned.

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Assessment and recommendations

Challenges facing the Netherlands
Ensuring a sustainable recovery
Improving fiscal policy
Making the banking sector more resilient
Promoting the development of efficient and dynamic SMEs

Challenges facing the Netherlands

The Netherlands is gradually emerging from a protracted double-dip recession and real gross domestic product (GDP) is about 3% below its first quarter 2008 peak. Pre-crisis growth was partly driven by banks' use of international capital markets to fund mortgage expansion. Rising house prices boosted household wealth and consumption, but the subsequent correction has exposed imbalances in the economy. Growth is improving but, due to deleveraging pressures, remains weak, which contributes to the persistence of a very high current account surplus of about 10% of GDP.

The authorities have implemented, or are going to put in place, significant structural reforms, in many instances consistent with OECD recommendations from past *Economic Surveys* and *Going for Growth* reports. Fiscal sustainability has been strengthened, notably with recent reforms of the pension system, health care and long-term care. Distortions in the housing market are expected to be reduced with the introduction of better targeting of social housing through rent increases depending on income and by lowering the property transfer tax. Since January 2013, new mortgages are eligible to interest tax deductibility only if they are regularly amortised. The functioning of the labour market is planned to be enhanced by diminishing segmentation, shortening the duration of unemployment benefits to two years, simplifying child benefits and improving the integration of the disabled. Product market regulation is the least restrictive in the OECD, which contributes to firms' creation, and several policies have been designed to stimulate innovation.

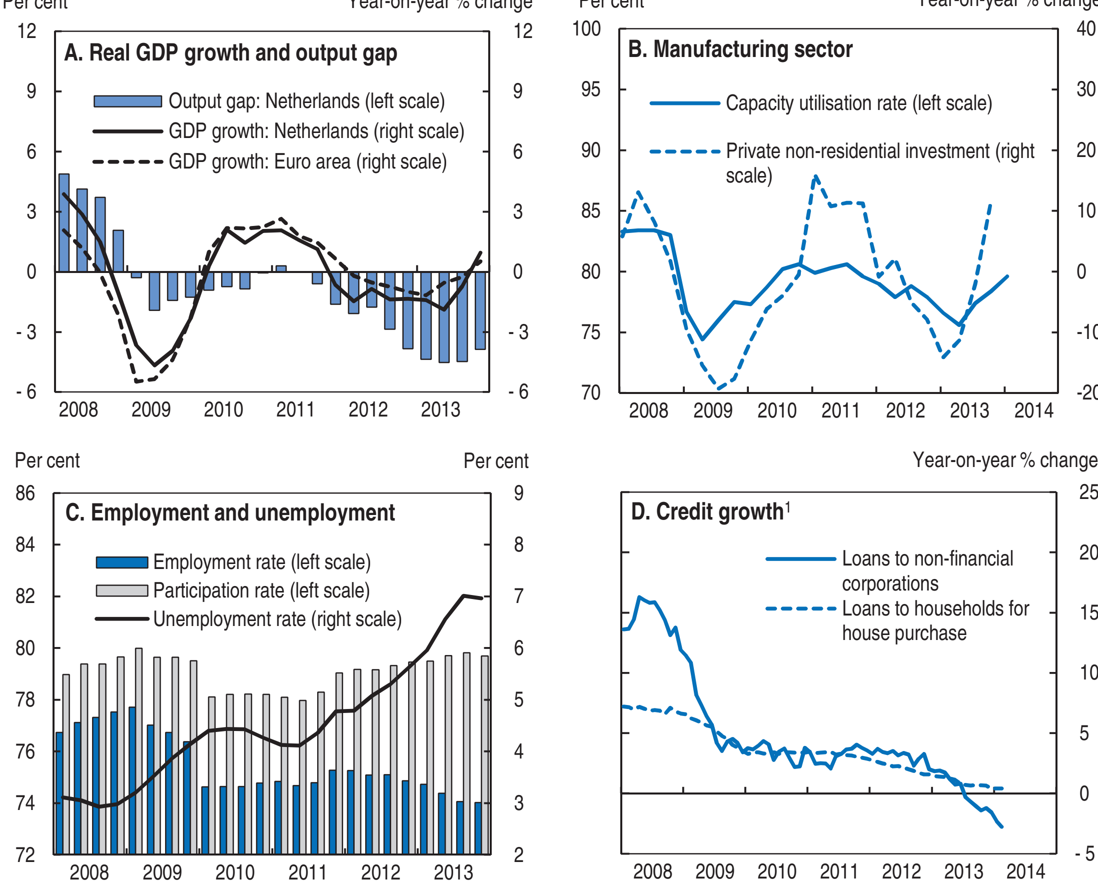
However, challenges remain to return to sustainable growth. Despite ongoing improvement following the financial crisis, the banking sector is still exposed to domestic property risks as falling house prices have put many households in a negative home equity position. Small and medium-sized enterprises (SMEs) face tight access to credit and have difficulties to grow. Structural reforms are needed to facilitate banks' and households' balance sheet restructuring (Chapter 1) and to enhance the dynamism of SMEs (Chapter 2).

Ensuring a sustainable recovery

Following a sharp downturn in 2009 and a short-lived recovery, faltering domestic demand has restrained GDP growth (Figure 1, Panel A). Reduced capacity utilisation rates in the manufacturing sector have held back business investment (Figure 1, Panel B); labour hoarding mitigated increases in the unemployment rate at an early stage to the crisis, but subsequently firms' restructuring efforts combined with difficulties to absorb increased labour supply pushed the unemployment rate to 7% in mid-2013 (Figure 1, Panel C); and credit growth has fallen to essentially zero for households and to negative territory for non-financial corporations (Figure 1, Panel D). Recently, GDP rose by 0.9% in the fourth quarter of 2013 partly driven by car purchases brought forward by businesses and households with

the introduction of new taxes in 2014, private sector confidence has improved supporting a turnaround in gross fixed investment, nominal house prices have stabilised 20% below their peak, and the unemployment rate has been broadly stable at around 7%.

Figure 1. **Key macroeconomic developments**



1. Data refer to loans granted by Dutch Monetary Financial Institutions (MFIs), including loans transferred by MFIs to special purpose vehicles (SPVs), and are adjusted for securitisations and breaks.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections*, *Main Economic Indicators* and *OECD Employment and Labour Market Statistics* (databases), April; Statistics Netherlands (2014), "Manufacturing and Energy", *Statline*, April and DNB (2014), "Domestic MFI-statistics", *Statistics DNB*, De Nederlandsche Bank, April.

StatLink http://dx.doi.org/10.1787/888933029337

Amid sizeable fiscal consolidation, with net *ex ante* budget measures of 2% of GDP in 2014 and 1% of GDP in 2015 corresponding to a tightening in the underlying deficit of about 1% of GDP per year, GDP is likely to recover only gradually (Table 1). Private consumption is projected to fall in 2014, albeit at a moderating pace, and to stabilise in 2015, supported by increases in real incomes. Business investment is set to pick up further assuming that SMEs can obtain credit and that large firms draw on their ample savings. Export growth should also rise as global growth gains momentum, followed by a progressive increase in imports as the economy recovers. The unemployment rate is

projected to continue to creep up owing to further declines in employment, and then to stabilise by late-2014 and to gradually recede in 2015. Latest forecasts of the public employment service (UWV) point to job losses reaching almost 1% in 2014 and the number of unemployment benefit claimants rising by about 10%. Harmonized consumer price inflation has recently dropped to below 1% and is expected by the OECD to remain low owing to the substantial economic slack.

Table 1. **Macroeconomic indicators and projections**

Annual percentage change, volume (2005 prices)

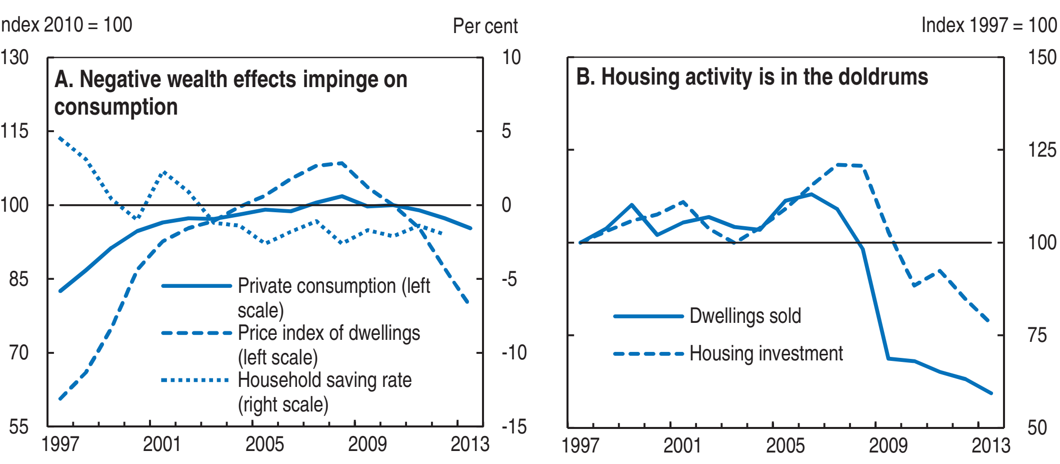
	2010 Current prices (million EUR)	2011	2012	2013	2014	2015
GDP	586 735	**1.0**	**-1.3**	**-0.8**	**1.0**	**1.3**
Private consumption	268 200	-1.1	-1.6	-2.1	-0.6	0.1
Government consumption	166 969	0.2	-0.7	-0.2	0.4	-0.2
Gross fixed capital formation	101 885	6.1	-4.0	-4.8	4.2	2.3
Housing	28 506	4.5	-8.2	-6.9	1.8	0.9
Business	52 042	12.3	-2.9	-4.3	7.2	3.7
Government	21 337	-7.0	-1.3	-3.5	-1.5	-0.1
Final domestic demand	537 054	0.7	-1.8	-2.0	0.6	0.4
Stockbuilding[1]	2 397	0.1	0.2	-0.3	0.0	0.0
Total domestic demand	539 451	0.8	-1.6	-2.4	0.6	0.4
Exports of goods and services	461 718	4.1	3.2	1.4	2.6	4.4
Imports of goods and services	414 434	4.2	3.3	-0.2	3.1	3.8
Net exports[1]	47 284	0.2	0.2	1.4	-0.1	0.9
Other indicators (growth rates, unless specified)						
Potential GDP	..	0.9	0.9	1.0	1.1	1.3
Output gap[2]	..	-0.5	-2.6	-4.3	-4.4	-4.5
Employment	..	0.6	-0.2	-1.0	-0.7	0.5
Unemployment rate	..	4.3	5.2	6.6	7.6	7.6
GDP deflator	..	1.1	1.3	1.4	0.0	0.5
Harmonised consumer price index	..	2.5	2.8	2.6	0.5	0.8
Harmonised core consumer prices[3]	..	1.7	2.2	2.5	0.7	0.7
Household saving ratio, net[4]	..	4.9	4.1	5.1	6.0	6.2
Current account balance[5]	..	9.1	9.5	10.4	8.9	9.8
General government financial balance[5]	..	-4.3	-4.0	-2.4	-2.7	-2.0
Underlying general government financial balance[2]	..	-3.7	-2.7	-0.9	0.0	0.7
Underlying general government primary balance[2]	..	-2.3	-1.4	0.3	1.2	1.9
Gross government debt (Maastricht)[5]	..	65.7	71.2	73.4	74.7	74.9
General government net debt[5]	..	38.8	42.2	44.4	46.7	47.9
Three-month money market rate, average	..	1.4	0.6	0.2	0.1	0.0
Ten-year government bond yield, average	..	3.0	1.9	2.0	2.1	2.5

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. Excluding energy, food, alcohol and tobacco.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), April.

There are numerous downside risks. Households may not sustain their consumption as their voluntary saving rate, which excludes mandatory contributions to pension funds, is negative and could increase more than expected (Figure 2, Panel A). Declines in real income could reduce consumption further and the impact would be magnified by negative wealth effects should house prices continue to fall. While being rough indicators, notably because they are not adjusted for the user cost of housing, price-to-rent and price-to-income ratios are still above their long-term averages by respectively nearly 5% and 20% in the last quarter of 2013. Additional price falls would also further impinge on housing transactions and residential investment (Figure 2, Panel B). Unemployment could rise more, which could put pressure on house prices and on banks through higher foreclosures. The latter have so far been limited but are favoured by strong creditor rights and substantial negative home equity. Results of the asset quality review and the stress tests by the European Central Bank (ECB) could ease or impinge on banks' access to funding in wholesale markets. On the upside, a stronger-than-expected rebound in consumer confidence would foster growth and encourage investment. A recovery in world trade would also boost activity given the large trade openness of the economy.

Figure 2. **The housing market weighs on the economy**[1]



1. Private consumption is measured in volume. Price index of dwellings is deflated by consumer prices. Both price index of dwellings and dwellings sold refer to purchase prices of all dwellings sold to private individuals. Household saving rate does not include mandatory contributions to pension funds.

Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), March; Statistics Netherlands (2014), "Construction and Housing", *Statline*, March and Netherlands Bureau for Economic Policy Analysis (2013), *Macro Economic Outlook (MEV) 2014*, September.

StatLink http://dx.doi.org/10.1787/888933029356

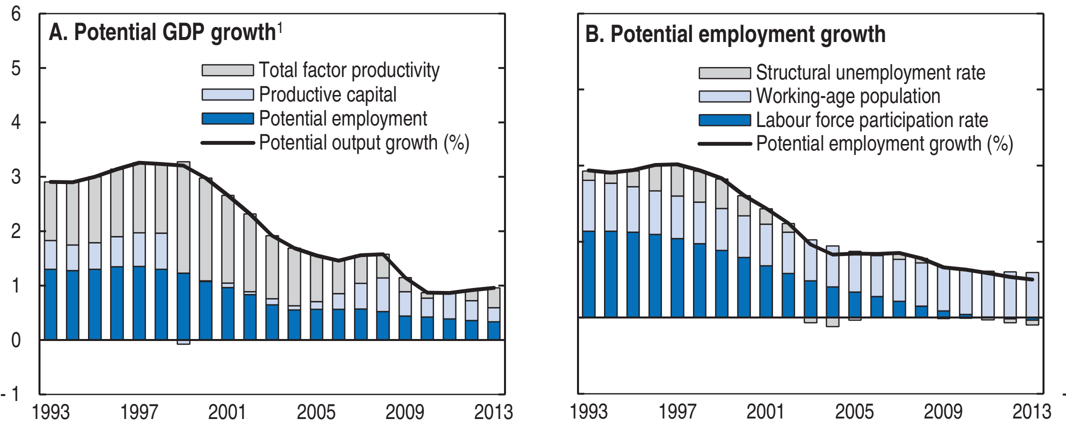
Sustaining high living standards

Potential output growth has been falling towards 1% (Figure 3). Total factor productivity (TFP) growth has slowed since the late 1990s, coming almost to a halt. The contribution of labour has also waned and population ageing will reduce it further. Productivity growth may recover somewhat (Johansson et al., 2013), but ensuring high total factor productivity gains will depend on implementing further structural policies. Reforms with rapid implementation towards the stances in best-performing OECD

countries would over the next ten years: i) raise TFP levels by around 3% when easing product market regulation in upstream sectors (typically network industries); ii) boost productivity levels by around 0.75% when reducing stringent labour regulations; and iii) increase employment rates by almost 1 percentage point when reducing labour tax wedges (Bouis and Duval, 2011). Overall, broad reforms of product and labour market regulations as well as benefit, tax and retirement systems would strengthen GDP per capita by 5% over a 10-year horizon.

Figure 3. **Potential growth has decelerated**

Potential output and employment growth with contributions, percentage points



1. Contributions to growth are calculated using a weight of 0.67 for potential employment and 0.33 for productive capital; total factor productivity is calculated as a residual. Productive capital excludes investment in housing, while potential employment abstracts from cyclical variations in the labour force and unemployment.

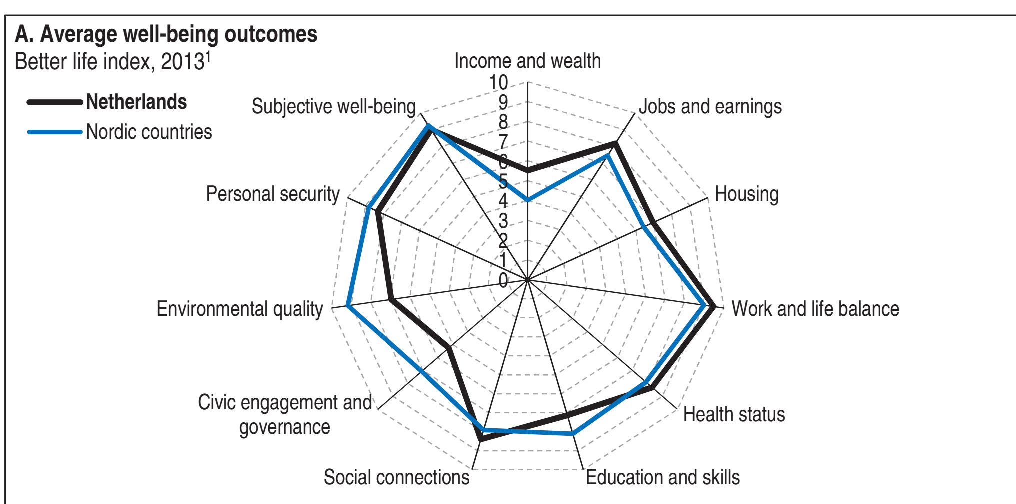
Source: OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), April.

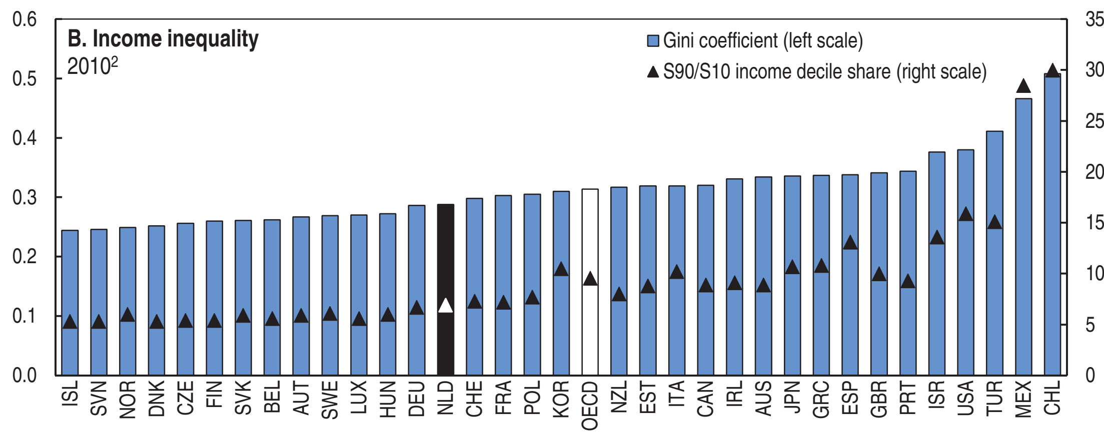
StatLink http://dx.doi.org/10.1787/888933029375

The Netherlands scores high on well-being outcomes (Figure 4, Panel A), with significant GDP per capita, sizeable employment rates, high quality of the education system as captured by good Programme for International Student Assessment (PISA) scores and long life expectancy at birth. Income inequality is comparatively low (Figure 4, Panel B) and has fallen during the crisis (OECD, 2013b). Rises in relative income poverty have been limited despite a jump in the poverty rate of youth. The top 10% of Dutch households owns more than 60% of domestic net wealth, a high ratio among advanced economies (IMF, 2013c; Davies et al., 2012).

Although the Netherlands has always been vulnerable to flooding, the awareness of Dutch citizens about this risk is surprisingly low, reflecting high confidence in the extensive flood-protection systems (OECD, 2013c). Population and assets of Rotterdam and Amsterdam are exposed to significant coastal flooding (Figure 5), but both cities have the highest flood defence standards in the world (Hallegatte et al., 2013). Nevertheless, exposure is expected to rise owing to climate change, subsidence and, more importantly, urban development in flood-prone areas, which need to be further contained (Figure 5). In parallel, the level of taxes paid by firms and households to district water boards should

Figure 4. **Social indicators are solid**





1. Each well-being dimension is measured by one to three indicators from the OECD Better Life indicator set. Normalised indicators are averaged with equal weights and they range between 10 (best) and 0 (worst) performing country in the OECD. The aggregate for Nordic countries (i.e. Denmark, Finland, Norway and Sweden) is calculated as an unweighted average.
2. The Gini coefficient is based on disposable income, after taxes and transfers. The S90/S10 ratio is the share of income received by the top decile divided by the share of income of the bottom decile. 2009 instead of 2010 for Chile, Hungary, Ireland, Japan, New Zealand, Switzerland and Turkey.

Source: OECD (2013), *OECD Better Life Index* and OECD (2014), *OECD Social and Welfare Statistics* (database), March.

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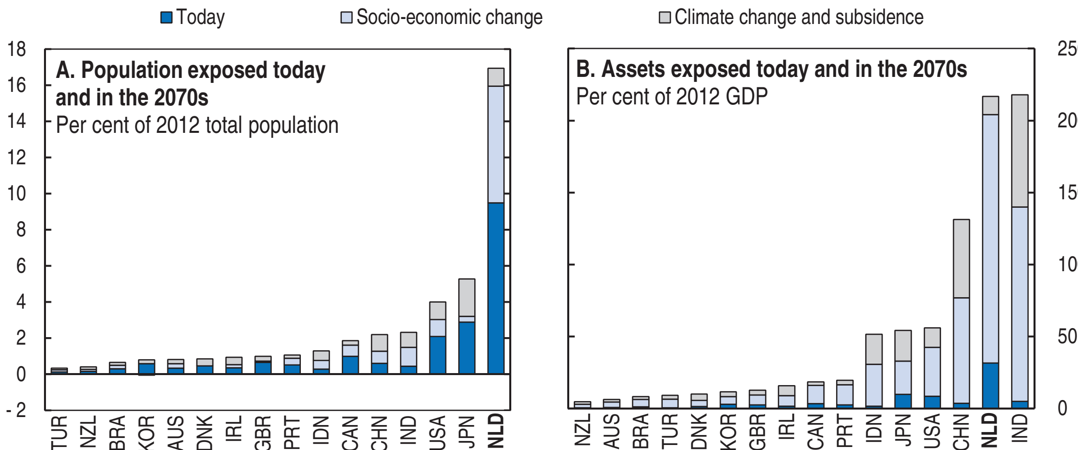
fully ensure that liabilities linked to building in exposed areas correspond to additional costs of protection. Properly internalising the costs of protection would ring-fence the housing market from unexpected shocks and would therefore safeguard household assets and banks' collateral.

Figure 5. **Exposure of major coastal cities to flood risks**[1]



1. Exposure refers to the population and assets that are threatened, taking no account of any flood defences or other adaptation. Socio-economic change refers to the scenario of current environmental situation with the 2070's economy and population. Climate change and subsidence refers to the scenario of future socio-economic situation with the 2070's climate change, natural subsidence/uplift and human-induced subsidence minus the impact of the scenario of socio-economic change.

Source: R.J. Nicholls et al. (2008), "Ranking Port Cities with High Exposure and Vulnerability to Climate Extremes: Exposure Estimates", *OECD Environment Working Papers*, No. 1, and OECD (2014), *OECD National Accounts Statistics* and *OECD Factbook Statistics* (databases), March.

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Improving fiscal policy

Fiscal policy has achieved a major adjustment

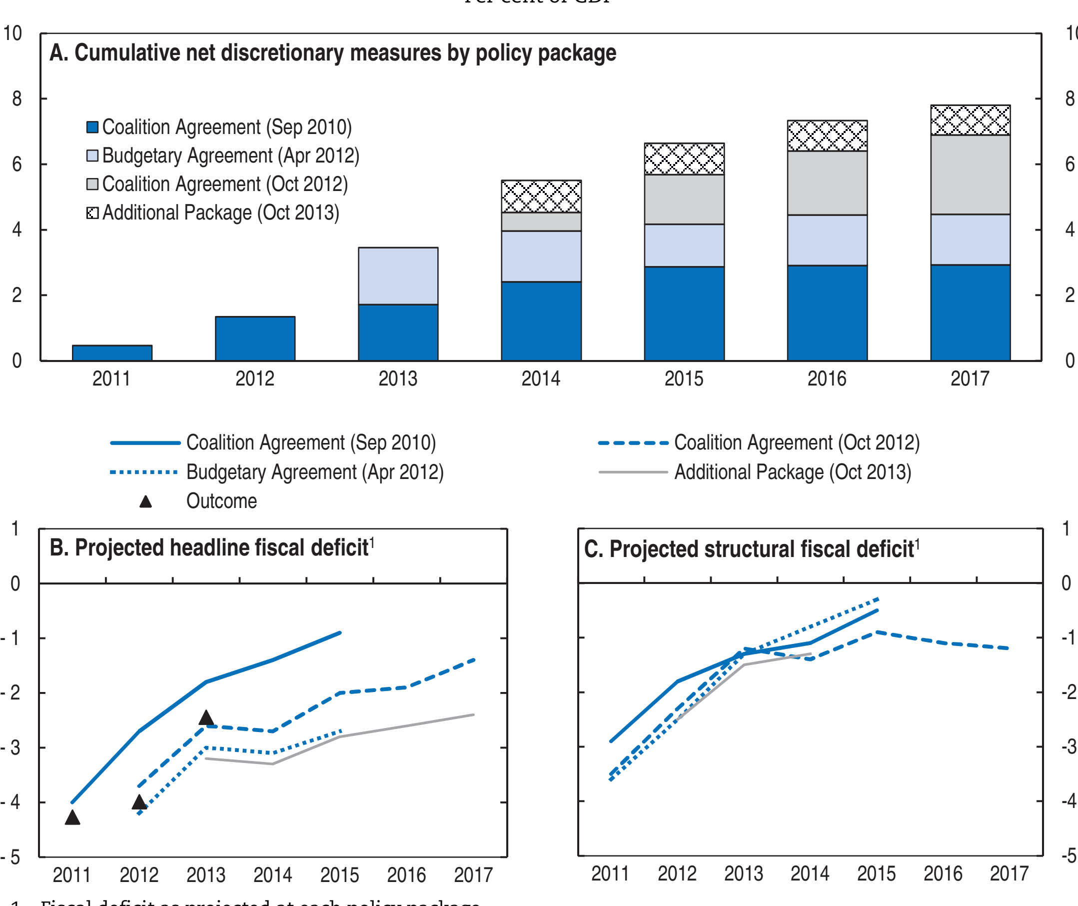
Strong public finances bolster macroeconomic stability and the authorities rapidly lowered the budget deficit to 3% of GDP to comply with the Stability and Growth Pact (SGP). Current consolidation plans aim to complete budget adjustment through an appropriate mix of spending growth restraints and revenues raises, and the cumulative net discretionary effort has been almost 8% of GDP between 2011 and 2017 (Figure 6, Panel A). The size of the effort has risen steadily as growth has weakened and budget deficits have widened more than envisaged (Figure 6, Panel B). The structural deficit, i.e. cyclically-adjusted fiscal balance net of one-offs, has been put firmly on a downward path (Figure 6, Panel C). As a result, the headline deficit was reduced from about 5.5% of GDP in 2009 to nearly 2.5% of GDP in 2013.

Returning to the initial fiscal framework

The Dutch fiscal framework is underpinned by a spending rule. Except for interest payments, expenditure items are subject to spending ceilings and every shortfall needs to be offset. This framework has been serving the Netherlands well for some time as it buttresses fiscal sustainability while leaving some flexibility to accommodate the economic cycle. However, automatic stabilisation on the revenue side has been suspended since 2011 in order to conform to the SGP, as legally mandated in the Netherlands in such cases. This has made fiscal policy pro-cyclical. As the budget deficit has been lowered to below 3% of GDP and is expected by the OECD (Table 1) and the Centraal Planbureau (CPB, 2014) to drop further in 2015, the authorities should return to their initial fiscal framework based on spending control and the work of automatic stabilisers on the revenue side.

Figure 6. **Fiscal consolidation has been sizeable**

Per cent of GDP



1. Fiscal deficit as projected at each policy package.

Source: Ministry of Finance and OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), April.

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Addressing growing ageing costs

The Netherlands has significantly improved long-term fiscal sustainability by mitigating ageing-related pressures on public budgets. Pension reforms have more than halved projected pension-related increases in public expenditure (European Commission, 2012a, b) and there are plans to accelerate the increase in the statutory retirement age to 67 by 2021 (instead of 2023 as initially planned). Total public health and long-term care spending is among the highest in the OECD and could rise significantly in the absence of policy actions (De la Maisonneuve and Oliveira Martins, 2013; Van der Horst and van Erp, 2011). Exploiting efficiency gains could significantly mitigate spending increases in health care while sustaining gains in life expectancy (Hribernik and Kierzenkowski, 2013).

Important reforms have been implemented and are being considered by the authorities, often in line with the recommendations in a special chapter on health care and long-term care of the previous *Survey* (OECD, 2012; Schut et al., 2013). In health care, steps are taken to rationalize the basic health package, enhance the gate-keeping role of primary-care doctors, strengthen incentives for health insurers to develop cost-effective purchases of health services, lower spending on medicines as well as boost savings in the hospital sector. In long-term care, the focus is to expand home care and allow

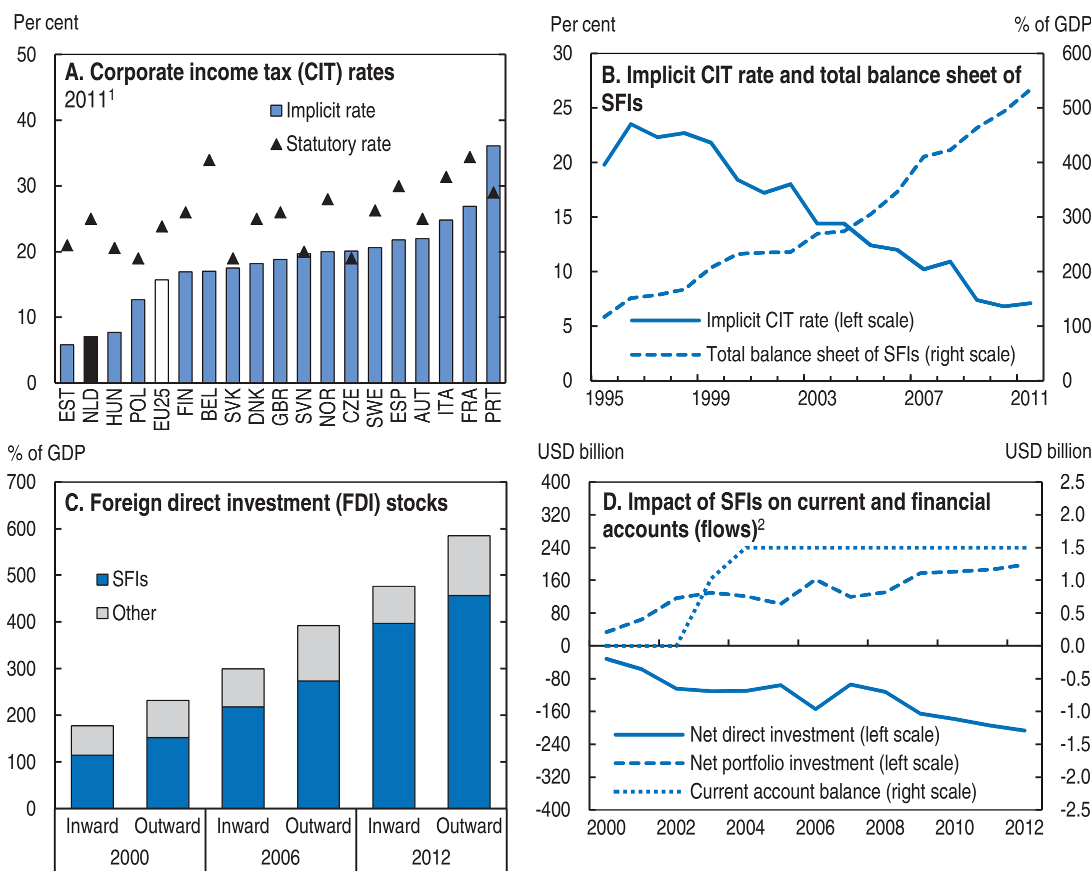
municipalities to play a more prominent role in the system, which is a step forward given their ability to generate cost-efficiency gains in home help with domestic activities. At the same time, those requiring intense care and rehabilitation would benefit from more cost-effective centralised institutional care, partly funded through greater involvement of health insurers and higher wealth-tested out-of-pocket payments.

Addressing tax planning strategies of multinationals

The Netherlands, among other countries, plays an important role in the business environment of multinational companies. It has a strong legal and financial infrastructure, has established an extensive network of bilateral taxation treaties and taxation information exchange agreements, and provides tax certainty with a system of "advance tax rulings". The Netherlands is a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) which reviews the legal and regulatory framework and the actual implementation of the international standard for effective exchange of tax information so as to counter cross-border tax evasion. The Netherlands is seen as largely compliant by the Global Forum on its implementation of the standard (OECD, 2013d). Moreover, while being complex to estimate, the gap between the Dutch implicit and statutory tax rates on corporate income is high in international comparison (Figure 7, Panel A). In 2011, the former was only about 7% in 2011, against a 25% rate for the latter (Eurostat, 2013). A low implicit tax rate illustrates the importance of special financial institutions (SFIs) of multinational companies, with the Netherlands being home to more than 14 000 of them. The gap between the statutory and implicit tax rates can be linked to the importance of dividends and capital gains channelled through the Netherlands, both reflected in the production and income accounts of the national accounts. The absence of withholding taxes on interest and royalty income, and a "participation exemption" that exempts partially or fully intra-firm transfers of dividends and capital gains from the Dutch corporate income tax (CIT), contribute to make the Netherlands an attractive country from a tax perspective (European Commission, 2013a; Broos et al., 2012).

SFIs are directly or indirectly controlled by non-resident parent companies and many of them are special purpose entities, which are so-called letterbox companies, as they have no or few employees and have no or limited physical presence. The majority of the hundred biggest foreign firms in the world have one or more SFIs in the Netherlands (Broos et al., 2012). A steadily diminishing implicit corporate income tax rate has been driven by large and growing assets of SFIs (Figure 7, Panel B), whose gross inward and outward financial transaction flows were estimated at nearly EUR 9 000 billion (15 times Dutch GDP) in 2011. SFIs command a large stock of inward and outward foreign direct investments (FDIs) (Figure 7, Panel C), but net FDI outflows are essentially offset by net portfolio and other investment inflows, resulting in a small impact of SFIs on the current account balance as estimated by the Dutch central bank (De Nederlandsche Bank, DNB) (Figure 7, Panel D). The Netherlands seems to be used as a tax conduit for multinational firms, such as Google (IMF, 2013c), or for firms from the euro area periphery, such as Portugal (Fernandez et al., 2013). Business profits reported by majority-owned affiliates of US parent companies in a group of countries, including the Netherlands, are large and disconnected with their actual economic activity in terms of employment or investment (Keightley, 2013; Gravelle, 2013). Dutch companies may also use tax planning strategies by setting up SFIs

Figure 7. **Corporate income tax rate, foreign direct investment and special financial institutions (SFIs)**



1. Data for implicit rate refer to 2009 for Denmark and Spain and to 2008 for Portugal. The EU25 aggregate is calculated as an unweighted average and it covers European Union member countries except for Bulgaria, Croatia and Romania.
2. Cumulative net direct investment and net portfolio investment flows from 2000. Portfolio investment flows also include other investment flows.

Source: Eurostat and European Commission (2013), *Taxation Trends in the European Union*; De Nederlandsche Bank and OECD (2014), *Foreign Direct Investment (FDI) Statistics* (database), March.

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abroad, as the recent case of the national rail operator shows. Therefore, international co-operation in setting tax policies would also benefit the Netherlands.

Base erosion and profit shifting is a growing international issue (OECD, 2013e, f). Recent steps have aimed to reduce the extent of profit shifting, which is welcome. In 2009, the government introduced requirements for material business presence and the number of SFIs is estimated by the DNB to have fallen by almost 500 in 2012. The authorities also plan to renegotiate their tax treaties and exchange tax information with 23 least-developed countries so as to tame incentives for multinationals in those countries to operate tax planning strategies through the Netherlands. In order to minimize base erosion and profit shifting, the Netherlands is encouraged to examine how their own domestic laws contribute to this and to actively participate in international negotiations to ensure that tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid

by artificially shifting profits to low-tax jurisdictions. As a general principle, profits should be taxed where economic activities deriving the profits are performed and where value is created.

Key fiscal recommendations

Return to the initial fiscal framework by adhering to medium-term spending ceilings while allowing automatic stabilisers to play fully on the revenue side.

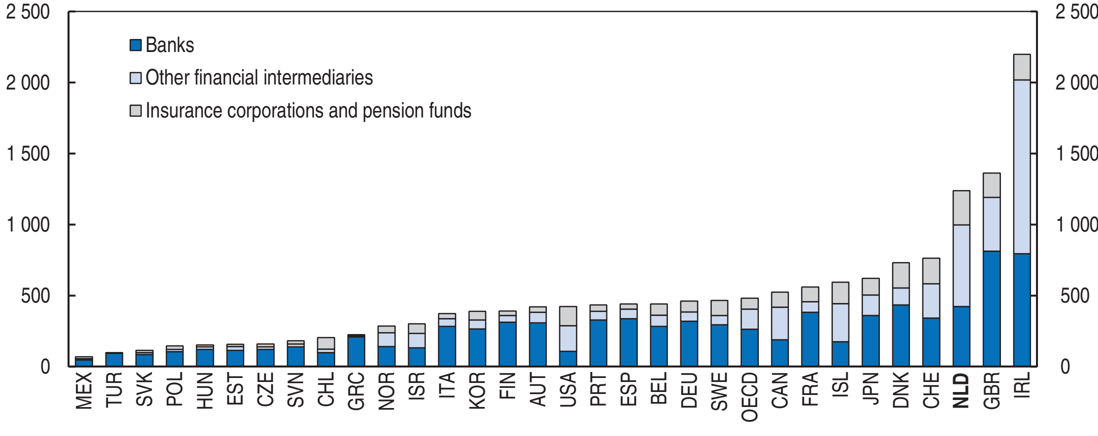
Continue to actively participate in international negotiations about co-ordinated action to combat tax base erosion and profit shifting of multinational enterprises and, within this international context, take appropriate domestic measures to support such action.

Making the banking sector more resilient

The Dutch banking sector is large compared to the size of the domestic economy (Figure 8) and the sector is dominated by three banks with cross-border linkages – ING, Rabobank and ABN AMRO. While important steps have been taken to make the sector more resilient, further efforts would help to head off worst-case scenarios triggered by future domestic or international shocks. A vulnerable, large and concentrated banking sector threatens the financing of the economy through lower credit availability and excessive risk aversion, endangers the taxpayer through bailouts and risks international financial stability through its large size.

Figure 8. **Assets of financial corporations**

Per cent of GDP, 2012[1]



1. 2011 for Israel and Switzerland. 2009 for Mexico. Figures for banks for Germany, Ireland, Italy, Poland and United Kingdom also include central bank assets. Other financial intermediaries refer to financial corporations (except insurance corporations and pension funds) that raise funds on financial markets, but not in the form of deposits, and use them to acquire other kinds of financial assets. The OECD aggregate covers 31 countries. Non-consolidated data from financial balance sheets.

Source: OECD (2014), *OECD National Accounts Statistics* (database), March.

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Risks facing the banking sector

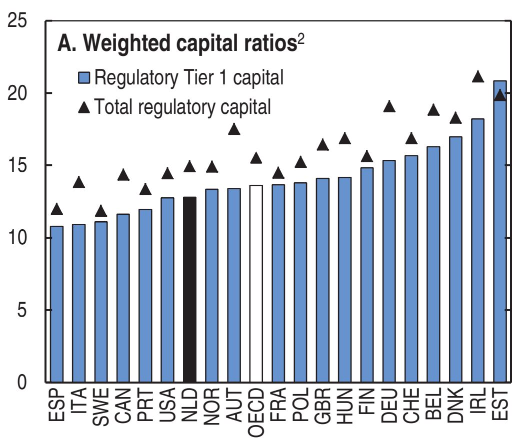
The Dutch financial sector incurred large losses linked to troubled foreign assets and suffered liquidity strains early in the global downturn, although domestic mortgage and

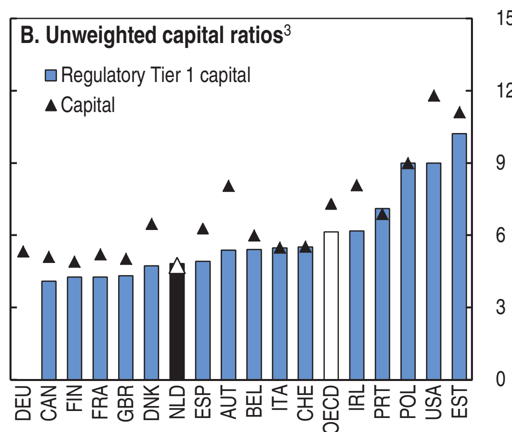
housing markets remained relatively stable (IMF, 2010; 2011). The government undertook a massive intervention to rescue the sector from collapse, as described in the 2010 *Survey* (OECD, 2010). The large international bank ABN AMRO has fallen under state ownership. The bailout of the financial sector increased gross public debt by around 15% of GDP, although two-thirds of the costs have now been recovered (IMF, 2013c). Contingent liabilities linked to the financial sector are expected to be scaled down to nearly 30% of GDP in 2014 (Ministry of Finance, 2013). A planned privatisation of ABN AMRO is a step in the right direction.

According to the DNB, Dutch banks are making significant progress in the implementation of Basel III standards that will come fully into force in 2019. For instance, they had a core Tier 1 ratio at 11.5% in the second half of 2012, although they still needed over 2% of GDP of net additional capital to meet all requirements (DNB, 2013a; 2014). Yet, international comparison can currently only be made on the Basel II basis and regulatory ratios of total and Tier 1 capital to risk-weighted assets are not particularly strong on this account (Figure 9, Panel A). Also, unweighted measures of capital ratios (or leverage ratios) are lower than in many OECD countries (Figure 9, Panel B). As well as asset composition driving a wedge between risk-adjusted and unadjusted capital positions, there is evidence of cross-country heterogeneity in banks' average risk weights driven by bank and supervisory practices, which could also lead to cross-bank heterogeneity within the same country (BIS, 2013a). In accordance with Basel II standards, banks are allowed by the regulator to develop internal models to determine risk-weighted assets.

Figure 9. **Capital ratios in the banking sector are comparatively low**

Per cent, third quarter of 2013[1]





1. Or latest quarter available. 2012 for Switzerland. Regulatory capital compiled in accordance with the guidelines of Basel II (except for the United States where Basel I is applied). For France there is no information available on Basel standards. The banking sector covers banks and other deposit takers (units engaging in financial intermediation as a principal activity).
2. Capital to risk-weighted assets. The OECD aggregate covers 30 countries.
3. Capital to total assets that are not risk weighted. Capital is measured as total capital and reserves as reported in the sectoral balance sheet. The OECD aggregate covers 29 countries for regulatory Tier 1 capital and 26 for capital.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, March.

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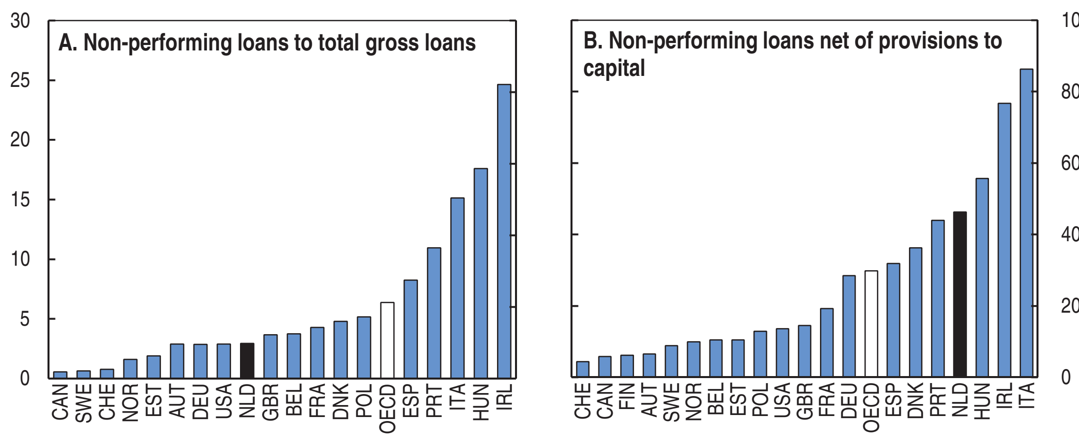
Provisioning is consistent with current international accounting standards of the incurred loss model (IAS 39), which is not sufficiently forward looking about future impairments (Knot, 2013). The share of non-performing loans (NPLs) in total loans is low

(Figure 10, Panel A), but the amount of NPLs not covered by loan loss provisions is high in relation to bank capital (Figure 10, Panel B). This means, for example, that notwithstanding the value of the collateral linked to loans, banks' capital would be cut by half if current NPLs were fully written off. Coverage ratios, measuring loan loss provisions as a percentage of NPLs, have been flat at around 35% and are ten percentage points lower than the median of ratios in the euro area (ECB, 2013a). Furthermore, a low incidence of loans in arrears could be underestimated, notably because there is no uniform definition of NPLs. This is also an issue in other euro area countries which is being addressed by the European Banking Authority so as a new definition of NPLs is used in the asset quality review of the ECB.

Figure 10. **Financial buffers to absorb losses from non-performing loans are relatively weak**

Per cent, third quarter of 2013[1]



1. Or latest quarter available. 2012 for Germany and Switzerland. The OECD aggregate covers 29 countries in Panel A and 30 in Panel B.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, March.

How to read this figure: Potential reduction of banks' capital to absorb losses assuming that all non-performing loans net of loan-loss provisions are written off.

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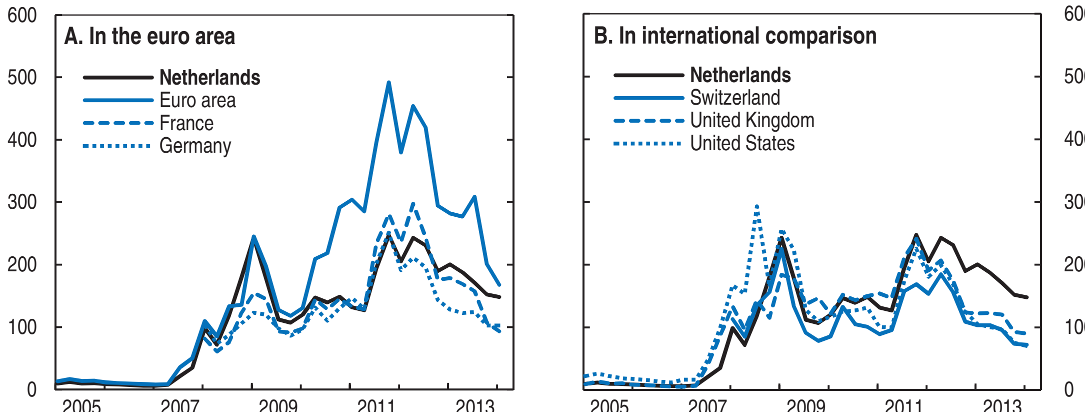
Dutch banks continue to depend heavily on international capital markets to fund their assets. Risk-free interest rates have dropped, but risk premiums facing banks have increased and have become more volatile (Figure 11). The cost of funding does not seem high in international comparison, but the exposure of Dutch banks to refinancing risks is large as they combine among the highest loan-to-deposit ratios and levels of external bank debt in the OECD (Figure 12). In particular, short-term external liabilities amount to about 45% of GDP.

Banks' exposure to the property market is extensive. The overall bank exposure to the domestic and foreign commercial property market is respectively almost EUR 80 billion and EUR 20 billion (in total around 15% of GDP or 4% of banks' total assets). The SNS Reaal bank-insurer was nationalised in early 2013 due to high losses of SNS Bank linked to commercial real estate. Losses originating from mortgage loans have been low so far and NPLs barely exceed 1% of total lending volume. Mortgages amount to close to 30% of total banks' assets and are a major component of total household debt, which at close to 290% of gross disposable income and around 130% of GDP in 2012, is one of the highest in the

Figure 11. **Risk premiums on market funding have become more costly and volatile**

Credit default swap (CDS) spreads of banking sectors, basis points[1]



1. Five-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve. Quarterly data calculated as the unweighted average of end-of-month figures. Figures for the Netherlands are calculated as the unweighted average of CDS spreads of four banks: SNS Bank, ING Bank, Rabobank and ABN AMRO.

Source: Datastream.

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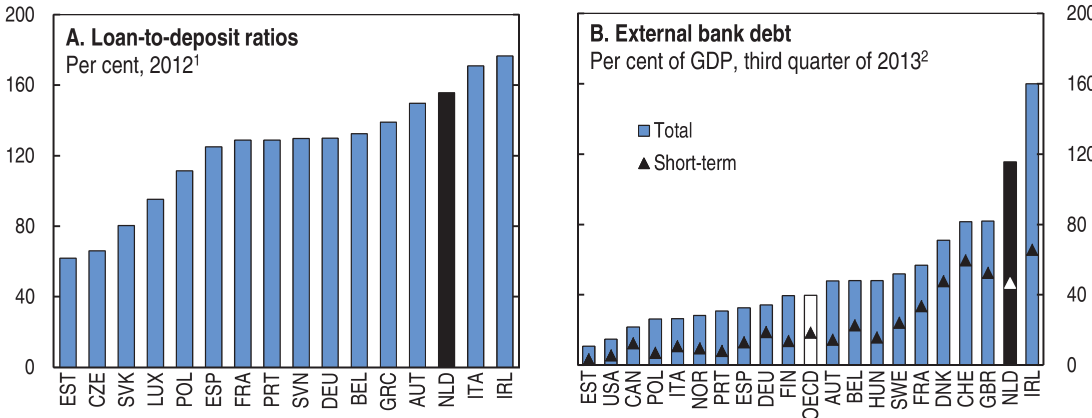
Figure 12. **Dependence on market funding remains high**



1. Ratio of loans and receivables including finance leases to total deposits other than from credit institutions. Data refer to domestic banking groups and stand-alone banks.
2. Total international debt liabilities and international debt liabilities with residual maturity below one year towards BIS reporting banks. The OECD aggregate excludes Luxembourg.

Source: ECB (2014), "Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, March and BIS (2014), "Consolidated Banking Statistics", *BIS Statistics*, Bank for International Settlements, March.

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OECD (Figure 13, Panel A). This contrasts with a more contained indebtedness of the non-financial corporate sector (Figure 13, Panel B).

Many borrowers have not started repaying the principal of their mortgages. More recently, redemptions have somewhat increased driven by lower interest rates on saving accounts, a cancellation of penalties for early repayments and tax incentives for intergenerational transfers of wealth used for house purposes. There are several types of mortgage products in the Netherlands. Around 35% of outstanding mortgages are 100% "interest-only" loans. They do not have any mechanism attached for the build-up of the

Figure 13. **Debt of households and non-financial corporations**

Per cent[1]

A. Ratio of household debt to gross disposable income[2]

B. Debt-to-equity ratio of non-financial corporations[3]

1. Debt is calculated as the sum of the following liability categories, whenever available/applicable: currency and deposits, securities other than shares, except financial derivatives, loans, insurance technical reserves and other accounts payable. Non-consolidated data from financial balance sheets.
2. Debt of households including non-profit institutions serving households. The OECD aggregate covers 29 countries. 2011 instead of 2012 for Japan and Switzerland. 2010 instead of 2012 for Canada.
3. Debt as a percentage of shares and other equity. This indicator measures the financial leverage or the extent to which activities are financed out of their own funds. The OECD aggregate covers 31 countries. 2011 instead of 2012 for Japan and Switzerland.

Source: OECD (2014), *OECD National Accounts Statistics* (database), March.

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principal, which has to be repaid in full only at maturity once a deferment period has expired. Approximately 25% are savings-based mortgages that are linked to a savings account in a bank or an insurance company to accumulate the principal that needs to be redeemed at maturity, although there is some but no regular amortisation. Only 5% of mortgages are subject to regular (linear or annuity) amortisation. Finally, nearly 35% of outstanding mortgages combine two or more products, for instance they may have a 50% part linked to a savings account in a bank or an insurance company for the accumulation of the principal and a 50% part which is "interest-only". Given the mortgage product mix, it is estimated by the DNB that around 55% of the overall loan portfolio is *de facto* "interest-only", against less than 10% in the mid-1990s, and that the share of loans linked to a savings account with a lump sum repayment of the principal reached 30% in 2012. At the same time, the market share of regularly amortising mortgages fell from 50% to 15%.

Loans with deferred amortisation were engineered to maximise mortgage interest tax deductibility (available for a maximum of 30 years) by not amortising and requiring a lump-sum repayment of principal at maturity. According to the DNB, many households are not accumulating equity sufficiently to pay back their mortgage debt (DNB, 2012; IMF, 2011). This applies to interest-only and also to savings-based mortgages. Interest-only mortgages, also a concern in the Nordic countries (IMF, 2013b), blunt the amortising behaviour, may exploit borrowers' short-sightedness and their gaps in financial literacy, and ultimately create macro-prudential risks. The share of maturing interest-only loans will begin to rise sharply from 2025, exposing banks to risks of default, even though risks are lower for older borrowers with high net wealth. Yet, the example of Denmark shows that a rising number of families can encounter difficulties in redeeming such loans (OECD, 2014).

Defaults have been limited so far. Lenders have full recourse, but strategic defaults (no payments despite financial ability to make them) cannot be ruled out if borrowers with negative home equity change their behaviour (IMF, 2013a). A large number of defaults could also occur if economic conditions deteriorate further. The unemployment rate has been rising, undermining the ability to service consumer debt. Of around 8.5 million borrowers recorded in the Dutch Credit Registration Office (BKR), close to 8.5% have recently been falling behind payment schedules by at least two months, and these difficulties could spread into mortgage debt (so far only about 1% have had difficulties in servicing their mortgages by three months or more). With falling house prices and maximum loan-to-value (LTV) ratios above 100% for new loans, nearly 40% of mortgage borrowers already have negative home equity (outstanding mortgage debt larger than the value of the home). Exposure to changes in interest rates is high. In 2008, around half of all mortgages had a remaining fixed interest period of four years or less reflecting the fact that around 70% of borrowers tended to fix the interest rate for a maximum period of 10 years (DNB, 2009). A hike in the policy rate by 300 basis points would increase the median debt service-to-net income ratio to nearly 25% and more than a fourth of households would face a ratio in excess of 40% (ECB, 2013b).

Households on average have assets that significantly exceed their liabilities, but both their composition and distribution reveal that they cannot easily be used to repay debt. *First*, the composition of assets has become more illiquid as the ratio of total financial assets (which exclude housing) to mortgage and total debt has dropped over time (Figure 14). When pensions and housing are excluded, assets exceed debt only marginally. Liquid assets to make an early repayment of debt or to offset potential increases in debt servicing costs are low.

Figure 14. **Household balance sheets have become more stretched**

Per cent[1]

Total financial assets | Financial assets excluding pensions | Liquid assets

A. Ratio of financial assets to mortgage debt

B. Ratio of financial assets to total debt

1. Figures from 2011 onwards are provisional. Financial assets include savings and other deposits, shares and other equities, the net equity of households in the pension funds reserves of resident pension funds and life insurance companies as well as the net equity of households in the life insurance reserves of resident and non-resident pension funds and life insurance companies. Liquid assets refer to savings deposits and other deposits that are all the savings of individuals and deposits (in euros and foreign currency) at any resident and non-resident bank, which are not immediately transferable without restrictions.

Source: Statistics Netherlands (2014), "Macroeconomics: Sector accounts", *Statline*, April.

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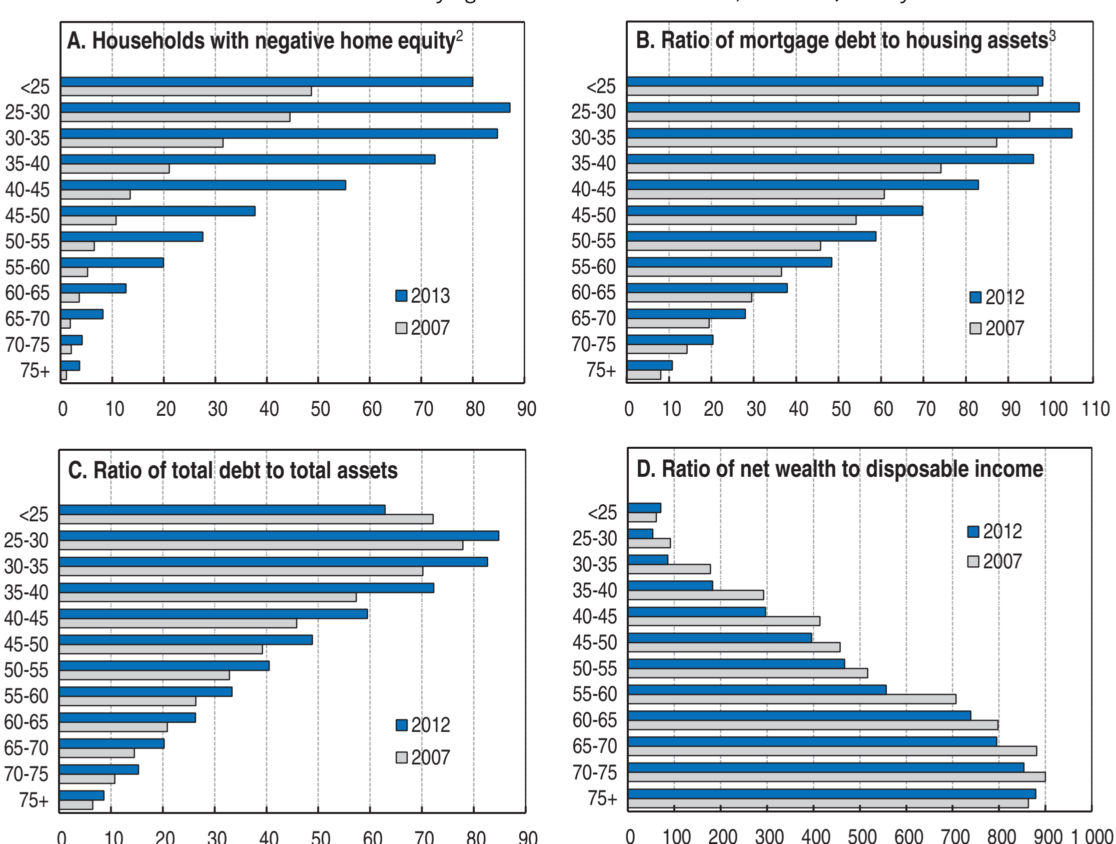
Second, the distribution of assets shows that young and prime-age households are particularly exposed to adverse developments in the housing market, as opposed to older borrowers, and risks have increased since the beginning of the crisis. Among home-owning households with a mortgage, the share of those aged below 40 with negative home equity was above 70% on 1 January 2013, and nominal house prices have been broadly flat since then (Figure 15, Panel A). For this group, the overall value of mortgage debt was almost equal or higher than the corresponding value of housing assets on 1 January 2012, latest data available, knowing that nominal house prices dropped by around 7% that year (Figure 15, Panel B). Total debt-to-assets ratios were high (Figure 15, Panel C) and net wealth as a share of disposable income was low (Figure 15, Panel D) for the young and the opposite was true for seniors (pension assets are disregarded in both cases as relevant data by age are unavailable).

Figure 15. **Risks are concentrated among young and prime-age households**

Per cent of households by age of the main breadwinner, data at 1 January[1]



1. Assets include current and saving accounts, bonds and stocks, own-home, business assets and other possessions, but exclude pension assets as relevant data by age are unavailable. Figures from 2012 onwards are provisional.
2. Home-owning households with a mortgage.
3. Housing assets refer to property owned and used as a main residence. Mortgage debt is associated with home ownership and represents the value of the debt on which interest is payable.

Source: Statistics Netherlands (2014), “Income and Spending”, *Statline*, March.

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Reducing refinancing risks

The Dutch government is considering setting up a National Mortgage Institute to securitise part of the mortgage debt and sell it to international and national institutional

investors, including Dutch pension funds. The objective is to increase banks' funding stability, lower banks' costs, and pass this advantage on to new borrowers and borrowers who renegotiate their interest rate. The government would take on no extra credit risk, as only mortgages covered by the public National Mortgage Guarantee (NHG) scheme (which insures against residual liabilities left after a sale of a property) would be eligible. While such an instrument would help reduce refinancing risks, it is important that the government's exposure to the NHG scheme (currently at 25% of GDP) remains contained and that pension funds' decisions remain prudent in terms of return, risk and investment diversification (also internationally).

Several other policies could also be considered. Higher amortisation of mortgages would narrow the gap between loans and deposits. Deferred-amortisation loans could be systematically linked to a bank account, but such a measure would need to be implemented progressively to prevent liquidity problems in insurance companies when households' stable assets are withdrawn. Further restructuring banks' balance sheets by rationalising non-core activities (loans represent only half of total assets) would also help to reduce their dependence on wholesale funding. To progressively shift the banks' funding model towards more stable sources, the government could consider raising the current tax on liabilities other than equity and deposits (KPMG, 2012). The small difference between the tax rates for liabilities for less and more than one year, respectively 0.044% and 0.022%, could also be increased.

Strengthening financial buffers

The authorities have launched an in-depth asset quality review of risks attached to commercial property loans. The aim is to ensure a realistic valuation of collateral in banks' books, greater scrutiny of banks' property models and higher provisions (DNB, 2013b). These are welcome steps. Banks' mortgage portfolios should receive the same degree of scrutiny as their commercial business. Regulatory authorities should continue to request banks to hold sufficient capital to make up for possible losses stemming from rising unemployment, the high share of households with negative home equity, sensitivity to interest rate shocks and low mortgage amortisation. New international accounting standards (IFRS 9) are not yet enforced, but banks may also choose to apply them as of now, notably the new impairment methodology based on the expected credit loss model. For instance, Danish banks have recently been asked to boost provisions for borrowers who are unable to start amortising their mortgages.

New Basel III regulation should improve both the quality and quantity of capital and will be phased in between 2014 and 2019. If the future counter-cyclical buffer were to be binding for the average Dutch bank in mid-2012, it would have amounted to 0.5% of risk-weighted assets (Bonner and Jongen, 2013), which could indicate little scope to support lending. Implementing a maximum Basel III counter-cyclical buffer of 2.5% of risk-weighted assets in good times would have required around 3.5% of GDP of additional capital in mid-2012. The systemically important bank capital buffer is planned by the authorities to be in the range of 1% to 3% of risk-weighted assets. Aiming for the upper bound would limit spillover effects and reduce the implicit guarantee of banks too big (or too interconnected) to fail.

Evidence by the OECD suggests that Tier 1 risk-weighted capital ratios do not reflect a distance to default of a bank, but leverage ratios do (Blundell-Wignall and Roulet, 2013). To be at a prudent distance from default with a leverage ratio of 5%, Dutch banks would need 4.5% of GDP of additional core Tier 1 capital (OECD, 2013a). The authorities' goal expressed in their "Banking vision paper" of a leverage ratio of at least 4% for systemically important

banks is commendable (Government of the Netherlands, 2013) and the Netherlands is the first euro area country doing it. Seeking a higher leverage ratio, as applied for the two biggest Swiss banks, could be considered given the size of the largest banks as this would provide a greater backstop against unexpected risks, further lower the cost of funding and create stronger incentives to recognise losses. Such a change would need to take into account the potential negative impact on lending in the short term and would need to be implemented progressively. Current discussions at the international level on the definition of the leverage ratio would need to be taken into account when defining its appropriate level.

Capital buffers should be raised by increasing the level of capital rather than by scaling back lending. Issuance of shares and increased retained earnings through lower dividend distribution and reduction of costs should bolster high-quality capital. In particular, there is scope to reduce salaries in the banking sector (DNB, 2013b). The government is considering introducing a limit on performance-related bonuses at 20% of salary which could favour financial stability by lowering risk-taking, but banks may compensate by raising salaries. Rabobank has announced a voluntary temporary freeze in pay and bonuses until 2015.

Containing household leverage when the housing market recovery is durable

Recent reforms have aimed to lower incentives to expand household leverage. Mortgage interest deductibility has been an important driver of the rise in household debt and tax breaks tended to be capitalised in house prices (Andrews et al., 2011). Since 2013, interest deductibility has been restricted to new mortgages with regular repayment of the principal within 30 years, which is a commendable measure. However, new borrowers can take a second interest-only loan to redeem up to 50% of the first loan (Van Leeuwen, 2013). The tax treatment of mortgage interest has been made less generous for both new and existing mortgages, but with a very gradual lowering of the tax relief from 52% to 38% between 2014 and 2042. The maximum value of a mortgage eligible for the NHG guarantee scheme has been reduced and will be diminished further and the maximum LTV ratio for new mortgages will be cut in steps from 106% in 2012 to 100% in 2018.

Reforms need to be deepened as soon as the housing market recovery is sustainable. To improve tax neutrality, the taxation of housing should be at a level consistent with the taxation of financial incomes (Andrews et al., 2011). The taxation of housing corresponds to the first-best policy as households benefit from mortgage interest deductibility and imputed rents are taxed. However, imputed rents are taxed at a maximum rate of only 0.7% of the economic value for dwellings below EUR 1 million. The fee to benefit from the NHG scheme should be adjusted for risk, for instance linked to the size of the LTV ratio. Further lowering the maximum LTV ratio significantly below 100% (most OECD countries have LTVs in the range of 70-80%) would limit the interest burden, decrease the incidence of negative home equity and reduce default rates. The latter noticeably increase for LTVs above 80% in the United States (Qi and Yang, 2009; White and Bauguess, 2013). Lower LTVs would also free up banks' capital and decrease their refinancing risks (SER, 2013). Alternatively, lower LTVs could be incentivised by the regulator by requiring banks to apply floor risk weights on new mortgages.

The Dutch rental sector is heavily skewed towards the public rental sector and developing the private rental market would give time to households to accumulate an adequate mortgage deposit. Recent reforms have initiated a welcome differentiation of rents depending on income in social housing (representing about 35% of the housing stock). They should be continued and would need to be coupled with tighter income

conditions for eligibility to ensure that social housing associations focus on providing affordable housing only for low-income households. In parallel, as assessed in a chapter on the housing market in the 2010 *Survey* (OECD, 2010; Høj, 2011), it is necessary to promote the development of the private rental market by progressively liberalising rents to create an alternative to homeownership and social housing. Ensuring a stronger role for a property's value in setting maximum rents, as currently planned, would be a step in the right direction. Additional far-reaching measures would include fully liberalising rents in new constructions and deregulating rents for new contracts in existing dwellings.

Additional measures are needed to lower household indebtedness in the medium term

Reforms need to be broadened to reduce the stock of household debt in the medium term. Regulatory authorities could prompt lenders to contact their borrowers holding interest-only mortgages and inform them about needed repayment of the loan at the end of the term as, for instance, in the United Kingdom (FCA, 2013). Well capitalised banks could be less willing to refinance borrowers with negative home equity who cannot repay their loan at maturity.

A more fundamental way to reduce household debt would be to more strongly incentivise amortising behaviour for existing mortgages once the housing market has recovered durably. In particular, this could be achieved by accelerating the reduction of the mortgage interest relief. Also, redemptions of loans with deferred amortisation should be closely monitored to prevent practices of "evergreening" by banks. Higher amortisation of existing mortgages would reduce banks' exposure to liquidity and solvency risks linked to the housing market, and improve consumer protection for vulnerable households. Concerns about the accumulation of illiquid and/or excessive net wealth by seniors are overstated. Assuming that underwriting standards remain solid, home equity could be extracted by developing home equity loans (repaid in regular instalments) and reverse mortgages (repaid from equity through the sale of the house).

For borrowers who would be unable to start paying the principal when they refinance their debt with a new loan, banks could propose another mortgage with regular amortisation and longer maturity, or otherwise it would be advisable that they raise their capital for expected losses or boost their loan loss provisions if borrowers are only able to pay the interest. Denmark has recently decided that debtors who have difficulties to begin amortising their mortgage with a LTV ratio of over 80% can convert it into a 30-years loan with amortisation; otherwise banks have to build higher provisions for borrowers only able to pay the interest on a new loan (OECD, 2014).

Balancing creditor and debtor rights would ease loan restructuring. Banks have priority among creditors and full recourse to the collateral and other borrower's assets, typically for three years and a maximum of five years, including claims on future income (Van Leeuwen and Bokeloh, 2012). Widespread repossessions could be socially and politically difficult to enforce in case of defaults, and would deepen banks' losses if large forced sales destabilise house prices. Also, lender-friendly foreclosure laws can weaken underwriting standards and have been found to be associated with a higher incidence of subprime originations in the United States (Curtis, 2013). On the other hand, the government is currently working on draft legislation to mitigate the debt burden of heirs linked to unexpected debts from inheritance, which could put high risks on creditors. Adjusting the personal insolvency regime by lowering the cost of restructuring for financially responsible debtors would ensure an orderly reduction of debt and support consumption, without jeopardising financial stability.

Improving bank resolution

Procedures to resolve banks are a crucial component of a financial stability toolkit, especially as this is a key instrument to avoid that "too big to fail" banks become "too big to save", namely that the cost for the taxpayer for rescuing the banking sector becomes exorbitant (as happened in Iceland or Ireland in recent years). Major progress has been made to ensure an orderly resolution of financial enterprises with the adoption of the Act on Special Measures for Financial Corporations (Intervention Act) in mid-2012. The Intervention Act has laid the ground to bail-in shareholders and junior creditors of the bank-insurer conglomerate SNS Reaal in early 2013. Further progress is expected with the adoption of the Bank Recovery and Resolution Directive (BRRD), which is set to harmonise rules for the recapitalisation and orderly resolution of banks at the European Union (EU) level by January 2015. According to the BRRD, from 2016 onwards, there should be a clear ranking of creditors to bail-in, including senior unsecured bondholders who did not incur any losses in the case of SNS Reaal at the expense of the taxpayer. Moreover, total losses of private investors will have to amount to at least 8% of the bank's balance sheet before drawing on a bank-financed *ex ante* domestic resolution fund (expected to reach the level of 1% of domestic covered deposits by 2025) and public funding. A recently agreed European single resolution fund of EUR 55 billion, to be built up over the next eight years, could also be used in periods of acute stress.

There is scope to enhance early intervention in bank supervision and secure a timely trigger of resolution procedures. Recently, a commission set up to evaluate the nationalisation of SNS Reaal has concluded to the absence of a timely and effective response to the growing problems of the conglomerate. In particular, the regulator was insufficiently informed about the risks taken by SNS Reaal before the crisis and there was little restructuring undertaken following government state aid attributed in late 2008. Therefore, there should be clear criteria and early-warning indicators when a resolution procedure needs to be launched. It is also important that the regulator specifies *ex ante* the measures to be taken in the event of a resolution procedure and the timing of their implementation, so as to reduce the risk of regulatory forbearance. Similarly, recovery and resolution plans (or "living wills") for an orderly wind up of systemically important banks are needed and the authorities are working in this direction.

Deposits under EUR 100 000 are fully protected if a bank fails. According to the BRRD, deposits of natural persons and SMEs above EUR 100 000 will also benefit from a preferential treatment as they will not suffer from losses before all other unsecured creditors' claims (shareholders, junior and senior bondholders, and depositors from large corporations) are absorbed. Two additional measures could be taken to further limit potential costs for the government, which ultimately guarantees deposits below EUR 100 000. *First*, the national deposit guarantee scheme should be funded *ex ante* by the banking sector. Such arrangement was delayed, but it is set to be introduced in the Netherlands in 2015.

Second, the amount of secured debt issued by banks, which is excluded from the scope of bail-in, should be closely monitored to ensure a high effectiveness of resolution procedures. Banks are increasing their secured funding, such as covered bonds, as a way to limit their funding costs. This form of debt insures the right of the creditor to payment against a certain share of banks' assets pledged as collateral. This leads to asset encumbrance and a higher probability that resolution procedures would lead to losses of insured deposits, putting back the cost to the taxpayer. At around 15%, average asset

encumbrance of Dutch banks is lower than the European average of 25%, partly owing to prudential limits set by the DNB for the volume of covered bonds issued (DNB, 2013c). However, there are a number of challenges how such caps could be designed and the regulator could, in addition, consider linking capital requirements to the level of asset encumbrance as a way to ensure that the risk-sharing burden is not unduly tilted towards unsecured creditors (BIS, 2013b).

Recommendations to improve the resilience of banks

Key recommendations

Encourage banks to further increase their capital adequacy ratios by issuing equity and retaining earnings.

Phase in maximum Basel III standards on systemically important bank capital buffers and aim for strong leverage ratios for systemically important banks.

Once the housing market starts to recover durably, accelerate the reduction of mortgage interest relief to increase incentives for amortisation of mortgages and further lower the maximum loan-to-value ratio significantly below 100%.

Other recommendations

Continue to request banks to hold sufficient capital for expected losses.

Adopt a uniform definition of a non-performing loan across banks.

To reduce potential costs of resolutions for taxpayers and depositors, link capital requirements to the level of asset encumbrance. Also, build a domestic resolution fund and a deposit guarantee scheme both funded *ex ante* by banks as foreseen at the euro area level to create a banking union.

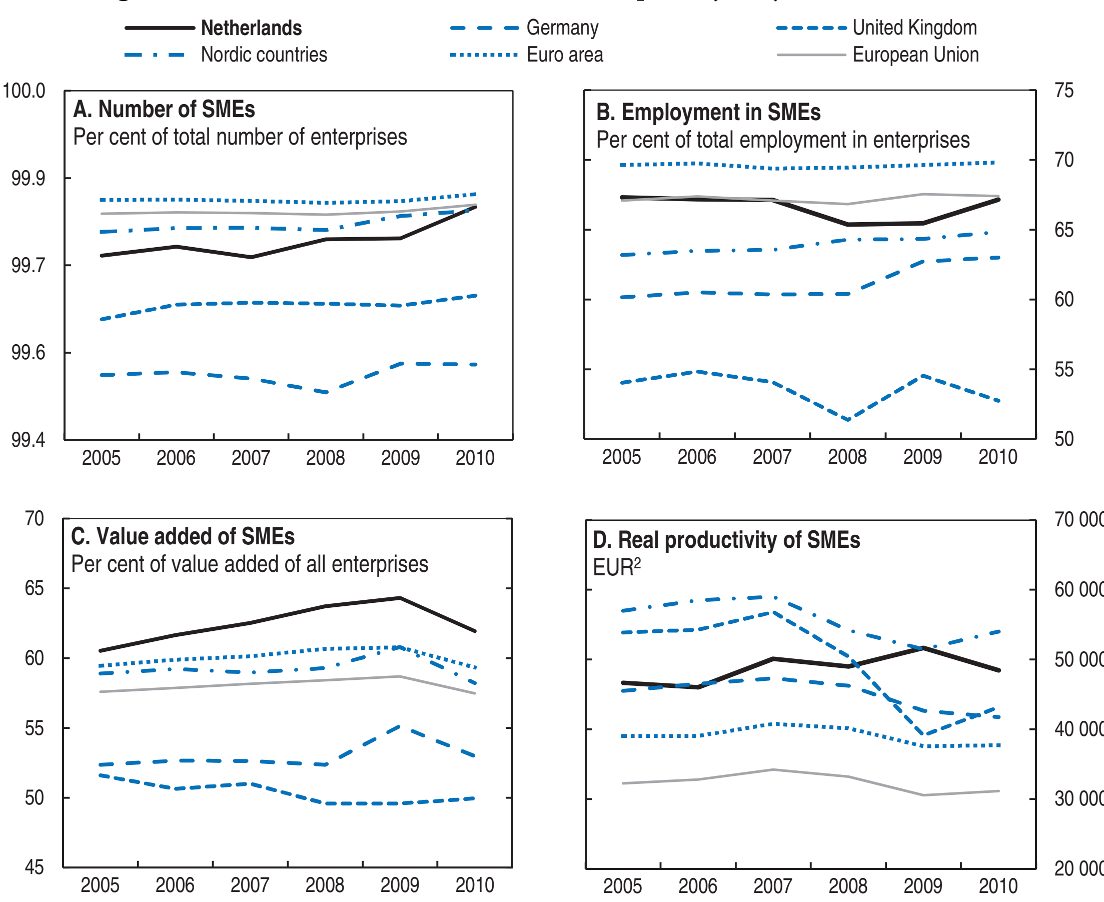
Continue to improve targeting of social housing to low-income households through means tested rent increases and ease rent regulations in the private rental market by increasing the role of property's value in setting maximum rents, freeing rents in new constructions and deregulating rents for new contracts in existing dwellings.

Promoting the development of efficient and dynamic SMEs

In Europe, SMEs are defined as firms with fewer than 250 employees. As elsewhere, they play an important role in the Dutch economy as they represent 99.7% of all enterprises, about the EU average (European Commission, 2013b). They also account for about a 65% share of total employment and a slightly smaller share in value added, and have a significantly higher level of labour productivity than the EU and euro area averages. In the run-up to the global downturn, and in its early stage, the SME sector fared well in comparison with other countries in terms of number of firms, employment and value added (Figure 16).

However, SMEs have been hit hard by the crisis. Corporate failures have increased briskly due to a difficult economic climate and weak domestic demand. Also, access to bank finance is difficult in particular for start-ups, high growth and innovative firms (OECD, 2013g). Moreover, there are around one million self-employed, three quarters of whom have no employees (so-called ZZP-ers in Dutch). The development of dynamic SMEs is hampered by labour-market impediments and there is scope to improve the quality of SMEs by better exploiting their innovation potential and reforming taxation. Also, women entrepreneurs could play a more prominent role in SME expansion. For instance, women

Figure 16. **Small and medium-sized enterprise (SME) sector indicators**[1]



1. The data cover the "business economy" which includes mining and quarrying, industry, construction, trade and services. The aggregates for Nordic countries (i.e. Denmark, Finland and Sweden), Euro area (i.e. EA15) and European Union (i.e. EU27) are calculated as unweighted averages.
2. Real productivity is defined as real value added (in euros) per person employed. Value added of SMEs is deflated by GDP deflator.

Source: European Commission (2014), *Annual Report on European SMEs 2012/2013* (database), DG Enterprise and Industry, January.

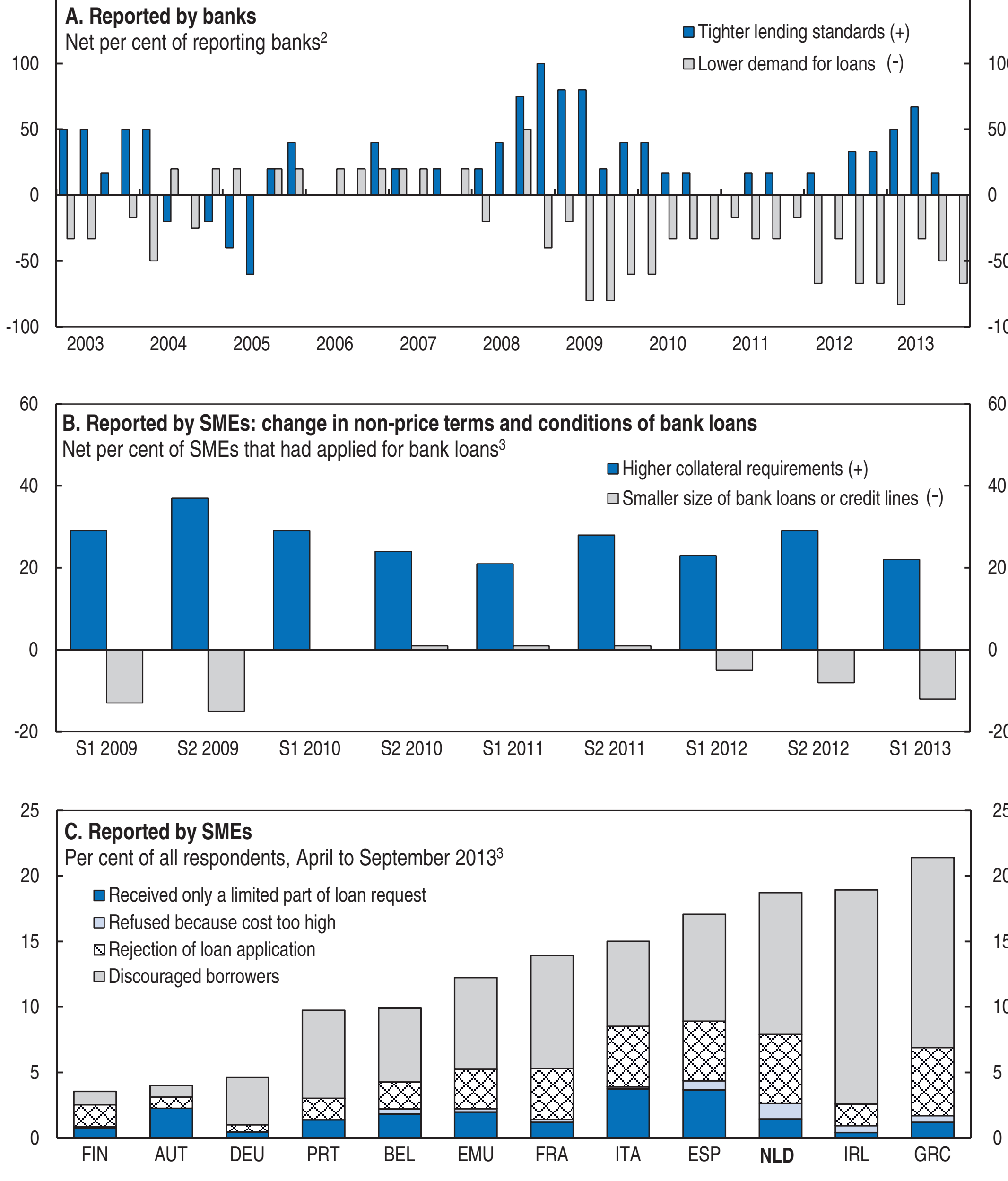
StatLink http://dx.doi.org/10.1787/888933029622

are more represented in businesses with a lower turnover than men. However, women's business creations appear to have been less affected by the crisis than those of men, which could partly be due to a higher propensity of the latter to enter sectors more affected by the crisis, such as construction or manufacturing (Piacentini, 2013).

Credit constraints facing SMEs are high

Dutch banks have been reporting reductions in loan demand since the beginning of the crisis, but they have also been rationing credit as lending standards have been tightened, mainly through stricter collateral requirements reported by SMEs (Figure 17, Panels A and B). In turn, tight credit standards have been weighing on business lending (Van der Veer and Hoeberichts, 2013). According to bank lending surveys, costs related to the capitalisation of banks have had a lower impact on lending conditions than poor industry, firm and economic outlook. Nearly 20% of all surveyed Dutch SMEs reported obstacles for receiving a bank loan around mid-2013, one of the highest ratios in the euro area (Figure 17, Panel C).

Figure 17. **Bank lending constraints for SMEs are high**[1]



1. SME: Small and medium-sized enterprises. For Panels A and B, the values of net percentages may vary between +100% (e.g. all banks tighten their lending terms and conditions) and -100% (e.g. all banks ease their lending terms and conditions).
2. SMEs are defined as having a net annual turnover of less than or equal to EUR 50 million.
3. SMEs are defined as having 0-249 employees. First semester (S1) refers to the period between April and September. Second semester (S2) refers to the period between October and March. EMU: European Monetary Union.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", *Statistical Data Warehouse*, European Central Bank, March and DNB (2014), "Domestic MFI-statistics", *Statistics DNB*, De Nederlandsche Bank, March.

How to read Panels A and B: For Panel A, net percentage of banks reporting an increase (+) of lending standards and reporting increases (+) or decreases (–) in demand for loans. For Panel B, net percentage of SMEs reporting an increase (+) of collateral requirements and reporting increases (+) or decreases (–) in bank loans or credit lines over time.

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Improving access to finance is critical

Ensuring adequate access to bank finance for viable SMEs is essential to support growth. Bank overdrafts, credit lines and bank loans are the most important sources of finance of Dutch SMEs (Figure 18). Even though bank lending is likely to remain a major financial channel, the authorities have undertaken commendable policy efforts to develop alternative sources of funding.

Figure 18. **Sources of external financing of SMEs**

Per cent of all respondents, April to September 2013[1]

1. Figures refer to the following question: "Turning to the financing structure of your firm, to finance normal day-to-day business operations or more specific projects or investments, you can use internal funds and external financing. For each of the following sources of financing, could you please indicate whether you used them or not during the past six months?" Small and medium-sized enterprises (SMEs) are defined as having 0-249 employees. The category of subordinated and participating loans also includes preferred stocks and other similar instruments. The category of bank overdraft and credit line includes credit cards overdraft.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", *Statistical Data Warehouse*, European Central Bank, March.

StatLink http://dx.doi.org/10.1787/888933029660

The government launched a number of programmes to ease access to finance during the crisis. These include higher guarantees to banks for lending to SMEs and start-ups with little or no collateral, and the possibility to delay the repayment of loans benefitting from state guarantees. Together with banks, the authorities started a microcredit institution, Qredits, in 2009. Public guarantees of equity stakes for venture capital investors and/or subordinated loans made by banks further eased small business finance. Other measures have aimed to stimulate direct public lending to new, fast-growing and innovative companies or to attract private investors (such as business angels) through public co-investments. More recently, public guarantees have been extended to non-bank institutions. The objective is to promote the development of credit unions or crowd funding, but also to entice pension funds and insurers into a planned SME financing fund and Netherlands Investment Institution. Steps to broaden access to finance are welcome and SME awareness about less used instruments could also be enhanced (OECD, 2013h).

SMEs face numerous market failures, which have become even more acute during the crisis, and the government has developed a range of instruments to overcome problems of access to finance. However, the type of projects eligible to state support could influence expected economic returns of public intervention. There is a trade-off between the levels of risk taken by the taxpayer and related potential economic benefits on the one hand, and

possible costs for the budget in case of failure on the other. The authorities should continue to evaluate policy instruments supporting access to finance while monitoring market inefficiencies faced by SMEs. Existing instruments should be adapted depending on results, but the government needs to avoid taking excessive risks. For instance, not all public guarantees for loans are being used in the Netherlands. If this reflects supply rather than demand problems and firms with strong economic potential are excluded from funding, then this would call for broadening access to guaranteed loans within well defined budget constraints. In parallel, to derive maximum efficiency and not to obstruct necessary restructuring of SMEs, the government should continue to seek high involvement of private sources of funding. Public money should leverage private money at different stages of firm growth, but only to offset well identified market failures.

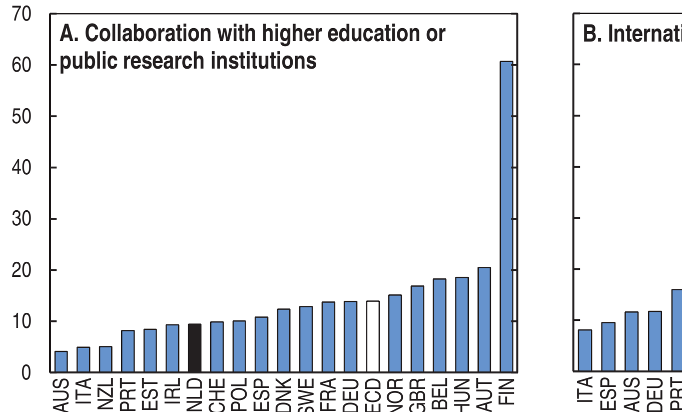
Fostering innovation

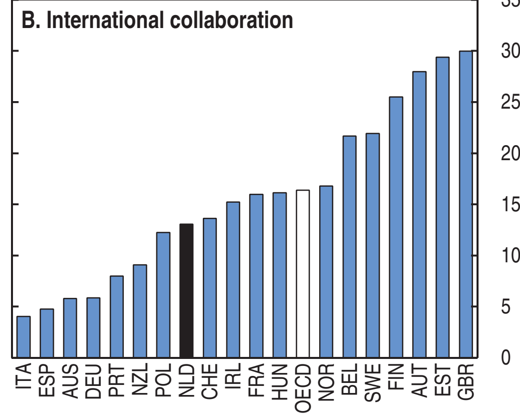
The Netherlands has launched an approach based on two complementary pillars to promote a healthy entrepreneurial system with innovation at its core. As discussed in a chapter on business-sector policies for the business sector to harvest the benefits of globalisation in the 2012 *Survey* and latest OECD Review of Innovation Policy (OECD, 2012; Gerritsen and Høj, 2013; OECD, 2013j), the aim is to enhance framework conditions for the entire business sector (the first pillar) and to develop sector specific policies to unleash research and development (R&D) and address bottlenecks hampering the growth of nine "top sectors" (the second pillar). R&D incentives for all firms are mainly available through indirect tax instruments, although direct support measures could be more suitable for young firms that may not have the upfront funds to start an innovative project (OECD, 2013i). There is a need to ensure that well established firms and industries within the "top sectors" do not effectively capture public support to the detriment of SMEs and emerging industries. The recent creation of knowledge and innovation contracts for "top sectors", involving an easier access of SMEs to the "top sector" instruments through an SME innovation scheme (so-called MIT scheme), is a step forward. The approach in the composition and the number of "top sectors" could also be made more dynamic/flexible, both to promote the development of small businesses in the services sector or implementing non-technological innovation.

There is scope to further strengthen the collaboration of SMEs on innovation (Figure 19) and efforts are made in this direction by supporting the creation of networks and ecosystems. Empirical evidence suggests that small Dutch firms engaged in collaboration with public research institutions (PRIs) are more likely to expand their innovation potential (OECD, 2013j). PRIs can commercialise their research through licence fees, but it would be more affordable for young businesses if PRIs could also take equity stakes. Moreover, R&D spillovers could be bolstered by permitting students to own their inventions, encouraging free access to university inventions (in particular to unexploited patents), merging technology transfer offices into regional centres, and promoting PRIs' funding schemes for faculty spin-offs and student start-ups (OECD, 2013k). More recently, the government has taken welcome steps to tackle the shortage of technicians with the adoption of a Technology Pact. This should raise the second-lowest share of graduates with a science or engineering degree in the OECD, reduce skills mismatches and enhance R&D spillovers benefitting SMEs.

Figure 19. **SMEs collaborating on innovation**

Per cent of product and/or process innovative firms, 2008-10[1]





1. 2011 for Australia, 2006-08 for Ireland, 2009-10 for New Zealand and 2009-11 for Switzerland. SME: Small and medium-sized enterprises. The OECD aggregate covers 30 countries in Panel A and 28 in Panel B.

Source: OECD (2013), *OECD Science, Technology and Industry Scoreboard 2013.*

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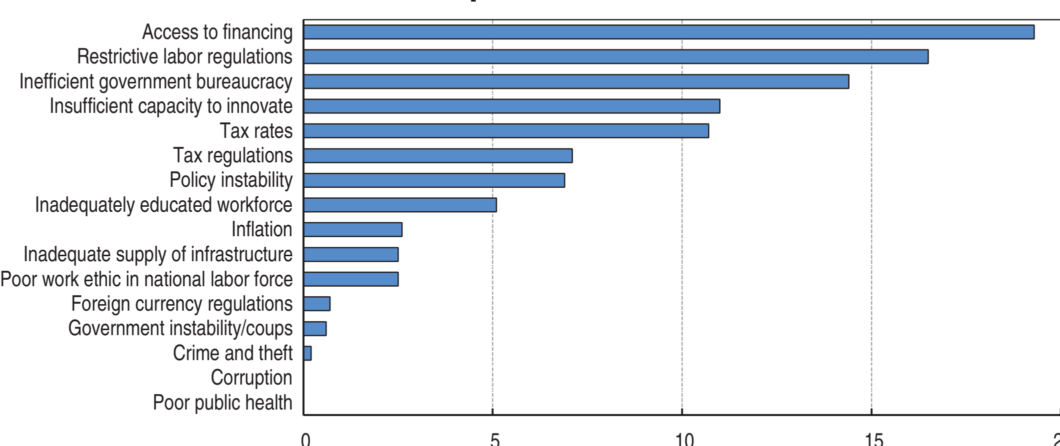
Reforming labour market institutions

After access to finance, restrictive labour regulations are cited as the second most important barrier for doing business in the Netherlands (Figure 20). Lower employment protection legislation (EPL) promotes the development of high-performing SMEs by reducing the opportunity cost of starting an uncertain career as a business founder against a secure salaried job; could encourage a future firm to reach an optimal size (Van Stel et al., 2007; OECD, 2013l); and it facilitates the reallocation of resources towards more productive uses and firms, which may enhance access of SMEs to the existing pool of skills and capital

Figure 20. **The most problematic factors for doing business**

Per cent of respondents, first half of 2013[1]



1. From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: World Economic Forum (2013), *The Global Competitiveness Report 2013-2014*, Geneva.

StatLink http://dx.doi.org/10.1787/888933029698

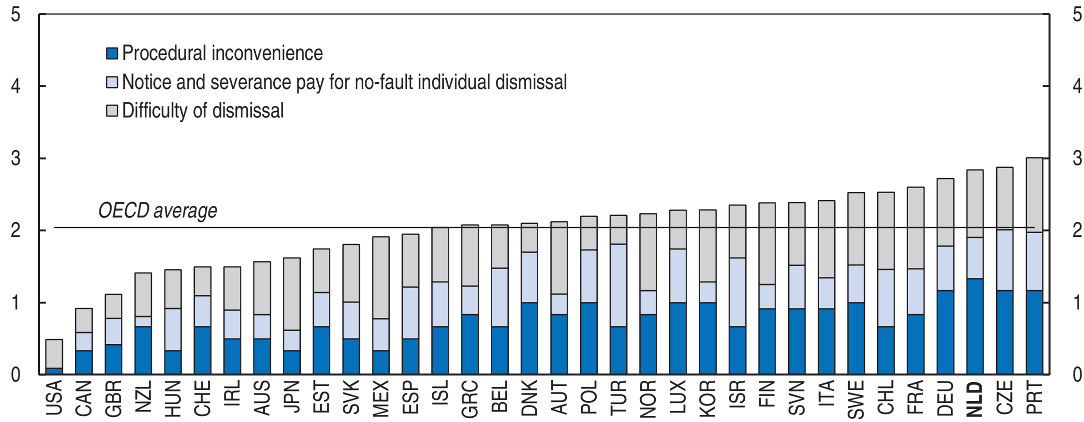
(Klapper et al., 2006; Martin and Scarpetta, 2012; OECD, 2009a, 2012, 2013m). As a result, adaptation to changes in technology or consumer demand is stronger (Bassanini et al., 2009) and the distribution of firms is more dynamic as risk taking and pressure on underperforming firms are higher (Bravo-Biosca et al., 2013). When the initial level of protection is high, positive effects of lower EPL are likely to outweigh its possible adverse effects on human capital investment or skill mismatches.

While self-employment can lead to a transition into salaried employment (CPB, 2011), tight labour regulations raise the incidence of last-resort self-employment for outsourcing purposes or owing to insufficient opportunities for salaried employment (Román et al., 2011, 2013). Stringent EPL also deters hiring decisions of self-employed with no personnel (Millán et al., 2013). Necessity-driven own-account self-employed have a lower entrepreneurial performance, run smaller firms and have weaker growth expectations for their businesses (Poschke, 2013). Yet, the share of necessity entrepreneurs appears to be relatively low and stable at about 10% in the Netherlands (De Vries et al., 2013).

Employment protection for regular contracts is extensive in the Netherlands (Figure 21). The authorities intend to increase the protection of employees on temporary contracts and to simultaneously reduce the protection of permanent contract. Plans to lower and cap severance payments and simplify dismissals would improve the labour market, as emphasised in the previous *Surveys* (OECD, 2006, 2008, 2010 and 2012), and would contribute to SME dynamism. Care is needed when reducing labour market segmentation by tightening the protection of temporary contracts as this may reduce needed flexibility for the development of SMEs, which on the other hand could also benefit from greater labour supply driven by unemployment benefit reforms. The overall impact of

Figure 21. **The strictness of employment protection legislation for permanent contracts is high**

Scale from 0 (least stringent) to 6 (most restrictive), 2013[1]



1. Contribution of sub-components to the indicator for employment protection for regular workers against individual dismissal (EPR). The EPR incorporates three aspects of dismissal protection: *i)* procedural inconveniences that employers face when starting the dismissal process, such as notification and consultation requirements; *ii)* notice periods and severance pay, which typically vary by tenure of the employee; and *iii)* difficulty of dismissal, as determined by the circumstances in which it is possible to dismiss workers, as well as the repercussions for the employer if a dismissal is found to be unfair (such as compensation and reinstatement).

Source: OECD (2013), *OECD Employment Outlook 2013*.

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planned labour market reforms needs to be carefully evaluated and further action should be taken if needed. Employer-paid sickness leave of up to two years has sharpened firms' incentives to contain the growth of sickness leave and the number of disabled workers, but could constitute a barrier to growth and job creation of SMEs. The costs of disability and related uncertainty could be lowered by mutualising risks across SMEs, for example through a fund to which SMEs would contribute.

Reviewing the tax system

Self-employment plays an important role in the flexibility of the supply side and sustains entrepreneurial motivations. Tax policies have also encouraged the growth of self-employment (Van Es and van Vuuren, 2010). These include tax allowances for start-ups, the possibility for the unemployed to use welfare benefits to start a business and the opportunity for disabled workers to get an extra tax credit to become self-employed. The government had considered scaling back some tax reliefs, but these plans did not go through. Bringing social charges paid by self-employed to a level closer to the one levied on salaried workers (paid by both employers and employees) would help to ensure that self-employment is driven by genuine entrepreneurial motivation and would reduce incentives for tax arbitrage by employees and/or employers. The issue of levying pension and disability contributions on self-employed has recently been mentioned in the policy debate.

The current corporate income tax (CIT) system, with two rates at 20% and 25%, may act as a disincentive for SMEs below the tax threshold to grow. Also, a lower CIT rate for SMEs does not ensure that market failures are adequately targeted, as opposed to measures acting directly on the distortions themselves, such as grants or loan guarantees to address credit market imperfections or earned income tax credits to boost employment of low-skilled workers (IFS, 2010; Crawford and Freedman, 2010; OECD, 2009b; IMF, 2007). This would call for the adoption of a single CIT rate, but without increasing the tax burden on SMEs. In parallel, broadening the corporate income tax base would ensure a level playing field between smaller and bigger companies and hence increase the effective tax rate paid by the latter.

Lowering regulatory burdens

To lower administrative burdens, which involve comparatively higher costs for SMEs than for large firms, the government has launched a welcome rationalisation of its business support network. Barriers to entrepreneurship have fallen significantly over the last 15 years (Figure 22, Panel A), but there is scope for improvement compared to the average of five best OECD performers, in particular by easing access to licences and permits (Panel B). Licences could follow the principle that "silence is consent rule" and be issued automatically beyond administrative deadlines. Exit policies are efficient as they imply low time and cost to close a small business, but costs required to transfer property and enforce contracts could be lowered as they are comparatively higher than in other European countries (European Commission, 2013b). Enhancing access to public services through the internet would be an additional step forward.

Figure 22. **Product market regulation (PMR): Barriers to entrepreneurship**

Index scale from 0 (least restrictive) to 6 (most restrictive)

1. There was no change in the PMR score for licence and permits system in 1998-2003 and 2008-13, nor for antitrust exemptions in 2003-08 and 2008-13, nor for barriers in network sectors in 2008-13.
2. For administrative burdens for sole proprietor firms the PMR score of the Netherlands is zero (i.e. least restrictive). For antitrust exemptions the PMR scores are zero.

Source: I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), “The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries”, *OECD Economics Department Working Papers*, forthcoming.

StatLink http://dx.doi.org/10.1787/888933029736

Recommendations to unleash SME dynamism

Key recommendations

Continue to evaluate policy instruments supporting access to finance in the light of existing market inefficiencies faced by SMEs and, if needed, ensure broader access to those instruments and in particular public loan guarantees.

Allow public research institutes to take equity stakes in young business, broaden access to academic research and increase the share of direct innovation grants to SMEs.

Reduce the protection afforded to permanent employment contracts by capping and lowering severance pay and by simplifying individual dismissals, as planned.

Recommendations to unleash SME dynamism *(cont.)*

Other recommendations

Consider converting the two-rate corporate income tax into a single rate tax system while not increasing the tax burden on SMEs and levelling the playing field between smaller and bigger companies by broadening the corporate income tax base.

Reduce the gap between social security contributions and coverage of own-account self-employed and employees and consider mutualising the costs of disability through a dedicated fund for SMEs.

Ease access to licences by issuing them automatically if they are not delivered by the end of the statutory response period and lower the administrative costs of enforcing contracts and transferring property.

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ANNEX

Progress in main structural reforms

This annex reviews action taken on recommendations from previous Surveys. *They cover the following areas: public finances, financial markets, labour market, transport system and housing policies. Each recommendation is followed by a note of actions taken since the June 2012* Surveys. *Recommendations that are new in this* Surveys *are listed in the relevant chapter.*

This annex presents under each theme:

Past recommendations

Action taken

Public finances

Secure long-term fiscal sustainability by implementing planned measures, such as increasing the retirement age in the state pension system and introducing more competition in the health sector, to curb ageing-related spending growth in the area of pensions and health spending as well as being ready to adopt additional measures if necessary.

The retirement age in the state pension system was increased by law in July 2012. Under the current legislation, the statutory retirement age will be increased to 67 in 2023. In 2014, there are plans to accelerate the phase-in of the retirement age of 67 to 2021.

In health care, steps are made to rationalise the basic health package, enhance the gate-keeping role of primary-care doctors, strengthen incentives for health insurers to develop cost-effective purchases of health services, lower spending on medicines and boost savings in the hospital sector.

Financial markets

Improve macro-prudential regulation and supervision of financial markets.

A macro-prudential advisory committee was created in November 2012, consisting of representatives of the Ministry of Finance, the Dutch Central Bank (De Nederlandsche Bank, DNB) and the Authority for Financial Markets (AFM).

Improve the awareness (among local governments) of the risks associated with deposits in banks not covered by the Dutch depositor protection scheme.

In 2013, a law was passed that compels local governments to hold their reserves in an account at the Ministry of Finance (the treasury banking facility). As a result, from 2014 onwards only a limited amount of working capital is being held in bank accounts. Long-term financial assets will be gradually transferred to the treasury banking facility.

Labour market

Strengthen job-search incentives of the unemployed by decreasing unemployment benefits more dynamically throughout their duration, shortening their duration and reducing their ceiling.

In November 2013, draft legislation was sent to Parliament to gradually shorten the duration of unemployment benefits from three to two years as from January 2016.

Focus on measures to increase activation and hours worked. Consider making active labour market policy (ALMP) spending more counter-cyclical. Relax employment protection legislation (EPL) and cap severance pay.

Since 2013, the maximum amount of the working person's earned income tax credit has been increased from EUR 1 611 to EUR 1 723, hence creating an incentive for low income earners to work and increase working hours.

In November 2013, draft legislation was sent to Parliament to somewhat simplify dismissal procedures, and the severance pay is planned to be capped up to EUR 75 000 or a year's salary, whichever is higher. These provisions are expected to come into force in July 2015.

Pension funds

Use a more stable long-term interest rate as the discount rate to assess pension funds' solvency.

Since October 2012, the interest rate to discount liabilities of pension funds at horizons beyond 20 years (so-called ultimate forward rate) has been set at a long-term rate of 4.2% (a sum of projected long-term inflation of 2% and real short-term interest rate of 2.2%). Since January 2015, an alternative methodology will be used which increases market information at long-term horizons, thereby improving pension funds' scope to hedge interest rate risks.

Make permanent the extension of the recovery period (from three to five years) for funds to restore solvency.

No action taken.

Provide greater information to support informed decisions on transfer of pension rights. Allow members to leave persistently underfunded or underperforming funds.

No action taken.

Strengthen the boards of the pension funds by increasing the representation of pensioners and sleepers and by making boards more professional.

In July 2012, new legislation was adopted which strengthens and improves the expertise of the pension funds governing boards. It also ensures that all parties are well represented, including employers, employees and pensioners.

Transport system

Improve the cost-benefit analysis (CBA) methodology of infrastructure projects. Require explicit justification in cases where CBA results are overruled.

In December 2013, new more transparent and better defined CBA guidelines were adopted for use not only for infrastructure projects, but also for other policy areas such as health care, education or environmental policies.

Implement a road pricing scheme.

No action taken.

Focus the tax-free commuting allowance on low-wage workers.

No action taken.

Taxation of diesel should be raised to better reflect the relative environmental costs of fuels.

Since July 2012, the private motored vehicle and motorcycle purchase tax – based on CO_2 emissions – includes a diesel surcharge. In 2014, the tax amounts to nearly EUR 73 per gram of CO_2 exceeding 70 grams CO_2/km.

Since January 2014, the excise duty rate of diesel has been raised from EUR 440 to EUR 477 per 1 000 litres.

As of January 2014, owners of old cars have been obliged to pay road taxes. Diesel cars between 26 to 40 years-old will be charged the full amount.

Facilitate new entry in public transport.

No action taken, but there are plans to liberalise the provision of rail services on some routes.

Housing market

Supplement planning needs by creating fiscal incentives for local municipalities to develop housing.

The central government has come to an agreement with local authorities and has lowered taxes to promote the conversion of vacant office space to housing.

Abolish (or lower) the property transfer tax.

The property transfer tax has been lowered from 6% to 2%.

Replace the tax deductibility of mortgage interest payments with the principle of taxing net housing value.

As of January 2013, only mortgages with an annuity repayment scheme are eligible for tax deduction. Since 2014, the maximum rate for mortgage tax deduction will be gradually lowered up until 2040, but the overall tax relief will remain generous.

Reduce income tax subsidies by increasing the taxation of imputed rent (and its scope).

In January 2014, the level of imputed rent tax increased from 0.6% to 0.7% of property value of between EUR 75 000 and EUR 1 040 000. For properties above EUR 1 040 000 the tax was increased from EUR 6 360 + 1.55% of the property value to EUR 7 350 + 1.8% of the property value.

Focus social housing associations on providing affordable housing for low-income households. Give incentives to housing associations to sell off dwellings. Transfer associated excessive capital gains to the government. Reduce the maximum rent of social dwellings.

The legal framework for selling dwellings by housing associations has been broadened. As of 2013, a special tax is in effect for housing associations, which should provide an incentive to sell dwellings. The proceeds of this tax are used for offsetting low-income earners for higher rent levels.

Liberalise rents in new constructions and deregulate rents for new contracts in existing dwellings. Index market based rents to reflect the cost of housing.

No action taken, but rents in new constructions may be liberalised when they meet some quality standards.

Extend means testing to sitting tenants.

As of 2013, sitting tenants in the regulated rental sector are subjected to a means (income) test, in order to determine the extent of rent increases. Between July 2013 and June 2014, maximum rent increases depending on annual incomes are 4% up to EUR 34 085, 4.5% between EUR 34 085 and EUR 43 602, and 6.5% above EUR 43 602.

Give priority in social housing to households with employment related reasons.

No action taken, but local communities and social housing associations are permitted to set priorities in the distribution of social housing and employment is one of the criteria.

Provide social housing through housing allowances.

A combination of rent increases in social housing, flanking measures for low-income earners and a new levy for landlords is expected by the government to lead to more allowance-based social housing.

Health and long-term care

Develop adequate performance indicators to allow performance-based contracting between health insurers and care providers, focusing on data collection at the individual patient level and the development of a better information infrastructure.

In January 2014, the national quality institute was created with the aim to support insurers, patients and providers in making standards for health care as well as performance indicators. This should facilitate the development of performance-based contracting between insurers and providers.

Allow health insurers to use alternative payment systems based on financial risk-sharing (e.g. risk-adjusted capitation payments) and performance as well as to, on a limited scale, vertically integrate with providers to reduce information asymmetries.

Draft legislation has been sent to Parliament under which vertical integration between insurers and providers is allowed only under certain circumstances.

Further improve the risk-equalisation scheme to reduce insurers' incentives for risk selection, particularly in view of the government's intention to terminate ex post compensations before 2015.

The functioning of the risk-equalisation scheme is constantly being monitored, in order to make improvements when necessary. Ex post compensations will be terminated before the end of 2015 for cure and in 2017 for care and mental health care.

Lift the current capacity constraints (*numerus fixus*) for medical schools and facilitate the recognition of foreign diplomas from outside Europe.

No action taken.

Allow for-profit hospitals to enter the hospital market. In addition, the orderly exit of bankrupt hospitals should be secured via measures to guarantee access to essential facilities.

Draft legislation has been sent to Parliament allowing hospitals that meet certain (financial) requirements to pay out profit. Clear legislation guaranteeing access to essential facilities in case of bankrupt healthcare providers is in force and communicated.

The Competition Authority should publish a clear methodology for assessing horizontal and vertical mergers between hospital and health insurers, as a way to base merger assessments solely on competition considerations, including consumer welfare concerns.

The competition authority has published guidance about the assessment of mergers and co-operations in the health care sector, with the opinion of health insurers and patients playing a key role.

Increase co-payments for higher income groups to encourage cost-effective choices, alleviate information asymmetries and improve budget control. Co-payments for chronically ill people should be better designed to give them more incentives for cost-efficiency.

The deductible in the health care insurance had been increased to EUR 360 in 2014 (from 220 euro in 2012). Lower income groups are fully compensated for this rise. Furthermore, wealth dependent co-payments were introduced in 2013 in the long-term care together with already existing income dependent co-payments.

Health insurers should not receive more responsibility for purchasing care until they are given proper incentives for cost-efficiency. In the longer term, the decentralisation of home care to municipalities could be completed and institutional patients should directly choose their care provider to push institutions to compete on quality to attract patients.

Draft legislation has been sent to Parliament with the aim to decentralise personal assistance to municipalities by 2015 and to transfer personal care and nursing care to health insurers by 2015.

Encourage home care by rewarding financially municipalities for reducing institutionalisation rates, through better screening and by higher co-payments for accommodation costs in institutions.

Municipalities have adopted screening methods based on client needs instead of entitlements. This approach is already being used for home care services. After decentralisation of individual support to the municipalities planned for 2015, this approach will also be used for personal assistance.

Keep the cash benefits scheme for home care but combine it with better screening and monitoring to avoid unintended use. To this end, a system of vouchers directly payable to professionals and topped up by co-payments should be envisaged.

No action taken to create a system of vouchers.

Thematic chapters

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Chapter 1

Making the banking sector more resilient and reducing household debt

Dutch banks were put under heavy strains early in the global downturn and have comparatively weak financial buffers to cope with new shocks. Falling house prices have increased the share of households with negative home equity to nearly 35% for home-owning households and 40% for mortgage holders. Even though defaults have so far been limited, mortgage amortisation is low and risks are concentrated among younger borrowers who often do not have sufficient resources to cope with adverse shocks. Banks are very large relative to the size of the domestic economy, have sizeable cross-border exposures and rely significantly on wholesale funding. Resolution procedures should be strengthened to reduce the potential cost for the taxpayer and the regulator's tools available to reduce risks should be expanded. In particular, banks should set aside sufficient provisions for expected losses and problem loans, which requires some harmonisation of the definition of non-performing loans across banks. Higher capital buffers would bolster financial stability and help ensure access to market funding while lowering its cost. Welcome measures have been taken to encourage household deleveraging, but deeper and broader steps are needed to bolster financial stability and improve consumer protection when the housing market starts to recover durably and over the medium term. The stock of existing mortgages should be gradually converted into amortising mortgages, the cap on the loan-to-value ratio reduced significantly below 100% and housing subsidies to homeownership cut more decisively.

The financial sector is facing a second difficult period since the start of the Great Recession in 2008. In the aftermath of the financial crisis, several financial institutions incurred major difficulties (OECD, 2010). In the banking sector, liquidity dried up and some banks were excessively leveraged or overly exposed to US subprime mortgages and financial instruments derived therefrom. ABN AMRO had to be nationalised in late 2008 following a failed takeover by Royal Bank of Scotland, Santander and Fortis. The solvency of pension funds was also put under pressure by financial market developments, as assessed in a chapter on the vulnerability of the pension system to financial crises of the 2010 *Survey* (OECD, 2010; Høj, 2011a). In both sectors, urgent measures were taken to circumvent the crisis which originated from a brutal, temporary and well identified shock.

Current challenges for banks arise from a more traditional and larger set of assets, i.e. loans to households and firms, and are potentially more long lasting. With the Netherlands being in recession or witnessing weak growth for five years and house prices regularly falling, highly indebted households see their net wealth progressively eroded, which pushes them to reduce their consumption and housing investment. This in turn undermines growth and house prices further, creating a negative spiral. Such a situation impacts banks in return as rising non-performing loans and a lower valuation of banks' collateral increase their exposure to the risks of default, which then leads them to restrict lending. Credit conditions are further tightened by poor growth prospects. In addition, the specific feature of the mortgage lending market in the Netherlands is creating a sizeable medium-term solvability risk when a significant number of loans whose amortisation has been deferred for many years will fall due. In the meantime, those mortgages have to be financed mainly through a heavy dependence on wholesale markets, which creates liquidity risks for banks.

After assessing the challenges arising from a large banking sector and the linkages between households' and banks' simultaneous deleveraging, this chapter analyses how to make the banking sector more resilient and encourage household debt reduction.

The banking system remains fragile and is exposed to high household indebtedness

The banking sector still bears the scars of the 2008-09 crisis

Banks continue to rely on state support

The Dutch financial sector was severely affected by the 2008-09 crisis. As a consequence, government intervention during the early stage of the crisis was substantial (OECD, 2010), involving equity injections with voting and non-voting rights (EUR 20 billion or 3.5% of GDP) and liquidity measures and guarantees (EUR 200 billion or 35% of GDP). As of today, the government still holds a substantial stake in most banks. The government owns EUR 2.25 billion of non-voting core capital securities at ING, ABN AMRO is

98%-controlled by the government and SNS Reaal was liable for EUR 850 million of public capital received in 2008, at the time of its nationalisation on 1 February 2013.

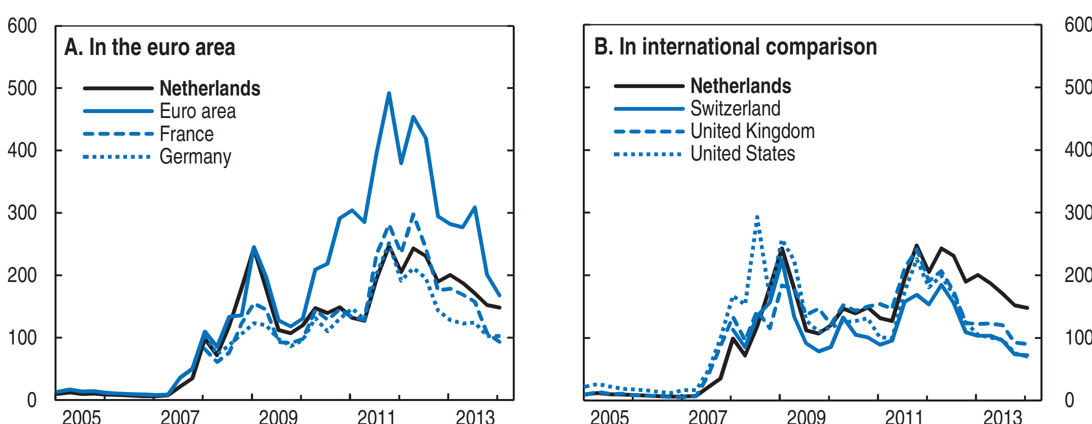
Government support is being gradually reduced, as disposal of impaired assets, restructuring and divestment are ongoing. Several financial institutions have repaid capital injections to the government through capital issuance and the sale of foreign operations. The bailout of the financial sector had increased gross public debt by around 15% of gross domestic product (GDP), but two-thirds of the costs have been recovered (IMF, 2013a). Contingent liabilities linked to the financial sector are expected to be scaled down to approximately 30% of GDP in 2014 (Ministry of Finance, 2013a). The government is developing a timetable that will determine its gradual exit from banks' ownership which would be a step in the right direction. ABN AMRO is planned to be privatised in 2015.

Banks' reliance on wholesale funding is still high

Dutch banks continue to depend heavily on international capital markets to fund their assets. Risk-free interest rates have dropped, but risk premiums facing banks have increased and have become more volatile (Figure 1.1). Credit default swap spreads on senior debt do not seem high in international comparison, but the exposure of Dutch banks to refinancing risks is large as they combine among the highest loan-to-deposit ratios and levels of external bank debt in the OECD (Figure 1.2). In particular, short-term external liabilities of Dutch banks are about 45% of GDP. Moreover, Dutch banks also face growing regulatory barriers to attract foreign deposits (Jansen et al., 2013).

Figure 1.1. **Risk premiums on market funding have become more costly and volatile**

Credit default swap (CDS) spreads of banking sectors, basis points[1]



1. Five-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve. Quarterly data calculated as the unweighted average of end-of-month figures. Figures for the Netherlands are calculated as the unweighted average of CDS spreads of four banks: SNS Bank, ING Bank, Rabobank and ABN AMRO.

Source: Datastream.

StatLink http://dx.doi.org/10.1787/888933029527

Prudential ratios are not that strong

Progress has been made to strengthen bank capital since the outset of the crisis. Yet, international comparison can currently only be made on the Basel II basis and regulatory ratios of total and Tier 1 capital to risk-weighted assets are not comparatively strong on

Figure 1.2. **Dependence on market funding remains high**

A. Loan-to-deposit ratios
Per cent, 2012[1]

B. External bank debt
Per cent of GDP, third quarter of 2013[2]

1. Ratio of loans and receivables including finance leases to total deposits other than from credit institutions. Data refer to domestic banking groups and stand-alone banks.
2. Total international debt liabilities and international debt liabilities with residual maturity below one year towards BIS reporting banks. The OECD aggregate excludes Luxembourg.

Source: ECB (2014), "Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, March and BIS (2014), "Consolidated Banking Statistics", *BIS Statistics*, Bank for International Settlements, March.

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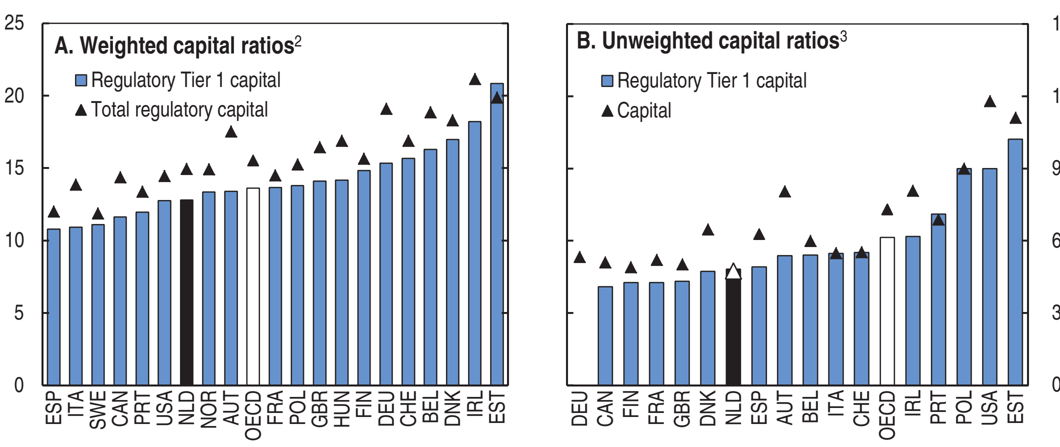
this account (Figure 1.3, Panel A). Also, unweighted measures of capital ratios (or leverage ratios) are lower than in many other countries (Figure 1.3, Panel B). According to the central bank (De Nederlandsche Bank, DNB), Dutch banks are making significant progress in the implementation of Basel III standards, which will be gradually introduced between 2014 and 2019. Based on end-state definition to be fully applicable in 2019, core Tier 1 ratio was at 11.5% in the Netherlands in the second half of 2012 and the leverage ratio was around

Figure 1.3. **Capital ratios in the banking sector are comparatively low**

Per cent, third quarter of 2013[1]



1. Or latest quarter available. 2012 for Switzerland. Regulatory capital compiled in accordance with the guidelines of Basel II (except for the United States where Basel I is applied). For France there is no information available on Basel standards. The banking sector covers banks and other deposit takers (units engaging in financial intermediation as a principal activity).
2. Capital to risk-weighted assets. The OECD aggregate covers 30 countries.
3. Capital to total assets that are not risk weighted. Capital is measured as total capital and reserves as reported in the sectoral balance sheet. The OECD aggregate covers 29 countries for regulatory Tier 1 capital and 26 for capital.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, March.

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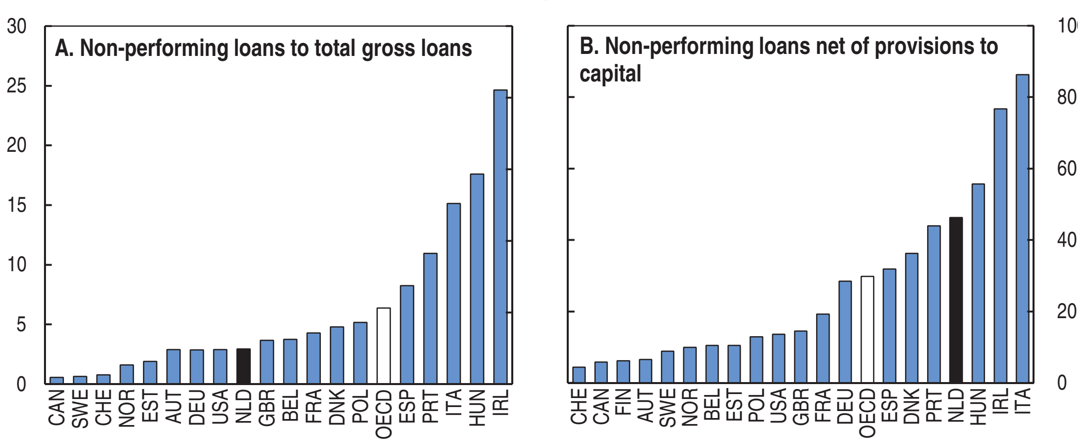
3.5% (DNB, 2013a). Yet, the Dutch banking sector still has a long way to go to meet all capital requirements, including over 2% of GDP of net additional capital (DNB, 2014). Beyond asset composition driving a wedge between risk-adjusted and unadjusted capital positions, there is evidence of cross-country and cross-bank heterogeneity in banks' average risk weights driven by bank and supervisory practices (BIS, 2013a).

The level of non-performing loans (NPLs) is not very high (Figure 1.4, Panel A). Yet the amount of provisions made relative to the value of non-performing loans and bank capital is relatively low. Provisions are such that banks' capital would be cut by half to absorb losses in case all NPLs were fully written off in the worst case scenario and notwithstanding the value of banks' collateral (Figure 1.4, Panel B). This is an indication of a rather low capacity of banks to withstand losses from NPLs. Coverage ratios, measuring loan loss provisions as a percentage of NPLs, have been flat at around 35% and are ten percentage points lower than the median of ratios in the euro area (ECB, 2013a). Moreover, a low incidence of loans in arrears could be underestimated, notably because there is no uniform definition of NPLs. A lack of harmonised definition is also a broader issue in the euro area which is being addressed by the European Banking Authority so as a new definition of NPLs is used in the asset quality review of the European Central Bank (ECB).

Figure 1.4. **Financial buffers to absorb losses from non-performing loans are relatively weak**

Per cent, third quarter of 2013[1]



1. Or latest quarter available. 2012 for Germany and Switzerland. The OECD aggregate covers 29 countries in Panel A and 30 in Panel B.

Source: IMF (2014), *Financial Soundness Indicators* (database), International Monetary Fund, March.

How to read this figure: Potential reduction of banks' capital to absorb losses assuming that all non-performing loans net of loan-loss provisions are written off.

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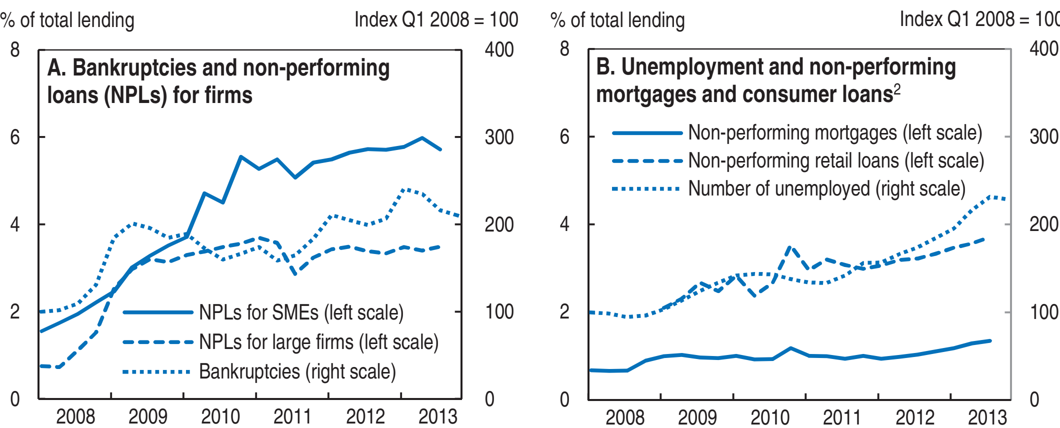
The banking sector is facing new risks

The weak economy is increasing non-performing loans

Corporate defaults in the non-financial sector and growing unemployment are weighing on banks' balance sheets. NPLs have steadily increased for small and medium-sized enterprises (SMEs) to about 6% and NPLs for large companies have been broadly flat at around 3.5% since mid-2009 (Figure 1.5, Panel A). NPLs for residential mortgages have remained at a low level of close to 1% when unemployment has more than doubled

(Figure 1.5, Panel B). However, households have had more difficulties to service their consumer debt. A lower debt service burden as interest rates have dropped, a low amortisation of mortgages and generous social safety nets could have helped to withstand the downturn. Another complementary explanation is that perhaps problem loans could be underestimated, notably because there is no uniform definition of NPLs.

Figure 1.5. **The crisis is weakening banks' balance sheets**[1]



1. Data on non-performing loans (NPLs) is based on a sample of large banks. NPLs are defined as loans with payment arrears of at least 90 days. NPLs for large firms include commercial property loans and exclude small and medium-sized enterprises (SMEs). Bankruptcies refer to businesses and institutions (i.e. single-owner companies and trading partnerships). For bankruptcies data from third quarter of 2012 onwards are provisional.
2. Residential mortgages.

Source: De Nederlandsche Bank, Statistics Netherlands (2014), "Security and Justice", *Statline*, March and OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), March.

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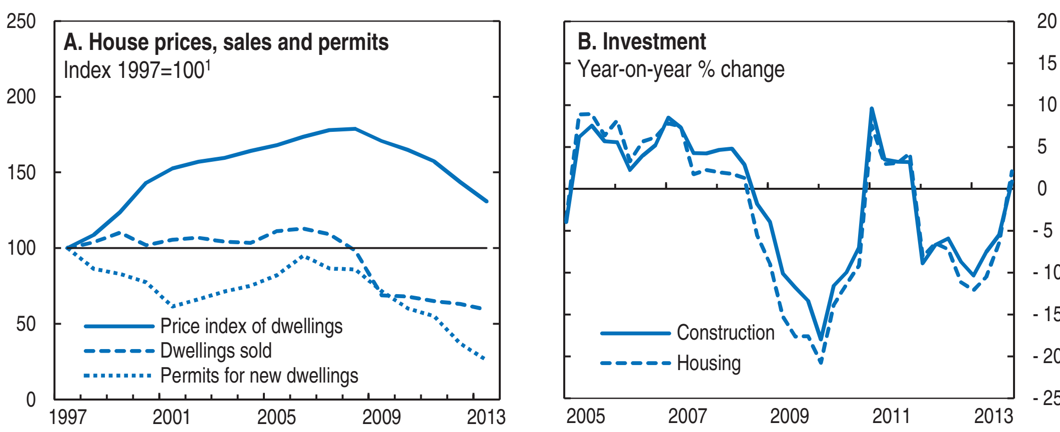
Household repayment difficulties could be expected to rise

Despite low NPLs, mortgages with payment difficulties have been trending upwards. According to the Dutch Credit Registration Office (BKR), the number of mortgages in arrears by 120 days or more reached almost 92 000 in October 2013 and increased by 13% over the previous six months. The number of calls on the National Mortgage Guarantee (NHG) scheme – which insures a fifth of mortgages against residual claims left after a sale of a property in case of unemployment, disability, divorce or death of partner – rose from less than 1 000 to 4 500 between 2008 and 2013. Forced sales have so far been contained at around 2 000 to 2 500 per year. However, according to the BKR some 740 000 people have had debt repayment problems based on data published in January 2014. Of around 8.5 million people in the credit register, close to 8.5% were falling behind payment schedules by at least two months. This suggests that growing payment difficulties on consumer loans could feed into mortgage loans at some point.

Defaults have been contained so far but a large number of them cannot be excluded if economic conditions deteriorate further and households with negative home equity change behaviour (IMF, 2013b). House prices peaked in August 2008 and have been continuously falling since then. From peak, the fall in nominal terms has reached 20% while the fall in real terms is nearly 30%. Around 35% of all homeowners and 40% of households with a mortgage – mostly young people who bought their dwellings over the past decade – now have negative home equity due to falling house prices and high loan-to-value ratios on their

mortgages. Despite some signs of stabilisation, the housing market is at depressed levels (Figure 1.6). While being rough indicators as they do not include the cost of capital, price-to-rent and price-to-income ratios suggest that additional downward price adjustment cannot be excluded (Figure 1.7). Exposure to changes in interest rates is high. In 2008, around half of all mortgages had a remaining fixed interest period of four years or less, reflecting the fact that around 70% of borrowers tended to fix the interest rate for a maximum period of 10 years (DNB, 2009). A hike in the policy rate by 300 basis points rate would increase the median debt service-to-net income ratio to nearly 25% and more than a fourth of households would face a high ratio in excess of 40% (ECB, 2013b).

Figure 1.6. **The housing market is depressed**



1. Price index of dwellings is deflated by consumer prices. Data refer to existing own homes except for permits.
Source: Statistics Netherlands (2014), "Construction and Housing", *Statline*, March and OECD (2014), *OECD Economic Outlook: Statistics and Projections* (database), April.

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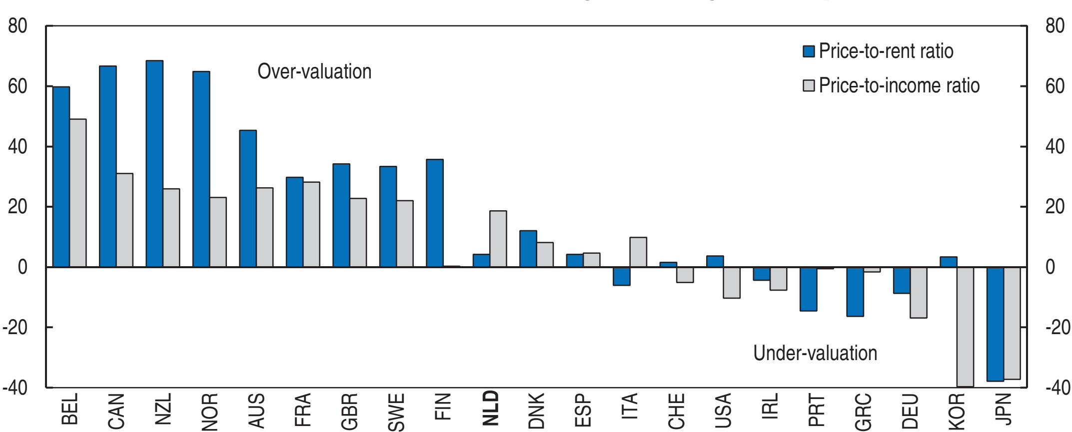
Figure 1.7. **House prices in relation to incomes and rents across the OECD**

Per cent of over or under-valuation relative to long-term averages, fourth quarter of 2013[1]



1. Third quarter of 2013 for Belgium, Italy, Japan and New Zealand. Countries are ranked by the average of the two indicators, from highest to lowest. The long-term average covers the period from 1980 (or earliest available date) to the latest available quarter.
Source: OECD (2014), *OECD Housing Prices Database*, Economics Department, April.

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Higher risks lie ahead when interest-only mortgages will fall due

The low ratio of NPLs for mortgages is due to the fact that many of these loans are not regularly amortised for a long period, typically 30 years. These mortgages could become non-performing when borrowers have to pay the principal and are unable to do so. There are several types of mortgage products in the Netherlands. Around 35% of outstanding mortgages are 100% "interest-only" loans. They do not have any mechanism attached for the build-up of the principal, which has to be repaid in full only at maturity once a deferment period expires. Approximately 25% are savings-based mortgages that are linked to a savings account in a bank or an insurance company to accumulate the principal that needs to be redeemed at maturity, although there is no regular amortisation. There are only 5% of mortgages subject to regular (linear or annuity) amortisation. Finally, nearly 35% of outstanding mortgages combine two or more products, for instance may have a 50% part linked to a savings account in a bank or an insurance company for the accumulation the principal, and a 50% part which is "interest-only". Given the mortgage product mix, it is estimated by the DNB that *de facto* around 55% of the overall loan portfolio is "interest-only", against less than 10% in the mid-1990s, and that the share of loans linked to a savings account with a lump sum repayment of the principal reached 30% in 2012 (Figure 1.8). At the same time, the market share of regularly amortising mortgages fell from 50% to 15%.

Figure 1.8. **Market share of mortgages with deferred amortisation has expanded sharply**

Per cent of total[1]

1. Unit based mortgages were zero in 1994.

Source: De Nederlandsche Bank.

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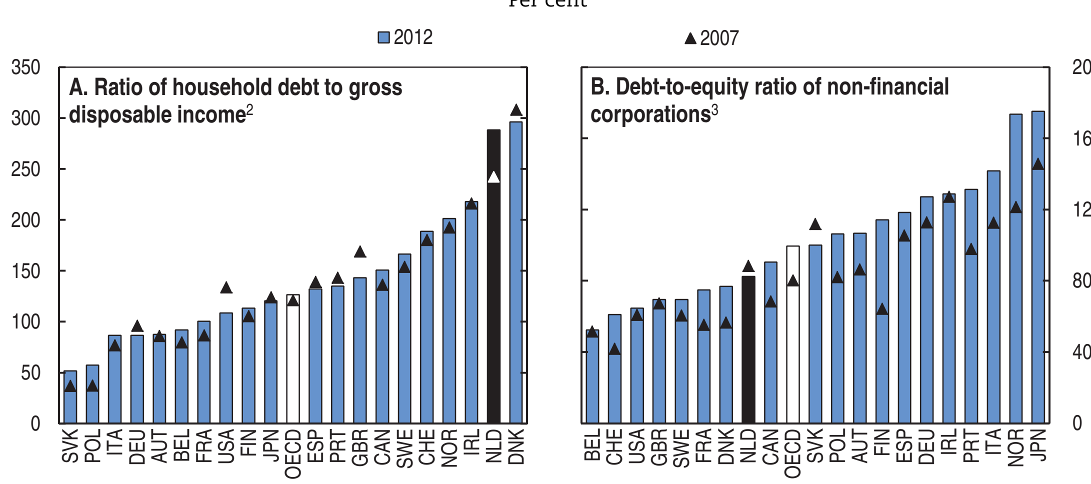
According to the DNB, many households are not accumulating equity sufficiently to pay back their mortgage debt (DNB, 2012; IMF, 2011a). This applies to interest-only, but also to savings-based mortgages. This is corroborated by negative voluntary (made on the top of mandatory contributions to pension funds) household saving ratios since 2003. Interest-only mortgages, also a concern in the Nordic countries (IMF, 2013c), blunt the amortising behaviour, may exploit borrowers' short-sightedness and their gaps in financial literacy and create macro-prudential risks. The share of maturing interest-only portfolio will begin to rise sharply in 2025. As a result, households' difficulties to repay their mortgage capital

could expose banks to significant losses, even though risks are lower for elderly borrowers who have high net wealth. The total exposure of the Dutch banking sector to mortgage loans accounts for close to 30% of total banks' balance sheets. Household gross debt has risen to historically high levels, reaching nearly 290% of disposable income and almost 130% of GDP in 2012. This contrasts with a more contained indebtedness of the non-financial corporate sector (Figure 1.9). Mortgage growth has continued at a decelerating pace during the crisis. The ratio of household debt to gross disposable income increased by almost 50 percentage points between 2007 and 2012, while the ratios were constant or dropped in other OECD countries.

Figure 1.9. **Debt of households and non-financial corporations**

Per cent[1]



1. Debt is calculated as the sum of the following liability categories, whenever available/applicable: currency and deposits, securities other than shares, except financial derivatives, loans, insurance technical reserves and other accounts payable. Non-consolidated data from financial balance sheets.
2. Debt of households including non-profit institutions serving households. The OECD aggregate covers 29 countries. 2011 instead of 2012 for Japan and Switzerland. 2010 instead of 2012 for Canada.
3. Debt as a percentage of shares and other equity. This indicator measures the financial leverage or the extent to which activities are financed out of their own funds. The OECD aggregate covers 31 countries. 2011 instead of 2012 for Japan and Switzerland.

Source: OECD (2014), *OECD National Accounts Statistics* (database), March.

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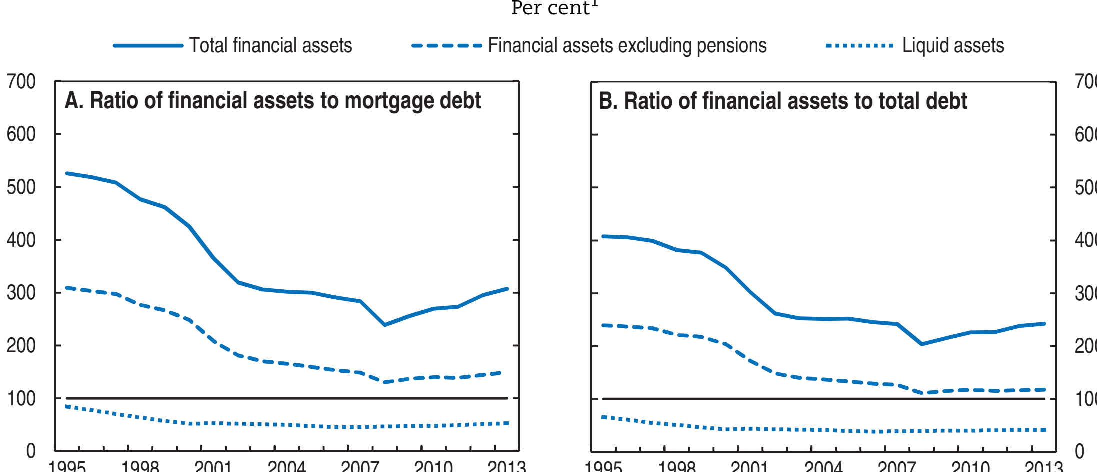
The key issue is whether households will have saved enough money to repay the capital. Currently, full redemption at maturity is not guaranteed because the borrower is not obliged to accumulate sufficient capital to pay back the mortgage. In principle, households can build up earmarked savings to repay the principal. However, given interest rate and stock market developments over the past decade and uncertainties surrounding future developments, incentives to step up savings could be low. On the other hand, redemptions have somewhat increased more recently driven by lower interest rates on saving accounts and a cancellation of penalties for early repayments. Tax incentives for savings products have also aimed to offset negative effects of mortgage interest deductibility on principal accumulation, further weighing on the public purse. For instance, since 2007, capital accumulation via bank savings accounts has been encouraged through tax exemptions, which had been allowed only for insurance products previously. Lately, the authorities have adopted additional tax reliefs to encourage the repayment of existing mortgage debt. The interest on residual mortgage debt left after a sale of a

dwelling has been made tax-deductible for up to ten years and the limit for tax-free gifts for house purposes, including for debt repayment, increased to EUR 100 000. However, these measures are not targeted to borrowers most in need and can be also viewed as a way to indirectly "bail-out" borrowers at the cost of the taxpayer.

Alternatively, households could use their accumulated wealth to repay the capital falling due. They have significant assets on average, but their composition and distribution reveal that they cannot easily be used to repay debt. *First*, the composition of assets has become more illiquid over time (Figure 1.10). Notwithstanding property assets, overall financial assets still largely exceed liabilities. Yet when housing and pension assets are excluded, remaining assets exceed debt only marginally. Liquid assets to make an early repayment of debt or to offset potential increases in debt servicing costs are low, also internationally (IMF, 2013c).

Figure 1.10. **Household balance sheets have become more stretched**

Per cent[1]



1. Figures from 2011 onwards are provisional. Financial assets include savings and other deposits, shares and other equities, the net equity of households in the pension funds reserves of resident pension funds and life insurance companies as well as the net equity of households in the life insurance reserves of resident and non-resident pension funds and life insurance companies. Liquid assets refer to savings deposits and other deposits that are all the savings of individuals and deposits (in euros and foreign currency) at any resident and non-resident bank, which are not immediately transferable without restrictions.

Source: Statistics Netherlands (2014), "Macroeconomics: Sector accounts", *Statline*, April.

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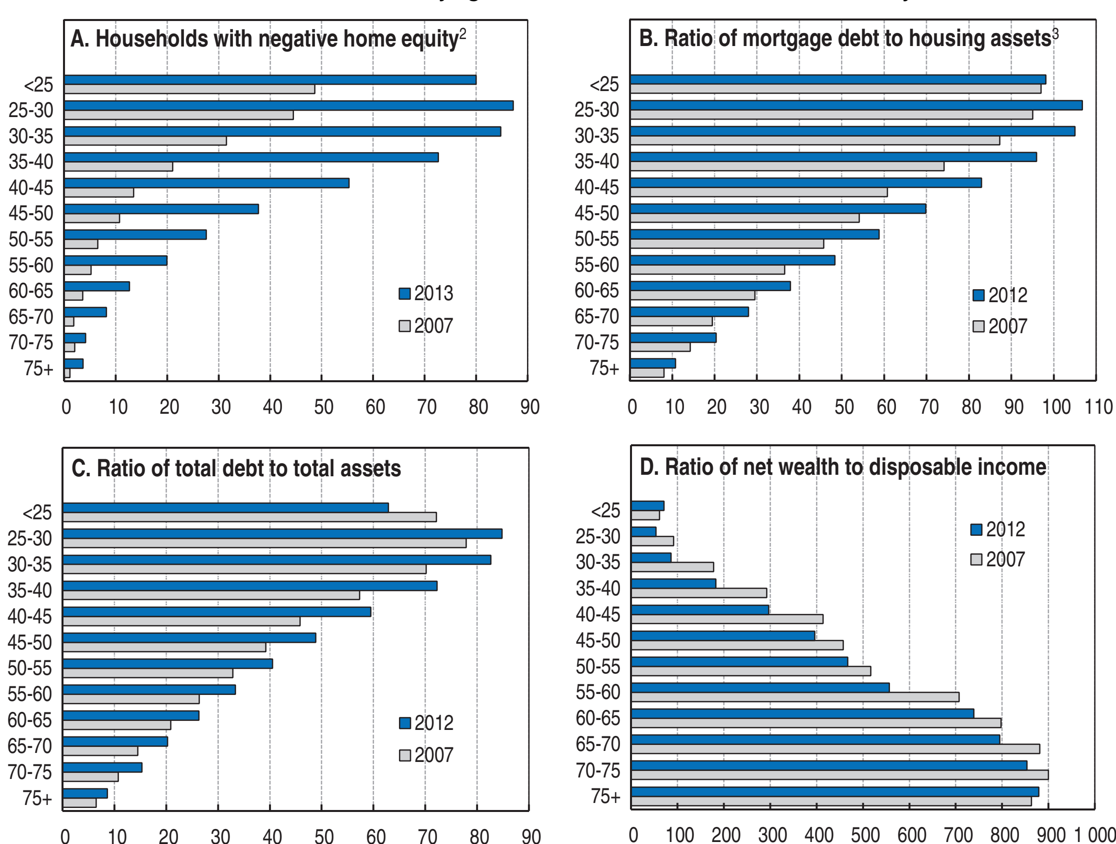
Second, the distribution of assets shows that young and prime-age households are particularly exposed to adverse developments in the housing market, and risks have increased since the beginning of the crisis. The share of debtors aged below 35 with negative home equity was above 70% on 1 January 2013, latest data available (Figure 1.11, Panel A). Since then, nominal house prices have fallen by only 0.5%. For borrowers aged between 25 and 35, the total value of mortgage debt was higher than the corresponding value of housing assets (Figure 1.11, Panel B). Total debt-to-assets ratios were high (Figure 1.11, Panel C) and net wealth as a share of disposable income was low (Figure 1.11, Panel D) for the young, and the opposite was true for seniors (pension assets are disregarded in both cases as relevant data by age are unavailable).

Figure 1.11. **Risks are concentrated among young and prime-age households**

Per cent of households by age of the main breadwinner, data at 1 January[1]



1. Assets include current and saving accounts, bonds and stocks, own-home, business assets and other possessions, but exclude pension assets as relevant data by age are unavailable. Figures from 2012 onwards are provisional.
2. Home-owning households with a mortgage.
3. Housing assets refer to property owned and used as a main residence. Mortgage debt is associated with home ownership and represents the value of the debt on which interest is payable.

Source: Statistics Netherlands (2014), "Income and Spending", *Statline*, March.

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Making the banking sector more resilient

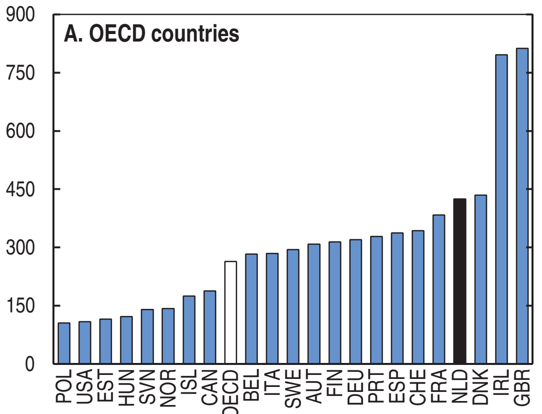
Reducing risks from a large and concentrated banking sector

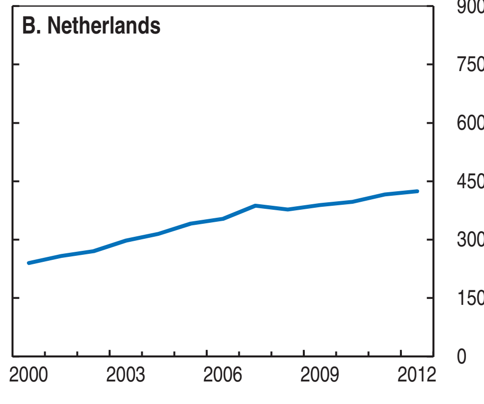
In the case of another financial crisis, the Netherlands would be particularly exposed as its banking sector is one of the largest in the OECD. Total assets are above 400% of GDP based on national account data (Figure 1.12), with assets of special purpose vehicles (involved heavily in mortgage lending via securitisation) amounting to 50% of GDP at the end of 2012. A vulnerable, large and concentrated banking sector threatens the taxpayer through bailouts. Moreover, the nature of financial deepening in the Netherlands – related to international exposure, a shadow banking sector and mortgage lending – could explain potential risks related to the large financial sector.

The Dutch authorities have encouraged the development of the Netherlands as an international financial centre. The value-added of this sector amounts to almost 8% of the GDP and is even higher now than in the pre-crisis period (Figure 1.13). While some business operations are justified by the fact that banks have continued to serve large multinational Dutch companies abroad (Schoenmaker and Werkhoven, 2013), this explains only a small

Figure 1.12. **The large banking sector poses systemic risks**

Total assets in per cent of GDP, 2012[1]





1. Figures for Germany, Ireland, Italy, Poland and United Kingdom also include central bank assets. The OECD aggregate covers 31 countries. 2011 for Switzerland. Non-consolidated data from financial balance sheets.

Source: OECD (2014), *OECD National Accounts Statistics* (database), March.

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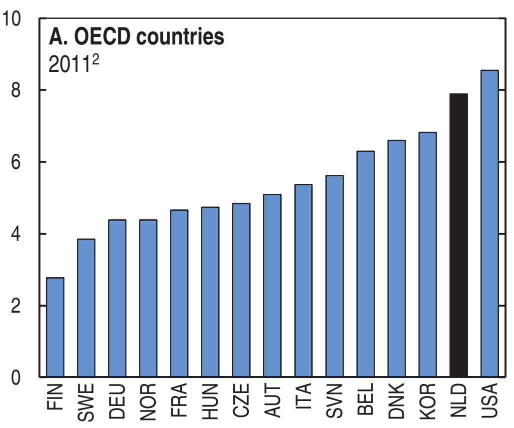
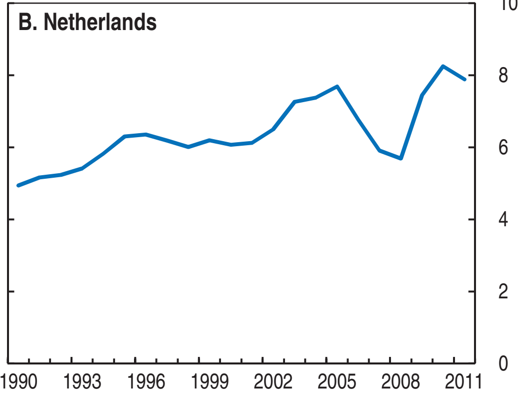
part of the growth in international activities. Financial internationalisation has proven to be profitable in the short-run, but it has led to an extensive exposure to cross-border risks. Liquidity risks were high as banks relied on short-term funding, such as *inter alia* funding by the US money market funds (Fitch Ratings, 2013).

Figure 1.13. **Value added of the financial sector**

Value added share relative to the total economy[1]





1. Financial sector covers financial and insurance activities (including activities auxiliary to financial service and insurance activities) based on the International Standard Industrial Classification of all economic activities, Revision 4 (ISIC Rev. 4).
2. 2010 for Hungary, Korea, Slovenia and United States.

Source: OECD (2014), *STAN: OECD Structural Analysis Statistics* (database), March.

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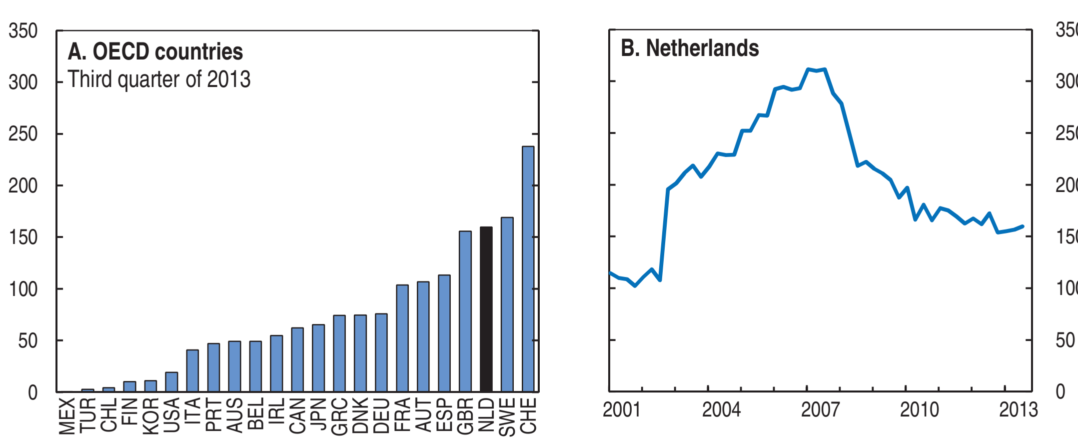
Foreign claims of Dutch banks (which include claims of their foreign subsidiaries) have declined from a peak of 300% of GDP in 2007 to 150% in 2013 (Figure 1.14). Therefore, currency mismatches of Dutch banks have been significantly reduced. US money market

funds, the largest suppliers of dollar funding to non-US banks, have experienced a run in the wake of the Lehman collapse and a "quiet run" (slower and longer withdrawal of funds) during the euro-crisis in 2011. The latter led to a sharp decline of their exposure to Dutch banks, which nevertheless managed to attract USD funding via other channels (Baba et al., 2009; Chernenko and Sunderam, 2012). Money market funds have returned to Netherlands and other core countries in the euro area at the end of 2013, but this means a renewed reliance on short-term funding for Dutch banks. In September 2013, liabilities of Dutch banks on a consolidated basis to the US money market funds amounted to EUR 20 billion or 30% of total liabilities to the United States on a non-consolidated basis (consolidated data is not available).

Figure 1.14. **Foreign claims of banks are large but have been reduced by half**

Per cent of GDP[1]



1. The BIS consolidated banking statistics (on the immediate borrower basis) report banks' on-balance-sheet financial claims on the rest of the world and provide a measure of the risk exposure of lenders' national banking systems.

Source: BIS (2014), "Consolidated Banking Statistics", *BIS Statistics*, Bank for International Settlements, March.

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The large size of the Dutch banking sector is also explained by a close interconnectedness with the large shadow banking sector. According to the Financial Stability Board (FSB, 2012), the Dutch shadow banking sector (defined as non-bank financial institutions that cannot be categorised as insurance corporations, pension funds or public sector financial entities) amounts to 490% of GDP, one of the highest shares in the OECD. Almost two thirds of these assets comprise special financial institutions (SFIs) that are typically owned by foreign multinationals to attract external funding and facilitate intra-group transactions (Figure 1.15). An important reason for their existence is tax planning, which is reflected in a low implicit corporate income tax rate as the Netherlands has notably an extensive tax treaty network. A large share of SFIs is non-financial institutions and is assessed by the central bank to have a low shadow banking content (Broos et al., 2012). Nevertheless, there could still be some interconnectedness between the rest of the shadow banking sector and banks as the latter have large claims on non-bank financial intermediaries (almost 20% of banks' assets) and also depend on them for funding (10% of liabilities). This can potentially lead to a transmission of shocks between the two sectors and this risk has increased since the global crisis as interconnectedness has further intensified (FSB, 2012).

Figure 1.15. **Structure of the shadow banking sector**

Per cent of total size of other financial intermediaries, end 2011[1]

1. Provisional data. Figures for non-financial and financial SFIs are estimates based on data from 2010. For SFIs the provisional total figure published by Statistics Netherlands for 2011 is EUR 2 028 billion. SFIs are established by foreign multinational corporations for the purpose of channelling financial assets from one country to another. The criteria applied to definition of SFIs include whether the entity is domiciled in the Netherlands, has a predominantly foreign shareholder base and has a balance sheet consisting primarily of channelled funds. Other includes money market funds, finance companies, hedge funds, private equity and investment firms among others.

Source: M. Menno Broos, K. Carlier, J. Kakes and E. Klaaijsen (2012), "Shadow Banking: An Exploratory Study for the Netherlands", *DNB Occasional Studies*, Vol. 10, No. 5, De Nederlandsche Bank.

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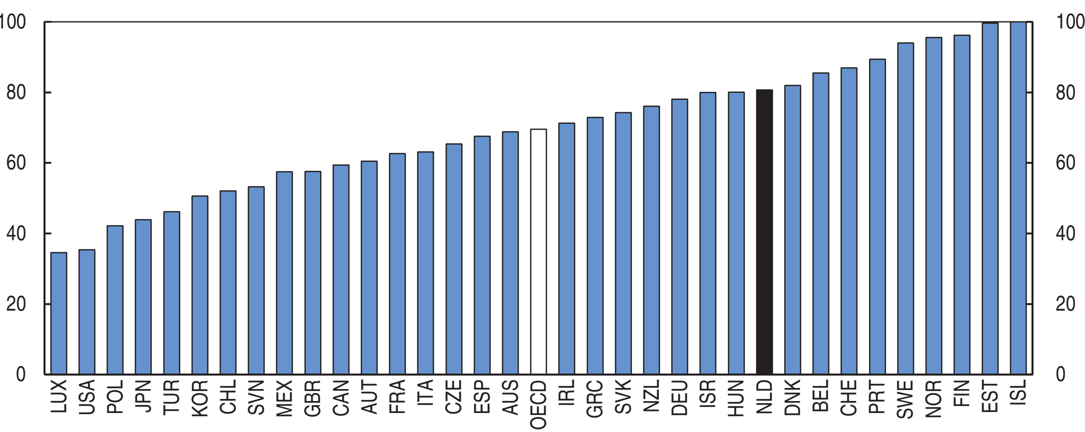
The banking system is also very concentrated (Figure 1.16). The four largest banks – ABN AMRO, ING, Rabobank and SNS Reaal – account for 80% of assets and are all classified as systemically important by the regulator. Moreover, the first three of them belong to 39 major cross-border European banks and the largest bank, ING (with a total value of assets of about 160% of GDP), is among the 29 systemically important financial institutions worldwide. The existence of such systemically important institutions poses risks because their disorderly failure would cause significant disruption to the wider financial system. Consequently, they have benefited from implicit government guarantees (that are acknowledged by rating agencies that document the highest level of state support), allowing them to have simultaneously lower capital buffers and lower funding costs. This distorts the level playing field by providing big banks with a comparative advantage over smaller institutions, hence creating incentives to grow even bigger.

Household credit constitutes more than 60% of overall bank credit, which has led to one of the highest levels of household indebtedness in the OECD. Spurred by generous interest rate deductibility, state guarantees and lenient lending practices related to insufficient consumer protection, such credit supply might have been achieved at the expense of servicing the domestic enterprise sector. Although further empirical evidence is needed, it appears that as banks had been allocating more lending to households and comparatively less to the corporate sector, the contribution of total factor productivity (TFP) to potential output growth fell in many OECD countries in the run-up to the crisis (Figure 1.17). In the Netherlands, this contribution turned around at the end of the 1990s when the housing market started to overheat and house prices exceeded long-term averages in relation to incomes and rents.

Figure 1.16. **Concentration of the banking sector**

Assets of three largest banks as a share of assets of all commercial banks, per cent, 2011[1]



1. 2007 for Chile.

Source: World Bank (2014), *Global Financial Development* (database), March.

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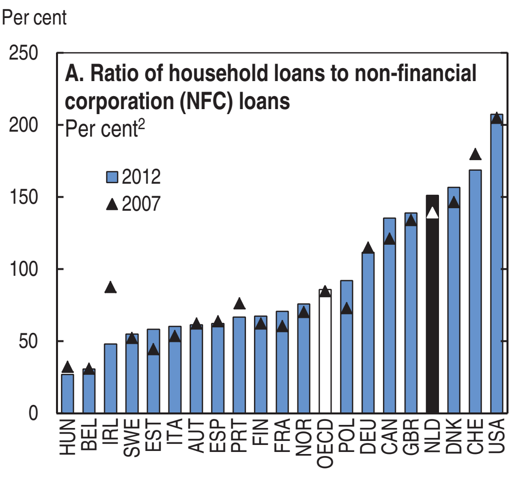
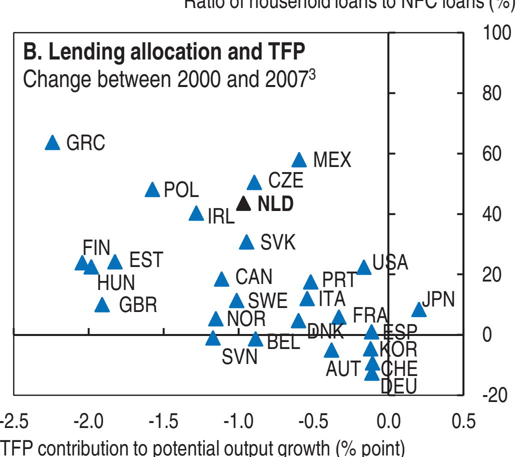
Figure 1.17. **The allocation of lending has been skewed towards households**[1]





1. Households include non-profit institutions serving households. Ratio of household loans to NFC loans is non-consolidated data from financial balance sheets. TFP: Total factor productivity.
2. The OECD aggregate covers 29 countries. 2011 instead of 2012 for Switzerland.
3. 2002-07 for Estonia and Korea. 2001-07 for Ireland and Slovenia.

Source: OECD (2014), *OECD National Accounts Statistics* and *OECD Economic Outlook: Statistics and Projections* (databases), March.

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Empirical research shows that to be beneficial for growth, financial deepening has to operate via enterprise credit and not household debt (Beck et al., 2012; Chakraborty et al., 2013). In addition, while the availability of finance is crucial for economic growth, an oversized financial sector could have no effect or even a negative impact on economic activity (Aghion et al., 2005; Arcand et al., 2012). Recent empirical literature on finance and growth suggests that there are decreasing returns to financial development and that policymakers should focus on lending to firms instead of consumers (Bijlsma and Mocking, 2014). Yet, on the other hand, higher homeownership rates and housing consumption could also raise households' wellbeing.

Several approaches to breaking the link between "too big to fail" banks and low capital ratios are currently being discussed in the Netherlands and internationally. Conceptually, the solution can be achieved via three complementary reforms: i) increasing of capital requirements for large banks to minimise the probability of their failure and to ensure that they internalise the costs of systemic risks related to their liquidation; ii) restricting the business scope of systemically critical institutions by separating their investment divisions; and iii) establishment of a framework that allows an orderly resolution of large institutions.

Accumulating higher capital buffers to internalise and absorb risks

The authorities plan to phase in new capital requirements between 2014 and 2019, which consist of Basel III regulations and the EU Capital Requirements Directive IV. In terms of risk-weighted assets, this includes a minimum total capital ratio of 8%, a 2.5% conservation buffer (in form of Common Equity Tier 1 [CET 1] capital), a 0-2.5% countercyclical buffer (in form of CET 1) and a systemic important bank (SIB) buffer of up to 3% (in form of CET 1). The DNB is considering a countercyclical buffer of 0-2.5% and a SIB buffer of 1-3% of risk-weighted assets (DNB, 2013b). A 1% Pillar 2 surcharge is also planned. Overall, this would lead to a total required capital ratio for systemic banks of 15 to 17% in good times and 12.5 to 14.5% in bad times.

New capital standards could be further strengthened by ensuring a maximum implementation of the SIB buffer of 3% for key banks. Yet a stronger buffer could be envisaged as well, reflecting the vulnerability of the economy to banks' size, concentration, international exposure and reliance on short-term funding. This would be in line with new regulations in Switzerland and Sweden, two other OECD countries that are home to large international banking industries and that are opting for high capital standards. The two largest Swiss banks are required to hold 19% capital (Tier 1 and Tier 2). The Riksbank recommends that four major Swedish banks should hold 12% of the CET 1 capital from 1 January 2015 and this requirement will increase when countercyclical buffers are triggered (Sveriges Riksbank, 2013).

The calculation of risk-weighted capital ratios relies on internal models that are bank specific and riddled with uncertainty (BIS, 2013a). Experts argue that international banks engage in lowering risk weights for some classes of assets, which improves regulatory capital adequacy ratios but undermines banks' resilience to losses (Haldane, 2011; Alloway, 2011). The DNB also finds wide disparities between the risk-weighted assets as banks tend to give different weightings to credit risks, even when they involve the same types of loan to the same counterparties. Moreover, internal bank models could be difficult to assess because the DNB does not have access to household credit registry data and because enterprise credit registry data is not collected. To address problems related to risk weights, the DNB conducts theme-based research on risk-weighting and model assessment and requires banks to harmonise their risk weights. Beyond Basel rules, it could additionally require banks to apply higher and floor risk weights for some assets classes deserving special attention. For example, risk weight for mortgages have recently been proposed to be raised from 0.15 to 0.25 in Sweden, which should create incentives for banks to issue loans with lower loan-to-value (LTV) ratios as otherwise banks will need to strengthen their capital to sustain lending.

In its "Banking vision paper" the Dutch government proposes to introduce a 4% leverage ratio for systemically important financial institutions (Government of the

Netherlands, 2013a) and the Netherlands is the first euro area country doing it. This is a welcome step, but current discussions at the international level on the definition of the leverage ratio need to be taken into account when defining its appropriate level. An ambitious leverage ratio is justified given the size of the largest banks, and would ensure that banks do not circumvent capital requirements. This would also mitigate errors related to models and new products for which risk weights are not precise (Blundell-Wignall and Roulet, 2013). Importantly, the denominator of the leverage ratio should include not only total assets but also off-balance sheet items. While a 5% leverage ratio would require 4.5% of GDP of additional capital (OECD, 2013a), it would bring Dutch banks closer to the OECD average leverage ratio of 6% for Tier 1 capital (Figure 1.3, Panel A). The US regulator has proposed that the eight largest banks hold a 3% supplementary leverage ratio (equity divided by assets) on top of the 3% minimum ratio required of smaller banks. Polish banks are required to have a leverage ratio of 9% before distributing dividends. In Switzerland, there is a discussion to increase the leverage ratio from 5% to 6-10% for the two largest banks. Indeed, several academic experts advise leverage ratios of at least 9-10% (Admati, et al. 2010; Ratnovski, 2013). Finally, leverage ratios of 10-20% have been common for Dutch banks for most of the 20th century, before the start of deregulation in the 1970s, without compromising the supply of credit (Berben et al., 2010).

Despite having a beneficial effect on banks' refinancing costs, a higher capitalisation of banks could have a potential negative impact on growth in the short term if banks reduce lending rather than raise the level of capital. Banks' funding costs were insensitive to their level of capital before the crisis, the crisis has strengthened market discipline and currently banks with higher capital buffers enjoy lower funding costs (Admati et al., 2010; Bank of England, 2013). There is some evidence that during the 20th century, there was no relationship between the level of capital on the one hand, and loan pricing and loan growth on the other (*The Economist*, 2012). Simulations by the Bank for International Settlements (BIS) indicate that each one percentage point increase in the capital ratio raises loan spreads by 13 basis points, but the net impact on growth is positive in the medium term due to enhanced resilience of the financial sector and lower crisis probability (BIS, 2010). Similar effects are found for the Netherlands by Berben et al. (2010).

Capital buffers should be raised by increasing the level of capital rather than by scaling back lending. Issuance of shares and increased retained earnings through lower dividend distribution and reduction of costs should bolster high-quality capital. In particular, there is scope to reduce salaries in the banking sector (DNB, 2013b). The government is considering introducing a limit on performance-related bonuses at 20% of salary which could favour financial stability by lowering risk-taking and by encouraging a faster accumulation of capital, but banks may compensate by raising salary. Rabobank has announced a voluntary temporary freeze in pay and bonuses until 2015.

Strengthening bank balance sheets with more provisioning

In the Netherlands, provisioning for losses is made in accordance with International Accounting Standards (IAS 39), i.e. on an incurred losses basis, which does not take into account expected losses on performing or restructured loans. Under such a framework, there is a risk that provisions are insufficient. The DNB gathers detailed data to monitor the structure and quality of mortgage portfolios, but there is scope for further improvement. Like in most OECD countries, the DNB could develop an asset classification system under which banks have to report the quality of their loans and advances using a common

regulatory scale (based on number of days that loans are overdue). Accordingly, there regulator could fix minimum levels for specific or general provisions for loans and advances. The DNB could require banks to write off non-performing loans after a specified period and collect comprehensive information on the degree to which Dutch banks have written off real-estate portfolios.

Banks' exposure to the property market is extensive. The SNS Reaal bank-insurer was nationalised in early 2013 due to the high losses of SNS Bank linked to commercial real estate. The overall bank exposure to the domestic and foreign commercial property market is respectively almost EUR 80 billion and EUR 20 billion (in total around 15% of GDP or 4% of banks' total assets). The authorities have launched an in-depth asset quality review of risks attached to commercial property loans. The aim is to ensure a realistic valuation of collateral in banks' books, greater scrutiny of banks' property models and higher provisions (DNB, 2013b). These are welcome steps.

Banks' mortgage portfolios should receive the same degree of scrutiny as their commercial business. Regulatory authorities should continue to request banks to hold sufficient capital for possible losses stemming from rising unemployment, the high share of households with negative home equity, large sensitivity to interest rate shocks and low mortgage amortisation. New international accounting standards (IFRS 9) are not yet enforced, but banks may also choose to apply them as of now, notably the new impairment methodology based on the expected credit loss model. For instance, Danish banks have recently been asked to boost provisions for borrowers who are unable to start amortising their mortgages.

Reducing the bank dependency on wholesale funding

To progressively shift banks' funding model towards more stable sources, several policies could be considered. Deferred-amortisation loans could be systematically linked to a bank account, but such a measure would need to be implemented progressively to prevent liquidity problems in insurance companies when households' stable assets are withdrawn. The government could consider raising the current tax on liabilities other than equity and deposits (KPMG, 2012). The small difference between the tax rates for liabilities for less and more than one year, respectively 0.044% and 0.022%, could also be increased. Continuing the restructuring of banks' balance sheets by rationalising non-core activities would also help to reduce their dependence on wholesale funding. Total loans granted to Dutch households and non-financial corporations represent only half of banks' total assets, against 80% in the mid-1990s.

The government is considering setting up a National Mortgage Institute, which would securitise part of the mortgage debt and sell it to international and national institutional investors, such as Dutch pension funds. The objective is to increase banks' funding stability, lower banks' costs and pass on this advantage to new borrowers and borrowers who renegotiate their interest rate. The government would retain the credit risk as only mortgages covered by the public National Mortgage Guarantee (NHG) guarantee scheme (which insures against residual liabilities left after a sale of a property) would be eligible. It is necessary to ensure that government's exposure to the NHG scheme (currently at 25% of GDP) does not increase further and that pension funds' decisions remain prudent in terms of return, risk and investment diversification, including internationally (total pension assets are 165% of GDP and 15% of them are already invested in the Netherlands).

Reducing risks to the banking sector by supporting household deleveraging

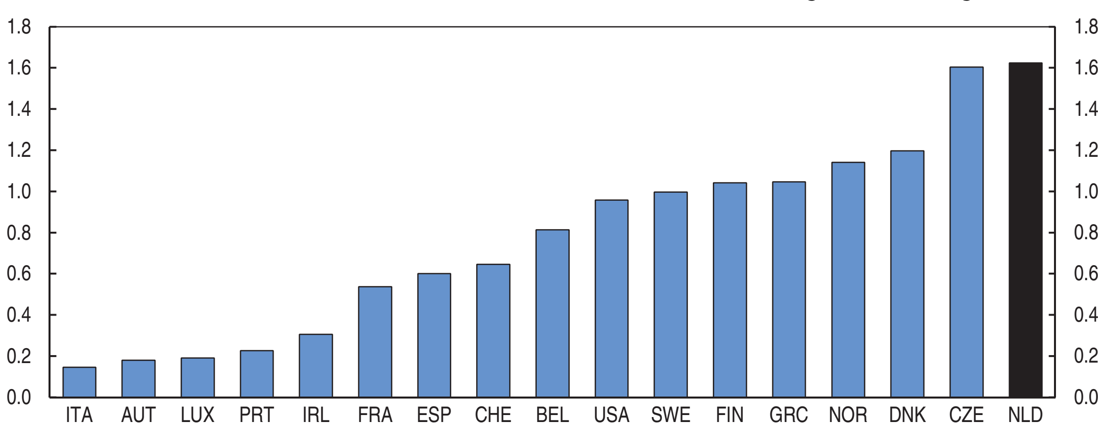
Mortgage loan delinquencies remain low, but low amortisation, rising joblessness, high sensitivity to changes in interest rates and falling house prices increase vulnerabilities as well as risks of social hardship. As discussed below, a key issue in this context for the Netherlands is to ensure a gradual deleveraging of households. Banks could be less willing to refinance borrowers with negative home equity who cannot repay their loan at maturity. Numerous repossessions could be socially and politically difficult to enforce in case of defaults, and would deepen banks' losses if large forced sales destabilise house prices.

Reducing the risk of future household over-indebtedness

Generous tax incentives for homeownership in the OECD (Figure 1.18) contributed to a simultaneous rise of house prices and household indebtedness in the run-up to the global crisis, magnifying the impact of lower interest rates and expectations of higher incomes and house prices. In fact, the rise in household indebtedness was much steeper than the rise in house prices in international comparison (Figure 1.19). Until recently, mortgage interest payments for primary residences were fully deductible from taxable income, up to a maximum period of 30 years. Deductions were not constrained in terms of amount and were worth the most for earners subject to the top marginal tax rate. Imputed rents were taxed, but at a maximum rate of only 0.6% (now at 0.7%) of the economic value for dwellings worth less than EUR 1 million (Andrews et al., 2011; Vandevyvere and Zenthöfer, 2012; OECD, 2010, 2012). These tax incentives fostered homeownership and indebtedness, including by encouraging deferred repayment of principal to enhance the tax benefit. In turn, tax breaks tended to be capitalised in house prices (Andrews et al., 2011). With rising values of collateral and growing public guarantees (NGH scheme), banks relaxed down-payment constraints and accepted ever higher LTV ratios, which for new mortgages reached 120% in 2010 (IMF, 2011a).

Figure 1.18. **Tax relief on debt financing cost of homeownership**

Difference between the market interest rate and the after-tax debt financing cost of housing, 2009[1]



1. This indicator takes into account if interest payments on mortgage debt are deductible from taxable income and if there are any limits on the allowed period of deduction or the deductible amount, and if tax credits for loans are available. For countries that have no tax relief on debt financing costs, this indicator takes the value of zero.

Source: D. Andrews, A. Caldera Sánchez and Å. Johansson (2011), "Housing Markets and Structural Policies in OECD Countries", *OECD Economics Department Working Papers*, No. 836.

StatLink http://dx.doi.org/10.1787/888933029945

Figure 1.19. **Feedback effects between house prices and household debt are strong**

Change from 2000 to 2007

Debt/gross domestic income ratio (% points)[1]

House prices (%)

1. 2001-07 for Japan, 2002-07 for Korea.

Source: OECD (2014), *OECD Housing Prices Database*, Economics Department, February and *OECD National Accounts Statistics* (database), February.

StatLink http://dx.doi.org/10.1787/888933029964

Several reforms have striven to control household leverage and make it more sustainable. In 2001, mortgage interest relief was restricted to primary residences, the maximum period of deductibility reduced to 30 years and the marginal tax benefit cut to 52%. In 2004, tax deductibility of mortgage interest in case of relocation was limited to the difference between the value of the new mortgage and capital gains on the previous dwelling. Since 2007, capital accumulation on bank savings accounts has been encouraged through tax exemptions, which had been allowed only for insurance products before. In 2011, the mortgage code of conduct used for self-regulation among mortgage originators recommended to cap the LTV ratio at 106% and underwrite interest-only mortgages up to a maximum of 50% of the property value.

More recently, additional reforms have been implemented and are steps in the right direction. Since 2013, interest deductibility has been restricted to new mortgages with regular repayment of the principal within 30 years, which is a commendable measure. However, new borrowers can take a second interest-only loan to redeem up to 50% of the first loan (Van Leeuwen, 2013). The tax treatment of mortgage interest has been made less generous for both new and existing mortgages, but with a very gradual lowering of the tax relief from 52% to 38% between 2014 and 2042. The maximum value of a mortgage eligible for the NHG guarantee scheme was reduced from EUR 350 000 in 2009 to EUR 290 000 in July 2013 and should drop to EUR 260 000 from July 2014. Also, a one-off fee borrowers pay for the scheme has been increased from 0.85% to 1% (previously raised from 0.7%). Finally, the maximum LTV ratio for new mortgages will be cut in steps from 106% in 2012 to 100% in 2018.

Reforms need to be deepened as soon as the housing market recovery is sustainable. To improve tax neutrality, the taxation of housing should be at a level consistent with the taxation of financial incomes (Andrews et al., 2011). The taxation of housing corresponds to the first-best policy as mortgage interest deductibility is allowed and imputed rents are taxed, but the former should be lowered more quickly and the latter taxed more. This

would diminish the bias in favour of owning a home instead of renting it, and reduce the bias in favour of housing investment compared to the allocation of savings to other asset classes. The fee to benefit from the NHG scheme should be adjusted for risk, by for instance linking it to the size of the LTV ratio. Continuing to cap the LTV ratio and lowering it significantly below 100% would limit the interest burden, decrease the incidence of negative home equity and reduce default rates. The latter noticeably increase for LTVs above 80% in the US (Qi and Yang, 2009; White and Bauguess, 2013). Lower LTVs would also free up banks' capital and decrease their refinancing risks (SER, 2013). Alternatively, instead of introducing a cap, lower LTV ratios could be incentivised by setting a floor for risk weights (FSB, 2011a).

The Dutch rental sector is heavily skewed towards the public rental sector and developing the private rental market would give time to households to accumulate an adequate mortgage deposit. Recent reforms have initiated a welcome differentiation of rents depending on income in social housing (representing about 35% of the housing stock). They should be continued and would need to be coupled with tighter income conditions for eligibility to ensure that social housing associations focus on providing affordable housing only for low-income households. In parallel, as assessed in a chapter on the housing market in the 2010 *Survey* (OECD, 2010; Høj, 2011b), it is necessary to promote the development of the private rental market by progressively liberalising rents to create an alternative to homeownership and social housing. Ensuring a stronger role for a property's value in setting maximum rents, as currently planned, would be a step in the right direction. Additional far-reaching measures would include fully liberalising rents in new constructions and deregulating rents for new contracts in existing dwellings.

Facilitating debt amortisation of existing loans

Reforms need to be broadened to reduce the stock of household debt in the medium term. Empirical evidence suggests that actual household debt as a share of GDP exceeds a sustainable ratio by almost 40 percentage points (European Commission, 2013). Debt will become more sustainable if house prices start to rise, but this seems unlikely soon (Figure 1.7). Time series regressions suggest diminishing but still existing overvaluation of house prices (IMF, 2013b,c). An eventual normalisation of the ECB policy rate and a projected long-term decline of total population in the absence of net migration (Johanson et al., 2013) would further weigh on house prices, though low housing supply and diminishing household size should provide some offset.

Low potential growth, estimated by the European Commission and the OECD to be respectively around 0.5% and 1% in 2014, suggests that income increases are unlikely to be sufficient to yield necessary deleveraging. Alternatively, deleveraging can occur through lower growth of new loans, increased debt repayments or debt restructuring. Regulatory authorities could prompt lenders to contact their borrowers holding interest-only mortgages and inform them about needed repayment of the loan at the end of the term as, for instance, in the United Kingdom (FCA, 2013). Well capitalised banks could be less willing to refinance borrowers with negative home equity who cannot repay their loan at maturity.

A more fundamental way to reduce household debt would be to more strongly incentivise amortising behaviour for existing mortgages once the housing market has recovered durably. In particular, this could be achieved by accelerating the reduction of the mortgage interest relief. Also, redemptions of loans with deferred amortisation should be closely monitored to prevent practices of "evergreening" by banks. Higher amortisation of

existing mortgages would reduce banks' exposure to liquidity and solvency risks linked to the housing market, and improve consumer protection for vulnerable households. Concerns about the accumulation of illiquid and/or excessive net wealth by seniors are overstated. Home equity could be extracted by developing reverse mortgages (repaid from equity through the sale of the house) or home equity loans (repaid in regular instalments). In particular, there is an important potential to introduce reverse mortgages in the Netherlands (Dillingh et al., 2013), but it is necessary to ensure that underwriting standards for such loans are well defined and robust.

For borrowers who would be unable to start paying the principal when they refinance their debt with a new loan, banks could propose another mortgage with regular amortisation and longer maturity, or otherwise it would be advisable that they raise their capital for expected losses or boost their loan loss provisions if borrowers are only able to pay the interest. Denmark has recently decided that debtors who have difficulties to begin amortising their mortgage (interest-only for ten years) with a LTV ratio of over 80% can convert it into a 30-year loan with amortisation; otherwise banks have to build higher provisions for borrowers only able to pay the interest on a new loan (OECD, 2014a).

Details remain unknown, but the government intends to open a debate on whether to allow borrowers to use their pension capital to redeem their mortgage debt (Government of the Netherlands, 2013b). While high levels of pension adequacy in the Netherlands (OECD, 2013b) could make this idea appealing at first sight, related challenges and risks are sizeable. These include the need to make a complete overhaul of the second pension pillar (which ensures risk sharing as there are no individual pension accounts), the risk of using assets without a corresponding reduction in liabilities (which would threaten the solvency of pension funds), the danger of a premature consumption of wealth if additional loans are contracted (which would ultimately lead to pressures on the government to improve pension adequacy) and the threat of undermining the stability of pension funds by assigning them duties going beyond their primary role. Instead of drawing on pension assets, the government could consider socialising losses of mortgage delinquencies or resolving failed banks.

Reviewing personal insolvency

Household insolvencies have experienced a significant increase between 2009 and 2011. Yet, the number of insolvencies per number of households is similar to countries with creditor-friendly regimes (France) and much lower than in debtor-friendly regimes (United Kingdom and United States) (Liu and Rosenberg, 2013). Given the sharp decline in house prices and the high debt burden of Dutch households, one could expect a higher number of insolvencies, suggesting that the Dutch personal insolvency regime is likely to be closer to creditor-friendly regimes rather than debtor-friendly ones.

Dutch mortgages are full recourse, with the creditor having recourse to other assets and even future income of the debtor (Van Leeuwen and Bokeloh, 2012). Since the new legislation in 2008, debtors are freed from their commitments if they cannot make significant contributions, rendering the system more debtor-friendly (London Economics, 2012). The Dutch framework for personal insolvency allows for out-of-court mediation and a fresh start after a period of 3 years (maximum 5 years), following the debt rescheduling regime ("schone lei"). In comparison, the rescheduling regime can go from one year in the United Kingdom to around eight years in France; it has recently been shortened from 12 to 3 years in Ireland and from 6 to 3 years in Germany (if 25% of the debt is repaid). Based on

these numbers, the Dutch regime appears relatively standard. Nevertheless, due to different judicial practices, these numbers do not allow proper understanding of how the rescheduling regime is enforced by courts. It is also uncertain to what extent banks allow informal mortgage debt rescheduling.

Under creditor-friendly insolvency and foreclosure laws, widespread repossessions could be socially and politically difficult to enforce in case of defaults, and would deepen banks' losses if large forced sales destabilise house prices. On the other hand, a new law is being prepared to cancel partially or fully "unexpected" debts linked to inheritance, which could put high risks on creditors. This is why it is important to balance creditor and debtor rights to ease loan restructuring and ensure household deleveraging in an orderly way, as well as protect some borrowers from extreme financial distress. In the case of the Netherlands, increasing the possibility of rescheduling for overindebted households, speeding it up and allowing greater debt discharge that takes into account borrower reimbursement capacity would be useful to facilitate household deleveraging. Also, lender-friendly foreclosure laws can weaken underwriting standards and have been found to be associated with a higher incidence of subprime originations in the United States (Curtis, 2013).

Enhancing supervision and consumer protection within the framework of the banking union

On behalf of the Dutch parliament, the De Wit (2010) and Scheltema (2010) commissions have undertaken an evaluation of causes and failures that led to the crisis. Based on their assessments, the regulator did not adequately recognise the main systemic vulnerabilities, such as large cross-border exposures, reliance on wholesale funding, increased leverage and sizeable portfolios of structured securities. Despite showing a high degree of compliance with banking regulatory standards, the supervising approach largely relied on moral suasion similar to other regulators, which became less effective as financial institutions became larger and more complex (IMF, 2011b).

When a single European supervisory mechanism is effectively established, national authorities in co-operation with the ECB will retain responsibilities in: i) day-to-day assessment of credit institutions and related on-site verification; ii) consumer protection; iii) macro-prudential policies that include countercyclical buffers and other measures to address systemic risks; and iv) early intervention and precautionary powers.

Limiting supervisory liability and making the supervisory approach more intrusive

The DNB new supervisory approach seeks to make supervision more intrusive. The DNB has set up a separate new division with a stronger role for experts, a department for internal risk management and a department responsible for intervention policy to safeguard timely responsiveness. This is accompanied by increased staff resources and changes in the organisational set-up of the DNB. The liability of the supervisors has been limited, which is crucial as 91 enforcement actions were contested in courts and one action was overruled between 2006 and 2010 (Cihák et al., 2012). In contrast, in most OECD countries courts are never or rarely involved, exceptions being Austria and Italy with respectively 91 and 10 contestations.

The Netherlands has implemented the Financial Stability Board (FSB) Principles for sound compensation practices (FSB, 2011b). The regulator has replaced senior management in the nationalised institutions (ABN AMRO and SNS Reaal). A law that bans

variable remuneration for all management board members of financial institutions that receive state aid came into force in June 2012 including a freeze of the fixed salary. A fit and proper test for managers of financial institutions has been improved. However, these steps may not be ambitious enough. Compensation packages should be supervised directly by the regulator as recommended by the Financial Stability Board (FSB, 2011b).

Macroprudential oversight is being improved by a financial stability committee in charge of recommendations on macroprudential policies (Box 1.1). The establishment of a committee for co-operation on macroprudential policy is welcome. However, the committee plays only an advisory role, and the reform does not change existing competencies. It is up to the individual authorities to consider and act on recommendations from the committee. To increase the effectiveness of the financial stability committee, its enforcement powers and accountability should be improved. To be able to react to emerging economic or financial conditions, the regulator should have the power to make use of macroprudential instruments such as the LTV ratio.

Box 1.1. **The framework of financial supervision**

Financial supervision is organised under the "twin peaks" supervisory structure. This approach to financial regulation separates regulatory functions by objectives allowing each regulator to focus on a single core mandate. In the Netherlands it involves two main institutions, the De Nederlandsche Bank (DNB) and the Authority for Financial Markets (AFM):

The DNB is the single prudential supervisor for all financial institutions. Micro and macroprudential oversight is concentrated in the DNB, so it has the ability to take a systemic view.

The AFM is the supervisor responsible for conduct-of-business supervision, including supervision of security market activities, with a strong focus on market behaviour and consumer protection.

The Ministry of Finance is responsible for financial sector legislation and makes the ultimate decision to provide public support to banks in crisis

To strengthen macroprudential oversight, a financial stability committee consisting of members of the Ministry of Finance, the DNB and the AFM was set up in January 2013 responsible for macroprudential supervision. The mandate of the Committee is to: *i*) facilitate the exchange of information and the analysis of risks; *ii*) align the policies of the participating authorities; *iii*) take stock of desirable improvements in macroprudential instruments; and *iv*) co-ordinate the follow-up to recommendations of the European Systemic Risk Board.

Improving cross-border arrangements

Another reason for the problems associated with banks' cross-border exposure during the 2008-09 crisis was that regulation did not keep up with the expansion of Dutch banks abroad. The collapse of Fortis highlighted the need for stronger co-operation between different national regulators and for a harmonisation of bank bankruptcy laws across countries. It also revealed diverging views of Belgian and Dutch regulators over the issue of who should be the main supervisor for the Belgian-Dutch company. Because the company's headquarters were located in Belgium, the Belgian regulator was the main

supervisor of the activities of the group, although, after acquiring ABN AMRO, the size and the importance of business units located in the Netherlands increased considerably (Marinc and Vlahu, 2011). While issues related to cross-border supervision will be resolved by the European single supervisory mechanism, there are still no effective international crisis management and resolution tools (OECD, 2012, 2014b).

Today, international exposures of ING account for most of the cross-border activities. There have been many efforts to improve cross-border banking regulation. The DNB has started to co-ordinate with other supervisory authorities through so-called supervisory colleges. Within these supervisory colleges, the DNB has established a separate Crisis Management Group (CMG), which includes the relevant supervisors, central banks and ministries of finance. Resolution plans of banks are shared and discussed with the members of the CMG. Further arrangements may need to be made with financial supervisors in countries hosting subsidiaries of Dutch banks. Legislation giving powers to the DNB to request information on foreign subsidiaries of Dutch banks is discussed, but should be passed as soon as possible.

Strengthening consumer protection

The responsibility for consumer protection in the area of financial products lies with the Authority for Financial Markets (AFM). International experience shows that lenient lending practices, such as interest-only mortgages and mortgages with high loan-to-value ratios, contributed to the subprime crisis (Demyanyk and Van Hemert, 2011) and had been responsible for bank failures during the Great Depression in the 1930s (Campbell et al. 2011). The ubiquitous nature of such practices in the Netherlands suggests that consumer protection needs to be strengthened through more intrusive regulation of mortgage products.

Better regulation is particularly important because mortgage products are key financial decisions for most households during their lifetime. Financial literacy is another element of consumer protection, which can complement but not be a substitute for it (OECD, 2009). There is a general agreement that it is essential for good financial decision-making and its lack could have been one of the reasons of the financial crisis (OECD, 2009; Lusardi and Mitchell, 2011). Despite its importance, financial literacy is poor in OECD countries, including in the Netherlands where 55% of people are not able to answer elementary questions about compound interest rates, inflation and diversification (see Box 1.2).

Improving financial literacy would be beneficial, but would also be costly and rather ineffective. Consumers do not appear to be interested even in free financial literacy courses, due to high costs related to time and effort, and in any case financial education does not lead to better financial decisions (Choi et al., 2011; Willis, 2011; Campbell et al., 2011). Interestingly, 60% of Dutch consumers trust the advice of financial institutions, despite potential conflicts of interest (European Commission, 2010). The AFM should make a comprehensive survey of financial products to understand their risks and be vigilant about the appearance of new financial products that might be sub-optimal for households and for financial stability.

Box 1.2. **Financial literacy in the Netherlands**

To measure consumer literacy, Lusardi and Mitchell (2011) designed a set of the following three elementary questions that were piloted in national surveys:

> Suppose you had USD 100 in a savings account and the interest rate was 2% per year. After five years, how much do you think you would have in the account if you left the money to grow?
>
> > More than USD 102; Exactly USD 102; Less than USD 102; Do not know; Refuse to answer
>
> Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?
>
> > More than today; Exactly the same; Less than today; Do not know; Refuse to answer
>
> Please tell me whether this statement is true or false. "Buying a single company's stock usually provides a safer return than a stock mutual fund."
>
> > True; False; Do not know; Refuse to answer

In Netherlands, only 45% of respondents succeeded in answering all three financial literacy questions correctly (Lusardi, 2013). It should be noted that this rate is rather high in international comparison (the corresponding rates are 53%, 27% and 30% in Germany, Japan and the United States). The above questions are very simple and their knowledge is not even nearly sufficient for decision making in the context of sophisticated and complex financial products. Van Rooij et al. (2012) show that only a tiny fraction of respondents (5%) are able to answer 11 more advanced literacy questions correctly. These are important findings as we cannot assume that consumers are knowledgeable and well-informed about their financial choice.

References: A. Lusardi (2013), *Financial Literacy Around the World (FLAT World)*, FINRA Investor Education Foundation; A. Lusardi and O. Mitchell (2011), "Financial Literacy around the World: An Overview", *Journal of Pension Economics and Finance*, Vol. 10, No. 4; M.C. van Rooij, A. Lusardi and R.J. Alessie (2012), "Financial Literacy, Retirement Planning and Household Wealth", *Economic Journal*, Vol. 122, No. 560.

Improving the resolution framework

Ensuring a better protection of taxpayers and depositors

A necessary reform to reinforce the effectiveness of supervision is to design an orderly resolution mechanism. This is a key element on the international agenda of financial market reform (FSB, 2011b; Zhou et al., 2012), which should help restructure banks in difficulty. In 2012, the Netherlands introduced a special resolution regime for banks – the Intervention Act – which provided the DNB and the Ministry of Finance with new resolution powers that can be exercised without shareholder consent. DNB has to submit a transfer plan to the court and, once approved, the court appoints a person to execute the plan. If the failure of a bank poses a serious and immediate danger to the stability of the financial system, the Minister of Finance has the power to intervene without court approval (FSB, 2013). New resolution powers of the DNB and the Ministry of Finance include: i) removal and appointment of senior management; ii) appointment of a "silent" administrator; iii) transfer of assets and liabilities; iv) establishment and operation of a bridge bank; v) transfer of assets to the asset management company; and vi) possibility to expropriate equity and subordinated debt.

The powers of the Intervention Act were tested for the first time to bail-in junior debt and shareholders when SNS Reaal was nationalised in February 2013. Currently, the government is working on the creation of a state-owned bad bank to transfer the property portfolio of SNS Reaal. The new framework reduces moral hazard and achieves a fairer burden sharing of bank bailouts. The Intervention Act could also be improved by introducing criteria and early-warning mechanisms as to when a resolution procedure should be launched. Similarly to the United States, the regulator could be allowed to trigger resolution procedures as soon as the capital is below a certain threshold, while still being positive, so as to limit the potential cost for the taxpayer. Asset encumbrance may also raise further the cost of bank resolution that is undertaken too late (Hardy, 2013). The threshold should be based on unweighted capital to avoid banks' manipulation of the risk weights. It is also important that the regulator specifies *ex ante* the measures to be taken in the event of a resolution procedure and at which stage they would need to be enforced so as to reduce the risk of regulatory forbearance.

Further progress is expected with the Bank Recovery and Resolution Directive (BRRD) at the EU level, which is set to harmonise rules for recapitalisation and orderly resolution of banks by 1 January 2015. From 2016, total losses of private investors will have to amount to at least 8% of the bank's balance sheet before drawing on a bank-financed *ex ante* domestic resolution fund (expected to reach the level of 1% of domestic covered deposits by 2025) and public funding. A recently agreed European single resolution fund of EUR 55 billion, to be built up over the next eight years, could also be used in periods of acute stress. The new framework should more easily allow the bail-in of senior bondholders, which was ruled out in the case of SNS Reaal, resulting in a higher cost for the taxpayer.

To buttress the protection of the taxpayer, it is important that banks maintain a sufficient level of debt that can be used for bail-in. Currently, many banks are increasing their secured funding as a way to limit their funding costs. Secured funding, such as covered bonds, grants creditors preferential claims that are guaranteed by collateral and are not eligible to bail-in. This leads to asset encumbrance and entails the risk of higher potential losses to unsecured creditors, including uninsured depositors (and potentially the taxpayer for the part of deposits insured by the government). At around 15%, average asset encumbrance of Dutch banks is lower than the European average of 25%, partly owing to prudential limits set by the DNB for the volume of covered bonds issued (DNB, 2013c). The monitoring of risks linked to asset encumbrance needs to be continued. To allow markets to price adequately unsecured debt and banks to get sufficient amount of such debt, the regulator should ensure that banks improve the disclosure of encumbered assets, as in Sweden (BIS, 2013b). In addition, to balance the risk-burden between secured and unsecured creditors, capital requirements could be linked to the level of asset encumbrance (BIS, 2013b).

Depositor preference provides guarantees for depositors in comparison with other unsecured creditors. According to the BRRD, deposits of natural persons and SMEs above EUR 100 000 will benefit from a preferential treatment as they will not suffer from losses before all other unsecured creditors' claims (shareholders, junior and senior bondholders, and depositors from large corporations) are absorbed. This should limit the potential cost for the government at the same time, which ultimately guarantees deposits covered by the national deposit guarantee scheme (DGS), i.e. all deposits below the ceiling of EUR 100 000 per bank. A bankruptcy of SNS Reaal would have activated the DGS to pay out depositors and would have induced large claims on other Dutch banks (since the current DGS is

funded *ex post* by banks) and might have triggered a bank run (since there is no depositor preference for uninsured depositors). The Dutch authorities plan to introduce a DGS funded *ex ante* by the banking sector. Such arrangement was delayed, but it is set to be introduced in the Netherlands in 2015. The introduction of both depositor preference and of an *ex ante* DGS will be an important improvement of the current resolution framework.

Effectively dealing with large banks

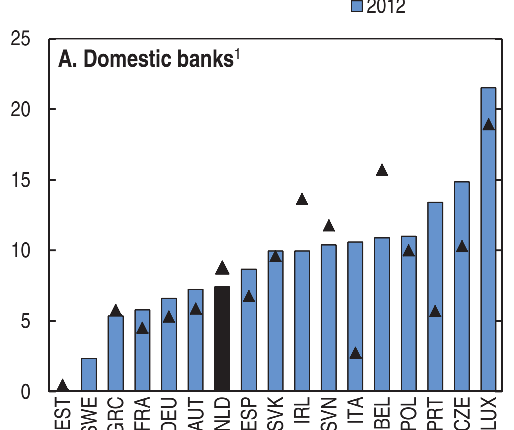
The Intervention Act equips the DNB and the Ministry of Finance with stronger intervention powers to address a financial turmoil, but their effective use could be uncertain for large banks. These often have a complex and opaque legal structure that consists of myriads of legal entities, set up in part to exploit regulatory and tax loopholes. Moreover, bank-insurer groups could have a "double leverage", as in the case of SNS Reaal, resulting in less equity at the conglomerate level than reported by each arm, which can hamper restructuring (Ministry of Finance, 2013b). Faced with such a legal structure, attracting potential buyers is more difficult. Also, the authorities may not be able to distinguish systemically important parts and could be forced to rescue the whole conglomerate due to fears of contagion. In doing so, they may reinforce the "too-big-to-fail" problem and increase moral hazard. To resolve this issue, banks should be required to draw up recovery and resolution plans ("living wills"), as has been proposed by the Dutch government in its "Banking vision paper" (Government of the Netherlands, 2013a). In these plans, banks should develop scenarios under which certain, less important, parts can be sold, or put into liquidation. The systemically important parts may then be rescued (Avgouleas et al., 2013).

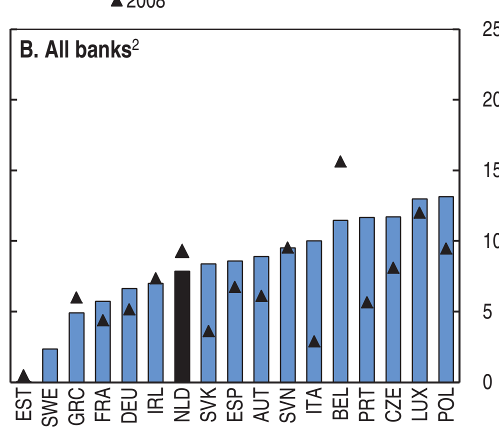
A credible "living will" requires a legal structure that is straightforward and that allows identifying and separating systemically important bank parts. Hence, the development of "living wills" should lead to a simplification of the legal structure. The supervisors should have the power to enforce such restructuring solely to improve resolution, as it is the case in Spain, Switzerland, the United Kingdom and the United States (FSB, 2011b). Moreover, banks should disclose the number of subsidiaries and branches abroad, including their presence in offshore financial centres (as it has recently been introduced in France, the United Kingdom and the United States).

Another option to reduce risks posed by large banks to the taxpayer is to restrict the business scope by separating their investment divisions, or at least proprietary trading as this is being implemented in some OECD countries (France, the United Kingdom and the United States), discussed at the EU level, and recommended by the Commission on the Structure of Dutch Banks (2013). The DNB (2012) argues that such separation of financial businesses is not necessary for Dutch financial institutions, as investment bank activities of Dutch banks are relatively small. Indeed, the ratio of available-for-sale assets to total assets of Dutch banks is low in international comparison and has further declined after the crisis (Figure 1.20). Nevertheless, a separation of such activities could be important for resolution purposes to ring-fence systemically important activities (such as market making) from proprietary trading that can be liquidated in times of financial distress.

Figure 1.20. **Available-for-sale financial assets**

Per cent of total assets





1. Domestic banking groups and stand-alone banks.
2. Domestic banking groups and stand-alone banks as well as foreign controlled subsidiaries and branches.

Source: ECB (2014), "Consolidated Banking Data", *Statistical Data Warehouse*, European Central Bank, March.

StatLink http://dx.doi.org/10.1787/888933029983

Box 1.3. **Main policy recommendations to increase the resilience of the banking sector**

Bolstering banks' financial buffers

Review the mortgage loan portfolio and continue to request banks to hold sufficient capital for expected losses owing to rising unemployment, the high share of households in negative home equity, exposure to interest rate changes and low amortisation behaviour.

Adopt a uniform definition of a non-performing loan across banks.

Encourage banks to further increase their capital adequacy ratios by issuing equity and retaining earnings through lower dividend payments and reduction of costs.

Phase in maximum Basel III standards on systemically important bank capital buffers and aim for strong leverage ratios for systemically important banks.

Tackling household mortgage debt overhang

Once the housing market starts to recover durably, increase incentives for amortisation of mortgages by accelerating the reduction of mortgage interest relief and work towards ensuring neutrality between the taxation of housing and the taxation of financial incomes. Lower the maximum loan-to-value ratio significantly below 100%.

Promote the development of home equity loans and reverse mortgages, and consider gradually linking mortgages with deferred amortisation to principal accumulation on a bank account.

For households unable to start paying the principal when they refinance their debt with a new loan, encourage banks to grant another mortgage with longer maturity and regular redemption. Require banks to increase provisions for distressed borrowers only able to pay the interest.

To ease loan restructuring, reform personal insolvency law by balancing creditor and borrower rights.

Box 1.3. **Main policy recommendations to increase the resilience of the banking sector** *(cont.)*

Continue to improve targeting of social housing to low-income households through means tested rent increases and ease rent regulations in the private rental market by increasing the role of property's value in setting maximum rents, freeing rents in new constructions and deregulating rents for new contracts in existing dwellings.

Improving the resolution of banks

To go beyond bail-in regulations to reduce potential costs of resolutions for taxpayers and depositors, link capital requirements to the level of asset encumbrance, and build a domestic resolution fund and a deposit guarantee scheme both funded ex ante by banks as foreseen at the euro area level to create a banking union.

Require large banks to draw up recovery and resolution plans ("living wills"). The De Nederlandsche Bank (DNB) should have the power to enforce a simplified legal structure and require banks to provide information about their subsidiaries and branches abroad, including in offshore financial centres.

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Chapter 2

Boosting the development of efficient SMEs

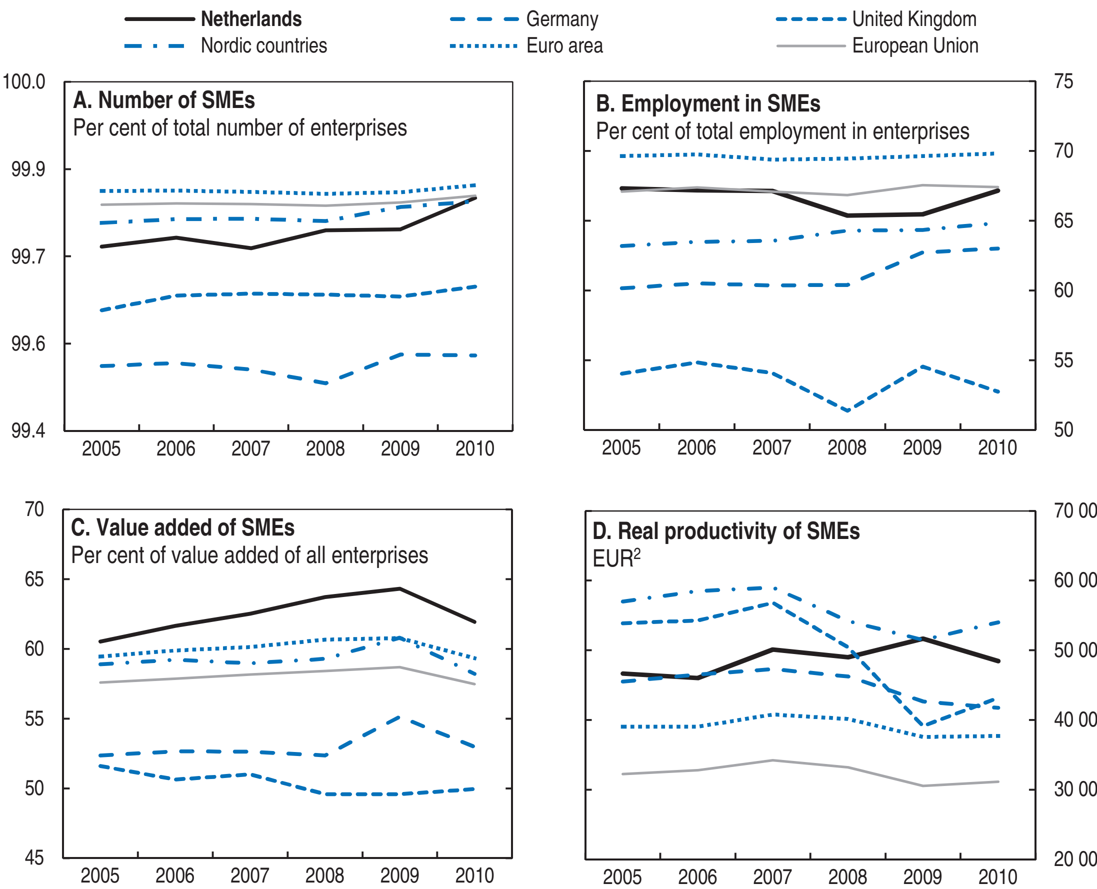
Entrepreneurship is an important driver of economic growth, job creation and competitiveness. However, the small and medium-sized enterprises (SME) sector has been severely affected by the crisis, with access to bank finance being particularly difficult. Various government-sponsored schemes have been introduced to ease credit conditions. Developing alternatives to bank lending options for SME finance is important but will take time. Restructuring banks' balance sheets is essential to step up bank lending to SMEs in the medium term. Beyond financing issues, boosting innovation would support productivity gains, and SME competitiveness and growth. Also, easing labour market regulation would further support SME development. A large share of small businesses consists of self-employed with no employees. The tax system should minimise distortions for the creation and expansion of businesses. Despite significant progress made in lowering barriers to entrepreneurship, there is scope to further reduce administrative burdens.

The role of SMEs in the Dutch economy

A snapshot of SMEs and key challenges facing the sector

In Europe, SMEs are defined as firms with fewer than 250 employees and an annual turnover and/or balance sheet of respectively less than EUR 50 million and EUR 43 million. They play an important role in the Dutch economy and are very heterogeneous as they represent 99.7% of all enterprises, very close to the European Union (EU) average of 99.8% (European Commission, 2013). They also account for about a 65% share of total employment and a similar share in value added and have a significantly higher labour productivity than the EU average.

Figure 2.1. **Small and medium-sized enterprise (SME) sector indicators**[1]



1. The data cover the "business economy" which includes mining and quarrying, industry, construction, trade and services. The aggregates for Nordic countries (i.e. Denmark, Finland and Sweden), euro area (i.e. EA15) and European Union (i.e. EU27) are calculated as unweighte.d averages.
2. Real productivity is defined as real value added (in euros) per person employed. Value added of SMEs is deflated by GDP deflator.

Source: European Commission (2014), *Annual Report on European SMEs 2012/2013* (database), DG Enterprise and Industry, January.

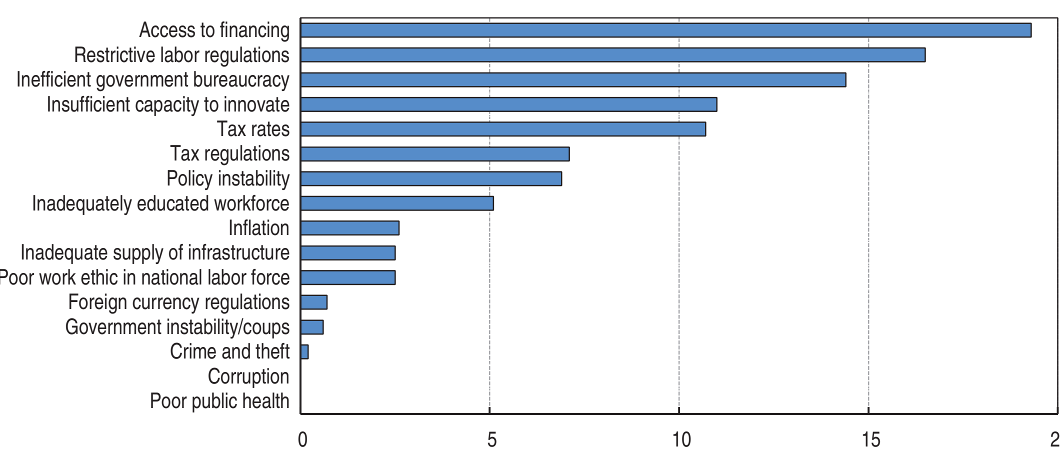
StatLink http://dx.doi.org/10.1787/888933029622

Total early stage entrepreneurship activity, a measure of start-up activity, is higher than in many other OECD countries, which is partly explained by a policy environment favourable to small firms (European Commission, 2013). The internationalisation of Dutch SMEs is strong, as almost 40% are involved in international trade and investment (Deutsche Bank, 2011). In terms of industry structure, services are the largest sector and almost 45% of SMEs offer knowledge-intensive services (mainly accounting, marketing or legal services), against 30% for the EU average (European Commission, 2013). In the run-up to the global downturn and in its early stages, the overall SME sector fared well in comparison with other countries in terms of number of firms, employment, value added and productivity (Figure 2.1).

Nevertheless, SMEs have been hit hard by the crisis. According to Statistics Netherlands, total annual pronounced corporate bankruptcies rose on average from 5 300 between 2000 and 2008 to 8 100 between 2009 and 2013, although the number of bankruptcies has been gradually receding since mid-2013. The Netherlands scores high on entrepreneurial attitudes and has a high number of entrepreneurs in the country's population, but the proportion of fast-growing firms is comparatively lower than in other innovation-driven economies (Van der Zwan et al., 2012). Access to bank finance has become the most important barrier for doing business according *The Global Competitiveness Report* (Figure 2.2). Moreover, there are around one million of self-employed, who play an important role in the flexibility of the supply side and sustain entrepreneurial motivations, but over three quarters of them do not have employees (so-called ZZP-ers in Dutch). The development of dynamic SMEs is hampered by labour-market impediments and remaining compliance costs for doing business (Figure 2.2), although the latter have been lowered significantly over the last 15 years or so. There is scope to improve the quality of SMEs by better exploiting their innovation potential and reforming taxation. Finally, women entrepreneurs could play a more prominent role in SME expansion. For instance, women are more represented in businesses with a lower turnover than men. However, women's business creations appear to have been less affected by the crisis than those of men, which could partly be due to a higher propensity of the latter to enter sectors more affected by the crisis such as construction or manufacturing (Piacentini, 2013).

Figure 2.2. **The most problematic factors for doing business**

Per cent of respondents, first half of 2013[1]



1. From the list of factors above, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: World Economic Forum (2013), *The Global Competitiveness Report 2013-2014*, Geneva.

StatLink http://dx.doi.org/10.1787/888933029698

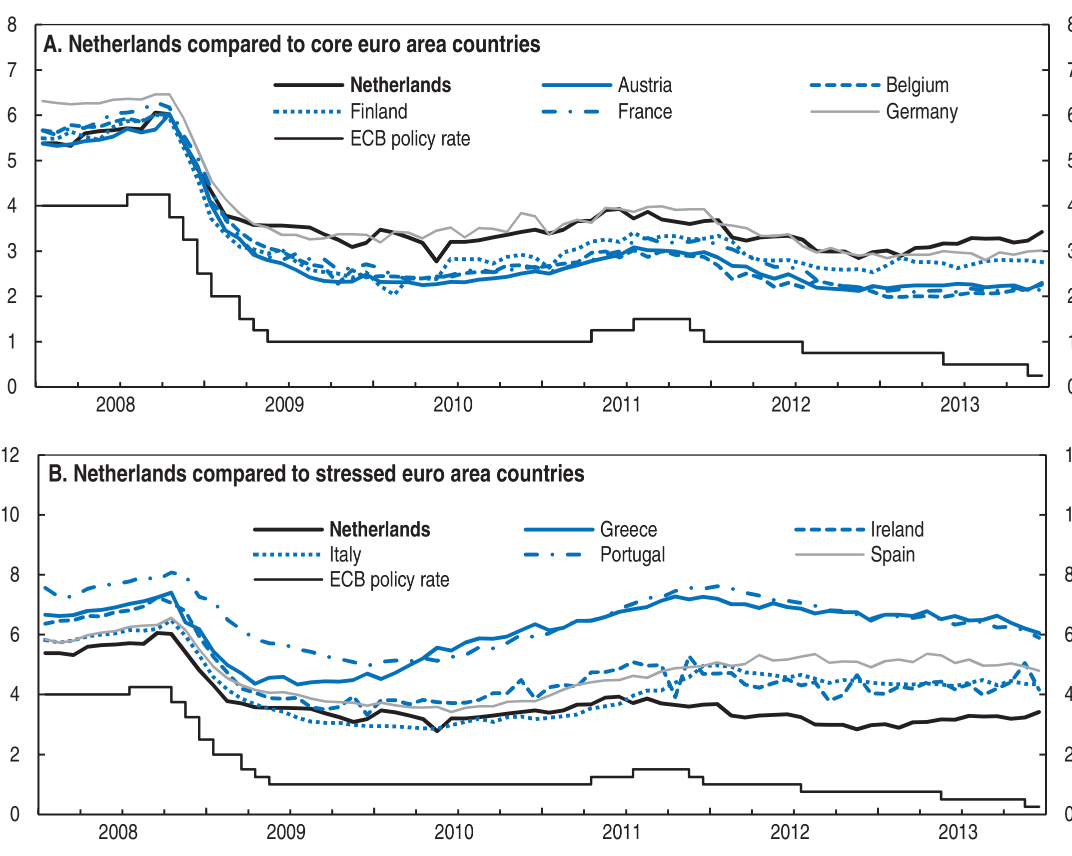
Poor access to finance is a major concern

Lack of statistics on lending to SMEs makes the analysis of credit availability difficult. Thus, a loan size of below EUR 1 million is used to approximate SME loans, which may introduce a bias to the extent that large firms seek smaller loans. Also, reporting is not harmonised across banks. It is important that the authorities implement plans to adjust reporting obligations of banks, so that the central bank (De Nederlandsche Bank, DNB) can get a timely, reliable and publicly available insight of SME bank financing. Nevertheless, there are indications that access to finance has been difficult during the crisis (OECD, 2013a). As opposed to large Dutch firms which fared better, start-ups, high growth and innovative SMEs have encountered major difficulties in getting finance.

The level of lending interest rates for loans below EUR 1 million has been broadly stable. It has been the highest among core euro area countries (Figure 2.3, Panel A) but still lower than in stressed euro area countries (Figure 2.3, Panel B). Given uncertainties about

Figure 2.3. **Change in the cost of bank loans**

Interest rate on loans up to and including EUR 1 million, per cent per annum[1]



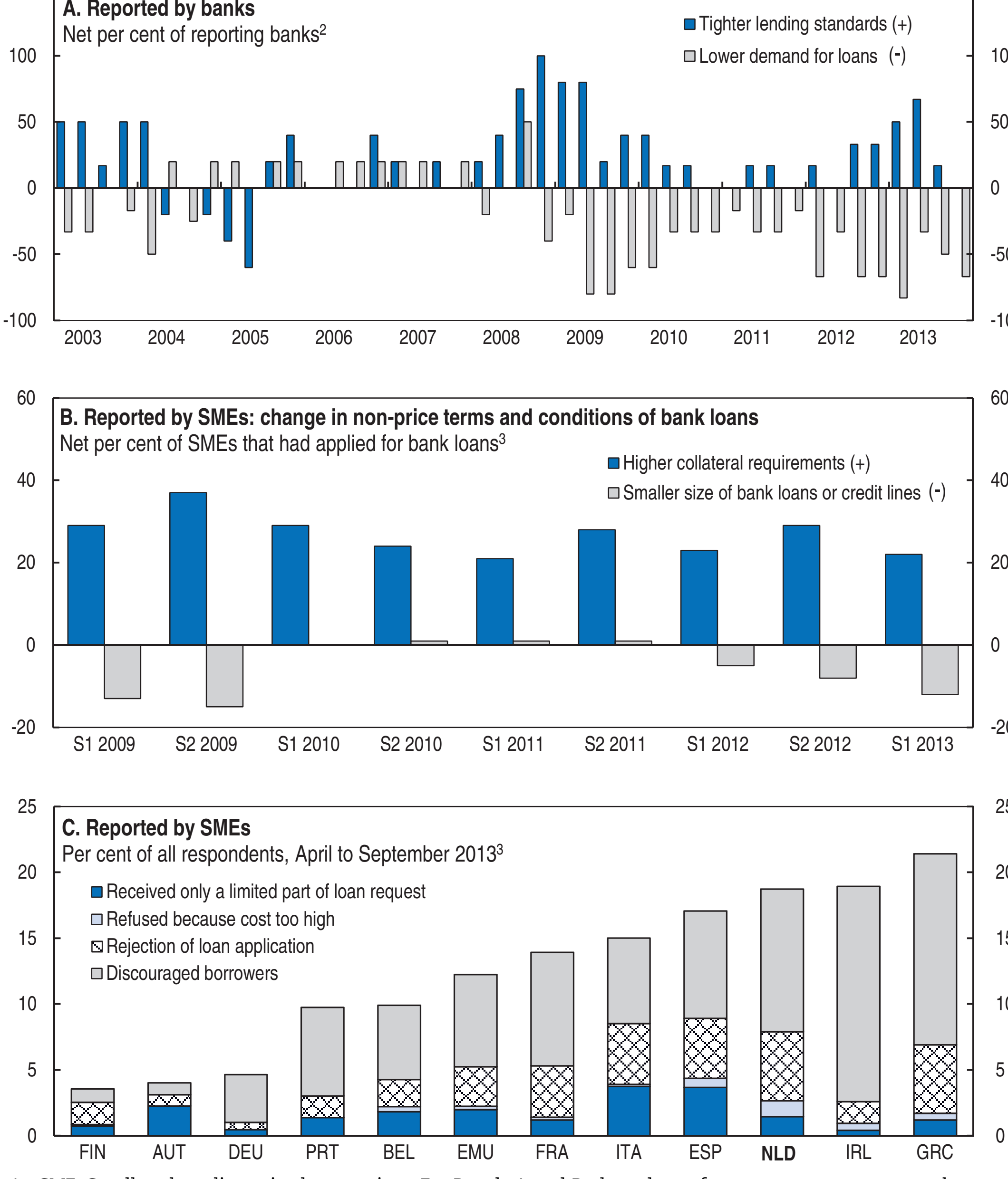
1. Figures refer to loans other than revolving loans and overdrafts, convenience and extended credit card debt.

Source: ECB (2014), "MFI Interest Rates", *Statistical Data Warehouse*, European Central Bank, March.

StatLink http://dx.doi.org/10.1787/888933030002

expected defaults in the context when non-performing loans for SMEs reached 6% of total lending volume in the third quarter of 2013 (DNB, 2013a), banks could consider that higher collateral requirements and lower interest rates would generate a higher *ex post* return than the counterfactual of higher interest rates and lower collateral standards.

Figure 2.4. **Bank lending constraints for SMEs are high**[1]



1. SME: Small and medium-sized enterprises. For Panels A and B, the values of net percentages may vary between +100% (e.g. all banks tighten their lending terms and conditions) and -100% (e.g. all banks ease their lending terms and conditions).
2. SMEs are defined as having a net annual turnover of less than or equal to EUR 50 million.
3. SMEs are defined as having 0-249 employees. First semester (S1) refers to the period between April and September. Second semester (S2) refers to the period between October and March. EMU: European Monetary Union.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", *Statistical Data Warehouse*, European Central Bank, March and DNB (2014), "Domestic MFI-statistics", *Statistics DNB*, De Nederlandsche Bank, March.

How to read Panels A and B: For Panel A, net percentage of banks reporting an increase (+) of lending standards and reporting increases (+) or decreases (–) in demand for loans. For Panel B, net percentage of SMEs reporting an increase (+) of collateral requirements and reporting increases (+) or decreases (–) in bank loans or credit lines over time.

StatLink http://dx.doi.org/10.1787/888933029641

There is some evidence of credit rationing. While Dutch banks have been reporting reductions in loan demand, they have also been tightening lending standards, which occurred mainly through stricter collateral requirements as reported by SMEs (Figure 2.4, Panels A and B). In turn, tight credit standards have been weighing on business lending (Van der Veer and Hoeberichts, 2013). According to bank lending surveys, the influence of weaker balance sheets of SMEs – as captured by greater banks' risk perception of the general economic activity and the outlook for the industry/company in question – has been a stronger determinant of tight lending supply, rather than weak balance sheets of banks – as captured by banks' assessment of costs related to their capitalisation (Figure 2.5).

Figure 2.5. **Factors influencing credit standards for loans to SMEs**

Net per cent of banks reporting factors contributing to tighter credit standards[1]

1. Figures refer to the question: "Over the past three months, how have the following factors affected your bank's credit standards as applied to the approval of loans or credit lines to enterprises?". Net percentages show the difference between the percentage of banks indicating that the factor in question contributed to a tightening of the credit standards and the percentage of those indicating that this factor contributed towards easing of the credit standards. The values may vary between +100% (e.g. all reporting banks indicate that costs related to their capitalisation contributed to tightening their credit standards) and -100% (e.g. all reporting banks indicate that costs related to their capitalisation contributed to easing their credit standards). Small and medium-sized enterprises (SMEs) are defined as having a net annual turnover of less or equal to EUR 50 million.

Source: DNB (2014), "Domestic MFI-statistics", *Statistics DNB*, De Nederlandsche Bank, February.

StatLink http://dx.doi.org/10.1787/888933030021

According to the latest European Central Bank (ECB) survey data from April to September 2013, financing obstacles facing SMEs remain high. A fifth of SMEs reported access to finance as the most pressing problem, similar to Ireland and Italy and more than twice the percentage in Germany and Austria (ECB, 2013). The gap between needed and available external sources of funding – bank loans, bank overdrafts, trade credit, equity and debt securities – increased further. The availability of bank loans continued to worsen driven by a decreased willingness of banks to grant loans. Around half of Dutch SMEs did not apply for a loan because they had sufficient internal funds, but a tenth did not do so because they expected rejection. Nearly 20% of all surveyed SMEs reported obstacles for receiving a bank loan, one of the highest ratios in the euro area (Figure 2.4, Panel C). Among those that applied for a loan, 30% declared a complete rejection of their loan application, a percentage as high as in Greece (Figure 2.6).

Figure 2.6. **Rejection rates for credits of SMEs**

Per cent of respondents applying for a loan, April to September 2013[1]

35 30 25 20 15 10 5 0

DEU AUT BEL FIN PRT EMU FRA IRL ITA ESP GRC NLD

1. Figures refer to the question: "If you applied and tried to negotiate for this type of financing over the past six months, did you receive all the financing you requested, or only part of the financing you requested, or only at unacceptable costs or terms and conditions so you did not take it, or you have not received anything at all?". Small and medium-sized enterprises (SMEs) are defined as having 0-249 employees.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", *Statistical Data Warehouse*, European Central Bank, March.

StatLink http://dx.doi.org/10.1787/888933030040

Creating appropriate framework conditions to promote the development of dynamic SMEs

Policy measures have aimed to improve access to bank finance

Sufficient access to finance for viable SMEs is indispensable to achieve a solid economic recovery and support growth. Bank overdrafts, credit lines and bank loans are the most important sources of external finance of Dutch SMEs (Figure 2.7). Tackling banking sector vulnerabilities would improve banks' ability to lend in the medium term as discussed in the previous chapter. Even though bank lending is likely to remain a major financial channel for SMEs, the authorities have undertaken commendable policy efforts to facilitate access to bank finance and develop alternative sources of funding during the crisis.

The government has initiated and expanded several loan guarantee programmes to ease access to bank lending. In late 2008, the maximum loan amount of the SME loan guarantee scheme (*Borgstellingsregeling MKB*, BMKB) was increased from EUR 1 million to EUR 1.5 million per enterprise, the size of firms that are eligible was increased from 100 to 250 employees, and the maximum guaranteed percentage was first expanded from 50% to 80% for start-ups and for existing enterprises at a later stage. The BMKB scheme provides guarantees to banks for lending to SMEs with little or no available collateral. The size of loans and guarantee coverage depend on the type of SME, but the risk profile of targeted firms is low. Participants in the BMKB scheme were also offered the opportunity to postpone the repayment of their loans up to two additional years. Yet, owing to budget constraints and growing losses, access to the scheme was tightened in 2012, with a one-off commission increased by 20%, and the maximum guarantee reduced from 80% to 50% for existing firms and from 80% to 75% for start-ups.

Figure 2.7. **Sources of external financing of SMEs**

Per cent of all respondents, April to September 2013[1]

Bank overdraft and credit line
Leasing or hire-purchase or factoring
Bank loan
Trade credit
Other loan
Retained earning
Subordinated and participating loans
Grants or subsidised bank loan
Equity
Debt securities issued
0 10 20 30 40 50
Netherlands
Euro area

1. Figures refer to the following question: "Turning to the financing structure of your firm, to finance normal day-to-day business operations or more specific projects or investments, you can use internal funds and external financing. For each of the following sources of financing, could you please indicate whether you used them or not during the past six months?". Small and medium-sized enterprises (SMEs) are defined as having 0-249 employees. The category of subordinated and participating loans also includes preferred stocks and other similar instruments. The category of bank overdraft and credit line also includes credit cards overdraft.

Source: ECB (2014), "Survey on the Access to Finance of SMEs", *Statistical Data Warehouse*, European Central Bank, March.

StatLink http://dx.doi.org/10.1787/888933029660

In 2009, the government also launched a business loan guarantee scheme (*Garantie Ondernemingsfinanciering*, GO facility) targeted to low-risk firms in the expansion or consolidation stage of development. The GO scheme provides banks with a 50% guarantee on new bank loans ranging from EUR 1.5 million to EUR 50 million. The maximum guarantee had been temporarily increased to EUR 150 million, but was scaled back to EUR 50 million in 2012.

Credit guarantee instruments generally proved effective in improving financing for credit-constrained SMEs in the early stage of the financial crisis (OECD, 2010; Carnegie Consult, 2011). However, fiscal constraints, higher risk exposure and growing losses owing to corporate failures led the government to reduce their generosity between 2012 and 2013. More recently, in view of the persistent problems in accessing bank finance by SMEs, the Dutch government has again temporarily expanded the guarantee schemes (Ministry of Economic Affairs, 2013). In particular, the GO scheme has yet again been provisionally expanded to include loans up to EUR 150 million.

The crisis has increased guarantee schemes to SMEs to around 0.5% of gross domestic product (GDP). Back-and-forth changes in the generosity of the schemes reflect uncertainties about the appropriate level of state support. There is a trade-off between the level of risk taken by the authorities and related potential economic benefits on the one hand, and possible costs for the budget in case of failure on the other. The authorities should continue to evaluate policy instruments supporting access to finance while monitoring market inefficiencies faced by SMEs. Existing instruments should be adapted depending on results. For instance, not all guarantees are being fully used in the Netherlands. If this reflects supply rather than demand problems then access would need to be broadened for the most promising business cases within well defined budget constraints. However, the government may not have the capacity to ensure the best

assessment of risks and to avoid those that are excessive, and should not obstruct necessary restructuring of SMEs either. Therefore, an important involvement of banks should be sought for a given level of risk. Risk could also be evaluated by other private investors to achieve an appropriate screening of loan applications implying a high exposure for the public purse.

A Credit desk for entrepreneurs (*Ondernemerskredietdesk*) has been established to collect questions and complaints regarding difficulties to access to bank finance. Since the beginning of 2013 it has been made possible for entrepreneurs to request a second opinion at the bank, via this desk, when they feel that they are still eligible to qualify for bank financing despite an initial rejection of the loan application. This is a step forward as evidence suggests that the involvement of a third party between banks and borrowers (so-called credit mediator) has been an effective mechanism for helping SMEs who had been denied credit and in facilitating the reversal of lending decisions by banks (OECD, 2013b). However, it is important to assess the effectiveness of the scheme by monitoring the amount of finance that is mobilised through credit mediation and the amount of jobs that are saved as, for instance, is done in Belgium.

Beyond credit guarantees and credit mediation, other channels have also been used to ease bank lending constraints. In 2009, the authorities launched a microcredit institution, Qredits, in joint co-operation with banks. A programme to support financial coaching and advice for micro entrepreneurs has been started as well. More recently, both the government and insurance companies have allocated additional funds to support micro finance via Qredits.

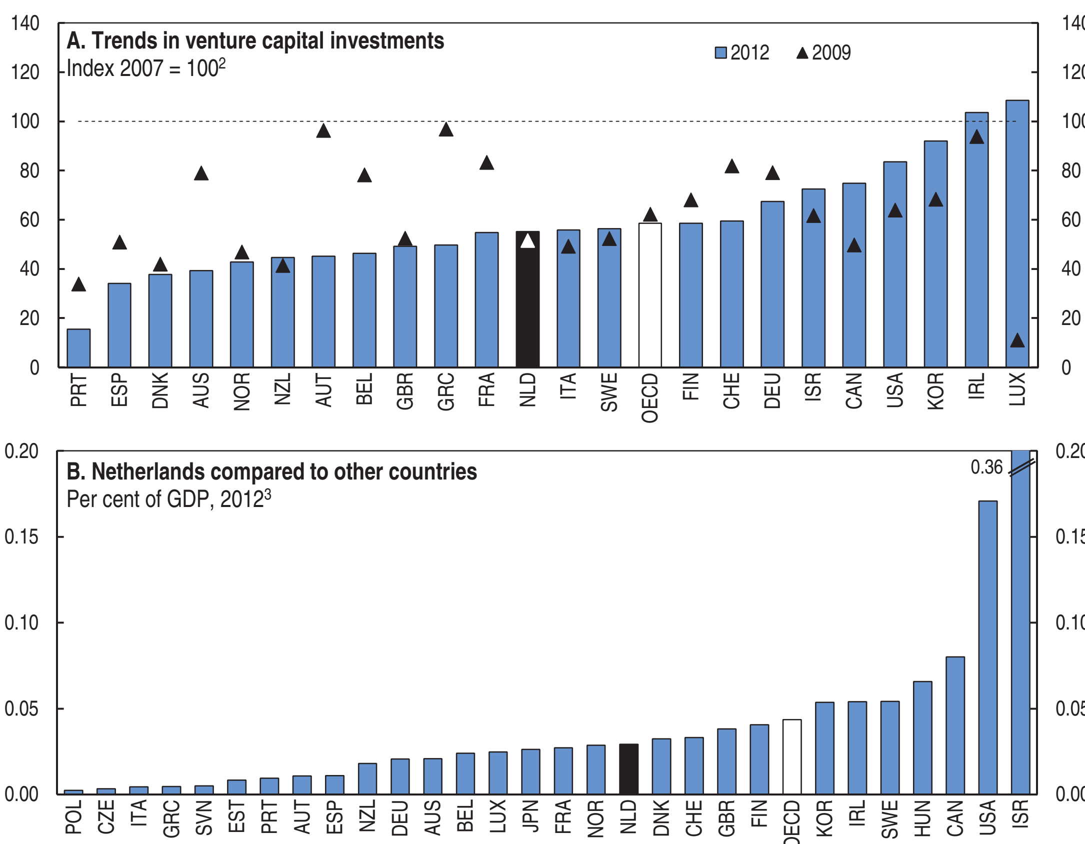
Developing alternative to bank lending sources of finance

Even with a sound bank lending channel, innovative start-ups, young firms and SMEs face particularly high barriers to obtaining finance due to their lack of collateral, cash flow and track record. Consequently, these SMEs have limited access to risk capital. This is exacerbated in the Netherlands by the impairment of the bank lending channel, further increasing the importance of other sources of finance for SMEs including angel investors, venture capital and public equity offerings (OECD, 2011, 2013c). Developing alternatives to bank lending sources of finance is necessary and welcome. Yet great care is required to ensure that public support broadening access to finance benefits mainly firms with the highest economic potential rather than firms that would minimise government's exposure. Also, public money should leverage private money at different stages of firm growth only for well-identified market failures so as not to crowd out the emergence of private sources of finance.

Promoting equity finance

Various programmes have been started or are about to be launched to improve access of SMEs to equity finance. For instance, the amount of venture capital investments has dropped by half since early in the crisis and the Netherlands does not stand out compared to other euro area countries (Figure 2.8). Yet venture capital could play a more prominent role in financing growth and innovation of SMEs in the Netherlands (NVP, 2013). Moreover, angel investors and venture capitalists also provide other benefits to start-ups and SMEs beyond equity finance, including business expertise on commercialising an invention and creating connections that will facilitate an eventual trade sale.

Figure 2.8. **Venture capital investments**[1]



1. Aggregation of investment data according to the location of the portfolio companies (i.e. the investee companies), regardless of the location of the private equity firms. Exceptions are Australia, Japan and Korea where data refer to the location of the investing venture capital firms. Due to the lack of standard international definitions of venture capital and diverse methodologies employed by data compilers, data are not strictly comparable across countries.
2. The OECD aggregate covers 23 countries. 2011 instead of 2012 for Canada, Greece and New Zealand.
3. The OECD aggregate covers 29 countries. 2011 for Canada, Estonia, Greece, Japan, New Zealand and Slovenia.

Source: OECD (2013), *Entrepreneurship at a Glance 2013*.

StatLink http://dx.doi.org/10.1787/888933030059

To contribute to the development of the venture capital market, which is often a key channel to finance innovations, the government has created a programme called "SME+ Innovation Fund" to back innovative and fast growing SMEs covering SMEs in the start-up, growth, expansion and consolidation stage (Box 2.1). Moreover, the Fund is complementary to innovation tax credits, which benefit comparatively less young innovative SMEs that often lack taxable income. However, there are several risks. The targeted recovery rate on investments (80%) may be too high to select the most risky projects even though these projects are potentially the most radically innovative. There is also a risk of crowding out private financing for the less risky projects. Another potential issue with the target recovery rate is that assessing returns on investment takes time, as investments from private venture capital funds typically take 5-10 years to materialise.

Recently, the government has announced an addition to the SME+ Innovation Fund of an early stage instrument and a co-investment facility for business angels, both expected to be launched in the first half of 2014. The early stage instrument focuses on two target groups: innovative start-ups arising from research institutions and existing innovative

Box 2.1. **The SME+ Innovation Fund**

In January 2012, the government launched the "SME+ Innovation Fund". The Fund is an umbrella for different (partly existing) innovation finance schemes. The aim is to mobilise private capital to close a perceived equity gap for investments, while avoiding interference with segments of the private market that work appropriately. The programme is designed as a "revolving fund", where on average about 80% of the invested amounts should return for new investments. It is open to the entire private sector, though part of its spending is earmarked for the top sector "creative industry". The Fund, with a budget of EUR 500 million for 2012-15, has three pillars.

The first pillar comprises direct "Innovation Credits" to support research and development (R&D) projects of enterprises, which are converted into subsidies in the case of failure of the project. If the project is successful, entrepreneurs must repay the credit and the accrued interest within ten years. For technical projects the interest rate is between 4% and 7%, and for clinical projects (development of a medicine or a medical product) it is between 7% and 10%. Small and medium-sized enterprises (SMEs) can use the Innovation Credit to finance 35% of the development costs of a project. Non-SMEs can finance 25% of the development costs. Companies can get a maximum Innovation Credit of EUR 5 million. Since December 2013, the government has increased the generosity of the instrument until the end of 2014. The credit percentage of the total funding for small businesses has been increased from 35% to 45%, and for SMEs that collaborate with a research institution or other companies up to 50%.

The second pillar includes the existing "SEED Capital", which is a co-investment scheme for early stage capital. Private equity funds that invest in risky technological start-ups can apply for a loan through the SEED capital, up to a maximum of EUR 4 million. The SEED capital facility has a flexible repayment schedule for investors. From the time that income is generated, the investment fund pays only 20% of the return to the government, until the private investment is recouped. Thereafter, 50% is paid until the government has recovered its loan. If after that the investment fund still receives income the revenue is split again in the ratio of 80-20% between the fund and the Dutch government.

The third pillar includes a new Dutch Venture Initiative (DVI) which is a "fund of funds" facility, i.e. it holds a portfolio of other investment funds. More precisely, it provides later stage capital for high growth innovative companies in the form of public participation in investment funds. In this pillar, the Dutch government works alongside the European Investment Fund of the European Investment Bank to manage the DVI with the aim to make a contribution to the financing of enterprises in the Netherlands.

Source: Ministry of Economic Affairs (2013), *Rapportage Ondernemingsfinanciering* (Reporting Business Financing), June.

SMEs. The government will co-invest with business angels via a Business Angel facility. The benefit of this scheme is that, besides leveraging private money with public money, it also helps to professionalise business angels.

To increase access to finance, the government is planning to attract long-term financial resources of pension funds and insurance companies as well as other domestic and foreign institutional investors. For this purpose, the authorities plan to set up a Netherlands Investment Institution (NII) (Box 2.2). The main objective of the NII is to remove barriers to long-term investment in the Dutch economy. As in the case of the National Mortgage Institute, which is planned to securitise part of the mortgage debt, it is

important that the NII is conducive to adequate pricing of risks and that pension funds' decisions remain undistorted to maximise returns from international investment diversification. Finally, public Regional Development Companies (ROMs) are also key players in providing risk capital to innovative starters and rapidly growing businesses in the Netherlands. A new ROM for the region of Zuid-Holland was launched in 2013 by the national and local authorities.

Box 2.2. **The Netherlands Investment Institution**

In September 2013, a number of major insurance companies, pension funds, pension providers and other stakeholders stated their intention to make more investments in the Netherlands. The statement followed a period of extensive exploration which was initiated by the government. The investments are intended to finance a range of societal challenges such as supporting small and medium-sized enterprises (SMEs), the transition to renewable energy and energy saving, innovation, the development of a private rental market, housing, investment in (residential) care real estate, school buildings, (energy) infrastructure and a competitive mortgage market. The increase of investment is planned to be achieved by the setting up of a Netherlands Investment Institution (NII) and the creation of an SME Financing Fund by insurance companies with a possible participation of pension funds.

The government, the pension funds and insurance companies intend to work together to establish the NII, in which banks can participate. The NII focuses on projects that cannot get the desired (bank) finance for various reasons. The core tasks of the NII would be to pool knowledge, standardise propositions, evaluate and select projects, and provide a sufficient scale and diversification of investments. The NII is planned to be an intermediary helping to attract long-term funding from institutional investors. It is expected to be given a broad mandate to be active in a wide range of sectors and investment categories. The NII will not attract investment capital (neither equity nor debt) and hence will not benefit from direct government guarantees or capital injections, except a one-off public transfer of EUR 10 million for the start of the institution. With time, the NII is expected to cover its operational costs with the fees charged for its services.

Source: Ministry of Economic Affairs (2013), "De oprichting van de Nederlandse Investeringsinstelling en andere resultaten uit het overleg van het kabinet met institutionele beleggers" (The Establishment of the Dutch Investment Institution and Other Results of the Consultation of the Cabinet with Institutional Investors), 17 September.

A vibrant Initial Public Offering market and secondary stock markets geared towards smaller firms are an important complement to earlier stage finance, allowing venture capitalists and angel investors to exit and recycle their funds into new companies (OECD, 2013c). While France and the UK have prosperous alternative stock exchange markets with lighter regulatory regimes for smaller companies, the Dutch alternative market, Alternext, has not taken off (KPMG, 2013). Alternext will be closed soon and stimulating alternatives is needed. The Government should work towards a reduction of regulatory barriers for stock market listing of SMEs. These include high listing costs and very high standards for financial reporting. Considering the critical role that exit markets play, it may be more important for the government to improve such framework condition rather than only trying to "catalyse" the seed and early stage market through financing instruments (OECD, 2013c).

Encouraging mezzanine finance

In the middle of the risk/return continuum, from "pure" debt to "pure" equity, there is a range of financing instruments that can be characterised as "hybrid instruments", in that they have some features of debt and equity. Mezzanine finance is a particular kind of hybrid instrument that is relevant as a source of growth capital for SMEs, which gives the right to convert debt into equity if the loan is not paid back. Mezzanine finance takes place only in private capital markets, which are restricted to professional and institutional investors. Mezzanine finance is most frequently used in a later (expansion phase) life cycle of the firm, after the company has attained profitability, and typically when a firm with a positive cash flow is approaching a turning point in its development. To obtain mezzanine finance SMEs need an experienced management team and sound financial and business information reporting capabilities, allowing the providers of mezzanine finance to evaluate and monitor their key risks and success drivers (OECD, 2013d).

The use of subordinated loans and participating loans is significant relative to the rest of the euro area (Figure 2.7). The government has supported the most common mezzanine instrument, subordinated debt, via the instrument called Growth Facility (GF). The GF offers banks and private equity enterprises a 50% guarantee on newly issued equity or mezzanine loans up to EUR 5 million, providing a guarantee which is half of that amount. However, the evaluation on the GF (Carnegie Consult, 2012) showed that banks have significantly reduced the provision of subordinated loans and it is unlikely that they will expand their activities in this market. To the extent that banks have remained active in this area and needed a government guarantee, they made use of the GO facility. Therefore, the government should limit the use of the GF scheme to private equity firms and qualified business angels and continue the GO guarantee facility for the banks.

Supporting other sources of finance

New SME finance institutions like SME funds, credit unions and crowd funding, are in development and some of them have already been introduced by private parties. The Dutch government responded to these alternatives by temporarily opening the guarantee scheme BMKB since 2012 and the GO facility since late 2013 to these non-bank initiatives till the end of 2014. In the course of this year, the government will evaluate this opening. The authorities should continue to increase diversification of SME financing sources including asset-based finance, credit unions and crowd funding and to improve the awareness about these alternative funding sources for SMEs.

Given the need for companies to finance working capital and given the fact that it is difficult for them to get finance from banks, there remains a potential for the development of asset-based finance in the Netherlands. Asset-based finance includes asset-based lending, leasing, factoring, purchase-order finance and warehouse receipts (OECD, 2013e). According to recent research (Panteia, 2013a) on equipment lease, auto lease and factoring, the use of these alternatives in the Netherlands varies according to the awareness about these instruments. The government is therefore recommended to give more attention to asset-based finance in its efforts to increase awareness of entrepreneurs on alternative forms of finance.

Leasing is a common form of asset-based finance. A SME may need capital equipment, real estate or motor vehicles, but banks would not be willing to lend funds due to the company's credit rating. With leasing, the financial leasing company purchases for

instance necessary equipment and retains ownership, but allows the SME to use it under a leasing contract while receiving lease payments. In case the company does not make the lease payments, the leasing company takes possession of the asset (OECD, 2014a). In the case of factoring, a company sells a receivable from a party with a good credit rating to a factoring company at a discount. In other terms, the factor buys the right to collect a firm's invoices from its customers, by paying the firm the face value of these invoices, less a discount.

The overall use of leasing, hire-purchase and factoring seems to be well developed in the Netherlands compared to the euro area average (Figure 2.7), but there is scope for further improvements in particular by increasing SME awareness about these instruments (Panteia, 2013a,b). The perception of leasing and factoring could be enhanced by drawing SME attention to the fact that costs are balanced by the service aspects of such sources of finance. Stronger demand would also encourage the development of supply. For instance, there are only a few companies that offer factoring services in the Netherlands.

The Netherlands does not have a tradition of credit unions. A credit union is a co-operative between SMEs with a view to creating a common fund and providing financing to SME entrepreneurs. Both lenders and borrowers are members and co-owners of the co-operative. Members who provide the credit funds act as coaches for experienced or novice borrowers. A credit union promotes solidarity between lenders and borrowers and has no profit objective as any benefits are redistributed to members at the end of the year. The Dutch government supports efforts aimed at the establishment of credit unions lending to SMEs and recently a new institution, Credit Union Netherlands, has been launched to stimulate their development. In early 2014, the Dutch Authority for Financial Markets (AFM) and the DNB announced that credit unions will be allowed to attract funds by issuing perpetual membership certificates. Since such certificates are not retrievable, credit unions will not need a banking licence. As with the other alternative forms of financing, the promotion, awareness and reputation of credit unions will also be of major importance for their success.

More recently, the use of online platforms to enable many unprofessional investors to invest small amounts in new ventures (so-called "crowd funding") has also started, making its way into the seed and early stage markets. Netherlands is one of the front-running countries (together with Belgium, France, Germany and the United Kingdom) that have active equity crowd funding platforms (OECD, 2013c). At the moment, there are eight operational platforms in the Netherlands. In 2012, 118 companies raised a total of EUR 11.4 million from this source, of which EUR 7 million was raised by only one company for the acquisition of two windmills (Panteia, 2013b). In 2013, EUR 32 million of crowd finance was raised and 1 250 projects and companies were supported. According to Douw & Koren (2013), a crowd funding consultancy firm, there is a strong potential to develop crowd finance in the near term, allowing SMEs to close part of their business finance gap. However, several obstacles remain. Most companies are not familiar with crowd finance yet. Platforms should work on professionalisation and have difficulties to finance their rapid expansion.

In the financial package of measures for 2014, the government has made EUR 5 million available to support alternative forms of financing such as crowd funding and credit unions, and for information and education for entrepreneurs seeking funding. The AFM together with the DNB has given an interpretation on how the financial Supervision Act

applies to crowd funding, to protect consumers and investors, and has defined conditions to get a licence. To date, there are two crowd funding platforms in the Netherlands with a license.

Fostering innovation

The Netherlands has launched a two-pillar approach to promote a healthy entrepreneurial system with innovation at its core. As discussed in a chapter on policies for the business sector to harvest the benefits of globalisation of the 2012 *Survey* and latest OECD Review of Innovation Policy (OECD, 2012; Gerritsen and Høj, 2013; OECD, 2013g), the aim is to enhance framework conditions for the entire business sector (first pillar). Another goal is to develop sector specific policies to unleash research and development (R&D) and to address bottlenecks hampering the growth of nine "top sectors" (second pillar).

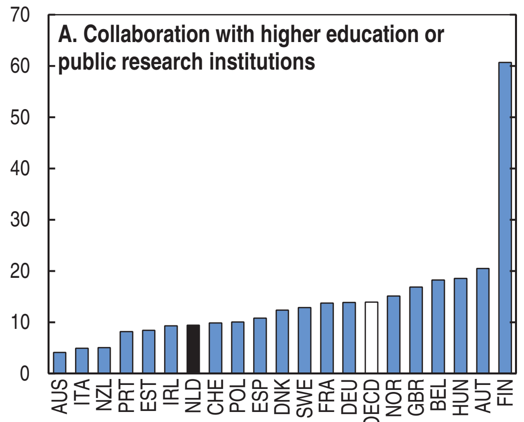
Regarding the first pillar, R&D incentives for all firms are mainly available through indirect tax instruments, although direct support measures could be more suitable for young firms who may not have the upfront funds to start an innovative project (OECD, 2013f). Yet innovation credits for SMEs developed as part of the SME + Innovation Fund represent a progress in this direction (Box 2.1). Concerning the second pillar, the previous *Survey* stressed the need to ensure that well established firms and industries within the top sectors do not effectively capture public support to the detriment of SMEs and emerging industries. A similar challenge appeared for the policy of competitiveness clusters in France (Kierzenkowski, 2009). The recent creation of knowledge and innovation contracts for "top sectors", involving an easier access of SMEs to the "top sectors" instruments through an SME innovation scheme (so-called MIT scheme), is a step forward. The approach in the composition and the number of "top sectors" could also be made more dynamic/flexible, both to promote the development of small businesses in the services sector or implementing non-technological innovation.

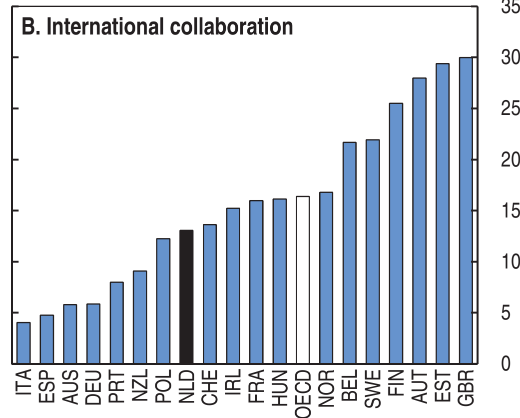
Public research institutions (PRIs) can commercialise their research through licence fees and all universities are participating in the government's "Knowledge Valorisation Programme" (in force until 2017) to promote the dissemination of their research. However, there is scope to further strengthen the collaboration of SMEs on innovation both with PRIs or higher education and internationally (Figure 2.9). Empirical evidence suggests that small Dutch firms that collaborate already with PRIs are more likely to expand their innovation potential (OECD, 2013g). Allowing PRIs to take equity stakes could be more affordable for young businesses rather than buying a licence. Moreover, R&D spillovers could be bolstered by permitting students to own their inventions, encouraging free access to university inventions (in particular to unexploited patents), merging technology transfer offices into regional centres, and promoting PRIs' funding schemes for faculty spin-offs and student start-ups (OECD, 2013h). More recently, the government has taken welcome steps to tackle the shortage of technicians with the adoption of a Technology Pact. This should raise the second-lowest share of graduates with a science or engineering degree in the OECD, reduce skills mismatches and enhance R&D spillovers benefitting SMEs.

Expanding linkages between different stakeholders (or developing a so-called "ecosystem") would also enhance spillover effects of R&D beyond traditional grants and subsidies and, more generally, favour a growth-oriented entrepreneurship beyond national framework conditions (OECD and Ministry of Economic Affairs, 2013). Such promising approach would notably involve: i) developing entrepreneurial connections with a view to supporting learning and investment, the government's role being that of a facilitator;

Figure 2.9. **SMEs collaborating on innovation**

Per cent of product and/or process innovative firms, 2008-10[1]





1. 2011 for Australia, 2006-08 for Ireland, 2009-10 for New Zealand and 2009-11 for Switzerland. SME: Small and medium-sized enterprises. The OECD aggregate covers 30 countries in Panel A and 28 in Panel B.

Source: OECD (2013), *OECD Science, Technology and Industry Scoreboard 2013.*

StatLink http://dx.doi.org/10.1787/888933029679

ii) promoting social values and organisational norms that are conducive to entrepreneurial risk-taking through education or awareness-raising campaigns (for instance, attributing awards for entrepreneurial successes); and iii) developing business advice and mentoring by experienced entrepreneurs.

Reforming employment protection legislation

Tight hiring and firing regulations can restrict the creation and development of SMEs

Strict employment protection legislation (EPL), which governs the hiring and firing of workers, may be an impediment to the development of high-growth firms through various channels. From the perspective of a potential entrepreneur, it increases the opportunity cost of starting a business insofar as this implies trading off a secure wage employment position against an uncertain position of a business founder (OECD, 2013i). Ambitious potential entrepreneurs could be discouraged from launching their activity if they consider that stringent labour regulations could prevent their future firm from reaching an optimal size (Van Stel et al., 2007). This could help to explain a significant discrepancy between high entrepreneurial attitudes (which refer to the perception of entrepreneurship) and low start-up intentions in the Netherlands (Van der Zwan et al., 2013).

More generally, overly demanding labour regulations could influence entrepreneurial choice by reducing firm entry in labour-intensive industries, driven by high compliance costs and difficulties in adjusting labour in downturns (Klapper et al., 2006). Exempting very small firms from some aspects of EPL (e.g. Germany, Italy or Portugal) could mitigate the negative impact of regulation on business creation, but its effect is likely to persist in the case of small and medium-sized firms (Scarpetta et al., 2002).

Tight labour market regulations weaken labour mobility among firms, which is likely to be necessary in the early stages of firm development (OECD, 2013i). Lighter EPL increases labour turnover and helps to reallocate labour resources towards more productive uses, both from less efficient to more efficient existing firms and by facilitating creative destruction with the exit of unproductive firms and the entry of new ones (Martin and

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Scarpetta, 2012; OECD, 2009a, 2013j). The net entry of firms in the manufacturing sector accounts for about a fourth of total labour productivity growth in the Netherlands (Martin and Scarpetta, 2012), though firm entry and exit generates a low job reallocation (OECD, 2009a). More generally, greater labour mobility supports productivity and growth performances notably by permitting a quicker adaptation to changes in technology or consumer demand, in particular if it is achieved through an easier use of permanent contracts (Bassanini et al., 2009). Inflexible labour markets lead to a less dynamic firm growth distribution (Bravo-Biosca et al., 2013). They hinder risk taking and favour more conservative firms' growth strategy, thereby reducing employment growth in innovative industries and lowering pressure on underperforming firms.

Labour regulations have an impact on the prevalence of self-employment

Self-employed are entrepreneurs who are sole owners, or joint owners, of the unincorporated enterprises in which they work. Men are usually motivated by pecuniary aspects, whereas a combination of family concerns as well as opinions of the family, friends and peers prevails for women (Allen and Curington, 2014). The Netherlands has witnessed a steady expansion of the share of self-employed in total employment from around 11% in 2000 to close to 15% in 2012 (Figure 2.10). This reflects entirely the increase in the number of self-employed without personnel, who have mainly a secondary and higher education and whose activity is predominantly in the service sector (CBS, 2012). The growth of self-employment has cushioned increases in unemployment while delivering higher levels of flexibility to firms, in particular in the construction and transport sectors (Van Steen and Pellenbarg, 2012).

Figure 2.10. **Prevalence of self-employment**

Per cent of total employment[1]

1. Population aged 15-64 years-old. The EU28 (i.e. European Union) aggregate is calculated as an unweighted average.

Source: Eurostat (2014), *Employment and Unemployment (Labour Force Survey)* (database), February.

StatLink http://dx.doi.org/10.1787/888933030078

Stringent labour market regulations affect the incidence of self-employment. Stricter EPL has a dampening effect on the probability of becoming self-employed for individuals with high educational attainment in comparison with those with low educational attainment (Baumann and Brändle, 2012). Tight EPL favours dependent self-employment (relying on contracting out or outsourcing with the objective of circumventing the most costly elements of labour regulation) to the detriment of independent self-employment

(based on a business profit opportunity) (Román et al., 2011). Yet, it is also necessary to distinguish between self-employed with employees and self-employed without employees and the degree of EPL. In this context, beyond a certain threshold strong levels of employment protection can increase the transition of unemployed into dependent self-employment driven by insufficient opportunities for paid employment (Román et al., 2013). This research suggests that with an overall EPL index for the Netherlands slightly below 2.5 (Venn, 2009), which is considered to be the limit between flexible and rigid labour markets, an additional increase in the degree of EPL could either increase or decrease the probability of entering self-employment from unemployment.

Stringent EPL may discourage hiring decisions of self-employed (Millán et al., 2013). This finding could explain the reluctance of Dutch own-account workers to take on employees. Almost three quarters of self-employed are without personnel and this percentage exceeds the euro area and EU27 averages of respectively around 67% and 72%. At the same time, empirical evidence suggests that "necessity-driven" own-account self-employed (about 10% of all entrepreneurs in the Netherlands) have a lower entrepreneurial performance in terms of annual turnover levels compared to "opportunity-driven" solo self-employed, who start a firm to take advantage of a business opportunity (De Vries et al., 2013). Cross-country empirical evidence suggests that necessity entrepreneurs tend to have lower educational attainment, run smaller firms and have weaker growth expectations for their businesses (Poschke, 2013). Within the group of own-account self-employed there are also significant dynamics of entry and exit from self-employment. Therefore, notwithstanding tight labour market regulation, self-employment can also lead to salaried employment. Half of Dutch self-employed quit after five years from starting a business, with 60% moving to paid employment and 40% to inactivity (CPB, 2011). Empirical evidence for Denmark also suggests that switching between dependent employment and self-employment within the same sector would not have negative consequences for incomes, including for high-income earners (Kaiser and Malchow-Møller, 2011).

Beyond EPL, the extension of working lives and population ageing also affect the growth of self-employment. A 2004 reform introduced tighter job-search requirements for elderly unemployed between 57.5 and 62, hence reducing the attractiveness of unemployment as a pathway into early retirement (Been and Knoef, 2012). As a result, some older workers may choose self-employment out of necessity rather than opportunity and have a higher probability to enter self-employment than to join paid employment. More generally, the incidence of self-employment increases with age like in many other European countries, to amount to a fifth of employment between 50 and 65 and more than half above 65 (Figure 2.11).

While older workers may face fewer opportunities for paid employment, age also has a strong impact on entrepreneurial activity and this linkage follows heterogeneous patterns (Kautonen et al., 2013): it increases linearly for those who prefer to only employ themselves; follows a bell-shaped curve with a peak at late forties for those who would like to hire workers; and is weakly tied in with age for those who are forced into self-employment for want of alternative employment opportunities. Therefore, the occurrence of self-employment can be expected to rise as the Dutch population ages, but older entrepreneurs may have a lower contribution to job creation in comparison with young business founders. On the other hand, recent research also shows that some Dutch people can opt for self-employment after retirement, with opportunity rather than necessity being the main driver (Van Solinge, 2013). Such decision would be taken by retirees with

Figure 2.11. **The incidence of self-employment increases with age**

Share of self-employed to total employment by age groups, 2012[1]

1. The EU28 (i.e. European Union) aggregate is calculated as an unweighted average.

Source: Eurostat (2014), *Employment and Unemployment (Labour Force Survey)* (database), February.

StatLink http://dx.doi.org/10.1787/888933030097

significant human and financial capital, high entrepreneurial attitudes, sensitivity to the emergence of new business opportunities and who consider their retirement to be involuntary. These findings bode well for sustaining labour resource utilisation and innovation despite demographic ageing.

Planned reforms of the Dutch labour market

Employment protection for regular workers is high in the Netherlands as reflected by the EPL indicators computed by the OECD for 2013 (Figure 2.12, Panel A). For no-fault individual dismissal, mandatory periods of advance notice and severance pay are high for long job tenures. In parallel, procedural inconvenience is the greatest in the OECD, driven by cumbersome notification procedures and long delays before notice periods can effectively start. The difficulty of individual dismissal is high, mainly as a result of an extended length of trial period and, to a smaller extent, the definition of justified or unfair dismissal. Despite major constraints for individual dismissals, additional provisions for collective dismissals are also stricter than in the average OECD country (OECD, 2013j). Considering the protection of permanent workers against both individual and collective dismissals, the Netherlands appears to be the country with the most restrictive labour market regulation in this regard in the OECD after Germany and Belgium.

Recent policy proposals alleviate the strictness of employment law for permanent contracts. The agreement with the social partners concluded in April 2013 seeks to simplify the current dual system of the Dutch dismissal law. If employer and employee do not agree about a termination of an open-ended contract, its dissolution can be proclaimed either by the public employment service (UWV) or by the civil court. The new envisaged rule is to restrict from 2015 the use of court procedures for dismissal for personal reasons, and to introduce a single redundancy procedure for both economic reasons and long-term incapacity for work reasons that would be subject to approval of UWV. There are plans to shorten the decision-making process of the latter route and should UWV oppose the dismissal, the court would still be allowed to terminate the employment contract. To make the SME sector more dynamic, the dismissal system needs to be made simpler, more predictable and less time-consuming.

Figure 2.12. **Differences in protection of permanent and temporary contracts are large**

Strictness of employment protection legislation, scale from 0 (least stringent) to 6 (most restrictive), 2013

1. Contribution of sub-components to the indicator for employment protection for regular workers against individual dismissal (EPR). The EPR incorporates three aspects of dismissal protection: *i)* procedural inconveniences that employers face when starting the dismissal process, such as notification and consultation requirements; *ii)* notice periods and severance pay, which typically vary by tenure of the employee; and *iii)* difficulty of dismissal, as determined by the circumstances in which it is possible to dismiss workers, as well as the repercussions for the employer if a dismissal is found to be unfair (such as compensation and reinstatement).
2. Contribution of regulations for standard fixed-term contracts and for temporary work agency employment to the indicator of employment protection legislation concerning temporary contracts (EPT).

Source: OECD (2013), *OECD Employment Outlook 2013*.

StatLink http://dx.doi.org/10.1787/888933030116

The authorities also consider introducing a cap on severance pay as from 2016, which would amount to up to a maximum of EUR 75 000 or a year's salary, whichever is higher. This would make the costs of lay-offs more predictable for employers. A more generous temporary scheme until 2020 is envisaged for workers over 50, although SMEs with fewer than 25 employees would be exempted. Also, courts would be allowed to grant an additional compensation (with no upper ceiling) should they find evidence of an employer's serious culpability. Overall, it is uncertain to what extent the overall reform would effectively cut dismissal costs for permanent contracts. As discussed in the previous *Economic Surveys* of the Netherlands (OECD, 2006, 2008, 2010 and 2012), a cap on severance pay would be welcome, but it is important that individual dismissals are made less costly and more predictable.

In the Netherlands, the regulation on fixed-term contracts and temporary-work-agency employment is among the most lenient in the OECD (Figure 2.12, Panel B). The incidence of temporary employment is high in the Netherlands, reaching almost 20% of dependent employment in 2012, against close to 12% in the OECD. This share has grown significantly as it stood at 14% in 2000 after temporary employment legislation had been loosened between the late 1980s and the late 1990s. There are plans to tighten the protection of temporary contracts by allowing temporary employees to qualify for a permanent contract sooner. Temporary contracts are now automatically transformed into a permanent contract after the third successive temporary contract or after a period of three years. A planned rule is that a contract will become permanent after two years, unless the chain of temporary contracts has been broken by an interval of six months or longer. The rules on successive contracts may be overridden in collective labour agreements, but only if the use of temporary contracts is necessary because of the nature of the sector. Care is needed when reducing labour market segmentation by tightening the protection of temporary contracts as this may reduce needed flexibility for the development of SMEs, which on the other hand could benefit from greater labour supply driven by unemployment benefit reforms. In particular, there are plans to reduce the ability of the unemployed to reject job offers and to gradually shorten the duration of unemployment benefits as from January 2016. The overall impact of planned labour market reforms needs to be carefully evaluated and further action should be taken if needed.

Greater flexibility of labour costs would also enhance the adaptability of the labour market and encourage the development of SMEs. Employer-paid sickness leave has sharpened firms' incentives to contain the growth of sickness leave and the number of disabled workers. However, beyond a negative effect on the employment of older workers (OECD, 2010), employer-paid sickness leave of up to two years (amounting to 70% of the basic wage up to a certain maximum) could also constitute a barrier to growth and job creation by SMEs. Therefore, the authorities could explore ways to create a fund which would mutualise risks of disability across SMEs.

Despite low union density of about 20%, collective labour agreements cover about 80% of workers in the Netherlands. As discussed in the 2012 *Survey* of the Netherlands, moving towards a more decentralised wage setting system would better take into consideration macroeconomic and local productivity developments (OECD, 2012). Shifting away from co-ordinated sectoral wage negotiations would also limit incentives for contracting firms to seek greater wage flexibility through self-employment, which is not part of collective labour agreements. Alternatively, the wage setting system could become more centralised to better internalise the macroeconomic consequences of wage bargaining. Delinking minimum and contractual wages would prevent low-skilled workers, whose productivity does not keep up with average worker productivity gains, from being pushed into self-employment (Van Vuuren, 2012). Finally, encouraging social partners to adjust wage-setting procedures by focusing less on tenure and seniority and more on performance (OECD, 2014b) would also strengthen the flexibility of SMEs.

Reforming the tax system

Seeking greater tax neutrality between different forms of businesses

The authorities should strive to ensure a more neutral tax treatment in the way businesses are structured. When excluding the effect of social security contributions, the

overall tax rate on incorporated businesses (when considering corporate income and dividend taxes) is lower than the tax rate levied on unincorporated businesses (liable to personal income taxes) in the Netherlands while, for instance, such distortions do not exist in the United Kingdom (OECD, 2009b). A proposal to reduce incentives for owner-managers (significant shareholders working in companies) to convert labour income into capital income would be a step forward to address tax avoidance in incorporated small firms (Van Dijkhuizen Committee, 2013). At the same time, there is a significant bias towards high-growth SMEs (when after-tax profits are retained) that are incorporated, with a tax rate on corporate profits significantly lower than the tax rate on unincorporated business income.

It is debatable whether the tax system should deliberately promote an increase in the number of small businesses in the economy (IFS, 2010; Crawford and Freedman, 2010; OECD, 2009b; IMF, 2007). Generic fiscal incentives for SMEs are probably not the best instrument to compensate for externalities, capital market imperfections or the higher compliance costs that they face. The small business sector is very heterogeneous, which implies that some firms are not credit constrained or do not generate spillover effects for the rest of the economy through greater employment, investment spending or research and development activities. Public support targeted to address well identified market failures would be more efficient than tax breaks on profits for all small businesses. For instance, government intervention could include loan guarantees in the presence of tight credit constraints, earned income tax credits to boost employment of low-skilled workers or investment allowances if there is evidence of higher social returns than for investment by larger firms. Such an approach would also obviate the need to develop costly anti-avoidance measures.

Since 2011, incorporated small businesses are taxed at a preferential corporate tax rate of 20% up to EUR 200 000 of taxable profit, against a basic rate of 25%. However, a two-rate structure may act as a disincentive for SMEs below the threshold to grow. This would call for the adoption of a flat-rate corporate tax, but without increasing the tax burden on SMEs. At the same time, broadening the corporate income tax base would also ensure a level playing field between small and big companies. The tax system should ensure a more symmetric treatment of profits and losses for all firms, which would encourage their risk-taking behaviour (IFS, 2010). Losses are "carried back" for only one year by offsetting them against past profits and "carried forward" for nine years by setting them against future profits, and they would also need to be adjusted by an interest rate to compensate for timing differences in their use.

Reducing tax incentives for self-employment

The growth of self-employment has also been spurred directly by government tax policies (Van Es and van Vuuren, 2010). There are various fiscal incentives to become self-employed. These include tax allowances for start-ups, the possibility for the unemployed to use welfare benefits to start a business (with a partial repayment depending on future income) and the opportunity for the disabled workers to get an extra tax credit to become self-employed. Unincorporated businesses benefit from several tax reliefs regarding personal income taxes, which are progressive with a top rate at 52%. This creates an additional inducement to choose self-employment over dependent employment. A Committee on personal income tax and allowances, also known as the Van Dijkhuizen Committee, recommended that the government discontinue an allowance for start-ups and abolish a lump sum deduction from the taxable income of self-employed

(Van Dijkhuizen Committee, 2012). More recently, the government was considering implementing the latter proposal, but these plans failed in the budget negotiations for 2014.

The authorities should aim to align more closely the tax treatment of income from employment and self-employment in order to reduce distortions on the decision margin as to whether to remain in dependent employment or, instead, create an unincorporated business. This would imply that average personal taxes on self-employment income should be on a par with average personal taxes on wage incomes. A differential tax treatment could be justified mainly to alleviate some negative effects of labour market rigidities, with well-targeted tax incentives acting as a stepping-stone to employment of low-skilled workers and other groups poorly attached to the labour market (Van Vuuren, 2012). Compared to employees, self-employed could still be liable to lower marginal taxes as they are more responsive to taxation because of longer hours worked and a higher propensity for tax evasion.

Greater homogeneity is also needed with regard to participation of self-employed in social security schemes. They are entitled to only basic welfare benefits, mainly in the form of health insurance and state old-age pension (*first* pension pillar) and since 2012 are also allowed to retain active membership in mandatory pension funds (*second* pension pillar) for ten years. However, they cannot claim public social benefits related to unemployment, disability and sickness. Lower social charges create an incentive for employers to push employees into dependent self-employment and for employees with low unemployment, sickness and disability risks to self-select into self-employment. The exit of good risks from the social security system can in turn undermine the sustainability of the system. Many self-employed do not save (or not sufficiently) for an additional pension and do not insure themselves against other social risks (Bekker and Posthumus, 2010) while private insurance is costly due to adverse selection (CPB, 2011).

The authorities should consider broadening the social security entitlements and charges of the self-employed and making them closer to those of employed workers (paid by both employers and employees). The issue of levying pension and disability contributions on the self-employed has recently been mentioned in the policy debate. This would increase the protection of self-employed and also help to ensure that self-employment is driven by genuine entrepreneurial motivation and would reduce incentives for tax arbitrage by employees and/or employers.

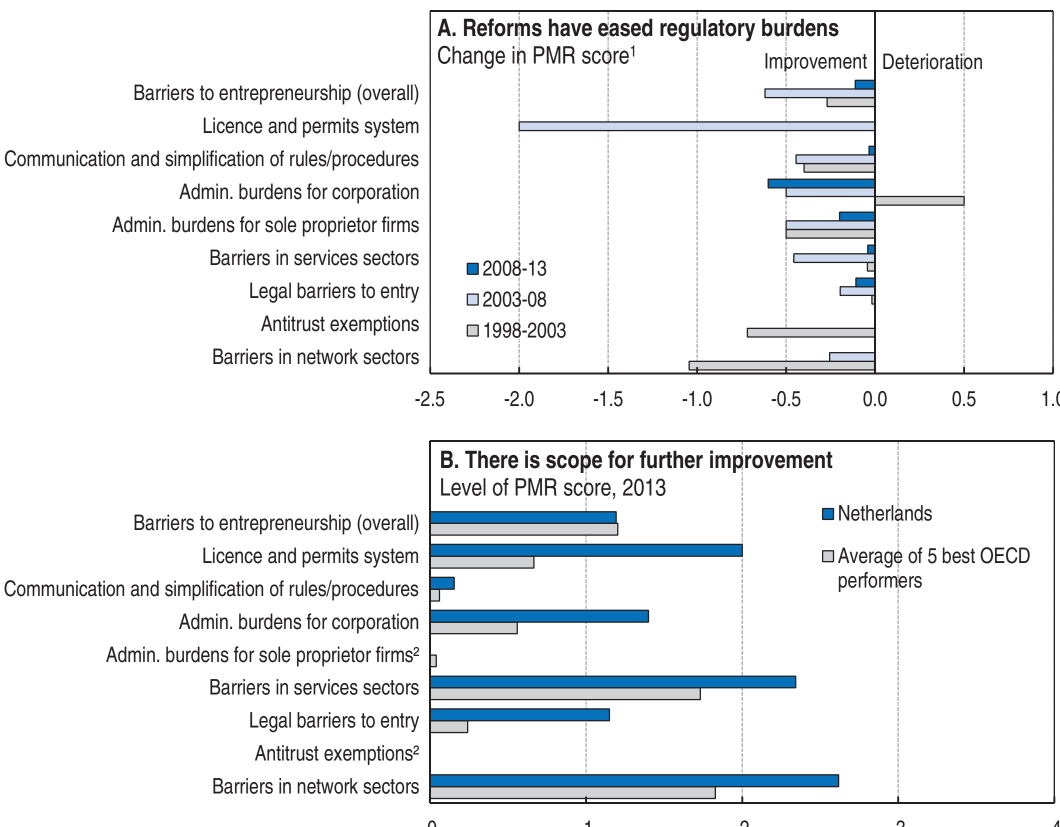
Reducing barriers to entrepreneurship

Administrative burdens are perceived as another impediment by firms while the cost of such barriers is certainly higher for SMEs than for large firms (Figure 2.2). The Netherlands has the least restrictive product market regulation in the OECD. Barriers to entrepreneurship have been significantly lowered over the last 15 years and are the third lowest in the OECD (Figure 2.13, Panel A). However, there is some scope for improvement in specific areas compared to the best-performing OECD countries (Figure 2.13, Panel B). Making the licence and permits system more business friendly would be an additional step forward. Licences could follow the principle that "silence is consent rule" and be issued automatically beyond administrative deadlines. Moreover, the government could establish a complete record of the number of permits and licenses required. There is also scope to lower barriers in services sectors, in particular to start a national road freight business (a large set of conditions needs to be fulfilled) or create a new retail outlet for both selling clothing and food (a registration in a commercial register is required). Finally, in the sector

of road transport, professional bodies or representatives of trade and commercial interests are involved in specifying or enforcing entry regulations, which could be another barrier for the development of SMEs in this sector.

Figure 2.13. **Product market regulation (PMR): barriers to entrepreneurship**

Index scale from 0 (least restrictive) to 6 (most restrictive)



1. There was no change in the PMR score for licence and permits system in 1998-2003 and 2008-13, nor for antitrust exemptions in 2003-08 and 2008-13, nor for barriers in network sectors in 2008-13.
2. For administrative burdens for sole proprietor firms the PMR score of the Netherlands is zero (i.e. least restrictive). For antitrust exemptions the PMR scores are zero.

Source: I. Koske, I. Wanner, R. Bitetti and O. Barbiero (2014), "The 2013 Update of the OECD Product Market Regulation Indicators: Policy Insights for OECD and non-OECD Countries", *OECD Economics Department Working Papers*, forthcoming.

StatLink http://dx.doi.org/10.1787/888933029736

Exit policies are efficient as they imply little time and low cost to close a small business, but costs required to transfer property and enforce contracts could be lowered as they are comparatively higher than in other European countries (European Commission, 2013). The government aims to achieve a further reduction of administrative burdens by 2017, which is planned to be partly achieved by expanding information technology and digital service provisions.

The government has also launched a welcome rationalisation of its support network for businesses, which should further promote the development of SMEs. In 2014 the local Chambers of Commerce, the National Chambers of Commerce and the Syntens Innovation Centre were merged into a single Chamber of Commerce organisation. The aim is to

centralise information on different support programmes and create one-stop shop services, notably through the internet. Various stakeholders are expected to collaborate in the new support network, including tax authorities and local governments.

Box 2.3. **Policy recommendations to boost the development of sound SMEs**

Improving access to finance

Continue to evaluate policy instruments supporting access to finance in the light of existing market inefficiencies faced by small and medium-sized enterprises (SMEs) and, if needed, ensure broader access to those instruments and in particular public loan guarantees.

Continue to develop alternative to bank lending sources of finance and enhance the information of SMEs about them, but ensure that public intervention is justified by well identified capital market imperfections.

Fostering innovation

Strengthen incentives for universities to commercialise their research by allowing them to take equity stakes in small businesses, encourage free access to research and unexploited patents, and continue to increase the share of direct innovation grants to SMEs.

Tackling labour market rigidity

Reduce the protection of permanent contracts against individual dismissals, in particular by shortening the length of trial period and by easing procedural inconvenience in terms of notification procedures and delays needed before notice can start.

Allow greater flexibility in labour costs by capping and lowering the accumulation of severance pay with tenure and delinking minimum and contractual wages.

Monitor and evaluate the impact of planned labour market reforms reducing protection of permanent contracts and simultaneously increasing the protection of temporary contracts, and take additional measures if needed.

Reforming the tax system

To prevent fiscal distortions on self-employment, adopt a similar average tax treatment of income from self-employment and dependent employment within the personal tax system, and reduce the gap between social security coverage and contributions on both forms of employment. Consider mutualising the costs of disability through a dedicated fund for SMEs.

Consider converting the two-rate corporate income tax into a flat-rate tax system while not increasing the tax burden on SMEs and levelling the playing field between smaller and bigger companies by broadening the corporate income tax base.

Align more closely effective tax rates on income from capital and labour of owner-managed companies to reach greater tax neutrality between incorporated and unincorporated businesses.

Reducing barriers to entrepreneurship

Ease access to licences by issuing them automatically if they are not delivered by the end of the statutory response period and lower the administrative costs of enforcing contracts and transferring property.

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(10 2014 08 1 P) ISBN 978-92-64-20690-8 – 2014

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Volume 2014/8
April 2014

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ISSN 0376-6438
2014 SUBSCRIPTION (18 ISSUES)
ISSN 1995-3305
SUBSCRIPTION BY COUNTRY

ISBN 978-92-64-20690-8
10 2014 08 1 P