Reforming Social Policy: Learning from the Dutch Experience

PHILIP R. de JONG*

1. INTRODUCTION

A decade ago the Netherlands was considered the sick man of Europe. The number of working age beneficiaries per 100 workers was 43. About half of those beneficiaries were in receipt of a sickness benefit or an invalidity pension. The other half were unemployed or had retired prematurely. More than one quarter of GDP was spent on benefits (including old-age) and, as a result, the average tax wedge between gross labour costs and net pay was about 40 per cent. In the eyes of many foreign observers the Netherlands now is a successful model of employment policy. Since 1995 employment grows at an average annual rate of 2.2 per cent, against an EU growth rate of 0.6, and an OECD rate of 1.2 per cent.

This raises two questions: (1) What was the «Dutch Disease» about? and (2) How, and to what extent, has it been cured?

In the following sections I chronologically describe the symptoms of the sickness from which the Dutch labour market and social welfare system suffered. Then some of the instruments that contributed to its cure are discussed. I focus on the most salient among the social policy problems that plague(d) the Dutch society: the management of an excessively generous and lenient disability insurance system. I end with an alternative model of private social insurance and a few lessons to be learned from the Dutch experience.

2. THE DUTCH DISEASE WAS ...

The Dutch disease was a combination of generous, and easily accessible, cash benefit schemes, a comparatively high minimum wage, and extensive job protection regulation. This adverse combination prevailed in the 1970s under a centre-left coalition that aimed at completing a Keynesian welfare state. In 1972 a statutory minimum wage was introduced, and between 1972 and 1980 both the minimum wage and social benefits rose faster than wages. An inflexible labour market served a labour union policy of protect-

* Erasmus University Rotterdam and Aarts & De Jong BV, The Hague.
E-Mail: adj@adj.nl
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ing the wage growth and job security interests of employees – the so-called insiders –, under a lethal combination of sluggish employment growth due to stagflation, and increasing labour supply by baby boomers and (married) women. The consequent threat of massive unemployment was countered by using a new, and unique, disability programme introduced in 1967 (see below) as a shelter for redundant (older) workers. High disability benefits (with a before-tax replacement rate of 80 per cent) supported the high wage policy of labour unions as they accommodated the adverse employment effects of such a policy (see Graafland, 1991).

In 1981, when a second round of oil-price increases triggered a deep international recession, the Dutch economy was in bad shape. There was inflationary pressure from both external price shocks and steep domestic increases in labour costs, and employment and GDP were decreasing. Apart from global factors which affect small, open, economies, like the Dutch, more than others, the Dutch economy was also destabilised by a macro-economic relationship called «The Social Security Trap». ¹ It is set into motion by an exogenous shock, for instance, a steep rise in labour supply as was caused by the baby boomers entering the labour market in the early 1970s, without employment growing to accommodate these new entrants. As a result, both official unemployment, and redundancies among older workers hidden under the labels of disability or early retirement, grew.²

Figure 1: The Social Security Trap

Swollen beneficiary volumes require higher contribution rates, and when these higher rates burden the wage-bill they have to be compensated by higher productivity demands. When productivity standards rise the number of marginally unemployable workers increases. They will seek shelter under unemployment and disability insurance schemes, or will be forced to do so by their employers, and increase the beneficiary volumes, fuelling a new round of rises in contribution rates, labour costs, and productivity standards.

The dynamism described by the social security trap also leads to a crowding-out of net-contributors to welfare state programs by net-recipients. A second trap, then, is a

¹. See Bernard van Praag and Victor Halberstadt (1980).
². For a description of the Dutch social welfare system including unemployment benefit and early retirement programmes, see Aarts et al. (1996).
political-economic one, as described in Persson and Tabellini (1994). They argue that if the median voter turns from a net-contributor into a net-recipient the political majority will vote for policies that promote redistribution at the expense of economic growth. After this shift elections can only be won on a redistribution ticket, thus further reinforcing the net recipient status of the median voter. The result of this mechanism is an increasingly equal distribution of post tax-transfer (secondary) incomes, but an increasingly unequal distribution of pre tax-transfer (primary) incomes.

This theory is illustrated by Dutch aggregate time-series data. Between 1970 and 1985 the labour force participation rate dropped from 57 to 48 per cent; unemployment increased from 1 to 12 per cent of the labour force, and the number of benefit recipients (including old age benefits) per 100 workers grew from 44 to 85. In 1985, the distribution of secondary incomes was among the least unequal, but factor incomes contained an increasing number of zeros, reinforcing primary income inequality.

By 1985, not only the unemployment rate had reached 12 per cent, but the disability beneficiary volume, by then, had grown to 11 per cent of the labour force. About 6 percentage points of these 11 per cent disability beneficiaries can be attributed to hidden unemployment. One way to obtain an estimate of the unemployment component hidden under disability is by comparison with Germany which, in terms of health and work conditions is comparable to the Netherlands, but has a less generous and better managed disability programme. The German number of disability beneficiaries was about 5 per cent of the labour force in 1985. Adding up, the true Dutch unemployment rate was in the order of 18 per cent in the mid 1980s.

3. ... CAUSED BY DISABILITY

The most salient feature of the Dutch social welfare system is the number of disability benefit recipients. Five features of the Dutch disability insurance scheme combine to make it a unique programme – and one that has proved very difficult to manage.

(1) Any illness or injury entitles an employee to a disability benefit after a mandatory waiting period of 12 months. These first 12 months are covered by sickness benefits. Thanks to collectively bargained supplements sickness benefits usually replace 100 per cent of net earnings.

(2) While other OECD countries distinguish people with disabilities by whether the impairment occurred on the job or elsewhere, only the consequence of impairment is relevant for the Dutch disability insurance programme. Often, programmes covering work-related risks offer higher benefits as they also cover the potential liability of

3. For a slightly lower, but more direct, estimate, see Aarts and De Jong (1992), Chapters 5 and 11.
the employer. Workers with disabilities, then, have an incentive to claim that their impairment is work related. In cases where the cause of disablement is hard to assess excessive litigation may be an unwanted outcome of such a dual system. In the Netherlands integration of the usual set of two separate disability programmes solved these causality problems. The more generous Work Injury scheme was taken as the standard for the integrated disability scheme that was introduced in 1967.

(3) The risk covered under the disability insurance program is loss of earning capacity. The degree of disablement is assessed by consideration of the worker’s residual earning capacity. As of 1994, capacity is defined by the earnings flowing from any job commensurate with one’s residual capabilities as a percentage of pre-disability usual earnings. Before 1994, only jobs that were compatible with one’s training and work history could be taken into consideration.

The Dutch disability programme is also unique in the way it classifies loss of earning capacity. It distinguishes eight disability categories ranging from less-than-15 percent, to 15–25 percent disabled, and so on, up to 80-100 percent disabled. The minimum degree of disability yielding entitlement to benefits is a 15 percent loss of earning capacity. Replacement rates depend on degree of disability: a 20% disablement yields entitlement to a benefit of 14% of covered earnings; 30% disablement to 21%, and so on; 80-100 percent disablement is compensated by a benefit with a replacement rate that never exceeds 70% of previous earnings. A partial benefit can be combined with labour earnings up to the level of the pre-disability wage. Partial benefits intend to work as a wage subsidy by allowing handicapped workers to offer themselves at a reduced price in order to compensate employers for their lower productivity.

(4) Theoretically partial benefits are an excellent idea as they may promote swift rehabilitation. In actual practice, however, disability benefit adjudicators often find it difficult to make assessments within the discrete disability categories that were laid down in law. Estimates of residual earning capacities are made by confronting a claimant’s capabilities with job demands. The earnings in commensurate jobs determine the residual capacity, whether such jobs are available or not. Such theoretical assessments, however, diverge from actual earning capacities if commensurate jobs are not available for persons with partial disabilities. Sometimes employers discriminate against impaired workers, or, in a slack labour market there may be no vacancies in general.

4. Disability benefits are capped by a maximum amount of covered earnings which equals about Dfl. 80,000, or Sfr. 60,000 per annum (in 1999). This is also the maximum amount of income taxable for disability (and unemployment) insurance.
Before the 1987 social welfare reforms the law recognised the potential discrepancy between theoretical and actual earning capacities. It stipulated that adjudicators, in their assessments of the degree of disability, should take account of the difficulties that persons with partial disabilities might experience in finding commensurate employment. This legal provision is usually referred to as the «labour market consideration».

The disability insurance administrators solved the problem of assessment of partial disability by liberal application of the labour market consideration, presuming that poor employment opportunities result from discriminatory employer behaviour, unless the contrary could be proven. The ensuing administrative practice was to treat partially disabled applicants as if they were fully disabled. This interpretation of the law made accurate assessment of theoretical earning capacity unnecessary, as a minimum earnings loss of 15 percent was sufficient to entitle a person to full benefits.

The result was an administrative culture that stressed income maintenance instead of rehabilitation and economic independence. The «social partners» that boarded the Insurance Agencies (see below) considered this procedure to be in conformity with their group interests. Employers found it a relatively easy and cheap way to release low productivity, or redundant, workers. Trade unions considered it a means of providing adequate income for people with severe disabilities, as well as a generous unemployment and early retirement option for workers with health complaints that are more difficult to verify.

As a consequence of these liberal procedures, the share of full awards steadily increased. In 1986, the year before the rule that allowed explicit labour market consideration was abolished, 88 per cent of new disability beneficiaries were declared fully disabled and were awarded a benefit of 70 percent of gross earnings.

(5) Until 1995, the insurance agencies that manage the employment related social insurance schemes (sickness benefits, disability and unemployment insurance) were organised according to branch of industry. Each enterprise was assigned to one of the agencies by law. Each social insurance agency, therefore, held a legally protected monopoly within its branch. Moreover, the agencies were run by the social partners – trade unions and employers’ representatives. As said, both partners had an interest in using the disability scheme leniently. They were allowed a large autonomy without bearing the financial consequences of their liberal award policies, as the benefits were paid out of nationally uniform pay-as-you-go contribution rates.

The key word here is moral hazard. Work disability, even if strictly defined and stringently administered, is an elusive concept. Even in cases where the medical part – the functional limitation – is clear-cut, the vocational part – the residual earning capacity – may be hard to assess. But if disability is self-declared, and not objectively assessable, reliable estimates of earning loss are virtually unavailable. In that case individual workers, or their employers, have ample room to determine the outcome of the benefit award
process. Interestingly, about 50 per cent of Dutch disability insurance benefits are based on subjective complaints, such as symptoms of stress and low back pain.

Under the adverse labour market conditions that prevailed between the 1970s and early 1980s redundant Dutch workers preferred disability over unemployment benefits that have limited duration and end in means tested public assistance. Likewise, employers preferred to use disability insurance as an instrument to adapt their manpower to changing economic conditions because it was a silent route and administratively easier than openly terminating an employment contract. And, finally, administrators and professionals (doctors and vocational experts) at the social insurance agencies had an easier, conflict-avoiding, job if they awarded everyone who claimed to be disabled a full benefit. The costs of such leniency were shifted to a national pay-as-you-go fund. And their clients – the firms – could not choose between agencies, nor had they other options, such as self-insurance, were they unsatisfied with their agency’s award policy. Moral hazard, therefore, affected all three parties mentioned above – employees, employers, and programme administrators.

For its generosity and accessibility the Dutch disability insurance contained small returns to prevent, or limit, benefit recipiency. The negative results of these inadequate incentive structures were only felt at the macroeconomic level, in terms of increasing contribution rates. As long as those politically responsible were reluctant to intervene and confront the parties involved with the financial consequences of their self-centred behaviour programme growth remained uncontrollable.

Micro-econometric research using survey data from the early 1980s shows that the probability of disability programme entry is determined both by medical and non-medical factors. Employment opportunities and income and leisure considerations appear to have remarkably powerful impacts on the disability risk. The main conclusion that emerged from this study was that «for lack of a manageable disability standard, disability insurance enrolment is largely at the discretion of individual employees and their employers» (AARTS and DE JONG, 1992, Chapter 10, and p. 354).

4. CURING THE DUTCH DISEASE IN THE 1980S

The social and fiscal pressures that emanated from these adverse trends led the Dutch federation of labour unions to change their policy. In 1982 they reached an agreement with employers’ organisations to subscribe to wage cost moderation as part of a package that also contained tax reduction and a reduction of standard full time work hours, from 40 to 38 hours per week. Given a budget deficit of 8 per cent tax reductions could only come from reducing government expenditures, including social welfare spending. The statutory minimum wage, cash benefits, as well as government sector wages were nom-

5. This agreement is called the Wassenaar agreement after the town where it was reached.
inally frozen in 1982 and 1983. In 1984 these incomes were cut by 3 per cent (while prices rose by 3.4 per cent); and in 1985 statutory, before-tax, replacement rates under sickness benefits, disability and unemployment insurance were reduced from 80 to 70 per cent of earnings. Despite the emergence, after 1980, of persistent long-term unemployment benefit expenditures as a percentage of GDP stabilised at around 26 per cent. Mainly as a result of unemployment growth the number of benefit recipients per 100 workers increased from 66 in 1980 to 82 in 1990 (Table 3). Over the same decade, however, average real benefits decreased by 16 per cent (Table 3).

Table 1: General Welfare

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<tbody>
<tr>
<td>Per capita GDP (dfl) (1990 prices)</td>
<td>25,037</td>
<td>29,544</td>
<td>34,684</td>
<td>39,375</td>
</tr>
<tr>
<td>Average real wage (1970 = 100)</td>
<td>100</td>
<td>112</td>
<td>112</td>
<td>116</td>
</tr>
<tr>
<td>Average annual work hours</td>
<td>1,800</td>
<td>1,612</td>
<td>1,475</td>
<td>1,385</td>
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<tr>
<td>Two earner families as a % of all households</td>
<td>–</td>
<td>30</td>
<td>37</td>
<td>60</td>
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Table 1 gives an impression of the effects of the bipartisan agreement on wage cost moderation over the 1980s. While per capita GDP grew by 17 per cent, average (before-tax) real wages stayed put. Average annual work hours decreased by 13 per cent. From these trends one may conclude that productivity growth was translated in increased leisure and higher profits. Additional results can be seen in Table 2. Although the unemployment rate grew by 25 per cent, and the steep downward trend in older male labour force participation continued, participation rates among younger males and (all) females increased. During the 1980s employment in persons grew by 9 per cent. However, many new entrants to the labour market were married women with a strong taste for part-time work. Employment growth in full time equivalents, therefore, was only 5 per cent. Nevertheless, the switch of the Dutch trade unions from a high wage/high benefit policy to a moderate wage growth/employment growth policy proved successful, especially when compared with the experiences in other European welfare states.

The reduction in average annual work hours, which continued in the 1990s, is the combined result of coercive consumption of leisure through a reduction in standard full time work hours and an increase in dual earner households (Table 1). The latter increase may partly be the result of the policy of moderate real wage growth that may have induced spouses to start working so as to support household earnings. It can also be explained by a combination of two substitution effects. Starting with the baby-boom gen-
eration married women are, on average, higher educated than previous generations. Higher education, together with advances in household productivity, makes market work a more attractive option for spouses. On the other hand, real wage cuts lead to increased preferences for part-time work among existing (male) workers. As a result, 32 per cent of Dutch workers were part-timer in 1990, which compares to an EU average of 14 per cent (see Van Soest et al., 1990).

<table>
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<th>Table 2: Labour force</th>
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<tr>
<td>Male labour force participation, total (%)</td>
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<td>Male labour force participation, aged 55–64</td>
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<tr>
<td>Female labour force participation (%)</td>
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<tr>
<td>Unemployment rate (%)</td>
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</tbody>
</table>

<table>
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<tr>
<th>Table 3: Social Welfare (Cash Benefits)</th>
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<tr>
<td>Benefit Expenditures as % of GDP</td>
</tr>
<tr>
<td>Benefit Recipients per 100 Workers</td>
</tr>
<tr>
<td>Average Annual Benefit Amount (x Dfl 1,000; 1997 prices)</td>
</tr>
</tbody>
</table>

Both among men and women the share of part-time workers is high. In 1996, 17 per cent of male workers, and 68 per cent of female workers, were part-timers. This compares to an EU average of 5 per cent for males, and 32 per cent for females. This salient feature of the Dutch labour market remains largely unexplained. It may be an effect of the importance of temporary work agencies (like the Swiss firm Adecco) that specialise in flexible types of work. In a 1992 report on the Dutch labour market the OECD writes with amazement: «A street of shops in the Netherlands is likely to contain not one but several temporary employment agencies. (...) the number of hours of work supplied [by these agencies] tripled between 1983 and 1991». (OECD, 1992, p.15)
Evidently, Dutch firms like to use the services of these agencies to evade the inflexibility of the standard labour contract. And by using these flexible forms of contingent work they may have also learned to manage the changing work-leisure preferences of their regular workers. What is more amazing is the acceptance of the wide use of the services of these agencies by the labour unions. Like the policy shift toward wage moderation in 1982, the acceptance of commercial employment agencies is another token of the co-operative, non-adversarial attitude of the Dutch unions.

5. CURING THE DUTCH DISEASE IN THE 1990S

Between 1985 and 1990, a combination of wage moderation, hours flexibility, and benefit cuts, caused employment to grow at a pace that was higher than anywhere in Europe. These new jobs, however, did not go to the long-term unemployed and disabled. Despite employment growth the number of beneficiaries of social welfare programmes kept growing. In 1990 the number of benefit recipients per 100 workers had reached 82. Apparently, benefit cuts and other changes in the disability insurance scheme, making eligibility rules stricter, did not sufficiently help to reduce the volume of beneficiaries. (See AARTS et al. 1996) The prospect of further growth of disability and old-age benefit volumes due to an ageing population, combined with a fiscal need to reduce budget deficits, prompted an acute awareness that the Dutch welfare state was still in crisis. A political majority decided that additional measures had to be taken to reduce the generosity and accessibility of the disability insurance programme.

5.1. The Disability Insurance Changes of 1993

Since August 1993, eligibility standards and the process for continued eligibility are considerably tighter. Previously benefit awards were considered to be permanent. No process existed for re-evaluation. In 1993 periodic review of those on the disability rolls was made a structural part of the system. The new eligibility standards require that the medical cause of disablement be objectively assessable. The high prevalence of conditions that are difficult to assess led system reformers to suspect substantial moral hazard problems which more objectivity-based rulings seek to reduce. Furthermore, since 1993

6. This made the Netherlands the first country to employ a policy that the current political leaders of the United States, United Kingdom and Germany now call «The Third Way» – a combination of a broad welfare state with flexible markets based on consensus among the social partners, and between the social partners and government. For a fuller account of the Dutch version of consensus seeking corporatism see VISSET and HEMERICK (1997).

7. A mechanical forecast from 1990 shows that due to ageing the disability beneficiary volume would peak in 2020 at a level 80 per cent higher than in 1990 (AARTS and DE JONG 1992, Chapter 11).
the extent of disablement is assessed with respect to all jobs in the economy, whereas before assessments were made with respect to a relatively strict notion of suitable employment. And, finally, disability benefits now are temporary awards and have to be reviewed after no more than five years. Previously, only very few beneficiaries were reviewed after the initial allowance was made, stressing the early retirement pension character of disability benefits.

Under the new benefit calculation process, enacted in August 1993 together with the stricter eligibility standards, the disability benefit period is divided into two parts: a short-term wage-related benefit, with the previously existing 70 percent replacement ratio, followed by a benefit with a potentially lower replacement ratio. Both the duration of the wage-related benefit period and the replacement ratio thereafter depend on one’s age at the onset of disablement.

Wage-related benefits range from none, for those up to 32 years of age, to six years for those aged 58 and over. All of these periods are preceded by the existing 12-month waiting time covered by wage-related sickness benefits. During the follow-up period, a fully disabled beneficiary receives a base amount of 70 percent of the minimum wage plus a supplement depending on age at onset according to the formula: 

\[ \text{replacement rate} = \left( \frac{\text{age} - 15}{100} \right) \times 1.4 \times \text{wage} - \text{minimum wage} \]

For beneficiaries with residual earning capacities, these replacement rates are adjusted in accordance with their degree of disability.

Evidence that the new rules are biting is that during 1994, benefit terminations due to recovery, i.e., being found fit for generally accepted work, increased by about 40 percent. The stricter regime has also affected the incidence of new disability awards. Among the total at risk population, awards decreased by about 15 percent. The decrease in awards may well be the combined result of increased stringency of the gatekeeper and lower application rates because disability benefits lost part of their financial appeal.

A smaller number of awards and a steep increase of benefit terminations resulted in a 3 percent decrease of the private employee disability insurance beneficiary population in 1994 an 1995 (see Table 4). These were the first years in the history of Dutch disability policy in which the population actually fell from the previous year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Netherlands</th>
<th>United States</th>
<th>Sweden</th>
<th>Germany</th>
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</thead>
<tbody>
<tr>
<td>1970</td>
<td>55</td>
<td>27</td>
<td>49</td>
<td>51</td>
</tr>
<tr>
<td>1980</td>
<td>138</td>
<td>41</td>
<td>68</td>
<td>59</td>
</tr>
<tr>
<td>1990</td>
<td>152</td>
<td>43</td>
<td>78</td>
<td>55</td>
</tr>
<tr>
<td>1997</td>
<td>142</td>
<td>64</td>
<td>106</td>
<td>47</td>
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</tbody>
</table>

5.2. Forms of Privatisation

These new benefit rules are a sharp break from a quarter century of disability entitlement to permanent wage-related benefits. Age now serves as a proxy for work history, or «insurance years», introducing a quasi-pension element into the disability system. The new rules substantially lower the government-provided replacement rates for the average Dutch worker. However, the reduction in government-provided disability insurance has also spurred a lively market in which private insurers are competing with corporate and industry pension funds to cover the gap between the old and new systems. These supplements are financed by premiums that differ by the firm’s level of risk. Specific firms and even complete branches of industry signed collective bargaining agreements that readjust the gap between the old and new replacement rate so that 85 percent of all employees are covered by such gap insurance.

Employers have shown a surprisingly strong willingness to purchase gap coverage. Apparently, their stated interest in reducing labor cost was outweighed by their desire to maintain a generous exit option for their redundant workers. The eagerness of private insurers to offer supplemental coverage in less surprising. After all, the new benefit calculation formula implies that younger and better paid workers face a lower replacement rate. In other words, workers with a low disability risk experienced the greatest cuts in their replacement rate. Under such favourable self-selection conditions, coverage of these cuts up to the original 70 percent replacement, or even higher, is an attractive proposition for private insurers.

An additional form of privatization was introduced in 1994, when employers were mandated to cover the first weeks of sick pay themselves and to contract with a private provider of occupational health services to monitor sick spells, advise firms on the nature and extent of the health risks to which their manpower is exposed, and suggest ways to reduce these risks. In March 1996, the Sickness Benefit Act was abolished and employer responsibility for coverage of sick pay was extended to a maximum of 12 months, after which Disability Insurance takes over. Apart from the obligation of firms to replace 70 per cent of earnings lost to sickness laid down in tort law, sick pay insurance is now completely privatised and firms may choose freely whether they want to bear their sick pay risk themselves or have it covered by a private insurer.

This is a remarkable change. A fully regulated monopoly market to which private insurers had no access has been transformed into a deregulated one on which private insurers freely bid for contracts with firms that seek to insure their sick pay liabilities. As a result sickness absence rates dropped by 25 per cent, from 6.7 percent in 1993 to 5.0 percent in 1997.

A more contentious effect of this drastic form of privatization is that employers scrutinize their job applicants more strictly than before on health, making the labor market less accessible for people with disabilities.

As of 1998 experience rating of firms is phased into the disability insurance scheme. Current benefits are still funded by the existing uniform pay-as-you-go contribution rates
but new beneficiaries will be paid out of premiums that are levied according to the «polluter pays principle». If an employee is awarded a disability benefit, the firm will face a higher contribution rate, and vice versa if a firm employs a disability beneficiary. Moreover, firms are allowed to opt out of the public insurance system, but only with respect to the coverage of the first five years of benefit recipiency.

All these changes are moving Dutch disability policy in the direction of assigning the program costs to individual firms and workers more directly and away from the socialization of risks that dominated past policies. As a result the share of partial benefits has increased from around 20 per cent until 1985 to 30 per cent in 1995, and more of those with partial benefits work.

More than 30 years after its introduction the partial benefit system now finally seems to work as originally intended – serving as an instrument to help partially disabled workers return to paid work. This result has been obtained by using the traditional instruments to reduce moral hazard: co-insurance and experience rating. By reducing statutory replacement rates, privatizing payment of sickness benefits, and introducing experience rating in the calculation of disability insurance premiums both workers and firms have changed their behaviour towards disability risks. But these changes have also been strongly supported by beneficial labour market conditions resulting not only from wage moderation but also from ageing. An ageing work force improves the employment opportunities of older workers as the competitive pressure of younger cohorts decreases. Given the correlation between age and disability risk this benign effect of ageing promotes vocational rehabilitation of the majority of persons with disabilities.

5.3. Changing the Administration

In the debate over disability policy the focus gradually shifted toward the program administrators. In 1993, a multi-party parliamentary committee investigated the administration of the wage-replacing social insurance programs, with special attention to the operation of the disability insurance scheme for private sector workers. A vast number of current and former administrators, civil servants, and those politically accountable were publicly interrogated by the committee. The picture that emerged from the nightly televised summaries was devastating to the image of the Social Insurance Agencies. What most suspected, and what had previously been shown by research, was now publicly confirmed. The committee’s report created broad political support for drastic changes regarding, in particular, the dominant and autonomous position of the «social partners» in the management of social insurance.

Political pressure stirred up by public disclosure of the traditionally lax policy of the administrators challenged gatekeepers to change their way of doing business. Ministerial directives to apply the new, more stringent eligibility standards appear to have taken hold.

In March 1997, the legally protected monopoly of the Social Insurance Agencies over the administration and coverage of unemployment and disability risks was broken.
These public agencies were abolished and replaced by a new coordinating body – the National Institute of Social Insurance. This Institute has a tripartite board (social partners plus public servants) and an independent president. Its main task is to set up and manage a market in which private firms that administer unemployment and disability insurance, and that once were completely controlled by the Insurance Agencies, have to bid against each other for contracts with firms or branches. In the near future this newly created market for social insurance administration and rehabilitation services will be open to all competitors not just the privatised administrations of the former public Insurance Agencies.

Given its current form, and the direction, in which it is moving according to current proposals, the administrative structure of the disability insurance programme is less consistent than one would wish. A first problem is due to the dual option that firms have in funding the first five years of a disability benefit. Since 1998, they can choose between staying in the pay-as-you-go financed public system, where premiums are now experience rated, or moving over to self- or private insurance. Up to now about 100 large, low-risk, firms have opted out of the public system. This financing system is inherently unstable, and the question is how, or rather when, this will end. If low-risk firms increasingly choose to leave the public system it will disappear. Privatisation of disability insurance is then obtained, not as a conscious result, but as the outcome of an adverse selection process.

A second problem is that, after a fierce political discussion on which parts of the administrative tasks should be privatised, the majority result was that the management of disability claims should stay under public control. The fear was that private parties would be overly strict in their disability assessments in order to serve the interests of their clients (firms). This fear is based on the, in all likelihood erroneous, assumption that the only interest of firms is to keep their disability insurance rates as low as possible. They probably rather weigh these lower rates against the cost of accommodating workers with disabilities. However, the proposed administrative design is one in which the financial risk may eventually be borne privately but the case management will remain in the hands of a public agent. Such a hybrid structure will prohibit reaping the full efficiency gains of a competitive insurance market.


6.1. Introduction

It might be better to fully privatise disability insurance, as was done in 1996 with sickness benefits. To answer the obvious question whether this can be done in a socially acceptable way one may look at the United States Workers’ Compensation system – a social insurance scheme that in a vast majority of states is administered by private insurance carriers.
Workers' Compensation is a social insurance programme providing cash benefits, medical care, and rehabilitation services to workers disabled by work-related injuries or diseases. Distinctive from most other social insurance programs in the United States, workers' compensation programs are operated at the state rather than at the federal level. In addition, it is the only social program that involves extensive use of private insurance carriers (Thomason and Burton 1993).

Workers' compensation covered 99 per cent of United States' workers and paid $42.4 billion in benefits in 1996. Its expenditures are about 60 per cent of the federal program that covers non work-related disability, Social Security Disability Insurance, which spent $68.8 billion in 1996 (Mont et al. 1999). 8

Except in Texas and New Jersey, employers have to buy workers' compensation insurance to cover their personnel. By this mandatory insurance the liability of employers is limited to the policy rules laid down in the workers' compensation statute of the state in which an employer operates. On the one hand, providing coverage under the State Workers' Compensation Act protects employers from additional claims by injured employees under tort law. It is said to act as an «exclusive remedy». On the other hand, every work-related disease or injury is covered. This «no-fault» approach means that an employee does not have to prove the employer's liability.

Each state can choose its own mode of insuring workers' compensation. In 28 states the provision of workers' compensation is completely left to the private market. Private insurance companies compete with each other and with self-insured firms on the workers' compensation market. Fourteen more states are «competitive state fund» states as they have a state fund competing with private carriers and the self-insured. Then there are six «exclusive state fund» states where the state fund holds a legally protected monopoly. In four of these states, however, self-insurance is allowed. And, finally, Texas and New Jersey are non-mandatory states.

6.2. Characteristics of the workers' compensation market

The interstate diversity of workers' compensation insurance modes can be seen as a natural experiment in private provision of social insurance. Exclusive state funds are similar to the way in which European welfare states use to organise their social insurance systems. Recently, competitive markets for social insurance have been introduced in Europe (sickness benefits in the Netherlands and the United Kingdom, and work injury schemes in, Switzerland, Belgium, Denmark, and Finland), or are being studied as an alternative to the traditional collective funds that hold national, or sectoral, monopolies.

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8. Spending on Social Security Disability Insurance includes health care covered by Medicare. A separate federal programme for those with no, or insufficient, entitlement, Supplemental Security Income, is omitted from this comparison.
Two general characteristics of workers' compensation markets strike European observers as pertinent to the privatisation discussion. First, while social insurances in Europe mostly are financed through uniform, pay-as-you-go, contribution rates, workers' compensation plans differentiate premiums by 500, or more, risk groups that are defined by industry and profession. In a competitive setting this detailed set of basic premiums will be further refined to take account of the risk experience of a firm. The extent of experience rating usually depends on firm size.

Not only private carriers use differentiated, and experience rated, premiums, the state funds, whether competitive or exclusive, do so too. Moreover, all market participants - whether private or public – use the same funding method, i.e., pre-funding. Pre-funding means that premiums are calculated such that the annual total premium sum of a carrier is sufficient to cover the discounted value of the expected benefit streams of those who have come to suffer a work-related injury or disease in the current year. This creates a level playing field for all the participants in a workers' compensation market (and solves the instability that plagues the current dual system of financing Dutch disability insurance benefits).

The second relevant feature of well functioning workers' compensation markets is a substantial involvement of the state. The state does not only define the basic policy standards (entitlements, replacement rates, et cetera) by legislative action, the state workers' compensation agency also monitors the operation of the program, or actively participates in the market through a state fund.

State agencies may promote efficient outcomes of privately run workers’ compensation systems in two ways. First, they can improve the quality of market outcomes by:

1. providing actuarial data to new insurers so that they have easy access to the market;

2. publishing the products and prices offered by competing carriers so that the market is as transparent as possible and firms can make informed choices;

3. establishing a residual market to which firms that cannot find a reasonable contract on the competitive market can be assigned. These firms may be new, or may have a bad risk history. Residual market premiums are set by the state agency. Naturally, they are lower than the commercial ones, and the ensuing losses are borne by the private carriers participating in the competitive market, proportional to their market shares.

The operation of a residual market, secondary to a competitive one but yet financed by the participants in the commercial market, has important advantages. Through a residual market private carriers can collectively guarantee that every firm can meet the obligation to provide its personnel with workers’ compensation coverage. If each separate insurer would be obliged to accept any firm that seeks insurance a competitive market for mandatory (social) insurance could only be managed by explicit price regulation with
inferior efficiency results. In contrast, the premiums charged in the residual market effectively act as a ceiling for the competitive rates.

A crucial task for the state agency, then, is to calculate the residual market rates as actuarially equivalent as possible. If, for instance for reasons of solidarity with difficult to insure firms, the rates are set too low the losses that are usually financed as a surcharge on the competitive rates increase. As the experience in some states shows these blown up competitive rates fuel a dynamic mechanism by which the residual market explodes and the competitive market dwindles;

The second way in which a state agency can promote efficiency is by implementing rules that reduce transaction costs, specifically litigation costs. Transparency of a workers' compensation statute, and appeals' procedures that induce settlement at an early stage have proven very effective. Crude calculations in AARTS and De Jong (1996) show that litigation costs vary from 4 percent of total program expenditures in Wisconsin to 20 percent in New Jersey. This variation can be explained by the extent to which state agencies are involved in the design and operation of appeal procedures.

As one would expect research shows that moral hazard is not completely eliminated. Butler (1994) reviews 18 papers in which a positive relation between benefit increases and claim frequency and severity is found. This positive effect is the balance of two opposite behavioural reactions: As benefits increase, employers attempt to reduce their (insurance) costs by providing safer workplaces, by selecting workers who have a good health record, or by fighting claims in court. Employees, on the other hand, take fewer precautions or file more, and more severe, claims. Apparently, the employee (moral hazard) effect dominates. Butler reports an average elasticity of 0.6 of claims with respect to benefit increases. If this result is combined with other results on moral hazard under workers' compensation a «guesstimate» of 10 percent is obtained. This compares to a similarly rough estimate of 50 percent under Dutch disability insurance.9

This relatively low figure should be set against the transaction costs of having social insurance provided by a competitive market. Aggregate operating costs of private insurers and state funds are, respectively, 25 and 12 percent of premiums (AARTS en De Jong, 1996, 51). This difference is due to the fact that state funds have no marketing and selling costs and, furthermore, are not taxed.

All in all, this American example shows that work-related disability risks can be covered by private insurers in a way that fulfils the prime function of social insurance: mandatory participation (of firms) and universal acceptance (by insurers). It also shows that combining the efficiency of a competitive market with the social function of accessibility requires a strong involvement of the state.

9. This estimate is derived from the hidden unemployment component discussed before.
7. LESSONS FROM THE DUTCH EXPERIENCE

The first lesson that can be drawn from the previous account of the Dutch disease, and its cure, is that employment growth can be stimulated by a package of wage cost moderation, lower taxes, and work hours flexibility. Trade unions were willing to comply with a policy of moderate wage demands combined with lower taxes in order to safeguard acceptable, though still moderate, increases in disposable income. In complying with this policy they also agreed to accept cuts in social insurance benefits as a way to reduce taxes.

A second lesson is that coercive consumption of a fixed lump of leisure under the standard full time contract is less effective in boosting employment than allowing for hours flexibility on a voluntary basis. As a result the Dutch job machine creates more part-time than full-time jobs.

Thirdly, wage cost moderation contributed to the surge of dual earner households.

Fourth, these new jobs went to new entrants, specifically additional (secondary) workers in a household, and not to the large numbers of long-term unemployed and (partially) disabled. Only the last few years have seen a reduction of long-term unemployed and disability beneficiaries. This is due to a combination of continued employment growth by persistently subscribing to wage cost moderation, a beneficial (global) economic tide, and reduced labour supply from new cohorts due to a steep decrease in fertility. Ageing of the work force improves the employment opportunities of older cohorts and offers possibilities of return to work to persons with disabilities that otherwise would stay on benefits.

Fifth, this beneficial effect of ageing can only be reaped if benefit programmes have appropriate incentive structures. Programmes, like disability insurance, that offer long-term entitlements should be used restrictively. The Dutch disability experience illustrates how lenient administration of a generous benefit system created a social and financial burden that takes decades to reduce to reasonable proportions.

Sixth, privatisation of the supply of social insurance can reduce the moral hazard problem considerably. To the extent that private insurers compete on the basis of premium rates and quality of service they have a strong interest in damage control. They, therefore, will induce their clients to take care through risk prevention and containment of damage after its onset.

The Dutch experience shows that privatisation of the supply of social insurance benefits is an option when the insurance covers risks that are privately insurable, as is the case with Sickness Benefits. For obvious reasons this excludes unemployment risks from privatisation. Although they may involve long-term entitlements disability risks can also be privatised. The United States Workers’ Compensation gives an example of how disability benefits can be allocated through a competitive market. This model may serve as an example for the privatisation of the Dutch and other public disability insurance schemes that are difficult to manage. It provides a framework for privatisation that is more consistent than the one currently discussed in the Netherlands.
REFERENCES


SUMMARY

A decade ago the Netherlands was considered the sick man of Europe. The number of working age beneficiaries per 100 workers was 43. About half of those beneficiaries were in receipt of a sickness benefit or an invalidity pension. In the eyes of many foreign observers the Netherlands now is a successful model of employment policy. This paper describes a number of factors that contributed to employment growth and lower social welfare spending. It focuses on the disability insurance programme – the «raw nerve» of Dutch social policy – and discusses the ways in which it was amended and compares current privatisation proposals with a more consistent model offered by the United States Workers’ Compensation scheme.

RESUME

Il y a une décennie, les Pays-Bas étaient considérés comme le grand malade d’Europe. Pour cent employés, 43 personnes en âge actif recevaient des rentes. Environ la moitié de ces rentiers bénéficieraient d’une allocation de maladie ou d’invalidité. Aujourd’hui la politique de l’emploi des Pays Bas est un modèle à succès aux yeux de beaucoup d’observateurs étrangers. Cet article décrit une série de facteurs ayant contribué à la croissance de l’emploi et à la réductions des dépenses sociales. Il se concentre sur le programme de l’assurance-invalidité – le point faible de la politique sociale néerlandaise – et discute comment ce programme a été amélioré. En outre, des propositions pour la privatisation de l’assurance-invalidité sont comparées avec un modèle plus consistant tel que le modèle américain d’assurance contre les accidents professionnels (Workers’ Compensation).

ZUSAMMENFASSUNG