



Foreign and Commonwealth Office

London SW1A 2AH

7 November 1984

Prime Minister

CDP

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Dear Charles,

The Foreign Secretary thinks that the Prime Minister might be interested to see the enclosed despatch on the Netherlands Government's economic policy, written by Sir Philip Mansfield, until recently our Ambassador at The Hague.

The Ambassador sets out the historical reasons for the Netherlands' present economic predicament - the generous welfare provisions based on the 1970s gas boom, which could not be sustained as recession bit at the end of the decade. Only since the Lubbers government took office in late 1982 has a serious attempt been made to encourage economic adjustment through cuts in public expenditure and a scaling down of the benefit system. This policy has begun to bear fruit, though the level of unemployment (around 15% of the working population) is disturbingly high.

The next elections in the Netherlands are due in late 1986.

Yours ever,
Colin Budd

(C R Budd)
Private Secretary

C D Powell Esq
10 Downing Street

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From the Private Secretary

11 November 1984

Thank you for your letter of 7 November enclosing a despatch from Sir Philip Mansfield on the Netherlands Government's economic policy. The Prime Minister has read this with interest.

TMB.

(C.D. Powell)

Colin Budd, Esq.,
Foreign and Commonwealth Office

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BRITISH EMBASSY
LANGE VOORHOUT 10
2514 ED
THE HAGUE

23 October 1984

The Right Honourable
Sir Geoffrey Howe QC MP
Foreign and Commonwealth Office

Sir,

THE ECONOMIC POLICY OF THE NETHERLANDS GOVERNMENT

Introduction

1. Two sides of the Dutch character are a desire to help one's neighbour, and a Calvinistic dislike of profligacy. It is not too imaginative to postulate that, so far as the Dutch economy is concerned, the first triumphed in the 1970s, but has been displaced since my arrival in 1981 by the second. This Despatch will show how and why this has happened and will suggest what the prospects are for the future.

The Post-War Decades

2. After the straitened circumstances of the immediate post-war years the Dutch economy revived in the 1950s and 1960s as businessmen resumed their former, successful roles as international traders. Benelux, followed by the European Community, confirmed the economic as well as the political importance to the Netherlands of its neighbours - especially the Germans, who have for many years taken about a third of Dutch exports and whose trade has made Rotterdam the biggest port in the world. The Common Agricultural Policy gave the

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Dutch the opportunity to develop their traditional farming and marketing skills until they were the second largest exporters of agricultural products in the world. At the same time the Dutch became major manufacturers of, inter alia, chemicals and electrical goods. Rotterdam established itself as an oil refining and storage centre for mainland Western Europe. By the late 1960s the country had recovered from the war.

The Boom of the 1970s

3. The discovery of large reserves of natural gas in the north of the country transformed the Dutch economic scene. The economic benefits of the gas accrued rapidly with export sales reaching 50bn m³ in 1976, and remaining around this level until 1979. The state benefitted by up to Fl.20bn annually, or 15% of total revenue. The Netherlands Government used this windfall to create an elaborate and generous system of social security. A Dutchman could do a full day's work and still claim some sickness benefit. If he was unemployed he would receive 80% of his previous salary for his first two years out of work. His two-week holiday on the Costa Brava would be funded by a holiday bonus, whatever his age and whether or not he was working. An employer received compensation for a sick employee in addition to the sickness benefit paid to the worker himself. Moreover wages and benefits were index-linked and adjusted twice a year.

Recession

4. The cost of this complex structure was unsustainable. The 1979 oil price rise, and the difficulties it created for

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the Netherlands' major trading partners, quickly made this very evident. Gas exports fell and industrial profits were eroded by increasing welfare premia contributions, automatic wage indexation and over-protective labour laws. Unemployment tripled to 10% (600,000) between 1979-82, and direct and indirect tax receipts stagnated. Depressed domestic demand caused difficulties for firms dependent on the home market, and the circle of recession was joined. PSBR, a moderate 4% of GNP in 1978, threatened to rise to almost 11% in 1983. The large sums required to sustain the social security system were a major reason for the severity of the recession from 1980-83, for which the Netherlands inherited the title of The Sick Man of Europe.

5. The Centre-Left (mainly Christian Democrat and Socialist) Coalition which was in power at this time was ill-equipped to deal with a recession. The cuts in public expenditure and freezing of incomes that the Prime Minister, van Agt, felt were necessary proved unacceptable to the Socialists, who left the Government. Following an election in September 1982, a Centre Right Coalition (Christian Democrat (CDA) and Liberal (VVD)) took over van Agt's far-reaching proposals for cuts in public expenditure and a freeze on all benefits and public sector pay. Austerity had begun.

The economic policies of the Lubbers Government

6. The Coalition agreed on a programme of economic recovery that combined reducing PSBR by severe expenditure cuts and by scaling down the benefit system and encouraging industry by

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reducing the tax burden and by deregulation. The 1984 Budget was a courageous first step to implement these policies, in sharp contrast to the Dutch tendency to delay or fudge hard political decisions. In addition to reductions in government spending programmes of Fl.11bn, the Government proposed to cut welfare benefits and public sector pay by 3.5%, and to reduce further the amounts paid in the principal benefits (unemployment and disability). In addition both categories would lose all or most of their automatic indexation. The budget's proposal for revitalising industry included a reduction in corporation tax from 48 to 43% and reduced employers' social insurance premia.

7. The proposed reductions in pay and benefits were strongly contested by the Labour opposition and by the unions involved. A campaign of industrial action followed including strikes, particularly in the transport and postal sectors. But the Government stood firm and its only concession was to shave 0.5% off the pay and benefit cut. The strikes collapsed after successful legal action in the courts by private sector interest groups. Business morale was given an important psychological boost by the Government's sympathetic approach to the private sector.

8. The first signs of recovery became evident in the first half of 1984. Exports to major EC trading partners increased by around 20% in value, and to the USA by 70%. Major Dutch firms with international interests recorded increased profits, but those companies dependent on a revival of the domestic economy saw little or no improvement in their position.

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Investment revived by about 10% in volume, but was mainly directed at the rebuilding of stock levels. Rises in production have been achieved by higher productivity and increased capacity utilisation. Industrial workers have not sought, and have not been given, wage increases. The result has been relative price and wage stability. Inflation at 2% is now the second lowest in the Community.

The 1985 Budget

9. The Cabinet, prompted by Lubbers' steadfast support for Ruding, his Minister of Finance, agreed a Budget for 1985 which continued the pattern set for 1984, namely reduction of Government expenditure and encouragement of industry. An important omission, however, was the promised further reduction in corporation tax in favour of more reductions in employers' social insurance premia, to the dismay of small and capital-intensive business which gains little from such measures. Another surprise was the first increase in real income in four years for the average private sector worker, achieved by lower personal taxes and welfare premia. This Budget was approved by the Second Chamber virtually intact, though den Uyl, the Leader of the Opposition, succeeded in outshining in debate the Prime Minister who gave an uncharacteristically lack-lustre performance and even revealed a most unusual ignorance of some of the facts involved. In particular, he had to concede that there would be a fall in purchasing power for benefit recipients and those on low pay of up to 3%. Some of his party then joined the Opposition to pass a motion to protect this group against next year's expected 1.5% inflation. This defeat has



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been aggravated by an unfortunate interview given by Ruding to a Dutch newspaper in which he said that many unemployed did not seek jobs vigorously. He has had to apologise and Lubbers has publicly distanced himself from the statement.

Assessment of the Government's Progress

10. The Coalition has made some progress towards its economic objectives, but it is not yet clear to what extent the general public will be content to accept the Government's continuing programme of austerity in the expectation that its economic strategy will lead the country decisively out of economic decline. The forthcoming negotiations over the latest proposals to cut benefits and public sector pay will be a first test of public feeling. They will be difficult and the unions will fight hard, but observers do not anticipate the scale of labour unrest of a year ago. On the other hand, as Rietkerk, the Minister responsible for these negotiations, told me recently it will not be possible to continue this tough policy for a third year.

11. Moreover Ministers would be the first to admit privately that the upturn in major industrial economies has been an important factor in the recovery here. With over 60% of GNP derived from international trade, the Dutch economy is in large measure at the mercy of others and a cold in Germany will sooner or later produce a sneeze in the Netherlands. The concentration of exports on EC countries (72% of the total in 1983) is a factor which fortuitously has worked in the Netherlands' favour as Western European economies moved out of recession.

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The US revival has been another lucky break in that American subsidiaries of Dutch firms have made crucial contributions to their parents' balance sheets during the last three years. The Dutch are also fortunate to be strong in two areas (chemicals and food) which respond quickly to upturns. Luck apart, sheer hard work (productivity should rise by 7% this year alone) and wage restraint have been crucial in keeping Dutch manufactures competitive. There is a good prospect that this situation will continue for the next two years to help the recovery of the Dutch economy.

12. But the failure of external success to revive the domestic economy has compounded the difficulties of the latter. The lack of measures to stimulate domestic activity in the budget is drawing increasing criticism from small and medium sized business and from bankers anxious about the fragile balance sheets of many of their customers. These were two groups which particularly welcomed the present Coalition, especially the VVD's participation in it, and their informed sniping at the inefficacy of the latest budget proposals must give Ministers cause for concern. Consumer spending is expected to increase by less than 1% next year so that little stimulation can be expected from this quarter. Prominent bankers are calling for stimuli to investment, such as tax concessions or a greater availability of venture capital, on the grounds that official moves on both these fronts have been inadequate. There are no signs so far that the Minister of Finance feels able to respond to these urgings.

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13. Since 1979 unemployment has quadrupled to over 800,000 (15% of the labour force). About half of this increase is due to a demographic accident: the Netherlands will have a relatively high proportion of young entrants to the labour market for the rest of the decade, because of a baby boom in the 1960s. Although the revival in exports has halted the rise in overall unemployment, it has not reversed the increase in the number of jobless youth. A third of people below the age of 22 are unemployed, 31% of the total jobless. The Government has developed several schemes, some modelled on those in the UK, to give at least temporary experience of work, training in relevant skills, and subsidies to employers taking on unemployed youth. The unions have been constructive, for example by agreeing shorter hours in several sectors so as to create vacancies for the young and by accepting low wage rates for young workers. The scale and apparent intractability of youth unemployment has moved it to the centre of politico-economic interest this year, and the degree to which the Government can make a dent in the figures will be a central issue at the hustings in 1986.

14. Linked to the problem of unemployment is the widening of income differentials between those who work and those who do not. There are many in this country who speak for the unemployed and the low wage-earners and the Government will have difficulty in resisting calls for maintaining real incomes at the lower end of the spectrum. So far they have been able to plead for time to let their ideas work, but improvement in the position of the unemployed and those on minimum incomes will be



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required before the 1986 election, if the present Coalition are to secure a further mandate.

15. Lubbers has been determined in holding his Cabinet to the Coalition agreement through an unprecedented period in Dutch politics, most notably during the formulation of the two budgets and the ensuing debates. His choice of Ruding, a career banker with few if any political ambitions, as Finance Minister was astute and has enabled the Government to develop a coherent and so far fairly successful economic strategy. There are some sceptics in the Cabinet, but there is no sign of a break in its unity on economic issues.

Conclusion

16. The Cabinet has so far stuck doggedly to its task of cutting back public expenditure and scaling down the welfare state to an affordable level. It may not achieve its objective of reducing PSBR to 7.5% during the life of the present parliament, but it will not be far from its target. There is also evidence that the Government's policies are beginning to bear fruit in other directions. Ministers can point to a surplus on the current account, declining inflation, a strong currency, improving investment and an increase in manufacturing output. But there is still a good way to go before a convincing case can be laid before the public that the sacrifices of the last few years have been worthwhile. One of the main issues at the election in 1986 is likely to be the social costs of reducing the financial deficit. The latest polls suggest that the present Coalition would not today obtain a majority to govern. But the Government is still two years away from that decisive

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date with another budget to come. Modification of present policies seems inevitable if the Government wishes to achieve a more broadly based recovery of the economy and reduce the present high level of unemployment. But in doing so it is unlikely to forsake its newly polished Calvinist principles and revert to the hedonism of the 1970s when budgets were more concerned with distributing than with creating wealth.

17. I am sending copies of this despatch to the Chancellor of the Exchequer, to the Secretaries of State for Trade and Industry and Employment, to the Governor of the Bank of England and to Her Majesty's Permanent Representatives to the OECD and the European Community and to Her Majesty's Ambassadors at EC Posts and Washington.

I am, Sir,
Yours faithfully,

A handwritten signature in cursive script that reads "Philip Mansfield".

Philip Mansfield

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SUMMARY

THE ECONOMIC POLICY OF THE NETHERLANDS GOVERNMENT

1. In the post-war years the Dutch economy experienced recovery, followed by a boom in the 1970s and a recession from 1979 (Paras. 1-5)
2. The economic policy of the present Coalition has been coherent. The 1985 Budget has continued the programme of austerity (Paras. 6-9)
3. Assessment of the results of the Government's policies and of external factors (Paras. 10-15)
4. The Government is sticking to its economic programme. There will be difficult negotiations with the public sector later this year, but the Government is likely to hold firm. There will be some relaxation in economic policy as the next election approaches in 1986, but there will be no reversion to the hedonism of the 1970s (Para. 16)

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