COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.1.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of the Netherlands, 2001-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 (formerly 109c) of the Treaty (from 1 January 1999, the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

The Netherlands' first stability programme covering the period 1999-2002 was submitted on 4 November 1998 and assessed by the Council on 1 December 1998[2].

The Netherlands submitted its most recent update of the stability programme, covering the period 2001-2007, on 14 October 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The update incorporates the 2004 budget. The budget was endorsed by Parliament with some limited modifications, which encompass the proposed budgetary policies of the government for its term of office until 2007. The programme is rich in information and complies with the requirements of the Code of Conduct on the content and format of the programmes. However, a few non-compulsory variables which are valuable inputs to compute cyclically adjusted balances using the common production function method were not included.
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> For 2003 and 2004 the update of the stability programme uses macroeconomic projections by the CPB Netherlands Bureau of Economic Policy Analysis (CPB) which were officially released on 16 September 2003. For the period 2005-2007, the update uses the medium term economic projections released by the CPB on 16 May 2003. According to the update, economic activity is expected to remain sluggish in the near term. Real GDP growth is expected to pick up gradually to 1% in 2004, from zero in 2003, and to 2½% in 2005, 2006 and 2007.
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> In recent years the general government balance deteriorated significantly, despite successive rounds of fiscal savings measures. To a large extent this deterioration reflects

[1] OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

[2] OJ C 3, 6.1.1999

[3] Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

[4] COM(2002) 668 final, 27.11.2002.

the impact of the sharp and prolonged economic downturn. The update expects a deterioration in the general government balance to a deficit of 2.3% of GDP in 2003, from 1.6% of GDP in 2002, despite substantial measures. This pattern mainly reflects the impact of the economic slowdown activity but the delayed impact of the tax cuts of the 2001 fiscal reform, and increases in tax-deductible pension premia and tax-deductible increases in mortgage interest payments play a role as well.

For the 2004-2007 whole period the update contains a substantial multi-annual consolidation package consisting of net expenditure cuts, and tax revenue raising measures. The measures to a large extent rely on expenditure reductions while the package is frontloaded in 2004 and 2005. The net ex-ante combined impact on the general government balance is equivalent to € 14.8 billion (around 3% of GDP) in the period 2004-2007. However, the cumulative improvement in the actual deficit is less because of negative second round effects. Overall, the nominal deficit would gradually decrease to 0.6% of GDP in 2007.

By contrast, in cyclically adjusted terms (calculated using the common production function method) a position close to balance is targeted to be reached earlier. According to the update, the cyclically adjusted balance would improve from a deficit of 1.3% of GDP in 2003 to 0.7 % of GDP in 2004. In the period 2005-2007, the cyclically adjusted deficit is projected to be at or below 0.5% of GDP. In this respect the update assumes that, in line with the Council's interpretation of the stability programmes of other countries, a cyclically adjusted deficit of no more than 0.5% of GDP qualifies as a position close to balance.

As regards the budgetary strategy underlying the update, a key element is the use of expenditure ceilings defined in real terms, as recommended in the 2003 Broad Economic Policy Guidelines. Expenditure windfalls can no longer be automatically used for increased expenditure. Automatic stabilisers on the revenue side of the budget would be allowed to work freely as much as possible. However, an expected increase of the general government deficit that would imply a violation of the Stability and Growth Pact has to be countered by additional savings measures.

The update expects the debt to GDP ratio to remain well below 60% of GDP, increasing from 52.4% of GDP in 2002 to 54.5% of GDP in 2004 - largely in line with the Commission Autumn forecast - before decreasing slowly to 52.2% of GDP in 2007.

The budgetary projections appear to be optimistic and outdated in view of more recent information, which suggests a further worsening of the economic situation and budgetary position. According to the Commission Autumn forecast, and new forecasts by the CPB released on 4 December 2003, economic growth in 2003 is likely to be much lower than estimated in the update. The Commission Autumn 2003 forecast estimates real GDP to shrink by close to 1% in 2003, while the CPB puts -¾%. Downside risks are also attached to the growth projections for 2005-2007.

The deficit forecasts for 2003 and 2004 in the update also seem too low, compared to the Commission Autumn 2003 forecast, according to which the deficit would reach 2.6% and 2.7% of GDP in 2003 and 2004 respectively, and decrease only slightly in 2005. Preliminary estimates for 2003 by the Ministry of Finance released on 14 January suggest that the deficit was 2.7% of GDP. Risks to the budgetary outlook for the period 2005-2007 appear skewed to the downside as well, in view of the likelihood of a worse budgetary starting point.

Despite these risks to the nominal deficit projections, the implications for fiscal adjustment in terms of improvements in the cyclically adjusted balance are not equally negative. The cyclically adjusted balances presented in the update almost coincide with the estimates in the Commission Autumn forecast for the period up to 2005. In both 2003 and 2004 the adjustment in the cyclically adjusted deficit would be at least the required 0.5 percentage point of GDP. The budgetary projections in the update show a position close to balance in 2005 to 2007 (assumed in the update to be a cyclically adjusted deficit of no more than 0.5% of GDP), a position that would be maintained over the remainder of the forecast horizon up to 2007. This confirms that a significant structural budgetary adjustment is underway and would be maintained even in the case of a weaker-than-expected economic recovery.

However, on unchanged policies and given normal macroeconomic fluctuations a sufficient safety margin not to exceed the 3% of GDP nominal deficit threshold is not provided for throughout the programme period. In the light of the considerations above, the risk of exceeding the threshold seems largest in 2004.

On the basis of the current policies, the risk of budgetary imbalances emerging in the Netherlands in the medium to longer run cannot be ruled out. According to Commission calculations on the basis of the update, on unchanged policies the debt to GDP ratio is expected to increase above 60% once the full impact of ageing takes place. In order to maintain public finances on a sustainable footing, debt should be reduced at a sufficient pace in the period prior to the budgetary effects of ageing population taking hold, along with continuing to control the factors influencing the expenditure ratio.

The update is broadly consistent with the 2003 Broad Economic Policy Guidelines, in particular those with budgetary implications, as regards pursuing budgetary adjustment towards a position close to balance, and containing expenditure over the cabinet period under ceilings in real terms.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the Stability Programme update for the Netherlands and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of the Netherlands, 2001-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[5], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [10 February 2004] the Council examined the 2003 update of the stability programme of the Netherlands, which covers the period 2001 to 2007. The updated programme complies with the data requirements of the revised "code of conduct" on the content and format of stability and convergence programmes.

The budgetary strategy underlying the update is based on keeping real expenditure below predetermined ceilings over the period 2004-2007, while at the same time pursuing significant savings measures. Measures are frontloaded in 2004 and 2005 and for a large part consists of expenditure cuts. In the strategy, expenditure windfalls can no longer be used for automatic expenditure increases. Automatic stabilisers on the revenue side of the budget should be allowed to work freely as much as possible, except that an increase of the deficit that would imply a violation of the Stability and Growth Pact has to be countered by additional savings measures.

The update projects real GDP growth at 0% in 2003, from 0.2% in 2002. In 2004 growth is estimated to pick up to 1%, whereas it would average 2½% in 2005-2007. Employment growth is expected to be -½% in 2004 and to increase to slightly above 1% on average in 2005-2007. HICP inflation is forecast to remain stable at 1½% in 2004-2007. On the basis of currently available information, the macro-economic scenario underlying the programme seems optimistic, in particular as regards the growth projections for 2003 and 2004, which are considerably higher than those of the Commission in its Autumn 2003 forecast.

[5] OJ L 209, 2.8.1997

The programme encompasses a substantial package of net savings, covering the period 2004-2007. However, in view of the sharp deceleration in economic activity the deficit is expected to rise in spite of the size of the measures taken. The programme targets a general government deficit of 2.3% of GDP in 2004, the same as the expected deficit in 2003 despite substantial measures aimed at limiting the deficit increase, in line with the Council recommendations on the previous stability programme update. For 2005, 2006 and 2007, the projections are for a nominal deficit of 1.6, 0.9 and 0.6% of GDP respectively. In cyclically-adjusted terms, based on Commission calculations according to the commonly agreed methodology, the update targets an improvement by around 0.6 percentage points in 2004 to a deficit of 0.7% of GDP. The cyclically adjusted deficit is expected to fall further to 0.5% of GDP or slightly below in each of the years 2005 to 2007.

The update expects the debt ratio to fall slightly to 54.5% of GDP in 2004, before falling to around 52% by 2007.

However, on the basis of currently available information, the projections on the budget balance appear too optimistic judging from the Commission Autumn forecast. For 2003, this is confirmed by the release released of a preliminary estimate of the deficit for 2003 of 2.7% of GDP by the Ministry of Finance on 14 January 2004. Because of the worse starting point, a higher nominal deficit than forecast in the programme also seems likely in 2004 and possibly in subsequent years. Despite substantial savings measures, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold under normal macroeconomic fluctuations throughout the programme horizon in view of the severity of the economic downturn. However, notwithstanding the downside risks to the nominal budgetary projections, the Commission Autumn forecast suggests that the planned improvement in the cyclically adjusted deficit, reaching a position close to balance from 2005 onwards, may still be achieved. Thus, the eventual achievement of medium-term position close to balance should be sufficiently established by the programme.

For the period up to 2005, the update expects a somewhat lower debt ratio than the Commission Autumn forecast. On the basis of current policies, the risk of budgetary imbalances emerging in the future cannot be ruled out once the full impact of ageing takes place. Securing an adequate improvement in the primary surplus before ageing reaches its peak, together with the necessary measures to stem the long-term increase in expenditure, is essential to ensure that the public finances are kept on a sustainable footing.

The economic policies as reflected in the updated programme are broadly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. This regards in particular the implementation of budgetary consolidation aimed at achieving and maintaining a budgetary position close to balance in the medium term. To this end the setting of expenditure ceilings in real terms has been crucial.