

Stability Programme
The Netherlands, 2001 – 2007

Update, November 2004

I Introduction and summary

With a total growth of no more than 1.1% over the past three years, the Dutch economy fell short of the expectations of experts and lay people alike. The disappointing performance is reflected in the downward adjustments to the growth projections for the Dutch economy. The worst shortfall was posted in 2003 when the Dutch economy actually showed a contraction of 0.9% - the first in twenty years. The labour market was one of the Dutch economy's key weak spots. In the period 1998 – 2003, unit labour costs in the Netherlands increased by over 11% more than in competing euro area countries, and by over 14% more than in competing countries in the rest of the world. One reason for the marked rise in labour costs was the exceptional tightness in the labour market seen in the second half of the 1990s. Despite substantial - in part collectively financed - inactivity, official unemployment fell back to a low level. Economic growth is slightly accelerating this year: real GDP in the first half-year was 1.2% up on the first half of 2003. The Dutch economy is expected to grow by 1¼% this year and by 1½% next year.

The sluggish growth was coupled with public finance setbacks. These setbacks were so extensive that the Netherlands, despite its advantageous point of departure and far-reaching and rapid fiscal measures, failed to meet the Maastricht Treaty requirements in 2003. The Ecofin Council of 2 June 2004 hence recommended the Netherlands to implement a package of measures aimed at improving the EMU balance by at least half a percentage point. Financial setbacks in the budget occurred across the board. Setbacks on the revenue side of the budget were seen particularly in corporation tax, wages and income tax and turnover tax (VAT). Notably corporation tax proved far more sensitive to economic fluctuations than previously expected. Setbacks were also recorded on the expenditure side of the National Budget. Moreover, the development of the local government balance, as defined in EMU terms, was especially weak. Two-thirds of the deterioration of the fiscal balance for 2003 from -2.3% of GDP in the update of the Stability Programme 2003 to -3.2% of GDP in the actual figures can be attributed to local government setbacks. Here too, experts and lay observers were surprised by the swift downturn. The IMF, for example, had expressed the opinion that, in view of its budget balance, the Netherlands had a promising basis in 2000 for allowing the automatic stabilisers to take effect.

In line with agreements laid down in the budget rules and the Ecofin Council recommendation, the Cabinet took additional policy measures. In drawing up this policy package, the Cabinet adhered to its own key policy principles. This meant that it made every effort to avoid generic increases in tax and premiums or measures that would impair economic growth. Priority was given to measures in keeping with the objective of sustainable public finances. In the field of public spending the Cabinet took measures to tighten its control of health care spending, made agreements on more effective tendering of large investment projects, and set additional efficiency targets. Other ways found to restrict spending included savings on rent allowances, the sale of agricultural land and the postponement of investments. Looking at the revenue side of the budget, the Cabinet decided to increase premiums under the Exceptional Medical Expenses Compensation Act (AWBZ), require two independent public sector agencies (Nederlandse Waterschapsbank and Bank Nederlandse Gemeenten) to pay corporation tax, and temporarily raise occupational disability insurance premiums. On 21 October last the Ecofin Council noted with satisfaction that, at present, the action taken by the Dutch

authorities in response to the Council's Recommendation of 2 June appeared sufficient to put an end to the present excessive deficit situation in the Netherlands by 2005.

Currently, the key uncertainties are oil prices and the euro rate. The oil price soared this year, moving between 45 and 52 dollars per barrel in September and October. The Dutch economy's sensitivity to oil price shocks has lessened considerably over the past thirty years. Unit oil consumption has more than halved since the oil crisis of the early 1970s. An oil price increase would have limited impact on the budget: the ensuing weaker economic growth and higher rate of unemployment would lead to budget setbacks which would be all but totally offset by higher non-tax revenue from natural gas.

In the near term, a higher euro rate would result in a decline in Dutch exports: it would erode competitiveness relative to non-euro countries while also adversely affecting intra-European trade because other euro countries would likewise suffer the disadvantages of the stronger euro. Output would hence slow down, although the downward pressure on inflation would favourably influence domestic demand. The lower economic growth would lead to a deterioration of the EMU balance.

In the Netherlands, as elsewhere in Europe, increasing attention is being paid to the quality of public finances. Owing to relatively sharp increases in spending on social security and health care, due in part to demographic ageing, policies seeking to strengthen the economic structure are in danger of being crowded out. While the public expenditure ratio will decline in 2004 and 2005, the Netherlands is nonetheless managing to make extra efforts in the areas of education, security, and research and development. Another priority of the Cabinet is to reduce the administrative and legislative burden. Entrepreneurs and enterprises should be less hampered by all kinds of government regulations; it has therefore set itself the target of reducing red tape by 25% during the cabinet term.

II The Dutch economy

Recent economic developments

The Dutch economy passed through a deep trough in the period 2001 – 2003, but is now back on a cautious upward path. With a total growth of no more than 1.1% over the past three years, the Dutch economy fell short of the expectations of experts and lay people alike. For one, in November 2001 the European Commission still expected economic growth in the Netherlands in 2003 to reach over 3%. One year later, the European Commission expected growth of just 0.9%. As it turned out, the economy showed a contraction of 0.9% last year. Box 2.1 looks at adjustments over time in the economic growth projections by professional private sector forecasters.

The sharp downturn in economic growth can be attributed to several causes, the first being the global economic slowdown. The open Dutch economy is heavily dependent on international economic developments. The international cyclical downturn, caused by the deflation of the ICT bubble among other reasons, had a major impact on the Dutch economy. But that is not the whole story. The downturn in economic growth was steeper than elsewhere because of the relatively large increase in unit labour costs seen in the Netherlands as of 1998. This led to a deterioration in competitiveness, costing the corporate sector a substantial loss of ground in both external and domestic markets. Firms limited the erosion of competitiveness by eating into their profit margins. But this took away from their profitability, putting pressure on investments.

The economic turnaround partly stems from an abrupt slowdown in private consumption growth. During the economic boom, Dutch households benefited hugely from the equity explosion and the steep rise in house prices, and the associated wealth effects contributed to the marked increase in consumption. But the stockmarket plunge and slowdown in house price inflation brought these favourable wealth effects to an end at the beginning of this century. Moreover, the deterioration in the pension funds' cover ratio caused by falling equity prices led to higher pension contributions. The increase in these contributions was one factor behind the rise in labour costs.

The labour market is a key weak spot in the Dutch economy (see Box 2.2). Measured in hours, labour participation is low in international terms. On average, Dutch employees work for only a small number of hours per year. Many people have part-time jobs, but even full-time employees only clock up a moderate number of hours. Labour participation not only increases if employees put in more hours, but also if the share of those in employment relative to the total employable population expands. Some groups still have a relatively low labour participation rate (older workers, the low-skilled, ethnical minorities and women). A higher participation rate could be realised by a reduction in collectively financed inactivity. In 2001, the official unemployment rate reached a record low of around 250,000 persons (3.3% of the labour force). But the total number of benefit claimants aged 15-64 was far higher (approximately 1.5 million). For every ten employees in 2001, more than three persons (younger than 65) drew benefits. This can largely be blamed on the fact that the Netherlands has a particularly large group claiming occupational disability benefits. The following table shows the key figures on the labour force in 2001 and 2005.

Table 2.1 Key figures on labour force in 2001 and 2005 (in millions of persons)

	2001	2005
Potential labour force (15 – 64 years)	10.8	11.0
Employment growth	7.3	7.2
Benefit claimants (younger than 65 years)	2.2	2.3
- unemployment or social security benefits	0.6	0.8
- other benefits*	1.7	1.6
Unemployed, no benefits	1.3	1.5

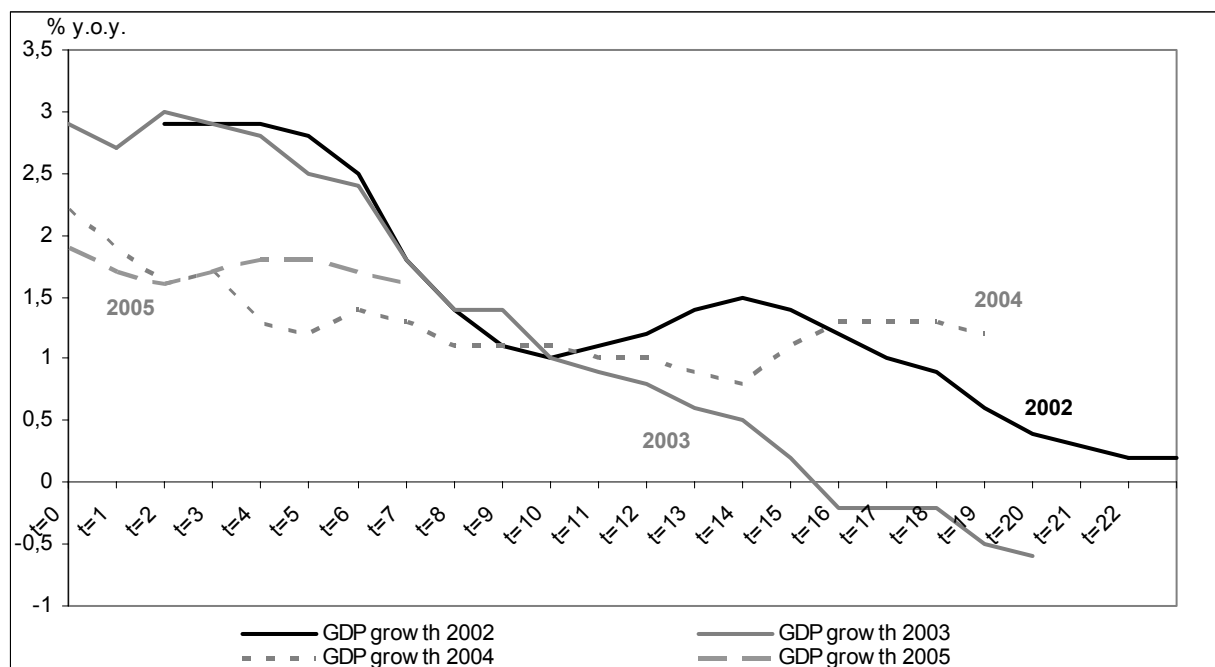
* Occupational disability, sickness, early retirement or dependants benefits

The Netherlands' failure to sufficiently reduce inactivity during the last economic boom resulted in an extremely tight labour market, leading to a sharp rise in wages as of 1998. Despite a sharp slowdown in labour productivity, wage inflation remained high from 2001 onwards, sustaining the rapid increase in unit labour costs. Calculated over the 1998-2003 period, the rise in these labour costs for the manufacturing sector was 11% faster than for euro area competitors and 14% than for competitors in the rest of the world. Unemployment remained quite low in recent years because firms were relatively slow to match employment to the changing economic conditions. Understandable, as they had to make considerable efforts to fill vacancies just a few years before. And since unemployment did not begin to soar, there was insufficient awareness of the need to seek wage moderation.

Box 2.1 Adjustments to expected economic growth

The extent to which the actual performance of the Dutch economy lagged the expectations of private sector professional forecasters is clearly reflected in the following chart, which shows the monthly development of the expected economic growth for the years 2002 up to 2005 according to The Economist Poll of Forecasts. The time $t = 0$ in the chart represents April of the year prior to the year for which the forecast was made. The chart hence illustrates that in April 2002 an economic growth rate of 2.7% was expected for the year 2003. One year later ($t=12=$ April 2003), the forecast for economic growth in 2003 was just 0.6%. It should be noted that it is not unusual for economic analysts to overestimate economic growth during a recession. Conversely, such analysts generally underestimate economic growth during the upward phase of the economic cycle. The growth expectation for 2004 and 2005 remained virtually consistent during the past year.

Chart B2.1 Economic growth projected by private institutions



Source: The Economist, Poll of Forecasts

The rapid increase in unit labour costs was initially masked by the depreciation of the euro. Since 2002, however, the euro has been on a steep climb (see Table 2.1), causing an erosion of Dutch competitiveness relative to both euro area and non-euro area countries as of that year. This year is likely to see the first very slight improvement in competitiveness relative to euro area competitors; but competitiveness relative to non-euro competitors is likely to deteriorate further because of the sluggish growth in labour productivity and the euro appreciation.

Table 2.2 Development of unit labour costs in the manufacturing sector (relative changes)

	2001	2002	2003	2004*
Unit labour costs				
Netherlands	5.1	4.5	3.4	-1½
Euro area competitors	2.8	1.9	1.3	-1
Non-euro area competitors	2.3	-4.9	-11.8	-5½
Compensation per employee				
Netherlands	4.6	6.5	3.8	3¼
Euro area competitors	3.2	4.0	3.0	2½
Non-euro area competitors	5.2	3.2	5.9	4¼
Labour productivity				
Netherlands	-0.5	2.0	0.3	4¾
Euro area competitors	0.3	2.0	1.7	3½
Non-euro area competitors	1.2	4.3	5.2	6
Effective exchange rate				
Euro area competitors	0.0	0.0	0.0	0
Non-euro area competitors	1.7	4.1	14.1	4

* Projection

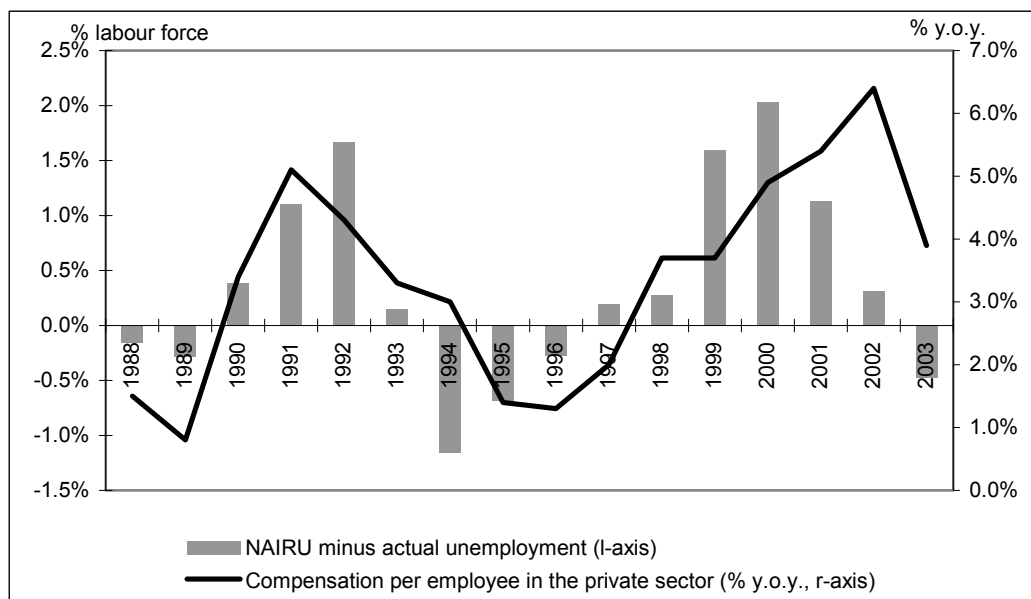
Source: CPB Netherlands Bureau for Economic Policy Analysis

Inflation, too, was for some years higher in the Netherlands than elsewhere in Europe, one reason being the development in labour costs. Over the period 2001 to September 2004, average annual inflation worked out at 2.5% (HICP: 2.8%). The peak in the rise of the consumer price index (CPI) in 2001 (4.5%) can be partly explained by the increase in indirect taxation arising from the tax reforms introduced in that year. As of 2002, inflation slowed down to 1.0% (HICP 1.1%) in September 2004 and has been lower than the euro area average since the beginning of this year. The worsened economic situation and the increased unemployment contributed to the fall-off in inflation, while the strong euro also had a downward influence. The rise in oil prices poses a risk to consumer price developments. Inflation accelerated to 1.4% in October, partly reflecting higher oil prices.

Box 2.2 The Dutch labour market miracle

The swift decline in natural and actual unemployment in the second half of the 1990s won fame abroad as 'the Dutch miracle'. In the period 1995 – 2001, equilibrium unemployment fell rapidly from 7.2% to 4.4%. But actual unemployment also decreased markedly in the same period from 7.5% to 3.3%. The steep fall in unemployment created tensions in the labour market, resulting in an accelerated wage rise in the second half of the 1990s. The chart below sets the development of the difference between equilibrium employment and actual employment against the development of compensation per employee in the private sector.

Chart B2.2 The increase in compensation per employee in the private sector and the difference between equilibrium employment and actual employment

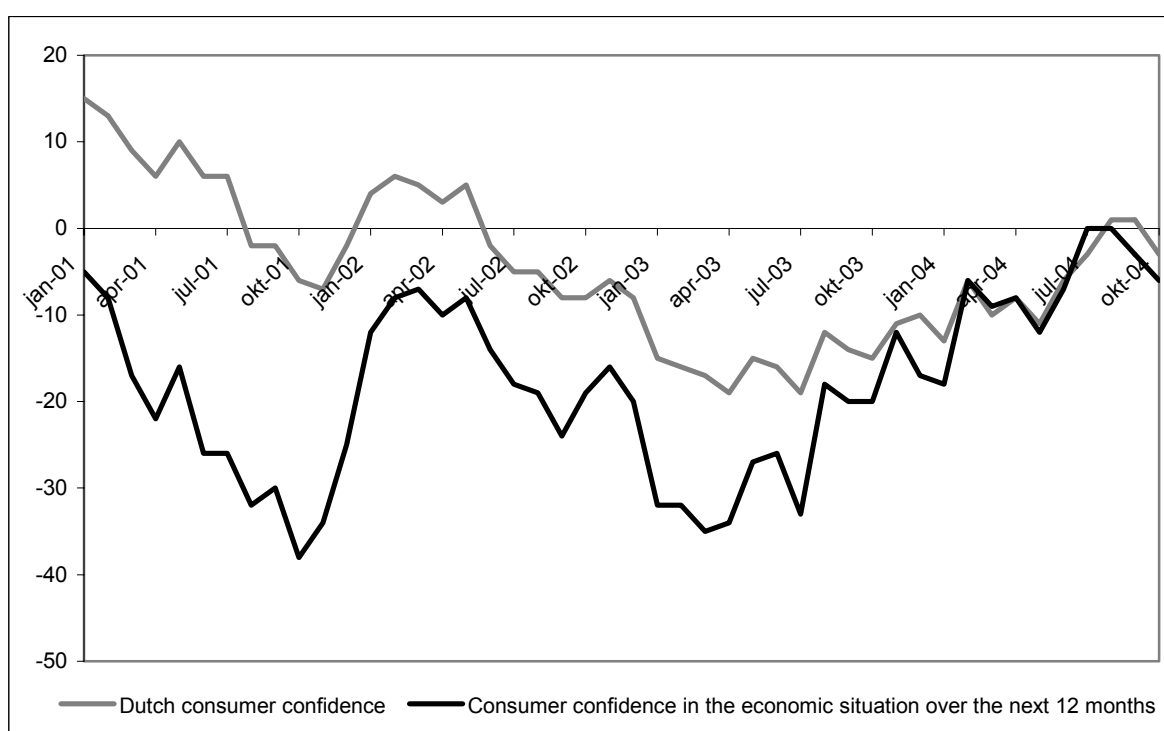


Source: Netherlands Bureau for Economic Policy Analysis

The chart shows a clear connection between wage developments and the tension in the labour market. During the heyday years for the Dutch economy, unemployment slipped below the equilibrium level. The tightness in the labour market resulted in a rapid rise in labour costs. Although unofficial unemployment was low, the Netherlands still had a considerable labour reserve, but it failed to tap this labour reserve during the last cyclical upturn (Table 2.1). If it had managed to do so, labour costs would not have risen so sharply and the economic downturn in recent years would have been weaker. To prevent this happening again, the Netherlands must firmly tackle inactivity in the coming years, encouraging more people to enter the labour market and employees to prolong their working lives.

Interestingly, recent macroeconomic figures look better than those for last year. In the first half of this year, gross domestic product has risen by 1.2% relative to the first half of 2003. In addition, the number of unemployed has fallen while the number of vacancies has increased. Finally, both producer and consumer confidence have improved this year compared to the dip in 2003. A striking development is that consumer confidence in the economy has been picking up since the spring of 2003 (see following chart). In contrast, at the start of the economic slowdown, this component of consumer confidence had fallen significantly. In the second quarter of 2003, the new Cabinet presented its coalition agreement containing ambitious plans for the Dutch economy, with the key theme of raising labour participation. Given that the problems were widely acknowledged, postponement of the planned measures could have generated more uncertainty among consumers. So the Cabinet's policy proposals did not hamper an increase in Dutch consumer confidence.

Chart 2 Development of consumer confidence and expected economic development



Source: European Commission

Outlook for 2005 – 2007

Economic growth is expected to pick up from 1¼% this year to 1½% in 2005. Notably exports will help to fuel economic growth. The greatest uncertainty is the recovery in private consumption. The Netherlands Bureau for Economic Policy Analysis (CPB) expects to see virtually no increase in consumption in 2005 because of a decline in purchasing power. By contrast, the Nederlandsche Bank is somewhat more optimistic as to the rise in private consumption in 2005.

Recent productivity figures confirm that an increase in productivity growth is to be expected in this phase of the economic cycle. The productivity increase in the market sector in 2004 is expected to amount to 3½ % and to 2¼% in the overall economy.

Table 2.3 Key figures

	2001	2002	2003	2004	2005	2006	2007
Short-term interest rate (in %)	4,3	3,3	2,3	2	2¼	3½	4½
Long-term interest rate (in %)	5,0	4,9	4,1	4¼	4¾	5	5¼
Euro exchange rate (dollars per euro)	0,90	0,94	1,13	1,21	1,20	1,20	1,20
Price of crude oil in USD (Brent)	24,5	25,0	28,9	36	35	36	36
	Changes in %						
World GDP	2,3	2,8	3,8	4¾	4¼	3½	3½
Euro area GDP	1,7	0,9	0,5	2	2¼	2½	2½
Relevant world trade volume	2,4	2,2	4,3	7¼	6¾	6½	6½
World trade volume	1,6	4,0	5,9	10¾	8½	8	7¾

NB No current projection is available for the years 2006 and 2007. The figures are hence based on the medium-term scenario as calculated by the CPB in July 2003.

The erosion in competitiveness will prevent the Netherlands from benefiting strongly from the international economic upswing. A robust economic recovery is only feasible in conjunction with controlled wage development. The labour income ratio is likely to reach a peak of 87% this year; it will probably decline only slightly next year, remaining at an historically high level. The proposed wage moderation is not sufficient to substantially boost corporate profitability. The expected recovery in corporate profitability can mainly be attributed to the acceleration in productivity growth, which will follow from the adjustment of the labour reserve and an economic upswing. Corporate investment will be positively influenced by the expected profit recovery, but will also come under downward pressure from the slight increase in long-term interest rates.

There are downward risks for economic growth. The economic performance could falter if, say, the euro rate should exceed that projected by the CPB, or if oil prices remain high. The central projection is based on information up to August 2004. Oil prices and the euro rate have risen since then. Euro appreciation would lead to an erosion of competitiveness relative to non-euro area countries; it would also have an adverse impact on intra-European trade because other euro countries would likewise suffer the disadvantages of the stronger euro. Higher oil prices would detract from households' purchasing power, reducing consumption. Moreover, corporate profits would be squeezed by rising energy prices.

Table 2.4 Economic growth and related factors *

	2001	2002	2003	2004	2005	2006	2007
	Changes in %						
Gross domestic product, volume	1,4	0,6	-0,9	1¼	1½	2½	2½
Gross domestic product, Level in EUR billions	429,3	445,2	454,3	464,5	475	494	514
GDP deflator	5,2	3,1	3,0	1	¾	1½	1½
CPI	4,5	3,4	2,1	1¼	1¼	1½	1½
HICP	5,1	3,9	2,2	1¼	1¼	1½	1½
Compensation per employee, market sector	5,5	6,6	3,8	2½	½	2½	2½
Contractual wages, market sector	4,2	3,5	2,7	1½	¾	1½	1½
Labour productivity (market sector)	0,6	0,6	0,8	3½	1¾	1¼	1½
Labour productivity (overall economy) †	-0,4	0,7	-0,3	2¼	1	-	-
Unit labour costs, manufacturing industry	5,1	4,5	3,5	-1½	-1¼	--	--
Employment growth (in persons)	1,9	-0,1	-0,5	-1	½	1½	1¼
Unemployment (in % of labour force)	3,3	4,0	5,1	6½	7	6½	6¼
Standardised unemployment	2,5	2,7	3,8	5¾	6¼	5¾	5½
Expenditure and output							
Private consumption	1,4	1,3	-0,9	¼	0	1¾	2
Public sector consumption	4,8	3,6	1,8	½	½	1½	1½
Gross investment	-1,8	-6,4	-3,5	1¼	¾	2	2¼
Inventories (change in % of GDP)	-0,1	-0,2	0,2	¼	¼	0	0
Exports of goods and services	0,3	0,9	0,5	5	7½	5¾	5½
Imports of goods and services	1,6	-0,2	1,0	4	5¾	4½	4¾
Share in GDP growth	Contribution in percentage points						
National expenditure	1,7	0,5	-0,5	¾	½	1½	1¾
- of which: inventory build-up	0,0	-0,2	0,0	¼	¼	0	0
Net exports of goods and services	-0,3	0,1	-0,4	½	1	1	¾

* Figures for 2006 and 2007 are based on the medium-term scenario as calculated by the CPB in June 2003, † GDP per employee

Source: CPB Netherlands Bureau for Economic Policy Analysis

Comparison with European Commission's Autumn Forecast

Comparison of the Dutch government's expectations for the Dutch economy with the European Commission's Autumn Forecast strikingly reveals that both projections assume a growth acceleration in the second half of 2005. The European Commission expects a slightly higher growth than the Netherlands itself. The European Commission expects the economy to grow by 1.4% (NL: 1¼%) in 2004 and by 1.7% (NL: 1½%) in 2005. For both years, the European Commission assumes a higher growth in private consumption, whereas the Netherlands expects residential investment to accelerate.

III Development of EMU balance and EMU debt

The worsening economic situation was attended by a deterioration in the Dutch fiscal balance. The setbacks were so substantial that, despite considerable and rapid budgetary action, the Netherlands did not succeed in 2003 in complying with the requirements of the Maastricht Treaty. The financial setbacks were mainly evident on the revenue side of the budget, notably in corporation tax, wage and income tax, and turnover tax (VAT). Corporation tax in particular proved much more sensitive to economic fluctuations than had been assumed earlier. Setbacks also made themselves felt on the expenditure side of the budget (especially in health care) and in the balance of local government (see the relevant section in this chapter).

In its latest country report¹, the IMF paid special attention to the disappointing budgetary developments. In its report, the Fund noted that “The magnitude of the deterioration in the Dutch fiscal position surprised many” and “Those who were surprised [...] had good reason to be so”. The IMF had assumed that, considering the fiscal surplus that had been recorded in 2000, the Netherlands had reached a position offering sufficient scope to allow the automatic stabilisers to take effect. The IMF concluded that the cyclical downturn accounted for nearly two-thirds of the decrease in the fiscal balance. In addition, tax cuts and higher spending on health care in particular, have contributed to the deterioration of public finances.

EMU balance

Table 3.1 Development of EMU balance since 2003 Stability Programme update

	2002	2003	2004	2005	2006	2007
EMU balance in Stability Programme update of October 2003	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6
Change relative to 2003 Stability Programme update	-0.3	-0.9	-1.2	-1.5	-1.5	-1.7
<i>of which: balance of local government</i>	<i>-0.3</i>	<i>-0.6</i>	<i>-0.7</i>	<i>-0.5</i>	<i>-0.3</i>	<i>-0.2</i>
Position excluding additional policy measures	-1.9	-3.2	-3.5	-3.1	-2.4	-2.3

Owing to the deterioration of the budgetary position, the prospect of sustainable public finances threatened to disappear from view. Mindful of demographic ageing, the Cabinet aims at achieving a structural fiscal surplus. In 2003, however, the 3% limit under the Maastricht Treaty was even exceeded. In March 2004 this was notified to the European Commission and, subsequently, on 2 June the Ecofin Council decided that an excessive deficit existed. The Council recommended that a package of measures should be implemented to improve the EMU balance by at least ½ percentage point. On 21 October last the Ecofin Council noted with satisfaction that, at present, the action taken by the Dutch authorities in response to the Council's Recommendation of 2 June appeared sufficient to put an end to the present excessive deficit situation in the Netherlands by 2005.

Package of policy measures

Based on the agreements embodied in the fiscal rules and on the recommendations of the Ecofin Council, the Cabinet has taken additional policy measures. The package of policy measures has been worked out with due observance of the rules underlying the Cabinet's policy. This means that general increases in the burden of taxation and social insurance contributions and measures dampening economic growth have been avoided where possible. The package focuses on measures matching the pursuit of sustainable public finances. The Autumn Accord, which was concluded recently, does not influence public finances for 2004. As yet, a minor expenditure increase – of EUR 165 million (0.03% of GDP) – is expected for 2005. The budgetary consequences of the Autumn Accord for 2005 and subsequent years will be incorporated in the Spring Memorandum, which is to be presented before 1 June.

On the expenditure side of the budget, measures have been taken to step up control over the growth of spending on health care. Furthermore, agreements have been made to improve efficiency in inviting tenders for major investment projects. In addition, additional efficiency targets have been set for the ministries. Additional expenditure cuts have been effected through economies on rent subsidies, through the sale of agricultural land and through delaying investment projects.

As regards the revenue side of the budget, it has been decided to raise contributions under the Exceptional Medical Expenses Compensation Act (AWBZ). This increase in the burden of taxation and social insurance contributions was made possible by higher-than-expected purchasing power of citizens as a result of lower inflation. In addition, two independent public sector agencies (Nederlandse Waterschapsbank and Bank Nederlandse Gemeenten) have been subjected to corporation tax and a temporary increase has been effected in contributions under the Occupational Disability Insurance Act (WAO). The overall package of measures involves an amount equal to 0.5% of GDP in 2005, thus ensuring compliance with the recommendations of the Ecofin Council.

Table 3.2 Development of EMU balance including additional policy measures (% of GDP)

	2004	2005	2006	2007
EMU balance excluding additional policy measures	-3.5	-3.1	-2.4	-2.3
Additional policy measures	0.5	0.5	0.4	0.3
<i>of which: expenditure</i>	<i>0.3</i>	<i>0.3</i>	-	-
<i>of which: revenue</i>	<i>0.1</i>	<i>0.2</i>	-	-
EMU balance	-3.0	-2.6	-2.1	-1.9

Structural balance

Next year, too, actual economic growth will fall short of potential growth. As a result, the cyclical component of the actual fiscal balance will show a further increase.

¹ IMF Country Report No. 04/301, September 2004, Kingdom of the Netherlands: Selected Issues.

Table 3.3 Development of structural EMU balance, 2002-2006 (% of GDP)

	2002	2003	2004	2005	2006	2007
Actual EMU balance	-1.9	-3.2	-3.0	-2.6	-2.1	-1.9
Cyclical component	-0.9	0.8	0.9	1.2	1.0	0.7
Structural EMU balance	-2.8	-2.4	-2.1	-1.4	-1.1	-1.2

Adjusted for cyclical effects, the budget still shows a considerable deficit. Still, in 2005 the structural fiscal balance will improve by 0.7 percentage point, in line with the requirements of the Stability and Growth Pact, as elaborated in the agreements of the euro group of October 2002. For 2006 and 2007 no recent economic projections are available as yet. Instead, technical assumptions have been used, based on an economic growth rate for 2006 and 2007 of 2½%. In these calculations, the overall revenue elasticity is around 1 (see Box 3.1). On the basis of this extrapolation, the structural fiscal balance would now show a slight improvement between 2005 and 2007. An up-to-date economic projection for 2006 will become available in the spring of 2005. The decision-making within the Cabinet on the 2006 budget will be based on this projection.

Box 3.1 Uncertainty about the overall revenue elasticity

The overall revenue elasticity indicates to what extent nominal revenue from taxes and social insurance contributions increase with the growth of nominal GDP. The overall revenue elasticity represents the endogenous¹ increase in taxes and social insurance contributions consequent on each percentage point growth of nominal GDP. If the endogenous increase in taxes and social insurance contributions is equal to nominal GDP growth, the overall revenue elasticity is equal to 1. Averaged over a large number of years, the overall revenue elasticity usually has this value. In the short run, however, it may show considerable fluctuations.

During a cyclical slowdown, the overall revenue elasticity usually has a lower value as a result of so-termed composition effects. In such periods, a shift is often observed from consumption subject to high tax rates to consumption subject to low tax rates, so that revenue from turnover tax is depressed. During a boom, on the other hand, the overall revenue elasticity often has a high value.

In the estimate of revenue for 2005, the Netherlands has assumed an endogenous growth rate of nominal revenue from taxes and social insurance contributions of 1.0% at a nominal GDP growth rate of 2.2%. Phrased differently, an overall revenue elasticity of 0.45 is assumed. Considering the long-run value of the overall revenue elasticity, this is a conservative assumption. The conservative nature of the assumption is due to, among other factors, the circumstance that proceeds from corporate tax are depressed by loss carry-forwards. Moreover, it is assumed that wage movements will be moderate, while the indexation of the thresholds of the tax brackets is based on the comparatively high inflation rates of the recent past. Finally, it is expected that the growth of consumption will fall short of the growth of GDP. For 2006 and 2007, it is assumed that the overall revenue elasticity will again be around 1.

¹ The endogenous development is defined as the overall development excluding policy effects.

EMU debt

The Cabinet holds that repaying government debt is an important instrument to prevent the burdens implied by demographic ageing from being shifted to future generations. At the same time, given the current economic environment, it would seem unavoidable that in 2007 government debt will be higher than at the time when the present Cabinet took office. The Cabinet attempts to reverse this development and to prevent an unjustifiable increase in debt. In addition, the Cabinet has stated that tackling the problems associated with the ageing process calls for a three-pronged approach. Apart from control over government debt, higher participation rates and adjustment of collective arrangements are essential. These policy aims have gained even more weight now that the reduction of government debt is encountering delays. For this reason too, the Cabinet holds that the measures regarding, for instance, early retirement and pre-pension schemes, the Occupational Disability Insurance Act and the Unemployment Act, and the reforms in the health care sector are of great significance. In addition to raising participation rates, boosting labour productivity growth and encouraging a longer working-life are important objectives (see the Memorandum on Opting for Growth (Groeibrief) presented to Parliament in July last).

Given the estimated development of government debt, the Netherlands is in compliance with the requirements of the Stability and Growth Pact. In each year in the period 2004 – 2007 the EMU debt ratio remains below the reference value of 60% of GDP. In the medium-term estimates, the debt ratio increases up to and including the year 2006. In the estimates, 2007 is the year when developments are reversed and the EMU debt ratio shows a decrease.

Table 3.4 Development of EMU debt ratio (% of GDP)*

	2002	2003	2004	2005	2006	2007
1. EMU debt ratio	52.6	54.1	56.3	58.1	58.6	58.3
2. Effect of EMU balance on debt ratio	1.9	3.2	3.0	2.6	2.1	1.9
3. Denominator effect (nominal GDP growth)	- 1.9	- 1.1	- 1.2	- 1.2	- 2.3	- 2.3
4. Change based on balance and growth (4=2+3)	0.0	2.1	1.8	1.4	- 0.2	- 0.5
5. Stock-flow adjustment	- 0.3	- 0.7	0.3	0.5	0.6	0.3
6. Total change in debt ratio (6=4+5)	- 0.3	1.5	2.2	1.9	0.4	- 0.2

* Figures may not add up due to rounding.

Analyses have shown that, compared to the situation in other Member States of the European Union, the stock-flow adjustment is relatively small in the Netherlands. The stock-flow adjustment is the difference between the change in outstanding debt and the annual fiscal deficit. In 2002 and 2003 the stock-flow adjustment was negative. During these years it was mainly financial transactions (notably on account of proceeds from sales of equities and repayments of loans) that contributed to this negative stock-flow adjustment. In the period 2004 – 2007 the stock-flow adjustments are expected to be positive throughout, causing government debt to increase by more than the amount of the EMU deficit.

The EMU balance by sector

The EMU balance represents the balance of expenditure and revenue of central government, social security funds, state government and local government. The Netherlands has no state government. In the years ahead the central government's deficit will account for the bulk of the general government deficit. The consequences of the economic downturn are making themselves felt most strongly on the revenue side of the central government's budget. Furthermore, the local government's fiscal balance unexpectedly swung markedly into deficit in 2002 and 2003. On account of this and other factors, the Netherlands exceeded the reference value for the general government deficit of 3% of GDP in 2003 (see the next section and Box 3.2). The social security funds are recording surpluses, not least because social insurance contributions have been set above the levels required to meet expenses.

Table 3.5 Development of EMU balance by government sector (% of GDP)*

	2000	2001	2002	2003	2004	2005	2006	2007
EMU balance	1.5	- 0.1	- 1.9	- 3.2	- 3.0	- 2.6	- 2.1	- 1.9
Central government	- 0.2	- 0.1	- 1.0	- 2.6	- 2.6	- 2.3	- 2.9	- 3.0
Local government	0.1	- 0.1	- 0.5	- 0.6†	- 0.7	- 0.5	- 0.3	- 0.2
<i>Social security funds</i>	1.6	0.1	- 0.5	0.0	0.3	0.2	1.1	1.3

* Figures may not add up due to rounding.

† Excluding the cash transaction adjustment of the VAT compensation fund to the amount of EUR 1.6 billion.

The development of local government finances

In March 2004 it unexpectedly became evident that in 2002 and 2003 the local government had been running considerable EMU deficits. As a result of this and other factors, the 2003 EMU deficit of the Netherlands exceeded the 3% limit. In last year's Stability Programme update, it had still been assumed that for 2003 and subsequent years the local government EMU balance would be nil. Now expectations for 2003 and subsequent years are for a local government deficit, which will, however, probably show a decrease after 2004. In 2003 the local government deficit was mainly accounted for by the municipalities (EUR 2.4 billion) and to a lesser extent by the provinces (EUR 0.2 billion) and the district water boards (EUR 0.1 billion). The other local government sectors (which include schools) ran a small surplus (EUR 0.1 billion).

Table 3.6 Local government EMU balance 2000-2007, in EUR billion and % of GDP

	2000	2001	2002	2003	2004	2005	2006	2007
EUR billion	0.3	-0.3	-2.0	-2.5	-3.2	-2.4	-1.6	-0.8
% of GDP	0.1	-0.1	-0.5	-0.6	-0.7	-0.5	-0.3	-0.2
2003 Stability Programme update (% of GDP)	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0

The estimate of the CPB for 2004 and subsequent years is in line with the results of a survey held among municipalities with more than 50,000 inhabitants. The survey will be updated in the months ahead.

Provinces, municipalities and district water boards have a financial responsibility of their own and operate an accrual accounting system. Until recently, the EMU balance did not feature as a control variable for local government. Compared to the calculation of the EMU balance, the differences mainly concern the treatment of capital expenditure and the allocation of proceeds from sales of assets. Owing to high levels of capital expenditure undertaken by municipalities and a positive balance from purchases and sales of land, the local government has been running considerable deficits on an EMU basis in recent years. In order to make sure that the Netherlands will be able to meet its European budget obligations, arrangements have been made this year about the way in which the local government sector may contribute to controlling the EMU balance (see Box 3.2). For the years ahead, expectations are that the local government deficits will slowly decrease.

Box 3.2 Measures aimed at controlling the local government's EMU balance

In September 2004 a kind of national stability pact was concluded between central and local government (municipalities, provinces and district water boards). The parties involved have made arrangements along two lines, aimed at achieving better control over the EMU balance of the local government sector.

Rapid supply of information about the local government's EMU balance

One of the problems in this context was constituted by the time lag before the local government's deficit became known. In this light, apart from improving the quality of the relevant figures, it was essential that this time lag was shortened. The problems regarding the supply of information had already been identified in the past. Hence, effective 1 January 2004, measures have been taken to improve the quality and the timeliness of the quarterly reports about local government expenditure and revenue. Since 1 January 2004 the local government sector has reported on a quarterly basis about its so-termed non-financial transactions. In combination with the existing quarterly reports about the local government sector's financial transactions, this makes it possible to achieve the required higher quality level. Furthermore, under the new system the time lag with which the annual figures become available is shortened by about four months. The supply of information is also being improved in other ways. Henceforth, the local government will incorporate the EMU balance into its budgets. In 2005 the local government's EMU balance will be monitored closely on the basis of the local budgets and data about budget implementation. The central and local government sectors not only seek to raise the quality of the supply of information but also aim at lowering the administrative reporting burden.

Arrangements for keeping the local government's EMU balance under control

Based on an aggregate maximum EMU deficit which municipalities, provinces and district water boards are allowed to incur in 2005, each of them is assigned a reference value. The maximum EMU deficit totals EUR 1,900 million for the municipalities, EUR 325 million for the provinces and EUR 250 million for the district water boards (totalling 0.5% of GDP). If the maximum threatens to be exceeded, further measures will be considered. This will be the case if the general government's EMU deficit exceeds the trigger value of 2.5% of GDP or if the present estimate for the local government's 2005 deficit (0.5% of GDP) is exceeded. This will be verified for the first time in the 2005 Spring Memorandum.

IV Comparison with previous update and sensitivity analyses

Comparison with October 2003 update

A comparison with the previous Stability Programme update shows that, on present views, economic growth in the years 2001-2005 is down markedly compared to earlier expectations. On a cumulative basis, the growth rate estimated for this period is about 1 percentage point below the rate envisaged in the Stability Programme update of October 2003. The growth rates for 2003 and 2005 in particular fall far short of last year's expectations. In 2003 the economy contracted by 0.9 percentage point, whereas a year ago zero growth had still been assumed. For 2005 expectations a year ago were for a cautious trend growth of 2½%. Now it is assumed that the growth rate will be 1½%, exactly a full percentage point lower. The lower growth estimates, combined with the deterioration of the local government's balance, account for the downward adjustments of the EMU balance from 2003 onwards.

In the absence of additional measures relative to the previous Stability Programme update, the EMU deficit would exceed the reference value of 3% of GDP in both 2004 and 2005. Owing to the additional package of policy measures, expectations are now for an EMU deficit of 3.0% of GDP for 2004 and 2.6% of GDP for 2005.

Table 4.1 Comparison of October 2003 and November 2004 Stability Programme updates

	2001	2002	2003	2004	2005
GDP growth					
Stability Programme update October 2003	1.2%	0.2%	0%	1%	2 ½%
Stability Programme update November 2004	1.4%	0.6%	-0.9%	1 ¼%	1 ½%
Difference (in percentage points)	0.2	0.4	-0.9	+ ¼	-1
Difference, cumulative since 2000 (in percentage points)	0.2	0.6	-0.3	-0.0	-1
EMU balance					
Stability Programme update October 2003	-0.0%	-1.6%	-2.3%	-2.3%	-1.6%
Stability Programme update November 2004	-0.1%	-1.9%	-3.2%	-3.0%	-2.6%
Difference (in percentage points)	-0,1	-0.3	-0.9	-0.7	-1.0
EMU debt					
Stability Programme update October 2003	52.9%	52.4%	54.0%	54.5%	53.7%
Stability Programme update November 2004	52.9%	52.6%	54.1%	56.3%	58.1%
Difference (in percentage points)	0.0	0.2	0.1	1.8	4.4

Future uncertainties and sensitivity analysis: oil price

As always, the projections are subject to uncertainties. One of the principal uncertainties at this juncture concerns the oil price. Oil prices have gone up sharply this year and in September and October they were between USD 45 and USD 52 per barrel. This is considerably up on the USD 35 per barrel that has served

as an assumption in the baseline projection for 2004 and 2005. Over the past thirty years, the Dutch economy's sensitivity to oil price shocks has diminished substantially. Since the oil crisis of the early 1970s, oil consumption per unit of output has been reduced by over one-half. In other industrialised countries, too, oil consumption per unit of output has shown a decrease, so that the Dutch economy's sensitivity to oil price fluctuations has also lessened in an indirect way. This is not to say, however, that the Dutch economy would be immune to an increase in oil prices. The CPB has computed the effects of an oil price that would permanently be USD 10 per barrel up on the level assumed in the baseline projection (see Table 4.2).

Table 4.2 Effects of a higher oil price (by USD 10 per barrel) from September 2004 onwards (USD 45 instead of USD 35)

	<i>Cumulative differences, in %</i>	
	2004	2005
Gross domestic product (GDP)	-0.1	-0.4
Private consumption	-0.1	-0.6
Corporate investment	-0.1	-1.5
Goods exports	-0.1	-0.6
Employment	0.0	-0.2
Consumer price index (CPI)	0.1	0.5
Contractual wage rates in market sector	0.0	0.0
EMU balance (level, % of GDP)	0.0	0.0

The higher oil price would depress world trade, causing world trade relevant to the Netherlands to be 0.6% lower in 2005. In addition, the higher oil price would lead to higher inflation in the Netherlands and elsewhere. Corporate profitability would decrease, so that investment would decline. Private consumption would be depressed by higher inflation and lower employment.

The lower economic growth rate and the higher level of unemployment would lead to fiscal setbacks. These would, however, be offset by a substantial increase in non-tax revenue from natural gas. Natural gas prices follow oil prices with a lag. As the two effects would cancel each other out, a higher oil price would have practically no influence on the EMU balance.

Future uncertainties and sensitivity analysis: the euro exchange rate

Another uncertainty concerns the development of the euro exchange rate. In the baseline projection for 2004 and 2005 a euro/dollar exchange rate has been assumed of 1.21 in 2004 and 1.20 in 2005. Table 4.3 provides an overview of the consequences for the Dutch economy of an increase in the euro exchange rate by about USD 0.10 to USD 1.30 in the course of 2004 and an average euro exchange rate of USD 1.30 in 2005.

Table 4.3 Effects of a lasting appreciation of the euro by USD 0.10 (from USD 1.20 to USD 1.30 at end-2004)

	<i>Cumulative differences, in %</i>	
	2004	2005
Gross domestic product (GDP)	-0.1	-0.5
Private consumption	0.1	0.3
Corporate investment	-0.2	-1.0
Goods exports	-0.5	-1.5
Employment	0.0	-0.4
Consumer price index (CPI)	-0.1	-0.6
Contractual wage rates in market sector	0.0	0.0
EMU balance (level, % of GDP)	0.0	-0.2

Source: Central Economic Plan 2004.

The stronger euro would lead to lower exports as a result of an impairment of price competitiveness. Moreover, the growth rate of world trade relevant to the Netherlands would be depressed to some extent because other euro area countries would also experience the adverse effects of the euro appreciation. Private consumption would be pushed up somewhat because imported products would become cheaper, slowing down inflation. On balance, output would go down because the adverse effect on exports would outweigh the positive effect on consumption. The lower level of output would depress investment and employment. The lower economic growth rate would result in a deterioration of the EMU balance (with government revenue declining and expenditure on unemployment benefits going up).

Future uncertainties and sensitivity analysis: interest rate level

Yet another uncertainty concerns the movements in the interest rate level. Changes in interest rates lead directly (through new capital market borrowing) and indirectly (through the economy) to changes in the government's interest payments. According to standard scenarios², a 1 percentage point interest rate increase leads in the same year to a deterioration of the EMU balance by about 0.1 – 0.2% of GDP. In the second year, the deficit goes up by 0.3 – 0.4% of GDP.

² See CPB Document 31, 2003.

V Quality of public finances

The preceding chapters of this update dealt with the development of the Dutch economy, the fiscal balance and government debt. In the Netherlands, as elsewhere in Europe, the quality of public finances is receiving increasing attention. Owing to relatively sharply increasing expenditure on social security and health care, not least on account of the ageing population, policies seeking to strengthen the economic structure are in danger of being crowded out. In the latest Public Finance Report, the development of public spending in the EU has been analysed, showing that the share of spending on social security and health care in overall public spending in Europe went up by a total of 7.9 percentage points in the period 1991 – 2002. Table 5.1 shows the movements, in real terms, in the various expenditure categories for the Netherlands for the period after 1995.

Table 5.1 Movements in public spending per year, in volume terms

	1996 - 2002	2003	2004	2005
Net public spending	0.6	2.2	$\frac{1}{2}$	1
Public administration	2.7	-0.1	-1 $\frac{1}{4}$	-1 $\frac{3}{4}$
Safety	4.7	6.3	$\frac{3}{4}$	3 $\frac{1}{4}$
Infrastructure	7.7	0.7	-3	$\frac{1}{2}$
Education	2.2	3.2	2 $\frac{3}{4}$	2 $\frac{1}{4}$
Public health care	2.9	4.2	2	1 $\frac{3}{4}$
Social security	-0.5	1.9	1	0
GDP	3.0	-0.9	1$\frac{1}{4}$	1$\frac{1}{2}$
	1995	2003	2004	2005
Public spending (% of GDP)	49.6	42.5	42.2	41.8
Taxes and social insurance contributions (% of GDP)	40.6	39.3	39.3	39.2

Source: CPB Netherlands Bureau for Economic Policy Analysis.

In the Netherlands, as in the other EU Member States, expenditure on health care showed a considerable increase in the period 1996 – 2002. Spending on social security, however, was successfully reduced during this period. In the period 1996 – 2002, the growth of expenditure on infrastructure and safety exceeded the growth of GDP and, for that matter, the growth of total public spending, causing the share of this expenditure in GDP and in overall public spending to go up. At the end of the period, spending on education was also marked by a relatively high growth rate. Averaged over the period, the growth of this spending fell, however, short of the increase in both GDP and total public spending. Expenditure on safety, infrastructure and education is often associated with the structural reinforcement of the economy.

For the coming period, the Cabinet has adopted the objective of achieving a further reinforcement of the Dutch economic structure. Whereas public spending expressed as a percentage of GDP will decline in 2004 and 2005, additional efforts will be made in the areas of education, research and development (witness, for instance, the EUR 700 million funding available for the knowledge-based economy), on the one hand, and safety, on the other. Where encouraging corporate investment in research and development is concerned, a case in point is the EUR 100 million increase in 2007 in the budget under the Research and Development Stimulation Act (WBSO). Especially medium-sized and small companies are finding it difficult to develop and apply new know-how. For this reason, the Netherlands has started an experiment involving so-called knowledge vouchers, permitting medium-sized and small companies to purchase know-how from universities, institutions for higher vocational education and research institutes.

Reduction of the administrative burden

It is not just important for the government to seek to reinforce the economic structure by implementing new policies. As a rule, a smaller and more efficient public sector contributes to economic growth. The decrease that has been achieved in public spending expressed as a percentage of GDP means that more scope is available for private enterprise. The Cabinet holds that it is important that entrepreneurs and enterprises should not be faced with undue government-imposed regulation. In this light, it has decided to seek to reduce red tape by 25% during its period of office. With the total administrative burden for the corporate sector being put at EUR 16 billion, measures have already been taken at the national level involving an amount of EUR 3 billion (2002 price level). Moreover, the Dutch government is seeking to reduce the red tape originating from Brussels. The focus is not just on the administrative burden itself, but also on other costs of complying with regulations as well as on regulatory inconsistencies.

The reduction of the administrative burden means that the private sector will need to spend less time and money when supplying information to the authorities. In the public sector, the reduction in the administrative burden will reduce bureaucracy. As a result, 24,000 employees who are now involved in administrative duties may be re-assigned to the primary process. The private sector will benefit as well. After some time, output will increase, as employment and labour productivity go up. The improvement in competitiveness will enable firms to step up sales. As it takes some time (an expected five to ten years) before the economy benefits from the lower burden, unemployment will rise in the short and medium term. The CPB expects that in the long run the measures will lead to an increase in GDP of 1.9%.³ Table 5.2 shows the consequences of a 25% decrease in the administrative burden for various macro-economic key variables, as computed by the CPB.

³ In the computations it has been assumed that the government leaves the fiscal balance unchanged. In this variant, budget neutrality is achieved by lowering wage and income tax.

Table 5.2 Cumulative effects of a 25% reduction in the administrative burden

	After 1 year	After 4 years	After 15 years
Market sector labour productivity (%)	0.5	1.0	1.7
Market sector employment (labouryears)	-6,000	-26,000	50,000
Private consumption deflator (%)	0.0	-0.4	-1.8
Goods export deflator, excluding energy (%)	-0.3	-0.6	-1.1
Market sector output	0.4	0.4	2.6
GDP (%)	0.2	0.2	1.9

Source: CPB Netherlands Bureau for Economic Policy Analysis.

VI Sustainability of public finances

In the decades ahead, the Dutch population will age rapidly. In 2040, it will probably include about 4 million people of 65 and over, against slightly more than 2 million at present. The elderly dependency ratio, i.e. the population aged 65 and over as a proportion of the population aged 20-64, will thus increase from about 22% at present to around 43% in 2040. This rise is attributable to three factors. The first is the post-war baby boom. From 2010 onwards, the large number of births during the first three to four years after the end of the Second World War will temporarily lead to a very large number of people of 65 and over. The second factor is the decrease in the total fertility rate. This means that in the future parents of 65 and over will, on average, have fewer children and grandchildren. The third factor is the higher life expectancy. It might be noted that the contribution of the baby boom to the ageing of the population is limited, so that the elderly dependency ratio will not show a substantial decrease once the baby boom generation has passed away.

The Cabinet is firmly convinced of the fact that demographic ageing calls for measures at this very moment. Box 6.1 discusses the consequences for public finances. The measures seeking to raise the participation rate for the elderly should be seen in this light. They include, for instance, the termination of tax deductibility arrangements for early retirement and pre-pension schemes. The Cabinet has adopted a three-pronged policy to cope with the burden entailed by the ageing population: increasing participation rates, adjusting collective arrangements and reducing government debt.

In general, there is still a considerable pool of unused labour (see chapter 2). One favourable development in recent years has been the increase in the participation rate of the elderly. Yet, this rate is still very low. The Cabinet holds that it is necessary to effect a further increase in the participation rate of the elderly. To that end, the retirement age will have to be raised. In order to increase the participation rate, the tax facilities now enjoyed by early retirement schemes will be terminated. A higher retirement age acts as a double-edged sword for the financing of pensions and public services. On the one hand, it raises total income available for payment of social insurance contributions and taxes and, on the other, older workers will come to rely to a lesser extent on early retirement and pre-pension schemes as well as on social security.

Secondly, the controllability of public finances should be improved by adjusting collective arrangements. In 2006 the Occupational Disability Insurance Act (WAO) will be revised, much more emphasis being placed on the degree to which people are still able to work. In addition, the revision of the system of health care not only seeks to improve the quality of health care services, but also to keep publicly financed health care expenses under control. If the public sector no longer regulates the supply of health care services, the control of health care expenses will have to be achieved by causing health care insurance companies to compete with each other when purchasing health care services. Moreover, higher co-payments may also help control health care expenditure.

Thirdly, in order to ensure that the higher public expenditure resulting from the demographic changes may in due course be absorbed within the budget without increasing taxes and social insurance contributions and

without scaling down public services, government debt must be reduced so as to achieve lower levels of interest payments. This is the basis underlying the Cabinet's efforts to restore order to public finances. The fact is that the current fiscal deficits result in increases in government debt and, hence, in interest payments, thus saddling future generations with an unpaid bill, which will have to be settled at a very time when budgetary scope is needed to cope with higher spending on state old-age pensions and health care. Table 6.1 presents a technical extrapolation of the long-term development of public finances. Next year an extensive study will be conducted of the consequences of demographic ageing for the Dutch economy and Dutch public finances. Such a comprehensive study will provide a better picture of the economic and budgetary consequences of demographic ageing.

Table 6.1 Sustainability of public finances

% GDP	2010	2020	2030	2050
Total public spending	48.0	49.8	55.5	56.3
Pensions	5.3	6.7	8.9	8.3
Health care	7.7	8.7	10.7	10.7
Interest payments	2.5	2.2	2.6	5.7
Total public revenue	44.6	45.7	48.1	47.7
Assumptions				
Labour productivity growth (%)	1 ³ / ₄	1 ³ / ₄	1 ³ / ₄	1 ³ / ₄
Real GDP growth (%)	1.8	1.6	1.4	1.8
Participation rate, men	82.0	81.2	81.5	81.8
Participation rate, women	66.3	72.6	72.9	73.2
Overall participation rate	75.0	76.5	76.8	77.1
Unemployment (% of working population)	4	4	4	4

Source: Calculations of the Ministry of Finance, in line with the pattern presented in "Ageing in the Netherlands".

Box 6.1 Demographic ageing in the Netherlands

In 2000 the CPB conducted a comprehensive analysis of the consequences of demographic ageing in the Netherlands. The results showed that, in the years until 2040, total expenditure on state old-age pensions and health care would go up by about 8% of GDP. This could be financed to the extent of about one-half from higher tax revenue, because future pension benefits are subject to taxation. The other half could be financed from lower interest payments resulting from repayment of government debt. The computations made by the CPB showed that a structural fiscal surplus of 1% of GDP would be sufficient to ensure the required repayment of government debt.

In 2003 the CPB partially updated its analysis of the costs of ageing. The new analysis led to comparable conclusions. In addition, it was established that an actual fiscal deficit of ½% of GDP in 2007 would roughly correspond to a structural fiscal surplus of 1% of GDP, because the fiscal balance in that year would be influenced by two factors. First, the positive economic and budgetary effects ensuing from the policies conducted by the present Cabinet will not yet be fully realised in 2007, so that the fiscal balance will show a further improvement in subsequent years. Moreover, expectations are that, as a result of the funding problems encountered by the pension funds, in 2007 pension premiums will still be above the level necessary to cover expenses. As these premiums are tax-deductible, 2007 will see a temporarily low level of tax revenue.

Hence, in 2003 it was reckoned that, at an actual fiscal balance of -½% of GDP in 2007, public finances would be sustainable. In the present medium-term estimates, expectations are for a fiscal balance in 2007 of -1.9% of GDP. Consequently, a further improvement of the fiscal balance is required. In this context it might be noted that the figures for 2006 and 2007 are technical in nature and that in the spring of 2005, on the basis of up-to-date economic projections, consideration will be given to the question whether additional measures are called for. Still, the foregoing does indicate that the budgetary situation in the Netherlands continues to require due attention.

ANNEX

Table 1 Economic growth and related factors*

	2001	2002	2003	2004	2005	2006	2007
	Changes, %						
Gross domestic product, volume	1.4	0.6	-0.9	1¼	1½	2½	2½
Gross domestic product, level in EUR billion	429.3	445.2	454.3	464.5	475	494	514
GDP deflator	5.2	3.1	3.0	1	¾	1½	1½
CPI	4.5	3.4	2.1	1¼	1¼	1½	1½
HICP	5.1	3.9	2.2	1¼	1¼	1½	1½
Compensation per employee, market sector	5.5	6.6	3.8	2½	½	2½	2½
Contractual wage rates, market sector	4.2	3.5	2.7	1½	¾	1½	1½
Labour productivity, market sector	0.6	0.6	0.8	3½	1¼	1¼	1½
Labour productivity, whole economy †	-0.4	0.7	-0.3	2¼	1	-	-
Unit labour costs, manufacturing	5.1	4.5	3.5	-1½	-1¼	-	-
Employment (persons)	1.9	-0.1	-0.5	-1	½	1½	1¼
Employment (% of working population)	3.3	4.0	5.1	6½	7	6½	6¼
Standardised unemployment rate	2.5	2.7	3.8	5¾	6¼	5¾	5½
Expenditure and output							
Private consumption	1.4	1.3	-0.9	¼	0	1¾	2
Government consumption	4.8	3.6	1.8	½	½	1½	1½
Gross investment	-1.8	-6.4	-3.5	1¼	¾	2	2¼
Change in inventories (% of GDP)	-0.1	-0.2	0.2	¼	¼	0	0
Exports of goods and services	0.3	0.9	0.5	5	7½	5¾	5½
Imports of goods and services	1.6	-0.2	1.0	4	5¾	4½	4¾
Shares in GDP growth							
	Contributions in percentage points						
National expenditure	1.7	0.5	-0.5	¾	½	1½	1¾
- of which: inventory build-up	0.0	-0.2	0.0	¼	¼	0	0
Net exports of goods and services	-0.3	0.1	-0.4	½	1	1	¾

* For the years 2006 en 2007 the figures correspond to the medium-term projection prepared by the CPB in June 2003.

† Real GDP per employee.

Source: CPB Netherlands Bureau for Economic Policy Analysis.

Table 2 Development of public finances, 1995-2007

% of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EMU balance ¹	-4.2	-1.8	-1.1	-0.8	0.7	1.5	-0.1	-1.9	-3.2	-3.0	-2.6	-2.1	-1.9
Central government	-3.6	-1.5	-2.1	-1.1	-0.7	-0.2	-0.1	-1.0	-2.6	-2.6	-2.3	-2.9	-3.0
Local government	0.3	0.2	1.0	0.1	0.1	0.1	-0.1	-0.5	-0.6	-0.7	-0.5	-0.3	-0.2
Social security funds	-0.8	-0.5	-0.0	0.3	1.2	1.6	0.1	-0.5	-0.0	0.3	0.2	1.1	1.3
Public revenue	48.3	48.8	48.0	47.2	48.1	47.7	46.5	45.4	45.3	45.0	44.9	44.6	44.1
Public expenditure	52.5	50.6	49.1	48.0	47.4	46.2	46.6	47.3	48.5	48.0	47.5	46.7	46.0
EMU balance ¹	-4.2	-1.8	-1.1	-0.8	0.7	1.5	-0.1	-1.9	-3.2	-3.0	-2.6	-2.1	-1.9
Interest payments, net	5.9	5.6	5.2	4.8	4.5	3.8	3.4	3.1	2.9	2.9	2.9	2.8	2.7
Primary balance	1.7	3.8	4.1	4.0	5.2	5.3	3.5	1.2	-0.3	-0.1	0.3	0.7	0.8
Breakdown of public finances													
Taxes	24.5	25.4	25.2	25.0	25.6	25.5	25.7	25.6	24.9	24.4	24.8	24.7	24.3
Social insurance contributions	16.0	15.5	15.5	15.3	16.0	16.0	14.3	13.9	14.5	14.6	13.9	13.9	13.9
Other	7.8	7.9	7.3	6.9	6.5	6.2	6.5	5.9	5.9	6.0	6.2	6.0	5.9
Public revenue, total	48.3	48.8	48.0	47.2	48.1	47.7	46.5	45.4	45.3	45.0	44.9	44.6	44.1
Breakdown of public expenditure													
Government consumption	17.2	16.8	16.4	16.3	16.6	16.3	16.8	17.4	17.8	17.7	17.5	17.2	16.9
Social security (in kind)	7.5	7.0	7.2	7.1	7.1	7.2	7.4	8.0	8.5	8.3	8.0	8.1	8.2
Social security (other)	15.3	14.8	13.9	13.2	12.7	12.3	12.1	12.2	12.7	12.9	12.7	12.7	12.2
Interest payments	5.9	5.6	5.2	4.8	4.5	3.8	3.4	3.1	2.9	2.9	2.9	2.8	2.7
Subsidies	1.7	1.7	2.0	1.8	1.9	1.8	1.7	1.8	1.7	1.5	1.5	1.4	1.4
Investment	3.0	3.1	2.9	2.9	3.0	3.1	3.2	3.3	3.2	3.2	3.1	3.1	3.1
Other	1.9	1.6	1.5	1.9	1.6	1.7	2.0	1.5	1.7	1.5	1.8	1.4	1.5
Public spending, total	52.5	50.6	49.1	48.0	47.4	46.2	46.6	47.3	48.5	48.0	47.5	46.7	46.0

¹ The EMU balance for 2000 does not include the proceeds from the auction of UMTS licences of 0.7% of GDP.

Table 3 Development of EMU debt, 1995-2007

% of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EMU debt	77.2	75.2	69.9	66.8	63.1	55.9	52.9	52.6	54.1	56.3	58.1	58.6	58.3
Change in debt ratio	2.6	-2.0	-5.3	-3.1	-3.7	-7.2	-3.0	-0.3	1.5	2.2	1.9	0.4	-0.2
Contribution to decrease in debt ratio:													
Primary balance	1.7	3.8	4.1	4.0	5.2	5.3	3.5	1.2	-0.3	-0.1	0.3	0.7	0.8
Interest payments	5.9	5.6	5.2	4.8	4.5	3.8	3.4	3.1	2.9	2.9	2.9	2.8	2.7
Denominator effect of GDP growth	-5.0	-4.2	-5.9	-6.1	-5.6	-4.4	-3.5	-1.9	-1.1	-1.2	-1.2	-2.3	-2.3
Other	3.4	0.4	-0.5	2.2	2.6	1.3	0.5	-0.3	-0.7	0.3	0.5	0.6	0.3

Table 4 Cyclical developments, 1995-2007

% of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
GDP growth	3.0	3.0	3.8	4.3	4.0	3.5	1.4	0.6	-0.9	1¼	1½	2½	2½
Actual EMU balance	-4.2	-1.8	-1.1	-0.8	0.7	1.5	-0.1	-1.9	-3.2	-3.0	-2.6	-2.1	-1.9
Interest payments	5.9	5.6	5.2	4.8	4.5	3.8	3.4	3.1	2.9	2.9	2.9	2.8	2.7

Table 5 Comparison of October 2003 and November 2004 Stability Programme updates

	2001	2002	2003	2004	2005
GDP growth					
Stability Programme update October 2003	1.2%	0.2%	0%	1%	2 ½ %
Stability Programme update November 2004	1.4%	0.6%	-0.9%	1¼ %	1½ %
Difference (in percentage points)	0.2	0.4	-0.9	+ ¼	- 1
Difference, cumulative since 2002 (in percentage points)	0.2	0.6	-0.3	-0.0	-1
EMU balance					
Stability Programme update October 2003	-0.0%	-1.6%	-2.3%	-2.3%	-1.6%
Stability Programme update November 2004	-0.1%	-1.9%	-3.2%	-3.0%	-2.6%
Difference (in percentage points)	-0.1	-0.3	-0.9	-0.7	-1.0
EMU debt					
Stability Programme update October 2003	52.9%	52.4%	54.0%	54.5%	53.7%
Stability Programme update November 2004	52.9%	52.6%	54.1%	56.3%	58.1%
Difference (in percentage points)	0.0	0.2	0.1	1.8	4.4