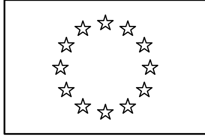

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 28.4.2004
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REPORT FROM THE COMMISSION

The Netherlands

Report prepared in accordance with Article 104(3) of the Treaty

1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration new data transmitted by the Netherlands on 31 March 2004, the general government deficit reached 3.2% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value (table 1). This represents a large slippage compared to the objective set in the 2003 budget of a general government deficit of 0.5% of GDP and of 1.6% of GDP targeted in the 2002 Stability Programme, which was submitted in June 2003[1]. The slippage results mainly from the impact of the deceleration in economic activity[2]. By 2004 and 2005, the deficit is projected to reach 3.5 % of GDP and 3.3 % of GDP respectively according to the Commission Spring 2004 forecast under a no policy change assumption.

Table 1: General government deficit and debt ratios

(% of GDP)	1998	1999	2000	2001	2002	2003	2004	2005
General government deficit	-0.8	0.7	2.2	0.0	-1.9	-3.2	-3.5	-3.3
General government debt	66.8	63.1	55.9	52.9	52.6	54.8	56.3	58.6

Source: Eurostat until 2003; Commission Spring 2004 forecasts for 2004 and 2005.

A general government deficit of greater than 3% of GDP provides prime facie evidence of the existence of an excessive deficit in the Netherlands, as set out in the EC Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for the Netherlands.

The application of the (EDP) is governed by Article 104 of the Treaty and Council Regulation No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria *[i.e. the ratio of the government deficit and of the government debt to GDP not exceeding the respective reference value]*, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State…".

This report, prepared by the Commission in accordance with Article 104(3), assesses recent and current budgetary developments in the Netherlands and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

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1 An earlier version of the 2002 Stability Programme was submitted in December 2002, but only the subsequent revision of June 2003 was discussed in the Ecofin Council.

2 According to the Commission Spring forecasts, the cyclically adjusted budget deficit improved by 0.7 percentage point in 2003. The 2003 budget projected an improvement by 1 % of GDP, whereas the 2002 update of the Stability Programme projected an improvement by 0.4 % of GDP.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

In the second half of the 1990s the Netherlands experienced a period of buoyant growth. Real GDP growth in the period 1996-2000 averaged 3.7%. Starting from mid-2001, the Netherlands entered a sharp economic slowdown, with real GDP growth weakening from 3.5% in 2000 to 1.2% in 2001 and 0.2% in 2002 (table 2). This reflected a combination of factors, including the reversal of imbalances that had built up in the private sector, and sharp price and wage increases that eroded external competitiveness, which added to the effect of the global downturn.

Contrary to what was expected in the budget for 2003, which projected real GDP growth at 1.5% in 2003, economic activity continued weakening last year. According to the most recent estimate of the national accounts, real GDP growth turned out to be -0.7% in 2003. This is more than 2 percentage points below the initial projection. Estimates of the output gap based on the commonly-agreed method for calculating potential output suggest that the economic downturn was the most severe since the early 1980s: the (negative) output gap reached 2.2% of GDP in 2003, the highest gap since 1983. Against a background of low confidence among producers and consumers, private consumption and investment growth were strongly negative in 2003. Exports did not rise due to the weakness in global trade, and to substantial losses in competitiveness. Employment declined and the unemployment rate increased markedly as the labour market responded with a lag to the economic downturn that had started in 2001. HICP inflation decreased from 3.9% in 2002 to 2.2% in 2003, mainly accounted for by lower import prices and falling profit margins in the context of a marked weakening of economic activity.

The economy started to show signs of improvement towards the end of 2003. In the fourth quarter of 2003 real GDP growth (quarter-on-quarter and seasonally adjusted) turned positive, after 5 previous quarters of negative or stagnant growth. According to the Commission Spring 2004 forecast, the Dutch economy is expected to recover in 2004 and 2005, but only slowly compared to previous cyclical upswings. Economic activity would remain weaker than the EU average. The Commission expects growth to pick up moderately in the course of 2004, to 1% on average for the year as a whole. In 2005 real GDP growth would strengthen to 1.6%. The upturn would be mainly driven by the recovery in external trade but is expected to remain quite weak compared to previous upswings. With price and wage increases subsiding from 2004 price competitiveness would start to improve only in 2005 reflecting also the movement of the exchange rate. Domestic demand would remain weak, reflecting a deteriorating labour market, the modest development of disposable income, ongoing balance sheet adjustments in the household and corporate sectors, and the impact of fiscal tightening.

The situation in the labour market is expected to worsen considerably in 2004. The unemployment rate is projected to rise substantially over the projection horizon, to 5.4% in 2004 and 5.7% in 2005, which would be the highest level since 1995. After strong wage growth in previous years, the growth rate of compensation per employee is expected to decline markedly in response to the deterioration in the labour market and the agreement among social partners to moderate wages. In combination with lower import prices this would lead to a further decrease in inflation (HICP inflation is forecast to decelerate to 1.4% in 2004 and 0.7% in 2005).

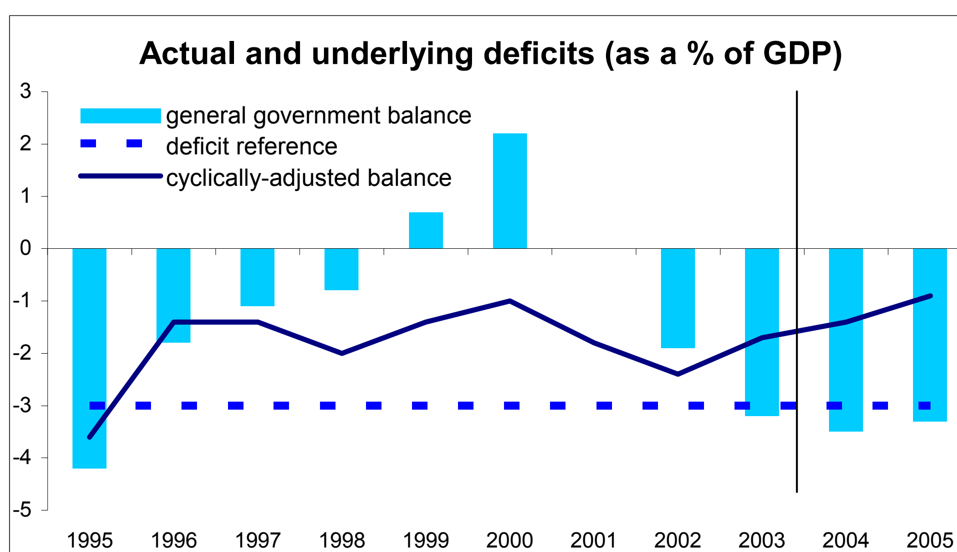
Table 2: Macroeconomic developments and outlook

		1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)		4.3	4.0	3.5	1.2	0.2	-0.7	1.0	1.6
Contribution:	Domestic demand	4.1	4.6	2.5	1.6	0.3	-0.8	0.2	0.8
	Change in stocks	0.4	-0.5	0.0	-0.1	-0.3	0.3	0.1	0.0
	External trade	-0.2	-0.1	1.1	-0.4	0.2	-0.3	0.7	0.7
Unemployment rate (% of labour force)		3.8	3.2	2.9	2.5	2.7	3.8	5.3	6.0
Unit labour costs (% change)		2.0	2.1	3.1	5.5	4.8	4.9	0.4	-1.1
HICP (% change)		1.8	2.0	2.3	5.1	3.9	2.2	1.4	0.7
Output gap		2.0	3.2	4.0	2.7	0.8	-2.2	-3.2	-3.5

Source: National accounts until 2003; Commission Spring 2004 forecasts for 2004 and 2005.

3. THE SITUATION OF GOVERNMENT FINANCES

The breach by the general government deficit of the 3% of GDP reference value in 2003 finds its origin in the fact that the Dutch government finances were in a more vulnerable position ahead of the cyclical downturn that started in 2001 than commonly appreciated at the time. In fact, based on recent calculations of the cyclically-adjusted budget balance for 1993-2001, it now turns out that throughout this period the cyclically adjusted deficit did not meet the requirement of the so-called 'minimal benchmark'[3] (a cyclically adjusted deficit of no more than 0.7% of GDP). This is even true for the year 2000, when the general government surplus reached 2.2% of GDP. In 2001 and 2002 a deterioration in the cyclically adjusted deficit occurred[4]. This was partly corrected in 2003 by a restrictive stance, but not to an extent sufficient to prevent the nominal deficit from increasing sharply, against the background of the deep recession that the economy went through.



Source: National accounts, Commission Spring 2004 forecasts for 2004 and 2005.

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[3] The minimal benchmark is the estimated cyclically-adjusted balance which in a normal cyclical slowdown would allow the automatic stabilisers to play fully without the deficit exceeding the 3% reference value.

[4] When excluding the UMTS payments (0.7% of GDP in 2000), it appears that the deterioration in the underlying budgetary position started in 2000.

3.1. *Recent budgetary developments until 2002*

During the period of buoyant economic growth in the late 1990s (table 3), the general government balance improved markedly. This resulted in a surplus of 2.2% of GDP (including UMTS receipts of 0.7 percentage point of GDP) in 2000. However, in 2001 and 2002 the government balance deteriorated substantially, by around 2 percentage points of GDP in each year.

The vanishing of the one-off UMTS revenues, weaker economic growth, and the major tax reform carried out in 2001 (which is estimated to have led to lower revenue of 0.8 percentage point of GDP), led to a fall in the revenue to GDP ratio. The fall in the revenue ratio in combination with expenditure growth remaining dynamic[5] explains the deterioration in the deficit in 2001. In 2002, protracted weakness in economic activity induced a slowdown in government revenues, to a large extent due to lower-than-projected receipts of corporate taxes. In addition, an increase in tax-deductible mortgage interest payments and tax-exempt pension premiums played a role. Furthermore, despite adherence to expenditure plans in 2002, an increase in the expenditure to GDP ratio occurred as GDP growth was lower than anticipated in the 2002 budget. The cyclically adjusted balance improved from 1998 to 2000 and deteriorated markedly in 2001 and 2002, suggesting a loosening of the fiscal stance in the two latter years.

The debt ratio declined sharply between 1998 and 2000 due to the combination of high nominal GDP growth and the build-up of surpluses. However, the decline in the debt ratio came almost to an end in 2001, in view of the economic and budgetary headwind.

Table 3: General government deficit and debt, GDP growth

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	4.3	4.0	3.5	1.2	0.2	-0.7	1.0	1.6
General government balance *	-0.8	0.7	2.2	0.0	-1.9	-3.2	-3.5	-3.3
of which : Central government	-1.1	-0.7	0.5	0.0	-1.0	-3.0	n.a.	n.a.
Social security	0.3	1.2	1.6	0.0	-0.4	0.0	n.a.	n.a.
Local government	0.1	0.1	0.1	0.0	-0.5	-0.2	n.a.	n.a.
Primary balance	4.1	5.1	6.0	3.4	1.2	-0.3	-0.7	-0.3
Total expenditures, of which :	47.2	46.9	45.3	46.6	47.8	48.8	48.6	48.1
Social benefits	24.9	24.5	23.8	24	24.9	26.1	26.4	26.0
Interest expenditures	4.8	4.5	3.8	3.4	3.1	2.9	2.9	3.0
Compensation of employees	10.1	10.2	10.0	10.1	10.5	10.9	10.9	10.8
Other current expenditures	3.6	3.6	3.9	4.1	4.2	4.1	3.8	3.8
Gross capital formation	2.9	3.0	3.1	3.2	3.3	3.5	3.4	3.3
Other capital expenditures	0.9	1.1	0.7	1.8	1.8	1.3	1.2	1.2
Total revenues, of which :	46.4	47.6	47.5	46.6	45.9	45.6	45.1	44.8
Taxes on products and imports	11.6	12.2	12.1	12.7	12.6	12.8	13.0	13.1
Taxes on income and wealth	12.2	12.2	12.1	11.9	12.0	11.2	10.7	10.9
Social security contributions	16.4	17.1	17.1	15.3	14.9	15.5	15.6	14.9
Other revenues	6.2	6.1	6.2	6.7	6.4	6.1	5.8	5.9
Cyclically-adjusted balance	-2.0	-1.4	-1.0	-1.8	-2.4	-1.7	-1.4	-0.9
General government debt	66.8	63.1	55.9	52.9	52.6	54.8	56.3	58.6

Source: National accounts until 2003; Commission Spring 2004 forecasts for 2004 and 2005.
** Figures may not add up due to rounding*

[5] While expenditure growth was quite high, the expenditure targets set in the 2002 budget were met.

3.2. Budgetary developments in 2003

The general government balance reached a deficit of 3.2% of GDP in 2003 (compared to 1.9% of GDP in 2002) according to revised data released on 31 March 2004[6]. Thus, the deficit exceeded the 3% of GDP reference value mentioned in the Treaty. The deterioration in the general government balance in 2003 was the result of a further worsening in the balance of the central government. At the same time, the balance of social security and local government improved, even though the deficit of local government turned out to be higher than expected.

The sharp deterioration in the 2003 deficit is mainly due to the impact of cyclical factors. Indeed, the strong deterioration in the government balance in 2003 occurred despite a substantial package of savings measures of around 1.2 percentage point of GDP incorporated in the 2003 budget, which allowed an improvement in the cyclically adjusted balance by 0.7 percentage point of GDP compared to 2002. This suggests that the fiscal stance was tightened appreciably in 2003.

Nevertheless, the 2003 budget results constitute a significant slippage from the initial deficit target of 0.5% of GDP set in the 2003 budget and also from the 1.6% of GDP deficit targeted in the revised 2002 Stability Programme update which was submitted in June 2003 (table 4)[7]. This largely reflects the fact that real GDP growth turned out to be 2.3 and 1.5 percentage point lower than expected in the 2003 Budget and the 2002 Stability programme respectively. However, the deviation from the deficit targets set in the budget and the 2002 Stability programme goes beyond what one could have expected from the real GDP shortfalls. This is because tax shortfalls were particularly large in 2003 mainly due to special factors such as the sharp fall in corporate profits, and higher tax deduction of mortgage interest and pension premiums in the wake of rises in house prices and falls in global asset prices. At the same time, nominal general government expenditure growth was broadly in line with initial plans of the 2003 budget (0.2 percentage point of GDP above what was projected).[8]

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6 On 1 March 2004, the Netherlands notified a 2003 deficit of 2.98% of GDP, just below the reference value of 3% of GDP. The most recent upward revision of the deficit of 31 March 2004 was mainly due to a higher-than-expected deficit for local government, for which no preliminary data for the full year 2003 were available earlier. The deficit projections in the Commission Spring 2004 forecast incorporate these latest data of 31 March 2004.

7 The 2003 budget results also constitute a significant slippage compared to the projections included in the 2003 update of the stability programme submitted on 14 October 2003. In this update, the Dutch authorities projected a 2003 deficit of 2.3% of GDP, under the assumption of a zero growth in real GDP.

8 The expenditure ceilings set in real terms according to the budgetary rules for a large part of total expenditure were exceeded by 0.2 percentage point of GDP, thus effectively accounting for the difference vis-à-vis the original target in the 2003 budget.

Table 4: General government deficit: from plans to outcomes

	2001	2002	2003
Draft budget for 2003 (September 2002)			
Real GDP growth	n.a	0.75	1.5
General government balance	0.1	-0.5	-0.5
Cyclically-adjusted balance	-1.4	-0.6	0.4
2002 Updated Stability programme (June 2003)			
Real GDP growth	1.3	0.2	0.75
General government balance	0.1	-1.2	-1.6
Cyclically-adjusted balance	-1.2	-1.2	-0.8
Outcome			
Real GDP growth	1.2	0.2	-0.7
General government balance	0.0	-1.9	-3.2
Cyclically-adjusted balance	-1.8	-2.4	-1.7

Source: Budget for 2003; 2002 and 2003 Stability programmes; Spring 2004 Commission forecast

3.3. Prospects for 2004

In the EDP notification of 1 March 2004, the Dutch authorities notified a planned deficit of 2.9% of GDP for 2004. This was based on an assumed deficit of 3% of GDP in 2003 (the latest figure available for 2003 at the time the EDP notification was sent), and on the assumption that further consolidation measures will be taken.

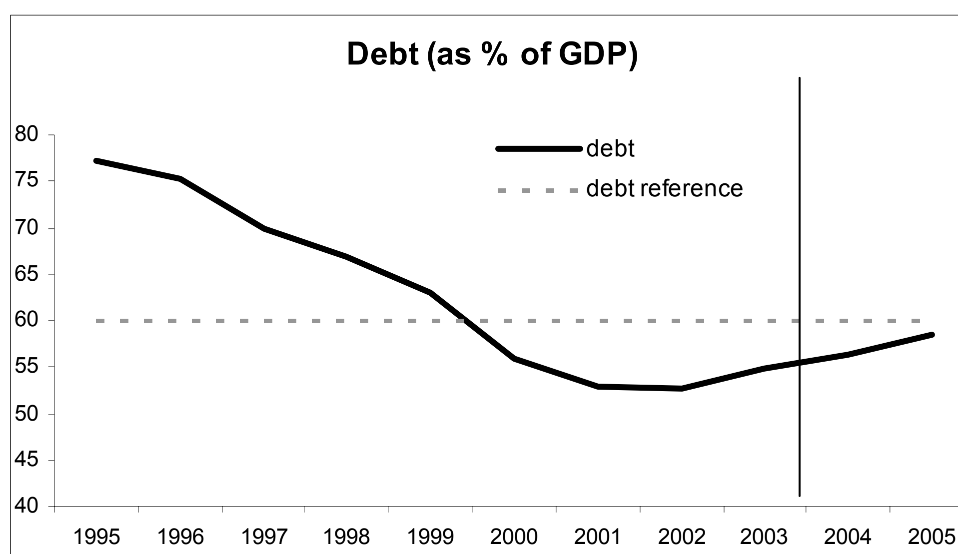
According to the Commission Spring 2004 forecast, the general government deficit will increase from 3.2% of GDP in 2003 to 3.5% of GDP in 2004. Whereas expenditure would slow down due to substantial savings measures of around 1.2% of GDP included in the 2004 Budget, tax revenues would still suffer from weak economic activity (2004 real GDP growth is projected at 1.0%). In cyclically-adjusted terms, the deficit is projected by the Commission to improve by 0.3 percentage point in 2004. This is less than the 0.6 percentage point improvement foreseen in the 2003 Stability Programme.

There are two main reasons for the difference between the 2004 deficit target in the EDP notification of 1 March 2004 (2.9% of GDP) and the Commission Spring forecast (3.5% of GDP). First, on 31 March 2004, the Dutch authorities informed the Commission that the 2003 deficit had reached 3.2% of GDP, i.e. 0.3 percentage point more than initially expected. Second, the Commission forecast of 7 April 2004 (which incorporates this updated information on the 2003 deficit) is based on the assumption of no changes in policy.

On 16 April the Dutch government introduced a new package of specified savings measures for 2004, which aim at reducing the deficit by EUR 2.9 billion or 0.6% of GDP. According to the government, for 2004 this would result in a general government deficit below the reference value of 3% of GDP, in line with the 1 March notification. If the measures yield the expected result and if there are no second-round effects on economic activity and on the budgetary outcome, the deficit would decrease to 2.9% of GDP in 2004 starting from the baseline of the Commission Spring forecast.

3.4. *Recent debt developments and prospects*

The debt to GDP ratio remains below 60% of GDP but increased from 52.6% of GDP in 2002 to 54.8% of GDP in 2003. This increase mainly resulted from the combination of an increasing deficit and weak nominal GDP growth: no privatisations or major debt consolidation operations affected the debt development in 2003. The Commission Spring 2004 forecast expects the debt to GDP ratio to rise further in 2004 and 2005, to around 58½% of GDP in the latter year, still below the 60% of GDP reference value[9].



Source: National accounts, Commission Spring 2004 forecasts for 2004 and 2005.

4. OTHER RELEVANT FACTORS

4.1. *Medium-term prospects*

For the period 2005-2007 the 2003 Stability Programme update projected an improvement in the nominal deficit from 2.3% of GDP in 2003 and 2004 to 1.6% of GDP in 2005 and to 0.6% of GDP in 2007, with the cyclically adjusted budget deficit at or below 0.5% of GDP from 2005 onwards. In the light of the latest reported data and the projections in the Commission Spring 2004 forecast, these targets are not within reach under current policies. According to the Commission Spring forecast, the nominal deficit would still be 3.3% of GDP in 2005 under a no policy change assumption, while the cyclically adjusted deficit would improve also in 2005, reaching 0.9% of GDP. This implies that a budgetary position close to balance would not yet be reached, even though an adjustment towards this medium-term objective would be underway. The additional savings package for 2004 announced by the government on 16 April also contained a reference to further measures for 2005, to be specified in September with the 2005 budget. These additional measures would be taken to ensure that the deficit would be below 3% of GDP in 2005.

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9 The projections take into account cash-deficit adjustments and an allowance for the phasing out of sales of state property and some financial operations related to independent public agencies.

4.2. *Investment*

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". The gross public investment to GDP ratio in the Netherlands has continuously increased in the last five years. It stood at 3.5% in 2003, a level significantly higher than the EU-15 average of 2.4%. All in all it can be concluded that the general government investment to GDP ratio did not fall during the downturn and that it has remained higher than the headline deficit to GDP ratio until 2003, while it is projected to remain broadly equal to this ratio in 2004 and 2005. This shows that in spite of adverse economic conditions since 2000, the Dutch authorities were able to protect general gross investment, which contrasts with practices in several other EU countries.

Table 5: General government fixed investment and deficit

(% of GDP)	1998	1999	2000	2001	2002	2003	2004	2005
General government deficit	0.8	-0.7	-2.2	0.0	1.9	3.2	3.5	3.3
General government gross investment	2.9	3.0	3.1	3.2	3.3	3.5	3.4	3.3

Source: Eurostat until 2003; Commission Spring 2004 forecasts for 2004 and 2005

4.3. *Long term sustainability of public finances*

A thorough assessment of the long term sustainability of the Dutch public finances was included in the Commission's assessment of the 2003 update of the Netherlands' Stability Programme. In summary, the assessment noted that, on the basis of current policies[10], the risk of budgetary imbalances emerging in the Netherlands in the medium to longer run could not be ruled out. According to Commission calculations on the basis of the 2003 updated stability programme, on unchanged policies the debt to GDP ratio would 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. In a situation where the 2003 deficit outcome is worse than expected, this assessment and the policy recommendations remain valid.

5. CONCLUSIONS

The 2003 general government deficit reached 3.2% of GDP. Against this background, the Commission has decided to initiate an excessive deficit procedure (EDP) in the case of the Netherlands.

The excess of the 2003 general government deficit over the 3% of GDP reference value by 0.2 percentage point of GDP did not result from an unusual event outside the control of the Dutch authorities. It is also not the result of a 'severe economic downturn', which is defined in the Stability and Growth Pact as an annual fall of real

10 This is based on a commonly agreed methodology by the Economic Policy Committee – See the Report "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003).

GDP of at least 2%. However, it occurred in a context of strongly negative growth and despite further consolidation measures implemented by the government. Real GDP growth in 2003 was -0.7%, while the output gap became increasingly negative at -2.2% of GDP according to the common production function method adopted by the Ecofin Council.

According to the Commission Spring 2004 forecast, on the assumption of no-policy change, the general government deficit would remain above the 3% of GDP reference value in 2004 and 2005. This suggests that the breach of the 3% of GDP reference value of the Treaty would not be temporary. However, the Commission forecast did not incorporate the additional savings measures taken by the government on 16 April 2004, which would bring the 2004 deficit below the 3% of GDP reference value according to the Dutch authorities.