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ECONOMIC ASSESSMENT OF THE STABILITY PROGRAMME OF THE NETHERLANDS (UPDATE OF NOVEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of the Dutch stability programme was submitted on 22 November 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 27 February 2007. Comments should be sent to Bouke Buitenkamp (bouke.buitenkamp@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as the Netherlands, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2006-2009, was submitted on 22 November 2006.

During the second half of the 1990s, the Netherlands experienced a prolonged cyclical upswing and performed better on average than the euro area both in terms of economic growth and unemployment. It was followed by a downturn in the early 2000s. On average, over this entire cycle, Dutch economic performance was better than that of the euro area. A large role in explaining the economic boom of the late 1990s was played by the strong developments in both housing and equity markets, which also led to temporary increases in tax elasticities. The fiscal rules that were in place could not fully prevent the fiscal policy stance from turning out pro-cyclical. Following a comfortable surplus in 2000, the general government balance deteriorated sharply turning into a deficit in 2001 and 2002 and exceeding the 3% of GDP threshold in 2003. A substantial budgetary consolidation was achieved in both 2004 and 2005, which reduced the deficit to 0.3% of GDP in 2005.

Against this background, the Dutch economy faces a challenge in the area of economic stabilisation. The current very high private financial debt levels risk becoming unsustainable in case of further interest rate increases, which could dampen private consumption and thereby bring about the next economic downturn. The recent increase in gas receipts to 1.5% of GDP in 2005 and 1.9% in 2006 (as compared to an average of 1% of GDP in the past decade) also represents a stabilisation challenge. A stability-oriented fiscal policy requires independence from gas price fluctuations to avoid pro-cyclical policies and to allow automatic stabilisers to work fully.

The macroeconomic scenario underlying the updated stability programme envisages that real GDP will grow by 3¼% in 2006, 3% in 2007 and 1¾% per year thereafter. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions for 2006 and 2007 and cautious ones thereafter. The programme's projections for inflation appear realistic until 2007 and seem to be on the low side thereafter in light of the expected tightness of the labour market. In light of (i) the strong improvement of the output gap, (ii) the pattern of revisions to the output gap in the past few years and (iii) the fact that the output gap is expected to nearly close in 2007, the Dutch economy can be considered to be in economic 'good times' from 2007 onwards.

For 2006, the general government position is estimated to be balanced in the Commission services' autumn 2006 forecast, against a target of -1.5% of GDP set in the previous update of the stability programme. This mainly reflects a strongly improved cyclical outlook resulting in higher tax revenues as well as higher receipts from the sale of natural gas. Information that has become available since the autumn forecast (monthly data on the general government balance) points to an even better budgetary outcome. The

[1] The analysis takes into account (i) the Commission services' autumn 2006 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

latest official estimate, contained in the latest Autumn Memorandum, puts the outturn for 2006 at a surplus of 0.4% of GDP.

The medium-term budgetary strategy in the programme aims at addressing the challenge of the cost of ageing through further fiscal consolidation. To this end, the programme projects the general government surplus to improve from 0.1% of GDP in 2006 to 0.9% in 2009. The primary surplus is targeted to improve from 2.4% of GDP in 2006 to 2.9% in 2009, which is fully concentrated in the final year of the programme, reflecting in large part the expected refunding in that year of the EU own resources contribution paid over the period 2007-2009. The nominal adjustment is fully explained by a fall in the expenditure-to-GDP ratio, which more than compensates a 0.2 percentage point decline in the revenue-to-GDP ratio. Compared to the previous update of the stability programme, the level of the general government balance is markedly higher throughout the programme period. This mainly reflects higher gas receipts, the improved macroeconomic situation in 2005 and outlook for 2006.

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is expected to deteriorate by around half a percentage point of GDP in 2007, stabilise in 2008 and improve by around half a percentage point of GDP in 2009. As in the previous update of the stability programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit ranging from 0.5 to 1% of GDP, which the programme plans to maintain throughout the programme period. The MTO is in line with the Pact.

The risks to the budgetary projections in the programme appear broadly balanced from 2007 onwards. On the one hand, the possibility of a positive carry-over into 2007 of the higher tax receipts in 2006 constitutes a positive risk to the budgetary outcome in 2007. Furthermore, for 2008 and 2009, a positive risk to the budgetary position stems from the cautious macroeconomic scenario. On the other hand, gas receipts may turn out lower than currently anticipated throughout the period. In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO throughout the programme period, as envisaged in the programme. In addition, it provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. Nevertheless, there is a risk that the fiscal policy stance implied by the programme may turn out to be pro-cyclical in 2007, when good times are expected. This would not be in line with the Pact.

The Implementation Report of the National Reform Programme (NRP) of the Netherlands, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 16 October 2006. The NRP identifies as key challenges/priorities: improving labour supply; achieving faster labour productivity growth, in particular by strengthening R&D, innovation and education; and improving price competitiveness, in particular by containing labour costs. The Commission's assessment (adopted as part of its December 2006 Annual Progress Report[2]) showed that the Netherlands is making good progress with the implementation of its NRP. While there are certain risks in the macro area, notably with regard to household indebtedness and potential wage inflation due to the tightening of the labour market, overall the policy framework is appropriate. Notwithstanding high headline employment rates for most groups, the picture in the

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery", 12.12.2006, COM(2006)816.

employment field is more mixed. Against the background of strengths and weaknesses identified, the Netherlands was recommended to take action to improve labour supply, notably of older workers, women and disadvantaged groups. The stability programme and the 2006 implementation report of the national reform programme do not seem well-integrated. However, both programmes describe the recent health care reform, the modifications to the corporate tax system and planned extra outlays, for instance on infrastructure.

The overall conclusion is that the medium-term budgetary position is sound. An important risk is that the current high level of gas receipts may not persist but overall the risks attached to the achievement of the budgetary targets are broadly neutral.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009
Real GDP (% change)	**SP Nov 2006**	**1.5**	**3¼**	**3**	**1¾**	**1¾**
	COM Nov 2006	1.5	3.0	2.9	2.6	n.a.
	SP Dec 2005	*¾*	*2½*	*2½*	*2¼*	*n.a.*
HICP inflation (%)	**SP Nov 2006**	**1.5**	**1½**	**1¾**	**1¾**	**1¾**
	COM Nov 2006	1.5	1.6	1.8	2.3	n.a.
	SP Dec 2005	*1.5*	*1.5*	*1.1*	*n.a.*	*n.a.*
Output gap (% of potential GDP)	**SP Nov 2006[1]**	**-1.9**	**-0.5**	**0.6**	**0.6**	**0.3**
	COM Nov 2006[5]	-2.0	-1.2	-0.4	0.0	n.a.
	SP Dec 2005[1]	*-2.3*	*-1.5*	*-0.9*	*-0.6*	*n.a.*
General government balance (% of GDP)	**SP Nov 2006**	**-0.3**	**0.1**	**0.2**	**0.3**	**0.9**
	COM Nov 2006	-0.3	0.0	0.1	0.3	n.a.
	SP Dec 2005	*-1.2*	*-1.5*	*-1.2*	*-1.1*	*n.a.*
Primary balance (% of GDP)	**SP Nov 2006**	**2.1**	**2.4**	**2.4**	**2.4**	**2.9**
	COM Nov 2006	2.1	2.3	2.3	2.3	n.a.
	SP Dec 2005	*1.4*	*1.1*	*1.4*	*1.5*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Nov 2006[1]**	**0.8**	**0.4**	**-0.1**	**0.0**	**0.7**
	COM Nov 2006	0.9	0.6	0.4	0.3	n.a.
	SP Dec 2005[1]	*0.0*	*-0.7*	*-0.6*	*-0.6*	*n.a.*
Structural balance[2] (% of GDP)	**SP Nov 2006[3]**	**0.8**	**0.4**	**-0.1**	**0.0**	**0.4**
	COM Nov 2006[4]	0.9	0.6	0.4	0.3	n.a.
	SP Dec 2005	*0.0*	*-0.7*	*-0.6*	*-0.6*	*n.a.*
Government gross debt (% of GDP)	**SP Nov 2006**	**52.7**	**50.2**	**47.9**	**46.3**	**44.2**
	COM Nov 2006	52.7	50.5	47.8	45.4	n.a.
	SP Dec 2005	*54.4*	*54.5*	*53.9*	*53.1*	*n.a.*

Notes:
[1]Commission services calculations on the basis of the information in the programme.
[2]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3]One-off and other temporary measures taken from the programme (0.3% of GDP in 2009; deficit-reducing).
[4]There are no one-offs and other temporary measures in the Commission services' autumn 2006 forecast.
[5]Based on estimated potential growth of 1.9%, 2.1%, 2.2% and 2.1% respectively in the period 2005-2008.

Source:
Stability programme; Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The November 2006 update of the Dutch stability programme, covering the period 2006 to 2009, was submitted to the Commission on 22 November 2006[3]. The programme was agreed upon by the Council of Ministers and sent to Parliament for information. It reflects the budgetary situation as it was presented in the 2007 budget, but it does not take on board budgetary information that has since become available. Most notably, although the recently published Autumn memorandum[4] is mentioned in the stability programme, the better-than-expected data reported therein was not incorporated in the programme's tables.

The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. All required compulsory data have been supplied. Some of the optional data suggested by the new code of conduct is missing, in particular the functional breakdown of government expenditures for 2009[5]. Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

This section is in five parts. The first provides a brief overview of the macroeconomic performance in terms of growth and other major macro-variables. The second part presents the results of a growth accounting exercise and tries to identify the main drivers of the Dutch growth performance vis-à-vis the euro area. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. The fifth part then identifies major economic challenges with implications for public finances.

2.1. Economic performance

Over the past ten years, average real GDP growth in the Netherlands was 2.6%, about half a percentage point higher than the euro area. However, this average hides substantial dynamics within the period[6]. During the second half of the 1990s, real annual GDP growth in the Netherlands averaged 4%, exceeding euro area economic growth by a significant margin. After the turn of the millennium, economic growth slowed significantly, to on average 1.2% per year, underperforming vis-à-vis the euro area (Figure 1). During the boom period, employment growth was strong, reaching on average 2.6% per year (Table 1). As a result, unemployment declined significantly but inflation remained fairly low in the late nineties, not exceeding 2% on average. Inflation

[3] Only an English version has been submitted.

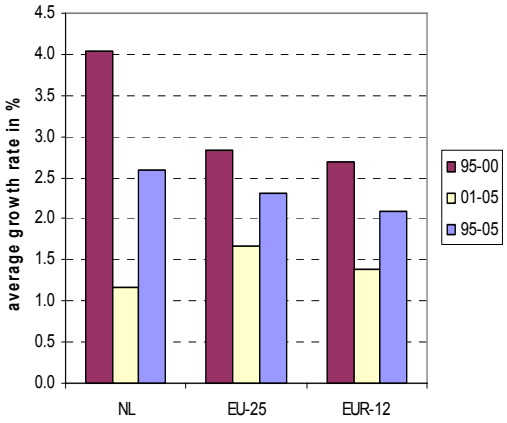
[4] The Autumn memorandum is a briefing to Parliament on budgetary developments. It contains updated information on the development of government revenues and expenditures for the current year. The 2006 Autumn memorandum was sent to parliament on 20 November 2006.

[5] Referring to the tables of the Code of Conduct (see Annex 2), missing optional data are: the breakdown of social transfers into 'in kind' and 'other than in kind' and compensation of employees (Table A.2), general government expenditure by function (Table A.3), privatisation proceeds, liquid financial assets and net financial debt (Table A.4), all figures for 2000 and interest expenditure (Table A.7).

[6] See also Bethuyne, G. and Buitenkamp, B., "Smooth versus bumpy: differences in growth dynamics in Belgium and the Netherlands", *Country Focus*, European Commission – DG Ecfin, Vol. III, Issue 9, July 2006 and Albers R. and Langedijk, S. "The Netherlands, from riches to rags", *Country Focus*, European Commission – DG Ecfin, Vol. I, Issue 13, July 2004.

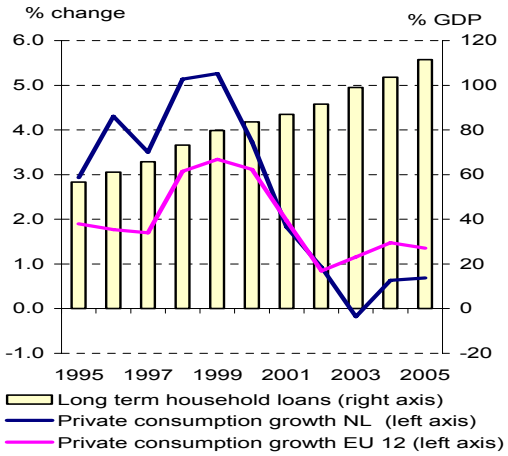
eventually caught up and spiked in 2001, fuelled by strong wage developments that were the result of the then very tight labour market.

Figure 1: Average GDP growth: The Netherlands vs. EU25 and euro area



Source:
Commission services

Figure 2: Private consumption growth and household indebtedness as % of GDP



Source:
Commission Services and Statistics Netherlands

The upswing in the second half of the 1990s was mainly driven by domestic demand. Although several intertwined factors explain this development, wealth effects from equity and housing markets have played a crucial role. The rise of double income households in the 1990s – mainly the result of increased labour participation of women – increased household spending power. Together with competition between mortgage providers, this resulted in the development of innovative mortgage products that took both household incomes into account and were geared to take maximum advantage of the virtually full interest rate deductibility. Jointly with the inherent supply restrictions in the Dutch housing market, the improved access of households to mortgage-backed loans was a contributing factor to the Dutch housing boom in the late 1990s.

The combination of the development of new mortgage products, the strong increase in housing prices and the fall in nominal interest rates led to significant re-mortgaging and equity withdrawal that fed into private consumption expenditure (Figure 2). The Nederlandsche Bank estimates the annual spill-over effect of mortgage equity withdrawal on GDP growth via consumption expenditure at 0.5 to 1 percentage point in 1998–2000, turning to a negative contribution of around 0.5 of a percentage point in the period 2001-2003 as equity withdrawal lessened[7]. A large share of households have re-mortgaged in the past years and - in light of rising interest rates - fixed the interest rate for a long period.

Another contributing factor to private consumption growth was full deductibility of interest payments not only covered mortgage-backed loans, but all consumer loans. Both

[7] Els, P.J.A van, End, W.A. van den & Rooij, M.C.J. van (2005), "Financial behaviour of Dutch households: analysis of the DNB Household Survey." *in:* "*Investigating the relationship between the financial and real economy*", BIS Papers, 22, pp. 1-40

aspects provided further impetus to consumer spending, amplifying and possibly prolonging the economic boom. With the tax reform of 2001, which came when the Dutch economy was already slowing down, the deductibility of interest paid on consumer loans was abolished. The effect of this policy on consumer spending was relatively minor, arguably because of the deductibility of interest paid on mortgages was largely left intact.

One of the consequences of the re-mortgaging was the strong increase in mortgage debt. Total long term financial liabilities nearly doubled in the past decade, from 57% of GDP in 1995 to 112% of GDP in 2005. The high level of private mortgage debt have made Dutch households more vulnerable to changes in key economic variables such as interest rates, since any increase in interest rates would in time raise the average debt service burden of households.

Booming equity markets around the world in the second half of the 1990s interacted pro-cyclically with the Dutch pension system. The high returns on stock market equities prompted several private pension funds to lower – or at least not increase – contributions from employers and employees. Some pension funds even gave 'premium holidays' for several years. For employers this amounted to a reduction in wage costs, while for employees it boosted purchasing power even further. After stock market returns turned negative following the stock market crash in 2000, premiums were raised again. Furthermore, in the early years of this millennium, the pension funds' supervisor[8] strengthened supervision. This led to a steep, and again pro-cyclical, increase in pension premiums as pension funds tried to raise funding ratios to the required level. In 2004, pension premiums amounted to 4.5% of GDP, more than double the figure for 1997 (2% of GDP).

Despite increasing labour participation, this high level of labour demand growth led to an impressive fall in unemployment from 6.6% in 1995 to 2.2% in 2001. Initially, the slowdown in economic growth from 2001 onwards resulted in labour hoarding, as employers were reluctant to dismiss personnel that had been previously so difficult to attract. As the economic trough persisted, superfluous labour was gradually shed and unemployment increased again somewhat. However, unemployment remained among the lowest levels in the euro area and reached a peak of 4.7% in 2005.

Wage developments remained subdued until 1999, but from that moment onwards, the tightness of the labour market started to feed into wages, which increased by 11% over the subsequent three-year period. The accompanying increase in unit labour costs halted the improvement of competitiveness that had started at the beginning of the 1990s, resulting in an appreciation of around 10% in real effective terms. Nevertheless, Dutch total exports remained fairly strong, in part due to the fact that the underlying loss in competitiveness was masked by the relative strength of re-exports. In the period 1995 to 2005, re-exports increased around 10% per year, while domestically produced exports only grew by 3% per year, resulting in a significant drop in the market share of domestically produced goods. In the past few years, the competitive position of the Dutch economy has been fairly stable.

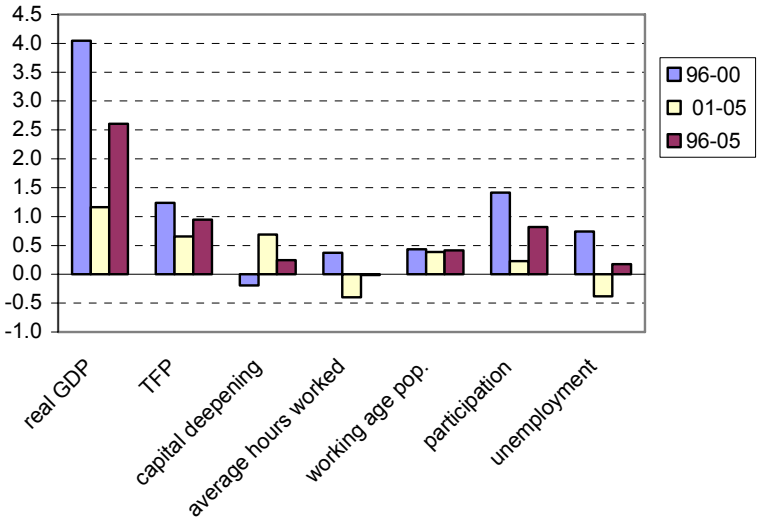
[8] The *Pensioen- en Verzekeringskamer*, PVK, that later merged with the Dutch central bank.

2.2. Anatomy of medium-term growth

Within the framework of a traditional growth accounting exercise, this section dissects the sources of medium-term growth as well as possible differences vis-à-vis the euro area. The growth accounting exercise is carried out on the basis of the Cobb-Douglas production function underlying the commonly agreed method for the assessment of stability and convergence programmes.

Figures 3 and 4 show the absolute growth performance of the Netherlands over the period 1996-2005 as well as relative to the euro area average, respectively. As indicated above, Dutch GDP growth outperformed GDP growth in the euro area in the second half of the 1990s by a significant margin but this situation reversed in the 2001-2005 period. The decomposition of economic growth into its components shows that the positive growth difference in the 1996-2000 period is explained fully by a higher overall net contribution from labour inputs in the Netherlands as compared with the euro area, while the contribution to growth from capital deepening was much lower and in absolute terms even negative.

Figure 3: Real GDP growth and its components in the Netherlands



Note:
Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP*, L employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L} \right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1 - ur)$ where WP stands for working age population, $PART$ denotes the participation ratio as a share of WP and ur the rate of unemployment. In terms of growth rates g this is:

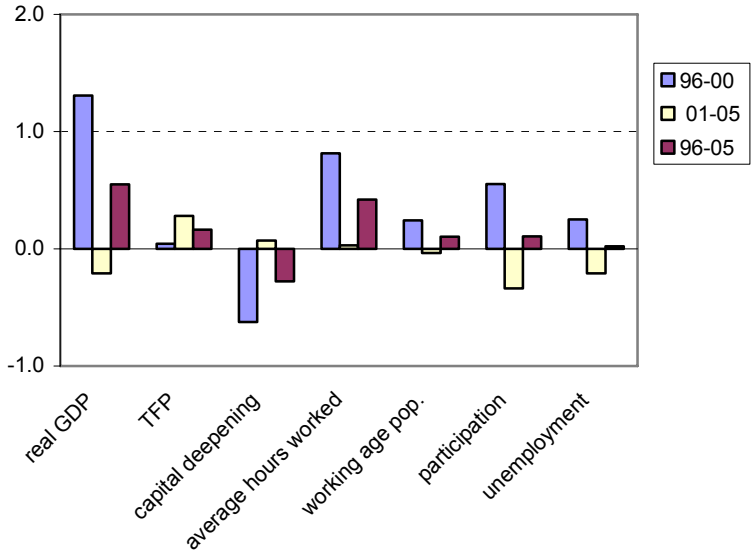
$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source:
Commission services

A slightly favourable composition of the working age population and the rapid decline in unemployment explain a small part of the relatively strong labour input contribution in the first five-year period, but the main distinguishing growth contributors in the Netherlands are the relatively strong (mainly female) increase in participation and in the average number of hours worked per person. In the booming Dutch economy of the late 1990s, the "encouraged workers effect" drew many of the formerly inactive to the labour market, leading to job-rich growth. The increase in the average number of hours worked took place in a period when the length of the full time working week was stable or even declining in some parts of the economy. It follows that the growth in average hours worked represented the transformation of part-time jobs into full time jobs or an increase in the average number of hours worked per week in part-time jobs as a response to the increasing tightness on the labour market. More disaggregated data show that these 'expanding' jobs were mainly held by women. The negative contribution of capital deepening to GDP growth during this period partly reflected diminishing slack in the economy as well as the fact that fixed capital formation did not keep pace with economic performance that continued to surprise on the upside. Finally, the large flood of labour with little or no work experience in the late 1990s acted as a brake on labour productivity growth, which translates into a relatively low contribution of total factor productivity when compared to the euro area average.

Figure 4: Real GDP growth and its components: difference vis-à-vis euro area



Note:
See note of Figure 3

Source:
Commission services

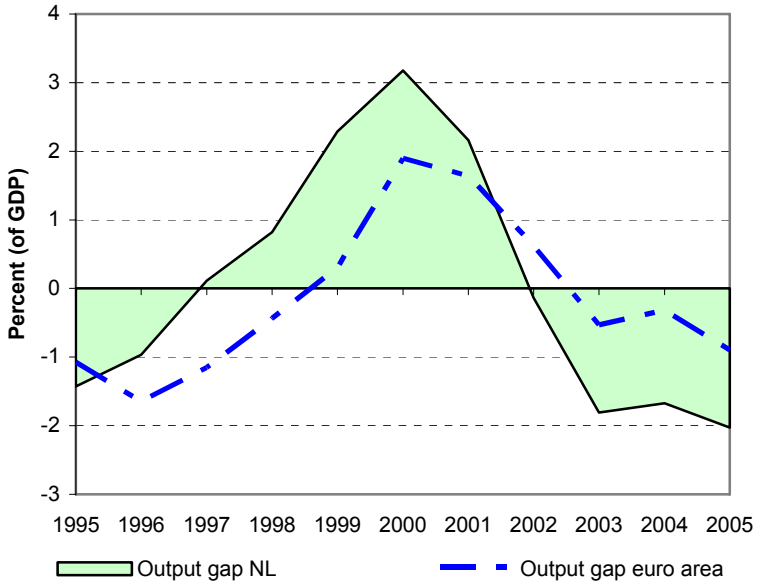
As indicated above, the economic performance of the Netherlands fell behind that of other euro area countries starting from 2001 as the country slid into an economic downturn and the unemployment rate rose from its trough in 2001 of 2.8% to 4.7% in 2005. Consequently, the growth contribution from labour turned negative. At first, the tight labour market resulted in widespread labour hoarding, but this effect diminished in

the following years. The contribution from labour participation to economic growth stalled and dropped far below the euro area average as it became more difficult for the economically inactive persons to enter the labour force in the economic downturn. Also, as labour hoarding unwound in subsequent years, a part of the workers that had entered the labour force in the economic boom of the 1990s were again laid off and exited from the labour market.

2.3. Macro-policies against the backdrop of the economic cycle

As can be seen from the previous sections, the amplitude of cyclical movements has been relatively large in the Netherlands. The prolonged economic boom in the second half of the 1990s resulted in a positive output gap of more than 3% of GDP in 2000, which deteriorated in the subsequent three years by around 5 percentage points of GDP (Figure 5). When compared to the euro area average, the Dutch economic cycle is not only more pronounced but also seems somewhat more elongated due to the fact that the upswing in the mid 1990s started earlier than in the euro area.

Figure 5: Output gap in the Netherlands and the euro area



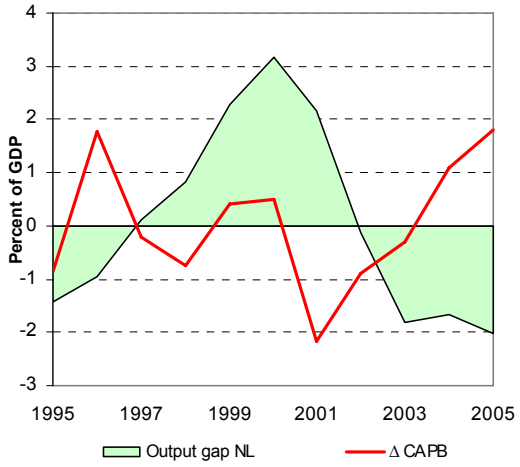
Source:
Commission services

In part, the high amplitude of the Dutch cycle can be related to the openness of the Dutch economy. Its export share in GDP is over 50%, which makes the Netherlands particularly susceptible to variations in world trade growth. Another explanation is private consumption, which, as explained above, was strong during the boom due to equity withdrawal, and was restricted from 2001 onwards by the abolishment of the deductibility of interest paid on consumer loans, the increase in the top VAT rate and the simultaneous increase in pension premiums.

Judging from the cyclically adjusted balance, the fiscal stance was mildly pro-cyclical over the whole period under review (Figure 6). On average, it was somewhat supportive

in the period 1997–2001, when the output gap was positive. The major tax reform that took place in 2001[9] came at a time when the economy was already slowing down significantly, but the output gap was still positive. It should be noted that during that period the real-time assessment of the change in cyclically adjusted balance would have been slightly more favourable for most years than it appears ex post due to the recent revisions to the underlying data. After the Netherlands went into excessive deficit, in 2003, the cyclically adjusted primary balance improved markedly as a result of a strong consolidation effort. As a fiscal consolidation had to be carried out during the economic slowdown, the pro-cyclical nature of the Dutch public finances continued over that period.

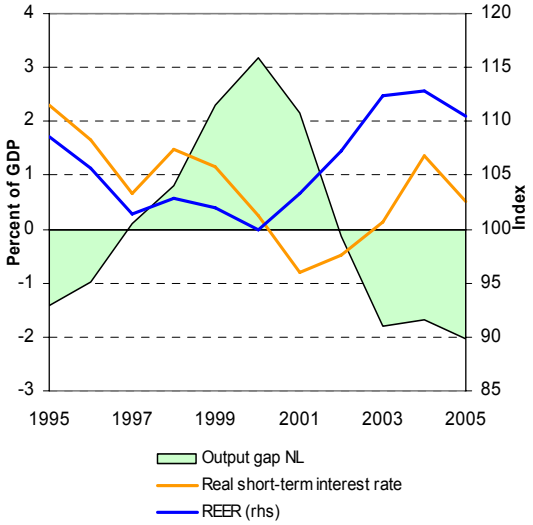
Figure 6: Output gap and fiscal stance



Note:
ΔCAPB denotes the change in the cyclically-adjusted primary budget balance

Source:
Commission services

Figure 7: Output gap and monetary conditions



Source:
Commission services

The monetary conditions were accommodative in the period of economic strong growth (Figure 7). The real interest rate started its decline in 1999 and even turned negative in the period 2001 – 2003, providing a sizable monetary stimulus. The main explanation for this development was the strong increase in domestic price levels, with HICP inflation reaching a peak of 5.1% in 2001. Similarly, around the year 2000, the real effective exchange rate reversed its earlier steady depreciation and appreciated by around 10% in cumulative terms in the following five year period, thereby contributing to a loss in competitiveness.

[9] The tax reform entailed an increase in VAT and several environmental tax rates, while lowering labour income tax rates, especially at the top. Furthermore, some tax deductions were abolished, among which the deductibility of consumer credit. In an effort to alleviate the negative consequences of the tax reform for certain groups, the tax reform entailed an overall net tax relief of around €3 billion, or 0.7% of GDP.

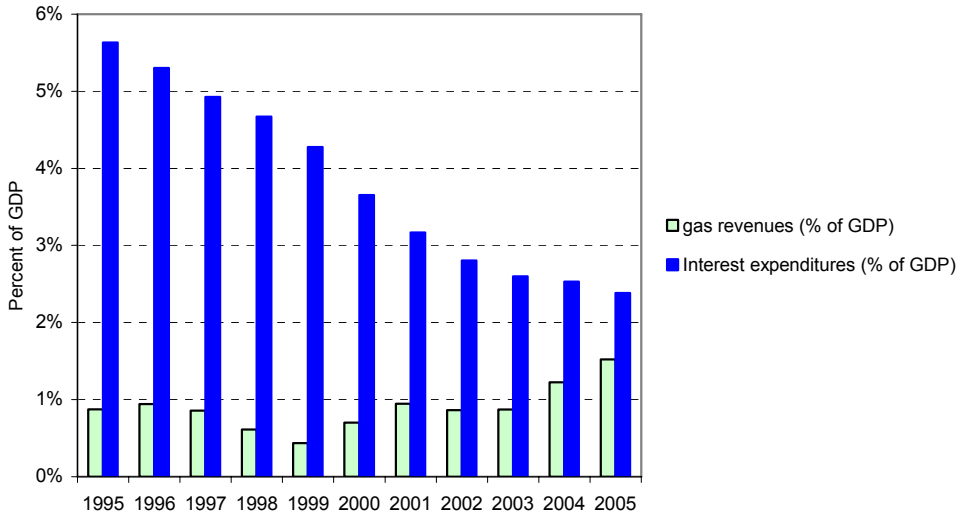
2.4. Public finances

Since 1994, a fiscal rule is followed that involves setting real expenditure targets for the whole government term when a new government takes office. The targets are based on a relatively cautious macro-economic scenario. The system entails a separation between revenues and expenditures and allows automatic stabilisers to work on the revenue side. Nevertheless, interactions between revenues and expenditures have remained, especially in the early years of this system, because some non-tax revenues are considered 'negative expenditures' (*inter alia* gas receipts). Despite the existence of this system, which has been strengthened over time, public finances have fluctuated considerably over the last ten years mainly because of strong cyclical swings. The nominal budget balance improved from a deficit of 1.9% of GDP in 1996 to a surplus of 2% of GDP at the peak of the economic cycle in 2000, partly as a result of temporary increases in tax elasticities. Subsequently, in a time span of three years, the surplus reversed into an excessive deficit of 3.1% of GDP in 2003, after which it again improved markedly to a deficit of 0.3% of GDP in 2005. Over the whole ten-year period under review, both the share of total government revenue to GDP and of total government expenditure to GDP declined. Given that the fall in expenditure was concentrated in current expenditure as opposed to capital formation, the consolidation effort should be considered relatively durable. This is further exemplified by the fact that over the whole period under review the recourse to one-off measures was very limited.

From 1995 to 2005, interest expenditures declined steadily, contributing to an improvement in the government balance by 0.3% of GDP per year on average. This was the result of both the reduction in general debt level (from 76.1% of GDP in 1995 to 52.7% of GDP in 2005) and the fall in interest rates over the period in line with financial market developments. For most of the period, gas receipts were a more or less constant source of income, yielding revenues of 0.7 – 0.9% of GDP yearly[10] (Figure 8). However, since 2004, gas receipts have increased significantly on the back of increasing international oil and gas prices to a level around 1½% of GDP in 2005.

[10] With the exception of 1999, when oil and gas prices were relatively low and government gas receipts only amounted to 0.4% of GDP.

Figure 8: Gas revenues and interest expenditures

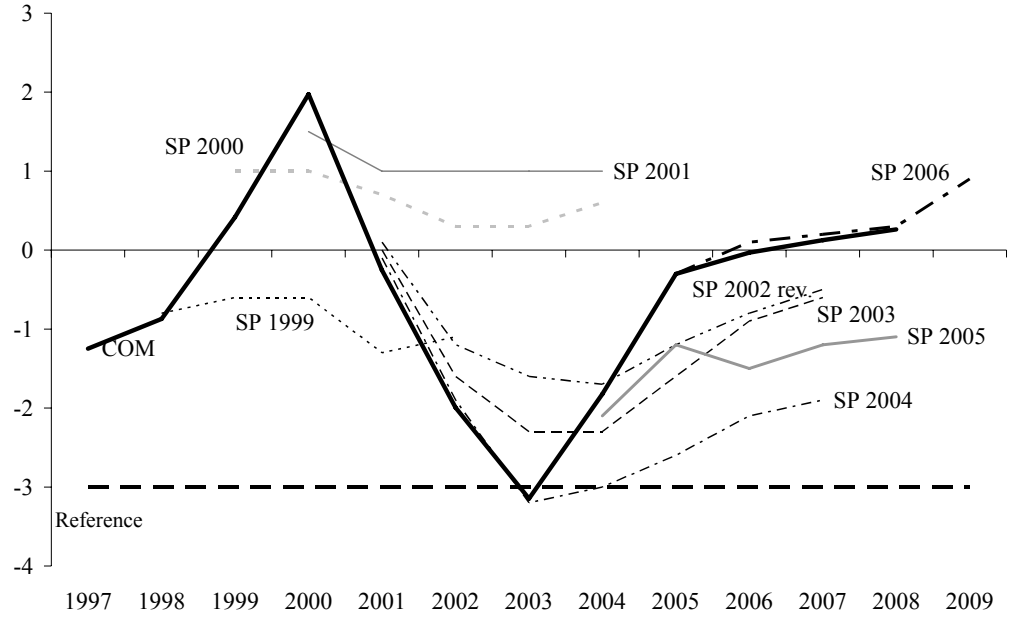


Source:
Statistics Netherlands, CPB, Ministry of Finance

The combined effect of falling interest expenditures and increasing gas revenues explains around ¾ percentage point of GDP of the budgetary consolidation since 2003, when the Netherlands were placed under the excessive deficit procedure. The increase in oil prices also had a depressing effect on various demand components but less than could have been expected which was due to a simultaneous increase in tax elasticities. Overall, it appears that the Dutch budgetary position is vulnerable not only to an increase in interest rates, but also to a fall in oil and gas prices.

Although large cyclical swings have strongly influenced the Dutch budgetary position in the past ten years, this effect has been only partially captured in successive stability programmes. Figure 9 shows that the successive stability programmes failed to recognise the strong swings in the general government balance. In particular, the budgetary surpluses in 1999 and 2000 as well as the rapid decline in the general balance in 2001-2003 seem to have come as a surprise. Moreover, due to the recent sizable upward revisions, the 2005 budgetary outcome is much better than was foreseen in the December 2005 update of the stability programme, mostly due to higher-than-expected tax revenues and gas-related revenues.

Figure 9: General government balance projections in successive stability programmes (% of GDP)



Source:
Commission services and national stability programmes

Over the course of the past ten years, the government gross debt ratio fell from 76.1% of GDP in 1995 to 52.7% of GDP in 2005. With some exceptions, stock-flow adjustments were not very sizable in the Netherlands, amounting to -0.1% of GDP per year over the period.

2.5. Medium and long-term policy challenges for public finances

During the second half of the 1990s, the Netherlands performed better on average than the euro area both in terms of economic growth and unemployment. With the benefit of hindsight, it is clear that the economic boom was not structural, but of a temporary nature, as it was followed by a downturn in the early 2000s. Over this entire cycle, Dutch economic performance was better than the euro area average, but a more stable growth pattern would be likely to have been beneficiary for the economy as a whole. The current very high private financial debt levels risk becoming unsustainable in case of further interest rate increases, restricting private consumption to such an extent that it could form the seed of the next economic bust. Furthermore, the strong developments in both housing and equity markets that played a large role in explaining the economic boom of the late 1990s also resulted in temporary increases in tax elasticities. The fiscal rules that were in place could not fully prevent the fiscal policy stance from turning out pro-cyclical.

Against this background, the Dutch economy faces the following challenge in the area of economic stabilisation:

The length and strength of the economic boom in the second half of the 1990s as compared to the euro area average made it especially more difficult to assess the level of potential growth, the output gap and the structural fiscal position in real time. This could be considered one of the main explanations of the pro-cyclical fiscal policy in the Netherlands over the past decade. Furthermore, in the past decade gas receipts have on average improved the general government balance by around 1 percentage point of GDP a year, but have recently increased to 1.5% of GDP in 2005. A stability oriented fiscal policy requires independence from gas receipts due to energy price volatility, to avoid pro-cyclical policies and to allow automatic stabilisers to work fully.

Table 1: Key economic indicators

	The Netherlands						euro area					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96–'05	'96–'00	'01–'05				'96–'05	'96–'00	'01–'05			
Economic activity												
Real GDP (% change)	2.6	4.0	1.2	0.3	2.0	1.5	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
Domestic demand	2.3	4.0	0.7	0.4	0.4	0.8	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.2	0.0	0.5	-0.1	1.4	0.7	0.1	0.1	0.1	-0.7	0.2	-0.2
Prices, costs and labour market												
HICP inflation (% change)	2.4	1.9	2.8	2.2	1.4	1.5	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	1.5	1.5	1.5	1.4	3.4	1.8	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.3	-0.5	-0.2	0.5	-0.4	-2.0	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	1.4	2.6	0.2	-0.5	-0.9	0.0	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	3.9	4.1	3.6	3.7	4.6	4.7	9.1	9.8	8.5	8.7	8.9	8.6
Competitiveness and external position												
Real effective exchange rate (% change)[1]	0.3	-1.5	2.2	4.6	0.3	-1.6	-	-	-	-	-	-
Export performance (% change)[2]	-	-	-	-	-	-	-	-	-	-	-	-
External balance (% of GDP)	5.4	4.5	6.4	5.9	8.4	6.8	-	-	-	-	-	-
Public finances												
General government balance (% of GDP)	-0.9	-0.3	-1.5	-3.1	-1.8	-0.3	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	58.1	64.6	51.7	52.0	52.6	52.7	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP)[3]	-	-	-	-2.1	-1.1	0.9	-	-	-	-3.2	-2.9	-2.0
Financial indicators[4]												
Long term real interest rate (%)[5]	2.2	2.9	1.6	1.9	3.3	1.7	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP)[6]	89.3	75.9	102.8	103.1	108.6	117.3	-	-	-	-	-	-
Corporate sector debt (% of GDP)[7]	92.2	88.8	95.7	95.6	92.0	95.3	-	-	-	-	-	-

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

[1]Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

[2]Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

[3]Cyclically-adjusted budget balance net of one-off and other temporary measures.

[4]Data available up to 2004.

[5]Using GDP deflator.

[6]Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

[7]Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:
Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic 'good' or 'bad' times.

3.1. External assumptions

The programme expects world GDP excluding the EU to grow at 6% in 2006 and 5% per year thereafter. This growth pattern is roughly in line with the Commission services' autumn forecast. The update of the stability programme assumes world import volumes to expand by around 10½% in 2006 and 2007 and 8¼% in 2008 and 2009, which is more buoyant than the assumption in the Commission services' autumn forecast, against the backdrop of a stronger assumed depreciation of the US dollar vis-à-vis the euro, to 1.30 in 2008.

The trajectory of the oil price is of special importance to the Netherlands, since the Netherlands is a producer of natural gas, the price of which is closely linked to oil price developments. The update of the stability programme assumes the oil price (Brent) to increase from $68 per barrel in 2006 to $70 in 2007, and to subsequently fall to $68 and $65 in 2008 and 2009, respectively. The levels are similar to the external assumptions of the Commission services' autumn forecast, which puts the oil price at a slightly lower level of $65.6 and $66.3 in 2006 and 2007, respectively and are identical for 2008. Overall, the programme's external assumptions appear broadly plausible and the differences with those of the autumn forecast are minor.

3.2. Economic activity

The programme projects a vigorous economic recovery in 2006 and 2007, with GDP growing by 3¼% and 3%, respectively. For the outer years, it expects growth to come out lower, at 1¾% of GDP. The programme indicates that the growth projection from 2008 reflects the latest medium-term scenario as developed by the Netherlands Bureau for Economic Policy Analysis (Centraal Planbureau, CPB). The output gap that is implied by the programme update and recalculated by the Commission services on the basis of the commonly agreed methodology is assumed to improve from -0.5 in 2006 to 0.6 in 2007 and 2008, respectively, and then to fall slightly to 0.3% in 2009.

Average real GDP growth over the programme period is expected to be 2.4%, which is slightly below its average over the past ten years (2.6%). However, compared to the growth performance of the past five years (1.2%), it represents a marked acceleration. This reflects the strongly improved cyclical position of the Dutch economy from 2006 onwards. Over the programme horizon, the growth contributions from different domestic demand components and from net exports are similar to the averages over the past ten years. The most notable exception is private demand, which is assumed to grow by a mere 1¼% in 2008 and 2009, as compared to an average of 2.6% over the past ten years (see Annex 4). However, it should be recalled that the historical average reflects a significant mortgage equity withdrawal that resulted in higher consumption growth (Section 2). The GDP growth pattern for 2006 and 2007 is highly similar to the projections in the Commission services' autumn forecast as well as the most recent

forecast by the CPB, which put GDP growth at around 3% in those years. The projected GDP growth in the programme is 1¾% in both 2008 and 2009. For 2008, this forecast is significantly below the autumn forecast, which foresees economic growth to turn out at 2.6% in 2008. The projected sudden fall in economic growth in 2008 would seem to reflect an overly cautious view, also in view of the relatively strong growth of world imports assumed in the programme. This also holds true, but to a lesser extent, for the growth forecast for 2009 as it is below the estimate of average potential growth of the period 2006-2008 in the Commission services' autumn forecast.

The composition of growth in both forecasts is very similar, with the notable exception of private consumption growth in 2006, which is assumed to be -1¼% in the programme, more than half a percentage point lower than the Commission services' autumn forecast despite similar GDP growth. However, the estimation of this growth figure is complicated by the reclassification of formerly private health care premiums from private to government consumption following the health care reform in 2006. As the forecast of private and government consumption combined is similar in both forecasts, this reclassification has no bearing on the underlying growth composition, which is roughly similar.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	3.0	3¼	2.9	3	2.6	1¾	1¾
Private consumption (% change)	-0.6	-1¼	1.8	2	2.1	1¼	1¼
Gross fixed capital formation (% change)	4.5	4¾	4.4	4	2.3	1¾	1¾
Exports of goods and services (% change)	8.2	6¾	6.8	6¼	6.5	6	6
Imports of goods and services (% change)	8.1	6¾	6.9	6½	6.3	6	6
Contributions to real GDP growth:							
- Final domestic demand	2.2	2.5	2.3	2.2	1.9	1.6	1.6
- Change in inventories	0.0	0.3	0.1	0.6	0.0	0	0
- Net exports	0.7	0.3	0.5	0.2	0.6	0.1	0.1
Output gap[1]	-1.2	-0.5	-0.4	0.6	0.0	0.6	0.3
Employment (% change)	1.7	2	1.6	2	1.2	¼	¼
Unemployment rate (%)	3.9	4	3.0	3¼	2.7	3¼	3¼
Labour productivity growth (%)	1.3	2½	1.5	2¾	1.8	1½	1½
HICP inflation (%)	1.6	1½	1.8	1¾	2.3	1¾	1¾
GDP deflator (% change)	1.7	1¾	2.1	1¾	2.1	1½	1½
Comp. of employees (per head, % change)	1.4	1½	2.9	2¼	3.0	3¼	3¼
Real unit labour costs (% change)	-1.4	-1¼	-0.5	-½	-0.7	-¼	-¼
External balance (% of GDP)	7.3	6.9	7.8	6.7	8.2	7.1	7.5

Notes:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.

Source:
Commission services' autumn 2006 economic forecasts (COM); stability programme (SP)

The programme projects lower growth of the compensation of employees in 2007 than is foreseen in the Commission services' autumn forecast, the difference amounting to almost ¾ percentage points. This reflects the combined effect of a lower expected employment growth and a more moderate wage development in the programme update as compared to the autumn forecast.

The path of the output gap that is implied by the programme and recalculated by the Commission services based on the commonly agreed methodology, differs significantly from the output gap that follows from the Commission services' autumn forecast[11]. Although in both forecasts the output gap closes during the projection period, the path implied by the programme is more pronounced, turning positive already in 2007 (Table 2). The differences between expected output gaps are primarily explained by the overly cautious growth projections in the outer years of the programme, which drag down the estimate of potential output growth and make cyclical conditions look more favourable throughout the programme period. It should be noted that despite the differences in the level of the output gaps, their main evolution over the course of the programme horizon is similar.

As is shown in Table 3, the assessment of cyclical conditions based on output gap estimates has changed significantly over the past few years. Almost without exception, the calculated output gaps in successive forecasts have improved steadily. This mainly reflects the continuous improvement of the economic outlook for the years 2006 and 2007, implying also some positive base effects for the output gap in 2008.

Table 3: Output gap estimates in successive Commission services' forecasts and stability programmes

(% of potential GDP)	2006		2007		2008	
	COM	SP[1]	COM	SP[1]	COM	SP[1]
SP November 2006	-	-0.5	-	0.6	-	0.6
Com Autumn 2006	-1.2	-	-0.4	-	0.0	-
Com Spring 2006	-1.6	-	-1.0	-	-	-
SP December 2005	-	-1.5	-	-1.1	-	-0.9
Com Autumn 2005	-1.9	-	-1.4	-	-	-
Com Spring 2005	-2.4	-	-	-	-	-
SP December 2004	-	-1.5	-	-0.9	-	-

Note:
[1]Commission services' calculations according to the commonly agreed method based on the information in the programme.
Source:
Commission services' forecasts, stability programmes and Commission services

3.3. Potential growth and its determinants

The Commission services' calculations according to the commonly agreed methodology, based on the information provided in the programme lead to an estimated potential growth of 1.8% for the years 2006 – 2008, and to an increase to 2% in 2009 (Table 4). These estimates are significantly below average GDP growth over the past ten years. They are also around 0.3 percentage points of GDP lower than the estimates in the Commission services' autumn forecast. This is explained by two factors of approximately equal weight. First, labour market developments are expected to be less dynamic in the programme than foreseen by the Commission services, especially in the outer years, which lead to a higher path of the NAIRU in the programme compared to the Commission services' autumn forecast. Second, the projected economic growth for the

[11] Furthermore, there are differences between the programme's output gaps as recalculated by the Commission services on the one hand and the programme's output gaps as presented in the programme itself. More specifically, the output gap as presented in the programme increases from -0.7 in 2006 to 0.2 in 2007, 0.0 in 2008 and fall to -0.2 in 2009. Hence, the differences amount to around half a percentage point on average in the years 2007-2009.

outer years of the programme update is relatively low. The observed differences in estimated total factor productivity growth are not considered to influence the plausibility of the programme. At best, they confirm the implausibility of the abrupt fall in economic growth in 2008 projected in the programme.

Table 4: Sources of potential output growth

	2006		2007		2008		2009
	COM	SP[2]	COM	SP[2]	COM	SP[2]	SP[2]
Potential GDP growth (%)[1]	2.1	1.8	2.2	1.8	2.1	1.8	2.0
Contributions:							
- Labour	0.2	0.0	0.2	0.0	0.1	-0.1	0.2
- Capital accumulation	0.6	0.6	0.7	0.7	0.7	0.7	0.6
- TFP	1.3	1.2	1.3	1.2	1.3	1.2	1.2

Notes:
[1]Based on the production function method for calculating potential output growth.
[2]Commission services' calculations on the basis of the information in the stability programme (SP).

Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

3.4. Labour market developments

The strong economic growth performance in 2006 and 2007 in the stability programme is considered to result in employment growth of 2% in 2006 and 2007, slightly higher than the Commission services' autumn forecast. However, in 2008 employment growth is expected to fall to a mere ¼% (compared to 1.2% in the Commission services' autumn forecast) and remain at that low growth level in 2009 as well. Averaging over the programme' horizon, this amounts to a similar employment growth as observed in the past ten years.

The labour content of real GDP growth, calculated as the percentage increase in employment vis-à-vis the percentage increase in real GDP, is around 0.6 in both 2006 and 2007, which is in line with historical averages and the labour content of growth as estimated in the Commission services' autumn forecast. For the years 2008 and 2009, however, the labour content of economic growth is virtually zero, implying that the economic development mimics labour productivity, which is fairly unrealistic. As a result of the assumed strong employment growth in 2006 and 2007, the unemployment rate is expected to fall from 4.7% in 2005 to 3¼% in 2007. It is expected to remain at that level for the rest of the programme period, i.e. until 2009. This pattern is fully in line with the expected strong improvement in the output gap in the years 2006-2007 and the projected subsequent stabilisation thereafter.

3.5. Costs and price developments

Compensations per employee are expected to increase from 1½% in 2006 to 2¼% in 2007 and further to 3¼% for the remainder of the programme period. For 2007, this is lower than foreseen in the Commission services' autumn forecast, despite similar employment projections. Labour productivity is seen to decline, from 2½-2¾% in 2006 and 2007 to 1½% in 2008 and 2009. For 2006 and 2007, this is relatively high as compared to the Commission services' autumn forecast. Finally, HICP inflation is expected to come out at 1½% in 2006 and at 1¾% in all remaining years of the programme period, which is lower than the Commission services' autumn forecast for the year 2008.

Hence, the expected increase in compensation per employee in 2007 is surprisingly low also in light of strong labour productivity growth, implying an expected continuation of wage moderation despite the projection that the labour market has by then tightened significantly, with the unemployment rate approaching 3%. Although consistent with moderate wage developments, consumer price inflation expectations can also be considered to be low. From 2008 onwards, the tension between on the one hand a tight labour market and on the other hand low wage growth is resolved by an expected increase in compensation per employee of more than 3% per annum. However, the strong development in compensation per employee is neither supported by high productivity growth in those years, nor does it result in upward price pressures. In fact, HICP inflation is expected to remain stable in those years.

3.6. Sectoral balances

The programme update projects net lending vis-à-vis the rest of the world to be fairly stable around 7% of GDP for the period 2006-2008 and increasing slightly to 7.5% of GDP in 2009. This implies that the country's net lending is expected to remain around its 2005 level and thereby break the upward trend that started in 1999. The programme does not provide an explanation for this levelling out. Net lending of the private sector is foreseen to be stable just below 7% of GDP from 2006 onwards. This apparently assumes that the changes in the household saving rate are fully offset by an opposite evolution of corporate profits, which would be in line with recent developments but unlikely in light of the expected strong recovery in 2006 and 2007, which is likely to improve both household saving and corporate profitability.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic ‘good’ or ‘bad’ times.

3.7.1. Plausibility of the macroeconomic scenario

The programme's projections for GDP growth are plausible for 2006 and 2007, when economic growth is assumed to be 3¼% and 3% respectively. However, GDP growth is expected to fall to 1¾% in 2008 (and remain at that growth level in 2009 as well), nearly 1 percentage point lower than in the Commission services' autumn forecast (2.6%). The underlying composition of growth is roughly similar, but the sudden fall in economic growth in 2008 seems to be overly cautious. This also holds true, but to a lesser extent, for the growth forecast for 2009 as it is below the average estimated potential growth of the period 2006-2008 in the Commission services' autumn forecast. Furthermore, in the outer years of the programme, the labour content of economic growth is virtually zero, implying that the economic development merely mimics labour productivity. The programme foresees a continuation of wage moderation in 2007 despite the projection that the labour market has by then tightened significantly, with the unemployment rate approaching 3%. Over the course of the programme, net lending of the private sector is foreseen to be stable around 7% of GDP from 2006 onwards. This is unlikely in light of the expected strong recovery in 2006 and 2007 that can be expected to improve both household saving and corporate profitability.

Assessed against currently available information, the programme's macroeconomic projections for 2007 appears plausible. However, from 2008 onwards, the

macroeconomic scenario appears overly cautious and inflation projections seem to be on the low side in light of labour market developments.

3.7.2. Economic good vs. bad times

The output gap estimates of the Commission services' autumn forecast is expected to improve vigorously from 2006 onwards. It is seen to improve from -1.2% in 2006 to -0.4% in 2007 and is expected to close fully by 2008. Furthermore, as analysed in Section 3.2, across successive forecast rounds the Commission services' output gap estimates have consistently been revised upwards for all forecast years. These positive dynamics that emerge from output gap developments are confirmed by a broader perspective on the Dutch economic developments. The economic recovery that started hesitantly in 2004 and 2005 turned into a strong above-potential growth performance in the course of 2006 and is expected to continue at a similar strength next year. In light of (i) the above-mentioned strong upward dynamic of the output gap, (ii) the pattern of revisions to the output gap in the past few years and (iii) the fact that the output gap is expected to nearly close next year, the Dutch economy can be considered to be in economic 'good times' from 2007 onwards.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme's medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The estimated outturn for the general government balance in 2006 in the current update is a surplus of 0.1% of GDP, compared to a deficit of 1.5% of GDP targeted in the December 2005 update. The estimated outturn in the new programme is very much in line with the latest Commission services' autumn forecast, deviating by only 0.1% of GDP. However, the Ministry of Finance's 2006 Autumn Memorandum, which was sent to parliament only two days before the submission of the stability programme, puts the budgetary outcome for 2006 at 0.4% of GDP, i.e. 0.3% of GDP higher than in the programme[12]. Although in the updated stability programme the Autumn memorandum is acknowledged, its figures are disregarded as their *"structural character [...] is, as yet, unknown"*. Nevertheless, the Autumn memorandum should represent the most recent insight into the budgetary stance, implying that the budgetary outcome in 2006 is likely to turn out higher than envisaged in the stability programme. This view is corroborated by monthly nominal data on the general government balance available from the Ministry of Finance that reconfirm the figures mentioned in the Autumn memorandum.

Apart from the markedly better outturn of GDP in 2005 and 2006 that resulted in a downward shift of general government revenue and expenditure levels by around ¾ percentage point as compared to the previous programme, the changes in the revenue and expenditure aggregates in 2006 are dominated by the overhaul of the health care system that came into effect and that raised government expenditures by around 1.5 percentage points of GDP as compared to 2005. Corrected for this effect, general government expenditures fell around 0.7% of GDP, mainly as a result of a reduction in the government wage bill. Total government revenues as a percentage of GDP increased by 1.2 percentage points due to higher tax revenues from production and imports and increased property income due to a rise in gas receipts from 1.5% of GDP in 2005 to 1.9% of GDP in 2006, while miscellaneous other revenues were lower by 1.2% of GDP. Social contributions increased by around 1.5 percentage point of GDP, which was related to the introduction of the new health care system, which overall had a negligible effect on the government balance. The budgetary improvement relative to the programme's estimate that is foreseen in the Autumn memorandum arises from unexpectedly strong corporate tax revenues of around EUR 2.2 billion or 0.4% of GDP, while income tax revenues are seen to fall short by EUR 0.3 billion or 0.1% of GDP compared to earlier estimations.

[12] On 18 January, the Dutch Minister of Finance indicated in a newspaper interview that the budget balance for 2006 would be even better, at 0.6% of GDP.

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009
General government balance (% of GDP)	**SP November 2006**	**-0.3**	**0.1**	**0.2**	**0.3**	**0.9**
	SP December 2005	-1.2	-1.5	-1.2	-1.1	n.a.
	SP December 2004	*-2.6*	*-2.1*	*-1.9*	*n.a.*	*n.a.*
	COM Nov 2006	-0.3	0.0	0.1	0.3	n.a.
General government expenditure (% of GDP)	**SP November 2006**	**45.5**	**46.3**	**45.6**	**45.6**	**45.3**
	SP December 2005	47.2	48.8	48.1	48.1	n.a.
	SP December 2004	*47.5*	*46.7*	*46.0*	*n.a.*	*n.a.*
	COM Nov 2006	45.5	46.6	46.2	45.7	n.a.
General government revenues (% of GDP)	**SP November 2006**	**45.2**	**46.4**	**45.8**	**45.9**	**46.2**
	SP December 2005	46.0	47.3	46.9	47.0	n.a.
	SP December 2004	*44.9*	*44.6*	*44.1*	*n.a.*	*n.a.*
	COM Nov 2006	45.2	46.5	46.3	46.0	n.a.
Real GDP (% change)	**SP November 2006**	**1.5**	**3¼**	**3**	**1¾**	**1¾**
	SP December 2005	¾	2½	2½	2¼	n.a.
	SP December 2004	*1½*	*2½*	*2½*	*n.a.*	*n.a.*
	COM Nov 2006	1.5	3.0	2.9	2.6	n.a.

Source:
Stability programmes (SP) and Commission services' autumn 2006 economic forecasts (COM)

4.2. The programme's medium-term budgetary strategy

This section covers the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The programme identifies the cost of ageing as the single most important challenge and hence points to the need for further fiscal consolidation. It refers to a sustainability gap of 1.5% (1.3% in the latest sustainability report published by the Commission[13]). The programme projects the surplus to gradually increase from 0.1% of GDP in 2006 to 0.3% in 2008 and then further to 0.9% of GDP in 2009 (Table 6). The primary balance is targeted to improve from 2.4% in 2006 to 2.9% in 2009. This improvement is fully concentrated in the final year of the programme.

Compared to the December 2005 update of the stability programme, the level of the general government balance is markedly higher throughout the programme period (Table 5). This mainly reflects higher gas receipts, the strongly improved macroeconomic outlook from 2006 onwards as well as the better-than-expected macroeconomic outturn in 2005. Within the budgetary framework in place in the Netherlands, the resulting revenue windfalls were used for debt amortisation (see section 2.4) and led to an upward correction of the balance in 2005, which had been estimated at -1.2% of GDP in the December 2005 update of the stability programme, but came out at -0.3% of GDP.

[13] The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

Table 6: Composition of the budgetary adjustment

(% of GDP)	2005	2006	2007	2008	2009	Change: 2009-2006
Revenues	45.2	46.4	45.8	45.9	46.2	**-0.2**
of which:						
- Taxes & social contributions[1]	38.7	40.5	40.0	40.0	40.0	**-0.5**
- Gas receipts[2]	1.5	1.9	2.2	2.1	1.9	**0.0**
- Other (residual)	5.0	4.0	3.6	3.8	4.3	**0.3**
Expenditures	45.5	46.3	45.6	45.6	45.3	**-1.0**
of which:						
- Primary expenditure	43.1	44.0	43.4	43.5	43.3	**-0.7**
of which:						
Collective consumption	10.6	10.6	10.5	10.5	10.5	**-0.1**
Transfers & subsidies	25.8	27.4	27.2	27.2	27.2	**-0.2**
Gross fixed capital formation	3.2	3.1	3.0	3.0	3.0	**-0.1**
Other (residual)	3.5	2.9	2.7	2.8	2.6	**-0.3**
- Interest expenditure	2.4	2.3	2.2	2.1	2.0	**-0.3**
General government balance (GGB)	**-0.3**	**0.1**	**0.2**	**0.3**	**0.9**	**0.8**
Primary balance	**2.1**	**2.4**	**2.4**	**2.4**	**2.9**	**0.5**
One-offs[3]	0.0	0.0	0.0	0.0	0.3	**-**
GGB excl. one-offs	**-0.3**	**0.1**	**0.2**	**0.3**	**0.6**	**0.5**

Notes:
[1]Excludes corporate tax revenues originating from the gas producing sector.
[2]Property income and corporate tax revenues originating from the gas producing sector. 2008 and 2009: Commission services' estimates.
[3]One-off and other temporary measures.

Source:
Stability programme update; Dutch Ministry of Finance; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

The envisaged consolidation of 0.8 percentage points of GDP over the programme horizon is fully explained by a 1.0 percentage point fall in the expenditures-to-GDP ratio, which overcompensates the 0.2 percentage point reduction in the revenues-to-GDP ratio. The nominal budgetary improvement is partly explained by the fact that interest payments on government debt are expected to decline by 0.1% of GDP per year, from 2.3% of GDP in 2006 to 2.0% of GDP in 2009, in line with the projected fall in the debt-to-GDP ratio (see Section 5). The 1 percentage point of GDP reduction in the expenditure ratio is consistent with the strong nominal government expenditure growth of 3.9% per year.

The improvement of the primary balance by 0.5 percentage points (which is back-loaded to 2009) is the result of the negotiated reduction in EU own resources of around EUR 1 billion per year (equivalent to almost 0.2% of GDP). To enter into force, the proposal for a new own resources decision must first be adopted by unanimity in Council and ratified by each Member State. The update of the stability programme expects this process to be finalised by 2009 and yield a structural fall in expenditures of little under 0.2% of GDP per year. As the system will take effect retroactively from 1 January 2007, retributions over the period 2007-2008 are expected to be paid out in 2009. These retributions constitute a one-off revenue of 0.3% of GDP (in 2009) and are as such identified in the update of the stability programme.

On the envisaged consolidation in 2007 (reduction in the expenditure ratio by 0.7 percentage point, more than compensating the fall in the revenue ratio by 0.6 percentage

point), the budget for 2007 (see Box 1) provides more detailed information than the stability programme on the measures supporting it; the programme provides only very partially the budgetary impact of measures that have been taken. The envisaged consolidation from 2008 onwards seems to be consistent with a no-policy-change assumption and no measures beyond 2007 are mentioned in the programme, suggesting a fully autonomous consolidation.

Dutch government revenues contain a relatively large share of property income, which reflects receipts from the sale of natural gas stemming from the Groningen field (Table 6). In fact, as pointed out in Section 2.4, since 2004, gas receipts have increased significantly on the back of increasing international oil and gas prices, reaching a level of 1.5% of GDP in 2005. In 2006 and 2007, the Dutch government expects gas revenues to increase further, to 1.9% and 2.2% of GDP respectively. For 2008 and 2009, according to Commission services' estimates, gas revenues are expected to again ease slightly (Figure 10). This expected fall is the result of an assumed easing of oil prices in the programme, from $70 in 2007 to $68 and $65 in 2008 and 2009, respectively.

Part of gas receipts are used to fund government investments. In fact, government investments in the Netherlands have averaged 3.2% of GDP in the past ten years, as compared to a euro area average of 2.7% of GDP. Over the course of the programme period, government investments are expected to decline slightly, to 3% of GDP at the end of the programme period (Table 6).

Box 1: The budget for 2007

The draft budget for 2007 was presented on 19 September 2006 and was adopted in parliament on 5 October 2006.

The budget targets a general government surplus of 0.2% of GDP in 2007, which is only marginally higher than the expected surplus of 0.1% in 2006. The table below specifies the main measures. Both the reduction of unemployment premiums and the overhaul of the corporate system were planned to be financed from the reduction of the EU own resources effective from 2007 onwards. However, since those funds are expected to only become available in 2009, the current government has decided to pre-finance these measures with a combined cost of 0.2% of GDP from the investment fund (that is fed by gas receipts).

Table: Main measures in the budget for 2007

Revenue measures*	**Expenditure measures****
o Increase in health care premiums (0.2% of GDP) o Reduction of income tax rates (-0.1% of GDP) o Reduction of unemployment premiums (-0.1% of GDP) o Overhaul of corporate tax system (-0.1% of GDP) o Increases in several tax breaks (-0.1% of GDP)	o Measures to improve security (0.1% of GDP) o Reduction of environmental fees, integration and asylum, education (combined 0.1% of GDP) o Increase in child allowance, reduction of child care costs for households, increased running costs of social benefit administration (combined 0.1% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services and Budget 2007.

4.2.3. The medium-term objective (MTO) and the structural adjustment

The November 2006 update presents a medium-term objective (MTO) for the budgetary position in the range of -1% to -0.5% of GDP, identical to the MTO that was put forward

in previous update of the stability programme. Furthermore, similar to the December 2005 update, the latest programme update aims to respect this range throughout the programme period.

Box 2: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

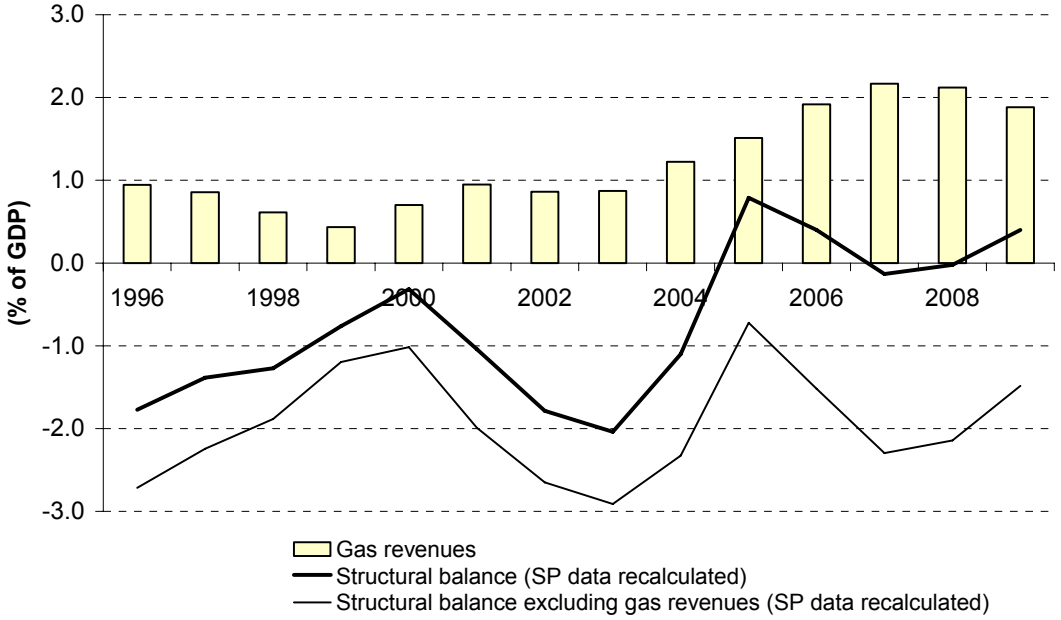
The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

In the case of the Netherlands, the lower bound of this MTO range is equal to the minimum benchmark (estimated at a deficit of around 1% of GDP), which is the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value. Hence, the achievement of the MTO should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

The structural balance according to the Commission services' calculations on the basis of the information in the programme is expected to deteriorate both in 2006 and in 2007 by around ½ a percentage point, broadly remain at a balanced position in 2008 and improve by almost ½ a percentage point in 2009 (Table 7). Note that the structural balance should be interpreted with caution due to the nature of the calculations involved, but that the general direction of the structural balance (which is based on calculated changes in output gaps) is relatively similar to the evolution in the Commission services' autumn forecast.

The structural deterioration in 2006 and 2007 coincides with a period of above-potential economic growth, indicating that the economic improvement is not fully translated into better budgetary outcomes in those years. Furthermore, as gas revenues represent a volatile revenue factor that is by convention not excluded from the structural balance, the recent rise in gas revenues has upwardly affected the structural balance. More specifically, gas revenues have increased from a recent historical average level of around 1% of GDP to roughly 2% of GDP over the programme period (Figure 10). In 2006 and 2007, the increase is 0.4 and 0.3 percentage point of GDP, respectively.

Figure 10: Structural balance and gas revenues



Source: Statistics Netherlands, CPB, Ministry of Finance, Commission services' estimates

Another factor that should be considered when assessing the structural balance is the small, but steady decline in the interest burden over the programme period that acts to improve the structural balance by 0.1% of GDP each year over the programme period. Finally, the improvement in the structural balance in 2009 partly reflects the above-mentioned structural improvement in EU own resources by around 0.2% of GDP.

In light of this analysis, the planned stance of fiscal policy is considered to be expansionary in 2006 and 2007, and broadly neutral thereafter.

Table 7: Output gaps and cyclically-adjusted and structural balances

(% of GDP)	2005		2006		2007		2008		2009	Change: 2009-2006
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-0.3	-0.3	0.0	0.1	0.1	0.2	0.3	0.3	0.9	0.8
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	-
Output gap[3]	-2.0	-1.9	-1.2	-0.5	-0.4	0.6	0.0	0.6	0.3	-
CAB[4]	0.9	0.8	0.6	0.4	0.4	-0.1	0.3	0.0	0.7	0.1
change in CAB	1.7	1.6	-0.3	-0.4	-0.2	-0.5	-0.1	0.1	0.7	-
CAPB[4]	3.3	3.2	2.9	2.7	2.6	2.1	2.4	2.1	2.7	0.0
Structural balance[5]	0.9	0.8	0.6	0.4	0.4	-0.1	0.3	0.0	0.4	-0.2
change in struct. bal.	2.0	1.9	-0.3	-0.4	-0.2	-0.5	-0.1	0.1	0.1	-
Struct. prim. balance[5]	3.3	3.2	2.9	2.7	2.6	2.1	2.4	2.1	2.4	-0.3
Notes:										

[1]Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme.
[2]One-off and other temporary measures.
[3]In percent of potential GDP. See Table 2 above.
[4]CA(P)B = cyclically-adjusted (primary) balance.
[5]Structural (primary) balance = CA(P)B excluding one-off and other temporary measures.

Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2008, Table 8 compares the detailed revenue and expenditure projections in the Commission services' autumn 2006 forecast, which are derived under a no-policy-change scenario, with those in the updated programme.

Table 8: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009
		COM	SP	COM	SP	COM[1]	SP	SP
Revenues	45.2	46.5	46.4	46.3	45.8	46.0	45.9	46.2
of which:								
- Taxes & social contributions	38.7	40.3	40.5	40.0	40.0	39.8	40.0	40.0
- Other (residual)	6.5	6.2	5.9	6.3	5.8	6.2	5.9	6.2
Expenditure	45.5	46.6	46.3	46.2	45.6	45.7	45.6	45.3
of which:								
- Primary expenditure	43.1	44.3	44.0	44.0	43.4	43.6	43.5	43.3
of which:								
Collective consumption	10.6	10.9	10.6	10.8	10.5	10.7	10.5	10.5
Transfers & subsidies	25.9	26.4	27.4	25.9	27.2	25.5	27.2	27.2
Gross fixed capital formation	3.2	3.1	3.1	3.1	3.0	3.0	3.0	3.0
Other (residual)	3.4	3.8	2.9	4.2	2.7	4.4	2.8	2.6
- Interest expenditure	2.4	2.3	2.3	2.2	2.2	2.1	2.1	2.0
General government balance (GGB)	-0.3	0.0	0.1	0.1	0.2	0.3	0.3	0.9
Primary balance	2.1	2.3	2.4	2.3	2.4	2.3	2.4	2.9
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3
GGB excl. one-offs	-0.3	0.0	0.1	0.1	0.2	0.3	0.3	0.6

Notes:
[1]On a no-policy change basis.
[2]One-off and other temporary measures.

Source:
Commission services' autumn 2006 economic forecasts (COM); stability programme update (SP); Commission services' calculations

As concluded in Section 3.7.1 above, the macroeconomic scenario appears plausible for 2006 and 2007 and somewhat cautious thereafter. Therefore, from 2008 onwards there is the possibility that the economic scenario may turn out to be more beneficial, implying an upward risk to the general budget from the economic scenario. Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point upward deviation from the real GDP growth projections in the programme over the 2006-2009 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2009, the cyclically-adjusted balance would be 0.7 percentage point of GDP above the central scenario.

As already indicated in Section 4.2.2 above, the budgetary target for 2007 in the programme update is identical to that in the budget for 2007, where the budgetary measures and their impact of measures are specified so that the target for 2007 can be considered plausible. While the stability programme makes no reference at all to measures to be taken beyond 2007, the envisaged consolidation seems to be consistent with a no-policy-change assumption, which suggests that the consolidation is planned to be fully autonomous.

The role of one-off and other temporary measures is insignificant over most of the programme horizon. Merely the expected refunding in 2009 of EU taxes paid over the period 2007-2008, amounting to 0.3% of GDP, is considered to be a one-off revenue. The yield of this one-off should be considered certain.

The upper half of Table 9 evaluates the programme's tax projections for 2007 and 2008 against those of the Commission services' autumn forecast by comparing the implied changes in the total tax-to-GDP ratio. For 2007, the programme assumes a fall in the tax-to-GDP ratio of 0.5 percentage points as compared to a fall of 0.4 percentage points in the Commission services' autumn forecast, which is explained by a difference in the discretionary and elasticity component. The breakdown of tax projections into four major tax categories as provided in Annex 5 indicates that under certain assumptions social contributions are implied to be lower than in the autumn forecast while taxes on production and imports are slightly higher. For 2008, the differences in the implied tax-to-GDP ratio between the programme's scenario and the Commission services' autumn forecast are nigh on negligible, which confirms the notion that the programme also builds on a no-policy-change assumption.

Table 9: Assessment of tax projections

	2007			2008			2009
	SP	**COM**	**OECD[3]**	**SP**	**COM[1]**	**OECD[3]**	**SP**
Change in tax-to-GDP ratio (total taxes)	-0.5	-0.4	0.0	0.0	-0.2	0.0	0.0
Difference (SP – COM)[4]	-0.2		/	0.2		/	/
Of which[2]:							
- discretionary and elasticity component	-0.2		/	0.1		/	/
- composition component	0.0		/	0.1		/	/
Difference (COM - OECD) [4]	/	-0.4		/	-0.2		/
Of which[2]*:*							
- discretionary and elasticity component	/	-0.4		/	-0.3		/
- composition component	/	0.1		/	0.1		/
p.m.: Elasticity to GDP	0.7	0.8	1.0	1.0	0.9	1.0	1.0

Notes:
[1]On a no-policy change basis.
[2]The decomposition is explained in Annex 5.
[3] Based on OECD ex-ante elasticity relative to GDP.
4 Due to rounding errors, this need not be identical to the change in the corresponding tax-to-GDP ratio.

Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

The increases in the price of energy products in the past two years have resulted in higher government revenues from the sale of gas. Gas receipts have increased from an average of under 1% per year in the past decade (see Section 2.4 above) to an anticipated level of 1.9% in 2006 and 2.2% of GDP in 2007. As natural gas prices typically move with oil prices, the government's property income and corporate taxes from the gas producing

sector are affected by changes in the oil price. The persistence of higher gas revenues is therefore - even in the short term - highly uncertain. The update of the stability programme describes a scenario of a fall in oil prices by the end of 2007 to $60 a barrel as compared to the programme's scenario of $70. In that scenario the fall in property income is expected to be exactly offset by increasing tax receipts due to an improved economic outlook which is associated with lower oil prices. However, as is evidenced by recent history, energy prices and the economic cycle may move in the same direction, suggesting that the economic impact of energy price movements may be smaller than anticipated in the programme and implying that the direct budgetary effects of a change in energy prices are not necessarily fully offset by the indirect budgetary effects. Although estimated gas receipts for 2006 should be considered certain, a possible fall in natural gas prices therefore constitutes a downward risk to the budgetary position from 2007.

The Netherlands has built up a relatively good budgetary track record in recent years (see Figure 7 in Section 2.4 above), resulting from prudent action as well as from adherence to a system of medium-term budgetary expenditure rules. Furthermore, the recent strengthening of the control of local governments' deficits as well as enhanced information requirements of local governments allow a better and more effective monitoring of local governments' budgetary developments (see Section 6). While there is some political risk at a general government level since the main budgetary rules that have been in place from 1994 onwards (see Section 2.4) are not laid down in law, all major political parties have signalled the importance of prudent fiscal policy in light of population ageing, and this should limit the risk of significant fiscal slippage from 2007 onwards.

As is indicated in the programme, the budgetary outcome for 2006 of 0.1% of GDP should be considered outdated as the latest official estimate of the budget balance in 2006 is 0.4% of GDP (in the 'Autumn memorandum'). This improved outcome in 2006 is due to increased corporate tax revenues, of which the programme indicates that the structural character is, as yet, unknown. Given the volatile nature of corporate tax receipts and in light of the changes to the corporate tax system in 2007, it is indeed not obvious that the higher results in 2006 will have positive carry-over effects into years to come. However, the possibility of a positive carry-over into 2007 of the higher tax receipts in 2006 constitutes a positive risk to the budgetary outcome in 2007.

Summing up, for 2008 and 2009, a positive risk to the budgetary position stems from the cautious macroeconomic scenario. Furthermore, the higher-than-expected tax receipts in 2006 and possibility of a positive carry-over into 2007 constitute a positive risk to the budgetary outcome in 2007. These upward risks are counterbalanced from 2007 onwards by the possibility that net gas receipts may turn out lower than currently anticipated. All in all, the risks to the budgetary outcomes are balanced from 2007 onwards.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 10: Overview of compliance with the Stability and Growth Pact

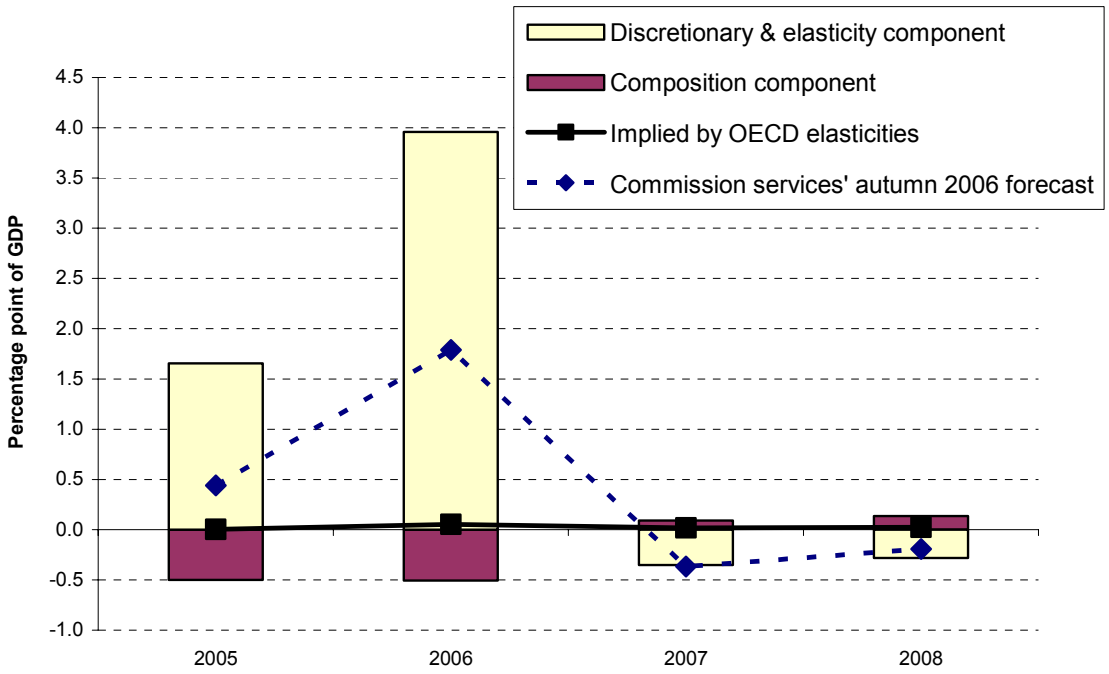
	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	risk that it may not (in 2007)	risk that it may not (in 2007)

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1% of GDP for the Netherlands). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.
Source:
Commission services

Taking into account risks to the budgetary projections, the budgetary strategy as outlined in the programme respects the MTO throughout the programme period and hence can be considered as appropriate under the Pact. In addition, the cyclically-adjusted balance in the Netherlands is better than the minimum benchmark (estimated as a deficit of around 1% of GDP for the Netherlands) throughout the programme horizon. Hence, the budgetary stance in the programme provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations over the programme horizon.
As regards the appropriateness of the fiscal stance and in particular the Pact's requirement that countries that have achieved the MTO avoid pro-cyclical fiscal policies in good times (taking into account tax elasticities), the lower part of Table 9 compares the tax projections in the Commission services' autumn forecast with the tax projections implied by the OECD standard elasticities. For 2007, it indicates that the tax system can be expected to yield less than implied by the OECD standard elasticities. The decomposition of the change in tax-to-GDP ratio into components is shown in Figure 11, which uses the methodology explained in Annex 5. It indicates that the lower expected yield is related to the discretionary and elasticity component. Indeed, as detailed in Section 4.2.2, the budget for 2007 contains several measures aimed at relieving the tax burden, such as the reduction in unemployment premiums, the reduction of income tax rates and the overhaul of the corporate tax system. This confirms the role of discretionary policies in the fall of the tax-to-GDP ratio and suggests that excluding these discretionary measures, the tax system is likely to yield approximately the value implied by the OECD standard elasticities.

As assessed in Section 3.7.2 above, the Dutch economy is considered to be in 'economic' good times from 2007 onwards. Furthermore, the analysis of tax elasticities does not suggest that the tax system can be expected to yield significantly lower tax revenues than implied by the OECD standard elasticities. Hence, from 2007 onwards, the Dutch economy is considered to be in good times (taking into account tax elasticities).

Figure 11: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' autumn 2006 forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

While the structural balance according to the Commission services' calculations on the basis of the information in the programme is expected to remain broadly unchanged in 2008 and improve in 2009 by almost ½ percentage point of GDP, it is projected to deteriorate by around ½ percentage point in 2007, i.e. pointing to an expansionary fiscal stance in good times. Although the deterioration in 2007 is smaller according to the Commission services' autumn forecast, of the order of ¼ percentage point of GDP, it should be recalled that the structural balance does not exclude gas receipts, which are planned to increase by some ¼ percentage point of GDP in 2007. Furthermore, in case the better budgetary outturn that is presented in the 2006 Autumn Memorandum does not carry over into 2007, the structural deterioration in 2007 will be larger by around ¼% of GDP in both calculations. Therefore, there is a risk of pro-cyclical fiscal policies in good times in 2007, which would not be in line with the Pact.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial

assets and other adjustments may also play a role.[14] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programmes targets, compares them with the Commission services' forecasts and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

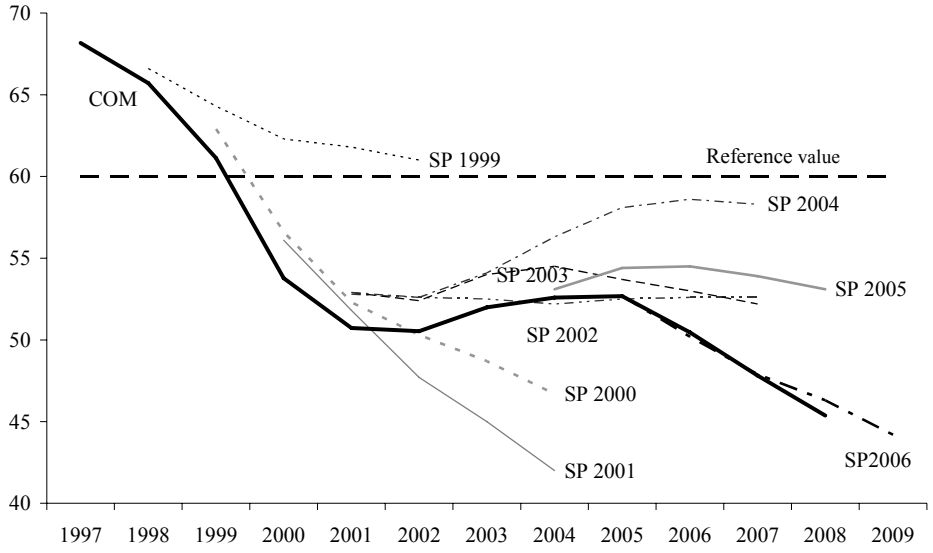
5.1.1. Debt projections in the programme

The debt-to-GDP ratio fell below 60% in 2000 (Figure 12) and reached a temporary low of 50.5% in 2002, before increasing to close to 53% in both 2004 and 2005. The debt development in 2005 was heavily influenced by accumulation of financial assets in connection with a restructuring in the gas sector; otherwise the debt ratio would have fallen by around 1¼% point of GDP For 2006, the debt-to-GDP ratio is expected to fall to close to 50%, significantly below the target set in the December 2005 update of the stability programme, that was 54.5%. The fall in the ratio results from a primary balance of 2.4% of GDP, and a "snow-ball" effect of -0.1% of GDP (Table 12). The "snow-ball" effect consists of interest expenditure of 2.3% of GDP and an increase in nominal GDP that results in a 2.4 percentage point lower debt-to-GDP ratio. The debt ratio as projected in the programme is slightly lower than in the Commission services' autumn forecast, reflecting several small factors including a slightly higher GDP growth forecast in the programme.

The programme targets do not reflect the better-than-expected budgetary outcome for 2006 that was presented in the Ministry of Finance's Autumn Memorandum of 20 November 2006. Furthermore, recent data on the sale of financial assets have not been incorporated in the programme. More specifically, this pertains to the completion of the privatisation of two formerly State-owned companies, KPN (telecommunications) and TNT (postal services). The sale of the final batches of these companies' shares has resulted in unanticipated privatisation receipts of around EUR 3.2 billion, or 0.6% of GDP. These receipts and the better budgetary outcome imply that the debt-to-GDP ratio in 2006 is likely to come out lower than anticipated in the programme, at around 49.4%.

[14] On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

Figure 12: Debt projections in successive stability programmes (% of GDP)



Source:
Commission services' autumn 2006 forecast (COM) and successive stability programme

The programme expects the debt-to-GDP ratio to continue to decline over the remainder of the programme horizon to around 44% at the end of 2009. This is mainly the result of nominal GDP growth aided by a small, but steady fall in interest expenditure over the programme horizon. For 2009, an additional factor is the expected increase in the primary balance of 0.5% of GDP.

Table 12: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009
			COM	SP	COM	SP	COM	SP	SP
Gross debt ratio[1]	**52.6**	**52.7**	**50.5**	**50.2**	**47.8**	**47.9**	**45.4**	**46.3**	**44.2**
Change in the ratio	-1.7	0.1	-2.2	-2.5	-2.7	-2.3	-2.4	-1.6	-2.1
Of which[2]*:*									
Primary balance	-1.9	-2.1	-2.3	-2.4	-2.3	-2.4	-2.3	-2.4	-2.9
"Snow-ball" effect	0.4	0.7	0.0	-0.1	-0.2	-0.1	-0.1	0.6	0.5
Of which:									
Interest expenditure	2.9	2.4	2.3	2.3	2.2	2.2	2.1	2.1	2.0
Growth effect (real GDP)	-0.9	-0.8	-1.5	-1.6	-1.4	-1.4	-1.2	-0.8	-0.8
Inflation effect (GDP deflator)	-1.7	-0.9	-0.9	-0.8	-1.0	-0.8	-1.0	-0.7	-0.7
Stock-flow adjustment	-0.2	1.4	0.1	0.0	-0.1	0.2	0.0	0.2	0.3
Of which:									
Cash/accruals diff.	0.2	0.3	-	0.4	-	0.2	-	0.2	0.2
Acc. financial assets	-0.4	1.1	-	-0.5	-	-0.1	-	0.1	0.1
Privatisation	-0.3	-0.2	-	-	-	-	-	-	-
Val. effect & residual	0.1	0.0	-	0.0	-	0.0	-	0.0	0.0

Notes:
[1]End of period.
[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Stability programme update (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

5.1.2. Assessment

The debt projections in the programme are similar to those in the Commission services' autumn 2006 forecast and differences primarily reflect differences in the projected evolution of nominal GDP. However, the better nominal budgetary outcome and higher privatisation receipts in 2006 will lead to a downward shift to the evolution of the debt-to-GDP ratio of almost 1% of GDP over the whole programme horizon. Hence, the risks to the debt-to-GDP ratio are skewed to the downside.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[15]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and

[15] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (See Box 3), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2009, the final year of the stability programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2009 provided in the stability programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2010. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 13 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections[16]. Non age-related primary expenditure and revenue is assumed to remain constant as a share of GDP.

Table 13: Long-term age-related expenditure: main projections

(% of GDP)	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	20.9	20.6	22.4	24.7	26.2	25.8	5.0
Pensions	7.7	7.6	9.0	10.7	11.7	11.2	3.5
Healthcare	6.1	6.3	6.7	7.1	7.4	7.4	1.3
Long-term care	0.5	0.5	0.5	0.8	0.9	1.1	0.6
Education	4.8	4.7	4.6	4.6	4.7	4.6	-0.2
Unemployment benefits	1.8	1.5	1.5	1.5	1.5	1.5	-0.2

Source: Economic Policy Committee and Commission services.

The projected increase in age-related spending in the Netherlands is above the average of the EU; rising by 5 percentage points of GDP between 2004 and 2050. This is particularly due to the expenditure on pensions in the Netherlands, projected to increase more than on average in the EU, by 3.5 percentage points, although the recent reform of the disability scheme (which is included in the pension projection) contributes to curb spending increases. The increase in health-care expenditure is projected to be 1.3 percentage points of GDP, lower than on average in the EU. For long-term care, the projected increase of 0.7 percentage points up to 2050 is slightly above the average in the EU.

Based on the long-term budgetary projections, sustainability indicators can be calculated.

[16] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1, 2006 (hereinafter Ageing Report).

Table 14: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	0.8	2.4	4.6	1.2	2.7	4.6
of which:						
Initial budgetary position	-2.1	-2.2	-	-1.8	-1.8	-
Debt requirement in 2050	-0.3	-	-	-0.3	-	-
Future changes in budgetary position	3.3	4.5	-	3.3	4.5	-
Source: Commission services.						

Table 14 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 0.8% of GDP. The sustainability gap (S2) which satisfies the inter-temporal budget constraint would be 2.4% of GDP. Compared with the results of the Commission's Sustainability Report, the sustainability gaps are larger in the present assessment, by around 1% of GDP. This is mainly due to a lower structural primary balance in 2006 (at 2.7% of GDP) compared with the structural primary balance for 2005 estimated in spring 2006 (at 3.6% of GDP) that was used in the Sustainability Report.

The initial budgetary position contributes to offset part of the impact of the increase in age-related expenditure up to 2050, but not completely. The budgetary plans in the programme implies an unchanged structural balance between 2006 and 2009. The estimated slight reduction in the structural primary balance over the programme period, though limited, has a negative impact on the sustainability gap of the "programme scenario". It shows the importance of maintaining a strong structural budgetary position to contain risks to the sustainability of public finances. According to both sustainability gaps, the long-term budgetary impact of ageing is relatively high.

The required primary balance (RPB) is about 4½% of GDP, higher than the structural primary balance of about 2.4% of GDP in the last year of the programme's period.

Moreover, the sustainability gap indicators would increase by about ¼% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Box 3 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) i**nitial budgetary position (IBP)**; and, (ii) l**ong-term change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2010-2014) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

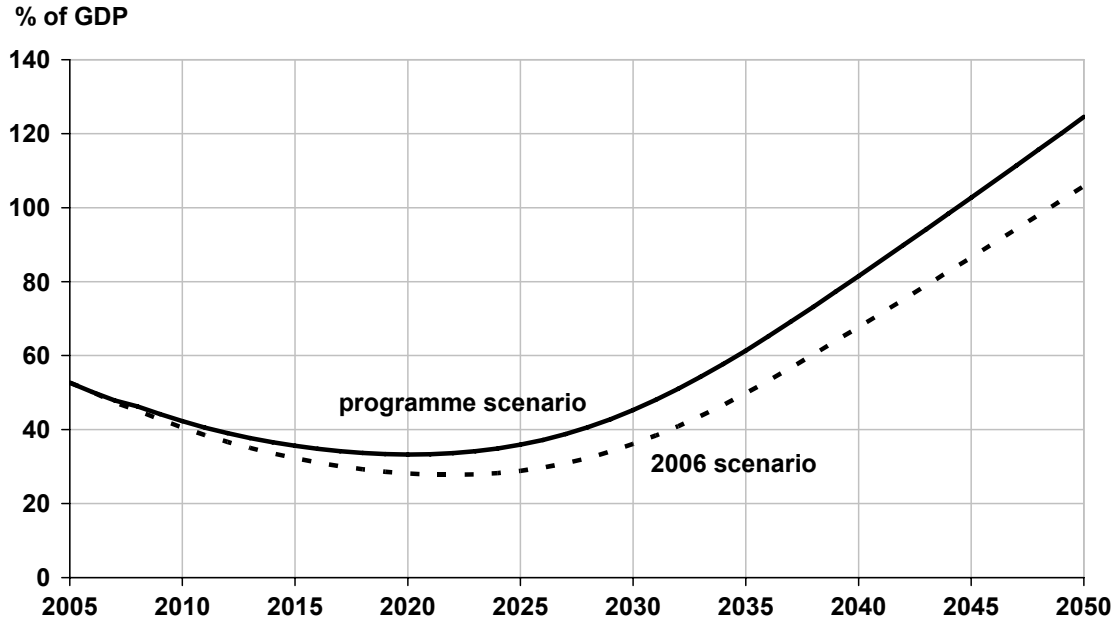
** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability.. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

Another way to look at the prospects for long-term public finance sustainability is to project the debt-to-GDP ratio over the long-term using the same assumptions as for the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 13.

The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at close to 50% of GDP in 2006. According to the "2006 scenario", the debt ratio is projected to decrease up to the mid-2020s and to thereafter start increasing considerably as the impact of ageing takes hold. A similar picture emerges in the "programme scenario", since the budgetary position in 2009 is rather close to the one in 2006.

Figure 13: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant issues are taken into account which in addition allows to better qualify the assessment with regard to where the main risks are likely to stem from.

First, the Dutch programme includes a projected decrease in government revenue as a share of GDP up to 2050, by around 1½ percentage points.[17] This results mainly from a decrease in property income over time, including the impact of the depletion of natural resources (gas). However, other revenue items could increase[18] by some 3 percentage points of GDP up to 2050.[19] This is chiefly due to an increase in taxes on pensions: at present, social contributions currently paid to occupational pension schemes (which are tax exempt) are larger than pension disbursements (which are taxable); however, the situation is expected to be reversed in the future, leading to higher tax revenue as a share of GDP. Overall, government revenue as a share of GDP would increase by around 1½ percentage points of GDP in the period to 2050, thus reducing risks to public finance sustainability.

Second, the considerable assets already accumulated in private pension schemes (at 140% of GDP in 2005), will contribute strongly to the income of pensioners in the future.

[17] See Chapter IV.3 in the Commission's Sustainability Report and CPB (2006), 'Ageing and the Sustainability of Dutch Public Finances' (2006).

[18] This is mentioned in the programme text with a reference to the CPB study, but it is not reflected in the tables of the programme.

[19] See Chapter IV.3 in the Commission's Sustainability Report and CPB (2006), 'Ageing and the Sustainability of Dutch Public Finances' (2006).

Indeed, occupational and private mandatory pensions paid will almost double as a share of GDP (from 4.6% in 2004 to 8.7% of GDP in 2050). This should enable to maintain a total (public and private) benefit ratio at its current level over the long-term.

5.2.3. Assessment

The long-term budgetary impact of ageing in the Netherlands is higher than the EU average, influenced notably by a relatively high increase in pension expenditure as a share of GDP over the coming decades.

The initial budgetary position with a small structural surplus in 2006, albeit declining as compared with last year, contributes to easing the projected long-term budgetary impact of an ageing population, but it is not sufficient to fully cover the substantial increase in age-related expenditure. The projected future rise of revenues as a share of GDP, mainly due to taxation of pensions, would partly compensate for the increase in public expenditure over the long-term. Ensuring high primary surpluses over the medium-term and/or implementing reform measures that curb the projected increase in age-related expenditure would contribute to containing risks to the sustainability of public finances.

Overall, the Netherlands appears to be at low risk with regard to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

On 22 November 2006, the day of the submission of the most recent update of the stability programme, general elections were held in the Netherlands. In light of the end of the term of the government that took up its function in 2003, only few reforms on this government's agenda are still to be implemented. In any case, the programme does not refer to any reforms to be implemented beyond 2007. Moreover, the programme does not deal in detail with the long-run economic implications of the far-reaching reforms that were implemented in the field of social security, such as tightening the eligibility criteria for unemployment benefits, shortening the duration of unemployment benefits and the abolition of tax benefits for early retirement. Arguably, these reforms should positively affect potential growth, labour participation and retirement, and the efficiency of public and social services and a more far-reaching discussion of these implications would be warranted. The programme briefly mentions that increased spending in 'priority areas like education' is on the policy agenda. However, according to the 2007 budget actual outlays on education as a percentage of GDP are expected to decrease from 5.6% of GDP in 2006 to 5.3% of GDP in 2007.

The current system of allocating gas revenues redirects around 60% of the direct gas receipts to debt amortisation, while the rest feeds into the Economic Structure Enhancing Fund (Fonds Economische Structuurversterking, FES). The FES is used to finance investments in several areas, see box 4. However, especially in light of the current strong inflows into the FES, the current situation highlights the risk that investment plans may not meet criteria of legitimacy, effectiveness and efficiency, as has been the case for several projects in the recent past. Furthermore, given the strong volatility of gas revenues and the resulting year-to-year uncertainty on the availability of funds, the current system does not do justice to the prolonged time span that is required by structural investments. Furthermore, despite high spending from the FES in 2006 and 2007 as a result of high gas revenue inflows, the total government investment ratio is actually projected to decline slightly from 3.2% in 2005 to 3% in 2007, suggesting that the extra investments from the FES have crowded out other government investments.

Box 4: The Economic Structure Fund

The Economic Structure Fund (Wet Fonds Economische Structuurversterking, FES) was established by law on 21 December 1995. Its purpose is to finance investment projects that aim to improve the infrastructure in the Netherlands. It identifies five focal areas, including traffic and transport as well as technology-, telecommunication- and knowledge infrastructure. In the recent past, two main projects stand out that have been funded from the FES: The High Speed Train (Hoge Snelheidslijn, HSL) that will connect Amsterdam with Brussels and the Betuwelijn, a freight train between Rotterdam and Germany. Both railways are planned to be operational from 2007 onwards. Other projects include investments aimed at solving traffic jams, the introduction of bio-fuels, the change-over to sustainable energy supply and soil sanitation.

The FES receives funding from several sources. Its primary source is gas receipts. Just over 40% of direct gas receipts[20] are transferred to the FES, amounting to EUR 3.4 billion in 2006. Furthermore, the fund receives the structural savings of government interest expenditure from the sale of assets, corrected for the expected loss in future dividends. Other miscellaneous funding

[20] Gas receipts excluding corporate tax receipts from the natural gas sector.

sources include an annuity based on the auctions of radio and UMTS frequencies. In total, funding from sources other than gas receipts amounted EUR 0.5 billion in 2006.

The Fund has a multi-annual character. In case funds are not spent in any given year, they remain dedicated to the FES and can be spent in subsequent years. At the end of 2006, EUR 3.7 billion, or 0.7% of GDP remains in the fund up from EUR 2.5 billion (0.5% of GDP) in 2005. According to ESA95 rules, the FES is part of the central government; therefore the build-up of funds improves the general government balance. Conversely, if in subsequent years these accumulated funds are ran-down, this will worsen the general government balance in those years.

In recent years, the FES has known some spurious use, mainly derived from the fact that it is outside the medium-term expenditure framework (See Section 2.4). On several occasions, planned outlays that were already funded from regular budgets but were also eligible for the FES, were reclassified to FES investments. This effectively got around national expenditure rules by allowing for increased spending in departmental budgets. Moreover, until recently the eligibility of investment projects was only judged against very broad concepts, which resulted in the funding of several projects that arguably had no clear relation with the improvement of the economic structure and hence should be funded from departmental budgets. Most recently, in the budget for 2007, the State decided to borrow EUR 1 billion from the FES in 2007 in order to pre-finance a reduction in the tax burden that will be funded from 2009 onwards with the reduction in Dutch contribution to the EU budget. Although these operations are neutral with respect to the general government balance in ESA95 terms, they circumvented national budgetary rules.

Several suggestions have been made to change the functioning of the FES in light of the above-mentioned challenges. Most recently, the study group on the budget margin (Studiegroep Begrotingsruimte)[21] advised to improve the management of the FES, tighten eligibility requirements for investment projects and change its funding into a multi-annual system.

In 2003, the Dutch government set a target to reduce the administrative burden on enterprises by 25%, or EUR 4 billion, by 2007. This policy goal has since been internationally recognised as a best practice, for instance in the latest Annual Progress Report by the Commission on the implementation of the National Reform Programme in the context of the Lisbon strategy. The programme indicates that the Netherlands is on track to reach this target, with further measures to be implemented in the remainder of 2006 and in 2007. Even if substantial progress has been made towards this policy goal, as indicated in the programme, to date only a EUR 2.3 billion reduction has been realised.

With respect to mortgage deductibility[22], the programme indicates that in 2003 steps have been taken to reduce it. These steps include limiting the time frame of mortgage deductibility to 30 years and are welcome, but should be considered limited. After all, mortgage deductibility for owner-occupied housing remain possible at the marginal tax rate, is without any upper bounds, and is only reduced after 30 years. In order to extend the tax base in the medium run, an abolition of mortgage interest deductibility is warranted, which would also improve the sustainability of public finances. Such an abolition should follow a gradual approach, needed to avoid short-term disruptions in the housing market.

21 Studiegroep Begrotingsruimte, *Vergrijzing en Houdbaarheid*, 12e rapport, June 2006.

22 See the European Commission (2005), European Economy, 'Public finances in EMU – 2005'.

The programme highlights measures in the area of labour participation. Among these, the recently introduced limitations on the fiscal incentives for early retirement are welcome. However, the impact on labour force participation is substantially mitigated by the length of transitional arrangements and by the possibility to partly use existing tax facilities for pension saving to indirectly fund early retirement. Another factor aimed at improving labour participation is the decision to introduce a mandatory contribution by employers to cover part of the costs of child care facilities from 2007 onwards, amounting to EUR 0.5 billion. This is an improvement over the voluntary system that was in place before, as it avoids possible cost increases for parents which might hinder labour participation. However, in order to help raise the participation rate of women, not only the costs of childcare are important, but also guarantees regarding quality and flexibility of child care.

The programme only briefly touches upon the changes to the corporate tax system that will come into effect in 2007. These changes entail a reduction in corporate tax rates from 29.6% to 25.5%. For profits below EUR 25,000, the rate is lowered by 5.5 percentage points to 20%. This significant reduction in tax rates is accompanied by a reduction in tax deduction possibilities, tightening of depreciation rules and limiting the possibilities of inter-temporal compensation of losses. Hence, the tax base is simultaneously expanded, limiting the overall budgetary effect of the measure. Furthermore, in the new system expected profits on unfinished products are taxed while in the old system, profits have to be declared only when they are final. The estimated structural effect on the tax burden on corporations will be a net relief of around 0.1% of GDP.

Finally, the programme indicates that the system of budgetary rules that applies to large sections of central government (a broad outline of these rules is provided in Section 2.4) does not apply to other layers of government. Triggered by the unforeseen deficit of local governments of 0.6% of GDP in 2003, that contributed to the Netherlands entering the excessive deficit procedure, the government concluded an administrative arrangement between on the one hand the central government and on the other hand the other government layers. These changes entail a close monitoring of the expenditures of local government entities facilitated by an expansion in data provisions requirements of local governments. The parties involved monitoring of the local government's deficits to ensure that in aggregate they do not amount to more that 0.5% of GDP. This arrangement is welcome as it improves budgetary discipline at a level of local governments and will allow for early intervention in case local government deficits threaten the general government balance significantly.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The measures in the stability programme appear fully in line with the National Reform Programme and the progress recorded in the Implementation Report thereof submitted in September 2006 in the context of the renewed Lisbon strategy for growth and jobs, despite the lack of detail in the description of the measures in the programme. Both the Implementation Report and the latest update of the stability programme report measures that have already been implemented as well as the measures in the budget for 2007. Furthermore, both reports regard the sustainability of public finances in light of population ageing a challenge for the Dutch economy. In Section 5.2, it is concluded that the Netherlands appears overall to be at low risk with regard to sustainability of public finances. The stability programme does not contain a qualitative assessment of the overall impact of the National Reform Programme (NRP) within the medium term fiscal strategy, nor does it contain detailed information on the direct budgetary costs (or savings) associated with the main reforms envisaged in the NRP. However, the degree of integration is considered to be high as both documents seem to reflect the same measures.

Box 5: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of the Netherlands, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 20 September 2006. The Commission's assessment of this report, which was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows.

The Netherlands is making good progress with the implementation of its National Reform Programme, which identified improving labour supply; achieving faster growth in labour productivity, innovation and education; and improving price competitiveness, in particular by containing labour costs as key challenges. While there are certain risks in the macro area, notably with regard to household indebtedness and potential wage inflation due to the tightening of the labour market, overall the policy framework is appropriate. Despite only moderate progress on R&D, the Netherlands is generally moving ahead significantly in the micro-economic field. Notwithstanding high headline employment rates for most groups, the picture in the employment field is more mixed. The Netherlands is reinforcing its National Reform Programme to respond to the commitments made by the 2006 Spring European Council but further steps will be needed.

Among the strengths of the Dutch National Reform Programme and its implementation are: the measures to boost competition; the application of the Standard Cost Model for measuring administrative burdens and the scheme for innovation vouchers, both of which being widely taken up by other Member States; measures on reforming pensions, health insurance and disability schemes and reforms aimed at raising educational attainment, expanding lifelong learning and creating better links between education and the labour market.

The policy area in the Dutch National Reform Programme where weaknesses need to be tackled with the highest priority is in improving labour supply. Against this background, it is recommended that the Netherlands takes further measures to improve labour supply, notably of older workers, women and disadvantaged groups. In addition, it will be important for the Netherlands over the period of the National Reform Programme to focus on: measures to increase private sector R&D expenditure; further action to fully meet the commitments agreed by the 2006 Spring European Council. In addition, if existing measures do not over time succeed in significantly raising overall hours worked in the economy, further incentives will need to be considered.

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the stability programme is broadly consistent with the broad economic policy guidelines.

Table 2: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].		X		
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.				X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X			
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X			

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

* * *

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance*, *primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt*.

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	505.6	1.5	3¼	3	1¾	1¾
2. Nominal GDP	B1*g	505.6	3.2	4¾	4¾	3¼	3¼
Components of real GDP							
3. Private consumption expenditure	P.3	247.1	0.3	-1¼	2	1¼	1¼
4. Government consumption expenditure	P.3	121.8	0.3	9	2¼	1½	1½
5. Gross fixed capital formation	P.51	97.7	3.6	4¾	4	1¾	1¾
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	0.1	-0.2	¼	½	½	¼
7. Exports of goods and services	P.6	353.6	4.8	6¾	6¼	6	6
8. Imports of goods and services	P.7	314.6	4.3	6¾	6½	6	6
Contributions to real GDP growth							
9. Final domestic demand		466.7	1.2	2.5	2.2	1.6	1.6
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-1.2	-0.1	0.3	0.6	0	0
11. External balance of goods and services	B.11	40.0	0.3	0.3	0.2	0.1	0.1

Table 1b. Price developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		100	1.7	1¾	1¾	1½	1½
2. Private consumption deflator		100	1.6	2¼	2	1½	1½
3. HICP[1]		100	1.5	1½	1¾	1¾	1¾
4. Public consumption deflator		100	2.2	1	2	2½	2½
5. Investment deflator		100	1.1	1½	1¼	¾	¾
6. Export price deflator (goods and services)		100	2.9	3¾	1¼	-1½	-1½
7. Import price deflator (goods and services)		100	3.1	4½	1¼	-1¾	-1¾

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		6918	0.0	2	2	¼	¼
2. Employment, hours worked[2]		11,1	-¼	1¾	1½	¼	¼
3. Unemployment rate (%)[3]		483000	4.7	4	3¼	3¼	3¼
4. Labour productivity, persons[4]		61.6	3¼	2½	2¾	1½	1½
5. Labour productivity, hours worked[5]			2.6	4½	3¾	1½	1½
6. Compensation of employees	D.1	252.2	1.7	1½	2¼	3¼	3¼

[1]Occupied population, domestic concept national accounts definition.
[2]National accounts definition.
[3]Harmonised definition, Eurostat; levels.
[4]Real GDP per person employed.
[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis rest of the world	B.9	6.9	6.9	6.7	7.1	7.5
of which:						
- Balance on goods and services		7.7	7.6	7.6	7.8	8.0
- Balance of primary incomes and transfers		-0.5	-0.4	-0.6	-0.4	-0.2
- Capital account[1]		-0.3	-0.3	-0.3	-0.3	-0.3
2. Net lending/borrowing of the private sector	B.9	7.3	6.8	6.5	6.8	6.6
3. Net lending/borrowing of general government	EDP B.9	-0.3	0.1	0.2	0.3	0.9
4. Statistical discrepancy		0.1	0	0	0	0

[1]Based on Autumn forecasts of 6 November 2006. For 2009 a technical extrapolation of the historical trend.

Table 2. General government budgetary prospects

	ESA code	2005 Level	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	-1430	-0.3	0.1	0.2	0.3	0.9[3]
2. Central government	S.1311	691	0.1	0.3	0.7	0.6	1.1
3. State government	S.1312	M	M	M	M	M	M
4. Local government	S.1313	-1597	-0.3	-0.3	-0.3	-0.3	-0.3
5. Social security funds	S.1314	-524	-0.1	0.0	-0.3	0.0	0.0
General government (S13)							
6. Total revenue	TR	228337	45.2	46.4	45.8	45.9	46.2
7. Total expenditure	TE[1]	229857	45.5	46.3	45.6	45.6	45.3
8. Net lending/borrowing	EDP B.9	-1430	-0.3	0.1	0.2	0.3	0.9
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	11963	2.4	2.3	2.2	2.1	2.0
p.m.: 9a. FISIM		660	0.1	0.1	0.1	0.1	0.1
10. Primary balance	[2]	10533	2.1	2.4	2.4	2.4	2.9
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		24.6	24.9	25.1	25.1	25.1	24.6
11a. Taxes on production and imports	D.2	12.6	13.0	12.9	12.9	12.9	12.6
11b. Current taxes on income, wealth, etc	D.5	11.6	11.6	11.9	11.9	11.9	11.6
11c. Capital taxes	D.91	0.3	0.3	0.3	0.3	0.3	0.3
12. Social contributions	D.61	14.1	15.6	14.9	14.9	14.9	14.1
13. Property income	D.4	2.3	2.9	3.0	3.2	3.1	2.3
14. Other (14=15-(11+12+13))		4.2	3.0	2.8	2.7	3.1	4.2
15=6. Total revenue	TR	45.2	46.4	45.8	45.9	46.2	45.2
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]		38.7	40.5	40.0	40.0	40.0	38.7
Selected components of expenditure							
16. Collective consumption	P.32	53449	10.6	10.6	10.5	10.5	10.5
17. Total social transfers	D.62+D.63	124485	24.6	26.2	26.0	26.0	26.0
17a. Social transfers in kind	P.31=D.63						
17b. Social transfers other than in kind	D.62						
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	11963	2.4	2.3	2.2	2.1	2.0
19. Subsidies	D.3	6306	1.2	1.2	1.2	1.2	1.2
20. Gross fixed capital formation	P.51	16136	3.2	3.1	3.0	3.0	3.0
21. Other (21=22-(16+17+18+19+20))		17518	3.5	2.9	2.7	2.8	2.6
22=7. Total expenditure	TE[1]	229857	45.5	46.3	45.6	45.6	45.3
p.m.: Compensation of employees	D.1						

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[3]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[4]Including one-off of 0.3% GDP due to the receipt in 2009 of restitution EU own recources *[sic]* for the years 2007 and 2008

Table 3. General government expenditure by function

% of GDP	COFOG Code	2004	2009
1. General public services	1	8.0	
2. Defence	2	1.4	
3. Public order and safety	3	1.8	
4. Economic affairs	4	4.7	
5. Environmental protection	5	0.8	
6. Housing and community amenities	6	1.2	
7. Health	7	4.4	
8. Recreation, culture and religion	8	1.4	

9. Education	9	5.2	
10. Social protection	10	17.4	
11. Total expenditure (=item 7=26 in Table 2)	TE[1]	46.3	

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009
1. Gross debt[1]		52.7	50.2	47.9	46.3	44.2
2. Change in gross debt ratio		+0.1	-2.5	-2.3	-1.6	-2.1
Contributions to changes in gross debt						
3. Primary balance[2]		-2.1	-2.4	-2.4	-2.4	-2.9
4. Interest expenditure (incl. FISIM)[3]		2.4	2.3	2.2	2.1	2.0
5. Stock-flow adjustment		-0.2	-2.4	-2.1	-1.3	-1.2
of which:						
- Differences between cash and accruals[4]		0.3	0.4	0.2	0.2	0.2
- Net accumulation of financial assets[5]		1.1	-0.5	-0.1	0.1	0.1
of which:						
- privatisation proceeds						
- Valuation effects and other[6]		-1.6	-2.3	-2.3	-1.5	-1.5
(of which denominator effect)[9]		(-1.6)	(-2.3)	(-2.3)	(-1.5)	(-1.5)
p.m.: implicit interest rate on debt[7]		4.4	4.3	4.3	4.3	4.3
Other relevant variables						
6. Liquid financial assets[8]						
7. Net financial debt (7=1-6)						

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. Item 10 in Table 2.

[3]Cf. Item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

[9] Extra line vis-à-vis code of conduct tables.

Table 5. Cyclical developments

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Real GDP growth (%)		1.5	3¼	3	1¾	1¾
2. Net lending of general government	EDP B.9	-0.3	0.1	0.2	0.3	0.9[1]
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 incl. FISIM	2.4	2.3	2.2	2.1	2.0
4. Potential GDP growth (%)		1.8	2.1	2.1	2.0	1.9
contributions:						
- labour		0.4	0.6	0.5	0.3	0.4
- capital		0.6	0.6	0.7	0.7	0.7
- total factor productivity		0.9	0.9	0.9	0.9	0.9
5. Output gap		-1.7	-0.7	0.2	0.0	-0.2
6. Cyclical budgetary component		0.9	0.3	-0.2	0.0	0.1
7. Cyclically-adjusted balance (2-6)		0.6	0.4	0.0	0.3	0.7[2]
8. Cyclically-adjusted primary balance (7-3)		3.0	2.7	2.2	2.4	2.7

[1]Including one-off of 0.3% GDP due to the receipt in 2009 of restitution EU own recources *[sic]* for the years 2007 and 2008

[2]Excluding one-off of 0.3% GDP due to the receipt in 2009 of restitution EU own recources *[sic]* for the years 2007 and 2008

Table 6. Divergence from previous update

	ESA Code	2005	2006	2007	2008	2009
Real GDP growth (%)						
Previous update		¾	2½	2½	2¼	-
Current update		1.5	3¼	3	1¾	1¾
Difference		+¾	+¾	+½	-½	-
General government net lending (% of GDP)	EDP B.9					
Previous update		-1.2	-1.5	-1.2	-1.1	-
Current update		-0.3	0.1	0.2	0.3	0.9

Difference		+0.9	+1.6	+1.4	+1.4	-
General government gross debt (% of GDP)						
Previous update		54.4	54.5	53.9	53.1	-
Current update		52.7	50.2	47.9	46.3	44.2
Difference		-1.7	-4.3	-6.0	-6.8	-

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure[1]		46.1	46.2	48.0	50.3	51.4
Of which: age-related expenditures		20.5	20.6	22.4	24.7	25.8
Pension expenditure		7.4	7.6	9.0	10.7	11.2
Social security pension		1.7	1.5	1.5	1.5	1.5
Old-age and early pensions		4.8	5.2	6.7	8.6	9.4
Other pensions (disability, survivors)		2.6	2.4	2.3	2.1	1.9
Occupational pensions (if in general government)		4.8	4.7	5.8	7.7	8.7
Health care		6.1	6.3	6.7	7.1	7.4
Long-term care *(this was earlier included in health care)*		0.5	0.5	0.5	0.8	1.1
Education expenditure		4.8	4.7	4.6	4.6	4.6
Other age-related expenditures		0	0	0	0	0
Interest expenditure						
Total revenue[1]		44.4	44.0	43.5	43.5	42.8
Of which: property income		2.3	1.9	1.4	1.4	0.7
of which: from pensions contributions (or social contributions if appropriate)		4.0	4.0	4.0	4.0	4.0
Pension reserve fund assets		140.8	159.0	196.1	230.5	241.9
Of which: consolidated public pension fund assets (assets other than government liabilities)		0	0	0	0	0
Assumptions						
Labour productivity growth		0.8	1.7	1.7	1.7	1.7
Real GDP growth		1.4	2.1	1.6	1.3	1.7
Participation rate males (aged 15-64)[2]		84.0	83.1	82.8	82.2	83.2
Participation rates females (aged 15-64)[2]		70.1	72.4	75.4	76.3	77.7
Total participation rates (aged 15-64)[2]		77.1	77.8	79.1	79.3	80.5
Unemployment rate		3.5	3.2	3.2	3.2	3.2
Population aged 65+ over total population		20.7	22.2	29.2	37.2	40.6

[1] These figures have not been published by the AWG. The method is known from the sustainability report 2006: the non-age related revenues and expenditures are kept constant at the 2005 level (taken from tabel a.3.5 of Public Finance Report 2006). Therefore, in this table the non-age related revenues and expenditures are set equal to the 2005 level from the latest economic outlook (MEV 2007). The age related revenues and expenditures are then added to reach the grand total.
[2]In the Code of conduct the age limits are 20-64

Table 8. Basic assumptions

	2005	2006	2007	2008	2009
Short-term interest rate[1] (annual average)	2.2	3	3½	3½	3½
Long-term interest rate (annual average)	3.4	4	4¼	4¼	4¼
USD/€ exchange rate (annual average)	1.24	1.24	1.25	1.30	1.34
Nominal effective exchange rate	-0.4	-¼	¼	1	1
World GDP growth[2]	4.7	5¼	4½	4½	4½
World excluding EU, GDP growth	5.5	6	5	5	5
EU GDP growth	1.5	2½	2¼	2	2
Growth of relevant foreign markets[3]	7.4	9¼	8¾	5¾	5¾
World import volumes, excluding EU	9.4	10.5	10.4	8.25	8.25
Oil prices (Brent, USD/barrel)	54.4	68	70	68	65

[1]If necessary, purely technical assumptions.
[2] Extra line vis-à-vis code of conduct table
[3] Taken to be equivalent to the Dutch "relevant wereldhandelsvolume"

Annex 3: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].	X		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.	X		
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.		X	
Significant divergences between the national and the Commission services' economic forecasts are explained[2].			Not applicable
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		

Guidelines in the code of conduct	Yes	No	Comments
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.		X	Only limited information on the effects of changes in main economic assumptions is provided
In case of "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.		X	
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.		X	
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		

Notes:
[1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.
[2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

The Netherlands - Key economic indicators

	Averages			2003	2004	2005
	1996–2005	1996–2000	2001–2005			
Economic activity						
Real GDP (% change)	2.6	4.0	1.2	0.3	2.0	1.5
Private consumption (% change)	2.6	4.4	0.8	-0.2	0.6	0.7
Government consumption (% change)	2.0	1.8	2.2	2.9	0.1	0.3
Investment (% change)	3.0	6.6	-0.6	-1.5	-0.8	3.6
Exports (% change)	6.2	8.8	3.6	1.5	8.0	5.5
Imports (% change)	6.4	9.5	3.2	1.8	6.4	5.1
Contributions to real GDP growth:						
Domestic demand	2.3	4.0	0.7	0.4	0.4	0.8
Net exports	0.2	0.0	0.5	-0.1	1.4	0.7
Output gap (% of potential GDP)	0.2	1.1	-0.7	-1.8	-1.7	-2.0
Prices and costs						
HICP inflation (% change)	2.4	1.9	2.8	2.2	1.4	1.5
Unit labour costs (% change)	2.2	1.9	2.5	2.7	0.3	-0.3
Labour productivity (% change)	1.5	1.5	1.5	1.4	3.4	1.8
Real unit labour costs (% change)	-0.3	-0.5	-0.2	0.5	-0.4	-2.0
Comparative price levels (EUR25=100)	106.2	105.7	106.6	108.2	106.5	106.4
Labour market						
Employment (% change)	1.4	2.6	0.2	-0.5	-0.9	0.0
Employment (% of working age population)	73.7	72.1	75.2	75.3	74.4	74.4
Unemployment rate (% of labour force)	3.9	4.1	3.6	3.7	4.6	4.7
NAIRU (% of labour force)	3.6	4.1	3.0	3.0	3.2	3.2
Participation rate (% of working age population)	76.5	75.1	78.0	78.1	78.0	78.0
Working age population (% change)	0.4	0.4	0.4	0.4	0.2	0.1
Competitiveness and external position						
Real effective exchange rate (% change) (1)	0.3	-1.5	2.2	4.6	0.3	-1.6
Export performance (% change) (2)	-	-	-	-	-	-
External balance of g & s (% of GDP)	5.9	5.1	6.7	6.3	7.2	7.7
External balance (% of GDP)	5.4	4.5	6.4	5.9	8.4	6.8
FDI inflow (% of GDP)	7.3	8.6	6.0	4.0	0.1	7.1
Public finances						
Total expenditure (% of GDP)	46.4	46.8	46.1	47.1	46.3	45.5
Total revenue (% of GDP)	45.5	46.4	44.6	43.9	44.5	45.2
General government balance (% of GDP)	-0.9	-0.3	-1.5	-3.1	-1.8	-0.3
General government debt (% of GDP)	58.1	64.6	51.7	52.0	52.6	52.7
Structural budget balance (% of GDP) (3)	-	-	-	-2.1	-1.1	0.9
Financial indicators (4)						
Short term real interest rate (%) (5)	0.6	1.0	0.1	0.1	1.4	0.5
Long term real interest rate (%) (5)	2.2	2.9	1.6	1.9	3.3	1.7
Household debt (% change) (6)	12.6	15.0	10.1	10.9	8.0	11.0
Corporate sector debt (% change) (7)	6.6	10.4	2.9	0.8	-1.2	6.4
Household debt (% of GDP) (6)	89.3	75.9	102.8	103.1	108.6	117.3
Corporate sector debt (% of GDP) (7)	92.2	88.8	95.7	95.6	92.0	95.3

Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source: Commission services;Eurostat

Euro area-key economic indicators

	Averages			2003	2004	2005
	1996–2005	1996–2000	2001–2005			
Economic activity						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption (% change)	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption (% change)	1.7	1.7	1.8	1.8	1.2	1.4
Investment (% change)	2.6	4.3	1.0	1.0	2.1	2.7
Exports (% change)	5.8	8.1	3.5	1.1	6.8	4.2
Imports (% change)	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth:						
Domestic demand	2.0	2.7	1.3	1.4	1.8	1.7
Net exports	0.1	0.0	0.1	-0.7	0.2	-0.3
Output gap (% of potential GDP)	-0.1	-0.2	0.1	-0.5	-0.3	-0.9
Prices and costs						
HICP inflation (% change)	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs (% change)	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity (% change)	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	73.6	73.9	73.2	73.2	72.9	72.7
Labour market						
Employment (% change)	1.2	1.5	0.9	0.7	0.7	0.8
Employment (% of working age population)	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate (% of labour force)	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU (% of labour force)	8.7	9.0	8.5	8.5	8.4	8.3
Participation rate (% of working age population)	69.9	68.5	71.2	71.4	71.7	71.8
Working age population (% change)	0.3	0.2	0.4	0.5	0.5	0.4
Competitiveness and external position						
Real effective exchange rate (% change) (1)						
Export performance (% change) (2)	-	-	-	-	-	-
External balance of g & s (% of GDP)	1.9	1.7	2.0	2.1	2.1	1.5
External balance (% of GDP)	-	-	-	-	-	-
FDI inflow (% of GDP)						
Public finances						
Total expenditure (% of GDP)	48.1	48.5	47.7	48.2	47.5	47.5
Total revenue (% of GDP)	45.8	46.4	45.1	45.1	44.7	45.1
General government balance (% of GDP)	-2.3	-2.1	-2.5	-3.0	-2.8	-2.4
General government debt (% of GDP)	70.8	72.3	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	-	-	-	-3.2	-2.9	-2.2
Financial indicators (4)						
Short term real interest rate (%) (5)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (%) (5)	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% change) (6)						
Corporate sector debt (% change) (7)						
Household debt (% of GDP) (6)						
Corporate sector debt (% of GDP) (7)						

Notes:

(1) Unit labour costs relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temprary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source: Commission services; Eurostat

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[23].

Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[24]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon'_{T_i,B_i}\varepsilon'_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon'_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon'_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

23 Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

24 The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i\,ex\,ante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i\,ex\,post}\frac{dB_i}{B_i}$.

then $d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i \varepsilon_{B_i,Y} + \beta_i \varepsilon_{T_i,B_i} + \alpha_i \beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i \varepsilon_{B_i,Y} \frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i \varepsilon_{T_i,B_i} \frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i \beta_i \frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i \varepsilon_{T_i B_i} \varepsilon_{B_i Y}$ with w_i the share of the *i-th* tax in the overall tax burden.

Assessment of tax projections by major tax category

	2007			2008			2009
	SP	**COM**	**OECD[1]**	**SP**	**COM[2]**	**OECD[1]**	**SP**
Taxes on production and imports:							
Change in tax-to-GDP ratio	-0.1	-0.2	0.0	0.0	-0.1	0.0	0.0
Difference SP – COM	0.1			0.1			/
of which[3]:							
- discretionary & elasticity component	0.1			0.1			/
- composition component	0.0			0.0			/
Difference COM – OECD	/	-0.2		/	-0.1		/
of which[3]:							
- discretionary & elasticity component	/	-0.1		/	0.0		/
- composition component	/	-0.1		/	0.0		/
p.m.: Elasticity							
- of taxes to tax base[4]	1.0	0.9	1.0	1.2	1.0	1.0	1.2
- of tax base[4] to GDP	0.8	0.8	1.0	0.9	0.9	1.0	0.9
Social contributions:							
Change in tax-to-GDP ratio	-0.7	-0.5	-0.3	0.0	-0.3	-0.2	0.0
Difference SP – COM	-0.3		/	0.3		/	/
of which[3]:							
- discretionary & elasticity component	-0.3		/	0.1		/	/
- composition component	0.0		/	0.1		/	/
Difference COM – OECD	/	-0.1		/	-0.1		/
of which[3]:							
- discretionary & elasticity component	/	-0.2		/	0.0		/
- composition component	/	0.1		/	0.1		/
p.m.: Elasticity							
- of taxes to tax base[5]	0.0	0.5	0.8	0.9	0.7	0.8	0.9
- of tax base[5] to GDP	0.9	0.9	0.7	1.1	0.9	0.7	1.1
Personal income tax[6]:							
Change in tax-to-GDP ratio	0.2	0.2	0.3	0.0	0.1	0.2	0.0
Difference SP – COM	0.0		/	-0.1		/	/
of which[3]:							
- discretionary & elasticity component	0.0		/	-0.2		/	/
- composition component	0.0		/	0.1		/	/
Difference COM – OECD	/	-0.1		/	-0.1		/
of which[3]:							
- discretionary & elasticity component	/	-0.2		/	-0.3		/
- composition component	/	0.2		/	0.2		/
p.m.: Elasticity							
- of taxes to tax base[5]	1.7	1.7	2.4	0.9	1.4	2.4	0.9
- of tax base[5] to GDP	0.9	0.9	0.7	1.1	0.9	0.7	1.1
Corporate income tax[6]:							
Change in tax-to-GDP ratio	0.1	0.1	0.1	0.0	0.0	0.1	0.0

Difference SP – COM	0.0		/	0.0		/	/
of which[3]:							
- discretionary & elasticity component	0.0		/	0.0		/	/
- composition component	0.0		/	0.0		/	/
Difference COM – OECD	/	-0.1		/	-0.1		/
of which[3]:							
- discretionary & elasticity component	/	-0.2		/	0.0		/
- composition component	/	0.1		/	0.1		/
p.m.: Elasticity							
- of taxes to tax base[7]	1.4	1.3	0.8	1.1	1.1	0.8	1.1
- of tax base[7] to GDP	1.1	1.1	0.7	0.9	1.1	0.7	0.9

Notes:
[1]Based on OECD ex-ante elasticity relative to GDP.
[2]On a no-policy change basis.
[3]The decomposition is explained in the text above.
[4]Tax base = private consumption expenditure.
[5]Tax base = compensation of employees.
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period.
[7]Tax base = gross operating surplus.

Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)