

Stability Programme
The Netherlands 1999 - 2002
2000 update

19 September 2000

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Executive summary

The present update of the 1999-2002 stability programme provides a description of the state of the Dutch economy, of Dutch policies and of Dutch public finance for the period from 1999 up to and including 2001, as presented in the budget, while also offering a vista of the financial position for the period 2002-2004. This is the first programme to note the achievement of a fiscal surplus. Moreover, this year will be the first since 1982 to see an EMU debt ratio below the reference value of 60% of GDP. In addition, two issues with longer-term implications are addressed: government investment and the consequences of the ageing population.

Although the risks are becoming more pronounced, there are no distinct signs of overheating. Against this background, 2001 will witness the continuation of existing policies, even more emphasis being put on the removal of (potential) impediments to growth. The expenditure frameworks will be maintained, so that expenditure will grow less strongly than the economy as a whole. In addition, within overall expenditure a higher priority has been assigned to components strengthening the economic structure, a move underlain in part by the conclusions of the European Council meeting in Lisbon. The tax reform – for which scope had been created in the longer-term budget framework – will be implemented in 2001, boosting the supply of labour. Although, under the formula for the allocation of fiscal windfalls and setbacks, the revenue side of the budget offers scope for larger tax cuts¹, the additional cuts in 2001 will be limited and will notably seek to stimulate the supply of labour by countering the so-termed poverty trap.² Next year, decisions will be taken about the magnitude and the design of the tax cuts, on the basis of the latest insights into economic conditions and public finance. Until that time, the unused proportion of the higher-than-estimated revenues which have arisen since 1999 relative to the *cautious* baseline projection, will benefit the EMU balance.

¹ Throughout this document, the term tax cuts, which is used for brevity, refers to cuts in taxation or cuts in social insurance contributions or a combination of the two.

² The poverty trap refers to the situation where persons on welfare at the lower end of the income scale have no or few incentives to seek work because working would not improve, or might even worsen, their overall income position.

Chart 1 EMU balance 199-2001 in 1999 and 2000 updates

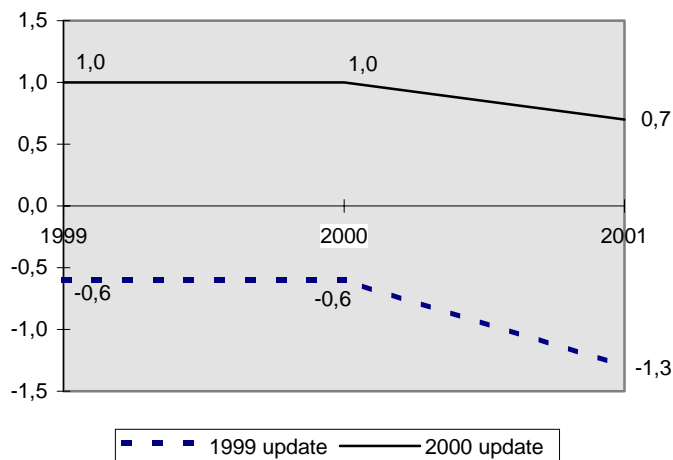
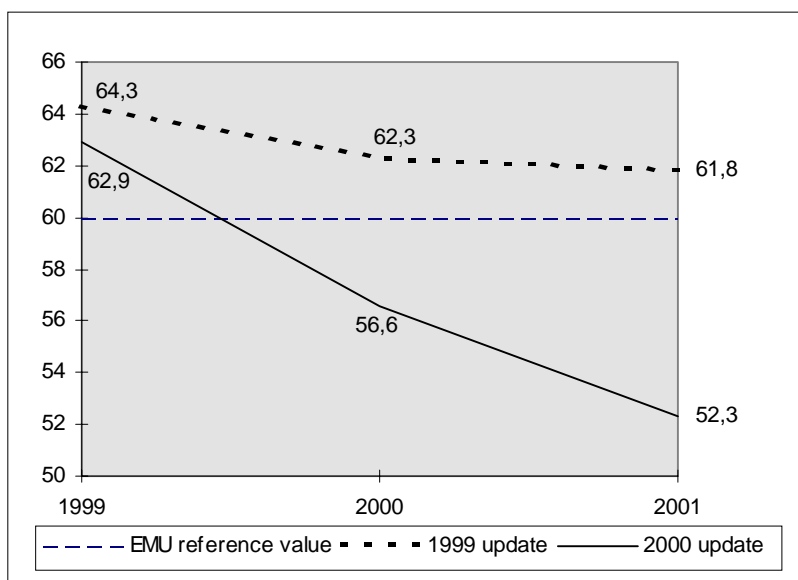


Chart 2 EMU debt ratio 1999-2001 in 1999 and 2000 updates



In the present update, as is shown in Charts 1 and 2, the pattern of public finance is much more favourable than it was expected to be at the time of the 1999 update. Meanwhile, it has become evident that in 1999 the Netherlands recorded the first fiscal surplus (1% of GDP) in twenty-five years' time, while 2000 (excluding 0.7% of GDP in proceeds from the auction of third-generation mobile phone licences) and 2001 (including tax cuts) are expected to see surpluses of 1.0% and 0.7% of GDP, respectively. This is in line with the Council opinion on the stability programme and with the Broad Economic Policy Guidelines, to the effect that a fiscal position of close to balance or in surplus should be attained before 2002. In the Netherlands, that position has now been achieved as early as in 1999. Furthermore, the EMU debt ratio will decrease much faster than expected earlier, dropping below the reference value of 60% of GDP in 2000 for the first time since 1982.

The projections for 2002 and subsequent years are more technical and are based on cautious assumptions. Nonetheless, even with *cautious* assumptions and a 50/50 division of any excess of actual over estimated revenues between tax cuts and debt reduction, a surplus is anticipated for

2002. The figures for 2003 and 2004 are likewise underlain by cautious assumptions. Since these years are beyond the period of office of the present Cabinet, unchanged policies have been assumed, and an implicit bandwidth is presented for the (incidentally positive) EMU balance.

Table 1 Estimated EMU balance and EMU debt 2002-2004 under cautious and favourable scenario

	2002	2003	2004
Cautious scenario			
GDP volume growth	2	2	2
EMU balance (% of GDP)	$\frac{1}{4}$	$\frac{1}{4}$	$\frac{1}{4}$
EMU debt (% of GDP)	$50\frac{3}{4}$	$48\frac{3}{4}$	$46\frac{3}{4}$
Margin (% of GDP)*		0	$\frac{1}{4}$
Favourable scenario			
GDP volume growth	$3\frac{1}{4}$	$3\frac{1}{4}$	$3\frac{1}{4}$
EMU balance (% of GDP)	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$
EMU debt (% of GDP)	$49\frac{1}{2}$	$47\frac{1}{4}$	$44\frac{3}{4}$
Margin (% of GDP)*		$\frac{1}{2}$	$1\frac{1}{4}$

* This is the margin available for higher expenditure, for tax cuts or for debt reduction, assuming a constant EMU balance relative to 2002.

The programme also addresses a number of developments with longer-run effects on the state of the Dutch economy and on Dutch public finance³. Suitably targeted investment may help remove impediments to economic growth, for instance in the area of mobility, and contribute to the further development of the Netherlands into a knowledge-driven economy. In addition, the ageing of the population has major consequences for the sustainability of public finance. Tentative calculations suggest an increase in expenditure on state old-age pensions and health care by about 8% of GDP in 2040. This higher expenditure is offset in part by higher revenues owing to the tax treatment of pension contributions and the funding of supplementary pensions. The higher revenues are not sufficient, however, to fully absorb the burdens consequent on the ageing population. By lowering interest expenditure through a reduction of public debt, a major contribution may be made towards the resolution of the ageing problem. Increasing the participation rate may serve to broaden the financial base for the public sector, thus simplifying debt reduction and creating scope for expenditure to strengthen the economic structure or, alternatively, for tax cuts.

³ For an overview of progress in the area of structural reform, reference is made to the Progress Report on Structural Reform, to be published shortly.

1 Introduction

This update of the Dutch stability programme addresses the financial and economic policies to be pursued in the period 2000-2004. The last two years of this period are beyond the term of office of the present Cabinet and are, therefore, beyond its responsibility. Hence, the data for the years 2003 and 2004 are highly technical, showing the pattern of public finance in the event of unchanged policies. Apart from providing some notes on the implementation of the budget in the current year and on the budget plans for next year, the present update also addresses the long-term sustainability of Dutch public finance and the changing composition of public expenditure. This update of the stability programme is based on the 2001 Budget Memorandum, as presented by the Government to Parliament on 19 September last. The envisaged policies in the financial and the socio-economic domains tally with the relevant agreements made by the three parties to the coalition government about expenditure and tax cuts, as laid down in the coalition agreement. Dutch financial and economic policies continue to be aimed at strengthening the country's economic structure. One of the instruments to that end is a stable and predictable fiscal policy. A key feature of the fiscal policy is the maintenance of the expenditure frameworks for the period 1999-2002, as they were laid down at the start of the period of office of the Cabinet. The expenditure frameworks are underlain by the cautious scenario employed within the Dutch budget system, making for a controlled development of expenditure. Higher-than-estimated revenues consequent on economic growth in excess of the rate assumed in the cautious scenario are used for tax cuts and for improving the EMU balance. Lower-than-estimated expenditure consequent on a higher economic growth rate may be used to intensify existing policies. The recommendation made in the Broad Economic Policy Guidelines 2000 to consider the use of expenditure frameworks in order to enhance expenditure control is evidence of the wide-ranging international recognition afforded to this policy. For an extensive description of the Dutch budget system, the reader is referred to last year's update of the stability programme.

2 The Dutch economy

2.1 Economic prospects

Since the previous update, economic prospects have improved further. The mild growth retardation which had been expected for 1999 as a consequence of the sharp slowdown of world trade in the second half of 1998 has been barely noticeable, if at all. Driven by a vigorous development of consumption and a remarkably rapid recovery of world trade, economic growth in 1999 was maintained at a relatively high level (3.9%). Meanwhile, the cyclical upswing spans more than eighteen quarters, the longest period of economic boom in the past fifty years. The latest economic forecasts of the Netherlands Bureau for Economic Policy Analysis⁴ suggest a continuation of the boom in 2000 and 2001. The economic growth rate forecast for 2000 (4½%) is the highest since 1989. Owing to the strong recovery of the European economy, exports perform exceptionally well. Coupled with the continued favourable movements in domestic expenditure (private consumption in particular), this makes for a positive economic outlook for 2000. Growing by 2½%, employment continues to develop well, causing unemployment to fall even slightly below the level anticipated in the previous update (3½% instead of 3¾%). Investment, too, shows substantial growth.

For 2001 the Netherlands Bureau for Economic Policy Analysis expects an economic growth rate of 4%. The growth of exports shows barely any weakening and closely follows the growth of world trade relevant to the Netherlands. Within domestic expenditure, the growth of private consumption continues. In the light of the growth of investment, production capacity, too, continues to grow at a robust pace. With productivity growth speeding up, employment growth is expected to weaken slightly to around 2¼%, reflecting increasingly tight conditions in certain segments of the labour market. Table 2.1.1 lists the principal economic key indicators.⁵ For comparison, the relevant figures for 2000 and 2001 from the European Commission's Spring Forecast are also given in the table. Where the external environment is concerned, the assumptions used differ to no more than a limited extent from those used by the Commission. The estimates for the dollar exchange rate and the oil price are almost identical. The movements in the volume of world trade, however, are estimated to be more favourable than in the Commission's forecast. The national forecasts for Dutch economic growth are slightly higher than those of the Commission. Notably for 2000, this is caused by more recent information about actual economic developments. The national forecast for employment is higher than the Commission's forecast; this is due to differences in definition.

Table 2.1.1 Macro-economic key indicators for the Netherlands

⁴ The Netherlands Bureau for Economic Policy Analysis is an independent government agency publishing short-term forecasts for the national and the international economy on a quarterly basis. The Government uses these economic forecasts when preparing and updating the budget.

⁵ For more information on the forecasts of the Netherlands Bureau for Economic Policy Analysis, the reader is referred to "Economic Outlook" in CPB report 2000/3 (on the Internet under http://www.cpb.nl/eng/pub/cpbreport/2000_3).

	1999	2000	2001	2000	2001	2002	2003	2004
	<i>Forecasts of the Netherlands Bureau for Economic Policy Analysis</i>			<i>European Commission's Spring forecast 2000</i>		<i>Cautious scenario</i>		
<i>International</i>								
Dollar exchange rate (in guilders)	2.07	2.30	2.20	2.25	2.25	2.05	2.05	2.05
Oil price (dollars per barrel)	17.9	26.5	24.0	24.2	21.2	17½	17½	17½
<i>Wages and prices (changes per annum)</i>								
Negotiated wage rates	2.5	3½	3½			2	2¼	2¼
Consumer price index	2.2	2½	3½	2.4	3.2	2½	1¾	1¾
Long-term interest rate	4.5	5½	5¾			6¼	6	6
Short-term interest rate	2,9	4¼	4¾			4	4	4
Price of GDP	1.7	2¾	3¾	2.4	3.4	2	1½	1½
<i>Expenditure and output (changes per annum)</i>								
Volume of world trade	4.2	9¾	8¾	8.1	7.2	4	4	4
Exports	6.3	9½	9	7.4	5.8	4	4	4
Private consumption	4.4	4¼	4½	3.9	3.9	2¼	1¾	1¾
Investment (excluding housing)	9.4	7	4¼	7.0	6.7	3	2¼	2¼
Volume of GDP	3.9	4½	4	4.1	3.7	2	2	2
<i>Labour market (changes per annum)</i>								
Employment (man-years)	2.9	2½	2¼	2.6	2.3	¾	¾	¾
Employment (persons)	2.8	2¼	2			1	1	1
Unemployment (% of labour force)	4,0	3½	3	2.4	2	3	3	3

Source: Macro-Economic Forecast 2000, Netherlands Bureau for Economic Policy Analysis (August 2000) and Spring 2000 Forecast for 2000 – 2001, European Commission (April 2000).

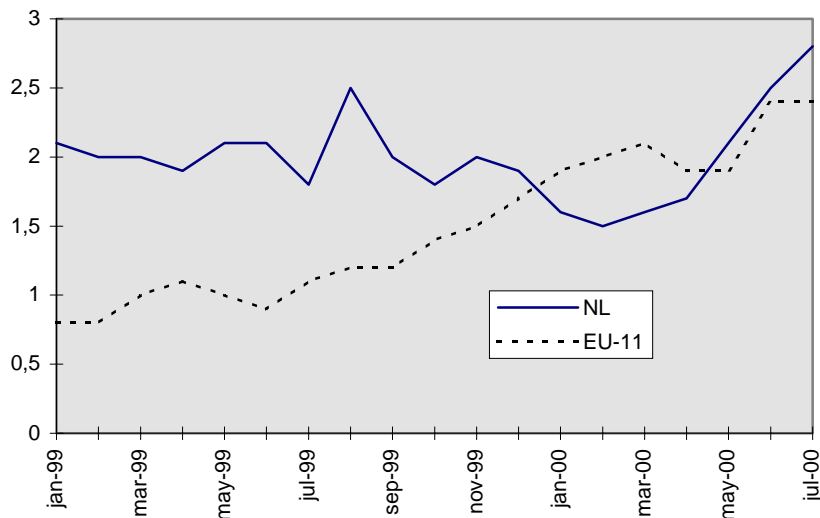
Table 2.1.1 also includes the assumed values of the economic key indicators for the years 2002 up to and including 2004. In accordance with the Dutch budget system, these values reflect a cautious economic growth scenario. Hence, there is an essential difference from the *expected* economic growth rates for 2000 and 2001. It is stressed that the cautious scenario for 2002 does not embody any expectations about economic developments in that year, but merely represents a technical assumption in budget planning. Using a cautious scenario as the basic assumption serves to make sure that, even in the event of economic setbacks, envisaged measures to intensify existing policies are securely covered and can, hence, be put into effect. The way in which actual deviations from the cautious scenario will be used or absorbed is based on predefined rules. Such a rule-based policy makes for calm and predictability in the annual budget cycle. The use of cautious economic assumptions is a key feature of the Dutch fiscal philosophy and has been instrumental in achieving the favourable outturns for public finance in recent years.

Of the three years 2002-2004, the last two are beyond the term of office of the present Cabinet. For these years, no forecasts are as yet available on the basis of a new, consistent macro-economic scenario. The values for the macro-economic variables used for these years are based on averages from the earlier cautious scenario for 1999-2002.

2.2 Recent economic position

The latest figures of Statistics Netherlands for economic growth in the second quarter of this year suggest a year-on-year growth rate of 4.1%. Thus far the signs which might suggest that the economy could be overheating have not been unequivocal. In the first half of this year, inflation was seen to go up, notably reflecting internationally higher energy prices. Compared to the euro area average, Dutch inflation has risen slightly since early 1999. During the past few months, Dutch inflation has moved around the euro area average. The forecast inflation rate for 2000 (2½%) has been depressed to the extent of one-half of a percentage point by the abolition of radio and television licence fees.

Chart 2.2.1 Average inflation in the Netherlands and Euro-11 (HICP, January 1999-July 2000)



Source: Eurostat.

For 2001 the Netherlands Bureau for Economic Policy Analysis forecasts the CPI to rise by 3½%.⁶ Of this, 1 percentage point is the result of the increase in indirect taxes in the context of the tax reform in 2001.⁷ At 1.9% in 1999, 2% in 2000 and 2¼% in 2001, underlying inflation (inflation excluding indirect taxes, energy and harvested products) is more moderate. These inflation figures do not constitute a clear indication of overheating; in the recent past the Netherlands recorded inflation rates of 2%-3% in periods marked by more subdued economic developments. Another traditional indicator of tension between supply and demand is the degree of capacity utilisation in manufacturing industry. At 84.2% in the second quarter of 2000, this indicator of tension in the product markets is below the peak recorded during the 1989-1990 boom (86.3%).

The labour market, however, is showing signs suggesting some tension, as evident from the level of unemployment, the number of unfilled vacancies and the movements in negotiated wage rates. Although estimates of equilibrium unemployment⁸ are marked by considerable margins of uncertainty, calculations of the Netherlands Bureau for Economic Policy Analysis suggest that the

⁶ Owing to differences in definition, the CPI and the HICP are not identical. For 2001 the Netherlands Bureau for Economic Policy Analysis forecasts the HICP to go up by 3¼%.

⁷ The 2001 tax reform is discussed in section 4.3.

⁸ That level of unemployment at which inflation is not yet pushed up.

current level of actual unemployment (255,000 persons) is below equilibrium unemployment. With actual unemployment declining further, the difference will, however, narrow in 2001, as the 2001 tax reform will depress equilibrium unemployment. In this context, it should be noted that the unemployment figure does not reflect the considerable labour potential that is still available. In the somewhat longer run, an additional number of over one million people (around 10% of the population aged 15-64) could be usefully employed in the labour market. One of the ways to achieve this is the reintegration of recipients of national assistance and incapacity for work benefits, representing a potential reservoir of some hundreds of thousands of people. Additionally, the reserve constituted by people who are currently not actively looking for a job or who wish to work longer hours could be used to advantage. The resilience of the labour market is, incidentally, evident from the fact that the increase in the number of economically active persons relative to the number of man-years has come to an end: because of the tight labour market conditions, people now work longer hours in their (part-time) jobs than they did a few years ago. The availability of a substantial reserve, over and above the unemployed labour force, coupled with the policy already initiated to stimulate the supply of labour, offers possibilities to absorb the tensions.

At 3½%, the increase in negotiated wage rates in 2000 is the most pronounced in recent years. In 2000 remuneration per worker goes up by 4¼% (2.9% in 1999); the increase in 2001 is likewise estimated at 4¼%. For 2001, such an increase would, incidentally, be broadly in line with the movements in inflation and labour productivity.

All in all, these mixed signals do not warrant the conclusion that the economy is overheating. Yet, the risk that, failing an adequate policy response, the Dutch economy will come up against capacity constraints is more pronounced than it was in the past. Against this background, the Government has adhered to the tax reform – strengthening as it does the economic structure – as announced in and financed in accordance with the coalition agreement, and has exercised restraint in deploying additional resources for tax cuts. Furthermore, labour market conditions have prompted various measures in the 2001 budget to stimulate the supply of labour (see section 4.3).

3 Movements in EMU balance and EMU debt

3.1 Estimates and outturns

In 1999 the EMU deficit turned into a surplus for the first time in twenty-five years. The fiscal surplus of 1% of GDP underlines the vast change that has been achieved within public finance. The outturn is as much as 1.6 percentage point better than the value expected in the 1999 update. This favourable development is a consequence of the budget system used and of the substantially higher-than-estimated revenues, which have been used to improve the EMU balance. The higher revenues are related to the fact that actual economic growth exceeded estimated growth by a considerable margin (3.9% against 2¾%). Moreover, the composition of economic growth was different, consumption being stronger and employment higher than expected. These factors contributed to boosting tax revenues by 0.5% of GDP, among other things from wage and corporation tax. One-off factors (within, for instance, dividend tax) caused the EMU balance to improve by 0.3% of GDP. In line with tax revenues, premiums received by the social security funds were also higher than expected, while the funds' expenditure was lower (total of 0.9% of GDP).

Table 3.1.1 EMU balance, by sector (% of GDP)

	1999	2000	2001
EMU balance, 1999 update	-0.6	-0.6	-1.3
• Central government	-1.7	-1.7	-2.1
• Social security funds	+0.8	+0.9	+0.5
• Local authorities	+0.3	+0.3	+0.3
EMU balance, 2000 update	1.0	1.0¹	0.7
• Central government	-0.5	-0.7 ¹	+0.4 ²
• Social security funds	+1.3	+1.4	+0.1 ²
• Local authorities	+0.2	+0.2	+0.2
Improvement	+1.6	+1.6	+2.0

¹ For comparability with the 1999 update, the one-off revenues from the auction of third-generation mobile phone licences (0.7% of GDP) have not been included.

² Shift between the central government and the social security funds owing to the tax reform and the phasing out of operating and financial surpluses at the social security funds.

The improvement in the EMU balance in 1999 does not represent a one-off development; on present views, the period 1999-2002 witnesses fiscal surpluses throughout, whereas the previous update still allowed for deficits.

In 2000 and 2001 the fiscal balance is expected to be much more favourable than anticipated last year. In these years, too, the improvement is attributable in large measure to stronger economic growth in relation to fiscal policy. At 0.3% of GDP, the decrease in the balance in 2001 is smaller than the 0.7% of GDP anticipated in the previous update, and is due to the tax cuts in the context of the 2001 tax reform. In line with the recommendations in the Broad Economic Policy Guidelines 2000, the decrease in the balance thus remains limited.

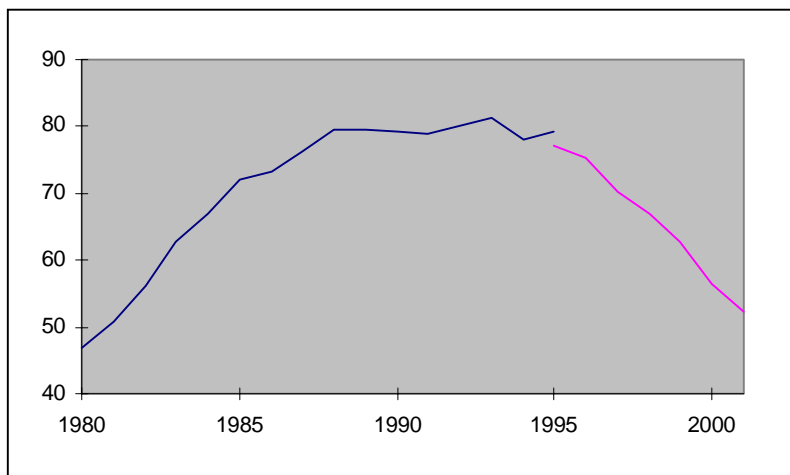
In 1999 the EMU debt ratio turned out to be 1½ percentage point lower than expected in the previous update. In 2000, for the first time since 1982, the debt-to-GDP ratio falls below the 60% reference value from the Maastricht Treaty. Compared to the previous update, the fall in the EMU debt ratio accelerates in 2001, since the present update no longer employs a cautious assumption for the economic growth rate in that year.

Table 3.1.2 EMU debt, by sector (% of GDP)

	1999	2000	2001
EMU debt, 1999 update	64.3	62.3	61.8
• Central government and social security funds	53.5	52.2	52.2
• Local authorities	10.7	10.1	9.6
EMU debt, 2000 update	62.9	56.6	52.3
• Central government and social security funds	52.2	47.0	43.5
• Local authorities	10.6	9.7	8.8
Difference	-0.5	-4.9	-8.8

On a longer-term view, the decrease in the EMU debt ratio is the mirror image of developments in the first half of the 1980s. Especially in the early 1980s fiscal deficits soared, causing the EMU debt ratio to go up between 1980 and 1984 by 20 percentage points. In the second half of the 1990s, the EMU debt ratio fell rapidly. Between 1996 and 2001 the fall totals over 20 percentage points of GDP.

Chart 3.1.1 Movements in the EMU debt ratio, 1980-2001^a (% of GDP)



^a Break in series in 1995 owing to revision of National Accounts, excluding proceeds from the auction of third-generation mobile phone licences in 2001.

3.2 Longer-term view and sensitivity analyses

At ¼% of GDP, the EMU balance in 2002, calculated on the basis of cautious assumptions regarding economic growth, turns out better – as does the balance in 2000 and 2001 – than in the previous update (-1% of GDP) but, viewed in isolation, developments relative to 2001 are less favourable than expected in the previous update. This is due to the reservation made for the assumed use of the remaining margin for tax cuts (around 0.8% of GDP), ensuing from the budgetary rules for the allocation of higher-than-estimated revenues (see section 4.2 on the tax burden). Moreover, the figures are underlain by a cautious economic growth assumption of 2%. At an economic growth rate of 3¼%, the 2002 surplus will be broadly equal to that in 2001 (see Table 3.2.1). On the basis of cautious assumptions, the EMU debt ratio comes out at 50¼% of GDP in 2002, whereas the 1999 update had anticipated a level of 61% of GDP.

Under the favourable economic growth scenario (3¼%), the EMU balance amounts to ½% GDP in 2002, which is broadly equal to that in 2001. The EMU debt ratio improves by about 2¾ percentage point. In these calculations, too, it has been assumed that the additional revenues ensuing from the higher growth rate in 2002 will be divided equally between debt reduction and tax cuts: 50% to reduce the debt and 50% to effect additional tax cuts. Next year, decisions will be taken about the magnitude and the design of the tax cuts, on the basis of the latest insights into economic conditions and public finance. Compared to the 1999 update, the fiscal outturns in 2002 in the present update are considerably better, both under the cautious and under the favourable scenario.

Table 3.2.1 Estimated EMU balance and EMU debt under cautious and under favourable scenario

	2002	2003	2004
Cautious scenario			
GDP volume growth	2	2	2
EMU balance (% of GDP)	$\frac{1}{4}$	$\frac{1}{4}$	$\frac{1}{4}$
EMU debt (% of GDP)	50 $\frac{1}{4}$	48 $\frac{3}{4}$	46 $\frac{3}{4}$
Margin (% of GDP)*	-	0	$\frac{1}{4}$
Favourable scenario			
GDP volume growth	3 $\frac{1}{4}$	3 $\frac{1}{4}$	3 $\frac{1}{4}$
EMU balance (% of GDP)	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$
EMU debt (% of GDP)	49 $\frac{1}{2}$	47 $\frac{1}{4}$	44 $\frac{3}{4}$
Margin (% of GDP)*	-	$\frac{1}{2}$	1 $\frac{1}{4}$

* This is the margin available for higher expenditure, for tax cuts or for debt reduction, assuming a constant EMU balance relative to 2002.

The years 2003 and 2004 are beyond the term of office of the present Cabinet. The fiscal projections for revenues and expenditure under both the cautious and the favourable scenario are based on the assumption of unchanged policies from 2002 onwards. Since the political priorities of the next Cabinet are not known, a constant EMU balance relative to 2002 has been assumed; it is stressed that this is a purely technical assumption. On this technical assumption as to the EMU balance, the margin has been ascertained which would, in the event of unchanged policies, be at the disposal of the next Cabinet for further reducing debt, increasing expenditure or reducing taxation. Under the cautious scenario, this margin is $\frac{1}{4}$ % of GDP. Under the favourable economic growth scenario, the margin available for the next Cabinet would, at $\frac{1}{2}$ % in 2003 and 1 $\frac{1}{4}$ % in 2004, be considerably larger than under the cautious scenario.

In order to gain an impression of the sensitivity of the Dutch fiscal outturns, the effects of changes in a number of economic key variables other than economic growth have also been ascertained. These analyses are based on calculations with the macro-economic model used by the Netherlands Bureau for Economic Policy Analysis for generating short-term forecasts, so that economic feed-through and feedback effects are included. A variant in which negotiated wage rates increase 1 percentage point faster than assumed in the 2001 budget shows that both expenditure and revenues go up by $\frac{1}{4}$ percentage point of GDP; in the short run the net effect on the EMU balance is neutral. In the longer run this net effect is negative owing to gradually deteriorating profitability and the increasing loss of employment.

Table 3.2.2 Sensitivity of the EMU balance to changes in economic variables (% of GDP)

	1 percentage point higher increase in negotiated wage rates	1 percentage point higher interest rate	USD 1 = NLG 2.40	Oil price = USD 30
Expenditure	+0.3	+0.1	+0.2	+0.1
Revenues	+0.3	0.0	+0.4	+0.2
EMU balance	0	-0.1	+0.2	+0.1

Sources: Central Economic Plan 2000 (April 2000) and Macro-Economic Forecast 2001 (August 2000), Netherlands Bureau for Economic Policy Analysis.

The variant based on a 1 percentage point higher long-term interest rate leads to a deterioration of the EMU balance by 0.1% of GDP. The higher dollar rate not only favourably affects economic activity through higher exports but it also leads to higher public sector revenues through higher income from natural gas. A higher oil price notably influences the EMU balance by way of higher revenues from natural gas.

4 Implementation of 2000 budget and draft 2001 budget

4.1 Expenditure

The lower expenditure on, for instance, social security benefits and interest payments (owing to better EMU balances) has created scope for other expenditure, allowing the Government to advance the implementation of policies already provided for in the coalition agreement and to develop new policies in line with the priorities set in said agreement. Yet, in the 2001 budget, too, the real expenditure ceilings established when the Cabinet took office, are maintained.

In the decision-making on adjustments to the 2000 budget and on the allocation of expenditure in the 2001 budget, allowance was also made for the objectives formulated at the European Council meeting in Lisbon. In quantitative terms, the principal measures to intensify existing policies are to be found in the domains of education and health care, but considerable spending impulses are also provided in such areas as infrastructural investment. This additional expenditure seeks to ensure the further modernisation of the educational system to match the demands of present-day society. Other additional expenditure serves to improve information and communication technology in the public sector. The ends to which this additional expenditure is put are in agreement with the recommendations in the Broad Economic Policy Guidelines 2000 to the effect that the focus of public finance should be shifted towards investment in physical and human capital, research and development and information technology.

Table 4.1.1 Composition of public expenditure, 1995-2001 (% of GDP)

	1995	1998	1999	2000	2001
Government consumption	24.6	23.4	23.4	23.3	22.8
Social security benefits	16.1	14.5	13.8	13.7	13.1
Interest payments	5.9	4.7	4.6	4.0	3.6
Subsidies	1.1	1.5	1.6	1.4	1.4
Government investment	3.0	3.1	3.2	3.3	3.4
Capital transfers	2,7	1.0	1.1	1.2	1.0
Total	53.3	48.2	47.6	46.9	45.2

Source: Netherlands Bureau for Economic Policy Analysis – Macro-Economic Forecast 2001.

At present, the composition of public expenditure is undergoing a major process of change. The share of interest payments in total public sector expenditure decreases from 11.0% in 1995 to 8.0% in 2001. At the same time the share of government investment rises from 5.6% in 1995 to 7.5% in 2001. As also noted in the Broad Economic Policy Guidelines 2000, such a reorientation of public sector expenditure contributes to enhancing the economy' growth potential.

4.2 Revenues and tax burden

Total revenues are 47.7% of GDP in 2000 and 45.8% of GDP in 2001. The difference between revenues (see Table 4.2.1) and expenditure (see Table 4.1.1) is the financial balance. It differs slightly from the EMU balance; the difference between the two concepts largely consists of financial transactions.

Table 4.2.1 Revenues, 1995-2001 (% of GDP)

	1995	1998	1999	2000	2001
Total	50.3	48.6	47.8	47.7	45.8
Direct taxes	12.7	12.4	12.6	12.1	11.6
Indirect taxes	11.8	12.5	12.9	13.2	13.9
Social insurance contributions	16.0	15.7	16.0	16.0	14.1
Natural gas income	0.5	0.4	0.3	0.3	0.4
Non-tax revenues	9.3	7.7	6.0	6.1*	5.8

Source: Netherlands Bureau for Economic Policy Analysis – Macro-Economic Forecast.

* Excluding proceeds from the auction of third-generation mobile phone licences.

Under the Dutch fiscal policy rules, the higher-than-estimated revenues consequent on the higher economic growth rate (relative to the cautious scenario) have created scope for additional tax cuts. The coalition agreement provides that, in a situation where the EMU deficit is below ¾% of GDP, additional revenues are used to the extent of 50% for debt reduction and to the extent of the remaining 50% for additional tax cuts during the present Cabinet's period of office. Up to and including the 2001 budget, the excess of actual revenues over the relevant figures contained in the coalition agreement is estimated at NLG 22 billion (2½% of GDP), caused by a higher economic growth rate than anticipated in the coalition agreement (Table 4.2.2).

Considering the fiscal rules as outlined above, it has been assumed that half the additional revenues are available for additional tax cuts. Thus, the margin for tax cuts throughout the period is widened by NLG 11 billion as a result of the additional revenues. Added to the tax cut of NLG

4½ billion already provided for in the coalition agreement, the total margin for tax cuts during the present Cabinet's period of office comes to NLG 15½ billion. Table 4.2.1 shows how the tax cuts are distributed over this period.

Table 4.2.2 Movements in the tax burden (billions of guilders)

	1999	2000	2001	2002	1999-2002
1998 stability programme (coalition agreement)	1½	n. a.	-5	n. a.	-4½
1999 update	2	-1½	-5	- ½	-5
2000 update	1½	-2	-6.6	(-8¼*)	(-15½)

* Assuming that one-half of the additional revenues are used for debt reduction and the other half for tax cuts.

In the coalition agreement, fiscal scope was created for the effectuation of a tax reform in the period 1999-2002. This reform will be effected in 2001. The 2001 budget provides for tax cuts totalling NLG 6½ billion (around 0.7% of GDP). The increase in this amount relative to the previous update (+ NLG 1½ billion) is due to the higher tax base since the time of the coalition agreement, among other factors. Of the total room for tax cuts available under the fiscal rules, only a very limited amount will be used for additional tax cuts in 2001. For the time being, the remaining scope has been reserved for additional tax cuts in 2002, the last year of the present Cabinet's term of office. With a view to economic developments and a well-balanced distribution of tax cuts over time, the Cabinet has decided that it would be inappropriate, considering the tax reform in 2001, to take the tax cuts in that year too much beyond the amount envisaged in the coalition agreement (NLG 5 billion). It is possible that the excess of actual over estimated revenues will increase further, since at this juncture the projections for 2002 still assume an economic growth rate of 2%. Next year, decisions will be taken about the magnitude and the design of the tax cuts in 2002, on the basis of the latest insights into economic conditions and public finance.

4.3 Tax reform 2001

The strengthening of the economic structure attending the tax reform is among the principal improvements to the supply side of the economy during the present Cabinet's term of office.⁹ Tax cuts enhance the dynamism and flexibility of an economy and may help raise the participation rate. The tax reform in 2001 is expected to push up the supply of labour in the long run by nearly 40,000 man-years (+0.7%). In early May the First Chamber of Parliament also gave its approval to the tax reform. The reform of the tax system will first of all forcefully boost employment and further strengthen the economic structure. The additional environmental improvements that form part of the package ensure that fiscal policy contributes to a durable economic development.

Table 4.3.1 Principal elements of the 2001 tax plan (on accrual basis, billions of guilders)

⁹ More information is available on the Internet (<http://www.minfin.nl/belasting2001>).

Increase in general VAT rate from 17.5% to 19%	+4.8
Increase in environmental levies	+1.9
Revised taxation of capital/income from capital	+2.6
Decrease in taxes on labour	-15.5
2001 tax reform	-6.2
Other changes in taxes and social insurance contributions	-0.4
Tax reduction	-6.6

Present conditions in the labour market, where tightness coincides with an untapped labour potential, have prompted a review seeking to ascertain whether the tax reform should be attended by additional measures. At the lower income levels in particular, financial incentives for welfare recipients to seek work or for workers to seek higher-paid jobs are limited. The 2001 tax reform mitigates the poverty trap¹⁰ for these low-income categories. Despite this improvement, the accumulation of a range of income-dependent state and municipal welfare schemes may cause the marginal burden for incomes between 100% and 140% of the statutory minimum wage to be in excess of 100%. Hence, mitigating this problem by a substantial reduction of the poverty trap problem has been assigned a high priority. In this light, this issue has been given extra attention in the 2001 budget. If further tax cuts were to be decided on in the years ahead, pronounced emphasis on encouraging the supply of labour would again be in order.

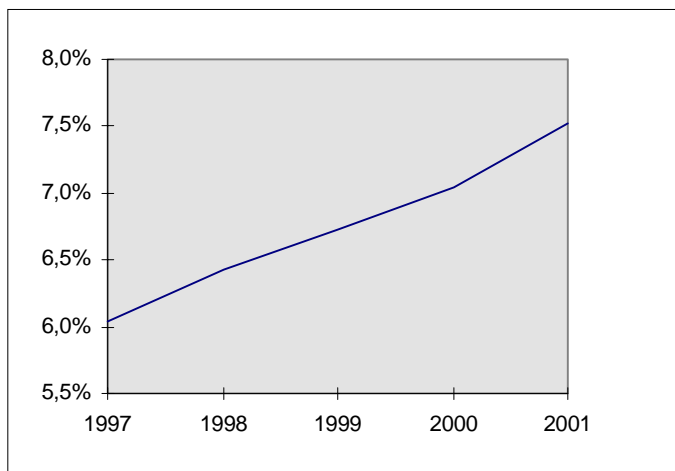
5 Long-term aspects

5.1 Investing in the future

Strengthening the physical and social infrastructure is among the principal policy challenges. The dynamics of economic development gives rise to problems as well as opportunities. A concrete example of a problem is the sharply increasing demand for mobility owing to the higher levels of economic activity and prosperity. Furthermore, the pressures on the environment have not yet been uncoupled from economic growth in all areas. Opportunities present themselves in the domains of the development of information and communication technology and the strengthening of the knowledge infrastructure in general. Investment targeted to meet these challenges leads to a structurally stronger supply side of the economy. In order to create room for fixed capital formation, the Economic Structure Reinforcement Fund has been set up in the past, whose resources come from structural natural gas revenues and interest income, arising from debt reduction ensuing from the sale of central government shareholdings and proceeds from auctions. In addition, where investment projects are concerned, public-private partnerships may offer opportunities for achieving better price-quality ratios.

At the start of its term of office, these considerations prompted the Cabinet to design an extensive package of investment projects for the period 1999-2010, leading to an increase in the share of investment in total public sector expenditure.

Chart 5.1 Government investment, 1997-2001 (% of public sector expenditure)



During the decision-making on the 2001 budget, it was decided to include yet another impulse. Together, the aggregate impulse averages 0.4% of GDP per annum. The increase in investment in the 2001 budget is financed through the Economic Structure Reinforcement Fund from structurally higher natural gas revenues and interest savings; the latter arise as proceeds from auctions and from the sale of government holdings in enterprises are used to reduce public debt. In this manner, income from government assets is used to build up new government assets.

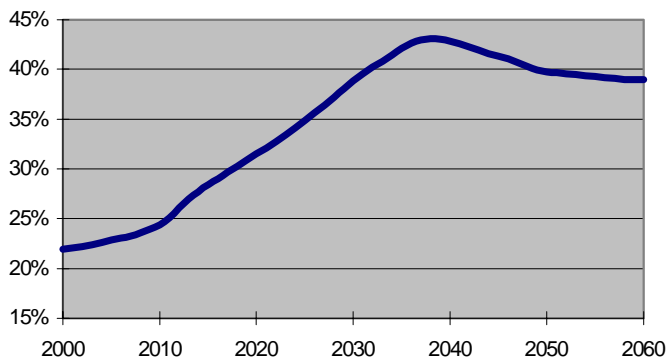
The magnitude and the time horizon of this investment package underscore the Cabinet's ambition to improve the quality of public sector expenditure and to achieve a shift in expenditure from consumption to productive investment.

5.2 Sustainable public finance in the long run

A number of long-run trends, such as demographic and technological developments and the progressing integration within Europe, will exert a major influence on public finance in the future. Where the budget is concerned, the ageing of the population is the predominant trend. After a slow increase in the elderly dependency ratio (the number of people of 65 and over relative to those aged 20-64) until 2010, the period 2010-2040 will see a sharp increase. Current demographic forecasts show that after 2040 this ratio will stabilise at a comparatively high level.

Chart 5.2.1 Elderly dependency ratio (people of 65 and over relative to those aged 20-64), 1960-2060

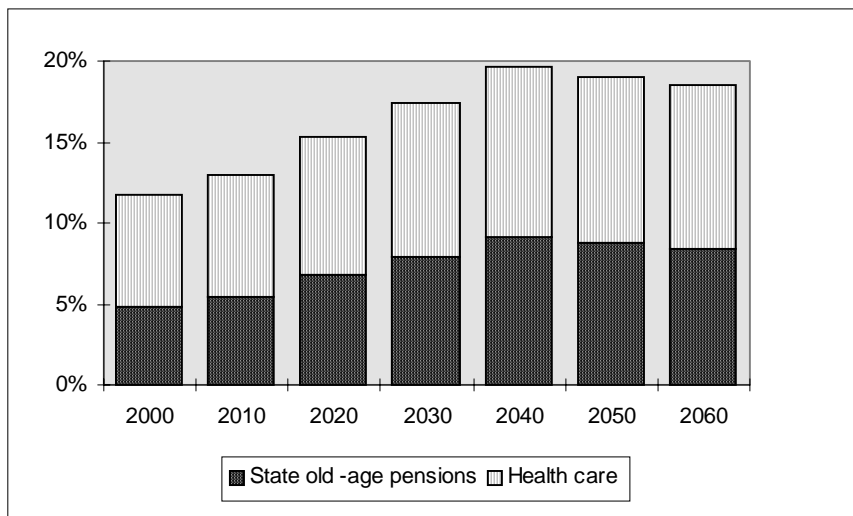
¹⁰ See footnote 2.



Source: Statistics Netherlands.

The changing composition of the population has consequences for the level as well as the composition of public sector revenues and expenditure. On the expenditure side, an impression of the budgetary consequences may be gained by looking at expenditure on state old-age pensions and health care. Depending on the exact assumptions as to changed or unchanged policies, tentative calculations show that between 2000 and 2040 this expenditure will go up by around 8% of GDP (from 11.7% to about 20% of GDP), followed after 2040 by a slight decrease. These recent estimates of the consequences of the ageing population for expenditure are even somewhat higher than those referred to in the previous update.

Chart 5.2.2 Expenditure on state old-age pensions and health care, 2000-2060 (% of GDP)

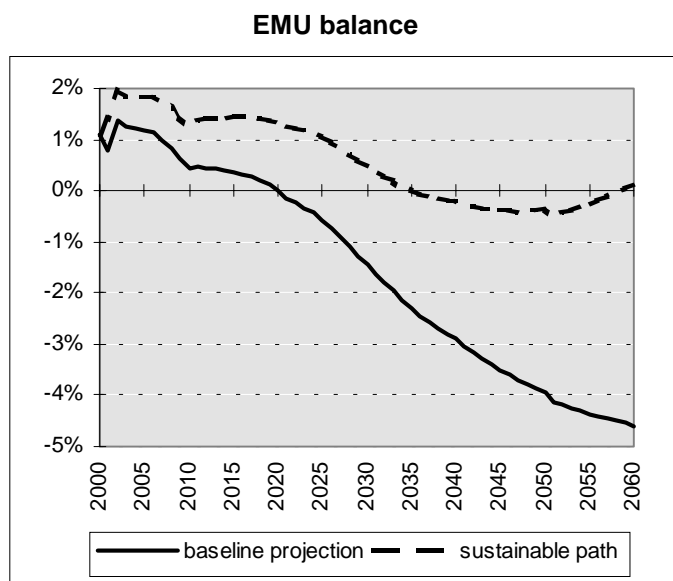
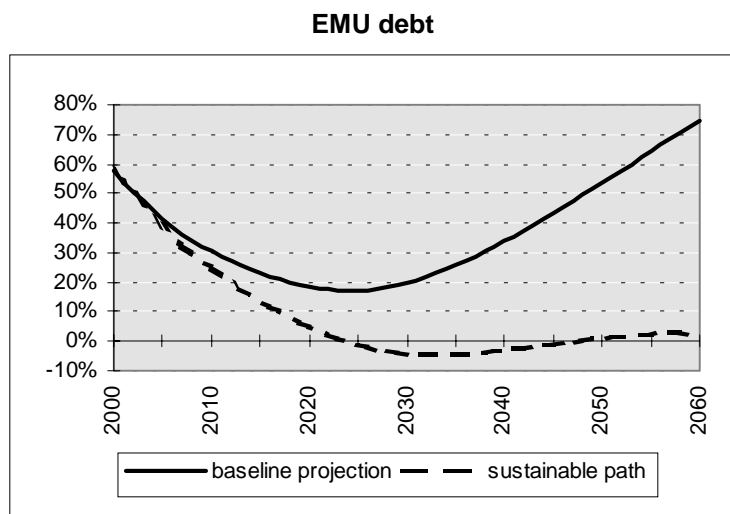


While expenditure will be higher, so will revenues. The tax treatment of pension premiums under corporate and privately arranged pension plans and of supplementary benefits under funded pension schemes as well as of civil servant's pension benefits ensures that, at unchanged tax rates, public sector revenues will also increase,¹¹ though insufficiently to cope with the burden consequent on the ageing population.

¹¹ In order to encourage the accumulation of appropriate supplementary old-age pension rights, pension premiums are tax-deductible in the Netherlands and pension benefits are taxed.

If not just demographically sensitive expenditure and revenues but aggregate expenditure and revenues are extrapolated, an impression may be gained of the long-run movements in public finance. Such an extrapolation also makes allowance for such factors as declining revenues on account of the depletion of the Dutch natural gas reservoirs. On the assumption of unchanged policies, the longer-term results show continuous increases in the deficit, in interest payments and in the debt ratio. In the absence of policy responses, the EMU debt ratio initially decreases to about 20% of GDP in 2025, to go up in subsequent years and ultimately to run out of hand owing to an accumulation of interest charges combined with a permanently different composition of the population.

Chart 5.2.3 EMU debt and EMU balance, 2000-2060 (% of GDP)



A sustainable development of public finance may be attained by several routes: reducing primary expenditure, increasing taxes or reducing debt so as to lower interest payments. A sustainable path for public finance is such a development of public finance in the long run that the debt ratio remains more or less stable. To indicate the magnitude of the challenge: annual fiscal surpluses of the order of 1 to 2% of GDP in the decades ahead would make for a sustainable path for public finance (see Chart 5.2.3). Under such a scenario, the EMU debt would be repaid in its entirety

round about the year 2025, so that the interest savings thus achieved could be used to finance the expenditure consequent on the ageing population.¹²

These calculations provide an impression of the magnitude of the challenge and of the required policy effort. Given the long time horizon and the assumptions used, the calculations are surrounded with a considerable margin of uncertainty. The more policy responses are delayed until the time when the ageing process gains momentum, the heavier the burden of adjustment will be. By means of further debt reduction, interest expenditure can be released so as to finance the costs of the ageing population. Increasing the participation rate, broadening as it does the financial base for the public sector, constitutes a forceful instrument to absorb the costs of the ageing population, simplifying the process of debt reduction and creating scope for expenditure to strengthen the economic structure or, alternatively, for tax cuts.

¹² In a recommendation to the Government, the Advisory Council on Government Policy comes to the same conclusion. See Advisory Council on Government Policy, *Generatiebewust Beleid* (1999).

Annex A Public sector, 1999-2004 with cautious scenario in 2002-2004

Table A.1 shows public sector expenditure and revenues and the resulting EMU balances for the period 1999-2004. Owing to differences in definitions, the figures in the table do not correspond fully to those in Tables 4.1.1 and 4.1.2; for instance, in the table below non-tax revenues are included in net expenditure from the central government budget rather than in revenues. In the table, the central government includes the social security funds.

Table A.1 Central government expenditure and revenues, cautious scenario in 2002-2004 (% of GDP)

		1999	2000 ¹	2001	2002	2003	2004
1	Central government expenditure	38.7	38.6	37.2	37.0	36.8	36.4
	• Net expenditure from central government budget	23.2	23.6	23.6	23.9	24.1	23.5
	• Expenditure on social security	9.4	8.9	8.6	7.9	7.7	7.6
	• Expenditure on health care	5.4	5.5	5.1	5.1	5.2	5.3
	• Other	0.7	0.6	-0.1	0.1	-0.2	0.0
2	Central government revenues	39.5	39.4	37.7	37.1	36.9	36.8
	• Direct taxes	11.1	10.8	10.5	10.9	10.9	10.9
	• Indirect taxes	12.4	12.6	13.3	13.2	13.1	12.9
	• Social insurance contributions	10.2	9.9	8.7	8.8	8.8	8.8
	• Health care premiums	5.8	6.0	5.2	5.0	5.0	5.0
	• Correction for reservation tax cuts 2002	-	-	-	-0.8	-0.8	-0.8
3	Margin available for higher expenditure, for tax cuts or for debt reduction	-	-	-	-	0	0.3
I	With the margin spent on higher expenditure or on tax cuts						
4	Central government EMU balance (2-1)	0.8	0.8	0.5	0.1	0.1	0.1
a							
4	Local authority EMU balance	0.2	0.2	0.2	0.2	0.2	0.2
b							
5	EMU-balance (4a+4b)	1.0	1.0	0.7	0.3	0.3	0.3
II	With the margin spent on debt reduction						
6	Central government EMU balance (2-1)	0.8	0.8	0.5	0.1	0.1	0.4
a							
6	Local authority EMU balance	0.2	0.2	0.2	0.2	0.2	0.2
b							
7	EMU-balance (6a+6b+3)	1.0	1.0	0.7	0.3	0.3	0.6

¹ Excluding proceeds from the auction of third-generation mobile phone licences (0.7% of GDP).

Table A.2 Interest expenditure and primary surplus, cautious scenario in 2002-2004 (% of GDP)

		1999	2000	2001	2002	2003	2004
1	Interest expenditure	4.4	3.9	3.3	3.2	3.1	3.0
	• Central government interest expenditure	3.6	3.2	2.7	2.6	2.5	2.4
	• Local authority interest expenditure	0.8	0.7	0.6	0.6	0.6	0.6
2	EMU balance	1.0	1.0	0.7	0.3	0.3	0.6
3	Primary surplus (1-2)	3.4	2.9	2.6	2.9	2.8	2.4

Table A.3 Movements in EMU debt, cautious scenario in 2002-2004 (% of GDP)

	1999	2000	2001	2002	2003	2004
EMU debt	62.9	56.6	52.3	50.3	48.7	46.7
Movements in EMU debt	-3.7	-6.2	-4.3	-2.1	-1.5	-2.1
• Of which: deficit effect	-1.0	-1.0	-0.7	-0.3	-0.3	-0.6
• Of which: denominator effect	-3.5	-4.7	-4.1	-2.1	-1.8	-1.7
• Of which: financial transactions	+0.8	-0.2	+0.5	+0.3	+0.5	+0.3

Table B.1 Central government expenditure and revenues, favourable scenario in 2002-2004 (% of GDP)

		1999	2000 ¹	2001	2002	2003	2004
1	Central government expenditure	38.7	38.6	37.2	37.0	36.8	36.4
2	Central government revenues	39.5	39.4	37.7	37.4	37.7	38.1
3	Margin available for higher expenditure, for tax cuts or for debt reduction	-	-	-	-	0.5	1.3
4	Central government EMU balance (2-1)	0.8	0.8	0.5	0.4	0.9	1.7
5	Local authority EMU balance	0.2	0.2	0.2	0.2	0.2	0.2
I	With the margin spent on higher expenditure or on tax cuts						
4	Central government EMU balance (2-1)	0.8	0.8	0.5	0.4	0.4	0.4
a							
4	Local authority EMU balance	0.2	0.2	0.2	0.2	0.2	0.2
b							
5	EMU-balance (4a+4b)	1.0	1.0	0.7	0.6	0.6	0.6
II	With the margin spent on debt reduction						
6	Central government EMU balance (2-1)	0.8	0.8	0.5	0.4	0.9	1.7
a							
6	Local authority EMU balance	0.2	0.2	0.2	0.2	0.2	0.2
b							
7	EMU-balance (6a+6b+3)	1.0	1.0	0.7	0.6	1.1	1.9

¹ Excluding proceeds from the auction of third-generation mobile phone licences (0.7% of GDP).

Table B.2 Interest expenditure and primary surplus, favourable scenario in 2002-2004 (% of GDP)

		1999	2000	2001	2002	2003	2004
1	Interest expenditure	4.4	3.9	3.3	3.0	2.7	2.4
	• Central government interest expenditure	3.6	3.2	2.7	2.4	2.1	1.8
	• Local authority interest expenditure	0.8	0.7	0.6	0.6	0.6	0.6
2	EMU balance	1.0	1.0	0.7	0.6	1.1	1.9
3	Primary surplus (1-2)	3.4	2.9	2.6	2.4	1.6	0.5

Table B.3 Movements in EMU debt, favourable scenario in 2002-2004 (% of GDP)

	1999	2000	2001	2002	2003	2004
EMU debt	62.9	56.6	52.4	49.5	46.5	42.2
Movements in EMU debt	-3.7	-6.2	-4.3	-2.9	-3.0	-4.3
• Of which: deficit effect	-1.0	-1.0	-0.7	-0.6	-1.1	-1.9
• Of which: denominator effect	-3.5	-4.7	-4.1	-2.6	-2.4	-2.7
• Of which: financial transactions	+0.8	-0.2	+0.5	+0.3	+0.5	+0.3