Stability Programme

The Netherlands 2000 - 2004

2001 Update

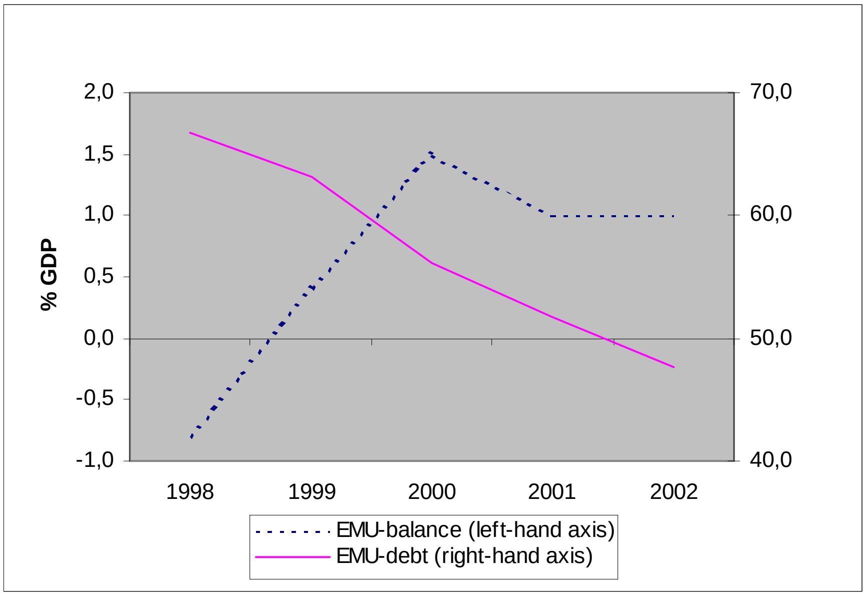
17 October 2001

Contents

Executive Summary

Supported by strong economic growth, the Dutch trend-based budgetary policy based on cautious economic assumptions has clearly paid off in recent years, leading to an improvement in the EMU budget balance. In 1998 the EMU budget balance was – 0.8% of GDP whereas an EMU balance of 1% of GDP is projected for 2002. EMU debt will be reduced from 67% of GDP in 1998 to 48% of GDP in 2002. This will be achieved by respecting the expenditure ceilings in 1999-2002 (no overspending) and by using the greater part (ca. 75%) of the revenue windfalls (measured against a cautious economic growth forecast of on average 2¼% of GDP[1] annually) for debt reduction.

Chart: Development of EMU budget balance and EMU debt 1998-2002



Following a period of buoyant economic activity, the economy is expected to weaken considerably in 2001 and 2002 to a GDP growth of 2%. For 2001, this means that expected economic growth will be halved in comparison to last year's stability programme which assumed a GDP growth of 4%. The main reason for this downward adjustment is a decline in the growth of private consumption and exports. For 2002 , the previous stability programme also assumed a GD growth of 2% (the prevailing cautious scenario[2]). Owing in part to the cautious assumptions, the lower growth rate can be accommodated without exceeding the expenditure ceilings. This underlines the soundness of the budgetary policy based on cautious assumptions. The growth projections given above are based on the latest forecasts, drawn up by the Netherlands Bureau for Economic Policy Analysis at the beginning of September. Projections of economic growth are always subject to uncertainty. In view of the recent events in the United States, these uncertainties are more significant than usual.

[1] 2¼% is the growth forecast including policy effects on growth.
[2] 2% growth is the cautious scenario without policy effects on growth.

Inflation (consumer price index) is expected to amount to 4½ %in 2001 (HICP 4¾%). Some of this inflation results from the implementation of policy measures such as the increase in the VAT rate from 17½% to 19% and a further rise in the small-user levies on energy. Since, among other reasons, these measures will not affect inflation in 2002, inflation for that year is forecast at 2½% (HICP 2½%). The tight conditions in the labour market, in combination with the favourable economic developments in recent years, have led to relatively high contractual wage increases, which also increases inflation. Contractual wage rates are estimated to increase by 4¼% in 2001 and by 3¾% in 2002.

Consistent with the recommendations in the Broad Economic Policy Guidelines and the Council Opinion of the Commission, budgetary policy in 2002 will not be expansionary. Despite a below-trend growth rate, the EMU balance remains stable. The EMU balance in both 2001 and 2002 amounts to 1% of GDP. Expectations are that, in line with the Coalition agreement, the expenditure ceilings drawn up under cautious economic assumptions will not be exceeded during the present Cabinet term. Within the expenditure ceilings room has been found for more productive spending on education and infrastructure as well as on health care and security. Particular attention has been paid to resolving labour market tensions in the public sector.

Partly in view of the inflation in 2001 and the development of the fiscal balance related to the ageing of the population, the Cabinet decided that in 2002 it would not fully apply its formula for distributing revenue windfalls and setbacks. The formula specifies that 50% of the revenue windfall goes towards a further reduction in the tax burden than set out in the coalition agreement and 50% to debt reduction. Most of the revenue windfall is used for debt repayments. For the Cabinet's entire term of office, EUR 2.9 billion (NLG 6¼ billion) of the revenue windfall of EUR 12 billion (NLG 26½ billion) was used for to additional tax cuts beyond the coalition agreement while the remainder (circa 75%) was used for debt reduction. The automatic stabilisers on the revenue side were thus to a large extent able to work ex post.

A EUR 1.3 billion (NLG 2.9 billion) package of tax cuts was agreed on for 2002. In view of the tight labour market conditions, these tax cuts are mainly aimed at stimulating laboursupply , especially among groups such as older workers and people who enter the labour market. This will contribute to efforts to keep labour costs under control. Broadening the support base for social security benefits by stimulating labour market participation is also important in connection with the ageing population.

As the current Cabinet's period ends in 2002, the projections for 2003 and 2004 have a different status than the forecasts for 2001 and 2002 . Consequently, these projections are more technical. Since the possible measures taken by the next Cabinet (elections are to be held in May 2002) are still uncertain, the projections are based on unchanged policies. The economic growth rate in these years is based on a cautious trend-based scenario with a growth of 2¼%, in line with the Netherlands Bureau for Economic Policy Analysis' latest insights for 2003-2006[3]. On the basis of this assumption, the Netherlands Bureau for Economic Policy Analysis calculated the margin available to a next cabinet – given a constant EMU budget balance from 2002 onwards – for further debt reduction, tax cuts or

[3] F.J.H. Don, Netherlands Bureau for Economic Policy Analysis, Document No. 001. *Het Nederlandse groeipotentieel op de middellange termijn* (The Dutch long-run growth potential) (March 2001).

spending increases.[4] This margin amounts to 0.2% of GDP in 2003 and to 0.3% in 2004. An indication of the effect of a higher growth rate on the margin available is that a ¼ percentage point of higher growth would provide an additional margin of almost 0.1% of GDP annually. The exact percentage of the additional margin depends on the cause of the faster growth rate (an increase in productivity or in employment).

Table EMU budget balance and EMU debt 2003-2004 (% of GDP)

	2002	2003	2004
Cautious trend-based scenario			
Economic growth		2¼%	2¼%
EMU budget balance	1.0	1.0%	1.0%
EMU debt	48%	45%	42%
Margin [a]		0,2%	0,3%

[a] Assuming a stable EMU balance at the 2002 level and unchanged policies in respect of premiums, taxes and expenditure. This margin is available for higher expenditure, tax cuts or improvements in the balance.

Like last year the current Stability Programme of the Netherlands also focuses on public finances in the long term. The consequences of the ageing population receive a substantial amount of attention in Dutch politics and there is wide support for debt reduction in this context. Various studies point to the need for complete debt repayment by 2025. Debt has already dropped sharply in recent years from 77% of GDP in 1995 to 48% of GDP in 2002. From a demographic and budgetary perspective, it is important to accomplish futher debt reduction in the period to 2010. The increase in expenditure related to ageing will still be relatively contained during that time, while the potential support base will continue to broaden. Encouraging labour market participation will play an important role in achieving debt reduction.

Structural and institutional reforms are of similar importance for sound and sustainable public finances. The Government has analysed the need for structural/institutional reforms in studies on the labour market, taxation, economic structure, health care, education and the social infrastructure. The quality of the public sector and new relationship between public authorities and society are crucial factors in the reform of public agencies. These studies form potential building blocks for a coalition agreement during the next Cabinet term.

[4] Based on calculations by the Netherlands Bureau for Economic Policy Analysis in which the fiscal margin for the period 2003-2006 is forecast at EUR 3¼ billion. It has been assumed that this margin is equally divided over the four years. Netherlands Bureau for Economic Policy Analysis Document No. 003. *Boekhoudkundige berekening budgettaire ruimte 2003-2006* (Accounting calculations of the fiscal margin for 2003-2006) (June 2001)

1. Introduction

This update of the Stability Programme of the Netherlands gives an adjusted picture of the financial and economic situation in the Netherlands in the period 2000-2002. Following a period of strong economic growth, the economy weakened appreciably in 2001 and 2002 to an expected growth rate of 2% of GDP. For 2001, this represents a drop of 2 percentage points relative to last year's Stability Programme. Partly thanks to the cautious assumptions for 2002, the budgetary agreements can still be met, despite the slowdown in 2002. These growth projections are based on the latest estimates by the Netherlands Bureau for Economic Policy Analysis, drawn up at the beginning of September. Owing to the recent events in the United States, the growth projections are subject to greater uncertainties than usual.
The years 2003 and 2004 fall beyond the current Cabinet's term of office. The data for these years are hence more technical and are based on the assumption that policies remain unchanged. In drawing up a new coalition agreement after the elections in May 2002, new agreements will have be made on the public finances for the period 2003-2006.

Multiple year agreements on expenditure covering a four-year Cabinet's term are central to the Dutch budgetary system. These multiple year agreements are reflected in the expenditure ceilings which are established for each year. These ceilings are set under cautious economic assumptions. At the start of the Cabinet's term 1999-2002, for example, the annual economic growth rate was assumed to be 2¼% . The expenditures must remain within these ceilings. This cautious system means that setbacks are less likely to occur than windfalls and provides stability in the budgetary process. On the revenue side, revenue benchmarks were established at the beginning of the Cabinet's period 1999-2002, likewise on the basis of cautious economic assumptions. Revenue windfalls resulting from a higher growth rate than that assumed in the cautious scenario will – if the EMU balance exceeds –¾% of GDP – be used for extra tax cuts (50% of the revenue windfall) and debt reduction (50% of the revenue windfall).

2. The Dutch Economy

Table 2.1 Growth and related factors

	National			EU Spring Forecast 2001		Cautious trend-based scenario	
	2000	2001	2002	2001	2002	2003	2004
	Annual percentage changes						
Gross Domestic Product	3.5	2	2	3.4	3.1	2¼	2¼
Gross Domestic Product, level in EUR	401	431	454	432	458	467	477
Gross Domestic Product Price	3.7	5¼	3¼	4.5	2.9	2	2¼
Consumer price index	2.6	4½	2½	4.3	2.9	2	2
Employment (in persons)	2.5	1¾	¾	-	-	-	-
Employment (in hours)	2.4	1¾	¾	2.0	1.8	¾	¾
Labour productivity, market sector	1.8	-¼	1½	1.4	1.3	1¾	1¾
Expenditure and output (changes per annum)							
1 Private consumption	3.8	2¼	3½	4.0	3.9	1¾	1¾
2 Public sector consumption	1.9	3½	1¾	2.6	2.3	-	-
3 Gross Investments (incl. inventories)	3.8	1¼	1	3.9	3.6	-	-
4 Exports	9.5	3½	4¾	6.9	6.3	-	-
5 Imports	9.4	4.25	5¾	7.9	7.3	-	-
Share in GDP growth							
Domestic demand	3.0	2.2	2.4	3.4	*3.3*	-	-
Net exports	0.5	-0.2	-0.4	-0.2	-0.3	-	-

Table 2.2: World trade, oil prices, dollar exchange rate, wages and interest rates in 2000-2004

	National			EU Spring Forecast 2001		Cautious trend-based scenario	
	2000	2001	2002	2001	2002	2003	2004
International							
World trade	12.9	2¾	6½	7.6	8.0	-	-
Euro exchange rate (against the dollar)	0.92	0.88	0.90	0.94	0.95	1.0	1.0
Oil price (dollars per barrel)	28.4	26.0	23.0	24.4	26.3	23.0	23.0
Wages and interest rates (annual changes)							
Contractual wage rates	3.3	4¼	3¾	-	-	3½	3½
Compensation per employee market sector	5.0	4¾	4¼	4.5	4.5	-	-
Long-term interest rate	5.4	5	5	4.6	5.4	5	5
Short-term interest rate	4.4	4½	4	3.0	4.4	4	4

2.1 The Dutch economy in 2000-2002

Since the previous update of the Stability Programme of the Netherlands, the growth forecast for the Dutch economy has been revised downwards. Following a period of buoyant economic activity, economic growth weakened noticeably in 2001. This deceleration began at end-2000 and will continue in 2001 and 2002.

Economic growth in 2000 amounted to 3,5%. The most recent figures on economic growth in the first half of this year indicate an annualised growth rate of 1½%. However, the growth rate for the first half of 2001 was distorted downwards by the anticipatory effects of the 2001 tax reforms and the impact of the foot-and-mouth crisis . Owing to the increase in the VAT-rate as of 1 January 2001, households brought purchases forward to end-2000. This mainly involved consumer spending on durable goods; it is an anticipatory effect which only arises occasionally. Estimates by the Netherlands Bureau for Economic Policy Analysis put the negative effect of anticipatory purchases on economic growth at 0.3 percentage points in the first quarter, and of the foot-and-mouth disease at 0.3 percentage points in the second quarter. Discounting the effects of the foot-and-mouth crisis and the anticipatory purchases prior to the tax reforms, the economy in the first half of 2001 grew by around 1.9% relative to the first half of 2000.

The Netherlands Bureau for Economic Policy Analysis expects economic growth in the Netherlands to pick up slightly in the second half of 2001, driven by a recovery in private consumption as consumers spend more of the sharp rise in purchasing power resulting from the tax reforms in 2001[5]. The Bureau forecasts a growth rate of GDP of 2% in 2001. Exports are expected to recover moderately next year although some uncertainty surrounds this projection, notably because it was made prior to the recent attacks in the United States. The Bureau's latest projections for 2002 show that the economy is expected to grow at the same pace as in 2001, namely by 2%.

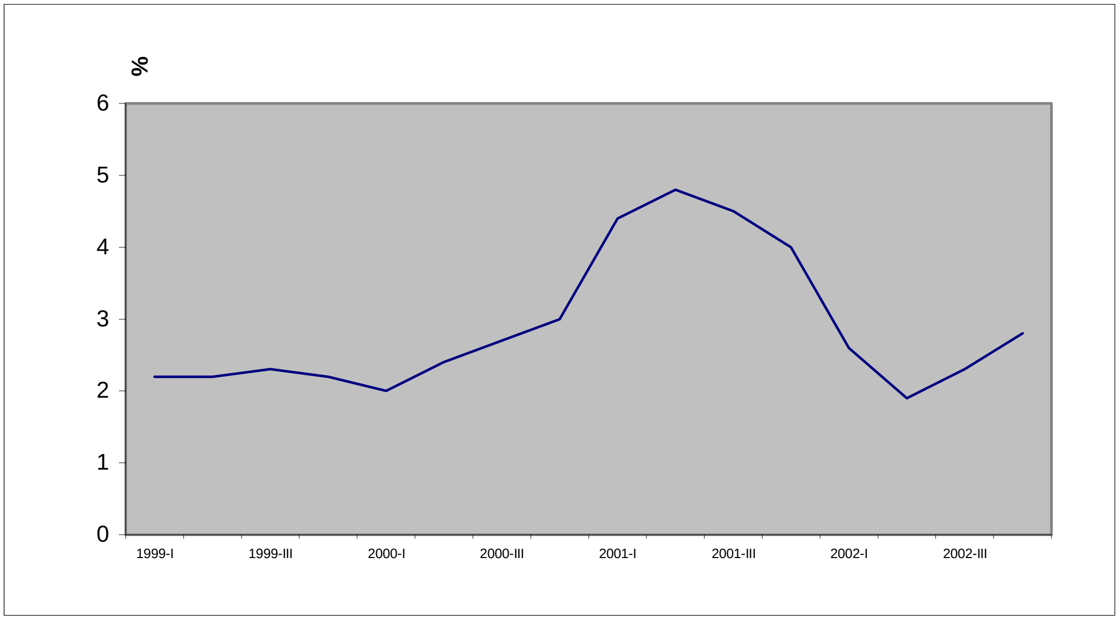
Unemployment has been below the equilibrium level for several years, creating tight labour market conditions and sharp rises in contractual wages. There are now more than 200,000 vacancies, half of which are difficult to fill. The increase in unfilled vacancies is now levelling off, however. Despite the tight labour market, the labour reserve is considerable. Employment in full time equivalents is still almost 40% lower than the potential labour force. The number of benefit years (excluding sickness benefits and early retirement) among those of working age amounts to around 1.5 million (circa. 25% of the labour force). Consequently, it is essential to further stimulate the laboursupply also by reducing the poverty trap. In designing the tax cuts for 2002, the top priority was therefore to boost the laboursupply. Owing to the slowdown in economic growth, unemployment in 2002 will move ½ percentage point (to 3¾%) closer to the (higher) equilibrium level.

The increase in contractual wages in the market sector in 2001 and 2002 is estimated at 4¼% and 3¾% respectively. These increases – relatively high in view of the economic growth in these years – will be generated by the current tight labour market conditions. Moreover, wages are slow to respond to a fall-off in growth since part of the increase in contractual wages has already been fixed in (sometimes long-term) collective labour agreements. Collective labour agreements for 2001 have already been concluded for 80% of employees, with an average wage increase of 4.2%.[6] For 2002, approximately 18% of employees have signed up to collective labour agreements for the entire year, with an annualised rise in the contractual wages of 4.0%. The deterioration in the economic outlook may result in a lower outcome for the collective labour agreements that have yet to be concluded. The tightening of the labour market has led to a more rapid increase in labour costs over the past years and has lowered business sector profitability. This is clear from the rise in the labour share in enterprise income (from 82% in 1999 to 84¼% in 2002). Corporate investment has also risen – from

[5] Netherlands Bureau for Economic Policy Analysis, Macro-Economic Forecast 2002, September 2001.

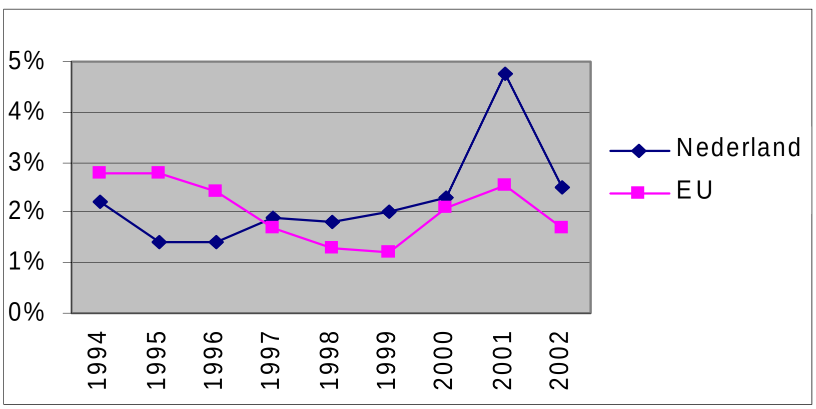
an international perspective too – partly in connection with the increased tension in the labour market. The investment ratio (as a percentage of GDP) will decline in 2001 and 2002 due to the deterioration in profitability.

Chart 2.1.1 Inflation (consumer price index), quarterly data 1999-2002*



*Changes on corresponding quarter of previous year
Source: Netherlands Bureau of Economic Policy Analysis – Macro-Economic Forecast 2002

Chart 2.1.2 HICP (in %), 1994-2002



Source: Netherlands Bureau of Economic Policy Analysis – Macro-Economic Forecast 2002

Inflation (consumer price index) amounted to 2.6% in 2000. Inflation was relatively high in the first half of 2001 and stood at 4.7% in August. In 2001 an average inflation of 4½% is expected. Of this high rate of inflation, 0.9 percentage point results from implemented policy measures: the rise in the general VAT-rate from 17½% to 19% (+1.5 percentage point) and the increase in the small-user levies on energy (0.4 percentage point). These are incidental factors.

[6] Source: Netherlands Bureau for Economic Policy Analysis

The effects of the increase in indirect taxes will no longer influence inflation in 2002, for this reason inflation will be 0.9percentage point lower than in 2001 (see Table 2.2.3). Partly for this reason, a relatively slight price increase of 2½% is forecast for 2002, against an expected inflation rate of 4½% in 2001.

In addition to these incidental, predicted factors in 2001, there was a sharp rise in oil and petrol prices and a strong appreciation of the dollar in the course of 2000 and 2001 which had not been foreseen. This led to higher import prices, including energy prices (notably gas, electricity, fuels) resulting in higher-than-expected inflation in 2001. If oil prices (and the dollar exchange rate) remain at the current level, the direct effect of the rise in oil prices (and the dollar exchange rate) will cease to influence the inflation rate in the course of this year. Gas prices react to oil developments with a time lag, however, explaining why, in the forecast by the Netherlands Bureau for Economic Policy Analysis, the gas price in 2002 is still making a 0.4% percentage contribution to inflation.

Table 2.2.3 Contribution to inflation by a number of incidental components, 1999-2002

	1999	2000	2001	2002
Annual percentage changes				
Consumer price index	**2.2**	**2.6**	**4½**	**2½**
HICP	2.0	2.3	4¾	2½
Contribution to CPI in percentage points				
Energy tax	0.3	0.3	0.4	
VAT			0.5	
Radio and TV licence fees		-0.4		
Gas*	-0.4	0.3	0.4	0.4
Contribution to inflation rate (CPI)	**-0.1**	**0.2**	**1.3**	**0.4**
Contribution to change in inflation (relative to previous year)	0.0	0.3	1.1	-0.9

* Excluding the small-users' levy and VAT
Source: Netherlands Bureau for Economic Policy Analysis

The tight labour market has exerted upward pressure on wages in recent years, expanding the contribution of labour costs to inflation. The inflationary pressure of labour costs will not disappear overnight. Next year's rise in contractual wages is expected to be lower than this year's (4¼% in 2001, 3¾% in 2002). Moreover, the growth in labour productivity will recover in 2002. On balance, this means that the contribution of labour costs to inflation next year will be smaller than that made this year (2001: 2%-point; 2002: 1¼%-point).

As well as the consumer price index , underlying inflation is also an indicator for inflation. Underlying inflation (inflation excluding the price development of fruit, vegetables, energy, public services and indirect taxes) is forecast at 3¼% in 2001 and at 2½% in 2002. The HICP-inflation in 2001 is forecast at 4¾% and in 2002 at 2½%[7].

All in all, the nominal development of the Dutch economy presents a mixed picture. Inflation has been pushed, partly by a number of incidental factors, to an exceptionally high level in 2001. The risk that the current high level of inflation be reflected in higher inflation expectations (and consequently higher wage demands) must be averted. Wage movements are subject to upward pressure from the tight labour market on the one hand and to downward pressure from the slowdown in economic growth on the other. Policy measures aimed mainly at expanding the supply of labour were already taken in 2001, and policy in 2002 will also be targeted at stimulating that supply. Chapter 5 will discuss this in more detail. Consistent with the Commission's Broad Economic Policy Guidelines, one of the policy aims in 2002 is to reduce the upward pressure on inflation in 2002 relative to 2001.

For the sake of comparison, the European Commission's Spring forecasts for 2001 and 2002 are presented in Table 2.1. The Commission's forecasts are more positive across the board, mainly because the turnaround in the Dutch economy could not be clearly seen until the second quarter of this year and recovery is taking longer than anticipated. The projections by the Commission were drawn up before publication of the second-quarter growth figures. Dutch forecasts in respect of external factors are lower and the same applies to private consumption and investments. On balance, this results in lower GDP growth in 2001 and 2002 than forecast by the Commission.

2.2 Cautious trend-based scenario for 2003 and 2004 (2¼% growth)

The years 2003 and 2004 lie beyond the current Cabinet's term of office. Consequently, data for those years have in any case a different status than the forecasts for 2001 and 2002. The figures for 2003 and 2004 are based on a cautious trend-based scenario with an expected GDP-growth of 2¼%. This cautious trend-based scenario is based on a recent publication by the Netherlands Bureau for Economic Policy Analysis on the Dutch growth potential in the medium term.[8]

---

[7] Owing to differences in definition, the CPI-inflation and HICP-inflation sometimes differ slightly.
[8] F.J.H. Don, Netherlands Bureau for Economic Policy Analysis, Document No. 001. *Het Nederlandse groeipotentieel op de middellange termijn* (The Dutch long-run growth potential) (March 2001).

3. Movements in EMU budget balance and EMU debt

3.1 Policy strategy

When the Governments Coalition Agreement was drafted - using cautious growth assumptions'- an improvement of the EMU balance of ¼ percentage point was projected, from –1¼% of GDP in 1998 to –1% of GDP in 2002. Considering the cautious assumptions used, it was held likely that the actual balance might turn out to be more favourable, but this was not formulated as an explicit objective. During the Cabinet's period of office, the fiscal rules regarding windfalls and setbacks are applicable. Where expenditure is concerned, the rule is that the expenditure ceilings, based on cautious growth assumptions, may not be exceeded. On the revenue side, the so-called revenue windfall and setback formula is in force. This formula provides that – at an EMU balance of more than –¾% of GDP – any windfalls should benefit the EMU balance to the extent of 50%, the remaining 50% being used for additional tax cuts. Any revenue setbacks should be absorbed by the EMU debt to the extent of 50%, the remainder being offset by tax increases. Since the past few years have witnessed considerable revenue windfalls, the formula has resulted in a considerably more favourable development of public finance than that implied in the cautious scenario, the more so because, ultimately, a larger proportion of the revenue windfalls than the 50% provided for in the Government's policy programme has been used for debt reduction. This, in turn, was possible as the Cabinet decided on a lower amount of tax cuts than that permitted by the windfalls and setbacks formula; it did so in view of inflation and the development of the budget balance also in the light of the ageing of the population.

3.2 EMU budget balance and EMU debt in 2000-2002

Over the past few years, the trend-based budgetary policy has resulted in significant improvements in the EMU budget balance and EMU debt. The use of cautious assumptions when drafting the Coalition agreement, the strict enforcement of expenditure ceilings, and the application of the revenue windfalls and setbacks formula have clearly borne fruit. In 1999 a surplus was recorded for the first time in 26 years, whereas in 1998 the EMU budget balance had still been –0.8% of GDP. In 2000 the surplus amounted to 1.5% of GDP (excluding proceeds from the auction of UMTS licences). For 2001, a surplus of 1.0% of GDP is anticipated. The deterioration relative to the year 2000 is caused by the tax reform in 2001, which, together with other measures, leads to tax cuts totalling EUR 3.3 billion (0.8% of GDP) in 2002. For 2002, despite the low rate of economic growth, current expectations are that the EMU budget balance will be virtually unchanged at 1% of GDP. Within the expenditure ceilings room has been found for expenditure on infrastructure, safety, health care and education. This is discussed in more detail in section 5.1.
Thanks to the improvement in the EMU budget balance and the high rate of economic growth (denominator effect), the EMU debt ratio has declined in recent years. In 2000 it came out at 56.1% of GDP. It is expected to decrease further, to 47.7% of GDP in 2002.

Table 3.2.1 Fiscal developments 1998-2002 (% of GDP)

	1998	1999	2000	2001	2002
EMU budget balance	**-0.8%**	**0.4%**	**1.5%** [a]	**1.0%**	**1.0%**
- Central government	-1.2%	-0.7%	-0.3%	0.1%	0.3%
- Social security funds	0.1%	1.2%	1.7%	0.7%	0.5%
- Local authorities	0.3%	0.1%	0.1%	0.2%	0.2%
Public revenues	47.2%	48.4%	48.3%	46.8%	46.5%
Public expenditure	48.0%	48.0%	46.8%	45.8%	45.5%
Interest expenditure	4.7%	4.6%	4.2%	3.5%	3.0%
Primary balance	3.9%	5.0%	5.7%	4.5%	4.0%

Table 3.2.2 EMU debt 1998-2002 (% of GDP)

	1998	1999	2000	2001	2002
EMU debt	**66.8%**	**63.1%**	**56.1%**	**51.8%**	**47.7%**
Change in debt ratio	-3.1%	-3.6%	-7.0%	-4.3%	-4.1%
Contribution to decrease in debt ratio:					
EMU balance	+0.8%	-0.4%	-1.5% [a]	-1.0%	-1.0%
of which: interest payments	4.7%	4.6%	4.2%	3.5%	3.0%
Financial transactions and miscellaneous	0.1%	0.3%	-1.2%	0.6%	-0.5%
Denominator effect GDP growth	-4.0%	-3.5%	-4.3%	-3.9%	-2.6%

[a] Excluding proceeds from auction of UMTS licences (0.7% of GDP).

3.3 EMU budget balance and EMU debt in 2003 and 2004

The revenue and expenditure projections for 2003 and 2004 are based on the technical assumption of unchanged policies from 2002 onwards and a cautious trend-based scenario of 2¼% economic growth, in conformity with the most recent views for 2003-2006 of the Netherlands Bureau for Economic Policy Analysis[9]. Since the priorities of the next Cabinet are as yet unknown, the EMU budget balance of 1% for 2002 is assumed to remain unchanged in 2003 and 2004. On this basis, the Netherlands Bureau for Economic Policy Analysis has computed the fiscal margin for the period of office of the next Cabinet (2003-2006). The fiscal margin represents the amount available to the next Cabinet – on the assumption of unchanged policies and an economic growth rate as referred to above – for further debt reduction, tax cuts or additional expenditure. The available margin is 0.2% of GDP in 2003, increasing to 0.3% of GDP in 2004.[10] This means that, on the assumption that no new policies (additional tax reductions and/or higher expenditure) are undertaken, the EMU budget balance will improve by 0.2% of GDP in 2003 and by 0.3% of GDP in 2004.

[9] F.J.H. Don, Netherlands Bureau for Economic Policy Analysis, document no. 001*, Het Nederlandse groeipotentieel op de middellange termijn* (The Dutch long-run growth potential) (March 2001).

[10] Based on calculations made by the Netherlands Bureau for Economic Policy Analysis, in which the fiscal margin for the period 2003-2006 is estimated at EUR 3¼ billion (0.7% of GDP). It has been assumed that this margin is equally distributed over the four years. Netherlands Bureau for Economic Policy Analysis, document no. 003, *Boekhoudkundige berekening budgettaire ruimte 2003-2006* (Accounting calculations of the fiscal margin for 2003-2006) (June 2001).

Table 3.3.1 EMU budget balance and EMU debt, 2003-2004 (% of GDP)

	2002	2003	2004
Cautious trend-based scenario			
Economic growth		2¼%	2¼%
EMU budget balance	1.0	1.0%	1.0%
EMU debt	48%	45%	42%
Margin [a]		0.2%	0.3%

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

In order to gain an impression of the consequences which a higher growth rate would have for the fiscal margin in 2003 and 2004, the effects on the margin have been calculated of a ¼ percentage point higher growth rate. Such a higher growth rate would result in an additional margin – increasing over the years – averaging barely 0.1% of GDP per annum. The exact magnitude of the additional margin depends on the origin of the higher growth rate (higher productivity or higher employment growth). The additional scope created by extra productivity growth is smaller than that created by extra employment growth, because extra productivity growth leads to additional increases in contractual wages, causing higher expenditure. The higher expenditure arises from the fact that civil servants' salaries and social security benefits are linked to market sector contractual wages. Moreover, the number of social security benefits is higher when the extra growth is caused by a higher productivity growth. In a scenario assuming a ¼ percentage point lower economic growth rate, the effects are similar, but opposite.

4. Comparison with previous update and sensitivity analysis

4.1 Comparison with 2000 Stability Programme update

Table 4.1.1 Differences relative to previous update 2000-2002[a]

	2000	2001	2002
GDP growth			
2000 update	4½%	4%	2%
2001 update	3½%	2%	2%
Difference	-1%	-2%	0%
EMU budget balance			
2000 update	1.0%[b]	0.7%	¼%
2001 update	1.5%[b]	1.0%	1%
Difference	+0.5%	+0.3%	+¾%
EMU debt			
2000 update	56.6%	52.3%	49½%
2001 update	56.1%	51.8%	47.7%
Difference	-0.5%	-0.5%	-1¾%

[a] 2000 update for 2002 based on cautious scenario.
[b] Excluding proceeds from auction of UMTS licences (0.7% of GDP).

Growth

In 2000 economic growth came out at 3½%, 1 percentage point below the rate expected in the 2000 Stability Programme. The decrease was caused in part by a more subdued growth of national expenditure and in part by a decline in the volume of operations of financial institutions in the last quarter of 2000.

For both 2001 and 2002, the Netherlands Bureau for Economic Policy Analysis now estimates a economic growth of 2%. For 2001, this represents a 2 percentage point downward adjustment relative to the previous update of the Stability Programme, caused by lower growth of private consumption (2¼% instead of 4½%) and substantially lower export growth (3 ½ % instead of 9%). Being a small open economy, the Netherlands keenly feels the effects of economic developments elsewhere in Europe and in the United States. This is reflected in a significant downward adjustment relative to the previous Stability Programme update of the growth of world trade relevant to the Netherlands (from 8¾% to 3%). In the previous update, the estimates for 2002 were based on the cautious scenario, providing for a 2% growth rate. The Netherlands Bureau for Economic Policy Analysis now estimates economic growth in 2002 at 2%, so that there is no change compared to the previous update.

EMU budget balance and EMU debt

In 2000 the EMU budget balance improved with 0.5 percentage point, thanks to improved balances at the central government and the social security funds. Despite the lower economic growth in 2001, the EMU budget balance and EMU debt are showing more favourable movements than those expected in the previous update. One reason is that revenues have shown barely any decrease compared to the previous update. This is due to changes in the composition of the tax base and new views about the development of revenues on a cash basis and of tax assessments. Elements of the tax base subject to relatively high tax rates (such as wages) are showing higher growth than elements subject to lower tax rates. Despite the lower economic growth rate relative to the previous Stability Programme update, the overall wage and salary bill has remained at the same level; a somewhat less pronounced slowing-down of employment growth is offset by a higher increase in contractual wages (+¾ percentage point). The fact is that contractual wages react to a growth adjustment with a lag, since most of the collective labour agreements have already been concluded. The lower profit growth owing to the lower economic growth rate takes some time to feed through into revenues from corporation tax on a cash basis. At the same time, estimated revenues from several taxes (including property transfer tax and dividend tax), whose levels are not directly related to the economic situation, have been adjusted upwards on the basis of outturns for the first half of 2001.

For 2002, too, the EMU balance shows an improvement compared to the previous update, despite the unchanged rate of economic growth. Apart from the more favourable EMU balance in 2001, the improvement is caused by the fact that in the present update the revenue windfalls are largely used for debt reduction. In the previous update it was assumed that in 2002 50% of the revenue windfalls would be used for tax cuts (EUR 3.6 billion). Ultimately, it was decided that in 2002 taxes will be reduced by EUR 1.3 billion (NLG 2.9 billion) and that the remainder of the revenue windfalls will be used to improve the EMU budget balance. The decision was underlain by considerations pertaining to the movements in inflation and those in the fiscal balance in connection with the ageing of the population. During the Cabinet's period of office as a whole (1999-2002), the available EUR 12 billion (NLG 26½ billion, or about 2.6 % of GDP) in revenue windfalls is used to the extent of EUR 9 billion (about 2% of GDP) for additional improvements in the EMU budget balance and to the extent of EUR 2.9 billion (about 0.6% of GDP) for additional tax cuts compared to the Coalition agreement. During the period as a whole, the bulk (about 75%) of the revenue windfalls is used for debt reduction. Hence, the automatic stabilisers on the revenue side have for the most part been able to work, all the more so if it is realised that the revenue windfalls are estimated relative to the Coalition agreement, which is based on cautious growth assumptions (instead of trend growth). A recent report of the Study Group on the Budget Margin entitled "*Stabiel en duurzaam begroten*" (Stable and sustainable budgeting) stresses the importance of the operation of the automatic stabilisers on the revenue side. The Study Group on the Budget Margin is a technical advisory committee which evaluates budgetary policy once every four years and issues recommendations on the budgetary policy to be pursued during the period of office of the next Cabinet.

4.2 Sensitivity analysis

The estimates for the Dutch economy in 2001 and 2002 are subject to a margin of uncertainty. In order to gain an impression of the effects on the budget of other macro-economic variables than those allowed for in the baseline projection, a number of uncertainty variants are analysed. These are technical variants providing tentative calculations of the effects of changes in macro-economic variables on revenues and expenditure. The principal uncertainties are to be found in the external environment. Hence, analyses have been made of the effects of lower output growth in the United States, a lower dollar exchange rate, higher oil prices and higher long-term interest rates on expenditure, revenues and the EMU balance.

Table 4.2.1 Baseline projection, 2001 and 2002

	2001	2002
GDP Netherlands	2	2
GDP United States	1½	2½
Dollar exchange rate (in terms of guilders)	2.50	2.45
Oil prices (US dollars per barrel)	26.0	23.0
Long-term interest rate	5	5

Table 4.2.2 Fiscal effects in 2002 of four uncertainty variants (% of GDP)

	Cumulative 1½ percentage points lower US output growth in 2001-2002	10% deprecation US dollar in 2002	USD 6 higher oil price	1 percentage point higher long-term interest rates in 2002
Expenditure	0.0%	+0.05%	+0.1%	+0.1%
Revenues	-0.1%	-0.1%	+0.2%	0.0%
EMU balance	-0.1%	-0.1%	+0.1%	-0.1%

Source: Netherlands Bureau for Economic Policy Analysis.

Lower output growth in the United States also leads to a lower growth rate of world trade. The net effect on the EMU budget balance is –0.1 percentage point . A lower dollar exchange rate impairs competitiveness, causing exports to decline. Through lower receipts from natural gas, this also leads to lower public revenues. Higher oil prices push up natural gas prices and, hence, boost public revenues. A 1 percentage point higher long-term interest rate gives rise to higher interest payments, causing the EMU budget balance to worsen by 0.1 percentage point of GDP.

5. Quality of public finance

Table 5.1 Public finance 2000-2004 (% of GDP)

	2000	2001	2002	2003	2004
Balance per sector					
Total government	1.5% [a]	1.0%	1.0%	1.0% [b]	1.0% [b]
Of which Central government	-0.3%	0.3%	0.4%	n.a.	n.a.
Of which Social security funds	1.7%	0.5%	0.4%	n.a.	n.a.
Of which Local government	0.1%	0.2%	0.2%	n.a.	n.a.
Total public sector					
Total revenues	48.3	46.8	46.5	n.a.	n.a.
Total expenditure	46.8	45.8	45.5	n.a.	n.a.
Fiscal balance	1.5	1.0	1.0	n.a.	n.a.
Interest payments	4.2	3.5	3.0	n.a.	n.a.
Primary balance	5.7	4.5	4.0	n.a.	n.a.
Revenues					
Tax revenues	25.1	25.5	26.2	n.a.	n.a.
Social security	16.3	14.3	14.0	n.a.	n.a.
Interest income	0.8	0.8	0.8	n.a.	n.a.
Other	6.1	6.2	5.5	n.a.	n.a.
Total revenues	**48.3**	**46.8**	**46.5**	n.a.	n.a.
Expenditure					
Consumption	16.3	16.3	16.5	n.a.	n.a.
Social security payments	14.5	14.4	14.5	n.a.	n.a.
Interest	4.2	3.5	3.0	n.a.	n.a.
Subsidies	1.4	1.4	1.4	n.a.	n.a.
Investment	3.3	3.4	3.5	n.a.	n.a.
Capital transfers	1.2	1.1	1.1	n.a.	n.a.
Other	5.9	5.7	5.5	n.a.	n.a.
Total expenditure	**46.8**	**45.8**	**45.5**	n.a.	n.a.

[a] Excluding the auction of UMTS licences (0.7% of GDP)
[b] The figures for 2003 and 2004 differ in nature from those for 2000-2002. For 2003 and 2004, it is assumed that a constant EMU balance will be in place as from 2002. In 2003 and 2004, 0.2% of GDP and 0.3% of GDP, respectively, will still be available (given the constant EMU balance of 1%) for an improvement of the fiscal balance, a reduction in taxation and social insurance contributions, or an increase in expenditure.
Source: Budget Memorandum2 2002 and Macro-Economic Outlook2002.

5.1 Expenditure

A key feature of budgetary policy in the Netherlands is the deployment of fixed real expenditure ceilings. Expectations are that these expenditure ceilings will not be exceeded during this Cabinet's term of office. This means that in the period 1999-2002, total public expenditure will increase by an average of 1½% annually in real term. Within the ceilings, expenditure on health care, education, safety and quality of living conditions, the infrastructure, nature and the environment has increased by much more than the 1½% rise in total expenditure, viz. by on average 3½% per year in real terms (see Table 5.1.2). The scope for this increase was created by lower interest payments (consequent on a lower EMU debt and lower interest rates) and lower expenditure on social security. Expenditure on social security has dropped as a result of the favourable economic growth in combination with the labour market policy pursued. Public spending on items other than interest and social security has expanded slightly faster than GDP. Although the expenditure ceilings have been maintained, the expenditures of the various sectors have undergone diverging developments. For an analysis of the development of public expenditure the development in real terms is taken (deflated by the price movements of GDP).

Table 5.1.2 Average real growth of public expenditure per year[3]

	1999-2002
Total public expenditure	1½%
Of which Social security	-½%
Of which Interest	-8¼%
Public expenditure excl. social security and interest payments	3½%
Of which Health care	4%
Of which Education	3¾%
Of which Safety an quality of Living conditions	6½%
Of which Infrastructure	9%
Of which Nature and the environment	8%
Of which Other[2]	2¼%
GDP	2¾%

[1] The average annual changes in real terms presented here are based on figures supplied by the Netherlands Bureau for Economic Policy Analysis (Macro-Economic Forecast 2002, Table A9) and calculations made by the Ministry of Finance (*Safety an quality of* living conditions, nature and the environment). Public expenditure does not include non-tax revenues.
[2] The category Other includes transfers to other countries, defence, public administration excluding living conditions, and the category Subsidies.
[3] Real expenditure is obtained by deflating nominal expenditure by the change in prices of GDP.

In 2002, as in earlier years, the expenditure ceilings provide scope for more productive spending on, for instance, education and the infrastructure, as well as on health care and safety. Special attention is paid to remedying labour market tensions within the public sector. Part of the increase d spending on the categories concerned was decided on when the coalition agreement was drawn up and was therefore already provided for in the expenditure ceilings. Another part was accommodated by lower-than-expected interest payments. In addition, there has been a shift in priorities within the expenditure ceilings.

From a macro-economic perspective, it is worthwhile to take a look at the share of public spending categories relative to GDP. Such an exercise gives an overall impression of the development of the public sector vis-à-vis the market sector. Viewed over the longer term, total public expenditure as a percentage of GDP fell by 9 percentage points in the period 1994-2002 (from 54.2% of GDP to 45.5%). This decrease was accounted for especially by expenditure on social security (4½ percentage points) and interest (3¼ percentage points).

5.2 Revenues

In 2002, revenues will be EUR 12 billion (NLG 26¼ billion) higher than anticipated in the coalition agreement of 1998. If the formula on revenue windfalls and setbacks is strictly applied, EUR 6 billion extra could have been spent on a reduction in taxation and social insurance contributions during the current Cabinet's term of office, in addition to the EUR 2 billion (NLG 4½ billion) decided on in the coalition agreement. In the period 1999-2001, an extra reduction of EUR 1½ billion was already agreed in addition to the EUR 2 billion reduction provided for in the coalition agreement. Under the windfall and setback formula, EUR 4½ billion was thus basically available for a reduction of the tax burden in 2002. However, with a view to, among other things, the development of inflation and the ageing of the population, the Government decided to lower taxes and social contributions by much less in 2002, viz. EUR 1.3 billion (NLG 2.9 billion; 0.3% of GDP).

In conformity with the Council Opinion on last year's Stability Programme, the reduction of the tax burden in 2002 is notably intended to boost the supply of labour in the face of the current labour market shortages. This is also in line with the quest for a moderate development of wage costs. Private enterprise is furthermore stimulated. In order to boost the participation rate, those aged over 58 are stimulated to continue working (by means of the introduction of a supplementary earned income tax credit) while non-participants are encouraged to enter the labour market (through a fixed income tax rebate). Another measure to raise the participation rate and to reduce the poverty trap is the increase in the general tax allowance for all employed persons. Further measures are intended to make it easier for people to combine working and caring for children. Employers recruiting or employing older persons, those re-entering the labour market and those incapacitated for work are rewarded through, for instance, a reduction in social insurance contributions. The Commission's broad guidelines recommend that the participation rate of notably older and disabled persons be raised by way of a reduction in taxation and social insurance contributions.

In order to boost the business climate, the corporation tax is reduced by 0.5 percentage point, to 34.5%. In the fiscal sphere, an expansion of the tax deduction of extraordinary expenses in 2002 is intended to bring relief for persons confronted with (high) medical expenses for longer periods, such as the disabled and the chronically ill.

Table 5.2.1 Tax cuts in 2002 (on a transactions basis); in EUR billions

Labour market and poverty trap	-0.7
Entrepreneurs	-0.3
Other measures	-0.
Total tax cuts in 2002	**-1.3**

Source: Budget Memorandum 2002

6. Public finance in the long term (ageing)

Demographic development

As indicated in the previous Stability Programme, the policy on long-term indebtedness is currently a much-debated item in the Netherlands in view of the ageing of the population. The elderly dependency ratio, that is the number of people aged 65 and over relative to those aged 20 to 64, will nearly double from 22% today to 43% in 2040, and then stabilise at the structurally high level of around 40%. The ageing process will take place mainly between 2010 and 2030 (see the Table below). In that period, the elderly dependency ratio will rise by an average of ¾ percentage point per annum. Ageing has consequences for the demand for public provisions (notably state old-age pensions and health care) and the financial base for these provisions. Ageing will only begin to make itself seriously felt from 2010, which means that the financial base for public provisions will remain relatively large until then.

Table 6.1 Demographic development 2002-2040

	Elderly dependency ratio Level at year's end	Change in elderly dependency ratio Average per annum (% points)	20-64-year-olds Change x 1000 persons	Over 65s Change x 1000 persons
2002	22%			
2002-2010	24%	+¼%	+250	+250
2010-2020	32%	+¾%	- 100	+700
2020-2030	39%	+¾%	-350	+600
2030-2040	43%	+½%	-300	+250
2002-2006		+¼%	+150	+100
2006-2010		+½%	+100	+150

Source: Statistics Netherlands

Costs of ageing

On the assumption of wage-linked schemes, ageing will push the costs of state old-age pensions and health care up from 12% of GDP today to 20% in 2040. If policies do not change, the number of people with a disability benefit is expected to increase further. The increase in the above expenditure is mainly structural in nature.

Table 6.2 Development of public expenditure and revenues 2000-2040 (% of GDP)*

Expenditure	**+8¾%**
State old-age pensions	+4¼%
Health care	+3¾%
Incapacity for work benefits	+¾%
Revenues	**+4¼%**
Direct taxes on higher pensions	+3%
Indirect taxes on higher pensions	+2%
Participation rate of women	+½%
Ageing of labour force	-½%
Fall in natural gas revenues	-¾%
Balance (still to be financed)	**4½%**

Source: Netherlands Bureau for Economic Policy Analysis, Ageing in the Netherlands, 2000
* Unchanged policy scenario: i.e. wage-linked public provisions and a constant burden of taxation and social insurance contributions.
In part, these figures deviate from the report of the EPC working group on the implications of ageing.

The higher expenditure is partly offset by higher revenues consequent on ageing. If tax rates and social insurance contributions remain unchanged, about half the costs of ageing can be financed from higher revenues from pensions paid. These higher revenues are the consequence of the fact that in the Netherlands pensions are taxed upon payment (pension premiums are not taxed). Besides this, revenues from indirect taxation also go up when these higher pension payments are spent. Higher revenues are also expected to ensue from the anticipated further rise in the participation rate of women. On the other hand, revenues are expected to decline to the same extent as a result of the ageing of the potential labour force. It must be remembered that the participation rate of older employees (over-50) is relatively low compared to that of persons under 50, so that the participation rate will decline when the potential labour force ages. In the long term, natural gas revenues will decline as stocks are depleted. On balance, about half the increase in public spending, of 8% of GDP, on state old-age pensions and health care can be financed if policy remains unchanged. The remainder of the higher expenditure will need to be financed from lower interest payments and a broader financial base for public spending.

Sustainable scenario

A sustainable scenario for public provisions entails that, on the assumption of constant public schemes, meaning that they are wage-linked, and assuming constant tax rates and social insurance contributions, the debt ratio will tend to move towards equilibrium in the long term. Such a sustainable scenario contains a accounting exercise whereby the debt will be repaid in its entirety by around 2025[10]. From a demographic and budgetary perspective, it is of considerable importance that a major effort be made to reduce the debt in the period before 2010. The turnaround of the EMU balance from –4% of GDP in 1994 to 1% in 2001 and 2002 constitutes an essential move towards that goal.

Table 6.3 Long-term sustainable scenario (% of GDP)

	2001	2005	2010	2020	2030	2050
Total expenditure	**44¾%**	**44¾%**	**45¾%**	**46¾%**	**49¼%**	**50¼%**
Of which state old-age pensions	4¾%	5%	5¾%	6¾%	8½%	8½%
Of which health care	7%	7¼%	7¾%	8½%	10%	10¾%
Of which interest payments	3½%	2¼%	1½%	¼%	-¼ %	¼%
Total revenues	**46½%**	**46¾%**	**47%**	**48%**	**49½%**	**50%**
Assumptions						
Growth of labour productivity	1¾%	1¾%	1¾%	1¾%	1¾%	1¾%
Real growth of GDP	2%	2%	2%	1¾%	1½%	1¾%
Participation rate for men (aged 20-64)	83%	82%	80%	80%	80%	80%
Participation rate for women (aged 20-64)	59%	67%	74%	74%	74%	74%
Overall participation rate (aged 20-64)	71%	74%	77%	77%	77%	77%
Unemployment rate	3¼%	3¼%	4%	4%	4%	4%

[10] Netherlands Bureau for Economic Policy Analysis, Ageing in the Netherlands, 2000.

7. Structural and institutional reforms

With a view to the next Cabinet's term of office, and the fact that much work remains to be done in the future, several forecasts have been made in the Netherlands with regard to fiscal developments, health care, education, the economic structure and the social infrastructure. Demographic changes, individualisation, the rapid technological developments and internationalisation are major trends affecting Dutch society and the role of the public sector. In order to augment the efficiency of public expenditure, public institutions will have to be subjected to reform. Efficiency and financial resilience will remain major objectives. In some sectors, the quality of public provisions can be raised by giving the institutions involved (such as schools and institutions providing health care) more leeway and greater responsibilities. The public authorities will then focus on giving direction and will hold the institutions providing the services accountable for the results achieved. This, in combination with increasing competition among service-providing institutions, may augment both their efficiency and their capacity to provide tailored services.
The Cabinet's Paper on how the health care system can be reformed fits into the above framework. In the system outlined, the public authorities will notably concentrate on the formulation of minimum requirements, and give insurance corporations and health care institutions greater leeway. The objective is to bring supply and demand in this field more into line with each other. Competition is furthermore boosted, and efficiency augmented. Within the education sector, the first move has been made towards giving schools a greater choice of teaching methods and ways of spending their financial resources.

The fiscal system has also been reviewed in the light of future trends. The Fiscal Forecast is aimed at the achievement of a broader base and a higher participation rate. Reports on individual issues address, among other things, possible ways of greening the tax system an improving the business climate so as to boost competitiveness vis-à-vis other countries. These studies offer a basis for policy-making by the next Cabinet.