# Stability Programme
# The Netherlands, 2001-2007

## June 2003,
## Revision of the December 2002 version

## 1. Introduction

Following elections in January — and one failed attempt for a coalition — the new Cabinet was installed May 27, 2003. The previous government was in office only for a limited amount of time (July – October 2002), although this Cabinet stayed on until the new Cabinet could take over.

The new Cabinet has laid down its policy lines in a coalition agreement known as the 'Global Agreement for Government Policy'. This Agreement contains the budgetary policy for the 2004-2007 Cabinet term of office. The Agreement also includes corrective measures for 2003. These measures, as well as the budgetary policy for 2004-2007 come on top of the policy that was introduced by the previous government for 2003-2006 in its Strategic Accord and supplementary package. This Stability Programme is based on the policies set out in both the previous Cabinet's Strategic Accord and the new Global Agreement for Government Policy. The Programme was approved by the Council of Ministers and sent simultaneously to Parliament and the European Commission.

After a period of buoyant economic growth in the second half of the 1990s and 2000, the economic climate worsened substantially from 2001 onwards. Growth in 2001 was only 1.3% and slowed further to 0.2% in 2002. Prospects for 2003 are dim with growth projected at only ¾% of GDP. First-quarter growth figures suggest that this projection is probably on the optimistic side. An update of the projection can be expected this Summer when the CPB Netherlands Bureau of Economic Policy Analysis does its regular forecasting exercise. The disappointing economic performance not only reflects the international slowdown in economic growth but also a deterioration in competitiveness due to rapidly increasing labour costs and an appreciation of the euro. Negative wealth effects owing to poor stock market performance also play a role. Compared to the forecast presented in the 2001 Stability Programme, economic growth over the period 2000-2004 is now cumulatively 5 (!) percentage points lower. The labour market too is feeling the impact of the downturn. Employment (in persons) is expected to drop ½% this year and will, on average, probably grow by no more than ¾% per year over 2004-2007. The unemployment rate this year may reach 5¼%, compared to 3.3% in 2001 (national definition) and is likely to rise further in the years to come.

The poor economic performance has led to a severe deterioration of the budgetary situation. On top of this, the strong increase in health care spending, that was particularly prominent last year, also contributed to the worsening of the fiscal position. The balance moved from a surplus of 1.5% of GDP in 2000 (excluding UMTS) to a deficit of 1.2% of GDP in 2002. Under the assumption of no policy change — that is; not including any measures of the new and previous government — the deficit in both 2003 and 2007 would likely be 2¼% of GDP, while during the in-between years the balance would move dangerously close to – or even reach -- the 3% deficit limit in the Maastricht Treaty.

Both the previous and the new Cabinet thus faced the enormous challenge of repairing the fiscal outlook, while also implementing the necessary structural changes to make the economy more resilient to shocks and to improve its growth potential. In the design of the policy measures, care also had to be taken that the fiscal situation would be addressed while leaving some room for the automatic stabilizers to work in the medium term. In the short term, moreover, it would be crucial to limit the extent to which the decline in public demand would undermine initial economic recovery.

A solution to this policy challenge was initiated by the previous Cabinet's Strategic Accord plus a supplementary policy package. The Strategic Accord was aimed particularly at a structural reinforcement of the economy, while savings of about 1% of GDP were intended to improve the EMU balance. Room was also created to allow for extra spending on health care, safety and education.

Given that global economic recovery was delayed and the downturn now seems deeper than what was initially expected, the Strategic Accord alone would be insufficient to render satisfactory results on both the economic and fiscal front. In its Global Agreement for Government Policy the new Cabinet, therefore, decided to introduce a large additional package for the years 2004-2007. This package includes spending cuts of 2.7% of GDP. It sets out to reduce the fiscal deficit, while at the same time improving structural economic conditions and allowing for a limited reduction of the tax burden (0.3% of GDP) relative to 2003. Of course, the new Cabinet will also implement particularly those measures that were introduced by the previous Cabinet for 2004-2007 and that are aimed at improving the economy's growth potential. In sum, a number of measures will be taken in the social insurance sector that will raise the effective labour supply. Particularly relevant is the implementation of the reform of the Disability Insurance Act (WAO), also recommended in the 2003 Broad Economic Policy Guidelines. In addition, unemployment benefit criteria will be tightened and specific measures will be taken to address the participation of older workers. Such measures will improve the outlook for the economic growth potential and will counter demographic developments. They will also help to repair the fiscal situation as the tax base is broadened and fewer people need to receive benefits. Other measures are geared more towards specifically improving the fiscal outlook and include the elimination or restriction of favourable tax treatments, where there is no apparent reason to maintain such treatments. An example is the tightening of the conditions for the tax deductibility of the mortgage interest payments to counter unintended use.

Implementation of the relevant policy measures from the Strategic Accord together with the package introduced by the new Cabinet will allow for an investment in the economic growth potential as well as in priority areas such as health care, infrastructure, safety and education. Investment in education is key also as part of the strategy adopted by the Lisbon European Council. Relative to 2003, the package designed by the new Cabinet leaves room for a limited reduction in the tax burden of 0.3% of GDP. With respect to the fiscal position, the new package will on net -- there are also additional expenditures planned of 0.7% of GDP by 2007 -- generate

savings of 0.6% of GDP in 2004 up to 1.7% of GDP in 2007. These come on top of the savings of 1% of GDP already accomplished in 2003. Savings of this size are certainly not easy to implement. They are considered necessary, however, not only to prevent a further deterioration of the balance but also to preserve the objective of sufficiently repaying government debt so that the future costs of ageing will not endanger long-term financial sustainability.

After accounting for the temporary losses that are inevitably incurred because of the economic impact of the budget cuts, the savings will limit the deficit in 2003 to 1.6% of GDP. Between 2004 and 2007, moreover, the balance will gradually improve from a deficit of 1.7% of GDP in 2004 to a deficit of 0.5% of GDP in 2007. Thanks to the sizeable package for 2003 (of over 1% of GDP), the cyclically adjusted deficit will, in 2003, decline to 0.8% of GDP. From 2004, the cyclically adjusted deficit improves further and by 2005 is close to balance.

Regarding the quality and composition of public finances, three issues are worth highlighting. For one, the two packages combined are geared towards both reducing the deficit and improving structural growth. The savings introduced by this Cabinet, furthermore, take place mainly on the spending side so that, at the same time, the tax burden can be slightly reduced.

Second, the new Cabinet has agreed to maintain the system of real expenditure ceilings and to let both revenue windfalls and setbacks flow into the budget balance. However, should the setbacks jeopardise compliance with the rules on the cyclically adjusted balance in the Stability and Growth Pact or with the Maastricht criteria for the EMU balance, measures will be taken to repair the budget deterioration.

Third, on the topic of health care, Cabinet will implement a new health care system in 2006. The new system will replace the present system. Prior to the introduction of the new system, Cabinet will introduce co-payments and deductibles. In addition, the public costs of health care will be reduced by limiting the public health insurance package. Together these measures amount to ½ of GDP. With the changeover to the new system Cabinet expects to improve the quality of health care provision, while also curbing costs.

## 2. The Dutch Economy

### 2.1. Review of 2001 and 2002 and the medium term forecast up to 2007

*Economic growth*

During the 1990s, economic growth in the Netherlands averaged close to 3% annually, exceeding average performance in Europe. In 2001, however, growth slowed to 1.3%. Since then, economic performance in the Netherlands has fallen behind the European average. The slowdown not only reflected the international downturn, but was exacerbated by the specific situation on the Dutch labour market. Owing to the strong economic performance of the past years, the labour market had become very tight. These conditions significantly pushed up labour costs. The sharp increase

in labour costs eroded competitiveness and caused the export sector to lose market share. Also, investments came under pressure owing to the steep rise in labour costs and slower output growth. A further deterioration of competitiveness plus the fact that investments were still hampered by the erosion of profitability, has limited growth in 2002 to 0.2%. Finally, the sharp fall in equity prices and the slower pace of house price increases have eliminated positive wealth effects on consumer spending.

Thanks to the international economic recovery, the economy is expected to pick up slightly in the second half of 2003 and overall growth for this year is projected to reach ¾%. Given that the first quarter growth figure was — at –0.3% — worse than was initially expected, the projected 2003 growth rate is probably optimistic. An update of the projections will be made this Summer as part of the regular forecasting exercise of the CPB Netherlands Bureau of Economic Policy Analysis. The slow rate of recovery in the Netherlands is partly related to the deterioration in the competitive position owing particularly to high labour costs, while the recent appreciation of the euro also plays a role. The sharp decline in confidence, moreover, is holding back both the increase in domestic consumption as well as investment growth. Investments are also still hampered by the erosion of profitability owing to high labour costs. An average annual growth rate of 2% is anticipated for 2004-2007. This growth assumption is based on the cautious economic growth scenario in the medium term reference scenario of last December albeit corrected for the impact of the policies set out in the Global Agreement for Government Policy. The cautious growth scenario takes account of a prudency-margin of ¼ percentage point. This implies that there is a small potential for an upside risk to the domestic growth projection. The potential growth rate for 2004-2007 is also assumed to be 2% annually.

*Employment*

In the seven years up to 2001, the Netherlands experienced a strong labour market performance. In 2001, the employment growth was 2% and the unemployment rate stood at only 3.3% (or 2.4% by the standardised definition). Despite the low unemployment rate, the number of inactive persons remains large. Approximately 1 million people claim disability benefits, representing almost 13% of the labour force. In addition, the economic slowdown has not left the labour market unscathed. Employment growth (in persons) fell to 0.7% in 2002, while a negative growth of ½% is expected for this year. In 2004-2007 employment growth will gradually restore to 1½% in 2007. The unemployment rate (national definition) is expected to increase from 3.3% in 2001 to a peak of 6¾% in 2005 and 2006. In 2007 the rate is projected to reach 6¼%, ½ percentage point above the estimated equilibrium rate. A similar pattern is likely to occur in the standardised rate. If the private sector were to follow the planned reduction in wage growth in the public sector (of 1 percentage point annually), employment could rise by an additional 30,000 full time equivalents (½%) by 2007.

### Table 2.1. Key figures, 2001-2007

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| Short-term interest rate (in %) | 4.3 | 3.3 | 2¼ | 2¼ | 3½ | 3½ | 3½ |
| Long-term interest rate (in %) | 5 | 4.9 | 4 | 4 | 5 | 5 | 5 |
| Dollar exchange rate against the euro | 0.90 | 0.94 | 1.08 | 1.08 | 1.10 | 1.12 | 1.13 |
| Price of crude oil in U.S. dollar | 24.60 | 25.00 | 26.00 | 23.50 | 23.25 | 23.50 | 24.00 |
| | Changes in % | | | | | | |
| Global GDP 1/ | 2.2 | 2.7 | 3½ | 4 | 3½ | 3½ | 3½ |
| GDP of EU-15 1/ | 1.6 | 0.9 | 2 | 2¾ | 2 | 2 | 2 |
| Volume of relevant world trade 1/ | 1.6 | 2½ | 6 | 8 | 6 | 6 | 6 |
| Volume of world imports 1/ | -0.3 | 3.2 | 7½ | 9½ | 7 | 7 | 7 |

1/ Figures are those underlying the medium term forecast from December 2002. An update of the medium term forecast will be made this Summer.

### Table 2.2. Economic growth and associated factors, 2001-2007 [1]

| | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
|---|---|---|---|---|---|---|---|
| | **Changes in %** | | | | | | |
| Gross domestic product, volume | 1.3 | 0.2 | ¾ | 1½ | 2 | 2½ | 2½ |
| Gross domestic product, level in EUR | 429.2 | 445 | 462 | 477 | 493 | 511 | 532 |
| GDP deflator | 5.3 | 3.5 | 3¼ | 1¾ | 1¼ | 1¼ | 1½ |
| CPI | 4.5 | 3.5 | 2½ | 1¾ | 1 | 1 | 1½ |
| HICP [2] | 5.1 | 4 | 2¾ | 1¾ | 1 | 1 | 1½ |
| Average wage inflation [3] | 0.3 | 0.4 | -1¼ | -1¾ | -¾ | -¼ | ¾ |
| Compensation per employee, market sector | 5.1 | 5.0 | 4¼ | 2¾ | 2 | 1¾ | 2¼ |
| Negotiated wage rates, market sector | 4.5 | 3.7 | 2¾ | 2 | 1¾ | 1½ | 2 |
| Labour productivity (market sector) | -0.6 | -0.1 | 2 | 2 | 1¾ | 1½ | 1½ |
| Unit labour costs, manufacturing industry | 4.9 | 4.3 | ½ | -1¾ | -- | -- | -- |
| Employment growth (in persons)[4] | 2 | 0.7 | -½ | -0 | ½ | 1¼ | 1½ |
| Unemployment (in % of working population) | 3.3 | 3.9 | 5¼ | 6¼ | 6¾ | 6¾ | 6¼ |
| Standardised unemployment (in % of working population) | 2.4 | 2.7 | 4¼ | 5½ | 6 | 6 | 5½ |
| **Expenditure and output, volumes** | | | | | | | |
| Private consumption | 1.2 | 1 | 1 | 1¼ | 1½ | 1¾ | 1¾ |
| Public sector consumption | 3.1 | 3½ | -¼ | ¾ | 1¼ | 1½ | 1¾ |
| Gross investment | -0.8 | -3¾ | - ¼ | 1 | 1½ | 1½ | 2½ |
| Inventories (change in % of GDP) | 0 | - ½ | ½ | 0 | 0 | 0 | 0 |
| Exports of goods and services | 1.7 | -1¼ | 3½ | 5 | 4¾ | 4¾ | 4½ |
| Imports of goods and services | 1.9 | -2 | 3¾ | 4¾ | 4 | 3¾ | 3¾ |
| **Share in real GDP growth** | **Contribution in percentage points** | | | | | | |
| Domestic demand | 1 | 0 | ¾ | 1 | 1½ | 1½ | 1¾ |
| Net exports of goods and services | 0.3 | ¼ | 0 | ½ | ½ | 1 | ¾ |

[1] For the sake of consistency, data from 2003 onward are based on the situation that was relevant when the medium term projection was made in December 2002. Data are corrected for the impact of the coalition agreement on this medium term forecast.

[2] The change in the HICP in 2004-2007 is assumed equal to the change in the CPI.

[3] Data reflect the *change* in the average wage inflation (calculated as the weighted average of the change in the wage inflation in the market sector and the business sector). The series is used to calculate the cyclically adjusted balance.

[4] For 2004-2007 it is assumed that employment growth including jobs of less than 12 hours a week, is equal to employment growth excluding such jobs.

*Inflation*

Consumer price inflation reached a peak-value of 4.5% in 2001 (or 5.1% according to the HICP). The rise in unit labour costs largely contributed to this acceleration in inflation. In addition, around 1 percentage point resulted from the increase in indirect taxation arising from the 2001 tax reforms. In 2002 inflation dropped to 3.5% (HICP: 4%). The depreciation of the U.S. dollar, of course, had a favourable impact. In addition, the 2001 tax reforms had no part anymore in the 2002 inflation figures. The strong increase in unit labour costs, however, remained an important factor also in 2002. Projected consumer price inflation for 2003 stands at 2½% (harmonised: 2¾%).

Inflation continues to be affected favourably by the depreciation of the U.S dollar. In the years after 2003, a more favourable development of the labour costs is expected to further moderate price increases. The projected average annual inflation for 2004-2007 is 1¼% (national definition). Government measures aimed at stimulating the effective labour supply and reducing labour demand by the public sector play an important role as they help to control the growth in labour costs. Policy is hence fully in line with the recommendation in the Broad Economic Policy Guidelines to prevent fiscal policy from fuelling inflation.

*Relevant policies*

Economic recovery in the medium term will be supported by the policy packages introduced as part of the Strategic Accord and the Global Agreement for Government Policy. The Cabinet created room, for instance, for extra spending on infrastructure, education, and on improving the interaction between business and education. The business sector will also benefit from the government's objective to further reduce the administrative burden. To stimulate future growth prospects it is, above all, essential that the effective labour supply be increased (especially given the projected slowdown in labour supply growth caused by demographic developments). To expand labour supply, government will adjust benefit regulations. For instance: The Disability Insurance Act (WAO) will be restructured so as to reduce the number claiming disability benefits, now amounting to close to 13% of the labour force. The new Act will be made accessible only to those who are fully incapacitated for work. In addition, the criteria for disability will be tightened. In the case of partial disability, both employees and employers are required to make every effort to bring employees back to the labour process, either in their former position or in another capacity. Labour supply will also be stimulated by tightening eligibility criteria *for*, and adjusting the duration *of*, unemployment benefits and by other measures geared towards further diminishing the poverty trap. Increased efforts are made, moreover, to raise the labour participation of older workers. Measures aimed at keeping older workers on the job include eliminating the favourable tax treatment of pre-pension arrangements and plans to reinstate the job-search requirement for those aged 57.5 years and over.

### 2.2. Risks relating to the forecasts for 2003-2007

*External risks*

The most prominent external risk is that global recovery will be delayed by more than what is currently anticipated. As is true for many European countries, recovery in the Netherlands will to a large extent depend on recovery of the world economy. If this recovery is delayed, growth (particularly in 2003) could be lower than is currently projected. Regarding the growth projection for 2004-2007, it should be kept in mind that this projection is based on the cautious economic growth scenario and that some margin for risk is thus already accounted for. There is, therefore, a small potential for upside risk to the domestic growth assumption for these years.

*Internal risks*

Apart from risks caused by factors outside the Netherlands, current projections are also subject to internal risks. For instance, although all partners involved seem well aware of the pressing need to moderate wage increases, it cannot be ruled out that a more pronounced increase in labour costs will occur than is currently projected. The increase in labour costs could also be more pronounced owing to higher pension premiums resulting from low equity prices. A sharper rise in labour costs than was projected will further undermine competitiveness and depress output growth and employment. It would also lead to higher inflation than is presently accounted for.

*Differences to Commission's Spring forecast*

Comparison of the Dutch economic scenario to the Commission's Spring forecast shows that the difference in the economic growth projection for 2003 is small. For 2004, the Commission's growth projection is slightly higher than the Dutch projection (the latter of which takes account of the implementation of the Global Agreement for Government Policy). National and Commission projections on employment growth and on the unemployment rate are similar. The same holds true for the national and Commission projections on the inflation rate for both 2003 and 2004.

**Table 2.3. Comparison between the Dutch projections and Commission's Spring forecast**

| | 2002 | | 2003 | | 2004 | |
|---|---|---|---|---|---|---|
| | NL | Cie | NL | Cie | NL | Cie |
| Gross domestic product (change in %, volume) | 0.2 | 0.3 | ¾ | 0.5 | 1½ | 1.7 |
| HICP (change in %) [1] | 4 | 3.9 | 2¾ | 2.8 | 1¾ | 1.7 |
| Compensation per employee, market sector (change in %) | 5.0 | 5.5 | 4¼ | 4.3 | 2¾ | 3.1 |
| Labour productivity (change in %) | -0.1 | -0.1 | 2 | 1.5 | 2 | 2.0 |
| Employment (in persons, change in %) | 0.7 | 0.4 | -½ | -0.8 | -0 | -0.1 |
| Unemployment rate (standardised) | 2.7 | 2.7 | 4¼ | 4.2 | 5½ | 5.2 |
| Short-term interest rate | 3.3 | 3.3 | 2¼ | 2.4 | 2¼ | 2.7 |
| Long-term interest rate | 4.9 | 4.9 | 4 | 4.1 | 4 | 4.7 |
| Euro exchange rate (dollars per euro) | 0.94 | 0.94 | 1.08 | 1.07 | 1.08 | 1.07 |
| Price of crude oil in U.S. $ | 25.0 | 25.0 | 26.0 | 30.0 | 23.5 | 24.0 |

1 The change in the HICP in 2004 is assumed to be equal to that in the CPI (at 1¾).

Sensitivity analyses based on some of the risks outlined above and deviations from the Commission's projections are included in section 4.

## 3. Developments in EMU-balance and EMU-debt

*EMU–balance*

Largely owing to the serious slowdown in economic growth, the fiscal position moved from surpluses during 1999-2001 to a deficit of 1.2% of GDP in 2002. The strong rise in health care spending added to the deterioration of the fiscal position. Without any policy action — that is; without the measures from both the Strategic Accord and the Global Agreement for Government Policy — substantial deficits would prevail also in the years to come. Indeed, the budget would probably show a deficit of some 2¼% of GDP in both 2003 and 2007 while in some of the in-between years deficits would move dangerously close to -- or even reach -- the Maastricht limit of 3%.

Likewise, the cyclically adjusted budget would show a substantial deficit and it is unlikely that the path would comply with the annual improvement of at least 0.5 percentage points that is required under the Stability and Growth Pact (Eurogroup agreement) to reach close to balance. The new Cabinet, therefore, decided on a large additional package of deficit-reducing measures that comes on top of the package already introduced as part of the previous Cabinet's coalition agreement.

*Deficit-reducing measures in 2003*

The previous Cabinet in its Strategic Accord introduced a substantial package of around 1% of GDP to repair the deterioration in the fiscal position. On top of this, extra savings were generated in the Spring memorandum for 2003. In total, the package in 2003 amounts to 1.2% of GDP. After taking account of the temporary losses that are inevitably incurred because of the economic impact of the budget cuts, this package will allow the EMU-deficit to be limited to 1.6% of GDP in 2003. Of course, the permanent character of these measures implies an improvement also for the balance in 2004-2007.

**Table 3.1. Policy package from Strategic Accord, supplementary package and Spring Memorandum, 2003-2007 (EUR billion, constant prices, cumulative) 1/**

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| Expenditure cuts, net | -2.4 | -2.6 | -1.4 | -2.0 | -2.1 |
| Tax revenue increases, net 2/ | -3.0 | -2.6 | -3.3 | -3.1 | -3.1 |
| Total | -5.4 | -5.2 | -4.7 | -5.1 | -5.2 |
| Total in % of GDP | -1,2 | -1,1 | -1,0 | -1,1 | -1,1 |

1/ A minus sign indicates savings for general government and thus an ex-ante improvement of the EMU-balance
2/ Owing to the convention under 1/ tax revenue increases are indicated with a minus sign and tax cuts with a plus sign.

Table 3.1 merely shows the bottom line of the policy package as designed by the previous Cabinet. The package naturally contains a host of measures and part of them will still need to be implemented in 2004-2007. The new Cabinet will take on board the remainder of the package from 2004 onwards. Many of the policy measures included concern not only an improvement of the fiscal position, but are also important to strengthen the economy's growth potential.

*Deficit-reducing measures of the new Cabinet, 2004-2007*

Because of a further deterioration in both the economic and fiscal outlook, the new Cabinet decided on an additional policy package that will come on top of the one implemented by the previous Cabinet. The new package is designed to help improve the fiscal outlook, but also leaves room for extra spending on this Cabinet's priority areas, and it even allows for a modest reduction in the tax burden. This tax relief compensates citizens to some extent for the unfavourable impact on purchasing power of more private contributions in health care and limitation of the public health insurance package. The policy package has spending cuts worth 13.1 billion euro (2.7% of GDP) in 2007. Of this amount, 3.4 billion euro (0.7% of GDP) is used for extra spending on priority areas, namely mobility, health care, justice and education. In addition a limited reduction of 0.3% of GDP is achieved in taxes and contributions. The remainder of 8.3 billion euro (or 1.7% of GDP) is intended to improve the fiscal position.

**Table 3.2 Policy package from the Global Agreement for Government Policy, Expenditures, 2004-2007 (EUR billion, constant prices, cumulative) 1/**

| | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| Expenditure cuts | -4.4 | -8.6 | -10.9 | -13.1 |
| Expenditure increases | 1.6 | 2.1 | 2.7 | 3.4 |
| Total | -2.8 | -6.5 | -8.2 | -9.7 |
| Total in % of GDP | -0.6 | -1.4 | -1.7 | -2.0 |

**Table 3.3 Policy package from the Global Agreement for Government Policy, Revenues, 2004-2007 (EUR billion, constant prices, cumulative) 1/ 2/**

| | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| Base broadening measures | -0.9 | -1.7 | -2 | -2.2 |
| Policy measures (e.g. knowledge-economy) | 0.2 | 0.7 | 0.8 | 0.8 |
| Tax deductions (elderly and children) | 0.3 | 0.5 | 0.5 | 0.5 |
| Tax measures to stimulate labour participation | 0.4 | 0.5 | 0.6 | 0.8 |
| Measures related to health care | -0.1 | -2.0 | -0.8 | -0.1 |
| Tax cuts included in baseline 3/ | 0.5 | 3.2 | 2.3 | 1.6 |
| Total | 0,3 | 1.2 | 1.4 | 1.4 |
| Total in % of GDP | 0,1 | 0.3 | 0.3 | 0.3 |

1/ A minus sign indicates savings for general government and thus an ex-ante improvement of the EMU-balance
2/ Owing to the convention under 1/ tax revenue increases are indicated with a minus sign and tax cuts with a plus sign.
3/ New cabinet measures include the tax-revenue package 2004-2007 also incorporated in the medium term reference scenario of 12-2002 (the baseline).

After again taking account of the temporary losses related to the cuts in public demand, this package will render a substantial improvement of the deficits in 2004-2007. As is shown in table 3.4, the balance will improve from a deficit of 1.7% of GDP in 2004 to a deficit of 0.5% of GDP in 2007. The government policy package also makes it feasible to gradually reduce the cyclically adjusted deficit from 0.8% of GDP in 2003 to 0.2% of GDP in 2007.

**Table 3.4. Fiscal developments, 2001-2007**

| **In % of GDP, unless stated otherwise** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** |
|---|---|---|---|---|---|---|---|
| Public expenditure | 46.8 | 47.7 | 47.6 | 47.3 | 46.7 | 45.9 | 45.2 |
| Public revenues | 46.9 | 46.5 | 46.0 | 45.6 | 45.5 | 45.1 | 44.7 |
| EMU-balance | 0.1 | -1.2 | -1.6 | -1.7 | -1.2 | -0.8 | -0.5 |
| Cyclically adjusted balance (EU-method) | -1.2 | -1.2 | -0.8 | -0.7 | -0.3 | -0.2 | -0.2 |
| **Memorandum items (in % of GDP):** | | | | | | | |
| Real GDP growth rate (in %) | 1.3 | 0.2 | ¾ | 1½ | 2 | 2½ | 2½ |
| EMU-balance in the absence of policy measures | | | -2.3 | -2.9 | -3.0 | -2.5 | -2.3 |

A detailed overview of the public finances and the development over time of the EMU-balance is provided in the Annex.

***Box; What is the impact on the balance if annual growth is ¼ percent higher? 1/***

The outcomes for the (cyclically adjusted) balance are based on a cautious (potential) growth assumption of 2% annually for 2004-2007. Suppose that the prudency-margin of ¼% a year turns out to be too cautious so that both the potential and actual growth rate are ¼ percentage points higher each year. If one assumes that half of this extra growth is generated through higher labour productivity growth and the other half comes from higher growth in the labour supply, the impact on the EMU balance (both actual and cyclically adjusted) would amount to 1.4 billion euros in 2007. That is equivalent to an improvement of ¼% of GDP by 2007.

1/ The calculation was derived from the CPB medium term forecast, Memo 26, December 2002, box page 18

In due time, the temporary losses will turn into gains which should facilitate a further improvement of the EMU balance after 2007. In addition, the full budgetary impact of some of the savings measures will only materialise after some time. This is the case, for instance, for the tightening of the conditions for the tax-deductibility of the mortgage interest payments and for the elimination of the tax-deductibility of pre-pension premiums. This too should lead to increased savings after 2007.

*EMU-debt*

**Table 3.5. EMU-debt, 2001-2007**

| In % of GDP | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| EMU-debt | 52.8 | 52.6 | 52.5 | 52.2 | 52.5 | 52.6 | 52.6 |

The EMU-debt in 2003 will amount to an estimated 52.5% of GDP. The debt ratio is expected to remain roughly constant up to 2007. A breakdown of the main factors leading to the change in the debt ratio is provided in the Annex.

## 4. Comparison with previous update and sensitivity analyses

### 4.1. Comparison with 2001 Stability Programme Update

Compared to the 2001 update of the Stability Programme, economic growth is now much lower than was forecast at that time. Since growth in 2000 was also some 0.3 percentage point below what had been expected earlier, the growth forecast up to 2004 is cumulatively 5 (!) percentage points lower. The severe slowdown in economic growth is the main explanation behind the deterioration of the EMU-balance.

**Table 4.1 Comparison of Stability Programme 2001 with the current Stability Programme**

| | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|
| **GDP growth** | | | | |
| Stability Programme 2001 | 2% | 2% | 2¼% | 2¼% |
| Revised Stability Programme 2002 (June 2003) | 1.3% | 0.2% | ¾% | 1½ % |
| Difference (in percentage points) | -0.7 | -1.8 | -1½ | -¾ |
| Difference, cumulative since 2000 (in percentage points) | -1 | -2.8 | -4¼ | -5 |
| **EMU-balance** | | | | |
| Stability Programme 2001 | 1.0% | 1.0% | 1.2% | 1.3% |
| Revised Stability Programme 2002 (June 2003) | 0.1% | -1.2% | -1.6% | -1.7% |
| Difference (in percentage points) | -0.9 | -2.2 | -2.8 | -3.0 |
| **EMU-debt** | | | | |
| Stability Programme 2001 | 51.8% | 47.7% | 45% | 42% |
| Revised Stability Programme 2002 (June 2003) | 52.8% | 52.6% | 52.5% | 52.2% |
| Difference (in percentage points) | 1 | 4.9 | 7.5 | 10.2 |

### 4.2. Sensitivity analysis

Section 2.2 discussed the risks surrounding the projections for the Dutch economy. The table below shows, for some of these risks, what the effect of a divergent development would be on economic growth, inflation and the EMU balance.

Before going to the risk scenarios, it should be pointed out that the cautious growth scenario that was assumed for 2004-2007, in fact, accounts for some of the downside risk that the Netherlands may face. Past experience also shows, however, that such a medium-term scenario is usually not overly pessimistic. The risk scenarios below are outlined relative to the *baseline* scenario which, for economic growth, in each year lies ¼ percent above the cautious growth scenario. This implies that to some extent the impact of, say, lower world trade or higher wage growth would fall within the prudency-margin.

The baseline scenario for the medium term forecast is based on an increase in the volume of world trade relevant to the Netherlands of 6% in 2003 and, on average, 6½% per year in 2004-2007. It could well be, however, that world trade growth relevant for the Netherlands turns out to be, say, 1.5 percentage points lower starting in 2004. Real GDP growth each year would then be ½ percentage point lower than what was assumed in the baseline. The EMU balance would eventually deteriorate by an extra 0.9% of GDP in 2007, while inflation would cumulatively be 0.6 percentage points lower than in the baseline owing to slightly looser labour market conditions.

**Table 4.2. Effects of 3 risk variants on economic growth, inflation and the EMU balance (cumulative deviations from the baseline projection, in %)**

| | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| **I. Permanent lower growth in world trade as of 2004 (-1.5%)** | | | | |
| GDP volume | -0.5 | -1.0 | -1.4 | -1.9 |
| CPI | -0.0 | -0.1 | -0.3 | -0.6 |
| EMU balance (in % of GDP) | -0.2 | -0.4 | -0.6 | -0.9 |
| **II. Appreciation of euro by 10% against all currencies, permanent** | | | | |
| GDP volume | -0.8 | -1.0 | -0.8 | -0.8 |
| CPI | -0.6 | -1.6 | -2.4 | -3.4 |
| EMU balance (in % of GDP) | -0.2 | -0.2 | -0.4 | -0.4 |
| **III. Permanent higher negotiated wage increase (+0.5% as of 2004)** | | | | |
| GDP volume | 0.1 | 0.1 | 0.0 | -0.2 |
| CPI | 0.2 | 0.4 | 0.7 | 1.0 |
| EMU balance (in % of GDP) | 0.0 | -0.0 | -0.1 | -0.2 |

Sources: For II the Nederlandsche Bank, for I and III Netherlands Bureau for Economic Policy Analysis (CPB)

The dollar exchange rate against the euro, of course, also remains uncertain. Relative to the baseline used for the medium term forecast it is possible that the euro appreciates an extra 10% against the dollar (and other currencies) and remains 10% above the baseline projection from then on. Growth in 2004 would deteriorate by 0.8 percentage points. Growth in the following years would slightly increase, bringing the GDP volume back to the baseline projection in the long run. Inflation would be 0.6 percentage point lower in 2004, while the annual inflation rate would be roughly 1 percentage point lower each year. The effect on the EMU balance is negative and, by 2007, will amount to a deterioration of 0.4% of GDP.

Regarding negotiated wages, the table shows that if a higher negotiated wage rise were agreed than is currently projected, this would eventually have a detrimental effect on economic growth,

inflation and the EMU balance. If negotiated wages were, for example, to rise by 0.5 percentage point a year more than is factored into the central projection, employment growth would be depressed immediately. Economic growth and the EMU balance would initially improve because of the rise in private consumption. However, in time, the deterioration in competitiveness would slow down GDP growth and reduce the EMU balance. Inflation would be about ¼ percentage point higher each year. Given that Cabinet has called on social partners to moderate wage demands, wage increases could indeed be modest so that this risk will not materialise.

**5. Quality and composition of public finances**

*Characteristics of the policy package*

While there is a strong focus on repairing the fiscal position, the policy package introduced by the previous Cabinet was carefully designed to also strengthen the economy's structural position. The new Cabinet takes on board the remainder of this package that is still to be implemented in 2004-2007. In addition it introduces a new package that allows for a substantial improvement of the fiscal outlook. Yet, care was taken that the measures would not harm the economic growth potential. What is more, since the savings measures are mainly on the spending side, some room was created for a modest reduction of the tax burden. This will, for instance, stimulate labour market participation.

*Fiscal rules*

Regarding the fiscal framework, the new Cabinet will maintain a strict separation between revenue and expenditure and it will continue the practice of real expenditure ceilings to curb spending growth. As public spending is divided into three sectors (health, social insurance and labour market, and other government spending), there are, in fact, three spending ceilings. It was agreed that each sector must stay under its ceiling.

The Cabinet has also agreed that revenue windfalls as well as setbacks will flow into the budget balance under the condition that the (cyclically adjusted) balance will not enter the danger zone with respect to the Maastricht criteria or the rules in the Stability and Growth Pact. Should the actual deficit threaten to fall below 2.5% of GDP, measures will be taken to repair the budget. The same holds true if the deterioration would cause the adjustment path for the cyclically adjusted deficit to no longer comply with the annually required improvement of 0.5 percentage points --up to the point where the cyclically adjusted deficit is less than 0.5% of GDP.

The new Cabinet feels that it is essential that the long-term sustainability of public finances be guaranteed, despite the strong increase in age related spending that can be expected in the future. Compliance with the rules set out in the Stability and Growth Pact is a necessary condition to help ensure long-term sustainability, but it is not sufficient. Cabinet, therefore, will take care to eliminate the cyclically adjusted deficit in the coming years so that it will become possible to move to a surplus position again.

*Health care*

In order to improve the provision of health care and curb spending growth in the health care sector, government will introduce a new health insurance system in 2006. Prior to the introduction of the new system, a significant shift towards private contributions in health care will take place through the introduction of co-payments and deductibles. In addition, the public costs of health care will be reduced by limiting the public health insurance package. Together, these measures will amount to ½ of GDP.

## 6. Long term public finances with a view to the ageing problem

The key question in respect of long-term policies on debt is how to guarantee the long-term sustainability of public finances, despite the steep rise in public spending that will be caused by the ageing of the population.

The CPB Netherlands Bureau of Economic Policy Analysis published in 2000 a comprehensive document on the consequences of ageing in the Netherlands. In this analysis it was shown that the number of people aged 65 and over would virtually double in the period up to 2040 from 2 to more than 4 million. Based on benefits indexed to the economy's welfare level, moreover, the costs of state old age pensions and health care would increase by around 8% of GDP. Approximately half of this increase could be financed through higher tax revenues from the occupational pensions. The other half would have to be covered through a reduction in government debt that would free up interest payments. The analysis concluded that, to achieve a level of debt-reduction that would sufficiently lower the interest burden, the Netherlands would, on average, need an annual structural budget surplus of over 1% of GDP. If fiscal policy were aimed at this medium to long term objective, long-term sustainability of public finances could be secured.

In the meantime some partial updates of the 2000 CPB analysis were made. Another full fledged analysis will not be made until the Budget Memorandum of 2004 is drawn up. Yet it is already clear that the revision will not alter the main conclusions that were drawn on the basis of the CPB analysis. In particular, the medium term underlying budget balance required to secure the long-term sustainability of public finances will remain at roughly 1% of GDP (1.1% to be exact). When the cycle is taken into account as well as the temporary loss in tax revenues owing to the temporary higher pension contributions (needed to cover the losses on stocks of the pension funds), an underlying budget surplus of 1.1% implies that the actual budget in 2007 should be roughly in balance. The analysis that will be incorporated in the 2004 Budget Memorandum will be discussed in detail in the next update of the stability programme.

A final note concerns the Global Agreement for Government Policy and its impact on the future costs of ageing. The Agreement is well in line with the three-pronged strategy that was adopted by the Ecofin Council of March 2001. For one, the reforms in the social insurance sector will help to counter demographic developments by raising participation rates. In addition, the effective retirement age should rise owing to the elimination of fiscal facilitation of pre-pension arrangements. Finally, the deficit-reducing measures that are being introduced will substantially improve the EMU balance and will keep within reach the medium to long term objective of sufficiently repaying the debt and ensuring long-term financial sustainability.

## Annex to Stability Programme 2001-2007

## Table 1. Measures by the new Cabinet for 2004 - 2007 (in EUR billion) 1/

| | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|
| **Expenditure increases** | **1.55** | **2.08** | **2.65** | **3.42** |
| Education and research | 0.20 | 0.30 | 0.40 | 0.70 |
| Safety | 0.21 | 0.35 | 0.46 | 0.55 |
| Health Care | 0.25 | 0.50 | 0.75 | 1.00 |
| Mobility | 0.53 | 0.53 | 0.53 | 0.53 |
| Miscellaneous | | | | |
| **Expenditure cuts / Reallocations** | **-4.74** | **-8.64** | **-10.89** | **-13.07** |
| Wage developments in the public sector | -0.68 | -1.35 | -2.03 | -2.71 |
| Labour participation | -0.95 | -2.40 | -3.57 | -4.54 |
| Of which: | | | | |
| Unemployment benefit measures (WW) | -0.01 | -0.15 | -0.28 | -0.44 |
| Retesting of eligibility for Disability Act (WAO) | | | | |
| Developments of benefits over time | -0.63 | -1.43 | -2.18 | -2.91 |
| Foreign affairs, defence and asylum | -0.40 | -0.50 | -0.54 | -0.63 |
| Reduction of bureaucracy and rules of the public sector | -0.52 | -0.91 | -1.08 | -1.21 |
| Restriction of government subsidies and strengthening of profit orientation | -1.02 | -1.38 | -1.56 | -1.87 |
| Health care costs | -1.17 | -2.10 | -2.11 | -2.11 |
| Of which: | | | | |
| Restriction of insurance coverage | -1.00 | -1.00 | -1.00 | -1.00 |
| Deductibles | | -0.90 | -0.90 | -0.90 |
| Volume effect of restricted coverage, co-payments and deductibles | -0.17 | -0.20 | -0.21 | -0.29 |
| **Tax measures (increase = – )** | **0.30** | **1.20** | **1.40** | **1.40** |
| Tax measures included in baseline (December 2002) | 0,50 | 3,20 | 2,30 | 1,60 |
| Tax-base broadening | -0,92 | -1,71 | -1,95 | -2,19 |
| Of which: | | | | |
| Eliminating favourable fiscal treatment of pre-pensions | | -0,23 | -0,36 | -0,50 |
| Tightening of conditions for tax-deductibility of mortgage interest payments | -0,10 | -0,20 | -0,30 | -0,40 |
| Policy measures | 0,20 | 0,74 | 0,76 | 0,77 |
| Tax deductions (for elderly and children) | 0,30 | 0,45 | 0,45 | 0,45 |
| Tax measures to stimulate labour participation | 0,40 | 0,53 | 0,63 | 0,75 |
| Measures related to health care | -0.10 | -2,00 | -0,80 | -0,06 |
| **Total** | **-2.8** | **-5.3** | **-6.8** | **-8.3** |

1/ A minus sign indicates savings for general government and thus an ex-ante improvement for the balance