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**2002 UPDATE**  
**OF THE CONVERGENCE PROGRAMME OF THE NETHERLANDS**  
**(2001-2007)**

**AN ASSESSMENT**

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## TABLE OF CONTENTS

|  |    |
|--|----|
| SUMMARY AND CONCLUSIONS .....  | 2  |
| 1. INTRODUCTION .....  | 7  |
| 2. IMPLEMENTATION OF THE 2001 STABILITY PROGRAMME .....                      | 8  |
| 3. MACROECONOMIC ASSESSMENT.....   | 9  |
| 3.1 External economic assumptions.....                                       | 9  |
| 3.2 Macroeconomic developments.....  | 9  |
| 4. BUDGETARY TRAGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES .....           | 11 |
| 4.1 Programme overview .....   | 11 |
| 4.2 Public finances in 2003 .....  | 13 |
| 4.3 Targets and adjustment in 2004 and beyond .....                          | 13 |
| 4.4 Sensitivity analysis .....   | 15 |
| 4.5 Debt ratio.....  | 15 |
| 5. THE SUSTAINABILITY OF PUBLIC FINANCES.....                                | 16 |
| 6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT.....   | 17 |
| 7. OVERALL ASSESSMENT OF COMPLIANCE WITH THE STABILITY AND GROWTH PACT ..... | 18 |

### ANNEX I

|  |    |
|--|----|
| SUMMARY TABLES FROM THE 2002 UPDATED STABILITY PROGRAMME ..... | 19 |
|--|----|

### ANNEX 2

|   |    |
|---|----|
| QUANTITATIVE ASSESSMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES..... | 23 |
|---|----|

## SUMMARY AND CONCLUSIONS

The Netherlands' first stability programme covering the period 1999-2002 was submitted on 4 November 1998 and assessed by the Council on 1 December 1998<sup>1</sup>. The first, second and third updates to the stability programme of the Netherlands were assessed by the Council on 31 January 2000<sup>2</sup>, on 27 November 2000<sup>3</sup>, and on 22 January 2002<sup>4</sup> respectively. The original 2002 update of the stability programme of the Netherlands, which covered the period 2001-2006, was presented on 9 December 2002. However, in view of the resignation of the previous cabinet in October 2002 and the prolonged formation process following the 22 January 2003 elections, it was not discussed in the Council. The Netherlands were required to submit a revised 2002 stability programme update that would incorporate the budgetary policies of an incoming government. The revised 2002 stability programme update (the update from now on), which covers the period 2001-2007, was submitted on 6 June 2003 only shortly after the installation of the new coalition government on 27 May 2003. The Commission services have carried out a technical evaluation of the revised version of the updated programme, taking into account the report of the Ecofin Council of 7 March 2003 on the Communication from the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies<sup>5</sup>. This evaluation warrants the following assessment.

The update incorporates the 2003 budget, which was endorsed by Parliament with some limited modifications compared to the draft prepared by the outgoing government, as well as the proposed budgetary policies of the new government covering its term of office until 2007. The programme is rich in information and complies with the requirements of the code of conduct on the content and format of the programmes and broadly complies with the 2003 Broad Economic Policy Guidelines.

Following the sharp deceleration in economic growth in 2001, economic activity continued to stagnate in the course of 2002. Real GDP growth was 0.2%, compared to 1.3% in 2001. In the fourth quarter of 2002 and the first quarter of 2003, quarter-on-quarter real GDP growth even turned negative. With respect to the underlying economic projections, for 2003 the update of the stability programme uses macroeconomic assumptions by the CPB Netherlands Bureau of Economic Policy Analysis (CPB) which were officially released on 27 March 2003. These assumptions have been corrected for the impact of the coalition agreement but have not been updated to incorporate more recent indicators on economic activity. For the period 2004-2007, the update is based on the medium term economic projections released by the CPB on 16 May 2003. These are essentially the medium term forecasts originally made in December 2002 even though they do incorporate the budgetary impact of the policies of the new government. Real GDP growth is expected to remain low in 2003 (¾%) and to pick up gradually to 1½% in 2004, 2% in 2005 and 2½% in 2006 and 2007. On the basis of real GDP data for the first quarter of this year and other short-term indicators, economic growth in 2003 is likely to be lower than projected in the update. The growth projections for subsequent years

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<sup>1</sup> OJ C 124, 5.5.1999

<sup>2</sup> OJ C 60, 2.3.2000

<sup>3</sup> OJ C 376, 29.12.2000

<sup>4</sup> OJ C 33, 6.2.2002

<sup>5</sup> COM (2002) 668 final, 27.11.2002.

appear still plausible, but the pace of recovery is contingent on a pick-up in global demand and the successful restoration of the competitiveness of the Dutch market sector.

For 2003 and 2004 the projections of main aggregates in the stability programme update and the Commission Spring forecasts are relatively close, provided one allows for the differences stemming from the use of a 'no policy change' assumption in the Commission forecast. In the update, real GDP growth is expected to be a mere ¾% in 2003 before accelerating to 1½% in 2004 (the Commission Spring forecasts are 0.4% and 1.7% respectively). The difference in 2004 can be largely accounted for by the effect of the mechanical assumption of less restrictive fiscal policies in the Commission forecast. It is to be noted that both sets of forecasts do not take into account recent macro-economic data, which suggest that real GDP growth in 2003 is likely to be lower than assumed.

As regards budgetary policy, the so-called 'Global Agreement' outlines the budgetary framework on which the policies of the new government are based. Key points of the budgetary strategy are the following. First, the use of expenditure ceilings defined in real terms, which was a pivotal mechanism of the previous governments' budgetary strategies as well and which the 2003 Broad Economic Policy Guidelines recommended to maintain. Second, as regards expenditure the three relevant sectors distinguished in the budgetary framework, namely central government, social security, and health care, will each have to respect separate expenditure ceilings, whereas overruns should be compensated within each sector. Finally, automatic stabilisers on the revenue side of the budget should be allowed to work freely as much as possible. Extra revenues will be fully used to improve the government balance. Revenue shortfalls should result in a mirror-image deterioration of the general government balance. However, a development of the general government deficit that would imply a violation of the Stability and Growth Pact has to be countered by additional measures. In any case, for reasons of prudence, the nominal general government balance will not be allowed to exceed the threshold of 2½% of GDP.

The general government balance deteriorated significantly, from a surplus of 1.5% of GDP (excluding UMTS receipts) in 2000, to a slight surplus of 0.1% of GDP in 2001 and to a deficit of 1.2% of GDP in 2002. This worsening reflects the deceleration in activity as well as expenditure overruns in health care in particular and the delayed impact of the tax cuts of the 2001 fiscal reform. As far as budgetary developments in 2003 are concerned, the update incorporates the 2003 budget – which was endorsed by Parliament with a few limited modifications only, despite the fall of the previous cabinet on 16 October 2002 – as well as measures announced by the new government to offset expenditure overruns that have become apparent since the budget was passed. The 2003 budget and supplementary measures form a package consisting of reallocations of expenditure, expenditure cuts and increases in some areas, and tax revenue raising measures. The net ex-ante combined impact of all these measures on the general government balance is an improvement of around €5.4 billion or 1.2 percentage point of GDP. However, despite the restrictive fiscal stance in 2003, the nominal deficit is still expected to rise to 1.6% of GDP (from 1.2% in 2002). This is partly due to the prolonged weakness in economic activity but also partly reflects a number of other factors including adverse developments in health care spending and increases in tax-deductible pension premiums and tax-deductible increases in mortgage payments. That said, according to the

update the cyclically adjusted deficit is projected to improve by 0.4 percentage point of GDP to 0.8% of GDP.

The new government decided for the period 2004 to 2007 on a package of consolidation measures equivalent to a cumulative €8.3 billion (1.7% of GDP) in constant 2003 prices. The package contains expenditure cuts equivalent to €13.1 billion (2.7% of GDP). These concern in particular less expenditure on social security (3.9 billion), public sector wages (€2.7 billion) and subsidies €1.2 billion). A total of €3.4 billion (0.7% of GDP) is reserved for increases in expenditure in certain priority areas, mainly in health care (€1.0 billion), education (€0.7 billion) and infrastructure investment (€0.5 billion). In addition a limited net reduction in taxes and contributions of €1.4 (0.3% of GDP) billion is presented. The extent of consolidation is substantial, while in terms of composition it to a large extent relies on measures to reduce expenditure. In this respect the package addresses key areas to curb net spending. However, as far as the presentation of the measures is concerned in terms of its composition, its relation to the policies of the present and the previous government, and the impact on the economy, the text of the update lacks clarity and transparency.

Despite the quite substantial overall consolidation effort, the nominal general government balance is forecast to only improve gradually over the 2004-2007 horizon. This reflects not only the sluggish pace of recovery but also upward trends in certain categories of expenditure, notably health care, that are largely independent of the cycle. In 2004, the nominal deficit would still rise marginally to 1.7% of GDP, despite the expected pick-up in real GDP growth and the consolidation package<sup>6</sup>. This largely reflects a further widening of the output gap as real GDP growth in 2004 is expected to remain below potential. Under the assumption of economic growth picking up to above potential in 2006 and 2007, the update projects the nominal general government deficit to gradually improve to a deficit of 1.2 and 0.8% of GDP in 2005 and 2006 respectively. Nevertheless, a small deficit of 0.5 percentage point of GDP is expected to still exist in 2007. By contrast, in cyclically adjusted terms a position close to balance would be reached earlier, from 2005 onwards, when the cyclically adjusted deficit is projected to be below 0.5% of GDP. In this respect the update assumes that, in line with the Council's interpretation of the stability programmes of other countries, a cyclically adjusted deficit of no more than 0.5% of GDP qualifies as a position close to balance. According to the projections in the programme, the cyclically adjusted balance is estimated to improve from a deficit of 1.2% of GDP in 2002 to deficits of 0.8% of GDP and 0.7 % of GDP in 2003 and 2004 respectively. The calculations of the cyclically adjusted balance presented in the update coincide with the estimates of Commission services on the basis of the input variables provided. According to the update, the cyclically adjusted deficit would be reduced in subsequent years to 0.3% of GDP in 2005 and 0.2% of GDP 2006 and 2007.

The government debt ratio is expected to remain comfortably below 60% of GDP over the horizon covered by the programme. However, the decline in the debt to GDP ratio is expected to slow markedly over the horizon covered by the programme largely due to the development of nominal GDP. The government debt ratio is expected to remain below

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<sup>6</sup> Note that the more pronounced deterioration of the government balance to 2.4% in 2004 according to the Commission Spring forecast is due to the application of the 'no policy change' assumption.

the level of 60% of GDP and to remain broadly stable, at around 52½% of GDP in the period 2002-2007.

The budgetary projections in the updated programme are partly in compliance with the requirements of the Stability and Growth Pact to the extent that in cyclically adjusted terms the general government balance is forecast to reach a position close to balance in 2005 (assumed in the update to be a deficit of no more than 0.5% of GDP), a position that would be maintained over the remainder of the forecast horizon up to 2007. However, in nominal terms a position close to balance would only be achieved in 2007. Nevertheless, with the full implementation of the consolidation measures announced by the new government and given normal macroeconomic fluctuations, a safety margin not to trespass the 3% of GDP deficit threshold should prevail over the horizon covered by the update. From 2002 to 2004 the projected improvement in the cyclically adjusted general government balance is a cumulative 0.5 percentage point of GDP over 2 years only, while an adjustment of 0.5 percentage point each year would be required. Moreover, this seems to be in contradiction with the budgetary framework presented in the update, which states (in section 5 on the Quality and composition of public finances, page 13) that *measures will be taken to repair the budget (...) 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*. These measures would have to apply until the budget reaches the “close to balance position”. Also the projections in the update seem at odds with the self-professed claim that the government *will take care to eliminate the cyclically adjusted deficit in the coming years*.

Developments in the general government balance have to be judged, however, against the background of the prolonged economic downturn and the size of the overall consolidation package, as well as the relatively low level of the debt ratio. Under even more severe macroeconomic conditions than assumed previously, the new government has chosen not to let the automatic stabilisers play fully during its term of office, but to tighten the fiscal stance appreciably in order to limit the increase in the nominal deficit and achieve a marked improvement in the underlying budgetary position. While the reduction of the debt ratio is expected to slow down markedly, the debt ratio is projected to remain well below the level of 60% of GDP. The programme also meets the recommendations in the 2003 Broad Economic Policy Guidelines to constrain government expenditure by setting clear ceilings in real terms for each of the three sub-sectors of government identified in the budgetary framework.

Risks to the economic and budgetary outlook appear to be skewed to the downside. Potential growth is estimated at 1.9% on average in the 2003-2006 period, which is in line with the estimated potential growth rate underlying the Commission Spring 2003 forecast. According to the central scenario of the updated stability programme, economic growth would average 1.9% between 2003 and 2007 (the same rate as estimated potential growth), while growth would accelerate to 2½% in 2006-2007 (around half a percentage point above estimated potential). This is equivalent to assuming that most of the output gap will have been closed in 2007 and, while certainly not unduly optimistic, this cannot be considered a particularly cautious baseline scenario. The expected profile of recovery may be too optimistic an assumption, given developments in unit labour costs, profitability, and competitiveness and, in particular, the risks attached to the external environment. As regards the projected profile of real GDP growth in the period

2004-2007, the underlying macro-economic assumptions effectively date back to December 2002. Recent indicators on economic activity in major trading partners and trends in exchange rates cast doubt on the assumed strength of the recovery of relevant world trade in the near term and thus of domestic economic activity underlying the baseline scenario.

The risk section of the programme shows that the general government balance could deteriorate markedly should downside risks materialise. Thus, additional fiscal adjustment may be needed to achieve and maintain a budgetary position close to balance. In this respect, it is important to note that the fiscal rules adopted by the Dutch government clearly state that additional measures will be taken to ensure that the deficit will not increase to above 2.5% of GDP, should changing circumstances require this.

With respect to the long-term sustainability of public finances, the assessment is based on the December 2002 update. On the basis of current policies, the Netherlands appear to be in a relatively good position to meet the budgetary costs associated with ageing. The starting debt to GDP ratio is already below 60% and it is expected to decrease further before the impact of ageing takes place. However, a slight reverse trend in the debt to GDP ratio in the long run cannot be excluded. To avoid imbalances over the long run, it would be necessary to fully implement the 'Global Agreement', in particular as regards the reforms in the social insurance sector that aim at increase participation rates and the effective retirement age.

Structural reforms are underway or have been proposed that aim to increase the labour market participation rate and improve the efficiency of government expenditure, in particular in health care. While these measures are to be commended, the projections in the update suggest that they will not lead to an appreciable increase of the rate of potential growth in the near term. A positive longer term impact on the growth potential of the economy is contingent on successful implementation of the measures proposed.

## 1. INTRODUCTION

The 2002 update of the Dutch stability programme was originally presented on 9 December 2002. It covers the period from 2001 to 2006, which is an extension of the 2000 to 2004 period covered in the 2001 update<sup>7</sup>. In view of the resignation of the cabinet on 16 October 2002 and subsequent general elections held on 22 January 2003, it was decided not to discuss the Dutch 2002 stability programme update in the Ecofin Council at the beginning of 2003. The Netherlands were required to submit a revised 2002 stability programme update that would incorporate the budgetary policies of the incoming government. Following relatively prolonged coalition negotiations, a new cabinet was sworn in on 27 May 2003. The coalition parties formulated their policy proposals in a coalition agreement known as the 'Global Agreement', which sets out the fiscal policy measures for the 2004-2007 cabinet term of office. In order to avoid a further deterioration in the budget balance, the newly formed cabinet also announced supplementary measures to amend the 2003 budget, that had been endorsed by Parliament with some limited modifications only despite the resignation of the previous cabinet. A revised 2002 stability programme update (the update from now on), which covers the period 2001-2007, was submitted on 6 June 2003 only shortly after the inauguration of the new coalition government.

With respect to the underlying economic projections, for 2003 the update of the stability programme uses macroeconomic assumptions by the CPB Netherlands Bureau of Economic Policy Analysis (CPB) which were officially released on 27 March 2003. These assumptions have been corrected for the impact of the coalition agreement but have not been updated to incorporate more recent indicators on economic activity. For the period 2004-2007, the update is based on the medium term economic projections released by the CPB on 16 May 2003. These are based on the medium term forecasts originally made in December 2002 but incorporate the budgetary and economic impact of the policies of the incoming government. Table 1 summarises some key elements from the sequence of recent projections.

| <b>TABLE 1A – REAL GDP GROWTH SEQUENCE OF RECENT PROJECTIONS (ANNUAL % CHANGE)</b> |             |             |                 |
|--|-------------|-------------|-----------------|
|  | <b>2002</b> | <b>2003</b> | <b>2004</b>     |
| 2002 Update of the Stability Programme <sup>1</sup> (9 December 2002)              | ¼           | ¾           | 2¾              |
| CPB medium-term assessment (17 December 2002)                                      | ¼           | ¾           | 2¼ <sup>1</sup> |
| CPB CEP 2003 (27 March 2003)   | ¼           | ¾           | 1¾              |
| Commission Spring forecast (9 April 2003)  | 0.3         | 0.5         | 1.7             |
| Revised 2002 Update of the Stability Programme (6 June 2003)                       | 0.2         | ¾           | 1½              |

<sup>1</sup> Average 2004-2006

<sup>7</sup> The initial stability programme covered the period 1999-2002 and was examined by the Council on 1 December 1998 (OJ.1999/C/3/02, 6.1.1999). The 1999 update, covered the period 1999-2002, and was examined by the Council on 31 January 2000 (OJ.2000/C/60/01, 2.3.2000). The 2000 update, covered the period 1999-2004 and was examined by the Council on 27 November 2000 (OJ.2000/C/376, 29.12.2000). The 2001 update covered the period 2000-2004 and was examined by the Council on 22 January 2002 (OJ.2002/C/33 6.2.2002).



| <b>TABLE 1B – GENERAL GOVERNMENT BALANCE – SEQUENCE OF RECENT PROJECTIONS (% OF GDP)</b> |             |             |             |             |             |             |
|--|-------------|-------------|-------------|-------------|-------------|-------------|
|  | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| 2002 Update of the Stability Programme (9 December 2002)                                 | -0.7        | -1.0        | -0.7        | -0.4        | 0.1         | -           |
| CPB medium-term assessment (17 December 2002)  | -0.8        | -1.1        | -1.8        | -2.0        | -1.5        | -1.1        |
| CPB CEP 2003 (27 March 2003)   | -1.1        | -1.6        | -2.4        | -2.5        | -           | -           |
| CPB updated medium-term assessment (1 April 2003)  | -0.9        | -1.6        | -2.4        | -2.5        | -2.0        | -1.8        |
| Commission Spring forecast (9 April 2003)  | -1.1        | -1.6        | -2.4        | -           | -           | -           |
| Revised 2002 Update of the Stability Programme (6 June 2003)                             | -1.2        | -1.6        | -1.7        | -1.2        | -0.8        | -0.5        |

The 2002 updated stability programme largely complies with the guidelines set in the Council opinion on the Code of conduct on 10 July 2001. However, as a relatively minor issue some aggregates - for instance unit labour costs - are provided in a definition not fully compatible with the exact definitions in Code of conduct. Furthermore, external macroeconomic assumptions differ somewhat from the common assumptions in the Commission Autumn forecast, but a sensitivity analysis is included.

## **2. IMPLEMENTATION OF THE 2001 UPDATED STABILITY PROGRAMME**

Forecasts of real GDP growth have been revised downwards very substantially since the 2001 updated stability programme, following worse-than-expected realisations into early 2003. Consequently, the estimates for the general government balance were revised substantially as well and now show a marked deterioration vis-à-vis the projections in 2001 update (see table 2). For 2003 and 2004 quite sizeable deficits are now projected instead of the surpluses still envisaged in the 2001 update. Moreover, in the current update the debt ratio is projected to decline only slowly compared to the 2001 update.

| <b>Table 2 – Divergence from the 2001 update</b>  |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
|   | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> |
| <b>Real GDP growth (% change)</b>   |             |             |             |             |
| 2001 update <sup>a</sup>  | 2           | 2           | 2¼          | 2¼          |
| Revised 2002 update   | 1.3         | 0.2         | ¾           | 1½          |
| Difference with 2001 update   | -0.7        | -1.8        | -1½         | -¾          |
| <b>General government balance (% of GDP)</b>  |             |             |             |             |
| 2001 update <sup>a</sup>  | + 1.0       | + 1.0       | + 1.2       | + 1.3       |
| Revised 2002 update   | + 0.1       | - 1.2       | - 1.6       | - 1.7       |
| Difference with 2001 update   | - 0.9       | - 2.2       | - 2.8       | - 3         |
| <b>General government debt (% of GDP)</b>   |             |             |             |             |
| 2001 update   | 51.8        | 47.7        | 45          | 42          |
| Revised 2002 update   | 52.8        | 52.6        | 52.5        | 52.2        |
| Difference with 2001 update   | 1           | 4.9         | 7.5         | 10.2        |
| <sup>a</sup> according to CPB estimates in the December 2001 supplement to the Stability Programme update |             |             |             |             |

As far as the general government balance is concerned, a large part of the difference between the 2001 update of the stability programme and the 2002 update is accounted for by revenue shortfalls due to lower real GDP growth. For the period 2001 to 2004 the shortfall in economic growth is a cumulated 4¾ percentage points. The programme does not provide details but crude estimates suggest that the resulting lower revenues account for around two thirds of the three percentage points deterioration in the budget balance by 2004. Lower revenue as a result of increases in tax deductible pension premiums and tax deductible payments of mortgage interest, and higher expenditure on social transfers (which are only partly related to cyclical developments) account for most of the remaining difference.

The 2002 updated stability programme estimates that, between 2001 and 2004 the reduction in the debt ratio will be very modest, compared to the pronounced decline projected in the previous update. This is mainly due to a lower denominator effect in line with weaker GDP growth but can also be partly ascribed to a slower pace of debt reduction owing to the deterioration in the budget balance.

### **3. MACROECONOMIC ASSESSMENT**

#### **3.1 External economic assumptions**

The external economic assumptions included in the stability programme differ somewhat from the Commission Spring 2003 forecast. While the stability programme assumes a quite similar exchange rate of the euro to the US dollar, the Spring forecast assumes a higher price for crude oil in 2003. In 2004, the Spring forecast assumes higher short-term and long-term interest rates. The main difference appears to be weaker real GDP growth in the EU-15 and weaker world import growth, notably in 2004, according to the Commission Spring forecast. This leads to somewhat with higher growth rates of relevant world trade vis-à-vis the Commission Spring forecast. The various alternative scenario's provided in the sensitivity analysis allow for an assessment of the sensitivity of the projections to changes in some key external assumptions, notably the assumptions on world trade and the effective exchange rate (see also section 4.4).

#### **3.2 Macroeconomic developments**

##### ***The macroeconomic projections of the stability programme***

Following the sharp deceleration in economic growth in 2001, economic activity continued to stagnate in the course of 2002. Real GDP growth was 0.2%, compared to 1.3% in 2003. In the fourth quarter of 2002 and the first quarter of 2003, quarter-on-quarter real GDP growth even turned negative. With respect to the underlying economic projections, for 2003 the update uses macroeconomic assumptions by the CPB, which were officially released on 27 March 2003. These assumptions have been corrected for the impact of the coalition agreement and for the slight modifications resulting from taking into account the CPB March forecast. However, more recent indicators on economic activity, which suggest that economic activity in the beginning of 2003 has been weaker than previously expected by the CPB, have not been incorporated. For the period 2004-2007, the update is based on the medium term economic projections released

by the CPB on 16 May 2003.<sup>8</sup> These incorporate the budgetary impact of the policies of the incoming government but are based on the medium term forecasts originally dating back to December 2002. Real GDP growth is expected to remain relatively weak in 2003 (¾%) and to pick up gradually to 1½% in 2004, 2% in 2005. The expected increase in real GDP growth to 2½% in 2006 and 2007 implies that growth in those years would exceed the estimated rate of potential growth of 2%, which in turn would mean a modest reduction of the output gap.

For 2003 and 2004 the projections of main aggregates in the stability programme update and the Commission Spring forecasts are relatively close, provided one allows for the differences stemming from the use of somewhat different external assumptions and the use of a 'no policy change' assumption in the Commission forecast with respect to fiscal policies. In the update, real GDP growth is expected to be a mere ¾% in 2003 before accelerating to 1½% in 2004 (the Commission Spring forecasts are 0.4% and 1.7% respectively). Major factors behind the slow expected recovery are the deterioration of competitiveness in recent years (largely reflecting high inflation and strong wage growth, the relatively owing to the previously very tight labour market) and the unwinding of positive wealth effects from the housing market and equity markets that had boosted private consumption and real GDP growth up to 2000. Again, both sets of forecasts do not fully take into account recent macro-economic indicators, which suggest that real GDP growth in 2003 is likely to come out lower than assumed.

### ***Assessment***

On the basis of real GDP data up to the first quarter of 2003 (when quarter-on-quarter real DGP growth was -0.3%, compared to -0.2% in the fourth quarter of 2002) and other short-term indicators, economic growth in 2003 is likely to be lower than the ¾% projected in the update and also lower than the Commission Spring forecast number (0.4%).<sup>9</sup> The delayed recovery would also imply that the risks attached to the growth projections for 2004 are skewed to the downside. This is not only because of recent data that suggest that the economic upturn may be delayed in response to weak demand conditions in major trading partners, but also because of other risks stemming from the external environment, for instance associated with recent trends in the effective exchange rate of the euro. Risks to projected medium-term real GDP growth in the period 2005 to 2007 in the update also appear to be skewed on the downside. On the domestic front it is likely that it will take considerable time to redress the macro-economic imbalances and losses in competitiveness that are largely responsible for the extent of the current economic slowdown. The impact of rising private pension premiums on labour costs is another relevant risk. The strength of the recovery in the medium term is contingent on a successful restoration of the competitiveness of the Dutch market sector. This does not only depend on appropriate wage developments but, probably much more important in the medium term, also on efforts to raise labour participation, to improve the functioning of labour and product markets, and to boost productivity.

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<sup>8</sup> CPB, *Budgettaire en economische gevolgen van het Hoofdlijnenakkoord*, 16 May 2003.

<sup>9</sup> According to macroeconomic projections published by De Nederlandsche Bank, real GDP growth in 2003 would be -0.4%. Subsequently economic growth would pick up to 0.8% and 1.8% in 2004 and 2005 respectively. When comparing these projections to the ones in the update or the Commission Spring forecast one should allow for differences in the external assumptions used.

The analysis of potential growth offers an additional way to put the risks to the growth forecasts in the update in perspective. The rate of potential real GDP growth implicitly assumed in the programme's macroeconomic projections, using the agreed common production function method, dropped sharply from 2.6% in 2000 to 1.8% in 2002. For the period 2003-2007 the estimated rate of potential growth is 1.9% on average (table 3). The estimated rate of potential real GDP growth is over the period up to 2004 is only slightly lower than according to the Commission Spring forecasts.<sup>10</sup> The update expects the average actual growth rate of real GDP in 2003-2007 to be around the estimated potential rate. Hence, from this perspective the medium-term growth projections underlying the budgetary projections do not seem overly optimistic. On the other hand, it is difficult to portray the baseline scenario as a particularly cautious one, as is stated on p. 5 of the update, in particular when one takes into account the downside risks that exist in the near term and the specific risks associated with the starting point the Dutch economy finds itself in.

|  | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|--|------|------|------|------|------|------|------|
| <b>Commission Spring forecast</b>                  |      |      |      |      |      |      |      |
| Real GDP growth (%)                                | 1.3  | 0.3  | 0.5  | 1.7  | -    | -    | -    |
| Potential real GDP growth (%)                      | 2.7  | 2.3  | 2.0  | 2.0  |      |      |      |
| Output gap   | 1.8  | -0.2 | -1.7 | -2.0 | -    | -    | -    |
| <b>Stability programme revised<br/>2002 update</b> |      |      |      |      |      |      |      |
| Real GDP growth (%)                                | 1.3  | 0.2  | ¾    | 1½   | 2    | 2½   | 2½   |
| Potential real GDP growth (%)                      | 2.6  | 2.2  | 1.8  | 1.8  | 1.8  | 1.9  | 2.0  |
| Output gap   | 1.9  | 0.0  | -1.2 | -1.5 | -1.4 | -0.9 | -0.3 |

#### **4. BUDGETARY TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES**

##### **4.1 Programme overview**

Tables 4 and 5 present an overview of the projections for the general government balance both in nominal and in cyclically adjusted terms. The update envisages the nominal budget balance to deteriorate markedly in 2003, to a deficit of 1.6% of GDP (compared to 1.2% in 2002), despite a restrictive budget. In 2004, the nominal government deficit is expected to increase marginally, while a gradual improvement is foreseen in subsequent years as a result of significant further fiscal tightening and a pick-up in real GDP growth. Nevertheless, a small deficit of 0.5% of GDP is expected to still exist in 2007. As regards the sub-sectors of general government, changes in the central government balance account for most of the change in the overall balance. Local government is projected to

<sup>10</sup> It does amount, however, to a quite substantial downward adjustment of earlier estimates by the CPB, which put potential growth at around 2¾%. The downwards revision is mainly due to a re-assessment of demographic and productivity trends.

register a small and stable surplus of 0.1% of GDP, while social security funds are expected to see surpluses increase markedly towards the end of the projection horizon, from 0.6% of GDP in 2004 to 1.3% in 2007.

The cyclically adjusted general government balance is projected to improve by 0.4 percentage point of GDP in 2003, to a deficit of 0.8% of GDP. In 2004 the update expects the cyclically adjusted balance to improve only marginally, to a deficit 0.7% of GDP. Thereafter, the balance would improve to a deficit of 0.3% of GDP in 2005 and 0.2% of GDP in both 2006 and 2007.

General government debt is projected to remain broadly stable declining slightly from 52.6% of GDP in 2002 to 52.2% of GDP in 2004, while reaching 52.6% of GDP again by 2007.

| <b>Table 4 – Development of general government balance</b> |             |             |             |             |             |             |             |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>In % of GDP</b>   | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| Revised update   | 0.1         | -1.2        | -1.6        | -1.7        | -1.2        | -0.8        | -0.5        |
| Commission Spring 2003 forecast                            | 0.1         | -1.1        | -1.6        | -2.4        | n.a.        | n.a.        | n.a.        |

| <b>Table 5 – Development of cyclically adjusted general government balance</b>  |             |             |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>In % of GDP</b>  | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| Revised update  | -1.2        | -1.2        | -0.8        | -0.7        | -0.3        | -0.2        | -0.2        |
| Commission Spring 2003 forecast   | -1          | -1          | -0.4        | -1.1        | n.a.        | n.a.        | n.a.        |
| Source: Commission services calculations based on the revised stability programme 2002 update, using the common production function method (the figures given in the update itself match these) |             |             |             |             |             |             |             |

In section 3 the 2002 update gives a summary overview of the budgetary measures entailed in the ‘Global Agreement’, the coalition agreement on which the policies of the new government are based, as well as of the policy package from the ‘Strategic Accord’, the coalition agreement of the previous government. The new government has taken on board many of the measures proposed by the previous government, with additional budgetary tightening in response to the worsened economic outlook. The update gives a breakdown of the budgetary impact of the measures proposed, distinguishing main categories on the revenue and the expenditure side. However, the presentation of the update lacks some clarity with respect to the total net impact of all measures to be implemented. In particular, while no double counting is involved, it is not possible to fully reconcile the information on the policy packages of the previous and the new government in tables 3.1 to 3.3 of the update with the budgetary projections in table 3.4 in order to obtain a consistent quantitative estimate of the impact of all measures combined on the actual budget balance. In particular, there is no full breakdown of the impact of the total policy package on economic activity and on the general government balance, which takes also into account the effect of policy on economic activity.

Changes in the overall general government balances are largely accounted for by central government. Local government is projected to register a small and stable surplus of 0.1% of GDP over the horizon of the programme. The surplus of the sub-sector social security is projected to increase rather markedly towards the end of the period covered, from 0.2% of GDP in 2004 to 1.3% of GDP in 2007 (appendix table 2 gives the detailed figures). The update estimates that the ratio of total government expenditure to GDP will decline

gradually from 46.5% of GDP in 2002 to 44.7% of GDP in 2007 in response to the economic slowdown. The expenditure ratio is expected to decrease also rather markedly, from 47.7% of GDP in 2002 to 45.2% of GDP in 2007. This reflects the emphasis on expenditure reduction in the consolidation package. Lower public consumption, lower interest rate payments as a percentage of GDP and a decrease in subsidies would be responsible for most of the decline. The ratio of public investment to GDP is expected to remain broadly stable. A gradual decrease in outlays on rail infrastructure will be offset by higher expenditure on roads.

#### **4.2 Public finances in 2003**

The stability programme estimates a rather marked deterioration of the general government balance, to a deficit of 1.6% of GDP in 2003, compared to a deficit of 1.2% of GDP in 2002. The expected widening of the deficit occurs despite a highly restrictive budget. The 2003 budget and supplementary measures form a package consisting of reallocations of expenditure, expenditure cuts and increases in some areas, and tax revenue raising measures. The net ex-ante combined impact of all these measures on the general government balance GDP (that is not taking into account the negative impact on growth) is an improvement of around €5.4 billion or 1.2 percentage point of GDP. The worsening of the nominal budget balance despite consolidation largely reflects the impact of the profound economic slowdown. However, other factors play a role as well, including autonomous expenditure increases in certain areas, such as health care, that are largely independent of the cycle<sup>11</sup> and increases in tax-deductible pension premiums and tax-deductible payments of mortgage interest.

The cyclically adjusted balance is projected to improve from a deficit of 1.2% of GDP in 2002, to a deficit of 0.8% of GDP in 2003. Since the starting position was out of balance, this improvement falls just short of the improvement of the cyclically adjusted balance by 0.5 percentage point of GDP required in the report of the Ecofin Council of 7 March 2003 on the Communication from the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies. However, in 2003 the shortfall is only very small.

#### **4.3 Public finances in 2004 and beyond**

The projections on trends in public finance from 2004 to 2006 are based on the multi-annual projections of the CPB which essentially date back to December 2002, but take into account the impact of the policies decided by the new government as well as changes in the macro-economic outlook for 2004 derived from the CPB forecast published on 27 March 2003.

The projections in the update take into account the fiscal consolidation package decided on by the new government. For the period 2004 to 2007 (spanning the term of office of the new cabinet) the package consists of consolidation measures equivalent to a

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<sup>11</sup> Note that while increase in certain areas, such as health care spending, were also higher than projected in 2002. Last year, this was compensated within the expenditure ceilings set and thus does not amount to slippage from the targets. A similar situation applies to 2003 where expenditure ceilings should be respected. However, keeping expenditure under the ceiling may not prevent the expenditure ratio and hence the deficit from rising in case economic growth is lower than expected.

cumulative €8.3 billion (1.7% of GDP) in constant 2003 prices. The consolidation to a large extent relies on expenditure reductions. The package contains expenditure cuts equivalent to €13.1 billion (2.7% of GDP). These concern in particular less expenditure on social security (3.9 billion), public sector wages (€2.7 billion) and subsidies (€1.2 billion). A total of €3.4 billion (0.7% of GDP) is reserved for increases in expenditure in certain priority areas, mainly in health care (€1.0 billion), education (€0.7 billion) and infrastructure investment (€0.5 billion). In addition a limited net reduction in taxes and contributions of €1.4 billion (0.3% of GDP) is presented. The extent of consolidation is substantial, while in terms of composition it to a large extent relies on measures to reduce expenditure. In this respect the package addresses key areas to curb net spending.

Despite the quite substantial overall consolidation effort, the nominal general government balance is forecast to only improve gradually over the 2004-2007 horizon (table 4). This reflects not only the sluggish pace of recovery but also upward trends in certain categories of expenditure, notably health care, that are largely independent of the cycle. In 2004, the nominal deficit would still rise marginally to 1.7% of GDP, despite the expected pick-up in real GDP growth and the consolidation package. This largely reflects a further widening of the output gap as real GDP growth in 2004 is expected to remain below potential. Note, furthermore, that the more pronounced deterioration of the government balance to 2.4% in 2004 according to the Commission Spring forecast is due to the application of the 'no policy change' assumption. Under the assumption of economic growth picking up to just above potential in 2006 and 2007, the update projects the nominal general government deficit to gradually improve to a deficit of 1.2 and 0.8% of GDP in 2005 and 2006 respectively. Nevertheless, a small deficit of 0.5 percentage point of GDP is expected to still remain in 2007.

By contrast, in cyclically adjusted terms a position close to balance would be reached earlier, from 2005 onwards, when the cyclically adjusted deficit is projected to be below 0.5% of GDP.<sup>12</sup> In this respect the update assumes that, in line with the Council's interpretation of the stability programmes of other countries, a cyclically adjusted deficit of no more than 0.5% of GDP qualifies as a position close to balance. According to the projections in the update, the cyclically adjusted balance is estimated to improve from a deficit of 1.2% of GDP in 2002 to deficits of 0.8% of GDP and 0.7 % of GDP in 2003 and 2004 respectively (see also table 5). Thus, in 2004 the projected improvement in the cyclically adjusted balance falls short by quite a margin, compared to the improvement by 0.5 percentage point of GDP required in the report of the Ecofin Council of 7 March 2003 on the Communication from the Commission to the Council of 27 November 2002. According to the update, the cyclically adjusted deficit would be reduced in subsequent years to 0.3% of GDP in 2005 and 0.2% of GDP 2006 and 2007.

Thus, the path of adjustment to the close balance position, which according to the update should be reached starting in 2005, falls short of the requirements, albeit not by a wide margin. Developments in the general government balance have also to be judged against the background of the prolonged economic downturn and the size of the overall consolidation package, as well as the relatively low level of the debt ratio. Under even more severe macroeconomic conditions than assumed previously, the new government has chosen not to let the automatic stabilisers play fully during its term of office, but to

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<sup>12</sup> The calculations of the cyclically adjusted balance presented in the update coincide with the estimates of Commission services on the basis of the input variables provided.

tighten the fiscal stance appreciably in order to limit the increase in the nominal deficit and achieve a marked improvement in the underlying budgetary position.

Nevertheless, the success of reaching the targets defined in the update depends on the successful implementation of announced measures in key areas, such as health care, where expenditure control in the recent past has proven to be difficult. There are additional downside risks attached to economic growth, and thus social security expenditure and tax revenues. To the extent that these risks would materialise, they suggest that substantial fiscal adjustment may be needed in 2004 and beyond to indeed achieve a budgetary position close to balance within the time horizon covered by the update.

#### 4.4 Sensitivity analysis

Calculations presented in the programme aim at evaluating the budgetary impact of a number of alternative scenarios. These are partly related to external developments, notably concerning world trade and the effective exchange rate. With respect to domestic developments, the sensitivity analysis highlights the risks associated with higher than forecast wage increases, Table 6 summarises the budgetary impact of the scenarios presented.

| <b>Table 6 – Effects on the general government balance of four risk variants</b> |             |             |             |             |
|--|-------------|-------------|-------------|-------------|
| <i>Cumulative deviations from the baseline projection, in % of GDP</i>           | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| I. Permanent lower growth in world trade as of 2004 (-1.5%)                      | -0.2        | -0.4        | -0.6        | -0.9        |
| II. Appreciation of euro by 10% against all currencies, permanent                | -0.2        | -0.2        | -0.4        | -0.4        |
| III. Permanent higher negotiated wage increase (+0.5% as of 2004)                | 0.0         | -0.0        | -0.1        | -0.2        |
| <i>Sources: For I and III the CPB, for II De Nederlandsche Bank</i>              |             |             |             |             |

#### 4.5 Debt ratio

The debt ratio fell under the 60% of GDP threshold in 2000 – declining 7.3 percentage points of GDP over the previous year – as a result of buoyant nominal GDP growth and an increasing government surplus. The debt ratio declined at a more moderate pace in 2001 in line with the economic slowdown and virtually came to a standstill in 2002 when it stood at 52.6%. The programme envisages a very modest further reduction of the debt to GDP ratio to 52.5% and 52.5% in 2003 and 2004 respectively, followed by a slight increase to 52.6% in 2006 and 2007 (table 7). An improvement in the primary balance and a fall in the interest charge ratio towards the end of the projection horizon are broadly offset by stock-flow adjustments, mainly due to the phasing out of sales of state property and some financial operations related to independent public agencies.<sup>13</sup> However, further growth and revenue shortfalls would have a negative impact on the deficit and on interest payments and could thus lead to a modest increase of the debt ratio over the forecast. For

<sup>13</sup> Information provided by the Ministry of Finance.



2003 and 2004, the Commission Spring forecast envisages a very similar debt ratio (52.4 and 52.8% of GDP respectively); the differences are inter alia accounted for by slightly different assumptions concerning nominal GDP growth and interest rates.

| <b>In % of GDP</b>                     | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <b>Change in government debt ratio</b> | <b>-3.0</b> | <b>-0.2</b> | <b>-0.1</b> | <b>-0.3</b> | <b>0.3</b>  | <b>0.1</b>  | <b>0.0</b>  |
| Primary balance                        | -3.6        | -2.1        | -1.5        | -1.2        | -1.6        | -1.9        | -2.1        |
| Interest payments                      | 3.5         | 3.4         | 3.1         | 2.9         | 2.8         | 2.7         | 2.6         |
| Nominal GDP growth                     | -3.5        | -1.8        | -2.0        | -1.7        | -1.7        | -1.8        | -2.1        |
| Stock flow adjustment                  | 0.6         | 0.3         | 0.3         | -0.3        | 0.8         | 1.1         | 1.6         |
| <b>Level of government debt</b>        | <b>52.8</b> | <b>52.6</b> | <b>52.5</b> | <b>52.2</b> | <b>52.5</b> | <b>52.6</b> | <b>52.6</b> |

Source: Commission services calculations based on SP 2002 update

## **5. THE SUSTAINABILITY OF PUBLIC FINANCES**

The June 2003 updated version contains a section on long term sustainability of public finances based on the December 2002 update. The latter includes national projections for public expenditures on pensions, health care and long term care which show an overall increase in age-related spending of 8.75% of GDP between 2000 and 2040. The programme also contains projections for the impact of ageing on tax revenues, which overall indicate that on the basis of the current tax rates, tax revenues as a share of GDP will also increase, by 4.25% over the same period.

It is first necessary to consider whether current budget policies can ensure that the SGP will continue to be respected in the future in light of budgetary implications of ageing populations. The Commission considers that on the basis of current policies, the Netherlands appears to be in a relatively good position to meet the budgetary costs associated with ageing population. On the positive side there is a starting debt to GDP ratio already below 60% and a plan to bring the budget ‘close to balance’ within the time span of the programme. To eliminate the risk of emerging budget imbalances, it would be necessary to achieve the additional savings in the health care sector envisaged as part of the ‘Global Agreement’ and to pursue social sector reforms. It should also be noted that sustainability in the stability programme relies upon projected increase in the tax ratio, which in part this is due to increases in the deferred taxes on pension income.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The budget targets set down in the stability programme should lead to a continued decline in the debt ratio in the coming years, but a slight upward trend of the debt ratio in the long run cannot be excluded. Additional measures may be needed if the Dutch authorities want to ‘sufficiently repaying government debt so that the future costs of ageing will not endanger long-term financial sustainability’, as stated in the programme.

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. The strategy to ensure sustainable public finances hinges upon achieving a large and sustained reduction in the

debt ratio as well as the implementation of the 'Global Agreement', in particular as regards the reforms in the social insurance sector that aim at increasing participation rates and the effective retirement age, and reforms in health sector.

## **6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT**

The update gives only summary information on the precise content of the measures encompassed by the 'Global Agreement' (and presented in more detail there) and does not discuss the quantitative effect on economic growth and on productivity. While clearly consolidation measures are the heart of the 'Global Agreement', in some aspects the general thrust of policies aimed at improving the structure of the economy pursued previously will be continued. For instance, as far as social security and pensions are concerned, the new government proposes to boost labour force participation, inter alia by measures to reduce the number of people claiming disability benefits, by tightening eligibility for unemployment benefits, and by further initiatives to reduce tax incentives for early retirement. Some of these already have been endorsed by Parliament as part of the 2003 budget.

Although the update is relatively silent on the net impact of budgetary policy on growth prospects in the medium and longer run, except the statement on p. 14 that '*care has been taken that the measures would not harm the economic growth potential*'. CPB calculations on the economic impact of the 'Global Agreement' suggest that the effect on potential real GDP growth is indeed broadly neutral compared to the 'no policy change' baseline<sup>14</sup>. Budgetary adjustment has a negative impact on demand and thus on real GDP growth. According to the CPB, from 2004 to 2007 real GDP growth will be lower by 0.2% on average. However, the negative impact on potential growth calculated using the agreed common production function method is offset by a projected decreases in the rate of labour productivity growth of the same order of magnitude.

In some cases the general thrust of policy in the 'Global Agreement' does not seem to be fully in line with some of the actual measures proposed. For instance, the intention to increase the female participation rate is difficult to square with the delay of a law that arranges for a statutory even split of the costs of child care between employers, parents and the government. Similarly, the emphasis on the importance of education and life-long learning stressed in the context of the Lisbon Strategy seems at odds with the abolition of fiscal arrangements to facilitate schooling.

Some inconsistencies exist with respect to the path of fiscal adjustment and budgetary rules. In section 5 of the update, the fiscal framework is discussed at some length. Key points of the budgetary strategy adopted by the new government are the following. First, the use of expenditure ceilings defined in real terms, which was a pivotal mechanism of the previous governments' budgetary strategies as well and which the 2003 Broad Economic Policy Guidelines recommended to maintain. Second, as regards expenditure the three relevant sectors distinguished in the budgetary framework, namely central government, social security, and health care, will each have to respect separate expenditure ceilings, whereas overruns should be compensated within each sector. Finally, automatic stabilisers on the revenue side of the budget should be allowed to work freely as much as possible. Extra revenues will be fully used to improve the government balance. Revenue shortfalls should result in a mirror-image deterioration of the general

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<sup>14</sup> CPB, *Budgettaire en economische gevolgen van het Hoofdlijnenakkoord 2004-2007*.

government balance. However, it is stated that a development of the general government deficit that would imply a violation of the Stability and Growth Pact has to be countered by additional measures. In any case, according to the fiscal rules the nominal general government balance will not be allowed to exceed the threshold of 2½% of GDP for reasons of prudence.

A strict interpretation of the fiscal rules discussed above cannot be fully reconciled with the projected development of the cyclically adjusted balance over the horizon covered by the stability programme. As noted earlier, from 2002 to 2004 the projected improvement in the cyclically adjusted general government balance is a cumulative 0.5 percentage point of GDP over 2 years only, while an adjustment of 0.5 percentage point each year would be required according to the Ecofin report on the Commission communication of 27 November 2002. Thus the actual projections given in the update seem to be in contradiction with the description of the budgetary framework on page 13 of the update which states that *'measures will be taken to repair the budget (...) 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 the budget reaches the "close to balance position". In a similar vein, it appears that the projections in the update are not fully in line with the self-professed claim that the government *'will take care to eliminate the cyclically adjusted deficit in the coming years'*, to the extent that the latter is interpreted as a cyclically adjusted balance of zero or in surplus.

## **7. OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP**

All in all, the current update of the stability programme partly complies with the main requirements of the Stability and Growth Pact. In cyclically adjusted terms the general government balance is forecast to reach a position close to balance in 2005 (assumed in the update to be a deficit of no more than 0.5% of GDP), a position that would be maintained over the remainder of the forecast horizon up to 2007. However, in nominal terms a position close to balance would only be achieved in 2007. Moreover, in 2003 and 2004 the projected improvement in the cyclically adjusted general government balance is a cumulative 0.5 percentage point of GDP over 2 years only, while an adjustment of 0.5 percentage point each year would be required. Nevertheless, with the full implementation of the consolidation measures announced by the incoming government and given normal macroeconomic fluctuations, a safety margin not to trespass the 3% of GDP deficit threshold should prevail over the horizon covered by the update. On the basis of the current policies, The Netherlands appears to be in a relative good position to meet the budgetary costs associated with ageing. However, a slight reverse trend of the debt to GDP ratio in the long run cannot be excluded. Therefore, to avoid the risk of imbalances in the long run, it would be necessary to fully implement the measures proposed with respect to the reforms in the social insurance sector that aim at increasing participation rates and the effective retirement age.

## SUMMARY TABLES FROM THE 2002 UPDATED STABILITY PROGRAMME

| <b>Table 1 – Growth and related factors</b>                     |             |             |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <i>Annual percentage changes unless otherwise mentioned</i>     | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| Gross Domestic Product  | 1.3         | 0.2         | ¾           | 1½          | 2           | 2½          | 2½          |
| GDP, level in billion €   | 429         | 445         | 462         | 477         | 493         | 511         | 532         |
| GDP deflator  | 5.3         | 3.5         | 3¼          | 1¾          | 1¼          | 1¼          | 1½          |
| Consumer price index  | 4.5         | 3½          | 2½          | 1¾          | 1           | 1           | 1½          |
| Employment (in persons)   | 2           | 0.7         | -½          | 0           | ½           | 1¼          | 1½          |
| Employment (in hours)   | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        |
| Labour productivity growth, market sector                       | -0.6        | -0.1        | 2           | 2           | 1¾          | 1½          | 1½          |
| <b>Sources of growth: percentage changes at constant prices</b> |             |             |             |             |             |             |             |
| 1 Private consumption   | 1.2         | 1           | 1           | 1¼          | 1½          | 1¾          | 1¾          |
| 2 Government consumption  | 3.1         | 3½          | -¼          | ¾           | 1¼          | 1½          | 1¾          |
| 3 GCF (incl. ch. in inventories)                                | -0.8        | -3¾         | -¼          | 1           | 1½          | 1½          | 2½          |
| 4 Exports of goods and services                                 | 1.7         | -1¼         | 3½          | 5           | 4¾          | 4¾          | 4½          |
| 5 Imports of goods and services                                 | 1.9         | -2          | 3¾          | 4¾          | 4           | 3¾          | 3¾          |
| <b>Contributions to GDP growth</b>                              |             |             |             |             |             |             |             |
| Domestic demand   | 1           | 0           | ¾           | 1           | 1½          | 1½          | 1¾          |
| Net exports   | 0.3         | ¼           | 0           | ½           | ½           | 1           | ¾           |

| <b>Table 2 - General government budgetary developments 2000-2007</b> |  |             |             |             |             |             |             |             |
|--|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| <i>(% of GDP)</i>  | <b>2000</b>  | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| <b>Net lending by sub-sectors</b>                                    |  |             |             |             |             |             |             |             |
| <b>1. General government</b>   | +1.5   | + 0.1       | - 1.2       | -1.6        | -1.7        | -1.2        | -0.8        | -0.5        |
| 2. Central government  | -0.2   | - 0.1       | -1          | -2.2        | -2          | -1.9        | -1.8        | -1.9        |
| 3. Social security funds   | +1.6   | + 0.1       | -0.4        | + 0.4       | + 0.2       | + 0.6       | + 1         | +1.3        |
| 4. Local authorities   | 0.0  | + 0.1       | + 0.1       | + 0.1       | + 0.1       | + 0.1       | + 0.1       | +0.1        |
| <b>General government</b>  |  |             |             |             |             |             |             |             |
| 5. Total receipts  | 48.1   | 46.9        | 46.5        | 46          | 45.6        | 45.5        | 45.1        | 44.7        |
| 6. Total expenditure   | 46.6   | 46.8        | 47.7        | 47.6        | 47.3        | 46.7        | 45.9        | 45.2        |
| 7. Budget balance  | + 1.5  | + 0.1       | -1.2        | -1.6        | -1.7        | -1.2        | -0.8        | -0.5        |
| 8. Interest expenditure  | 4.0  | 3.5         | 3.3         | 3.1         | 2.9         | 2.8         | 2.7         | 2.6         |
| 9. Primary balance   | + 5.5  | + 3.6       | + 2.1       | +1.5        | +1.2        | +1.6        | +1.9        | +2.1        |
| <b>Components of revenues</b>  |  |             |             |             |             |             |             |             |
| Tax revenues   | 25.0   | 25.7        | 25.5        | 25.5        | 24.7        | 25.6        | 25.5        | 25.1        |
| Social security  | 16.0   | 14.1        | 14.2        | 14.6        | 14.4        | 13.8        | 13.8        | 13.8        |
| Interest income  | 0.7  | 0.7         | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        |
| Other <sup>a</sup>   | 6.4  | 6.4         | 6.8         | 6.0         | 6.4         | 6.0         | 5.9         | 5.8         |
| Total revenues   | 48.1   | 46.9        | 46.5        | 46.0        | 45.6        | 45.5        | 45.1        | 44.7        |
| <b>Components of expenditure</b>                                     |  |             |             |             |             |             |             |             |
| Consumption  | 16.2   | 16.5        | 17.2        | 16.9        | 16.7        | 16.4        | 16.2        | 15.9        |
| Social security payments   | 19.0   | 19.0        | 19.4        | 20.1        | 20.0        | 20.1        | 20.0        | 19.6        |
| Interest   | 4.0  | 3.5         | 3.4         | 3.1         | 2.9         | 2.8         | 2.7         | 2.6         |
| Subsidies  | 1.4  | 1.4         | 1.4         | 1.3         | 1.2         | 1.0         | 0.9         | 0.9         |
| Investment   | 3.3  | 3.5         | 3.6         | 3.7         | 3.6         | 3.6         | 3.5         | 3.5         |
| Capital Transfers  | 0.7  | 0.8         | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        | n.a.        |
| Other <sup>b</sup>   | 2.0  | 2.1         | 2.7         | 2.5         | 2.9         | 2.8         | 2.6         | 2.7         |
| Total Expenditure  | 46.6   | 46.8        | 47.7        | 47.6        | 47.3        | 46.7        | 45.9        | 45.2        |
| <sup>a</sup>   | <i>Including interest between 2002 and 2007</i>          |             |             |             |             |             |             |             |
| <sup>b</sup>   | <i>Including capital transfers between 2002 and 2007</i> |             |             |             |             |             |             |             |

| <b>Table 3 - General government debt developments 2000-2007 (% of GDP)</b> |             |             |                   |             |             |             |             |             |
|--|-------------|-------------|-------------------|-------------|-------------|-------------|-------------|-------------|
|  | <b>2000</b> | <b>2001</b> | <b>2002</b>       | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| <b>Gross debt level</b>  | <b>55.8</b> | <b>52.8</b> | <b>52.6</b>       | <b>52.5</b> | <b>52.2</b> | <b>52.5</b> | <b>52.6</b> | <b>52.6</b> |
| Changes in the debt ratio  | -7.3        | -3.0        | -0.2              | -0.1        | -0.3        | 0.3         | 0.1         | 0.0         |
| <b>Contributions to changes in the debt ratio</b>                          |             |             |                   |             |             |             |             |             |
| Primary balance  | -5.5        | -3.6        | -2.1 <sup>a</sup> | -1.5        | -1.2        | -1.6        | -1.9        | -2.1        |
| of which: interest payments  | 4.0         | 3.5         | 3.4               | 3.1         | 2.9         | 2.8         | 2.7         | 2.6         |
| Financial transactions and miscellaneous                                   | 1.8         | 0.6         | 0.3               | 0.3         | -0.3        | 0.8         | 1.1         | 1.6         |
| Effect of nominal GDP growth   | -7.6        | -3.5        | -1.8              | -2.0        | -1.7        | -1.7        | -1.8        | -2.1        |

| <b>Table 4 – Cyclical developments</b>             |             |             |               |             |             |             |             |
|--|-------------|-------------|---------------|-------------|-------------|-------------|-------------|
| <i>% of GDP unless otherwise mentioned</i>         | <b>2001</b> | <b>2002</b> | <b>2003</b>   | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| GDP growth (annual % change)                       | 1.3         | 0.2         | $\frac{3}{4}$ | 1½          | 2           | 2½          | 2½          |
| Potential real GDP growth (annual % ch.) *         | 2.6         | 2.2         | 1.8           | 1.8         | 1.8         | 1.9         | 2.0         |
| Output gap *                                       | 1.9         | 0.0         | -1.2          | -1.5        | -1.4        | -0.9        | -0.3        |
| Cyclical component of general government balance * | 1.3         | 0.0         | -0.8          | -1.0        | -0.9        | -0.6        | -0.2        |
| Actual general government balance                  | 0.1         | -1.2        | -1.6          | -1.7        | -1.2        | -0.8        | -0.5        |
| Cyclically adjusted general government balance *   | -1.2        | -1.2        | -0.8          | -0.7        | -0.3        | -0.2        | -0.2        |
| Interest payments                                  | 3.5         | 3.3         | 3.1           | 2.9         | 2.8         | 2.7         | 2.6         |
| Cyclically-adjusted primary balance *              | 2.3         | 2.1         | 2.3           | 2.2         | 2.5         | 2.5         | 2.4         |

*Source: Revised 2002 Update to the Stability Programme of the Netherlands*

\* Computed by Commission services using the production function approach as agreed by the Ecofin Council on 12 July 2002

| <b>Table 5 – Divergence from previous update</b>  |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
|   | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> |
| <b>GDP growth</b>   |             |             |             |             |
| 2001 update <sup>a</sup>  | 2%          | 2%          | 2¼%         | 2¼%         |
| Revised 2002 update   | 1.3%        | 0.2%        | ¾%          | 1½%         |
| Difference with 2001 update   | -0.7        | -1.8        | -1½         | -¾          |
| <b>EMU budget balance</b>   |             |             |             |             |
| 2001 update <sup>a</sup>  | + 1.0%      | + 1.0%      | + 1.2%      | + 1.3%      |
| Revised 2002 update   | + 0.1%      | - 1.2%      | - 1.6%      | - 1.7%      |
| Difference with 2001 update   | - 0.9       | - 2.2       | - 2.8       | - 3         |
| <b>EMU debt</b>   |             |             |             |             |
| 2001 update <sup>a</sup>  | 51.8%       | 47.7%       | 45%         | 42%         |
| Revised 2002 update   | 52.8%       | 52.6%       | 52.5%       | 52.2%       |
| Difference with 2001 update   | 1%          | 4.9%        | 7.5%        | 10.2%       |
| <sup>a</sup> according to CPB estimates in the December 2001 supplement to the Stability Programme update |             |             |             |             |

| <b>Table 6 – Basic assumptions used in the update</b> |             |             |             |             |             |             |             |
|---|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
|   | <b>2001</b> | <b>2002</b> | <b>2003</b> | <b>2004</b> | <b>2005</b> | <b>2006</b> | <b>2007</b> |
| USD/€exchange rate                                    | 0.90        | 0.94        | 1.08        | 1.08        | 1.10        | 1.12        | 1.13        |
| World real GDP growth                                 | 2.2         | 2.7         | 3½          | 4           | 3½          | 3½          | 3½          |
| EU-15 real GDP growth                                 | 1.6         | 0.9         | 2           | 2¾          | 2           | 2           | 2           |
| Growth of relevant world trade Euro area              | 1.6         | 2½          | 6           | 8           | 6           | 6           | 6           |
| Short-term interest rates (in %)                      | 4.3         | 3.3         | 2¼          | 2¼          | 3½          | 3½          | 3½          |
| Long-term interest rates (in %)                       | 5           | 4.9         | 4           | 4           | 5           | 5           | 5           |
| Oil prices (Brent. USD/barrel)                        | 24.6        | 25.0        | 26.0        | 23.5        | 23.25       | 23.5        | 24.0        |

## QUANTITATIVE ASSESSMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES

This is the second assessment of the sustainability of Dutch public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC.<sup>15</sup>

The June 2003 updated programme does not contain quantitative information on long term sustainability. Therefore, the following analysis is based on the figures on age-related expenditure and revenues presented in the December updates. The latter includes budgetary projections for public expenditures on pensions, health care, long term care as well as tax revenues. The Dutch authorities produced also a more complete breakdown of the future trends on which the programme is based<sup>16</sup>. The projections on the basis of this source (see table below) show an increase in age-related spending of 7.0% of GDP over the period 2007-2050. The data also contain projections for the impact of ageing on tax revenues: they are projected to increase by 3.1% of GDP over the same period<sup>17</sup>.

In assessing the sustainability of public finances, the Commission has to draw a balance between using national projections which may be more comprehensive and up to data, and the need to ensure comparability across countries. The Commission used the detailed national projections provided in running the sustainability indicators for The Netherlands. The table below presents the debt and budget balance development according to two different scenarios, a “programme scenario” and a “2002 situation scenario”. The “programme scenario” is calculated on the following basis:

**the projections for age-related expenditures come from the source indicated in the stability programme;**

**the projections for government revenues come from the source indicated in the stability programme; however, a prudential path is projected.<sup>18</sup>**

**the starting point for gross debt and the primary surplus are the 2007 levels reported in the programme.**

The “2002 situation scenario” is based on the budgetary data for 2002 in the programme. It is that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2007. This allow one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme. As shown in the table below, there are no main differences between the two scenarios, since - according to the programme - primary balance in 2007 is expected to be at the same level as 2002 (2.1% of GDP).

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<sup>15</sup> ‘How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years’, Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

<sup>16</sup> *Ageing in Netherlands*, CPB Netherlands Bureau for Economic Policy Analysis.

<sup>17</sup> Due to uncertainty in future revenues, only additional income taxes from pension income are included.

<sup>18</sup> See footnote 3.



## Quantitative indicators on the sustainability of public finances

| <b>Main assumptions - baseline scenario (as % GDP)</b> | <b>2007</b> | <b>2010</b> | <b>2020</b> | <b>2030</b> | <b>2040</b> | <b>2050</b> | <b>changes</b> |
|--|-------------|-------------|-------------|-------------|-------------|-------------|----------------|
| Total age-related spending                             | 15.7        | 16.4        | 19.0        | 21.0        | 21.4        | 22.7        | 7.0            |
| Pensions   | 5.2         | 5.4         | 6.8         | 7.9         | 9.0         | 8.7         | 3.5            |
| Health care  | 7.5         | 7.7         | 8.6         | 9.6         | 9.0         | 10.5        | 3.0            |
| Other age related expenditures                         | 3.1         | 3.3         | 3.6         | 3.5         | 3.4         | 3.5         | 0.4            |
| Total non age-related spending*                        | 26.9        |             |             |             |             |             |                |
| Total revenues   | 44.8        | 44.9        | 45.7        | 46.7        | 47.8        | 47.8        | 3.1            |

\* constant

| <b>Results (as % GDP)</b>      | <b>2007</b> | <b>2010</b> | <b>2020</b> | <b>2030</b> | <b>2040</b> | <b>2050</b> | <b>changes</b> |
|--------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|----------------|
| <i>Programme scenario</i>      |             |             |             |             |             |             |                |
| Debt                           | 51.4        | 48.1        | 50.4        | 68.5        | 93.0        | 125.4       | 74.0           |
| Net borrowing                  | -0.5        | -1.0        | -2.8        | -4.7        | -5.5        | -8.5        | -8.0           |
| <i>2002 situation scenario</i> |             |             |             |             |             |             |                |
| Debt                           | 49.5        | 43.5        | 44.9        | 61.9        | 84.9        | 115.6       | 66.1           |
| Net borrowing                  | -0.4        | -0.8        | -2.5        | -4.4        | -5.0        | -7.9        | -7.5           |

| <b>Tax gaps</b>         | <b>T1*</b> | <b>T2**</b> | <b>T3***</b> |
|-------------------------|------------|-------------|--------------|
| Programme scenario      | 1.7        | 1.3         | 4.7          |
| 2002 situation scenario | 1.6        | 1.1         | 4.3          |

\* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 10.7%

\*\* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

\*\*\* It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

According to the quantitative indicators, there is a possibility of budgetary imbalances emerging that are not fully in compliance with SGP requirements on the basis of current policies. Debt is expected to decrease for the next two decades but to turn to an upward trend in the long-term. This confirms the main conclusions contained in the analysis presented by the Dutch authorities in their updated programme. A financing gap between 1 and 2 remains to fulfil the SGP requirements over the long term.