Stability Programme

The Netherlands, 2001-2007

Update, October 2003

1. Introduction and summary

Following the installation of the new Cabinet on 27 May 2003, an update of the Stability Programme was submitted in June. The June update was based on the new Cabinet's coalition agreement, known as the Global Agreement on Government Policy, and the previous Cabinet's Strategic Accord and supplementary package, both of which were fully adopted by the new Cabinet. Since the submission of the Stability Programme update in June, Cabinet has resolved to additional savings in response to the continuing deterioration of the economic and budgetary situation in the Netherlands. Contrary to the June update, the current update of the Stability Programme takes account of the Cabinet's additional package and is fully in line with the Budget Memorandum for 2004. The programme was sent simultaneously to Parliament and the European Commission.

Following a sharp slowdown in economic growth as of 2001, the Dutch economy will probably show zero growth this year. The poor economic performance not only reflects the international economic downturn, but also a deterioration in competitiveness resulting from a relatively large increase in unit labour costs. The weakening in economic growth was also linked to the drop in stock market prices and the cooling of the Dutch housing market. Supported by an international economic upswing, the recovery of the Dutch economy is expected to get slowly under way during the second half of this year.

Owing primarily to the unfavourable economic development, the budgetary situation has deteriorated considerably, and since 2002, the government balance is again showing a deficit. Following the release of the Stability Programme update in June of this year, the CPB Netherlands Bureau for Economic Policy Analysis again revised downwards its projections for economic growth. Without any additional policies[1], the EMU deficit in each year of the cabinet term 2004 - 2007 would, therefore, be larger than previously expected. In fact, the EMU deficit would amount to 2.6% of GDP in 2004 and to over 1% of GDP in 2007. The structural deficit would also widen considerably. In order to meet the requirements of the Stability and Growth Pact, additional measures were adopted that come on top of the measures agreed to in the Global Agreement on Government Policy. As a result of this additional package, the actual deficit in 2007 will be 0.6% of GDP whereas the structural deficit will be 0.5% of GDP.

The additional package is in line with the recommendation made by the Ecofin Council to implement extra measures if the fiscal balance were to deteriorate further as a result of weak economic development. With an actual deficit of 0.6% of GDP in 2007, there is still a prospect of repaying government debt - a necessary step in view of demographic ageing. According to

[1] Relative to the Stability Programme update of June 2003 which accounted for budgetary measures totalling EUR 20½ billion gross in 2007 (see section 3).

a recent calculation by the CPB, public finances will be sustainable if the actual budget deficit in 2007 is narrowed to ½% of GDP.

Taking the additional package into account, total expenditure cuts of this Cabinet will amount to EUR 23 billion in 2007 (over 4% of GDP[2]). Nonetheless, the automatic stabilisers are still operating to some extent, thereby limiting the impact of the international economic downturn on the Dutch economy. The savings measures that were selected will help to expand the effective labour supply. One way in which this will be realised is through a reform of the Disability Insurance Act (WAO) and through a discontinuation of the fiscal facilitation of early retirement and pre-pension schemes (both measures are in line with the recommendations in the Broad Economic Policy Guidelines). By stimulating labour supply and limiting the rise in public sector wages and benefits, the government will contribute to wage restraint. More moderate wage growth is desirable in order to prevent a rapid further rise in unemployment.

Cabinet has not only resolved on the above-mentioned expenditure cuts to improve the fiscal balance, but has also agreed to release funds for extra spending on the following policy priorities: knowledge and education, health care, safety and infrastructure (totalling EUR 8 billion in 2007). To enhance the effectiveness of government policy, the number of regulations will be curtailed while citizens, enterprises and institutions will be given greater responsibility. Cabinet wants to reduce the administrative burden in 2007 by one quarter relative to 2002. Moreover, apart from implementing social security adjustments, this Cabinet will also tackle specific bottlenecks in health care.

2. The Dutch economy

Economic development 2001-2003

Starting in 2001, economic growth in the Netherlands slowed significantly. Whereas economic growth in 2000 still amounted to 3.5%, it was no higher than 1.2% in 2001 and continued to weaken to 0.2% in 2002. The Dutch economy even contracted in the first two quarters of this year. The economy is expected to pick up in the second half of this year, so that annualised economic growth may be zero. The observed weakening of economic growth only partly reflects the international cyclical downturn. The worsened economic situation can primarily be attributed to the deterioration in competitiveness caused by a relatively sharp rise in unit labour costs. The Netherlands is paying a price for the favourable development of its economy in the 1990s. Strong economic growth was then coupled with a considerable increase in employment, resulting in a tight labour market. This was accompanied by a large rise in labour costs. Since labour productivity growth lagged behind, unit labour costs rose steeply. Subsequently, the slowdown in economic growth as of 2001 was linked to a marked

[2] The immediate improvement of the EMU balance will be smaller owing to the adverse second round effects that occur in the short-term (see Box 3.1).

weakening in productivity growth caused by labour hoarding. As wages were not adjusted downwards, unit labour costs rose even more rapidly.

Apart from the sharp rise in unit labour costs, the appreciation of the euro in 2002 and 2003 also contributed to the deterioration in competitiveness relative to countries outside the euro area. Companies narrowed their profit margins so as to retain market share. This led to a significant reduction in corporate profits. The deterioration in profitability is reflected in the rise in the labour share. This year, the labour share in enterprise income is likely to be 86%, five percentage points higher than in 1998. The profits of *listed* companies have suffered, in addition, from the slump in equity prices and the dollar depreciation, which meant that holdings had to be marked down in value at the expense of profits. The decrease in corporate profitability has led to a fall in investment. The slump in equity prices has – through negative wealth effects and an adverse impact on consumer confidence – also tempered private consumption. Moreover, capital gains resulting from strong growth in house prices are no longer stimulating consumption now that house prices have virtually stagnated.

Not only households and listed companies, but also pension funds have suffered from the fall in equity prices. The pension funds' reserves were already under pressure as the sharp wage increase has driven up the costs of pension indexation. In addition, the interest rate has, from a historical perspective, been low for a long period of time. Repairing the pension funds' coverage ratio requires either higher pension contributions or an adjustment of the terms and conditions for receiving a pension. Wage moderation can also help to control the costs of pension indexation.

After the unemployment rate dropped to 3.3% of the labour force on the back of the strong economic performance in the 1990s, the slowdown in economic growth as of 2001 led to a marked increase in the number of unemployed. In 2003, the unemployment rate will amount to 5½% of the labour force, implying that the labour market is no longer tight.

The inflation rate was rather high in recent years, reaching a peak of 4.5% in 2001. This was due, in part, to the strong rise in labour cost. About 1 percentage point of the price increase may be attributed to the increase in indirect taxation included in the reform of the tax system. From 2002 inflation has been levelling off and is likely to come out at 2% this year. This deceleration is also partly the result of the appreciation of the euro which makes imports from outside the euro area cheaper.

Outlook for 2004-2007

The recovery in the Dutch economy is expected to get slowly under way in the second half of 2003. Supported by the international economic upswing, the economy is likely to expand by 1% next year. The pick-up in output growth in the market sector will be linked to an acceleration in productivity growth, leading to a reduction in unit labour costs. Stronger productivity growth will also have a positive impact on corporate profitability. However, corporate investment is not expected to increase next year, one reason being a reduced investment in office buildings owing to the amount of vacant office space. A slight rally in equity prices may push up consumption growth to ¾% next year. This despite a decline in negotiated real wage growth.

Since enterprises have large internal labour reserves, employment is likely to continue to fall next year, despite the cautious recovery in economic growth. Unemployment will continue to rise to almost 7% of the labour force in 2004, and will hence clearly exceed the equilibrium rate (which the CPB estimates at 5½% in 2004)**.** Owing to the strong increase in unemployment and a drop in inflation, the negotiated wage rise in the market sector is likely to drop from 2¾% this year to 1½% next year. The decline in inflation is the result of both a more moderate growth in labour costs and a pick-up in productivity growth. At a projected rate of 1½%, inflation next year will be the lowest since the 1980s.

The projections for 2004 take account of the economic effects of the additional package. For the period 2005-2007, however, no update of the CPB projections incorporating these effects is available. The changes to the economic variables in this period shown in table 2.1 are therefore based on the medium-term projection published by the CPB in June 2003. This projection assumes an annual economic growth rate of 2½% for the years 2005-2007. According to the CPB, however, the additional package will, in the short term, temper economic growth somewhat. The consequences of this for the budget have been taken into consideration as explained below (see Box 3.1).

Table 2.1 Key figures

	2001	2002	2003	2004	2005	2006	2007
Short-term interest rate (in %)	4.3	3.3	2¼	1¾	2	3	4
Long-term interest rate (in %)	5.0	4.9	4	4	4¼	4½	4¾
Euro exchange rate (dollars per euro)	0.9	0.9	1¼	1¼	1¼	1¼	1¼
Price of crude oil in USD	24.6	25.0	27¼	24	24¼	24¾	25
	Changes in %						
World GDP	2.3	3.0	3	3¾	3¾	3½	3½
Euro area GDP	1.6	0.9	½	1¾	2½	2½	2½
Relevant world trade volume	2.0	2.5	3¾	6½	7¼	6½	6½
World trade volume	0.0	3.2	4¼	7¾	8½	8	7¾

Table 2.2 Economic growth and related factors

	2001	2002	2003	2004	2005	2006	2007
	Changes in %						
Gross domestic product, volume	1.2	0.2	0	1	2½	2½	2½
Gross domestic product, level in EUR	429.1	444.6	457	468	488	508	530
GDP deflator	5.4	3.4	2¾	1½	1½	1½	1½
CPI	4.5	3.5	2	1½	1½	1½	1½
HICP	5.1	3.9	2¼	1½	1½	1½	1½
Compensation per employee, market sector	5.6	5.0	4	2½	2½	2½	2½
Contractual wages, market sector	4.5	3.4	2¾	1½	1½	1½	1½
Labour productivity (market sector)	0.1	0.1	1¼	2¾	1½	1¼	1½
Unit labour costs, manufacturing industry	5.8	4.6	¾	-2	--	--	--
Employment growth (in persons)	1.7	0.8	-¾	-½	1½	1½	1¼
Unemployment (in % of labour force)	3.3	3.9	5½	6¾	6¾	6½	6¼
Standardised unemployment	2.4	2.8	4½	5¾	6	5¾	5½
Expenditure and output							
Private consumption	1.4	0.8	0	¾	1¾	1¾	2
Public sector consumption	5.4	3.4	2¾	1½	1½	1½	1½
Gross investment	-0.1	-4.5	-1½	¾	1½	2	2¼
Inventories (change in % of GDP)	-0.1	-0.3	0	¼	0	0	0
Exports of goods and services	1.7	0.1	1	4¾	6¼	5¾	5½
Imports of goods and services	2.4	-0.2	1½	4½	4½	4½	4¾
Share in GDP growth	**Contribution in percentage points**						
Domestic demand	1.6	0.1	0	¾	1½	1½	1¾
Net exports of goods and services	-0.4	0.2	-¼	¼	1¼	1	¾

Comparison with Commission's Spring forecast

The economic scenario presented above is less favourable than that shown in the Commission's Spring forecast. Whereas the CPB assumes zero growth for this year, the Commission, in its Spring forecast, anticipated a growth of 0.5%. For 2004, the CPB's current economic growth projection is around ¾ percentage point lower than the Commission's Spring forecast. The Commission's Autumn forecast, however, is expected to anticipate lower economic growth for both 2003 and 2004.

As always, projections are marked by uncertainties. Section 4, therefore, presents several scenarios to illustrate the effects of a weaker than expected international economic recovery, a higher interest rate, a lower euro exchange rate and, finally, a smaller rise in wages.

3. Development of EMU balance and EMU debt

EMU balance

Table 3.1 Development of EMU balance without further policy measures, 2001-2007 (in % of GDP)

	2001	2002	2003	2004	2005	2006	2007
EMU balance Global Agreement (May 2003)	0.1	-1.2	-1.6	-1.7	-1.2	-0.8	-0.5
Adjusted EMU balance (August 2003)	0.0	-1.6	-2.3	-2.6	-2.0	-1.3	-1.1
Structural EMU balance Global Agreement (May 2003)	-1.2	-1.2	-0.8	-0.7	-0.3	-0.2	-0.2
Adjusted structural EMU balance (August 2003)	-1.5	-1.8	-1.1	-1.1	-1.1	-0.8	-1.0

As a consequence of the marked slowdown of economic growth since 2001, the budget has been in deficit from 2002 onward. When the Global Agreement was drawn up, the EMU deficit was assumed to reach 1.2% of GDP in 2002 and 1.6% in 2003. As a result of the measures agreed for the period 2004-2007, the EMU deficit would then expand slightly further in 2004 (to 1.7% of GDP) before declining to 0.5% in 2007. Following the conclusion of the Global Agreement, the CPB adjusted downwards its estimations of economic growth in 2003 and 2004. Furthermore, an updated figure has since become available for the EMU balance in 2002. This figure is less favourable than the figure that was available when the Global Agreement was drawn up, notably because Statistics Netherlands (CBS) now presents a less favourable balance for local government. The budgetary situation also worsened because spending on health care has proved higher than was previously expected. Without further policy measures, the EMU balance would deteriorate materially vis-à-vis the Global Agreement. In fact, the EMU deficit would reach 2.6% of GDP in 2004, and over 1% in 2007.

Because the factors mentioned are partly structural in nature, the structural budget balance was also adjusted downward since the Global Agreement was signed. Without additional policy measures, therefore, the structural deficit would amount to 1.1% of GDP in 2004. In subsequent years, it would barely improve, with a structural deficit of 1% of GDP still in 2007. This means that during the entire Cabinet term 2004-2007 the Netherlands would fail to meet the conditions of the Stability and Growth Pact. The Pact requires that structural deficits in excess of 0.5% of GDP be reduced by at least 0.5 percentage point annually. Repayment of the public debt needed to cope with demographic ageing would then also become beyond reach.

Measures aimed at budget consolidation

The current Cabinet's budgetary rules include the agreement that further measures will be taken if the structural EMU balance fails to meet the requirements of the Stability and Growth

Pact and/or if the actual EMU deficit rises to 2½% of GDP or more. Now that the economic and budgetary projections have been adjusted, both situations have arisen. In 2004 the actual deficit would rise to 2.6% of GDP while the structural deficit would not be reduced at the required pace. Since the conclusion of the Global Agreement, Cabinet has, therefore, introduced an additional package amounting to around EUR 3.8 billion in 2007.

Table 3.2 Additional package 2004-2007; a minus indicates an improvement of the budget balance (EUR billion, constant prices, cumulative)

	2004	**2005**	**2006**	**2007**
Net expenditure cuts	-1.3	-1.5	-1.5	-1.9
Net increase in taxation	-0.8	-1.6	-1.6	-2.0
Total 1/	**-2.1**	**-3.0**	**-3.1**	**-3.8**

1/ Due to rounding, the sum of the components may deviate from the total.

The additional package is structured along the policy lines of the Global Agreement, as set out in the Stability Programme of June 2003. It provides for budgetary consolidation in combination with reinforcement of the structural growth potential and a guarantee of well-balanced income ratios. This means that the Cabinet has decided not to introduce general tax increases and not to curb growth-enhancing expenditures (education and infrastructure) where possible. The emphasis is on structural reforms which stimulate labour participation. The Global Agreement incorporated a reform of the Disability Insurance Act (as recommended in the Broad Economic Policy Guidelines) and adjustments to the unemployment scheme. The additional package goes further in that it seeks to boost the labour participation of older workers by moving forward the abolition of the fiscal facilitation of early retirement and pre-pension schemes. The Global Agreement already included a restriction on the rise in contractual wages in the public sector. The additional package also limits wage drift in the public sector in 2004 and 2005. Likewise, other policy measures contained in the Global Agreement are pursued further in the additional package. Public expenditure on health care will, for instance, become more manageable thanks to a further restriction of the insurance coverage and the introduction of co-payments, which are intended to boost a greater sense of responsibility among the insured. Finally, the time schedules for several policy measures contained in the Global Agreement have been adjusted.

The (net) increase in the tax burden contained in the additional package results mainly from the abolition of the fiscal facilitation of early retirement and pre-pension arrangements. As noted, this measure is conducive to the labour participation of older workers, and hence strengthens the economic structure. Another major element in the additional package is the increase in excise duties on tobacco. This measure, too, is intended to favourably impact behaviour.

A detailed overview of the measures contained in the additional package can be found in the Annex.

Table 3.3 Total policy package 2004-2007; a minus indicates an improvement of the budget balance (EUR billion, constant prices, cumulative)

	2004	2005	2006	2007
Gross expenditure cuts (total, starting with Strategic Accord)	-10.9	-16.8	-20.5	-22.9
Expenditure increases (total, starting with Strategic Accord)	3.9	5.5	7.5	8.1
Net development of the tax burden, 2004-2007	-1.2	-2.3	-1.5	-1.9

As a result of the additional package thus introduced by Cabinet, expenditure cuts of nearly EUR 23 billion will be realised by 2007 (over 4% of GDP). Of this amount, EUR 7½ billion is provided for by the Strategic Accord and supplementary package introduced by the previous Cabinet. These measures were adopted by the new Cabinet. The Global Agreement provides for further cuts, totalling over EUR 13 billion. The additional package that comes on top of these measures provides for expenditure cuts of around EUR 2½ billion.[3] The expenditure cuts will be used mainly to improve the EMU balance. Scope has furthermore been created for expenditure increases (EUR 8 billion) on policy priorities, namely: knowledge and education, health care, safety and infrastructure. Taking account of the additional package, 2007 will see a cumulative increase of the tax burden of EUR 1.9 billion.[4]

Box 3.1 Adverse second round effects of budget consolidation

In the short term, measures intended to improve the budget balance result in a smaller improvement of both the actual and the structural balance than the amount involved in these measures, because the consolidation measures have adverse second round effects. This is due, first of all, to the fact that, in the short term, deficit-reducing measures usually dampen economic growth somewhat resulting in lower public revenues. If, in addition, employment initially contracts somewhat expenditures on unemployment benefits may increase slightly.

In the projection of the actual and structural budget balances, allowance was made for these adverse second round effects. As, in the short term, the deficit-reducing measures usually put greater pressure on actual economic growth than on potential economic growth, second round effects can be assumed to be smaller for the structural balance than for the actual balance. This is particularly true for deficit-reducing measures that reinforce the structural growth potential of the economy. The CPB has calculated the second round effects of the measures taken in the Global Agreement. However, no CPB calculations were available on the effects of the Cabinet's additional package. For the projections of the budget balance in this Stability Programme it was assumed, therefore, that the adverse second round effects of the additional measures match those expected on the basis of previous experience.

[3] The additional package provides for EUR 2½ billion worth of gross expenditure cuts, and EUR ½ billion worth of expenditure increases. Net, the expenditure cuts amount to EUR 1.9 billion.

[4] As a result of a technical adjustment of the burden of taxation, the total reduction of the tax burden for 2004-2007 provided for in the Global Agreement reaches EUR 0.1 billion according to current insight. Including the EUR 2 billion worth of tax measures contained in the additional package, this Cabinet term will see an increase in the tax burden of EUR 1.9 billion.

Table 3.4 Fiscal developments, 2001-2007

In % of GDP	2001	2002	2003	2004	2005	2006	2007
Public spending	46.6	47.7	47.6	47.3	46.7	45.9	45.2
Public revenues	46.6	46.5	45.5	45.1	44.7	44.8	44.6
EMU balance	0.0	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6
Structural EMU balance	-1.5	-1.8	-1.3	-0.7	-0.5	-0.3	-0.5

As a result of the additional measures, the actual budget deficit will be reduced from 2.6% of GDP to 2.3% in 2004. The EMU deficit thus again clears the limit of 2½% of GDP that Cabinet had announced in the Global Agreement. After 2004, the budget deficit will gradually decline further and reach 0.6% of GDP in 2007. The deterioration of the budget balance in 2007 that had occurred since the conclusion of the Global Agreement is thus compensated for almost entirely. The prospect of repayment of public debt necessitated by demographic ageing is thus retained. In line with the Stability and Growth Pact and the recommendation made by the Ecofin Council in respect of the previous update of the Netherlands' Stability programme, the structural balance will improve by at least 0.5 percentage point in 2004. By 2005, the structural deficit will have been reduced to 0.5% of GDP.

By 2007, the actual EMU deficit will have improved 1.7 percentage points compared to 2004, while the structural deficit will have improved by only 0.2 percentage point. This is due to the fact that economic growth is reckoned to exceed potential growth as from 2005, so that the cyclical component of the budget deficit will gradually decline in the years 2005-2007.

EMU debt

Table 3.5 EMU debt, 2001-2007

In % of GDP	2001	2002	2003	2004	2005	2006	2007
EMU debt	52.9	52.4	54.0	54.5	53.7	53.0	52.2

As at end-2004, EMU debt is estimated to reach 54.5% of GDP, a slight increase on end-2003. Expectations are that the debt ratio will decline annually as from 2005, to around 52% of GDP in 2007. This means that by the end of the current Cabinet's term it will be over 10 percentage points below the debt-level at the start of EMU in 1999. A breakdown of the factors underlying the change in the debt ratio can be found in the Annex.

4. Comparison with previous update and sensitivity analyses

Comparison with June 2003 update

Comparison with the previous update of the Stability Programme shows that economic growth in the years 2001-2004 will, according to current expectations, be down markedly compared to the expectations held at the time. On a cumulative basis, the growth rate for this period will be about 1¼ percentage points below the rate envisaged in the June Stability Programme. The lower estimate for economic growth also explains the deterioration of the EMU balance. Compared with the previous update of the Stability Programme, the EMU balance would have worsened by 0.9 percentage point in 2004 if no further measures had been taken (from -1.7% to -2.6% of GDP). Thanks to the additional package, the deterioration of the EMU balance will be limited to 0.6 percentage point in 2004. This deterioration is entirely due to lower-than-expected revenues ensuing from the downward adjustment of estimated economic growth. The additional package offers only a partial compensation for this setback.

Table 4.1 Comparison of the June 2003 Stability Programme and the current Stability Programme

	2001	2002	2003	2004
GDP growth				
Stability Programme June 2003	1.3%	0.2%	¾%	1½%
Current Stability Programme (October 2003)	1.2%	0.2%	0%	1%
Deviation (in percentage points)	-0.1	0	-¾	-½
Cumulative deviation since 2000 (in percentage points)	-0.1	-0.1	- ¾	-1¼
EMU balance				
Stability Programme June 2003	0.1%	-1.2%	-1.6%	-1.7%
Current Stability Programme (October 2003)	-0.0%	-1.6%	-2.3%	-2.3%
Deviation (in percentage points)	-0.1	-0.4	-0.7	-0.6
EMU debt				
Stability Programme June 2003	52.8%	52.6%	52.5%	52.2%
Current Stability Programme (October 2003)	52.9%	52.4%	54.0%	54.5%
Deviation (in percentage points)	0.1	-0.2	1.5	2.3

Future uncertainties and sensitivity analyses

The projections are subject to uncertainties. For this year there is a clearly discernible downward risk, also in view of the disappointing figures for economic growth in the first two quarters of 2003 supplied by Statistics Netherlands. Contraction of the Dutch economy can be avoided only if international economic activity recovers fairly vigorously in the second half of the year. A slower recovery of the world economy would mean a delayed recovery in the Netherlands. Should worldwide GDP growth in 2003 be ¼ percentage point lower than currently projected and should it gradually return to its original growth path in the first half of next year, Dutch economic growth will be 0.2 percentage point lower this year and 0.4 percentage point lower in 2004. In that case, inflation in 2004 would be 0.3 percentage point lower and the EMU deficit would be 0.2 percentage point higher.

Another source of uncertainty is the interest rate level. The baseline projection assumes that interest rates will rise when the world economy picks up. Should that recovery persist, interest rates could rise more than estimated in the baseline projection. If both long and short-term interest rates in 2004 turn out ½ percentage point higher than assumed in the baseline projection, economic growth in 2004 will be 0.3 percentage point lower, owing to adverse effects on domestic consumption and investment, and a slower recovery of the international economy. In that case, inflation will be 0.1 percentage point lower and the EMU deficit 0.1 percentage point higher.

The baseline projection also assumes an average euro exchange rate of USD 1.15 for the second half of this year as well as for next year. But the euro exchange rate, too, is uncertain. Should the American economy pick up relatively strongly, the euro/dollar rate could turn out to be lower than anticipated in the baseline projection. Should the euro rate come out USD 0.05 lower in the second half of this year and next year, economic growth in 2004 will be 0.2 percentage point higher because exports will expand more. It would, however, adversely affect inflation. In this case the EMU balance in 2004 would improve 0.1 percentage point compared to the baseline projection. Another possibility is a higher euro/dollar rate than that assumed in the baseline projection. In that case, the signs in the Table are reversed.

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

	2003	2004	2005	2006	2007
I. Delayed recovery of world economy					
GDP volume	-0.2	-0.6	--	--	--
CPI	-0.1	-0.4	--	--	--
EMU balance (in % GDP)	0.0	-0.2	--	--	--
II. Interest rates in 2004 ½ percentage point higher					
GDP volume	--	-0.3	--	--	--
CPI	--	-0.1	--	--	--
EMU balance (in % GDP)	--	-0.1	--	--	--
III. Euro/dollar rate USD 0.05 down, second half 2003 and 2004					
GDP volume	0.1	0.3	--	--	--
CPI	0.1	0.4	--	--	--
EMU balance (in % GDP)	0.0	0.1	--	--	--
IV. Wage moderation of 0.5 percentage point in 2004 and 1.5 percentage points in 2005					
GDP volume	--	0.0	-0.1	--	0.2
CPI	--	-0.1	-0.4	--	-0.5
EMU balance (in % GDP)	--	0.0	-0.1	--	0.0

Apart from these external uncertainties, there are internal uncertainties as well. The rise in negotiated wage rates could, for instance, be lower than assumed in the baseline projection. If market sector wages were to rise 0.5 percentage point less in 2004 and a further 1.5 percentage points less in 2005 than foreseen in this projection (cumulatively 2 percentage points), GDP will be adversely affected in the short term because private consumption will expand by slightly less. In the medium term, however, the impact on GDP will be favourable, because the competitive position will improve. In this variant, GDP growth in 2007 will be 0.2 percentage point higher than in the baseline projection. As a result of a smaller wage rise, the EMU balance will deteriorate slightly vis-à-vis the baseline projection in the short term, because public revenues will be lower. However, the effect on the EMU balance in 2007 is negligible because employment will develop favourably in this variant. The CPB has furthermore calculated that the structural budget deficit (CPB method) will be smaller in 2007.

5. Quality and composition of public finance

Role of government reconsidered

With a view to an improvement of the quality of public services, the government's role is being reconsidered. Seeking to achieve a variety of objectives, the government issues regulations so as to influence the behaviour of citizens, enterprises and institutions. However, so many regulations are currently in force in some areas that the effectiveness of government policy would be boosted by a reduction in the number of regulations. Greater simplicity would benefit the implementation and enforcement of these regulations. Citizens, enterprises and institutions will be given greater leeway to develop initiatives of their own, but also more responsibility. The Cabinet furthermore intends to reduce the administrative burden for the public and the business sector by one quarter in 2007 relative to 2002.

Specific bottlenecks in public services are also being dealt with through institutional innovation. To begin with, a new health insurance system is to be introduced in 2006. Under this new system, health insurers must compete for health care services. This is to make health care more efficient, and to align supply and demand to a greater extent. With a view to greater manageability of health care costs, insurance coverage will be restricted starting next year and co-payments will be introduced. In order to protect people with chronic illnesses and disabilities, as well as the elderly, a new compensation scheme will be introduced supplementary to tax relief for extraordinary expenses. As a result of these adjustments, the insured, the institutions providing health care services and the insurers will be given a greater responsibility of their own and health care will remain affordable in the future.

The activating nature of social security will be strengthened. In order to curb the relatively large number of persons receiving disability benefits in the Netherlands, the Disability Insurance Act is to be reformed in 2006. Under the new scheme, only those who are completely incapacitated for work will qualify for a benefit. A wage supplement scheme is to stimulate the reintegration of those who are partially incapacitated for work. The activating nature of the unemployment scheme will also be reinforced by tightening the eligibility requirements for receiving benefits and by curbing their duration. In order to boost the labour supply, the fiscal facilitation of early retirement and pre-pension schemes will be terminated; this will raise the participation rate of older workers. Cabinet is furthermore seeking to boost the participation rate of the low-skilled by tackling the poverty trap.

Public finance reallocations

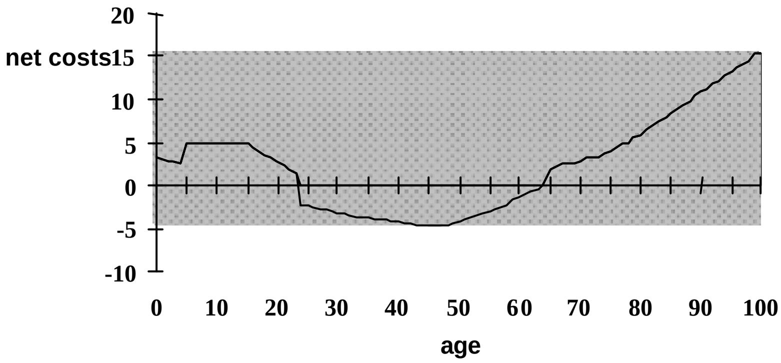
The Cabinet seeks to strengthen structural economic growth. Its policy therefore places emphasis on structural economic reforms, while refraining from introducing general tax rises and curbing growth-enhancing expenditures. In order to reinforce the growth potential of the economy, the effective labour supply must be augmented. This is all the more advisable because the expansion of the labour supply is set to decline, slowly but surely, as a result of the ageing of the potential labour force. In addition, the Cabinet has created scope for extra spending on policy priorities such as knowledge and education, health care, safety and infrastructure.

Where innovation, knowledge and education are concerned, the Cabinet's policy aims especially at realising high productivity growth. It has allocated extra resources towards this goal. The Cabinet has given an impulse to innovation by setting up an Innovation Platform chaired by the Prime Minister. It is made up of government officials and prominent persons from the business sector, universities and scientific institutions. The Platform will work out ideas and plans for a strategy on the development and exploitation of knowledge. It will also address measures aimed at increasing the availability of (foreign) "knowledge workers" and professionals. The parties involved will be accountable for the contributions they can make, both individually and collectively, towards achieving these goals. In addition, resources will be allocated towards knowledge workers (in science, technology and other fields), cooperation in R&D, and technology entrepreneurs. Cabinet also wants to boost (scientific) research and achieve greater concentration and focus in the research areas, for instance, through close cooperation between research institutions and the business sector.

6. Sustainability of public finance

Like in other Member States, the population in the Netherlands will be ageing rapidly over the next few decades. The ratio of the number of people aged 65 and over to the number of people aged 20 to 64, the so-called 'grey pressure', will consequently rise from about 22% today to around 43% in 2040. Spending on public pensions and health care will therefore increase sharply, though part of this increase will be offset by higher tax revenues from pensions. If the future rise in public spending is not adequately anticipated, taxes may have to be raised in the future, or public services toned down. To prevent this, the public debt needs to be reduced. The smaller interest burden consequent on a lower public debt would give budgetary scope for absorbing higher expenditures on public pensions and health care.

Figure 6.1 Government costs per age category, net (EUR thousand)



Source: CPB.

The CPB has mapped the consequences of ageing for public finance. It first estimated the government's net costs for people of all ages. These net costs are calculated by deducting taxes and social insurance contributions from the benefit gained by people from public services. The government's net costs are positive for people under 25 and those aged 65 and over. The benefit which they derive from public services exceeds what they pay in taxes and social insurance contributions. The reverse goes for people between 25 and 65. Their tax payments and social insurance contributions exceed the benefit which they reap from public services. Public finances are sustainable when existing public services can increase in line with prosperity without necessitating an increase in taxes and social insurance contributions or causing an explosive rise in public debt. This is possible only when interest payments can be sufficiently reduced, in other words, when public debt can be brought down at a sufficient speed.

Table 6.1 Sustainable EMU balance in 2007 (in % of GDP)

Actual sustainable EMU balance	-0.6%	
Temporary factors	1.7%	
Of which:		
"Pipeline effects"		*1.2%*
Pension premiums		*0.5%*
Underlying sustainable EMU balance	1.1%	

Source: CPB.

According to a recent CPB calculation, public finances are sustainable when the actual budget deficit in 2007 is no larger than ½% of GDP. Although there will still be an actual budget deficit in 2007, the prospect of repaying public debt in the future remains because the underlying balance in 2007 is in surplus.. Adjusted for temporary factors which are incorporated in the actual budget balance, the CPB calculation yields an underlying budget surplus of 1.1% of GDP in 2007. The temporary factors are twofold. To begin with, the fruits of the Cabinet policy aimed at strengthening the economic structure cannot be fully reaped during this Cabinet's term (in 2007 this results in so-called "pipeline effects"). The social security reforms, for instance, will continue to have a positive effect on economic growth beyond 2007. Assuming no policy change, the budget balance will consequently improve by another 1¼ percentage points after 2007. The second factor concerns the pension premiums. Given the funding problems now confronting pension funds, pension contribution rates in the next few years will exceed their cost-covering level (in order to replenish the pension funds). As pension premiums are tax-deductible, the temporarily higher contribution rates will negatively impact the budget balance. Once, in a few years time funds have been replenished and the temporary extra increase in contribution rates is undone, the budget balance will improve by about ½ percentage point. The CPB estimates that, taken together, these two factors, will improve the budget balance by 1¾% of GDP given the policy now envisaged.

Two remarks are in order where the above CPB calculation is concerned. First of all, the distortion of the budget balance of 1¾% of GDP is uncertain. Notably the positive effects which the social security reforms will have on economic growth beyond 2007 are hard to estimate. Secondly, even if the distortion has been properly estimated, the budget balance will only improve by 1¾% of GDP after 2007 if the more favourable budget balance is not used for an extra increase in public spending or a tax cut. If that happens, the budget balance will improve less beyond 2007.

Figure 6.2 Sustainable EMU balance in the baseline scenario, 2007-2080

Source: Budget Memorandum 2004.

At a CPB-estimated underlying sustainable budget balance of 1.1% of GDP in 2007 and an estimated distortion of the actual budget balance of 1¾% of GDP, sustainable public finances are achieved when the actual EMU deficit comes out at ½% of GDP in 2007. This indicates that, as things now stand, the reduction of the budget deficit to 0.6% of GDP envisaged by the Cabinet will generate sustainable public finance in 2007.

Annex to Stability Programme 2001-2007

Table 1 Additional package of measures 2004 - 2007 (EUR million)

	2004	2005	2006	2007
Expenditure	**1256**	**1492**	**1495**	**1865**
Public sector wage drift	180	360	360	360
Stimulating labour participation (i.a. retesting eligibility for disability benefits)	115	260	410	545
Limiting bureaucracy/public sector regulations	5	5	10	20
Limiting public subsidies and enhancing benefit principle	219	265	506	555
Keeping health care costs under control (including restricted coverage and co-payments)	200	300	300	300
Other	537	302	-91	85
Tax burden	**838**	**1552**	**1643**	**1965**
Tax base broadening	518	1237	1583	1935
Of which:				
- adjustment transitional arrangement early retirement/pre-pensions	0	520	830	1150
- increase in excise duties on tobacco	400	435	435	435
Policy measures	0	75	0	0
Tax deductions (for children)	100	150	0	0
Tax measures to stimulate labour participation	220	90	60	30
Total	**2094**	**3044**	**3138**	**3830**

Table 2 Development public finances, 1995-2007

In % GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EMU balance 1/	-4.2	-1.8	-1.1	-0.8	0.7	1.5	-0,0	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6
Central government	-3.6	-1.5	-2.1	-1.1	-0.7	-0.2	-0.0	-1	-2.6	-2.6	-2.0	-1.9	-2.0
Local government	0.3	0.2	1	0.1	0.1	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0
Social security funds	-0.8	-0.5	0	0.3	1.2	1.6	0.1	-0.4	0.3	0.3	0.4	1.0	1.4
Public revenues	49.3	49.1	48.2	47.3	48.5	47.7	46.6	46.5	45.5	45.1	44.7	44.8	44.6
Public expenditure	53.5	50.9	49.3	48.1	47.8	46.2	46.6	47.7	47.6	47.3	46.7	45.9	45.2
EMU balance 1/	-4.2	-1.8	-1.1	-0.8	0.7	1.5	-0.0	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6
Interest payments, net	5.9	5.5	5.1	4.7	4.6	3.8	3.4	3.3	2.9	2.9	2.8	2.7	2.7
Primary balance	1.7	3.7	4.0	3.9	5.3	5.3	3.4	1.7	0.6	0.6	1.2	1.8	2.1
Breakdown of public finance													
Taxation	25.1	25.9	25.1	25.4	25.2	25.5	25.7	25.6	24.6	24.7	24.8	24.5	24.3
Social security contributions	16.0	15.5	15.5	15.3	16.0	16.0	14.3	13.9	14.7	14.6	14.1	14.3	14.3
Other	8.2	7.7	7.6	6.6	7.3	6.2	6.6	6.2	6.2	5.8	5.8	6.0	6.0
Public revenues, total	49.3	49.1	48.2	47.3	48.5	47.7	46.6	45.7	45.5	45.1	44.7	44.8	44.6
Breakdown of public expenditure													
Government consumption	17.1	16.8	16.4	16.3	16.6	16.3	16.8	17.4	17.5	17.3	16.8	16.6	16.3
Social security (in kind)	7.5	7.0	7.2	7.1	7.1	7.2	7.4	8.0	8.2	8.2	8.3	8.3	8.4
Social security (other)	15.3	14.8	13.9	13.0	12.5	11.8	11.6	12.1	12.5	12.7	12.2	11.8	11.4
Interest payments	5.9	5.5	5.1	4.7	4.6	3.8	3.4	3.1	2.9	2.9	2.8	2.7	2.7
Subsidies	1.1	1.2	1.5	1.4	1.5	1.8	1.7	1.8	1.7	1.4	1.3	1.2	1.1
Investment	3	3.2	3	3.1	3.1	3.1	3.2	3.3	3.4	3.3	3.2	3.3	3.4
Other	3.6	2.4	2.2	2.5	2.4	2.2	2.5	1.6	1.6	1.6	1.7	1.8	1.8
Public spending, total	53.5	50.9	49.3	48.1	47.8	46.2	46.6	47.7	47.8	47.4	46.3	45.7	45.2

1/ The 2000 EMU balance does not include the proceeds from the auction of UMTS licences of 0.7% of GDP.

Table 3 Development of EMU debt, 1995-2007

In % GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
EMU debt	77.2	75.2	69.9	66.8	63.1	55.9	52.9	52.4	54.0	54.5	53.7	53.0	52.2
Change in debt ratio	2.6	-2.0	-5.3	-3.1	-3.7	-7.2	-3.0	-0.5	1.6	0.5	-0.8	-0.7	-0.8
Contribution to lower debt ratio:													
Primary balance	-1.7	-3.7	-4.0	-3.9	-5.3	-5.3	-3.4	-1.7	-0.6	-0.6	-1.2	-1.8	-2.1
Interest payments	5.9	5.5	5.1	4.7	4.6	3.8	3.4	3.1	2.9	2.9	2.8	2.7	2.7
Denominator effect GDP growth	-5.0	-4.2	-5.9	-6.1	-5.6	-4.4	-3.5	-1.8	-1.4	-1.3	-2.2	-2.1	-2.1
Other	3.4	0.4	-0.5	2.2	2.6	-1.3	0.5	-0.1	0.7	-0.5	-0.2	0.5	0.7