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2003 UPDATE OF THE STABILITY PROGRAMME FOR THE NETHERLANDS 2001-2007

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The Netherlands submitted its most recent update of the stability programme, covering the period 2001-2007, on 14 October 2003. The update incorporates the 2004 budget. The budget was endorsed by Parliament with some limited modifications, which encompass the proposed budgetary policies of the government for 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. However, a few non-compulsory variables which are valuable inputs to compute cyclically adjusted balances using the common production function method were not included.

For 2003 and 2004 the update of the stability programme uses macroeconomic projections by the CPB Netherlands Bureau of Economic Policy Analysis (CPB) which were officially released on 16 September 2003. For the period 2005-2007, the update uses the medium term economic projections released by the CPB on 16 May 2003. According to the update, economic activity is expected to remain sluggish in the near term. Real GDP growth is expected to pick up gradually to 1% in 2004, from zero in 2003, and to 2½% in 2005, 2006 and 2007.

In recent years the general government balance deteriorated significantly, despite successive rounds of fiscal savings measures. To a large extent this deterioration reflects the impact of the sharp and prolonged economic downturn. The update expects a deterioration in the general government balance to a deficit of 2.3% of GDP in 2003, from 1.6% of GDP in 2002, despite substantial savings measures. This pattern mainly reflects the impact of the economic slowdown activity but the delayed impact of the tax cuts of the 2001 fiscal reform, and increases in tax-deductible pension premia and tax-deductible increases in mortgage interest payments play a role as well.

For the whole 2004-2007 period the update contains a substantial multi-annual consolidation package consisting of net expenditure cuts, and tax revenue raising measures. The measures to a large extent rely on expenditure reductions while the package is frontloaded in 2004 and 2005. The net ex-ante combined impact on the general government balance is equivalent to € 14.2 billion (around 3% of GDP) in the period 2004-2007. However, the cumulative improvement in the actual deficit is less because of negative second round effects. Overall, the nominal deficit would gradually decrease to 0.6% of GDP in 2007.

By contrast, in cyclically adjusted terms (calculated using the common production function method) a position close to balance is targeted to be reached earlier. According to the update, the cyclically adjusted balance would improve from a deficit of 1.3% of GDP in 2003 to 0.7 % of GDP in 2004. In the period 2005-2007, the cyclically adjusted deficit is projected to be at or 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.

[1] This assessment has been carried out on the basis of information available as of 22.01.2004.

The update expects the debt to GDP ratio to remain well below 60% of GDP, increasing from 52.4% of GDP in 2002 to 54.5% of GDP in 2004 - largely in line with the Commission Autumn forecast - before decreasing slowly to 52.2% of GDP in 2007.

The budgetary projections appear to be optimistic and outdated in view of more recent information, which suggests a further worsening of the economic situation and budgetary position. According to the Commission Autumn forecast, and new forecasts by the CPB released on 4 December 2003, economic growth in 2003 is likely to be much lower than estimated in the update. The Commission Autumn 2003 forecast estimates real GDP to shrink by close to 1% in 2003, while the CPB puts -¾%. Downside risks are also attached to the growth projections for 2005-2007.

The deficit forecasts for 2003 and 2004 in the update also seem too low, compared to the Commission Autumn 2003 forecast, according to which the deficit would reach 2.6% and 2.7% of GDP in 2003 and 2004 respectively, and decrease only slightly in 2005. Preliminary estimates for 2003 by the Ministry of Finance released on 14 January suggest that the deficit was 2.7% of GDP. Risks to the budgetary outlook for the period 2005-2007 appear skewed to the downside as well, in view of the likelihood of a worse budgetary starting point.

Despite these risks to the nominal deficit projections, the implications for fiscal adjustment in terms of improvements in the cyclically adjusted balance are not equally negative. The cyclically adjusted balances presented in the update almost coincide with the estimates in the Commission Autumn forecast for the period up to 2005. In both 2003 and 2004 the adjustment in the cyclically adjusted deficit would be at least the required 0.5 percentage point of GDP. The budgetary projections in the update show a position close to balance in 2005 to 2007 (assumed in the update to be a cyclically adjusted 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. This confirms that a significant structural budgetary adjustment is underway and would be maintained even in the case of a weaker-than-expected economic recovery.

However, on unchanged policies and given normal macroeconomic fluctuations a sufficient safety margin not to exceed the 3% of GDP nominal deficit threshold is not provided for throughout the programme period. In the light of the considerations above, the risk of exceeding the threshold seems particularly large in 2004.

As regards the budgetary strategy underlying the update, a key element is the use of expenditure ceilings defined in real terms, as recommended in the 2003 Broad Economic Policy Guidelines. Expenditure windfalls can no longer be automatically used for increased expenditure. Automatic stabilisers on the revenue side of the budget would be allowed to work freely as much as possible. However, an expected increase of the general government deficit that would imply a violation of the Stability and Growth Pact has to be countered by additional savings measures.

On the basis of the current policies, the risk of budgetary imbalances emerging in the Netherlands in the medium to longer run cannot be ruled out. According to Commission calculations on the basis of the update, on unchanged policies the debt to GDP ratio is expected to increase above 60% once the full impact of ageing takes place. In order to maintain public finances on a sustainable footing, debt should be reduced at a sufficient pace in the period prior to the budgetary effects of ageing population taking hold, along with continuing to control the factors influencing the expenditure ratio.

The update is broadly consistent with the 2003 Broad Economic Policy Guidelines, in particular those with budgetary implications, as regards pursuing budgetary adjustment towards a position close to balance, and containing expenditure over the cabinet period under ceilings in real terms.

1. INTRODUCTION

The 2003 update of the Dutch stability programme (the update henceforth) was submitted on 14 October 2003. It covers the period from 2001 to 2007. The update incorporates the 2004 budget, which was approved by Parliament with relatively few changes from the original proposal. The 2004 budget contains a substantial package of additional consolidation measures compared to the coalition agreement (which was incorporated in the revised version of the 2002 stability programme update), in order to avoid a further deterioration in the budget balance. With respect to the underlying economic projections, for 2003 and 2004 the update of the stability programme uses macroeconomic assumptions by the CPB Netherlands Bureau of Economic Policy Analysis (CPB) which were officially released on 16 September 2003, at the same time as the 2004 budget. For the period 2005-2007, the update uses the medium term economic projections for 2004-2007 released by the CPB on 16 May 2003.
The update largely complies with the guidelines set in the Council opinion on the Code of conduct on the content and format of programmes.[2] However, as a relatively minor issue some aggregates of a few non-compulsory variables which are valuable inputs to compute cyclically adjusted balances using the common production function method were not included in exactly the format requested – for instance compensation per employee and unit labour costs.

2. MACROECONOMIC ASSESSMENT

2.1 External economic assumptions

The external macroeconomic assumptions included in the update differ somewhat from the common assumptions in the Commission Autumn forecast, but a sensitivity analysis is included. The comparisons with Commission projections in the update refer to the Spring forecast and not the Autumn forecast (which was not yet available at the time the update was submitted) which renders these comparisons outdated. Nevertheless, as regards real GDP growth and relevant world trade, the external assumptions adopted are quite close to the Autumn Forecast, with world real GDP growth and euro area GDP growth assumed a bit lower according to the update. While exchange rate assumptions are quite similar, the main difference appears to be that the update assumes a somewhat lower price for crude oil in 2003 and 2004. The various alternative scenarios provided in the sensitivity analysis allow for an assessment of the sensitivity of the projections to changes in some key external assumptions, notably on the pace of recovery of the world economy, on the interest rate, and on the exchange rate of the euro versus the dollar.

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

2.2 Macroeconomic developments

The macroeconomic projections of the stability programme

The forecasts of real GDP growth have been revised in the course of 2003 and hence also compared to the revised 2002 stability programme update, following worse-than-expected realisations (table 1).

TABLE 1 – REAL GDP GROWTH – SEQUENCE OF RECENT PROJECTIONS

	2002	2003	2004	2005	2006	2007
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	2	2½	2½
2003 Stability Programme Update (14 October) [1]	0.2	0	1	2½	2½	2½
Commission Autumn 2003 forecast	0.2	-0.9	0 .6	2.0	-	-
CPB Winter forecast (4 December)	0.2	-¾	1	-	-	-

[1] based on CPB Autumn forecast (16 September)

However, more recent indicators on economic activity, which suggest that economic activity in the first three quarters of 2003 has been even weaker than previously expected, were not incorporated. In fact, the Commission Autumn forecast and the most recent CPB projections (released in early December 2003) suggest that real GDP will actually decline in 2003, According to the Commission Autumn forecast, real GDP will also grow less in 2004 than anticipated in both the update and the most recent CPB forecast (compare table 1). For the period 2005-2007, the update uses the medium term economic projections released by the CPB on 16 May 2003. After several years of economic growth below the potential rate, the expected increase in real GDP growth to 2½% in 2005, 2006 and 2007 implies that growth in those years would exceed the estimated rate of potential growth of slightly below 2%, which in turn would mean some reduction of the output gap.

For 2003 to 2005, the labour market forecasts in the stability programme update are slightly more optimistic on employment growth than the Commission Autumn forecast, while the unemployment projections are broadly similar. By contrast the update expects HICP inflation to remain at around 1½% in 2004 and 2005, whereas HICP inflation would fade to slightly below 1% by 2005 according to the Autumn forecast.

Evaluation by the Commission

The macro-economic scenario presented in the update is derived from CPB forecasts published in September 2003 (see above). Since then new information has become available. On the basis of real GDP data up to the third quarter of 2003 (when quarter-on-quarter real GDP growth recovered slightly following three quarters of negative growth), economic growth in 2003 almost certainly will be much lower than the by now outdated 0% estimate in the update. The Commission Autumn forecast has -0.9%, which is quite close to the latest CPB forecast released in December 2003 which puts real GDP growth in that year at -¾%. For 2004, the Autumn forecast projects weaker economic growth than anticipated in the update and in the most recent CPB forecast. In view of the more recent estimates, the projections on economic activity and employment in the update for 2003 appear clearly too optimistic. On the one hand, the balance of risks to projected real GDP growth in 2004 in particular but perhaps also in 2005-2007, appears to be skewed on the downside as well. On the domestic side it is likely that it will take considerable time to redress the macro-economic imbalances and losses in competitiveness that were largely responsible for the extent of the current economic slowdown. The impact of rising private pension premia on labour costs is another relevant risk. On the other hand, it is not unrealistic to assume that economic activity and labour productivity can accelerate quite a bit after a downturn in which the output gap has widened considerably. In the past the strength of an economic upswing has often been underestimated in the early stages of the upswing. Hence, there are some upside risks as well. At any rate, the strength of the recovery in the medium term is contingent on a successful restoration of the competitiveness of the Dutch market sector. This depends to some extent on appropriate wage developments. In this regard the recent wage agreement has brought some relief in the near term. That said, probably much more important in the medium term are the measures taken aiming to raise labour participation, to improve the functioning of labour and product markets, and to boost productivity.

Another point to be considered is that for 2005-2007 the update uses CPB medium term projections released by the CPB already in May 2003. These figures have not been adjusted to link to the revised short-term projections up to 2004 in a fully consistent way. This entails that the macro-economic projections in the update for 2005-2007 do not take into account the impact of policy measures taken from June 2003 onwards by the incoming government.

Growth, output gap and productive potential growth

The analysis of potential growth offers an additional way to put risks to the growth forecasts in the update in perspective (table 2). The rate of potential real GDP growth implicitly assumed in the programme's macroeconomic projections (estimated using the agreed common production function method) dropped sharply from 2.5% in 2001 to 2.1% in 2002. For the period 2003-2007 the estimated rate of potential growth is expected to moderate further to slightly below 2% on average (table 2).

Table 2 – Real GDP growth, potential real GDP growth and output gap calculated applying the production function method agreed by the Ecofin Council

	2001	2002	2003	2004	2005	2006	2007
Commission Autumn forecast							
Real GDP growth (%)	1.2	0.2	-0.9	0.6	2.0	-	-
Potential real GDP growth (%)	2.5	2.1	1.8	1.7	1.7		
Output gap	2.6	0.7	-2.0	-3.0	-2.7	-	-
Revised 2003 SP update							
Real GDP growth (%)	1.2	0.2	0	1	2½	2½	2½
Potential real GDP growth (%)	2.6	2.2	1.8	1.8	1.8	1.9	2.0
Output gap	1.9	-0.1	-1.9	-2.7	-2.0	-1.3	-0.7

The estimated rate of potential real GDP growth over the period 2003-2005 is quite lacklustre, slightly below 2%, an estimate comparable to the Commission Autumn forecasts.[3] The update expects the average actual growth rate of real GDP in 2005-2007 to be only slightly above the estimated potential rate, with the negative output gap persisting into 2007 and closing only slowly. Hence, from this perspective, the medium-term growth projections underlying the budgetary projections do not seem overly optimistic. On the other hand, more up-to-date forecasts may imply an even slower closure of the output gap than assumed.

Sectoral balances and other variables

Information provided in the programme does not allow a rigorous assessment of sectoral balances. That is, it is not feasible to assess the internal consistency of the projections on the basis of the presented changes in the financial deficits of general government vis-à-vis the rest of the world and/or the private sector. One reason is the very marked swings in the balances of these sectors due to special write-offs on external assets and other financial flows of unusual magnitude that occurred in the aftermath of the turmoil on world financial markets. However, there would not seem to be any major inconsistency in the sectoral balances underlying the programmes macro-economic projections as these are based on the complete and internally consistent multi-annual projections of the CPB. The broad trends in the sectoral balances of the private sector and the rest of the world in the CPB estimates are comparable to the ones in the Commission Autumn forecast, allowing for the overall difference in the macro-economic scenarios. Nor would there seem to be any implausibility between the projections of real expenditure components and (perceived) movements in sectoral balances. This is because the programme assumes a gradual pickup in domestic demand along with an improvement in net exports that is line with the assumed cyclical recovery.

Higher employment growth in the update compared to the Commission Autumn forecast is in line with higher expected real GDP growth. The broad similarity of unemployment estimates would reflect the reasonable assumption that labour supply would decrease more in the event a stronger slowdown (as envisaged in the Autumn forecast). As regards HICP inflation, the difference with the Commission Autumn forecast can be partly accounted for by the higher projected growth of compensation per employee in the update, which did not take into account the effect of the agreement among social partners to freeze contractual wage increases in 2004 and 2005, an agreement settled after the update had been submitted. Differences in the assumptions on import prices (not given in the update) may explain most of the remaining difference.

[3] 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.

3. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF PUBLIC FINANCES

3.1 Programme overview

Tables 3 and 4 present an overview of the projections for the general government balance both in nominal and cyclically adjusted terms. In 2004, the nominal government deficit is expected to stabilise at a deficit of 2.3% of GDP in spite of substantial fiscal consolidation. A gradual improvement is foreseen in subsequent years as a result of further fiscal tightening and a pick-up in real GDP growth. Nevertheless, a small nominal deficit of 0.6% 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 retain a balanced position over the projection horizon, while social security funds are expected to see their surpluses increase markedly towards the end of the projection horizon, from 0.3% of GDP in 2004 to 1.4% in 2007.

The cyclically adjusted general government balance is projected to improve by 0.5 percentage point of GDP in 2003, to a deficit of 1.3% of GDP. The update expects the cyclically adjusted balance to improve by another 0.6% of GDP in 2004. Thereafter, the balance would improve slightly further to a deficit of 0.5% of GDP in 2005 remaining at or below that level in 2006 and 2007.

General government debt is projected to increase by half a percentage point in 2004, to 54.5% of GDP and to decline slightly in subsequent years to 52.2% of GDP in 2007.

Table 3 – Development of general government balance

In % of GDP	2001	2002	2003	2004	2005	2006	2007
2003 update	0.0	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6
Commission Autumn 2003 forecast	0.1	-1.6	-2.6	-2.7	-2.4	n.a.	n.a.

Table 4 – Development of cyclically adjusted general government balance

In % of GDP	2001	2002	2003	2004	2005	2006	2007
2003 update	-1.5	-1.8	-1.3	-0.7	-0.5	-0.3	-0.5
Commission Autumn 2003 forecast	-1.7	-2.1	-1.3	-0.7	-0.6	n.a.	n.a.

Source: Commission services calculations based on the 2003 stability programme update, using the common production function method

3.2 Size and composition of budgetary consolidation

The update gives a summary overview of the several rounds of budgetary consolidation packages adopted since the spring of 2002. These include the policy packages of the 'Strategic Accord' (the coalition agreement of the previous government), measures entailed in the so-called 'Global Agreement', the coalition agreement on which the policies of the current government are based, as well as the additional package for

2003-2007 provided in the 2004 budget from which the multi-annual projections given in the stability programme update are derived.

The total consolidation effort consists of reallocations of expenditure, expenditure cuts partly compensated by expenditure increases in some areas, and tax revenue-raising measures. The update gives a breakdown of the budgetary impact of the measures proposed, distinguishing main categories on the revenue and the expenditure side. Expenditure reductions are mainly achieved by spending less on social security, public sector wages and subsidies. The consistent computation in the update of second-round effects of budgetary tightening on economic activity and the budgetary position, as explained in a separate box, is to be commended. Nevertheless, the presentation of the update lacks some clarity with respect to distinguishing the ex-ante and ex-post impact of the net savings measures. In future updates, it would be helpful to include a table distinguishing the ex-ante and ex-post impact of fiscal measures. It has to be stressed that the calculations in the update do attempt to take into account the so-called second round effects of fiscal tightening on the actual budget balance, largely owing to the negative impact of fiscal restraint on economic activity in the near term. In other words, allowance is made for the fact that the immediate impact of consolidation measures will be negative. Hence, the ex-ante amount of consolidation is larger than the improvement in the actual (ex-post) budget balance, and even considerably so given the size of the multipliers. The precise effect depends on the composition of measures and the time horizon covered. However, as regards the presentation it is not possible to fully reconcile the figures on the total size of the policy packages given in tables 3.1 to 3.3 of the update with the budgetary projections in table 3.4 that give a quantitative estimate of the impact on the actual budget balance.

In order to shed some more light on this issue table 5 gives an overview of the total consolidation effort in each year for the entire 2003-2007 period, distinguishing measures on the expenditure and the revenue side. Total consolidation measures in the period 2003-2007 add up to 3% of GPD by 2007. The table also distinguishes the size of total net ex ante measures and their (ex post) effect on the actual budget balance, after taking into account second-round effects.[4]

[4] The table does not take into account the impact of the delay or modification of some measures in the aftermath of the wage agreement reached among social partners, which was settled after submission of the update. The CPB estimates that there is no impact on the cyclically adjusted balance. The actual deficit, however, would be somewhat higher, by 0.1 percentage point of GDP in 2004, 0.2 percentage point of GDP in 2005, and 0.1 percentage point of GDP in 2006 and 2007. This is because wage moderation will initially lead to lower tax revenues, while the tax increases due to higher profits and employment would take some time to materialise.

Table 5 – Composition impact of fiscal consolidation 2003-2007					
In % of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
Net expenditure reductions (ex ante)	0.6	1.0	0.5	0.3	0.3
Net increase in taxation (ex ante)	0.7	0.3	0.4	-0.3	0.1
Total ex ante improvement of balance	1.3	1.3	1.0	0.1	0.4
Second round effects	-0.6	-0.5	-0.3	-0.1	-0.2
Actual improvement in the balance (ex post)	0.7	0.8	0.7	0.0	0.2
Source: Commission services calculations based on the 2003 SP update and the 2004 budget Figures may not add up due to rounding					

3.3 Implementation of the previous update

In view of weaker than expected real GDP growth, the estimates for the general government balance were revised downwards vis-à-vis the projections in the revised 2002 update (see table 6). The programme does not provide details, but crude estimates suggest that the lower revenues due to weaker-than-expected economic activity account for around two thirds of the deterioration in the budget balance in 2003 and 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), as well as somewhat higher than expected expenditure (notably in health care, but probably not implying an overrun of expenditure ceilings) account for most of the remaining difference.

Table 6 – Deficit projections: divergence from the revised 2002 update					
In % of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance					
Revised 2002 update	- 1.6	- 1.7	- 1.2	-0.8	-0.5
2003 update	-2.3	-2.3	-1.6	-0.9	-0.6
Difference Revised 2002 update	-0.7	-0.6	-0.4	-0.3	-0.1

3.4 Adjustment in 2004

The update estimates a deficit of 2.3% of GDP in 2004, the same as in 2003. Hence, the deficit is not expected to improve, but without the savings measures in the highly restrictive budget the balance would have deteriorated. This pattern largely reflects the impact of the profound economic slowdown on revenue and thus on the nominal general government balance. However, other factors play a role as well, including autonomous expenditure increases in certain areas, such as health care (even though this is not expected to lead to an overrun of pre-determined ceilings that were calculated under the assumption of stronger economic activity), that are largely independent of the cycle and increases in tax-exempt pension premiums and tax-deductible payments of mortgage interest. The cyclically adjusted balance is projected to improve from a deficit of 1.3% of

GDP in 2003, to a deficit of 0.7% of GDP in 2004. This estimated change reflects the tight 2004 budget. Of course, a substantial package of savings measures was already incorporated in the 2003 budget, leading to an estimated improvement in the cyclically adjusted balance by 0.5 percentage point in that year according to the update. Because of the largely structural nature of measures taken, efforts to improve the balance in 2003 have an impact also in subsequent years. The estimated adjustment in 2004 is in line with an improvement in the cyclically adjusted balance by at least 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, according to more recent data and projections, the actual deficit in 2003 and 2004 will be higher than the 2.3% given in the update, in the wake of weaker economic activity (compare section 3). According to the Commission Autumn forecast, the deficit would increase to 2.6% of GDP in 2003, rising to 2.7% of GDP in 2004. The autumn note on budgetary implementation, released on 1 December 2003 by the Ministry of Finance, also quotes an expected deficit of 2.7% of GDP for 2003, mainly due to shortfalls in corporate tax revenues. The note gives no estimate for 2004 but it is likely that a large part of the setbacks would have an effect also in that year. In addition, the modification or delay of some consolidation measures in response to the Autumn 2003 wage agreement leads to an estimated deterioration in the actual nominal budget balance of 0.1% of GDP in 2004.[5] CPB forecasts released in early December painted a gloomier picture still, with the deficit rising to 3% of GDP in 2003 and to 3¼% of GDP figure in 2004.[6] It should be noted that the Ministry of Finance recently published a preliminary estimates of the 2003 deficit of 2.7% of GDP. This estimate, which is in line with the autumn note, incorporates preliminary data on government revenue and expenditure for the full calendar year.[7]

The implications of a higher-than-expected actual deficit for the cyclically adjusted deficit are not clear-cut. To the extent that the deterioration in the actual deficit is caused by weaker economic growth, the deterioration concerns only the cyclical component. Hence, there should be no impact on the cyclically adjusted balance. According to the Commission Autumn forecast the estimated improvement in the cyclically adjusted deficit, from 1.3% of GDP in 2003 to 0.7% of GDP in 2004, would indeed remain broadly the same.

The projected 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 tighten the fiscal stance appreciably in order to limit the increase in the nominal deficit and achieve an improvement in the underlying budgetary position.

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5 As regards the latest CPB estimates, which relate to rounded figures, no details are available on how they were derived. However, it seems that the differences with the budgetary implementation note released at around the same time by the Ministry of Finance mainly relate to tax receipts, notably corporate taxes. Cf. note from the Minister of Finance to Parliament on “Budgettaire effecten van het Najaarsakkoord” d.d. 14 October 2003.

6 One should bear in mind that the CPB does not release ‘official forecasts’ as it is an independent institution. That said, in practice CPB figures form a key input in the budget.

7 Ministry of Finance, press release d.d. 14 January 2004.

3.5 Adjustment in 2005 and beyond

The projections on trends in public finance from 2005 to 2007 are taken from the 2004 budget. Details of the impact of the measures for these years were already given in tables 3 and 4 in section 3.1. In 2005, the extent of consolidation is still substantial, while in terms of composition it relies roughly equally on measures to reduce expenditure and measures to increase net taxes. The consolidation effort in the years 2006 and 2007 is somewhat smaller than in previous years. In view of the quite substantial overall consolidation effort, the update assumes the nominal general government balance to improve substantially in 2005 and 2006. With some further improvement in 2007, a small nominal deficit of 0.6 percentage point of GDP is expected to still remain in 2007.

By contrast, according to the update a position close to balance in cyclically adjusted terms would be reached already in 2005 and would be maintained in the two following years. 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 (see also table 4).

Overall, the fiscal stance in 2005-2007 remains restrictive with the aim to achieve and maintain a cyclically adjusted fiscal position close to balance. However, as is the case with respect to the projections for the year 2004, more recent budgetary projections than entailed in the 2003 update suggest that a worse outcome for public finances in 2005 is likely under the assumption of no policy changes. In particular, the Commission Autumn forecast expects the nominal deficit to decrease only slightly in 2005, by 0.3 percentage point of GDP to 2.4% of GDP. This deterioration would be to a large extent due to weaker economic activity and its effect on social security expenditure and tax revenues. That said the implications of a higher nominal deficit in 2005 (and possibly beyond) for the cyclically adjusted deficit are not clear-cut. For instance, the Commission Autumn forecast projects a slight improvement in the cyclically adjusted deficit, from 0.7% of GDP in 2004 to 0.6% of GDP in 2005. This is nearly the same figure as quoted in the update (compare table 4) on the basis of more optimistic but outdated estimates.

Finally, some downside risks are attached to the implementation of announced measures in key areas, such as health care, where expenditure control in the recent past has proven to be difficult. All in all, to the extent that downside risks would materialise, further measures might be needed in 2005 and beyond to achieve and maintain a budgetary position close to balance.

3.6 Sensitivity analysis

Calculations presented in the programme aim at evaluating the budgetary impact of a number of alternative scenarios. These are mainly related to external developments, notably concerning the time profile of the recovery of the world economy, interest rates and the euro-dollar exchange rate. Overall, the estimated impact on the budget balance in any of these scenarios is relatively small. The largest estimated impact concerns a delayed recovery of world trade, resulting in real GDP growth lower by ¼ percentage point in 2003. This would lead to a higher deficit of 0.2 percentage point by 2005. With respect to domestic developments, the sensitivity analysis highlights the effects of wage moderation, which is particularly relevant as social partners reached an agreement to moderate wage increases shortly after the update had been submitted. The wage moderation scenario presented gives an order of magnitude that is quite close to the estimated impact of the wage agreement on total compensation per employee according to the Commission Autumn forecast.[8] The estimated budgetary impact of this variant is quite small, a slight deterioration in the deficit by 0.1% of GDP in 2004 and a neutral effect in 2005.

3.7 Debt path

The programme foresees an increase in the debt to GDP ratio to 54.0% in 2003 (from 52.4% of GDP in the previous year). This is followed by an increase to 54.5% of GDP in 2004. Thereafter, the update expects the debt ratio to fall slightly again, to 52.2% of GDP in 2007 (table 7). Towards the end of the projection horizon an improvement in the primary balance and a fall in the interest charge ratio would be partly 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[9]. For the 2003-2005, the Commission Autumn forecast envisages a more pessimistic development, with the debt ratio rising to 55.5% of GDP in 2004 and 2005. According to the Commission Autumn forecast, weaker economic growth and revenue shortfalls vis-à-vis the baseline scenario in the update would have a negative impact on the deficit and thus on the debt.

Table 7 – Decomposition of changes in the government debt ratio

In % of GDP	2001	2002	2003	2004	2005	2006	2007
Change in government debt ratio	**-3.0**	**-0.5**	**1.6**	**0.5**	**-0.8**	**-0.7**	**-0.8**
Primary balance	-3.4	-1.7	-0.6	-0.6	-1.2	-1.8	-2.1
Interest payments	3.4	3.3	2.9	2.9	2.8	2.7	2.7
Nominal GDP growth	-0.6	-0.1	0.0	-0.5	-1.3	-1.3	-1.3
Stock flow adjustment		0.2	0.8	-0.4	-0.3	0.5	0.7
Level of government debt	**52.9**	**52.4**	**54.0**	**54.5**	**53.7**	**53.0**	**52.2**

Source: Commission services calculations based on 2003 SP 2003 update

With respect to the debt, estimates have been revised upwards compared to the previous update (table 8). The current update estimates that the debt ratio will increase in 2004, and modestly decline thereafter, compared to the stronger 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.

[8] In the Autumn forecast the estimated effect of the agreement on compensation was incorporated.

[9] Information provided by the Ministry of Finance.

Table 8 – Debt projections: divergence from the revised 2002 update					
In % of GDP	**2003**	**2004**	**2005**	**2006**	**2007**
General government debt (% of GDP)					
Revised 2002 update	52.5	52.2	52.5	52.6	52.6
2003 update	54.0	54.5	53.7	53.0	52.2
Difference Revised 2002 update	1.5	2.3	1.2	0.4	-0.4

4. THE QUALITY OF PUBLIC FINANCES

The update gives information on the size and content of the various consolidation packages adopted since the summer of 2002, but does not discuss in detail the effect on economic growth and on productivity in the medium and longer run. While clearly consolidation is at the heart of current budgetary policies, some of the measures taken also aim to improve the structure of the economy. For instance, as far as social security and pensions are concerned, the government proposes to boost labour force participation, inter alia through measures to reduce the number of people claiming disability benefits, to tighten eligibility for unemployment benefits and to reduce tax incentives for early retirement. Some of these measures were endorsed by Parliament as part of the 2004 budget, while others are still pending in the aftermath of the agreement reached among social partners to freeze contractual wage increases in 2004 and 2005. This concerns in particular the delay in important measures to reform the Disability Insurance Act (WAO) and to end fiscal facilitation of early retirement and pre-pension schemes. The question is to what extent measures that were considered beneficial should have been delayed or modified in exchange for across the board wage moderation. First, it seems that moderation of wages was for a large part taking shape already in response to market forces. Furthermore, while it is clear that the central wage agreement will have a beneficial impact on labour costs and external competitiveness in the near term, the longer term beneficial effects of general wage moderation are less clear-cut. In the Dutch case, it seems that more wage differentiation across sectors is called for in the longer term, to promote innovation, competition, and an efficient distribution of production factors.

In some cases the proclaimed intention to reinforce the growth potential of the economy 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. In addition, the emphasis on the importance of education and life-long learning stressed in the context of the Lisbon Strategy is not reflected in planned expenditure on education. The update claims (page 13) that "the Cabinet has created scope for extra spending on policy priorities such as knowledge and education…". However, according to the 2004 budget total nominal spending on education remains the same between 2004 and 2007. Total education expenditure as a percentage of GDP even is set to decrease, from 5.6% of GDP in 2003 to 5.0% of GDP in 2007. Furthermore, in some cases measures to increase the activating nature of social security may have undesired side effects to the extent that they would discourage career breaks for education and the care of young children (which are deemed beneficial to human capital formation). Finally, it is at present unclear how much additional resources will actually be made available to support the work of the newly set up Innovation Platform, or how individual members of the Platform can be held accountable in a meaningful way.

In line with the recommendation in the 2003-05 Broad Economic Policy Guidelines, the government has decided to maintain the key elements of the budgetary strategy already used by previous governments. Key points of the current 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. 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. Expenditure windfalls can no longer be automatically used for additional spending and this should strengthen the working of automatic stabilisers somewhat. Finally, automatic stabilisers on the revenue side of the budget should be allowed to work freely as much as possible. Extra revenues have to be fully used to improve the government balance. Revenue shortfalls should result in a mirror-image deterioration of the general 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 consolidation measures.

5. THE SUSTAINABILITY OF PUBLIC FINANCES

5.1 Quantitative indicators

The assessment of the sustainability of Dutch public finances is based on both quantitative and qualitative indicators. The quantitative indicators are run on the basis of a commonly agreed methodology by the Economic Policy Committee[10]. The purpose of the indicators is to signal possible unbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results of these quantitative indicators need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcome and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of "no policy change". The quantitative indicators projects debt and budget balance development according to two different scenarios, to take into account uncertainties over the medium term. The "programme" scenario is calculated on the following basis:

- The projections for age-related expenditures come from the source indicated in the stability programme update, complemented with the Economic Policy Committee harmonised projections;

[10] See the Report "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003), available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

- The projections for government revenues come from the source indicated in the update. They are kept constant at the (cyclically adjusted) level in 2007, except for the projected increase due to pension income;
- The starting point for gross debt and the primary surplus are the 2007 levels reported in the update.

A "2003 position" scenario is based on the budgetary data for 2003 in the update. Debt levels are extrapolated from 2007 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2007 remains the same as the 2003 level and no stock-flows operations take place.

The table below presents the debt and the budget balance development according to the two different scenarios. Projections are based on national projections on pensions, health care and other social security expenditures while education and unemployment benefits projections rely on the EPC common exercise. Overall, age-related expenditure are foreseen to increase by 6.5% of GDP between 2008 and 2050. Revenues increase slightly (+2.9% of GDP) to take into account only the future increase of direct taxation on pensions.

Long term sustainability: summary results

The Netherlands

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	24.3	24.9	27.3	29.1	31.2	30.8	6.5
Pensions	5.2	5.4	6.8	7.9	9.0	8.7	3.4
Health care	7.5	7.7	8.6	9.6	10.6	10.5	2.9
Education'	5.0	5.0	4.9	4.8	4.9	4.9	-0.1
Unemployment benefits'	1.4	1.5	1.5	1.4	1.4	1.4	0.1
Others	5.2	5.3	5.5	5.4	5.3	5.4	0.2
*Total primary non age-related spending**	18.4						
Total revenues	44.7	44.8	45.6	46.6	47.6	47.6	2.9

' based on the EPC projections

* constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	50.8	49.1	51.4	67.6	99.5	140.0	89.2
Net borrowing	-0.8	-1.2	-2.8	-4.5	-7.3	-9.1	-8.3
2003 scenario							
Debt	54.2	53.8	63.5	88.7	132.0	185.9	131.6
Net borrowing	-1.5	-2.0	-4.0	-6.1	-9.6	-12.1	-10.6

Sustainability gap	S1*	S2**
Programme scenario	2.0	2.2
2003 situation scenario	2.6	2.7

* S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. P.m. debt to GDP ratio at the end of the period: 10.9%

** S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

It is possible to verify whether the projected level of debt respects the requirement to stay below 60% of GDP reference value for public debt at all times. Failure to do so would *a priori* indicate that there may be a risk of budgetary imbalances emerging in light of ageing populations and that measures may be required to place public finances on a more sustainable footing.

According to the quantitative indicators, there is the possibility of budgetary imbalances emerging that are not in compliance with the Treaty requirement. The debt to GDP ratio is expected to increase above 60% once the full impact of ageing takes place, i.e. after 2030. There are differences in methodology with the CPB's calculations presented in the update. In the latter, a small deficit in the near term would be due to the delayed effect of growth enhancing measures feed through and the return of pension contributions to lower levels, having been set temporarily higher to replenish buffers. This would preserve sustainability in the CPB set-up. The risk of imbalances increases if the projections in the update would fail to materialise. In the Commission projections, the deficit at the beginning of the projection period (2008) in the "2003 scenario" will then be higher (-1.6% of GDP instead of -0.8% of GDP), speeding up the deterioration of debt in the long term.

According to the Commission projections, a sustainability gap therefore arises. In order to equalise the present value of debt and future expenditures with revenues up to 2050, an effort of slightly more than 2% of GDP will be required in a no policy change scenario under the baseline (see indicator S2). This effort will increase slightly if the consolidation process does not materialize in the next years. Therefore, all efforts to bring debt down in the next years should be pursued.

5.2 Additional qualitative features

As underlined in the EPC report on "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme"[11] (October 2003), several qualitative factors should be taken on board to avoid a mechanistic interpretation of the quantitative indicators. On the positive side, the Dutch debt development in the programme period is not seriously affected by stock-flow operations so that they are not a source of concern for future trends of the debt to GDP ratio. Also, some reforms are envisaged to raise labour participation among older workers: the government has the intention to seize the fiscal support to early retirement schemes from the beginning of 2005 in order to discourage early retirement.

However the assumption that current policies are sustainable over the long run relies upon the deduction from the actual budget in 2007 of the cost of the pension reform that may temporally increase the actual deficit. Moreover, it is expected that savings measures already decided will have a positive impact on the deficit in the medium to long run, after second round effects have petered out. It is important to note that the increase in contribution rates is intended to replenish depleted buffers of private pension funds and is therefore of a temporary nature. Nevertheless, since these transitional additional costs are protracted beyond the programme period, some elements of risk arise on whether they will really disappear.

5.3 Overall assessment of sustainability

On the basis of the current policies, the risk of budgetary imbalances emerging in the future cannot be ruled out once the full impact of ageing takes place. This conclusion is in

[11] Available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

contrast with those made on basis of stability programmes submitted in earlier years, where it was concluded that the Netherlands was in a good position to meet the costs of ageing populations thanks to a well structured pension system and a policy of reducing debt at a fast pace by running balanced budget positions or even small surpluses.

Concern about the risk of budgetary imbalances arising beyond the programme horizon is due to the cyclically-adjusted budget position. It deteriorated markedly in recent years even though it is expected to return to close to balance at the end of the programme period, in response to substantial corrective measures. Nevertheless, securing sustainability may involve additional measures to maintain a medium-term budget position close to balance.

Foreseen reforms in the health care sector to improve the efficiency, and reforms to reduce fiscal support to early retirement need to be adopted and implemented. In addition, the costs of ageing, which would peak beyond the time horizon covered by the update, would imply reducing debt at a sufficient pace in the period prior to the budgetary effects of ageing taking hold.