Stability Programme
The Netherlands, 2001-2006

December 2002 Update

December 9, 2002

1. Introduction

Following elections in May, the new Cabinet was installed in July 2002. The coalition parties laid down their policy lines in a coalition agreement known as the ‘Strategic Accord’. The Strategic Accord contains the fiscal policy for the 2003-2006 Cabinet term of office. The present Cabinet prepared the Budget for 2003 and drew up the 2003 Budget Memorandum. However, the Cabinet fell on 16 October 2002, before the Budget could be dealt with in the Lower House of Parliament. New elections will be held on 22 January 2003.

The Lower House has since discussed the 2003 Budget. The outcome of the Budget discussions was that the policy for 2003 is broadly in line with Cabinet policy as formulated in the Strategic Accord (including a supplementary package drawn up shortly afterwards).

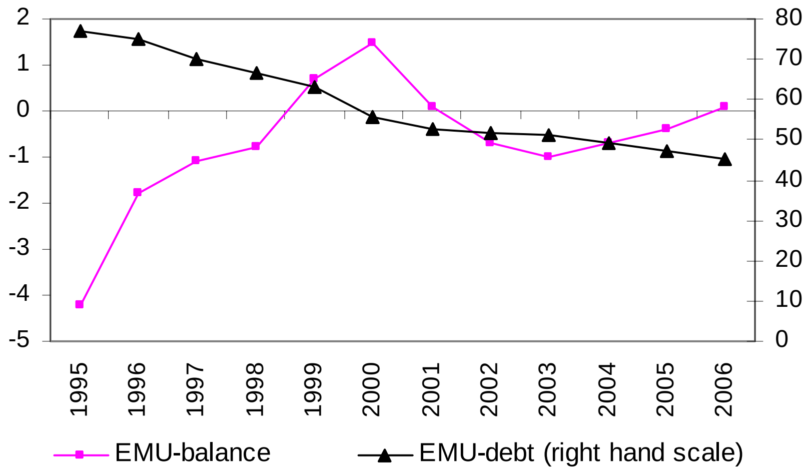
The fall of the Cabinet and the significant worsening of the economic climate over the past half year have influenced the picture presented in this programme. Nonetheless, the Programme gives insightful information regarding the economic situation in the Netherlands and the development of public finances. For the year 2003, the Programme reflects the 2003 Budget. For the medium term, the Programme is based on the policies proposed by this Cabinet, although of course the next Cabinet will have the final say in these. Moreover, up to 2003, the latest economic insights have been incorporated into the scenario and the existing fiscal rules are assumed to apply. This Stability Programme has been approved by the Council of Ministers and sent simultaneously to Parliament and the European Commission.

Since the previous update of the Stability Programme, economic growth has slowed considerably. Growth in 2001 amounted to 1.3%, 0.7 percentage point lower than had been expected last year. Economic growth of ¼% is expected for 2002, 1¾ percentage points below last year’s forecast. The disappointing economic performance not only reflects the international slowdown in economic growth, but also a deterioration in competitiveness due to rapidly increasing labour costs. In line with international economic recovery, the economy will pick up slightly in 2003: growth is forecast at ¾% of GDP, 1½ percentage points lower than had been expected last year. Projected growth for the 2004-2006 period amounts to 2¾% annually. This growth assumption is derived from the 2003 Budget Memorandum and is higher than the cautious economic growth scenario that was used for the Strategic Accord, owing to a deterioration in the cyclical starting position. The less favourable starting position probably implies higher growth rates in the years to come, at least, if it is assumed that the cyclical imbalances in the economy will gradually even out. Calculated for the entire 2003-2006 period, economic growth comes to 2¼% annually. The government is currently analysing to what extent the potential economic growth rate, on which the actual growth rate for 2004-2006 is based, needs to be revised in light of recent economic developments. Expectations are that potential growth has been slightly overestimated.

The labour market too has since felt the effects of the weaker economic situation. Employment, expressed in persons, will drop by ½% next year while standardised unemployment is expected to increase from 2.4% in 2001 to 4¼% in 2003. Unemployment will not fall in 2004 and may actually rise further, since the economic downturn affects the labour market with a delay.

Having reached a peak of 5.1% in 2001, inflation (measured by the harmonised index of consumer prices, HICP) will start to decline from this year onward. First, the 2001 tax reforms will no longer affect inflation in 2002. In addition, the depreciation of the dollar has a favourable impact on inflation. For 2003, inflation is expected to come out at 2½% (HICP: 2¾%). Price developments are affected favourably by a slowdown in labour cost growth. Owing mostly to a further deceleration in labour costs growth, inflation is expected to be even lower in the years following 2003. Fiscal policy also helps to bring inflation down. Particularly relevant in this respect is the policy that is geared towards generating an increase in labour supply combined with a reduction in labour demand from the government. The policy is hence in line with the recommendation to the Netherlands in respect of inflation contained in the Broad Economic Policy Guidelines.

Chart 1.1. EMU balance and EMU debt (in % of GDP), 1995-2006



The disappointing economic performance has also affected the fiscal position. Whereas the previous Stability Programme assumed an annual average surplus of more than 1% of GDP for 2001-2003, the government is now faced with deficits. A small surplus of 0.1% of GDP remained in 2001, but deficits of 0.7% and 1.0% of GDP are expected for 2002 and 2003 respectively. This forces the conclusion that the Netherlands has not been wholly successful in meeting the recommendation of the Broad Economic Policy Guidelines (that the government balance should not deteriorate in 2003); a small deterioration of 0.3% of GDP emerges in comparison to what is, moreover, a far lower level in 2002. The economic climate during which this recommendation was made was obviously much more favourable than the current situation. Moreover, with a package of deficit-improving measures balancing out at no less than 1% of GDP in one year, the Cabinet has done all it could.

Regarding the fiscal rules, this Cabinet has maintained the system of real expenditure ceilings. This is completely in line with the recommendation in the Broad Economic Policy Guidelines. It was agreed that the automatic stabilisers on the revenue side will be allowed to operate as freely as possible, provided that the EMU balance remains within the range of between 0 and 2½% of GDP. If the balance fell below 0, as is now the case, the government will review the situation. In drawing up the Budget for 2003, this has resulted in a substantial package of deficit-reducing measures aimed both at preventing further deterioration of the fiscal position in 2003 and at preserving the long-term objective of repaying the government debt within one generation. Repaying the debt is necessary in order to cover the future costs of the ageing population. Without any such measures, deficits would prevail throughout virtually the entire Cabinet term.

The costs of demographic ageing can obviously be covered in several ways; by broadening the tax and premium base—through encouraging labour participation; by raising taxes and contributions; by cutting back on benefits; or by curtailing interest expenditure. The Netherlands wants to absorb the costs primarily by increasing labour participation as well as labour productivity, and by freeing up interest expenditure through elimination of the government debt within one generation.

The Netherlands is very concerned to safeguard the long-term sustainability of public finances and is hence in favour of monitoring the long-term position via the Stability and Convergence Programmes. The Cabinet, given the importance it attaches to the long-term sustainability of public finances, chose to take measures which would limit the deterioration of the EMU deficit in 2003, and which would enable the Netherlands to return to a situation of surpluses within the foreseeable future. In such a situation, the automatic stabilisers can take full effect.

Regarding the composition and quality of public finances, it can be observed that the tax burden declined notably in 2001 and 2002, largely because of the tax packages for 2001and 2002. In line with the recommendations in the Broad Economic Policy Guidelines, furthermore, the tax cuts were mainly aimed at increasing the effective labour supply. The Strategic Accord of the present Cabinet also contained measures to boost the labour supply. These policy measures are part of a package that seeks to reinforce the growth potential of the economy by increasing labour supply as well as labour productivity. Higher productivity should be achieved mainly through an improvement of the infrastructure.

2. The Dutch Economy

2.1. Review of the years 2001 and 2002

Economic growth

In the 1990s, the Dutch economy grew at an average 2.9% annually and economic growth outpaced the European average. In 2001, however, economic growth in the Netherlands slowed to 1.3%, bringing it under the European average (1.5%). This slowdown in growth not only reflected the international economic slowdown, but was exacerbated by a deterioration in competitiveness. This deterioration, which had already emerged in previous years, led the export sector to lose some of its market share. Owing to the sharp fall in equity prices and the slower pace of house price increases, favourable wealth effects no longer fuelled growth in consumer spending in 2001. Finally, investments came under pressure due to slower output growth and the drop in earnings resulting from the steep rise in labour costs. Economic growth of just ¼% is expected for 2002. That can be blamed on the further deterioration of competitiveness in the export sector and on the fact that investment is still dropping because of the erosion of profitability. Economic growth over these two years is hence cumulatively 2½ percentage points lower than was estimated in the previous update of the Stability Programme.

Employment

Thanks to the good economic performance in the 1990s, employment grew rapidly and unemployment declined. According to the national definition, unemployment in 2001 was only 3.3%. The corresponding standardised unemployment rate was 2.4%, 0.9 percentage point under the 2002 equilibrium rate of unemployment as estimated by the Commission. Despite the low unemployment rate, the number of inactive persons remains large, notably those claiming sickness and disability benefits. Approximately 1 million people currently claim disability benefits, representing almost 9% of the working age population—a very high number, from both a national and an international perspective. In addition, with some lag, the slower economic growth has not left the labour market unscathed. Employment in persons rose this year by only ¾% (against 2% in 2001), and the increase in employment in working years was only ½%. Unemployment in 2002 will amount to 3¾% (or 3% on a standardised basis).

Inflation

Dutch inflation, measured by the consumer price index, rose to a peak of 4.5% in 2001 (or 5.1% according to the HICP). The development in unit labour costs largely contributed to the acceleration in inflation. In addition, around 1 percentage point of inflation in 2001 resulted from the increase in indirect taxation arising from the 2001 tax reforms. In 2002 inflation is expected to drop to 3½% (HICP: 4%). The recent depreciation of the U.S. dollar has a favourable effect on inflation. Additionally, the 2001 tax reforms have no bearing anymore on the inflation figures this year. However, the strong increase in unit labour costs remains an important factor for inflation, an effect exacerbated by the fact that the cyclical downturn was coupled with a steep fall in labour productivity growth. Last year productivity even declined. The difference in the development of inflation in the Netherlands compared to the rest of Europe is largely due to differences in the development of labour costs.

Table 2.1. Key figures

		2001	2002	2003	2004	2005	2006
Short-term interest rate (in %)		4.3	3½	3¾	4	4	4
Long-term interest rate (in %)		5	4.9	4.6	5	5	5
Dollar exchange rate against the euro		0.90	0.94	1.00	1.00	1.00	1.00
Price of crude oil in U.S. $		24.60	24.90	24.40	23.00	23.00	23.00
	Changes in %						
Global GDP		2.4	2¾	3½	3¾	3¾	3¾
GDP of EU-15		1.6	1	2	2½	2½	2½
Volume of relevant world trade		1.7	2½	6	6½	6½	6½
Volume of world imports		-0.2	3¼	7½	8¾	8¾	8¾

Table 2.2. Economic growth and associated factors, 2001-2006

		2001	**2002**	**2003**	**2004**	**2005**	**2006**
	Changes in %						
Gross domestic product, volume		1.3	¼	¾	2¾	2¾	2¾
Gross domestic product, level in EUR		429.2	446.0	463.8	487.3	509.5	531.3
GDP deflator		5.3	3¾	3¼	2¼	1¾	1½
CPI		4.5	3½	2½	1½	1	1¼
HICP [1]		5.1	4	2¾	1½	1	1¼
Compensation per employee, market sector		5.1	5¼	4¼	3¼	2¾	3
Negotiated wage rates, market sector		4.5	3¾	2¾	3	2½	2½
Labour productivity (market sector)		-0.6	-½	2	2¼	2¼	2¼
Unit labour costs, manufacturing industry		4.9	5	1	--	--	--
Employment growth (in persons)[2]		2	¾	-½	1	1¼	1¼
Unemployment (in % of working population)		3.3	3¾	5	5	5	5
Standardised unemployment		2.4	3	4¼	--	--	--
Expenditure and output							
Private consumption		1.2	1	1	3½	3	2½
Public sector consumption		3.1	3¼	0	1¼	1¼	1¾
Gross investment		-0.8	-4	1¼	1½	2½	2½
Inventories		0	-¼	0	¼	¼	¼
Exports of goods and services		1.7	-2½	3½	5¾	6	5¾
Imports of goods and services		1.9	-2¼	3¾	5 ¾	5½	5¼
Share in GDP growth	**Contribution in percentage points**						
Domestic demand		1	½	¾	2¼	2¼	2
Net exports of goods and services		0.3	-¼	0	½	½	¾

[1] The change in the HICP in 2004-2006 is assumed to be equal to that in the CPI.
[2] For 2004-2006 it is assumed that employment growth including jobs of less than 12 hours a week, is equal to employment growth excluding such jobs.

2.2. Forecasts for 2003-2006

Relevant policies

Despite the fall of the Cabinet, the entire 2003 Budget was discussed in the Lower House and most policy measures, of the total package balancing out at 1% of GDP, were approved. For the medium term, the policy proposals from the Strategic Accord formed the terms of reference in a technical sense. The incoming Cabinet will obviously have to take concrete decisions on the policy proposals for the 2004-2006 period.

Although the labour market is not as tight now as it was a few years ago, the slowdown of growth in labour supply means that policymakers need to take rather tight labour market conditions into consideration for the medium to long term. The policy proposals of this outgoing Cabinet were hence aimed at stimulating the (effective) labour supply. These policies would support the objective of tempering labour costs while stimulating structural economic growth. In order to expand the labour supply, the Strategic Accord proposes a reform of the Occupational Disability Insurance Act (WAO) so as to reduce the number claiming disability benefits, now amounting to almost 1 million people (or close to 9% of the working age population). To reduce the number of people on disability, the new Occupational Disability Insurance Act should be made accessible only to those who are fully incapacitated for work. In addition, the criteria for occupational disability need to be tightened. In the case of partial occupational disability, both employees and employers will be stimulated to make every effort to bring employees back to the labour process, either in their former position or in another capacity. The labour supply will also be stimulated by tackling the poverty trap. An earned income tax credit was introduced in 2001 as one of the measures to ease the burden of taxes and premiums. To further stimulate the effective labour supply, this earned income tax credit will be gradually increased. Also relevant are the efforts aimed at increasing labour participation among older workers by replacing early retirement benefits by actuarially neutral schemes. In addition, employees older than 58 qualify for a supplementary earned income tax credit.

Economic growth

Expectations are that the economic recovery will be slow to get under way. Economic growth will pick up to ¾% next year, but that is still around 1¾ percentage points below the European Commission's projection of potential growth for 2003. Moreover, at this figure, economic growth in 2002 is likely to trail the European average by over 1 percentage point. The slow rate of recovery in the Netherlands is partly related to the (further) deterioration in competitiveness which depresses growth in exports. Moreover, consumer confidence has declined sharply in the recent period, making for just a moderate increase in domestic consumption. Average economic growth of 2¾% is anticipated for the years 2004-2006. This growth assumption is derived from the 2003 Budget Memorandum and is higher than the cautious economic growth scenario that was used for the Strategic Accord, owing to a deterioration in the cyclical starting position. The less favourable starting position probably implies higher growth rates in the years to come, at least, if it is assumed that the cyclical imbalances will gradually even out. Calculated for the entire 2003-2006 period, economic growth comes to 2¼% annually. The projection for potential economic growth is currently being revised. The new projection is likely to be lower than the current one. The sensitivity analysis (section 4.2) therefore includes a variant that results in an annual growth rate for 2004-2006 that is ½ percentage point lower than in the baseline projection. Attention is also given to the impact this would have on the EMU balance.

Employment

As a lagged reaction to the slackening off of economic growth, employment in persons will fall by ½% in 2003. Calculated in working years, employment will fall even more sharply. Unemployment is expected to reach 5% next year (or 4¼% on a standardised basis). Higher unemployment will relax labour market conditions. The projection is that unemployment in 2006 will still be 5%, somewhat higher than the estimated equilibrium rate.

Inflation

Inflation (on the basis of the CPI) is projected at 2½% for 2003 (or 2¾% on the basis of the HICP). As in 2002, the rise in labour costs will be a large contributor to inflation. Inflation will be significantly lower in the years after 2003. Fiscal policy will have a favourable effect on inflation. This is due largely to the fact that measures that stimulate the effective labour supply and that reduce labour demand by the government sector will help bring about a controlled development of labour costs. The policy is hence in line with the recommendation in the Broad Economic Policy Guidelines to prevent fiscal policy from fuelling inflation.

2.3. Risks relating to the forecasts for 2003-2006

External risks

A number of external risks can be seen in respect of the current economic scenario. The current baseline projection assumes an oil price of US$24.40 per barrel for 2003 and US$23.00 for the following years. Oil prices are still subject to significant movements due to the political tensions in the Middle East. So there is always a risk that oil prices will be higher (or lower) than anticipated in the baseline projection. Another assumption underlying the economic scenario is that the volume of world trade relevant to the Netherlands will increase by 6% in 2003, while the average annual increase in the following years will be 6½%. There is a risk that the global economic recovery will be less quick than is now generally assumed. This will obviously have consequences for Dutch exports, as will be reflected in GDP growth, and will also have an impact on both inflation and the EMU balance. Turning to the situation in the financial markets, it should be noted that, from an historical perspective, rather low equity prices have been factored into the current scenario (in line with the current situation in the stock market). Nonetheless, the risk exists that equity prices will decline still a bit more, further damaging consumer confidence and the investment climate. The dollar exchange rate remains an uncertain factor too. If the dollar—despite the recent depreciation—remains overvalued and if it continues to depreciate against the euro, euro area competitiveness, in the short term, will be eroded and economic recovery delayed. Another possibility is that the dollar exchange rate will actually rise in the short term in response to positive expectations for economic growth in the United States.

Internal risks

Apart from risks that are mainly caused by factors outside the Netherlands, the current projections are also subject to internal risks. One such risk would be a more pronounced increase in labour costs than is projected owing to a failure to acknowledge that the situation in the labour market requires wage moderation. The increase in labour costs could also be more pronounced owing to higher pension premiums resulting from low equity prices. A sharper rise in labour costs than was hitherto projected will further undermine competitiveness and depress output growth and employment. Moreover, this would lead to higher inflation than is presently accounted for.

Differences to Commission's Autumn forecast

Comparison of Dutch economic scenario to the Commission's Autumn forecasts shows that the differences in the economic growth projections up to 2003 are small. Starting in 2004, the Commission's growth projection is ½ percentage point lower than the Dutch number. The unemployment rate for 2004 diverges slightly too. Looking at the consumer price index, the Commission projects a higher inflation than the Netherlands. The 2004 numbers were derived from the cautious economic growth scenario adjusted for the less favourable starting position.

Regarding the assumptions underlying the economic scenario, it emerges that, in general, the projections more or less correspond to those of the Commission. However, the oil prices as of 2003 assumed by the Netherlands are higher than those projected by the Commission. And the Commission projects a slightly lower dollar exchange rate against the euro than the Netherlands. Finally, the Dutch estimates for the world import volume are above those of the Commission.

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

	2002		**2003**		**2004**	
	NL	**Cie**	**NL**	**Cie**	**NL**	**Cie**
Gross domestic product (change in %, volume)	¼	0.2	¾	0.9	2¾	2.2
HICP (change in %) [1]	4	3.9	2¾	2.8	1½	2.4
Compensation per employee, market sector (change in %)	5	5.1	4½	4.2	--	3.9
Labour productivity (change in %)	-0.6	-0.1	2	1.5	2¼	2.0
Unit labour costs, manufacturing industry (change in %) [2]	5	--	1	--	--	--
Employment (in persons, change in %)	¾	0.3	-½	-0.5	1	0.2
Unemployment rate [3]	3	3.1	4¼	4.3	4¼	4.6
World import volume (change in %)	3¼	1.9	7½	6.2	8¾	7.1
Short-term interest rate	3½	3.3	3¾	--	4	--
Long-term interest rate	4.9	4.9	4.6	--	5	--
Euro exchange rate (dollars per euro)	0.94	0.94	1.00	0.98	1.00	0.98
Price of crude oil in U.S. $	24.90	25.5	24.40	24.10	23.00	22.50

[1] The change in the HICP in 2004-2006 is assumed to be equal to that in the CPI.

[2] The Commission publishes the unit labour costs for the whole economy. This cannot be compared to the unit labour costs for the manufacturing industry.

[3] Standardised unemployment for 2004 is estimated on the basis of unemployment as a percentage of the working population in that year (5%).

[4] The 2004 numbers are technically speaking no estimates but derived from the cautious economic growth scenario adjusted for the less favourable economic starting position.

Sensitivity analyses based on some of the risks outlined above and deviations from the Commission's projections are included in section 4. That section presents what possible deviations from the baseline scenario would mean for economic growth, inflation and the EMU balance. It shows, for instance, the impact that lower growth in the 2004-2006 period would have on the EMU balance and how a greater wage increase would push up inflation.

3. Developments in EMU balance and EMU debt

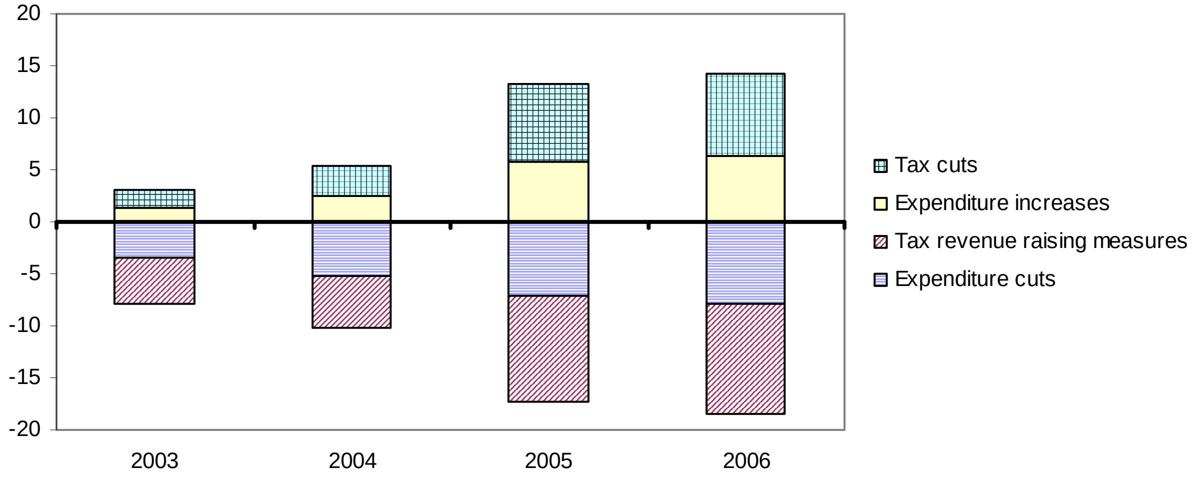
Fiscal rules

As described in section 2.2, the current Cabinet, which has since resigned, based its fiscal policy on an economic growth in 2003-2006 of 2¼ -2½% annually. It also kept to the system of expenditure ceilings which determine maximum real public expenditure. For the revenue side, the Cabinet had planned that as long as the EMU balance remained between 0% and +2½% of GDP, the automatic stabilisers could be allowed to operate. However, it was also agreed that if the balance were to exceed +1% of GDP, and if this could be attributed to revenue windfalls, 25% of these windfalls could be spent on tax cuts, up to a maximum of EUR 1 billion. Should the balance fall outside of the set range, the question of whether to let automatic stabilisers operate would be reviewed. Indeed, if the balance exceeded 2½% of GDP, structural growth might well be higher than initially projected, enabling a further evaluation of fiscal policy. If a deficit arose however, it would mean an increase in government debt (in euro) which would jeopardise the long-term objective of repaying government debt within one generation. Repaying government debt is essential because the rapidly ageing population will considerably push up spending on health care and old age pensions. In order to guarantee the long-term sustainability of public finances despite the mounting costs of ageing, without requiring future increases in taxation or unacceptable welfare cutbacks, the debt—according to an intergenerational calculation—must be fully repaid within this generation.

Policy package

At the start of the Cabinet period, an EMU deficit was forecast for both 2002 and 2003. Since this brought the budget balance under the warning level of 0%, the Cabinet - in line with the Strategic Accord and in view of the long-term sustainability of public finances - decided when drafting the 2003 Budget that the automatic stabilisers on the revenue side should not be allowed to take full effect, but that the deterioration of the EMU balance should be prevented by budgetary measures where possible.

Chart 3.1. Proceeds and application of measures to increase budget leeway 2003-2006 (EUR billion, cumulative).



Of the total package of reallocations and tax revenue raising measures contained in the Strategic Accord, and the supplementary package for the 2003-2006 period, around 1% of GDP is intended for the EMU balance. The remaining room will be used on the one hand for extra spending on health care, education and security and, on the other, for tax cuts. The package has been phased over time in such a way that the tax revenue raising measures will be offset by substantial tax cuts only after 2003. The tax cuts are related in large part to the implementation of the new health care system, but they are also aimed at raising the effective labour supply. As the policy measures in the Strategic Accord are aimed at a structural reinforcement of the economy, they will facilitate a further improvement of the EMU balance after 2006.

Most of the policy package for 2003 was accepted during the Budget discussions. The changes made during the Budget discussions have been incorporated into the overall picture as presented in the table below. The impact of the changes on the EMU balance is limited since it was agreed that the amendments would also be financed. A detailed breakdown of the package for 2003 is given in the Annex.

Table 3.1. Package of measures by the current Cabinet for 2003-2006 (EUR billion, in current prices, cumulative)

	2003	**2004**	**2005**	**2006**
Reallocations	-3.6	-5.5	-7.6	-8.6
Expenditure increases	1.2	2.5	5.9	6.8
Tax revenue increases (mainly through base broadening measures)	-4.3	-4.8	-10.1	-10.3
Tax cuts	1.8	2.7	7.3	7.7
Total	-4.9	-5.1	-4.4	-4.5

EMU balance

The serious slowdown in economic growth in 2001 and 2002 has considerably harmed the fiscal position. When the 2003 Budget Memorandum was drawn up—in September of this year—expectations were that the EMU balance in 2002 would amount to –0.5% of GDP and that, if no further policy steps were taken, it would fall to –1.2% of GDP in 2003. Thanks to Cabinet policy, stabilisation of the EMU balance at –0.5% in 2003 appeared possible. Since the economic growth projections for 2002 and 2003 are now even lower than those made a few months ago, the EMU deficit in 2002 is likely to amount to 0.7% of GDP and, despite a sound and restrictive fiscal policy, is likely to widen slightly to 1% of GDP in 2003. This is based on the assumption that, as of 2003, any expenditure setbacks will be compensated within the expenditure ceilings. An actual decision on this will not be made until the beginning of next year.

Table 3.2. Fiscal developments, 2001-2006

In % of GDP	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Budget Memorandum 2003 (September 2002)						
Public expenditure	46.8	47.1	46.8	45.9	45.7	45.2
Public receipts	46.9	46.6	46.3	45.7	45.8	45.8
EMU balance	0.1	-0.5	-0.5	-0.2	0.1	0.6
Expenditure setbacks	--	-0.0	[-0.1]	[-0.1]	[-0.1]	[-0.1]
Income setbacks	--	-0.2	-0.5	-0.5	-0.5	-0.5
Current EMU balance (before additional policies by the new Cabinet)	0.1	-0.7	-1.0	-0.7	-0.4	0.1

Table 3.2 is further based on the technical assumption that the revenue setback as of 2003, amounting to around 0.5% of GDP, will, for the time being, lead to a deterioration of the budget balance. A decision on precisely how the revenue setback will be dealt with will likewise be taken early next year as part of a wider evaluation by the new Cabinet. At that point, special attention will be paid to the deterioration of the projected EMU balance for 2006 from 0.6% of GDP in September to 0.1% of GDP currently. Specific attention for the deterioration of the balance is essential in view of the objective of repaying the debt in order to absorb the costs of ageing.

EMU debt

Table 3.3. EMU debt, 2001-2006

In % of GDP	**ESA code**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
EMU debt		52.8	51.9	51.2	49.0	47.4	45.3

The EMU debt in 2003 will amount to an estimated 51.2% of GDP, 1.6 percentage points below the 2001 level. The debt ratio is expected to decline further to 45.3% in 2006, some 18 percentage points less than at the start of EMU in 1999. A breakdown of the main factors leading to the change in the debt ratio is given in the Annex.

4. Comparison with previous update and sensitivity analyses

4.1. Comparison with 2001 Stability Programme Update

Compared to last year's update of the Stability Programme, economic growth is now much slower than was forecast at that time. Since growth in 2000 was also some 0.3 percentage point below what had been expected last year, the growth forecast up to 2004 is now cumulatively 3¾ percentage points lower.

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

	2001	2002	2003	2004
GDP growth				
Stability Programme 2001	2%	2%	2¼%	2¼%
Stability Programme 2002	1.3%	¼%	¾%	2¾%
Difference (in percentage points)	-0.7	-1¾	-1½	½
Difference, cumulative since 2000 (in percentage points)	-1	-2¾	-4¼	-3¾
EMU balance				
Stability Programme 2001	1.0%	1.0%	1.2%	1.3%
Stability Programme 2002 [1]	0.1%	-0.7%	-1.0%	-0.7%
Difference (in percentage points)	-0.9	-1.7	-2.2	-2.0
EMU debt				
Stability Programme 2001	51.8%	47.7%	45%	42%
Stability Programme 2002	52.8%	51.9%	51.2%	49.0%
Difference (in percentage points)	1	4.2	6.2	7

[1] A further decision on the setbacks as of 2003 is required early next year. The balance as of 2003 is based on the technical assumption that the revenue setback is included in the balance for the time being.

The serious slowdown in economic growth also largely explains the deterioration of the EMU balance. The remaining part can be attributed to the fact that the income elasticity of taxes and premiums up to 2001 is slightly less than was projected last year. In addition, expenditures that do not fall under the expenditure ceiling came out slightly higher last year than was previously estimated.

4.2. Sensitivity analysis

Section 2.3 discussed the risks surrounding the projections for the Dutch economy. The table below shows, in respect of a number of these risks, what the effect of a divergent development would be on economic growth, inflation and the EMU balance. In the central projection, for example, calculations have been made for 2003 with an oil price of US$24.40 per barrel and of US$23.00 for the following years. If the oil price in 2003 were to rise to an average of US$30 and returned to the baseline projection in 2004, GDP growth in 2003 would slow by 0.1 percentage point, while CPI inflation would be 0.2 percentage point higher. In 2006, growth would be cumulatively 0.1 percentage point lower and inflation actually 0.1 percentage point higher. The effects on the EMU balance are limited. The economic scenario is also based on an increase in the volume of world trade relevant to the Netherlands of 6% in 2003 and 6½% in the following years. If, for instance, annual growth in the relevant volume of world trade in the 2004-2006 period were 1½ percentage point lower, economic growth would be depressed by ½ percentage point annually (cumulative 1½ points in 2006). The EMU balance would eventually deteriorate by an extra 0.6% of GDP in 2006, while inflation would come out cumulatively 0.3 percentage points lower than the baseline projection owing to more relaxed labour market conditions and subsequently less pressure on wages. The dollar exchange rate against the euro remains uncertain too. If, say, the euro were to appreciate in 2003 by 5% against the dollar (and other currencies) and were to remain 5% above the baseline projection from then on, economic growth in 2003 would deteriorate by 0.4 percentage point. Growth in the following years would slightly increase, bringing the GDP volume back to the baseline projection in the long term. Inflation would be 0.3 percentage point lower in 2003, while annual price increases in the following years would be 0.5 percentage point lower. The effect on the EMU balance is negative and, by 2006, will amount to a deterioration of 0.2% of GDP. Regarding negotiated wages, the table shows that if a higher negotiated wage rise were agreed than is currently projected, this would eventually have a detrimental effect on economic growth, inflation and the EMU balance. If negotiated wages were, for example, to rise by 1 percentage point a year more than is factored into the central projection, employment growth would be depressed immediately. Economic growth and the EMU balance would initially improve because of the rise in private consumption. However, in time, the deterioration in competitiveness would slow down GDP growth and reduce the EMU balance. Inflation would be about ½ percentage point higher each year.

Table 4.2. Effects of 4 risk variants on economic growth, inflation and the EMU balance (cumulative deviations from the baseline projection, in %)

	2003	2004	2005	2006
I. Higher oil price ($30 in 2003 instead of $24,40, return to baseline projection in following years)				
GDP volume	-0.1	-0.1	-0.1	-0.1
CPI	0.2	0.4	0.1	0.1
EMU balance (in % of GDP)	0.0	0.0	0.0	0.0
II. Permanent lower growth in world trade as of 2004 (-1½%)				
GDP volume	0.0	-0.5	-1.0	-1.4
CPI	0.0	-0.0	-0.1	-0.3
EMU balance (in % of GDP)	0.0	-0.2	-0.4	-0.6
III. Appreciation of euro by 5% against all currencies, permanent				
GDP volume	-0.4	-0.5	-0.4	-0.4
CPI	-0.3	-0.8	-1.2	-1.7
EMU balance (in % of GDP)	-0.1	-0.1	-0.2	-0.2
IV. Permanent higher negotiated wage increase (+1% as of 2003)				
GDP volume	0.1	0.1	0.0	-0.3
CPI	0.3	0.8	1.4	1.9
EMU balance (in % of GDP)	0.0	-0.0	-0.2	-0.4

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

5. Quality and composition of public finances

Table 5.1 shows the development of public finances since 1995. What comes to the fore on the revenue side is that the tax burden has fallen considerably over the past two years from 41% in 2000 to a projected 39.6% of GDP in 2002. The tax packages in 2001 and 2002 contributed significantly to this reduction. Tax cuts in recent years were specifically geared to freeing up bottlenecks in the labour market. A case in point is the earned income tax credit introduced in 2001 (with a view to tackling the poverty trap) and the supplementary earned income tax credit for employees aged over 58 that was introduced in 2002.

Table 5.1. Development of public finances, 1995-2002 (in % of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002
Revenues	49.3	49.1	48.2	47.3	48.5	48.1	46.9	46.4
Tax burden	41.1	41.4	40.6	40.7	41.2	41.0	39.8	39.6
Taxes					25.2	25.0	25.7	25.7
Contributions					16.0	16.0	14.1	13.9
Interest income	1.2	0.9	0.7	0.7	0.7	0.7	0.7	0.7
Other	7.0	6.8	6.9	5.9	6.6	6.4	6.4	6.1
Expenditure	53.5	50.9	49.3	48.1	47.8	46.6	46.8	47.1
Consumption	17.1	16.8	16.4	16.3	16.6	16.2	16.5	16.9
Social security payments	22.8	21.8	21.1	20.1	19.6	19.0	19.0	19.4
Interest payments	5.9	5.5	5.1	4.7	4.6	4.0	3.5	3.4
Subsidies	1.1	1.2	1.5	1.4	1.5	1.4	1.4	1.4
Investment outlays	3.0	3.2	3.0	3.1	3.1	3.3	3.5	3.6
Capital transfers	0.9	0.6	0.4	0.6	0.7	0.7	0.8	0.5
Other	2.7	1.8	1.8	1.9	1.7	2.0	2.1	1.9
EMU balance	-4.2	-1.8	-1.1	-0.8	0.7	1.5	0.1	-0.7

As regards fiscal discipline on the expenditure side, notably the introduction and enforcement of the real expenditure ceilings have played an important role. Indeed, the realisation of the desired development in public spending as a percentage of GDP since 1995 can partly be attributed to this system. Owing to the policy measures to reduce government debt in more recent years, interest payments have also declined sharply. The level of public investment, on the other hand, was kept roughly constant expressed as a percentage of GDP.

Despite the strict expenditure limits, the Cabinet has been able to invest extra resources over the years in priority policy areas such as health care and education through reallocations and lower than expected expenditure elsewhere. The real increase in expenditure in the health care sector amounted to almost 5.8% annually in the period 2000-2002, while expenditure on education rose by an annual 3.1% in real terms. That is more than the real increase of both GDP (at an annual average of 1.6%) and total public spending (at an annual average of 1.2%). According to the policies set out in the Strategic Accord, the budget for the health care sector would increase in real terms by an annual average of 3¾% over the 2003-2006 period, while education and safety would on average each receive an extra 2¼% per year. In addition, specific attention would be paid to institutional reform of these and other policy areas in the public sector with the objective of raising the efficiency of government outlays in these sectors.

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

The key question in respect of long-term policies on debt is how to guarantee the long-term sustainability of public finances, despite the steep rise in public spending arising from ageing.

As in other Member States, the Dutch population will age rapidly in the coming decades. The number of people aged 65 and over will virtually double in the period up to 2040 from 2 million at present to more than 4 million. Based on benefits that are indexed to the economy's welfare level, the costs of state old age pensions and health care will increase by around 8% of GDP. Approximately half of this increase can be financed through higher tax revenues from the occupational pensions (as a rule, contributions to pension funds are not taxed but pension incomes are).

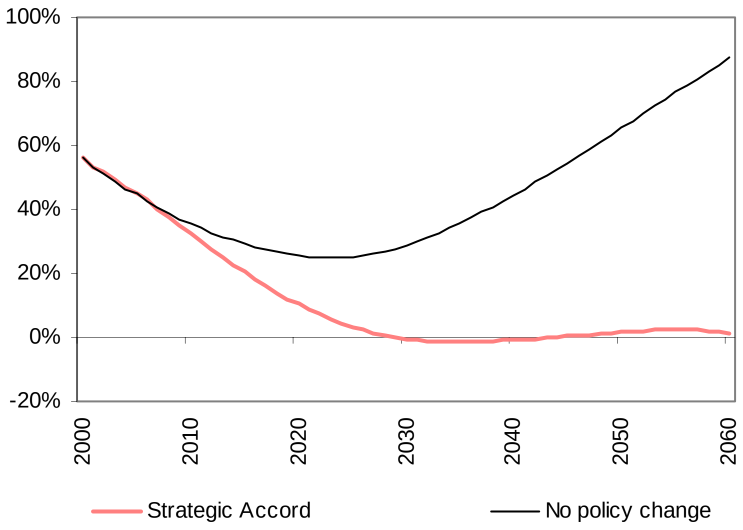
Table 6.1. Development of expenditure and revenues related to ageing, 2000-2040 (in % of GDP)

Expenditure	**8¾%**
State old age pensions	4¼%
Health care	3¾%
Occupational disability benefits	¾%
Revenues	**4¼%**
Tax revenue on pension payments	5%
Increase in participation rate of women	½%
Ageing of working age population	-½%
Loss of natural gas revenues	-¾%
Remaining borrowing requirement	4½%

Source: Ageing in the Netherlands, 2000, The Netherlands Bureau of Economic Policy Analysis (CPB)

To ensure the long-term sustainability of public finances, the remaining requirement needs to be financed as well. In theory, this could be realised by expanding the tax and premium base through an increase in the participation rate, by raising taxes, by cutting back on benefits, or by curbing interest rate spending. The present Strategic Accord was aimed at absorbing the remaining share of the costs primarily by increasing the participation rate and by freeing up interest payments through repayment of the government debt within this generation. The chart—derived from the 2003 Budget Memorandum—shows that implementation of the Accord would enable repayment of the government debt in about 25 years time. This contrasts sharply with the rising debt scenario that would prevail if no new policy were pursued.

Chart 6.1. EMU debt with no policy change and with implementation of the Strategic Accord (chart dates from the 2003 Budget Memorandum)



Policy is not aimed solely at finding coverage for the extra costs arising from population ageing; it also seeks to reduce the costs themselves by advancing the participation rate for older workers in particular, alongside efforts to boost general participation. Increasing the participation rate for older workers notably affects the costs of pre-pension schemes. The costs of social security for the government will be reduced if less older workers begin claiming occupational disability or unemployment benefits. Moreover, the expansion of the tax and contribution base will lead to an increase in tax and contribution revenues from wages and salaries. Finally, as an employer, the government will also benefit from the reduction in the costs of pre-pension schemes as people stay in employment longer.

In addition to the state financed pension scheme, the Netherlands has a sizeable second pillar. This pillar is important to help warrant adequate pension provision, while at the same time preventing the burden on public finances from becoming too large. A pension system financed on both a pay-as-you-go and a funding basis is generally more robust than one financed on a pay-as-you-go basis only, since the risks in a differentiated system are more evenly spread. One of the risks to which the funding part is exposed is the situation in the equity markets. Pension funds invest their assets and are hence exposed to equity market developments. As equity prices, from a historical perspective, are now particularly low, some pension funds are faced with the problem of slipping below the statutory degree of cover. The losses generated by the low equity prices can be offset in various ways and raising pension premiums should not be seen as the only option. Alternatives include examining the method of indexing pensions and taking a closer look at other pension rights.

Table 6.2. Pension fund assets, 1991-2001 (in % of GDP)

	Assets, total	Capital market investments			Other
		Of which in equity	Of which in bonds	Of which in real estate	
1991	73	12	53	7	1
1992	75	13	52	7	3
1993	80	17	53	7	3
1994	78	17	52	7	2
1995	81	21	51	6	3
1996	87	27	52	7	1
1997	93	33	52	6	2
1998	98	41	49	6	2
1999	117	60	48	7	2
2000	111	54	48	6	3
2001	101	51	43	6	1

Source: Annual report, Nederlandsche Bank (DNB)

Annex to Stability Programme 2001-2006

Table 1. Measures by the present Cabinet for 2003 (in EUR billion)

	2003
Expenditure increases	1.2
Safety	0.2
Health care	0.7
Education	0.1
Miscellaneous	0.2
Reallocations	-3.6
Public administration	-0.8
Social security and labour market	-0.9
Health care	-0.3
Mobility, spatial planning, environment and economy	-0.2
Foreign affairs and asylum	-0.3
Other	-1.1
Tax revenue raising measures (namely base broadening)	-4.3
Reduction in fiscal package for the environment and energy	-0.5
Restructuring of the tax burden	-0.6
Reduction of poverty trap	-0.9
Restriction of employee savings scheme	-0.4
Discontinuation of wage cost subsidy for low earners (SPAK)	-0.2
Other	-1.7
Tax cuts	1.8
Earned income tax credit	0.4
Conditional tax cuts	0.5
Other	0.9
Total	-4.9

Table 2. Developments in public finances, 2001-2006

In % of GDP	ESA code	2001	2002	2003	2004	2005	2006
EMU balance	S13	0.1	-0.7	-1.0	-0.7	-0.4	0.1
Central government	S1311	-0.1	-0.5	-1.4	-1.1	-0.8	-0.3
Local government	S1313	0.1	0.2	0.2	0.2	0.2	0.2
Social funds	S1314	0.1	-0.4	0.2	0.2	0.2	0.2
Public revenues	ESA	46.9	46.4	45.8	45.2	45.3	45.3
Public expenditure	ESA	46.8	47.1	46.8	45.9	45.7	45.2
EMU balance	B9	0.1	-0.7	-1.0	-0.7	-0.4	0.1
Interest payments, net		3.5	3.4	3.1	2.8	2.6	2.5
Primary balance		3.6	2.7	2.1	2.1	2.2	2.6
Composition of public revenues							
Taxes	D2+D5	25.7	25.7	25.2	25.5	26.0	26.1
Contributions	D61	14.1	13.9	14.1	13.5	13.4	13.4
Other		7.1	6.8	6.5	6.2	5.9	5.8
Public revenues, total	ESA	46.9	46.4	45.8	45.2	45.3	45.3
Composition of public expenditure							
Public consumption	P32	16.5	16.9	16.6	16.5	16.4	16.3
Social security (in kind)	D63	7.4	7.7	7.9	7.9	8.0	8.1
Social security (other)	D62	11.6	11.7	11.9	11.7	11.6	11.4
Interest charges	D41	3.5	3.4	3.1	2.8	2.6	2.5
Subsidies	D3	1.4	1.4	1.3	1.2	1.0	0.9
Investment	P51	3.5	3.6	3.6	3.3	3.3	3.2
Other		2.9	2.4	2.4	2.5	2.8	2.8
Public expenditure, total	ESA	46.8	47.1	46.8	45.9	45.7	45.2

Table 3. EMU debt, 2001-2006

In % of GDP	ESA code	2001	2002	2003	2004	2005	2006
EMU debt		52.8	51.9	51.2	49.0	47.4	45,3
Change in debt ratio		-3.0	-0.7	-0.7	-2.2	-1.6	-2.1
Contribution to reduction of debt ratio							
Primary balance		-3.6	-2.7	-2.1	-2.1	-2.2	-2.6
Interest charges	D41	3.5	3.4	3.1	2.8	2.6	2.5
Denominator effect of GDP growth	B1g	-3.5	-2.0	-2.0	-2.5	-2.1	-1.9
Other		0.6	0.6	0.3	-0.4	0.1	-0.1