COMMISSION OF THE EUROPEAN COMMUNITIES

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EU

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997 on the updated Stability programme of the Netherlands, 2001-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to this Council and the Commission by 1 March 1999. In accordance with Article 5 of the Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme. According to the Regulation, the updated stability programmes, to be presented annually, may be examined by the Council in accordance with these same procedures.

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

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

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1 OJ L 209, 2.8.1997
2 OJ C 124, 5.5.1999
3 OJ C 60, 2.3.2000
4 OJ C 376, 29.12.2000
5 OJ C 33, 6.2.2002
6 COM (2002) 668 final, 27.11.2002.

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

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

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

The general government balance deteriorated significantly, from a surplus of 1.5% of GDP (excluding UMTS receipts) in 2000, to a slight surplus of 0.1% of GDP in 2001 and to a deficit of 1.2% of GDP in 2002. This worsening reflects the deceleration in activity as well as expenditure overruns in health care in particular and the delayed impact of the tax cuts of the 2001 fiscal reform. As far as budgetary developments in 2003 are concerned, the update incorporates the 2003 budget – which was endorsed by Parliament with a few limited modifications only, despite the fall of the previous cabinet on 16 October 2002 – as well as measures announced by the new government to offset expenditure overruns that have become apparent since the budget was passed. The 2003 budget and supplementary measures form a package consisting of reallocations of expenditure, expenditure cuts and increases in some areas, and tax revenue raising measures. The net ex-ante combined impact of all these measures on the general government balance is an improvement of around € 5.4 billion or 1.2 percentage point of GDP. However, despite the restrictive fiscal stance in 2003, the nominal deficit is still expected to rise to 1.6% of GDP (from 1.2% in 2002). This is partly due to the prolonged weakness in economic activity but also partly reflects a number of other factors including adverse developments in health care spending and increases in tax-deductible pension premiums and tax-deductible increases in mortgage payments. That said, according to the update the cyclically adjusted deficit is projected to improve by 0.4 percentage point of GDP to 0.8% of GDP.

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

Despite the quite substantial overall consolidation effort, the nominal general government balance is forecast to only improve gradually over the 2004-2007 horizon. This reflects not only the sluggish pace of recovery but also upward trends in certain categories of expenditure, notably health care, that are largely independent of the cycle. In 2004, the nominal deficit would still rise marginally to 1.7% of GDP, despite the expected pick-up in real GDP growth and the consolidation package[7]. This largely reflects a further widening of the output gap as real GDP growth in 2004 is expected to remain below potential. Under the assumption of economic growth picking up to above potential in 2006 and 2007, the update projects the nominal general government deficit to gradually improve to a deficit of 1.2 and 0.8% of GDP in 2005 and 2006 respectively. Nevertheless, a small deficit of 0.5 percentage point of GDP is expected to still exist in 2007. By contrast, in cyclically adjusted terms a position close to balance would be reached earlier, from 2005 onwards, when the cyclically adjusted deficit is projected to be below 0.5% of GDP. In this respect the update assumes that, in line with the Council's interpretation of the stability programmes of other countries, a cyclically adjusted deficit of no more than 0.5% of GDP qualifies as a position close to balance. According to the projections in the programme, the cyclically adjusted balance is estimated to improve from a deficit of 1.2% of GDP in 2002 to deficits of 0.8% of GDP and 0.7 % of GDP in 2003 and 2004 respectively. The calculations of the cyclically adjusted balance presented in the update coincide with the estimates of Commission services on the basis of the input variables provided. According to the update, the cyclically adjusted deficit would be reduced in subsequent years to 0.3% of GDP in 2005 and 0.2% of GDP 2006 and 2007.

The government debt ratio is expected to remain comfortably below 60% of GDP over the horizon covered by the programme. However, the decline in the debt to GDP ratio is expected to slow markedly over the horizon covered by the programme largely due to the development of nominal GDP. The government debt ratio is expected to remain below the level of 60% of GDP and to remain broadly stable, at around 52½% of GDP in the period 2002-2007.

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

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

have to apply until the budget reaches the "close to balance position". Also the projections in the update seem at odds with the self-professed claim that the government *will take care to eliminate the cyclically adjusted deficit in the coming years*.

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

Risks to the economic and budgetary outlook appear to be skewed to the downside. Potential growth is estimated at 1.9% on average in the 2003-2006 period, which is in line with the estimated potential growth rate underlying the Commission Spring 2003 forecast. According to the central scenario of the updated stability programme, economic growth would average 1.9% between 2003 and 2007 (the same rate as estimated potential growth), while growth would accelerate to 2½% in 2006-2007 (around half a percentage point above estimated potential). This is equivalent to assuming that most of the output gap will have been closed in 2007 and, while certainly not unduly optimistic, this cannot be considered a particularly cautious baseline scenario. The expected profile of recovery may be too optimistic an assumption, given developments in unit labour costs, profitability, and competitiveness and, in particular, the risks attached to the external environment. As regards the projected profile of real GDP growth in the period 2004-2007, the underlying macro-economic assumptions effectively date back to December 2002. Recent indicators on economic activity in major trading partners and trends in exchange rates cast doubt on the assumed strength of the recovery of relevant world trade in the near term and thus of domestic economic activity underlying the baseline scenario.

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

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

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

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the revised updated stability programme of the Netherlands and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n° 1466/97 of 7 July 1997 on the updated Stability Programme of the Netherlands, 2001-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[8], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [15 July 2003] the Council examined the revised updated stability programme of the Netherlands, which covers the period 2001-2007. The revised update complies with the code of conduct on the format and content of stability programmes and broadly complies with the 2003 Broad Economic Policy Guidelines.

In 2002, real GDP growth decelerated sharply to 0.2%, from 1.3% in 2001, well below the forecast included in the 2001 stability programme. Government finances deteriorated markedly in 2002, partly in response to the economic slowdown but also due to adverse trends in certain categories of expenditure, notably health care. In 2002 the general government balance showed a deficit of 1.2% of GDP, compared to a slight surplus of 0.1% of GDP in 2001. HICP inflation decelerated to 3.9% on average in 2002, from 5.1% in 2001, to a large extent due to trends in import prices and the fading of the impact of increases in indirect and energy taxes in 2001 in the wake of the tax reform.

The Council notes that since the presentation of the initial 2002 updated stability programme in December 2002, the macro-economic projections have been significantly revised downwards, with a negative impact on budgetary conditions. The Council notes that while the gradual but relatively muted economic recovery projected in the programme appears plausible, risks are clearly skewed to the downside and that the expected recovery is contingent on a pick-up in global demand and the successful restoration of the competitiveness of the Dutch market sector. The latter requires appropriate wage developments and an increase in the rate of productivity growth.

The Council welcomes the main elements of the budgetary framework put in place by the new government, which inter alia encompass the use of separate expenditure ceilings defined in

[8] OJ L 209, 2.8.1997

real terms for the three sub-sectors of government defined, the rule that extra revenues should be exclusively used to reduce the deficit (or the debt should the deficit disappear), and the requirement that a development of the general government deficit that would imply a violation of the Stability and Growth Pact has to be countered by additional measures.

The Council notes that in the central projection of the update the government balance is expected to deteriorate initially from a deficit equal to 1.2% of GDP in 2002 to a 1.7% deficit in 2004. A subsequent improvement is expected subsequently to reach a deficit of 0.5% of GDP in 2007. The government debt ratio is expected to remain below the level of 60% of GDP and to remain broadly stable, at around 52½% of GDP in the period 2002-2007.

The Council notes the consolidation effort entailed in the 2003 budget and in the coalition agreement of the new government for the period 2004-2007. Against the background of a steeper economic downturn than previously expected, budgetary policies are expected to lead to an improvement in the cyclically adjusted general government balance by 1% of GDP between 2002 and 2005. A position close to balance in cyclically adjusted terms would be reached in 2005 and maintained in the two subsequent years. The nominal general government balance is expected to reach a position close to balance only in 2007. The Council considers that with the full implementation of the consolidation measures announced by the new government and given normal macroeconomic fluctuations, a significant safety margin is provided not to trespass the 3% of GDP deficit threshold.

However, as far as the projected changes in the cyclically adjusted general government balance are concerned, the Council regrets that in 2003 and 2004 the path of adjustment falls short of the requirement to reduce the cyclically adjusted deficit by at least half a percentage point in each year, albeit not by a wide margin. The Council recommends the Dutch authorities to do the necessary to ensure an improvement in the cyclically adjusted general government balance of 0.5 percentage point of GDP in 2004.

Given the downside risks attached to the growth projections, the Council notes that additional measures might be needed to ensure that a budgetary position close to balance or in surplus would be maintained in the medium term. Against this background, the Council welcomes the readiness of the Dutch authorities to take additional measures to ensure compliance, should downside risks materialise.

The Council considers that on the basis of the current policies, The Netherlands appears to be in a relative good position to meet the budgetary costs associated with ageing. The debt to GDP ratio will continue to decline in coming years. However, a slight reverse trend of the debt to GDP ratio in the long run cannot be excluded. To avoid the risk of imbalances in the long run, it would be necessary to fully implement the 'Global Agreement', in particular as regards the reforms in the social insurance sector that aim at increase participation rates and the effective retirement age.