

No. W06.20.0288/III

15 September 2020

## **Assessment in view of independent fiscal monitoring**

### **1. Introduction**

The Advisory Division of the Council of State has been charged with the monitoring of compliance with (European) fiscal rules as referred to in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) and Article 5 of Regulation (EU) 473/2013. It is the task of the independent fiscal monitoring institute to draw up an assessment of whether European fiscal rules are being met. In its assessment, the Advisory Division works closely with the CPB Netherlands Bureau for Economic Policy Analysis. The division of tasks entails that the drawing up of independent economic and budgetary forecasts and analyses are assigned to the CPB. The Advisory Division has been charged with the more normative assessment of compliance with (European) fiscal rules.

The Advisory Division generally publishes two reports a year, in April and in September. In the reports it provides an assessment of the expected budgetary developments and intentions as adopted by the government in the Stability Programme and Budget Memorandum, respectively.

In the interests of quality and meticulousness in drawing up the assessment, for the September report the Advisory Division was able to consult a draft version of the Budget Memorandum. On the basis of this, the Advisory Division has drawn up a draft assessment, which has been reviewed with the government on the principle of adversarial debate. The Advisory Division has made its final assessment after being informed of the government's response. The government's response is included in full in this report. The response from the government has not prompted the Advisory Division to change the report.

The conclusion of the independent fiscal monitoring of the Budget Memorandum 2021 is twofold:

- European fiscal rules in the Stability and Growth Pact have been temporarily suspended by the European Commission because of the COVID-19 pandemic (the so-called general escape clause has been activated), but this does not mean that the sustainability of government finances can be neglected. The SGP still applies and in the medium term requires the enforcement of or return to a sustainable level of government finances. In the 'basic scenario' forecast provided by the CPB Netherlands Bureau for Economic Policy Analysis, next year government debt will rise above the European fiscal rule of 60% of gross domestic product and will remain above this rule the following year as well. If a

scenario involving a second wave of COVID-19 were to occur, government debt could rise above 70% next year.

- The large number of incidental supplementary budgetary laws and the many changes in expenditure ceilings impair both the view of expenditure related to combating the COVID-19 crisis and the view of other, regular, expenditure. As a result, this impairs both control over expenditure and accountability to parliament. Therefore, the Advisory Division has a preference for presenting expenditure related to the COVID-19 pandemic and the corresponding support measures separately (whether or not in a different framework) alongside the existing expenditure frameworks, as is the case in the Budget Memorandum 2021 with the tax measures.

This report begins with the assessment based on European rules (section 3.2). This is followed by an assessment based on national fiscal rules (section 3.3). Lastly, in section 3.4 we address a number of important uncertainties and risks. The government's response is included in section 3.5.

## **2. Assessment based on European rules**

The first assessment in the context of independent fiscal monitoring is performed using the European fiscal rules arising from the SGP. This usually involves an assessment of the EMU balance, the structural balance and the debt ratio (see Table 2 for an overview). The European fiscal rules do not apply due to the SGP general escape clause being activated.<sup>1</sup> The escape clause enables Member States to deviate from the path towards the medium-term objective for the structural balance (MTO), providing it does not jeopardise the sustainability of government finances in the medium term. Therefore, it is still important to closely monitor and assess the development of government finances. It is expected that the escape clause will apply both this and next year.

Table 2 provides an idea of the forecasts related to balance and debt in relation to the fiscal rules that apply to the Netherlands, as long as the Netherlands finds itself in the preventive arm of the SGP.<sup>2</sup>

According to the CPB's forecast in the Macroeconomic Outlook (MEV) the EMU balance rapidly increases to a large deficit (over 7% of GDP). This year, debt remains below 60%, but will be higher next year. In the scenario with the second wave of COVID-19 (see paragraph 2) the EMU balance would be -8.3% of GDP this year and -9.3% of GDP next year. In the alternative scenario debt would increase this year above 60% and would rise to 72.1% of GDP next year. Government finances were in good shape before the COVID-19 pandemic. Debt is rising quickly due to the economic shock.

The CPB published an update of the previously issued Medium Term Forecast (MLT) with the Macroeconomic Outlook (MEV). The consequences of the COVID-19 outbreak

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<sup>1</sup> European Commission, Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact. COM (2020) 123 final, 20 March 2020.

<sup>2</sup> In case of an excessive deficit a Member State moves to the corrective arm. In 2014, the Netherlands was discharged from the excessive deficit procedure and has since been placed in the preventive arm. In the preventive arm the medium-term objective (Medium Term Objective, MTO) and (if the MTO is not achieved) the expenditure rule apply as fiscal rules. The objectives arising from the preventive arm are aimed at sustainable government finances.

in 2020 are processed in this updated forecast of the economic and budgetary development in the period 2022-2025. The COVID-19 crisis will also continue to produce a negative effect after next year. First and foremost, sustainability deteriorates as a result of the government deficit. In addition, the growth of productivity and the supply of labour arising from migration due to the COVID-19 pandemic are probably lower than previously forecast. This puts economic growth under pressure.<sup>3</sup> It has an impact on the earning capacity of the Netherlands and thus also on government finances.

**Table 1: Medium-term forecast key figures of government finances 2022-2025**

(in % BBP)	2020	2021	2022	2023	2024	2025
EMU balance	-7,6	-5,1	-3,2	-2,4	-2,0	-1,7
Structural balance	-4,7	-3,6	-2,3	-1,8	-1,6	-1,5
Debt ratio	59,9	62,0	63,8	65,1	66,1	66,8

Forecasts for the coming term of government related to balance and debt indicate that debt is expected to remain above 60% and gradually increase due to actual deficits. The structural balance also displays a deficit that is higher than the target (-0.5% of GDP), although it is gradually decreasing.

In a second wave scenario these negative effects will probably be even worse and government debt will rise to 84% of GDP in 2025. All things considered the sustainability will deteriorate due to the COVID-19 outbreak; according to the current forecast for the basic scenario the sustainability deficit is -3.0% of GDP. This figure says something about the extent to which tax measures will be needed in the future for the continued financing of the current collective arrangements. The government does not respond to this in the Budget Memorandum.

In Spring this year, the Advisory Division said that it was desirable for the government to provide an insight into how it will ensure sustainability of government finances in the medium term, at the latest in the Budget Memorandum.<sup>4</sup> The Budget Memorandum provides a few considerations for the sustainability of the increased and anticipated further rise in government debt. Nonetheless, in time, the way in which the SGP's medium term objective is fulfilled deserves greater focus.

### **3. Assessment based on national fiscal rules**

As the independent national budget supervisory authority, the Advisory Division also has the task of assessing compliance with national fiscal rules. Since 1994, the choice has been for trend-based fiscal policy. In the Initial Policy Memorandum of the Coalition Agreement the Rutte III cabinet confirmed it would apply trend-based fiscal policy.<sup>5</sup> It

<sup>3</sup> Y. Adema, W. van den Berge and A. Zulkarnain, Langdurige effecten van de coronacrisis voor de arbeidsmarkt (Lasting effects of the COVID-19 crisis on the labour market), CPB COVID-19 publication August 2020 and A. Elbourne, Y. Adema, L. Bettendorf, B. Kramer, R. Loginbuhl and A. Zulkarnain, Blijvende economische schade van de coronacrisis (Persistent economic damage from the COVID-19 crisis), CPB COVID-19 publication August 2020.

<sup>4</sup> Letter dated 15 April 2020, Parliamentary Papers II 2019/20, 21501-07, no. 1688.

<sup>5</sup> Annex 1: Fiscal Rules 2018-2022, as established by the Rutte III cabinet, Appendix 1 to the Initial Policy Memorandum: Parliamentary papers II 2017/18, 34 775, No. 54.

also cites the objective of trend-based fiscal policy: to manage government finances, a targeted allocation of resources and to contribute to economic stability. This objective can best be achieved through stability in political decision-making by making integral considerations at fixed moments. It also promotes orderly political accountability by the government to parliament.

In the context of trend-based fiscal policy, frameworks are set for expenditure as well as for revenue (taxes). Agreements are made on these matters at the beginning of the government term. For each year a ceiling is established for the total expenditure agreed, which may not be exceeded, the so-called expenditure ceiling. There is a general ceiling of expenditure containing three sub-domains each with their own ceiling: State Budget, Social Security and Healthcare.<sup>6</sup> It was decided to include the expenditure that counted towards the EMU balance under the total expenditure ceiling.<sup>7</sup> Changes in expenditure for unemployment and welfare due to other economic developments fall outside the expenditure ceiling; this provides automatic stabilisation in government expenditure. Ceilings may only be adjusted under certain conditions.<sup>8</sup> Transparency of the budget must not suffer as a result of adjustments, because it may impair the government's political accountability to parliament.

For the revenue side of the budget, the policy-related tax development is established for the full government term in the so-called revenue ceiling. This ceiling must be complied with on a cumulative basis over the full government term, but unlike the expenditure ceiling, this does not apply for each individual year of the government term. For the revenue side of the budget the principle of automatic stabilisation also applies: revenue windfalls benefit the government balance, revenue setbacks burden the government balance. This means that higher revenue – such as higher tax revenue as a result of greater economic growth – cannot be used for additional expenditure. On the other hand, in principle, setbacks on the revenue side do not result in cut-backs. Policy developments in tax and social security contributions must be compensated on the revenue side. The revenue ceiling can also be adjusted.

### *Support measures and ceilings*

This year is exceptional due to the economic shock resulting from the COVID-19 crisis. This also extends to fiscal policy. First and foremost the COVID-19 crisis gave rise to support measures in addition to the automatic stabilisers on the revenue and expenditure side.<sup>9</sup> On 18 March, the government announced extensive support

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<sup>6</sup> The State Budget ceiling (R) relates to all expenditure and non-tax revenue of the State Budget, which cannot be allocated to the revenue side of the budget and the other two budget discipline sectors. The Social Security ceiling (S) relates to the total expenditure in the sector. Lastly, the collective healthcare expenditure falls under the Healthcare (Z) ceiling. Total expenditure under the Social Security and Z ceilings concern expenditure financed via the State Budget as well as expenditure paid out through contributions.

<sup>7</sup> The elements that do and do not count towards the EMU balance are established by Eurostat and definitions of the national accounts. Financial transactions such as the provision of (study) loans or the sale of shares or shareholdings are not relevant to the EMU balance.

<sup>8</sup> Last year, the Advisory Division was critical of the adjustment of the ceilings: "Although the adjustment of expenditure and revenue ceilings does not presently constitute a significant threat to the economy and the health of Dutch government finances as long as this is effectively a one-off, the government does not explain why it must now deviate from the principles of trend-based fiscal policy." (IFI report September 2019), <https://www.raadvanstate.nl/begrotingstoezicht/rapportages/>

<sup>9</sup> The support measures are 'discretionary' and were possible because the timing of the downturn was obvious, as the economic downturn was a direct result of measures to limit the pandemic.

measures.<sup>10</sup> These measures are intended to bridge the difficult period, with the aim of preventing long-term economic damage. It concerns measures on both the expenditure side and the revenue side.

After announcing the emergency measures in March, a total of 34 incidental supplementary budgetary laws were submitted by the government in several stages up to the end of August.<sup>11</sup> In the Spring Memorandum 2020 the government presented the situation at that time.<sup>12</sup> The Appendix to the Budget Memorandum includes a detailed table of all the COVID-19 measures. The fact that Table 3 runs to three pages indicates the number of different measures concerned. The Budget Memorandum 2021 includes a third extensive package of support measures.<sup>13</sup>

On the expenditure side the government opted to place the extra expenditure related to the COVID-19 pandemic under the expenditure ceiling, but to simultaneously increase this ceiling by the same amount. Therefore, the extra expenditure related to the COVID-19 pandemic led to a deterioration of the EMU balance and an increase in the EMU debt.<sup>14</sup>

From the point of view of transparency, the Advisory Division has a preference for presenting expenditure related to the COVID-19 pandemic and the corresponding support measures separately alongside the expenditure ceilings (whether or not in a separate ceiling) as is the case in the Budget Memorandum 2021 with the tax measures.

This is because on the revenue side a differentiation is actually made between COVID-19 measures and regular policy and all fiscal COVID-19 measures are placed outside the ceiling.<sup>15</sup> And therefore, the fiscal COVID-19 measures also have a direct effect on the EMU balance and the EMU debt.

### *Ceiling assessments*

In the Budget Memorandum the actual development of the expenditure is assessed using the ceilings. The ceiling assessments are shown in Table 3. The total ceiling is not exceeded, but this is because excesses in the State Budget and Social Security are offset by underspending in the Healthcare ceiling.

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<sup>10</sup> Parliamentary Papers II 2019/20, 35420-2.

<sup>11</sup> <https://www.rijksoverheid.nl/documenten/begrotingen/2020/03/18/overzicht-suppletoire-begrotingen-financiele-maatregelen-coronavirus>

<sup>12</sup> Parliamentary papers II 2019/20, 35 450, No. 1, Spring Memorandum, 24 April 2020.

<sup>13</sup> Parliamentary papers II 2019/20, 35 420, No. 105, letter "Support and recovery package." dated 28 August 2020.

<sup>14</sup> This means that the standard expenditure ceiling does not apply to the expenditure arising from the emergency package and the expenditure does not therefore result in an effect on the indexation of the Municipal and Provincial Fund. Municipalities receive funds via the emergency package to cover the increase in implementation costs. In addition the State continues to monitor the financial situation of municipalities and effects resulting from the COVID-19 crisis.

<sup>15</sup> Furthermore, the Budget Memorandum 2021 indicates compliance with the revenue ceiling.

**Table 2: Ceiling assessments**

(bn €, - is underspending)	2020	2021
<b>Aggregate</b>		
Expenditure ceiling	335,7	327,7
Expenditure level	335,6	327,7
<i>Over-/underspending</i>	<i>0,0</i>	<i>0,0</i>
<b>State Budget</b>		
Expenditure ceiling	155,4	154,3
Expenditure level	156,6	155,1
<i>Overspending</i>	<i>1,1</i>	<i>0,8</i>
<b>Social Security</b>		
Expenditure ceiling	105,5	96,8
Expenditure level	105,5	97,2
<i>Overspending</i>	<i>0,1</i>	<i>0,4</i>
<b>Healthcare</b>		
Expenditure ceiling	74,7	76,6
Expenditure level	73,5	75,5
<i>Underspending</i>	<i>-1,2</i>	<i>-1,1</i>

Source: Budget Memorandum 2021, Appendix Table 1.2

For the State Budget and Social Security the ceilings are increased in order to include the support measures. Table 4 summarises the adjustment of the ceilings. The expenditure ceilings are adjusted in the Budget Memorandum. Table 4 indicates, per ceiling, how this has changed compared with the previous Budget Memorandum.

The adjustments in the State Budget and Social Security ceiling can largely be attributed to the emergency measures taken. The results of the ceiling assessments in the current Budget Memorandum consequently now offer limited information. This means the view of the developments in standard expenditure is impaired by not keeping the COVID-19 measures outside the ceilings.

**Table 3: ceiling adjustments in the Budget Memorandum 2021 compared with 2020**

in bn €	2020			2021		
	BM 2020	BM 2021	adjustment	BM 2020	BM 2021	adjustment
Aggregate	302	333,3	31,3	312,0	317,1	5,1
State Budget	142,5	155,3	12,8	146,0	146,7	0,7
Social Security	84,9	103,4	18,5	87,6	92,7	5,1
Healthcare	74,7	74,5	-0,2	78,4	77,8	-0,6

The Healthcare ceiling also shows underspending this year. Considering all the extra healthcare expenditure resulting from the COVID-19 crisis this requires a more satisfactory explanation than the one provided in the Budget Memorandum. What positive and negative effects does the COVID-19 crisis exert on healthcare expenditure, separated into healthcare insurance contributions (ZVW) and long-term care contributions (Wlz)? Is there a windfall resulting from the reduced demand for healthcare (due to COVID-19), to what extent is there a structural effect? What is the impact of the system used for wage and price adjustments on underspending? And how does the downward adjustment to the Healthcare ceiling for 2021 relate to the continuous focus on the structural increase in healthcare costs, as also described in diverse Budget Memoranda?<sup>16</sup> Given the major importance of developments in healthcare costs for managing government expenditure, the Advisory Division recommends the presentation and analysis of the Healthcare ceiling be less technical and more informative in terms of policy, including a clear distinction between developments in cure and care.

Lastly, on the revenue side there are two types of ceiling corrections to spread out incidental or short-term effects over a longer period (and not to burden the balance).<sup>17</sup> For incidental setbacks with a major impact it is a political decision to spread them out and not burden the balance in this way.<sup>18</sup>

The transparency of the Budget Memorandum 2021 is further impaired because the numerical substantiation is included in appendixes and only to a limited extent in the main text. As a result, the difference between the main text and the detailed, and not always equally accessible, information in the appendixes, is considerable. The information supplied in the appendixes has a predominantly technical character and does not offer sufficient insight into the underlying political decisions. This impairs parliamentary scrutiny on allocation and accountability retrospectively.

#### 4. Uncertainties and risks

Yet again, the COVID-19 crisis makes it clear that uncertainty is not a mere theoretical given. It is good that attention is also devoted in the Budget Memorandum to making the conditions of the guarantee schemes more flexible. A guarantee is a conditional financial obligation undertaken by the State to a third party, which is only paid out in the event a risk arises. This kind of guarantee is always subject to a maximum amount.

<sup>16</sup> See also the third recommendation by the Study Group on Fiscal Policy in the letter regarding the postponement of the report. Parliamentary papers II 2019/20, 35 300, No. 82.

<sup>17</sup> With regard to reforms (such as those in the context of recommendations by the Ter Haar Commission on the fiscal treatment of multinationals and scaling back the self-employed deduction) adjustment of the ceilings is permitted. The idea is that reforms actually pay for themselves in time.

<sup>18</sup> The decline in tax revenue as a result of the Sofina ruling (€910 million) and the rental income tax (over €1 billion) is so great that spreading them out is desirable. See Table 3.4 Appendix to the Budget Memorandum for all ceiling corrections.

The volume of guarantees has increased by circa 8% of GDP due to the support measures and what's more, existing schemes have been expanded and made more flexible.<sup>19</sup> Guarantees are not free when and insofar as they are used and subsequently lead to government expenditure, and furthermore due to the increased flexibility of the conditions the anticipated 'claims paid out' are higher than in the past. Therefore, they constitute a potential risk to the budget and it is important that they are critically monitored. For this purpose a reserve is maintained and it is important that it is sufficient but not excessively high.<sup>20</sup>

## **5. Response from the government**

The government thanks the Advisory Division of the Council of State (hereafter called: the Advisory Division) for its assessment on the development of government finances and to which extent this development complies with the rules of the Stability and Growth Pact (SGP). The Advisory Division concludes that European fiscal rules in the Stability and Growth Pact have been temporarily suspended by the European Commission because of the COVID-19 pandemic (by activating the so-called general escape clause), but this does not mean that the sustainability of government finances can be neglected. The Advisory Division also notes that in a scenario involving a second wave, government debt can increase considerably faster than is currently expected.

The government agrees with this conclusion by the Advisory Division. Activating the escape clause means that Member States may temporarily deviate from the standard requirements for the development of the structural balance. At the moment, it is still unclear how long this clause will remain in force. However, it does not detract from the importance of sustainable government finances and a managed development of the level of debt. The crisis reveals that shocks can emerge from unexpected corners and lead to high costs for the government in the short term. Therefore, it is important to ensure that the budget will also be able to withstand a major shock in the future. The government asked the 16th Study Group on Fiscal Policy to issue advice on the budgetary objective and budgetary system for the coming years.

In addition the Advisory Division notes that bringing the COVID-19 measures under the expenditure ceiling (by correcting the expenditure ceiling) impairs the view on standard expenditure development as well as that of the COVID-19 measures. The adjustments to the expenditure ceiling can largely be attributed to the emergency measures. According to the Advisory Division the results of the ceiling assessment consequently offer limited information. The Advisory Division prefers the various COVID-19 measures to be presented separately alongside the expenditure ceiling. In addition the Advisory Division recommends that in particular the transparency of (the growth of) healthcare expenditure be improved.

The government acknowledges the impression that the expenditure ceiling adjustments are considerable and that the large number of COVID-19 measures do not simplify insight into the budget. Since this case concerns an increase in the level of expenditure

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<sup>19</sup> A number of existing schemes, such as the Business loan guarantee scheme (GO) and the SME guarantee scheme (BMKB) have been expanded and made more flexible. In addition, the government provides a guarantee for the financial risks arising from the collective purchase of medical resources and equipment related to the treatment of COVID-19, for supplier loans to retail businesses and the loan to KLM. The Netherlands has also undertaken international obligations to combat the crisis.

<sup>20</sup> An excessively high risk reserve can become a budget reserve.

as well as the expenditure ceiling, the ceiling assessment still reveals the extent to which standard expenditure exceeds or falls short of the ceiling. Moreover, the government aims to provide insight into all expenditure related to the COVID-19 crisis in Appendix 1.3 to the Budget Memorandum. Lastly, the government strives to provide information about adjustments under the Healthcare expenditure ceiling and developments in healthcare expenditure through a number of budget documents, including the Healthcare Financial Picture related to the Ministry of Health, Welfare and Sport (VWS) draft budget. It also discusses the initial (potential) effects of the COVID-19 crisis on healthcare expenditure.

The Advisory Division also reflects on uncertainties and risks. The Advisory Division rightly points out that entering into new risk schemes and expanding and increasing the flexibility of the conditions of various existing guarantee schemes comes at a cost. In the government's view, guarantees are an effective instrument in times of crisis and contribute to economic recovery by eliminating uncertainty. At the same time, the government agrees with the Advisory Division that guarantees constitute a potential risk to the budget and it is important that they are critically monitored. Twice a year (with the Budget Memorandum and the Annual State Financial Report) the government provides an overview of the State's outstanding risk schemes. In order to manage the risks to government finances and promote the consideration of different policy instruments, the government uses a 'no-unless' policy in relation to risk schemes.

In the conviction that the Advisory Division, as an independent budgetary authority, provides parliament with an expert opinion of the budget, on behalf of the government I sincerely thank the Advisory Division for its diligent cooperation.