Raad van State

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Summary

The Dutch economy is expected to grow by 1.7% in both 2016 and 2017. This forecast is lower than envisaged last spring, especially because of increased uncertainties as a result of the outcome of the Brexit referendum. Public finances will nonetheless improve in both years, mainly as a result of higher tax revenues. In the forecast by CPB Netherlands Bureau for Economic Policy Analysis, the actual budget deficit results in 1.1% of GDP in 2016 and 0.7% of GDP in 2017. The structural budget deficit (the budget deficit adjusted for the economic cycle and one-off measures) also improves in both years and is gradually approaching the European medium-term objective (MTO) of 0.5% of GDP.

Since 2014, the Advisory Division of the Council of State has assessed whether the forecast and realised development of public finances complies with the rules of the European Stability and Growth Pact. ***For the year 2016, on the basis of forecasts in the 2017 Macro Economic Outlook by the CPB, the Advisory Division concludes that Dutch public finances are compliant with European fiscal rules.***

In 2017, the structural government balance will approach the European medium-term objective and general government debt will drop fast enough towards the Maastricht criterion of 60% of GDP. Nonetheless, both development of the structural government balance and growth in public expenditure in the current CPB forecasts for 2017 do not fully comply with European fiscal rules. The deviations continue to stay below the threshold above which they are considered to be a 'significant' deviation. ***On balance, the Advisory Division concludes that the 2017 budget does not fully comply with European fiscal rules.***

The Advisory Division observes that within the national budgetary framework the government adjusts the expenditure and revenue ceilings to fit in additional expenditure for social priorities and improvement of purchasing power. ***These adjustments to expenditure and revenue ceilings are inconsistent with the national budgetary framework****, which assumes fixed expenditure and revenue ceilings that are ascertained at the beginning of a new government term for the entire period. This is an issue, since the government assured in the spring to maintain the regular national budgetary framework to comply with European fiscal rules. If the government had followed the regular national budgetary framework, then the 2017 budget would probably have complied fully with European fiscal rules.*

Finally, the Advisory Division points out that in light of the European fiscal rules, the importance of a consistent and effective national budgetary policy has increased even further. In the last few decades the Dutch trend-based fiscal policy has proven its usefulness, but its success depends on the degree to which the

government adheres to the rules to which it has committed itself. ***By adjusting the expenditure and revenue ceilings without further explanation merely to fit in additional policy measures, the credibility of trend-based fiscal policy is undermined.***

1. Introduction

The Advisory Division of the Council of State has been designated as the body responsible for the independent monitoring of compliance with (European) fiscal rules as provided for in the Treaty on Stability, Coordination and Governance (TSCG) and Article 5 of Regulation (EU) 473/2013. It is the task of the independent budget supervisory authority to establish publicly accessible assessments on whether a Member State complies with European fiscal rules.

So the Advisory Division publishes a report twice a year, in which it provides an assessment on the expected budgetary developments and the intentions as adopted by the government. The Spring Report is published in April and is linked to the Stability Programme; the September Report at hand, relates to the Budget Memorandum and the departmental budgets. The September Report is supplemental to the recommendations published by the Advisory Division in respect of the Budget Memorandum.

Assessments by the Advisory Division are established in close cooperation with the Netherlands Bureau for Economic Policy Analysis (CPB). The division of tasks entails that the drawing up of independent economic and budgetary forecasts and analyses, by tradition, are assigned to the CPB. The Advisory Division of the Council of State has been charged with the more normative assessment of compliance with European fiscal rules. In so doing, for its September Report the Advisory Division makes use of the CPB's Macro Economic Outlook.

For the sake of the quality and accuracy of the assessment to be drawn up, the Advisory Division is given access to the draft version of the Budget Memorandum. On this basis the Advisory Division has drawn up a draft assessment which was discussed with the government. The Advisory Division makes its final assessment after being informed of the government's response. The government's response is included in full in this report. Accordingly, the procedure guarantees that justice is done to the differentiated responsibilities and possible differences in considerations. This is reported in the final assessment.

Section 2 of the report contains a brief discussion of the macroeconomic and budgetary prospects. Section 3 reviews the budgetary prospects and the Budget Memorandum in respect of the assessment framework. Section 4 reflects the government's response to the draft assessment. Section 5 concludes with the final assessment.

2. Macroeconomic and budgetary prospects

2.1 The macroeconomic prospects in 2016 and 2017

For 2016 and 2017 for the Eurozone, the CPB forecasts a continuing but moderate economic recovery,[1] with economic growth in both years just above 1.5% (see table 1).

Table 1: Key data of macroeconomic developments

	2015	2016		2017	
(changes in % per annum)		2016 CEP	2017 MEV	2016 CEP	2017 MEV
Eurozone					
Gross domestic product (economic growth)	1.5	1.6	1.6	1.7	1.5
The Netherlands					
Gross domestic product (economic growth)	2.0	1.8	1.7	2.0	1.7
Household consumption	1.8	1.6	1.3	2.0	1.8
Investments in housing	27.4	7.7	10.3	4.1	4.5
Private investments in other fixed assets	7.4	5.7	7.2	3.7	2.6
Exports of goods and services	5.0	3.6	3.2	4.1	3.1
Employment market sector (hours)	1.2	1.4	1.6	1.2	0.9
Unemployment (level, % of workforce)	6.9	6.5	6.2	6.3	6.2
Actual general government balance (% of GDP)	-1.9	-1.7	-1.1	-1.2	-0.7
Structural general government balance (% of GDP)	-1.1	-1.6	-0.9	-1.2	-0.8

Source: CPB, 2016 Central Economic Plan and 2017 Macro Economic Outlook

For the Netherlands, the economic growth forecast is fractionally higher. Uncertainties about the consequences of the outcome of the Brexit referendum have led to a downward readjustment of forecasts by 0.3pp in 2017 compared to the spring. This adjustment is roughly in line with studies by international organisations such as the Organisation for Economic Cooperation and Development (OECD) and the European Commission.[2] Now the CPB forecasts a growth of 1.7% for both 2016 and 2017.%.

To a considerable degree economic growth is supported by domestic spending, particularly investments in housing and other fixed assets of companies. Inflation is projected even lower than in the spring and that, in any case, supports the short-term purchasing power of households. In 2016 unemployment drops faster than previously forecast, but stabilizes in 2017. For 2017 an unemployment rate of 6.2% is forecast. That is more than 1pp (approximately 100,000 persons) lower than in 2014, the largest drop since the financial crisis, but still more than 2pp higher than in the years directly prior to the crisis.

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[1] CPB, 2017 Macro Economic Outlook, September 2016.

[2] See R. Kierzenkowski, N. Pain, E. Rusticelli and S. Zwart, The Economic Consequences of Brexit: A Taxing Decision, OECD Economic Policy Paper 16, April 2016, and EC, The Economic Outlook after the UK Referendum: A First Assessment for the Euro Area and the EU, European Economy Institutional Paper, no. 032, July 2016.

Higher tax revenues contribute to the fact that both the actual and structural government balances for 2016 and 2017 are more favourable, by about 0.5% of GDP, than was forecast in the spring. Part of this higher tax revenue is of an incidental nature, because current interest rates make it more attractive to pay taxes earlier. Furthermore, in 2017 temporary additional revenues are forecast as a result of the phasing out of personal pension fund management schemes (*pensioen-in-eigen-beheer*) for directors-principal shareholders (*directeuren-grootaandeelhouders*).

Forecasts for economic growth, as always, are enveloped with uncertainties. Risks for economic growth are mostly downwards. Aside from the previously mentioned uncertainties about the consequences of the outcome of the Brexit referendum, the CPB also points out some still unresolved issues in the European banking sector, the possibility of a sudden adjustment of growth driven by debt accumulation in China, and of geopolitical uncertainties in Turkey for example, with possible consequences of a new rise in asylum seeking migrants and a suspension of the Schengen Agreement.[3]

2.2 Public finances in 2016 and 2017

Gross public expenditure, in respect of GDP, fell by 3pp between 2012 and 2017 (table 2). Due to the recovering economy, expenditure for unemployment benefits is decreasing. At the same time, the various expenditure cut-back measures in the coalition agreement provide for a rising budgetary revenue, which likewise contributes to a reduction of the public expenditure ratio.

Table 2: Key statistics on public finances

(in % of GDP)	**2012**	**2013**	**2014**	**2015**	**2016**	**2017[a]**
Gross public expenditure	47.1	46.9	46.4	45.5	44.5	44.1
Tax and national insurance contributions	36.0	36.5	37.5	37.7	38.2	38.7
Non-tax revenues	7.2	8.0	6.6	5.9	5.1	4.8
Actual general government balance	-3.9	-2.4	-2.3	-1.9	-1.1	-0.7
General government balance of which for local governments	*-0.4*	*-0.4*	*-0.2*	*-0.3*	*-0.3*	*-0.3*
Structural general government balance	-2.1	-0.7	-0.6	-1.1	-0.9	-0.8
Government debt	66.4	67.7	67.9	65.1	63.3	61.8

Source: CPB, 2017 Macro Economic Outlook

(a) In the 2017 Budget Memorandum forecasts for the actual and structural government balance in 2017 are slightly more favourable at -0.5% respectively -0.6% of GDP.

Juxtaposed to the relative decrease in public expenditure is an increase in tax and national insurance contributions. This increase is partially explained by

[3] CPB, 2017 Macro Economic Outlook, September 2016, paragraph 1.1.

endogenous causes, such as growth of the tax base. What is particularly apparent, is the strong increase in corporation tax revenue in 2016. This is because most of the deductible losses of the recession have been settled in the meanwhile. Together with policy-related tax burdening measures in the years 2013 to 2015, the € 5 billion package of tax-relief measures in 2016 and the phasing out of personal pension fund management schemes for directors-principal shareholders in 2017,[4] this means that on a macroeconomic level, the tax and social security contributions in 2017 will, on balance, be 2.7% of GDP higher than in the recession year of 2012.

Finally, the major drop in natural gas revenues since 2013 leads to a substantial drop in non-tax revenues, which, on balance in 2017, will be 2.4% of GDP lower than in 2012 (see text box 'The development of natural gas revenues and interest expenditure').

The development of natural gas revenues and interest expenditure

For a better understanding of budgetary development during recent years, it is useful to pay more attention to the development of natural gas revenues and interest expenditure. The following table contains a number of key statistics.

At the start of this government a reduction in the natural gas revenues of € 2.5 billion was already envisaged for this government term. A considerable production restriction in Groningen and lower energy and natural gas prices in recent years, mean that € 2.8 billion worth of natural gas revenues will trickle into the treasury's coffers in 2017, which is merely a quarter of the level forecast at the end of 2012 for 2017. When compared with forecasts at the start of this government, this means a setback for the treasury of € 8.8 billion in 2016 and € 8.3 billion in 2017.

Table: Comparison of projected natural gas revenues and interest expenditure, 2013-2017

(in € billion)	2013	2014	2015	2016	2017
Natural gas revenues [(a)]					
Forecast Initial Policy Memorandum 2012	13.5	12.7	12.0	11.6	11.0
Forecast Budget Memorandum 2017	15.2	10.3	5.3	2.8	2.8
Difference (effect on budget balance)	1.7	-2.4	-6.7	-8.8	-8.3
Interest expenditure [(b)]					
Forecast Initial Policy Memorandum 2012	9.1	9.9	10.6	11.7	12.4
Forecast Budget Memorandum 2017	8.7	8.4	7.9	7.1	6.4
Difference (effect on budget balance)	-0.5	-1.4	-2.7	-4.6	-6.0
Net effect on budget balance	2.2	-0.9	-4.0	-4.2	-2.2

Source: Initial Policy Memorandum 2012 (Parliamentary Papers II 2012/13, 33 400, no. 18) and various Budget Memoranda, Annex 1, tables 1.9 (interest expenditure) and 1.14 (gas revenues).

(a) Natural gas revenues on a transaction basis including corporate tax revenues.

(b) Interest expenditure excluding interest rate swaps.

4 2017 Budget Memorandum, table 3.5.5.

These setbacks for the budget balance are compensated to a significant degree by much-better-than-projected interest expenditure for the State. Due to the current, very low interest rate in the capital market, interest expenditure will be halved in 2017 vis-à-vis projections at the start of this government. At present interest expenditure for the State in 2017 is projected at € 6.4 billion, whereas at the start of this government, € 12.4 billion interest expenditure was forecast for 2017.

When setbacks for natural gas revenues and windfalls for interest expenditure are totalled, then on balance for 2015, 2016 and 2017, there are considerable setbacks for the budget balance, amounting to € 4.0 billion in 2015, € 4.2 billion in 2016 and € 2.2 billion in 2017. On balance, this has severely burdened the budgetary issues facing this government in recent years. Were interest expenditure to rise again somewhere in the future due to a normalisation of monetary policy, natural gas revenues will structurally remain lower than in the past. In structural terms, that means that it must enable a significant setback in the budget.

On balance, higher revenues and lower expenditure lead to an improvement of the budget deficit. The actual budget deficit drops to 1.1% of GDP in 2016 and 0.7% of GDP in 2017, including incidental factors (contributions to the EC, personal pension fund management schemes). When excluding these factors, the deficit would reduce much less to 1.4% of GDP in 2016 and 1.0% of GDP in 2017. In the Macro Economic Outlook the structural government balance in 2017 gradually approaches the medium-term budgetary objective (MTO) (for the Netherlands, not higher than –0.5% of GDP).

On some points the government maintains somewhat more optimistic forecasts than the CPB, among other things in respect of the growth of revenue, the growth of wages in the public sector, and the development of various regulations for social security. Hence both the actual and structural deficit in 2017 in the Budget Memorandum are more favourable by 0.2pp than in the Macro Economic Outlook. These deviations with the Macro Economic Outlook are not explained in more detail in the Budget Memorandum.

In recent actual figures and forecasts, the budget balance of local and regional governments has shown a very steady development (consistently around –0.3% of GDP), which is in line with the gradual reduction of the deficit of local and regional authorities on a macro-level, as agreed to in the Financial Agreement between the government and the local and regional governments in January 2013.

General government debt reduces further and results in 63.3% of GDP in 2016 and 61.8% in 2017. This means that the debt is gradually approaching the European criterion of 60% of GDP.

2.3 The medium-term outlook
The CPB has also presented an update of its forecast for the medium term.[5] The macroeconomic prospects are marginally lower than forecast last spring,[6] mainly because of the uncertainty as a result of the outcome of the Brexit referendum. For the 2018-2021 period, the CPB now forecasts an average growth of 1.7% per annum. Economic growth is broadly based. However, expectations are enveloped with uncertainties, which are mostly downwards.

Steady recovery of the Dutch economy in the years 2018-2021 is also expressed in an improvement of public finances, assuming a no-policy-change scenario. As from 2019 the actual budget balance will reverse in the medium-term forecast from a deficit into a surplus and will result in 0.9% of GDP in 2021. At the end of 2021, general government debt amounts to just over 52% of GDP.

In its 2018-2021 Medium-term forecast, the CPB also provided a new analysis of sustainability of public finances in the long term.[7] This showed that, given certain assumptions, public finances are sustainable in the long term.[8] In the medium-term forecast update, the sustainability balance results in 0.4% of GDP.[9] However, given the uncertainties surrounding such analyses, in its recommendations on the 2017 Budget Memorandum, the Advisory Division placed some comments to put this into perspective.

3. <u>Assessment under European and national fiscal rules</u>

3.1 Assessment framework
In the context of independent budgetary supervision, the Advisory Division assesses whether the actual and forecast development of public finances complies with European and national fiscal rules. In respect of *European fiscal rules*, the assessment framework is guided by the Stability and Growth Pact (SGP) of 1997, and later amendments related to it.[10]

Since 2014 the Netherlands falls under the so-called ‘preventive arm’ of the SGP. Certain rules apply under the preventive arm in respect of the structural budget balance, which is the budget balance adjusted for the economic cycle and one-off measures, and the growth in public expenditure adjusted for discretionary tax measures, fluctuations in investment expenditure and the cyclical component of unemployment benefits expenditure.

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[5] CPB, 2017 Macro Economic Outlook, September 2016, chapter 4.
[6] CPB, 2018-2021 Medium-term Forecast, March 2016.
[7] CPB, 2018-2021 Medium-term Forecast, 30 March 2016.
[8] In its 2016 Spring Report, the Advisory Division has dealt with this in more detail (2016 Budget Supervision Spring Report, no. W06.16.0070/III/B, 8 April 2016, paragraph 3.4 (annex to Parliamentary Papers II 2015/16, 21 501-07, no. 1352)).
[9] CPB, 2017 Macro Economic Outlook, September 2016, chapter 4.
[10] In particular the supplements which emanate from the so-called ‘Six Pack’ (2011), the Treaty on Stability, Coordination and Governance (TSCG) in the Economic and Monetary Union (EMU) (2012) and the so-called ‘Two Pack’ (2013).

Each particular fiscal year is assessed at three different points in time: prior to (*ex ante*), during (*in year*) and after the ending of the fiscal year (*ex post*). The *ex post* assessment takes place based on the European Commission's Spring Forecast in the spring following the fiscal year under review, and is important because the Commission uses this as a basis to establish whether there is cause to start a formal ‘significant deviation procedure’. Such a procedure could ultimately lead to financial sanctions. It's for this reason that the Advisory Division has paid separate attention in its 2016 Spring Report to the development of public finances for the year 2015.[11] In the report at hand, the year 2015 is not under review, because the *ex post* assessment is concluded in the spring following the year under review. This report therefore only assesses the financial years 2016 (*in year*) and 2017 (*ex ante*).

The Sustainable Public Finances Act provides the assessment framework in respect of *national fiscal rules*. In Article 2, this legislation regulates that the government pursues a trend-based fiscal policy, with due observance of fixed expenditure ceilings and the principle of automatic stabilisation on the revenue side of the budget, and with due observance of European fiscal rules. The Advisory Division assesses the extent of compliance and also includes the fiscal rules as established by the government in the so-called Initial Policy Memorandum at the beginning of the government term in its assessment.[12] In the Stability Programme last spring, the government indicated that it shall apply the regular national budgetary framework.[13]

3.2 Assessment under European fiscal rules

Table 3 reflects statistical data relevant for the assessment under European fiscal rules, derived from the 2017 Macro Economic Outlook. The assessment takes place based on this data. In the 2017 Budget Memorandum the government maintains somewhat more favourable figures for both the actual as well as the structural deficit.

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[11] See 2016 Budget Supervision Spring Report, no. W06.16.0070/III/B, 8 April 2016 (annex to Parliamentary Papers II 2015/16, 21 501-07, no. 1352).
[12] Initial Policy Memorandum 2012, annex 1 (Parliamentary Papers II 2012/13, 33 400, no. 18).
[13] 2016 Stability Programme, page 3 (annex for Parliamentary Papers II 2015/16, 21 501-07, no. 1352).

Table 3: Data on European fiscal rules

	2015	2016 *in year*	2017 *ex ante*
Rule in respect of development of the structural balance (% of GDP)			
General government balance (actual)	-1.9	-1.1	-0.7
General government balance cyclical component	-0.8	-0.4	-0.2
One-off and other temporary measures	0.0	0.3	0.3
General government structural balance (EC method)	-1.1	-0.9	-0.8
Change in general government structural balance	-0.5	0.2	0.1
Required budgetary effort [a]	-0.3	-0.2	0.4
Deviation	-0.1	0.3	-0.3
Expenditure rule			
Adjusted net public expenditure (actual change in %)	0.4	0.8	0.7
Required budgetary effort[b]	1.4	1.2	-0.3
Deviation	-1.1	-0.4	0.9
Deviation (% of GDP)	-0.5	-0.2	0.4
Debt criterion (% of GDP)			
General government debt	65.1	63.3	61.8
Maximum debt based on debt criterion[c]			64.9

Source: CPB, 2017 Macro Economic Outlook, table 3.2

(a) In the required budgetary effort for the structural balance, a positive sign should be read as the minimum improvement required of the structural deficit in % of GDP; a negative sign should be read as the maximum permitted deterioration of the structural deficit, likewise in % of GDP.

(b) In the required budgetary effort for the expenditure rule, a positive sign should be read as the maximum permitted growth (in %) of the adjusted net public expenditure. A negative sign implies a negative growth margin.

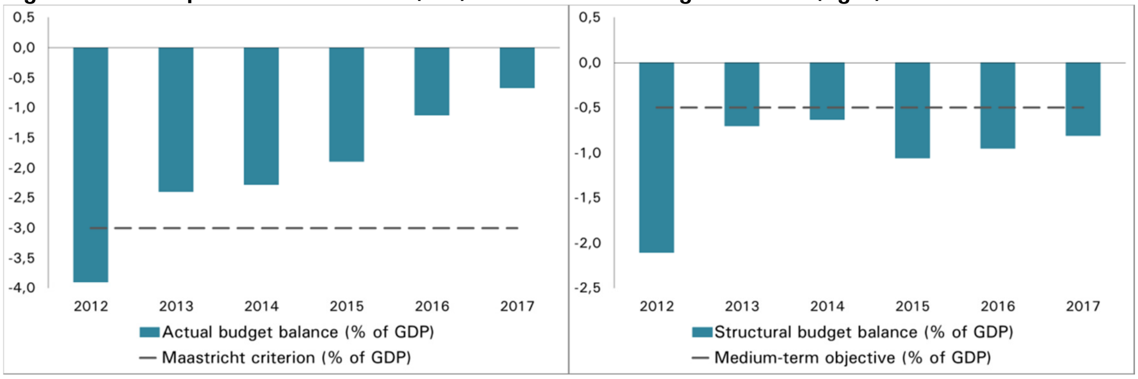
(c) Maximum permitted general government debt in % of GDP compliant with the requirement that general government debt must reduce annually by one-twentieth of the deviation between the actual debt and the Maastricht criterion of 60%.

Budget deficit development

The *actual budget deficit* is improving and according to the Macro Economic Outlook will remain below 3% of GDP in both 2016 and 2017 (see figure 1, left). This means that the actual budget deficit complies with the European reference value of 3% of GDP.

The Advisory Division's assessment is therefore geared towards the *structural budget deficit*, the budget deficit adjusted for the economic cycle and one-off measures. According to European fiscal rules, the structural government balance must comply with the *medium-term budgetary objective* (MTO) applicable to The Netherlands. At this point in time an MTO of –0.5% of GDP applies for the Netherlands.

Figure 1: Development of the actual (left) and structural budget balance (right)



In the Macro Economic Outlook, the CPB forecasts a structural deficit of 0.9% of GDP for 2016; the structural deficit in 2017 is 0.8% of GDP. This means that the structural deficit in both years does not comply yet with the MTO, but it is gradually approaching the objective (see figure 1, right). As long the structural budget balance does not comply with the MTO, the structural government balance must improve every year until the objective has been achieved. As a benchmark, an improvement of the structural budget balance by 0.5% of GDP per annum is required, but the precise extent of the required budgetary effort depends on the economic cycle and the extent of general government debt. Taking the required budgetary effort for the structural balance for the year 2017 as an example, a further explanation is given in the text box below about the manner in which the required budgetary effort is established.

The required budgetary effort for the year 2017

Agreements apply in the preventive arm of the Stability and Growth Pact in respect of development of the structural government balance and development of public expenditure net of discretionary tax measures, fluctuations in investment expenditure and some cyclical items. As long the structural budget balance of a Member State does not comply with the MTO for that Member State, the structural government balance must improve every year until the objective has been achieved. In this, an improvement of the structural budget balance by 0.5% of GDP per annum is required as a benchmark, but the SGP offers some room for flexibility.

In 2015 the European Commission proposed an elaborated operational definition of that flexibility,[14] in which the annually required improvement of the structural government balance is dependent on the cyclical situation in a Member State (measured by the extent of the so-called *output gap*, the deviation between the actual and forecast production capacity), the extent of general government debt, and the sustainability risk. The Council of Finance Ministers (ECOFIN Council) adopted the Commission's proposal in respect of establishing the required budgetary effort early 2016.[15]

[14] See EC, Making the best use of flexibility within the existing rules of the Stability and Growth Pact (COM(2015) 12 final/2), 10 February 2015, annex 2.

[15] Adoption by the ECOFIN Council of Council document 14345/15 ('A commonly agreed position on Flexibility within the SGP') of 12 February 2016.

The required budgetary effort for the structural government balance, the minimum improvement required as long as the MTO is not complied with, is based on the matrix below. The required budgetary effort for the structural balance for year *t* is determined in the spring of the year *t−1*, based on the forecast structural balance for the year *t−1* in the European Commission's Spring Forecast of that year. Thereafter the required budgetary effort is 'frozen' and in principle is not adjusted anymore, unless a reduced required budgetary effort emerges from a later forecast.

		Required annual fiscal adjustment (in % of GDP)	
	Condition	*Debt ≤ 60% and low/medium sustainability risks*	*Debt > 60% or high sustainability risks*
'Exceptionally bad' times	*Real growth < 0 or output gap < −4*	No adjustment needed	
'Very bad' times	*-4 ≤ output gap < −3*	0	0.25
'Bad' times	*-3 ≤ output gap < −1.5*	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.5 if growth above potential
'Normal' times	*-1.5 ≤ output gap < 1.5*	0.5	> 0.5
'Good' times	*Output gap ≥ 1.5*	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	≥ 0.75 if growth below potential, ≥ 1 if growth above potential

The method described above for the *ex ante* review for 2017 implies, that for the required improvement of the structural government balance, the 2016 structural government balance in the European Commission's 2016 Spring Forecast must be used. In the Spring Forecast the structural government balance in 2016 resulted in −1.5% of GDP,[16] with which the structural government balance for the Netherlands did not comply with the MTO. Based on the economic cycle ('normal' economic times, output gap between -1.5 and 1.5) and the extent of general government debt (> 60% of GDP), for the Netherlands this results, based on the matrix, for 2017 in a required budgetary effort of > 0.5% of GDP, which, as a matter of convention, means a required improvement of the structural government balance of at least 0.6% of GDP. This is also in line with the country-specific recommendations that the Council of Finance Ministers addressed to the Netherlands in the spring.[17]

In the 2017 Macro Economic Outlook, the CPB forecasts a structural deficit of 0.9% of GDP for 2016. In that case, an improvement of 0.6% of GDP would mean that the structural government balance would improve by more than what is strictly necessary to achieve the MTO. Since, on grounds of European fiscal rules, a Member State does not have to overachieve on its MTO, the 2017 required budgetary effort for the structural government balance, based on the 2017 Macro Economic Outlook, now results in 0.4% of GDP, or 0.2pp lower in comparison with the spring forecast.

[16] EC, European Economic Forecast: Spring 2016, European Economy Institutional Paper, no. 025, May 2016.
[17] Official Journal of the European Union 2016, C 299/10.

The extent of the required budgetary effort for the structural government balance is also relevant for the required budgetary effort for the expenditure rule. Due to the required budgetary effort for the structural government balance being lower, slightly more room to manoeuvre also applies for the 2017 expenditure rule than was expected on grounds of the European Commission's Spring Forecast.

With regard to 2016, based on the assumption of ‘freezing the required budgetary effort’, the European Commission's 2015 Spring Forecast is relevant.[18] Since compliance with the MTO was still assumed in 2015 in the 2015 Spring Forecast,[19] for 2016 a minor deterioration of the structural government balance of 0.2% of GDP, is permitted. As the 2016 structural government balance improves slightly (by 0.2% of GDP in respect of 2015) according to the Macro Economic Outlook, the structural government balance complies with the required budgetary effort in 2016 (figure 2, left).

Based on the current required budgetary effort the 2017 structural government balance must improve by 0.4% of GDP. According to the Macro Economic Outlook the 2017 structural government balance improves by 0.1% of GDP in respect of 2016. Hence the improvement falls short in respect of the required budgetary effort. However, this deviation remains below the threshold above which it would qualify as a so-called ‘significant’ deviation. A deviation is considered to be significant if development of the structural budget balance, calculated over one year, deviates by at least 0.5% of GDP (in a negative sense) from the required budgetary effort.[20] Furthermore, a deviation is considered significant if there is a deviation over two years accumulatively of at least 0.5% of GDP, or, if taken over a period of two years, on average there is a deviation of 0.25% of GDP or more per year.

<u>Growth in adjusted net public expenditure</u>

The European expenditure rule sets a limit on the permitted growth of public expenditure net of discretionary revenue measures. In this, public expenditure is adjusted for the cyclical component of unemployment benefits expenditure, interest expenditure, and for fluctuations in investment expenditure. The maximum permitted growth of adjusted net public expenditure is based on the long term trend-based economic growth and is further dependent on the required budgetary effort for the structural government balance.

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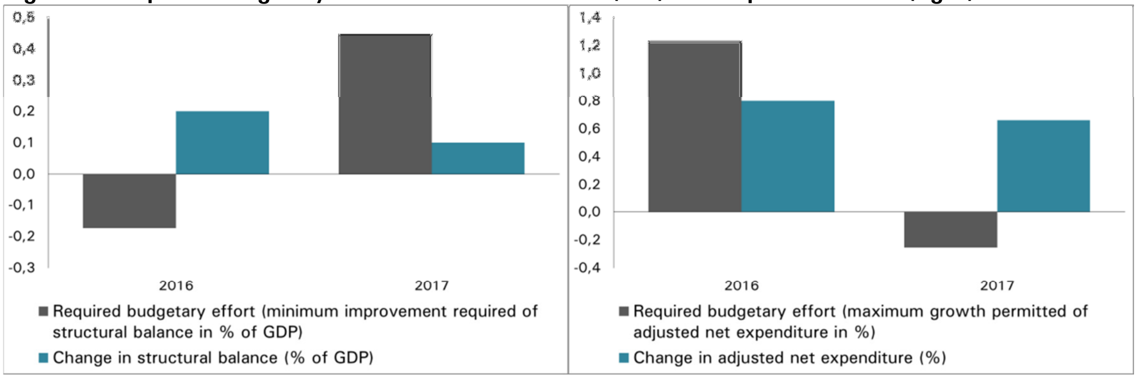
[18] In the 2016 Spring Report the Advisory Division has dealt with the principle of freezing the required budgetary effort in more detail. See 2016 Budget Supervision Spring Report, no. W06.16.0070/III/B, 8 April 2016, page 17 (annex for Parliamentary Papers II 2015/16, 21 501-07, no. 1352).

[19] EC, European Economic Forecast: Spring 2015, European Economy, no. 2, May 2015.

[20] Article 6(3) of Regulation (EC) 1466/97, amended in Regulation (EU) 1175/2011.

Figure 2: Required budgetary effort structural balance (left) and expenditure rule (right)



Since the structural budget balance itself was still below the MTO in the European Commission's 2015 Spring Forecast, based on the expenditure rule the adjusted net expenditure may rise by a maximum of 1.2% in 2016. According to the Macro Economic Outlook the adjusted net public expenditure in 2016 will grow by 0.8%, which means that this growth remains within the maximum permitted growth margin (figure 2, right).

Due to the 2016 structural government balance no longer being compliant with the MTO, according to the European Commission's 2016 Spring Forecast,[21] in 2017 the rise of adjusted net public expenditure based on European fiscal rules must lag behind the economic growth trend for the medium-term, or must be compensated by discretionary measures on the revenue side. On the basis of CPB's Macro Economic Outlook, for 2017 this translates into a required budgetary effort which entails that the adjusted net public expenditure must fall by 0.3% in respect of 2016.[22] With the current rise of corrected expenditure of 0.7% envisaged for 2017, this rule is not being complied with. The deviation remains below the threshold of 0.5% of GDP above which this would qualify as a significant deviation.

Development of general government debt

The European debt criterion determines that general government debt must be lower than 60% of GDP or, on exceeding the criterion, that the general government debt decreases every year by at least one-twentieth of the difference between the actual general government debt and the threshold, in which, in brief, the average annual reduction is monitored over a period of three years.[23]

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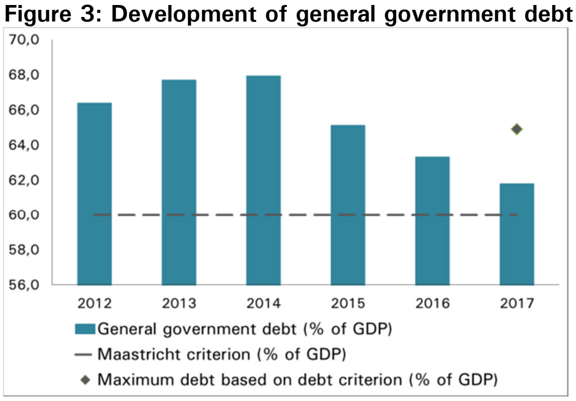
[21] EC, European Economic Forecast: Spring 2016, European Economy Institutional Paper, no. 025, May 2016.

[22] Since the 2016 structural government balance is projected more favourably in the CPB's 2017 Macro Economic Outlook than in the European Commission's 2016 Spring Forecast, the required budgetary effort for the expenditure rule is also lower in comparison with that in the spring.

[23] For Member States, including the Netherlands, which still found itself in an excessive deficit procedure in 2011, a transition period for the debt rule applies for the subsequent three years after the year in which the actual deficit was brought below the reference value of 3% of GDP. The transition period therefore still applies for the debt rule for 2016, because the Netherlands corrected its excessive deficit in 2013.

Figure 3: Development of general government debt



General government debt, as measured in relation to the GDP, reached its highest level since the financial crisis in 2014. Since 2015, general government debt has been declining (figure 3). In the 2017 Macro Economic Outlook general government debt in 2016 results in 63.3% of GDP, and 61.8% of GDP in 2017. Though this means that general government debt is still above the criterion of 60% of GDP, the debt quote drops fast enough in both years to comply with the European debt criterion.[24]

The years after 2017

The Advisory Division has previously pointed out that a full assessment, in its opinion, should also relate to the years after the budget years, and advocated the drawing up of more up-to-date and consistent medium-term forecasts.[25] In a qualitative context, the European Commission also uses the medium-term forecast for its assessment.[26] After all, a medium-term forecast places the fiscal years under consideration in context. This is also relevant because the methodology of 'freezing' the required budgetary effort for one year, could have consequences for the required budgetary efforts in later years.[27]

From the medium-term forecast update it appears that public finances in the Netherlands will improve further after 2017. As from 2018, under the assumption of a no-policy-change scenario, public finances comply with European fiscal rules.[28] In the medium term, the structural budget deficit complies with the MTO,

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[24] The maximum permitted general government debt compliant with the requirement that general government debt must reduce annually by one-twentieth of the deviation between the actual debt and the Maastricht criterion of 60%, amounts to 64.9% of GDP for 2017.

[25] 2015 Budget Supervision September Report, no. W06.15.0305/III/B, 14 September 2015, page 14 (annex for Parliamentary Papers II 2015/16, 34 300, no. 3).

[26] See EC, Vade Mecum on the Stability and Growth Pact: 2016 edition, European Economy Institutional Paper, no. 021, March 2016, page 32.

[27] The Advisory Division therefore also endorses the recommendations, made in the fifteenth report of the Study Group on Fiscal Policy, to update the medium-term projections annually (Van saldosturing naar stabilisatie, Fifteenth Report of Study Group on Fiscal Policy, July 2016 (annex for Parliamentary Papers II 2015/16, 34 300, no. 74)).

[28] CPB, 2017 Macro Economic Outlook, September 2016, chapter 4.

it meets the expenditure rule, and general government debt also complies with the Maastricht criterion of 60% of GDP. For 2021 a minor structural surplus is forecast. At the end of 2021 general government debt is expected to amount to just over 52% of GDP. It should be noted, however, that these results assume that the available room for budgetary manoeuvre is used in favour of the budget balance and is not applied for additional tax-relief measures (for example, in compensation of rising health insurance premiums) or increasing public expenditure.

Conclusion

Taking the three criteria in conjunction with each other into consideration, the Advisory Division comes to the conclusion that the 2016 budget is compliant with European fiscal rules.

In 2017 the structural government balance approaches the MTO, in which it is also of relevance to include the working method of the European Commission in its *ex post* assessment.[29] General government debt also decreases sufficiently. In the medium term the structural government balance complies with the MTO and general government debt is below the criterion of 60% of GDP. Nonetheless, in 2017 both development of the structural government balance and development of the adjusted net public expenditure in current forecasts are not compliant with the required budgetary effort. Deviations continue to stay below the threshold above which they would be considered to be a ‘significant’ deviation. On balance, the Advisory Division concludes that the 2017 budget does not fully comply with European fiscal rules.

Table 4 shows a summarized result of the review under European fiscal rules.

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[29] Given the uncertainties inherently surrounding the calculation of the structural government balance, in its *ex post* assessment the European Commission maintains a margin of uncertainty of ¼ % of GDP to ascertain compliance with the MTO. However, this margin of uncertainty does not apply for the *in year* and *ex ante* assessments (see EC, Vade Mecum on the Stability and Growth Pact: 2016 edition, European Economy Institutional Paper, no. 021, March 2016, page 37). Nonetheless, the 2017 structural government balance, based on the Macro Economic Outlook, approximates the MTO when taking into account the maintained margin of uncertainty.

Table 4: Summarizing overview of reviewed European fiscal rules

	2016	2017
Actual budget balance	✓	✓
Structural government balance [(a)]	✓	O
Expenditure rule[(a)]	✓	O
Government debt	✓	✓

Explanatory note on symbols used:

✓ compliance with the relevant rule

O there is evidence of a deviation from the rule, but this deviation is not significant

× there is evidence of a deviation from the rule, and calculated over 1 year and/or over 2 years, on average this deviation is significant (only applies for structural government balance and expenditure rule, see note)

(a) For the structural budget balance and the expenditure rule there is evidence of a 'significant' deviation if the deviation (in a negative sense), calculated over one year amounts to at least 0.5pp of GDP. It also qualifies as a significant deviation if there is evidence of a deviation of at least 0.5pp of GDP cumulatively over two years.

3.3 Assessment under national fiscal rules

As the independent national budget supervisory authority, the Advisory Division also has the task of making assessments regarding national fiscal rules publicly accessible.[30] In the Advisory Division's opinion the national fiscal rules should also be reviewed now that the government in the Stability Programme has stated it will apply the regular national budgetary framework. In the Stability Programme the government assured that as a result of applying the regular framework, the Netherlands would remain within the permitted margins of European fiscal rules under the preventive arm of the Stability and Growth Pact.[31] In its response to the Spring Report by the Advisory Division, the government furthermore stated that “government efforts are geared towards maintaining the expenditure and revenue ceilings”.[32]

The national fiscal rules, the principles of which are provided for in the Sustainable Public Finances Act, assume maintaining the so-called revenue and expenditure ceilings. At the start of every government term the national rules are established in the so-called Initial Policy Memorandum. For the duration of the government term, the national framework of expenditure frameworks establishes a fixed ceiling for each individual year of the total expenditure. For the revenue side of the budget, a so-called revenue ceiling is set for the total policy-related tax development (increases in the tax burden or alternatively tax relief) for the full government term. 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.

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30 Article 5(2) of Regulation (EU) 473/2013.

31 2016 Stability Programme, page 3 (annex for Parliamentary Papers II 2015/16, 21 501-07, no. 1352).

32 2016 Budget Supervision Spring Report, no. W06.16.0070/III/B, 8 April 2016, page 27 (annex for Parliamentary Papers II 2015/16, 21 501-07, no. 1352).

The Advisory Division ascertains that forecasts for both the budget balance and general government debt for 2016 and 2017, according to the Macro Economic Outlook, are more favourable than were expected at the beginning of the government's term, and the structural government balance, in the meanwhile, is approaching the MTO. In light of the fact that the Initial Policy Memorandum did not comply with European requirements, that is certainly an achievement, especially when considering that in 2017 the government had to incorporate a net negative effect of € 2.2 billion of lower natural gas revenues in the budget (see text box 'The development of natural gas revenues and interest expenditure').

At the same time the Advisory Division observes that both the expenditure ceiling and revenue ceiling for 2017 are adjusted to enable additional policy measures (additional expenditure for social priorities and improvement of purchasing power). However, a detailed explanation on these so-called adjustments to expenditure and revenue ceilings is not presented in the Budget Memorandum. In total this concerns an amount of € 2.7 billion, of which € 2.2 billion is on the expenditure side and € 0.5 billion on the revenue side.[33]

The Advisory Division points out that these adjustments to expenditure and revenue ceilings are inconsistent with the Netherlands' trend-based fiscal policy. Trend-based fiscal policy, which has proven its usefulness over the past few decades and is also respected internationally, assumes fixed expenditure and revenue ceilings which are established at the beginning of a new government term for the entire period.[34] An interim adjustment of the ceilings merely to enable additional policy measures, is inconsistent with the national budgetary framework.

The aforegoing is an issue, since the government assured in the Stability Programme to maintain the regular national budgetary framework in order to comply with European fiscal rules. If the government had followed the national budgetary framework and fitted the invigoration of policy within the ceilings, as prescribed by the national fiscal rules, then the 2017 budget would have complied fully with European fiscal rules.

Finally, the Advisory Division points out that in light of European fiscal rules, the importance of a consistent and effective national budgetary policy has increased even further. In the last few decades the Dutch trend-based fiscal policy has proven its usefulness, but its success depends on the degree to which the government adheres to the rules to which it has committed itself. By adjusting the expenditure and revenue ceilings without further explanation merely to enable

[33] Of this, € 1.6 billion relates to the package of 'social priorities' and € 1.1 billion to improvement of the purchasing power package (2017 Budget Memorandum, table 3.2.1). In order to relieve the 2017 budget, movements of funds will take place both to 2016 as well as to later years (2017 Budget Memorandum, table 3.6.2). In addition, the phasing out of the personal pension fund management schemes for directors-principal shareholders likewise leads to windfall revenues of € 2.1 billion in 2017.

[34] See the Explanatory Memorandum of the Sustainable Public Finances Act (Parliamentary Papers II 2012/13, 33 416, no. 3, page 4).

additional policy measures, the credibility of the trend-based fiscal policy is undermined.

4. Response from the government

In the interests of quality and meticulousness in drawing up the assessment, a draft assessment was presented to the government. The Advisory Division makes its final assessment after being informed of the government's response. The government's response to the draft assessment is included in full in this report.

“The government thanks the Advisory Division of the Council of State (hereafter called: the Advisory Division) for its assessment on the development of public finances and to which extent this development complies with the rules of the Stability and Growth Pact (SGP).

The government is pleased to have taken due note of the Advisory Division's assessment that the 2016 budget complies fully with European fiscal rules. The Advisory Division also points out that certain aspects of the 2017 budget are not in line with requirements for development of the structural government balance and development of public expenditure, but that the deviations are not considered as significant. If a Member State deviates from the criteria, but the deviations are not significant, then the budget falls within the margins of the preventive arm of the SGP. In such circumstances, the European Commission analyses the budgetary situation in more detail without imposing any additional measures. The government is looking forward to the European Commission's analysis with confidence.

Public finances are also improving strongly in the medium term, as also the Advisory Division concludes. Without additional policy, the government is expecting to show both an actual as well as a structural surplus in the 2019 budget. According to the Budget Memorandum, general government debt will drop to below the prescribed criterion of 60% of GDP in 2019. Moreover, the Netherlands has a sustainability surplus; in the long-term, future generations can make use of the same provisions for the same tax burden, as do current generations.

The coalition agreement of the Rutte-Asscher government is based on three pillars. In addition to strengthening public finances, the government wants to ensure equitable income distribution and to stimulate sustainable economic growth. The government has strengthened the public finances and, the Advisory Division notes that, given the lower natural gas revenues, this is an achievement in itself. The strengthening of public finances has gone hand in hand with sacrifices which have been made by groups in society.

In light of this, the government believes it is desirable to make funds available in 2017 for policy areas that call for additional attention due to current circumstances. Take for example, the changing security situation along the borders of Europe. The government is also reversing an intended budgetary cut-back in nursing home care, and it has assured a well-balanced growth in purchasing power for 2017.

In its assessment, the Advisory Division notes that financial room for budgetary manoeuvre for these social priorities has been found by the government by adjusting the expenditure and revenue ceilings. The trend-based fiscal policy is a prized possession and a good custom in the Netherlands; it provides guidelines for a healthy development of public finances. Hence, maintaining the frameworks has also been the starting point for the government in its preparation of the budget. The efforts of this requirement, including a considerable challenge as a result of the 'terms of trade' issue, have already ensured at an early stage of the budget preparation that the Netherlands complies with the Stability and Growth Pact. In the eventual choices made for the budget, the government has sought a balance between the three pillars in the coalition agreement. With the prospect of a surplus within a few years and a general government debt that will decrease below the criterion of 60% of GDP in the same period, the government considers it justified to make additional budgetary resources available, now that, in the government's opinion, current developments are calling for it."

The response from the government does not prompt the Advisory Division to change its assessment.

5. Assessment

In light of the findings and conclusions in the analysis above, as well as the response from government on the draft assessment, the Advisory Division of the Council of State assesses the following.

1. In respect of the year 2016, based on forecasts in the Macro Economic Outlook, the Advisory Division concludes that the Netherlands' public finances are compliant with European fiscal rules.

2. In 2017 the structural government balance gradually approaches the MTO and general government debt reduces sufficiently. In the medium term the structural government balance complies with the MTO and general government debt is below the criterion of 60% of GDP. Nonetheless, in 2017 both development of the structural government balance and development of the adjusted net public expenditure in current forecasts are not compliant with the required budgetary effort. Deviations continue to stay below the threshold above which they would be considered to be a 'significant' deviation. On balance, the Advisory Division concludes that the 2017 budget does not fully comply with European fiscal rules.

3. In respect of the national budgetary framework, the Advisory Division ascertains that both the expenditure and revenue ceilings are adjusted to enable additional policy measures (additional expenditure for social priorities

and improvement of purchasing power). These adjustments to expenditure and revenue ceilings are inconsistent with the national budgetary framework. This is an issue, since the government assured in the Stability Programme to maintain the regular national budgetary framework to comply with European fiscal rules. If the government had followed the national budgetary framework and fitted the invigoration of policy within the ceilings, as prescribed by the national fiscal rules, then the 2017 budget would have complied fully with European fiscal rules.

4. Finally, the Advisory Division points out that in light of European fiscal rules, the importance of a consistent and effective national budgetary policy has increased even further. In the last few decades the Dutch trend-based fiscal policy has proven its usefulness, but its success depends on the degree to which the government adheres to the rules to which it has committed itself. By adjusting the expenditure and revenue ceilings without further explanation merely to enable additional policy measures, the credibility of the trend-based fiscal policy is undermined.

Vice-President of the Council of State,

[signed]