

Budget Supervision Spring Report 2015

1. Introduction

Under the Sustainable Public Finance Act (the HOF bill), the Advisory Division of the Council of State has been designated as the body responsible for the independent monitoring of compliance with EU fiscal rules as provided for in the Treaty on Stability, Coordination and Governance (TSCG) and Article 5 of Regulation 473/2013 / EU. It is the task of the independent fiscal monitoring institution to establish publicly available reviews on whether a country fulfils the European budget commitments.

In September 2014, the Advisory Division first assessed the budget and the Budget Memorandum (Miljoenennota) in the light of the European fiscal rules.¹ Given the essential steps in the national budgetary policy cycle and the evolving practice in other European countries, the Division concluded that it would also report in the spring. In the spring, the Netherlands Bureau for Economic Policy Analysis (CPB) publishes the first short-term forecasts of economic and fiscal outlook, the outlines of the fiscal policy are formulated by the government and the government presents the annual stability program to the European Commission.

An assessment in the context of the independent fiscal supervision will cover the expected budgetary developments and plans as adopted by the government; in the spring they are contained in the Stability Program and in the autumn in the Budget Memorandum.

In the interest of the quality and accuracy of the established review, the Division has the opportunity to take note of the draft version of the Stability Program. Subsequently, the Division has adopted a concept assessment. The government has been able to comment on this before it adopted its final Stability Program. The Division then established its final assessment on the basis of this definitive Stability Program. The official response from the government on this concept assessment is mentioned in paragraph 4 and is included in full in the appendix. This will ensure that justice is done in the procedure to the respective responsibilities and possible differences in considerations and that it is reported in the final assessment of the Division. This procedure is similar to the state of affairs in the reports of other High Councils of State such as the Court of Auditors and the National Ombudsman.

During the September assessment of the budgetary proposals of the government as contained in the Budget Memorandum, it will be dealt with in accordance. This assessment will then be distinguished from the advice that the Division delivers

¹ See the separate chapter in the advice of the Advisory Division of 11 September 2014 on the Budget Memorandum (case no. W06.14.0284 / III / B).

annually regarding the policy proposals of the Government in the Budget Memorandum.

The assessments of the Division are established in close cooperation with the CPB. The distribution of tasks means that the establishment of independent forecasts and analyses is the responsibility of the CPB, as stipulated in the HOF bill. The more normative assessment of compliance of the European budgetary commitments has been filed with the Advisory Division by the legislature. The spring report therefore makes more particular use of the first short-term forecasts of the economic and fiscal outlooks published in the Central Economic Plan and in September of the Macroeconomic Outlook.

The assessment framework of the independent fiscal supervision stems from the Stability and Growth Pact (SGP) in 1997, and the subsequent adjustments (especially through the so-called 'Six pack'). Member States have also entered into additional commitments in the intergovernmental Treaty on Stability, Coordination and Governance in the EMU, which entered into force in 2013 and is further put into operation in two Regulations (the 'Two Pack').

The assessment framework is shown in more detail in paragraph 3.1.

Since 2014, the Netherlands has been in the so-called '**preventive arm**' of the Pact. In this situation, the assessment focuses mainly on whether the structural government balance complies with the medium-term objective (MTO), or whether sufficient improvement can be seen in the direction of the MTO and whether the *expenditure growth* lags behind the estimated potential growth of the economy. If the *public debt* exceeds 60% of GDP, further assessment will be performed as to whether it drops towards 60% quickly enough.

Furthermore, it will be assessed whether - if relevant- circumstances require application of a '*correction mechanism*' or *recovery plan*, or whether there are exceptional circumstances that legitimize temporarily deviation.

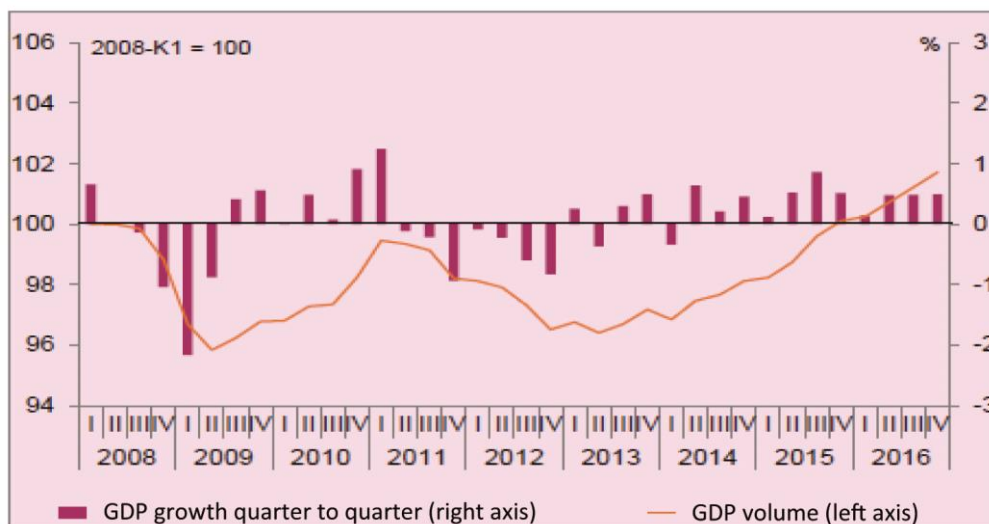
This report consists of a discussion of the macroeconomic outlook and fiscal development, as reflected in the Stability Programme and the Central Economic Plan (section 2). Paragraph 3 contains the review on the basis of the outlined assessment framework. Paragraph 4 contains the response of the Government to the concept assessment. In paragraph 5, the report concludes with the assessment of the Division. The appendix contains the full text of the response of the government.

2. Macroeconomic and fiscal development

The economy in the Euro area shrank by almost 0.5% in both 2012 and 2013, but positive growth can again be recorded from 2014. Over 2014 it remains modest with barely 1%, but for the Euro area, the CPB estimates a further accelerating economic growth of 1.4% in 2015 and 1.8% in 2016 in the Central Economic Plan 2015. On balance, the impact of European budgets on the European economy is almost neutral. A lower Euro exchange rate, lower oil prices and an expected modest positive effect of the purchasing program of the ECB give the European economy tailwind.

For the Netherlands, this leads to a comparable economic development. From 2014, the growth in the Netherlands - unlike in the years 2010 to 2013 - no longer lags behind the average of the Euro area. For 2015 and 2016, the CPB estimates growth rates of respectively 1.7% and 1.8% per year.^{2 3} Incidentally, this means that it will take till end 2015 for the scale of economic activity in the Netherlands to return to the levels of early 2008, the year in which the financial crisis erupted. This illustrates how serious the economic downturn in the Netherlands was and how hesitant the recovery has progressed so far: see Figure 1. Table 1 contains some important key data on the macroeconomic development.

Figure 1 GDP volume in the Netherlands, 2008 – 2016



The great recession in Europe and the Netherlands also highlights the continuation of the significant change in global economic relations. While the gross domestic

² The 'Winter Forecast' of the European Commission, published in early February, have a marginally lower growth forecast of 1.4% in 2015 and 1.7% in 2016.

³ For the production in the private sector (excluding gas), CPB expects a growth rate that is significantly higher; 2.4% in 2015 and 2.6% in 2016. The government production and production in the health sector does not grow as a result of the deficit reducing measures in recent years and gas production shrinks significantly due to the planned drop in production from the Groningen field, so that the growth of total gross domestic product lags behind the growth in the private sector rather significantly.

product in the Netherlands in 2015 reached the level of seven years earlier, Asian growth continued at a fast pace in recent years and gross domestic product in China in 2015 is approximately 75% above the 2008 level, and in India about 55% above the 2008 level.

Table 1 Key data of macroeconomic development, 2010 – 2016

	2010-2013	2014	2015	2016
	(average) mutations per year in percent			
Euro area Economic growth (GDP)	0.7	0.9	1.4	1.8
the Netherlands Economic growth (GDP)	0.1	0.8	1.7	1.8
Household consumption	- 0.7	0.1	1.5	1.7
Employment market sector	- 0.8	0.4	1.2	1.3
Unemployed labour force (in % of labour force)	5.8	7.4	7.2	7.0

Source: Central Economic Plan 2015

The Dutch economy is gradually creeping out of the valley through a difficult recovery of domestic expenditure. This originates in a residential market with high mortgage debt and a malfunctioning rental market; in the banking sector with the need to strengthen their capital position and the funded pension system, with its susceptibility to financial shocks. The recent study by De Nederlandsche Bank "De vermogensopbouw van huishoudens: is het beleid in balans (The wealth of households: is policy in balance)?" And the previous SER report 'Nederlandse economie in stabielere vaarwater; een macro-economische verkenning' brengen dit in beeld (Dutch economy into calmer waters; a macroeconomic study)' reflect this.^{4 5}

For more than two decades, domestic consumption in the Netherlands has fluctuated more than in other European countries. This volatility stems from changes in the (large) value of capital recorded by Dutch households in houses and pensions, as reflected in a recent CPB publication.⁶ Due to the long balance sheets of households with high debt and many fixed and little free savings, households have little other options to adapt than reducing their consumption in case of negative shocks to their income or wealth. As a result the economic contraction during the recession years in the Netherlands was larger than in

⁴ SER, 2013, 'Nederlandse economie in stabielere vaarwater; een macro-economische verkenning (Dutch economy into calmer waters; a macro-economic study)', p. 9.

⁵ DNB, 2015, 'De vermogensopbouw van huishoudens: is het beleid in balans (The wealth of households: is policy in balance)?'

⁶ See CPB Policy Brief 2015/3: 'De Nederlandse consumptie: Goede tijden, slechte tijden (Dutch consumption: The good times and the bad times)'.

neighbouring countries such as Germany and Belgium; which is a mirror image of the development in the ten years before, when growth in the Netherlands was higher than in neighbouring countries. This influence of capital and its volatility also increases the uncertainty surrounding the forecasts of consumption, economic growth and public finance.

The various forecasts show that the process of balance sheet recovery in households, banks and government, while not yet completed, will have a lot less depressing effect on domestic spending in coming years, compared to the past few years. The moderate recovery in home prices helps with that, but the balance sheet recovery seems to be a long process.

After years of stagnation or contraction in consumption, household consumption is once again starting to grow by 1.5% respectively 1.7% in 2015 and 2016 thanks to the increase in real disposable income.

Unemployment has started dropping modestly since early 2014. The growing employment also attracts quite a lot of additional labour supply, which is encouraging for the long-term economic growth.

Some key information about the budgetary development is summarized in Table 2. To place the years 2013 - 2016 in perspective, the five-year period immediately prior to the financial crisis is also included, as well as the year 2010, basically the height of the recession.

Table 2 Key data government finance, 2003 – 2016.

	2003-2007	2010	2013	2014	2015	2016
	as a percentage of GDP					
State expenditure ⁷	23.1	24.9	23.3	23.0	21.9	21.8
Interest expenditure	2.2	1.8	1.5	1.5	1.3	1.2
Social security	11.0	12.1	12.8	12.9	12.7	12.6
- AOW/ANW	4.5	4.7	5.2	5.3	5.3	5.3
- other items	6.5	7.4	7.6	7.6	7.4	7.3
Healthcare	8.2	9.4	9.9	9.9	9.6	9.5
Total gross expenditure	44.5	48.2	47.5	47.3	45.5	45.1
Total revenue	43.5	43.2	45.3	44.8	43.6	43.9
EMU balance	-1.0	- 5.0	- 2.3	- 2.6	- 1.8	- 1.2

Source: Central Economic Plan 2015. The figures for the period 2003 - 2007 relate to the average for the period and are adjusted for the effect of the introduction of the new healthcare system (ZVW) in 2006 (see footnote b, p.90, CEP 2015)

Ten years ago, the Netherlands had a period with a modest budget deficit and, before the recession broke out, even a few years with a budget surplus, which meant that there was a small buffer for bad years. This gave room for manoeuvres to allow the automatic stabilizers to work during the recession, but the budget

⁷ Excluding the state funded expenditure for healthcare and social security and interest expenditure

deficit quickly exceeded 5% of GDP during the deep recession, which was the worst since the thirties.

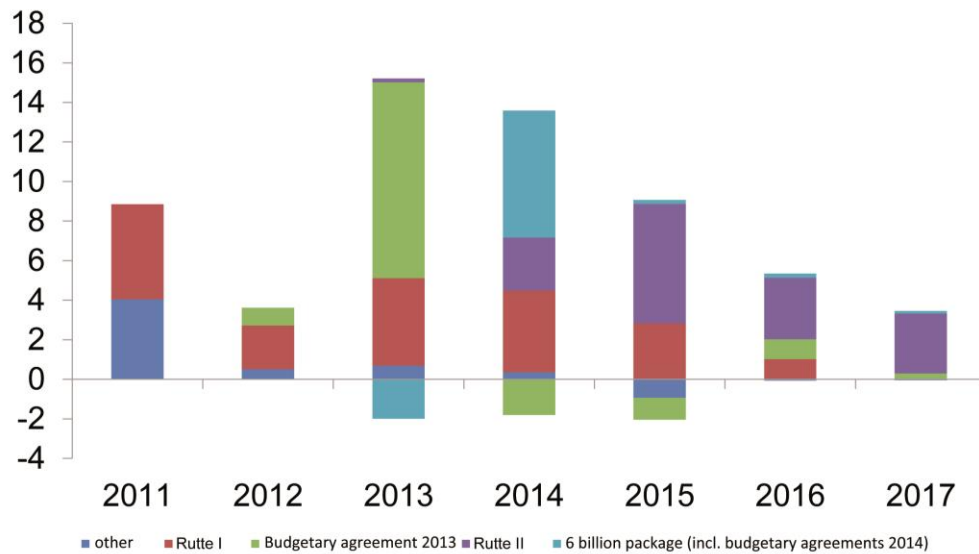
Overall, the increase in collective expenditure exceeded the growth in gross domestic product. In 2010, the gross expenditure ratio was more than 3.5% GDP above the level prior to the recession. Supported by a gradual recovery of economic growth, the growth of collective expenditure clearly lags behind the growth of the economy in the years 2015 and 2016, for the first time since the recession. After years of strong growth, the growth of healthcare expenditure lags behind the growth of the economy from 2015, and the cost of the AOW (state pension) seems to have relatively stabilized from 2014. Nevertheless, social security expenditure and healthcare expenditure together are almost 3% GDP higher in 2016 than in the period prior to the financial crisis, and expenditure in the state budget (excluding interest) is significantly lower.

Due to the strong increase of the deficit, the Netherlands found itself in the excessive deficit procedure of the Stability and Growth Pact in 2009 and was given up to 2013 to gradually reduce the deficit below the ceiling of 3% GDP. In various coalition agreements and supplementary budgetary agreements, packages of measures were put into motion over the past five years, totalling up to € 51 billion in 2017. 70% of these packages was on the expenditure side of the budget, 30% on the side of revenue.

Figure 2 provides a graphical representation of the scope of the deficit-reducing measures, as they have been implemented through the various agreements from 2011. In the years 2015 and 2016, these packages can realise an increase in cuts of € 8 respectively € 5 billion.⁸ A number of reforms such as raising the retirement age, limiting mortgage interest deduction and pension savings will result in significant saving, especially after 2017.

These packages of measures were partly so big because the underlying growth - that is growth without additional policies - in healthcare expenditure and state pension was so high. Many savings measures therefore lead to 'less of more' on balance.

⁸ Also see the Financieel Jaarverslag van het Rijk (Annual State Financial Report), 2013, p. 35.

Figure 2 Scope of deficit-reducing measures, 2011 – 2017

Source: CPB

According to the forecasts in the CEP, summarized in Table 2, this will result in a level of collective expenditure in 2016 that will be 3% lower than at the height of the crisis, but is still higher than the five-year period prior to the recession. Despite high government deficits since the financial crisis, the extremely low interest rates have led to the level of interest expenditure being much lower than before the crisis.

The composition of collective expenditure over the past decade has indeed changed significantly; healthcare expenditure and the state pension expenses for the ageing population grew much stronger than the economy, and expenditure in the state budget, particularly for public administration, lagged significantly behind economic growth. Education expenditure, important for the quality of the workforce in the longer term, are an exception in this context; it followed economic growth.

This picture of growth in healthcare expenditure is true despite numerous cutbacks in the area of healthcare. The affected AOW (state pension) measures grow very gradually. As a result, the state pension expenditure continues to grow due to the many baby boomers retiring during the past five years.

Together with more than € 15 billion revenue increasing measures, it was possible to get the actual budget deficit below 3% GDP in 2013; a daunting task because the economy started shrinking from 2011 as a direct result of the Euro crisis, the strong domestic problems in the housing market and the problems with capital-funded pensions.

Table 3 gives an overview of the figures of the budget deficit and public debt. The assessments of the preventive arm of the Pact refer to the development of the cyclically-adjusted and for non-recurring items adjusted so-called structural balance, and not to the development of the actual balance unless the ceiling value of 3% is exceeded.

Table 3 Budget balance and debt, 2013 - 2016

	2013	2014	2015	2016
	as a percentage of GDP			
EMU balance (actual)	- 2.3	- 2.6	- 1.8	- 1.2
of which EMU balance local authorities	- 0.3	- 0.3	- 0.2	- 0.2
EMU balance structural	- 0.4	- 0.4	- 0.5	- 0.5
EMU debt	68.6	69.0	68.8	67.8

Source: Central Economic Plan 2015

In relative terms, the EMU balance of local governments improved to the same degree as the EMU deficit of the central government, so that it easily met the appointments made in the Administrative consultation between the government and the local governments at the beginning of the government term. The ambition which was agreed in the Financial Agreement between the Government and the local governments of January 2013, will be achieved in the years up to 2016 according to current forecasts, and the agreed standard for the actual EMU deficit of local governments (up to 0.5% of GDP, up to and including 2015) is generously undercut.

3. Review under the European fiscal rules

3.1 *Assessment framework*

In the context of the independent budget supervision, the Division assesses whether the actual and projected development of public finances meet the rules that the Netherlands has to comply with under the Stability and Growth pact.

Since 2014, the Netherlands has been in the preventive arm of the Pact. Based on this, the assessment focuses on whether the *structural government balance* complies with the medium-term objective (MTO), or whether sufficient improvement can be seen in the direction of the MTO. For the Netherlands there is currently a structural MTO balance of -0.5%. This objective is – deriving from the European budget agreements – updated every three years and derived from the long-term sustainability of the public finances of a member country.⁹ It should also be assessed whether the expenditure growth lags behind the estimated potential growth of the economy.¹⁰ If the *public debt* exceeds 60% of GDP, it will be further assessed whether it drops quickly enough towards 60%.¹¹

If countries implement structural reforms with positive effects on public finances in the long term the European budget rules provide more flexibility in applying the above rules.¹² This room was further explained in a recent Communication of the European Commission and provided with criterion.¹³ It involves: the so-called '*structural reform*' clause (temporarily higher deficit possible with structural reforms that increase economic growth and the budget positively) and the so-called '*investment*' clause (specific extra, structural improvement investments via European Funds can be kept outside consideration when assessing the compliance of the budget rules).

In the Stability program the Dutch government does not appeal to these rules in the recent Communication. Therefore, it does not appear in the current assessment.

Although not explicitly described by the SGP, a good assessment, in the opinion of the Division, should partly be related to the long term sustainability of public finances and this should include a risk analysis. Exact numbering creates a false sense of certainty. That makes it desirable in reviews to also pay attention to the uncertainties and risks affecting both forecasts and analysis. Furthermore it is appropriate to monitor in the assessments to what extent possible country-specific recommendations of the EU Council (Ecofin Council) are complied with by the Government.¹⁴

⁹ Article 5, first section, of Regulation 473/2013, in conjunction with section 1bis, article 2bis of Regulation 1466/97.

¹⁰ Article 5, first section, of Regulation 1466/97.

¹¹ Article 5, first section, of Regulation 1466/97

¹² Article 5, of Regulation 1466/97, and article 2, second section, of the Regulation 1466/97.

¹³ COM (2015)12 of 13 January 2015.

¹⁴ Article 5, section two, of Regulation 1466/97.

The Division assesses the fiscal rules by using information of the CPB and the Ministry of Finance. In the recently published Central Economic Plan all forecasting information relevant for the testing under the European budget rules is included in a separate section.¹⁵ This is reflected in table 4. Figures 3 and 4 are also directly copied from the Central Economic Plan. The CPB provides graphic presentations that increase the accessibility and comprehensibility of the information.

Table 4 CPB -forecasts relevant for European budget rules

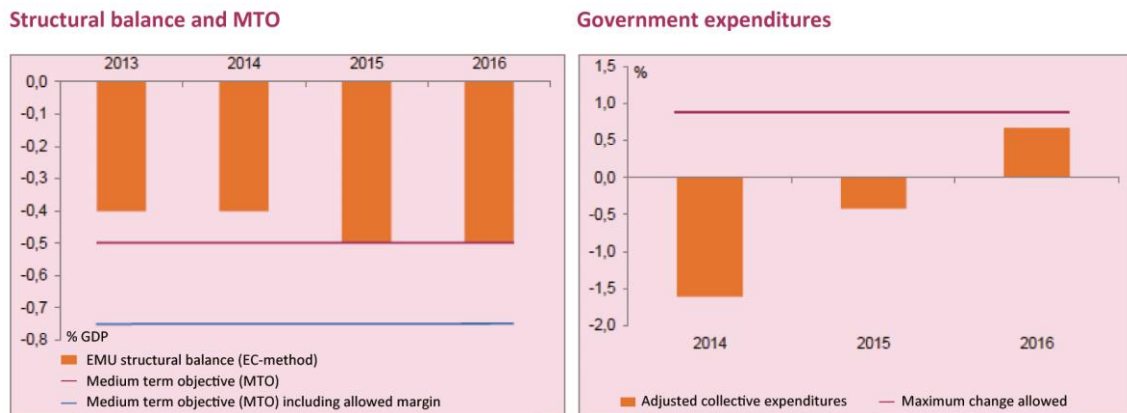
	2013	2014	2015	2016
EMU balance (% GDP)	-2,3	-2,6	-1,8	-1,2
EMU balance cyclical (EC-method, % of GDP) (a)	-2,3	-2,0	-1,3	-0,7
EMU balance one-off and other temporary measures (% of GDP)	0,4	-0,1	0,0	0,0
EMU structural balance (EC-method, % of GDP) (a)	-0,4	-0,4	-0,5	-0,5
Mutations to EMU structural balance (EC-method, % of GDP)		0,0	-0,1	0,0
Expenditure rule: (b)				
Adjusted collective expenditures (volume, %)		-1,6	-0,4	0,7
% Maximum growth-adjusted collective expenditures (c)		0,9	0,9	0,9
Difference (d, e)		-2,5	-1,3	-0,2
Difference (% GDP, e)		-1,1	-0,6	-0,1
EMU debt	68,6	69,0	68,8	67,8
Debt criterion during the transition period (f)				
Estimated change in structural balance		0,0	-0,1	0,0
Minimal change in structural balance based on criterion		-0,6	-1,2	-1,7
Difference (g)		0,6	1,1	1,7
<p>(a) Based on the current OECD / European Commission forecast of a budget elasticity of 0.65 that is applied. See Mourre, G.et al, 2014, Adjusting the budget balance for the business cycle: the EU methodology, European Economy, Economic Papers 536. (link)</p> <p>(b) The development of adjusted government expenditure should not exceed the growth of the potential growth in countries with structural balance in accordance with the MTO. For countries with a structural balance that is more negative than the MTO, the increase in adjusted government expenditures should be such that the structural EMU balance converges sufficiently towards the MTO (Medium Term Objective). Government expenditure is excluding interest payments and the cyclical part of the unemployment benefits, and are adjusted for policy changes in public revenue.</p> <p>(c) For euro countries where the structural EMU balance is at least equal to the MTO, the reference mutation of the adjusted government expenditure is equal to the long-term average growth potential. For countries where the structural balance in the previous year is at least 0.5% GDP more negative than the MTO, the reference mutation is normally equal to the long-term average of the potential growth minus the convergence margin, consistent with an improvement in the structural balance of 0.5% GDP.</p> <p>(d) The expenditure criterion requires a difference of zero or negative.</p> <p>(e) Based on unrounded numbers.</p> <p>(f) See footnote to figure 3.3.</p> <p>(g) This difference may not be less than 0.25% GDP per year and, after the first year of the transition period, may cumulatively not be less than -0.75% GDP.</p>				

Source: Central Economic Plan 2015, p.51

The general picture of the three main evaluation criterion in the preventive arm, such as numerically presented in table 4, is graphically reflected in figures 3 and 4.

¹⁵ Refer to the Central Economic Plan 2015, section 3.2, p. 50-56.

Figure 3 The forecasts and the relevant European rules on government deficit and government expenditures



Source: Central Economic Plan 2015, p.51

Below we discuss the various budgetary rules and other elements of the assessment separately.

3.2 Development of structural budget

The structural budget must meet the MTO of structural balance or there has to be a sufficient visual improvement in the direction of the MTO.

The forecast data reflected in tables 3 and 4 show that the so-called structural budget balance (cyclically adjusted budget balance and corrected for non-recurring items) in the years 2013 – 2016, to current estimates, still lies at the MTO-objective of -0.5% GDP. Thereby the forecast of the structural budget balance in the years 2014 through 2016 meets the MTO.

The Central Bureau of Statistics (CBS) very recently published a first realization of the budget deficit of 2014. This figure (- 2.3% GDP) was not yet known at the conclusion of the Central Economic Plan and is therefore not included in table 4 and figures 3 and 4. This figure is more favourable than the estimate in the CEP (- 2.6% GDP). The ministry of Finance estimates that this is also largely reflected in the estimate of the structural budget (- 0.2% GDP instead of - 0.4% GDP). Right now there is no information on the effect of this in later years.

It may be noted that the current projection of the actual budget deficit in 2016 (- 1.2% GDP) is more favourable than estimated at the start of the cabinet in the so-called Start note (-1.9% GDP). This is favourable in itself.

The Division points out that in the preventive arm of the Stability and Growth Pact, Dutch budget performance is assessed on the structural budget and not on the actual budget. The structural budget balance in the Start note (-1.1% GDP in 2016 and -1.2% GDP in 2017) at the start of the cabinet did not meet the agreed European rules, in this case growing towards an MTO of -0.5% GDP. However, the current estimates meet this. This 'windfall' with regard to the forecasts at the

start of the Cabinet (Start note) is therefore required to give substance to the budget rules in the preventive arm of the Pact (an MTO of -0.5% GDP).

3.3 *Development (corrected) public spending*

The growth of the government expenditure (adjusted to amongst other the cyclical component of unemployment expenditure, interest expenditure, and discretionary fiscal measures) should remain below the estimated potential growth of the economy until the MTO is reached and then the adjusted government expenditure should not exceed the potential growth.

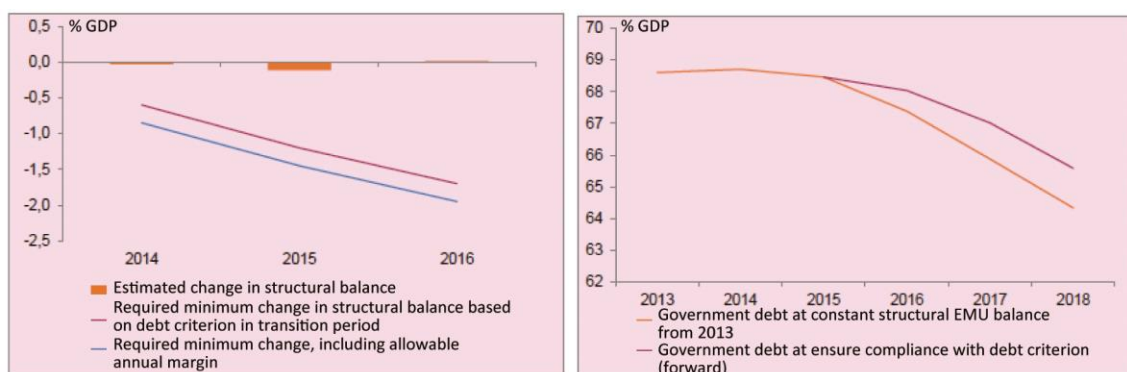
The figures presented in Table 4 show that the (*corrected*) public expenditure in 2014 and 2015 is dropping steadily in volume and hence in those years remained significantly behind the estimated potential growth of the economy, as highlighted by the right-hand side of figure 3. In 2016, a volume increase of the (*corrected*) public expenditures is provided, but these are estimated slightly lower than the potential growth of the economy.

3.4 *Development of government debt*

The government debt should, if it amounts to more than 60% GDP, decrease sufficiently rapidly toward 60%. In other words it should decrease by 5% of the difference with the 60% standard per year.

The extremely low inflation in combination with the absent or low growth hinders a decline in government debt-to-GDP; only in 2016 a significant decrease is in the offing.

Figure 4 The forecast and the relevant European rules on government debt



Source: Central Economic Plan 2015, p. 53

For countries like the Netherlands who were in the excessive deficit procedure at the time of tightening the debt standard, a lighter transition regime applies for three years after being released from this procedure.¹⁶ This is managed through the structural budget balance, which is now low enough to meet the requirement

¹⁶ Also see the Central Economic Plan 2015, p. 52).

of the debt criterion in the transition period, as shown graphically in Figure 4. The CPB shows, in the right part of figure 4, that with plausible assumptions for the years after 2016, the debt will easily drop to 60% of GDP. Thus, the reduction of government debt is sufficiently large to meet the debt criterion.

3.5 Sustainability of public finances in the long term

Given that the MTO will be updated every three years and derived from long-term sustainability analysis, it is necessary, in addition to the development in the medium-term (MTO), to include the long-term sustainability of public finances in the assessment.

The objective of structurally balanced budget in the medium-term is derived from the desirability to absorb shocks in economic adversity and to have sustainable public finances in the long term in an ageing society. Public finances are sustainable if future tax revenues are sufficient to offer inflation-proof public services (so-called constant arrangements) to future generations, in an ageing world, and to pay interest costs without rising debt and therefore making it unsustainable in the long term.

Recent years, several measures have been taken to improve the long-term sustainability of public finances. Raising the retirement age and linking it to life expectancy, reducing the tax-deductibility of pension contributions, many measures in healthcare and the reduction of mortgage interest deduction, make an important contribution to the sustainability of public finances in the long term.

The CPB released a new sustainability study in mid-2014.¹⁷ This study presents a noticeably more positive outlook than previous studies, due to the measures taken since 2010. In the long term, a positive sustainability balance of the 0.4% GDP is even possible, *provided* that the assumptions of the study are met. The main uncertainty and challenge then lie in the area of healthcare expenditure.

In the outlined scenario, healthcare expenditures grow in accordance with the demographics and prosperity, coupled with wage growth. In that case, the share of public health expenditure increases by 3% GDP. However, in the period 1973 - 2010, healthcare expenditures grew on average 1.6% per year faster than the demographics and wages. While there has been progress in the control of healthcare expenditures the last two years, the question is how stable this is. The medium term figures for the period 2016 - 2019, included in the 2015 Budget Memorandum, show a fairly high growth.

To get an idea of how crucial this is for the final conclusion with respect to sustainability, the CPB also provides sensitivity analyses in the study. If the growth of healthcare expenditures was 1% higher year in and year out, this would result in a long term deterioration of the sustainability balance by 5.6% GDP.

¹⁷ CPB, 2014, 'Overheidsfinanciën houdbaar, minder zorgen om vergrijzing (Public finances sustainable, less concerns about ageing)'.

About the same as the sustainability benefit of all measures taken in the last five years.

Once again, this shows just how essential and necessary it is to control the growth of public health expenditure in order to prevent that because of an excessive growth of this expenditure, essential public services (such as public administration, security, justice and other expenditures significant to welfare including investment) are subjected to pressure, or to prevent public finances as a whole from becoming unsustainable. Sustainable public finances in the long term, with inflation-proof public services are possible, as can be deduced from the CPB study, but this requires permanent control of expenditures and, where necessary, appropriate necessary policy measures.

3.6 *Uncertainties and risks*

Risk analysis should form a systematic part of assessments and reports.¹⁸

It should be prevented that seemingly precise figures, suggest certainty with regard to the presented projections. Which is why the Division believes that it is worthwhile to pay due regard to the uncertainties and risks with which both forecasts and analyses are burdened. As supervisor, the Division concentrates on the negative risks to the budget. It distinguishes the uncertainties and risks in the economic outlook and in the estimated budgetary development.

Economic forecasts are always fraught with uncertainty. To illustrate this, the CPB has included for the first time in the Central Economic Plan - like many international organizations and economic institutions - so-called fan charts in which the seemingly precise forecasts of some key variables are provided with uncertainties derived from the forecasting errors since 2001.

For the current year - 2015 - the uncertainty margins as expected may be considerably smaller than for the year 2016, which is further into the future. The uncertainty surrounding the forecast two years ahead of the EMU balance appears to be particularly large, but also in terms of economic growth in 2016, it is shown that there is 20% probability that the predicted growth of 1.8% will turn into a contraction of the economy.¹⁹

The uncertainties in the projections, both downwards and upwards, can also be appointed more specifically.

The situation surrounding Greece, where especially the size of the indirect consequences of a possible collapse of the Euro area are difficult to forecast. The political tensions around the Ukraine and Russia and the uncertain situation in the Middle East remain current examples of ongoing uncertainty. The low Euro exchange rate and low oil prices give the European economy an extra temporary

¹⁸ Also refer to: OECD, Senior Budget Officials, OECD Principles of Budgetary Governance, Principle 9.

¹⁹ See Central Economic Plan 2015, p.11 and CPB Background Document 'Onzekerheid rondom CPB-ramingen, in kaart gebracht met fan charts (Uncertainty surrounding CPB projections, mapped with fan charts)'.

boost, but for how long? Is the economic recovery in the Anglo-Saxon world even faster than currently estimated? Will China's growth rate decrease further?

To illustrate the sensitivity of the forecasts, the Stability Program contains an alternative scenario, in which the effects of a one-off and permanent drop of world trade by 1% are visualized.²⁰ The example assumes a growth in relevant world trade by 3.3% in 2015 instead of the 4.3% forecasted in the Central Economic Plan. The level of economic activity in the next year, in 2016, is 0.3% lower and the budget deficit in 2016 worsens by 0.2% of GDP.

Finally, an uncertainty of purely domestic origin is important: the volume of gas production from the Groningen field. In accordance with the now officially adopted policy, CPB assumes in its forecasts that to a higher level of gas production will be returned to by mid-2015. If it is assumed that by the middle of this year, it will be decided to stick to the reduced level of the first half of 2015, then, according to the CPB, the forecast of economic growth this year will be 0.1 to 0.2% lower, with implications for the gas revenues of € 800 á € 900 million in both 2015 and 2016.

The budgetary outlook includes not only a number of general risks, but also a number of specific risks. The automatic impact of the economy on the public finances and especially on government revenues means that the uncertainties in the economic outlook have a significant - and often disproportionate - effect on the budget.

The innovation in the CEP to bring in view uncertainty in projections using 'fan charts', also extends to the forecast of the budget deficit. Fuelled by the developments surrounding the financial crisis, the uncertainties of the forecast of the deficit appear high.

The projection of the actual budget deficit in 2016 was 1.2%. The figure in the CEP, p.11 shows that, despite the seemingly large margin to -3%, there is still a chance of over 20% that the limit of the excessive deficit procedure will be exceeded.

The CPB also reports that not only is the uncertainty surrounding the projection of the actual deficit large, but that it also applies to the uncertainty surrounding the estimate of the structural deficit. Over the period 2007 - 2013, an average absolute deviation of 0.5% GDP of the forecast was reported.²¹

3.7 Monitoring recommendations of the European Council

The Division sees it as its task to regularly review whether and to what extent the recommendations of the Council of Ministers of the EU (ECOFIN), which are relevant to fiscal policy, are followed by the government.

At present, the intentions of the government as laid down in the Stability Program, give the Division no reason to go back on previous recommendations of the European Council.

²⁰ See Stability Program of the Netherlands, April 2015, Chapter 4, Table 4.2.

²¹ CEP 2015, p.14, footnote 4.

4. Comments by the Government on the concept assessment

The concept assessment was submitted to the Government. In its response, the government endorsed the concept assessment. The government response is included in full in the attachment to this report. This is followed by the final assessment, which is identical to the concept assessment.

5. Assessment

Since June 2014, the Netherlands has been member of the preventive arm of the Stability and Growth Pact, after having been recorded in the excessive deficit procedure of the Pact for 5 years, with all the stringent requirements that apply there. Bringing the actual budget deficit below the 3% ceiling is no longer the target variable of fiscal policy, the budget must comply with the medium-term objective for the structural budget. This means that it is important to strive after a balanced budget to build sufficient buffer space for economically worse years, and to work towards long-term sustainability of public finances.

The Advisory Division of the Council of State is of the opinion that the fiscal outlook which the government included in the Stability Program (based on the Central Economic Plan 2015), complies with European fiscal rules. Given the uncertainties in the economic and fiscal outlook for 2015 and 2016, the margins are however still very narrow. In the opinion of the Division, this calls for caution and alertness.

The Division has the following considerations and issues:

- *there is little room in the expenditure rule for 2016 based on current forecasts of the CPB: more than 0.1% of GDP, and the forecast for the structural balance in both 2015 and 2016, is exactly on the MTO objective, although the European Commission takes into account a margin of 0.25% GDP in a review, because of the uncertainties in the forecast of the structural balance.²² This margin is also included in the Figures 3 and 4.*
- *The uncertainties in predicting the deficit two years, ahead seem large. Thus, the analysis in the Central Economic Plan (p. 11), using the so-called "fan charts", indicate that while the estimated deficit for 2016 (-1.2% of GDP) appears to be far from the ceiling of -3%, there is a chance of over 20% that the ceiling of the excessive deficit procedure (-3.0%) will be exceeded.
The forecast of the structural budget deficit, which is what the assessment of the preventive arm is about, has an absolute prediction error of 0.5% GDP in the period 2007 - 2013.*
- *The positive outlook of the sustainability of public finances in the long term, outlined in the recent sustainability study by the CPB, is largely determined*

²² For this uncertainty margin, refer to European Commission, 2014, Commission opinion on the troika Budgetary plan of the Netherlands, 28 November 2014, page 13, Table 6, footnote 1.

by the assumed control of healthcare expenditures. Although progress has clearly been made in controlling healthcare expenditure over the past two years, the question remains as to how sustainable this is: the medium term figures in the 2015 Budget Memorandum indicate a fairly high growth for the years leading to 2019. It is uncertain whether and to what extent further structural measures in healthcare will be necessary to realize the idea of sustainable public finances, outlined in the CPB study.

- *The budgetary position of the government has been extremely volatile over the past fifteen years. Budget surpluses at the turn of the century and prior to the financial crisis quickly proved to be able to change into deficits exceeding 3%, resulting in the inclusion in the excessive deficit procedure. Structural reforms in the housing market and the pension market, as suggested by the recent DNB study "De vermogensopbouw van huishoudens: is het beleid in balans (The wealth of households: is policy in balance)?", can reduce the risks of long balance sheets with households, and reduce the macroeconomic volatility and volatility of the budget balance. A long process is required with such reform before results can be seen. This makes it sensible to build up sufficient buffer space in the budget for lean years in cyclically good years, while a tax review will inevitably also require the necessary. Sufficient buffer space means realizing actual budget surpluses in good years.*
- *In addition to more general uncertainties, the actual risk on the extent of domestic gas production also applies. A higher gas production in the second half of 2015 than in the first half is not certain, which means that gas revenues and thus the budget deficit in 2015 and 2016 could be worse. Lower gas prices associated with lower oil prices and lower volumes also can't be ruled out.*
- *Earlier it was noted that the projection of the actual budget deficit in 2016 (-1.2% of GDP) is more favourable than expected at the start of the cabinet in the so-called Start Note (-1.9% of GDP). However, from the European fiscal rules, fiscal performance has to be reviewed to the structural budget balance and not to the actual balance. The 'windfall' compared to the forecasts at the start of the Cabinet (Start Note) is required to comply with the agreements in the preventive arm of the Pact, as the structural balance in the Start Note of the government (-1.1% of GDP in 2016 and -1.2% of GDP in 2017) did not meet the agreed European fiscal rules. With the current projections, they are now met. Therefore, considering the European rules, there is no additional operational space.*

The vice president of the Council of State,

J.P.H. Donner

Appendix Full government response

10 April 2015

Dear Mr Donner,

In the Sustainable Public Finances law (HOF bill), European budgetary agreements are legally embedded and the Council of State is designated as the independent body responsible for supervision of compliance with fiscal rules (as set out in Article 5 of Regulation 473/2013). For this assessment, the Advisory Division of the Council of State makes use of independent forecasts of the CPB.

The main task of the independent fiscal monitoring is to establish publicly accessible reviews about whether a Member State complies with the European budgetary agreements. For an adequate fulfilment of the independent fiscal monitoring, it is therefore important that it reflects the most important moments in the national budget cycle. The Advisory Division has therefore revealed that, in addition to the assessment at the time of the Budget Memorandum, it intends to publish a review in the Spring. This intention of the Advisory Division is interpreted for the first time with this Stability Program. The Spring forecasts of the Central Economic Plan (CEP) of the CPB are based on standing policies and form the basis for the Stability Program. An assessment of the Council of State in the spring can be considered by the government in the budget preparation process and can thus be a valuable addition to the Dutch budget cycle.

Based on the figures on the public finances of the CEP, the Advisory Division will assess whether the stability program complies with European fiscal rules. The government agrees with this assessment of the Advisory Division. Besides the opinion, the Advisory Division indicates a number of issues for the future. At present, the budget preparation for 2016 is taking place. The concerns of the Council of State will of course be considered in this process. Just as the Advisory Division, the government sees the need for caution given the uncertainties in the forecasts of the CPB and the risks to the EMU balance in respect of the domestic gas production.

While drafting the budget for 2016, maintaining the expenditure ceiling remains in full force as a basic principle. The focus will be on the implementation of the already agreed measures that have been made in the coalition agreement and subsequent agreements. Besides, the government remains fully committed to the European budgetary commitments.

The government appreciates the attention demanded by Advisory Division for sustainable and sound public finances in the longer term. Structural reforms play an important role, as the Division indicates in its advice. The government has implemented a large number of structural reforms. These have led to greater sustainability of public finances. Raising the retirement age and changing the mortgage interest deduction are examples thereof. The Advisory Division also calls attention to the development of healthcare expenditure that is important to the

positive outlook regarding the sustainability of public finances as it follows from the sustainability study of the CPB.

The government endorses the message of the Advisory Division that continued attention is needed for the sustainability of public finances and also the development of healthcare expenditure. Also given the uncertainties in the forecasts and assumptions of the CPB. The message of the Advisory Division that it is wise to build in sufficient buffer space in public finances in cyclically good years to cover lean years, is consistent with the impact test in the 2015 Budget Memorandum.

Finally, with this initial assessment of the Stability Program, a productive start is given to the independent fiscal monitoring and I look forward to further cooperation in the future.

Yours sincerely,
Minister of Finance,

J.R.V.A. Dijsselbloem