

Twelfth Report by the Study Group on the Budget Margin

Ageing and sustainability

22 June 2006

Letter from the Minister of Finance

Date	Your reference	Our reference
22 June 2006		BZ 2006-477M

Subject
Advice by the Study Group on the Budget Margin

To the Speaker of the House of Representatives of the States General

Herewith I am sending you the recommendations by the Study Group on the Budget Margin, which I have received in response to my advice request of September 2005. The Study Group on the Budget Margin advises on the budgetary policy to be pursued in the next government's term of office. In its report the Study Group also considers the role of the Economic Structure Enhancing Fund (FES).

As usual in the case of reports by the Study Group on the Budget Margin which relate to the next government's term of office, the government submits the Study Group's considerations and recommendations to you without comment.

The Minister of Finance
Gerrit Zalm

Letter from the Treasurer

Date	Your reference	Our reference
22 June 2006		AFEP 2006-295

Subject
Advice by the Study Group on the Budget Margin

To the Minister of Finance

In response to your advice request of September 2006, I am herewith sending you the recommendations by the Study Group on the Budget Margin on the budgetary policy to be pursued in the next government's term of office.

In accordance with the advice request, the report also considers the role of the Economic Structure Enhancing Fund (FES).

The Treasurer
Laura van Geest

1. Ageing and sustainability: summary and recommendations

1.1. Introduction

Each government has the task of preserving and if possible improving the performance of the Dutch economy. Each government builds on the efforts of its predecessors, but it also faces new challenges. The trends which will affect the Dutch economy in the future are well known: population ageing, globalisation, technological advances, and growing social heterogeneity. But the world does not stand still, familiar issues will take on a greater urgency or perhaps even a different complexion. This applies in particular to the ageing problem. This has been a focus of debate for years. New for the next government's term of office is that population ageing is now becoming a clearly visible factor in the economic situation.

Population ageing has major social implications. The key challenge is that, under unchanged policies, the group of people who create the wealth that provide the foundation for our public services will become structurally smaller. This has consequences for the expected performance of the Dutch economy and for the public finances over the long term. It also raises new and complex questions about the distribution of incomes and risks, between young and old, between today's parents and their children. And it makes the Dutch economy more vulnerable to shocks.

Budgetary policy can make a major contribution to dealing with the implications of ageing. The budget is one of the mechanisms by which the costs are spread across the generations. Budgetary policy also affects a country's economic performance. A considered formulation of budgetary policy may help to temper the inevitable fluctuations in the economic cycle. And finally, the choices made with regard to public spending and taxation have a direct impact on the economy's growth potential and resilience.

This report sets out the findings of the Twelfth Study Group on the Budget Margin. It builds on the recommendations made by the Eleventh Study Group in its report "Stabiel en duurzaam begroten ("Stable and sustainable budgeting") (2001). Much has happened since the publication of the previous Study Group report. The Dutch economy has had a difficult time. In the first few years after the previous Study Group report, growth lagged sharply behind the cautious growth scenario. The economic downturn was accompanied by a rapid deterioration of the public finances. Because the government took remedial action quickly and because the economy recovered, the public finances have improved significantly again. This will also have a favourable effect over the longer term. Even so, the ageing of the Dutch population will pose a major challenge for the next administration as well. This means

that further future-proof choices will have to be made. This report outlines the factors to be considered when making these choices.

1.2. Ageing is started

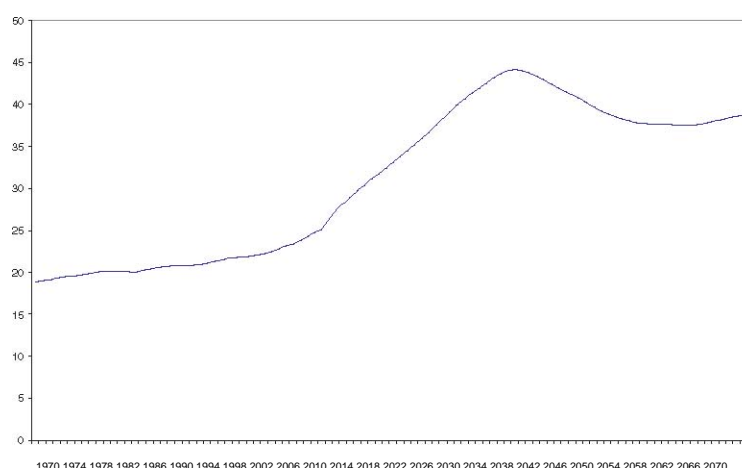
1.2.1. Demographic changes

Demographic changes will pose challenges to the Dutch public finances over the coming decades. The current administration and its predecessors have already recognised these challenges. What is new in the next government's term of office is that ageing is no longer approaching, it is actually starting.

The number of pensioners is growing as life expectancy rises. The ratio between pensioners and workers, the "elderly dependency ratio" (also called, more informally, "grey pressure" in the Netherlands), will increase from more than two in ten at the moment to nearly five in ten by 2040. The elderly dependency ratio will start to rise sharply towards the end of the next government's term of office (see figure 1.1). From 2010 onwards the generation born immediately after the Second World War, the "baby boomers", will reach the statutory retirement age.

Contrary to what is widely believed, the rise in the elderly dependency ratio will not be a temporary phenomenon. The composition of the population will change permanently because of the high life expectancy and the historically low birth rates.

Figure 1.1: Ratio between pensioners and workers (i.e. elderly dependency ratio, or "grey pressure"), 1970-2070



Source: CBS

1.2.2. The public finances are not sustainable

Under unchanged policies, the demographic changes will lead to a sharp and structural increase in public spending, especially on state pensions and healthcare. Government revenues from taxes on pensions will also increase, but not enough to cover all the costs. Under these circumstances we are systematically spending more than we earn. This means that the government has to continue to borrow money to pay for the public services. This process creates a snowballing effect: the government has to borrow ever more in order to pay for the public services; this pushes up interest payments on the public debt; and to cover these, the government has to borrow yet more. The actual EMU balance will continue to deteriorate in this situation.

The Netherlands Agency for Economic Policy Analysis (CPB) predicts that, under unchanged policies, the public debt will escalate to such an extent that it will gradually spiral out of control and eventually become unmanageable. So the public finances are not “sustainable”. But what does this mean exactly? The public finances are sustainable if the existing public services can expand in line with overall prosperity without taxes having to be raised in the future or without the public debt spiralling out of control. In that case all generations will enjoy an equal net benefit from the state.

To make the public finances “sustainable” again will require an additional budgetary effort equivalent to around 3% of GDP (or EUR 15 billion, see also section 1.6). The CPB’s ageing calculations relate to a long period of time and are therefore sensitive to the assumptions used, to new risks and to unforeseen social and economic developments. Nevertheless, the Study Group takes the view that these calculations, despite all the ifs and buts, currently provide the best available indication of the magnitude of the problem and of the upside and downside risks in the future. These calculations therefore constitute the best starting point for policy formulation.

1.3. Towards sustainable public finances

1.3.1. Better late than never

Sooner or later public spending will have to be brought back in line with government revenues. Taking the required decisions now has a number of major advantages over postponing them.

Firstly, pushing the bill into the future is not without cost. The overall bill will rise because the relatively favourable years from an ageing perspective will not be used to “save” for the future. Postponement thus means not only that future generations will have to pay a larger share of the bill, but also that the total bill will be higher. Postponement of measures implies a heavier burden for future generations. Postponement also implies uncertainty about the government’s future budgetary policy, about who has to pay the bill. Both are bad for the

functioning of the Dutch economy. Moreover, avoidance behaviour becomes easier in a globalising world in which capital and labour become ever more mobile.

Secondly, intervening now has the major advantage that appropriate transitional arrangements can be agreed. Experience shows that institutional changes take a very long time in practice. With transitional arrangements in place, people can adapt to the new situation gradually and in time. This is desirable from the perspective of securing the broadest possible political support for the reforms and to avoid disruptions to the economy. What is more, it also improves the reliability of the government.

Thirdly, trends such as ageing and globalisation mean that any shocks can be absorbed less easily in the future than they are today. For instance, ageing leads to a greater sensitivity to demographic shocks, such as an unexpected rise in life expectancy. Such a shock would mean, say, that more money would have to be spent on pensions and healthcare. This will have a greater impact in an aged society. After all, the group which benefits from pensions and healthcare for longer will be that much larger. Consequently the total additional outlays owing to a rise in life expectancy will be higher.

Against this background the Study Group recommends that decisions on measures to make the public finances sustainable again should be taken in the next government's term of office. This does not mean that all measures have to lead to actual improvements in 2011. This because sustainability can also be achieved by matching government revenues and expenditures more closely in the future. This can be done, for instance, by taking measures now which will depress the increase in ageing-related spending in the future. If this approach is adopted, then less will have to be "saved" in the next "government's term of office" and a less ambitious balance target can be set for 2011. How income and expenditure are matched in the future has consequences for people's income positions. It is therefore important that the situation is explained well in time, so that people can respond appropriately. This calls for clear decisions by the next government.

1.3.2. Sustainable choices

By identifying the implications of ageing clearly, it is possible to distribute the burdens in a balanced way across the generations, among today's pensioners, today's workers, their children and their grandchildren. The adjustments required to achieve sustainable public finances will touch all generations alive today in some way or other. If these measures are introduced gradually, as seems reasonable, then the implications will be bearable for all generations.

The next government will have a relatively wide choice of measures at its disposal to address the sustainability problem. Essentially, there are three directions for a solution:

adapting the terms of old-age provision, promoting labour market participation, and saving resources by cutting spending or raising taxes. These three options will be discussed below.

The challenge for the next government is to make “sustainable” choices. The measures should not only restore the sustainability of the public finances, they should also be sustainable in social, economic and political terms. This means that measures should be assessed not only for their contribution to the public finances, but also for their implications for the intra- and intergenerational distribution of burdens and benefits, economic growth, and political and administrative durability. This will lead to robust choices which will do justice to the uncertainties which are inextricably linked to long-term developments.

Adjusting the terms of old-age provision

The core of the sustainability problem is that the ageing-related outlays, above all pension payments and healthcare spending, are rising faster than government revenues. This will create an ever widening hole in the public finances from 2015 onwards. A logical starting point for finding a solution is therefore to reform what have been called the “ageing-related institutions”.

Many of the ageing-related institutions – the public provisions for old age and health and long-term care – were established in the 1950s and 60s. Much has changed since then. Life expectancy has risen sharply. So have the number of years that people are in retirement. At the moment life expectancy for 65-year-olds is nearly another 16 years for men and more than 19 years for women. What is more, pensioners enjoy most of these years in good health and without restrictions¹. The income positions of most older people are also better than in the past, not least because many receive supplementary funded pensions. Life expectancy is expected to rise further in the future, and the income positions of older people are also expected to improve further. These developments raise the question whether the arrangements for old-age provision are still appropriate for this day and age. This issue does not only play in the Netherlands of course. Other European countries are also looking for answers to the ageing problem. In Germany and the United Kingdom, for instance, the plan is to raise the statutory retirement age gradually to 67 years and 68 years respectively.

A major advantage of the adjustment of the ageing-related institutions is that it helps the public finances in two ways. Firstly, the public finances will improve over the short but above all over the longer term, because ageing-related spending will rise by less as the number of older people increases. And secondly, the adjustment of the ageing-related institutions will reduce the economy’s vulnerability to unexpected shocks. Depending on the measure chosen, it may also boost labour market participation, which would significantly limit the negative effects of ageing on the economy.

Examples of adjustments to the ageing-related institutions include raising the statutory retirement age, abolishing the old-age allowance in income tax, and increasing personal contributions to healthcare costs (through higher nominal contributions and means testing, for instance).

Raising labour market participation

Part of the sustainability problem is also caused by the potential relative or absolute narrowing of the tax base for the public services. Raising labour market participation broadens the tax base. This will make it easier to absorb the rising costs in the future. Labour market participation will rise anyway over the coming decades, not least because younger generations of women are more used to working than older generations (“cohort effects”) and because of previous policy measures, such as changes to the pre-pension arrangements. However, these effects have already been included in the CPB’s ageing calculations. New measures will therefore be required to raise labour market participation further. Among those that spring to mind are new incentives for people to enter the labour market, such as individualising the general tax credit or reducing the volume of unemployment benefit claims (by shortening the period of entitlement, for instance). There is also the possibility of changing the tax treatment of owner-occupied homes. The budgetary revenues resulting from these measures could be used to cut tax rates and to make working more rewarding. This will have a positive effect on labour market participation.

“Saving” for later

Another possibility is to “save” for the future, by cutting spending or by raising taxes. This can create a budget surplus, which can be used to pay off the public debt more quickly. The interest payments on the public debt will then decline. The resources released in this way can be used to finance the higher outlays on state pensions and healthcare, for instance. It is of course logical (and good practice) to intervene where inefficiencies occur. Saving fits in well with the precautionary principle, that is, to secure the future. However, especially in the case of raising taxes, the saving option has a negative effect on economic growth.

For each of these three possible solutions it would also make sense to commit to strengthening the economic structure and to bear in mind the distribution of the burdens across the generations. In contrast with an increase in labour participation, an increase in labour productivity does not make a direct contribution to solving the financial problems in the narrow sense. This is because much of public spending increases in line with economic growth. For instance, teachers’ and nurses’ pay and unemployment and welfare benefits rise in line with pay trends in the market sector. Hence economic growth alone will not solve

¹ See SCP (2006), “Rapportage ouderen 2006, veranderingen in leefsituatie en levensloop”, Social and Cultural

the ageing problem. However, in the light of the ageing process, the promotion of economic growth becomes ever more important in maintaining prosperity growth. Greater prosperity will also broaden the public support for measures aimed at making the public finances sustainable. A strong and flexible economy is conducive to the implementation of necessary reforms to secure the sustainability of the public finances. After all, the objective of achieving sustainable public finances will always compete with social demands for higher public spending. A situation where prosperity continues to grow makes it easier to deal with this tension. And a flexible economy also makes it easier to respond to any shocks.

Addressing the core of the problem

The new government will face a serious challenge. Even so, the Study Group has come to the conclusion that there are many options available to address the problems and to spread the pain. The Study Group takes the view that in formulating the required measures, the government should not only consider the effects on the public finances, but also the likely effects on economic growth and the distribution of risks and burdens across the generations. The administrative sustainability of measures is also a legitimate consideration.

Against this background the Study Group recommends that the government addresses the core of the problem. This means putting the emphasis on reforming the ageing-related institutions and on broadening the tax base.

1.4. Budget system

1.4.1. Continuation of the trend-based budgetary policy

A “trend-based budgetary policy” has been pursued in the Netherlands since 1994. The Study Group on the Budget Margin wishes to reaffirm the usefulness of this approach. It reflects three key objectives of sound budgetary policy: imposing budgetary discipline and political calm, smoothing cyclical fluctuations, and enhancing the reliability of the government.

However, during the recent economically turbulent years the trend-based budgetary policy did not function optimally. On the one hand, the sharp cyclical fluctuations of recent years and some incidental developments caused major changes in the EMU balance. To some extent, however, these were a logical and desirable consequence of the operation of the automatic stabilisers. On the other hand, it became clear with hindsight that the safety margin for the Treaty of Maastricht’s 3% deficit limit proved too small during the boom period around 2000. This was due in part to burden relief after higher than expected tax receipts and the use of the financial scope within the expenditure frameworks. Because of these two

factors, the budget deficit was pushed beyond the 3% limit in 2003. Savings and cuts then had to be made during an economic downturn.

In light of this experience, the Study Group analysed a range of possible changes to the budget system. In the first instance the Study Group considered potential alternatives to the trend-based budgetary policy, such as gearing policy to changes in the structural budget balance. However, the structural budget balance proves an unsuitable steering mechanism for budgetary practice. Hence the Study Group recommends instead to make changes to the existing system. Specifically, these concern the safety margin for the EMU limit, the cautionary margin, making the budget system more cycle-proof, and increasing transparency.

1.4.2. Safety margin for the EMU limit

The experiences of previous administrations underline the importance of maintaining a safety margin for the 3% of GDP budget deficit limit set out in the Treaty of Maastricht. Cyclical and incidental movements in the EMU balance may cause the 3% limit to be breached, as happened in 2003. Cyclical movements in the budget balance may arise because income and expenditure move in line with economic growth. Thus higher economic growth leads to higher tax receipts, lower unemployment benefit volumes and a wider pay and price differential between the public and private sectors (and hence to higher healthcare spending, for instance). Incidental changes in the EMU balance may be caused by fluctuations in natural gas revenues, by fluctuations in the budget balances of the lower-tier authorities and other factors. A structural budget surplus is the minimum requirement for absorbing the cyclical and incidental changes in the EMU balance without breaching the 3% limit.

1.4.3. Cautious trend-based growth

Given the magnitude of the challenge posed by ageing, it is imperative – now more than ever – to remain realistic. Since it is not possible to predict the state of the economy five years hence, the usual approach is to use economic scenarios. Since 1994 the government has relied on cautious trend-based growth scenarios. The experiences with this cautious approach have been encouraging. There have been fewer occasions where austerity measures had to be implemented to deal with disappointing budgetary developments. Even so, over the period as a whole the budget balance has not turned out higher than expected. This shows that a cautious scenario is not a needless luxury. The Study Group therefore recommends that in the coming period budgetary policy continues to be based on the CPB's cautious trend-based growth scenario.

1.4.4. Interest payments outside the expenditure frameworks

The Study Group has examined how to avoid a procyclical policy. In the current budget system cyclically sensitive expenditures are included in the expenditure frameworks. The main cyclically sensitive expenditures are unemployment and welfare benefit payments (under the Unemployment Benefit Act [WW] and the Work and Welfare Act [WWB]), interest payments, and pay rates and prices. This can lead to a procyclical policy.

During an economic boom period, on the volume of unemployment and welfare benefits and interest payments are likely to fall. Against this, pay rates and prices in the public sector are likely to rise faster compared to those in the private sector. On balance, however, some scope will be created within the expenditure frameworks; if used, this will lead to additional spending as economic growth accelerates. (This is called a “procyclical policy”). So what matters on the expenditure side is to prevent cyclical windfalls developing in the expenditure frameworks during economic boom periods which can be used procyclically.

In theory the simplest way of achieving this is to place cyclically sensitive expenditures outside the expenditure frameworks. These include interest payments on the public debt, unemployment and welfare benefit payments, and the pay and price inflation differential (i.e. the relative pay and price changes between the public and private sectors). During boom periods interest payments and the volume of unemployment and welfare benefits will fall, but outlays arising from the pay and price inflation differential will rise. Placing these types of expenditure outside the expenditure frameworks should help to improve the operation of the automatic stabilisers.

Although placing all or part of the unemployment and welfare benefit payments and the pay and price inflation differential outside the expenditure frameworks may be desirable in theory, there are some practical objections to doing so. For one thing, in practice it is very difficult to identify economic windfalls and setbacks due to fluctuations in the economic cycle. For another, the Study Group has observed that the cyclical windfalls and setbacks in unemployment and welfare benefit payments on the one hand and the pay and price inflation differential on the other tend to cancel each other out over time. It is true, however, that the windfalls in unemployment and welfare benefit payments often occur at an earlier stage than the setbacks in the pay and price inflation differential.

Windfalls and setbacks may also occur with regard to interest payments on the public debt. When the windfalls are due to a more favourable movement in the public debt during an economic boom period, for instance, it would be undesirable to use these for additional public spending. When the windfalls are due to lower interest rates, this is an additional argument for not using it to increase public spending. This because lower interest rates

aggravate the ageing problem over the long term (see also the CPB's ageing calculations)². However, in the framework system a reduction of interest payments compared to the assumptions used in the coalition agreement will immediately create budgetary scope. This raises the risk that these windfalls will be used for outlays which will not contribute to the sustainability of the public finances. When setbacks occur with regard to interest payments, it is not necessary to compensate for them, because they are of a temporary nature, given the policy of debt reduction. All in all, then, there are serious disadvantages to keeping interest payments within the expenditure frameworks.

In light of the above considerations, the Study Group recommends that interest payments should be placed outside the expenditure frameworks, but that unemployment and welfare benefit payments and the pay and price inflation differential should remain within them. The Study Group also recommends that stricter agreements are made to ensure that any scope in unemployment and welfare benefit payments on the one hand and pay and price inflation differential effects in the expenditure frameworks on the other is not squandered. Conversely, it seems reasonable – because of the connection between the pay and price inflation differential and unemployment and welfare benefit payments – to use any pay and price inflation differential windfalls during lean economic times to offset setbacks in the social security and labour market budget discipline sector.

1.4.5. Oscillating revenues

The Study Group recommends that, in accordance with current practice, the automatic stabilisers are allowed to operate on the revenue side. This means that the government will allow revenues to move in line with the performance of the economy. From the perspective of budgetary control, this does mean, however, that agreements will have to be made on the desired structural development of the burdens which the government imposes on citizens and businesses. Hence it is necessary to agree how the effects of policy measures on the revenue side (tax cuts, for instance) can be distinguished from other revenue developments. The Study Group sees two options in this context. The first option is to use an indicator which reflects the EMU balance, what might be called a “revenue indicator”. This should reduce the chances of any unforeseen deviations from the budget balance target. The disadvantage of this indicator is that a gap may open up between the reported tax burden trend and people's perceptions of the tax burden. The second option is to use an indicator which reflects people's perceptions of the tax burden, what might be called a “tax burden indicator”. The disadvantage of this indicator is that it offers a lower level of certainty about the budgetary outcomes of policies. The Study Group has elaborated two alternative indicators. Depending on the new government's priorities, a choice will have to be made between these indicators.

² CPB (2006), “Ageing and the Sustainability of Dutch Public Finances”, Netherlands Bureau for Economic Policy

1.4.6. Greater transparency

Transparency in budgetary policy is very important as a basis for making honest and prudent choices. Recently the International Monetary Fund (IMF) praised the Netherlands for its clear and transparent budget system³. Nevertheless, the Study Group takes the view that some aspects of the transparency in the budget system can be improved further.

Better management of the FES resources

The Study Group calls for an improvement in the management of the Economic Structure Enhancing Fund (FES) resources. The Study Group has prepared some proposals for improving the FES's management structure, tightening its criteria and improving its funding system. The intention is to guarantee the quality of FES investments. The Study Group recommends that the FES's funding level is decided at the start of the government's term of office. This should prevent windfalls or setbacks in the FES during the term. This provides political calm and tempers the spending urge (or reduces the risk of investments being made whose social benefits do not weigh up against the costs). Medium-term investment agendas will be drafted for the spatial economy and for knowledge and innovation which will set the parameters for disbursements from the FES. Furthermore, the FES criteria will be tightened by putting greater emphasis on the one-off nature of investments and by putting greater weight on cost-benefit analyses in the evaluation of projects.

Focus on tax expenditures

The Study Group takes the view that more attention should be paid in the budget process to what are called "tax expenditures" and schemes which resemble tax expenditures or constitute significant drains on the budget. The reason for this recommendation is that many of these schemes are similar to spending programmes, but for practical reasons they do not fall under a similarly strict control regime. This raises the risk of a certain bias in favour of these schemes. The existing restrictive assessment framework for the introduction of new tax expenditures and the associated agreements on the evaluation of introduced tax expenditures should be retained. Furthermore, the existing overview of the budgetary development of tax expenditures should be extended to include a number of schemes which resemble tax expenditures or constitute significant drains on the budget (including schemes linked to owner-occupation and pensions). In accordance with current practice, policy-based changes and new tax expenditures should be included within the taxation framework.

1.5. Budgetary margin in the next government's term of office

Analysis (CPB), The Hague.

³ IMF (2006), "Netherlands: Report on the Observance of Standards and Codes-Fiscal Transparency Module, and the Aide-Mémoire Regarding the Fiscal Framework", International Monetary Fund (IMF), Washington.

1.5.1. Balance improvement under unchanged policies

Under the cautious trend-based growth scenario the Dutch economy is likely to expand by an average of 1¾% per year during the next government's term of office. In light of the current growth forecasts for 2006 and 2007 of around 3%, that may seem cautious indeed. But these two years are years of recovery after a period of low economic activity. Underlying trend-based growth rates are much more modest. One positive factor is that labour productivity growth is expected to increase between 2008-2011. In this scenario labour productivity in the market sector is expected to rise by 2% per year. This is slightly higher than the average growth rate over the past few decades. This average was not reached during the last economic cycle (1993-2003), for instance. Against the projected increase in labour productivity growth, however, employment growth is likely to decline. The main reason for this is the contraction of the labour supply owing to the ageing of the population. Moreover, the projected growth in the labour market participation rate among women will be appreciably lower than it has been since the early 1990s.

Ageing is already playing a major underlying role. Healthcare spending is likely to increase sharply, by EUR 8¼ billion in real terms. Around 15% of this is due to ageing. Moreover, the number of state pension recipients will increase by 215,000, which implies an increase in outlays by EUR 2¼ billion in real terms. The impact of ageing is also evident on the revenue side. The rapid increase in pension incomes among the over-65s will boost tax revenues by EUR 1¼ billion. And under the new health insurance system, the premiums (paid under the Health Insurance Act [ZVW]) will be set to cover costs. This means that premiums will rise in line with the associated healthcare spending, which implies an increase of around EUR 5 billion (not including the EUR 1 billion increase in the healthcare allowance).

On the basis of the cautious trend-based growth scenario, the CPB has calculated that under unchanged policies the budget figures will improve between 2008-2011 to end up broadly in balance by 2011. But this improvement is predicated on an increase in the tax and premium burden through an increase in health insurance premiums. On the basis of an unchanged tax and premium burden, the budget balance improvement will come out around ¾ percentage points of GDP lower than is the case at the moment⁴.

1.5.2. Effort required to achieve sustainability

Achieving sustainable public finances during the next government's term of office will require a budgetary effort equivalent to around 3% of GDP (or EUR 15 billion). This figure has been calculated on the basis of the required improvement in the underlying "robust" EMU balance.

⁴ Under the old system (before the introduction of the new health insurance system), the assumption of unchanged policies implied that the calculation of the budgetary scope was based on an unchanged tax and premiums burden. Since the health insurance premiums will be set in a competitive market, they cannot be set below cost-covering levels over the long term. The premiums will rise in line with the increases in healthcare spending, and will thus rise automatically in line with costs.

The “robust” balance is the budget balance adjusted for the phase of the economic cycle, net interest payments and natural gas revenues. The “robust” EMU balance is a better indicator for sustainability than the normal EMU balance, because it is adjusted for factors which have only a temporary impact on the public finances (for an explanation, see box 2.5).

According to the CPB’s ageing calculations, the “robust” budget balance has to come out at a surplus of around 2% of GDP by 2011. On the basis of current perceptions, however, this balance will come out – under unchanged policies – at a deficit of around 1% of GDP (see table 1.1). This makes the technical assumption that the increase in health insurance premiums due to rising healthcare costs will be offset in full. Consequently the balance in 2011 will come out EUR 4 billion lower than in the CPB accounting calculation⁵ (i.e. a EUR 5 billion increase in the tax and premium burden to cover additional healthcare spending minus a EUR 1 billion increase in the healthcare allowance).

Table 1.1: EMU balances of the public sector in 2011 under unchanged policies (in % of GDP)

EMU balance according to accounting calculation	0
Adjustment for unchanged tax and premium burden (-)	¾
Interest payments (+)	1¼
Natural gas revenues (-)	1½
“Robust” EMU balance	-1

Source: CPB.

The precise figure for the budgetary effort used during the coalition negotiations will thus depend on the “robust” balance with which the new government starts its work. Specifically this means that the effort required to achieve sustainability will not change if at the start of the next government’s term the EMU balance will be positively affected by higher than expected natural gas revenues or lower than expected interest payments. However, the required effort will be affected by other - structural - changes in expenditures or revenues.

Finally, although the required budgetary effort is derived from the “robust” balance in 2011, this does not mean that the public finances can only be made sustainable by improving the balance in 2011. The required effort, or the required “robust” EMU balance, will come down if reforms are introduced which restrict ageing-related public spending in the future, or which boost government revenues in the future by raising the labour market participation rate (see also section 1.3).

1.6. Task for the next government’s term of office

⁵ CPB (2006), “Boekhoudkundige berekening budgettaire ruimte 2008-2011”, Netherlands Bureau for Economic Policy Analysis (CPB), The Hague.

It is very important that the next government takes the decisions which put the public finances back on a sustainable path. According to the Study Group, the budgetary effort required is equivalent to around 3% of GDP (or EUR 15 billion). The government can choose between three types of measures: reforming the ageing-related institutions (state pensions and public healthcare), broadening the tax base, and accelerating the repayment of the public debt (or "saving"). If the government does not take any measures, then the tax and premium burdens on citizens and businesses will surge in the future. This will be detrimental to the economy and means that the ageing bill will be passed on to today's children and future generations.

The Study Group recommends that the government addresses the core of the problem. This means putting the emphasis on reforming the ageing-related institutions and broadening the tax base. Such measures will not yet lead to major budgetary savings during the next government's term of office, but they will have a major impact on sustainability. This because they will restrict ageing-related public spending in the future or raise government revenues in the future.

Given the magnitude of the problem, around 3% of GDP, part of the solution will also have to come from "saving". From the perspective of ageing, the period until 2011 is still a favourable one. On the basis of current assumptions in the CPB's budgetary margin calculations, the Study Group recommends that the government aims for a structural budget surplus of at least 0.5% of GDP by 2011. If it emerges at the start of the term that the natural gas revenues will come out higher than projected at the moment (which is not too far-fetched given the developments on the oil market), then the target will have to be revised upwards to a structural surplus of at least 1% of GDP by 2011. After all, the natural gas revenues are of a temporary nature, whereas permanent improvements in the EMU balance are needed to achieve sustainability. These surpluses will also achieve a safety margin for the Treaty of Maastricht's 3% deficit limit. To achieve these budget targets, a substantial part of the total adjustment will have to take place by reforming the ageing-related institutions and broadening the tax base.

Making the public finances future-proof will require changes to the financing of public services. These changes will lead to a fairer distribution of the burdens between the current generation of workers, young people and future generations. The required changes and the measures to bring them about will be considerable. However, the Study Group wishes to stress that, by historical standards, the required measures are not exceptional in terms of their institutional and budgetary implications.

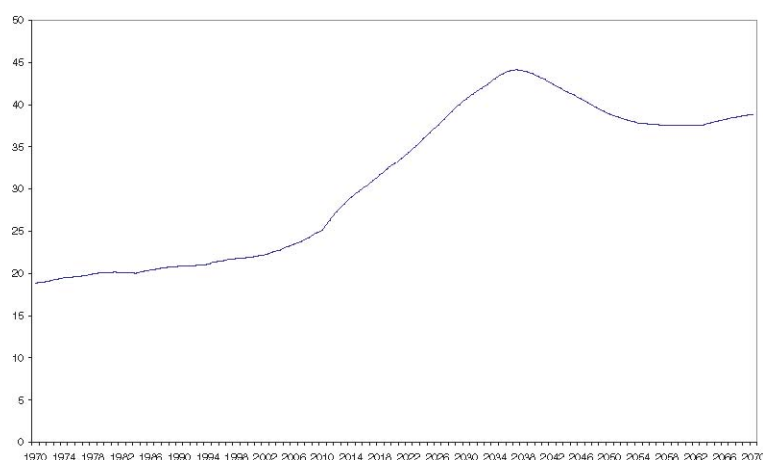
2. Long-term sustainability of the public finances

2.1. Ageing has started

The Netherlands stands on the eve of an historically unprecedented trend change in its demographic development. The gradual process of ageing evident over the last few decades will accelerate. The number of pensioners will increase from 2.3 million at the moment to nearly 4 million in 2040. Over the same period the potential labour force (i.e. people aged between 20-64 years) will decrease from 10 million to 9 million.

The upshot of these developments is that the ratio between pensioners and workers, the “elderly dependency ratio” (also called, more informally, “grey pressure” in the Netherlands) will increase during this period from 23% to 45% (see figure 2.1). At the moment there are roughly 2 pensioners for every 10 workers. This ratio will increase to more than 4.5 pensioners for every 10 workers by 2040.

Figure 2.1: Ratio between pensioners and workers (i.e. elderly dependency ratio, or “grey pressure”), 1970-2070



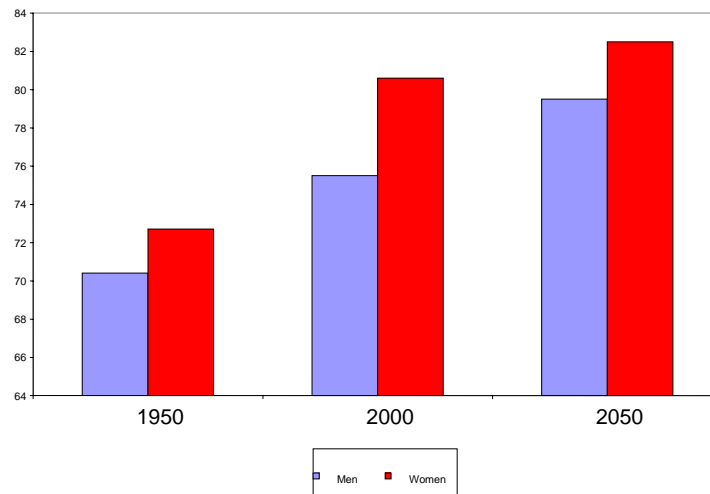
Source: CBS

Moreover, the demographic changes will not be a temporary phenomenon. The elderly dependency ratio will remain at a higher level permanently. That is to say, in the future there will be more older people (because of the higher life expectancy) and fewer young people (because of low birth rates)

Positive development at an individual level

In itself, ageing is a positive development. People live longer and in good health. Since 1950 life expectancy at birth has risen sharply, for women by more than seven years and for men

by five years. And life expectancy is expected to continue to rise over the coming decades (see figure 2.2).



Sources: CBS and RIVM

Life expectancy for 65-year-olds – and hence the period during which people are retired – has also risen over the past decades. At the moment life expectancy at 65 years is 15.8 years for men and 19.4 years for women. During this time men and women say that they enjoy an average of 10 years “in good health” and around 12 years “without restrictions”. This means, incidentally, that although older women live longer, they are less healthy in their final years⁶.

The income and wealth position of older people have improved significantly over the past decades. This should be qualified, however, in that “older people” are not a homogeneous group. There are wide age differences within the group, sometimes up to 30 years. The income position of the various age cohorts currently also differ considerably: some older people have only the state pension to live on, while many older people in the younger age cohorts in particular enjoy higher incomes than in the past thanks to their high supplementary pensions. And the health situations of the various cohorts also differ considerably. All this makes uniform arrangements for the group of over-65s less obvious.

The average income and wealth position of older people are expected to improve further over the coming decades. Compared to the disposable incomes of working people (under-65s), the disposable incomes of older people (over-65s) will increase over the coming decades. Here too a key factor is that the overwhelming majority of people (more than 90%) are participating in a supplementary pension scheme and are actually accumulating pension rights. By 2020 the average disposable incomes of over-65s under unchanged policies will

⁶ See SCP (2006), “Rapportage ouderen 2006, veranderingen in leefsituatie en levensloop”, Social and Cultural Planning Office (SCP), The Hague.

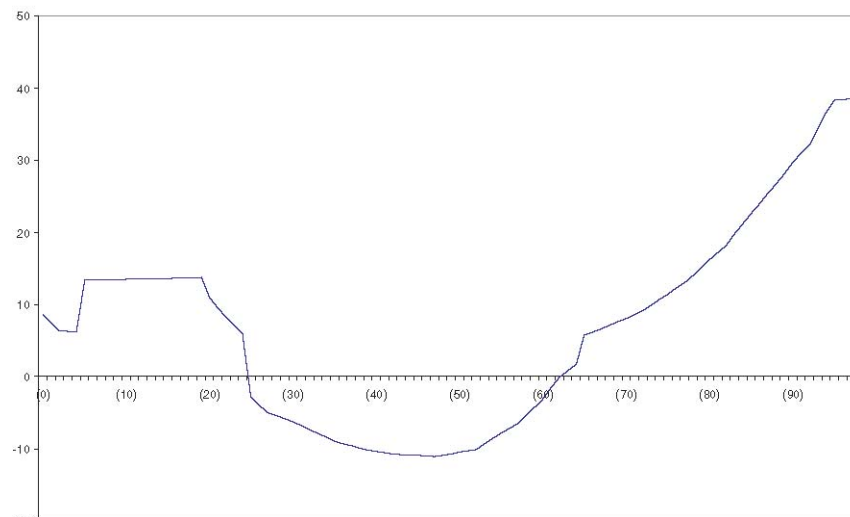
stand at more than 80% of the average disposable incomes of workers under the age of 65⁷. What is more, the fixed costs of the over-65s, such as for accommodation and childcare, are often lower than those of working people. Nevertheless, there will still be older people in the future who will have to make do with a minimum income. This is true, for instance, for a proportion of over-65s from the ethnic minorities, because these people came to the Netherlands at a later stage in their lives and will not have been able to accumulate full state pension rights.

2.2. Ageing and the public finances

Despite the positive developments in the life expectancies and income positions of older people, ageing also entails new challenges in many spheres, for society, for the economy and for the welfare state. This chapter examines the sustainability of the public finances and considers the contribution which the government budget can make in the area of population ageing.

The impact of ageing on the public finances can be illustrated with figure 2.3. This figure gives an overview of what is called the “net benefit” which the average individual enjoys during his or her life from the state, that is, from public services. During its first few years a child benefits from the state, through child benefit or the funding of schools for instance. As a working adult the individual then pays taxes, and the net benefit is negative. The situation changes again when the individual reaches retirement, because of the payment of the state pension and, especially towards the end of life, the provision of healthcare services.

Figure 2.3: Individuals’ “net benefit” from the government by age, 2006 (in EUR 000s)
Figuur 2.3 Profijt van de overheid naar leeftijd (1000 euro, 2006)



Source: CPB

⁷ Ministry of Social Affairs and Employment (2002), “De inkomenspositie van ouderen: toekomstige ontwikkelingen en de fiscalisering van de AOW-premie”, working document 230, The Hague.

Because of population ageing, the number of people who receive money from the state on balance will double, while those who make payments to the state on balance will fall by 10%. Moreover, people's working lives have shortened steadily over the past decades, while their periods of economic inactivity have lengthened. People enter the labour market at a later age, leave the labour market before reaching the statutory retirement age, and live longer. This creates a problem for the public finances because it narrows the tax base for the public services, at a time when public spending is actually increasing. The magnitude of this problem depends on many factors. The Netherlands Bureau for Economic Policy Analysis (CPB) has recently published a study on the development of the public finances over the long term⁸. Its findings will be considered in the next section.

Box 2.1: Misunderstandings surrounding the Pension Trust Fund

Repayment of the public debt is one of the possible solutions to the challenge which ageing poses for the public finances. After all, repayment of the public debt will reduce interest payments, and the resources released in this way can then be used to cope with the ageing costs. This idea lay behind the establishment of the Pension Trust Fund (AOW-Spaarfonds) in the 1990s.

In economic terms there is no difference between holding assets in the form of government bonds in a fund or paying off the public debt by the same amount. To prevent unnecessary bureaucracy, the government decided at the time to pay the repayments of the public debt for the purpose of keeping the state pension affordable in the future into the Pension Trust Fund. The Fund thus does not hold any debt certificates, but is a record of the repayments of specific debt instruments. Since the establishment of the Pension Trust Fund, around EUR 23 billion of public debt has been paid off in this way.

In the current situation the impression may take hold that the ageing problem will be solved as long as sufficient payments are made into the Pension Trust Fund. This is not the case, however. This because the sustainability of the public finances depends on the overall development of expenditures and revenues. Without additional economies, higher contributions to the Pension Trust Fund will simply translate into higher budget deficits. These contributions have no impact on overall sustainability. The Pension Trust Fund offers no additional scope besides or above normal debt repayment.

2.3. How serious is the problem?

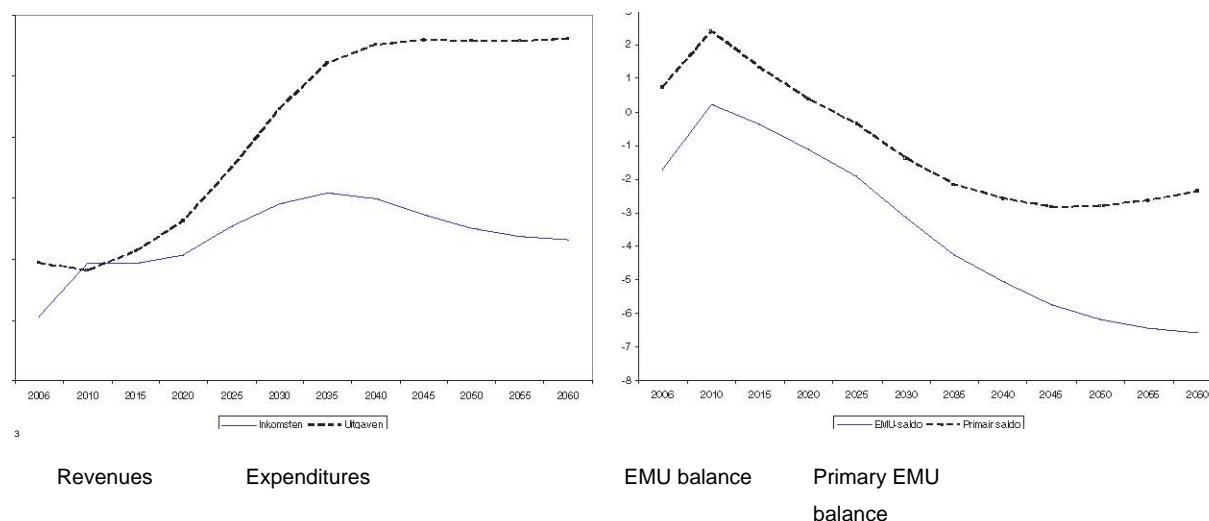
Trends in revenues and expenditures

Under unchanged policies, public spending is expected to increase by 7% of GDP until 2040. Ageing-related expenditures such as state pension payments and healthcare spending play a major role in this respect. Both will increase by more than 4% of GDP. At the same time the outlays on occupational disability and unemployment benefits will fall slightly (by -0.8% of GDP) owing to the reforms introduced over the past years. Government revenues will increase by nearly 4% of GDP during this period. Higher tax receipts will account for the lion's share of this (+5.9% of GDP). The receipts from taxes on pension payments will play a major role in this. However, at the same time the natural gas revenues

⁸ CPB (2006), "Ageing and the Sustainability of Dutch Public Finances", Netherlands Bureau for Economic Policy Analysis (CPB), The Hague.

flowing to the government will decrease because the natural gas reserves will have been exhausted towards 2030. This will depress government revenues by 1.5% of GDP. The other sources of government revenues will also decline somewhat on balance. Figure 2.4 shows the outcomes for overall government revenues and expenditures.

Figure 2.4: Government revenues and expenditures (left) and actual EMU balance and primary EMU balance under unchanged policies (right), 2006-2060 (in % of GDP)



Source: CPB

The public finances are not sustainable

Under unchanged policies, the Dutch public finances are not sustainable over the longer term. This is because we are systematically spending more than we earn. This is evident from the development of the “primary” EMU balance (i.e. the balance of revenues and expenditures excluding interest payments on the public debt, as shown in the right-hand chart in figure 2.4). This means that the government will have to continue to borrow in order to finance the public services. This process creates a snowballing effect: the government has to borrow ever more to pay for the public services; this pushes up interest payments on the public debt; and to cover these, the government has to borrow yet more. The actual EMU balance will continue to deteriorate in this situation. The CPB predicts that, under unchanged policies, the public debt will escalate to such an extent that it will gradually spiral out of control and eventually become unmanageable.

In short, the public finances are not “sustainable”. But what does this mean exactly? The public finances are sustainable if the existing public services can expand in line with overall prosperity without taxes having to be raised in the future and without the public debt spiralling out of control. “Sustainability” is essentially about solidarity between generations. The public finances are “sustainable” if there is a constant solidarity between young and old. Specifically this means that all generations now and in the future pay the same taxes and social security

contributions and enjoy the same institutional arrangements and public services in relative terms (i.e. as a percentage of GDP). The costs of ageing will then be distributed in proportion to the various generations' incomes across their life cycles.

Returning the public finances to a sustainable path will require, according to the CPB, an additional budgetary effort equivalent to around 3% of GDP (or just over EUR 15 billion; see also chapter 4).

Box 2.2: Ageing in Europe

All of Europe is ageing. However, there are major differences among the EU member states. The elderly dependency ratio in Italy and Germany, for instance, will rise to higher levels than in the Netherlands. Because of the contraction of the potential labour force, the potential economic growth for the EU as a whole is likely to decline from 2.4% per year between 2004-2011 to 1.2% per year between 2031-2050 (see also table b2.2.1).

Ageing-related expenditures will increase in all EU member states over the coming decades. On the expenditure side, it is striking that outlays will rise faster in the Netherlands than in other countries (see table b2.2.1). This is due in particular to the increase in state pension payments. These outlays will rise much faster in the Netherlands than in other countries. This is because in the Netherlands the level of the state pension is linked to the growth in general prosperity. In many other countries, state pension provisions have been curtailed in recent years in response to the impending population ageing, for instance by not or only partially indexing payments (United Kingdom) or by gradually reducing them (Germany, Italy). Such measures certainly contribute to the sustainability of the public finances, but it is unclear whether they will be *politically* sustainable. This because it is unclear to what extent a society will accept the consequent reductions in older people's incomes.

When the revenue side is taken into account, the outlook for the Netherlands should improve somewhat. Through the funded second pillar of the pension system, the Netherlands has already saved to some extent for future pensions. Against this, however, unlike many other EU member states, the Netherlands currently enjoys the positive effect of natural gas revenues on the public finances, but these revenues will decline in the coming decades. Unfortunately, the European Commission cannot provide a comprehensive comparison of both government revenues and expenditures for all EU member states.

Not least with an eye to population ageing, various Dutch governments have committed themselves to strengthening the economic structure and improving the public finances. It is clear that many other countries still have much to do in addressing this problem. For that reason many countries are considering raising the statutory retirement age. Germany will raise the retirement age gradually to 67 years, and the United Kingdom is considering raising it to 68 years.

Table b2.2.1: Population ageing effects in five EU member states and the EU-25, 2004-2050

	Elderly dependency ratio (in %) ^a		Potential annual growth rate (in % of GDP)			Ageing-related expenditures (in % of GDP) ^b	
	2004	2050	2004-2010	2010-2030	2031-2050	2004	Increase 2004-2050
Germany	26	52	1.7	1.4	1.2	22.4	3.0
France	25	46	2.2	1.8	1.6	25.5	3.3
Italy	28	62	1.9	1.5	0.9	25.8	1.8
Netherlands	20	41	1.7	1.6	1.7	19.1	5.2
United Kingdom	24	45	2.8	2.1	1.5	19.2	4.1
EU-25	24	51	2.4	1.9	1.2	22.5	3.8

^a "Elderly dependence ratio": ratio between pensioners (over-65s) and the potential labour force

^b Public spending on pensions, health and education

Source: EPC; for further details and information on other countries, see http://ec.europa.eu/economy_finance/epc/epc_sustainability_ageing_en.htm

Policy making amid uncertainties

The CPB's ageing calculations relate to a long period of time, and are therefore sensitive to the assumptions used and to new risks.

Firstly, there are demographic uncertainties. For instance, it is possible that the expected rise in life expectancy may turn out differently. New medical advances may boost life expectancy. This will then have an impact on state pension payments and possibly also on healthcare spending. The connection between healthcare spending and life expectancy is not clear-cut. The fact that most healthcare costs are incurred in the final year of life suggests that healthcare costs will not increase proportionately as life expectancy rises. What matters in particular in this context is whether people will be "healthy" or "ill" during the additional years of life. Higher life expectancy without health gains will undermine the sustainability of the public finances. By contrast, a rise in the birth rate will not have much impact on the public finances. This largely because it will take a long time before the new generations will make a net contribution to the state.

Secondly, there are economic uncertainties. For instance, in the CPB's ageing calculations the level of interest payments (and the discount rate) plays a major role. The CPB has based its calculations on a real return and a discount rate of 3%. A higher return is good for the pension funds, and through lower pension contributions also for the public finances. Incidentally, these figures are not excessively high or low by historical standards. Other

international economic institutions base their calculations on similar returns and interest rates in the future⁹.

Thirdly, there are policy uncertainties. For instance, the CPB assumes that public spending will increase in line with economic growth. But past experience shows that this is not always the case in practice, for instance because the level of benefit payments is linked to contractual pay rates, and contractual pay rates do not increase in line with labour productivity growth (because of wage drift and other factors). Moreover, some expenditure categories are not linked to pay trends. In fact, in the past healthcare spending has increased at a faster pace than economic growth (see also box 2.3).

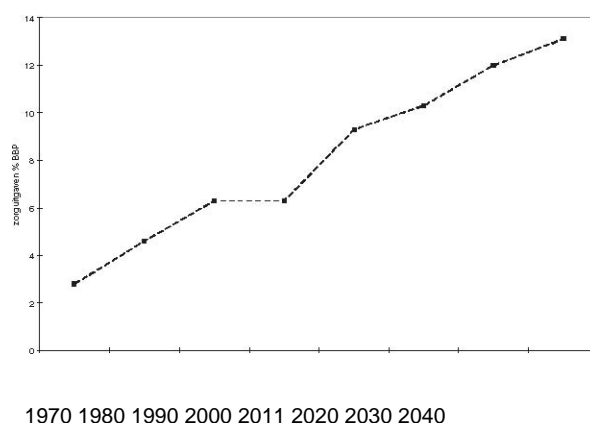
Despite these uncertainties, the Study Group takes the view that the ageing calculations currently provide the best available indication of the magnitude of the problem and of the upside and downside risks in the future. The Study Group recognises the volatility of the calculations, but despite all the ifs and buts, these calculations constitute the best starting point for policy formulation. These uncertainties can also be taken into account in policy formulation. For instance, if the decision is taken to solve the sustainability problem solely by “saving” (i.e. economies), then the eventual outcomes will depend heavily on interest rate trends over the coming decades. This will apply far less if the solution is sought in reforming the ageing-related institutions, for instance.

The following sections will consider the questions of “when” and “how” adjustments will have to be implemented.

Box 2.3: Healthcare costs over the long term

Healthcare spending will increase sharply over the coming decades. This is not a new phenomenon. Over the past decades healthcare spending also rose sharply as a percentage of GDP, from 2.5% in 1970 to 8.8% of GDP at the moment. Spending on public health is expected to increase to more than 13% of GDP by 2040. This means that healthcare spending will increase by around 4.3% of GDP (see figure b2.3.1).

Figure b2.3.1: Healthcare costs, 1970-2040 (in % of GDP)



⁹ See e.g. the ageing studies by the Organisation for Economic Cooperation and Development (OECD), the European Commission and the International Monetary Fund (IMF).

Sources: CPB, historical series (1970-2000); and CPB (2006), "Ageing 2006" (2011-2040).

Demographic changes account for only one-third of the increase in healthcare spending over the coming decades. The other two-thirds can be attributed to advances in medical technology and increases in real incomes. In its ageing calculations the CPB assumes an income elasticity factor of 1: that is, healthcare spending will increase in line (one-to-one) with the increase in incomes. International research often shows up an income elasticity above 1, however¹⁰. An explanation for this is that healthcare is a luxury good. This means that people want to spend more on good healthcare as they become more affluent. Furthermore, healthcare can also become more expensive as attractive new technologies become available. If this also applies to the Netherlands, then healthcare spending will increase by more than evident from the ageing calculations.

In principle it is not unwelcome that healthcare spending is rising. We spend more on healthcare, but in doing so we procure a service to which we attach a high value. But this is not the whole story. After all, we can only spend money once. Rising healthcare spending will crowd out other types of spending, for instance on social security benefits (e.g. the state pension and occupational disability benefit), education and essential investments in infrastructure (e.g. dikes) and the knowledge economy. An alternative solution is to raise the tax and premium burden in the future in order to pay for the additional healthcare spending. In this case healthcare spending will crowd out private spending. Moreover, as taxes rise, so do the transfers from the young to the old. Another option is to increase the personal contributions to healthcare costs. This stimulates a more conscious consideration of the different types of spending.

2.4. Painful choices

The public finances are not "sustainable". Under unchanged policies, expenditures will consistently exceed revenues. Sooner or later the government will have to take measures to bring revenues back in line with expenditures. This can be done by increasing revenues (simply paying the bill), by cutting spending programmes (reducing the bill) or by combining the two. After all, just like a normal household, the government cannot consistently spend more than it earns. However, one difference between the government and a normal household is that the government can shift "bills" between generations by passing on debts or other financial commitments to the future. Essentially, then, the issue is how we divide up the bill for ageing. Choices will have to be made, and eventually the bill will have to be paid.

The allocation of the costs depends on two factors. Firstly, it depends on whether the question is decided *now* or in the *future*. If the decisions are taken now, then the costs involved in moving towards sustainable public finances can be distributed across all the generations. If the decisions are postponed to the future, for instance because of the uncertainty about the precise magnitude of the problem, then the ageing bill will be paid by young people and future generations.

Secondly, the allocation of the costs depends on the choice between measures which have an impact *immediately* or measures which work *gradually*. In the case of gradual measures, the effects will be felt above all by today's workers, young people and future generations. For instance, a gradual raising of the statutory retirement age, say from 65 years to 67 years by

¹⁰ See e.g. OECD, paper.

one month per year, will mean that the effects of this measures will be felt exclusively by people who are currently under 40, and not at all by today's pensioners. By contrast, immediate measures are likely to hit all generations (to a greater or lesser extent), for instance through an immediate increase in taxes.

Leaving aside the philosophical point about the desirability of spreading the bill across the generations, not taking decisions now carries a number of economic and political risks.

Firstly, not choosing now means that the adjustment burden will be heavier. Passing on the bill to the future is not without cost. It implies additional interest payments and the need for more sweeping measures in the future. Specifically, if the adjustments are postponed to 2020 or 2040, for instance, then the adjustment burden will be respectively 1 and 1½ percentage points of GDP higher than at the moment. This higher adjustment burden will also be more disruptive to the economy. This because higher taxes have negative effects on the labour supply. This in turn has negative effects on the tax base for the public services. Furthermore, the opportunities for avoiding higher burdens will increase if capital and labour become ever more mobile in a globalising world.

Secondly, the future prosperity trends are unclear. As with investments, it is true for economic growth that past performance offers no guarantee for the future. Moreover, the starting point for the Dutch economy is different from what it was several decades ago. Hourly productivity in the Netherlands is among the highest in the world. The demographic changes will make the Dutch economy more vulnerable to shocks. It will be far more difficult to absorb such shocks in the future, because there will be fewer workers and more pensioners.

Thirdly, the advantage of intervening now is the possibility for good transitional arrangements. Experience shows that institutional changes take a very long time in practice. Instead of sudden interventions, people can adapt to the new situation gradually and in time. This is desirable from the perspective of securing the broadest possible political support for adjustments (which enhances the reliability of government) and to avoid disruptions to the economy.

On the basis of the above economic and political arguments, the Study Group takes the view that it would be unwise to postpone adjustments to the future. In recognition of the precautionary principle, it is prudent to launch a range of policies now which offers a solution to the problem of the public finances.

This approach fits in with government policy over the last 25 years, which been focused – albeit in different ways and with varying intensities, but still virtually continuously – on strong economic growth, high labour market participation, sustainable public finances and the budgetary policy required to foster those objectives. A good example of this is the reform of

the occupational disability scheme (enshrined in the Income according to Capacity for Work Act [WIA]) introduced by the current administration. This has improved the sustainability of the public finances compared to the previous projections from 2000. In short, prudent measures do help.

Box 2.4: Economic growth: the size of the cake, and how to divide it

The sustainability of the public finances is essentially a distribution issue: who pays the bill? That is only one side of the coin, however. Future generations will also attach importance to the size of the “cake”, the level of prosperity, that is. For that reason it is not only the level of the public debt that matters, but also such aspects as the human and physical capital passed on to future generations.

What is more, economic growth can also help to solve the financial problems with the public finances. After all, it is easier to divide up a larger cake than to divide up a small cake. The Dutch economy is expected to expand over the coming decades mainly on the back of a rise in labour productivity. Government policies can contribute to the greater prosperity, for instance through investments in education, infrastructure and knowledge and innovation.

In contrast with an increase in labour participation, an increase in labour productivity does not make direct solution to solving the problem of the public finances: the Netherlands cannot “grow itself out of the problems”, as it were. This is because much of public spending increases in line with productivity growth. For instance because teachers’ and nurses’ pay and social security benefits are also linked, indirectly, to the rate of economic growth. Incidentally, the past decades have shown that most expenditures are not linked one-to-one to productivity growth. Some expenditures have increased faster, such as healthcare spending, while others have increased more slowly, such as benefit payments.

Another aspect is that, if the cake becomes larger, then future generations will become richer, and they can therefore make a stronger contribution (in relative terms) to the sustainability of the public finances. This can be done by charging these generations a higher price for the public services, or by raising public spending by less than the economic growth rate.

Government policies aimed at achieving sustainable public finances can also contribute to strengthening the economic structure of the Netherlands. By opting for measures which not only have budgetary and redistributive effects but also boost economic growth, the government can work towards a solution to the problem of the public finances from two directions.

2.5. Policy options

What measures can be taken to tackle the financial challenges ahead? Firstly, it makes sense to ensure that the measures address the core of the problem. This means giving thought to reforming the ageing-related institutions. Secondly, measures should be implemented which broaden the tax base for the public services. This will make it easier to cope with the rising costs in the future. And thirdly, the emphasis should be on “saving” for the future by improving the public finances.

For each of these three possible solutions it would also make sense to commit to strengthening the economic structure, as well as to bear in mind the distribution of the burdens across the generations and the administrative sustainability of the measures. As

mentioned in box 2.4, a strong and flexible economy helps to implement the required adjustments to ensure the long-term sustainability of the public finances. A strong economy makes it easier to take measures. When the economy is expanding, it is easier to secure the political support for measures aimed at achieving sustainable public finances. And a flexible economy makes it easier to respond to any shocks.

Reforming the ageing-related institutions

The terms of old-age provision, the ageing-related institutions, can be reformed. As mentioned in section 2.1, much has changed since the introduction of these institutions in the 1950s and 60s. People live considerably longer on average, and their income and wealth positions have also improved significantly over the past decades. The life expectancies and income positions of older people are expected to improve further over the coming decades. This raises the question whether the arrangements for old-age provision are still appropriate for this day and age.

Reforms of these institutions can contribute to making the public finances sustainable as well as to strengthening the economic structure. This happens in three ways. Firstly, the reforms are aimed at keeping the ageing-related institutions affordable. This will improve the public finances over the short term, but above all also over the longer term, because the ageing-related expenditures and revenues will increase as the ageing process unfolds. Secondly, the reform of the ageing-related institutions will in some cases also broaden the tax base for the public services. Thirdly, these reforms may also be aimed at making the public finances less vulnerable to shocks associated with ageing, such as changes in life expectancy or healthcare consumption. Specific examples of reforms (gradual or otherwise) are raising the statutory retirement age, abolishing the old-age allowance in income tax, and increasing personal contributions to healthcare costs (through higher nominal contributions and means testing, for instance).

Other reforms to broaden the tax base

A second option that can be considered is to broaden tax base for the public services, for instance by raising the labour market participation rate. Labour market participation will rise anyway over the coming decades, not least because younger generations of women are more used to working than older generations (“cohort effects”). It will also rise due to previous policy measures, such as changes to the pre-pension arrangements. However, these effects have already been included in the CPB’s ageing calculations.

New measures will therefore be required to raise labour market participation further. Among those that spring to mind are new incentives for people to work longer or for people to enter the labour market. In a recent study, “Reinventing the Welfare State”, the CPB has costed

various measures and scenarios. Specifically the measures could include individualising the general tax credit, shortening the period of entitlement to unemployment benefit or relaxing employment protection legislation. There is also the possibility of changing the tax treatment of owner-occupied homes. The budgetary revenues resulting from these measures could be used to cut tax rates and to make working more rewarding. This will have a positive effect on labour market participation.

Reducing public spending or raising taxes

A third option is to reduce public spending. It is of course logical (and good practice) to apply the measures where inefficiencies occur. And a fourth option is to raise government revenues, for instance with a generic hike in taxes or pension contributions. It should be noted, however, that higher taxes may actually erode the tax base for the public services. This because higher taxes have a negative effect on labour market participation. This should be borne in mind when implementing measures.

Box 2.5: A sustainability indicator: the required “robust” EMU balance

Budgetary policy works with different budget balances, namely the “actual balance” and the “structural balance”. In addition to these, the CPB’s ageing study introduces the “robust primary structural balance”, in short the “robust balance”.

The actual EMU balance is the balance of the revenues and expenditures by government (i.e. the central government, the lower-tier authorities and the social security funds). The structural EMU balance is the actual balance adjusted for the phase of the economic cycle. The robust EMU balance is the actual balance adjusted for the phase of the economic cycle (structural balance), interest payments on the public debt (primary balance) and the natural gas revenues and dividends from state participations (robust balance).

The robust balance is adjusted for the phase of the economic cycle because otherwise there is a danger that temporary higher revenues (generated during an economic boom) are spent permanently (through additional outlays or additional tax and contribution cuts). This would create problems for the public finances once the economy slows down again. This would jeopardise the long-term sustainability of the public finances. Another adjustment made is for interest payments on the public debt. This is because interest payments are not directly comparable to “normal” public expenditures. However, changes in the volume of interest payments have only a limited impact on the sustainability of the public finances. Most of the resources released should be used to improve the EMU balance as part of the effort to achieve sustainable public finances¹¹. And finally, with regard to the natural gas revenues, it must be remembered that these are of a temporary nature (since the supplies are finite) and will decline over time. Temporary windfalls in the natural gas revenues will therefore not help to make the public finances sustainable.

Putting the public finances back on a sustainable path will require an additional budgetary effort equivalent to around 3% of GDP. There are two ways of achieving this. Either by improving the above-mentioned “robust primary structural EMU balance” by around 3% of GDP by 2011. Or by matching government revenues and expenditures more closely, for instance by reforming the ageing-related institutions or broadening the tax base. In that case the robust balance required to achieve sustainable public finances will be lower.

Ultimately, then, changes in the required robust primary structural EMU balance will be decisive in evaluating the effects of measures aimed at achieving sustainable public finances.

¹¹ See also CPB (2006), “Ageing and the Sustainability of Dutch Public Finances”, p. 47.

What are the consequences of the various measures?

At the Study Group's request the CPB has considered a number of specific measures. Table 2.1 summarises the consequences of a number of different measures. It shows the overall effect of the measure on the sustainability of the public finances. The table and the annex do not provide an exhaustive overview, but rather a selection of measures which have already been raised in public debate. The Study Group does not make any recommendations for specific measures.

For all these measures the assumption is that the revenues are used directly to improve the public finances. When some of the revenues are used to restore purchasing power, for instance, the budgetary revenues will be correspondingly smaller. When some or all of the budgetary revenues are used to cut taxes on labour, this will also reduce the contribution to the solution of the financial problem. But a lower tax and premium burden will have a positive effect the Dutch economy's growth potential.

Table 2.1: Examples of measures in terms of their effects on sustainability and growth

Measure	Effect on sustainability of public finances (in % of GDP)	Effect on economic growth	Ageing-related
Raise statutory retirement age to 67 year over 20 years	0.6% of GDP	+	v
Gradually abolish old-age allowance in income tax	0.7% of GDP	-	v
Reduce health insurance cover (with unchanged contributions) or increase personal contributions by 0.5% of GDP	0.7% of GDP	0	v
Shorten entitlement to unemployment benefit to 18 months	0.2% of GDP	+	
Individualise the general tax credit	0.7% of GDP	+	
Change tax treatment of owner-occupied homes	0.1-0.2% of GDP	+	
Cap tax break for pension saving at 1.5 times the average	0.2 % GDP	-	
Reduce material government consumption by 0.5% of GDP	0.5 % GDP	0	

Source: CPB

Calculations by the CPB show that the budgetary and economic effects of the various measures differ. Moreover, the measures also have different distribution effects. Gradual measures, such as the step-by-step raising of the statutory retirement age or economies in healthcare spending, will transfer a larger share of the adjustment burden to young people and future generations. By contrast, measures with an immediate effect will share the bill out among all the generations.

Addressing the core of the problem

The new government will face a serious challenge. Even so, the Study Group has come to the conclusion that there are many options to address the problems and to spread the pain. The Study Group takes the view that in formulating the required measures, the government should not only consider the effects on the public finances, but also the likely effects on economic growth and the distribution of risks and burdens across the generations. The administrative sustainability of measures is also a legitimate consideration.

Against this background the Study Group recommends that the government addresses the core of the problem. This means putting the emphasis on reforming the ageing-related institutions and on broadening the tax base.

3. Operation of the budget system

3.1. Trend-based budgetary policy

A “trend-based budgetary policy” has been pursued in the Netherlands since 1994. The trend-based budgetary policy reflects three key objectives of budgetary policy: imposing budgetary discipline and political calm, smoothing cyclical fluctuations (see box 3.1), and enhancing the reliability of government.

The following sections will elaborate the operation of the trend-based budgetary policy. Two phases can be distinguished in this context: its operation during the coalition negotiations, and its operation during the government’s term of office.

Box 3.1: The importance of cyclical stabilisation

Smoothing cyclical fluctuations in economic growth, or “cyclical stabilisation”, is important, because stable economic development promotes an efficient utilisation of capital and labour and provides certainty for citizens and businesses. Fluctuations in economic growth create uncertainty about jobs, incomes and returns on investments. This may not only have temporary but also structural implications. An inefficient utilisation of the production factors (i.e. capital and labour) can lead to underinvestments in physical and human capital. This will depress the growth potential over the longer term. Sharp positive spikes in economic activity increase the risk of a pay and price spiral taking hold. And overinvestment can lead to capital destruction over time (through vacant office buildings, for instance).

How can budgetary policy contribute to the desired cyclical stabilisation?

Experience has shown the futility of the government pursuing an active anticyclical budgetary policy. This is when the government tries to stimulate demand when the economy is struggling and curb it when it is thriving. The main reason why this is ineffective has to do with the timing of measures. The government’s measures often come too late, because the implementation of budgetary adjustments takes time and the economic situation will have changed again in the meantime. Furthermore, there is also a tendency towards asymmetric action. That is to say, the government tries to stimulate demand during the lean times, but “forgets” to apply the brakes during the good times. This has negative effects on the budget balance and the public debt.

An alternative to an active anticyclical policy is to allow the “automatic stabilisers” to operate in the budget. The idea is that the government does not take measures to stabilise economic growth, but allows the impact of the economic cycle to work through on the budget balance and the public debt. Any windfalls on the expenditure or the revenue side should not be used for new policy commitments, while setbacks need not require a policy response. This smoothes the cyclical fluctuations. A welcome side effect is that it brings calm to the budget process.

The extent of automatic stabilisation in the trend-based budgetary policy system has increased over the years. Initially a windfall formula was applied to the revenue side, under which some of the cyclical or other revenue windfalls were channeled back to citizens and businesses in the form of temporary or permanent cuts in taxes and social security contributions. However, following a recommendation by the previous Study Group on the Budget Margin, the second Balkenende administration decided to abolish the windfall formula. Consequently the automatic stabilisers are now also allowed to operate fully on the revenue side when the economy is performing well. In this report the Study Group will consider in greater detail the possibilities of strengthening the operation of the automatic stabilisers on the expenditure side.

3.1.1. Operation during the coalition negotiations

At the start of a government's term of office the CPB calculates the "free budgetary margin" or scope under unchanged policies (see also chapter 4). The budgetary margin can be used for new spending commitments, tax and contribution cuts and/or to improve the budget balance. The margin can be extended by economising on existing outlays, raising taxes and/or social security contributions, or accepting a higher budget deficit. These are political choices.

During the coalition negotiations the potential coalition partners are free to decide the balance between spending programmes, taxes and social contributions and the budget balance. In the trend-based budgetary policy the final decisions will be anchored with the formulation of a target for the budget balance. This budget balance target is informed by two demands: the need for cyclical stabilisation over the short term, and the need for the long-term sustainability of the public finances.

With regard to cyclical stabilisation over the short term, the key point is that disappointing economic developments do not immediately require spending cuts or tax hikes. The Treaty of Maastricht sets a deficit of 3% of GDP as the bottom limit for the EMU balance. The budget balance target will therefore have to take account of a safety margin for this 3% of GDP. This implies that the budget balance target should be expressed in structural terms (i.e. adjusted for cyclical fluctuations).

With regard to the long-term sustainability of the public finances, the key point is to take account of the projected widening of the budget deficit as a result of population ageing (which will lead to higher state pension payments and healthcare spending). This may have implications for the budget balance now, because "saving" or economising is one of the ways of coping with the increase in expenditures in the future (see also chapter 2).

Once the budget balance target has been set, the potential coalition partners will have to decide the level and composition of expenditures and revenues. Expenditures are eventually tied to maximums for each year of the government's term of office, the "expenditure frameworks". And the budgetary margin for policy changes on the revenue side is laid down in the "revenue framework" for the whole term (see also below).

By estimating economic growth cautiously when deciding the budgetary margin, there is a built-in chance that revenues in particular will come out higher than expected. Consequently there is a relatively good chance that the budget balance target will be met, even if structural growth lags behind somewhat (see also section 3.6).

3.1.2. Operation during the government's term of office

During the government's term of office the budget balance is merely an outcome of the actual expenditures and revenues. At this time the lead role falls to the expenditure and revenue frameworks.¹²

The expenditure and revenue frameworks are important above all for budgetary discipline. The expenditure frameworks set maximums for spending. When the frameworks are in danger of being exceeded, economies will have to be made. The basic principle underlying the setting of the expenditure frameworks is that expenditures which count towards the EMU balance should also count towards expenditures under the expenditure ceiling (see also annex 6).

There are three budgetary frameworks or "budget discipline sectors": (i) the "central government in the narrow sense" sector covers all expenditures and non-tax revenues of virtually all ministries; (ii) the "social security and labour market" sector covers all expenditures in that sphere, both those in the central government budget and those financed by social security contributions; and (iii) the "health" sector covers all public healthcare spending. In principle no resources can be transferred between the three budget discipline sectors. Any overruns should be compensated within the same sector (and within the separate departmental budgets in the case of the central government budget in the narrow sense). The cabinet decides what to do with any net windfalls.

The revenue framework lays down the maximum increase and reduction in the overall tax and premium burden over the government's term of office. If these parameters are exceeded, a compensatory adjustment will have to be made. Incidentally, there is no obvious choice for the indicator to be used to measure the policy intentions on the revenue side. The Study Group sees two options. The first is to link the revenue indicator to the EMU balance. This should reduce the chances of any unforeseen deviations from the budget balance target. A second option is to use an indicator which reflects people's perceptions of the tax and premium burden. This will be considered in greater detail in annex 3.

The Study Group takes the view that more attention should be paid to what are called "tax expenditures" and schemes which resemble tax expenditures or constitute significant drains on the budget. The reason for this recommendation is that many of these schemes are similar to spending programmes, but for practical reasons they do not fall under a similarly strict control regime. This raises the risk of a certain bias in favour of these schemes. The existing restrictive assessment framework for the introduction of new tax expenditures and the associated agreements on the evaluation of introduced tax expenditures should be retained. Furthermore, the existing overview of the budgetary development of tax expenditures should be extended to include a number of schemes which resemble tax expenditures or constitute

¹² The technical elaboration of the rules applying during the government's term of office is laid down in the budgetary rules (see Budget Memorandum 2004, annex 9).

significant drains on the budget (including schemes linked to owner-occupation and pensions). In accordance with current practice, policy-based changes and new tax expenditures should be included within the taxation framework. This will be considered in greater detail in annex 4.

It should be noted that in the trend-based budgetary policy, revenues and expenditures are strictly separated (see also annex 2). Revenue windfalls cannot be used to finance additional spending (nor to cut taxes and social security contributions, see below). By the same token, revenue setbacks will not lead to economies either. The reason for the separation of revenues and expenditures is that revenues in particular react strongly to economic fluctuations. If decisions on the scope for new outlays took account of these fluctuations every time, the upshot would be considerable administrative unrest. Ministries now have certainty about their spending allocations and can concentrate on realising their policy objectives.

Incidentally, because the real growth in expenditures has been fixed, overall spending is also relatively unaffected by upward or downward fluctuations in economic growth. This implies in principle that government expenditures stimulate relatively more when economic growth is lower than expected, and restrict relatively more when growth is higher than expected. However, the expenditure frameworks will not provide cyclical stabilisation if cyclical windfalls in the expenditure frameworks are used for additional spending (see also section 3.3).

On the revenue side the budgetary rules automatically provide cyclical stabilisation. In the system the revenues move wholly in line with economic developments (apart from any policy scope laid down in the revenue framework), so that the automatic stabilisers can operate. If the economy is thriving, tax receipts will rise. But the government will only use these additional revenues to reduce the public debt, not to make new spending commitments. This acts as a slight brake on economic activity. If the economy is struggling, citizens and businesses will pay less tax. In this situation the government will not change policy, but will borrow additional resources, which will stimulate growth.

Budgetary discipline requires that limits are set to automatic stabilisation, however. If the budget balance deteriorates to such an extent that the Treaty of Maastricht's 3% of GDP limit is in danger of being breached, the government will have to reassess the situation in the light of further revenue setbacks and the expenditure frameworks.

If the expenditure frameworks and the revenue framework are not exceeded during the government's term of office, the structural balance target will be achieved "automatically", that is, regardless of economic developments (unless any cyclical scope within the expenditure frameworks is used up). If the economy performs differently than envisaged in the coalition agreement, the actual budget balance will deviate, but that is desirable from the perspective of smoothing cyclical fluctuations.

If the structural economic developments turn out differently than expected, the budget balance target will not be met under unchanged policies. Under the system, the government does not respond immediately to structural developments. After all, it takes some time before it becomes clear whether a development is structural or not. There will be an opportunity to review budgetary policy once every four years, during the coalition negotiations.

Finally, it should be mentioned here that currently there is in principle a single main decision-making moment in the annual budget cycle. This is important for budgetary discipline. All expenditure and revenue proposals can be considered together at this point. This approach also prevents adjustments to the budget in the course of the year. This benefits political calm. By placing the main decision-making moment in the spring, any necessary legislative processes can be started in time, so that the desired or required changes can be implemented at the start of the financial year (1 January in the Netherlands). It is of course possible to introduce measures during the year, but this will exact a high cost in the form of additional administrative burdens. It must be said, by the way, that the spring is now a rather busy period, with discussions and debates on the Central Government Annual Financial Report, the Spring Memorandum on the current financial year in the House of Representatives, and the draft budget for the coming year in the cabinet. Furthermore, it has become apparent in practice that the period between the spring and the Third Tuesday in September, "Prinsjesdag", when the budget is unveiled, often leads to further discussions in August, so that a second decision-making moment has emerged in addition to the main decision-making moment.

3.2. Possible adjustments to the budget system

The previous paragraphs set out the ideal operation of the expenditure and revenue frameworks. The Study Group recognises that the achievement of this ideal depends on the extent to which the rules are observed on the one hand and are transparent and understandable on the other. Of course there is a connection between these two aspects. Internationally the trend-based budgetary policy is regarded as an excellent and transparent system.¹³ The Study Group also takes the view that the trend-based budgetary policy broadly speaking remains a very useful concept. However, the experiences of the Kok and Balkenende administrations have thrown up two issues that require attention.

Firstly, during the recent economically turbulent years the trend-based budgetary policy did not function optimally. On the one hand, the sharp cyclical fluctuations of recent years and some incidental developments caused major changes in the EMU balance. To some extent, however, these were a logical and desirable consequence of the operation of the automatic

¹³ See e.g. IMF (2006) "Netherlands: Report on the Observance of Standards and Codes-Fiscal Transparency Module, and the Aide-Mémoire Regarding the Fiscal Framework", International Monetary Fund (IMF), Washington.

stabilisers. On the other hand, it became clear with hindsight that the safety margin for the Treaty of Maastricht's 3% deficit limit proved too small during the boom period around 2000. This was due in part to burden relief after higher than expected tax receipts and the use of the financial scope within the expenditure frameworks.¹⁴ Because of these two factors, the budget deficit was pushed beyond the 3% limit in 2003. This meant that the free operation of the automatic stabilisers had to be restricted. Savings and cuts had to be made during an economic downturn. The question is, how can the budget system be adjusted to ensure that such a procyclical policy is avoided in the future.

Secondly, in the context of the CPB's ageing studies questions were raised concerning the extent to which the trend-based budgetary policy provides a sufficient assurance that a balance target in line with sustainable public finances can actually be achieved during the government's term of office. Specifically, the question is how to prevent cyclical windfalls being spent structurally, and whether it is prudent to keep interest payments within the expenditure frameworks.

In light of this experience, the Study Group considered a range of possible adjustments to the budget system. In the first instance the Study Group considered potential alternatives to the trend-based budgetary policy, such as gearing policy to changes in the structural budget balance. However, the structural budget balance proves an unsuitable control variable for budgetary practice (see box 3.2). Hence the Study Group recommends instead to make changes to the existing system.

¹⁴ See also the Eleventh Report by the Study Group on the Budget Margin, "Stabiel en duurzaam begroten", pp. 30-35.

Box 3.2: Structural budget balance

The structural budget balance is the balance adjusted for the state of the economy.¹⁵ In theory the structural balance is thus a good indicator of the underlying situation and development of the public finances. The structural balance could help to prevent a procyclical budgetary policy, because it brings to light budgetary easing (if the structural balance deteriorates) or budgetary tightening (if the structural balance improves). Budgetary tightening is unwelcome when the economy is struggling, just as budgetary easing is unwelcome when the economy is thriving.

The usefulness of the structural balance as a control variable is limited in practice, however. At the time when decisions are taken, no reliable figures are available. In particular the level of the structural balance is difficult to estimate and often needs to be revised subsequently (see table b3.2.1). For instance, it turned out that in 2001, 2002 and 2003 the structural balance was far worse than was thought at the time when decisions were taken. The Budget Memorandum 2002 still projected a structural surplus of 0.8% of GDP for 2002. The situation then deteriorated sharply during the financial year. According to the latest data, there was actually a structural deficit of 1.9% of GDP. So whereas at the time of the Budget Memorandum it was still thought that the safety margin for the 3% limit was maintained, it emerged subsequently that this margin had been significantly exceeded.

Table b3.2.1: Structural budget balance (in % of GDP)

	2000	2001	2002	2003	2004	2005
In Budget Memorandum (September year t-1)	-0.3	-0.1	0.8	0.0	-0.7	-1.0
In Spring Memorandum (June year t)	0.6	0.2	0.2	-0.4	-1.4	-0.4
In Budget Memorandum (September year t)	0.7	0.8	-0.6	-1.3	-1.4	-0.6
According to spring forecast 2005	-0.6	-1.3	-1.9	-2.1	-0.9	1.0

Source: European Commission forecasts

The year-on-year change in the structural balance is not very reliable either, but it is a bit more stable than the change in the actual balance (see tables b3.2.2 and b3.2.3). In 2002, for instance, the change in the actual balance was far greater than that in the structural balance. So the structural balance does offer a better insight into the underlying consolidation (or easing) than the actual balance. The year-on-year change thus provides a useful sidelight in the evaluation of budgetary developments.

Table b3.2.2: Changes in structural balance compared to previous year (in % of GDP)

	2000	2001	2002	2003	2004	2005
In Budget Memorandum (September year t-1)	n.a.	0.2	0.9	-0.8	-0.7	-0.3
According to spring forecast 2006	0.8	-0.7	-0.6	-0.2	1.2	1.9

Source: European Commission forecasts

Table b3.2.3: Change in actual balance compared to previous year (in % of GDP)

	2000	2001	2002	2003	2004	2005
In Budget Memorandum (September year t-1)	n.a.	0.7	-0.1	-1.7	-1.6	0.4
According to spring forecast 2006	1.5	-2.0	-1.8	-1.1	1.2	1.6

Source: European Commission forecasts

¹⁵ In the European Commission definition, the structural budget balance is the "cyclically adjusted budget balance", which also strips out one-off measures. In this report structural balance and the cyclically adjusted balance are used interchangeably, because in the Dutch practice both balances are almost invariably identical. (But in the past an adjustment was made for the proceeds from the auction of UMTS licences, for instance.)

3.3. Cyclically sensitive expenditures

In the current budget system, cyclically sensitive expenditures are included in the expenditure frameworks. The main cyclically sensitive expenditures are unemployment and welfare benefit payments (under the Unemployment Benefit Act [WW] and the Work and Welfare Act [WWB]), interest payments, and pay rates and prices. This can lead to a procyclical policy.

Impact of cyclically sensitive expenditures on the budget

When the economy is thriving, the higher output leads to a rise in employment and a fall in unemployment. Lower unemployment in turn leads to lower outlays on unemployment and welfare benefits. Conversely, when the economy is struggling, the volume of unemployment and welfare benefit payments will rise. This is welcome, because these benefits are intended in part as an insurance against macroeconomic headwinds. It is precisely during an economic downturn that people should be able to call on these benefits.

In addition to unemployment and welfare benefit payments, interest payments are also indirectly affected by the economic cycle. Interest payments are determined by the size of the public debt and the level of interest rates. If the economy is thriving, government revenues will rise, and on the assumption that no new policy commitments will be made, the EMU balance and EMU debt will improve and hence interest payments will fall. An economic upswing has no direct effects on the level of interest rates in the Netherlands. Dutch interest rates are largely determined by financial and economic developments abroad. It is of course quite possible that higher interest rates and higher economic growth go together in the Netherlands. Higher interest rates should in principle lead to higher interest payments. But the main factor is the *volume* of interest payments.

However, a thriving economy not only means lower government expenditures. The higher output also generates upward pressure on pay rates and prices. Pay rates in the public sector and the health service tend to track contractual pay rates in the market sector. And benefit rates also rise, because they are linked to contractual pay rates. The increases in pay rates and prices thus lead to additional public spending. Moreover, the increases in pay rates and prices in the public sector usually exceed the increases in the price of national expenditure. This means that the pay and price inflation differential between the public sector and the whole economy – the public sector's and hence the government's "terms of trade", as it were – will deteriorate. This will reduce the budgetary margin, because in the framework system only general price trends are compensated (by indexing the frameworks with the deflator for national expenditure).

In short, then, during an economic boom period unemployment and welfare benefit payments and interest payments are likely to fall. Against this, pay rates and prices in the public sector are likely to rise faster than those in the economy as a whole.

Possible procyclical operation of the framework system

The expenditure frameworks are formulated on the basis of projected economic growth during the years of a government's term of office. The framework system may lead to procyclical policy if growth comes out differently or if the impact of growth on expenditures differs from that expected at the time of the coalition negotiations.

The current framework system leads to a procyclical budgetary policy if, as a result of unexpected cyclical movements, unemployment and welfare benefit payments and interest payments together change by more than the pay and price inflation differential. This will create scope within the expenditure frameworks if the economy performs better than projected in the coalition agreement. Using this cyclical scope within the frameworks will then provide an additional stimulus to the economy. And if economic growth comes out lower than expected, the expenditure frameworks will come under pressure. If the government then has to economise to compensate for cyclical setbacks, macroeconomic demand will fall, precisely at the time when the economy is not performing well. If the government decides to save on unemployment and welfare benefits, then the desirable insurance element of benefits will be undermined.

To determine the extent of the budget's sensitivity to cyclical developments, the Study Group asked the CPB to conduct a number of simulations with the SAFFIER model. Table 3.1 shows two sources of cyclical fluctuations: an export shock and a consumption shock. These were standardised in such a way that the effect on GDP is 1 percentage point in the first year. (The CPB model does not consider the effects on the financial markets and financial positions.) The table shows that the source of the spending impulse is not a significant factor in the development of the cyclically sensitive expenditures. The table also shows that the effects over the short term, after two and three years, are greater than after four years. The reason for this is the time lag in the full effect of the deterioration in the pay and price inflation differential. It takes four years before the fall in unemployment and welfare benefit payments and interest payments is finally largely offset by the deterioration in the pay and price inflation differential. After four years there remains a margin of around EUR 250 million. In the second and third years government expenditures come out around EUR 500 million lower on balance.

With regard to temporary windfalls, the budgetary rules state that "scope within the expenditure framework created by temporary or permanent windfalls owing to more favourable macroeconomic developments (such as lower interest payments, a lower volume in social security outlays, or an improvement in the pay and price inflation differential) should not automatically be used for additional spending." But there is of course a risk that this scope will be used for additional spending after all. Another point to consider is that shocks may be greater than the equivalent of 1% of GDP. For instance, during the second Kok administration

the cumulative growth differential widened to 2.5% after two years, but after four years it was actually slightly negative (-0.2%).

Table 3.1: Setbacks compared to the expenditure frameworks for various economic shocks equivalent to 1% of GDP (in EUR billions)

	1st year	2nd year	3rd year	4th year
Export shock				
Interest payments	0.0	-0.1	-0.2	-0.4
Unemployment and welfare benefit payments	-0.2	-0.7	-0.8	-0.6
Pay and price inflation differential	0.3	0.3	0.5	0.8
Total	0.1	-0.5	-0.4	-0.2
Consumption shock				
Interest payments	0.0	-0.1	-0.3	-0.4
Unemployment and welfare benefit payments	-0.1	-0.5	-0.6	-0.5
Pay and price inflation differential	0.2	0.3	0.5	0.7
Total	0.1	-0.4	-0.4	-0.3

Source: CPB

How large are the actual cyclical windfalls and setbacks?

Table 3.2 shows the differences between the actual figures and the estimates in the Budget Memorandum 1999 for the years 1999-2002 and in the Budget Memorandum 2004 for the years 2003-2005.¹⁶ These Budget Memorandum estimates are virtually identical to the expenditure frameworks set out in the coalition agreement and the Global Agreement for Government Policy (Hoofdlijnenakkoord). Between 1999 and 2001, when economic growth was high, there were substantial windfalls on the expenditure side.¹⁷

Another question is to what extent the windfalls compared to the expenditure frameworks are actually due to economic developments. The deviations from the frameworks may be due to economic developments, but they may also be due to new policies or estimation errors. In the context of the analysis of the procyclical operation of the frameworks, the cyclical deviations are particularly important. The cyclical effect has been estimated with the help of the SAFFIER model. If this cyclical margin is used up, the upshot will be a procyclical policy. Table 3.2 shows that there were substantial cyclical windfalls during the second Kok administration. But it also shows that a considerable proportion of the windfalls compared to the frameworks was due to new policies and/or estimation errors. For instance, the reduction in interest payments can be explained by substantial windfalls on the revenue side, which depressed the public debt and the interest payments needed to service it.

It is striking that, according to SAFFIER, no substantial cyclical setbacks occurred during the second Balkenende administration. This seems to be due largely to the recalibration of the

¹⁶ This table is based on figures from the Interdepartmental Budgetary Consultation System (IBOS), which keeps a record of all the central government's expenditures and non-tax revenues.

¹⁷ Exactly how large the windfall was at that time is difficult to estimate now, because there are no figures for the pay bill of the publicly financed health service. Consequently it is not possible to give aggregate figures.

frameworks at the start of the administration's term. As usual, part of the cyclical effect was incorporated into the frameworks at that time.

Table 3.2: Deviations from the coalition agreement, 1999-2005 (in EUR billions)

	1999	2000	2001	2002	2003	2004	2005
Unemployment benefit payments	-0.2	-1.2	-1.1	-0.8	-0.2	-0.6	0.1
of which cyclical effect	-0.1	-0.7	-1.1	-0.4	0.0	0.0	0.0
of which new policy / estimation error	-0.1	-0.5	0.0	-0.4	-0.2	-0.6	0.1
Welfare benefits	-0.4	-0.5	0.0	0.0	-0.2	-0.4	-0.8
of which cyclical effect	0.0	-0.1	-0.2	-0.1	0.0	0.0	0.0
of which new policy / estimation error	-0.4	-0.4	0.2	0.1	-0.2	-0.4	-0.8
Pay bill ^a	-0.2	0.2	1.2	2.7	-0.1	-0.8	-1.1
of which cyclical effect	0.4	0.7	0.4	0.2	-0.1	0.2	-0.7
of which new policy / estimation error	-0.6	-0.5	0.8	2.5	0.0	-1.0	-0.4
Interest rate payments	-0.3	-1.2	-2.5	-3.3	-0.4	-0.5	-0.5
of which cyclical effect	-0.1	-0.2	-0.4	-0.4	0.0	0.0	0.0
of which interest rate effect	-0.2	-0.4	-0.7	-1.0	0.0	0.0	-0.1
of which new policy / estimation error	0.0	-0.6	-1.4	-1.9	-0.4	-0.5	-0.4

^a Excludes pay bill of the publicly financed health service

Source: Ministry of Finance

How to prevent a procyclical budgetary policy

To prevent the cyclically sensitive expenditures leading to a procyclical budgetary policy, the cyclically sensitive expenditures could be placed outside the expenditure frameworks. At issue here are unemployment and welfare benefit payments, interest rate payments, and pay rates and prices (as expressed in the pay and price inflation differential). Placing these expenditures outside the expenditure frameworks would improve the operation of the automatic stabilisers. This would smooth cyclical fluctuations. The CPB estimates that, under the current framework system, the cyclical fluctuations would be amplified by around 10% after four years if the cyclical windfalls were used up in full. By contrast, if the unemployment and welfare benefit payments were taken out of the expenditure frameworks, the cyclical shock would actually be moderated by around 10%. However, a better operation of the automatic stabilisers would inevitably make the EMU balance more volatile.

Unemployment and welfare benefit payments

The unemployment and welfare benefit payments could be placed outside the expenditure frameworks by placing the endogenous development in these payments outside the frameworks. In that case a separate framework would have to be formulated for the effects of policy measures. Budgetary control would then be assured by compensating any additional spending increases compared to the coalition agreement. The disadvantage of this approach would be that structural deteriorations in the volume of unemployment and welfare benefit payments during the government's term of office could not be controlled directly or would prompt policy adjustments. Such deteriorations could occur as a result of, for instance, an

erosion of the Netherlands's international competitiveness or an unexpected or miscalculated leakage from other policy areas (following a reform of the Income according to Capacity for Work Act [WIA], for instance). The appropriate place for considering and agreeing any policy initiatives to correct such structural deteriorations would be the coalition negotiations every four years.

Another way of dealing with cyclical expenditures would be to leave the unemployment and welfare benefit payments inside the expenditure framework, but to adjust the framework for cyclical effects. A cyclical setback would then raise the framework, while a windfall would reduce it. However, it is difficult to determine the cyclical effect on benefit payments. The risk is that there would be constant arguments about which part of a windfall or setback is cyclical and which part structural. Situations may also arise in which large cyclical windfalls and structural setbacks occur at the same time. According to the rules, the cyclical windfalls would then be left out of consideration but the structural setbacks would lead to austerity measures. That would undermine the transparency of policy.¹⁸

Pay and price inflation differential

Pay rates and prices move in line with cyclical developments in the economy. The current framework system accommodates a proportion of the increases in pay rates and prices in the public sector. The consequent higher expenditures have a procyclical effect, however.

To prevent this procyclical effect, the expenditure frameworks could be given the form of nominal frameworks. This means that at the start of a government's term of office a decision would be taken about the permitted pay and price increases in the three budget discipline sectors (i.e. central government in the narrow sense, social security and labour market, and health). The frameworks would then not be adjusted again in response to changing macroeconomic conditions. A disadvantage of this approach would be that austerity measures would have to be introduced during an economic boom period in order to accommodate the accelerating pay rates and prices in the public sector.

If the preference is to accommodate these pay and price changes at all times, then a good option might be volume frameworks. At the start of a term of office the government would then decide the permitted volume growth of expenditures. Each of the three budget discipline sectors would then be allocated specific pay and price increases every year. This means that the specific pay and price trends would not be controlled if volume frameworks were used. This would also imply a procyclical effect.

¹⁸ An example that springs to mind in this context is the behavioural effects (i.e. incentives for municipalities) resulting from the introduction of the new Work and Welfare Act (WWB). These are likely to be of a structural nature. The CPB has said that it cannot as yet put a figure to the structural effect.

The current system uses real frameworks. These frameworks are formulated by deflating the nominal expenditures estimated in the coalition agreement with the price of national expenditure. Once agreed, the frameworks can only be adjusted for trends in the price of national expenditure and not for price trends in the specific outlays themselves. In effect the real frameworks are thus an intermediate form between volume and nominal frameworks. They have the advantage that the permitted nominal development is not fixed (as would be the case with nominal frameworks). Real frameworks thus strike a balance between unexpected price developments on the one hand and budgetary control on the other.¹⁹ For the sake of clarity it should be said that the real framework system only applies to adjustments made after the drafting of the coalition agreement; specific price developments are used during the coalition negotiations, however.

Interest payments

The volume of interest payments is influenced by, among other aspects, debt repayment policy, changes in interest rate levels, and cyclical developments in the economy. The cyclical component should ideally be placed outside the expenditure frameworks, to strengthen the operation of the automatic stabilisers. But there are also other grounds for taking interest payments outside the frameworks.²⁰

Existing budgetary policy is aimed in part at reducing the public debt and thus at reducing interest payments. This creates budgetary scope to absorb the higher expenditures in the future arising from population ageing. In the framework system a reduction of interest payments compared to the assumptions used in the coalition agreement will immediately create budgetary scope. However, changes in the volume of interest payments have only a limited impact on the sustainability of the public finances. Most of the resources released should be used to improve the EMU balance as part of the effort to achieve sustainable public finances.²¹ However, this raises the risk that these unexpected interest windfalls will be used for outlays which will not contribute to the sustainability of the public finances. When the interest windfall is due to lower interest rates, this is an additional argument for not using it to increase public spending. This because lower interest rates aggravate the ageing problem over the long term.²² Under unchanged policies (i.e. debt reduction), setbacks in interest

¹⁹ That the specific pay and price increases are generally accommodated in full anyway is largely due to the windfalls in the social security and labour market budget discipline sector arising from lower than expected unemployment and welfare benefit payments. In this way deteriorations in the pay and price inflation differential are implicitly accommodated in the current system. If unemployment and welfare benefit payments are placed outside the expenditure frameworks, an explicit choice will have to be made about accommodating deteriorations in the pay and price inflation differential.

²⁰ Placing interest payments outside the expenditure frameworks might also unintentionally affect the level playing field for a decision whether an investment project should be financed by the government alone or in cooperation with private players in a public-private partnership (PPP). This because this decision is based in part on the reduction in interest payments that a PPP project would entail. This calculation (specifically, the budget-neutral conversion of cash budgets into availability budgets) should of course remain possible even if interest payments are no longer included in the expenditure frameworks.

²¹ See also the box on p. 47 of CPB (2006), "Ageing and the Sustainability of Dutch Public Finances", Netherlands Bureau for Economic Policy Analysis (CPB), The Hague.

²² A change in the nominal component of interest rate levels has no effects on the long-term sustainability of the public finances. But the general argument about the resources released due to lower interest payments does apply.

payments are temporary and therefore have no influence on the sustainability of the public finances. This is an argument for placing interest payments outside the expenditure frameworks.

Conclusion

The current framework system provides scope for a degree of procyclical budgetary policy. The operation of the automatic stabilisers could be improved by placing the unemployment and welfare benefit payments and interest payments outside the expenditure frameworks. At the same time the frameworks' deflator could be adjusted to ensure that changes in the pay and price inflation differential are no longer accommodated automatically.

Placing all or part of the unemployment and welfare benefit payments outside the expenditure frameworks would have the disadvantage of diminishing the budgetary control over these expenditures. If this were done by adjusting the frameworks, there would be the issue of how to determine the endogenous, cyclical component of unemployment trends. Moreover, the system of expenditure frameworks would become less transparent.

Furthermore, the Study Group has observed that the cyclical windfalls and setbacks in unemployment and welfare benefit payments on the one hand and in the pay and price inflation differential on the other tend to cancel each other out over time. It is true, however, that the windfalls in unemployment and welfare benefit payments often occur at an earlier stage than the setbacks in the pay and price inflation differential.

Placing the interest payments outside the expenditure frameworks promotes the operation of the automatic stabilisers. Otherwise there is a risk that cyclical windfalls in interest payments, especially as a result of a better than expected development of the public debt, are used immediately for additional spending increases, and vice versa. Using any windfalls in interest payments is also undesirable from the perspective of the sustainability of the public finances. After all, policy is aimed at using the released resources to create scope for future increases in spending in order to pay for the ageing costs. When setbacks occur with regard to interest payments, it is not necessary to compensate for them, because they are of a temporary nature, given the policy of debt reduction.

In light of the above considerations, the Study Group recommends that interest payments should be placed outside the expenditure frameworks, but that unemployment and welfare benefit payments and pay and price inflation differential effects should remain within them. The Study Group also recommends that stricter agreements are made to ensure that any scope in unemployment and welfare benefit payments on the one hand and pay and price inflation differential effects in expenditure frameworks on the other is not squandered. Conversely, it seems reasonable – because of the connection between the pay and price

inflation differential and unemployment and welfare benefits payments– to use any pay and price inflation differential windfalls during lean economic times to offset setbacks in the social security and labour market budget discipline sector.

3.4. Safety margin for the 3% limit

Cyclical and incidental movements in the EMU balance may cause the 3% limit in the Treaty of Maastricht to be breached, as happened in 2003. In such cases the “safety margin” refers to the range within which the budget balance needs to move freely without any danger of this limit being breached.

The budget elasticities method

The safety margin is determined primarily by the cyclical movement in the budget balance. The idea is that at the bottom of the economic cycle, when the negative impact of economic developments on the balance is at its greatest, the 3% deficit limit should not be breached. The safety margin is then calculated in comparison to a situation in which the impact of economic developments is nil. Subtracting the safety margin from the 3% limit figure then yields the budget balance which should be maintained in a neutral phase of the economic cycle. During a boom period the balance will be better than that, and during lean times it will be worse.

The European Commission calculates the cyclical safety margin for all EU member states. The Commission calculates this fluctuation margin on the basis of the extent to which the budget balance moves in line with the economic developments – what is called “budget elasticity” – on the one hand, and a representative low point in the economic cycle on the other. Here the state of the economy is quantified on the basis of the difference between actual output and potential output, expressed as a percentage of potential output, what is called the “output gap”.²³

In its calculations the Commission also relies on the budget elasticity as estimated by the Organisation for Economic Cooperation and Development (OECD). The OECD first estimates the cyclical sensitivity of four revenue categories (i.e. income tax, social security contributions, corporation tax and indirect taxes) and one expenditure category (primary public expenditure). It then combines the five series into a single figure to indicate budget elasticity. In its calculations the OECD only takes account of the resource flows of the central government and the social security funds; it does not take account of those of the lower-tier authorities (e.g., in the case of the Netherlands, the provinces and municipalities) and other public bodies.

²³ Potential output is the level of output or production which can be achieved with the available production factors (i.e. capital and labour) without generating tensions in the economy (e.g. tightness on the labour market).

For the Netherlands the OECD estimates the budget elasticity at 0.55. This means that a deterioration of 1 percentage point in the output gap leads to a deterioration of 0.55 percentage points of GDP in the budget balance.

The European Commission calculates the representative bottom of the economic cycle for the Netherlands as the average of the volatility of the output gap for the Netherlands on the one hand and the unweighted average of the output gap at the bottom of the economic cycle in the EU member states on the other.²⁴ The Commission's time frame in this context is the period from 1980. The representative bottom of the economic cycle is expressed in terms of the output gap; for the Netherlands this figure is -3.6%.

Multiplying the budget elasticity with the output gap yields the safety margin. For the Netherlands this is 2.0% of GDP (= 0.55 * 3.6).

National shocks confuse the picture

The estimation methods used by the European Commission and the OECD are internationally standardised and do take account of specific national developments which are beyond the government's influence but which do affect the fluctuations in the budget balance. For the Netherlands these are, in particular: (i) the recent convergence of the progression factor²⁵ and GDP growth; (ii) fluctuations in the natural gas revenues; and (iii) fluctuations in the aggregate budget balance of the lower-tier authorities.

Regarding the recent convergence of the progression factor and GDP growth, the progression factor at the bottom of the economic cycle in 2003 was extremely low (-0.7). That is to say, when nominal growth was still positive, government revenues were falling. This low progression factor was related to the stock market crash and the sharp rise in pension contributions. Such a negative progression factor may well recur at some point in the future. The OECD's budget elasticity estimations do not take account of such a negative development. According to calculations by the Study Group, the safety margin as calculated by the European Commission may therefore be underestimated by around 1 percentage point.²⁶

²⁴ European Commission (2002), "Public Finance Report 2002", Brussels.

²⁵ The macroeconomic progression factor is an indicator of the extent to which tax revenues move in line with economic growth. The progression factor is equal to the percentage endogenous growth in tax receipts (i.e. the increase in tax receipts excluding policy implications) divided by the percentage growth of nominal GDP.

²⁶ The progression factor at the bottom of the economic cycle in 2003 was very low (-0.7). Such a negative progression factor, which was related to the stock market crash, the sharp rise in pension contributions and other factors, may well recur at some point in the future. But it is very difficult to gauge the implications for the safety margin for the 3% limit. The OECD's calculations are based on elasticities, which means that they take account of the average convergence between the progression factor and economic performance. One starting point could be that the OECD's calculations implicitly assume a progression factor of +0.6 at the bottom of the economic cycle (which is the average of the troughs since 1970). Multiplying the difference in the progression factor (1.3) with nominal GDP growth at the bottom of the cycle (2%) and the tax and premium burden (around 40% of GDP) can then give an indication of the effect of the extremely low progression factor on revenues (-1.0% of GDP) in comparison with the average bottom of the economic cycles.

Regarding the fluctuations in the natural gas revenues, the European Commission does not include these revenues when calculating the safety margin. The natural gas revenues have fluctuated between 0.4% of GDP and 4.2% of GDP since 1980 (the period over which the Commission makes its estimations). The high percentages were recorded in the 1980s, and do not seem very representative for the situation these days. Over the last decade the natural gas revenues have fluctuated between 0.4% of GDP and 1.2% of GDP. The corresponding safety margin is 0.4% of GDP (calculated as twice the standard deviation).

And finally, regarding the fluctuations in the lower-tier authorities' aggregate budget balance, the European Commission does not take account of the impact of the lower-tier authorities on the overall balance.²⁷ The contribution of the lower-tier authorities to the EMU balance has fluctuated between -1.0% of GDP and +1.0% of GDP since 1980. The corresponding safety margin is 0.8% of GDP (calculated as twice the standard deviation). The safety margin for the last decade is the same as for the longer period.

Distortions of the structural balance

Another important factor to consider is that it is difficult to determine whether the safety margin for the 3% limit is being maintained during the government's term of office. This is because normally no account is taken of the overestimation of the structural balance during an economic boom period. This problem is relevant because the safety margin is expressed in structural terms. If the safety margin is maintained, the structural balance will remain constant (in theory at least), while the actual balance will fluctuate. During a boom period the actual balance will come out more favourably than during lean times. How much more favourably depends on the size of the output gap. If the structural balance is overestimated, then it may emerge with hindsight that the actual balance had not improved sufficiently. As mentioned in section 2.1, such an estimation error occurred during the economic boom period around 2000.

Conclusion

Table 3.3 gives an overview of the factors which may exert a negative influence on the budget balance and on its estimation. The overall effect of these factors is difficult to gauge. It is not simply a case of adding together the full fluctuation margins for the natural gas revenues, the lower-tier authorities' aggregate budget balance and the phase of the economic cycle. This would imply an assumption that the natural gas revenues and the lower-tier authorities' aggregate balance are not sensitive to cyclical fluctuations. In the past both have in fact shown some correlation with the state of the economy, albeit not always equally strongly. But bearing in mind the incidental factors and the potential bias in the estimations of the structural

balance, a structural budget surplus would certainly be desirable from the perspective of maintaining a safety margin for the 3% limit.

Table 3.3: Possible fluctuations in the EMU balance (in %of GDP)

Cyclical sensitivity of the EMU balance	2.5%
of which convergence between the progression factor and GDP growth	1.0%
Fluctuations in the natural gas revenues	0.4%
Fluctuations in the lower-tier authorities' aggregate budget balance	0.8%
Distortion in the estimation of the structural balance (during economic boom periods)	memorandum item

3.5. Signal value

As mentioned, it is difficult to estimate the level of the structural balance at the decision-making moments in the budget process. Hence it is also difficult to estimate whether an unexpectedly widening deficit or surplus is due to a cyclical development or to a change in underlying structural growth. If it is due to the latter, there may be cause to reconsider the situation in the light of further revenue windfalls or setbacks. As the Eleventh Study Group on the Budget Margin observed, signal values can be used in this context.

However, a signal value may be incompatible with the idea that the automatic stabilisers should be allowed sufficient scope to operate during a normal economic cycle, and thus also during the peaks and troughs of a cycle. And from the perspective of political calm it is important that such signal values are not reached during regular fluctuations in the budget balance.

In the light of these considerations, the best option might be to abolish the signal value, especially if the budget balance target already implies a wide margin for the 3% limit. It is important, incidentally, to ensure that the safety margin for the 3% limit is maintained in each year of the government's term of office. This suggests a rapid implementation (or "frontloading") of any budgetary consolidation that might be required to stay within this margin. This offers advantages from the perspective of budgetary calm in particular, but this must be set against the time required to implement measures, both for technical reasons and because of the need to generate the necessary public support.

3.6. Cautious trend-based growth

²⁷ This does not take account of a possible extension of the taxation powers of the lower-tier authorities. This could widen the fluctuation margin for the lower-tier authorities' aggregate budget balance.

One of the principles of the trend-based budgetary policy is the use of cautious basic assumptions. The report of the Ninth Study Group on the Budget Margin adduces two reasons for using cautious basic assumptions:

- (i) cautious basic assumptions prevent unwelcome developments in the EMU balance;
- (ii) as the cautious basic assumptions get closer to economic growth forecasts, the chances of setbacks increases; past experiences show that policy responses are more difficult to agree for setbacks than for windfalls; hence a certain caution promotes budgetary calm and the durability of budgetary policy.

The above analysis shows that the cyclical effects within the expenditure frameworks tend to cancel each other out over a four-year period. This especially if interest payments are taken out of the expenditure frameworks. On the revenue side the budgetary rules prescribe the full operation of the automatic stabilisers: windfalls and setbacks in the revenues should work their way through in the budget balance. The revenue framework prevents a situation where windfalls could be used for tax and social security contribution cuts after all. This makes the political calm argument less pressing.

The argument concerning the budget balance target remains in force, however. If the automatic stabilisers are allowed to operate on the revenue side, then cautious projections are likely to yield windfalls which will have an impact on the balance. The main consequence of abandoning cautious projections is that the bias in favour of the budget balance target will be lost.

Whether any cyclical windfalls will actually materialise in practice remains to be seen. There is considerable uncertainty about economic growth (and the consequent budget balance trends). It is worth noting that it is clear that, with hindsight, the CPB's cautious trend-based growth scenario was not so much cautious but actually realistic for both the second Kok administration and the second Balkenende administration, as shown by the actual growth rates over the two government's terms of office. (This conclusion is based on the actual growth rates for 2004 and 2005 and the CPB's growth forecasts for 2006 and 2007.)

Given the magnitude of the challenge posed by ageing, it is imperative – now more than ever – to remain realistic. Since it is not possible to predict the state of the economy five years hence, the usual approach is to use economic scenarios. Since 1994 the government has relied on cautious trend-based growth scenarios. The experiences with this cautious approach have been encouraging. There have been fewer occasions where austerity measures had to be implemented to deal with disappointing budgetary developments. Even so, over the period as a whole the budget balance has not turned out higher than expected. This shows that a cautious scenario is not a needless luxury. The Study Group therefore recommends that in the coming period budgetary policy continues to be based on the CPB's

cautious trend-based growth scenario. For GDP growth by volume this implies a caution margin of ¼% per year.

4. Budgetary margin

4.1. Introduction

This chapter is about the budgetary margin. That is to say, how much free financial margin or scope will the politicians have at their disposal in the next government's term of office to improve the budget balance, increase public spending or ease the tax and premium burden under unchanged policies? And how does this free margin relate to the challenge to make the public finances sustainable?

This chapter first examines the main underlying factor in determining the budgetary margin, namely economic growth. Then it will outline the development of expenditures and revenues in the next government's term of office under unchanged policies. And finally, it will consider the relationship to the long-term sustainability of the public finances. As usual, this chapter relies heavily on the analyses published by the Netherlands Bureau for Economic Policy Analysis (CPB), such as CPB Document 118, "Boekhoudkundige berekening budgettaire ruimte 2008-2011". The projections for 2007 from the Spring Forecast 2006 and the multi-year projections from the Budget Memorandum 2006 provide the starting point for the CPB's calculations. These calculations have been supplemented with the implications of the government's decisions taken this spring.

4.2. Economic growth

Economic growth is a major variable in budgetary policy. This because it affects, firstly, the tax base (i.e. the volume of tax receipts and social security contributions), and secondly, the volume of unemployment and welfare benefit payments and the outlays on pay and prices. An accurate forecast of economic growth is therefore very important in determining the budgetary margin. The problem is that forecasting economic growth is fraught with difficulties.

For the next government's term of office, economic forecasts have to look two to six years ahead. Of course it is not possible simply to extrapolate from the past years' growth rates. But it is possible to make a considered projection of the Dutch economy's growth potential over the medium term. In this context the CPB uses high-growth and low-growth scenarios, because it is not feasible to give precise growth figure for six years ahead. The CPB looks in particular at the projected trend-based developments in employment and labour productivity. "Potential growth" is then defined as the rate of economic growth which can be achieved with a normal utilisation of the production factors (i.e. capital and labour). Cyclical factors are not taken into account at this stage.

The CPB incorporates cyclical developments in its projections by assuming that a period of strong economic growth (resulting in a positive output gap) or a period of weak economic growth (resulting in a negative output gap) will disappear during the government's term of office and that the economy will end the term in balance (with no output gap). This implies that projected growth will be slightly higher than potential growth if the output gap is negative at the start of a government's term of office. Conversely, projected growth will be slightly lower than potential growth if the output gap is positive at the term start. Potential growth adjusted for cyclical developments is called "trend-based growth". On the basis of current perceptions, the next government will start its term with a small positive output gap.

At the moment the CPB expects the Dutch economy to expand by an average 2% per year during the next government's term of office. In light of the current growth forecasts for 2006 and 2007 of around 3%, this may seem cautious. But these two years are years of economic recovery after a period of low economic economy. Underlying trend-based growth rates are much more modest. A closer analysis of structural economic growth between 2008-2011 shows that an increase in labour productivity growth will be offset by a clear decline in employment growth. Structural growth in labour productivity in the market sector is expected to be 2¼% per year during the period. This average was not reached during the last economic cycle (1993-2003). Employment growth in labour years will definitely fall in the coming years, because the labour supply will contract owing the ageing of the population.

The Study Group recommends that the calculations of the free budgetary margin for the next government's term of office continue to be based on the CPB's cautious trend-based growth scenario (see also chapter 3). The cautious trend-based growth scenario projects GDP growth of 1¾% per year.

4.3. Free budgetary margin

Assumptions

What is called the "free budgetary margin" is the difference between developments in the revenues and expenditures by the central government and the social security funds under unchanged policies. "Under unchanged policies" means that the CPB makes the following assumptions:

- agreed policies will be implemented; the cabinet's provisional decisions taken this spring are also included in the calculations;
- on the revenue side, tax and social security contribution rates will remain unchanged at their 2007 levels, and the usual indexations of payroll tax and social security contributions will be applied; this with the exception of the health insurance premiums (under the Health Insurance Act [ZVW]): since health insurance premiums will be set in a competitive

- market, they cannot be set below cost-covering levels over the long term, so these premiums will rise in line with the increases in healthcare spending;
- on the expenditure side, the usual indexations and links will be applied, and the projections of the volume trends in social security benefits will be based on demographic and labour-market-related developments.

The CPB also assumes that the free budgetary margin will be used to improve the EMU balance. And it assumes that the aggregate budget balance of the lower-tier authorities will be a constant -0.3% of GDP.

The calculations are based on a cautious trend-based growth scenario of an average of 1¼% GDP growth per year. This growth figure is systematically supplemented with the other macroeconomic variables which are relevant for the budgetary costings. Table 4.1 gives an overview of the macroeconomic assumptions.

Table 4.1: Macroeconomic assumptions, 2008-2011

	% change per year
GDP growth, by volume	1¾
GDP growth, in current prices	1½
Consumer price index (CPI)	1¼
Contractual pay rates, market sector	3
Pay drift, market sector	¼
Employment, market sector (in labour years)	¼
Labour productivity, market sector	2
	change from 2007
Unemployment (in % of labour force)	-½
Labour share in enterprise income (in %)	-¾
	end-year level
Long-term interest rates (10-year bond yield, in %)	4
Oil price (Brent crude, USD per barrel)	48

Source: CPB

Calculated free budgetary margin

The CPB has calculated a free budgetary margin of EUR 6½ billion (see table 4.2). The free budgetary margin is expressed in real terms, which means that the nominal budgetary developments between 2008-2011 have been deflated by the increase in GDP prices.

Table 4.2: Budgetary margin in 2011, at 2007 prices (in EUR billions)

Real increase in net expenditures	17
..of which health (excl. healthcare allowance and pay indexation)	6
..of which benefit payments (excl. indexations)	-¼
..of which indexation of pay rates and benefit payments	7½
..of which non-tax natural gas revenues	1¾
..of which healthcare allowance	1

..of which other	1
Real increase in revenues	23½
..of which national taxes (endogenous)	13
..of which increase in social security contribution rates	5
..of which social security contributions (endogenous)	5½
Budgetary margin (improvement in EMU balance)	6½

Source: CPB

The CPB expects overall public spending to increase by a total of EUR 17 billion. The impact of population ageing is already evident in the basic situation. Healthcare spending is expected to increase sharply by EUR 6 billion in real terms (excluding pay indexation). Around EUR 2 billion of this can be attributed to ageing. Furthermore, the number of state pension recipients will increase by 215,000, which implies an increase in outlays of EUR 2¼ billion in real terms. Not least owing to the reform measures, the outlays on other benefits (such as unemployment benefit and occupational disability benefit) will fall by a total of EUR 2½ billion. Because of the link to developments in the market sector, the outlays on public sector pay and benefit payments will also increase sharply, by EUR 7½ billion in real terms (of which EUR 2¼ billion in the health service). The non-tax natural gas revenues are expected to fall by EUR 1¾ billion. Because of the link to healthcare premiums, the outlays on the healthcare allowance will increase by around EUR 1 billion. The “other” line includes transfers to the Municipalities and Provinces Fund.

According to the CPB, government revenues will rise even faster, by EUR 23½ billion in real terms. In fact, they will increase faster than GDP growth. The endogenous increase of in taxes and social security contributions is concentrated in payroll tax and income tax. This is largely due to the progressive nature of the tax system. As real pay rates rise, more people will move into a higher tax bracket. The impact of ageing is also evident on the revenue side. The rapid increase in pension incomes (including the state pension) among the over-65s will boost tax revenues by EUR 1¼ billion. As mentioned, the CPB has assumed that the health insurance premiums (under the Health Insurance Act [ZVW]) will be set to cover costs. This means that premiums will rise in line with the associated healthcare spending, implying an increase of around EUR 5 billion.

The previous administrations have demonstrated that the free budgetary margin can be widened by reprioritising certain expenditures and revenues. Box 4.1 examines the specific options for controlling healthcare spending in the wake of the recent reform of the health insurance system.

Box 4.1: Control of healthcare spending

Healthcare spending in the Netherlands will increase relatively sharply during the next government's term of office. It will also rise faster than assumed in the CPB's ageing calculations. This is because the new projections also take account of lagging productivity growth in the health service and with the introduction of new, relatively expensive

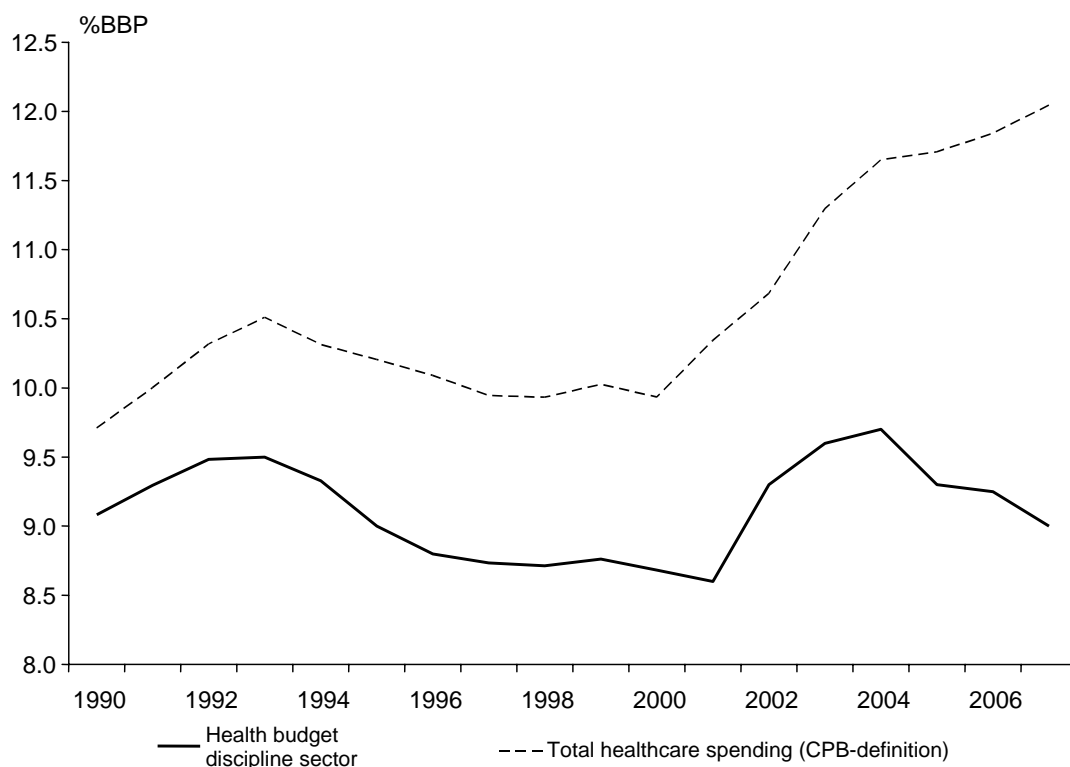
medical technologies over the medium term. Between 2008-2011 healthcare spending will thus increase by around 4.0% per year, of which 1.0 percentage point is due to demographic factors. In its ageing calculations the CPB worked with increases of 2.6% per year in real terms.

The increases in publicly financed healthcare are managed through the expenditure frameworks in health budget discipline sector. For budgeting purposes, the health sector is divided into three compartments:

- (i) the first compartment comprises publicly financed long-term high care under the Exceptional Medical Expenses Act (AWBZ); in 2005 AWBZ expenditures (excluding personal contributions) came to EUR 20 billion;
- (ii) the second compartment comprises publicly financed curative care; in 2005 curative care expenditures (excluding personal contributions and administrative costs) came to EUR 21 billion;
- (iii) the third compartment comprises privately financed healthcare; this is often provided under supplementary private insurance policies; some of these healthcare services used to be publicly insured in the past under the old compulsory health insurance scheme (dental care, for instance); in 2005 the expenditures in this compartment came to around EUR 15 billion.

Only the first and second compartments are funded from taxes and social security contributions and are budgeted within the health budget discipline sector. Figure b4.1 shows that publicly insured health cover has contracted over time, and that citizens are increasingly paying for treatments themselves directly or through supplementary insurance policies.

Figure b4.1: Healthcare spending as a percentage of GDP, 1990-2006



Source: CPB

Health care spending in the health budget discipline sector total healthcare spending (CPB definition)

In the 1990s healthcare spending was controlled through the budgets of healthcare providers (i.e. supply management). As waiting lists lengthened, this approach was modified. Medical charges are still controlled on the whole. But the number of medical treatments is no longer controlled directly. If the expenditures on publicly financed healthcare rise too fast, the government can consider either reducing the health insurance cover (while preserving essential healthcare) or raising the number and/or level of personal contributions. Furthermore, a number of voluntary agreements have been signed in some subsectors within the health service with the aim of containing expenditures. An example is the Drugs Covenant. One aim of the reform of the health insurance system is to build in stronger

efficiency incentives by making the insurance companies bear risks and giving them the freedom to contract providers selectively.

The range of instruments to control healthcare spending require decisions at the political level. These are often complicated by the side effects they cause. For instance, the choice between more personal contributions or a smaller health insurance package entails purchasing power effects. Compensation of these effects, for instance through tax and contribution cuts, implies that instruments to control healthcare spending often do not lead to the desired improvement in the budget balance. Because of statutory constraints, voluntary agreements can only be used as long as they preserve the right to healthcare and respect competition legislation. Moreover, it should be noted that it is too early to draw any conclusions on the operation of the voluntary agreements – or on the operation of the new health insurance system, for that matter.

Sensitivity analyses

The size of the free budgetary margin is sensitive to the composition and the level of economic growth (see table 4.3). The first variant in table 4.3 shows a change in the composition of growth. Compared to the baseline scenario, technological advances are set $\frac{1}{4}$ percentage point lower and labour supply and employment growth $\frac{1}{4}$ percentage point higher. As economic growth is generated more from employment growth and less from labour productivity growth, the budgetary margin will come out higher. The main reason for this is the lower real pay increases and hence lower costs for the government arising from indexations and linkages. The second and third variants indicate that lower economic growth will narrow the budgetary margin, while higher economic growth will widen the budgetary margin. They also show that the effect of a change in labour supply growth by $\frac{1}{4}$ percentage point per year has a stronger impact on the budgetary margin than the same change in labour productivity growth. The fourth variant is based on the caution margin of $\frac{1}{4}$ percentage point of GDP, half of which is allocated to labour productivity and half to labour supply in the macroeconomic assumptions.

Table 4.3: Sensitivity analysis for the on budgetary margin, at 2007 prices (in EUR billions)

	Composition of economic growth	Lower labour productivity growth	Higher labour supply growth	Caution margin
Real increase in revenues	$-\frac{1}{4}$	-3	$2\frac{3}{4}$	$2\frac{3}{4}$
Real increase in expenditures	-1	$-1\frac{1}{4}$	$\frac{1}{4}$	$\frac{3}{4}$
Change in budgetary margin	$\frac{3}{4}$	$-1\frac{1}{2}$	$2\frac{1}{4}$	2

Source: CPB

4.4. Relationship to the sustainability of the public finances

Achieving sustainable public finances during the next government's term of office will require a budgetary effort equivalent to around 3% of GDP (or EUR 15 billion). This figure has been calculated on the basis of the required improvement in the underlying "robust" EMU balance. The "robust" balance is the budget balance adjusted for the phase of the economic cycle, interest payments and natural gas revenues. According to the CPB's ageing calculations, the "robust" budget balance has to come out at a surplus of around 2% of GDP by 2011. On the

basis of current perceptions, however, the robust balance will come out at a deficit of around 1% of GDP (see table 4.4).

Table 4.4: EMU balance of the public sector in 2011 (in % of GDP)

EMU balance according to accounting calculation	0
Adjustment for unchanged tax and premium burden (-)	$\frac{3}{4}$
Interest payments (+)	$1\frac{1}{4}$
Natural gas revenues (-)	$1\frac{1}{2}$
"Robust" EMU balance	-1

Source: CPB

According to the CPB's accounting calculation, the EMU balance will reach equilibrium in 2011. This calculation assumes that the EMU balance in 2011 will not be affected by cyclical economic developments. Otherwise an adjustment for the phase of the economic cycle would have to be made, since there is a danger that temporary higher revenues (generated during an economic boom) are spent permanently (through additional outlays or additional tax and contribution cuts). This would create problems for the public finances once the economy slows down again. This would jeopardise the long-term sustainability of the public finances.

Under unchanged policies the health insurance premiums will rise during the next government's term of office due to rising healthcare costs. But it is assumed that this increase will be compensated in full. Consequently the balance in 2011 will come out EUR 4 billion lower than in the CPB's accounting calculation (i.e. a EUR 5 billion increase in the tax and premium burden to cover additional healthcare spending minus a EUR 1 billion increase in the healthcare allowance).

An adjustment for interest payments on the public debt has to be made, because interest payments are not directly comparable to "normal" public expenditures. However, changes in the volume of interest payments have only a limited impact on the sustainability of the public finances. Most of the resources released should be used to improve the EMU balance as part of the effort to achieve sustainable public finances.

And an adjustment for the natural gas revenues has to be made, because these revenues are of a temporary nature (since the supplies are finite) and will eventually disappear. The key point for the long-term sustainability of the public finances, then, is that the natural gas revenues will decline over time. Temporary windfalls in the natural gas revenues will therefore not help to make the public finances sustainable.

The precise figure for the budgetary effort used during the coalition negotiations will thus depend on the "robust" balance with which the new government starts its work. Specifically this means that the effort required to achieve sustainability will not change if at the start of the next government's term the EMU balance will be positively affected by higher than expected

natural gas revenues or lower than expected interest payments. However, the required effort will be affected by other – structural – changes in expenditures or revenues.

Finally, although the required budgetary effort is derived from the “robust” balance in 2011, this does not mean that the public finances can only be made sustainable by improving the balance in 2011. The required effort, or the required “robust” EMU balance, will come down if reforms are introduced which restrict ageing-related public spending in the future, or which boost government revenues in the future by raising the labour market participation rate (see also chapter 2).

5. The Economic Structure Enhancing Fund (FES)

5.1. Introduction

The establishment of the Economic Structure Enhancing Fund (FES) in 1993 has introduced greater “rationality” and more “discipline” in the decision-making process on public-sector investment projects.

However, the recent surge in the natural gas revenues has put decision making in the FES under pressure. This prompted the government to ask the Study Group on the Budget Margin to review the operation of the FES in general and its management structure in particular.

This chapter will consider the current structure and function of the FES, the issues for concern, and the recommendations by the Study Group.

5.2. Structure and function

The Economic Structure Enhancing Fund (FES) was established in 1993, as a response to the need to invest in the economic infrastructure. The idea was to earmark a proportion of the natural gas revenues for the financing of additional investment projects of national significance which would strengthen the economic structure. One stipulation, enshrined in the law establishing the FES, was that the natural gas revenues could only be used for specific time-limited projects, because a structural increase in public spending or structural tax and contribution cuts would erode the sustainability of the public finances over the long term, since the natural gas revenues are of course of a temporary nature.

The FES is funded from two sources: (i) natural gas revenues and (ii) resources released due to lower interest payments (as the public debt comes down). The proceeds for the state from the sale of natural gas consist of corporation tax receipts and non-tax revenues. Some 42% of the non-tax revenues are channeled into the FES. The other natural gas revenues flow into general revenues during the government’s term of office. The amount of the natural gas revenues depends on the US dollar’s exchange rate, the oil price and production levels. Thus if the euro appreciates against the dollar, the natural gas revenues will fall. And if the oil price (which is denominated in dollars) rises, the link between the oil price and the natural gas price ensures that the natural gas revenues will rise. In addition to natural gas revenues, the FES is also funded from the resources released due to lower interest payments, minus the dividend payments forgone because the proceeds from the sale of state participations are deducted from the public debt.

The FES has two administrators, the Ministry of Economic Affairs (in the person of either the minister or the state secretary) and the Ministry of Finance (in the person of the minister). The government receives advice on the FES from two official advisory bodies, the Interdepartmental Committee on the Spatial Economy (ICRE) for projects in the spatial economy sphere, and the Committee for Science, Technology and Innovation (CWTI) for projects in the knowledge and innovation sphere. The advantage of an interdepartmental construction is that it allows a broad-based consideration of potential investment projects. With regard to the selection of investment projects the good practice has developed that the committees are advised in turn by the various policy analysis bureaus, and in the case of the CWTI also by a “committee of wise persons”, that is, experts in the field. Another criterion is that projects submitted to the FES must be subjected to a social cost-benefit analysis. These analyses identify the various costs and benefits of specific investment projects. In this way projects can be compared with each other and weighed against each other. This puts the government’s investment policy on a more rational footing.

The FES is a distributive fund. The actual project expenditures are substantiated, estimated and reported in the other budget chapters. However, these expenditures are included in the expenditure frameworks. The FES expenditures are broadly distributed across the domains of transport and mobility, knowledge and innovation, environment and sustainability, and the spatial economy. Table 5.1 gives an overview of the allocation of FES resources. Since its establishment in 1993, the FES has disbursed more than EUR 31 billion, most of it on investments in the transport sphere. A separate expenditure line in the FES budget is what is called the “FES bridge”. This is used to finance FES-worthy projects in the regular central government budget (mainly on infrastructure). This creates scope in the regular central government budget for the financing of other (non-FES-worthy) public spending.

Table 5.1: Summary of FES expenditures by domain, 1993-2010

Domain	Expenditure (in EUR billions)	Share
Transport and mobility	21.9	71%
Knowledge and innovation	3.3	10%
Environment and sustainability	2.6	8%
Spatial economy	1.0	3%
FES bridge	2.5	8%
Total	31.1	100%

Source: Ministry of Finance (situation on adoption of Final Budget Act 2005)

5.3. Specific concerns and recommendations

Recently questions have been raised from several quarters about the operation of the FES.

The focus is on four concerns:

- the spending urge in the FES sparked by large natural gas revenue windfalls;
- the erosion of the FES criteria;
- the potential adverse effect of the FES bridge;

- the effectiveness of the FES's management structure.

5.3.1. Spending urge in the FES sparked by large natural gas revenue windfalls

Concern

The high oil price has recently brought substantial windfalls in the natural gas revenues. Because the FES's funding is linked to natural gas revenues, this generates more resources for the FES. This may in turn lead to a spending urge in the FES. This urge heightens the risk of investments being made whose social benefits do not weigh up against the costs.

Recommendation

To eliminate the likelihood of windfalls and setbacks in the FES in the future, the Study Group recommends the introduction of a fixed funding level. This would largely resolve the recent problem of the FES's "spending urge". During the government's term of office there would be no windfalls or setbacks which might lead to additional spending on or cuts in investment projects.

In a system of fixed funding, it does not matter that much to what the funding will be linked. During the government's term of office there is no essential difference between linking the funding to natural gas revenues or to, say, a percentage of GDP. However, to prevent incidental, temporary peaks or troughs in the oil price leading to a much higher or lower funding of the FES, any link with the oil price would have to be based on a long-term historical average of the oil price. A link with GDP would have to ensure that funding would not fluctuate in line with GDP growth during the government's term of office. One option would be to link the funding to a GDP projection at the start of the government's term and not to allow any adjustments subsequently.

Furthermore, the "year-end margin" in the FES will be maintained at 100%. This means that FES expenditures can be transferred to successive years, which does justice to the regular shifts in cash payments associated with investment spending.

5.3.2. Erosion of the FES criteria

Concern

In connection with the previous point, it can be argued that the substantial windfalls in the natural gas revenues have brought about a relaxation of the FES criteria. To guarantee the quality of FES expenditures, it has been suggested that the FES's "domains" should be circumscribed more closely in an amended version of the Economic Structure Enhancing Fund Act.

Recommendation

The Study Group recommends that, in order to guarantee the quality of FES expenditures, the criteria which FES-worthy projects are required to meet should be tightened.

The types of investments eligible for financing from the FES should meet the following criteria:

- the project should be an investment project of national significance which strengthens the structure of the Dutch economy;
- the project should be one-off and temporary;
- the project should fit in with the medium-term investment agendas in the spheres of infrastructure and sustainability on the one hand and education, knowledge and innovation on the other;
- the project should be subjected to a detailed cost-benefit analysis, which examines the legitimacy, effectiveness and efficiency of the investment.

The above criteria emphasise the investment nature of the expenditures to be financed from the FES. The quality of FES investments is assured in two ways. Firstly, the legitimacy, effectiveness and efficiency of the investment project is examined by means of a detailed cost-benefit analysis. This makes it possible to weigh projects against each other, and thus to achieve an optimum application of resources. And secondly, the investment projects must fit in with the medium-term investment agendas in the spheres of infrastructure and sustainability on the one hand and education, knowledge and innovation on the other.

In the new structure, the government will set a medium-term investment agenda for infrastructure and sustainability on the one hand and education, knowledge and innovation on the other. Both investment agendas will guide the formulation of the priorities and challenges which lie ahead in these spheres. To some extent both investment agendas will draw on resources from the FES. In the first instance these projects will fall within the domain definitions used in the current FES law. However, this does not rule the possibility that projects which meet the above-mentioned FES criteria but which may not meet the old FES law's domain definitions can be considered for FES financing. All projects will have to be subjected to a detailed cost-benefit analysis.

5.3.3. Potential adverse effect of FES bridge

Concern

By means of the "FES bridge" it is possible to release FES resources indirectly for the regular budgets and for regular government consumption. The concern is that this FES bridge raises the risk that temporarily higher revenues will be used to increase regular expenditures.

Recommendation

The FES bridge undermines the FES's objective of promoting investment. It is also a less than transparent means of considering investment expenditures and current expenditures in conjunction. The Study Group therefore recommends that the FES bridge is abolished under the next coalition agreement.

In this context the Study Group would like to stress that investment spending deserves a certain degree of protection. In the Study Group's view this protection is assured in two ways. Firstly, by retaining a separate fund. In this way investments are not spread across different budgets. This means that departments cannot immediately turn to investments within their own budgets when looking to make economies. And secondly, this protection is assured through the 100% year-end margin, which means that projects can be shifted over time.

5.3.4. Effectiveness of the FES's management structure

Concern

The FES's current management structure is centred on two administrators (the Ministry of Economic Affairs and the Ministry of Finance) and two official advisory bodies (the Interdepartmental Committee on the Spatial Economy [ICRE] and the Committee for Science, Technology and Innovation [CWTI]). This has two potential disadvantages, namely that the FES is managed by departments which are also beneficiaries of FES resources, and that partitions are created between the spatial economy and knowledge and innovation domains. This is also the background to the debate on the House of Representatives' legislative proposal prompted by the report by the Temporary Committee on Infrastructure (TCI or Duijvestein Committee). The House of Representatives has called for a "national commission" (rijkscommissie) to be established which would advise both government and parliament on FES project selection and financing. Such a national commission would have an independent chair.

Recommendation

The Study Group calls for the modification of the FES's management structure. The current two administrators, the Ministry of Economic Affairs and the Ministry of Finance, should continue to manage the FES in the Study Group's view. But instead of the current two official advisory bodies (the ICRE and CWTI), the Study Group recommends that a new body be set up, the Interdepartmental Committee for the Economic Structure (ICES). This committee would cover the whole spectrum of investment domains, ranging from the spatial economy to knowledge and innovation.

In the Study Group's view, the ICES should include representatives of the Ministry of Economic Affairs (chair and administrator), the Ministry of Finance (administrator), the Ministry of General Affairs, the Ministry of Transport, Public Works and Water Management, the Ministry of Housing, Spatial Planning and the Environment, the Ministry of Agriculture, Nature and Food Quality, the Ministry of Education, Culture and Science and the Netherlands Bureau for Economic Policy Analysis (CPB). Representation in the ICES may be expanded if more departments become involved with projects in the medium-term investment agendas. The ICES will be supported by two working groups, one in the sphere of infrastructure and sustainability and one in the sphere of education, knowledge and innovation. At the ICES's request, the working groups will collect and preselect proposals in the context of an investment impulse.

This construction will promote a broad-based consideration of investment projects as well as knowledge exchange among the departments about the planning and execution of investment projects. It also offers an opportunity to set investment agendas for the medium term.

Contrary to the wishes of the House of Representatives concerning the advisory function of the proposed ICES, the Study Group takes the view that the ICES should only advise the cabinet. After all, as an official committee it is accountable to the various ministers.

5.5. Summary of recommendations

In summary, then, the Study Group on the Budget Margin recommends that the FES is maintained, with a year-end margin of 100% and with a fixed funding level decided at the start of a government's term of office. The revamped FES, like the current FES, would only be allowed to finance time-limited projects.

The Study Group calls for the abolition of the FES bridge. The Study Group recommends that the type of investments eligible for financing from the FES should meet a number of criteria. Investment projects should be of national significance, strengthen the structure of the Dutch economy, and be one-off and temporary. In future the selection of projects should be based on medium-term investment agendas in the infrastructure and knowledge spheres, with cost-benefit analyses serving as a hard criterion.

With regard to the management structure, the Study Group recommends that the current structure of two administrators (the Ministry of Economic Affairs and the Ministry of Finance) is maintained. But the two official advisory bodies could be streamlined into a single committee, to be chaired by the Ministry of Economic Affairs and with the participation of the spatial economy departments as well as the Ministry of Education, Culture and Science and the Ministry of Finance.

The Study Group believes that this proposal reserves the good elements of the FES while also resolving the real and potential problems with the FES.

Annex 2: Separation of expenditures and revenues

Strict separation between expenditures and revenues

The strict separation between expenditures and revenues is one of the cornerstones of trend-based budgetary policy. The separation of expenditures and revenues means that changes in revenues have no effect on the margin within the expenditure frameworks. In other words, additional revenues cannot be used for additional outlays, and lower revenues do not require expenditure cuts. This strict separation makes budgetary policy less sensitive to cyclical developments in the economy. After all, windfalls and setbacks on the revenue side as a result of cyclical developments do not result in higher or lower spending in the expenditure frameworks. Consequently there is no need to make expenditure when revenues (i.e. taxes and social security contributions) come out lower than expected during lean times, which would mean that budgetary policy accentuates the economic downturn. A similar argument applies during economic boom periods. This approach allows for a more trend-based budgetary policy.

Three expenditure frameworks and government revenues

The spending of the central government and the social security funds is controlled by means of real expenditure frameworks. Expenditures must remain below the agreed expenditure ceilings. “Expenditures” are defined as net expenditures, that is to say, gross expenditures minus non-tax revenues. Non-tax revenues include dividends, fines and interest income, for instance. By volume they constitute a relatively small proportion of total government revenues.

Government revenues comprise the sum total of taxes, social security contributions and non-tax revenues. The revenues from taxes and social security contributions fall outside the control system of the expenditure frameworks. Windfalls and setbacks in tax and social security contribution revenues have in principle no implications for the net expenditures within the expenditure frameworks. Taxes and social security contributions are also referred as the “collective burden”.

Scope of collectieve burden

A strict separation between expenditures and revenues in the everyday practice of budgetary policy requires a clear demarcation between taxes and social security contributions – or “taxes” for short – on the one hand and non-tax revenues on the other. The Eleventh Study Group on the Budget Margin defined a “tax” (or *collectieve last* in Dutch) as follows: “A tax in the Netherlands is a compulsory payment to a government authority imposed by the government for which nothing specific, individual or payment-related is

received in return, or which is a personal contribution to a scheme in which participation is compulsory”.²⁸ Thus there are three elements to a tax. Firstly, it must be a compulsory payment. Secondly, it must be a payment to the government or another public body. And thirdly, it must be a payment for which nothing specific, individual or payment-related is received in return. All three elements must be present for the payment to qualify as a tax. The taxes on income and profit as well as the contributions to social security (i.e. the employee insurance schemes and national insurance schemes) fall under this definition and should thus be included in the “collective burden”. Dedicated levies such as the noise charge on civilian aircraft landing at Schiphol Airport are generally also regarded as taxes. Such levies are likely to meet the criteria of “compulsory payment” and “payment to the government”. The deciding factor will be whether they meet the criterion of “nothing received in return” for the payment.

Recent debates on the issue of “mobility levies” prompted the Study Group to consider the two cases of toll charges and road pricing. The National Platform “Another Way of Paying for Mobility” (Nationaal Platform “Anders Betalen voor Mobiliteit”, or the Nouwen Platform) and others have called for a new approach to charging for mobility. The following sections will consider how to deal with toll charges and road pricing – the latter known as the “kilometre charge” (kilometerheffing) in the Netherlands – in the context of the separation of expenditures and revenues.

Charging for mobility: tolls

Given the strict separation between expenditures and revenues, it is not clear whether toll charges can be used as a source for financing expenditures. The Study Group notes that if the revenues from toll charges fall under the definition of a tax, then they cannot be used to finance expenditures. But if tolls are not a tax but a non-tax revenue, then the investment outlays can be linked directly to the toll revenues. The key factor here is whether the toll is charged for new or existing infrastructure (which brings into play the “nothing received in return” criterion).

Whether toll revenues are relevant for the expenditure frameworks therefore depends on the specific characteristics of the toll. In the case of a toll on the use of new infrastructure, the motorist receives something specific in return for paying the toll. This is not a tax, then. The toll revenues are therefore relevant for the expenditure frameworks and can be used towards the financing of the construction of the new road, bridge or tunnel.

By contrast, a toll charged for the use of existing infrastructure does qualify as a tax. After all, yesterday motorists could use the road for free, but today they have to pay for it without receiving anything specific in return. Consequently these toll revenues cannot be used for the financing of new infrastructure.

²⁸ Ninth Report by the Study Group on the Budget Margin, “Naar een trendmatig begrotingsbeleid”, p. 63.

However, there is a practical problem if motorists start to use “rat runs” or alternative routes on existing infrastructure to avoid the toll charge on new infrastructure. This problem is topical in particular with projects in urban areas where new and existing infrastructure serve as a network. For this reason the Study Group recommends that a toll charge on existing infrastructure should be regarded as a tax if the proceeds are used for new maintenance on and/or improvement of the existing infrastructure, and/or for new infrastructure in the immediate vicinity.

Charging for mobility: kilometre charge

The Eleventh Report of the Study Group on the Budget Margin concluded that, in analytical terms, road pricing or the “kilometre charge” is little different from fuel excise duty, although it does offer more opportunities for variation by time and place.²⁹ But nothing specific seems to be received in return for the payment, and the charge is effectively compulsory for motorists. Consequently the Study Group regards the kilometre charge as a tax. In connection with the separation of expenditures and revenues, dedicated levies such as the kilometre charge can therefore not be used directly to finance expenditures.

However, within the expenditure framework system there is some scope for placing outlays financed by tax-like levies within the frameworks. This applies above all when setting the expenditure frameworks. Fluctuations in the proceeds from the kilometre charge (both upwards and downwards) during the government’s term of office will definitely remain outside the expenditure frameworks. But fluctuations (both undershoots and overshoots) in the associated expenditures during the government’s term of office will fall within the expenditure frameworks.

The Study Group calls for the continuation of this practice.

Conversion of car taxes into a kilometre charge

Two phases need to be distinguished in the conversion of car taxes – the private motor vehicle and motorcycle tax (BPM) and the motor vehicle tax or road tax (MRB) – into road pricing schemes. The first phase involves a neutral conversion of the car taxes into a kilometre charge. The second phase is the dynamic phase, during which the proceeds from the kilometre charge can fluctuate compared to the initial projections, for instance if the number of motor vehicles rises by more than expected.

The neutral first phase consists of two steps. The first step is the budget-neutral conversion in the budget of current car taxes (BPM and MRB) into a kilometre charge. (The basic principle is that, at the start, the proceeds from the kilometre charge should be identical to

the revenues from the car taxes.) The total revenues from taxes on motor vehicles will remain the same. Hence there is no effect on the EMU balance and on the scope for expenditures from the infrastructure fund (no additional margin will be created in the expenditure frameworks, in other words). The second step is the replacement of the current financing of infrastructure fund outlays from general resources with the revenues from the car taxes. Again, this second step has no effect on the EMU balance and on the scope for expenditures from the infrastructure fund.

It should be noted that the conversion of the private motor vehicle and motorcycle tax (BPM) into the kilometre charge in particular may create transitional problems. It may be perceived as unfair that owners of a car which was subject to the BPM in the past pay the same kilometre charge as owners of a car which was not subject to the BPM. To impose comparable burdens on citizens, the government may decide to approve transitional arrangements. How these will be incorporated into the budget will be decided at the time, and of course in accordance with the relevant budgetary rules.

The neutral conversion phase is followed by the dynamic phase. In the dynamic phase the proceeds from the kilometre charge may fluctuate compared to the initial projections, for instance if the number of motor vehicles rises by more than expected or if the number of kilometres travelled comes out less than expected. The question is how these fluctuations are dealt with under the principle of the separation of expenditures and revenues.

Two options seem to offer themselves in the dynamic phase. The options differ in terms of the effect of the proceeds from the kilometre charge on the available margin in the infrastructure fund. In both cases the assumption is that the 2.8% real growth in infrastructure fund outlays will be reaffirmed in the next coalition agreement.

In the first option, if the proceeds from the kilometre charge are higher than expected, more money will flow into the infrastructure fund. The additional spending will need to be fitted into the expenditure frameworks. If the proceeds from the kilometre charge are lower than expected, less money will flow into the infrastructure fund and there will be less scope for expenditures from the fund. The cabinet decides what to do with any additional margin within the frameworks.

In the second option, the expenditures from the infrastructure fund are financed partly from general resources and partly from the kilometre charge. Fluctuations in the proceeds from the kilometre charge are compensated through adjustments in the financing from general resources (specifically, the contribution from the Ministry of Transport, Public Works and Water Management to the infrastructure fund). This is like a system of communication vessels. On balance there will be no effects on the expenditure frameworks. A special situation may arise in the second option if the proceeds from the kilometre charge exceed

²⁹ Eleventh Report by the Study Group on the Budget Margin, p. 81.

the central government contribution. This results in a negative central government contribution, as it were. But because of the separation of expenditures and revenues, it seems appropriate to use the negative central government contribution to reduce the kilometre charge rate and/or to set the central government contribution off against the public debt.

The Study Group concludes that, if a kilometre charge is introduced both options for the dynamic phase are practicable.

Annex 3: Clarification of the micro burden concept and selection of a budgetary indicator on the revenue side

1. Background

Since 1995 the concept of the “tax and premium” has been used to measure developments in taxes and social security contributions – called the “tax and premium burden” in international parlance – for citizens and businesses. During this government’s term of office the government used a different definition of “micro burden” than the Netherlands Bureau for Economic Policy Analysis (CPB). The Study Group considers this undesirable from the point of view of transparency. For that reason a merged definition of “micro burden” is proposed in section 2.

The current budget system assumes that the automatic stabilisers are allowed to operate on the revenue side. The Study Group recommends the continuation of this practice. This means that this government will also have to select an indicator to distinguish the effects of policy measures on the revenue side from other revenue developments. Two options are elaborated in section 3.

2. Clarification of the micro burden concept

The Study Group recommends the following definition of “micro burden”: “All measures in the area of taxes and social security contributions in so far as they materially alter the economic choice between consumption and saving or between leisure time and work or investing. The micro burden is a macroeconomic benchmark of the ex ante effects of these measures.”

The following principles apply in this context:

- The measure must be a specific policy measure. Changes in the operation of existing legislation, arising from judicial decisions or anti-fraud campaigns for instance, are not included in the micro burden.
- The measure must be a government revenue. Purchasing-power-related expenditures are not included in the micro burden unless they involve a financing shift.
- The effects must be material. This means that the micro burden is adjusted for financing shifts between taxes and private payments (consistently for both an increase and a decrease in private payments). It is also adjusted for intertemporal effects and for payments to non-government authorities but which are imposed by the government.
- In principle the elements of “material effect” and “government revenue” are of equal weight. This means that in case of a financing shift between government revenue and a

public expenditure the micro burden is also adjusted for the material effect in the year in which the shift occurs.

3. Selection of a budgetary indicator on the revenue side

3.1. Automatic stabilisation on the revenue side

The Study Group recommends the continuation of the current policy of allowing the full operation of the automatic stabilisers on the revenue side. This means that once the coalition agreement has been signed, the government will in principle not introduce any supplementary policies in response to economic developments. This because any attempts to actively manage the economic cycle are fraught with difficulties, not least because of information and timing problems. Precisely because the government does not intervene during its term of office, the budget system moderates the cyclical fluctuations. When the economy is struggling, government revenues will fall and the EMU balance will be allowed to deteriorate. When the economy is thriving, the additional revenues will improve the EMU balance.

Of course the government can decide to take structural or other policy measures on the revenue side. It could cut taxes or social security contributions, for instance. To distinguish the effects of policies from endogenous developments on the revenue side, an indicator is needed which measures the effects of government policies. This indicator can then be compared with a framework based on the provisions of the coalition agreement. If these match, then on balance no supplementary policies will have been introduced and the change in revenues can be attributed entirely to developments in the economy.

The choice of indicator depends on its purpose. If the main purpose of the indicator is to control the structural development of the public finances, then an indicator will have to be selected which aligns closely with the definition of the EMU deficit. But if the main purpose of the indicator is to facilitate firm agreements on the tax burden for citizens and businesses, then a better option would be an indicator which reflects the perceptions of general taxation developments among citizens and businesses. The Study Group has no preference on this matter. The government will have to decide which aspect it wishes to emphasise. From this will follow the particular choice of indicator as a control variable for budgetary policy.

3.2. Two alternative indicators for budgetary policy

3.2.1. Revenue indicator: aligning with the definition of the EMU deficit

The revenue indicator is centred on the budgetary effects of budget policy and the achievement of the budget balance target by the end of the government's term of office. The

revenue indicator also lets the EMU balance move as automatically as possible in line with economic developments.

Under the trend-based budgetary policy, the coalition agreement sets a target for the structural balance at the end of the government's term of office and makes a projection of revenue and expenditures trends consistent with this target. The expenditure frameworks ensure that expenditures do not exceed the ceilings laid down in the coalition agreement. The revenue indicator ensures that no deviations occur on the revenue side. Revenues are allowed to move in line with the performance of the economy. But if revenues move symmetrically around a certain basic path, then over the whole economic cycle the EMU balance will develop in accordance with the projection in the coalition agreement.

The Study Group defines the revenue indicator as follows: "Any formal change (as a result of a new measure) or material change (as a result of a substantive change in the implementation of existing policy) in government policy which has an effect on taxes and contributions relevant for the EMU balance."

This means that only measures which have an impact on the development of EMU-relevant taxes and contributions are included in the measurement provided by the revenue indicator. Changes in private payments are not included, because they are not government revenue. The revenue indicator follows on from the measurement of government revenues in the national accounts (tables D0.1 and D0.5).³⁰ Because of the adoption of the definition used by Statistics Netherlands (CBS), government policy cannot cause any deviations in the EMU balance.

Further to the above definition, several other factors will have to be taken into account to achieve effective budgetary control:

- To ensure an EMU-balance-neutral treatment of financing shifts, a symmetric accounting method will have to be applied on the expenditure side. This means that (i) in the case of a financing shift between private and public due to a system change³¹, neither private expenditures nor private payments are included on the revenue side and the expenditure side, and (ii) both the expenditure framework and the revenue framework are adjusted.
- An increase in health insurance contributions leads to an increase in the revenue indicator. Part of the compensation for this currently takes place automatically through the healthcare allowance. Formally this is an expenditure. Because of the close relationship with the health insurance contribution, which is also treated as a tax, the

³⁰ Revenues channeled to the Economic Structure Enhancing Fund (FES) are not taken into account.

³¹ A "system change" is change in the financing system of an accounting nature and in which the statutory rights and duties obligations remain unchanged (for instance, the extension to two years of the employer's obligation to pay sick employees). In other words, accounting changes are not policy changes which translate into different statutory rights and obligations, such as a change in the health insurance package or a change in the no claims bonus scheme.

Study Group recommends, however, to include the healthcare allowance in the revenue indicator (and thus to place it outside the expenditure framework). This prevents that an increase in health insurance contributions will not have to be compensated with a tax or contribution cut elsewhere, while at the same time the increase in health insurance contributions causes an overshoot in the expenditure framework, which will require cutbacks to be made.

- Substantial changes in the government revenues which are not due to a new measure but are caused by a broader application of an existing measure (on the basis of a judicial decision, for instance) are included in the revenue indicator.
- In accordance with the budgetary rules laid down in annex 9 of the Budget Memorandum 2004, it should remain possible to apply a statistical adjustment on the revenue framework for any changes during the government's term of office which are evidently of an accounting nature. The background to this is often a change in the financial structuring of policy compared to the situation provided for in the coalition agreement. An example would be the transfer of a measure from the revenue side to the expenditure side (or vice versa). At the moment the budgetary rules insist that a change is only of an evidently accounting nature if the provision level and the target group remain the same. The Study Group recommends that this condition should be extended to cases where the provision level and the target group remain *virtually* the same. In all cases, however, the adjustment must be neutral in terms of the EMU balance.
- Measures which involve deferred taxation may lead to a situation where a budgetary gain may occur during the government's term of office which is offset by a budgetary loss in the future (or vice versa). These are called "intertemporal effects". The revenue indicator only measures the changes in government revenues during its term of office. However, it would be irresponsible to ignore the budgetary loss in the future. That is why the revenue framework is adjusted for intertemporal effects. This ensures that the measurement of the revenue indicator continues to align with developments in the EMU-relevant revenues, while it also takes account of future budgetary effects, an important consideration from the point of view of the sustainability of the public finances.

3.2.2 Tax burden indicator: reflecting people's perceptions of the tax burden

If the government decides that the budgetary control variable on the revenue side should primarily reflect general taxation developments as perceived by citizens and businesses, then the micro burden concept as defined in section 2 can be used as the required indicator, supplemented with the healthcare allowance ("micro burden plus").

Consequently the tax burden indicator can be defined as follows: "All measures in the area of taxes and social security contributions in so far as they materially alter the economic choice between consumption and saving and leisure time and work or investing. The micro burden is a macroeconomic benchmark of the ex ante effects of these measures."

The following principles apply in this context:

- The measure must be a specific policy measure. Changes in the operation of existing legislation, arising from judicial decisions or anti-fraud campaigns for instance, are not included in the tax burden indicator.
- The measure must be government revenue. Purchasing-power-related expenditures are not included in the tax burden indicator unless they involve a financing shift.
- The only exception to the previous rule is the inclusion of the healthcare allowance.
- The effects must be material. This means that the tax burden indicator is adjusted for financing shifts between taxes and private payments (consistently for both an increase and a decrease in private payments). It is also adjusted for intertemporal effects and for payments to non-government authorities but which are imposed by the government.
- In principle the elements of “material effect” and “government revenue” are of equal weight. This means that in case of a financing shift between a tax and a public expenditure the tax burden indicator is also adjusted for the material effect in the year in which the shift occurs.
- The healthcare allowance is an expenditure, not a tax. Strictly speaking the healthcare allowance therefore does not belong in a tax burden indicator. That is why it is not included in the micro burden concept. An increase in health insurance contributions leads to an increase in the tax burden indicator. Part of the compensation for this currently takes place automatically through the healthcare allowance. Formally this is an expenditure. Because of the close relationship with the health insurance contribution, which is also treated as a tax, the Study Group recommends, however, the inclusion of the healthcare allowance in the tax burden indicator (and thus to place it outside the expenditure framework). This means that an increase in health insurance contributions will not have to be compensated with a tax or contribution cut elsewhere, while at the same time the increase in health insurance contributions causes an overshoot in the expenditure framework, which will require cutbacks to be made.

3.2.3. Similarities and differences between the revenue indicator and the tax burden indicator

The following applies for both the revenue indicator and the tax burden indicator:

- Both are macroeconomic benchmarks. This means that they do not take account of distribution effects at micro level, but only of the effects on citizens or businesses in general. (An example would be a reduction in the health insurance cover.)
- Both are ex ante benchmarks. This means that they do not take account of behaviour effects, unless these satisfy the exception rule as defined in section 4.8 of the Budget Memorandum 1993.

The main differences between the revenue indicator and the tax burden indicator relate to financing shifts (such as a reduction in health insurance cover and an increase in personal contributions) and to payments to a non-public authority imposed by the government. These

differences are actually mainly relevant once the coalition agreement has been signed, after the expenditure frameworks and the revenue framework have been laid down, that is. During the coalition negotiations no frameworks are laid down. During the coalition negotiations the potential coalition partners are free to decide the balance between revenues, expenditures and the budget balance target. One condition is that measures which are not reflected in the tax burden indicator but do have implications for the public finances (such as a reduction in health insurance cover) must be reflected in the balance target aimed at putting the public finances on a sustainable path. After the coalition agreement has been signed, the frameworks are laid down. From that moment it matters whether the revenue indicator or the revenue indicator is used as a control variable.

3.2.4. Conclusion

During this government's term of office the government and the Netherlands Bureau for Economic Policy Analysis (CPB) treated the micro burden differently in a number of areas. The fact that different figures were being used created confusion and undermined transparency. In the next government's term of office this will have to be avoided with the selection of a single indicator for budgetary policy which reflects a single aspect of government policy.

The Study Group recommends the revenue indicator if the next government is particularly committed to certainty about the budgetary outcomes of policy. Or the government can opt for the tax burden indicator if it wants to have certainty mainly about the effects of policy on general taxation developments as perceived by citizens and businesses. Regardless of the choice of budgetary indicator, however, the micro burden remains a useful sidelight for the government.

Annex 4: Tax expenditures

The Study Group has explored the development and control of tax expenditures. The reason is that many tax expenditures are similar to spending programmes but do not fall under a similar control regime. This raises the risk of a certain bias in favour of tax expenditures, because most tax expenditures are substitutes for expenditures and because there is no framework for the endogenous development of tax expenditures. Moreover, the Budget Memorandum includes only an annual overview of tax expenditures in the strict sense, even though there is also a “grey area” between primary taxation revenues and tax expenditures. This “grey area” is of substantial budgetary importance. And finally, the budgetary figures are often little more than estimates, also in realisation years, so that the quality of the figures must be constantly monitored.

Background

The Study Group has discussed the standardisation of tax expenditures on several occasions in the past. In the Tenth Report it argued that, from a budgetary control perspective, existing and new tax expenditures should be standardised by placing them within the expenditure frameworks. It also called for the publication of a regular overview of tax expenditures, to enhance the transparency of the public sector in general and of specific fiscal measures in particular.

Since the publication of the Tenth Report of the Study Group on the Budget Margin, significant steps have been taken to enhance transparency, and the criteria which new tax expenditures have to meet have been tightened. This has improved the transparency of policy and increased the controllability of tax expenditures.

Both the number and the budgetary volume of tax expenditures rose steadily in the years to 2001. This trend was not sustained in the following years, partly as a result of policy decisions. At the time of the introduction of the new income tax system in 2001, a number of tax expenditures was abolished. Partly as a result of the abolition of these tax expenditures, the total volume of tax expenditures in the strict sense declined from the equivalent of 2.67% of GDP to 2.23% of GDP between 2003-2006. A full overview of these tax expenditures has been available since 2003.

Table a4.1: Volume of tax expenditures, according to the Budget Memorandum, 2003-2006

	2003	2004	2005	2006
Tax expenditures in EUR millions	12,728	11,545	11,225	11,402
Tax expenditures in % of GDP	2.67%	2.36%	2.27%	2.23%

Since 1999 the Budget Memorandum includes an annex with an overview of tax expenditures in the strict sense and their budgetary consequences. Initially only the tax expenditures in the payroll tax, income tax and corporation tax spheres were included. But since the Budget Memorandum 2003 the tax expenditures in the indirect taxes are also listed.

In the Budget Memorandum 2000 the government of the day did not adopt the Study Group's recommendation that existing and new tax expenditures should be included in the expenditure frameworks. It was decided that placing tax expenditures within the frameworks "would not significantly contribute to the controllability of tax expenditures".

However, in order to get a better grasp of tax expenditures, the Budget Memorandum 2001 introduced an "assessment framework". This assessment framework to a large extent implemented the recommendations by the Court of Audit in its report "Belastingen als beleidsinstrument" ("Taxes as a policy instrument"), published in 1999, such as a careful and explicit consideration of the use of tax expenditures. In the Budget Memorandum 2003 this assessment framework was included in the budgetary rules. Under the budgetary rules this assessment framework must be applied in the context of the submission of the policy letter or (if applicable) in the discussions at cabinet level. A major new element in the assessment framework was the provision that evaluation of the tax expenditure must be sufficiently assured. In the Budget Memorandum 2004 the assessment framework was further supplemented with the provision that new tax expenditures and extensions of existing tax expenditures should in principle be budgeted and that the possibility of budgeting existing tax expenditures should be investigated further.

Under the assessment framework, before a new tax expenditure can be introduced the government must first demonstrate that intervention is warranted and that the introduction of a tax expenditure is the most efficient or effective instrument. To this end the assessment framework asks a series of questions about the usefulness and necessity of a tax expenditure. Its effectiveness and efficiency must also be determined on the basis of an evaluation after a period of time.

Since the Budget Memorandum 2004, the government reports every year on the tax expenditure evaluations that have been carried out and on the plans for the next financial year. As prescribed by the Central Government Performance and Evaluation Scheme (RPE), tax expenditures are generally evaluated at least every five years according to the "from budgetary policy to budgetary accountability" (VBTB) process. That is to say, the evaluations are aimed primarily at testing the effectiveness and efficiency of policy. In this way all tax expenditures will be reviewed over a five-year period.

Current policy

In summary, the annual overview of tax expenditures in the strict sense has enhanced transparency. Budgetary control has improved because the budgetary effects of new tax expenditures are included – together with measures in the primary taxation structure – in the taxation framework. The assessment framework and the evaluations also have a disciplining effect on the volume of tax expenditures. The budgetary rules allow the conversion of an expenditure into a subsidy (and vice versa), in which case the expenditure frameworks and the taxation framework are adjusted accordingly. The precondition for this statistical correction is that the target group and the provision level remain the same.

The Study Group regards the current policy as a significant improvement, but it also sees some opportunities for increasing the effectiveness of this policy by applying it to a broader area than tax expenditures in the strict sense.

Demarcation of tax expenditures

As early as 1987 the Schoemaker Working Group published a report on the definition of tax expenditures. This working group defined a “tax expenditure” as “a government expenditure in the form of a forfeit or deferral of tax receipts, which flows for a statutory provision in so far as this provision does not accord with the primary taxation structure of the act in question”.

The Schoemaker Working Group defined the “primary taxation structure” as “the most neutral reference to the actual fiscal objective that a tax is levied to finance public expenditures, in such a way that the consequent burdens are distributed equitably”. In the case of income tax, for instance, the ability to pay – the taxpayer’s financial capacity – is the criterion for the equitable distribution of the burden.

This definition leaves some room for debate on what should be understood by the “primary taxation structure”. The upshot is that, in addition to tax expenditures in the strict sense there is a “grey area” with regard to the definition of tax expenditures. Schemes from this “grey area” are not included in the overview of tax expenditures published in the Budget Memorandum.

The Study Group takes the view that the focus on the costs of tax measures should be widened beyond tax expenditures in the strict sense, because of the budgetary consequences on the one hand and because it will allow a more transparent comparison with “normal” expenditures on the other.

A major example of the “grey area” is the tax deductibility of pension contributions. This should be seen in conjunction with the “reversal” principle, under which pension contributions are tax-deductible but the pension payments in due course are taxed. If one takes the view that a pension scheme merely provides income in the future, then the

deductibility of pension contributions forms part of the primary taxation structure. But if one takes the view that a pension scheme is a form of saving from income, then it should be treated in the same way as other savings schemes. In that case the deductibility of pension contributions is a tax expenditure, because it is given preference over other saving forms.

Tax credits such as the labour tax credit, the child tax credits and the combination tax credit can also be included in the “grey area”. As an expense incurred in the acquisition of income, the labour tax credit forms part of the primary taxation structure. Depending on whether the margin compared to the actual expense has been set too generously, the labour tax credit may be regarded as a tax expenditure aimed at stimulating the labour supply. If one takes the view that the child tax credits and the combination tax credit relate to the taxpayer’s financial capacity, then they form part of the primary taxation structure. But one if one takes the view that they are incentive schemes to stimulate labour market participation, then they are tax expenditures.

The tax deductibility of mortgage interest is also a substantial budgetary item, whose volume has increased in recent years in particular. For income tax purposes the taxpayer’s own home is regarded as a source of income which generates financial capacity and it is therefore taxed as primary income (in the form of the notional rental value for owner-occupiers). Taxation of the taxpayer’s own home thus forms part of the primary taxation structure. This means that any expenses incurred in the acquisition of this primary source of income are deductible and that these expenses are not tax expenditures. However, there is an alternative view, which regards the mortgage interest allowance as a tax subsidy aimed at stimulating home ownership. In that case the mortgage interest allowance would also belong to the “grey area”.

Table a4.2: Budgetary losses due to pension contributions, mortgage interest allowance, labour tax credit, child tax credits and combination tax credit (in EUR billions)^a

	2001	2002	2003	2004	2005	2006	2007
Employer’s pension contributions	2.0	2.1	2.7	3.1	3.2	3.0	3.2
Balance of mortgage interest allowance and notional rental value for owner-occupiers	5.6	6.3	7.6	7.9	8.3	8.6	8.7
Labour tax credit	5.7	5.9	6.8	7.2	7.6	8.1	8.4
Child tax credits	0.2	0.4	0.5	0.6	0.8	1.0	1.0
Combination tax credit	0.3	0.5	0.5	0.8	1.0	1.0	1.1

^a This table is based on CPB figures, supplemented with a technical assumption of an average marginal tax rate of 40%. The series may differ from figures published by the Ministry of Finance. With regard to the tax deductibility of pension contributions, only the budgetary losses in “box 1” (“income from work and home” in the Dutch tax system) have been taken into account.

Source: CPB, own calculations

Recommendations by the Study Group

The Study Group recommends that the monitoring of the budgetary consequences and the application of the assessment framework are not restricted to tax expenditures in the strict sense, but are extended to other schemes as well. The Study Group realises that this should be a specific list, because in practical terms it will not be possible to chart the budgetary effects of each element in the tax system. Specifically, the Study Group proposes to extend the monitoring of the budgetary consequences and the application of the assessment framework to the notional rental value for owner-occupiers, the mortgage interest allowance, pension payments and pension contributions, and those tax credits which can also be regarded as subsidies (i.e. labour tax credit, child tax credits and combination tax credit).

This approach will not mean that the total annual costs of these tax schemes are brought into a standardised framework, but it will improve budgetary reporting and the understanding of budgetary developments. Reporting in the Budget Memorandum can make the effects of these measures on income distribution and their macroeconomic function transparent. It will also allow a broad-based comparison with other expenditures.

Monitoring tax expenditures is not directly comparable with monitoring “normal” budget expenditures. Even so, it is possible to provide a good insight into the budgetary consequences and developments on the basis of the available information. But the figures on the volumes associated with tax expenditures are less accurate and less reliable than for other expenditures, because in many cases no clear and easily measurable cash flows are available. Projections are often made on the basis of indicators. In contrast with other expenditures, figures on what has actually been disbursed are often not available. This is particularly true for tax expenditures in the income tax and corporation tax spheres. The Study Group calls for an improvement in the reliability of the projections, so that the uncertainties surrounding the budgetary consequences are kept to a minimum.

Annex 5: Position of the social security funds

Introduction

Until 1999 inclusive the decisions on the levels of social security contributions were based on the assumption that they would be cost-covering on annual basis. In 2000 policy was changed to the effect that social security contributions would in principle remain constant. Table a5.1 shows the capital balances of the funds for the employee insurance schemes, namely the Occupational Disability Fund and the General Unemployment Fund (AWF) and Public Sector Benefits Fund (UFO) combined, during this government's term of office.

Table a5.1: Capital balances of the employee insurance funds, 2003-2007 (in EUR billions)

	2003	2004	2005	2006	2007
Occupational Disability Fund	4¼	4	4	3¾	3
General Unemployment Fund (AWF) / Public Sector Benefits Fund (UFO)	4½	4¼	4	4	4¾

Source: Spring Forecast 2006, p.139 (not including decisions in Budget Memorandum 2007)

The capital surpluses of these funds will more than double in the years to 2011, according to projections on the budget margin prepared by the Netherlands Bureau for Economic Policy Analysis (CPB).

Cost-covering contributions

Most of public spending is funded from general resources. Some benefit schemes, however, are financed on the basis of separate contributions. It follows from this construction that the contributions to these schemes should be set at cost-covering levels.

Cost-covering contributions have the advantage that the expected and actual benefit costs are borne by those groups of citizens who will enjoy the benefit in question.³² This reinforces the insurance concept. What is more, cost-covering contributions make cost trends more visible, because these lead to higher contributions. This creates incentives to keep costs under control. Conversely, structural reforms in the employee insurance schemes which reduce payment volumes will also be reflected in lower contribution rates.

Furthermore, setting contributions at cost-covering levels prevents structural surpluses or deficits accumulating in the social security funds. These are not desirable. For budget purposes the actual division between taxes and social security contributions does not pose a problem, but in practice a false impression may take hold that the social security funds'

³² It should be remembered, however, that the social security contributions are supplemented with annual contributions from the central government's general resources.

capital surpluses are unused resources which could be spent without affecting the EMU balance, while capital deficits may wrongly suggest additional budgetary problems. However, the operating balances of the social security funds count in full towards the EMU balance, and their capital balances are included in the calculation of the EMU debt. So if, for instance, the current capital surpluses are reduced by cutting contribution rates, this will certainly have adverse implications for the EMU balance and the EMU debt.

Stable contributions

Given the ambition of cost-covering contributions, for reasons of stability it is preferable to achieve this over a whole economic cycle. This means that no account is taken of annual fluctuations in economic performance.

Cost-covering contributions over the whole economic cycle are more suited to the current trend-based budgetary policy. If the ambition were cost-covering contributions on an annual basis, then the accumulation of surpluses in the social security funds during economic boom periods would lead to contribution cuts, whereas contributions would have to be raised during lean times. This would make contribution setting procyclical.

However, the current trend-based budgetary policy is based on the separation of expenditures and revenues and on the operation of automatic stabilisers on the revenue side. The coalition agreement sets out a range of decisions on particular taxes and social security contributions, which are laid down in a taxation framework. Fluctuations in revenues arising from economic developments will then in principle not lead to adjustments in tax or social security contribution rates, but they will be fully reflected in the EMU balance. Under the framework system, a change in contribution rates would have to be offset by a tax measure. This would lead to changes in purchasing power and taxation distribution, while nothing changes in budgetary terms, because the social security funds are included in the EMU balance and the EMU debt.

Furthermore, the ambition of cost-covering contributions on an annual basis raises practical objections arising from estimation uncertainties, which means that contribution rates have to be adjusted afterwards. These adjustments can prove quite substantial and are undesirable not least because of the destabilising effects of such an approach on taxation distribution and purchasing power.

From an economic perspective, it is also more attractive to keep fluctuations in tax and social security contribution rates to a minimum, in order to avoid the adverse effects on living standards associated with rate changes.

Cost-covering contributions in practice

In short, then, the overall objective for the social security funds should be to achieve cost-covering contributions over the economic cycle as a whole. This was also the recommendation by the previous Study Group on the Budget Margin. This recommendation was subsequently elaborated by the Taxation Structure Working Group in its report published in May 2002.

The problem here is that it is difficult to define the economic cycle. This can be overcome by fixing contribution rates in the coalition agreement in principle for the whole of the government's term of office. But here too the annual decision-making process may be affected by other factors which may play a role in setting contribution rates, such as the EMU balance, the purchasing power situation and general taxation developments.

For instance, at the current expenditure level, the ambition of cost-covering contributions and lower capital surpluses would have to translate into cuts in contribution rates. If no compensating measures are taken in the tax system, the upshot would be a deterioration in the EMU balance, which would have to be accommodated in the overall budget.

Moreover, changes in tax and social security contribution rates may lead to shifts in purchasing power which may run counter to the aims of general purchasing power policy. The basis for the social security contribution regime is not the same as the basis for the tax regime. For instance, the self-employed and pensioners (including those taking early retirement) do not pay unemployment insurance contributions. And the unemployment insurance scheme has a contribution-free allowance. This means, for instance, that a reduction in the unemployment insurance contribution coupled with an increase in tax rates would lead to a deterioration of purchasing power at the bottom end of the income scale and an improvement at the top end.³³ Similarly, a change in the employer unemployment insurance contribution rate would lead to shift in labour costs between higher-paid and lower-paid employees.

And finally, the setting of contribution rates has an impact on general taxation levels and on the distribution of the tax burden between citizens and businesses. The ambition of cost-covering contributions may well prompt a reduction or increase in employer occupational disability or unemployment insurance contributions, but this will lead to a lighter or heavier burden for businesses, which will have to be considered in the context of the overall taxation situation. It should be noted that, with regard to the employer contributions, employers have relatively few suitable opportunities for taking compensatory measures.

Accumulated capital surpluses

³³ This problem is aggravated by the fact that taxation does not work as a purchasing power instrument for those groups of people who do not pay tax.

In recent years the setting of contribution rates has been dependent on considerations concerning the overall budgetary decision-making process in relation to the EMU balance, the purchasing power situation and general taxation developments. The accumulation of capital surpluses must be set against this background. The current capital surpluses developed in part as a result of policy decisions in the past, with no distinction being made between the central government and the social security funds. In the previous government's term of office there were examples of contribution rates being raised in order to cut taxes, and vice versa. The decision making for all these measures concentrated on the effect on the EMU balance, purchasing power and the general taxation levels, while at the same time a shift occurred between the social security funds' revenues and the central government's budget balance. Although the financial position of a particular social security fund was always taken into account, in practice this did not always prove to be the decisive factor.

Given the interchangeability of taxation and the social security funds in recent years, it would not be entirely logical to simply channel the surpluses in the social security funds back to employees and employers. This would not do justice to past decisions. Let us assume that a tax cut (in income tax or corporation tax, for instance) was offset by an increase in social security contributions. If the consequent capital surpluses were returned under these circumstances, the budget neutrality of the measures would be negated. The previous Study Group on the Budget Margin also observed that surpluses should not be used immediately for burden relief. The converse is also true, incidentally The Compulsory Health Insurance Fund had negative operating balances for years. On the termination of the old health insurance system (at the end of 2005), the Fund's capital deficit stood at more than EUR 3 billion. This was transferred to the central government without having an impact on the EMU balance or the EMU debt.

Conclusion

The CPB's projections on the budget margin show that employee insurance contribution rates (under the Unemployment Insurance Act [WW] and the Income according to Capacity for Work Act [WIA]) are still slightly above cost-covering levels.

The Study Group calls on the next government to try to take a step towards cost-covering contributions. In that case the existing capital surpluses would not rise further. During the government's term of office the ambition should be to keep contribution rates as stable as possible. The Study Group draws attention to a number of other aspects which may play a role in practice in this context.

Capital surpluses as such are no sufficient reason for contribution cuts. But an attempt could be made to reduce the capital surpluses during the next government's term of office. This could be achieved by temporarily setting contribution rates below cost-covering levels, while remaining within the available budgetary margin. In this way the surpluses would gradually

come down. Furthermore, the Taxation Structure Working Group has suggested that specific government expenditures aimed at reducing unemployment or occupational disability could be charged to the social security funds. However, many of the expenditures which the Working Group identified as candidates for this approach have been stopped since the publication of its report.

The extent to which the move to cost-covering contributions and perhaps also to a reduction of the existing capital surpluses in the social security funds can be realised will depend on the available budgetary margin as well as on the coalition partners' decisions on public spending levels, taxation levels and the target for the structural budget balance at the end of the government's term of office.

The new Health Insurance Act (ZVW) explicitly provides for a system of cost-covering contributions.³⁴ The Study Group believes that this system should be maintained.

The other national insurance schemes – specifically those under the Old Age Pension Act (AOW), the Exceptional Medical Expenses Act (AWBZ) and the Surviving Dependents Act (ANW) – do not have the problem of cost-covering contributions. Virtually everyone pays AWBZ and ANW contributions. And the financing of the state pension is deliberately based on partial funding from the central government. The AWBZ and ANW schemes also receive funding from the central government, so that their contributions are effectively below cost-covering levels. And in the case of the AWBZ and the ANW any unwanted operating or capital balances can simply be corrected with a shift in the tax and contribution rates for the lowest and second-lowest brackets, since the bases for both are virtually identical. Against this background, the Study Group recommends that no policy changes should be made in the national insurance schemes in order to bring about cost-covering contributions.

³⁴ It should be noted, however, that the government pays for children's healthcare and for the healthcare allowance (as compensation for higher contribution levels), and that both of these have to be financed from general resources.

Annex 6: Budget flexibility

The Study Group has been asked to examine the degree of flexibility in the current budget system (in light of the structure of public spending). Being in government is about making choices. But how are the most efficient and effective measures or policies selected? What tensions are there between the decisions on choices on the one hand the quality of public spending on the other? “Quality of public spending” is defined in this context as “The allocation of resources and the efficient and effective use of these resources in relation to formulated strategic priorities”.³⁵

The following three questions have been put to the Study Group:

- (1) Is there a problem with “low-hanging fruit” and a “spending urge”?; and if so, what can be done to improve the situation?
- (2) Is it desirable to except certain expenditures from the expenditure frameworks.
- (3) How can budget flexibility be enhanced?

(1) Low-hanging fruit and spending urge

Under budgetary and political pressure the government may decide to make savings and cuts which yield money over the short term. This has been called “picking the low-hanging fruit”. Incidental measures are one type of “low-hanging fruit”. Efficiency measures are another. However, picking low-hanging fruit does not always contribute to the quality of the public finances.

An analysis of the austerity measures approved by the second Kok and the first and second Balkenende administrations shows, however, that only a relatively small number of the measures were of an incidental nature. The respective coalition agreements did not include any incidental measures. During each government’s term of office (specifically the second, third and four years), incidental measures were used very sparingly (amounting to between EUR 100 million and EUR 200 million per year). In short, incidental measures have not been significant problem in Dutch budgetary policy in recent years.

However, all three administrations did make extensive use of the instrument of efficiency gains and targets. (The respective volumes and proportions were: for the second Kok administration, EUR 900 million, equivalent to 14% of the austerity measures; for the first Balkenende administration, EUR 1.3 billion, equivalent to 20% of the austerity measures; and for the second Balkenende administration, EUR 1.6 billion, equivalent to 8% of the austerity measures.) Efficiency measures and targets seem to have been an effective means of trimming the central government budget. Their effectiveness seems to be greatest

³⁵ This is the definition used in European Commission (2004), “Public Finance Report 2004, Brussels.

if one major efficiency target is agreed at the start of the government's term of office, rather than many small targets agreed over a longer period. This stimulates prioritisation and avoids the "death by a thousand tiny cuts" approach.

The Study Group notes that there is a certain logic to creaming off efficiency gains. Under normal circumstances the public sector – like the market sector – can be expected to operate more efficiently over time. This means that parts or all of the public sector begin to generate higher output without intervention and without any prior political decisions. Creaming off the efficiency gains allows the government to make decisions about where to reallocate scarce resources. The problem of course is how to measure productivity increases in parts or all of the public sector. In other countries (e.g. Germany, Sweden) this is done with references to the market sector (especially business services).

The government can also make explicit choices to do certain things less or not at all. Such choices can be fleshed out in volume terms (cutting the number of civil servants, for instance), but also in money terms (in which the organisation in question can decide how to achieve the set target).

Apart from being under pressure to pick low-hanging fruit, the government may also find itself under political pressure or be tempted by the available budgetary margin to announce additional spending increases on an ad hoc basis. This has been called the "spending urge". Measures of this kind are often prompted by the public concerns and preoccupations of the day, and are often not based on structured policy formulation.

It is difficult to make a judgement on the quality of the additional spending increases in recent years. An analysis of the additional spending increases by the second Kok and the first and second Balkenende administrations shows that most of the outlays related to the priority areas already identified by the respective administrations in their coalition agreements: that is to say, public safety, health, education and youth, and infrastructure. The Study Group suggests that major outlays (laid down in a coalition agreement, for instance) are reserved centrally in the first instance, and that the resources are only transferred to the relevant budget when the specific spending plans have been prepared. This may dampen the spending urge. This method was used successfully during the two Kok administrations. The spending pressure which has arisen in the Economic Structure Enhancing Fund (FES) as a result of large windfalls has been discussed separately in chapter 5.

(2) Is it desirable to except certain expenditures from the expenditure frameworks?

The budget system is intended to provide appropriate budgetary control, but it should also make a contribution to the quality of the public finances. In most cases the two go together. A sound budgetary system ensures that the budget can be prepared on the basis of

medium-term plans and that the priorities can be weighed properly. The question whether it may be desirable to except certain expenditures from the expenditure frameworks will be addressed here from two perspectives:

- (a) the tension between quality and control;
- (b) the match between the expenditure frameworks and the EMU balance.

(a) Tension between quality and control

Incorporating all expenditures and non-tax revenues into frameworks restricts the scope for increasing expenditures which are regarded as priorities. According to some, this undermines the quality of the public finances. Against this, however, a framework system can also work as a catalyst for structural reforms and a more effective prioritisation of public spending. Despite this there are regular calls to keep certain expenditure categories outside the framework system.

In the context of the negotiations on the renewal of the Stability and Growth Pact, some EU governments argued that certain expenditure categories should be excepted from the EU budgetary rules. The Dutch government was among those which opposed this approach, and it was not adopted. But the new Stability and Growth Pact does stipulate that outlays on “structural reforms” may justify a temporary deviation of the medium-term objective. This will apply to structural reforms which will yield demonstrable budgetary benefits over the longer term. An example is reform of the pension system. It has also been agreed that a minor and temporary breach of the 3% limit will prompt an investigation whether there are relevant factors which might justify this breach. Expenditures under the Lisbon strategy (aimed at raising the EU’s growth potential) and for investment may qualify as “relevant factors” in this sense, as may the extent of debt reduction and budgetary efforts in previous years.

This may be a reason for looking again at whether structural reforms and investments should be considered for exception from the framework system.

With regard to structural reforms, it can be said that in many cases these involve measures which yield money. Hence the expenditure frameworks are not constrictive here, but may actually be an additional incentive to implement reforms. Incidentally, an estimation of what are called the “positive revenue effects” of these measures is also important. Although structural reforms are useful and necessary for the long-term sustainability of the public finances, there is a danger that the positive revenue effects and other effects will be overestimated, so that the future will appear all too rosy. It is also worth noting that most structural reforms are already agreed in the coalition agreements, which means that the expected and actual effects can be built into the frameworks. All in all, then, the Study Group sees no reason to make an exception for this type of expenditure.

With regard to investments, the Study Group observes that these are already protected in the budget system because they are financed through fund constructions, as discussed in greater detail in chapter 5.

(b) Match between the expenditure frameworks and the EMU balance

From the perspective of budgetary control, all expenditures should in principle be incorporated into frameworks.³⁶ For that reason the Study Group recommended in its previous report that the expenditure frameworks and the EMU balance should match each other as closely as possible. This principle was adopted by the second Balkenende administration. Despite a “tidying up” operation at the start of the administration’s term, there are still some expenditures which are not included in the expenditure frameworks but which are included in the EMU balance. The Study Group recommends that a further step is taken towards matching the expenditure frameworks and the EMU balance, for instance by including the consolidated balances of the government agencies in the expenditure frameworks.

3. How can budget flexibility be enhanced?

The quality of public spending can also be influenced by the degree of flexibility built into the multi-year projections. The more expenditures in the future are tied to commitments entered into in the past, the smaller the scope in the budget for responding to changing needs and for reprioritising resources. In this way one government can constrain the freedom of action of its successors. That is why departments now provide information in their budgets about which parts of their multi-year cash expenditures are required by law. All expenditures which are not required by law can be up for discussion. At the behest of the House of Representatives, the departments will from the 2007 budget onwards provide information on the budget flexibility within each operational objective.

The Study Group wishes to underline the importance of appropriate flexibility in the budget. In its view the main opportunity for enhancing budget flexibility is to use what are called “sunset clauses” in the multi-year projections. Sunset clauses are provisions under which laws and regulations are automatically rendered inoperative after a specified period of time. In the budget context this system can be applied to certain expenditure categories (subsidy schemes in particular), so that these do not continue indefinitely but are reviewed as to their utility and necessity every few years.

³⁶ Either through the expenditure frameworks or the taxation framework, as in the case of the healthcare allowance and several dedicated levies.

Annex 7: Budgetary risks on the expenditure side

Background

The Study Group has been asked to provide insight into budgetary risks. This annex will consider specifically the risks on the expenditure side. The risks on the revenue side have been considered in annex 4, which deals with tax expenditures.

For an effective standardisation of expenditures, the estimates and projections must have a high reality content. But even when estimates and projections are realistic, unexpected cash expenditures will pose a threat to the scope for other expenditures. That is why it is imperative that the budget system reduces the risk of unexpected spending increases. The most relevant budgetary risks in this context are debudgeting constructions and open-ended schemes.

Debudgeting constructions

Debudgeting occurs when direct budget financing is exchanged for guarantees or loans.³⁷ Guarantees and loans are regarded as a form of debudgeting because, under the current budgetary rules, these obligations are not included in the expenditure frameworks when they are undertaken, although they do carry the risk of future setbacks such as losses and defaults. Guarantees and loans are therefore subject to a “no, unless” policy. That is to say, guarantees and loans may only be extended in case of serious societal risks which private players cannot and will not bear but which the government feels should be covered in the public interest, or if efficiency gains can be achieved for the government in comparison with subsidies.³⁸

Under the current budgetary rules, guarantees and loans have a certain appeal. Entering into guarantees and loans is perceived as “free money”³⁹, because they have no consequences for the expenditure frameworks. But of course there is no such thing as “free money”. Guarantees and loans entail explicit or implicit subsidies such as remissions,

³⁷ At the end of 2005 the government had extended guarantees worth around EUR 67 billion (see www.rijksbegroting.nl/garanties). Guarantees on credits (around EUR 14 billion) and loans to third parties (around EUR 10 billion) are particularly suspect in debudgeting terms. Recent examples are a guarantee extended in late 2005 on loans taken out by private juvenile offender institutions with commercial banks, and a loan extended to the Society for the Preservation of Nature (Natuurmonumenten) in 2004. For more information on the volume and characteristics of guarantees and loans, see a report by the Court of Audit published on 20 April 2005 (www.rekenkamer.nl). And for information on the volume of interest subsidies on loans, see the Court of Audit's December 1995 report to the House of Representatives (House of Representatives [Tweede Kamer], session 1995-1996, 24 555, no. 1-2).

³⁸ See the Central Government Annual Financial Report 2005.

³⁹ Other than cost-covering schemes, such as export credit insurance and other insurance policies.

waivers or interest terms and other terms more favourable than the recipient would be able to secure in the free market. Otherwise there would be no role for the government.

The question arises why the government is willing to pay this subsidy. In terms of efficiency, guarantees and loans are often inferior to direct subsidies. For instance, guarantees on loans for which the government itself pays the subsidy to service the loan cannot make financial sense. This because the interest charged by private lenders will be higher than the interest at which the government can borrow. More generally, it would be prudent to consider the business case in each instance. Why should the government outsource risk management (i.e. the extension of guarantees) when it can lend money itself (with or without collateral)? And why should the government lend money itself if it can also extend an interest subsidy or other subsidy?

In current budget practice, explicit and implicit subsidies are not clearly identified. This makes a proper efficiency analysis more difficult. There is a strong argument for identifying subsidies in the future when guarantees and loans are extended. This could be done with a step-by-step approach: if possible and sensible, the subsidy elements could be determined directly on the basis of available experiential information, such as historical loss series. If this proves too difficult or is not sensible (because of heavy administrative costs), then a more uniform and practical determination of the subsidy element would seem the best approach. The subsidy element could be set at 3%, for instance.⁴⁰ These subsidies would then have to be included in the expenditure frameworks.

The responsibility for and the management of guarantees and loans lie with the departments in question. From a control perspective, the explicit or implicit costs of the extended guarantees and loans should be charged to the budget. But this raises the question of how any losses should be dealt with. Such losses could impose a disproportionate burden on a departmental budget. A central-government-wide approach (in the spirit of "risk pooling") therefore seems appropriate. The explicit subsidies would be deposited into a central reserve, and withdrawals from this reserve (for the benefit of the budget) would be made when a loss transpired. Incidentally, as part of effective risk management the department in question should always pay a proportion of the incurred loss from its own budget (excess).

In summary, the Study Group recommends the continuation of the current "no, unless" policy for existing and new guarantees and loans. But for the sake of transparency the costs should be identified when guarantees or loans are extended. The explicit and implicit subsidy elements of guarantees and loans could then be incorporated into the budget by means of a specific calculation (if historical information is available) or by means of a subsidy premium of 3%. The Study Group recommends that the subsidy is deposited in a

⁴⁰ This percentage is based on the general risk premium as formulated in the government position on risk values (House of Representatives [Tweede Kamer], session 2003-2004, "Waardering van risico's bij publieke investeringsprojecten", 29 352, no. 1).

central reserve, from which payments would be made in the event of losses. As an incentive for proper control of guarantees and loans, a proportion of any incurred loss should be charged to the budget of the department in question. However, losses on guarantees and loans related to serious societal risks (a nuclear accident, for instance) which private players cannot and will not bear will be borne centrally.

Open-ended schemes

An open-ended scheme is a specific regulatory measure under which natural and legal persons are awarded a legally enforceable claim to a benefit from the state, without a maximum budget being set. Open-ended schemes could constitute a serious budgetary risk because of the lack of a budget cap. The current expenditure framework system already significantly reduces this risk. Open-ended schemes generally fall under an expenditure framework and are controlled in this way. This limits the budgetary risk of open-ended schemes during a government's term of office.

The desirability of specific open-ended schemes is evaluated at regular intervals through policy reviews. Policy reviews examine the policy objectives and the policy instruments (in this case, open-ended schemes) as well as the results achieved and the expenditures involved. Policy reviews focus on general and operational policy objectives, and they are conducted independently. They also decide whether it is appropriate for a scheme to have an open-ended character.⁴¹ Schemes which are wrongly open-ended or which are not incorporated into an expenditure framework can thus be flagged up.

The Study Group regards the existing range of instruments as sufficient to reduce the budgetary risks arising from open-ended schemes. The Study Group therefore recommends the continuation of the practice of policy reviews.

⁴¹ The intention is that policy reviews rely as much as possible on previously conducted evaluations. Specifically, a policy review considers the analysis of the problem at hand, the motivation of the role of government, the policy objectives, the policy instruments used and their societal effects, and the structure of the budgets. A well known example of an open-ended scheme is the renewable electricity consumption subsidy disbursed under the Environmental Quality of Electricity Generation Act (MEP).

Enclosure 1: Advice request to the Study Group on the Budget Margin

The Hague, September 2005

To the Chair and Members of Study Group on the Budget Margin,

In order to give proper consideration to all aspects of budgetary policy after this government's term of office, it is important that an analysis of the challenges facing budgetary policy in the coming years and an evaluation of the budget system in recent years are available well in time.

Against this background I ask the Study Group to outline the considerations which a future cabinet can take into account when deciding the budget objectives for the period 2007-2011. The key issue is that the public finances are made as future-proof and cycle-proof as possible. In its analysis the Study Group can draw on the medium- and long-term calculations made by the Netherlands Bureau for Economic Policy Analysis (CPB). Following on from this, the CPB's medium-term calculations can provide insight into the overall budget margin available in the next government's term of office. I ask the Study Group to take account of possible measures which broaden the tax base for public services and/or influence the ageing-related expenditures. I believe that the Study Group should also pay attention to the effect on the intergenerational distribution of burdens and benefits.

I also ask the Study Group to examine specifically, in the context of its recommendations on the budget system, the following: the cyclical sensitivity of the budget, the definition of the micro burden, the budgetary risks, and the degree of budget flexibility in the current system (also in light of the structure of public spending).

I also ask the Study Group to review the operation of the Economic Structure Enhancing Fund (FES) in general and its management structure in particular. At least with regard to the FES's funding system, an advance report would be appreciated.

I would ask you to make your recommendations before the summer of 2006.

The Minister of Finance
Gerrit Zalm

Enclosure 2: Composition of Study Group on the Budget Margin

Chair:	Laura van Geest	Treasurer, Ministry of Finance
Members:	Henk Brouwer	Executive Director, De Nederlandsche Bank (DNB, the Netherlands central bank)
	Coen Teulings	Director, Netherlands Bureau for Economic Policy Analysis (CPB)
	Marcel van Gastel	Director-General for Social Care, Ministry of Health, Welfare and Sport
	André de Jong	Director-General of the Budget, Ministry of Finance
	Tjerk Kroes	Director General and Socio-Economic Affairs Directorate, Ministry of Social Affairs and Employment
	Rob Kuipers	Director-General Public Sector Management, Ministry the Interior and Kingdom Relations
	Bertholt Leeftink	Director-General Economic Policy, Ministry of Economic Affairs
	Maarten Ruys	Secretary-General, Ministry of Social Affairs and Employment
	Maarten Verwey	Deputy Director, Financial and Economic Policy, Ministry of Finance
	Helmer Vossers	Director Budget Affairs, Ministry of Finance
	Hans Vijlbrief	Director-General Economic Policy, Ministry of Economic Affairs
Secretariat:	Richard van Zwol	Deputy Secretary-General, Ministry of General Affairs
	Wouter Koolmees	Financial and Economic Policy Directorate, Ministry of Finance
	Focco Vijselaar	Budget Affairs Directorate, Ministry of Finance

The following also attended meetings of the Study Group: Broer Akkerboom (Ministry of the Interior and Kingdom Relations), Casper van Ewijk and Rocus van Opstal (Netherlands Bureau for Economic Policy Analysis [CPB]), Manon Leijten and Peter Martens (Ministry of General Affairs), Raymond Gradus and Michiel Sweers (Ministry of Social Affairs and Employment), Theo van Uum (Ministry of Health, Welfare and Sport), Annemarie van der Zwet (De Nederlandsche Bank [DNB]).

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