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Interim Report on Fiscal Monitoring November 2017

Since 2014, the Advisory Division of the Council of State has been charged with independent monitoring of compliance with the European fiscal rules as provided for in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. It is the task of the independent fiscal institution to assess compliance with the (European) fiscal rules against the broader background of the long-term sustainability of public finances. The Advisory Division generally publishes two reports per year, in April and in September, in which it provides an assessment of the expected budgetary developments. In its September Report 2017, the Advisory Division stated that, following publication of the new Coalition Agreement, it would prepare an interim report of the proposed budgetary policy.[1]

A. ASSESSMENT

1. Introduction

The Advisory Division has taken note of the Coalition Agreement and the financial annex as published on 10 October 2017,[2] of the economic and budgetary analyses of this agreement as compiled by the CPB/Netherlands Bureau for Economic Policy Analysis dated 4 and 27 October 2017,[3] and of the Initial Policy Memorandum in which the Coalition Agreement's budgetary policy proposals are translated into the departmental budgets for 2018 and the medium-term figures. On the basis of this, the Advisory Division prepared a draft assessment which was discussed with the government. The Advisory Division drew up its final assessment after being informed of the government's response. The government's response is included in full in part B of this report.

The Advisory Division concludes that according to the CPB analysis of the Coalition Agreement, Dutch public finances continue to comply with the European fiscal rules. However, it also makes some additional comments. For example, it considers the margin with respect to medium-term objective for the structural budget balance to be useful, but also modest given the major (budgetary) uncertainties and the extent to which these uncertainties are factored in. The Advisory Division also points to the worsening sustainability balance, which would have been even bigger without the tax measures being introduced post-2021. The Advisory Division considers these points in more detail below.

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[1] September Report 2017, 14 September 2017 (W06.17.0282/III), Parliamentary Papers II 2017/18, 34 775, no. 4.

[2] 'Vertrouwen in de toekomst' (Trust in the Future), Coalition Agreement 2017-2021 by the VVD, CDA, D66 and ChristenUnie, 10 October 2017 (annex to Parliamentary Papers II 2017/18, 34 700, no. 34).

[3] CPB, Analysis economic and budgetary effects of the financial appendix to the Coalition Agreement, CPB Communication, 4 October 2017, and CPB, Updated medium-term forecast 2018-2021 (including Coalition Agreement), CPB Communication, 27 October 2017.

2. Budgetary frameworks selected in the light of the European fiscal rules

The agreed increases in expenditure and tax-relief measures totalling €14.5 billion in 2021 will, under the economic circumstances assumed, result in a small budget surplus of on average approximately 0.5% of GDP in the new government's term of office. This calculated budget surplus is, however, also determined by the favourable economic cycle. The (cyclically adjusted) structural government balance, assessed in the context of the European rules, paints a rather less favourable picture. In 2018, the medium-term objective for the structural budget balance of –0.5% of GDP, set out in the European context, will almost be met.[4] From 2019, there will almost be a balanced budget, resulting in a margin of approximately half a percentage point compared with the European rules for the budget balance. These budget surpluses, in combination with a projected economic growth of 2% and a rate of inflation also of (around) 2%, will result in a gradual decrease in the debt quote towards 45% of GDP in 2021.

The Advisory Division concludes that – based on current forecasts – the European fiscal rules are met. It makes a number of additional comments, however.

3. Economic growth forecasts applied above potential growth

The budgetary agreements in the Coalition Agreement are based on economic growth of on average 2% per year, as projected by CPB. In its analysis of the agreement, the CPB states that this is a growth percentage that is significantly above the structural growth of the Dutch economy.[5] Using a growth percentage that is significantly above structural growth, increases the chance of actual growth being lower in future years. International uncertainties (e.g., a hard or soft Brexit, the pace of reducing the European Central Bank's unconventional monetary policy, unforeseen events in the eurozone) may mean that reality fails to match the forecast gradual 2% growth path.

The question, then, is how to tackle disappointing developments in the budgetary policy. Because dealing with setbacks in political and administrative practice is generally more tricky than handling windfalls, in the past there was a call for applying a cautious scenario as the starting point for the budgetary policy to be implemented. A cautious scenario assumes a growth rate that is somewhat lower than the estimated structural growth in the economy. Caution can also be incorporated in other ways (see next paragraph).

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[4] According to the Initial Policy Memorandum, the 2018 structural balance is expected to be –0.7% of GDP. Taking into account the 0.25 per cent margin of uncertainty which the European Commission applies in its *ex post* assessment, this should be sufficient to meet the European fiscal rules.

[5] CPB, 4 October 2017, page 8.

The Advisory Division notes that this choice was not made when drawing up the Coalition Agreement, as a result of which there is a bigger chance of setbacks than would have been the case in a more cautious scenario. It is unclear whether the risks of disappointing developments have been anticipated in some other way when defining the budgetary framework.

4. Scope and structure of the additional policy package

The Coalition Agreement includes, on balance, increases in expenditure of €7.9 billion in 2021 and tax-relief measures of around €6.6 billion.[6] Taken together, this implies a fiscal impulse of approximately €14.5 billion.[7] Now that the economy is growing more strongly than the estimated structural growth rate – from an economic perspective – an additional policy package of up to €14.5 billion (1.8% of GDP) in 2021 qualifies as strong. The impulse is also very much focused on 2018. In the current forecasts for 2018, this supports a procyclical budgetary policy. We do not yet know the economic cycle for subsequent years, and so cannot assess whether or not it will be procyclical. The Study Group on Fiscal Policy has previously pointed out that the Dutch fiscal policy has generally been procyclical since the introduction of the system of trend-based fiscal policy.[8] There does not currently seem to be any break from this trend.

Since no cautious scenario has been selected as the starting point in estimating structural growth, alternative options need to be considered to absorb the consequences of setbacks. The conditional assignment of extra expenditure for subsequent years, and working with an expenditure reserve or a so-called ‘envelope’, should provide greater scope for flexibility, and so allow a better response to potential negative developments or new political priorities which may emerge during the government’s term of office.[9] This may be coupled with the process of conditional assignment of new expenditure, as outlined at the start of the annex to the Coalition Agreement: first make a reservation for these new funds, pending concrete and targeted proposals, and then assign these annually in tranches. Such a method may yield administrative and social uncertainty, but otherwise aligns well with a good and critical test into the efficient and effective use of additional funds which the government aims to launch with the operation 'Insight into quality'.

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[6] Coalition Agreement, annex, table 1, page 56.

[7] In mid-2016, the Study Group on Fiscal Policy saw no reason to call for a net increase or net cuts given the economic forecast for the medium-term at that time. However, the budget deficit at that moment was considerably less favourable than it is now; in mid-2016, a budget deficit of more than -1% of GDP was forecast for 2016, while the year closed with a budget surplus of almost 0.5% of GDP. See the 'Van saldosturing naar stabilisatie' (From balance control to stabilisation) report of the 15th Study Group on Fiscal Policy, July 2016 (annex to Parliamentary Papers II 2015/16, 34 300, no. 74), page 8.

[8] Report of the 15th Study Group on Fiscal Policy, box 2.1, page 20.

[9] Report of the 15th Study Group on Fiscal Policy, page 47.

The revenue framework, which imposes a cumulative change in taxes over four years, can in addition provide a margin for flexibility by allocating assets to individual years at a later date.

From the explanatory notes to the Coalition Agreement, the Advisory Division is unable to determine whether any scope for flexibility has been included to allow for greater room for manoeuvre in the event of unforeseen disappointing developments.

5. More detailed assessment of the margin in the structural balance

As noted above, the fiscal proposals, in combination with the economic growth forecasts for 2018 applied, result in a forecast that complies with the European rules for the structural government balance and in subsequent years to almost structural balance, yielding a margin of 0.5% of GDP with respect to the fiscal rules agreed by the member states as of 2019. The Advisory Division asks itself how to appreciate this margin.

The Advisory Division has referred to the highly volatile character of the Dutch economy, and in particular of Dutch public finances, in previous reports.[10] This volatility arises not just because of the economic structure, but also because of institutions (and how they are treated in the Dutch tax system) in the housing market, and pensions. Since the turn of the century, there have been five years with a budget surplus recorded, and five years with a budget deficit of 3% of GDP, or more. It is also notable that reversals happened very quickly, and were virtually never predicted in the short-term forecasts. This occurred when a surplus became a deficit in excess of 3% of GDP (2002/2003), as well as when there were budget surpluses (2000, 2006, 2016). In the light of the relatively strong volatility, for the Netherlands the margin between the medium-term objective of a structurally balanced budget (–0.5% of GDP) and the ceiling at which the excessive deficit procedure starts (–3.0% of GDP) can be considered narrow. Including an additional margin of 0.5% of GDP in the structural budget balance thus adds a useful degree of prudence to the budgetary policy.

A second factor that is also important in the assessment of this margin is a change in the fiscal rules. In the Coalition Agreement, the cyclical part of unemployment benefits expenditure is placed outside the framework of expenditure ceilings, in order to increase the stabilising effect of the budget on the economy.[11] The consequence of this is potentially a greater margin for automatic stabilisation in the budget balance. This choice thus raises a second argument for a more generous margin with regard to the –3% of GDP reference value, so that the desired additional stabilisation via unemployment benefits expenditure is allowed to work without being forced to adopt a procyclical policy at a time when

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[10] See for example Spring Report on Fiscal Monitoring 2017, 13 April 2017 (W06.17.0081/III/B), annex to Parliamentary Papers II 2016/17, 21501-07, no. 1434.
[11] Coalition Agreement, paragraph 1.8, page 20.

the economy is performing poorly. There have been too many negative experiences with this in the past ten years. Furthermore, it should be noted that the margin from 2019 is a *forecast* margin; these years are some way off, we do not know what the economic cycle will be like then, so this margin is uncertain.[12]

A third relevant factor in the assessment of this margin concerns the methodology of this budgetary policy. The structural balanced budget as used in the European fiscal rules is, in practice, rather volatile in nature, and difficult to estimate. This means that it is difficult to control this variable in the annual budgetary process. It has therefore been agreed in the Coalition Agreement that the Netherlands' own national budgetary framework will continue to be used.[13] This requires consideration of a certain margin in respect of the margins to avoid having to deviate too often from the national framework because European limits have been exceeded. The margin in the current forecasts compared with the European rule of 0.5%of GDP from 2019 thus facilitates the decision to steer in accordance with national fiscal rules.

In addition to international uncertainties, uncertainties and risks in two other areas should also be considered. Firstly, the future development of the interest rate. Interest rates are currently very low (0.6%); the Coalition Agreement forecast assumes a rise to 1.8% in 2021. Inflation is also forecast to rise, meaning that the real interest rate will fall even further. This will put pressure on the government's interest expenditure. If the real interest rate rises, however, this will result in setbacks in the interest charges on the budget. In the Coalition Agreement, interest expenditure is brought under the expenditure ceiling, requiring compensating measures to be taken immediately when interest rates rise in order to manage this risk. This then results in expenditure being reduced elsewhere.

The control of healthcare expenditure also continues to demand attention. The Coalition Agreement aims to restrict the increase in curative healthcare expenditure to €1.9 billion in 2021, as a result of new agreements to be concluded with the health care sector; the CPB allows for lower forecasts for the additional revenue (€0.9 billion).

Overall, from the perspective of prudent budgetary policy, the current margin in the structural government balance from 2019 on can be qualified as useful and necessary. However, the scope of the margin can at the same time be qualified as modest in the light of the great uncertainties that now afflict budgetary forecasts.

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[12] The economic forecasts used assume, for example, a gradual increase in relevant world trade of on average 4.5% per annum. If the outlined international uncertainties (Brexit, reducing current monetary policy, eurozone) manifests themselves to some extent, or in a different way, and if the growth rate of world trade would as a result be 1% lower, for example, this margin would virtually disappear. This can be derived from M. Ligthart, M. Vromans and P. Westra, Varianten SAFFIER II, Background document to CPB document 217, 18 January 2011.

[13] Coalition Agreement, paragraph 1.8, page 20.

6. The budgetary policy in the light of the European country-specific recommendations

In the context of the European Semester, this July the Economic and Financial Affairs Council (ECOFIN) advised the Netherlands, via the so-called country-specific recommendations, to support potential growth and domestic demand via the fiscal policy 2017 and 2018, including by investing in research and development, taking into account medium-term objectives.[14] A structural budget surplus of 0.3% of GDP was then forecast for 2018. Following analysis of the Coalition Agreement's set of policies, the CPB forecasts a structural government balance for 2018 of –0.6% of GDP,[15] fractionally below the medium-term objective of –0.5% of GDP. Thus, the European recommendation for 2018 is met.

Via the country-specific recommendation, the Council also requested a reduction in the tax deductibility of interest on mortgages, a reduction in the tax deduction for the self-employed, the promotion of social protection for the self-employed, reform of the pension system and the promotion of growth in real wages.

The Advisory Division notes that the new Coalition Agreement meets many of these recommendations.

7. Budgetary frameworks assessed in the light of the long-term

The financial annex to the Coalition Agreement and the CPB analyses indicate that the impact of the Coalition Agreement package will be considerably greater in 2021 (€14.5 billion) than in the long term (€8.5 billion). The package will – after the macro-economic effect is included – worsen the structural government balance with 1.2% of GDP. After 2021 however, this amount will decrease considerably to approximately half the level in 2021 due to tax measures. The Coalition Agreement contains a complex body of tax measures that will work very differently up until 2021 than in the years and decades afterwards. Table 1 in the financial annex to the Coalition Agreement states that the tax-relief measures of €6.6 billion in 2021 will increase taxes with €0.6 billion in the long term.

The introduction of the two tranche system in the income tax in 2019 will be coupled with a generous tax-relief package that will reach €6.4 billion in 2021. Because income tax rates were already expected to fall structurally as a result of housing market regulations, this is largely bringing a tax-relief measure forward in time.

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[14] Recommendation from the European Council dated 11 July 2017 regarding the Dutch National Reform Programme 2017, and with an advise from the Council regarding the Dutch Stability Programme 2017 (PB 2017, C 261), page 79.

[15] In the Initial Policy Memorandum, the Minister of Finance forecasts a structural balance of –0.7% of GDP in 2018.

After 2021, taxes will continue to rise in other areas. Families will see a gradual increase in the tax burden of €1.9 billion (staged abolition of the Hillen Act, abolition of the sustainable energy netting arrangement, top rate starting point in the income tax). The tax-relief measures for businesses (partly due to lower corporation tax) are in the long run also €1.8 billion lower than in 2021 (€1.2 billion instead of €3.0 billion). Together with the sharp increase in taxes already included in the baseline (increase in tax to finance stimulation measures for sustainable energy (SDE) of €0.4 billion in 2021 to €3.3 billion structurally, and the introduction of a national CO2 tax on electricity generation), there will be a staged increase in the tax burden, rising to around €7 billion in the long term.

In August 2017, the CPB forecast a sustainability *surplus* of 0.2% of GDP (€1 billion).[16] With the inclusion of the policy proposals from the Coalition Agreement, this is expected to fall by 0.6% of GDP (approximately €5 billion), as a result of which in the long term there will be a sustainability *deficit* of 0.4% of GDP. Stated otherwise: at some time in the future, expenditure will have to be reduced or revenues increased to the amount of around €3 billion.

Furthermore, the tax measures set out in the Coalition Agreement will occur in the years/decades after 2021, in a period when the costs of the ambitious climate policy are increasingly being felt. A closer look is recommended as to how and where the costs of the climate policy will be imposed towards 2030, and to what extent any additional policy will influence the financial frameworks more heavily in this term of office and in subsequent years in order to achieve the international climate agreements.[17] Extension of the SDE+/ODE scheme was already included in the CPB baseline. Further extension of the climate policy by 2030 will result in additional costs. If this is not expressed in extra ODE (Sustainably Energy Financing) tax, the question is how the additional costs will be raised and where costs will be imposed (families, companies or government).[18]

The Advisory Division notes that – as a consequence of the Coalition Agreement – the previously forecast sustainability surplus will become a sustainability deficit of 0.4% GDP (approximately €3 billion). This sustainability deficit would actually have been higher without the tax measures due to enter into effect after 2021, totalling some €7 billion.

B. GOVERNMENT RESPONSE

On 3 November 2017, the Minister of Finance, on behalf of the government, issued a (written) response to the Advisory Division's draft assessment. This response is included in full below.

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[16] CPB, Updated medium-term forecast (MLT), 16 August 2017

[17] See also PBL, Analysis of the Rutte III Coalition Agreement: Effects on climate and energy, 30 October 2017.

[18] Coalition Agreement, annex, table 1, footnote 1, page 56.

“The government would like to thank the Advisory Division of the Council of State (hereinafter: the Advisory Division) for its letter concerning the new government's budgetary policy.

The government was pleased to see the Advisory Division's observation that public finances will comply sufficiently with the Stability and Growth Pact (SGP) rules in the new government's term of office. And that the measures under the Coalition Agreement also meet many of the country-specific recommendations of the European Council.

The Advisory Division also makes a number of comments to the fiscal policy for forthcoming years. For example, it points to uncertainty in economic forecasts and risks which may materialise during the next term of government. The Advisory Division wonders whether sufficient margin has been maintained to weather economic headwinds.

The government is continuing the Dutch tradition of trend-based budgetary policy. It has adopted the recommendation of the 15th Study Group on Fiscal Policy regarding adjustments in the system of expenditure ceilings. This involves further strengthening of automatic stabilisation.

As the Initial Policy Memorandum states, the government is on course for an actual budget surplus over the full term of office. The structural balance remains within the defined European rules. This all means that the debt quote will fall towards 47% in 2021, close to the debt level from before the crisis. It is a well-considered decision on the part of the government to invest in the Netherlands after previous years of thrift. At the same time, the government maintains margins with regard to the European fiscal rules.

Like the Advisory Division, I too look forward to constructive collaboration and dialogue during the forthcoming term of office based on mutual respect for each other's position.

Yours sincerely,
The Minister of Finance,

W.B. Hoekstra”

The response from the government has not prompted the Advisory Division to change its assessment.

The vice-president of the Council of State,

[signed]