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The Dutch medium-term outlook and the European budgetary rules

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1 Introduction

This Background document makes available in English work recently published in Dutch on structural budget balances in a medium-term framework.[1] In addition, it provides input for the current debate initiated by eight ministers of finance on the calculation of potential output. It shows the impact in the Dutch case of moving from a two-year to a four-year forecasting horizon on potential output.

Work on structural budget balances in a medium-term framework was done as part of CPB's publication on the medium-term outlook for the Dutch economy.[2] This medium-term outlook will serve as the baseline for a coalition agreement after the general elections of March 2017.[3]

GDP volume growth is projected at 1.8% per annum in the years 2018-2021 (Table 1.1). This gradual moderate upturn leads to a sluggish drop in unemployment. With oil prices no longer falling and the economic recovery continuing, inflation is picking up somewhat. The current account surplus is projected to remain substantial.

[1] Two text boxes were published in Dutch: 'Berekening van het structurele saldo' (link) , 'De verkenning en de Europese begrotingsregels' (link).
[2] CPB, 2016, Middellangetermijnverkenning 2018-2021. (link)
[3] Suyker, W., 2015, CPB's role in the Dutch medium-term budgetary framework, presentation at the 7th Annual meeting of OECD Parliamentary budget officials & independent fiscal institutions, Vienna. (link)

Table 1.1 Main economic indicators

	1998-2005	2006-2013	2014-2017	2018-2021
	Percentage changes per year			
International economy				
Relevant world trade (volume)	5.4	3.0	3.9	4.6
GDP euro area (volume)	2.1	0.6	1.4	1.6
Oil price (in US dollars per barrel; level, end of period)	54.4	108.7	37.7	42.5
Euro-dollar exchange rate (level, end of period)	1.24	1.33	1.09	1.16
Dutch long-term interest rate (level, end of period)	3.4	2.0	0.6	1.9
Volume GDP and spending				
GDP	2.5	0.8	1.7	1.8
Private consumption	2.4	-0.3	1.3	1.0
Government consumption	2.8	2.5	0.5	1.3
Investments (including stocks)	1.6	-0.7	5.0	2.7
Exports	5.7	3.2	4.0	4.3
Imports	5.7	2.9	4.6	4.2
Prices and wages				
GDP	2.5	1.4	0.8	1.5
Consumer price inflation (hicp)	2.5	1.9	0.5	1.6
Contractual wages market sector	2.8	1.8	1.4	2.0
Purchasing power, static, median all households	0.6	0.0	1.2	0.0
Labour market				
Labour force	1.1	0.9	0.4	0.8
Working population (hours)	1.1	0.7	0.6	1.0
Unemployment rate (level, end of period)	5.9	7.3	6.3	5.5
Other				
Labour income share (level, end of period)	75.9	79.6	78.2	78.4
Current account balance (% GDP, level, end of period)	7.3	11.0	10.5	10.2

The outlook for the government budget is based on unchanged policy. As a consequence, government outlays excluding health care drops as a percentage of GDP. Health care outlays are rising as a percentage of GDP as the projection is based on the long-term trend excluding policy measures and on demographic developments. Nevertheless, total government outlays as a percentage of GDP falls. The tax burden rises somewhat due to social security premiums financing rising cure outlays (Table 1.2). The general government budget balance switches from a deficit into a surplus. Gross government debt falls below 60% of GDP.

Table 1.2 Government budget 2016-2021

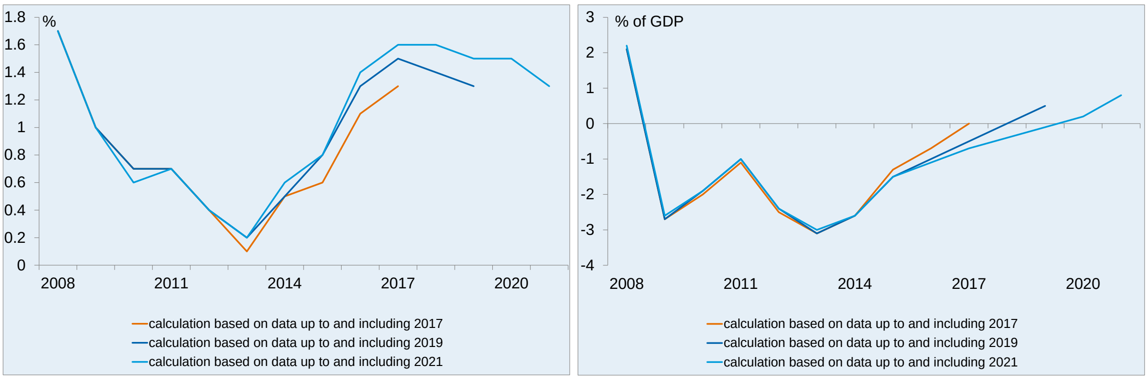
	2016	2017	2018	2019	2020	2021
	% of GDP					
Gross government outlays	43.8	43.4	42.8	42.5	42.2	41.9
Taxes and social security contributions	37.5	37.7	38.0	38.3	38.5	38.6
Non-tax government income	4.6	4.5	4.4	4.2	4.1	4.0
General government budget balance	-1.7	-1.2	-0.4	0.1	0.4	0.6
Gross government debt (EMU)	65.4	64.1	61.6	58.9	56.4	54.0

2 The structural budget balance

The structural budget balance, which corrects the nominal government budget balance for one-offs and business cycle effects, is used to assess the underlying fiscal policy effort. Estimates of the structural budget balance play a central role in the preventive arm of the Stability and Growth Pact. The business cycle effects are determined by the output gap estimate. CPB applies the method commonly agreed by EU member states to calculate the structural budget balance, as this definition of the structural balance is relevant for surveillance of European fiscal rules.[4]

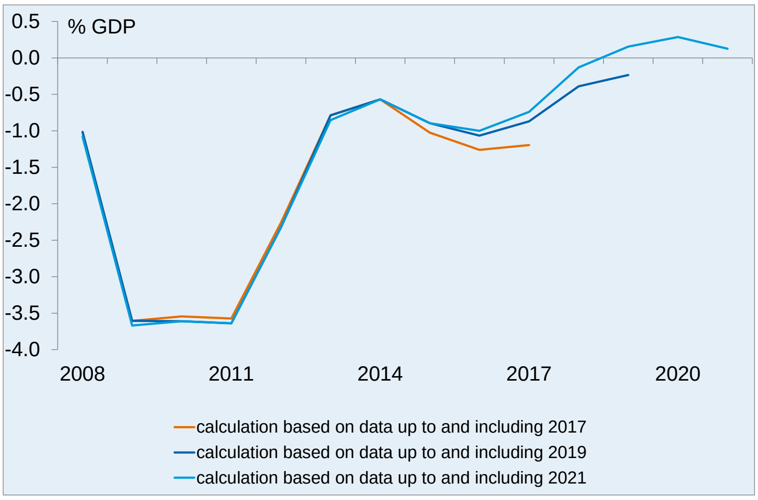
The size of the output gap depends on the projection horizon as is shown in Figure 2.1. The commonly agreed method on potential output is using the projection horizon of the short-term forecast, that is two years. Currently, this is up to 2017. This period matters not only for the output gap but also for the structural budget balance as is shown in Figure 2.2. On the basis of the current medium-term outlook (2016-2021) with actual GDP growth somewhat above potential, adding years to the calculation of potential output is increasing potential output growth, decreasing the output gap and increasing the structural budget balance.

Figure 2.1 Potential output and output gap (EC-method)



[4] Havik, K., et al, 2014, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, European Economy. Economic Papers. 535. (link). Mourre, G. et al, 2014, Adjusting the budget balance for the business cycle: the EU methodology, European Economy, Economic Papers 536 (link)

Figure 2.2 Structural budget balance (EC-method)



3 The medium-term outlook and the European budgetary rules

A policy relevant question is whether the current medium-term outlook for the government budget, based on unchanged policy and moderate medium-term economic growth, is consistent with the European budgetary rules for the structural budget balance (MTO) and the corrected government expenditures (expenditure rule). This paragraph answers this question, strictly adhering to the two-year approach applied by the European Commission and Council in the annual assessment of the government budgets of euro area countries. As a consequence, the assessment of 2017 is based on potential output estimates using data up to and including 2017, the assessment of 2018 is based on the potential output estimates using data up to and including 2018, etc.

The annual benchmarks for the change in the structural budget balance and the corrected government expenditures depend on the structural budget balance in the previous year. A more negative structural balance in the previous year requires a bigger budgetary effort (a bigger positive change in the structural budget balance and a smaller rise in the corrected government expenditures). The budgetary outlook is not (fully) compliant with the European budgetary rules in the short term (2017 and 2018),[5] while there is substantial fiscal space in following years (Figure 3.1, Figure 3.2 and Table 3.1).

[5] See for 2017 also Council of State, Budget Supervision Spring Report 2016. (link)

Figure 3.1 The structural budget balance (EC-method)[6]

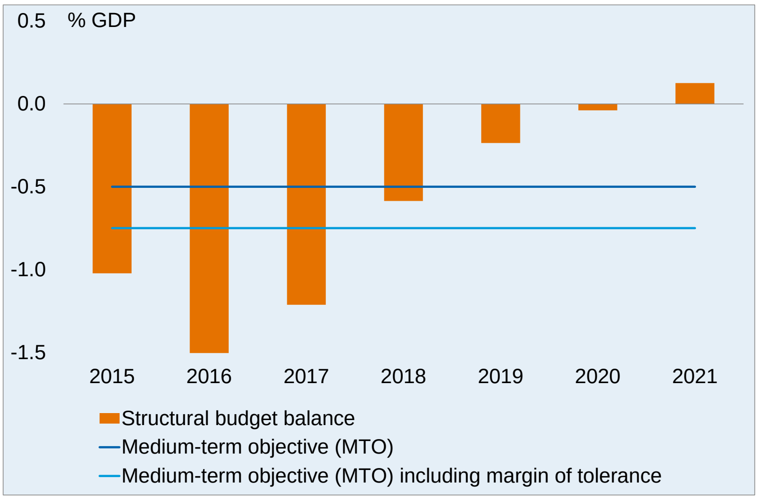


Figure 3.2 Fiscal effort and fiscal requirements

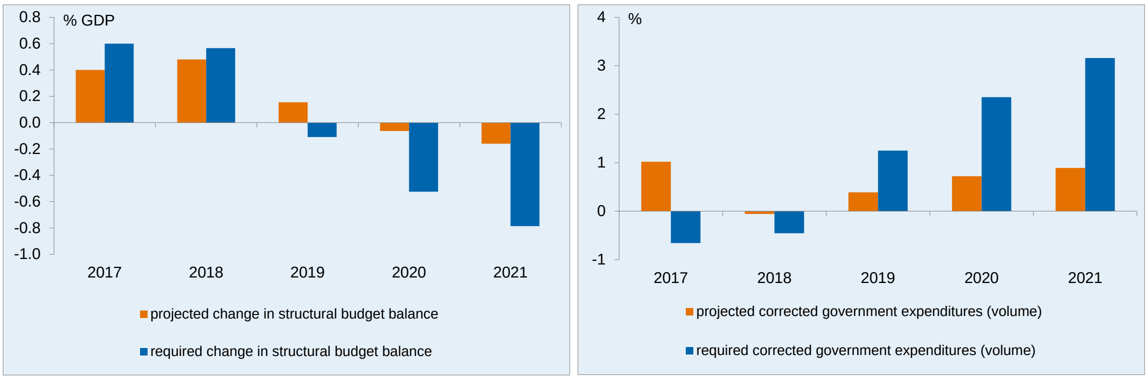


Table 3.1 Fiscal effort and fiscal requirements (based on standard 2-year horizon potential output)

	2017	2018	2019	2020	2021
	in % GDP				
Deviation in change structural budget balance					
Deviation in year t	-0,2	-0,1	0,3	0,5	0,6
Deviation in year t and t-1	-0,3	-0,1	0,1	0,4	0,5
Deviation in expenditure benchmark (% of GDP)					
Deviation in year t	0,7	0,2	-0,3	-0,7	-0,9
Deviation in year t and t-1	0,3	0,4	-0,1	-0,5	-0,8
Compliance					
A non-significant deviation from budgetary target.					
A significant deviation from budgetary target					

[6] A member state is considered at its MTO if the difference of the structural budget balance with the MTO is less than the 0.25% GDP margin of tolerance. See European Commission, 2016, Vade Mecum on the Stability and Growth Pact – 2016 edition. (link)

European rules on gross government debt require a debt ratio of less than 60% of GDP or at least approaching 60% of GDP at a satisfactory pace. Satisfactory pace requires that the difference with the 60% benchmark has decreased over the previous three years at an average rate of 1/20th per year. The projected government debt is in line with these requirements.

4 Final remarks

The calculation presented in the previous paragraph strictly adheres to the two-year approach applied in the annual assessment by the European Commission and Council. Recently, ministers of finance of eight euro area countries have "strongly suggested" to switch to a four year approach.[7] In a four year approach potential output for 2016 and 2017 is calculated based on historical data and projections up to 2019 instead of the 2017 in the current 2-year approach; potential output in 2018 is based on actual output projections up to 2020 etc. This is increasing the importance of the medium-term projection. It would require an extension of the endorsement or forecasting by the national independent fiscal institute from 2 years to 4 years.

Table 4.1 Fiscal effort and fiscal requirements (based on standard 4-year horizon potential output)

	2017	2018	2019	2020	2021
In % GDP					
Deviation in change structural budget balance					
Deviation in year t	-0,4	0,3	0,7	0,8	0,6
Deviation in year t and t-1	-0,2	-0,1	0,5	0,7	0,7
Deviation in expenditure benchmark (% of GDP)					
Deviation in year t	0,7	-0,1	-0,6	-0,8	-0,9
Deviation in year t and t-1	0,3	0,3	-0,3	-0,7	-0,8
Compliance					
A non-significant deviation from budgetary target.					
A significant deviation from budgetary target					

Table 4.1 shows the fiscal requirements in the Dutch case in a 4-year approach. The switch to the 4-year horizon would - given the forecast for actual GDP in table 1.1 - modify the output gap in 2017 from 0.0% of GDP to -0.5% of GDP; the output gap in 2016 would be modified from -0.7% of GDP to -1.0% of GDP.[8] This would result in a less negative structural budget balance: -0.9% of GDP instead of -1.2% of GDP in 2017 and -1,1% of GDP instead of -1,3% of GDP in 2016. The smaller structural deficit is reducing the fiscal effort required in the

[7] Ministers of Finance of Spain, Italy, Latvia, Lithuania, Luxembourg, Portugal, Slovenia and Slovakia, 2016, Letter to the European Commission on the extension of the EC's potential output forecasting horizon, March 22. (link)

[8] The impact of the shift (0.3% to 0.5%) is less than the 0.8% reported for Italy. See Steinhauser, G., 2016, Mind the output gap: Ministers eye changes in key econometric metric, Wall Street Journal, April 1. (link)

following year. On a one-year basis, it would mean that the structural budget balance change is already complying in 2018 to the required effort; in the 2-years-approach this is from 2019 onwards. The switch has a comparable impact on the expenditure benchmark. In summary, switching to a four year approach can make a difference for the assessment of fiscal requirements, and makes this assessment (more) sensitive to the forecast for actual growth in future years. Optimistic forecasts for actual GDP in later years support a more favorable assessment, and this might give governments an incentive to produce optimistic forecasts. Hence, it underlines the importance of an independent production or endorsement of these forecasts, on the national and European level.

The ministers also highlight that more substantial doubts have been raised about the commonly agreed methodology. They do not go into details. More specific is the EU presidency in a note for the informal ECOFIN meeting in Amsterdam.[9] The note suggests a greater role of the expenditure benchmark and a smaller role of the change in the structural budget balance. A comparable change was also recently proposed by Bruegel.[10] Such a change would simplify the European fiscal framework and would make the assessment of fiscal effort less vulnerable for atypical tax swings and potential growth volatility.[11]

[9] EU Presidency, 2016, Improving predictability and transparency of the Stability and Growth Pact, note for the informal ECOFIN meeting of April 23. (link)

[10] Claes, G., Z, Darvas and A. Leandro, 2016, A proposal to revive the European fiscal framework, Bruegel policy contribution 2016/07, March. (link)

[11] See Hers, J. and W. Suyker, 2014, Structural budget balance, A love at first sight turned sour, CPB Policy Brief 2014/07. (link)

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