CPB Netherlands Bureau for Economic Policy Analysis

Macro Economic Outlook 2016

# MEV 2016, translation of chapter 1

1   Summary

The world economy and world trade are experiencing a setback, this year. Price adjustments on the world market are expected to stimulate demand again, causing an accelerated growth in world trade, next year. However, because of the recent reduction in world trade and downward risks, such as that of a further cooling of the Chinese economy, there are large uncertainties around the growth in world trade. The Dutch economy is growing in many areas. Despite disappointing world trade levels, the increase in exports remains robust. Consumption levels are rising, as a result of an increase in disposable incomes. Recovery is supported by growth in investments and an improving housing market. Unemployment is decreasing this year to 6.9% and next year to 6.7%, under increasing employment in the market sector and a growing labour supply. The 5-billion-euro package of tax measures, together with the measures aiming at an improvement of purchasing power for 2016, will cause an increase in the median purchasing power, next year, of 1.4%. The employed are benefiting the most, with 2.5%. The purchasing power of pensioners and social benefit recipients will increases by 0.2%. The government deficit is projected to decrease to 2.1% of GDP in 2015 and 1.4% in 2016. Continued economic recovery will boost tax revenues and reduce unemployment benefit expenditure. The structural government deficit will increase from 0.5% of GDP in 2014 to 1.2% by 2016.

1.1   Summary and introduction

Steady recovery of the world economy, uncertain world trade developments

The global picture is varied and characterised, on the one hand, by a weakening growth in emerging economies, expressed in a very disappointing increase in world trade, and by continued economic recovery in Europe and the United States, on the other. In the first quarters of 2015, world trade has slowed down, particularly due to disappointing trade levels in Asia and Latin America. The world trade that is relevant for the Netherlands was also disappointing during these quarters although less so, because of the continued growth of its main trade partners in Europe and the United States. GDP in the eurozone is showing positive developments. The relatively low growth in relevant world trade of this year has not had a clear impact on Dutch export levels. The increase in relevant world trade is expected to recover over the rest of this year and the next, and is projected to come to 2.8% in 2015 and 5.4% in 2016 (Figure 1.1, left-hand side). This acceleration is in line with the leading indicators on the eurozone, which point to a continued recovery, supported by a low oil price and depreciation of the euro. GDP growth in the eurozone, for these years, is projected at 1.3% and 1.9% respectively, mainly thanks to the robust German economic growth. This does not alter the fact that there is greater uncertainty than usual about the development in relevant world trade, in light of recent realisations. An uncertainty variant is presented in a text box below, showing how the projections could be affected by 2% less growth of relevant world trade.

Figure 1.1   Setback in world trade this year, recovery next year (left); low oil and resource prices and the euro all support recovery (right)
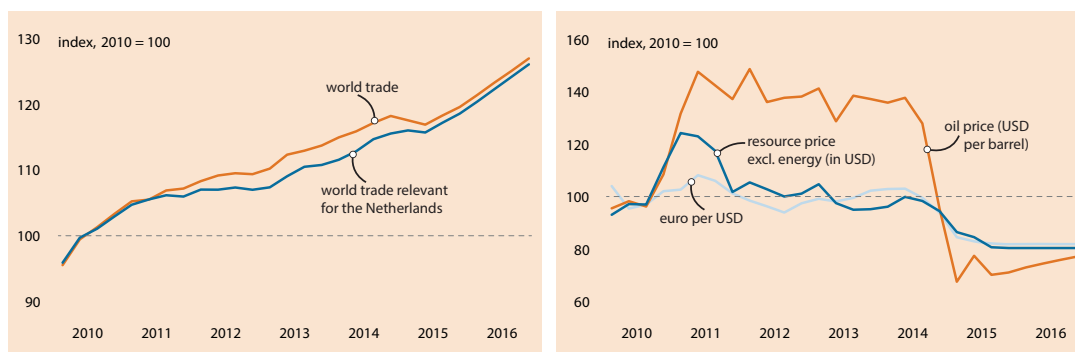
Sources: OECD, IMF, HWWI, CPB

This spring, long-term interest rates have risen in the Netherlands, similar to those in the United States and Germany.[1] Oil prices have decreased some more, and the euro's exchange rate has more or less stabilised, after depreciating in the second half of last year (Figure 1.1, right-hand side). Both developments boost the European economy. In addition, the low oil prices this year are also having a negative impact on inflation in the eurozone. In order to counter price decreases in the eurozone and to bring inflation back on target, the ECB started a programme of quantitative easing in March of this year. Over the March–July period, the ECB, on average, bought around 61 billion euros in securities per month – mostly (for over

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[1] The projected foreign picture was based on realisation data available on 27 July 2015.

51 billion euros) in government bonds. Inflation (HICP) in the eurozone is projected at 0.2% for this year and 1.3% next year. The eurozone's projected (five-yearly) inflation expectation has increased, since early this year to 1.8% in July, although it recently decreased again.

The specific risks coming from the international side are mostly downward. A further decline in economic growth in China, as a result of structural adjustments, share bubbles and too much available credit, is not unlikely. China is fourth on the list of countries that are most important for the Netherlands in terms of added value of exports to final destinations, and it is also important for other trading partners of the Netherlands. A halving (-4 percentage points) of Chinese domestic spending could next year, via both channels, lead to a reduction of 0.9 percentage points in relevant world trade, roughly equalling an impact of -0.3 percentage points on Dutch GDP. The agreement with Greece's creditors has somewhat stabilised the situation since mid July, but a downturn cannot be ruled out for the Greek economy. The direct impact on the Dutch economy, however, would be limited. The Greek economy is relatively small in comparison to that of the eurozone. And, compared to the 2012 situation, it also seems that Portugal, Spain and Ireland have only been infected by the crisis in Greece to a limited degree – although a new crisis of confidence cannot be ruled out. Increased volatility on financial markets – such as happened recently as a result of uncertainty about Chinese economic development – also increases the level of uncertainty and may lead to postponement of both investments and consumption. Along these lines, Dutch GDP could, in addition to the uncertainty about China, also be negatively affected by an escalation of the Ukrainian conflict and by unexpected changes in the pace of normalisation of US monetary policy.[2]

Recovery of the Dutch economy in many areas
Recovery of the Dutch economy will continue, with a growth of 2% this year and 2.4% the next. This year, for the first time since the start of the financial crisis, GDP will rise again above the 2008 level – although not yet for GDP per capita. In 2015 and 2016, GDP growth in the Netherlands will be higher than elsewhere in the eurozone, after lagging economic growth between 2011 and 2013.

This growth will be realised nearly fully by the market sector; the public sector and health care will hardly show any growth. The decision to limit natural gas extraction in Groningen will dampen this year's growth by around 0.5 percentage points (Figure 1.2, left-hand side).[3] On the other hand, the Netherlands will benefit greatly this year from the low exchange rate and a strong increase in housing investments. For next year, the economy is projected to grow over a wide range, due to an acceleration of relevant world trade and an increase in domestic spending, supported by an improving housing market and tax reductions (the 5-billion-euro package of measures). However, there are a number of hidden uncertainties that surround these projections.

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[2] Also see the related text box in Chapter 1 of the full Dutch report .

[3] For these projections, natural gas extractions from the Groningen field of 33 billion m^3 in 2015 are assumed (30 billion m^3 production and 3.3 billion m^3 from gas reserves) and 33 billion m^3 in 2016. The Dutch Cabinet will decide on the actual production level for 2016 at the end of the current year.

Uncertain times for world trade and the housing market

World trade variant

The main projections attribute the low growth in world trade since the Great Recession to the weak level of demand caused by the need to shorten balance sheets and reduced government debt. Now that demand is increasing in the advanced economies, the growth in world trade will accelerate. Because of the decrease in global goods trade in the first half of this year and the uncertain economic development in China, world trade could be lower than assumed in these projections. Under an alternative vision on a slow development of world trade, this is attributed to the integration of eastern Europe and China into the world economy, which could cause the growth in world trade to end up structurally below the level of the 1985–2005 period. Under this vision, such accelerated growth is unlikely, and there would be a downward risk for the main projections.

The variant shows a world trade growth that, next year, will be 2% lower than according to the main projections, with an increase of 0.9% this year and 3.1% in 2016. In line with the weak growth level of world trade, relevant world trade will also be close to 2% lower, and international trade prices will drop, slightly. For the Netherlands, this means lower export levels, less investment and slightly less consumption in 2016. GDP growth will be lower; this year by 0.1 percentage points and next year by 0.5 percentage points. As a result of the decelerated growth, unemployment will increase next year, and the EMU balance will be down, slightly.

Housing market variant

Since its low point in early 2013, the housing market has improved. The number of house sales has increased substantially and there has been a gradual rise in house prices again for some time. This has been followed, recently, by an increase in the demand for new housing. Lately, therefore, housing investments have increased substantially. The main projections take a continued positive development into account, with a levelling off of the number of transactions, as the market recovers further. Because of the increase in the number of privately owned houses and catch-up demand, the expected number of transactions may very well be higher than in the past.

This scenario, however, assumes that the number of transaction does not level off, but will grow by over 21%, both this year and the next. In addition, a faster improving housing market also leads to a rise in house prices by half as much as under the main projections. This will lead to an increase in housing-related consumption, while capital effects also will have an upward impact on consumption. A more robust recovery of the housing market also leads to more restorations and renovations, and to a higher demand for new housing. The increase in domestic spending will cause the economic growth to be higher; this year by 0.1 percentage points and next year by 0.3 percentage points. This will result in a decrease in unemployment of 0.1 percentage point next year, and to an increase in the EMU balance of 0.2 percentage points.

Consequences for the Netherlands of disappointing developments in the global economy and better-than-expected developments on the housing market; impact on annual growth and levels

	Disappointing world trade		Faster recovering housing market	
	2015	2016	2015	2016
Relevant world trade volume (excluding energy)	-0.2	-1.9	0.0	0.0
Competitor prices (excluding energy)	0.0	-0.3	0.0	0.0
Imported goods	0.0	-0.2	0.0	0.0
House prices	0.0	-0.5	0.4	1.7
Gross domestic product (market prices)	-0.1	-0.5	0.1	0.3
Household consumption	0.0	-0.1	0.1	0.5
Investments (including stocks)	0.1	-0.8	0.2	1.5
of which investment in houses	0.0	0.0	0.8	3.4
Exported goods and services	-0.2	-1.5	0.0	0.0
Imported goods and services	-0.1	-1.3	0.0	0.2
Employment (employment years)	0.0	-0.2	0.0	0.1
Unemployment percentage (% of GDP)	0.0	0.2	0.0	-0.1
EMU balance (% of GDP)	0.0	-0.2	0.0	0.2

(a) For the world trade variant, the NiGEM model was used, which is a macroeconomic model of the global economy, by the *National Institute of Social and Economic Researc. see* (link).

A negative risk consists of the development in emerging economies, which for the Netherlands is expressed in relevant world trade. Within the Netherlands, there is a positive risk of the housing market recovering faster than assumed under the current projections. The impact on the Dutch economy is described in the text box on uncertainties.

All spending categories are expected to contribute to economic growth next year. The disappointing relevant world trade in the first half of this year has hardly affected Dutch exports, which also this year will benefit from the positive developments of the competitive pricing position. A temporary deviating development of the relevant world trade and export is not unusual; over the past years, there have been more years during which exports – sometimes temporary – have not followed a decrease in the growth in relevant world trade. Over the period included in the projections, export growth will accelerate to 5.1% in 2016, influenced by an accelerated growth in relevant world trade, thereby substantially contributing to GDP growth (Figure 1.2, right-hand side).

Figure 1.2   Recovery continues despite lower natural gas production (left); all spending categories contribute to growth (right)
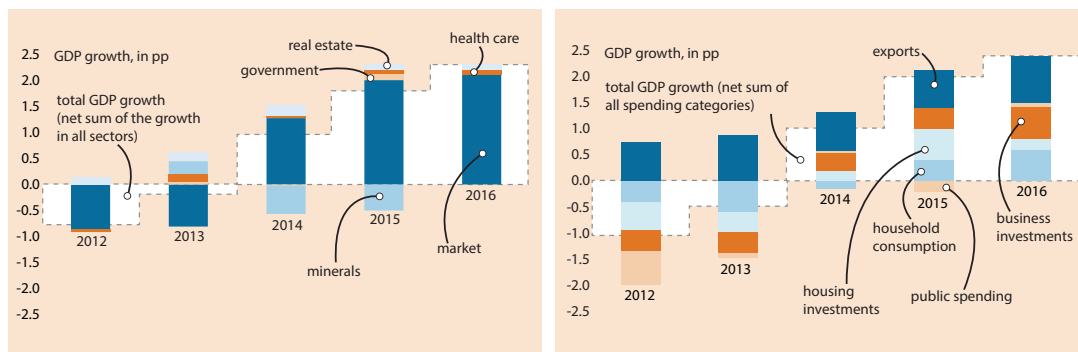
(a) The contribution of public spending to GDP growth concerns only the direct spending impacts of consumption and investments by the government. The impact of other public spending, such as income transfers and subsidies, may contribute to growth through household and business spending. This is also true for taxation.
Source: CBS; CPB calculations (link).

Household consumption is projected to grow both this year and the next, by 1.6% and 1.9% respectively, thus also contributing substantially to GDP growth. This growth is particularly due to higher disposable incomes. Wage incomes will increase because of the increase in real wages and employment. The announced reduction in tax burden due to the 5-billion-euro package of measures will generate additional income in 2016; the economic impact of these measures in 2016 and 2017 is described in the text box below. Average pension premiums will decline in 2015 and slightly increase in 2016. The decline this year is mainly due to a reduction in pension-related tax benefits (*Witteveenkader*). Their delayed impact will also reduce premiums for next year, as will the collective labour agreements for civil servants based on the results of the negotiations between government and trade unions. However, at the same time, a lower solvency ratio, the reformed Dutch FTK regulation (nFTK) and the adjustments to the Ultimate Forward Rate (UFR) will have an upward impact on premiums.

The economic and budgetary impacts of the 5-billion-euro package of measures

The 5-billion-euro package of measures will affect the Dutch economy and public finances. The package has been adjusted for 2016. For example, the 0.5 billion euros in lower income advantage (LIV) that will not come into effect until 2017, is incidentally used for a once-only increase in health care and rental allowances in 2016. The package will stimulate economic growth in 2016 and beyond. In addition, it will have an impact on structural employment and income inequality.

The table below shows the macroeconomic impacts of the package of tax measures. These have been calculated using the Saffier-II model (b). Because of the higher disposable income level, household consumption will grow by an additional 0.6% in 2016 and an additional 0.7% in 2017. As the demand for goods and services increases, so will business investments. In 2016, GDP will grow by an additional 0.2% and in 2017 by and additional 0.3%. Lower wage taxes will lead to a slightly lower increase in contractual (?) wage and labour income share, because in the short term, employees are likely to agree to a more moderate wage rise in wage negotiations. Higher production levels will cause employment to increase, but because the package also leads to more labour supply, on balance, unemployment in the short term will remain more or less stable. The EMU balance will deteriorate in both years by 0.6 percentage points, or over 4 billion euros.

Macroeconomic impacts of the 5-billion-euro package of measures, impact on annual growth and levels

	2016	2017
	in %	
Spending volume		
Gross domestic products	0.2	0.3
Household consumption	0.6	0.7
Business investments	0.3	0.7
Wages and prices		
Contract wages market sector	-0.2	-0.2
Consumption prices	-0.1	-0.1
Labour market		
Employment (employment years)	0.1	0.2
	level	
Unemployed labour force (in %)	0.0	-0.1
Labour income share market sector (in %)	-0.3	-0.5
EMU balance (% of GDP)	-0.6	-0.6
EMU debt (% of GDP)	0.6	1.1

These impacts differ from those of the standard variants of Saffier-II (c), which calculates lower wage and income taxes and a lower burden on employers. In particular, the impact on contract wage developments is lower. Because of the moderate wage developments of the past years, the improving economy and relatively high company profitability, it is unlikely for contract wages to increase less than inflation. Besides, a number of collective labour agreements have already been finalised.

The package also has consequences in the long term, which have been determined using Micsim (d). Structural employment will increase due to the measures in 2016 by 28,000 employment years (0.4%), because more people are entering the labour market. This impact will increase to 35,000 employment years (0.5%), after the LIV in 2017 will replace the measures aimed at purchasing power in 2016. Certain measures, such as the increases in earned0income tax credit, in income-dependent combination of tax credits and in child care allowance, will make being employed more financially rewarding. Finally, the package will also lead to a small increase in income inequality: the Gini coefficient (e) increases by 0.3%.

(a) See the Parliamentary letter of 19 June last (in Dutch; link).
(b) CPB, 2010, SAFFIER-II;1 model for the Dutch economy, in 2 qualities, for 3 uses, CPB Document 217 (link).
(c) Es, F. van, 2015, Policy variants using Saffier-II, CPB Background document, June 2015 (in Dutch; link).
(d) Jongen, E. ,H. de Boer and P. Dekker, 2014, Micsim, A behavioural micro-simulation model for the analysis of tax-benefit reform in the Netherlands, CPB Background document, (link).
(e) Gini coefficient of the disposable household income for all households, calculated using equivalence factors.

Over the 2010–2013 period, the housing market was one of the main factors behind the reduction in consumption, but now it is doing the opposite, driving up consumption both this year and the next. After the recovery in 2014, the housing market also in the first half of this year has seen a positive development. For the first time since the beginning of the crisis, house prices are expected to rise faster than inflation, in both 2015 and 2016. The issue of negative equity is becoming smaller; particularly as a result of rising house prices, which are contributing to a relatively large consumption increase, compared to the increase in wage and social benefit incomes in both these years. In 2012 and 2013, the reverse was happening (Figure 1.3, left-hand side).

Figure 1.3   Increase in income together with consumption growth (left); increase in capacity utilisation and investments (right)
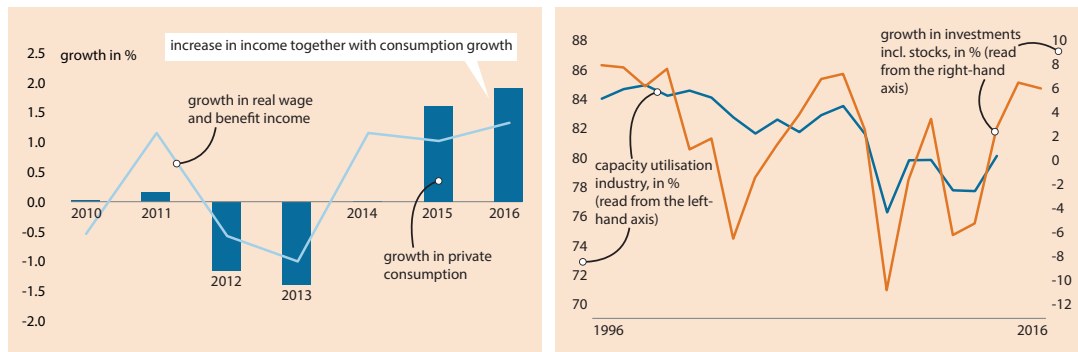
Sources: CBS; CPB calculations (link).

Housing investments are projected to increase by 22.1% for this year and by 5.6% for next year. In both these years, the recovery of the housing market will drive housing investments. The peak this year can be explained by the fact that many investments were moved up, because of the announced termination – on 1 July of this year – of the temporary reduction in the VAT tariff (BTW) for construction.

Business investments are also projected to rise, substantially, in 2015 and 2016 (Figure 1.3, right-hand side). The increase in domestic and foreign demand has already lead to substantial production growth in the market sector. In industry, capacity utilisation is once again rising towards the multi-annual average, and producer confidence has also increased. This leads to more investments, while profit margins are increasing because the lower energy prices and labour costs are not yet incorporated in the retail prices, thus giving particularly the larger companies more financial room to make such investments. However, the provision of credit by banks, especially to SMEs, is still not picking up. Credit provision up to the end of last year was still decreasing, with a certain degree of stabilisation during the last quarter.

Unemployment slowly declining under increasing employment and labour supply
Production growth in the market sector leads to improving employment levels. Labour productivity in the market sector is also projected to grow; in 2015 by 2.0% and in 2016 by 1.7%. For next year, the increase in productivity is projected to slow down a little, under an acceleration of employment, which is a common phenomenon in this economic phase.

Companies first utilise the room in their production capacity to restore productivity and only start hiring new staff after some time.

Table 1.1   Main data for the Netherlands, 2012–2016

	2012	2013	2014	2015	2016
	changes per year, in %				
International economy					
Relevant world trade volume of goods and services	1.4	2.2	3.9	2.8	5.4
Competitor prices (a)	5.3	-3.2	-1.3	7.5	0.7
Oil price (in USD per barrel)	111.7	108.7	99.0	57.2	60.1
Euro exchange rate (USD per euro)	1.28	1.34	1.33	1.10	1.09
Long-term interest the Netherlands (in %)	1.9	2.0	1.5	0.7	0.9
Volume GDP and spending					
Gross Domestic Product (GDP, economic growth)	-1.1	-0.5	1.0	2.0	2.4
Household consumption	-1.2	-1.4	0.0	1.6	1.9
Public consumption	-1.3	0.1	0.3	-0.4	0.8
Investments (including stocks)	-6.2	-5.3	2.7	6.5	6.0
Exportation of goods and services	3.8	2.1	4.0	3.7	5.1
Importation of goods and services	2.7	0.9	4.0	4.1	5.7
Prices, wages and purchasing power					
Price level Gross Domestic Product	1.4	1.4	0.8	0.8	1.0
Export prices goods and services, excluding energy	1.2	0.5	-0.7	1.6	1.1
Import price levels	3.2	-1.6	-3.1	-3.0	1.9
Inflation, Harmonised Index of Consumer Prices (HICP)	2.8	2.6	0.3	0.5	1.1
Contract wages market sector	1.6	1.2	1.0	1.3	1.4
Purchasing power, static, median all households	-2.0	-1.3	1.3	0.7	1.4
Labour market					
Labour force	1.5	0.8	-0.4	0.5	0.8
Working population	0.6	-0.8	-0.6	1.0	1.1
Unemployed labour force (x thousand persons)	516	647	660	620	605
Unemployed labour force (in % of labour force)	5.8	7.3	7.4	6.9	6.7
Market sector (b)					
Production	-1.2	-1.2	1.9	2.9	3.0
Labour productivity (per employment year)	-0.4	-0.2	1.8	2.0	1.7
Employment (in employment years)	-0.8	-1.0	0.1	0.9	1.3
Wage rate	2.5	1.7	1.9	0.8	2.6
Labour income share (in %)	78.6	79.8	79.4	77.2	77.5
Other					
Individual saving share (in % disposable income) (c)	-0.8	-0.4	0.8	0.6	0.5
Balance current accounts (in % of GDP)	10.2	11.0	10.6	10.9	10.7
	level in % of GDP				
Public sector					
EMU balance	-3.9	-2.4	-2.4	-2.1	-1.4
EMU debt (ultimo year)	66.1	67.6	67.9	66.4	64.5
Collective financial burden	36.0	36.6	37.5	37.0	37.1

(a) Goods and services, excluding resources and fuels.
(b) Businesses, excluding health care, mineral mining and the real estate sector.
(c) Level; disposable household income, including collective saving.

Employment in the health care sector will decline this year, and for next year no growth is projected for both this sector and the public sector. On balance, the contribution to growth from these two sectors over both years will be negative. Declining health care employment is one of the explanations for the slower decline in unemployment than in previous periods of low or negative growth. Over the 1996–2012 period, this sector contributed to employment, irrespective of the economic situation (Figure 1.4, left-hand side).

Figure 1.4   **Increase in employment in 2015 and 2016 in the market sector (left), employment barely increases faster than the labour supply (right)**
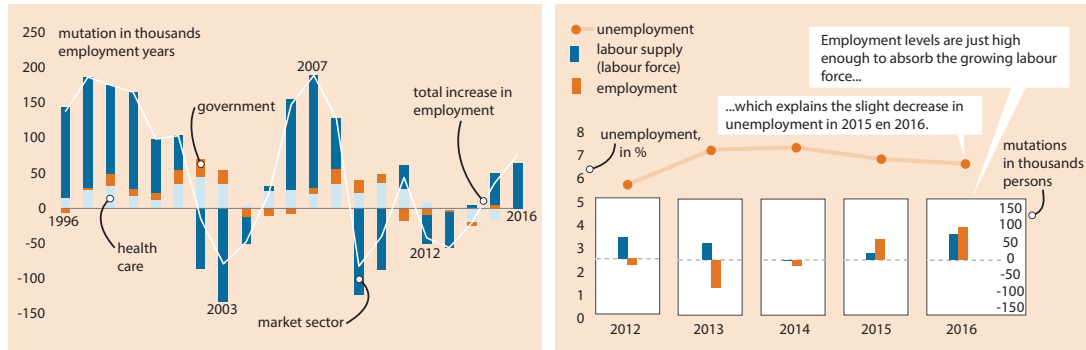
Sources: CBS; CPB calculations (link).

Another explanation for the slow decline in employment is the increase in labour supply. The labour supply shows a structural increase due to the increase in the share of particularly women and people over 50 (cohort effect). The structural increase is still largely compensated this year, because of the economic withdrawal of discouraged employment seekers, but for next year this will no longer be the case. In addition, policy measures such as the 5-billion-euro tax relief will lead also next year to a larger labour supply. On balance, the increase in employment is a little higher than in labour supply (Figure 1.4, right-hand side). Unemployment will go down to 6.9% this year and to 6.7% the following year.

Purchasing power increases due to low inflation and a reduced financial burden
The Harmonised Index of Consumer Prices (HICP) will increase this year by 0.5% and next year by 1.1%. Since January, inflation has been increasing again. The low oil prices, compared to last year, still have a dampening effect on inflation this year. This effect will no longer apply in 2016, given the technical projections of more or less stable oil prices. Policy measures dampen inflation in both years. As a result of an agreement between tenants associations and housing corporations soon to be passed into law, rents will rise by no more than 1% above the inflation rate. This means that rent development will be lower than in 2014. Next year, the package of measures will also have a dampening effect on labour costs and thus on inflation.

Labour productivity growth in the market sector will lead to a slight improvement of 1.3% in contract wage development in 2015 and for next year this will be 1.4%. The increase will remain limited due to low inflation and high unemployment. Measures from the 5-billion-euro package will dampen wages in 2016 (see also the text box on the impact of the package), although this effect remains limited, given the moderate wage developments of the

past years and the fact that some collective labour agreements for 2016 have already been finalised. Contract wages in the public sector will clearly increase more – with 2.1% and 2.6% – than in the market sector, due to the wage negotiations agreement reached for the public sector last July.

Real wage increases, both this year and next year, will contribute to purchasing power. This year, median purchasing power will improve by 0.7%. The employed will experience the largest improvement, with 1.2%. The purchasing power of pensioners will remain on the 2014 level, because pensions have been indexed only partially. Median purchasing power will increase next year by 1.4%. The increase in real wages will be limited. The upward effect on median purchasing power of the 5-billion-euro package of measures including the agreement on purchasing power for 2016 will be 1.5%. The positive impact will be largest for the employed, with 2.5%. They benefit from certain measures in the 5-billion-euro package, such as the higher earned-income tax credit. Employed people with children also have the advantage of the increase in income-dependent combination of tax credits, the increase in government expenditure on child care and the child-related budget. All households will have the advantage of the limited increase in general tax deduction. Lowering of the second and third tax brackets will have a positive effect on the purchasing power of households in the second income bracket and over. The median purchasing power of pensioners will increase by 0.2%. The one-time increase in pensioner deduction together with the health care allowance compensate for the abolition of the pensioner allowance in Box 3, the lowering of pensioner deductions and the increase in the tariff for the income-dependent contribution (IAB). The median purchasing power of social benefit recipients also increases by 0.2% because of the increase in health care allowance and the increased government expenditure on the child-related budget.

Government deficit declines, structural deficit increases

The government deficit this year will improve to 2.1% of GDP and next year to 1.4%. This decrease is driven by increasing tax revenues and lower expenditure on unemployment benefits due to the improving economy and the earlier agreed spending cuts. The lower natural gas revenues will have an upward impact on the deficit in both years. For next year, also the 5-billion-euro package of measures will have a positive effect on the deficit of 0.6 percentage points of GDP (see the text box on the package of measures). On balance, this reduction in burden is cancelled out by the earlier agreed spending cuts. Public spending as a percentage of GDP is projected to be back on the 2008 level by next year. The reduction in tax burden will stabilise the share in the collective financial burden next year at 37.1%. The medium-term objective (MTO) for the structural deficit according to EU fiscal rules will be 0.5% in 2016.

The government debt peaked last year at 67.9% of GDP; the highest since the onset of the Great Recession. For next year, the debt is projected to decrease to 64.5% of GDP, due to the lower government deficit, economic growth (denominator effect), privatisation of the ABN-AMRO bank, and the mandatory treasury banking by subnational authorities.

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1.2   Analysis

The elections of 2017 cast their shadow forward. Political parties are preparing their election programmes, and the first government studies on budgetary policy will be started in the coming six months.[4] This is a good time to elaborate on how the Netherlands scores on traditional budgetary functions – those of allocation, redistribution and macroeconomic stabilisation.

The *allocation* function centres around the production of goods and services that are not or insufficiently generated by the market. Distribution of the available means over the various public goods (e.g. public health, education, infrastructure and defence) is a typically political issue. An international comparison shows that preferences in the Netherlands do not deviate much from those in other countries, but that relatively much is being spent on public health and education (see Figure 1.5, left-hand side).[5] There is no lack of attention for allocative details when articulating the choices for adjustment of this distribution – even on the level of Government Agreements (see Figure 1.5, right-hand side).

Figure 1.5   Composition of public spending (left); many measures with budget limitations in Government Agreements (right)
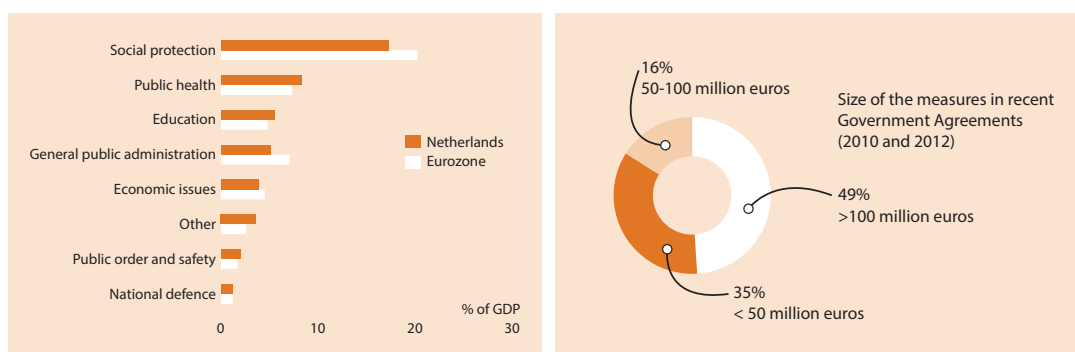
Sources: Eurostat, CPB calculations (link).

Whether these political preferences can also be achieved in an efficient way, is another matter. International studies have shown that the Netherlands scores well above average on efficiency of and satisfaction with its public sector.[6] The country works with a variety of agreements to enhance an efficient allocation, from evaluations (including mandatory policy evaluations) and mandatory cost-benefit analyses of large infrastructural projects, to interdepartmental policy assessments, reassessment reports and ad-hoc committees. The structural budgetary policy also favours structured and integral considerations aimed at the medium term, over ad-hoc interventions. These are all elements that are also greatly appreciated abroad. Nevertheless, there is some room for improvement. For example, the

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[4] This concerns policy reviews of budgetary policy and advice applications made to the Advisory Group on Fiscal Policy (Studiegroep Begrotingsruimte).

[5] The differences in public spending per function are not only affected by political preference, but also by the economic situation, demographic differences and public administration efficiency.

[6] See SCP (2012), Comparing countries on public performance, press release (in Dutch; link). Also see OECD, 2015, Government at a glance 2015 (link).

Netherlands Court of Audit has concluded that policy assessments offer little insight into policy effectiveness and efficiency[7], and there is no mandatory standard audit in place for tax expenditures[8]. Moreover, a stronger focus seems to be on accountability instead of on experimenting and learning. Many problems could be avoided if experiences abroad were considered and small-scale experiments were held, before any policy was implemented on a large scale.[9] In actual practice, however, well-executed experiments are difficult to start and are far from easy to conduct .[10] Perhaps policymakers could be persuaded to start experimenting more often by offering them a choice between conducting either mandatory (ex-post) policy assessments or ex-ante experiments.

Budgetary policy contains more discipline on the spending side than in relation to tax expenditures or tax measures. Think of the strong interventions in child care and personal health care budgets under the Balkenende IV Cabinet, versus the rather mild reaction to the disappointing tax revenues that were caused by the behavioural response to the fiscally friendly approach to energy efficient cars. The less stringent assessment can be explained by the more rigid measurements in spending frameworks (measurements show the facts, knowing the facts means you can act). A better balanced handling of tax expenditures and other expenditures will improve not only efficiency, but may also lead to less complex additions to the tax system; after all, considerations on the income side are likely to improve.

For the *redistribution* function, the issue is about what could be considered a fair distribution of income.[11] This distribution can be corrected through taxation, premiums, benefit payments and/or subsidies. It is an issue that is at the heart of Dutch politics, as is shown in the annual debates on purchasing power and the discussion on poverty in the Netherlands. The Dutch figures clearly indicate that the distribution of income is rather stable in the Netherlands (Figure 1.6, left-hand side). The primary distribution of income became slightly less fair after 2001, but the government is compensating for this fact with policy. The distribution can be corrected in various ways, with possibly widely diverging economic effects. The stacking of instruments to achieve a detailed correction of the purchasing power, however, leads to a high and erratically marginal tax burden, particularly for lower incomes (an example is shown in Figure 1.6, right-hand side). The marginal tax burden has a negative impact, among other things, on labour participation.

[7] Netherlands Court of Audit, 2015, Verantwoordingsrapport 2014 [accountability report (in Dutch)] (link).

[8] Netherlands Court of Audit, 2015, Wanneer zijn de huidige belastinguitgaven voor het laatst geëvalueerd? [When were current tax expenditures last evaluated? (in Dutch)] (link).

[9] See many examples in King, A. and I. Crewe, 2013, The Blunders of our Governments.

[10] See e.g. Elk, R. van, 2014, Evidence based beleid [evidence-based policy (in Dutch)], contribution to L. Borghans, I. Waterreus and R. Klarus (ed.), 2014, Wat is goed onderwijs? [What constitutes a good education? (in Dutch)] Contributions from 'de onderwijseconomie', Boom Lemma.

[11] Relevant for budgetary policy here is also the complex relationship between income inequality and economic growth. See Sarah Voitchovsky, S., Inequality and economic growth, Chapter 22 in Nolan, B. et al. (eds), 2012, *Oxford Handbook of Economic Inequality* (link).

Figure 1.6 **Income policy ensures a stable distribution of income (left) (a), but also leads to a high and erratically marginal tax burden (right) (b)**
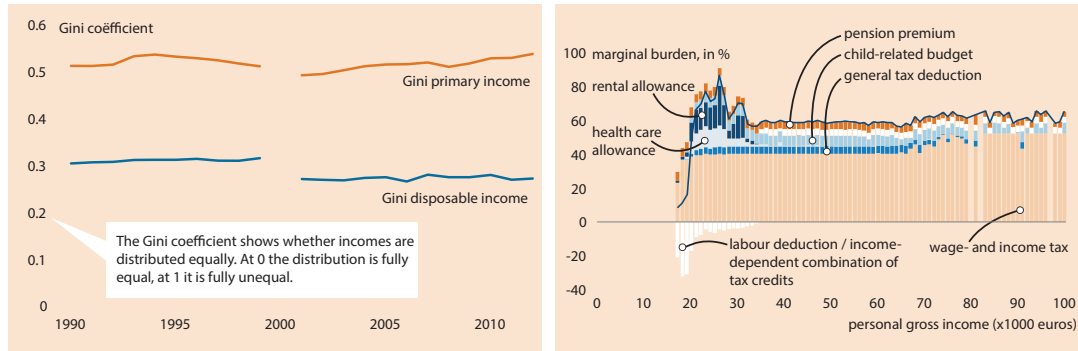
(a) Based on the Gini coefficient. A trend break in series in 2000. The higher this indicator, the larger the income inequality.
Source: Caminada, K.,et al., 2014, Een kwart eeuw inkomensongelijkheid in Nederland [A quarter century of income inequality in the Netherlands (in Dutch)], *ESB*, 2 May (link).
(b) Single parent. Decomposition of the average marginal burden, according to regulation, 2016. See also Quist, A., 2015, Marginale druk en participatiebelasting per huishoudtype in 2015 [Marginal burden and participation tax per household type in 2015 (in Dutch)], CPB Background document (link) (link).

The *macroeconomic stabilisation* function involves dampening the economic cycle in order to reduce fluctuations in unemployment, inflation, capacity utilisation and production. Taxes and premiums, in addition to unemployment benefits, are the budgetary mechanisms that automatically dampen the cycle. Dutch budgetary regulations explicitly provide room for automatic stabilisation on the revenue side of the budget. Discretionary measures may enhance the impact of the automatic stabilisers (anti-cyclical policy), or reduce or even more than nullify the impact (pro-cyclical policy). Empirical research shows that a pro-cyclical policy has dominated in the Netherlands (see Figure 1.7, left-hand side). Studies on other EU Member States have provided similar results. In the Netherlands, the medium-term orientation of structural budgetary policy has proven not to be shock-proof, as can be seen from the Great Recession and its aftermath, and from the economic downturn around 2002 and 2003. Both situations resulted in ad-hoc interventions in the budget with a pro-cyclical outcome.

There are various possible explanations for the observation that budgetary policy often has been pro-cyclical. At the beginning of a Cabinet period, when choosing a target – and the pathway towards it – for the EMU balance for the end of the Cabinet period, hardly any attention is paid to the state of the economy. In addition, over the last Cabinet periods, much attention was awarded to sustainable public finances; to whether current arrangements could be maintained or if they would lead to the government debt increasing to unsustainable proportions. The sustainable balance is relevant, in this respect, and has greatly been improved by policy over the last years. The desire to improve the sustainable balance – also, or perhaps particularly, during times of economic adversity – may have also led to pro-cyclical policy, in practice. The same holds for the requirements from Brussels; first for joining the euro, later by the Stability and Growth Pact (SGP). Political-economic considerations (first the bitter, then the sweet – it is easier to implement harsh measures in

times of crisis)[12] play a role particularly when phasing packages. The automatic stabilisers on the revenue side of the budget do not offer enough counterweight against these mechanisms.

Figure 1.7   Stabilisation function of the budget underutilised (left); European budgetary rules have expanded (right)
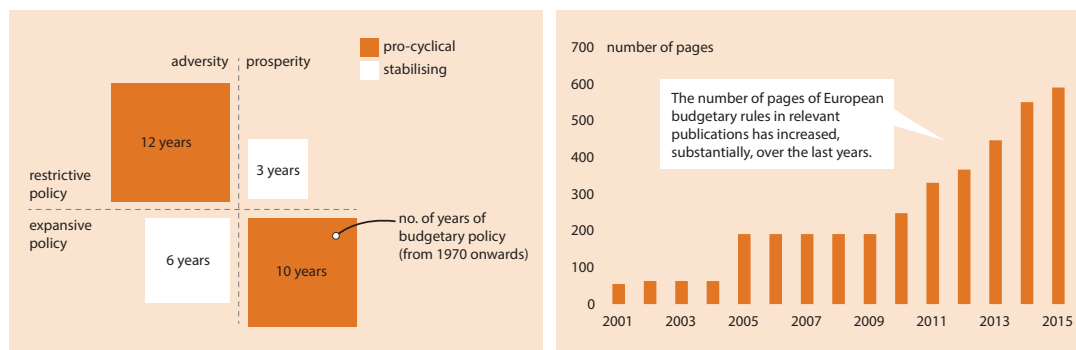
The left-hand figure is based on structural budget balances in order to typify budgetary policy. Expansive policy is defined as a deterioration of the primary structural balance by over 0.5 percentage points of GDP, while restrictive policy is an improvement of this balance by at least 0.5 percentage points. Years in which the changes in primary structural balance have remained within these boundaries have been characterised as neutral, and were therefore not included in this figure. Good economic times are defined as such when the output gap was positive, and for bad economic times this gap was negative. To determine the output gap, the EC method was used. For details, see Homan, E. and W. Suyker, 2015, *Hoe anticyclisch is het Nederlandse discretionaire begrotingsbeleid?* [How anti-cyclical is the Dutch discretionary budgetary policy? (in Dutch)], CPB Background document (link).

The budget can fulfil its three traditional functions effectively only when there are sufficient buffers. The discussion about the appropriate debt level is still ongoing in academic circles. The issues discussed are about the level at which the debt will become unsustainable, at which level the government debt would begin to hinder economic growth, whether an uncertainty margin is needed, and to what extent the restrictions on debt sustainability are more stringent for economies that do not have their own monetary policy. This debate seems to have been largely settled in the Netherlands, with the choice for the euro and the related agreements about budgetary issues. These agreements, however, are subject to continual change. The aggregate of European budgetary rules has expanded over time, with respect to variables, calculation methods and process (Figure 1.7). Transparency, automatic stabilisation and the medium-term orientation, with its related governmental calm and effectiveness, become stuck when public finances are not at a safe distance from the threshold values set by EU budgetary regulations. The risk of pro-cyclical policy in response to unexpected adversity, therefore, is great. Here, buffers may provide a solution. Although it is spring rather than summer for the current economy, it would not be a bad idea to consider how, after seven lean years, the perhaps next seven years of plenty could be best utilised.

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[12] Høj, J., et al., 2006, The Political Economy of Structural Reform: Empirical Evidence from OECD Countries, OECD Economics Department Working Paper No. 501 (link).

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