The new coalition agreement*

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Abstract
On May 27th of this year the new cabinet in the Netherlands has been installed. The economic and fiscal outlook for the new cabinet is worrisome, with negative economic growth in the past two quarters implying an official recession for the first time since the early eighties. In the negotiations between the coalition parties much attention was paid to the economic and fiscal effects of the proposals under consideration. CPB assisted in this part of the process by assessing the economic effects of different proposals and of the final coalition agreement.

Introduction
After more than a year of political turmoil in the Netherlands—with two elections, one cabinet period of only 87 days and one failed attempt at a coalition that lasted nearly three months—there is now a cabinet in office that can present to parliament the fiscal and other plans for the coming four-year period. The Balkenende II coalition is formed by the Christian Democrats (CDA), the Liberal Party (VVD) and the Liberal Democrats (D66).
The starting point for the new cabinet is less favourable than it was a year ago, when the Balkenende I administration started. Economic growth is expected to emerge between zero and 1% for four years in a row (2001-2004). This has substantial implications for the government budget balance. Keeping in mind the management of future costs of an ageing population, reduction of the government debt is an important goal of the new cabinet. The coalition agreement therefore proposes large reductions in government expenditures and social security spending, as well as increases in the tax burden.

Coalition agreement measures [1]

Expenditures
The coalition agreement anticipates net spending cuts of 8 billion euro in 2007, nearly 2% of GDP. Gross spending cuts amount to 11 billion euro in 2007. Half of these cuts consist of reductions in the salaries of civil servants and personnel in the health care sector and in the level of social benefits. Salaries in the public sector will lag 1% per year behind the increase of the wage rate in the market sector. Compensation for incidental increases in salaries (e.g. to compensate for increases in the average age of the workforce or for stimulating and upgrading the personnel) will also be cut. Due to rapidly increasing pension contributions, government salaries in the base scenario were already lagging more than ¾% per year behind the wage rates in the market sector. The rise of social benefits will no longer follow wage rises in the market sector, but will be linked to the wage rise in the government sector.
The other major cuts in government expenditures are efficiency cuts for the ministries and local governments, substantial decreases in a wide range of subsidies, reduction of the entitlements to unemployment and disability benefits and a reduction of the health care services reimbursed by the public health insurance.
Extra government spending will amount to over 3 billion euro in 2007. More than half is earmarked for health care and for the knowledge economy (education and research). The remainder will be spent on infrastructure (rails and roads), public order (police, judges, crime prevention) and the natural environment (e.g. subsidies for stimulating private maintenance).

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Rising health care expenditures
In the coalition agreement of the Balkenende I administration, expenditure ceilings for health care showed 2.5% volume growth per year in the period 2003-2006. Population growth plus ageing of the population contributes 1%-point a year to volume growth. For addressing new medical technologies and social-cultural changes, the coalition reserved 1.5% volume growth a year.
In recent years a shift in health care policy has taken place, from supply control to a demand-driven system. In this system, individual patients have a right to obtain the necessary health care services, no matter the macro expenditure ceilings. This change in policy already had huge effects on health care expenditures, as demand rose much faster than 2.5% a year. First of all, the old system of supply control had caused waiting lists for various health care services. Reduction of these waiting lists attracted new patients who had not come forward before. As a result, the volume of health care expenditure grew by 6% on average in the years 2000-2002.
The new cabinet will introduce a new health insurance system in 2006. More competition between health care insurers and providers should curb spending by improving efficiency. Prior to the introduction of the new system, more co-payments will be introduced and the public health care package will be limited. If these policy measures are not sufficient to curb health care expenditures, co-payments will have to rise, and supply control may have to be reintroduced for parts of the health care sector.

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Taxes
On balance, the new cabinet plans to raise taxes by 3¼ billion euro by 2007. The main themes of the new tax plans are financing rising health care costs, tax base broadening and reinforcement of the environmental orientation of the tax system.
Health care policy has evolved in the last few years from supply-restrained to demand-driven health care. This has resulted in steeply rising costs associated with health care provision. To finance these rising costs, premiums will be raised by 3¼ billion euros. To compensate for these massive premium rises, the new cabinet introduces a tax relief package of 1½ billion euro, which features (among other measures) lower tax rates in the first two income tax brackets, and higher tax credits for earned income, the elderly, children and working parents.
The new cabinet broadens the tax base by abolishing the tax deductibility of early retirement savings schemes, by abolishing the tax credits for employee education, and by narrowing the generous tax deductibility of mortgage interest. Together, these measures add 1¼ billion euro to the tax burden.
Finally, the new cabinet also reinforces the environmental orientation of the tax system. First of all, the planned reduction of petrol and diesel excises in 2004 has been scrapped; the cabinet thereby raises taxes on environmentally harmful activities by ½ billion euro. In addition, the consumption tax on electricity and natural gas will be raised by another ½ billion euro. The latter is fully compensated for by appropriate reductions in the corporate and personal income tax rates.

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Change in health insurance system
A new health insurance system will be introduced in 2006. This will replace the existing system comprising the Compulsory Health Insurance Act (ZFW, a public insurance for people on incomes up to 32,000 euros per year) and private insurance schemes (for people on higher incomes). What are the effects of the introduction of the new insurance system on the public finances, labour costs and purchasing power?
The ZFW insurance premiums are largely income-dependent and to a limited extent fixed or ‘nominal’; the premiums for the private insurance scheme are wholly nominal. The premiums and personal contributions for the new insurance system are intended to cover costs and are half variable

(i.e. percentage-based; payable by employers) and half nominal (payable by households). The nominal premium for children up to the age of 17 is set at half that for adults. Child premiums will be paid by the government.

The introduction of the new health insurance system will benefit low income households, especially single earners with insured partners. Among the measures to compensate for the income effects arising from the introduction of the new system, a health subsidy for lower-income groups will be introduced. At the same time the residential property tax for users will be abolished.
The system change including the compensation implies a relief of 0.9 billion euros in 2006. Most of this will flow to employers in the market and public sectors. The wage and salary bill for businesses and government will fall by 0.6 billion euros in 2006, or 0.2%.
The introduction of the new health insurance system will also benefit those who are now privately insured and have underage children. After all, in the new system the children's premiums will be paid by the government. The extent to which the introduction of the new system will benefit these households depends in part on the number of children in the family. This is clearly illustrated by the spread of the purchasing power effects for single earners (see figure).
The privately insured over the age of 65 will also be better off under the new system. The premiums for the new insurance will be lower than those for the existing standard private health insurance schemes. The degree of risk solidarity in the new system will be higher than in the existing private insurance schemes.

Purchasing power effects of new health insurance system, including compensation, 2006, change in %

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A conservative growth scenario
The new cabinet has chosen to use a conservative growth scenario as the basis for budgetary policy. This conservative scenario for the period 2004-2007 describes an economic growth path with moderate growth in production. The prudence used in this estimate implies that there is a better than even chance that actual economic development is positive and that budgetary windfalls occur.

Table 6 Key macroeconomic data

	Conservative scenario	Policy impact[a]	Conservative scenario incl. policy
	annual changes in %		
Wages and prices			
Contractual wages market sector	2	– 0.6	1½
Compensation per employee market sector	2¾	– 0.7	2
Consumer price index	1½	– 0.2	1¼
Real labour cost market sector	1	– 0.5	¾
Price index national expenditure	2	– 0.3	1¾
Demand and output (volume)			
Private consumption	2¼	– 0.7	1½
Government consumption and investment[b]	1¼	– 0.1	1¼
Private non-residential investment	2	– 0.4	1½
Exports of goods, excluding energy	5¾	0.2	6
Gross domestic product (GDP)	2½	– 0.2	2¼
Structural GDP	2	0.0	2
Labour productivity market sector	1¾	– 0.2	1¾
Labour market			
Employment market sector (fte)	¾	– 0.1	¾
Employment public sector (fte)	1	0.0	1
Employment (> 12 hrs/week, persons)	1	0.0	¾
Labour supply (> 12 hrs/week, persons)	1	0.0	1¼
	level in end-year in % labour force		
Unemployment (> 12 hrs/week, persons)	6	0.3	6¼
Equilibrium unemployment (> 12 hrs/week, persons)	5¾	– 0.1	5¾
	level in end-year in %		
Miscellaneous			
Labour share in enterprise income	83¾	– 0.7	83
Replacement rate	54¾	– 3.1	51½
	level in end-year in % GDP		
Public sector			
EMU balance	– 2.2	1.3	– 0.9
Structural EMU balance (EC method)	– 2.5	1.7	– 0.8
Structural EMU balance (CPB method)	– 1.6	1.7	0.1
EMU debt			52.2

[a] Based on CPB Communication 49 (16 May, 2003).

[b] Government consumption and investment corresponds roughly to government spending excluding social security, development assistance, subsidies and interest payments.

The first column in Table 6 summarises the conservative scenario. Even in the conservative scenario, economic growth is expected to recover from the current recession, with an annual GDP growth rate of 2¼%. This growth rate is moderate in historical perspective. Over the last decade annual average GDP growth exceeded 2½%. The growth rates of private consumption and investment are in line with GDP growth, but government consumption lags behind. On the other hand, exports benefit from the world trade growth of 6¾% per year.
Labour productivity is the driving force of production in the coming period. The average growth rate of real contractual pay rates is slightly below (by 1%) the growth rate of labour productivity, due to the increasing unemployment rate. Employment growth is moderate, and insufficient to absorb the supply of labour, which implies that the unemployment rate increases to 6% in 2007. In the conservative scenario, the government deficit in 2007 is –2.2% GDP.

Macroeconomic impact

The new cabinet's measures shave 0.2 percentage points off the annual economic growth (GDP growth) projected in the conservative growth scenario of the Economic Outlook 2004-2007. This lower growth rate is caused above all by the spending cuts. Although extensive, the package of measures will not affect structural economic growth.
Contractual pay increases in the market sector will come out 0.6% lower per year. Two factors play a role here. Firstly, various benefits will be cut, so that the replacement rate will fall by more than 3 percentage points. Secondly, the tension on the labour market will ease because of an increase in the labour supply sparked by social security measures. The reduction in labour costs will be passed on in prices only in part and with a time lag, so that profitability will increase in 2007.
Employment in the market sector will be tempered by the lower output growth, but will be stimulated by the more moderate increases in labour costs. On balance employment in the market sector in 2007 will come out 10,000 person-years lower than in the Economic Outlook.
Social security policy and the abolition of the tax deductibility of early retirement savings schemes will stimulate the labour supply, but this will be tempered by lower increases in net earnings. On balance the modest rise in the labour supply and the modest fall in employment will raise the unemployment rate by 0.3 percentage points in 2007.
Disposable incomes will fall mainly because of the restrictions on public sector pay and benefit levels, as well as by additional measures in the social security sphere. Consequently private consumption growth will decline by 0.7 percentage points per year. This reduction in consumer spending will lead to a reduction in imports, and is also the main reason for the lower output growth in the market sector. Demand for capital goods will track the lower output growth and will also come out lower.
Employment in the market sector will come out 20,000 person-years higher than in the Economic Outlook, because most of the additional labour supply will be absorbed into the market sector and because the equilibrium unemployment rate will fall slightly owing to the lower replacement rate. But because structural labour productivity growth will moderate slightly, the policy measures will not on balance have any effect on the structural GDP growth rate[2]. Set against the adverse effect of the austerity measures on actual growth, this means that the negative output gap will widen (in absolute terms).
The proposed package of austerity measures comprises a total of 3¼ billion euros in tax and premium increases and 8 billion euros of net savings. Of the ex ante improvement in the EMU balance of 2.2% of GDP, 1.3% of GDP remains after the macro-economic effects. Including the projection in the Economic Outlook 2004-2007 (updated in July), this results in an actual deficit of 0.9% of GDP in 2007. The main negative revenue effects occur among the planned savings. The reduction in public sector pay and benefit levels leads to lower payroll tax revenues, and also to lower VAT receipts (because they put a brake on private consumption). This negative revenue effect is stronger over the short term than the long term. Over the long term the improved export performance will offset part of the lost spending impulse, so that output and employment will increase. The improvement of the structural EMU balance in 2007 (according to both the CPB method and the European Commission [EC] method) will consequently be stronger than the improvement in the actual balance. According to the CPB method, the structural EMU balance will come out at 0.1% of GDP in 2007; according to the EC method, it will be – 0.8% of GDP. The difference between the two methods is explained in a box.

Income effects
Under the policies in the coalition agreement, household purchasing power will decline on average by ¼% per year between 2004 and 2007. This is because increases in pay and benefits will barely exceed inflation and because the tax and premium burden on households will increase by 0.6% of GDP on balance. However, the effects differ considerably between groups of households.
The purchasing power of employees will increase somewhat between 2004 and 2007. However, there will be a considerable difference between employees in the market sector and those in the public sector. Employees in the market sector will be a ¼% per year better off on average. As the government has decided to reduce pay increases in the public sector, employees in the health service will be a ¼% per year worse off on average, and civil servants will be ¾% per year worse off on average. As the increases in social security benefits will be linked to civil servant contractual pay increases, the purchasing power of benefit recipients will decrease by ½% per year on average; that of the over-65s will remain broadly the same. The income effects differ widely due to differences in the number of children, home-ownership, and kind of health insurance.

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Structural EMU balance: EC- vs. CPB method
The government budget balance (EMU balance) is sensitive to cyclical developments in the economy. To analyse the state of public finances, it is common to calculate a cyclically adjusted budget balance. CPB uses a slightly different approach than the EC, which is clear in the results in table 6. What are the main differences?

- The EC uses a production function to estimate the structural level of total GDP, while CPB uses a production function for the market sector and adds to this the production of the non-market sector
- In the estimation of equilibrium unemployment, the EC adjusts the series for actual unemployment, taking account of the acceleration in wages. CPB, however, uses a structural model for equilibrium unemployment, which depends on the level of employee taxes and social security premiums, on the replacement rate and on capital costs.
- Finally, CPB uses the lagged output gap, which reflects lags in the economy, while the EC takes the output gap in the current year.

As a result of the demand effects of the policy measures, unemployment in 2007 turns out higher than in the baseline scenario. Equilibrium unemployment in the EC methodology, which is linked to actual unemployment, doesn’t change much. CPB, however, estimates a fall in equilibrium unemployment, mainly as a result of the large reduction in the replacement rate. This implies that potential employment and thereby potential growth turns out higher in the CPB method, compared to the EC approach. The cyclically adjusted budget balance in the CPB method is estimated at 0.1% of GDP, compared to only – 0.8% of GDP in the EC method.

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Notes

[1] The base scenario already contains the measures from the Balkenende I administration (see *CPB Report* 2002/3). Here we only expound on the new measures.

[2] Specific ‘programme effects’, such as additional outlays on the knowledge economy and infrastructure or reduced municipal services to local businesses, have not been quantified in this analysis