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Filling the Sustainability Gap after the Crisis: The Case of the Netherlands

Roel Beetsma* and
Raymond Gradus**

Introduction

Although the Dutch Budget for 2009 was presented a few days after the demise of Lehman Brothers in September 2008, it was still optimistic that the upcoming economic recession would not affect the Dutch economy too badly (Ministry of Finance 2008). Originally, the budget foresaw a reduction in the public debt/GDP ratio to 38 percent in 2010, the lowest level in 35 years. However, the economic and financial events unraveled in a very different way than was foreseen. The financial crisis affected the world economy in a severe way, thereby also causing substantial damage to the Dutch and other European economies. The consequences for the Dutch government's financial situation are rather dramatic. The latest predictions by the CPB Netherlands Bureau for Economic Policy Analysis (2010) are deficit/GDP ratios for 2010 and 2011 of 6.3 percent and 4.9 percent, respectively, and debt/GDP ratios of 66.5 percent and 68.9 percent at the end of 2010, respectively 2011. The unforeseen increase in the public debt does not even include a potential loss of resources that might occur if some of the contingent liabilities to the financial sector materialize. For example, the Dutch government has guaranteed interbank lending up to 200 billion euro and it shares in the risks of an Alt-A mortgage portfolio held by ING bank.

Public finances after 2010

Of course, the development of the government's finances after 2010 will depend on how the economy fares in the coming years. Part of the current deficit will vanish through higher tax revenues and falling expenditure on unemployment benefits as the business cycle hopefully improves the coming years. However, a substantial share of the fall in output is structural in nature. Recessions caused by financial crises have larger long-term or structural consequences than "normal" recessions. Firstly, banks are more reluctant to provide credit, making it harder to invest and employ people. Hence, it will take more time for unemployment to fall to its pre-recession level. Secondly, a financial crisis makes agents more risk averse, leading them to become more selective in their investment activity. Also for this reason investment will fall, causing a slowdown in productivity growth. Thirdly, in view of the more gloomy market perspectives firms will spend less on research and development. According to the CPB Netherlands Bureau for Economic Policy Analysis (2010), around three-quarters of the deficit is structural. In particular, the structural deficits are estimated at, respectively, 4.9 percent of GDP in 2010 and 4.0 percent of GDP in 2011. Not surprisingly, these projections are subject to unusually large uncertainty. The size of the structural deficit will only become clearer once the economy has recovered. In last-year's supplementary budget the government agreed that in case the economy would be growing again by at least half a percentage point the structural deficit in 2011 would be reduced by 0.5 percent of GDP, or three billion euros. The projection for the structural budget in 2010 assumes that over the coming years actual growth will exceed structural growth by a cumulative amount of around three percentage points. This projection is based on the estimated output gap, which is calculated according to the methodology employed by the European Commission. Specifically, it is obtained by dividing the business-cycle component of the public budget by the output elasticity of the budget (0.55 for the Netherlands).

The size of the sustainability gap

The financial crisis has severely undermined the sustainability of public finances. The sustainability gap equals the difference between actual structural bud-

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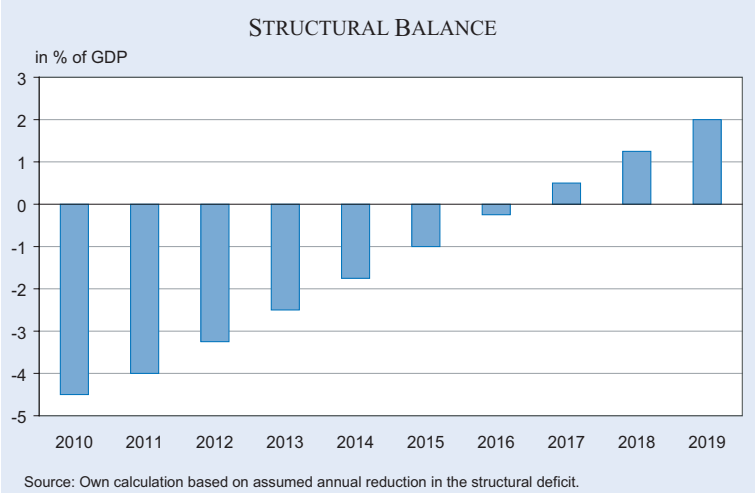
get and the structural budget that is considered sustainable in the long run.[1] In other words, it is the permanent reduction in public spending or increase in public revenues that produces public finances that are sustainable in the long run. The CPB Netherlands Bureau for Economic Policy Analysis (2010) estimates the sustainability gap in 2015 at 4.5 percent or approximately 29 billion in current prices.[2] This implies a 1.5 percentage-point deterioration when compared with the previous calculations in CPB Netherlands Bureau for Economic Policy Analysis (2006). The deterioration can be broken down into a 1.25 percentage-point deterioration due to a worsening of the new starting position as a result of the crisis. The increase in life expectancy since the previous assessment accounts for a deterioration of 1.75 percent, while improvements in the health status of the elderly lower the sustainability gap by 0.75 percentage points.

The sustainability gap estimated by the Bureau projects a structural deficit of 2.9 percent in 2015. However, this structural deficit is computed under the assumption of some policy adjustments over the coming years. In particular, the Bureau assumes an increase in private contributions to health care and a reduction in the public sector wage bill relative to our baseline. The total amounts to a reduction in the structural deficit of around 1 percent of GDP. The measures just mentioned seem to be rather uncertain given the political uncertainty at the moment. Hence, we will proceed under the assumption that the government faces a sustainability gap of 5.5. In view of the considerable uncertainties ahead, such as those regarding life expectancy and medical costs, we add a 0.5 percent safety margin and arrive at a 6 percent gap, which we assume has to be eliminated during the next two governments (i.e., a period of 8 years).

Towards sustainable public finance

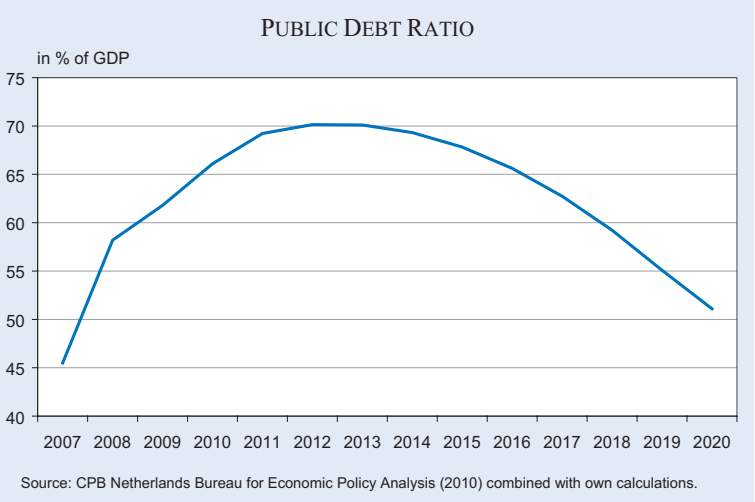
A reduction of the gap by 6 percentage points is a substantial, but not insurmountable, task (Smit Committee 2009). The original gap before the spring 2009 crisis package was presented by the previous government was around 8 percent. However, two percentage points of this gap were already covered by the package (Ministry of General Affairs 2009). Hence, a sustainability gap of 6 percentage points still remains. In its coalition agreement the previous government aimed at a structural surplus of 1 percent of GDP at the end of its tenure in 2011. Our proposal would be to strive for a structural surplus of 2 percent over the next two governments. Within ten to twenty years the public debt would be back at pre-

Figure 1



Source: Own calculation based on assumed annual reduction in the structural deficit.

Figure 2



Source: CPB Netherlands Bureau for Economic Policy Analysis (2010) combined with own calculations.

[1] This comes close to the second sustainability gap measure S2, as defined by the European Commission (2006).

[2] The CPB Netherlands Bureau for Economic Policy Analysis (2010) projects a structural deficit of 2.9 percent in 2015. However, this structural deficit is computed under the assumption of some policy adjustments over the coming years. In particular, the Bureau assumes an increase in private contributions to health care and a reduction in the public sector wage bill relative to our baseline. This amounts in total to around 1 percent of GDP.

crisis levels, which is still substantially higher than originally foreseen. This is achieved through an annual improvement of the structural budget by 0.75 percent per year. Figure 1 shows the path for the structural balance under this scenario, under the assumption that the 2010 (structural) deficit will be reduced by 0.5 percent. Assuming a neutral business cycle situation over the period 2012–19, the public debt will start falling from 2014 onwards (see Figure 2).

A scenario analysis

Economic prospects are very uncertain at the moment. There is still some chance of a relapse for the industrialized economies, in particular because it is the rebuilding of inventories that explains a substantial part of the recent increase in growth. Also the crisis around Greece and possibly other southern European countries may have unforeseen effects on the rest of the EU. Hence, it is important to use a scenario analysis to study the consequences for public finances. Different scenarios for the structural budget and implicitly also for future growth are explored. A more pessimistic scenario implies a later recovery. If the recovery stagnates in 2011 then the new government, as was agreed in last-year's supplementary budget, will not take any deficit-reducing measures in 2011. In that case, the structural deficit will not shrink in 2011, implying an additional three billion of structural reductions on top of the initial figure of EUR 36 billion. It may also be the case that as a result of the financial crisis potential output has to be revised downwards. After all, the assumed structural deficit for 2010 requires an additional business-cycle driven cumulative growth of around three percent. Also the amount that the government needs to contribute to the restoration of the financial sector is highly uncertain. These upward uncertainties can be translated into a scenario of a higher than expected structural deficit. Suppose that the current deficit is completely structural and no deficit reducing measures are implemented in 2011, then the structural deficit in that year will be on the order of five to six percent. A two percent target at the end of the next two governments will then require almost a one-percent per year reduction in the structural deficit, which is larger than under the baseline as sketched above. In this more pessimistic scenario around 45 billion of deficit-reducing measures would need to be implemented.

It is equally possible that we find ourselves in a more positive situation. In particular, the financial sector may recover faster than originally anticipated, while the economy may make up later for the loss in growth during the crisis. For example, after its own financial crisis in the beginning of the 1990s, Sweden managed to achieve growth rates that made actual GDP catch up with the level that would have prevailed had there not been a financial crisis. However, the 2010 budget (Ministry of Finance 2009) also argues that the post-crisis scenario in Sweden is an exception. Its additional growth can be explained by the structural reforms it implemented after its crisis, such as reforms aimed at making labour and product markets more flexible. Unexpectedly beneficial developments may result in a lower-than-expected structural deficit. Suppose that the structural deficit in 2011 is two percent of GDP. This implies a cumulative additional growth of around 7 percentage points. Assuming a structural surplus of 2 percent after the next two governments, a structural deficit reduction of 0.5 percent per year would be needed. However, it could make sense to implement an annual structural reduction of 0.75 percent during the next government, which would result in a surplus at the end of its tenure and a correspondingly smaller structural correction after 2015. Unexpected new losses can then be more easily dealt with. Under these more benign circumstances the required contractive measures amount to around EUR 25 billion.

Of course, we can also rely on the benchmark scenario and fill part of the needed deficit reduction through growth-enhancing measures. We shall now turn to discuss this and other options.

Sustainability measures

To eliminate a sustainability gap of around six percent of GDP, structural measures are needed that aim at increasing public revenues or reducing public expenditures (Table). Higher revenues can be achieved through higher productivity, higher labor market participation or by increasing taxes. Higher taxes are the least desirable option, because they will feed into higher wages and, hence, undermine exports and investments. To the extent that these taxes fall on wages, they also undermine the labor supply. However, there is no need for increasing the tax burden. Timely implementation of structural reforms would rapidly reduce the deficit and the associated rise in the public debt. The earlier those measures are taken, the larger the effect on sustainability, as the public debt will rise by less and an increase in the interest payments on the debt is limited.

Measures to improve fiscal sustainability in the Netherlands

Objective	% GDP (approx.)	Billions of euros (approximation)
Structural improvement	6	36
Options	contribution	
Productivity increase	1	6
Wage moderation public sector	1	6
More efficient public administration	$1^1/_4$	7.5
Individual contributions	$^3/_4$	4.5
Increased labour market participation	1	6
Improvements health care sector	1	6

Source: Smit Committee (2009) and calculations by the CDA-WI (CDA Scientific Institute, the Hague).

Solutions

There are various ways in which the sustainability gap can be reduced without raising taxes. In view of the uncertainty we will explore several options and provide provisional figures for the contribution of these options. Improvements in the economic structure, such as more research and development, a better educated labor force and completion of the internal market, all raise labor productivity. Calculations based on the 2006 electoral programs of the various political parties in the Netherlands show a potential for improving structural growth. An annual increase in productivity by 0.25 percentage points above the baseline would improve sustainability by one percentage point.

Beyond this, it is possible to raise labor market participation by reducing the demand for welfare. A more activating welfare system will reduce public spending and is conducive to labor force participation. A contribution to sustainability of one percent of GDP should be achievable. Concretely speaking, the government should consider work insurance as suggested in the Commission for Labour ("Bakker Commission"), which would reduce the inflow into WAJONG (i.e., disability benefits for handicapped young persons without any working history), and decentralizing the budgets for labour market participation. Research suggests that the timely decentralization of the poverty assistance system produced substantial efficiency gains. A reduction in the maximum duration of unemployment benefits to one year as proposed by the Bakker Commission would improve sustainability by 0.2–0.3 percent of GDP. The same gains may be obtained through a reduced inflow into the WAJONG.

Part of the structural deficit reduction can be achieved by forcing public sector wages to adjust to the loss of productivity during the crisis. Not only will this be beneficial for the public budget, it will also be helpful from the perspective of solidarity between civil servants and the market sector. Market sector wages were already reduced in 2008 and 2009 (CPB Netherlands Bureau for Economic Policy Analysis 2009). In parts of the public sector wages still need to be adjusted. Some of the reduction in the public sector wage bill can also be achieved by the retirement of relatively expensive baby boomers, in particular in the education sector. These people will be replaced by younger employees on lower salaries. About one-sixth of the sustainability gap can be eliminated by reducing public sector wages. Further, an important fraction of the sustainability gap can be filled by a more efficient public administration. Over recent years, the public administration sector has grown by one percent of GDP. We estimate that more efficient public administration could produce a deficit reduction of 1.25 percent of GDP. This amounts to 25 percent savings on the expenses of public administration. Important elements include the streamlining of administrative processes and administrative bodies, fewer rules and inspections. Also the tax system can be simplified by introducing the "social flat tax", and subsidies can be limited.[3] By raising individual contributions for the use of public services, such as the social housing sector, public transportation and higher education, a deficit reduction of 0.75 percent can be achieved. A richer population can take more responsibility for collectively financed services. In addition, technological advances make it easier to assign the benefits to individuals. Finally, the deficit can be reduced by a further one percent of GDP by changing the health care sector. In particular, more efficiency can be achieved in the AWBZ, the long-term care system. By separating the provision of accommodation from that of long-term care, by transferring curative care to the Health Insurance Law and by transferring the responsibility for support to the local authorities (Bovenberg and Gradus 2008), a structural deficit reduction can be achieved. A re-

[3] The social flat tax is a form of flat tax with a tax-exempt bracket for low incomes. The highest marginal tax rate would be around 30–35 percent. Many central and eastern European countries introduced it after they abolished the communist system.

cent investigation shows a substantial potential for efficiency gains (Gupta Strategists 2010). All measures together reduce the sustainability gap by six percent of GDP.

Closing the sustainability gap in other EU countries

Obviously, the situation of the Netherlands is not unique. Most other countries in the European Union are facing a structural deterioration of their public budget as a result of the financial and economic crisis. The European Commission (2009) projects an average structural deficit for 2010 of 4.7 percent for the Euro area and a corresponding figure of 5.5 percent for the entire EU. Actual deficits are generally higher due to the negative output gaps. Greece, Ireland, Portugal, Spain and the UK all feature double digit deficit figures. Further, virtually all EU countries are on exploding debt paths if policies do not change (European Commission 2009, 40). By 2060, Greece, Latvia and Ireland would all have debt ratios of over 800 percent of GDP, a number that in reality will never be reached as those countries would be forced to default long before reaching those levels. While sustainability gaps were already positive before the current crisis, the crisis has worsened them further. The most extreme cases are Ireland with a sustainability gap of 15 percent and Greece with a sustainability gap of slightly over 14 percent.

Total age-related public spending for the EU-27 is projected to increase by 4.6 percent points over the period 2010–60 (European Commission 2009, 29). Of this total, 2.7 percentage points are accounted for by an increase in public pensions and 1.3 percentage points by both an increase in health-care spending and an increase in long-term care spending.[4] In other words, public pensions account for only half of the rise in age-related spending, although they usually receive most of the attention in the discussions about the costs of ageing. A reduction by 0.2 percentage points can be obtained through lower spending on unemployment benefits. However, those EU-wide averages hide substantial dispersion across countries. At present, the most extreme cases are Greece with an expected rise in age-related public spending by 16 percentage points and Luxemburg with an increase by 18.2 percentage points.

Countries are free to select their own policies to close the sustainability gap. Raising taxes is one such policy. One of the consolidation measures Greece presented in January this year was a crackdown on tax fraud. However, given that taxes are already high in most European countries and fraud is not as great a problem as in Greece, further hikes in the tax burdens would negatively impact their economies because of reduced work incentives. Substantial reductions in public spending and, in particular, social spending will be necessary, especially for Greece (Gros 2010). Of course, reductions in public spending may in the short run have negative demand effects but in the longer run will crowd in private consumption and investment by limiting the tax burden. A commitment to substantial spending cuts will also send a positive signal to the financial markets. After all, a lack of confidence in the resolve of the Greek government has raised its interest rate to now unmanageable levels. As for the Netherlands, sustainability gaps in southern Europe can, and probably need, to be reduced through increases in labour market participation, which should be partly achieved through increases in the retirement age and measures that stimulate economic growth. In addition, all of southern Europe has suffered from a loss in competitiveness since joining the euro-zone. Therefore, labour market institutions are badly in need of reform. An internal devaluation, through wage cuts, will probably be inevitable to restore competitiveness relative to other European countries, in particular Germany.

Conclusion

There is a natural limit to the level of public debt. Therefore, it is important that the Dutch government, as well as other governments, start reducing the sustainability gap. Such a reduction is necessary to avoid shifting too much of the bill to future generations. To halt the growth in the public debt ratio, a balanced budget is needed. A credible commitment to limiting the public debt is necessary to keep the interest rate at a low level. This will also send a signal to other European countries that effective control of the public debt is necessary to ensure the independence of the ECB and its ability to pursue price stability.

We have indicated how sustainability might be achieved and discussed a number of possible options

[4] Using EU average data based on the European Commission (2006) and taking into account the presence of other age-related spending, Beetsma and Oksanen (2008) show that a transition from a pay-as-you-you go public pension system to a funded, actuarially neutral system would require a budget surplus of 1.6 percent of GDP over the next two generations. The surplus is needed to convert to (explicit) public debt the implicit debt in the form of accumulated pension rights to the workers.

for the Netherlands. These options try to avoid an increase in the tax burden and are aimed primarily at achieving sustainability by increasing structural economic growth and labour force participation. Obviously, other choices are possible. However, it is important that they be consistent with achieving sustainability. Sustainability implies that future generations continue to profit from essential public services without having to pay substantially higher taxes.

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