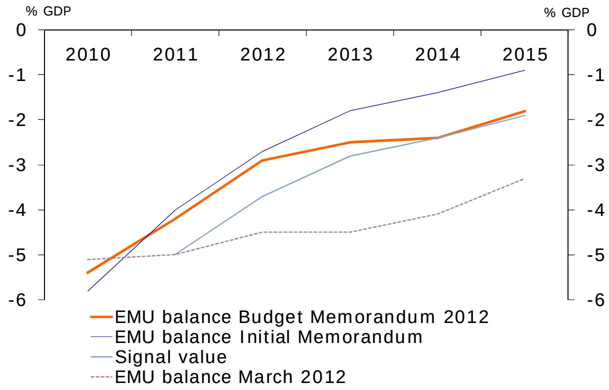
Reforms or spending cuts?

Barely two years after taking office, the current Dutch government has booked the Prime Minister's official residence called 'the Catshuis' for three weeks in March to iron out an agreement on billions in new spending cuts. The Dutch government says restructuring government finances in the short term is the only real answer to the current crisis. Will the Dutch government once again choose achieving its short-term financial targets over long-term structural reforms?

Figure 1: Budget deficit once again higher than expected



Source: CPB, Dutch Ministry of Finance

The Dutch austerity policy ...

While the Netherlands was able to escape unscathed in early January and kept the highest credit rating, credit rating agency S&P said a sharp deterioration of the Dutch government budget during this cabinet term could still lead to the Netherlands' credit rating being lowered. The Dutch government is convinced this S&P statement and the tightened European budget rules justify additional spending cuts. Because despite previous austerity measures and due in main part to the deteriorated growth outlook, the budget deficit in 2012 is expected to stand at 4.5% of GDP, more than 1.8%-point higher than the deficit stated in the financial version of the coalition agreement in the Initial Memorandum. As such it will exceed the signal value (figure 1). In order to lower the budget deficit next year to the European deficit standard of 3% of GDP, the Dutch government is going to have to introduce an estimated € 9 billion in additional spending cuts. It presently appears that the current term of government will conclude in 2015 with a budget deficit of 3.3% of GDP, more than 2%-point higher than the amount the Dutch government forecast at the time of taking office. In order to be able to achieve the targeted budget balance stated in the Initial Memorandum by the end of the term of government, the extra spending cuts will run up to at least € 16 billion on top of the existing package of measures totalling € 18 billion. Dutch policymakers are afraid slackening budget discipline will come at the expense of Dutch creditworthiness and will consequently bring about a down-ward spiral of increasing interest expenses and rising government debt. Calculations made by the Dutch State Treasury Agency of the Dutch Ministry of Finance (2011), however, reveal that if the average interest on new government debt gradually climbs to 5% in 2015, the extra interest payments in this period will rise to slightly more than € 6 billion (approximately 1% of GDP).[1] The interest the Dutch government pays on newly issued government paper is currently among the lowest in Europe due to the safe haven effect (figure 2).

[1] Dutch State Treasury Agency (2011), *Outlook 2012*, Dutch Ministry of Finance, The Hague.

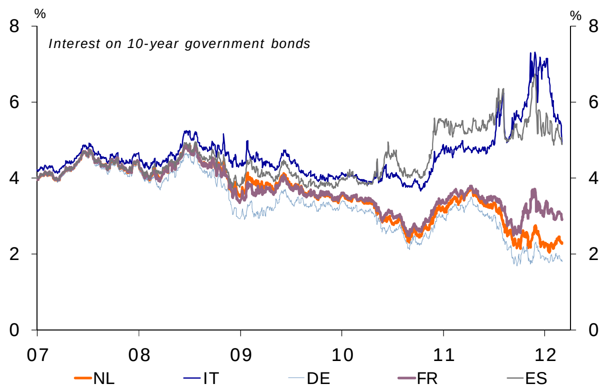
...cuts two ways

The amount of government debt and the budget balance are key indicators that determine a country's credibility as a borrower. A country's growth capacity also plays an important role. This creates a field of tension within the current economic climate. Due to the fact that both the Dutch government's and the European budget rules prescribe extra austerity measures, spending cuts can result in a negative spiral of spending cuts and slowdown in growth. Within this context, credit rating agency S&P wrote the following in 2012 with respect to the recent downgrading of nine eurozone countries: '*As such, we believe that a reform process based on a pillar of fiscal austerity alone risks becoming self-defeating, as domestic demand falls..., eroding national tax revenues*.'[2]

The extent to which the aforementioned consideration comes into play depends on the degree to which government policy influences economic developments in the short term. The effect of this in open economies, such as the Dutch economy, is generally speaking relatively limited because part of the spending or austerity impulses leak away to other countries (OECD, 2012).[3] This suggests that budgetary restructuring can be realised in the Netherlands at relatively limited costs with respect to economic growth. According to Auerbach and Gorodnichenko (2011), this is opposed by the fact that budget multipliers are greater during a recession than during periods of economic growth.[4] This resonates with the economic theory that stimulus measures are primarily effective when there is cyclical unemployment and underutilisation of production capacity. Extra austerity measures could have a strong procyclical effect on the Dutch economy within the current uncertain economic climate, in which all European countries are simultaneously cutting spending (figure 3). A recent study from the IMF (2011) concludes on the basis of 173 budget consolidations in the period 1980-2009 in fifteen developed countries that austerity measures can within two

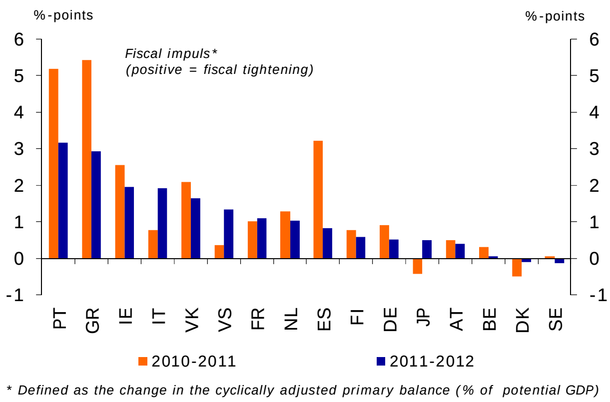
[2] Standard & Poor's (2012), *Standard & Poor's takes various ratings actions on 16 Eurozone sovereign governments*, Ratings Direct.
[3] OECD (2012), Fiscal consolidation, OECD Economics Department, to be published.
[4] Auerbach and Gorodnichenko (2011), *Fiscal multipliers in recession and expansion*, NBER working paper No 17447, Cambridge, MA: NBER.

Figure 2: Safe haven effect



Source: Reuters EcoWin

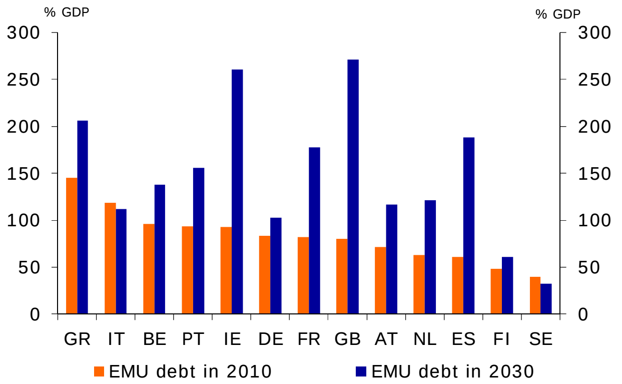
Figure 3: Budget consolidation from an international perspective



Source: IMF (2011)

years result in a real decrease in economic activity of 0.5% compared to the base path. The loss of GDP can rise to 2% in the short term when the benchmark rate cannot be cut much further and there is simultaneous budget consolidation as is currently the case in the eurozone.[5] This means any achieved budgetary gains are partially lost as a result of the disappointing economic developments and the accompanying deteriorating debt and balance ratios due to the so-called denominator effect. According to the IMF, the combination of low economic growth and extensive spending cuts can lead to rising interest on government bonds due to a worsened economic outlook, even when the budget deficit is shrinking.

Figure 4: How high is the unsecured account?



Source: Eurostat, EC (2009)

Reform, but how?

The design of budgetary reform is crucially important for both putting government finances in order and avoiding a considerable slowdown in economic growth. Alesina and Ardagna (2010) say reducing government spending, such as reducing social security expenditure, is more effective than increasing the tax burden or lowering government investment.[6] The cumulative loss of GDP as a result of tax and premium increases is 1.3% after two years, while this percentage is only 0.3% in the case of lower government spending (IMF, 2011).

Even after the current crisis, the problem with Dutch government finances will lie primarily in the unsecured account for the future. Compared to other countries, the Netherlands has generous social security services and an extensive (public) healthcare system. Providing the policy remains unchanged, government spending will increase sharply on an autonomous basis due to the ageing population. As a result Dutch government debt is, according to the calculations of the European Commission (2009), at risk of doubling over the next two decades (figure 4).[7] With a view to the long-term sustainability of government debt, it will be impossible to avoid taking measures that will structurally curb the (future) growth in government spending. This will include steps such as integral reform of the housing market and accelerated increase in the retirement age to 67 combined with further linkage to life expectancy and greater cuts in the collective healthcare expenditure financed from the Exceptional Medical Expenses Compensation Act (AWBZ).

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[5] IMF (2011), Will it hurt? Macroeconomic effects of fiscal consolidation, In: *World Economic Outlook: Recovery, Risk and Rebalancing*, Washington.

[6] Alesina and Ardagna (2010), *Large changes in fiscal policy: taxes versus spending*, NBER working paper No. 15438, Cambridge, MA: NBER.

[7] European Commission (2009), *Sustainability report 2009*, European Economy 9, Brussels.

While limiting government spending is the type of austerity measure that gives financial markets the most confidence, it is also a move that is extremely difficult from a political standpoint. The proceeds of these ‘smart’ reforms are scarcely noticeable in the short term, while the burdens can be felt immediately. This makes a series of relatively small measures and cuts across the board look much more effective at first glance. So it is not surprising that 121 austerity measures, which will be taken during this term of government, are bringing about insufficient structural effects to guarantee the long-term sustainability of Dutch government finances (CPB, 2010).[8] If the Netherlands wants to meet the tightened budget rules in 2013, the Dutch government will have no choice but to take fast and visible action. A lack of major structural reforms in the years ahead would mean being forced to get the cutting board out of the cupboard. Because the Dutch government does not have much choice: either introduce far-reaching reforms in order to lower government spending or pass the bill to businesses and households (tax and premium increases).

In conclusion

The Netherlands is facing an important choice. Will the Dutch government opt for structural reforms to prevent the ever-greater bill from being passed to future generations? Political inability to tackle the controversial issues in the field of pensions, the labour market for older employees, healthcare and the housing market in a timely fashion could be the main reason for financial markets and credit rating agencies to doubt the solvency of Dutch government finances. This demands that Dutch politicians make clear structural choices in the short term that will result in a credible reform strategy for the medium term.

Or will the Dutch government use short-term budgetary spending cuts and tax and premium increases in order to meet its austerity target? Dutch politicians have limited their own room for manoeuvre by pushing hard in Europe for rock-solid budget agreements. As a result the Dutch government has no alternative but to set the good example itself. This means quickly intervening in government finances will be imperative to the Dutch government’s credibility, even if such action will damage the economy in the short term. The relatively limited changes will also mean the urgency of structural reforms will only fade into the background temporarily. Because what the politicians do not seem to realise is that the longer it takes to make the necessary structural reforms, the greater the costs will be for taxpayers. So, seen in this light, the short-term gains could bear a heavy price in the long term.

[8] CPB (2010), *Analysis of economic effects financial framework*, CPB Communication, The Hague.

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