POSTWAR FISCAL RULES IN THE NETHERLANDS: WHAT CAN WE LEARN FOR EMU?

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1. Introduction

In the post-war period there have been several striking developments in the Dutch fiscal stance (Figure 1). The fiscal balance was on average in deficit (2.4 % of gross domestic product, GDP), with a 'peak' in 1982 at 6.6% of GDP[1]. The public sector expanded rapidly in the following period reflected in a rising net public spending ratio (expenditure consolidated with non-tax funds). The principal reason for this lay in the fact that a large part of the expenditure was based on open-ended arrangements. Since an open-ended arrangement by definition means there is no link between the size of the available budget and the possible claims on that budget, such expenditure is difficult to control. This was proved very true in practice. The most striking example is in the field of social security, where transfer payments to households showed a sharp rise from around 7% of GDP in 1955 to approximately 26% of GDP in 1980. Taxation and social security contribution revenues also began to grow strongly from 1955 onwards, although the level of revenues remained less than the level of expenditure.

All in all the budget balance showed a small deficit throughout the 1960s and early 70s. The debt ratio fell, partly owing to the strong economic growth but partly also as a consequence of inflation. In the years following 1975 the fiscal balance deteriorated sharply, which was also reflected in a sharply rising debt-to-GDP-ratio.

The major fiscal consolidation process in the Netherlands started after 1983 and can arguably be considered as completed in 1999 with the

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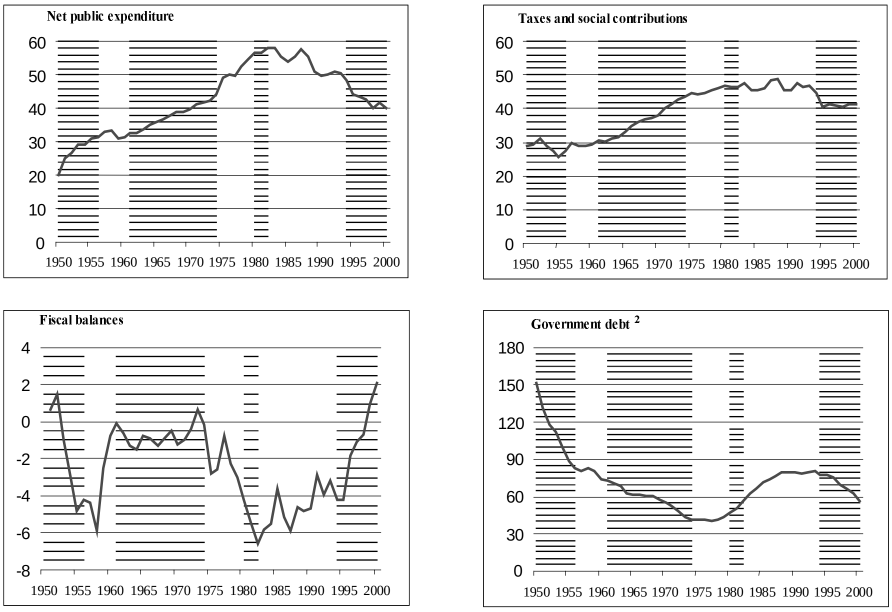
* De Nederlandsche Bank. The views expressed in this paper are those of the author and are not neccessarily those of De Nederlandsche Bank.

1 Unless otherwise mentioned, fiscal balance refers to net lending of general government as defined in ESA79 before 1995 and ESA95 thereafter. The budget balance measure used by the government in the period up to and including 1994 was the financial deficit of central government i.e. net lending including financial transactions, without social security and lower government levels. The denominator was net national income (NNI) rather than GDP. Measured in those terms the peak occurred in 1983 at 10% of NNI.

Fig. 1

Key Fiscal Data 1950-2000
(percent of GDP)



Source: Netherlands Statistics and CPB.

1. Shaded/non shaded areas denote period in which a particular fiscal rule was in operation (see Table 1).
2. Prior to 1975: net debt; after 1975: gross debt; after 1988 in percent of harmonized GDP.

occurrence of a fiscal surplus. Despite the very strong expansion of the public sector and persistent deficits, budgetary control procedures have been in operation in the Netherlands throughout the postwar period[2]. This raises the question of what role fiscal rules had to play in controlling the growth of the public sector in the Netherlands. The second question addressed in this paper relates to the establishment of EMU. With the provisions of the Maastricht Treaty including the Stability and Growth Pact now in place, the question emerges what role national fiscal rules (with respect to the fiscal balance) still have to play in situations of surpluses.

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[2] As early as 1814 a fiscal rule was in operation in the Netherlands. Until the Second World War these fiscal rules where variants on the principle of a balanced budget (Stevers, 1976).

2. Postwar Fiscal Rules in the Netherlands[3]

In the period since the Second World War, various fiscal rules have been in operation in the Netherlands. In Table 1 seven primary rules are identified (also shown in Figure 1). Most of them are rules with respect to some measure of the financial balance[4].

Table 1

Overview of Postwar Dutch Fiscal Rules

Period	Primary Rule	Target Variable	Quantitative goal
1945-1956	Capital Principle	$FB_{cap.exp}$	
1957-1960	Cyclical Deficit Rule	FB_{cycl}	
1961-1974	Structural Budget Rule	FB_{struct}	stood at -3% of NNI in 1974
1975-1979	1% Rule on Tax Burden	T	maximum increase of 1%-point p.a.
1980-1982	Actual Financial Deficit	FB_{actual}	target of -4 and -5% of NNI
1983-1994	Time Path Approach	FB_{actual}	1983/86 reduction with 1.5%-point p.a.
		FB_{actual}	1986/90 reduction with 1.0%-point p.a.
		FB_{actual}	1990/94 reduction with 0.5%-point p.a.
1994-2002	Real Net Expenditure Rule	G_n	1995/98 declining ceiling 0.7% p.a.
		G_n	1999/02 increasing ceiling 1.5% p.a.

Note: Start of period refers to first year of application. New fiscal rules for year t are generally introduced in Budget Memorandum t, published in September t-1. The standard term for government is four years.
Goal variables: FB = Financial Balance central government, T = Taxes, G_n = General Government expenditure (net, consolidated with non-tax revenue); NNI = Net National Income.

2.1 Constant Capital Principle

In the initial post-war years, the capital principle was the formal guide for the national budget. Under this classical norm current expenditure and revenue should balance each year. In contrast it was mandatory to borrow to finance capital expenditure so that public capital

3 A part of this section is based on Wellink (1996).

4 Sometimes a secondary rule (a fiscal rule with a lower priority than the primary rule) on expenditure or revenue was introduced as well. These rules are not considered in this paper.

remained constant. However, in view of the deplorable state of government finances at the end of the war, the generally accepted priority was to put the house in order. The broad support for this made a tight fiscal policy possible, so that by the early fifties the government was running a surplus. Until the mid-fifties government finances were dominated by the necessary financial reconstruction after the war. This was due to the high rate of economic growth and the surpluses enjoyed by the central government as a result of recovery of unpaid taxes in respect of the war years.

2.2 *Cyclical Deficit Rule*

In the second half of the 1950s a strong relationship was established between the state of the economy and the size of the budget deficit. In 1957 an official switch was made to the cyclical deficit rule as the primary budgetary norm, partly in response to a deteriorating economy. According to this norm, based on a Keynesian model, the main purpose of the budget was to smooth the business cycle by means of an anticyclical policy. The experience with that rule was not favorable, partly because it was applied asymmetrically: when the economy was weak, demand was indeed stimulated but the brakes were not applied when the economy surged ahead. The difficulty of identifying the turning points in the business cycle in time also contributed to the lack of success of the cyclical norm. In the few years that this norm was the primary guide, the debt ratio rose slightly, contrasting sharply with the rapid decline in this ratio over the preceding decade.

2.3 *Structural Budget Rule*

In 1961 the cyclical norm was replaced by the structural budget rule[5]. In contrast to the cyclical deficit rule, the emphasis of this rule was in fact on cyclical neutrality. The idea behind the structural budget rule was to match the government deficit to the structural level of borrowing in the other sectors of the economy (the private sector and abroad). For the latter sector the desired level of the current account on the balance of payments was a surplus of 0.5 to 1.0% of NNI (in order to finance current spending on development aid from the capital account of the balance of payments). If the actual rate of economic growth was different from the trend rate of

[5] Also known as the Zijlstra rule. Zijlstra was then Minister of Finance.

growth, then under this policy rule the actual budget deficit was permitted to depart from the level deemed acceptable in the long term. The discrepancy between actual and structural deficit levels was not subject to a norm. However, to avoid misallocation among the sectors of the economy, a Structural Budget Margin was established within the constraints of the targeted structural deficit. This additional rule defined the maximum amount of money available for changes in expenditure and tax policy. The advantage of such a rule is that it strengthens the hand of the finance minister since colleagues in the spending departments have to come to an agreement within the permitted budget margin.

2.4 1% Tax Burden Rule

In the mid-seventies - without completely abandoning the structural budget rule - a new rule representing a relative restriction on the cost of the public sector, the so-called 1% rule, was introduced by the then Minister of Finance Duisenberg. This norm aimed at limiting the rise in the tax burden (relative to GDP) to one percentage point per annum. Although this rule seems very generous by today's standards, it nevertheless implied a major intervention in those days when one considers that, without this change of direction, an average annual increase in the cost of the public sector of two percentage points would have been included in the estimates.

The Budget Memorandums in the early years of the structural budget rule made no attempt to put a figure on the acceptable level of the deficit in the long term (Sterks, 1982). Moreover, the calculation method was altered several times over the years (e.g. taking a different year as the basis). As a result, direct comparisons between the target and the outcome is only possible for a limited number of years. In the period 1974-1980 the structurally acceptable deficit underwent a significant overall upward adjustment, ultimately standing at 3% of NNI. Almost without exception the actual deficit in any one year was in excess of the target and the gap widened despite the relaxation of the norm. The weaknesses of the structural budget rule became clear after the first and second oil crises of the seventies. The Dutch current account showed an increasing surplus but was positively distorted by the country's gas revenues during that period. This led to overestimation of the scope for domestic spending and hence excessive fiscal deficits.

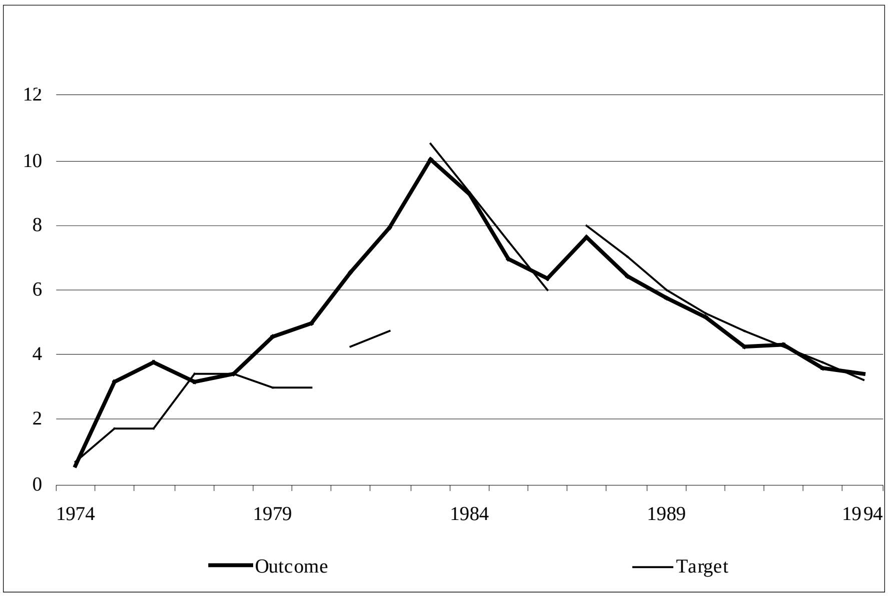
2.5 *Actual financial deficit control*

The sharp rise in the actual budget deficit, partly caused by the recession, led to the abandonment of the structural budget norm at the end of the seventies. From the outset, however, the aim was to return as quickly as possible to the structural budget policy[6]. But it was to be almost twenty years before the fiscal stance showed a surplus. The key issue then was to get the actual budget deficit down. Cutting the deficit was also necessary from the point of view of stabilization, however, in order to create the latitude within which the automatic stabilizers would be able to operate. In the years 1981 and 1982, ad hoc targets were set for the deficit (between 4% and 5% of NNI) but these were unable to prevent the fiscal situation from deteriorating fast (see Figure 2).

Fig. 2

Financial deficit central government

(percent of net national income)



6 To quote the Budget Memorandum 1980 (p. 39): "as soon as the actual budget deficit has been reduced to more acceptable proportions".

Whereas the draft budget for 1982 (in September 1981) showed a budget deficit of 4.8% of NNI, just three months later the figure had been revised to 5.5%. Another three months on, 6.3% was being forecast and the Spring Budget of 1982 was based on a government deficit of 8% of NNI, despite the fact that the latter figure took account of additional spending cuts of NLG 3 billion (0.9% of NNI). The then finance minister spoke in his introduction to the 1983 Budget Memorandum of an 'almost explosive growth in the deficit'. In retrospect, that was the time in which the need for fiscal consolidation was greatest, in view of a record post-war deficit figure.

It was not until 1983 that multi-annual targets for reducing the deficit ratio were drawn up, the so-called time path approach. In the three governments in the period 1983-1994 (under Prime Minister Lubbers), a four-year (straight-line) time path for reducing the deficit was plotted. In each successive government the planned reduction in the budget deficit was smaller, however: down from an annual reduction of 1.5 percentage points to half a percentage point a year. It may nevertheless be concluded that the three time paths were closely adhered to, with the exception of 1987, when the deficit jumped sharply and the time path for the reductions had to be shifted upwards by 2 percentage points (Figure 2). In the course of time, the time path approach did reveal certain weaknesses, however. To begin with, the budgeting process tended to become a very hectic affair. Owing to the tight margins imposed with respect to the annual targets, every setback meant a revised budget. As a consequence the budget horizon was quickly reduced to one year, so that short-term considerations gained the upper hand at the expense of an integral approach to spending and revenues. Secondly, the chance of coming in under target, due to windfalls on the revenue side especially was reduced. Towards the end of the eighties, therefore, budgetary discipline began to slip as tax windfalls were used to compensate overspending or to fund additional spending (Brouwer and Ter Haar, 1994). Thirdly, the budget deficit figure became increasingly 'contaminated' with incidental components and adjustment items, so that the rule was in fact eroded although on paper it was still being adhered to. In the final year of the time path approach (1994) the deficit contamination amounted to a number roughly equal to the target level of the budget deficit (2.2% of NNI), making the underlying deficit 4.3% of NNI. The result of this rule erosion process was that the necessary structural cutbacks were deferred.

2.6 Real Net Expenditure Rule

In August 1994 when a new cabinet took office a new fiscal rule, the real net expenditure rule was introduced[7]. Under this rule total real net public expenditure (i.e. public expenditure including social security outlays, consolidated with non-tax funds) was bound to a ceiling. During the first government term of Prime Minister Kok the ceiling (which can be interpreted as the maximum allowed) declined with an average annual rate of 0.7% (Budget Memorandum 1995) while in his second cabinet the constraint was relaxed to an average increase of 1.5% per annum. Given the large increase in real net expenditure of approximately 2.5% per annum (actual outcomes) in the years 1990-1994, the target under the net expenditure rule can be considered as ambitious. In addition to the net expenditure rule, a secondary norm regarding tax revenues has been introduced in 1998. The experience with the net expenditure rule has been favorable so far as the steep upward trend in expenditure in the early 90s has been broken in 1994 and that the targets have been met. The latter success is partly the result of applying cautious assumptions, which resulted in an *a priori* higher chance of windfall gains. For details on the assumptions and further aspects of this rule, see Heeringa and Lindh (2001).

3. The Life Cycle of Dutch Fiscal Rules

On average, the time span of a fiscal rule in the Netherlands (based on the categories distinguished in Table 1) is about seven years. To investigate the factors behind this limited time span we study two not mutually exclusive candidates. First, the general economic condition, which is proxied by average output growth. In times of recession or low trend growth more often than not a fiscal rule becomes really binding, implying tough policy measures. Depending on the commitment of the government to that particular rule it is sometimes easier to implement a new, less binding rule. Second, the political environment i.e. changes in central government. This is tackled by considering whether the announcement of a new fiscal rule coincides with the formation of a new cabinet since at those points in time a new fiscal rule can easily be

[7] This rule is also known as the Zalm-rule, according to the custom that a rule bears the name of the finance minister (Zalm) who introduces it. Real is used here in the sense that nominal government expenditure is deflated with the GDP-deflator (and not the deflator of government expenditure).

introduced signaling a fundamental change in government policy. Between 1945 and 2000 22 cabinets have been formed in the Netherlands[8]. Apart from these two factors there is a third complicating factor, an administrative phenomenon that could be described as 'rule erosion': the tendency that over time adaptations and exceptions are made with respect to the rule effectively undermining the constraint put forward by the rule.[9] These alterations to the rule can be put forward by both the cabinet and parliament. Rule erosion can also be seen as an easy alternative to a completely new rule. Usually however the rule becomes less transparent which implies a cost[10]. The effect of rule erosion is however that it is often difficult to pinpoint where one fiscal rule is *de facto* replaced by another fiscal rule. Hence the seven periods shown in Table 1 and 2 are to some extent open to different interpretations. An example already mentioned above is the calculation of the structural budget and the budget margin in the period 1961-1974. Over the years the method and the base year were altered leading to an increase of the 'acceptable' deficit. Another example is the inclusion and exclusion of certain items in the definition of the financial balance of the central government during the time path approach. At the start (1983) only one item existed (off budget expenditure items, introduced in 1974, were included in the deficit figure). At the end (1994) there were 8 items ranging from the acceleration of tax collection, the sale of public assets and various loans (to housing corporations and students). The quantitative importance of the items varied but could in some years well exceed 1% of NNI which is large compared to the annual decrease in the target under the time path approach.

The following picture emerges from Table 2, where data with regarding the first two factors is shown. First, the change in government plays a clear role in only two cases (indicated by the first year, 1983 and 1994), although these cases are the two most recent ones. A third case (1945) is less relevant as these changes follow mainly from the resumption of government after the war. Second, the general economic condition

8 This is only one simple but unambiguous way of measuring changes in government. See De Haan and Sturm (1997) for alternatives e.g. the number of parties in a coalition, whether or not a minority government, or the political orientation of a coalition (left or right wing).

9 See e.g. Stevers (1993). There is a parallel with Goodhart's Law (Wellink 1996).

10 To quote Oort and De Man, (1968): "...the problem of fiscal rules is in essence a question of political rules and a commitment to play by the rules. A game which inevitably involves so many players must have simple, transparent and acceptable rules; it must not be allowed to become a tournament open only to the grand masters who know all the moves and gambits." (translated from the Dutch).

Table 2

Two Factors influencing the Life Cycle of a Fiscal Rule

Period	Primary Fiscal Rule	New cabinet [1] (name)	Output growth in period [2]		
			Average	Minimum	Maximum
1945-1956	Capital Principle	yes (Schermerhorn-Drees)	5.3	1.7	8.4
1957-1960	Cyclical Deficit Rule	no (Drees III)	3.9	-1.0	9.0
1961-1974	Structural Budget Rule	no (De Quay)	4.9	2.8	8.6
1975-1979	1% Rule on Tax Burden	no (Den Uyl)	2.4	-0.1	5.1
1980-1982	Actual Financial Deficit	no (Van Agt I)	-0.3	-1.2	0.9
1983-1994	Time Path Approach	yes (Lubbers I)	2.6	0.8	4.7
1994-2002	Real Net Expenditure Rule	yes (Kok I)	3.6	2.3	4.5

[1] (new) Cabinet in first year of a new fiscal rule.
[2] Data refer to time period in first column.

seems to be a factor in explaining the abandonment of several fiscal rules in the 1970s and 1980s. After the first oil crisis it is clear (with the benefit of hindsight) that the 'golden' growth performance in the previous period (1961/74) of almost 5% with a slowest growth of 2.8%, came to an end. In the following period (1975/79) growth stagnated for the first time in more than a decade and the average annual growth rate fell to 2.5%. Another point in case is the period at the beginning of the 1980s when a major recession hit the Netherlands and fiscal balances deteriorated quickly, leading to the abandonment of the 1% rule on the tax burden in favor of actual deficit control. From these examples one may infer that the length of the life cycle of fiscal rules in the Netherlands is influenced by changes in government or adverse economic conditions (e.g. recessions).

4. What National Fiscal Rule in EMU?

With the start of the third stage of Economic and Monetary Union (EMU) on 1 January 1999 member states must avoid so-called excessive deficits. Under the Maastricht Treaty the lowest allowable fiscal balance is set at -3% of GDP, the relevant goal variable in this case is the actual fiscal balance. In addition, the budgetary provisions of the Stability and Growth Pact (Pact) act as a constraint for national fiscal policy. Under the Pact member states are to maintain a position close to balance or in surplus over the medium term. This situation should be reached preferably in 2001 but in 2002 at the latest. The interpretation of the provision 'over the medium term' taken here is that the goal variable must be some measure of a cyclically adjusted budget balance which must then remain close to balance or in surplus), otherwise the provision 'over the medium' would be superfluous. In addition member states should also consider all other influences which might put the actual fiscal balance (too) close to the 3% limit, such as the effects of an ageing population or a high debt level. If these effects are taken into account almost all countries should indeed aim for a surplus (in cyclically adjusted terms), as argued in Brits and De Vor (2000).

Hence it is clear that the European fiscal rules limit the choice for designing national fiscal rules[11]. There are two possible responses to this European budgetary framework. Firstly, for countries with a federal government structure it may be advantageous to translate the commitment of the Pact to lower levels of government (national stability pacts). This option is less relevant for the Netherlands as lower levels of government (provinces and municipalities) have little discretion given the requirement of a balanced budget. Secondly, given the requirement of a cyclically adjusted budget close to balance or in surplus there is little need for a national rule limiting the fiscal balance in some additional way (assuming of course that the requirements of the Pact are fulfilled). One important function of the budget is however still open to national budgetary authorities, the macroeconomic stabilization function. Indeed, under EMU it becomes increasingly important to utilize all possible adjustment mechanisms in order to deal with asymmetric shocks. Hence national fiscal rules should contribute to a stable economic development as much as possible. It is however broadly understood that active fiscal policies to stabilize the economy ('fine tuning') are surrounded by several problems:

- The 'correct' economic model is unknown, which makes it difficult to predict future growth and inflation. The relevant forecast horizon for drawing up most budgets is one year. Recent calculations on the forecast error for GDP one year ahead (measured by the mean absolute error) for the Netherlands come out in the order of 1 per cent (CPB 1999). This corresponds to results for most other industrialized

[11] Rules with respect to some measure of the fiscal balance. Level rules (on expenditure or taxes) could still usefully be applied as European rules only restrict the difference between expenditure and taxes.

countries found elsewhere in the literature (Koutsogeorgopoulou 2000). Given this magnitude of the error it is clear that a forward looking fine-tuning rule is not likely to succeed in a dampening of the cycle in practice;

- There is the risk of a pro-cyclical fiscal policy as a result of slow parliamentary approval and implementation of measures;
- Another risk is that the active fiscal rule is applied asymmetrically, resulting in too little fiscal consolidation in economic upturns;
- Frequent changes in taxes and public spending may also cause supply side inefficiencies (Van den Noord 2000).

Hence, passive fiscal policy with respect to cyclical influences i.e. letting the automatic stabilizers work to the extent possible, seems to be a more obvious way to contribute to macroeconomic stability (given a sound fiscal stance)[12]. The above mentioned problems do not apply to automatic stabilizers. Another advantage is that the automatic stabilization rule is transparent: all cyclical influences on the fiscal balance are simply accommodated. It should be noted that the emphasis put above on the automatic fiscal stabilizers does not imply that fiscal policy should be the only or the main adjustment mechanism to country-specific shocks. There are of course several other adjustment mechanisms that may potentially supplement fiscal stabilizers, e.g. wage flexibility and labor mobility.

5. Concluding remarks

Dutch experience with budgetary control in the postwar period has been mixed. One thing which stands out is how typical of their periods fiscal rules are, as a result of which there have been frequent changes. During times when adhering to the rule poses difficult political decisions, more often than not there is a tendency for the rule to be eroded, and then to be replaced in due course by a new one. Given the new institutional environment created by EMU, the importance of a domestic rule with respect to some measure of budget balance is limited to its stabilization property. It is argued that automatic stabilizers have some advantages in this respect.

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[12] Recently there is a growing interest in the literature on automatic fiscal stabilizers (Van den Noord, 2000; Cohen and Follette, 2000).

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