

The Dutch Fiscal Framework: History, Current Practice and the Role of the Central Planning Bureau

by
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Major features of the Dutch fiscal framework are the trend-based fiscal framework with real net expenditure ceilings for the whole term of government, the role of independent organisations like the Central Planning Bureau (CPB), Statistics Netherlands and the Netherlands Court of Audit, and the intermediary role of the National Advisory Group on Budgetary Principles. This article describes the Dutch fiscal framework, its role in managing public expenditure, its history since 1814, the most recent national discussions and the role of the CPB.

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Executive summary

According to the International Monetary Fund and OECD, the Dutch fiscal framework is rather unique and its design and implementation are highly recommendable. This article discusses this framework. Attention is paid to the history and current practice of the fiscal framework, the role of the Central Planning Bureau and the most recent changes recommended by the National Advisory Group on Budgetary Principles. Key statistics on Dutch public finance, *e.g.* debt, public expenditure and taxes as a percentage of GDP, are presented for the period 1814-2006.

History

Three periods can be distinguished in the development of Dutch fiscal policy: the balanced budget as official principle (1814-1956), Keynesian deficit norms (1957-1979), and norms for reducing deficit and debt (1980 to the present day).

Since 1814, the official notion of a balanced budget has changed substantially over time. First, when debt was excessive, it imposed the redemption of loans. Later, a golden rule of finance was introduced, allowing new loans for “productive” expenditure. Official fiscal principles were occasionally relaxed by bookkeeping tricks; this often reflected unexpected fiscal difficulties (*e.g.* war expenditure, economic crisis, rapidly falling revenues from Indonesia). Also, sometimes the fiscal principles were tightened in view of temporary windfalls.

The principle of the balanced budget was supplemented with two other budgetary rules: no or limited increase in tax burden and, in the case of excessive debt, a priority for reducing this debt to a sustainable level. At the end of the 19th century, the prominent Dutch economist and politician Pierson stressed that each generation should bear its own burden and should not leave excessive debt for the next generations.

After the Second World War, the classic view of the government was replaced by a macroeconomic view: the state budget was presented as part of a set of national accounts on the Dutch economy. Since then, the CPB, being an independent institute, provides the official estimates on the macroeconomic developments. Directly after the Second World War, this new macro view was combined with a strict budgetary control: all expenditure by the state was monitored and approved in detail by Minister of Finance Liefstinck.

The period of Keynesian deficit norms started in 1957. In order to reduce the overheating of the Dutch economy and improve the balance of payments position, it was decided to reduce government expenditure. However, due to time delays in the implementation, these plans resulted *de facto* in a pro-cyclical policy. In 1961, a trend-based deficit norm was introduced by Minister of Finance Zijlstra. Its purpose was to provide a simple and stable macroeconomic framework for budgetary decision making. It was a Keynesian fiscal norm, as the trend-based estimates for government deficit should match those of private saving.

The 1970s turned out to be a major watershed. Supply side thinking became much more popular among Dutch economists and politicians. The new macroeconomic model of the CPB was widely discussed. The priorities gradually became to regain control of public finance by reducing deficit and debt and to reduce (the increase in) taxes and public expenditure. Since 1980, these are the major official fiscal principles.

The budgetary process became chaotic in the 1970s and 1980s. This was due to the drastically increased size and complexity of Dutch public finance, unexpected economic setbacks and substantial fluctuations in natural gas revenues. The introduction in 1994 of trend-based budgeting with expenditure ceilings for the whole term of government, and one decision-making moment a year, turned out to be effective solutions.

In managing and controlling public expenditure, cost-benefit analysis and creating the proper incentives for all parties involved have become more and more important since the 1990s. Such a microeconomic approach had already been advocated by the Dutch public finance expert Willem Drees Jr. in the early 1970s.

Since about 2000, a forward-looking view of Dutch public finance has become dominant: Dutch public finance should be sustainable in view of the net extra costs of ageing and the falling revenues from natural gas.

A common feature of Dutch fiscal policy since 1814 is that excessive debt is not acceptable. When it nevertheless occurs, *e.g.* because of war and foreign occupation, or becomes a very serious threat, the first priority is to bring debt to a sustainable level. This has shaped Dutch fiscal policy in 1814-1840, 1945-1952 and since 1983.

Most of the time, a common philosophy was also that taxes should be stable and as low as possible in order to avoid adverse effects on the entrepreneurial spirit and economic growth; the Keynesian episode (1957-1979) is the exception to this rule.

Specific circumstances have often affected the fiscal rules. In general, when there were unexpected windfalls, fiscal policy principles became tighter and – in the case of setbacks – official principles were often relaxed; sometimes, bookkeeping tricks were also used to circumvent officially proclaimed rules.

Current practice and the role of the Central Planning Bureau

Major features of the current Dutch fiscal framework are the trend-based fiscal framework with multi-annual expenditure ceilings and the role of independent organisations like the CPB, Statistics Netherlands and the Netherlands Court of Audit. The National Advisory Group on Budgetary Principles plays an important intermediating role. One year before the start of a new government, the advisory group issues a report which bridges the gap between the experts (CPB and the Dutch Central Bank) and policy practice (the ministries most involved with fiscal and economic policy).

The framework is set with reference to a target for the fiscal balance based on longer-term budgetary sustainability considerations. The CPB analysis of short-term, medium-term and long-term developments in Dutch public finance is the backbone of this framework. When – in the case of unexpected economic setbacks – the actual general government deficit is expected to exceed 2% of GDP, additional measures are to be taken and the expenditure ceilings do not apply anymore. When this policy is successful and the general government deficit is no longer close to 2% of GDP, the old expenditure ceilings are reinstalled. The latter may induce unstable decision making and also – in the case of economic recovery – lead to a pro-cyclical policy.

The expenditure ceilings are not expenditure norms in terms of GDP. At the start of a new government, they are determined on the basis of a realistic assessment of expected public expenditure, while taking into account the new government plans. CPB estimates of the various public expenditure, *e.g.* with respect to social benefits and health care, play an important role as a critical benchmark. The ceilings are in real terms, *i.e.* they are annually updated with the most recent estimate of prices. All changes in wages and prices not expected at the start of the government lead to changes in the margin for expenditure under the ceilings.

No explicit corrections are made for business cycle fluctuations. A reason for this is that cyclical windfalls and setbacks in the volume of social benefits tend to cancel out the wage and price inflation. Since 2002, there is a qualitative clause that cyclical windfall in expenditure under the ceiling should not be spent.

The major changes proposed by the National Advisory Group on Budgetary Principles are to remove interest payment from the expenditure ceilings, to break the direct link between natural gas revenues and investments in infrastructure and knowledge, and to start reporting about the budgetary importance of major items of tax deduction, *e.g.* interest on mortgages and pension contributions. The advisory group also recommended continuing with cautious economic growth assumptions for the medium-term framework. However, since February 2007, there has been a new government, and it has already been decided that trend-based estimates will be used.

The CPB plays an important role in financial and economic decision making in the Netherlands. The CPB estimates of the Dutch economy and public finance are the backbone of the budgetary process. Political parties and the government ask the CPB to analyse the economic effects of their election platforms, coalition agreements and alternative budgetary proposals. Strategic economic thinking and decision making are influenced by CPB studies, *e.g.* general long-term scenario analyses and specific studies about the welfare state, education, innovation and health care. The decision making about major specific projects, *e.g.* on infrastructure, is guided by cost-benefit analysis by the CPB. The CPB is also represented in influential advisory groups.

The role of the CPB as an independent expert fits well in the Dutch tradition of consultation and coalition agreements. Directly after the Second World War, the CPB had a good start, with an outstanding director (Jan Tinbergen) and economic and political circumstances providing it with a clear role. This unique role is maintained by formal laws and protocols, by regular external checks on the policy relevance and scientific quality of the CPB work, and by the existence of a free press.

1. Introduction

For years, IMF and OECD have been stressing the importance of national fiscal rules and institutions. The two organisations have provided standards for good practice and given overviews of best practice (IMF, 2001a, 2001b, 2005; OECD, 2002). In the annual country reports by IMF and OECD, national fiscal frameworks are always discussed in view of these standards and best practices.

According to IMF and OECD, the Dutch fiscal framework is in many respects unique and highly recommendable. This applies, for example, to the medium-term expenditure ceilings, the use of independent macroeconomic estimates in the budgetary process, the analyses and estimates by the CPB about Dutch public finance, and the role of Statistics

Netherlands, the Netherlands Court of Audit and the National Advisory Group on Budgetary Principles.

At present, medium-term expenditure ceilings are only used in a few countries, e.g. Finland, the Netherlands, New Zealand, Sweden and the United States. However, IMF and OECD regard such expenditure rules as a very effective and efficient tool for managing public finance. Anderson and Minarik (2006, pp. 193-194) even argue that expenditure rules are, on balance, superior to deficit-based rules like the general government budget balance rule used by the European Economic and Monetary Union (EMU):

- “[] rules that set only... a maximum limit on the deficit might be thought to encourage countries to run the largest deficits permitted, creating risks of excessive deficits under unexpected adverse conditions. In contrast, a spending rule would provide firm guidance to policy makers whether the economy and the budget are strong or weak.
- [] deficit-based rules provide no incentive for counter-cyclical policy in strong economies, and can limit even the operations of automatic stabilisers in the budget in weak economies. In contrast, spending rules allow the automatic stabilisers to work in full at all times and in any economic conditions.
- Violations of a spending rule are transparent and incontrovertible. In contrast, non-compliance with a deficit rule... can be hidden behind optimistic economic assumptions or unlikely plans for future spending and revenue discipline.
- [] spending rules make the availability of resources more predictable, notably with respect to annually appropriated funding for... core functions of government.
- [] the more predictable fiscal behaviour encouraged by spending rules can lead to easier co-ordination with monetary policy, and to greater confidence and steadier behaviour within the private sector.”

Anderson and Minarik therefore advocate that the EMU government deficit rules should be complemented by national expenditure rules.

According to Wyplosz (2002, p. 9), rules do not suffice for sound fiscal policy, because “they tend to be rigid and artificial (arbitrary debt or deficit limits, golden rules based on thin air and falsifiable accounts), which makes them ultimately impossible to defend in the face of public opinions”. Institutions are therefore essential for combining a credible commitment to long-run debt stability with sufficient short-run flexibility. Wyplosz discusses a constitutional approach (a limit on debt or deficit in the constitution, like in the states of the United States) and three approaches relying on independent outside institutions:

- International control and peer pressure, as with IMF programmes and the European Stability and Growth Pact.
- National fiscal policy committees or councils like the central banks’ monetary policy committees. The committee would consist of a small group of experts supported by a staff producing its own forecasts of the national economy and public finance. They would set annual deficit figures as a percentage of GDP ahead of the government budgetary cycle. They would also check the spending and revenue projections of the budget bill before it becomes law.
- A national court of wise persons. The court would share most of the characteristics of the fiscal policy committee but its decisions would not have the power of law. The court would issue guidelines on the size of the following year’s budget balance and report on

the previous year's budget execution. Its findings and recommendations would be made public, possibly presented solemnly to the government and Parliament.

In the Netherlands, independent national institutions are also very important for fiscal policy. However, the Dutch approach is in several respects quite different from those discussed by Wyplosz. For example, the CPB work does not give explicit guidance on fiscal policy targets; this is the task of the National Advisory Group on Budgetary Principles. This advisory group is actually a mix of inside and outside institutions, as it includes representatives from the most involved ministries and from independent expert institutions (CPB and the Central Bank).

This article provides an overview of the Dutch fiscal framework and its role in managing public expenditure.¹ Section 2 discusses the history of the Dutch fiscal framework since 1814. This historical perspective serves various purposes:

- It shows that the current framework has a long and typically Dutch tradition. For example, since 1945 the CPB has played an important role as independent expert on economic and fiscal policy. This role fits well in the Dutch tradition of consultation and coalition governments.
- It illustrates the tensions between official fiscal rules, changing economic circumstances and political pressure. Bookkeeping tricks can then help to circumvent official fiscal rules.
- It sheds light on the process of institutional learning, *e.g.* the failures and successes about how to manage rapidly increasing public expenditure and to organise cutback management when necessary.
- It shows that some specific circumstances are much less unique than commonly thought, *e.g.* high public debt, stagnating economic growth and substantial temporary non-tax revenues (revenues from Indonesia, Marshall aid and natural gas revenues).
- It demonstrates the important role of changes in the opinions of politicians and economists; several times this amounted to old insights being rediscovered or becoming relevant again.

The development of Dutch public expenditure since the Second World War was recently analysed by F. Bos (2006a). Why did public expenditure increase from about 30% of GDP in 1950 to 60% in 1983? And why did it decline to about 50% in 2003? Starting from a breakdown of public expenditure into nine functions (*e.g.* social security, health care, public administration, interest), the role of a wide range of determinants was investigated, such as demography, labour market participation, interest rate, public debt, relative wage increases in the public sector, productivity in the public sector (Baumol's cost disease model), and changes in the tools and tasks of the government. This article complements that analysis by looking at the role of the fiscal framework.

Section 3 discusses the current practice of the fiscal framework (*e.g.* the expenditure ceilings), the role of the Central Planning Bureau and the most recent changes recommended by the National Advisory Group on Budgetary Principles. Attention is paid to the preparations for the next government (*e.g.* the CPB analyses of election platforms and coalition agreements) and the fiscal framework during the term of government (*e.g.* how are unexpected windfalls and setbacks and changes in political plans managed?).

2. A historical perspective

2.1. Introduction

Three periods will be distinguished in discussing the development of the Dutch fiscal framework:

- 1814-1956: The balanced budget as official principle. This principle was accommodated with two other budgetary rules: no or limited increase in tax burden and, in the case of excessive debt, a priority for reducing this debt to a sustainable level. This extended balanced budget rule is often labelled a classical fiscal norm: the role of the government in producing and subsidising activities should be very limited, high tax rates harm the entrepreneurial spirit and the national economy, some public investments (roads, railway tracks, canals) have a beneficial effect on the national economy, but the role of public expenditure in stimulating demand is not acknowledged.
- 1957-1979: Keynesian deficit norms; the underlying principle was to better manage the national economy by the size of the government deficit.
- 1980 to the present day: Norms for reducing deficit and debt. These norms were supplemented by the idea that the drastically increased level of government expenditure and tax and social security contributions had more and more become a burden for future economic growth. Also, the efficiency and effectiveness of government expenditure were receiving more and more attention.

Table 1 provides a more detailed overview of the major changes in fiscal policy principles since 1814. Table 2 and Figures 1 through 5 present key statistics on the development of Dutch public finance since 1814.² The story behind these developments is told in the subsequent sections.

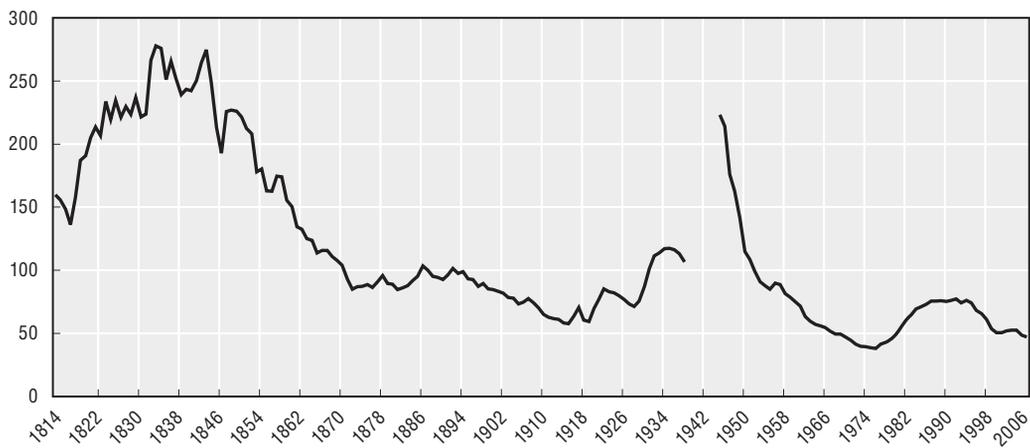
Table 1. **Fiscal policy in the Netherlands since 1814: Official principles**

1814-1956	I. Balanced budget, no or limited increase in tax burden and reducing excessive debt
1814-1859	Balanced budget for total revenue and expenditure, including the redemption of loans in order to reduce the high government debt.
1860-1889	Balanced budget for total revenue and expenditure, but for rail infrastructure and other extraordinary expenditure new loans are allowed.
1890-1906	Balanced budget for total revenue and expenditure; only new loans for specific temporary peaks in expenditure.
1907-1939	Balanced budget for current revenue and expenditure; only new loans for expenditure generating revenue at least equal to the extra interest payments ("golden rule of finance").
1945-1956	Balanced budget for current revenue and expenditure; new loans are allowed for all capital expenditure, but focus is to reduce high government debt by budget surpluses. The budget is embedded in a macroeconomic view of the national economy.
1957-1979	II. Keynesian deficit norms
1957-1960	Anti-cyclical deficit norm.
1960-1979	Trend-based deficit norm to match the surplus of private saving.
1975-1979	Increase in tax burden maximised at 1% of national income per year.
1980 to the present day	III. Norms for reducing deficit and debt
1980-1982	A maximum actual deficit.
1983-1994	A time path approach for reducing the actual deficit.
1993-	European norms for actual deficit and debt.
1994-	Trend-based budgeting with expenditure ceilings and a focus on reducing government debt have been embedded since 2000 in a forward-looking view on public finance. Incentives and cost-benefit analysis become major official tools for controlling and managing public expenditure.

Table 2. Fiscal policy in the Netherlands since 1814: Key statistics (per cent of GDP)

	Public debt	Public expenditure	Taxes and social security contributions	Other revenue	Public balance
1814	160	11	7	3	-1
1840	243	13	7	6	1
1860	155	12	7	8	3
1890	94	11	8	1	-1
1907	75	12	8	4	0
1921	70	19	15		
1939	107	29	15		
1948	176	35	28	10	15
1957	90	33	28	6	0
1973	42	45	39	7	1
1979	43	54	43	9	-2
1983	60	60	44	11	-5
1993	77	57	45	9	-3
2007	47	46	40	6	0

Source: Figures compiled by the author using various different sets of time series from Statistics Netherlands; public debt figures during the 19th century were obtained from the Dutch economic historian J.L. van Zanden.

Figure 1. Dutch public debt as a percentage of GDP since 1814

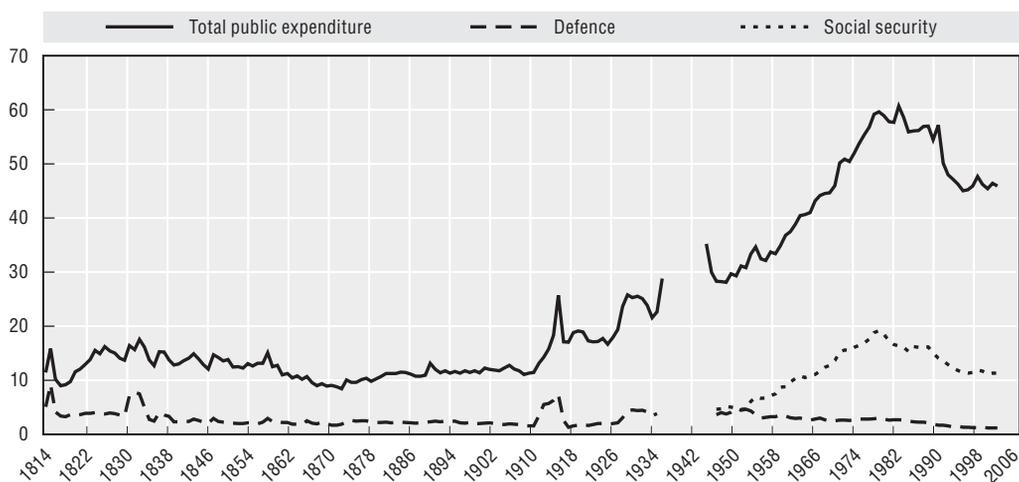
Source: Figures compiled by the author using various different sets of time series from Statistics Netherlands; public debt figures during the 19th century were obtained from the Dutch economic historian J.L. van Zanden.

2.2. The balanced budget (1814-1956)³

1814-1859: From chaos to consolidation

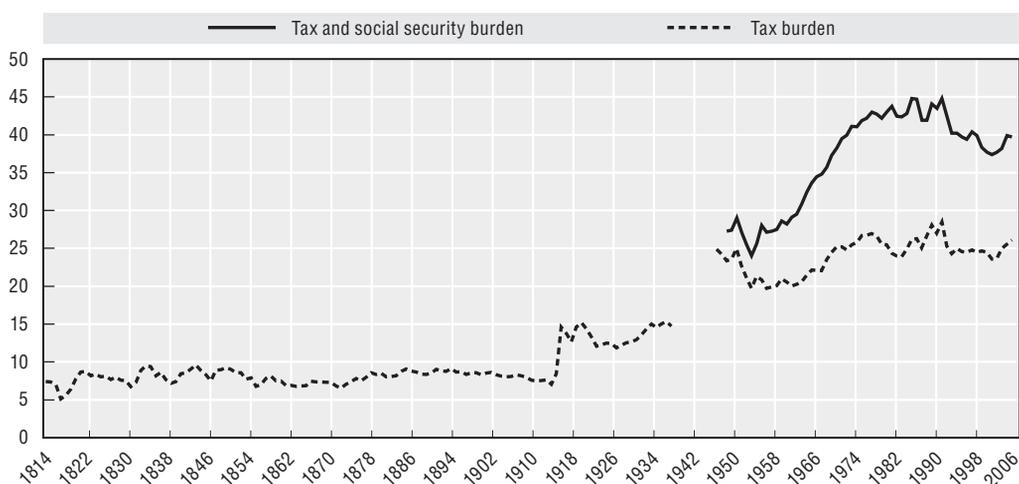
In 1814, after the departure of the French and two centuries of decentralised rule by the Republic of Seven United Provinces, the United Kingdom of the Netherlands was founded. King William I was an autocratic and unselfish ruler with hardly any countervailing power from the Parliament. He stimulated the construction of roads and canals (“canal king”) and granted cheap loans to industries like iron manufacturing, textiles and mining. His reign started with a substantial debt (160% of GDP excluding deferred debt⁴). As a consequence, the official fiscal norm was that total expenditure should not exceed revenue minus the redemption of loans. Furthermore, several ministers of finance expressed the intention of keeping public expenditure at a low level in order to minimise the tax burden.

Figure 2. Dutch public expenditure as a percentage of GDP since 1814



Source: Figures compiled by the author using various different sets of time series from Statistics Netherlands.

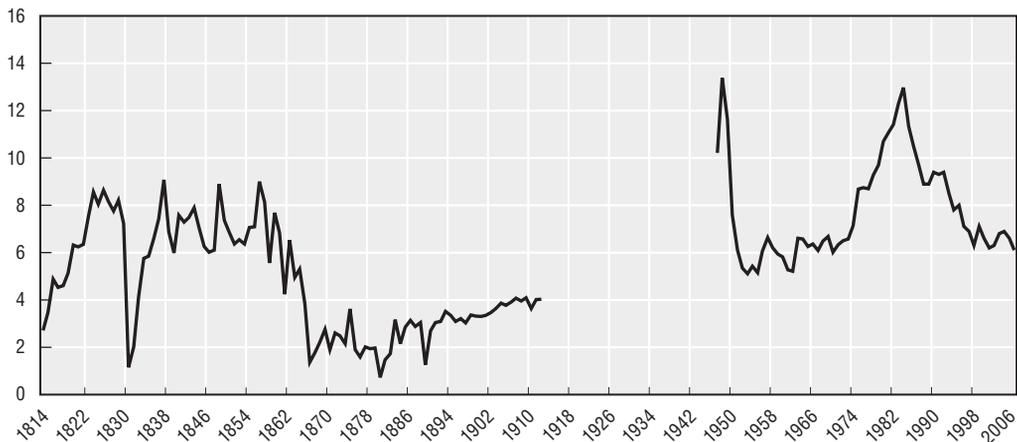
Figure 3. Dutch taxes and social security contributions as a percentage of GDP since 1814



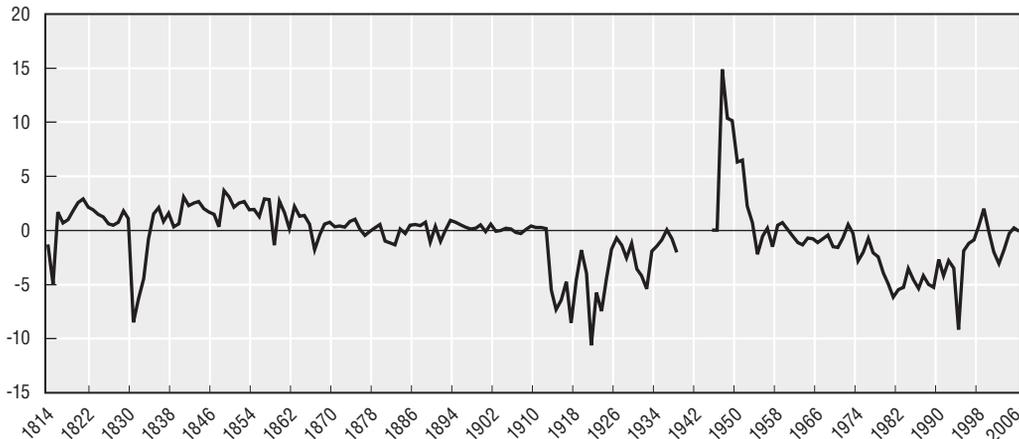
Source: Figures compiled by the author using various different sets of time series from Statistics Netherlands.

Nevertheless, despite stable and rapid economic growth and budgets that were officially but not materially balanced, government debt increased from 160% of GDP in 1814 to 243% in 1840. This increase was caused by high military expenditure (e.g. due to the war of secession with Belgium), expenditure on canals and industrial policy, lower tax revenue due to the abolishment of some excise duties, and higher interest rates fuelled by the rising debt.

The rapidly deteriorating situation of Dutch public finance reflected a Parliament with hardly any say in fiscal policy. Parliament could only accept or reject the complete budgetary proposal; parliamentarians could not propose any changes. Parliament also lacked fundamental information about the budget, as this information was generally not very transparent or complete and lacked detail.⁵ For example, the official budget contained

Figure 4. **Other government revenue as a percentage of GDP since 1814**

Source: Figures compiled by the author using various different sets of time series from Statistics Netherlands.

Figure 5. **Government balance as a percentage of GDP since 1814**

Note: After the Second World War, the government balance is derived from the national accounts and therefore equal to (very close to) the general government budget balance. However, for the period before the Second World War, more administrative concepts have been used, e.g. in the 1920s, substantial loans were included. For an explanation of the underlying concepts, see CBS (1959). In 1995, the annual subsidies to housing corporations were bought off; this increased government deficit by 4.9% of GDP.

Source: Figures compiled by the author using various different sets of time series from Statistics Netherlands.

only part of the interest payments and did not show secret loans to the government by the Central Bank. Furthermore, when the Parliament did not approve of expenditure on canals and industrial policy, the King decided to finance these expenditure via the fund intended for the redemption of government debt. Revenues were also artificially boosted by the sale of land and real estate and by recording future revenue as current revenue, e.g. income from the colony Indonesia.

After the secession of Belgium in 1839, the autocratic rule by King William was no longer accepted. New loans and the budget for 1840 were unanimously rejected by Parliament. Furthermore, Parliament demanded complete and well-audited public information about the budget, a sound budgetary policy, and redemption of the huge public debt.

The King abdicated and the constitution was changed; this resulted in much more power and information for Parliament. The budget became annual, complete, much more detailed and much better audited; the separate fund for the redemption of government debt was abolished.

Government debt was drastically reduced. In 1841, the deferred debt of 130% of GDP (NLG 800 million) was translated into normal debt by a conversion rate of 7%.⁶ In 1844, government debt of NLG 400 million with an average interest rate of about 5% was converted into a debt with an average interest rate of 3.5%. Crucial to the success of this conversion was the threat of introducing a new tax on income and property.

Since 1840, the central government's budget not only balanced formally but also materially. This was achieved without raising taxes and did not reflect only the savings on public debt and interest payments. It was also due to a very frugal policy with respect to defence and other government expenditure: for twenty years these expenditures stayed at the same level nominally. Furthermore, the increasing revenue from Indonesia allowed the redemption of public debt and the abolishment of some excise duties.

1860-1906: The need for public investments and the revenue from Indonesia

Limited progress in private railroad construction stimulated the government to regard railroad construction as a new public task. Initially this new task could be financed without additional loans and higher taxes. However, when revenues from Indonesia were rapidly shrinking and public debt was reduced to 155% of GDP in 1860, loans for financing railroad construction were officially allowed.

Twenty years later, when economic growth and tax revenues declined and revenues from Indonesia had nearly disappeared, loans for other purposes were also officially allowed, *e.g.* for the purchase of ocean-going ships and the construction of fortresses, canals and harbours. These new loans implied a break with 30 years of debt reduction.

An important innovation of the 1878 loan (see Lörtzer, 1997) was that it did not concern perpetual personal government bonds but anonymous bonds for a fixed period. This financial innovation increased the attractiveness of government bonds as a financial asset and made it much easier for the government to raise money in a short time. Nevertheless, when economic growth became better and tax revenues rapidly increased, only the expenditure for railroads and some canals were financed by loans. Pierson, the Minister of Finance, officially declared to prefer that also the latter expenditure was financed by current revenue.

This illustrates that official fiscal principles were applied flexibly and in view of the changing economic circumstances. In his textbook on economics, Pierson advocated a golden rule of finance (see Box 1). Some years later, as Minister of Finance, he did not want to spend the unexpected windfalls and therefore advocated a much tighter fiscal principle.

At the start of the 20th century, an increase in current expenditure, *e.g.* on education, was met by higher taxes. However, fiscal discipline was also relaxed, as loans were granted to the state mines and housing corporations and interest-free advance payments were given to the state's insurance bank and the colonies.

1907-1939: The golden rule of finance, war expenditure and economic crisis

In the government's budget for 1907,⁷ the golden rule of finance was declared to be the fiscal norm. This complied with Pierson's view on the best fiscal policy and was broadly in

Box 1. Pierson on fiscal policy

At the end of the 19th century, Nicolaas Gerard Pierson¹ was one of the most famous economists in the world and respected by contemporaries like Marshall, Hayek, Edgeworth and Bohm Bawerk. His textbook on economics (Pierson, 1884 and 1890) was used for teaching at Dutch universities for decades and was translated into English, French, Italian and Japanese. Pierson was not only a professor of economics, but also director and president of the Dutch Central Bank (1868-1891), Minister of Finance (1891-1894 and 1897-1901) and Prime Minister (1897-1901). He favoured a golden rule of finance² and low and stable tax rates (“tax smoothing”). However, for investments with a very uncertain return, temporary increases in tax rates are to be preferred. Each generation should balance its budget; in contrast to Ricardo, unbalanced budgets due to war and temporary bad economic circumstances were allowed. Some quotations from his textbook (Pierson, 1890, pp. 592-600) can illustrate and clarify these ideas.

“The best fiscal policy is the one that increases taxes the least. This implies that loans for productive investments should not be condemned but be approved. A municipality setting up a gas factory, constructing tram rails for leasing out or building water supply. A state spending millions on railways. ... Unnecessary is a tax intended to finance expenditure that, when financed via a loan, would generate revenues that are sufficient to pay for the interest... However, some exceptions should be made to this general rule. Firstly, when a state wants to reduce its government debt... Secondly, when a concurrence of favourable circumstances generates a temporary budget surplus, e.g. abundant harvests leading to extra tax revenues.”

“Permanent increases in tax rates are harmful and we therefore reject a structural government deficit. Sudden large temporary increases in tax rates are also harmful. We therefore prefer to finance unexpected new needs via temporary increases in loans. This conflicts with the opinion of Ricardo: war expenditure should immediately be financed via an increase in taxes and not via loans. This would imply that France during the war of 1870-1871 should have increased its taxes with 500 per cent in such a harsh time! Never was entrepreneurial spirit so low, the transport so difficult and production bereft of its best people. Under such circumstances Ricardo demands to raise taxes to a level even unbearable during normal times! ... We do not reproach England that it financed seven-twelfths of its war expenditure [in the period 1688-1856] by loans, but that the current generation should still bear the burden of these expenditures is lamentable. ... Each generation should bear its own burden. This can be achieved by not letting debt increase to an excessive level and by spreading the burden [of sudden large extra expenditure] over a certain amount of years.”

“In order to be justified, capital expenditure should be financially productive. However, who guarantees that the expectations about the financial returns are reasonable? The Netherlands is now digging its Merwede-canal: will the tax revenue increase with the interest on the expenditure for this canal?... In a well-governed municipality, there is no serious danger that chronic deficits arise due to all other expenditure. However, it is not at all unlikely that there will be expensive and loan-financed expenditure on facilities for trade, which will turn out to be financially unproductive.”

1. See Holtrop, 1978, and Heertje, 1992.

2. Loans are only allowed for investments generating revenues sufficient to cover at least the extra interest payments and the redemption of the loan.

line with fiscal practice since 1900. In the short run, the new official fiscal norm hardly affected the fiscal practice. Nevertheless, the new norm was immediately regarded by contemporaries as very important, as it gave a clear and rather strict view on what was allowed and what was not. Loans were allowed for financially productive investments, *i.e.* those very likely to generate a rate of return sufficient to cover the interest and redemption of the loan. However, loans were forbidden for “financially unproductive” investments like canals and fortresses, for incidental peaks in expenditure like the purchase of new guns or buying the freedom of slaves in 1867, and for normal current expenditure.

Challenges to the new official norm arose from the increasing expenditure on education and social assistance and from the two economic crises of the early 1920s and of 1930. One result was a substantial budget cut, *e.g.* a 17% reduction of the budget of all ministries in 1921. Increases in tax rates were not acceptable: “The high rates of taxes and tariffs are one of the major causes of the relatively high prices in our country and one of the most serious obstacles to economic recovery... the tax rates should be reduced to a level that is close to that in countries in our neighbourhood” (Budget for 1928, cited in Stevers, 1976, p. 127).

The official fiscal norm was not relaxed, *e.g.* by officially allowing loans for all capital expenditure irrespective of their direct financial return. Instead, many budgetary tricks were used to suggest that, according to the golden rule of finance, the budget was nearly balanced. For example, the transfers by the state to the social funds for old age and disablement were reduced without reducing the claims on these funds. Also, loans were granted directly or through special funds to many financially unproductive purposes, *e.g.* coastal defence, reclamation of land from the Zuiderzee, the fortress of Amsterdam, canalisation of the river Maas, private house building and social expenses linked to the economic crisis. Another bookkeeping solution was *ad hoc* reduction of capital consumption.

The transparency and accessibility of information on the state budget declined rapidly: the number of pages increased from 30 in 1850, to 1 500 in 1900 and 3 000 in 1930; this drastically increased the amount of detailed information, but a reliable and comprehensible overview of the state’s financial position was absent.

A Keynesian policy of stimulating demand resulted from the gradual extension of expenditure for which loans were, in practice, allowed. According to Stevers (1976, p. 139), in the 1930s the annual deviation from the official fiscal norm was about 2% of GDP. Considering the relatively low level of state expenditure in that period, this was a very substantial stimulus of demand.

1945-1956: Recovery and consolidation with Marshall aid

During the Second World War, the Netherlands was forced to pay EUR 4 billion for German expenses. As a consequence, government debt increased from about 100% of GDP in 1939 to over 200% in 1946. The priority of fiscal policy was to generate budget surpluses and reduce this debt. This was achieved by substantial cuts (*e.g.* the number of civil servants was reduced by 40% and war damage was partly compensated and only at pre-war prices), a tax on property gains during the war (EUR 1.4 billion in 1948 and 1949), a low interest policy, Marshall aid⁸ (EUR 1.6 billion during 1948-1952), very conservative estimates of tax revenues⁹ and increased efficiency in managing and monitoring

government expenditure, *e.g.* by new units for budget control and auditing and by the personal interference of Minister of Finance Liefstinck with nearly all items on the budget. The successful consolidation policy and the rapid economic recovery caused the public debt to drop to 109% of GDP in 1952.

The drastically improved financial position of the government allowed a reduction of tax rates in 1955; these had already been considered to be too high for a long time. The reduction of tax rates also fitted with the view of the Catholic party that the government had been accumulating wealth while citizens and companies stayed poor.

The budget of 1946 was presented in a national accounting framework showing supply and use in the whole national economy. Since then, the Dutch Minister of Finance also gives an official statement on the financial-economic development of the Netherlands. This macroeconomic view on fiscal policy implied a break with the classical fiscal norms and was inspired by the Keynesian revolution in economic thought and new United Kingdom practice (see Meade and Stone, 1941). It also reflected the substantial increase in the importance of government revenue and expenditure *vis-à-vis* the national economy.

The estimates on the national economy were provided by the CPB.¹⁰ The CPB was founded in 1945; Jan Tinbergen, the first Nobel Laureate in economics, was its first director. It is an independent institute financed from the budget of the Ministry of Economic Affairs. The task of the CPB was to help economic recovery by providing forecasts and economic advice. Once a year, in April, a “Central Economic Plan” is published; this report contains forecasts and analyses about the Dutch economy in the short run (the current year and following year).

The new macroeconomic view on the budget implied that the Ministry of Finance's estimates on public revenue and expenditure became linked to the CPB estimates of the national economy. The latter became the official consensus view on the national economy. As a consequence, the Ministry of Finance could no longer make its own estimates or assumptions on economic growth, unemployment, inflation and wage rates. This limits the possibility for the Ministry of Finance to manipulate its own estimates on Dutch public finance and increases the credibility of the ministry's estimates as the starting point of budgetary negotiations, *e.g.* between the Ministry of Finance and the Ministry of Social Affairs.

2.3. Keynesian deficit norms (1957-1979)

1957-1960: Anti-cyclical fiscal policy

The rapid economic recovery in production and spending, stimulated by the reduction in tax rates in 1955, deteriorated the balance of payments position, exhausted the foreign currency reserves and thus threatened the import of raw materials essential for further economic growth. A priority of the fourth Drees government was therefore to reduce the overheating of the Dutch economy and improve the balance of payments position. As tax rates were still considered too high, it was decided to reduce government expenditure. However, time delays in the implementation of these plans resulted *de facto* in a pro-cyclical policy (see CPB, 1963).

1961-1972: Trend-based deficit matching the surplus of private saving

In 1961, the trend-based deficit norm was introduced by Minister of Finance Zijlstra. The drastically improved financial position of the government had increased the claims

from politicians and lobby groups on the government budget and had weakened the position of the Minister of Finance. A trend-based deficit norm would remedy this, would ensure stability in decision making, would be simple and easy to explain, and would serve as a multi-annual framework for evaluating and comparing, at an aggregate and detailed level, the merits of extra public expenditure with those of less taxes (see Zijlstra, 1993). Furthermore, by matching public saving and private saving in the medium term, pro-cyclical policy could be avoided and long-term growth would be served.

At the start of the cabinet period, the real budget margin was determined for the state; the revenue and expenditure of social security funds were ignored. The real budget margin was calculated on the basis of expected trend-based economic growth, while assuming unchanged policy and tariffs. In principle, all expenditure increases and tax reductions had to be financed from this real margin. The only exception was the increase in salaries. It was assumed that this could be financed from the extra increase in taxes caused by inflation.

According to Romme, the leader of the Catholic party in Parliament, expenditure by the state should be constant as a percentage of national income. Following this “Romme norm”, the real budget margin for the state was split into two parts: expenditure could increase with the increase in national income, and the remainder could be used for reducing taxes (see Postma, 2006, p. 55, and Zijlstra, 1993, p. 31).

In the 1960s, economic growth was high and on average 5%. Increasing tensions in the labour market resulted in a wage explosion in 1964. At the same time, there was continuing pressure to expand collective arrangements. The entire budget margin was actually used to increase expenditure by the state. Tax increases were also often necessary to cover additional expenditure. Government salaries and social security expenditure rapidly increased, but were outside the real budget margin. The unexpected and rapidly increasing revenues from natural gas since 1970 improved the balance of payments and could therefore also be used for financing extra government expenditure.

As a consequence of the trend-based deficit policy and the specific economic circumstances, Dutch public expenditure increased from 34% of GDP in 1961 to 45% in 1973, while the tax and social security burden increased from 29% to 39%. Through a denominator effect, the flourishing economic growth ensured that public debt declined in this period from 75% of GDP to 42%.

In 1961, the CPB started producing a second annual publication on the Dutch economy: the “Macroeconomic Outlook” (MEV). It is published at the same time as the government’s annual budget. This implies that when the government presents its new plans to Parliament, a complete and independent forecast and analysis of the Dutch economy and public finance is also available.

Since 1971, an official advisory group (*Studiegroep Begrotingsruimte*, National Advisory Group on Budgetary Principles) reports on fiscal principles before the start of a new government. The group evaluates current fiscal policy principles and practice and gives advice for the next period of government. The group consists of representatives from the ministries most involved with financial-economic policy (e.g. Ministry of Finance, Ministry of Economic Affairs and Ministry of Social Affairs) and the directors from the CPB and the Central Bank. The new government is not required to follow the advice, but in practice the advice given has been very influential.

1973-1979: Reducing the increase in public expenditure and the tax burden

In the 1970s, the Dutch economy gradually stagnated. First, unemployment rose rapidly, then inflation and wage rises became high – fuelled by the high energy prices due to the 1973 oil crisis – and in 1975, Dutch economic growth declined structurally: from about 5% in the 1960s and early 1970s to an average of about 2% since 1975. This stagflation increased public expenditure, *e.g.* on unemployment benefits and government salaries, while reducing tax revenues. As a consequence, the small government budget surplus in 1973 was succeeded by a deficit of 3% of GDP in 1975.

According to the CPB, there was a supply-side problem: Dutch labour costs were too high, which was bad for the competitiveness of the Dutch economy and therefore affected economic growth. The policy recommendation to moderate the increase of wages was illustrated by the new CPB VINTAF model (see Don and Verbruggen, 2006). The earlier models can be characterised as Keynesian expenditure models with the emphasis on the demand side of the economy. In the new model, the negative effects of high wage rates on exports, profits, private investments and economic growth were made explicit.

The new model reflected major changes in economic thinking. The attempt to apply Keynesian policies, in particular in the United States and Britain, resulted in alternating periods of rising inflation and rising unemployment; this contrasted with the fine and stable trade-off between inflation and unemployment (the Philips curve) which the Keynesians sought. The monetarists advocated stable policy rules that reduce variability and uncertainty for private decision makers. They argued that the government serves the economy best by enhancing stability and acting predictably, not by trying to engineer carefully timed changes in policy actions. The new model also reflected a general change in economic circumstances: the rapid increase in imports and exports in the 1950s and 1960s resulted in more and more open economies in which Keynesian policies lost their effectiveness. As a consequence of these changes in economic thinking and circumstances, supply-side policies such as wage moderation became more and more popular among Dutch economists and politicians. The powerful secretary-general of the Ministry of Economic Affairs, Rutten, also played a major role in introducing supply-side thinking in the Netherlands.¹¹

The new CPB model attracted much public and professional attention and was widely discussed in the Netherlands. There was not only applause, but also heavy criticism. For example, can models provide a basis for formulating and implementing policy in a situation that is very different from the past, the period to which these models are geared both in terms of their specification and the estimation of parameters? Also, the lack of a monetary sector and the conflict with short-run income policy and employment were emphasised.

According to the Dutch Central Bank, the Dutch economy had a monetary problem: the high government deficit would raise interest rates and therefore increase the interest paid by the government, producers and consumers and deteriorate the exchange rate, thus harming economic growth and public finance. The policy advice was therefore to reduce the government deficit. Despite the rules of the structural budget policy, various expenditure-increasing measures were introduced in the 1970s. With the intention of reducing the surplus on the balance of payments, partly as a result of the increase in natural gas revenues, it was decided to stimulate spending. In the mid-1970s, Minister of Finance Duisenberg supplemented the structural budget norm with a norm for taxes and

social security contributions: the maximum increase allowed was 1% of national income per year. The idea was that this would limit shifting the cost of public spending from taxes and social security contributions to wages.

This norm for government revenue was not very strict, as it ignored the exploding gas revenues; these increased from 0.4% of GDP in 1973 to 2% in 1979 and even 4% in 1984. Furthermore, in order to avoid budget cuts, increases in the VAT rate were left outside the norm, and transfers by the state to the social funds were increased in order to avoid increases in the social security contributions. Finally, unexpectedly lower revenues were not compensated by extra budget cuts (see Toirkens, 1988, pp. 47-51).

2.4. Norms for reducing the deficit (1980-1993)

1980-1982: A maximum actual deficit

In the period 1979-1982, the budget deficit increased rapidly from 2% to 6% of GDP; this excluded the extension of loans to corporations. In 1978, following CPB estimates of medium-term economic growth, the multi-annual growth estimates used by the new cabinet were lowered from 3.75% to 3%. This was nevertheless far too optimistic: partly due to the second oil crisis, the average growth in 1979-1982 turned out to be -0.25%. The many downward adjustments in subsequent CPB economic growth estimates were only included in the budget for the current and forthcoming year. The macroeconomic assumptions for later years were hardly adjusted. The huge budget deficit and stagnated economic growth also implied a rapid increase in government debt: from 41% of GDP at the end of 1978 to 61% at the end of 1983. This was accompanied by high long-term interest rates, e.g. 9% in 1978, 11.5% in 1981 and 10% in 1982.

This period should be regarded as a period of transition. The structural budget policy remained in place, but the need for a much tighter fiscal policy was not yet accepted. For example, in 1980, Minister of Finance Andriessen proposed additional budget cuts of EUR 2 billion. However, the other ministers did not agree. They only wanted to accept a budget cut of EUR 1 billion, and Minister of Finance Andriessen resigned.

The government became more and more aware that public expenditure was out of control and that the budgetary organisation and information had to be improved drastically. The new National Advisory Group on Budgetary Principles was asked to report on this. The advisory group characterised budgetary practice during the 1970s and early 1980s¹² as:

Budgetary problems were evaded instead of solved. Multi-annual budgeting was left in favour of annual budgeting; this shift was motivated by the size of the budgetary problems, in particular in the long run. The substantial debudgeting of expenditure on housing, the increase in taxes, not or insufficiently specified budget cuts and the shifting from public to private expenditure by changes in regulation did not provide real solutions. The pressure on the decision-making process increased. ... The decision-making process became chaotic and focused more on symptoms and political presentation than on reorganising and downsizing public expenditure. The downward inflexibility and the upward dynamics of public expenditure were mostly left unchanged. [Studiegroep Begrotingsruimte (1983), "Zevende rapport", *Beheersbaarheid van de collectieve uitgaven*, p. 4]

Following this report and a report by the Court of Audit in 1984, budget control and budgetary decision making were drastically improved. For example, multi-annual budgeting

was re-introduced with horizontal and vertical overviews per item, i.e. an up-to-date overview of the expected development over a number of years and a summary of the changes made in successive horizontal overviews. The automated system with an up-to-date multi-annual overview of expenditure and revenue of all ministries (Interdepartmental Budgetary Consultation System, or IBOS; see Dutch Ministry of Finance, 2007) drastically improved the quality and transparency of information on the budget. The rules about budgetary decision making, in particular when budget cuts were required, became much stricter and linked to the most recent macroeconomic developments. The report also gave the push to a wave of deregulation: public corporations were (partly) sold (privatisation) and specific public service units were introduced, at arm's length from their ministries. Such deregulation would not only serve the efficiency of these corporations and units, but would also substantially reduce the scope for bookkeeping tricks, for example *ad hoc* increases of the dividends of public corporations and manipulation of the financing of social housing.

1983-1993: A time path approach for reducing the actual deficit

In 1983, reducing the deficit through a time path approach became the new fiscal norm: regardless of the cyclical development, the actual deficit should be reduced by 1% of GDP per year, while the burden of taxes and social security contributions was to remain stable and at a minimum.

A detailed coalition agreement was set up in order to realise substantial budget cuts, e.g. reductions in the salaries of civil servants and in the rates of social benefits. Setbacks, from both the expenditure and income sides of the budget (taxes, social security contributions and natural gas revenues), required frequent new cutbacks, which made the budget process very turbulent.

Ten years later, in 1993, public expenditure as a percentage of GDP was reduced by 3%, while the collective tax burden had slightly increased. Following the national definition of deficit, a substantial reduction had been achieved. In terms of the general government budget balance, which excludes financial transactions like loans, there was also a reduction of the deficit, but somewhat smaller: from 5% of GDP in 1983 to 3% in 1993; this was just sufficient to meet the EMU limit. However, public debt had continued to rise from 60% of GDP in 1983 to 77% in 1993.

In 1987, during discussions about the budget, Bert de Vries, the leader of the Christian Democratic Party in Parliament, raised the issue of the optimal size of Dutch public expenditure in the long run (see de Vries, 1987). Due to budget cuts, public expenditure had been reduced by 5% of national income since 1983. According to the coalition agreement, a further reduction of 2% of national income could be expected. Was this reduction enough? In de Vries' opinion, a small public sector was not a requirement for good economic growth performance.

However, some further reduction of public expenditure to 60% of national income was necessary for sound public finance and a healthy and stable balance between business and the public sector. In terms of current definitions and statistics, this 60% "Bert de Vries norm" corresponds to a size of public expenditure of about 51% of GDP.¹³

De Vries also recommended that the total budget for public expenditure should be broken down by policy area and take account of increasing ageing-related expenditure and

Box 2. European norms for actual deficit and debt

The treaty of Maastricht in 1992 implied that monetary policy became a responsibility of the European Central Bank and that national fiscal policy should comply with the European norms of actual deficit and debt. Deficit should not exceed 3% of GDP and debt must be below 60% of GDP or be declining towards the 60% norm at a satisfactory rate. According to the Stability and Growth Pact, the budget balance should be close to balance or in surplus in the long run.

As a consequence, the national concepts on public finance were replaced by the new European concepts based on the national accounts. This had several practical implications:

- A change in concepts. For example, according to the national accounts concept of budget balance, revenue and expenditure like taxes and interest payments should be recorded on a transactions basis. Financial transactions like loans and the sale of equity are irrelevant, and the government includes not only the state and social security funds, but also municipalities, provinces and many other non-market units mainly financed and controlled by the government.
- The concepts can no longer be changed over time by the government.
- A link to national accounts statistics and therefore a new role for Statistics Netherlands and a more limited role for the Ministry of Finance. The official figures reported to the European Commission and the European Central Bank should be consistent with those reported by Statistics Netherlands. In the end, therefore, Statistics Netherlands is responsible for translating the general European concepts into operational concepts for the Netherlands and for making the best estimates for these operational concepts.

The transition towards European concepts does not imply that bookkeeping and bookkeeping tricks have become irrelevant. Like all national concepts of taxable income, the European concepts on public finance can affect actual behaviour (*e.g.* stimulate leasing of capital goods to reduce the deficit or stimulate the sale of public equity in order to reduce public debt) and the specific institutional arrangements chosen.* Furthermore, they are not optimal from an economic-theoretic point of view (*e.g.* not forward-looking, and ignoring financial assets and implicit liabilities like future pensions) and may not well take account of the current economic situation in the Netherlands. They are the outcome of political negotiations in view of the circumstances in Europe in 1992 and the purposes of the criteria, *i.e.* to provide signals that countries are willing and able to live with the discipline required by EMU (see Bovenberg and de Jong, 1996, p. 18).

* On the merits and limitations of the EMU targets of government deficit and debt, see also F. Bos (2003a, Chapter 8; 2007).

decreasing expenditure for child benefits. This proposal for expenditure ceilings was not put into practice.

2.5. Trend-based budgeting (1994 to the present day)

The reduction of the government deficit enabled Minister of Finance Zalm¹⁴ to supplement the European norms with a national policy of trend-based budgeting. Since 1994, the major features of this policy are:

- cautious macroeconomic assumptions (however, since 2007, trend-based assumptions are used; see Box 6 in Section 3.4);

- net real expenditure ceilings for the whole term of government (four years);
- one main decision-making moment a year;
- a focus on reducing public debt.

Furthermore, there are also some supplementary fiscal rules and principles:

- A monitor for the *ex ante* micro tax and social security burden. This monitor shows the expected changes in taxes and social security contributions in billion euros due to official changes in tariffs and regulations. Unlike the collective tax and social security burden, the monitor is not affected by non-policy factors, *e.g.* purely administrative changes, general changes in consumption patterns or changes in the labour participation of women.
- An investment fund mainly financed by 40% of the natural gas revenues (FES fund; see Box 3); the remainder of the natural gas revenues are to be used for debt reduction.
- A signal value for the general government deficit of 2 or 2.5% of GDP. Surpassing this signal value implies that additional measures are to be taken and that the expenditure ceilings no longer apply. This may result in pro-cyclical policy.
- The use of incentives and cost-benefit analysis for reorganising and controlling public expenditure.

The combination of cautious macroeconomic assumptions and a long-term real expenditure ceiling limits the risk of budgetary turmoil resulting from economic setbacks. On the income side of the budget, automatic stabilisers are allowed to work freely.¹⁵ Income setbacks can be compensated in the budget balance and do not immediately require intervention by reducing expenditure or increasing taxes. The introduction of one main decision-making moment a year was intended to create a more stable and less hectic budgetary decision-making process, as was the case in the time path approach.

The framework is set with reference to a target for the fiscal balance based on longer-term budgetary sustainability considerations. The CPB analyses of short-term, medium-term and long-term developments in Dutch public finance are the backbones of this framework.

The trend-based fiscal framework, budget cuts, economic recovery and some specific factors, like the increased labour market participation of women and the rapid drop of interest rates on public debt (see also F. Bos, 2006a), resulted in a drastic reduction of public expenditure and debt: public expenditure fell from 57% of GDP in 1993 to 46% in 2007, and public debt was reduced from 77% of GDP in 1993 to 47% in 2007. However, the improvement in the net financial position of the Dutch government was much less favourable (see Box 4).

2.5.1. Public debt and sustainability

In the mid-1990s, Dutch politicians explicitly addressed the issue of sustainability by creating two funds: the FES fund and the old-age state pensions fund. These funds were to help ensure the sustainability of Dutch public finance in view of the exhaustion of natural resources and the expected rise in old-age state pensions due to ageing. However, the solutions offered were only formal solutions:

- Forty per cent of the natural gas revenues were to be used for financing FES investments. The motto was to turn underground assets into assets above ground. In particular, when cost-benefit analysis for FES investments was not obligatory (see Box 3), there was no guarantee that this would result in a higher return than alternative options, *e.g.* extra

Box 3. FES and the use of cost-benefit analysis in the budgetary process

The Economic Structure Improvement Fund (FES) was established in 1993. Government investments in infrastructure had fallen from about 3% of GDP in 1970 to 1.5% in 1993. By using the FES to earmark about 40% of the natural gas revenues for financing “additional investments of national significance”, the structure of the Dutch economy should be improved. Another FES revenue, but of secondary importance, is the interest on public debt saved due to the sale of equity of public corporations.

The Betuwelijn, a railway track from Germany to the Rotterdam harbour, was the first major project financed by the FES. It also initiated the reintroduction of cost-benefit analysis at the CPB.* At that time, the Dutch government was not at all happy with the CPB conclusion that such a publicly financed railway track would not be a good idea. Nevertheless, the Betuwelijn has been built, and at present transporters are not even willing to pay compensation for using the railway track. In 2004, an official parliamentary commission (Commissie Duijvestein) published a very extensive report about what went wrong with big infrastructure projects like the Betuwelijn and the high-speed railway between Amsterdam and Belgium. However, lessons have been learned and, for some years now, the financing of projects by means of the FES is scrutinised by a cost-benefit analysis. This has also stimulated the use of cost-benefit analysis for infrastructure projects not financed through the FES. All these analyses (see, for example, Dijkman and Verrips, 2002) should comply with the new national guidelines on cost-benefit analysis, *e.g.* with respect to the social discounting rate, the risk premium and the inclusion of indirect effects (see Eijgenraam *et al.*, 2000, and CPB, 2003a).

Since 1993, the FES has disbursed more than EUR 31 billion. In the beginning, the FES investments mainly focused on transport and mobility, *e.g.* roads, railway tracks and channels. However, expenditure on knowledge, innovation and the environment are now also financed through the FES.

Recently, changes in oil prices doubled natural gas revenues in some years. These windfall gains were not good for political calm and drastically stimulated the urge for spending. In a very short term, the CPB had to make cost-benefit analyses of a wide range of new projects. The new National Advisory Group on Budgetary Principles therefore recommended that the FES funding level should be decided at the start of the new government's term. The FES investments should be embedded in medium-term investment agendas and the projects should be selected with the aid of cost-benefit analysis which has to be proofed by the CPB or an independent scientific committee. The coalition agreement of the new government has accepted these proposals.

* In 1954, under the supervision of CPB director Tinbergen, a cost-benefit analysis was made of the delta works. After budget cuts in the early 1980s, such project appraisals were scrapped at the CPB.

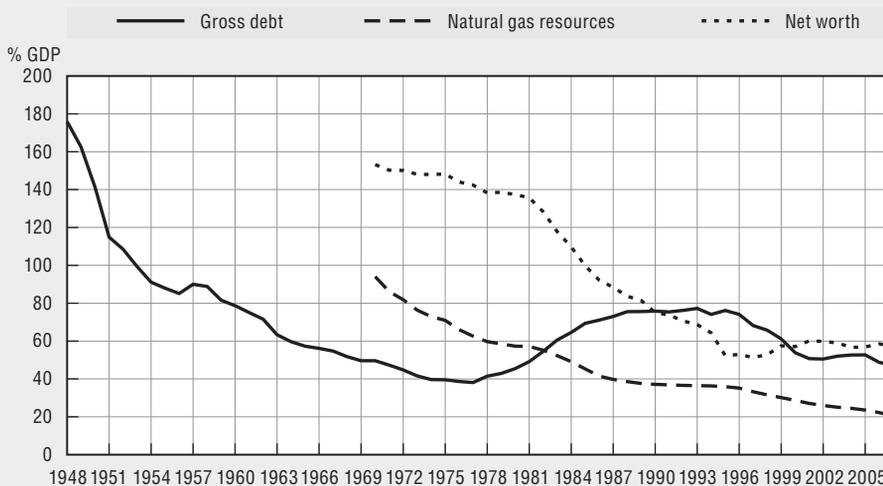
expenditure on education or extra reduction of public debt. As a consequence, the FES fund is important for changing the composition of public expenditure, but its contribution to sustainability is not clear.

- The remainder of the natural gas revenues (60%) is said to be used for reducing debt; this corresponds to an annual amount of 0.6% of GDP. However, the official medium-term policy targets for deficit and debt were not adjusted for the exhaustion of this part of the natural gas revenues. As a consequence, the exhaustion of natural gas revenues was not compensated by any extra reduction in public debt by means of a more ambitious deficit target.

Box 4. Gross debt is not a good yardstick for the financial position of the Dutch government

Gross government debt in the Netherlands declined from 176% of GDP in 1948 to 38% in 1977. During the 1980s, gross government debt increased to over 70% of GDP and then started to decline; at present, gross government debt is below 50% of GDP. This is substantially below the debt criterion of the European Economic and Monetary Union. However, this criterion only takes into account explicit debt and does not provide a complete picture of the financial position of the government.*

Gross government debt, natural gas stock and net worth of the government in the Netherlands, 1948-2007



Source: Figures compiled by the author using national accounts and other data from Statistics Netherlands.

The major assets of the Dutch government are the natural gas stock, the fixed capital stock and the financial assets. The discounted value of the natural gas stock was 90% of GDP in 1970. At present, the value has declined to 20% of GDP. The value of the fixed capital stock of the government, like infrastructure, buildings and computers, was 55% of GDP in 1970. It increased to 74% in 1983; since then it has gradually decreased to the current level of about 60% of GDP. The Dutch national accounts include data on the financial assets of the Dutch government since 1990. In 1983, the value of these financial assets was 45% of GDP. Mainly due to the sale of equity and the redemption of the loans to housing corporations, the value has declined to 24% of GDP.

If these assets are also taken into account, a totally different picture of the financial position of the Dutch government results. During 1970-1977, gross government debt decreased by more than 10% of GDP. At the same time, the value of the fixed capital stock increased by more than 10% of GDP. However, this was overshadowed by the decrease in the value of the natural gas stock. As a consequence, the net worth of the government decreased by 7% of GDP. In the period 1978-1993, the size of government debt doubled by an increase of 38% of GDP. The government's net worth decreased much more strongly, due to a decrease in the gas stock (-26% of GDP) and the financial assets (-9% of GDP in the period 1990-1993). Since 1994, Dutch gross government debt decreased by 27% of GDP. This substantial decrease in debt is more than compensated by a decrease in the natural gas stock and other property: net worth decreased by 14% of GDP.

Box 4. Gross debt is not a good yardstick for the financial position of the Dutch government (cont.)

Analyses of the sustainability of government finance are based on discounting future expenditure and revenue and taking account of present net worth. Following these analyses, sustainability is achieved by anticipating the forthcoming costs of ageing by an increase in net worth (see also sub-section 2.5.1 on public debt and sustainability). In particular due to the exhaustion of Dutch natural gas reserves, this is not the same as reducing government debt.

* This was already noted at the start of EMU. See, for example, van Hoek and Zalm, 1992.

- In 1996, a separate fund was installed for financing the expected rise in old-age state pensions (*AOW-spaarfonds*); each year about 0.7% of GDP is paid by the state to this fund. In order to save administrative costs, it was decided that the fund itself would only exist in the tables of the annual budget. The official medium-term policy targets for deficit and debt were not adjusted to take account of the payments to this fund. As a consequence, the formal existence of this fund is irrelevant for sustainability. The major inspirer of the fund, Jan van Zijl from the Labour party, realised this, but argued that this fictitious saving for the future served a “political-psychological effect”.

However, some years later, official medium-term policy targets for deficit and debt were explicitly linked to calculations on the sustainability of Dutch public finance. Following the seminal work by Auerbach, Gokhale and Kotlikoff (1991), the CPB began to calculate generational accounts for the Netherlands (see, for example, ter Rele, 1998; van Ewijk *et al.*, 2000, 2006). These calculations demonstrated that current policy arrangements (taxes, public expenditure on social security, education and health care, subsidies, etc.) in the Netherlands are not sustainable.

Under unchanged policies, the ageing population will lead to a sharp and structural increase in public expenditure, in particular on state pensions and health care. Government revenue from taxes on funded pensions will also increase, but not enough to cover the extra expenditure and the falling revenues from natural gas. As a consequence, in the long run without policy adjustments, public debt will explode and Dutch public finance will be out of control. Adjusting policy in time is efficient (tax smoothing limits the distortion of the labour and capital markets) and intergenerationally fair. Major solutions are to increase labour participation, adjust the ageing-related public expenditure (old-age state pensions and health care) and save for later by raising taxes or by cutting other public expenditure.

The forward-looking approach of generational accounting is the new paradigm for Dutch public finance.¹⁶ The report by the National Advisory Group on Budgetary Principles in 2001 was called “Stable and Sustainable Budgetary Policy” and the report in 2006 was entitled “Ageing and Sustainability”. The new keyword is sustainability: “The challenge for the next government is to make ‘sustainable’ choices. The measures should not only restore the sustainability of public finance, but should also be sustainable in social, economic and political terms. This means that measures should be assessed not only for their contribution to the public finances, but also for their implications for the intra- and intergenerational distribution of burdens and benefits, economic growth, and political and administrative durability. This will lead to robust choices which will do justice to the uncertainties which are inextricably linked to long-term developments” (Studiegroep Begrotingsruimte, 2006, p. 5).

Some recent figures can illustrate the importance of this paradigm switch for the Netherlands. According to the most recent CPB estimates, without policy change the general government budget balance in 2011 will be a surplus 1% of GDP. However, this is not sufficient for sustainability: the Dutch sustainability gap is then roughly 2.5% of GDP.

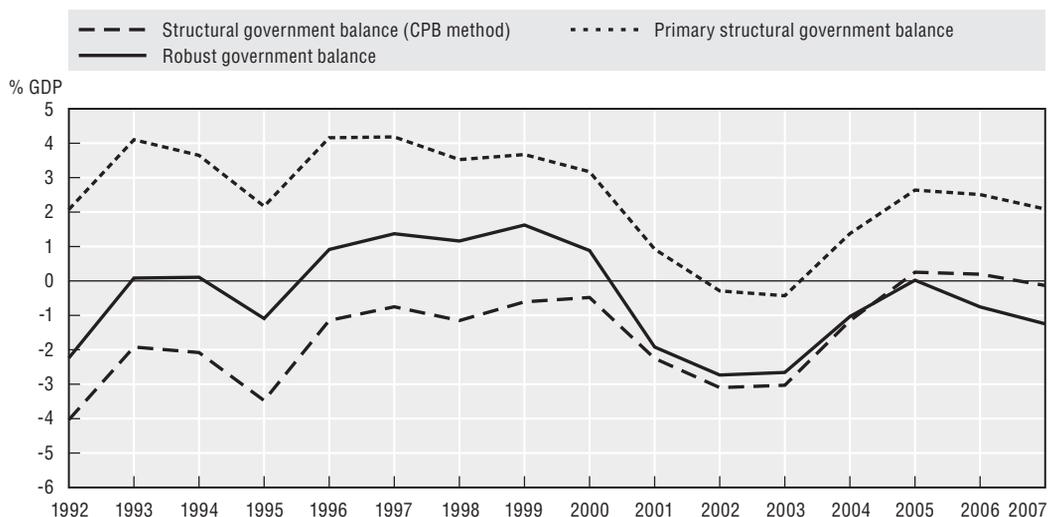
In order to monitor changes in sustainability, the actual and structural general government budget balances – i.e. the actual balance corrected for cyclical fluctuations – are very misleading. For this purpose, the concept “primary structural government balance” is commonly used, i.e. the structural budget balance minus interest payments. Current interest payments are ignored as, in the long run, interest payments and debt have only a limited impact on the sustainability of public finance.

The CPB has decided to use an alternative concept for monitoring sustainability: robust budget balance (see van Ewijk *et al.*, 2006). This concept differs in two respects from the primary structural budget balance. It is equal to the structural budget balance corrected not only for interest payments, but also for interest and dividend revenues and revenues from natural gas. In the primary structural balance, interest payments are left out, but interest receipts and revenues from dividends are still included. As a consequence, changes in the financial portfolio of the government, *e.g.* reducing government debt by selling public equity stock, change the primary balance. However, such changes are irrelevant for assessing sustainability, as they reduce revenue (interest and dividends received) by approximately the same amount as expenditure (interest payments).

The second difference with the primary structural balance reflects specifically Dutch circumstances. In about 25 years, Dutch natural gas reserves are expected to be exhausted. Temporary windfalls in natural gas revenues, *e.g.* due to changes in oil prices, will not help to make Dutch public finance sustainable. For monitoring changes in the sustainability of Dutch public finance, changes in the natural gas revenues are therefore ignored.

Using the robust balance – and not the structural balance or the primary structural balance – really matters. For the past 15 years, it has given quite a different picture of the changes in sustainability of Dutch public finance (see Figure 6).

Figure 6. Robust government balance, robust primary structural government balance and structural government balance in the Netherlands, 1992-2007



Source: CPB (2007), *Macroeconomic Outlook 2007*, p. 29.

Box 5. Incentives as a tool for managing and controlling Dutch expenditure

An early Dutch proponent of the use of incentives for managing and controlling public expenditure was Willem Drees Jr. (1955, 1985, 1995; see also de Groot *et al.*, 1992). Drees Jr. was successful as an applied economist in the Dutch public service (for example, as deputy director of the CPB and as director of the budget at the Ministry of Finance). In 1970, he started a new political party advocating budget cuts and a more efficient government. The proposals put forward in his many articles and as a member of Parliament reflected a solid understanding of incentives, moral hazard and external effects, *e.g.* with respect to social insurance, the environment, immigration and the budgetary process.*

In particular since 1990, the CPB is also investigating the efficiency and effectiveness of the rules and institutions underlying Dutch public expenditure. Major studies have been published about social security arrangements, the health care system and education. Also the impact of immigration on Dutch public finance has been investigated. In 1997, embedded in a general analysis of the interplay of institutions, trade-offs, performance and trends, a comprehensive comparison of German and Dutch economic institutions was published (CPB, 1997). The use of explicit incentives has become one of the major issues of the Dutch public-service modernisation agenda. CPB studies have investigated the usefulness of performance contracts and performance pay in various (semi-)public sectors, *e.g.* the social benefit administration, the police force, the education sector, universities, physicians and the major technical research institute in the Netherlands (TNO).

Incentives have now become a major tool for reorganising Dutch public expenditure. The policy measures taken include the following examples:

- Official minimum wages have been constant in real terms since 1980; this means a substantial saving on social benefits related to this minimum wage, *e.g.* social assistance and state pensions. It also implies a greater incentive for looking for paid work instead of receiving social assistance.
- Scholarships have become conditional on the performance of students.
- Since 1994, paid sickness leave has gradually become less a responsibility of the government and more that of the employer. Employers do not have to pay social security contributions for paid sickness leave, but should finance the paid sickness leave of their employees during the first two years. The purpose is to stimulate employers to reduce the sickness of their employees and in this way also reduce disability benefits.
- Municipalities could claim most of their social assistance expenses from the state. However, since 2004, they receive a fixed budget which is linked by the CPB to the macroeconomic developments. As a consequence, municipalities now have an incentive to reduce the number of social assistance benefits. This new policy was very successful, as social assistance benefits hardly increased in 2004 and 2005 despite a substantial increase in unemployment.

* According to Willem Drees Jr., widespread misunderstanding led to the rapid increase in Dutch public expenditure. The political colour of the cabinet was not relevant, as most of the time a right-wing coalition of Christian Democrats and Liberals (CDA and VVD) was in charge. Initially, during the 1950s and 1960s decisions were made – as well as possible – by comparing marginal costs and benefits (Drees Jr., 1985, p. 84). This principle was gradually put aside. “This is caused by a lack of interest for specific types of expenditure; the exceptions are lobby groups. At school and in the national economy, business economics dominates. In general economics and public finance, the focus is on macroeconomic aspects, government deficits and taxes. ... Official and scientific papers are full of misunderstanding, *e.g.* that public expenditure provides collective services. However, most of the expenditures are subsidies for individual services and income transfers... Many expenditures do not have any effect at all, as they are counteracted by other expenditure or tax measures. ... A misunderstanding about politicians is that they are obsessed by maximising the votes for the next election. This is not true in the Netherlands” (Drees Jr., 1985, p. 15).

2.5.2. Performance budgeting as a tool for increasing efficiency

In 1999, the project “From policy budgets to policy accountability” (*Van beleidsbegroting tot beleidsverantwoording*, or VBTB) was launched to reorganise the budget (see Debets, 2004). The purpose was to improve the transparency and accessibility of the budget and to improve the efficiency of government policy by a link with the results of government actions. For each policy field, the budget was to give the answer to three questions:

1. What do we want to achieve (e.g. a decrease in crime by 20% in 2010)?
2. What will we do to achieve it?
3. How much will we allow it to cost?

In this way, budgetary policy could focus more directly on the achievement of political objectives. Nevertheless, when answering the three initial questions, the budgetary framework is still constrained by the financial ceilings, e.g. the EMU criteria and the national fiscal goals.

The new budgetary structure was evaluated after five years (IOFEZ, 2004). Despite some clear improvements,¹⁷ many objectives in the budget were still vague, and it was often unclear to what extent the government contributes to achieving the objectives. It was concluded that the two purposes of VBTB were hard to achieve with only one tool, i.e. the budget. Transparency of the budget is not served by specifying the objectives for each item. Efficiency of government policy is not served by an explicit link to the format of the budget. Each purpose should therefore be served in a different way. The budget should focus on its role of authorisation and control: the government asks permission for expenditure and needs to justify the expenditure afterwards. Efficient government policy should be served by all kinds of specific *ex ante* and *ex post* studies. Quantification of objectives can be useful, but should be restricted to where it is really useful.

3. The current fiscal framework and the role of the Central Planning Bureau

3.1. Introduction

Major elements of the current trend-based fiscal framework, like the link to calculations on the sustainability of Dutch public finance, the role of cost-benefit analysis and the introduction of incentives, were discussed in Section 2.5. In this section, the focus will be on the budgetary process, the role of the CPB and some specific aspects of the current framework that are frequently misunderstood.

In Section 3.2, the road to a new medium-term framework will be discussed. The annual budgetary process is the topic of Section 3.3. In Section 3.4, the use of expenditure ceilings and cautious economic assumptions will be investigated. Furthermore, the most recent major recommendations by the National Advisory Group on Budgetary Principles are summarised. For people from other countries, the important role of the CPB in Dutch financial-economic decision making is often puzzling and incomprehensible. In Section 3.5, the role of this important and typically Dutch institution is therefore further discussed.

3.2. The road to a new medium-term framework

One year before elections, the road to a new coalition agreement and medium-term framework starts. The CPB makes provisional estimates of the Dutch economy and public finance in the medium term. These estimates are later updated and supplemented with an analysis of Dutch public finance in the long run.

Table 3. **The road to a new medium-term framework**

One year before the elections	CPB estimates of the Dutch economy and public finance in the medium and long term, assuming no changes in policy. Report by the National Advisory Group on Budgetary Principles.
Five months before the elections	New CPB estimates of the Dutch economy and public finance in the medium term, assuming no changes in policy.
Two months before the elections	CPB analysis of the election platforms.
After the elections	CPB analysis of the coalition agreement.
Some months after the elections	The new medium-term framework based on new CPB estimates for the Dutch economy.

All these estimates serve as inputs for the National Advisory Group on Budgetary Principles. The government makes explicit which topics should at least be addressed by the advisory group. Over a period of roughly six months, this group writes a report evaluating past budgetary performance and making recommendations for the next period of government. The Ministry of Finance serves as the secretary of the advisory group. The CPB provides estimates on the economy and public finance and is often asked to take a further look into some specific issues, *e.g.* conduct an analysis of the consequences of alternative assumptions and principles.

In the run-up to the general elections, the CPB publishes an analysis of the economic effects of election platforms.¹⁸ The CPB conducts this analysis at the request of the political parties in question. In November 2006, eight election platforms were analysed (see CPB, 2006). This was the sixth occasion since 1986 that such an evaluation of election platforms was done.

The CPB study makes it possible to compare the parties' election platforms on economic aspects. Key elements of the analysis are the implications for public finance, macroeconomic developments and purchasing power.^{19, 20} As far as the budgetary effects are concerned, the CPB devotes attention to the implications of the proposed measures for the revenues and expenditures of the public sector as a whole (general government budget balance, debt and sustainability in the long run).

The CPB analysis ("Charting Choices") helps to broaden understanding of the contents of the parties' election platforms and extends their comparability in several ways:

- The same underlying economic base scenario for the next government's term in office is used to evaluate each election platform. This means that differences in outcomes between the parties cannot be due to diverging assumptions about economic developments.
- The political parties have to elaborate and explain their proposals in such a way that the CPB is able to analyse them. This means that the parties cannot (on the basis of unfounded optimism) exaggerate the benefits and/or understate the costs of their proposals.
- The policy proposals and their financial consequences are presented in a comparable way. This means that the parties' commitments in the financial and economic sphere can be compared to each other.
- The CPB systematically investigates the consistency of the programmes. In their initial proposals they are sometimes guilty of "miscalculations", but such issues are invariably resolved in the detailed discussions between the party in question and the CPB.

- The CPB only includes in its analysis measures which are expected to be technically and legally feasible. If the CPB does not have the in-house expertise to judge the feasibility or legality of certain proposals, it obtains advice from other institutions.

“Charting Choices” is not only useful for voters, maybe not even in the first place. As soon as the results of the CPB analysis are published, the political parties use these results to defend their policy proposals. It is not unusual for politicians to bombard each other with CPB figures during election debates.

The study comes in handy after the elections, during the formation of a new coalition agreement. In the Netherlands, parties usually form governments on the basis of wide-ranging coalition agreements. The coalition agreement plays an exceedingly important role during the government’s term in office. It sets out the result of the give and take among the coalition partners on many policy issues. It is also the starting point for discussions on the government’s decisions about whether or not new developments demand a policy response.

The CPB study offers an initial overview of the economic and financial implications of the parties’ proposals. It is therefore a good starting point for negotiating the terms of a coalition agreement. This applies not only to the proposals of parties involved in the coalition agreement. In practice, the CPB overview serves as a database on all kinds of policy measures that could be considered during the negotiations; in particular, the budget cuts and extra revenue-generating measures by other parties are a popular source of inspiration.

The CPB also provides an analysis of the coalition agreement for which the previous analysis of the election platforms is a great help. When no entirely new policy measures are proposed, a standard analysis (i.e. checking on the plausibility and feasibility of the measures proposed and their *ex ante* budgetary implications, macroeconomic effects and effects on purchasing power) can be done within a relatively short time.

The Ministry of Finance ultimately calculates the medium-term framework. For example, the level of the real expenditure ceilings is fixed considering the coalition agreement and the most recent information about expenditure and revenue. Other ministries, in particular those responsible for social affairs and health care, may also have a clear opinion on the development of their expenditure. Estimates by the CPB, in particular those on social security, taxes and health care, serve as a critical benchmark for fixing the medium-term framework.

This process for deciding on a new coalition agreement implies that policy measures are checked in an early stage for their feasibility and their consequences on the national economy and public finance in the medium term and long run. Before the elections, the policy measures proposed by all major political parties are analysed. In drawing up the coalition agreement, the policy measures in the successive drafts are also analysed.

3.3. The annual budgetary process

The annual budgetary process is summarised in Table 4. The CPB plays two important roles in this process. First, it provides the macroeconomic estimates regarding, for example, economic growth, prices and wage rates, for the budget. These estimates also play an important role in wage negotiations for the public and private sectors. Second, the CPB provides elaborate estimates on Dutch public finance (see Table 5 for an overview of the standard tables, and F. Bos, 2003b, for a more extended explanation). As a consequence,

Table 4. The annual budgetary process

T is the budget year

Due dates	Activities
November in T – 2	Budget circular from the Ministry of Finance to line ministries to start internal preparations.
January/February in T – 1	Provisional “Central Economic Plan” by the CPB to ministries containing updated macroeconomic and public finance estimates for the budget year and beyond.
February in T – 1	Line ministries send policy letters to the Ministry of Finance indicating spending priorities and likely budgetary developments.
March/April in T – 1	Preparation of the recalibrated multi-year expenditure framework, with proposed shifts in allocations/cutbacks brought to the cabinet by the Ministry of Finance, based on policy letters.
March in T – 1	“Central Economic Plan” published by the CPB on the basis of unchanged policy.
April/May in T – 1	Decision by the cabinet on the expenditure side of the budget. Sent by the Ministry of Finance to line ministers in the “totals letter”.
May/June in T – 1	Detailed negotiations between the Ministry of Finance and line ministries on the composition of their budgets.
Early June in T – 1	“Provisional Macroeconomic Outlook” by the CPB to ministries; this contains updated estimates on the Dutch economy and public finance and incorporates new fiscal decisions.
June in T – 1	“Spring Memorandum”: Parliament is informed of the outline of the current year’s budgetary plans and on budget execution in the first quarter.
August in T – 1	Further fine-tuning of the budget on the basis of the “Provisional Macroeconomic Outlook” provided by the CPB to ministries, and decision making on the income side of the budget.
Third Tuesday in September in T – 1	Submission of the state budget to Parliament together with the CPB “Macroeconomic Outlook” (MEV).
September in T – 1	Discussion of the state budget in the second chamber and then in the first chamber of Parliament. First general political and macro-fiscal discussion, then discussions per budget chapter. Input for general discussion also includes the CPB analysis of opposition parties’ budgetary proposals.
Before end December in T – 1	Approval by both chambers of Parliament of all budget chapters.

there is always a critical benchmark for the estimates on Dutch public finance by the Ministry of Finance. An essential feature of the CPB estimates is that they can be based on the most recent budgetary information and decision making, even when this information is not yet officially published.

In general, for the annual debate with the government about the budget (in September), several opposition parties ask the CPB to also analyse their alternative budgetary proposals. The CPB analysis of their plans serves as a check (*e.g.* are they realistic?) and also gives an indication of their short-run economic effects in terms of economic growth, inflation, general government budget balance and purchasing power of various groups of households.

3.4. The current framework and recommendations for change

The Dutch expenditure ceilings are commonly misunderstood. Examples of such misunderstanding are:

- The expenditure ceilings are based on conservative estimates of public expenditure.
- The expenditure ceilings assume gradually increasing or decreasing changes in public expenditure.
- The expenditure ceilings are fixed in terms of GDP.
- Due to the use of expenditure ceilings, unexpected deteriorations in the general government budget balance can only occur due to unexpected reductions in tax and social security revenues, *e.g.* related to unexpected lower economic growth.
- Changes in the deflator for the expenditure ceilings automatically imply changes in the margin for expenditure under the ceiling.

Table 5. **CPB standard tables for monitoring and analysing Dutch public finance**

Table	Explanation
Key figures of Dutch public finance	<ul style="list-style-type: none"> Public revenue, expenditure, government balance and debt as a percentage of GDP. Expenditure broken down by type of expenditure (<i>e.g.</i> compensation of employees, capital formation, social benefits in kind via market producers, interest, income and capital transfers in cash); income and capital transfers in cash broken down by sector of destination (households, corporations and rest of the world). Non-tax revenue broken down into sales, natural gas revenues and other. General government balance broken down by type of government (national, other central, local, social security funds). Actual general government balance and structural general government balance (adjusted for cyclical effects). Some other information, <i>e.g.</i> annual change in employment in general government, change in wage rate in general government, ratio of inactive <i>versus</i> active. Footnotes indicate quantitative impact of major incidents and institutional changes; this is essential for proper interpretation.
Public expenditure by function	<ul style="list-style-type: none"> Public expenditure by function as a percentage of GDP, volume changes (%) and price changes (%), GDP volume and price change. Functions: public administration, safety, defence, infrastructure, education, health care, social security, transfers to corporations, international co-operation, interest. Functions only partly COFOG, linked to national accounts via type of expenditure and industry classification/sector of destination/type of asset. Volume of compensation of employees (part of public administration, safety, defence and education): employment in full-time equivalents; residual change in compensation of employees = price change (= change in average wage rate). Volume of social security: for major regulations: number of social benefits; other: value deflated by price change GDP. Volume of health care: linked to volume of social benefits in kind via market producers (only the health care part). Volume of infrastructure: volume change government's gross capital formation in infrastructure. Price of interest: average interest rate on gross debt. Volume transfers to corporations and international co-operation: value deflated by GDP.
Volumes of major social benefits	Absolute number of social benefits for major regulations, <i>e.g.</i> old age act, sickness act, disablement act, unemployment act and social assistance act.
Public expenditure and the expenditure ceilings	A comparison in billion euros of the expenditure ceilings drawn up at the start of the government and the most recent estimate of the expenditure subject to the ceiling.
Social security contributions	Overview of official tariffs, thresholds (income, 65+), maxima and deductible items (<i>e.g.</i> for working).
Micro tax burden	An overview in billion euros of the changes in the micro tax and social security burden due to policy; corrections are made for shifts between private and collective arrangements (<i>e.g.</i> health care and social security).
Tax and social security revenue	<ul style="list-style-type: none"> An overview of the major taxes and social security revenue as a percentage of GDP (<i>e.g.</i> wage tax, VAT and corporation tax). The annual change as a percentage of GDP is broken down into changes due to policy and other changes (<i>e.g.</i> changes in economic growth, purely administrative changes in the collection of tax revenue).

A major purpose of this section is therefore to address these misunderstandings. Furthermore, the Dutch practice of cautious macroeconomic assumptions is discussed in Box 6. Finally, the most recent major recommendations of the National Advisory Group on Budgetary Principles are listed. This list gives an impression of the strengths and weaknesses of the current framework; it also gives an impression of the work of this important advisory group.

3.4.1. *Expenditure ceilings reflect the coalition agreement and realistic expenditure estimates*

The multi-annual expenditure ceilings are determined at the start of a new term of government. They are not simple policy ambitions about the size of public expenditure as a percentage of GDP without any clear and realistic underpinning. They are bottom-up calculated levels of expected public expenditure in constant prices. They reflect the coalition agreement and are intended to be realistic estimates of the expected expenditure.

Box 6. Cautious economic assumptions?

Since 1994, cautious trend-based estimates have been used in formulating the general government budget balance and debt targets of the coalition agreement (EMU deficit and debt). This reduces the likelihood of budgetary disappointments disrupting the decision-making process and increases the likelihood of attaining the budgetary targets.

The uncertainty about the medium-term development is large. Recently, Kranendonk and Verbruggen (2006) evaluated the accuracy of the medium-term CPB forecasts in the past 30 years. The average forecasting error for most of the macroeconomic variables was less than 0.3%. However, these small average errors are the net result of substantial over- and underestimation that cancel out to a great extent. For GDP volume growth, the average absolute forecasting error was 1.1%.

For managing public finance, uncertainty consists not only in the macroeconomic development, but also in many specific incidents and developments. In 2000, there was a general government budget surplus of 2% of GDP, but already in 2003 the Dutch government deficit was pushed beyond the 3% deficit limit, and savings and cuts had to be made during an economic downturn. Various specific factors account for this rapid deterioration of the general government budget balance. The sale of telecom frequencies pushed the surplus in 2000 upwards by 0.7% of GDP, while an unexpected deficit of the local government in 2003 increased the general government budget deficit by 0.6% of GDP. The revision of the tax system in 2001 was accommodated by a structural tax relief of 0.5% of GDP. Expenditure on health care was structurally enlarged when business cycle fluctuations generated temporary extra margin under the expenditure ceiling. Finally, two major items of tax deduction grew much more than expected. These concerned the interest on mortgages and the private pension contributions; the latter had increased due to the crash in the stock market.

Since February 2007, there has been a new government in the Netherlands. According to the coalition agreement, the fiscal target is a structural general government surplus of 1% of GDP in 2011. Contrary to Dutch fiscal practice since 1994 and the recommendations of the National Advisory Group on Budgetary Principles, the basic economic assumptions will be trend-based and not cautious. Expenditure ceilings will be used again; but when the actual general government budget balance exceeds the deficit limit of 2% of GDP (“a signal value”), additional policy measures are to be taken, *e.g.* budget cuts.

These new fiscal principles, in particular the dismissal of cautious economic assumptions, reflect the opinion of the leader of the Labour party and the new Minister of Finance. In his opinion (W. Bos, 2006), cautious economic assumptions do not serve political stability, because they create “windfalls on paper... and seduce politicians to play for Santa Claus during election years. They also stimulate pro-cyclical policy: during an economic boom, windfall gains on the revenue side can be used for reducing taxes, and in economic bad times there will be a rising deficit and a need for additional budget cuts. This is economically not very meaningful and only serves the political agenda of conservatives and liberals for a smaller government... My alternative is a fiscal policy based on a realistic but not cautious estimate of economic growth. It is linked to the structural deficit and not the actual deficit. This is cyclically neutral, disciplines short-sighted politicians and is better than current fiscal policy, both economically and politically.”

Cautious economic assumptions about growth only affect these estimates to a limited extent. For example, current expenditure on education and police are mainly extrapolated on the basis of demography. Furthermore, higher volumes in unemployment benefits are

partly compensated by a more modest development of wages. The major exception is therefore the expenditure on health care: the high income elasticity of health care (*e.g.* reflecting its “luxury good” character) ensures that a lower assumption of economic growth implies also a lower estimate of health care expenditure.

For determining the expected social security benefits and health care under the expenditure ceiling, the CPB estimates serve as a critical benchmark. This helps to avoid (political) biases in determining the expenditure ceiling. Nevertheless, estimating the budgetary effects of new policy measures is subject to substantial uncertainty, and estimation errors influence the margin for expenditure under the ceiling. For example, a new policy measure that is much more successful in reducing expenditure on social assistance benefits leads to an unintended additional margin for expenditure.

The coalition agreement may imply specific time patterns, *e.g.* first the “sour” of budget cuts and then the “sweet” of tax relief and extra expenditure. These patterns could reflect political economy considerations (maximising the votes for the next election), but may also be motivated by administrative arguments: it takes time to organise reforms, and their benefits will arrive with substantial delay. Such previously agreed time patterns in government expenditure and revenue may unexpectedly imply a pro-cyclical policy.

3.4.2. Delimitation, flexibility and possibilities for substitution

In 2006, net expenditure under the ceilings amounted to 38% of GDP. Three different ceilings are distinguished: net state expenditure narrowly defined (18%), expenditure on social security and labour market affairs (11%) and expenditure on health care (9%).

The ceilings cover not only expenditure, but also some revenue such as fines, school fees, dividends of the Central Bank and state corporations, and interest received. This implies that extra expenditure under the ceiling could be financed by increasing some of these revenues and that setbacks in these revenues should be compensated by reducing expenditure. The IMF questions the merits of including such revenues under the expenditure ceiling.

Table 6. **Expenditure ceilings and the general government budget balance as a percentage of GDP, 2006**

State taxes and social security contributions	38.4
Net expenditure by the state, narrowly defined	18.4
General transfer to municipalities and provinces	2.7
Revenues of the old age fund	-0.7
Other revenues (<i>e.g.</i> fines, school fees, dividends, interest received)	-1.4
Other net expenditure (<i>e.g.</i> wages, transfers to schools, interest payments)	17.8
Expenditure on social security and labour market	10.8
Expenditure on health care	8.5
Total net expenditure under the expenditure ceiling	37.7
Net other expenditure	0.6
Natural gas revenues	-1.5
Old age fund (minus)	0.7
FES expenditure on infrastructure and innovation	0.4
Social assistance in cash for health care	0.5
Other (<i>e.g.</i> cash <i>versus</i> accrual, local government, administrative costs for health care)	0.4
General government budget balance	0.2

Source: Figures compiled by the author using information from the Dutch government budget 2007 and the Dutch national accounts.

In principle, three different budget sectors with specific expenditure ceilings for each sector are distinguished. However, since 1994, shortages at one ceiling (notably health care) were several times compensated by surpluses at other ceilings.

To some extent, shortages and surpluses can also be shifted in time. For example, departments are allowed to shift 1% of their expenditure to the successive year. Furthermore, the expenditure under the ceiling is mostly recorded on a cash basis. As a consequence, by advancing or postponing payments and receipts (*e.g.* with respect to infrastructure) expenditure under the ceiling can be managed.

Since 2002, there is a clause that cyclical windfall in expenditure under the ceilings should not be spent. However, these windfalls were not precisely defined; as a consequence, the clause can be used by the Minister of Finance in a discretionary and flexible way.

The criteria for expenditure to be financed by means of the FES were not very strict. As a consequence, some extra expenditure and the abolishment of school fees for 16 and 17 year olds have been financed by the FES fund. The most recent recommendations of the National Advisory Group on Budgetary Principles were therefore to demolish the so-called “FES bridge” by introducing more strict criteria for FES investments.

Public health care expenditures are a major challenge for the expenditure ceilings. They are a major item of public expenditure, have been increasing rapidly for many years and may also grow more than expected when drawing up the expenditure ceiling. This rise in public health care expenditure can be reduced by shifting between public and private expenditure, *e.g.* by reducing the standard health care package. In the Ministry of Finance’s monitor of the tax burden, this is not regarded as an increase of the tax burden. Such solutions for health care expenditure exceeding the ceiling are thus allowed. But in the CPB concept of the tax burden used for monitoring and analysing Dutch public finance, such solutions are nevertheless presented as an increase in the tax burden.

The expenditure under the ceiling might also be “controlled” by substitution with tax expenditure (see Hemels and Ros, 2006). However, in principle, the ceilings are corrected for such institutional changes. Furthermore, new tax expenditure could be signalled by a separate monitoring of such expenditure. In the period 1994-2001, there was no explicit monitoring or evaluation of tax expenditure. The budget of 2001 contained a first set of criteria for tax expenditure. In the budget of 2003, new explicit criteria were introduced for tax expenditure, *e.g.* is the purpose SMART (specific, measurable, agreed, realistic and timebound), why is government intervention required and why is tax expenditure the preferred tool?

Since 1999, the budget contains a separate chapter on tax expenditure; this includes an overview of the major tax expenditure, *e.g.* income tax reduction for specific groups, VAT differentials and tax reduction for employers with employees on parental leave or long-term unemployed. According to the most recent overview in the budget, tax expenditure as a percentage of GDP was 2% in 2006. However, some experts argue that several major items of tax expenditure are ignored, *e.g.* the different treatment of pension savings *vis-à-vis* other savings,²¹ the personal income tax deductibility of interest on mortgages, labour tax credit, child tax credit and the tax credit for bread winners (*i.e.* for households where only one of the parents earns labour income). This does not serve a proper allocation: unexpected increases in major items of expenditure like health care and education are restricted by expenditure ceilings, while unexpected increases in major items of tax expenditure are not restricted at all and even fully ignored.

Alternative substitutes for expenditure under the ceiling are guarantees or cheap loans. The budget also contains an overview of these guarantees, *e.g.* for loans by public and private non-profit institutions. According to the budget of 2007, the financial risk of state guarantees was about 12% of GDP in 2006.

3.4.3. *Expenditure ceilings and the general government budget balance*

The net expenditure under the ceiling, the taxes by the state and the social security contributions do not add up to the general government budget balance. The difference is a complicated mix of items, for example:

- It includes some expenditure by the state, like the FES expenditure on infrastructure and innovation and social assistance in cash for health care.
- It contains some corrections on expenditure under the ceilings, *e.g.* for the difference between cash recording under the ceiling and a transactions-based recording for the general government budget balance or for the irrelevance of the old age fund for the general government budget balance.
- Revenues from natural gas are to be included.
- The budget balance of the local government is part of the general government budget balance. Most of the state transfers to local government are included under the expenditure ceiling. As a consequence, the net effect of these two items is to be added in order to arrive at the budget balance of the general government.

Unexpected changes in all these items lead to unexpected changes in the general government balance.

3.4.4. *“Exchange rate risks” of the real expenditure ceilings*

At the start of a new term of government, the real expenditure ceilings are fixed in view of the new coalition agreement and the expected developments of wage rates, prices, the interest rate and volumes. During the term of government, the estimates are revised. The real expenditure ceiling is inflated with a new estimate of the ceilings’ deflator (price change of national expenditure). The estimate of the various types of expenditure under the ceilings is adjusted by new estimates of wage rates, prices, the interest rate and volumes.

Changes in the ceilings’ deflator not expected at the start of the period of government lead to changes in the real expenditure ceiling. However, this does not imply a change in the margin for expenditure under the ceiling. Only changes in the ratio of the deflator of the ceiling and the price of the various types of expenditure not foreseen at the start of the new term of government change the margin for expenditure. For example, when wage rates increase during the four-year term of government by 8% more than previously expected and the deflator of the expenditure ceiling also increases by 8%, then there is no change in the margin for wage-related expenditure. However, if the ceilings’ deflator is only 4% more, then there is an “exchange rate loss” of 4% for the wage-related expenditure. Suppose that expenditure under the ceiling amounted to 40% of GDP of which 60% is wage-related. This implies that the margin for expenditure has been reduced by 1% of GDP $[(8\% - 4\%) \times 60\% \times 40\% \text{ GDP}]$.

Some state expenditure under the ceiling, *e.g.* interest payments or EU contributions, is not affected by unexpected changes in wages and prices. For such expenditure, an unexpected increase of the ceiling’s deflator of 1% implies an increase in the margin for

expenditure. Supposing that such expenditure amounts to 10% of the expenditure under the ceiling, the increase is then about 0.2% of GDP [$4\% \times 10\% \times 40\%$ GDP].

Supposing that all other prices move in line with the ceiling's deflator, the overall net effect is then a reduction of the expenditure margin of 0.8% of GDP. Such unexpected losses in the ceilings' "exchange rate", i.e. the ratio of the deflator of the ceiling and the price of the various types of expenditure, change the margin for expenditure under the real ceilings. In the case of a volume-based ceiling, the unexpected increase in the real wage rate would have increased the ceiling by 0.8% of GDP. In the case of a nominal ceiling, the reduction in the margin for expenditure would have been larger, i.e. about 1.8% of GDP.²²

The advantage of real expenditure ceilings is that the nominal development is not entirely fixed, like with nominal ceilings. However, unlike ceilings in terms of volumes, the development of wages and prices is not entirely out of control. Real expenditure ceilings could therefore be regarded as a compromise between flexibility and control (see also van Ewijk and Reininga, 1999).

By adjusting the real expenditure ceilings with the most recent estimates of the price change in national expenditure,²³ the margin for expenditure moves in line with the development of macroeconomic prices. Since 2002, following the report of the eleventh National Advisory Group on Budgetary Principles, the price change in national expenditure is preferred as the inflator for the expenditure ceilings; in the period 1994-2002, the price of GDP was used. As a consequence, the often widely fluctuating estimates of import and export prices no longer directly influence the expenditure ceiling. Of course, in the long run changes in import and export prices are also incorporated in the price of national expenditure.

For a given year, final national accounts statistics about prices, wage rates and economic growth arrive after some years of delay. Linking the budgetary process to the arrival of these final estimates is therefore not wise. To ensure stability in decision making, the expenditure ceilings for a given year in nominal terms become final by using the CPB estimates in April of that year (the CEP estimates of year t); all differences between these estimates and the most final national accounts statistics are therefore irrelevant for the budgetary process.

3.4.5. Recommendations by the National Advisory Group on Budgetary Principles

In 2007, the National Advisory Group evaluated the current framework. The group's major recommendations are:

- A structural budget surplus is the minimum requirement for absorbing the cyclical and incidental changes in the general government budget balance without breaching the 3% EMU limit; steering on an actual surplus is rejected.
- Realistic and conservative estimates of growth should be used; this reduces the likelihood of budgetary disappointments and increases the likelihood of attaining the budgetary targets.
- Interest payments should be outside the expenditure framework. However, other cyclically sensitive expenditure, like unemployment and welfare benefit payments and the real wage rates, should remain within the framework. A reason for the latter is that cyclical windfalls and setbacks in unemployment and welfare benefit payments tend to cancel out the pay and price inflation differential. For example, in an economic boom, unemployment will probably be lower than previously expected, but the real salaries of civil servants may be relatively high.

- Automatic stabilisers are allowed to operate on the revenue side. This means that revenues are allowed to move in line with the performance of the economy. From the perspective of budgetary control, this means that there should be agreement on how the effects of policy measures on the revenue side, like tax cuts, can be distinguished from all other revenue developments.²⁴
- The FES funding level should be decided at the start of the new government's term and not linked to fluctuating revenues in natural gas (see Box 3 above).
- The existing restrictive assessment framework for the introduction of new tax expenditures should be retained. Furthermore, the existing overview of the financial size of tax expenditure should be extended by also including major items of tax deduction, *i.e.* the interest paid on mortgages and pension contributions. This will serve budgetary control, transparency and decisions about allocation.
- The next government should take decisions to put public finance back on a sustainable path. To this end, the ageing-related institutions (*e.g.* health care and state pensions) should be reformed and the tax base broadened.

3.5. Understanding the role of the CPB

The CPB plays an important role in the financial and economic decision-making process in the Netherlands (see also CPB, 2003b). Its short-term, medium-term and long-term estimates of the Dutch economy and public finance are the backbone of the budgetary process. Political parties and the government ask the CPB to analyse the economic effects of their election platforms, coalition agreements and alternative budgetary proposals. Strategic economic thinking and decision making are influenced by CPB studies, *e.g.* general long-term scenario analyses and specific studies about the welfare state, education, innovation and health care. The decision-making process about major specific projects, *e.g.* infrastructure, is guided by cost-benefit analysis by the CPB. The CPB is also represented in influential advisory groups, *e.g.* the Central Economic Commission, the Socio-Economic Council and the National Advisory Group on Budgetary Principles.

How should this dominant role be understood? What is the logic behind this role? How can the CPB serve as an independent expert, while being financed completely by the Dutch government? How can the quasi-monopolistic role of the CPB coincide with good quality of the estimates and analyses?

The role of the CPB as advisor and arbitrator fits well in the Dutch tradition of consultation and coalition governments. Directly after the Second World War, the CPB had a good start (see van den Boogaard, 1998; F. Bos, 2006b, pp. 232-237; Passenier, 1994). The need for a joint strategy for economic recovery gave a clear role for the CPB estimates and analyses. Furthermore, the outstanding qualities of the director, Jan Tinbergen, both as an economist and political advisor and as a moral authority, contributed directly and indirectly to the appreciation of CPB work.

Provided the CPB is independent and provides good quality estimates and analyses, then the dominant role of the CPB can be regarded as an efficient solution. It avoids unnecessary duplication of work and avoids discussions about which estimate is the best. It ensures continuity which is essential for both producers and users of policy advice. For example, for specific topics standard tables can be used. Continuity is essential for building up expert knowledge about Dutch institutions. It is also important for generating specific

skills and tacit knowledge essential for policy advice, *e.g.* how to handle confidential inside knowledge and how to meet tight time schedules essential for coalition agreements.

The independence of the CPB is arranged in various ways. “First there is the formal structure, as laid down in the law of 1947. It is a very short and simple law, which regulated, *e.g.*, the appointment procedure of the members of the Board of Directors and the existence of the Central Planning Commission. The members of the Board of Directors are appointed for a long period by the Minister of Economic Affairs in consultation with seven other ministers named in the law. So a broad support for those appointments is required. But more important than formal law are tradition and practice developed in Dutch social-economic life for 40 years, which have strengthened the independent position of the Bureau. For the Bureau itself it is essential to maintain its independence. The position and prestige of the Bureau would be seriously weakened if the general public or the opposition parties would no longer trust its unbiased judgement. Also, checks and balances exist in the democratic system. For instance, when assessing the economic consequences of policy programmes of political parties, the Bureau works for several political parties. All assumptions and results are published and, in principle, can be verified. Also the model, the data and the results for the forecasting period are made available. Pressure put on the CPB by ministers or ministries evokes counter forces. The Parliament and the press are quick in scenting trouble. The permanent Parliamentary Commission for Economic Affairs regularly invites the Director of the CPB to discuss recent publications of the Bureau. This Commission is also keen on any hint of pressure of the government on the Central Planning Bureau. And the free press is perhaps the best ally one can have to protect independence in an open democratic society” (Don and van den Berg, 1990, pp. 20-21).

This extensive quotation from a paper that is nearly two decades old is still relevant. Three elements could be added:

- Yearly, the CPB receives advice regarding its work plan from two organisations: the Central Planning Commission, containing members from business and science, and the Commission for Economic Affairs, with official representatives of ministries that are most closely involved in economic policy. The commissions’ work provides an important external check on the policy relevance of the CPB work.
- About every five years, the policy relevance and scientific quality of the CPB work is assessed by visitation commissions (see, for example, CPB, 2003c). The Central Planning Commission advises on the composition of the visitation commissions.
- There is substantial mobility of personnel, *e.g.* people moving between the CPB and universities, ministries, trade unions, politics and the press. This ensures that the CPB is not an ivory tower and that outside the CPB there is a lot of inside knowledge about the merits and limitations of CPB work.

Notes

1. Alternative overviews are provided by IMF (2006), Postma (2006), Tijsseling and van Uden (2004), and Berndsén (2001).
2. These statistics have been calculated on the basis of regular national accounts statistics, CPB short-term forecasts on Dutch public finance (“CEP2007”), special time series publications by Statistics Netherlands (CBS, 1959 and 2001) and historical debt figures obtained from Professor van Zanden.

3. The major sources for this section are Stevers (1976), van Zanden and van Riel (2000), van Zanden (1996), van Popta (1994), and Postma (2006); on the early state budgets, see also Fritschy and van der Voort (1994).
4. In 1810, Napoleon decided to pay only interest on one-third of public debt (*tiërcering*). William I continued this policy, but added that each year lots were drawn to convert a very small amount of the deferred debt into normal debt; this implied that after about three centuries all deferred debt would have been converted.
5. Each chapter in the budget contained only one or two figures; only the annexes provided some additional information.
6. One thousand guilders of deferred debt was converted into 70 guilders of actual debt.
7. This was also the first budget presented on paper instead of orally by the Minister of Finance. Therefore, the budget for 2006 was celebrated as the 100-year anniversary issue on paper.
8. The funds had to be spent on goods and services from the United States, e.g. raw materials and machinery essential for recovery by Dutch business.
9. Estimates always had to be adjusted upwards substantially.
10. On the history of the Dutch national accounts and the CPB, see F. Bos (2006b), Don and Verbruggen (2006), and Passenier (1994).
11. Minister Zalm started his career at the Ministry of Economic Affairs as one of the “Rutten boys”. There he learned that being right was not enough: you should also know how to get right, i.e. ensure that your ideas are accepted and are implemented (see Zalm, 1990).
12. Budgetary practice in the period 1975-1986 is analysed extensively by Toirkens (1988 and 1989). She investigated in detail the decision-making process by the council of ministers. This is rather unique, because most other studies on the politics of the budgetary process focus on the outcomes. A central thesis of her study is that “decisions by the council of ministers and individual ministers are made via a political decision-making process in which continuously the interests – public, group, sectoral and individual – are weighted. However, the complexity of this process implies that common explanations like maximalisation of votes... or minimalisation of conflict can only explain part of the behaviour of the council of ministers and individual ministers... [Such theories] stress one aspect and ignore the dynamic character of cutback policy” (Toirkens, 1989, p. 6).
13. The difference occurs for various reasons: a different denominator (GDP and not net national income), conceptual changes in the denominator due to changes in the guidelines of the national accounts, numerical changes in the denominator due to the use of new data and compilation methods by Statistics Netherlands, and change in the expenditure concept (e.g. with respect to loans granted).
14. Mr. Zalm was Minister of Finance for 12 years (1994-2006); his previous jobs included Director of the Budget at the Ministry of Finance and director of the CPB.
15. During the period 1998-2002, a windfall formula for tax and social security contributions was also applied. In the case of a general government deficit of less than 0.75% of GDP, 50% of the windfall was to be used for deficit reduction and 50% for additional tax relief. If the general government deficit was more than 0.75% of GDP, then 75% of the windfall was to be used for deficit reduction and 25% for additional tax relief.
16. In 2006, the forward-looking approach was extended with an analysis of the redistribution of current Dutch policies over the life cycle (ter Rele, 2005). On a lifetime basis, the size of redistribution depends on the net effect of the separate arrangement at different stages of the life cycle; they are to some extent counterbalancing. For example, in the Netherlands, high lifetime income earners typically feature a high lifetime tax burden and low benefits from health care relative to low lifetime income earners. However, they are also relatively large beneficiaries of government expenditure on education, cultural facilities, housing subsidies and tax-favoured saving through the second pillar pension system. The life-cycle approach gives a new view on a fair and efficient policy of redistribution. For example, the lifetime marginal wedge on labour income can differ substantially from the annual wedge.
17. For example, including the objectives-stimulated thinking about the purposes and tools of government policy.
18. On the merits and limitations of this analysis, see the papers in Graafland and Ros, 2003.
19. The macroeconomic effects concern the implications for the Dutch economy, specifically those for structural GDP, employment in the private and public sectors, consumption, wages, inflation and

so on. The purchasing power effects cannot be easily expressed in a single figure, because the implications of the party programmes may differ widely between types of households. These effects are therefore expressed in a scatter diagram and by means of specific figures for different groups of households.

20. In the analysis for 2002, the environmental implications were also taken into account. However, due to the fall of the coalition government and the consequent calling of early elections, time pressure was too high to include this environmental analysis again. Also in 2002 an analysis of the strengths and weaknesses of the reforms proposed for the health care sector was included. In November 2006, an analysis was included for the first time on education, science and innovation. The parties' proposals were classified, on the basis of empirical research, into promising, not promising, and proposals that cannot be judged along these lines on the basis of such research.
21. Contributions to supplementary pension schemes are tax deductible, but the pension payments in due course are taxed.
22. For the wage-related expenditure, the loss is $8\% \times 60\% \times 40\%$ GDP, i.e. 2% of GDP. For the non-wage and price-related expenditure, like interest payments, the gain is $4\% \times 10\% \times 40\%$ GDP, i.e. 0.2% of GDP.
23. National expenditure is equal to final consumption plus capital formation.
24. This is an important issue where the devil is in the detail, e.g. how to treat shifts between public and private expenditure, like on health care or insurance for social risks.

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