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BELGIUM

SELECTED ISSUES

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BELGIUM

SELECTED ISSUES

February 12, 2015

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European Department

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CONTENTS

TABLES

APPENDIX

REFERENCES

BELGIAN HOUSE PRICES: EVOLUTION AND RISKS[1]

1. **The purpose of this paper is to illustrate the recent evolution in Belgian house prices and assess the risk of a rapid price correction and the potential repercussions for the real economy.** Belgian house prices peaked at the end of 2013 after a persistent increase that was almost continuous for 30 years. The stabilization of prices, combined with policy changes on the fiscal and macro-prudential fronts, raises the question how house prices are likely to evolve and how a price decline would affect the Belgian economy.

2. **The paper argues that an orderly and limited decline in house prices - coupled with a marginal negative effect on the real economy - is the most plausible scenario.** This conclusion is based on the fact that much of the price increase can be explained by real and financial drivers. Accordingly, the estimated over-valuation is lower than a casual look at historical data would suggest. While policy changes are expected to put pressure on housing demand and equilibrium prices, the strong household balance sheets, the high owner occupancy rate, and the generally prudent lending standards reduce the risks of a disorderly correction.

3. **Despite these fundamental strengths the housing market requires continued vigilance.** Unexpected changes in housing-related policies and a large drop in expected future income could destabilize the housing market and lead to larger and more rapid price fluctuations. Continued vigilance by lenders and supervisors and a coordinated and communicated housing strategy can reduce the risk that such a scenario materializes.

A. Are House Prices Overvalued and by How Much?

4. **Estimates of the house price overvaluation can provide information on the need and potential size of a price adjustment.** Given the recent price dynamics, many observers have warned of a substantial overvaluation that makes a downward adjustment unavoidable. This section illustrates this evolution, but also puts it in the international context. It will further present estimates of overvaluation that take into account the real- and financial drivers of housing demand.

House prices have increased dramatically.

5. **Since 2000, nominal house prices have more than doubled.** Similar to many other European countries, the biggest increase happened before the 2007 financial crisis. However, unlike many countries, Belgium did not witness a significant price decline subsequently. Since the beginning of 2008, house prices have increased by another 15 percent.

6. **House prices increased much faster than both the price of consumption goods as well as wages.** While the house price index increased by 115 percent since 2000:Q1, harmonized

[1] Prepared by Johannes Eugster (EUR).

consumer prices and wages increased by 35 and 45 percent respectively (Figure 1). In real terms, house prices thus increased by close to 80 percent[2]. The price-to-rent and price-to-income ratios have increased by about 60 percent over the same period.

7. **Despite important regional differences in the price level, house price increases have been fairly comparable.** In 2013, the average single family residence in Brussels was 70 percent more expensive than the one in Flanders and more than twice as expensive as in Wallonia. The rates of price increases are however comparable: since 1990, the average house price increased by a factor of almost four in Brussels, 3.4 in Flanders and almost three in Wallonia.

8. **Unsurprisingly, Belgium comes on top of the list of house price increases in an international comparison.** The Belgian price increase since the beginning of the millennium is among the biggest in Europe; also in relation to income and rental prices (Figure 1). The cumulative change in France has been quite similar, although prices have been more volatile and started to decline in 2011. Also for the Netherlands, the cumulative increase masks a substantial price decline since 2008. In Germany, the price increase started more recently, after flat or slightly falling prices during the first years of the millennium.

9. **However, despite the sustained price increase, average Belgian house prices remain relatively affordable.** The average Belgian single family home – abstracting from important regional differences - costs approximately € 225,000 (Figure 1). This is almost 25 percent less than in Germany and almost 15 percent less than in France. Even in Netherlands, where house prices have fallen considerably since 2008, the price of a typical single family home is still above its Belgian equivalent. This points to catch-up effects behind the house price increases in Belgium.

Despite the sizeable appreciation, our estimates point to a moderate overvaluation.

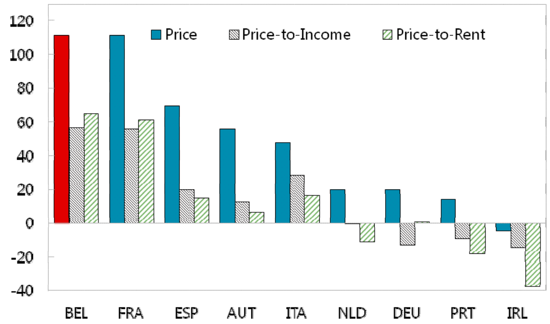
10. **Crude measures based on the price evolution suggest that the house price overvaluation can be as high as 50 percent.** If the average value since 1993 is taken as reference, the price-to-income (PTI) and price-to-rent (PRR) ratios suggest an overvaluation of 30 and 35 percent respectively (Figure1). If the average is calculated over the 1980–2013 period, the overvaluation increases to 47 and 58 percent. However, equilibrium estimates based on historical PTI and PTR ratios are imperfect. Not only do they abstract from the nominal level, but also ignore the underlying drivers of housing demand and supply, and hence of the price formation.

[2] Residential propriety prices are deflated by HICP inflation.

Figure 1. Belgium: House Price Developments

Belgian house prices have more than doubled since 2000…

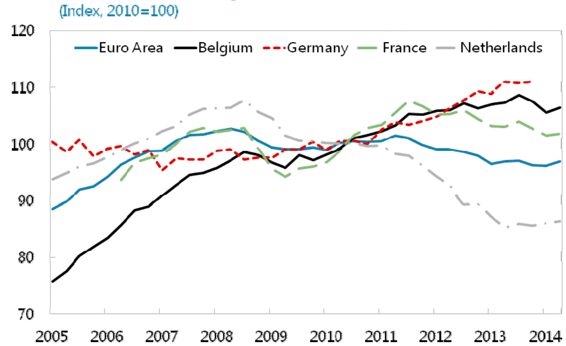
House Price Evolution between 2000 and 2013
Residential Property Price Indeces, Price-to-Income, Price-to-Rent, 2000=100



Sources: ECB, own calculation

…and were almost unaffected by the global financial crisis.

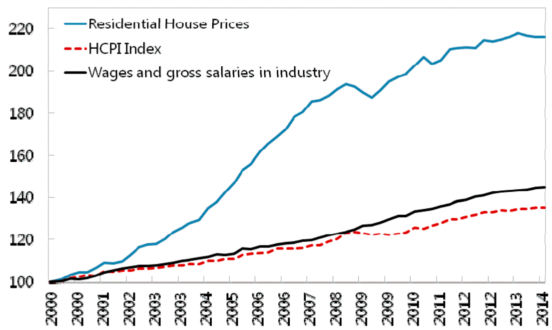
International Comparison of House Price Evolutions
(Index, 2010=100)



Sources: EuroStat

House prices have outgrown both wages and consumer prices by large margins…

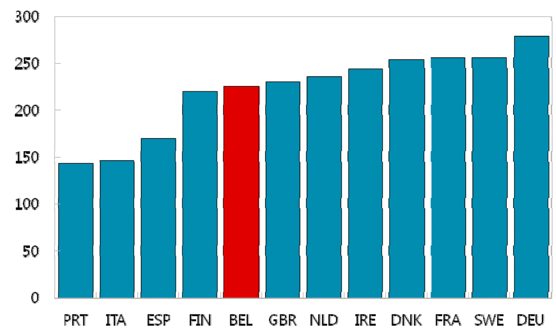
House Prices and Inflation
Residential Property Prices, existing dwellings, NSA, 2000Q1=100



Sources: BIS, NBB

…but nevertheless remain affordable by international standards

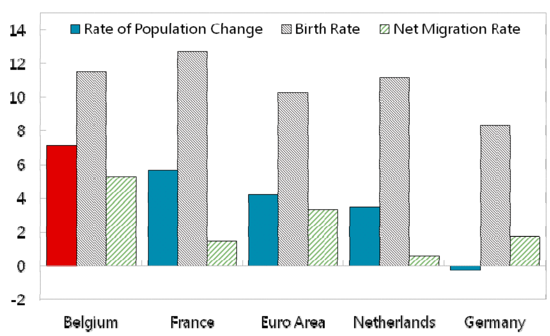
Average Single Family Home Price, 2014Q2
(In thousands of euros)



Sources: KBC Research

Among the real and financial drivers, faster than average population growth has contributed to higher demand.

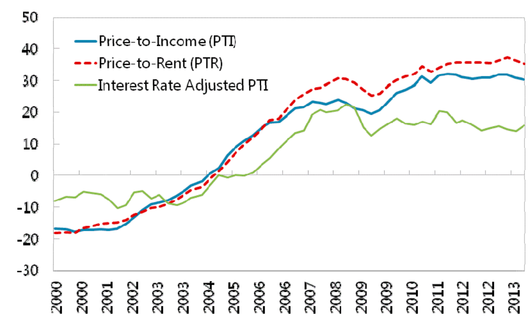
Population Growth
(crude rates, in 1000 inhabitants, averages over 2003-13)



Sources: EuroStat

Estimates of overvaluation vary, but are probably lower than simple historical ratios would suggest.

Overvaluation based on PTR and PTI
Price-to-rent and price-to-income relative to respective average since 1993



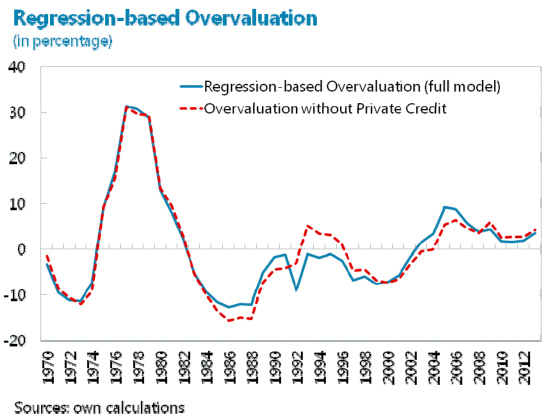
Sources: own calculation, based on 1993Q1-2013Q2 sample

Sources: ECB, BIS, NBB, KBC Research, own calculations.

11. **Real and financial factors have boosted housing demand and, given supply constraints, both market and equilibrium prices.** More than other countries, the Belgian housing market is experiencing demand pressure due to comparably high net immigration and fertility, and reduced household sizes (Figure 1). Given the Belgian preference for home ownership, the cheaper access to credit and a small and regulated rental market, the higher housing demand was mostly directed towards owner-occupied rather than rental proprieties.

Box 1. Regression Based Overvaluation

To account for the impact of the increased purchasing power and population growth, the log of the house price index is regressed on the logs of per capita GDP, the working-age population and the long-run interest rate[3].



Additionally, the log of domestic credit to the private sector (in percent of GDP) is included, as proxy for financial development and/or higher risk taking by banks and households. While the increase in Belgian mortgage credit over the since the late 90s potentially reflects a mixture of these two drivers, the outstanding stock of mortgage credit does not raise immediate concerns. The stock of mortgage credit - 46 percent of GDP in 2013 - is high compared to the 27 percent of 2000, but it is still only half of the average peak level in countries affected by housing crises[4]. The sample is composed of yearly data starting in 1970.

The difference between the actual house price and the one predicted by the linear regression is plotted in the graph. The blue line shows the result for the full model, whereas the red line omits private credit and hence excludes the possible effect of risk taking from the calculation of the equilibrium price. The result is quite surprising. While the regression suggests an overvaluation of more than 30 percent in the late 1970s - which was followed by a protracted nominal house price decline - current prices are very close to the regression-implied equilibrium. The estimated overvaluation peaked again in 2005 at close to 10 percent before falling to about 3.6 (blue) or 4.2 (red) percent in 2013.

12. **Adjusting the price-to-income ratio for borrowing costs reduces the estimated overvaluation substantially.** One of the most visible changes in recent years has been the substantial drop in mortgage rates, and with it of the effective monthly cost for any given price. At the beginning of 2014, a typical mortgage rate with 10-year rate fixation was 3.8 percent, barely half

[3] In the interest of sample size, the mortgage rate (available only from 1993 onwards) is replaced by the government bond rate as reported by the IMF's IFS database. For the same reason, per capita GDP and working-age population are used as proxy for average household income and number of households. The variables can be downloaded from the World Banks WDI database.

[4] The countries included are Netherlands, Denmark, Ireland, Spain, the United Kingdom and the US.

of the value at the beginning of the millennium. Taking the changing borrowing costs into account reduces the estimated overvaluation to 16 percent (Figure 1).

13. **A regression-based empirical model suggests that the current price could actually be very close to equilibrium.** The empirical analysis in Box 1 additionally accounts for other relevant real and financial factors. The yearly house price index since 1970 is regressed on disposable income, the borrowing rates, private credit and population growth. The results point to an overvaluation of merely 3.6 percent.

14. **Given the recent policy changes, the overvaluation estimates are surrounded with substantial uncertainty.** The above regression–based estimate assumes a constant linear relationship between the underlying variables. Policy changes alter this relationship and the recent changes to mortgage tax deductibility in Flanders and Wallonia could affect the equilibrium price quite considerably – in the case of Flanders by 10 percent over two years according to some estimates. If market prices have not incorporated the policy change, our overvaluation estimate would be rather conservative.

B. What are the Factors that Could Trigger a Rapid Adjustment?

15. **Catalyzing factors can accentuate price adjustments.** When estimates of overvaluation are uncertain, initial price adjustments can trigger destabilizing dynamics and possible undershooting. Falling prices can create reinforcing dynamics through various channels. A supply-overhang, balance sheet vulnerabilities, or a tightening of lending standards are factors that can reinforce price pressure. This section analyzes potential catalyzing factors and argues that many of them are unlikely to play a major role.

Is there a Housing Supply Overhang?

16. **The Belgian housing market has not witnessed the kind of construction boom that led to excess supplies in other European countries, such as Spain and Ireland.** Requests for building permits as well as building starts have remained generally constant (Figure 2). The same applies for an aggregate construction index. According to the cadastral statistics, the average growth rate since 2001 of the existing stock of houses and apartment buildings has been a mere 0.65 percent; close to the growth rate of total population. There is thus little reason to believe that the housing supply has been expanding unsustainably and could thus trigger a rapid price correction in the secondary market.

Are Household Balance Sheets Vulnerable to a Housing Price Correction?

17. **The financial vulnerability of Belgian households in aggregate is limited.** While the debt-to-GDP ratio is comparable with neighboring countries, leverage is among the lowest in the region (Figure 2), with a debt-to-financial asset ratio of merely 20 percent in 2013. Furthermore, even though the share of household wealth invested in real estate has increased since the early 2000s, it accounts for only half of gross wealth—a lower ratio than for French or German

households. The strong financial asset position reduces the risk of a real estate price change translating into large balance sheet adjustments, which could further depress consumption and housing demand.

Could Access to Credit be Constrained?

18. **Demand could become constrained by limitation on access to mortgage credit.** As most Belgian house buyers finance their purchase with a mortgage loan, a correction in bank lending behavior could therefore affect prices. Such an event could be triggered by distress in the general financial system, limiting the ability of banks to lend or alternatively, by a tightening of mortgage lending standards in reaction to perceived higher risks, or regulatory changes.

19. **As the ECB's asset quality review (AQR) has shown, the Belgian banking sector is generally well capitalized and able to supply the necessary credit to households and businesses.** This is partially the result of major restructuring in recent years and ongoing efforts to reduce risks as well as costs. Most banks have refocused their business model on more traditional and domestic activities, which means that mortgage financing will remain a core activity of the Belgian banking sector.

20. **Pockets of vulnerability exist, but in the aggregate risk exposure has been declining reducing the chance of a sudden tightening of credit standards.** Since 2003, the aggregate loan-to-value (LTV) ratio has fallen from around 80 to just above 60 percent (Figure 3). This number however masks substantial heterogeneity. While more than half of all mortgages have an initial LTV ratio below 50 percent, for more than a third, this number is above 90 percent. One mortgage out of five has at origination a debt-service-to-income ratio above 50 percent. Nevertheless, the aggregate household overburden rate (which includes rental costs) was below European average in 2013 (Figure 3).

21. **The predominance of fixed-rate mortgages shifts the interest rate risk from the borrowing household to the banks (Figure 3).** With interest rates so close to zero, interest rate risk is now highly asymmetric. Besides lowering the demand and the equilibrium price of houses, an unexpected increase in rates could create servicing difficulties for some households. However, given the prevalence of fixed rate mortgages the exposure of the aggregate household sector is limited. In the light of the current economic situation, such an unexpected interest rate hike is seen as carrying a low probability.

Is the Household Debt Servicing Capacity Sensitive to the Cycle?

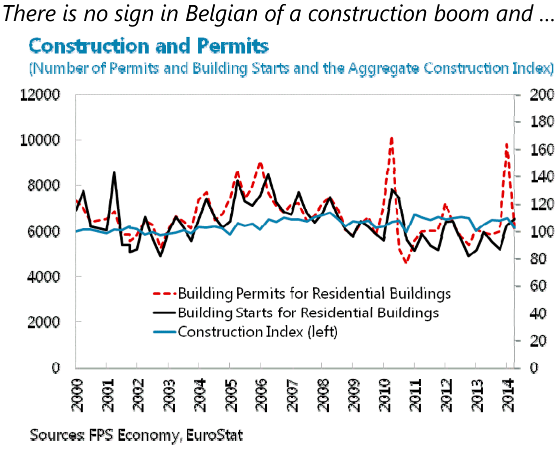
22. **Household income is relatively insensitive to the cycle, owing to stabilizing features in wage determination and pro-employment policies.** Wage indexation tends to smooth out labor income through the cycle, notably by limiting downward pressures on wages during the downturn. At the same time, the possible employment effect of slower wage adjustment tends to be muted by various employment protection schemes that are typically activated during a downturn, such as partial unemployment schemes. While the financing of the related fiscal cost might discourage

equilibrium employment, they tend to reduce income volatility and hence contribute to the resilience of the households' debt servicing capacity over the cycle.

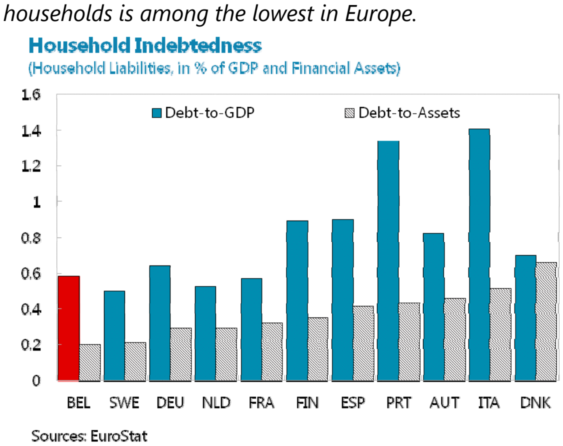
23. **Indeed, difficulties in servicing mortgages are both relatively rare and temporary.** Since 2007, the share of outstanding mortgages that is overdue has fluctuated between 1.5 and 2 percent (Figure 3), much lower than for consumer credits. Various mechanisms exist to avoid that temporary payment difficulties translate into a full default. Initially, the lender may take steps to facilitate repayment by the borrower. If unsuccessful, an amicable arrangement has to be attempted with the help of a judge before a foreclosure process can be initiated. The fact that the share of new overdue mortgages (in percent of total new mortgages) is somewhat higher than the outstanding stock, suggests that these measures help in keeping payment difficulties temporary.

Figure 2. Household Balance Sheet and Real Factors

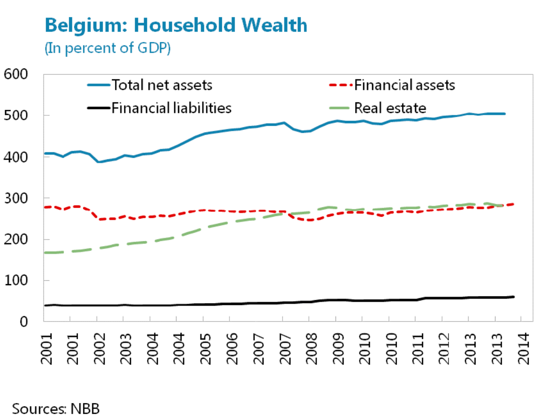
There is no sign in Belgian of a construction boom and ...



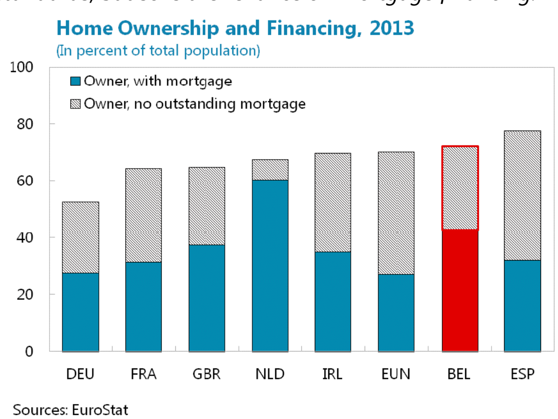
...the debt-to-financial asset position of Belgian households is among the lowest in Europe.



Household wealth has increased steadily, with the share of housing currently approximately at par with the one of financial assets.



The owner occupancy rate is high by international standards, but so is the reliance on mortgage financing.

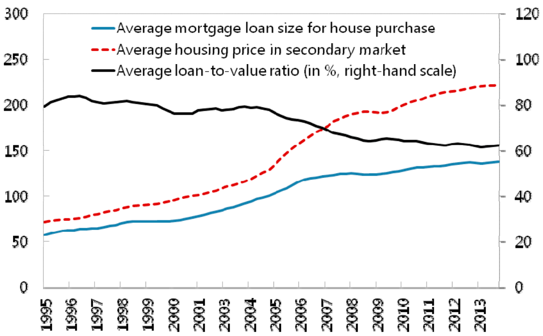


Sources: EuroStat, NBB, FPS Economy

Figure 3. Belgian Mortgage Lending

Aggregate loan-to-value ratios have declined since 2003…

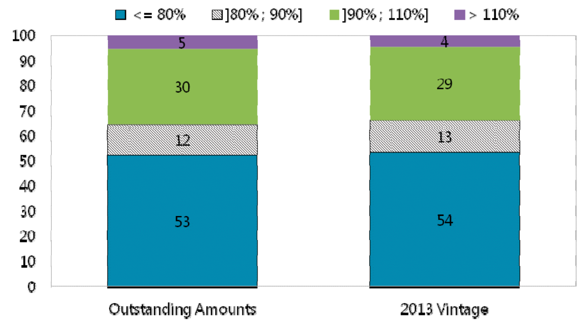
Average Loan-to-Value Ratio
(in € thousand, unless otherwise stated)



Sources: NBB

…but substantial heterogeneity remains. Sometimes very high LTVs …

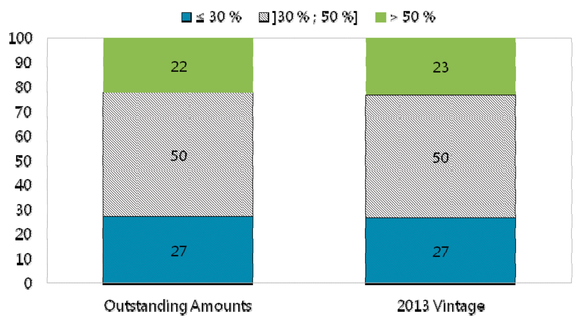
Loan-to-Value Ratio at Origination
(in percent of total loans)



Sources: NBB

…translate into high debt-service-to-income ratios.

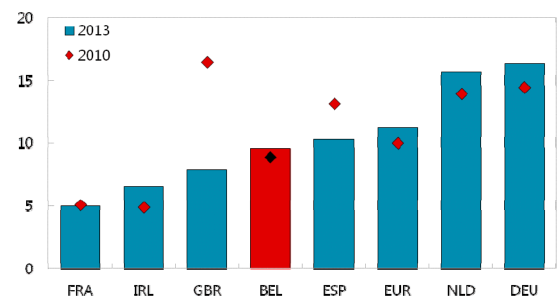
Debt-Service-to-Income Ratio at Origination
(in percent of total loans)



Sources: NBB

Nevertheless, the housing cost overburden rate remains below euro area average.

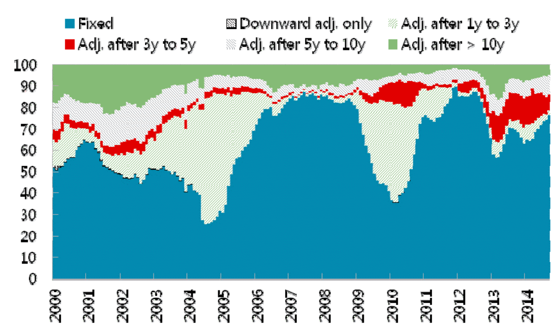
Housing Cost Overburden Rate, 2013
(Percentage of the population living in households where the housing costs, net of housing allowances, represent more than 40 percent of disposable income)



Sources: EuroStat

The predominance of fixed-rate mortgages, shift interest rate risk from borrowers to lenders…

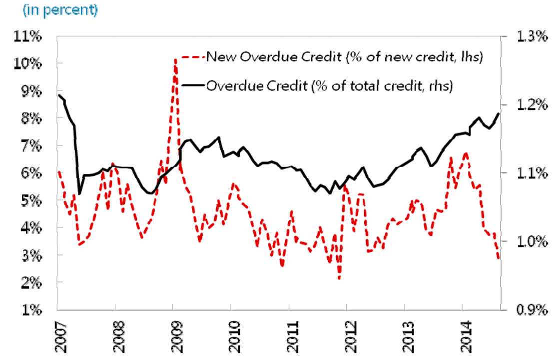
Fixed- vs. Adjustable Rate Mortgages
(Percentage of new mortgages)



Sources: UPC-BVK

… and might contribute to relatively constant share of overdue mortgages.

Mortgage Credit Arrears
(in percent)



Sources: Central Credit Registery (NBB)

Sources: NBB, EuroStat, UPC-BVK

24. **Default incentives are delinked from house prices due to full recourse loans.** Belgian borrowers remain liable for the entirety of the outstanding loan when defaulting, even when the collateral is seized. A strategic default to offload the wealth effect of a price decline onto banks is thus not possible. This eliminates the connection between the default incentives and prices in the secondary market and incentivizes steady loan repayment. The risk that an initial drop in house price is amplified by a wave of strategic defaults, which would reduce the banks' equity and thus their lending capacity, is hence small. On the other hand, the absorption of the wealth shock by households could adversely affect consumption and hence the real economy.

C. What Would be the Effect of a House Price Shock on the Real Economy?

25. **House prices can affect the real economy through various channels.** While a disruptive drop seems unlikely, prices might still adapt to changes in macro-prudential and fiscal policy. Independently of the speed of adjustment of prices, the reduction in wealth can affect the household saving behavior and thus consumption. Financial multipliers, owing for instance to changes in the perceived risk of lending due to lower household wealth, could accentuate these effects.

26. **A vector auto-regression (VAR) based on historical quarterly data, suggests that the macro-economic effects of a drop in house prices are relatively modest.** The figures in Box 2 show the impulse-response functions (IRF) of a 10 percent drop in house prices on the growth rates of GDP, private consumption and real estate investment with 95 percent confidence intervals. The results suggest that house prices have historically had little effect on GDP and consumption, but do lead to a significant and protracted drop in residential investment.

27. **An empirical analysis is a good starting point, but some specificities need to be taken into account.** Many of the characteristics of the Belgian housing market have not changed dramatically over the recent years, which makes the above analysis on historical data an appropriate benchmark. However, additional factors should be taken into consideration.

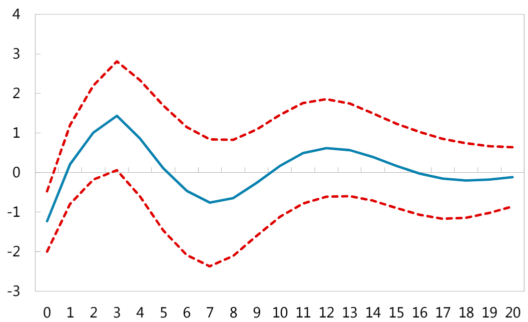
a. **Historical data is badly suited to capture the non-linearities of a large price drop.** House prices have increased quite steadily since 1993. Presumably, the identified price shocks are thus comparatively small to a situation in which prices decline more dramatically than expected. Given the non-linearities, the estimated effect on the real economy should not be extended to the sort of price collapse that has happened in Ireland, Spain or Netherlands.

b. **The analysis does not take into account changes in the equilibrium prices related to policy changes.** As shocks are identified with the help of the macro-economic variables only, the model would fail to capture the impact of changes in taxation or in lending standards on the underlying equilibrium price. Such policies were relatively stable through the sample period and so are unlikely to have affected the results. However, the recent tightening of tax policies (see below) would reduce the equilibrium price below the estimated level.

c. **While the aggregate household leverage remains low, the distribution of exposure might have become more uneven.** As house price have risen much faster than wages and wealth, the need for external funding has increased particularly among young and low-income households. The distributional changes might have affected the reaction function, particularly of consumption, that aggregate numbers fail to capture.

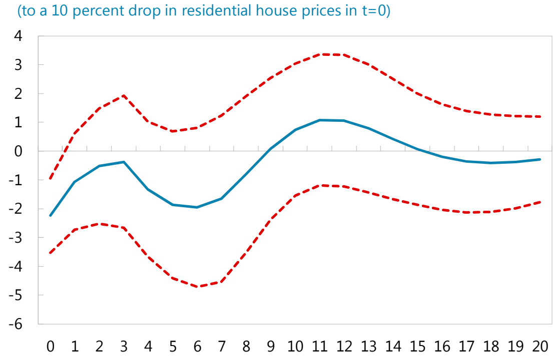
Box 2. House Prices and the Real Economy

IRF of Real Private Consumption Growth
(to a 10 percent drop in residential house prices in t=0)



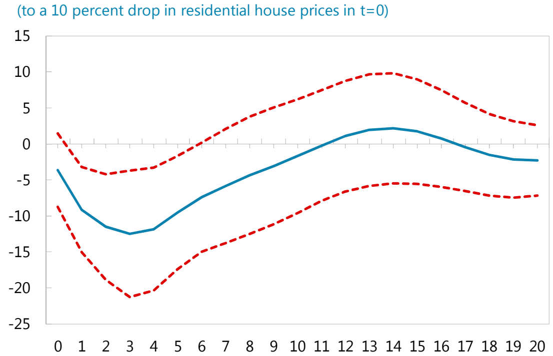
Sources: Own Calculation basedn NBB/IMF data

IRF of Real GDP Growth
(to a 10 percent drop in residential house prices in t=0)



Sources: Own Calculation basedn NBB/IMF data

IRF of Real Residential Investment Growth
(to a 10 percent drop in residential house prices in t=0)



Sources: Own Calculation basedn NBB/IMF data

This box illustrates how a house price decline historically affected the real economy in Belgium. The impulse response functions (IRF) are drawn from a vector-autoregression (VAR) using the growth rates of the residential house price index, real GDP, real private consumption and real residential investment as well as the short-terminterest rates and CPI inflation. The data set is of quarterly frequency from 1993 to 2014. The shocks are orthogonalized with a Choleski decomposition, which assumes the real variables to be able to react contemporaneously to changes in house prices.

The IRFs of GDP- and consumption growth are hardly significant. The negative (and significant) effects on GDP and consumption in Q0 might be driven less by house prices itself, than by a common underlying driver. The growth rate of real residential investment is however reduced for more than a year. This result is both economically and statistically significant. A price decline of 10 percent – seen as a reasonable scenario by the authorities – could reduce residential investment by an approximately equivalent amount.

[5] The implied elasticity is bigger than the estimate pointed to by the authorities, namely that a 10 percent price decline would cumulatively reduce residential investment by 3.7 percent.

D. Policy Risks and Recommendations

28. **The surge in house prices and risks of overvaluation have caused Belgian policy makers to react.** The two most important policy changes are the following:

a. Since the last quarter of 2013, the NBB requires banks to include a 5 percent add-on when risk weights for Belgian mortgage loans are calculated with an internal model. This macro-prudential policy was motivated by concerns that risk-weight models based on continuously increasing historical house prices would underestimate risks.

b. More recent changes were made at the fiscal front. As the tax deductibility of mortgage payments has become a regional competence, Flanders and Wallonia have announced a reduction of the deductable rate from 45 to 40 percent and, in the case of Flanders, capped the total amount of the abatement. The Brussels-Capital region will revisit the tax regime in 2017. Also in Wallonia, further policy changes should not be excluded.

29. **The effects of the policies are surrounded with uncertainties.** According to some estimates, the Flemish policy change in mortgage deductibility would lead to a price decline of close to 10 percent over two years. Uncertainties however remain related to the size and the speed of the price adjustment. The strength of the household and bank balance sheets should prevent an amplification of downward pressures through the financial accelerator channel. Nonetheless, uncertainty about future tax policy and/or shocks to expected future income could still lead to a destabilizing adjustment and undershooting prices.

30. **While the implemented policies seem appropriate, policy makers have to remain vigilant.** Policies should accompany, and support, an orderly adjustment of prices toward their equilibrium level.

a. Macro-prudential measures taken in 2013 were appropriately timed. In a context of continued monetary easing, and remaining banking segmentation in the euro area, possible risks related to domestic mortgage lending call for continued closed monitoring.

b. Changes in the tax deductibility of mortgages were motivated by fiscal and efficiency considerations. By affecting the equilibrium price of housing, however, they can have macroeconomic impacts through asset price movements. If additional measures are foreseen, it will be important to proceed with similar caution, and to ensure that policy changes at the fiscal level are coordinated with macro-prudential policies.

E. Conclusion

31. **This paper analyses the risks of a rapid house price adjustment in Belgium and the potential repercussions for the Belgian economy.** The paper argues that current house prices are closer to their equilibrium than simple historical ratios would suggest and that given the moderate overvaluation, a gradual and limited adjustment seems a plausible scenario. Strong household balance sheets, a seemingly well-managed mortgage market and various institutional characteristics reduce the risk of an abrupt correction. Given that historical house price changes have had moderate macro-economic effects – with the exception of residential investment – the repercussions of a gradual decline seem manageable.

32. **There is a continued need for vigilance and policy coordination.** Recent changes in macro-prudential and fiscal policy seem appropriate to make the housing market safer and reduce untargeted fiscal expenditures. To assure that the price adjustment remains orderly and does not lead to overshooting, future policy changes should be gradual and coordinated among different institutions. A well communicated housing strategy could help to avoid price mis-alignments in the future.

TOWARD A GROWTH-FRIENDLY FISCAL CONSOLIDATION IN BELGIUM[1]

1. **Belgium faces two main fiscal challenges that call for a durable fiscal consolidation.** First, at above 105 percent of GDP, public debt creates vulnerabilities, which are masked today by historically low interest rates. The debt service is costly (about 6 percent of total spending in 2014) and sensitive to interest rate movements. Second, the aging population and early access to pension benefits will lead in the medium term to significant fiscal costs. The number of elderly (i.e., population of at least 65 years old) will increase by 33 percent between 2009 and 2025 and the public pension expenditure in percent of GDP will increase nearly ⅓ to -14 ½ percent of GDP (OECD, 2012). This is among the largest increases in the OECD (after South Korea, Norway, and Luxemburg).

2. **To address these challenges, the government plans to achieve a balanced budget (both headline and structural) by 2018.** This requires a significant fiscal effort that cannot, as in the past, rely mainly on piecemeal revenue measures. The effort will be shared by all levels of governments so close coordination between the federated government entities will be needed to keep fiscal consolidation on track.

3. **The purpose of this paper is to assess whether government plans meet the objectives of growth-friendly and sustainable adjustment.** It is organized as follows. The first section describes Belgium's record of fiscal consolidation. In light of lessons from the empirical literature on how to achieve durable and growth friendly fiscal consolidation, the second section highlights the features of a high quality fiscal consolidation in Belgium. The third section analyzes the implications of decentralization for fiscal consolidation.

A. Belgium's Record of Fiscal Consolidation

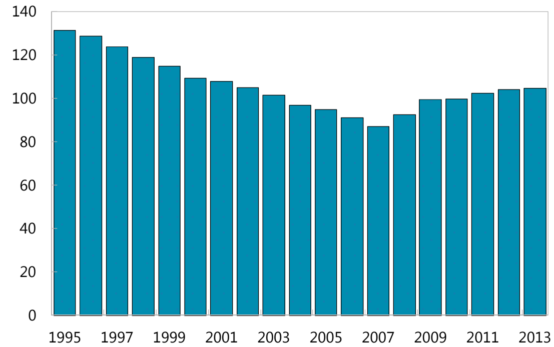
4. **Belgium has an impressive record of fiscal consolidation** (Figure 1). It managed to bring down its debt-to-GDP ratio from 131 percent of GDP in 1995 to 87 percent of GDP in 2007. During this period, the primary surplus averaged 4.8 percent of GDP and the structural primary balance averaged 4.5 percent of GDP. However, since the early 2000's, real primary expenditure growth outpaced real GDP growth. Real primary spending grew at 2.8 percent per year over the period 2002–07 and remained at 2.7 percent even during the financial and economic crisis.

[1] Prepared by Jean-Jacques Hallaert and Sylwia Nowak (both EUR). The authors thank the National Bank of Belgium, Jörg Decressin, and Edward Gardner for their suggestions and comments.

Figure 1. Belgium: Fiscal Consolidation Efforts, 1995–2013

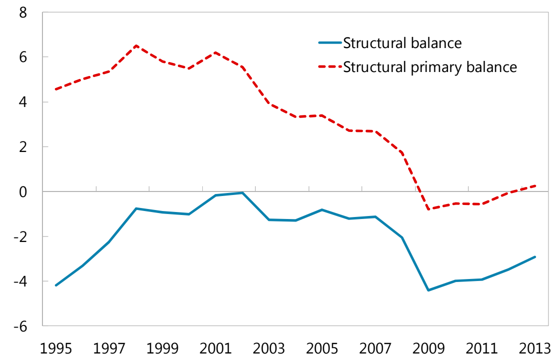
Historically, Belgium has an impressive track record of debt consolidation…

General Government Debt
(In percent of GDP)



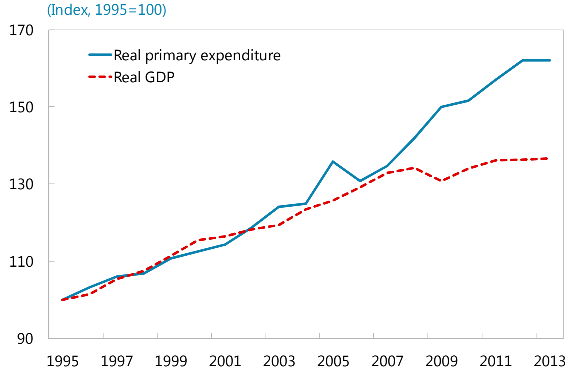
…and running considerable structural primary surpluses…

General Government Structural Balances
(In percent of GDP)



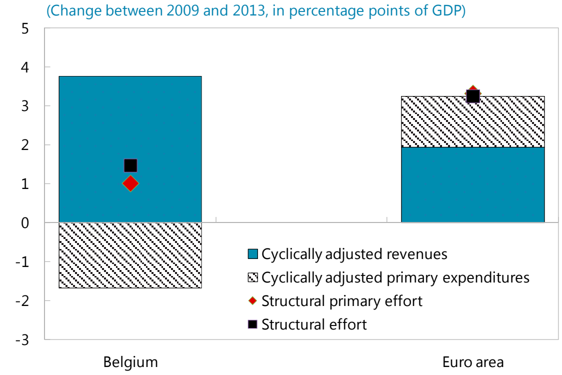
…though real primary expenditure grew faster than the real GDP since early 2000s.

Real Primary Expenditure and Real GDP
(Index, 1995=100)



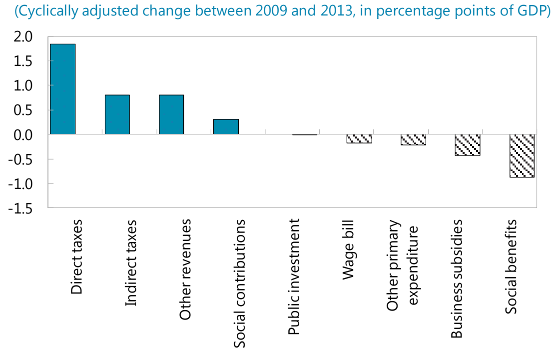
The recent consolidation—modest compared with the overall euro area effort—was due to revenue increases only …

Fiscal Adjustment Effort
(Change between 2009 and 2013, in percentage points of GDP)



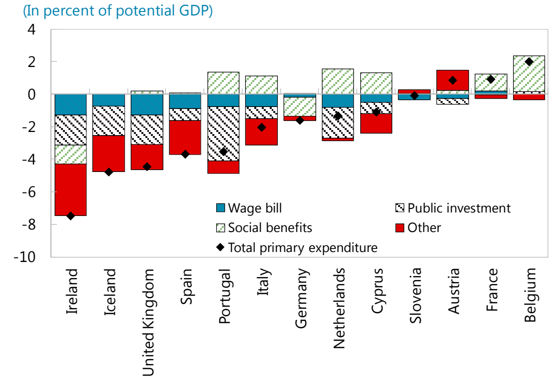
…mostly direct taxes…

Sources of Consolidation[2]
(Cyclically adjusted change between 2009 and 2013, in percentage points of GDP)



…unlike in other European countries.

Change in Primary Expenditure, 2009–13[1]
(In percent of potential GDP)



Sources: Haver Analytics, Eurostat, and IMF's *Fiscal Monitor* database and staff calculations.
[1] Estimated using the ESA95 methodology.
[2] Other revenue is the sum of received interests, other property income, current transfers from other sectors, current sales of produced goods and services, and capital transfers from other sectors.

6. **However, the recent fiscal consolidation has been modest and achieved mostly through revenue increases.** During the period 2009-2013, structural adjustment reached only 1½ percent of GDP, less than half the level of the euro area as a whole.[2] Both tax and non-tax revenue increases contributed to the structural adjustment with the largest contribution coming from direct tax hikes. The structural impact of revenue increases was partly offset by an increase in structural expenditure. This is in sharp contrast with the situation in the euro area as a whole where expenditure containment contributed to most of the structural adjustment. The negative contribution of spending to the structural adjustment in Belgium is mostly explained by the large increase in social benefits and tax expenditures. While social benefits increased in most euro area countries, they increased less than in Belgium and, more importantly, they were more than offset by a decline in other type of spending (except in France and Austria).

B. A Growth-Friendly Expenditure-Based Fiscal Consolidation in Belgium

7. **The new government intends to implement an expenditure-based fiscal consolidation combined with a "tax shift."** The government announced that it intends to balance the budget in 2018 through expenditure containment (Table 1). By contrast, revenue measures (0.7 percent of GDP) are meant to finance planned labor tax reductions.

8. **Belgium is well placed to benefit from a shift to an expenditure-based fiscal consolidation.** The tax-to-GDP ratio is the third highest in OECD (Figure 2) and the economic costs of further tax hikes are likely to be high. Also, past increases in spending were specifically concentrated in the areas which the literature has identified as most inefficient from a growth perspective (Figure 3).[3] In this context it should be noted that literature highlights that cuts in public investment are particularly damaging for growth and employment.[4] Therefore, without precluding scope for increased efficiency, investment spending should be ring fenced especially given the pressing need in Belgium for growth-enhancing investment in transportation, energy, education, and social housing (OECD, 2013).

Shifting the Tax System from Labor Taxes

9. **The government intends to rebalance the tax burden away from labor taxation in order to improve competitiveness.** Belgium has the highest labor tax wedge in the OECD. Its reduction should indeed help improve export performance (Hallaert, 2013). It would also help increase the employment rate which at 67.2 percent is below both the EU average of 68.5 percent and Belgium's target of 73.2 percent by 2020.

[2] Based on the IMF staff's estimates of potential GDP.

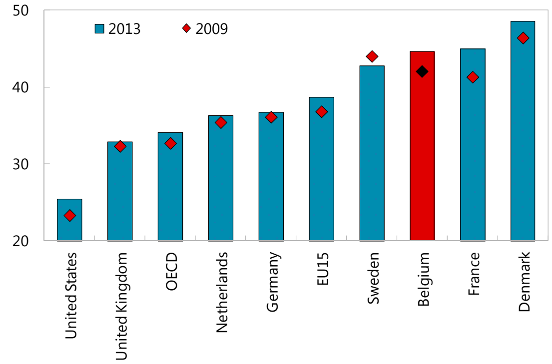
[3] See also Alesina and Ardagna, 2009; Alesina and Perotti, 1995 and 1997; Bermperoglou *et al.*, 2013; Cournède *et al.*, 2013; Hernández de Cos and Moral-Benito, 2011; Guichard *et al.*, 2007; Molnar, 2012; and von Hagen *et al.*, 2002.

[4] Bermperoglou *et al.* (2013), and Broadbent and Daly (2010).

Figure 2. Belgian Tax Primer[1]

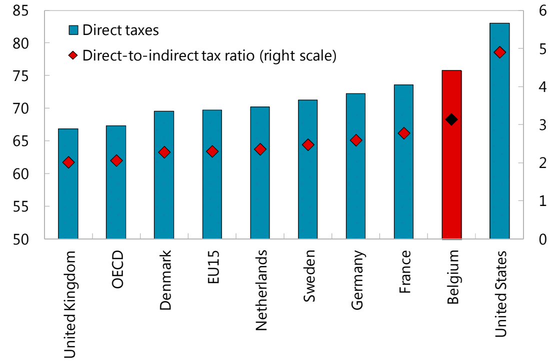
The tax level in Belgium is amongst the highest in OECD …

Total Tax Revenue, 2009–13
(In percent of GDP)



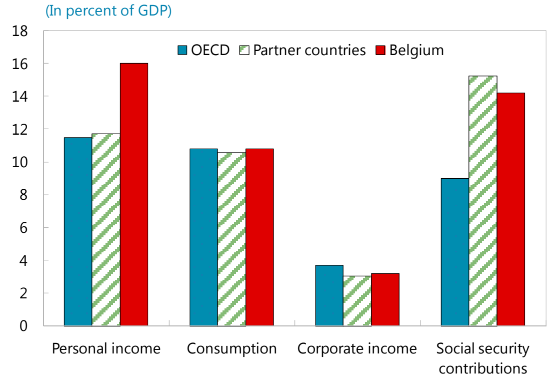
…with the tax mix skewed toward direct taxes.

Tax Mix, 2013
(In percent of total tax revenue; ratio)



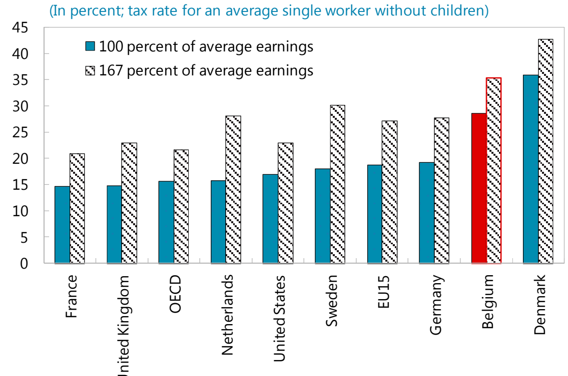
The high direct tax revenue stems from above-average taxation of personal incomes…

Structure of Tax Revenue, 2013[2,3]
(In percent of GDP)



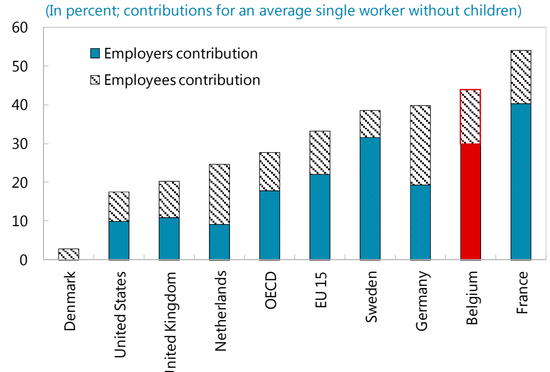
…with average personal income tax rates being the second highest among advanced countries…

Average Income Tax Rate, 2013
(In percent; tax rate for an average single worker without children)



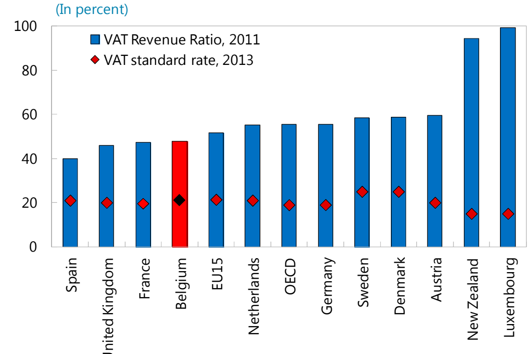
…and mandatory social security contributions further adding to the tax burden on labor income.

Social Security Contributions, 2013
(In percent; contributions for an average single worker without children)



Indirect taxes, mostly VAT, bring in about a fourth of total tax revenue but its efficiency is relatively low.

VAT Revenue Ratio and Standard Rate [4]
(In percent)

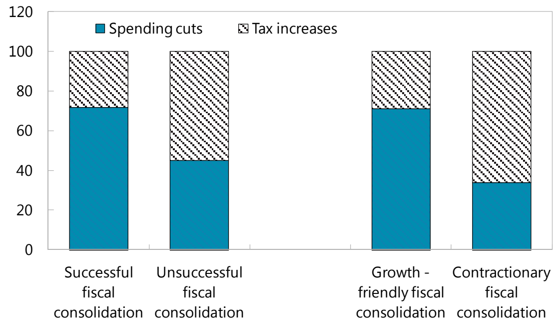


Sources: OECD, PricewaterhouseCoopers, and IMF staff estimates.
[1] Estimated using the ESA95 methodology. OECD and EU15 are simple averages for OECD and EU15 countries, respectively.
[2] Income taxes include taxes on income and net wealth plus capital taxes.
[3] Partner countries are simple averages for Germany, France, and the Netherlands.
[4] The VAT revenue ratio is defined as the ratio of VAT revenue to final consumption, divided by the standard tax rate. It measures the difference between the VAT revenue actually collected and potentially possible if VAT was applied at the standard rate to the entire tax base.

Figure 3. Options for a Lasting, Growth and Equity-Friendly Fiscal Consolidation

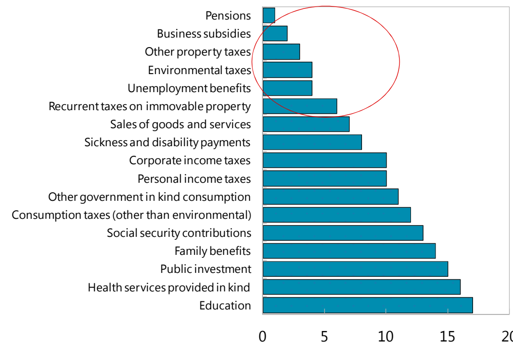
The experience of other countries suggests that spending-based fiscal consolidations are more successful and growth friendly.

Composition of Fiscal Adjustments[1]
(Contribution to overall change in primary deficit over an episode of fiscal consolidation in percent)



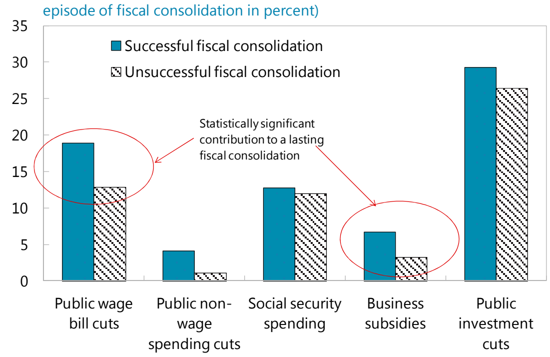
Achieving a growth-and equity-friendly consolidation involves curbing pensions, business subsidies, and unemployment benefits, along with higher property and environmental taxes.

Ranking of Fiscal Consolidation Measures[2]
(Ranking from most to least desirable measure)



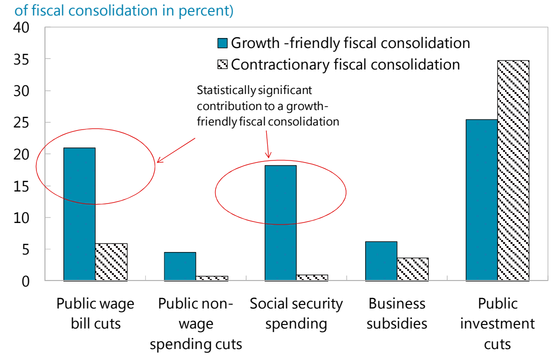
Amongst spending cuts, lowering the public wage bill and business subsidies tends to make most significant contribution to a lasting fiscal consolidation…

Best Policy Options for a Lasting Fiscal Consolidation[1]
(Spending-cuts contribution to overall change in primary deficit over an episode of fiscal consolidation in percent)



…whereas public wage bill cuts and lower social security spending result in a more growth friendly consolidation.

Best Policy Options for a Growth-Friendly Consolidation[1]
(Spending-cuts contribution to overall change in primary deficit over an episode of fiscal consolidation in percent)



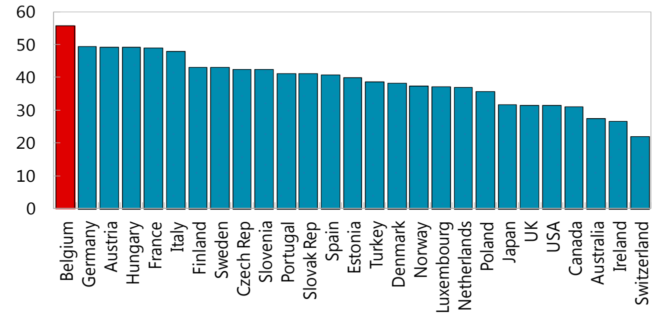
Sources: Cournède, Goujard, and Pina (2013) and Alesina and Ardagna (2013).

[1] A period of fiscal adjustment is successful if the debt to GDP ratio 2 years after the end of a fiscal adjustment is lower than the debt to GDP ratio in the last year of the adjustment. A period of fiscal adjustment is growth-friendly if real GDP growth during the adjustment period is higher than the average growth the country experienced in the 2 years before. See Alesina and Ardagna (2013) for details.

[2] Cluster-specific ranking for Belgium and 10 other European countries. Ranking takes into account short- and long-term impacts on growth and inequality. See Cournède et al. (2013) for details.

10. **Belgium could go further in rebalancing its tax system toward taxes that are less harmful for growth and employment than envisaged by the authorities** (Figures 2 and 4). The Belgian authorities estimate that their planned reduction of labor contributions would reduce fiscal revenue by ½ percent of GDP. To offset this loss, the government has announced several measures described in Table 1. However, there is scope for a larger tax rebalancing. In particular:

Labor Tax Wedge at Average Wage, 2013[1]
(In percent of wage)



Sources: OECD and IMF staff calculations.
[1] Average wage is the average annual gross wage earnings of adult, full-time manual and non manual workers in the industry.

- *Environmental taxes and VAT efficiency*. The level of environmental taxes and VAT efficiency are both low by international standards. The impact of imperfect implementation,[5] though larger than in most OECD countries, contributes little to the VAT inefficiency (about 1/5 of the measured C-inefficiency).[6] The main reasons are rate differentiation and widespread exemptions (Keen, 2013).

- *Taxes on capital gains*. In Belgium, capital gains on shares are taxed only at the corporate level. This contributes to a low combined tax rate on corporate and individuals' capital gains on shares of 8 percent—by far the lowest in the OECD (Harding, 2013). Except for few minor exceptions, capital gains on real property are not taxed. Belgium's High Council of Finance estimates that a comprehensive reform of the capital income taxation could increase the revenue by 1 to 2 percent of GDP per year (High Council of Finance, 2014).

- *Taxation of savings*. The preferential tax treatment of retail bank savings—a tax exemption of around EUR 2,000 per account—has resulted in a massive shift of household savings toward callable saving accounts. In order to create a level-playing field and encourage the reallocation of short-term saving toward longer-term instruments, the tax benefit could be extended to all financial instruments. By capping it at the current level, the measure would be revenue neutral; and by phasing it gradually, it would not disrupt banks' operations.

- *Property taxes*. Property taxes could be rebalanced from transaction taxes toward recurrent taxes on immovable property. This shift, even if fiscally neutral, would be growth-friendly as it could shift private investment out of tax-subsidized housing into more productive business activities and thus increase the rate of economic growth (Arnold *et al.,* 2011). At the same time, lowering taxes on property transactions could aid labor mobility given the currently high transaction costs incurred by changing property.

[5] Imperfect implementation measures the shortfall in VAT revenue due to the fact that the consumption of commodities that are actually taxed is lower than the true consumption (for details, see Keen, 2013).

[6] C-efficiency is an indicator of the departure of the VAT from a perfectly enforced tax levied at a uniform rate on all consumption.

Table 1. Belgium: Announced Fiscal Measures, 2015–18

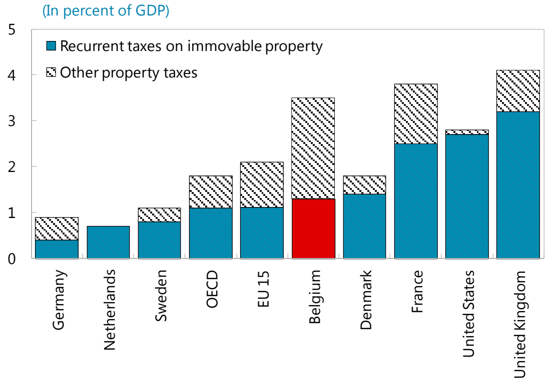
	In billions of euros	In percent of GDP
SPENDING	**8.0**	**1.9**
Federal government primary spending cuts	2.8	0.7
Business subsidies cuts	0.6	0.1
Lower debt service	0.5	0.1
Defense	0.4	0.1
Official development assistance	0.2	0.0
Other primary (incl. operating costs and investment)	1.1	0.3
Social security spending cuts	5.2	1.2
Healthcare reforms	2.9	0.7
Pension reform including early retirement	0.6	0.1
Unemployment benefit	0.4	0.1
Sickness and disabilities	0.3	0.1
Fight against fraud	0.3	0.1
o/w other social transfers		0.0
Child benefit	0.2	0.1
Social correction of non-indexation	-0.1	0.0
Other (incl. operating costs)	0.7	0.2
REVENUE	**0.0**	**0.0**
Revenue increases	2.8	0.7
Excise on tobacco and diesel	0.7	0.2
Liquidation bonus	0.5	0.1
Fight against fraud	0.3	0.1
Non-tax revenue	0.3	0.1
Early taxation of retirement saving	0.3	0.1
Broaden CIT base	0.2	0.1
Taxation of financial sector and financial transcations	0.2	0.1
Broaden VAT base	0.2	0.0
Non-adaptation to inflation of tax expenditures	0.2	0.0
PIT (net effect, including transparency tax)	-0.9	-0.2
Other revenue measures	0.8	0.2
Reduction in labor taxes	-2.8	-0.7
TOTAL	**8.0**	**1.9**

Source: Belgian authorities and IMF staff calculations.

Figure 4. Belgium: Potential for Rebalancing the Tax System

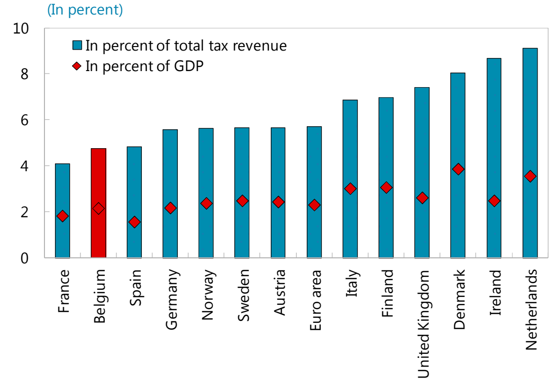
Overall property taxes are high but inefficient and should be rebalanced toward more growth friendly recurrent taxes on immovable property.

Property Taxes, 2012[1]
(In percent of GDP)



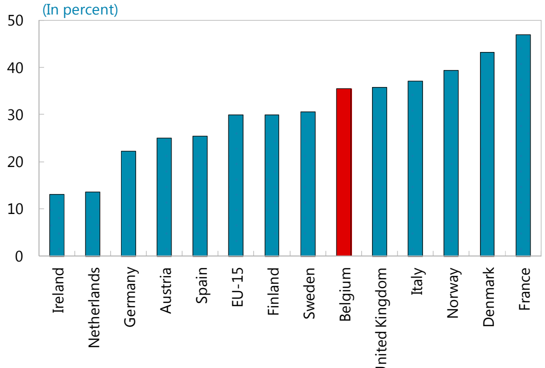
There is also room to raise more revenue from environmental taxes.

Environmental Taxes, 2012
(In percent)



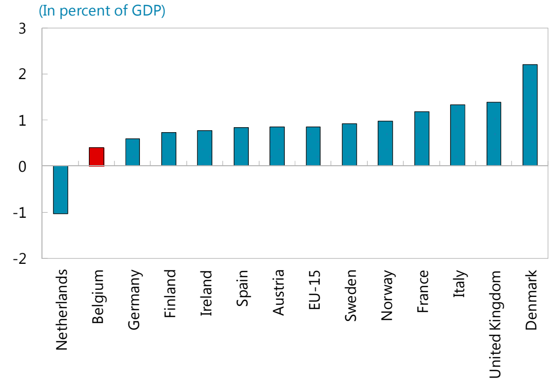
While implicit tax rates on capital are close to the EU15 average...

Implicit Tax Rate on Capital, 2012[1,2]
(In percent)



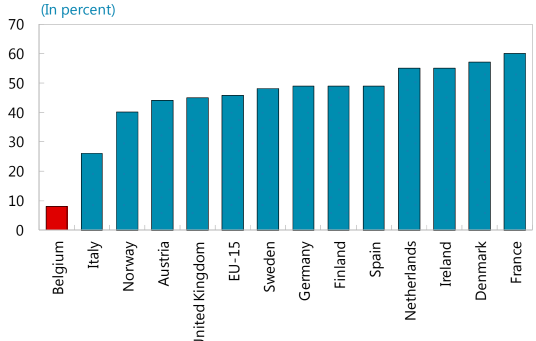
...tax revenue from households' capital income is low, with capital gains on shares or real estate not taxed at all.

Tax Revenue from Households' Capital Income, 2012[1]
(In percent of GDP)



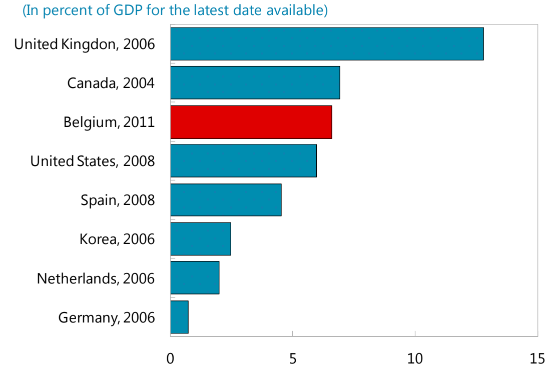
The combined statutory tax rate on capital gains on shares is the lowest amongst peer countries. Capital gains on real property are not taxed.

Combined Statutory Tax Rate on Capital Gains on Shares, 2012[1]
(In percent)



There is also room to reduce tax expenditures.

Tax Expenditure
(In percent of GDP for the latest date available)



Sources: Eurostat, Harding (2013), OECD, and IMF's staff calculations.

[1] EU15 is a simple average for EU15 countries.

[2] The implicit tax rate is the ratio between revenue from all capital taxes and all potentially taxable capital and business income in the economy.

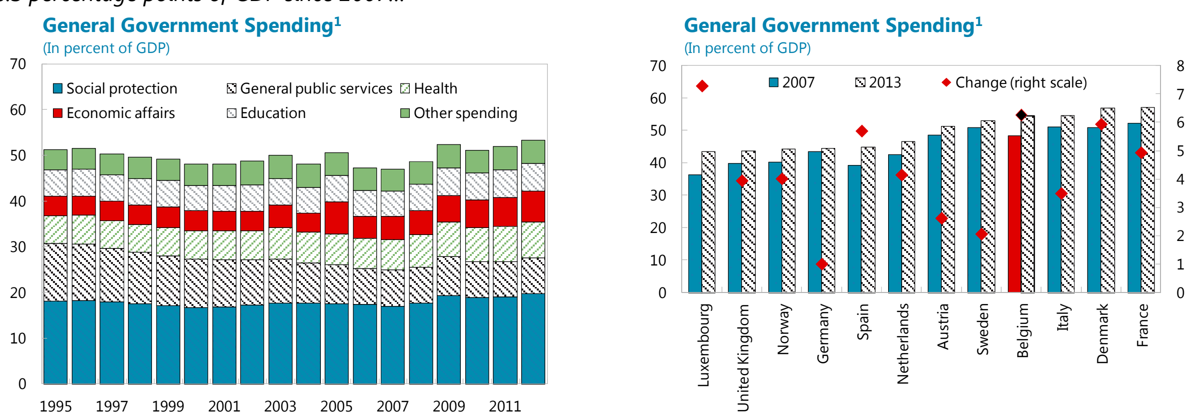
Priority 1: Increasing the Efficiency of Spending on Social Protection

11. **Government expenditures are high by European standard yet continue to rise fast (Figure 5).** General government spending has increased by about 6½ percentage points of GDP since 2007. This is mainly due to the high social spending. At 30 percent of GDP (50 percent of primary spending), the public share of social spending is among the highest in the OECD (Figure 6 and Table 2). As in other European countries, social protection and health spending increased during the recent crisis. However, social spending growth in Belgium was mostly driven by spending on sickness benefits, pensions, and healthcare, as opposed to unemployment benefits. Moreover it increased relatively more than in other countries in the first phase of the crisis and, in contrast with other European or OECD countries, continued to do so when fiscal consolidation was implemented.

Figure 5. Belgium: General Government Spending, 1995–2013

General government spending has increased by 6.3 percentage points of GDP since 2007…

…to one of the highest levels in Europe.



Sources: Haver Analytics, Eurostat, and IMF's *Fiscal Monitor* database and staff calculations.

[1] Estimated using the ESA95 methodology.

12. **Pension and unemployment benefits were the areas where spending were most significantly larger than in the rest of the OECD in 2010.** At 8.2 percent of GDP, income support to working age population was the highest in the European members of the OECD after Denmark and Ireland. This income support includes unemployment benefits which, at almost 4 percent of GDP, were again the largest in the OECD. At 10.1 percent of GDP, spending on pensions was about 2 percent of GDP higher than the OECD average but slightly above EU average (Table 2 and Figure 6).

13. **Recent reforms of pensions and unemployment benefits have slowed somewhat the growth of social spending** (Appendix 1). The pension reform focused on reducing the generous early retirement schemes (including the "pre-pension" schemes) and encouraging longer employment. Pre-crisis, real spending on early retirement had been growing at almost 4 percent per year, second only to health care spending. As a result of the recent reforms, this expenditure is now declining. However, spending on pension continued to increase fast, as in other European countries. The reform of the unemployment benefits reduced slightly the growth of unemployment spending

despite the crisis, but the parallel increase in the demand for sickness and disability allowances suggests the presence of substitution effects across benefits (Figure 6).

14. **Going forward, population ageing will result in increase in health cost.** At 7.9 percent of GDP health spending are already the fourth largest in the OECD and requires reforms to remain sustainable. The OECD (2013) pointed to potentially large saving and efficiency gains from cutting back on excessive drugs consumption and reliance of long term care in institution.

Table 2. Public Social Expenditure by Broad Social Policy Area in 2010
(In percent of GDP)

	Pensions (old age and survivors)	Health	Income support to the working-age population 1/	Other social services	Active Labor Market Programs	Total
France	14.0	8.7	5.5	2.2	1.1	31.7
Denmark	8.2	6.8	8.6	4.2	2.0	29.9
Belgium	**10.1**	**7.9**	**8.2**	**1.7**	**0.8**	**28.8**
Finland	11.4	5.6	8.2	2.4	1.0	28.7
Austria	14.1	6.8	6.0	0.8	0.8	28.6
Sweden	10.1	6.7	7.4	2.6	1.2	27.9
Italy	15.9	7.2	3.3	0.9	0.4	27.8
Germany	11.0	8.2	5.0	1.8	0.9	26.8
Spain	10.8	6.9	6.9	1.1	0.9	26.7
Netherlands	6.4	8.0	6.8	1.3	1.2	23.7
Ireland	5.7	6.1	9.0	1.3	0.9	23.3
Luxembourg	7.6	6.1	7.6	1.2	0.6	23.0
United Kingdom	6.2	7.8	5.6	3.0	0.4	22.8
Norway	7.3	5.7	6.9	2.0	0.6	22.4
Poland	11.3	4.7	3.5	0.5	0.7	20.7
Czech Republic	8.7	6.0	4.2	0.6	0.3	19.9
Switzerland	6.7	6.4	5.2	0.4	0.6	19.5

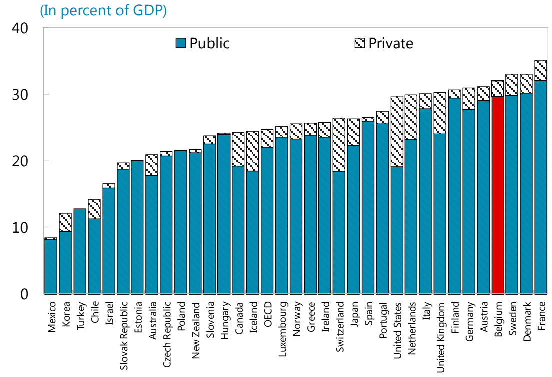
[1] Income support to the working-age population refers to spending on: incapacity benefits, family cash benefits, unemployment, and other social policy areas categories.
Source: OECD's *Social Expenditure* database.

15. **Therefore, the government plans to contain the social spending growth appears appropriate.** As shown in Table 1, containment of social spending amounts to ⅔ of the spending containment effort. Most of the saving is expected to come from maintaining the real growth of health care cost at its current rate of 1½ percent, which is significantly lower than the average real growth of 3 percent experienced since 1995. This would be achieved by a reform of the hospital system, a temporary de-indexation of physician's fees, and a rationalization of prescriptions and medical tests. In addition, the reforms of the unemployment benefits and pensions would be deepened. Various reforms of the unemployment benefits would also reduce unemployment spending by EUR 384 million. The increase of the retirement age from 65 to 66 years by 2025 and 67 by 2030 will not provide immediate fiscal saving but further reducing early retirement schemes will. The sickness and disabilities system will also be reformed in order to provide more incentives to join the labor force and in order to increase the financial cost of the system for employers using the system. This should reduce incentives to use sickness scheme as an early retirement mechanism.

Figure 6. Belgium: General Government Social Spending, 1995–2013

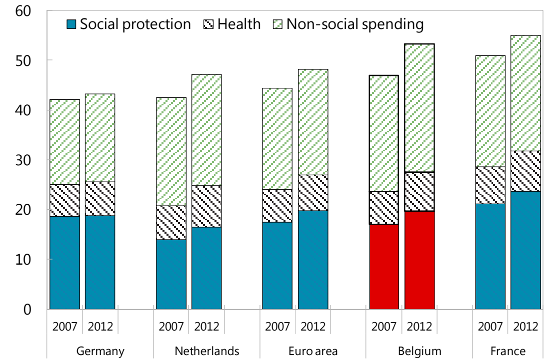
Belgium's social spending is the fourth largest in OECD…

Public and Private Social Expenditure, 2009
(In percent of GDP)



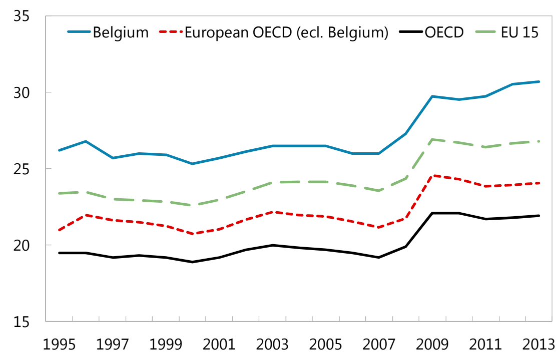
…yet higher social spending contributed to about 2/3 of additional spending since 2007.

Breakdown in General Government Spending[1]
(In percent of GDP)



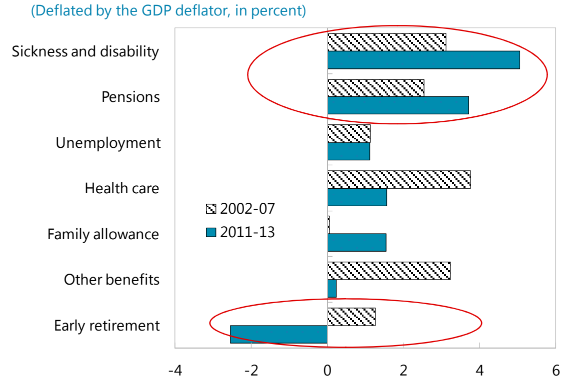
As in other advanced countries, social spending increased in the immediate aftermath of the crisis but unlike in most other countries it continued to do so during the fiscal consolidation.

Public Social Spending in Advanced Countries
(In percent of GDP)



Social spending growth is mostly driven by spending on sickness and disability benefits, pensions, and healthcare. Reforms of early retirement benefits seem to have resulted in considerably higher sickness and disability spending.

Real Annual Growth in Social Spending[2]
(Deflated by the GDP deflator, in percent)



Sources: Haver Analytics, OECD *Social Expenditure Statistics*, Eurostat, Belgian authorities, and IMF staff calculations.

[1] Estimated using the ESA95 methodology.

[2] Unemployment benefits adjusted for cyclical developments.

Priority 2: Reducing Business Subsidies

16. **Subsidies are significantly larger in Belgium than in other countries and planned reductions are limited.** At 2.3 percent of GDP, subsidies are about 3 times larger in Belgium than on average in the three main neighbors or in the euro area (0.8 percent of GDP in both cases; Figure 7). Moreover, subsidies increased by 0.8 percent of GDP over 2007–12, while they remained broadly constant in other European countries. The government intends to reduce business subsidies over 2015–18 by EUR 600 million (0.1 percent of GDP). These cuts focus on the subsidies to the railway company and leave untouched other subsidies.

17. **A large share of subsidies is intended to reduce labor costs.** Some of these subsidies, such as the services vouchers, act as in-work-benefits aimed at providing jobs to low-skilled. Others, which represent a larger share, aim at boosting competitiveness by reducing the labor costs or reducing the cost of innovation (9 percent of labor subsidies are directed to R&D jobs). The use of business subsidies to offset the impact of other distortions (such as high taxes) creates other inefficiencies. As room for tax cuts is created, some of the subsidies could be phased out.

Priority 3: Containing the Wage Bill

18. **Through wage moderation and a policy of reducing the number of civil servants, the federal and regional governments intend to reduce the wage bill.** Wage growth will be reduced by temporary suspension of indexation and wage moderation. In addition, the federal government plans to reduce the number of civil servants by replacing only one out of five civil servants that retire. Similar plans are in place in regional governments.

19. **Wage bill containment is an important component of the fiscal consolidation going forward.** Besides the fact that international experience suggests that wage bill containment is conducive to successful fiscal adjustments, it should play a role in Belgium for two main reasons. First, the targeted fiscal consolidation envisaged by the authorities cannot be achieved without a contribution from a large spending line such as the wage bill (close to ¼ of total spending). Second, if the growth of the wage bill is not reduced, it may undermine the whole consolidation effort or require even more effort to reduce social spending.

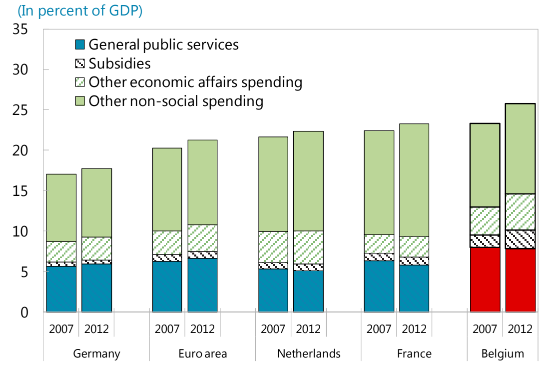
20. **By European standards, the wage bill is large in Belgium and has continued to grow faster in recent years** (Figure 8). It accounts for almost 13 percent of GDP i.e., about 2½ percentage points more than the euro area average and over 5 percent of GDP more than in Germany or Switzerland. This suggests that efficiency gains could be achieved in the civil service without affecting the quality of public services. Recently, the wage bill increased faster than GDP and, as a result, the wage-bill-to-GDP ratio increased by 0.3 percent of GDP over 2010–12. This contrasts with a reduction of the ratio in most European countries.

Figure 7. Belgium: Fiscal Cost of Business Subsidies, 1995–2013

General public spending and economic affairs expenditure—especially business subsidies—are large…

Breakdown in General Government Non-Social Spending[1]

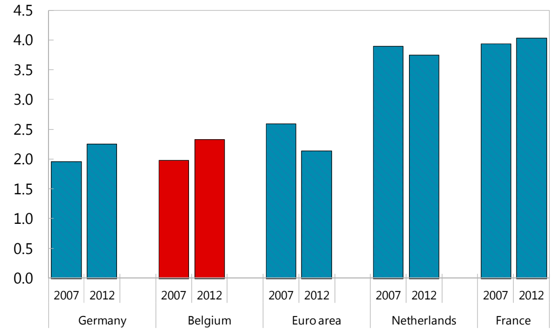
(In percent of GDP)



…in part offset by lower public investment spending.

General Government Public Investment

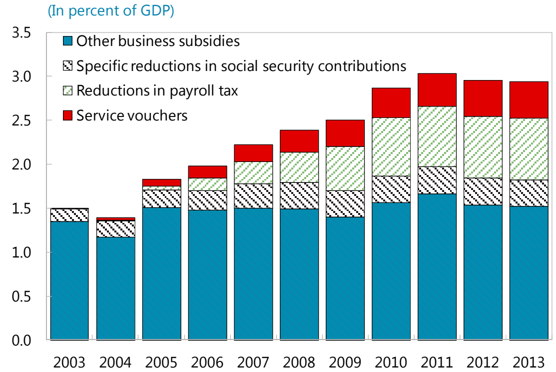
(In percent of GDP)



The cost of business subsidies rose steadily due to higher spending on wage subsidies.

Business Subsidies

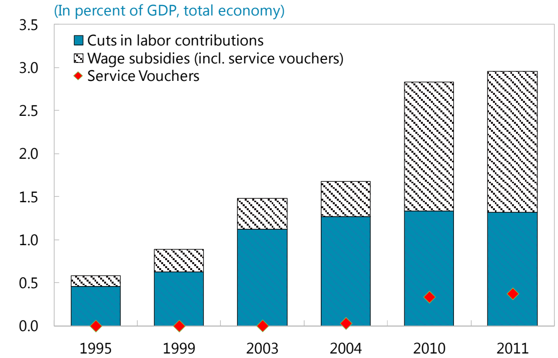
(In percent of GDP)



The cost of measures to cut labor cost has increased rapidly and their nature has shifted toward wage subsidies.

Fiscal Cost of Labor Cost Measures

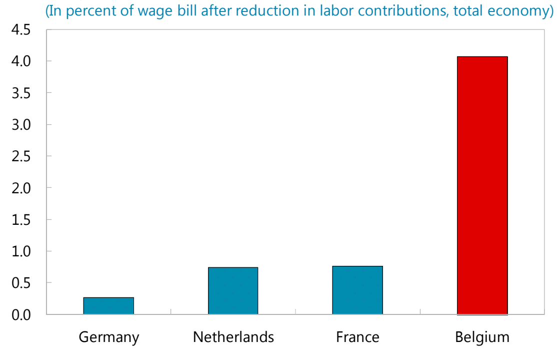
(In percent of GDP, total economy)



Wage subsidies are large by international standards…

Wage Subsidies, 2011

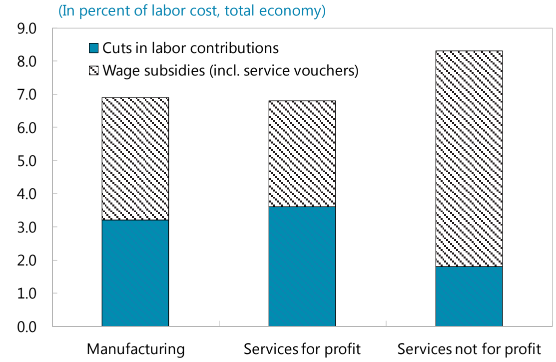
(In percent of wage bill after reduction in labor contributions, total economy)



…but they benefit relatively less sectors exposed to the international competition.

Labor Cost Reductions by Branch, 2011

(In percent of labor cost, total economy)



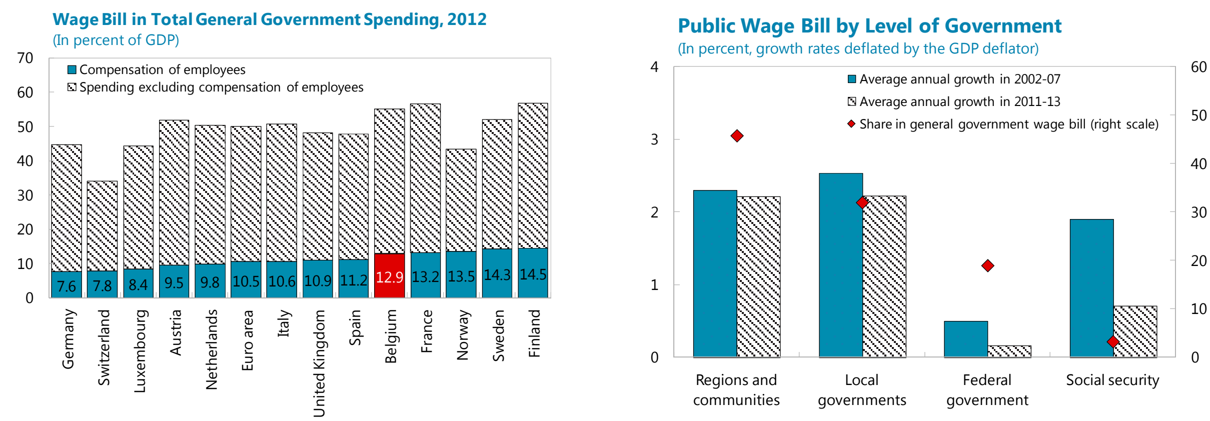
Sources: Eurostat, Groupe d'experts "Compétitivité et Emploi," Belgian authorities, and IMF staff calculations.

[1] Estimated using the ESA95 methodology.

21. **Wage bill containment should take place at all levels of government.** While the real wage bill growth has slowed at all levels of the government since 2011, it remains at above 2 percent per year in Entity II (regions, communities, and local governments) compared much less than 1 percent for Entity I (federal government and social security). Nonetheless, Entity II accounts for over ¾ of the general government's wage bill so most of the effort to contain the wage bill needs to be undertaken at that level.

Figure 8. Belgium: Employee Compensation, 2002–13

By European standards, the wage bill is large in Belgium… *…and continues to increase steadily at subnational levels.*



Sources: Eurostat, Haver Analytics, and IMF staff calculations.

C. Implications for the Burden-Sharing Agreement between Levels of Governments

22. **Primary structural adjustment of 2.9 percent of GDP in 2015 and beyond is still needed to meet the 2014 Stability Program medium-term surplus objective of 0.75 percent of GDP.** Under the burden sharing agreement of December 2013, regions and communities were to contribute 0.6 percent of GDP in 2015–16 to the consolidation of public finance. Additional contribution of 0.5 percent of GDP is expected in the medium-term,[7] and the 2015 Stability Program may further distribute the remaining adjustment between Entity I and Entity II. This is in contrast to the past, when fiscal adjustment burden was borne mostly by the federal government while sub-federal governments roughly balanced their budgets.

23. **Belgium operates one of the most 'federalist' systems of governments when it comes to spending** (Figure 9). Entity II is responsible for about a third of public spending. The three economic regions (Flanders, Wallonia, and the Brussels Region) hold powers linked to territory, economic policy, employment, and public transport (excluding the state-owned railway company). The regions also oversee local governments. Energy policy responsibilities are split between the

[7] IMF Country Report Number 14/76.

federal and regional governments. The three linguistic communities (French, Flemish, and German) are responsible for education, cultural affairs, some public health (hospitals and prevention), and social assistance. The Sixth Reform of the State, negotiated in October 2011, further increased the degree of fiscal federalism by devolving additional spending responsibilities to subnational governments. As of 2015 (the first full year in which the reform applies), Regions are responsible for a significant share of labor market policies; policies on tax exemptions for mortgages on the owner's first house, energy savings; and service vouchers. Communities are responsible for family allowances, elderly care, and some other health care expenditure. The spending responsibilities, including fiscal expenditure, devolved to Regions and Communities amount to about 4.6 percent of GDP (Bisciari *et al.*, 2014).

24. **Given the division of spending responsibilities, most of the adjustment by Entity I will have to come from lower social expenditure.** Social benefits are almost entirely paid for by the social security, with pensions and healthcare accounting for most of the spending. Thus fiscal adjustment by Entity I is well aligned to the need for structural reforms to lengthen working life and increase employment.

25. **Adjustment by Entity II should focus on lowering public wage and non-wage bill.** Entity II accounts for ¾ of public sector wage and other current spending bill. In 2013, the sub-national governments' wage bill accounted for about 10 percent of GDP, or about four times the federal government's wage bill. Further, public employment in the sub-national governments continued to grow very strongly in the recent year, with almost no growth at the federal level. Thus public wage bill containment at the Entity II level should be an important component of the fiscal consolidation going forward.[8] The same is true for the sub-national governments' non-wage current spending, which was four times larger than that of the federal government in 2013 and rising, versus a small decline at the federal level.

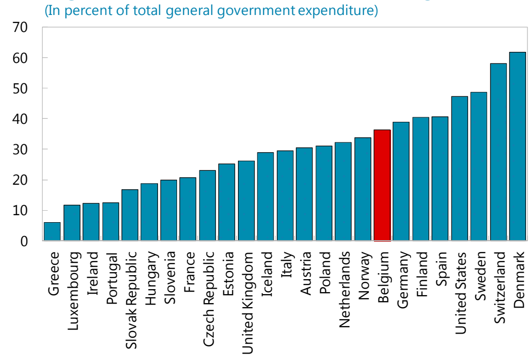
26. **Business subsidies can be lowered across the levels of government.** In 2013, subsidies granted by Entity I added up to 2.3 percent of GDP whereas subsidies paid by Entity II amounted to 0.6 percent of GDP. At the Entity I level, that expenditure includes investment granted to the national railway and postal company (subsidies to both companies will be reduced as part of the 2015 budget), service vouchers, and reductions in payroll tax.

[8] Except for the transfer of staff linked to the transfer of responsibilities.

Figure 9. Belgium: Fiscal Federalism

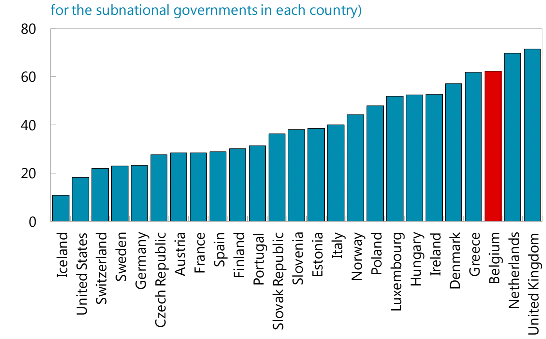
Belgium operates one of the most 'federalist' systems of governments when it comes to spending…

Regional and Local Governments' Spending, 2012[1]
(In percent of total general government expenditure)



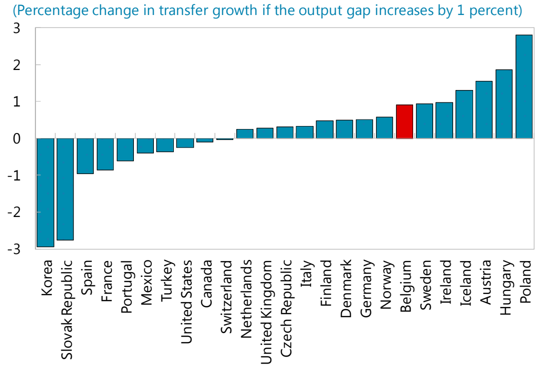
…but its sub-national governments finance themselves mostly through transfers from the federal government …

Intergovernmental Transfer Revenue, 2012
(From the central to subnational goverments, in percent of total revenue for the subnational governments in each country)



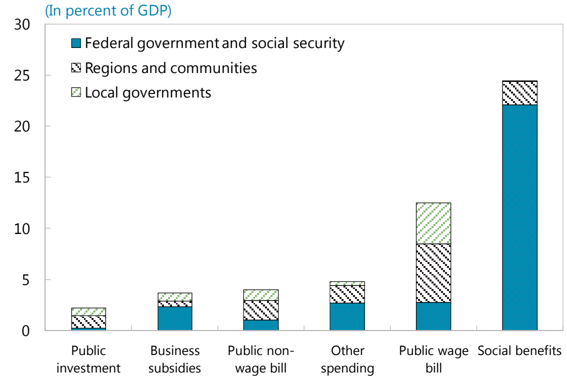
…which are highly procyclical.

Procyclicality of Intergovernmental Transfers, 1970-2009[2]
(Percentage change in transfer growth if the output gap increases by 1 percent)



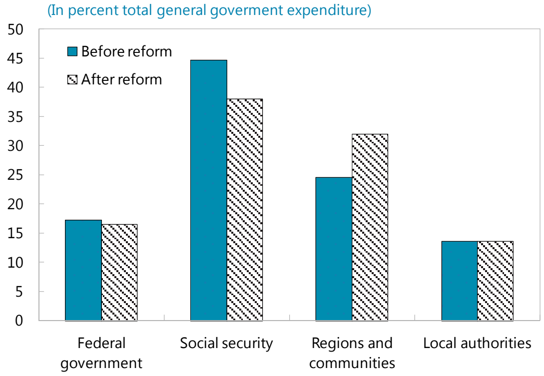
The sub-national governments account for most spending on public wage and non-wage bill, and public investment.

Government Spending by Level of Government, 2013
(In percent of GDP)



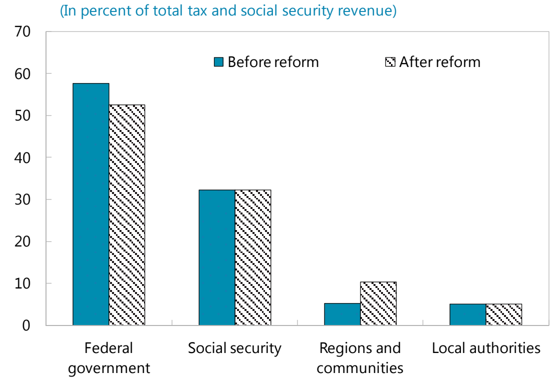
The Sixth Reform of the State substantially increased the degree of fiscal federalism by devolving additional spending responsibilities to subnational governments…

Final Primary Expenditure[3]
(In percent total general goverment expenditure)



…while increasing tax autonomy of the Regions.[4]

Tax and Social Security Revenue[3]
(In percent of total tax and social security revenue)



Sources: Belgian authorities; OECD; Bisciari *et al.* (2014); Blöchliger and Égert (2013); Decoster and Sas (2013); and IMF's staff calculations.

[1] Regional and local goverments' spending is defined as total spending minus the inter-governmental transfer spending of that government level.

[2] A negative value means an anti-cyclical transfer system; a positive value means it is pro-cyclical. See Blöchliger and Égert (2013) for details.

[3] Estimates based on 2015 figures. Expenditure net of transfers to other levels of the government.

[4] Language communities do not have their own tax base and only rely on transfers.

D. Conclusion

27. **In order to achieve its medium-term fiscal objective, Belgium plans to undertake an expenditure-based adjustment.** So far, fiscal consolidation has been very modest and has been achieved through revenue increases. Shifting from a revenue-based adjustment to an expenditure-based adjustment will increase the quality of the consolidation and its sustainability.

28. **Based on international past experience with fiscal consolidation and specificities of the Belgian economy, this paper argues that in order to be as growth-friendly and sustainable as possible, fiscal consolidation should focus on three main areas:**

a. *Increasing the efficiency of spending on social protection*. Social spending, notably pension and unemployment, are among the highest in the OECD and are increasing fast. Generous schemes discourage market participation. Moreover, health care costs need to be contained to face the upcoming impact of a rapidly ageing population.

b. *Reducing business subsidies*. Business subsidies are significantly larger in Belgium than in other euro area countries notably because of measures to reduce labor cost. However, if reducing the labor cost can help in the short term, competitiveness and employment cannot be sustained in the long run by increasing wage subsidies. A reduction in subsidies would be made possible by competitiveness gains through structural reforms and tax cuts.

c. *Containing the public wage bill*. Again, the wage bill is large in Belgium by European standard. Given its weight in total spending, a fiscal consolidation in the magnitude considered by the authorities cannot be achieved without containing the wage bill at all levels of governments.

29. **Without precluding scope for increased efficiency, investment spending should be ring fenced given the negative impact of cuts in these areas on growth potential in the medium term.** Though, there is a pressing need for growth-enhancing investment in transportation, energy, education, and social housing, real public investment dropped by 5.4 percent in 2013 and the decline is expected to continue according to federal and regional governments fiscal plans.

30. **If the shift from a revenue-based to an expenditure-based consolidation is needed, this does not mean that there should be no reform of the taxation system.** There is ample room to reduce tax expenditures. This would create fiscal space for a reduction in overall tax rates while removing economic distortions. Moreover, the tax system can be rebalanced from personal income taxes and labor contributions toward taxes that are less harmful for growth and employment. This would include (i) environmental taxes and broadening the base of VAT while reducing rate differentiation; (ii) taxes on capital gains; and (iii) shifting property taxes from transaction to recurrent taxes on immovable property.

31. **Achieving this high-quality fiscal adjustment requires that expenditure saving is implemented at all levels of government**. Given the division of spending responsibilities, most of the adjustment by Entity I will have to come from lower social expenditure. Adjustment by Entity II

should focus on lowering public wage and non-wage bill. Business subsidies can be lowered across the levels of government.

32. **The federal government program meets some of these objectives.** Measures that contain social security and healthcare spending should help achieve a growth-friendly and lasting consolidation. However, more could be done across the federated government entities notably to cut the public wage bill and business subsidies.

Appendix I. Reforms of Unemployment Benefits and Pension (2012–15)

2011	2012/2015	Status
UNEMPLOYMENT BENEFITS		
Search requirements		
Suitable job is 25 km away or less	Suitable job is 60 km away or less	Implemented
Restrict rights to search for the same kind of job to six months	Restrict right to search for the same kind of job to three months (young unemployed) and five months (other unemployed)	Implemented
Monitor search efforts for 18–21 months after unemployment, with an annual follow-up	Monitor search efforts nine months (<26 years old) or 12 months (26 or older) after start of unemployment, with follow-ups every nine months	Implemented
Search requirement until 60	Search requirements applicable until 65	Planned by the new government
Exemption of search requirements for familial and social reasons	Elimination of the exemption	Planned by the new government
To obtain unemployment benefits, unemployed have to be registered as job seekers within 2 weeks from the day they are laid off	Registration as job seeker has to be done within 4 weeks following the notice of lay-off	Planned by the new government
Unemployment benefit levels		
Initial unemployment benefits are 60 percent of last wage, falling after one year to 55 percent for people living alone and 40 percent for people living in a family with another income	Initial unemployment benefits are 65 percent of last wage for three months, then 60 percent for the following nine months. After 13 months there is a reduction to 55 percent for people living alone and 40 percent for people living in a family with another income. Between 15 and 24 months of unemployment, depending on career length before unemployment, a stepwise reduction to arrive after maximum 48 months at a level just above social assistance	Implemented
Higher unemployment benefits for unemployed above 50	Higher unemployment benefits for those above 55	Implemented
Seniority complement is granted above 50	Eliminated for new entrants	Planned by the new government
Unemployment benefit based on the wage of the last work period of at least 4 weeks	Unemployment benefit based on the average wage of the last 12 months	Planned by the new government

Involuntary part time workers can obtain an allowance for income support so that their net income is higher than the unemployment benefit in case of full unemployment	Allowance for income support in case of part time job (AGR) is divided by 2 after one year Calculation of the allowance for income support (AGR) will be reviewed based on the calculation that was made before 2008	Planned by the new government
Unemployment benefits for the young entering the labor force		
Available after nine months of unemployment	Available after 12 months of unemployment	Implemented
Evaluation of search efforts before opening the right on unemployment benefits for young people leaving school	Two evaluations of search efforts 7 and 11 months after registering as jobseeker. Opening of right on unemployment benefits only after two positive evaluations	Implemented for all youngsters that have left school after June 1, 2013
Search effort requirement every 12 or 16 months when on unemployment benefits	Evaluation of search requirements every six months. In case of negative evaluation: no UB until the next evaluation, and no earlier than after 6 months	Implemented
Unlimited	Limited to three years (five years for worker on the margin of the labor market) for unemployed living with family with other income, or until the age of 33 in other family situations. Period of three years could be extended by six months if at least worked six months in the last 24 months.	Implemented
Young school leavers can apply for unemployment benefit if they have participated in the secondary education final exam	Until 21, young school leavers can apply for unemployment benefit if they have obtained a secondary education degree	Planned by the new government
For school leavers, the maximum age to introduce a demand for unemployment benefits is 30	Maximum age reduced to 25	Planned by the new government
Easing the transition to the labor market for low-skilled youth		
	Yearly creation of 10 000 internships for low-skilled school leavers. Reduced employer contribution in case of hiring after internship. Additionally, employers are asked to create 1 percent internship positions under the form of, for example, apprenticeships	in progress
Government subsidy for temporary unemployment		
Without employer penalty	Employers will pay a penalty if there is excess use of the system	Implemented
Allowance for temporary unemployment is 70 percent of last salary	Reduced to 65 percent of salary	Planned by the new government

No limits on the use by employers of temporary unemployment	The number of days of economic unemployment will be limited for employers	Planned by the new government
Government subsidy for time-credit and career break system		
Five year duration before the age of 50	One year duration (two to five years if part-time) before the age of 55, with supplementary credit of maximum 36 months for motivated breaks, such as childcare or studies (maximum 48 months for specific cases such as taking care of a handicapped child less than 21 year old)	Implemented
	Elimination of the rights to benefits for one year non-motivated break. For childcare, one supplementary year of break with benefits	Planned by the new government
Unlimited duration above the age of 50	Unlimited duration above the age of 55	Implemented
	Unlimited duration above the age of 60	Planned by the new government
72 month duration in public sector	60 month duration in public sector	Implemented
More favorable rights on career breaks in the public sector	Progressive harmonization of career break in the public sector with time credit in the private sector (full harmonization by 2020)	Planned by the new government
PENSION BENEFITS		
Pre-pension benefits (renamed to "Unemployment benefits with employer top-up")		
No job search requirement	Job search requirement until the age of 60	Implemented
	Job search requirement until the age of 65	Planned by the new government
Minimum age 58	Minimum age 60 for new collective agreements (2015 for existing agreements and 2024 for women)	Implemented
	Minimum age 62 for new entrants Minimum age 58 for new entrants in case of hardship jobs or long career (60 by 2017)	Planned by the new government
Minimum career length 38 years for men, 25 years for women	Minimum career length 35 years (women) / 40 years (men) for new collective agreements (2015 for existing agreements)	Implemented
Pre-pension years count fully toward pension rights at the last wage level	Pre-pension years below the age of 60 do not count toward pension rights at last wage level but on a lower fictive level	Implemented
Reduced social security contributions on employer's top-up payment	Employer social security contributions will be higher and linked to age of worker entering pre-pension	Implemented
The age limit in restructuring companies and loss-making companies is 53 and raising to 58 in 2018	The age limit will be 60 starting in 2017 for new entrants	Planned by the new government

Part-time pre-pension system		
Part-time pre-pension system	No new entries from 2012	Implemented
Government subsidy for working time reduction to part time (time-credit with unlimited duration)		
Minimum age 50	Minimum age 55 (with exceptions for physically demanding jobs)	Implemented
	Minimum age 60 (no exceptions)	Planned by the new government
Pre-pension for collective dismissal		
Minimum age 50	Minimum age 52 for loss-making companies (from 2012), raised by six months every year to 55 in 2018, 55 for restructuring companies (from 2013)	Implemented
	Minimum age 60 for new entrants for loss-making companies or restructuring companies as from 2017	Planned by the new government
Standard social security contributions	Employer social security contributions will be higher and linked to age of worker entering pre-pension	Implemented
Unemployment benefits in the pre-pension system		
No job search requirement for those above the age of 50	Job search requirement until the age of 60	Implemented
	Job search requirement until the age of 65 from 2015	Planned by the new government
Early retirement benefit		
Minimum age 60, full career length 35 years	Minimum age increased by six months every year to 62 by 2016, full career length increased by one year every year to 40 years by 2016	Implemented
	Minimum age will increase by six months in 2017 and 2018 to 63 on condition of a full career length that will increase by one year to 41 in 2017 and to 42 in 2019 Exceptions for long career will be stricter: required career length to retire at 60 will increase from 42 years to 43 years in 2017 and 44 in 2019 (from 41 to 42 in 2017 and 43 in 2019 for a early retirement at 61)	Planned by the new government
Pension bonus	Access to bonus stricter: bonus starts not earlier than 12 months after earliest possible date for early retirement. Bonus continues after 65 years. Only real working days create bonus-rights	Implemented

	Pension bonus will be phased out. Only people who meet conditions for early retirement by December 31, 2014 or are 65 year old and have a career of 40 before December 31, 2014 are eligible to a pension bonus.	Implemented
Diploma bonus: Years spent to get a bachelor or a master degree required to become civil servants are accounted for in the calculation of the career condition for early retirement	Diploma bonus will be phase out (6 months each year)starting 2016	Law in preparation
Employer obligations toward older workers		
None	Draw up a plan to retain older workers	Implemented
Social security contributions		
Reduced for hiring of older long-term unemployed	Reduced for hiring of older long term unemployed and pre-pensioners	Implemented
Reduced for older workers from 50 years on	Adapted in 2013: stronger reduction, but starting at 54 years instead of 50 years and only for those with gross wage under 4.453/month	Implemented
	Additional social security contribution reductions for mentors; first 5 hires in SME; (very) low-skilled (unemployed) youth; medium-skilled youth ; handicapped persons	Implemented
	Strengthening of the structural social security contribution reductions	In progress
Encourage longer employment via pension system reforms		
Encourage longer employment	For pensioners aged 65 or more, abolish ceiling on permitted earned incomes for those with careers spanning more than 42 years	Implemented
	No limits to income for pensioners who are 65 year old or have a career of 45 years	Law in preparation
Full valorization of assimilated periods in pension calculation at last wage earned: unemployment, unemployment with company top-up and time credit	Limited valorization of assimilated periods in pension calculation: • 3rd period unemployment, unemployment with company top-up before 60 and end of career time credit before 60 at pension minimum wage • unmotivated time credit limited to 1 year assimilation	Implemented
	Unmotivated time credit will be abolished	Planned by the new government

Pension bonus for workers and self-employed persons: EUR 2,2974 for every day worked extra, if 62 or a career of 44 years Pension complement for statutory government employees: percentage increase for every month worked after 60	Unified pension bonus for workers, self-employed persons and statutory government employees: progressively increasing lump sum amount (from EUR 1.5 to EUR 2.0) for every day worked extra , if person continues working for longer than 1 year after fulfillment of early retirement conditions	Implemented
Survivors' pension for widow(er)s: always for survivors of 45 years and older, under certain conditions in case of survivors younger than 45	For widow(er)s younger than 45: survivors' pension replaced by transition allowance (12 months if no children, 24 months if children) that can be combined without limitation with work income, followed by automatic access to unemployment benefit if no gainful occupation and entitled to appropriate and early guidance. Eligibility age of 45 increased gradually to 50 by 2025	Implemented
	As for 2025, the eligibility age of 50 will increase gradually by one year each year to reach 55	Planned by the new government
In workers' and self-employed persons' pension schemes the months of professional activity in the year of retirement are not taken into account for pension calculation.	In workers' and self-employed persons' pension schemes the months of professional activity in the year of retirement are taken into calculation.	Implemented
Principle of career unity in pension calculation in pension schemes of workers, self-employed persons and statutory government employees: career fraction or sum of career fractions cannot exceed 1 (45/45)	Notion career no longer expressed in years (45), but in full time equivalent days (14,040)	Social partners have given positive advice – Law project is sent to the Parliament
Increased taxation of the second pillar system in case of early retirement	From July 1, 2013, 20 percent instead of 16.5 percent if leaving at 60 and if leaving at 61 without legal pension 18 percent instead of 16.5 percent	Implemented
Legal age for fill pension is 65	Increased to 66 in 2025 and 67 in 2030	Planned by the new government
Decrease pension expenditure		
Pension complement for frontier or seasonal workers in workers' pension scheme: frontier or seasonal workers residing in Belgium granted pension complement to increase foreign pension to level of pension they would have received if they had worked in Belgium	From July 1, 2014 no new rights to pension complements for frontier or seasonal workers will be constituted Pension complements granted paid out from July 1, 2014 modified on two points: • only awarded from moment person concerned fulfills receipt conditions of foreign pension • amount of pension complement will be based on all foreign pension benefits	Social partners have given positive advice – Law project is sent to the Parliament

	• Pension complement for frontier or seasonal workers removed as from 2015	Law in preparation
	Pension complements granted from January 1, 2015 will be modified (not applicable to those who could have taken up their pension before that date) will be based on all foreign pension benefits	Law in preparation
Minimum pension: Career condition to benefit from 1/45th of the minimum pension is 30 years of 208 days	From 2015, at least 52 days in a year are required to obtain 1/45th of the minimum pension.	Royal Decree in preparation
Structural reform of the pension scheme		Planned by the new government

Sources: Belgian Federal Public Service Employment, Labor and Social Dialogue, National Bank of Belgium, National Employment Office, Federal Planning Bureau, Ministry of Pensions, and Belgian Stability Program 2012–15.

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