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Belgium: Selected Issues

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BELGIUM

Selected Issues

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Overview

1. Over the past decade and a half, Belgium has made great strides in addressing macroeconomic imbalances. Public consumption was reduced significantly during the 1980s; steps were taken to improve efficiency and limit the growth in social transfers, notably during the late 1980s and early 1990s; monetary policy, linked to the deutsche mark, achieved high credibility; wage pressures were contained and competitiveness preserved; and ambitious targets for entry into EMU were achieved. These reforms have had a major impact on economic performance. In the public finances, consistently high primary surpluses led to an improved government saving ratio, and a lower public debt burden. Inflation subsided and interest premia declined. Corporate investment has increased markedly while, with a more convincing fiscal policy, precautionary saving declined appreciably. As a result, a solid potential has been created for economic recovery.

2. Advancement to the threshold of EMU marks a significant passage for the Belgian economy. With efforts to redress critical imbalances having largely paid off, it would be natural for policy to become mainly focused on short-term targets. History, however, shows clearly that such a focus can have unfortunate consequences—and underlying structural weaknesses can lead all too quickly to first order macroeconomic problems. It is in light of the prolonged and often painful adjustment that was required to restore the current measure of macroeconomic balance that present policy challenges should be viewed, and in particular the need to address a number of key structural problems in the economy.

3. In particular, with entry into EMU and continuing market liberalization, Belgium's economic structure will need to become more flexible. High unemployment and low employment growth present a continuing fiscal burden and constraint on growth. Related to this, in the public finances, the challenge remains to reduce the tax burden on labor income while implementing a spending program that is sustainable and consistent with commitments on the overall deficit. This challenge, in both the public finances and the labor market, will have to be addressed in the context of Belgium's federal system of government and the complications engendered by differential regional performance. Moreover, an aging population and broad social entitlements are compelling reasons for a forward-looking policy agenda. There is a likelihood that, absent market reform, employment creation will be disappointing, while the needed reduction in the tax burden on labor income would play a critical role in influencing the structure of investment and employment growth. The demographic challenge thus needs to be addressed through a range of policies including entitlement reform and further preemptive fiscal consolidation. In all these areas, including the public finances, it is thus the structural as much as the broad financial dimension that is at issue.

4. In distilling the priorities that will equip the economy for EMU and population aging four messages emerge as key. First, in the context of the EMU, the costs of falling short on fiscal objectives are high: a forward-looking fiscal policy that yields an appropriate safety margin has great merit. Second, along with the need to create room for a reduction in the tax wedge on labor income, this requires action to restrain the growth of primary spending to well

below the growth of GDP with particular efforts in social security and the regions and communities. Third, in a changing environment, the process of wage formation and the efficiency of the labor market will need to be addressed, and unemployment benefits made more conditional on efforts to seek work and training-priorities underscored by wide local variations in unemployment. Finally, with the demographic shock in mind, continuing measures to restrain pension and health care spending are crucial if more disruptive adjustment is to be avoided at a later stage.

5. Success in each of these areas will depend closely on the adoption of a comprehensive approach: the linkage between the current policy challenges is striking. High structural unemployment raises issues of product as well as labor market reform, while also reflecting the high tax burden on labor income. In turn, given fiscal constraints, any sizable cut in the tax burden implies difficult choices in public spending. On the other hand, well-designed policies offer the prospect of a virtuous circle of employment generation, fiscal improvement, and economic growth.

I. THE PUBLIC FINANCES: STRUCTURAL ISSUES AND POLICY OBJECTIVES[1]

A. Introduction

6. Belgium has made major progress in restoring the public finances to a sound position.[2] During the 1980s, facing unsustainable fiscal deficits—which peaked at 11.5 percent of GDP in 1983—and a surging public debt, government primary spending was pared back while the taxation of labor income was increased. During 1981-91, government primary spending fell from 51.3 percent of GDP to 40.2 percent and, with this, the overall fiscal deficit was reduced from 12.7 percent of GDP to 5.5 percent, over the same period. Following a lapse in the late 1980s, efforts to improve the public finances were renewed in 1992, beginning with the EU Convergence Program for 1992-96, established to meet the objectives of the Maastricht Treaty. Under this and succeeding convergence programs—which relied largely on tax increases, and falling interest payments, while keeping primary spending in check—the overall deficit in public finances was reduced by 4.3 percentage points of GDP, and the structural deficit by 6.6 percentage points, over a five-year period. The convergence program was complemented in 1993 by the "Global Plan", which realigned the indexation mechanism and targeted ceilings for social spending growth. By 1997, the fiscal deficit (at 2.3 percent of GDP) was below the Maastricht reference value and the public debt had fallen by 11.5 percentage points (from its 1993 crest), to 123.6 percent of GDP.

7. Over the medium and long term, fiscal policy faces a number of challenges: ensuring that targets are met under the EMU Stability and Growth Pact, dealing with looming

[1]Prepared by Kenneth Meyers.

[2]See Staff Country Report No. 97/8 for a discussion of fiscal adjustment since 1982.

demographic pressures, and reducing the tax burden, which is among the heaviest in the advanced economies. In reviewing these issues, it is apparent that the deficit reduction targeted under the current convergence program (covering 1996-2000) will derive essentially from a decline in interest payments: in the near-term, under present policies, growth in primary spending is expected to be only slightly below the trend GDP growth rate. Over the medium and longer term, however, if fiscal policy does not address structural spending issues, then outlays on wages, health care, and pensions will continue to grow apace. In the long term, the fiscal impact of demographic changes is likely to be substantial (Box I.1).

8. A further key consideration is that, over the longer term, the feedback channel between adjustment in the labor market and fiscal performance will become critical. Because flows of financial capital are highly sensitive to changes in tax rates, revenue generation is skewed toward labor income. Taken together with market rigidities, and the current implementation of benefit programs, this leads to high structural unemployment and low labor market participation: the result is increased public spending on social programs and decreased revenue buoyancy.

9. Seen in a long run perspective, the challenge to policy is thus to break out of a cycle involving high and rising public spending, a high tax wedge, and poor employment performance. While, in 1998-99, it seems likely that the revenue ratio will decline somewhat as a result of changes in the composition of economic activity, and some planned cuts in social security contributions, in the longer run spending pressures appear to imply a rise in the tax burden.

10. To achieve favorable fiscal outcomes, with a sustainable deficit, a lower tax burden, and higher employment, restraints over the growth of primary spending are key. Identifying opportunities for further saving and improved efficiency is important both to increase the safety margin relative to the Growth and Stability Pact (under the EMU) and to reduce the tax burden on a durable basis. A clearly articulated program for spending restraint over the near and medium term would preclude the necessity of more difficult and less productive measures, if adjustment is deferred. As a renewed effort at fiscal consolidation would secure room for a decrease in wage- and salary-based taxation, it would also create the possibility of lowering the effective cost of labor. Potentially, a virtuous circle of employment increases, improved public finances, and reduced labor taxes could be set in motion.

11. In this setting, the challenge for policy is to identify a strategy and appropriate priorities for slowing spending growth. Such a strategy would need to address the shifting of resources from low-priority uses to institutions and activities needing redress. It would also need to address adjustments at the various levels of government—federal, regional, language community, and local. Given the devolution of government responsibilities in Belgium, this will require a concerted effort.

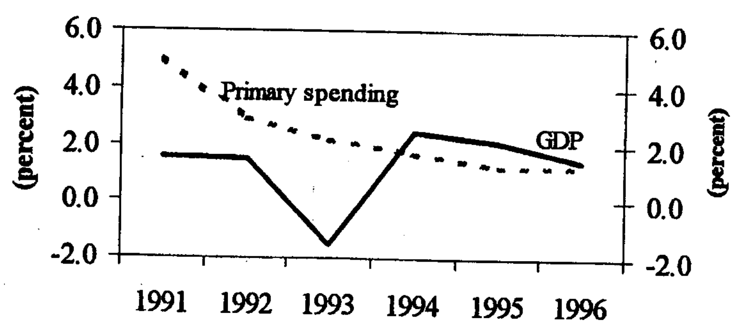
B. The Composition of Public Expenditure

12. The relative share of Belgium's general government outlays in GDP, at 49.3 percent, is high in comparison with other European Union members (Table I.1). The task of limiting the growth of public expenditure is complicated by a spending structure that reflects the gradual overall adjustment pace of the 1980s, the formal devolution of government responsibilities to the regions and language communities in 1989, and the composition of the fiscal adjustment since 1992 to meet the criteria for EMU eligibility.

13. The heavy burden of **interest payments**, on a net public debt equivalent to 123.6 percent of GDP in 1997, is the most significant explanator of the comparatively high share of government spending. In 1997, interest payments on the public debt were equivalent to 7.9 percent of GDP—some 3.5 percentage points above the EU average. Given the need to keep non-labor tax rates competitive, and the distortionary effects of high labor taxation, achieving EU deficit limits while servicing a relatively large interest burden implied reducing primary spending, in the 1980s, to just below the EU average.

14. Following this successful adjustment, the record on limiting the growth of **primary spending** has been somewhat troubling over the past five years. While such spending, equivalent to 41.4 percent of GDP, is estimated to have been 0.5 percentage points below the average for the EU in 1997, the favorable spread against average has decreased by 3.2 percentage points during 1993-97—with primary spending growing roughly in line with GDP in Belgium, at 1.5 percent in real terms (Figure I.1), while most EU members continued to make strides in reducing the burden of such expenditures.

Figure I.1. Belgium: Growth of GDP and Primary Spending



Sources: National Bank of Belgium; and High Council for Finance.

15. The principal factor underlying the current level of primary spending is the government's profile in redistributing income. In 1997, general government **transfer payments** (including interest and subsidies) amounted to BEF 3.1 trillion (35.8 percent of GDP) and constituted 72.5 percent of total spending. Of this, the share of transfers payments

Table I.1. Belgium: Comparative General Expenditure, 1980, 1994-97

(Percent of GDP)

	1980	1994	1995	1996	1997
General government expenditure					
Belgium	53.7	51.4	50.3	49.9	49.3
France	42.7	51.4	50.8	51.1	50.4
Germany	46.0	47.3	47.8	47.4	46.5
Netherlands	53.1	52.2	51.7	49.9	48.8
Average, European Union 1/	42.7	48.9	48.4	47.8	46.3
Comparative general government primary expenditure					
Belgium	48.4	42.0	41.7	41.6	41.3
France	41.9	48.3	47.5	47.7	47.1
Germany	44.7	44.6	44.7	44.3	43.4
Netherlands	50.7	47.4	46.6	44.8	44.4
Average, European Union 1/	40.7	44.2	43.5	43.0	41.9
Comparative general government Interest payments					
Belgium	5.3	9.4	8.6	8.3	7.9
France	0.8	3.1	3.3	3.4	3.3
Germany	1.3	2.7	3.1	3.1	3.1
Netherlands	2.4	4.8	5.1	5.1	4.4
Average, European Union 1/	2.0	4.7	4.9	4.8	4.4

Sources: European Community, National Bank of Belgium, OECD; and staff calculations.

1/ Average of 15 current European Union members.

to households amounted to 24.2 percent of GDP (Table I.2). Considering recent trends and the structure of spending, limiting the real growth of transfers to households, which averaged 1.6 percent per annum over the past five years, is clearly a central challenge for policy.

16. Among transfers to households, pension payments and health insurance outlays comprised 60.8 percent of the total in 1997. Disbursements for other entitlements (including unemployment insurance, early retirement, and family allowances) accounted for 19.6 percent, with the remaining outlays being for diverse items such as accident insurance, minimum income support, aid to handicapped individuals, and guaranteed income to the elderly.

17. To a significant extent, the size and structure of transfers to households reflect the administrative arrangements in place as well as long-established policy priorities. A large share of spending is not normally subject to concerted review in the annual budgeting process—the basic components of unemployment insurance, family allowances, and health care expenditure reflect entitlements that embody a well-established social consensus. Administratively, less than 15 percent of the receipts of the social security administration are discretionary transfers from other levels of government, while the funding of certain social spending activities at the regional, community and local level (e.g., example, public health programs) is reflected in the revenue sharing formula established under the Special Law of 1989 (see Section I.C below).

18. In general, except during periods of crisis, modifications to social spending have been intramarginal. For example, while the burden of unemployment insurance and early retirement payments is amplified by labor market rigidities and weak incentives built into the entitlement structure, these outlays constitute only 11.4 percent of household transfers, and revisions currently under consideration will not substantially alter their magnitude. Similarly, the basic entitlement for family allowances is not under review.

19. Recent attempts to restrain the growth of health care expenditure echo this point. While total spending on health care, as a share of GDP, is only somewhat above average spending in the advanced economies, its growth rate is relatively high. In 1992, the share of such outlays, was 1 percentage point above the average for advanced economies,[3] while health care transfers (6.1 percent of GDP in 1997) are estimated to have grown at annual average rate of 2.8 percent in real terms during 1993-97, with spending growth averaging 5.9 percent during 1995-96 (Figure I.2).

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[3]See New Directions in Health Care Policy for a discussion.

Box I.1. Belgium: Is There Really a Demographic Shock?

A recent study by the Belgian Bureau du Plan would seem to suggest that Belgium, unlike other countries, will hardly be affected by the upcoming demographic shock. Between 2000 and 2030, the share of social expenditure in GDP would grow by only 1.5 percent. While expenditure on pensions and health care would increase by 3 percentage points, unemployment benefits and family allowances would decline by 1.5 percentage points (Table 1).

Closer scrutiny, however, reveals that the results of the Bureau du Plan hinge on two assumptions: first, that the replacement ratio of pensions drops significantly; and second, that the employment ratio increases sharply. The Bureau du Plan estimates that if present policies are continued, the ratio of average pensions to average wages will decline from 32 percent now, to 29 percent in 2030, and 26 percent in 2050. With a continuing increase of the participation rate of women, as well a an increase in the participation rate of elder workers, the participation rate would increase; with unchanged employment, and a decline in the working age population, this would result in an increase of the employment ratio by about 7 percentage points.

Without these two assumptions, the impact of the demographic shock would be much larger (Table 2). If the assumption of the relative decline in average pensions is dropped, the increase in pension and health care expenditure increases from 3.0 percent to 3.9 percent; if the assumption of an increase in the employment ratio is also dropped the increase augments even further to 5.5 percent—a demographic shock that is roughly in line with that in neighboring countries.

These results are consistent with other projections (including those prepared by Fund staff), which indicate that an increase in the participation rate could to a large extent offset the impact of the demographic shock. Indeed, given the currently very low participation rate, Belgium has in theory more room to offset the impact than countries that already have a high participation rate. It would be dangerous, however, to characterize this as an unchanged policies scenario. While it might be tempting to think that if the working age population shrinks, the employment ratio would rise automatically, it is more likely that with unchanged policies, labor market tensions would result in relatively higher real wages, thereby reducing employment. Moreover, while current pension indexing rules would allow such a decline in replacement rates, the final determination of this is deferred to future, year-by-year decisions.

Thus, the results of the Bureau du Plan should be interpreted as an outcome that is within reach if structural reform is accelerated, not as something that will be achieved on present policies. The envisaged increase in participation would likely occur only in a much better functioning labor market, which would require major reforms.

Box I.1. Table 1: Social Expenditure, 1996-2030

(In percent of GDP)

	2000	2030	Difference
Total	18.3	19.8	1.5
Pensions	6.6	8.4	1.8
Civil servants	0.9	1.1	0.2
Private sector	5.7	7.3	1.6
Health care	5.5	6.7	1.2
Unemployment	2.0	1.3	-0.7
Early retirement	0.6	0.7	0.1
Family allowances	1.6	1.0	-0.6
Other	2.1	1.9	-0.2

Sources: Bureau du Plan; and staff calculations.

Box I.1. Table 2: Increase in Pension and Health Care Expenditure, 2000–2030
(In percent of GDP)

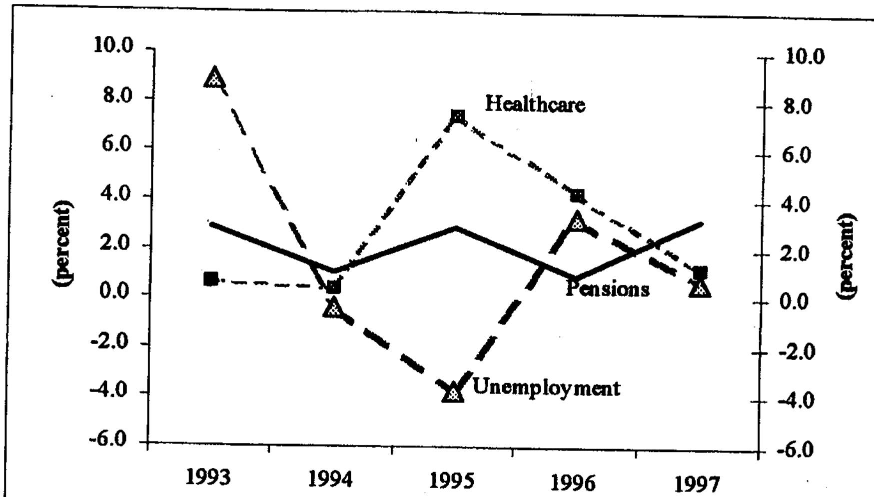
	Baseline	No change relative pension	Idem, with no increase participation
Pension and health care	3.0	3.9	5.5
Pensions	1.8	2.7	3.6
Health care	1.2	1.2	1.9

Sources: Bureau du Plan; and staff calculations.

20. Earlier efforts to constrain health care spending achieved some measure of success. A prospective global budget system for hospitals, introduced in 1982, standardized budgets across hospitals, and was complemented by moratoria on building, and improved incentives. This system was extended to other aspects of the health care system in 1991.[4] New spending pressures emerged, however, by the mid-1990s, and this led to the implementation of stopgap measures beginning at end-1996. Doctors' fees were temporarily frozen, prices of drugs marketed for at least 15 years were lowered by 4 percent, and the daily rate for hospital stays was increased. The measures taken in recent years indicate the significant and continuing efforts to improve the administrative efficiency of the health care delivery system. The underlying issues related to basic entitlements and microeconomic reforms, however, have yet to be fully addressed.

[4]See IMF Staff Country Report No. 97/19 for a discussion of these developments in a comparative context.

Figure I.2. Belgium: Real Growth in Transfers to Households



Source: Data provided by the national authorities

21. Limiting the growth of pension outlays (equivalent to 8.8 percent of GDP in 1997) constitutes a problem in both the near- and longer-term. In the aggregate, with extended life expectancy and an aging population, pension payouts will grow substantially in the period ahead, failing changes in the parameters of the pension systems. Again, however, the record on addressing entitlement issues is subject to question, as shown by recent inaction on the issue of civil service pensions. These pensions account for some 2.5 percent of GDP (27 percent of total pension outlays in 1997) and have risen in relative terms while the share of other pension outlays in GDP was level. They are indexed to prices, subject to high ceilings, and benefit from peréquation—adjustments for changes in the salary of working counterparts of the same rank. Special executive authority to address civil service pension issues lapsed during the summer of 1997, without action. In other state-provided pensions, reforms undertaken in 1996 leave considerable uncertainty about future indexing practices.

Table I.2. Belgium: Composition of Consolidated Government Spending, 1981-97

(Percent of GDP)

	Average 1981-85	Average 1986-89	Average 1990-95	1996	Estimated 1997
Total primary expenditure	50.1	44.4	42.3	41.6	41.3
Of which: transfers to households	26.2	24.6	24.7	24.7	24.2
salaries	11.0	9.5	9.1	9.2	9.2
goods and services	3.6	3.3	2.4	2.1	2.1
subsidies	3.1	2.5	2.1	1.9	1.7
transfers to rest of world	1.7	1.7	1.6	1.7	1.8
fixed investment	2.9	1.7	1.3	1.2	1.4
other capital	1.6	1.1	1.1	0.9	1.0
Interest payments	9.4	10.6	10.3	8.5	7.9

Source: Data provided by the authorities.

22. While transfers to households continued to grow apace in recent years, **government consumption** in Belgium has been relatively restrained—growing by an annual average of 1.3 percent during 1993-97. As in most of the advanced economies, Belgium's share of government consumption in GDP increased substantially in the late 1970s and contributed to the growth in public debt. During the 1980s, with critical efforts to rein in fiscal deficits, Belgium undertook a number of administrative reforms and reduced government consumption from an average 17.6 percent of GDP during 1981–85 to 15.4 percent during 1986–89 and, further, to 14.6 percent in 1997. In aggregate, and in relative terms, government consumption does not appear to be out of line with other advanced economies (Table I.3).[5]

[5]Relative comparisons need to be approached with caution. Following standard national accounting procedures, the value of government consumption has been reduced to reflect the value of services sold (e.g., including waste collection and energy services). For Belgium, in 1997, this reduction—mostly at the local government level—amounted to about one-third of estimated gross consumption.

Table I.3. Belgium: Comparative General Government Consumption and Investment, 1971-95

(Percent of GDP)

	Average 1971-75	Average 1976-80	Average 1981-85	Average 1986-90	Average 1991-95
Consumption					
Belgium	**15.2**	**17.5**	**17.6**	**15.4**	**14.6**
Denmark	22.4	24.8	26.9	25.2	25.7
France	15.6	17.8	19.6	18.7	19.4
Germany	18.3	19.8	20.3	19.3	19.7
Italy	14.7	14.4	16.6	17.2	17.5
Netherlands	16.2	17.7	17.0	15.2	14.4
United Kingdom	19.7	20.9	21.8	20.3	21.6
United States	18.9	17.9	18.5	18.4	16.9
Investment					
Belgium	**3.9**	**3.6**	**2.9**	**1.6**	**1.4**
Denmark	4.1	3.6	2.4	2.2	2.1
France	4.1	3.4	2.7	2.4	2.7
Germany	7.0	11.4	12.2	15.9	18.4
Italy	3.1	3.1	3.7	3.4	2.7
Netherlands	4.2	3.6	3.1	2.6	2.7
United Kingdom	4.7	3.1	1.9	1.9	1.9
United States	3.7	3.4	3.4	3.5	3.2

Sources: International Financial Statistics; and OECD analytical database.

23. The aggregate share of government consumption may well, however, mask underlying inefficiencies. In the drive to compress the fiscal deficit during the 1980s, civil services wages and employment were held largely in check and, as a result, the share of the wage bill (excluding pension payments) in GDP fell from 11.4 percent to 8.7 percent. The check on wage growth gave way in 1991-92, with the wage bill returning to 9.3 percent in the latter year. At the same time, evidence suggests that, overall, government employment in Belgium may be on the high side. In the intervening years the rate of increase in real wage outlays has been just below GDP growth.

24. While wage outlays regained lost ground during the 1990s, it is estimated that net spending on goods and services declined by an average 0.7 percent per annum during 1993-97. A normative ratio between wage outlays and goods and service spending cannot be definitively specified—this is a relation that depends strongly on the modalities of government, including whether labor-intensive functions are implemented by government agencies or are carried out by private sector services. It is clear, however, that a significant relative compression in government spending on goods and services has take place. In the period until 1989, the ratio of the consolidated government wage bill to goods and service spending ranged around 3.1 (Table I.4). With the devolution of functional authority to the levels of federal government in the latter year, spending on goods and services fell in nominal terms while the growth in wage outlays was only marginally below the rise in GDP. This shift has been especially pronounced at the level of the federal government and the regions and communities, where ratio rose from 2.4 in 1988 to 2.9 in 1990, and has steadily increased to 4.4 in 1997. This shift reflects a relative compression in spending on education, which is labor intensive, that was built into the allocation formula for federal resources and, in some part, an increase in the charges for government services that are marketed, following the restructuring of government authority.

25. As a rule, in advanced economies, the share of **government investment** in GDP has decreased significantly and continuously since the early 1970s. In this regard, Belgium is no exception. Capital spending was compressed sharply, from an average 4.8 percent of GDP during 1980-89, to 2.2 percent of GDP in 1989 and been largely held in check since.[6] The compression in government investment in Belgium over the past 25 years has been more severe than in other industrial countries. While, during the early-1970s, Belgium's investment share was in line with international comparators, by the 1990s, its investment share had fallen well below those comparators. In light of this, it seems doubtful whether the volume of government investment can be maintained at its current, reduced level over the long-term, at least with investment financing arrangements as they are currently designed.

C. The Structure of Fiscal Authority

26. The structure of government spending in Belgium and its evolution over time reflect clearly changes in the institutional structure of government, the associated allocation of financial resources, and the unfolding fiscal objectives of government at its various levels. To

[6]The data on total capital outlays include capital transfers and, thus, differ somewhat from the evolution of investment spending as shown in Table I.5. Of the estimated BF 202 billion in capital spending in 1998, some 42 percent corresponded to capital transfers, rather than fixed capital formation.

Table I.4. Belgium: Structural Changes in the Consumption and Investment Outlays, by Level of Government

	Average 1980-84	Average 1985-88	1989	1990	1991	1992	1993	1994	1995	1996	1997
Ratio of Spending on Wages to Goods and Services, by Level of Government											
General government	3.1	3.0	3.3	3.6	3.6	4.0	4.2	4.3	4.4	4.3	4.4
Central government 1/	2.7	2.5	2.9	3.1	3.1	3.5	3.7	3.9	4.0	4.0	4.2
Federal government 1/	...	...	2.0	2.2	2.2	2.4	2.5	2.7	2.8	2.8	3.1
Regions and communities 1/	...	...	4.2	4.1	4.2	4.9	5.0	5.3	5.2	5.1	5.2
Local authorities	7.7	8.0	8.4	9.8	9.9	10.6	10.4	10.5	10.8	8.7	8.2
Social security administration	2.9	2.2	2.0	2.1	2.3	2.1	2.2	2.2	2.3	2.3	2.3
Share of Investment in GDP, by Level of Government											
General government	4.8	3.1	2.2	2.1	2.1	2.3	2.5	2.5	2.3	2.1	2.3
Central government 1/	3.3	2.0	1.4	1.4	1.6	1.5	1.4	1.5	1.3	1.5	1.8
Federal government 1/	...	...	0.9	0.7	0.5	0.5	0.5	0.4	0.3	0.1	0.3
Regions and communities 1/	...	...	0.6	0.7	0.9	1.1	0.9	1.0	1.2	1.2	1.3
Local authorities	1.3	0.8	0.7	0.7	0.7	0.7	1.0	1.0	0.8	0.7	0.8

Sources: National Bank of Belgium; and staff estimates.

1/ Until 1989, data corresponding to federal, regional, and community government is consolidated as central government.

an important extent, the course of government consumption over the past decade was foreseen in the devolution among the various levels of the federal system. The Special Law of 1989 (SL89) fixed both the administrative responsibility and the allocation of resources (see Appendix II). Most aspects of social security administration remained at the national level; the federal government retained responsibility for defense, justice, and federal public finances; the regions were assigned responsibility for socio-economic affairs within their boundaries; and the communities were delegated responsibility for education, culture, and certain welfare policies.[7]

[7]The federal structure is multi-faceted. The regions are Brussels, Flanders, and Wallonia. Communities were established for Flanders and Wallonia, along with a German-speaking community. Their is no distinction between the Flemish community and Flemish region, while the Flemish and Walloon communities have jurisdiction over community matters in Brussels.

27. During 1990 to 1997, personal income tax and VAT revenue shared with the regions in communities has risen from the equivalent of 8.6 percent of GDP to 9.6 percent. Associated with this, and in line with the devolution of governmental responsibility in 1989, centrally

Table I.5. Belgium: Primary Spending by Level of Government, 1981-97 1/

(Percent of GDP)

	Average 1981-85	Average 1986-89	1989	1990	1991	1992	1993	1994	1995	1996	Prel. 1997
Central government 2/	22.4	19.0	...	...	...	...	...	...	...	...	...
Federal government 3/	...	...	10.2	9.3	9.2	8.8	8.8	8.6	8.3	8.0	7.8
Regions and communities	...	...	6.6	7.2	7.9	8.0	8.2	8.3	8.5	8.6	8.6
Local government	6.4	5.6	5.2	5.1	5.1	5.1	5.6	5.7	5.5	5.5	5.6
Social security administration	21.3	19.7	18.7	18.6	19.3	19.6	19.9	19.4	19.4	19.6	19.3

Sources: Data provided by the authorities; and staff estimates.

1/ Primary spending net of transfers to other levels of domestic government.

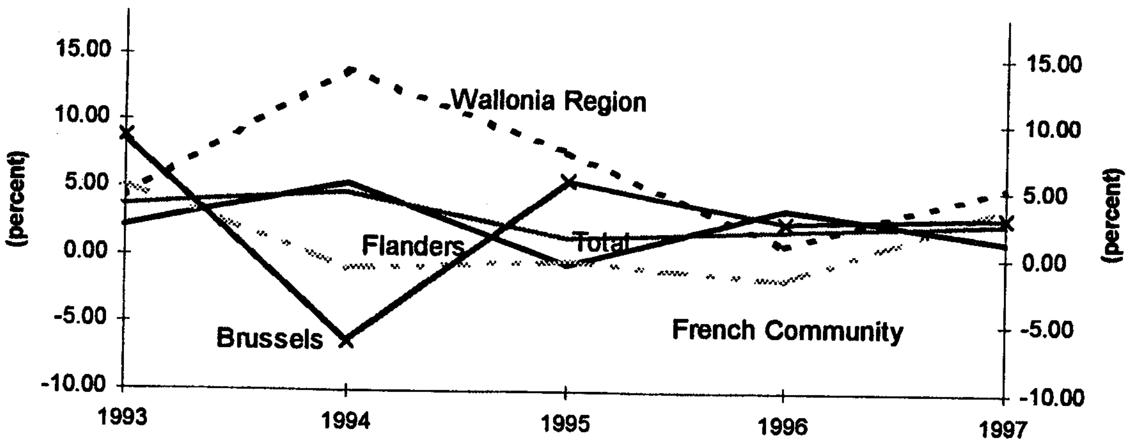
2/ The structure of government changed in 1989, with a shift of responsibilities to the regions and communities. Data after 1988 refer to combined federal government, regions and communities.

3/ Data in Federal government calculated as a residual.

administered spending dropped by nearly half, from 17 percent of GDP to around 8 percent. Outlays by the regions and communities reached a rough parity with federal-level spending by 1996. Local government expenditure as a share of GDP has varied slightly below 6 percent (Table I.5).

28. With the continuing federal transition, and the associated increase in the share of federally-collected revenue allocated to the regions and communities, their primary spending increased from the equivalent of 9.7 percent of GDP in 1989 to 11.5 percent of GDP in 1997. All but 0.3 percentage points of this increase took place during the first phase of the transition, 1989-93. By 1994, the aggregate growth rate for their real primary spending had reached 4.7 percent, a level which was unsustainable in light of both agreed fiscal targets and the need to adjust to the prospective stabilization of revenue transfers at the end of the transition period. In the event, the slowing of spending by the regions and communities has been pronounced, if uneven (Figure I.3).

Figure I.3. Belgium: Growth in Regional and Community Spending
(Real growth rates, commitment basis)



Source: Conseil Superieur des Finances, Raport Annuel 1997

D. Factors Underlying Changes in Expenditure Structure

29. In the early 1990s, Belgium began a drive to enter a virtuous fiscal cycle with the benefit of a downturn in interest payments and a rebound in economic growth from 1994, and succeeded in reducing the overall deficit share in GDP below the rate of nominal growth of income (Table I.6). The decline in interest payments resulted partly from a reduction in the debt stock as fiscal policy targeted high primary surpluses from the early 1990s, and as risk premia fell with growing confidence in the authorities' policy commitment. With the objective of entering the EMU in the first round, a four-year (1992-96) convergence program was established, continuing the tight linkage of the Belgian franc to the deutsche mark established in 1990, and aiming for a four-year reduction in the general government financial deficit from 5.8 percent of GDP in 1993 to 3 percent by 1996 (Table I.7)

30. On an aggregate basis, fiscal consolidation under the convergence program principally relied on revenue increases and declining interest charges to achieve targeted declines in the deficit and public debt—with primary spending as a share of GDP falling by 0.8 percentage points (Appendix III). The convergence plan did foresee, however, a sharp decline in primary spending at the level of the federal government, with the latter declining in real terms from 1994. This apparent compression at the federal level reflected the continuing shift in revenue to the regions and communities under SL89 and the corresponding deficit targets by level of government. Correspondingly, primary spending by the regions grew significantly in real terms, although at a decelerating rate.

Table I.6. Belgium: Economic Conditions and the Overall Balance

	1990	1991	1992	1993	1994	1995	1996	1997
Government bond yield (percent, period average)								
Belgium 1/	10.06	9.28	8.64	7.18	7.76	7.34	6.26	5.49
Germany 1/	8.88	8.63	7.96	6.28	6.67	6.50	5.63	5.02
Spread against German interest rates (percentage points)	1.18	0.65	0.68	0.90	1.09	0.84	0.63	0.47
GDP growth rate (percent)	3.0	1.6	1.5	-1.5	2.4	2.1	1.5	2.8
Inflation (consumer prices, percent, period average)	3.4	5.1	4.8	2.7	2.4	1.4	2.1	1.5
General government finances (percent of GDP)								
Revenue	45.2	45.3	45.4	46.0	47.1	46.8	46.9	47.0
Primary spending	40.2	41.5	41.6	42.4	42.0	41.7	41.6	41.3
Interest payments	10.5	10.1	10.7	10.7	10.0	9.0	8.5	...
Overall deficit	-5.5	-6.3	-6.9	-7.1	-4.9	-3.9	-3.2	-2.3

Sources: National Bank of Belgium; International Financial Statistics; and staff estimates.

1/ Data for 1997 refer to third quarter.

31. Revenues of the regions and communities (on a consolidated basis) rose from 10.1 percent of GDP in 1992 to 11.6 percent by 1997. At an aggregate level, budgeted revenue grew at an annual rate in excess of 3 percent during 1993-97 (Table I.8). Within the regions and communities, however, there were singular differences. The revenues of the Walloon Region grew at an average of 6.6 percent per annum, reflecting primarily the temporal revenue shift established under the transition formula. At the same time, the revenues of the French community grew by an average 1 percent, as its income was largely tied in real terms to demographic changes. Revenues of the Flemish Community, which comprised both regional and linguistic administrations, grew at an intermediate pace of 3.4 percent—still well above the average 1.5 percent growth rate of GDP for the period.

32. The convergence plan targets for the regions and communities were established with the dual objectives of stabilizing the debt/revenue ratios of each of the federated entities and

allowing for a moderating growth in primary spending over the period through 2010. In aggregate, budgeted spending by the regions and communities grew more slowly than their revenues, averaging 2.3 percent per annum, allowing for the planned reduction in the deficit of these entities. Once again, however, spending growth was not uniform among the regions and communities and varied considerably across the period 1993-97, reflecting their differing revenue positions and as administrative changes were implemented in order to bring spending in line with plan.

Table I.7. Belgium: Government Deficit Objectives for 1993-97
Under the Convergence Plan

(Percent of GDP) 1/

	1993	1994	1995	1996	1997
Global target	5.8	4.7	3.9	3.0	2.8
Entity I 2/	...	4.2	3.3	2.6	2.6
Entity II 2/	...	0.5	0.6	0.4	0.2

Sources: Conseil Superieur des Finances, Rapport Annuel 1997.

1/ Targets for 1993-96 from June 1994 program; 1997 from Dec. 1996 program.

2/ Entity I consists of the federal government and the social security administration; Entity II includes regional, community, and local government.

33. In transferring the responsibility for education and vocational training to the linguistic communities, SL89 provided that revenue transfers would be fixed in real terms on the basis of prevailing costs and indexed only for changes in the size of population being educated. During the transition period, the indexation of the allocated revenue was based on annual estimates of the population 18 and under. The approach to indexation will be reviewed at the end of the period with the objective of replacing this proxy for the population with a measure

that is more closely linked to the actual services provided. The financial impact of this modification is not apparent at this time.

Table I.8. Belgium: Real Revenue and Spending Growth in the Communities and Regions, 1993-97 1/ (Annual growth rates, percent)

	1993	1994	1995	1996	1997	Average 1993-97
Flemish Community						
Revenue	1.91	3.06	2.95	3.24	6.03	3.44
Spending	4.21	1.41	0.32	2.49	2.53	2.19
Wallonia Region						
Revenue	7.23	14.96	7.22	4.55	-0.74	6.64
Spending	3.52	12.87	5.29	5.08	-3.27	4.70
French Community						
Revenue	4.27	-0.50	1.78	-0.91	1.11	1.15
Spending	4.04	-0.36	1.55	-1.31	1.07	1.00
Brussels-Capital Region						
Revenue	0.55	-8.88	10.35	7.56	2.31	2.38
Spending	-0.61	-4.47	6.16	4.39	2.22	1.54
Total						
Revenue	3.22	3.78	3.83	2.57	3.52	3.38
Spending	3.64	3.07	1.87	2.07	1.07	2.34

Source: Conseil Superieur des Finances, Annual Report; and staff estimates

1/ Data based on initial budgets. Real values calculated using nonmarket services deflator.

E. The Fiscal Medium- and Long-Term Outlook

34. Smooth integration into EMU is set to remain the primary focus of fiscal policy. Over the near term, this implies that the overall general government balance will need to fall comfortably beneath the 3 percent limit set under the Stability and Growth Pact (SGP), allowing adequate scope for automatic stabilizers to operate. At the same time, the importance of achieving further fiscal consolidation, to meet the looming demographic shock, is gaining heightened awareness. Achieving such further consolidation will hinge importantly on a reassessment of existing expenditure commitments and, in this connection, scope needs to be found also to ensure a durable reduction of the labor tax burden, as part of a comprehensive reform of labor market policies aimed at increasing labor force participation—an issue discussed in Section II of this paper.

35. Belgium's public finances remain relatively sensitive to variations in economic growth. Fund staff estimates suggest that the current elasticity of the general government financial balance to real GDP growth is 0.58, which is greater than that for Germany (0.50), France (0.53), and the EU on average (0.48).[8] Taken together with the near-term baseline outlook, the elasticity estimate implies that a 1½ percentage point slowdown in GDP growth over a two-year period (e.g., a slowing of GDP growth to 1 percent during 1999-2000) would lead to a breach of the 3 percent SGP ceiling. Historical evidence indicates that the risk of such a downside scenario is not negligible—a recent OECD study noted that the mean value of the maximum output gap in recessions over the past two decades has been 1.8 percentage points.[9] With the structural deficit at a level of, for example, 1½ percent, the deficit target would be breached with a slowdown of the magnitude experienced in 1981-86, and 1992-94. Sensitivity of the government deficit to changes in economic conditions is heightened by Belgium's elevated debt position. Given the current maturity structure of government debt, a one percentage point increase in nominal interest rates would lead to a 0.2 percent of GDP increase in interest charges in the following year.

36. In this light, maintaining the present level of the actual primary surplus (5.5 percent of GDP) as an anchor over the next few years would appear to entail significant risks with respect to observing Maastricht ceilings. Leaving aside the provision of any safety margin in projecting the fiscal balance and taking into account previously noted elasticities, economic performance similar to that during the 1993-96 slowdown would lead to an output gap in excess of 2.5 percent and would result in a deficit above 3 percent of GDP. This degree of risk would figure prominently in the assessment of the potential for and timing of policies reducing the tax burden.

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[8] The staff estimate for the total elasticity (current plus lagged) is 0.61, which is marginally above the EU average. These estimates are broadly consistent with of the OECD and the European Commission. See OECD Economic Outlook 62.

[9] OECD, 1997b.

37. The importance of an appropriate primary balance target an anchor can be illustrated by assessing the effect of maintaining the primary surplus at the equivalent of 5.5 percent of GDP, as a lower bound, during 1998-2005. On this basis, the structural deficit would remain above 1 percent through 2002 and the budget would not reach balance until the second half of the decade ahead.[10] By contrast, maintaining the **structural** primary surplus unchanged at its 1997 level would achieve a more rapid decline in the debt burden and interest payments, and thus contribute more strongly to meeting deficit targets.

38. As in other advanced economies, Belgium faces an impending demographic wave that is set to lead to a significant aging of the population and a concomitant very large increase in social transfer payments. This prospect, which has been documented in fiscal projections by the staff (see, for example Country Report No.97/8) has recently been corroborated by generational accounts (Box I.2). Planning for and adjusting to the consequences of a graying population constitutes both a challenge and an opportunity—the greater the efficiency of policies adopted, the greater the room for improving the competitive position of the economy and growth potential. By the year 2010, the ratio of non-active population to working population will increase from its present level of 0.39 to somewhere in the range of 0.43.[11] By 2030, this ratio will have risen to somewhere in the range to about 0.61. With an aging population, demand for health care is likely to increase significantly. More clearly, given the current parameters for pension benefits, pension obligations will rise very substantially (Box I.1).

39. Without action to limit benefits or to increase labor force participation, spending on social security is set to increase by 1.4 percentage points of GDP between 2000 and 2010, as increases in pension outlays and health care are only partially offset by decreased unemployment outlays and family allowances. Staff projections show that aggregate social security spending will increase by a further 2.1 percentage points during 2010-2020, and by 2.3 percentage points during 2020-2030. Thus, over the next three decades, expenditure increases resulting from demographic factors are set to increase government spending by 5.8 percentage points of GDP, while fiscal revenue, as a share in national income, appears likely to remain flat.[12]

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[10]The primary surplus realized in 1997 is estimated to be 5.6 percent of GDP. Underlying this scenario, GDP growth is projected to accelerate to 2.6 percent in 1998, and accelerate to 2.8 percent in 1999, while real interest rates are expected to remain stable in 1998 and increase by 0.1 percentage point in 1999. Corresponding to this, the fiscal deficit in 1998 would amount to 2.3 percent of GDP. It is projected that the output gap will be progressively reduced during the period 1998-2001, and that growth will remain at potential thereafter.

[11]Ratio of population aged 60 and over to population aged 20 to 59.

[12]IMF Staff Country Report No. 97/8 provides a detailed overview of the underlying factors.

40. A number of different approaches may be adopted in order to moderate the fiscal impact of the impending demographic wave. First, limiting the future indexation of benefits could yield this effect, although such a policy would affect the character of Belgium's system of social entitlements.[13] Second, a number of measures could lengthen the effective working life required to secure a full pension. Third, an increase in the labor force participation could serve to moderate the net impact of increased social spending on the overall deficit (Box I.1), although increased labor force participation will not be an automatic byproduct of a shrinking working-age population. This latter approach, which holds considerable potential, nonetheless sets constraints on the way in which fiscal consolidation can be achieved. Specifically, the relatively high share of fiscal revenue in GDP, along with the need to remain competitive with other EU economies on corporate taxation and VAT rates, effectively rule out the extensive use of structural revenue increases as an approach to reducing the deficit and increasing the safety margin (Box I.3). In fact, given the continued elevated level of structural unemployment, consideration continues to be given to reducing the tax wedge on labor income in the near-term.

41. The net effect of a reduction in the tax wedge on the fiscal balance is subject to some uncertainty. Studies indicate that, in the short run, the employment effects of reductions in the

Box I.2. Belgium: Generational Accounts

Generational accounting is a technique developed by Auerbach, Gokhale and Kotlikoff (1991) and Kotlikoff (1992) that can be used to study the effects on different generations of the government's fiscal policy. Generational accounts show the present value of the expected net tax payments of a representative individual of a given generation, where "net taxes" refers to taxes paid less transfers received, and a "generation" is defined as a cohort of individuals of the same age and sex.

Generational accounting provides a useful way to calculate the impact of the aging of the population on tax payments of future generations. By comparing the lifetime net tax rates of future generations, of the generation of people just born, and of different generations born in the past, it can be used to determine how much generations future generations are likely to pay in net taxes as compared to generations alive today.

A recent study for Belgium would suggest that the impact of the demographic shock is quite substantial (see Stijns, 1997). Future generations will face a minimum 61 percent increase of their net taxes as compared to the newborn generation in 1995, with old-age pensions and health care transfers as the main determinants of the sharp increase.

These results for Belgium are in closely similar to the result found in a staff analysis of the generational accounts of France, which found a 63 percent tax increase. The imbalance is lower than the found for Italy (326 percent) and the United States (100 percent) but higher than in Sweden (23 percent) and Germany (25 percent).

Thus, generational accounting would suggest that the impact of the demographic shock in Belgium is no less severe than in other European countries. Moreover, the sharp increase in the tax burden would come on top of a current revenue burden that is already one of the highest in Europe, which would make its impact even more dramatic.

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[13]A discussion of the issues surrounding replacement rates in Belgium can be found in Section II of this paper.

tax wedge are limited.[14] In addition to this, while structural unemployment remains elevated on an aggregate basis, regional unemployment profiles differ significantly. Absent a broad-based effort to tackle labor market distortions, a lowered tax wedge would have the immediate consequence of increasing labor demand nationwide, including those areas that are beginning to experience labor shortages, creating an upward pressure for wage adjustment.

42. Drawing together these various constraints on fiscal policy, it would appear that (i) maintaining a focus on structural fiscal consolidation is critical, but (ii) if the tax burden on labor income is to be reduced, medium-term spending goals need to be set and respected, and long run entitlement reforms pressed through. This need to constrain both the fiscal deficit and the level of spending is clear in the near term, as well as in a longer-run, demographic perspective. Under the current EU convergence program, the deficit target corresponding to the currently projected growth path would be adjusted downward to 1.3 percent of GDP in 1999. Under the projected composition of GDP growth, the income elasticity of revenue is estimated at 0.7 percent in 1999. Thus, achieving the adjusted deficit target would require slowing the growth of primary spending to well below the rate of growth of GDP in real terms. Continuing to constrain primary spending growth path in the succeeding years would allow for achieving balanced government financial operations before the year 2002, as well as some reduction in the tax burden.

43. Continued real primary spending growth of less than one percent per annum would imply, however, a significant change in government spending trends. Current norms for growth in social security spending have been set at 1.5 percent per annum and, in the setting of the debt stabilization targets for the regions, primary spending growth ranging from 1.4 percent to 1.8 percent per annum was envisaged. Other things equal, allowing overall primary spending to grow by an average 1.7 percent per annum would delay achieving a balanced budget beyond 2005.

[14]For example, one Fund staff study indicates that, in the short-term, a one point reduction in targeted employer social security tax rates would lead to a 0.1 percent increase in overall employment—increased tax collections resulting from the employment gain are marginal and the tax reduction is almost fully reflected in a higher fiscal deficit. See IMF Staff Country Report No. 97/8, and Hendrickx et. al., 1997.

Box I.3. Belgium: Fiscal Revenue and Levies on Labor Income

In 1997, total government revenue in Belgium was equivalent to 47 percent of GDP. Historically, revenue collections have been high compared with neighboring countries—only the Netherlands ranked above Belgium (Box I.3, Table 1). Fiscal revenue and social security levies on labor income in 1997 are estimated to have accounted for 97 percent of total general government revenue, evidence that, given the total revenue comparison, taxation in Belgium is relatively heavy.

Of the revenue collected, about 60 percent is tied to labor income, through the personal income tax and social security levies, and about 27 percent derives from indirect taxes. In terms of the weight of taxes on labor income (including social security contributions) Belgium is heavily assessed. The remainder of fiscal revenue is collected from business taxes (about 7.5 percent in 1996) and diverse elements including property and inheritance taxes.

The burden of business taxes and the value added tax in Belgium are approximately in line with other industrial country standards. In 1993, direct business taxes were equivalent to 3.2 percent of GDP, which was above France, Germany, and the United Kingdom, but below Japan and the Netherlands. Similarly, for value added tax, collection as a share of GDP is in line with other European economies, below France and in line with Germany and the Netherlands (Box I.3, Table 2).

44. The 1998 budget—which was based on a projected GDP growth rate of 2.5 percent and which did not include any significant structural measures—could provide the basis for a decline in the overall balance for general government to some 2.0 percent of GDP in 1998, which is slightly less ambitious than adjustments to targeted balances under Belgium's convergence program. Achieving this outcome would entail limiting primary spending growth in real terms, a rate broadly similar to that estimated for 1997 and somewhat higher than the targeted growth rate for such spending implicit in the budget.

Box I.3 Table 1 Taxes in Comparison

	Average 1970-73	Average 1974-79	Average 1979-89	Average 1990-95
		(percent)		
Comparision of Revenue as a Share of GDP				
Belgium	35.4	40.2	44.5	44.2
France	27.1	35.8	40.6	40.6
Germany	25.3	26.9	29.3	30.8
Netherlands	31.5	47.2	50.5	48.5
United Kingdom	34.0	34.6	36.1	36.0
Comparison of Labor Taxes as a Share of Compensation 1/				
Belgium	**40.0**	**46.4**	**53.9**	**55.9**
France	27.1	28.4	31.3	33.3
Germany	30.9	35.1	37.8	40.8
Netherlands	45.5	49.3	53.9	57.6
United Kingdom	18.4	25.8	25.2	25.4
Comparison of Direct Business Taxes, 1969-95				
Belgium	**2.6**	**2.9**	**2.6**	**2.6**
France	2.2	2.4	2.5	2.4
Germany 2/	5.0	4.9	3.9	3.0
Japan	4.1	4.5	5.1	4.6
Netherlands	2.7	2.8	2.8	3.3
United Kingdom	2.6	1.8	3.0	2.0
United States	3.5	3.5	2.6	2.6

Sources: International Financial Statistics; OECD Analytical Database; and staff estimates.

1/ Employer and employee social security contributions as a percentage of employee compensation.

2/ Data are for West Germany.

Box I.3. Table 2: Comparison of Value Added Taxes, 1993

	Share in Revenue	Share in GDP
	(percent)	
Belgium	15.14	6.9
France	16.81	7.4
Germany	17.55	6.9
Netherlands	14.50	7.0
United Kingdom	19.53	6.6

Source: Belgian Ministry of Finance, 1997.

F. Policies to Restrain Public Spending

45. Over the long-term, it appears that demographic pressures will increase the level of public spending relative to GDP, although the magnitude of this prospective change is sensitive to underlying economic assumptions. In particular, estimates of the endogenous rise in the employment ratio and of replacement rates are critical to the outcome. These factors will have a significant impact on future outlays for social security and the growth of primary spending. Related to this, in assessing the long-term outlook, consideration must also be given to the concern that the current tax burden on employment is too high and, as such, contributes to the elevated level of structural unemployment.

46. Given these factors, it is clear that efforts reduce the overall fiscal deficit to a safe level must depend primarily on constraining primary spending growth. Achieving such constraint on a durable basis is likely, however, to prove a challenge. As previously noted, final primary spending at the level of the federal government constitutes only 20 percent of the total, and such spending at the federal level has steadily fallen in real terms in recent years. Thus, to a large extent, efforts to limit the growth in primary spending will need to focus on social security outlays, and spending by the regions, communities, and local government.

47. The share of social security outlays in GDP ranks Belgium among the highest in the EU (Table I.9), and improving the efficiency of incentives—while maintaining basic social welfare principals—needs to be given due weight. A review of the overall entitlement program would need to distinguish between adjustments required to meet short-term deficit objectives and the longer-run problems associated with the looming demographic shift. In limiting the growth of social security spending, the focus will need to be on pension and health care outlays, which total over 60 percent of the total and 15 percent of GDP, and have been growing most rapidly in recent years.

48. The reform of the pension system is a long-term key issue. Revision to general entitlements under the pension program are not currently under review and, given workers currently covered by the system may have their benefits grandfathered, budgetary savings may be limited in the short-term. Looking at specific programs, it is likely that the public sector pension program will be reassessed, with benefits brought closer in line with entitlements under the general system. In the long-run, however, revisions to pension indexation will be critical to contain spending growth—but if replacement rates are to be significantly cut, the development of privately funded pensions is important.

49. A key element in slowing the growth of social security outlays, in the short- to medium-term, will remain the containment of health care benefits. Here a number of structural policies and administrative changes are underway or under consideration. In particular, the development of computerized patient profiles, in prospect, will improve the ability to track the use of pharmaceuticals, facilities, and physician services. The resulting improved view of the function of the health care system will allow the authorities to increase the system's efficiency:

consolidating facilities, revising co-payment requirements, and providing the basis for identifying problem issues quickly. Another critical factor, wage increases for health care providers, will be determined within the overall wage framework. Since the effect of these measures on spending growth is difficult to estimate a priori, specific contingent policies would need to be developed in order to assure that spending objectives can be met.

Table I.9. Belgium: Comparative Social Security Benefits, 1971-95
(Percent of GDP)

	Average 1971-75	Average 1976-80	Average 1981-85	Average 1986-90	Average 1991-95
Belgium	**16.5**	**21.1**	**23.6**	**21.9**	**22.1**
Denmark	11.8	14.9	17.3	17.4	20.6 1/
France	15.6	18.3	21.4	21.4	22.9
Germany	14.8	17.3	17.2	16.3	17.5
Italy	13.3	14.3	16.7	17.5	19.1
Netherlands	15.8	19.3	20.6	19.3	20.2
United Kingdom	8.5	10.1	12.5	11.4	13.4
United States	9.7	10.9	11.9	11.5	13.5

Source: OECD Analytical Database.
1/ 1991-94

50. Efforts to limit the growth of spending at the level of the regions, communities, and localities may prove an even greater challenge. As previously noted, the budgetary objectives of the regions through 2010 were set, in the context of overall government finances, with an eye towards stabilizing the debt-revenue (in 2000 in the case of Wallonia and 2010 for Flanders) and assuring an acceptable growth in real spending. Theses stabilized growth rates, reflecting the end of the ten-year transition ending in 1999, are well below the average rates realized in recent years. While the growth of regional spending has generally decelerated from its peak in 1994, this deceleration has not been uniform and has taken advantage of resources from the sale of capital assets to moderate the slowing of budgetary spending. No comprehensive basis exists for assessing whether the regional governments will be able to effectively sustain their operations in line-with the legislated post-transition resource transfer.

51. Prospects are more difficult for the language communities. Effectively, since the unit (per pupil) allocation from federally collected taxes is fixed in real terms, the share of income

transferred to the linguistic communities has declined steadily during the transition period.[15] Under the guiding legislative framework, this declining share is to continue into the future. The French Community has partially compensated for this decline, on an ad hoc basis, by selectively selling its capital infrastructure and leasing it back—a process that cannot continue indefinitely. While it is true that the number of students being educated is projected to decline in the coming years, adherence to the revenue allocation formula and maintenance of an overall financial balance implies that the relative salaries paid in education will continue to decline over time, while there is no provision for additional capital spending that might be required to replace aging schools or to adapt them to new technology and changed teaching methods.

52. As an indication of the dimensions of the adjustment being faced, the share of personal income tax and VAT collections transferred to the regions will peak at 9.9 percent of GDP in 1999. Maintaining agreed overall balance targets for 1998-2000 would still allow spending by the regions to grow faster than trend GDP in 1998 and 1999 but, over the succeeding decade they would be faced with significant slowdowns.[16] As a numerical illustration, if debt stabilization targets are retained—roughly stabilizing the overall balance for the regions and communities (scenario 1), aggregate primary spending would drop to just above one percent during 2000-2002 and would fall to about one percent by the end of the following decade (Table I.10). Real spending by the French Language Community would barely increase over this period. On the other hand, allowing for the regions to maintain growth rates for real spending closer to trend GDP, would lead to an 0.5 percentage points of GDP increase in the overall deficit (scenario 2).

53. The uniform indication that the regions and communities must compress their spending relative to GDP in the period ahead, will not easily allow for the comparatively low level of public investment in Belgium to be addressed. Under the federal system, almost all of fixed capital investment is undertaken at the regional, community, and local levels. These same administrative units of government have chosen to compress investment in favor of current consumption, with limited exceptions, even in periods of growing financial resources. Thus, it is unclear under what circumstances public investment will be increased to efficient levels and which relative cuts in current operations will be made to effect such an increase.

54. Modifications in social security spending and regional and community outlays will need to figure prominently in Belgium's fiscal outlook. How these changes will be effected will depend on a number of factors including the wage formation process, and regional

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[15]This holds strictly only for the French Community, since the combined administrative structure of the Flemish Region and the Flemish Community allow transferred resources to be shifted freely between educational and vocational uses and regional functions.

[16]The illustrative data presented exclude the impact of inter-regional transfers under the provision of the Solidarity Fund.

disparities in growth and unemployment. The wage formation process in place in recent years has been geared to restoring competitiveness vis-à-vis neighboring economies. In this way, the share of labor income in GDP has declined substantially, entailing a moderation in wage growth and, hence, the pressure of wage growth on the budget. With no clear wage formation procedure in place, the possibility that the relative burden of the government wage bill will increase can not be precluded.

55. More fundamentally, a persistence of differential regional and growth and employment performance carries the potential for undermining the sustainability of the current structure of devolved government: the national character of social security system is affected by the skew in unemployment rates and benefits; the aggregate growth-indexed allocation of federally collected taxes may be viewed as creating an implicit transfer from the better-performing regions; while a continuing significant transfer under the provisions of the Solidarity Fund overtly alter regional finances. Added to this, given the continuing relative decline in transfers to the language communities, the asymmetry inherent in the administrative-financial structure of those communities seems likely to lead to policy tensions.

56. The institutional challenges in slowing spending growth, and the multiple routes that need to be followed to meet the demographic shock, illustrate powerfully that Belgium's long-run fiscal problems can be treated efficiently only as part of a comprehensive effort to improve economic performance.

57. First, a concerted effort is needed to improve voluntary, interregional coordination in order to facilitate increased factor mobility, public investment having a national character, and greater labor force participation seem critical. In this view, the reforms to labor policies discussed in Section II of this paper are fundamental to sustained fiscal health. This way only, pressures to decentralize can be channeled powerfully to achieve improved performance within the national framework.

58. Second, regarding the impact of the coming demographic wave, increased participation rates are needed to help allay the problem. However, an analysis by the Fund staff suggests that, with unchanged policies, a decrease in the working age population will be associated with a decrease in employment, rather than an increase in the participation rate. As will be discussed in Section II, rigidities in the current structure of the labor market, such as the centralized wage bargaining system, constrain effective adjustment in the labor market and tend to favor a continuing substitution of capital for labor. In this light, it appears clear that strong reform measures will be needed to address the looming problem.

Table I.10. Belgium: Regions and Communities, Illustrative Spending Growth and Deficit Scenarios
(Spending growth in percent, deficit in percent of GDP)

	1999	2000	2001	2002	2005	2010
Scenario 1: Debt Targets						
Flemish Community						
Spending growth	1.8	1.8	1.4	1.4	1.0	1.2
Primary spending	2.0	2.1	1.7	1.7	1.2	1.3
Overall balance	0.1	0.1	0.1	0.1	0.1	0.1
Wallonia Region						
Spending growth	2.2	2.0	1.6	1.6	1.6	1.6
Overall balance	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
French Community						
Spending growth	0.4	-0.7	0.5	0.5	0.3	0.1
Overall balance	-0.1	0.0	0.0	0.0	0.0	0.0
Brussels-Capital Region						
Spending growth	2.3	2.3	1.2	1.2	1.0	1.0
Overall balance	0.0	0.0	0.0	0.0	0.0	0.0
Total						
Spending growth	1.6	1.3	1.2	1.2	0.9	1.0
Overall balance	0.0	0.0	0.0	0.0	0.0	0.0
Scenario 2: Regional Spending Relaxed						
Flemish Community						
Spending growth	2.0	1.8	1.8	1.8	1.8	1.8
Primary spending	2.3	2.1	2.0	2.0	1.9	1.9
Overall balance	0.1	0.1	0.1	0.1	0.0	-0.2
Wallonia Region						
Spending growth	2.0	2.0	2.0	2.0	2.0	2.0
Overall balance	0.0	0.0	0.0	0.0	-0.1	-0.1
French Community						
Spending growth	0.8	0.8	0.8	0.8	0.8	0.8
Overall balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2
Brussels-Capital Region						
Spending growth	2.0	2.0	2.0	2.0	2.0	2.0
Overall balance	0.0	0.0	0.0	0.0	0.0	-0.1
Total						
Spending growth	2.0	1.5	1.6	1.6	1.6	1.6
Overall balance	0.0	0.0	-0.1	-0.1	-0.3	-0.5

Source: Staff projections.

59. Notwithstanding the tensions to be faced in slowing spending, the practical limitations on revenue rasing measures and the real constraints on the fiscal deficit imply that most of the adjustment to the demographic shock will need to take place on the expenditure side. In addition, as previously noted, the current level of government consumption is not excessive in comparative terms while government investment appears low—further significant compression of nonsocial primary spending does not appear to be a sustainable option. The reduction of interest outlays towards EU average levels, as envisaged under the Maastricht Treaty, could create an expenditure offset roughly equal in magnitude to the adjustment required over the next two decades. The most efficient approach to achieving the corresponding debt reduction would be to limit the growth of primary spending in the period ahead, taking advantage of the virtuous circle of interest reductions induced by such a policy.

G. Fiscal Performance and the Economic Setting

60. Moving forward into EMU, policy options for responding to variations in economic conditions relative to the monetary union will narrow while the need to improve efficiency will increase. Overall, economic performance will hinge more critically on choices in public administration and finance. Given this, the importance of improving the efficiency of government, and forward-looking policies aimed at avoiding unduly abrupt adjustments is magnified. It will be necessary to get the balance right: between revenue and expenditure, and between social transfers, consumption and investment. This will require a clear identification of the core government program: its objectives, institutional and administrative structure, and its resource requirements. Recent efforts targeting the administration of the justice system indicate that the need to undertake this exercise may be pressing in a number of areas.

61. Belgium has achieved the best fiscal performance when there has been firm commitment to clear fiscal objectives. Recently, the Global Plan and the Convergence Program under the EU Stability Pact have served this end. For the longer-term horizon, beyond the 2000 targets under the convergence program, the objective should be to set a strategic course to navigate the effects of the looming demographic shock.

62. With this objective, under present policies and in the near-term, it appears that substantial tax cuts cannot be effected without reducing necessary safety margins vis-à-vis Maastricht targets. Over the medium-term, there is a pressing need to replace stop gap approaches for limiting primary spending growth, with targeted, market-oriented measures that will sustain a the smooth transition to the longer-term deficit objective. In the longer term, in order to assure a sustainable fiscal position a number of basic issues will need to be addressed including, health care benefits, civil service wages, and pensions. At the same time, the approach to public investment and its funding should be reviewed.

63. The management of the public spending programs is confronted by the realities of a multi-level public administration that constrains the administrative choices, and places limits both the allocation of resources and concerted action in the implementation of policies (see below). In the period ahead, the mechanism for the distribution of public resources is set to

give rise to a number of tightly binding constraints that will test the sustainability of current arrangements.

64. Achieving efficiency within the existing constitutional structure presents a challenge. The general budgeting principal in force is that, given constitutionally mandated resource transfers, regions, communities, and localities will use funds efficiently. However, where national interests transcend the decentralized administrative structure, concerted efforts are required. A key example is the need for coordination to counter unemployment.

65. This approach—fiscal constraint and structural reform—can create room over the longer term for the reduction of taxes, including tax wedge on labor income. Careful management of primary spending appears to be a prerequisite for achieving this outcome. However, once achieved, a virtuous circle of tax cuts and employment creation can be set in motion.

II. THE LABOR MARKET: RECENT EXPERIENCE, REFORM OPTIONS, AND FISCAL IMPACT[17]

A. Employment and Unemployment Trends

66. Belgium's labor market, in common with that in a number of advanced economies, is currently experiencing low labor force participation and high unemployment, notwithstanding significant employment in government initiated programs. Indeed, unemployment continues at a high level in a context of stable prices (inflation is currently under 2 percent) and steady growth (the output gap having fallen significantly since 1993). Over the past 30 years, the standardized unemployment rate has risen from 2 percent to a peak (in 1983) of 11.1 percent, and is currently somewhat below 10 percent. At the same time, the employment rate (total employment as a percentage of the working-age population) has fallen from 61 percent in 1970 to 56 percent in 1995-96, one of the lowest rates among the advanced economies. In addition to the rise in unemployment, the fall in the employment rate reflects a large shift out of the labor force into various schemes aimed at alleviating the impact of the restructuring of older industries on employment. Despite the realization of some improvements during 1984-90, the situation has clearly deteriorated relative to the early 1970s (Figure II.1).

67. Unemployment in Belgium has distinctive dimensions. It is most widespread among the oldest and youngest cohorts in the labor force. Although the rate is higher for women, in relative terms over time its increase has been greatest for men. It weighs disproportionately on the less-schooled and the lower-skilled, and on former workers in Belgium's traditional industrial sectors—mining, textiles, and basic iron and steel. It also has a geographical aspect, being significantly greater in the Brussels-Capital and Wallonia regions, but with marked local variations. While this structure reflects, importantly, underlying demographic trends, it also shows the impact of fiscal and labor-market policies.

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[17]Prepared by Marie-Odile Louppe.

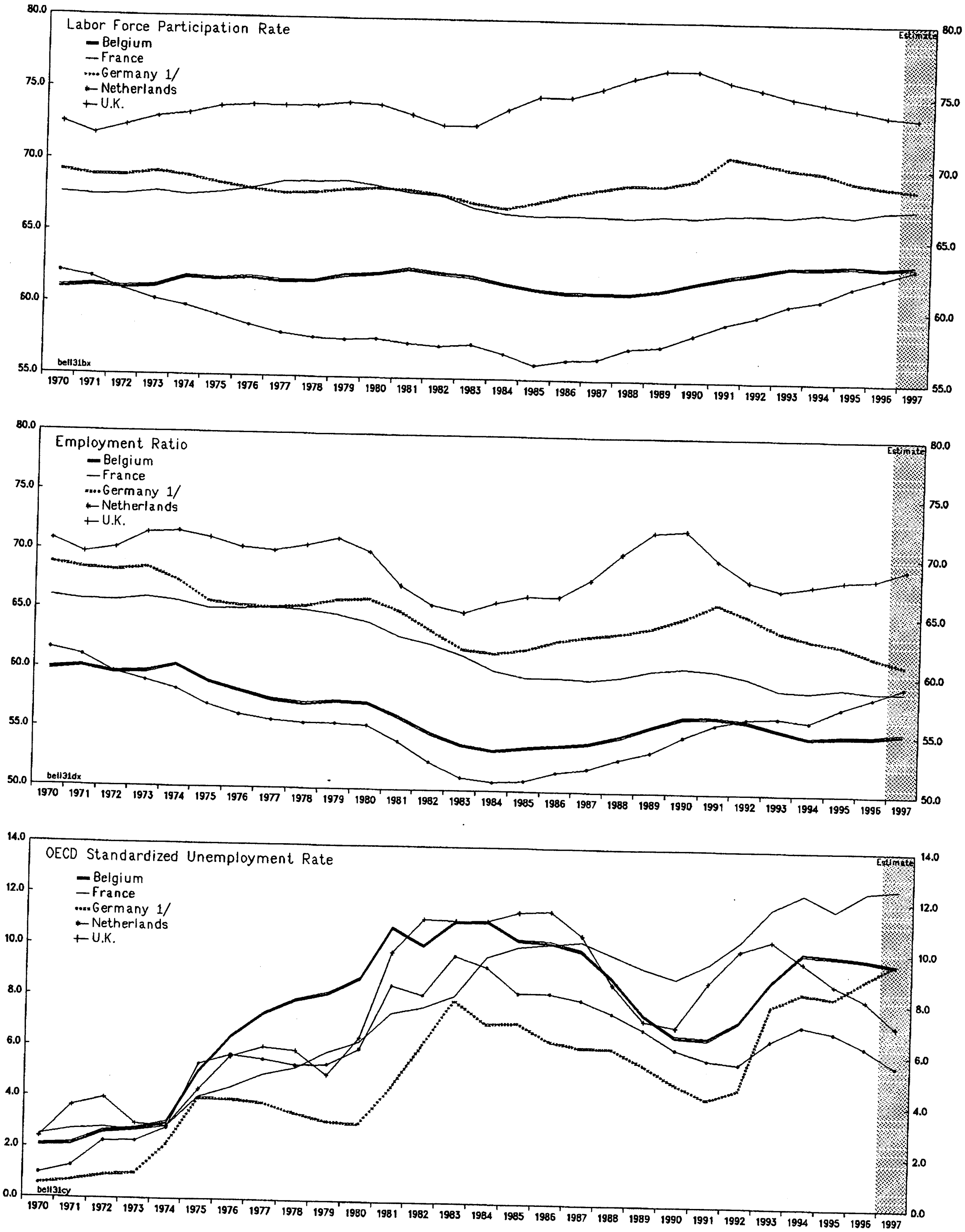
68. The growth of Belgium's labor force, averaging one-half percent per annum since 1970, has been below the average for the EU. The factors behind this limited growth have been demographic, as immigration and changes in the participation rate have made only marginal contributions. Although the female participation rate has risen, reflecting essentially a trend rise in overall part-time work, this has been offset by a fall in the male participation rate, as early-retirement programmes have focussed primarily on male workers (Table II.1). There has also been a striking fall in participation rates for lower and higher age brackets, with youth leaving school later than in other EU countries (schooling is compulsory until age 18), and delaying their entry in the labor market given limitations on prospects for employment. Similarly, older workers have enrolled in early retirement and other special unemployment-related schemes. The net result of these factors is an overall participation rate that has barely risen in Belgium, and is among the lowest in the EU.

69. While labor force growth was limited, total employment has not expanded at all, with the number of jobs in 1996 virtually unchanged from that in 1970. The composition of employment has, however, changed significantly during that period. Male employment fell by 8 percent, while female employment rose by 29 percent, a shift that was associated with structural adjustment away from industry and into services. Private sector employment declined by 2.5 percent relative to 1970, as job creation in the service sector did not fully offset losses due to the contraction in industry. Indeed, the industrial sector was hit hard by the oil-shocks and the cyclical downturns in the 1970s and early 1980s and, as a result, the share of industrial employment in total employment fell from some 33 percent in 1973 to 20 percent. Following these major shocks, the steel, coal and textile sectors contracted sharply and the structure of employment shifted from the industrial sector to the service sector, with restructuring increasingly achieved through the outsourcing of services. By 1995, the share of employment in services in total employment had reached 71 percent, compared with 55 percent in 1973. Public sector employment has played a limited direct role in the creation of jobs, growing at an annual average of 0.9 percent. Of these, a number of positions were added through the development special employment programs.

70. While general employment growth was weak, part-time work has been gaining importance since the early 1980s and has progressively become the engine of employment growth. By 1996, part-time employment had reached 16 percent of the total, only slightly below the EU average. The great majority of part-time workers are female, with 32 percent of employed women working part-time, compared with 3.2 percent of men. For women, the creation of new part-time jobs, mostly in services (notably hotels, retail and wholesale trade and public services), over the past twelve years has compensated the loss of full-time jobs. On the other hand, temporary work is relatively unusual, and labor mobility within the country, apparently reflecting strong cultural and linguistic differences, and high fiscal and legal costs attached to real estate transactions, is limited.

FIGURE II.1
BELGIUM

Labor Market Indicators



Sources: OECD, Economic Outlook; and IMF, World Economic Outlook.
1/ Data prior to 1991 are for West Germany only.

Table II.1. Belgium: Labor Force and Participation, 1970-1996
(Percent of relevant working-age population)

	1970	1981	1991	1996
Labor force (thousands)	3,769	4,094	4,210	4,295
Participation rate (percent)	61.9	63.0	63.1	64.1
Of which: male	(84.3)	(78.2)	(72.8)	(71.6)
female	(39.8)	(47.7)	(53.2)	(56.5)

Source: National Statistical Institute.

71. With these trends in participation rates, and taking account of annual hours worked per employee, Belgium has the lowest overall labor supply of the advanced economies. This labor supply measure, an aggregation of the employment ratio and the number of hours worked per year, reflects the proportion of potential hours worked in the economy.[18] In Belgium, the labor supply is 40 percent of potential, compared with some 50 percent in France and Germany and about two-thirds in Japan and the United States.

72. Given these underlying factors—a slowly growing labor force and essentially flat employment—the unemployment rate, as a trend, has been rising. The standardized unemployment rose from 2.1 percent in 1970 to 10 percent in 1994. After peaking at 11.1 percent in 1983, the standardized unemployment rate fell during the rapid upswing in the second half of the 1980s, but thereafter rose again as economic growth slowed. In recent years, cyclical unemployment peaks have remained below that of the early 1980s, at least partly as a consequence of changes in the administrative definition of unemployment, wage restraints, early retirement, and some impact of measures to subsidize the low paid. Since 1975, increasing numbers have found work in special programmes, thus withdrawing from the labor force, or gained employment through job creation programmes (see below). Though clearly problematic, the rate of unemployment in Belgium is not out of line in comparison with that in a number EU countries—since 1988, the standardized unemployment rate has been below the EU average. They key problems, rather than measured unemployment, are low participation and weak job creation.

73. As in other European Union countries, the composition of unemployment in Belgium has changed significantly over time. It is characterized by high shares of low-skilled, youth, female and long-term unemployment, although targeted policy measures have modestly improved the situation of the first two groups. In terms of national definitions, youth

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[18]For an in depth discussion of this measure, see Nickell, 1997, and OECD, 1996.

(14-24 year old) unemployment edged down from 25 percent in the early 1980s to 15 percent in 1990, as a result of better economic conditions, demographic factors, higher school enrollment and job creation schemes, but it rose steeply to over 20 percent in 1995. The share of prime-age unemployment (25-50 years old) in total unemployment has sharply risen since 1980, probably reflecting the increasing number of young adults leaving the youth employment programmes and not finding a job (Figure II.2). Female unemployment is higher than male unemployment, with the female unemployment rate 7 percentage points above the rate for men in 1997.

74. A particular problem is long-term unemployment (one year and over), whose share in total unemployment in Belgium is the highest among the advanced economies. It reached a peak of some 70 percent (national definitions) in 1986, fell markedly over the following years, to 57 percent in 1993, but resumed rising again thereafter, largely reflecting cyclical developments. In this regard, eligibility conditions for the unemployment scheme were tightened in 1991, and 152,000 people were excluded from the scheme in the period 1991-96 on account of abnormally long unemployment. Skills and education levels are clearly contributing factors, with the least educated (primary and lower secondary schooling) recording the highest rate of unemployment. Low-skilled unemployment, however, fell between the early 1970s and the end of the 1980s in line with the overall rise in the education level, and also probably the various training schemes. However, in the 1990s, enterprises faced with a mismatch between labor supply and labor demand, have hired in some cases "overqualified" people, which was mirrored in a resurgence of low-skilled unemployment rates. Thus skill shortages are in part a matching problem.

75. Available evidence points to the fact that the structural component of unemployment is very high—thus, notwithstanding some persistence effects, an improvement consequent to cyclical upturns cannot be expected to restore the low unemployment rates prevalent at the beginning of the 1970s. A number of studies have identified point estimates for one measure of structural unemployment—the nonaccelerating inflation rate of unemployment (NAIRU).[19] Estimated values depend critically on the definition of unemployment being measured, since the level of the unemployment rate differs significantly depending on whether those taking advantage of special benefit programs are counted in the labor force.[20] In line with staff estimates, a 1995 study by the European Commission found NAIRU estimates ranging between 70 percent (for 1990) and 80 (for 1993) of prevailing unemployment. In addition, evidence indicates that most of the increase in unemployment through the mid-1980s was structural in nature and that this structural part, having peaked 1994, has declined only slightly in the succeeding years.[21]

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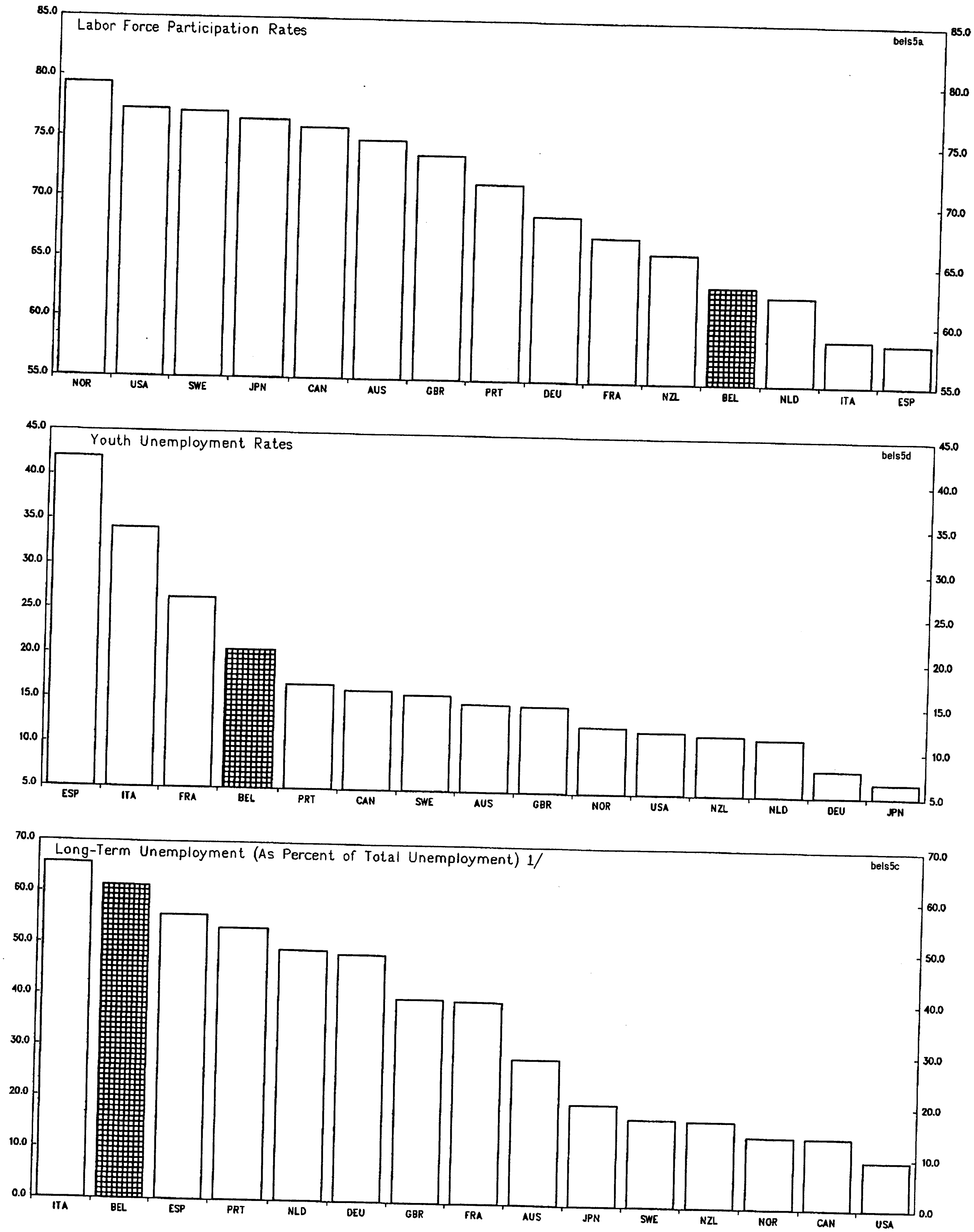
[19]An overview of estimated values for the NAIRU in Belgium is presented in Verlinden.

[20]The standardized rate, currently at 9.7 percent, is a narrow measure of unemployment. See below.

[21]NAIRU estimates are highly sensitive to changes in the specification of the wage equation.

FIGURE II.2
BELGIUM

Labor Market Indicators in Selected Industrial Countries in 1996 1/



Source: OECD, Employment Outlook, July 1997.
1/ 1995 data for Germany.

Countries are: AUS=Australia, BEL=Belgium, CAN=Canada, FRA=France, DEU=Germany, ITA=Italy, JPN=Japan, NLD=Netherlands, NZL=New Zealand, NOR=Norway, PRT=Portugal, ESP=Spain, SWE=Sweden, GBR=United Kingdom, USA=United States.

76. If unemployment is assessed in the wider sense, the unemployment problem in Belgium looks even more serious.[22] Since the mid-1970s, an increasing share of the unemployed have joined a wide array of government programmes, allowing them to leave the labor force, to become partly unemployed or to join subsidized jobs (Table II.2). The numbers involved in these public schemes reached a peak in 1982 of 15 percent of the broad labor force and declined to 12 percent in 1996, as labor market policies were reoriented and programs tightened under the Global Plan in 1993. During the 1990s, "broad unemployment" (a concept admittedly open to challenge) has hovered within a narrow band of 23 to 25 percent of the broad labor force, despite the cyclically-induced rise in the narrow unemployment rate.

77. Unemployment also has a regional dimension. In comparing the two largest regions, Flanders and Wallonia, unemployment has been especially pronounced in Wallonia. In 1996, the unemployment in the Wallonia was more than double that in Flanders. In the early 1980s, rates in the regions differed by two percentage points or less. Between 1983 and 1989—a period of relatively strong growth—unemployment decreased substantially in Flanders and declined only marginally in Wallonia. While the rate gap narrowed somewhat between 1989 and 1992, the regional difference remained constant in the ensuing years. Within regions, some sharp local variations exist.

78. Wage pressures have often emerged, even at times of significant slack in the economy and high unemployment. In the 1970s and early 1980s, average real wages increased sharply and at higher rates than productivity gains, weakening Belgium's international competitiveness and overall economic and employment performance. Wages rose significantly faster than elsewhere in Europe in the wake of the first oil shock, and the ensuing correction was slower. To prevent wages from rising too sharply, threatening competitiveness, the government intervened actively in the wage formation process. For most of the past 15 years, wage norms have been in place and wage growth has been moderated (see below).

B. Trends in Wages, Costs and Competitiveness

79. Changes in labor costs over the past decade and a half have clearly had a major impact on the evolution of unemployment. In this regard, two main developments stand out: labor costs increased significantly, largely as a result of successive increases in required employer social security contributions; and real wage rates, essentially flat before 1989 and after 1992; rose substantially during the boom in the early 1990s (Figures II.3, II.4, and II.5).

80. Comparison with labor cost developments in Belgium's neighbors helps to frame their evolution in terms of effects on competitiveness (see Box II.1 and Appendix I). Real labor costs in Belgium rose by 22 percent during 1982-96. The real labor cost increase in the Netherlands was less than a third of that in Belgium. Moreover, unlike Belgium, there was no

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[22]Statistic on unemployment in the wider sense, often labeled "broad unemployment", encompasses both the "narrow unemployment" included in standardized measures along with those working unemployment-related programmes.

major acceleration in wage costs in the Netherlands during the early 1990s. At the same time, labor cost increases in France and Germany straddled those in Belgium during 1982-92, and were more restrained in Belgium in the following years (in line with measures in the 1993 "Global Plan").

81. About a third of the rise in real labor costs during 1982-96 can be attributed to rises in employers' social security contributions. Such increases, for the most part, took place in annual 2 percentage point increases during the 1983-87 period. Under this policy, agreed with the social partners, wages were de-indexed from inflation in order to offset the impact of higher contributions on enterprises costs. By 1987, the share of employers contributions in GDP had risen by 2½ points to 13.8 percent. Increases in labor taxes, continuing until 1993, partly to help fund outlays associated with rising unemployment, further fueled the upward movement of labor costs.

82. A sharp rise in nominal wages (some 14 percent) during 1989-92, when wage norms were not in effect, also contributed to the rapid increase in labor costs. Behind the rise were pent-up wage demands in the wake of the 1982-88 real wage freeze and the impact of an economic upswing, which raised corporate profits, and their short-term capacity of businesses to support wage increases. Added to this, consideration needs to be given to the role of insider-outsider effects—as significant wage increases were agreed even though high unemployment persisted (see Section II.C). In this respect, it is noteworthy that in the manufacturing sector, which is subject to strong competitive pressures from abroad, wages grew substantially more slowly than in the more sheltered services sector.

83. Under the conviction that, without intervention, wages would rise even faster, the Belgian authorities have sponsored wage norms during most of the last decade and a half. The statutory basis and the design of the wage freezes in much of the past 15 years have varied, but they essentially targeted the maintenance of external competitiveness. Between 1982 and 1986, government intervention took the form of a real wage freeze and of suspending and later interfering with automatic wage indexation system. In 1987, freedom of negotiations was reinstated with the proviso that external competitiveness be preserved. In 1989, the law on competitiveness was introduced, giving the government the authority to intervene if the social partners did not succeed in re-establishing competitiveness. In November 1993, faced with mixed results, the authorities introduced the Global Plan which redefined the index used for adjusting wages. Employers contributions for low-skilled workers were cut and, later, a real wage freeze was implemented for 1995-96. Finally, in July 1996, a new law limited the maximum rise in labor costs to 6.1 percent in nominal terms over the two-year period 1997-98 (Box II.1).

Table II.2. Belgium: Employment and Unemployment, Broadly Assessed

(Thousands)

	1990	1992	1994	1995	1996	Prel. 1997
I. Narrow unemployment	365	511	554	555	545	541
II. Other unemployed	230	214	178	159	149	125
Seasonal unemployed	25	48	36	35	50	50
Part-time unemployed	205	166	142	124	99	75
III. Special programmes	463	435	420	409	427	445
Exempted from job search	123	121	116	115	131	150
Due to age	72	75	74	74	95	114
Other	51	46	42	41	36	36
Special leave	49	58	54	51	51	56
Early retirement	163	146	141	134	134	129
Direct job creation	128	110	109	109	111	110
IV. Unemployment and special	1,058	1,160	1,152	1,123	1,121	1,111
Percent of broad labor force 1/	23.4	25.4	25.1	24.4	24.3	24.0
Memorandum items:						
Share in labor force, percent						
Narrow unemployment	8.7	12.1	12.9	12.9	12.7	12.6
Other unemployed	5.5	5.1	4.2	3.7	3.5	2.9
Special programmes	11.1	10.3	9.8	9.5	9.9	10.4
Broad labor force 1/	108.0	107.7	107.3	107.0	107.4	107.8

Source: Data provided by the authorities.

1/ Sum of labor force, exempted from job search, special leave and early-retirement.

84. Through these wage policies an important objective has been achieved: overall, competitiveness has been safeguarded, notwithstanding the structural problems in the labor market. Indeed, staff analysis suggests that policy has neither overachieved nor underachieved this goal, with Belgium's sizable external surplus not signaling distortions or tensions in the level of the real exchange rate (Appendix I).

85. As regards the costs of the wage policies pursued since the early 1980s, an important consideration is that these have constrained wage differentials within and across sectors and, thus, may have constrained relative adjustment reflecting changes in sectoral labor costs in

partner countries. Available evidence shows a distinct difference between wage developments in the main economic sectors—manufacturing wages have been restrained over time, reflecting the openness of the economy, while service sector wages have been more buoyant. On the other hand, given labor market distortions, national wage policy, de facto, may have helped to restrain service sector wages, avoiding additional damage to job growth.

86. Data are not sufficiently comprehensive to allow a complete analysis of the importance of this factor. (For example, they exclude the service sector.) However, wage dispersion in Belgium appears to be among the lowest in OECD countries and lower than in its main trading partners.[23] In Belgium as in Germany, the earnings distribution at the lower half of the range has been compressed. Earnings dispersion across sectors is somewhat larger for women than for men, in line with the different mix of jobs. Labor cost dispersion among skilled and unskilled workers is low and was essentially unchanged in the 1980s, increasing slightly in the 1993-97 period.

87. The minimum wage in place since 1975 for adult workers, combined with wage norms, may actually have set a floor for wages. On average, the real minimum wage and real average earnings have grown at about the same pace over the past 20 years or so. An exception to the floor set by the minimum wage is the youth minimum wage which under collective agreements lowers the minimum wage payable from 94 percent of the standard for 20 year olds progressively to 70 percent for those aged 16 and under. Furthermore, the generalized system of wage indexation in place implies that a decline in real wages is unlikely to occur in Belgium. The commitment to the hard-currency policy, leading to a trend nominal appreciation of the Belgian Franc, adds to the rigidities inherent in indexation. The system works with long lags and costs take even longer to feed through to prices thus making the economy more vulnerable to an appreciation of its currency, with the associated risk that it will lead to a loss of competitiveness and employment.

88. In the face of rapidly increasing labor costs, employers continuously substituted capital for labor as they acted to improve the profitability of their operations. While, in terms of unit labor costs, Belgian competitiveness has been rather good since the early 1980s, the record on employment appears to indicate that real labor costs remain too high to motivate a reversal of the capital-labor substitution and an associated acceleration of job creation. This shows clearly in a comparison with the Netherlands, which has had a better record in employment creation over the past fifteen years. It also seems likely that the significant retrenchment in employment that took place following the second oil shock could have been limited had the increase in labor costs been more restrained. Here, the feedback link between the tax wedge on labor and increasing fiscal outlays and deficits (as described in Section I) clearly played a deleterious role. Beyond this, a number of factors at the regional level seem to have contributed to the destructive growth-employment-fiscal cycle that occurred.

[23]See OECD, 1996 for a discussion.

FIGURE II.3
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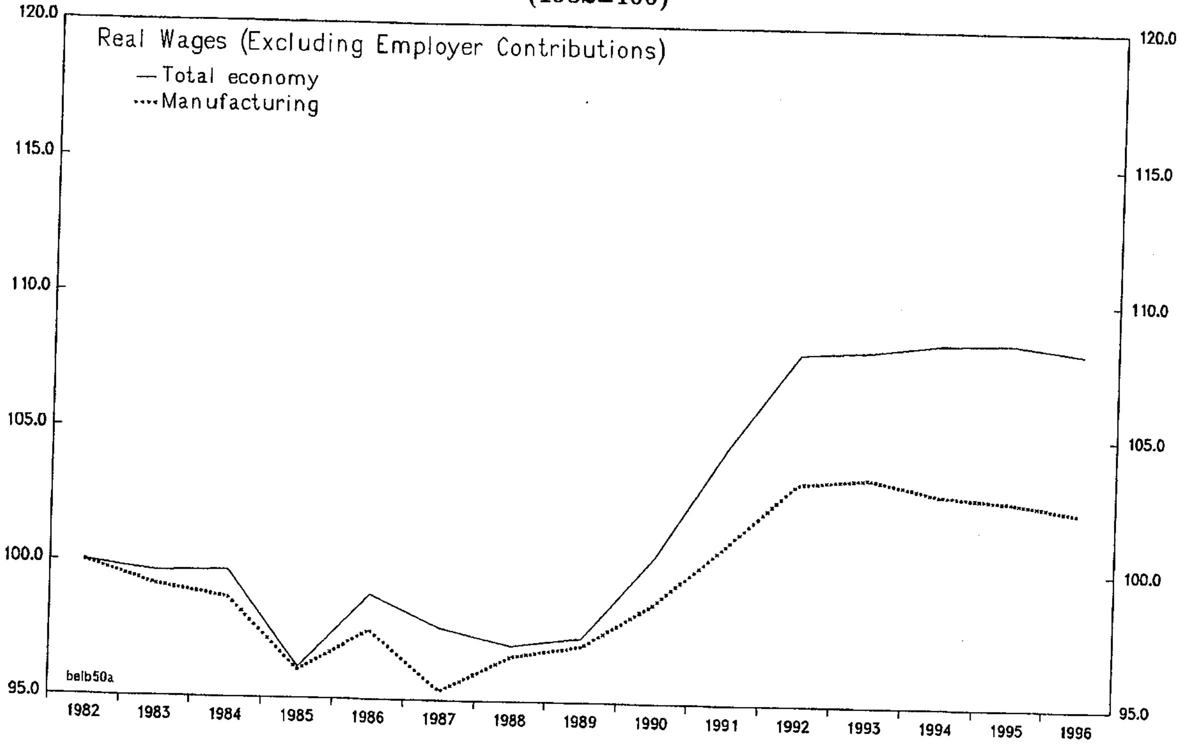
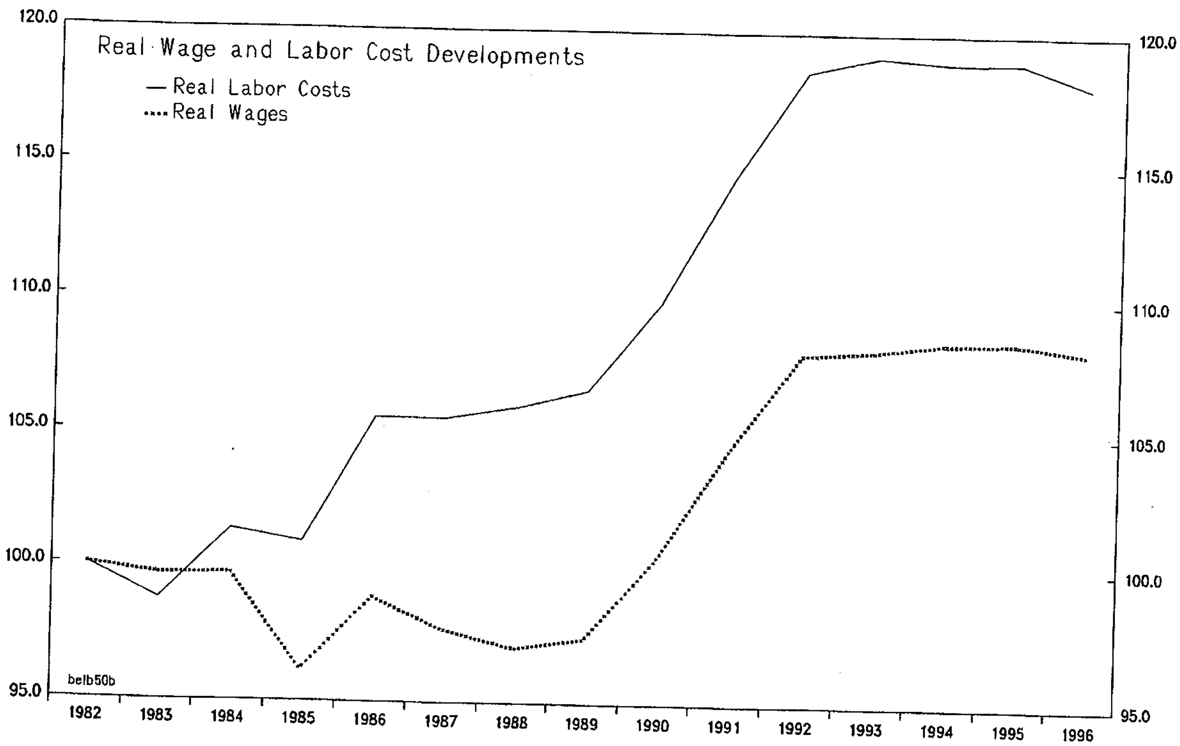
Real Wage and Labor Cost Developments

(1982=100)

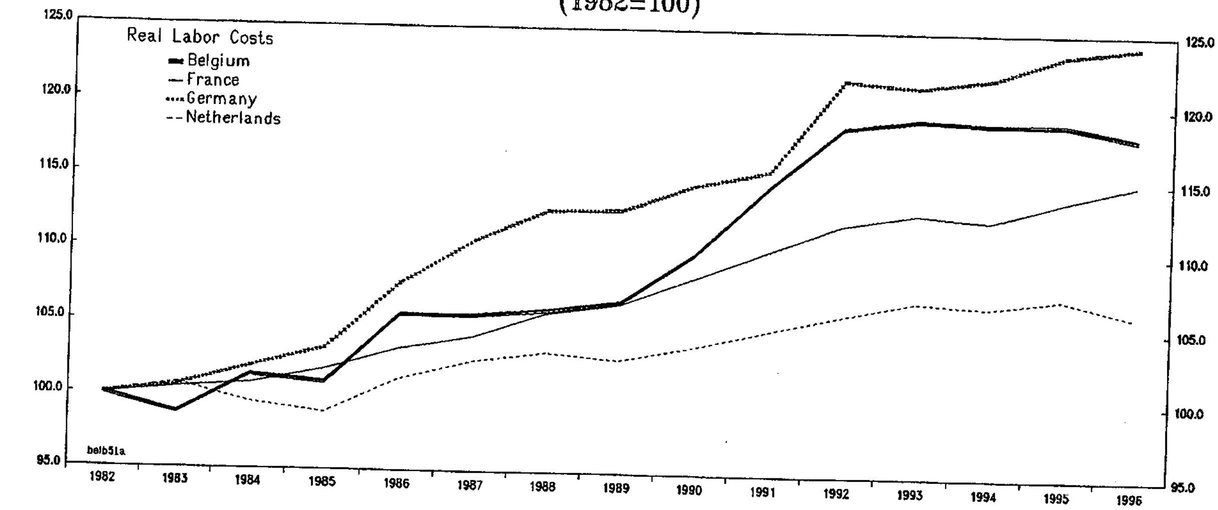


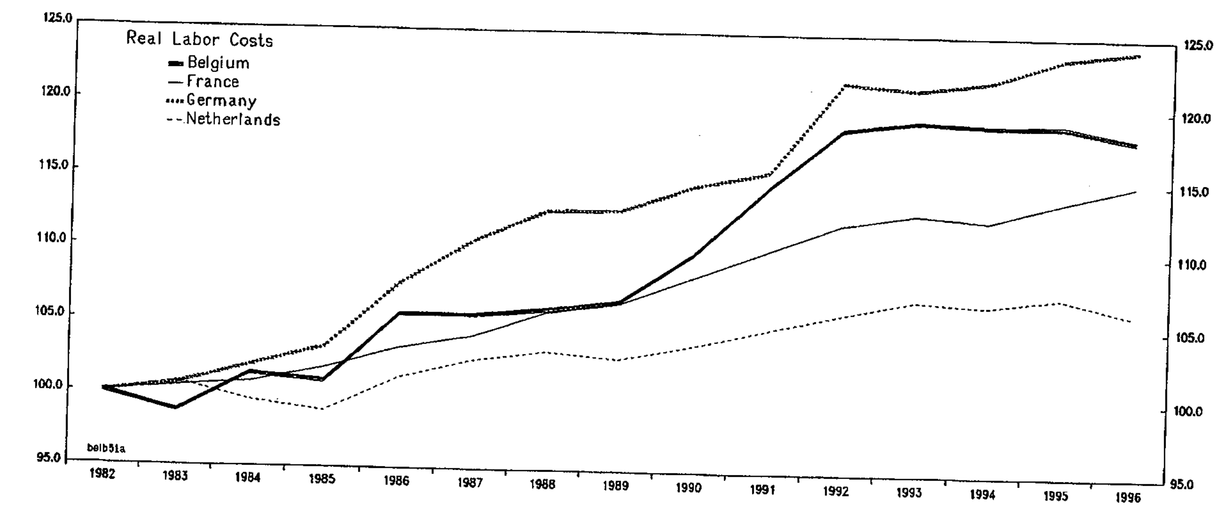


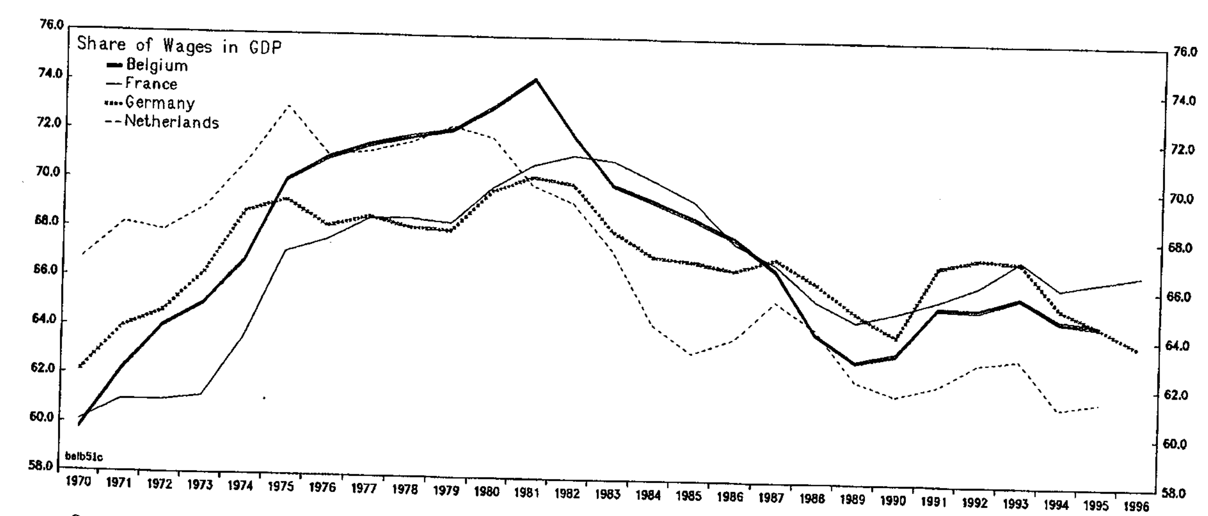
Source: Analytical Database.

FIGURE II.4
BELGIUM

Real Labor Costs and Employment in Selected Countries
(1982=100)







Source: Analytical Database.

FIGURE II.5
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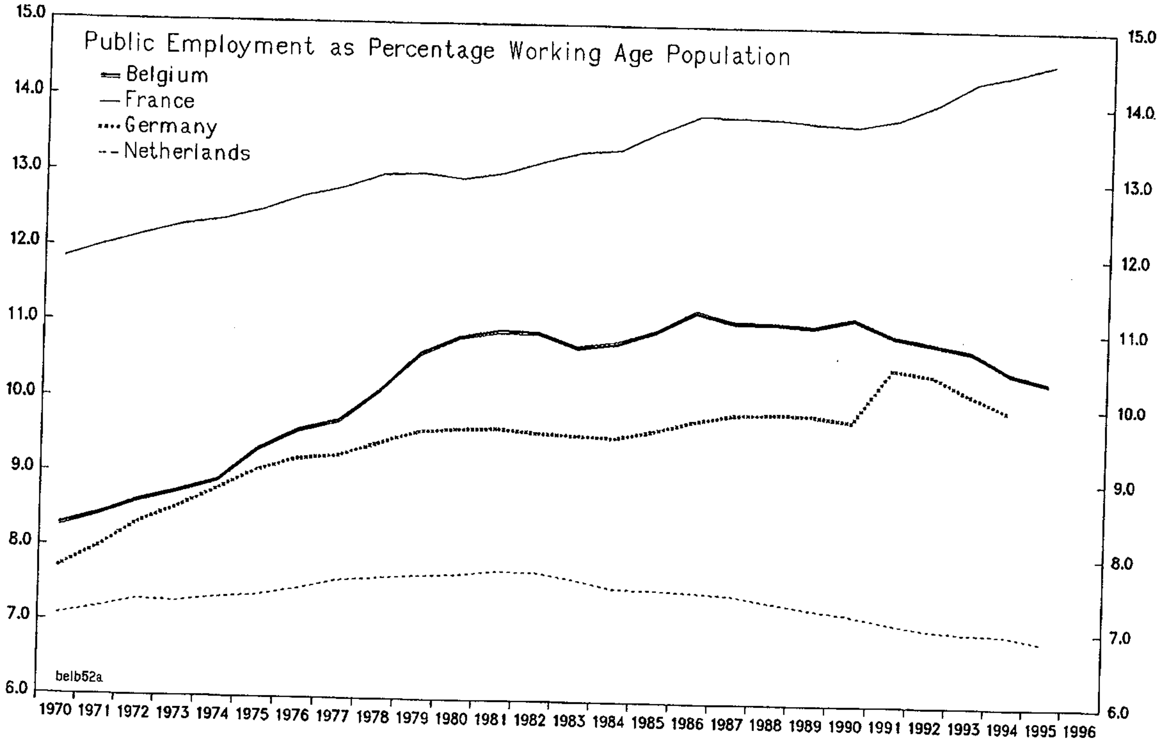
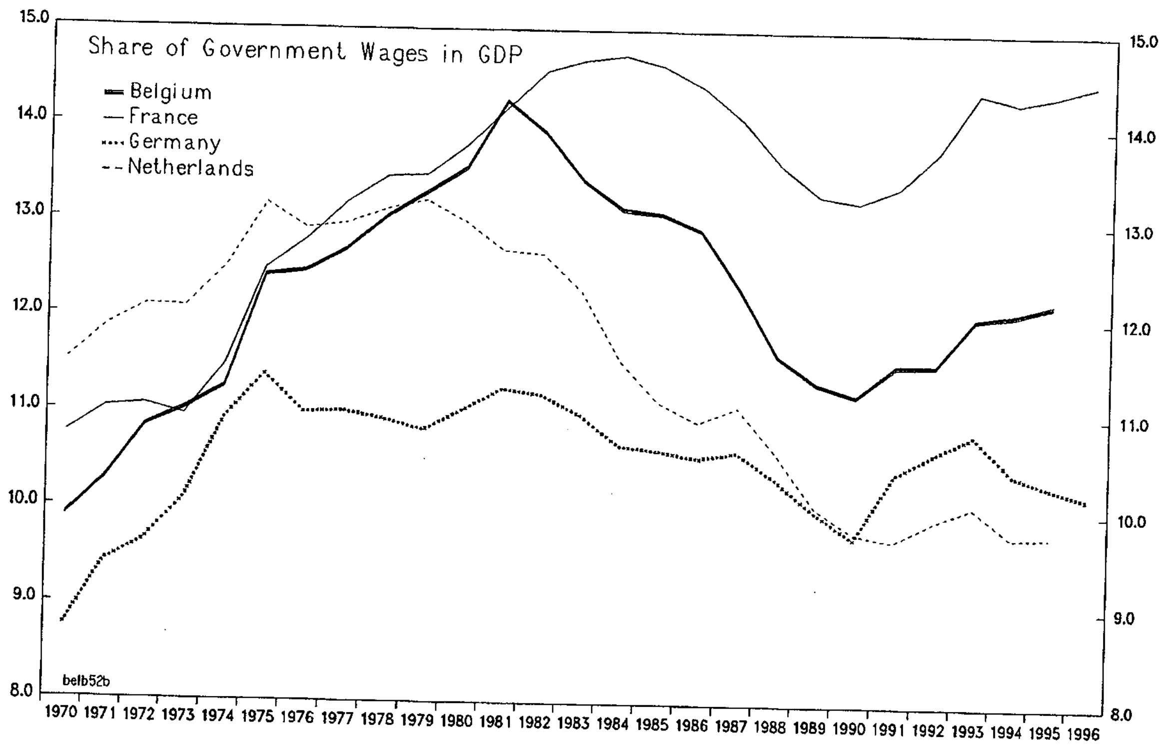
Public Employment





Source: OECD, Analytical Database.

Box II.1. Belgium: Wage Norms

Since 1982, the government has intervened continuously in the private wage setting process. In the 1982-86 period, real wages were frozen and the authorities interfered with the automatic wage indexation system. Indexation was suspended between early 1982 and August 1983, the indexation period was lengthened in 1983, and the 6 percent increase in nominal labor costs resulting from automatic wage indexation was passed on to the budget (i.e., wage increases were not paid to employees but incremented employers' social security contributions to the budget) in the three following years. As a result, real wages fell by 6 percent over the period and the tax wedge widened. A first norm on competitiveness was introduced in 1983, stipulating that labor costs in Belgium should not rise more than in the weighted average of its seven main trading partners; the norm was prolonged in 1985-86. In 1987 and 1988, however, wages were negotiated freely between social partners, with the condition that wage increases did not hamper competitiveness.

In 1989 a Law on Competitiveness was introduced, as a complement to the wage indexation system and a way to enhance awareness of the importance of wage moderation to maintain competitiveness without employment costs. Social partners were required to regularly assess competitiveness of the economy, notably export performance and labor costs, and report to the authorities, which could take redressing measures. In line with mixed results on competitiveness, as wage growth did not moderate sufficiently to preserve competitiveness and employment, the government decided on corrective action. In early 1993, with social partners disagreeing on remedial measures, the government reduced social security contributions of enterprises in the exposed sector. This Maribel-bis operation was fully financed by a new tax on the consumption of energy by non-industrial sectors, and was thus budget-neutral. In the fall, a number of additional measures were introduced in the "Global Plan", of which a change in wage indexation which was to be based on a price index excluding tobacco, alcohol and oil (the "health" index); a real wage freeze in 1995-96; and a Maribel-ter with a 50 percent increase in employers contributions cuts decided upon earlier in 1993.

The law on competitiveness did not reduce the rigidities deriving from full wage indexation and wage negotiations at the national, sectoral and firm levels, coupled with slow growth, resulted in real effective wage increases more than productivity. The 1993 corrective measures contributed little to maintaining competitiveness: the health index was a step in the right reduction, but, in line with EU recommendations, cuts in employers contribution were enlarged to all sectors. In the short-run, labor cost increases moderated, from 6 percent in 1989-92, on average, to 2.3 per cent in 1992-95. The level of labor costs in Belgium nevertheless remained too high.

With a view to reframing the wage bargaining system, while supporting employment and preserving international competitiveness, a new law was voted in July in 1996. Wage and labor cost growth in Belgium are to be kept in line with the weighted average increase in the three major partner countries; further progressive cuts in employers contributions; further reduction in hours worked (39 hour work week) to accelerate work redistribution, and measures to improve part-time work; and better training. Overall a 6.1 percent wage growth norm for 1997-98 was decided by the government, as social partners did not come to an agreement. Contrary to previous norms, the present law incorporates sanctions if wages grow faster than the growth norm.

Corrective measures, in retrospect, have helped constraining wage increases in the short term, thus competitiveness of Belgian products, but are no long-term solutions to the employment and competitiveness problem, as evidenced by repetitive action on labor cost and the dismal performance of job creation.

C. Tensions in the Policy Framework

89. The policies employed in addressing Belgium's labor market issues may well have profound effects on overall economic performance. At the aggregate level, channeling human resources into productive uses, desirable in its own right, will have consequences for growth potential. In terms of political economy, alleviating youth unemployment, providing opportunity for the long-term unemployed, and creating an adjustment dynamic that supports the elimination of geographical imbalances would all seem to be of some merit. In achieving these ends, issues including the process of wage formation, the outline of social entitlements, the regulatory framework, and the structure of taxes and levies on labor income will have to be addressed. In addition, institutional structure and education will likely come under review.

90. Institutional rigidities of the labor market and education have resulted in a **wage formation process and wage structure** that does not reflect market signals adequately, as well as reduced incentives to work. In this setting, insider problems blossom. According to the OECD, Belgium is among the countries having a consistently centralized wage bargaining system, and a higher collective bargaining coverage rate, reflecting the system of administrative extension of sectoral wage agreements or by law.[24] With relations between unions and employers often less than fully cooperative, the government has resorted to the enforcement of wage contracts: together with generous unemployment benefits, early-retirement schemes, and legally-backed wage norms, this reflects an administratively imposed "equilibrium." Overall, the process has yielded high unemployment while constraining the role of the price mechanism in clearing labor market.[25]

91. In coming to grips with tensions in the current system, it will be necessary to confront in a more market-related manner the role that "insider-outsider" relations continue to play in wage setting and employment determination. As evidence for the importance of this issue, a previous staff study showed that hysteresis (persistence effects) does play a significant role in Belgium: incumbent workers ("insiders") appear to exercise market power in wage determination, taking greater account of their own interest than those of the unemployed.[26] The market power employed by "insiders" makes it more difficult to re-employ newly unemployed "outsiders".

92. The next steps in the wage formation process are unclear. During 1997, the social partners did not arrive at an agreement for replacing the current wage setting process, which will expire towards the end of 1998. Wage norms have likely restrained wage growth, but at the expense of constraining wage dispersion and, thus, limiting market forces that underpin the matching for labor demand a factor that prompted the authorities to intervene. Wage flexibility was also enhanced by giving firms that have increased their headcount the right to

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[24]OECD, 1997.

[25] Nickell, 1997.

[26]See Moghadam, et. al.

grant additional income to employees through profit sharing over and above the economy-wide upper wage limit. However, the results are disappointing as few firms have used this facility. Finally, the legislation on job protection is strict, and has probably made firms more cautious in hiring, thus adding to employment rigidities.

93. As regards the **demand side** of the labor market, there is awareness that the high level of non-wage costs, mainly social security contributions, has contributed significantly to the relatively high labor costs and, through this, to restraining employment growth. It is in this context that significant pressure has begun to build for the reduction of non-wage labor costs and employment promotion. Employers' contributions (as a percent of gross wages) were the third highest among industrial countries in the early 1990s, and the tax wedge was very high in Belgium by international standards. For example, the average tax wedge for a single person earning 66 percent of an average production worker's income was just above 40 percent in 1992, compared with an OECD mean of some 30 percent. Including consumption taxes, the total tax wedge in Belgium, at 50 percent of wages, is in the top half in industrial countries.

94. Measures cutting employer social security contributions were implemented under the 1993 Maribel-bis and the Global Plan. These measures were targeted to sectors exposed to international competition, essentially in manufacturing, and to specific labor market groups: workers paid close to the minimum wage (the "low-paid"), youth, and the long-term unemployed. In 1997, in line with the recommendations of the European Commission, cuts in employers social security contributions were extended to white-collar workers and to all sectors of the economy and favor labor-intensive enterprises.[27] Overall, since 1993, employers premiums (on a cumulative basis) have been reduced by BF 41 billion, i.e., about one percent of GDP with their share in total social contributions falling by 2.5 percentage points between 1993 and 1997, to 56 percent. By 1997, cuts in employer contributions resulted in a reduction in labor costs by some 14 percent for the low-paid, and, combined with all other measures in the Global Plan, are estimated by the National Bank of Belgium to have resulted in the creation of some 25,000 jobs (0.8 percent of dependant employment in the private sector). However, in the absence of statistics on the duration of job tenure, it is difficult to assess whether these measures effectively allowed the targeted groups to be reintegrated in the labor market. These programs are generally estimated to have allowed some 20 percent of the young and long-term unemployed to find a job, with the remaining representing a substitution effect.

95. Given fiscal constraints, the reduction in employer social security contributions has been offset by various special contributions on taxable income and indirect taxes. In 1997, 8.7 percent of total current revenue of social security administration was budgeted from "alternative financing." According to the Federal Planning Bureau, this alternative financing has had mixed effects. Financing social security by raising taxes produces a transfer to the public sector budget and lowers private sector income, thus having an adverse impact on

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[27] The European Commission had found that the selective sectoral measures introduced distortions in competition conditions.

consumption and investment. Additional levies on direct taxes slightly raise the level of prices but has a clearly positive impact on the budget. Financing through higher indirect taxes can have an inflationary effect, while having only a slight positive impact on the budget. An increase in VAT rates appears to be the least attractive option, as induced macroeconomic effects are negative and the budgetary impact is barely positive.

96. As regards the **supply side** of the labor market, some measures taken from the mid-1970s onward to address unemployment effectively diminished the labor force. They included the introduction of a full-time early-retirement scheme, which was set in place in 1975, complemented in 1993 by a part-time early-retirement scheme. Additionally, a special-leave scheme, introduced in 1985, allowed workers to work less hours or to stop working at their convenience while receiving a benefit and keeping their social security rights. These measures, taken together, have contributed to a 6-7 percent decline in the labor force in the period since 1993.

97. Against this, unemployment regulation has been modified in order to reduce the number of qualifying unemployed and the authorities are taking some steps to redress incentives in some areas. Qualifying conditions for early retirement under the age of 57 have been progressively tightened in the 1990s, and the early-retirement age was raised from 57 to 58 in 1997. The rules governing the exclusion from the unemployment schemes on the grounds of abnormally long periods of unemployment and older workers were modified in 1991 and 1996, respectively (lowering the qualifying age from 55 to 50).

98. Some of the measures undertaken have aimed at enhancing work flexibility, notably with the objective of supporting more rapid employment growth in the services sector. However, policies remain, for the most part, geared towards raising the demand for labor. In addressing flexibility, the 1993 Global Plan and subsequent measures widened the scope for fixed-term contracts and promoted labor sharing through lump-sum reductions in employers contributions for additional jobs created under company agreements on job sharing. The results of these measures have been limited, as relaxed rules for short-term contracts were hardly used and time sharing has created only a few thousand jobs.

99. The unemployment benefit system is another important factor affecting the supply-side of the labor market in Belgium. The generosity of the system, in terms of eligibility, levels of replacement rates and duration of benefits, reduces the financial incentives to job search, favors inactivity and decreases downward pressures on real wages. In the early 1990s, average gross unemployment benefits in Belgium were the third highest in the European Union, after Denmark and the Netherlands. On a net basis—allowing for taxes, children benefits, social assistance and housing benefits—replacement ratios are even higher. Long statutory benefit duration induces people to register as job-seekers for a longer time than in other countries where claimants can eventually qualify for social assistance. Initial replacement rates are not high compared with other EU countries, but they rise with the duration of previous employment. The virtually unlimited duration of benefits contributed to the high proportion of long-term unemployment in total unemployment, notably among women (Meyer, 1990, OECD, 1991 and Nickell, 1997).

100. With high replacement ratios and minimum wage, many of the unemployed face tax and benefit traps—where the net financial result of from moving off of social benefits to employment is negative. The traps typically affect those on the minimum social welfare benefit (MINIMEX) moving to part-time work, youth for whom the statutory wage is below the normal minimum wage, unskilled labor, single parents, and couples at the minimum wage level. In addition, some measures provide major disincentives against returning to work, such as the loss of moratoria for debt repayments for individuals below a specified, low level of income.

101. Until the mid-1980s, rising unemployment was met with passive labor market policies (unemployment benefits and early-retirement) reflecting, in part, equity and other social considerations. These passive measures proved costly both in their direct expenses (3.5 percent of GDP at their peak in 1985) and the indirect effects on employment generation induced by offsetting increases in social contributions covering the costs. This approach also limited downward pressures on wages as the number of job-seekers declined. To redress the imbalance in labor market and to offset the cost of generous benefits, active measures were introduced to promote job seeking by the unemployed. A number of these measures aimed at training or retraining the long-term unemployed and youth. In particular, in early 1993, a personalized support plan (*plan d'accompagnement des chomeurs*) was introduced by the federal government in cooperation with the regions and the communities. Under the plan, monitoring, counseling and retraining was provided to the fully-insured unemployed aged 45 and under after a 10 months qualifying period. With the devolution of Federal authority (see Appendix II) and the consequent restructuring of the national employment service (ONEM), the regional authorities have become responsible for the employment service and vocational training for adults. They assess the skills of the unemployed and their prospects to reintegrate the active work force and provide them with a programme for action. Participation is compulsory—should the claimant refuse it, his/her unemployment benefit is suspended.

102. The move towards a more active labor policy and was also felt at the local level. In 1994, the mission of the local employment agencies was drastically modified as the long-term unemployed and those receiving the MINIMEX were given an entitlement to work part-time for local authorities, and with this the opportunity to earn an income supplement. At the end of 1997, a new measure, aimed at alleviating unemployment in these same groups, provided additional benefits in the private sector, notably services. The measure exempted employers from paying social contributions for hiring targeted unemployed under work contracts providing normal wages, up to ceiling. A supplementary benefit guarantees that work income, under the program, is at least equal to the unemployment benefit for those employed part-time. Finally, unemployed taking up a part-time job are entitled to an income guarantee benefit higher than the unemployment benefit received by the full-time unemployed.

103. The shift away from passive policies has been clearly reflected in the evolution of social spending. The share of active expenditure in total public expenditure on labor market policies, rose from 28 percent in 1985 to 34 percent in 1995, somewhat less than in Germany and marginally below the EU average. Expenditure on direct job creation is much higher in Belgium than the EU average, but spending on vocational training is lower. Expenditure on

labor market policies, as a whole, reached the equivalent of 4.8 percent of GDP in 1985, abating somewhat thereafter, to 4.2 percent in 1995.

104. With the move to active labor policies, the educational system has gained heightened importance. Despite a number of reforms, the Belgian education system, including apprenticeship, still faces a number of serious problems in meeting the requirement for employment promotion. Although training was developed in a number of new activities, apprenticeship programs are limited in size and occupational scope and, in a position to programs such as that in place in Germany, are not generally viewed as a satisfactory alternative to academic study at the upper secondary and tertiary levels. This appears to be most notably the case in the French-linguistic community. As a result, a large share of students leave school early and/or fail to complete their studies at a higher level of education. Participant inflow into training programs and related expenditure are lower than in other European countries. Shortcomings in training, especially for youth, along with policy weaknesses affect the labor market through the low productivity of workers with limited education attainment and through mismatches in terms of skills and qualifications. It seems likely that the large share of insufficiently-skilled workers in the Belgian labor force have contributed to the high rates of unemployment at the lower end of the labor market. Mismatches appeared in the second half of the 1980s, in the upswing, when vacancies increased faster than unemployment fell, as job seekers did not have the right skills and qualifications. More recently, business have encountered increasing difficulties in hiring staff with required skills. Further adaptation of education and training program, coupled with a continued movement away from passive labor market policies could play a role in improving the Belgian labor market.

D. Reform Options and Links to the Public Finances

105. Given the complex and interrelated problems of the labor market, a critical mass of changes is required to make labor market reform work, and to ensure that the "rules of the game" adjust accordingly; and these changes need to be supported by product market reform. The importance of progress on a broad front is particularly clear in connection with wage norms: in order to achieve an efficient outcome once the centralized system of wage negotiation is weakened, the strengthening of market signals and incentives clearly needs to play a significant role.

106. Improving the **responsiveness of the labor market** could accelerate job creation. Decentralizing the wage bargaining system and constraining the administrative and legal extension of the sectoral wage agreements could allow greater wage flexibility, slow the rise in labor costs for low-skilled workers and, thus, improve their employment prospects. Along with this a reassessment of real wage floors, over time could also increase market flexibility. While the minimum wage grading by age favors employment of very young workers, sectoral minimum wages appear to restrain job creation in services, and—coupled with effective wage floors stemming from the welfare system—still price the low-skilled and, to a lesser extent,

youth out of the market.[28] A freeze in real sectoral minimum wages could help lower wages in services to productivity levels. At the sectoral level, the extension of wage agreements, even when requested by unions and employers, can result in misalignments between wage agreements and productivity growth at the firm level. Given this, in undertaking adjustment, it will also be necessary to address insider issues—with systemic changes internalized within the prevailing social framework. Reforms could be complemented by further measures to smooth out steep effective marginal tax rates (i.e., forms of income guarantee benefit) and by enhanced flexibility at the firm level, whether through exemptions to the minimum wage for employers hiring targeted groups, or by enlarging the profit-sharing system, or through an increased for parallel work reorganization at the enterprise level. On the **demand side** of the labor market, lowering the tax wedge, would also have the effect of further boosting employment demand.

107. Strictly in the **supply side**, additional efforts to raise the labor force through returning unemployed to the active labor force and curbing early-retirement could have beneficial effects. Taking account of social policy objectives and equity concerns inherent to the Belgian social model, improvements in wage flexibility could be complemented by measures to enhance work incentives and remove unemployment traps, particularly for low-skilled and discouraged workers. Tightening benefit eligibility by shortening the duration of earning-related benefits could reinforce the impact of active labor market policies on long-term unemployment, while adjusting the level of unemployment benefits and of basic assistance to the more flexible wage structure could help to lower youth unemployment.

108. Supply-side measures addressing early retirement, the deregulation of labor legislation and the administration of benefits could also yield positive results. Further action to phase out early retirement by progressively raising the qualifying age would raise the employment ratio of older workers and, thus, contribute to alleviating the fiscal impact of an aging population in the decades ahead. Addressing the latter problem may also necessitate a review of the retirement age, as in other European countries. Easing restrictions on dismissal, especially for white-collar workers (for example, by further shortening notice periods) could reduce employment risks and ease the return to the working world for the unemployed—an option that would imply a systemic shift under which insiders accepted moderated wage growth in exchange for enhanced job security. De-restriction of fixed-term contracts could also make the labor market more flexible.

109. It seems clear that, where major industries have declined, marginal policy changes will not be adequate to address the underlying problems. In areas of deep unemployment, the functioning of the labor market will need to be strengthened, by incentives to acquire labor new expertise (including language skills), to engage more vigorously in job search, and to expand the boundaries for commuting and moves. Faced with rigid wages and ill-adapted skills, capital has been drawn to locations with inherent advantages, such as ports and special communications facilities. While such advantages may create possibilities for an escape from

[28]See Nickell for a discussion on this point.

economic stagnation, without this, the continuation of existing industrial policy can have the effect of prolonging decline. The failure to increase flexibility and foster new activity can undermine the base for generating supporting services, and the move to a faster growth track. In this light, it can be seen that the motivation for the policies set out for improving labor market function is strengthened by the various regional and historical factors noted in the preceding sections.

110. Given these factors, efforts to improve the administration of employment, training, and benefit services could prove to be pivotal. At present, these services are provided by different levels of government working largely independently. Implementing recommended changes in benefits administration would require improved coordination between levels of government, a re-orientation of educational programs, strengthened training of personnel, and shift from an orientation from maintaining those dependent on the system to finding ways to put the unemployed to work.

111. An acceleration, in parallel, of **product market reform** could clearly complement supply side measures, especially with the move to a single currency in EMU. Improvements in the overall regulatory structure and market performance could play a critical role in fostering employment growth. Until 1993, Belgian competition legislation was neither strict nor comprehensive. This has began to change—a recently-created Competition Council has as its objective the support of more competitive conditions.[29] In the period ahead, undue labor intensity in some services (banking, energy) is likely to be corrected under market or regulatory pressures, with progressive market liberalization in the EU (Box II.2). How these issues are addressed will play an important role in the creation of employment opportunities in the period ahead.

112. An efficient competition policy will help sectors most affected by EMU. Adjustment by banks to the changes consequent to the establishment of the EMU and the failure of less dynamic enterprises to deal effectively with increased competition could lead to a reduction in employment. Given this, the recent increase in the resources of the Competition Council appears to be well targeted. Deregulation in some sectors would be likely to increase efficiency with significant labor-shedding in the short run (banking, energy, railways and local transportation). In other areas, fuller liberalization should encourage job creation. In the distribution sector, in which, contrary to other countries, output has grown moderately and employment remained almost flat since 1980, the highly-restrictive authorization procedure required to establish or enlarge facilities could be loosened, along with a liberalization of shopping hours. In the longer term, new job could be created in retail distribution, information technology and contracting-out services. Benefits of product market reform experienced in other countries could also come about in Belgium. The removal of barriers to competition could help to lower prices and increase output, which, coupled with greater wage flexibility at low pay levels, could help create jobs.

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[29]The Council resigned in late 1997 in light of a lack of resources and clarity on its role. Subsequently resources were increased significantly and the Council resumed work.

113. The complex and wide ranging product market reforms under consideration need to be balanced in a manner that enhances opportunities for job creation in expanding sectors as rationalization in more mature sectors progresses. A gradual approach to raising labor market efficiency that is well-coordinated and comprehensive, including product markets, could well bear fruit. Whatever the path chosen, the change would be much easier to initiate during a cyclical upswing.

114. As regards, finally, the **fiscal impact of labor market reforms**, it is evident that labor market policies in recent years have placed a significant burden on the budget. Although reductions in the tax burden have been largely targeted to the lower end of the market, support programmes and benefits have markedly raised public expenditure. Intuitively, it is clear that labor market reforms have the potential, over time, to contribute significantly to fiscal consolidation, but a number of important caveats need to be borne in mind.

115. In the near-term, notably the net effects of employment raising measures on the public finances are uncertain. Declines in unemployment lead to a gross improvement in the fiscal position as tax revenues increase and unemployment and early-retirement benefits fall. However, the net incidence for the financial position of government of the above-mentioned reforms will depend on the policy instruments employed, as different approaches have significantly varied fiscal implications. Granting income-guarantee benefits, lowering the tax contribution of employers, and enlarging the scope and quality of training are measures which will tend to raise the fiscal deficit. On the other hand, tightening benefit eligibility and generosity, and scaling back early retirement would lower labor-related public spending. The financial implications for the budget of extending activation of unemployment benefits for youth to all private sector services, and linking training and job search to unemployment benefits for youth are less clear, as they may require hiring qualified workers to train the targeted unemployed. Furthermore, some of these measures may indirectly raise other social expenditure: older workers may enter unemployment schemes as early-retirement is made less available, and the long-term jobless not qualifying for unemployment benefits would, nonetheless, receive the MINIMEX.

116. In the short term, therefore, it would be misleading to assume that programs to raise the level of employment will make a significantly positive contribution to the public finances, and this applies even to supply-side initiatives, such as efforts to address unemployment. Decisions on the composition and timing of labor-reform policies will be affected by fiscal constraint: in particular, the extent and phasing of reductions in the tax burden will need to be decided in light of expenditure policies and fiscal targets.

Box II.2. Belgium: Product Market Competition

The Belgian economy has been largely open to foreign competition, but domestic competition is still likely to increase in the period ahead. Major liberalization efforts in a number of sectors, notably networks, have been triggered by EU initiatives, and critical steps to lower remaining barriers to competition are probably not too far in the offing. The *1993 law on competition* aimed at strengthening competition and brought Belgian arrangements closer to European Union Law: it sets the burden of proof of abuse of a dominant position on companies, and mergers and the authorities must be notified about acquisitions resulting in a concentration of more than 25 percent of the relevant market share and in sales exceeding BF 3 billion. While these guidelines are roughly in line with other EU countries, the thresholds are low, and, as a result, a significant workload is created for the regulatory authorities.

Competition policy is handled by three entities. The Competition Council, an independent agency consisting of magistrates and experts on competition, is the decision-making body. The Competition service, within the ministry of economic affairs, is charged with conducting investigations and submits its conclusions and proposal for action to the Council, and executes the Council's decisions. Finally, the Competition Commission represents specific interests of industry and consumers and plays a consultative role. While the 1993 law and institutional framework provides a solid base for competition policy, until recently, the institutions have suffered from a lack of resources, which may have prevented them from acting more decisively. Resources for competition bodies have been increased substantially of late, and a new law is under consideration, including a realignment of the respective roles of the Competition Council and the Competition Service, a raise in the threshold levels for market share and sales, and allowing more time to handle the cases of restrictive practices.

In a number of sectors, barriers to competition are a matter of policy:

- In the *distribution sector*, establishment of new shops is restricted by zoning laws, which largely constrain large corporations. Restricted shop-opening hours, which also tend to protect small shops, appear to be more restrictive in Belgium than in many advanced economies.

- In *air transport*, despite EU initiatives to fully liberalize the sector, public ownership is still important, with 50½ percent of Sabena's shares still owned by the government, although rules allowing greater foreign participation were recently decided.

- In *electricity*, Electrabel is by far the dominant actor in generation (93 percent), transmission (100 percent) and distribution of electricity. There is an apparent link between limited competition and high tariffs charged to households and small business.

- In *telecommunications*, following the sale of an interest in Belgacom to a foreign consortium, the government still holds 50 percent of the shares outstanding plus 1 share. Full liberalization of the telecommunications sector is slated to begin in 1998, and a number of firms have already expressed interest in entering the market and provisional approvals granted. Belgacom, however, retains responsibility for negotiating the interconnection fees that will be charged to new entrants.

Source: OECD 1997.

117. Over the longer-run, by contrast, labor market reforms are likely to play a critical role in assuring sustainable public finances. With the aging of Belgium's population in prospect, the labor force will contract significantly. The potential for sustaining economic growth and offsetting the impact budgetary impact of higher health and pension outlays will depend critically on improving labor market efficiency and labor force participation. The benefit of such changes for the public finances was illustrated in the discussion, in Section I of this paper, of the long-term fiscal impact of comprehensive structural reforms.

THE CURRENT ACCOUNT OF THE BELGIUM-LUXEMBOURG ECONOMIC UNION[30]

Introduction

118. Since the early 1980s, the current account of the balance of payments of the Belgium-Luxembourg Economic Union (BLEU) has increased, from a deficit of more than 4 percent of GDP in 1980, to a surplus of more than 5 percent in 1997. This appendix examines the causes of this increase from both a balance of payments and a saving-investment perspective. It will first look at each perspective separately; and then assess whether the results of the two approaches are compatible. It will also look at the *underlying* current account, and investigate whether it is similar to the long-run trend in the saving-investment balance; or, in other words, whether there is any indication of policy tensions.

The current account from a balance of payments perspective

119. A breakdown of the current account into its various components reveals that the striking improvement in the current account can be attributed mainly to the improvement of two of its components: the trade balance and the income balance. While the other components of the current account have at times been quite volatile, they have either not shown a clear trend, or quantitatively not very important (see Appendix I, Figure 1).

120. Since the early 1980s, the **trade balance** of the BLEU has improved by about 7 percent of GDP. The improvement in the trade balance came in two steps. From 1981 to 1985 the balance shifted from a deficit of 3½ percent to a surplus of 1½ percent; then, after having been stable for half a decade, from 1992 onwards, the balance increased further, to 3½ percent of GDP in 1995. The **income balance** has shifted from about zero in the early 1980s to 2½ percent of GDP in the mid 1990s. An important reason for the growing surpluses on the income balance may have been the surpluses on the current account that the BLEU has experienced since the mid-1980s.[31] The contribution of other components to the current account was not very significant. There has been no trend in the **services balance,** which has hovered around 1 percent of GDP. The **balance on current transfers** has shown a steady deterioration, and now amounts to about -1½ percent of GDP, but quantitatively this deterioration was not very important.

121. Thus, movements in the current account balance can be mainly attributed to developments in the trade balance, both directly as well as indirectly—through its impact on the income balance. Three main factors seem to have played a role in this increase of the

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[30]Prepared by Bas Bakker.

[31]Interest rates have not contributed to the trend in the income balance, as they have been on a downward trend since the early 1980s.

Belgian trade surplus: a substantial real exchange rate devaluation in the early 1980s; large terms of trade gains in the mid-1980s, and weak domestic demand in both the early 1980s and mid-1990s.

Exchange rate developments and competitiveness

122. In the early 1980s, Belgian competitiveness, as measured by the unit labor costs based real effective exchange rate, improved considerably. This improvement, which followed a marked deterioration of competitiveness in the 1970s, was due to three factors: first, repeated devaluations of the Belgian franc vis-à-vis the Deutsche mark (2 percent in 1979, 5.5 percent in 1980, 8.5 percent in 1982, and 4 percent in 1983); second, the strong appreciation of the dollar vis-à-vis European currencies; and third, a better performance in unit labor costs (Appendix I, Figure 2, top and middle panel). This improvement in competitiveness was used not only to reduce relative export prices but also to improve profitability. The decline in relative export prices was well below the decline in relative unit labor costs, which would suggest that a quite substantial part of the improvement in competitiveness was used to restore profitability. (see Appendix I, Figure 2, middle panel).

123. Between the early 1980s and 1995, there was some erosion of Belgian competitiveness, as the real effective exchange rate gradually appreciated. This appreciation was the result of a gradual nominal appreciation of the Belgian franc vis-à-vis other EMS-currencies, as well a nominal appreciation vis-à-vis the dollar. The increase in relative unit labor costs was well above the increase in relative export prices—suggesting some squeeze of exporters' profits margins. Thus, while developments of the real effective exchange rate can explain the shift in the trade balance in the early 1980s, they cannot explain the further increase thereafter. Indeed, if the trade balance would have been determined by competitiveness only, one would have expected a gradual deterioration from the early 1980s onward. Since 1995, however, there has been a renewed improvement in competitiveness, as the Belgian franc depreciated vis-à-vis the dollar, pound sterling, and the lira.

Terms of trade

124. The observed increase in the trade balance since the early 1980s does not result from export *volumes* growing faster than import *volumes*. Indeed, when measures in constant prices, the trade balance actually worsened over this period (Appendix I, Figure 3.). Instead, the improvement in the trade balance is associated with a substantial improvement of the terms of trade. Since the mid-1980s, the terms-of-trade have improved by some 10 percent (Appendix I, Figure 4, top panel). These terms of trade gains were associated with a sharp drop of import prices of raw materials. (Appendix I, Figure 4, bottom panel). For Belgium, as a large exporter of manufactures and importer of raw materials, the relative price of manufactures and raw materials is an important determinant of its terms of trade. Indeed, the terms of trade in manufacturing hardly changed.

Domestic demand

125. The sharp turnaround of the trade balance in the early 1980s was associated with a decline in imports, rather than a surge in exports. Between 1980 and 1983 real imports declined; in 1983, their *level* was 4 percent below that in 1980. (See Appendix I, Figure 5, top panel). This decline in imports may have been the result of a notable decline in domestic demand. By 1984, the *level* of domestic demand had declined to 5½ percent below its 1980 level, and only in 1987 did demand get back to its 1980 level. (Appendix I, Figure 5, middle panel, and Appendix I, Figure 6). The sharp increase in the trade balance in 1993 was also associated with a decline in domestic demand. Domestic demand declined by 1½ percent in 1993, and only went back to its 1992 level by 1995 (Appendix I, Figure 5, bottom panel). However, an assessment of the role of domestic demand in the *structural* increase of the current account—rather than its cyclical role—is only possible from a saving-investment perspective. A relative decline in domestic demand could have improved the current account in two ways: by reducing investment, or by increasing saving.

The current account from a saving-investment perspective

126. From a saving-investment perspective, the *trend increase* in the current account balance since the early 1980s is associated with an increase in the government saving surplus as well as an increase in the saving surplus of enterprises. The saving surplus of households has not changed much (Appendix I, Figure 7).

127. The increase in the various periods can be broken down as follows:

- from 1980 to 1986, the saving surplus increased sharply, mainly as the result of an increase in the surplus of enterprises. During this time, the saving surplus of enterprises increased by 7 percent of GDP. The saving surplus of government increased from 1982 onwards, but in 1986 was still below its 1980 level;

- from 1986 until 1992, the saving surplus did not change much, as a further increase in the saving surplus of government as well some increase in the saving surplus of households was offset by a decline in the saving surplus of enterprises;

- in 1993, the saving surplus increased significantly, mainly due to a jump in the saving surplus of households; and

- after 1993, the saving surplus did not change much, as a further increase in the saving surplus of government was offset by a declining saving surplus of households.

Government saving surplus

128. The government saving surplus has increased remarkably since the early 1980s, from a deficit of 11½ percent in 1981, to a deficit of under 2 percent in 1997 (Appendix I. Figure 8, bottom panel). The increase in the saving surplus was the result of fiscal consolidation, and,

over this whole period, mainly reflects a reduction of primary expenditure by some 8 percentage points of GDP. The saving surplus is now back close to the level it had in the early 1970s. However, while the *balance* of government saving and investment is the same, both saving and investment are well below their earlier level. Government investment, for instance, is now close to 1 percent of GDP—compared with 4 percent in the early 1970s.

Household saving surplus

129. The household saving surplus displays a very pronounced cyclical pattern (Appendix I, Figure 8, middle panel). More particular, there seems to be a strong link with changes in the unemployment rate: if the unemployment rate rises, saving can be observed to increase, while if it goes down, saving declines as well (Appendix I, Figure 9). This strong link could result from the impact of a rise in unemployment on household confidence: if unemployment goes up, confidence decreases—stimulating precautionary savings. However, the household saving surplus has not shown any trend. Thus, while this surplus plays an important role in *cyclical* fluctuations of the current account, it has not contributed much to developments in its trend.

Enterprises saving surplus

130. The enterprise saving surplus increased substantially in the early 1980s, as saving increased sharply, and investment went down. (Appendix I, Figure 8, top panel). Between 1980 and 1985, the saving balance went up by 7 percentage points, from a deficit of 4 percent of GDP in 1980, to a surplus of 3 percent in 1985. Both saving and investment contributed to this increase; saving increased by 5 percentage points, and investment was reduced by 2 percentage points.

131. Since the early 1980s, the saving surplus has displayed a cyclical pattern, but it has been at a structurally higher level than in the 1970s. Two factors may have been behind the structural increase: the increase in real interest rates, which made borrowing more expensive, and the negative experiences of enterprises in the deep recession of the early 1980s, which may have made them adverse to borrowing:

- Real long-term interest rates went up sharply in the late 1970s. Following their fluctuation around 3 percent in the 1960s, and their temporary decline after the first oil crisis to -3½ percent, they went up to 8 percent in 1980; and stayed at an average of almost 6 percent since (Appendix I. Figure 10).

- The large bank loans in the 1970s made firms very vulnerable in the recession of the early 1980s, when demand declined at the same time as interest rates went up. This experience may have increased firms' risk perception of bank loans and reduced their willingness to finance investment though loans—a pattern that has been observed in the Netherlands also. Thus, firms now finance their investments almost entirely out of retained earnings.

132. However, the increased saving surplus may also partly reflect the impact of fiscal credibility; worried about the sustainability of the public finances, Belgian firms may have increased their savings and depressed their investment.

The link between both approaches, and the current account in the future

133. The analyses in the previous two sections seem to yield quite different results. From a balance of payments perspective, the main factors behind the increase in the current account surplus seem to have been the exchange rate depreciation, the terms of trade improvement, and weak domestic demand. From a saving-investment perspective, on the other hand, the dominant factors seem to have been fiscal consolidation, as well as a shift in enterprise behavior.

134. Upon closer scrutiny, however, many of the factors suggested by one approach, also hold up when analyzed in the other approach:

- Fiscal consolidation increased the saving surplus by increasing government saving; it reduced imports by reducing government consumption and investment; this effect was exacerbated by the impact of fiscal consolidation on disposable income of households.

- The real exchange rate depreciation improved the trade balance by making exports more competitive and imports more expensive; it improved the saving surplus by boasting profitability and hence the saving surplus of enterprises.

- The shift in enterprise behavior improved the saving-investment balance by reducing enterprise investment relative to enterprise saving; it reduced by imports through it s negative impact.

- Weak domestic demand was to some extent the result of the desire of several sectors to increase their saving surplus. Government demand was weak as a result of fiscal consolidation; private investment was weak as a result of the shift in the enterprise saving-investment balance, it may also have been depressed—especially in the early 1980s—by lack of fiscal policy credibility.

135. Terms of trade improvements, on the other hand, which seemed important from a balance of payments perspective, do not seem important from a saving-investment perspective. While they do raise income, their effect on saving is probably only temporary; and when their impact on saving peters out, the resulting spending increases will be reflected in higher imports.

136. Combining both analyses would thus suggest the following main factors behind the current account improvement in Belgium: fiscal consolidation, the real exchange rate depreciation, and the shift in enterprise behavior.

137. What do both approaches suggest for developments of the current account in the next few years?

- From a balance of payments perspective, some further increase is to be expected, as the present level is somewhat below the *underlying current account*. Indeed, both the lagged impact of the real effective exchange rate depreciation as well as the closing of the relative output gaps in other countries would point to some further increase in the current account balance.

- Looking at the savings-investment side, one would also expect some increase, as the government saving-investment balance may improve in the cyclical upswing, and corporate profits will be boosted by the exchange rate depreciation—although this may be offset to some extent by an increase in private investment, resulting from the closing of the output gap, and possibly bolstered by a further improvement of confidence in the policy framework.

138. More fundamentally, the high level of the saving-investment balance seems to reflect "fundamentals": a relatively high per capita income, a relatively low dependency rate—which will increase sharply in the future, and a structural fiscal deficit that is relatively low.

139. This analysis is broadly born out by a multilateral assessment of trends in current account balances. Starting from a 1997 current account balance of 5.6 percent, this suggests that the underlying current account balance, at 5.9 percent—based on WEO projections—is virtually equal to a long-run trend in the saving-investment balance of 6.2 percent, suggesting an absence of tension between a trade-based assessment of the current account and domestic economic fundamentals. While very broad confidence ranges surround such estimates, they give no signal that policies aimed at preserving competitiveness have overachieved or underachieved. However, in terms of the desirable patterns of saving and investment, a further improvement in the government saving balance (through an increase in saving) and a reduction in the enterprise saving balance (through a rise in investment) would appear consistent with more favorable economic outcomes.

Conclusion

140. The improvement in the current account, which mainly reflects an increase in the trade balance (and its impact on the income balance), seems primarily due to the following factors:

- fiscal consolidation, which improved the government saving balance, and by reducing the share in GDP of government consumption and government investment depressed imports;

- the large real exchange rate devaluation in the early 1980s; and

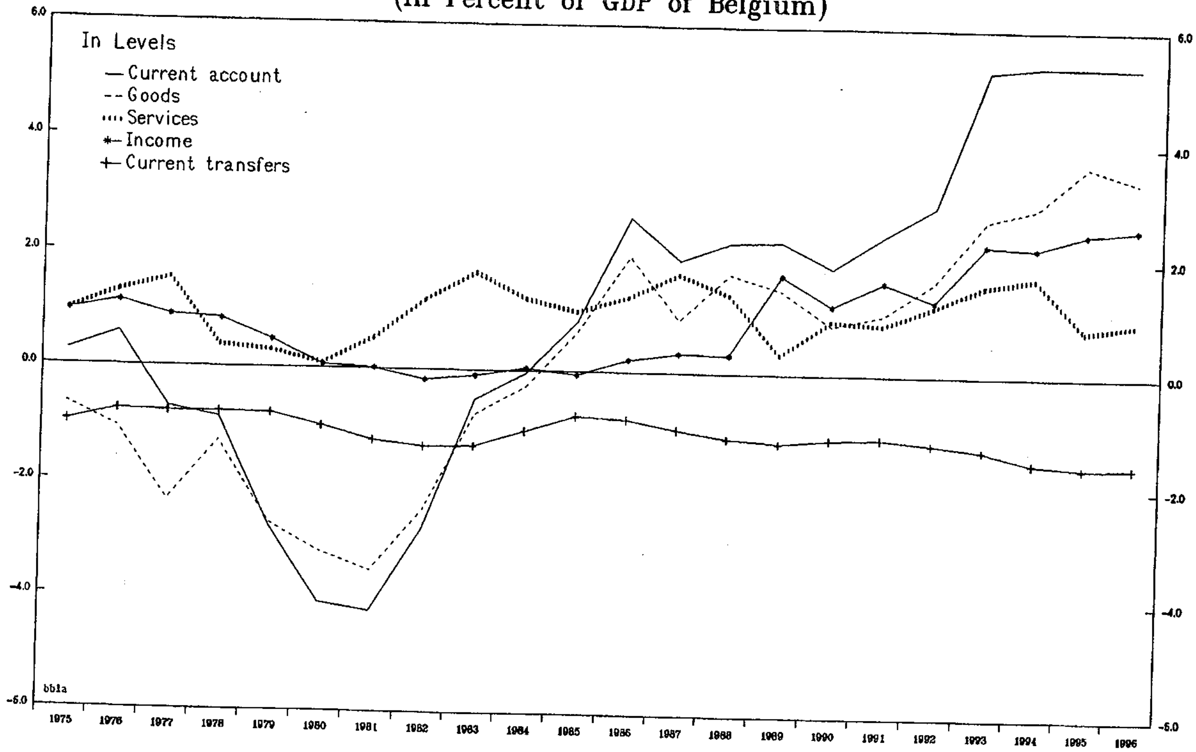
- a structural shift in behavior of enterprises, which now finance virtually all their investment out of retained earnings, rather than partly through borrowing.

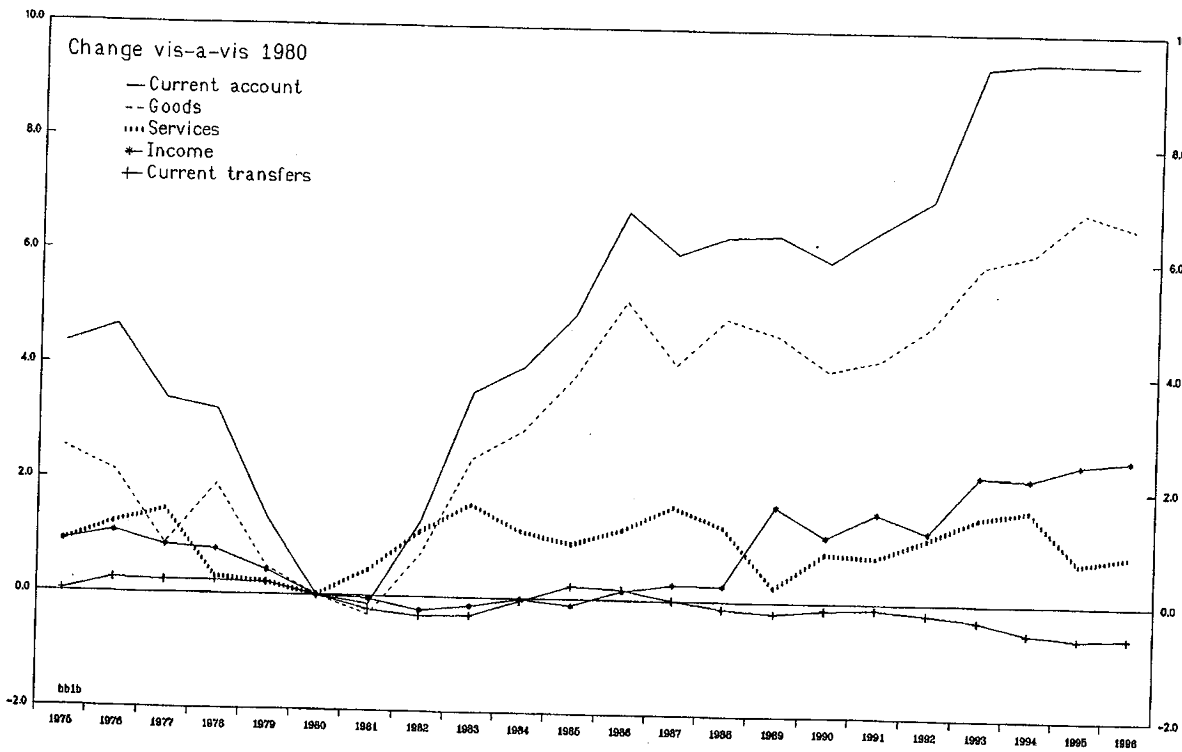
141. In the next few years, some further rise of the current account can be expected as the output gap in neighboring countries closes, and the lagged effects of the real exchange rate devaluation are felt. However, there is no tension between a broad-based assessment of the current account and domestic economic fundamentals, and thus no evidence that policies aimed at preserving competitiveness have either overachieved or underachieved.

FIGURE 1
BELGIUM

Current Account BLEU and its Components

(In Percent of GDP of Belgium)

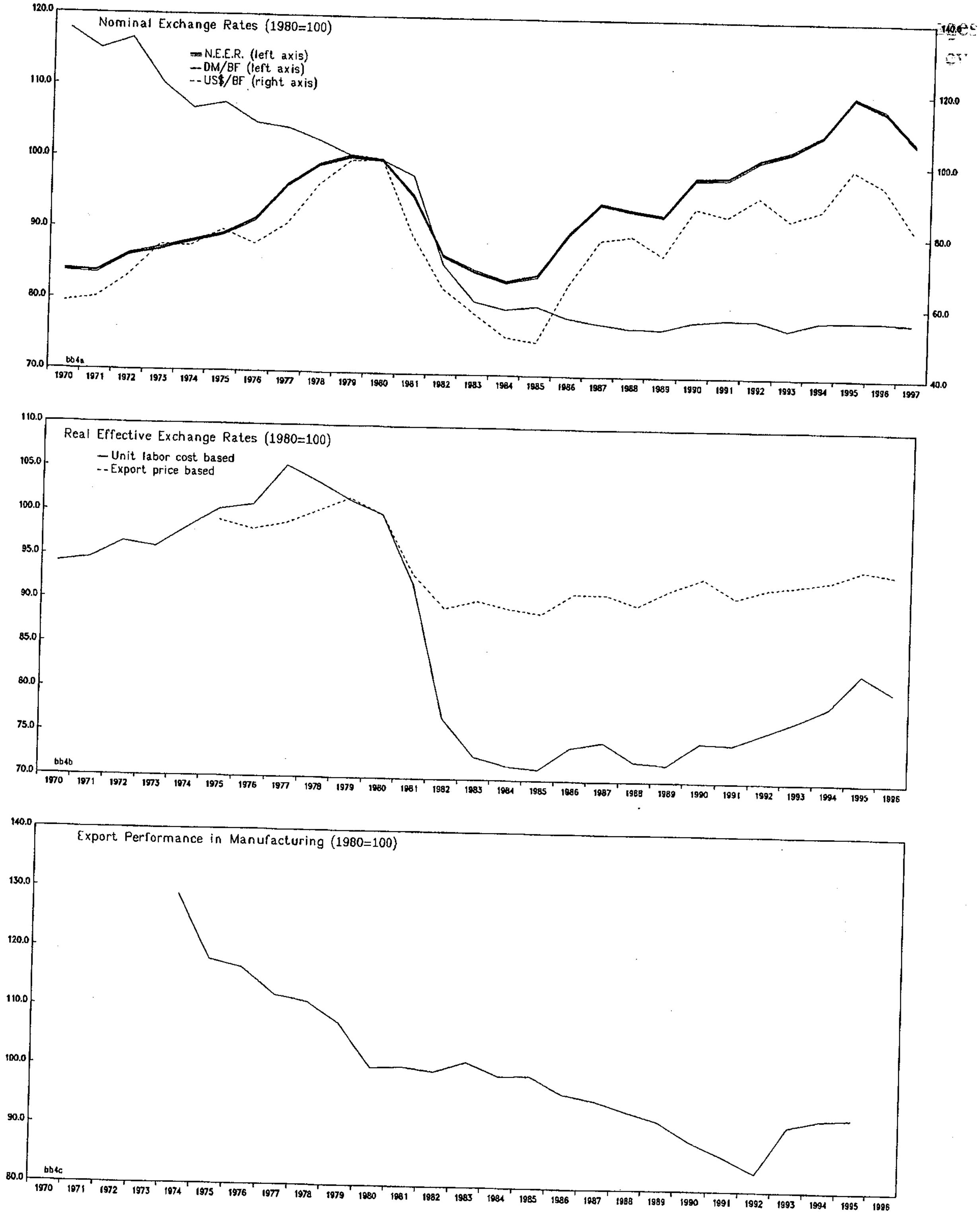




Source: IMF, Balance of Payments Statistics.

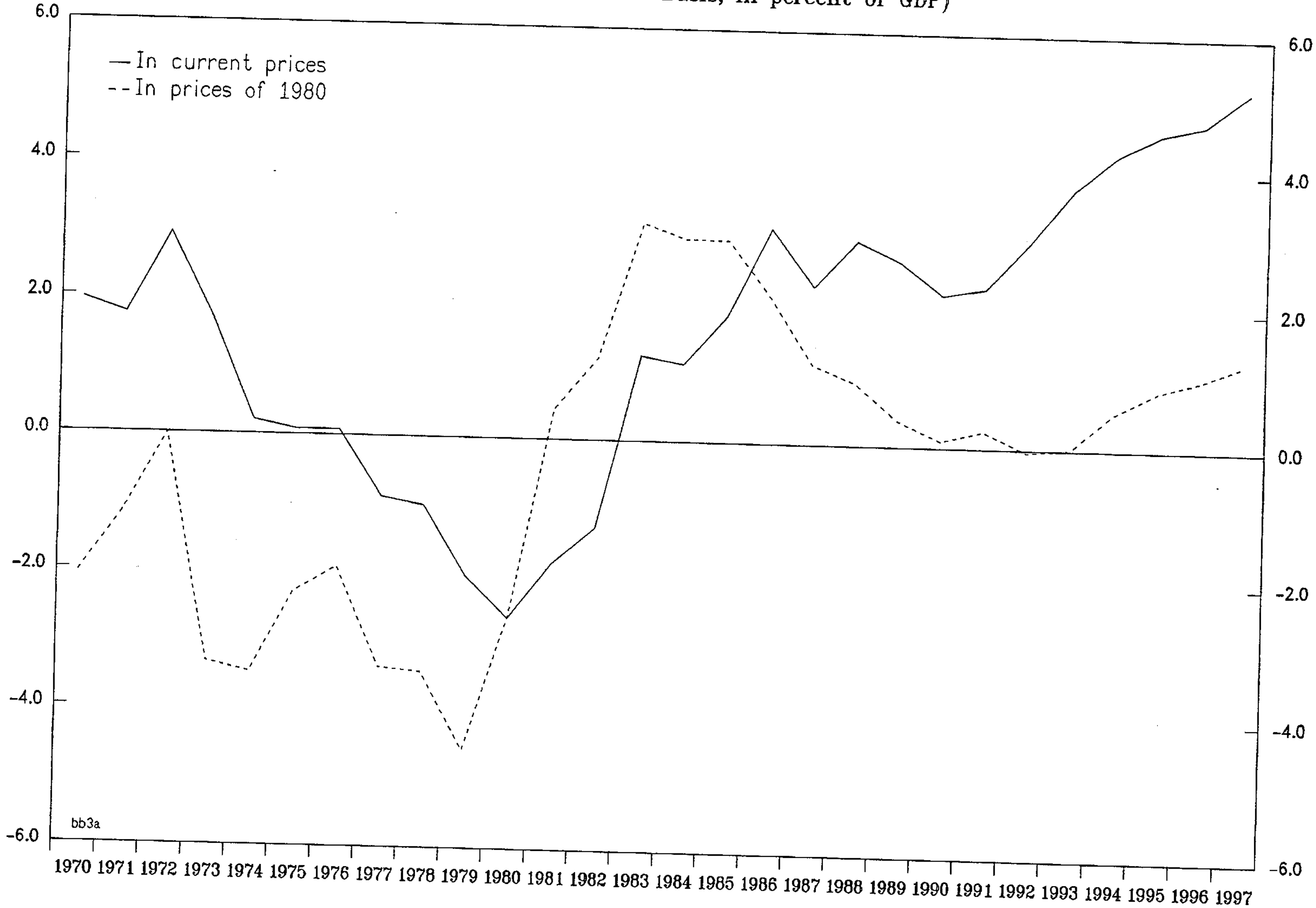
FIGURE 2
BELGIUM

Indicators of Competiveness



Sources: IMF, International Financial Statistics; and OECD, Analytical Database.

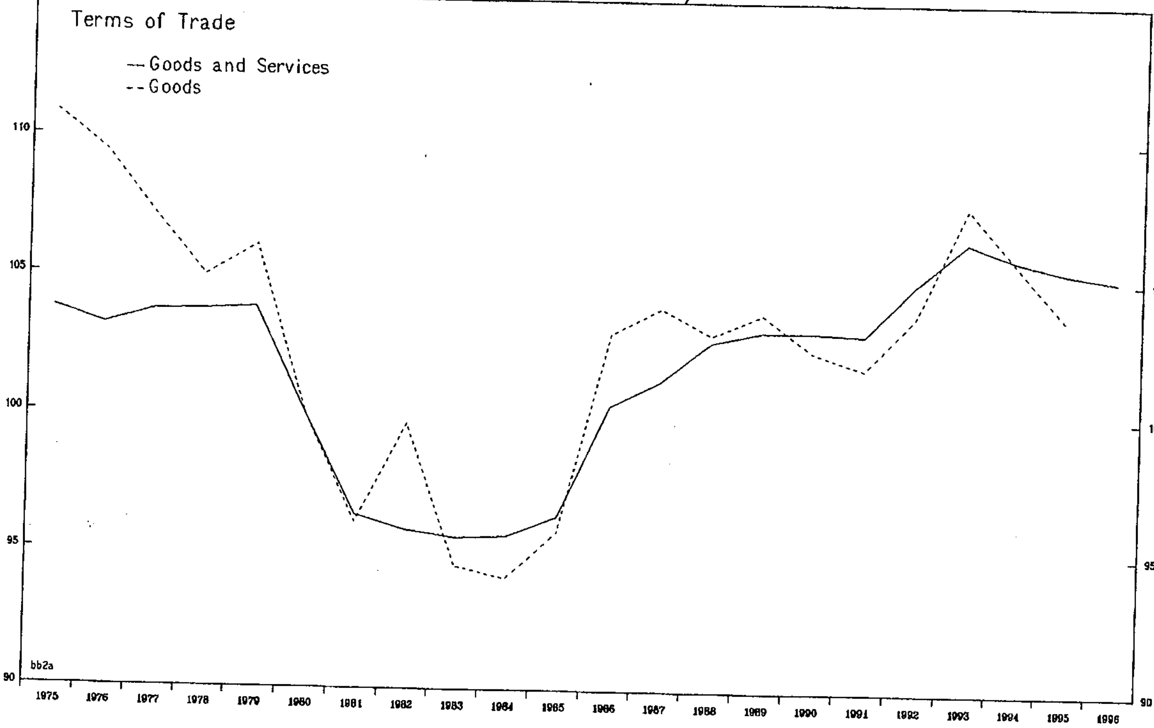
FIGURE 3
BELGIUM
Balance of Goods and Services Belgium
(On National Accounts Basis, in percent of GDP)

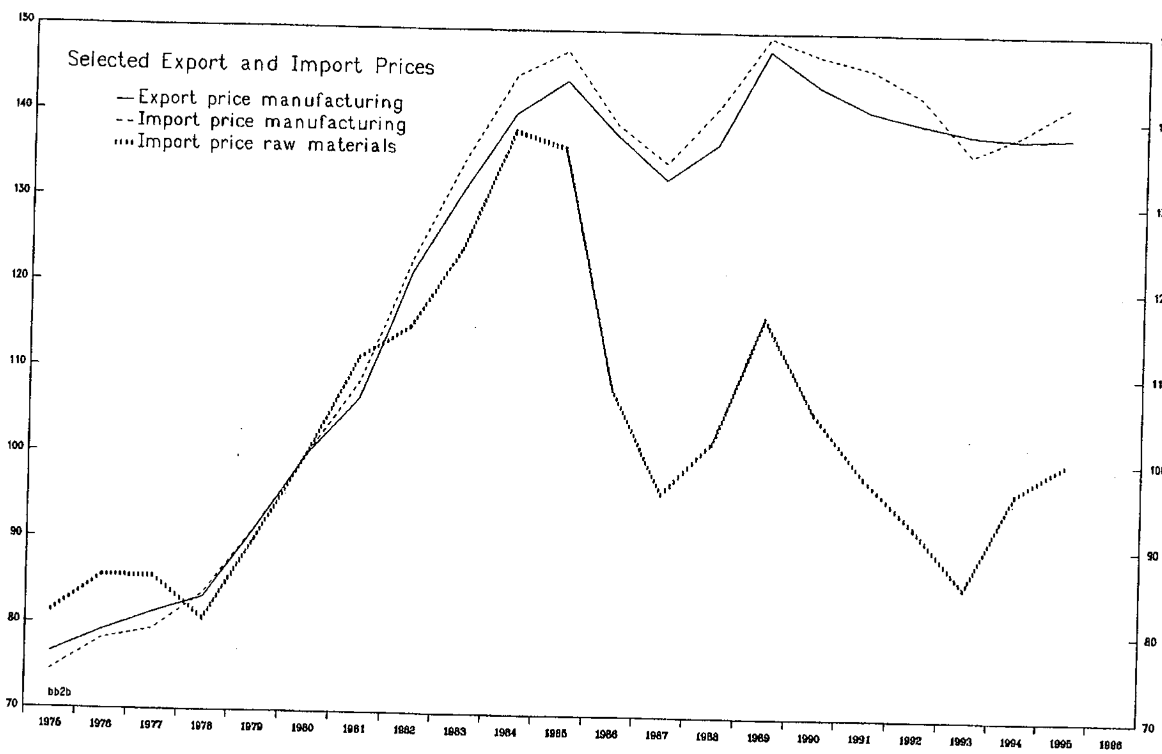


Source: OECD, Economic Outlook Database

FIGURE 4
BELGIUM

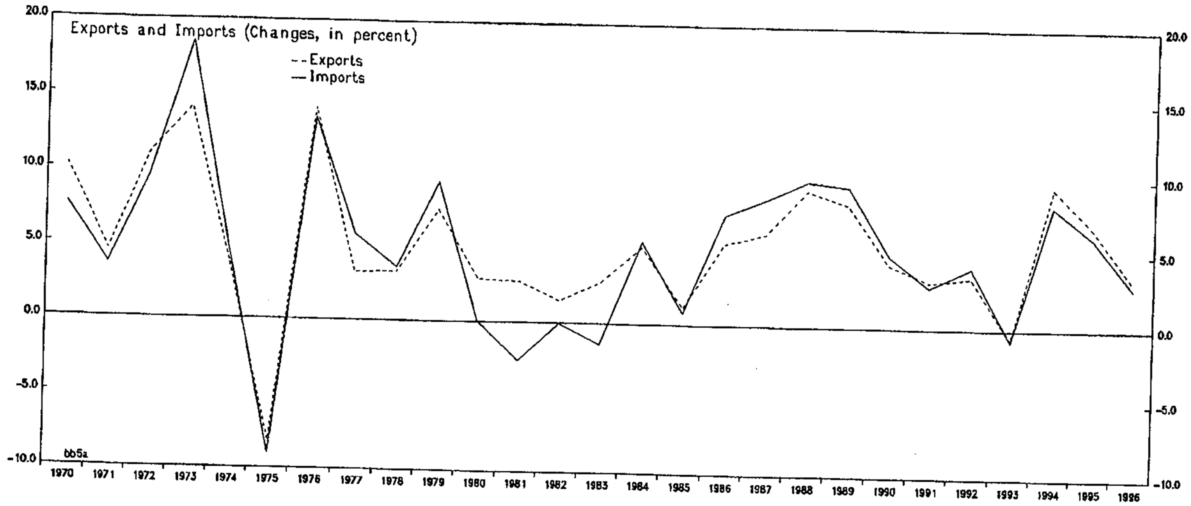
Terms of Trade Belgium
(1980=100)

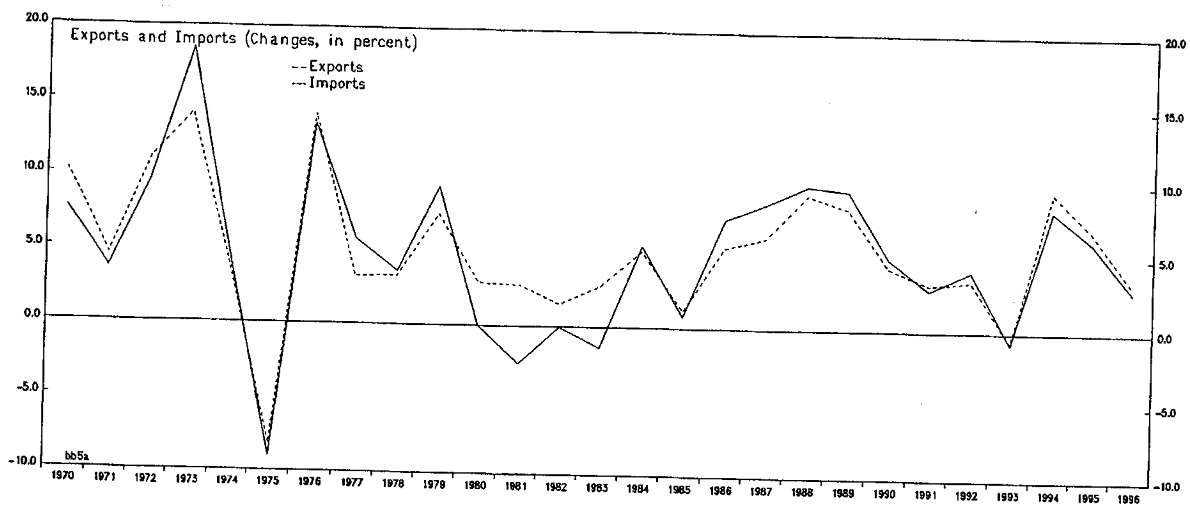


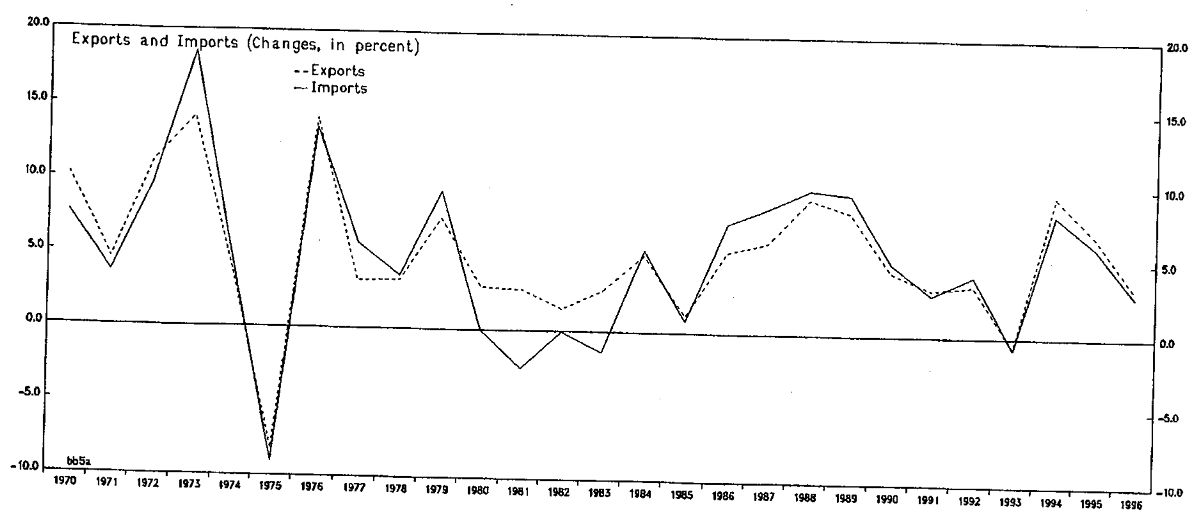


Source: OECD, Analytical Database.

FIGURE 5
BELGIUM
Exports, Imports, and Domestic Demand







Source: OECD, Economic Outlook Database.

THE FEDERAL SYSTEM AND THE STRUCTURE OF SPENDING[32]

Structure of fiscal authority

142. With the enactment of the Special Law of 1989, there was a substantial shift in responsibility from central government to the regions and communities. Under the new federal structure, the regions were delegated authority over affairs related to socio-economic affairs within their boundaries, and the communities were delegated responsibility for education, culture, and certain welfare policies.[33]

143. On the whole, under Belgium's constitution, the federal government has an extremely limited ability to influence the amounts transferred to the Regions and Communities.[34] The Special Law of 1989 (SL89) can only be modified by the same majority need to change the constitution. In addition, the variables used in calculating the value of transfers (inflation, nominal GNP growth, interest rates, and the number of people younger than 18) are not control variables.

144. In addition, the Regions and Communities cannot be subject to any expenditure or deficit norm, although they can voluntary agree to them. SL89 provides for a consultation procedure among the different levels, and includes the possibility of limiting public borrowing by a Region or Community for a maximum of two years. A prominent role is assigned to the "Borrowing Needs Section" of the High Council on Finances, on whose recommendations the limitation process can be initiated.[35]

145. While in theory, as part of the collective concertation process, norms have been set for the growth of primary spending (at both the federal and regional level), in practice, the growth of spending at the regional and community level has been determined by the level of shared

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[32]Prepared by Kenneth Meyers.

[33]The federal structure is complex. The regions are Brussels, Flanders, and Wallonia. Communities were established for Flanders and Wallonia, along with a German-speaking community. Their is no distinction between the Flemish community and Flemish region, while the Flemish and Walloon communities have jurisdiction over community matters in Brussels.

[34]For the period until 1999, complex formulae have been set to govern the distribution of federal revenue to the regions and communities. Such transfers (earmarked shares of personal income taxes and VAT) constitute more than four-fifths of the income of the regions and communities.

[35] The High Council on Finances (Conseil Superieur des Finances or CSF) is an independent consultative body which periodically issues recommendations for the various levels of government. Under the (EU) convergence framework (of 6/92) it submits a report on the implementation of the convergence program for the preceding year, indicating the target balances of the various levels of government.

revenue in combination with the agreed targets for fiscal balances.[36] In past years, the ability of the National Bank and the Federal Ministry of Finance to strongly influence the agreements on deficit norms was aided by their respective roles in mobilizing financing to cover deficits. In the coming years, the importance of this factor will diminish as Flanders moves into balance in 1998 and into surplus in 1999. This development, which reflects, in part, a shift in the regional distribution of resources established under the SL89, is likely to figure prominently in the discussions on setting budgetary objectives for the regions and communities for the period after 1999.

Shifts during the transition period

146. While the shift of responsibility under SL89 was immediate, the financial adjustment corresponding to the devolution was designed to take place over a ten year period. The sharing of revenue for 1989, determined on the basis of the 1989 budget, reflected the costs of carrying out the tasks devolved to the regional, community, and local authorities.[37]

147. At the level of the linguistic communities, the sharing of revenue under SL89 reflected the explicit differentiation between the evolution of funding amounts linked to education expenditure and non-education responsibilities. The funding of education—which is a responsibility of the linguistic communities—was identified with VAT revenue, based on the 1989 education budget, and adjusted annually to demographic changes in the population aged 18 or under, and indexed to the consumer price index.

148. At the same time, funding for culture, sports, training, health services, and various other local competencies of the linguistic communities was set to be determined on the basis of an earmarked share of personal income tax receipts (IPP), indexed to price increases and progressively, over time, to real GDP growth, would adjust following the funding pattern the regions. Resources to be shared with the regions were also identified with an initial share of the IPP base, indexed to consumer prices and progressively, over time, to real GDP growth.

149. In the succeeding decade, variations in the rate of growth of IPP-related allocations to the various regional and community governments, again based on formulae set in SL89 and under the modifying law based in July 1993, were scheduled to shift the revenue shares to reflect the relative shares of regional income in the national total at the end of the ten-year

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[36]At present, a real growth norm of 1.5 percent has been set for spending on social security, and 0.8 percent on federal spending (with underlying increases in spending on justice and no growth in military spending). The comparable norm for regions and localities ("Entity II") has been benchmarked at 1.3 percent.

[37]While the finances of the local authorities remained separate from those of the regional authorities, under the law, they were accountable to accountable. Technically, the shared revenue deriving to the local authorities is transferred out of the revenue share of the relevant regional government.

transition. Thereafter, shares of IPP-related revenue in GDP would be fully indexed to real GDP growth and the consumer price index—thus limiting the change in the GDP share of such revenue to the effect of divergences between the consumer price index and the GDP deflator.

150. In addition to the change from expenditure-based to income share-based revenue sharing, SL89 provided for a temporal shift in the sharing of revenue between the federal government and the regions, communities, and localities. SL89 provided for the regions and communities to run deficits during the transition period (through 1999) and set up a mechanism (annuities) through which the federal government would increase transfers to eventually compensate the Regions and Communities for the associated interest costs. It also contains provisions requiring the Regions and Communities to decrease accumulated debt once intended financing shortfalls have been reversed.

151. The transferred from the federal level to Entity II authorities is supplemented by a number of varied own-income sources. Regional governments receive radio and television license fees, real estate taxes, inheritance taxes, and additional points added to the IPP and to the corporate income tax. The also received proceeds from various funds under their control. At the local government level, governments receive proceeds based on shared ownership of telecommunications, water, and electricity distribution networks as well as income from the provision of various services including transportation and waste disposal.

152. Within the CFS framework, the Regions and Communities agreed, in 1993, to stabilize their debt/revenue ratios after 2000 (2010 in the case of the Flemish Community). In line with this, in July 1994, they agreed to reduce their overall deficit from 0.6 percent of GDP in 1995 to 0.3 percent in 1997. In the event, a deficit equivalent to 0.6 percent of GDP was realized in 1995 and 0.2 percent in 1996, with a deficit of 0.4 percent projected for 1997. Under the Accord (nouvel) de Cooperation avec le Gouvernment federal agreed in July 1996, the Regions and Communities agreed to deficit targets of 0.2 percent in 1998 and overall balance in 1999.

153. To a limited extent, the restraints posed by the fiscal norms of the Entity II authorities during 1994 to 1997 were eased by proceeds from of asset sales. In the case of the French Community, about BF 40 billion was received from the sale of school buildings (to societies managed by the regional authorities created for this purpose) during the period. Against this, the Community budgets will be increased by the cumulated leasing fees in the period ahead. The Flemish community realized some BF 6 billion received from the sale of the Flemish Investment Society, while local governments shared BF 20 billion from the sale a 15 percent interest in Credit Communal.

Evolution in spending by fiscal authority

154. During 1989 to 1997, revenue shared with the regions in communities has risen from the equivalent of 9.2 percent of GDP to 10.0 percent. Associated with this, and in line with the devolution of governmental responsibility in 1989, central government spending dropped

by more than half, from 19 percent of GDP to around 9 percent. Outlays by the regions and communities reached a rough parity with federal-level spending by 1996. Local government expenditure as a share of GDP has varied slightly below 6 percent.

155. At the same time, adjustments in the sharing of revenue, as described above, have had pronounced effects on the regional and community composition of resources. The share of income transferred to the Flemish region increased from 1.7 percent of GDP in 1989 to 2.2 percent in 1997. Similarly, revenue going to Wallonia increased from 1.0 percent of GDP in 1990 to 1.3 percent in 1997, including amounts transferred under the Solidarity Fund.[38]

156. Reflecting the combined effect of the progressive IPP-indexation and temporal redistribution, the revenue share of the linguistic communities peaked in 1995—at 3.6 percent of GDP in Flanders and at 2.6 percent of GDP for the French Community. Failing a major adjustment when the formula for education-related revenue is revised at the end of the transition period, the GDP-share of income received by the communities will gradually decline in the period ahead.[39]

[38]SL89 provided for a mechanism, known as the Solidarity Fund, to partially offset the effects of the differences in regional income levels on resource allocation between the regions. Under the Solidarity Fund, which does not affect the amount transferred from the federal level, an interregional financial transfer based on income differentials is set annually. Transfers under this provision from Brussels-Capital region and Flanders to Wallonia grew from BF 15 billion in 1990 to BF 34 billion in 1997. In 1998, for the first time, the income level in Brussels-Capital region fell below the income parity level and, as a result, will receive transfers from Flanders under the Solidarity Fund mechanism.

[39]As noted above, under SL89, revenue attributed to education was indexed to changes in the population aged 18 and under. From 1999 onwards, an agreement is being sought on an approach to indexing such revenue to the actual student population.

FISCAL ADJUSTMENT 1992-1997[40]

157. Between 1992 and 1997, the Belgian budget deficit declined from 6.9 percent of GDP to 2.4 percent. Sixty percent of the reduction was the result of a decline in interest payments. (Box Tables I.1 and 2) This in turn was mainly the result of the decline in interest rates—both the interest rate premium vis-à-vis Germany and German interest rates went down. The decline in the debt ratio also contributed—the debt ratio went down by more than 10 percentage points.

158. Approximately one-third of the reduction was the result of revenue increases, which amounted to 1½ percent of GDP. Revenue increasing measures amounted to 3 percent of GDP, but they were partially offset by two composition effects; firstly, the labor income share in GDP declined, which depressed taxes as profits are being taxed less than labor, and secondly, the share of consumption and housing building—the only two components of GDP that are taxed—declined.

159. Only 7 percent of the reduction was the result of a decrease in primary expenditure. Primary expenditure declined by 0.3 percent of GDP. While the primary expenditure ratio was pushed up by low GDP growth, this was compensated by slower growth of the price component of expenditure relative to the GDP-deflator. Thus, while the size of the fiscal adjustment was impressive, its composition was problematic in a long-run perspective. Primary expenditure adjusted relatively little, and the already high tax burden increased further.

[40]Prepared by Bas Bakker.

Table 1. Breakdown of the Improvement in the Budget Balance, 1992-1997

(In percent of GDP)

1992 budget balance	-6.9
1997 budget balance	-2.3
Change	4.6
Of which:	
Interest savings	2.7
Change in primary balance	1.9
Of which:	
Cyclical change	-1.6
Cyclical impact on expenditure (denominator effect)	-1.0
Change structure revenues (decline labor income share in GDP)	-0.8
Change structure macro-economic expenditure (decline share consumption and housing building in GDP)	-0.7
Change in relative prices (different development consumer prices and GDP deflator)	0.9
Measures	3.2
Revenues (+ denotes increase)	3.0
Expenditure (+ denotes decrease)	0.4

Table 2. Breakdown Revenue and Primary Expenditure Changes, 1992-1997

(In percent of GDP)

Revenues 1992	45.4
Revenues 1997	47.0
Change	1.5
Cyclical	-1.5
Change structure revenues (decline labor income share in GDP)	-0.8
Change structure macro-economic expenditure (decline share consumption and housing building in GDP)	-0.7
Measures	3.0
Primary expenditure 1992	41.6
Primary expenditure 1997	41.3
Change	-0.3
Cyclical	-0.1
Cyclical impact on expenditure (denominator effect)	-1.0
Change in relative prices (different development consumer prices and GDP deflator)	0.9
Measures	-0.4

Source: Data provided by the authorities.

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