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Belgium-2004 Article IV Consultation

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Preliminary Conclusions1.Belgium has an enviable record of high living standards based on high productivity, which together with its extensive social welfare system has delivered social peace and low poverty rates. Sound policies have underpinned this favorable performance. Gradual structural reforms have improved economic efficiency. Sustained fiscal consolidation-culminating in balanced budgets or small surpluses in each of the past five years-has resulted in an impressive reduction of the public debt burden. Together with tax cuts, these policies are contributing to the current robust economic recovery, which is stronger than in most other euro-area countries.2.Notwithstanding these accomplishments, there is no room for complacency in light ofthe considerable challenges posed by impending population aging and increasing global competitive pressures. As recognized by the authorities and social partners, further fiscal adjustment is needed to build up budget surpluses to fund aging costs and avoid the need for future tax increases or cuts in already low pension benefits. Similarly, employment rates-which are among the lowest in the industrialized countries-need to be lifted to raise growth, facilitate fiscal consolidation, and preserve favorable social outcomes. This is not a new message, but decisive action has become pressing. 3.The economy has been performing remarkably well, propelled by strong household spending-on both consumption and residential investment-and supported by international trade. Tax cuts and wage increases have sustained disposable income growth, while household savings resumed a declining trend, reflecting an improved fiscal and economic outlook and some spending in connection with the repatriation of assets related to the EU savings-taxation directive and, to a lesser extent, the tax amnesty. Developments in business investment have remained erratic, however, while the state of the labor market is difficult to gauge in view of the startup of the new methodology to collect employment data. 4.The outlook for 2005 is auspicious and the authorities' projection of GDP growth of about 2.5 percent appears within reach. Private consumption is expected to continue to drive growth, albeit at a moderately slower pace, while a broadening of the recovery in main trading partners should lead to a strengthening of business investment. Inflation is likely to rise somewhat in 2005, mainly owing to indirect tax and energy price increases. The key downside risks to the growth outlook consist of further euro appreciation, weaker demand in major trading partners, and oil prices. Domestically, wages could grow faster than expected, which would boost consumption and growth in the short run, but at the expense of investment, competitiveness, and medium-term growth. A weaker response of employment to the recovery would dampen growth prospects.5.Against this background of robust economic growth, achieving balanced budgets in 2004-2005-an appropriate objective-is feasible, though not without further efforts, which should preferable be of durable nature. From this perspective, the continuing reliance on one-off measures, albeit declining appreciably in comparison with previous years, is regrettable. For 2004, there remains some uncertainty on the outcome as higher-than-expected regular tax revenues are unlikely to suffice to cover the projected large overrun in health care spending and the lower-than-anticipated yield of the tax amnesty. The amnesty should, however, not be extended. To continue to balance the budget in 2005, additional measures are needed, particularly in the health care sector where welcome proposals are at an advanced stage.6.More broadly, fiscal efforts should be stepped up substantially in order to create the budgetary room needed to deal with the fiscal cost of population aging. In this regard, we strongly support the government's objective to attain a small surplus by 2007 as well as the long-standing recommendation of the High Finance Council (HFC) to achieve a structural surplus of 1.5 percent of GDP by 2011-an objective which has been endorsed by the federal parliament. However, in light of the upward revision of the long-term costs of aging, these objectives should be considered a minimum. Moreover, reaching them could be an uphill struggle because of a likely intensification of spending pressures in the run up to elections in 2006 (municipal) and 2007 (federal), the high projected growth of social security spending, and the ongoing tax reform which is expected to reduce fiscal revenues by an additional 0.5 percentage point of GDP in 2006. Consequently, primary spending growth should be curbed sharply and the current level of the primary surplus maintained. 7.Securing medium- and long-term sustainability of public finances requires structural reforms in key spending areas: * Health care: the authorities' early detection of and response to spending overruns is commendable. Existing claw back mechanisms will help, but the other remedial proposals that have been identified should be implemented as soon as possible. In addition, during this government's term, the health care sector will need to be prepared for a return to lower and more sustainable real spending growth rates than the 4.5 percent norm agreed for 2004-07.* Civil service and decentralization: with the adoption of information technology, the impending wave of retirements in the civil service offers scope for substantial savings. The example set by one regional government, which has suspended net replacement of retirees, could usefully be extended to the rest of the public sector. In addition, a zero-based budgeting approach should be adopted to streamline redundant or overlapping functions at the various levels of government. * Social security benefits: as part of a comprehensive labor market reform (see paragraphs 10-13) the coverage of entitlements should be narrowed, which could yield large synergies between fiscal adjustment and reforms that raise employment rates.8.To successfully lock in structural fiscal adjustment and achieve budget objectives over the medium term, the focus of fiscal management should shift away from nominal targets for the fiscal balance toward multiyear primary spending limits at all levels of government. Meeting nominal balance objectives has certainly fostered internal fiscal discipline, but it has drawbacks. The continuous pursuit of one-off measures to secure the targets masks the underlying fiscal position and often involves a trade off of current benefits for future outlays (as in the case of the 2003 transfer to the state of Belgacom's pension fund and its associated future liabilities). Moreover, it has led to a relaxation of fiscal effort in recent years with savings on the interest bill being used to fund higher spending and tax cuts, causing the primary surplus to decline precipitously. In contrast, a multiyear primary expenditure-level framework would have none of these drawbacks, facilitate the political economy of achieving and sustaining surpluses, and support the economy through a transparent rather than disguised operation of automatic stabilizers.9.Apart from the issue of budgeting technique, a renewal and strengthening of the internal stability pact between the federal and regional governments is needed. The High Finance Council's recommendations regarding the budgetary positions of various levels of government for 2005-10 appear broadly appropriate and should be cast in a formal agreement. Following the example of the health care sector, regional budget proposals and their execution should be monitored in a timely manner, e.g., by the HFC, which could give advance warnings about non-compliance. Measures to enforce compliance could be usefully strengthened.10.Boosting labor utilization is a vital component of the authorities' strategy to deal with population aging. With employment rates comparatively very low in several important segments of the labor market, the potential benefits of labor market reform are large. They are also necessary to enhance the effectiveness of cuts in taxes and social security contributions for job creation and keep up with neighboring countries which are embarking on substantial labor market reforms. In essence, raising employment rates requires lowering the relative cost of labor and eliminating disincentives to work within a wide-ranging approach.11.In support of creating more jobs, social partners, assisted by the government, should ensure that ongoing negotiations in the context of the 2005-06 interprofessional agreement lead to wage moderation not just at the national level but also at the sectoral and enterprise levels. In our view, because labor costs have outpaced those in main trading partners while employment rates are still lagging, there is little or no room for increases in gross nominal wages. This should be acceptable to employees as ongoing cuts in income taxes and increases in the earned income tax credit would still allow net take-home pay to rise. Beyond the near term, there is a need to revamp the collective bargaining system. In the medium term, wage indexation should be abandoned. Meanwhile, in line with practices elsewhere and in some sectors in Belgium, the use of all-in arrangements based on expected inflation, including indexation, should be extended. To promote wage dispersion and labor mobility, anomalies such as sectoral, regional, and age-related minimum wages should be abolished and more leeway should be allowed to enterprise-level agreements. Work and overtime arrangements should be made more flexible as this will benefit employees and employers alike, contribute to higher productivity, and ease the downward pressure on wages.12.Improving the employment opportunities for older workers will require a comprehensive approach. By making the retirement decision actuarially fair across all pension schemes, and providing regular full information about its financial consequences, the decision about when to retire can be left to the individual. Early retirement schemes should best be phased out since they create perverse incentives at a significant cost to society (e.g., it pays to be laid off into early retirement rather than to keep working past the age of 60). Nonetheless, since corporate restructurings are a reality, additional forms of assistance for older workers could be considered, e.g., a temporary subsidy for on-the-job training with a new employer. In addition, the challenge of keeping older workers in the labor force calls for accompanying programs such as life-long learning and more flexible work arrangements, but care should be taken that measures in this regard do not create new disincentives for hiring.13.A number of welcome measures has been implemented to promote the employment of the low-skilled and the young and could be further strengthened. The streamlining of the earned income tax credit and its application to employee social security contributions is beneficial. Consideration should be given to expanding this instrument, provided the necessary budgetary means can be found. The tightening of job-search and availability requirements and the improved follow-up of the unemployed is likely to increase the speed at which people move into new jobs. To buttress this approach, the duration of unemployment benefits should be limited. Further changes in the tax system could also contribute: the targeting of the low-paid with reductions in employer social security contributions could be improved within existing budgetary objectives, while tax advantages for non-working spouses could be redesigned and better targeted to mitigate the associated inactivity trap. More generally, the evaluation of the effectiveness of all labor market policies and their fine tuning should be continued.14.In product markets, ongoing progress in liberalizing network sectors and promoting competition should be broadened to all regions and accelerated to ensure that it translates into benefits for the consumer. In the electricity sector, initiatives to remove technical obstacles to cross-border integration and establish a cross-border market for power are promising developments, though they will take time to materialize. The change in the corporate structure of the railways, facilitated by the takeover by the state of some of the old debt, is a step forward, but to secure lasting efficiency gains it should be complemented by a gradual reduction of subsidies. In certain areas (e.g., fixed-line telecommunications and domestic postal services) effective competition remains to be introduced. In this regard, the establishment of a new competition council is welcome. Efforts to reduce the administrative burden on enterprises and taxpayers are beginning to pay off, but further progress is necessary to reap the full benefits of available information technology.15.In the financial sector, banks have performed well but profitability in the life insurance sector continues to suffer from the low interest rate environment. The merger of banking and insurance supervisors is progressing apace and should improve supervision of the banking-insurance conglomerates. The regular publication by the central bank of financial stability reviews is helping market participants and contributing to transparency. The authorities' decision to participate in the IMF's Financial Sector Assessment Program is welcome and should lead to the publication of an in-depth review of the quality of supervision and compliance with standards in all segments of the financial sector by early 2006.16.The ongoing increase in official development assistance and the authorities' commitment to raise it to the U.N. target are welcome. In this context, the authorities should also use their position in international institutions to promote multilateral trade liberalization.Brussels, November 22, 2004