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IMF-Belgium—2005 Article IV Consultation

INTERNATIONAL MONETARY FUND

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Preliminary Conclusions

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1.Belgium enjoys high living standards based on high productivity, while the broad coverage of its social welfare system ensures that all citizens benefit. Fiscal discipline, as evidenced in balanced budgets in each of the past five years and a steady reduction in the public debt ratio, has helped prepare for the impact of population aging. Efficiency-enhancing reforms and a wage setting framework tying domestic wage developments to those of trade partners has so far preserved the economy's ability to compete in a globalized environment. Recognizing that the key to meeting the challenges of aging and increasing globalization lies in achieving higher growth, social partners and the government are finalizing the Generation Pact, aimed at raising employment rates. Meanwhile, progress in economic deregulation and in reducing the administrative burden on businesses and tax payers is freeing resources for growth. An in-depth analysis of the financial sector, under the IMF's Financial Sector Assessment Program (FSAP), has found that the sector overall is sound and stable, and that supervision is continuously being adapted to changing needs. Economic policies are thus rightly oriented, but reform momentum needs to be build further, particularly in the labor market.2.Sound policies have contributed to the recent favorable economic performance and the positive near-term outlook. Growth exceeded the euro area average in 2003 and 2004, based on strong household spending, including residential investment. Weakness in the external environment caused exports to decline and growth to soften in early 2005, but the recovery has resumed and is expected to strengthen into 2006. Employment has continued to edge up but at too timid a pace to prevent a slight increase in the unemployment rate. Looking ahead, the final stage of the multiyear income tax reduction program will boost disposable income and consumption, while investment is set to rise steadily. Demand from trading partners, especially Germany, appears to be strengthening thus helping export growth. Consequently, the authorities' growth projections of about 1½ percent in 2005 and somewhat more than 2 percent in 2006 appear realistic. Boosted by energy price increases, inflation will average around 2½ percent per year, on a harmonized definition.3.The risks to this outlook are broadly balanced. The easing of oil prices from historic peaks and the softening of the euro could fuel growth, but the resolution of global imbalances could involve euro appreciation and weaken the outlook. At this juncture, the impact of the recent economic policy announcements in Germany remains uncertain. Domestic wage increases—while below headline inflation—are set to exceed those of key trading partners during 2005-06, due to partial indexation to higher-than-expected inflation and much lower-than-anticipated wage settlements in Germany and the Netherlands. While this may support household demand in the short-run, the associated deterioration in competitiveness could adversely impact exports and investment. In a context of rising real interest rates, real estate price growth and residential construction activity might slow down, dampening growth.4.Heightened external competition and population aging are the major medium- and long-term economic challenges. The direction of the policy response to these challenges has been correct, but the pace of structural reform and fiscal consolidation should be stepped up and policies need to be made fully consistent with the objective of raising job creation. In terms of labor utilization, Belgium trails its main trading partners by a sizable margin. While great progress has been made in cutting public debt, it remains high. Pension reforms have established a viable pension system, consisting of a basic, not overly generous first pillar and complementary second and third pillars. Even so, population aging will raise pension outlays appreciably. The Generation Pact is likely to increase employment, but the continuation of early retirement schemes—even if made more restrictive—will limit the ensuing benefits for the labor market and the budget.5.Constrained by the wage bargaining framework, it is not clear how current policies will be able to reconcile raising real wages and disposable income with the objectives of achieving fiscal consolidation and boosting employment rates. As experience demonstrates, within the current framework, cuts in social security contributions and taxes are seen by social partners as creating room for higher wages. Consequently, such cuts, when translated into higher wages, are not effective in creating new jobs and on balance worsen the fiscal position. Therefore, further cuts in income taxes and social security contributions should be conditional on wage moderation, and financed by expenditure restraint. In addition, real declines in labor costs in neighboring countries cannot be imported because of indexation. Indexation also makes it very difficult to claw back past overruns, or to allow increased labor supply to feed swiftly into job creation. Simply put, even if Belgian employment rates may rise in line with those of trading partners, catching up with their higher level seems virtually impossible. In this context, the authorities' invitation to social partners to discuss these issues should be used to explore an obvious trade-off: the more those with jobs accept to moderate wage demands, the more likely and the faster those out of jobs will find employment. Significant progress in this direction would start a virtuous circle of higher employment, a stronger fiscal position, a reduced burden of aging, and further room for growth-enhancing fiscal measures.6.We support the authorities' commitment to fiscal consolidation, which is an important component of their strategy to deal with the cost of aging. The ongoing achievement of balanced budgets and the intention to reach a small surplus in 2007 and raise it further in the medium-term are commendable. In 2005, despite the slowing of growth and the higher deficit of local authorities, stronger-than-expected revenues and additional measures, including some one-offs, kept the budget in balance. In 2006, the authorities are likely to ensure a balanced budget again, though on current plans a deficit of a bit less than ½ of one percentage point of GDP remains to be eliminated. Recourse to one-off measures is continuing to compensate electoral spending by local authorities and part of the last stage of the income tax reduction program. Spending restraint will be very tight at the federal level, requiring more than usual discipline.7.The credibility of the fiscal consolidation strategy has been well established and should not be allowed to erode. Recourse to one-off measures needs to be replaced with fundamental expenditure restraint. While occasional use of such measures is not detrimental to the credibility of this strategy, their recurrent use creates uncertainty about the ability of the authorities to pursue lasting fiscal consolidation in the context of tax cuts. Well-established medium-term targets, such as the surplus of 1.5 percent of GDP by 2011 recommended by the High Finance Council (HFC) and endorsed by parliament, should be adhered to.8.A fundamental issue is how to achieve the overall fiscal consolidation objective in the context of a federalized state. Indeed, following the devolution of powers and tax revenues to the regions, revenues of the regions have recently been growing at a pace faster than those of the federal government and social security (Entity I). However, the regions already have a consolidated surplus, owe little debt, and face fewer spending pressures than Entity I. Consequently, they are unlikely to agree to maintain budget surpluses indefinitely, making it nearly impossible for the federal government to ensure overall consolidation objectives. 9.Apart from resolving the substance of this mainly political issue, a renewal and strengthening of the internal stability pact are needed. In this context, it will be imperative to reappoint the High Finance Council (HFC) as soon as possible, as has been the intention for some time, so that the HFC can resume its essential tasks of formulating independent views on the fiscal outlook and coordinating consolidation targets among various levels of government. The HFC's role in assessing the regions' budget proposals, monitoring their execution, and providing advance warning about non-compliance should be strengthened.10.To lock in structural fiscal adjustment and achieve budget surpluses over the medium term, there is merit in adopting a multiyear primary expenditure framework. Such a framework would reconcile fiscal balance and tax cut objectives and the evolution of the interest bill with the degree of discretionary spending restraint necessary at all levels of government. Owing to the absence of a focus on the development of primary expenditures, the non-interest surplus has continuously declined in the recent past, as savings from the shrinking interest bill were devoted to higher spending and tax cuts. A multiyear expenditure-based framework would also facilitate the political economy of achieving surpluses, while supporting the economy through the operation of automatic stabilizers. As a minimum alternative, the focus of budget management should shift to primary surplus targets.11.Securing sustainability of public finances requires structural reforms in key spending areas. On health care, a source of overruns in the past, recent measures have succeeded in bringing spending back on track, but the target still exceeds the likely growth of contributions. It should be lowered in conjunction with the implementation of measures toachieve a durable reduction in health spending growth. In this context, the agreement between social partners and the government to fund overruns from general budget resources, which are scarce, should be seen as a call for heightened discipline. Further, the impending wave of retirements in the civil service should be used to increase efficiency. Similarly, functions at the various levels of government need to be streamlined to avoid duplication. Finally, social security spending can be curbed through successful labor market reforms.12.Tax policy is fittingly oriented toward reducing the tax burden on labor and increasing efficiency, but a more comprehensive approach is desirable and tax cuts should not run ahead of expenditure restraint. As the authorities recognize, consistent with the EU Savings Directive, there is some room to shift taxation towards income from capital, which enjoys significant exemptions and low rates. However, the proposals to tax securities investments in mutual funds and life-insurance products reflect a partial rather than a comprehensive approach and risk creating new distortions. Similarly, tax rebates introduced on certain types of energy products should be phased out as intended. In contrast, introducing a notional interest rate deduction on equity capital corrects an existing distortion which favored debt over equity as source of financing. The operations involving the securitization of tax arrears in both 2005 and 2006, while accompanied by a strengthening of the tax administration, will obviously reduce future budgetary revenues. The suspension of penalties to induce disclosure of undeclared tax liabilities, while carefully circumscribed, nonetheless poses issues of moral hazard. More generally, it will be important to further increase the chances of being caught for tax evasion.13.With employment rates very low in several important segments of the labor market, the potential benefits of labor market reform are large. In this context we support the direction of reform taken with the Generation Pact, and welcome the fact that many measures of the pact were designed on the basis of a prior assessment of their effectiveness. Targeted cuts in social security contributions for the young, a renewed focus on on-the-job training, a stricter enforcement of job search requirements, and increased resources devoted to workers laid off in company restructurings will have positive results.14.Nonetheless, labor market reforms need to be taken further. To keep older workers in the labor force it will be important to upgrade their human capital throughout their career, improve their working conditions and arrangements, and provide a closer link between productivity and pay. In the medium-term, building on the first steps taken with the Generation Pact, early retirement regimes should be folded into the regular retirement system, leaving it up to the individual to retire before reaching a full career or to work beyond this period, induced by actuarially fair discounts and bonuses. The intended annual provision of information to individuals outlining their accumulated pension rights under various options will be essential. To buttress the efficient functioning of employment services, the duration of unemployment benefits will need to be limited in time. Finally, building on good progress, remaining inactivity traps should be removed.15.Progress in reducing the administrative and regulatory burden is commendable and should be continued. Together with ongoing and planned product market reforms it will improve economic efficiency and consumer welfare. One illustration of the effectiveness of such reforms is that electricity tariffs in the parts of the country where liberalization is most advanced have fallen considerably. Similarly, consumers are benefiting from an effectively functioning competition authority and the planned divestiture of the post office. Reforms of the railway company are boosting productivity, providing room to curb subsidies. The intended simplification of economic regulation and licensing requirements in construction and some services sectors will free resources for more productive activities. The reduction in the administrative burden on enterprises and taxpayers is beginning to pay off, but further progress is necessary to reap the full benefits of information technology. Efforts to promote research and development should focus on improving the enabling environment.16.The recently completed evaluation of the financial sector by the IMF under its FSAP found that overall the financial system is sound and stable. The resiliency of the financial system to macroeconomic shocks, already evident from its record in weathering past business cycles, has been confirmed by stress test results. Reflecting the economic recovery in 2004, the financial systems performance strengthened considerably with a rise in bank profitability and a marked improvement in key financial soundness indicators.17.A number of Belgium-specific features anchors financial stability, including a large and stable pool of savings; low holdings of equity; large holdings of government securities;a traditional cautious attitude to risk by banks; and high standards of banking supervision. Nevertheless, the increased complexity and evolving strategies of bank-insurance (bancassurance) groups, the system's openness and related large cross-border activities, the pressures for growth, performance and outward expansion, and the special role played by global payments and securities settlement systems will pose challenges for the authorities.18.On the institutional front, the establishment of the Banking, Finance, and Insurance Commission (CBFA) as a consolidated supervisor and the Financial Stability Committee (CSF) should help the financial system meet these challenges. The advantages of a consolidated supervisory framework are readily apparent in a system dominated by bancassurance conglomerates. Good progress in shaping the CBFA supported by the National Bank of Belgium's focus on macroprudential analysis and overall financial stabilitywill help preserve Belgium's excellent record of financial stability. It will be important to (i) meet the challenges posed by the move to Basel II while keeping pace with rapidly evolving markets, complexity of financial groups and regulations against the backdrop of European integration; (ii) upgrade insurance and pension fund supervision and closely monitor developments in the insurance sector in the context of a low interest rate environment; and (iii) devote adequate capacity to, and ensure seamless coordination of the oversight and prudential supervision of the payments and securities settlement systems. With the decision to phase out bearer securities, Belgium's framework to combat money laundering and terrorism financing will be aligned with international standards.19.The ongoing increase in official development assistance and the authorities' commitment to raise it to the U.N. target level are commendable.Brussels, November 21, 2005