



Economic Survey of Belgium, 2009

How is the economy coping with the global economic crisis?

How can fiscal sustainability be assured?

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Summary

After four years of strong growth, the Belgian economy entered a deep recession during the second half of 2008 under the impact of the international crisis. The economy was first affected by the turmoil in the banking sector and subsequently by the collapse in international trade. The government swiftly intervened to support the financial system and implemented a moderately sized fiscal stimulus package that is broadly appropriate for a small open economy with substantial fiscal sustainability problems. The main challenge ahead is to support the economy by allowing the automatic stabilisers to work while restoring the path towards fiscal sustainability and implementing structural reforms to enhance long-term growth.

Public finances are moving further away from sustainability. Budgets were roughly balanced in the first half of the 2000s. Thereafter, budget slippages began to appear and in 2008 the public-debt-to-GDP ratio began to rise for the first time since 1993 as a result of the financial sector interventions. If fiscal policies remain unchanged, the debt ratio will continue to rise, further adding to the already high contingent liabilities associated with ageing. Thus, a credible medium-term strategy to secure fiscal sustainability needs to be implemented. Belgium made a step in this direction by stipulating in the Stability Programme a path, starting in 2010, back towards a balanced budget in 2015.

There is a need for rebalancing revenue and spending responsibilities across the federation to ensure fiscal sustainability. Until now, fiscal federalism arrangements have left the federal government with slower income growth than other levels of government. Furthermore, the bulk of the responsibility for financing ageing related costs rests at the federal level. Moreover, the current system and the overlapping spending responsibilities provide few incentives for pursuing spending efficiency. Better incentives could come from aligning spending and revenue powers as well as reorganising spending responsibilities to pursue efficiency.

This Policy Brief presents the assessment and recommendations of the 2009 OECD Economic Survey of Belgium. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussion, and issued under the responsibility of the Committee.

Despite reforms in the 2000s, the tax system still relies too much on relatively growth-distorting taxes, such as labour and corporate taxes. The interaction of personal income tax, the social security and the benefit systems creates a range of labour market traps, mostly reflecting high marginal rates combined with numerous tax exemptions. Taxation of saving differs across vehicles, where particularly mortgage financed owner-occupied housing is tax favoured, hampering the optimal allocation of capital and thus growth. At the same time, there is scope for increasing less-distortive taxes, such as those on immovable property and consumption. Regarding the latter, the standard VAT rate is relatively high, but the effective rate is much lower because of the widespread use of reduced rates.

The competition framework was reformed in 2006 so as to be aligned with EU legislation and to boost the powers of the competition authority. The framework now looks like those in most other European countries. While the first results are encouraging, the authority's staffing remains an issue to be dealt with. On the other hand, competition in retailing is hampered by strict sector regulation. Moreover, network regulation lags behind, raising the question of whether the relevant regulatory authorities are strong enough to deal with the main issue of the dominant position of the incumbents, who appear to be responsible for internationally high prices. ■

How is the economy coping with the global economic crisis?

During the second half of 2008, following four years of strong growth, the economy was hit in earnest by the international crisis. By the end of the year, the economy was going through a historically severe contraction under the impact of the financial crisis and the retrenchment in world trade. As a result, bank lending to non-financial firms and to households slowed down. The economy's contraction is expected to continue through most of 2009. Thereafter, a slow recovery is expected as a result of looser monetary policy, the easing of financial sector distress, fiscal stimulus and a pick-up in world trade. The fiscal deficit will remain high over the next years. Consequently, policies to counter the economic downturn should avoid endangering long-term economic prospects, and there should be no delay in implementing structural reforms to improve the economy's potential growth.

The Belgian financial sector was initially hit by the global liquidity crisis. During autumn 2008 there was a tightening of credit conditions on the interbank market as observed in other euro-area countries. The slowing of credit to non-financial firms and households corresponds broadly to developments in other euro-area countries. The first financial institution to be affected was the financial conglomerate Fortis, which turned out to be financially overstretched by the previous year's acquisition of the Dutch bank ABN-AMRO, leading the government to recapitalise the Belgian part of Fortis. Other financial groups have since been supported through further recapitalisation, and the government has offered inter-bank loan guarantees. The total cost of recapitalisation and direct government loans amounted to about 7% of GDP, which has mostly been financed through an increase in public gross debt. As in other OECD countries, the situation for the financial institutions, however, remains fragile. The swift reaction of the authorities was appropriate. Divestment strategies to avoid ending up with a long-term public ownership position in the sector should be further developed and implemented.

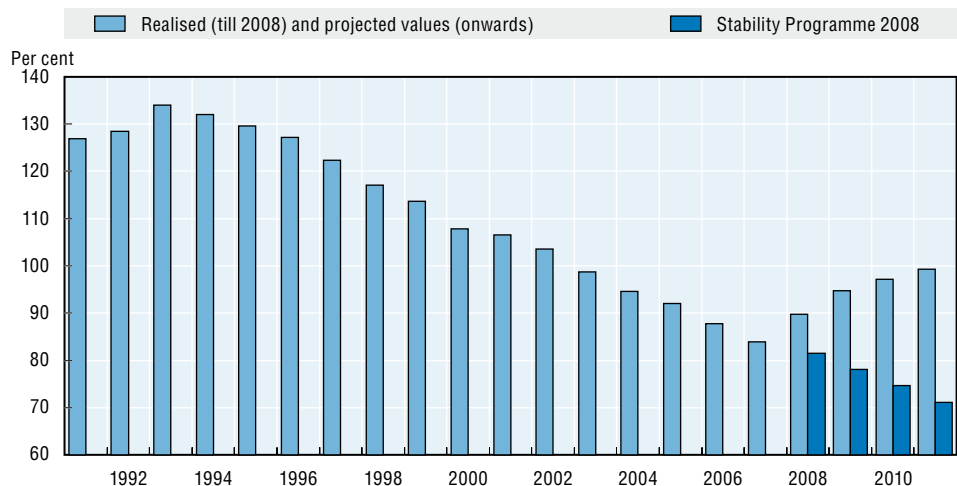
The government added a fiscal package to support the economy to the already expansionary 2009 budget as other EU countries were undertaking similar fiscal stimulus packages. The total 2009-10 discretionary fiscal stimuli amount to almost 1½ per cent of GDP and are expected to boost GDP by about ¼ per cent over the period. Including the impact of the automatic stabilisers, the general government deficit will widen and could reach as much as 6% of GDP in 2010. *The modest size of the fiscal stimulus to counter the worst effects of the crisis is broadly appropriate.* The fiscal stimulus measures focus mainly on sustaining purchasing power and employment as well as supporting enterprises. Some of the measures tend to be permanent in nature. The employment sustaining measures are centred on stimulating investments, reduced work time arrangements and enhanced guidance for workers subject to restructuring. Hence, not all measures may take effect early enough to counter the rising unemployment due to the crisis. The enterprise supporting measures aim at easing liquidity constraints and lowering taxation to neutralise the effect of the wage agreements on

total labour costs. A number of the measures are not timely, temporary or targeted. At this stage, the government should aim at ensuring that such measures, insofar as they do not contribute to potential growth, are withdrawn as the economy recovers. The room for fiscal manoeuvre is restricted by the large public debt-to-GDP ratio and the wider long-term interest differential vis-à-vis Germany, although the latter has narrowed recently. Current projections indicate that the debt-to-GDP ratio could reach 100% by the time the economy recovers. Empirical evidence indicates that in countries where the public debt-to-GDP ratio exceeds around 75%, the effectiveness of fiscal policy is severely reduced by higher private savings. Thus, additional discretionary fiscal stimulus should be avoided since it would have limited effects on economic growth but add to the growing fiscal sustainability problems. Moreover, if additional fiscal stimulus were deemed necessary, then it should be accompanied by structural reform and measures that will eventually improve the cyclically adjusted budget balance. ■

How can fiscal sustainability be assured?

An important part of the government’s long-standing strategy to deal with the cost of population ageing was to establish a path of increasing surpluses on the general government account. So far this objective has not been achieved. Moreover, given the current crisis, this is neither feasible nor advisable in the short-term. Instead, Belgium should design a strategy to secure a credible path towards fiscal sustainability. A step in this direction was made in the recent Stability Programme, which stipulated a path, starting in 2010, back towards a balanced budget in 2015. This may require annual fiscal tightening on average of about 1% of GDP from 2010 onwards. The next step is to design concrete measures, at all levels of government, to achieve the objective of securing long-term fiscal sustainability. The governments at all levels are encouraged to start this process with their 2010 budgets. The credibility of the fiscal policy framework should be strengthened by making the structural

Figure 1.
THE RISING DEBT IS INCREASING THE CHALLENGE FOR THE SUSTAINABILITY OF PUBLIC FINANCES
 General government gross debt as a percentage of GDP



Source: OECD(2009), Economic Outlook database, High Council of Finance and Stability Programme 2008-2011.

budget targets operational. This could be achieved by implementing expenditure rules and introducing multi-annual budgeting to extend the planning horizon and as a self-corrective measure in case of budget slippage. Furthermore, the role of external experts could be enhanced to improve budget assessments. At this point, fiscal sustainability cannot easily be secured through pre-funding alone, and dealing with the increase in ageing-related costs will require pension and health care reform as well as measures to expand the tax base. The government is already pursuing the latter through a more active labour market policy, and a particularly well suited instrument would be to increase the effective retirement age. The government has already implemented some measures in this area, but it should close remaining loopholes for entering early retirement. However, this is unlikely to suffice and the government should follow the example of other OECD countries and raise the legal pension age, preferably in a way that reflects past and future gains in life expectancy. ■

Can the fiscal federalism systems be reformed to help secure fiscal sustainability?

The devolution of spending responsibilities from the federal level to the sub-federal levels has left the federal government with the two main spending responsibilities of repaying public debt and financing the social security system. The increasing ageing costs will thus fall disproportionately on the federal government. *The fiscal capacity of the federal government should therefore be strengthened by improving its revenue sources and by shifting some spending obligations to sub-federal levels of governments, such as the pensions of retirees from sub-federal levels of government.*

A factor behind the limited fiscal capacity of the federal government is the revenue sharing scheme. As sub-federal levels of governments have limited taxing powers, the scheme is equivalent to a transfer scheme with predetermined parameters. The scheme leaves sub-federal levels of government with relatively strong revenue growth, which together with the limited taxing powers create poor incentives for spending control. *Thus, there is a need to realign spending and revenue raising responsibilities. Transfers are based on allocating personal income tax revenues to the region of residence, leaving workplace regions with no automatic or proportional compensation for providing infrastructures and other services to commuters, creating horizontal imbalances. To correct for these imbalances in the system, the revenue sharing scheme could include a workplace element.*

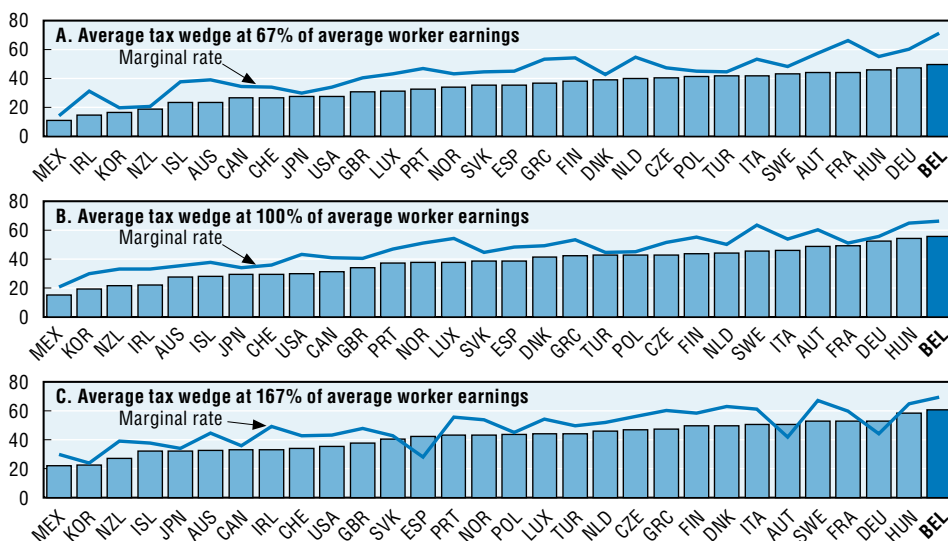
In principle, the devolution of federal responsibilities to regions and communities helps to better tailor public services to the needs and preferences of the recipients. In addition, it enables some elements of benchmarking between jurisdictions, providing an incentive for improving public spending efficiency. In practice, the devolution in Belgium has created overlapping responsibilities in areas such as employment, R&D, training, energy and environmental policies. This has in a number of cases led to diseconomies of scale, resulting in institutional complexity and fragmentation of policies. This may help to explain why Belgium has benefited less from improved public spending efficiency through devolution

than other countries. *Policy coherence and the spending efficiency of sub-federal governments should be improved.* This could include: improving labour market activation policies by applying best practices nationwide; evaluating R&D policies to select and implement the most effective ones; pursuing best practices to ensure the provision of high quality education across the country, including greater freedom for using economic instruments (tuition fees and income contingent loans); in the area of environmental policies merging the regional markets for green certificates to create a single pan-Belgium market; and in energy policies reviewing the current multi-layer and multi-regulator structure to enhance the allocation of responsibilities. A political consensus for such a reform may be easier to achieve if reforms were perceived as a means to increase public sector efficiency rather than redistributive changes. ■

Can the tax system be made more conducive to growth?

The tax system was reformed in the 2000s with the aim of enhancing growth through lowering of labour and corporate taxation. Nevertheless, considerable scope remains to make the tax system more conducive to growth. As the tax burden is among the highest in the OECD, reforms need to be self-financed unless accompanied by spending cuts. In terms of structure, the tax system relies too heavily on relatively distorting taxes, such as those on labour and business, and too little on less distorting taxes, such as those on consumption and immovable property. *Thus, to promote growth, a tax reform should aim at shifting the tax burden from labour and business to consumption and immovable property.*

Figure 2.
THE TAX WEDGE REMAINS HIGH¹
As a percent of gross labour costs, for a single person with no children



1. The average tax wedge is defined as the share of income tax and all social security contributions minus benefits in gross labour costs, marginal rates are defined as the increase in tax and all social security contributions minus benefits as a share of the related increase in gross labour costs.

Source: OECD, Tax database.

Although reforms in the 2000s aimed at reducing taxation of labour, average and marginal rates remain high, which depress both participation and hours worked. In particular, the way spouses' income is taxed leads to high marginal tax rates for second earners with relatively low incomes, distorting their labour supply incentives. *The first step in reforming personal income taxation should be to complete the tax separation of spouses.* Moreover, the personal tax system is characterised by a large number of tax expenditures, structural reliefs and taxable income brackets. The tax exemptions and reliefs are often regressive and they substantially shrink tax bases. *The second step in reforming the personal income tax system should be to drastically reduce exemptions and structural relief so as to broaden the tax base to allow a lowering of marginal tax rates.* Reforms have also been implemented to reduce employers' social security contributions and introduce wage subsidies to promote employment prospects for low-skilled, younger, older, R&D and shift-and-night workers as well as for long-term unemployed. The wide scope of these measures has led to a complex, costly and poorly targeted system, which at times has conflicting objectives as some of the targeted groups compete for the same jobs. The cuts in social security contributions will be refocused on low wage workers from 2010 onwards. *To enhance the structural effectiveness of wage subsidies in terms of employment and participation, they should be targeted at low-wage workers. During the crisis, a special attention should be given to the low-skilled youth who are at a greater risk of dropping out of the labour market.* The interaction between the personal income tax, the social security, and the benefit systems has created numerous labour market traps, creating barriers to the labour market inclusion of low-wage workers. *To address the remaining labour market traps, spikes in the effective marginal tax rates should be removed.*

During the 2000s, the corporate tax system was reformed to make it more neutral with respect to various financing forms by making debt financing less attractive. Nevertheless, in comparison with other countries, the corporate tax rate remains relatively high, which lowers the after-tax rate of return on investments, thereby reducing the attractiveness of investing and growth. *Thus, corporate tax rates should be cut to levels comparable to other European countries.* Moreover, the gap between the nominal and the effective rates remains relatively large as a result of reduced rates for SMEs and tax deductions for investments, particularly in R&D. The former has little effect on tax revenues as SMEs often do not have high profits, but the system of reduced rates creates a risk that small firms do not grow to their optimal level, thereby not maximally contributing to overall productivity and employment growth. *Thus, the nominal tax rate should be reduced by broadening the tax base through a removal of exemptions and unnecessary tax deductions.* Furthermore, the system is still not fully neutral among various forms of financing because the risk capital allowance is based on the risk free long-term government rate and thus below the actual market rate. In addition, double taxation of dividends through the personal income and the corporate tax system is still an issue. *Thus, the risk capital allowance should be based on actual market rates.* ■

Is there room to shift the tax burden towards property and consumption taxes?

The tax treatment of savings differs across vehicles. The most tax favoured saving vehicles are owner-occupied housing, second and third pillar pension investments, and tax favoured savings accounts (effectively similar to demand deposits). Although this structure aims at stimulating private savings, at a substantial fiscal cost, it does not appear to stimulate overall savings. Rather, it affects the allocation of savings, away from those with higher pre-tax returns, distorting capital allocation and thus hindering growth. The principal reason for the favourable treatment of owner-occupied housing is the below market value assessment of properties used for computing the tax on imputed rents. *A first step to remove the tax favouring of owner-occupied housing would be to base assessments on current market values.* However, that would still leave Belgium with a smaller reliance on immobile tax revenues than other countries. *The tax rate on imputed rent should also be increased. On the other hand, the taxes on buying and selling owner-occupied houses should be reduced to enhance labour market mobility.* Subsequently, tax neutrality among savings vehicles should be improved by *aligning the taxation of other savings vehicles with that of owner-occupied housing, which implies the removal of exemptions and the introduction of similar rates as well as of capital gains taxation across relevant savings vehicles.* An important development in this respect is that Belgium has endorsed the OECD standard for the exchange of information in tax matters and is now actively engaged in implementing the standard. Once implemented, the standard will enable Belgian tax authorities to respond to requests for information, including banking information, from other tax authorities for all tax purposes. Belgium has already finalised discussions with a number of countries to change the relevant treaties. *Belgium is also engaged in a process to implement the OECD standards in this area with respect to other countries and has sent more than 80 draft protocols to other treaty partners with a view to updating the existing treaties.*

From a growth perspective, taxes on consumption are among the least distortive taxes. In some respects, the Belgian system does place a considerable importance on consumption taxes. For example, the VAT rate is higher than in neighbouring countries. However, the effective VAT rate is lower because of the relatively widespread use of reduced rates to pursue social objectives, even though such measures are poorly targeted and the associated social objectives could be more effectively reached through targeted social transfers. *The consumption tax base should be broadened by abolishing all reduced rates and exemptions.* Such a measure could generate additional revenues of about 2% of GDP, although the net revenue gain would be smaller as some of the additional resources would be needed to finance targeted social transfers. Such a measure should be implemented carefully to avoid second round inflationary effects arising from existing wage indexation arrangements. A greater reliance on environmentally motivated taxes would have similar benefits as consumption taxes. Belgium relies less on such taxes than other OECD countries, which can be largely explained by low excise duties on fuels, particularly for diesel. The government has introduced a “ratchet” tax (*le mécanisme du cliquet*) on transport fuels, where

a fall in oil prices is partly offset by an increase in excise taxes. Higher taxation of fuels will support environmental objectives and increase the tax system's reliance on less distortive consumption taxes. *The government should introduce a more environmentally friendly taxation of fuels that is based on their emissions of CO₂ and other pollutants, implying a relatively higher taxation of diesel, and the excise taxes should be increased to internationally comparable levels.* ■

How can competition policies be strengthened to improve consumer welfare and economic growth?

The framework for competition policies was reformed in 2006, bringing the competition law in line with EU legislation and strengthening the competition authorities. These measures will increase competitive pressures in the economy, resulting in higher consumer welfare and productivity growth, through a reduction of the relatively high Belgian prices and more vigorous innovative activity. The effects of the new competition framework are encouraging as it has transferred resources towards anti-trust activities and away from less important merger control. Based on international experiences, however, further action is needed to achieve best practices. Although the independence of the Competition Authority has been strengthened, as it is now financed through a separate budget line, the Authority remains a Directorate General inside the Ministry of Economy and thus may appear as potentially subject to political pressures. *Therefore, the situation should be monitored, in particular regarding the authority's degree of independence and accountability.* An effective competition authority needs adequate resources. The Belgian authority's resources are relatively limited compared with other small economies, and they have not been sufficient to clear backlogs, deal with court appeals and assume a proactive role, such as undertaking market studies. *Thus, resources may need to be reviewed and eventually increased to levels observed in other small economies with a proactive competition enforcement stance.* Another aspect of an effective competition framework is to have sanctions that are sufficiently important to have a deterrent effect and to create incentives to participate in the leniency programme. As in other European countries, fines can reach 10% of turnover, but fines issued so far have been relatively small. *However, the effectiveness of the Authority should be enhanced by expanding its panel of possible sanctions by introducing criminal sanctions, such as prison sentences, for hard-core cartels.*

The retail sector is characterised by many small shops, a relatively small employment share, and very slow increases in productivity. The sector is also much more regulated than in other OECD countries, not only by regulations that exist in other countries (such as rules for large outlets, shop opening hours and prohibition of sales below costs) but also by Belgian specific regulation. The latter includes a ban on tied sales and announcements of price reductions within six weeks before the sales period (the so-called "black-out period"). Such regulation was intended to protect consumers, but the main effect has been to protect existing shops against entry by competitors with innovative business models and to reduce consumer welfare. Many of these regulations are currently being reviewed, particularly in the context of the EU Services Directive. *Competition inhibiting*

regulation should be scrapped and zoning laws for large outlets should be restricted to evaluating spatial effects.

The liberalisation of network sectors has not kept up with the reform of the general competition framework, despite the fact that prices in many network sectors are higher than in other countries. A common competition problem in many network sectors is the dominant position of the incumbent. The regulatory set-up varies across sectors, and there is no systematic or common approach to promote best practices. Some network sectors have regulators both at the federal and regional levels. Similar set-ups can be found in other OECD countries, but in the Belgian case, it is not easy to identify the economic benefits of such arrangements, particularly the comparative advantages of the sub-federal regulators. For example, the electricity market has effectively been divided into three sub-markets, where important network effects in terms of economies of scale and scope are lost. *In the energy sectors, the complicated regulatory structures should be streamlined, preferably by establishing a single, independent and nationwide regulator with complete competencies. Moreover, the further development of wholesale markets and international interconnection capacity should be encouraged to facilitate new entry. A positive market opening measure was the government requiring the incumbent in the electricity sector to auction off part of its production capacity. This measure should be continued and expanded.* In some network sectors, such as rail and postal services, liberalisation has been only enough to meet minimum EU requirements, and the sectors may thus not be prepared for the eventual full market opening. In addition, in many sectors there is an unusually wide scope of universal service obligations, posing problems in terms of an implicit barrier to entry and expansion of competitors. *The first step to facilitate new entry should be the introduction of standardised universal service obligations that focus on generally accepted provision standards. Moreover, contracts for universal service obligations should be subject to competitive tendering and financed by the government imposing the obligations.*

The liberalisation of the telecommunication sector has led to a decline in prices. However, the sector is dominated by incumbents, leading to higher prices and a slower roll-out of new technologies than in other countries. The sector needs extensive reform to promote competition to boost consumer welfare through lower prices and a more rapid introduction of new technologies. *The telecommunication regulator should have greater powers to prevent the incumbents from exploiting their dominant positions. Moreover, efforts to dilute regulatory powers by delegating some responsibilities to community level broadcasting regulators should be strongly resisted.* In fixed-line telephony, the main hindrance for new entry lies in the ability of the incumbent to delay local loop unbundling. *To secure effective local loop unbundling stricter conditions should be imposed on the incumbent – a measure that should be backed up by greater use of sanctions in case of violations.* In mobile telecommunication, there are an internationally high number of alternative providers, but their combined market share is lower than in other countries. *Mobile termination charges should*

be further lowered and a fourth network operator should be introduced as soon as possible. Consumer switching should be facilitated by reducing maximum contract duration. ■

**For further
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More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2009 edition.

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