

Economic Survey of Belgium, 2007

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Summary

The Belgian economy is in a strong recovery phase. The balancing of the budget since the start of the decade has allowed public debt to fall fast relative to GDP, providing a favourable macroeconomic background for the recovery. Moreover, structural reforms, particularly in the labour market, are showing signs of success. Output has accelerated and was by mid-2006 growing at 3% – the fastest pace since 2000. With growth well above potential, some production factors are already under strain. The challenge will be to persist with stability and reform-oriented policies to bolster the economy's trend growth, a challenge made more acute by the impending ageing of the population.

Maintaining public finances on a sustainable footing in the long term will require additional reforms. Ageing-related social security spending is projected to increase by some 6 percentage points of GDP by 2050. The current government strategy focuses on securing the system until 2030, pointing to the need for additional measures to secure fiscal sustainability thereafter. A further lowering of marginal tax rates could help to expand labour market participation and thereby also broaden the tax bases, but such cuts could only be sustained if expenditure growth is tightly constrained. Spending restraint is essential, not only at the federal government level, but also at other levels, where spending has been the most dynamic. All government levels need to share the burden of preparing for ageing.

This Policy Brief presents the assessment and recommendations of the 2007 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 discussions, and issued under the responsibility of the Committee.

Labour market policies are aiming to increase participation. The government has started to close early-retirement routes, make unemployment benefits for prime-age workers conditional on job-search efforts and improve the exchange of information between public employment services. The results are positive so far, but small. Activation policies are in place, but not all unemployed are fully subject to job-search obligations. Moreover, there is no tapering off of unemployment benefits, as practiced in a number of other countries. There is still room to increase employment rates as early exit routes are not entirely closed and wage subsidies are not fully targeted to low-wage workers. Also, the centralised wage bargaining system does not allow wage developments to sufficiently reflect local labour market conditions.

Tertiary education has been expanded over the past decades, setting Belgium on course towards having a relatively high human capital endowment. However, there has been no matching increase in funding, which, in the absence of reform, over time will have a detrimental impact on teaching quality. Raising tuition fees would provide tertiary education institutions with independent funding and spur competition further among them. Such a measure encourages students to internalise the cost of their studies and match capabilities and choice of study. The latter should be facilitated by the publication of information concerning study quality and future labour market prospects. Financial barriers to access can be reduced through income-contingent student loans, possibly combined with means-tested grants. As an alternative to increasing tuition fees, other forms of economic incentives may be introduced to encourage students to make efficient use of the tertiary education system.

The well-functioning financial sector has contributed to growth, but it could work even better. Cross-selling of retail banking services intended to boost consumer loyalty may have increased switching barriers and reduced competitive forces. In a similar vein, a number of tax incentives have been introduced to influence household savings behaviour and achieve a variety of policy goals. Their cost effectiveness needs to be assessed against the potential benefits of lower tax rates. There are also various consumer-protection rules that restrict the take-up of credit. In particular, there is little demand among consumers to borrow against their housing wealth, which may partially be related to the lack of adequate mortgage regulation. ■

What are the main policy challenges?

Belgium's economic recovery is becoming more durable. During 2006, the economy has picked up momentum, reaching an annual rate of 3% year-on-year. The economy has benefited from the EU-wide pick-up in activity, supportive monetary conditions and the beneficial effects of the multi-annual tax and labour market reforms that the government has implemented. Growth has slightly outpaced the euro area average since 2002. The upturn is projected by the OECD to continue at a rate exceeding potential over the next two years, almost closing the output gap by the end of 2008. Nonetheless, there are already signs that some production factors are under strain; capacity utilisation is approaching historical highs and an increasing number of firms report problems finding and hiring qualified workers. Moreover, exporters are losing market shares as external competitiveness has deteriorated, partially because of more rapid increases of unit labour costs than among trading partners, but also for structural reasons, such as sectoral and geographical export composition. This indicates that further strengthening of the productive potential and a greater degree of wage flexibility will be essential to bolster long-term growth prospects. The persistence of high unemployment – despite stronger job creation – suggests that labour market reform should continue to be high on the policy agenda.

In a broader sense, the Belgian economy exhibits a number of strengths. The cyclical deviation of output from its trend has tended to be small in international comparison, reflecting sound macroeconomic policies. This relative stability has perhaps reduced the potential costs of a fairly high degree of nominal rigidity insofar as very large adjustments in product and labour markets have not been needed in recent decades. The level of income per capita has remained high internationally. Belgium has also maintained comfortable current account surpluses, allowing for the continued accumulation of net foreign assets. While productivity growth has not been very dynamic in recent years, the average level of productivity of Belgian workers is among the highest in the world, which may in part reflect the under-representation of low-skill, low productivity jobs. Associated with this, employment levels are low in international comparison, though participation rates are now on a clearly rising trend. Overall, Belgium seems reasonably well placed to reap the benefits of globalisation and to cope with population ageing. But successful adjustment will require policies that in the medium and long term promote continued stronger growth in productivity, while in the short term continue to raise the share of people in work. The authorities have been aware of the need for reforms and their actions have produced visible outcomes: for instance, the consistent achievements of balanced

government budgets have led to a sharp reduction of public debt relative to GDP; likewise, the pickup in job creation has been accompanied by higher labour market participation rates, especially among older workers. The government intends to stay on the course of economic reforms and has accordingly focused its national reform programme on key priorities to achieve long-term sustainable growth prospects, such as creating a more dynamic labour market, consolidating the budget, securing the future of the welfare system and better protecting the environment. More emphasis on strengthening product market competition in a range of sheltered sectors should likewise be a priority. While the present *Survey* does not encompass all of these priorities, it discusses in detail: i) the overall strategy to deal with the sizeable fiscal consequences of ageing; ii) the labour market reforms undertaken by the government to boost employment gains; iii) the increasing enrolment of new students into tertiary education institutions and related stresses; and iv) the contribution of the financial system to long-term prosperity. ■

How could fiscal policy be put on a sustainable path?

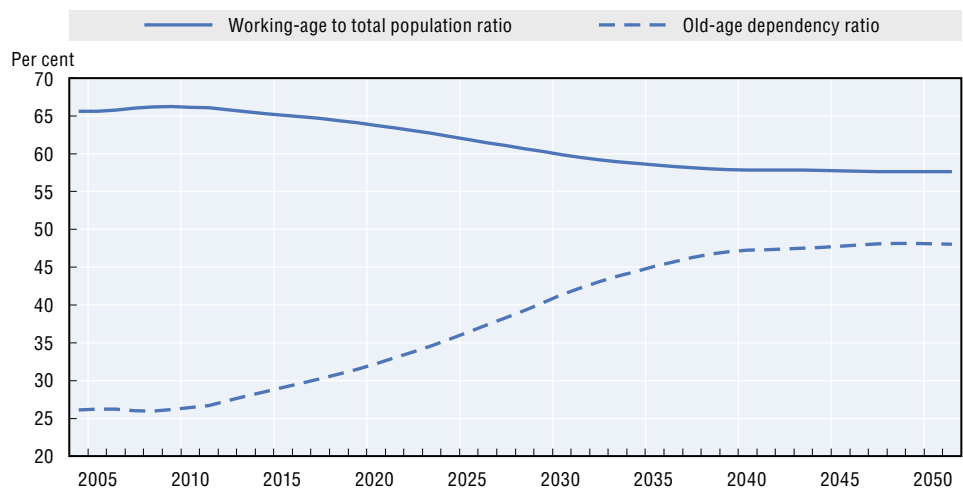
Since 2000, the general government budget has been kept in strict balance, helping to reduce the level of gross debt from about 110% to below 90% of GDP in 2006. However, it will be more difficult to reduce the debt ratio from now on. This is because the primary surplus has been lowered considerably (from 6½ per cent of GDP in 2000 to about 4% in 2006) as the government used some of the savings in interest charges to increase spending. While this expansionary fiscal policy stance has helped the recovery, the dissipating of windfall gains in interest payments has made it more difficult to keep public finances on a sustainable basis in the longer term. The balancing of the budget has been achieved with the help of one-off fiscal measures (such as sale of real estate, special dividends from public companies and securitisation of tax arrears) equivalent to an average of 0.5% of GDP every year, which have helped to postpone the necessary consolidation.

The objective for fiscal policy is once again becoming more ambitious. As part of the government's strategy for pre-funding the cost of ageing, the government's long-term plan is to generate a budgetary surplus of 0.3% of GDP in 2007 and then have it growing by 0.2 percentage point of GDP every year until the surplus reaches nearly 1½ per cent of GDP in 2013. The surplus is maintained at this level until 2018, after which surpluses will be gradually reduced to zero by 2030. The surpluses are earmarked to the Ageing Fund – the main pre-funding vehicle – which will be used to finance additional ageing-related spending. The

implementation of this plan requires important fiscal consolidation efforts, not only because of the more ambitious targets for fiscal policy, but also because interest charges will decline less rapidly in the future. An additional concern is whether the time horizon of the fiscal strategy is sufficiently long to deal with the bulk of the consequences arising from population ageing. The government’s pre-funding strategy aims at financing additional ageing-related costs only until 2030; yet important fiscal burdens of ageing will also materialise in the following decades. Hence, the government’s fiscal targets need to be made even more ambitious through a combination of further pre-funding, tax base broadening, expenditure restraint and labour market reform. The necessary amount of additional efforts could be reduced by tightening the pension replacement rates – but they are already internationally low. A more realistic prospect would be to increase the effective retirement age, for example, by linking over time the statutory age of full pension eligibility to developments in life expectancy. Meeting the fiscal challenges of ageing will require enhanced accountability and close coordination across levels of government, in particular because, under current arrangements, most of the additional ageing-related spending growth falls onto the federal level, without appropriately offsetting revenue prospects.

The amount of needed fiscal consolidation suggests that action is required both on the spending and the revenue side. Fiscal consolidation through expenditure restraint cannot be achieved by the federal government alone, as its discretionary spending power is relatively limited. Thus, all government levels need to participate in the consolidation process

Figure 1.
POPULATION TRENDS
As per cent of total population



Source: OECD, Eurostat.

by reining in spending. Indeed, the significant extent of fiscal decentralisation means that all levels of governments need to generate surpluses in order to participate in the pre-funding effort. To this end, all levels of government might consider working together to establish an expenditure rule that would cap the growth of general government spending. Moreover, attention needs to be paid to surpluses in structural terms, so as to avoid pro-cyclical spending patterns, and defined to exclude the use of one-off measures, which are not sustainable indefinitely. On the revenue side, if the beneficial effects of the government's recent efforts to lower marginal tax rates are to be preserved and extended, the revenues needed to sustain fiscal consolidation can only be realised by directly and indirectly broadening the tax base, such as by phasing out a range of tax expenditures and by expanding labour market participation. ■

How could the functioning of the labour market be improved?

Since 2000, a significant share of new jobs has been created in the public sector, although more recently a welcome development has been the emergence of the private sector as the main source of employment growth. The increase in the level of employment has been accompanied by an expansion of the labour supply and the unemployment rate has therefore hardly changed. Belgium therefore remains characterised by a high level of unemployment, rising but still low participation rates and a significant mismatch between labour demand and labour supply, which is illustrated by large geographical differences in labour market situations. The authorities should therefore continue focussing their efforts on improving labour market outcomes.

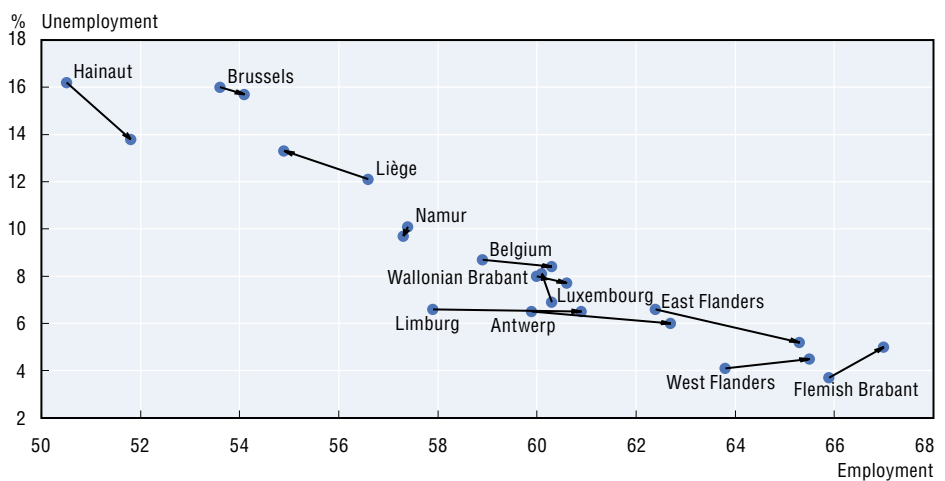
The Belgian government has recently taken a series of steps to discourage early exits from the labour market and encourage re-entry of those who have stayed out of activity. These measures have included the closing of some early-retirement paths, as stipulated in the Solidarity Pact between the Generations. As well, activation measures have been enacted, notably in the form of individualised road maps for returning to work, follow-up interviews and possible sanctions in case of insufficient job search activities. Activation, however, is only applied to unemployed less than 50 years old and with a relatively long unemployment history. Meanwhile, other labour market policies have been kept unchanged, notably the unemployment benefit system. More emphasis has therefore to be placed on interventions to make work pay. *The effectiveness of labour market activation measures could be enhanced by limiting unemployment benefit duration. Alternatively, the government should consider gradually phasing down benefits. This could possibly be combined with a higher initial replacement rate. The monitoring of search effort should be jointly undertaken by the federal and regional public employment services, which would also help to secure consistency of feedback*

and sanctioning mechanisms. To increase the employment rates of groups with weak labour market attachment, a number of measures should be applied, including further closing of exit routes for early retirement, applying early activation to young school leavers, reducing high effective marginal tax rates for low-income earners and better targeting of wage subsidies to low-skilled earners. ■

How could wage developments better reflect local labour market conditions?

An important pillar of the authorities' strategy is the emphasis on wage moderation. The centralised wage bargaining system is based on preserving external competitiveness by setting an indicative norm for maximum labour cost increases that keep developments in line with the three main trading partners. There is also a lower bound for wage increases stemming from the system of automatic indexation of wages to price developments. The indexation system is mandatory for all and existing opt-out rules in sectoral wage agreements are rarely applied. These features mean that bargaining can only take place within a narrow range defined by the indexation floor and the wage norm ceiling, which has recently been in the order of only 1 to 2½ per cent over the two year period covered by the wage agreements. As a result, there is in practice little differentiation of wage developments across geographical locations. Thus, the centralised wage bargaining system should be revised to allow wage developments to better reflect local labour market conditions. As a minimum, this requires facilitating the use of opt-out rules and promoting the use of all-in agreements. In the medium term, it would be advisable that the social partners consider phasing out the wage indexation system, so as to allow greater real wage

Figure 2.
EMPLOYMENT AND UNEMPLOYMENT RATES IN BELGIAN PROVINCES 1999-2004



Source: Eurostat.

flexibility. Inspiration for reforms can also be found in the development of the wage negotiations in some of the Nordic countries, where local conditions are increasingly taken into account in the central bargaining framework. ■

How could the efficiency in tertiary education be improved?

Tertiary education has expanded rapidly over the past several decades, turning the system from having an elite orientation to providing tertiary education to a much larger share of each generation. In the process, the low educational attainment of the population has been increased, setting Belgium on course to having a relatively high human capital endowment. The tertiary system is currently based on the principles of open access, low tuition fees, and the right of students to get a second chance after a first failure in higher education. Some measures have been taken at the community level to further improve the quality of tertiary education, such as adapting the curriculum, introducing a system of learning accounts, limiting time to graduation, giving greater admission possibilities based on professional experience and enhancing competition between tertiary education institutions. However, there is a concern that the improvement of quality will be difficult to sustain in an environment of rising enrolment without a corresponding increase of funding. Tuition fees are at present too low to provide significant funding to raise quality. The low levels of tuition fees also imply that many students consider tertiary education as a free good. Enrolment rates are therefore high in the first year, where there is limited initial screening, but the failure rate is high at the end of the first year and leads to a frequent change of study fields. *A first measure to enhance the efficiency of the tertiary education system would be to secure a better match between capabilities of the students and the requirements of the studies. This is best done by strengthening screening systems, either at the upper-secondary level or at entry into tertiary education. However, directing students through more extensive counselling could also help.*

Another response to these problems would be to enhance price signals. On the side of the tertiary education institutions, *raising tuition fees to higher cost-recovery levels would provide for an independent revenue source* that would depend on the ability to attract students, thus giving the institutions the financing needed to adapt their supply and quality of teaching. On the student side, higher tuition fees would give an incentive to match capabilities and choice of studies as well as an encouragement to reduce study time. Should tuition fees eventually be raised, financial barriers to access might become an issue. Because capital markets do not accept intangible investments in human capital as collateral, tuition

fees cannot be a stand-alone measure and *accessibility should be secured through the introduction of income-contingent student loans, possibly combined with means-tested direct student grants*. Such a combination of measures would also counter the social bias in tertiary education. Moreover, an important contribution of tuition fees would be to further stimulate competition between the tertiary education institutions. However, to alleviate asymmetric information problems and to allow students to make informed choices, recent measures to disseminate relevant information concerning the quality of education should be expanded and combined with career counselling regarding future labour market prospects. As an alternative to increasing tuition fees, the government could consider introducing other forms of economic incentives, so as to encourage students to make an efficient use of the tertiary education system. ■

Could the performance of the financial sector be improved further?

The financial sector is sound, dynamic and stable. Banks have shown a capacity for adapting to new market conditions, such as a declining reliance on intermediation of government debt and greater international exposure. They have contributed to economic growth not only by the expansion of their own activities but also, more importantly, by mobilising the large accumulated stock of household savings and intermediating it effectively to meet financing needs. The fact that no serious banking problems have been experienced for several decades, unlike in a number of other countries, is a testimony to the sector's persistent health.

A defining feature of the Belgian financial system is its concentration in the hands of four large "bancassurance" conglomerates, which offer customers a mix of insurance, banking and financial services. The authorities considered that the emergence of such conglomerates would enhance diversification and contribute to financial stability. These institutions, however, also tend to capture customers by the use of cross-selling strategies, which as such raise switching costs and reduce price transparency, leading to lower competitive pressures. Some steps have been taken by the government to improve price transparency and facilitate switching. The government has also requested an examination of competitive pressure in the savings account market segment, but more needs to be done. *The authorities should reconsider the regulation allowing the tying of a mortgage interest rate reduction and the purchase of certain insurance products. More generally, measures aimed at strengthening competition and contestability in the financial market can be pushed forcefully by the competition authority.* ■

Could less prescriptive regulation be effective and enhance competition?

Government intervention in the consumer credit and mortgage loan markets is also more extensive than in a number of countries. The authorities seek to protect consumers notably against over-indebtedness via a variety of administrative measures, including a grid of maximum interest rates. However, this regulation risks stifling innovation in some particular segments of the credit market. Also, the interest rate grid has become the norm for certain credits, notably for credit or store cards. Although the regulation seems effective, it appears to be overly prescriptive. This raises the question as to whether the same results could be achieved in a less prescriptive way, for instance by making the grid indicative. *Empirical research on the various effects of the interest rate grid could contribute to a debate among interested parties and help the government to formulate possible reforms. This should be accompanied by bolstering financial education to enable customers to adapt to the new market-based regulatory environment.*

Government interventions in the housing and mortgage markets are also extensive. Regulation caps the allowable variability of interest rates on floating-rate mortgage loans. Fees on early repayment of mortgages are also capped at three months of interest payments. High transaction costs on the housing market have reduced the incentive to withdraw equity by trading down to a smaller house or moving to a rental; recent regional decisions to lower transaction costs go in the right direction, but more could be done. Likewise, lengthy foreclosure procedures may add to banks' operating costs, potentially increasing the prices of mortgage loans in certain market segments. Also, mortgages are almost exclusively provided by banks; the near absence of non-bank mortgage institutions may be explained by the lack of mortgage bond legislation and the absence of a mortgage-backed securities market. Mortgage loans can only be reloaded up to the initial value of the loan – reducing the incentive to tap increasing housing equity to smooth consumption. Altogether, there is little use of financial instruments to borrow against housing wealth, such as home equity withdrawal. *So as to modernise the mortgage market, adjustment caps on interest rates should be left to individual decisions, early repayment fees should be cost-based, high real estate transaction costs should be cut and the lengthy foreclosure period should be reduced. Competition in the market for mortgages can be enhanced by introducing mortgage bond legislation. Moreover, consumption smoothing for households should be facilitated by modernising home equity withdrawal and reverse mortgage legislations to make it easier to take out new mortgages on capital gains.*

The authorities have also used tax policy to shape financial developments. There are a number of tax incentives favourable to household savings accounts, pension savings plans, life insurance schemes and mortgage payments, with a corresponding tax expenditure of close to 1% of GDP. Such measures do not necessarily increase saving rates and they do not obviously benefit the consumer, but they do influence the allocation of saving. Furthermore, they require higher income tax rates than otherwise. *Thus, the costs and benefits of the various tax incentives favouring specific savings vehicles should be reviewed and, where needed, tax incentives should be reconsidered.* ■

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Economic Outlook No. 80, December 2006.

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, 2007 edition.

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