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The previous Survey of Belgium *was issued in March 2007.*

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BASIC STATISTICS OF BELGIUM, 2008

THE LAND

Area (1 000 km^2)	30.5	Major urban areas (thousand inhabitants)	
Agricultural area (1 000 km^2)	17.3	Brussels	1 048
		Antwerp	970
		Liège	597
		Ghent	517

THE PEOPLE

Population (thousands)	10 667	Total labour force (thousands)	4 859
Inhabitants per km^2	349	Total domestic employment (thousands):	4 436
Net increase	59 118	Agriculture	80
Net migration (thousands)	55.4	Industry and construction	1 096
		Other	3 260

THE PRODUCTION

Gross domestic product (billion euro)	344	Gross domestic product by origin, at market prices (2007, %):	
Gross domestic product per head (USD)	47 141	Agriculture	0.7
Gross fixed investment:		Industry	16.6
Per cent of GDP	23	Construction	4.7
Per head (USD)	10 692	Other	78.0

THE GOVERNMENT

General government (% of GDP):		Composition of the House of Representatives (number of seats):	
Current expenditure	50.0	Liberals	41
Current revenue	48.8	Socialists	34
Gross debt	89.8	Christian-democrats	34
		Ecologists	12
		Others	29
		Last election: 10.6.2007	

FOREIGN TRADE

Exports of goods and services (% of GDP)	85.8	Imports of goods and services (% of GDP)	84.2
Main exports (% of total)		Main imports (% of total)	
Chemical products	27.2	Chemical products	22.5
Machinery and equipment	12.6	Machinery and equipment	13.8
Textile products	1.7	Textile products	1.0
Transport equipment	11.0	Transport equipment	11.2

THE CURRENCY

Irrevocable conversion rate	40.3399	Currency units of euro per USD, average of daily figures	
		Year 2008	0.6840
		May 2009	0.7320

Executive 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.*

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.*

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Assessment and recommendations

The economy has entered a severe economic recession

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 government responded swiftly to the financial crisis

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 fiscal manoeuvre room is constrained by the growing fiscal sustainability problems

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.*

Fiscal sustainability needs to be secured

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 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

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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*.

Securing fiscal sustainability requires a reform of the fiscal federalism system

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*.

The current transfer system does not align spending and taxing responsibilities

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*.

The organisation of the federation is not promoting public sector efficiency

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.

The tax system is relying too much on growth distorting taxes

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*.

Despite reform, labour taxation continues to contribute to substantial labour market traps

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*.

Corporate tax rates are relatively high

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,

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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*.

Taxation of saving vehicles varies widely without clear social benefits

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.*

Taxation of consumption should be increased to reduce distortion in the tax system and to pursue environmental objectives

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* CO_2 *and other pollutants, implying a relatively higher taxation of diesel, and the excise taxes should be increased to internationally comparable levels.*

Competition policies are being strengthened which will improve consumer welfare and 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.*

Competition in the retail sector is hindered by unusually extensive sector regulation

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 regulatory setup in network industries needs to be revised

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 been less successful than in other countries

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.*

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Chapter 1

Coping with the crisis while pursuing structural reforms

The Belgian economy has plunged into a historically deep recession, driven by the crisis in the financial sector and a sharp contraction in world trade. The government has reacted swiftly to restore confidence in the financial sector. Monetary easing by the European Central Bank has been coupled with a fiscal stimulus to support economic activity. Nevertheless, the economy is unlikely to recover strongly within the next couple of years. While the preceding period of high growth benefited from structural reforms, it also revealed weaknesses. Thus, bad times should not be used as an excuse to postpone structural reforms necessary to foster potential growth. Structural reforms should aim at making the labour market more flexible and raising productivity growth through improving the tax system and the competition policy framework. The other main challenge is to put public finances on a sustainable path as soon as the economy picks up in order to cope with costs of ageing.

Belgium has plunged into a severe crisis

Following several years of strong growth, the Belgian economy first slowed and then started to contract at the end of 2008, largely in line with developments in the euro area. The economy is now in a deep recession, which is expected to last for a prolonged period accompanied by continued increases in unemployment (Figure 1.1 and Table 1.1). This chapter first describes how the financial crisis has hit the Belgian economy and the channels through which the crisis continues to unfold. Subsequently, the government's interventions are analysed. Finally, based on an analysis of structural features and long-term growth potential of the Belgian economy, the chapter concludes with the key challenges for improving the economy's growth potential.

The crisis started in the financial sector…

In the second half of 2008, the Belgian financial sector started to suffer from the global crisis. In particular, the three largest financial conglomerates (Fortis, Dexia, KBC) and a large insurance group (Ethias) experienced severe market pressures and, some of them, liquidity problems. The assets of these institutions amounted to about five times Belgian GDP. These institutions have been exposed to the crisis for slightly different reasons. Fortis, the largest group in Belgium, was exposed to structured assets in the United States and suffered from a fragile balance sheet resulting from the acquisition of ABN AMRO in 2007. Dexia, the third player on the Belgian financial market, fell victim to its exposure to toxic assets via its US bond insurance subsidiary (FSA) and a troubled German bank. This development also had a small negative effect on Ethias through its 5% ownership in Dexia. Finally KBC, the second largest banking group, experienced a loss of confidence amid concerns about its exposure in the United States and in Central and Eastern Europe.

… and is playing out through a number of channels

The real economy was surprisingly resilient throughout most of 2008, but the year ended with an abrupt and substantial contraction of activity affected by the fall in world trade. Unemployment started to rise in early 2009, and in particular as the number of workers on reduced working time (*chômage temporaire*) has been increasing sharply. The negative impact on trade from the collapse in world trade is now compounded by subdued domestic demand, as households are increasing savings even faster than in the rest of the euro area. Capacity utilisation remained remarkably high before it collapsed in early 2009, while the rate of bankruptcies has significantly increased (Figure 1.2). Together with historically low business sentiment – reflecting, among others, collapsing new orders (particularly for exports) and falling demand expectations – this implies that production and employment will shrink further (Figure 1.2).

Figure 1.1. **General developements**

Source: OECD, *Economic Outlook database*.

Declines in both households' real and financial wealth are depressing consumption

The current crisis is affecting the value of both real and financial wealth, which is creating a strong negative wealth effect for Belgian households. Home ownership is high by international standards (71%), and real house price increases have been among the highest in Europe since 1985. In the 2000s, cumulative growth in real house prices amounted to about 100%. More recently, real house prices decelerated from a frothy 15% in 2005 to a still relatively high 5% in 2007 (Statbel). Much of these increases can be explained by falling user costs (Hilbers *et al.*, 2009). However, user costs started increasing over the past year due to higher real interest rates and the expected negative capital gains. Thus, a correction in house prices is expected, and its extent will be a function of (permanent) changes in the user cost and current overvaluation of house prices. The latter was estimated to be around

Table 1.1. **Main indicators**

Percentage changes from previous period, at constant prices, unless indicated

	Current prices Euro billion 2003	2004	2005	2006	2007	2008	2009	2010
Private consumption	146.9	1.1	1.5	2.1	2.0	0.8	–1.1	0.5
Government consumption	63.2	1.8	0.4	0.1	2.3	2.1	1.9	1.6
Gross fixed capital formation	51.7	6.8	7.3	4.8	6.1	5.1	–5.2	–4.8
Public sector	4.6	0.5	15.5	–10.6	3.4	1.5	4.6	0.7
Residential	12.4	9.8	10.0	7.9	1.3	1.0	–2.0	–0.8
Business	34.7	6.5	5.2	5.6	8.5	7.1	–7.4	–7.1
Stockbuilding[1]	0.5	0.1	0.3	0.7	0.1	–0.1	–0.9	0.1
Total domestic demand	262.3	2.5	2.7	2.9	3.0	1.9	–2.2	–0.4
Exports of goods and services	222.8	6.1	3.9	2.7	3.9	2.1	–17.5	–0.5
Imports of goods and services	210.4	6.0	4.9	2.7	4.4	3.3	–15.4	–0.2
Foreign balance[1]	12.4	0.4	–0.6	0.1	–0.3	–1.0	–1.8	–0.2
Gross domestic product	274.7	2.8	2.2	3.0	2.6	1.0	–4.1	–0.5
Memorandum item:								
Consumer price index		2.1	2.8	1.8	1.8	4.5	0.3	0.7
Unemployment rate[2]		8.3	8.4	8.2	7.5	7.0	8.3	10.6
Households saving ratio[3]		7.8	7.4	8.0	9.0	9.0	11.1	11.5
Government financial balance[4]		–0.3	–2.7	0.3	–0.3	–1.2	–4.6	–6.1
Current account balance[4]		3.5	2.6	2.7	1.7	–2.6	–0.2	–0.4

1. Contribution to GDP growth.
2. As a percentage of labour force.
3. As a percentage of disposable income.
4. As a percentage of GDP.

Source: OECD, *Economic Outlook database*.

14% in 2007 (IMF, 2007), which is much less than in countries like Ireland and the United Kingdom (Figure 1.3, Panel A). This result, however, contrasts with the finding that the house prices to GDP ratio is relatively low in Belgium, and that offer prices in Brussels are lower than in most European capitals (Figure 1.3, Panel B). Even if a strong house price correction takes place, negative equity is unlikely to be a widespread phenomenon as the mortgage loans to GDP ratio of around 40% is relatively low compared with the EU15. In sum, the likely house price correction should be less drastic than in some other OECD economies and the impact will be moderated by the low indebtedness of Belgian households. On the other hand, a contraction of construction activity is expected, as the number of new building permits has shrunk, despite the targeted tax cuts to support the sector (KBC, 2009).

The impact of the crisis on Belgian households' financial wealth will have a strong dampening effect on domestic demand. In 2007, households had a large amount of financial assets (around 270% of GDP) by international comparison, of which a relatively large part of this (directly and indirectly) is held in shares (40%) and life insurance schemes (20%) (Figure 1.4, Panel A). Since then, however, financial wealth has been sharply reduced, as the stock market lost 70% of its value between the historical high of mid-2007 and March 2009, with particularly large losses in blue-chip stocks of the three largest banks (Figure 1.4, Panel C). The large losses incurred may induce households to sharply increase savings, in particular for retirement, as the ageing of the population is going to accelerate from 2011 onwards. Such a development could create a risk of a deeper and more

Figure 1.2. **The mood is souring**

Balance

Business confidence: industry

15, 5, -5, -15, -25, -35

1998, 2000, 2002, 2004, 2006, 2008

Number,s.a.

Bankruptcies: all sectors

850, 800, 750, 700, 650, 600, 550, 500

1998, 2000, 2002, 2004, 2006, 2008

Per cent

Rate of capacity utilisation: manufacturing

86, 83, 80, 77, 74

1998, 2000, 2002, 2004, 2006, 2008

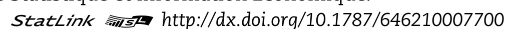
2000 = 100,s.a.

Industrial production: all sectors

120, 115, 110, 105, 100, 95, 90

1998, 2000, 2002, 2004, 2006, 2008

Source: OECD, *Main Economic Indicators* and Direction Générale Statistique et Information Économique.



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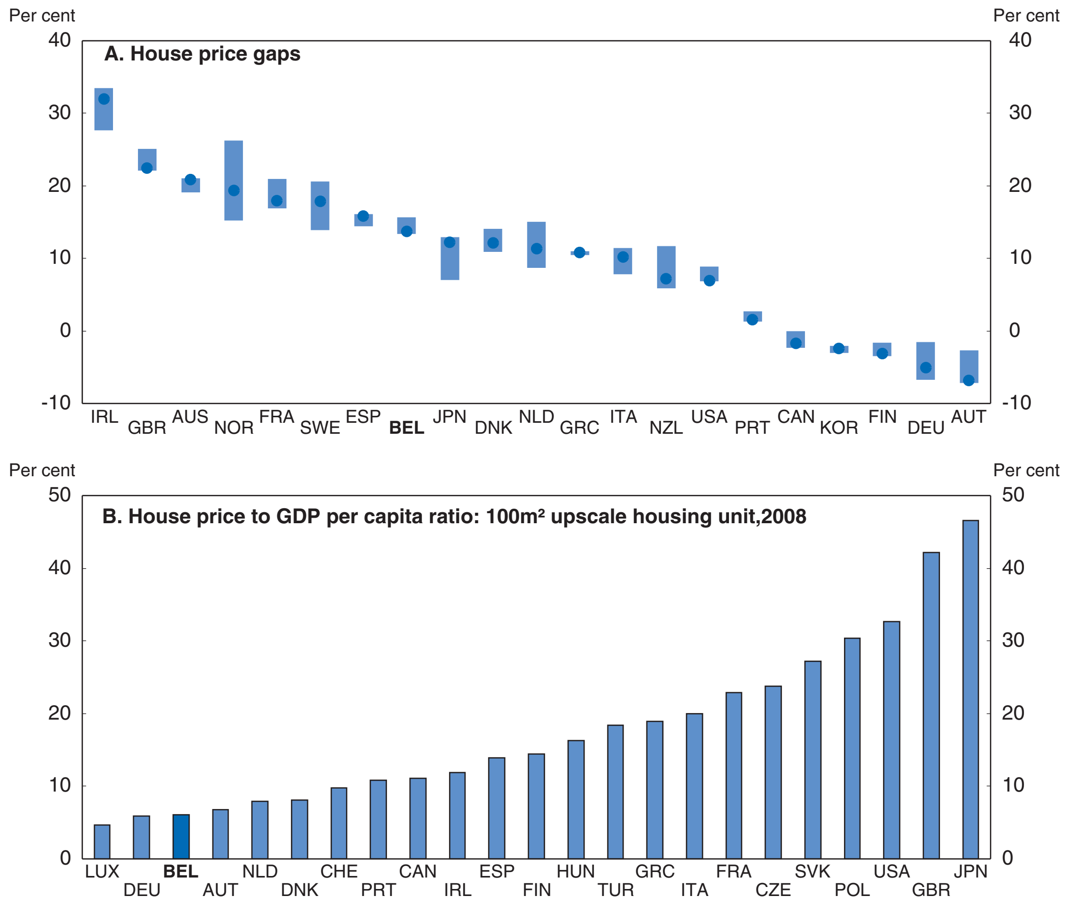
prolonged crisis. Overall, the losses households are incurring in terms of real and financial wealth will induce them to increase their savings. Households are expected to further increase precautionary savings as unemployment climbs, which will further dampen domestic demand while external demand will remain weak. Nonetheless, a number of specific characteristics make the final impact on the real economy quite uncertain. The pay-as-you-go pension system has an internationally low replacement rate (OECD, 2008b) giving households strong saving incentives to offset losses in financial wealth. Moreover, assets in the second and third pillar pension schemes are relatively small, suggesting that developments in this area may not trigger significant increases in private savings. However, this could be the case for other savings that are not directly linked to pensions, but assessing the impact is complicated by the fact that many of these are in non-quoted (and illiquid) shares (Figure 1.4, Panels A and B) (Stinglhamber *et al.*, 2007).

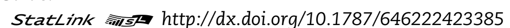
Figure 1.3. **House prices in Belgium and selected OECD countries**

House price gap estimates, 2007[1]



1. The percentage of increase in house prices between 1997 and 2007, relative to the average 1994-97 price which cannot be explained by fundamentals – point estimate and intervals obtained by small variations of the model.

Source: IMF (2007), *World Economic Outlook* and *Global Property Guide*.

StatLink  http://dx.doi.org/10.1787/646222423385

Companies face a plummeting export market…

The openness of the Belgian economy (exports and imports sum up to 180% of GDP) makes it highly vulnerable to the collapse of international trade and Belgian companies saw their exports collapse in the fourth quarter of 2008. This compounds an already relatively weak export dynamism as illustrated by the relatively large market share losses that Belgian exporters have experienced over the past decade (Figure 1.5, Panel A) which is partly related to a loss in external price competitiveness, as higher nominal wage growth in Belgium compared with the three main trading partners was not offset by higher productivity growth (see also previous *Survey*).[1] A closer analysis of sectoral export performance shows that nearly 40% of exports come from the chemical and automobile industries, which together account for about 3% of all employment. What these two sectors have in common is that they export to international markets that were relatively fast expanding over the past decade and which are cyclically sensitive. While most of Belgian exports are in sectors in which world trade was growing rapidly, only the chemical sector has succeeded in increasing its market share, and the automobile sector has lost

Figure 1.4. **Financial market impact**

A. Households equity wealth: as a percentage of GDP in 2007 [1]

Shares
Insurance
Other assets

Per cent

SVK POL CZE HUN NOR FIN GRC IRL AUT SWE KOR MEX ESP DEU FRA PRT DNK ITA **BEL** CAN NLD GBR JPN USA CHE

B. Total private pension assets: as a percentage of GDP in 2007

Per cent

GRC TUR ITA SVK CZE FRA KOR HUN NZL ESP POL MEX **BEL** DEU AUT JPN PRT NOR SWE FIN IRL GBR CAN AUS USA DNK ISL NLD CHE

C. Stock indexes

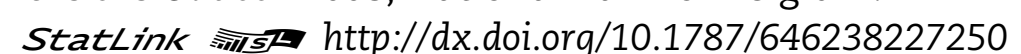
Index 2006 = 100

BEL 20 index
DJ Europe Stoxx 50 P IDX
Dow Jones Industrial
Nikkei index

2006 2007 2008

1. Data refer to 2006 for Japan and are not available for Iceland, Luxembourg and Turkey.

Source: OECD, *National Accounts database*, OECD (2009), *Private Pensions Outlook* 2008, National Bank of Belgium.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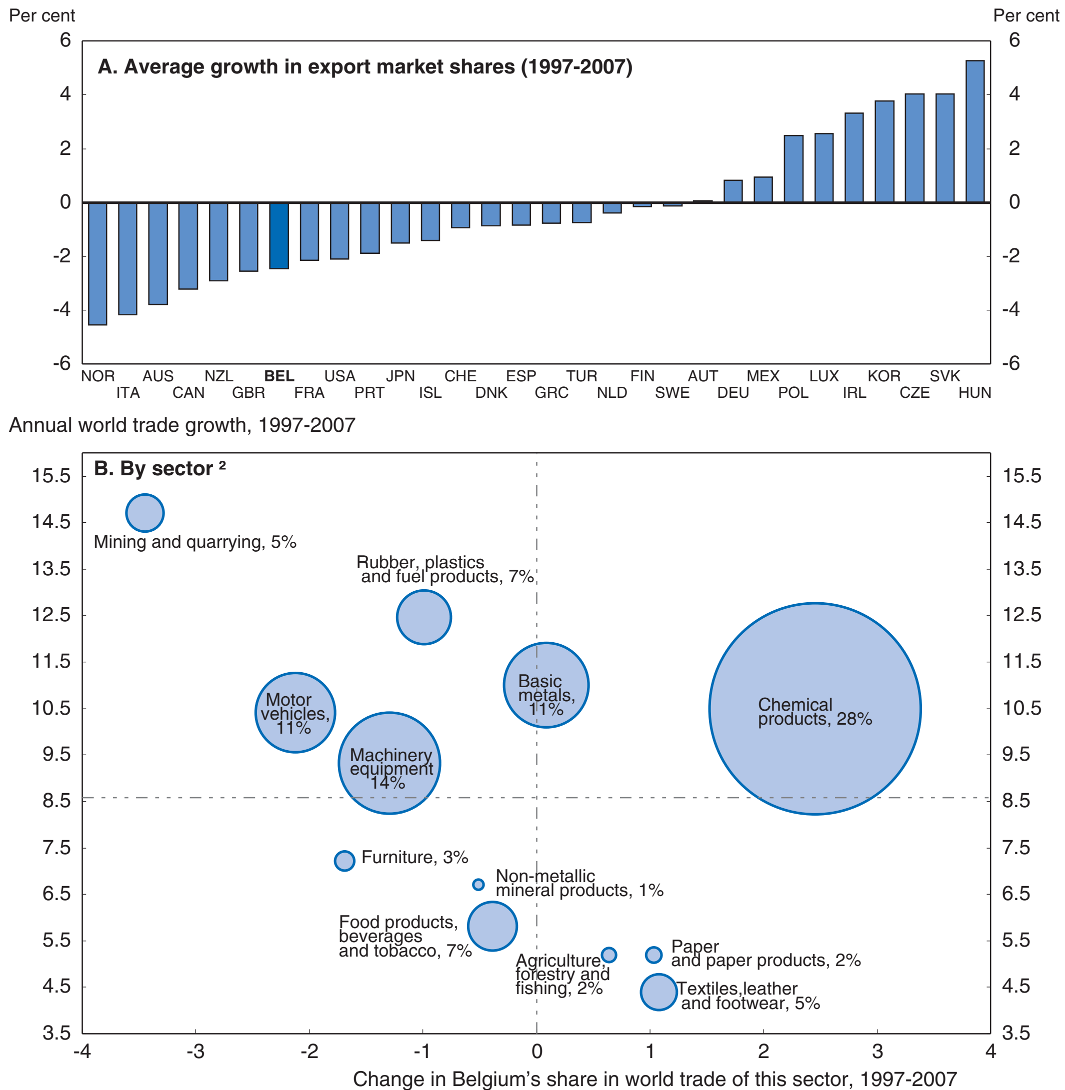
significant market shares (Figure 1.5, Panel B). Since 1995, the outsourcing of production has led to a marked increase in the import shares from China and Eastern European countries due to higher imports of parts and components of office machines and motor vehicle components (Michel, 2008). Eastern European countries (together with the United States) have become more important export destinations, but not China or other Asian countries. Looking forward, considering that a larger share of Belgian exports is going to countries in relatively deep and prolonged crises and against whose countries the euro has appreciated, the eventual recovery in exports is likely to be slow.

Inflation may remain higher than in other European countries

High energy price increases in 2008 were behind the accelerating Belgian headline inflation from the lowest level in the euro area in June 2007 to among the highest by

Figure 1.5. **Automobile exporters have been particularly hard hit**[1]



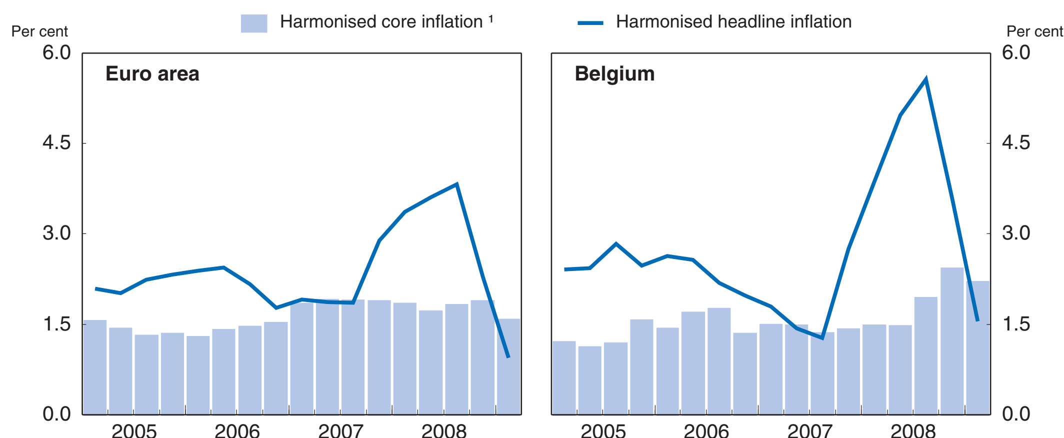
1. Volumes in first panel and values in the second one.
2. Commodities based on ISIC Rev.3 classification. The size of the bubble indicates the share of the sector in total Belgium's exports in 2007.

Source: OECD, *Analytical database*, OECD/UN (2009), *International Trade by Commodity Statistics*, *Joint database*.

StatLink http://dx.doi.org/10.1787/646278360426

July 2008 (NBB, 2008). This development was in part due to regulatory problems of enforcing lower energy transmission and distribution tariffs, and in part because a lack of competition pressures in these markets (Chapter 5 discusses this in more detail). Since then, inflation has fallen (Figure 1.1, Panel B and Figure 1.6) but remains among the highest in the euro area – partly related to the automatic indexation of wages (see below). Consequently, Belgian core inflation (excluding food, energy, tobacco and alcohol) continued to increase in early 2009, in contrast to the deceleration observed in most euro area countries since the end of 2008, leaving Belgium with one of the highest core inflation rates in the euro area by spring 2009. Higher inflation may lead to a further loss in competitiveness *vis-à-vis* trading partners, in particular those inside the euro area.

Figure 1.6. **Headline and core inflation**



1. Core inflation is equal to headline inflation excluding food, energy, alcohol and tobacco.

Source: OECD, *Main Economic Indicators* and *Analytical database*.

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Policies promptly reacted to sustain the economy

The first actions aimed at saving the ailing financial sector…

The drastic developments in the financial sector in September and October 2008 forced the government to intervene in an attempt to restore confidence and boost liquidity (Box 1.1). Recapitalisation was chosen over the alternative options – such as creating a bad bank or the purchase of troubled assets – primarily due to the relative easiness and speed of implementation and was combined with asset and liability guarantees. These measures succeeded in improving the liquidity position of the groups and preventing an implosion of the system, and even if some uncertainty lingered with respect to the Fortis intervention (subsequently resolved) confidence improved (Box 1.1). The first round of interventions was followed in January 2009 by a second recapitalization of KBC, carried out by the Flemish Regional government. In May 2009, the government had supported KBC with asset guarantees. Since autumn 2008, credit conditions have been tightening in a similar manner as in the euro area and the interventions may have prevented a stronger tightening.

Box 1.1. **Government interventions in the financial market in response to the crisis**

Interventions

In late September 2008 the unwinding of the global financial crisis swept through the Belgian financial sector, sparking a number of government interventions. In order to secure confidence in the markets and save the main financial groups suffering from liquidity problems, the Belgian government decided on the following measures:

- *Deposit guarantees:* in early October 2008 the deposit guarantee was increased from EUR 20 000 to EUR 100 000 per account.
- *Recapitalisations and asset transactions:* a number of interventions were executed in the third quarter of 2008, while an additional capital injection was provided in January 2009 (Table 1.2). The emergency acquisition of Fortis Bank from Fortis Holding in October 2008 started with a 49.9% share acquired in co-ordination with the Dutch and Luxembourg

Box 1.1. **Government interventions in the financial market in response to the crisis** *(cont.)*

governments and followed with the acquisition of the remaining part trailing the nationalisation of the Dutch branch Fortis NL by the Dutch government. The government subsequently attempted to sell the bank and the Belgian insurance branch to BNP Paribas, but the entire deal was upheld in court in a case brought by the Fortis Holding shareholders. In mid-February, the general assembly of Fortis shareholders marginally rejected the sale of Fortis Bank. Consequently, the government negotiated a new deal with BNP Paribas in early March 2009 which was eventually approved by the Fortis General Shareholders meeting in April 2009. The Belgian state maintained a 25% stake in Fortis bank and acquired a minority share in BNP Paribas in return for the rest of Fortis shares. The deal made the Belgian State the second largest shareholder of BNP Paribas (next to the French State).

- *Inter-bank loan guarantees:* the State had offered to guarantee new bank loans of Belgian banks, *i.e.* inter-bank deposits, bonds and institutional investments. Guarantees were first provided to Dexia (announced in October 2008) in combination with the recapitalisation and then extended on the same terms to all banks wishing to apply for them. The guarantees cover obligations expiring before 30 October 2011 and issued until 31 October 2009, renewable for a further year. The guarantee is subject to a fee and is capped at EUR 91 billion for Dexia (up to a total of EUR 150 billion together with the French and Luxembourg governments). The available EUR 150 billion guarantee for Fortis has not been activated.
- *Asset guarantees:* in mid May 2009 the State announced a guarantee to KBC, to back its structured credit portfolio. The guarantee ceiling totals EUR 22.5 billion and is divided in three steps. The first step covers losses of up to EUR 5.7 billion which will be covered by the KBC itself. Losses in excess of this sum can result in a recapitalisation of KBC by the government of up to EUR 2 billion. Further losses are to be borne in 90% by the government and 10% by KBC. KBC is to pay a EUR 1.2 billion guarantee fee, however the exact details are to be established.
- *International loans:* in January 2009, the Belgian government announced a EUR 160 million loan to the Luxembourg government in order for the Luxembourg government to take over the Luxembourg Kaupthing operations (through Kaupthing Luxembourg S.A.). The purpose of the loan is to guarantee the pay-out of the savings of 20 000 Belgians at Kaupthing Luxembourg S.A.

Exit strategies

The interbank loan guarantees are only valid for a limited time frame, and thus, will be automatically phased out. The fees accompanying the KBC guarantee scheme provide an incentive to pull out of the agreement when the guarantee is no longer necessary. Of the recapitalisation deals, only the interventions in KBC have a clear exit strategy as KBC can buy out the securities at any time for 115 to 150% of the issue price (depending on the timing). The Federal and Flemish governments have the right to an annual coupon of at least 8.5% or 120% of the dividend on normal shares in 2009, increasing to 125% in the following years. The payment is conditional on KBC paying a dividend (EC, 2008). The intervention in Ethias was approved by the European Commission on the condition that it is limited to a maximum of six months during which the government is to submit a restructuring plan by April 2009.

Box 1.1. **Government interventions in the financial market in response to the crisis** *(cont.)*

Table 1.2. **Capital injections of the Belgian governments in the financial sector**

Company	Cost (euro billion)	Details
Fortis (largest banking and insurance group in Belgium)	9.4 (Sept. and Oct. 2008)	In two steps, the Belgian federal government first acquired 49.9% and subsequently nearly 100% of the shares in Fortis Bank (and Belgian insurance activities).
	0.6	A stake in the Royal Park Investments defeasance special purpose vehicle (SPV) for the structural asset investments.
	5.0	Loans to Fortis holding and to SPV.
Dexia (third largest banking group in Belgium)	2 (Oct. 2008)	In coordination with the French and Luxembourgish governments and with a handful of institutional shareholders the Belgian governments recapitalised Dexia in return for newly issued standard shares (combined 11.5% of total Dexia shares). The federal government intervened with EUR 1 billion, Flanders EUR 0.5 billion, Wallonia EUR 0.35 billion, Brussels-Capital EUR 0.15 billion.
Ethias (second largest insurer in Belgium)	1.5 (Oct. 2008)	Recapitalisation in return for newly issued voting shares. Federal, Flemish and Walloon governments EUR 0.5 billion each, in return for blocking minorities of 25%.
KBC (second largest banking group in Belgium)	3.5 (Oct. 2008)	In return for newly issued non-transferable, non-voting core-capital securities of a total of 8.5% of KBC shares.
	2 (Jan. 2009)	Intervention similar to the one from October 2008 was conducted by the Flemish government alone. An option for an additional EUR 1.5 billion was made available for the next 5 years.
Total cost of interventions taken	**24.0**	Includes loans, all levels of government, realised interventions only.
In per cent of GDP	**6.8%**	
Increase in general government debt	**23.5**	
In per cent of GDP	**6.7%**	

Concurrently, as a response to the drying up of confidence on capital markets, the government also pledged to guarantee certain interbank loans and increase deposit guarantees. However, some of the interventions lack clear-cut exit strategies (Box 1.1). On the one hand the KBC recapitalisation incorporates incentives for the private sector to buy out the government shares and the guarantee schemes have a time limit, while on the other hand the Dexia recapitalisation and ownership in Fortis and more recently BNP Paribas have no explicit sunset clauses. Hence, despite government declarations that it does not intend to remain a player in the financial markets, it is not clear how and under what conditions it will be able to withdraw. Altogether, the interventions are expected to increase the public debt to GDP ratio by about 7% of GDP.[2] The long term impact on public finances is hard to assess, due to the uncertainty of the value of acquired assets, which will only become clear once the crisis subsides.

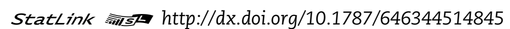
The European Central Bank reacted by lowering interest rates…

Monetary conditions became much looser in 2008 as the ECB lowered policy rates. Together with inflation accelerating the real short-term interest rate was reduced by more than 2 percentage points, bringing it close to zero (Figure 1.7, Panel A). Insofar as the surge in inflation is temporary, a more relevant measure for evaluating monetary conditions is

Figure 1.7. **Short term interest rate and Taylor rate for Belgium**

1. Taylor rate = 2 + CPI + 0.5 * (CPI – target (= 1.9)) + 0.5 * gap.
2. Taylor rate = 2 + PCORE + 0.5 * (PCORE – target (= 1.9)) + 0.5 * gap.

Source: OECD, *Economic Outlook database.*



core inflation. From this perspective, short-term interest rate developments have been in line with a simple Taylor rule, suggesting that monetary conditions were roughly neutral, especially towards the end of 2008 (Figure 1.7, Panel B). Looking forward, the widening output gap in the euro area may induce a further lowering of policy rates, which, together with relatively strong degree of inflation persistence, could further ease monetary conditions. On the other hand, the effects of the easier monetary conditions have been reinforced by lower nominal long-term interest rates, but somewhat less than in other euro countries. The long-term interest rate spread *vis-à-vis* Germany has widened from end 2007 to reach above 120 basis points in early 2009. It has since come down to a level of about 60 basis points (May 2009), significantly higher than the pre-crisis levels (Figure 1.7, Panel C). As argued below, the high and increasing public debt is likely to translate into a

high degree of persistence in the spread. Moreover, there is an overall muted pass-through from lower policy rates to lending rates, largely due to the grim outlook and low levels of confidence. As the economy shows signs of revival and as confidence increases, the effectiveness of monetary policy should be reinforced.

... while the government responded with fiscal stimulus

The federal government has adopted fiscal stimulus in two steps. The initial discretionary fiscal stimulus measures in the 2009 Budget amounted to 0.2% of GDP in 2009 and 0.3% of GDP in 2010. The second stimulus came in December 2008, when the government presented an additional fiscal stimulus package (*Plan de Relance*) which included new measures of around 0.5% and 0.4% of GDP in 2009 and 2010, respectively (Tables 1.3 and 1.4). The moderately-sized package focuses on relief for companies, supporting consumers' purchasing power and employment (the impact of these measures on fiscal sustainability is discussed in Chapter 2).[3] OECD calculations, using estimated fiscal multipliers for various types of government spending and revenue measures, show that the expected effect on Belgium GDP amounts to about 0.3% over the 2009-10 period. As a result, the general government deficit could reach 4½ per cent of GDP in 2009 and widen further thereafter (Table 1.5). With unchanged policies, the public debt to GDP ratio could reach 100% already in 2010.

Table 1.3. **Initial budget measures to stimulate the economy**

	2009 (million €)	2010 (million €)
Welfare adaptation of social benefits	291.5	570.1
Reduction of employee taxes	85	85
Other social benefits (for aged persons, heating, families, etc.)	200.5	249.4
Other measures	32.0	30.0
Total	**609.0**	**934.5**
Total as per cent of GDP	**0.2**	**0.3**

Source: Belgian government's own calculations.

The fact that the fiscal stimulus is being implemented alongside similar measures in other EU countries should boost its effectiveness. Nevertheless, there is a risk that, as the crisis unfolds, the government will come under pressure to implement additional fiscal stimulus. However, additional unilateral fiscal stimulus is likely to be much less effective than what has been already implemented. Fiscal multipliers are fairly low in a small open economy (OECD, 2009c). Moreover, the observed significant widening of the long-term interest rate differential *vis-à-vis* Germany has been estimated to be mainly driven by the widening public deficit, the increased cost of servicing public debt, and the long-term pension exposure (Haugh *et al.*, 2009a). Thus, it is likely that additional fiscal stimulus may be crowded out by the effects of higher interest rates (Figure 1.8). An additional crowding out effect may arise from higher private savings. International evidence shows that public debt levels above 75% of GDP, additional fiscal spending is to a significant part crowed out by higher private savings in the anticipation of higher future taxes (Berben and Brossens, 2007). In this light, the government should refrain from adopting an additional fiscal package, as the effectiveness of such a package is likely to be low.

Table 1.4. The federal government's fiscal stimulus package – *Plan de relance*

	2009 (million €)	2010 (million €)
Relief for enterprises		
Payment facilities for companies in financial difficulties	443.5	8.5
Reduction of labour charges in line with the AIP[1]	184.0	428.0
Changes to AIP support fund	44.4	45.1
Reduction of net charges for public enterprises	24.1	56.6
General reduction of withholding tax	233.0	590.0
R&D researchers withholding tax reduction	38.0	38.0
Abolition of credit insurance tax	15.0	15.0
Assuring employment and purchasing power		
Unemployment benefits for workers on reduced working time (*chômage temporaire*)	152.0	102.8
Restructuring measures	16.0	16.0
Electricity bill reductions	135.0	0.0
Investment in sustainable development		
Green investments[2]	18.8	52.5
Energy consumption reduction fund	9.0	9.0
Acceleration of public investment[2]	126.9	100.0
Measures for the construction sector	300.0	7.6
Total	**1 739.7**	**1 469.1**
Total as per cent of GDP	**0.5**	**0.4**

1. Inter-professional agreement.
2. A total of EUR 232 million over the following years, increasing.

Source: Belgian government's own calculations.

Table 1.5. General government financial balance

Percentage of potential/actual GDP

	2006	2007	2008	2009	2010
Current receipts	47.9	47.4	48.0	48.5	48.4
Current disbursements	47.5	47.1	48.9	52.7	54.0
Current receipts cyclically adjusted[1]	47.9	47.4	48.0	48.4	48.1
Current disbursements cyclically adjusted[1]	48.4	48.2	49.3	49.5	49.5
Current disbursements, adjusted and excluding interest charges[1]	44.3	44.3	45.5	45.8	45.8
A. General government balance	0.2	–0.3	–1.2	–4.6	–6.1
B. Net interest charges	3.8	3.7	3.6	3.8	3.8
C. Net primary balance (= A + B)	4.0	3.4	2.4	–0.8	–2.3
D. Cyclical component	0.8	1.0	0.4	–2.8	–4.0
E. Cyclically adjusted net primary balance (= C – D)	3.3	2.4	2.0	1.9	1.7
F. Non recurrent factors	0.8	–0.2	0.0	0.1	0.0
G. Structural net primary balance, net of one-off measures (= E – F)	2.5	2.6	1.9	1.9	1.7
H. Structural general government balance (= A – D – F)	–1.3	–1.1	–1.7	–1.9	–2.1

1. The cyclical- adjustment reparates cyclical influences on the budget balance resulting from the divergence between actual and potential output from those which are non-cyclical.

Source: OECD, *Economic Outlook database*.

Despite the government measures, particularly with respect to rescuing the major financial institutions, funding problems still persist. Loans to both households and non-financial corporations decelerated roughly in line with other euro area countries. The tightening of lending conditions since late 2008, which according to the Bank Lending Survey, came largely as a result of balance sheet constraints and liquidity problems was roughly similar to that in the rest of the euro area, while the amount of applications for new loans appeared to fall somewhat more rapidly in Belgium in early 2009.

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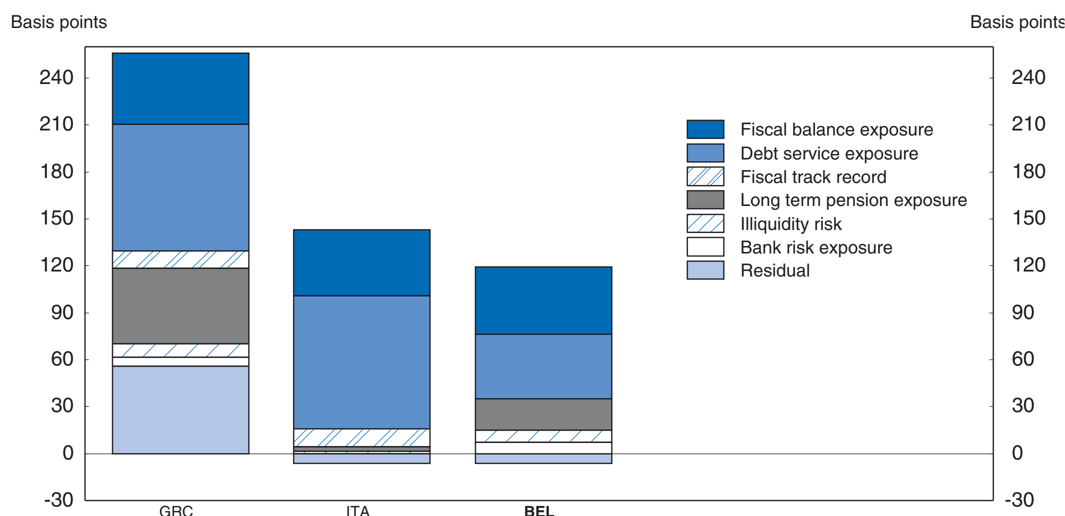
Figure 1.8. **Spread on 10-year-government bonds *vis-à-vis* Germany**[1]

March 2009



1. Components are defined as:
Fiscal balance exposure: Expected deficit in the following 5 years multiplied by a risk aversion measure.
Debt service exposure: Gross government interest payments divided by current government receipts multiplied by risk aversion.
Fiscal track record: Debt service multiplied by a track record index.
Long term pension exposure: Change in pension expenditure by 2050 multiplied by risk aversion.
Illiquidity risk: 1/ (share of the euro denominated long-term government securities market * risk aversion).
Bank risk exposure: Commercial bank exposure to central eastern European countries multiplied by risk aversion.

Source: Haugh, D., P. Ollivaud and D. Turner (2009), "What Drives Sovereign Risk Premiums? An Analysis of Recent Evidence from the Euro Area", *OECD Economics Department Working Paper,* forthcoming.

StatLink http://dx.doi.org/10.1787/646372562565

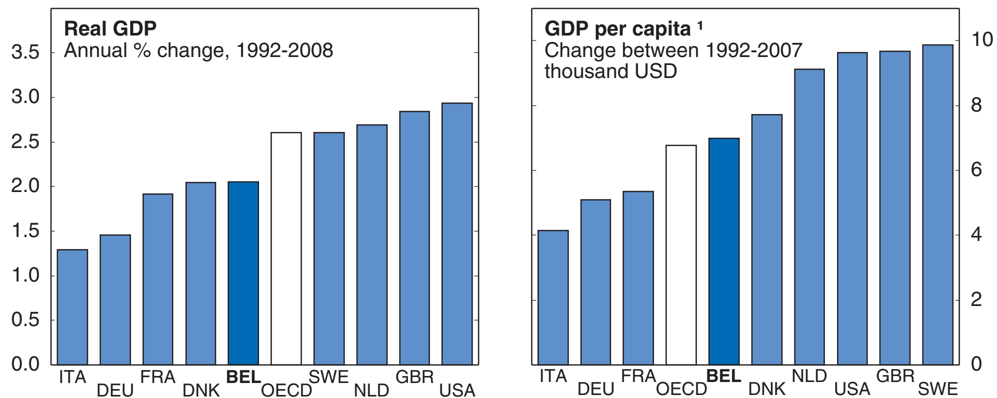
Nevertheless, the economic crisis is likely to be deep and prolonged

In sum, the crisis, which began as an external shock to the economy, is now spreading to most sectors in the economy, pointing to further economic contraction throughout 2009. Evidence from banking crises in other countries shows that such crises are associated with output losses that are typically two to three times greater than in other downturns, and the recovery back to capacity is at least twice as long (Haugh *et al.*, 2009b). Thus, despite the policy responses, the OECD Secretariat projects that the crisis will continue well into 2010, and the recovery will not suffice to prevent a further widening of the output gap before the end of 2010 and the return to full capacity is even further away (Table 1.1).

Improving potential growth depends on structural reforms

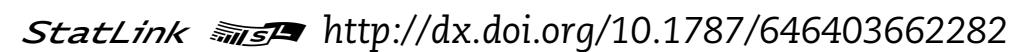
Over the past one and half decades, the economy has, on average, expanded at a slower pace than the OECD average and at the same pace as the euro area, and the expansion of income per capita has not matched the development in the high growth countries (Figure 1.9) (OECD, 2009b). Moreover, unemployment is at the same high level as in the early 1990s, in contrast with the falling unemployment observed in most other OECD countries. The main factors behind this development are a relatively weak productivity growth, a relatively slow expansion of employment (Table 1.6) and adverse developments in price competitiveness. Recent developments tend to confirm the weakening productivity performance described in the last *Survey*. Thus, the main challenges remain: improving productivity and employment growth, notably through an increased flexibility of the labour

Figure 1.9. **Growth of GDP and GDP per capita**



1. GDP in constant prices, constant purchasing power parities.

Source: OECD, *Economic Outlook database*.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market (discussed below), and assuring the sustainability of public finances (discussed in Chapter 2). The government has included these challenges in its objectives and has reconfirmed its determination to pursue relevant reforms. Political economy experiences drawn from OECD countries show that major reforms tend to be pursued in severe recessions (defined as the negative output gap exceeding 4%), which should increase the probability of implementing long term structural improvements this time around (Høj *et al.,* 2006).

Productivity growth has remained slow

As discussed in the previous *Survey*, the Belgian workers are among the most productive in the OECD, reflecting, among other factors, a specialisation in capital-intensive industries and relatively low employment of low-skilled workers. On this background, it is perhaps not surprising that productivity growth has been relatively slow compared with other countries, hovering just above 1% since 1995. On the other hand, other high productivity countries, notably the United States, experienced, in the same period, an acceleration in productivity. Decomposing labour productivity growth in Belgium since 1995 shows that the main driver has been capital deepening (particularly in the form of information and communication technology capital) and a modest contribution from the employment shift towards higher-skilled workers. On the other hand, there has been a negative contribution from total factor productivity (TFP), indicating a decrease in the overall efficiency in the combined use of labour and capital (Biatour and Kegels, 2008b). The observed slowdown in labour productivity can partly be explained by a composition effect, where the contribution from the manufacturing sector has fallen and that from the market services sector increased (Biatour and Kegels, 2008b).

The productivity performance at the sectoral level has been varied. Apart from the construction sector, developments have been relatively poor. In manufacturing, productivity growth has remained below most OECD countries and even more so compared with best performing countries (Table 1.6) and only one sector has performed better than its peers (Biatour and Kegels, 2008a). Developments in the service sector have been well below those in many other OECD countries. Particularly, the distribution sector's performance has been disappointing compared with the sectors in the more liberalised Anglo-Saxon and Nordic

Table 1.6. **Productivity growth in the OECD**

	Belgium	Germany	Netherlands	France	Italy	Spain	Sweden	Finland	United States	Czech Republic	OECD[4]
A. Growth decomposition, 1996-2006											
Average GDP growth	**2.2**	1.5	2.7	2.2	1.4	3.7	3.1	3.7	3.1	3.0	3.3
Of which:											
Productivity	**1.3**	1.1	1.3	1.4	0.2	–0.4	2.3	2.1	1.8	3.2	1.9
Employment	**1.0**	0.4	1.4	0.8	1.2	4.2	0.8	1.5	1.3	–0.2	1.4
Of which:											
Unemployment[1]	**0.1**	–0.2	0.3	0.1	0.5	1.1	0.4	0.9	0.1	–0.3	0.4
Labour force	**0.8**	0.5	1.1	0.7	0.8	3.0	0.4	0.6	1.2	0.1	1.2
B. Labour productivity growth, 1996-2006[2]											
Agriculture and forestry[3]	**1.4**	2.1	2.0	1.9	2.3	0.3	5.1	3.1	5.3	6.1	2.5
Total manufacturing	**3.1**	3.8	3.0	3.6	0.3	0.7	7.2	6.6	5.1	6.4	4.1
Chemicals and chemical products	**3.0**	5.5	5.6	5.9	0.4	–0.7	7.9	2.5	2.9	3.2	2.9
Motor vehicles, trailers and semi-trailers	**3.8**	3.0	…	3.3	0.8	…	8.9	4.8	…	9.8	2.6
Electricity, gas and water	**2.6**	3.3	3.2	2.9	3.5	2.5	0.4	4.3	2.7	1.0	2.8
Construction	**2.2**	0.3	–0.2	–0.3	–0.6	–0.5	–0.6	–1.3	–2.5	–1.9	–0.1
Total services	**0.8**	0.3	1.2	0.8	–0.1	–0.4	1.4	0.6	1.8	2.1	1.1
Wholesale and retail trade	**0.2**	1.3	2.7	0.6	–0.6	–1.1	3.7	2.8	3.1	5.6	3.1
Communication	**2.1**	3.1	4.7	4.5	2.6	0.4	3.3	4.2	4.2	2.8	3.2
Financial services	**5.3**	0.3	1.6	2.3	1.9	5.8	3.4	0.5	4.0	2.7	3.6

1. A positive sign indicates that unemployment has declined and contributed to boost output growth.
2. 1996-2005 for Sweden.
3. Including hunting and fishing.
4. Arithmetical average of available countries (AUS, AUT, BEL, CAN, CZE, DNK, FIN, FRA, GER, ESP, SWE, NOR, USA, NLD, HUN, KOR, LUX, ITA, ISL, IRL, PRT).

Source: OECD, *STAN database*, Edition 2008.

countries. However, as discussed in Chapter 5 a number of special factors may contribute to this development. In particular, the retail sector is subjected to more sector specific regulation than in most other countries, which, combined with strict zoning and opening hour regulations, have prevented a restructuring towards larger shops that can exploit economies of scale and scope. Similarly, insufficient competition burdens the performance in the communication sector, where the dominant position of the incumbent has prevented the sector from enjoying leaps in productivity similar to those observed in most other countries. Empirically, OECD studies show that relatively tight market regulation has a disproportionately large negative impact on growth in the ICT-using sectors and hinders the allocation of resources towards the most dynamic and efficient firms (Arnold *et al.*, 2008). The only well performing service area was the financial services sector; however, it is difficult to imagine that the sector can maintain such a strong performance in the present circumstances. Thus, as discussed in detail in Chapter 5, there are large potential gains for individual sectors as well as for the economy as a whole from reducing the relatively strict regulation and allowing competitive forces to work.

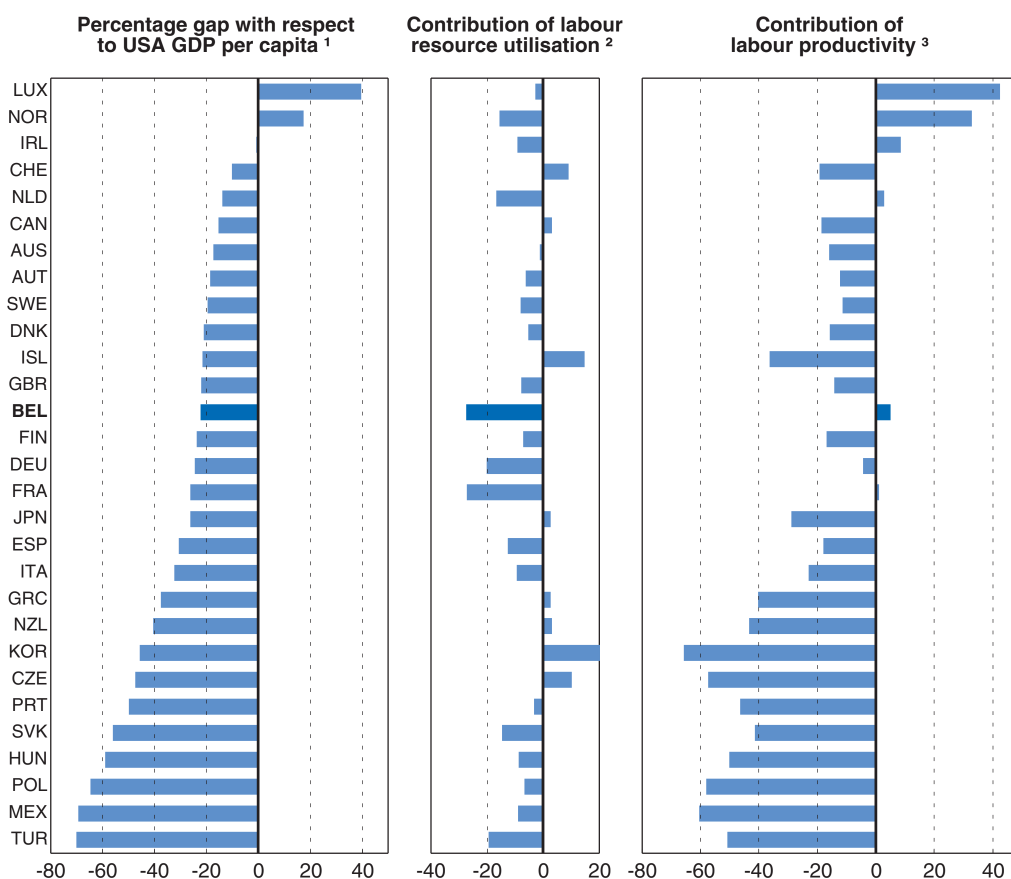
Labour utilisation is low

Despite the internationally high level of productivity, Belgian average real incomes are about 20% below the level in the United States as labour utilisation is among the lowest in the OECD (Figure 1.10 and Figure 1.11). This reflects internationally high unemployment levels and low average working hours. The latter are negatively affected by high marginal tax rates that depress hours worked of low-skilled females (see also Chapter 4), while for males, international evidence indicates that the more important negative effect comes from employment protection for workers on regular contracts (which is not particularly strict in Belgium) and, more importantly in Belgium, competition-restraining product market policies (Causa, 2008). A common negative factor for both sexes is the relatively strict working-time regulation. The labour market participation rate for younger workers has been depressed by strict employment protection legislation for workers on temporary contracts and for older workers by the numerous pathways into early retirement as described in the previous *Survey* (Figure 1.12). In addition, slightly less than one-third of the employment rate gap *vis-à-vis* the United States can be explained by the differences in population structure, particularly lower education attainment and the share of prime-age persons in the working-age population in Belgium (Boulhol, 2009).

The strong employment growth in the past couple of years did not benefit all

The two years preceding the onset of the crisis saw historically strong employment creation. The jobs were mostly created in the rapidly expanding construction and services sectors – particularly the financial sector – whereas the workforce in manufacturing continued to shrink. The first signs of a weaker labour market started to emerge during the autumn 2008 as the number of workers on reduced working time began to increase. The registered unemployment rate only shot up at the very end of the year and was concentrated in Flanders and, to a lesser extent, in Brussels. Part of this good performance of the labour market can be explained by the enhanced emphasis on active labour market policies, as described in the previous *Survey*. This has manifested itself in a sharp increase in the number of sanctions issued for insufficient job search efforts, contributing to similar declines in unemployment for workers with different educational attainment, and was particularly successful in lowering youth and long-term unemployment. Unemployment among older workers continued to

Figure 1.10. **The source of real income differences, 2007**



1. Based on current purchasing power parities and current prices. For Luxembourg, the population is augmented by the number of cross-border workers in order to take into account their contribution to GDP.
2. Labour resource utilisation is measured as total number of hours worked divided by population.
3. Labour productivity is measured as GDP per hour worked.

Source: OECD (2009), *Going for Growth*.

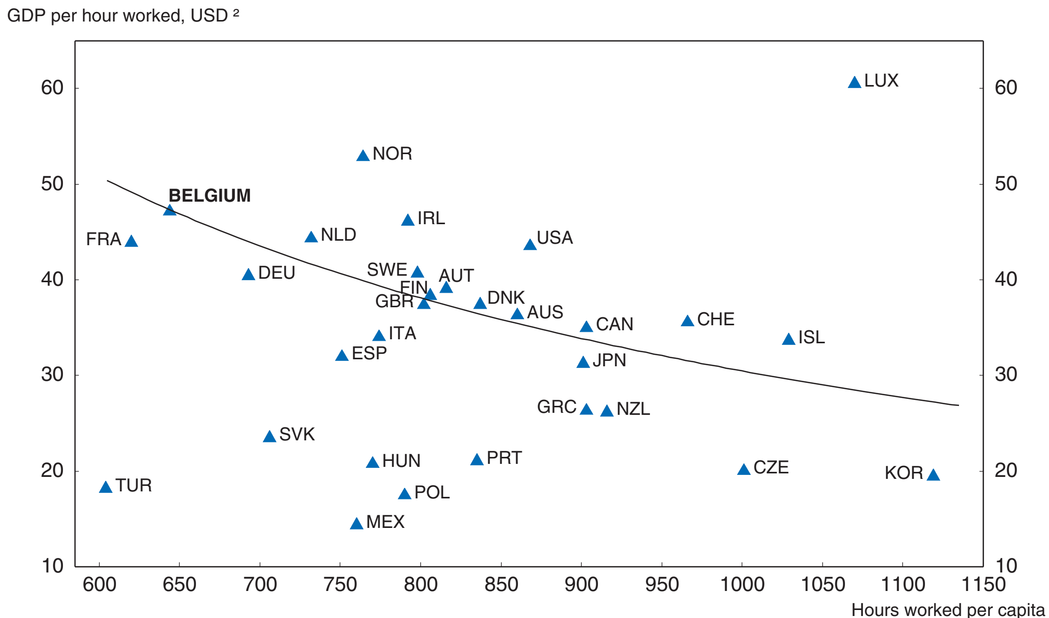
StatLink http://dx.doi.org/10.1787/646442513842

increase, reflecting, among other reasons, their exemption from the activation measures and the reintroduction of the obligation for older workers to remain available on the labour market (this obligation for long-term unemployed has been suspended since mid-2007). Despite this progress, both high unemployment and low labour market participation remain important issues for young, unskilled and older workers, pointing to the need for pursuing additional labour market reforms (Table 1.7 and Figure 1.12). Thus, the planned earlier activation (after 6 months for young unemployed and after 9 months for others) should be implemented, but the measure should applied sooner and include older unemployed as recommended in the last *Survey* (see also Annex Table 1.A1.1).

The falling unemployment in 2007-08 seems to mostly reflect business cycle developments. Changes in the main policy drivers of the structural unemployment suggest that it has remained stable around 8% over the past couple of decades (Gianella *et al.*, 2008). These drivers are the tax wedge, the unemployment benefit replacement rate, union density and the level of product market regulation, and of these, only product market regulation has been slightly eased, suggesting only a minor decrease in the structural

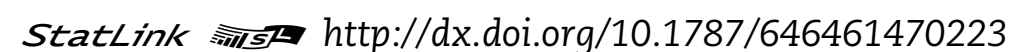
Figure 1.11. **Labour utilisation and productivity**[1]

2007



1. The curved line running through Belgium represents contributions of labour utilisation and productivity that correspond with the same level of GDP per capita.
2. GDP in constant prices in US dollars using 2000 purchasing power parities.

Source: OECD (2009), *Productivity database*, March.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unemployment rate, although the effect could be strengthened somewhat by the improvements in the general competition policy framework (see Chapter 5). Looking ahead, there is a risk that the structural unemployment increases. The expected swell in unemployment will boost the number of long-term unemployed, which eventually translate into larger structural problems. Such a development can only be countered through continued structural reform.

Wage inflation will be relatively high despite the sharply deteriorating labour market

Wages rose faster than expected in 2008, as the automatic wage indexation mechanism triggered in many sectors three indexations of 2% during the year and to a lesser extent because the tightening labour market induced some wage drift. The collective wage agreements for 2009 and 2010 are likely to result in very modest real wage increases.[4] Somewhat unusually, wage increases are expressed in absolute terms, allowing a maximum increase of EUR 250 for the two year period of which EUR 125 may be granted in 2009.[5] If the maximum amount is granted in all sectors, then the impact on labour costs should be ½ per cent over the two year period. This impact on total wage costs, however, will be offset by the central wage agreement's provisions for allowing employers to keep part of the withheld income tax, whereby employers deduct the full amount of the payroll tax from wages and only transfer, corresponding to the relevant reductions, a part of the payroll taxes to the public treasury.[6] The provisions include:

- The reduction in withholding tax for shift and night worker will be increased from 10.7% to 15.6% in 2010.
- The amount of overtime benefiting from a reduction in charges will be doubled to 130 hours in 2010.

Figure 1.12. **Labour participation rates for selected groups**

As a percentage of working age population

A. 15-24 year-olds

B. 55-64 year-olds

C. By educational attainment: contributions to 25-64 year-olds labour participation rate

Tertiary education
Upper secondary education
Less than upper secondary education

Source: OECD (2009), *Labour Force Statistics database.*

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- The general reduction in withholding tax granted to all firms will be tripled to 0.75% on 1 July 2009 and increased further to 1% on 1 January 2010.
- The agreement also stipulates higher unemployment benefit for workers with forced reduced working time, which does not affect total wage costs.

Nominal wage increases may be higher than the ½ per cent. In some sectors, their automatic wage indexation mechanism may lead to other indexations over the wage agreement period, depending on price developments. The price adjustment will be higher than the increase in the headline inflation as the indexation mechanism uses the so-called health index (consumer price index excluding transport fuels, tobacco, and alcohol). Moreover, the very modest real wage increases in the wage agreement do not recuperate past losses in external competitiveness (an accumulated to 4.1% over the period 1996-2008

Table 1.7. **Unemployment by characteristics**

In per cent of working-age population

	2003	2004	2005	2006	2007	2008	2009 Q1[1]
By gender : total population							
Men	7.4	6.6	7.4	7.8	6.7	6.6	6.8
Women	8.0	8.3	9.0	9.0	8.7	7.5	7.7
By age							
15-24 years	19.0	17.5	19.9	18.9	19.2	17.2	18.5
25-54 years	7.0	6.6	7.2	7.5	6.8		
55-64 years	1.7	3.6	4.4	5.4	3.8		
By education level – 25-64 years old							
Less than upper secondary level	10.7	11.7	12.4	12.3			
Upper secondary level	6.7	6.9	6.9	6.7			
Tertiary level	3.5	3.9	3.7	3.7			
By birth status							
Foreign-born	18.2	14.9	17.1	17.3	16.4		
Native-born	6.9	6.4	6.9	7.0	6.4		
Total	**7.7**	**7.4**	**8.1**	**8.3**	**7.6**	**6.3**	**7.2**

1. Belgostat data.

Source: OECD (2008), *OECD Employment Outlook*; OECD (2008), *Education at a Glance*; OECD (2006, 2007, 2008, 2009), *International Migration Outlook*.

according to the benchmark in the 1996 law on promotion of employment and safeguarding of competitiveness). There is a risk that these losses will further increase as the automatic wage indexation puts a lower floor on nominal wage increases, whereas other OECD countries have more flexible wage formation processes and thus faster wage responses to negative labour market developments. Thus, as stipulated in the previous *Survey*, there is a need for the social partners to consider phasing out the wage indexation system to increase real wage flexibility. Moreover, the sector level wage determination forces individual firms to adapt to shocks through an adjustment of their workforce, in the process exaggerating the cyclical development in unemployment (Fuss and Wintr, 2009).[7] More flexible wage determination at the firm level can address this problem. This can be introduced in the current wage determination system by making the use of existing opt-out rules dependent on an approval of the firm and its employees rather than the present approval requirement from the sectoral joint committee (see also previous *Survey*).

Challenges facing the Belgian economy

The economy is expected to grow below potential until late 2010, though possibly even further if a recovery in world trade fails to materialise. Thus, in the short-term the economic imbalances, such as unemployment and general government deficit, will continue to widen. Within this unfavourable setting, the government has to formulate policies to counter the effects of the recession as well as to enhance the economy's potential growth rate. The key challenges in this respect are the following:

- **Restoring fiscal sustainability.** By 2010, the public-debt-to-GDP ratio will be close to 100% of GDP, which is about 25% of GDP more than stipulated in the 2008 Stability programme. Shortly thereafter, ageing related costs will start to increase more sharply. Thus, a major challenge for the Belgian government is to restore fiscal sustainability. This is discussed in Chapter 2.

- **Securing fiscal sustainability requires a reform of the fiscal federalism system.** The federal government's main spending responsibilities are to service public debt and the social security system, implying that most of the increase in ageing related costs falls on the federal government. At the same time, the revenue sharing system is such that the federal government in the past has had the slowest growing revenues. Thus, under the current fiscal federalism arrangements the federal government alone cannot assure the strategy to prefund the rising ageing cots. These challenges are discussed in Chapter 3.
- **Making the tax system more conducive to growth.** The main hindrances in the tax system to faster growth are that the large tax burden on labour distorts labour participation decisions and that the allocation of capital is distorted by the large variation in the taxing of saving vehicles, both contributing to reduce potential growth. These challenges are discussed in Chapter 4.
- **Enhancing growth through more intense competition.** More intense product market competition puts pressures on producers to innovate production and products, boosting productivity growth and consumer welfare. Despite recent improvements in the general competition framework, numerous regulations and strong incumbents in network sectors still dampen competitive pressures. This challenge is addressed in Chapter 5.

Notes

1. Other factors are also important in determining the international competitiveness of a country. For example, it is difficult to believe that the collapse in Belgium's international diamond trade can only be explained by the deterioration in unit labour costs.
2. Part of the Flemish Regional governments' interventions will be financed through a decrease in their financial assets.
3. This excludes the indexation of personal income tax brackets in 2009 which was labelled by the government as a fiscal stimulus measure. The indexation has been argued to constitute more of a structural measure. If this was to be included the total size of the fiscal stimulus for 2009 would be 1% of GDP. Moreover, the earlier payment of government invoices is also excluded as this is mainly a liquidity measure, with no consequences for accrual accounts.
4. The Belgian wage setting system is best characterised as a highly coordinated on the sectoral level, where only about a quarter of all firms have wage agreements concluded as the firm level (Druant *et al.*, 2008). The system has become slightly more flexible as age based wage increases have been replaced by a system where pay grade schemes are based on competence or seniority, following an EU court ruling that age based wage systems are discriminatory.
5. The wage increases would take the form of a widening of tax-exempt wage components (*e.g.* lunch vouchers), implying a total revenue loss of EUR ¾ billion over the two year period. The agreement also contained a provision for increasing unemployment benefits for workers on reduced work time arrangement, implying a total revenue loss of another EUR ¾ billion over the two-year period.
6. To avoid that the reductions lead to higher net wages, the employers have to deduct the full amount of the payroll tax (tax on earned income) and then, corresponding to the relevant reductions, only pay a part to the public treasury. In terms of the national account standards (ESA95) the unpaid part is recorded as a subsidy and not a direct reduction in labour charges. As a result, in the national accounts these measures will not influence labour costs nor the competitiveness of Belgian firms as defined in the 1996 law on promotion of employment and safeguarding of competitiveness (which is behind the set-up of the wage agreements) despite their potential improvement of competitiveness. For example, the reduction for shift- and night work carries an average fiscal cost per year of about EUR ½ billion.
7. The authors also find that the sluggish wage response in the services sector can be related to the observed higher price stickiness for services than for other goods. The rigid real wages in Belgium is party confirmed in another recent empirical work (Messina *et al.*, 2008).

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ANNEX 1.A1

Table 1.A1.1. **Progress in structural reform**

Past recommendations	Actions taken and current assessment
A. Fiscal policy	
Raising available prefunding resources to secure long-term fiscal sustainability.	Commitments to build up structural surpluses laid down in the Stability Programme (since the December 2000 update) never materialised. Moreover, budget slippages have appeared since 2007. The government now aims at restoring a balanced budget by 2015.
Supplement the prefunding strategy by lowering future pensions cost by reducing the pension replacement rate and by increasing the effective retirement age.	The 1996 reform to equalise the legal retirement age for women with that of men (65) was finalised in 2009. In 2008, access to early retirement pension schemes was limited to people 60+ with a career spanning 30 and 26 years for males and females, respectively – to be increased to 35 and 28 years by 2012. Early retirement at the age of 58 requires longer work life career.
	Additional measures to discourage early retirement include: companies have to make other options available and contribute to the costs of early retirement; "time credits" for non-work activities were reduced; lower implicit taxation through a "work resumption supplement" for over-50s; reduced employers' social security contribution for elderly low-income workers; in Flanders, an employment premium for hiring elderly workers was introduced.
	The EU Directives on discrimination (in particular age-related pay) have been implemented in May 2007 and became effective in wage contracts from 2009.
To avoid disruptive changes in federally funded programmes, fiscal consolidation needs to take place at all levels of governments.	No action taken.
Establish an expenditure rule for all levels of government to cap growth of general government spending.	No action taken.
Spending restraint should focus on public employment in health care spending.	The 2009 Budget includes a 1% linear saving in federal government employment; as a result a total of about 5 000 retiring public servants will not be replaced.
Improve the current co-ordination framework for fiscal consolidation	No action taken.
Each level of government should have a set of clear and binding fiscal objectives with appropriate feed-back mechanisms.	A new political dialogue structure has been set up in 2008 in order to discuss and improve the allocation of competences between the federal State, the Communities and the Regions.
Alternatively, taxation powers should be realigned with spending obligations.	No action taken.
Broaden the tax base by phasing out costly and distortive tax expenditures and by expanding labour market participation.	The government aims at widening the tax base through increasing labour market participation (see above).
	In 2008, the exemption from personal social security contributions for minimum salary workers has been increased from EUR 143 to EUR 175 per month.
	Enhancing current activation policies (*e.g.* mobility bonus for commuters) is under discussion.
	The economic recovery plan temporarily reduced VAT rates for the construction sector.
The fiscal norm should be refocused on the structural balance for the general government (defined as excluding one-off measures).	In the 2009-2013 Stability Programme the government stipulated reaching a balanced budget in both nominal and structural terms by 2015 or a comparable time span (depending on economic growth).

Table 1.A1.1. **Progress in structural reform** *(cont.)*

Past recommendations	Actions taken and current assessment
B. Labour market policies	
Unemployment benefits should be phased out with unemployment duration, perhaps requiring higher initial net replacement rates.	Unemployment benefits for the initial periods of unemployment have been raised starting January 2009.
The activation measures should include workers over 50 and earlier monitoring of young school leavers receiving the *allocation d'attente*.	In both Flanders and Wallonia, numerous new incentives have been implemented to stimulate job search and mediation for younger unemployed.
	Since 2008, Flemish school leavers that become unemployed will be offered earlier intervention, such as job mediation and job counselling.
	Employers hiring older workers may receive an annual premium of EUR 400-1 000 during the first year. An additional subsidy is offered to companies that engage in a diversity plan that includes older employees.
	In 2008, the Flemish government and the social partners established in a declaration "Together for 50+" the following pillars for increasing the employment of older workers: career guidance, job mediation, premiums for hiring older workers, and screening.
Better coordination of the public employment services to improve the effectiveness of activation measures.	In 2007, the regional PES created "Synerjob" to enhance cooperation and mobility between regions.
	In 2008, an "interregional job summit" discussed progress and ways forward.
Continuous education should be encouraged to reduce skill mismatches. Training and continuous education needs to be supported further, in particular through enhancing the supply conditions for vocational training.	In Flanders, measures have been taken to expand and improve workplace training in secondary and higher education as well as in vocational training. New legislation on adult education (modular system, e-learning) is being passed. The budget for training vouchers has been expanded. Additional measures in 2009 include the introduction of "Professional Higher Education" (post secondary education); strengthening of the recognition of acquired competences and career guidance for employees; and the implementation of the "European Qualifications Framework".
Improve employment rates of groups with weak labour market attachment	
Reduce effective marginal effective tax rates to increase labour supply and lower structural wage pressures.	Personal income tax brackets were indexed in 2008.
	Social security contributions for low wage employees were reduced in April 2007 and October 2008.
	In Flanders, the targeted tax reduction of EUR 125 to low-wage workers was increased to EUR 200 and generalised to all workers. In 2009, the allowance was increased to EUR 250 (EUR 300 for low-wage workers)
All wage subsidies and reductions of social security contributions should be targeted to low-wage earners to avoid substitution effects between different support schemes. Other reductions of social security contributions should be phased out.	The April 2007 flat cut in employers' SSC cuts for elder workers has a bigger impact on older low-income earners than on older high-income earners.
	The 2008-09 wage agreement increased the wage subsidy for overtime, night and shift workers, researchers as well as for all workers. The social partners agreed on the gradual dismantling of social security reductions in favour of target groups (such as long-term unemployed, low-qualified young workers and older workers) in order to increase the structural reduction in contributions, in particular for low wage earners. The implementation of this agreement is blocked by the Flemish parliament. The government expects to implement this law in 2010.
Early retirement schemes should be phased out more rapidly and the existing exit routes should be closed.	No action.
The authorities should consider adjusting the legal retirement age with increases in life expectancy.	The programme to realign the female legal retirement age with the 65 years in place for men was completed.

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Table 1.A1.1. **Progress in structural reform** *(cont.)*

Past recommendations	Actions taken and current assessment
Increase sensitivity of wages to local conditions	
The centralised wage bargaining system should be revised to allow wage developments to reflect local labour market conditions. As a minimum this requires abolishing wage indexation. Moreover, wage increases should only be subject to negotiations on the firm level. In addition, the use of opt-out rules should be facilitated.	A guideline in the 2007-2008 collective wage agreement encourages increased use of "correction mechanisms" (*e.g.* all-in provisions), which may allow that higher than expected indexation is deducted from agreed real wage increases or even stating that an agreed nominal collective wage increase (including expected indexation) is fixed.
C. Tertiary education	
Introduce tuition fees that are high enough (*i.e.* to partial cost-recovery levels) to become an important source of financing for tertiary education institutions.	No action taken.
Accessibility should be secured through the introduction of income-contingent student loans.	No action taken.
The introduction of a screening system to matching students' capabilities with the demands for tertiary education.	No action taken.
All institutions should be obliged to publish relevant information concerning the provided quality of education and future labour market prospects.	The French community has made it mandatory to disseminate such information.
D. Financial markets	
Measures favouring the cross-selling of products by bancassurance conglomerates	
Abolishing the explicit regulation allowing tying of a mortgage interest rate reduction and the purchase of certain insurance products.	No action taken.
The competition authorities should assess if current cross-selling practices are in line with competition principles.	No action taken.
Measures to facilitate households' access to credit	
Modernise home equity withdrawal legislation.	No action taken.
Reduce the real estate transactions costs to stimulate the market for mortgages.	Walloon Region: Registration tax for sales of houses by a person benefiting from the premium for the acquisition of a house has been set at zero.
	Flemish Region: The maximum reduction in taxes on house transactions was raised in 2007.
	As from January 2009 an additional abatement for acquisition of family house or grounds for building a family house on which a mortgage is to be concluded.
	The Flemish government established a committee to monitor the effectiveness of these measures.
Introduce legislation on mortgage bonds (covered bond legislation).	No action taken.
The lengthy foreclosure period of non-performing loans should be lowered to comparable levels in other countries.	No action taken.
Caps on early repayment fees should be cost-based to allow creditors to charge a fair and objective fee to compensate the loss.	No action taken.
Regulation of adjustment caps on interest rates should be phased out and left to individual decisions.	No action taken.
Evaluate and possibly reform the interest rate grid on consumer credit.	A revision of the Consumer Credit Act is foreseen.
Promote the principle of "full harmonisation" of the EU consumer credit directive with a minimum of national legislation.	A draft revision of national legislation is under discussion.
Measures to facilitate households' access to credit	
Promote consumer information and financial literacy.	The financial supervisor (CBFA) and the Ministry of Economy have been conducting policy information campaigns. A CBFA report on the state of financial education, including proposals for action, was sent to the government.

Table 1.A1.1. **Progress in structural reform** *(cont.)*

Past recommendations	Actions taken and current assessment
Tax treatment of households' financial transactions	
Tax domestic savings accounts at the same rate as those applied to intra-EU cross-border deposits.	No action taken.
Tax deductibility granted to mortgage loans should be re-evaluated against its original goal of home ownership and restricted to the interest component.	No action taken.

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Chapter 2

Securing fiscal sustainability during the economic downturn and beyond

The current crisis is undermining the fiscal position while the increase of costs of ageing is expected to start accelerating substantially in the coming years. Thus, the room for discretionary fiscal policy to support the economy is limited and the effectiveness of unilateral stimulus measures beyond those already adopted is constrained. However, such short-term measures provide an opportunity for introducing long-term structural reforms as part of the package. The fiscal consolidation efforts, supported by relatively high GDP growth and low interest rates on public debt during the past years, have recently faltered and the objective of generating increasing surpluses has become unrealistic in the medium run. Looking forward, the main challenge for fiscal policy is to devise a realistic and credible path towards fiscal sustainability. With a weaker than earlier expected role for prefunding, renewed efforts to control the growth in ageing related costs should include a pension reform. Significant institutional reforms can help improve the credibility of future commitments.

The current strategy toward fiscal sustainability needs to be revised

The government needs to revise its pre-funding strategy for securing fiscal sustainability through generating increasing surpluses in order to reduce the high public debt-to-GDP and thus free up resources to finance the costs of ageing (as laid down in the Ageing Law and described in Stability Programmes). The current crisis is significantly widening Belgium's sustainability gap. Prior to the crisis, the sustainability gap in Belgium was above the average in euro area countries and the relative position has deteriorated since previous assesments. Estimates from the European Commission show that maintaining fiscal sustainability (*i.e.* financing ageing related costs without abrupt spending cuts or tax increases) requires a primary surplus of 6.3% of GDP during 2012-2016 (EC, 2008). However since then, the starting point for the primary fiscal balance has deteriorated, which leads to a significant worsening of the sustainability gap estimates. Moreover, previous estimates were based on macroeconomic assumptions that may no longer be relevant. Potential growth was assumed to fall on the back of an ageing population, but also to be sustained by higher labour productivity and higher participation rates. However, if the current crisis turns out to have a long-lasting negative impact on the functioning of the economy – especially if the government does not succeed in maintaining growth-oriented policies during the current downturn (Chapter 1) – the assumptions on productivity growth and higher participation rate will prove unrealistic and the sustainability gap estimates could deteriorate further (Box 2.1).

A new strategy for securing fiscal sustainability needs to be credible. Accordingly, it should avoid fiscal stimulus measures that will lead to a structural deterioration in the fiscal balance and, in case this is not possible, offset the negative impact of such measures by implementing policies that will eventually have a positive impact on the structural fiscal balance. If these requirements are fulfilled, new fiscal measures will support the economy during the downturn without putting the sustainability of public finances at risk in the medium term. The government should aim at supplementing the pre-funding strategy by reducing the burden of ageing, primarily through more ambitious pension reforms. It should also strengthen the credibility of a new medium-term strategy by accompanying it with stronger fiscal rules and a larger role for external experts. Finally, the institutional arrangement between the federal and the regional levels of government should be revised in a way that preserves, or even improves, fiscal sustainability, as discussed in Chapter 3.

Short-term fiscal measures should not be detrimental to long-term sustainability

As discussed in Chapter 1, the government has adopted fiscal stimulus measures in order to support the economy during the crisis. However, some of the adopted measures may further undermine long-term fiscal sustainability, as they are permanent and not accompanied by a sunset clause that would automatically withdraw the measure once fiscal stimulus is no longer necessary (Box 2.2). Permanent or likely permanent measures

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Box 2.1. **Ageing costs and sustainability gaps remain daunting**

According to the most recent study of the Study Committee for Ageing (June 2008) the net cost of population ageing will increase by 6.3% of GDP from 2007 to 2050 – an estimate that is in line with that of the European Commission (Table 2.1 and HCF, 2008). On the other hand, OECD calculations indicate that ageing related increases in health costs could be larger (see previous *Survey*).

Table 2.1. **Budgetary costs of ageing**

In per cent of GDP

	New projections, June 2008				
	2030 level	2050 level	2007-13 change	2007-30 change	2007-50 change
Entity I (Federal government and social security)					
Pensions	12.1	13.0	0.7	3.5	4.5
Of which pensions of Entity II	2.0	2.2	0.3	0.8	1.0
Health costs	8.1	9.6	0.8	1.9	3.3
Other social and work related expenditure	5.2	4.6	–0.1	–1.1	–1.5
Total	**25.3**	**27.3**	**1.6**	**4.3**	**6.3**
Entity II (regional and local governments and communities)					
Pensions	2.2	2.5	0.3	0.8	1.1
Of which charged to Entity I	–2.0	–2.2	–0.3	–0.8	–1.0
Costs of health and social aid	0.7	0.7	0.0	0.0	0.0
Other social expenditure	0.7	0.7	–0.1	–0.1	–0.1
Total	**1.6**	**1.6**	**–0.1**	**0.0**	**–0.1**
Total (Entity I and II)	**26.9**	**28.9**	**1.5**	**4.3**	**6.3**

Source: High Council of Finance (2008), *Annual Report.*

A usual way of assessing sustainability of public finance is to estimate the permanent adjustment of fiscal revenues necessary to achieve sustainability, the so-called tax gap or "sustainability gap". These gaps come in different versions. The European Commission calculates a sustainability gap – the so-called S2 indicator – which shows the difference between the primary balance required in order to meet the criterion for sustainable fiscal policy over the infinite period – equating the current value of debt and future discounted values of primary surpluses – and the actual structural primary balance. In 2007, the sustainability gap was estimated to be 3% of GDP (EC, 2008). However, the primary balances have since then deteriorated, and the accumulating public debt is also raising the required primary balance. Thus, with the 2008 structural primary balance at about 1.8% of GDP (Stability Programme, 2009), new estimates of the sustainability gap exceed 4% of GDP. Looking forward, with the assumption of unchanged policies, the sustainability gap is likely to exceed 7% of GDP by 2011. In addition, deviations in the macroeconomic assumptions could further increase the sustainability gap. Sensitivity scenarios by the European commission show that a permanent decrease of labour productivity by 0.25 percentage point increase the tax gap by 0.3 percentage point; a decrease of the total employment rate by 1 percentage point would increase the tax gap by the same amount.

include those taken in the context of the wage agreement, some of the energy subsidies, the general reduction of labour charges and the additional reduction for night and shift workers. On top of their (quasi) permanent nature, a number of these measures do not

appear timely (some public investments will be implemented with a considerable delay) or well targeted to households and companies most affected by the crisis (most of the energy subsidies will affect all households, the general reduction of labour charges will affect all employers and the additional reduction for night and shift workers, aimed at assuring competitiveness of exporting industries will also affect workers in domestic-oriented sectors). Also, some measures, such as the higher benefits for workers on reduced working time (*chômage temporaire*) or energy subsidies, will dampen the incentives for structural adjustment or harm attempts to meet environmental objectives.

Box 2.2. **Fiscal stimulus measures in response to the crisis**

The discretionary fiscal stimulus measures adopted by the government in response to the unfolding crisis concentrate mainly on sustaining purchasing power, employment, and supporting enterprises. More specifically, the fiscal actions are oriented at:

- Relief for enterprises:
  - Facilitating credit access and the abolition of the tax on credit insurance.
  - Measures to improve the liquidity of companies in financial trouble, including possible deferral of tax payments, reduction of penalty interest rates, and faster VAT refund on behalf of the government.
  - Measures intended to compensate companies for the rise in salaries, agreed upon in the inter-professional agreement: reduced taxes and charges including wage subsidies implemented through a reduction of withholding taxes paid by companies (both general subsidies and specific subsides for the employment of night, shift and R&D workers) and a tax reduction for overtime.
  - a reduced VAT rate for a number of construction activities.
- Guaranteeing employment and purchasing power:
  - The increase of: benefits for workers on reduced working time (*chômage temporaire*); certain professional deductions; pensions for employees and self-employed, social benefits (*enveloppe bien-être*). Introduction of an electricity bill subsidy.
  - Measures oriented at facilitating job-seeking for workers subject to restructuring.
- Investing in sustainable growth:
  - Additional funds for environmentally friendly investments to reduce energy consumption, including investments in public buildings, accelerating a number of infrastructure projects.
  - The government also included the improvement of export financing facilities under this heading.

Furthermore, in late 2008, the regional governments have announced their own limited fiscal stimulus packages. Both the Flemish and Walloon plans are to focus on facilitating credit access, some labour market policy initiatives and measures to accelerate public investments. The costs of these investments are to be financed through public private partnerships. The Flemish government decided to add a second stimulus package in January 2009.

In this light, the government should, as a priority, implement scenarios for phasing out the stimulus measures as soon as they are no longer necessary. If the government is determined to introduce further fiscal stimulus, it should simultaneously incorporate measures improving fiscal sustainability over the medium term. For example, packaging

short-term stimulus together with compensatory long-term structural improvements may take the form of combining a rise in unemployment benefits with a restriction in their duration and an increase in their regressivity. Such accompanying measures will create more dynamic job search incentives once the crisis subsides – hence fostering growth and alleviating sustainability issues in the long term – without damaging the immediate discretionary fiscal support to the economy.

Postponing fiscal consolidation will shift the ageing cost burden to younger generations

As a result of the fiscal response to the crisis, the fiscal deficits have widened further. The High Council of Finance (HCF) has recently estimated that the general government deficit in 2009 will reach 3.5% of GDP and, with unchanged policies, will rise to 5.1% of GDP in 2011, which is 6 percentage points below the government's target as presented in the previous Stability Programme (Stability Programme 2008 and Table 2.2). OECD projections are more pessimistic with projected deficits of around 4.5% of GDP in 2009 and above 6% of GDP the following year (OECD, 2009). The path back to a balanced budget has *de facto* been significantly shifted away. The HCF calculated that, under unchanged policies, a significant tightening of 1.1% of GDP per year starting already in 2010, would be necessary to achieve a fiscal balance by 2013 (HCF, 2009). In response to the aggravating problem with the sustainability of public finances, in April 2009 the government presented an updated Stability Programme, which stipulates a more gradual adjustment to achieve a fiscal balance by 2015, in accordance with an alternative HCF scenario. The government's plans condition the consolidation in a given year on real GDP growth, but so far no details have been given on how the consolidation will be achieved. Therefore the next step should be to design concrete measures, starting in 2010 and at all levels of government, to achieve this objective. If this consolidation path is to be reached without an increase in taxes, it would require the government to at least stabilise expenditures in real terms, which is an ambitious task given the average (structural) real primary expenditure growth of about 2.5% in the period 2002-2008.

Table 2.2. **Medium-term fiscal balance paths**

	2008	2009	2010	2011	2012	2013	2014	2015
	Per cent of GDP							
Previous strategy (SP 2008-2011)	0.0	0.3	0.7	1.0	...	...	...	...
HCF unchanged policies scenario	–1.1	–3.5	–4.4	–5.1	–5.1	–4.9	...	...
Proposed strategy (equilibrium in 2013)	–1.1	–3.5	–3.4	–2.8	–1.5	0.0	...	...
April 2009 Stability Programme targets (equilibrium in 2015)	–1.2	–3.4	–4.0	–3.4	–2.6	–1.5	–0.7	0.0

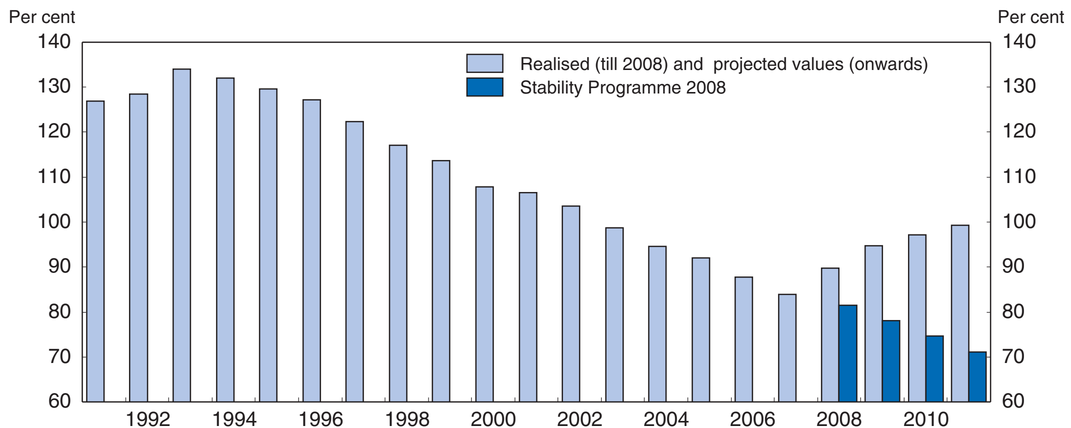
Source: Stability Programmes and High Council of Finance (2009), *Avis sur les perspectives budgétaires en préalable au programme de stabilité 2009-2014*.

The fiscal response to the crisis, coupled with the government interventions in the financial sector (Chapter 1) and budgetary slippage in the previous years, will lead the public debt-to-GDP ratio at the end of 2010 to be about 26% of GDP higher than in the scenario laid out in the previous Stability Programme (Figure 2.1). OECD calculations show that, in order to reduce this additional burden of public debt by 2050, the primary balance generated annually over 2011-2050 will have to be on average 0.7% of GDP higher than in the previous, already ambitious scenario (the additionally required primary balance is 0.5% of GDP if debt increases resulting from interventions in the financial sector are excluded). The previous pre-funding scenario already assumed generating primary balances above 4%

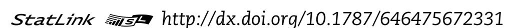
of GDP until 2020, only gradually reducing to a primary balance by 2040 and roughly maintaining it afterwards (Stability Programme, 2008). The additional effort required makes the prefunding objective, which has already proven difficult to achieve, increasingly problematic. This points to the fact that prefunding needs to be complemented with reforms to reduce ageing costs and boost the potential growth of the economy (see below).

Figure 2.1. **Public debt is rising subtantially**

General government gross debt as a percentage of GDP



Source: Historical data from *OECD Economic Outlook database*, projections from Stability Programme 2008-2011 and High Council of Finance (2009), *Avis sur les perspectives budgétaires en préalable au programme de stabilité 2009-2014*, Mars 2009.


StatLink http://dx.doi.org/10.1787/646475672331

Moreover, postponing prefunding has implications on intergenerational equity, putting a disproportionate burden on future generations. Simulations comparing scenarios of "early adjustment" (increasing primary balance till 2015 in order to achieve a balanced budget by 2050) and "gradual adjustment" (spreading the increases over 2008-2050) show that early adjustment entails a more even cost of ageing to be borne by all generations born after 1990, while gradual adjustment entails a sharp increase in costs for future generations (Balassone *et al.*, 2009). For example, in the gradual adjustment scenario, the life-time cost for Belgian men born in 2015 would be about 25% higher than for those born in 1990 and the cost for men born in 2050 would be 40% higher than for those born in 1990.

Restoring a credible path towards sustainability requires better expenditure control and institutional reforms

As laid out in the new stability programme, the government intends to maintain the prefunding element of its strategy to restore fiscal sustainability. Hence, the government should aim at bringing public finances in line with medium-term objectives as soon as possible, which is a challenging task. One way to close the sustainability gap is through increasing taxes. As the tax system is complicated and generally not particularly conducive to growth, there is room for tax reform, which is discussed in Chapter 4. However, the tax burden in Belgium is already high and even higher taxes will hamper economic growth. Therefore, government needs to increase the emphasis on the other elements of the strategy. Structural reforms increasing labour market participation and enhancing productivity have been proposed in the previous *Survey* and in Chapter 5 of this survey. But, because most of

these reforms will have their full effects only in the long run and their eventual impact remains uncertain, the government should not take into account such effects when revising its medium-term fiscal objectives, which should be based on conservative growth assumptions. Higher growth owing to structural reform should be treated only as an upside risk. Consequently, the main element of the strategy should be to limit expenditure growth, given the empirical evidence that consolidation through the control of expenditures tends to be the most sustainable in the long run (see Guichard *et al.*, 2007). In that respect, controlling the increase in ageing-related expenditures is a key issue.

The delayed pre-funding strategy requires more ambitious pension reform

Theoretically, there are a number of areas for potential savings or outcome improvements on the expenditure side beside ageing-related expenditures. For example, while health spending seems relatively efficient compared to other European countries, there seems to be room for improvement in the efficiency of spending on public order and safety, and on education in the French-language Community (Eugène, 2008). Another route, which the federal government is intending to follow, is to take advantage of the age structure of the federal employees to reduce their number. The fact that during the next decade a large number of federal civil servants will retire, allows potential savings by only partially replacing retiring staff.[1] However, the delayed pre-funding strategy, while ageing costs are about to rise significantly, requires a more thorough control of expenditure by implementing a more ambitious pension reform.

The costs of ageing will mostly fall on the social security system which is a federal responsibility. Indeed static calculations indicate that if these costs were to be financed only through the social security contributions, these would have to increase by roughly 50% (from 12% of GDP to 18%). This implies that the standard contribution rate would have to go up from around 48% to above 70%.[2] The magnitude of these results highlights the fact that substantial reform is urgently needed.

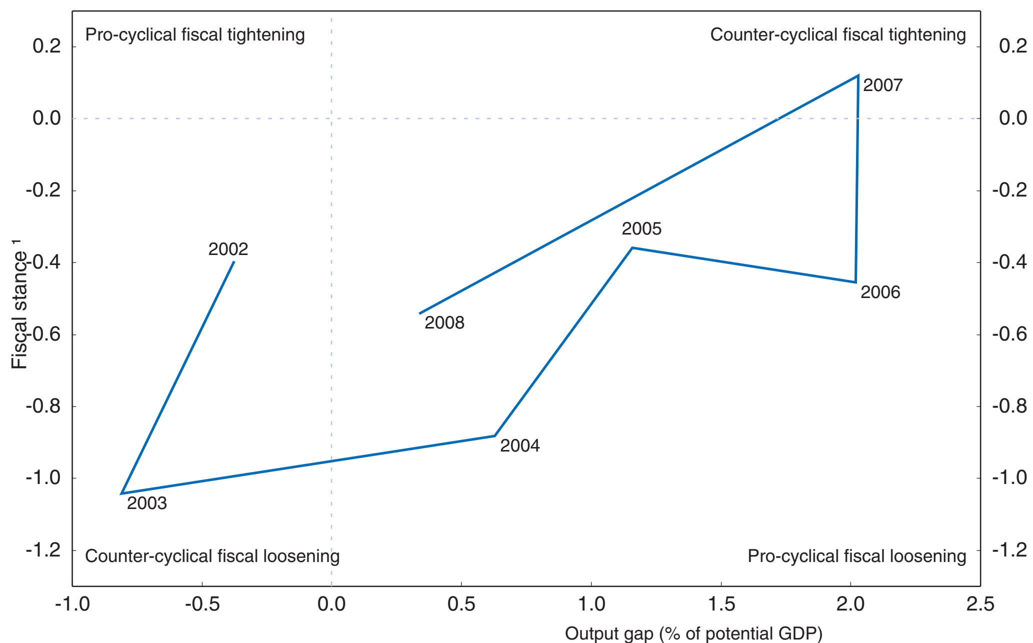
The replacement ratio (pension payouts relative to the final salary) is already relatively low compared to many other OECD countries, in particular outside the public sector (OECD, 2007a). Therefore, there seems to be little room for a substantial lowering of future pension payouts. On the other hand, the effective retirement age, slightly below 60 in 2007, is low by international comparison (OECD, 2006). Previous *Surveys* recommended further steps to discourage early retirement and, although the measures adopted are starting to yield effects, they will not be sufficient and efforts should be increased. Furthermore, they should be accompanied by an increase in the legal retirement age, currently at 65. The government has already increased the legal retirement age for females making it equal to the one for males, however a number of OECD countries have a higher legal retirement (*e.g.* Norway, Iceland and since recently Germany) of 67 and others are seriously considering such an increase (*e.g.* the Netherlands). In order to improve the incentives to work beyond the official retirement age, the government needs to lower the effective taxation of continued work, for example through an enhanced bonus/malus system linking pension payouts to the age at retirement.

Institutional reform should foster the credibility and the ownership of the medium-term strategy

The previous *Surveys* discussed in detail the past achievements of consolidation of public finances. Historically, the impressive decrease in public debt to GDP ratio in the

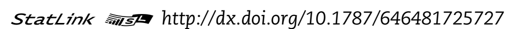
second half of the 1990s owed much to a structural improvement in public finances, although the decrease in interest payments also played a positive role. However, the track record has deteriorated more recently. Despite high GDP growth, fiscal policy has generally remained expansionary throughout the 2000s (Figure 2.2). Political problems with establishing a government lead to delayed approvals of 2007 and 2008 budgets, and may have resulted in less ambitious objectives, as reflected in the 2008 Budget, which aimed at a general government balance significantly below the High Council of Finance's advised scenario of a 0.5% surplus (HFC, 2008).

Figure 2.2. **The fiscal stance has been expansionary**



1. Fiscal stance is measured by the changes in cyclically-adjusted primary balance, excluding one-off measures. The potential output and thus the output gap have been revised since the previous survey.

Source: OECD, *Economic Outlook database.*

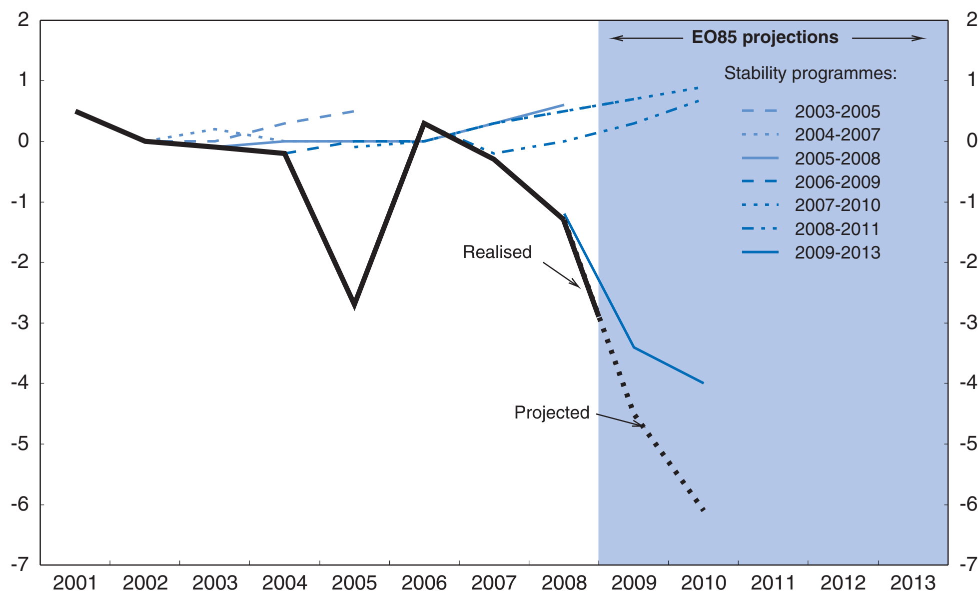
StatLink  http://dx.doi.org/10.1787/646481725727

These recent slippages (Figure 2.3) emphasised that a durable improvement in the fiscal balance needs to be of structural nature. In that respect, more recent achievements are disappointing: the fiscal balance deteriorated by a cumulative 0.7% of GDP between 2001 and 2007 despite lower interest rates and favourable cyclical developments. The deterioration in the structural primary balance reached above 3.5% of GDP over the same period. An analysis of the factors behind the changes in the structural balance, Box 2.3 shows that the negative impact of tax reduction on the structural balance (1.8% of GDP over the 2002-2007) was only partially offset by an expenditure effort and partly rested on non-discretionary factors, which may prove unsustainable. This also means that the tax reductions in 2000s (see Chapter 4) were not fully backed with expenditure control.

This analysis suggests the government needs to refine the institutional framework for fiscal policy in order to favour sustainable improvement in the fiscal balance. As emphasised in previous *Surveys*, the government should adopt an explicit structural target for the budget

Figure 2.3. **Fiscal surpluses have been postponed from one year to another**[1]

Fiscal deficit as percentage of GDP



1. The fiscal deficit for 2005 includes the budgetary costs of the assumption of railway pensions equal about 2.5% of GDP (Eurostat).

Source: Eurostat, Stability Programmes, *OECD Analytical database*.

StatLink http://dx.doi.org/10.1787/646503821384

balance. A cyclically adjusted target, which excludes one-off measures, should allow the budget to achieve the long-term goal of fiscal sustainability while allowing for automatic stabilisers to fully work in the short-term. The government could draw some inspiration

Box 2.3. **To what extent do discretionary efforts contribute to the fiscal sustainability?**

An improvement in the structural fiscal balance has different implications for fiscal sustainability depending on whether it originates from new tax measures or from a better control of expenditures. Empirical research shows that consolidation through the control of expenditures tends to be more sustainable (see Guichard *et al.*, 2007). Furthermore, an increase in tax collection does not necessarily reflect a discretionary effort by the government to collect extra revenues. Tax elasticity fluctuates overtime and may lead to exceptional – and consequently unsustainable – tax revenue levels.

This phenomenon has an important consequence: it blurs the interpretation of the structural balance change. An improvement in the structural balance owing to higher tax elasticity may be attributed to government efforts although it is out of the government control. This fallacious interpretation stems from the construction of the structural balance, which is computed as the "residual" between the actual balance and its cyclical component (the structural balance is derived from the "cyclically-adjusted" balance, a concept computed as the "residual" between the actual balance and its cyclical component). Consequently, any factor that does not explicitly appear in the cyclical balance is, by construction, of structural nature, including short-term fluctuations in tax elasticity.

Box 2.3. **To what extent do discretionary efforts contribute to the fiscal sustainability?** *(cont.)*

A more satisfactory measure of the discretionary component of public finances has been proposed, among others, by Duchêne and Levy (2003). Their analysis focuses on two "structural effort" factors that explain changes in the structural balance: *i)* the gap between the growth in public expenditure and potential growth, which may be called the "structural expenditure effort", and *ii)* the new measures affecting the tax burden (compulsory levies collected by the general government). These two factors clearly show the discretionary power of the government as limiting the expenditure growth rate or raising taxes can lead to a sustainable improvement in the government balance. The residual part of the change in the structural balance can be attributed to non-discretionary factors as it mainly arises from changes in tax elasticities (and more marginally to non-tax revenues) that do not lead to a sustainable improvement in the government balance. Using this approach, Table 2.3 below helps analysing the underlying factors of the change in the Belgium fiscal balance since end-2001.

Table 2.3. **Fiscal consolidation in the 2000s**

Per cent of GDP

	2002	2003	2004	2005	2006	2007
General government fiscal balance	–0.1	–0.1	–0.3	–2.7	0.3	–0.2
Change in the general government fiscal balance	–0.5	0.0	–0.2	–2.4	3.0	–0.5
Of which: cyclical component	–0.8	–0.7	0.1	–0.2	0.6	0.4
Of which: structural component	0.3	0.7	–0.3	–2.2	2.4	–0.9
Of which: discretionary effort	–1.0	–1.3	1.3	–2.7	2.9	–0.3
Of which: new measures affecting the tax burden	–0.5	–0.3	0.0	–0.1	–0.4	–0.1
Of which: effort in controlling nominal expenditure growth	–0.5	–1.0	1.3	–2.6	3.3	–0.2
Of which: non-discretionary component	1.3	2.0	–1.6	0.5	–0.5	–0.6

Source: OECD (2008), *Economic Outlook No. 84 database*, National Bank of Belgium and OECD calculations.

Between end-2001 and end-2007, this analysis indicates that the cumulative change in the structural balance is equal to zero. This is insufficient in view of the long-term sustainability of Belgium public finances. First, the evolution of the structural fiscal balance obscures the fact that a substantial fiscal loosening is partially offset by the fall in interest payments of more than 2.5% of GDP in the same period. Second, even a neutral fiscal stance is not sufficient to address the projected rise in ageing-related costs. Third, the analysis through the "structural effort" concept shows lacks of discretionary efforts, which may endanger fiscal sustainability. Over the 2002-2007 period, new tax measures have led to a reduction in tax burden by 1.4% of GDP. The negative impact of this tax reduction on the structural balance was only partially offset by an expenditure effort (0.4% of GDP over the period) and, overall, the discretionary effort to improve fiscal sustainability was negative during this period (–1% of GDP). Financing of tax reductions mainly relied on an improvement in non-discretionary factors (1% of GDP).

The above analysis suggests that Belgium financed three quarters of tax reduction with higher revenues from non-discretionary factors (above average tax elasticity or changes in non-tax revenues), which may prove unsustainable and consequently endanger the long-term sustainability of the fiscal balance.

from countries such as Switzerland (or Chile) which have structural targets in place, especially on how to solve some technical difficulties, such as the estimation of the business cycle (*e.g.* the end-of-sample problem, estimating potential output). The rule should be kept as transparent as possible. The forecasts and estimations of structural and cyclical components should be delegated to an independent institution such as the Federal Planning Bureau (FPB) to enhance the transparency and credibility of such a measure.

The credibility of the above commitment should be strengthened by switching to multi-year budgeting, which has proven effective in a number of OECD countries including Australia, New Zealand, the Netherlands and the United Kingdom and imposing explicit expenditure rules, which can be done either at the overall level of the budget or at the level of individual spending departments. Multi-year budgeting allows for a more coherent long-term path of government policies together with the prioritisation of strategic goals, which can be planned within a longer time frame. Individual budget line units such as ministries and government agencies should be subject to strict expenditure control and should be responsible for reaching their sub-part of the planned multi-year budget within the overall spending target. This would induce automatic compensation for overspending in one area with cuts in other areas, leaving some room for manoeuvre while saving overall fiscal discipline. The credibility of multi-year budgeting could be enhanced by requiring the government to explain deviations to the legislature, as part of the budget presentation. An additional benefit of multi-year budget plans may be apparent in the Belgian context of repeated problems with establishing a government coalition. If these problems were to reappear in the future, multi-year budgeting could help maintain fiscal policy on its desired path during the interim period.

The budgetary process has been favourably judged in the previous *Survey* for the involvement of independent institutions and thorough budget controls (see also NBB, 2008). Nonetheless, further increasing the role of independent institutions should enhance the budget control. The Federal Planning Bureau (FPB) is already in charge of preparing the macroeconomic forecasts to be used as inputs for the assumptions for the budget. Its role in this process should be expanded to evaluate the projected budget outcomes with the assumption of unchanged policies, to provide a publicly available baseline for the effects of fiscal policy. A somewhat similar setup seems to function well in the Netherlands. Additionally, more transparency in the budgetary process should benefit credibility. In order to clarify the budget objectives, therefore, newly introduced measures should be accompanied by the expected non-fiscal effect of the measure (*e.g.* number of created jobs), in order to facilitate their *ex post* evaluation. The performance of the measure relative to the initial assumption could be later evaluated by the FPB, and the government should be obliged to explain any substantial deviations in the budget outcomes before the parliament.[3]

While a very detailed overview of the government budget proposal is published on the parliament website a simpler and concise overview of the budget should also be available. This would ideally include the main budget assumptions and objectives, the main figures, assumptions (*e.g.* tax elasticities), policy changes and their foreseen effects and an analysis of the fiscal stance. Some of this information is already available in the budget *Overview*. Moreover, the budget, together with all the related documents (*e.g.* results of the Budget Control), should also be available on the website of the single delegated ministry responsible. This would increase the transparency of the budget and facilitate access to

information for the wider public, thereby contributing to the credibility of the government's long-term objectives.

Finally, much of the consolidation responsibility lies at the federal level. As a result of the devolution of powers and the tax revenue sharing mechanism (see Chapter 3), the federal level is faced with a mismatch between its dynamically increasing spending responsibilities, mainly through the social security system, and relatively slow-growing revenues. Consequently, substantial changes to the fiscal federalism framework are needed to realign the spending and revenue responsibilities and improve the incentives to curb expenditure on all levels of the government (see Chapter 3).

Box 2.4. **Policy recommendations to secure fiscal sustainability**

- In light of the severe economic downturn, the automatic stabilisers should be allowed to work fully. However, the government should restrain from further discretionary stimulus, in particular if unilateral, given the severe problems with fiscal sustainability.
- The government should ensure the measures already introduced are withdrawn once the crisis subsides. Any further measures to stimulate the economy, if necessary, should be timely, *i.e.* lead to a short-term stimulus effect, well targeted at groups most affected by the crisis, and accompanied by a sunset clause to guarantee automatic withdrawal.
- It is desirable for counter-cyclical measures to be coupled with measures improving long-term sustainability. Such measures can take the form of, for example, an increase in unemployment benefits together with a limit on their duration and steeper regressivity to provide more dynamic job-search incentives.
- The government should supplement the strategy of prefunding upcoming costs of ageing with structural reforms in the pension and health systems in order to reduce these costs. Therefore pension reform should be sped up by increasing the effective and legal retirement age in order to reflect past and future gains in life expectancy.
- In order to assure partial catch-up to the previous budgetary targets over the medium term, the pre-funding strategy should set realistic medium-term targets and be accompanied by credible instruments to guarantee their achievement. The budget targets should be structural, in order to reduce the pro-cyclical tendency of the fiscal policy during periods of high growth. Multi-year budgeting should improve the room for manoeuvre in the short term while stressing the priority long term goals. Individual ministries and agencies should be subject to strict spending targets and should compensate overspending in one area with cuts in another. An additional improvement can come from the introduction of expenditure rules.
- The credibility of the budgetary process can be increased by fostering the role of independent institutions. For example, the Federal Planning Bureau should not only prepare the macroeconomic budget assumptions but also evaluate the budget proposal and carry out updates during the year. It should assess the effectiveness of budgetary measures in terms of fulfilling their economic objectives.
- In order to increase the transparency, the budget should also be presented in a more streamlined version, including the main figures on assumptions (*e.g.* the tax elasticity) and outcomes, and new measures introduced together with their expected (fiscal and non-fiscal) impact. It should also be placed on the website of the responsible minister together with the results of budget controls and adjustments made to the budget.

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Notes

1. About 30% of the public servants at all levels of government are expected to retire, however estimates of the number of federal public servants expected to retire in the coming decade range as high as 40%.
2. This calculation assumes that contribution rates for all the groups currently enjoying lower rates (*e.g.* self-employed) would also increase by 50%. If they would increase less, the standard rate would have to increase by more.
3. An example of such a commitment mechanism can be found in the monetary policy framework in the United Kingdom, where the Governor of the Bank of England must explain substantial deviations of inflation from the targets in a letter to the Chancellor of the Exchequer.

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Chapter 3

Improving fiscal federalism

The current system of fiscal federalism is creating imbalances between the federal and the sub-federal governments (vertical imbalance), and between sub-federal governments (horizontal imbalance). Without reform, the vertical imbalance will widen as the fiscal burden from the ageing of the population falls mainly on the federal level. Reform should therefore strengthen the fiscal capacity of the federal government by improving its revenue sources and by shifting some spending obligations to sub-federal governments. The imbalance between regions arises because of the lack of coherence between taxation and spending. Shared revenues from the personal income tax are allocated to the region of residence, while the region of the workplace does not benefit, which particularly affects Brussels' revenue level. This imbalance could be eliminated by allocating more of the shared personal income tax to the region of the workplace. Furthermore, the system of equalisation grants should be re-designed to provide incentives to the recipient regions to develop their own revenue base. The performance of the fiscal system could further be improved by raising the efficiency of spending in areas of national interest which have been assigned to sub-federal governments or where there are overlapping responsibilities, such as in employment, R&D, training, education, energy and environmental policies.

For about 15 years, Belgium has achieved an impressive degree of fiscal consolidation with a significant reduction of the debt-to-GDP ratio. Fiscal consolidation has been achieved against the background of the transition from a unitary state to a federal state, which in practice was mostly implemented in 1988-89 before being constitutionally established in 1993 (see Annex 3.A1). In line with annual agreements between all levels of government, the federal government significantly reduced its budget deficit (aided by falling interest payments) while sub-federal governments roughly balanced their budgets. On the other hand, the sharing of tax revenues is such that it has contributed to the non-federal governments ending up with the fastest growing tax revenues, which means that these levels of government as a whole have been faced with limited budgetary pressure to rein in spending.

Overall, it appears that the devolution of responsibilities to regions and communities has helped to better tailor public goods and services to the preferences of the people; it also introduced some benchmarking between jurisdictions, which increased the efficiency of the public sector. However, devolving spending and revenues to regions and language communities appears to have been, to some extent, at the cost of the federal budget. Furthermore, there is a risk of excessive institutional complexity, fragmentation of policies and diseconomies of small scale in the provision of public services. A recent cross-country econometric study of 21 OECD countries, including Belgium, over the period 1970 to 2000, finds that generally fiscal decentralisation has improved public sector efficiency, although in Belgium the improvement was rather small despite significant decentralisation during the 1990s (Adam *et al.*, 2008).

Reforming fiscal federalism will also have to consider political economy issues, as attempts to rationalise were frequently blocked by some parties fearing they may lose too much or not gain enough. Perceptions of net gains/losses can actually be misleading. For example, the income gap between the two main regions has continued to widen since 1965, while Brussels-Capital has achieved the highest income per capita (Table 3.1). However, a closer look reveals that income gaps not only exist between the northern and southern regions but also within each regions/communities. In international comparison, income gaps in Belgium are not particularly large and Belgium still belongs to the group of highly egalitarian countries in the OECD (OECD, 2008a); an important reason for this relatively narrow income distribution are the implicit transfers of the fiscal system to individuals, independent of their regional location.

Overall, fiscal federalism in Belgium has to cope with two main challenges. The first is to ensure fair burden-sharing of public spending between the different levels of government, including the upcoming ageing costs. The second is to increase efficiency of spending at all levels of government by reducing economic disincentives in the transfer system and by improving policy co-ordination and co-operation in public service provision. The following sections address these challenges.

Table 3.1. **GDP per capita in the regions of Belgium**

Mean of EU15 countries = 100

	Walloon Region	Flemish Region	Brussels-Capital Region	Belgium
1955	103	92	155	103
1965	93	93	163	100
1975	90	106	161	107
1985	87	106	167	106
1995	83	111	230	113
2000	77	105	215	106
2005	78	107	213	108
2006	77	107	208	107

Source: Capron, H. (2000), "The sources of Belgian prosperity", in: H. Capron and W. Meeusen (eds.), *The National Innovation System in Belgium*, until 1985; National Bank of Belgium for more recent data, which, for EU15, include German new Länder.

Despite decentralisation, the bulk of the deficit reduction has been achieved by the federal budget

A main driving force for fiscal consolidation in the 1990s was the convergence plan to fulfil the Maastricht criteria of EMU. As shown in Table 3.2, both the federal government and the sub-federal entities have contributed to the improvement in the general fiscal deficit. However, the federal government has achieved a substantially bigger primary surplus than sub-federal government entities. The primary surplus was improved by reducing the ratio of primary spending to GDP, while this ratio has increased for regional entities. Only part of this evolution relates to devolution of government expenditures to regions. This was the case in the early 1990's, when more spending responsibilities were allocated to the regions than shared tax revenue, which led (during a brief transitional period) to a so-called "natural deficit" of the regions (Stienlet, 2000; Gérard, 2002). More recently, it is the more dynamic revenue growth of the regions that explains the bulk of the increase in primary spending. The bigger effort of the federal government in controlling expenditures related to a decentralisation process that did only require federal entities to balance their budget while granting them more dynamic revenues than the revenues of the federal budget.

The burden-sharing with respect to fiscal consolidation assigned to regions has been limited since regions only committed to reach a balanced budget from a relatively limited initial deficit. In the Co-operation Agreement (Accord de Coopération) of 1996, regions and communities promised to achieve balanced budgets. This commitment did not require a major effort since the fiscal deficit of regions as a whole was already roughly balanced, although larger efforts were required by some of the sub-federal levels governments as compared with others. Also, tax revenues raised by the regions, especially Flanders, have been dynamic, which limited the necessary efforts in controlling expenditure. Other measures to foster the role of sub-federal governments in fiscal consolidation had only a limited impact on expenditure growth. The federal government can impose restrictions on sub-federal loan financing if regional debt financing interferes with macroeconomic goals or if there is a risk of structural slippage in the budgetary position of a non-federal government. The High Council of Finance (HCF) was strengthened with the objective to ensure budgetary discipline at all levels of government, but only as an advisory and co-ordinating body.

Table 3.2. **Fiscal developments of the federal government and of Regions and Communities**

Percentage of GDP

	1990-94	1995-99	2000-04	2005-07
Federal government[1]				
Revenue[2]	17.9	17.6	17.7	15.6
Primary expenditure	13.8	12.8	12.5	13.0
Primary balance	4.1	4.7	5.1	2.6
Interest payments	10.0	7.2	5.4	3.8
Fiscal balance	–5.8	–2.5	–0.2	–1.2
Regions and Communities				
Revenue	11.8	13.2	13.9	14.3
of which: transferred taxes	8.6	9.3	8.9	8.5
Primary expenditure	12.4	13.0	13.5	13.9
Primary balance	0.6	0.2	0.5	0.4
Interest payments	0.2	0.3	0.2	0.1
Fiscal balance	–0.8	–0.1	0.2	0.2

1. Excluding social security.
2. Excluding transferred taxes.
Source: National Bank of Belgium.

Conversely, the devolution process has left the federal government with the bulk of consolidation efforts. Following the special Finance Act (1989), the existing debt burden, and the related high debt service, has remained almost entirely with the federal government. The social security system also remained at the federal level, implying that the federal government is confronted with the responsibility of financing the expected increase in ageing related costs. The increase has such amplitude that it necessitates a considerable amount of prefunding as part of the overall strategy to finance the budgetary consequence of population ageing (see below). However, as described in Chapter 2, prefunding has repeatedly been delayed and will, according to the Stability programme, only start after 2015 and will require a strengthening of the federal government's fiscal position. The federal government was allowed to compensate for the regionalisation of some taxes and fees (such as the road fund tax and the registration fee on the transfer of real property) and the increase in contributions to the EU by cutting the amount of shared taxes to the regions (the so-called negative term). Although this arrangement was broadly revenue-neutral for Wallonia and the Brussels-capital region, Flanders benefited as its revenues from shared income tax increased more than the negative term, *i.e.* the amount by which shared taxes were reduced. As a result, and to ensure horizontal neutrality for Brussels and Wallonia, the federal government could not reduce the transfers (shared taxes) to the regions as much as would have been necessary to cover its fiscal costs from decentralisation (van der Stichele and Verdonck, 2002). Maintaining horizontal neutrality was *de facto* achieved by renouncing to vertical neutrality, with a higher burden on the federal government.

Spending pressure from demographic change will mainly affect the federal government budget

Due to population ageing, there will be significant pressure on future public spending. Public pensions are most affected, but public health care spending is also expected to increase, while education spending could decline. As a result, the federal level of

government (social security and the federal budget) will bear more than 90% of the fiscal costs stemming from ageing, with the share financed by Regions and Communities will be comparatively small (Chapter 2).

The government decided to pre-fund an important part of the ageing cost by – as stipulated in the December 2006 update of the Stability Programme – generating budgetary surpluses from 2007 onwards, reaching about 1½ per cent of GDP between 2013 and 2018, and then gradually reduce the surpluses to zero until 2030. However, as mentioned in Chapter 2, this strategy needs to be revisited in light of the slippages in recent years and the increased deficits arising from the economic crisis. This raises two issues. First, as the contribution of pre-funding to the cost of ageing will be smaller than expected, more emphasis needs to be put on structural reform of the pension system (Chapter 2). Second, to achieve a fair burden sharing of age-related costs, fiscal relations between the different levels of government need to change in favour of the federal budget. This could be done by reforming tax sharing arrangements or by re-allocating spending responsibilities. An obvious candidate for shifting spending from the federal to the regional level is the payment of civil servant pensions of regional and community administrations, which is currently a federal government responsibility. This would relieve the federal budget and reduce the incentives of the regions and communities to allow their civil servants to retire early. Such a change in spending responsibilities could also induce regions and communities to pre-fund part of these pension liabilities, thereby increasing their contribution to the pre-funding objectives.

Sub-federal governments spend almost 40% of total government expenditure

In 2006, Belgian sub-federal governments (Regions, Communities and local authorities) spent around 38% of total government expenditure, an increase of about 5 percentage points since the mid-1990s (Table 3.3). The basic principle in Belgium for assigning spending power is that devolved responsibilities, which can be organised on a territorial basis, are assigned to regions, while those related to the use of language are assigned to communities. Both the regions and the communities can also – within their specific areas of responsibility – cooperate internationally, which allows them to conclude treaties and agreements of cooperation with other countries and the EU. While responsibilities of Communities are defined by the Constitution (Articles 127-30), those of the regions are listed in Special Laws, which are adopted by both houses of parliament with a two-thirds majority.

The devolution of powers to regions has significantly reduced the power of the federal state; its main remaining responsibilities are defence and police, parts of economic policy, public debt financing, social security, state-owned enterprises, and parts of judiciary, as well as foreign relations in those areas (see Box 3.1). There has been continued demand from Flemish groups to decentralise parts of social security, notably unemployment insurance and health insurance. However, there are good economic reasons for keeping social insurances centralised such as risk sharing and the capacity for a homogenous use of sanctions. At the same time, decentralisation of some parts of social policy, such as labour market activation policies can – if properly designed – be efficient, as has been shown in the Netherlands (OECD, 2008b).

Table 3.3. **Spending and revenues by levels of government**

	Share in general government spending[1]								Share in general government revenues[2]							
	Federal government		Intermediate level		Local government		Social security		Federal government		Intermediate level		Local government		Social security	
	1995[3]	2006[4]	1995[3]	2006[4]	1995[3]	2006[4]	1995[3]	2006[4]	1995[3]	2006[4]	1995[3]	2006[4]	1995[3]	2006[4]	1995[3]	2006[4]
Federal countries																
Austria[5]	46.3	45.7	13.1	15.1	15.3	12.2	25.3	26.9	42.2	44.2	14.4	15.3	16.0	12.8	27.4	27.6
Belgium	31.7	23.2	20.5	23.6	12.3	14.1	35.4	39.1	57.3	55.9	5.4	9.1	8.1	7.3	30.0	28.2
Canada	35.7	29.6	40.4	45.1	18.6	19.3	5.3	6.1	40.4	39.2	42.1	42.9	11.8	10.4	5.7	7.4
Germany	29.6	19.1	18.7	21.9	14.2	15.2	37.5	44.0	27.5	28.2	24.0	23.7	12.8	12.2	38.9	37.5
Switzerland	17.4	14.8	31.0	33.7	23.3	20.9	28.3	30.6	30.0	33.0	27.6	28.3	22.2	20.0	23.5	20.2
United States[6]	58.3	56.3			42.8	44.9			63.7	63.6			37.6	37.7		
Unitary countries																
Czech Republic	64.9	60.3			22.8	27.5	12.3	12.3	72.8	67.8			19.9	20.1	10.7	14.0
Denmark	38.2	31.8			53.8	63.3	8.0	5.0	64.7	62.3			33.4	35.8	1.9	1.9
Finland	36.8	29.9			30.5	39.2	32.8	30.9	46.2	48.4			26.7	26.5	27.6	26.0
France	39.3	35.0			17.4	20.2	43.2	44.7	41.2	38.6			15.0	16.2	45.1	46.2
Greece	63.0	53.7			4.9	6.3	32.1	39.9	69.7	66.4			3.9	3.9	28.7	32.0
Hungary	51.4	49.4			24.9	24.7	23.7	26.0	59.6	58.2			15.1	17.1	28.1	31.6
Iceland	55.2	50.0			27.6	31.7	17.2	18.3	77.1	74.5			23.4	25.7	0.0	0.2
Ireland	58.0	69.7			30.6	19.7	11.4	10.6	79.8	81.5			13.7	13.0	10.7	10.8
Italy	49.7	33.5			24.0	31.5	26.3	35.0	61.1	53.2			12.9	20.3	28.0	28.1
Japan[5]	35.1	33.8			38.5	31.9	26.5	34.4	29.4	32.2			37.0	32.9	33.6	34.9
Korea	43.2	40.4			45.2	45.5	11.5	14.2	67.5	59.6			22.0	22.0	15.8	22.5
Luxembourg	44.6	45.9			13.6	11.5	41.8	42.6	64.9	67.2			9.7	7.4	26.3	26.4
Netherlands	32.4	29.5			33.7	33.5	33.9	37.0	55.6	58.7			13.5	11.9	32.5	30.6
New Zealand	89.5	89.3			10.5	10.7	0.0	0.0	90.9	91.4			9.1	8.6	0.0	0.0
Norway	63.9	68.8			36.1	31.2	0.0	0.0	80.0	86.3			20.0	13.7	0.0	0.0
Poland[5]	53.8	35.4			19.0	30.7	27.2	33.9	48.4	50.5			18.6	18.9	33.0	30.9
Portugal	62.5	54.1			11.1	12.9	26.4	33.0	63.7	61.0			10.6	11.5	27.9	29.8
Slovak Republic	61.4	48.4			13.2	17.5	25.5	34.1	61.1	53.0			6.5	13.6	32.6	35.0
Spain	34.4	22.4	21.6	35.8	11.3	13.4	32.6	28.5	52.2	37.7	7.4	23.5	10.6	10.9	31.4	29.7
Sweden	52.3	43.9			37.7	44.8	9.9	11.3	56.1	54.3			33.6	34.7	10.6	11.0
United Kingdom	74.2	71.6			25.8	28.4	0.0	0.0	91.8	91.1			9.1	10.7	0.0	0.0

1. Excluding the transfers paid to other levels of government.
2. Excluding the transfers received from other levels of government and including tax sharing arrangements. In Belgium, the so called shared tax is not included but treated as a transfer.
3. Or earliest year available: 1996 for Japan, Netherlands and Norway; 1997 for the Czech Republic; 1998 for Iceland; and 2000 for Greece, Korea and Hungary.
4. Or latest year available: 2005 for New Zealand.
5. Unconsolidated data (only in 1995 for Poland).
6. For the United States, no breakdown between state and local governments is available.

Source: OECD National Accounts database, Statistics Canada, US Bureau of Economic Analysis.

Box 3.1. **Responsibilities of regions and communities**

Communities are mainly responsible for education (except determining the beginning and end of compulsory schooling, minimum conditions governing granting of diplomas and the pension plan), parts of public health (hospitals and prevention), social assistance and cultural affairs, including radio and television broadcasting. Regions are responsible in particular for economic policy, employment policy, public transport (excluding the state-owned railway company), zoning, environment, housing, water policy (except distribution), agriculture and parts of energy policy. Energy policy responsibilities are split between the federal and regional governments (see Chapter 5).

Regions are principally responsible for designing and implementing policies for energy efficiency, renewable, non-nuclear energy R&D and market regulation for the distribution and supply of electricity and gas through distribution networks. The federal government is responsible for issues such as electricity and gas tariffs, market regulation for large infrastructure for storage, transport and transmission of energy, the nuclear fuel cycle and R&D in both nuclear fusion and fission. In addition, the municipalities have a legal monopoly on electricity distribution. Nearly all municipalities have transferred the distribution of electricity to inter-municipal companies, called "intercommunales", which partially finance the local municipal governments (IEA, 2006). Regions also supervise local authorities (provinces and municipalities). There are 589 municipalities, which are grouped into five provinces in each of the Flemish and the Walloon region and into the Brussels-Capital-Region, which includes 19 municipalities.

Despite increased taxing power of regions, their revenues continue to be dominated by transfers from the federal government…

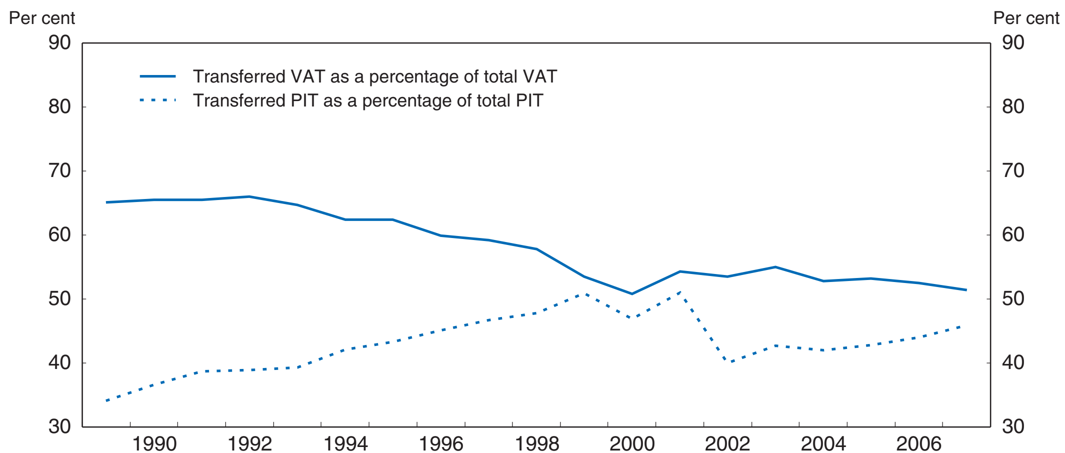
According to the Belgian constitution, regions can levy their own taxes on any activities provided that there is no federal tax on this activity, although in some cases the autonomy to set the tax base is restricted. Regions do set bases and rates for the following taxes and fees: the estate, inheritance and gift taxes; registration fees on real estate transfers; mortgage registration fees; tax on gambling and betting; taxes on the opening of drinking establishments; tax on automatic amusement devices; radio and television licence fees; road fund tax on automobiles; vehicle registration fees and Eurovignette. The regions have also the right to add to the federal personal income tax (but not on the corporate income tax) by levying a percentage of the amount which the taxpayer has to pay to the federal government, but this possibility is not used. Regions can also grant personal income tax reductions (currently an opportunity only used by the Flemish region).[1] The tax surcharges or reductions by the regions do not affect the transfers (shared taxes) from the federal government but affect only their own revenues. Municipalities levy a local property tax on homeowners, which is calculated on the imputed rental value attributed by the federal government to the property (Chapter 4). The tax paid varies according to the commune and generally lies between 20 and 50% of the deemed rental value. Regionalised tax policies can lead to tax competition. Some tax competition exists between Belgian regions, but its degree appears to be limited.

After the 2001 devolution of taxing power, regional taxes have gained in importance, although most of the tax revenues continue to accrue at the federal level. A good part of federal government tax revenues is, however, automatically transferred as "shared taxes" to the regions and communities. Since 2002, there has been some transfer of tax autonomy

to sub-federal levels of government, but the degree of tax autonomy remains limited. The regions and communities combined have full taxing power over about a fifth of their total revenues (increasing to one third for the regions alone) and the main sources include tax on real estate, registration tax on cars, inheritance tax, and some environmental taxes. The regions also have some powers with respect to personal income taxes. For example, in the Flemish region, a tax rebate on earned income will reduce tax revenues by EUR 730 million in 2009 compared with total revenues of EUR 20.4 billion in 2007.

Two main taxes are shared: the personal income tax (usually referred to below as the "income tax") for the regions and the VAT for the communities. In 2007, about 45% of personal income tax revenues (PIT) and more than half of VAT revenues were transferred to the regions and communities. The share of transferred PIT increased during the 1990s, before declining after regions have received more own taxes (due to the so-called negative term as mentioned above). More recently, it has started to increase again. The share of transferred VAT has declined from 65% in the early 1990s to 50% since 2000 (Figure 3.1). Shared taxes continue to be the main revenue source of regions and communities (Table 3.4).

Figure 3.1. **Shares of VAT and personal income tax revenues, which are transferred to regions and communities**



Source: National Bank of Belgium.

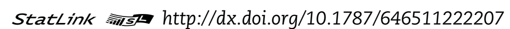

StatLink http://dx.doi.org/10.1787/646511222207

Table 3.4. **Revenue sources of regions and communities**

	As a percentage of their total revenue				As a percentage of GDP			
	1990	1995	2000	2007	1990	1995	2000	2007
Total revenue	100.0	100.0	100.0	100.0	11.1	12.6	13.2	14.3
Of which:								
Own taxes	6.7	7.6	8.8	16.6	0.7	1.0	1.2	2.4
Transferred taxes	74.7	71.6	69.2	59.3	8.3	9.0	9.1	8.5
Revenues from other government transfers	9.1	8.5	8.7	9.5	1.0	1.1	1.1	1.4
Other revenue	9.5	12.3	13.3	14.7	1.1	1.5	1.8	2.1

Source: National Bank of Belgium, OECD calculations.

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… which are not aligned neither with actual revenue collection nor spending needs

The tax sharing arrangement in Belgium differs, however, from that in other OECD countries where sub-federal governments receive a fixed share of actual tax revenues. In Belgium, the so-called "shared taxes" which are distributed to regions and communities are not directly dependent on actual government tax receipts. They are therefore, according to OECD principles, not treated as shared taxes but as transfers. The total annual amount of the "shared income tax" is derived from a lump sum amount, which has been defined in 1989 and is indexed mainly to the consumer price inflation and national real GDP.

The allocation of personal income tax between regions and communities is also independent on any measure of spending needs. The overall amount of the shared income tax to the regions is based on each regional income tax yield (according to the principle of "fair return"). This allocation favours Flanders, which has a relatively large personal income tax base. The part of the VAT, which is transferred to communities, is partly allocated according to the share of the population below the age of 18 and partly to the share of pupils. Hence, some link between the transfer received and communities' education spending needs is maintained. It has, however, been decided by law to gradually and partially change the distribution criteria away from needs towards taxing power (similar to the shared income tax), so that this indirect link to education spending will become weaker in the future. This will further disconnect shared-taxes to spending needs.

For Brussels, a problem arises from the fact that the shared revenue from the personal income tax is fully allocated to the region of the residence of the taxpayer while the region of the workplace does not benefit. As more than half of the Brussels workforce is living in the neighbouring Flanders and Wallonia, this arrangement reduces revenues of the Brussels-Capital region and increases revenues of Flanders and (to a lesser extent) Wallonia. The Brussels-Capital region receives a transfer from the federal government which is meant to cover the additional costs which arise from carrying out its function as an international city (BELIRIS programme) and it also receives equalisation transfers as its per capita revenue from personal income tax is below the national average (see below). However these transfers do not fully compensate Brussels for the additional costs and for the spill-over of its public services to the citizens who are living in the other regions; as a result, Brussels has a relatively weak revenue base despite the relatively high share of GDP which is produced in this region (see Box 3.2).

Table 3.5 shows that per capita expenditure and revenue are much larger in Flanders than in Wallonia and in the Brussels-Capital region. However, this is also due to the fact that the Flemish Community has merged with the Flemish Region while the budgets of Wallonia and the Brussels-Capital Region are limited to regional matters as the French Community provides the community services to the French-speaking citizens of these regions. If one allocates (approximately) the budget of the French Community to these two regions, the per capita spending and revenue in Flanders and Wallonia are quite similar, while per capita spending in the Brussels-Capital Region is about 25% higher (numbers in brackets). Considering that urban agglomerations tend to have higher spending per capita (due to higher unit costs and more spillovers of service benefits to neighbouring regions) this difference in per capita spending is rather small.

The problems of Brussels are in many ways similar to those in agglomerations in other OECD countries and in others unique to the region. It has been shown that the additional

Box 3.2. **Fiscal problems of the Brussels-Capital Region**

The Brussels-Capital Region (BCR) has some specific characteristics as compared with the other two regions. Both spending and revenue per capita are higher than in Flanders and Wallonia, which internationally is also observed in other agglomerations with high population density. The BCR is divided into 19 municipalities, which are responsible for providing communal services. In addition, there is also a special administrative district that largely coincides with the BCR and which is responsible for cross-municipality areas, such as disaster control, gun legislation and visa delivery. Brussels is a bilingual city with the French and Flemish Communities being responsible for education and culture (and some other personal services) in the city. Infrastructure projects, which are linked to the status of Brussels as a major international city and urban agglomeration, are financed by a special programme of the federal government (BELIRIS programme, amounting to EUR 124 million in 2007). As personal income tax receipts have fallen below the national average, the BCR also receives from the federal government equalisation transfers (ISN). Furthermore, the BCR is (partly) compensated for the revenue losses due to the exemption of federal government buildings from the real estate tax (so-called main-morte), but not for revenue losses due to tax-exempt government buildings, which belong to the other regions and the communities.

The main revenue sources of the BCR are regional taxes and fees which amount to about half of total revenues. Taxes and fees on holding and buying real estate, on inheritance, on gifts and on road vehicles are the most important own revenues. The introduction of road charge tolls for trucks (following the German example) is also discussed but no agreement has been reached so far between the three regions. Other main revenue sources of the BCR are the shared personal income tax and the equalisation transfer ISN.

On the spending side, the largest share (about a quarter) is spent on equipment and public transport (mostly for the "Société des Transports Intercommunaux de Bruxelles"/ "Maatschapij voor het Intercommunaal Vervoer te Brussel"), followed by housing, transfers to municipalities and administration.

While the fiscal position of the BCR has improved in recent years, also helped by the strengthening of the economy, revenues remain vulnerable to cyclical downturns including the housing sector. Furthermore, revenues are generally considered as insufficient to finance the regional and municipal spending needs of the city (de Callataÿ, 2007). This is partly due to the fact that many people who work in Brussels (more than half of Brussels workforce) are living in Flanders and (to a lesser extent) in Wallonia. As the revenues from the personal income tax are allocated according to the residence of individuals and not to their workplace, Brussels´ share of personal income tax revenues is relatively low. As a result, the revenue of Brussels from this source is below average. Thus, the Brussels-Capital region, despite being the richest region in terms of GDP per capita, has below-average personal income tax revenue, qualifying for receiving equalisation grants from the federal government. Furthermore, the many international civil servants living in Brussels are exempt from personal income tax. In 2003, it was estimated that the additional cost of the BCR as the capital of Belgium and international city amounted to around EUR 490 million while the compensatory transfers to cover these costs have been much less (de Callataÿ, 2007 and van der Stichele, 2003). The fact that Brussels must provide public infrastructure to many people who do not contribute to its tax base, leads to a risk of underinvestment. The 1 million people living in Brussels have to finance infrastructure and public services for themselves and ½ million daily commuters. (van der Stichele, 2003).

Box 3.2. **Fiscal problems of the Brussels-Capital Region** *(cont.)*

Fiscal problems in the BCR may, however, also arise from inefficiencies in spending. There seems to be room for improving spending efficiency in many of the institutions, which provide public services, such as job placements, hospitals, public housing and economic development and also in the administration of the BCR (de Callataÿ, 2007). Furthermore, responsibilities between the BCR and the 19 municipalities in Brussels should be clarified, as there are sometimes overlapping activities and problems of co-ordination. Efficiency could, perhaps, also be improved by amalgamating municipalities in Brussels or, more radically, by abolishing the municipal level and the special administrative district altogether and transferring municipal responsibilities and revenues to the BCR.

Table 3.5. **Expenditure and revenue of regions and communities**[1]

2007, in euro per capita

	Flemish Region and Community	Walloon Region	Brussels-Capital Region	French Community
Expenditure	3 623	1 781 (3 615)[2]	2 670 (4 496)[2]	1 921
Revenue	3 755	1 848 (3 677)[2]	2 672 (4 491)[2]	1 915
Own revenue	705	643	1 240	0
Transfers received	2 714	965 (2 612)[2]	723 (2 362)[2]	17 250
Other revenue	337	240 (420)[2]	709 (889)[2]	189
Population	6 117 440	3 435 879	1 031.215	4 260 851

1. The numbers in bracket (approximately) allocate spending and revenues of the French Community to these two regions by using population shares.
2. Including expenditure and revenue of the French Community.

Source: National Bank of Belgium, OECD calculations of the numbers in brackets.

costs of the Brussels-Capital Region and the spillover benefits of its public services to citizens of the other regions, including through public transport, are substantial (van der Stichele, 2003). There are various ways to address this problem although the measures differ with respect to practicability, accuracy and distributional effects:

- First, enlarging the Brussels-Capital region by including the local communities where the majority of the commuters live, so that the region receives a larger part of the taxing power of its workers. Such amalgamation, although it happened in the past, is politically difficult today and may not be an effective measure today due to the distance that many commuters travel every day.
- Second, changing the allocation of the shared income tax so that the region where the firm of the worker is located receives a proper share ("workplace principle"). However, the tax allocation according to the location of the firm can pose problems if a firm has workplaces in different regions while wages are paid by a centralised wage accounting unit. This problem does not arise if the allocation between regions is based on regional employment or regional GDP shares, but then revenue from the progressivity of the income tax does not accrue to the region where the higher wage earners work, but is distributed between the regions according to the regional shares of employment or GDP.
- Third, granting a higher weight to the population of Brussels when calculating federal transfers. For example, in Germany, the city-states (Hamburg, Bremen and Berlin) get a special treatment in the horizontal equalisation system by assuming that their spending needs per capita are higher than in the other states; as a result, a correction factor

ensure that city-states either receive higher transfers from the other states or pay lower transfers (Hamburg). Austria also provides higher weights to the populations of larger cities before calculating interregional transfers and Australia gives a higher weight to the population of the National Capital Territory.

- Fourth, compensating the costs of spillover effects by matching grants from the federal government. The federal government could, for example, increase the BELIRIS programme and reduce its transfers to the other regions accordingly. There are many examples in OECD countries where agglomerations receive special matching grants from provincial or federal governments (*e.g.* Canada and the United States).

Equalisation transfers penalise economic efforts

Regions with personal income tax yield per capita that are below the national average receive an equalisation transfer from the federal government, the National Solidarity Measure (NSM); its size is proportional to the percentage point gap in per capita personal income tax yield. Originally, only the Walloon Region received this transfer but over the past ten years, the Brussels-Capital region has also been a beneficiary.

The fiscal equalisation system in Belgium leads, as does any redistributive system, to a trade-off between equity and efficiency objectives. The reduction of the revenue gap of poorer regions by the additional transfer enables them to improve their infrastructure and provide better public services to their population, thus narrowing differences in living standards across the country and meeting equity objectives. At the same time, however, the fiscal equalisation system may provide disincentives to the poorer regions to develop their growth potential as an increase in their tax base reduces the transfers from the federal government, thus levying an implicit tax on economic efforts of the region.

Cattoir and Verdonck (1999) and Gérard (2002) found that this implicit tax is above 100% for Wallonia and Brussels, *i.e.* if Wallonia or Brussels increase their income tax base, their overall revenue declines as the increase in the transferred income tax from the federal is outweighed by the reduction in the equalisation transfer. Conversely, if economic performance (as defined by the contribution to the federal income tax yield) weakens in Wallonia and Brussels, the decline in the transfer from the shared income tax is more than offset by the increase in the equalisation transfer (Table 3.6). In a recent study, Algoed and Heremans (2008) confirm the large adverse effects of the transfer system on economic incentives for catching-up. They find that an autonomous increase in GDP in Wallonia reduces revenues of the Walloon government, as the loss of equalisation transfers is larger than the gain in other revenues. Brussels can, according to their calculations, expect a positive effect on its revenue from an increase in its GDP, but this effect is very small. On the other hand, as the communities and municipalities would see an increase in their share of the personal income taxes, there would be a mitigating effect when considering the geographical areas.

There are two reasons for the economic disincentives of the transfer system. First, the amount of equalisation for each percentage point of the tax gap is relatively large. Second, the federal government distributes only part of the additional income tax yield to the regions. If a region, which receives equalisation transfers, improves its tax base, the federal government has a double gain as it receives a higher tax yield and can also reduce equalisation transfers to this region. As for the region, the withdrawal of the equalisation grant outweighs the increase in transferred income tax, implying that the region has no

Table 3.6. **Budgetary effects of autonomous increases in the personal income tax yield in Belgian regions**

Change in total revenues

	Wallonia	Flanders	Brussels	Federal government
Increase in PIT yield in Wallonia	–	–	+	+++
Increase in PIT yield in Flanders	+	+	+	++
Increase in PIT yield in Brussels	+	–	–	+++

Source: Gérard, M. (2002), "Fiscal Federalism in Belgium", Paper presented at the Conference on Fiscal Imbalance, based on Cattoir, Ph. and M. Verdonck (1999), "La péréquation financière, analyse de quatre pays", in F. Docquier (editor), *La solidarité entre les Régions : Bilan et Perspectives*, de Boeck Université.

overall revenue gain, and may experience a loss. By contrast, an autonomous increase in the income tax yield in Flanders increases revenues in Flanders, which does not receive an equalisation transfer and therefore is not affected by a transfer cut; higher tax revenues in Flanders also benefit Wallonia and Brussels because the increase in the tax gap raises equalisation transfers. To reduce the disincentive effects for Wallonia and Brussels to develop their tax base, the equalisation transfers should be made less progressive, for example by reducing the amount of equalisation for each percentage point of the tax gap.

How big are inter-regional transfers?

In Belgium, the political debate about the appropriate degree of decentralisation is influenced by a discussion about the size of transfers between the regions. As there are no direct transfers between regions (as for example in Germany) interregional transfers arise implicitly through the tax and social security system. Earlier studies found relatively continuous net transfers from the Flemish Region to the Walloon Region and sometimes also to the Brussels-Capital Region. These mainly reflected differences in the demographic structure and economic performance leading to differences in the ability to pay taxes and in the need of unemployment and other social benefits. However, the estimates of interregional transfers differ significantly between various studies. De Boeck and van Gompel (1998) estimate that the implicit transfer of Flanders to Wallonia amounted to EUR 4.6 billion in 1996 (2.2% of national GDP). This is double the estimate in the study by Cattoir and Docquier (1999), but slightly smaller than the estimate by Abafim (the Flemish authority for Finance and the Budget).

The National Bank of Belgium recently examined the size of interregional transfers (Dury *et al.*, 2008), using net tax payments *i.e.* taxes including social security contributions paid to the central government minus social benefits received from the central government. If the per capita net tax payment of a region is above the national average, the region is defined as a contributor to interregional transfers, and if the per capita net tax payment is below the national average, the region is defined as a recipient. The study finds that the Flemish Region transferred through the tax and social security system EUR 5.8 billion in 2005 (1.9% of national GDP) to the Walloon Region and the Brussels-Capital region transferred 212 million (0.1% of national GDP). The main reasons for the implicit transfers to the Walloon Region are its lower personal income, which leads to a lower base for income tax and social security contributions, and its higher unemployment, which leads to higher social benefits.

The study also projects how inter-regional transfers could develop until 2030 under different scenarios regarding labour market developments in the three regions. In the

scenario, which assumes persistence of current divergences of employment rates, the net contribution of the Flemish Region is more than halved while the contribution of the Brussels-Capital Region increases and the transfer to the Walloon region declines. The main reason for the change in inter-regional transfers is the relatively faster ageing of the population in Flanders, leading to net transfers to Flanders in the areas of pensions and health care. In a second scenario, which assumes convergence of employment rates by 2030, the Flemish Region would switch from a net contributor to a recipient of interregional transfers by 2030. The Walloon Region would remain a beneficiary of inter-regional transfers but these would be less than half of the level in 2005 while the Brussels-Capital region would be the only contributor (Table 3.7).

Table 3.7. **Estimate of implicit interregional transfers**

In per cent of national GDP

	2005	2030	
		Scenario A[1]	Scenario B[2]
Flanders	–1.9	–0.8	0.2
Wallonia	2.0	1.6	0.9
Brussels	–0.1	–0.7	–1.1

1. Scenario A: Current differences in employment rates persist.
2. Scenario B: Employment rates converge in 2030.

Source: Dury. D., B. Eugène, G. Langenus, K. van Cauter, L. van Meensel (2008), "Interregional transfers and solidarity mechanisms via the government budget", National Bank of Belgium, *Economic Review, September 2008*.

An alternative and broader approach to analysing interregional transfers would be to consider that the federal government returns a good part of its tax collection back to the regions through shared taxes and through other transfers (including equalisation transfers to the Walloon and the Brussels-Capital regions) so that the net tax payment of the regions to the federal government and thus the overall amount of interregional transfers would be smaller.[2]

Another problem of estimating inter-regional transfers is how to treat tax payments of commuters who live in one region and receive their income (and their tax base) in another region. In the above-mentioned study, tax payments of commuters are fully allocated according to the "residence principle" (as generally used in income taxation).[3] However, if one instead applied the "source principle" (as is done when measuring the contribution of commuters to regional GDP), the inter-regional transfers would be different; the Brussels-Capital Region would be a much larger contributor, Flanders would be a smaller contributor, and Wallonia would be a larger net beneficiary.

Improving coherence of policies of sub-federal governments in areas of national interest

Given the complex division of responsibilities between the federal and sub-federal governments, it is a major challenge to achieve policy goals that have been fixed at the national level. In a number of areas, such as employment, economic growth, energy and environment, there are clear national responsibilities and commitments although policies of sub-federal governments have major influences. It is therefore of key importance that actors at all levels of government co-operate closely so that national goals can be achieved. In this respect, dialogue between different institutional levels is pursued through a number

of sector specific bodies, such as the Belgian Forum of Regulators. By contrast, insufficient co-ordination and co-operation reduces effectiveness and efficiency of policies for the whole country.

The management of the unemployed is part of ***labour market policy*** and therefore mostly a regional and partially a community responsibility. Regions are responsible for employment policy while Communities are responsible for training. Due to the merging of the Flemish community with the Flemish region these policies are integrated in Flanders. Employment policy and training have also been integrated between the Walloon region and the French-speaking Community, while these policies are not integrated in the Brussels-Capital region. However, the payment of unemployment benefits is part of social security, which falls under federal jurisdiction. This inconsistency between responsibility and funding suggests that there may be not enough incentives for the lower level of government to pursue activation measures for the unemployed with the necessary vigour. Indeed, it has been argued that the employment agency in the Walloon Region has in the past been relatively lax with the unemployed who refuse job offers (Gérard, 2002). More recently, measures have been taken in all regions to improve activation policies and also to increase labour mobility between the regions by improving exchange of information between regional employment offices. Currently, the resident principle in the revenue sharing system gives regional governments stronger incentives to facilitate job offers to unemployed from its own region as compared with those living and commuting from other regions. Labour mobility could also be improved by better training and by systematically informing people about job offers in the various regions. Furthermore, limiting the duration of unemployment benefits would shift some of the costs for the long-term unemployed from the federal government to the municipalities. Transferring budgetary and implementation responsibilities of social assistance to the municipalities and allowing them to use budget savings in this area for other purposes should also be considered. Such a scheme has been implemented in the Netherlands and is providing strong incentives to monitor and activate benefit recipients (OECD, 2008b).

In the area of ***R&D policies,*** responsibilities are divided between regions, communities and the federal government so that altogether five governments are in charge of R&D policies (governments of the three regions, the French Community and the federal government). Regions are responsible for all research, which is carried out in the areas under their competence, such as economic policy, energy, agriculture and environment. This includes most of applied research, including the promotion of business R&D. As the Flemish region has been merged with the Flemish Community, it is also responsible for the research of Flemish universities and higher education colleges, while the French-speaking Community is responsible for research in its universities and higher education colleges. The federal government is responsible for international research in the area of aerospace, for the legal framework of property rights (patents), for research that requires co-ordination between different regions and communities, such as joint projects of universities in different regions (pôles d'attraction interuniversitaire) and for research in the federal scientific institutions. While it can be argued, that the regionalisation of R&D has the advantage of adjusting policies better to the local needs, there is a clear risk of fragmentation with projects and research centres failing to meet the critical mass. According to the European Innovation Scoreboard (EIS) Belgium belongs to the group of countries which are classified as "innovation followers". This also suggests that there is room for improving R&D policies. By contrast, four other smaller European countries

(Sweden, Finland, Switzerland and Denmark) are classified by EIS as "innovation leaders" (together with Japan and Germany) (European Innovation Scoreboard, 2007). In order to improve R&D policies, it would be desirable to evaluate R&D policies in Belgium at all levels of government and to consider if efficiency could be improved by giving more responsibility to the federal government. At the minimum, all ministries involved with R&D policies need to cooperate closely and also exchange information about the effectiveness of policies.

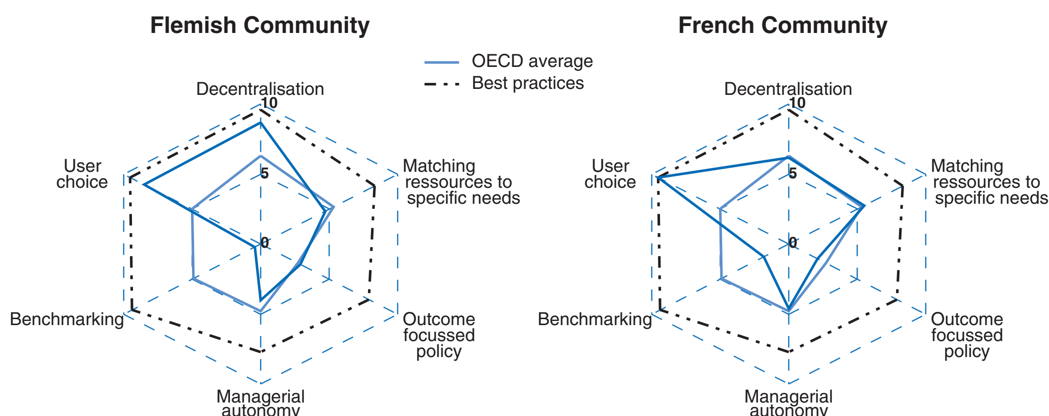
Human capital formation is of key importance for economic growth and, given the ageing of the population, this source of growth will become even more important in the future. The decentralisation of education to the three linguistic communities (Flemish, French and German) has led to a degree of heterogeneity of educational institutions in Belgium which is probably larger than in any other OECD country (Joumard and Kongsrud, 2003). Such heterogeneity is not necessarily a problem, and could even be beneficial, if it reflects different preferences of citizens or leads to quality-enhancing competition. Problems arise, however, if regionalisation of education policies leads to major differences in the quality of education in the various parts of the country. The last *Survey* analysed in more detail issues concerning tertiary education and found that in Belgium tertiary education has been expanded over the past decades, setting the country on a course towards having relatively high human capital formation, but it also found that there has been no matching increase in funding (OECD, 2007). Spending per student is significantly lower in the French community than in the Flemish community so that without additional means, the quality of tertiary education for French speakers could suffer, restraining growth in Wallonia and in Belgium as a whole.

In primary and secondary education, a study by the OECD (Gonand *et al.*, 2007) found that in both the Flemish and the French communities, efficiency of spending is below OECD best practices. While the sub-indicator "user choice" is in both communities close to best practices, and the Flemish Community (but not the French Community) also receives a high ranking with respect to "decentralisation", the other sub-indicators are close to OECD average with the exception of "benchmarking" which appears to be very poor in both communities and receives the lowest ranking in the Flemish Community (Figure 3.2).

In the area of ***environmental and energy policies***, the regional and the federal governments are taking measures to tackle climate change and achieve their part of the Kyoto commitment through such measures as rigorous building performance measures and green certificate trading schemes. In energy policy, a notable recent positive development is the decision to create a centralised oil stockholding agency (IEA, 2006). There are various bodies to co-ordinate energy and environmental policies between the regions and the federal government. The Cellule (*CONCERE/ENOVER* or *Concertation État-Régions pour l'Énergie/Energieoverleg*) is an advisory body for discussions between the federal government and the regional governments on all energy matters, which have been transferred to the regions. The National Climate Commission is a forum for policy cooperation, which will propose a draft National Climate Plan to the Extended Interministerial Conference for the Environment. Another forum for policy co-ordination is the federal Interdepartmental Commission for Sustainable Development. Furthermore, the various regulators of the electricity and gas markets have established a regular

Figure 3.2. **Intermediate indicators for assessing efficiency of public spending in primary and secondary education**

September 2008



Source: Gonand. F., I. Joumard and R. Price (2007), "Public Spending Efficiency: Institutional Indicators in primary and Secondary Education", *OECD Economics Department Working Paper*, No. 543.

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consultation process. Nonetheless, there is room for improving policies in these areas (see IEA, 2006), in particular by:

- Further harmonizing regional energy markets rules and regulations. While significant progress has been made in liberalising the electricity market by allowing transparent and non-discriminatory access to the grid, this market is not fully integrated as market rules and regulations are not fully harmonised across the regions, which creates higher costs for market participants and particularly new entrants. The current multi-layer and multi-regulator structure should be reviewed. At the very least, co-ordination and co-operation among the regulators should be further strengthened and regional and federal governments should work together to fully harmonise rules and regulations (including public service obligations and licence requirements) (see also Chapter 5).
- Creating an integrated green certificate trading scheme by making all the green and combined heat and power (CHP) certificates transferable between all regions; currently, most certificates issued in different regions cannot be traded between regions, except between Wallonia and the Brussels-Capital region.

The political economy of reforming the fiscal system

The implementation of reform needs to take political economy considerations into account. It has been argued that specifying responsibilities of the regions by Special Laws rather than by changes in the Constitution provides more flexibility to adjust to new developments. Nonetheless, regions and language communities have *de facto* the power to prevent changes in fiscal federalism, which they perceive as unfair. A reform of the current division of competences between the federal State, the Communities and the Regions requires either a revision of the Constitution or a so-called "special law". The political renegotiation process in Belgium is therefore complicated and has also been critisised as favouring sub-federal governments at the expense of the federal government (Choudhry and Perrin, 2007).

Although in Belgium there seems to be agreement that the fiscal system should be reformed, it is difficult to find a consensus in which direction to go. The parties involved have so far not been able to agree on a new reform, originally planned after the June 2007 federal elections. However, without reform, the federal budget will probably not be able to carry the whole burden of consolidation and of age-related costs and – if the resistance to reform persist – could be forced to shift the burden to citizens through higher taxes, which are already among the highest in the OECD (see Chapter 4). Furthermore, persisting vertical horizontal imbalances could in the end also lead to lower growth and lower living standards in Belgium as a whole. Finding a consensus therefore requires that all parties have to be convinced that they gain from the reform in the longer run even if some of the measures may be costly for them in the short-term. Reinforcing the longer-term perspective will be easier if the reform package is broad enough and is not perceived as being purely redistributive, but rather as being essential to increase efficiency of the public sector and of living standards in the whole country. The main policy recommendations are presented in Box 3.3.

Box 3.3. **Main policy recommendations for improving fiscal federalism**

Strengthen the fiscal position of the federal government

- Improve the revenue base of the federal government by reducing the amount of shared income taxes, which is transferred to the regions. Redesign the shared income tax in a way that these transfers are not growing faster than actual tax revenues.
- Allocate pension expenditure for civil servants of sub-federal administrations, which is currently a federal responsibility, to the lower government levels. This would reduce incentives of sub-federal governments for allowing early retirement of their civil servants, as they would have to bear the full costs.
- Encourage sub-federal governments to better use their potential to create own revenues (such as personal income taxes or property taxation and user fees).

Redesign the allocation of shared personal income tax between regions

- Take measures to internalize fiscal externalities between regions, notably in the Brussels-Capital region. This could be done, for example, by allocating (partially) the shared income tax to the region where the firm of the worker is located ("workplace principle").

Redesign the system of equalisation transfers

- Reduce the disincentives for regions which receive equalisation transfers to develop their own tax base. This could be achieved by reducing the amount of equalisation for each percentage point of the tax gap so that the system becomes less progressive.

Improve coherence of policies and spending efficiency of sub-federal governments in areas of national interest

- In the area of ***employment policy***, activation policy should be improved to best practice. People should be systematically informed about job offers in all regions, for example by creating a joint website for vacancies in Belgium. The duration of unemployment benefits should be limited to shift some of the costs for the long-term unemployed from the federal government to the municipalities. Furthermore, consideration should be given to transfer budgetary and implementation responsibilities of social assistance to the municipalities and allowing them to use budgetary savings in this area for other

Box 3.3. **Main policy recommendations for improving fiscal federalism** *(cont.)*

purposes, providing the municipalities with strong incentives to monitor and activate benefit recipients.

- In the area of **R&D policies**, evaluate R&D policies at all levels of government and also explore where efficiency could be improved by giving more responsibility to the federal government. At the minimum, all ministries involved with R&D policies need to cooperate closely and also systematically exchange information about the effectiveness of policies.
- In the area of ***education***, ensure that a high quality is offered in the whole country. This requires an adequate allocation of transfers from the federal government, increasing spending efficiency and efforts at the sub-federal level to create own revenues, such as from tuition fees in tertiary education, combined with income contingent loans.
- In the area of ***environmental policy***, create an integrated green certificate-trading scheme by making all the green and combined heat and power (CHP) certificates transferable between all regions.
- In the area of ***energy policy***, review the current multi-layer and multi-regulator structure and, at the very least, strengthen co-ordination and co-operation among the regulators and fully harmonise rules and regulations (see also Chapter 5).

Notes

1. The fiscal autonomy margins for additional taxes and tax reductions were set at 3.25% until end 2003 and at 6.75% up from 2004 of the income tax yield in the region. The federal government passes these changes on by changing the withholding taxes.
2. In 2007, the transfers received from the federal budget amounted for the Flemish Community (and Region) to EUR 16.6 billion (per capita EUR 2 714), for the French Community to EUR 7.35 billion (per capita EUR 1 725), for the Walloon Region, EUR 3.32 billion (per capita EUR 965) and for the Brussels Capital Region EUR 745 million (per capita EUR 723). If one attributes (approximately) the transfers received by the French Community to the Walloon Region and the Brussels Capital Region by using their shares in population (around 77% for the Walloon Region and 23% for the Brussels Capital Region) in order to make the numbers comparable with those in Flanders, the Walloon Region received about EUR 9 billion (per capita EUR 2 610) and the Brussels-Capital Region around EUR 2.5 billion (per capita EUR 2 376).
3. The redistributive effects which are derived from applying the residence principle show, strictly speaking, the inter-personal redistribution of income between the people who are living in the different regions while, when applying the source principle, the effects show the redistribution of income between the regions where income is created independent of the places where people are living.

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ANNEX 3.A1

Main historical steps of Belgium's federalism

Belgian federalism is an evolving process as is illustrated below (van der Stichele and Verdonck, 2002). The Lambermont Agreement of 2001 was the most important recent reform, and a consensus for a new reform has not been reached yet despite the setting up of a group of experts (2007).

- **First state reform 1971:** The Constitution recognises the existence of three regions (Flanders, Wallonia and Brussels) and three cultural communities (French, Dutch and German).
- **Second state reform 1980:** The regions and the communities were fully established with their own responsibilities for matters relating to the person (communities) and the territory (regions).
- **Third state reform** (special financing act, 1989): Belgium became *de facto* a federal state composed of regions and communities, which received expanded responsibilities, including the financial sovereignty over the use of transfers from the federal government.
- **Fourth state reform 1993:**
  - Saint Michel act, 1993: Revision of financing mechanism concerning regions and communities.
  - Saint Quentin decree, 1993: transfer of some tasks from the French-speaking community to the Walloon region and the Brussels region (Commission communautaire française or "Cocof").
  - Saint Éloi act 2000: Revision of the allocation of the VAT transfer between communities.
- **Fifth state reform** with Lambermont (or Saint Polycarpe) agreement, January 2001: reform of community financing; extension of taxing power of the regions.
  - Lombard act, April 2001: Financial assistance for community commissions and communes in Brussels to ensure the functioning of the institutions.
  - Saint Boniface agreement, June 2001: Solidarity measure among French-speakers as the Walloon region and Cocof provided financial assistance to the French-speaking community. Furthermore, it was determined how the French-speaking community should use the future funds obtained after the Lambermont agreement.

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Chapter 4

How to reform the tax system to enhance economic growth

Individual elements in tax systems affect the growth process through different channels and to a varying degree. Consumption taxes are among the least distortive for growth, and there is considerable scope to increase the reliance on this tax source in Belgium. Differential taxation of saving vehicles distorts investment decisions, hampering the reallocation of capital towards its most productive use. However, the most distortive taxes are on labour through their effects on workers' labour market decisions. Recognising the latter, the Belgian authorities have aimed at reducing taxation on labour. However, its level remains internationally high, reflecting numerous exemptions, which reduce tax bases and thus require higher tax rates than otherwise. To promote labour market prospects for individual groups on the labour market, wage subsidies and social security contribution reductions have been used extensively, leading to a complex system, often poorly targeted and at times subject to conflicting objectives. The end result is that the interaction between the personal income tax, the social security contributions, and the generous benefit systems has created a multitude of labour market traps which hold back employment. New tax reforms are constrained by the large and growing fiscal sustainability problem, implying that, unless substantial expenditure cuts are implemented, new tax reforms must be self-financed. This can be achieved by shifting the reliance of the tax system towards the least distortive sources and by broadening tax bases to allow lower tax rates.

The tax system relies heavily on labour taxes

The main concern of the chapter is how taxes affect growth through their influences on the decisions of households to save, supply labour and invest in human capital, the decisions of firms to produce, create jobs, invest and innovate, as well as on investors' choice of savings vehicles. Taxes affect these decisions through both their levels and structures, implying that tax reform to promote growth should address high tax rates as well as shifting taxes to less distortive tax bases. Overall, there is a "tax and growth ranking" among taxes, where property taxes are the least distortive, followed by consumption taxes, personal income taxes and corporate taxes.

Since the early 2000s, Belgian tax reforms have tended to follow international trends towards becoming more supportive of growth with reduced taxes on labour and a modernisation of corporate taxation. This contrasted with developments in the 1990s, where tax policies were mainly aimed at fiscal consolidation in order to qualify for the euro entry.[1] The tax reforms first phased out most of the 1990s' fiscal consolidation measures (full restoration of indexation of tax brackets and ending the crisis surcharge). Then, starting in 2002, a series of the tax reforms lowered personal income taxes, social security contributions and reduced corporate tax rates, with a total overall fiscal cost of 1.3% of GDP. The personal income tax reform was phased in over four years with four distinct parts (the first two constituted the bulk of the reform):

- Part 1 lowered the tax burden on earned income through: *i)* a tax credit for low-wage earners; *ii)* an increase in the standard deduction for occupational expenses in the lowest tax bracket *iii)* a rise in the second and third income brackets; and *iv)* abolishing the highest marginal tax rates.
- Part 2 further generalised individual taxation and introduced lifestyle neutrality by treating married couples as cohabiting persons.
- Part 3 aimed at equalising allowances for taxpayers with dependent children.
- Part 4 promoted environmentally friendly taxation.

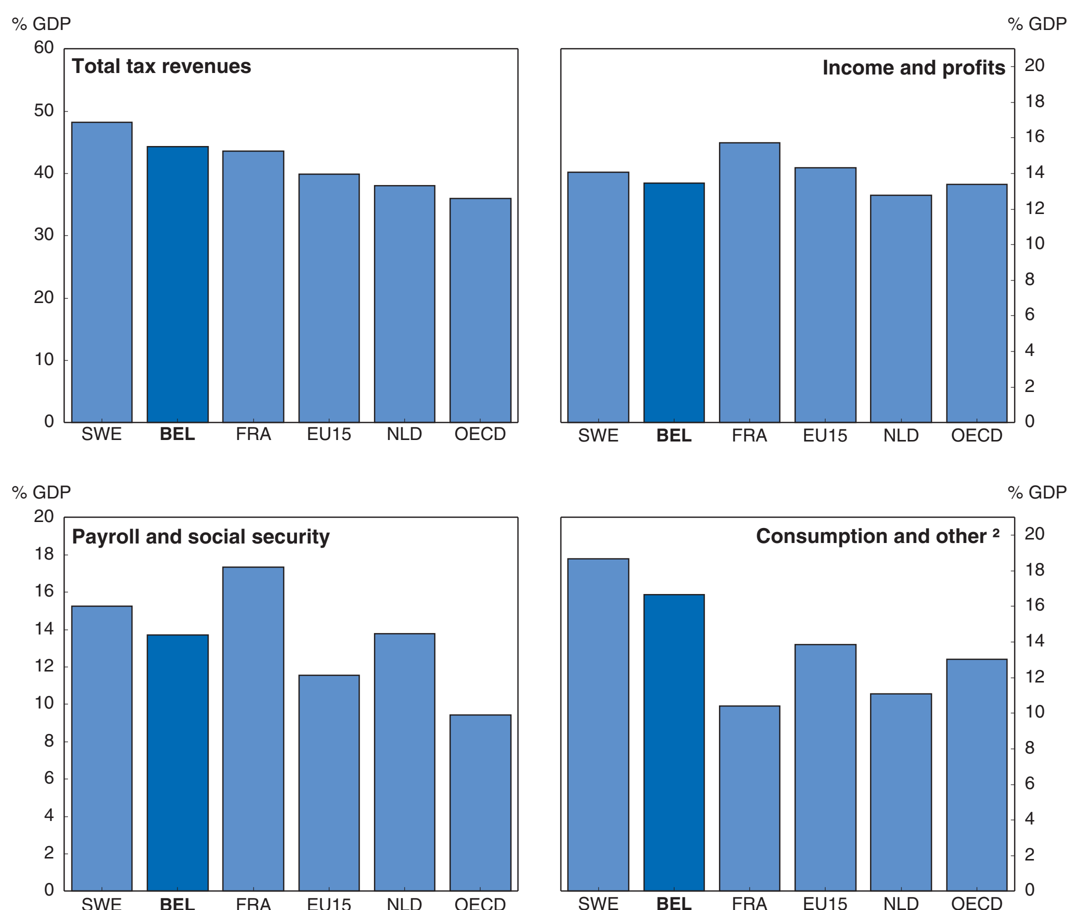
The making-work-pay part of the tax reform lowered average tax rates across the income schedule, though relatively more for low income tax payers, to enhance the positive impact on participation incentives. However, a consequence of the targeting of low-wage workers was to introduce a spike in marginal tax rates, reaching about 72%, for incomes at around half of average earnings (arising from the phasing out of the reduction of individual social security contributions) and another somewhat smaller spike at two-thirds of average wages. Only incomes above one and two-thirds of average wages experienced a reduction in marginal taxes, although the effect on income redistribution was marginal. The full effects on growth of the 2002 tax reform are probably still emerging as structural reforms typically tend to affect structural unemployment with a 5-10 years time lag (Mourougane and Vogel, 2008).There is evidence that the tax reform (including

other measures introduced in the first half of the 2000s) has had a relatively large positive effect on private consumption, but one that dissipated relatively fast (Bodart *et al.*, 2008).

Nevertheless, the tax burden remains among the highest in the OECD (Figure 4.1). Revenues from social security contributions and indirect taxes expressed as a share of GDP are higher than in other OECD countries. However, revenues from indirect taxes as a share of total taxation revenues are lower than in most other OECD countries. Moreover, the Belgian tax system is more reliant on revenues from social security contributions and indirect taxes than other OECD countries. The changes to the tax structure arising from the tax reforms in the 2000s lowered taxes on personal income and increased the reliance on business and VAT taxes (Figure 4.2). Finally, the relatively high corporate tax rate remains an issue in Belgium, although there is more funding neutrality than in other countries.

Figure 4.1. **Overall tax revenues as a share of GDP**

2006[1]



1. Or latest available.
2. Including taxes on goods and services and property.

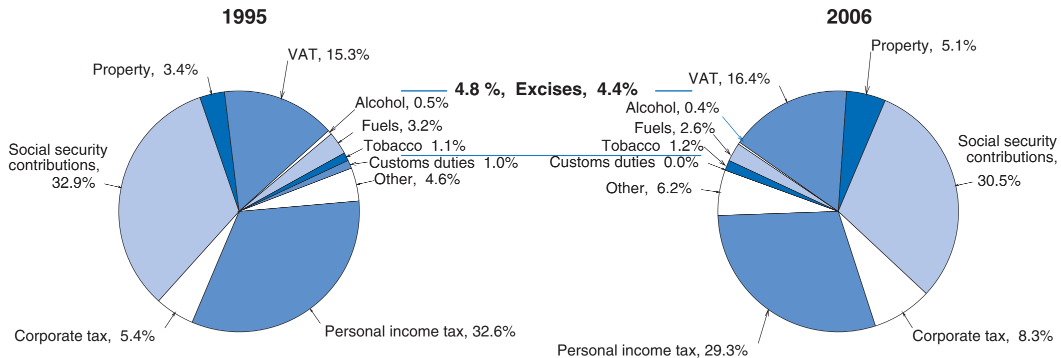
Source: OECD, *Revenue Statistics database*.

http://dx.doi.org/10.1787/646577874701

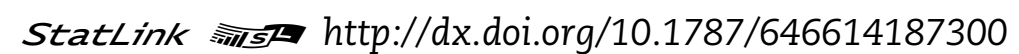
These reforms have been implemented under the constraint of securing fiscal sustainability which remains an issue (Chapter 2). Thus, in the absence of spending cuts, a prime concern for any future tax reform is to be revenue neutral. This chapter will discuss

Figure 4.2. **Structure of tax revenues**

Per cent of total tax revenues



Source: OECD, *Revenue Statistics database.*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how tax reforms can boost growth without endangering fiscal sustainability. The chapter commences with a discussion of how taxation of labour reduces participation and hours worked. Next, the chapter analyses capital income taxation and its distorting effects on savings and investment decisions. Subsequently, the chapter considers how corporate taxation shapes financing decisions. Bearing in mind the fiscal sustainability constraint, the chapter thereafter considers how the tax system could rely more on consumption taxes as an alternative revenue source and concludes with a set of policy recommendations.

The high taxes on labour have a negative impact on labour supply

The personal income tax system is designed to be highly progressive

Belgium has a (semi-) dual income tax system, where different nominal tax rates apply to labour and capital income. Wage income is subject to progressive taxation with a five-bracket structure (Figure 4.3). Despite the abolition of the top marginal tax bracket in the 2002 tax reform, the top statutory tax rate on wage income and the average income tax for a single individual with average earnings remains among the highest in the OECD (Figure 4.4). Other countries have reduced the progression of the income tax rates, leaving Belgium's as one of the steepest in the OECD (Figure 4.5). However, most of the progression is taking place at relatively low incomes as the highest marginal tax rate is applied to incomes that are below annual average earnings for singles (Figure 4.3 and Figure 4.6).[2]

As a result, a relatively high marginal tax rate of 40% is applied to incomes that are not much above many of the sectoral minimum wages, implying that more than two-thirds of all tax units have marginal tax rates above 40% (Decoster and van Camp, 2005). At the same time, almost 18% of all tax units pay no income taxes (Decoster *et al.*, 2008). Thus, despite the highly progressive design of the income tax system, in practise it resembles in many respects a flat income tax system with a relatively large basic tax allowance (Box 4.1). Nevertheless, a number of studies have found that the combined system of labour taxation (*i.e.* personal income tax and social security systems) is progressive (Decoster and van Camp, 2005; Valenduc, 2006). There is redistribution in the social security system as no or limited social security contributions are payable by low-income households, including social benefit recipients, while there is not upper income ceiling for contributions unlike

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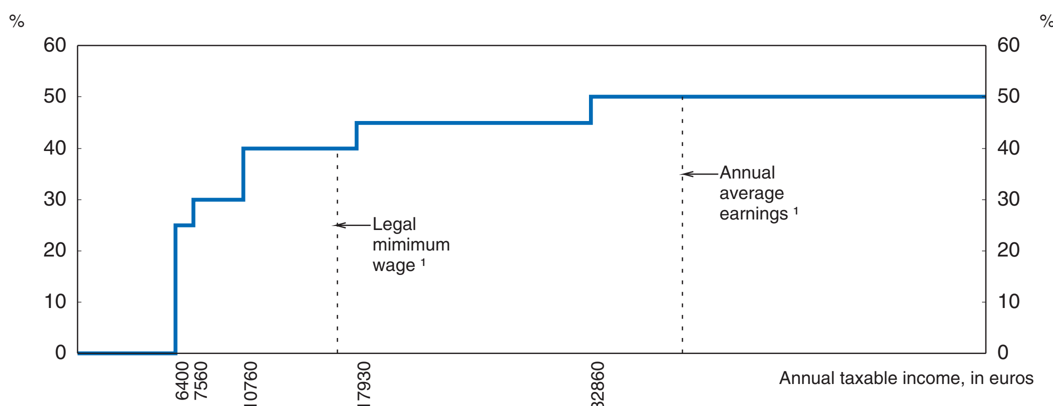
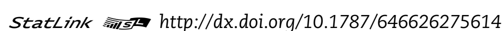
Figure 4.3. **Marginal tax rates by taxable income**

2008



1. Legal minimum wage in 2008 equals EUR 16 657 and annual average earnings EUR 38 681.

Source: OECD, *Taxing Wages database.*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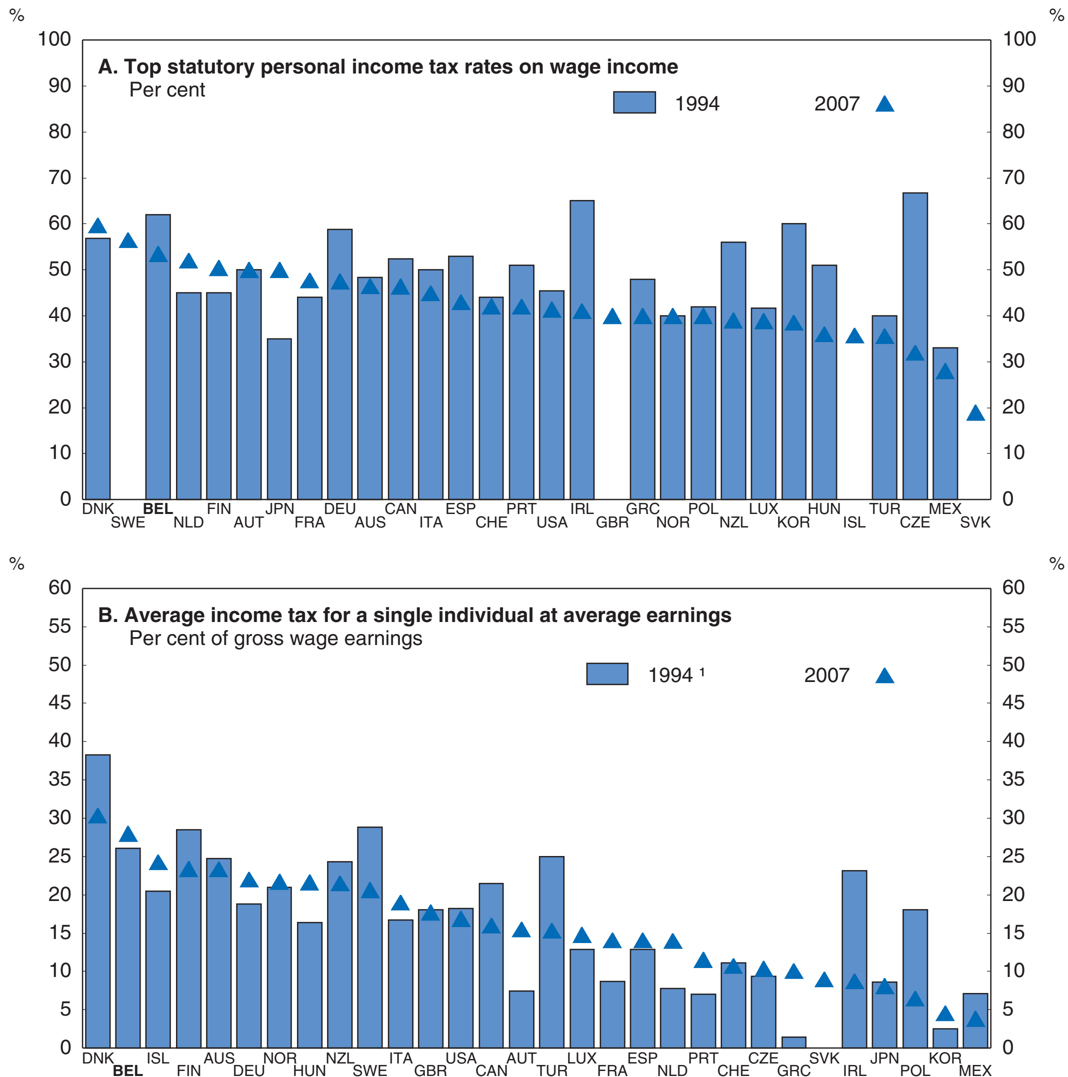
the case in a number of other OECD countries (see below) (Decoster *et al.*, 2006). Also taking into account the effects of social security benefits, this system contributes the largest part to redistribution. The personal income tax system contributes to income redistribution *via* the progressive tax rates. It should be mentioned, however, that some elements in the system are *de facto* regressive. The municipal supplementary income tax rates tend to be somewhat regressive as richer municipalities apply the lowest rates. The tax allowances tend to be regressive as more than two-thirds of the highest income groups benefit from the tax allowance on mortgage repayments as compared with very few in the lowest income groups (High Council of Finance, 2002; Valenduc, 2004; and van Cauter and van Meensel, 2006).[3]

The use of tax relief is widespread and narrows the tax base, leading to higher-than-otherwise tax rates. The most important component is structural relief that is not considered to be a tax expenditure in Belgium because of its general nature, such as the deductibility of mortgage interest payments. The latest available data from 2003 show that foregone revenues arising from structural relief amount to about 6% of GDP, which is equivalent to more than one-third of all personal income taxes and is much larger than tax expenditures (OECD, 2006; Chambre des Représentants de Belgique, 2007). Close to half of this can be explained by the basic tax allowance. Other important tax breaks are related to work allowances (about 1% of GDP) and for social purposes, such as various child and family allowances which are associated with revenue losses of nearly 1% of GDP, and the so-called "quotient conjugal" (the system of co-taxation of spouses *via* the tax splitting system and which mainly affects one-earner households) with a loss of 0.3% of GDP. Such tax relief replaces spending to reach social objectives, implying that abolishing it might not, in itself, reduce the overall tax burden as social spending would have to rise to compensate. However, the main problem with such structural tax relief in a tax system with a strong emphasis on income redistribution is its poor targeting. Better targeting by replacing tax relief for social purposes with targeted social spending would boost tax revenues by more than the necessary increase in social spending, allowing for some reduction of tax rates. Thus, as a base broadening measure, the government should replace structural tax relief by more targeted measures to pursue its social objectives.

Figure 4.4. **Top statutory personal income tax rates and average income tax for average earnings in the OECD**



1. 1995 for Hungary, Poland and Korea, 1996 for Australia. The Belgian data include the local personal income tax surcharge.

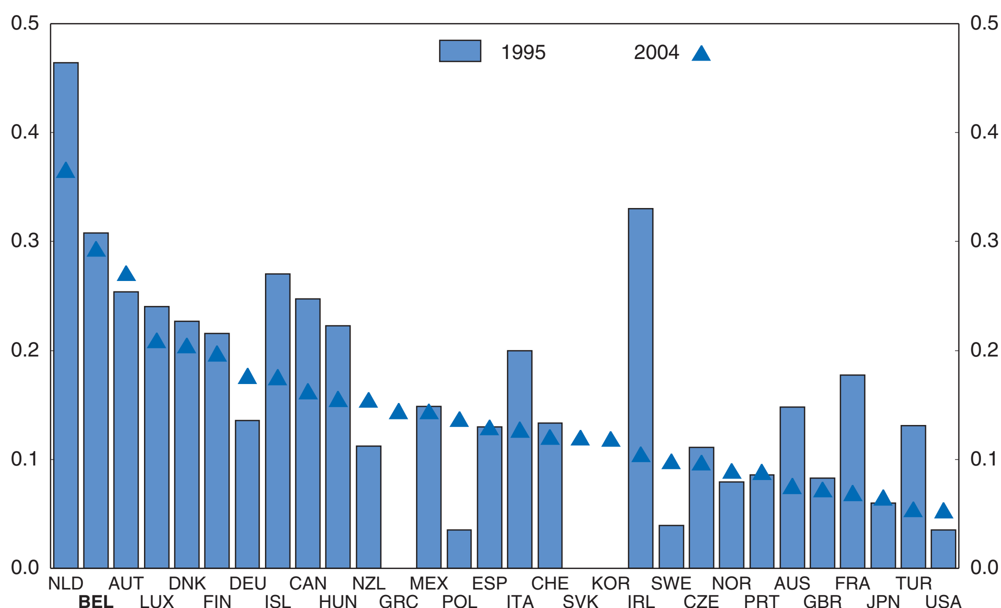
Source: OECD, *Tax database.*

StatLink http://dx.doi.org/10.1787/646642286387

Tax expenditures, which are much narrower than structural tax relief, amount to almost 3% of GDP, which appears high compared with many other OECD countries. In the 2000s, there has been an increasing trend in the use of tax expenditures, such as for housing and energy saving investments in the personal income taxation and the introduction of reduced VAT rates for labour-intensive services in 2002. From a growth perspective, the main problem with tax expenditures is that they narrow tax bases and force tax rates to be higher than otherwise. Also, in terms of income redistribution, tax expenditures suffer from poor targeting – one example is that writers and other artists enjoy a preferential tax regime of a maximal tax rate of 15% on the first EUR 50 000. Moreover, some tax expenditures serve little economic purpose, such as those associated

Figure 4.5. **Statutory income tax progressivity for single individuals at average earnings**[1]

Index increasing with progressivity



1. The measure of progressivity used is the difference between the marginal and average personal income tax rates, divided by one minus the average personal income tax rate, for a single person earning the average wage. Higher numbers indicate higher progressivity.

Source: OECD (2009), *Going for Growth*.

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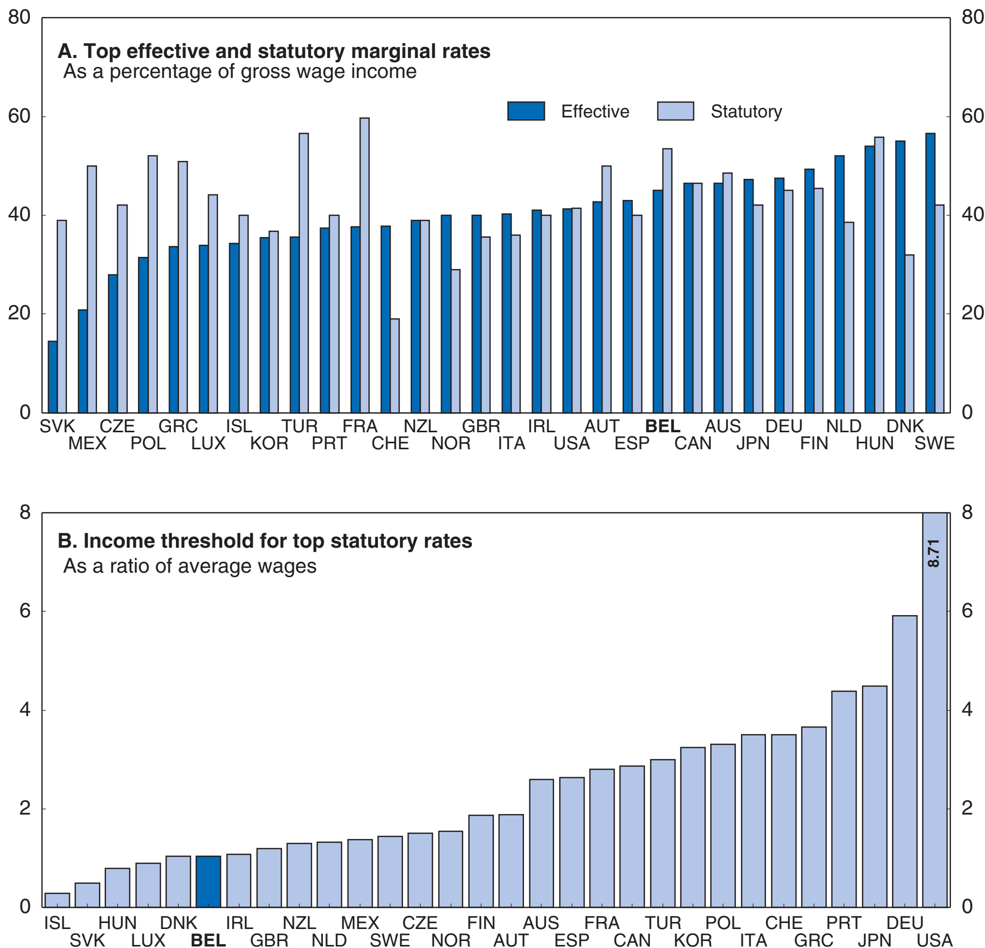
Box 4.1. **A flat tax rate system for Belgium**

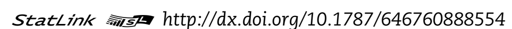
The personal income tax system with the fewest distortions on labour supply decision is a flat tax system as it gives no disincentives for expanding hours worked and would favour entrepreneurship and associated risk taking, thereby boosting productivity growth. In the Belgian context, moving to such a system but with a generous basic tax allowance would to a considerable degree have the same overall effects on income distribution as the present system. It should be noted, however, that income distribution would be affected, particularly for individuals, and that the introduction of such a system in a welfare state is fraught with difficulties. In addition, over the longer term a mitigating effect on possible changes in income distribution of moving to a (revenue neutral) flat tax system would be that its largest effects on participation incentives would be felt by lower income households. Decoster *et al.* (2008) estimate that introducing a revenue neutral flat tax system and maintaining basic tax exemptions would allow a flat tax rate of 37% and boost the (full time equivalent) labour supply by 2%, while removing all tax exemptions would allow a revenue neutral tax system with a flat rate of 26% (Decoster *et al.*, 2008). The scope for a lower flat tax rate within a revenue neutral framework is larger if other exemptions are removed, such as those related to mortgage loans. This would have the additional advantage of addressing some of the distributional concerns. Besides, the positive effects on participation incentives, such a reform would also have the advantage of lowering administrative and compliance costs.

Figure 4.6. **Top marginal rates and corresponding income threshold**

2007



Source: OECD, *Tax database.*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with the tax-exempt savings accounts (see below). Reducing tax expenditures to the level observed on average in the three neighbouring countries (1% of GDP) could actually generate additional net revenues of about 1% of GDP, even by assuming that spending on social and income distribution measures had to increase by a similar size. Tax model calculations by the Ministry of Finance indicate that halving the tax expenditures could finance a reduction in the average tax rate of nearly 1 percentage point (without taking into account dynamic effects) and lead to a mild improvement in post-tax income distribution. Thus, tax expenditures should be reduced, as a tax base broadening measure, to allow lower tax rates while maintaining tax revenues.

The many income tax brackets and large number of tax deductions in the Belgian personal income tax system make it more complex than in many other countries and both administrative and compliance costs are also higher than in most other OECD countries (OECD, 2009). Moreover, the high marginal tax rates reduce work incentives, as discussed below. In addition, OECD research shows a negative impact of higher tax rates on

productivity via entrepreneurship as the high rates reduce the risk-taking by individuals with a particularly strong effect in industries with potentially high rates of enterprise creation (Johannson *et al*., 2008). Another negative effect on growth is that high marginal tax rates contribute to the low expected private rate of return on human capital investments, which over the longer term has a negative effect on the quality of labour supply (Høj, 2007; Oliveira Martins *et al*., 2007).

With such high taxes on labour income, both employers and employees have an interest in tax exempt fringe benefits (Table 4.1). In total, fringe benefits amount to about 20% of wage costs in the private sector and only 10% of the workforce do not enjoy any fringe benefits (High Council of Finance, 2007). Such tax privileges are likely to be extensively used when marginal tax rates are high, leading to increasing tax expenditures. Moreover, a high take-up rate, such as in the case of the estimated half a million company cars, may be incompatible with achieving other government objectives like CO_2 abatement. For example, more than three quarters of the company cars have diesel engines compared with less than half for private cars.

Table 4.1. **Partial or full tax exempted fringe benefit provided by the employer**

	Nature of exemption	Additional conditions
Partially tax exempt		
Private use of company cars (including commuting)	Only the first 5 000 or 7 500 km, depending on the daily commuting distance, are taxable.	The employer has to make a contribution to the social security system, based on the CO_2 emission of the company car.
Stock options	A favourable tax rate of 15% is applied when issued; implying that capital gains are tax free and capital losses cannot be offset in the tax assessment.	If the stock option can be exercised before 5 years from issuances, a higher tax rate is applied.
Lunches	Generally tax exempt when provided in company canteens or purchased *via* vouchers ("chèques-repas")	
Computers and Internet connections		Purchasing a computer at below market price *via* the employer
Loans with preferential rates	Some taxation of the differences between the applied rate and the market rate.	
Housing	Taxed according to the cadastral value of the property, which is set well below market values.	
Furniture and electricity		
Domestic services		Include servants, drivers, etc and include salaries as well as in-kind benefits, such as food and lodging.
Fully tax exempt		
Gifts with a social aspect	Wedding, new born, additional health insurance, use of enterprise child care facilities, subscriptions, tickets for cultural events, etc.	The tax exemption is limited to legally fixed and rather low maximum amount.
Subscriptions	Additional pension arrangements; various insurances against income lost, such as life and disability insurance.	Income from such schemes is fully taxable.
Eco chèques	Exempt from taxes and special security contributions.	The cheques can only be used for acquiring certain ecological products and services such as trees, toilets with eco-flushes, etc.

Source: Submission from the Belgian Government.

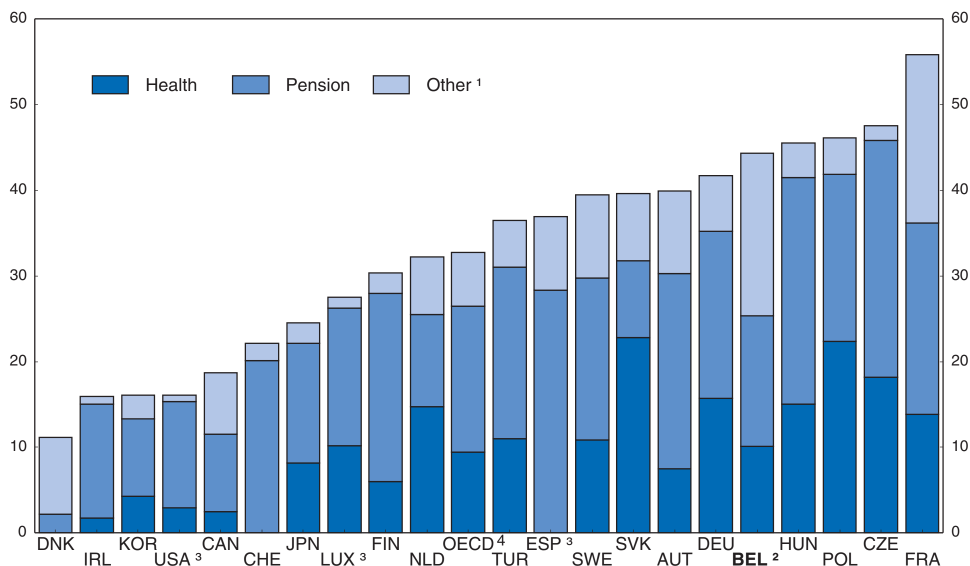
The personal income tax system needs to be reformed, taking into account the beneficial growth effects of base broadening and lower rates. However, such a system may conflict with the income equality objectives in the Belgian society. Taking these objectives into account points to a tax reform that eliminates some of the income tax brackets and increases the remaining sufficiently to ensure that only a relatively small part of the population is exposed to the highest marginal tax rate. Moreover, the highest marginal tax rate should be reduced to stimulate hours worked, while the average tax rate should be lowered to stimulate participation. In the absence of spending cuts, such reforms would have to take place within a revenue neutral framework, pointing to the need for tax base broadening by removing exemptions. It is often argued that such tax reforms carry a high fiscal cost. However, static estimates suggest that abolishing the highest marginal tax rate would entail a revenue loss of less than ¼ per cent of GDP and a 1 percentage point reduction in the average tax rate would lead to an even smaller revenue loss.

Social security contributions pose a heavy burden on labour

Employers' contributions to unemployment insurance and work-related illnesses and accidents schemes have been gradually reduced. However, this progress was offset by increases in other contributions, and in total they remain high by international comparison (Figure 4.7). There is also a special social security contribution, which is levied on the basis of the net taxable income of the households and is applied to all employed persons. This special contribution differs from the ordinary social security contribution for

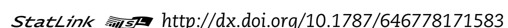
Figure 4.7. **Structure of social security contributions**

Social security contributions for a single worker without children at 100% average worker wage, Percentage of gross wage, 2005



1. The "other" category mainly includes unemployment insurance and work-related illness and accident insurance.
2. The "other" category includes family allowances (6%) and wage restraint (6.6%).
3. Pension includes disability. For Spain, it also includes health.
4. Average for countries shown except Luxembourg, Spain and the United States.

Source: OECD (2007), *OECD Employment Outlook*.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wage earners by exhibiting declining nominal rates and an income cap. However, due to a very large zero rate band, this contribution ends up being progressive at the overall level, although for incomes outside this band the contribution is regressive (van Cauter and van Meensel, 2006).[4] In total, social security contributions add up to close to 48% of gross wage earnings, of which 13 percentage points are paid by employees (Table 4.2).

Table 4.2. **Composition of social security contributions**

Per cent of wages

	Employee	Employer	Total
Unemployment insurance	0.87	3.16	4.03
Health care and insurance	4.70	6.15	10.85
Work-related illnesses and accidents		1.31	1.31
Pensions	7.50	8.86	16.36
Family allowances and child care		7.05	7.05
Placement services, business closures and education leave		0.43	0.43
Wage restraint		7.59	7.59
Total	13.07	34.55	47.62

Source: OECD (2009), *Taxing Wages* (forthcoming).

Despite the high social security contribution rates, the degree of self-financing of the system is only around 72% currently and, with the ageing of the population, is set to fall to around 60% by 2040 (Decoster *et al.*, 2006). The declining degree of self-financing can be explained by the general exemptions (Box 4.2) and the introduction of measures to stimulate employment of selected groups on the labour market, all of which also contribute to increasing the complexity of the system.

Box 4.2. **Main general exemptions in the social security system**

- Pensioners pay reduced contributions, amounting to a solidarity contribution of up to 2% on the highest pensions and a 3.55% health care contribution.
- Disability beneficiaries and people on collectively agreed early retirement allowances pay a reduced pension contribution of 3.5%.
- Unemployed pay no social security contributions on their benefits (van Cauter and van Meensel, 2006).
- Self-employed pay regressive social security contributions. A rate of 19.65% is applied to the income of the first EUR 47 203, where after a rate of 14.16% is applied until EUR 69 568. No contributions are applied to incomes above this level.

Numerous reductions in employers' social security contributions and wage subsidies have been introduced to improve the labour market prospects of selected groups on the labour market – a policy that has been successful so far as, without these measures, business sector employment would have been some 90 000 lower (Federal Planning Bureau, 2006) (Table 4.3). The main elements include:

- An across-the-board standard rebate in all employers' social security contributions.

Table 4.3. **Reductions in employers' social security contributions and wage subsidies**

Employers' social security contributions	Measures
Across the board	A general rebate of EUR 400 on social security contributions, benefiting all employees. In addition, supplementary rebates are provided for low-wage (less than EUR 5 870 per quarter) and high-wage earners (more than EUR 12 000 per quarter).
Second-tier cuts[1]	
Long-term unemployed (Plan Activa)	EUR 400-1000 (expires).
Low-wage earners below 26 years	EUR 400 (expires at age 26).
First-time hiring by start-ups	EUR 400 (expires).
Older workers (older than 50 years)	EUR 50-800 (increasing with age).
Restructuring firms[2]	Quarterly social security cuts (expires).
Third-tier cuts	
Low-wage earners in the age bracket 18-29 years	EUR 300-30 (declining with age).
Wage subsidies	(Cost in 2008 EUR 2.6 billion).
Non-profit (Social Maribel)	Per head (Social security system) (EUR 0.6 billion).
Long-term unemployed (Plan Activa)	Per head (Social security system) (EUR 0.3 billion).
Low-wage workers in small firms	Per head (Walloon region) (EUR 0.02 billion).
Shift and night workers[3, 4]	Pro rata (Federal Government) (EUR 0.7 billion).
Researchers in the private sector[4, 5]	Pro rata (Federal Government) (EUR 0.07 billion).
Young low-wage workers in non-profit activities	Per head (Social security system).
Employment premium for hiring older workers[6]	Staggered per head (Flemish region) (EUR 0.03 billion).
General	Pro rata (Federal Government) (EUR 0.2 billion).
Household service vouchers	Social security system (EUR 0.7 billion).

1. In general mutually exclusive.
2. Collective cuts in work time, re-organisation to a 4-workday per week regime, restructuring plan for troubled firms.
3. Covers workers that are in engaged in overtime, night work, and shift work activities. Was introduced gradually with stepwise increases in the nominal rate from 1% in 2003 to 10.7% in 2007. As part of the 2009-10 wage agreement, the rate was increased further to 15.6% by 1 June 2009.
4. Provided as a discount on withholding personal income taxes to be transferred by firms to the government.
5. In 2008, there was a harmonisation of the (partial) exemption from paying withholding tax on salaries of researchers with the maximum rate of 65% being applied to all categories of researchers.
6. The Flemish government increased in 2009 in the premium paid to workers over the age of 50 who start a new job and the premium (an additional EUR 500) for companies who employ them.

Source: Stockman (2007), "Wage and age related employers' SSC cuts and wage subsidies in the 2007 vintage of HERMES", *Federal Planning Bureau Working Paper,* 12-07.

- Employers' social security contributions are reduced for workers that were previously long-term unemployed, younger and older workers, as well as workers in firms that are being restructured.
- Wage subsidies in the form of a reduction in employees' social security contributions are granted to low-wage earners and workers that take up employment with a new employer after having been dismissed in a restructuring firm (collective dismissals). In practise workers on the legal minimum wage are not subject to social security contributions.
- Wage subsidies, in the form of a rebate on the withholding income tax paid by employers, are granted to shift and night workers, researchers in the private sector and a limited amount of overtime. The measure was extended in connection with the 2009-10 wage agreement to include an across-the-board rebate to offset the effects of the agreed real wage increases on total labour costs.[5]

Cuts in contributions are unlikely to have long-term positive effects on employment if these measures are financed through increases in income taxes and may even in a rigid labour market as the Belgianone lead to higher wages. However, a positive impact on the medium term can be achieved depending on the design of the cut. In Belgium, the actual

design implies a relatively greater percentage reduction for lower-wage workers, inducing some substitution effects between low and high wage workers. Empirical work indicates that by far the strongest employment effects are achieved with measures targeting young low-wage workers or more generally targeting low-wage workers. Less efficient measures are across-the-board reductions, while those aimed at older workers, and shift and night workers are the least effective (Stockman, 2007). The latter result reflects that subsidies directed to shift-workers are mostly aimed at supporting the manufacturing sector, where employment is less responsive to wages than in the service sector.

The total budgetary cost of the reductions in social security contributions and wage subsidies amounts to some EUR 6.5 billion (of which about two-thirds is accounted for by the general cut in employers' social security charges) and the cost per job created or saved varies significantly across measures. Reflecting the modest tax receipts from low-wage workers, the self-financing rate is only 13% for young low-wage workers, slightly higher for shift-worker subsidies and about 30% for across the board cuts in social security contributions and measures targeted at older workers. On the other hand, the measures aimed at young low-wage workers are the most cost effective with a net budgetary cost of EUR 51 420 per job created – a cost that is comparable with what can be observed in other countries (Immervoll and Pearson, 2009; Grubb and Martin, 2001). In contrast, the least cost effective measure is the measure for shift-workers, with a net budgetary cost that is about three times higher – about EUR 150 000; the measure covers about 300 000 workers with a fiscal cost of nearly EUR 600 million, which is set to nearly double in 2009 (see Chapter 1) – raising the question of whether the associated benefits are sufficiently large to warrant such a measure.

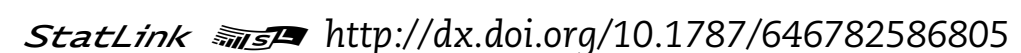
The programmes cover relatively large groups. For example, about 35% of all jobs are eligible for the reduced low-wage social security contribution and the special programmes (for hard-to-employ unemployed and employment in start-ups) encompass about 5% of all jobs (Stockman, 2007). The programmes' multiple objectives are conflicting; econometric work indicates that the reduction in social security contributions for older workers reduces the employment prospects of younger low-wage earners (Stockman, 2007). Most of the beneficiaries of the wage subsidy measure for shift and night workers are actually found in the non-exposed service sector, where it is unlikely to have much of an impact on employment. On the other hand, the measure is likely to improve the external competitiveness in parts of the manufacturing sector, particularly the chemical and the automobile industries, which have a relatively strong employment effect in other sectors. Moreover, such targeted cuts may help to counter the incentives for outsourcing of production embodied in high social security contributions and high minimum wages (van den Cruyce and Wera, 2007; Koskela and Poutvaara, 2008). However, in a globalised world, price competitiveness is becoming less important for developed countries as their export markets are maintained through the ability to move up the value-added chain. Thus, in the short term, this measure may preserve jobs, but at a very high fiscal cost. In the longer term, the measure is unlikely to be more successful than earlier vintages of industrial policy.

Alternative instruments to promote employment prospects of selected labour market groups may be more cost efficient. For example, during economic crises low-skilled younger workers will be disproportionately affected indicating that in the short term the cut in employers' social security contribution may seem appropriate to stimulate labour demand for this group (Figure 4.8). In the longer term, such a measure should be age-neutral to avoid threshold effects and the labour prospects of this group should be improved through other instruments. For example, a less costly measure in fiscal terms – an important consideration

Figure 4.8. **Labour market prospects for younger workers in the OECD**

2007, 15-24 year olds

Source: OECD, *Employment Outlook database.*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in view of the fiscal sustainability problems – would be to have a more gradual increase in the minimum wage for younger workers, which is currently going from 70% at the age 18 to 82% at age 18 before reaching 100% by the age of 21. Empirically, there is some, but not conclusive, evidence that such a measure may stimulate employment of younger workers (Bassanini and Duval, 2006). Cost efficiency of the many measures could probably be increased by focusing on one instrument for each group. For example, the wage subsidies are basically countering the negative labour market effects of high sectoral minimum wages. These are considerably higher than the legal one, which relative to averages wages is higher than in almost all other OECD countries (Immervoll and Pearson, 2009). Moreover, the relatively high sectoral minimum wages indicate some scope for social partners to improve the employment prospects of low-wage workers. A similar situation is true for the generally well paid workers in the automobile and chemical industries (who also have generous compensation for working unusual hours) and for older workers that benefit from seniority or age related pay (age based systems are being replaced by systems based on competence or seniority, following an EU court decision, see Chapter 1). However, the scope for social partners reaching job preserving wage agreements is limited by the automatic wage indexation.

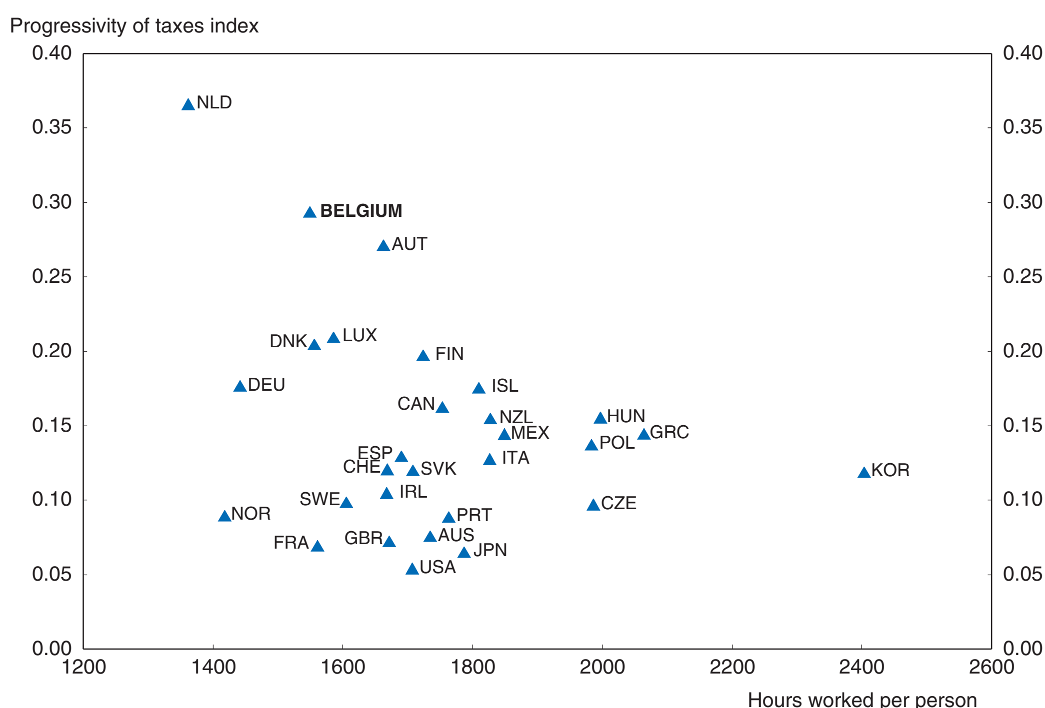
Despite government intervention, labour market traps remain substantial

Effective marginal tax rates are high for most workers. Using a micro-simulation model, Decoster *et al.* (2008) showed that the majority of both males and females (independently of their family situation) are faced with marginal tax rates above 50%. Moreover, the effective marginal tax rates tend to be even larger as more than three-quarter of single women and about half of married women are faced with rates of

60% or more. Particularly, the tax splitting system subjects the low-income spouse (typically one that prefers part-time work) with higher marginal income tax rates than singles with similar incomes. As the labour supply elasticity of female workers is relatively high, this appears to have contributed to the relatively low average hours worked (Figure 4.9) (Jaumotte, 2003). In addition, non-working spouses are covered in the social security system through the working spouse's contributions, implying even higher effective marginal tax rates. To stimulate hours worked by low-income spouses, the government should complete the full tax separation of spouses as implemented in many other OECD countries. The number of men faced with similar effective tax rates is even higher, but they have relatively inelastic labour supply.

Figure 4.9. **Progressivity of taxes and hours worked**

2004



Source: OECD (2009), *Going for Growth* and OECD *Productivity database*.

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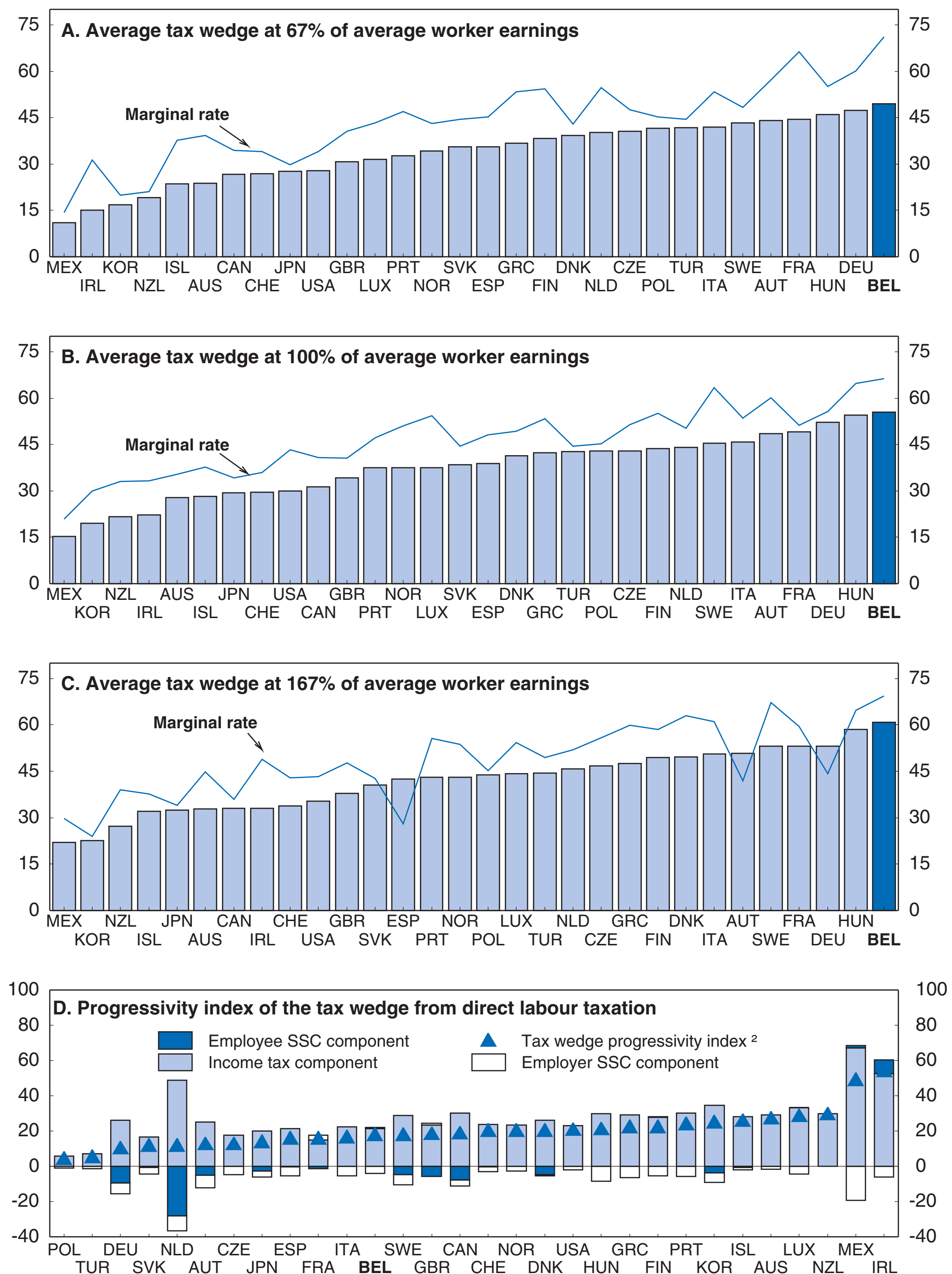
The 2002 tax reform and subsequent measures to lower labour costs reduced effective marginal tax rates for all household types and income levels (OECD, 2008). Further measures implemented in 2008 include higher in-work benefits, allowing job seekers that accept part-time employment to receive a top-up unemployment benefit, which is attributed independently of the family situation and of in-work benefits. In addition, a childcare wage complement is in place and a mobility complement is considered to enhance incentives for unemployed to expand their job search to beyond 75 km from their place of residence and to encourage sole parents to return to the labour market. Nevertheless, the Belgian tax-wedges are among the highest in the OECD which, in rigid labour markets such as Belgium, hampers the smooth adaption of real wages to labour market disequilibria (Figure 4.10). Moreover, the 2007 reassessment of the OECD Jobs

Figure 4.10. **Tax wedge across countries in 2007**[1]

As a per cent 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.
2. The progressivity index of the tax wedge is calculated as (TW167 – TW67)/ TW167, where TW167 and TW67 is the tax wedge for workers at 167% and 67% of average wage, respectively.

Source: OECD, *Tax database*.

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Strategy showed that a 10 percentage points reduction of the tax wedge in an average OECD country boosts over time the employment rate by 3.7 percentage points (OECD, 2005).

The high tax wedges combined with the withdrawal of the various reductions in social security contributions leads to unemployment, inactivity and low-wage traps for low-wage workers. An effective marginal tax rate of above 80% on moving from unemployment to a low-wage job remains among the highest among European OECD countries (Table 4.4). Inactivity traps, measured by the effective tax rate for social welfare beneficiaries of moving into a low-wage job, are not as high, but still a deterring 70% for a single earner household with children. Moreover, low-wage workers are faced with high marginal effective tax rates when moving up the wage scale as benefits are reduced. Depending on the family situation, the low-wage traps vary between 45 and 58% for the lowest incomes, which is relatively high among European OECD countries.

Table 4.4. **Financial work incentives in Europe**

	Unemployment trap		Inactivity trap				Low-wage trap indicator				Net replacement rate	
	Single[1]		Single[1]		1 earner couple with 2 children[2]		Single[3]		1 earner couple with 2 children[3]		Single[1]	
% of average production worker wage	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07
Austria	68	0.6	64	–2.8	82	–6.9	38	3.1	65	–17.2	55	–12.7
Belgium	**83**	**–2.3**	**66**	**0.1**	**63**	**–3.5**	**59**	**2.3**	**45**	**2.7**	**74**	**–8.9**
Czech Republic	83	–2.3	66	0.1	63	–3.5	59	2.3	45	2.7	74	–8.9
Denmark	90	–1.7	88	–1.9	84	–11.4	56	–3.3	72	–21.5	85	–2.0
Estonia	82	1.7	44	1.6	52	–5.8	26	1.2	10	–18.0	78	2.4
Finland	75	–5.4	73	–4.3	92	–5.7	62	6.7	100	4.0	67	–7.0
France	81	0.2	61	–2.7	80	–0.1	41	–2.6	63	–5.9	75	–8.4
Germany	75	0.7	68	1.6	81	5.2	51	–1.4	82	1.7	61	–20.9
Greece	59	2.1	17	0.3	16	0.1	19	0.4	16	0.1	50	–13.3
Hungary	77	5.9	46	–4.5	59	1.6	37	–4.6	37	9.1	73	7.9
Ireland	76	3.7	76	3.7	88	1.2	52	7.9	78	–3.8	74	5.0
Italy	72	12.5	22	2.2	–8	–0.4	34	4.2	11	–0.6	64	14.5
Luxembourg	88	0.0	68	0.3	89	0.4	51	7.7	110	14.6	85	0.3
Netherlands	86	7.0	85	4.5	88	1.0	59	–2.6	78	–3.2	80	0.4
Poland	79	–1.5	56	4.1	63	–3.8	38	0.4	72	–4.0	70	2.5
Portugal	82	0.5	37	0.4	57	–0.1	22	1.2	56	–1.5	78	–7.9
Sweden	82	–5.2	73	–6.6	90	–7.8	47	–12.9	80	–15.8	76	–5.8
UK	68	–0.3	68	–0.3	80	4.0	57	–0.4	85	7.2	58	–5.5

1. 67% of average income.
2. 67% of average income.
3. 33-67% of average income.

Source: European Commission services, based on the joint EC-OECD METRS project.

A reform of labour taxation needs to consider the personal income tax and the social security contributions together. In any case, with the many exemptions and targeted cuts, most employees are likely to already consider their social security contributions as another tax rather than as deferred benefits. To broaden the base for the social security contributions implies that contributions should be a function of income. Thus, the exemptions for self-employed and pensioners should be abolished.[6] Moreover, to increase the cost-effectiveness of wage subsidies, their scope should be narrowed to groups with

weak labour market prospects, *i.e.* low-wage workers. Some temporary targeted cuts could be preserved for young unskilled workers and should be supplemented by a more gradual phase in of minimum wages. The social partners should become responsible for the employment prospects of other groups rather than relying on government finances to achieve this objective. This reform should be concluded by removing spikes in the effective marginal tax rates to address the remaining labour market traps.

The corporate income tax system has become more neutral *vis-à-vis* types of financing

Corporate income taxes affect growth through their effect on the after-tax rate of return on investments that are the basis for jobs creation, and on higher productivity through the introduction of new goods and technologies. These considerations were behind the cuts in nominal and effective corporate tax rates in the 2002 tax reform, although they remain relatively high (Figure 4.11). An additional reform in 2005 made the corporate tax system more neutral *vis-à-vis* various types of funding sources through the introduction of the so-called risk capital allowance, largely removing the incentives for debt financing found in many other OECD countries. Preliminary estimates indicate that the 2002 reform was broadly neutral in budgetary terms as initially expected, although they vary strongly with the business cycle (Figure 4.12) (OECD, 2004).

The origin of the 2005 reform was a European Commission decision that the previous regime with coordination centres for multinational companies was not compatible with EU state aid rules (Box 4.3) (Burggraeve *et al.*, 2008). The risk capital allowance (commonly known as "the notional interest deduction") took effect from the 2007 tax year and it allows companies to deduct from their tax base a notional amount of interest (based on the rate on 10-years government bonds two years before the tax year) on their (adjusted) equity capital.[7] The system is fairly unique internationally, although some countries have had such systems in place in the past (Brazil and New Zealand) or have incorporated elements in their tax code (Austria, Italy, Ireland, Luxembourg and Switzerland). Besides the neutrality objective, the reform also aimed at providing international firms that used the system of coordination centres with an attractive alternative as a way of securing Belgium's somewhat unique position in OECD as a net recipient of FDI – an important source of technology transfer (OECD, 2007a). A European Commission infringement procedure was opened in early 2009 because the notional capital allowance is not extended to Belgian firms investing abroad.

Preliminary analysis indicates that whereas the old system favoured debt financing for all types of investors, the new system is more neutral (Gérard, 2009). In the new system, the preferred funding for individual investors is through retained earnings, while for holding companies the system is almost neutral between new equity financing and retained earnings. This is likely to have contributed to a marked increase in equity capital (nearly EUR 250 billion for the period 2006-07), of which about half came from abroad. At the same time, the share of equity capital in the non-financial sector increased, partly as the result of larger cross-holding, but could nevertheless indicate an improvement in solvency, particularly as firms at the same time appeared to rely less on debt financing. Using the risk-free government interest rate for calculating the notional rate means that the latter is lower than the interest rate on debt financing, implying that, from the point of view of the companies, there remains some advantage to debt financing. Completing the reform to make corporate taxation fully neutral *vis-à-vis* various types of financing, for

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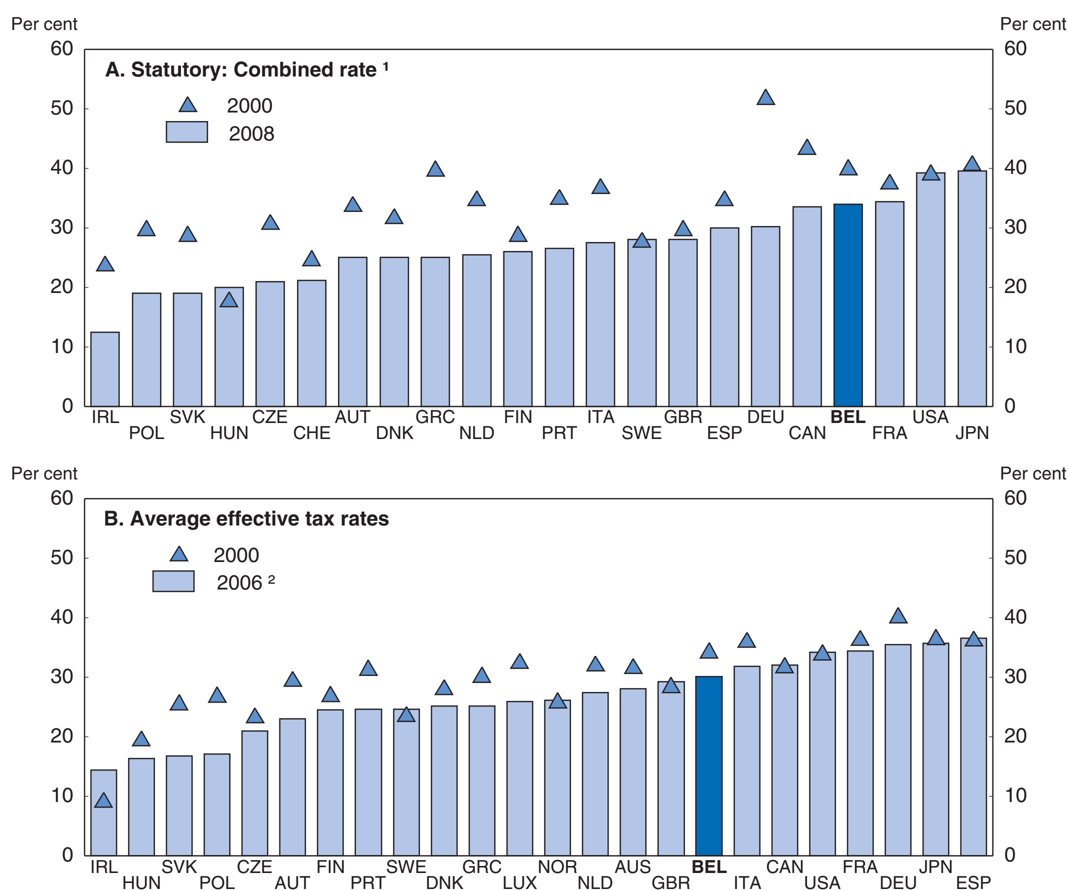
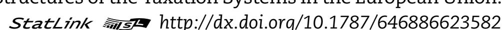
Figure 4.11. **Corporate tax rates in international comparison**



1. Basic combined central and sub-central (statutory) corporate income tax rate. Aggregates are unweighted averages and EU 10 covers the new EU member states.
2. Data refer to 2005 for Australia, Canada, Japan, Norway and United States.

Source: CTPA/CFA/WP2(2007)14 and International Financial Statistics, OECD (2007), *Tax database*, *www.oecd.org/ctp/taxdatabase* and European Commission (2006) Structures of the Taxation Systems in the European Union.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example by using a notional rate that corresponds more to the actual cost of financing, could improve total factor productivity (TFP) growth because financing forms would be independent of the tax treatment, which for example would improve financing conditions for knowledge based industries that typically rely on equity to finance investments in intangible property (Johansson *et al.*, 2008).

A number of measures have been taken to stimulate growth and innovation in young innovative companies, who are enjoying reduced corporate tax rates and a special tax allowance for young innovative SMEs – defined as companies with less than 50 employees, less than 10 years old and with an annual turnover below EUR 7.3 million, of which at least 15% is on spend R&D – in addition to the general wage subsidies and tax allowances for R&D personnel (Johansson *et al.*, 2008; van Cauter *et al.*, 2004). In addition, there are additional large R&D subsidies at the regional level, particularly for SMEs. At the general level, tax credits for R&D investments are more effective in stimulating innovative activities than direct subsidies, but the time lags are long and the effect is modest. Moreover, higher R&D spending has only a small effect on overall TFP growth (Jaumotte

Figure 4.12. **Corporate tax rates and revenues**

A. Implicit tax rate and statutory rate for Belgium

%

Implicit tax
Statutory rate

1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008

B. Corporate income tax revenues as a percentage of GDP

%

Belgium
OECD average

1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008

Source: Eurostat (2008, 2007), *Taxation trends in the European Union* and OECD, *Tax database.*

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and Pain, 2005a and b). However, such measures are likely to be less effective when aimed at SMEs because of their limited research capacity. This calls into question the cost efficiency of such measures. Indeed, stimulating R&D is more efficiently done through flexible product and labour markets (see also Chapter 5). The reduced corporate tax rates for SMEs are normally justified by financial or product markets failures, but as small young companies rarely pay corporate taxes, given that many of them are start-ups with low profitability, the measure is not effective in alleviating such market failures. On the other hand, reduced rates may be an impediment for small companies expanding beyond a size that is below their optimal scale of production. Given the limited corporate tax revenues from small business and the potential damaging effect on growth of reduced corporate tax rates, they could just as well be abolished. The relatively high standard corporate tax rate should be lowered to bolster the after-tax rate of return on invested capital, thereby stimulating private investments and TFP growth (Johansson *et al.*, 2008). This is particularly important for catching-up firms (to best productivity practices) as such firms are likely to finance their R&D activities through retained earnings. The extent of the lowering should reflect the need for maintaining a favourable environment for future FDI inflows.

Box 4.3. **Coordination centres**

Coordination centres are companies that belong to multinational groups and whose sole purpose is to provide finance, treasury management, accounting, consultancy, and other services to other companies in the same group. Special tax rules are applied to coordination centres, with a particularly attractive regime for inter-firm transactions. The associated tax expenditures amounted to just below EUR 1.9 billion in the 2004 tax year. Coordination centres in this context are defined as companies that manage the financial flows in a multinational group with operations in at least four countries. To qualify for the special tax rules, the companies need a consolidated turnover of at least EUR 240 million and a consolidated capital of at least EUR 24 million. An additional requirement is that foreign equity must be at least EUR 12 million or 20% of the group's foreign equity capital. Moreover, the coordination centres must employ at least 10 full-time workers after two years of operation.

As the European Commission found the special tax system for coordination centres incompatible with state aid rules, the Belgian government is phasing out the regime by end 2010. When the coordination centres lose or relinquish their approval, they come under the scope of the ordinary corporate taxation rules and can therefore use the risk capital allowance. The latter seems particularly suited to coordination centres, which are characterised by having high equity capital (a total of some EUR 170 billion in 2006) and for the relatively low return they normally obtain on that equity, as their main revenue tend to come from interest on loans that they extend to other companies within the group.

Following the introduction of the new rules, the number of active coordination centres has declined from 226 in 2004 to 74 in the spring of 2008. Some of these have opted to move their activities to other financial centres, particularly Switzerland. Moreover, a number of coordination centres have chosen to use the risk capital allowance. Furthermore, there has been a substantial net capital increase, reflecting some initial capital outflows followed by higher inflows, although the final effect can only be assessed once all coordination centres have been closed. A preliminary conclusion could be that many coordination centres consider the risk capital allowance as an acceptable alternative.

The tax treatment of savings vehicles varies considerably

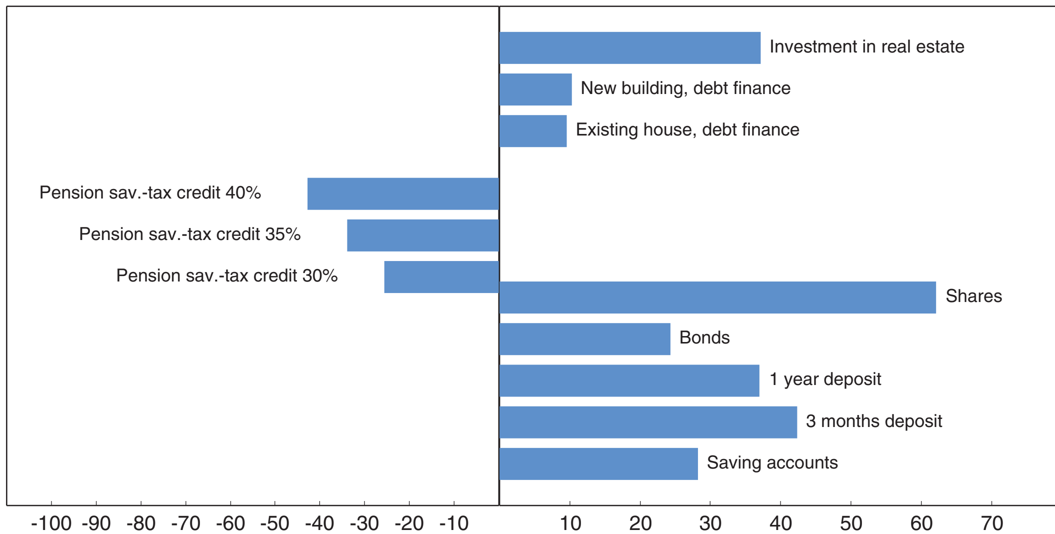
There is a very wide difference in the tax treatment of various savings vehicles (Figure 4.13). Owner-occupied housing and third pillar pension investments are relatively more favoured by the tax system than savings in other financial instruments, such as bank deposits, government bonds or equity. The tax favouring of individual vehicles aims at stimulating private savings. As discussed in the previous *Survey*, such tax measures do not boost overall private savings, despite the often substantial fiscal cost, and thus have little effect on growth. On the other hand, these measures channel savings towards specific savings vehicles, which are not necessarily the same as those with the highest pre-tax returns, hindering capital allocation and thus productivity growth.

Taxation of owner-occupied housing is lenient

Revenues from taxes on immovable property are less important than in most other OECD countries (Figure 4.14). The personal income taxation of owner-occupied housing contains two main elements: the tax deductibility of mortgage payments; and a tax on imputed rent. Since 2005, the tax deductibility is at the top marginal tax rate and is more inclusive than in other countries, as all of the repayment (*i.e.* interest payments, capital

Figure 4.13. **Effective taxation of saving vehicles varies widely**

Effective taxation rates, 2001-2004[1]



1. Effective taxation rates are defined by the ratio of the difference between gross and net return rates, and real gross return rate (deflated by inflation). Effective taxation rate varies with net return rate as taxation differs for each type of vehicle. Taxation of shares is today lower than indicated in the figure because of the introduction of the notional interest deduction.

Source: Valenduc, C. (2003), "Effective taxation of households saving in Belgium", paper presented at the 59th Congress of the International Institute for public finance, Public Finance and Financial markets, Praha, 25-28 August 2003.

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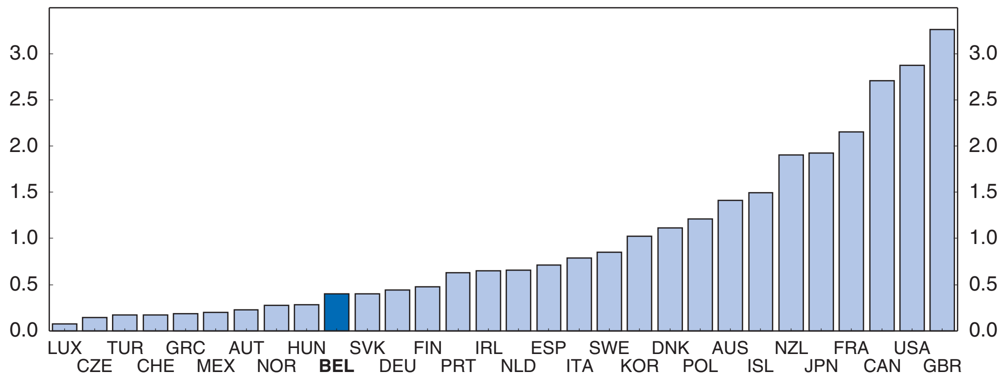
Figure 4.14. **Immovable property taxes**

Per cent of GDP, 2007[1]



1. 2006 for Australia, Belgium, Greece, Mexico, Netherlands and Poland.

Source: OECD, *Revenue Statistics database.*

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repayment and life insurance premium) can be deducted and there is a generous upper limit of EUR 1 990 for each spouse and with an additional EUR 660 the first 10 years on the maximum amount exempted per year (OECD, 2007b). This tax advantage is in theory balanced by the tax on imputed rent. However, the assessed value of the property is based on its value in 1975 and since 1991 has been indexed to the development in the consumer

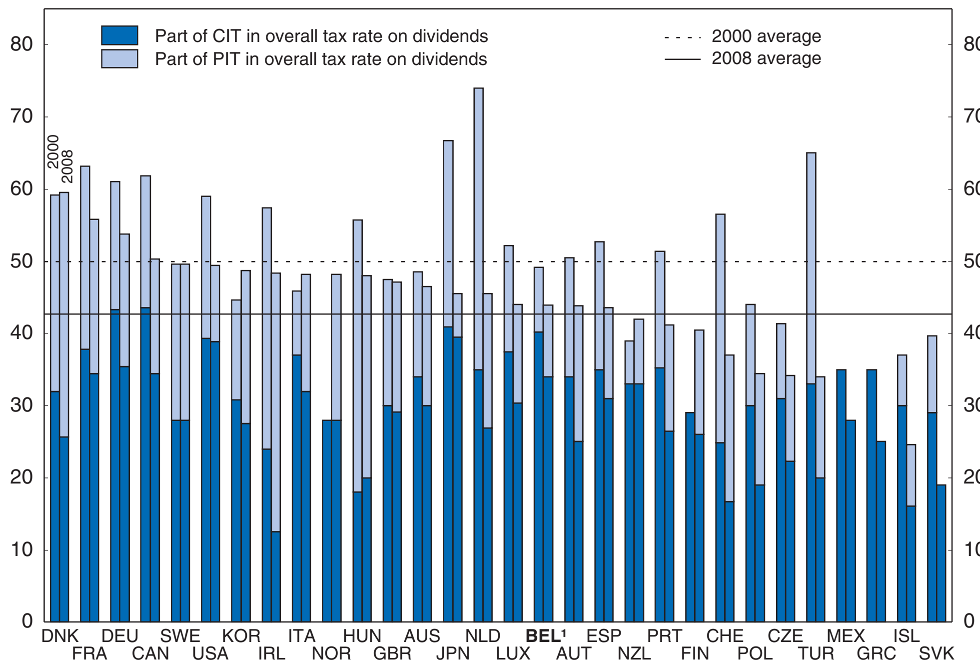
price index, leaving (on average) the assessed value at less than half of the market value. This is despite the fact that the law stipulates a new assessment every 10 years. However, the Federal Ministry of Finance has few fiscal incentives to fulfil its costly assessment responsibility as the resulting increase in tax revenues benefits the regions and, to a larger extent, the municipalities (through a proportional rate levied on the tax value of the property). Moreover, as part of the 2005 changes to the tax code, imputed rent is no longer subject to taxation (Valenduc, 2008).

The winners in the system are the owners of private rental housing as a result of the widening gap between the market rental value of their property and the imputed rent, while the losers are inhabitants in formerly high price neighbourhoods in larger cities, such as Brussels, who have maintained their taxation despite the relative fall in the value of their dwellings. Moreover, growth is also impaired by the preferential tax treatment of housing as this will ultimately lead to higher house prices which together with the internationally high transaction taxes (as described in the previous *Survey*) reduce labour mobility and thus the efficient allocation of labour. Thus, to boost growth, enhance income redistribution measures, and increase the reliance on the least growth-distorting tax source taxation of housing should be increased. This should principally take place through a higher effective taxation of imputed rent through a more realistic assessment of property prices and extending the measure to all properties. A realistic assessment could be assured by making the value assessment of properties the duty and responsibility of the regions. Moreover, the tax deductibility of mortgage repayment should be restricted to the interest part payments and not the capital repayment. Such a reform could generate additional revenues in the order of 0.2% of GDP.[8] That would still leave Belgium with less reliance on immovable property taxes than in other countries, so the rate of taxation should also be increased to allow a reduction of taxation in other areas. If it proves difficult to reform taxation of imputed rents, an alternative measure would be to drastically reduce the tax deductibility of mortgage payments.

A number of financial saving vehicles also benefit from preferential tax treatment, such as regulated savings accounts, life insurance contracts, second and third-pillar pension funds. The associated tax expenditures may be warranted insofar as such treatment boosts overall savings and thus long-term growth. The tax-exempt savings accounts are particularly popular (totalling more than 50% of GDP and the number of accounts is some 70% larger than the population) as the first EUR 1 730 of interest (for 2009) is fully tax exempt and as the accounts are almost effectively just normal drawing accounts, as deposited funds can in many cases be withdrawn without notice (OECD, 2007c). Interest above the tax exempt amount is subject to a 15% withholding tax. Contributions to the tax-preferred life-insurance contacts and third-pillar pension plans are tax exempt (for 2007 up to EUR 1 950 and EUR 810 respectively). Also contributions to second-pillar pension plans are exempt, where there is a limitation on pension payouts that is equal to 80% of the last working income. Moreover, policy holders of tax-preferred life-insurance contracts are subject to a 10% personal income tax on the capital paid out at the end of the contract (a rate of 16.5% is applied to contributions paid before 1992), augmented with a 3.55% contribution to the social security system to cover for health insurance.[9] In comparison, taxation of dividend income is much heavier reflecting a personal income tax rate on dividends of 25% (15% in some cases), which together with the corporate tax rate leaves the total statutory tax rate at above 40%, just above the OECD average (Figure 4.15). The heavier taxation can be circumvented as the lack of capital gains

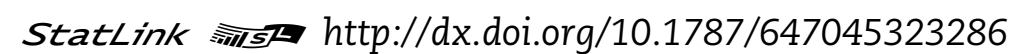
Figure 4.15. **Overall statutory tax rates on dividend income**

2008



1. For shares issued before 1 January 1994 the (withholding) personal income tax rate is 25 per cent. The withholding tax is final, if the shareholder so chooses. The lower the return on equity before tax, the lower the effective tax rate due to the allowance for corporate equity (ACE). *E.g.* the effective corporate tax rate is only half the nominal (statutory) corporate income tax rate when the return on equity before tax is twice the notional interest rate (4.307% in 2008).

Source: OECD, *Tax database*.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taxation means that financing investments through retained earnings can boost the (tax-free) share value. However, investments made for tax reasons may not necessarily have the highest possible rate of return, which leads to a misallocation of capital and thus lower-than-otherwise productivity growth. Moreover, the system may also reduce the amount of funding available for new firms and entail a competitive disadvantage for young firms that have to finance investment with newly issued equity (as investors require a higher return on newly issued equity).

The associated tax expenditures are about 0.25% of GDP, which is higher than in most other OECD countries, (OECD, 2007b). The lack of lock-in in the savings accounts makes them almost indistinguishable from standard current accounts, indicating they are unlikely to add to savings incentives. In addition, the benefits of the tax exemption have not entirely been captured by the savers as the effective net tax rates on taxable deposits are higher than on savings accounts (Valenduc, 2003). With respect to life-insurance contracts, international evidence indicates that tax-preferred accounts have a positive effect on overall savings only if they are taken up by moderate-income households. However, participation increases with income, indicating at most a rather modest effect on savings and probably not enough to warrant the high level of tax expenditures. To sum up, the tax preferred savings scheme seems to have little effect on savings, but carry

substantial fiscal costs. Thus, from the perspective of boosting economic growth, such tax preferences should be phased out to broaden the tax base and rates should be aligned across saving vehicles, including the introduction of capital gain taxation across relevant savings vehicles. Such a reform should be implemented over a sufficiently long time period to avoid additional financial instability.

A welcome development in this area is Belgium's explicit endorsement of the OECD standard on information exchange for tax purposes and the withdrawal of its reservation on Article 26 of the OECD Model Convention on Income and on Capital in March 2009. Belgium had already signed its first income tax convention consistent with the standard of Article 26 in 2006 and indicated its general willingness to negotiate further income tax conventions allowing for the exchange of bank information both in civil and in criminal tax matters. Belgium has already written to more than 80 countries to propose the conclusion of protocols to existing treaties so as to update Article 26 of those treaties. Belgium is expecting to finalise and ratify those protocols as soon as possible.

The reliance on consumption taxes is relatively low

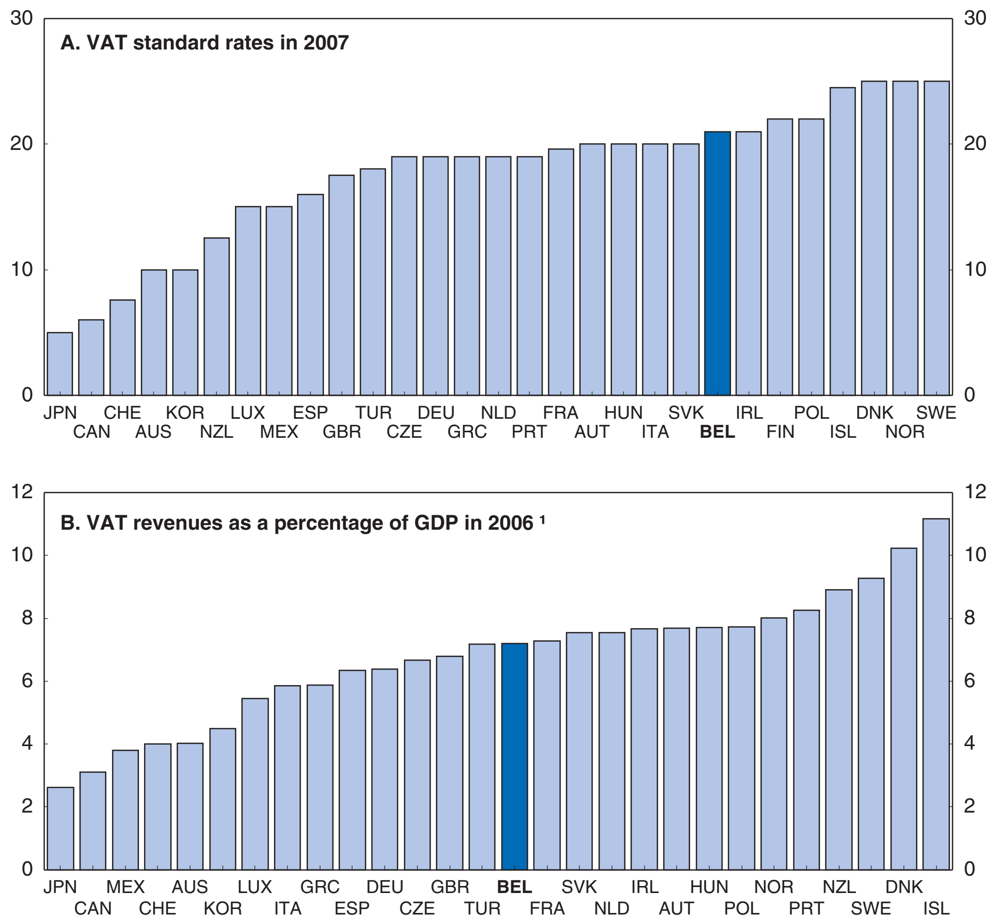
VAT revenues as a share of GDP are only about average in the OECD, despite a relatively high standard VAT rate, implying scope for increasing the reliance on this, from a growth perspective, less distortive tax source (Figure 4.16). VAT collection is reduced by the fairly widespread application of reduced rates (affecting nearly 30% of the tax base). A rate of zero is applied to daily papers, rents and school fees. Another rate of 6% is applied to basic products and some labour intensive services (food, flowers, water consumption, magazines and books, hotels or camping site accommodation, sporting and cultural activities, passenger transport, and renovation work on residential property) amounting to some 28% of the relevant tax base. Finally, a rate of 12% is applied to margarine, coal and cable television. Other OECD countries also apply reduced rates to various goods and services. Nevertheless, the efficiency of VAT collection is amongst the lowest in the OECD, reflecting more exemptions than in other countries (Figure 4.17). As a redistributive instrument the reduced rates are not well targeted as low income households pay almost twice as much in indirect taxes relative to their gross income as do high income groups, despite the lower VAT rate applied to basic consumption goods (Decoster *et al.*, 2006). Indeed, economic literature emphasises that either lump-sum payments based on households' socio-economic characteristics or direct targeted transfers to low-income households are more effective in enhancing equity (Johannson *et al.*, 2008).

Larger consumption-tax revenues could finance a lowering of other taxes. Increasing consumption taxes may induce more cross-border shopping, thereby eroding the tax base. However, the majority of the population lives within some distance from the Belgian borders, indicating some room for differentials in consumption taxes *vis-à-vis* neighbouring countries. Abolishing all reduced VAT rates and exemptions would in a static analysis yield additional VAT revenues of nearly EUR 6 billion (1.9% of GDP). Given that a relatively small part of the population would need such transfers and currently the entire population enjoys the reduced rates, such a change could easily generate about 1% of GDP in additional revenues that could be used to lower taxation in other areas.

A greater reliance on environmentally motivated taxes would have the same benefits as greater reliance on consumption taxes. Indeed, such taxes generate less revenue than in other OECD countries (Figure 4.18). This can to a large extent be explained by lower excise

Figure 4.16. **VAT rates in OECD countries**

In per cent



1. 2005 for Australia, Belgium, Greece, Japan, Iceland, Ireland, Mexico, Portugal and Poland. 2004 for Italy.

Source: OECD, *Revenue Statistics database* and OECD, *Consumption Tax Trends*.

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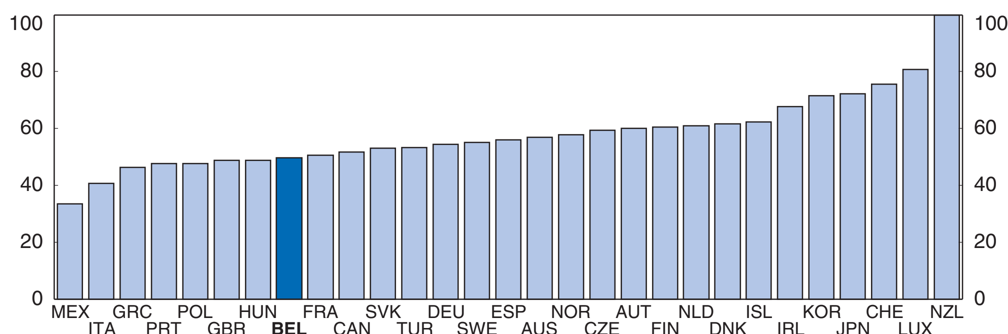
duties on fuels than in most other OECD countries. In addition, the excise duty on diesel is lower than for gasoline despite the higher CO_2 (and of other pollutants) content in diesel, implying that the tax system is favouring the relatively more polluting fuel. In this view, it is perhaps not surprising that two-thirds of all automobiles have diesel engines whereas for a quarter of a century ago the stock was dominated by vehicles with gasoline engines (High Council of Finance, 2007). Often such excise duties are driven by developments in neighbouring countries to avoid "fuel-tourism" and its implied loss in revenues. However, such Belgian excise duties are, apart from Luxembourg, lower than in the neighbouring countries (Figure 4.19).[10] As part of the 2009 Budget, a "ratchet" tax (*le mécanisme du cliquet*) is being imposed on transport fuels, whereby a fall in oil prices is partly offset by an increase in excise taxes. However, this measure will not realign excise taxes on transport fuel with their environmental impact.

A more environmentally friendly taxation of fuels would be based on their CO_2 and other pollutant contents, implying a relatively higher taxation of diesel. Moreover, the level

Figure 4.17. **VAT revenue ratio in OECD countries**[1]

Per cent, 2005



1. Index increasing in efficiency. The VAT revenue ratio is defined as the share of VAT revenues to consumption divided by the standard rate, expressed as a percentage ((VAT revenues/National consumption × 100)/(Standard VAT rate)) x 100. National consumption includes salaries and wages of the public sector which are generally not subject to VAT. Hence, variations of the VAT revenue ratio across countries to some extent reflects differences in the size of government.

Source: OECD (2008), *Consumption Tax Trends*, VAT/GST and excise rates, trends and administration issues.

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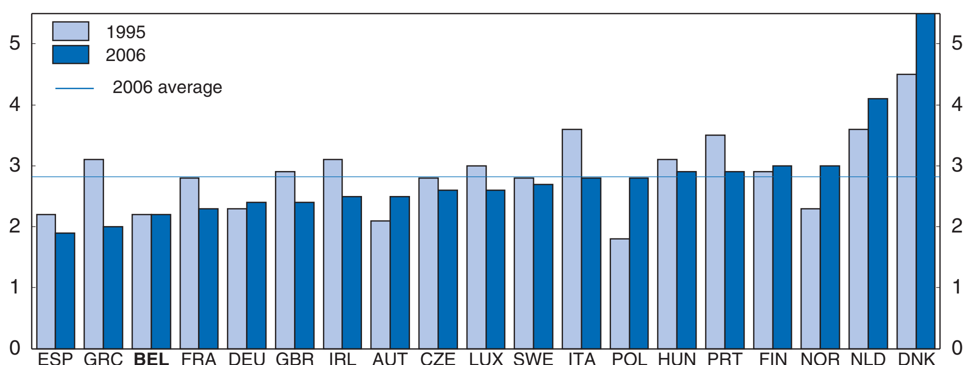
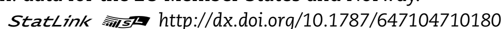
Figure 4.18. **Revenues from environmentally-related taxes**[1]

Per cent of GDP



1. Data refer to revenues from environmentally related taxes for pollution control.

Source: Eurostat (2008), Taxation trends in the European Union: data for the EU Member States and Norway.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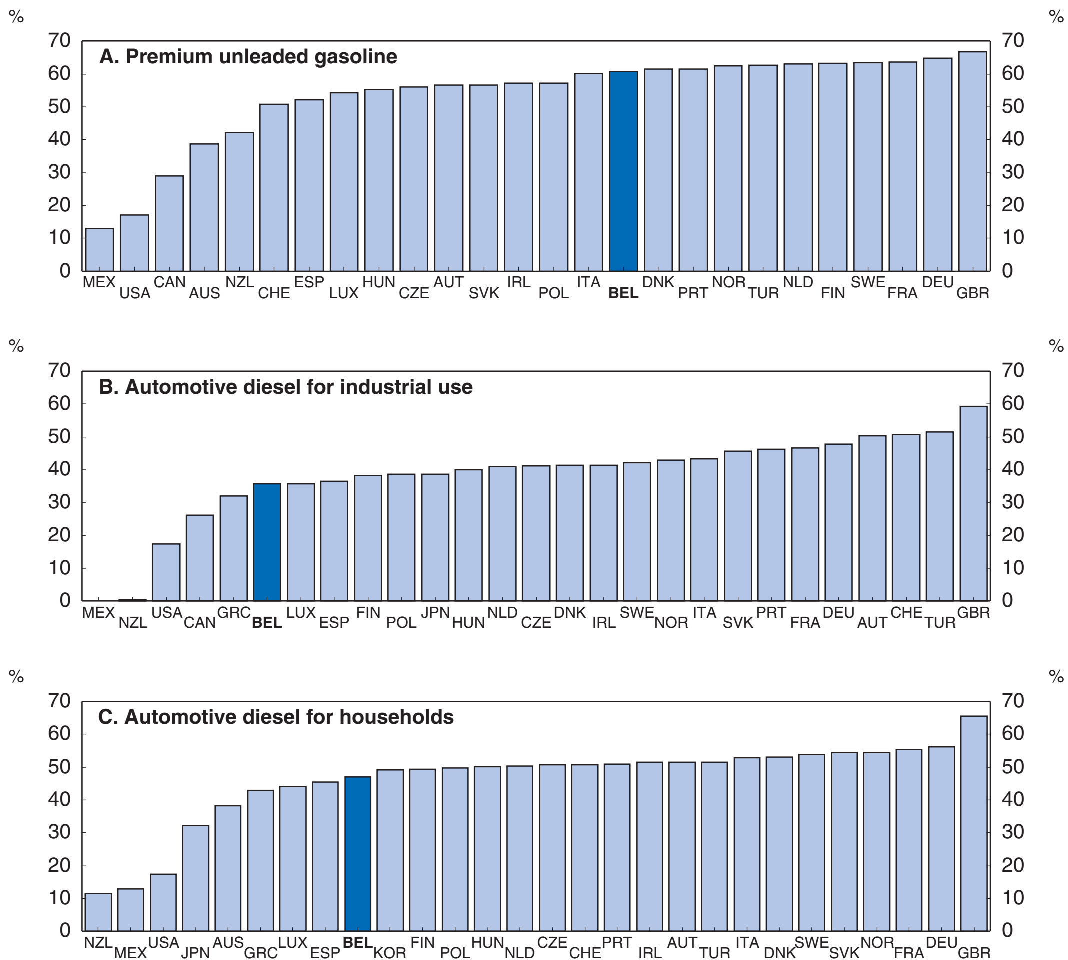
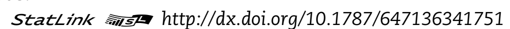
of excise taxes should be increased to internationally comparable levels. Indeed, simulations of how Belgium can reach the EU emission reduction targets by 2020 indicate that energy prices have to increase by around 13% and transport fuel prices by about 7% relative to a baseline scenario (Bossier *et al.*, 2008). Moreover, unlike in most other EU countries only a small excise duty is imposed on relatively polluting heating oil, representing only 4% of the sale price (van Cauter and van Meensel, 2006). The low taxation of heating oil reflects social and income distribution objectives, but it also blunts incentives for investing in less polluting heating systems. Naturally, other instruments, such as emission trading or road pricing (particularly for heavy vehicles as suggested by the High Council of Finance in 2007), can be used to reach environmental objectives. However, the government should increase taxation of fuels not only to pursue environmental objectives, but also to increase the tax system's reliance on less distortive consumption taxes.

Figure 4.19. **Share of taxes in fuel prices**

Per cent, 2007



Source: OECD (2008), *Energy Prices and Taxes*, Fourth quarter 2008.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The design of tax systems needs to take into account several objectives. At the overall level, tax revenue generating capacity, including effects on tax bases, must suffice to finance public expenditures. These include future spending, implying that any tax reform must be self-financed – a point also recognised by the High Council of Finance (2007). Underfinanced tax reforms can only be contemplated if accompanied by measures to reduce public spending or increase public sector spending efficiency. Nevertheless, the benefits from implementing a revenue neutral tax reform that relies less on distortive taxes can be substantial. Empirical work shows that lowering labour taxation by 1% of GDP with an equal sized increase in indirect taxes, raises value added and employment in the business sector by 0.56% and 0.83%, respectively (Stockman and Lebrun, 2009; and with similar results in Decoster *et al.*, 2006) A set of detailed policy recommendations to pursue revenue-neutral tax reform is presented in Box 4.4.

Box 4.4. Tax policy recommendations to enhance growth

The tax system should become more reliant on less distortive tax sources and broader tax bases

- The tax system should rely more on less distortive tax sources, such as consumption and owner-occupied housing taxes, to allow a reduction in distortive taxes such as those on labour and on corporations. Reform should aim at broadening tax bases to allow for lower rates.

Making labour taxation more growth enhancing by boosting labour demand and supply

- To address the remaining labour market traps, spikes in the effective marginal tax rates should be removed.
- To increase the internationally low number of hours worked, the highest marginal tax rates should be lowered. To increase labour market participation, the average labour tax should be reduced. To enhance labour market incentives for low-income spouses, the government should complete the full tax separation of spouses as implemented in many other OECD countries.
- To broaden the tax base to allow lower rates, the scope of tax expenditures and structural relief should be drastically reduced. Instead social objectives should be pursued through more targeted and direct measures.
- To achieve more cost-efficient use of wage subsidies and social security contribution reductions, these measures should be scaled back and narrowed in scope to focus on difficult-to-employ workers, such as low-wage workers. During the crisis, a special attention should be given to the low-skilled youths who are at a greater risk of dropping out of the labour market. The social partners should assume responsibility for securing the labour market prospects of other groups.

Make the corporate taxation system more favourable for enhancing business

- To stimulate SMEs to grow to their optimal production size, reduced corporate tax rates should be abolished.
- The relatively high standard corporate tax rate should be lowered to bolster the after-tax rate of return on invested capital.
- Make the system more neutral *vis-à-vis* funding sources by choosing a notional interest rate that reflects market conditions.

Increase the neutrality of capital income taxation

- The taxation of owner-occupied housing should be increased. This should principally take place through a higher effective taxation of imputed rent through a more realistic assessment of property prices. Moreover, the tax deductibility of mortgage repayment should be restricted to the interest part. If higher effective taxation of imputed rent is not implemented, then as an alternative the tax deductibility of mortgage payments should be drastically reduced.
- Taxation of other savings vehicles should be made neutral *vis-à-vis* owner-occupied housing, particularly by phasing out tax preferences by realigning applied rates and the introduction of capital gain taxation across relevant savings vehicles.

Box 4.4. **Tax policy recommendations to enhance growth** *(cont.)*

A higher reliance should be placed on consumption taxes as a revenue source

- All reduced VAT rates should be increased to the level of the standard VAT rate.
- The government should increase taxation of fuels, particularly of diesel, to reflect emission abatement objectives. An additional instrument in this respect would be the introduction of road pricing, particularly for heavy vehicles.

Notes

1. The consolidation measures included a suspension of automatic indexation of tax brackets and the introduction of a 3% crisis surcharge, a special social security contribution and a "solidarity" levy on pension income (OECD, 2004).
2. Recent tax measures by the regions have done little to address the incentive problems in the tax system. The Flemish region introduced a fixed annual income tax reduction of EUR 125 in 2007 for low-income workers, which was increased by EUR 75 the following year, before being increased again and extended in 2009 to all workers residing in Flanders. The Walloon region has abolished its radio license fee (EUR 27.57 per radio) which again is a limited measure, but which increases the demands on other taxes, including labour taxes.
3. The most regressive tax allowances are those granted for group insurance and the shares granted to employees, where the two highest income deciles represent about 85% of the associated budgetary costs (High Council of Finance, 2002; Valenduc, 2004; and van Cauter and van Meensel, 2006).
4. Households with net taxable income of less than EUR 18 592 per year do not pay this special contribution. For next EUR 2 500 a rate of 9% is applied. Thereafter a rate of 1.3% is applied for incomes below EUR 60 162. Beyond this level the maximum contribution is fixed at EUR 731.
5. From the point of view of the employer the rebate on payment of withhold taxes is similar to a cut in the social security contribution rate. In terms of national accounts, the difference is that a cut is not registered, while the rebate is considered as a transfer from the government to the corporate sector. As a consequence, the increase in labour costs associated with the agreed (real) wage increases in the 2009-10 wage agreement will be registered in the national accounts, but the accompanying across-the-board rebate will not, leading official statistics to have higher wage cost developments than the *de facto* development.
6. For income distribution reasons, abolishing the exemptions for pensioners may require an increase in their pensions.
7. For SMEs, the allowed rate is increased by 0.5 percentage point. There is an additional cap on increases in the allowed rate as it is not allowed to diverge more than 1 percentage point between years. Moreover, companies which have insufficient profits to fully benefit from the risk capital allowance can carry the allowance forward for seven years, creating a tax reserve.
8. Such a reform could also involve an adjustment of the rate of the regional real estate tax (*précompte immobilier*) and of the municipal surcharge on the regional real estate tax as the rates have drifted upwards to compensate for the partial indexation of house prices.
9. If the policy is surrendered before the end of the contract, the insurance has to pay a 33% tax on the surrender value. In addition, the tax payer is entitled to a tax credit valued at the average tax rate of the *premia* paid in one year. The value of the tax credit is limited to 15% of the first EUR 1 500 of income plus 6% of the remaining income with an upper fixed limit of EUR 1 800 (2003).
10. In terms of total taxation of gasoline and diesel, the effects of the lower excise duties are partly off-set by the slightly higher VAT rate in Belgium. Nevertheless, taxation of gasoline and diesel is lower than in the neighbouring countries with the exception of Luxembourg.

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Chapter 5

Promoting competition to strengthen economic growth

Prices for many goods and services are higher than in other countries, reflecting generally weak competitive pressures. The government has recently introduced several reforms to strengthen the competition policy framework. Nevertheless, to reap the full benefits of competitive markets, past reforms should be complemented with a number of further measures. The powers of the Competition Authority can still be enhanced. Its effective degree of independence, substantially improved in the recent reform, and its accountability should be monitored in order to assess whether further measures in this direction are needed. In the retail sector competition-restricting regulations still protect existing companies against new entry and inhibit the diffusion of new business models and technologies. The reform efforts in the network sectors remain patchy. In the energy and telecommunication sectors the main issues are the dominant positions of the incumbents and the failure of network sector regulators to introduce a level playing field in order to allow new entry and expansion of competitors. In other sectors, such as postal services and rail transport, major steps towards liberalisation are still to come. Overall, sectoral regulators will need more independence and powers in order to tackle uncompetitive behaviour of the incumbents, while better communication between the regulatory authorities is necessary. These steps should help to secure the necessary basis for bringing productivity growth in line with best performance.

The Belgian government is putting a greater emphasis on competition as a productivity enhancing tool and has implemented a number of reforms in this area. The government is now promoting competition with the objective of increasing consumer welfare, preserving purchasing power and encouraging entrepreneurship through facilitating new entry (Stratégie de Lisbonne, 2008, Accord du Gouvernement, Plan de Relance). However, there remains substantial scope to increase competitive pressures in order to boost potential growth of the economy and benefit consumers. The authorities have identified retail trade, food, energy and telecommunication as priority sectors in this respect. The retail sector regulation is more pervasive than in most OECD countries, protecting existing shops from competitive pressures as the entry of innovative business models and the diffusion of new technologies are inhibited. At the same time, the liberalisation of network sectors has been slower than elsewhere in the OECD while concentration is high and the effective functioning of regulators has proven difficult to achieve. As a result, prices are often higher than in other countries pointing to the need for reducing the barriers to entry and assuring a more level playing field. The chapter starts with a general review of the competition framework. Then, the inherently competitive retail trade sector is analysed. Subsequently, the difficulties of introducing competition in the incumbent-dominated network sectors are considered. The chapter concludes with a set of policy recommendations.

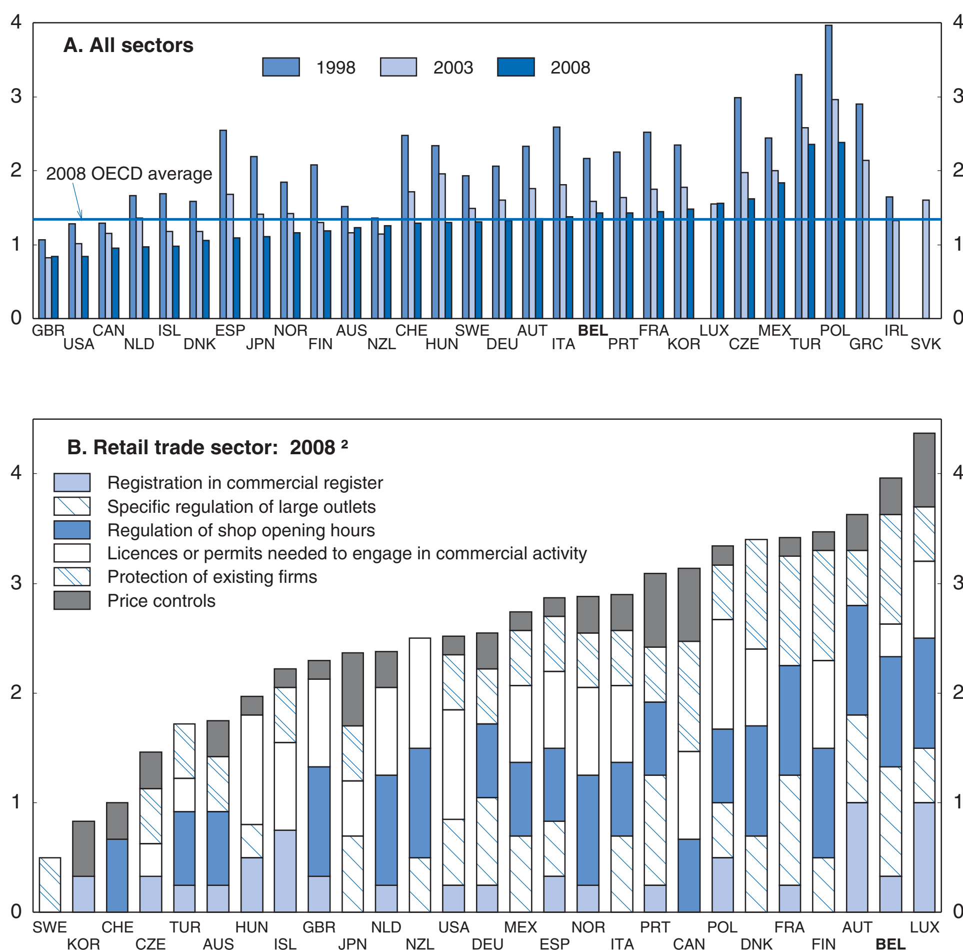
More competition to benefit productivity, employment and consumer welfare

Over the past ten years, productivity and employment growth have remained somewhat slower relative to many other OECD countries (Table 1.6). At the same time progress in opening markets to competition has not been as fast as in the leading countries and the amount of restrictions to competition remains above the OECD best practice (Figure 5.1, Panel A; and Wölfl *et al.*, 2009). A growing body of empirical literature points to the existence of a positive link between competition and productivity growth on the one hand (Nicoletti and Scarpetta, 2003; Conway *et al.*, 2006) and between competition and employment on the other hand (Bassanini and Duval, 2006), suggesting that insufficient competition policy enforcement may have lowered economic growth in Belgium. Furthermore, it appears that the Belgian consumer may be paying a high price for the lack of well-functioning, competitive markets (Figure 5.2).[1] The final prices of many retail goods appear somewhat higher than the euro area average while prices in network sectors also tend to be on the high side, motivating the review of competition-inhibiting regulation in Belgium.

The Competition Authority needs further strengthening

The competition policy framework has notably improved over the past several years as legislation was adapted to EU standards (Box 5.1). The merger review threshold was raised, freeing up resources to deal with the cases of price fixing and abuse of dominant position. The reform also included changes in the institutional structure of the competition bodies. The Competition Authority is a so-called dual authority, consisting of the Directorate General of the Ministry of Economy (the investigative body) and the Competition Council (the administrative

Figure 5.1. **Product market and retail trade regulation in the OECD**[1]



1. "Ten years of product market reform in OECD countries – insights from a revised PMR indicator", *OECD Economics Department Working Paper*, No. 695 and in Conway, P. and G. Nicoletti (2006), "Product Market Regulation in the Non-Manufacturing Sectors of OECD Countries: Measurement and Highlights", *OECD Economics Department Working Papers*, No. 530.
2. No data for Greece, Ireland and Slovak Republic.

Source: OECD, *PMR database*.

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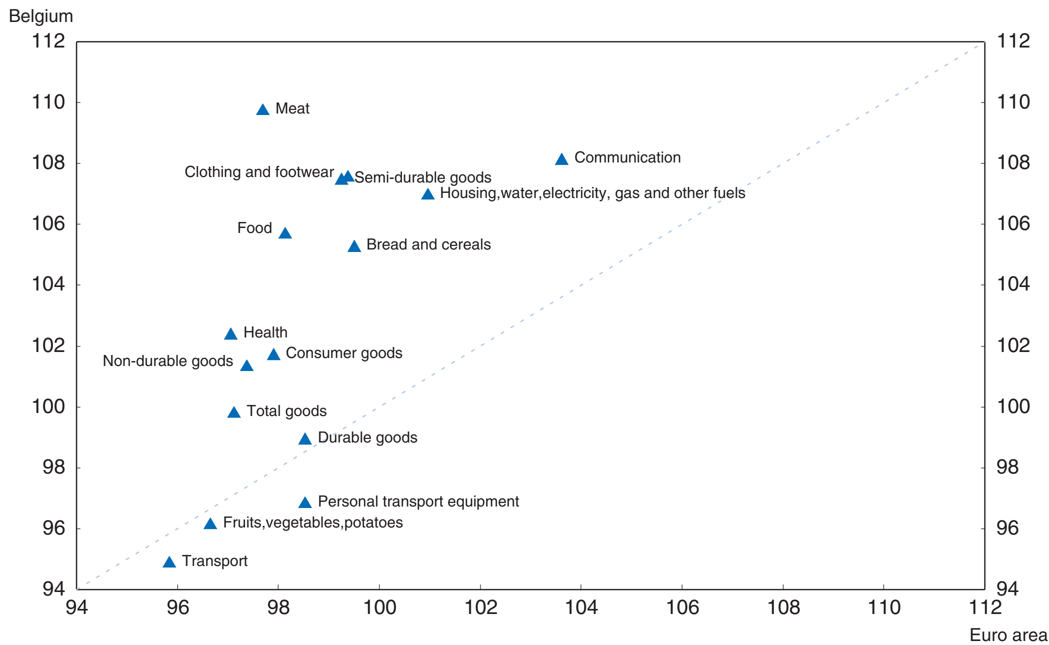
tribunal). The latter includes the Council (a court) and the College of Competition Prosecutors (the investigative and prosecuting body). Further reforms included putting in place a leniency programme and putting an end to the immunity from fines granted to associations of undertakings and professionals under the previous law. The reforms have started to yield visible results: cartel infringements have been found, the leniency programme has begun to work and cartel participants have been fined. Nevertheless, as the improvements to the framework are rather recent, it will take some time for the full effect on competition to be felt, however there still seems room for refining of the setup.

Although the independence of the Competition Authority has been strengthened (it is now financed through a separate line in the government's budget), the investigative part of the Authority continues to be a Directorate General inside the Ministry of Economy. The Directorate's resources remain largely determined by the federal government and a

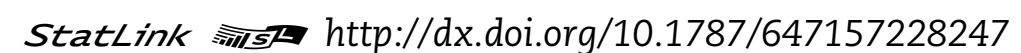
Figure 5.2. **Comparative price levels**[1]

2007, EU15 = 100



1. The PPPs are divided by the current nominal exchange rate to obtain a price level index (PLI) which expresses the price level of a given country relative to another, or relative to a group of countries like the EU15.

Source: Eurostat database.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Box 5.1. **The new competition and law enforcement framework**

The competition framework was reformed in 2006 after the Court of Audit (*Cour des Comptes*) had found that the previous setup produced little enforcement and that procedures took too long. The competition authorities were tied down in mandatory merger reviews with few resources for other competition matters. Out of nearly 200 matters between 1993 and 2005, barely a third resulted in a decision, and only one resulted in a fine. Most investigations were taking more than 2 years to complete, excluding cases that expired instead of having a formal closure decision. In matters other than interim measures and mergers from 1997-2001, the Council reached only one decision per year and the average time for cartel infringement proceedings was over six years. The Court of Audit found that the principle reasons for this state of affairs were, in addition to the resource requirements of the mandatory merger reviews, poor organisation and the lack of support for a coherent policy of protecting competition to promote economic efficiency. The new competition law tracks the EU legislation based on the prohibition of anti competitive restrictive agreements and abuses of dominant positions and gives a legal basis for leniency. In addition, the latest EU substantive standard for mergers, which is based on the concept of a "substantial impediment to effective competition", rather than solely a "dominance" test, is incorporated in the law. The reform did not introduce changes to the fines which can be imposed by the Authority, which can be as high as 10% of annual turnover. Staff at the Competition Authority is about 70 person years, which is the same as Switzerland, but less than in the Netherlands and the Nordic Countries.

Box 5.1. **The new competition and law enforcement framework** *(cont.)*

The 2006 reforms also modified the institutional structure. The Belgian Competition Authority is not a single integrated agency but a so-called "dual authority". It has two principal parts, the Competition Council and the Directorate General for Competition. The Council includes the general assembly of the Council (in a narrow sense), which is the decision making body for competition enforcement. The law authorises six full time and six part-time members (councillors), who are appointed by the government for six-year, renewable terms. The College of Competition Prosecutors (with a statutory maximum of ten members) is attached to the Council. The competition prosecutors initiate and direct investigations and present enforcement matters to the Council and rely upon the staff of the Directorate General for Competition for investigative and other support. There is therefore institutional separation between the investigation, prosecution and decision making powers within the authority. Unlike in some other countries, the Competition Authority is not responsible for consumer protection, which is the responsibility of the Directorate General for Market Regulation under the same ministry. There is also an advisory Commission for Competition in the Central Council for the Economy.

Merger review procedures require advance notification and approval for transactions that involve a total turnover in Belgium of over EUR 100 million (and at least two of the undertakings concerned have turnover in Belgium exceeding EUR 40 million). These thresholds are more than twice the limits in the pre-reform procedures, inducing a substantial reduction in merger reviews. The competition authority is not fully independent in this area as the government can override a Council decision rejecting a merger allowing it to go forward "for reasons of general interest which outweigh the risk of competition." It may also overrun any conditions imposed on the merger by the Competition Council. In particular, the Council of Ministers may consider matters of national security, international competitiveness, employment and consumer interests. This provision has not been used to date. The leniency programme was updated in October 2007 to make it consistent with now standard European practices, so a cartel member may be fully or partly exempted from sanctions for bringing the cartel to the attention of the enforcement authority, bringing in evidence the authority did not have, or admitting participation.

In the first full year under the new competition regime (2007), the Council reached three cartel infringements decisions and considered six applications for leniency. In the second year, the number of decisions on cartel infringements rose to five and six applications for leniency were considered. The first cartel fine (of slightly below EUR 500 000) ever imposed under Belgian law was in early 2008 in a case that started with a leniency application. The relatively small fine reflects that the cartel ended in 2002 and the smallness of the market. A recent decision illustrates the importance of the recent changes to the statute. In July 2008, the Council ruled against a trade association "ethical" rule setting minimum fees (for interior designers), but could not impose a fine because the law in effect during the period of the violation, from 2002 to 2005, did not authorise fines against an association. Other small fines have been issued to trade associations to signal that co-ordination dampening price competition will no longer be acceptable.

The Competition Council may end up with important functions in regulatory matters. As is usual elsewhere, it already acts in co-operation with sector regulators. Under the competition law, the Competition Council may also be empowered to decide appeals from decisions of sectoral regulators. This function will depend upon enactment of corresponding authorizations in the sector regulatory laws. The Directorate General has engaged in policy advocacy by issuing reports or opinions on taxicab regulation, real estate and interlocking directorates.

number of supporting costs (location, information and communication technology, etc.) are provided by the Ministry outside the budget line. Thus, the Competition Authority applies the centralised hiring procedures of the civil service and it remains physically located in the Ministry's building. Furthermore, the large backlog of old cases has led to problems in meeting legal deadlines and has forced the College of Prosecutors to prioritise cases. This has been done based on criteria, the origin of which have not been made sufficiently clear to the wider public, and may lead to accusations that political priorities affect the ranking of cases. Therefore, the situation should be monitored, in particular regarding the authority's degree of independence and accountability. If necessary, a potential improvement would entail giving the authority a status of a fully independent agency with a complete budget decided by the parliament and granted full freedom in hiring. In terms of improving the authority's perceived independence, physically moving out of the Ministry building and enhancing the transparency of the selection of the prioritisation criteria may be considered. Despite the reinforcements made in the past years, there are still signs the Competition Authority may be in need of additional resources. The current staffing may be reconsidered as it appears on the low side when compared with other small economies such as the Netherlands and the Nordic countries (Høj, 2007), and it has not proved sufficient for dealing with the large amount of old cases and court appeals against its decisions and for assuming a more proactive role.

There is a need for strong signalling of the Competition Authority's determination to enforce competition law. The fines imposed up to date have not been particularly high. However, in the future the Competition Authority will inevitably be dealing with larger cases in crucial sectors and the use of high fines will be desirable in order to signal the tough stance against infringements and to deter future uncompetitive practices. High fines will also increase the incentives to apply for leniency thereby facilitating the policing of cartels. Deterrence would be enhanced by introducing criminal sanctions such as prison sentences for hard-core cartel infringements. To enhance the Authority's effectiveness, clear and efficient communication procedures (in particular regarding confidential information) between the Authority and the sectoral regulators are essential. Finally, plans to establish the Council as the sole institution for appeal against sectoral regulator decisions are commendable. This is the case in many OECD countries, as the Council is well placed to rule on competition cases in the network sectors. If this is to increase the speed with which cases are settled it may imply the Council will need additional resources.

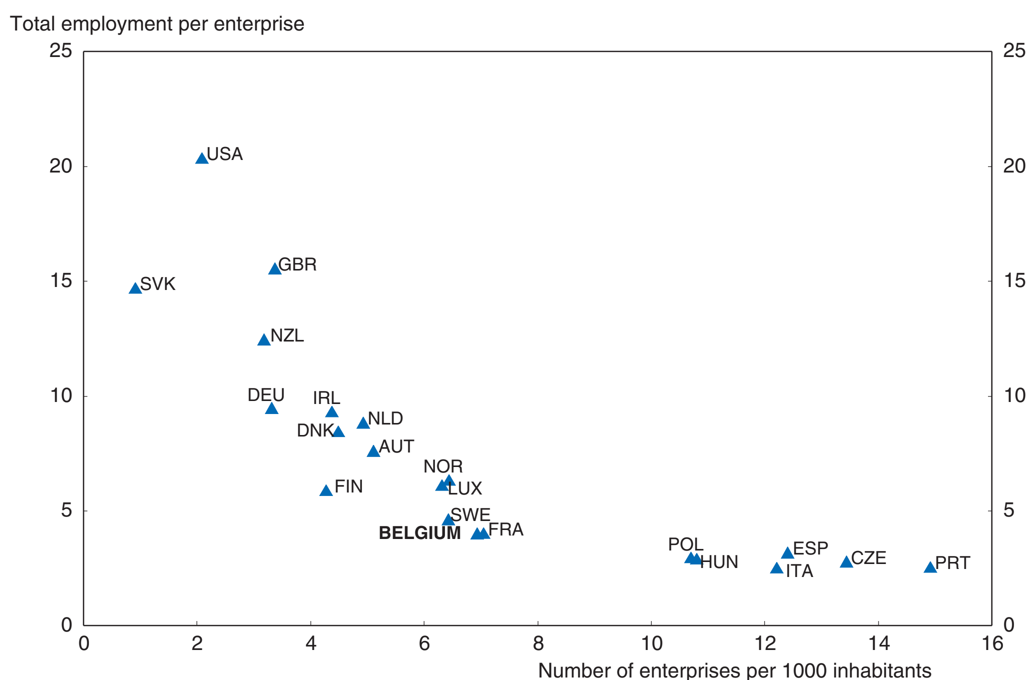
The notable progress in the reform of the Competition Authority does not appear to be coupled with comparable developments in the regulation of the network sectors (see the sections below). In order to fulfil the government's goal of stimulating economic activity and improving consumer welfare through the strengthening of competition in Belgian markets, a determined approach to competition policy needs to be implemented and enforced at all levels of regulation (SPF Economie, 2008). The government has recently created a price observatory which will aim at increasing the price transparency in the market, but care should be taken in order not to further complicate the regulatory structure and to minimise the risk of this authority becoming a price setter.

Competition in retail distribution is burdened by heavy regulation

The retail sector in Belgium is characterised by a relatively large number of small shops (Figure 5.3), a structure that may have a number of advantages in terms of accessibility. However, at the same time, the employment share of the sector is below the

Figure 5.3. **The retail sector is characterised by a large share of small shops**

2003-2005 averages[1]



1. 2003-2004 averages for United States and Czech Republic, 2004-2005 for Sweden.

Source: OECD, *Structural Business Statistics database.*

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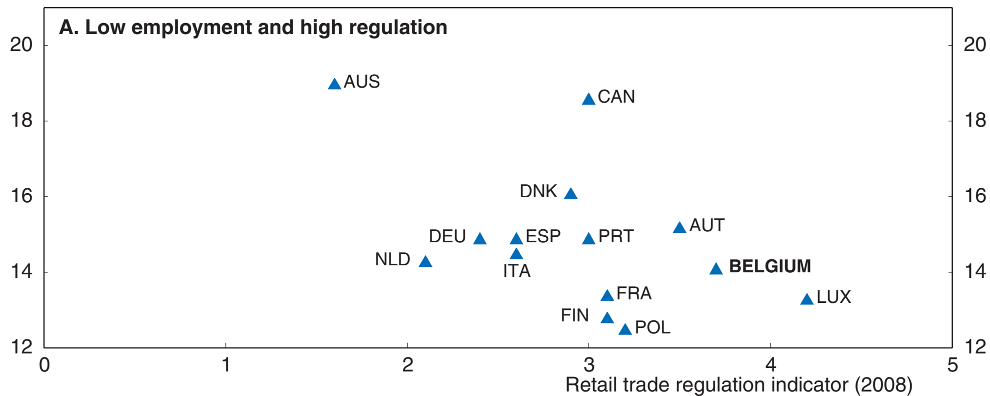
average of the OECD countries (Figure 5.4, Panel A) pointing to a relatively large scope for jobs creation. Moreover, productivity in the sector has been growing slower than in most OECD countries (Figure 5.4, Panel B and Biatour and Kegels, 2008).[2] Finally, the price levels of many of the goods associated with retail distribution are notably higher than in other euro area countries (Figure 5.2). At the same time, the sector is much more regulated than in most other OECD countries, especially in the areas of protection of existing firms, specific regulation of large outlets and shop opening hours (Figure 5.1, Panel B). This regulation shields existing shops from competitive pressures which in many cases leads to the protection of local monopolies (Høj *et al.*, 1995, provides evidence on the relation between regulation, prices and size of shops). Therefore, deregulation of retail distribution can be expected to boost productivity. This conclusion is backed by the results of OECD simulations, which show that Belgium is among the countries with the highest potential gains from the liberalisation of the retail sector (Box 5.2). Hence, as retail trade is an inherently competitive sector, scaling back the regulation should benefit consumer welfare. A number of studies have shown that lowering entry barriers can increase the efficiency of retail trade leading both to lower prices (Pilat, 1997, Haffner and van Bergeijk, 1997) and higher employment (Bertrand and Kramarz, 2002; CPB, 1995; Creusen *et al.*, 2006). The scope for the increase in employment in the sector should not be overlooked in the Belgian context, given the fact that these are likely to be jobs for low skilled workers and for flexible part-time workers, such as females returning to the labour market.

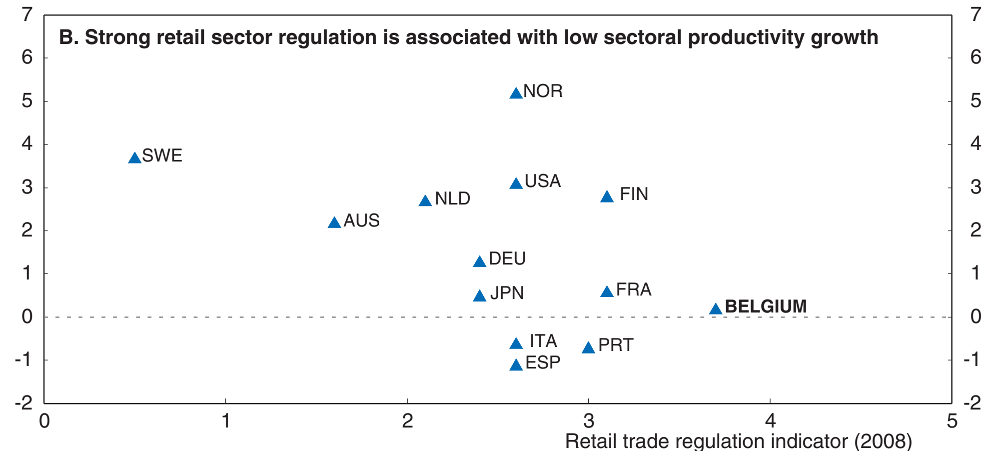
Box 5.3 provides a detailed overview of the main restrictions to competition in the Belgian retail sector, which generally protect existing shops, in particular those of smaller

Figure 5.4. **Belgian retail is characterised by low employment, low productivity growth and strong regulation**

Employment share of wholesale and retail trade (2007)[1]

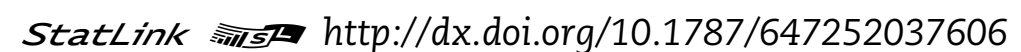


Productivity growth in wholesale and retail trade sector (1996-2006)



1. 2006 for Australia, Hungary, Ireland, Portugal and Spain. The number of observations is limited by data availability.

Source: OECD, *PMR database*, *STAN database* and OECD calculations.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size, from the entry of new innovative business models. The prohibition of sales below costs prevents retailers from easily selling unwanted stocks, increasing the risk for new entrants. The ban on announcements of price reductions before sales periods ("the black-out period") reduces consumers access to information on prices, while the prohibition of tied sales (better known in Belgium as "joint-sales") inhibits the diffusion of innovative products or new technology (in April 2009 the European Court of Justice declared this law as incompatible with European legislation). The government is currently working on the modification of most of the above regulation. The changes proposed so far do not appear substantial. As the Competition Authority should deal with the abuse of dominant position, the restrictions on prices and assortment should be scrapped altogether. In order to improve consumer welfare, providing consumers with the possibility of shopping outside standard hours and the retailers with flexibility to better meet consumer demand, the shop opening hour regulation, which is among the more restrictive in the OECD, should be abandoned. Finally, zoning regulation for large outlets, which was reformed in 2005 resulting in a faster decision making process, should be restricted to

Box 5.2. **Anti-competitive regulation and labour productivity OECD simulations**

OECD calculations report that aligning sectoral regulation (in retail trade, electricity and gas and professional services) with international best practice would boost labour productivity in the entire economy by nearly 16% over the next decade. Reforms in the retail sector only, could raise productivity by almost 12% if regulation was brought in line with OECD best practice. Similarly, for reforms in the energy sector, productivity is calculated to increase by 3.5%, which is well above the average of the countries analysed (Table 5.1).

Table 5.1. **The simulated effect of liberalisation on labour productivity in the future**

Simulated percentage increase in productivity over 10 years

	Sectors simulated					
	All sectors		Electricity and gas		Retail	
	Degree of reform					
	To 2007 best practice	To EU 75th percentile	To 2007 best practice	To EU 75th percentile	To 2007 best practice	To EU 75th percentile
Belgium	**15.8**	**15.6**	**3.5**	**3.5**	**11.9**	**11.7**
Netherlands	8.3	7.4	3.2	2.8	4.8	4.3
France	10.3	10	1.4	1.3	7.4	7.2
Denmark	8	7.3	2.6	2.3	5.4	5.1
Italy	14.1	13.7	2.6	2.5	4.9	4.8
Canada	14.4	14.1	5.6	5.5	7.8	7.6
Finland	6.8	6	2.1	1.8	4.2	3.9
Portugal	12.2	11.8	3.8	3.6	7.2	6.9
Spain	13.9	13.8	4.5	4.5	10.9	10.8
Total	11.4	10.9	2.6	2.6	6.9	6.4

Source: OECD (2008), *Regulatory Review of Italy.*

Box 5.3. **Examples of competition restricting regulation in retail distribution**

Price and transparency control

- Sales below costs are prohibited outside the sales season or liquidation of the outlet and the sale season is limited to two periods of one month each year.

This type of regulation limits retailers' flexibility and reduces their ability to get rid of unwanted stock, thereby constituting an implicit deterrent to entry and reducing consumer welfare. Moreover, the definitions of costs and minimum margins are cumbersome and the verification problematic, especially for start-ups with no history of costs.

- Announcements of price reductions within 6 weeks before the sales period are prohibited ("the black-out period"). It is also prohibited to announce reductions which are to take place during these 6 weeks.

The black-out period legislation reduces price transparency and impedes the consumers' access to a full set of price information for their choice.

- Tied sales of products are prohibited.

Box 5.3. **Examples of competition restricting regulation in retail distribution** *(cont.)*

This regulation aims at disallowing the cross-subsidising of products (or products and services), to enhance transparency. It protects smaller retailers who may have less scope to offer products tied together and has notably increased the complexity of retail regulation. Many exceptions have been granted, for example for the sale of an *ensemble* (*e.g.* frames with lenses) or for the sale of a product together with its packing. As the notion of an *ensemble* is unclear *a priori*, the law increases uncertainty for new products and hampers the diffusion of new technology.

Regulation of opening hours

- Shops may be open on weekdays between 5 h and 20 h, on Fridays (and days preceding holidays) till 21 h. They have to be closed for one period of 24 hours a week (by default Sundays, though any day of the week can be chosen as long as it is kept the same for at least six months.) The law allows for an additional opening during 6 Sundays a year.
- Exemptions include: small shops linked to gas stations, night shops (under 150 m^2, selling groceries and hygienic materials may be open 18 h-7 h) and shops in designated tourist areas.
- The law foresees fines, shop closure and prison penalties for infringement and is enforced by state officials.

Restrictions on shop opening hours protect existing retailers, in particular small night shops, against new innovative business models. Such regulation also limits the retailers' ability to adjust to changes in consumer demand and hurts consumer welfare by reducing the ability to choose when to do shopping. In Belgium, such regulation is aimed at enhancing workers' welfare despite its potential employment-reducing effects.

Regulation of large outlets

- The location decision is based on the evaluation of four types of possible effects: *i)* spatial effect (urban planning, access and road safety); *ii)* on consumer interests (product range and prices); *iii)* on employment (gross and in existing commerce); and *iv)* on the balance between small, medium and large commerce.
- Decisions for shops between 400-1 000 m^2 of surface are taken by the municipality, while for shops above 1 000 m^2 the National Economic and Social Committee for Retail has to be consulted. In case of surfaces above 2 000 m^2 the neighbouring municipalities have to be consulted.
- The Economic and Social Committee is composed of representatives of ministries, regions, consumer associations, labour organisations, independent retailers and SME's and integrated commerce.
- The decision must be made and communicated within a maximum of 75 days and can be appealed against to the Inter-ministerial Committee for Retail (Comité Interministériel pour la Distribution). Silence is consent.

Zoning regulation may be desirable due to issues of urban planning, traffic congestion and security, but is often used to protect existing retailers against new entrants. As emphasised in OECD (2008), the evaluation of consumer interests should be left to the consumers themselves, who will ultimately decide whether the new business serves them better than the existing ones through their shopping choices.

Other regulation

- Further strict regulations concern advertising, specific retail sectors (*e.g.* pharmaceuticals) and sales at the home of the customer.

issues of urban planning, transport and safety (in line with the recent recommendation from the Ministry of Economy, SPF Economie, 2008). This would allow market forces, rather than a nation-wide committee with a strong representation of existing retailers or the local municipality, to decide on the consumers' benefits arising from a new retail outlet.

Regulators in network industries are faced with dominant positions of incumbents

The liberalisation in the network sectors remains limited. The degree of opening is patchy and the diversity of regulatory structures complicates regulation (Box 5.4). There exists no uniform definition of regulatory bodies. The role of network sector regulation and the lack of coordination between the sectoral regulators and the Competition Authority have been identified as the most serious issues of the design of the Belgian system (SPF Economie, 2008). Another important issue concerns the unusually wide scope of universal services which poses a barrier to entry and the expansion of competitors, while benefiting the incumbents due to problematic schemes for financing. The universal service obligations (USOs) are summarised in Box 5.5 and their effect on competition is discussed below.

Box 5.4. **Regulation of network sectors**

The regulation of network sectors in Belgium differs substantially across the individual sectors. In general, the Competition Authority deals with the cases of the abuse of dominant position and cartel pricing in competitive sectors and the competitive segments of the network sectors. Non-discriminatory third party access to monopoly segments is the competence of sectoral regulators which have various structures and varying degrees of independence from the executive and different sources of financing. The network sector regulators are usually also in charge of issuing market entry licenses, assuring universal services and having some advisory tasks as regards sector strategies.

The energy sectors (electricity and gas) are regulated by a single federal authority, the Commission for Electricity and Gas Regulation (known by its French and Flemish abbreviation CREG), and three regional authorities. The federal regulatory tasks concern mainly the approval of transmission and distribution tariffs (in both gas and electricity) and advising the government in the other segments of the markets. In the electricity market, its regulatory powers are limited to transmission and distribution networks above a certain threshold (70 kV).

The federal authority's independence seems in line with OECD best practice: CREG has its own budget which is funded through a surcharge on customer utility bills securing it from potential political intervention, although the management remains nominated by the government. On the other hand, regional regulators are responsible for appointing distribution network operators in gas and distribution grid operators in electricity, issuing retail supply licenses, ensuring the implementation of universal service obligations and advising the regional governments. The independence of the regional regulatory authorities from the sub-national levels of government does not seem as well assured as in the case of the federal regulator.

Box 5.4. **Regulation of network sectors** *(cont.)*

In principle, sub-national level regulators may be better prepared to deal with regional regulatory tasks as they may be better prepared to deal with issues of local distribution and supply as well as consumer needs due to their local knowledge and relative proximity to the final market. However such a structure may cause problems of regulatory powers (overlap of powers, lack of regulatory coverage of certain segments, lack of economies of scale) and coordination (both of the objectives and of enforcement decisions). This structure may lead to lengthy communication procedures and increase bureaucracy. Three regulatory environments are an additional entry cost for competitors and this structure has been frequently criticised (IEA, 2006). One of the effects of the set-up was the different progress in the legal opening of the electricity market for consumer choice, which was functional in Flanders in 2003, while taking until 2007 in Wallonia and the Brussels-Capital region.

The telecommunication and postal sectors are regulated by the Belgian Institute for Postal Services and Telecommunication (BIPT). The regulator's independence was strengthened in 2003, formerly being part of the Ministry which executed ownership powers in the incumbent. Financing is assured mainly through licensing fees. Despite the improvement, some controversies about the issue of independence remain: the members of the Council (decision making body), including the head, are nominated and can be dismissed on the proposal of the executive. There remains some uncertainty about the possibility of the government to overturn BIPT decisions and about the political influence on the regulators priorities (Platform, 2007). Contrary to the energy markets, the regulatory tasks are concentrated in a federal body; however there seems to be pressure from the language-Community level regulators (who have competencies over broadcasting content) to gain regulatory powers over infrastructure common to broadcasting and telecommunication (*e.g.* Internet). In 2006, these resulted in a cooperation agreement which laid down the procedures for resolving disputes of joint competencies, causing some concern due to the increased scope for bureaucratic consultation and leaving decision power over unresolved issues at the ministerial level, thereby somewhat weakening the regulator. In November 2008, the federal government proposed measures to strengthen the regulator: the procedure for imposing a fine is to become easier, and fines may become higher. BIPT is to acquire more powers for intervention in the market. In the cases that occur, its defence before the Court of Appeal is to become less elaborate.

The energy sector: strong incumbents and high implicit barriers to entry

Electricity

The liberalisation of the energy market essentially began in April 1999 with the transposition of the first EU electricity and gas directives. The second EU directives were transposed in June 2005 while the electricity market for households was fully legally opened on 1st June 2003 in Flanders. Wallonia and Brussels-Capital followed on 1st January 2007 when supplier choice was granted to all consumers. Despite the liberalisation, electricity prices remained well above those in OECD countries with the most competitive electricity markets (Figure 5.5). Moreover, energy prices have been found to contribute strongly to the large positive inflation differential between Belgium and the euro area in late 2008.[3]

Historically, all segments of the electricity market have been concentrated in the hands of Suez and Gaz de France. Following their merger, the companies agreed with the European Commission to reduce their involvement in certain segments (Box 5.6). However,

Box 5.5. **Universal services in energy, telecoms and post**

Universal service obligations (USOs) are intended to assure the universal access to a designated service at a specified quality and an affordable price. In practice however, they may serve as a barrier to deter new entrants, securing of an incumbent's position or a subsidy for the latter. In general each World Trade Organisation member has the right to set the desired scope of USO. The specific rules for EU member states are set out in the Universal Service Directive (for telecoms) and in the Postal Directive. In general USO's, if constituting a cost to the supplier, must be compensated for with profits made in other markets. They can be financed directly from the government budget (through the acquisition of a service), from a fund to which market participants contribute (*e.g.* pay or play fund) or through a designated segment of the market (*e.g.* through the reserved area in postal services, through distribution tariffs in distribution).

In Belgium, no uniform approach to universal services exists. While provisions for auctioning off some of the services to the provider with best offers exist, other services are imposed on all operators. The scope of universal service tends to be unusually broad in all sectors while differing across regions (Table 5.2).

Table 5.2. **Universal service obligations in Belgium**

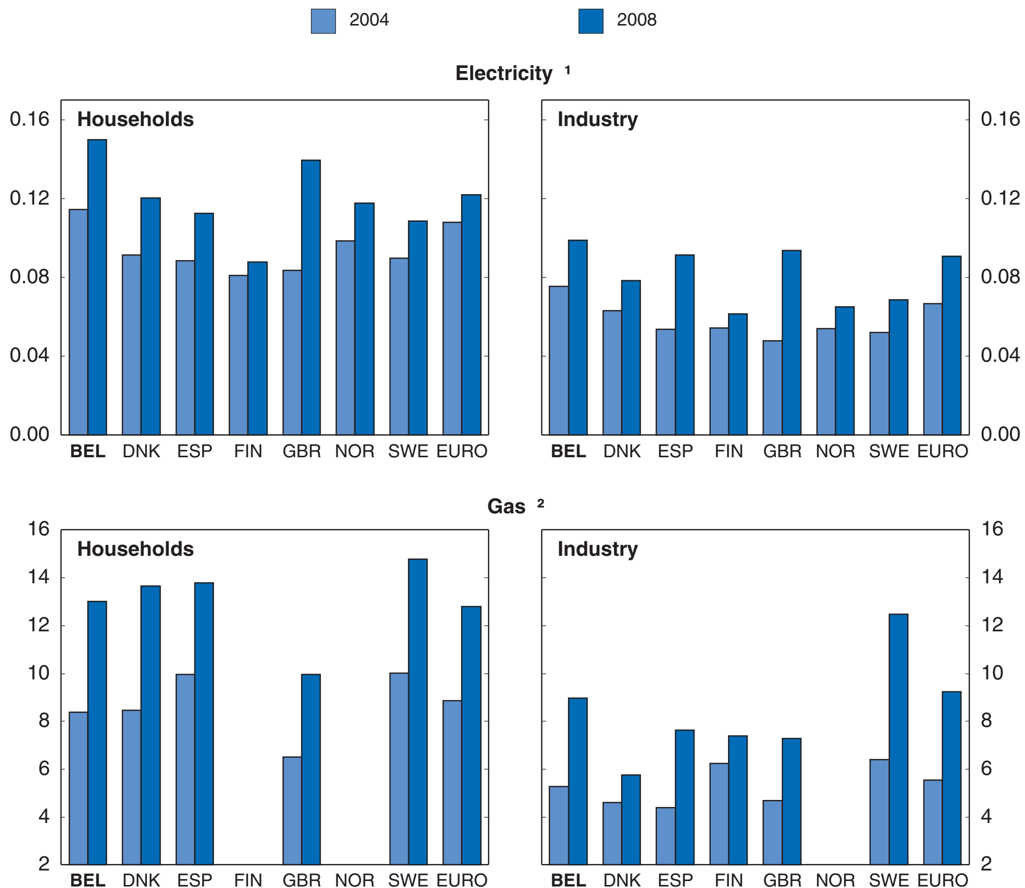
By network sector

Sector	USO
Energy (electricity and gas)	• Social tariffs for low income households. • Free annual electricity quota for all Flemish households. • Arrangements for households unable to pay bills. • A fixed deduction for gas, electricity and fuel for each household. USOs are regional competencies, thus the scope differs across regions. The federal regulator incorporates the regional specificities of USOs into the individual network distribution tariffs.
Telecoms	• Access to the infrastructure of fixed line telephony (at an affordable price). • The availability of directory enquiry services. • Provision of public phone booths over the entire national territory. • Publication of universal white pages. • Application of social tariffs for disabled and elderly/low income (fixed and mobile). Since 2007, the government has implemented tendering procedures in order to designate the provider of each of the first four services. There are no procedures for tendering social tariffs as these are imposed on all providers and funded through a fund to which all market participants contribute. There are no legal tools to assess that the USO provision actually constitutes an unfair burden, which would justify the additional financing. The European Commission has launched an infringement procedure and has recently taken Belgium to the European Court of Justice.
Post	• Daily collection and delivery, sorting and transport of letters and parcels within a size limit. • Minimum of one access point per municipality. • Handling military mail. • Early delivery of newspapers and certain periodicals. • In-house payments of pensions and financial post services. • Management of the State account treasury. • Printed election material delivery at reduced rates. USOs are provided by the incumbent in return for proceeds from the reserved segment of the market. The law foresees a possibility of financing USO costs from a fund paid by all license holders which, although not used, increases the uncertainty of the legal environment. The first two services are rather standard in other countries, while the others are Belgian-specific.

Source: OECD and European European Commission (2006), "Commission staff working document SEC(2006) 445", Impact assessment report, annex to the report regarding the outcome of the *Review of the scope of universal service in accordance with article 15(2) of Directive 2002/22/EC*.

Figure 5.5. **Electricity and gas prices**

Pre-tax



1. Euros per kWh, medium consumption.
2. Euros per gigajoules, medium consumption. 2007 for Denmark.

Source: *Eurostat database.*

StatLink http://dx.doi.org/10.1787/647285846060

most of the segments of the market are set to remain highly concentrated in the hands of the merged company GDF-Suez. As now only legal separation of the transmission operator and accounting separation of other segments are required, the government's efforts to strengthen separation, including a favourable stance towards the introduction of ownership separation of transmission network operators are commendable. Notably, the government has taken steps to encourage auctioning off some of the incumbent's spare capacity which are yielding results (for example in late 2008 the incumbent agreed to sell 10% of Belgian production capacity) and efforts to introduce new players should therefore be continued. Nonetheless, a number of additional barriers to entry should be removed in order to encourage new competitors as the sector remains burdened by more competition-restricting regulation than international best practice (Figure 5.6, Panel A). The wholesale exchange pool, established in 2006, has failed to play a significant role (in 2008, only about 13% of daily electricity consumption was traded on the day-ahead market[4]), despite that such a measure has proven beneficial for competition in a number of OECD countries. The lack of liquidity and high prices on the wholesale market have

Box 5.6. **The Gaz de France-Suez merger and concentration on the Belgian energy market**

The merger between Gaz de France (GDF) and Suez was announced in February 2006 and due to its large-scale characteristics was subject to the EU regulation regarding limits on concentration. The Commission authorised the deal in November 2006, amid concerns regarding the large role of the new company in specific markets. Before the deal, the two companies had strong positions in the Belgian energy markets, thus the merger posed problems of further increasing the concentration of the already highly concentrated energy sector. In order to receive the approval of the merger by the European Commission the companies made a number of commitments regarding the Belgian markets (Table 5.3).

Table 5.3. **The Belgian energy market and GDF-Suez**

Concentration before and after the merger

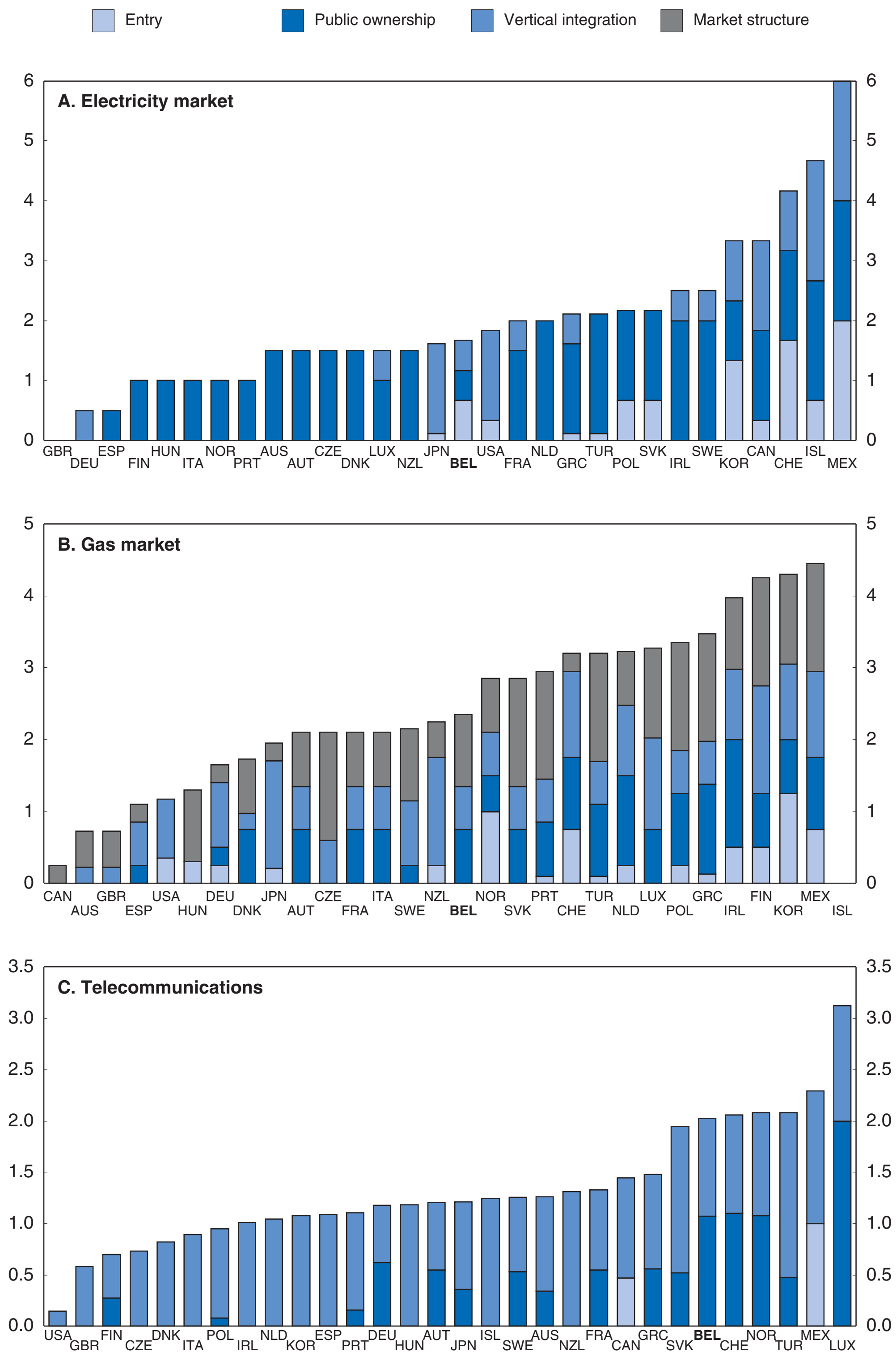
Segment of the market	Role of GDF and Suez before the merger	Commitments of GDF and Suez in light of the merger
Production, imports and wholesale	Electricity: 85% of electricity production was in the hands of Suez-owned Electrabel, while another 8% was in the hands of SPE (partly owned by GDF).	Full spin-off of SPE (remaining share was sold to Centrica in January 2009).
	Gas: Suez-owned Distrigas controlled over 85% of the wholesale market (including control of the main international hub and LNG terminal in Zeebrugge) while GDF held another 10.4%.	Sale of Suez's holding in Distrigas (with some restrictions, was sold to ENI in May 2008). Creation of Fluxys International with a maximum 60% ownership of the GDF-Suez from part of Fluxys (the transmission system operator) in order for the group to retain control of the Zeebrugge import hub and LNG terminal.
Transmission	Electricity: Suez had the blocking minority in the electricity transmission system operator (Elia) while SPE also held a small share.	GDF-Suez reduced its stake in Elia to below a blocking minority of 25%, in accordance with a previous commitment (December 2007).
	Gas: Suez held over 57% of shares in Fluxys (the transmission system operator).	Reduction of the group's stake in Fluxys (was reduced to just below 39% in September 2008 in a transaction with the municipal holding Publigaz).
Distribution	Electricity: Electrabel (owned by Suez) had shares in roughly 80% of the distribution system operators, within the regional restrictions limiting private sector participation to minority shares.	
	Gas: Suez had stakes in 80% of the distributors.	
Supply	GDF and Suez jointly controlled over 70% of the electricity supply market and about 80% of the gas supply market.	Sale of Suez's holding in Distrigas (with some restrictions, was sold to ENI in May 2008).

Source: International Network of Energy Regulators and European Commission.

deterred entry in the supply market and therefore further efforts to increase interconnection capacity is desirable to enhance competition. Moreover, although the retail electricity prices are not regulated, most suppliers choose to use a variation of a cost indexation formula calculated by the federal regulator (CREG), which was used historically to determine the regulated price before the markets were liberalised. The publication of the components by CREG should be ceased, as they bring little value added while posing the risk of the regulator acting as a price coordinator on the retail market. As this formula is based, among others, on the Zeebrugge hub spot gas price and available nuclear plant capacity, both of which can be strongly influenced by the incumbent companies, increased vertical separation in the market should ensure this is not the case. The transmission and distribution tariffs are accompanied by high uncertainty, undermining potential new business models of new entrants. Switching to multi-annual tariffs for transmission (in 2008) and distribution

Figure 5.6. **Competition restricting regulation in energy and telecommunications**

2008 Indicators



Source: OECD (2009), *PMR database*.

StatLink http://dx.doi.org/10.1787/647354733036

(in 2009) are significant steps towards a more stable environment, however the legal uncertainty related to the details of the introduction of such legislation has, so far, undermined its effect. Another example of the uncertainty surrounding tariffs was when the lowering of tariffs by CREG led to an appeal against its decisions and its subsequent annulment in 2008. This resulted in a number of suggestions that the regulator needs additional tariff-setting powers in the distribution segments (NBB, 2008).

Another potentially important deterrent to entry is the complicated regulatory structure (Box 5.4) which effectively divides Belgium into three separate energy markets, thereby increasing entrants' (fixed) costs. The federal regulator seems sufficiently independent and equipped to regulate the areas within its competence. In April 2008, the government increased the investigative powers of its officials and thus improved the toolset of the federal regulator. However, the set-up of the regional regulators does not seem as well developed. Firstly, their independence does not seem as well secured, as they are financed directly by regional government budgets, while the senior staff is appointed by the regional government, and their objectives are not necessarily in line with each other nor with those of the federal body. Secondly, although regional regulators in downstream segments may, in principle, be better equipped to fulfil their tasks, being closer to the final consumer, such a structure risks unnecessary bureaucratic delays in communication and the loss of economies of scale, in particular in the Belgian context where divided regulators are dealing with a very concentrated market. In addition, there is a risk that regional regulators may be more prone to regulatory capture, in particular given their weak independence from the governments and the strong involvement of municipalities in distribution networks.[5] Therefore the regulatory structure should be revisited and the regulatory tasks should be concentrated in one authority. As a second best, strong independence and sufficient powers of the regional regulators need to be secured, while the current voluntary dialogue forum should be replaced by a binding co-operation and co-ordination framework between regulators of all levels is necessary and to align their priorities. Finally, universal service obligations appear overly broad and may deter entry due to a higher cost of adapting to the regional specificities (Box 5.5). In order for them not to constitute a barrier to new competitors, regional authorities wishing to conduct additional social policy based on energy provision, should purchase energy within their own budget or use transfer policies instead of the regulated tariffs.

Gas

Gas is imported mainly through the Zeebrugge hub and LNG terminal. Roughly one half of the households use gas for heating and cooking and the role of gas in the generation of electricity, is set to increase significantly over the coming two decades (IEA, 2006). A number of issues concerning the gas sector are also common to the electricity sector, and thus have already been discussed in the previous section. The sector was liberalised in a similar time frame as the electricity sector. Gas prices were generally near the EU average until 2007, but as in electricity the subsequent fall was due to a regulatory lowering of tariffs, which were annulled in 2008 (Figure 5.5).

The main regulatory problems in the gas market concern high implicit barriers to new entry and the resulting strong position of the incumbent, while explicit entry barriers are low (Figure 5.6, Panel B). The gas market is highly concentrated (GDF and Suez) and the commitments accompanying the merger of the two companies are unlikely to improve the situation (Box 5.6). As a result, the transmission network capacity has been, to a large

extent, unavailable to new entrants as it was contracted out for very long time periods. Measures to resolve this situation have been imposed by the Commission in late 2007 (EC, 2007a and 2007b) however it will take time to evaluate whether they are sufficient. Moreover, installing a well functioning wholesale pool for natural gas, which has proved to benefit competition in a number of OECD countries, is recommended.[6] Given the strong position of GDF-Suez in various segments of both the gas and electricity markets, regulatory efforts should be increased to ensure that the legal interdiction of cross-subsidisation within the same company, both between the different segments of the gas market as well as between gas and electricity products, is respected. As in electricity, the law currently requires legal separation of the transmission and distribution segments and accounts separation of the other segments. The introduction of mandatory vertical ownership separation between different segments or of strengthening the existing formal separation, in line with the government's proposals, would be a desirable step. In this light, the government should continue its efforts to make sure that the main market players do not have a blocking minority participation in the ownership structure of the Zeebrugge hub and the LNG terminal. This should be done with the goal of assuring non-discriminatory third party access to the terminals and to transmission capacity from the terminals, which has proven a serious problem in the past. The Ministry of Energy is currently working on this issue, as part of the new Code of Conduct on third party access to the gas network.

The performance of the telecommunication sector over the past decade has been disappointing

Productivity growth in the telecommunication sector was well below that in most other OECD countries (Table 1.6) and consumers were often forced to pay higher prices than in neighbouring countries and the introduction of new technologies was lagging. Although explicit barriers to entry do not seem to be a problem in most segments of the market (Figure 5.6, Panel C), one of the most visible issues is the high concentration of the sector.

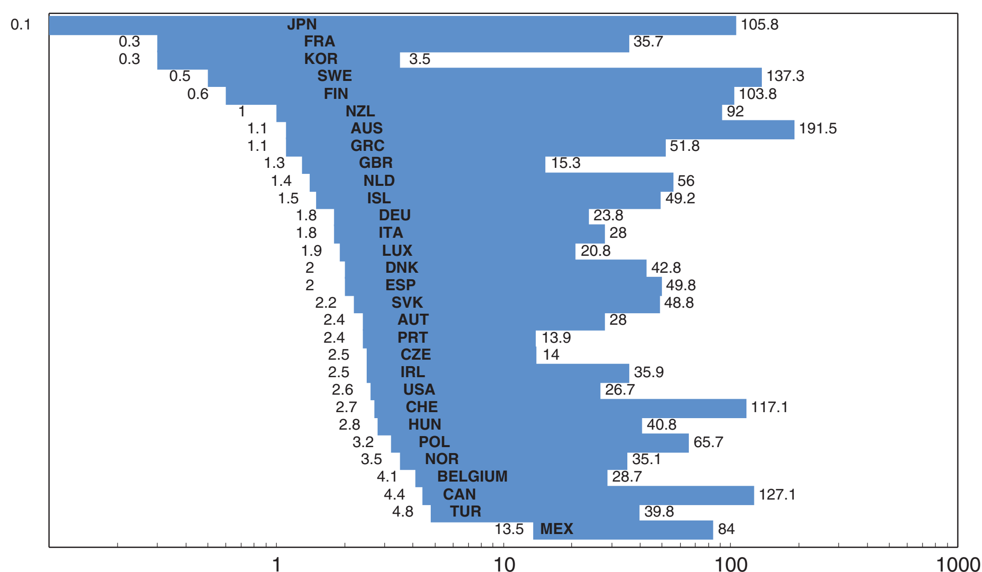
Fixed telephony

Following the liberalisation of telecommunications on 1st January 1998, new entrants have not been able to gain a strong position in some of the key segments of the market, which remained concentrated in the hands of the majority state-owned incumbent Belgacom. Belgian broadband offers remain on the expensive side in comparison to other OECD countries (Figure 5.7). Moreover, a particular feature of the Belgian broadband is that practically all offers have monthly download quotas (bit-caps) which tend to be lower than in other countries. This further raises the price of Internet usage as exceeding the quota entails an additional cost.[7] Furthermore, the Belgian consumer does not have access to top technology (*e.g.* fibre-to-the-home) and the advertised speeds remain well below the fastest offers in leading OECD countries (Figure 5.8). As a result, broadband penetration, among the highest in the OECD in 2002, has since been growing slowly and is lower than in many countries (though still above average). Finally, the Belgian consumer pays an excessive price for triple-play offers (broadband, TV and telephone) while the offers are of inferior quality (Table 5.4 shows a comparison with France, where the regulator has been particularly active in the telecom market).

Broadband is provided mainly through DSL lines and to a smaller, but still internationally high, extent *via* cable. Local loop unbundling (LLU) of cable networks is technically infeasible and due to the high concentration in the cable sector, this technology

Figure 5.7. **Broadband Internet is relatively expensive**[1]

Price per unit of maximum download speed[2] (USD)



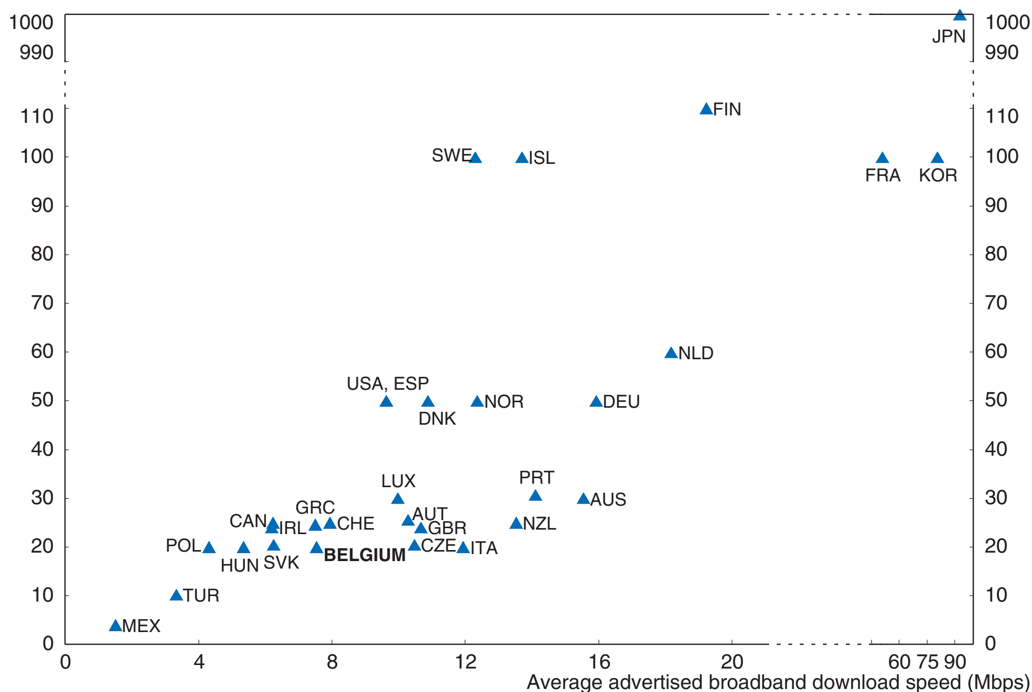
1. October 2008, logarithmic price scale.
2. USD per 1 Mbps of maximum advertised download speed.

Source: OECD (2009), *OECD Communications Outlook* (forthcoming).

StatLink http://dx.doi.org/10.1787/647364260430

Figure 5.8. **Advertised download speeds are relatively low**

September 2008



Source: OECD (2009), *OECD Communications Outlook* (forthcoming).

StatLink http://dx.doi.org/10.1787/647367722765

Table 5.4. **Triple-play is significantly more expensive than in France**

Company	Internet connection speed (download, Mbps)	Bitcap (GB)	Television channels	Telephone (unlimited free calls included)	Price (€)
France					
Free	28	…	50+	70 countries	29.99
Neuf	20	…	50+	60+ countries	29.99
Orange	18	…	50+	National only	39.99
Numéricable	100	…	50+	45 countries	31.90
Belgium					
Belgacom	1	1	50+	Off peak only (1 country)[1]	47.00
Belgacom	4	4	50+	Off peak only (1 country)[1]	57.00
Belgacom	12	25	50+	Off peak only (1 country)[1]	67.00
Telenet	4	5	50+	Off peak only(36 countries)	40.00
Telenet	12	30	50+	Off peak only(36 countries)	50.00
Telenet	20	30	50+	Off peak only(36 countries)	60.00
Telenet	25	100	50+	Off peak only(36 countries)	70.00
Numéricable	100	100	50+	42 countries[2]	59.99

1. Fixed EUR 5 activation fee for international calls.
2. Very limited promotional offer.
Source: Company websites, December 2008.

has failed to put sufficient competitive pressure on the incumbent's DSL offer. In DSL itself, the main alternatives to the incumbent's offer are provided via bitstream (renting capacity from the incumbent and reselling it) which is incapable of challenging the incumbent's position as it does not allow for sufficient differentiation of products (*e.g.* providing television over Internet). Overall, the level of local loop unbundling of DSL lines is very low when compared with OECD countries with a liberalised market, despite a comparable regulated price of provision.[8] Until 2007 this was largely a consequence of high (regulated) prices of unbundling, which have since been lowered to internationally low levels (EC, 2008a). Nevertheless the latter development has failed to benefit the final consumer. Part of the explanation is historical and the effects of lower tariffs should eventually be felt. However, many costs related to unbundling remain high (*e.g.* collocation, installation and de-installation) increasing the cost of entry. Secondly, for a number of years, the incumbent has failed to comply with requirements concerning the timing and quality of provisioning and servicing of lines, and the regulator has failed to enforce these obligations.[9] Furthermore, the incumbent has appealed against almost all of BIPT's decisions and cases get held up in the Court of Appeal or in some cases at the Competition Council for a relatively long time given the dynamic nature of the sector. In the end BIPT's decisions were often annulled on formal grounds, increasing uncertainty for new entrance (Platform, 2007). Such developments create an implicit barrier for new entrants, who face high uncertainty regarding the quality of services provided by the incumbent, and therefore potential problems with assuring a high quality of the end product.

The regulatory and legal framework was earlier criticised for lacking a consistent and systematic approach and giving the impression of improvisation (Dehousse and Zgajewski, 2003). The regulator's powers still seem somewhat weaker when compared with the OECD best practice. Firstly, what is rather unusual, dispute settlement is outside its competencies and is carried out by the Competition Council. Second, the regulator appears to have fewer tools available to enforce its decisions than for example regulators in Finland, Sweden and Spain (ECTA, 2008). BIPT is unable to impose periodic penalties to ensure compliance, to

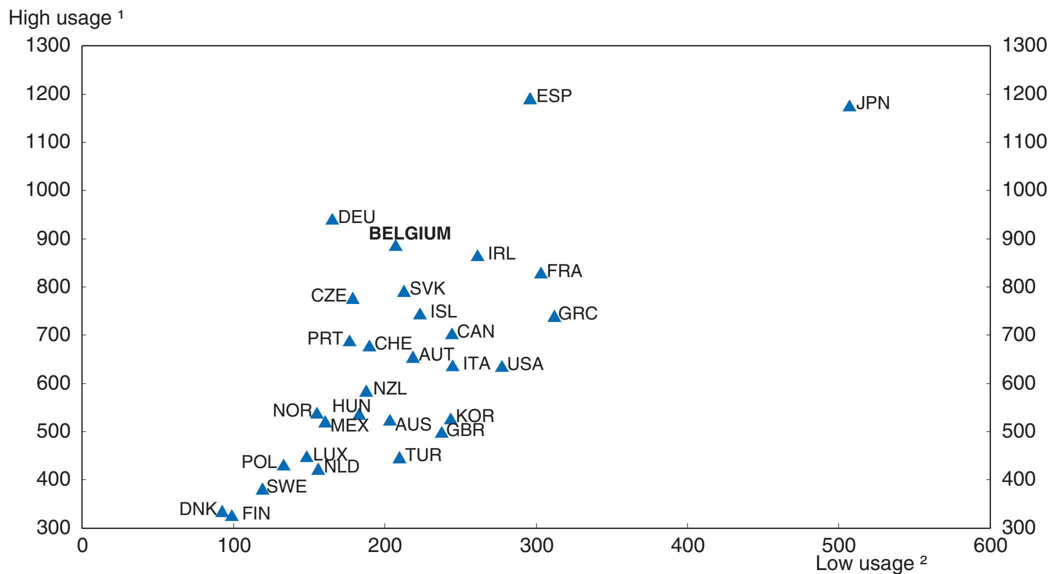
suspend an introduction of an offer until the *ex ante* obligations are fulfilled and is tied up by a strict confidentiality law.[10] Moreover, although BIPT's independence was improved in 2003, there are indications it may still need strengthening in particular given the controlling share of the state in the incumbent (Box 5.4). As a consequence, Belgacom is a significant contributor to the federal budget, which leads to a potential conflict of interest: the state is a regulator in charge of promoting competition and the state benefits from the incumbent's profits. Therefore, the privatisation of Belgacom would further clarify the incentives to empower the sectoral regulator. In the past years, a number of sources have accused the regulator of being under political influence (Platform, 2007, ECTA, 2008, Test-Achats, 2007, 2008) and of neglecting the enforcement of local loop unbundling (Platform, 2007). Each of these issues should be reviewed and addressed, so that the regulator can take an active part in promoting competition on the telecom market in order to bring telecommunication productivity growth more in line with other OECD countries and to allow consumers to benefit from lower prices and better offers. This should be done primarily through a tough stance on the incumbent's violations, including a determined use of fines in order to lower implicit entry costs and encourage LLU. Furthermore, any pressures to dilute the regulatory powers, for example due to the overlaps of competencies with the Community-level broadcast content regulators, should be strongly resisted. Notably, the government is preparing a reform which should improve the powers of the regulator (Box 5.4).

Another important issue is the imposition of social tariffs on all the operators in fixed line telephony and their funding (Box 5.5). The implementation of the social tariffs has raised numerous problems, including the problems of competitors' access to the database which would allow the verification of eligibility (Platform, 2007) which now seems to have been solved. Moreover the compensation mechanism seems not to be in line with the EU's Universal Service Directive as there are no legal instruments to establish whether provision of social tariffs constitutes an unfair burden. Due to the larger share of those benefiting from social tariffs among Belgacom's clients, the fund risks being an effective subsidy to the incumbent. If the government is determined to pursue the social tariff element of universal service, it should consider periodically auctioning off the service in a competitive bid, or at the least obliging the regulator to conduct investigations whether this service constitutes an unfair burden, equipping it with the necessary legal tools. Last but not least, there could be concerns for the future development of competition in the market if Belgacom upgrades its network using VDSL, since this technology increases the cost of unbundling for new entrants. Therefore the regulator needs to examine how to ensure competition with this technology (steps in this direction would include assuring access to passive infrastructure and backhaul facilities). It is also desirable to encourage the development of fibre-to-the-home (FTTH) technology.

Mobile telephony

Mobile call charges in Belgium tend to be on the expensive side: low-usage charges appear close to the OECD average, despite an internationally high number of virtual operators (MVNO's) and resellers targeting this market, while high-usage prices are among the most expensive (Figure 5.9). Mobile phone penetration is among the lowest in the EU, showing little signs of catching up. The market is divided between three network operators, including the dominant player Proximus, which is owned by the fixed telephony incumbent, Belgacom.[11] The numerous resellers and MVNO's (above 25), contrary to other countries, have failed to gain a significant market share and to bring down the price of

Figure 5.9. **Prices for mobile phone calls tend to be high**
Total price in USD, February 2008



1. The OECD basket of mobile telephone charges (high usage) includes subscription and usage (1 680 minutes of voice calls, 660 SMS messages and 12 MMS, distributed between peak and off-peak hours and based on an average call duration) over a one-year period. Calling patterns were all determined through extensive discussions with carriers across the OECD.
2. The OECD basket of mobile telephone charges (low usage) includes subscription and usage (360 minutes of voice calls, 396 SMS messages and 8 MMS).

Source: OECD, *Communications Outlook database*.

StatLink http://dx.doi.org/10.1787/647383533420

mobile calls (the combined market share remained below 1% by 2008, EC, 2008a). Mobile termination charges, despite being lowered in 2008, remain well above those in competitive markets like the United Kingdom, Sweden and Finland. Moreover, in 2008 the College of Competition Prosecutors has found evidence of the abuse of dominant position by Belgacom Mobile (in the period 2002-2005) and the case is currently pending before the Council (the complaint was filed in 2005). The incumbent's appeals against the lowering of termination charges lead to lengthy legal procedures in the Court of Appeal and significantly increase uncertainty for resellers.

The regulator should focus on lowering mobile termination rates to meet the levels in the most competitive markets. In order to assure that the business models of the resellers are not undermined by uncertainty related to the incumbent challenging the regulator's decisions, the court cases should be speeded up in order to assure that they better match the dynamic nature of the sector. This should be achieved through appointing the Competition Council as the institution of appeal against all decision of the regulator, which may possibly require increasing the Council's resources. In order for the reduction of mobile termination rates to benefit the final consumer, sufficient competitive pressure on retail and wholesale prices must be assured. A desirable step in this direction, already under consideration by the government is the introduction of the fourth network license. To facilitate the expansion of resellers and the potential new operator, the long length of service contracts should be reduced by limiting their maximum duration. The process for number portability should be streamlined to reduce the time taken to port a number. As for

the social tariffs, the benefits of the extension to mobile phones are disputable (EC, 2006). As in fixed telephony, if the government considers social tariffs desirable, it should consider periodically auctioning off the service in a competitive bid and pay for it directly from the budget.

Liberalisation in postal services and rail transport in lagging

The liberalisation of both the rail transport and postal services market is proceeding slowly, in line with the requirements of the European Commission. The latter stipulates the eventual full opening of both markets to competition: rail transport by January 2010 and postal services by January 2011. In the postal services sector, while competition seems to be well in place in the courier services, it is practically non-existent in the addressed letter segment (van der Lijn *et al.*, 2008). As a consequence, despite the favourable characteristics of a relatively evenly spread, dense population, Belgian consumers suffer from higher prices, in particular for letters, and from a poorer quality of services that in most neighbour countries (Deutsche Post, 2008 and EC, 2008b). The sectoral regulator has, according to some sources, been perceived as inactive in the field of postal services (Baeke, 2008). Indeed the quality criteria agreed with the State have not been met by the incumbent, but no sanctions were issued. Although the situation is expected to improve as new sorting centres have been put in place, sanctions for the violation of preset quality standards should be significant and automatic, leading to stronger incentives to improve the quality of services. Moreover, new entry may be deterred by a number of additional Belgium-specific regulations. These include a VAT exemption on certain services provided by the incumbent and a particularly broad range of universal service obligations (Box 5.5). The former distorts the market, biasing the incumbent towards servicing the residential market and the competitors towards the business market while the broadness of USO's leads to a high cost of provision.[12] This may result in the subsidisation of the incumbent who, even in a fully liberalised market, will remain the only player with sufficient infrastructure to provide the broad USO's. Thus it would be desirable that each of the services currently included in the USO bundle, if deemed indispensable by the government, to be separately auctioned off according to best offer. Until then, the pricing should fully take into account the benefits of brand display.

As concerns rail transport, virtually no steps have been taken towards opening the passenger transport market to competition. The freight market is legally open for international connections since January 2006 and one year later for national connections, but remains strongly dominated by the state-owned incumbent. The publicly owned incumbent consists of the monopolist passenger transport service provider, the dominant freight service provider and the infrastructure operator. The passenger and freight segments have separate accounts while the infrastructure operator is required to be legally separated from the service providers. However, this separation is incomplete due to overlaps in terms of high level personnel. The sectoral regulator, which remains an agency within the Ministry of Transport, is in need of strengthening and more independence in order to assure non-discriminatory third party access to tracks, slots and marshalling facilities. Moreover at the moment, passenger connections are negotiated between the infrastructure operator, the monopoly service provider and the state which has a monopsonistic position. Once the market is liberalised lower levels of governments should be empowered to purchase desired services (as for example in Germany) to introduce a more market-based provision of services. Strengthening the regulator, finalising the legal

separation and changes in the service acquisition framework are recommended along with the swift full opening up to competition. Finally, successful introduction of competition in the rail sector would also be facilitated by a uniform, market-oriented approach to universal service across the network sectors in order to guarantee a level playing field and to avoid entry barriers to new competitors.

Conclusion

Recent reforms of competition policy enforcement and the favourable stance of the government towards more competition constitute undeniable progress towards more competitive domestic markets. However, this may not suffice to bring productivity in certain sectors, such as retail distribution, telecommunication and energy, in line with that of the leading OECD countries. In order to reap the full benefits of liberalisation in terms of higher productivity and employment growth as well as competitive prices, further steps need to be taken. Overall, the system of regulation as a whole may need reconsideration in order to be aimed at a clearly defined, efficient role of each regulatory authority and at securing effective cooperation between the authorities. A number of additional policy measures which should be taken in order to assure that Belgian consumers benefit from competition on the market are summarised in Box 5.7.

Box 5.7. **Policy recommendations to enhance competition**

The Competition Authority needs further strengthening

- The effective independence and the accountability of the Competition Authority should be monitored, in order to assess whether further strengthening in these areas is necessary. Resources may need to be reviewed and eventually increased to levels observed in other small economies with a proactive competition enforcement stance.
- In order to avoid foregoing or postponing important cases and to allow the Competition Authority to adopt a more proactive role in analysing the market, its resources should be increased. The Competition Council should be established as the institution of appeal against all the decisions of the sectoral regulators.
- In order to improve deterrence, the law should provide for criminal sanctions for hard-core cartel infringements. High fines should not be avoided as they deter anticompetitive practices and increase the attractiveness of applying for leniency. Confidentiality rules should be reviewed and possibly loosened with a goal of facilitating the cooperation of the Authority with network sector regulators.

Competition-burdening regulation in retail distribution should be abolished

- In order to benefit from the competitive nature of the retail sector, with the goal of creating employment, improving purchasing power and bringing productivity in line with other OECD countries, the competition inhibiting regulation should be scrapped (*e.g.* restrictions on sales below cost, opening hours and tied sales, black-out periods). Zoning laws for large outlets should be restricted to evaluating spatial effects (urban planning, access, safety) in order to assure they do not protect existing retailers against new competition.

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Box 5.7. **Policy recommendations to enhance competition** *(cont.)*

Sectoral regulation needs to focus on implicit barriers to new entry

- To improve the effectiveness of regulatory action in the *energy sectors*, the complicated regulatory structure should be reconsidered. Reforming the setup to establish a single, independent nationwide regulator with competencies including the areas of distribution and supply of gas and electricity in order to deal with the local monopolies, should reduce the bureaucratic procedures and the burdens for new entrants. Alternatively the binding co-operation procedures between the regulatory bodies should be introduced in order to align the objectives of regional regulators, increase the efficiency of communication procedures. Independence of the regional regulators from the governments should be assured.
- In order to facilitate new entry, ownership separation between different segments of the electricity and gas markets should be considered. For the same reason, regulatory efforts should be strengthen to ensure that the ban on cross-subsidisation between electricity and gas markets is enforced.
- New entry should be promoted by improving the role of the wholesale exchange and reconsidering the universal service obligations (USOs) and their variation across regions. If sub-federal governments wish to implement additional social policies they should finance it from their own budget rather than through distribution tariffs.
- In the *electricity sector* further efforts should be made to increase interconnection capacity, encourage new entry and continue auctioning off of the incumbent's production capacity.
- An anonymous wholesale pool for *gas* should be developed in order to facilitate new entry. Assuring strong vertical separation, between the Zeebrugge gas hub and the LNG terminal on the one hand, and the dominant players in the energy market on the other is strongly advised in order to assure third party access. The effectiveness of recent measures to reduce long contract lengths in the gas wholesale market should be evaluated and if necessary new measures should be adopted.

The telecommunication regulator needs to toughen its stance against incumbent's violations

- The regulator should be given the ability to introduce periodic penalties and to block the introduction of offers if *ex ante* conditions are not fulfilled. Furthermore, the regulators independence may need explicit strengthening while the government should proceed with the privatization of the incumbent.
- In *fixed telephony* the regulator should increase efforts to encourage local loop unbundling (LLU) through strengthening its stance on the incumbents violations in the areas of deadlines for LLU provision, service level agreements, collocation and the quality of services provided. Fines for the incumbent's violations should be used more widely and preferably be automatic. The regulator should strongly promote competition in new generation networks.
- In order to avoid inefficient complication of the regulatory structure and the dilution of powers, any pressure from Community-level broadcasting regulators to gain power to regulate transmission infrastructure should be strongly opposed.
- In *mobile telephony* the regulator should increase efforts to lower the mobile termination charges and to decrease the uncertainty surrounding its decisions through a better preparation to defend them in court.

Box 5.7. **Policy recommendations to enhance competition** *(cont.)*

- The fourth network operator should be introduced as soon as possible. Maximum contract duration should be reduced in order to increase flexibility and facilitate entry. USOs should be funded from the government budget *via* competitive tendering.

Faster opening up of the other network sectors is essential

- Competition should be introduced in all segments of *postal services*. Efforts to decrease entry barriers should be increased: the scope of USOs should be reconsidered and the clause on additional fund for USO financing should be eliminated. Again USO's (each service individually) should be financed directly from the budget through competitive tenders.
- Faster opening up of the *rail transport sector* should be accompanied with strengthening the independence and powers of the regulator.

Notes

1. The figures presented do not take account of differences in VAT tax rates across countries. However, although the Belgian standard VAT rate is higher than in many euro area countries, the differences are of a small order of magnitude (on average 1.6 percentage point higher) and would not change the conclusion. Furthermore the Belgian VAT tax is characterised by a large number of reductions and exemptions (Chapter 4).
2. Although labour productivity growth in the Belgian distribution sector (which consists of wholesale and retail trade and repair shops) has been slow in the past decades, there are findings that the actual level of productivity in Belgian distribution is among the highest in the OECD (Inklaar and Timmer, 2008). The main reason for the low productivity growth is the low growth rate of total factor productivity. The high productivity levels are due to very high capital intensity (both information and communication technology capital and other types of capital). This may seem somewhat in contrast with the fact that the Belgian retail sector is characterised by a large amount of small shops. Partial explanations for this phenomenon may include the wide definition of the sector, encompassing far more than just retail trade and the relatively restricted opening hours (due to opening hour regulation and working hour regulation).
3. The favourable development in 2007 has been due to a transmission and distribution tariff decrease imposed by the federal regulator, which was later annulled by the court on the grounds of the regulator exceeding its competencies. The decreases of electricity (and gas) prices in 2007 relative to other countries have been reversed as a result of the tariff increase ranging from below 10% in Wallonia (where they remain the highest) to almost 50% in Flanders (where they still remain the lowest). This caused final energy prices to increase sharply. The 22% inflation (year-on-year) of Belgian energy prices in September 2008, is estimated to have been only 13% if not for the change in distribution tariffs, and below 8% (in line with Euro area average) if additionally capacity was kept at 2007 levels. Of the 1.8 percentage point differential in headline inflation between Belgium and the euro area (September 2008) 1.2 percentage points can be explained by gas and electricity price increases (NBB, 2008).
4. Monthly variation can be considerable, *e.g.* in May 2008 the traded volumes reached a third of Belgian demand.
5. The municipalities have a legal monopoly in electricity distribution, and nearly all of them transferred the distribution to inter-municipal companies (intercommunales). The income from the energy-related activities constitutes an important figure in the municipal budgets reaching 10% of the revenues.
6. Although APX Zee (a within-day and day-ahead gas trading platform) already exists, its role is negligible with a total of 33 transactions done in the whole of 2008, of which 11 since February.
7. Caps generally prevail in countries where geography limits the connection to the rest of the world (*e.g.* located on islands) and in principle Belgium's location does not explain the prevalence of caps. In 2008 only four OECD countries had 100% of offers with caps (Australia, New Zealand, Canada and Belgium) while Iceland and Ireland had a domination of offers with caps (OECD broadband portal). The average level of caps in Belgium was the second lowest in the OECD, of a range comparable with only New Zealand (on average 20 GB in 2008, but being as low as 250 MB in the

low-end offers). Belgian bit-caps are reached relatively fast, compared to the advertised maximum download speed and may impose a higher *de facto* charge for high users. In mid-2008 one challenging provider started offering uncapped downloads, but has since been followed by only one competitor (in December 2008).

8. By January 2008, out of over 1.6 million DSL lines, less than 40 000, that is 2.5% of the total, were fully unbundled. In contrast, 18% of lines are unbundled on average in the EU 27, 31% in Germany, 23% in France and 10% in the Netherlands. Shared access lines constitute slightly above 1% of total lines in Belgium.

9. The regulator generally has refrained from fining Belgacom. As regards local loop unbundling, by July 2006 BIPT registered numerous complaints from the alternative operators about Belgacom not meeting legal deadlines for line installation and service works. Instead of adopting a tough stance on the violations BIPT effectively doubled legal time limits for Belgacom. This decision had an adverse impact on consumer welfare instead of forcing the incumbent to devote additional resources to LLU and servicing. The penalties for exceeding the maximum timeline were revised, detaching them from the monthly rental fee, however they have been capped at relatively low levels. Since then the timing schedules are to be reduced gradually, however despite recent improvements, Belgacom still seems to have problems fulfilling them, but uses inevitable deviations from the forecasts on LLU which the competitors are obliged to provide in order to avoid fines. Similarly, Belgacom's competitors give details on the problems BIPT has experienced in forcing Belgacom to include ADSL2+ in to its reference offer for bit stream (despite persistent refusal to fulfil BIPT's request no fine was issued). Only recently (July 2008) a EUR 3 million was issued for failing to comply with BIPT's decision on mobile phone charges.

10. For example, the decision whether data passed on to BIPT is confidential or not is left to its author. No motivation must be given, and the regulator cannot challenge this decision, thus the use of obtained data may be limited.

11. The three market players are Proximus (owned by Belgian fixed-line incumbent Belgacom) with 45-49% of the market according to different estimates, Mobistar (owned by the French incumbent France Telecom) with 31-34% of the market and BASE (owned by the Dutch incumbent KPN) with the remaining share of around 20%.

12. The lack of VAT on postal services provided by *La Poste* in the area subject to USO gives an advantage to the incumbent towards customers unable to reclaim their VAT (mainly households) and a disadvantage towards other customers. Households, pay the nominal price on which the incumbent does not pay VAT. Business customers also pay the nominal price but they can reclaim the VAT from the competitors' price while not from the incumbent's price. Moreover, as the incumbent uses inputs subject to VAT, it cannot reclaim the tax when offering a service not subject to value added taxation.

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