Belgian Financial Forum

# Public Finances: Will Belgium Have Fiscal Maneuvering Room to Overcome Future Challenges?

**Koen Algoed**
Secretary-General
Flanders Finance & Budget Department

## ABSTRACT

**Since the nineteen seventies, our country has built up a bad reputation with respect to its state of public finances. We didn't comply with the Maastricht rules nor do and did we comply with both the preventive and the corrective arm of the Stability and Growth pact. On top of that, there are several fiscal headwinds which put an upward pressure on future Belgian public debt. Ageing and climate change are two well-known elephants in the policymakers' room.**

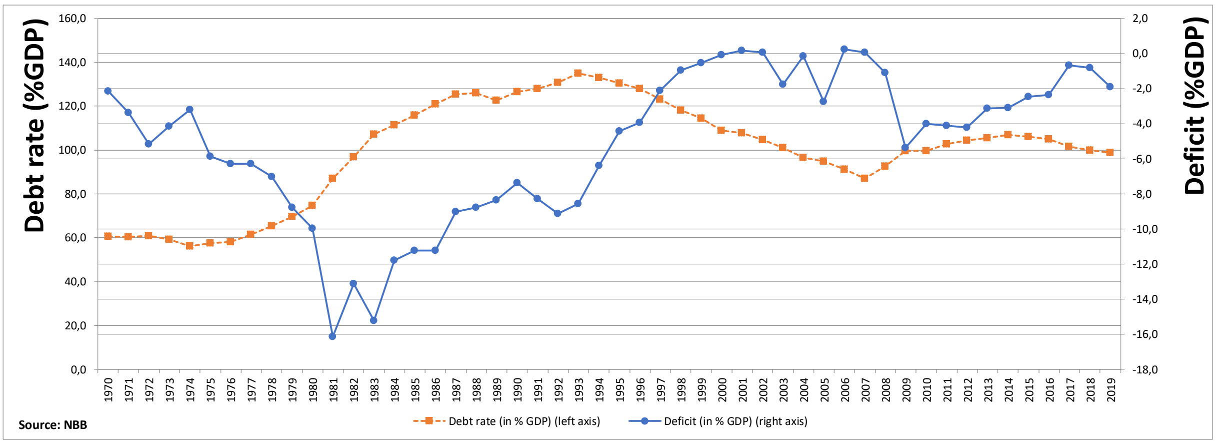
**Hence the fiscal maneuvering room to overcome future challenges seems limited in our country. There are, however, also several areas where the gains from structural reform are relatively high. The paper discusses a non-exhaustive list of some of these fiscal opportunities. Finally, we question our obsolete budgetary processes.**

## Historical overview

Since the nineteen seventies, Belgium has built up a bad reputation with respect to its state of public finances. As can be seen in figure 1 below, in the beginning of the seventies, the debt ratio was below 60%, but has been steadily increasing afterwards to reach its maximum of 134.9% in 1993.

Budget deficits were written in double digits in the nineteen eighties. Balanced budgets were the exception to the ruling deficits. It is only because of external pression (obtaining access to the European Monetary Union) that some fiscal consolidation took place in the second half of the nineties, resulting in a primary surplus of almost 6% of GDP. However that consolidation stopped in the beginning of this century, when declining interest expenditures were invested in a phasing out of that primary surplus.

**Figure 1. Debt rate (%GDP) and deficits (% GDP) in Belgium between 1970 and 2019**




History nevertheless shows that we can live with a high level of outstanding government debt. Belgium has only in the nineteen thirties repudiated debt vis-à-vis the United States. But high indebtedness also comes with a price: debts are not reflected on the asset side of the government balance; there is an interest rate risk when outstanding debt must be renewed; the maneuvering room for future shocks (such as COVID-19) diminishes and, more generally, there is a constant risk that debt levels may (be perceived to) become unsustainable. A recent NBB paper analyzes when accumulating additional public debt does become unsafe, as for public debt the sky may *not* be the limit. The study estimates the critical debt level, beyond which the risk of losing control of debt dynamics becomes large, to lie at 120% of GDP for Belgium. This level differs across countries and time, because besides the initial debt level, the risks imposed by the country's banking sector are also taken into account.

## Incomplete compliance with international obligations

Ever since the introduction of the euro and the European Monetary Union, Belgian fiscal policy is also increasingly the subject of international regulation, which aim to ensure fiscal prudence. Most importantly, the Maastricht rules negotiated in 1990-1991 imposed well-known numerical criteria on budget deficit (3%) and debt (60%) for joining the euro area and were later complemented by the Stability and Growth Pact (SGP), which further institutionalizes budgetary prudence in the EMU.

Belgium didn't comply with the Maastricht rules. Today, it also does not comply with both the preventive and the corrective arm of the SGP. It suffices to look at the 2019 figures in figure 1 to see that, even in the pre-Covid era, public finances of the overall government in our country have been deteriorating instead of improving.

The Medium-Term Objective (MTO) set by the EU for our country has been revised upwards to a balanced budget (from minus 0.5% of GDP), given the worsening impact of ageing on the budget. Because of the higher than 60% public debt rate and conditional on a normal business cycle, the structural balance should ameliorate on an annual basis with minimally 0.5 percentage points of GDP. For 2019, an exception of 0.1 percentage point improvement was awarded instead of the warranted 0.6 percentage point, because our country could invoke the flexibility clause of structural reforms. Notwithstanding that, the structural balance in 2019 decreased with 0.6 percentage points of GDP, from -1.8% of GDP to -2.4% of GDP. A deviation of 0.7 percentage points of GDP, whereas the maximal allowed annual deviation in the Stability and Growth Pact amounts to 0.5 percentage points of GDP. Particularly worrisome is the primary balance, which turned into negative in 2019: minus 0.4% of GDP[1].

Neither did we comply with the other gauge in the preventive arm, the so-called expenditure benchmark. Considering the flexibility clause, expenditures of overall government could increase in 2019 by 2.8% in nominal terms. In reality, they increased by 4.3%.

Regarding the requirement imposed by the corrective arm, with respect to progressing to the 60% debt ratio ceiling, we didn't comply with none of the methods (backward looking, forward looking or cyclically adjusted) to measure the warranted progress regarding debt reduction. The debt ratio was pinpointed at 98.63% at the end of 2019 and according to, for example, the backward-looking method, it should have been 97.97%.

## Belgium's future fiscal challenges

In addition, there are several fiscal headwinds the put an upward pressure on future Belgian public debt. Ageing and climate change are two well-known elephants in the policymakers' room.

---

[1] The negative primary balance together with 2% of GDP interest expenditures sum up to the structural deficit of 2.4% of GDP.

The ageing bill, especially for Entity I (federal government and social security), will only increase the coming years, just like the costs associated to the climate change. In its latest report, the Committee on Ageing forecasts an increase of the social expenditures by 2.8 percentage points of GDP in 2025, and 5 percentage points of GDP in 2040, starting from a level of 24.8%  in 2019. If one continues with today's policies, additional deficit spending will be required each year.  There has been no pre-funding for these ageing costs, as has been illustrated by foregoing the built-up primary surplus at the end of the previous century. The so-called Silver Fund, aimed to fund the ageing bill, turned out to be an empty box. It gave the impression to the public that policymakers were dealing with the ageing problem. In reality, the buyer of the Silver Fund bonds was the same as the issuer of these bonds and the Silver Fund didn't at all invest in bonds of other governments or in real financial assets.

With respect to efforts tackling climate changes, additional efforts are needed to meet the targets for greenhouse gas emissions and renewable energy.

### Belgium's future fiscal opportunities

There are, however, also several areas where the gains from structural reform are relatively high. Below is a non-exhaustive list of some of these fiscal opportunities.

First, there is room for an expenditure shift towards public investment, especially at the level of the regions. In 2019, investment by the overall government was low and stood at 2.59% of GDP: 1.36% on behalf of the regions/communities, 0.76% by the municipalities and 0.48% on the account of the federal government. Nearly all gross investment has been replacement investment, whereas what matters for economic growth is investing in additions to the capital stock. The low level of net government investment also weighs on economic growth. Net investment is even negative, as the public net capital stock declined by 15 percentage point of GDP since 1995 (EC figures). Nevertheless, the multiplier effect of this kind of government expenditure is amongst the highest.

Second, there is room for a reform of the tax system. As is well known, Belgium has a high level of taxation, but also substantial tax expenditures[2]. The EC 2017 figures are illuminating. In 2017, Belgium tax revenues represented 44.8% of GDP (EU average 39.2%). However, the share of tax expenditure in most tax categories is also high (23.1% of

[2] Tax expenditures alter the horizontal and vertical equity of the basic tax system by allowing exemptions, deductions, or credits to select groups or specific activities.

personal income tax receipts; 13.4% of corporate income tax receipts; 32.3% of value added tax receipts). Some 47% of the foregone tax revenue resulting from tax expenditures supports social measures (e.g. pensions). The rest covers employment (13.5%), real estate (15.9%), R&D (8.3%) and specific sector provisions (6.4%). The extensive use of tax exemptions and deductions makes the tax system complex, inefficient and unfair. In addition, the high tax on labour discourages labour participation and lifelong learning.

Third, there is an opportunity to tackle falling productivity growth. The annual productivity gains are low (merely 0.3% a year), notwithstanding the low share of low educated in the labor force. We must strive for higher participation and employment rates of the low-skilled, but the productivity figures show that other factors are responsible for the slowdown and these factors should be dealt with. A report of the OECD (2019) outlines a 7-point action plan to tackle the erosion of productivity growth, proposing to 1) promote competition and ease regulatory restrictions in services, 2) improve the effectiveness of government support for R&D, 3) strengthen risk capital and reduce costs on risk-taking, 4) facilitate the job mobility of workers away from ailing firms, 5) support the creation of a new culture of lifelong learning, 6) give firms and workers more freedom to set wages and 7) make the public finances more friendly to productivity growth.

Fourth, the effective retirement age needs to be brought closer to the statutory retirement age of 65 years. In Belgium, the effective retirement age remains substantially below the statutory retirement age, in particular in the public sector. The figures in the latest EC country report on Belgium are stunning. At 61.7 years for men and 60.1 for women in 2017 the effective retirement age was substantially lower than the statutory retirement age of 65 years. Despite recent reforms tightening eligibility criteria for early retirement, which resulted in an increase in the employment rate of older workers[3], in 2017 a substantial share of pensioners was younger than 65 years. In the public sector, 53.8% of civil servants draw a pension at the age of 60 or earlier (58.8% for women). In the private sector, even if the share of people leaving the labour market with a pension before the age of 60 is lower (15.1% of employees and 9.6% of self-employed people), a significant share of employees (34.4%) and self-employed (37.7%) leaves before the age of 65.

Fifth, employment rates and the skill mismatch on the labor market need to improve. Belgian employment rates remain low, especially amongst the elderly, the low-skilled and people originating outside the EU. The differences in the average regional employment

[3] For example, the employment rate in Flanders for the 55-64-year old increased from 23.7% in 1992 to 54.9% in 2019.

rates are equally striking: in Flanders, the overall employment rate of the 20-64-year-old stood at 75.5% in 2019, compared to 64.6% in Wallonia and 61.7% in Brussels. Yet we have one of the highest vacancy rates in the euro area, due to a mismatch between the skills demanded by employers and those offered by jobseekers. There are considerable shortages in professional, technical and scientific occupations.

Sixth, the insurance character of the Belgian social security should be reinforced by removing redistributive elements, which are better dealt with through a tax reform. To give but a few examples of redistributive elements that gradually eroded the insurance character of social security in Belgium: in the 1980's the abolition of the contribution ceilings was a first serious blow. Until then, social security contributions were capped to an upper threshold of the earned wages; transitioning to uncapped contributions was a big incentive for the roll out of company car schemes. Another example lies in the narrowing gap between minimum and maximum benefits, while the entitlement height is based on categories (unemployed, age) instead of income. The blurred link between contributions paid and entitlements may have discouraging effects on labor market incentives, while increasing participation and employment rates is the key answer to cope with the budgetary effects of ageing.

### Will COVID-19 serve as a crossroads?

All these issues are well known and have been documented for many years by international organizations including the EC, OECD, IMF. Today, their significance boils boils down to the following question: will it be easier to implement these structural changes in the post-Covid era, or will we stick to the solutions of the past which didn't work well? The risk is that we will only tackle the current problems by spending more without a long-term perspective and with leaving ineffective current policy measures in place. One illustrating example is the demand to reinstate preretirement schemes to deal with the impact of the Covid 19 crisis, while these measures are known to curb labor supply and hamper economic growth. The discussion on the so-called arduous jobs offers another point in case, as the proposed system would reduce rather than differentiate individual working careers. This analysis suggests several alternative structural reforms that aim to increase fiscal prudence and future economic performance, in turn improving capacity to deal with ageing and climate costs.

As the COVID-19 crisis has also shown, several political scientists (*De Standaard Weekblad, 2020*) worry that Belgian decision making involves too many partners and stakeholders (political parties, social partners, federal and regional governments) which can veto decisions and cripple the policy cycle, turning the '*Wetstraat*' into one giant compromise-producing machine. A reform of our obsolete budgetary processes could also help to tackle these institutional constraints in the fiscal realm. First, though we have no tradition in our country to evaluate current government expenditures, Belgium should follow EC recommendations to institutionalize in-depth reflections on the quality of public finances through the implementation of spending reviews across all levels of government. Second, though budgetary coordination across the different levels of government hasn't seen the light of the day, Belgium should set up a procedure generating explicit budgetary targets for each and every government.

Bibliography:

Country Report Belgium 2020, European Commission
De Standaard Weekblad (26 september 2020), *"Ziek van politiek"*, Filip Rogiers)

Xavier Debrun Mariusz Jarmuzek Anna Shabunina, *Public debt: Safe at any speed?,* Economisch Tijdschrift van september 2020,NBB
OECD (2019), *In-Depth Productivity Review of Belgium*, OECD Publishing, Paris, *https://doi.org/10.1787/88aefcd5-en*.

Studiecommissie voor de Vergrijzing, jaarlijks verslag, juli 2020, https://www.plan.be/publications/publication-2018-nl-studiecommissie_voor_de_vergrijzing_jaarlijks_verslag