4. Public finances

4.1 Belgian public finances improve, but major challenges remain

Significant reduction in government deficit in 2017

Belgium ended 2017 with a general government deficit of 1 % of GDP – an improvement of 1.5 percentage points on 2016, when the defict stabilised. The reduction was due in part to a structural improvement in public finances, reinforced by the continuing upturn in the economy and strong jobs growth, the low interest rate environment and a number of one-off factors. After several years of virtually no improvement, these factors enabled solid progress to be made in 2017 on the road to achieving sound public finances. However, more still needs to be done: a structural balance has not yet been achieved and general government debt remains very high – though it did fall substantially in 2017, for the first time in years, down 2.9 percentage points to 102.8 % of GDP.

The improvement in the budget balance can be attributed to higher revenue and a reduction in both primary expenditure and interest payments as a proportion of GDP. The rise in the revenue ratio was mainly due to higher income from taxes on company profits, caused largely by the sharp increase in advance payments. Other revenues remained virtually flat, as levies on employment were not reduced further in 2017 in the context of the tax shift. Primary expenditure grew moderately, and more slowly than economic activity. The combination of higher revenue and reduced expenditure as a percentage of GDP boosted the primary surplus to 1.5 % of GDP, its highest level since 2008. At the same time, interest payments continued their downward trend, falling by 0.3 percentage point to 2.5 % of GDP.

Federal government still accounts for most of the deficit

The general government deficit is attributable almost entirely to the federal government, which saw its deficit

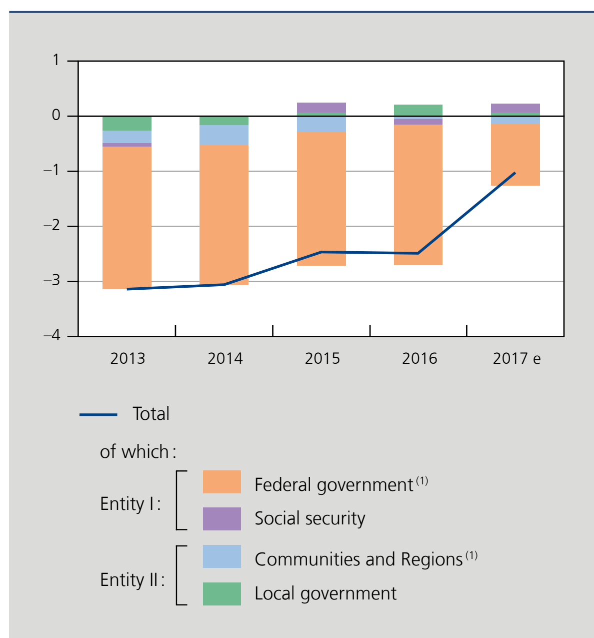
TABLE 11 GENERAL GOVERNMENT OVERALL BALANCE AND DEBT
(in % of GDP)

	2013	2014	2015	2016	2017 e
Revenue	52.7	52.1	51.3	50.7	51.2
Primary expenditure	52.5	51.9	50.8	50.3	49.7
Primary balance	0.2	0.2	0.6	0.4	1.5
Interest charges	3.3	3.3	3.0	2.9	2.5
Overall balance	–3.1	–3.1	–2.5	–2.5	–1.0
General government debt	105.5	106.8	106.0	105.7	102.8

Sources: NAI, NBB.

CHART 55 FEDERAL GOVERNMENT STILL IN DEFICIT, WHILE OTHER SECTORS OF GENERAL GOVERNMENT ARE VIRTUALLY IN BALANCE

(overall balances as % of GDP)

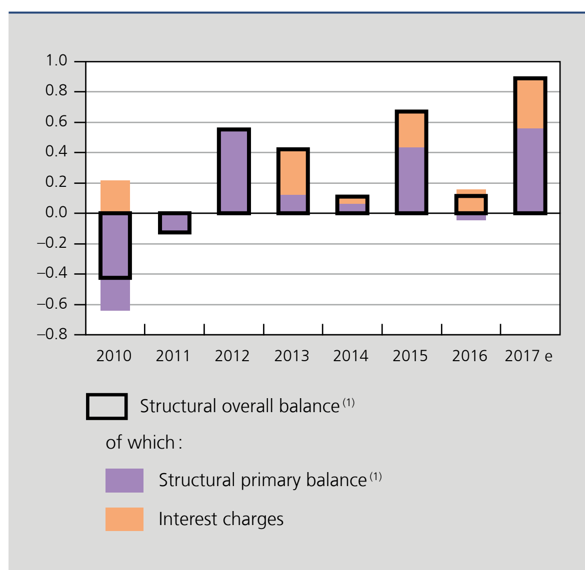


Sources : NAI, NBB.

(1) With effect from 2015, these figures include advance payments on the regional additional percentages on personal income tax although, according to the ESA 2010 methodology, these advance payments are regarded as purely financial transactions and are only taken into account at the time of collection. This approach is in line with the guidelines for developing fiscal targets in the recommendations from the Public Sector Borrowing Requirement section of Belgium's High Council of Finance, as well as in stability programmes.

CHART 56 IMPROVEMENT IN BOTH STRUCTURAL PRIMARY BALANCE AND STRUCTURAL OVERALL BALANCE IN 2017

(changes compared to the previous year, in percentage points of GDP)



Sources : EC, NAI, NBB.

(1) The cyclical component of the structural primary balance and the structural overall balance is determined based on EC methodology and figures.

fall from 2.5 % of GDP to 1.1 % in 2017. The social security accounts showed a surplus of 0.2 % of GDP, while the Communities and Regions closed the year on a slight negative result amounting to 0.1 % of GDP ; more specifically, the French Community and Walloon Region both recorded modest deficits. Finally, local government maintained a small surplus of 0.1 % of GDP, a slight reduction compared with 2016.

Improvement of 0.9 percentage point in structural overall balance

The nominal balance was helped in 2017 by both the performance of the economy and non-recurrent factors, which contributed 0.2 and 0.3 of a percentage point, respectively. The structural balance, obtained by stripping out cyclical and temporary factors, consequently improved by 0.9 percentage point in 2017. The structural primary balance, which is a better reflection of discretionary fiscal policy because it is immune to the influence of movements in interest rates, improved by 0.6 percentage points of GDP.

All in all, Belgium's public finances showed a marked improvement in 2017. Despite this, the structural budget deficit still stands at 1.2 % of GDP, and, on the assumption of no policy change, is unlikely to improve in the 2018-20 period.

The European fiscal framework must be the guideline to achieve a structurally balanced budget

The fiscal policies of the euro area countries must be aligned with the European governance framework for public finances, which is intended to promote fiscal discipline and avoid unwanted fiscal outcomes. Belgium is currently in the preventive arm of the Stability and Growth Pact, which sets achieving the medium-term objective (MTO) as a key requirement. This objective is set for the different countries based on the level of government debt, the estimated potential growth and the costs of population ageing. For Belgium, the MTO set in the stability programme in April 2017 was a structurally balanced budget. This would enable Belgium to reduce its government debt to 60 % of GDP sufficiently quickly, another key objective of the European fiscal framework. These actions are necessary in order to build buffers for the future and create the necessary policy headroom

TABLE 12 TARGETS FOR THE BELGIAN GENERAL GOVERNMENT OVERALL BALANCE

(stability programme targets; unless otherwise stated; in % of GDP)

	2014	2015	2016	2017	2018	2019	2020
Nominal balance							
April 2014	**−2.1**	−1.4	−0.4	0.6			
April 2015		**−2.5**	−2.0	−1.0	−0.2		
April 2016			**−2.5**	−1.4	−0.4	−0.2	
April 2017				**−1.6**	−0.7	−0.2	−0.1
October 2017 (draft budget)				−1.5	**−1.1**	−1.4 [1]	−1.3 [1]
p.m. Actual/Budget	*−3.1*	*−2.5*	*−2.5*	*−1.0 e*			
Structural balance [2]							
April 2014	**−1.4**	−0.7	0.0	0.75			
April 2015		**−2.0**	−1.3	−0.6	0.0		
April 2016			**−1.7**	−0.8	0.0	0.0	
April 2017				**−1.0**	−0.4	0.0	0.0
October 2017 (draft budget)				−1.1	**−0.8**	−1.2 [1]	−1.3 [1]
p.m. Actual/Budget	*−2.9*	*−2.2*	*−2.1*	*−1.2 e*			

Sources: EC, FPS Policy and Support, FPS Finance, NAI, NBB.
(1) Estimates if policy remains unchanged.
(2) The cyclical component of the structural balance was determined for the line Actual/Budget based on the EC methodology and figures, while Federal Planning Bureau estimates were used for the stability programmes and other budgetary documents.

to meet the costs of an ageing society. Those costs are considerable, despite the mitigating effect of measures being taken in the context of pension reforms. Further structural consolidation efforts must be in line with the European framework.

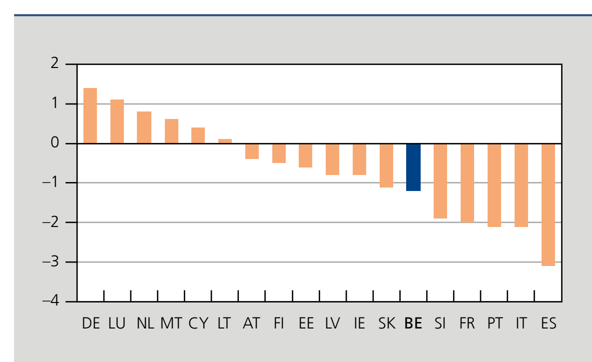
The April 2017 stability programme, which sets out the fiscal plans for 2017 and the subsequent three years, is based on recommendations published by the Public Sector Borrowing Requirement section of Belgium's High Council of Finance in March 2017. It comprises an amended budget trajectory in which the achievement of a structurally balanced budget is deferred from 2018 to 2019. The target for 2017 was a reduction in the structural budget deficit of one percentage point of GDP.

The draft budget published in October 2017 amended the budget path again. The target of a better structural budget balance for 2018 was retained, but with a reduction in the envisaged improvement. No targets were set for 2019 and 2020, but, on the assumption of no policy change, the structural budget deficit of the general government would turn out at 1.3 % of GDP in 2020. Based on the economic projections published by the Bank in December 2017, the structural deficit will increase slightly from 2018.

Based on the October 2017 draft budget and its own autumn forecasts, the EC concluded that there was a risk that Belgium would deviate significantly from the adjustment path to the MTO in 2017 and 2018 as set out by

CHART 57 FURTHER CONSOLIDATION NEEDED IF BELGIUM IS TO ACHIEVE ITS MEDIUM-TERM OBJECTIVE (MTO) [1]

(difference between structural overall balance for 2017 and MTO, in percentage points of GDP)



Sources: EC, NBB.
(1) The chart shows data for countries in the euro area excluding Greece, for which no new MTO has yet been defined because Greece is subject to an adjustment programme.

the preventive arm of the Stability and Growth Pact. As for the corrective arm of the Pact, Belgium must meet the debt criterion stipulating that its public debt should diminish at a satisfactory pace towards the reference value of 60 % of GDP, based on an average annual reduction in the debt ratio of one-twentieth of the difference compared with the reference value. According to the EC's analysis, Belgium was not expected to meet this debt criterion in either 2017 or 2018.

No cooperation agreement on fiscal targets again in 2017, but internal fiscal coordination remains crucial

European obligations relate to the budget position of the general government, which is the sum of the results of the federal government and the social security sector (Entity I) on the one hand and the Communities and Regions and local government (Entity II) on the other. Efforts must therefore be shared across all these government sub-sectors.

The cooperation agreement signed on 13 December 2013 between the federal government, the Communities, the Regions and the Community Commissions provides a formal framework for fiscal coordination within Belgium. The agreement stipulates that the Consultative Committee, a consultation and coordination platform for the different levels of government, must agree on annual fiscal targets in the stability programme and their allocation across government sub-sectors based on a recommendation by the Public Sector Borrowing Requirement section of the High Council of Finance.

Since signing the cooperation agreement, the Consultative Committee has been unable to agree on the allocation of the budgetary path as set out for the general government in the stability programme. In 2017, as in 2015 and 2016, the Communities and Regions merely took note of the budgetary path for the general government and its allocation between Entity I and Entity II. The April 2017 stability programme stated that both the general government and the two entities would achieve a structural balance in 2019; however, it did not contain any targets for the individual Communities and Regions.

Yet, continued failure to agree on effective fiscal coordination between the different levels of government will have major consequences. In the absence of approved targets for each level of government, the High Council of Finance's Public Sector Borrowing Requirement section cannot determine whether there is any significant deviation, and the operation of the automatic correction mechanism can therefore not be guaranteed. The PSBR section has accordingly called on the different governments to approve targets. The EC and Ecofin Council have also repeatedly expressed their concerns about the lack of internal fiscal coordination and have urged Belgium to reach a binding agreement on the allocation of the budget path between the different levels of government and to ensure an independent monitoring system to track the budgetary outcomes.

4.2 Developments in Belgian public finances in 2017

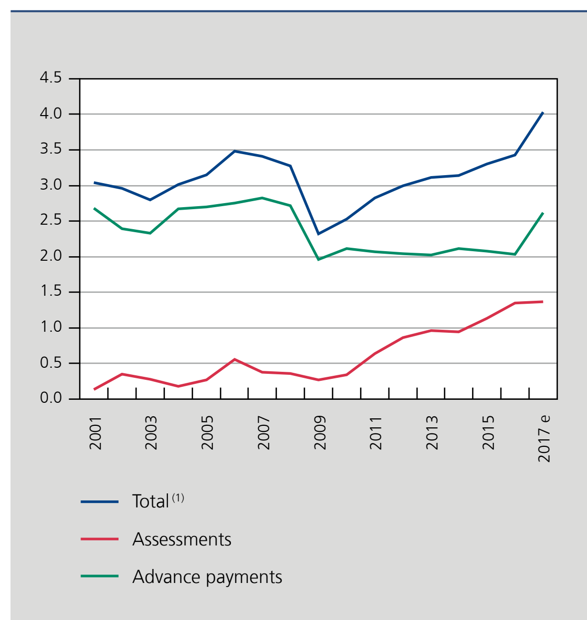
Increased revenue and corporation tax reform

Government revenues rose by 0.5 percentage point of GDP in 2017, halting the downward trend that has characterised recent years.

The revenue ratio rose mainly thanks to higher taxes on company profits. Revenue from corporation tax had also risen in previous years, against the backdrop of a positively trending economy and growth in corporate earnings, but the increase in 2017 was significantly greater, at 0.6 percentage point of GDP. Advance payments by

CHART 58 SHARP RISE IN REVENUE FROM CORPORATION TAX

(in % of GDP)



Sources: NAI, NBB.
(1) Including other taxes, of which withholding tax is the most important.

TABLE 13 GENERAL GOVERNMENT REVENUE [1]

(in % of GDP)

	2013	2014	2015	2016	2017 e
Fiscal and parafiscal revenue	45.2	45.0	44.6	43.8	44.2
Levies weighing chiefly on earned income	26.4	26.3	26.1	25.0	24.8
Personal income tax [2]	11.8	11.7	11.5	11.1	11.0
Social contributions [3]	14.7	14.6	14.6	14.0	13.9
Taxes on company profits [4]	3.1	3.1	3.3	3.4	4.0
Levies on other incomes and on assets [5]	4.4	4.5	4.3	4.2	4.2
Taxes on goods and services	11.2	11.1	11.0	11.2	11.2
of which:					
VAT	6.9	6.9	6.7	6.8	6.8
Excise duties	2.1	2.1	2.1	2.2	2.3
Non-fiscal and non-parafiscal revenue [6]	7.5	7.1	6.7	6.9	7.0
Total revenue	52.7	52.1	51.3	50.7	51.2

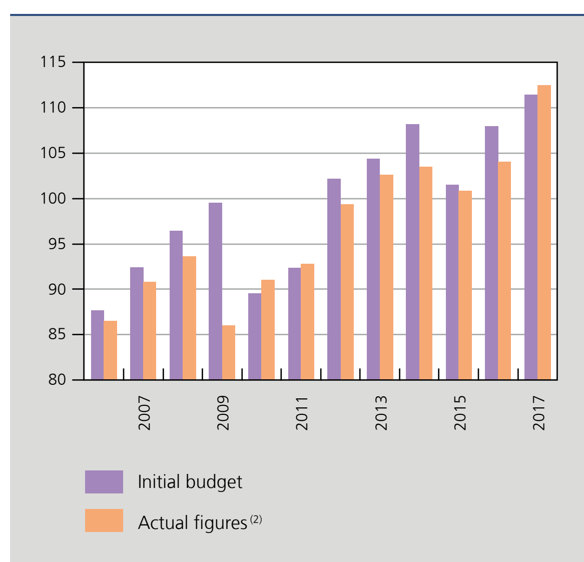
Sources: NAI, NBB.
(1) In line with ESA 2010, total revenue of general government does not include the proceeds of customs duties transferred to the EU or the revenues levied directly by the EU.
(2) Mainly payroll tax, advance payments, assessments and additional percentages on personal income tax.
(3) Including the special social contribution and the contributions of people not in work.
(4) Mainly advance payments, assessments and withholding tax.
(5) Mainly withholding tax on income of individuals, withholding tax on income from immovable property (including the proceeds of additional percentages), inheritance taxes and registration fees.
(6) Income from assets, imputed social contributions, current transfers and capital transfers from other sectors, plus sales of goods and services produced, including revenues on guarantees granted by the State on interbank loans.

companies rose particularly strongly and appear to be back at their level prior to the economic and financial crisis. This sharp rise in advance payments in 2017, which generates a temporary surplus because it will reduce the collection via assessments in the ensuing years, can be explained in part by the increase in the tax surcharge due in the event of insufficient advance payments: the base rate for the tax surcharge was doubled for advance payments in 2017 (assessment year 2018) to 2.25 %. The corporation tax reform, the main elements of which are explained in box 7, provide for a further increase to 6.75 % from 2018 (assessment year 2019). This is likely to lead to an increase in the share of advance payments in 2018. The reduction in the rate for notional interest deductions to 0.237 % for 2017 (assessment year 2018) also contributed to the extra revenue from corporation tax.

Levies on earned income declined by 0.2 percentage point of GDP, principally because of a reduction in social security contributions. This reflected the full impact in 2017 of the lowering of the rate of employer contributions with effect from 1 April 2016. Revenue from personal income tax more or less stabilised after having fallen sharply in previous years due to the tax shift.

CHART 59 ESTIMATED VERSUS ACTUAL FISCAL REVENUE [1]

(in € billion)



Source: Federal government budget documents.
(1) Fiscal revenue collected by the federal government on a cash basis. Where a shift takes place in collection between the initial budget and actual revenue, a correction is applied to ensure comparability.
(2) The actual revenues in 2017 relate to expected fiscal cash receipts for 2017 from the initial budget for 2018.

TABLE 14 MAIN FISCAL AND PARAFISCAL MEASURES [1]

(in € million, differences compared to the previous year)

	2015	2016	2017 e
Total fiscal measures	–781	380	611
Structural measures	–70	400	1 066
Federal government and social security	–153	42	1 147
Personal income tax	–540	–1 562	221
Corporation tax [2]	82	127	117
Levies on other incomes and on assets	50	511	447
Taxes on goods and services	255	966	362
Communities and Regions and local authorities	82	358	–81
Non-recurrent measures	–711	–20	–455
of which:			
Tax regularisation	–837	–276	15
Liquidation levy	–665	298	–298
Tax agreements and court decisions	174	–174	150
Advance tax payments on private pension savings	198	–21	–18
Excess profit rulings	0	391	–267
Energy levy for unutilised sites	0	120	–120
Measures on social security contributions	–51	–1 668	–788
Total	–832	–1 288	–177
p.m. In % of GDP	*–0.2*	*–0.3*	*0.0*

Sources: Budget documents, NBB.

(1) This generally concerns the presumed influence of the measures according to the budget documents. The final impact may be different.

(2) Excluding the impact of the change in the reference rate of notional interest deductions and changes to the base rate for the tax surcharge in the event of insufficient advance payments.

There were no further reductions in levies on employment, though additional cuts are planned for the coming years in both personal income tax and social security contributions.

Revenue from levies on other income and on assets stayed more or less flat. The impact of the increase in the standard rate of withholding tax from 27 % to 30 % from 1 January 2017 was offset by a reduction in revenue due to low interest rates on fixed-income financial assets. In addition, the federal government has decided to introduce a subscription tax on custody accounts.

Taxes on goods and services were also virtually unchanged, due to stabilising VAT revenues and a slight increase in revenue from excise duties after tobacco and alcohol duties were raised.

In contrast to previous years, the targets set in the initial budget were achieved in 2017, mainly due to the above-mentioned increase in corporation tax revenue.

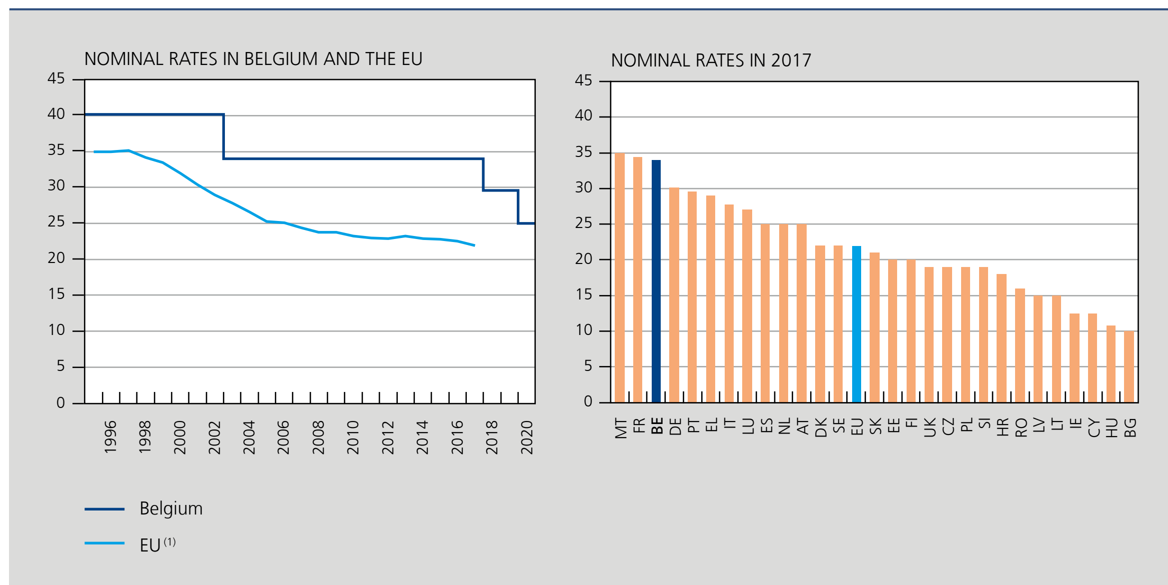
Finally, non-fiscal and parafiscal revenues rose by 0.1 percentage point of GDP, principally due to the full impact of the kilometre-based charge for heavy goods vehicles introduced by the Regions on 1 April 2016.

Box 7 – Reform of corporation tax in Belgium

Until 2017, the standard corporation tax rate in Belgium was 33 %. This was increased by a supplementary crisis contribution of 3 %, taking the nominal tax rate to 33.99 %. Reduced rates applied for company profits not exceeding € 322 500.

These rates meant that Belgium had the third highest nominal tax rate in the European Union, after Malta and France. The nominal rate in Ireland, Cyprus, Hungary and Bulgaria was actually below 15 %, and the unweighted average rate for the EU as a whole was 21.9 %. The trend towards lower rates, which began before the economic and financial crisis but virtually ground to a halt thereafter, appears to have been resumed in the recent period, with some EU Member States having already lowered their rates or planning to do so.

NOMINAL STANDARD CORPORATION TAX RATES
(in %)

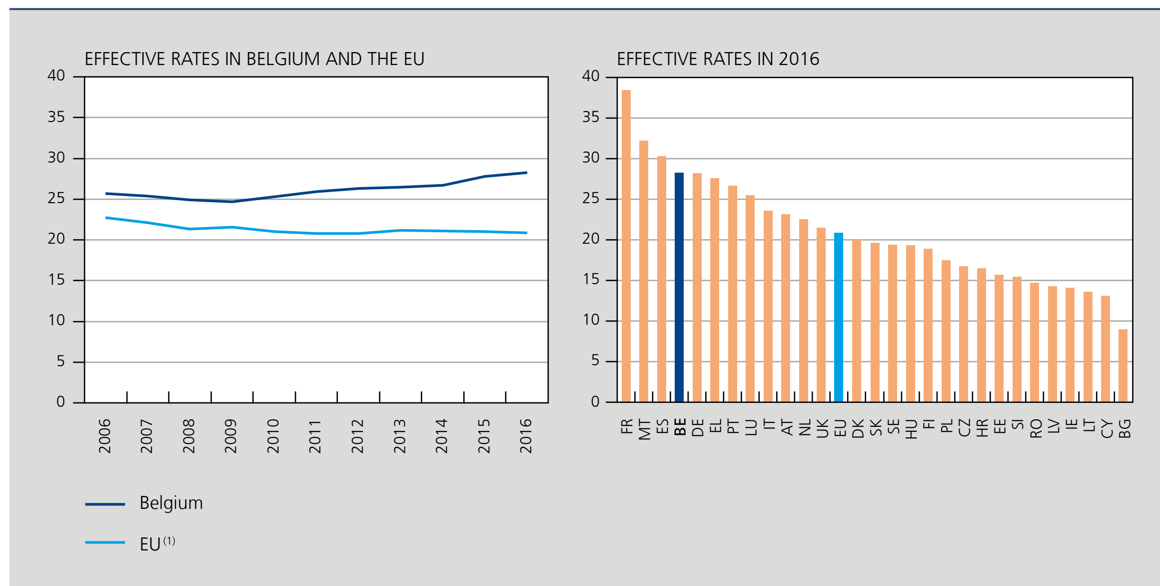


Source: EC.
(1) Unweighted average.

An overview of the highest nominal rates in different countries provides only a partial picture of the actual tax burden weighing on companies, however, because the actual burden is also dependent on tax deductions or preferential systems. Tax rates calculated on the basis of actual tax paid provide a better impression of the real tax burden.

The actual burden of taxation on companies is below the nominal rate in virtually all EU Member States. In Belgium, for example, the difference between the nominal rate and the average actual rate of 28.3 % was around six percentage points. This illustrates the policy of the Belgian government, with a relatively high nominal rate being linked to a relatively limited tax base.

AVERAGE EFFECTIVE CORPORATE INCOME TAX RATES
(in % of the tax base before tax allowances)



Source : ZEW.
(1) Unweighted average.

The appropriateness of such a fiscal niche strategy based on preferential systems combined with relatively high nominal rates has been questioned by the Taxation and Social Security Contributions section of the High Council of Finance in the light of international developments. Initiatives have for example been taken at the instigation of the OECD, with support from the G20, to prevent undermining the tax base and counter the relocation of profits purely for fiscal reasons. These initiatives lay at the basis of the Anti-Tax Avoidance (ATAD) Directive [1], which is intended to ensure the coordinated implementation of actions across the EU. Also, the measures aimed at full transparency of tax regimes, not least regarding prior tax rulings or pricing arrangements, should prevent profits being transferred to countries where they will be subject to little or no tax. Rules have also been implemented which must be met by a preferential tax system for income from patent rights (patent boxes). This led to the Belgian system, which was very favourable for businesses from an international perspective, being replaced on 1 July 2016 by an innovation income deduction. The EC also concluded that the earlier excess profit rulings, which enabled multinationals to enjoy sometimes substantial tax advantages, were against EU rules on state aid. These initiatives, aimed at combating tax avoidance, warrant full support given the unfairness and macroeconomic inefficiency of tax evasion.

To limit distortions from the corporation tax, Belgium therefore decided to lower existing nominal corporation tax rates. The proposed reform was adopted by the Belgian Parliament on 22 December 2017, and henceforth a strategy will be employed which is based on a reduction of the nominal rates and a broadening of the tax base.

Specifically, the corporation tax reform reduces the general nominal rate to 29 % in 2018 (2019 assessment year) and finally to 25 % in 2020 (2021 assessment year). The supplementary crisis contribution will also be cut to 2 % in 2018 and abolished in 2020. The rate for SMEs will fall from 2018 (2019 assessment year) to 20 % for taxable profits smaller than € 100 000.

(1) Council Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

A system for offsetting losses for companies affiliated in a group is also being introduced, and the participation exemption has been raised from 95 % to 100 %. The investment allowance for SMEs has been temporarily raised to 20 % and the exemption for remittance of withholding tax has been extended to researchers with Bachelor's degrees.

A number of compensatory measures have been introduced in the light of the rate reduction and other stimulus measures to broaden the tax base, with a view to ensuring that the reform of corporation tax is budget-neutral. In principle, therefore, the average tax burden should remain unchanged.

The main compensatory measures are in the reform of the system of notional interest deduction. Up to 2017, notional interest deduction was related to the total outstanding amount of own equity. The reform considerably restricts this system by only taking account of the increase in equity, i.e. incremental capital. However, the reform will also reduce the economic benefits of the system.

A number of deductions are also being merged in a basket, in particular the carried-forward participation exemption, carried-forward innovation income, previous losses, carried-forward notional interest deduction and the new system of incremental notional interest deduction. Available tax deductions for this basket are limited to 70 % of the tax base before application of the basket, with the first € 1 million being fully deductible. This means that 30 % of the tax base exceeding € 1 million represents the minimum corporation tax base.

Another key aspect of the reform is the transposition of the EU Directives on combating tax evasion, and in particular the Anti-Tax Avoidance Directive. As these Directives aim to prevent the tax base from being undermined due to extreme tax planning, they can help fund the proposed reform. The transposition of these Directives will limit the tax-deductibility of borrowed capital, entail taxation of the controlling domestic company in respect of certain income received by foreign companies, and include measures to combat "hybrid mismatches", where entities or financial instruments are classified in different ways in two countries' tax regimes, which means they are sometimes not taxed at all.

A more complete picture of the corporation tax reform can be found in the study published by the Bank on 6 December 2017 on the macroeconomic and budgetary aspects of the reform (1).

(1) See https://www.nbb.be/doc/ts/publications/other/ds1711552fr.pdf.

Primary expenditure continues to develop at a moderate pace

In nominal terms, primary expenditure rose less quickly than the rate of economic activity, thus continuing its downward trend as a share of GDP in 2017, taking it below 50 % for the first time since 2010.

The moderation of primary expenditure was helped by a number of non-structural factors which supported efforts to consolidate public finances. These included the easing or disappearance of a series of unexpected factors which had weighed on the overall balance in 2016, for example substantial tax rebates in response to court rulings, as well as exceptional efforts made to accommodate the inflow of asylum-seekers. There was also a temporary reduction in 2017 in Belgium's contribution to the EU budget, which is based on gross national income. These factors moderated the growth in expenditure by 0.3 percentage point. The strength of the economy also pushed down primary expenditure thanks to a reduction in unemployment benefits.

Adjusted for the influence of temporary factors, the cyclical effect and the time lag between inflation and indexation, real primary expenditure in 2017 is estimated to have risen by 0.8 %. Although expenditure rose more steeply than in the three preceding years, when it was virtually flat, the increase was nonetheless limited and lower than GDP growth by volume.

Social benefits fell to 25 % of GDP, 0.2 percentage point below 2016. The reason was the reduction in

TABLE 15 GENERAL GOVERNMENT PRIMARY EXPENDITURE

(deflated by the GDP deflator, percentage changes compared to the previous year, unless otherwise stated)

	2013	2014	2015	2016	2017 e	Average 2000-2016
Level recorded [1]	52.5	51.9	50.8	50.3	49.7	47.6
1. Real recorded growth	0.7	0.2	−0.9	0.6	0.4	2.5
2. Influence of non-recurrent or fiscally neutral factors [2]	−0.8	0.1	0.0	0.2	−0.3	0.0
3. Influence of cyclical factors [2]	0.2	0.0	−0.1	−0.1	−0.1	−0.2
4. Indexation effect [2], [3]	0.7	−0.4	−0.1	0.4	0.0	0.1
5. Adjusted real growth (1 − 2 − 3 − 4)	0.7	0.6	−0.6	0.1	0.8	2.6

Sources: DGS, NAI, NBB.

(1) In % of GDP.

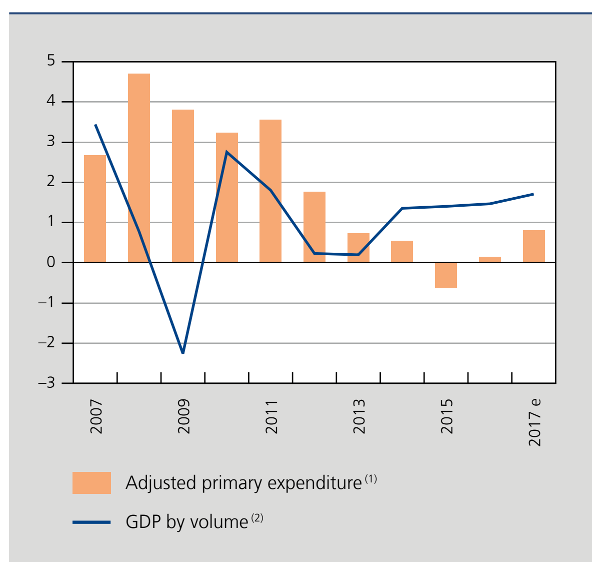
(2) Contribution to real recorded growth of primary expenditure.

(3) Effect caused by the difference between the actual indexation (or the theoretical indexation for 2015 and 2016 in view of the index jump) of public sector wages and social security benefits and the rise in the GDP deflator. The other effects due to differences between inflation measured by the GDP deflator and the movement in price factors influencing other expenditure categories – whether these are attributable to the indexation mechanisms or to divergent patterns in the prices of certain expenditure categories – are not adjusted, owing to the absence of sufficient information.

unemployment benefits, which fell for the fourth year running due to the combined effect of the healthy economy and the restrictions on benefit entitlements introduced in recent years which are gradually having an impact. This latter factor is partially offset by a shift to other expenditure categories, as some people who were excluded from unemployment benefit moved onto subsistence benefit.

CHART 60 EXPENDITURE INCREASES MORE SLOWLY THAN ECONOMIC GROWTH

(percentage changes compared with previous year)



Sources: NAI, NBB.

(1) Primary expenditure deflated by the GDP deflator and adjusted for cyclical and non-recurrent or budget-neutral factors, and for the indexation effect. The latter is caused by the difference between the actual indexation (or the theoretical indexation for 2015 and 2016 in view of the agreed index jump) of public sector wages and social security benefits and the rise in the GDP deflator.

(2) Calendar adjusted data.

Sickness and disability benefits, which had been rising steeply for years, increased less quickly in 2017, though still faster than GDP. The measures taken to mitigate the increase in these benefits appear to be bearing fruit, even though benefits from the National Institute for Health and Disability (INAMI/RIZIV) are not falling. Expenditure on health care and pensions more or less kept pace with economic growth. The spontaneous increase in the budgets for these two categories due to population ageing has been moderated by a series of measures taken to mitigate this effect. In health care, a raft of measures have been taken, in some cases supported by the pharmaceuticals industry. On the pensions front, stricter conditions governing early retirement were introduced in 2017; and there was an increasing budgetary impact of the abolition of the pension bonus in 2015, and of the phasing out of the "diploma bonus" system used in calculating the career length of civil servants as from 2016.

The controls on government expenditure also touched on the other current spending categories, such as civil service salaries, which grew more slowly than the rate of economic activity and accounted for 12.3 % of GDP. This was largely the result of the virtual freeze on civil service employment.

CHART 61 SPENDING ON UNEMPLOYMENT, SICKNESS/DISABILITY, HEALTH CARE AND PENSIONS

(data deflated by the GDP deflator; percentage changes compared with the previous year, unless otherwise stated)

Sources: Federal government budget documents, NAI, NBB.

(1) Expenditure adjusted for the indexation effect caused by the difference between the actual indexation (or the theoretical indexation for 2015 and 2016 in view of the agreed index jump) of public sector wages and social benefits and the rise in the GDP deflator.

Purchases of goods and services remained unchanged compared with 2016, at 4 % of GDP. The impact of the structural reduction in operating budgets at federal level was cancelled out by an increase in expenditure at other government levels.

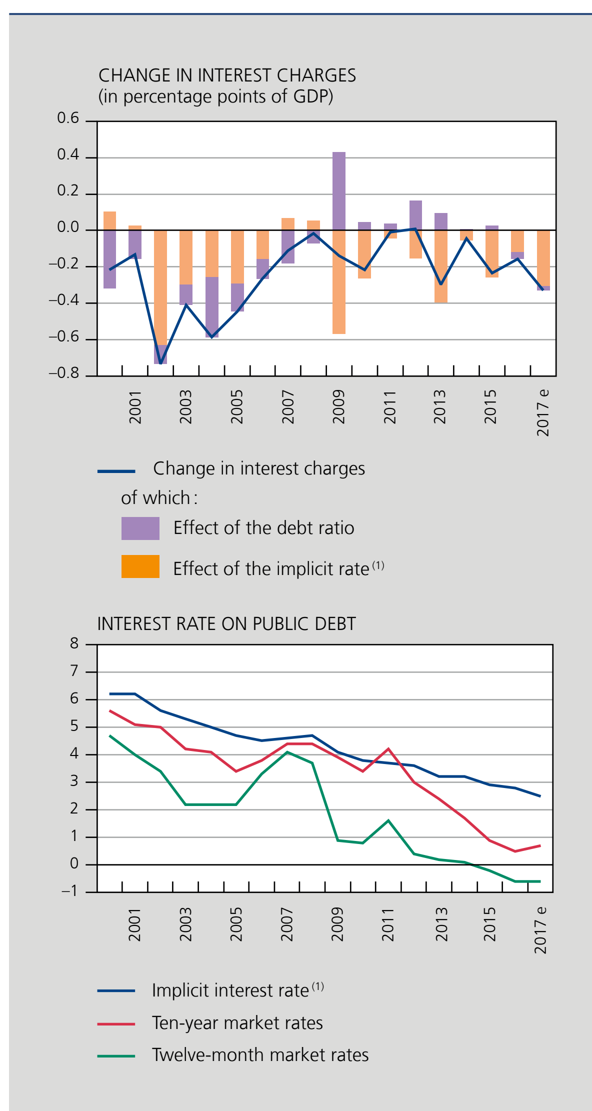
Public investment was also stable compared with 2016, at 2.2 % of GDP. However, this investment cannot be assessed on an annual basis as it normally spans a cycle of six years, corresponding to the municipalities' electoral cycle, since local government accounts for roughly a third of public investment. The share of public investment generally rises in the run-up to municipal and provincial council elections, and contracts again afterwards. Comparing the trend in public investment in the present electoral cycle with past trends reveals that public investment growth has been below its usual rate for some years. While in the short term this is helpful to the aim of consolidating public finances, it is counter-productive in the longer term because of the positive effect this expenditure has on potential growth.

Further reduction in interest charges

Interest charges fell further in 2017, by 0.3 percentage point of GDP. As in 2016, this reduction was due almost entirely to the fall in the implicit interest rate. This rate, which is the computed interest charge as a proportion of outstanding public sector debt at the end of the previous year, will continue to trend downwards as long as the market interest rate on new issues remains lower than yields on mature securities and government loans.

CHART 62 INTEREST CHARGES STILL BENEFITING FROM REDUCTION IN IMPLICIT INTEREST RATE

(in %, unless otherwise stated)



Sources : FPS Finance, NAI, NBB.
(1) Interest charges in the current year as a proportion of the outstanding debt at the end of the preceding year.

In the short term, the government was able to generate some funds through the issuance of Treasury bills with maturities of less than one year, because interest rates remained negative throughout the year. Yields on ten-year reference bonds fluctuated between 0.5 % and 1 % throughout 2017.

Government debt down, but still high

The debt ratio fell by almost three percentage points in 2017, to 102.8 % of GDP. This was the first substantial fall in the debt ratio in ten years and marks a clear reversal in the upward trend since the onset of the financial crisis, which pushed up the ratio by almost 20 percentage points. Belgium is thus following the trend in the euro area, albeit at a slightly slower pace. As a result, Belgium's debt remains much higher than in most other countries.

The reduction in the debt ratio in 2017 was due to endogenous factors. The fact that nominal GDP growth was substantially higher than the implicit interest rate on government debt reduced the debt ratio. Over the last ten years, the implicit interest rate has by contrast generally been higher than nominal growth, creating upward interest rate-growth dynamics which explained just over half the increase in the debt ratio over that period.

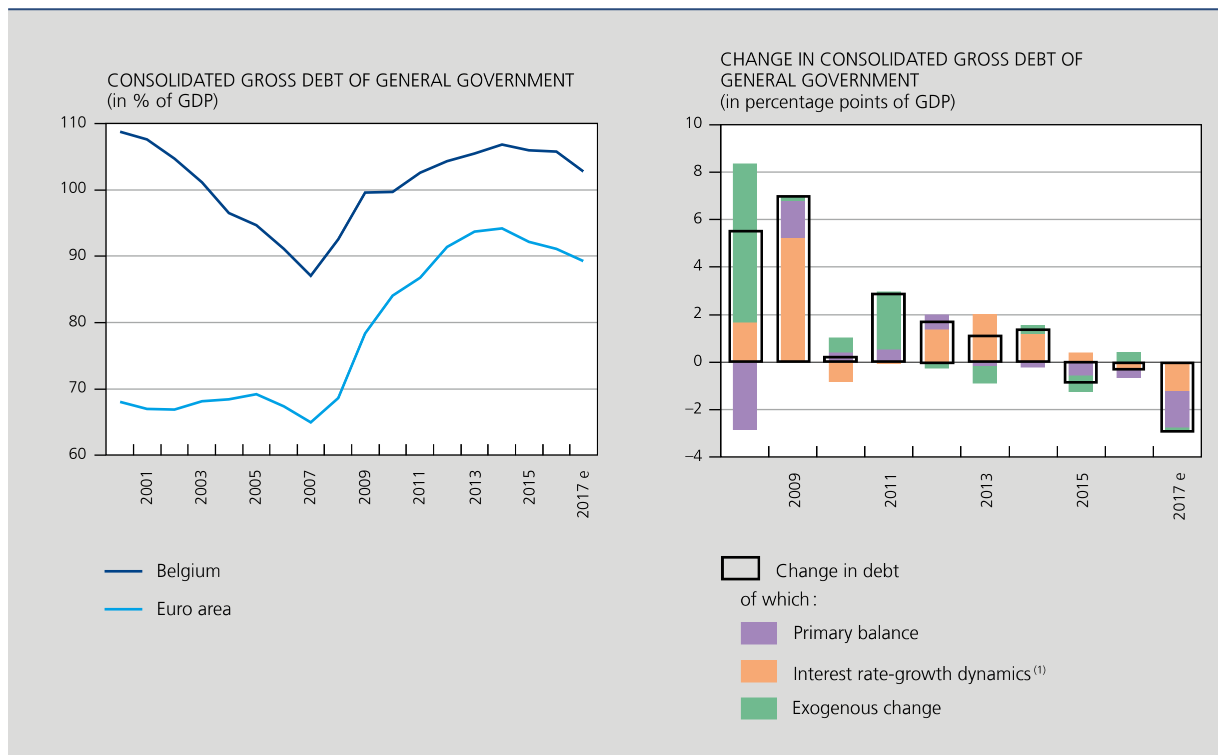
Reducing the debt ratio more structurally will require a sustained primary budget surplus. As stated, in 2017, this surplus rose to 1.5 % of GDP.

Exogenous factors, which affect debt but not the overall balance, also lowered the debt ratio slightly. The proceeds from the partial sale of the federal government's investment in BNP Paribas and the positive impact on cash revenues from the tax receipts in 2017 (based on assessments in 2016) were partially offset by an increase in loans provided by the Regions in the context of social housing policy, pension commitments of pension funds acquired from the private sector in the past, and a number of factors relating to debt management. The interest payments on a cash basis were higher than those on a transaction basis, whereas the latter serve as the reference for interest charges in the government accounts. The reason for this is that the nominal coupon on bonds issued in recent years has exceeded the market interest rate, creating a downward effect on the debt in the year of issue equivalent to the issue premiums, because the issue value of the securities exceeds their nominal value. This effect gradually disappears as the higher coupon is paid out, however. The downward effect of issue premiums has exceeded the upward effect of the difference in interest payments over the last five years, but in 2017 the reverse was the case.

Management of the federal government debt, by far the most important component of Belgium's total public debt, led to a further increase in the average maturity of the debt, from six years in 2009 to nine years and three months in 2017. The gross balance to be financed fell significantly in 2017 due to the reduction of the budget deficit in cash terms, helped by the partial sale of the stake in BNP Paribas. The smaller borrowing requirement

CHART 63 REDUCTION IN DEBT RATIO IN 2017

(in % of GDP)



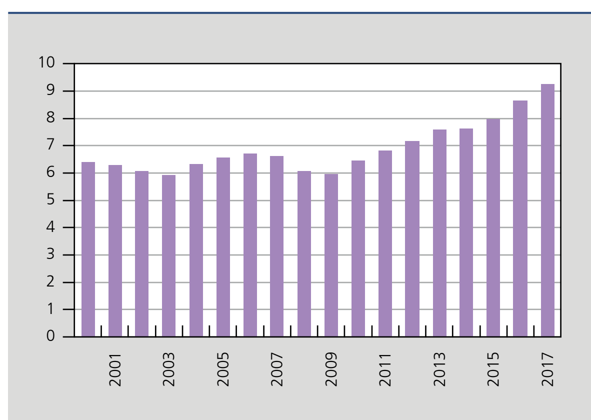
Sources: EC, NAI, NBB.

(1) The difference between the implicit interest on debt and nominal GDP growth, multiplied by the ratio of the debt at the end of the preceding year to the GDP over the period under review.

was accommodated principally by a reduction in the issue of – short-term – Treasury bills and, to a lesser extent, of long-term debt.

CHART 64 FURTHER INCREASE IN AVERAGE MATURITY OF FEDERAL GOVERNMENT DEBT

(average maturity of federal government debt, in years)



Source: FPS Finance.

4.3 Need for further reduction in budget deficit and government debt

Ensuring the sustainability of the public finances is crucial

Sound public finances are essential for securing the trust of economic agents, and help secure sustainable growth which promotes employment.

Although Belgium's public finances improved in 2017, further consolidation is needed. This will require determined action to reduce the budget deficit to a sustainable structural balance, enabling a reduction in government debt, which is still well above the threshold of 60 % of GDP set in the Maastricht Treaty. This is essential first and foremost to create the policy scope needed to accommodate the costs of an ageing society; although those costs are mitigated by the measures taken to reform pensions, they are still considerable.

The opportunities offered by the current positive economic climate need to be grasped in order to build buffers

to allow the economy to be supported during periods of cyclical downturn. The economic and financial crisis has shown that an active fiscal policy can be helpful, especially during periods of severe recession or when the opportunities for further easing of monetary policy are limited. The creation of these buffers could also enable other social challenges to be addressed, including investment in infrastructure, education and environmental protection, as well as sustaining prosperity and social protection.

Population ageing will continue over the coming decades at a substantial cost

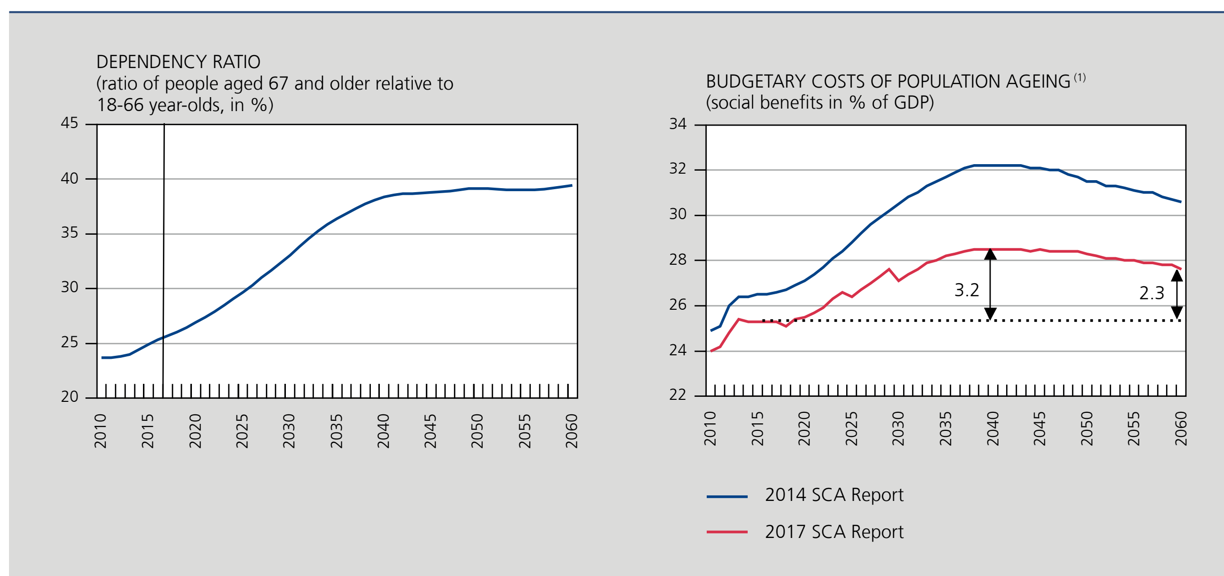
The populations of most advanced nations are ageing rapidly, and Belgium is no exception to this trend, which is set to continue in the coming decades. The dependency ratio of older people, defined here as the number of people aged 67 years and older relative to the population aged between 18 and 66 years, rose in Belgium from 21.1 % in 1995 to 25.7 % in 2017, and demographic forecasts suggest a further increase to almost 40 % by 2060. Whereas in 1995 there were around five potential workers for every retiree, that number will more than halve by 2060. Moreover, forecasts suggest that the number of people of working age will decline in the 2021-36 period.

These trends have an enormous impact on society, including on public finances. All things being equal, the slowdown in growth (and even temporary contraction) of the working-age population will act as a brake on employment and economic growth, in the latter case driven mainly by an increase in productivity. At the same time, the sharp rise in the older population will lead to higher public spending on pensions, health care and elderly care.

Estimates by the Study Committee on Ageing (SCA) in July 2017 suggest that social benefits will continue to rise over a long period, from 25.3 % of GDP in 2016 – a figure that is close to the ratio currently estimated for 2017 – to 27.6 % in 2060, after peaking at 28.5 % in the 2038-43 period. This suggests a gradual increase in the costs of ageing from 2016 to 3.2 percentage points of GDP between 2038 and 2043 ; afterwards they would gradually fall back to 2.3 percentage points in 2060.

These projections are based on a number of hypotheses, including the rise in labour productivity, which is assumed to accelerate from an average of 0.5 % between 2015 and 2020 to 1.5 % after 2035. Simulations by the Study Committee on Ageing suggest that if productivity growth in the 2035-60 period were to turn out 0.5 percentage point lower, this would increase the costs of ageing by 1.1 percentage points in 2060. In other words, if the rise in productivity growth were reduced by 0.5 percentage point, this would roughly double the budgetary costs assumed in the reference scenario.

CHART 65 SHARP RISE IN DEPENDENCY RATIO WILL DRIVE UP SOCIAL BENEFIT EXPENDITURE



Sources : DGS, SCA, NBB.
(1) There was a downward effect on the level of social benefits, expressed as a % of GDP, due to the revising upwards of GDP after the switch to the ESA 2010 methodology in the national accounts in September 2014.

Addressing the challenge of population ageing requires three-pronged strategy

Against the backdrop of population ageing, the long-term sustainability of public finances must be assured through a three-pronged approach in which three components reinforce each other, namely achieving sound public finances, boosting potential GDP and mitigating ageing-related expenditure.

As far as public finances are concerned, the additional consolidation measures needed to achieve a structurally balanced budget in the medium term, and thus to reduce the level of debt, must be focused mainly on selectively reducing expenditure.

Given the relatively low employment rate in Belgium, the best way of raising potential GDP is by creating jobs. Labour productivity also needs to be supported. Although this is generally achieved mainly through private initiatives, the government can make a key contribution by creating favourable conditions through targeted investment and spending on education and R&D, by promoting more efficient market operation, encouraging entrepreneurship and creativity, improving the functioning of institutions, etc.

The federal government has already taken a series of measures to reform the pension system in recent years in a bid to keep the costs of ageing under control. The most radical measures were taken in 2015 and entailed raising the statutory retirement age, introducing stricter conditions for early retirement and scrapping the pension bonus. One measure, the gradual raising of the age at which people are eligible for survivor pensions (from 50 in 2025 to 55 in 2030), was annulled by the Constitutional Court at the end of November 2017. However, this has only a minimal impact on the budgetary costs of population ageing.

In its 2015 report, the Study Committee on Ageing estimated the effect of the main 2015 pension reforms in 2060 on the labour market, economic activity and the costs of ageing. It estimated that those costs would turn out 2.1 percentage points of GDP lower, made up of 1.5 percentage points in lower pension expenditure and 0.6 percentage point in reductions in other social benefits. The estimates suggested that GDP and employment would both grow by 5.6 %.

The pension systems have been slightly modified again since. The main thrust in 2017 was on harmonising the incorporation of periods of study in pension calculations in the three main pension systems (employees, civil servants and self-employed workers). The government also decided to raise the wage ceiling up to which pension entitlements can be accrued, enabling entitlements to be accrued for careers spanning more than 45 years (abolition of the 'unity of career' principle) and revising the calculation of pension rights for periods of unemployment and early retirement. A number of changes are also in preparation, the most important of which relate to introducing a points-based pension system, taking into account heavy and arduous work when calculating pension entitlements, and introducing part-time pensions. As stated, the Study Committee on Ageing believes that social benefit payments will increase sharply in the future despite these measures.

Fiscal strategy must be aimed at achieving a structurally balanced budget

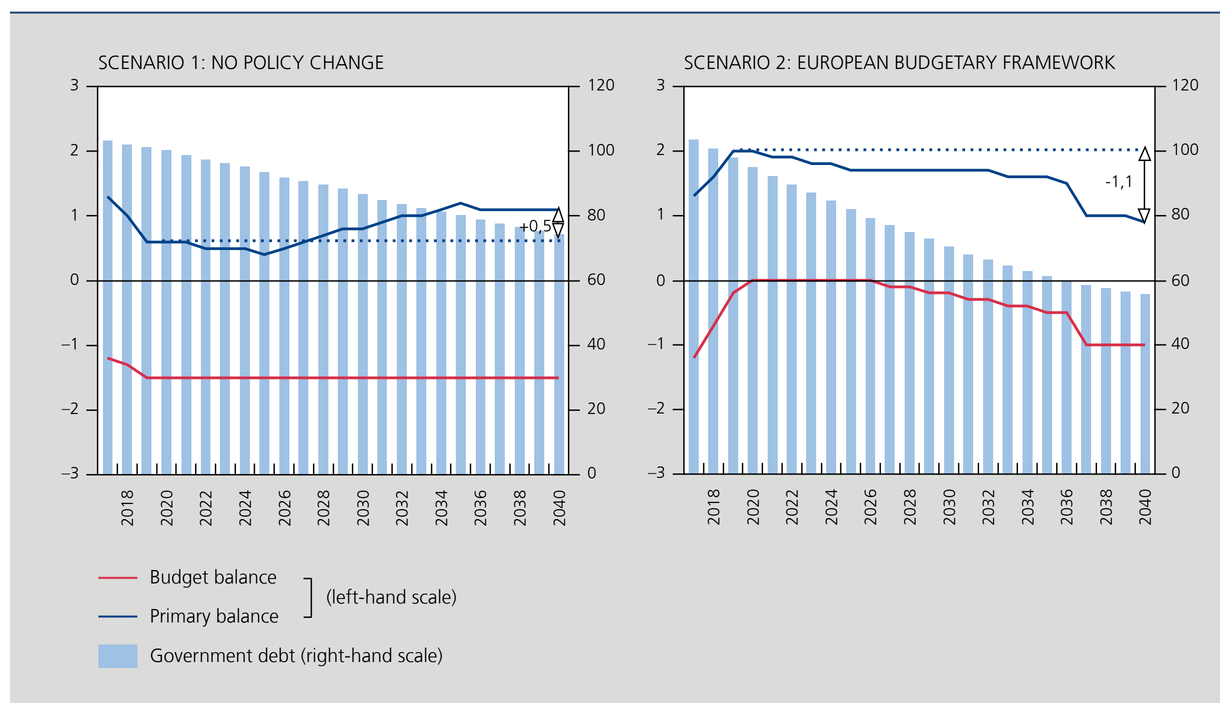
Belgium could assure the sustainability of its public finances by adhering to the European fiscal framework. The resultant fiscal buffer could be used to accommodate some of the costs of population ageing. The accelerated debt reduction would drive down interest charges, while at the same time the budget balance could ease gradually.

This view is supported by the outcomes of a simulation of the course of public finances over the long term. Two scenarios were compared, in which the costs of ageing – 3 % of GDP over the 2020-40 period – were initially left out of consideration. In the first scenario, the primary balance and budget deficit deteriorate by 2020 to 0.6 % and 1.5 % of GDP, respectively. These are the projected results for that year based on the Bank's December 2017 projections if policy remains unchanged. From 2020 onwards, the budget deficit is projected to stabilise until 2040. Given the expected rise in interest charges over that period, the primary balance would therefore need to increase by 0.5 % of GDP. Adding the costs of population ageing pushes up the total fiscal measures required to 3.5 % of GDP by 2040.

The second scenario assumes a balanced budget from 2020 onwards ; this would require a primary surplus in that year of 2 % of GDP. The budget would then remain balanced for five years, after which the overall balance, in line with the European fiscal framework, would gradually tend towards a deficit of 0.5 % of GDP. Once the debt ratio has fallen below 60 % of GDP in 2037, the deficit would rise to 1 % of GDP. The gradual easing of the fiscal targets, combined with lower interest charges due to the more rapid fall in government debt than in the first scenario, enables a fiscal buffer of 1.1 % of GDP to be established. Since these factors would together cover just over a third of the costs of population

CHART 66 A FISCAL POLICY AIMED AT ACHIEVING A STRUCTURALLY BALANCED BUDGET WOULD ENABLE THE COSTS OF AGEING TO BE PARTIALLY FUNDED AND ALLOW DEBT TO REDUCE MORE QUICKLY[1]

(excluding the costs of population ageing, in % of GDP)



Sources: NAI, SCA, NBB.

(1) Based on the macroeconomic hypotheses used in the reference scenario of the Study Committee on Ageing, with no allowance made for the potential impact of the budget path on GDP, and on the hypothesis that the implicit interest rate on government debt would increase to the nominal rate of GDP growth in 2035 and stabilise at that level. Inflation is projected to reach 1.9 % from 2021 onwards. The simulation assumes that the structural balance is equal to the nominal balance from 2020 onwards.

ageing, the fiscal measures needed by 2040 based on the hypotheses in this technical exercise would be limited to 1.9 % of GDP.

Achieving a structurally balanced budget

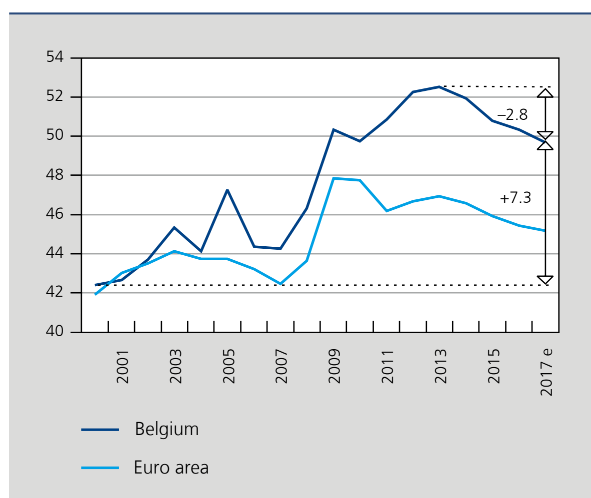
The government has two levers to help it achieve a structurally balanced budget: revenues and primary expenditure. Interest charges also play a role, though their contribution depends not only on the debt dynamics, but also on movements in interest rates.

Thus far, considerable savings have been made on interest charges thanks to the reduction in interest rates in recent years. These charges should reduce further over the next few years due both to the fall in the implicit interest rate and the reduction in government debt. However, this reduction will be slower than between 2012 and 2017, and will slow further in the future. It will moreover depend on how the current benign climate evolves. To illustrate the impact of interest rate movements on interest charges, three scenarios were simulated for the medium term based on an unchanged finance structure. In the first scenario, the most favourable for the public finances, it is assumed that market interest rates remain at their very low 2017 level until 2020. In the second – more central – scenario, it is assumed that interest rates increase slightly in line with the assumptions used in the Bank's December 2017 projections, which took into account the expectations of the financial markets. The third, relatively unfavourable scenario assumes a sharper increase in interest on government loans, of 10 basis points per quarter for short-term rates and 15 basis points for medium- and long-term rates. The assumptions on the evolution of debt were also taken from the autumn forecasts. In the favourable scenario, interest charges would fall from 2.5 % of GDP in 2017 to 2 % in 2020. In the central scenario, interest charges would amount to 2.1 % of GDP in 2020, while in the unfavourable scenario, they would turn out at 2.3 % of GDP.

The degree to which interest charges could fall and revenues rise in the years ahead is limited, and achieving a structurally balanced budget will therefore predominantly require new savings in primary expenditure. Although Belgium's public spending ratio has trended downwards

CHART 67 INCREASE IN PUBLIC EXPENDITURE SINCE THE CRISIS REMAINS CONSIDERABLE

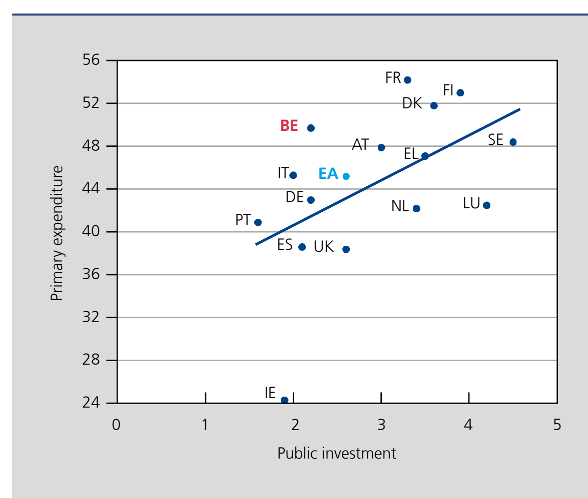
(primary expenditure, in % of GDP)



Sources: EC, NAI, NBB.

CHART 68 SHARE OF PUBLIC INVESTMENT REMAINS LOW IN BELGIUM

(estimates for 2017, in % of GDP)



Sources: EC, NBB.

since 2013, it remains high compared with the rest of the EU, whereas the ratios prior to the crisis were comparable. In 2017, primary expenditure in the euro area as a whole stood at 45.2 % of GDP, 4.5 percentage points lower than in Belgium. Public expenditure in Belgium has risen by 7.3 percentage points of GDP since 2000, twice the rate of the euro area, having started at virtually the same level. After peaking at 52.5 % of GDP in 2013, the reduction in primary expenditure has however contributed fully to restoring the health of public finances.

However, public spending should not be regarded purely as a means of fiscal consolidation. In the first place, it is an indispensable instrument in enabling the government to fulfil its various tasks in the public interest. Moreover, public expenditure also contributes to economic growth, chiefly in the short term though to some extent also in the longer term. It is therefore extremely important to make policy choices which optimise both functions.

Logically, the extent of primary expenditure should be reflected in the quality of services delivered to the community. This is indeed the case in some areas of government activity, for example health care, but by no means everywhere. All in all, the Belgian government achieves only moderately efficient results compared with the European average. The findings of a study into the efficiency of government activity in Belgium were published in the Bank's Economic Review (1).

Within a given fiscal framework, it is worthwhile adjusting the composition of public expenditure so as to give priority to categories that can reinforce economic growth in the long term. The tax shift fitted in with that aim on the revenue side, by reducing the burden of taxation on employment. A similar "expenditure shift" is recommended on the spending side, in which the share of the available resources flowing into investment is stepped up, specifically in the form of investment in infrastructure, as well as an increase in productive investment in areas such as support for R&D and innovation and expenditure that contributes to helping the labour force adapt to the digital age. The share taken by investment in government expenditure in Belgium is relatively low; countries with comparable expenditure levels devote a much bigger share to investment, while other countries which invest as much as Belgium generally spend less.

(1) See Cornille D., P. Stinglhamber and L. Van Meensel (2017), "Public sector efficiency in Belgium", NBB, *Economic Review*, June, pp. 31-41.