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2003 UPDATE OF THE STABILITY PROGRAMME OF BELGIUM (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The fifth update of the stability programme for Belgium, covering the period 2004-2007, largely complies with the data requirements of the "code of conduct" on the content and format of stability and convergence programmes.

Following the sharp deceleration in economic growth in 2001, economic activity remained very weak in the course of 2002 and in the first half of 2003. Real GDP growth slowed down from 3.8% in 2000 to 0.7% in 2002. It is estimated in the update to have averaged 0.9% in 2003, the third year in a row under 1%. The updated programme projects growth of 1.8% in 2004 and 2.8% in 2005. As to 2006-2007, growth is expected to slow down moderately to 2.3%. Employment growth in the updated programme is expected to pick up from -0.1% in 2003 to 0.7% in 2004 and to an average 0.8% in 2005-2007. Inflation as measured by the HIPC is projected to remain stable at 1.4% over the 2004-2007 period after 1.6% in 2003.

In general, the macroeconomic scenario in the programme seems realistic. A question mark, however, concerns 2005 when GDP is assumed to grow at 2.8%, which is ½ percentage point higher than the Autumn 2003 forecast by the Commission.

Despite the sharp slowdown in economic activity in 2003 the general government accounts posted a slight surplus (the latest estimate is 0.3% of GDP, 0.1 percentage point higher than in update) for the fourth consecutive year. Apart from the control of expenditure, some one-off measures had a decisive influence on the budget. Most important was a payment by the mainly publicly owned telecommunications company Belgacom to the government in exchange for the transfer to government of responsibility with the pensions of the employees. Eurostat is still considering whether such a payment (1.9% points of GDP) can be counted as a reduction in government deficit. The budget was also influenced by two other one-off measures for a total of 0.7% of GDP going in the opposite direction[2]. All in all, one-off measures in 2003 provided a positive contribution of about 1.2% of GDP to the budget balance. Excluding them, the budget would have recorded a deficit of about 0.9% of GDP.

In 2004, the programme targets a budget in balance, relying on one-offs gains of 0.7% of GDP, including an estimated 0.3% of GDP revenue from the capital repatriation amnesty law (*fr*. Déclaration libératoire unique). For the period 2005-2006, the target is a budget in balance and for 2007 it is a surplus of 0.3% of GDP. In the horizon of the update, the adjustment relies largely on the continuous reduction in interest payments as a result of the steady fall in the debt ratio, while the primary surplus moves from 5.6% of GDP in 2003 to 4.8% in 2005 and then stabilises.

[1] This assessment has been carried out on the basis of information available as of February 13, 2004.

[2] The two deficit-increasing one-off measures are a capital transfer to La Poste and the government decision of anticipating from 2004 to 2003 the payment of subsidies to SNCB (the public railway company).

In cyclically adjusted terms, based on Commission calculation on the programme data according to the commonly agreed methodology, the budget balance moves from a surplus of 0.8% of GDP in 2003 to a balanced budget in 2004-06 and a small surplus in 2007. Excluding one-off measures, the cyclically adjusted figures would show an improvement from a deficit of 0.4% of GDP in 2003 to a surplus of 0.3% in 2007.

Under plausible macro-economic and budgetary assumptions, a budgetary position of close to balance or in surplus should most likely be maintained over the programme period. This would also provide a safety margin against breaching the 3% of GDP threshold with normal cyclical fluctuations.

The government debt-to-GDP ratio has been falling steadily since its peak of 138% of GDP in 1993 to slightly more than 100% in 2003. It is expected to fall below 100% in 2004 and to reach 87% of GDP in 2007. As economic activity slowed down it proved more difficult to secure high primary surpluses, and keep the debt ratio on a downward trend. One-off measures such as the transfer of the Belgacom pension fund aimed at accelerating debt reduction. However, the Belgacom operation will have a negative impact on the budget and the debt in the future, when pensions have to be paid out, something that is not mentioned in the update. Also, debt figures do not take into account the assumptions by the government of part of the debt of the public railway company (SNCB) which is, planned for 2005. To cope with future budgetary costs of ageing, the authorities created in 2001 an Ageing Fund (*fr.* Fonds de vieillissement). This instrument, which is funded by non-tax receipts and invested in government securities, is planned to reach 3.4% of GDP by end 2004.

The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. However, Belgium still presents some risks of long-term unbalances, linked to the consequences of aging. The outstanding level of debt requires attention and maintaining high primary surpluses in the next 10 to 15 years as planned is necessary to keep Belgium on a sustainable path. Also, as indicated in the Broad Economic Policy Guidelines, reducing the debt, increasing the retirement age, strengthening efforts to finance the Ageing Fund and pursuing the reform of the pension system are needed to prepare for the budgetary implications of population ageing.

The economic policies as reflected in the updated programme are partly consistent with the recommendations in the Broad Economic Policy Guidelines, specifically those with budgetary implications. While the programme contains a renewed commitment to allocate, as a matter of priority, proceeds stemming from higher than expected economic growth to improve the budgetary position, the updated programme lacks information on how the authorities intend to comply with the commitment to limit the increase in real expenditure in Entity I (Federal Government and Social Security) to 1.5%.

1. INTRODUCTION

The 2003 update of Belgium's stability programme, covering the period 2004-07, was approved by the government on 28 November 2003 and submitted to the Commission on the same day.

Public finances have for some years complied with the Stability and Growth Pact (SGP) and this is maintained as a central principle in the updated programme, which has three main objectives: to maintain budgets close to balance or in surplus; to continue the progressive reduction of the debt ratio; and to promote employment. These objectives aim to ensure sustainability of public finances in the medium and long term, meeting the challenges associated with the ageing of the population. Should economic development become more favourable than assumed in the programme, resulting in higher than expected revenues, these revenues would be used to improve the budget balance.

2. MACROECONOMIC ASSESSMENT

2.1 External economic assumptions

The external macroeconomic assumptions underlying the programme are in general similar to those in the Commission services' autumn 2003 forecasts. The main difference between the programme and the Commission forecast concerns projected growth in the non-EU area, assumed in the programme to average 3.6% during the period 2003-2005, about ½ percentage point lower than assumed by the Commission.

2.2 Domestic macroeconomic developments

Compared to the previous update, the present one shows significant downward revisions in GDP growth in 2003 and 2004. GDP growth has been revised down by slightly more than 1 percentage point in 2003 and by about ¾ of a percentage point in 2004 (Table 1). Macroeconomic developments in the stability programme are similar to those in the Commission forecast, although GDP growth in 2005 is somewhat more optimistic and exceeds the Commission forecast by a half-percentage point. Subject to this latter point, the macroeconomic projections in the update seem reasonably prudent.

Table 1 – GDP forecast (real annual percentage change)

	2002	2003	2004	2005	2006	2007
2002 stability programme update	0.7	2.1	2.5	2.5		
2003 stability programme update	0.7	0.9	1.8	2.8	2.5	2.1
Commission 2003 Autumn forecast	0.7	0.8	1.8	2.3		

Source: Updated stability programmes and the Commission 2003 Autumn forecast

Growth of private consumption is projected to strengthen up to 2006 but then to decelerate sharply (Annex Table A2). However, its uneven profile, like that of some other GDP components, is not well explained. The programme does not explain what drives private consumption after 2004. Wage increases are assumed to remain modest, given the current general wage agreement and the slack in the labour market. However, disposable income is assumed to be supported by the impact of personal income tax reform and increasing employment. Given the projected development of employment and a likely decrease in the household savings rate, due to the improvement of the labour market, the projected growth in private consumption seems reasonable.

Investment also contributes to the increase in domestic demand. In 2003 and 2004, this is boosted by increased profitability, due to moderate wage increases compared to productivity developments, the low level of interest rates and the expected increase in private consumption. Investment growth is expected to peak in 2005. The following deceleration is not explained but may reflect higher interest rates and slower increases in exports and private consumption.

Both exports and imports are projected to increase faster than in the Commission forecasts. However, the differences are small and the contribution from net exports is about the same. Only in 2005 is there a notable difference in the contribution of net exports, amounting to 0.3 percentage points. This difference explains most of the deviation in total growth between the stability programme and the Commission forecasts in that year.

Potential growth in the updated programme has been revised down by about a half-percentage point each year. Slowly increasing, it averages 2% in the period 2003-2007. In the update, average actual economic growth equals potential growth. The output gap and potential growth Commission figures (method agreed by the Council) deviate only slightly from those in the programme.

Reflecting several years of weak economic activity, a significant output gap emerged in 2003. Growth, which picked up slowly in the third quarter of 2003, is expected to strengthen further in 2004 and 2005. The output gap is estimated to be largely closed as from 2005. During the following years the economy is projected to operate close to its potential growth. This projection is similar but somewhat more optimistic than the calculation by the Commission services, in line with the more optimistic GDP growth in 2005 in the update.

The figures provided in the stability programme do not allow an analysis of sectoral balances. However, the macroeconomic scenario seems broadly consistent. Public finances are projected to be in balance throughout the period, except for 2003 and 2007 when small surpluses are projected. Private consumption is expected to increase slightly less than disposable income in 2003 and 2004, implying an increase in the savings ratio. Subsequently, given the improvement of the labour market, the savings ratio would decrease. Growth of investment in the business sector rises to 2005 and then eases, but profitability is assumed to increase. Finally, the contribution from net exports is zero or slightly positive for all years, except 2003. All in all, unless the terms of trade change considerably, this scenario seems compatible with a relatively stable current account balance.

3. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF PUBLIC FINANCES

3.1 Programme overview

The updated programme confirms adherence to the objectives of the Stability and Growth Pact, although the change in macroeconomic environment compared to that foreseen in the previous update has resulted in revised budgetary targets of balance in 2004 and 2005 (previously surpluses of 0.3% and 0.5% of GDP respectively). The budget is also targeted to be in balance in 2006 and to achieve a small surplus in 2007 (table 2).

Table 2 – Comparison with 2002 update of the stability programme

% of GDP	2002	2003	2004	2005	2006	2007
Actual budget balance						
2002 programme update	0.0	0.0	0.3	0.5		
2003 programme update	0.1	0.2	0.0	0.0	0.0	0.3
Gross debt levels						
2002 programme update	106.1	102.3	97.9	93.6		
2003 programme update	106.1	102.3	97.6	93.6	90.1	87.0

Source: Updated stability programmes

Despite a progressive decline in the revenue-to-GDP ratio, the budget remains in balance or surplus throughout the period. This is made possible by falls in the expenditure ratio due to lower unemployment-related and interest expenditures. Between 2003 and 2007 interest payments as a percentage of GDP decline by close to 1 percentage point. The primary surplus declines from 6.1% of GDP in 2002 to 4.8% in 2005 but then stabilises around that level.

The cyclically-adjusted budget balance, in surplus by 0.8% of GDP in 2003, eases significantly by 2005 (table 3). However, this is due to the absence of one-off measures beyond 2004: without the impact of such measures in 2003, the cyclically-adjusted balance in that year would have been a deficit of about 0.4% of GDP, improving to a cyclically adjusted surplus of 0.2% of GDP in 2005. Thus, disregarding such measures, both the actual and the cyclically-adjusted balances are projected to improve between 2003 and 2005. In 2006 and 2007 the cyclically-adjusted budget is in balance and slight surplus respectively.

Gross debt is projected to decrease steadily from 102.3 % of GDP at end-2003 to 87% in 2007, close to the path projected in the previous update. However, the present projection includes the effect of one-off measures in 2003 and 2004. These substantially helped to offset the impact of the weak economic growth on public finances and speeded up the reduction of the debt ratio. According to the authorities' latest estimates, the debt ratio at end-2003 was 100.4% of GDP, close to 2 percentage points lower than assumed in the programme. This is partly due to the bringing-forward of one-off measures from 2004 to 2003. Among these, the payment by Belgacom improves the budget balance and reduces debt in the short term. However, there will be an opposite impact spread over time that is not estimated or mentioned in the programme.

Table 3 - General government revenue and expenditure							
In % of GDP	2002	2003	2004	2005	2006	2007	2003-2007
Total revenue	50.5	50.5	49.7	49.0	48.4	48.2	-2.3
Total expenditure	50.4	50.2	49.6	49.0	48.4	47.9	-2.3
Budget balance	0.1	0.2	0.0	0.0	0.0	0.3	0.1
Interest payments	6.0	5.4	5.0	4.8	4.7	4.5	-0.9
Primary balance	6.1	5.6	5.1	4.8	4.7	4.8	-0.8
	Main components of revenue						
Taxes	31.1	30.2	30.5	30.1	29.7	29.7	-0.5
Social security contributions	16.7	16.5	16.3	16.2	16.2	16.2	-0.3
Other	2.7	3.7	2.8	2.6	2.5	2.4	-1.3
Total revenue	50.5	50.5	49.7	49.0	48.4	48.2	-2.3
	Main components of expenditure						
Consumption expenditure (compensation & intermediate consumpt.)	15.4	15.4	15.2	15.0	14.8	14.8	-0.6
Social benefits in kind	6.6	6.9	7.0	7.1	7.2	7.4	0.5
Other social benefits	16.1	16.3	16.1	15.6	15.2	15.0	-1.3
Interest charges	6.0	5.4	5.0	4.8	4.7	4.5	-0.9
Subsidies	1.6	1.5	1.6	1.6	1.6	1.6	0.1
Gross fixed capital formation	1.6	1.6	1.6	1.8	1.9	1.7	0.1
Other	3.1	3.1	3.1	3.1	3.1	3.0	-0.1
Total expenditure	50.4	50.2	49.6	49.0	48.4	47.9	-2.3

Source: the 2003 updated stability programme

Table 4 – Cyclically-adjusted budget balance						
% of GDP	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
GDP growth at constant prices	0.7	0.9	1.8	2.8	2.5	2.1
Net borrowing	0.1	0.2	0.0	0.0	0.0	0.3
Potential GDP growth	1.8	1.9	1.9	2.1	2.2	2.1
Output gap	0.1	-0.9	-1.0	-0.4	-0.1	-0.1
Cyclical component	0.0	-0.6	-0.6	-0.2	0.0	0.0
Cyclically adjusted balance	0.1	0.8	0.6	0.2	0.0	0.3
CAB net of one-off measures	n.a.	-0.4	-0.1	0.2	0.0	0.3

Source: Commission services' calculations, using the agreed method and on the basis of the data of the 2003 updated stability programme.

Box A: ONE-OFF OPERATIONS AND THE BELGIAN GOVERNMENT ACCOUNTS

The 2003 and 2004 Belgian government accounts are influenced by a number of one-off transactions. Most important is a payment by Belgacom to the Government in relation to future pensions. Though the programme assumes that such a transaction is recorded as revenue in 2003 and 2004, it now appears that it will have no impact on the 2004 accounts, while the impact on 2003 (of 1.9% of GDP) is still under discussion (see below for further details). Moreover, after the release of the programme, the government decided to bring forward to 2003 subsidies and capital transfers to be paid to SNCB (railways) and La Poste (post office) of 0.5% and 0.3% of GDP, respectively. In net terms, the government balance for 2003 is 1.2% of GDP better than it would be without these three operations. The 2004 accounts will benefit from the bringing-forward of the above-mentioned subsidies and transfers. Moreover, the capital repatriation amnesty law (*Déclaration libératoire unique* or DLU) is expected to increase government revenue by 0.3% of GDP. However, such an impact is surrounded by considerable uncertainty.

The transaction between Government and Belgacom

At the end of 2003, the Belgian government assumed the responsibility of paying future pensions to employees of Belgacom, S.A., enjoying the retirement conditions of civil servants. Therefore, a group of employees moved from a private pension scheme to the general pension system. In exchange for the assumption of pension responsibilities by the State, Belgacom pays to government around € 5 million (or 1.9% of GDP). In the budget bill for 2004 and in the stability programme, this amount was recorded as government revenue at the time of the effective payments: € 3.6 million was paid in 2003, while the remaining € 1.5 million is to be paid in 2004.

Accounting rules for pension schemes

ESA95 does not recognise pension-related obligations as financial liabilities when they relate to unfunded pension schemes. This means that pension rights accumulated by the members of an unfunded scheme are not recognised in the balance sheets of households and of the pension schemes. As a result, contributions paid to and pensions paid by unfunded schemes are recorded as capital transactions which improve or worsen the deficits or the surpluses of the respective sectors. On the basis of these rules, Eurostat confirmed on 21.10.2003 that "*payments received by a government (…) in the context of a transfer of unfunded pension obligations (…) are treated as an unrequited transaction, classified as capital transfer*", which reduce the government deficit. In contrast, in the case of funded pension schemes, national accountants recognise financial assets and liabilities in the accounts of households and of the pension schemes. Contributions paid to and pensions paid by funded schemes do not have any impact on the deficits or the surpluses of the respective sectors. Transfers from funded schemes to other funded schemes are recorded as purely financial transactions.

The specificity of the "Belgacom case"

The Belgian authorities have been in contact with Eurostat to discuss how the transactions between the government and Belgacom should be recorded in the government accounts. Concerning the time of recording of the operation, there was an agreement that the transaction would have to be fully recorded in 2003. This is because transactions should be recorded in ESA95 accounts at the time they take place, irrespective of the timing of effective cash disbursements. There was also consensus that the transaction could reduce the government debt. Payments to government allow the latter to reduce debt issuance or to buy back government debt, while future pension payments by social security are not recognised as government debt. The question whether the operation is eligible to reduce the government deficit has been much more difficult. The first difficulty is whether the Belgacom pension scheme was funded or unfunded. In fact, the ESA95 definition of a funded scheme is relatively vague and does not help much when classifying borderline cases, such as this one. If the scheme is classified as unfunded, then the Eurostat decision of 21.10.2003 referred to applies, and the accounting of the operation is trivial. If the Belgacom pension scheme is classified as funded, a second difficulty emerges. Transactions between funded schemes have clearly a financing nature and do not have any impact on the deficit/surpluses of the respective schemes. However, in the Belgian case, the transaction consists in integrating a presumably funded pension system into the unfunded general pension system. Among national accountants there is no consensus whether the determining element is the nature of the pension scheme before the transaction or after the transaction. A final decision is expected to be announced by Eurostat before the end of February 2004, in time for the EDP reporting of government deficit and debt levels. Prior to its final decision, Eurostat will consult the Committee on Monetary, Financial and Balance of Payment Statistics (CMFB), as is customary in such circumstances.

3.2 Outcome in 2003 and adjustment in 2004

The latest estimates of the 2003 budget outturn indicate a surplus of 0.3% of GDP, compared to 0.2% in the programme. However, this outturn (and also the target for 2004) incorporates significant one-off measures; excluding them, shows a 2003 budget deficit of 0.9% of GDP. Since the updated programme was approved, changes have occurred in the timing of implementation and statistical recording of these measures. As explained in the Box A, the most important of the one-offs, namely a payment by Belgacom to the Government in relation to future pensions (amounting to 1.9% of GDP) is still subject to validation by Eurostat.

The low economic growth for the third consecutive year had an important impact on the budget figures leading to the 0.9% of GDP deficit without one-off measures. On the revenue side, taxes and to a much lesser extent social security revenue fell in percentage of GDP, whereas on the expenditure side, social security payments rose more than nominal GDP. The substantial fall in interest payments, of 0.6% of GDP, mitigated the impact on the general government accounts of those negative factors.

The update targets a balanced budget in 2004. This projection is more optimistic than that of the Commission 2003 Autumn forecast, according to which the budget will run a deficit of 0.4% of GDP. In cyclically-adjusted terms the position eases in the update from a surplus of 0.8% of GDP to 0.6%.

The budget for 2004 is influenced by several factors. On one hand there are positive impacts stemming from the gradual decrease of the debt ratio and an improvement in the business cycle. On the other, there is a negative influence from a smaller positive net contribution from one-off measures and from the short-term impact of structural reforms aimed at reducing the tax-ratio and promoting employment.

The chief positive impact on the budget comes from the reduction of the debt, which allows interest payments to decline considerably. Payments are estimated to decline from 5.4% of GDP in 2003 to 5.0% in 2004. Given GDP growth, rising from 0.9% in 2003 to an expected 1.8% in 2004, with output still slightly below potential, the cyclical component no longer deteriorates but remains negative at -0.6%. One-off measures contribute 0.7% of GDP which nonetheless compares with a net 1.2% in the previous year.

As regards the impact of structural reforms, there will be some short-term minor losses from the final phase of implementation of income tax reform and from the reduction in social security contributions. All in all, the effort needed to meet the budget target in 2004 will be slightly higher than in 2003 and also compared with that estimated when the update was presented, because of a smaller contribution from one-off measures.

3.3 Adjustment in 2005 and beyond

The key objective for the period 2005 to 2007 is to keep the budget in balance or in slight surplus. Moreover, fiscal policy will be directed towards reducing the debt, decreasing fiscal and non-fiscal revenues as a share of GDP and promoting employment. The budget is projected to remain in balance in 2005 and 2006 and to post a slight surplus of 0.3% of GDP in 2007. This is expected to be supported by economic growth close to potential and lower interest expenditure. This downward trend will tend to decelerate towards the end of the period owing to the end of the fall in the implicit interest rate.

In 2005, compared to 2004, there will be one negative component resulting from the absence of one-off measures which in 2004 amount to about 0.7% of GDP. This is also roughly the total decrease in revenue in 2005. The cyclically-adjusted balance decreases by 0.4 percentage points to reach 0.2% of GDP. This implies that there is an underlying (excluding one-off measures) structural improvement of some 0.3 percentage points. Social security expenditures are projected to decrease by 0.4 percentage points, which matches the cyclical component, as a result of the projected decline in unemployment. Interest charges are projected to decrease by 0.2 percentage points of GDP.

A surplus of 0.3% of GDP is projected for 2007 (0.2% in cyclically adjusted terms). This implies that, even if the programme were slightly too optimistic, it seems possible to have a budget close to balance or in surplus during the later years of the period.

The programme does not, however, present information regarding an intention to limit the real increase in primary expenditures in Entity I (State plus social security) by 1.5%, as recommended in the 2003-05 Broad Economic Policy Guidelines. Such information would have been particularly useful as social security is a major source of expenditure overrun.

3.4 Sensitivity analysis

The update includes two different sensitivity simulations concerning the interest rate assumption and the growth rate. These simulations show that the programme provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations.

For some years, management of the debt has been oriented towards a reduction of the ratio of short-term debt. The share of short-term euro-denominated debt is presently below 13%, which has made public finance less sensitive to interest changes, as illustrated in the simulations. In the base scenario the long-term interest rate is assumed to increase from 4.1% in 2003 to 5.4% in 2007, in line with the assumptions in the Commission forecasts as regards the period 2003-2005. An alternative scenario is simulated with a 100 points higher interest rate than in the base scenario, throughout the period 2004-2007. The impact of such an increase on the interest burden increases over time, from 0.1% of GDP in 2004 to 0.4% of GDP in 2007.

As regards the sensitivity analysis of GDP growth, three alternative scenarios are projected. In one scenario, GDP growth equals potential growth. That implies a slightly lower growth rate on average than in the base scenario (average growth of 2% for 2003-2007), except for 2005 when growth is 0.8 percentage points lower. The cumulative impact on the budget balance over the period 2004-2007 is -0.5% of GDP. Two other scenarios are projected, with growth diverging by 0.5 and -0.5 percentage points respectively from the base scenario. The impacts on the budget balance are 0.3 and -0.3% of GDP per year. In other words, in the “weaker growth scenario”, the budget balance would be -0.9% of GDP in 2007, compared to a surplus of 0.3% in the base scenario.

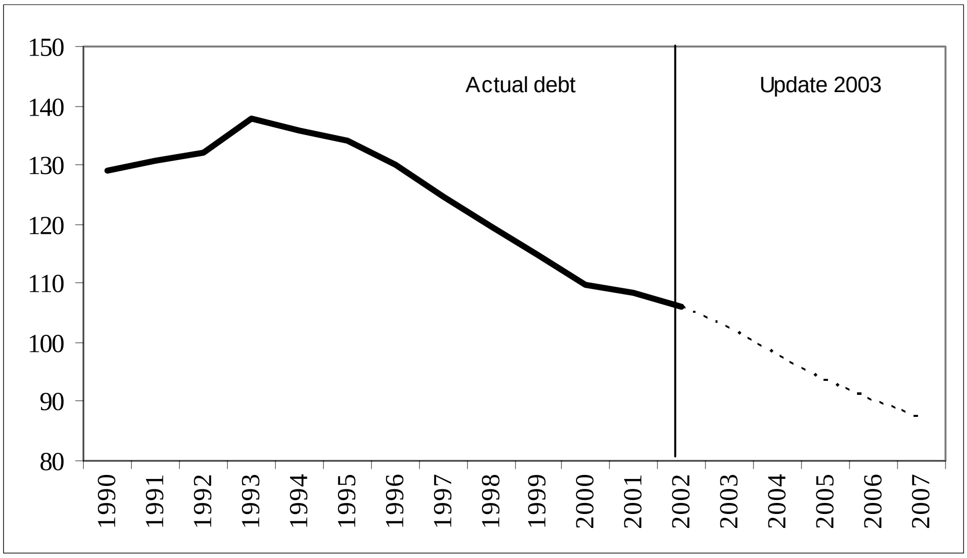
Table 5 – Sensitivity analysis				
% of GDP	2004	2005	2006	2007
Deviation of interest charges	0.1	0.3	0.3	0.4
Stability programme				
Real growth of GDP	1.8	2.8	2.5	2.1
Budget balance	0.0	0.0	0.0	0.3
Potential growth				
Real growth	1.8	2.0	2.2	2.2
Budget balance, compared to basis scenario	0.0	-0.4	-0.2	0.1
Weaker growth				
Real growth	1.3	2.3	2.0	1.6
Budget balance, compared to basis scenario	-0.3	-0.3	-0.3	-0.3

Source: the 2003 updated stability programme

3.5 Public debt ratio

With gross government debt still exceeding 100% of GDP at the end of 2003, the objective of continuing to reduce the debt ratio is a central aim of fiscal policy. The debt ratio peaked in 1993 at some 138% of GDP but decreased rapidly and fell below 110% of GDP in 2000. More recently, the poorer economic developments have contributed to smaller primary surpluses and to lower nominal GDP contributions to debt ratio reduction. The programme envisages a further reduction in the stock of debt from 102.3% of GDP in 2003 to 87% in 2007 (Graph 1).

Graph 1 Public debt ratio



Source : Eurostat and the 2003 updated stability programme

As stated above, to offset the lower contributions to debt ratio reduction stemming from the cycle, the government decided to undertake one-off debt-reduction measures. A major operation is the transfer of the Belgacom pension fund discussed above. In addition, subsequent to the update, the government took other one-off, partly offsetting measures, specifically, increasing the capital of the Post and bringing forward to 2003 the subsidies planned to be allocated to SNCB in 2004, together amounting to 0.7% of GDP. In addition, a financial transaction involving FADELS, a social housing loan amortisation fund, which was planned for 2004 was actually carried out in 2003. This largely explains the substantial negative 2004 stock-flow adjustment in the update.

From 2005 onwards no major additional one-off operations are included. In particular, the projections do not take into account the possible transfer of part of the debt of SNCB (the Belgian railway company) in 2005, which adds uncertainty to the projected debt reduction path.

Table 6 provides a decomposition of the debt ratio development based on the projections in the programme. Evident from the table is the importance of high primary surpluses for the reduction of the debt ratio. Primary surpluses are planned to stay high but to be lower than in the first years of the decade. Lower projected primary surpluses will be partly compensated by lower interest payments.

Table 6 – Decomposition of changes in the government debt ratio						
% of GDP	2002	2003	2004	2005	2006	2007
Change in government debt ratio	-2.5	-3.8	-4.7	-4.0	-3.5	-3.1
Contribution of primary balance	-6.1	-5.6	-5.1	-4.8	-4.7	-4.8
Interest payments	6.0	5.4	5.0	4.8	4.7	4.5
GDP dynamics	-2.5	-3.5	-3.4	-4.1	-3.7	-3.0
Stock-flow adjustment	0.7	-0.1	-1.3	0.1	0.1	0.2
Government debt ratio	106.1	102.3	97.6	93.6	90.1	87.0

Note: The decomposition of changes in the gross debt ratio is based on the following equation for the budget constraint.

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{i_t - y_t}{1 + y_t} \bullet \frac{D_{t-1}}{Y_{t-1}} + \frac{SF_t}{Y_t}$$

D = government debt, PD = primary deficit, Y = GDP at current market prices,
i = implicit interest rate on government debt, y = nominal GDP growth rate, and
SF = stock-flow adjustment.

Source: Commission estimates based on budgetary projections given in the stability programme.

4. QUALITY OF PUBLIC FINANCES

Reforms foreseen in the programme period include the gradual reduction in fiscal and parafiscal pressure on work, measures to promote employment, measures to improve the business environment, the modernisation of public enterprises and the opening of energy markets. These measures are not expected to have a positive influence on the budget in the short-term and on balance the impact is probably negative. However, by improving the functioning of labour and product markets, employment is expected to increase, which should be reflected in the medium term in lower expenditure related to unemployment and early retirement.

The reform of personal income tax, initiated in 2001, will be fully implemented as from 2004. The short-term impact is negative (no estimate of the magnitude is provided in the programme), but it might have a positive medium-term influence on labour supply by making work pay better.

Employment-promoting measures include reductions in social security contributions in 2004. The full-year impact is estimated at 0.3% of GDP. Only about half this amount will affect the budget in 2004, as the reduction will become effective as from July. Other measures are planned for 2004 but of limited budgetary impact. In addition, the fight against abuse and fraud of the social security system and against employment in the black economy will be strengthened and better co-ordinated.

Among the measures to improve the business environment, the simplification of administrative procedures is a priority, the goal being by 2005 to shorten to three days the time required for administrative procedures when setting up an enterprise. These measures probably have only small short-term budgetary costs and might have a positive impact in the medium term. The business sector is also benefiting from a company tax reform initiated in January 2003. The reform includes reductions of tax rates as well as tax exemptions for reinvested earnings. This is posited to be budgetary neutral, but it is not clear from the programme how lower revenues resulting from lower tax rates will be compensated.

Some investments are planned in the framework of the modernisation of public enterprises. An investment plan for SNCB covers the period 2004-2007 and the modernisation of La Poste will accelerate, focusing on automation. Costing of these measures, which could be expensive, is not provided in the programme.

5. SUSTAINABILITY OF PUBLIC FINANCES

5.1 Quantitative indicators

The assessment of the sustainability of public finances is based on both quantitative and qualitative indicators. The quantitative indicators are run on the basis of a commonly agreed methodology by the Economic Policy Committee[3]. The purpose of the indicators is to signal possible unbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results of these quantitative indicators need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of “no policy change”.

The quantitative indicators project debt and budget balance development according to two different scenarios, to take into account uncertainties over the medium term. The “programme” scenario is calculated on the following basis:

- Macroeconomic assumptions on GDP growth from 2008 onwards, interest rates and inflation are based on the agreed assumptions used in the EPC;

- The projections for age-related expenditures come from the stability programme, complemented with the Economic Policy Committee harmonised projections and with additional information provided by the Belgian authorities. Since projections presented by the authorities in the stability programme cover only the period up to 2030, additional information provided by the authorities from 2030 up to 2050 have been used to provide an assessment of long term sustainability of public finances.

[3] See the Report “The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme” (October 2003), available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

- The projections for government revenues come from the programme. They are kept constant at the (cyclically adjusted) level in 2007.

- The starting point for gross debt and the primary balance are the 2007 levels reported in the programme.

A "2003 position" scenario is based on the budgetary data for 2003 in the programme. Debt levels are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2007 remains the same as the 2003 level and no stock-flows operations take place.

Table 7 below presents the debt and the budget balance development according to the two different scenarios. Projections are based on national projections on pensions, health care and other social security expenditures while education projections rely on the EPC common exercise. Overall, age-related expenditure is foreseen to increase by 4.4% of GDP between 2008 and 2050. The increase of pension and health care expenditures is partially offset by the projected decrease of other age-related expenditures.

It is possible to verify whether the projected level of debt respects the requirement to stay below 60% of GDP reference value for public debt at all times. Failure to do so would *a priori* indicate that there may be a risk of budgetary imbalances emerging in light of ageing population and that measures may be required to place public finances on a more sustainable footing. In the case of Belgium, the debt to GDP ratio should first be reduced to reach the 60% reference value.

According to the quantitative indicators alone, Belgium appears to be on a sustainable path. The primary surplus is projected to remain above 4% of GDP over the next 15-20 years and this will reduce the debt ratio at a fast pace. The "2003 scenario" appears to be more favourable, with a debt to GDP ratio that move towards negative values. This is due to the fact that the programme foresees a decline in the cyclically adjusted primary balance during the programme period while this scenario assumes it constant.

Table 7

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	26,8	26,4	27,5	29,8	30,8	31,2	4,4
Pensions	8,8	8,8	10,0	11,8	12,6	12,6	3,8
Health care	7,1	7,2	8,0	8,7	9,4	9,9	2,8
Education	4,1	4,0	3,7	3,8	3,7	3,7	-0,4
Unemployment benefits	2,0	1,8	1,3	1,1	1,0	1,0	-1,0
Others	4,7	4,6	4,5	4,4	4,1	4,0	-0,7
*Total primary non age-related spending***	16,5						
*Total revenues***	48,1						

* EPC projections

** constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	83,2	74,8	35,9	11,5	1,5	-5,0	-88,2
Net borrowing	0,3	1,0	2,1	1,1	0,7	0,7	0,4
2003 scenario							
Gross debt	78,7	67,2	10,8	-35,7	-73,7	-114,3	-192,9
Net borrowing	2,0	2,8	4,8	5,0	6,2	8,0	6,0

Sustainability gap	S1*	S2**
Programme scenario	-0,3	0,3
2003 scenario	-5,1	-1,0

* it expresses the constant difference between projected revenues and the revenues required to reach in 2030 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 18,6%

** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

Source: Commission calculations

5.2 Additional qualitative features

As underlined in the EPC report on “The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme”[4] (October 2003), several qualitative factors should be taken on board to avoid a mechanistic interpretation of the quantitative indicators. On the positive side, surveillance on long term trends has been strengthened through the Strategy Document on Ageing that the government is required to prepare each year. This will increase transparency on long term trends of public finances. Also, Belgian budgetary projections seem to rely on prudent long term assumptions on real growth: updated figures show a less favourable GDP real growth compared to the previous EPC agreed projections.

However, several factors warrant attention. First, the actual level of debt to GDP ratio is still far from the Treaty requirement. In order to reduce it, a sustained primary surplus is projected in the coming years. Also, a high primary surplus is needed to finance the Ageing Fund in the next few years, which is part of the overall Belgian strategy to cope with ageing populations. A failure to achieve such a surplus would considerably weaken the long term sustainability of public finances. Second, the rise in health care expenditure is a matter of concern since it has progressively increased in recent years, and at a faster pace than expected. Third, some of the savings

[4] Available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

foreseen in the projections are at risk: not only education expenditures could increase in the long term to match the higher demand for skilled workers, but also the foreseen savings in other social security expenditures seem optimistic (a decrease of about 25% between 2008 and 2050) and warrant some clarification.

5.3 Overall assessment

On the basis of the current policies, risks of long term unbalances cannot be ruled out. The quantitative indicators examined by the Commission show that the debt to GDP ratio will continue to fall as a consequence of sustained primary surpluses and the implied reduction of interest payments. However, the outstanding level of debt still warrants attention: a failure in maintaining a high budgetary surplus during the next 10 to 15 years could put Belgium on an unsustainable path. A priori, this cannot be excluded. Pressures to reduce the tax burden or to increase some expenditure items can arise in the future, putting at risk the overall strategy. Also, some of the foreseen savings in age-related expenditures are projected partially to offset the likely increase of pension and health care expenditures, limiting the impact of ageing on public finances. Should these savings not materialise, the downward trend of the debt to GDP ratio would reverse in the medium to long term.

Maintaining sustained primary surpluses is key to improving the sustainability of public finances. Also, the improved attention on long term issues through the Strategy Report on Ageing is welcomed. The authorities have also been addressing the problem of employment creation. However, such measures will have to be complemented by a comprehensive reform of the pension system so as to reduce the primary expenditure ratio. Without such reforms, the objectives of reducing the tax ratio over the medium-term will come into conflict with that of keeping the stock of debt onto a steady downward path.

SUMMARY TABLES FROM THE 2003 UPDATED STABILITY PROGRAMME

Table A1 Main assumptions

	2003	2004	2005	2006	2007
Short-term interest rate	2.2	2.3	3.5	4.3	4.5
Long-term interest rate	4.1	4.3	4.8	5.2	5.4
USD/euro exchange rate	111.5	111.3	111.0	110.8	110.6
GDP growth – world (excl. EU)	3.2	3.7	3.8	3.8	3.8
GDP growth – EU	1.0	1.9	2.5	2.3	2.3
Growth of relevant external markets	3.0	5.8	5.9	5.5	5.4
Global imports, by volume (excl. EU)	5.4	6.6	6.7	6.7	6.7
Oil price (USD)	28.1	25.2	25.8	26.5	27.1

Table A2 Growth and associated factors

	2002 (1)	2003 (1)	2004 (1)	2005 (2)	2006 (2)	2007 (2)
Growth of GDP at constant prices	0.7	0.9	1.8	2.8	2.5	2.1
Level of GDP at current prices (in billions of euro)	260.0	268.9	278.0	290.6	302.4	312.9
GDP deflator	1.7	2.5	1.6	1.6	1.5	1.4
Change in HICP	1.6	1.6	1.4	1.4	1.4	1.4
Change in employment	-0.8	-0.1	0.7	0.9	0.9	0.6
Unemployment, Eurostat definition (as a % of active population)	7.3	8.0	8.2	8.0	7.9	7.9
Change in labour productivity	1.5	1.0	1.1	1.9	1.6	1.4
	Growth sources: change at constant prices					
1. Final consumption expenditure of individuals	0.4	1.3	1.5	2.3	2.7	1.9
2. Final consumption expenditure of general government	1.9	1.9	1.6	1.6	1.4	1.6
3. Gross fixed capital formation,	-2.5	2.1	2.9	4.6	3.4	1.4
4. Exports of goods and services	1.0	-1.1	4.8	5.5	5.1	5.0
5. Imports of goods and services	1.2	-0.1	5.0	5.4	5.4	4.8
	Contribution to growth of GDP					
6. total final demand	0.1	1.6	1.8	2.5	2.5	1.6
7. Change in stocks	0.7	0.2	0.0	0.0	0.0	0.0
8. Balance of goods and services	-0.1	-0.9	0.0	0.3	0.0	0.4

(1) Source: Federal Planning Bureau/NAI Budget, September 2003.
(2) Source: Federal Planning Bureau, Projection

Table A3 General government budgetary developments

In % of GDP	2002	2003	2004	2005	2006	2007
	Financing balance of the sub-sectors					
General government	0.1	0.2	0.0	0.0	0.0	0.3
Federal government	-0.2	0.3	-0.5	-0.3	-0.2	-0.1
Communities and regions	-0.1	0.2	0.3	0.1	0.1	0.1
Local authorities	0.2	0.1	0.1	0.1	0.0	0.2
Social security institutions	0.3	-0.4	0.1	0.1	0.1	0.1
	General government					
Total revenue	50.5	50.5	49.7	49.0	48.4	48.2
Total expenditure	50.4	50.2	49.6	49.0	48.4	47.9
Financing balance	0.1	0.2	0.0	0.0	0.0	0.3
Interest charges	6.0	5.4	5.0	4.8	4.7	4.5
Primary balance	6.1	5.6	5.1	4.8	4.7	4.8
	Main components of revenue					
Taxes	31.1	30.2	30.5	30.1	29.7	29.7
Social security contributions	16.7	16.5	16.3	16.2	16.2	16.2
Other	2.7	3.7	2.8	2.6	2.5	2.4
Total revenue	50.5	50.5	49.7	49.0	48.4	48.2
	Main components of expenditure					
Consumption expenditure (compensation & intermediate consumpt.)	15.4	15.4	15.2	15.0	14.8	14.8
Social benefits in kind	6.6	6.9	7.0	7.1	7.2	7.4
Other social benefits	16.1	16.3	16.1	15.6	15.2	15.0
Interest charges	6.0	5.4	5.0	4.8	4.7	4.5
Subsidies	1.6	1.5	1.6	1.6	1.6	1.6
Gross fixed capital formation	1.6	1.6	1.6	1.8	1.9	1.7
Other	3.1	3.1	3.1	3.1	3.1	3.0
Total expenditure	50.4	50.2	49.6	49.0	48.4	47.9

Table A4 General government debt developments

% of GDP	2002	2003	2004	2005	2006	2007
Gross debt ratio	106.1	102.3	97.6	93.6	90.1	87.0
Change in gross debt ratio	-2.7	-3.8	-4.7	-4.0	-3.5	-3.1
	Factors determining the movement in the gross debt ratio					
Primary balance	6.1	5.6	5.1	4.8	4.7	4.8
Interest charges	6.0	5.4	5.0	4.8	4.7	4.5
Nominal growth of GDP	2.4	3.4	3.4	4.5	4.1	3.5
Endogenous change in the debt	-2.7	-3.7	-3.3	-4.2	-3.7	-3.3
Other factors influencing the debt ratio	0.0	-0.1	-1.4	0.2	0.2	0.2
P.m.: implicit level of interest rates	5.7	5.3	5.1	5.1	5.2	5.2

Table A5 Cyclical developments

In % of GDP	2002	2003	2004	2005	2006	2007
1. GDP growth at constant prices	0.7	0.9	1.8	2.8	2.5	2.1
2. Actual balance	0.1	0.2	0.0	0.0	0.0	0.3
3. Interest charges	6.0	5.4	5.0	4.8	4.7	4.5
4. Potential growth of GDP	1.9	1.8	1.8	2.0	2.2	2.2
5. Output gap	0.0	-0.9	-0.9	-0.1	0.2	0.1
6. Cyclical component of the budget	0.0	-0.6	-0.6	-0.1	0.1	0.1
7. Cyclically adjusted financing balance (2-6)	0.1	0.8	0.6	0.1	-0.1	0.2
8. Cyclically adjusted primary balance (7+3)	6.1	6.2	5.6	4.9	4.5	4.8

Table A6 Divergence from previous update

In % of GDP	2002	2003	2004	2005	2006	2007
Growth of GDP						
previous update	0.7	2.1	2.5	2.5		
current update	0.7	0.9	1.8	2.8	2.5	2.1
deviation	0.0	-1.2	-0.7	0.3		
Financing balance						
previous update	0.0	0.0	0.3	0.5		
current update	0.1	0.2	0.0	0.0	0.0	0.3
deviation	0.1	0.2	-0.3	-0.5		
Gross debt ratio						
previous update	106.1	102.3	97.9	93.6		
current update	106.1	102.3	97.6	93.6	90.1	87.0
deviation	0.0	0.0	-0.3	0.0		

Table A7 Long-term sustainability of public finances

% of GDP	2002	2010	2030	2002/2030
Pensions	9.2	8.8	11.8	2.6
Health care	6.6	7.2	8.7	2.1
Pensions and health care	15.8	16.0	20.5	4.7
Other social security expenditure (1)	7.1	6.4	5.5	-1.6
Total	22.9	22.4	26.0	3.1

(1) This includes expenditure on family allowances, unemployment, early retirement pensions, industrial accidents, occupational diseases and a number of residual schemes.