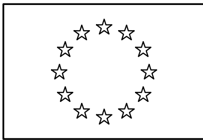

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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DECEMBER 2005 UPDATE OF THE STABILITY PROGRAMME OF BELGIUM (2005-2009)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The 2005 update of the Belgian stability programme was submitted on 5 December 2005, one week after the deadline. It covers the period 2005-2009. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[2].

In Belgium, real annual GDP growth over the last decade has been close to 2% on average, slightly above the euro area average. However, the employment rate is low (around 60%) and unemployment is characterised by significant regional disparities and a high level of long-term unemployment. Since 2000, Belgium has maintained a budgetary position close to balance.

The macroeconomic scenario presented in the programme foresees a moderate improvement of real GDP growth to 2.2% on average over the period 2006-2009 after a relatively weak performance in 2005 (1.4%), accompanied by a slow but steady growth in employment (0.7% annually). This scenario can be considered plausible and differs only marginally from that in the Commission services' autumn 2005 forecast. Towards the end of the programme period, the programme foresees a narrowing of the negative output gap. Although the inflation projections in the programme are slightly higher than in the Commission services' autumn forecast, they appear realistic given the somewhat less favourable external assumptions.

In its opinion of 17 February 2005 the Council endorsed the budgetary strategy presented in the 2004 update of the stability programme of Belgium. As regards budgetary implementation in 2005, the Commission services' autumn 2005 forecast projects a balanced general government budget for 2005, which is in line with the target in the previous update of the stability programme, despite significantly lower GDP growth. However, the statistical recording of some one-off transactions still has to be clarified with Eurostat and might lead to a large one-off increase in the 2005 deficit outcome[3].

The budgetary strategy outlined in the update aims at keeping a balanced general government position until 2006 and at building up surpluses afterwards (up to 0.7% of GDP by 2009), in order to maintain the debt ratio on a downward trend. After a gradual decline from 7.2% of GDP in 2001 to 4.3% in 2005, the primary surplus should stabilise at just above 4% of GDP from 2006 onwards. The programme foresees a decrease in the

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1 This technical analysis, which is based on information available up to 24 January 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 1 February 2006. It as been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Gerrit Bethuyne (gerrit.bethuyne@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

2 The programme does not have a separate section on institutional features of public finances. It also has gaps in the compulsory data and does not provide all optional data prescribed by the new code of conduct.

3 For the time being, the assumption of railway company debt (2.5% of GDP) by the government in 2005 has been treated without direct impact on the government deficit, while the securitisation of tax arrears in 2005 (0.2% of GDP) has been recorded as deficit-reducing.

government revenue ratio (mainly as a result of a reduction of the tax burden on labour), but this is more than compensated by a cut in the expenditure ratio (mainly interest expenditure). One-off and other temporary measures still play a significant role in 2006 (0.6% of GDP), although the Belgian authorities project that the recourse to such measures should decrease from 2006 onwards. The new update largely confirms the budgetary strategy outlined in the previous programme against a broadly similar growth outlook.

Based on Commission services' calculations on the basis of the programme, according to the commonly agreed methodology, the structural balance (i.e. cyclically adjusted, net of one-off and other temporary measures) is estimated to improve by almost 1% of GDP over the programme period. It deteriorates from zero in 2005 to a deficit of ¼% of GDP in 2006, followed by an improvement to a surplus of ½% of GDP in 2007. Thereafter, the improvement in the structural position, to a surplus of almost 1% of GDP in 2009, is more gradual. The Belgian authorities have identified a medium-term objective (MTO) as meant in the Stability and Growth Pact as a structural surplus of 0.5% of GDP, which is expected to be reached by 2007. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO can be considered appropriate under the current assessment, as it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than implied by the debt ratio and average potential output growth in the long term.

On balance, the budgetary outcomes could be worse than projected in the programme, especially in 2006-2007. While the macroeconomic scenario can be considered plausible and the government has recently introduced new measures to better control health-care expenditure, for 2006 the tax revenue envisaged in the programme appears to be on the optimistic side and the expenditure projections do not seem to provide an adequate buffer against adverse developments. For 2007 the programme does not explain how it will compensate for the expiration of a significant package of one-off and other temporary measures. However, it should be acknowledged that the Belgian authorities have in the recent past demonstrated a strong commitment to achieving their balanced budget targets.

Taking into account the risk assessment above, the budgetary stance in the programme may not be sufficient to ensure that the programme's MTO is achieved by 2007 as foreseen by the Belgian authorities. However, as stated above, the programme's MTO is more demanding than required by the Stability and Growth Pact and the programme's budgetary strategy seems sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact throughout the programme period. The budgetary stance in the programme also provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations. Although the average annual improvement in the structural balance is small, the pace of adjustment towards the MTO can be considered as broadly appropriate. In 2006, however, the adjustment is not in line with the Pact, as the structural balance is planned to deteriorate by ¼% of GDP in a situation where the output gap (though still negative) is narrowing.

The Belgian debt ratio remains well above the 60% of GDP reference value (94% of GDP at the end of 2005) but has been on an impressive downward path since 1993 (137% of GDP). After a temporary slowdown in 2005 following a debt take-over from the national railway company SNCB (of 2.5% of GDP), the debt ratio is projected to continue its decline, to below 80% of GDP by 2009. The main driver behind the decline

continues to be the high primary surplus (which however has decreased from over 7% of GDP in 2001 to over 4% in 2005). Debt developments could be less favourable than projected in the programme given the above-mentioned possibility of worse-than-anticipated budgetary outcomes. Nevertheless, the debt ratio seems to be sufficiently diminishing towards the reference value and approaches it at a rapid pace.

With regard to the sustainability of public finances, Belgium appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The current level of gross debt, while declining, remains well above the reference value and a steady reduction of the debt ratio hinges upon sustaining high primary surpluses for a prolonged period of time. The Belgian strategy of putting longer-term concerns at the heart of fiscal policy, including by reducing debt, will undoubtedly alleviate sustainability risks and the 'ageing fund law' reinforces the political commitment by setting legally binding budgetary targets. Furthermore, recent measures aimed at increasing the effective retirement age and the employment ratio should contribute positively to sustainability. However, the current budgetary position may not be sufficient to cover fully the substantial increase in expenditure due to ageing populations, underlying the importance of maintaining large primary surpluses in the coming years.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the debt ratio is being reduced at a satisfactory pace and some reforms are undertaken to improve the sustainability of the social security system. However, the deterioration of the structural balance in 2006 is not fully in line with the integrated guideline that calls for taking all necessary corrective measures to achieve the MTO.

The National Reform Programme (NRP) of Belgium, submitted on 26 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: (i) to support employment by reducing the tax burden on labour, and (ii) to keep the general government budget close to balance and to start building up surpluses from 2007 onwards, in order to maintain the debt ratio on a downward trend. However, the budgetary implications of the actions outlined in the NRP are not sufficiently reflected in the budgetary projections of the stability programme. Measures in the area of public finances envisaged in the stability programme seem to be broadly in line with the actions foreseen in the NRP.

In view of the above assessment, the budgetary position can be considered sound and the continued debt reduction envisaged in the programme provides an example of fiscal policies conducted in compliance with the Pact. However, it would be appropriate for Belgium to step up the structural adjustment in 2006 and, in the subsequent years, to identify and implement additional structural measures to reach the budgetary targets, thereby limiting the recourse to one-off measures.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	**SP Dec 2005**	**2.6**	**1.4**	**2.2**	**2.1**	**2.3**	**2.2**
	COM Nov 2005	2.6	1.4	2.1	2.0	n.a.	n.a.
	SP Dec 2004	*2.4*	*2.5*	*2.5*	*2.1*	*2.0*	*n.a.*
HICP inflation (%)	**SP Dec 2005**	**1.9**	**2.9**	**2.8**	**2.0**	**1.9**	**1.7**
	COM Nov 2005	1.9	2.7	2.6	1.9	n.a.	n.a.
	SP Dec 2004	*1.9*	*2.0*	*1.8*	*1.8*	*1.8*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2005[1]**	**-0.2**	**-0.8**	**-0.6**	**-0.6**	**-0.5**	**-0.4**
	COM Nov 2005[2]	-0.1	-0.8	-0.8	-1.0	n.a.	n.a.
	SP Dec 2004[1]	*-0.8*	*-0.5*	*-0.2*	*-0.4*	*-0.5*	*n.a.*
General government balance (% of GDP)	**SP Dec 2005**	**0.0**	**0.0**	**0.0**	**0.3**	**0.5**	**0.7**
	COM Nov 2005	0.0	0.0	-0.3	-0.5	n.a.	n.a.
	SP Dec 2004	*0.0*	*0.0*	*0.0*	*0.3*	*0.6*	*n.a.*
Primary balance (% of GDP)	**SP Dec 2005**	**4.8**	**4.3**	**4.1**	**4.2**	**4.1**	**4.1**
	COM Nov 2005	4.8	4.4	3.8	3.4	n.a.	n.a.
	SP Dec 2004	*4.9*	*4.5*	*4.4*	*4.5*	*4.7*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2005[1]**	**0.1**	**0.4**	**0.3**	**0.6**	**0.8**	**0.9**
	COM Nov 2005	0.1	0.4	0.1	0.0	n.a.	n.a.
	SP Dec 2004[1]	*0.5*	*0.3*	*0.1*	*0.5*	*0.9*	*n.a.*
Structural balance[3] (% of GDP)	**SP Dec 2005[4]**	**n.a.**	**0.0**	**-0.3**	**0.4**	**0.7**	**0.9**
	COM Nov 2005[5]	-0.6	0.0	-0.4	0.0	n.a.	n.a.
	SP Dec 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2005**	**94.7**	**94.3**	**90.7**	**87.0**	**83.0**	**79.1**
	COM Nov 2005	96.2	94.9	91.1	88.1	n.a.	n.a.
	SP Dec 2004	*96.6*	*95.5*	*91.7*	*88.0*	*84.2*	*n.a.*

Notes:
[1]Commission services calculations on the basis of the information in the programme
[2]Based on potential growth of 2.0%, 2.1%, 2.1% and 2.3% respectively in the period 2004-2007
[3]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures
[4]One-off and other temporary measures taken from the programme (0.4% of GDP in 2005 and 0.6% in 2006; all deficit-reducing). The figures for the one-off measures from 2007 onwards (0.2% in 2007, 0.1% in 2008 and 0.0% in 2009) were provided by the Belgian authorities after the submission of the programme with the caveat that they "should be considered as assumptions and do not prejudge any decision by the Belgian authorities".
[5]One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (0.4% of GDP in 2005 and 0.5% in 2006; all deficit-reducing)

Source:
Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Belgian 2005 stability programme update was approved by the Belgian government on 2 December 2005 and submitted on 5 December 2005[4] to the Commission. It incorporates the results of the 2006 budget proposal, as approved by Parliament on 15 December. The programme covers the period 2005-2009.

The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct, although a separate section on institutional features of public finances is missing (section 7 of the code of conduct). However, some information on these issues has been provided in other sections. The programme also has some gaps in the compulsory[5] and optional data prescribed by the new code of conduct, but the missing variables are not essential for the assessment of the programme. Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

Over the last decade annual real GDP growth has been close to 2.1% on average, slightly above the average for the euro area. Until 2004 HICP inflation remained moderate (around 1.7% on average), but recently consumer prices reacted more sharply to the increase in oil prices than in the rest of the euro area, with an inflation rate of 2.9% in 2005. The employment rate is low (around 60%), especially for young and older people. Meanwhile the (harmonised) unemployment rate has remained fairly constant since 1995 (around 8%), below the average of the euro area (8.9%). However, unemployment is characterised by significant regional disparities and a high level of long-term unemployment. Labour productivity has grown at the speed of the EU average over the last decade, but the level is among the highest of the EU.

The macroeconomic scenario presented in the update foresees a moderate improvement of GDP growth from 2006 onwards (with real GDP growth around 2.2%) after a relatively weak performance in 2005. Final domestic demand is the main driver behind economic growth in 2006, but from 2007 onwards the programme also projects an increase in net external demand. The output gap (calculated by the Commission services based on the information in the programme) is expected to remain negative throughout the programme period, but to narrow slowly from 2007 onwards.

Overall the macroeconomic scenario differs only marginally from the Commission services' autumn forecast. The anticipated growth rate until 2007 is nearly identical, although the Commission services' forecast anticipates a more rapid increase in the contribution from external demand. Both the autumn forecast and the programme foresee a moderate growth of private consumption expenditure (slightly above 1.5% in 2006), although the projected compensation of employees is somewhat higher in the programme. The latter assumption can partly be explained by the programme's inflation projections, which also exceed the Commission services' forecast. As for the outer years

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4 The English translation was received on 16 December 2005.

5 The programme correctly reports interest expenditure including FISIM, but it does not provide separate information on the share of FISIM in interest expenditure (table 2 of the code of conduct). The programme does not mention the nominal effective exchange rate (table 8).

of the programme period, the update anticipates a real GDP growth that is very close to the potential growth rate estimated in the Commission services' autumn forecast (2.3% in 2007, the last available year in the forecast). Therefore, the growth assumptions presented in the programme can be considered plausible.

The external outlook behind the programme slightly differs from the assumptions of the Commission services' forecast. In particular, it assumes a slightly stronger euro and somewhat higher oil prices, and lower interest rates for 2006.

The labour market developments assumed in the programme are nearly identical to the Commission services' forecast, with a fairly constant employment-to-GDP ratio, close to the historical average. The update foresees that employment is accelerating slightly towards the end of the programme period, as the output gap narrows. Correspondingly, the unemployment rate decreases. Nevertheless, employment developments remain vulnerable in light of the strong wage moderation in the neighbouring countries (especially Germany). In a system with automatic wage indexation and social agreements fixing real wage increases, higher-than-expected inflation could lead to a loss in competitiveness and employment growth. Finally, HICP-inflation in the programme is plausible although slightly higher than in the autumn forecast, which is in line with the somewhat less favourable assumptions on oil prices.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		**2006**		**2007**		**2008**	**2009**
	COM	**SP**	**COM**	**SP**	**COM**	**SP**	**SP**	**SP**
Real GDP (% change)	1.4	1.4	2.1	2.2	2.0	2.1	2.3	2.2
Contributions:								
- Final domestic demand	1.9	1.8	1.9	2.2	1.8	1.7	2.1	2.0
- Change in inventories	-0.1	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0
- External balance on g&s	-0.4	-0.3	0.3	0.0	0.3	0.4	0.2	0.2
Output gap[1]	-0.8	-0.8	-0.8	-0.6	-1.0	-0.6	-0.5	-0.4
Employment (% change)	0.7	0.7	0.6	0.7	0.7	0.7	0.9	0.8
Unemployment rate (%)	8.0	7.8	7.9	7.8	7.8	7.8	7.6	7.5
Labour productivity growth (%)	0.8	0.7	1.4	1.5	1.3	1.3	1.4	1.4
HICP inflation (%)	2.7	2.9	2.6	2.8	1.9	2.0	1.9	1.7
GDP deflator (% change)	2.6	2.4	2.3	2.3	1.9	2.0	2.1	1.9
Compensation of employees (% change)	3.5	3.9	3.6	4.1	3.3	4.0	4.6	4.6
External balance (% of GDP)	3.0	2.6	3.1	3.1	3.3	3.4	3.8	4.1

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

Source:
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)

As shown in Table 2, the potential growth rate (calculated by the Commission services according to the commonly agreed methodology based on the information in the programme) increases slowly towards 2007-2008 after which it decreases again. Overall, the potential growth based on the information in the programme is very close to the estimate in the Commission services' autumn forecast, although there are some differences in the decomposition of the potential growth rate: the contribution of labour is generally larger on the basis of the information in the stability programme, whereas the contribution of total factor productivity is lower.

Table 2: Sources of potential output growth

	2005		2006		2007		2008	2009
	COM	SP[2]	COM	SP[2]	COM	SP[2]	SP[2]	SP[2]
Potential GDP growth[1]	2.1	2.0	2.1	2.0	2.3	2.1	2.2	2.0
Contributions:								
- Labour	0.3	0.6	0.2	0.5	0.3	0.7	0.7	0.5
- Capital accumulation	0.6	0.5	0.6	0.5	0.6	0.5	0.5	0.5
- TFP	1.2	0.9	1.2	0.9	1.3	1.0	1.0	1.0

Notes:
[1]based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

As regards the sectoral balances, the external balance projected in the programme (Table 1) is largely in line with the assumptions from the macroeconomic scenario in the programme. Belgium currently has a net-lending position towards the rest of the world (about 3.1% of GDP in 2004), which according to the programme is expected to deteriorate slightly in 2005. From 2006 onwards it should improve again to reach 4.1% of GDP by the programme horizon. As for the private sector balance, after a slight decrease of the net-lending position, it is expected to gradually improve again towards 2009, which is also in line with the programme's macroeconomic scenario and (until 2007) with the Commission services' autumn forecast. Therefore, the overall development of sectoral balances appears to be broadly consistent with the macroeconomic scenario assumed in the programme.

3. General government balance

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous stability programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

3.1. Targets in successive programmes and implementation in 2005

The current update of the stability programme aims at maintaining a balanced budget (in general government terms) until 2006 and at gradually building up surpluses starting from 2007. Table 3 and Figure 1 provide an overview of the evolution of budgetary targets in successive updates of the programme. In terms of the general government balance projections until 2007, there is no difference between the current and previous two updates despite downward revisions of GDP growth (especially for 2005). However, the surplus envisaged for 2008 has been slightly reduced, despite an improvement in the anticipated GDP growth rate (2.3% against 2.0% assumed in the previous update). The revenue and expenditure projections (as a percentage of GDP) in the current update remain close to the projections in the previous programme.

As for the budgetary implementation in 2005, on 5 January 2006 the government confirmed that it expects a a balanced budget (for the general government) has been

reached, as also estimated in the programme and in the Commission services' autumn forecast. However, the outcome depends on the approval by Eurostat of the statistical treatment of a number of operations. For the time being, the assumption of a 2.5% of GDP debt from the national railway company SNCB by the government has been treated without direct impact on the government deficit, while the securitisation of tax arrears (0.2% of GDP) has been recorded as deficit-reducing. Should Eurostat decide that such operations should be recorded differently, the deficit for 2005 could increase by up to 2.7% of GDP. Fiscal revenue was not as much affected by the growth slowdown as could have been expected. Moreover, substantial budgetary overruns in health care expenditure in 2004 (7.8% real growth against a planned 4.5%) appear adequately curtailed by structural measures taken in 2005. These include promoting the role of the general practitioner, controlling drug expenditure, and promoting good practice regarding medical prescription, the use of specialists and heavy medical equipment.

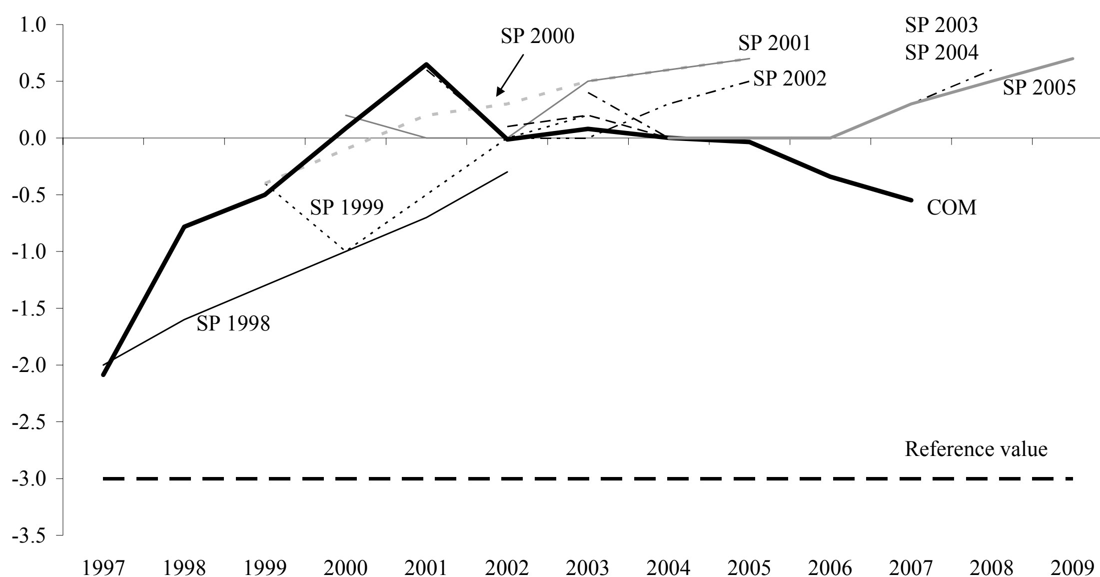
Nevertheless, in order to achieve the balanced budget target for 2005, the government decided - after the submission of the stability programme - to include close to 0.2% of GDP in additional one-off measures by taking over pension obligations from the state railway company SNCB and the Antwerp port authorities. Therefore, the total impact of one-offs in 2005 is estimated at about 0.5% of GDP (against 0.4% as mentioned in the update).

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008	2009
General government balance (% of GDP)	**SP December 2005**	**0.0**	**0.0**	**0.0**	**0.3**	**0.5**	**0.7**
	SP December 2004	0.0	0.0	0.0	0.3	0.6	n.a.
	SP November 2003	*0.0*	*0.0*	*0.0*	*0.3*	*n.a.*	*n.a.*
	COM Nov 2005	0.0	0.0	-0.3	-0.5	n.a.	n.a.
General government expenditure (% of GDP)	**SP December 2005**	**49.4**	**49.7**	**49.4**	**48.9**	**48.3**	**48.0**
	SP December 2004	49.6	49.4	49.0	48.8	48.5	n.a.
	SP November 2003	*49.6*	*49.0*	*48.4*	*47.9*	*n.a.*	*n.a.*
	COM Nov 2005	50.2	49.8	49.3	48.8	n.a.	n.a.
General government revenues (% of GDP)	**SP December 2005**	**49.4**	**49.7**	**49.4**	**49.2**	**48.8**	**48.7**
	SP December 2004	49.6	49.4	49.0	49.1	49.1	n.a.
	SP November 2003	*49.7*	*49.0*	*48.4*	*48.2*	*n.a.*	*n.a.*
	COM Nov 2005	50.2	49.8	49.0	48.2	n.a.	n.a.
Real GDP (% change)	**SP December 2005**	**2.6**	**1.4**	**2.2**	**2.1**	**2.3**	**2.2**
	SP December 2004	2.4	2.5	2.5	2.1	2.0	n.a.
	SP November 2003	*1.8*	*2.8*	*2.5*	*2.1*	*n.a.*	*n.a.*
	COM Nov 2005	2.6	1.4	2.1	2.0	n.a.	n.a.

Source:
Stability programmes (SP) and Commission services' autumn 2005 economic forecasts (COM)

Figure 1: General government balance projections in successive stability programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive stability programmes

3.2. The programme's medium-term budgetary strategy

This section covers the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

3.2.1. The main goal of the programme's budgetary strategy

The budgetary strategy outlined in the update aims at keeping the general government budget close to balance and at creating a nominal surplus towards the end of the programme period, in order to maintain the debt ratio on a downward trend to prepare for the ageing shock ahead.

Table 4 illustrates the objectives contained in the current update. They include a balanced budget for 2005 and 2006 and thereafter a surplus that rises from 0.3% of GDP in 2007 to 0.5% in 2008 and 0.7% in 2009, mainly as a result of reduced interest expenditure. In 2005, the primary surplus decreased by 0.5% of GDP compared to the previous year, which is slightly more than anticipated in the previous update. In 2006 it is expected to deteriorate further, to just above 4% of GDP, and to remain at that level throughout the rest of the programme period. As mentioned above, the new update broadly confirms the budgetary strategy (and targets) outlined in the previous programme against the background of a similar growth outlook.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2005
Revenues	49.4	49.7	49.4	49.2	48.8	48.7	**-1.0**
of which:							
- Taxes	30.5	30.9	30.8	30.7	30.4	30.2	**-0.7**
- Social contributions	16.3	16.1	16.0	16.0	15.9	15.9	**-0.2**
- Other (residual)	2.6	2.7	2.6	2.5	2.5	2.6	**-0.1**
Expenditure	49.4	49.7	49.4	48.9	48.3	48.0	**-1.7**
of which:							
- Primary expenditure	45.1	45.4	45.3	45.0	44.7	44.6	**-0.8**
of which:							
Collective consumption	15.7	15.8	15.7	15.6	15.5	15.4	**-0.4**
Transfers & subsidies	24.4	24.6	24.6	24.6	24.6	24.5	**-0.1**
Gross fixed capital formation	1.6	1.8	1.8	1.7	1.7	1.6	**-0.2**
Other (residual)	3.4	3.2	3.2	3.1	2.9	3.1	**-0.1**
- Interest expenditure	4.8	4.3	4.1	3.9	3.6	3.4	**-0.9**
General government balance (GGB)	**0.0**	**0.0**	**0.0**	**0.3**	**0.5**	**0.7**	+0.7
Primary balance	**4.8**	**4.3**	**4.1**	**4.2**	**4.1**	**4.1**	-0.2
One-off and other temporary measures[1,2]	n.a.	0.4	0.6	0.2	0.1	0.0	-0.4
GGB excl. one-off & other temporary measures	**n.a.**	**-0.4**	**-0.6**	**0.1**	**0.4**	**0.7**	**+1.1**

[1] One-off measures for 2005 were taken from the programme and do not include new measures taken after the submission of the programme, which would increase the total impact of one-off measures by about 0.1% of GDP.
[2] The figures for the one-off measures from 2007 onwards were provided by the Belgian authorities after the submission of the programme with the caveat that they "should be considered as assumptions and do not prejudge any decision by the Belgian authorities".

Source:
Stability programme update; Commission services' calculations

3.2.2. The composition of the budgetary adjustment in the programme

The update foresees that government revenue will decrease by 1% of GDP over the programme period, but this should be more than offset by a 1.7% of GDP reduction in expenditure. The corresponding budgetary improvement primarily stems from reduced interest expenditure (-0.9% of GDP over the programme period), resulting from the ongoing debt reduction and the refinancing of existing debt at lower interest rates. The implicit interest rate decreased by 0.4 percentage points to 4.7% in 2005 and is expected to decrease further to 4.3% by the end of the programme period. Meanwhile the programme assumes that the market interest rate will increase from 3.3% in 2006 towards 5.3% in 2009, in line with the assumptions from the previous update of the stability programme.

The programme also foresees a decline in primary expenditure by 0.8% of GDP, half of which is the result of reduced collective consumption, without explaining how this reduction will be achieved. Gross fixed capital formation (which is typically subject to a strong electoral cycle) is projected to remain high in 2005 and 2006 in the run-up to the 2006 local elections and to return to a more moderate level afterwards. Nevertheless, part of the budgetary margin created through reduced expenditure is used to allow for a continuous decrease of government revenue (by 1.0% of GDP until 2009), partly due to the impact of the 2001 direct tax reform which will reach its final stage in 2006 (with an

additional negative budgetary impact of 0.5% of GDP)[6] and continued planned efforts to reduce social contributions on labour (see also Box 1 on the 2006 budget).

One-off measures continue to play a significant role in the budgetary projections. For 2005 the programme mentions some real estate operations (0.2% of GDP) and the securitisation of direct tax arrears[7] (0.2%). Together with the additional one-off measures decided after the programme was submitted (mentioned earlier and not included in Table 4), the total impact of one-offs would be about 0.5% of GDP. In 2006 a new series of one-off measures is planned for about 0.6% of GDP (see Box 1), but the authorities project a decrease in the recourse to one-off measures from 2007 onwards.

Excluding the impact of one-off and other temporary measures and the declining interest burden, the adjustment over the programme period is just ¼% of GDP. Moreover, the pace of adjustment is very uneven. While the general government balance excluding one-off and other temporary measures decreases in 2006 by almost 0.2% of GDP, it is projected to improve by 0.7% of GDP in 2007 (although the programme does not include precise measures that can account for this anticipated improvement).

Box 1: The budget for 2006

The draft budget for 2006 was presented on 11 October 2005 and was approved by parliament on 15 December. The budget targets a balanced general government budget in 2006. It includes the final stage of the 2001 direct tax reform (which would further reduce direct tax revenue by 0.5% of GDP from 2006 onwards) and the impact of some recent measures to further reduce social contributions (0.1% of GDP).

To compensate for these losses in income, the 2006 budget plans a strict control of primary expenditure to limit real growth of federal public services to 0.3% (with exceptions for certain priority areas like mobility, justice and security). After a serious overrun of health care expenditure in 2004 (7.8% real growth against a projected 4.5%), a series of measures were introduced in the course of 2005 to curb expenditure growth. On the revenue side, the main consolidation measures include new taxes on the income from certain mutual investment funds and on premiums for life-insurance products (estimated at some 0.2% of GDP). These new taxes have been supplemented with a significant package of one-off measures (close to 0.6% of GDP). These include several real-estate operations (0.2% of GDP) and a new fiscal regularisation procedure (0.1%). The 2006 budget also considers the proceeds from the securitisation of VAT arrears (0.2%) as deficit-reducing, but for the moment the accounting treatment of similar operations is still being discussed with Eurostat.

Since the government aims to maintain the social security system in balance, it has also taken measures to reinforce its structural funding and to make the system less dependent on social contributions on labour. From 2006 onwards additional revenue stemming from excise duties on tobacco and a levy on income from financial assets will be assigned to the social security system. Although this reinforces the social security system as such, the measure has no effect on the general government balance. Finally, the federal government also reached an agreement with the regional authorities to limit their expenditure in 2006, against a relaxation in future years.

[6] In 2001, the Belgian government approved a reform of household direct income tax to be implemented progressively on taxable income earned in the years 2001-2004, which would lower tax revenue by 1½ % of GDP in total. A new steady state will prevail as from 2006, the first year in which taxpayers will receive the full benefits of the reform (income earned in 2004 is subject to a tax withheld at source, but the final amount of tax due is known and settled only in 2006, hence there is also an impact on 2006 tax revenue).

[7] As mentioned earlier, the statistical treatment of the securitisation operations (as well as a debt-transfer from SNCB, the railway company) is still being discussed with Eurostat.

The gradual move from a balanced budget in 2005 and 2006 to an increasing surplus in subsequent years is expected to be mainly supported by the federal government and (to a lesser extent) by the local authorities. For the moment the federal and local governments are still showing a small deficit (estimated at 0.1% of GDP each in 2005), while the social security sector and the regional governments present a small surplus (0.1% each). However, expenditure by local authorities should decrease after the 2006 local elections, while the federal government will benefit most from reduced interest payments (90% of total government debt is issued by the federal government with interest payments representing over ⅓ of its expenditure). By the end of the programme period, the update projects that each government subsector records either a balanced budget (for the regional level) or a surplus (for all other subsectors, but mainly at the federal level). This reliance on all subsectors of general government is in line with Belgium's recent history of successful fiscal consolidation (see also Box 2).

3.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The Belgian authorities have identified a medium-term objective (MTO) as meant in the Stability and Growth Pact of 0.5% of GDP, which they expect to reach by 2007. Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the improvement in the structural balance is close to 1% of GDP between 2005 and 2009 (excluding interest expenditure, the structural position is unchanged). In 2006, the structural balance would deteriorate to a deficit of 0.3% of GDP from a balanced position in 2005, owing partly to reduced income from direct taxes (as a result of the final stage of the implementation of the 2001 direct tax reform), and an increased recourse to one-off measures in the 2006 budget. The fiscal effort is mainly concentrated in 2007, for which the Belgian authorities project a significant improvement (by 0.7% of GDP) of the structural balance. The programme refers to the improvement of the fiscal balances of local authorities after the 2006 local elections and reduced interest payments as contributing factors to this improvement, but this only explains some 0.3% of GDP of the improvement. From 2007 onwards, the structural balance continues to slowly improve, mainly as a result of reduced interest payments. According to the programme, the proposed adjustment path would allow to approach the MTO from 2007 onwards.

Table 5: Output gaps, cyclically-adjusted and structural balances

	2004		2005		2006		2007		2008	2009	Change: 2009-2005
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance	0.0	0.0	0.0	0.0	-0.3	0.0	-0.5	0.3	0.5	0.7	+0.7
One-offs[2]	0.8	n.a.	0.4	0.4	0.5	0.6	0.0	0.2	0.1	0.0	-
Output gap[3]	-0.1	-0.2	-0.8	-0.8	-0.8	-0.6	-1.0	-0.6	-0.5	-0.4	+0.4
CAB[4]	0.1	0.1	0.4	0.4	0.1	0.3	0.0	0.6	0.8	0.9	+0.5
change in CAB	-0.4	n.a.	0.3	0.3	-0.3	-0.1	-0.1	0.3	0.0	0.2	-
CAPB[4]	4.9	4.9	4.9	4.7	4.2	4.4	3.9	4.5	4.4	4.3	-0.4
Structural balance[5]	-0.7	n.a.	0.0	0.0	-0.4	-0.3	0.0	0.4	0.7	0.9	+0.9
change in struct. bal.	0.1	n.a.	0.7	n.a.	-0.4	-0.3	0.4	0.7	0.2	0.2	-
Struct. prim. bal.[6]	4.1	n.a.	4.5	4.3	3.7	4.0	3.9	4.3	4.3	4.3	0.0

Notes:
[1]Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures. The figures for the one-off measures from 2007 onwards were provided by the Belgian authorities after the submission of the programme, with the caveat that they "should be considered assumptions and do not prejudge any decision by the Belgian authorities".
[3]In percent of potential GDP (see Table 1 above)
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.
[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

3.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

3.3.1. Appropriateness of the programme's medium-term objective

As the MTO chosen by the Belgian authorities is more demanding than the minimum benchmark (estimated at a deficit of just over 1% of GDP in the case of Belgium), it fulfils the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than what would be implied by the debt ratio and average potential output growth in the long term. This choice of MTO is part of Belgium's forward-looking strategy to prepare for the ageing shock ahead by building up surpluses and reducing the debt ratio.

3.3.2. Risks attached to the budgetary targets

Overall there is a risk that the budgetary outcomes could be worse than targeted. While the risks related to the macroeconomic scenario seem minor (the outlook used in the programme can be considered as plausible and differs only marginally from the Commission services' autumn forecast), there are the following downside risks:

- The 2006 budget law counts on strict expenditure restraint by the federal government (see also Box 1), which appears somewhat optimistic, as the budget provides almost no margin against possible adverse developments. Moreover, as pointed out by the

Belgian Court of Audit, the budget also does not foresee funds for some expenses that can be anticipated for 2006 [8].

- As illustrated in Table 6, the assumptions about the tax intensity of economic activity appear plausible, except perhaps for 2006. While the loss in revenue linked to the final stage of the 2001 direct tax reform and reductions in social contributions has been partly compensated in the 2006 budget by new measures to levy taxes on the proceeds from certain investment funds and insurance products, the Commission services' autumn forecast estimated total taxes in 2006 to be lower (by 0.6 percentage points) than projected in the programme. Differences can be partly explained by the Commission services' lower estimates of revenue from the newly introduced taxes (which is still somewhat uncertain) and personal income tax (which may turn out somewhat lower due to the sale of tax arrears in 2005). However, as presented in Annex 4 it mainly stems from rather optimistic assumptions on taxes on production and imports (for which the programme implies an elasticity of taxes to tax base of 1.8, against 1.1 in the Commission services forecast).
- As mentioned earlier, there are also some risks attached to the statistical recording of a transfer of railway company debt (2.5% of GDP) and the securitisations of tax arrears of (0.2% of GDP), both in 2005. For 2006 the government foresees a new securitisation operation of 0.2% of GDP, which is subject to the same risk. However, as these operations are one-off measures, a reclassification will only affect the budgetary outcome of 2005 and 2006, without a carry-over effect to the following years.
- As for 2007, when the largest improvement in the structural position is planned to take place, the programme does not fully explain which structural measures will be taken to compensate for the expiration of the package of one-off measures in the 2006 budget of 0.6% of GDP (mainly a number of real-estate operations, the securitisation of VAT-arrears and the fiscal regularisation procedure). The programme mentions reduced spending by local authorities (after the 2006 local elections, by 0.2% of GDP) and reduced interest expenditure (0.2% of GDP), but these are partly offset by the planned reduction in social contributions (0.2%). Therefore it is still unclear how the government plans to realise the structural improvement of 0.7% of GDP projected in the programme.

Nevertheless, it should be acknowledged that in recent years the Belgian authorities have established a good track record by achieving their balanced budget targets. Belgium has set up an efficient and relatively transparent framework to enforce budgetary discipline at all levels of government, which resulted in a significant improvement of the budgetary position, evenly spread over the different levels of government (see also Box 2).

In the light of the above, the budgetary targets set in the programme can be considered ambitious, although they are not necessarily out of reach. However, in order to achieve them some additional structural efforts will be required, especially in 2006 and 2007 (which is an election year for the national parliament).

[8] For example, the Belgian Court of Audit reports that in 2006 the Belgian state could be condemned in a number of court cases to pay damages (up to 0.05% of GDP).

Table 6: Assessment of tax projections

	2006		2007		2008	2009	p.m.: OECD[1]
	COM	SP	COM[2]	SP	SP	SP	
Total taxes Change in tax-to-GDP ratio	-0.8	-0.1	-0.3	-0.3	0.0	0.0	/
Difference	0.6		0.0		/	/	/
of which[3]: - elasticity component	0.6		0.0		/	/	/
- composition component	0.1		0.0		/	/	/
p.m.: Observed elasticity to GDP	0.6	1.0	0.8	0.8	0.8	0.9	1.0

Notes:
[1]OECD ex-ante elasticity relative to GDP
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Box 2: Fiscal federalism in Belgium

Belgium has managed to reduce its high deficit of around 8% of GDP in the nineties to a balanced budget since 2000, which has resulted in an impressive reduction of the debt ratio from 137% of GDP in 1993 to about 95% in 2005. The deficit reduction, which benefited from a decline in interest rates, went hand in hand with a process of fiscal decentralisation which started as early as 1970, but only became fully operational with the adoption of the 'Special Financing Law' in 1989.

The expenditure by regional entities (regions and communities) now represents over 11% of GDP. Meanwhile federal expenditure (excluding social security, which represents close to 20% of GDP) is less than 12% of GDP (of which over one-third goes to interest expenditure), against almost 30% of GDP in 1988. The debt remained largely at the federal level. In 1989 less than 3% of all government debt (standing at about 130% of GDP at that time) was transferred to the regions and communities.

Starting from 1989, regions and communities also inherited part of the substantial federal deficits. Their combined deficit peaked in 1992 at 1% of GDP, but since then their deficits have generally followed a downward trend. In 1997, the Flemish budgetary balance entered positive territory and its surplus soon became large enough to compensate for the deficits of other regions and communities. At the same time, the federal deficit was brought down from over 7% of GDP in 1992 to less than 0.5% of GDP in recent years.

This result required clear budgetary targets for all levels of government and an efficient mechanism to enforce them. In Belgium, a key role has been played by the 'Public Sector Borrowing Requirements' section of the Belgian High Finance Council (HFC), set up as part of the 1989 Special Financing Law. It is composed of high-level experts from ministries, the National Bank, the Federal Planning Bureau and academia. Its members have a renewable five-year mandate which is incompatible with a political office to ensure the Council's independence, and the chairman is an academic.

Every year the HFC produces an analysis of the borrowing requirements of the regional entities and the budgetary policy to be adopted, including recommendations on the budget balances of the various levels of government and an annual ex-post evaluation of the implementation of the stability programme. Unfortunately, in 2005 the 'Public sector borrowing requirements' section did not produce an annual report, because the Belgian authorities have not yet replaced some of its members after their mandate expired.

The HFC recommendations and ex-post evaluation of the implementation of the stability programme unquestionably played a major role in achieving Belgium's fiscal consolidation. They created a transparent system with clear objectives and the opportunity to 'name and shame'

authorities that did not meet their targets. This imposes discipline and helps policy makers to resist pressures to increase expenditure. The HFC recommendations also form the basis of a series of 'budgetary conventions', which take the form of political agreements between governments at federal and regional level. They set the medium-term budgetary targets and act as internal stability programmes. Until 1997 they were also integrated in the Belgian convergence programme and since then have been integrated in the Belgian stability programmes. Overall, regions and communities have demonstrated a strong commitment to stick to the medium-term targets set in the conventions and usually perform better than planned.

See also: Gerrit Bethuyne, Federalisation and fiscal consolidation: the Belgian experience, ECFIN Country Focus Series, Volume II, Issue 16, September 2005.
http://www.ecfineuropa.cec/comm/economy_finance/publications/countryfocus_en.htm

3.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Taking into account the risk assessment above, the budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO will be reached within the programme period, although its achievement could be somewhat later than targeted and may require some additional consolidation efforts in 2006 and 2007. In any case, it seems sufficient to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact throughout the programme period. The programme also offers a sufficient safety margin against breaching the 3% of GDP threshold for the deficit with normal cyclical fluctuations.

As for the adjustment towards Belgium's MTO, the annual improvement in the structural balance is less than the 0.5% of GDP "benchmark" for euro-area (and ERM II) Member States set in the Pact. However, the adjustment path can be considered as broadly appropriate, except in 2006 since there is a deterioration of the structural balance (by 0.3% of GDP according to the information in the programme, or even by 0.4% of GDP according to the Commission services' autumn forecast). The lack of progress in 2006 reflects the implementation of the final stage of the 2001 direct tax reform (with an estimated impact of 0.5% of GDP) and reductions in social contributions (0.1% of GDP). These revenue losses are planned to be partly financed by several new taxes, but also by a number of one-off measures which do not contribute to an improvement of the structural balance.

As regards the pace of the structural adjustment in good versus bad times, the output gap is negative throughout the programme period (see Table 5 above). It remains relatively stable until 2007 (at about -1% of GDP according to both the programme's and the Commission services' projections) and then gradually narrows towards the end of the programme period. This points to the prevalence of bad rather than good times. Concerning tax elasticities, the relatively low estimates of tax revenue (indicated by the comparison of the observed and ex ante tax elasticities in Table 7) mainly reflect discretionary measures in direct income taxes and social contributions mentioned before. This is confirmed in more detail in Annex 4, which contains the assessment of the tax elasticities by major tax category. The observed change in the tax-to-GDP ratio net of the effect of discretionary measures appears to be close to the one implied by the OECD elasticities.

Table 7: Assessment of tax elasticities

	2006		2007	
	COM (observed)	**ex-ante**[1]	**COM**[2] **(observed)**	**ex-ante**[1]
Total taxes Change in tax-to-GDP ratio	-0.8	0.0	-0.3	0.0
Difference	0.7		0.3	
of which[3]*: - elasticity component*	0.8		0.5	
- composition component	0.0		-0.1	
p.m.: Elasticity to GDP	0.6	1.0	0.8	1.0

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

The strategy for the general government balance is broadly consistent with the broad economic policy guidelines in this area (see integrated guideline No 1 in Annex 3), except for the adjustment towards the MTO in 2006, which is negative (there is a structural deterioration).

3.4. Sensitivity analysis

The programme provides a sensitivity analysis for the nominal budgetary targets with respect to changes in interest rates and economic growth. As regards the sensitivity to interest rate variations, the programme reports simulations of the effect of an increase by 1 percentage point above the central scenario. The anticipated effect is estimated to be an increase of 0.1% of GDP in interest payments in 2006, gradually increasing to 0.4% of GDP towards the programme horizon. The relatively slow impact of interest rate increases is explained by the term structure of Belgian government debt, which contains some 85% long-term debt. The programme's estimate of the effect of different growth scenarios is based on sensitivities of revenue and expenditure estimated by the OECD (which are also used by the Commission services). Based on the overall sensitivity of public finances of 0.54, the programme reports the general government balance corresponding to the potential growth rate, and to a growth rate which is 0.5 percentage point above/below the central scenario in the update. In the worst case of a 0.5 percentage point growth deceleration, the anticipated budgetary impact would be -0.26% of GDP. Overall, the results of the sensitivity analyses reported in the programme can be considered plausible.

Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2009 period; (ii) trend output based on the HP-filter[9] and (iii) no policy response (notably, the expenditure level is as in the central scenario[10]), reveal that, by 2009, the cyclically-adjusted balance would be 0.8 percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.8 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.[11]

4. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

4.1. Debt developments in the programme

The Belgian debt ratio remains very high, but has been on a steady downward path since 1993 (see also Figure 2). This mainly stems from high – though declining – primary surpluses. Moreover, the debt development also benefited from decreasing interest rates. The estimated debt ratio at the end of 2005 is somewhat better than anticipated in the 2004 update of the stability programme, but this is entirely the result of the upward revision of GDP of October 2005 by about 1.5% due to the inclusion of FISIM (financial intermediation services indirectly measured) and correspondingly reduced the debt ratio by about 1.4% in 2005. It is somewhat worse than projected in the Commission services' autumn forecast on account of a higher stock-flow adjustment.

As already anticipated in the previous update of the stability programme, the continuous reduction of government debt was somewhat slowed down in 2005, mainly as a result of the assumption of a EUR 7.4 billion (2.5% of GDP) debt from the national railway company SNCB by the government.

Over the programme period, the debt ratio is expected to remain on a downward path, falling by a substantial 15 percentage points of GDP to below 80% of GDP by 2009. Primary surpluses remain the driving force behind the projected debt reduction, although they have been decreasing in recent years (from 7.2% of GDP in 2001 to 4.3% in 2005). For the future, the update does not foresee any major operations (such as privatisations, or other debt assumptions) with a large impact on the debt.

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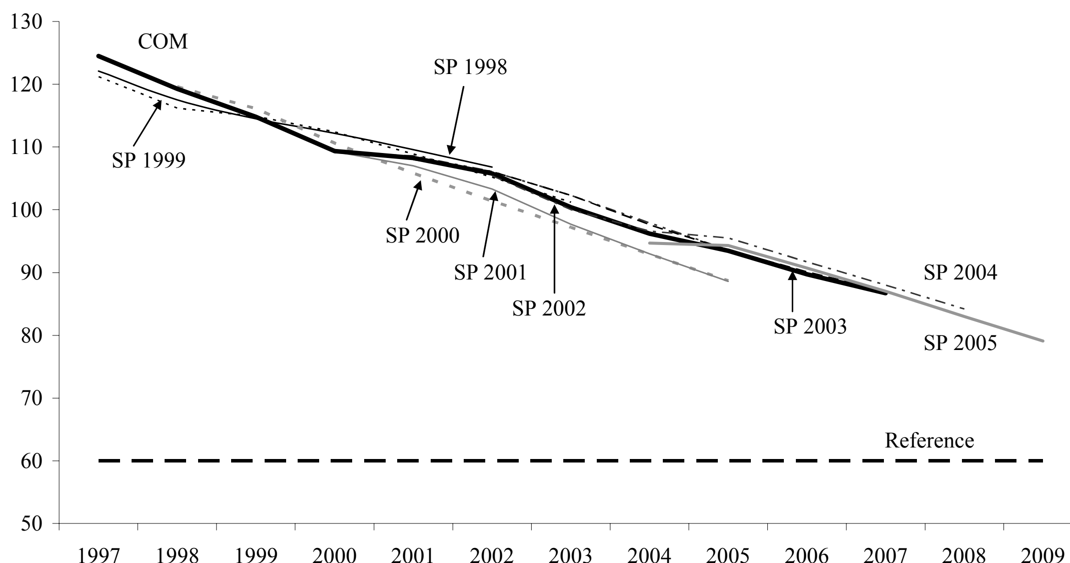
[9] In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[10] The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

[11] Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

Figure 2: Debt projections in successive stability programmes (% of GDP)



Source : Commission services' autumn 2005 forecast (COM) and successive stability programmes

Table 8: Debt dynamics

	average 2000-2004	2005		2006		2007		2008	2009
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	102.1	93.4	94.3	89.7	90.7	86.8	87.0	83.0	79.1
Change in debt ratio (1 = 2+3+4)	-3.8	-1.3	-0.4	-3.7	-3.6	-2.9	-3.7	-4.0	-3.9
Contributions:									
- **Primary balance** (2)	-6.0	-4.4	-4.3	-3.8	-4.1	-3.3	-4.2	-4.1	-4.1
- **“Snow-ball” effect** (3)	1.8	0.7	0.8	0.1	0.0	0.5	0.3	-0.1	0.1
- Interest expenditure	5.8	4.4	4.3	4.1	4.1	3.9	3.9	3.6	3.4
- Real GDP growth	-2.0	-1.3	-1.3	-1.9	-2.0	-1.7	-1.8	-1.9	-1.8
- Inflation (GDP deflator)	-1.9	-2.4	-2.2	-2.1	-2.2	-1.7	-1.7	-1.8	-1.6
- **Stock-flow adjustment** (4)	0.3	2.4	3.0	-0.1	0.5	-0.1	0.2	0.2	0.1
- Cash/accruals	0.5								
- Accumulation of financial assets	-0.5								
of which: Privatisation proceeds	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual adj.	0.3								

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect.

Source:
Stability programme update (SP); Commission services’ autumn 2005 economic forecasts (COM); Commission services’ calculations

4.2. Assessment

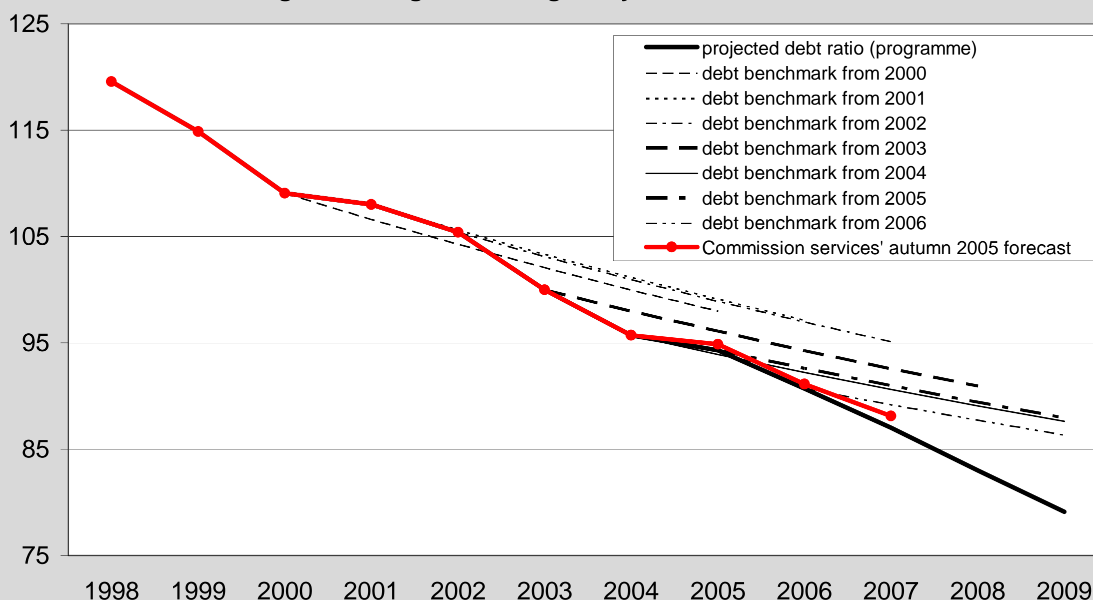
Until 2007, the programme's debt projections differ only marginally from the Commission services' forecast. Risks to the debt projections mainly stem from the possibility of lower-than-anticipated (primary) surpluses (see Section 3.3.2 above). As virtually all Belgian debt is euro-denominated, exchange rate risks are almost non-existent. Despite the large size of Belgian government debt, possible risks stemming from interest rate changes are relatively limited, because the Belgian debt has been increasingly financed with long-term bonds (about 85% of the Belgian government debt has a residual maturity of over 1 year). Based on information provided in the programme, the impact from an immediate 1 percentage point increase in interest rates can be estimated at about 1.2% points increase in the debt ratio (compared to the programme's baseline projection) by the end of the programme period.

Box 3: The rolling debt reduction benchmark

In Belgium, the debt ratio has been exceeding the 60% of GDP reference value since the presentation of the initial stability programme in 1998.

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2005 forecasts until 2007 (which are based on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (see Annex 5). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2005 is compared with the value obtained for the same year by applying the formula starting in 2000. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio. The graph clearly shows that the planned reduction of the debt ratio in the update is more than what is implied by the five-year rolling debt reduction benchmark.

Figure 3: Belgium: rolling five-year debt benchmark



Source: Stability programme and Commission services

Overall, although the evolution of the debt ratio could turn out to be slightly less favourable than projected in the programme (given the risks to the budgetary targets mentioned above), the projected debt reduction remains impressive. Therefore the debt

ratio can clearly be considered to be sufficiently diminishing towards the 60% of GDP reference value. It thereby provides an example of fiscal policies conducted in compliance with the Pact. The debt reduction strategy in the update is also largely consistent with the broad economic policy guideline calling for a satisfactory pace of government debt reduction to strengthen public finances (see integrated guideline No 2 in Annex 3).

5. Structural reform, the quality of public finances and institutional features

As regards expenditure control, following an overrun in health care spending (by over 0.2% of GDP in 2004), several measures were taken in 2005 to curb expenditure growth. From April 2005 until the end of the year, the minister of social affairs was given a mandate to take necessary measures without prior parliamentary (or other) consultation. Measures included the stricter control on drug prescription and the use of heavy medical equipment, stimulating the role of general practitioners and increased use of generic drugs. So far these measures appear to be effective in reducing the real growth of health care expenditure below its target of 4.5%.

Concerning tax reforms, government revenue will decrease in 2006 due to the last stage of the 2001 direct tax reform. Tax cuts introduced in previous years (up to 2004) have not yet been fully integrated in the tax on labour income withheld at source, which will result in a substantial loss in tax revenue (about 0.5% of GDP) from 2006 onwards. Moreover, the government recently presented a comprehensive programme called the ‘Generation Pact’ to increase Belgium’s low employment rate. Among others, the generation pact contains several selective reductions in social contributions (see Box 4). It also includes measures to improve the structural funding of the social security system by attributing part of the revenue from taxes on financial income and excise duties to the social security system, but this has no effect on the budgetary position of the government sector as a whole, as it only entails a structural transfer from the federal government to the social security system.

Box 4: Labour market reform and the sustainability of public finances

Recently the Belgian authorities launched a ‘generation pact’ which includes several measures to increase the employment rate, which is among the lowest in the EU (around 60%). The generation pact contains new measures to strengthen existing active labour market measures, to tackle youth unemployment and to promote a more comprehensive active ageing strategy. The generation pact also aims to tighten the eligibility criteria for early retirement schemes, although the impact of these measures will depend on the extent to which exceptions and alternative routes remain.

The generation pact also includes a number of selectively targeted reductions of social contributions. In particular, the generation pact foresees a reduction of social contributions for young and low-skilled workers from 1 July 2006 onwards, which would reduce revenue by EUR 240 million (0.1% of GDP) on an annual basis. A similar reduction would also be introduced for older workers from 1 April 2007 (EUR 272 million or 0.1% of GDP). The government also plans to reduce the advanced levy on labour income from shift work, to improve the competitiveness of Belgium’s industrial sector.

While the lowering of social contributions decreases government revenue in the short term, increased labour market participation could make a significant positive contribution to the long-term sustainability of public finances. As in many European countries, Belgium will be confronted with the budgetary impact of an ageing population, estimated by the Ageing Commission of the Belgian High Finance Council at 3.6% of GDP in 2030 (see also Section 6

below). Increasing the employment rate beyond the prudent projections of the High Finance Council could lower this cost due to reduced unemployment benefits. Moreover, a higher employment rate would also increase the tax base and therefore create some budgetary margin for a further reduction of the tax burden on labour, which is one of the key challenges Belgium has put forward in its National Reform Programme for the Lisbon strategy.

One-off measures continue to represent a substantial part of government revenue for Belgium although the authorities envisage reducing their reliance from 2007 onwards. The latest update reports a total of 0.4% of GDP in one-offs for 2005, but this figure does not include new measures taken near the end of 2005 to take over pension obligations from the national railway company and the Antwerp port authorities (against a one-off payment of 0.2% of GDP). As for 2006, some new taxes were introduced on private investment funds and life insurance schemes, which partly (some 0.2% of GDP) compensate for losses in revenue (due to the one-offs, the 2001 tax reform and reductions in social contributions). Nevertheless, the proceeds from one-off operations slightly increase to 0.6% of GDP, including some real-estate operations (0.2% of GDP), securitisation of tax-arrears (0.2%) and a fiscal regularisation procedure (0.1%). Several of these one-off measures also increase the future liabilities in the form of increased pension liabilities and the cost for renting office spaces. Others, like the securitisation of tax arrears, have a negative impact on future revenue. As pointed out by the Belgian Court of Audit, the absence of a cost-benefit-analysis provided by the authorities makes it difficult to evaluate the precise impact of these operations on public finances.

Despite the continued reliance on one-off measures, the policies described above (regarding the quality of public finances and structural reforms etc.) are generally consistent with the broad economic policy guidelines in the area of public finances included in the Integrated Guidelines[12] for the period 2005-2008 (see also Annex 3). Especially the labour market reform initiated in the Generation Pact and the efforts to reduce the tax burden on labour should have beneficial effects on Belgium’s employment rate and growth potential. Reforms in social security and health care can also contribute to improving the long-term viability of these systems. Moreover, the Belgian stability programme mentions explicitly that in case growth exceeds expectations, the authorities are committed to using the additional budgetary margin to improve the general government balance.

The measures described above are also in line with the National Reform Programme, submitted on 26 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, which identifies the creation of government surpluses in order to reduce the debt ratio as a key challenge for Belgium. However, neither the National Reform Programme nor the stability programme fully explains how the Belgian authorities plan to achieve the budgetary targets set in the stability programme while at the same time reducing the tax burden on labour by 2.2% of GDP by 2010 (as proposed in the National Reform Programme). More generally, the budgetary implications of the actions foreseen in the National Reform Programme are not always quantified and therefore it is difficult to assess whether they are sufficiently reflected in the budgetary projections presented in the stability programme.

Box 5: The level and composition of government expenditure in Belgium since 1990

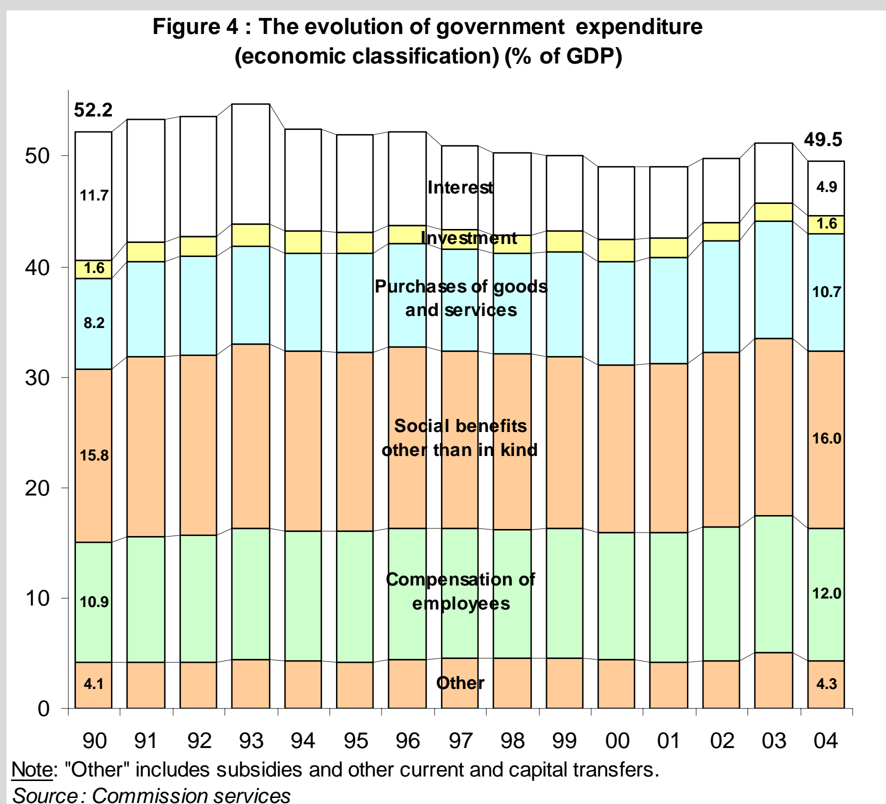
[12] European Commission, Communication to the spring European Council, Integrated Guidelines for Growth and Jobs, 2005.

Since 1990, the Belgian government expenditure has decreased from 52.2% of GDP to 49.5% of GDP. According to an economic classification shown in Figure 4, the main expenditure-reducing factor is interest expenditure, which decreased from 11.7% of GDP in 1990 to 4.9% in 2004. The reduction is the combined effect of Belgium's continuous efforts to reduce its debt level (from its peak level of 137% of GDP in 1993 to 95% of GDP in 2004) and to refinance the existing debt at lower interest rates (the implicit interest rate decreased from 9.3% in 1991 to 4.7% in 2005). However, the latter source of reductions in interest expenditure seems to be nearly depleted, as the market interest rate is expected to increase, which will eventually also have an increasing effect on the implicit interest rate on government debt.

The reduction in the interest burden was only partly translated into reduced expenditure. A substantial part of the available margin was used to increase expenditure in various other categories of the economic classification. As could be expected, 'social benefits other than in kind' (which include notably unemployment benefits) are most sensitive to the business cycle. As a percentage of GDP, they reached a maximum in 1993 with 16.6%. At the peak of the cyclical upswing in 2000, they reached their lowest point at 15.2% of GDP but since then increased again to 16%. In view of the ageing population and recent decisions to adjust pensions to welfare developments, an underlying upward trend in this category of expenditure can certainly be expected.

Purchases of goods and services show a slow but steady increase. Meanwhile the government's compensation of employees increased mainly at the beginning of the previous decade (+1% of GDP between 1990 and 1993). Since then its share has remained fairly stable at around 12% of GDP. Finally, in 2003 government expenditure temporarily increased due to a one-off advancement of subsidies to the national railway company SNCB (0.4% of GDP) and a capital injection to the postal company La Poste (0.1% of GDP) from the 2004 to the 2003 budget, recorded in the residual category 'other'.

Figure 4 : The evolution of government expenditure (economic classification) (% of GDP)

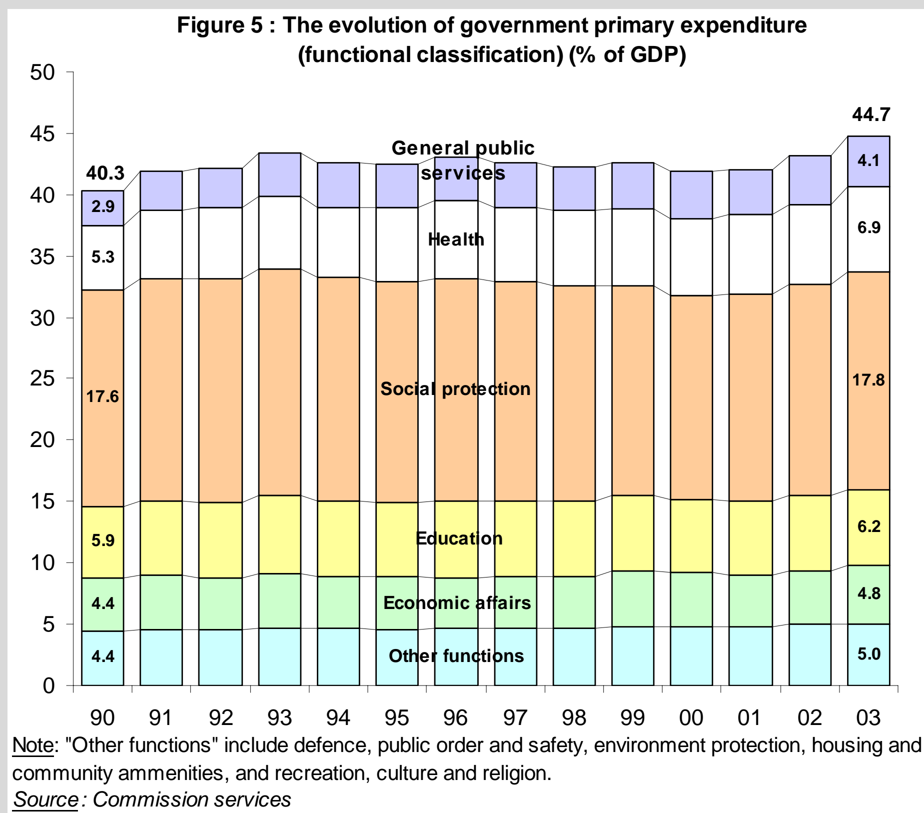


Note: "Other" includes subsidies and other current and capital transfers.
Source: Commission services

Also in terms of the functional classification, the increase in primary expenditure is fairly evenly distributed over all different categories of expenditure, as illustrated[13] in Figure 5. Social

[13] Due to a different data vintages numbers in figure 4 and 5 may not be entirely comparable.

protection is the most volatile component in this classification (with a peak of 18.5% of GDP in 1993 and a low point of 16.7% in 2000). In absolute term, the largest increase occurred in health expenditure (+1.6% points of GDP), while in relative terms the most pronounced increase occurred in primary expenditure on general public services (from 2.9% of GDP in 1990 to 4.1% in 2003. Finally, as in the previous figure, the marked (and temporary) increase in 2003 is due to one-off advancements of expenditure from 2004 to 2003, recorded in the category 'economic affairs'.



Note: "Other functions" include defence, public order and safety, environment protection, housing and community ammenities, and recreation, culture and religion.
Source: Commission services

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Belgium's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[14] remains unchanged at the 2005 level throughout the programme period.

On the basis of information in the programme, age-related expenditure is foreseen to increase by 6.0 percentage points of GDP between 2009 and 2050[15], to which pensions contribute the most (4.2 percentage points of GDP) (see Table A2 in Annex 6). The analysis is based on the set of government expenditure items covered by the common

[14] The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out.

[15] Long-term projections in the update are available up to 2030. Additional information for the period 2030-2050 was provided by the *Bureau Fédéral du Plan*.

projections carried out by the Economic Policy Committee (EPC)[16]. In addition to these expenditure items, the Belgian programme includes a projected fall in family allowances.

The gross debt ratio is projected to keep decreasing significantly in the next 20 years but would increase strongly afterwards and breach the 60% of GDP Treaty threshold again, towards the very end of the period for the long-term projections (2050)[17] (see Table A4 in Annex 6).

Indeed, according to the S1 indicator, a small sustainability gap emerges for Belgium. Despite a high level of debt, the large primary balance, which enabled to considerably reduce gross debt in the recent past, more than compensates the future increase in expenditure up to 2050. However, S1 only takes into account changes in the primary balance up to 2050, which underestimates the cost of ageing.

A more demanding measure is the government's inter-temporal budget constraint, captured by the S2 indicator, according to which a sustainability gap of about 1½% of GDP emerges in both scenarios. The initial budgetary position is not sufficiently high to fully offset the future budgetary impact of ageing. This sustainability gap translates into a required primary balance (RPB) of about 5½% of GDP, higher than the structural primary balance of about 4% of GDP of the last year of the programme period.

Moreover, the sustainability gap, as measured by the S2 indicator, would increase by around 0.1% GDP if the (budgetary or structural) adjustment were postponed by 5 years (see Table A3 in Annex 6).

Table 9: Sustainability indicators and the required primary balance

	Sustainability indicators and RPB					
	2005 Scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value (of which)	**0,0**	**1,5**	**5,6**	**0,1**	**1,5**	**5,7**
initial budgetary position	*-3,3*	*-3,3*		*-3,3*	*-3,2*	
debt requirement in 2050	*0,3*	*:*		*0,3*	*:*	
future changes in budgetary position	*3,0*	*4,7*		*3,0*	*4,7*	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[18]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission (2005), European Economy, 'Public finances in EMU – 2005', Section II.3 for a further description.

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16 Namely, government expenditure on pension, health-care, long-term care, education and unemployment benefits. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period.

17 It should be recalled that, 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 should not be seen as a forecast.

18 The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

In interpreting these results, several factors need to be taken into account.

GDP and labour productivity grow somewhat faster, in the long run, in the programme than in the EPC report and the larger reduction in unemployment in the programme contributes to halving the unemployment benefits to GDP ratio. The update also includes a reduction of family allowances (0.4% of GDP) that could slightly alleviate the risk of long-term sustainability.

The strategy outlined in the programme to face ageing is mainly based on gross debt reduction through running relatively large (though somewhat declining) primary surpluses. Instead of directly reducing the debt, the Belgian authorities have opted to channel most of the future surpluses to an 'ageing fund', created in 2001. According to the 'ageing fund law', this fund can only invest in assets which, for the calculation of the 'Maastricht debt', can be deducted from Belgium's gross public debt. Therefore, from an economic and accounting point of view, investing in the fund is equivalent to a direct debt reduction. Nevertheless, the ageing fund law has the advantage that it sets legally binding targets for the government surplus, thereby reinforcing the political commitment to the targets.

The tax burden is relatively high in Belgium (47.3% of GDP in 2004 against an EU average of 41.0%) and the government is currently making efforts to reduce it. In particular, the direct tax reform decided in 2001 will enter its final stage in 2006, with a 0.5% of GDP cost on the budget balance (through a reduction of tax revenues). Moreover, the government recently decided a series of selective reductions in social contributions: for young and low-skilled workers from 1 July 2006 onwards and for older workers from 1 April 2007. The government also plans to reduce the advanced levy on labour income from shift work, to improve the competitiveness of Belgium's industrial sector. In addition, new measures included in the recently decided generation pact (discussed in Box 4) aimed at increasing employment rates and fostering growth, could ease pressure on public finances.

* * *

Annex 1: Summary tables from the stability programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	246.2	2.6	1.4	2.2	2.1	2.3	2.2
2. Nominal GDP	B1*g	288.1	4.9	3.8	4.6	4.1	4.5	4.2
Growth sources: change at constant prices								
3. Private consumption expenditure	P.3	129.1	1.5	1.3	1.6	1.5	2.0	2.0
4. Government consumption expenditure	P.3	54.2	2.0	1.0	2.2	2.3	2.7	2.1
5. Gross fixed capital formation	P.51	48.8	1.6	1.8	1.8	1.7	1.7	1.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	0.0	0.1	0.0	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	204.1	6.2	2.2	5.1	5.6	5.7	5.8
8. Imports of goods and services	P.7	190.2	6.4	2.8	5.4	5.5	5.9	5.9
Contributions to real GDP growth								
9. Final domestic demand		-	2.1	1.8	2.2	1.7	2.1	2.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.4	0.0	0.0	0.0	0.0	0.0
11. External balance of goods and services	B.11	-	0.2	-0.3	0.0	0.4	0.2	0.2

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		115.6	2.3	2.4	2.3	2.0	2.1	1.9
2. Private consumption deflator		118.2	2.5	2.9	2.8	2.0	1.9	1.7
3. HICP[19]		114.4	1.9	2.9	2.8	2.0	1.9	1.7
4. Public consumption deflator		122.0	2.7	3.1	3.0	2.4	2.3	2.3
5. Investment deflator		110.9	1.9	2.1	2.6	1.8	1.6	1.6
6. Export price deflator (goods and services)		117.0	2.4	4.2	2.2	1.0	0.9	0.8
7. Import price deflator (goods and services)		120.6	2.9	4.8	2.7	0.8	0.5	0.5

[19] Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[20]		4162.0	0.6	0.7	0.7	0.7	0.9	0.8
2. Employment, hours worked[21]		6510.3	0.6	0.6	0.6	0.6	0.8	0.7
3. Unemployment rate (%)[22]		7.8	7.8	7.8	7.8	7.8	7.6	7.5
4. Labour productivity, persons [23]		59.2	2.0	0.7	1.5	1.3	1.4	1.4
5. Labour productivity, hours worked[24]		37.8	2.0	0.9	1.6	1.5	1.5	1.5
6. Compensation of employees	D.1	148.2	4.1	3.9	4.1	4.0	4.6	4.6

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	3.1	2.6	3.1	3.4	3.8	4.1
of which: - Balance on goods and services		3.3	2.4	1.8	2.2	2.5	2.7
- Balance of primary incomes and transfers		0.3	0.3	0.1	0.1	0.1	0.2
- Capital account		-0.6	-0.7	-0.7	-0.7	-0.6	-0.6
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	3.1	2.6	3.1	3.1	3.3	3.4
3. Net lending/borrowing of general government	B.9	0.0	0.0	0.0	0.3	0.5	0.7
4. Statistical discrepancy		-	-	-	-	-	-

[20] Occupied population, domestic concept national accounts definition (thousands).

[21] National accounts definition (millions of hours).

[22] Harmonised definition, Eurostat; levels.

[23] Real GDP per person employed (thousands of euros).

[24] Real GDP per hour worked (euros).

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	4.7	0.0	0.0	0.0	0.3	0.5	0.7
2. Central government	S.1311	-414.1	-0.1	-0.1	0.1	0.2	0.3	0.4
3. State government	S.1312	684.2	0.2	0.2	0.1	0.0	0.0	0.0
4. Local government	S.1313	-253.5	-0.1	-0.2	-0.2	0.0	0.1	0.2
5. Social security funds	S.1314	88.1	0.0	0.1	0.0	0.1	0.1	0.1
General government (S13)								
6. Total revenue	TR	142 329.6	49.4	49.7	49.4	49.2	48.8	48.7
7. Total expenditure	TE[25]	142 324.9	49.4	49.7	49.4	48.9	48.3	48.0
8. Net lending/borrowing	EDP B.9	4.7	0.0	0.0	0.0	0.3	0.5	0.7
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	13 745.8	4.8	4.3	4.1	3.9	3.6	3.4
pm: 9a. FISIM								
10. Primary balance	[26]	13 750.5	4.8	4.3	4.1	4.2	4.1	4.1
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		87 972.5	30.5	30.9	30.8	30.7	30.4	30.2
11a. Taxes on production and imports	D.2	37 463.3	13.0	13.1	13.5	13.4	13.1	13.0
11b. Current taxes on income, wealth, etc	D.5	48 324.1	16.8	17.2	16.8	16.6	16.6	16.6
11c. Capital taxes	D.91	2 185.1	0.8	0.6	0.6	0.6	0.6	0.6
12. Social contributions	D.61	46 870.3	16.3	16.1	16.0	16.0	15.9	15.9
13. Property income	D.4	1 666.1	0.6	0.6	0.6	0.6	0.5	0.5
14. Other (14=15-(11+12+13))		5 820.7	2.0	2.0	2.0	2.0	2.0	2.0
15=6. Total revenue	TR	142 329.6	49.4	49.7	49.4	49.2	48.8	48.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[27]		-	47.4	47.7	47.5	47.3	46.9	46.7
Selected components of expenditure								
16. Collective consumption	P.32	45 224.5	15.70	15.77	15.72	15.59	15.45	15.35
17. Total social transfers	D.62 + D.63	66 702.1	23.2	23.2	23.2	23.2	23.1	23.0
17a. Social transfers in kind	P.31 =D.63	20 597.7	7.1	7.1	7.2	7.4	7.4	7.5
17b. Social transfers other than in kind	D.62	46 104.4	16.0	16.0	16.0	15.8	15.7	15.6
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	13 745.8	4.8	4.3	4.1	3.9	3.6	3.4
19. Subsidies	D.3	3 515.5	1.2	1.4	1.4	1.4	1.5	1.5
20. Gross fixed capital formation	P.51	4 589.5	1.6	1.8	1.8	1.7	1.7	1.6
21. Other (21=22-(16+17+18+19+20))		53 772.0	18.7	18.9	18.9	18.7	18.6	18.5
22=7. Total expenditure	TE[28]	142 324.9	49.4	49.7	49.4	48.9	48.3	48.0
Pm: compensation of employees	D.1	34 683.9	12.0	12.1	12.1	12.0	11.9	11.7

[25] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[26] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[27] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[28] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

% of GDP	COFOG Code	1993	2008
1. General public services	1	9.4	
2. Defence	2	1.2	
3. Public order and safety	3	1.7	
4. Economic affairs	4	4.8	
5. Environmental protection	5	0.7	
6. Housing and community amenities	6	0.3	
7. Health	7	6.9	
8. Recreation, culture and religion	8	1.2	
9. Education	9	6.2	
10. Social protection	10	17.8	
11. Total expenditure (= item 7=26 in Table 2)	TE[29]	**50.1**	

Table 4. General government debt developments

% of GDP		2004	2005	2006	2007	2008	2009
1. Gross debt[30]		94.7	94.3	90.7	87.0	83.0	79.1
2. Change in gross debt ratio		-3.8	-0.4	-3.6	-3.7	-4.0	-3.8
Contributions to changes in gross debt							
3. Primary balance[31]		4.8	4.3	4.1	4.2	4.1	4.1
4. Interest expenditure (incl. FISIM) [32]		4.8	4.3	4.1	3.9	3.6	3.4
5. Stock-flow adjustment		0.8	3.0	0.5	0.2	0.2	0.2
of which: - Differences between cash and accruals[33]		0.4	0.2	0.1	0.0	0.0	0.0
- Net accumulation of financial assets[34]		-0.1	0.2	0.2	0.2	0.2	0.2
of which: *- privatisation proceeds*		0.4	0.0	0.0	0.0	0.0	0.0
- Valuation effects and other[35]		0.5	2.7	0.2	0.0	0.0	0.0
p.m. implicit interest rate on debt[36]		5.1	4.7	4.5	4.4	4.3	4.3
Other relevant variables							
6. Liquid financial assets[37]							
7. Net financial debt (7=1-6)							

[29] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[30] As defined in Regulation 3605/93 (not an ESA concept).

[31] Cf. item 10 in Table 2.

[32] Cf. item 9 in Table 2.

[33] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[34] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[35] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[36] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

[37] AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)		2.6	1.4	2.2	2.1	2.3	2.2
2. Net lending of general government	EDP B.9	0.0	0.0	0.0	0.3	0.5	0.7
3. Interest expenditure (incl. FISIM recorded as consumption)	EDP D.41 +FISIM	4.8	4.4	4.1	3.9	3.6	3.5
4. Potential GDP growth (%) (1)		1.9	2.0	2.1	2.1	2.0	1.9
contributions:							
- labour		0.5	0.6	0.6	0.6	0.5	0.3
- capital		0.5	0.5	0.6	0.6	0.6	0.6
- total factor productivity		0.9	0.9	0.9	1.0	1.0	1.0
5. Output gap		-0.4	-1.0	-0.9	-0.9	-0.6	-0.3
6. Cyclical budgetary component		-0.2	-0.5	-0.5	-0.5	-0.3	-0.1
7. Cyclically-adjusted balance (2-6)		0.2	0.5	0.5	0.8	0.8	0.8
8. Cyclically-adjusted primary balance (7-3)		5.0	4.9	4.6	4.7	4.4	4.3

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008	2009
Real GDP growth (%)							
Previous update		2.4	2.5	2.5	2.1	2.0	-
Current update		2.6	1.4	2.2	2.1	2.3	2.2
Difference		0.2	-1.1	-0.3	0.0	0.3	-
General government net lending (% of GDP)	EDP B.9						
Previous update		0.0	0.0	0.0	0.3	0.6	-
Current update		0.0	0.0	0.0	0.3	0.5	0.7
Difference		0.0	0.0	0.0	0.0	-0.1	-
General government gross debt (% of GDP)							
Previous update		96.6	95.5	91.7	88.0	84.2	-
Current update		94.7	94.3	90.7	87.0	83.0	79.1
Difference		-1.9	-1.2	-1.0	-1.0	-1.2	-

Table 7. Long-term sustainability of public finances

% of GDP	2004	2005	2010	2020	2030	2050
Total expenditure	49.4	49.7	47.8	47.4	48.7	
Social expenditure	23.7	23.5	23.5	24.9	27.3	
Of which: age-related expenditures						
Pension expenditure	9.3	9.2	9.0	10.4	12.3	
Social security pension						
Old-age and early pensions						
Other pensions (disability, survivors)						
Occupational pensions (if in general government)						
Health care	7.3	7.2	7.9	8.6	9.5	
Long-term care *(this was earlier included in the health care)*						
Education expenditure						
Other age-related expenditures						
Other social expenditure	7.2	7.1	6.6	5.9	5.5	
Interest expenditure	4.8	4.3	3.3	2.0	1.3	
Total revenue	49.4	49.7	48.7	48.7	48.7	
Of which: property income						
of which: from pensions contributions (or social contributions if appropriate)						
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Assumptions						
Labour productivity growth	1.8	0.9	1.3	1.8	1.8	
Real GDP growth	2.6	1.4	2.2	1.6	1.5	
Participation rate males (aged 20-64)	86.2	86.2	85.6	84.3	83.3	
Participation rates females (aged 20-64)	72.0	72.7	75.3	76.9	77.4	
Total participation rates (aged 20-64)	79.2	79.5	80.5	80.6	80.4	
Unemployment rate (1)	14.4	14.5	12.7	9.4	7.5	
Population aged 65+ over total population	17.2	17.2	17.5	20.3	24.1	

(1) according to the definition of the Federal Planning Bureau

Table 8. Basic assumptions

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	2004	2005	2006	2007	2008	2009
Short-term interest rate[38] (annual average)	2.1	2.1	2.1	2.8	3.6	4.0
Long-term interest rate (annual average)	4.0	3.4	3.3	4.1	5.0	5.3
USD/€exchange rate (annual average) (euro area and ERM II countries)	124.4	126.2	126.5	126.5	126.5	126.5
Nominal effective exchange rate						
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	-	-	-	-	-	-
World excluding EU, GDP growth	5.7	4.9	4.5	4.0	4.0	4.0
EU GDP growth	2.2	1.3	2.0	2.5	2.4	2.2
Growth of relevant foreign markets	8.1	6.3	6.1	6.7	6.6	6.6
World import volumes, excluding EU	12.2	9.0	7.6	7.6	7.6	7.6
Oil prices, (Brent, USD/barrel)	38.2	57.4	67.5	64.8	63.7	62.6

[38] If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].		**X**	
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	**X**		No separate sect. 7
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	**X**		
The programme provides all compulsory information in these tables.		**X**	
The programme provides all optional information in these tables.		**X**	
The concepts used are in line with the European system of accounts (ESA).	**X**		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		**X**	Parliament is not involved
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		**X**	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.		**X**	
Significant divergences between the national and the Commission services' economic forecasts are explained[12].			Not applicable
The possible upside and downside risks to the economic outlook are brought out.	**X**		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		**X**	
c. Monetary/exchange rate policy			
The <u>convergence</u> programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	**X**		
In case a new government has taken office, the programme			Not applicable

Guidelines in the new code of conduct	Yes	No	Comments
shows continuity with respect to the budgetary targets endorsed by the Council.			
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.		X	
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		
Information is provided on one-off and other temporary measures.	X		For 2005 and 2006. Additional information for 2007-2009 was provided separately
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	 a) X b) X	 d) X	 c) Not applicable
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		Without specific reference to BEPGs
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in		X	- Deviations in the

Guidelines in the new code of conduct	Yes	No	Comments
the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.			projections regarding pensions are indicated in the programme. - Projections in the programme end in 2030, but additional projections until 2050 have been made available
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	**X**		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the Integrated Guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	**X** Althoug h not for 2006		
– Member States should avoid pro-cyclical fiscal policies[2].	**X**		
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].			**X**
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			**X**
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.	**X**		
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	**X**		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	**X**		
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”. [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[39]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY_i}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[40]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

---

[39] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[40] The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i ex post}\frac{dB_i}{B_i}$.

$$d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) = \left[\left(\varepsilon^{'}_{T_i,B_i}\varepsilon^{'}_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y} .$$

If $(\varepsilon^{'}_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon^{'}_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)^{'} - d\left(\frac{T_i}{Y}\right) = \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_tB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

Assessment of tax projections by major tax category

	2006		2007		2008	2009	p.m.:
	COM	SP	COM[2]	SP	SP	SP	OECD[1]
Taxes on production and imports:							
Change in tax-to-GDP ratio	0.0	0.4	0.0	-0.1	-0.3	-0.1	/
Difference	0.4		-0.1		/	/	/
of which[3]: - elasticity component	0.4		0.0		/	/	/
- composition component	0.0		-0.1		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base[4]	1.1	1.8	1.0	1.0	0.6	0.9	1.00
- of tax base[4] to GDP	1.0	1.0	1.0	0.9	0.9	0.9	1.0
Social contributions:							
Change in tax-to-GDP ratio	-0.3	-0.1	-0.3	0.0	0.0	0.1	/
Difference	0.2		0.3		/	/	/
of which[3]: - elasticity component	0.1		0.2		/	/	/
- composition component	0.0		0.0		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base[5]	0.8	1.0	0.6	1.0	0.8	0.9	1.1
- of tax base[5] to GDP	0.8	0.9	0.8	1.0	1.0	1.1	0.7
Personal income tax[6]:							
Change in tax-to-GDP ratio	-0.4	-0.3	0.0	-0.2	0.0	0.0	/
Difference	0.1		-0.2		/	/	/
of which[3]: - elasticity component	0.0		-0.2		/	/	/
- composition component	0.0		0.1		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base[5]	0.4	0.5	1.2	0.7	1.0	0.9	1.6
- of tax base[5] to GDP	0.8	0.9	0.8	1.0	1.0	1.1	0.7
Corporate income tax[6]:							
Change in tax-to-GDP ratio	-0.1	-0.1	0.0	0.0	0.0	0.0	/
Difference	0.0		0.0		/	/	/
of which[3]: - elasticity component	0.0		0.0		/	/	/
- composition component	0.0		0.0		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base[7]	0.3	0.4	0.9	0.7	1.0	1.1	1.0
- of tax base[7] to GDP	1.2	1.1	1.2	1.0	1.0	0.9	1.6

Notes:
[1]OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	ex-ante[1]	COM[2] (observed)	ex-ante[1]
Taxes on production and imports:				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
Difference	0.0		0.0	
of which[3]: - elasticity component	0.0		0.0	
- composition component	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[4]	1.1	1.0	1.0	1.0
- of tax base[4] to GDP	1.0	1.0	1.0	1.0
Social contributions:				
Change in tax-to-GDP ratio	-0.3	-0.1	-0.3	-0.1
Difference	0.1		0.2	
of which[3]: - elasticity component	0.2		0.3	
- composition component	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	0.8	1.1	0.6	1.1
- of tax base[5] to GDP	0.8	0.7	0.8	0.7
Personal income tax[6]:				
Change in tax-to-GDP ratio	-0.4	0.1	0.0	0.0
Difference	0.4		0.0	
of which[3]: - elasticity component	0.6		0.2	
- composition component	0.0		-0.1	
p.m.: Observed elasticity:				
- of taxes to tax base[5]	0.4	1.6	1.2	1.6
- of tax base[5] to GDP	0.8	0.7	0.8	0.7
Corporate income tax[6]:				
Change in tax-to-GDP ratio	-0.1	0.1	0.0	0.1
Difference	0.2		0.1	
of which[3]: - elasticity component	0.1		0.0	
- composition component	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base[7]	0.3	1.0	0.9	1.0
- of tax base[7] to GDP	1.2	1.6	1.2	1.6

Notes:
[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Annex 5: The rolling debt reduction benchmark

The rolling debt reduction benchmark discussed in Box 3 is calculated for successive five-year periods through a recursive application of the formula:

$$\left(\frac{D_t}{Y_t}\right)_{benchmark} = 0.05 * \left[60 - \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{benchmark}\right] + \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{benchmark}$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio).

The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \left(\frac{y_t}{1 + y_t}\right) * \left(\frac{D_{t-1}}{Y_{t-1}}\right) \cong \frac{DEF_t}{Y_t} - y_t * \left(\frac{D_{t-1}}{Y_{t-1}}\right)$$

where DEF is the government deficit and y represents nominal GDP growth.

Noting that 0.05*60 = 3, the formula for the rolling debt reduction benchmark describes the path for convergence of the debt ratio towards 60% of GDP, which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. For nominal GDP growth rates higher than 5%, the benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the benchmark necessitates deficits lower than 3% of GDP.

Annex 6: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	**SCP**	**EPC**	**SCP**	**EPC**	**SCP**	**EPC**	**SCP**
Labour productivity growth	**1,7**	**1,3**	**1,8**	**1,8**	**1,7**	**1,8**	**1,7**	**1,8**
Real GDP growth	**2,7**	**2,2**	**1,6**	**1,6**	**1,3**	**1,5**	**1,5**	**1,6**
Participation rate males (aged 20-64)	**79,2**	**85,6**	**79,8**	**84,3**	**80,1**	**83,3**	**80,5**	**82,6**
Participation rates females (aged 20-64)	**65,5**	**75,3**	**69,3**	**76,9**	**70,2**	**77,4**	**70,8**	**77,1**
Total participation rates (aged 20-64)	**72,4**	**80,5**	**74,6**	**80,6**	**75,2**	**80,4**	**75,8**	**79,9**
Unemployment rate	**7,0**	**12,7**	**6,5**	**9,4**	**6,5**	**7,5**	**6,5**	**7,4**
Population aged 65+ over total population	**17,5**	**17,5**	**20,5**	**20,3**	**24,6**	**24,1**	**27,3**	**26,3**

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**	**Impact on S2**
Total age-related spending	24,6	24,5	25,9	28,5	29,6	30,6	6,0	4,7
Pensions	10,8	10,7	12,1	14,0	14,5	14,9	4,2	3,4
Health care	6,7	6,8	7,3	8,0	8,3	8,6	1,9	1,5
Care of the elderly	1,1	1,1	1,3	1,5	1,9	2,2	1,1	0,8
Education	4,1	4,0	3,8	3,8	3,8	3,8	-0,3	-0,3
Unemployment benefits	2,0	1,9	1,4	1,2	1,2	1,1	-0,9	-0,8
Total primary non age-related spending	20,0	20,0	20,0	20,0	20,0	20,0	0,0	0,0
Adjusted total revenues	48,9	48,9	48,9	48,9	48,9	48,9	0,0	0,0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

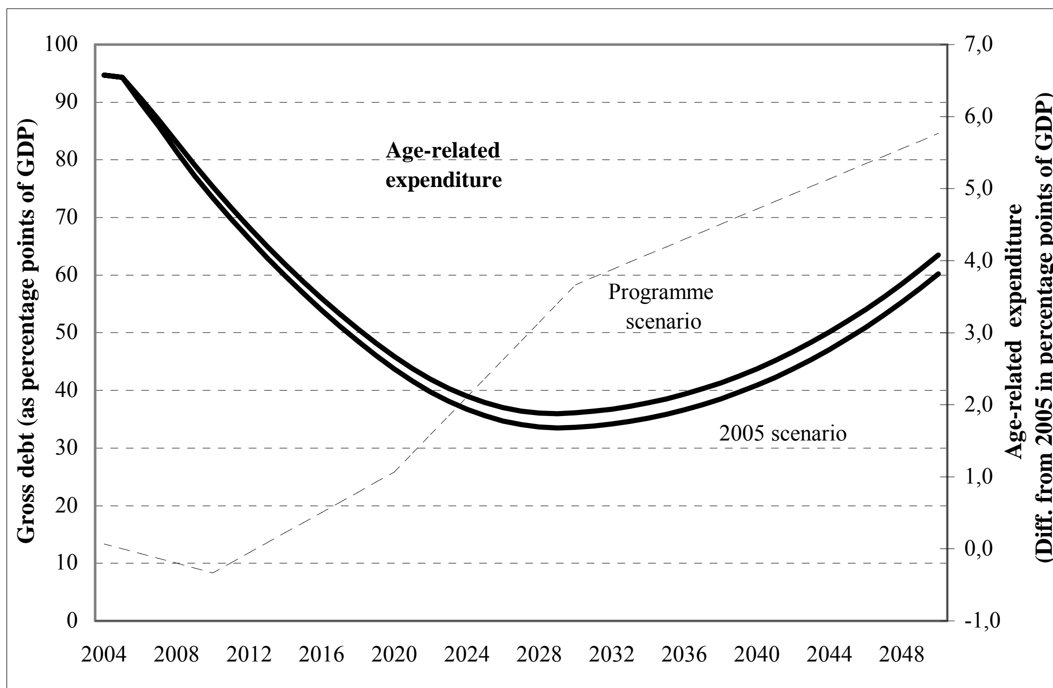
	S1	**S2**
2005 scenario	**0.0**	**0.1**
Programme scenario	**0.0**	**0.1**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Programme scenario							
Gross debt	79,1	75,3	45,9	36,1	43,8	63,5	-15,6
*Gross debt, i + 1**	*79,1*	*76,1*	*53,3*	*49,8*	*65,3*	*96,1*	*17,0*
*Gross debt, i - 1**	*79,1*	*74,6*	*39,2*	*25,2*	*28,5*	*42,6*	*-36,5*
Adjusted gross debt	79,1	75,3	45,9	36,1	43,8	63,5	-15,6
2005 Scenario							
Gross debt	77,2	73,4	43,7	33,6	40,9	60,2	-17,0
*Gross debt, i + 1**	*77,2*	*74,1*	*51,0*	*46,8*	*61,4*	*91,3*	*14,1*
*Gross debt, i - 1**	*77,2*	*72,7*	*37,3*	*23,2*	*26,4*	*40,3*	*-36,8*
Adjusted gross debt	77,2	73,4	43,7	33,6	40,9	60,2	-17,0

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.


Gross debt (as percentage points of GDP)
Age-related expenditure
(Diff. from 2005 in percentage points of GDP)
Age-related
expenditure
Programme
scenario
2005 scenario
100
90
80
70
60
50
40
30
20
10
0
7,0
6,0
5,0
4,0
3,0
2,0
1,0
0,0
-1,0
2004
2008
2012
2016
2020
2024
2028
2032
2036
2040
2044
2048