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Fiscal Federalism in Belgium: Challenges in Restoring Fiscal Sustainability

Belgium

Yu Ching Wong

SIP/2023/016

***IMF Selected Issues Papers* are prepared by IMF staff as background documentation for periodic consultations with member countries.** It is based on the information available at the time it was completed on February 10, 2023. This paper is also published separately as IMF Country Report No 23/099.

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Prepared by Yu Ching Wong

Authorized for distribution by Mark Horton
March 2023

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ABSTRACT: *Fiscal decentralization in Belgium progressed substantially in 2015-19. However, as decentralization of expenditure responsibilities continued to outpace decentralization of revenue authority, vertical fiscal gaps and greater reliance on transfers from shared resources may have reduced spending discipline. Consecutive shocks (pandemic, energy prices) have worsened the fiscal positions of all levels of government, requiring urgent and concerted effort to improve fiscal and debt sustainability. Fostering better fiscal policy coordination across all levels of government would improve the efficiency of Belgium's decentralized fiscal framework. We recommend that fiscal adjustment at the subnational levels should be a part of the general government fiscal consolidation plan, with strict spending limits applying; integrating systematic spending reviews in the budgetary process; and adopting a more strategic, multi-annual fiscal framework to support adjustment. Implementing the 2013 Cooperation Arrangement—intended to provide fiscal rules to govern and coordinate public finances at all levels—is important. Also, the cost of overborrowing at the regional level should be fully internalized; recalibration of transfers could be considered; and some flexibility should be retained in the pace and scope of further decentralization. Finally, there is scope to improve the integration of fiscal sustainability objectives in federal and subnational structural reforms.*

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Belgium

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BELGIUM

SELECTED ISSUES

February 10, 2023

Approved By
European Department

Prepared By Andre Geis, Yu Ching Wong (both EUR) and Nate Vernon (FAD).

CONTENTS

FISCAL FEDERALISM IN BELGIUM: CHALLENGES IN RESTORING FISCAL SUSTAINABILITY[1]

Fiscal decentralization in Belgium progressed substantially in 2015-19. However, as decentralization of expenditure responsibilities continued to outpace decentralization of revenue authority, vertical fiscal gaps and greater reliance on transfers from shared resources may have reduced spending discipline. Consecutive shocks (pandemic, energy prices) have worsened the fiscal positions of all levels of government, requiring urgent and concerted effort to improve fiscal and debt sustainability. Fostering better fiscal policy coordination across all levels of government would improve the efficiency of Belgium's decentralized fiscal framework. We recommend that fiscal adjustment at the subnational levels should be a part of the general government fiscal consolidation plan, with strict spending limits applying; integrating systematic spending reviews in the budgetary process; and adopting a more strategic, multi-annual fiscal framework to support adjustment. Implementing the 2013 Cooperation Arrangement—intended to provide fiscal rules to govern and coordinate public finances at all levels—is important. Also, the cost of overborrowing at the regional level should be fully internalized; recalibration of transfers could be considered; and some flexibility should be retained in the pace and scope of further decentralization. Finally, there is scope to improve the integration of fiscal sustainability objectives in federal and subnational structural reforms.

A. Introduction

1. **Belgium is one of the most fiscally-decentralized advanced economies.** Fiscal decentralization—the devolution of revenue collection and expenditure execution responsibilities from the federal to the subnational authorities—has progressed in stages under six state reforms implemented over five decades (Box 1). However, as expenditure decentralization outpaced revenue decentralization, the vertical financing gap is high in Belgium, compared with most other peer economies. Belgium has the most decentralized spending autonomy among euro area economies and ranks fourth globally among advanced economies after Canada, Switzerland, and the U.K. Subnational governments in Belgium are responsible for 46 percent of total spending, while own tax revenues are equivalent to 16 percent of total tax revenues. With the combined effect of strong revenue centralization and decentralization of spending to subnational governments, Belgium's vertical fiscal imbalance—the share of sub-national own spending not financed through own revenues—was high at 50 percent in 2019.[2,3]

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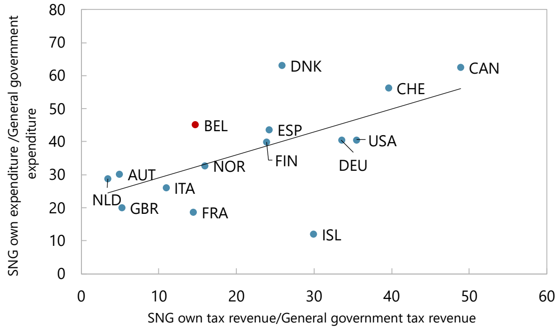
[1] Prepared by Yu Ching Wong (EUR), with valuable comments by Mark Horton, participants at a National Bank of Belgium seminar, and other NBB and government officials.

[2] Subnational government comprises state and local governments in the OECD Fiscal Decentralization database. This corresponds to regional and community governments and local provincial and municipal authorities, respectively, in Belgium.

[3] See ¶6 and ¶11 for a discussion of vertical fiscal imbalance estimates.

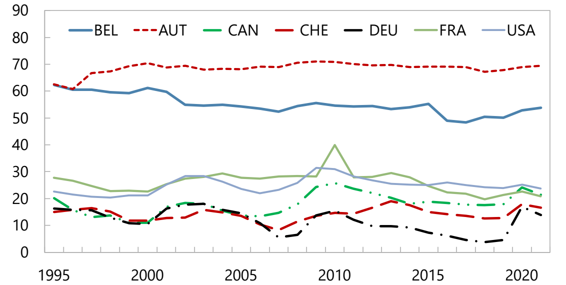
Belgium: Highly Decentralized in Spending with High Vertical Fiscal Imbalances

Decentralization of Expenditure versus Revenue
(Percent, data as of 2021)



Sources: OECD and IMF staff calcuations.

Vertical Fiscal Imbalance of Subnational 1/
(Percent)



Sources: OECD and IMF staff calculations.
1/ Subnational (SNG) is sum of state and local governments; except France and the U.S. are state only. Vertical fiscal imbalance= 1 - [(SNG own revenue)/(SNG own spending)]

2. **Fiscal decentralization has strengths and weaknesses.** One of the key merits of decentralization of public spending is that it may improve effectiveness of delivery of public services (planning, execution, accountability) that are more tailored to local needs. Shifting spending decisions and execution from the federal government has been attractive in Belgium, in light of considerable economic and social heterogeneity among its three regions—Flanders, Wallonia, and Brussels-Capital and three communities (Flemish-, French-, and German-speaking). By contrast, fiscal decentralization may pose challenges for fiscal discipline. Subnational government may have little incentive to save shared revenues ("common pool" problem), particularly if arrangements or past central government support created moral hazard, if strong heterogeneity of subnational jurisdictions is not adequately addressed in the design of intergovernmental fiscal relations and transfers, or if there are privileges (or disadvantages) from constitutionally-established arrangements and autonomy among the subnational governments (Ter-Minassian (2007)). Many of these factors are present in Belgium.

3. **A high reliance on grant-based transfers poses continuing challenges for fiscal discipline in Belgium.** The predominance of grant-based transfers in the financing of subnational governments in Belgium, rather than a more balanced mix of expenditure and tax autonomy, affects incentives, budgetary processes, and the direction of resource distribution between the federal and subnational governments. Past studies (e.g., Jennes (2014)) have highlighted that fiscal federalism arrangements in Belgium, which rely heavily on grant transfers from the federal government and the social security system, may result in a soft-budget constraint, with scope for rapid spending increases at the regional and community levels and with fewer incentives to rationalize expenditures in the absence of binding budgetary targets. By contrast, local authorities, which have very limited own revenues, have a good track record in keeping their budgets balanced due to the requirement to adhere to a strict budgetary framework. Grant transfers also appear to be not fully compensated by revenue mobilization or expenditure restraint at the levels of the government that provide the transfers. These features of regional finances appear to have affected fiscal discipline and contributed to fiscal imbalances at the general government level. Heterogeneity among the regions has added complexity in managing public finances, as there is political support in Flanders to seek

greater autonomy, while in the two other regions, there is strong interest in maintaining solidarity and distribution among regions and communities, supported by interregional transfers (Gerard (2015)).[4]

4. The recent series of shocks—the Covid-19 pandemic and spillovers from Russia's war in Ukraine—have significantly affected Belgium's fiscal position. The combined effect of structural spending increases in response to the crises and increasing costs from population aging and social benefits over the medium term, are weighing on public finances at all levels of government. The need to strengthen policy efforts to improve public debt sustainability and restore fiscal space to safeguard the economy from the impact of future shocks is clear. Significant fiscal adjustment is needed, and this effort will be more difficult if federal and regional/subnational policies are not well aligned and pulling in the same direction.

5. This paper reviews the key challenges of fiscal federalism and decentralization in Belgium in the context of strengthening the fiscal framework and ensuring fiscal and debt sustainability. It focuses on two main questions. First, how have the multi-level governance framework and fiscal decentralization evolved and impacted fiscal performance in recent years? Second, to the extent that fiscal decentralization contributes to persistent deficits and rising public debt, what are ways to improve the fiscal framework and budgetary processes to support medium-term fiscal consolidation and robust policies? Recognizing the substantial breadth and depth of the past literature on fiscal federalism in general and its relevance to Belgium in particular, this paper focuses on a narrower aspect: the role of fiscal decentralization in supporting consolidation and ensuring debt sustainability.

B. How Has Fiscal Decentralization Evolved in Belgium?

6. The decentralization of expenditure responsibilities in Belgium has outpaced devolution of revenue authority. The most recent push of decentralization took place during 2015-19, following implementation of Belgium's sixth state reform in 2014. The spending share of subnational and regional and community (excluding municipalities) governments increased from 38 percent and 25 percent, respectively, to 46 percent and 33 percent of general government total expenditure in 2019. On the revenue side, subnational and regional and community government (again, excluding municipalities) own tax collections also increased, from 10 percent and 5 percent in 2014 to 16 percent and 11 percent of general government tax revenue, respectively.[5] By 2019, subnational government own spending increased to 24 percent of GDP against their own revenue of 12 percent of GDP, closing the vertical financing gap by 5 percentage points between 2015 and

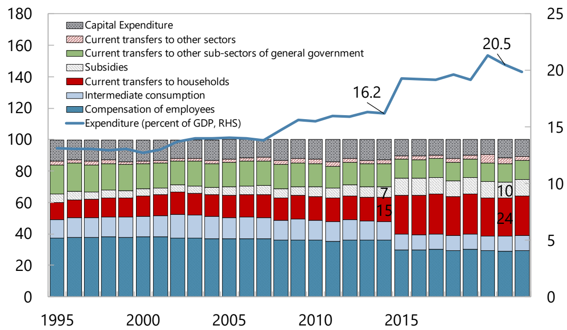
[4] Community governments are linked to languages and include the Flemish, French, and German communities. They are responsible for specific expenditure functions, importantly, in education. The Flemish community government is aligned with the Flemish regional government, whereas the French and German community governments are not as integrated with the respective regional governments (Wallonia and Brussels-Capital and Wallonia, respectively).

[5] "Regions have autonomy over taxation and enjoy exclusive competence (rate, basis, and exemptions) over most regional taxes. About 36 percent of their total resources come from own revenues. By contrast, communities have very low revenue autonomy and no fiscal autonomy." (European Committee of the Regions (CoR) -Division of Powers)

2019, but remaining elevated at 50 percent (Figure 1). As discussed below, most of the gap was covered by federal revenue and grant transfers, with some subnational borrowing.

Belgium: Transfer to Households and subsidies have increased

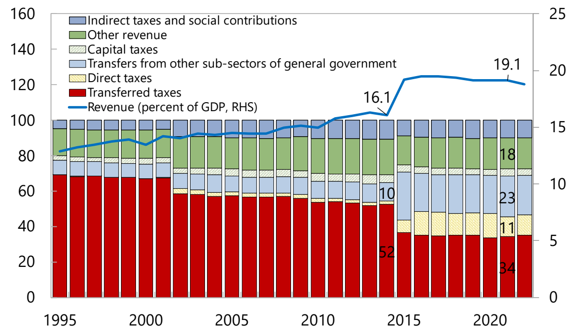
Expenditure of Regions and Communities
(Percent of total, unless noted otherwise)1/



Source: NBB.
1/ Figures for 2022 are estimates.

Belgium: Grant Transfers have Doubled While Taxes Collected Directly have Increased with a Reduction in Transferred Taxes

Revenue of Regions and Communities
(Percent fo total, unless noted otherwise)1/



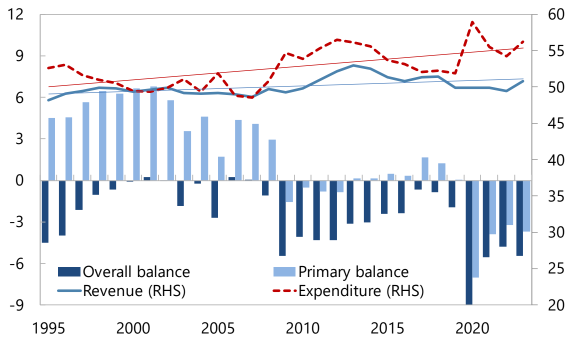
Source: NBB.
1/ Figures for 2022 are estimates

C. Key Challenges in Federal and Subnational Public Finances in Belgium

7. **Recent changes in Belgium's fiscal-federalism set-up, starting from 2011, have coincided with a series of shocks that have worsened the fiscal outcome.** The deterioration of fiscal balances and rising gross public debt from the global financial crisis started to be reversed around 2012 with economic recovery and fiscal consolidation. The improvement in fiscal sustainability was, however, first affected by large, discretionary spending measures in 2020 to mitigate the impact of the pandemic. The overall fiscal deficit widened sharply to 9 percent of GDP before narrowing to 5.6 percent of GDP in 2021. The fiscal position was expected to improve further from 2022 as most Covid-19 support measures were phased out, but instead is projected to remain elevated at 5½ percent of GDP in 2023 due to subsequent fiscal measures for the energy crisis and spillovers from the war in Ukraine. Without policy action, fiscal deficits will remain elevated over the medium term, as the expiration of these temporary measures will be met with aging related and interest payment cost increases. Consolidated public debt to GDP ratio is expected to decline to 107 percent in 2022 (due largely to denominator effect from high GDP deflator) from a recent peak of 112 percent in 2020, but is projected to rise to 120 percent in the medium term under unchanged policies. Historically, Belgium's high public debt level has fluctuated between 75 percent (1980) and 140 percent of GDP (1995).

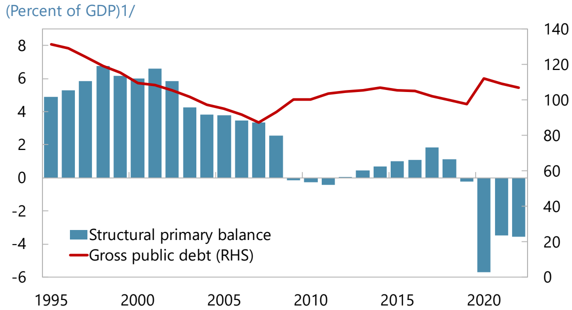
Belgium: The Pandemic and Energy Crisis Have Worsened the General Government's Fiscal Position

General Government Fiscal Positions
(Percent of GDP) 1/



Sources: NBB and IMF staff calculations.
1/ Figures for 2022 and 2023 are estimates.

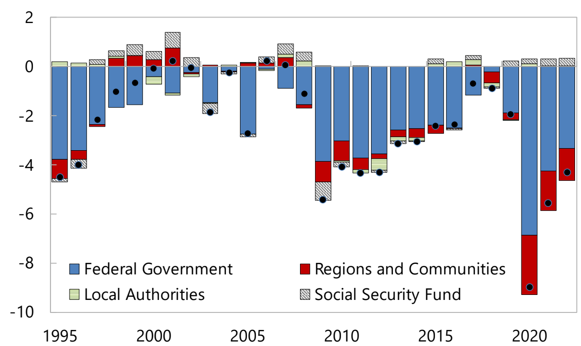
General Government Gross Debt and Structural Primary Balance
(Percent of GDP)1/



Sources: NBB and IMF staff calculations.
1/ 2022: proj.

8. With successive shocks in recent years, fiscal positions at the regions and communities' level have deteriorated. For the first time, overall combined deficits of regions and communities became significant, reaching 2.4 percent and 1.6 percent of GDP in 2020 and 2021, respectively, accounting for about 30 percent of general government deficits. Recent estimates by the National Bank of Belgium (NBB) suggest that region and community deficits narrowed to 1.3 percent of GDP in 2022 and will remain around this level in 2023-25 (Figure 2).

Overall Fiscal Balance
(Percent of GDP) /1



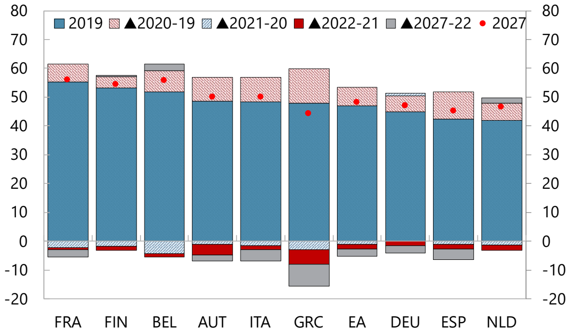
Source: NBB.
1/ Figures for 2022 are estimates.

9. Large public expenditures create challenges for fiscal sustainability. Belgium's public expenditures—at over 50 percent of GDP—were the third highest among euro area countries in 2019. The sizable increase of discretionary spending in 2020-21 during the pandemic was followed by less-than-full withdrawal in 2022. With unchanged policies, Belgium's public expenditures would rank highest in percent of GDP in the euro area by 2027. Four major functions— general public services, economic affairs, education, and health—account for half of general government spending, and Belgium's spending in these four areas is higher than in neighboring countries, by 0.3-2.1 percentage points of GDP in 2020. Spending on social protection accounts for close to 40 percent of general government expenditures, of which old age and sickness and disability outlays account for one half. A rapid increase of public expenditure took place during 2019-20, largely in healthcare and social protection. This was undertaken by the federal government and federal social security funds, with implications for the design and execution of fiscal consolidation.

Belgium: The Third Highest Public Expenditure to GDP in Euro Area, Spending 6 Ppt of GDP More than Neighboring Peers

Public Expenditure

(In percent of GDP, projections for 2023-27)

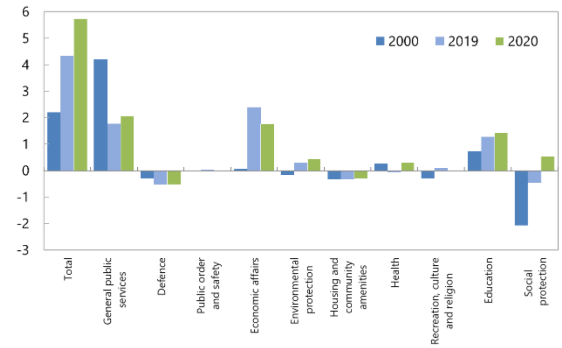


Source: IMF World Economic Outlook, October 2022.

General Government Expenditure by Function (COFOG)

Deviation from the simple average of France, Germany, and the Netherlands

(Percentage points of GDP)

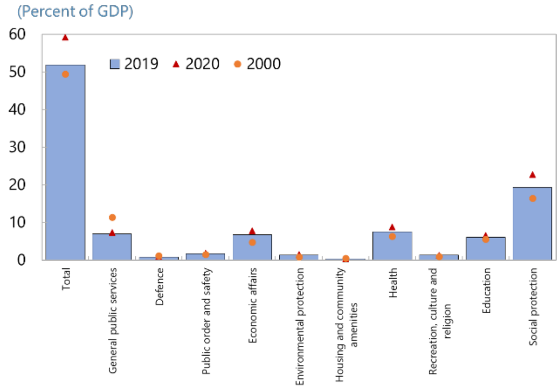


Sources: European Commission and IMF staff calculations.

Belgium: Social Benefits Account for the Bulk of the Spending in General Government

General Government Expenditure by Function (COFOG)

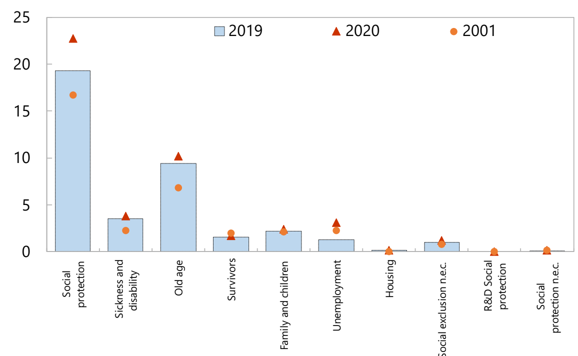
(Percent of GDP)



Sources: European Commission and IMF staff calculations.

General Government Expenditure : Social Protection

(Percent of GDP)

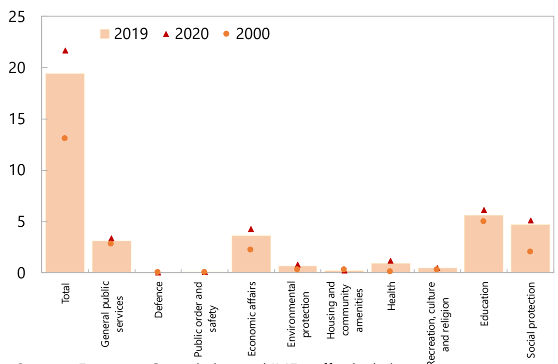


Sources: EC and IMF staff calculations.

10. With changes in spending decentralization, functional expenditure categories that are mainly executed by the state governments have increased. In addition to education (community competency), state governments managed more than half of total spending on housing, environmental protection, and economic affairs in 2019.

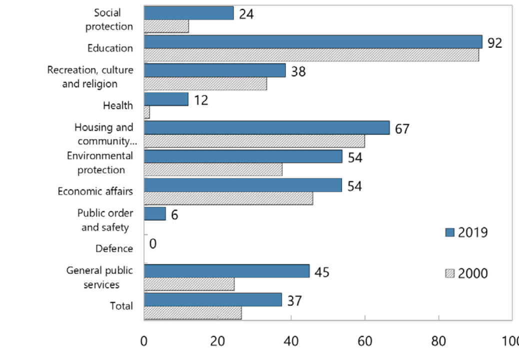
Belgium: Expenditure Functions Mainly Executed by the State Governments have Increased

State Government Expenditure by Function (COFOG)
(Percent of GDP)



Sources: European Commission and IMF staff calculations.

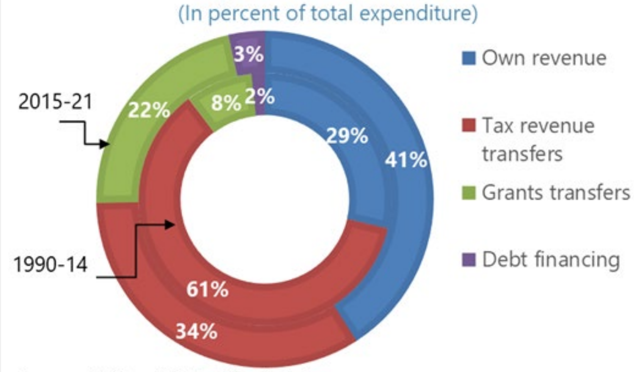
Share of State Government Expenditure by Function
(Percent of General Government Expenditure)



Sources: European Commission and IMF staff calculation.

11. The large vertical fiscal imbalances are financed by inter-governmental transfers, adding complexity to regional equalization and the overall fiscal burden. Vertical fiscal imbalance (VFI) at the subnational government measures the extent to which subnational government expenditures are not financed through their own revenues, but financed by net transfers from other units of the general government (i.e., the federal government and federal-level social security funds) or by subnational government borrowing, all expressed as shares of subnational own spending. Transfers include tax revenue transfers and grants (i.e., current and capital transfers from other public authorities). Revenue devolution on its own would lower VFI, while spending decentralization would raise it. In fact, the reliance on 'current and capital transfers from other public authorities' (i.e., grant transfers) has increased. Grants transfers increased to 4.4 percent of GDP in 2015-21 from 1-1.7 percent of GDP during 1990-2014. While own revenues collected by region and community governments have increased with correspondingly lower transfers of tax revenues, the combined financing from tax revenue rose from 13 percent of GDP in 1990-2014 to 15 percent in 2015-21. Overall, grant transfers are formula-based with limited flexibility for *ad hoc* determinations or adjustments. As the leeway for subnational governments to increase their own revenues is relatively limited (although the regional governments could possibly utilize surcharges), additional support to subnationals—especially in the aftermath of a large negative shock—may increasingly rest on the federal government. Below are some specific features of financing sources of expenditures of regions and communities.

Financing Sources of Expenditure in Regions and Communities
(In percent of total expenditure)



Sources: NBB and IMF staff calculation.

- Own revenues of the regions include some twelve own-sourced taxes, such as registration duties on sales of real estate, tax on vehicles, and taxes on goods and services.

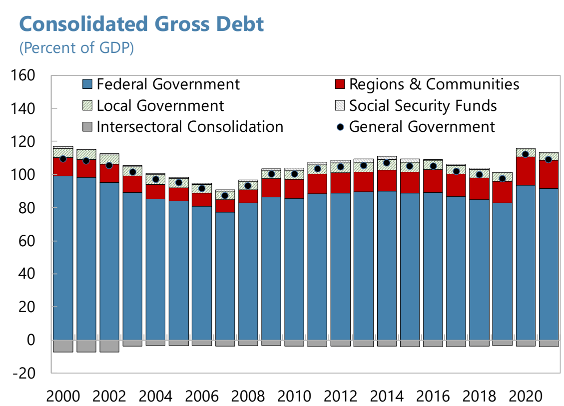
- Tax revenue transfers are shared taxes, as the regions receive a portion of personal income tax (PIT) revenues collected on their territory. Since 2014, the regions may also levy an additional regional tax on federal PIT.

- In contrast, communities do not have their own taxes, and are mainly financed by shared tax revenues from the PIT collected in their area and the VAT tax. Under an equalization mechanism, interregional revenue transfers take place via the federal government to regions whose average PIT yield is below the national average. Studies such as Gerard (2014) show that the Brussels and Walloon regions receive transfers with income per capita lower than the national average, while the Flemish region contributes.

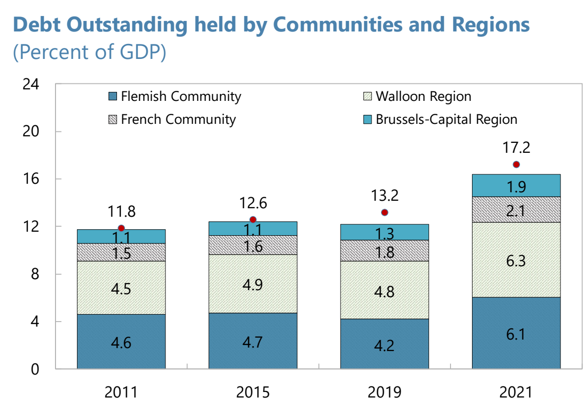
- The regions and communities receive specific federal grants to implement spending policies corresponding to their respective powers. Similar to tax revenue, the grants give rise to an interregional transfer only if the per capita amount of the region's grants differs from the national average of per capita grants.

- Estimates of fiscal resources redistributed through revenues and grants of the federal government and social security funds (NBB (2021)) show that Flanders made a net implicit contribution to interregional transfers of €6.2 billion (€900 in per resident). Brussels was also a net contributor of €900 million (€800 per capita), while Wallonia, received €7.1 billion (€1,900 per capita) in 2019.[6]

Belgium: Increasing Contribution of Communities and Regions Debt to 16 Percent of Consolidated Gross Debt



Sources: NBB and IMF staff calculations.



Sources: NBB andMF staff calculations.

12. The rapid increase in general government debt in 2020-21 included large increases in debts incurred by regional and community governments. Debts of regional and community governments, aggravated by the widening of deficits during the pandemic, increased from an average of 12 percent of Belgium's GDP in 2010-2015 to 17 percent of GDP in 2021. Debt

[6] For implicit transfers among regions, Flanders has been a net contributing region since the 1960s, whereas Wallonia has been a net beneficiary region (Gerard (2014)).

outstanding increased by 1.9 ppt of GDP in the Flemish region, 1.4 ppt of GDP in the Walloon region, and 0.6 ppt of GDP in the Brussels-Capital region over 2019-21. The dependency on debt financing to cover expenditures has increased rapidly—to about 22 percent for the Brussels Capital region and to 17 percent for the Walloon region, compared with less than 5 percent for the Flemish region in 2021 (Table 1). This steep buildup of the debt burden, together with the expected deterioration of regional fiscal positions over the medium term with unchanged polices and rising deterioration of regional fiscal positions over the medium term with unchanged polices and rising interest rates, are likely to have large, long-term impacts on the sustainability of regional finances.[7]

Table 1. Belgium: Financing Sources of Expenditure in Flanders, Wallonia, Brussels, and the French Community

	2011	2015	2019	2020	2021	2011	2015	2019	2020	2021
	Percent of GDP					Percent of total expenditure				
Flemish Region and Community										
Total revenue	9.2	11.1	11.2	11.2	11.2	99.6	98.9	100.2	89.6	95.1
Own revenue	3.4	4.1	5.1	5.2	5.0	36.3	36.6	45.2	41.6	42.0
Tax revenue transfers from other public authorities	5.0	3.9	3.8	3.6	3.7	54.1	35.1	33.6	28.9	31.5
Current and capital transfers from other public authoritie:	0.9	3.1	2.4	2.4	2.6	9.3	27.2	21.5	19.1	21.7
Debt financing (=Overall deficit)	0.0	0.1	0.0	1.3	0.6	0.4	1.1	-0.2	10.4	4.9
Total expenditure	9.2	11.2	11.2	12.5	11.8	100.0	100.0	100.0	100.0	100.0
Transfers to other public authorities and other sectors	1.5	1.6	1.5	2.1	1.7	16.6	14.0	13.5	16.7	14.6
Expenditure (excl. transfers)	7.7	9.7	9.7	10.4	10.1	83.4	86.0	86.5	83.3	85.4
Walloon Region										
Total revenue	2.1	3.2	3.1	3.1	3.1	90.5	96.1	96.6	86.8	83.0
Own revenue	1.0	1.3	1.6	1.7	1.6	41.4	38.8	50.4	47.4	41.4
Tax revenue transfers from other public authorities	1.0	0.7	0.6	0.6	0.6	41.3	19.8	18.0	15.7	15.1
Current and capital transfers from other public authoritie:	0.2	1.2	0.9	0.8	1.0	7.8	37.6	28.2	23.7	26.5
Debt financing (=Overall deficit)	0.2	0.1	0.1	0.5	0.6	9.5	3.9	3.4	13.2	17.0
Total expenditure	2.3	3.3	3.2	3.6	3.7	100.0	100.0	100.0	100.0	100.0
Transfers to other public authorities and other sectors	0.6	0.7	0.6	0.8	0.8	26.8	21.0	19.7	23.4	21.5
Expenditure (excl. transfers)	1.7	2.6	2.6	2.7	2.9	73.2	79.0	80.3	76.6	78.5
Brussels Capital Region										
Total revenue	0.8	1.1	1.0	1.1	1.1	88.9	103.0	87.6	79.2	79.4
Own revenue	0.5	0.6	0.7	0.7	0.7	50.8	56.3	56.0	52.9	49.2
Tax revenue transfers from other public authorities	0.3	0.3	0.2	0.2	0.2	28.0	25.2	19.5	16.7	16.8
Current and capital transfers from other public authoritie:	0.1	0.2	0.1	0.1	0.2	10.0	21.5	12.1	9.5	13.4
Debt financing (=Overall deficit)	0.1	0.0	0.1	0.3	0.3	11.1	-3.0	12.4	20.8	20.6
Total expenditure	0.9	1.1	1.2	1.3	1.3	100.0	100.0	100.0	100.0	100.0
Transfers to other public authorities and other sectors	0.3	0.3	0.3	0.4	0.4	27.0	27.1	25.2	32.3	31.6
Expenditure (excl. transfers)	0.7	0.8	0.9	0.9	0.9	73.0	72.9	74.8	67.7	68.4
French Community										
Total revenue	3.4	3.6	4.3	4.2	4.2	94.6	98.6	99.0	98.3	92.7
Own revenue	0.8	0.8	0.8	0.8	0.8	21.0	22.5	17.6	17.6	17.4
Tax revenue transfers from other public authorities	2.1	2.2	2.1	2.1	2.0	59.4	60.6	49.0	48.4	43.6
Current and capital transfers from other public authoritie:	0.5	0.6	1.4	1.4	1.4	14.1	15.5	32.4	32.3	31.7
Debt financing (=Overall deficit)	0.2	0.1	0.0	0.1	0.3	5.4	1.4	1.0	1.7	7.3
Total expenditure	3.6	3.7	4.3	4.3	4.5	100.0	100.0	100.0	100.0	100.0
Transfers to other public authorities and other sectors	0.7	0.7	1.5	1.4	1.5	20.9	19.3	33.7	33.5	32.9
Expenditure (excl. transfers)	2.8	3.0	2.9	2.8	3.0	79.1	80.7	66.3	66.5	67.1

Sources: NBB and IMF staff calculations.

[7] In December 2021, Moody's downgraded the long-term debt rating of the Walloon region by one notch to A3, reflecting the long-lasting impacts of the Covid-19 crisis, the expectation that substantial deficits will elevate the region's debt for an extended period, and a less favorable assessment of the Walloon regional economy compared with Belgian and European peers.

In particular, relying on market-based risk assessment to influence regional debt issuance and debt sustainability may not be effective, especially if the federal authorities are perceived as responsible for supporting subnational borrowers.[8]

13. The outlook for regional public finances is challenging. The economic performance of the regions has been affected by initial conditions and by the pandemic, the energy crisis, and other shocks. The economy of Flanders recovered relatively quickly from Covid-19, surpassing its pre-pandemic GDP level in 2021. The Walloon economy has also recovered to pre-Covid-19 levels, but experienced devastating flooding in 2021; Wallonia also faces structurally higher unemployment. The post-pandemic catch-up has been slower in the Brussels-Capital Region, where activity was expected to reach its pre-Covid-19 levels in 2022 (FPB July 2022). The regions and communities are relatively well protected against the effects of inflation, due to the indexing of federal grants, but still faced additional costs for responses to the recent shocks. Looking forward, their fiscal deficits are expected to remain higher than before the pandemic.[9] Local authorities, however, are expected to continue to be in balance or record small deficits—in line with balanced budget requirements—while relying on revenue transfers from regional governments (Table 2).

Table 2. Belgium: Summary of Fiscal Positions: Net Lending (+)/Borrowing (-)
(Percent of GDP)

	2019	2020	2021	2022[1/]	2023[1/]
General government	**-1.9**	**-9.0**	**-5.6**	**-5.2**	**-5.8**
Entity I	-1.6	-6.7	-4.0	-3.4	-4.1
Federal government	-1.9	-6.9	-4.2	-3.0	-4.1
Social Secutiry Funds	0.2	0.2	0.3	-0.4	0.0
Entity II	-0.3	-2.3	-1.6	-1.8	-1.6
Regions and Communities	-0.3	-2.4	-1.6	-1.7	-1.4
Local government	0.0	0.1	0.0	-0.1	-0.2

Sources: FOD BOSA; and NBB.
[1/] 2022 and 2023 are based on 2023 Draft Budgetary Plan.

[8] Past episodes of implicit federal bailouts include amendments of the Special Finance Act in 1993 and 2001 to increase federal grants to the communities after the French community repeatedly ran large deficits; in 2003, the Brussels region received unconditional grants from the federal government to balance its budget (Schnabel (2019)). Credit rating agencies appear to assume (e.g., Moody's 2021 credit opinion on the Walloon Region) a high likelihood of extraordinary support from the federal government reflecting considerations such as Article 54 of the Special Financial Act, which allows regions and communities to offset insufficient or delays in payments by contracting loans guaranteed by the federal government.

[9] The overall deficit of the Walloon Region is expected to decrease to -0.45 percent of GDP (€2.58 billion) in 2023 and -0.35 percent of GDP in 2025, while the deficit of the Brussels-Capital Region is expected to be broadly unchanged from 2023 (-0.2% of GDP) to 2027 (-0.3 % of GDP). The French Community is expected to see the overall deficits increase to -0.2 percent of GDP (€1.1 billion) in 2023 and to -0.3 percent of GDP in 2025. The Flanders budget is expected to reach a balance by 2027, although interest costs are expected to triple by 2027 to €1.2 billion (0.2% of GDP) (FPB July 2022, HCF and NBB December 2022; all figures are in percent of national GDP).

D. Policy Options to Improve Debt Sustainability Under Fiscal Decentralization

14. Urgent and concerted effort is needed to reduce fiscal deficits and place debt on a firmly downward trajectory. Belgium's public debt sustainability risks will remain elevated given the high and rising level of outstanding debt, high continuing primary deficits, higher interest cost from rising interest rates over the medium term, aging costs, and other expenditure requirements, such as the green transition and energy and national security. An ambitious, sustained adjustment is needed.[10] To place debt on a downward path, staff recommends adjustment of at least 0.6 percent of GDP to restrain the rise of overall deficit in 2023 and of 0.8 percent of GDP or more annually during 2024-30 to reach structural balance (see Belgium 2022 Article IV Consultation Staff Report) The size and duration of the proposed adjustment are demanding and will require a comprehensive approach involving both the federal and subnational governments. Non-essential expenditures should be reduced, and new spending accommodated in a reduced envelope.

15. To support fiscal adjustment, several policy actions related to the fiscal federalism framework should be considered:

- ***Recommendation 1:*** **Fiscal adjustment at the subnational levels should be a part of an overall general-government consolidation plan, with strict spending limits applying.** With the devolution of spending responsibilities from the federal government, expenditures by the regional and community governments are currently equivalent to one-third of total general government spending. The burden of spending restraint therefore must be shared. Consideration could be given to a federal-regional/community split of 67-33 to share the burden of adjustment. This would imply annual reduction of spending of about 0.3 percent of GDP over the medium term at the level of the regions and communities under staff's proposed adjustment path. In addition, introducing expenditure rules for all levels of government would improve transparency and accountability for compliance with spending limits.

- ***Recommendation 2:*** **Integrate systematic spending reviews in the budgetary process.** Spending reviews currently taking place at the federal and subnational levels should be expanded and integrated systematically in budgeting and execution—recognizing that these are resource-intensive nature—with clear macroeconomic objectives, including reining in the rapid growth of public expenditure. The expansion spending reviews that are well integrated with the budgetary process would ensure that the reviews go in depth to help to identify and rationalize spending, delivering efficiency gains by focusing on results while reducing budgetary cost. The reviews should also help form a strategic and medium-term view to managing increasingly

[10] The authorities in 2021 envisaged an adjustment of 1.4 percent of GDP over 2021-24, but events were overtaken by spillovers from the war in Ukraine and energy price support to firms and households. Adjustment of 0.6 percent of GDP for 2023-24 was envisaged in the 2023 Draft Budgetary Plan. Adjustment plan have consisted of annual fixed (0.2 percent of GDP) and variable components, the latter calibrated to the level and growth of output.

scarce public resources. Undertaking these at the federal and regional levels would help identify gaps and synergies, within the current framework for competencies.

- ***Recommendation 3:* Adopt a more strategic, multi-annual approach to fiscal policy making to support adjustment and reforms.** While Belgium has medium-term budgetary procedures in place for the development of Stability Programs that all EU member states are obliged to submit annually (T+3), there is no multi-annual document that is produced alongside the Stability Program (EC 2015).[11] Multi-year budgetary trajectories prepared by the federal and subnational governments are often of a more indicative nature, with limited substantiation. Fully developing medium-term budgetary frameworks for all levels of government would be critical in facilitating a rules-based approach and raising accountability. It would also support "correction" of overspending in particular years (not "letting bygones be bygones"), such that the excessive deficits incurred in one year would be offset in the subsequent 2-3 years, helping incentivize savings to accumulate buffers or pay down debt.

- ***Recommendation 4:* Implement the 2013 Cooperation Arrangement to strengthen budgetary coordination between different levels of government.** Budgetary coordination provides safeguards against poor incentives and excessive deficits in one or more of the federated entities.[12] A Cooperation Agreement was established in Belgium in December 2013, aiming at ensuring budgetary coordination of all levels of government.[13] However, the Agreement has yet to be implemented in practice. While the regions and communities take note of the budgetary objectives and trajectories recommended by the High Council of Finance (HCF), there has limited political will for binding budgetary commitments at the intergovernmental level. Non-endorsement by the federal, regional, and community governments of budgetary targets proposed by has constrained the HCF from fulfilling its role in

[11] No formal medium-term expenditure or fiscal framework is in place. Each new government in Belgium must submit medium-term fiscal policy objectives (OECD 2019); the coalition agreement of the current federal government sets out medium-term strategic plans.

[12] Characterized as "institutionalized cooperation" between different tiers of government in Belgium via the High Court of Finance, the Coordination Committee and the Inter-Ministerial Conference on Finance and Budget (see Husson (2017)).

[13] The Cooperation Agreement on fiscal coordination was concluded between the federal government and the regional and community governments, setting out that the budgets of the contracting parties must be in line with the objective of balancing government accounts, which will be considered met if the annual structural balance of the general government meets the medium-term objective or respects the adjustment path towards this objective as set out in the Stability Program (SP). The local authorities are not among the contracting parties but the rules of the Cooperation Agreement apply to the collective government, including the local authorities. The Agreement also introduced a structural government budget balance rule at general government level. In this context, the annual budgetary targets of the general government, are distributed in nominal and structural terms among the various parts of the general government, based on the advice from the Public Sector Borrowing Requirements" (PSBR) Division of the High Council of Finance (HCF). A temporary deviation from the medium-term objective or from the adjustment path is only permitted in exceptional circumstances by the PSBR-HCF. It also sets out that a significant deviation of a contracting party in relation to its commitments must be immediately justified and take corrective action to put an end to the deviation within a period of 18 months, unless the economic or institutional reality justifies a longer period.

establishing credible, multi-annual budget plans and in monitoring outcomes.[14] Therefore, advancing cooperation among the federated entities would be an important step to adhere to medium-term budgetary objectives, to restore buffers, and to ensure fiscal sustainability.

- ***Recommendation 5:* Fully internalize the cost of overborrowing and recalibrate grant transfers.** The introduction of debt sustainability guidelines for subnational governments would help impose discipline with respect to overspending and debt financing. This would help, in turn, reduce the consolidation burden of the federal government and lower the risk of a deterioration of ratings. Grant transfers should preferably incorporate elements that improve incentives and outcomes, while transfers should be linked to demonstrated spending efficiency gains. This will be essential for the consolidation effort.

- ***Recommendation 6*: Retain some flexibility in the pace and scope of fiscal decentralization.** When considering further fiscal decentralization, careful attention should be paid to: (i) reviewing if the federal government has retained a sufficient share of expenditures and revenues to conduct counter-cyclical policies to mitigate the impact of external or internal shocks; and (ii) the alignment of the pace of expenditure and revenue decentralization, to address vertical fiscal imbalances.

- ***Recommendation 7:* Improve the integration of fiscal sustainability objectives in structural reforms**. Structural reforms, including pension and labor-market reforms, should have clear fiscal consolidation objectives. More specifically, reform proposals should be accompanied by cost-benefit assessments and budgetary cost estimates—at the federal and subnational levels—to inform policy deliberations, agreement, and monitoring. In some cases, federal and regional competencies are closely associated (e.g., labor market intervention and support at the regional level and social protection spending, especially for unemployment benefits, sickness, and disability at the federal government). In these areas close coordination is particularly needed, including to align incentives and outcomes.

E. Conclusions

16. While fiscal decentralization progressed during 2015-19 vertical imbalances remained high. Devolution of spending from the federal government outpaced revenue decentralization. The resulting vertical fiscal gaps and reliance on grant-based transfers appear to have reduced spending discipline; this may have made control of rapid expenditure growth during 2020-22 even more challenging. Going forward, retaining some flexibility in the pace and scope of further devolution of competency and in the decentralization of fiscal resources will be important.

[14] The HCF recommends fiscal targets and provides normative policy assessments, and its "Public Sector Borrowing Requirements" (PSBR) section has specific competencies for intergovernmental fiscal coordination. The annual budget recommendations of the HCF-PSBR section were intended to serve as the basis for budgetary conventions and as "internal stability pacts" by setting the medium-term budgetary targets for the different levels of government (HCF and CoR).

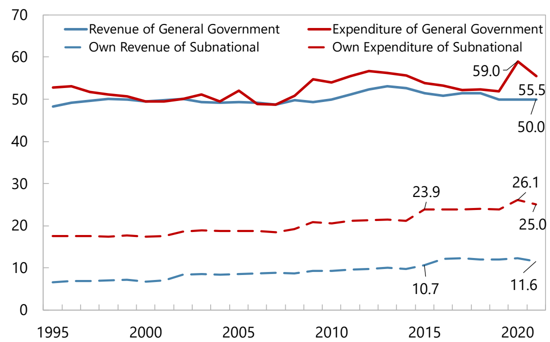
17. Belgium's fiscal and debt sustainability has deteriorated after a series of shocks; this calls for urgent and concerted efforts to implement fiscal consolidation. Credible and systematic efforts are needed to rationalize spending, including systematically incorporating spending reviews in budgetary processes, applying strict spending limits, increasing revenues via tax and revenue administration reforms, and enhancing growth and employment through decisive structural reforms. In the context of Belgium's decentralized fiscal framework, linking expenditures and interregional transfers to spending efficiency should be enhanced.

18. Fostering better fiscal policy coordination across all levels of government would improve the efficiency of Belgium's decentralized fiscal framework. Clear communication, strong fiscal institutions (fiscal rules and fiscal councils), a good track record on past fiscal performances, and importantly, political will for all levels of government would be needed to enhance fiscal credibility. In addition, implementing federal, regional, and community governments cooperation and burden sharing, as well, will be essential for the fiscal consolidation effort.

Figure 1. Belgium: Progress in Fiscal Decentralization (1995-2020)

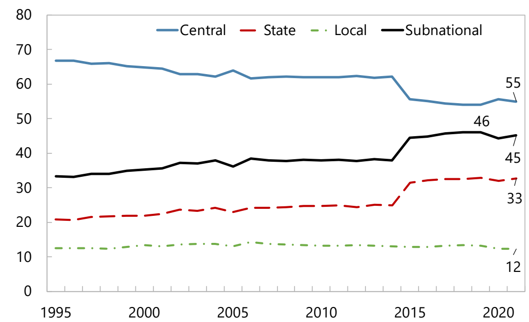
Subnational governments[1/] gained higher shares in their own revenue and expenditure since 2015…

Revenue and Expenditure
(Percent of GDP)



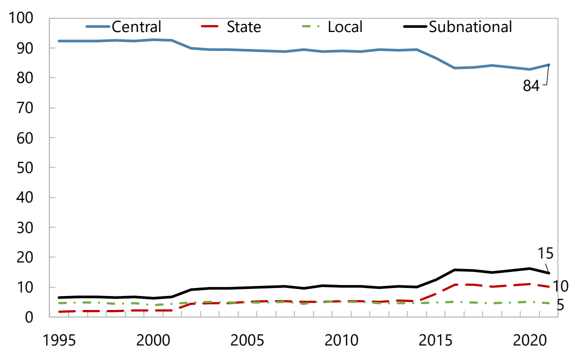
…with spending share reached 46 percent of general government total expenditure in 2019 before lowering slightly during the pandemic.

Expenditure Decentralization
(Percent of own spending to general government total spending)



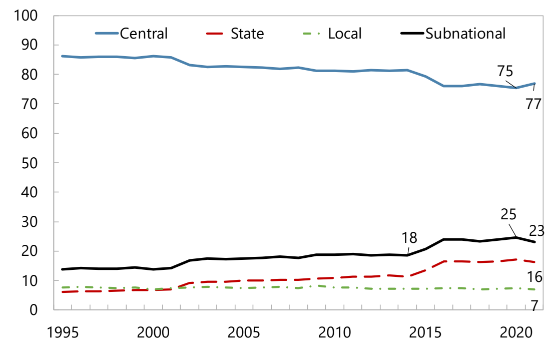
Subnational governments' own tax collection increased from 10 percent in 2014 to 16 percent in 2020…

Tax Decentralization
(Percent of general government tax revenue)



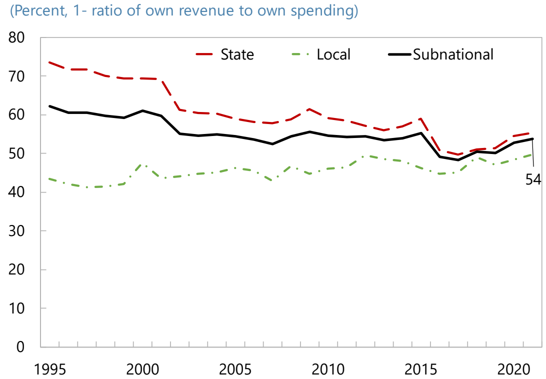
…while revenue, including inter-government transfers, rose from 19 percent to 25 percent of general government total revenue.

Revenue Decentralization
(Percent of general government total revenue)



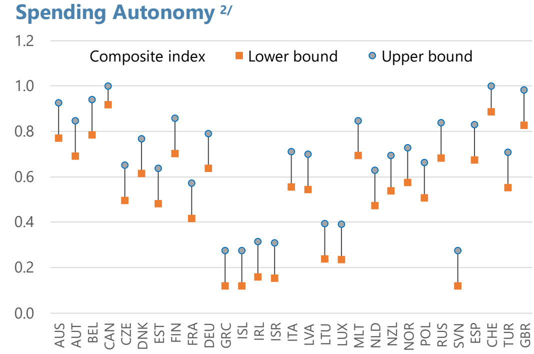
Vertical fiscal gaps have declined gradually but have risen again since 2018 due to faster spending increases.

Vertical Fiscal Imbalance
(Percent, 1- ratio of own revenue to own spending)



Belgium ranks high in decentralized spending autonomy.

Spending Autonomy [2/]

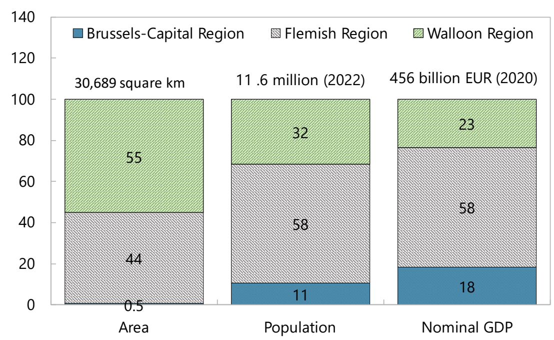


Sources: OECD Fiscal Decentralization Database and IMF staff calculation.
1/ Subnational government comprises state and local governments in the OECD Fiscal Decentralization database. This corresponds to regional and community governments, and local provincial and municipal authorities, respectively in Belgium.
2/ Composite spending autonomy indicator from OECD Fiscal Decentralization Database; scale of 0 (most centralized) to 1 (most decentralized).

Figure 2. Belgium: Economic and Social Characteristics by Regions

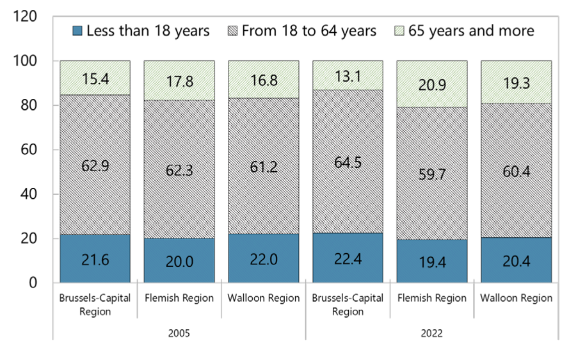
French-speaking Wallonia makes up over half of the land area but only a third of Belgium population.

Area, Population and GDP Size
(Percent)



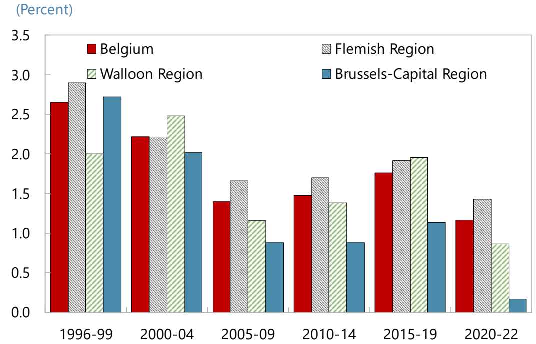
The densely populated Brussels-Capital Region (BCR) has a younger population with more inflow of immigrants.

Structure of Population
(Percent)



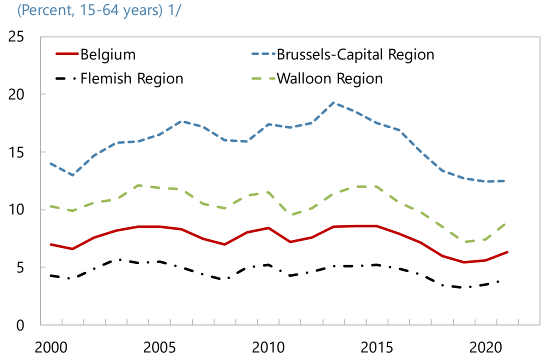
Dutch-speaking Flanders has higher economic growth…

Real GDP Growth
(Percent)



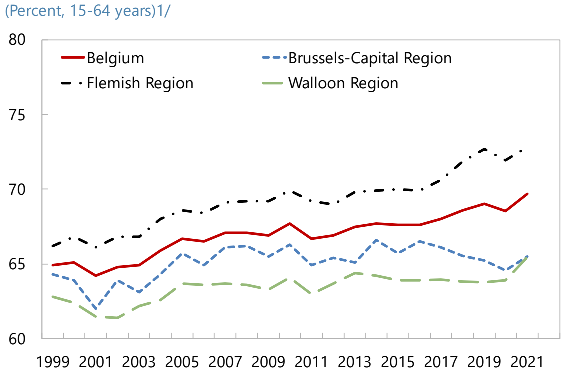
…with lower unemployment rate over the years.

Unemployment Rates
(Percent, 15-64 years) 1/



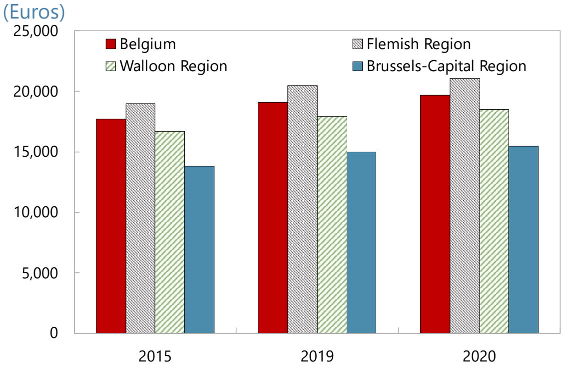
Activity rates are slow to rise in Wallonia and BCR.

Labor Force Participation Rates
(Percent, 15-64 years)1/



Flanders is richer with average tax income per capita above the national average.

Average Tax Income Per Population
(Euros)



Sources: StatBel; NBB; Federal Planning Bureau; and IMF staff calculation.
1/ As the Labor Force Survey has undergone considerable changes in collection methods and compilation methodology in 2017, the figures obtained before 2017 are not directly comparable.

Box 1. Belgium: Evolution of Fiscal Federalism in Belgium

The Belgian federation has three levels of government—the Federal government, the regional and community governments, and the local governments. The territory of the federal state is divided into six federated entities, comprised of three language communities (Flemish, French and German), and three geographical regions (Flanders, Wallonia and Brussels Capital), ten provinces, and 589 municipalities." 1/

Six state reforms took place in 1970, 1980, 198-89, 1993, 2001 and 2011, resulting in a progressive move from a unitary to a federated state. The Sixth State Reform enhanced the fiscal autonomy of the federated entities (e.g., regional personal income tax) and transferred more powers/competencies from the federal to the regional and community levels. There is no hierarchy between the federal authority, the regions and the communities—all three are equal from a legal perspective and are granted specific powers and responsibilities in different areas. The regions are competent in territorial matters (including economic development, transports, environment, housing) as well as employment, whereas the communities have competencies in language, culture and sports.

Box Table 1. A Summary of Belgian Six State Reforms and Fiscal Decentralization

Reforms	Key Changes in Institutions	Fiscal Decentralization and Changes in Financing
1970	Created three cultural communities	Grants from the Federal authority
1980	Established the Flemish Region and the Walloon Region; each community was given more power of decision and created its own parliament and government	The 1980 Act of Regionalization introduced a limited devolution of revenue-raising powers. Regional and community governments are permitted to levy taxes but non bis in idem with the exception of PIT, joint tax. Receiving transfers from part of the revenue of some taxes; and loans.
1988-89	Established a bilingual Brussels Capital Region	*Large scale expenditure decentralization*. Communities are given responsibility in education and the regions are granted responsibility in transport and public work. Equalization transfer introduced in 1990 to compensate regions if regional PIT per habitant is smaller than the federal level; "taxes collected by the federal government were transferred to sub-nationals by means of a set of "repartition keys." Two new grants for communities: a claim on VAT revenue for education; and a claim on PIT for other competencies.
1993	Creation of the Belgian Federal State	Due to the lack of resources, the French-speaking Community transferred competencies to Walloon region and Brussels French-speaking Community commission, but not all the corresponding means.

Box 1. Belgium: Evolution of Fiscal Federalism in Belgium (Concluded)

Reforms	Key Changes in Institutions	Fiscal Decentralization and Changes in Financing
2001	The Flemish Parliament became directly elected under the Lombard Agreement	*Strong push on revenue decentralization*. Established the Lambermont Agreement, among which the regions were granted an extension of their fiscal powers and the communities provided with financial measures. More tax autonomy for the regions: to levy positive or negative surcharges on PIT within a limit of 6.75 percent of the PIT. Refinancing of communities: additional grant and increased VAT claim for education; PIT adopted for the future.
2011	Substantial state reform will take place in several stages	*More competences were shifted from the federal level.* The regions were made responsible for territorial matters (e.g., infrastructure) in economy, employment and tax matters, and the communities become responsible for people related matters (e.g., culture, education), and family policy (e.g., healthcare, family allowance). The reform in 2011-13 included a first partial decentralization of Social Security (a transfer of 61 million euros); and decentralized competences of 20 billion euros, including child allowances (6 billion euros), employment policy (4 billion euros) and health policies (4 billion euros). Increased decentralized financing (e.g., increased tax autonomy of 12 billion euros and expanding regional PIT competences).

Sources: Gerard (2014); Peeters & Haljan (2016); Karpowicz (2012); and European Committee of the Regions (CoR) - Division of Powers.

The increase in budgetary autonomy of subnational governments granted in the sixth state reform includes the right to run fiscal deficits and to finance by borrowing. Regions and communities are authorized to issue debt on financial markets to fund current and capital expenditures while local governments (municipalities and provinces) can only borrow to fund investment projects. The federal authorities, based on recommendation of the High Council of Finance 2/, could, if considered it necessary, impose borrowing limits on regions if they have not respected their budgetary targets, to prevent endangering economic stability or the external balance 3/, while in practice, the implementation is likely far more complex.

1/ The institutions of the Flemish Community and the Flemish Region were merged at the beginning, such that one Parliament and one Government exercise both the regional and the community powers, to prevent the number of members of parliament to increase excessively.

2/The High Council of Finance, composed of members nominated by the federal, regional, and community levels, and the National Bank of Belgium, monitors and analyzes the borrowing requirements of all levels of government at regular intervals, and based on fiscal/debt sustainability, formulates recommendations about the medium- and long-term budgetary targets for the different government levels.

3/European Committee of the Regions (CoR) - Division of Powers; and Martinez-Vazquez and Vulovic (2016).

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