

## **Belgium: Selected Issues**

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INTERNATIONAL MONETARY FUND

BELGIUM

**Selected Issues**

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Approved by the European Department

January 12, 2007

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## EXECUTIVE SUMMARY

As emphasized in the staff report for the 2006 Article IV consultation with Belgium, fiscal consolidation and an increase in the flexibility of labor markets are key economic policy priorities. Together, they should make headway in addressing the long-term challenge of population aging, while reform in the labor market would also address concerns about external competitiveness going forward and improve the economy's ability to take advantage of global dynamics. These issues are documented in the following two chapters of this selected issues paper.

The first chapter focuses on the fiscal challenge in coping with population aging, including the sustainability of prevailing fiscal federalism arrangements across levels of governments. The analysis demonstrates that the current strategy of upfront consolidation is likely to fall short of achieving sustainability. Further reductions in aging-related spending and growth- and productivity-enhancing reforms beyond those assumed under the authorities' strategy appear to be necessary. In addition, the parameters of the current arrangements of revenue sharing and allocation of expenditure responsibilities across levels of government are forcing an unworkable degree of fiscal adjustment onto the federal government. A modification of the arrangements has become essential, but the substance of the changes are a political issue. It will be important that any further devolution of spending be accompanied by heightened accountability and improved coordination of fiscal and other economic policies across levels of government.

The second chapter assesses whether the wage bargaining framework, a key labor market institution, is conducive to preserving external competitiveness and raising employment rates. It finds that during 1996–2006, the increase in labor costs in Belgium was largely in line with the average of three neighboring countries, but that Belgium's competitive edge has eroded, especially in its manufacturing sector. This is mainly because the framework does not take into account differential productivity growth in setting the margin for wage increases and the practice of indexation places a floor under domestic wage increases. While full decentralization of wage bargaining may not be feasible in the short term, some changes to the framework are necessary to prevent further losses in competitiveness. "All-in" agreements should be encouraged to minimize high wage increases due to inflation surprises, and any tax cuts should be used solely to reduce labor costs. The law that past overruns of the wage norm should be corrected in subsequent wage agreements needs to be enforced. In the longer run, the framework needs to be changed to take into account developments in productivity and allow more wage dispersion at the sectoral and enterprise levels.

## I. FISCAL SUSTAINABILITY AND COORDINATION IN A FEDERAL STATE<sup>1</sup>

### A. Introduction

1. **Coping with the rising fiscal costs from population aging remains one of Belgium's main challenges.** In its latest report, the High Council of Finance's (HCF) Study Committee on Aging (SCA) estimates net aging costs to rise by 5.8 percentage points of GDP between 2005 and 2050.<sup>2</sup> Even if the Belgian population is aging at a comparable pace with those of other EU countries, the increase in aging-related costs is among the highest in the European Union, reflecting a rapid rise in pension and health care expenditures.

2. **To deal with the rising costs, the government is pursuing a multi-pronged strategy of building up fiscal surpluses and implementing growth and productivity-enhancing reforms.** It is targeting a 0.3 percent surplus in 2007 and wants to increase the surplus by 0.2 percent each year to 1.3 percent of GDP by 2012. Meanwhile, its latest Stability Program calls for a significant structural improvement in labor supply and productivity.<sup>3</sup> Nonetheless, while improvements in productivity growth and labor supply are key, the pre-funding of the estimated aging costs through up-front fiscal consolidation remains at the center of the strategy, partly reflecting concerns about intergenerational fairness.<sup>4</sup>

3. **However, implementation risks are significant, and a clear fiscal framework to ensure sustainability encompassing all levels of government still needs to be determined.** While fiscal balance has been preserved in recent years and the government remains committed to accumulating surpluses starting in 2007, fiscal policy has relied on one-off measures to achieve its objectives without implementing a durable strategy and without appreciably improving the public sector's net worth. In addition, the SCA's latest estimates of aging-related costs suggest that fiscal sustainability is not necessarily secured under the current policy approach. Moreover, with spending pressures varying across levels of government, the sustainability of fiscal arrangements among the various levels of governments needs to be established. This becomes increasingly important in light of calls for greater fiscal devolution and tax autonomy.

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<sup>2</sup> The latest report of the Study Committee on Aging can be found at:  
[http://docuфин.fgov.be/websedsdd/intersalgr/hrfcsf/adviezen/PDF/veillissement\\_2006\\_05.pdf](http://docuфин.fgov.be/websedsdd/intersalgr/hrfcsf/adviezen/PDF/veillissement_2006_05.pdf).

<sup>3</sup> See Belgium's 2007–10 Stability Program  
[http://ec.europa.eu/economy\\_finance/about/activities/sgp/country/countryfiles/be/be20062007\\_fr.pdf](http://ec.europa.eu/economy_finance/about/activities/sgp/country/countryfiles/be/be20062007_fr.pdf).

<sup>4</sup> See Langenus (2006).

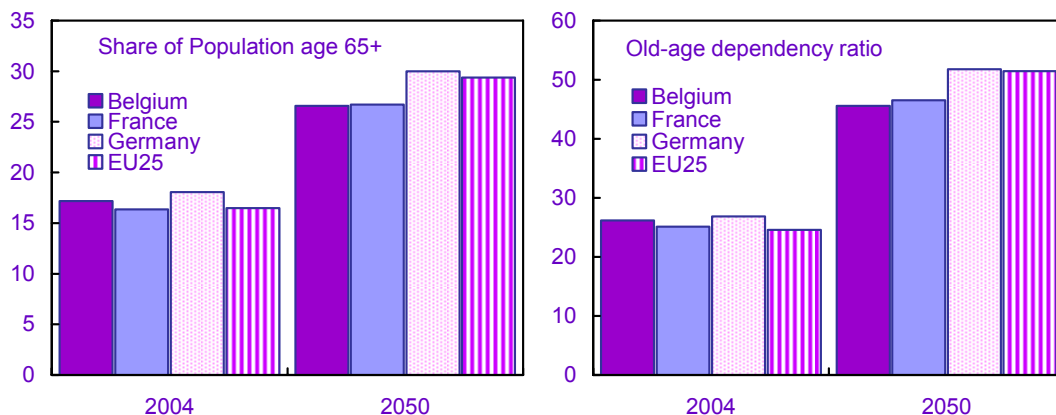
4. **Against this background, this chapter assesses Belgium’s fiscal challenge of coping with population aging and sustainability under the current fiscal arrangements across levels of governments.** The analysis shows that the current strategy of upfront consolidation does not ensure sustainability and suggests that further reform of social spending and growth- and productivity-enhancing reforms beyond those assumed under the authorities’ strategy would be necessary. In addition, the fiscal adjustment should remain consistent with an equitable burden-sharing across levels of government to ensure that all entities contribute to fiscal consolidation. In this context, as the burden of population aging falls almost entirely within the responsibilities of the federal government, further devolution of social spending and consideration of the tax-sharing system should be mindful of the implications on the fiscal sustainability across levels of government.

5. **This chapter is organized as follows:** Section B points to the challenges of population aging focusing on the latest estimates of its fiscal costs. Section C assesses fiscal strategies to deal with rising costs from population aging, noting that the current government policies do not suffice and that further reforms might be called for. Section D reviews the new challenges to the current fiscal arrangement in Belgium. Section E concludes.

### B. Challenge of Population Aging

6. **Belgium’s population is projected to age fast, but the demographic change is no more dramatic than in other industrialized countries.** According to the SCA’s baseline, the population is projected to rise by 5 percent by 2050 led by an increase in the fertility rate and life expectancy and an essentially constant net positive migration. At the same time, the elderly population is expected to jump by over 63 percent and would represent over a quarter of the total population by 2050. However, the aging profile in Belgium is broadly comparable if not slightly better than in most of Europe. Belgium’s old-age dependency ratio would reach 45.6 percent in 2050 compared with an average of 51.4 percent among EU25 countries (Figure 1).

Figure 1. Belgium: Demographic Changes Among EU Countries



Sources: European Commission; and Study Committee on Aging.

7. **This dramatic demographic change will have significant repercussions on public finances.** According to the SCA, total social spending is projected to increase by 3.8 percent by 2030 and 5.8 percent by 2050 (Table 1). In Belgium, like in many other European countries, the provision of pensions and health care, arguably the two most affected spending items, are almost entirely funded by public resources. Not surprisingly, pension and health care costs account for the bulk of aging-related expenditures adding 3.9 percent and 3.7 percent to the fiscal burden by 2050, respectively. At the same time, a reduction in unemployment charges (resulting from a projected drop in unemployment) and lower child-related support due to the demographic changes would provide fiscal relief of about 1.7 percent of GDP.<sup>5</sup>

Table 1. Belgium: Projections of the Fiscal Costs of Aging, 2005–50  
(In percent of GDP)

	2005	2011	2030	2050	2005–11	2005–30	2005–50
Pension	9.1	9.0	12.0	13.0	0.0	2.9	3.9
Health care	7.1	7.9	9.5	10.8	0.9	2.4	3.7
Other	6.8	6.6	5.4	5.1	-0.4	-1.5	-1.9
<i>Of which</i>							
Work disability	1.2	1.2	1.2	1.1	0.0	0.0	-0.1
Unemployment	2.2	2.1	1.3	1.2	-0.2	-1.0	-1.1
Family allocations	1.6	1.5	1.2	1.1	-0.2	-0.4	-0.6
Total social spending	23.1	23.4	26.8	28.8	0.4	3.8	5.8

Source: Study Committee on Aging.

8. **The SCA's estimates of the costs of aging are based on sanguine macroeconomic assumptions, in particular with regard to employment and output growth.** In its central scenario, the SCA projects an increase in the employment ratio of 7.5 percentage points to 69.5 percent by 2030. The improved performance in the employment ratio reflects higher female employment rates (up 10.4 percentage points), which are expected to follow from the gradual replacement of older women by younger women with a higher educational attainment and stronger attachment to the labor market. In addition, the employment rate of older workers (aged 55 to 64) is projected to increase sharply (up 12 percentage points), partly reflecting the recent reversal of the decades-long trend towards earlier retirement as

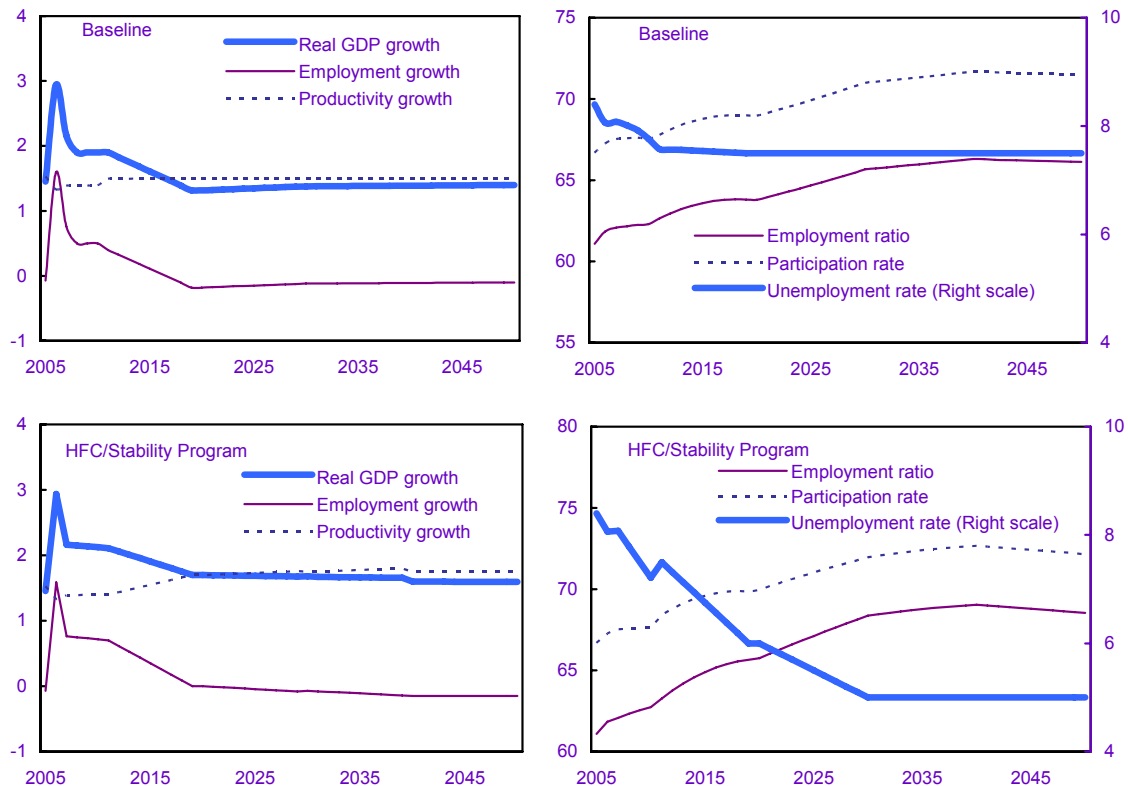
<sup>5</sup> The 2005 Generation Pact is estimated to have a net positive impact of 0.1 percent of GDP on the costs of aging through 2050. Measures to discourage early retirement and prolong work life would boost labor supply and growth (by 1 percent), leading to higher revenues (+0.5 percent). At the same time, increases in social spending including the adjustment of pension wage bases and social benefits to well-being could add up to 0.36 percent.



well as the estimated positive effects of recent reforms.<sup>6</sup> At the same time, this scenario presumes appreciable labor market reforms, as suggested by the sharp decline in long-run unemployment.

9. **Rising employment rates, however, would only provide a temporary cushion as employment growth would begin to decline by around 2020.** Between 2005 and 2011, the size of the working age population and overall level of employment will continue to rise. Beyond 2011, rising employment rates will offset the projected decline in the size of the working-age population brought about by the baby-boom generation entering retirement until about 2020 (Figure 2). By then, the trend towards higher female employment rates will have come to an end, and the employment rate of older workers would reach a steady state. Hence, the weight of demographic change will begin to prevail, contributing to a gradual drop in employment after 2020.

Figure 2. Belgium: Macroeconomic Assumptions for Scenarios, 2005–45



Sources: 2007–10 Stability Program; Study Committee on Aging; and IMF staff calculations.

<sup>6</sup> The 2005 Generation Pact is expected to lift employment growth by 1 percent from 2005 to 2030 for an increase in the employment ratio of 0.7 percentage point. Key measures that are expected to boost labor supply include the tightening of conditions for early retirement and the introduction of a pension bonus for workers aged 62 or older. In addition, the impact of recent policies to discourage workers from dropping out of the labor market have partially resulted in an upward revision retention rates.

**10. Demographic change is expected to weigh on output growth over the long run.**

The SCA's central scenario points to a slowdown of output growth from 2.2 percent per year on average in the 2005–11 period to 1.6 percent by 2050 (Table 2). With employment growth trending downward soon after 2011, productivity growth will become the dominant source of growth. The SCA foresees an increase of annual labor productivity growth to 1.75 percent, consistent with TFP productivity growth of 1.1 percent per year (which corresponds to estimates of the EU's TFP growth during the 1970–2004 period) and a 0.6 percent contribution of rising capital intensity over the long run.

Table 2. Belgium: Macroeconomic Assumptions, 2005–50

	2005–11	2011–30	2005–30	2005–50	2030–50
<b>Baseline</b>					
Real GDP growth 1/	2.0	1.5	1.6	1.5	1.4
Employment growth 1/	0.6	0.0	0.1	0.0	-0.1
Labor productivity growth 1/	1.4	1.5	1.5	1.5	1.5
Employment ratio 2/	1.6	3.0	4.6	5.0	0.5
Participation ratio 2/	1.1	3.2	4.3	4.8	0.5
<b>SCA scenario</b>					
Real GDP growth 1/	2.2	1.8	1.9	1.8	1.6
Employment growth 1/	0.7	0.1	0.3	0.1	-0.1
Labor productivity growth 1/	1.4	1.6	1.6	1.7	1.8
Employment ratio 2/	2.2	5.1	7.3	7.5	0.2
Participation ratio 2/	1.7	3.6	5.3	5.5	0.2
<b>Active reform</b>					
Real GDP growth 1/	2.2	2.0	2.0	2.0	2.0
Employment growth 1/	0.7	0.1	0.3	0.1	-0.1
Labor productivity growth 1/	1.5	1.9	1.8	1.9	2.0
Employment ratio 2/	2.2	5.1	7.3	7.5	0.2
Participation ratio 2/	1.7	3.2	4.9	5.1	0.2

Sources: Study Committee on Aging, IMF staff.

1/ Period average, percent change.

2/ Change in percentage points.

**11. To illustrate the importance of macroeconomic assumptions, a less sanguine “baseline” scenario is considered, in particular with regard to employment and productivity growth.** Annual labor productivity growth is assumed to average 1.5 percent during 2005–50, in line with the average productivity growth over the past two decades. In addition, the improvement in labor participation is less dramatic, reflecting only cohort effects on female employment and the impact of recent reforms on elderly retention rates, and otherwise unchanged labor market policies. As a result, the employment rate is projected to increase by 5 percentage points over the projection period.

**12. Under the baseline macroeconomic assumptions, the fiscal burden of age-related spending is significantly higher than under the SCA's macroeconomic scenario.** The baseline projection implies that the burden of social spending would increase by about 2¾ percentage points of GDP over the SCA's estimate of 5.8 percent of GDP by 2050. As the development of age-related spending is constructed using the SCA's projections, it is

assumed that pension outlays follow the projected path in nominal terms while health care costs track it proportionally. Evidently, the two macroeconomic scenarios would imply markedly different debt dynamics under similar fiscal strategies.

### C. Policy Strategy to Achieve Sustainability

13. **Based on the two macroeconomic scenarios described earlier, two stylized fiscal scenarios are presented with the objective of assessing the current strategy to achieve fiscal sustainability.** The first scenario considers an upfront fiscal adjustment based on the staff's recommended surplus of 1.5 percent by 2011 under the baseline macroeconomic assumptions (Table 3). The second one follows the fiscal consolidation path outlined in the 2007–10 Stability Program based on the authorities' more optimistic macroeconomic scenario.

Table 3. Belgium: Long-Term Fiscal Scenarios, 2005–50  
(In percent of GDP; unless otherwise indicated)

	2005	Projection			Percent change		
		2011	2030	2050	2005–11	2005–30	2005–50
Scenario 1: Adjustment without reform							
Primary balance	4.4	4.9	0.5	-2.3	0.5	-3.9	-6.7
Fiscal balance	0.1	1.5	-0.9	-5.2	1.5	-0.9	-5.3
Social expenditure	19.4	20.1	25.1	27.9	0.8	5.8	8.5
Debt	91.5	69.0	28.8	66.4	-22.5	-62.7	-25.1
Real nonsocial spending growth 1/	5.4	0.0	1.4	1.4	-5.4	1.2	1.3
Scenario 2: SCA scenario based on the Stability Program's medium-term fiscal objectives							
Primary balance	4.4	4.5	1.4	-0.6	0.1	-3.0	-5.0
Fiscal balance	0.1	1.1	0.2	-1.8	1.0	0.2	-1.9
Social expenditure	19.4	19.7	23.1	25.1	0.3	3.8	5.8
Debt	91.5	69.2	24.1	27.4	-22.3	-67.4	-64.0
Real nonsocial spending growth 1/	5.4	1.8	1.7	1.6	-3.6	1.9	1.7
Scenario 3: Consolidation and active reform							
Primary balance	4.4	4.8	1.7	0.2	0.5	-2.7	-4.2
Fiscal balance	0.1	1.4	0.6	-0.4	1.4	0.6	-0.4
Social expenditure	19.4	19.7	22.8	24.3	0.3	3.5	4.9
Debt	91.5	68.2	19.9	10.4	-23.3	-71.6	-81.1
Real nonsocial spending growth 1/	4.9	1.5	1.8	1.9	-3.4	1.8	1.8

Sources: 2007–10 Stability Program; Study Committee on Aging; and IMF staff estimates.

- *Adjustment without reform.* This scenario assumes an upfront fiscal adjustment of 1.5 percent of GDP by 2011, reaching 1.8 percent by 2012, and consistent with an average primary balance close to 4½ percent over the medium term. This would significantly reduce the debt ratio initially to a low of around 30 percent points of GDP by 2030, but thereafter, rising costs of aging begin to dominate, pushing the debt ratio on an upward path, above 60 percent of GDP (Figures 3 and 4). Indeed, the interest savings obtained in this strategy are insufficient to cover the costs of aging, and indebtedness would again rise without bound, though later and at a slower pace than in the baseline.

Figure 3. Public Debt Scenarios, 2005–45  
(In percent of GDP)

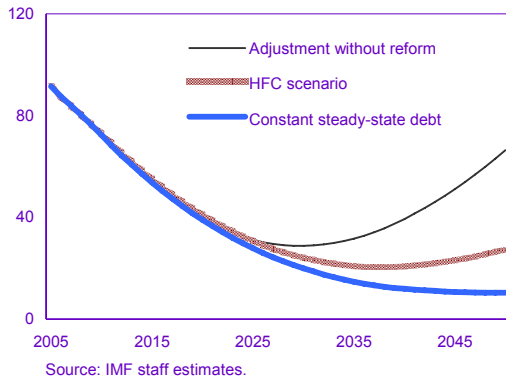
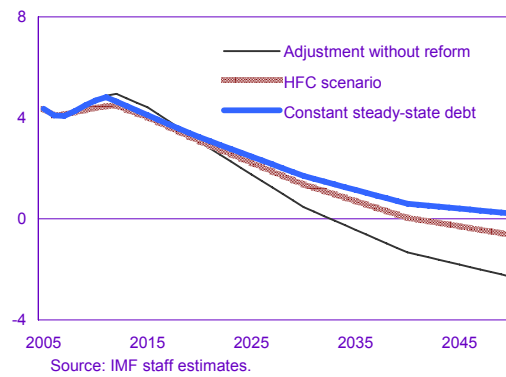


Figure 4. Belgium: Primary Balance Scenarios, 2005–45  
(In percent of GDP)



- Stability Program scenario.* In this scenario, the fiscal path is essentially consistent with maintaining the primary balance at about  $4\frac{1}{4}$  percent of GDP through 2011 (about  $\frac{1}{4}$  percentage point below the staff's recommended path) and saving the decline in interest payments for debt reduction. This scenario comes closer to achieving fiscal sustainability and brings the public debt-to-GDP ratio down to about 20 percent of GDP around 2035. Because of the more sanguine macroeconomic assumptions, the debt dynamics is more contained despite a more moderate medium-term fiscal adjustment. However, aging costs continue to rise appreciably until 2050, by which date the public debt ratio will have resumed an upward trend.

14. **Neither of the two fiscal scenarios satisfies the government's inter-temporal budget constraint over the long run.** To better illustrate the size of the budgetary imbalance under the two macroeconomic assumptions, we consider a measure of the size of the budgetary adjustment needed to ensure sustainability.<sup>7</sup> This could translate into a medium-term primary balance target that will achieve a steady-state debt-to-GDP ratio. Under the current framework, the required primary balance would be equivalent to the primary balance that is sufficient to pay interest on outstanding debt and to cover the increase in age-related expenditure.

15. **Under the baseline macroeconomic assumptions, the required primary balance would need to reach close to 7 percent of GDP over the medium term.** This implies a structural adjustment of about 3 percent of GDP over five years, compared with the  $1\frac{3}{4}$  percent structural adjustment recommended by the staff. The required adjustment would lead to a significant accumulation of net financial assets (about 40 percent of GDP) by the public sector to achieve the desired prefunding strategy. From a political economy point of view, it is rather evident that this strategy is untenable.

<sup>7</sup> Sustainability is achieved when the government's inter-temporal budget constraint is met in the very long run (i.e., beyond 2050). This is equivalent to achieving a steady-state debt-to-GDP ratio.

16. **In comparison, the required primary balance under the authorities' macroeconomic assumptions would have to attain 5¼ percent of GDP.** The required structural adjustment amounts to about 1½ percent over five years, essentially twice as much as the adjustment considered under the Stability Program. As in the previous case, net financial assets would have to be accumulated, albeit representing only about 5 percent of GDP. A tighter fiscal adjustment, consistent with the staff's recommended path, in the context of these more favorable macroeconomic assumptions would also fall short of the required adjustment by over ¼ percent of GDP. At any rate, reaching and sustaining the required structural primary balance would imply running larger surpluses, which might not be feasible.

17. **The presence of a fiscal sustainability gap shows that in addition to upfront fiscal adjustment, structural reforms are key to ensuring stable debt dynamics over the long run.** To illustrate this point, a purist scenario derives the gains in productivity growth needed to ensure convergence to a constant steady state debt-to-GDP ratio, assuming that an average primary balance of 4½ is maintained over the medium term, broadly consistent with the recommendation made by the Public Sector Borrowing Requirements Section of the High Council of Finance in its 2004 report. This would require additional reforms to yield an extra ¼ percent of productivity growth per year compared with the authorities' macroeconomic scenario (or ½ percentage point higher when compared with the baseline). This active-reform scenario illustrates the importance of implementing structural reforms to boost TFP growth and allow for capital deepening.

18. **That said, the parameters of the scenarios considered in this analysis are subject to considerable uncertainty.** The values retained in the Stability Program (notably TFP growth) seem to be on the sanguine side. Similarly, the timing and impact of structural reforms under the active-reform scenario could prove optimistic. However, relatively small reforms to reduce the projected increase in the health and pension cost of aging (e.g., 0.5 percent of GDP by 2030 and 1 percent by 2050) would constitute a prudent insurance policy against uncertainty surrounding the key macroeconomic and reform parameters of the projections.

#### **D. Challenges to the Current Fiscal Framework**

19. **Achieving fiscal sustainability would require broad political consensus and an efficient fiscal framework in the context of Belgium's complex federal system.** Over the past decade and half, Belgium managed to achieve remarkable fiscal consolidation while proceeding with fiscal devolution. The large transfer of expenditure responsibilities and revenues, including a restricted increase in tax autonomy, to regions and communities was accompanied by a sharp reduction in the general government deficit. Undoubtedly, this successful fiscal adjustment reflected a strong political will to control public finances and put the debt burden firmly on a downward path. At the same time, this result required clear budgetary targets for all levels of government and an efficient mechanism to enforce them.

Belgium's mix of a cooperative approach across all levels of government and the watchdog role of the HCF has proved successful in achieving and sustaining balance budgets since 2000. However, closing the current sustainability gap would require to accumulate substantial surpluses on a durable basis.

20. **This section analyzes the fiscal challenge of coping with population aging to the current fiscal arrangement that guides policy coordination and implementation across all levels of government.** The analysis raises a fundamental question: whether the current system provides the necessary means to ensure fiscal sustainability, in particular with regard to the implementation of the required adjustment targets. Similarly, mounting pressures for devolution of some elements of social spending represent an important challenge to the current system.

### **Policy coordination and the role of the High Council of Finance**

21. **Coordination of fiscal policy has been a central feature of the process of federalism in Belgium.**<sup>8</sup> With the decentralization of public spending and, to a lesser extent taxation power, and the significant role of each entity on public finances, regions and communities had to participate in the fiscal consolidation process. In addition, given the country's fiscal commitments under the Maastricht Treaty and Growth and Stability Pact, the federal government had to secure the cooperation of the other entities. At the same time, communities and regions enjoy a large degree of budgetary autonomy and are in equal hierarchical stance with the federal government. As a result, a cooperative model of coordination was implemented under which the federal, regional, and community governments reach multi-year agreements on fiscal coordination. These cooperation agreements are based on political commitments to clearly specified budgetary targets.<sup>9</sup>

22. **The HCF has played a key role in the coordination mechanism.**<sup>10</sup> Its role has been to provide transparency, recommend clear fiscal objectives to the different levels of government, and give incentives to policymakers to meet their targets. The HCF produces annual advisory reports, with an evaluation of the financial needs of each government entity and fiscal policy recommendations, including short and especially medium-term targets.<sup>11</sup>

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<sup>8</sup> See Gerard (2001) and De Smet (2004) for a detailed description of the process of decentralization in Belgium.

<sup>9</sup> To date, five agreements were concluded with the first one in July 1994 for the 1994–96 period, then in July 1996 for the 1996–99 period, in November 1999 for 2000–02, in December 2000 for 2001–05, and finally the last agreement reached in August 2005 covering the 2006–09 period.

<sup>10</sup> It is composed of high-level, politically-independent experts from academia and various government institutions, including public ministries, the National Bank of Belgium, and the Federal Planning Bureau. The members have renewable five-year mandates.

<sup>11</sup> In fact, it is the “Public Sector Borrowing Requirements” section (PBR) of the HCF that is in charge of making the recommendations. These reports, however, were not available for 2005 and 2006.

These recommendations form the basis of the political agreements that take the form of internal stability programs. Since 1999, these targets have been integrated in Belgium's stability program, as defined in the Growth and Stability Pact.

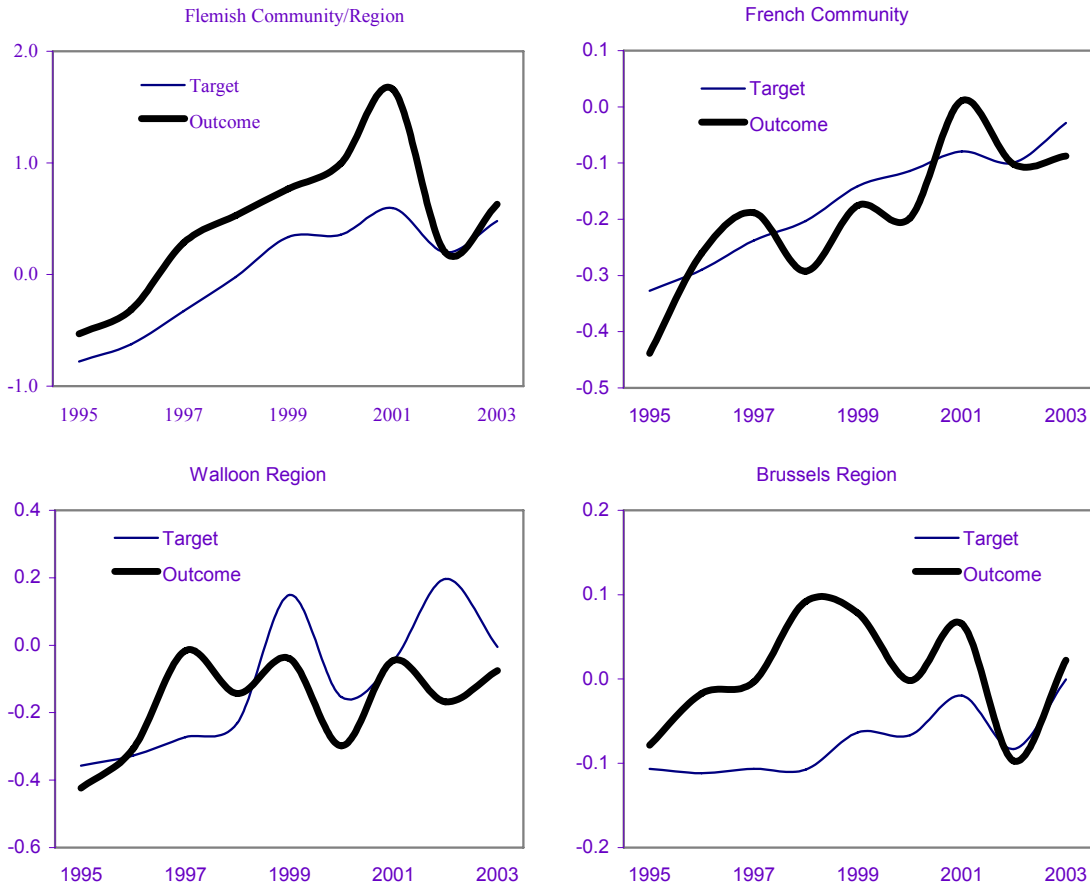
23. **The HCF also contributes to the enforcement of internal agreements.** On an annual basis, it publishes an ex-post evaluation of the implementation of the budgetary programs. This provides the opportunity to “name and shame” policy makers that have not respected their commitments while stressing the importance of maintaining a sound fiscal policy. In addition, following a special request by the federal minister of finance or on its own initiative, the HCF could also express an opinion on the merits of limiting the borrowing capacity of regions or communities. Although this situation has not happened until now, it remains a potentially useful instrument.

24. **The current fiscal framework based on cooperation and the disciplining role of the HCF has worked well until now.** Regions and communities have demonstrated a strong commitment to meeting, and even surpassing, medium-term targets laid out in the cooperation agreements. Between 1994 and 2003, the difference between the budgetary target and the actual outcome expressed as a percentage of total revenue was on average 2 percent for all entities (Figure 5). The HCF has been a key player imposing discipline and helping policy makers to resist pressure to increase expenditure.

#### **Some fissures in the system**

25. **However, the fiscal challenge from population aging could expose some weaknesses in the system.** In particular, garnering political support for accumulating significant surpluses could prove more difficult than explaining the need for achieving and maintaining balanced budgets. In addition, the fiscal adjustment burden-sharing across levels of government could complicate the cooperative approach. At the same time, the lapse of the guiding and monitoring role of the HCF in 2005 and 2006 questions the sustainability of the current arrangement.

Figure 5. Budgetary Performance of Regions and Communities, 1995–2003  
(In billions of euros)



Source: Belgian authorities.

26. **The cooperation agreement reached in August 2005 illustrates some of the potential problems.** Table 4 summarizes the targets reached in the agreement together with the goals outlined in the 2005 Stability Program. Put together, regions and communities are expected to maintain surpluses through 2009, but Flanders would account for most of the surpluses even though its debt burden is the lowest. More significantly, the federal government would carry the burden of all the fiscal adjustment over the medium term, consistent with the present strategy, given that the bulk of the debt belongs to the federal government. However, to meet the fiscal targets without increasing the already high tax burden, federal spending growth, excluding social security, would need to decline at an unprecedented level, magnifying the risks for slippage.



Table 4. Belgium: Budgetary Targets Across Levels of Government, 2005–10  
(In percent of GDP)

	Budget Balance					
	2005	2006	2007	2008	2009	2010
Regional governments						
Flemish community/region	0.2	0.1	0.1	0.0	0.0	0.0
French community	0.0	0.0	0.0	0.0	0.0	0.0
Walloon region	0.0	0.0	0.0	0.0	0.0	0.0
Brussels region	0.0	0.0	0.0	0.0	0.0	0.0
2007–10 Stability Program						
General government	0.1	0.0	0.3	0.5	0.7	0.9
Entity I	0.0	0.0	0.2	0.4	0.5	0.7
Federal government	-0.1	-0.1	0.0	0.3	0.4	0.6
Social security	0.1	0.1	0.2	0.1	0.1	0.1
Entity II	0.1	0.0	0.1	0.1	0.2	0.2
Regions and communities	0.3	0.2	0.1	0.0	0.0	0.0
Local government	-0.2	-0.2	0.0	0.1	0.2	0.2

Source: Belgian authorities.

27. **Belgium’s contributive-capacity-based tax-sharing system could also dent the sustainability of the current arrangements.** Under the current system, taxes are collected by the federal government, and some of them are transferred to local governments according to explicit repartition keys.<sup>12</sup> However, while the socio-economic conditions of regions and communities have continued to evolve, the repartition keys remained largely unchanged, and revenue growth has varied greatly across regions and communities, leaving them with diverging budgetary pressures.<sup>13</sup> In addition, while the 1999 and 2001 fiscal reforms set out principles for vertical and horizontal budgetary neutrality, the feasibility of maintaining vertical neutrality in subsequent years has been questioned.<sup>14</sup>

28. **In addition, mounting pressures for devolution of some elements of social spending could further complicate the system.** Social security contributions are collected at the federal government level, and the federal government is responsible for paying the benefits, including pensions, unemployment benefits, early retirement benefits, and health care. Because social security contributions and benefits are, to some extent, unequally

<sup>12</sup> About three quarters of the communities’ and regions’ revenues result from personal income tax and VAT transfers by the federal government in accordance to parameters laid down in the 1989 Finance Act, supplemented by the 1993 Saint Michel Agreement, the 1999 Saint-Eloi Agreement, and the 2001 Lambermont Agreement. See Claeys and others (2004) and Zhou (2003) for how the repartition keys are set across subcentral governments.

<sup>13</sup> At the same time, with the 2001 Lambermont Agreement, part of VAT transfers linked to GDP have been progressively linked to relative personal income tax revenue.

<sup>14</sup> See Van der Stichele and Verdonck (2001).

distributed across regions (due to differences in regional economic activity and demographics), the social security fund transfers income across regions.<sup>15</sup> This asymmetry has led to calls for increased devolution of social spending, in particular with regard to health care.

29. **Finally, coordination of growth- and productivity-enhancing reforms across levels of government would be key to achieving fiscal sustainability.** Closing the fiscal sustainability gap would require the implementation of structural reforms that would involve the various levels of government. For instance, policies to foster the diffusion of ICT technologies, rising competition in the tertiary sector, and continuous investment in human capital (life-long learning) and R&D would necessarily entail carving common strategies for the federal and regional governments.

### E. Concluding Remarks

30. **Coping with the rising fiscal costs from population aging remains a key challenge for Belgium.** The government is pursuing a multi-pronged strategy to build up fiscal surpluses and implement growth-enhancing reforms. However, the government's policy objectives fall short of fully addressing the sustainability gap, and implementation risks are significant. While upfront fiscal adjustment remains essential, structural reforms are key to ensuring stable debt dynamics over the long run. Relatively small reforms to reduce the projected increase in the health and pension cost of aging would constitute a prudent insurance policy against uncertainty surrounding the key macroeconomic and reform parameters of the projections.

31. **In addition, achieving sustainability requires broad political consensus and an efficient fiscal framework in the context of Belgium's complex federal system.** The current fiscal framework based on cooperation and the disciplining role of the HCF has worked well until now. However, the fiscal challenge from population aging could expose some weaknesses in the system, in particular with regard to garnering political support for accumulating significant surpluses and maintaining an equitable fiscal adjustment burden-sharing across levels of government. It will be essential to ensure the sustainability of the role of the HCF and the active engagement of the cooperative process. Given the importance of growth-enhancing reforms for fiscal sustainability, the regional and federal governments should work closely together to develop common development strategies.

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<sup>15</sup> See De Maesschalck and Verbist (2005).

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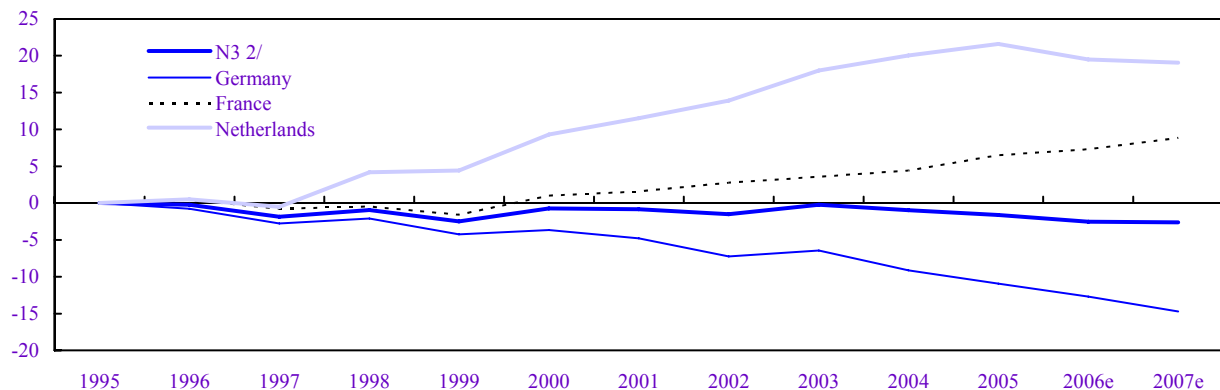
## II. WAGE FORMATION AND COMPETITIVENESS IN BELGIUM<sup>16</sup>

### A. Introduction

32. **In 1996, Belgium introduced a law to promote employment and preserve external competitiveness vis-à-vis France, Germany, and the Netherlands, its three major trading partners.** Specifically, the law requires that the growth of nominal hourly labor costs for enterprises in a period of two years should not exceed a “wage norm”: a weighted average of the projected increases in labor costs in the three neighboring countries. The law stipulates that overruns of the wage norm should be corrected in the subsequent wage agreements. In addition, wages are fully indexed.

33. **The law seems to have largely achieved its objective of keeping the growth of Belgian labor costs in line with the average of the three neighboring countries.** Based on the official data, between 1997 and 2006, the accumulated deviation from the average of the three neighboring countries was small (Figure 1). However, the deviations have been always one-sided, with the increase in Belgium higher, never lower, than the average of the three neighboring countries. This would suggest that the wage norm might have served more as a floor for wage increases, rather than a ceiling as intended. Moreover, the deviation has been rising since 2003—especially relative to Germany where real wages have declined recently—and is likely to rise further in 2006–07. As discussed below, even with the competitiveness law, Belgium’s ability to import low or negative real wage growth from the neighboring countries is restricted by another important feature of its wage formation process, the full wage indexation rule.

Figure 1. Belgium and Three Neighboring Countries: Hourly Labor Costs, 1995–2007 1/  
(In percentage points; difference compared to the index for Belgium)



Sources: OECD, CCE Report (November 2006); and IMF staff estimates.

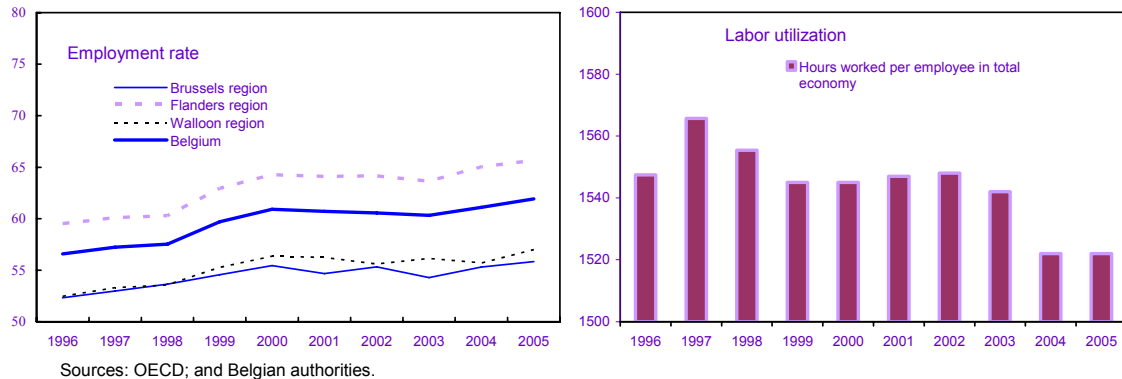
1/ Private sector; index =100 for 1995.

2/ N3: the GDP-weighted average of Germany, France, and the Netherlands.

<sup>16</sup> Prepared by Jianping Zhou (jzhou1@imf.org).

34. **However, labor utilization has remained low** (Figure 2). Employment rates, after rising in the late 1990s (partly reflecting a change in the statistical method in 1998–99), are still far below the Lisbon objective of 70 percent, while the unemployment rate has remained stubbornly high at more than 8 percent. Average working hours now are lower than in 1997 when the law was introduced. At the regional level, the country continues to be confronted with substantial regional gaps in unemployment and the employment rate.

Figure 2. Belgium: Labor Utilization, 1996–2005



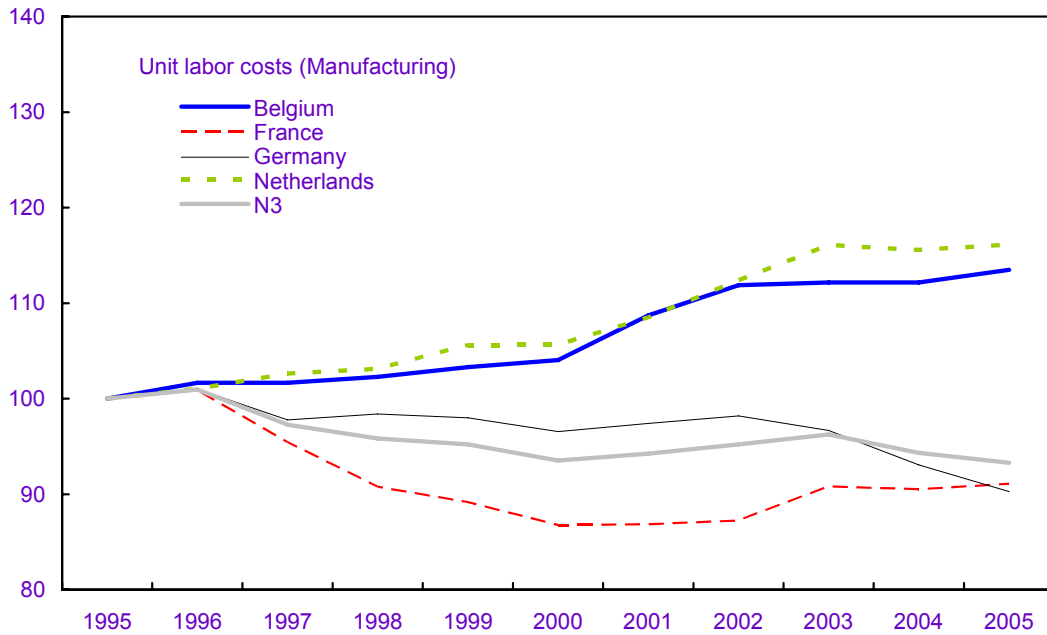
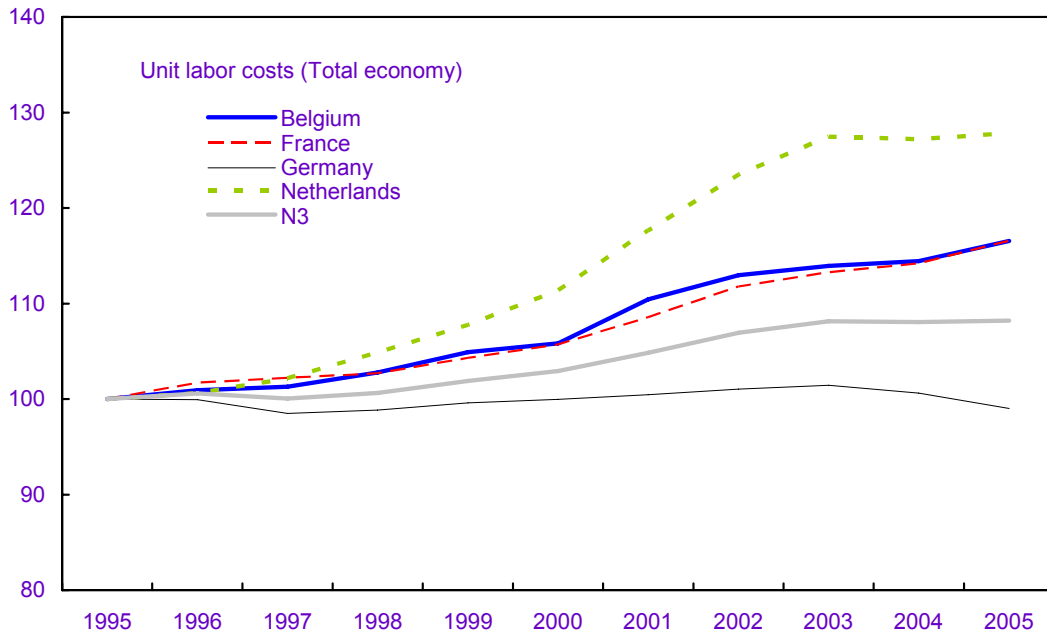
35. **Moreover, Belgium’s competitiveness edge has eroded since 1996, especially in its manufacturing sector** (Figure 3). While competitiveness has not yet become a problem—as demonstrated by export market shares in nominal terms both globally and in its key trading partner countries—it could be if the trends continue.<sup>17</sup>

36. **Dissatisfaction with the current wage formation framework has amplified during the recent years.** To limit the risk of excessive wage increases, a rising number of sectors have included in their collective wage agreements an “all-in” clause, whereby the wage norm was used only as a reference and the ex ante agreed nominal wage increases will be respected ex post, independent of actual inflation. The wage norm itself has undergone some changes as well: during the last negotiation period, the norm was not formalized in a legal act. Therefore, enforcement became impossible. Furthermore, even when the norm was legally binding, enforcement in practice was not easy, and no sanctions were ever imposed, though certainly a certain dissuasion effect existed.

37. **These developments raise the following questions:** Has the framework of wage norm been effective in preserving Belgium’s external competitiveness? Is the current wage formation framework conducive to employment growth, especially in the regions where labor market indicators are lagging behind the national average? Based on the available data, this paper tries to answer these questions by looking at the trend growth as well as the levels of wages and productivities in Belgium relative to the three neighboring countries. In doing so, the paper identifies the problems with the existing wage formation system that may lead to losses in competitiveness and job growth.

<sup>17</sup> Export market shares have fallen in volume but not in value, suggesting suspiciously strong pricing power, which may reflect statistical shortcomings related to exports and imports deflators.

Figure 3. Belgium and Three Neighboring Countries: Unit Labor Costs, 1995–2005  
(Index, 1995=100) 1/



Sources: OECD; and IMF staff estimates.

1/ N3 refers to the GDP-weighted average of the labor costs in France, Germany, and the Netherlands.

## B. Wage Formation in Belgium

38. **The wage formation in Belgium can be characterized as one with intermediate wage coordination, as opposed to centralized and decentralized wage formation systems.** Wages paid by Belgian companies result from negotiations held successively at three levels: the national, the sector, and the firm level. Although firm-level agreements have gained considerable importance over the last few years, wages are predominantly determined at the sector level. These negotiations take place every two years with three key components: the Interprofessional Agreement (IPA) followed by sectoral negotiations; administrative extension of sectoral wage agreements; and indexation of wages to prices during the contract. The IPA is a product of negotiations within the joint committees (*commissions paritaires*), which have equal employer and employee representation and are organized by sectors of economic activities.<sup>18</sup> The IPA determines a national wage norm and a national minimum wage, which serve as the upper and lower limits for the sectoral- and enterprise-level wage negotiations.

### Wage norm

39. **The wage norm sets a ceiling for the growth of nominal hourly labor costs for Belgian enterprises.** It is set every two years (usually in October) in the IPA by the social partners for a two-year period, based on estimates provided by the official Central Economic Council (CCE/CRB). Specifically, the CCE/CRB estimates the nominal wage norm as the weighted average of the expected increase in nominal labor costs in Germany, France, and the Netherlands, according to projections published by the OECD's Economic Outlook and corrected for average working hours.

40. **The wage norm effectively establishes a target for real wage increases.**<sup>19</sup> Estimations of expected automatic indexing of nominal wages, based on inflation projections, and estimations of labor cost growth through scale adjustments (i.e., wage drifts),<sup>20</sup> are subtracted from the nominal wage norm to determine the maximum room for real wage increases. Therefore, the wage norm effectively sets a real wage target, which is determined by the expected wage growth in the three neighboring countries and adjusted by the expected inflation in Belgium. To the extent that the wage growth in the neighboring countries reflects their productivity growth, the real wage target is thus set according to the productivity growth in the neighboring countries, but not to that in Belgium. Moreover, the real wage growth target applies to all sectors and regions in Belgium, despite the sectoral and regional productivity differentials.

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<sup>18</sup> The number of joint committees now exceeds 100, because economic sectors are narrowly defined.

<sup>19</sup> Throughout this paper, the term “wages” refers to labor costs, unless otherwise noted.

<sup>20</sup> Resulting from seniority, age, normal promotions, or individual changes of category, and traditionally estimated at 0.5 percent per year.

### Wage indexation rule and ex post corrections

41. **Wages in Belgium are fully indexed to a health index of consumer prices (HI), implying that real wage growth in Belgium cannot be negative.** (The HI index is defined as the national index of consumer prices (NICP) with the exclusion of alcoholic beverages, tobacco, and motor fuels.) The implementation of the indexation, however, is subject to sectoral negotiations during the contract period. In some cases, wages are adjusted at certain intervals (e.g., every two, three, or four months); while in other cases, they are adjusted when the health index of consumer prices exceeds a certain threshold. On average, wages are indexed to the HI by a lag of one quarter.

42. **The implementation of indexation partly determines whether or not the nominal wage norm is respected ex post.** The ex post nominal increase in gross wages is codetermined by the agreed real wage increase and the realized HI inflation. If the realized HI inflation is higher than expected, the wage norm would be exceeded.

43. **Deviations from the actual average wage increase in three neighboring countries could arise because of forecast errors or wage drift.** Wages in Belgium can grow faster, for example, if there is a positive bias in forecasting labor cost evolutions in the three neighboring countries, or if effective wage drifts were larger than the expected (0.5 percent per year). Pressures for high wage increases tend to intensify when cuts in employers' social security contributions are planned: in the past, these tax cuts have largely translated into higher take-home pay rather than lower labor costs (Stockman, 2004).

44. **To prevent potential ratchet effects, the law stipulates that any excess nominal wage increases relative to the actual average wage increase in the three neighboring countries during the two-year period should be corrected in the subsequent two-year agreement.** Specifically, the ceiling for labor costs (i.e., the wage norm) estimated by the CCE/CRB for the new agreement can be decreased with differences in labor costs that stem from a higher labor cost growth in Belgium compared to these reference countries over the past two years, as far as such a derailment is assessed by the CCE/CRB and given that the new margin for labor cost growth must encompass at least the automatic indexing and scale adjustments.

### C. Has the Wage Norm Been Effective in Preserving Competitiveness?

45. **Since the introduction of the 1996 law, the wage norm has been largely adhered to.** During the period 1997–2006, the accumulated increase in the Belgian labor costs (24.7 percent) was broadly in line with the accumulated increase implied by the wage norm (24.4 percent). However, the norm was exceeded in 2001–02, due to a higher-than-anticipated inflation and a large increase in social security contributions (Table 1).

46. **Overall deviations from the actual average wage increases in three neighboring countries (N3) have been small.** Over the period 1997–2006, the accumulated increase exceeded the average increase in the N3 only slightly. The deviation was smaller than the



positive forecast errors (4.4 percentage points), thus suggesting that the impact of forecasting errors was in practice limited. One possible explanation is that the wage norm may not be binding for all firms because of their limited pricing power, thus pushing down the general wage level. If this were the case, the reason for having an intermediate wage formation system would have been weakened.

Table 1. Belgium: Unit Labor Costs in the Private Sector, 1997–2006  
(Percentage change from previous year, adjusted for seasonal and calendar effects)

	1997–98	1999–2000	2001–02	2003–04	2005–06	1997–2006
<b>Gross wages per hour worked</b>	<b>2.8</b>	<b>6.1</b>	<b>7.1</b>	<b>3.7</b>	<b>4.5</b>	<b>24.2</b>
Collectively-agreed wages 1/	3.7	4.4	7.1	4.2	5.0	24.4
Agreed real wage increases	1.0	1.8	2.2	1.4	1.0	7.4
Indexations	2.7	2.6	4.9	2.8	4.0	17.0
Wage drift 2/	-0.9	1.7	0.0	-0.5	-0.5	-0.2
Employers' social security contributions 3/	1.1	-1.3	1.1	-0.1	-0.3	0.5
<b>Labor costs per hour worked</b>	<b>3.9</b>	<b>4.8</b>	<b>8.2</b>	<b>3.6</b>	<b>4.2</b>	<b>24.7</b>
In France, Germany, and the Netherlands	3.5	5.4	6.7	4.5	3.5	23.6
Labor productivity 4/	3.4	3.1	2.7	3.2	2.6	15.0
<b>Unit labor costs</b>	<b>0.5</b>	<b>1.7</b>	<b>5.5</b>	<b>0.4</b>	<b>1.6</b>	<b>9.7</b>

Source: Belgian authorities.

1/ Wage increases fixed by Interprofessional Wage Agreements (IPA).

2/ Resulting from increases and bonuses granted by firms, as well as from changes in employment structures.

3/ Contribution to changes in labor costs.

4/ Value added at constant prices per hour worked by employees and self-employed persons.

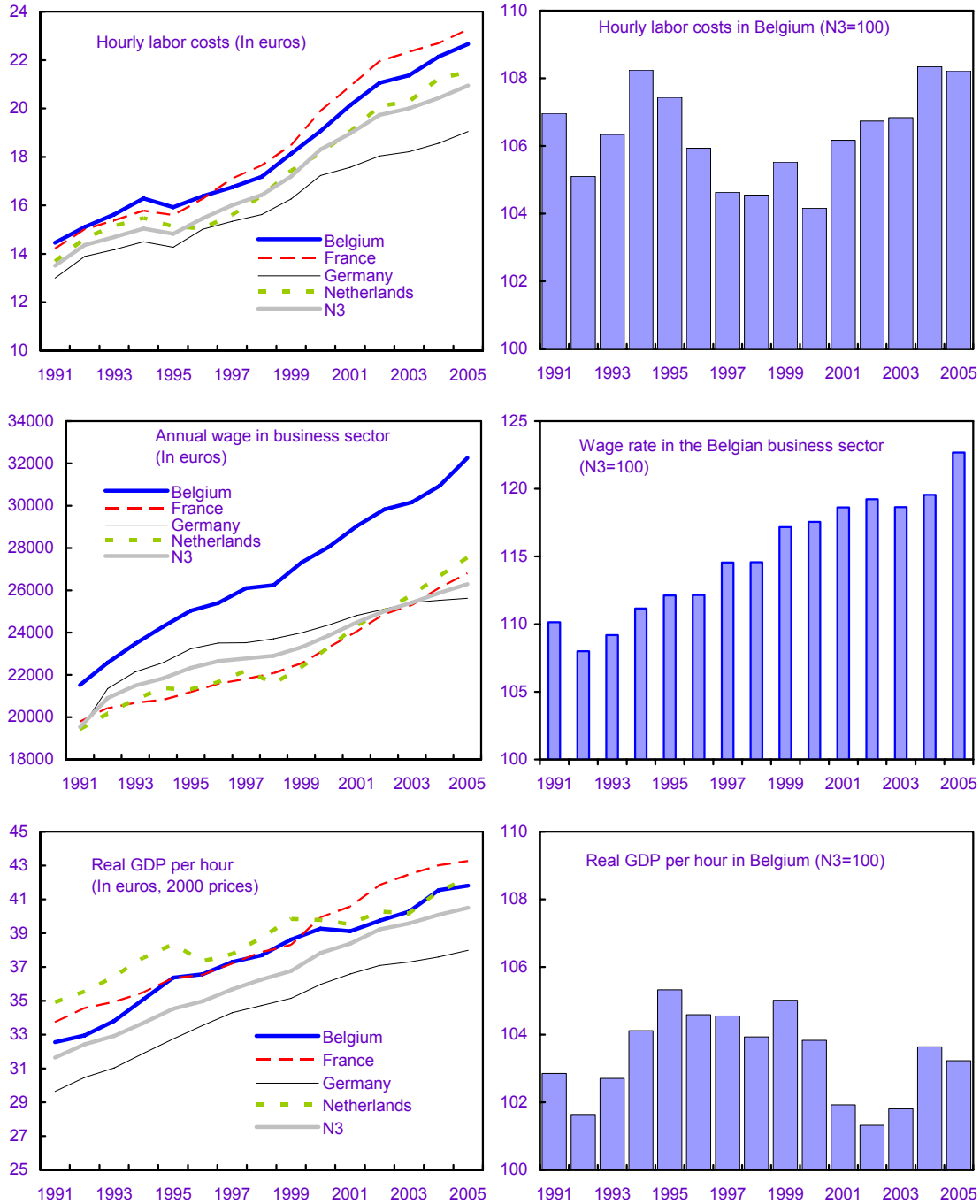
47. **However, the wage levels in Belgium have stayed higher than in neighboring countries, and in some sectors, the wage gaps have widened** (Figure 4). Based on the OECD data, average business sector wage in Belgium was about 12 percent higher than in N3 in 1996; by 2005, it was more than 22 percent higher. The hourly labor costs for the whole economy based on national accounts data also confirm that the wage gap has widened since 2000, though with a smaller magnitude. The widening wage gaps were apparently not supported by larger increases in labor productivity leading to an erosion in competitiveness.

48. **For the manufacturing sector, the large erosion in competitiveness was almost entirely due to high labor costs that were not sustained by high labor productivity growth.** Based on the available data, productivity growth in manufacturing during 1996–2005 was much lower than in all three neighboring countries (Figure 5), while the increase in labor costs during this period was at the same pace of the average for the three countries.

49. **The current wage-setting framework, however, lacks the mechanism to correct past erosions of competitiveness.** First of all, it **lacks the mechanism to reduce past wage gaps.** Full indexation puts a wage floor under domestic wage increases, and the “competitiveness” law ties these increases to wage growth in three neighboring countries. Although there is a legal provision against overruns, its implementation in practice is restricted by strong union bargaining powers and the indexation rule. There has been no evidence that any of the derailments since 2001 were corrected in the subsequent agreements, thus leading to further widening of wage gaps. Most importantly, the current wage formation framework **lacks the mechanism to adjust real wage developments to domestic productivity growth.** As discussed earlier, the wage norm effectively sets a ceiling for real

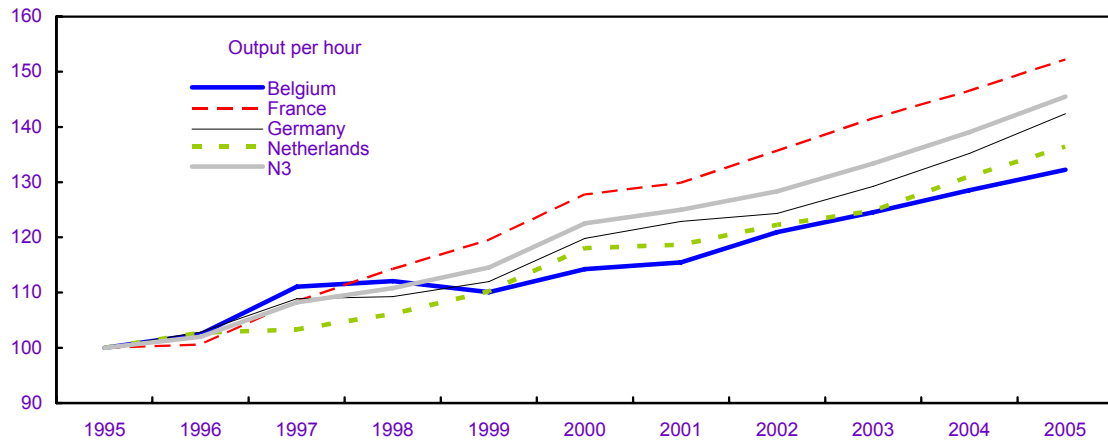
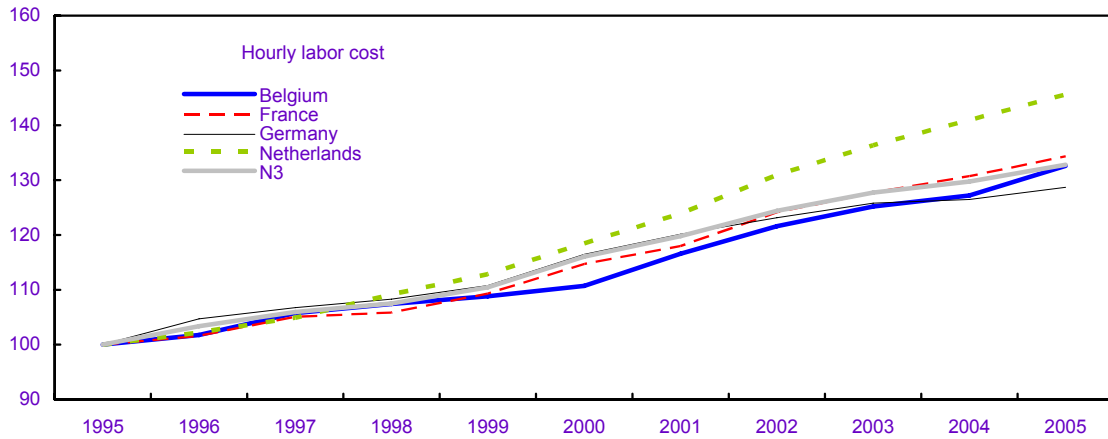
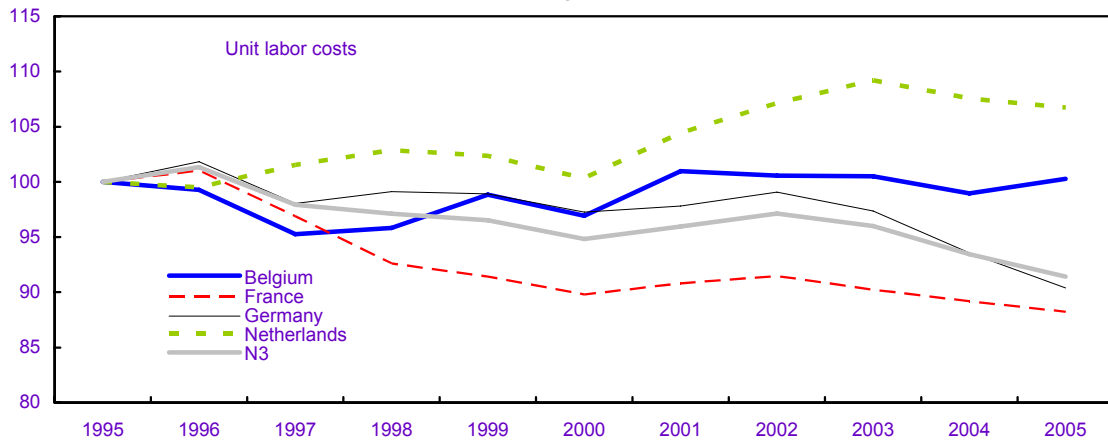
growth according to wage growth in three neighboring countries, without taking into account developments in productivities in Belgium.

Figure 4. Belgium and Three Neighboring Countries: Wages and Productivity, 1991–2005



Sources: OECD; and IMF staff estimates.

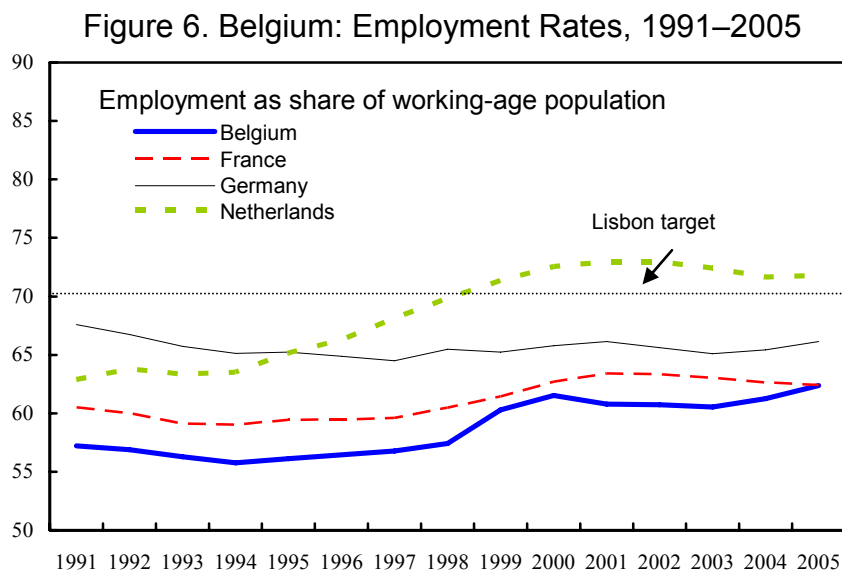
Figure 5. Belgium and Three Neighboring Countries: Unit Labor Costs in the Manufacturing Sector, 1995–2005



Source: U.S. Department of Labor, Bureau of Labor Statistics.

### D. Is the Wage Formation Framework Conducive to Employment Growth?

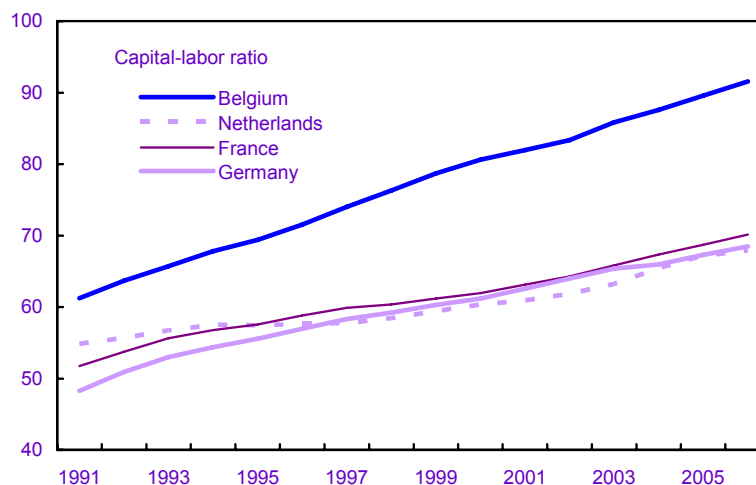
50. **Employment rates in Belgium have remained lower than those in France, Germany, or the Netherlands** (Figure 6). Increasing the employment rate to the Lisbon target continues to be a policy challenge. Is the current wage formation framework conducive to achieving this Lisbon objective? While it is difficult to quantitatively assess the employment effects of the wage framework, one could conclude that the framework has not succeeded in preserving external competitiveness. To the extent that real wages do not adjust to changes in productivity, the framework could have undesired effects on employment.



51. **The current wage framework has undermined the effectiveness of the tax cut strategy to raise employment.** Since the early 1980s, reducing the tax wedge on labor has been an important component of the authorities' strategy to increase employment rates. Specifically, if the wage norm is binding, tax cuts might not have the desired effect on labor costs. Hence, tax cuts affect employment only through higher demand due to higher disposable income. Furthermore, with the unions' strong bargaining power, cuts in employers' social security contributions to reduce labor costs have tended to be interpreted as room for high take-home pay increases—as reflected in the larger wage drift during 1999–2000 (Table 1)—with limited effect on employment.<sup>21</sup> Indeed, high labor costs have resulted in continued capital deepening, as reflected in the rising capital-labor ratio, which may not be desirable as such capital deepening is not the most efficient way to economic growth (Figure 7).

<sup>21</sup> See Stockman (2004), Zhou (2004), and Burggraeve and Du Caju (2003).

Figure 7. Belgium: Capital Intensity, 1991–2005

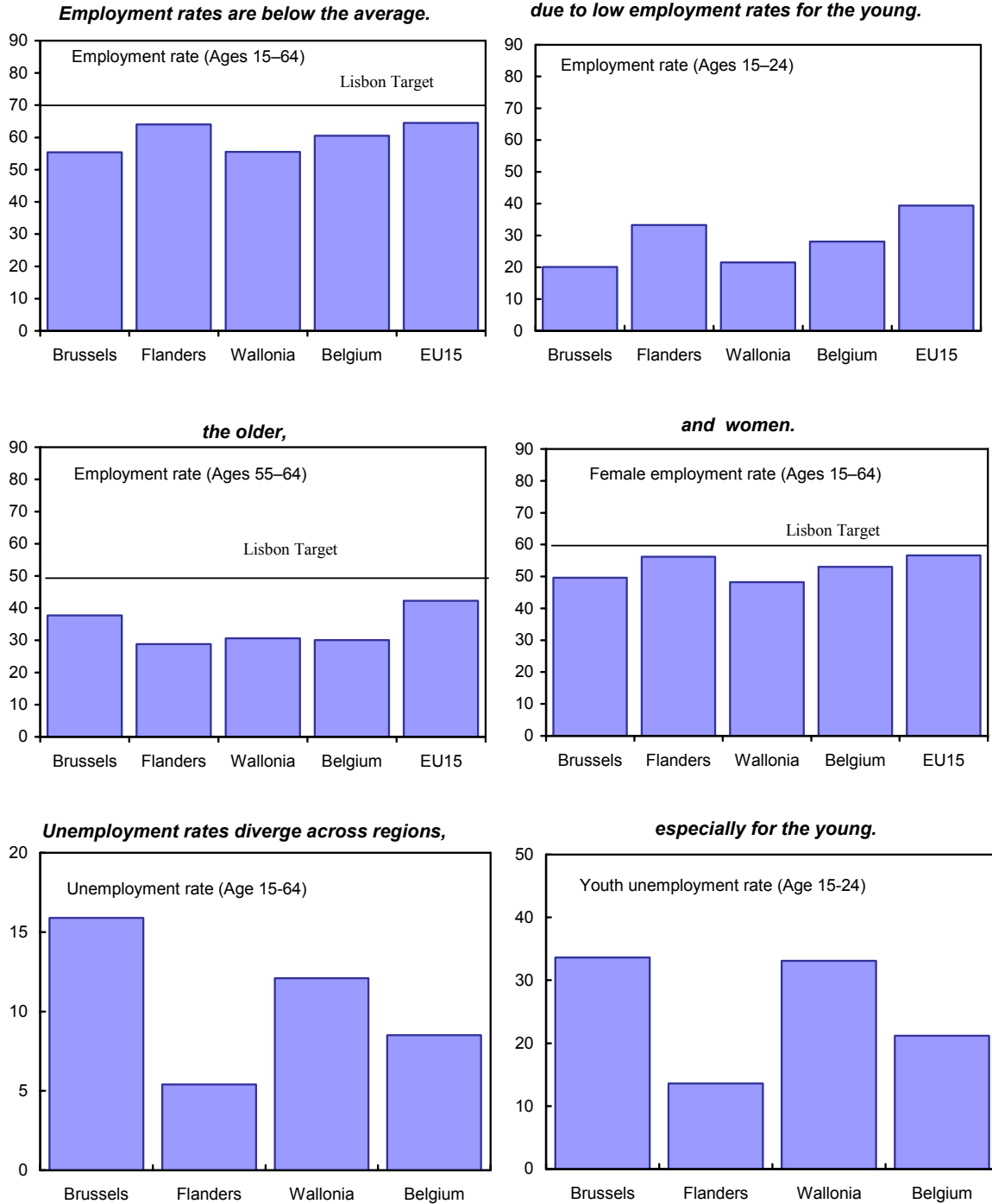


Source: Cronos.

52. **Without taking into account sectoral productivity differences, the wage framework limits the wage flexibility that is needed to adjust to sector-specific economic shocks.** Plasman, Rycx, and Tojerow (2006) find that during the period 1995–2002, the magnitude, dispersion, and significance of Belgian industry wage differentials decreased sharply. The sectoral nature of economic shocks in Belgium points to a need for intersectoral labor allocations. However, the role of interregional labor mobility as an adjustment mechanism is limited, and the wage adjustment mechanism is constrained by the current wage framework that fails to take into account sectoral productivity differentials domestically as well as vis-à-vis foreign competitors.

53. **Without taking into account differences in regional economic conditions, the framework is not conducive to narrow regional employment gaps** (Figure 8). In the absence of regional fiscal policy instruments (local taxing powers, for example) and with the limited interregional labor mobility, the wage adjustment mechanism becomes one key policy instrument to address the large gaps in the regional employment and unemployment outcomes. The large employment and unemployment gaps across regions were, to a certain extent, a result of the limited interregional labor mobility and a lack of an effective wage adjustment mechanism.

Figure 8. Belgium: National and Regional Employment Rates, 2Q:2006



Sources: Belgian authorities, and Eurostat.  
 1/ In percent of population aged 15-64.

### E. Concluding Remarks

54. **Although the “wage norm” has been largely adhered to, Belgium’s competitive edge has eroded, especially in its manufacturing sector.** This is mainly because real wage growth was linked to that in three neighboring countries, but not to the developments in relative productivity growth. Large erosions in competitiveness in Belgium’s manufacturing sector were almost entirely due to high labor costs that were not sustained by high labor productivity growth.

55. **While decentralization of the wage-bargaining framework may not be politically feasible in the short term, some changes to the framework are necessary to prevent losses in competitiveness.** For the current 2007–08 wage negotiations, “all-in” agreements should be encouraged to minimize high wage increases due to inflation surprises, and any tax cuts should be used solely to reduce labor costs. The law that past overruns of the wage norm should be corrected in the subsequent wage agreements needs to be enforced. In the longer run, the framework needs to be changed to take into account developments in productivity in Belgium as well as productivity differentials at the sectoral and enterprise levels.

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