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REPORT FROM THE COMMISSION

Belgium

Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU or the Treaty) lays down the excessive deficit procedure (EDP). That procedure is further set out in Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1], which is part of the Stability and Growth Pact (SGP). Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3 %; and (b) whether the ratio of government debt to GDP exceeds the reference value of 60 %, unless it is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Article 126(3) TFEU provides that, if a Member State does not fulfil the requirements under one or both of those criteria, the Commission has to prepare a report. That report must also "*take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*".

This report, which represents the first step in the EDP, analyses Belgium's compliance with the deficit and debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

Data notified by the Belgian authorities on 29 March 2018[3] and subsequently validated by Eurostat[4] show that the general government deficit in Belgium reached 1.0% of GDP in 2017, while debt stood at 103.1% of GDP, above the 60% of GDP reference value. For 2018, the notification planned a deficit of 0.9% of GDP and a debt ratio of 100.5% of GDP, while

[1] OJ L 209, 2.8.1997, p. 6. The report also takes into account the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", adopted by the Economic and Financial Committee on 5 July 2016, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm .

[2] Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (OJ L 140, 27.5.2013, p. 11).

[3] According to Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Belgium can be found at: http://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables.

[4] Eurostat news release No 69/2018, http://ec.europa.eu/eurostat/documents/2995521/8824490/2-23042018-AP-EN.pdf/6e5b346e-e302-4132-920a-854b00ac196d

Belgium’s 2018 Stability Programme (SP), received by the Commission on 27 April 2018, plans a deficit of 1.0% of GDP and a debt ratio of 101.2% of GDP.

The notified data show that Belgium did not comply with the debt reduction benchmark[5] in 2017 (see Table 1), as the gap to the benchmark is 0.9 percentage points (pp.) of GDP. Belgium is forecast not to comply with the debt reduction benchmark in 2018 and 2019 as its debt-to-GDP ratio is expected to remain 0.9 pp. of GDP above the forward-looking debt reduction benchmark according to the Commission 2018 spring forecast. On the basis of the scenario included in the 2018 SP compliance with the debt criterion is planned as of 2018, with an overachievement of the forward-looking debt reduction benchmark by 0.1pp. and 0.7 pp. of GDP in 2018 and 2019 respectively.

Belgium's non-compliance with the debt reduction benchmark in 2017 provides evidence of a *prima facie* existence of an excessive deficit for the purposes of the Stability and Growth Pact before, however, considering all factors as set out below.

The Commission has therefore prepared this report to comprehensively assess the departure from the debt reduction benchmark and examine whether the launch of an excessive deficit procedure is warranted after all relevant factors have been considered. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the assessment of compliance with the required adjustment path towards the MTO. The report takes into account the Commission 2018 spring forecast, released on 3 May 2018.

Table 1. General government deficit and debt (% of GDP)

		2014	2015	2016	2017	2018		2019	
						COM	SP	COM	SP
Deficit criterion	General government balance	-3.1	-2.5	-2.5	-1.0	-1.1	-1.0	-1.3	-0.7
Debt criterion	General government gross debt	107.0	106.1	105.9	103.1	101.5	101.2	100.2	99.4
	Gap to the debt reduction benchmark	n.r.	n.r.	n.r.	0.9	0.9	-0.1	0.9	-0.7
	Change in structural balance	0.1	0.7	0.1	0.8	-0.1	0.2	-0.3	0.2
	Required MLSA	1.4	2.2	3.2	n.r.	n.r.	n.r.	n.r.	n.r.

Source: 2018 Stability Programme (SP) and Commission 2018 spring forecast (COM)

2. DEFICIT CRITERION

Belgium’s general government deficit narrowed from 2.5% of GDP in 2016 to 1.0% in 2017. According to the Commission 2018 spring forecast, the deficit would widen slightly to 1.1% in 2018, still respecting the 3% of GDP Treaty reference value. In 2019, the Commission forecast projects the deficit to rise further to 1.3% of GDP under a no-policy-change assumption.

The multiannual trajectory included in the 2018 SP puts forward a stabilisation of the deficit to 1.0% in 2018 and a reduction to 0.7% in 2019. The difference in 2018 between the

[5] Compliance with the debt benchmark is assessed on the basis of three different configurations: the backward-looking, the forward-looking and the debt reduction benchmark adjusted for the impact of the cycle.

Commission forecast and the SP stems from a number of measures that have not been included in full in the Commission forecast, e.g. tax regularisation or anti-fraud measures. For 2019 the difference is caused by the fact that the Commission projections only include measures that have been sufficiently detailed.

Belgium thus complies with the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/97.

3. DEBT CRITERION

Public debt peaked at 107% of GDP in 2014 and fell to 105.9% in 2016. In 2017 debt fell further to 103.1% of GDP thanks to a growing primary surplus, a downward snowball effect (lower interest payments combined with higher nominal GDP growth) and negative stock-flow adjustments. Debt dynamics are discussed in more detail in Section 4.3.

The Commission forecast expects a mild debt reduction in coming years, to 101.5% of GDP in 2018 and 100.2% in 2019. The annual downward impact of 2.1 pp. of GDP on average rendered by primary surpluses and the snowball effect is projected to be partially offset by upward stock-flow adjustments in 2018-2019. The gap towards the debt reduction benchmark would remain unchanged in 2018 and 2019 at 0.9 pp. These projections do not account for the impact of potential financial sector asset sales.

According to Belgium's 2018 SP the debt ratio would decline to 101.2% of GDP at the end of 2018 and to 99.4% of GDP in 2019. The difference from the Commission's projection at unchanged policy mainly stems from a lower planned headline deficit in the SP with broadly similar nominal growth assumptions, and slightly lower stock-flow adjustments in 2018.

Table 2: Debt dynamics

	2014	2015	2016	2017	2018		2019	
	COM	COM	COM	COM	COM	SP	COM	SP
Government gross debt ratio	107.0	106.1	105.9	103.1	101.5	101.2	100.2	99.4
Change in debt ratio [b] (1 = 2+3+4)	1.5	-0.9	-0.1	-2.8	-1.6	-1.9	-1.4	-1.9
Contributions:								
• Primary balance (2)	-0.2	-0.5	-0.4	-1.4	-1.2	-1.3	-0.8	-1.5
• 'Snowball' effect (3)	1.2	0.4	-0.3	-1.3	-1.1	-1.1	-1.2	-1.1
of which:								
Interest expenditure	*3.3*	*3.0*	*2.9*	*2.5*	*2.3*	*2.3*	*2.2*	*2.2*
Real GDP growth	*-1.4*	*-1.4*	*-1.5*	*-1.7*	*-1.8*	*-1.8*	*-1.7*	*-1.7*
Inflation (GDP deflator)	*-0.7*	*-1.1*	*-1.6*	*-1.9*	*-1.6*	*-1.6*	*-1.7*	*-1.5*
• Stock-flow adjustment (4)	*0.5*	*-0.7*	*0.6*	*-0.1*	*0.7*	0.5	*0.7*	0.7

Notes:

[a] In percent of GDP.

[b] The change in the gross debt ratio can be decomposed as follows:

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

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

Source: 2018 Stability Programme (SP) and Commission 2018 spring forecast (COM)

Following the abrogation of the excessive deficit procedure in June 2014, Belgium was subject to a three-year transition period to comply with the debt reduction benchmark. That transition period started in 2014 and ended in 2016. Since 2017, after the end of the transition period, the standard debt reduction benchmark is applicable. The notified data show that Belgium did not comply with the debt reduction benchmark in 2017 (see Table 1), as the gap to the benchmark is 0.9 % of GDP. Belgium is forecast not to comply with the debt reduction benchmark in 2018 and 2019 as its debt-to-GDP ratio is expected to remain 0.9% of GDP above the debt reduction benchmark according to the Commission 2018 spring forecast.

On the basis of the scenario included in the 2018 SP, compliance with the debt criterion would be ensured as of 2018 as the gap to the forward-looking debt reduction benchmark would be -0.1% of GDP in 2018 and -0.8% of GDP in 2019. The 2017 SP planned compliance with the debt criterion as of 2019. The difference with the Commission forecast is due to a deficit reduction that is 0.1% higher in 2018 and 0.6%. higher in 2019 given that the Commission forecast is based on a no-policy change assumption whereas the SP reflects the planned effort. Part of the difference for 2018 also stems from lower expected stock flow adjustments in the SP. In addition, the differences in the forward-looking debt reduction benchmark between the Commission forecast and the SP also reflect different macroeconomic assumptions taken from 2020, beyond the Commission spring forecast horizon, which impact the estimate of public debt in the medium term. Broadly speaking, the technical assumptions followed by the Commission beyond its forecast horizon are more conservative than those of the SP, resulting in a slower debt reduction.

The analysis thus suggests that *prima facie* the debt criterion for the purpose of the Treaty and Regulation (EC) No 1467/1997 is not fulfilled based on the 2017 outturn data and the Commission 2018 spring forecast as well as the 2018 SP before, however, consideration is given to all relevant factors set out below.

4. RELEVANT FACTORS

Article 126(3) TFEU provides that the Commission report "*shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*". Those factors are further clarified in Article 2(3) of Regulation (EC) No 1467/97, which also provides that "*any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with the deficit and debt criteria and which the Member State has put forward to the Council and to the Commission*" need to be given due consideration.

In case of apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted given that debt dynamics are to a larger extent influenced by factors outside the control of the government than is the case for the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which provides that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach. In that respect, at least the following three main aspects need to be considered (and have been considered in the past) when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability:

1. adherence to the MTO or the adjustment path towards it, which, is supposed to ensure sustainability or rapid progress towards sustainability under normal macroeconomic circumstances. As by construction the country-specific MTOs take into account the debt level and implicit liabilities, compliance with the MTO or the adjustment path towards it should ensure convergence of the debt ratios towards prudent levels at least in the medium term;

2. structural reforms, already implemented or detailed in a structural reform plan, which are expected to enhance sustainability in the medium term through their impact on growth, thereby contributing to bring the debt-to-GDP ratio on a satisfactory downward path. Overall, adherence to the MTO (or the adjustment path towards it) alongside with the implementation of structural reforms (in the context of the European Semester) is expected under normal economic conditions to bring debt dynamics on a sustainable path through the combined impact on the debt level itself (through the achievement of a sound budgetary position at the MTO) and on economic growth (through the reforms).
3. unfavourable macroeconomic conditions, and in particular low inflation, which can hamper the reduction of the debt-to-GDP ratio and make compliance with the SGP provisions particularly demanding. A low-inflation environment makes it more demanding for a Member State to comply with the debt reduction benchmark. Under such conditions, adherence to the MTO or the adjustment path towards it is a key relevant factor in assessing compliance with the debt criterion.

In view of those provisions, the following subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO and the development of public investment; (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors considered relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term economic position

Macroeconomic conditions have improved and can no longer be argued to be a major mitigating factor in explaining Belgium's gaps to compliance with the forward-looking debt reduction benchmark. Although a protracted period of low inflation until 2015 made debt reduction more difficult, nominal growth is expected to remain robust until 2019. Belgium made limited progress in addressing the 2017 CSRs, but undertook important structural reforms in the past years to increase the sustainability of the pension system and to reform taxation and wage indexation so as to support competitiveness.

Cyclical conditions, potential growth and inflation

The Belgian economy proved to be rather resilient following the global economic recession in 2009. GDP quickly regained pre-crisis levels, thanks to strong economic growth in 2010 and 2011. That recovery period was followed by stagnation, though, with flat GDP growth in 2012 and 2013. In 2014 and 2015, economic activity rebounded and growth reached 1.7% and 1.5% respectively. It slighlty dipped to 1.2% in 2016 as the security situation linked to the terrorist attacks of March 2016 is considered to have had a negative, though transitory, impact on the Belgian economy. Growth rose again to 1.7% in 2017 and is expected to continue growing at around the same pace according to the Commission 2018 spring forecast, reaching 1.8% in 2018 and 1.7% in 2019 on the back of domestic demand, more specifically private consumption and investment.

Potential growth estimates for Belgium are rather moderate, at 1.4% on average over 2015-2019. The slowdown compared to the pre-2009 situation is broad-based as it reflects the continuation of a long-term trend of declining gains in total factor productivity (which is estimated to have stabilised at a low level in recent years), a decline in the contribution of labour to potential growth (due to a slower growth of the working age population) and somewhat lower capital accumulation. The negative output gap narrowed to -0.3% in 2017 compared to a trough of -1.6% in 2013. It is expected to close in 2018 and rise to 0.4% in 2019.

After a protracted period of low domestic price growth until 2015, inflation accelerated in Belgium to 1.8% in 2016 and 2.2% in 2017. The relatively low GDP deflator until 2015 has had an important impact on the evolution of the debt-to-GDP ratio in past years and increased the structural adjustment required to assure that the debt ratio stays on a firm downward path as required by the forward-looking debt benchmark. Moreover, the primary balance was also impacted by those cyclical conditions, which fed through in public debt. Economic conditions thus partly explain non-compliance with the debt reduction benchmark in past years.

However, the ongoing improvement in macroeconomic conditions means that they can no longer be regarded as a major mitigating factor in explaining the gap compared to the forward-looking debt benchmark (0.9% of GDP in 2017). While the GDP deflator is expected to decline slightly from 1.9% in 2017 to 1.6% in 2018, nominal growth is expected to remain robust at 3.4% in 2018 and 2019.

Table 3: Macroeconomic and budgetary developments[a]

	2014	2015	2016	2017	2018		2019	
	COM	COM	COM	COM	COM	SP	COM	SP
Real GDP (% change)	1.4	1.4	1.5	1.7	1.8	1.8	1.7	1.7
GDP deflator (% change)	0.7	1.1	1.6	1.9	1.6	1.6	1.7	1.6
Potential GDP (% change)	1.0	1.2	1.4	1.4	1.4	1.3	1.4	1.4
Output gap (% of potential GDP)	-0.8	-0.6	-0.5	-0.2	0.1	0.1	0.4	0.4
General government gross debt	107.0	106.1	105.9	103.1	101.5	101.2	100.2	99.4
General government balance	-3.1	-2.5	-2.5	-1.0	-1.1	-1.0	-1.3	-0.7
Primary balance	0.2	0.5	0.4	1.4	1.2	1.3	0.8	1.5
One-off and other temporary measures	0.3	0.1	0.0	0.4	0.2	0.0	0.1	-0.1
Government gross fixed capital formation	2.3	2.3	2.2	2.2	2.4	2.4	2.5	2.4
Cyclically-adjusted balance	-2.6	-2.1	-2.2	-0.9	-1.2	-1.1	-1.6	-1.0
Cyclically-adjusted primary balance	0.7	0.9	0.7	1.6	1.1	1.2	0.6	1.2
Structural balance[b]	-2.9	-2.2	-2.1	-1.3	-1.4	-1.1	-1.7	-0.9
Structural primary balance	0.3	0.8	0.7	1.2	0.9	1.3	0.5	1.3

Notes:

[a] In percent of GDP unless specified otherwise.

[b] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: 2018 Stability Programme (SP) and Commission 2018 spring forecast (COM)

Declining interest rates have created a supportive context for budgetary consolidation. The implicit nominal interest rate on Belgian public debt has fallen continuously over the past two decades and that trend has accelerated in recent years. As a consequence, total interest expenditure by the general government has continued to decrease as a share of GDP. Between 2007 and 2017 interest expenditures fell by approximately 1.5 pp. of GDP amounting to a decrease in interest expenditure of 0.1 pp. of GDP in 2016 and 0.4 pp. of GDP in 2017. Against that background of falling interest expenditure, the change in the structural balance in 2017-2018 according to the Commission forecast (0.8 pp. and -0.1 pp. respectively) is accompanied by an improvement in the structural primary balance in 2017 and a deterioration in 2018 (0.5 pp. and -0.3 pp. respectively). The sensitivity analysis in the 2018 SP highlights how a linear increase of the yield curve by 100bp would imply 0.07% of

GDP higher costs in 2018, rising to 0.25% of GDP in 2021[6], though relative to a baseline of falling interest payments. It underscores the risks inherent to a consolidation strategy that leans significantly on windfall gains stemming from lower interest expenditures.

Structural reforms

In its Communication of 13 January 2015, the Commission strengthened the link between effective implementation of structural reforms, investment, and fiscal responsibility in support of jobs and growth, within the existing rules of the SGP.

The 2018 Country report for Belgium concluded that the country had made limited progress in addressing the 2017 country-specific recommendations. There has been limited progress with distributing fiscal targets among the various levels of government and with improving the composition of public expenditure. While the Concertation Committee for the first time approved the overall budgetary trajectory included in the 2018 SP, no agreement was made on annual fiscal targets at all levels of government. Some progress has been made with eliminating tax breaks that causes distortions. There are no plans at federal level to introduce a systematic review of public spending as a permanent feature of budget planning. The National Plan for Strategic Investment provides for an increase in infrastructure investment. Some progress has been made as regards equal opportunities to participate in quality education and vocational training, as Communities are phasing in major school reforms, but progress on equal access to the labour market remains limited. There has been some progress with encouraging investment in knowledge-based capital, even if measures vary in scope at the regional, community and federal levels. Progress on sectoral regulation has been overall limited. For certain professional services regulatory restrictions still impact competition. Limited progress has been made in improving the functioning of the retail sector for the benefit of businesses and consumers and in improving market mechanisms in network industries. Additional measures were announced after the Country report publication. Further steps have been made towards the adoption of the necessary amendments to increase the independence of the national fiscal council.

The Country report highlights as well the reform of the corporate income tax, adopted at the end of 2017, which lowered statutory rates and contributes to simplify the tax system through the revision of possibile deductions and exemptions. Still, many exemptions and distortionary incentives remain and the opportunity to shift taxes to more growth-friendly bases could have been further used. The report also aknowlegdes that, over the course of the last few years some progress has been made regarding a number of challenges. Measures have notably been taken to reverse previous losses in competitiveness. Between 2013 and 2017, various wage moderation policies have been implemented to improve the gradually eroding cost-competitiveness, including a real wage freeze, parametric changes to the indexation calculation mechanism and a temporary suspension of wage indexation agreements. In addition, in the framework of the on-going tax reform, measures have been taken to reduce the tax wedge on labour through gradual decreases in personal income taxation and employers' social security contributions, with more than proportional reductions for lower salaries. The targeting of low wages favours the young and the low-skilled, who tend to have lower wages, but also the lowest employment rates, and thus supports activation for some of the most vulnerable groups. Nevertheless, despite the recent reforms, the Belgian tax system

[6] Stability Programme Belgium 2018-2021, p. 20.

remains hampered by widespread distortions which narrow tax bases and contribute to the system's complexity. Taxation also continues to lean heavily on labour taxation, even after the recent reforms, and additional tax reductions at the lower end of the pay scale would contribute to reducing unemployment and low wage traps for second earners, singles and single parents.

As was already discussed in previous Article 126(3) reports, Belgium has also modernised its public pension system in recent years. Pension reforms were adopted in 2015, reducing early exit possibilities by further tightening the standard eligibility requirements for both early and pre-retirement. The legal retirement age will also rise from 65 to 66 in 2025 and to 67 in 2030. The long-term impact of that set of measures is discernible in the 2015 projections of the Ageing Working Group: pension expenditures are projected to rise by 1.3 pp. of GDP between 2013 and 2060, compared to 3.3 pp. before the most recent reforms. The difference is mostly due to the pension reform itself (-1.6% of GDP). Those more positive ageing projections allowed Belgium to lower its MTO under the SGP from a structural surplus of 0.75% of GDP to a balanced budget in structural terms. While the positive impact of the 2015 pension reforms is not put in question, the forthcoming 2018 projections of the Ageing Working Group project a higher than previously expected increase in the pension expenditure; the upward revision is almost exclusively due to less favourable demographic projections. In 2017 an agreement was reached about the harmonisation of the valorisation of years of study in the three pension schemes, which is estimated to lower the projected increase in ageing costs by 0.1% of GDP in 2060. Thus, although already enacted reforms have substantially reduced the projected rise in public pension spending, curbing the expected increase in age-related spending further through additional reforms would improve fiscal sustainability in the long term. Moreover, there are signs of a strong shift from early exit through the pension and unemployment systems to the sickness and disability schemes, which would partially offset the projected gains from the enacted reforms. Spending on sickness and disability has been rising rapidly: from a broadly stable level of around 1.2% per year until 2007 to 1.9% in 2016. By the end of its term in 2019, the government intends to lay the groundwork for the introduction of a credit-based public pension system as of 2030. Once fully implemented such a system would allow for automatic adjustment mechanisms in response to demographic or economic developments.

4.2. Medium-term budgetary position

The ex-post assessment of Belgium's compliance with the preventive arm finds that there is currently not sufficiently robust evidence to conclude on the existence of a significant deviation from the adjustment path towards the MTO in Belgium in 2017 and over 2016 and 2017 together. As regards 2018, the fiscal adjustment is not expected to be sufficient to comply with the preventive arm requirements for Belgium.

Headline, structural balance and adjustment towards the MTO

Headline balance

Belgium's headline deficit fell from 2.6% of GDP in 2016 to 1.0% in 2017. The revenue-to-GDP ratio rose by 0.4 pp. of GDP while the expenditure-to-GDP ratio fell by 1 pp. of GDP. The 2017 headline deficit was impacted by additional expenditure related to exceptional security measures in the light of the terrorist threat. According to the Commission, the eligible additional expenditure in 2017 amounted to 0.02 % of GDP.

MTO and structural balance

The 2018 Stability Programme does not provide information on the budgetary impact of the exceptional security-related measures in 2017. However, the Belgian authorities, in a letter dated 9 May 2018, provided adequate evidence of the scope and nature of those additional budgetary costs. According to the Commission, the eligible additional expenditure linked to the security measures amounted to 0.02% of GDP in 2017. The provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow for that additional expenditure to be catered for, in that the severity of the terrorist threat is an exceptional event, its impact on Belgium's public finances is significant and sustainability would not be compromised by allowing for a temporary deviation from the adjustment path towards the MTO. The required structural improvement in 2017 has consequently been reduced from 0.6% of GDP to 0.58% of GDP.

In the 2016 SP, the Belgian authorities revised their MTO to a balanced budget in structural terms, down from a structural surplus of 0.75% of GDP. The MTO appears sufficiently stringent under what can be considered as normal economic conditions to ensure debt rule compliance in the medium and long term. In the 2018 SP, Belgium confirmed the MTO but postponed the planned achievement of it from 2019 to 2020. According to the Commission 2018 spring forecast, this would require a structural improvement of 1.4% of GDP over 2018-2020. At the same time, the Commission forecast expects the structural balance to deteriorate by 0.1 pp. of GDP in 2018 and 0.3 pp. of GDP at unchanged policy in 2019, the last year of the Commission projections. According to the High Council of Finance the implied deterioration in 2020 would represent 0.02% of GDP[7]. As a result, achieving the MTO in 2020 will require substantial additional measures and a strict execution of the budget in view of implementation risks towards the end of the current legislative period.

Compliance with the recommended adjustment towards the MTO

In 2017, Belgium was recommended to pursue an annual structural adjustment towards the MTO – corrected for the impact of unusual events – of at least 0.58% of GDP. Based on outturn data and the Commission forecast, the growth of primary government expenditure, net of discretionary revenue measures and one-offs, exceeded the expenditure benchmark (corrected for the impact of unusual events), leading to a gap of 0.4% of GDP, pointing to some deviation. The structural balance is estimated to have improved by 0.8% of GDP in 2017, 0.2% of GDP above the recommended effort of 0.58% of GDP, pointing to compliance.

However, over 2016 and 2017 together, the average deviations were larger in view of the deviation that was also observed in 2016, when Belgium was recommended to pursue an annual structural adjustment towards the MTO – corrected for the impact of unusual events – of at least 0.47% of GDP. Indeed, over those two years, the deviation based on the expenditure benchmark amounted to 0.5% of GDP, above the treshold of significance. In turn, the structural balance points to a deviation of 0.1% of GDP, pointing to some deviation.

This calls for an overall assessment, in which the following three main factors are to be considered:

[7] High Council of Finance (2018), Avis 'Trajectoire budgétaire en préparation du Programme de Stabilité 2018-2021'. Based on data provided by the Federal Planning Bureau.

First, the change in the structural balance was inter alia positively impacted by lower interest expenditure, contributing to 0.4 pp. of GDP of the change. That windfall improves the reading of the fiscal effort based on the structural balance but does not affect compliance with the expenditure benchmark, which is therefore considered to reflect more appropriately the underlying fiscal effort.

Second, both in 2016 and 2017, the expenditure aggregate was negatively impacted by higher than expected inflation. Whereas the reference growth rate for the expenditure benchmark is based on a GDP deflator forecast of 1.0% for 2016 and 1.5% for 2017, the actual GDP deflator used for the structural balance amounted to 1.6% in 2016 and 1.9% of GDP in 2017. The impact on expenditure growth from higher than anticipated inflation transpired in the fact that the automatic indexation of social benefits and public sector wages occurred earlier than expected in the Commission forecast. While the inflation surprise resulted in higher-than-expected public expenditure, it had a positive impact on tax revenues (as private wages are generally indexed to inflation). However, the expenditure benchmark only captures the expenditure side and thus the negative impact of the inflation surprise, and therefore under-estimates the underlying fiscal effort. The impact of higher inflation was estimated at around 0.2% of GDP for 2016 and 0.1% of GDP in 2017, correcting the GDP deflator for the share of public expenditure directly indexed on inflation. The deviation for the expenditure benchmark would thus be reduced from 0.43% to 0.37% of GDP in 2017 and from 0.5% to 0.4% of GDP over 2016 and 2017 together.

Third, there are substantial uncertainties regarding the treatment of the substantial increase in advanced corporate income tax payments collected in 2017 (around ½ % of GDP in 2017). This revenue increase stems notably from the introduction, in 2017, of significantly higher surcharges for non-payment of advanced tax payments. This measure introduces a permanent change in the timing of recurrent revenue, by shifting -at least in part- tax collection from ex-post tax settlement to advance tax payments, and therefore it creates an exceptional and temporary peak in tax revenue in 2017[8]. In the baseline scenario of the 2018 spring forecast, the Commission considered that any tax collection in excess of the trend was to be considered as a one-off, temporary revenue, which would eventually be offset by lower tax settlement revenue in the following years.

However, other analyses, such as that of the National Bank of Belgium or of the government, consider a higher share of the CIT revenue increase in 2017 as structural. While the Commission acknowledges that this is indeed a possibility which should not be discarded, it considered it as an upside risk rather than a factor to be integrated in the baseline scenario. The uncertainty surrounding this measure is highlighted by the fact that its permanent impact will only be measurable after several years, while the outturn corporate income tax data for 2018 will provide a preliminary indication of the magnitude of the impact.

This issue will remain relevant over the coming years, given that from 1 January 2018 the surcharge rate will further increase, from the current 2.25% to 6.75%, while the currently applicable credit rate rewarding sufficient tax advanced payment will also be adjusted. Advanced payments are thus expected to become considerably more important for companies that are interested in avoiding extra tax liabilities.

[8] European Commission, Report on Public Finances in EMU 2015, p. 58.

Amid such uncertainty as to the future evolution of corporate income tax revenue, it is worth noting that an ex post upward revision of the permanent effect of the measure could considerably improve the assessment of the underlying budgertary position and potentially reduce the deviation from the expenditure benchmark in 2017, bringing it below the significance threshold.

Therefore, in the context of this report, the relatively more conservative stance from the Commission clearly represents a relevant factor to be considered in the overall assessment, given both the magnitude of the extra revenues (around ½ % of GDP in 2017), as well as the high level of uncertainty as regards the extent of their temporary nature.

On that basis, while the deviation from the adjustment path towards the MTO in 2016 and 2017 together remains significant when taking into account the impact of the higher-than-anticipated inflation on the share of public expenditure directly indexed on inflation, the Commission is of the view that, given the high uncertainty regarding the treatment of the additional corporate income tax revenues, there is currently not sufficiently robust evidence to conclude on the existence of a significant deviation in Belgium over 2016 and 2017 together.

In 2018, Belgium is recommended to pursue an annual structural adjustment towards the MTO translating into a nominal growth rate of net primary government expenditure which does not exceed 1.6%, which would correspond to a structural adjustment of at least 0.6% of GDP. Based on the Commission spring forecast, the growth rate of the expenditure aggregate is projected to exceed the expenditure benchmark, leading to a gap of 0.8% of GDP that points to a risk of significant deviation. At -0.1% of GDP in 2018, the projected deterioration in the structural balance also significantly deviates from the recommended structural adjustment. Over 2017 and 2018 taken together, the expenditure benchmark points to a risk of significant deviation, with an average deviation of -0.6% of GDP. The projected average deviation for the structural balance over the same period amounts to -0.2% of GDP according to the Commission forecast, indicating a risk of some deviation.

When correcting for the impact of unforeseen inflation in 2017 discussed supra (estimated at 0.1% of GDP), the deviation for the expenditure benchmark in 2017-2018 remains above the threshold for significant deviation. The remaining difference with the average gap for the structural balance reflects the impact of the decline in interest expenditure in both years. As a result, the overall assessment points to a risk of a significant deviation from the recommended adjustment path towards the MTO in 2018 over 2017 and 2018 taken together.

Public investment

Over the forecast horizon, public investment is projected to rise to 2.5% of GDP due to large investment projects at regional level and an acceleration of local government investment in the run-up to municipal elections in 2018. From 2009 to 2016, public investment was lower than the general government deficit, but the latter fell below the investment ratio in 2017.

The federal government has been pursuing a 'National Investment Pact', which aims to accelerate investment in key areas by mobilising public and private means as well as by identifying obstacles for private investment. Regions and Communities can join the initiative.

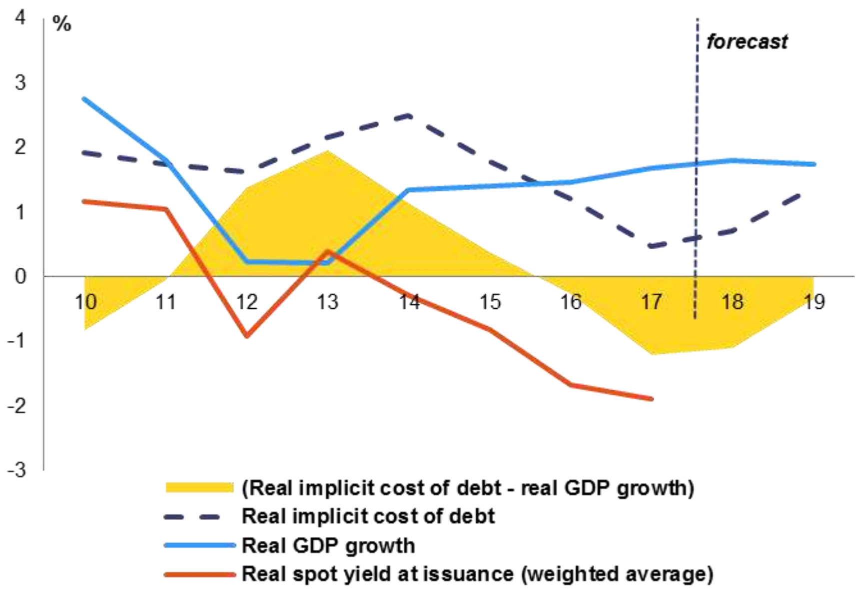
4.3. Medium-term government debt position

Debt dynamics

Between 1997 and 2007, Belgium's government debt-to-GDP ratio decreased by 36 pp., thanks to sizeable (although gradually declining) primary surpluses. That trend of sustained debt reduction was halted by the financial and economic crisis of 2008. At the end of 2007, Belgium's general government debt stood at 87% of GDP. It rose to 107% of GDP in 2014, an increase of 20 pp. It compares to an increase of 27 pp. in the euro area.

The main drivers behind the increase between 2007 and 2014 were the upward snowball effect (+10.5 pp.) and stock-flow adjustments (+9.4 pp.), with the erstwhile primary surpluses gone (see Graph 1). The snowball effect reflects how interest spending generally surpassed nominal growth since 2008. Yet, at 1.4 pp. on average, the annual upward impact of that dynamic in 2008-2015 was similar to that in 1997-2007, as the denominator effect of lower nominal growth was offset by the nominator effect stemming from lower interest spending in terms of GDP. The latter ratio continued to decline after 2007 as continuously declining interest rates compensated for an increasing debt ratio. A further decline in interest spending in recent years resulted in a slightly downward snowball effect in 2016 for the first time since 2011.

Graph 1. Drivers of "snowball effect" on government debt



The substantial debt increase due to stock-flow adjustments occurred predominantly in 2008 and 2011, when the Belgian State had to intervene in the financial system. In 2008 authorities had to step in to save Fortis, KBC, Dexia and Ethias. In 2011 the Belgian State acquired Dexia Belgium, the current Belfius bank. The recovering of part of the financial sector bailout resulted in downward stock-flow adjustments representing 3.9% of GDP in 2012-2017. Remaining participations include a share of 7.8% in BNP Paribas, 100% of Belfius, 100% of insurer Ethias (including stakes of regional and local authorities), and 50% of Dexia bank. Dividends paid by financial institutions represented about 0.1% of GDP in 2017.

The negative stock-flow adjustment of 0.1% of GDP in 2017 mainly reflects interest rate swaps, income from the sale of shares in BNP Paribas, the difference between accrued and paid interest and regional loans for social housing.

While the accumulated impact on the debt ratio from the primary balance has been about zero since 2008, the contrast with the situation prior to 2008 is striking. Between 1997 and 2007 the attainment of substantial primary surpluses allowed for an annual debt reduction of around 5 pp. In that respect, the disappearance of the primary surplus can be considered the main driving force behind the increase in the debt ratio since 2007. It highlights how the return to substantial primary surpluses is a precondition for putting debt on a clear downward trajectory and complying with the debt reduction benchmark.

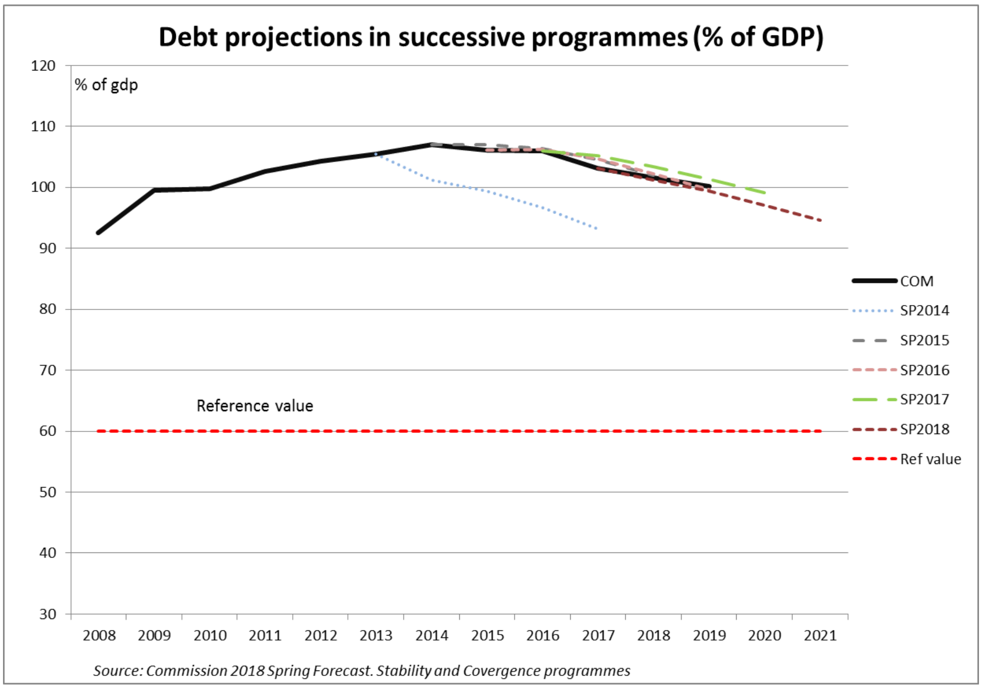
According to the Commission 2018 spring forecast, the debt-to-GDP ratio would fall by 1.6 pp. in 2018. A primary surplus of 1.2% of GDP and a sizeable downward snowball effect of 1.1% of GDP as a result of rising nominal growth and decreasing interest expenditures are partially offset by upward stock-flow adjustments stemming from loans at the regional level for the financing of social housing investment and interest rate swaps. The same trend is expected in 2019 when debt would decrease to 100.2% of GDP at unchanged policy.

Interest expenditure

In line with the general trend in the euro area, interest rates on Belgian debt instruments are at historical lows. The ten-year bond yield averaged 0.85% during the first quarter of 2018. The spread between Belgian and German bonds has been broadly stable for several years. It averaged 32, 37, 41 and 30 basis points in 2015, 2016, 2017 and the first quarter of 2018 respectively, compared to a maximum of 366 basis points at the end of November 2011. The implicit interest rate declined steadily in recent years, from 4.6% in 2007 to 2.4% in 2017. It is projected to decline further to 2.1% in 2019.

Debt sustainability

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



Belgian authorities have been using favourable market conditions to refinance the outstanding debt against much lower rates at considerably longer maturity. The average maturity of long-term issuance remained at a high level at 15 years in 2017 (17.5 years in 2016 and 13.6 years in 2015) with an average weighted yield of 0.9% (0.8% in 2016 and

0.9% in 2015). As a result, the average life to maturity of the total federal debt portfolio[9] rose to 9.3 years at the end of 2017 and 9.2 years at the end of February 2018[10]. It is the longest ever and compares to around 6 years until 2009 and 8 years at the end of 2015[11]. The 12-month and 60-month refixing risk[12] of the federal debt decreased from around 20% and 57% at the end of 2012 to around 18.5% and 41.9% at the end of 2017[13]. Currently, Belgium does not appear to face a risk of financial stress in the short term. If interest rates were to start rising, the high debt level implies a substantial hike in interest expenditure over time, though the high average life to maturity means that that hike would materialise only gradually.

The sensitivity to potential shocks in nominal growth and interest rates as well as the unfavourable starting point result in high sustainability risks in the medium term. At unchanged policy, the debt level is projected to decline to 94.8% of GDP by 2028[14]. A 1 pp. increase in the interest rate assumptions or 0.5 pp. lower GDP growth would bring the debt level to 100% of GDP in 2028. Adequate progress towards Belgium's MTO, as required by the Stability and Growth Pact, would put the debt on a sustained downward path, arriving at 76% of GDP by 2028. However, the fiscal effort required for reaching the MTO is substantial, considering that the structural deficit is estimated at 1.6% of GDP in 2019 at unchanged policy. Moreover, rising expenditure might require additional measures once at the MTO.

Lastly, the sustainability of public debt is also determined by the economy's growth potential. As described above, the gradual decline of total factor productivity growth since the beginning of the 1990s has lowered potential growth. It underscores the importance of implementing structural reforms in order to boost potential growth. Progress with regard to reforms was discussed in Section 4.1.

4.4. Other factors considered relevant by the Commission

Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3) of Regulation (EC) No 1467/97).

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9 The federal debt represents 84% of the general government debt.

10 Belgian Debt Agency, Annual report 2017.

11 Belgian Debt Agency, Borrowing requirements & Funding plan 2018.

12 The proportion of outstanding debt which matures in a given time period or which is subject to changes in interest rates because of a floating interest rate.

13 Belgian Debt Agency, Borrowing requirements & Funding plan 2018.

14 2017 Debt Sustainability Monitor. Those projections start from the European Commission 2018 winter forecast, with the no-policy change assumption translated into a structural primary balance kept constant (excluding ageing costs) at the level of the last year of the forecast (2019). The baseline scenario is based on the following macroeconomic assumptions for the long term: potential GDP growth remains around 1.4%; inflation and the change in the GDP deflator stabilise at 2% in the medium term; long-term interest rates on new and rolled-over debt converge to 3% in real terms by 2026 and short-term rates to a value consistent with the long-term interest rate and historical (pre-crisis) euro area yield curve (see also European Commission, 2012). Projected ageing costs are based on the 2015 Ageing Report.

Rescue operations in the financial sector explain part of the debt increase since 2007 as discussed in section 4.3. The direct cumulative debt impact of those operations reached almost 7% of GDP in 2011 but declined to around 3% of GDP as of 2017 due to the sale of some of the acquired assets as well as the reimbursement of loans. Contingent liabilities related to guarantees granted to the financial sector all relate to Dexia. Awaiting full resolution, the Belgian State guarantees 51.4% of Dexia's liabilities. Those guarantees reached 7.8% of GDP as of April 2018, down from 8.7% at the end of 2016.

Article 12(1) of Regulation (EU) No 473/2013 requires that this report considers also "*the extent to which the Member State concerned has taken into account the Commission's Opinion on the country's Draft Budgetary Plan, as referred in Article 7(1)*" of the same Regulation. The Commission Opinion on Belgium's draft budgetary plan for 2018 pointed to a risk of non-compliance with the provisions of the SGP in 2017-2018 and invited the authorities to implement all planned measures within the national budgetary process and to ensure that the 2018 budget complies with the SGP. The federal budget was adopted by Parliament on 14 December 2017 without major changes compared to the Draft Budgetary Plan. In March 2018 the federal government carried out a budget review, which largely consisted of updated assessments of earlier announced measures and of underlying assumptions, with some additional spending and revenue measures announced as well. The overall impact of the March review on the Commission projections is estimated at 0.1 pp. of GDP in 2018.

4.5. Other factors put forward by the Member State

On 9 May 2018, the Belgian authorities transmitted a letter with relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97. The analysis presented in the previous sections already broadly covers the key factors put forward by the authorities.

On top of reforms in the area of competitiveness, the federal government highlights the tax shift away from labour in 2015-2020 as well as planned changes to the pension system such as a reform of assimilated periods, the extension of the second pension pillar to all workers and the introduction of a partial pension. The authorities also highlight the planned increase in public investment through a national strategic investment pact, which is expected to support potential growth. In their letter, the Belgian authorities also point to the fact that the debt ratio has fallen since 2015 and would continue decreasing. The letter highlights the upward impact that weak growth, support to financial institutions, lending to Greece and contributions to the EFSF/ESM have had on the debt ratio. According to the authorities' calculations, the budgetary path presented in the 2018 SP should enable compliance with the debt criterion by 2018.

Furthermore, the authorities invoke exceptional costs related to the refugee situation and security measures. While they are neutralised with respect to the adjustment path towards the MTO through the application of the unusual event clause (see section 4.2), they have an impact on the headline balance and thus on public debt developments. Overall, the exceptional costs amounted to 0.3% of GDP in 2017 according to the authorities. The letter provides adequate evidence of the scope and nature of those additional budgetary costs linked to the exceptional security-related measures. According to the Commission, the eligible additional expenditure linked to the exceptional security measures amounted to 0.02% of GDP, in 2017. The provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow that additional expenditure to be catered for, in that the severity of the terrorist threat is an exceptional event, its impact on Belgium's public finances is significant and sustainability would not be compromised by allowing for a temporary deviation from the adjustment path towards the MTO. The required structural improvement in 2017 has consequently been reduced from 0.6% of GDP to 0.58% of GDP.

The letter also provides some explanatory factors for the significant rise in corporate income tax advanced payments in 2017. On the one hand, it is presented as the result of a structural increase in advance payments due to, among other things, the reduced notional interest deduction rate and the increase in the gross operating surplus of companies. On the other hand, the government considers there is a one-off effect due to a shift from tax enrolments to prepayments as a result of the increased penalty for companies that do not make advance payments as from 1 January 2017.The letter argues that the high tax payments received in the first quarter of 2018 lend additional credibility to the authorities' assumption.

Finally, the authorities detail the main factors behind the higher-than-expected inflation in 2017, which can be mostly explained by a strong year-on-year increase in the price of energy products.

5. CONCLUSIONS

General government gross debt stood at 103.1% of GDP at the end of 2017, well above the 60% of GDP reference value. Belgium did not comply with the debt reduction benchmark in 2017. Moreover, the Commission forecast does not expect Belgium to comply with the debt reduction benchmark either in 2018 or in 2019, based on a no-policy-change assumption. This suggests that before consideration is given to all relevant factors, the debt criterion as defined in the Treaty does not appear to have been fulfilled *prima facie* in 2017. In line with the Treaty, this report also examined the relevant factors.

Based on an overall assessment of compliance with the preventive arm, and given large uncertainties related to key factors of fiscal performance in 2017, there is no sufficient evidence to conclude that Belgium is non-compliant with the required adjustment path towards the MTO in 2017 and over 2016 and 2017 together. However, Belgium is assessed to be at risk of significant deviation in 2018 and over 2017 and 2018 together. Hence, the necessary measures should be taken as of 2018 to comply with the provisions of the Stability and Growth Pact. The use of any windfall gains to further reduce the general government debt ratio would be prudent.

Belgium has made progress in implementing the structural reforms announced since the beginning of 2015, notably in the area of pensions, competitiveness and taxation. For several of those reforms progress is considered substantial. They are expected to contribute to enhancing the economy's growth potential and reducing the risks of macroeconomic imbalances, thereby having a positive impact on debt sustainability in the medium to long term. The non-budgetary neutral nature of the tax reform undertaken has worsened the budgetary position, though. In a letter sent to the Commission on 9 May 2018, the Belgian authorities highlighted their commitment to continue structural reforms, in particular regarding the pension system and the implementation of a strategic public investment plan.

Finally, unfavourable economic conditions in the recent past partly explain non-compliance with the debt criterion in 2017. However, economic conditions have been improving and are no longer considered a mitigating factor in explaining Belgium's gap compared to the forward-looking dimension of the debt reduction benchmark in both 2018 and 2019 according to the Commission forecast.

The analysis presented in this report includes the assessment of all the relevant factors and notably: (i) the previously unfavourable but improving macroeconomic conditions, which makes them less of a factor to explain Belgium's large gaps as regards compliance with the debt reduction benchmark; (ii) the fact that there there is currently not sufficiently robust evidence to conclude on the existence of a significant deviation in Belgium in 2017 and over 2016 and 2017 together; and (iii) the implementation of growth-enhancing structural reforms in recent years, several of which are considered substantial and projected to help improve debt sustainability. Overall, as there is currently not sufficiently robust evidence to conclude on the existence of a significant deviation in Belgium in 2017 and over 2016 and 2017 together, the current analysis is not fully conclusive as to whether the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 is or is not complied with. However, the adjustment in 2018 appears inadequate to ensure compliance with the adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast. The Commission will reassess compliance on the basis of the ex-post data for 2018 to be notified in Spring 2019.