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OECD Economic Surveys: Belgium

Chapter 4

How to reform the tax system to enhance economic growth

Individual elements in tax systems affect the growth process through different channels and to a varying degree. Consumption taxes are among the least distortive for growth, and there is considerable scope to increase the reliance on this tax source in Belgium. Differential taxation of saving vehicles distorts investment decisions, hampering the reallocation of capital towards its most productive use. However, the most distortive taxes are on labour through their effects on workers' labour market decisions. Recognising the latter, the Belgian authorities have aimed at reducing taxation on labour. However, its level remains internationally high, reflecting numerous exemptions, which reduce tax bases and thus require higher tax rates than otherwise. To promote labour market prospects for individual groups on the labour market, wage subsidies and social security contribution reductions have been used extensively, leading to a complex system, often poorly targeted and at times subject to conflicting objectives. The end result is that the interaction between the personal income tax, the social security contributions, and the generous benefit systems has created a multitude of labour market traps which hold back employment. New tax reforms are constrained by the large and growing fiscal sustainability problem, implying that, unless substantial expenditure cuts are implemented, new tax reforms must be self-financed. This can be achieved by shifting the reliance of the tax system towards the least distortive sources and by broadening tax bases to allow lower tax rates.

The tax system relies heavily on labour taxes

The main concern of the chapter is how taxes affect growth through their influences on the decisions of households to save, supply labour and invest in human capital, the decisions of firms to produce, create jobs, invest and innovate, as well as on investors' choice of savings vehicles. Taxes affect these decisions through both their levels and structures, implying that tax reform to promote growth should address high tax rates as well as shifting taxes to less distortive tax bases. Overall, there is a "tax and growth ranking" among taxes, where property taxes are the least distortive, followed by consumption taxes, personal income taxes and corporate taxes.

Since the early 2000s, Belgian tax reforms have tended to follow international trends towards becoming more supportive of growth with reduced taxes on labour and a modernisation of corporate taxation. This contrasted with developments in the 1990s, where tax policies were mainly aimed at fiscal consolidation in order to qualify for the euro entry.[1] The tax reforms first phased out most of the 1990s' fiscal consolidation measures (full restoration of indexation of tax brackets and ending the crisis surcharge). Then, starting in 2002, a series of the tax reforms lowered personal income taxes, social security contributions and reduced corporate tax rates, with a total overall fiscal cost of 1.3% of GDP. The personal income tax reform was phased in over four years with four distinct parts (the first two constituted the bulk of the reform):

- Part 1 lowered the tax burden on earned income through: *i)* a tax credit for low-wage earners; *ii)* an increase in the standard deduction for occupational expenses in the lowest tax bracket *iii)* a rise in the second and third income brackets; and *iv)* abolishing the highest marginal tax rates.
- Part 2 further generalised individual taxation and introduced lifestyle neutrality by treating married couples as cohabiting persons.
- Part 3 aimed at equalising allowances for taxpayers with dependent children.
- Part 4 promoted environmentally friendly taxation.

The making-work-pay part of the tax reform lowered average tax rates across the income schedule, though relatively more for low income tax payers, to enhance the positive impact on participation incentives. However, a consequence of the targeting of low-wage workers was to introduce a spike in marginal tax rates, reaching about 72%, for incomes at around half of average earnings (arising from the phasing out of the reduction of individual social security contributions) and another somewhat smaller spike at two-thirds of average wages. Only incomes above one and two-thirds of average wages experienced a reduction in marginal taxes, although the effect on income redistribution was marginal. The full effects on growth of the 2002 tax reform are probably still emerging as structural reforms typically tend to affect structural unemployment with a 5-10 years time lag (Mourougane and Vogel, 2008).There is evidence that the tax reform (including

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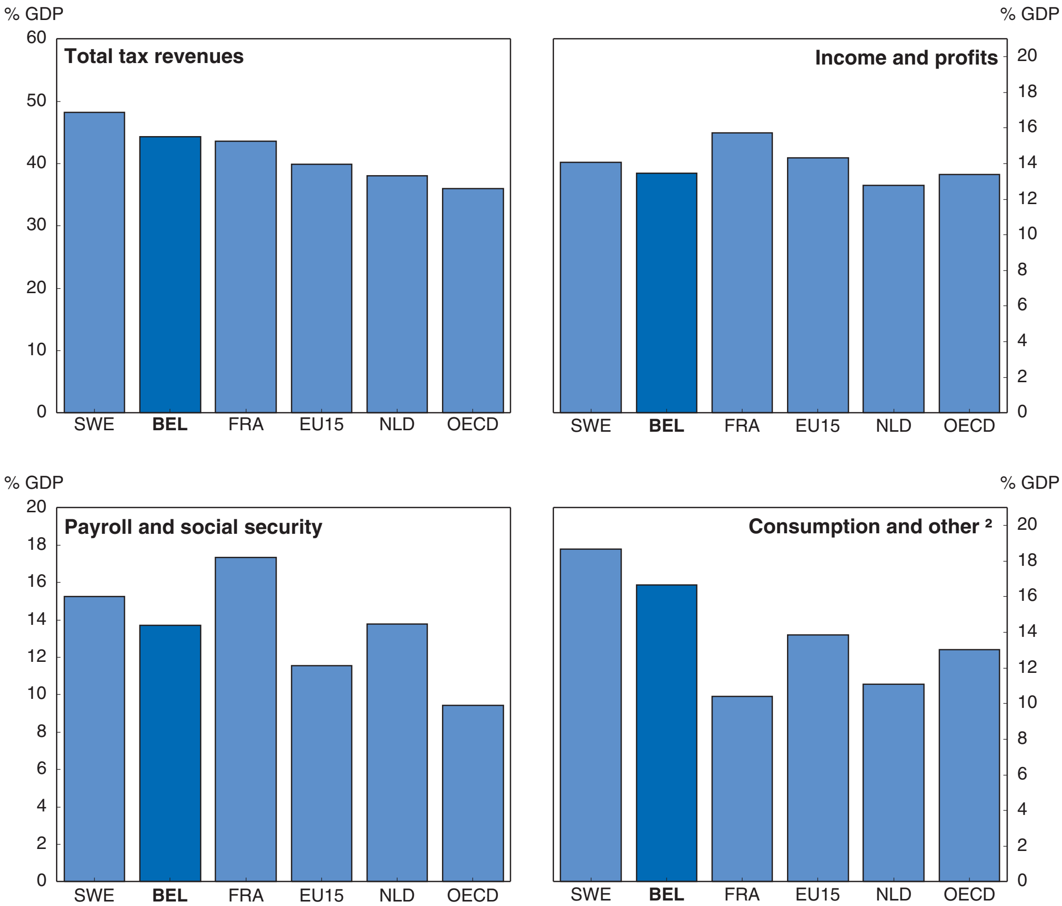
other measures introduced in the first half of the 2000s) has had a relatively large positive effect on private consumption, but one that dissipated relatively fast (Bodart *et al.*, 2008).

Nevertheless, the tax burden remains among the highest in the OECD (Figure 4.1). Revenues from social security contributions and indirect taxes expressed as a share of GDP are higher than in other OECD countries. However, revenues from indirect taxes as a share of total taxation revenues are lower than in most other OECD countries. Moreover, the Belgian tax system is more reliant on revenues from social security contributions and indirect taxes than other OECD countries. The changes to the tax structure arising from the tax reforms in the 2000s lowered taxes on personal income and increased the reliance on business and VAT taxes (Figure 4.2). Finally, the relatively high corporate tax rate remains an issue in Belgium, although there is more funding neutrality than in other countries.

Figure 4.1. **Overall tax revenues as a share of GDP**

2006[1]



1. Or latest available.
2. Including taxes on goods and services and property.

Source: OECD, *Revenue Statistics database.*

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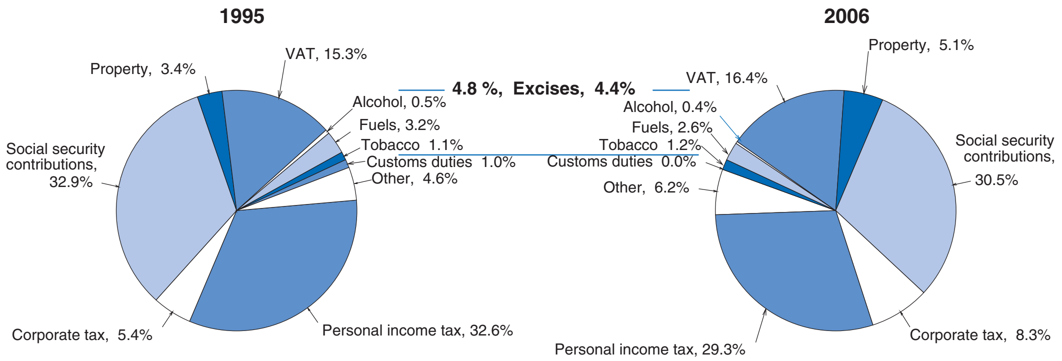
These reforms have been implemented under the constraint of securing fiscal sustainability which remains an issue (Chapter 2). Thus, in the absence of spending cuts, a prime concern for any future tax reform is to be revenue neutral. This chapter will discuss

Figure 4.2. **Structure of tax revenues**

Per cent of total tax revenues



Source: OECD, *Revenue Statistics database.*

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how tax reforms can boost growth without endangering fiscal sustainability. The chapter commences with a discussion of how taxation of labour reduces participation and hours worked. Next, the chapter analyses capital income taxation and its distorting effects on savings and investment decisions. Subsequently, the chapter considers how corporate taxation shapes financing decisions. Bearing in mind the fiscal sustainability constraint, the chapter thereafter considers how the tax system could rely more on consumption taxes as an alternative revenue source and concludes with a set of policy recommendations.

The high taxes on labour have a negative impact on labour supply

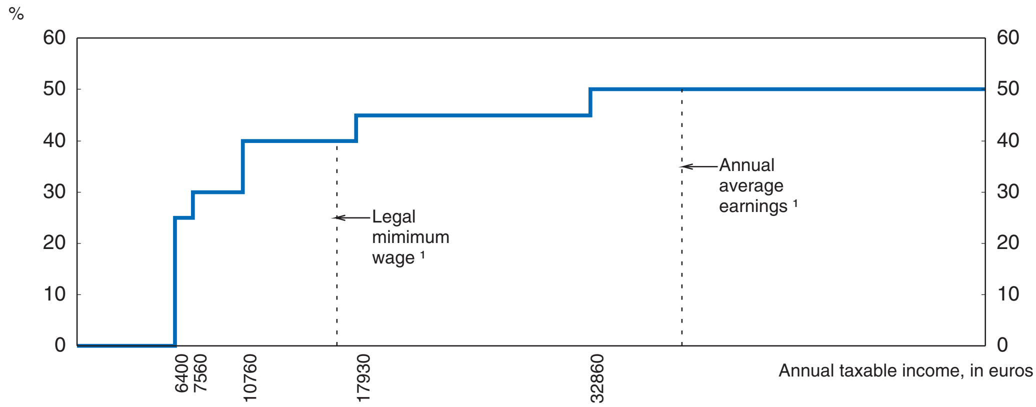
The personal income tax system is designed to be highly progressive

Belgium has a (semi-) dual income tax system, where different nominal tax rates apply to labour and capital income. Wage income is subject to progressive taxation with a five-bracket structure (Figure 4.3). Despite the abolition of the top marginal tax bracket in the 2002 tax reform, the top statutory tax rate on wage income and the average income tax for a single individual with average earnings remains among the highest in the OECD (Figure 4.4). Other countries have reduced the progression of the income tax rates, leaving Belgium's as one of the steepest in the OECD (Figure 4.5). However, most of the progression is taking place at relatively low incomes as the highest marginal tax rate is applied to incomes that are below annual average earnings for singles (Figure 4.3 and Figure 4.6).[2]

As a result, a relatively high marginal tax rate of 40% is applied to incomes that are not much above many of the sectoral minimum wages, implying that more than two-thirds of all tax units have marginal tax rates above 40% (Decoster and van Camp, 2005). At the same time, almost 18% of all tax units pay no income taxes (Decoster *et al.*, 2008). Thus, despite the highly progressive design of the income tax system, in practise it resembles in many respects a flat income tax system with a relatively large basic tax allowance (Box 4.1). Nevertheless, a number of studies have found that the combined system of labour taxation (*i.e.* personal income tax and social security systems) is progressive (Decoster and van Camp, 2005; Valenduc, 2006). There is redistribution in the social security system as no or limited social security contributions are payable by low-income households, including social benefit recipients, while there is not upper income ceiling for contributions unlike

Figure 4.3. **Marginal tax rates by taxable income**

2008



1. Legal minimum wage in 2008 equals EUR 16 657 and annual average earnings EUR 38 681.

Source: OECD, *Taxing Wages database.*

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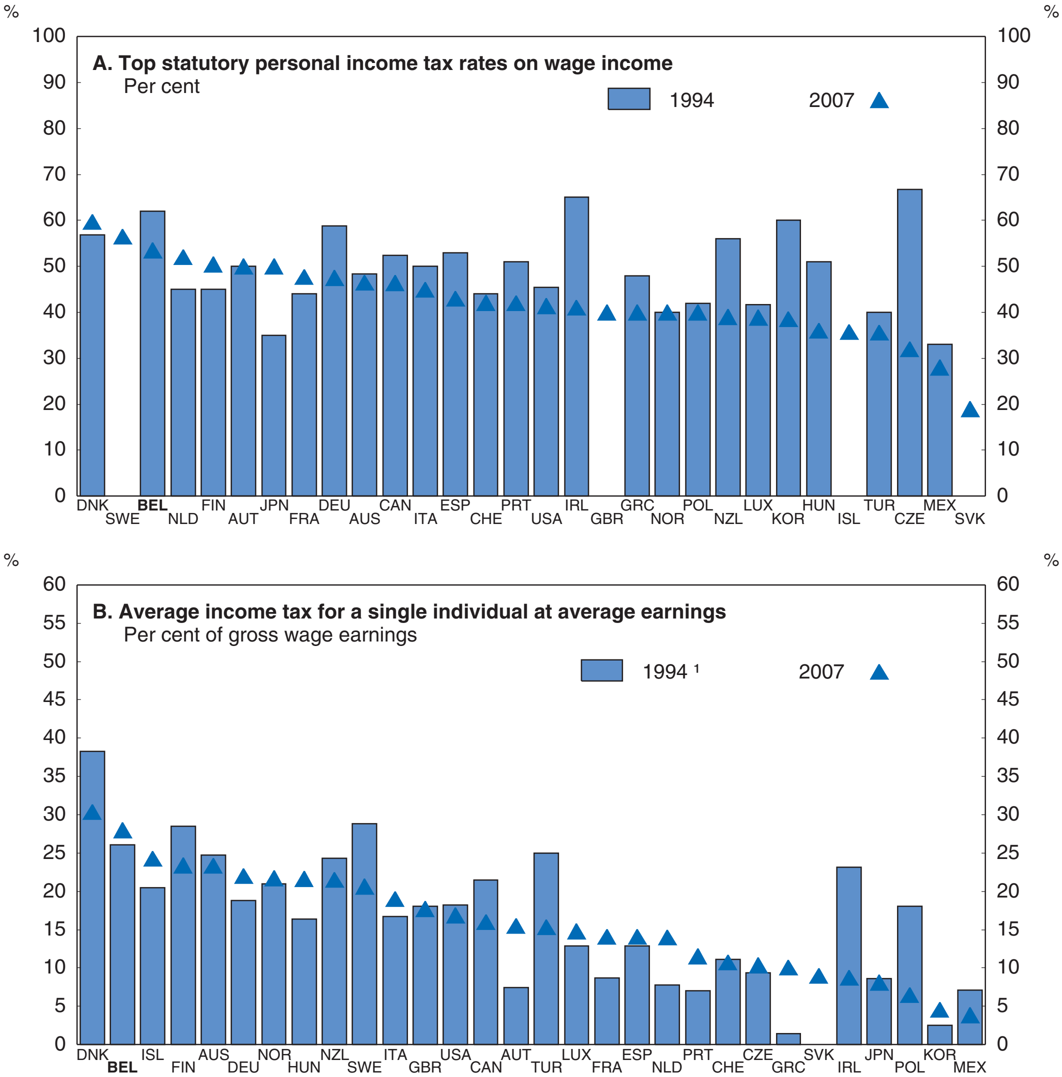
the case in a number of other OECD countries (see below) (Decoster *et al.*, 2006). Also taking into account the effects of social security benefits, this system contributes the largest part to redistribution. The personal income tax system contributes to income redistribution *via* the progressive tax rates. It should be mentioned, however, that some elements in the system are *de facto* regressive. The municipal supplementary income tax rates tend to be somewhat regressive as richer municipalities apply the lowest rates. The tax allowances tend to be regressive as more than two-thirds of the highest income groups benefit from the tax allowance on mortgage repayments as compared with very few in the lowest income groups (High Council of Finance, 2002; Valenduc, 2004; and van Cauter and van Meensel, 2006).[3]

The use of tax relief is widespread and narrows the tax base, leading to higher-than-otherwise tax rates. The most important component is structural relief that is not considered to be a tax expenditure in Belgium because of its general nature, such as the deductibility of mortgage interest payments. The latest available data from 2003 show that foregone revenues arising from structural relief amount to about 6% of GDP, which is equivalent to more than one-third of all personal income taxes and is much larger than tax expenditures (OECD, 2006; Chambre des Représentants de Belgique, 2007). Close to half of this can be explained by the basic tax allowance. Other important tax breaks are related to work allowances (about 1% of GDP) and for social purposes, such as various child and family allowances which are associated with revenue losses of nearly 1% of GDP, and the so-called “quotient conjugal” (the system of co-taxation of spouses *via* the tax splitting system and which mainly affects one-earner households) with a loss of 0.3% of GDP. Such tax relief replaces spending to reach social objectives, implying that abolishing it might not, in itself, reduce the overall tax burden as social spending would have to rise to compensate. However, the main problem with such structural tax relief in a tax system with a strong emphasis on income redistribution is its poor targeting. Better targeting by replacing tax relief for social purposes with targeted social spending would boost tax revenues by more than the necessary increase in social spending, allowing for some reduction of tax rates. Thus, as a base broadening measure, the government should replace structural tax relief by more targeted measures to pursue its social objectives.

Figure 4.4. **Top statutory personal income tax rates and average income tax for average earnings in the OECD**



1. 1995 for Hungary, Poland and Korea, 1996 for Australia. The Belgian data include the local personal income tax surcharge.

Source: OECD, *Tax database.*

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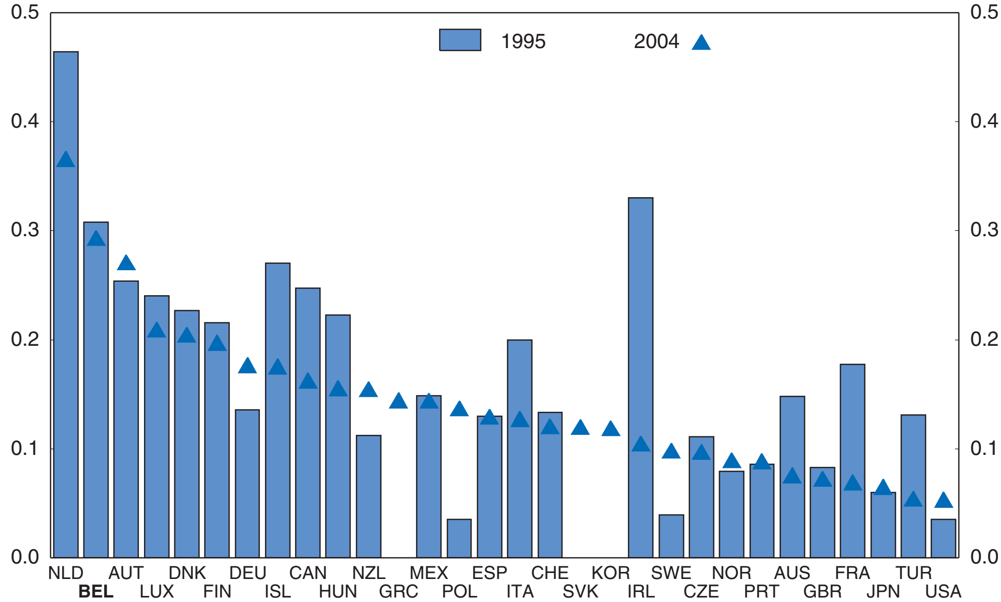
Tax expenditures, which are much narrower than structural tax relief, amount to almost 3% of GDP, which appears high compared with many other OECD countries. In the 2000s, there has been an increasing trend in the use of tax expenditures, such as for housing and energy saving investments in the personal income taxation and the introduction of reduced VAT rates for labour-intensive services in 2002. From a growth perspective, the main problem with tax expenditures is that they narrow tax bases and force tax rates to be higher than otherwise. Also, in terms of income redistribution, tax expenditures suffer from poor targeting – one example is that writers and other artists enjoy a preferential tax regime of a maximal tax rate of 15% on the first EUR 50 000. Moreover, some tax expenditures serve little economic purpose, such as those associated

Figure 4.5. **Statutory income tax progressivity for single individuals at average earnings**[1]

Index increasing with progressivity



1. The measure of progressivity used is the difference between the marginal and average personal income tax rates, divided by one minus the average personal income tax rate, for a single person earning the average wage. Higher numbers indicate higher progressivity.

Source: OECD (2009), *Going for Growth*.

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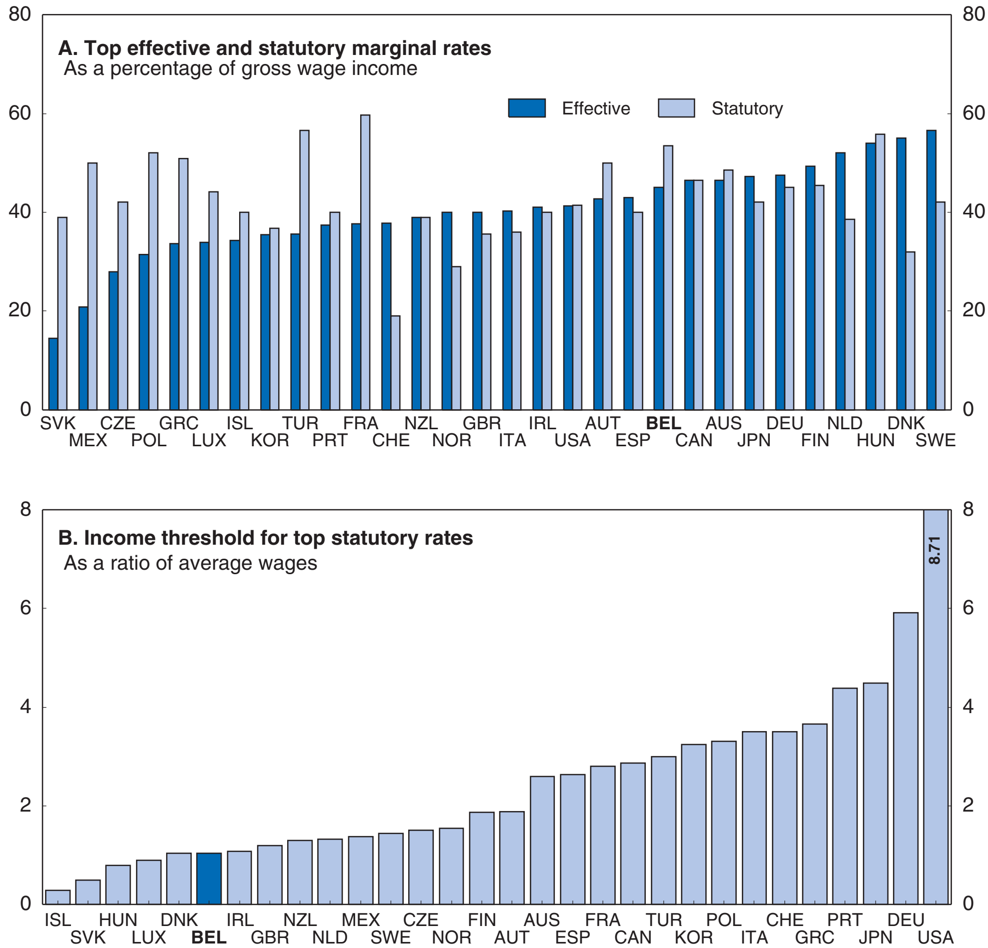
Box 4.1. **A flat tax rate system for Belgium**

The personal income tax system with the fewest distortions on labour supply decision is a flat tax system as it gives no disincentives for expanding hours worked and would favour entrepreneurship and associated risk taking, thereby boosting productivity growth. In the Belgian context, moving to such a system but with a generous basic tax allowance would to a considerable degree have the same overall effects on income distribution as the present system. It should be noted, however, that income distribution would be affected, particularly for individuals, and that the introduction of such a system in a welfare state is fraught with difficulties. In addition, over the longer term a mitigating effect on possible changes in income distribution of moving to a (revenue neutral) flat tax system would be that its largest effects on participation incentives would be felt by lower income households. Decoster *et al.* (2008) estimate that introducing a revenue neutral flat tax system and maintaining basic tax exemptions would allow a flat tax rate of 37% and boost the (full time equivalent) labour supply by 2%, while removing all tax exemptions would allow a revenue neutral tax system with a flat rate of 26% (Decoster *et al.*, 2008). The scope for a lower flat tax rate within a revenue neutral framework is larger if other exemptions are removed, such as those related to mortgage loans. This would have the additional advantage of addressing some of the distributional concerns. Besides, the positive effects on participation incentives, such a reform would also have the advantage of lowering administrative and compliance costs.

Figure 4.6. **Top marginal rates and corresponding income threshold**

2007



Source: OECD, *Tax database.*

StatLink http://dx.doi.org/10.1787/646760888554

with the tax-exempt savings accounts (see below). Reducing tax expenditures to the level observed on average in the three neighbouring countries (1% of GDP) could actually generate additional net revenues of about 1% of GDP, even by assuming that spending on social and income distribution measures had to increase by a similar size. Tax model calculations by the Ministry of Finance indicate that halving the tax expenditures could finance a reduction in the average tax rate of nearly 1 percentage point (without taking into account dynamic effects) and lead to a mild improvement in post-tax income distribution. Thus, tax expenditures should be reduced, as a tax base broadening measure, to allow lower tax rates while maintaining tax revenues.

The many income tax brackets and large number of tax deductions in the Belgian personal income tax system make it more complex than in many other countries and both administrative and compliance costs are also higher than in most other OECD countries (OECD, 2009). Moreover, the high marginal tax rates reduce work incentives, as discussed below. In addition, OECD research shows a negative impact of higher tax rates on productivity via entrepreneurship as the high rates reduce the risk-taking by individuals with a particularly strong effect in industries with potentially high rates of enterprise creation (Johannson *et al.*, 2008). Another negative effect on growth is that high marginal tax rates contribute to the low expected private rate of return on human capital investments, which over the longer term has a negative effect on the quality of labour supply (Høj, 2007; Oliveira Martins *et al.*, 2007).

With such high taxes on labour income, both employers and employees have an interest in tax exempt fringe benefits (Table 4.1). In total, fringe benefits amount to about 20% of wage costs in the private sector and only 10% of the workforce do not enjoy any fringe benefits (High Council of Finance, 2007). Such tax privileges are likely to be extensively used when marginal tax rates are high, leading to increasing tax expenditures. Moreover, a high take-up rate, such as in the case of the estimated half a million company cars, may be incompatible with achieving other government objectives like CO_2 abatement. For example, more than three quarters of the company cars have diesel engines compared with less than half for private cars.

Table 4.1. **Partial or full tax exempted fringe benefit provided by the employer**

	Nature of exemption	Additional conditions
Partially tax exempt		
Private use of company cars (including commuting)	Only the first 5 000 or 7 500 km, depending on the daily commuting distance, are taxable.	The employer has to make a contribution to the social security system, based on the CO_2 emission of the company car.
Stock options	A favourable tax rate of 15% is applied when issued; implying that capital gains are tax free and capital losses cannot be offset in the tax assessment.	If the stock option can be exercised before 5 years from issuances, a higher tax rate is applied.
Lunches	Generally tax exempt when provided in company canteens or purchased *via* vouchers ("chèques-repas")	
Computers and Internet connections		Purchasing a computer at below market price *via* the employer
Loans with preferential rates	Some taxation of the differences between the applied rate and the market rate.	
Housing	Taxed according to the cadastral value of the property, which is set well below market values.	
Furniture and electricity		
Domestic services		Include servants, drivers, etc and include salaries as well as in-kind benefits, such as food and lodging.
Fully tax exempt		
Gifts with a social aspect	Wedding, new born, additional health insurance, use of enterprise child care facilities, subscriptions, tickets for cultural events, etc.	The tax exemption is limited to legally fixed and rather low maximum amount.
Subscriptions	Additional pension arrangements; various insurances against income lost, such as life and disability insurance.	Income from such schemes is fully taxable.
Eco chèques	Exempt from taxes and special security contributions.	The cheques can only be used for acquiring certain ecological products and services such as trees, toilets with eco-flushes, etc.

Source: Submission from the Belgian Government.

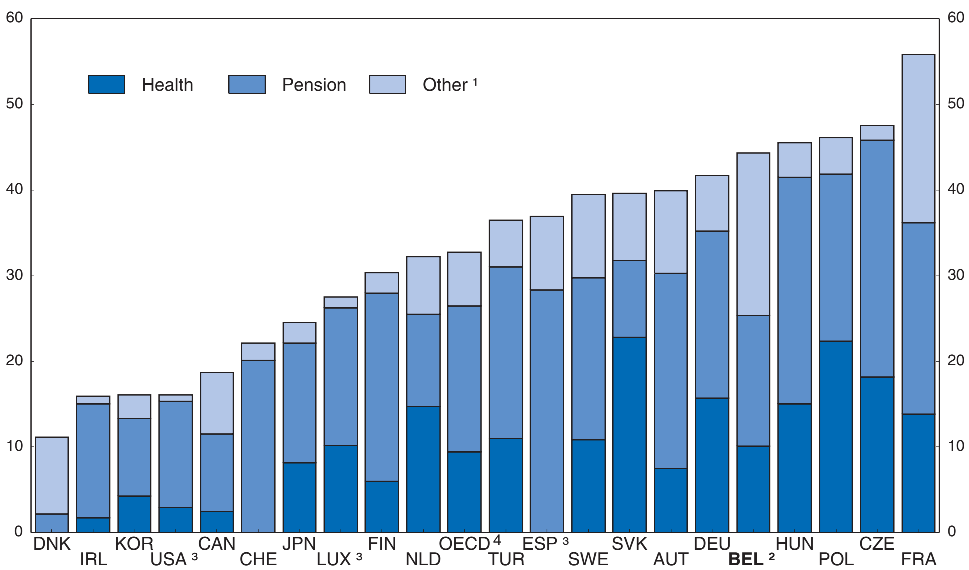
The personal income tax system needs to be reformed, taking into account the beneficial growth effects of base broadening and lower rates. However, such a system may conflict with the income equality objectives in the Belgian society. Taking these objectives into account points to a tax reform that eliminates some of the income tax brackets and increases the remaining sufficiently to ensure that only a relatively small part of the population is exposed to the highest marginal tax rate. Moreover, the highest marginal tax rate should be reduced to stimulate hours worked, while the average tax rate should be lowered to stimulate participation. In the absence of spending cuts, such reforms would have to take place within a revenue neutral framework, pointing to the need for tax base broadening by removing exemptions. It is often argued that such tax reforms carry a high fiscal cost. However, static estimates suggest that abolishing the highest marginal tax rate would entail a revenue loss of less than ¼ per cent of GDP and a 1 percentage point reduction in the average tax rate would lead to an even smaller revenue loss.

Social security contributions pose a heavy burden on labour

Employers' contributions to unemployment insurance and work-related illnesses and accidents schemes have been gradually reduced. However, this progress was offset by increases in other contributions, and in total they remain high by international comparison (Figure 4.7). There is also a special social security contribution, which is levied on the basis of the net taxable income of the households and is applied to all employed persons. This special contribution differs from the ordinary social security contribution for

Figure 4.7. **Structure of social security contributions**

Social security contributions for a single worker without children at 100% average worker wage, Percentage of gross wage, 2005



1. The "other" category mainly includes unemployment insurance and work-related illness and accident insurance.
2. The "other" category includes family allowances (6%) and wage restraint (6.6%).
3. Pension includes disability. For Spain, it also includes health.
4. Average for countries shown except Luxembourg, Spain and the United States.

Source: OECD (2007), *OECD Employment Outlook*.

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wage earners by exhibiting declining nominal rates and an income cap. However, due to a very large zero rate band, this contribution ends up being progressive at the overall level, although for incomes outside this band the contribution is regressive (van Cauter and van Meensel, 2006).[4] In total, social security contributions add up to close to 48% of gross wage earnings, of which 13 percentage points are paid by employees (Table 4.2).

Table 4.2. **Composition of social security contributions**

Per cent of wages

	Employee	Employer	Total
Unemployment insurance	0.87	3.16	4.03
Health care and insurance	4.70	6.15	10.85
Work-related illnesses and accidents		1.31	1.31
Pensions	7.50	8.86	16.36
Family allowances and child care		7.05	7.05
Placement services, business closures and education leave		0.43	0.43
Wage restraint		7.59	7.59
Total	13.07	34.55	47.62

Source: OECD (2009), *Taxing Wages* (forthcoming).

Despite the high social security contribution rates, the degree of self-financing of the system is only around 72% currently and, with the ageing of the population, is set to fall to around 60% by 2040 (Decoster *et al.*, 2006). The declining degree of self-financing can be explained by the general exemptions (Box 4.2) and the introduction of measures to stimulate employment of selected groups on the labour market, all of which also contribute to increasing the complexity of the system.

Box 4.2. **Main general exemptions in the social security system**

- Pensioners pay reduced contributions, amounting to a solidarity contribution of up to 2% on the highest pensions and a 3.55% health care contribution.
- Disability beneficiaries and people on collectively agreed early retirement allowances pay a reduced pension contribution of 3.5%.
- Unemployed pay no social security contributions on their benefits (van Cauter and van Meensel, 2006).
- Self-employed pay regressive social security contributions. A rate of 19.65% is applied to the income of the first EUR 47 203, where after a rate of 14.16% is applied until EUR 69 568. No contributions are applied to incomes above this level.

Numerous reductions in employers' social security contributions and wage subsidies have been introduced to improve the labour market prospects of selected groups on the labour market – a policy that has been successful so far as, without these measures, business sector employment would have been some 90 000 lower (Federal Planning Bureau, 2006) (Table 4.3). The main elements include:

- An across-the-board standard rebate in all employers' social security contributions.

Table 4.3. **Reductions in employers' social security contributions and wage subsidies**

Employers' social security contributions	Measures
Across the board	A general rebate of EUR 400 on social security contributions, benefiting all employees. In addition, supplementary rebates are provided for low-wage (less than EUR 5 870 per quarter) and high-wage earners (more than EUR 12 000 per quarter).
Second-tier cuts[1]	
Long-term unemployed (Plan Activa)	EUR 400-1000 (expires).
Low-wage earners below 26 years	EUR 400 (expires at age 26).
First-time hiring by start-ups	EUR 400 (expires).
Older workers (older than 50 years)	EUR 50-800 (increasing with age).
Restructuring firms[2]	Quarterly social security cuts (expires).
Third-tier cuts	
Low-wage earners in the age bracket 18-29 years	EUR 300-30 (declining with age).
Wage subsidies	(Cost in 2008 EUR 2.6 billion).
Non-profit (Social Maribel)	Per head (Social security system) (EUR 0.6 billion).
Long-term unemployed (Plan Activa)	Per head (Social security system) (EUR 0.3 billion).
Low-wage workers in small firms	Per head (Walloon region) (EUR 0.02 billion).
Shift and night workers[3, 4]	Pro rata (Federal Government) (EUR 0.7 billion).
Researchers in the private sector[4, 5]	Pro rata (Federal Government) (EUR 0.07 billion).
Young low-wage workers in non-profit activities	Per head (Social security system).
Employment premium for hiring older workers[6]	Staggered per head (Flemish region) (EUR 0.03 billion).
General	Pro rata (Federal Government) (EUR 0.2 billion).
Household service vouchers	Social security system (EUR 0.7 billion).

1. In general mutually exclusive.
2. Collective cuts in work time, re-organisation to a 4-workday per week regime, restructuring plan for troubled firms.
3. Covers workers that are in engaged in overtime, night work, and shift work activities. Was introduced gradually with stepwise increases in the nominal rate from 1% in 2003 to 10.7% in 2007. As part of the 2009-10 wage agreement, the rate was increased further to 15.6% by 1 June 2009.
4. Provided as a discount on withholding personal income taxes to be transferred by firms to the government.
5. In 2008, there was a harmonisation of the (partial) exemption from paying withholding tax on salaries of researchers with the maximum rate of 65% being applied to all categories of researchers.
6. The Flemish government increased in 2009 in the premium paid to workers over the age of 50 who start a new job and the premium (an additional EUR 500) for companies who employ them.

Source: Stockman (2007), "Wage and age related employers' SSC cuts and wage subsidies in the 2007 vintage of HERMES", *Federal Planning Bureau Working Paper,* 12-07.

- Employers' social security contributions are reduced for workers that were previously long-term unemployed, younger and older workers, as well as workers in firms that are being restructured.
- Wage subsidies in the form of a reduction in employees' social security contributions are granted to low-wage earners and workers that take up employment with a new employer after having been dismissed in a restructuring firm (collective dismissals). In practise workers on the legal minimum wage are not subject to social security contributions.
- Wage subsidies, in the form of a rebate on the withholding income tax paid by employers, are granted to shift and night workers, researchers in the private sector and a limited amount of overtime. The measure was extended in connection with the 2009-10 wage agreement to include an across-the-board rebate to offset the effects of the agreed real wage increases on total labour costs.[5]

Cuts in contributions are unlikely to have long-term positive effects on employment if these measures are financed through increases in income taxes and may even in a rigid labour market as the Belgianone lead to higher wages. However, a positive impact on the medium term can be achieved depending on the design of the cut. In Belgium, the actual design implies a relatively greater percentage reduction for lower-wage workers, inducing some substitution effects between low and high wage workers. Empirical work indicates that by far the strongest employment effects are achieved with measures targeting young low-wage workers or more generally targeting low-wage workers. Less efficient measures are across-the-board reductions, while those aimed at older workers, and shift and night workers are the least effective (Stockman, 2007). The latter result reflects that subsidies directed to shift-workers are mostly aimed at supporting the manufacturing sector, where employment is less responsive to wages than in the service sector.

The total budgetary cost of the reductions in social security contributions and wage subsidies amounts to some EUR 6.5 billion (of which about two-thirds is accounted for by the general cut in employers' social security charges) and the cost per job created or saved varies significantly across measures. Reflecting the modest tax receipts from low-wage workers, the self-financing rate is only 13% for young low-wage workers, slightly higher for shift-worker subsidies and about 30% for across the board cuts in social security contributions and measures targeted at older workers. On the other hand, the measures aimed at young low-wage workers are the most cost effective with a net budgetary cost of EUR 51 420 per job created – a cost that is comparable with what can be observed in other countries (Immervoll and Pearson, 2009; Grubb and Martin, 2001). In contrast, the least cost effective measure is the measure for shift-workers, with a net budgetary cost that is about three times higher – about EUR 150 000; the measure covers about 300 000 workers with a fiscal cost of nearly EUR 600 million, which is set to nearly double in 2009 (see Chapter 1) – raising the question of whether the associated benefits are sufficiently large to warrant such a measure.

The programmes cover relatively large groups. For example, about 35% of all jobs are eligible for the reduced low-wage social security contribution and the special programmes (for hard-to-employ unemployed and employment in start-ups) encompass about 5% of all jobs (Stockman, 2007). The programmes' multiple objectives are conflicting; econometric work indicates that the reduction in social security contributions for older workers reduces the employment prospects of younger low-wage earners (Stockman, 2007). Most of the beneficiaries of the wage subsidy measure for shift and night workers are actually found in the non-exposed service sector, where it is unlikely to have much of an impact on employment. On the other hand, the measure is likely to improve the external competitiveness in parts of the manufacturing sector, particularly the chemical and the automobile industries, which have a relatively strong employment effect in other sectors. Moreover, such targeted cuts may help to counter the incentives for outsourcing of production embodied in high social security contributions and high minimum wages (van den Cruyce and Wera, 2007; Koskela and Poutvaara, 2008). However, in a globalised world, price competitiveness is becoming less important for developed countries as their export markets are maintained through the ability to move up the value-added chain. Thus, in the short term, this measure may preserve jobs, but at a very high fiscal cost. In the longer term, the measure is unlikely to be more successful than earlier vintages of industrial policy.

Alternative instruments to promote employment prospects of selected labour market groups may be more cost efficient. For example, during economic crises low-skilled younger workers will be disproportionately affected indicating that in the short term the cut in employers' social security contribution may seem appropriate to stimulate labour demand for this group (Figure 4.8). In the longer term, such a measure should be age-neutral to avoid threshold effects and the labour prospects of this group should be improved through other instruments. For example, a less costly measure in fiscal terms – an important consideration

Figure 4.8. **Labour market prospects for younger workers in the OECD**

2007, 15-24 year olds

Source: OECD, *Employment Outlook database*.

StatLink http://dx.doi.org/10.1787/646782586805

in view of the fiscal sustainability problems – would be to have a more gradual increase in the minimum wage for younger workers, which is currently going from 70% at the age 18 to 82% at age 18 before reaching 100% by the age of 21. Empirically, there is some, but not conclusive, evidence that such a measure may stimulate employment of younger workers (Bassanini and Duval, 2006). Cost efficiency of the many measures could probably be increased by focusing on one instrument for each group. For example, the wage subsidies are basically countering the negative labour market effects of high sectoral minimum wages. These are considerably higher than the legal one, which relative to averages wages is higher than in almost all other OECD countries (Immervoll and Pearson, 2009). Moreover, the relatively high sectoral minimum wages indicate some scope for social partners to improve the employment prospects of low-wage workers. A similar situation is true for the generally well paid workers in the automobile and chemical industries (who also have generous compensation for working unusual hours) and for older workers that benefit from seniority or age related pay (age based systems are being replaced by systems based on competence or seniority, following an EU court decision, see Chapter 1). However, the scope for social partners reaching job preserving wage agreements is limited by the automatic wage indexation.

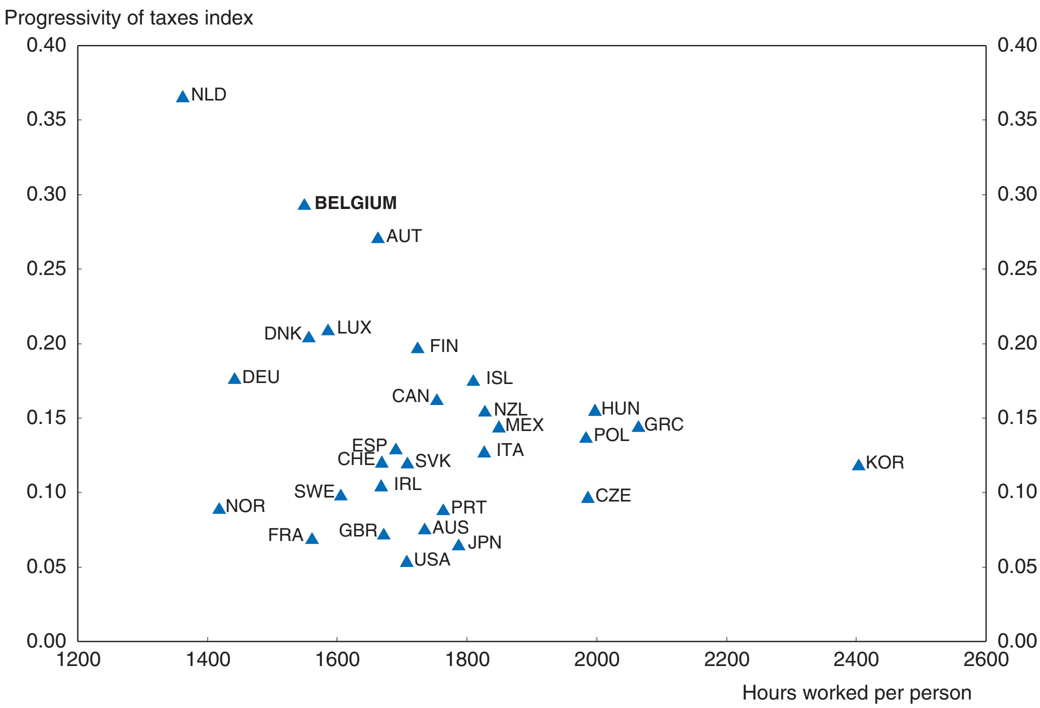
Despite government intervention, labour market traps remain substantial

Effective marginal tax rates are high for most workers. Using a micro-simulation model, Decoster *et al.* (2008) showed that the majority of both males and females (independently of their family situation) are faced with marginal tax rates above 50%. Moreover, the effective marginal tax rates tend to be even larger as more than three-quarter of single women and about half of married women are faced with rates of

60% or more. Particularly, the tax splitting system subjects the low-income spouse (typically one that prefers part-time work) with higher marginal income tax rates than singles with similar incomes. As the labour supply elasticity of female workers is relatively high, this appears to have contributed to the relatively low average hours worked (Figure 4.9) (Jaumotte, 2003). In addition, non-working spouses are covered in the social security system through the working spouse's contributions, implying even higher effective marginal tax rates. To stimulate hours worked by low-income spouses, the government should complete the full tax separation of spouses as implemented in many other OECD countries. The number of men faced with similar effective tax rates is even higher, but they have relatively inelastic labour supply.

Figure 4.9. **Progressivity of taxes and hours worked**

2004



Source: OECD (2009), *Going for Growth* and OECD *Productivity database.*

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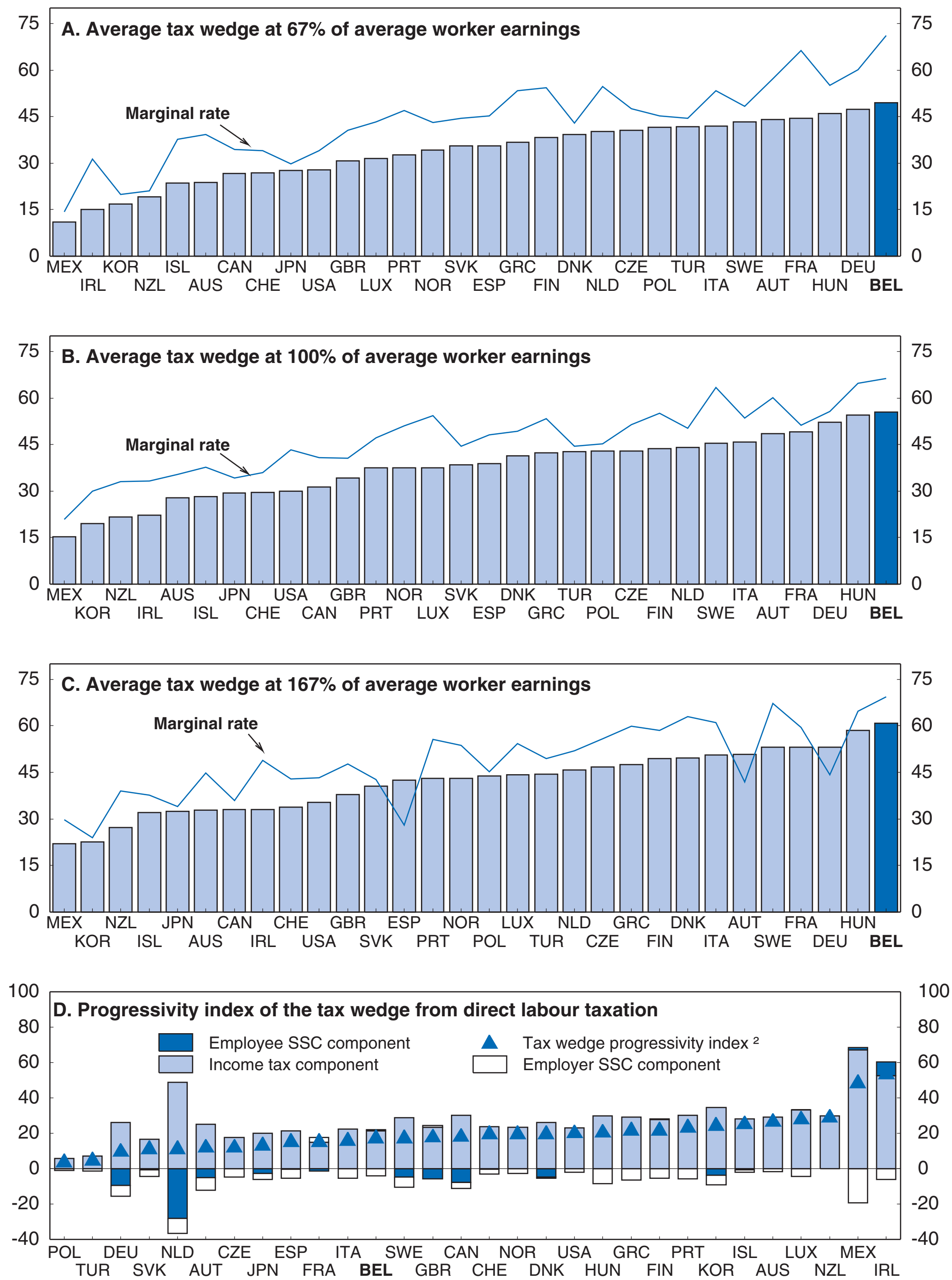
The 2002 tax reform and subsequent measures to lower labour costs reduced effective marginal tax rates for all household types and income levels (OECD, 2008). Further measures implemented in 2008 include higher in-work benefits, allowing job seekers that accept part-time employment to receive a top-up unemployment benefit, which is attributed independently of the family situation and of in-work benefits. In addition, a childcare wage complement is in place and a mobility complement is considered to enhance incentives for unemployed to expand their job search to beyond 75 km from their place of residence and to encourage sole parents to return to the labour market. Nevertheless, the Belgian tax-wedges are among the highest in the OECD which, in rigid labour markets such as Belgium, hampers the smooth adaption of real wages to labour market disequilibria (Figure 4.10). Moreover, the 2007 reassessment of the OECD Jobs

Figure 4.10. **Tax wedge across countries in 2007**[1]

As a per cent of gross labour costs, for a single person with no children



1. The average tax wedge is defined as the share of income tax and all social security contributions minus benefits in gross labour costs, marginal rates are defined as the increase in tax and all social security contributions minus benefits as a share of the related increase in gross labour costs.
2. The progressivity index of the tax wedge is calculated as (TW167 – TW67)/ TW167, where TW167 and TW67 is the tax wedge for workers at 167% and 67% of average wage, respectively.

Source: OECD, *Tax database*.

StatLink http://dx.doi.org/10.1787/646873613776

Strategy showed that a 10 percentage points reduction of the tax wedge in an average OECD country boosts over time the employment rate by 3.7 percentage points (OECD, 2005).

The high tax wedges combined with the withdrawal of the various reductions in social security contributions leads to unemployment, inactivity and low-wage traps for low-wage workers. An effective marginal tax rate of above 80% on moving from unemployment to a low-wage job remains among the highest among European OECD countries (Table 4.4). Inactivity traps, measured by the effective tax rate for social welfare beneficiaries of moving into a low-wage job, are not as high, but still a deterring 70% for a single earner household with children. Moreover, low-wage workers are faced with high marginal effective tax rates when moving up the wage scale as benefits are reduced. Depending on the family situation, the low-wage traps vary between 45 and 58% for the lowest incomes, which is relatively high among European OECD countries.

Table 4.4. **Financial work incentives in Europe**

	Unemployment trap		Inactivity trap				Low-wage trap indicator				Net replacement rate	
	Single[1]		Single[1]		1 earner couple with 2 children[2]		Single[3]		1 earner couple with 2 children[3]		Single[1]	
% of average production worker wage	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07	2007	Change 2001-07
Austria	68	0.6	64	–2.8	82	–6.9	38	3.1	65	–17.2	55	–12.7
Belgium	**83**	**–2.3**	**66**	**0.1**	**63**	**–3.5**	**59**	**2.3**	**45**	**2.7**	**74**	**–8.9**
Czech Republic	83	–2.3	66	0.1	63	–3.5	59	2.3	45	2.7	74	–8.9
Denmark	90	–1.7	88	–1.9	84	–11.4	56	–3.3	72	–21.5	85	–2.0
Estonia	82	1.7	44	1.6	52	–5.8	26	1.2	10	–18.0	78	2.4
Finland	75	–5.4	73	–4.3	92	–5.7	62	6.7	100	4.0	67	–7.0
France	81	0.2	61	–2.7	80	–0.1	41	–2.6	63	–5.9	75	–8.4
Germany	75	0.7	68	1.6	81	5.2	51	–1.4	82	1.7	61	–20.9
Greece	59	2.1	17	0.3	16	0.1	19	0.4	16	0.1	50	–13.3
Hungary	77	5.9	46	–4.5	59	1.6	37	–4.6	37	9.1	73	7.9
Ireland	76	3.7	76	3.7	88	1.2	52	7.9	78	–3.8	74	5.0
Italy	72	12.5	22	2.2	–8	–0.4	34	4.2	11	–0.6	64	14.5
Luxembourg	88	0.0	68	0.3	89	0.4	51	7.7	110	14.6	85	0.3
Netherlands	86	7.0	85	4.5	88	1.0	59	–2.6	78	–3.2	80	0.4
Poland	79	–1.5	56	4.1	63	–3.8	38	0.4	72	–4.0	70	2.5
Portugal	82	0.5	37	0.4	57	–0.1	22	1.2	56	–1.5	78	–7.9
Sweden	82	–5.2	73	–6.6	90	–7.8	47	–12.9	80	–15.8	76	–5.8
UK	68	–0.3	68	–0.3	80	4.0	57	–0.4	85	7.2	58	–5.5

1. 67% of average income.
2. 67% of average income.
3. 33-67% of average income.

Source: European Commission services, based on the joint EC-OECD METRS project.

A reform of labour taxation needs to consider the personal income tax and the social security contributions together. In any case, with the many exemptions and targeted cuts, most employees are likely to already consider their social security contributions as another tax rather than as deferred benefits. To broaden the base for the social security contributions implies that contributions should be a function of income. Thus, the exemptions for self-employed and pensioners should be abolished.[6] Moreover, to increase the cost-effectiveness of wage subsidies, their scope should be narrowed to groups with weak labour market prospects, *i.e.* low-wage workers. Some temporary targeted cuts could be preserved for young unskilled workers and should be supplemented by a more gradual phase in of minimum wages. The social partners should become responsible for the employment prospects of other groups rather than relying on government finances to achieve this objective. This reform should be concluded by removing spikes in the effective marginal tax rates to address the remaining labour market traps.

The corporate income tax system has become more neutral *vis-à-vis* types of financing

Corporate income taxes affect growth through their effect on the after-tax rate of return on investments that are the basis for jobs creation, and on higher productivity through the introduction of new goods and technologies. These considerations were behind the cuts in nominal and effective corporate tax rates in the 2002 tax reform, although they remain relatively high (Figure 4.11). An additional reform in 2005 made the corporate tax system more neutral *vis-à-vis* various types of funding sources through the introduction of the so-called risk capital allowance, largely removing the incentives for debt financing found in many other OECD countries. Preliminary estimates indicate that the 2002 reform was broadly neutral in budgetary terms as initially expected, although they vary strongly with the business cycle (Figure 4.12) (OECD, 2004).

The origin of the 2005 reform was a European Commission decision that the previous regime with coordination centres for multinational companies was not compatible with EU state aid rules (Box 4.3) (Burggraeve *et al.*, 2008). The risk capital allowance (commonly known as "the notional interest deduction") took effect from the 2007 tax year and it allows companies to deduct from their tax base a notional amount of interest (based on the rate on 10-years government bonds two years before the tax year) on their (adjusted) equity capital.[7] The system is fairly unique internationally, although some countries have had such systems in place in the past (Brazil and New Zealand) or have incorporated elements in their tax code (Austria, Italy, Ireland, Luxembourg and Switzerland). Besides the neutrality objective, the reform also aimed at providing international firms that used the system of coordination centres with an attractive alternative as a way of securing Belgium's somewhat unique position in OECD as a net recipient of FDI – an important source of technology transfer (OECD, 2007a). A European Commission infringement procedure was opened in early 2009 because the notional capital allowance is not extended to Belgian firms investing abroad.

Preliminary analysis indicates that whereas the old system favoured debt financing for all types of investors, the new system is more neutral (Gérard, 2009). In the new system, the preferred funding for individual investors is through retained earnings, while for holding companies the system is almost neutral between new equity financing and retained earnings. This is likely to have contributed to a marked increase in equity capital (nearly EUR 250 billion for the period 2006-07), of which about half came from abroad. At the same time, the share of equity capital in the non-financial sector increased, partly as the result of larger cross-holding, but could nevertheless indicate an improvement in solvency, particularly as firms at the same time appeared to rely less on debt financing. Using the risk-free government interest rate for calculating the notional rate means that the latter is lower than the interest rate on debt financing, implying that, from the point of view of the companies, there remains some advantage to debt financing. Completing the reform to make corporate taxation fully neutral *vis-à-vis* various types of financing, for

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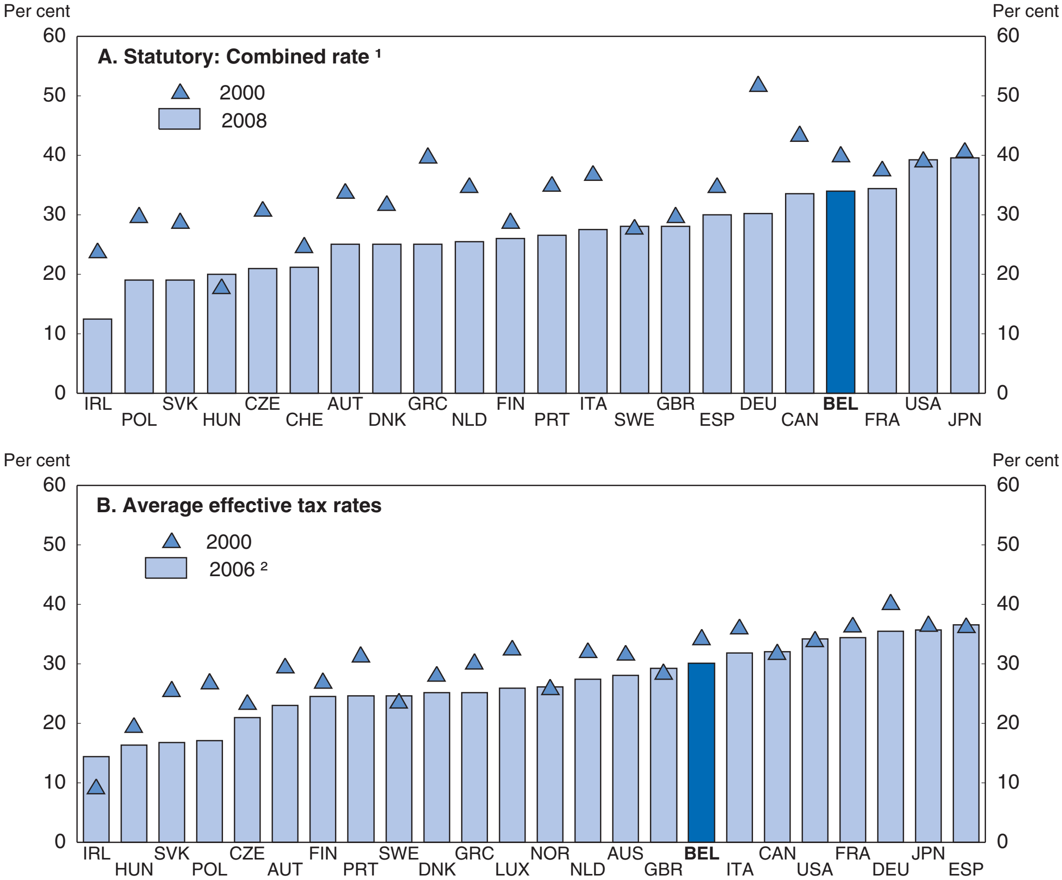
Figure 4.11. **Corporate tax rates in international comparison**



1. Basic combined central and sub-central (statutory) corporate income tax rate. Aggregates are unweighted averages and EU 10 covers the new EU member states.
2. Data refer to 2005 for Australia, Canada, Japan, Norway and United States.

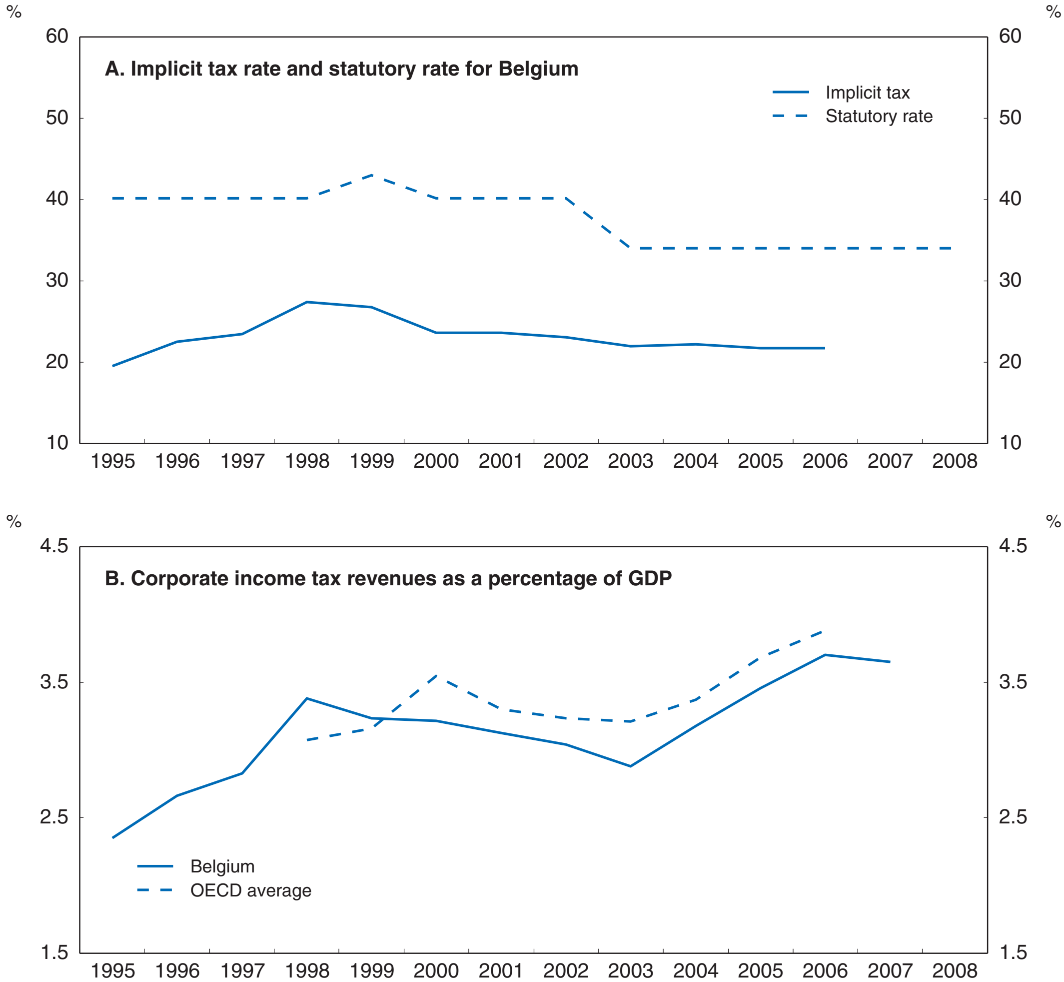
Source: CTPA/CFA/WP2(2007)14 and International Financial Statistics, OECD (2007), *Tax database*, *www.oecd.org/ctp/taxdatabase* and European Commission (2006) Structures of the Taxation Systems in the European Union.

StatLink http://dx.doi.org/10.1787/646886623582

example by using a notional rate that corresponds more to the actual cost of financing, could improve total factor productivity (TFP) growth because financing forms would be independent of the tax treatment, which for example would improve financing conditions for knowledge based industries that typically rely on equity to finance investments in intangible property (Johansson *et al.*, 2008).

A number of measures have been taken to stimulate growth and innovation in young innovative companies, who are enjoying reduced corporate tax rates and a special tax allowance for young innovative SMEs – defined as companies with less than 50 employees, less than 10 years old and with an annual turnover below EUR 7.3 million, of which at least 15% is on spend R&D – in addition to the general wage subsidies and tax allowances for R&D personnel (Johansson *et al.*, 2008; van Cauter *et al.*, 2004). In addition, there are additional large R&D subsidies at the regional level, particularly for SMEs. At the general level, tax credits for R&D investments are more effective in stimulating innovative activities than direct subsidies, but the time lags are long and the effect is modest. Moreover, higher R&D spending has only a small effect on overall TFP growth (Jaumotte

Figure 4.12. **Corporate tax rates and revenues**



Source: Eurostat (2008, 2007), *Taxation trends in the European Union* and OECD, *Tax database.*

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and Pain, 2005a and b). However, such measures are likely to be less effective when aimed at SMEs because of their limited research capacity. This calls into question the cost efficiency of such measures. Indeed, stimulating R&D is more efficiently done through flexible product and labour markets (see also Chapter 5). The reduced corporate tax rates for SMEs are normally justified by financial or product markets failures, but as small young companies rarely pay corporate taxes, given that many of them are start-ups with low profitability, the measure is not effective in alleviating such market failures. On the other hand, reduced rates may be an impediment for small companies expanding beyond a size that is below their optimal scale of production. Given the limited corporate tax revenues from small business and the potential damaging effect on growth of reduced corporate tax rates, they could just as well be abolished. The relatively high standard corporate tax rate should be lowered to bolster the after-tax rate of return on invested capital, thereby stimulating private investments and TFP growth (Johansson *et al.*, 2008). This is particularly important for catching-up firms (to best productivity practices) as such firms are likely to finance their R&D activities through retained earnings. The extent of the lowering should reflect the need for maintaining a favourable environment for future FDI inflows.

Box 4.3. **Coordination centres**

Coordination centres are companies that belong to multinational groups and whose sole purpose is to provide finance, treasury management, accounting, consultancy, and other services to other companies in the same group. Special tax rules are applied to coordination centres, with a particularly attractive regime for inter-firm transactions. The associated tax expenditures amounted to just below EUR 1.9 billion in the 2004 tax year. Coordination centres in this context are defined as companies that manage the financial flows in a multinational group with operations in at least four countries. To qualify for the special tax rules, the companies need a consolidated turnover of at least EUR 240 million and a consolidated capital of at least EUR 24 million. An additional requirement is that foreign equity must be at least EUR 12 million or 20% of the group's foreign equity capital. Moreover, the coordination centres must employ at least 10 full-time workers after two years of operation.

As the European Commission found the special tax system for coordination centres incompatible with state aid rules, the Belgian government is phasing out the regime by end 2010. When the coordination centres lose or relinquish their approval, they come under the scope of the ordinary corporate taxation rules and can therefore use the risk capital allowance. The latter seems particularly suited to coordination centres, which are characterised by having high equity capital (a total of some EUR 170 billion in 2006) and for the relatively low return they normally obtain on that equity, as their main revenue tend to come from interest on loans that they extend to other companies within the group.

Following the introduction of the new rules, the number of active coordination centres has declined from 226 in 2004 to 74 in the spring of 2008. Some of these have opted to move their activities to other financial centres, particularly Switzerland. Moreover, a number of coordination centres have chosen to use the risk capital allowance. Furthermore, there has been a substantial net capital increase, reflecting some initial capital outflows followed by higher inflows, although the final effect can only be assessed once all coordination centres have been closed. A preliminary conclusion could be that many coordination centres consider the risk capital allowance as an acceptable alternative.

The tax treatment of savings vehicles varies considerably

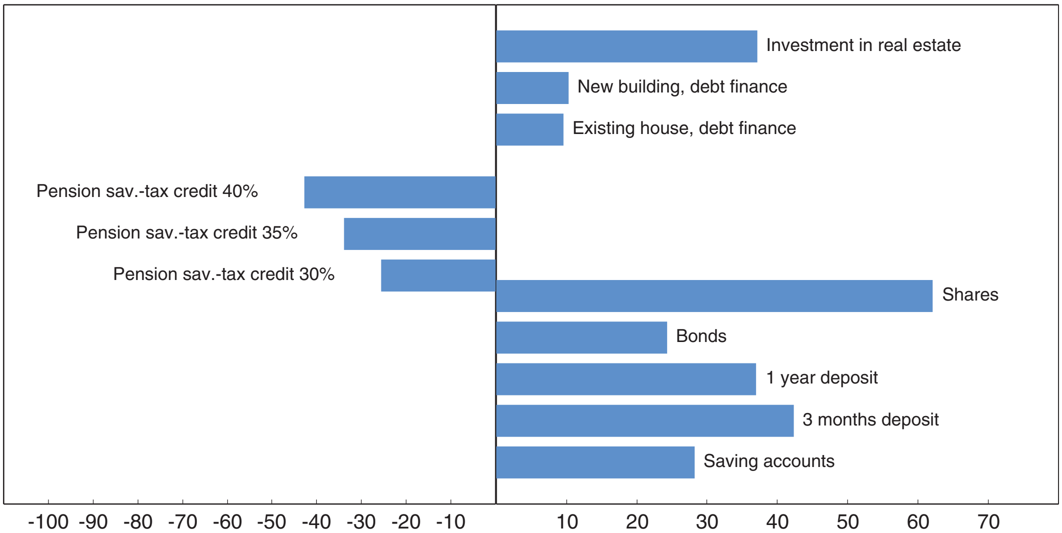
There is a very wide difference in the tax treatment of various savings vehicles (Figure 4.13). Owner-occupied housing and third pillar pension investments are relatively more favoured by the tax system than savings in other financial instruments, such as bank deposits, government bonds or equity. The tax favouring of individual vehicles aims at stimulating private savings. As discussed in the previous *Survey*, such tax measures do not boost overall private savings, despite the often substantial fiscal cost, and thus have little effect on growth. On the other hand, these measures channel savings towards specific savings vehicles, which are not necessarily the same as those with the highest pre-tax returns, hindering capital allocation and thus productivity growth.

Taxation of owner-occupied housing is lenient

Revenues from taxes on immovable property are less important than in most other OECD countries (Figure 4.14). The personal income taxation of owner-occupied housing contains two main elements: the tax deductibility of mortgage payments; and a tax on imputed rent. Since 2005, the tax deductibility is at the top marginal tax rate and is more inclusive than in other countries, as all of the repayment (*i.e.* interest payments, capital

Figure 4.13. **Effective taxation of saving vehicles varies widely**

Effective taxation rates, 2001-2004[1]



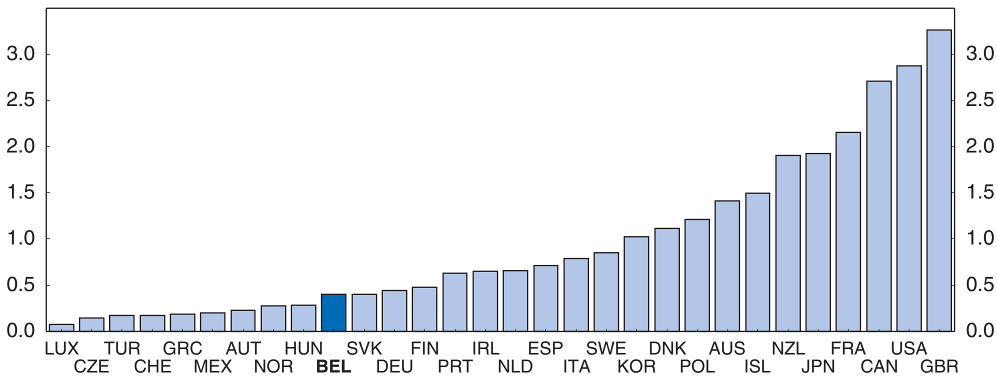
1. Effective taxation rates are defined by the ratio of the difference between gross and net return rates, and real gross return rate (deflated by inflation). Effective taxation rate varies with net return rate as taxation differs for each type of vehicle. Taxation of shares is today lower than indicated in the figure because of the introduction of the notional interest deduction.

Source: Valenduc, C. (2003), "Effective taxation of households saving in Belgium", paper presented at the 59th Congress of the International Institute for public finance, Public Finance and Financial markets, Praha, 25-28 August 2003.

StatLink http://dx.doi.org/10.1787/647030035415

Figure 4.14. **Immovable property taxes**

Per cent of GDP, 2007[1]



1. 2006 for Australia, Belgium, Greece, Mexico, Netherlands and Poland.

Source: OECD, *Revenue Statistics database.*

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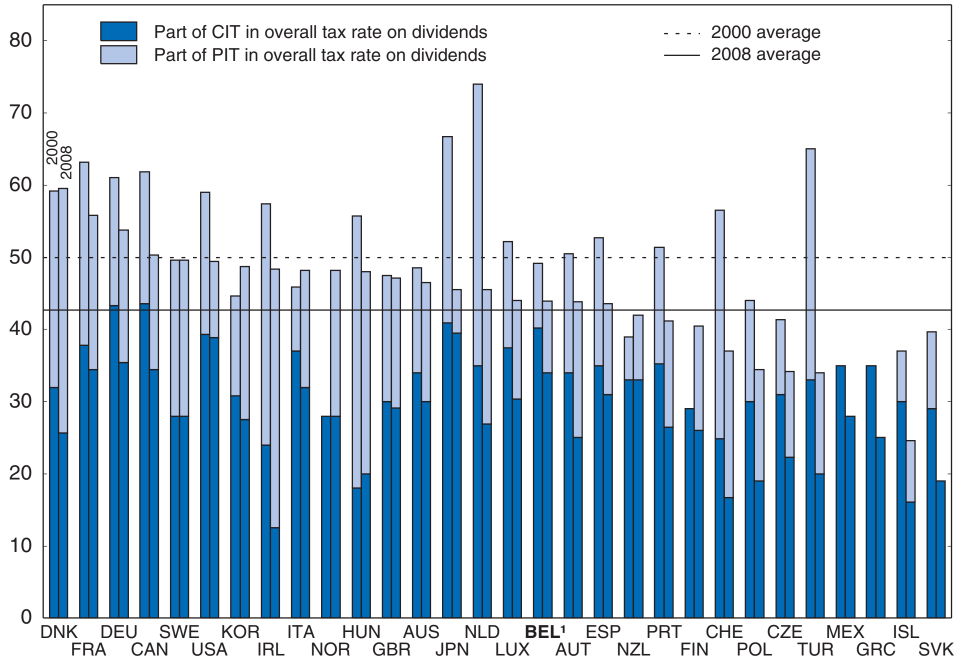
repayment and life insurance premium) can be deducted and there is a generous upper limit of EUR 1 990 for each spouse and with an additional EUR 660 the first 10 years on the maximum amount exempted per year (OECD, 2007b). This tax advantage is in theory balanced by the tax on imputed rent. However, the assessed value of the property is based on its value in 1975 and since 1991 has been indexed to the development in the consumer price index, leaving (on average) the assessed value at less than half of the market value. This is despite the fact that the law stipulates a new assessment every 10 years. However, the Federal Ministry of Finance has few fiscal incentives to fulfil its costly assessment responsibility as the resulting increase in tax revenues benefits the regions and, to a larger extent, the municipalities (through a proportional rate levied on the tax value of the property). Moreover, as part of the 2005 changes to the tax code, imputed rent is no longer subject to taxation (Valenduc, 2008).

The winners in the system are the owners of private rental housing as a result of the widening gap between the market rental value of their property and the imputed rent, while the losers are inhabitants in formerly high price neighbourhoods in larger cities, such as Brussels, who have maintained their taxation despite the relative fall in the value of their dwellings. Moreover, growth is also impaired by the preferential tax treatment of housing as this will ultimately lead to higher house prices which together with the internationally high transaction taxes (as described in the previous *Survey*) reduce labour mobility and thus the efficient allocation of labour. Thus, to boost growth, enhance income redistribution measures, and increase the reliance on the least growth-distorting tax source taxation of housing should be increased. This should principally take place through a higher effective taxation of imputed rent through a more realistic assessment of property prices and extending the measure to all properties. A realistic assessment could be assured by making the value assessment of properties the duty and responsibility of the regions. Moreover, the tax deductibility of mortgage repayment should be restricted to the interest part payments and not the capital repayment. Such a reform could generate additional revenues in the order of 0.2% of GDP.[8] That would still leave Belgium with less reliance on immovable property taxes than in other countries, so the rate of taxation should also be increased to allow a reduction of taxation in other areas. If it proves difficult to reform taxation of imputed rents, an alternative measure would be to drastically reduce the tax deductibility of mortgage payments.

A number of financial saving vehicles also benefit from preferential tax treatment, such as regulated savings accounts, life insurance contracts, second and third-pillar pension funds. The associated tax expenditures may be warranted insofar as such treatment boosts overall savings and thus long-term growth. The tax-exempt savings accounts are particularly popular (totalling more than 50% of GDP and the number of accounts is some 70% larger than the population) as the first EUR 1 730 of interest (for 2009) is fully tax exempt and as the accounts are almost effectively just normal drawing accounts, as deposited funds can in many cases be withdrawn without notice (OECD, 2007c). Interest above the tax exempt amount is subject to a 15% withholding tax. Contributions to the tax-preferred life-insurance contacts and third-pillar pension plans are tax exempt (for 2007 up to EUR 1 950 and EUR 810 respectively). Also contributions to second-pillar pension plans are exempt, where there is a limitation on pension payouts that is equal to 80% of the last working income. Moreover, policy holders of tax-preferred life-insurance contracts are subject to a 10% personal income tax on the capital paid out at the end of the contract (a rate of 16.5% is applied to contributions paid before 1992), augmented with a 3.55% contribution to the social security system to cover for health insurance.[9] In comparison, taxation of dividend income is much heavier reflecting a personal income tax rate on dividends of 25% (15% in some cases), which together with the corporate tax rate leaves the total statutory tax rate at above 40%, just above the OECD average (Figure 4.15). The heavier taxation can be circumvented as the lack of capital gains

Figure 4.15. **Overall statutory tax rates on dividend income**

2008



1. For shares issued before 1 January 1994 the (withholding) personal income tax rate is 25 per cent. The withholding tax is final, if the shareholder so chooses. The lower the return on equity before tax, the lower the effective tax rate due to the allowance for corporate equity (ACE). *E.g.* the effective corporate tax rate is only half the nominal (statutory) corporate income tax rate when the return on equity before tax is twice the notional interest rate (4.307% in 2008).

Source: OECD, *Tax database.*

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taxation means that financing investments through retained earnings can boost the (tax-free) share value. However, investments made for tax reasons may not necessarily have the highest possible rate of return, which leads to a misallocation of capital and thus lower-than-otherwise productivity growth. Moreover, the system may also reduce the amount of funding available for new firms and entail a competitive disadvantage for young firms that have to finance investment with newly issued equity (as investors require a higher return on newly issued equity).

The associated tax expenditures are about 0.25% of GDP, which is higher than in most other OECD countries, (OECD, 2007b). The lack of lock-in in the savings accounts makes them almost indistinguishable from standard current accounts, indicating they are unlikely to add to savings incentives. In addition, the benefits of the tax exemption have not entirely been captured by the savers as the effective net tax rates on taxable deposits are higher than on savings accounts (Valenduc, 2003). With respect to life-insurance contracts, international evidence indicates that tax-preferred accounts have a positive effect on overall savings only if they are taken up by moderate-income households. However, participation increases with income, indicating at most a rather modest effect on savings and probably not enough to warrant the high level of tax expenditures. To sum up, the tax preferred savings scheme seems to have little effect on savings, but carry substantial fiscal costs. Thus, from the perspective of boosting economic growth, such tax preferences should be phased out to broaden the tax base and rates should be aligned across saving vehicles, including the introduction of capital gain taxation across relevant savings vehicles. Such a reform should be implemented over a sufficiently long time period to avoid additional financial instability.

A welcome development in this area is Belgium's explicit endorsement of the OECD standard on information exchange for tax purposes and the withdrawal of its reservation on Article 26 of the OECD Model Convention on Income and on Capital in March 2009. Belgium had already signed its first income tax convention consistent with the standard of Article 26 in 2006 and indicated its general willingness to negotiate further income tax conventions allowing for the exchange of bank information both in civil and in criminal tax matters. Belgium has already written to more than 80 countries to propose the conclusion of protocols to existing treaties so as to update Article 26 of those treaties. Belgium is expecting to finalise and ratify those protocols as soon as possible.

The reliance on consumption taxes is relatively low

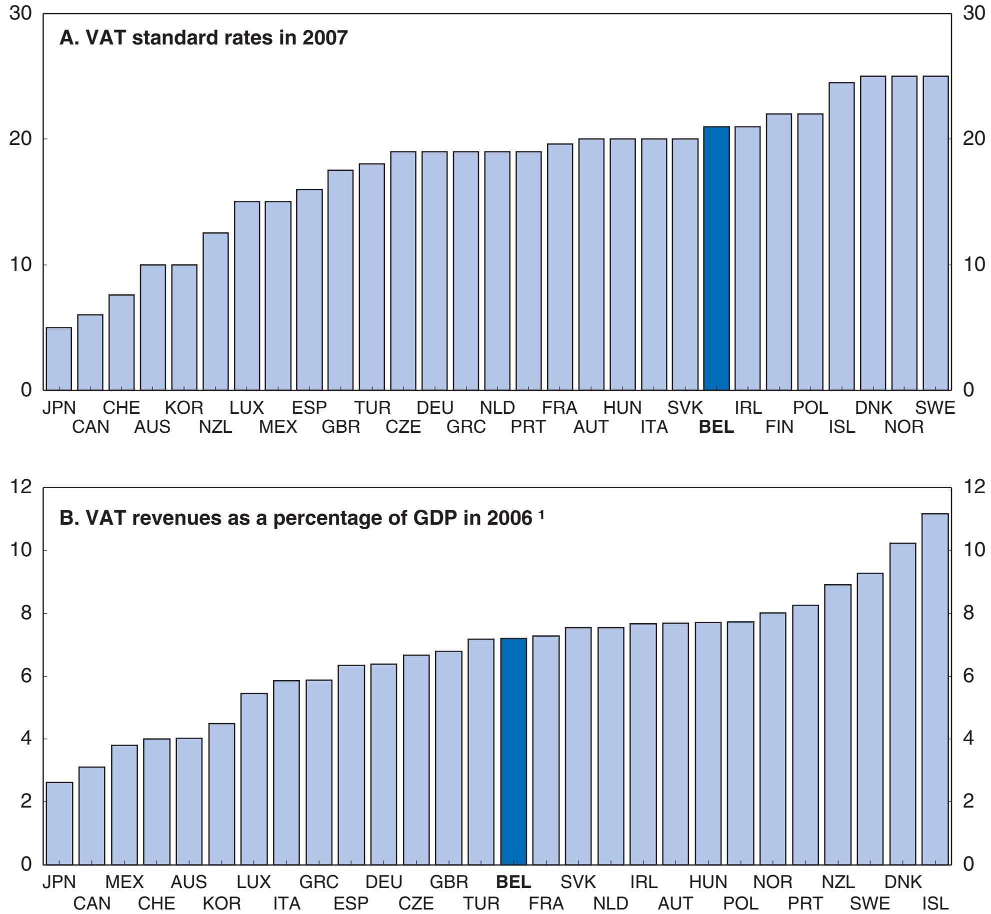
VAT revenues as a share of GDP are only about average in the OECD, despite a relatively high standard VAT rate, implying scope for increasing the reliance on this, from a growth perspective, less distortive tax source (Figure 4.16). VAT collection is reduced by the fairly widespread application of reduced rates (affecting nearly 30% of the tax base). A rate of zero is applied to daily papers, rents and school fees. Another rate of 6% is applied to basic products and some labour intensive services (food, flowers, water consumption, magazines and books, hotels or camping site accommodation, sporting and cultural activities, passenger transport, and renovation work on residential property) amounting to some 28% of the relevant tax base. Finally, a rate of 12% is applied to margarine, coal and cable television. Other OECD countries also apply reduced rates to various goods and services. Nevertheless, the efficiency of VAT collection is amongst the lowest in the OECD, reflecting more exemptions than in other countries (Figure 4.17). As a redistributive instrument the reduced rates are not well targeted as low income households pay almost twice as much in indirect taxes relative to their gross income as do high income groups, despite the lower VAT rate applied to basic consumption goods (Decoster *et al.*, 2006). Indeed, economic literature emphasises that either lump-sum payments based on households' socio-economic characteristics or direct targeted transfers to low-income households are more effective in enhancing equity (Johannson *et al.*, 2008).

Larger consumption-tax revenues could finance a lowering of other taxes. Increasing consumption taxes may induce more cross-border shopping, thereby eroding the tax base. However, the majority of the population lives within some distance from the Belgian borders, indicating some room for differentials in consumption taxes *vis-à-vis* neighbouring countries. Abolishing all reduced VAT rates and exemptions would in a static analysis yield additional VAT revenues of nearly EUR 6 billion (1.9% of GDP). Given that a relatively small part of the population would need such transfers and currently the entire population enjoys the reduced rates, such a change could easily generate about 1% of GDP in additional revenues that could be used to lower taxation in other areas.

A greater reliance on environmentally motivated taxes would have the same benefits as greater reliance on consumption taxes. Indeed, such taxes generate less revenue than in other OECD countries (Figure 4.18). This can to a large extent be explained by lower excise

Figure 4.16. **VAT rates in OECD countries**

In per cent



1. 2005 for Australia, Belgium, Greece, Japan, Iceland, Ireland, Mexico, Portugal and Poland. 2004 for Italy.

Source: OECD, *Revenue Statistics database* and OECD, *Consumption Tax Trends*.

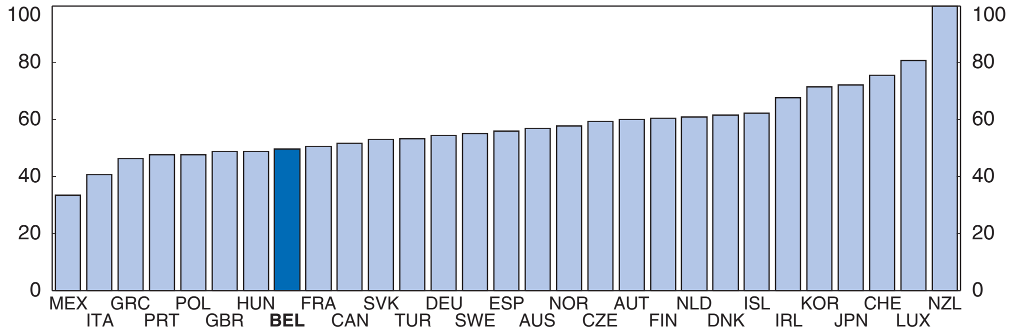
StatLink http://dx.doi.org/10.1787/647101766585

duties on fuels than in most other OECD countries. In addition, the excise duty on diesel is lower than for gasoline despite the higher CO_2 (and of other pollutants) content in diesel, implying that the tax system is favouring the relatively more polluting fuel. In this view, it is perhaps not surprising that two-thirds of all automobiles have diesel engines whereas for a quarter of a century ago the stock was dominated by vehicles with gasoline engines (High Council of Finance, 2007). Often such excise duties are driven by developments in neighbouring countries to avoid "fuel-tourism" and its implied loss in revenues. However, such Belgian excise duties are, apart from Luxembourg, lower than in the neighbouring countries (Figure 4.19).[10] As part of the 2009 Budget, a "ratchet" tax (*le mécanisme du cliquet*) is being imposed on transport fuels, whereby a fall in oil prices is partly offset by an increase in excise taxes. However, this measure will not realign excise taxes on transport fuel with their environmental impact.

A more environmentally friendly taxation of fuels would be based on their CO_2 and other pollutant contents, implying a relatively higher taxation of diesel. Moreover, the level

Figure 4.17. **VAT revenue ratio in OECD countries**[1]

Per cent, 2005



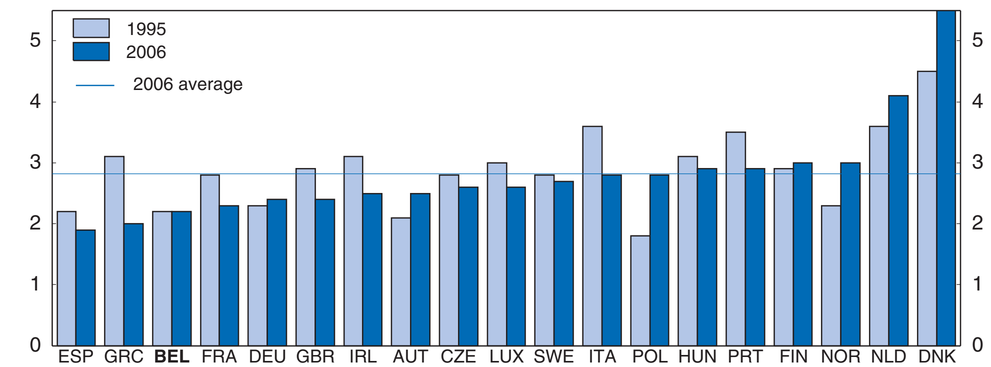
1. Index increasing in efficiency. The VAT revenue ratio is defined as the share of VAT revenues to consumption divided by the standard rate, expressed as a percentage ((VAT revenues/National consumption × 100)/(Standard VAT rate)) x 100. National consumption includes salaries and wages of the public sector which are generally not subject to VAT. Hence, variations of the VAT revenue ratio across countries to some extent reflects differences in the size of government.

Source: OECD (2008), *Consumption Tax Trends*, VAT/GST and excise rates, trends and administration issues.

StatLink http://dx.doi.org/10.1787/647104647672

Figure 4.18. **Revenues from environmentally-related taxes**[1]

Per cent of GDP



1. Data refer to revenues from environmentally related taxes for pollution control.

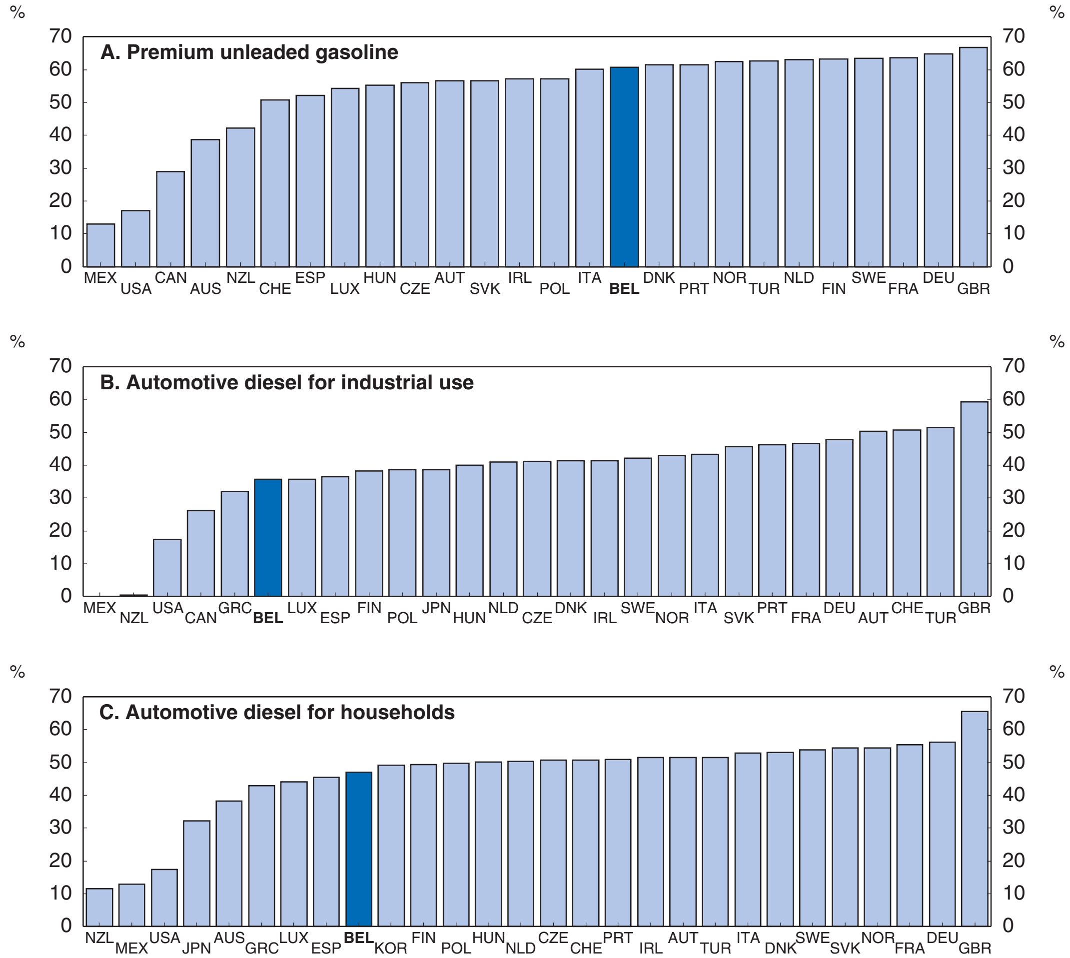
Source: Eurostat (2008), Taxation trends in the European Union: data for the EU Member States and Norway.

StatLink http://dx.doi.org/10.1787/647104710180

of excise taxes should be increased to internationally comparable levels. Indeed, simulations of how Belgium can reach the EU emission reduction targets by 2020 indicate that energy prices have to increase by around 13% and transport fuel prices by about 7% relative to a baseline scenario (Bossier *et al.*, 2008). Moreover, unlike in most other EU countries only a small excise duty is imposed on relatively polluting heating oil, representing only 4% of the sale price (van Cauter and van Meensel, 2006). The low taxation of heating oil reflects social and income distribution objectives, but it also blunts incentives for investing in less polluting heating systems. Naturally, other instruments, such as emission trading or road pricing (particularly for heavy vehicles as suggested by the High Council of Finance in 2007), can be used to reach environmental objectives. However, the government should increase taxation of fuels not only to pursue environmental objectives, but also to increase the tax system's reliance on less distortive consumption taxes.

Figure 4.19. **Share of taxes in fuel prices**

Per cent, 2007



Source: OECD (2008), *Energy Prices and Taxes*, Fourth quarter 2008.

StatLink http://dx.doi.org/10.1787/647136341751

The design of tax systems needs to take into account several objectives. At the overall level, tax revenue generating capacity, including effects on tax bases, must suffice to finance public expenditures. These include future spending, implying that any tax reform must be self-financed – a point also recognised by the High Council of Finance (2007). Underfinanced tax reforms can only be contemplated if accompanied by measures to reduce public spending or increase public sector spending efficiency. Nevertheless, the benefits from implementing a revenue neutral tax reform that relies less on distortive taxes can be substantial. Empirical work shows that lowering labour taxation by 1% of GDP with an equal sized increase in indirect taxes, raises value added and employment in the business sector by 0.56% and 0.83%, respectively (Stockman and Lebrun, 2009; and with similar results in Decoster *et al.*, 2006) A set of detailed policy recommendations to pursue revenue-neutral tax reform is presented in Box 4.4.

Box 4.4. **Tax policy recommendations to enhance growth**

The tax system should become more reliant on less distortive tax sources and broader tax bases

- The tax system should rely more on less distortive tax sources, such as consumption and owner-occupied housing taxes, to allow a reduction in distortive taxes such as those on labour and on corporations. Reform should aim at broadening tax bases to allow for lower rates.

Making labour taxation more growth enhancing by boosting labour demand and supply

- To address the remaining labour market traps, spikes in the effective marginal tax rates should be removed.
- To increase the internationally low number of hours worked, the highest marginal tax rates should be lowered. To increase labour market participation, the average labour tax should be reduced. To enhance labour market incentives for low-income spouses, the government should complete the full tax separation of spouses as implemented in many other OECD countries.
- To broaden the tax base to allow lower rates, the scope of tax expenditures and structural relief should be drastically reduced. Instead social objectives should be pursued through more targeted and direct measures.
- To achieve more cost-efficient use of wage subsidies and social security contribution reductions, these measures should be scaled back and narrowed in scope to focus on difficult-to-employ workers, such as low-wage workers. During the crisis, a special attention should be given to the low-skilled youths who are at a greater risk of dropping out of the labour market. The social partners should assume responsibility for securing the labour market prospects of other groups.

Make the corporate taxation system more favourable for enhancing business

- To stimulate SMEs to grow to their optimal production size, reduced corporate tax rates should be abolished.
- The relatively high standard corporate tax rate should be lowered to bolster the after-tax rate of return on invested capital.
- Make the system more neutral *vis-à-vis* funding sources by choosing a notional interest rate that reflects market conditions.

Increase the neutrality of capital income taxation

- The taxation of owner-occupied housing should be increased. This should principally take place through a higher effective taxation of imputed rent through a more realistic assessment of property prices. Moreover, the tax deductibility of mortgage repayment should be restricted to the interest part. If higher effective taxation of imputed rent is not implemented, then as an alternative the tax deductibility of mortgage payments should be drastically reduced.
- Taxation of other savings vehicles should be made neutral *vis-à-vis* owner-occupied housing, particularly by phasing out tax preferences by realigning applied rates and the introduction of capital gain taxation across relevant savings vehicles.

Box 4.4. **Tax policy recommendations to enhance growth** *(cont.)*

A higher reliance should be placed on consumption taxes as a revenue source

- All reduced VAT rates should be increased to the level of the standard VAT rate.
- The government should increase taxation of fuels, particularly of diesel, to reflect emission abatement objectives. An additional instrument in this respect would be the introduction of road pricing, particularly for heavy vehicles.

Notes

1. The consolidation measures included a suspension of automatic indexation of tax brackets and the introduction of a 3% crisis surcharge, a special social security contribution and a "solidarity" levy on pension income (OECD, 2004).
2. Recent tax measures by the regions have done little to address the incentive problems in the tax system. The Flemish region introduced a fixed annual income tax reduction of EUR 125 in 2007 for low-income workers, which was increased by EUR 75 the following year, before being increased again and extended in 2009 to all workers residing in Flanders. The Walloon region has abolished its radio license fee (EUR 27.57 per radio) which again is a limited measure, but which increases the demands on other taxes, including labour taxes.
3. The most regressive tax allowances are those granted for group insurance and the shares granted to employees, where the two highest income deciles represent about 85% of the associated budgetary costs (High Council of Finance, 2002; Valenduc, 2004; and van Cauter and van Meensel, 2006).
4. Households with net taxable income of less than EUR 18 592 per year do not pay this special contribution. For next EUR 2 500 a rate of 9% is applied. Thereafter a rate of 1.3% is applied for incomes below EUR 60 162. Beyond this level the maximum contribution is fixed at EUR 731.
5. From the point of view of the employer the rebate on payment of withhold taxes is similar to a cut in the social security contribution rate. In terms of national accounts, the difference is that a cut is not registered, while the rebate is considered as a transfer from the government to the corporate sector. As a consequence, the increase in labour costs associated with the agreed (real) wage increases in the 2009-10 wage agreement will be registered in the national accounts, but the accompanying across-the-board rebate will not, leading official statistics to have higher wage cost developments than the *de facto* development.
6. For income distribution reasons, abolishing the exemptions for pensioners may require an increase in their pensions.
7. For SMEs, the allowed rate is increased by 0.5 percentage point. There is an additional cap on increases in the allowed rate as it is not allowed to diverge more than 1 percentage point between years. Moreover, companies which have insufficient profits to fully benefit from the risk capital allowance can carry the allowance forward for seven years, creating a tax reserve.
8. Such a reform could also involve an adjustment of the rate of the regional real estate tax (*précompte immobilier*) and of the municipal surcharge on the regional real estate tax as the rates have drifted upwards to compensate for the partial indexation of house prices.
9. If the policy is surrendered before the end of the contract, the insurance has to pay a 33% tax on the surrender value. In addition, the tax payer is entitled to a tax credit valued at the average tax rate of the *premia* paid in one year. The value of the tax credit is limited to 15% of the first EUR 1 500 of income plus 6% of the remaining income with an upper fixed limit of EUR 1 800 (2003).
10. In terms of total taxation of gasoline and diesel, the effects of the lower excise duties are partly off-set by the slightly higher VAT rate in Belgium. Nevertheless, taxation of gasoline and diesel is lower than in the neighbouring countries with the exception of Luxembourg.

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The economic situation and policies of Belgium were reviewed by the Committee on 14 May 2009. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 28 May 2009.

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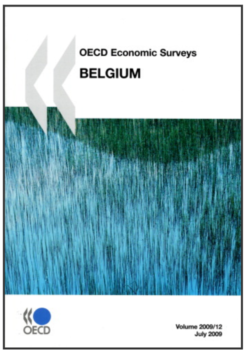

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