



## Is Belgium Prepared for the Cost of Aging?



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In a few years, the baby boom generation will start transforming itself into a retirement swell, raising the share of retired people noticeably during the following fifteen years. With good quality health care contributing to longer lives, this generation can count on a couple of decades of happy retirement from market-based activities. Since pensions and health care are provided by the public purse on a pay-as-you go basis, demands on the resources of the social security system will rise considerably. Is Belgium prepared for the associated sharp increase in budgetary outlays?

For some time now, a broad consensus has existed behind a strategy to cope with the rising costs of aging, as elaborated by the aging unit of the High Finance Council (HFC). In annual updates of progress in implementing this strategy one of the common findings of the HFC has been that progress is wanting and—not unrelated—the cost of aging rising with every update. Does

this point to fundamental problems with Belgium's strategy to deal with aging? What are the consequences of these recurrent delays? And what needs to be done, and when?

This paper takes a look at the overall strategy to deal with the projected rise in the budgetary costs of aging. It does not present a new set of estimates, but instead discusses the costs of delaying reform, highlights the magnitude of the implementation gaps so far, and describes the tensions and synergies between the different components of the strategy required to deal with aging. Against this background, and based on cross-country experience, it provides some suggestions about the course ahead.

### **1. Size and location of the aging swell are relatively well-known**

Demographics is a slow moving process, which has the advantage that it is relatively easy to observe but also the disadvantages that its effects are felt only in the long run and that small deviations from assumptions matter a lot. And surprises do occur. The baby boom was unprecedented and is likely to remain a unique event. Just before it happened, calculations of the projected cost

of aging looked very similar to what they do today, even as several decades have elapsed since then. This has led some observers to argue that, since projections have been wrong before, one can wait for parameters to turn more favorable again. An increase in fertility rates or immigration and improvements in technology are often hoped for to ease the burden of aging. However, the baby boom has been the exception, and the underlying causes of the rise in the cost of aging are more fundamental and would have been in play even without it.

The large projected increases in social security spending have two principal sources: longer life expectancies and increased medical costs per beneficiary. The former is certainly welcome, but it leads to longer periods of retirement even as the growth rate of the work force declines. As a result, by 2050, one in four citizens will be 65 years or older, compared to just one out of six today (S3 ). Belgium's total population is expected to rise by 5 percent by 2050, but the number of persons over 65 will go up by a staggering 63 percent. More technically, the old age dependency ratio is set to rise from .26 today to .46 by 2050.

This means that, whereas now one retiree is supported by three workers, by 2050, one worker will need to provide for one retiree. The fact that fewer persons will need to be educated brings little relief, especially as the quality of education will need to be stepped up continuously to maintain high productivity.

In contrast with most sectors of the economy, vast advances in technology do not seem to lead to lower per patient costs in the health care sector. This observation has a technical component: much still remains to be discovered with respect to diagnosis and treatment and improved technology allows broader access to health care than before. It

also has an economic component: price mechanisms do not work very well in the health care sector. Moreover, be it through the market system, as in the United States, or through the democratic process, as in continental Europe, demand for health care services is very strong and more than proportional to income. Hence, with societies getting richer, consumption of health care services is likely to be in an updraft for a while.

Taking pensions and health care together, the HFC estimates that the net cost of aging will increase by 6.1 percent of GDP by 2050 (S4). Note that this is a net cost: it already takes out savings in other transfer systems, such as from the projected reduction in unemployment.

The HFC baseline projection is subject to a wide margin of uncertainty, but it provides a sensible and useful starting point for assessing the budgetary implications of aging. Its implication is that by 2050, every worker will need to contribute an extra €8,000 per year (in 2008 prices) to the social security system.

Conceptually, dealing with the cost of aging requires a

combination of three types of reforms: direct cuts in the entitlements that give rise to the increase in spending in the first place, a transfer of budgetary resources from other spending programs (including from declining public debt, the so-called pre-funding component) or through taxes, or an increase in the economic base from which revenues and contributions are drawn. By now, almost all countries, including Belgium, have gone through pension reforms to varying degrees.

Belgium's current strategy is therefore focused on fiscal prefunding, using interest savings from the decline in the public debt burden to cover somewhat more than half of

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the rising costs of aging, increasing the size of the economy by bringing more people into the labor force, expected to cover over a third of the costs, and boosting productivity to deal with the remainder. The first part of the strategy is seen to be in line with society's preferences for intergenerational fairness. Most people agree that an important element in ensuring that the next generation inherits a stronger economy is a move toward fiscal policies that are sustainable, efficient and equitable across generations.

## 2. Costs of delay: hitting the iceberg

One of the first and most important victims of the repeated delays in meeting the fiscal objectives of the HFC baseline scenario is intergenerational fairness. Indeed, a key feature of the HFC baseline scenario is that the share of wages going to fund social security is broadly constant through time (S6). More up-front adjustment would obviously have raised the cost to the current generation at the benefit of future generations. However, with the shortfall in budget performance from the HFC-recommended path, reality has been moving in the opposite direction. Assume, in line with revealed preferences by policymakers, including in the 2008 budget, that the general government budget would remain balanced for as long as needed to achieve fiscal sustainability. In such a scenario, future generations would need to give up about an additional €2,000 per year at today's prices, in wage-adjusted equivalents. This adjustment corrects for the trend productivity effect on wages from which future generations are expected to benefit, implying that the real cost will rise with productivity growth.

On current policies, budgets are not likely to remain in balance. Indeed without policy changes, the rising cost of aging will

translate into rising deficits. But deficit financing is not really an option in the long run. Higher levels of debt in turn require higher interest payments. A vicious circle will develop in which investors will demand higher interest payments to compensate for the risk of holding rapidly increasing levels of public debt, which in turn feeds into larger deficits and perpetuates the cycle.

Even if sufficient measures could be implemented to prevent the rising costs of aging from translating into budget deficits, and sufficient pre-funding takes place to achieve intergenerational fairness, fiscal sustainability will not be achieved without other reforms. This would, however, not become evident until about 2035 (S7). The limits to the fiscal pre-funding strategy can also be seen from the amount of interest savings embedded in the baseline strategy. Without shocks to interest rates total savings will amount to somewhat more than 3 percentage points of GDP, which is only slightly over half of the projected increase in the costs of aging.

Insufficient adjustment today will need to be corrected by more-than-proportional adjustment tomorrow, either through tax increases or drastic spending cuts. Belgium has experience with such episodes of adjustment when public debt had risen to unsustainable heights in the 1980s. Tax increases are not a very interesting option, if they are effective at all (S8). In the Belgian context, almost all taxes tend to adversely affect employment; higher income taxes lead people to supply less labor to the market place, while higher indirect taxes feed into wage demands and losses of competitiveness and ultimately into higher unemployment. Spending cuts would need to be very drastic to achieve the savings necessary to compensate for the lack of a declining interest bill (S9). For example, non-social security spending would need to fall in real

*Intergenerational fairness is the first victim of delays in meeting fiscal objectives*

terms by almost 1 percent a year during a period of more than 5 years to make room for the share of the rising costs of aging that is currently planned to be covered by declining interest payments.

### 3. Changing tack: closing three gaps

The Belgian economy has had a good run over the past decade, even though some shadows are now clouding the outlook.

Growth and job creation have been solid and structural unemployment seems to have declined. Participation in the labor force has surprised positively and population growth has also been somewhat stronger than expected. The cost of aging has not yet shown any signs of rising in relation to output of the economy. Direct spending on old age pensions has remained at 8.5

percent of GDP since 2000, while public spending on health care has risen from 5.7 percent of GDP in 2000 to 6.4 percent of GDP in 2007, as a result of a deliberate policy of expansion, not because of aging.

Against this background and with aging distant on the political horizon, policymakers seem to have been lulled into a false sense of security. Rather than setting aside the decline in the interest bill since 2000 (2.6 percent of GDP—a handsome payoff of the strong economic policies that were implemented in the 1990s), two thirds of the savings were used to raise primary spending (including tax expenditure) and one third to

reduce the tax burden. The increase in spending was mostly on transfers, while spending on infrastructure was cut back. Overall, the use of fiscal resources improved the functioning of the labor market, though some resources were defensively geared toward industries which may not have the brightest long-term future. If half of the interest savings had been set aside, the fiscal adjustment component of the aging strategy would have been largely complete, with only the relative easy task of setting further interest savings aside remaining.

To correct the delay in pre-funding, surpluses will now need to be raised faster and to higher levels than under the HFC baseline strategy. Otherwise the level of public debt will permanently remain too high to generate the required interest savings. In addition, the sooner

the surplus is increased, the more favorable debt dynamics will be. From this perspective, it seems necessary to achieve a general government primary surplus (i.e., excluding interest payments) of 4 percent of GDP as soon as possible and to maintain it at that level for the medium term (S11). Hence, the overall nominal budget balance will have to rise to a surplus of 1½ percent of GDP by 2011 and then further to about 2¼ percent of GDP by 2015, a level at which it needs to be maintained for several years. Interest savings cannot be counted upon to contribute as in the past, and are expected to amount to only about 0.1 percentage point of GDP per year going forward.

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It is important that fiscal adjustment take place through durable measures. In the past, and still to some extent in the 2008 budget, one-off measures have been a standard feature in the quest to balance the budget. Typically, these measures trade current gains for future expenditure. Takeovers of pension funds are the clearest example: the capital value of the fund is reflected as revenue in the current year's budget, but exactly the equivalent amount in net present value terms will appear as a stream of expenditures in future years. Tax amnesties and shifts in tax payments are very similar.

Raising employment rates is another key component of the strategy to deal with aging. In the baseline, the employment rate is expected to be lifted by 7½ percentage points to a level just below 70 percent (S12). A reduction in structural unemployment as well as higher participation are both expected to contribute. Natural cohort effects and measures

undertaken in recent years in the context of activation policies and the Generation pact are likely to close 5½ percentage points of this gap. Hence, further labor market reforms will need to generate the additional 2 percentage points. Failing to do so would keep the cost of aging above the baseline forecast by more than ½ percentage point of GDP, and even more if the shortfall from the employment objectives stems from a failure to reduce structural unemployment.

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*Belgium is far from prepared to meet the challenges of (the projected rise in the budgetary costs of) aging*  
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Finally, labor productivity growth is expected to increase from current levels of about 1¼ percent per year to 1¾ percent per year (S13). This productivity gap is often overlooked since productivity assumptions have been cast in a technical manner and not directly associated with policy changes. It is merely expected that total factor productivity growth will rise again to the average of the past four decades, while at the same time some additional capital deepening (i.e., an increase in the available capital per worker) would further boost labor

productivity. Even though this may be possible, if labor productivity growth failed to increase to the expected rate, the total cost of aging would be higher by ½ percent of GDP.

#### 4. Dealing with cross-currents in reforms: resolving tensions and exploiting synergies

In any comprehensive aging strategy success depends on the simultaneous achievement of multiple objectives. In the

particular case of Belgium, higher productivity growth, higher employment rates, and fiscal adjustment are all necessary to validate the baseline strategy. At the same time, policies in pursuit of one objective may not necessarily facilitate the achievement of the others, depending on their design and the political economy context. It will be important to transform tensions inherent in Belgium's strategy to deal with aging into opportunities to exploit synergies among reforms.

Fiscal adjustment and job creation are not easy to reconcile when the tax burden on labor is already very high. Further tax increases to help build fiscal surpluses are likely to destroy jobs and discourage labor supply (S15). Indeed, Belgium's very low ranking in terms of hours worked per person in the formal economy is prima facie evidence of an excessive tax burden. Conversely, reductions in social security contributions and taxes on labor are useful instruments to boost job creation and labor supply. But they are at odds with achieving fiscal adjustment. Tax cuts are very unlikely to pay for themselves, because of large deadweight losses. Model simulations show that targeted cuts to groups that face large inactivity traps (i.e., little or no gains in terms of disposable income from moving from welfare or unemployment to work) have a large employment effect, but still negative consequences for the budget. These effects occur because the tax cuts also need to be granted to people who are already in jobs in similar circumstances as the inactive persons targeted by the cuts.

Raising labor productivity may be difficult to reconcile with the objective of boosting employment rates, especially if it requires bringing the low-skilled back into jobs. Indeed, Belgium's productivity and labor costs are near the highest in the world, a mirror image of the economy's highly capital intensive mode of production. As a consequence, low productive labor has been priced out of the market, leading to high structural unemployment among the low skilled, strong recourse to early retirement schemes, and a reluctance to employ older

workers. Recent reforms have correctly begun to address these anomalies. But these reforms seem to have dampened labor productivity growth, and in turn adversely affected the budget (S16).

Health care policies have been at odds with the parameters built into the HFC baseline projection. One of the key causes of the recurrent upward revision in the costs of aging stems from a higher rate of current spending on the health care system, unrelated to aging. By deliberately allowing spending to rise by 4.5 percent per year in real terms for a number of years, policymakers have increased the base level of health care spending and raised expectations for the future. Even a return in health care spending growth to a lower trend observed over the past couple of decades would boost the costs of aging by a further 3.1 percentage points of GDP by 2050, compared to the baseline scenario of the HFC (S17).

Fiscal imbalances among federal and regional government entities have been diverting attention from the strategy to deal with aging and threaten to jeopardize the achievement of fiscal consolidation objectives. Vertical imbalances between the federal government and social security on the one hand and the regions on the other, are particularly pertinent to the strategy to deal with aging (S18). The parameters of the tax revenue allocation between levels of government are such that the regions have been benefiting most, while the federal government has seen its revenues erode as a result of the use of fiscal resources to boost job creation. At the same time, spending pressures are the strongest for the federal government and the social security system. The 2008 budget exemplifies this tension: without a commitment by the regions to run larger-than-budgeted surpluses, an overall balanced budget

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*Embracing additional pension reforms (is needed) to keep the cost of aging manageable and improve labor market performance.*

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objective would have remained far out of reach.

There is a good opportunity to turn these tensions and risks into overall gains by carefully exploiting potential synergies among reforms. Judicious devolution of competencies to regions can achieve a number of them. It can strengthen incentives for regions to no longer burden the social security system without paying for the related costs and to tackle deep-seated labor market problems. Similarly, streamlining fiscal federalism arrangements by reducing overlap of administrations and lowering the regulatory and administrative burden on households and enterprises would boost productivity. Synergies between fiscal adjustment and labor market objectives lie in phasing out early retirement systems, limiting the duration of unemployment benefits, and revamping the tax-benefit system to remove inactivity traps. Making pension systems fully actuarially fair would help both the budget and boost employment rates of older workers.

### 5. Lessons from successful reformers and effectiveness of reforms

Three main features characterize countries that are the furthest along in dealing with the cost of aging: strong fiscal frameworks, complete pension reforms, and effective structural reforms boosting participation and productivity.

In terms of fiscal frameworks, Belgium is certainly in the league of the better performers. Budgets are based on independent economic forecasts, the HFC provides objective advice on the aging problem and the allocation of fiscal objectives among government entities, and an internal stability pact effectively enforces commitments. A weakness of the framework has nonetheless been its reliance on nominal budget targets, rather than the primary balance or the structural balance, and on year-to-year achievement of nominal targets through the use of one-off measures. Countries that focused more on underlying targets within a medium-term expenditure framework achieved more consolidation (S20).

Pension reforms have gone further in taking into account rising life expectancy and establishing completely actuarially fair pension systems in other countries. The Belgian pension system is not seen to be generous in terms of the income replacement rate or the length of career to obtain a full pension. However, the legal retirement age is static and there are scant incentives to work beyond the age of 62. Other countries (e.g., France) have tied the contribution period required to obtain a full pension to life expectancy by adjusting it gradually in a way as to maintain a broadly constant old-age dependency ratio (i.e., the ratio of time spent in retirement to the number of years worked). Several countries have introduced actuarial fairness (in both directions), whereas in Belgium the discount applied for earlier retirement is actuarially too small (i.e., the net present value of the lower pension, applied to the full remaining life expectancy is higher than that obtained for retiring at 65). Several countries have also introduced bonuses for working longer than required that are closer to actuarially fair. In the case of Belgium, establishing actuarial fairness has been estimated to have the potential to reduce the cost of aging by about 1¼ percent of GDP. Raising the effective retirement age to 67 (the current highest level among OECD countries) would yield a further ¼ percent of GDP.

Finally, successful reformers have been outpacing Belgium in the area of productivity growth and levels and increases of employment rates (S21). Progress in product market reform has been essential for the former, while more flexible labor markets or comprehensive labor market reforms have underpinned the latter.

On the basis of cross-country experience and estimates of reform impacts in the Belgian context, further reforms can be ordered in terms of their effectiveness in dealing with the costs of aging. Fiscal pre-funding remains at the top of the list, followed by establishing actuarial fairness of the pension system (including the phasing out of early retirement schemes), reducing structural unemployment, boosting productivity growth, and raising labor force participation. Establishing actuarial fairness has a relatively high payoff because it would lengthen the effective

contribution period while shortening the effective payout period. Reducing structural unemployment is more effective in

lowering the costs of aging than raising labor force participation because, while both increase contributions, the former yields the additional benefit of reducing fiscal expenditure on transfers while the latter yields additional outlays for future pensions. In contrast with some other countries where pensions are fully indexed to wage growth and productivity gains have no payoff, further labor productivity gains would dampen the costs of aging in Belgium. By the same token, increasing the degree of indexation to wages would dramatically raise the cost of aging.

## 6. Concluding remarks

While Belgium is no doubt in a better position to deal with aging than it was a decade ago, it is far from prepared to meet the challenges of the projected rise in the budgetary costs of aging. To do so

effectively, policy corrections are needed to: recoup delays in fiscal adjustment and labor market reform; validate the assumptions of the HFC baseline scenario with respect to the projected evolution of health care expenditure and productivity growth; exploit synergies among fiscal federalism reform, fiscal adjustment, and labor market reforms; and embrace additional pension reforms to keep the cost of aging manageable and improve labor market performance. Reforms of fiscal federalism arrangements will need to be fully consistent with fiscal consolidation objectives of the aging strategy. With the window to address population aging before its onset closing rapidly, addressing these issues can no longer be postponed and will take persistence and willingness to make difficult choices.

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