Introduction

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This E-book contains revised versions of two pieces on tax decentralization in Belgium, written respectively by Namur and Leuven researchers, which were presented in a Re-Bel meeting in December 2009. It ends with a comment co-written by a discussant of that session (André Decoster) and Philippe Van Parijs.

The decentralisation of Belgium has led to a situation in which the Communities and the Regions now manage about 25% of total government spending (including social security). As a result, Belgium has become a federal state very much like Germany. This substantial spending power, however, is not translated into an equally important taxing power of the Communities and Regions. The largest part of the revenues of these regional entities takes the form of transfers from the federal government, leaving very little scope for an autonomous power to tax. The latter has remained firmly in the hands of the federal government and parliament.

The fact that the regional authorities possess less taxing than spending power is not necessarily a bad thing. Taxation often leads to "externalities", i.e. taxation by one entity (e.g. a region) affects revenues of another entity (region). The reason is that those who pay taxes may move their activities. This phenomenon can set in motion tax competition leading to a decline in revenues. This is the most important reason why the Belgian process of devolution has been an asymmetric one, i.e. one allowing for large transfers of spending power not matched by a transfer of taxing power to the regional entities.

A growing consensus has emerged among economists that this asymmetry has gone too far and that it makes good governance difficult. This is made very clear by the contribution of the Leuven and Namur researchers who develop an at-first surprisingly similar analysis of the problem.

Not so long ago, it would have been very difficult for Flemish and Francophone researchers to converge about the way to reform the financing system of the Belgian regions and communities. After comparing the CERPE and the CES-VIVES proposals for reform of the financing mechanism of Belgium's regions and communities that are developed in this e-book, one is struck by the degree of convergence in thinking achieved in both parts of the country. Both the Leuven and Namur researchers come to the conclusion that the present financing system of communities and regions stands in the way of good governance. The reasoning is the following.

In the present financing system, most of the revenues of the regions and the communities come from grants from the federal government. These grants increase yearly as a result of inflation and GDP growth. Thus efforts by a region to expand regional economic activity and the regional tax base do not directly affect the regional government's revenues. It does this only indirectly by increasing Belgium's GDP. The benefits of this policy are then shared by the other regions. These externalities may discourage regions from introducing structural reforms aimed at boosting regional economic activity. (We hasten to add here that during the discussion of these proposals at the December 2009 Re-Bel meeting, several observers noted that it is not clear how these macro-incentives really affect the decisions of politicians at the micro level; this point is detailed in the Decoster-Van Parijs comment).

In the view of the Leuven and Namur researchers, it is even worse than that. When a region successfully increases regional economic activity and, in so doing, raises per capita income, it loses revenue from the revenue equalization system. Thus, good regional governance is penalized. The two teams of researchers from Leuven and Namur concur that this is reason enough to change the system.

Both teams of researchers also concur on the basics of how to reform the financing system. The centre piece in both proposals is the introduction of a regional personal income tax system. This means that the yearly variations of regional revenues would be determined by the variations of the regional tax base, and not as today by the variations in the federal consumer price index and GDP. Thus, efforts by the regional authorities to boost regional economic activity would be rewarded by increased revenues.

In addition both proposals agree that the rate setting power, i.e. the power to set the personal income tax rates, should remain in the hands of the federal government and parliament.

A move towards a regional personal income tax system creates the risk of more regional income inequality. That is why both proposals agree on the need to maintain a solidarity mechanism with the following features. Regions that fall below a certain threshold in terms of their per capita income should receive some compensation from the others. This compensation scheme should be such that it does not lead to a perverse mechanism whereby a region that improves its per capita income is punished by less revenue.

There are of course also differences between the two proposals. The most important ones are the following. First, in the Leuven proposal the solidarity mechanism is organized "horizontally", i.e. the region falling below the threshold obtains compensations directly from the other regions. In the Namur proposal this compensation is organized "vertically", i.e. the federal government provides for the compensation. The importance of this difference can be debated. While one could think that it is of second order compared to the principle that such compensations should exist and that the anomalies in the present compensation system are eliminated, Decoster and Van Parijs argue it is not, and propose a hybrid solution which is neutral in terms of incentives while being in their view simpler and more transparent.

Second, the Leuven proposal goes a step further than the Namur proposal in that it also wants to change the nature of the VAT-grants to the communities. In the Leuven proposal the grant would become a fixed percentage of the federal VAT-revenues. This would make it a true shared tax. The Namur proposal does not envisage changing the VAT-grant system to the communities. It is not immediately clear what the advantage is of such a change. Probably its simplicity, and maybe the fact that the risk of volatility of the VAT-revenues are shared equally between the federal government and the communities. This is not the case in the present system.

As stressed earlier, we are impressed by the degree of agreement between the two proposals, both at the level of the analysis of the shortcomings of the present Special Financing Act and at the level of the proposals made to change it. We add some comments that should help stimulate the discussion.

The dimension where further research is clearly needed concerns the economic implications of the suggested reforms. The simulations included in the two pieces differ radically in this respect: the Namur piece assumes away any impact on employment, looking at a 'ceteris paribus scenario'; instead, the Leuven piece assumes a strong positive employment response. This makes the details of the two pieces hard to compare at this point. And since, as far as politics is concerned, 'the devil will be in the detail', it would be very useful to be able to compare the two scenarios under similar macroeconomic assumptions.

Both proposals put a lot of emphasis on improving incentives of the regional entities. Better incentives will make better governance possible. As economists, we find little to object to this. However, one can also sometimes overestimate the importance of incentives. These are necessary for making better governance possible but they are not sufficient.

The main problem we face today in Belgium is the centrifugal force pulling the two linguistic communities apart. These centrifugal forces have different causes. One is political and finds its origins in the fact that Belgian politicians now have an exclusive regional allegiance making it very difficult for them to defend a "Belgian interest". Whether this is good or bad is not the issue here. It is just a fact that helps explaining the centrifugal forces. A second cause of centrifugal forces is sociological and cultural. There was a time when the Flemish elite had a strong affinity to French culture and mixed easily with the Belgian establishment. This created a glue that helped keep the country together. Today the Flemish and French elites have drifted apart. There is no such thing as a Belgian elite anymore. Again whether this is good or bad is not the issue. It helps explaining the centrifugal forces.

The centrifugal forces can become strong enough to overpower the incentive effects stressed by the Leuven and Namur researchers. Thus even if we fix the governance of the financing system by giving better incentives, which is a very good idea, this will not by itself be sufficient to keep the country together. So let's reform the financing law; good governance is always better than bad governance. But let's keep in mind that good governance may be a weak force compared to the strong centrifugal forces now at work.