

# A new structure for the financing of Belgium's Regions and Communities through personal income tax: The CERPE Model

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## 1. INTRODUCTION

Many people, academics<sup>1</sup> and politicians alike, call for a reform of the financing of the Belgian Regions and Communities to ensure more efficiency and responsibility. In particular, it is suggested to reform the current sharing of the Personal Income Tax (PIT) between the federal and federated entities (Regions and Communities) and the equalization mechanism.

This paper proposes a reform of the Special Finance Act of 1989 as lastly amended in 2001 (SFA) in order to meet several economic principles of good governance. It focuses on the PIT revenues *sensu lato* which are transferred from the federal level to the Regions and the Communities according to the SFA (PIT grant *sensu stricto* to the Regions, equalization mechanism, reduction of grants due to the transferred taxes i.e. Lambermont negative term<sup>2</sup>, additional PIT grants for transferred competences<sup>3</sup>, and PIT grants to the Communities). We estimate that such PIT revenues will amount to 15.4 billion EUR in 2010.

Our proposal does not deal with the VAT revenues transferred to the Communities (estimated at 13 billion EUR in 2010) through a sharing system based on the needs of the respective schooling systems in each Community. Moreover, it is constructed *ceteris paribus* with unchanged distribution of competences between the federal level and the Regions and Communities as the optimal allocation of competence is a separate debate.

The paper is as follows. Section 2 confronts the SFA with some principles of fiscal federalism, Section 3 presents our proposal for a shared PIT, Section 4 illustrates the implementation of the proposal, and Section 5 concludes.

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<sup>1</sup> See for instance Algoed (2009), Algoed et al. (2008), Kirsch (2008), Verdonck et al. (2009).

<sup>2</sup> Compensation for the revenues of the federal taxes transferred to the Regions.

<sup>3</sup> Agriculture and sea fishing, scientific research in agriculture, trade, and provincial and municipal law.

## 2. AN ASSESSEMENT OF THE SPECIAL FINANCE ACT IN THE LIGHT OF SOME PRINCIPLES OF FISCAL FEDERALISM

The evolution and the current system of the Special Finance Act have been extensively dealt with (see for instance, Deschouwer and Verdonck (2003), Pagano (2002), Van Der Stichele and Verdonck (2001). On the basis of some principles of fiscal federalism (as summarised by Oates, 1999), we conclude that some parts of the SFA need to be corrected, others need to be maintained, while others still need to be added.

Firstly, different provisions of the SFA need to be corrected:

- The SFA creates horizontal externalities between regions<sup>4</sup> as the economic performance of one region influence the PIT grants of the other regions. Hence there is no direct link between economic performance and PIT revenues (see Chaidron et al., 2009: 34-35).
- The SFA equalization mechanism induces a perverse effect as when a region improves its economic performance, the decrease in the revenues generated by the equalization mechanism is more important than the increase in revenues related to a larger share of the PIT grants. This leads to a 'development trap' as first shown by Cattoir and Verdonck (1999) and well documented since then (Algoed, 2009; OECD, 2009:70-71)<sup>5</sup>.

Secondly, elements of the SFA need to be maintained from our perspective:

- Currently, the use of the tax autonomy by one region does not directly<sup>6</sup> affect the revenues of the other regions. Moreover, boundaries to the tax autonomy of the regions have been set to alleviate harmful tax competition (race to the bottom)<sup>7</sup>.
- In the framework of the SFA, the federal level is in charge of the interpersonal and institutional solidarity. In particular, it is responsible to determine the marginal rates of the PIT, hence the scale of progressiveness. The federal level is also in charge of the vertical equalization mechanism.

Thirdly, in our view, elements could be added to the SFA:

- The Brussels region as administrative and economic capital city of the federation incurs extra costs due to the numerous commuters who consume public services in Brussels while their PIT is only returned to federate entities of their residence place (also OECD, 2009:67).
- With the SFA, the federal level will be confronted with a structural deficit. Indeed, the future cost of ageing will mainly be supported by the Entity I comprising the federal level and social security (OECD:2009: 63)<sup>8</sup>. As a consequence, according to the Federal Planning Bureau, the needs of financing of the federal level will be proportionally much more important than the needs of the Regions and Communities<sup>9</sup>.

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<sup>4</sup> The term "Region" refers to the political entity whereas "region" refers to the territorial entity.

<sup>5</sup> This effect is observed for the Walloon Region and for the Brussels-Capital Region. However, when the Walloon Region, the Brussels Region and the French-speaking Community are consolidated, the development trap is not observed any more.

<sup>6</sup> It could be the case indirectly if there is an interregional move of the population due to the change in taxation.

<sup>7</sup> Art.9(1) of the SFA provides for the possibility of regional tax autonomy within a limit of 6.75 % of the PIT. However, the Regions have not yet used this possibility to a large extent.

<sup>8</sup> Another reform, which is independent of the proposals made here, could be that the Regions and Communities support an additional part of the retirement benefit of their officials: as recommended by OECD (2009:76). That implies a reform of the Special Act of 5 May 2003, M.B., 15.5.2003, p. 26 434.

<sup>9</sup> Economic Forecast 2009-2014 of the Federal Planning Bureau.

### 3. THE CERPE PROPOSAL TO REFORM THE SFA

#### 3.1. A Shared PIT with a revised equalization mechanism

On the basis of this analysis, we propose to replace the current PIT grants *sensu lato* by a new mechanism of sharing the PIT revenues between the federate entities and the federal level. For simplicity, we consolidate on a territorial basis the Regions and the Communities and leave to each territorial authority the responsibility of sharing its means between Regions and Communities<sup>10</sup>.

The mechanism of sharing the PIT revenues rests on four steps.

##### Step 1: The Regional and Proportional PIT (RP-PIT)

The main part of the new PIT revenues of a region is made up of a Regional and Proportional PIT levied on the region's citizens (the so-called RP-PIT). The federal level stays in charge of determining the tax schedule and the progressiveness of the PIT's rates and remains responsible for collecting the PIT. It transfers to each region the RP-PIT that is owed and keeps the rest.

At the beginning of the implementation of the system, all regions have the same RP-PIT rate (the reference RP-PIT rate) and each taxpayer pays the same PIT as previously. Afterwards, each region may decide to change the RP-PIT rate of its territory. If a region decides to lower its rate, its citizens pay less taxes and the region receives less PIT revenues. Conversely, if a region decides to increase its rate, its citizens pay more taxes and the region receives more PIT revenues. In addition, the regions may also give to their citizens' tax credits that are related to their exclusive competences. If they do so, they receive less PIT revenues. However, the regional tax autonomy is exercised within certain limits which are decided by consensus<sup>11</sup>.

On the one hand, as the main PIT revenue of each region is explicitly linked to its tax base, the proposed system ensures a direct link between the economic performance of a region and its revenues. It also guarantees the independence of these revenues with respect to the performance of other regions (there are no more horizontal externalities).

On the other hand, any change of the PR-PIT in one region only affects its own resources and does not impact the resources of the other regions.

##### Step 2: A vertical equalization (solidarity) mechanism

Our proposal provides for a vertical equalization mechanism in favour of the less developed regions. Additional resources are granted to partly compensate a tax base *per capita* that is below the national tax base *per capita*.

The equalization mechanism for the region  $r$  can be set up as follows:

$$\gamma \times a \times \left[ \frac{\sum_{i=1}^3 TB_i}{\sum_{i=1}^3 P_i} - \frac{TB_r}{P_r} \right] \times P_r$$

<sup>10</sup> In the rest of this contribution, "region" refers to the territorial entity, whereas "Region" (with a capital letter) means the political entity.

<sup>11</sup> If it is decided to maintain the same boundaries provided in Art. 9 SFA (i.e. 6.75 % of the PIT), boundaries of 1.4% of the RP-PIT should be adopted.

Where  $\gamma$  is the compensation rate of the difference between the national tax base *per capita* and the regional tax base *per capita* of the region  $r$ ,  
 $\alpha$  is the base rate,  
 $TB_i$  is the tax base of the region  $i$ ,  
 $P_i$  is the population of the region  $i$ .

This mechanism removes the ‘development trap’ (as shown in Chaidron et al., 2009: 38-39)<sup>12</sup>. It is vertical to ensure that institutional solidarity remain the responsibility of the federal and be stable over time.<sup>13</sup>

### Step 3: A stable compensation basis to ensure fiscal neutrality in the first year

A fixed compensation ensures fiscal neutrality with the current SFA the first year of implementation. By assumption, this compensation remains unchanged over time, hence it is neither adapted with inflation nor with growth.

### Step 4: The possibility of an additional financing for the Brussels region and the federal level

Finally, our proposal allows for an additional financing by the federal level to the Brussels region in order to take into account its charges as the capital city of the federation<sup>14</sup>. It also allows for a progressive additional financing of the federal level, by the different regions in proportion of their tax bases, to take into account of the future costs of ageing that will mainly be supported by the federal level.

## **3.2. An assessment in the light of the fiscal federalism principles**

Our proposal meets several principles of good governance.

- (1) *Transparency and simplicity* of the RP-PIT system, which in turn leads to accountability of the public authorities, as our proposal replaces a complex system of grants.
- (2) *Responsibility* of the Regions and the Communities as our proposal removes horizontal externalities between regions and corrects the pervert effect of the equalization mechanism. Moreover, our proposal allows for a federal financing of the Brussels region to compensate the consumption of the public services by commuters and other costs linked to its role of capital city.
- (3) *Correction of vertical imbalances* as our proposal replaces the grant system by a shared PIT and ensures that the future costs of ageing are taken into account.
- (4) *Regional tax autonomy without harmful tax competition* as our proposal maintains by assumption the boundaries set up in the current SFA.
- (5) *Interpersonal and institutional solidarity* at the federal level as our proposal ensures that the progressiveness of the PIT remains decided by the federal level and that equalization mechanism stays vertical.

Next to those principles, our proposal ensures a fiscal neutrality of the system for the first year of its implementation.

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<sup>12</sup> This is not the only way to suppress the ‘development trap’ The OECD (2009:76) suggests to simply reduce the amount of equalization of the current SFA. However, this option cannot guarantee the disappearance of the development trap for any growth scenario unless the equalization is reduced to a very small amount.

<sup>13</sup> Heremans et al. (2008), and Verdonck et al. (2009) are in favour of a horizontal equalization mechanism.

<sup>14</sup> The OECD (2009:76) suggests an extra financing of the Brussels region by allocating (partially) the shared income tax to the region where the firm of the worker is located (‘workplace principle’).

#### 4. AN EXAMPLE OF IMPLEMENTATION FOR THE PERIOD 2010-2015

##### 4.1. The current SFA revenues taken into account

Under the assumptions detailed in Annex, the implementation of the current SFA leads to PIT revenues for the Regions and Communities of 15 439 million EUR in 2010 and of 18 899 million EUR in 2015.

Table 1a. PIT grants for the Regions in 2010 according to SFA (millions EUR)

	Brussels Region	Flemish Region	Walloon Region	Total
PIT grant <i>sensu stricto</i>	1 050	8 000	3 562	12 612
Equalization mechanism	312	-	830	1 142
Reduction of grant for transferred taxes: Lambermont negative term	-488	-2 604	-1 113	-4 205
Additional grant for transferred competences	3	132	87	223
<b>Total</b>	<b>877</b>	<b>5 528</b>	<b>3 366</b>	<b>9 771</b>

Source : CERPE.

Table 1b. PIT grants for the Communities in 2010 according to SFA (millions EUR)

	French speaking Community	Flemish speaking Community	Total
PIT grant	1 960	3 708	5 668

Source : CERPE.

Table 2a : PIT Grants for territorial regions in 2010 according to SFA (million EUR)

	Brussels	Flanders	Wallonia	Total
PIT grant <i>sensu strict</i> to Regions	1 050	8 000	3 562	12 612
Equalization mechanism	312	-	830	1 142
Reduction of grant for transferred taxes: Lambermont negative term	-488	-2 604	-1 113	-4 205
Additional grant for transferred competences	3	132	87	223
PIT grant to Communities <sup>15</sup>	514	3 585	1 568	5 668
<b>Total</b>	<b>1 391</b>	<b>9 114</b>	<b>4 934</b>	<b>15 439</b>

Source : CERPE

<sup>15</sup> The PIT grants of the Communities are shared between territorial regions according to population data, with the key 80/20 to determine in Brussels, the French-speaking and the Flemish-speaking population respectively.

Table 2b: Forecast of PIT revenues and sharing between regions and the federal level according to the SFA (million EUR)

	Brussels	Flanders	Wallonia	Total	Federal level	Total PIT revenues
2010	1 391	9 114	4 934	15 439	19 644	35 083
2015	1 750	11 205	5 944	18 899	23 804	42 703

Source: CERPE

#### 4.2. The implemented scenario and its assumptions

Firstly, the three regions adopt a common rate of RP-PIT of 8.37%. Such a rate ensures the same PIT financing (including equalization) than the SFA for the Brussels region in 2010. It leads to a small loss for Flanders and Wallonia.

Secondly, according to the equalization mechanism, additional resources are given to regions whose tax base *per capita* is below the national tax base *per capita*. The compensation rate is set up at 85%.

Thirdly, to ensure fiscal neutrality with regard to the current SFA the first year of implementation, additional revenues are given to Flanders (174 million EUR) and Wallonia (310 million EUR) in 2010. By assumption, those revenues remain unchanged over time.

Finally, additional financial means are progressively granted to Brussels and to the federal level. They start in 2011 to reach in 2015 respectively 100 million EUR for Brussels and 700 million EUR for the federal level. Such amounts are purely illustrative and do not prejudice of what might be objectivised<sup>16</sup> or negotiated before the implementation of the reform. To achieve the additional financing of the federal level, each region should contribute, on its RP-PIT revenues, at a cumulative annual rate of 0.071% of its tax base from 2011.

#### 4.3. The PIT resources for the regions : the implemented scenario

With those assumptions, the CERPE proposal leads to the following results:

Table 3a: Revenues of each region, before additional financing for Brussels and the federal level (million EUR)

Step 1: RP-PIT with an identical rate at 8,37%				
	Brussels	Flanders	Wallonia	Total
2010	1 143	8 940	4 346	14 429
2015	1 338	10 927	5 287	17 551
Step 2: Equalization mechanism (compensation rate at 85%)				
	Brussels	Flanders	Wallonia	Total
2010	249	0	278	527
2015	386	0	340	726

<sup>16</sup> See for instance Lambert *et al.* (1999) and Van der Stichele (2003) who estimated that the additional cost of the Brussels Capital Region as capital city of Belgium and international city amounted to around EUR 490 million. See also Cattoir *et al.* (2009) and de Callatay (2007).

<b>Step 3: Compensation to ensure first year fiscal neutrality in 2010</b>				
	<b>Brussels</b>	<b>Flanders</b>	<b>Wallonia</b>	<b>Total</b>
<b>2010</b>	0	174	310	484
<b>2015</b>	0	174	310	484
<b>Total of resources (without additional financing for Brussels and the federal level)</b>				
<b>2010</b>	1 391	9 114	4 934	15 439
<b>2015</b>	1 723	11 101	5 936	18 760

*Table 3b: Additional means for Brussels and the federal level (million EUR)*

<b>Step 4: Additional means for Brussels (<i>in fine</i> 100 million EUR compared to current SFA)</b>				
	<b>Brussels</b>	<b>Flanders</b>	<b>Wallonia</b>	<b>Total</b>
<b>2010</b>	0	0	0	0
<b>2015</b>	184	0	0	184
<b>Contribution of the regions to the additional financing of the federal level (<i>in fine</i> 700 million EUR compared to current SFA )</b>				
	<b>Brussels</b>	<b>Flanders</b>	<b>Wallonia</b>	<b>Total</b>
<b>2010</b>	0	0	0	0
<b>2015</b>	-57	-464	-224	-745

Source: CERPE

*Table 4: Total PIT revenues and comparison with the SFA (million EUR)*

<b>CERPE Proposal</b>						
	<b>Brussels</b>	<b>Flanders</b>	<b>Wallonia</b>	<b>Total</b>	<b>Federal level</b>	<b>Total PIT revenues</b>
<b>2010</b>	1 391	9 114	4 934	15 439	19 644	35 083
<b>2015</b>	1 850	10 637	5 712	18 199	24 504	42 703
<b>Comparison with SFA</b>						
	<b>Brussels</b>	<b>Flanders</b>	<b>Wallonia</b>	<b>Total</b>	<b>Federal level</b>	<b>Total PIT revenues</b>
<b>2010</b>	0	0	0	0	0	0
<b>2015</b>	100	-568	-232	-700	700	0

Source: CERPE

#### **4.4. The Robustness of the proposal**

In Deschamps et al. (2009: 705-709), we show that the CERPE proposal is sufficiently robust with variations of the RP-PIT reference rate, of the equalization compensation rate, or the amounts for the additional financing to the Brussels region and/or the federal level. It is also robust with changes in assumptions regarding the growth rate or the tax bases.

## 5. CONCLUSION

This paper proposes a reform of the Special Finance Act in order to ensure that the Act meets several good governance principles: transparency and simplicity, responsibility of the public authorities, correction of vertical imbalances between the federal level and the Regions and Communities, regional tax autonomy without harmful tax competition, and interpersonal and institutional solidarity.

It proposes to introduce a shared PIT with a regional PIT which is proportional and which replaces several PIT grants which are currently transferred from the federal level to the Regions and the Communities according to the SFA (PIT grant *sensu stricto* to the Regions, equalization mechanism, reduction of grants for transferred taxes *i.e.* Lambermont negative term, additional PIT grant for transferred competences, and PIT grant to the Communities). Such a Regional and Proportional PIT will be accompanied by a reformed vertical equalization mechanism exempt of any ‘development trap’.

To ensure a smooth transition between the current SFA and the new proposed system, a fixed compensation ensures fiscal neutrality for the first year.

Finally, our proposal allows for a progressive additional financing to the Brussels region to take into account its role of capital city of the federation, and to the federal level to take into account the costs of ageing that will mainly be supported by that level.

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