

# Towards a more efficient and responsible financing mechanism for the Belgian federation

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## 1. *Introduction*

Federalism is an ever ongoing process. After twenty years of experience with the Special Finance Act (SFA)<sup>18</sup> for the Regions and Communities (R&C) in Belgium, an evaluation is to be made.

Hence, we will first look into the analytical insights of federalism that underlie the SFA. Whereas the SFA refers to some traditional criteria from the normative theory of economic federalism, new insights from the political economy approach are to be taken into account in a critical evaluation. They may explain many inefficiencies in the present SFA, and help to devise a reform, taking into account aspects of efficiency, accountability and transparency.

Secondly, we present an alternative financing system (NSFA) for the R&C that captures the main critiques. The emphasis will be on responsibility via direct budgetary returns giving the right incentives for regional governments to pursue activity enhancing policies. This effect of the NSFA on the activation of the labour force should be the key for a win-win reform improving the prospects of public finance for all federated entities.

## 2. *From a normative fiscal federalism to a political economy perspective of the Belgian SFA*

Multi-level governance in a federation involves a continuous trade-off between various criteria, the result of which may evolve over time.

According to the (traditional) normative theory of fiscal federalism, first and foremost, a better matching of ("heterogenous") preferences is obtained by decentralization, whereas the realization of economies of scale, on the contrary, may require centralization. Also externalities, when they are complex and not to be solved by Coasian bargaining<sup>19</sup>, have to be internalised by centralization.

An ideal system would then consist of functionally overlapping jurisdictions optimally "carved out" for each government function.<sup>20</sup> However, given substantial transaction costs,

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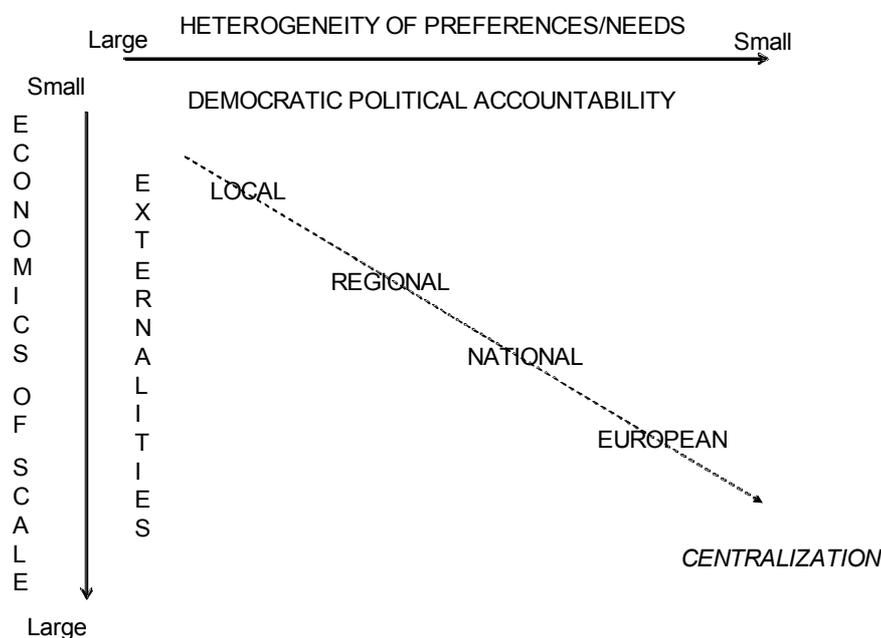
<sup>18</sup> Special Act concerning the financing of the Communities and the Regions (1989) and its complement along the same lines, the Lambermont Agreement (2001).

<sup>19</sup> The Coase theorem states that when trade in an externality is possible and there are no transaction costs, bargaining will lead to an efficient outcome.

<sup>20</sup> In an ideal world without transaction costs individuals organize themselves for each public function in the particular size of jurisdiction which maximizes their welfare for that particular public service.

organisational costs and scope economies, such a far reaching functional decentralization appears to be unfeasible in practice. As a result, public functions will be grouped in a few types of jurisdictions, as illustrated in *Figure 1*.

*Figure 1 Allocation of competences*



Traditionally, the nation state, coinciding with market size, and its economic and monetary union providing the framework (internalizing the externalities) for market operations, has been the "nexus" of the previous trade-offs.<sup>21</sup> Due to market integration at EU level, and even at the global level, this central role is being eroded:

- it requires further centralization of market linked policies at the higher EU-level
- and it leaves more opportunities for welfare improvements by better accommodating heterogenous preferences and needs by decentralization at the lower level of the regions (subsidiarity).

In addition, arguments for decentralization have been strengthened by recent political economy approaches of fiscal federalism. As governments are no longer considered per se as benevolent social planners, decentralization may contribute to more democratic political accountability in order to discipline and check government failures. The political economy perspective may especially affect the funding of the components in a federation. Until now, this perspective has not received much attention in the debate on the Special Finance Act (SFA) for the Regions and Communities (R&C) in Belgium.

<sup>21</sup> Alesina, A., Spolaore, E. 2003. The size of nations. MIT Press, Cambridge, Mass.

## 2.1 *Funding of the components in a federation: normative theory and the Belgian SFA.*

### 2.1.1 Normative fiscal federalism

The *Equivalence Principle* dictates that the users of public goods and services also pay for it. Hence, the subcentral entities should have the obligation and the power at the tax side to raise the necessary revenues to match the expenditure side of their public goods provision.

However, when applying the different fiscal federalism criteria discussed above, due to externalities at the tax side, the trade-off reveals to be more complex than at the expenditure side. Indeed, fiscal decentralization may involve *externalities and efficiency distortions*:

- at the *vertical level*, tax competition may lead to an overexploitation of the shared tax base.
- at the *horizontal level*, (strategic) tax competition for a mobile tax base may lead to a "race to the bottom": as taxes are set too low it may result in an undersupply of public goods and services.

Moreover, besides the efficiency considerations to internalize tax externalities, also *redistribution and solidarity concerns* with respect to differences in tax capacities among subnational entities may point to more centralization at the revenue side. The set-up of the SFA in Belgium has been dominated by these criteria.

Hence, the commonly held notion according to the normative theory is that the revenue-raising authority should be more centralized than the expenditures authority in a federation. It results typically in a *vertical fiscal gap* between revenues and expenditures on own account at the central and subcentral levels.

### 2.1.2 The size of the vertical fiscal gap

The size of the vertical fiscal gap is defined by the magnitude of the cash transfers that flow from the central to the subnational governments. As Table 1 indicates, the size of the vertical fiscal gap differs widely among federations. The financing gap in Belgium for the federated entities (intermediate level)<sup>22</sup> amounted to 61%, and is much wider than the 38% in Austria and 15% in Canada. It raises questions, as similar trade-offs w.r.t. efficiency and redistribution are involved in other federations. Are there more dangers for tax externalities, and/or is there more need for redistribution in the Belgian federation?

At the level of local governments in Belgium, the fiscal gap of 47% appears to be smaller. Are there less dangers for tax externalities, and less redistribution needs at the local level?

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<sup>22</sup> It can be argued that when only looking at the Regions and thus excluding Community finances from the "federated entities", the fiscal gap turns out to be lower. However, including the Communities gives a more correct and transparent view of all financing at the intermediate level. Notice that the Region of Flanders and the Flemish Community merged into one governmental entity right from the start. Including Community finances is also common practice in international comparisons.

**Table 1: Vertical fiscal gap in federal states**

	Share in general government spending		Share in general government revenues		Fiscal gap	
	Intermediate level	Local government	Intermediate level	Local government	Intermediate level	Local government
Austria	17.2	14.6	10.6	15.0	38.4	-2.7
Belgium	23.2	13.8	9.0	7.3	61.2	47.1
Canada	50.4	10.5	42.8	9.8	15.1	6.7
Germany	21.6	14.9	23.6	11.9	-9.3	20.1

Source: OECD, 2007: numbers of 2005

Whatsoever, more fiscal equalization (redistribution) should reduce the danger of tax externalities. Fiscal equalization reduces the incentives to lower tax rates in order to attract mobile tax bases, so that fiscal externalities are internalized (see Buettner, 2001)<sup>23</sup>. A horizontal equalization system, as opposed to the current vertical equalization system in Belgium, would be better suited to internalize these fiscal externalities.<sup>24</sup> Hence, both arguments (i.e. the existence of tax externalities and redistribution concerns) should not be cumulated in order to limit fiscal autonomy and to increase the fiscal gap.

### 2.1.3 Fiscal imbalances in the complex Belgian SFA

The funding of the components of the Belgian federation in the Special Finance Act, as summarized in Table 2, is very complex and certainly lacks transparency.

The outcome of very complex arrangements and political compromises is that nearly 80% of the funding of subnational governments consists of "grants", and only 20% of own taxes. It is in sharp contrast to the funding of Belgian local authorities, deriving nearly half of their financing from own tax income.

From an efficiency point of view several features of the SFA are to be questioned:

- *vertical imbalances*: relying mostly on grants, the funding of the subnational components is rather guaranteed, benefitting from a rather stable evolution over time. Residual revenue risks due to fluctuations in tax income affect mainly the federal budget. Moreover, regional revenues are not directly, nor unambiguously linked to the economic performance of the respective regions.
- *horizontal externalities*: as there is no direct link with its economic performance, the revenues of one subnational entity may be (substantially) affected by the economic performance of other entities.

<sup>23</sup> Buettner, T. 2001. Fiscal externalities in local tax competition: empirical evidence from a panel of German jurisdictions. ZEW Discussion Papers 01-11.

<sup>24</sup> In a vertical solidarity system, the first move of the richer region towards a lower tax rate, which attracts part of the tax base from other regions, would not be punished by increased solidarity payments from that region to the other regions. This argument was pointed out in: Verdonck, M. 2009. Evaluating the decentralization of tax powers: Lessons from the Belgian regions. mimeo.

**Table 2: Overview of regional financing (2008)**

	% of total R&C revenues	Vertical evolution	Horizontal division key
<b>Regional taxes</b>	20.14%	/	/
<b>PIT grant to the Regions</b>	21.98%	Lump sum payment <sup>25</sup> , tied to CPI and GDP-growth	Relative contribution to federal PIT revenues
<b>Solidarity (Revenue equalization) for Regions</b>	2.57%	Yearly calculated lump sum payment	Underperformance w.r.t. national average of per capita PIT revenues
<b>Miscellaneous specific purpose grants</b> - to regions - to communities	8.37% - 5.37% - 2.99%	Constant or linked to CPI	Division keys based on expenditures in the past
<b>PIT grant to the Communities</b>	14.39%	Lump sum payment, tied to CPI and GDP-growth	Relative contribution to federal PIT revenues
<b>VAT grant to the Communities</b>	32.55%	Lump sum payment, tied to CPI and evolution of number of people younger than 18	Relative number of school-aged people (6-17 years) <sup>26</sup>

Secondly, the SFA also implies some paradoxical redistributive effects, as solidarity overcompensates "juste retour". Setting the national average per capita revenues at 100 for 2008, the per capita own regional and transferred personal income tax revenues by Flanders are 3.6 percentage points above the national average (as can be seen in *Figure 4* in Appendix). After the implementation of the equalization and specific purpose grants, the per capita means for Flanders drop 3.3 percentage points below the national average. The per capita revenues for the Walloon Region increase from 90% to 98.8% of the national average and become higher than the per capita revenues in Flanders. The Brussels Capital Region (BCR), starting from 111.9, ends up with 123.3 compared to the national average of one hundred.

As to the funding of the Communities, the French-speaking Community ends up with 1934 euro per capita in 2008, somewhat above the Flemish Community, receiving 1855 euro per capita in 2008 (as illustrated by *Figure 5* in Appendix).

Moreover, despite the smaller per capita financial means, Flanders has contributed substantially in restoring the consolidated Belgian public finances to an equilibrium, since the budget surplus of Flanders was on average 509 million euro on a yearly basis in the period 1996-2005. The French-speaking Community and the Walloon Region registered in the same period a budget deficit of, on average, respectively 115 and 82 million euro.

The economic (efficiency) consequences of these fiscal imbalances are further to be analyzed in a political economy approach better suited to take into account incentive problems and conflicts of interest created by the SFA.

<sup>25</sup> Lump sum payments are based on a historically determined amount of money. Consequently, their linking to particular tax revenues of the federal government (PIT, VAT) is only fictitious.

<sup>26</sup> The additional means of the Communities provided by the Lambertmont Agreement in 2001 (extra lump sum amounts and the proceeds of the indexing of the total VAT-grant to 91% of real GDP-growth) will from 2012 onwards be divided between the two Communities exclusively on the basis of the Region's PIT revenues. In the meantime (2002-2012) the number of school-aged people is also taken into account in order to determine the horizontal division key.

## 2.2 *A political economy perspective on the SFA*

### 2.2.1 Political economy approach of federalism<sup>27</sup>

In the political economy view government officials are no longer conceived of as per se benevolent social planners, but rather as political representatives subject to political agency problems. Hence, fiscal federalism has to focus on the incentives given to politicians and on designing disciplining mechanisms for good governance. It implies that the criteria determining the trade-off in normative fiscal federalism have to be supplemented and revised as:

- aggregate preference matching at the central level will be reduced through failures of the central political process
- accountability failures at the central level are to be taken into account due to stalling of the "voice" mechanisms<sup>28</sup>, more serious information problems in monitoring and in controlling centralized decision makers.

One of the key mechanisms to improve the performance of governments is *yardstick competition*, requiring decentralization:

- it puts competitive pressure on politicians, as the presence of several competing decentralized governments empowers citizens to better discipline their political representatives into serving the interests of their constituency.
- it implies the potential to compare the results of the competing governments requiring visibility and transparency, the information being more accessible at lower government levels.

Financial responsibility and fiscal transparency are important instruments of political accountability and yardstick competition. As governments become responsible for raising their own tax revenues, the citizens/taxpayers can compare better the benefits of public service provisions with the tax burden.

Finally, it is to note that even in the absence of heterogeneity of preferences, decentralization may still be desirable in order to achieve better democratic political accountability.

### 2.2.2 Soft budget constraints in the SFA

Transfer dependency in the SFA presents problems of soft budget constraints for the regional governments. As the federated entities spend the money given by the federal government (chequebook federalism), they lack political accountability.

It involves several types of moral hazard problems:

- *common pool problem*: federal tax revenues are a common pool of resources. It gives incentives to use the federal budget for policies with regional benefits and stimulates an overprovision of public goods and services at the federal level. It leads to an inevitable tendency to overexploitation of the federal tax revenues (raiding of the commons).

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<sup>27</sup> See Ahmad, E. and Brosio, G. 2006. *Handbook of Fiscal Federalism*, Cheltenham, E.Elgar.

<sup>28</sup> An enhanced civic "voice" is thought to promote greater accountability of public institutions, which improves institutions' performances and increases their responsiveness.

- *fiscal illusion* for voters and politicians: when the governments of the federated entities call for more federal transfers, they pretend this could be done without increasing the federal tax and debt burden on their own citizens.
- *bail-out problems*: by lack of substantial own fiscal revenues, the governments of the federated entities operate with the expectation that their fiscal deficits will be "bailed out" by the federal government. Bail-out expectations create a "moral hazard" problem, as they soften the budget constraint for subnational governments and induce them to "inefficient" spending behaviour. Moreover, in case of debt accumulation at the subcentral level, they obviate the disciplining by financial markets.

The subsequent changes to the SFA in Belgium, mainly to "refinance" the French-speaking Community, are a good illustration of this overexploitation of the fiscal commons. The French-speaking Community has solved its budgetary problems by having the federal grants towards the federated entities increased. Hence, the continuing difficulties of federal public finances do not come as a surprise under the present SFA.

### 2.2.3 Non transparency of the SFA: economic and redistributive inefficiencies

According to the political economy view, a funding system should give the *right incentives* for *accountability*:

- to government officials, not to pursue their own interests, but to respond to the needs of their constituency and to create welfare by promoting activity enhancing investments (responsiveness)
- to citizens/taxpayers to control and monitor the behaviour of their political representatives requiring visibility and transparency

It is clear that the complex, nontransparent SFA fails in terms of accountability as it contains no clear signals and unambiguous feedback mechanisms due to externalities. When a regional government invests in activity enhancing policies, the return on its own financial means is only indirect and not predictable as it also depends on the performance of other subnational governments:

- First, at the *vertical level*, it may have a positive effect on the global volume of personal income tax (PIT) grants, by contributing to overall GDP growth. The final outcome, however, also depends upon the performance of the other governments. Moreover, the volume effect will be lower than the increase of the PIT tax base, as only the federal level will benefit from an elasticity effect larger than one.
- Second, at the *horizontal level*, it may involve a positive substitution effect provided that there is a relative change in the region's GDP (depending upon the performance of other regions) which affects its PIT revenues and hence the distribution formula.

Contrary to these complex links, accountability would require to exclude these externalities by a straightforward link, the region obtaining a percentage of its contribution to PIT revenues and not being dependent upon the other regions.

In addition, the vertical equalization system for the regions in the SFA has adverse incentive effects, as first analyzed by Cattoir-Verdonck (2002) and widely documented in more recent studies<sup>29</sup>. It leads to a "development trap" for the regions benefitting from equalization

<sup>29</sup> - Cattoir, Ph., Verdonck, M. 2002. Péréquation financière et fédéralisme. In *Autonomie, solidarité et coopération*. Cattoir et al. (eds).

- Algoed, K., Heremans, D. 2007. Financing the Communities and Regions in Belgium: Vertical and horizontal fiscal imbalances, chapter 4 in Algoed, K., Heremans, D. (eds) *The Political Economy of Fiscal Federalism. Issues of decentralisation in Belgium*, Proceedings of the Symposium of October 5th 2007, Steunpunt Fiscaliteit en Begroting.

- Algoed, K., Heremans, D., Peeters, T. 2007. Voorrang geven aan meer financieel-fiscale verantwoordelijkheid in een nieuwe staatsvorming. *Leuvens Economisch Standpunten*, n° 115.

(solidarity) grants, in casu Wallonia and Brussels. Any economic catching-up increasing tax revenues in one of these regions according to the "juste retour" mechanisms, leads to losses in the region's solidarity grant. This loss in equalization grant is larger than the gain in PIT grants. Hence, it is not obvious that government officials will have an interest in increasing their PIT tax base by investing in activity enhancing policies. It may also help to explain the lack of convergence in economic performance among the regions.<sup>30</sup>

At the redistribution level, the combination of funding and equalization in a combined system does not really contribute to the transparency of the SFA. Not only the "solidarity grant", but more importantly the transfers through VAT grants and specific purpose grants are tools of redistribution. Hence, the largest part of permanent equalization is not laid down in explicit equalization formulas like the solidarity grant, but is more or less "hidden" in the historical division keys in the SFA.

Hence, it is not surprising that the SFA does not stand up to the goals of redistribution policies in a federation<sup>31</sup>:

- Reducing long-term fiscal disparities across regions? The SFA overcompensates (in per capita terms) long-term differences in the relative position of a region.
- Smoothing against asymmetric macroeconomic shocks by stabilizing revenues of regional governments? It is found that interregional equalization in the SFA can only to a minimal degree be explained on grounds of macroeconomic stabilization against idiosyncratic shocks to primary income.<sup>32</sup>
- Redistribution in order to give incentives for growth and to promote convergence among the regions? It is clear that this objective is not met by the present SFA.

#### 2.2.4 Conclusion: need to improve the SFA

It follows that there is a need for more transparent, accountable and efficiency enhancing arrangements in the SFA.

First, there is a need to reduce the fiscal gap by substituting (part of) the grant system by own tax revenues for the federated entities.

Second, the choice of own tax instruments should trade-off the following criteria:

- It should contribute to *visibility, transparency and accountability of government actions*. It could refer to the decentralization of income taxes and corporate taxes. However, yardstick competition would be served by maintaining a common (federal) tax base for the tax instruments.
- It should provide in *tax instruments for economic policy* competences<sup>33</sup> for the regions as an alternative to the overreliance on subsidies. It refers to decentralization of part of corporate taxes and income taxes.
- It should provide the *right incentives for activity enhancing policies*. The federated entities should benefit directly from improved economic activity, as would be the case when they receive directly part of corporate taxes, and personal income taxes.

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- Algoed, K., Heremans, D., Van Hecke, A. 2009. De impact van vergrijzing op de overheidsfinanciën. Eindrapport Steunpunt Fiscaliteit en Begroting.

<sup>30</sup> - Persyn, D., Algoed, K. 2009. Interregional redistribution, growth and convergence. Vives discussion paper 4.

- Kessler, A.S., Lessmann, C. 2008. Interregional redistribution and regional disparities: How equalization does (not) work. mimeo.

<sup>31</sup> Van Hecke, A. 2009. Revenue equalization and stabilization in the Belgian federation. Working Document Steunpunt Fiscaliteit en Begroting, CES, K.U.Leuven.

<sup>32</sup> PIT grants provide no relative smoothing. VAT grants are stabilizing as they are independent from regional economic performance. As in other federations, the driving force for equalization in Belgium is equity, not stabilization.

<sup>33</sup> Following Verdonck (2009) the greater part of the changes in regional tax rules over the period 2002-2008 could be motivated on the basis of a better adjustment of taxes to local conditions and preferences (innovations were mostly initiated by Flanders and followed by the other two Regions).

- *Negative (horizontal) externalities* due to mobility of the tax base should be limited. Mobility, however, is not limited to interregional mobility within Belgium, but has to be seen within the broader context of tax competition with regions in neighbouring countries. Potential negative external effects in Belgium have to be weighted against potential positive effects of broadening the tax base vis à vis other countries. Negative interregional tax externalities can also be reduced by maintaining a common tax base at the (federal) level. Moreover, incentives for tax competition are also reduced, as disparities are compensated by equalization grants. Hence, the strict limits on fiscal autonomy in the present SFA are not (necessarily) justified by negative externalities.
- Finally, for *interregional redistributive concerns* the requirement of maintaining federal progressivity in personal income taxes, as is the case under the present SFA, is rather ambiguous. It appears that the interregional redistribution effects of interpersonal solidarity hinge almost entirely upon financial flows through the social security system, the contribution of (progressive) income taxation being minimal.<sup>34</sup> Hence, from this point of view the strict maintenance of federal progressivity for regional taxes on personal income can be questioned.

Third, better incentive compatible solidarity mechanisms among the regions should be designed at the horizontal level. A new horizontal equalization scheme among the Regions is preferred to the current vertical arrangement between the federal government and the Regions because of the following reasons:

- First, the vertical equalization scheme together with the current financing system based on grants leads, as explained before, to a "development trap" for the Regions which are recipients of this solidarity mechanism.
- Second, it is a more transparent expression of loyalty between regions in a federation.
- Third, it puts an end to the increasing solidarity grants that come from the federal budget since 2000, creating room to meet the rising costs of an ageing population.
- Fourth, it eliminates the rather complicated and strange mechanism, whereby economically weaker regions first contribute to the federal budget, and receive extra money afterwards.
- Finally, as we mentioned earlier, a horizontal solidarity system is better suited to internalize horizontal tax externalities, in comparison to a vertical arrangement.

### 3. Proposal for an Improved SFA

#### 3.1 *Guiding principles*

In order to strengthen the necessary fiscal autonomy and financial accountability of the Regions and the Communities, we propose to replace the current, mainly grant-oriented system of financing arrangements laid down in the Special Finance Act as follows:

1. *The federal grants to the Regions are replaced by an own regional personal income tax (PIT).*<sup>35</sup> The regional PIT should preferably take the form of an additional percentage tariff, applied to the federally defined tax base (possibly within pre-agreed limits to restrict extreme tax competition).
2. *The federal VAT-grant remains the main source of income for the Communities.* But the total grant will be determined as a *fixed* percentage of the federal VAT revenues, which means that it becomes a true shared tax. The horizontal attribution between the Communities will remain unchanged. The horizontal assignment on the basis of

<sup>34</sup> Van Hecke, A. 2009. Revenue equalization and stabilization in the Belgian federation. Working Document Steunpunt Fiscaliteit en Begroting, CES, K.U.Leuven.

<sup>35</sup>This could possibly be extended with a partial regionalization of the corporate income tax, as is the case in other federal states.

school-aged children (between 6 and 17 years) assures a first built-in solidarity mechanism.

3. *The other federal grants to the Communities are substituted by a PIT levied by the Regions, who will transfer the proceeds to the respective Communities.* In the Brussels Capital Region (BCR) the proceeds of this personal income tax are shared between the French-speaking and the Flemish Community on the basis of the current 80/20 division key.
4. *A horizontal, transparent and reversible equalization mechanism, comparable to the German 'Finanzausgleich', is put in place.* This mechanism guarantees to each Region up to 95% of the average per capita PIT-revenues in Belgium. As a consequence, Regions with higher per capita PIT will transfer revenues to the lower per capita PIT Regions. Contrary to the existing SFA arrangements, this solidarity mechanism between the Regions takes into account the PIT revenues which the Regions will transfer to the Communities. In this way, the solidarity mechanism is enlarged because it also applies between the Communities.
5. *The Brussels Capital Region is further entitled to a special compensation for the burden linked to its particular function as capital of Belgium.*
6. *Nothing will be changed, of course, to the current own regional taxes.*
7. *At the start of the system each Region and Community is guaranteed at least the financial resources it is entitled to under the current SFA.*

The new financing system constitutes an improvement with respect to numerous aspects.

- First, the burden and responsibility for the solidarity grants is transferred from the federal government to a mutual responsibility of the Regions.
- Second, it devolves a substantial amount of fiscal autonomy and financial responsibility to the R&C.
- Third, it assures an enhanced simplicity and transparency in comparison with the current SFA.
- Fourth, the system ensures a clear risk- and advantage-sharing of cyclical and structural changes in PIT and VAT revenues by the federal and regional governments.
- Fifth, the solidarity mechanism now also applies to the revenues of the Communities.
- Finally, and perhaps most importantly, the new system offers a much sharper and clearer incentive mechanism for the stimulation of economic growth and employment. An increase of the regional tax base will directly favour the region through extra revenues (whereas the current SFA penalizes an improved economic performance). This "incentivation" of regional governments will also have beneficial effects on the budget challenge of the federal government, especially in the light of the extra costs linked to an ageing population.

### **3.2 How to reform the current SFA?**

In order to demonstrate the aforementioned guiding principles for a more orthodox New Special Financing Arrangement (NSFA), we make a comparison with the outcome under the current SFA. *Table 3* summarizes the financial resources available under the SFA for the R&C on the basis of data for 2005.

Under the proposed NSFA, the own regional taxes and the federal VAT grants to the Communities remain unchanged. But the federal grants to the Communities other than the VAT grants, the federal grants to the Regions, and the federal solidarity grants are replaced by

an own regional PIT that is (preferably) levied as an additional percentage on the federal PIT. In total about 14.8 billion euro of federal grants to the R&C thus become revenue from a regional PIT together with a horizontal equalization mechanism. This represents 47.72 % (about half) of total federal PIT and 11.77 % of the total PIT base in 2005. Based on these percentages we simulate the outcome of the proposed NSFA.

Important to notice is that the definition of the PIT base and the progressivity of the tax rates –and thus the interpersonal redistributive character of the PIT– remain unchanged and within the competence of the federal government in this proposal.

*Table 3: Financing of R&C, 2005 (in 1000€): according to the SFA*

	Flanders (including Flem. Comm.)	Wallonia (including French Comm.)	BCR	Total
1. Own regional taxes	3,424,053	1,521,816	895,896	5,841,765
2. Federal VAT grant to the Communities	6,512,815	4,867,593		11,380,408
3. Federal grants to the Communities other than VAT <sup>36</sup>	3,767,751	2,067,310		5,835,061
4. Federal grants to the Regions <sup>37</sup>	5,068,923	2,412,045	555,767	8,036,735
5. Federal solidarity grant	0	754,199	169,212	923,411
6. Total	18,773,542	11,622,963	1,620,875	32,017,380
<b>7. Total without VAT grants and own regional taxes</b>	<b>8,836,674</b>	<b>5,233,554</b>	<b>724,979</b>	<b>14,795,207</b>
Grants without VAT grant as % of PIT revenues	44.65%	54.97%	46.54%	47.72%
Grants without VAT grant as % of the tax base of the PIT	11.23%	12.70%	12.41%	11.77%

Source: VIVES Beleidspaper 1<sup>38</sup>

### 3.3 Financing of the R&C under the NSFA

The outcome of the NSFA-simulation is shown in *Table 4*. In comparison with the current SFA Flanders (including the Flemish Community) would gain 140.2 mio euro, the BCR 92.4 mio euro and Wallonia (including the French-speaking Community) would lose 232.6 mio euro. According to guiding principle 7, the latter amount is to be compensated by the other two regions in order to leave the starting situation unchanged for all parties involved.

The purpose of the proposed NSFA is to enhance the responsibility of the respective levels of government for their own tax revenues, and thus providing better incentives for good governance and political accountability. Activity enhancing policies are crucial at all levels of government, but especially to stimulate the catching-up of weaker economic regions with the rest of the country. Solidarity and equalization grants are necessary, but of even more

<sup>36</sup> These grants comprise the PIT-grant, the allocation for foreign students and radio and television license fees.

<sup>37</sup> These grants include the PIT-grant and grants for unemployment relief works.

<sup>38</sup> Algoed, K., Heremans, D. en Peeters, T. Oktober 2008. Een Staatshervorming als Reddingsboei voor de Overheidsfinanciën, Vives Beleidspaper 1.

importance is a successful policy of higher employment levels and economic growth. Taking incentives for enhanced regional performances into account, we take a look at where this could bring us by considering a ‘convergence scenario’. Given the significant disparities in the regional employment rates<sup>39</sup> we notice that there is plenty of room for activation of the labour market which could trigger interregional convergence. In our reference year 2005, the Flemish employment rate of 65% is substantially higher than the employment rates of Wallonia (55.9%) and Brussels (49.2%).<sup>40</sup> Moreover, when comparing those figures to 93 EU27-regions, we see that even Flanders ranks only among the average performers, while Brussels and Wallonia are part of the worst performing cluster of 12 regions.<sup>41</sup>

For the simulation of our convergence scenario, we look at a convergence of activity rates<sup>42</sup>, which make a correction for commuting between regions. In practice, we look at the influence on the tax base of a convergence of the activity levels of Wallonia and Brussels to the activity level of Flanders<sup>43</sup>, and we simulate what would have been the funding of the R&C under the NSFA. The results are presented in the second part of *Table 4*.

**Table 4: Financing of R&C, 2005 (in 1000€): according to NSFA<sup>44</sup>**

	Flanders (including Flemish Comm.)	Wallonia (including French Comm.)	BCR
<b>Current SFA</b>			
Federal grants (excl.VAT)	8,836,674	4,479,355	555,767
Solidarity transfer	0	754,199	169,212
<b>Total</b>	<b>8,836,674</b>	<b>5,233,554</b>	<b>724,979</b>
<b>NSFA</b>			
Revenues from PIT	9,180,978	4,460,260	1,153,969
Solidarity transfer	-313,130	104,790	208,340
Community transfers from BCR	108,985	435,939	-544,923
<b>Total</b>	<b>8,976,833</b>	<b>5,000,989</b>	<b>817,385</b>
<b>NSFA Convergence scenario</b>			
Revenues from PIT	9,180,978	4,879,490	1,416,054
Solidarity transfers	-8,989	0	8,989
Community transfers from BCR	114,003	456,014	-570,017
<b>Total</b>	<b>9,285,992</b>	<b>5,335,504</b>	<b>855,026</b>

Source: VIVES Beleidspaper 1

In practice, we start from the working age population in every region. Next, we assume that Brussels and Wallonia reach the Flemish ratio of active versus inactive population. This will increase employment in Brussels and Wallonia by respectively 124,442 and 224,096

<sup>39</sup> The employment rate is defined as the ratio of working people that live in a particular region to the number of people of working age in that region.

<sup>40</sup> Data from [www.steunpuntwse.be](http://www.steunpuntwse.be).

<sup>41</sup> Vives Beleidspaper 1 and Stevens, E., De Winne, S. & Sels, L. 2007. Europa regionaal. Arbeidsmarktprestaties in een comparatief perspectief, Steunpunt WSE rapport 2007.

<sup>42</sup> The activity rate is defined as the ratio of the number of people who work in a particular region over the people of working age in that region.

<sup>43</sup> The tax base of a region depends, among other things, on the ratio between the active and inactive part of the population. This ratio is partly driven by demographic factors (the number of pensioners, the size of the population of working age, ...), but also by the labour market performance (employed versus unemployed, public or private employment, structural or cyclical unemployment...).

<sup>44</sup> In the following calculations, only PIT revenues are considered (VAT grants and regional taxes are not included). Calculations are based on a regional tariff of 11.77% in the personal income tax, an equalization to 95% of the national average and settlement for Community means in Brussels.

people.<sup>45</sup> An enlarged working population is reflected in an increased tax base and higher own regional PIT revenues as shown in *Table 4*.<sup>46</sup>

Two important conclusions result from this simulation.

- First, solidarity transfers almost disappear. Only a small equalization grant from Flanders to BCR of about 9 mio euro remains. The often claimed need for solidarity between ‘rich’ and ‘poor’ appears to be rather a solidarity between a more active population in one part of the country and a more inactive population elsewhere. It makes an activity-enhancing fiscal system for the Regions all the more compelling.
- Second, all Regions improve their financing base. Flanders (including the Flemish Community) by 5.1% because of much lower equalization transfers. Wallonia (including the French-speaking Community) by 1.9% and BCR even by 17.9% because of higher own PIT revenues, notwithstanding lower solidarity transfers.

The importance of a solidarity mechanism that reduces disparities in fiscal capacity is illustrated in *Table 5*. The interregional disparities in average per capita tax base are substantial. However, the convergence scenario reduces them significantly.

*Table 5: Average tax base<sup>47</sup> per capita in € (convergence scenario)*

Average tax base per capita (in €): incomes 2005			
Belgium	Flanders	Wallonia	BCR
11962.87	12836.88	11103.85	9626.70
Deviation from the national average	+7.31%	-7.18%	-19.53%
Average tax base per capita (in €): Convergence scenario			
Belgium	Flanders	Wallonia	BCR
12513.75	12836.88	12147.52	11813.08
Deviation from the national average	+2.58%	-2.93%	-5.60%

Source: VIVES Beleidspaper 1

Most importantly, the budgetary situation of the federal government and the social security system would also improve substantially. Under the considered convergence scenario, total regional PIT revenues increase by 681.3 million euro. The federal government tax revenue increases by a similar amount. The income tax base of the active population goes up by 6.4 billion euro, whereas that of the unemployed population decreases with 604.7 million euro (which results in a net increase in the income tax base of 5.8 billion euro).<sup>48</sup>

### 3.4 *Effect on per capita budgets of Regions and Communities*

We now look at the effect of the two scenarios on the financial means of the Regions and the Communities separately. Figures 2 and 3 allow a comparison of per capita means. The budgetary means of the Communities in

<sup>45</sup> This would be a large step in the direction of the objective of 500,000 extra people at work proposed by representative employers organizations some time ago.

<sup>46</sup> We suppose that the extra employed people in Brussels and Wallonia earn the current average regional income.

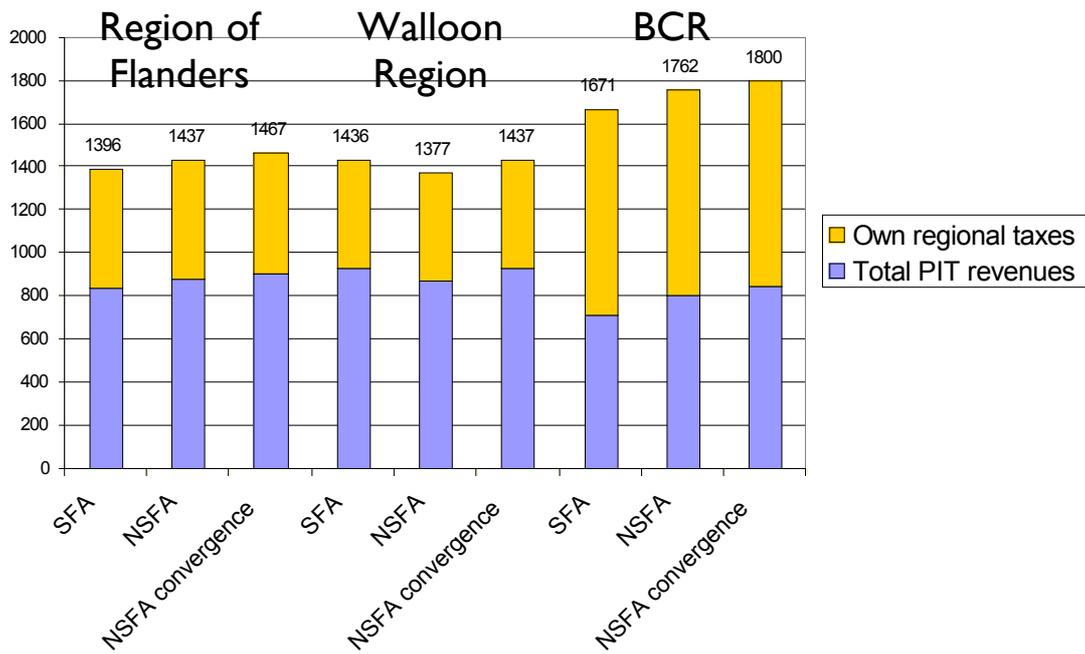
<sup>47</sup> Remark that these regional tax bases already include the interpersonal solidarity through the social security system.

<sup>48</sup> The social security contributions will, of course, also benefit from the convergence scenario. A rough estimate puts these benefits at 1.1 billion euro for Wallonia and 207.4 million euro for Brussels.

*Figure 3* are the sum of the share of each Community in the VAT revenue and the transfer of 40% of the regional PIT. For BCR, this latter amount is split according to the 80/20 key. For Wallonia, we use a transfer of 35% instead of 40% of the regional PIT to the French-speaking Community, in order to create a win-win-situation for every entity. The VAT revenue is shared between the Flemish and the French-speaking Community on the basis of the relative share of school-aged children between 6 and 17 years.

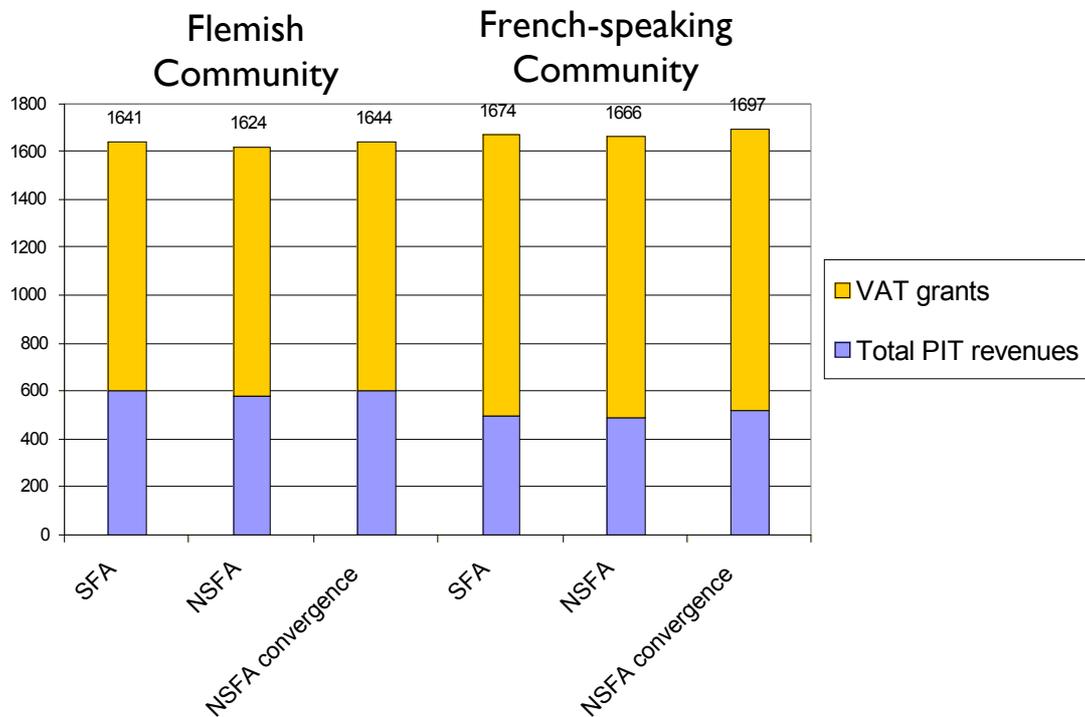
Under the current, mainly grant-based SFA BCR receives only 715.8 euro per capita compared to 836.3 euro for Flanders and 929.9 euro for Wallonia. But BCR more than compensates this with significantly higher own regional tax revenues on a per capita basis than Flanders and Wallonia (but these higher own regional taxes are not taken into account in the calculations of the equalization scheme). Moreover, it is clear that especially BCR benefits from our alternative scenarios.

Figure 2: Funding of the Regions: budgetary means in € per capita in 2005



Source: VIVES Beleidsplan 1+own calculations

Figure 3: Funding of Communities: budgetary means in € per capita in 2005



Source: VIVES Beleidsplan 1+own calculations

### 3.5 *Extra compensation for Brussels for the burden as federal capital?*<sup>49</sup>

So far we have not included any extra grant to BCR to compensate for its burden as federal capital. This is mainly a political matter and in this respect there are no simple rules to apply. An argument often put forward to give extra financial resources to BCR refers to the share of BCR in the national GDP: 20%, compared to a population share of 10%. To the extent that this is a valid argument, it should be dealt with through a regional production tax<sup>50</sup> alongside the regional PIT and the regionalized share of the (VAT) expenditure tax. A regional PIT transfer from Flanders and Wallonia (or from the federal budget), based on the number of commuters that earn their income in BCR but pay taxes in their region of residence, is not the right answer to this issue.

Compensating BCR for the high net labour inflow would in principle require double taxation agreements with Flanders and Wallonia (as is the international practice), in order to avoid double (income) taxation.

Arguing that BCR should be compensated for the congestion costs caused by the large net labour inflow is a more sensible argument. But simple compensation for these negative externalities through extra federal grants does not stimulate BCR to directly address these congestion problems. Such a subsidization of the BCR congestion costs will have a perverted effect. It would give the BCR government a permanent incentive to increase the net labour inflow at the expense of work for its own citizens, especially under the current SFA. The subsidy will rather create more congestion and thus more costs. A more efficient solution is to discourage congestion (and the net labour inflow) and thus tax the commuting phenomenon itself. This would at the same time provide an extra incentive to put more people living in BCR at work.

As mentioned under the guiding principles, we do not exclude extra financial resources for the burden of BCR as the Belgian and European capital. But the arguments put forward so far by the supporters of extra financial compensations are less convincing than they would like them to be. Moreover, more money for BCR can hardly be dissociated from an in-depth discussion about the efficiency and the overall structure of the BCR governing bodies.

## 4. *Final comments*

It should be kept in mind that the previous conceptual exercise is limited to a kind of comparative static framework for 2005, mainly based on tax data. Compared to the current SFA, a new NFSFA is devised in order to give the proper incentives for activity enhancing policies. Only the additional employment effects are simulated under the benchmark case of a convergence scenario, which allows to compare these effects on the financing of the R&C to a NSFSA without convergence and to the current SFA. No time path is set forward, and productivity growth and inflation, necessary to reflect the true numbers of funding of the R&C in the future, are not taken into account. Such an exercise requires a more encompassing model making predictions for the future. Within the context of the wider Vladymo model<sup>51</sup>, taking also demographic evolutions, regional GDP growth and inflation into account, a similar convergence scenario for employment is in the process of being simulated. The first results confirm the win-win outcomes for the R&C, but even more importantly for federal finances and social security.<sup>52</sup> Remark that, besides considering a convergence scenario of Wallonia and Brussels catching up with Flanders, in a European

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<sup>49</sup> See also Algoed, K. April 2009. *De onderfinanciering van Brussel: een mythe?* Vives Beleidspaper 7. April 2009.

<sup>50</sup> This could be an argument for regionalization of the corporate tax.

<sup>51</sup> Vlaams Dynamisch Model van de Overheidsfinanciën.

<sup>52</sup> For the Vladymo model, see a recent study by Algoed, K., Heremans, D., and Van Hecke, A. Maart 2009. *De impact van de vergrijzing op de overheidsfinanciën: eindrapport. Steunpunt Fiscaliteit en Begroting.*

context there is still room for improvement in Flanders too. Taking enhanced Flemish performances into account would even strengthen the win-win-situation.

The implementation of the NSFA has a negative impact at the start for the funding of some federated entities, when compared to the current SFA. Indeed, the beneficial effects will only become visible by creating employment along the path towards convergence. In particular the consolidated entity Wallonia-French-speaking Community should be compensated at the start according to guiding principle 7 (see *Figure 6* in Appendix). Hence, a *transition scenario* that, however, maintains the necessary incentive effects should be developed: e.g. on top of the necessary compensation at the start of the NSFA they already could be granted gradually by anticipating some of the benefits they are entitled to in the PIT as they proceed in creating additional employment. As for the entities that gain at the start, i.e. BCR and Flanders, they could only gradually be granted these additional means.

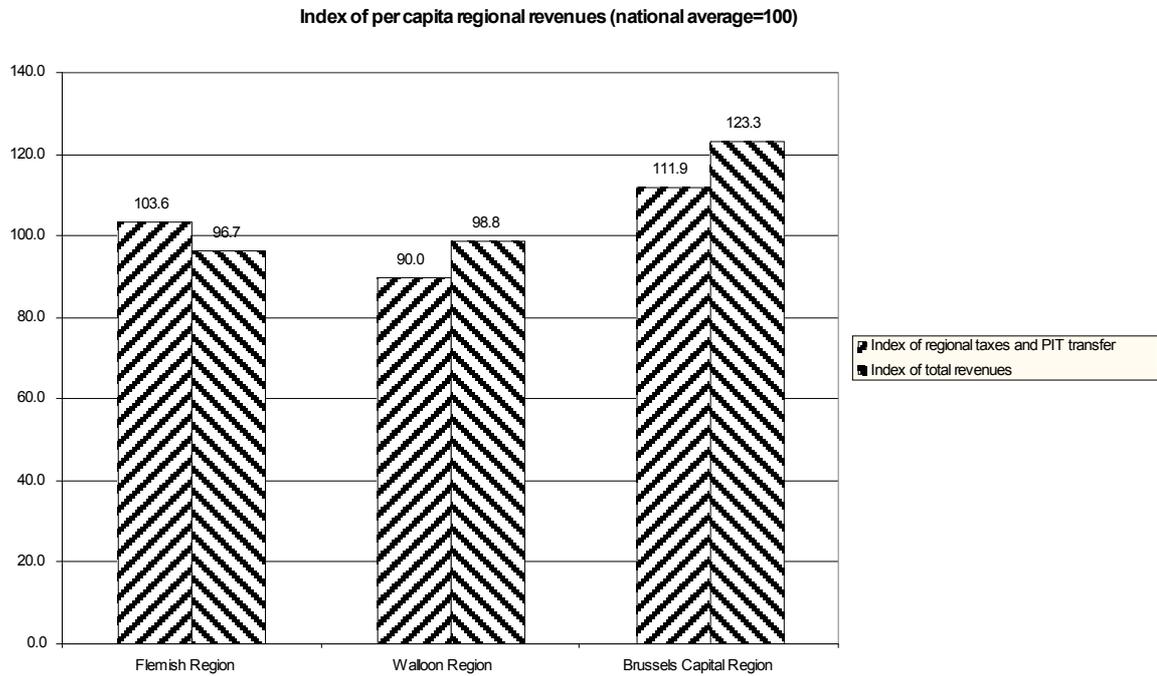
Finally, the transition towards convergence could eventually be further activated by providing in the transition phase specific incentives for employment as they can be derived from several recent proposals for regional labour market policies (RLP).<sup>53</sup> Such proposals may be useful to stimulate economic activity and reduce unemployment. However, as the financing relies mostly on federal grants, they increase the fiscal gap and reduce fiscal responsibility. This is to be avoided by combining the RLP programs with the new financing system (NSFA), allowing to gradually replace (part of) the grants by personal income tax (PIT) as convergence proceeds. Hence, the RLP programs would not evolve into an additional grant system becoming permanent, but would be replaced in the process and sustained by additional PIT income. The elaboration of such scenarios and their assessment await further simulations within a more comprehensive model (Vladymo).

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<sup>53</sup> For RLP, see Dewatripont, M., Struyven, D. 2009 Garantir une "solidarité responsable et durable" en Belgique en améliorant les incitations à la création d'emplois par les entités fédérées? In: *Quel état pour quelles performances économiques? Proceedings of 18e congrès des économistes Belges de langue française*, and Van Rompuy, P. 2009. Regional labour market policies: scope and limits in a federal state. In: Re-Bel e-book 2.

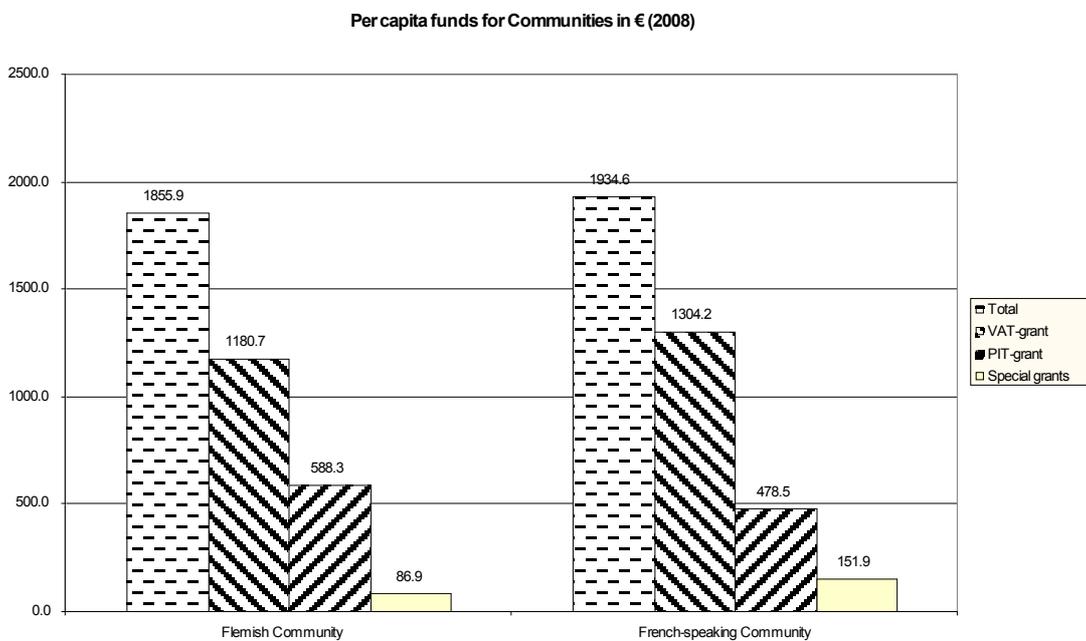
# APPENDIX

Figure 4: Index of per capita regional revenues (national average = 100) (2008)



Source: Own calculations

Figure 5: Per capita funds for Communities in € (2008)



Source: Own calculations

Figure 6: Budgetary means of R&C under the SFA and the NSFA in 2005 (in 1000€)

