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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[1] 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)[2], additional PIT grants for transferred competences[3], 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). Moreover, it is made *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.

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.

First, the following parts of the SFA which need to be corrected:

- Horizontal externalities between regions[4] 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).
- Pervert effect of the equalization mechanism as when a region improves its economic performance, the decrease in revenues coming from equalization mechanism is more important that the increase in revenues coming from the larger share of the PIT grants, leading to a 'development trap' as first shown by Cattoir and Verdonck (2002). 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.

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[1] See for instance Heremans et al. (2008), Kirsh (2008), Verdonck et al. (2009).
[2] Compensation for the revenues of the federal taxes transferred to the Regions.
[3] Agriculture and sea fishing, scientific research in agriculture, foreign trade, and provincial and municipal law.
[4] The term "Region" refers to the political entity whereas "region" refers to the the territorial entity.

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

- The use of the tax autonomy of one region does not directly affect the revenues of the other regions. Moreover, boundaries to tax autonomy of the regions are set to alleviate harmful tax competition (race to the bottom)[5].
- 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 (gross) equalization mechanism.

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

- The charges of the Brussels region as a capital city of the federation where many non residents are commuting and consuming public services without affecting their PIT at their Brussels workplace.
- The future cost of ageing that will mainly be supported by the federal level should be taken into account[6]. Indeed, according the Federal Planning Bureau, the needs of the Entity I (comprising the federal level and social security) will be proportionally much more important than the needs of the Regions and Communities[7].

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 share the PIT revenues. One part goes to the Regions and the Communities and the other part to the federal level. The part going to the Regions and Communities replaces the current PIT grants *sensu lato*. For simplicity, we consolidate on a territorial basis the Regions and the Communities and leave to each territorial authority the sharing of its means between Regions and Communities[8].

Thus, our proposal takes place in four steps.

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

The main part of the PIT revenues of a region comes from a Regional and Proportional PIT levied on the tax base of the citizens of the region (the so-called RP-PIT). The remaining PIT revenues go to the federal level, which also decides on the progressiveness of the PIT's rates.

At the beginning of the implementation of the system, all regions have the same RP-PIT (the reference RP-PIT rate). Then, 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

[5] 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.

[6] 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.

[7] Economic Forecast 2009-2014 of the Federal Planning Bureau.

[8] Thus region means the territorial entity, whereas Region (with block letter) means the political entity.

their citizens' tax credits that are related to their exclusive competences. If they do so, they receive less PIT revenues. The regional tax autonomy is exercised within certain limits which are decided by consensus[9].

Thus our system ensures that there is a direct link between the economic performance of a region and its public resources and that any decision of one region affects only its own resources and does not impact the resources of the other regions (no horizontal externalities).

Step 2: A vertical equalization (solidarity) mechanism

In a second step, our proposal provides for a vertical (gross) 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:

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

Where γ 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*,
a 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). It is vertical to ensure that institutional solidarity remain the responsibility of the federal and be stable over time.[10]

Step 3: A basis to ensure revenue neutrality in the first year

A fixed compensation ensures budgetary 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: A possible additional financing for Brussels region and the federal level

Finally, our proposal allows for a progressive additional financing by the federal level to Brussels region in order to take into account its charges as the capital city of the federation. It also allows for a progressive additional financing of the federal level, by the different regions

[9] If it is decided to maintain the same boundaries provided in Art. 9 SFA (i.e. 6.75 % of the PIT), that would mean boundaries of 1.4% of the RP-PIT as the latter is calculated on the tax base and not any more on the income tax.
[10] Heremans et al. (2008), and Verdonck *et al.* (2009) are in favour of a horizontal equalization mechanism.

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. Those additional financing are provided from 2011.

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

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 the role of capital city generating an important part of the Belgian GDP.

(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 is decided by the federal level and that equalization mechanism remains vertical.

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

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

4.1. Economic and demographic assumptions

The revenues taken into account

Under the assumptions explained 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 *sensu stricto*	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
Total	**877**	**5 528**	**3 366**	**9 771**

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 *sensu strict* 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[11]	514	3 585	1 568	5 668
Total	**1 391**	**9 114**	**4 934**	**15 439**

Source : CERPE

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

[11] 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.

Data for the basis scenario

First, the three regions adopt an identical rate for the RP-PIT at 8.37% in our basis scenario. 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.

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

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

Fourth, an additional financing of 100 million EUR is foreseen for Brussels and of 700 million EUR for the federal level in 2015. Such amounts are purely illustrative and do not prejudge of any amount that may be objectivised[12] 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 beginning in 2011.

4.2. The PIT resources for the regions : basis 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 (percentage rate at 85%)				
	Brussels	**Flanders**	**Wallonia**	**Total**
2010	249	0	278	527
2015	386	0	340	726
Step 3: Compensation to ensure first year revenue neutrality in 2010				
	Brussels	**Flanders**	**Wallonia**	**Total**
2010	0	174	310	484
2015	0	174	310	484
Total of resources (without additional financing for Brussels and the federal level)				
2010	1 391	9 114	4 934	15 439
2015	1 723	11 101	5 936	18 760

[12] See for instance Lambert *et al.* (1999), Cattoir *et al.* (2009).

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

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

Source: CERPE

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

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

Source: CERPE

4.3. 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 budgetary 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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ANNEX: NATIONAL AND REGIONAL GROWTH ASSUMPTIONS

Data	**Source et last available data**	**Forecast methodology**
PIT revenues	Ministry of Finance : PIT by Regions (tax year 2007, income year 2006)	**At the national level** : Economic Forecasts 2009-2014 of the Federal Planning Bureau **At the regional level** : Forecasts on the basis of past growth differential
Inflation	Ministry of Finance : CPI (May 2009)	Economic Forecasts 2009-2014 of the Federal Planning Bureau
National growth of GDP	ICN : (National Account up to 2007)	Economic Forecasts 2009-2014 of the Federal Planning Bureau
Tax base	DGSEI[13] : Tax statistics up to tax year 2006, income year 2005	**At the national level :** Evolution of the unemployment and retirement benefits according to the growth rate of the social benefits assessed by the Economic Forecasts of the Federal Planning Bureau Evolution of other income according to the growth rate of the wages assessed by the Economic Forecasts of the Federal Planning Bureau **At the regional level :** Forecasts on the basis of past growth differential
Forecasts of data in 2015		Average of growth rate for 2011-2014 (Economic Forecasts 2009-2014 of the Federal Planning Bureau)
Population	DGSIE : Data on 1 January 2008	Population forecasts of the Federal Planning Bureau 2007-2060, updated with data of 1 January 2008

[13] Directorate-General Statistics and Economic information.