Intergovernmental Fiscal Relations, and Structural Problems of Federalism in Belgium

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Executive Summary

Background

1. Belgium has undergone a dramatic process of transferring powers from the federal to the regional and community authorities since 1970. The major reforms of 1988-89 not only asserted the Communities, but also established the Regions as equal partners within central government and bestowed them with substantial expenditure functions.

2. Measured in terms of primary public expenditures net of intergovernmental transfers, the federal government’s share of GDP has shrunk to 8 percent in 2005, without social security funds. This compares to 11.5 percent of GDP for the Regions and Communities, and 6.6 percent of GDP for local governments. The social security funds absorbed 19.4 percent of GDP.

Vertical fiscal imbalances

3. The federal government is an important broker in the presence of fiscal conflicts among regional government and emerging vertical fiscal imbalances. To achieve political consensus the federal government has tended to “bail-in” Regions and Communities through financial concessions. Often enough the federal government has shied away from including sub-federal entities into co-responsibility.

4. Moreover the federal government was stripped of a large part of its assets, but left with most of its explicit and implicit liabilities, in particular for national public debt, pensions, and health programs. While national debt appears to have come under control over the last 10 years, the pensions and health expenditures will be particularly sensitive to the costs of ageing. This foreshadows vertical fiscal imbalances that will put pressure onto the federal government’s budget.

5. Roughly 90 percent of age-related expenditures fall onto Entity I (federal government plus social security funds), only the smaller portion on Entity II (regions, communities, local governments). So in Belgium the generation conflict finds its expression in an institutional conflict between layers of government.

6. As to vertical fiscal balance there are doubts whether the Belgian fiscal arrangements will be sustainable beyond 2012 without reform. The long-lasting political rows between Regions and Communities that have absorbed (and are still absorbing) so much political energy are likely to be compounded by the imminent problems of vertical fiscal imbalances.

Tax competition

7. The grants arrangements are basically immune to changes in federal tax policy, and hard to change in practice. However this gives the federal government a strong position when negotiating with the Regions and Communities. Moreover the federal government could use its policy lever to increase tax revenue for Entity I unilaterally since the grants to sub-federal entities do not follow automatically. And it could use federal tax policy to mitigate horizontal fiscal imbalances by restructuring the tax system (increasing VAT while decreasing personal income tax). This could be an important advantage when addressing fiscal rebalancing and the financial problems of ageing simultaneously.

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1 The debt on social housing is the only exception.
8. The devolution of taxing powers to the Regions following the Lambermont Agreement has increased the risk of horizontal tax competition. However it is contained at the regional level through effective policy coordination. But there are continuing demands for extending the Region’s taxing powers even further. In particular the request to transfer business taxation – in particular the corporate income tax – to the Regions raises concerns. It would increase the risks of harmful horizontal tax competition.

**Intergovernmental fiscal relations**

9. The intergovernmental fiscal arrangements in Belgium are formally transparent. They allow focusing on strategic aspects of vertical fiscal imbalances and sustainability irrespective of interjurisdictional conflicts at the same level of government. They also allow identifying structural horizontal imbalances.

10. Horizontal imbalances have emerged from economic developments that have tended to favor the Flemish Community/Region. Flanders’ favorable relative position is reflected in personal income taxes collected on its territory, which in turn impinges upon its budget through the grants system.

11. Regional asymmetries pose de facto a dilemma for the federal government, which has to act in a symmetrical fashion in political terms. While a moderate equalization program (« solidarité nationale ») was acceptable to the parties, this program is insufficient to cope with remaining horizontal fiscal imbalances. These will jeopardize coordinated political action to address the vertical imbalances resulting from ageing, because the economically weaker partner is likely to expect others to bear the costs of adjustment.

**Outlook**

12. Given these economic and political constraints it is important to keep a firm grip on budget constraints at all levels of government. Relaxing it for one entity asymmetrically will put the necessary national consensus in question. Moreover a hard budget constraint is needed to spur structural reforms at all levels of government.

13. The Mission has doubts about the chances of re-negotiating the basic principles of the grants system in the near future, so the policy options in Belgium would have to focus on two alternative strategies: one that puts the focus on federal tax policy; the other that emphasizes a decentralization of age-related expenditure responsibilities. Both policy options offer a number of possibilities to redress fiscal imbalances implicitly.

14. Difficult as these policy choices may appear, they are necessary in view of pending contingencies and future challenges. It is the Mission’s belief that eventually a consensus will be reached on these issues. Belgian Federalism has put in place a number of coordinative instruments and institutions that could be further developed to reach these goals.
Introduction

1. Belgium is a constitutional monarchy and a federal state with a number of unique features. Given its unitary past it has a central government with lower-tiers autonomous territorial jurisdictions, the provinces and municipalities with their own executives and elected local councils. In that respect Belgium is comparable to many other countries. What is unique is that the central authority is shared between a federal, and regional and community governments and their corresponding parliaments that act in conjunction, and at par, with each other. This entails additional complexities in view of the transparency of fiscal and budgetary arrangements.

2. Initially – and these are a singular feature of federalism in the world – three distinct “personalized” entities were created to account for linguistic and cultural differences in Belgium: the Flemish-speaking, the French-speaking and the German-speaking Communities. The Communities complement three regional authorities with territorial competencies: the Flemish Region, the Walloon Region, and – later – the Capital City of Brussels. Each of the Communities and Regions has its own government and parliament, each controls certain legally defined expenditure functions, and each disposes of own revenues, mostly in the form of intergovernmental transfers.

3. The community and regional concepts gave rise to a number of asymmetries. For instance the Flemish Region and the Flemish Community have “merged” their institutions, notably their budgets, which is not the case in the rest of the kingdom. The French-speaking Community and the Walloon Region can mutually transfer (and have transferred) certain functions to each other, which entails additional complexities. Given that the German-speaking Community is territorially part of the Walloon Region, the latter can transfer (and has transferred) competencies to the German-speaking Community.

4. As regards the Capital City of Brussels role of the Communities has been complicated by the fact that only limited functions are clearly tied to a particular linguistic group (e.g., francophone schools). To overcome these limitations three separate institutions have been created that exercise Community functions in Brussels’s 19 municipalities: the Flemish Community Commission, the French Community Commission, and the Joint Community Commission. Again each of these Commissions has a legislative body (assembly) and an executive (college). Given the large number of institutions in Belgium it is obvious that politicians and parliamentarians typically assume more than just one function, i.e. public institutions are personally intertwined.

5. Clearly the division of public functions and the resulting financial arrangements of the Belgian State must at first seem bewildering to an outside observer, but they are less intransparent than might appear. The expenditure functions are reasonably well distinguishable by jurisdiction, in fact with some overlap but not worse than in other decentralized countries. The taxing powers of each layer of government are well defined, and the intergovernmental transfer system is formally transparent. Moreover the allocation of functions and the financial arrangements rest on firm legal ground, which is dependable and even more difficult to change than in most other federations.

6. Nevertheless there exists a number of fiscal conflicts between the various jurisdictions that exhibit elements of interjurisdictional tax competition, an implicit redistribution of funds with lacking transparency, vertical and horizontal fiscal imbalances that could intensify over time, and a general need to coordinate budgetary and fiscal policies in view of shared national
and supranational policy goals such as the sustainability of public budgets at all levels of
government, the avoidance of internal tax competition, the control of consolidated deficits and
public debt in accordance with the European Stability and Growth Pact, and public savings to
accommodate the cost of ageing.

7. In order to get a picture on how to coordinate such policies, there are a number of
institutional and contractual arrangements and elements of cooperative federalism in Belgium
that need further examination.

The assignment of functions

8. The assignment of expenditure functions to the Communities is defined in Articles
127 to 130 of the Constitution (1994 coordinated version). Basically these are: cultural affairs,
education, use of language (except for the German-speaking Community), and the
cooperation among Communities and with international bodies on cultural and educational
affairs. Article 4 of a Special Law passed with qualified majorities in 1980 further specifies
these functions.

9. The same Special Law of 1980 (Articles 6, 6bis, and 7) identifies the competencies of
the Regions: management of the territory, environment, management of water and rural
resources, conservation of nature, housing, economic and energy policies, public works and
transport, employment policies, and the supervision of lower tiers of government. More
recently, as a result of the Lambermont Agreement of 2001, the federal level ceded further
functions to the Regions, in particular agriculture, science related to agriculture, and foreign
commerce.

10. It is obvious that the functions of the Communities follow a personal principle while
those of the Regions are territorial-based. But the capture of regional functions by the Flemish
Community and the transfer of functions between the Walloon Region and the French
Community have blurred this conceptual distinction. For instance the French Community
(Saint-Quentin Agreement of 1993) has transferred its competencies in sports, tourism, social
promotion, school transport, health policy and social support to persons to the Walloon
Region. And the Walloon Region has transferred certain regional functions to the German-
speaking Community (e.g. employment policy). These transfers of functions were effected in
the spirit of contractual federalism with a view toward eliminating emerging fiscal imbalances
between entities. Despite involving an element of negotiation, these arrangements cannot be
said to be non-transparent because they were politically controlled, follow a contractual logic,
and were cast into pertinent legislation (decrees).

11. There are no concurrent competencies among the Belgian jurisdictions as in other
federations. Every function not explicitly transferred to non-federal entities for now remains
in the hands of the federal authorities. This also renders the arrangements more transparent
than in other federations (e.g. Germany). So important residual federal powers remain such as
defense, foreign affairs, police, and social security. Also policy for the most important taxes
(VAT, personal income tax, corporate income tax) remains an important prerogative of the

2 The Constitution gives the residual competencies to the Regions/Communities, but the
implementing Special Law has not yet been approved (Article 35).

3 However more recently, local police zones have been formed that involved the re-
assignment of federal police staff to the local level, which is financed, partly, through federal
grants to local governments.
federal government. This will be of crucial importance for the future, and give the federal government an important policy lever to achieve political consensus.

12. While a transfer of public assets accompanied the transfer of functions to Communities and Regions, the liabilities have largely remained on the budget of the federal government. This had important repercussions when the level of public debt was still very high – peaking slightly above 135 percent of GDP in the early 1990s – and interest rate levels included higher inflationary and risk premiums. Although the so-called “snow-ball effect” of public debt is now under control, federal indebtedness continues to bear on intergovernmental fiscal relations.

13. For 2005 the relative importance of the different layers of government in Belgium is illustrated in Chart 1 (NAI classification). It is shown in terms of their relative share in primary expenditures, primary expenditures net of intergovernmental transfers, primary balances, and net financing as percentages of GDP.

14. It is noteworthy that – of a total share of 45.5 percent of GDP for primary public expenditures net of intergovernmental transfers – the federal government executed 17.6 percent, Regions and Communities 25.3 percent, local governments 14.5 percent, and social security funds 42.6 percent. Chart 2 depicts the shares of total spending, including interest payments, by level of government. It demonstrates that the servicing of public debt falls almost entirely onto the federal government. Its interest payments represented 8.2 percent of total government spending in 2005, or 4.1 percent of GDP.

4 In 2005 interest charges of general government were 4.4 percent of GDP (compared to 8.9 percent in 1995), of which the federal government carried 94 percent of the total (National Bank, Report 2006).

5 Charts 1 through 3 are based on the Report 2006 of the National Bank (published February 2007).
The financial arrangements: vertical dimension

15. The present intergovernmental financial arrangements were established through the major institutional and financial reforms of 1988 and 1989, in particular through a Special Law of January 16, 1989, which was amended by the Special Law of July 13, 2001, following the Lambermont Agreement.

16. For evaluating these intergovernmental financial arrangements, it is useful to distinguish between aspects of vertical and those of horizontal fiscal balance.

17. As regards the vertical fiscal balance, the following characteristics of the arrangements are worth noting:

**Taxing autonomy**

18. *The federal government* retains the prerogative to define tax bases and rates for all of the important taxes. Federal tax policy is practically the only instrument for redressing vertical fiscal imbalances in Belgium since the grants system is virtually “cast in stone”.

19. *The Regions* obtained, as a result of the Lambermont Agreement, restricted sovereignty on a number of regional taxes although most of these taxes continue to be administered by the federal government. The Regions can legislate on these decentralized taxes and benefit directly and exclusively from their proceeds. Some tax policy measures require the previous consent of the other two Regions however.

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6 The term “vertical imbalance” is not strictly correct for Belgium because the federal, regional, and community governments are at par. However we shall continue to use this terminology as is common international practice.

7 These taxes are *inter alia* the property transactions tax (*droits d’enregistrement*), the taxes on gifts and inheritances, the motor vehicle tax (*taxe de circulation*), the property tax (*précompte immobilier*), and certain stamp taxes or fees (radio and television, gambling and betting, automatic amusement devices, *eurovignette*). In 2004 these taxes produced 30 percent of total revenue of the Walloon Region, and 38 percent of those of the Flemish Region.
20. This transfer of taxes to the Regions has not quenched their thirst for additional taxing autonomy, and there are claims, in particular in Flanders, to obtain control over business taxes, notably the corporate income tax. If accepted, it would introduce an important additional element of horizontal tax competition, which could be harmful for the regions. It could erode the taxable potential of this tax, which is already under strain from international tax competition.

21. In addition to their own taxes, the Regions receive two types of federal transfers: a transfer said to be based on the regionalized revenue from personal income tax, and an equalization grant: a “national solidarity” transfer. It is important to note that the volume of these transfers is totally detached from the proceeds of any particular tax, which renders them immune against the vagaries of the business cycle. Moreover the Regions can levy their own taxes – provided these do not conflict with federal tax law –, they control non-tax revenue and are allowed to borrow from the capital market.

22. The Communities do not possess own taxes and are (almost) totally dependent on federal transfers. These transfers are of three types: a transfer based on the regionalized revenue from personal income tax (similar to the one perceived by the Regions); a transfer said to be based on VAT; and selected smaller transfers reflecting historical circumstances.

(Chart 3: Revenue composition of government accounts)

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8 The term “tax sharing” is therefore misleading. Nevertheless we shall use the term in line with familiar Belgian concepts.

9 Communities also have some non-tax income.

10 These smaller transfers include a compensation for the cession, in 2001, of the radio and television fee to the Regions, a share of the National Lottery, and a compensation for foreign university students.
**Intergovernmental transfers**

23. A detailed picture of vertical intergovernmental financial flows for the year 2005 is found in Chart 3. It reveals the importance of fiscal imbalances between the federal and other layers of government in Belgium.

24. In order to assess the vertical fiscal implications of intergovernmental financial arrangements it is necessary to have a look at the working of the most important transfer mechanisms, those relating to (i) personal income tax sharing, including (ii) a so-called negative term, (iii) the interregional equalization grant (“national solidarity”), and (iv) VAT sharing.

(i) *Personal income tax sharing*. The sharing of the personal income tax between the federal government on the one hand, and Regions and Communities on the other, is *not* based on the derivation principle as in other countries, i.e. one cannot say that a certain percentage of the regionally collected tax is returned to the Region or the Community. The mechanism rather works through formula allocation and the transfer is basically an indexed fixed base grant. The size of the income tax pools and their allocation onto Regions and Communities was established for the base year 1989 in accordance with the total of the previous federal grants plus the costs of newly acquired outlay responsibilities (except for education), and then indexed to account for inflation and – later – for growth.\(^\text{11}\)

(ii) *Negative term*. Given that the cession of taxes to Regions following the Lambermont Agreement has substantially increased their own revenue capacity, the vertical budgetary impact of these arrangements was neutralized through a so-called negative term (« *terme négatif* ») that is incorporated into the personal income tax sharing arrangements with the Regions (but logically not with the Communities). The amount is again based on a formula, but fixed yearly by a Royal decree of the federal government after consultation with the Regions. The formula converts the average yearly revenue of the ceded taxes for 1999 to 2001 into an adjusted base figure for 2002, which is then indexed for inflation and for 91 percent of the real growth rate.\(^\text{12}\) This correction expires in 2012.

(iii) *Equalization grant*. There is also an equalization grant the cost of which is fully borne by the federal government. It is worth noting that this mechanism, contrary to other transfers, is an “open pool” since it is sensitive to population growth and the shortfall of per capita personal income tax in the poorer region(s) relative to the national average. However its impact onto the federal budget is limited in the longer

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\(^{11}\) For a transition period of ten years the growth factor was set to 0 percent, which tended to twist the vertical fiscal balance in favor of the federal government. This element (no growth factor) was eliminated in 1999. During the transition period there were further elements favoring the federal government through interjurisdictional borrowing that need not be considered here.

\(^{12}\) There is a special provision for radio and television fees. There is also an additional transitory correction of the negative term, by which the calculated revenue for 2002 is compared with the actual revenue under a no-policy-change assumption. This complication is unlikely to have a significant effect in a growing economy.
run since there is no indexing for growth. It is likely to decline in relative terms eventually.

(iv) VAT sharing. As for personal income tax sharing the VAT share (« masse TVA ») is based on a formula allocation mechanism, which is again fully detached from VAT revenue and its development. The grant is used to finance education expenditures, which represent about half of the expenditures of sub-federal entities in toto. These outlays fall onto the Communities. For the base year 1989 the amount of the « masse TVA » corresponded to the costs of education, which was then indexed. The index varied (and will vary) over the years.

a. At first the amounts for each Community were tied to inflation only, i.e. the federal government had a structural advantage since VAT returns usually reflect real growth in addition to inflation. Conversely it tended to constrain the budgets of the Communities to the extent that teacher salaries grew faster than the rate of inflation.

b. This vertical bias was corrected through a reform, which introduced an additional supplement in 2002 that was indexed
   (i) for inflation during 2003-06,
   (ii) for inflation plus 91 percent of the rate of growth during 2007-11, and
   (iii) for inflation plus 91 percent of the rate of growth plus the growth rate of population younger than 18 years thereafter.

c. From 2012 on the « masse TVA » will also be indexed for 91 percent of real growth in addition to inflation.

**Preliminary assessment**

25. The intergovernmental financial arrangements were settled through various agreements cast into special legislation that can only be changed by qualified majorities. This makes them resistant to major policy change in practice. So the financial arrangements are bound overall to set the future pace of budget developments irrespective of budgetary pressures from the expenditure side. Judging from the results over the last decade this constraint was respected by general government, however, as it has managed to convert the significant budget deficits of the early 1990s into a balanced budget in a consistent fashion.

26. These positive results were partly attributable to transparent and predominantly closed-funded transfer schemes for both the Regions and Communities that were indexed to

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13 It implies that the equalization grant will, ceteris paribus, erode with the pace of real economic growth over time.
14 The term “VAT share” or « masse TVA » is thus misleading. It would be better to talk of a simple block grant (« dotation »).
15 For horizontal allocation there is need to distinguish between the basic grant (« masse TVA ») and the supplement.
16 One may argue, however, that the present budgetary situation of general government not just reflects a structural reversal of policies but is also an expression of one-off measures and the business cycle.
17 Partly they are also attributable to the cooperative arrangements set up to coordinate budgets in view of the deficit criteria defined in the Stability and Growth Pact (see infra).
macroeconomic indicators such as inflation and growth. In the past these indices tended to favor the federal government to the extent that indexation to real growth was either absent (from 1989 through 1999) or only partial (thereafter). This bias in favor of the federal government was introduced deliberately in order to enable it to serve and redeem the national debt, *inter alia*. However from 2012 on, the indexing scheme will be almost completely based on inflation and real growth.

27. The budget of the federal government has been supported by a progressive personal income tax system that entails a revenue elasticity of greater than one. This is not sustainable over the longer term because “bracket creep” will lead to tax payers facing ever-higher tax rates, which will be politically resisted. The federal government is thus compelled to adjust the personal income tax schedule regularly. ¹⁸

28. Moreover the federal corporate income tax is likely to be constrained by increased global tax competition as in most other industrialized countries. Such policy risks are practically absent at the regional and community levels as they benefit from regular federal grants based on macroeconomic indicators and own revenue that is less sensitive to the business cycle.

29. As said the equalization grant is an “open pool” whose costs are borne entirely by the federal government. It is sensitive to population growth and the shortfall of per capita personal income tax in the poorer region(s) relative to the national average, which is hard to predict over the longer run. In the long run its relative importance will decline. But in the short run this mechanism, which bears testimony of the federal government’s readiness to “bail-in” political compromise, will continue to bear on the federal budget.

30. There are additional indications of the federal government being seen as accommodating in the presence of emerging vertical fiscal imbalances. These are clearly visible in the realm of social policies.

a. Traditionally the federal government tended to fill gaps that emerged between social security contributions and social spending through regular transfers to the O.N.S.S. In particular the reductions of social security taxes to stimulate employment were fully absorbed by additional federal transfers, the so-called alternative financing scheme (« *financement alternatif* »). The scope of this instrument has recently been widened.

b. A so-called “silver fund” (« *fond argenté* ») was set up in 2001, by which the federal government has begun to make provisions, mainly from one-off revenue, for the costs of ageing that could fall onto the social security schemes.

In all these instances the federal government has basically shied away from including sub-federal entities into co-responsibility.

31. There are clear indications that the costs of demographic change will soon go beyond the pace of macroeconomic developments and the global tax envelope. ¹⁹ Moreover they are

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¹⁸ Personal income tax reductions will also affect the tax bases of local governments, which have the right to levy surcharges on the tax. And it could affect the budgets of the Regions to the extent they can make use of their right to use « *centimes additionnels ou remises* » (see *infra*, point 39). However these options are limited in practice.

¹⁹ The Ageing Committee of the High Council of Finances publishes estimates of ageing-related expenditure pressures based on projections by the Bureau fédéral du Plan, which are
likely to be borne mainly by the federal government rather than sub-federal entities.\textsuperscript{20} The latter are somewhat immunized by a clear vertical assignment of functions, which transfers such risks to a great extent onto Entity I, the federal government and social security funds. However the indexing provisions of the arrangements help the federal government to expand its resource envelope in the order of about 2 percent of GDP by 2050. Conversely Entity II will experience a decline in its grants entitlements.\textsuperscript{21} Nevertheless this will not suffice to carry the full ageing costs that could be in the order of 5-6 percent of GDP in 2050.

32. A number of policy options relating to redressing pending vertical fiscal imbalances will be addressed below. One important instrument is continued debt reduction in the short run as long as the demographic effects on budgets will not yet materialize. It would allow the federal government to reduce its interest payments and thus create room for structural adjustments.

33. Another instrument is federal tax policy. This instrument is highly effective in Belgium since the grant arrangements are technically (although perhaps not politically) insensitive to tax policy changes. So increased tax revenue mainly flows to the budgets of Entity I. Only where sub-federal authorities use surcharges or give rebates would they be affected by federal tax policy.

34. Moreover federal tax policy could also serve to redress horizontal fiscal balances among regions. As discussed in the next Section, the apportionment of the important grants relating to personal income tax follows the derivation principle. So a revenue-neutral restructuring of federal taxes from personal income tax to VAT could eventually mitigate existing regional fiscal disparities.

35. The long-lasting and prominent political tensions between Regions and Communities that have absorbed (and are still absorbing) so much political energy are likely to be compounded by the imminent problems of vertical fiscal imbalance. It requires a look onto horizontal fiscal arrangements in Belgium.

**The financial arrangements: horizontal dimension**

36. The financial arrangements do not only affect relativities between layers of government, they also bear on the relative position at the same level of government: among Regions, Communities, and local governments. These horizontal effects depend on two main factors: the relative growth of the underlying economies and their tax bases; and on the institutional arrangements of allocating public funds among sub-federal entities.

37. It is important to look first at the institutional arrangements to understand how they interact with the vagaries of an economy that tends to produce systematically diverging results among the three Belgian regional constituencies.

\textsuperscript{20} Subnational entities may however been asked to contribute through social security contributions on the payroll of their civil servants if such policy measures would be adopted.

\textsuperscript{21} This is the result of a simple model simulation using constant growth rates. The results are reasonably robust against parameter change.
Tax autonomy, tax competition, and regional imbalances

38. From an institutional point of view, the devolution of taxing powers to the Regions is symmetrical in Belgium, i.e. all entities can exercise their functions within the same institutional framework. *De facto*, however, relatively stronger economic growth in the North has given the Flemish authorities a greater scope for tax policy action than the Walloon Region. And the widened regional tax autonomy of the Lambermont Agreement has introduced a new element in the Belgian fiscal machinery: tax competition. Horizontal tax competition affects both regional and local governments. The focus will be on tax competition between Regions.

39. To strengthen the accountability of regional governments, the Special Law of 1989 introduced the possibility to levy, in addition to the regional taxes, regional surcharges or rebates (*“centimes additionnels ou remises”*) on the personal income tax and radio and television fee. However the former is subject to a coordination procedure between the federal government and the regional entities, and it can be limited unilaterally by the Council of Ministers of the federal government. Although there were political pressures in the past to use this instrument for tax rebates, particularly in the Flemish Region, the political constraints have prevented it from playing that role (except for the radio and television fee). It would have broken a political consensus on the need to consolidate public budgets in view of the Maastricht budget criteria.

40. As to the regions’ own taxes, the Lambermont Agreement has restricted potential competition by imposing certain constraints on regional tax policies. Two categories of taxes have to be distinguished in this respect:

a. On the one hand, a tax whose base is regionally immobile (such as the property tax, the tax on automatic amusement devices, or on gambling and betting) is not subject to any policy restrictions.

b. On the other hand, where there are risks of strategic delocalization as in the case of personalized taxes (e.g. gift and inheritance taxes), such incentives are contained through various legal provisions (in this case the relative to the location of the donor). However there are no restrictions as to the tax rates of these taxes. As regards fully mobile tax bases such as for motor vehicles taxes, registration fees and the *eurovignette*, the Lambermont Agreement requires the Regions to enter into mutual agreements to avoid harmful tax competition among jurisdictions. Taxes on companies such as the corporate tax are uniform at the national level, so there is at least no significant tax competition within the country as long as existing regional demands to assume responsibility in this area are resisted.

Intergovernmental transfers

41. Fortunately the intergovernmental fiscal arrangements in Belgium allow looking at vertical and horizontal aspects separately, which proves that the setting up of the machinery was guided by principles of transparency. This allows focusing on strategic aspects of vertical fiscal imbalances and sustainability irrespective of interjurisdictional conflicts that arise.

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22 This provision applies only to the Regions, not to the Communities.

23 Yet – as other countries – Belgium faces such problems at the international level. It implies that the scope for further increasing taxes on companies is limited, which puts an additional constraint on the federal budget over the longer run.
among entities at the same level of government. And it allows identifying emerging structural horizontal imbalances although the scope for responding to these pressures by re-designing the grants system is legally restricted.

42. In the following the main transfer categories are examined as to their horizontal implications on regional, communal, and local government budgets.

(i) Personal income tax sharing. The reforms of 1988/89 recognized a fundamental principle for apportioning the grant onto regions: proportionality as to regionalized personal income tax proceeds.24 While the size of the grant is totally unrelated to revenues from personal income tax, its horizontal allocation mechanism incorporates regional tax revenue as the key parameter. This fundamental choice had a tremendous bearing on intergovernmental fiscal relations and has exacerbated horizontal economic and fiscal imbalances.

At the time, the immediate application of the new sharing rule would have touched upon a sensitive political tenet: protecting the status quo. This applies to both the Regions and the Communities. So a grandfathering rule was adopted by which the grant was initially allocated onto sub-federal entities in proportion to their former grants plus the costs of newly acquired outlay functions (without education). This provision was essential to accommodate the budget situation of the Walloon Region.

However the grandfathering rule was to be phased out over a period of 11 budget years (1989-99) and in a transparent fashion. It was clear from the beginning that the Walloon Region, while benefiting from a temporary protection of its budget in the short run, would have to adapt its budget to the new conditions over time.

The principle of proportional allocation according to regionalized personal income tax is now fully operational since 2000. It implies a strengthening of regional accountability and economic efficiency as taxpayers see a link between personal income tax and the level and the quality of services provided by the Region or the Community. This is independent of the amount of the grant, which is “capped” only in accordance with macroeconomic indicators, not with income tax collections.

(ii) Negative term. The negative term was introduced in order to neutralize the effects of a vertical reassignment of taxes following the Lambermont Agreement. The horizontal effects need not be considered here.

(iii) Equalization grant. The equalization grant (« solidarité nationale ») for the Region (not to the Communities) is seen to represent an additional share of the personal income tax given to Regions whose average product of personal income tax per capita is below the corresponding figure for the kingdom. Again it bears no relationship to the proceeds from personal income tax, neither as to its size, nor to its regional allocation. It is a fixed amount per person (€11.60) indexed for inflation, which is given for each percentage point the Region’s per capita personal income tax falls short of the national average, multiplied by the number of its population.

This solidarity mechanism is non-discriminatory in that it always favors economically weaker regions relative to the national average, i.e. its impact could be reversed if relative fiscal positions change. It was initially designed to support the Walloon Region, but since 1997 the Capital of Brussels also draws on it. Experience from other

24 In practical terms the allocation is more complex however, but this can be neglected for the purposes of this analysis.
countries demonstrates that relative economic positions of regions could indeed be reversed. This makes it somewhat hard to predict the working of the Belgian solidarity grant over a longer term. However the grant is indexed only for inflation, so its relative importance will decline. It would fall even more if the disparities of incomes per capita between Regions would decline.

(iv) VAT sharing. The Special Law of January 1989 foresees the allocation of the « masse TVA » to the Communities in accordance with the number of registered pupils in each Community. Again the immediate application of this rule would have produced budget disruptions in particular for the French Community, which also called for a transition phase after the reform. This phase was concluded in 1999. The horizontal allocation of this grant onto Communities is now based on the resident population in school age (below 18 years).

43. Personal income tax sharing, including the negative term and the solidarity grant, represented about 56 percent of budget revenue for the Walloon Region and 30 percent for the Capital City of Brussels in 2004. It is not possible to indicate these figures for the Flemish Region because it has merged its budget with that of the Flemish Community.

**Preliminary assessment**

44. Regional autonomy is important in many respects: It strengthens the political accountability of local officials and politicians, and tends to increase the level and quality of local service delivery. Moreover it is instrumental for regional governments’ ability to generate operating budget surpluses, which in turn strengthens their creditworthiness and ability to attract EU funding, hence their potential to invest in local infrastructure. Local government public service delivery and infrastructure development are crucial for producing economic growth and employment, which will consequently increase the ability of all governments to generate additional public revenue and/or to exploit new tax sources. In Belgium there appears to be a reasonable degree of fiscal autonomy at sub-federal levels of government (except for the Communities).

45. The Communities – for lack of a clearly identifiable constituency – are almost entirely dependent on grants. Grants dependency typically generates inefficiencies since politician cannot be held accountable; they easily escape by blaming the donor government. However, keeping a firm grip on intergovernmental transfers is important to re-focus these politicians onto the expenditure side of the budget and induce necessary structural reforms. This also applies to public entities that suffer from a structural fiscal disadvantage such as the French Community.

46. At the regional level there is some interjurisdictional competition in the realm of personal income taxes, which benefits from personal income tax through the horizontal allocation mechanism. In Flanders there are populist demands to hand back to taxpayers parts of the buoyant transfers. Such tendencies are however limited by institutional rules requiring policy coordination among governments and were resisted so far.

47. Overall it is fair to note that some degree of interregional tax competition may be healthy where it enhances the accountability and responsibility of sub-federal public officials and politicians. It entails positive economic incentive effects and may increase efficiency within the public sector. Generally speaking interregional tax competition does not appear to

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25 A prominent example is Germany after World War II.

be a serious problem in Belgium (yet). However the high degree of taxing autonomy is a mixed blessing for the sub-federal entities: On the one hand it gives them a large degree of discretion, fiscal independence from grants, and hence greater accountability; on the other hand it exposes them more to regionally diverging economic developments.

48. Economic developments in Belgium have tended to favor Flanders in the recent past. Its favorable relative position is reflected in personal income taxes collected, which in turn impinges upon their budgets through the grants system. However such mechanism do not work for the VAT share that is used to finance education expenditures by the Communities.

49. The fact that the Flemish Community and the Region have merged their budgets has helped to overcome the structural difficulties of education financing, while the French Community continues to experience constraints. This reflects a political choice for an institutional setting that should be respected, but not necessarily be honored through financial concessions. Moreover the financial constraint may be helpful in focusing policy makers’ attention in the French Community onto education reform, which could generate healthy effects over time. Political demands to accommodate a possible budget squeeze through financial concessions should be resisted in view of the challenges of an ageing society.

50. Resisting political pressure to relax a given budget constraint does not exclude intergovernmental budget support. It is common practice, in particular in federations, to establish interjurisdictional equalization mechanisms in one form or another as an act of national solidarity. The aim is to achieve political and economic cohesion. The degree of interregional redistribution is a political choice, however, and it varies widely among countries. From an international point of view fiscal equalization in Belgium is rather moderate for a federation.  

51. Seen from a transparency point of view a separate equalization fund helps to distinguish equity from efficiency considerations, and the costs of interregional assistance are clearly marked on budgets. That does not imply that it contains all regional redistribution effects however.

a. The most important redistribution mechanism works through the social security funds. They are financed on a broad national base, but their benefits are biased toward the most vulnerable groups: the old, the sick, and the unemployed. To the extent that these contingencies are unequally distributed among regions, there are implicit regional redistribution effects. It is common to consider such personalized transfer schemes as risk pooling instruments that should not be confused with regional equalization.

b. Another redistributive effect among regions works through the federal government’s budget. Often defense spending is used in support of economically weaker regions. Given the Belgian tradition of assigning a mitigating political role to the federal government, such redistributive effects are likely to be small however.

52. Although the regional allocation of the personal income tax grant is based on relative tax proceeds, it does not return the full share («juste retour») or even a fixed share of the tax. This is because the tax is “capped” and tied to the evolution of macroeconomic indicators.

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27 Moreover it is bound to diminish over time by virtue of the indexation mechanism, and – hopefully – by a reduction of regional income differentials.

28 This is a common euphemism that has nothing to do with justice.
This “capping” was essential for achieving the positive macro-fiscal results that characterize Belgian budget policies over the last fifteen years. Again, pressures to apply the «juste retour» principle to the personal income tax, or a full devolution of the tax, could jeopardize macroeconomic stability and the long-term sustainability of budgets.

**Fiscal policy coordination**

53. Belgium is characterized by a high degree of interpersonal and interagency cooperation that has helped to face a number of political challenges, not only the large fiscal deficits and public debt of the early 1990s. Dispute settlement mechanisms such as interdepartmental conferences or meetings between representatives of different levels of government are regularly organized with a view to coordinating, harmonizing and implementing policies in Belgium. Moreover there are elements of cooperative federalism that find their expression in coordinating institutions.

54. The Conseil d’État provides a uniform, consistent interpretation of legislation and gives opinions on draft legislation and decrees to avoid conflicts among jurisdictions. It can also refer to a Comité de concertation to resolve conflicts noted in draft legislation. The committee, made up of representatives of all governments, is responsible for reaching a consensus to provide a single opinion on a contentious issue. As for dispute settlement, the Cour d’arbitrage is empowered to settle jurisdictional disputes between the federal government, the Communities and the Regions resulting from legislative measures, including disputes originating in the allocation of competencies.

55. A very important element in the coordinative machinery was set up in the context of the federalism reforms: the Financing Section of the High Council of Finance and a coordination mechanism provided for by the Special Finance Law of January 1989. The Council’s role is to analyze and study fundamental budgetary, financial and fiscal issues and suggest the adoption of conforming reforms. It is supported by a Bureau, which organizes the activities of the High Council and coordinates its studies. The High Council of Finance comprises two permanent Sections and a Study Group. The first Section looks into public sector borrowing requirements, the second into taxation and social security contributions. In view of the pending structural problems relating to ageing, the High Council has also set up a Study Group on Ageing.

56. The High Council of Finance has an advisory role only and its recommendations are not binding. However the politically balanced composition of its members and the high quality of its work has given it an important role in the Belgian political machinery. Its reports are authoritative and delineate, de facto, the scope of policy action with a focus on structural issues and consistency. Without any doubt this authoritative role of the High Council has played an important role for achieving political compromise that was needed to prepare Belgium for entry into the European Monetary Union. It has consistently redirected public and political attention onto reducing public debt and sound budgeting.

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29 The special Section is composed of twelve members, nominated for five years by Royal Decree. The Regions and communities are represented by six members on their proposal. The Minister of Finance is represented by one member and the National Bank by three members. Strict linguistic parity applies and the political independence of the members is guaranteed by a list of incompatibilities (see: Paul van Rompuy, *The Coordination of Budgetary Policies in Belgium: 15 Years of Experience with the High Council of Finance*).
57. The budget coordination mechanism adopted by the High Council of Finance relies on a cooperative approach between different layers of government. First a global target is established for each year in terms of the consolidated primary budget surplus (SEC 95 methodology). Second, these targets are allocated onto levels of governments and the cast into a formal agreement among governments within the Comité de Concertation. Finally, compliance with the agreement is made public by the High Council of Finance in the form of an ex-post evaluation of budgetary results. In the case of a failure to reach the target, the government concerned could be asked to submit, to the High Council of Finance, a budgetary multi-annual program indicating how the fiscal balance would be redressed.

58. The report of the High Council establishes informal peer pressure by other governments and by the general public. Moreover the coordination mechanism directs fiscal policies of all governments onto one clear objective, which is widely shared because there were external pressures via the European Growth and Stability Pact and, at the time, the risk of failing to join the European Monetary Union. In addition to consensual action and peer pressure the law has also established a political sanction mechanism in the form of restrictions on the borrowing capacity of a sub-federal entity as recommended by the High Council of Finance and decided upon by the federal Council of Ministers. This mechanism has however never been applied.

59. After Belgium’s admission to the European Monetary Union the political pressures were maintained through internal Stability Programs that were submitted to the European Authorities. In these Programs the consolidated budget targets are extended over time, and the plans contain concrete measure defined to reach the planned trajectory of debt reduction for all public entities. Budget equilibrium was targeted for 2003, followed by a gradual build-up of budget surpluses thereafter.

60. The High Council of Finance has now put the finger onto another major structural problem of the future: the challenge of ageing. This was already reflected in the annual reports of 2002 and 2003. An “Ageing Fund” was created to protect positive budgetary margins for additional future commitments due to an ageing population. In its annual report 2004 the High Council of Finance reconfirmed this commitment and recommended a structural medium-term budget surplus of 1.5 percent of GDP as target for 2001.

61. After the 2004 elections the new regional government could not agree on the composition of the High Council of Finance, which entailed a hiatus of about two years in which its work was interrupted. This also shed some doubts on the independent role of the High Council of Finance whose members –despite their individual independence – have to be proposed by respective political authorities. After having been recomposed in September 2006, the High Council of Finance has resumed its work and is expected to present its first report on the costs of ageing in March 2007 and on current and proposed budgets in mid-2007.

**Preliminary assessment**

62. It is noteworthy that Belgium, despite its linguistic, cultural, social and economic cleavages has matured into a cooperative federal structure whose workings may at first sight be inaccessible to foreigners, and hence be opaque from a transparency point of view. But

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30 The legal basis of this coordination mechanism is found in the Special Finance Act of January 1989, Article 49 (6) that created the permanent Section “Borrowing Requirements” of the High Council of Finance.
intergovernmental and inter-agency cooperation and policy coordination have produced remarkable results, particularly after the fundamental reforms of 1988/89. One could argue that the structural reduction of public debt, of course also assisted by external effects such as a reduction of interest rates, was possible only because of fiscal decentralization. Under a unitary structure the federal government is likely to have spent more to “bail-in” consensus. Decentralization has co-opted the Regions and Communities into a coordinative framework that was successful in achieving results as long as there was a shared national policy objective.

63. The High Council of Finance and its role in setting the pace for much needed structural reforms is a promising innovation in Belgium. But its role could still be strengthened and expanded by including further structural policy issues that bear on intergovernmental financial relations such as pension and health reform. These are important policy areas when it comes to constraining the costs of an ageing population. While much of this success of the High Council of Finance resulted from personal interaction, pressure of peer groups, contractual arrangements, and incentives by the federal government, it is now time for Belgium to consolidate these positive features into a more robust institutionalized framework for cooperation and policy coordination.

Overall assessment

64. Complex as they may be, the intergovernmental fiscal arrangements are reasonably transparent compared to other federations. However they exhibit institutional rigidities that will be difficult to overcome. And these arrangements are producing (and will produce) vertical and fiscal imbalances that impinge on future reform processes. On the one hand, they impose constraints that could refocus the discussion on underlying problems, in particular those relating to an ageing society. On the other, these imbalances will have to be redressed eventually in view of a longer-term sustainability of budgets.

65. The Mission has doubts about the feasibility of re-negotiating the grants arrangements in the near future, so the policy options in Belgium would have to focus on two major strategy strands:

66. One strategy puts the focus on federal tax policy:

a. The policy of generating structural primary surpluses in view of alleviating the burden of debt should be maintained. It is essential to further reduce the level of debt before the age-related expansion of outlay responsibilities sets in. It would create additional room for maneuver through the reduction of interest payments.

b. In the shorter run, say the next 5 years, continuing budget pressures could inspire structural reforms that are unavoidable in view of the future challenges. For instance a vertical fiscal imbalance affecting Entity I could help to focus the attention onto pension and health sectors. The horizontal imbalance affecting the South, in particular the French Community, could encourage reforms in the education sector.

c. The use of federal tax policies is likely to become the major instrument for redressing both vertical and horizontal fiscal imbalances and generate the savings needed to meet both the objectives of the Stability and Growth Pact and expanding claims on public budgets by ageing. Immediate results are unlikely to be reached however.
d. A revenue-neutral restructuring of the federal tax system away from personal income tax toward VAT could be an effective instrument to rebalance fiscal positions among sub-federal entities over time. It would implicitly change the redistributive effects of the grants arrangements, and hence the political choice to be made by authorities is likely to be difficult.

67. The other option to be considered is a transfer of age-related expenditure responsibilities from Entity I to Entity II. This transfer would be fully funded initially to avoid budget disruptions, but the incremental costs would increasingly fall onto the budget of sub-federal governments thus alleviating the pressures on the budgets of Entity I.

a. A first example could be health expenditures. This will become a complex issue since it has to be seen in conjunction with reforming the health care system. Potentially however there are economies to be reaped from greater cost effectiveness and better responsiveness to citizens’ need via decentralization.

b. A second focus could be pensions related to the civil service sector. And possibly to citizens at large if Belgium would opt for strengthening the private provision for old-age income support as in neighboring countries. Given a culture of incrementalism, which is particularly useful with regard to pension reform, this could lead to a marginal reduction in social security contributions in pace with the build-up of private pension entitlements. Such reforms could be assisted by federal and regional tax policies, which again could compensate for horizontal fiscal imbalances.

68. Again it is up to the authorities to make the choice. This process of decision-making will be difficult, but the coordination machinery that now exists in a federal Belgium may considerably assist it. It is the Mission’s contention that the High Council of Finance will continue to play a major role in this process, so there is a case for strengthening its informal authority without jeopardizing its independence and consensus-forming capacity.

31 A consequence would of course be that the levels of private pension supplements would differ among regions, and outcome that may be easier to accept politically.