
TOWARDS A MORE EFFICIENT AND RESPONSIBLE FINANCING MECHANISM FOR THE BELGIAN FEDERATION

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Introduction

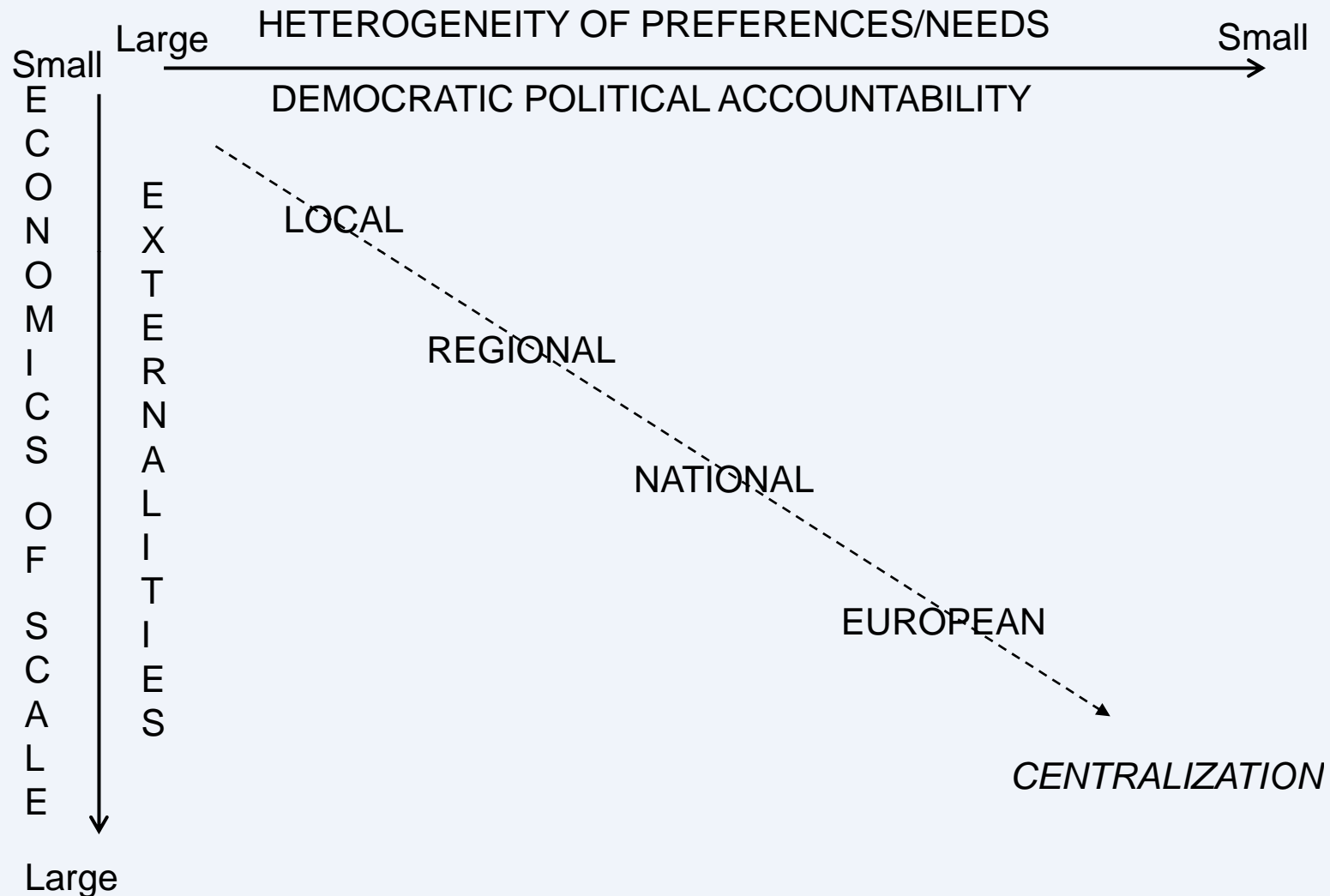
- Evaluation of the Special Finance Act (SFA) for the Regions and Communities (R&C) in Belgium
 - SFA refers to traditional criteria from normative theory of economic federalism
 - New insights from political economy approach point at inefficiencies in the present SFA and designate the direction of reform, taking into account aspects of efficiency, accountability and transparency
- Proposal for an improved New Special Financing Arrangement (NSFA)
 - Focus on responsibility via direct budgetary returns, giving the right incentives to regional governments to pursue activity enhancing policies
 - Key for a win-win reform improving public finance for all federated entities and for the federal government

Overview of the presentation

1. From normative fiscal federalism...
2. ...to a political economy approach
3. The Belgian Special Finance Act (SFA)
 - Overview
 - Critiques
 - Points of action
4. Proposal for an improved New Special Financing Arrangement (NSFA)
5. The NSFA in action
6. Final comments

1. Normative fiscal federalism

Allocation of competences: centralization vs decentralization



1. Normative fiscal federalism

FUNDING OF REGIONS



Decentralized

Preference-matching
Equivalence Principle

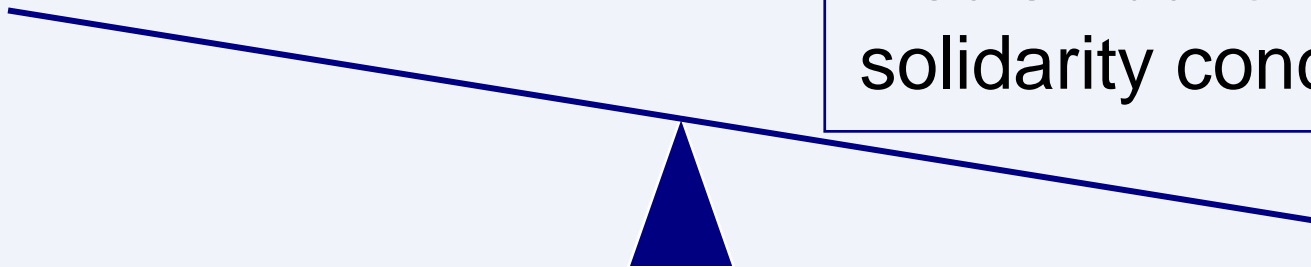


Centralized

Externalities and
efficiency distortions:

- vertical
- horizontal

Redistribution and
solidarity concerns



→ Vertical Fiscal Gap

1. Normative fiscal federalism

Size of the *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

1. Normative fiscal federalism

FUNDING OF REGIONS



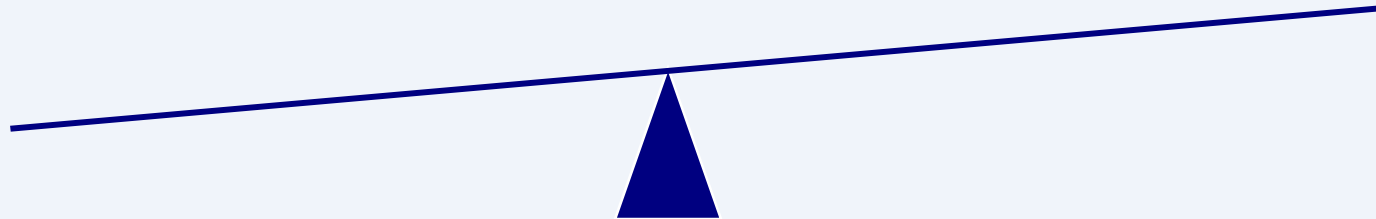
Decentralized



Centralized

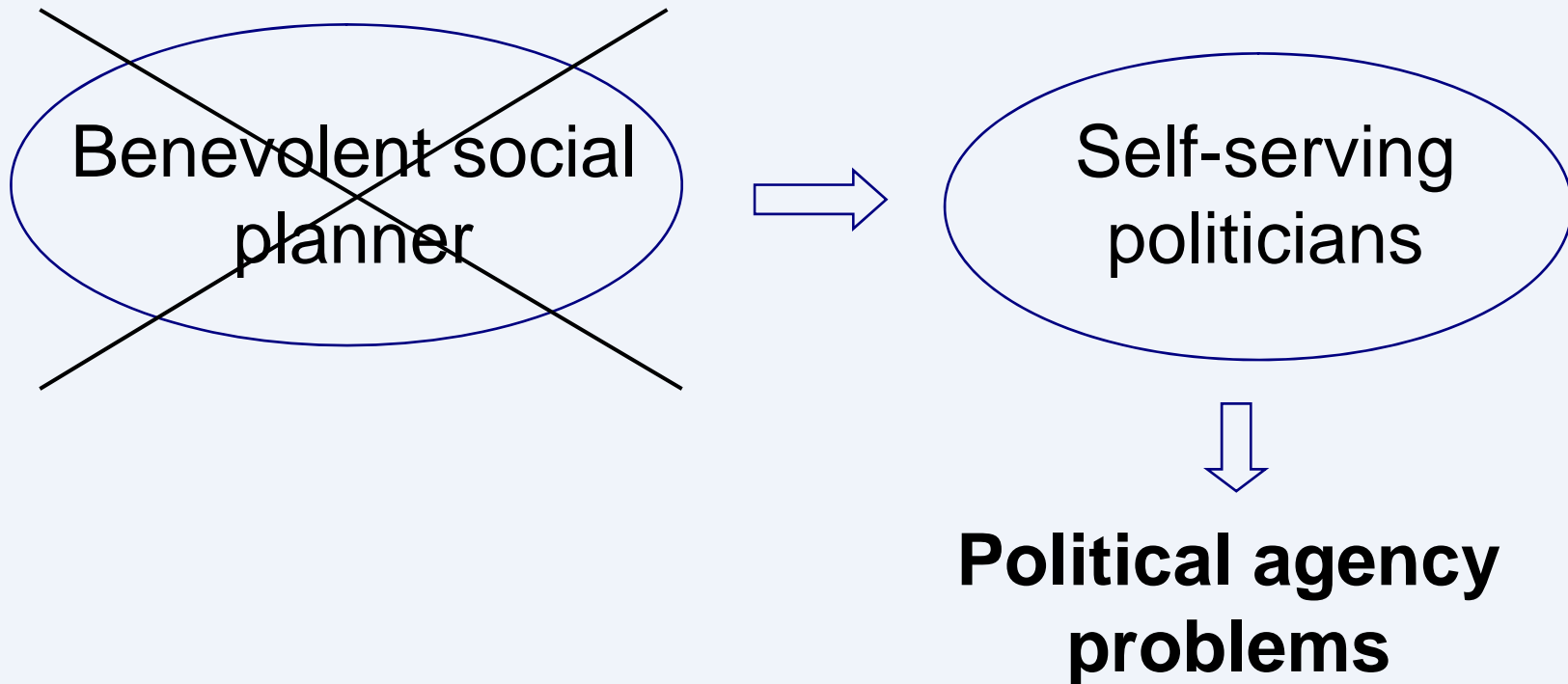
Preference-matching
Equivalence Principle

Fiscal equalization
reduces tax externalities



**➔ Need for more fiscal autonomy
(Close the vertical fiscal gap)**

2. *Political economy approach*



Solutions


- YARDSTICK COMPETITION
- POLITICAL ACCOUNTABILITY

2. *Political economy approach*

YARDSTICK COMPETITION?

- Requires *decentralization*
- Requires *fiscal transparency*

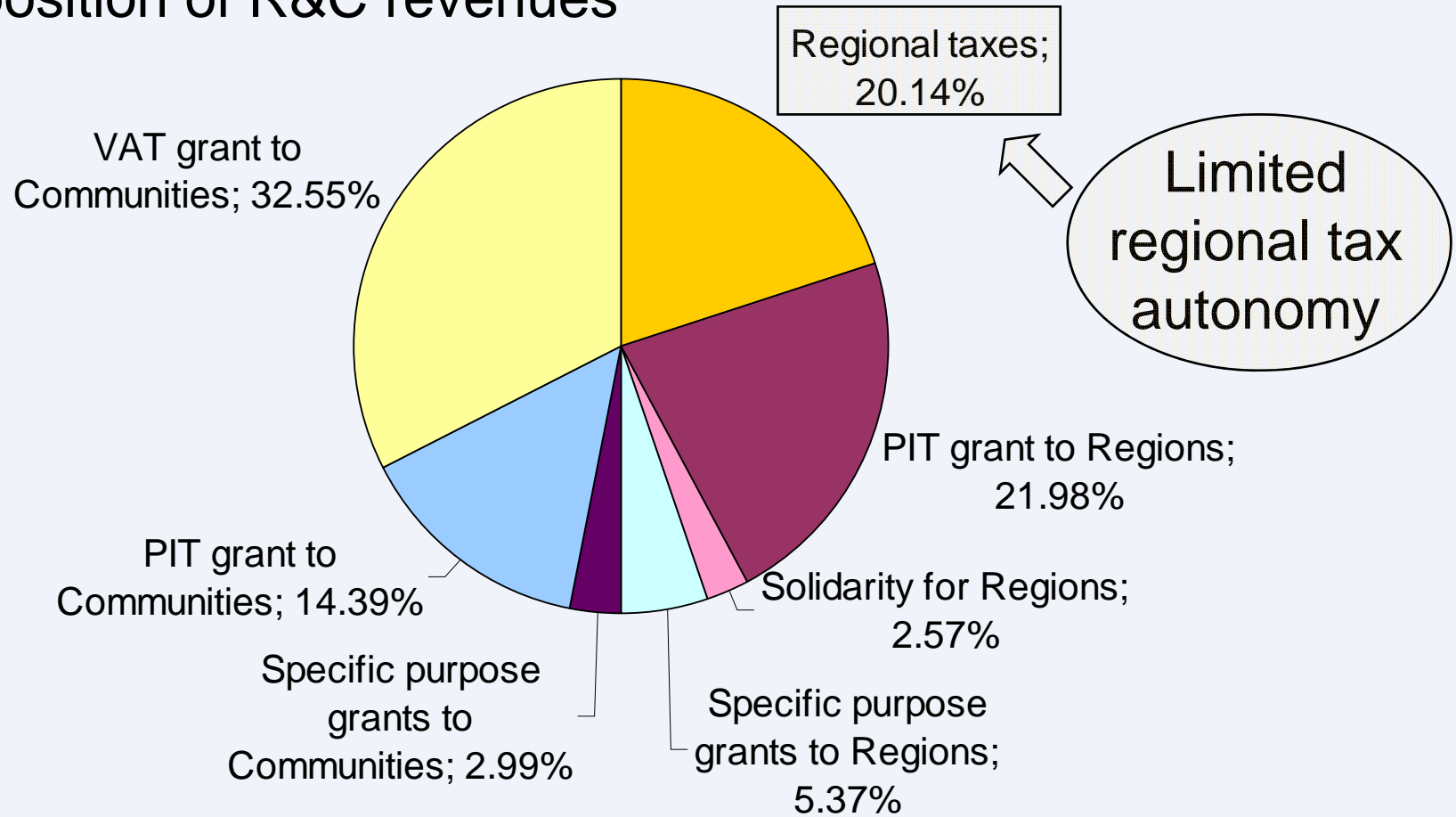
POLITICAL ACCOUNTABILITY?

- Requires *financial responsibility* (and  thus *tax autonomy*)

Chequebook federalism & soft budget constraints stimulate moral hazard problems (common pool problem, fiscal illusion, bail-out problems)

3. The Belgian SFA: overview

Composition of R&C revenues



3. The Belgian SFA: overview

COMPOSITION OF R&C REVENUES	% of total R&C revenues	Vertical evolution	Horizontal division key
Regional taxes	20.14%	/	/
PIT grant to the Regions	21.98%	Lump sum payment, tied to CPI and GDP-growth	Relative contribution to federal PIT revenues
Solidarity (Revenue equalization) for Regions	2.57%	Yearly calculated lump sum payment	Underperformance w.r.t. national average of per capita PIT revenues
Miscellaneous specific purpose grants - to regions - to communities	8.37% - 5.37% - 2.99%	Constant or linked to CPI	Division keys based on expenditures in the past
PIT grant to the Communities	14.39%	Lump sum payment, tied to CPI and GDP-growth	Relative contribution to federal PIT revenues
VAT grant to the Communities	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)

3. *The Belgian SFA: critiques*

ANALYSIS OF THE BELGIAN SFA

- **NO ACCOUNTABILITY:** *no straightforward link between a region's performance and its financial means, because of*
 - Vertical externalities
 - Volume of grants from federal government to R&C depends also on performance of other regions
 - No true shared tax: elasticity effect larger than one benefits the federal government
 - Horizontal externalities
 - Volume of grants to a region depends on *relative* performance, and so on other regions' performances
 - Solidarity overcompensates 'juste retour', inversion of per capita means
 - Development trap
 - Economic catch-up of poorer regions leads to losses in financial means of these regions
- **NO TRANSPARENCY**
 - Complex rules, fictitious links to particular taxes
 - Combined system of funding and (implicit) equalization

3. *The Belgian SFA: points of action*

IMPROVEMENTS TO BE MADE

1) Reduce the fiscal gap by *more own tax revenues* for the federated entities

- Improve visibility, transparency and accountability of government actions
- Provide tax instruments for economic policy competences <> reliance on subsidies
- Give the right incentives for activity enhancing policies

Take care of

- Potential negative (horizontal) fiscal externalities
- Interregional redistributive concerns

3. The Belgian SFA: points of action

2) Design a *better incentive compatible* solidarity mechanism at the *horizontal* level

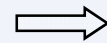
- More transparent expression of loyalty *between* regions in a federation
- Put an end to the increasing solidarity grants coming from the federal budget, creating room to meet the rising costs of an ageing population
- Better suited to internalize tax externalities
- Eliminate the “development trap” for regions which are recipients of solidarity grants

4. Proposal for an improved NSFA

SFA

NSFA

Own regional taxes



Own regional taxes

VAT **grant** to Communities



True **shared tax**: fixed percentage of federal VAT revenues

PIT **grant** to Regions

Solidarity grant to Regions

PIT **grant** to Communities

Specific purpose grants

- Radio and television license fees
- Allocation for foreign students
- Grants for unemployment relief works
- **Other**



Own regional PIT % tariff on federal defined tax base

Horizontal solidarity transfers to guarantee **95%** of average per capita PIT revenues to each Region ~ *'Finanzausgleich'*



Specific purpose grant for Brussels

4. *Proposal for an improved NSFA*

- *Transition period:* 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 own PIT is collected by the Regions, which transfer part (e.g. 40%) of it to the Communities (80/20 division key for Brussels)
- Extra compensation for Brussels for the burden as federal capital?
 - Part of PIT of commuters?
 - Other options, e.g. regional production tax
 - Don't subsidize but tax congestion (also beneficial for employment of people living in Brussels)
 - Own regional taxes (per capita) are much higher in Brussels due to its function as capital (see further)

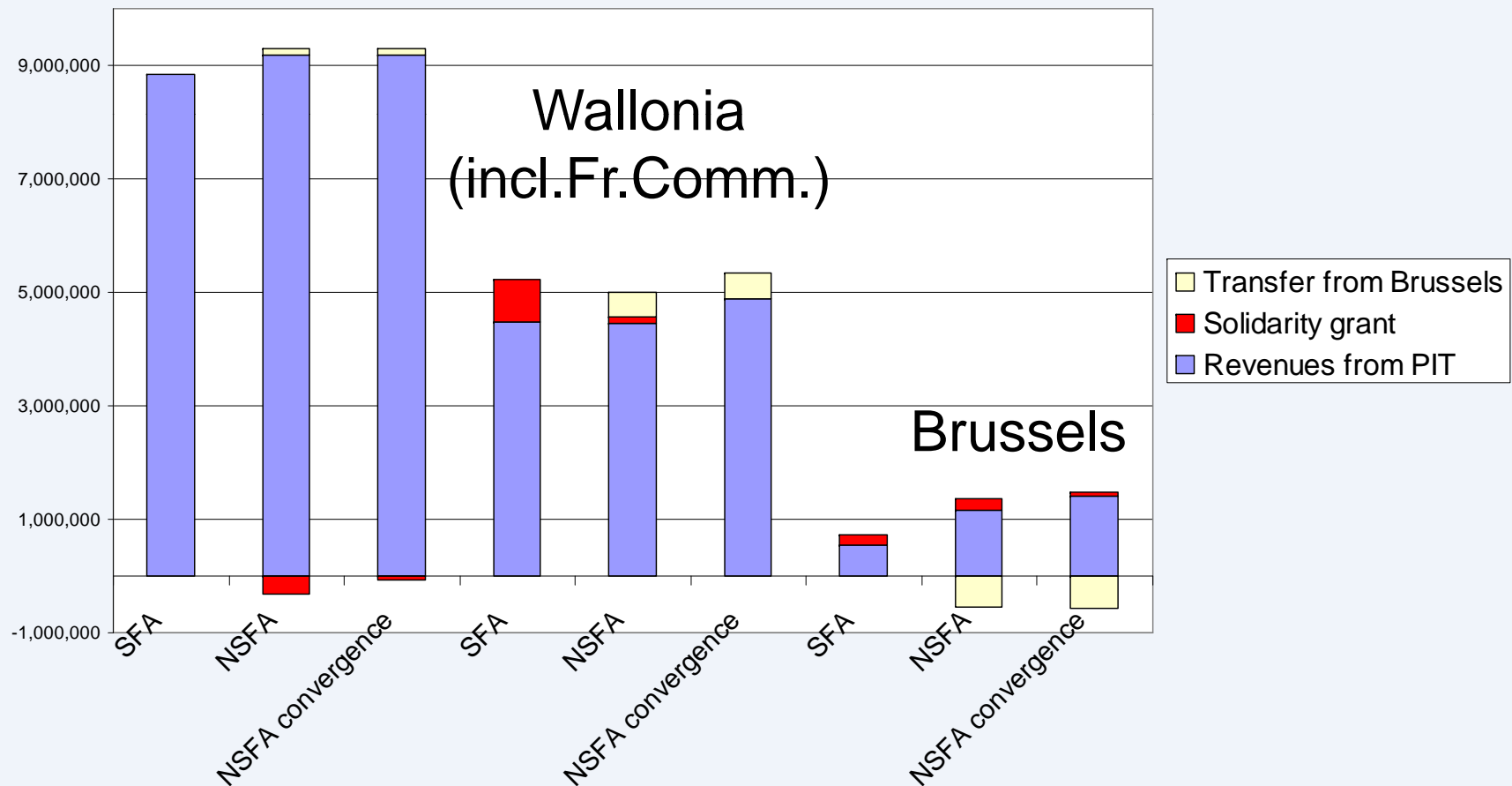
5. The NSFA in action

Financing of the R&C, 2005 (in 1000 €)

Flanders (incl. Flem. Comm.)

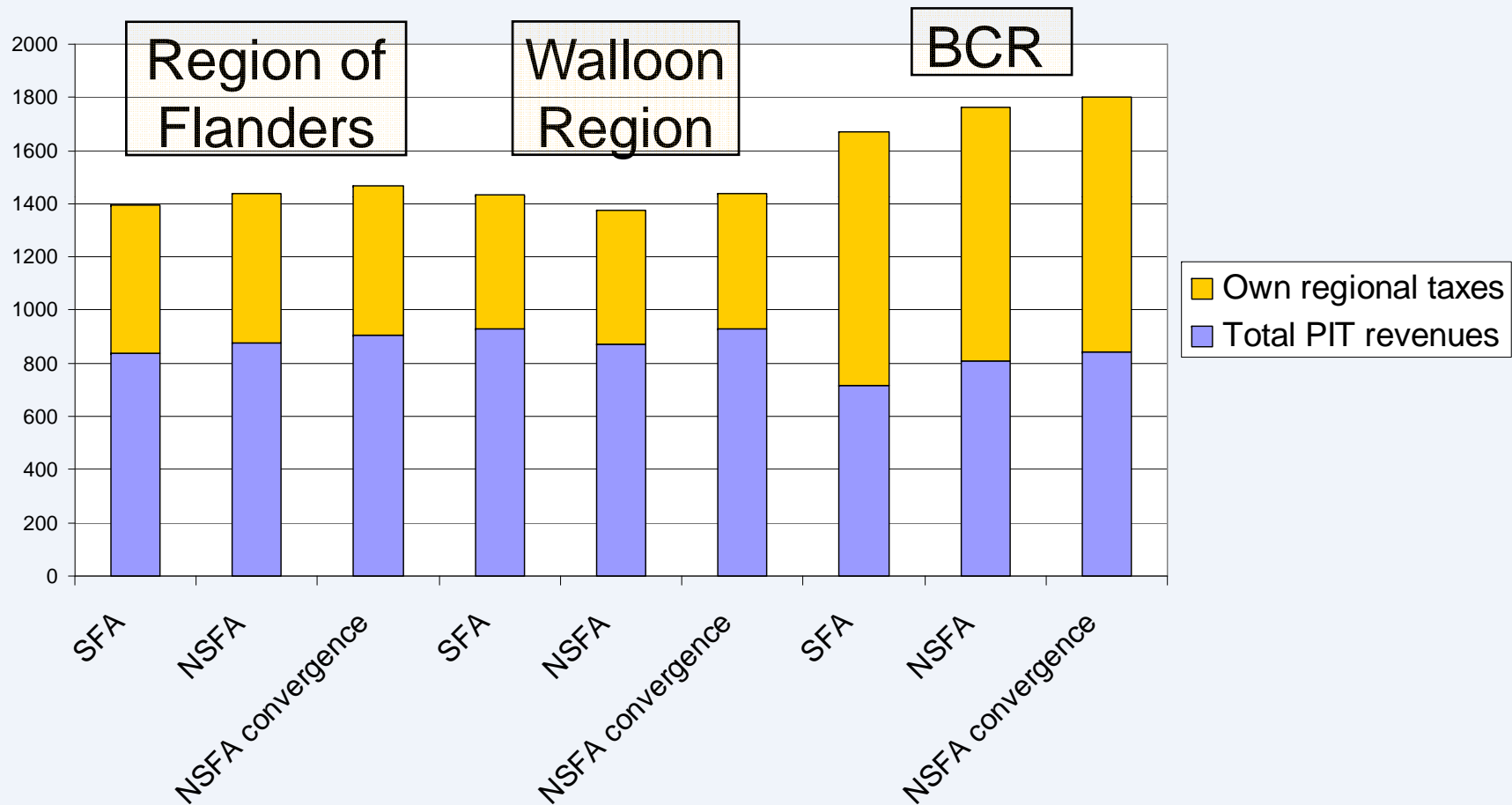
Wallonia (incl. Fr. Comm.)

Brussels



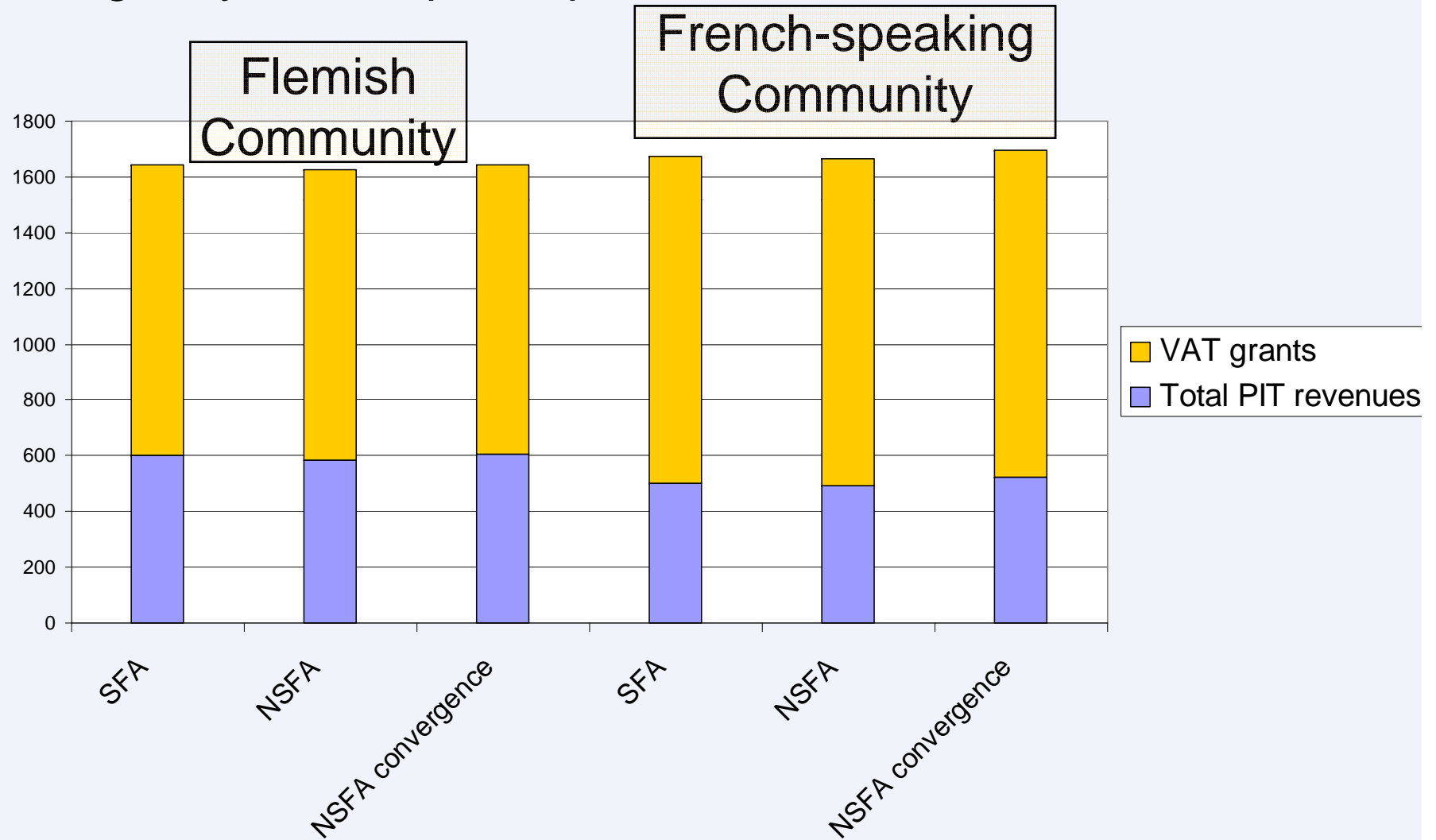
5. The NSFA in action

Funding of REGIONS:
Budgetary means per capita in 2005 in €



5. The NSFA in action

Funding of COMMUNITIES:
Budgetary means per capita in 2005 in €



6. *Final comments*

- Guarantee of the same amount of financial means at the start of the NSFA: the consolidated entity Wallonia-French-speaking Community should be **compensated at the start**
- **Transition scenario:** as regions proceed in creating additional employment, they may be granted gradually in anticipation some of the benefits that activity convergence will bring along (see graph)
- Activation of the labour force and convergence could be stimulated by additional **regional labour market policies** (e.g. bonus-malus system) *but only during the transition phase* => such grant system should be gradually replaced and sustained by additional PIT income
- By giving the right stimuli for activity enhancing policies, the NSFA should lead to a **win-win situation** for all regional governments and the federal government

6. Final comments

