Toward more responsible Regions?

André Decoster (KULeuven) & Philippe Van Parijs (UCLouvain)

There will be no major reform of the Belgian federal state without some significant changes in the way in which its federated entities are funded. And no such change will happen if it cannot be sold as a win-win-win reform, as a reform from which, albeit with some time lag, all three of our Regions can reasonably expect to benefit. Hence the importance of intelligent and thorough contributions such as the two lead pieces of the present Re-Bel e-book. Both aim to improve on the existing setup by increasing transparency, accountability and the financial incentive structure faced by regional governments, while protecting both intra- and inter-regional solidarity. This is the sort of proposal we need to get a serious debate off the ground. It is to this debate that we wish to contribute, by raising a number of questions on some of the central issues.[54]

1. "Political economy": what regional governments are meant to be driven by

First of all, let us express our agreement with the authors of both lead pieces that there is much to be said for making governments — whether at a national or regional level — bear responsibility for the economic consequences of the policies that lie within their competences. Admittedly, we should not to be misled by too close an analogy with individual decisions. It is arguably not only efficient but also fair to make adult human beings bear responsibility for the economic consequences of the choices they deliberately make. As regards public policies, the ethical case is much weaker. To put it mildly, it is not self-evidently fair to make the population of a whole country or region suffer or benefit from the consequences of policies adopted by its current government, let alone by its past governments, irrespective of whether those suffering or benefiting supported those governments and played any part in electing and re-electing them. Whether fair or not, however, making a country or a region bear, albeit it in part, the economic consequences of the quality of its decisions is definitely efficient. Full neutralization of these consequences through compensatory transfers from the virtuous to the defective would create damaging moral hazard from which everyone would suffer in the long run. Keeping this moral hazard in check does not require that there should be no transfer from affluent regions to less prosperous ones — the prosperity of a region is strongly affected by exogenous factors beyond any government's control —, but it does require that bringing about greater regional prosperity should be in the regional governments' financial interest. According to the authors of both lead pieces, this is not sufficiently the case in the complex set up currently in place.

More specifically, Heremans & al. sensibly insist that politicians cannot be assumed to be benevolent policy-makers and that they can be expected to respond to incentives. They thereby invite us to move beyond the "first generation" normative approach to fiscal federalism associated with Kenneth Arrow, Richard Musgrave and Paul Samuelson and to supplement it with insights from the so-called political economy approach associated with "second generation" theories.[55] To start with, it can safely be assumed that one major incentive, for any politician in power, stems from the wish to be re-elected. In any context in which transfers from other federated entities do not fully compensate the population's income losses, whether a federated entity is doing well or badly in economic terms can be assumed to affect, and be believed by politicians to affect, the probability of re-election. The existing trans-regional redistribution — which operates mainly through the federal social

[54] Partly in the light of our earlier thinking on these matters. See Roland, Vandevelde & Van Parijs (1996), Van Parijs (2005, 2009), Decoster & Verwerft (2009).
[55] See Bouton & Verardi (2010) for a more precise characterization of the distinction.

security system and only to a limited extent through the federal funding of regional budgets[56] — is of course very far from providing full compensation. The governments of all three regions therefore do have some incentive to use whatever competences they have to improve the prosperity of their region. But not enough, according to both lead pieces.

Particularly worrying is that, under some circumstances, the current setup implies that greater prosperity for a region translates into smaller revenues for its government. Viewing this as a perverse incentive structure need not be interpreted cynically as attributing to politicians in power a desire to pocket some of these revenues for personal gain. More charitably (and hopefully more plausibly), it can be interpreted as ascribing to them a desire to increase the scope for expenditures that will (be seen to) benefit their electorate and thereby enhance the probability of their re-election. Under the complicated current financing system that grew out of an insufficiently coordinated sequence of compromises, a decrease in the economic prosperity of one region, as reflected in the volume of income tax collected in its territory, can lead to an increase in the revenues of its government. The simpler and more transparent systems proposed by both lead pieces get rid of this anomaly, commonly referred to as a "dependency trap".

This is all fine. But one should beware of making too much of the alleged "incentive effects" of (re)establishing a monotonically positive relationship between a region's prosperity and its revenues. Deschamps & al. (§2) mention that the "dependency trap" has been "well documented", and Heremans & al. (§ 2.2.3) that the "adverse incentive effects" have been "widely documented". But as far as we can see, the studies to which they refer go no further than an arithmetic exercise that consists in displaying the perverse structure of budgetary constraints faced by the regional governments. As important as such constraints may be in trying to explain behaviour, they certainly are only part of the story. Neither of the pieces provides any evidence showing that regional policies — in particular those of the Walloon government — would have been noticeably more favourable to regional economic prosperity if the latter had affected the region's revenues in a more straightforward way.

On the contrary, there are several grounds for doubting that this is the case. Firstly, as noted by Deschamps & al. (footnote 5), the dependency effect vanishes when the revenues of regions and communities are consolidated. Secondly, regional governments must realize that the region's level of prosperity should have some positive effect on its ability to raise revenues through regional taxes of a different sort. And thirdly, as mentioned earlier, the region's perceived prosperity itself should have a significant direct effect on re-election: expecting worse prospects for jobs and wages to be compensated in the electorate's eyes by slightly higher public expenditure looks like a risky bet for the governing parties to make. Even a small effect would therefore be surprising, not to mention an effect of such a magnitude that it would produce the spectacular convergence postulated in Heremans & al's scenario (§ 3.3). Removing the anomaly through a simpler and more transparent system, as proposed in both lead pieces, would be welcome. But neither piece gives any ground for expecting it to have a significant impact on regional growth, let alone on inter-regional convergence. [57]

[56] To get a sense of perspective, it is useful to bear in mind that he solidarity component in the Special Finance Law — the object of the present discussion — amounts to slightly more than 1 billion euros in 2009 (see Algoed and Van Den Bossche, 2009), while interregional transfers generated by interpersonal redistribution through social security (benefits and contributions) and personal income taxes are estimated to be between 5 and 6 billion euros (Table 1 in Denil 2010).

[57] Challenging papers by Algoed and Persyn (2009) and Persyn (2010) do go beyond sheer arithmetic by providing an econometric analysis of the relationship between inter-regional redistribution and regional growth in the European Union. However, in so far as they succeed in establishing a relevant impact at all, it is the impact that would be produced by a massive shrinking of the whole redistributive system (including social security), coupled with a decentralization of wage formation, and not the comparatively insignificant strengthening of the link between regional revenues and the income tax base. Moreover, the structural model conjectured to underlie the econometric results has to do with factor mobility across small adjacent "regions" — for example between wealthy Brabant wallon and poor Hainaut,—, not with the "political economy" of regional decision making — for example by the Flemish or the Walloon government.

2. *Political cosmetics: what "transparent" transfers are meant to display*

Getting rid of the perverse incentives associated with the dependency trap is only one implication of organizing the funding of our federated entities in a simpler, more rational way, as proposed in both lead pieces. Both propose a transparent combination of responsibility and solidarity. Responsibility is achieved through a tangible positive relationship between the tax base in the region and the regional government's revenues. Solidarity is to a large extent achieved in the background, through the federal funding of social security transfers and education, but also directly through subsidies to the budgets of the regions with more modest per capita tax bases. However, the two proposals differ from each other in the way in which this combination of responsibility and solidarity is structured. And they both differ from a third, equally simple way, in which the funding of the regions could articulate responsibility and solidarity — and for which we believe a strong case can be made.

In all three formulas, the federal government collects income taxes in all three regions, using a progressive tax schedule determined at the federal level, but the next step takes three distinct forms:

(1) The regions' share of the federal income tax is distributed to the regional governments in proportion to the taxes raised in the region, but the region(s) with an above-average per capita tax base transfer funds to the region(s) with a below-average per capita tax base, according to a fixed formula that compensates partly the difference (Heremans & al.'s horizontal equalization formula).

(2) The regions' share of the federal income tax is distributed to the regional governments in proportion to the taxes raised in the region, but the federal state transfers additional funds to the region(s) with a below-average per capita tax base, according to a fixed formula that compensates partly the difference (Deschamps & al.'s vertical equalization formula).

(3) Part of the federal income tax is distributed to the regional governments in proportion to the population living in the region, while another part (the rate of which may vary from region to region) is distributed to the regions in which it was raised. (Formula analogous to the *opcentiemen/ centimes additionnels* on the federal tax that partly fund the municipalities.)

Under all three formulas, some degree of "responsibility" is achieved: the revenues of each region will grow monotonically with the income tax base of the region. Under all three formulas, some degree of "solidarity" is achieved: richer regions will contribute to funding the public expenditures of poorer ones. How much "responsibility" and how much "solidarity" is achieved is in no way determined by the formula, but by the specific parameters chosen.[58] The incentive argument, therefore, could not possibly discriminate between the three formulas. What other considerations could guide the choice?

To justify their preference for (2) over (1), Deschamps & al. (§3.1 step 2) mention that vertical equalization serves "to ensure that institutional solidarity remain the responsibility of the federal level and be stable over time". But the necessity of such a link is questionable.

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[58] Deschamps & al.'s (§ 4.2) vertical equalization mechanism transfers to Regions with a per capita personal income tax (PIT) base below the federal average 85% of the revenues they failed to collect as a consequence of falling short of the average. Heremans & al.'s (§ 3.1) horizontal equalization mechanism guarantees to each Region 95% of Belgium's per capita PIT revenues. In the event of small divergences between Regions, the former proposal implies more "solidarity" and less "responsibility" than the latter. In the event of large divergences, the opposite is the case. Both proposals can easily be amended to incorporate more "solidarity" or more "responsibility": by increasing or decreasing the rate of vertical compensation in the former proposal, by increasing or decreasing the threshold that triggers horizontal transfers in the latter. In the third proposal, the degree of solidarity is simply expressed in the percentage of the federal PIT allocated to the Regions on a per capita basis (possibly modulated by some simple coefficient reflecting objective needs). This percentage can be determined so that the PIT revenues per capita allocated to all Regions match those accruing (after equalization) to the poorest Region under either of the other two proposals. It can be increased or decreased in order to reflect more "solidarity" or more "responsibility", respectively.

Indeed, in Heremans & al's horizontal equalization proposal, transfers are of course not left at the regions' discretion, but fixed by a formula determined at the federal level.

To justify their own preference for (1) over (2), Heremans & al. argue that horizontal equalization is "better suited to internalize fiscal externalities", more specifically that it would "reduce the incentives to lower tax rates in order to attract mobile tax bases" (§§ 2.1.2, 2.2.4).[59] However, this argument seems hardly more convincing. Firstly, under horizontal equalization, when deciding to lower tax rates in order to attract taxpayers, the anticipation of higher transfers to the region whose tax base one is hoping to "plunder" will generally weigh little compared to the loss of revenues from taxes on the region's pre-existing tax base. Secondly, under vertical equalization, a regional government cannot be totally blind to the fact that plundering another region's tax base will mean, for its population, a proportionally higher share in a higher absolute volume of federal transfers to the region being plundered. And thirdly, the vertical equalization formula could be so structured that it operates with a closed envelope: if federal compensation to one below-average region needs to increase, the federal distribution of income tax to the other regions automatically decreases.

If this is right, arguments in terms of incentives, externalities, efficiency, etc. are not decisive either way, essentially because any combination of regional responsibility and inter-regional solidarity can be achieved by both vertical and horizontal equalization, and indeed by the third formula too. The real reason for preferring one or the other formula may therefore rather lie at another level, which might be labelled "political cosmetics". Thus, in their plea for horizontal equalization, Heremans & al. (§ 2.2.4) offer an altogether distinct argument, which has nothing to do with the incentive structure. They argue that "it is a more transparent expression of loyalty between regions in a federation" and, relatedly, that "it eliminates the rather complicated and strange mechanism, whereby economically weaker regions first contribute to the federal budget, and receive extra money afterwards".

To appreciate what is involved in this reasoning, it may be revealing to transpose it to redistribution across municipalities. The federal or regional government could first distribute the whole of the communes' share in the income tax it collects to the authorities of the communes in which the tax originates, and then require those with an above-average tax base to transfer revenues to those with a below-average tax base, using some fixed algorithm. Would we welcome this as a "more transparent expression of loyalty between the *communes*", or as "eliminating the rather complicated and strange mechanism, whereby economically weaker *communes* first contribute to the federal budget, and receive extra money afterwards"? Is it not, instead, both simpler and more transparent to let the federal (or regional) government collect resources from taxpayers all over the territory and then allocate them to local authorities in proportion to their population (and possibly some characteristics reflecting the needs of that population) so that they can provide adequate services to all citizens? What would be the point of returning first to Brasschaat, Waterloo or Uccle the revenues collected there? Just to make the people living there feel superior, or generous? Or to make the people in Beringen, La Louvière or Molenbeek feel humbled, or grateful? Or to encourage a political rhetoric in terms of "us (here, rich) and them (there, poor)"? This would seem rather petty. Is there any better reason for proceeding in this "complicated and strange" way at the level of regions than at the level of communes, apart from it being less cumbersome with 3 regions than with 583 municipalities?

If not, the third formula sketched above seems the best one of the three. It is simple and transparent. And it is just as capable as the other two of achieving whatever balance between responsibility and solidarity is deemed to be desirable.

[59] Footnote 10 refers to Verdonck (2009), who spells this out as follows: " 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.

3. *The Brussels headache: why economists would love to redraw boundaries*

Both lead pieces sometimes speak of "federated entities", so as to cover both regions and communities. But most of the time, they speak of regions. Wisely so. If we want to make federated entities more responsible by making their revenues more sensitive to the taxes collected, we must be talking of territorially defined entities, endowed with a power to tax. We must also be talking about entities with competences that are comprehensive enough to affect significantly the tax base in the territory under their authority. This is clearly the case for the Flemish region, where a single government has exercised from the start both the "territory-related" regional competences and the "person-related" community competences. This has also become nearly the case for Wallonia since March 2008, when the governments of the Walloon Region and the French Community were united under a single minister-president. But it is clearly not the case for the Region of Brussels-Capital. If anything should be expected to have a major impact on the tax base of a region, it is no doubt the formation of its human capital. But 20% of education in the Brussels Region is under the authority of the Flemish government, and the remaining 80% is under the authority of two Walloon ministers in a government headed by the president of the Walloon Region. Anyone dreaming of giving our regions significantly more financial responsibility must have as a top priority giving the Brussels Region too a coherent and comprehensive package of competences, and above all the power to regulate its education system. Let us be frank: this would be a significant move towards making Belgium a simple federation of regions. But it is hard to think of a major and intelligent institutional reform that would not involve a decisive move towards such a straightforward, classic territorial federalism.

Focusing on the Brussels region also forces us to think harder on another central aspect of both proposals taken for granted so far. If people tend to work and sleep in the same region, it makes little difference whether the tax base to which we want to link more closely the region's revenues is attached to the place where people work or to the place where people sleep. If we were just talking of the Flemish and Walloon Regions, this would hardly make a difference. But about half the people working in the Brussels Region sleep in one of the other two Regions. At first sight, the implication is obvious. Is the point of regional "responsibilization" to encourage regional authorities to favour the creation of productive jobs or of comfortable bedrooms? Surely the former. In a context in which people's workplace and residence cannot be assumed to be overwhelmingly in the same region, it therefore seems obvious that the tax base to which regional revenues should be made more sensitive is the value added generated in the region. This could be done, for example, by making regions share in the corporation tax levied on the businesses located in the region or in the social security contributions paid by (or on behalf of) the people working in the region, whether or not these are residents. By contrast, making the regions share more significantly in the yield of the income taxes paid by the people sleeping in the region — as both proposals recommend — seems a particularly weird idea.

This reasoning is far too simple, however. For how many jobs can be generated in the Brussels region and how productive they are is affected by the education, training, activation, public health or mobility policies that are being implemented in its Flemish and Walloon hinterland. And conversely, the people educated, trained, activated, cared for or transported in Brussels must be enabled to take up jobs in Zaventem or Rixensart. That this should happen far more than now is certainly part of what the Brussels government, once put in charge of education, should see as its central mission, in particular by making its fast growing young population far more trilingual than the youth of the Flemish and Walloon periphery, and not less as is currently the case. What follows from these key features of the situation in and around Brussels? That proper responsibilization of the regions should make their revenues dependent not only on the incomes earned in the region, but also on the incomes of the people living in the region? In other words, that we should go for some sort of compromise between what commonsense suggests and what is assumed both in the current system and in both proposals ? Not exactly.

The fundamental point is rather that the externalities are of such a magnitude that the room for sensible responsibilization is unfortunately quite limited. The Brussels Region is simply the cosmopolitan central neighbourhood of a much larger cosmopolitan area.[60] Externalities would no doubt be far more limited if Brussels were simply swallowed by the Flemish Region, or if Brussels expanded so as to absorb both Vlaams Brabant and Brabant wallon. True, they would not vanish altogether under these scenarios, but they would become sufficiently manageable for the pursuit of efficiency — if not of distributive justice — to be consistent with a high degree of financial responsibilization, indeed even, arguably, with separation into two or three sovereign states. But whether we find it regrettable or not, we all know that neither of these scenarios will ever happen, and efficiency-minded economists will therefore have to reconcile themselves with the idea of putting up, not only with the Belgian federal state, but also with a very modest degree of regional responsibilization.

It is the merit of both pieces to explore what can be meaningfully done in this direction, not with vague slogans but with explicit, precise and honest proposals. It is partly because such proposals are specific enough to lend themselves to careful scrutiny and assessment that they will help us correct some of the undeniable defects of the present arrangements.

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[60] See Thisse & Thomas (2010).

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