Published by the Forum of Federations · www.forumfed.org · Publié par le Forum des fédérations

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FISCAL FEDERALISM AND REGIONAL INTEGRATION
LESSONS FROM BELGIUM

Conference"Fiscal federalism in the Mercosur: the challenges of regional integration"
Porto Alegre, Brazil, June 26-27, 2002.

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19 June 2002

draft - comments welcome

Abstract

After presenting some features of federalism in Belgium, this paper examines the coordination mechanisms set up in Belgium in the fields of taxation and budgetary policies and their links with coordination at the EU level. It shows that coordination mechanisms at both levels can complement each other. In particular, the EU and Belgian institutions played a complementary role in the considerable reduction in the budget deficits and the national debt in Belgium. The paper concludes that a proper design of institutions in order to achieve coordination in the taxation or budgetary fields can bring about substantial benefits. In this respect, the Belgian experience could prove interesting for other countries involved in a process of regional integration.

1. INTRODUCTION

In Europe as well as in Belgium, the past decades have witnessed tremendous institutional changes. Born a few years after the war, the European Community has turned into a European Union (EU). Whereas the competencies of the European

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Community were limited to interventions in specific sectors (agriculture, coal, steel or nuclear energy), the actions of the EU embrace a vast array of fields from agriculture to trade, from competition to environment, in a Single market characterised by a free movement of goods, services, labour and capital. Furthermore, the EU is also increasingly active in the areas of foreign and security policy, justice and home affairs.

The transformation of the European institutions has strongly affected the constituent parts of the EU, that is, its Member States. In particular, major State competencies, such as the monetary policy for 12 countries[2], are now managed at a supra-national level, while national policies of the Member States are increasingly coordinated. For instance, the "Growth and Stability Pact" sets clear guidelines and procedures for monitoring budgetary policies for countries involved in the Economic and Monetary Union (EMU)[3]. As a consequence, EU coordination mechanisms can involve changes within each country.

Belgium has also gone through fundamental institutional reforms. Indeed, the country was highly centralised until 1970. It progressively created and developed new institutions, the Regions and Communities, which are competent for a wide array of fields (education, culture, economic policies, infrastructure, etc.). Belgium became a federal country in 1993. So, contrary to the process of integration observed at the European level Belgium has gone through what is sometimes seen as a "disintegration" process.

The decentralisation of competencies in Belgium has made it necessary to create mechanisms for the coordination of fiscal policies. Although the latter are often mainly motivated by national concerns, the broader framework of EU policies can also influence them. This paper therefore presents some coordination mechanisms in the Belgian institutional framework. It also examines some of the links between EU policies and the coordination of fiscal policies in Belgium. However, coordination mechanisms between the Member States of the EU are not examined here.

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[2] The "Euroland" does not include the UK, Denmark and Sweden.

The rest of the paper is structured as follows. Section 2 briefly presents some features of federalism in Belgium. Special attention is devoted to financial arrangements between the federal level, Regions and Communities. Section 3 presents coordination mechanisms in the budgetary and taxation fields in Belgium. Section 4 contains some conclusions on fiscal policy coordination in Belgium.

[3] See other contribution to this seminar "Macroeconomic challenges: coordinating fiscal and monetary policies among economically integrating countries" *(Paul Bernd Spahn, Goethe Universität, Frankfurt, Robert Devlin, IADB)*

2. FEDERALISM IN BELGIUM

2.1. Five State reforms at a glance

To facilitate an understanding of the Belgian institutions and some of its main features, a brief historical overview may be useful. Starting from a relatively centralised and unified organisation, the country has progressively turned into a federal and relatively decentralised system. This results from five main reforms completed over the past 30 years[4]:

In the first reform (1970) the concepts of Regions and Communities were introduced in the Constitution. The 3 Regions are the Walloon Region, the Flemish Region, and the Brussels-Capital Region. The 3 Communities are the French Community, the Flemish Community and the German-speaking Community. This co-existence of both types of federated entities next to the federal government is undoubtedly one of the most original characteristics of the Belgian federation.

In the second reform (1980), the first competencies of Communities were defined, as well as the exact territory of Regions[5]. Moreover, the Flemish Community "absorbed" the Flemish Region. Concretely, the Flemish Parliament deals with matters related to both the Community and the Region. There is a single budget for the Flemish entity including both regional and Community resources. However, there are still some distinct features relating to the Flemish Region[6]. As a consequence, the federal system is characterised by a deep asymmetry of institutions. Indeed, the richer and more populated Flemish entity, Flanders, encompasses both the Flemish Region and the Flemish Community while the other federated entities remain distinct.

In the third reform (1988-1989), the central Region of Brussels-Capital - which had been introduced in the constitution but did not yet have a concrete existence - was set up, albeit with some distinctive features compared to the other Regions. Furthermore, a large number of competencies, in particular the competencies linked to education,

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[4] In what follows, few specific references to the German speaking Community or the Community Commissions in Brussels will be made. For more details on Belgian institutions, see www.fedgov.be.
[5] Maps in Annex 1 present the institutions in Belgium.

industrial policy, infrastructure and telecommunications, were transferred from the federal government to the Communities and the Regions, respectively. Substantial changes in the financing laws of the Communities and the Regions were designed as a consequence[7].

In the fourth reform (1993), Belgium officially became a federal State, thereby recognising Regions and Communities as sovereign constituencies next to the federal level. More competencies were transferred to Regions and Communities. At the same time, the French Community abandoned some of its competencies for budgetary reasons in favour of the Walloon Region and a Community commission in Brussels (see section 2.3 below).

During the latest reform (2001), a few additional competencies, such as those linked agriculture and development assistance, were transferred to Regions and Communities. A particular attention was given to tax and budgetary issues and an extended revision of the Special Financing Law (SFL) was necessary.

2.2. Current sharing of competencies in Belgium - expenditures

This rather short overview highlights the centrifugal dynamics of competencies in Belgium seen from the central/federal viewpoint. Whereas most of the competencies were attributed to the national level, a large proportion of the competencies have now been attributed to the newly created Regions and Communities, while other competencies were attributed to European institutions[8]. It also underlines that Belgian institutions are characterised by a number of asymmetries, which complicates their study.

The main tasks of the Federal government are only partly defined in the Constitution, often in a rather general wording. Simplifying, one can say that the federal level is in

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[6] The exact relationship between the Flemish Region and Community is relatively complex and will not be examined further here.
[7] The "Special Financing Laws" (SFL), which define the framework of the financing for Communities and Regions, are presented and discussed in the following section.
[8] We do not examine issues linked to communes and provinces (local public sector) here.

charge of foreign relations[9], justice, national defence, police[10] and most of the public debt. The Federal level also plays a major role in the social security system[11], which in budgetary terms represented BEF1,600.5 bn in 1998 as compared to BEF1,679.6 bn for the federal budget[12], and it keeps some control on parts of Region and Communities competencies.

Table 1 below presents the expenditures of the federal government. The first striking element of this table is the diminution in real terms of federal expenditures (except interest) between 1980 and 1998. The expenditures remained broadly stable since 1980. This is particularly due to the substantial transfer of competencies to Regions and Communities in the 1988-1989 institutional reform. The increase in federated entity competencies is best highlighted by the last row of the table: transfers of revenues (grants or taxes raised by the federal government on account of the Communities and Regions) represented 55.6% of total federal expenditures in 1998. This ratio is undoubtedly higher after the 2001 State reform and will continue increasing. Lastly, the structure of federal expenditures also shows a remarkable evolution in interest expenditure across time. The latter represented 37.9% of the federal budget in 1998.

The main tasks of the Communities and Regions have been explicitly defined in the Constitution and in special laws[13]. These state that Communities are competent for cultural matters, education, prevention of communicable diseases, assistance to families and children, and social assistance (see table 3). Regions, on the other hand, are responsible for the overall organisation of the economy, except when it comes to, mainly, the protection of the "economic and monetary union". In practice, Regions are competent for industrial policy, tourism, employment policy, infrastructure and

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[9] Regions and Communities are competent for external relations, including signing treaties, in their fields of competences. Regions are partially competent for development assistance.

[10] Communes (the local governments) are also involved in police matters.

[11] Social security mainly includes child, unemployment and retirement allowances and health care. Communes are responsible for the local public centers for social assistance. Communities are involved in some parts of social security ("dependence assistance", agreements for hospitals, …). See Cattoir (1998).

[12] The social security system is mainly managed by the State and the social partners (unions and business representatives). 1 Euro = 40.3399 BEF.

[13] Special laws require a 2/3 majority in the federal Parliament and a simple majority in the French-speaking and the Dutch-speaking groups in the Parliament (art. 4 of the Constitution).

telecommunications, public works, environment, natural resources, research and development activities.

Table 1: Expenditures of the federal government[a] (bn BEF)

Departments	1980	1988	1989	1990	1996	1998	1998 (%)
Education	230.0	288.7	14.6	24.2	0.0	0.0	0.0
Public infrastructure	83.8	106.1	81.7	66.1	0.0	0.0	0.0
Transport	87.0	106.3	74.5	72.6	94.6	91.2	5.4
Home affairs[b]	66.8	81.7	21.4	12.1	12.0	13.2	0.8
Economic affairs	30.0	54.5	44.9	39.6	9.3	12.7	0.8
Parliament	2.9	5.4	5.4	5.6	11.6	12.5	0.7
Prime Minister	4.2	6.9	6.9	7.9	20.6	21.1	1.3
Justice	19.5	22.8	23.3	24.7	33.6	40.0	2.4
Foreign relations	18.3	23.3	23.5	29.5	27.1	32.9	2.0
Defence	81.5	100.7	95.6	98.4	94.6	98.4	5.9
Police	12.4	18.7	20.5	21.4	27.3	30.0	1.8
Public sector	33.6	45.4	50.5	46.0	68.7	73.1	4.4
Retirement allowances	118.9	194.9	199.1	210.1	235.3	225.0	13.4
Middle-class and agriculture	14.3	21.7	19.4	17.7	17.9	49.0	2.9
Employment	89.3	59.0	55.4	34.6	25.5	24.3	1.4
Health care, assistance	137.9	218.4	223.6	211.6	314.1	309.4	18.4
Post, telecommunications	15.6	14.0	12.4	13.1	13.4	8.5	0.5
Miscellaneous	0.0	0.0	0.0	0.0	0.0	2.5	0.1
TOTAL except interest	1,046.0	1,368.5	972.7	935.2	1,005.6	1,043.8	62.1
Interest on debt	142.4	393.8	447.6	535.1	650.1	635.8	37.9
TOTAL	**1,188.1**	**1,762.3**	**1,420.3**	**1.470.3**	**1.655,7**	**1,679.6**	**100.0**
Grants and revenues for Communities and Regions	72.1	179.3	599.7	607.3	836,6	933.9	55.6

[a] Except transfers to the EU
[b] Mostly transfers to local governments
Source: Bulletin de document du Ministère des Finances; Conseil supérieur des Finances; Pagano (1999)

The fact that the Flemish Community "absorbed" the Flemish Region makes it difficult in practice to present detailed figures for Regions or Communities budgets. This is so because the budget for Flanders includes a mix of the Region and Community data, which are difficult to disentangle. Therefore, table 2 only presents figures for total Regions and Communities expenditures[14]. This table highlights the

[14] An excellent presentation of the various budgets has been made by G. Pagano *in* Docquier Ed. (1999). Most of the budget figures presented in this section are drawn from this reference. The French Community Commission and the Common Community Commission in Brussels are not presented here.

asymmetry of institutions in Belgium, Flanders accounting for more than half the total federated entities spending in 1998.

Table 2: Expenditure for the Regions and Communities (in bn BEF)

	1998	1998 (%)
Walloon Region	183,843.0	17.3
Brussels-Capital Region	61,806.9	5.8
Flanders (=Flemish Region + Community)	573,510.8	53.9
French Community	241,681.9	22.7
German-speaking Community	4,142.9	0.4
Total	1,064,985.5	100.0

Source: Pagano *in* Docquier Ed. (1999)

Table 3 : A simplified overview of Community and Regions competencies[a]

Communities competencies	Cultural matters, e.g. financing of museums, theatres, public librairies, tourism, professional education Education (except beginning and end of compulsory education, minimum standards for obtaining diplomas, retirement regimes) "Matières personalisables", e.g. prevention of communicable diseases, policy towards disabled persons and families Use of languages for public purposes, education, and for the relationship between employers and employees Cooperation among Communities, international cooperation including signing treaties, for cultural matters, education, "matières personalisables"
Regions competencies	Support to investment and employment Employment policies transport Public work Financing of local governments (provinces and communes) Research policy related to regional competencies Purification and distribution of water Waste policy, protection of the environment External trade Agriculture International relations related to their competencies

[a] Notes

Several exceptions should be reminded of, in particular:
1/ the absorption of the Flemish Region by the Flemish Community
2/ the transfer of some competencies of the French Community towards Brussels (French Community Commission) and the Walloon Region. These competencies include tourism, professional education, health, policy towards families

2.2. Current sharing of competencies in Belgium - revenues

The analysis of the revenue side of the Belgian entities gives a rather different picture than the one presented for expenditures. Indeed, the federal government keeps a major role in the most important taxes, despite the considerable responsibilities of Regions and Communities on the expenditure side. Consequently, a major part of federated entities financing still occurs through grants, despite recent efforts to increase tax autonomy of the Regions. It should also be noted that unlike in many other federal systems taxes are usually "exclusive" competencies, i.e. the competence of one level of government excludes intervention in the same field by another public authority. This is mainly due to the principle of "*non bis in idem*", which forbids a federated entity to create a tax where there already exist a federal tax of the same nature. Figure 1 illustrates the main financial features of the financing system for Regions and Communities after the 2001 State reform.

The federal government is competent for the main taxes: the personal income tax (PIT), corporate income tax (CIT), VAT, withholdings on savings income, excise and customs duties. These taxes largely cover federal expenditures (BEF 2,400.5 bn in 1998 as compared to total federal expenditures of BEF 1,679.6 bn)[15]. It also raises a number of regional taxes, the proceeds of which are transferred to the Regions (see below). Parts of federal tax proceeds are also transferred to the social security system[16]. Finally, the federal government gives grants to the social security system, and the Communities and Regions.

The Regions benefit from a variety of resources. The most important one is the PIT-grant[17] (around 2/3 of total Regions revenues in 1998). This grant was designed in order to allow the Regions to cover the expenditures linked to the transfer of competencies to Regions in 1988-1989[18] and it grows in line with national GDP. It is shared between the Regions according to the share of federal PIT that is collected on their territory. This PIT-grant is completed by a National solidarity intervention

[15] Non tax revenues accounted for BEF 104,1 bn and other revenues for BEF 54,8 bn. Source : Pagano *in* Docquier Ed. (1999).
[16] The social security financing is not examined further here.
[17] In the SFL, this grant is called a shared tax since its funding comes from the proceeds of the PIT.

(NSI). This solidarity mechanism benefits any Region where the PIT per capita is lower than the national average. The amount is calculated as a price-indexed amount (defined in 1989) multiplied by the population of the recipient Region and a factor of the difference of PIT per capita between the regional and the national levels. In practice, the NIS benefits the Walloon Region and the Brussels-Capital Region. The Regions receive other, more specific grants, from the federal government[19]. Next to grants, Regions are competent for a number of well-defined taxes: taxes on gaming and betting, gambling machines and on the opening of alcohol retail outlets, inheritance and gift taxes, various property taxes, taxes on vehicles and their use, tax on the use of televisions and radios[20]. It should be underlined that the revenues corresponding to a number of these taxes accrued to the federal level until 2001 (and part of the corresponding revenues where transferred to the Regions)[21]. In the context of the latest state reform negotiations it was agreed to increase the tax autonomy of Regions provided that it would not affect the federal budget (principle of "budgetary neutrality"). Concretely, from 2002 the PIT-grant will be decreased by an amount corresponding to the new tax revenues ceded to the Regions[22]. Regions can also raise other taxes but they have to respect the principle of *non bis in idem*. In practice, there are few other regional taxes. Lastly, the Regions can set an additional tax on the federal PIT or offer credits on the latter. The latest State reform defined the limits of regional intervention. In order to maintain budgetary neutrality with regards to the federal budget, the PIT grant will be decreased if a Region chooses to offer credits on the PIT.

The financing of the French and the Flemish Communities is based only on non-tax revenues and, in particular, on two main grants from the federal government. The PIT-grant was originally designed to cover expenditures corresponding to a number of new Community competencies following the 1988-1989 reform. It grows according to

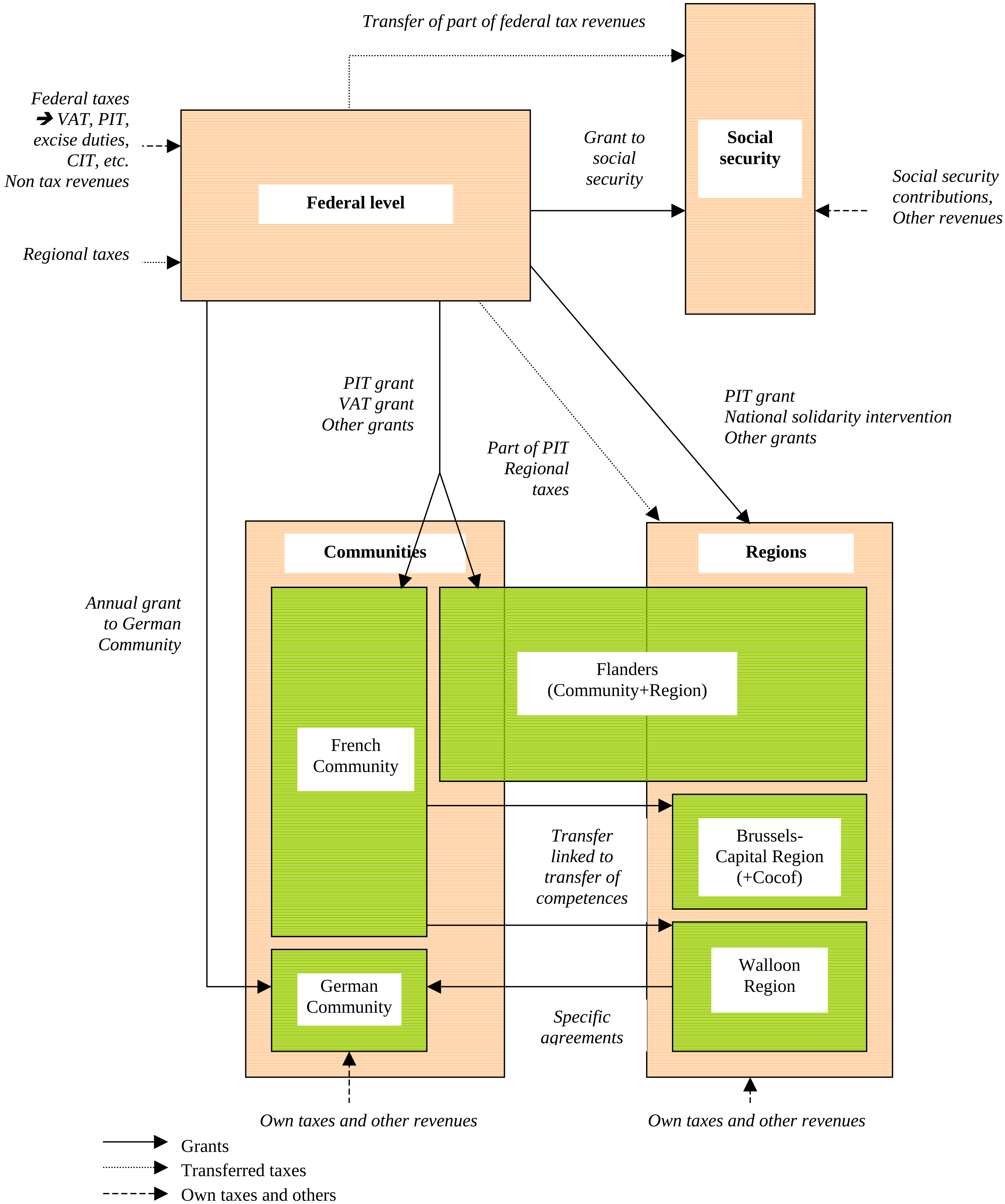
[18]The main grants to Regions and Communities (defined in 1989) covered a part only of the expenditures corresponding to competencies transferred to them at the time, in order to encourage them to take part to the efforts to reduce public deficits.
[19] A detailed analysis of grants in Belgium can be found in Cattoir *et al.* (2002).
[20] If the Regions so wish, the federal administration can take care of the collection of these taxes (with an exception for the tax on the use of televisions and radios). For a detailed presentation of the financial mechanisms after the latest state reform, see Van der Stichele et Verdonck (2001).
[21] The revenues of the tax on the use of televisions and radios accrued to Communities.
[22] The Regions must also compensate Communities for the transfer of the tax on the use of televisions and radios. The corresponding financial flows are not presented in figure 1.

national GDP and is shared between Communities according to the PIT raised on the territory over which they exert their competencies. Since two Communities are competent over the territory of Brussels-Capital, 80% of the PIT proceeds in Brussels are deemed to originate from French-speaking people and 20% from Dutch-speaking, Flemish, people. The VAT-grant was also designed to cover the financing of other competencies (mainly education) attributed to Communities in 1988-1989. The growth rate of that grant was linked to the price index and the sharing between Communities was (roughly) based on the number of students.

Unsurprisingly, the evolution of the VAT-grant has not been sufficient to cover the needs of the Communities, and in particular, of the French Community. Indeed, in the long run the expenses of Communities - for a large part wages - tended to increase in line with nominal GDP while the Community financing was almost fixed in real terms. The budgetary imbalance could be partially coped with by Flanders, due to the existence of a single budget for the Flemish Region and Community. The French Community, however, was in a very difficult financial situation and required additional revenues. This is at the heart of the 1993 and 2001 reforms. In 1993, the French Community abandoned part of its competencies to the Walloon and the Brussels-Capital Regions[23], while making financial transfers equivalent to a part only of the corresponding expenditures. It was only in 2001 that the problem of long-term growth of the VAT-grant was solved, by granting additional revenues to the Communities for the coming years and modifying the growth rate of the VAT-grant. Lastly, it has to be noted that the smaller German-speaking Community mainly benefits from a yearly allowance passed by law by the federal Parliament.

[23] More precisely, the French Community Commission in Brussels.

Figure 1: Financial relationship - Federal, Regional and Community level (2002)



3. COORDINATION OF FISCAL POLICIES

Two main facets of the coordination of fiscal policies are examined here: the coordination of budgetary policies and the coordination of tax policies. The issues related to coordination of expenditures are not examined in this paper.

3.1. Coordination of budgetary policies

Context

As indicated in the introduction, the coordination of budgetary policies in Belgium is strongly influenced by its participation in the European institutions. Therefore, the coordination of budgetary policies has to be seen in a two-tier perspective: the EU-tier defines a broad budgetary framework for the Member States. The latter then find ways to respect this budgetary framework, while taking into account national necessities and circumstances.

The EU budgetary framework is well documented and a detail analysis of the latter falls outside of the scope of this paper[24]. However, it should be recalled here that the 1993 Maastricht Treaty, which paved the way for the creation of a common currency (the Euro), defines strict budgetary criteria to take part in the Economic and Monetary Union (EMU). In particular, the required maximum public deficit is 3% of GDP "*unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value*". Moreover, the debt level cannot exceed 60% of GDP, "*unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*"[25]. These criteria have been followed by other, more stringent, criteria of financial sustainability within the framework of the Stability and Growth Pact. These were aimed at ensuring progress towards the medium term target of budget balances which, according to SGP, should be close to balance or in surplus.

[24] For a more detailed analysis, see European Commission (2000), *Public Finances in the EMU*, SEC(2000)846.
[25] Article 104 Treaty of the European Union (ex article 104c).

These criteria have to be compared with the state of public finance in Belgium in 1993 (see figure 2). At the time, the public deficit reached 7.3% of GDP, while the public debt amounted to 138.2% of GDP, the highest level in the OECD. Participation in the EMU from 1 January 1999 thus required a considerable budgetary effort by public authorities to achieve a substantial and continuous decline of deficits and a decline of the debt ratio and, later, a balanced budget. However, public support for a substantial reduction in public deficits was made easier by concerns regarding the financing of social security in the long run[26]. Furthermore, the ability of governments to conduct their policies was clearly hindered by the massive payments (10.7% of GDP in 1993) required to service the public debt. Many politicians felt that efforts made to structurally reduce the public deficit in the short term would give governments more room to manoeuvre in the long term.

Figure 2 illustrates the new dynamics of public finance that was launched in 1993 and the resulting effects in terms of debt and deficits. Starting from a deficit of 7.3% of GDP and a total public debt of 138.2% in 1993, public authorities implemented a policy of progressive reduction of deficits. As a consequence, the public deficit amounted to 0.2% in 2001 and the debt to 107.7% of GDP. The sustained and structural diminution of deficits and the consecutive diminution of the national debt suggest that the strategy followed by the public authorities was right. In this context, it is then useful to examine what have been the respective roles of the federal, regional, Community and other authorities and the manner in which they could coordinate their action.

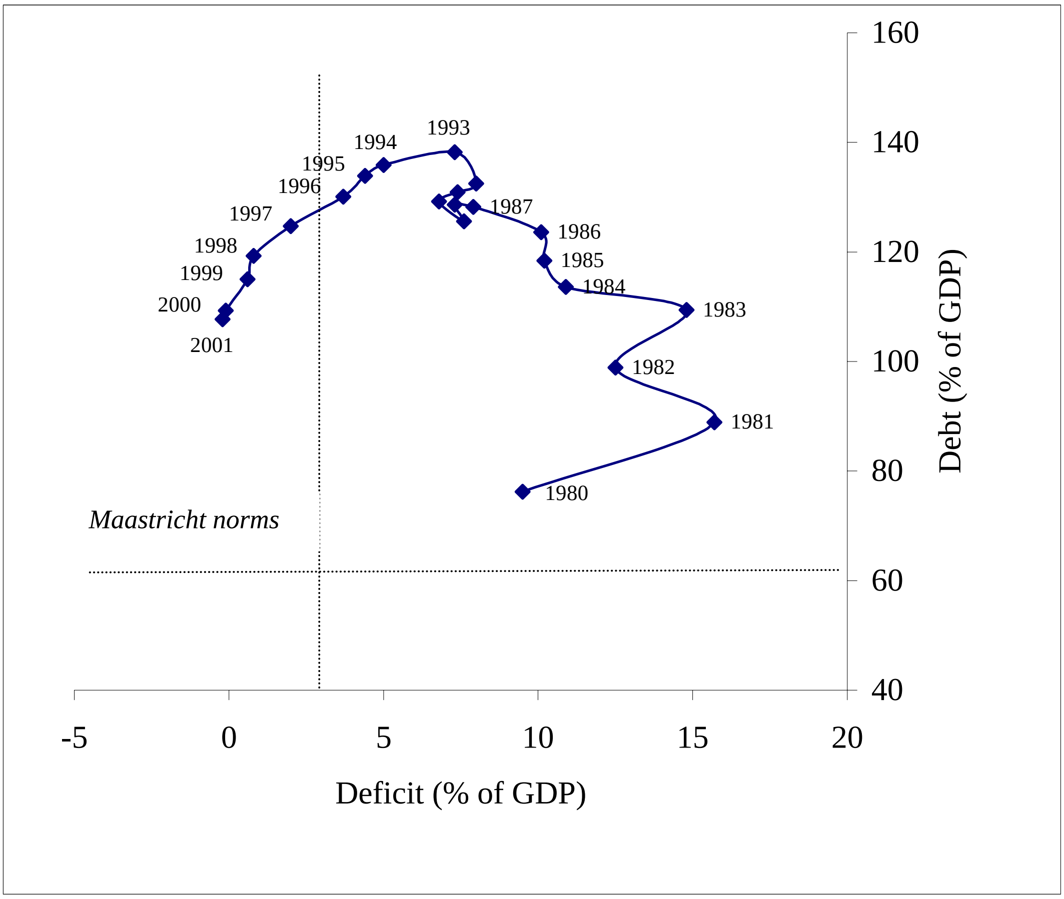
Coordination in practice

In the context of a fast and ongoing decentralisation of competencies a strategy of deficits and debt reduction necessarily required involving Regions and Communities. The coordination of their budgetary policies was mainly achieved through two complementary instruments, namely the recommendations of the "High Council of Finance" and the "cooperation agreements". These instruments proved rather successful in facilitating budgetary reforms.

[26] Implicit debt linked to the payment of pensions and health care has been estimated at 210,9% of

The High Council of Finance (HCF)[27] is an institution that provides advice and recommendations to the governments in a number of areas. It is composed of high level experts designated by various bodies and branches of the federal, regional and Community government (ministries, national bank, planning bureau, etc.). The experts, although designated on a political basis, are relatively independent from public authorities because of incompatibilities between their position and a number of public offices, e.g. a member of the HCF cannot at the same time be adviser to a minister or hold political positions.

Figure 2: Public deficits and debt in Belgium (1980-2001)



Currently, the HCF is composed of four "permanent sections" and a study group. The sections are called "Public sector borrowing requirement", "Taxation and social security contributions", "Financial institutions and markets" and "transfer of federal

GDP with constant policies. See Cattoir and Docquier (2000).

[27] For more information, see www.docufin.fgov.be (High Council of Finance).

collected tax revenues". The study group works on the budgetary and social consequences of ageing.

The "Public sector borrowing requirement" section of the HCF, which played a central role in the coordination of budgetary policies, in particular since 1993, was created in June 1989[28]. Each year, the section publishes two reports. In March, an assessment of the implementation of the (EU) "stability programme" in the previous year is made. In June, the section's annual report analyses the borrowing requirements of public authorities. On this occasion, the HCF also expresses recommendations on the budgetary policy. These recommendations usually constitute the yardstick to define and evaluate budget policies at all levels of government in the short- and long-run. They also serve as a basis for pluri-annual cooperation agreements between the federal, regional and Community governments (see below). Overall, these HCF reports provide the opportunity to "name and shame" authorities that have not respected their commitments while stressing the importance of maintaining a sound budgetary policy. Apart from the two yearly reports, it should also be underlined that the section can, on its own initiative or following a request by the federal Minister of Finance, express an opinion on the opportunity to limit the borrowing capacity of a public authority. This can be done to protect the (Belgian) economic and monetary union, to avoid disruptions of external and internal monetary balances, e.g. safeguard price stability, and to prevent a structural increase of public deficits. Although this possibility has never been used, it is a potentially powerful instrument.

Albeit an important element to facilitate a rational debate on budgetary policies, the recommendations and advice of the High Council of Finance would not be as effective if they were not complemented by a political commitment by all federated entities and the federal government. This commitment takes the form of a "cooperation agreement" signed by the governments concerned and ratified by their parliaments. The agreement defines budgetary norms for periods of several (normally 5) years, which can be revised if necessary. They also take into account EU norms, such as the ones defined in the Growth and Stability Pact.

The latest of such agreements was signed on 15 December 2000 and defines budgetary objectives for 2001-2005. As is illustrated by abstracts in Box 1, it reflects the role of both the EU budgetary norms and the High Council of Finance.

Box 1 : example of a budgetary cooperation agreement[29]

"Article 1: The parties to the present agreement support the budgetary objectives of the [EU] *Stability Programme 2001-2005 for Belgium aiming at progressively raising the financing capacity of the public sector from 0,2% of GDP in 2001 to 0,7% of GDP in 2005, thereby accelerating the reduction of the public debt.*

Article 2, §1: The parties to the present agreement have acted upon the recommendations of the High Council of Finance for the budgetary year 2001, as they are stated in the annual report 2000 of the "Public sector borrowing requirement" section.

Article 9 [last article]*: In order that the budgetary policy of Communities and Regions conform with the current and future Stability Programmes of Belgium, the Communities and the Regions each commit to develop an internal pluri-annual Stability Programme in line with the present agreement. Its duration must in no case be lesser than the Stability Programme of Belgium. In these internal Stability Programmes, Communities and Regions will indicate how they shall achieve the aforementioned objectives for each of the budgetary years concerned. The "Public sector borrowing requirement" section of the High Council of Finance will, on a yearly basis, make an assessment of the implementation of these Stability Programmes".*

Agreement signed on 15 December 2000 by the federal PM, minister of budget and minister of Finance; by the PM of Flanders, by the PM and the ministry of budget for the French Community; by the PM of the German-speaking Community; by the PM and the minister of budget of the Walloon Region; by the PM and the minister of Finance of the Brussels-Capital Region.

Taken together, these coordination mechanisms offer a number of clear advantages. Firstly, they create a transparent framework where the budgetary objectives in the short, medium and long term are clearly defined for all levels of government. This transparency also imposes discipline. Indeed, failing to comply can be seen as a sign of bad management. Naming and shaming is also particularly important in a federal system, in particular when there are few Regions and Communities. Lastly, these

[28] See article 49§6 of the Special Financing Law of 16 January 1989 and the implementation articles (AR/KB of 20 June 1989 and modification of 10 August 1998).
[29] Own translation. The original is in French and Dutch.

factors facilitate the task of policy-makers, who can better resist pressures to increase expenses and decrease taxes thanks to long term formal political agreements.

3.1. Coordination of taxation policies

Context

The context in which the coordination of taxation policies is envisaged in Belgium is certainly quite different from the one that exists in many other parts of the world, in particular the Americas. Indeed, some geographic and institutional circumstances of Belgium should be underlined. Belgium is a territory of only 32,545 km^2 with a maximum distance between any two points of 280 km (by comparison, the Brazilian territory has an area of 8,511,965 km^2). Within a range of 300 km from the capital, Brussels, one finds: London (UK), Paris and Lille (France), Amsterdam and Rotterdam (the Netherlands), Bonn and Köln (Germany), Luxembourg. Adding to geographic proximity, a close economic integration can also be observed in the EU. The European Community Single Market is characterised by a free mobility of goods, services, capital and labour. Undoubtedly, tax arbitrages are easier in such a context than in the context of very extended territories with a lower degree of economic integration.

These factors, and the efforts made at the EU level to eliminate (tax) distortions to the proper functioning of the Single Market explain the increasing importance of EU intervention in the tax field. Parts of indirect taxes (excise duties and VAT) are harmonised at the EU level, while important efforts are being made in order to eliminate "harmful tax competition" in the fields of company and savings income taxation, in the framework of the "tax package".

Recent debates in Belgium, in the context of the latest State reform, have shown that the European framework can affect demands for "tax autonomy", i.e. increased competencies in the tax field for federated entities. In particular, the fact that some taxes are being harmonised at EU level made demands for regional autonomy in the same fields somewhat useless, since increased autonomy in these fields would in practice not lead to differentiated policies at the regional level. This line of arguments can be best illustrated by positions taken by the HCF's "Taxation and social security contributions" section in an influential report on tax autonomy. Examining the possibility of decentralizing the competencies for CIT, VAT and excise duties, the section stated that "*one cannot recommend harmonisation on the one hand and decentralisation on the other*". Therefore, considering the "*wish for harmonisation at EU level*" it "*logically*" suggested that the most important elements of these taxes should remain at the federal level[30].

<u>Coordination in practice</u>

It should be remembered that federated entities in Belgium were created in the 70s and developed mostly in the late 80s and 90s. Regions and Communities had no tax competencies until the 1988-1989 reform and even then, they only received a fairly limited tax power in practice. Notwithstanding that this has progressively changed, many people consider(ed) that a fair way of coordinating tax policies is to leave the tax competencies at the national/federal level. Not decentralising tax competencies would simply lead to an uniformed, harmonised, tax policy. Ultimately, it would eliminate risks of mutually damaging tax competition, etc. The discussions preceding the state reform of 2001 allowed for a healthy debate on the pros and cons of increasing tax competencies of Regions and Communities, and how to facilitate the coordination of tax policies. These debates have resulted in a number of interesting coordination mechanisms.

As indicated in section 2.2, Regions can now add a tax on the federal personal income tax (PIT) or, on the contrary, offer credits on the latter. In the latest state reform, a number of mechanisms were introduced so as to limit the risk of a tax competition between Regions. Firstly, when setting additional taxes or offering credits on the federal PIT the Regions cannot decrease the (overall) progressivity of the PIT. Secondly, there are limits to the regional intervention in the PIT: from 2004 the amounts raised or credited cannot exceed 6.75% of the federal tax raised in the Region. When a Region wishes to introduce changes in the PIT, it must inform the federal government as well as the governments in the other Regions. The technical applicability of the reform proposed must be assessed[31]. The Region must then request an opinion from the federal Audit Office, the body in charge of auditing

[30] Own translation. See Conseil supérieur des Finances, Section Fiscalité et Parafiscalité (1998), pp. 155-156 (French version).

government financial accounts and practices. The Audit Office must examine whether the proposed policy respects the limits stated in the special financing law. Lastly, following the state reform of 2001 the Audit Office must develop a model for the assessment of Region proposals. It must also publish an annual report on the effects of regional tax policies.

Although these opinions and the inter-regional dialogue on tax reforms do not lead to binding constraints[32], they are important politically. Indeed, experiences have shown that a "*face-to-face*" discussion and better and increased information can facilitate cooperative behaviours. In the context of Belgium, "*the meetings between Regions' PM [...] should be seen as strengthening the link between federated entities in the framework of a cooperative federalism*"[33].

The 2001 tax reform also led to a debate on the coordination mechanisms for the new regional taxes. A number of regional taxes have tax bases that are relatively immobile. This applies to taxes on houses, alcoholic drink outlets, gambling machines, etc. No coordination mechanisms have been envisaged in these cases. With other taxes, however, risks of tax arbitrages are much higher. For example, 80% of the proceeds of the (regional) inheritance tax originate from only 10.8% of successions[34]. In this case, the special financing law (SFL) has set clear constraints on the definition of the location of the tax base. The inheritance tax benefits the Region where the deceased person used to live (or lived longest) in the past five years. For taxes on vehicles and their use, the SFL specifies that a compulsory cooperation agreement has to be signed between the Regions, which now have exclusive competence concerning these taxes. The agreement must define the tax rates and the tax base when the tax is imposed on vehicles owned by a company or for commercial use. This is mainly to avoid a risk of harmful tax competition between Regions in order to attract companies with leasing activities.

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[31] A compulsory cooperation agreement between the Regions and the federal state must define the exact proceedings of the coordination (see art. 92bis, §3 of the special law of 8 August 1980).

[32] See Van der Stichele et Verdonck (2001).

[33] Own translation. See Mintz, J. and H. Tulkens, "coopération et design des institutions: une perspective économique", *in* Cattoir *et al.* (2002), pp. 475-476.

[34] Conseil supérieur des Finances (1998), p. 117.

Although still modest in scope, these coordination mechanisms reflect the will to take into account possible fiscal externalities between Regions and to protect the overall tax revenues in the case of decentralisation of tax competencies.

4. CONCLUSION

The issue of coordination appears both at the international level and at the national levels. Coordination mechanisms at both levels can complement each other in order to achieve more efficient policies.

This paper highlights that the EU and Belgian institutions played a complementary role in considerably reducing budget deficits and the national debt in Belgium. The existence of the "Maastricht criteria" and the following "Stability and Growth Pact" set clear limits on budgetary policies of EU Member States. This was complemented in Belgium with a coordination of budgetary policies between the federal and federated authorities through cooperation agreements.

In the taxation field, coordination of policies can also be observed at both the European and the national levels. The European intervention in the tax field has likely imposed some limits to the decentralisation of tax competencies in Belgium, where taxes are subject to harmonisation at the EU level. Moreover, the existence of a highly integrated economic and geographic framework led to a number of coordination mechanisms in order to avoid harmful tax competition both in the EU and in Belgium.

The experience of Belgium highlights the need to create appropriate institutions to solve fiscal problems. Cooperation agreements, opinions of a High Council of Finance, or automatic exchange of information linked to tax reforms are three such instruments, which might prove useful examining for other countries involved in a process of regional integration.

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