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Highlights in this issue:

- **Since 1970 Belgium has developed an elaborate federal system**
- **During the last decade, fiscal consolidation has gone hand in hand with decentralisation**
- **An independent fiscal council plays a key role in the budgetary coordination process**

Federalisation and fiscal consolidation: The Belgian experience

*By Gerrit Bethuyne**

Summary

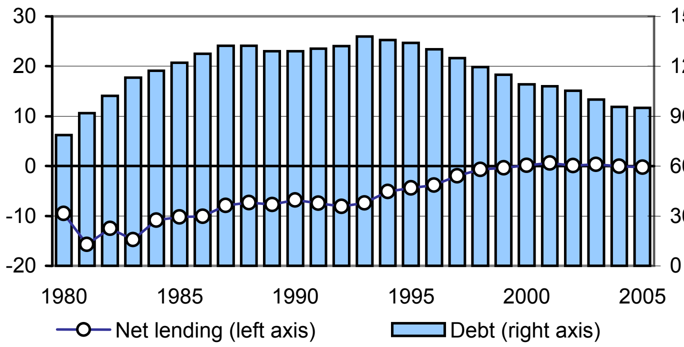
Since the constitutional reform of 1970, Belgium has evolved from a strictly unitary state into a rather complex federal structure of regions and communities. These regional entities now cover over 20% of all government expenditure. They are financed mainly with transfers from the federal personal income tax and from VAT revenue as well as some regional taxes. Budgetary conventions, largely based on agreements between the federal and regional level, act as internal stability programmes, setting medium-term targets for regions and communities. Clear objectives and an ex-post evaluation by a relatively independent supervisory agency (the High Finance Council), combined with the possibility of limiting the borrowing capacity of non-compliant regions or communities, have created the necessary conditions to turn the historically high deficit into a balanced budget.

Fiscal consolidation and federalisation

In the nineties, Belgium managed to reduce its high deficits of around 8% of GDP to a balanced budget which it has maintained since 2000. At the same time it has brought the debt ratio down from its historical highpoint of 138% of GDP in 1993 to about 95% in 2005 (see chart 1). This impressive fiscal consolidation was backed by a strong political will to match the Maastricht criteria and subsequently the close-to-balance target of the Stability and Growth Pact. The deficit reduction went hand in hand with a process of fiscal decentralisation which transformed Belgium in a fully fledged federal state.

Since the early 90's fiscal consolidation and decentralisation went hand in hand

Chart 1: Debt and net lending as % of GDP



Source: European Commission, Ameco database

* **Directorate for the Economies of the Member States.**

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Fiscal decentralisation in Belgium had started as early as 1970, with a constitutional reform that created the current framework of regions and communities (see box). However, it was not until 1989 that the current system became fully operational with the adoption of the “Special Financing Law” and the creation of the "Public Sector Borrowing Requirements" section within the High Finance Council, a supervisory agency composed of relatively independent high-level experts. This provided the framework for the current system of “budgetary conventions”, which are political agreements between the federal and regional governments that set medium-term targets and act like internal stability programmes (Van Rompuy, 2005).

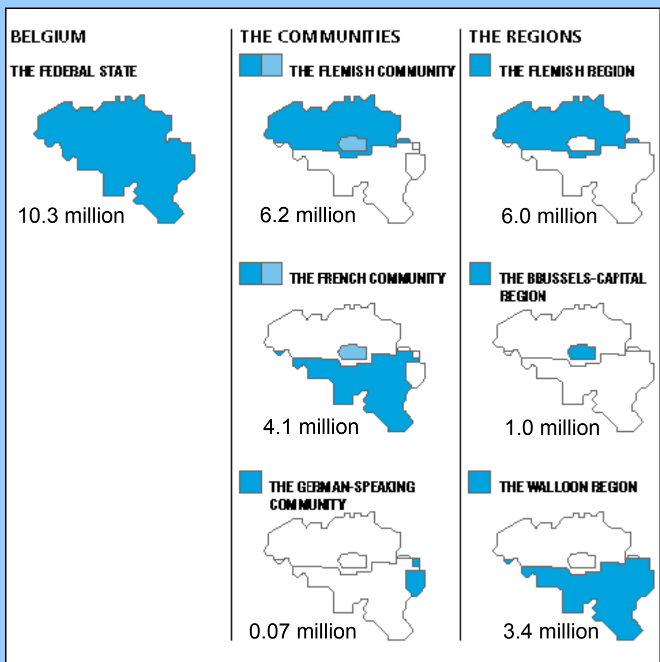
Since 1970 Belgium evolved from a unitary to a federal state with three regions and three communities ..

Box: The institutional context

Since 1970, Belgium has evolved from a strictly unitary state into a rather complex federal structure of regions (Flanders, Brussels and Wallonia) and communities (the Flemish, French and German-speaking Communities). The administrative reform was implemented in five separate phases (1970, 1980, 1988/89, 1993 and 2001), in which powers were increasingly delegated to the regions and communities. Currently, the communities exercise powers directly relating to people, such as education, culture, welfare and certain aspects of health policy. Regional powers include town and country planning, housing, the environment, public works and certain aspects of agriculture, energy, transport, employment and the economy. The regions also exercise the supervision over local authorities (Senelle *et al.*, 2003).

Since 1980 (and 1989 for Brussels) each region and community also has its own council (or parliament) and government. In Flanders the regional and community institutions have been merged given the large overlap in the population concerned. That said, there is no simple correspondence between the territories of regions and communities. Although, the Flemish Region – except for Brussels - coincides with the (Dutch-speaking) Flemish Community, the Walloon Region encompasses the French and German-speaking Communities. And while the bilingual area of Brussels is a region, it is not a separate community.

Regions and communities and their population



Source: Website federal government: www.belgium.be

… although the Belgian federation is in essence bi-polar

Despite the existence of three regions and three communities, the Belgian federation is in essence bi-polar, with a Dutch- and a French-speaking language group. The German-speaking Community is in fact too small to have a significant political or economic impact, while Brussels is a bilingual region. The bi-polar nature is institutionalised in many ways, primarily through the Belgian constitution. Representatives in the federal parliament are divided into two language groups (art. 43 of the constitution), which each have an effective veto against new federal legislation (art. 54). In the federal government, both language groups have an equal number of ministers (excluding the prime minister – art. 99). Finally, contrary to most other federal states, political parties are strictly separated by language: there are no parties with representatives from both communities.

Making federalisations work

Federalisation could contribute to more efficient public spending ...

In recent decades more and more countries in- and outside the EU are moving towards decentralised forms of government. Economic theory offers several reasons for favouring such forms of government. In particular, economic theory often argues that decentralisation makes it possible to adjust government services better to the needs and preferences of each region. It could lower administrative costs, and competition between regional governments may even contribute to organisational and political innovations (Oates, 1999, and Buti and Franco, 2005). Moving responsibilities to the regions could also reduce inefficient spending by tackling 'internalities' whereby services benefiting essentially one region are financed by other regions either directly or through the central budget. This effect is heightened by the fact that decisions from the central government are often difficult compromises between coalition partners representing different regions (especially in Belgium where political parties are strictly separated on the basis of language). In such a system, regional governments normally have less coalition partners, facilitating the decision-making process (See Alesina and Perotti, 1995).

… but its success depends on assigning responsibilities and taxes to the proper level of government …

However, in order to make a federal state work, responsibilities and fiscal instruments have to be alligned with the proper level of government. The normative theory of fiscal federalism usually assigns to regional governments the provision of those services whose consumption is limited to their own jurisdiction. The assignment of taxes to the regional entities is also a potential source of inefficiencies. In view of efficient macroeconomic stabilisation and redistribution, the bulk of the tax bases should stay at the federal level, especially those tax bases that are more mobile and sensitive to cyclical factors such as income tax and VAT. On the other hand regional taxes should have relatively immobile tax bases to make economic units pay for the benefits they receive from their regional government (the so-called 'benefit principle' - see e.g. Oates, 1999).

… and an efficient mechanism to enforce fiscal discipline

A second element that determines the degree of success of decentralisation is the mechanism used to enforce fiscal discipline. Several different solutions can be envisaged, ranging from market discipline to administrative rules. In a pure market mechanism, sub-entities with excessive deficits are sanctioned in the form of higher risk-premiums on their loans. However, market discipline may not work in federations, mainly because it requires a strict limitation of interregional transfers to avoid the possibility of bailing-out regions with excessive deficits. As an alternative, many countries have attempted to impose fiscal discipline by setting limits to annual budget deficits for the regional entities. Peer pressure, supported by the ultimate threat of penalties could be an effective instrument to ensure fiscal discipline (a principle that also lies at the basis of the Stability and Growth Pact).

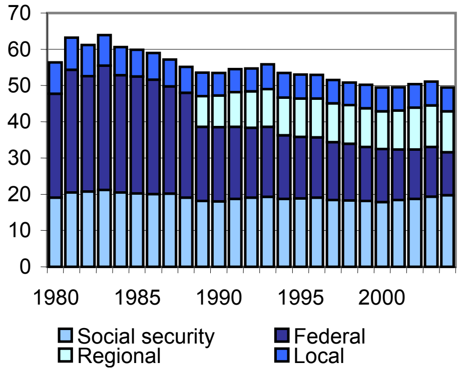
Budgetary decentralisation in Belgium

The regions and communities now represent over 20% of government expenditure

Although before 1989, regional entities already had some limited budgetary autonomy (about 3% of GDP by 1988), their funding solely consisted of federal government allocations. From 1989 onwards regions and communities received structural funding based on the new Special Financing Law[i] and became responsible for their own treasury management (Dexia, 2004). While in 1988 federal expenditure (excluding social security) was still almost 30% of GDP, it is now down to less than 12% (of which over one third can be attributed to the interest payments on federal government debt). On the other hand, regional expenditure is now over 11% of GDP (about 23% of total public expenditure – see chart 2). The assignment of responsibilities to appropriate levels of government is still an ongoing process and the subject of much political debate. While culture and education have been moved to the communities, the power for economic and employment policies are divided between the regions and the federal government (Senelle, 2003). There have been some calls to move elements of the health care system to the communities, based on structural differences between the communities. So far however, any proposal to transfer part of the social security system (including health care and employment policy) has been strongly opposed.

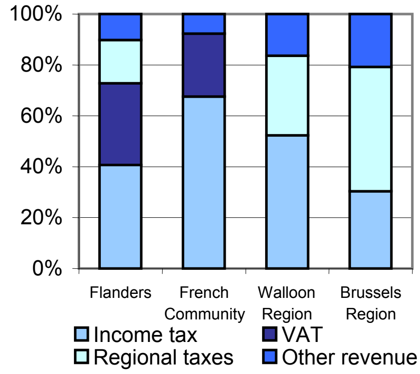
In 2004 about 55% of all regional and community expenditure originated in Flanders (where the community and regional institutions have been merged). The French Community accounted for about 21%, the Walloon Region for over 17% and the Brussels Region for some 6%. The German-speaking Community represented a share of less than 0.5%. Because of the fundamentally different powers of regions and communities and because of their territorial overlap, it is difficult to compare the per capita expenditure between regions and communities. However, by artificially attributing community expenditure to the regions (Bastaits *et al.*, 2004), per capita expenditure in 2004 can be calculated at EUR 2910 in Flanders, EUR 3296 in Wallonia and EUR 4114 in Brussels.

Chart 2: Government expenditure as a % of GDP



Source: National Bank, Belgostat database

Chart 3: Revenue sources for regions and communties in 2004



Source: SPF Finances, Note de conjoncture

Federal transfers and regional taxes are the main sources of funding …

The sources of funding attributed by the Special Financing Law are different between regions and communities (chart 3). Currently, regions and communities are mainly financed with a transfer from the federal personal income tax revenue and (for communities only) a transfer from federal VAT revenue. The Special Financing Law provides an elaborate framework of rules, assigning these funds to the different entities on the basis of past figures and objective parameters such as inflation, economic growth. Although the regional distribution of funds is increasingly linked to how much each region or community contributes to the total personal income tax revenue, there are also some special solidarity mechanisms for regions where the per capita personal income tax revenue is below the national average.

… supplemented by regional taxes

Regions also derive funding from a dozen types of taxes exclusively assigned to them, including registration taxes (on real estate sales, mortgages and gifts), inheritance taxes and road taxes. They can create new taxes, provided that the same tax base is not already in use for a federal tax, but except for the Brussels Region (where they represent over 7% of total revenue) these new taxes play only a marginal role (Dexia, 2004). The remaining sources of revenue for the regions and communities are quite diverse, including allocations for foreign students (to the communities), drawing rights to finance re-employment programmes (to the regions), and especially for the Brussels region, an allocation to compensate for its function as the capital. Finally, regions and communities can also use loans to finance their expenditure, subject to notification to and approval by the federal government.

Overall it seems that tax competition between has been carefully avoided in Belgian Special Financing Law. The tax base and tax rates for income tax and VAT remain largely at the federal level[ii], where it is most effective in terms of stabilisation and redistributive policy. On the other hand, regional taxes have a tax basis that is relatively immobile (e.g. the registration tax on real-estate sales), while in other cases special provisions have been foreseen to avoid harmful tax-competition (for instance in the form of compulsory cooperation agreements between the regions).

And what about budgetary coordination?

Regions and communities inherited part of Belgium's deficit, but little of its debt

Despite the large transfer of revenue since 1989, less than 3% of all government debt (about 130% of GDP at that time) was transferred to the regional level in the form of indirect debt (i.e. debt of sub-entities falling within the government perimeter, which were moved from the central to the regional or community level). The rest remained at the federal level for the most part (some 90%) with a small amount remaining at the local authority level (7%). However, from the start, regions and communities also inherited part of the (substantial) federal deficits, which they had to finance with new loans. Their combined deficit peaked in 1992 at 1% of GDP. But since then, backed by the federal efforts to meet the Maastricht criteria and subsequently, the close-to-balance target of the Stability and Growth Pact, their deficits have generally followed a downward trend. In 1997 Flanders entered positive territory and its surplus soon became large enough to compensate for the deficits of other regions and communities. As a result, the regional debt level, which had continued to increase until 1997 (at just over 7% of GDP), has since fallen to less than 5% of GDP (Dexia, 2004). At the same time, the federal deficit has been brought down from over 7% of GDP in 1992 to less then 0.5% of GDP in recent years.

The High Finance Council is a key player in the coordination mechanism

This result required clear budgetary targets for all levels of government and an efficient mechanism to enforce them. In Belgium, a key role has been played by the "Public Sector Borrowing Requirements" section of the Belgian High Finance Council (HFC). It is composed of high-level experts from ministries, the National Bank, the Federal Planning Bureau and academia. Its members have a renewable five-year mandate which is incompatible with a political office to ensure its independence and the chairman is an academic. Every year the HFC produces an analysis of the borrowing requirements of the regional entities and the budgetary policy to be adopted, including recommendations on the budget balances of the various levels of government. It also publishes an annual ex-post evaluation of the implementation of the stability programme.

Budgetary conventions act like internal stability programmes

The HFC-recommendations form the basis of a series of 'budgetary conventions', which take the form of political agreements between governments at federal and regional level. They set the medium-term budgetary targets and act as internal stability programmes. Until 1999 they were also integrated in the Belgian convergence programme and since then have been integrated in the Belgian stability programmes (Van Rompuy, 2005, and Conseil Supérieur des Finances, 2004). The objectives laid down in the latest convention (1 June 2005) are summarised in table 1.

The benefits of independent fiscal councils, entrusted with the evaluation of the long-term sustainability of the governments' policies, have been emphasized by the European Commission, which has proposed to implement it in EU countries in order to strengthen the enforcement of the Stability and Growth Pact (European Commission, 2004 and Sapir *et al.*, 2004). Its role is to provide transparency, set clear objectives to different levels of government and give incentives to policy makers to meet their targets (see also Annet *et al.*, 2005).

Table 1: Target government balance for regions and communities*

	Flanders	French community	Walloon region	Brussels capital region	German speaking community	Total	Total as % GDP
2005	419.04	0.95	-21.78	11.72	0.46	410.38	0.14
2006	344.33	8.38	-26.81	1.03	0.46	327.40	0.11
2007	299.58	13.34	-7.45	8.27	0.46	314.20	0.10
2008	247.18	15.82	17.67	15.62	0.46	296.76	0.09
2009	183.88	15.82	40.51	25.41	0.46	266.07	0.08

* Unit: million €

Source: Budget Minister's website (www.johanvandelanotte.be)

Conclusion

The Belgian coordination mechanism is largely based on a consensus between the different governments. Although the federal government (at the recommendation of the High Finance Council) can limit the borrowing capacity of a non-compliant region or community, which puts the long-term sustainability of its public finances at risk, it has not been considered necessary to use this sanctioning mechanism so far.

Transparency, ownership and intergovernmental cooperation have made the system work

Overall regions and communities have demonstrated a strong commitment to stick to the medium-term targets set in the conventions. Usually, regions and communities perform even better than planned. The Belgian National Bank (Claeys *et al.*, 2004) calculated that between 1994 and 2003, the difference between the budgetary target and the actual outcome expressed as a percentage of total revenue was on average 2.4% for Flanders, 0.3% for the Walloon Region and 5.2% for the Brussels Capital Region. Only the French Community had an average performance slightly below the target (-0.4% of its revenue). Therefore it could be concluded that federalism has worked well for Belgium. It has given regions and communities effective ownership of their budgets and allowed them to develop policies that are better suited to their particular needs.

From an institutional point of view, the High Finance Council has unquestionably played a major role in achieving this result. Its recommendations and ex-post evaluation of the implementation of the stability programme created a transparent system with clear objectives and the opportunity to 'name and shame' authorities that did not meet their targets. This imposes discipline and helps policy makers to resist pressures to increase expenditure. Finally, since the early nineties there has been a strong political commitment to reduce the deficits and government debt in order to meet the criteria for euro-area membership. Although the federal government has been the driving force behind this process, intergovernmental cooperation has benefited from the often complete (or at least substantial) overlap in government coalitions at federal and regional level.

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[i] The Special Financing Law of 16 January 1989 was later amended by the special laws of 16 July 1993 and 13 July 2001. A separate arrangement was created earlier in 1983 for the (much smaller) German-speaking Community (Senelle *et al.*, 2003).

[ii] There is a possibility for the regions to grant tax-rebates on the personal income tax, but these are limited in size and subject to ex ante and ex post evaluation by the federal audit office in order to avoid "disloyal fiscal competition" (Senelle *et al.*, 2003).

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

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