Fiscal federalism and solidarity: In search of an ideal formula[1]

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How can one best combine fiscal decentralization and solidarity? In this brief analysis, I start by succinctly revisiting the main advantages and disadvantages of fiscal decentralization. Then, I sketch what I present as the optimal formula and defend it against two possible objections. Following on, I assess the actual formula currently managing the funding of the Belgian regions and examine why it differs from my own. I then conclude by expressing my personal convictions regarding the direction in which our own youthful fiscal federalism ought to progress.

1. The advantages and disadvantages of fiscal federalism

The advantages and disadvantages of fiscal decentralization are generally well-known.

In terms of advantages, fiscal decentralization allows for:

(a) a better adjustment of the forms and level of taxation in order to take account of the specific conditions of regions (or municipalities, counties, provinces, states, etc.) and the preferences of their populations;[2]
(b) regional innovation and experimentation in matters of fiscal policy, in a manner that can prove beneficial to all;
(c) the subjection of those responsible for the expenditure of the tax yield to scrutiny by an electorate that is more local and thus better informed and more directly affected than would be the case at the central level;
(d) increasing the responsibility of regions in such a way as to ensure that they bear the burdens of their decisions, which may be considered beneficial in terms of efficiency (it provides them with incentives to do better) but also in terms of justice (they get what they deserve).

In terms of disadvantages, fiscal decentralization risks:

[1] The present chapter originates in a comment I was invited to make on an interesting analysis of the recent history of the financing of French municipalities by Alain Guengant and Jean-Michel Josselin (2005) and on Kristian Orsini's (2005) instructive comparison of the funding of social security in four relatively decentralized states. An earlier version was published in *Le Fédéralisme fiscal* (M. Mignolet ed.),2005, and translated into English by Jean-François Grégoire and Michael Jewkes to serve as a basis for the present updated version. The latter benefited greatly from detailed feedback by Willem Sas (KU Leuven).

[2] In what follows, I will use the term 'region' to designate a component of a state that enjoys a high level of autonomy. The reasoning will nonetheless apply *mutatis mutandis* to municipalities, counties, or other such sub-units.

(a) reducing efficiency, typically by foregoing economies of scale (including in the insurance of risks), by failing to internalize externalities and by hindering beneficial mobility;
(b) diminishing solidarity *between* regions (which is the more important, the *less* the inter-regional mobility of individuals is a real possibility);
(c) diminishing solidarity *within* regions (which is the more fragile, the *more* the inter-regional mobility of individuals and businesses is a real possibility).

2. An ideal formula?

How can one reconcile as far as possible the advantages of centralization and decentralization? The essence of the answer has, to me at least, always seemed simple and clear:[3]

(1) Finance the major decentralized spending requirements through taxation at the most centralized level possible, and distribute between the regions not according to their actual spending choices but according to their 'burdens', that is to say on the basis of objective indexes which capture, to the best possible extent, the needs that decentralized spending is supposed to meet;[4] and
(2) Allow regions to collect complementary taxes (whether in the form of additional percentages on central taxes or in the form of regional taxes designed according to their wishes).

Of course, in practice this simple and clear formula will encounter, albeit in innumerable guises, two fundamental problems:

(a) Where should one draw the line between essential needs – which whilst addressed locally must be funded by the central administration – and optional expenditures – the financing of which can be left to the discretion of regional authorities on the basis of their own cost-benefit analysis?
(b) How can one refine the notion of 'burdens' for each spending domain, in a way that moves beyond the mere calculation of resident population in order to better reflect the distribution of needs (e.g. taking into account size of territory in the case of infrastructure and communication, population age in the case of healthcare and education services, or the number of commuters in the case of urban services, etc.) without rewarding inefficient regional policies (for instance in the areas of employment or public health)?

One cannot avoid a certain degree of arbitrariness in formulating an answer to these two multidimensional questions. However, because the divergent assessments of the different dimensions may offset one another, we can expect a rough convergence upon the allocation of grants funded by the centre to cover decentralized expenditures.

[3] For a more explicit development, see also Van Parijs 2004, 2009.
[4] This corresponds to the notion of 'charges' used by Guengant and Josselin 2005.

The large degree of autonomy that is left to the regions regarding the use that they make of central grants allows them to better adjust their expenditure to circumstances, preferences, and regional debates as well as opening up a vast space of experimentation. The fact that these grants are lump-sum provides an incentive to make the most judicious use of them possible, as every extra cost will have to be covered by an increase in regional taxation. At the same time central funding has the advantage of protecting solidarity within each component against fiscal competition whilst providing inter-regional insurance and solidarity.[5] Thus, autonomy and security, responsibility and solidarity are effectively combined, at least as far as is possible, bearing in mind the difficulties of distinguishing between exogenous circumstances (those which inter-regional solidarity should neutralize) and the results of decentralized decisions (for which each region must be held responsible).

3. Too much competition? Not enough responsibility?

Some people might think that such a system is still far too vulnerable to inter-regional competition, owing to the residual fiscal autonomy that is left to the regions. This prompts two responses. Firstly, even in the complete absence of fiscal autonomy, nothing would prevent the regions from adopting a stance that is detrimental to their own internal solidarity by favouring spending policies that work to the advantage of the richest and most mobile. Secondly and more importantly, the stakes of such competition are not high when operating within the general scheme of a fiscal system that is essentially centralized. Attempting to ensure the continued residence of wealthy taxpayers – whether by reducing their tax burden or selectively targeting spending to their benefit – is unlikely to look attractive to the regional authorities if the bulk of their financial contribution to the regional budget is collected at the central level, and thus remains unaltered regardless of whether they cross regional boundaries.[6]

Others might consider, on the contrary, that such a structure does not allocate enough responsibility to the regional governments, because it essentially neutralizes the impact of the relative prosperity of the regions – partially attributable to their own policy choices – on the tax revenues they collect. This objection would have a certain force if we could attribute to regional governments the sole objective of maximizing their own revenues. It seems more reasonable though, to assume that the overall prosperity of their population (and not only the

[5] This argument does not assume that the dominant conception of social justice or solidarity is exactly the same in the various components of the federation. It assumes a conception of justice that serves as a standard for the evaluation of the institutions being discussed and endorses a significant degree of redistribution both within and across the components of the federation. This broad characterization is consistent with the views actually held on reflection by a large proportion of citizens in our developed liberal societies — and publicly asserted by an even larger proportion of the parties claiming to represent them. But even if it were not, this would not affect my evaluation of the desirability of the various arrangements — it is not a welfarist evaluation taking the preferences of the people involved as the ultimate standard — but only the assessment of their short-term political feasibility.

[6] This argument could however turn out to be insufficient if it were true that the regional governments worried more about the GDP of their region than about their tax yield. In such cases there may be good reasons to constrain the fiscal autonomy of regions. For more on this see Roland et al. 2001.

part of it that stems from whatever the government does with its revenues) also features in their utility function. And whereas an essentially centralized financing arrangement comes close to neutralizing the impact of growth differentials on the regions' capacity to provide the public spending they are responsible for, it only very partially neutralizes its impact on the average income of the region's population. In the case of all regional governments that do not act in a very peculiar manner towards their electorate therefore, the weight of their responsibility is still largely left intact.

Note that I am here taking for granted that 'responsibilization' through making the revenues of a regional government dependent on GDP per capita in that region, and even more on taxable personal income of the taxpayers living in that region, quickly reaches a limit in the Belgian context because of the country's central metropolitan area being shared between all three regions. About half the people who draw their income from work in the Brussels region live in Flanders or Wallonia, and there is moreover a constant migration flow from all over Belgium into Brussels and from Brussels mainly to its Flemish and Walloon periphery. Externalities between Brussels and each of the other two regions are therefore massive (especially relative to Brussels' GDP or taxable income). Consequently, it is often argued that dependence of a region's revenues on its taxable income or GDP is an excessively crude and often perverse way of 'responsibilizing' a regional government: an invitation to encourage housing for wealthy sleepers or to locate shopping centres in the wrong places rather than an incentive to make the economy strong and the society fair.[7] If greater 'responsibilization' of the regional policy makers is deemed necessary in some areas, a more refined scheme linking funding to the achievement of some objectives would need to be designed. But it may be tricky to reach a consensus at the federal level about shared objectives and about indices of regional performance (within the control of the regional authorities) (Vandenbroucke and Meert 2010). I am not excluding this approach, however, but only as a marginal amendment to a simple basic model consisting of federal burden-sensitive lump sum grants covering the bulk of the expenditures, combined with regional top ups.

4. What about the Belgian model?

It is the state reform of 1980 that first organized the financing of the regions. It consisted essentially in federal grants that distributed a proportion of the yield of the federal personal income tax according to three criteria: population, size of the territory, and yield of the tax in each region. In 1989 both lump-sum components were eliminated from the criteria, keeping only the third one, based upon what is sometimes called the 'derivation principle' or more often (and misleadingly) the 'juste retour' (*fair return*). Irrespective of their autonomous taxation powers and non-fiscal resources, the regions thus came to be financed by a reimbursement of that part of the public revenue that was collected on their own territory as personal income tax. In addition, in the case of a region where the per capita personal income

[7] The drawing of the borders of the components of the Belgian federal state was not exactly guided by the concern to make a decentralization of competences to these components as efficient as possible. See the discussion of the dilemma "Brussels big or Belgium strong" in Van Parijs 2012.

tax yield is below the national average, the federal funding includes a 'solidarity grant'. This grant amounted to 468 Belgian Francs per capita (or about 12 euros, 1988's base figure subsequently adjusted for inflation), multiplied by the difference in percentage between the region's personal income tax per capita and the country-wide personal income tax per capita.[8] In combination with later additions resulting from laborious compromises, this system became very opaque and generated some anomalies that can, when highlighted, threaten the legitimacy of the system.[9] The 2013 state reform maintains the same basic logic, gets rid of these anomalies by simplifying the architecture, combines the 'juste retour' component with fiscal autonomy by reducing the level of federal income taxation and expanding the margin within which the regions can top up federal taxes, involves a gradual reduction of the federal solidarity transfer and includes special measures that should help secure the funding of the Brussels region despite its personal tax base being very low relative to its GDP per capita.[10]

With an appropriate choice of parameters, this sort of system can be made financially equivalent to a system using lump sum grants and top up taxation, and hence the same degree of inter-regional solidarity and the same degree of 'responsabilization'.[11] Moreover, using top ups ('opcentiemen', 'additionnels') rather than the misleadingly called 'juste retour' looks like a step in the direction of the ideal I was advocating above. Yet, I remain convinced that a system that implements cross-regional solidarity is to be preferred (even if financially equivalent) to one that combines an allocation biased in favour of rich regions (the allocation of part of the personal income tax to the region where it is collected) with one that is biased in favour of poor regions (the solidarity grant). For it induces a significantly different framing of net transfers. In a system of lump sum grants, net inter-regional transfers are spontaneously perceived as the normal by-product of a scheme that redistributes from 'all of us' (according to our capacities) to 'all of us' (according to our needs). With a combination of 'juste retour'

[8] The figure of 468 Francs was chosen in such a way as to ensure that the amount transferred to Wallonia by way of solidarity payments corresponds to the amount tacitly implied by the various regions at the time of the negotiations regarding the new financing rules (1988).

[9] Thus, in 1997, it amounted to funding the Walloon region at a higher per capita level than the Flemish region (BEF 85.791 and 80.815 respectively). This outcome is not as uncomfortable as the "*inkomensparadox*" the revelation of which provoked the outbreak of demands to regionalise social security in the early 1990's (See Van Rompuy, 1989, 1993). In a situation in which primary (i.e. pre-tax-pre-transfer) income per capita is much higher in Flanders than in Wallonia, the fact that Walloon authorities are better funded than Flemish authorities (the anomaly noted here) is not as disturbing as the fact that, for a few years, transfers turned an inferiority in terms of primary income into a superiority in terms of disposable income. Some Flemings' feeling of having been hoodwinked (for example Schiltz, 1997) by an opaque system is most understandable, and was by no means favourable to the mutual trust and serenity that is required for the harmonious development of a system of solidarity.

[10] For a lucid analysis of the 6th state reform, see Decoster and Sas 2013a, 2013b.

[11] Decoster and Van Parijs (2010b) show this potential equivalence between the CERPE model (juste retour + vertical solidarity), the VIVES model (juste retour + horizontal solidarity) and the LOVANIUM model (lump sum grants + autonomous top up). Given this equivalence, it is not the case that the 'juste retour' model is likely to provide regional authorities with an incentive to participate more zealously in the collection of taxes because they recover proportionally more from the total that is collected. As the solidarity grant is calculated on the basis of the discrepancy with the country-wide average personal income tax (and not, for example, on the basis of a discrepancy with the country-wide GDP per capita), there is no reason to believe that regional authorities would be more concerned with the collection of taxes under a 'juste retour' regime than with lump sum grants.

and ‘solidarity grants’, by contrast, they are perceived as an expression of a discretionary solidarity, consented to, and revocable by, one region for the benefit of another one regarded as needy’.[12]

In this whole discussion, it should of course be borne in mind that the regional competences are only part of the decentralized competences in Belgium’s federal state. The person-related competences attributed to the Communities – mainly education – have been funded from the start essentially by lump sum grants from the federal state proportional to the school population. Subsequent reforms, including the most recent one, have not changed this basic logic. Indeed the person-related competences devolved de facto the regions by the 2013 state reform – child benefits, childcare, elderly care and some aspects of health care – are all to be funded by the federal state according to needs-modulated population parameters. If one day the Belgian federal state were to be turned into a simpler, purely territorial federation and hence all the community competences transferred to the regions, the bulk of the latter’s funding would consist again in federal grants – unless one tried to use that opportunity to turn it all into regional top ups and a (shrinking?) solidarity grant.[13]

The history of Belgian fiscal federalism is far from over. Indeed it is only just beginning. It has much to gain from international and interdisciplinary encounters where lessons can be learnt from what is being done elsewhere, without overlooking the peculiarities of the Belgian situation nor forgetting to make room, besides many technical aspects, for due reflection upon the ends which should ultimately be pursued.

[12] This point is spelled out in Van Parijs 2009 and Decoster and Van Parijs 2010a.

[13] Indeed, one might contemplate regionalizing more person-related competences currently vested at the federal level, for example the bulk of the healthcare system as in Denmark (Orsini 2005). But as usual, the question of how to handle Brussels would be crucial (Van Parijs 2004).

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