Box 2 - Budgetary rules in local government

This box aims to present, in a concise but comprehensive manner, the budgetary rules applicable to Local Government (AdL) so that it can serve as a reference for consultation, namely for a better understanding of the reports published by CFP on the budget execution and evolution of Local Government debt, which began with CFP Report No. 3/2018 of April 2018.

According to the Glossary of Public Finance Terms (only in Portuguese), published by CFP (2015), a fiscal rule is commonly defined as a "permanent constraint on fiscal policy, expressed through a summary indicator of fiscal performance".[1] It is intended to anchor economic agents' expectations regarding the stance of fiscal policy, economic stabilization and the sustainability of public finances. They can assume four different types, based on the fiscal indicator they restrict: fiscal balance, debt, expenditure and revenue.

The financial regime of local authorities and inter-municipal entities - or, more simply, the Local Finance Law (LFL), approved by Law no. 73/2013, of 3 September – entered into force on 1 January 2014, providing for the numerical budgetary rules applicable to AdL. Considering the above typology, the LFL includes rules on the balance of the budget balance, debt (total debt limit), expenditure (Multiannual Budgetary Programming Framework - municipal MBPF), and the revenue execution rate. Among the various changes to the law since its initial version[2], particular reference should be made to those introduced by Law no. 51/2018, of 16 August. The changes resulting from the latter law came into force from the beginning of 2019. In addition, for that year, and as in previous years, the State Budget Law (SBL) [3]introduced and renewed the possibility of extending the exceptions and/or compliance with legal obligations with regard to the total debt rule.

Budget balance

Overall balance

Municipalities are subject to the rule set out in no. 1 of art. 40 of LFL/2013, according to which "[t]he budgets of local sector entities provide for the necessary revenues to cover all expenses". This rule of overall balance establishes the obligation for the budget to provide for balance or a positive balance between total revenues and total expenditures. This principle is similar to the one established by the Budgetary Framework Law for the general government as a whole and would imply, if the implementation of the budget fully respected the forecast for each year, the non-existence of commitments assumed and not paid at the end of the economic year.

Current equilibrium

In addition to the overall balance, the LFL commits to what can be termed a modified public finance golden rule by imposing the current budget balance plus the amount of (average) loan repayments.

[1] Kopits, G. and S. Symansky (1998), Fiscal Rules, IMF Occasional Paper 162.

[2] Including 2 rectifications, the 12th version results from the changes introduced to the statute by the State Budget Law for 2019 (SBL/2019, approved by Law 71/2018, of 31 December).

[3] Law No. 71/2018, of 31 December (Law of the State Budget for 2019 - SBL/2019). Decree-Law no. 84/2019, of 28 June, establishes the necessary provisions for the implementation of the State Budget for 2019 (SB/2019).

Specifically, the LFL requires that the gross current revenue collected should be at least equal to the current expenditure plus the average repayments of medium and long-term loans. In a given year this value may be negative, as long as it is less than 5% of total current revenue and must be compensated in the following year.

The above-mentioned rule, although not explicitly revoking the principle of budgetary balance that is established in paragraph e) of point 3.1.1. of POCAL[4] , ends up doing so implicitly, since it adds to it the additional obligation for current revenues to cover average repayments of loans, in addition to expenses of the same nature. This rule should also be considered at the various stages of the budget cycle, i.e. both in the preparation and in the budgetary amendments and implementation.

In the practical application of this rule, however, the question has been raised of how to calculate the average repayments for loans already existing at the time of the entry into force of the 2013 LFL. This is because this law adopted a transitional provision in the sense of considering as average repayments of loans the amount corresponding to the division of the outstanding capital at the date of the entry into force of the law by the number of years of remaining useful life of the contract.

To answer these and other methodological doubts, a technical note from SATAPOCAL[5] was first produced. Even so, IT difficulties arose given that the POCAL loan map, which municipalities must report to DGAL through the Integrated Local Government Information System (SIIAL), did not have all the fields necessary to calculate the average repayment of loans. This situation led the DGAL to change, in the last quarter of 2016, the map of loans to be reported. Law no. 51/2018 subsequently amended the wording of no. 4 of article 40 of the LFL clarifying that average loan repayments should consider the capital used and not the contracted capital. It also added the article integrating the treatment to be given to the balance of the previous management – which thus relegates in the proportion of current expenditure to be financed or revenue to be replaced (it should be noted that this rule is based on public accounting data, from a cash perspective).

Revenue

Revenue outturn

Within the early warning mechanisms, the LFL also provides (in no. 3 of art. 56) that, in the case of two consecutive years of an implementation rate of less than 85% of the revenue foreseen in the respective budget, the members of the Government and the presidents of municipal bodies are informed.

Expenditure

Municipal multi-annual framework and expenditure ceilings

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[4] Official Accounting Plan of Local Authorities, approved by Decree-Law no. 54-A/99, of 22 February, as amended by Law no. 162/99, of 14 September, Decree-Law no. 315/2000, of 2 December, Decree-Law no. 84-A/2002, of 5 April and by Article 104 of Law no. 60-A/2005, of 30 December.

[5] Subgroup of Technical Support for the Application of POCAL. It is made up of representatives of the Directorate-General of Local Authorities (DGAL), which coordinates; the five Coordination and Regional Development Commissions (CCDR) of the mainland; the services responsible for local administration in the Autonomous Regions of the Azores and Madeira. Representatives of the Court of Auditors and the Inspectorate-General of Finance are also invited to participate in SATAPOCAL.

The LFL determines the presentation by the municipalities, together with the municipal budget proposal presented after the inauguration of the budgetary executive body, of a proposal for a multi-annual budget programming framework (MBPF), in articulation with the Major Plan Options (GOP).

The MBPF takes the form of defining limits for municipal expenditure, which should also include projections regarding its financing (revenues, which should discriminate between those collected by the municipality, i.e. own revenues, and those from the State Budget) on a mobile basis that includes the following four years, with the limits being binding for the year of the budget's fiscal year and indicative for the following years. [6]

No information is available to monitor compliance with this rule. Furthermore, in addition to the fact that the reporting of this information to the DGAL is not legally explicit, the LFL itself referred the respective regulation to subsequent legislation, which led many municipalities to consider that the legal and regulatory conditions for the full application of the MBPF at municipal level were not met.

Debt

Total municipal debt limit

The LFL (total debt limit) borrowing limit for municipalities is a quantitative limit on the stock of municipal debt in gross terms, i.e. without deduction/compensation with financial assets as compared to a given volume of revenue. Thus, on 31 December of each year, the total debt of the municipality's budgetary operations[7], including the relevant debt of entities invested by the municipality[8], cannot exceed 1,5 times the average net current revenue collected in the previous three financial years. For the calculation of the cap for 2019, the average net current revenue collected in the years 2016 to 2018 is calculated, considering the revenue of the same nature collected for municipal and intermunicipal services, consolidated with the respective municipalities.

The concept of indebtedness used is more comprehensive than that of the Maastricht debt. In addition to financial debt, the concept of total debt from budgetary operations also includes debt to suppliers/commercial, but excludes liabilities resulting from extra-budgetary operations (e.g. retention of social security discounts as employer). In addition to the municipality, the delimitation of relevant entities also includes the entities in which the municipality participates, as shown in the table below:

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6 From 2019. In the previous version of LFL the limits were binding for the year following the financial year of the budget and indicative for the others.

7 In addition to financial debt, the concept of indebtedness used includes debt to suppliers/commercial, excluding, however, liabilities resulting from extra-budgetary operations. The notion of off-budget operations typically includes treasury operations and current accounts. In the first case, it includes collections made by local authorities with the obligation to deliver the respective amounts to third parties (e.g. withholding of social security discounts as employer). In the second case, receipts for collection relating to municipal revenues charged to the treasurer, or also guarantee and guarantee deposits, submitted by suppliers and contractors, in which case the respective accounting movements are made on current accounts.

8 See Table 1 of the CFP Report no. 3/2018

Table 1 – Entities relevant for debt purposes and for calculating the total municipal debt limit

Type of entities	Contribution to total municipal debt	Revenue treatment
Municipal services	Debt resulting from budgetary operations, except for that which is simultaneously recognised in the accounts in the municipality	Revenue considered for the calculation, being object of consolidation
Intermunicipal services	Debt resulting from budgetary operations, except for that which is simultaneously recognised in the accounts in the participating municipalities, "as defined in an agreement concluded for this purpose".[9]	Revenue considered for the calculation, being object of consolidation
Intermunicipal entities and municipal associations	Regardless of the legal regime under which they were created, according to "criteria to be established by their deliberative bodies, with the agreement of the respective municipal assemblies". In their absence, in proportion to the municipal quota for operating expenses	Revenue not considered for the calculation
Local and affiliated enterprises (except those belonging to the State or Autonomous Region's business sector)	Proportional to the participation of the municipality in its share capital, in case of non-compliance with the applicable balancing rules	Revenue not considered for the calculation
Cooperatives and cooperative régies [(a)]	Similar to local and affiliated companies	Revenue not considered for the calculation
Other cooperatives and foundations	Proportional to the participation of the municipality	Revenue not considered for the calculation
Other entities over which there is control or presumption of control by the municipality	By the total amount	Revenue not considered for the calculation

Source: Prepared based on the current wording of the Local Finance Law and Law No. 50/2012 of August 31 (local business activity regime). | (a) In which municipalities may exercise a dominant influence in the terms provided for by law.

Thus, the universe relevant for the total debt of municipalities is more comprehensive than the perimeter of the AdL in national accounts, since it includes entities outside the scope of the general government in which the local authority participates, and which may result in future obligations for the municipality. It should also be considered that the relevant revenue for the indebtedness limit is calculated on a cash basis (public accounting), integrating only that of the municipality and municipal or intermunicipal services, since these operate as a department of the municipality, with enhanced autonomy.

The LFL also requires that:

- Whenever that limit is not complied with, the municipality reduces in the following year at least 10% of the excess amount until it is complied with, without prejudice to the provisions of the LFL on early warning and financial recovery mechanisms;
- If that limit is complied with, as a general rule, in each financial year only the value corresponding to 20% of the margin available at the beginning of the year can be increased.

[9] In practice, it has been customary to consider a fair distribution of debt. As of June 30, 2019, there were only 2 intermunicipal services (Oeiras and Amadora; Loures and Odivelas).

Non-compliance with these requirements is equivalent to exceeding the legal limit of indebtedness for the purpose of determining financial responsibility. [10]

There are also operations which, in legal terms, are not relevant for the purposes of the total debt limit. These exceptions, which have been successively extended, include:

- Loans to finance the recovery of municipal infrastructure affected by public calamity situations (provided for in the LFL);
- The amount relating to the municipality's contribution to the capital of the FAM, under a rule that has been included annually in successive laws of the State Budget since 2015;
- Loans for the financing of the national counterpart of projects supported by European funds, which are now excepted from 2016 with the amendment of the LFL by the State Budget Law for that year;
- The debt assumed by the local authorities regarding the national counterpart of projects co-financed by European funds (standard renewed by SBL/2018 and incorporated into the LFL by the August 2018 revision of this law; applicable to cases in which they assume this expenditure, by agreement with the central government, since other co-financed projects and in which the local authorities themselves are beneficiaries are already excluded since 2016 as mentioned above);
- From 2019, the debt resulting from the process of decentralization and transfer of powers to local authorities.

In addition, under a transitional rule of the LFL, the debt excepted before the entry into force of the LFL that placed the municipalities that were compliant above the current debt limit is not relevant for sanctioning purposes, although it is considered in the calculation.

For the purposes of compliance with the legal obligations contained in the LFL and respective measurement, consider the changes introduced by the State Budget Laws from 2016 to 2019, which enable the extension and/or derogation of the general rules referred to above. As a result, it is recovered and updated to 2019 within the framework of CFP Report no. 10/2018, of September 2018, which contains these provisions, some of which were later integrated into the LFL's own articles.

[10] Under the terms of the Law of Organization and Process of the Court of Auditors, approved by Law No. 98/97, of August 26, in its current wording.

Table 2 - Provisions of the State Budget laws since 2016 regarding the total debt ceiling in the LFL

Requirement	SBL legal forecast	Type of debt	OE 2016	OE 2017	OE 2018	OE 2019
Calculation of debt relevant for compliance with the total debt limit	Possibility of the debt being excepted (i.e. not counting towards the calculation)	Loans to finance investments under the Strategic Plan for Urban Waste (PERSU 2020)		x		
		Debt settlement agreements			x	x
		Loans for payment to concessionaires arising from a judicial or arbitral decision or redemption of the concession agreement	x	x	x	x
		Debts arising from the assumption of obligations in the context of the process of decentralisation of powers			x	
		local authorities, in agreement with the central government, to assume expenditure relating to the national counterpart of projects co-financed by European funds		x	x	
Obligations stemming from the municipality's position regarding the limit (reduction of excess or use of the available margin)	Failure to consider for the purposes of discharging the above obligations	Debts arising from the assumption of obligations in the context of the process of decentralisation of powers			x	
		Debts contracted under the fires of 2017 and 2018			x	x
		Loans to support natural persons or households in connection with fires in 2017			x	x
Obligation to reduce the amount of excess debt by 10%.	Exemption from the reduction obligation	Debt settlement agreements			x	x
		Liquidation of Polis companies			x	x
Limit of 20% on the margin of indebtedness available at the beginning of the year.	Possibility of extending the use of the available debt margin	Acquisition of rental object (up to 60% of the margin)			x	x
		Loans for financing urban regeneration operations (up to 30% of the margin)			x	x
		Acquisition of rustic buildings for the legalization of the Santa Rita American quarter, in Azores (up to 60% of the margin).				x

Source: Adapted from Municipality Portal /DGAL. Local Finance Law and State Budget Laws since 2019.

The ratio of the total debt stock to the average revenue considered is the indicator underlying the early warning mechanisms of deviations and municipal financial recovery, in addition to making it possible to assess the situation of compliance with the established limit. Adherence to any of the mechanisms provided for in the LFL is mandatory or optional depending on the level of financial imbalance at 31 December of each year (Table 3).

Table 3 - Summary of the early warning and municipal financial recovery mechanisms of the LFL

Total debt ratio	Expected consequences
Between 75% and 100%	1. informing the members of the Government responsible for finance and local authorities, as well as the presidents of the executive and deliberative bodies of the municipalities
Between 100% and 150%	1. information to the same entities in the previous case 2. Possibility of adhering to financial reorganization (borrowing)
Between 150% and 225%	1. information to the same entities and to Banco de Portugal 2. Compulsory adherence to financial reorganization (borrowing)
Between 225% and 300%	1. information to the same entities and to Banco de Portugal 2. Mandatory adherence to financial or voluntary sanitation to the FAM
Exceeding 300% (financial rupture)	1. information to the same entities and to Banco de Portugal 2. Mandatory membership of the FAM (municipal financial recovery)

Source: CFP, based on the provisions of the Local Finance Law.
Notes: The total debt ratio is calculated in relation to the average net current revenue collected in the three previous years. There is also an obligation to adhere to financial reorganisation if the total debt of the municipality, less the debt from loans, is higher than 75% of the same average revenue considered for the calculation of the total debt limit. According to the wording given to the LFL by Law no. 51/2018, of 16 August, the presidents of the executive and deliberative bodies of the municipalities are informed of the situation through the Integrated Information System of Local Authorities (SIIAL).

The monitoring carried out by the DGAL is based on the information reported to it by the municipalities via SIIAL, although this body carries out several validations to increase the reliability of the information sent. For example, the calculation of municipal debt for 2017 was published on the Municipal Portal in February 2019, based on data relating to the rendering of accounts extracted from the SIIAL in that month. [11]

In addition, the rule of debt reduction of municipalities is repeated annually since the 2014 State Budget Law, which requires entities included in the perimeter of AdL in national accounts to reduce by the end of the year to which the budget respects at least 10% of arrears with more than 90 days recorded in September of the previous year. In the event of default, a reduction in the value of the transfers of the State Budget defined in the LFL in an amount equal to that of the missing reduction is foreseen.

Indebtedness limits applicable to parishes

The use of medium and long-term debt by the parishes is forbidden by LFL. However, they may resort to short-term credit revenues to overcome cash flow difficulties, as well as to the signing of leasing contracts for the acquisition of movable property (e.g. vehicles) for a maximum period of five years and, similarly, for immovable property, for a maximum period of ten years[12], provided that they bear the respective charges through their own revenue. Access to short-term debt is limited to 20% of the transfer received by the parish from the State Budget in respect of the participation of these parishes in State taxes, provided for by the LFL (*Fundo de Financiamento das Freguesias* - FFF). [13]

[11] Available in the Municipal Portal. According to the LFL, the documents of individual accountability of the municipalities are assessed by the municipal assemblies in April of the year following the one to which they refer.
[12] In the version of the LFL prior to Law 51/2018, it was five years.
[13] Before the wording given to LFL by Law 51/2018, this limit was 10%. In 2018, the total amount of the FFF contained in Map XX attached to the State Budget was 197.8 M€, so that the maximum amount possible to be used by all the parishes would be about

As regards the non-financial debt, the LFL stipulates that the total budgetary debts of the municipalities to third parties (excluding those relating to short-term loan contracts or credit openings) may not exceed half of the total revenues collected in the previous year, establishing the obligation to reduce by one tenth the surplus that exists in each subsequent year, a provision similar to that foreseen for the municipalities whose total debt exceeds the respective limit.

The responsibility for verifying compliance with each of the rules in force is identified in the table below, originally published as an annex to the CFP Report no. 3/2018, of April 2018 and updated in the meantime.

Table 4 - Budgetary rules applicable to Local Government: indicators, targets, results and entities responsible for monitoring

Budgetary Rule	Type	Legal Forecast	Indicator(s)	Goals	Results	Identification of (non)compliance is the responsibility of:
Total debt	Debt	Articles 52 and 54 of the LFL	• Total debt of budgetary operations (TD) • Average net current revenue collected in the three previous years (RLC) • Total debt ceiling (LDT)=1,5×RLC • Total debt ratio (RDT)=DT/RLC	RDT<150%RLC (at 31-12-t)	• If DT>LDT, reduction of 0.1(DT-LDT) by t+1 • If DT<LDT, ΔDT ≤ 0,2(DT-LDT) *[as a general rule; there may be specific situations arising from the provisions of the annual laws of the State Budget].*	• City's own organs • DGAL
Budgetary balance	Balance	Article 40 LFL	• Gross current revenue (RCB) • Current expenditure (DC) • Average repayments on medium and long-term loans (AME)	RCB ≥ (DC+AME)	• If |RCB-(DC+AME)| > 5%RCB default • If |RCB-(DC+AME)| < 5%RCB offset deviation in the following year.	• Local authorities' own bodies and local sector entities
Executing the Revenue	Revenue	No. 3, Art. 56 RFLAEI	• Revenue execution rate (TER)	$TER_{t,t-1} \geq 85\%$	• If TERt,t-1 <85%, early warning guardianship (central government) and	• Municipality's own bodies DGAL

19.8 M€. In 2019, the FFF amounts to 208.1 M€. Taking into account the extension of the limit and the new value of the FFF, the maximum amount possible became € 41.6 million.

Budgetary Rule	Type	Legal Forecast	Indicator(s)	Goals	Results	Identification of (non)compliance is the responsibility of:
					presidents' municipal bodies	
Short-term indebtedness of the parishes	Debt	No. 5, article 55 of the LFL	• Short-term debt (ECP) • Parish Financing Fund (FFF)	ECP<20%FFF	• If CP debt + loan to be contracted exceeds the limit it is not possible to contract it	• Own organs of the parish
Non-financial debt of the parishes	Debt	No. 8, article 55 of the LFL	• Budgetary debt to third parties (DOT) • Total revenue (RT)	$DOT_t<50\%RT_{t-1}$	• Se DOTt > 50%RTt-1 • Mandatory reduction in t+1 in 10%*(DOTt-50%RTt-1)	• Own organs of the parish
MBFP	Expenditure	Article 44 of the LFL	• Expenditure	Limits (ceilings) for the expenditure of the municipality as well as for the revenue projections broken down between those from the State Budget and those collected by the municipality.	• Expenditure ceilings binding for the financial year of the budget and indicative for the others.	• Municipality's own bodies

Notes: DGAL - *Direção-Geral das Autarquias Locais* (General Directorate of Local Authorities); MBFP - Multiannual Budgetary Programming Framework; LFL - *Lei das Finanças Locais* (Local Finance Law), approved by Law no. 73/2013, of 3 September, as amended by Law no. 51/2018, of 16 August and no. 71/2018, of 31 December.

Extended version of "Box 2 - Local government fiscal rules", originally published in Report 9/2019, "Local government fiscal developments until June 2019", September 2019