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TITLE: Analysis of the Legal Proposals for New Subnational Finance Laws

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Analysis of the Legal Proposals for New Subnational Finance Laws

RESUMO

Esta comunicação ilustra o papel que um conselho de finanças públicas pode ter em qualquer país para ajudar os cidadãos em geral e os actores políticos em particular a tomarem decisões informadas sobre assuntos orçamentais locais e regionais. Comenta e aconselha sobre duas propostas de lei estruturantes para as finanças públicas que o Parlamento português discute no primeiro semestre de 2013: uma nova lei de finanças locais ("Proposta de Lei n.º 122/XII/2.ª") e uma nova lei de finanças regionais ("Proposta de Lei n.º 121/XII"). O Conselho das Finanças Públicas português (CFP) disponibiliza no Relatório que subjaz a esta comunicação uma análise económica de ambas as propostas legislativas. Concentra-se nos incentivos comportamentais dos governos locais, regionais e central relativamente à sustentabilidade das finanças públicas. O CFP reconhece o acolhimento que sugestões suas anteriormente apresentadas teve nas propostas de lei e regista os muitos progressos que estas trazem face ao quadro legal vigente. Todavia, permanecem por resolver deficiências importantes e algumas disposições apresentadas geram incentivos perversos. Todos os problemas assinalados são acompanhados no Relatório de recomendações de solução à atenção do processo de decisão colectiva.

Palavras-chave: *conselho das finanças públicas; enquadramento orçamental; finanças locais; Portugal; reforma das finanças públicas.*

ABSTRACT

This document illustrates the role that a fiscal council may have in any country to help citizens at large and political actors in particular to make informed decisions on local and regional finance issues. It comments and offers advice on two structural public finance bills that the Portuguese Parliament is discussing in the first semester of 2013: a new local finance law ("Proposta de Lei n.º 122/XII/2.ª") and a new regional finance law ("Proposta de Lei n.º 121/XII"). The Portuguese Public Finance Council (CFP) offers in the Report underlying the congressional presentation an economic analysis of both bills. It focuses on the behavioural incentives of local, regional and central governments with respect to public finance sustainability. The CFP recognises that some of its suggestions made on earlier occasions were taken on board and acknowledges many progresses put forward by the bills. Yet, important flaws remain unaddressed and some envisaged norms create perverse incentives. All flagged problems are accompanied with suggested improvements for the benefit of the collective decision-making process.

Keywords: *fiscal council; fiscal framework; local finance; Portugal; public finance reform.*

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The *Portuguese Public Finance Council*

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Executive Summary

The Parliament is now discussing two structural public finance bills: a new local finance law ("Proposta de Lei n.º 122/XII/2.ª", hereafter referred as PPL 122) and a new regional finance law ("Proposta de Lei n.º 121/XII", or PPL 121). The Portuguese Public Finance Council (CFP) offers in this Report an economic analysis of both bills. It focuses on the behavioural incentives of local, regional and central governments with respect to public finance sustainability. The CFP recognises that some of its suggestions made on earlier occasions were taken on board and acknowledges many progresses put forward by the bills. For the sake of space, this summary highlights the chief suggestions for improvement. Justifications, along with other recommendations, are presented in the following sections.

i. Fiscal rules—a number of substantive problems with the multiannual budgetary framework and current balance equilibrium (also known as "golden rule") in both bills recommend a different setup. The CFP proposes a medium-term rule and an annual debt rule. The former is either a medium-term global balance equilibrium rule or a medium-term spending rule. In either case, the expenditure budget is adjusted to the actual financing capacity of the government, the risk of optimistic revenue projections is significantly reduced, annual budgets get framed in a medium-term perspective headed for fiscal sustainability and the measurement or application flaws of the golden rule are avoided. The debt rule proposed by the CFP is an upgrade to that prescribed in the bills; basically, the CFP recommends the adoption of the same debt definition for local and regional entities and the introduction of several important adjustments.
ii. Specific improvements to the debt rule—as with local governments, the set of entities exposed to the debt limit at the regional tier should comprehend all entities outside the Eurostat consolidation ring that are subject to the control of regional authorities and whose liabilities are ultimately borne by taxpayers. Also, the introduction of length limits to long-term loans and grace periods should be considered. For both government tiers, the denominator of the debt indicator should comprehend all effective revenue, and not only current revenue, and there are consolidation fixes to be made on both the numerator and the denominator. Several inconsistencies in the bill need to be removed.
iii. Transparency—with a minimum administrative cost, basic information on tax decisions and the fiscal position of each government, including its compliance with fiscal rules, can be mailed to the respective taxpayers, together with tax notifications. This would enhance the general awareness with public finance and the political ownership of subnational revenues, as well as it would help to reinforce the links between voters' preferences and government's fiscal choices.
iv. Stability of rules—both bills allow for discretionary suspensions of structural public finance principles on behalf of exceptional and transitory circumstances justifying stricter local and regional budget constraints. By invoking a similar principle, the central government used the annual State budget law in most of the last ten years to reduce, on a fully discretionary basis and across-the-board, transfer endowments and debt ceilings. The bills enlarge this possibility. Instead of hardening, these recurrent practices end up by softening subnational budget constraints; ultimately, discretion compromises the accountability of subnational governments and induces bailing out demands. Perhaps the requirement in PPL 121 and 122 of a qualified majority voting on the specific State budget law articles operating the changes in the rules of the game could avoid

the banalisation of these discretionary practices. To eliminate the moral hazard problem of applying uniform reductions to all subnational governments irrespective of their financial performance, the CFP proposes that any reduction in the amount of transfers or the debt cap *vis-à-vis* the rules set in the subnational finance laws could only be applied to individual subnational governments in proportion to their failure to comply with the respective fiscal rules.

v. Excessive debt corrective mechanisms at the local level—on the local finance bill (PPL 122), care should be paid to the feasibility of the financial sanitation device. It rests on the presumption that a private agent will always be ready to lend the necessary funds. Recent experience casts serious doubts on the plausibility of this arrangement. Awareness about the fragility of this mechanism leads to the belief by local governments that the State will come forth with the necessary money if an excessive debt situation materialises. The central government would then face the demand for bailing outs based on its own rules. In order to avoid such bailing out demands, the legislators may wish to state explicitly that sanitation loans must be contracted with private institutions and that the requirement for sanitation holds up only up to the point that it is feasible under market conditions. Alternatively, the Municipal Support Fund could be extended to provide financial sanitation loans when such financing is not available in the marketplace.

vi. Excessive debt corrective mechanisms at the regional level—criteria here are much less specific and forward-looking than at the local level. Possibilities to access a financial assistance programme granted by the central government are loosely defined and it is not clear how the latter can stick consistently to the no bailout rule. More content on the specific guidelines to such an assistance mechanism would be helpful to protect the State more effectively against the effects of fiscal laxity on the part of autonomous regions.

vii. Inconsistencies with other legal diplomas—the Report calls attention to several contradictions between current and proposed finance laws and other existing diplomas. Concrete examples are listed, involving the decree-law setting the official accounting chart for local authorities ("POCAL"), the proposal to amend the budget framework law (PPL 124) and the two bills commented here (PPL 121 and 122). Hence, an in-depth legal cross-examination before the final vote on PPLs 121, 122 and 124 is recommended.

viii. Conflicts between local and regional finance regimes—formally, PPL 122 sets a single regime for the local subsector in the entire Portuguese territory. Yet, PPL 121 allows the regional governments to introduce an additional transfer instrument to which only insular parishes and municipalities can access. In addition, such grants are definable by the paying government with full discretion whereas discretionary transfers by the central government are explicitly forbidden. Unrestricted subsidies cast doubts about transparency and fair competition for resources from the donor government and, in principle, they should not be permitted. Hence, the Parliament may wish to clarify how many local finance regimes should Portugal have and the latitude for discretionary donations.

ix. Information requirements
   a. PPL 122 sets a complicated system of triple consolidation levels for the local subsector, although the principle of accounting and fiscal rules consolidation is very much welcome. Further technical work seems necessary to decide whether it makes sense to exempt services and funds with financial autonomy from account reporting obligations and submit subnational companies to a current balance rule, on top of specific accountability obligations set in subnational corporate sector legislation.
   b. Consolidation at the regional level requires more ambition. PPL 121 restricts its application to the set of entities enclosed in the regional subsector as defined by European legislation for purposes of national accounting reporting. All entities outside this set are exempted from fiscal rules in PPL 121 and do not consolidate their accounts with those inside. This arrangement is not sufficient to prevent the emergence of surprises with the financial performance of entities beyond the Eurostat ring. Hence, the bill should impose a broader accounting consolidation and, at least, the regular public disclosure of a broadly-consolidated debt stock so that a timely knowledge of the comprehensive regional public subsector may become publicly available.

c. Accrual accounting credibility is at stake with the vague obligation of adopting the official chart of public accounting. A similar obligation, with a two-year enforcement deadline, was inscribed seven years ago in the current regional finance law and is now repeated and without deadline.
d. A minimum of monitoring obligations for central administration departments should be set, together with public disclosure duties. For example, the Directorate-General of Local Governments (DGAL) could publish individual and consolidated accounts broken down by the four-levels of local groups defined in PPL 122. The Directorate-General of the Budget (DGO) could publish along the year the position of each regional government with respect to the fiscal rule indicators defined in PPL 121.
e. Even with the obligations originally defined in the two bills, DGAL, DGO and possibly some inspection services of the central government will face a substantial increase on their activity. Fiscal rules whose monitoring is not timely and professional are not effective. Given the persistent deterioration of the technical capacity of these departments, the credibility of Portugal' budgetary framework at each government tier may become at stake if an appropriate recapitalisation of their capacity is not undertaken in the near future.
f. Earlier CFP suggestions to create a treasury single account system and a public finance data warehouse (IOS—Simplified Budgetary Information) are still valid and were not considered.

x. Taxation—political ownership of own revenues needs to be strengthened. As explained in the September 2012 Report, the CFP advocates larger responsibility at the local and regional levels to define tax parameters. This does not imply any tax burden increase; more responsibility for providing the financial resources leads to more responsible spending decisions.
   a. There is scope in PPL 122: to increase the maximum IRS participation rate, taking into consideration the substantial decline in central government spending with transfers; to give municipal assemblies the responsibility to set the rates of the property tax on rustic units within a centrally defined interval; to give priority to a general reassessment of rustic units. Attention should be paid to the increasing tax capacity asymmetries between urban and rural municipalities, as the reduction on central government transfers will penalise municipalities in low population density territories much more than metropolitan ones in relative terms.
   b. PPL 121 insists on setting an asymmetric regional adjustment margin for the tax rates of the three major taxes (IRS, IRC and IVA), allowing regional legislative assemblies to choose actual rates up to 20 percent below those prevailing in the mainland. The CFP proposes a symmetric "–20; +20" percent band around the mainland rates. Again, this does not imply any actual tax increase but reinforces the margin of manoeuvre of regional constituencies and their governments to cope with their financing needs in "rainy days" or to meet eventual regional preferences in favour of larger governments. The role of smaller tax rates as a compensation for the important economic handicap of outermost regions should not be exaggerated as PPL 121 provides several other tools to address this problem.
   c. Linked to the transparency requirements mentioned above, the invoices of visible subnational taxes (perhaps the IMI at the municipal level and the IRS at the regional level) could contain the logo of the recipient government and the applicable tax rate as decided by the subnational government, along with information on compliance with fiscal rules.

xi. Transfers from central to local governments—a number of problems deserve attention.
   a. PPL 122 states that municipalities whose average tax capitation is below 75 percent of the national average are lifted to 125 percent of that mean. This penalises municipalities whose capitation lies between 75 and 125 percent of the national average and creates a very strange and adverse incentive for municipalities close to but above the 75 percent threshold: if they destroy own tax capacity, they are compensated with a subsidy paid by taxpayers from all other jurisdictions. The legislators may wish to correct this mistake.
   b. The tax capacity index that is used to distribute the Municipal Cohesion Fund should reflect all local taxes, including the IRS participation. The bill restricts the index to the property tax (IMI).

c. On the Municipal Social Fund, two remarks are made. First, the article that governs the endowment of each municipality will become obsolete as soon as the central government changes the division of responsibilities with local governments. Thus, the bill should contain a provision to the effect that the central government must provide an increase in the Financial Equilibrium Fund or the creation of new, specific transfers with the sufficient means in such situations. Second, the endowment is a function of pre-defined and across-the-board technical coefficients; this reduces the focus on effectiveness (results). Alternatively, transfers to individual municipalities could be negotiated together with standards for performance and output indicators.

xii. Transfers from central to regional governments—two remarks on the Cohesion Fund for the Outermost Regions. First, the bill defines it as an earmarked funding for specific investment projects or programmes defined by the regional government. Yet, if any of these items is not executed, there is no obligation to return the money. This removes credibility to the Cohesion Fund. The Parliament may wish to clarify if this transfer is indeed earmarked or not. In the first case, there should be conditionality strings attached to the use of the transfer. If the Parliament prefers the alternative interpretation, the Cohesion Fund becomes an unconditional lump-sum subsidy, with no qualitative differences to the "budget transfers" defined in Art. 48; hence, the Cohesion Fund should disappear and its financial envelope aggregated to the "general budget transfers" endowment. Second, the national statistical authority is now releasing regional gross domestic product statistics with a two-year lag (*e.g.*, the 2010 final data were published on 19 December 2012). If that authority is able to anticipate in three months this release, the legislator may gain one year and use fresher data on the mark-up formula of the Cohesion Fund over the amount of the "general budget transfers", which is desirable on equity grounds.

The CFP hopes the analysis in this Report will be useful for citizens at large and the political stakeholders, notably the Members of the Parliament, to ponder which feasible and desirable improvements can still be introduced in the local and regional public finance bills, PPL 121 and 122.

List of Abbreviations

Acronym	Meaning
BFL	Budgetary Framework Law
CDO	Unequal Opportunities Compensation
CF	Tax Compensation
CFP	*Portuguese Public Finance Council*
CMMi	Tax Capitation of Municipality *i*
CMN	National Tax Capitation
DGAL	*Directorate-General of Local Governments*
DGO	Directorate-General of the Budget
ESA	European System of National and Regional Accounts
EU	European Union
FAM	Fundo de Apoio Municipal (Municipal Support Fund)
FCM	Fundo de Coesão Municipal (Municipal Cohesion Fund)
FEF	Fundo de Equilíbrio Financeiro (Financial Equilibrium Fund)
FFF	Fundo de Financiamento das Freguesias (Parishes' Financing Fund)
FGM	Fundo Geral Municipal (General Municipal Fund)
FSM	Fundo Social Municipal (Municipal Social Fund)
IMI	Municipal Tax on Real Estate Property
IMT	Municipal Tax on Real Estate Transactions
INE	*Instituto Nacional de Estatística* (the Portuguese statistical authority)
IOS	Simplified Fiscal Information
IRC	Corporate Income Tax
IRS	Personal Income Tax
IUC	Tax on Motor Vehicle Property
PPL	Bill or Law Proposal by the Government to the Parliament

1. Introduction

The *Portuguese Public Finance Council* (CFP) is responsible for undertaking an “independent assessment of the consistency, compliance and sustainability of public finances and to enhance, through increased transparency, the quality of democracy and economic policy decision-making”—article 4 of Law No. 54/2011, of 19 October. The assessment of the financial condition of regional and local governments is one of its tasks—article 6. Following the Government’s announcement last year of its commitment to present a new legal framework for subnational public finances in Portugal, the CFP has published, in September 2012, a report—CFP (2012)— laying out the principles of local and regional public finance and some desiderata for reform in Portugal. A technical Working Group was set up by the Government (Resolution No. 8/2012, of 13 February) to propose the new legal instruments. The CFP was part of the Accompanying Commission branch of this group and gave some input into the process.

More recently, the Government has presented its proposals for revising the Law on Local Finances (Proposta de Lei No. 122/XII/2.ª, hereafter referred as PPL 122) and the Law on the Finances of the Autonomous Regions (Proposta de Lei No. 121/XII, hereafter PPL 121), both dated December 27, 2012. The CFP is very pleased to see that many of the issues and desiderata suggested in its earlier Report have been addressed in these proposals. Both bills are currently undergoing the legislative process at the Parliament.

In this Report, we briefly recapitulate the main points raised in our earlier Report (Section 2). The underlying economic reasoning is common to local and regional finance. Hence, for the sake of brevity, we address together a number of issues in the two legal proposals which we think deserve further attention. For the readers' convenience, problems or suggested solutions are marked with bold type characters. The structure of this document parallels that of CFP (2012). Section 2 runs the bills according to the kind of issues proposed in that paper: accounting, reporting and monitoring, political ownership of subnational revenues and medium-term fiscal framework. A detailed attention to fiscal rules is paid in Section 3, which includes the CFP proposal for a different set of budget balance and spending rules. Section 4 identifies some contradictions between PPL 121 and PPL 122 and Section 5 concludes.

2. Issues for reform

The CFP's earlier paper spelled out some normative guidelines for the design of a framework for local and regional public finances and reviewed the institutional framework and economic context of subnational finances in Portugal. Based on this, the CFP pointed out a number of critical areas for reform, grouped in three categories: (1), accounting, reporting and monitoring, (2), political ownership of revenues, and, (3), medium-term budgeting. In this section, we restate these areas and briefly indicate how the Government's legislative proposals deal with them.

2.1 Accounting, reporting and monitoring

It is important for sustainability that each unit of government runs accounting systems on effective cash and accruals bases. Although municipalities were the first layer of government to implement accrual accounting in Portugal and their experience may prove useful for the efforts currently being undertaken at the central administration level, some imperfections still need to be addressed. Public finance information must be consistent, comparable across time and government units, comprehensive and transparent to deliver the right information for sound, forward-looking management decisions and to monitor the compliance with fiscal rules in force. Areas to intervene include:

- criteria harmonization—charts of accounts, including accounting rules, and accompanying implementation handbooks need some adjustments so as to minimise the margin for arbitrary interpretation;
- account consolidation across entities and government layers (including central administration)—government fragmentation needs to be reconciled with a comprehensive view of the entire set of entities held by the holding unit (a municipality or a regional government): municipalised services, autonomous funds and services, local and regional companies, etc.;
- data pooling—a unified public finance warehouse would minimise compliance costs of reporting entities, improve transparency, reduce data discrepancies and would facilitate analytical work by monitoring agencies, thus improving common knowledge on subnational public finance;
- treasury account unification—all entities belonging to a municipal or regional group would adopt the same single bank account to improve treasury consolidation and facilitate cash flow tracking.

2.1.1 Local finance

These issues have been addressed by the legislative proposal for local finances in the following ways. There is a reinforced emphasis on accrual accounting data (Title IV and scope of debt limits) and external audit (Art. 86), and the bill enlarges considerably the perimeter of account consolidation. Art. 85 requires a uniform, standardised and simplified accounting system for the local authorities ("autarquias locais", defined as parishes and municipalities), the intermunicipal entities and their associative entities for economic and financial management. Art. 86 requires the presentation by all municipalities, intermunicipal entities and their associative entities of accounts consolidated with the units they hold or on which they participate. Art. 89 requires the local authorities, intermunicipal entities, municipal associative entities and reclassified public entities to submit their account information in a timely manner to the central administration (Directorate-General of Local Governments—DGAL). Furthermore, they are required, by Art. 90, to publish detailed expenditure and revenue information online as well as their annual budget proposals, reports on planned and past activities, their multiannual budget and investment plans and data related to the annual execution of the multiannual plans. Revenues and expenditures must be presented according to economic classifications. Art. 16, No. 2 recognizes the fiscal consequences of tax exemptions as tax spending, *i.e.*, as fiscally equivalent to transfers paid out of the municipal budget, but it does not require them to be budgeted explicitly.

2.1.1.1 Consolidation of public finance data

The CFP signalled the risks of fiscal fragmentation on its earlier Report and therefore welcomes the significant enlargement of the scope of consolidation of local finances. However, the fact that the proposed legislation creates three different levels of consolidation in the local public subsector may be a **source of unnecessary confusion**. Table 1 summarises the list of local entities now recognised as part of the subsector. For purposes of accounting production and reporting, the bill clearly moves from the strict municipality boundary towards the notion of municipal group. In each "concelho", the municipality [unit ii)] becomes the holding unit and consolidates accounts with all subsidiary units—units v) to ix). The law accompanies the evolution in the real world and defines two other types of local groups: intermunicipal entities [units iii)] and municipal associative entities [units iv)]. These holdings are also requested to consolidate accounts with all subordinated entities—units v) to ix). A subordinated entity is a unit, irrespective of its legal form, whose financial and operational policies are managed by either a municipality, an intermunicipal entity or a municipal associative entity so that its activities may benefit the holding.

Table 1—Local sector units

	Designação / Name		**Definição na PL / Bill definition[1]**
	Unidades individuais / Individual units		
i)	Freguesia / Parish		
ii)	Município / Municipality		
iii)	Entidade intermunicipal / Intermunicipal entity		Art. 2, b)
iv)	Entidade associativa municipal / Municipal associative entity		Art. 2, d) [2]
v)	Empresa local não reclassificada / Unreclassified locally-owned company		Art. 2, e)
vi)	Serviço ou fundo autónomo do setor local / Local sector autonomous service or fund		Art. 2, f)
vii)	Entidade pública reclassificada /Reclassified public entity		Art. 2, g)
viii)	Cooperativa ou fundação participada por município / Cooperative or foundation with a municipal stake		Art. 54, 1b)
ix)	Associações participadas não exclusivamente por municípios / Subsididary associations which are not solely held by municipalities		Art. 54, 2
	Agregações / Aggregations	**Unidades incluídas / Included units**	**Definição na PL / Bill definition[1]**
x)	Autarquias locais / Local authorities	i)+ii)	Art. 2, a)
xi)	Definição restrita de sector local / Narrow definition of local sector	Segundo SEC / According to ESA [3]	Art. 2, c)
xii)	Definição abrangente de sector local / Comprehensive definition of local sector	i)+...+ix)	

Notes

1. Referência na PPL 122 / Reference in PPL 122.
2. Não é claro na referência legal se a definição inclui a unidade viii) / Inclusion of unit viii) in the definition is not clear from the legal reference.
3. Âmbito variável; o agregado corresponde, em cada momento, ao conjunto de entidades incluídas no subsector da administração local no âmbito do Sistema Europeu de Contas Nacionais e Regionais (SEC), nas últimas contas publicadas pela autoridade estatística nacional / Variable extension; this aggregate corresponds to the set of entities included in the local administration subsector according to the European System of National and Regional Accounts (ESA), in the latest accounts published by the national statistical authority.

For budget balance rules and debt limits, the scopes are different and need clarification before the bill is approved. Table 2 helps to frame the following comments.

In the case of the budget balance rules set by Art. 40, each and every local entity[1] is supposed to comply with them on an unconsolidated basis. We do not know if this was what the Government really meant to do but the wording in No. 1 of that article ("local sector entities") combined with the definition of local sector in Art. 2 [(*i.e.*, aggregate xi) in Table 1] subject the thousands of involved units to comply with the rules. However, services and funds with administrative and financial autonomy [units vi)] are exempted from reporting their accounts to DGAL, according to No. 1 of Art. 89. The Government may wish to explain if **this option is deliberate e porquê**. Indeed, a rule whose compliance cannot be checked does not make sense. Currently, only the so-called local authorities ("autarquias locais") report their accounts to the central government:[2] 308 municipalities and 4,259 parishes. Yet, the central government does not show to the public how the parochial accounts are monitored or analysed. In fact, there are no monitoring obligations in the local finance law, both current and proposed. As CFP (2012) signalled, the local subsector statistics on the Internet, including the Budget Office monthly synthesis, ignore the parochial tier. Hence, for the sake of transparency, comprehensiveness and sustainability of public finance, it might be a good idea **to insert a public monitoring obligation clause in PPL 122 regarding all entities subject to reporting obligations.** Yet, making the monitoring compulsory does not assure its quality. Probably the current flaw in this area **raises doubts about the capacity of DGAL to monitor, process and publish data in a timely and effective way**, which means that monitoring agencies should be given the sufficient resources to carry on their tasks effectively—see more throughout this heading. Note also that in order to reinforce the quality of the monitoring, its results should be regularly made public. More substantially, the CFP is not convinced that the budget indicators underlying the rules (especially the corrected current balance, No. 2 of Art. 40) are appropriate for both companies and traditional public administration.[3] Units i), ii) and iii) have political bodies and are politically accountable; the same is not true for units iv) and vii), as they ultimately depend on the political leadership of municipalities. **So either the latter units should not be subject to budget balance rules (only to debt rules in this PPL)[4] or the balance rules should apply to consolidated balances by local groups**.

[1] All units included in the local administration subsector by the national statistical authority in the last sectoral account publication—Art. 2, heading c). They make up aggregate xi) in Table 1.

[2] Art. 50 of Law No. 2/2007.

[3] A firm's financial performance is nowhere assessed by its current balance and it makes no sense to impose a uniform classification of transfers (current/capital disentanglement) across-the-board.

[4] Specific legislation on the local corporate sector sets additional economic and financial accountability for managers.

Table 2—Consolidation levels of public finance data

Purpose		Entidade consolidante / Holding entity	Universo / Universe	Ref. legal / Legal ref. [1]
Accounting	Grupo freguesia / Parochial group	i)	i)	Art. 89, No. 4
	Grupo municipal / Municipal group	ii)	ii) + v) + (...) + ix)	Arts. 86 e / and 89, Nos. 1, 11
	Grupo intermunicipal / Intermunicipal group	iii)	iii) + v) + (...) + ix)	
	Grupo associativo municipal / Municipal associative group	iv)	iv) + v) + (...) + ix)	
Budget rules	Para efeitos de cumprimento / for compliance purposes	Orçamentos e contas de entidades individuais, não consolidados / Budgets and accounts of individual units, unconsolidated [2]	Todas as entidades do agregado xi) / All units of aggregate xi)	Arts. 40 e / and 42
	Para efeitos de reporte e acompanhamento / for reporting and monitoring purposes		i), ii), iii), iv) e / and vii)	Art. 89, Nos. 1, 4
Debt rule	Grupo municipal + participações indirectas através de entes iii) e iv) / Municipal group + indirect subsidiaries through units iii) and iv)	ii)	Agregado xii) sem entes i) /Aggregate xii) but units i)	Arts. 54 e / and 89, No. 3

Notes
1. Clausulado da PPL 122 / Clauses in PPL 122.
2. Excepto para os serviços e fundos sem autonomia financeira, cujos orçamentos são incluídos na entidade i), ii) ou iii) à qual pertencem / Except for services and funds without financial autonomy, whose budgets are included in unit i), ii) or iii) to which they belong.

All local entities except parishes are subject to the debt rule defined in Art. 52. The consolidating unit is the municipality and, for this purpose, intermunicipal entities and municipal associative entities, as well as all firms, cooperatives, foundations and any other units subordinated to them, are treated as municipal subsidiaries.

These different levels of consolidation can be justified on various grounds, *e.g.*, that budget balances reflect different levels of political decision making, while debt figures should reflect the true direct and indirect financial liabilities of a municipality. Nevertheless, the proposed consolidation rules will result in the incomparability of these three sets of data: accounts, budget balances and debts. In order to assure transparency and to facilitate a comprehensive assessment of their financial situation, **this triple consolidation does not help**. The legislators may want to revise this arrangement or, at least, to set it as a transitory regime until mature ideas on numerical targets for budget aggregates exists. One additional suggestion with respect to data consolidation goes for transparency. **DGAL should publish individual and consolidated accounts by (the four levels of) local groups** indicated in Table 2—i) to iv). At this moment, nobody knows for sure how much revenue and spending exist at the local level—DGAL only publishes strictly municipal data and with considerable delay on its website (2009 being the latest year at the time this Report is finished). Note that there are transfers across local groups and transfers within local groups. Hence, data consolidation involves professional work that goes well beyond summing accounts and budgets received from individual units.

2.1.1.2 Other issues

The local finance bill demands a considerable effort on the part of local entities to comply with the new accounting and reporting rules. Important implementation doubts will arise in the coming years, notably on compatibility across information and accounting systems to enable the various data consolidation exercises. **The central administration must prepare itself to help local governments in their adjustment work**, e.g., providing handbooks on time to secure rigorous data comparability across jurisdictions and to minimise arbitrary interpretations of possible unclear accounting rules. Also, with such a large volume of additional data, the central administration inherits a **larger responsibility with respect to data treatment and Internet publication**. There are, of course, resource implications from these new rules at the local and central government levels that cannot be ignored by the legislators and the Government.

These enlarged information requirements make even more pertinent the earlier CFP recommendation for a public finance data warehouse—the ***Simplified Fiscal Information*** **(IOS)** toolbox. It would help to keep compliance costs to a minimum as reporting and monitoring obligations will increase substantially. A specific reference to data pooling in the bill would be most useful.

Finally, although reporting entities are forced to publish much of their financial information on their websites, the CFP thinks they are not the best outlet to strengthen fiscal accountability before citizens. Therefore, the Council renews its recommendation for **inclusion of synthetic indicators in local tax invoices:** latest position of the government with respect to fiscal rule targets, local tax rates and logo of the ultimate tax receiving authority.

2.1.2 Regional finance

The legislative proposal for the Finances of the Autonomous Regions, in contrast, is simpler and less ambitious. We make three remarks.

First, the data consolidation. There is one consolidation perimeter only (Art. 2, No. 2): the set of regional public administration entities, plus all entities, irrespectively of their nature and legal form, that have been included in the regional subsector defined by the European System of National and Regional Accounts (ESA) in the latest sectoral accounts published by the national statistical authority. In other words, this is a narrow definition of the actual regional public sector. It leaves outside the monitoring radar entities such as companies, cooperatives, foundations and other entities participated by regional governments or over which the regional governments enjoy a dominance relationship.[5] For a comparison with the local finance bill, it corresponds to aggregate xi) in Table 1. Although the adoption of a single consolidation level facilitates the economic and financial analysis of the aggregate,

[5] Provided they have not been reclassified as public administrative units by the national statistical authority.

the CFP believes that this arrangement poses a considerable financial risk for regional and national taxpayers. Accounting reporting and monitoring, and fiscal rules compliance defined over a fraction of the true regional sector leaves too much information outside the concern of decision-makers and the public at large. Contrary to the effort in the local finance bill of accounting as much as possible for all pending liabilities, the solution in the regional finance bill incentives off-budgeting practices, whose disadvantages are likely to come in the future with an adjustment price tag. Recent experience with off-budgeting practices at the three layers of government **strongly recommends a wider scope for consolidation**.

Second, **accrual accounting** demands are also weaker at the regional level. Art. 72 compels regional authorities to adopt a relevant official chart of accounts "after the entry into force of the current law". The law still in force, dated from 2007, gave two years to the Autonomous Regions to adopt the very same charts. The fact that the same norm reappears seven years later means that accrual accounting plans failed at the regional level. It is important to understand why before passing a new rule, otherwise the **credibility of legislation is at stake**. The credibility problem is aggravated by the fact that the new article no longer includes a deadline for the full implementation of accrual accounting. As it is, Art. 72 can be met whether the adoption occurs one day or ten years after the entry into force of the bill.

Finally, the **transparency requirements** need to be stronger. Arts. 21 and 22 set the reporting obligations of regional governments. The former defines the requirements within the excessive deficit procedure whereas the latter outlines the obligations with respect to budget outturn estimates. Surprisingly, all data reports happen within the administrative circuit and are not disclosed to the public at large by law. There are neither accrual accounting report obligations in the bill nor obligations for the central government to make public comparable monitoring results. Thus, the CFP recommends **appropriate publicity on the internet and regional tax invoices** with summary fiscal data, as argued for local governments above and in line with its Report No. 2/2012.

Both bills ignored the CFP claim for a treasury single account system. Under this system, each entity could run an own bank account but such account would consolidate with the accounts of all other entities belonging to the same group. A centralised management at the holding unit of this consolidated account would improve the cash flow tracking by the ultimate political authority within the group and would also give the group more bargaining capacity to deal cash surplus or shortage operations with the bank. T**he legal requirement of a treasury single account system should be set in both bills or in the Budgetary Framework Law (BFL)**.

We close Subsection 2.1 with two alerts on overlapping or conflicting legislation. Firstly, **we point out that there is separate legislation regulating the accounting rules for local and regional governments**. For example, the official chart of local accounts is defined in Decree-Law No. 54-A/99, of 22 February. This diploma contains a fiscal rule that is not foreseen in the local finance law in force (Law No. 2/2007, of 15 January): the current balance equilibrium. Moreover, this is just one out of eight budgetary principles that also exist, sometimes with different wording and content, in the local finance law. This legislative technique is dangerous: the same subject should not be set in separate diplomas and, in particular, all fiscal discipline rules ought to be in frame laws, not on subordinated diplomas. Hence, **the CFP regards the passing of the new laws on local and regional finance as an excellent occasion to go through that legislation and expurgate all norms that contend with the former, so as to assure the consistency of all relevant rules**. The result would be one comprehensive law for each subnational sector with the benefit of greater transparency and legal safety.

Secondly, there are common issues dealt in the proposal for the 7th amendment of the Budget Framework Law (Proposta de Lei No. 124/XII, hereafter PPL 124) and the subnational bills. Footnote 22 below presents an example in the area of accounting obligations. It seems that the drafting of the three bills was not coordinated. Hence, **the CFP recommends a careful cross-examination at the Parliament before any of them is approved**. A possible principle to adopt is to merge into the same document analogous issues. This would make legal compliance much easier.

2.2 Subnational revenues from taxes and vertical transfers

An important prerequisite for maintaining sound public finances is that political constituents perceive their own contribution to each euro of public spending they benefit from. This helps to align public with private preferences, induces greater accountability of incumbents to voters, and reduces the margin for blaming funding difficulties at the local level on higher government levels; as a result, the public budget constraint gets harder. Portuguese subnational governments rely heavily on transfers from higher government layers. On the one hand, these are important to reduce economic inequalities due to the large degree of economic heterogeneity. On the other hand, the resulting high degree of vertical imbalance may mislead subnational policy-makers and their constituents about the true relative cost of public services. To enhance the political ownership of revenues, the CFP suggested the following issues for reform:

- for municipalities
    - either to increase the ceiling of the Variable Participation in the personal income tax (IRS) substantially[6] (in exchange for lower central government transfers), at least for municipalities with fiscal capacity above a threshold to be determined politically;
    - or to move from rebate (the current variable participation in IRS) to a local surcharge on the net IRS collection but at a substantially higher effective tax rate (also in exchange for a reduction on central government transfers);
    - to increase the taxpayers’ perception about the consolidated intertemporal local budget constraint by changing the layout of local tax invoices to display the municipality’s logo and basic numerical information on local public finance;

[6] The current ceiling is 5% of the IRS revenue collected by the national tax authority in the jurisdiction (after deductions). For an average effective gross tax rate of 10%—the official figure in 2008 to 2010, according to Autoridade Tributária e Aduaneira (2012)—that ceiling corresponds nearly to just 0.5% of the average taxpayer’s gross income.

- to grant municipal parliaments some autonomy to set parameters in the transfer-like taxes (on automobile ownership, at least);
- to consider a credible calendar to reassess the base of the rustic real estate property tax;

- for regional governments
  - to increase regional discretion over tax parameters;
  - to partially exchange transfers from the central government for own taxes;
  - to increase the visibility of own revenues for regional constituencies;
  - to consider lessons from the Madeira's economic and financial adjustment programme.

2.2.1 Local taxes

Art. 14 lists the own taxes of the local governments. The Government proposes to eliminate the municipal tax on real estate transfers (IMT, Art. 92, No. 1), which was supported by CFP (2012). Local governments continue to have the right to set a variable withholding rate of up to five percent on the state income tax (IRS) collected from residents of their territory.[7] Personal income tax invoices will, in the future, state the local withholding rate and amount. This is a step towards increasing the political ownership of local taxes, albeit a very small one.

The CFP notes that **the current proposal does not use the opportunity to give municipalities more room to choose their own tax rates**. As explained in the CFP's earlier paper, this would have been useful to strengthen the political ownership of local public policies and the accountability of municipal governments. In that document, the CFP had suggested to **increase the maximum surcharge rate on IRS** (or the maximum withholding rate on the IRS participation) significantly in order to give local governments more freedom to choose their own policies. The legislative proposal does not move in that direction. The **property tax on rustic units** (now passed entirely to parishes) **continues to be a *de facto* transfer as no decision-making power is decentralised. As it will no longer accrue to municipal coffers, municipal assemblies will lose their incentive to deliberate on rates or exemptions, which will represent a step backward**. Neither do changes occur with respect to the decentralisation of other tax competences (the **municipal fraction of IUC**). The reassessment of urban units, which will be concluded in 2013, will increase, even more, the **asymmetries in tax capacity between large and small municipalities**. **It is regrettable that the reassessment of rustic units for IMI purposes** is not a political priority. It might be wise **to set a phasing-out calendar for the IMT** so as to smooth its effects on taxpayers' transactions and local revenues—for example, a reduction of one third in the statutory rate in 2014 and another third in 2015. By offering instead a once and for all tax saving from 2016 onwards, many real estate transactions may be postponed until then.

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[7] The bill insists on classifying the "variable participation in IRS" as a vertical transfer. Yet, from an economic point of view, this is a local tax because the municipal parliament faces the political onus of setting the withholding rate.

Art. 16, No. 1 exempts central, regional and local governments from all municipal taxes (with the exception of IMI on buildings not assigned to public interest activities). **This privilege, *vis-à-vis* private economic agents, is very questionable on both equity and efficiency grounds**. For a given revenue target, such reduction of the tax base forces businesses and households to pay higher taxes and distorts the relative price of taxed goods or assets between public and private agents. For example, in the case of property tax, by paying a lower relative price, the public sector is induced to overconsume property services.

2.2.2 Regional taxes

Regional governments keep their right to the revenue generated in their territories by almost all national taxes. They can still launch specific taxes while they do not exist at the central level, although, to the best of our knowledge, this prerogative was never used so far. Regional parliaments have wide possibilities to change parameters (rates, exemption levels, tax benefits). The VAT appropriation is reset to the capitation regime, adjusted for the difference between regional and mainland rates, and the additional compensations for regions present in the current law[8] are eliminated. The lower bound of regional rates for the three major national taxes (IRS, IRC and IVA) will be increased, from 30 to a 20 percent maximum discount *vis-à-vis* the mainland rates.[9] The bill also supresses a few other prerogatives that allowed for a lower tax burden in the Autonomous Regions through the adaptation of the rules prevailing in the mainland: higher markups in household expenditures deductible to the IRS collection and higher limits to tax benefits targeted for job creation (Art. 56, Nos. 5, 6 and 8 of the Organic Law No. 1/2007).

The CFP notes that its earlier recommendation for enhancing significantly the visibility of fiscal options before citizens was not followed. For example, **neither bill foresee the obligation of handing regional and local taxpayers an invoice note with the logo of the receiving government and information about compliance with fiscal rules**. Given the fact that almost all tax revenue decisions were already decentralised to the Autonomous Regions, very little could be made in the bill to strengthen the tax onus of regional authorities. Yet, political responsibility at the regional level can still benefit from adopting a symmetric approach to the differentiation between regional and mainland rates in IRS, IRC and IVA. **Instead of just allowing for a reduction up to 20 percent, the law should also allow for the same regional autonomy margin with respect to rates above the levels in the mainland.** A "-20; +20" percent band of maximum differentiation would not imply any actual tax burden increase in Azores and Madeira but it would give regional constituencies additional manoeuvre room to overcome future fiscal distress bouts on their own, before accepting the conditional strings inherent to a central government support programme. Additionally, this symmetric band would allow regional

[8] Compensations defined in Art. 22, Nos. 3 to 5 of Organic Law No. 1/2007.

[9] The memoranda of understanding signed in 2012 between the central and regional governments had reduced already this autonomy margin, albeit for a limited period.

communities, if that would be their will, to afford a government relatively larger than the one in the mainland. These options may still be considered by the legislators to improve the political ownership of revenues.

2.2.3 Vertical transfers

2.2.3.1 Financial Equilibrium Fund

Municipal dependence on vertical transfers from the State will be cut across-the-board, from 25.3 percent to 18.5 percent of the arithmetic average of revenues from the IRS, the corporate income tax (IRC), and the valued added tax (IVA) collected by the State on their territories as a "general subsidy" through the *Fundo de Equilibrio Financeiro* (FEF).[10] This is the size of the reduction on the endowment available for distribution among the 308 municipalities. Whether or not this reduction will increase **the political ownership of revenues** depends a lot on the magnitude of tax revenue changes. A seven percentage-point drop is a very significant cut in the aggregate, and the financial consequences would vary strongly across municipalities depending on their base for own taxes. **To avoid the creation of non-viable financial outcomes for some municipalities, which could result in the non-sustainability of local debts in some cases, the CFP suggests that this cut should be evaluated together with the changes in local taxes in numerical simulation exercises.** Perhaps a non-uniform reduction could minimise the problem but, in any case, without appropriate data it is impossible to justify the absence of horizontal imbalance impacts.

From the central government perspective, spending with general subsidies for local administrations will be smaller in the future. In the current law, 25.3 percent of the average net revenue from the three major taxes is paid to municipalities (as FEF) and 2.5 percent to parishes (*Fundo de Financiamento das Freguesias*, FFF). With this bill, 18.5 percent is paid to municipalities (which have to transfer a fraction for the FAM and intermunicipal entities), 2 percent to parishes (as FFF) and a small fraction to intermunicipal entites (1 percent of the FEF endowment for the metropolitan areas of Lisbon and Oporto and 0.5 of the FEF endowment for municipalities included in the intermunicipal communities). Even without access to numerical simulations to figure out the split within intermunicipal entities, it is clear that the central government will pay less transfers to the local subsector.

The base for calculating the general subsidy is the net revenue collected in the penultimate tax year. This lag in the calculation introduces an anti-cyclical element into local government revenues, as revenues will be less than proportional to current incomes (*i.e.*, net collection of major taxes) in an economic upswing and more than proportional to current incomes in a downswing. This element minimises the pro-cyclical nature of own revenues, which is good.

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[10] 4.3 percent of the FEF amount (or 0.8 percent of that average of the major central taxes) is earmarked for other local units: 4% goes for the new Municipal Support Fund (FAM) and 0.3% for the intermunicipal entities (Art. 25, No. 1a).

Half of the FEF subsidies are paid through the General Municipal Fund (*Fundo Geral Municipal*, FGM). This part is divided into a flat payment (5 percent), a payment proportional to the (weighted) population of the municipality (65 percent), and a payment proportional to the (weighted) area of the municipality's territory (30 percent). The formula for calculating the subsidy gives advantages to very small municipalities (the first 5,000 residents are counted threefold in the population criterion), and discriminates against medium-sized municipalities (residents between 10,000 and 80,000 receive less than full weight). Thus, for instance, the weighted population of five small municipalities of 5,000 residents each counts for 75,000 residents, while the weighted population of a single municipality of 25,000 residents counts for only 25,000 residents. This creates incentives against reforms consolidating small municipalities into larger ones and a bias in favour of cooperation among small municipalities through intermunicipal entities.

The other half is paid through the Municipal Cohesion Fund (FCM) and takes into account the tax capacity of the individual municipalities. FCM has two parts, a tax compensation, CF, and a compensation for unequal opportunities, CDO, based on an index of unequal opportunities, which aims at compensating municipalities for long-term, structural development weaknesses. Subsidies under CF introduce an element of horizontal equalization. Payments are based on the difference between a municipality's *per-capita* own-tax collections, including its IRS participation (CMMi), and the national mean *per-capita* own-tax collection of all municipalities (CMN). Municipalities whose CMMi is between 75 percent and 125 percent of the national average are unaffected by CF. Municipalities whose CMMi is below 75 percent of the national average receive *per-capita* payments equal to the difference between 125 percent of that value and their own CMMi, *i.e.*, they are lifted up to 125 percent of the national mean. Municipalities whose CMMi is above 125 percent of the national mean for at least three consecutive years pay 22 percent of the difference between their CMMi and the upper threshold into the FCM.

We call the readers' attention to a possible important mistake with the wording of this device. Art. 33, No. 3 of PPL 122 (p. 35) states that municipalities whose CMMi is below 75 percent of the national average are lifted to 125 percent of the national mean**. The CFP regards this as a typo, since that formula would penalize municipalities falling between 75 percent and 125 percent of the national mean and create very strange and adverse incentives for municipalities close to but above 75 percent.** Such municipalities would have a strong incentive to destroy their own tax capacity in order to benefit from the transfers scheme. However, the same formula exists in the current law (Art. 27, No. 3 of Law No. 2/2007), which may suggest an intentional mistake. This is not a detail and the Parliament may wish to have a word on this issue.

Mechanisms of horizontal equalization create incentive problems for local policies aimed at strengthening local economic development and tax capacity. The more redistributive a mechanism is, the weaker are the incentives for local governments to undertake policies strengthening their own tax capacities. The proposed mechanism leaves municipalities with relatively strong tax capacities the amount of 78 cents for every euro of additional tax revenues they collect. This reduces the incentive for local policies to further increase tax capacity somewhat, but not very much. The mechanism seems much more problematic with regard to local governments with relatively weak tax capacities. Here, the mechanism implies that any increase in local tax collections is offset by an equivalent reduction in CF transfers. From this point of view, **it does not pay at all for local governments to invest in strengthening their municipalities' tax capacity**.

Legislators may also wish to fix a few other apparent errors in Art. 33, besides the one mentioned above as a typo. Firstly, No. 1 says the fiscal capacity is computed with the collection of the municipal taxes (we stress the plural) referred to in heading a) of Art. 14. Yet, this heading contains one tax only, IMI. Law No. 2/2007, from which that wording was copied, indeed contains IMI, IMT and the municipal fraction of the Single Road Tax (IUC)—heading a) of Art. 10. **Why limiting tax capacity appraisal to IMI?** All other local taxes listed in Art. 14, together with the IRS participation, should also be included in this measure. Secondly, No. 10 mentions an index ("ICF") that is not used in any formula. Should it instead be read as "CF"? If this is the case, our criticism above to the perverse tax incentive of low-capacity governments no longer applies. Anyway, **the usefulness of common parameters to assess the tax capacity of individual jurisdictions is not exhausted by IMI, as No. 10 states; the same principle should be applied to all own revenues entering the tax compensation, including the participation in IRS**. Finally, Art. 33 entails complex interactions among variables and unfortunately the wording is confusing. **A little appendix with the full algebraic description of the tax and unequal opportunities compensations would help a lot to grasp what is at stake and avoid errors.** The same suggestion applies to the operation of maximum and minimum yearly changes in the sum of FEF and the Municipal Social Fund (FSM) amounts under Art. 35. Art. 33, No. 5 foresees that the annual balance of the FCM, *i.e.*, its original national endowment plus the net of the municipalities' total contributions and benefits, is used for the CDO.

Article 35 specifies that transfers from and contributions to the FEF and the FSM cannot increase by more than five percent annually nor fall by more than five (2.5) percent for municipalities above (below) 125 percent of the mean local tax revenues *per capita*. If applying these limits results in a shortfall of funds, the deficit is covered by reducing the payments to those municipalities which receive more than the minimum payment to which they are entitled—*i.e.*, more than 95 (97.5) percent of the previous year's transfer. If it results in an excess of funds, the surplus is paid out proportionally to those municipalities whose average own tax capitation (CMMi) is not kept above the national mean (CMN) in three consecutive years. If the variations addressed here result mainly from asymmetric cyclical shocks, this creates a rather strange risk sharing arrangement, as the downward risk falls on municipalities participating in CMN and the upside risk falls on municipalities not participating in it. Furthermore, limiting any increases of the transfers to five percent means that the municipalities bear the risk of bouts of inflation, as the limits apply to nominal amounts. It would be preferable to define these limits in real values. **The Government may want to explain the rationale of this rather complex arrangement**.

2.2.3.2 Municipal Social Fund

In addition to the subsidies under FEF, local governments will receive specific subsidies through the *Fundo Social Municipal*, FSM (Arts. 30 and 34). These transfers target local policies in the areas of education, health, and social action. They are paid according to the number of students enrolled in educational programmes and the number of beneficiaries of local public health and social care programmes. Effectively, being earmarked and matching subsidies, these transfers reduce the relative price of such policies for the local governments and thus increase the incentive to undertake them.

A problem with the proposed law is that the total amounts to be distributed through the FSM each year are fixed in the Government's annual budget law. This exposes local policies in these areas to the risk of discretionary and unpredictable changes in the transfers, reducing the local governments' ability to plan ahead and possibly creating a preference for short-term oriented policies, which can be expanded or contracted on an annual basis, rather than for stable policies over time. **The Government might consider tying the amounts to a three-year moving average or introducing upper and lower limits on the annual variation of these transfers similar to the case of FEF**.

The CFP notes that the transfers through the FSM are linked to the number of individuals enrolled in the relevant social policy programmes. On the one hand, this leaves municipalities the freedom to choose the schooling, health and social care policies most adequate given their specific circumstances. On the other hand, the Government renounces the possibility to influence the performance of the municipalities in these areas with a view towards better and more desirable results. Alternatively, **transfers could be negotiated together with standards for performance and output indicators with individual municipalities, assuring that the policies financed through them achieve at least some minimum standards of outcomes defined by the Government**.

In closing this section, we note that the current proposal is static in the sense that it takes the division of responsibilities over public policies between the Government and the local governments as given. Yet, one cannot exclude the possibility that future governments will want to change that division and give local governments more responsibilities, be it because that would be regarded as a more efficient solution, be it because the Government finds itself in financial distress.[11] Local governments should be assured that they will not be burdened with taking over responsibilities from the Government without getting the sufficient financial resources. In order to account for that possibility, **the CFP suggests that the new law should contain a provision to the effect that the Government must provide**, through an increase in FEF or the creation of new, specific transfers**, local governments with the sufficient financial means in such situations**.

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[11] Indeed, the Government has just launched an initiative with this purpose: "Aproximar – Programa de Descentralização de Políticas Públicas". It aims at identifying central administration responsibilities that may be carried on by local authorities with efficiency gains. Details in Resolution of Council of Ministers No. 15/2013.

2.2.3.3 Transfers for regional governments

Autonomous Regions are entitled to six kinds of transfers: a) lump-sum subsidy, defined in Art. 48, and simply labelled as “budget transfers”; b) Cohesion Fund for outermost regions (Art. 49); c) national co-funding to support the productive sector under EU financial incentive systems (Art. 50); d) State financing of common interest projects (Art. 51); e) financial protocols (Art. 52); and f) specific transfers to finance spending responsibilities decentralised to regions (Art. 53). Compared to the Organic Law No. 1/2007 still in force, the only differences lie with types a) and b) transfers. Their overall amount is reduced. Each year, the endowment transferred to regions under type a) is indexed to a nominal amount set in the law for the first year it is in force. The initial value was 355.8 million euros (M€) in 2007 and is adjusted to 322.5 M€ in 2014. The annual rate of change mirrors the relative variation of the actual State current spending in the penultimate year (excluding transfers to Social Security subsector and *Caixa Geral de Aposentações*). The regional Cohesion Fund is a mark-up on the general lump-sum subsidy a). The amount for each region is earmarked to finance a list of investment programmes and projects previously defined by the regional government. Currently, the mark-up is a 35 percent addition every year in each region. The bill proposes to turn the percentage into a variable figure, with a 20 percent top over the same indexant. Interestingly, the actual mark-up percentage each year will differ across regions, depending in each one on the GDP *per capita* difference between the region and the country. If the regional output capitation lags behind by more than 10 percent, the mark-up rate is 20 percent; if the regional output capitation exceeds the national equivalent, the mark-up rate is zero; 5 and 12.5 percent rates apply to intermediate differences.

As with transfers for municipalities, the reduction in the overall transfer amount is in line with the CFP concern about political ownership of revenues, although **the recommendation to extend tax autonomy powers was not followed**. The indexation of transfers a) to State spending is reasonable given the need to assure subnational governments some stable revenue sources and the fact that these proceedings are supposed to fund in the islands approximately the same kind of spending that exists in the mainland. The division of the endowment between Azores and Madeira is reasonable, being proportional to the differences with respect to the following indicators: total resident population, aged population, juvenile population, index of physical outer-periphery, and tax effort. In particular, the tax effort indicator implies the right incentive suggested by the CFP Report No. 2/2012: more transfers do not induce lower regional tax burdens.

Art. 49 defines the Cohesion Fund as a earmarked transfer for particular investment programmes and projects previously defined by the recipient government. However, if any of these items are not executed, there is no obligation to return the transfer or justify the alteration. This silence of the law removes credibility to the earmarking nature of the Cohesion Fund. Hence, the CFP thinks that the Parliament might want **to clarify if this transfer is an unconditional lump-sum subsidy**, exactly as type a) transfer—and, in this case, subsume the Cohesion Fund amount in the general subsidy a)—**or attach conditionality strings to the use of the Cohesion Fund**. The mark-up formula, an innovation *vis-à-vis* the current law, seems more equitable from a national perspective because it takes into consideration the relative prosperity levels. It resembles the EU rationale to allocate structural funds to NUTS II regions within regional policy. Art. 49, No. 3 determines the use of GDP data with a four-year lag. As the national statistical authority is able to publish regional GDP with a two-year lag,[12] perhaps that clause could be amended **to reflect the availability of fresher data**.

To conclude the analysis on intergovernmental transfers, the CFP recalls one key message of its earlier Report. **Discretion by the central government to set the amounts to be transferred annually to subnational governments results in soft local and regional budget constraints**. **The same can be said about debt limits**. Although the subnational finance laws have always stated a rule-based approach for transfers and debt limits, too many times in the past decade the rules have been replaced by discretion in the annual State Budget laws, thus offsetting any attempt to create a stable multiannual fiscal environment. At the end of the day, **discretion compromises the accountability of subnational governments and induces bailing out demands**. The two bills open the door to continued discretion in the future. In fact, Art. 8 (Nos. 2 and 3) of PPL 122 and Art. 14 of PPL 121 allow the Government to introduce more stringent limits in face of exceptional circumstances required to meet national obligations springing from the Stability Programme; PPL 122 even enlarges the scope for discretionary changes, by allowing the central government to introduce restrictions to management decisions with financial implications (end of Art. 8, No. 2). The problem with this safeguard clause is that it is not subject to scrutiny; being in force since the early 2000's, it is debatable why the exceptionality became the rule since then. **Perhaps the Parliament may wish to consider the requirement of a qualified majority in the future to suspend subnational rules for transfer endowments and debt ceilings.** Moreover, if the Government decides to cut transfers or debt ceilings though the State Budget law, it will do it across-the-board (see, for instance, Art. 14, No. 3 of the regional bill), penalising all jurisdictions equally and irrespectively of their financial behaviour. **This incentive is at odds with sound fiscal attitudes. Perhaps the introduction in both bills of a proportionality requirement could remedy this latter problem:** any reduction in the amount of transfers or the debt cap *vis-à-vis* the rules in the subnational finance laws would be applied to individual subnational governments in proportion to their current failure to comply with their fiscal rules.

2.3 Medium-term budgeting

In its earlier Report, the CFP recommended the introduction of an effective medium-term budgeting framework for each subnational government. As a prerequisite for such a framework, the CFP pointed

[12] *Instituto Nacional de Estatística* (INE) released the 2010 final data and the 2011 preliminary data on 19 December 2012. If these lags are sustainable (and INE only can guarantee this), we can count on the availability of preliminary regional *per capita* GDP of year *t*-3 at the time the State Budget is prepared (summer) and modify the bill appropriately. If INE is able to anticipate in three months this release, even final data of year *t*-3 or preliminary data of year *t*-2 will be timely available.

out that local frameworks for forecasting revenues and expenditures should be strengthened. According to that Report, a sound medium-term framework should include fiscal rules on spending and debt applying to annual budgets, rules that would help governments to keep their finances sustainable. In this subsection, we will focus on the spending limits proposed by the Government. As a lot more needs to be said on fiscal rules, we leave an in-depth analysis of fiscal rules for Section 3.

The legislative proposals introduce medium-term budgeting both at the local level and at the regional level. At the local level, governments are required to submit, together with the annual budget proposal, spending limits and revenue projections for the next four years. These projections are to be separated into own revenues and transfers from the State. The wording of Art. 44, No. 2 suggests that the limit applies to total annual spending only but a precise definition is recommendable (effective, effective plus expenditure with financial operations, primary spending, what is the indicator?). Hence, **the bill should me more specific about the spending indicator**. The spending limits are binding for the year following the next budget year and indicative for the remaining years. The overall spending limit and revenue projections are to be updated annually for the following four years.

These rules can strengthen the medium-term orientation and the sustainability of municipal finances significantly. However, the current proposal seems to rely strongly on the political power and the rationality of local assemblies forcing their local governments to present realistic revenue forecasts and to keep the spending limits in line with these forecasts. In the context of government budgeting, revenue forecasting is notoriously optimistic in order to avoid hard choices at the time of passing the budget and regularly leading to negative "surprises" *ex post*. **One way to reduce the consequences of such an optimistic bias would be to require the spending limits to be tied to actual revenues from recent past years**. This could still allow for a rising trend in revenues, but it would introduce a greater degree of realism into the process.

The bill on the Finances of the Autonomous Regions foresees a different medium-term framework. According to its Art. 20, regional governments present to their parliaments a legal proposal for a multiannual budget programme before May 31 each year. It defines spending limits at the level of each budgetary programme, groups of programmes, and the total of all programmes, which will be set in accordance with the objectives of the Stability Programme. Importantly, these limits will be binding, respectively, for the following first, second and the third and fourth years fiscal years. Actually, the wording in this article resembles very much the one applying to central administration in Art. 12-D of the BFL. **It is unclear whether it is possible to plan ahead with a sufficient degree of reliability to implement such limits**. More importantly, Art. 20, No. 3 allows the multiannual budget to be updated annually in the same legislative act that passes the annual budget, which typically occurs a few months after the adoption of the multiannual framework. Thus, even the spending limits for year *t*+1 can be changed a few months after being originally set in year *t* if this is deemed convenient for that year's budget.[13] As a result**, the medium-term framework currently foreseen will be completely ineffective**.

Comparing this proposed law with its counterpart for municipal governments, it is strange that Art. 20 does not require regional governments to present multiannual revenue projections together with the multiannual spending limits. There is, thus, ample room for optimistic assumptions regarding revenues and, in view of this, a tendency to set spending limits at levels which are unlikely to be binding may be the result. Furthermore, Art. 20, No. 6 authorizes the regional governments to prorate any budget balances and, in particular, borrowing authorizations to subsequent years. This could be a useful flexibility tool under a hard medium-term framework; as it is not the case, the carry-over facility adds to the lack of credibility of the multiannual budget programming.

For all these reasons, it will be **hard for the Government and the general public to hold regional governments accountable to their multiannual budget programmes**. In view of this, the medium-term framework for regional governments seems considerably weaker than that for municipalities. **The CFP suggests that the Regions should be given a medium-term framework similar in these respects to that of the municipalities.**

While the introduction of medium-term budgeting is a step in the right direction, **there is little in the current proposals assuring that it will be enforced effectively**. There are no formal rules or mechanisms for dealing with deviations from the spending limits or with excessively optimistic revenue forecasts. Unless political pressures from subnational assemblies and subnational public opinions force subnational governments to stick to their medium-term budgets, it is foreseeable that, in the annual updates of the programmes, past deviations will simply be incorporated in the new baselines. The result will still be considerable fiscal drift and slippage.

In view of the above limitations, **the CFP advocates a different approach for multiannual budget frameworks at subnational tiers**. This alternative framework will be better spelled out in conjunction with the fiscal rules to be discussed in Section 3.

3. Fiscal rules

In its earlier Report, the CFP recommended that the medium-term framework for subnational public finances should contain spending ceilings, debt limits, as well as penalties for violating the targets and mechanisms of adjustment to bring governments back on track, that would help each government group to build fundable annual budgets (*i.e.*, to secure financial sustainability).

[13] The same criticism was made by CFP in previous occasions to the BFL. For instance, see CFP (2013a).

The new regimes in the bills rest on a combination of spending ceilings, balanced budget rules, debt limits and mechanisms for correcting deviations from these norms. In addition, the Law on Municipal Finances will create a subnational rescue fund for municipalities in distress, financed by contributions from all municipalities. This new fund will be an expression of solidarity at the subnational level. We will cover these issues in what follows. Subsection 3.1 will tackle the proposed budget balance rule and the serious problems it raises; such limitations, together with the shortcomings of the multiannual framework, justify the presentation in Subsection 3.2 of an alternative set of fiscal rules. Subsection 3.3 will discuss public debt rules and Subsection 3.4 the financial rescue fund.

3.1 Golden rule

Art. 40, No. 2 of PPL 122 introduces a version of the "Golden Rule" of public finance. It focuses on the difference between current revenues and current expenditures including the average amortisation of medium and long-term debt and requires that this difference be positive. The average amortisation is calculated based on the total amount of medium and long term debt contracted and does not depend on the timing of the actual payments, thus protecting the principle against accounting gimmicks such as balloon loan, where the total capital comes due only at the end of the contract. Furthermore, Art. 40, No. 3 requires that the realised value of this difference cannot be lower than minus five percent of current revenues and that any deficit in excess over this limit must be corrected in the following budget year. Taking the two together indicates that the requirement of Art. 40, No. 2 applies both to the budget as passed by the municipal assembly and the budget implementation by the executive branch, *i.e.*, both in *ex-ante* and *ex-post* senses. **The legal wording could be more specific to speed-up its understanding. Actually, this suggestion applies to both bills**.

Art. 31, No. 3 allows municipalities to decide how to divide their FEF transfers between current and capital revenues, with a cap of 90 percent for current revenues. Combined with the golden rule, this provision implies that municipalities can increase the amount they can borrow annually by declaring a larger share of their FEF transfers as current revenues. By the way, the wording of that norm needs clarification. CFP has interpreted it as allowing the municipality, in the limit, to classify 90 percent of the received FEF amount as a current transfer. Yet, a different interpretation is equally legitimate, according to which, after the choice made by the municipality, total current revenue (*i.e.*, capital transfers plus taxes, fees, user charges, etc.) cannot exceed 90 percent of the total FEF grant received by the municipality. **It seems absurd to cap current revenue but, indeed, this is the literal interpretation of what is written under No. 3. Therefore, it is desirable that the Parliament will improve the writing, should it insist on imposing artificial transfer classifications.** Such classification would be unnecessary in case the Parliament choses the alternative fiscal rules set that the CFP proposes in Subsection 3.2.

Art. 16, Nos. 2 and 3 of PPL 121 introduces a similar rule for the autonomous regions, with the difference that the golden rule has to be met on average throughout the political tenure of the government (No. 2). No. 3 of this article, however, does not require an immediate correction for a realized current deficit corrected for amortisations in excess of 5 percent of current revenues. For the autonomous regions, therefore, **there is a larger potential for slippage away from the golden rule**. According to UTAO (2013), none of the regions would meet No. 2 and No. 3 if they were applied retroactively to the past four years.

There are no provisions for enforcement spelled out in these legal proposals. Thus, it remains unclear what will happen when the rules are violated.

The rationale for a current balance equilibrium rule springs from intergenerational efficiency and equity concerns. Theory assumes that current spending generates contemporaneous benefits and capital spending, interpreted as investment expenditure only, generates future benefits, which spread through many years ahead of its execution. With this understanding, investment (net of capital revenue) is financed out of the current surplus and net debt. In other words, the golden rule sets a ceiling for annual indebtedness, which is net investment spending. As long as debt service payments are synchronised with the benefits generated by net investment, the golden rule assures that debt costs are born by people who benefit from debt and in line with enjoyed benefits.

However, **there are a number of reasons why, in practice, the golden rule fails to deliver those outcomes**. We simply state a few. First, the rule rests on **the rigorous definition of current and capital items**, on both sides of the budget. This is a tricky exercise. The classification of some items is absolutely artificial; as mentioned above, it is up to each local government to decide how to divide the FEF amount into current and capital revenue. The payment for the very same economic operation (e.g. road pavement) can be classified as current outlay (e.g. fuel used by municipal machinery to pave the road) or capital expenditure (if the machinery belongs to a contractor and its use is paid as part of a road investment project. There is a large scope in accounting for creative classifications; at each tier, subnational governments will differ across themselves in these classifications and possibly over time, thus rendering meaningless aggregate figures for the subsectors or time series for each government.[14] Second, the **rule pays no attention in practice to the quality of investment**. Any capital spending is a good excuse to indebt the government. Indeed, by excluding investment spending from deficit limits, the golden rule softens the political pressure for a rigorous cost-benefit analysis of each investment project. In the absence of an effective debt stock ceiling, this effect combined with the political dividends usually associated with investment spending in Portuguese municipalities,[15] may contribute towards unsustainable debt increases. Third, the golden rule **assumes no intertemporal benefits are**

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[14] Ter-Minassian (2007, p. 6) also warns against the perverse incentive of targeting limited budget operations, such as the golden rule, to "creative accounting practices aimed at circumventing the rule, including reclassification of expenditures, accumulation of arrears, and the use of public entities off-budget to perform investment operations". Manoel *et al.* (2011) argue against the golden rule on the basis of its vulnerability to manipulation.

[15] See, for instance, the empirical evidence on political business cycles at the Portuguese municipal level in Baleiras and Costa (2004) and Veiga and Veiga (2007).

produced by current spending and this is not true. Wages to doctors and teachers allow for human capital accumulation in patients and students and the impact of this accumulation on growth and economic development is widely accepted in the literature. Fourth, compliance with the golden rule is likely to force subnational spending choices (between current and capital items) which do not maximise welfare in these jurisdictions[16] and **imposes rigidity to the spending composition**. Suppose that net borrowing is zero; subject to a current balance surplus, capital spending must be at least equal to capital revenue, no matter what the preferences of the subnational community are. The golden rule tends to replicate the revenue structure to the expenditure side of the budget or even to bias spending in favour of capital items—Pereira and Silva (2008, p. 9). Finally, **the golden rule is at odds with historical experience**. It may have had some appeal in the past when subnational governments played a major role in public investment.[17] Yet, this is no longer the case. The politico-economic paradigm of infrastructure provision is past and municipalities are being called to assume new responsibilities, in the areas of culture, education, health and social care, which are immaterial goods to a large extent and whose provision cost is recorded as current spending. This argument is even stronger in the case of Portuguese regional governments. They are responsible in their territories for almost all spending tasks the central government performs in the mainland territory (main exceptions are social security, sovereignty and higher education items). By a continuity argument, requiring them to comply with the golden rule would amount to demand the same for the central government.

For all these reasons, **the CFP recommends a rethinking of the balance rule proposed in the two bills**. At the same time, the multiannual framework and its spending rules need a review. We tackle the two issues together in the following subsection.

3.2 An alternative set of fiscal rules

Earlier in this Report (Subsections 2.3 and 3.1), we expressed serious doubts with respect to the usefulness of medium-term and current balance rules as they are proposed in both bills. We offer here an alternative framework which seems superior to ensure the sustainability of subnational public finances.

Joumard and Kongsrud (2003) argue that targeting structural position indicators or excluding special expenditure or debt categories, like the golden rule does, suffers from measurement weaknesses, a criticism we underlined above. Instead, they favour targets on the overall budget deficit or the comprehensive debt stock with a minimum of escape clauses.

[16] Pereira and Silva (2008) shows how the golden rule prevents a subnational community from attaining the bliss spending composition of the median voter.

[17] Up to the beginning of the 21st century, capital spending accounted systematically for more than 40 percent of total local effective expenditure, exceeding 50 percent quite often, well above the typical shares in central administration—Baleiras (1997, 2005). Given the low rates of infrastructure, Portuguese municipalities focused on providing basic facilities after the restoration of democracy.

The CFP considers that a sound fiscal environment requires a wise combination of rules on flows and stocks and, in principle, the more comprehensive they are, the better. A debt limit (which is a stock rule) alone, as well as a budget balance requirement (which is a flow rule) alone, may be satisfied via higher expenditures and taxes, but with the attendant effects for economic growth affecting all jurisdictions—Joumard and Kongsrud (2003). A spending ceiling (another example of a flow rule) alone, just like a budget balance rule, is not sufficient to prevent debt accumulation because governments may push expenditure operations out of the present budget; for example, by sending them to public firms beyond the Eurostat ring or by contracting Public-Private Partnerships or traditional borrowing to pay in the future for present purchases.

Hence, we deviate from PPLs to put forward a different approach with respect to fiscal rules for Portuguese subnational governments. The approach combines a debt ceiling (to be discussed in Subsection 3.3) with either a global budget balance requirement or a spending cap conceived within a medium-term perspective. The following paragraphs focus on the alternative new rules:

Either

1. *Medium-term global balance equilibrium*: for each political term, the global balance[18] must be, on average, nonnegative; a negative global balance can happen in two years at the most. 31 December is the reference date. This rule forces an administration to compensate any annual deficits during the same tenure. Penalties for non-compliance could combine transfer withholdings with public disclosure and an automatic adjustment obligation (reduction of the excessive deficit) in the four subsequent years. To avoid the penalties being passed to a new government in case the incumbent leaves, a variant of this rule could define the four-year period so as to overlap two tenures: the last two years of an administration and the first two of the subsequent one. This would reduce the incentive for the incumbent government to extract the political dividends for itself and send the political cost to the future government.

or

2. *Medium-term spending ceiling*: the forecasted and outturned total effective spending at the end of year *t* shall not exceed the average of total effective revenue net collection in years $t-2, t-3, t-4$ and $t-5$ by more than a small *x* percentage.[19] The indicator applies to spending irrespective of its financing form. There may be different weights attached to the actual net collections in these years, to be set in the bills. This arrangement would adjust spending responsibilities to a pretty close indicator of how much funding can a subnational government

[18] Difference between total effective revenues and total effective expenditures. Balance in public accounting is preferable to the accrual basis because it is easily monitorable throughout the year (subnational authorities provide monthly budget outturn reports on a public accounting basis to the central government, according to Art. 89 of PPL 122 and Art. 22 of PPL 121).

[19] Niskanen (2008, p. 135) proposed 10% for the US federal budget. Note this budget was near 20% of US GDP. As the author says, the 10 percent "rule would lead to a small annual surplus in strong economic years, a small annual deficit in recession years, and a roughly balanced budget over time". The appropriate actual *x* figure for Portuguese subnational governments has to be fine-tuned in case the political authorities find the suggestion interesting. In such event, the guidelines provided in the source above may be useful.

afford, something the medium-term budgeting frameworks proposed in the bills do not achieve.

Either rule 1 or rule 2, by focusing on total effective revenue and spending, avoid the problems with the disentanglement between current and capital items and the manipulation problems referred to in the literature. Both rules enjoy a medium-term perspective that minimises the risk of optimistic revenue collection biases. They also minimize the risk of externalising the default cost to other administrations, thus helping to secure political accountability.

One may question if asking and administration to compensate for a deficit within the same tenure drives to a pro-cyclical policy stance, which would be an undesirable outcome of the above proposition. We do not think there is such risk. On municipal finance, there is ample evidence of political business cycles in Portugal—Baleiras and Costa (2004) and Veiga and Veiga (2007). They follow the opportunistic pattern,[20] with higher indebtedness and investment in pre-electoral years and lower indebtedness and investment in post-electoral years. This pattern is irrespective of the output stance. So we find no reason to expect local cycles to have a definite pro-cyclical or anti-cyclical orientation. Note that automatic stabilisers at the local level are very limited. Portuguese municipalities do not run social policies with significant fiscal size, IRS participation is very small and FEF transfers react with a two-year delay to changes in the major national tax revenues. If we look at the last thirty five years of municipal budget balances (either primary or effective), we find a pretty regular four-year pattern of positive and negative values (in euros), yet with a downward (pro-deficit) drift on several occasions. This leads us to expect that imposing a zero-global balance rule on four-year averages would neither be politically hard to accept by stakeholders nor economically detrimental when compared to a current balance rule. Political business cycles could still be possible but with the benefit of preventing the installation of a deficit trend.

For regional governments, the preference for a global (effective) balance rule is not so strong. On the one hand, and to the best of our knowledge, there are no empirical studies on political business cycles. On the other, one must take into account that the spectrum of regional budgets is wider, almost as much as the central government's, and the regional budget impact on the economy is higher too, when compared to municipal budgets and local economies. Thus, the spending rule (proposal 2) may seem more appealing in the context of regional finance. The *x* factor would allow for moderate indebtedness on a yearly basis while the debt rule would maintain the liabilities stock on a sustainable path. In any case, one should not exaggerate the belief on the economic stabilisation capacity of regional fiscal policies. Azores and Madeira are very small and very open economies, which means that much of the

[20] The theoretical literature distinguishes between two types of cycles. Opportunistic cycles spring from the optimisation of the incumbent leadership's personal interests (vote maximisation, welfare in case of electoral defeat, etc.). Partisan cycles induce intertemporal asymmetries on fiscal variables as a result of ideological preferences of the incumbent leadership (inflation *vs* unemployment is the classical case).

stimulus from eventual anti-cyclical regional fiscal policies leaks the archipelagos to benefit other economies.

In the fiscal environment the CFP envisages for subnational governments, a debt rule should co-exist with either the m*edium-term global balance equilibrium* (rule 1 above) or the *medium-term spending ceiling* (rule 2). PPLs 121 and 122 put forward debt rules, which apart some inconsistencies and possible reviewing of the denominator, do not present substantial problems. Shall the Parliament wish to consider this alternative set of fiscal rules, the CFP is ready to co-operate with further technical work. As with the indicators prescribed in PPLs 121 and 122, we recommend a careful analysis of past data before endorsing specific numerical parameters, such as the annual weights that make up the revenue averages. Regional governments may find harder to comply with rule 1 because of their starting point but a transitional, phasing-in mechanism could be devised. There is no prior against using the primary balance equilibrium instead of the global one in rule 1. Primary spending rather than total effective spending could be used in the indicator of rule 2 with a numerical target below the *x* percent of the past mean revenue collection. These are technical aspects to be dealt with if there is political will to study in detail this alternative set of rules.

3.3 Debt rules

As mentioned before, CFP (2012) argued in favour of debt limits and automatic back-on-track correction mechanisms for governments violating those ceilings. For reasons spelled out in the Report, current (regional) debt service caps should be replaced by ceilings for the stock of debt or the ratio of debt to revenues. A fully comprehensive debt definition should be implemented.

Indeed, both legal proposals develop wide-ranging and detailed provisions for regulating subnational government debt. Both define debt in a very comprehensive way, thus protecting the regimes against creative accounting. In particular, the notion of debt includes payment arrears and financial liabilities of all local entities and the regional sector (ESA-95 definition). However, **the regional finance bill leaves debt from entities outside the Eurostat ring beyond the jurisdiction of the debt ceiling, a weakness that should be corrected**.

Municipalities, parishes, intermunicipal entities, and autonomous regions are authorized to incur debt. For municipalities, intermunicipal entities and autonomous regions, this applies to short-term (maturities below one year) and long-term debt, while parishes may incur only short-term debt (Art. 55, Nos. 1 and 2, PPL 122) to finance revenue shortfalls during the year.[21] There are some inconsistencies in the treatment of municipalities, parishes and intermunicipal entities. Intermunicipal

[21] Leasing contracts up to five years long to buy goods are the only medium to long-term credit facility parishes may undertake. No. 7 of the same Article mentions that the debt of parishes excluding short-term loans and credit lines cannot exceed 50 percent of their total revenues of the previous year.

entities are prohibited from borrowing on behalf of municipalities, while the reverse is permitted. Municipalities are not prohibited from borrowing on behalf of parishes and vice-versa. Municipalities are obliged to borrow exclusively in euros (Art. 49, No. 2), the same is true neither for parishes nor for intermunicipal entities. Similarly, there is no obligation to borrow exclusively in euros for autonomous regions. According to Art. 51, municipalities are allowed to borrow medium- and long-term only to finance investment projects or in the context of a municipal financial recuperation procedure. Long-term loans cannot exceed maturities beyond 20 years. Amortisation must not be deferred for more than two years and the annual amortisation payment must be at least 80 percent of the average payment. Similar specifications exist neither for parishes nor for intermunicipal entities. **These inconsistencies should be corrected to guarantee equal rules for all three types of local entities and avoid incentives for shifting debts among them**. Autonomous regions are not subject to similar rules concerning the parameters of the loans they incur. They are allowed to contract medium and long-term debt ("dívida fundada") to finance investments or to refinance or amortise existing debt only (PPL 121, Art. 37, No. 1). Regions can also incur in short-term debt ("dívida flutuante") to meet treasury needs only (Art. 38).

The proposed Law on Local Finances includes a no-bailout provision according to which the State cannot assume the liabilities of municipalities and parishes (PPL 122, Art. 57, No. 3), while the proposed Law on the Finances of the Autonomous Regions includes a similar provision with regard to regional debt (PPL 121, Art. 45). Art. 42 of the latter proposal rules out a State guarantee for loans issued by the autonomous regions. A similar no-bailout provision does not exist for intermunicipal entities. A number of comments follow. First, the word "obrigações" has a double sense in Portuguese and can mean either a bond or a liability. In this context, **to avoid any interpretation conflict, the legislators may wish to use the word "compromissos" instead**. Second, **a no-bailout clause for intermunicipal entities, municipal associative entities and all subordinated entities should be introduced.** Finally, the CFP notes that the BFL under discussion at the Parliament at this time (Proposta de Lei No. 124/XII, hereafter PPL 124) has also a no-bailout clause for subnational entities (Art. 10-F, No. 2). Here, "compromissos" is rightfully employed and the clause applies only to subordinated entities within the Eurostat ring. **The CFP recommends introducing the most comprehensive and clear no-bailout clause in one legal diploma only.** Having one definition in the BFL and another in each subsectoral finance law is a source of confusion and waste of time to apply the legal framework. By the way, there are a number of other issues that are dealt not exactly in the same way by PPL 24 and either PPL 122 our PPL 121.[22] **These overlaps should be eliminated and the issues dealt in one diploma only**.

[22] Just an example: art. 68 in PPL 124 obliges municipalities and autonomous regions to report to the Ministry of Finance several accounting tables. Some of these tables and other documents have also to be reported and under different schedules to DGAL (by municipalities, intermunicipal entities, municipal associative entities and local reclassified entities), according to Art. 89 of PPL 122, and to the national statistical authority and the Ministry of Finance, according to Arts. 21 and 22 of PPL 121. **It seems there was no coordination in the preparation of the three bills**.

For each municipality, the total debt limit is fixed at 150 percent of their average net current revenues in the three preceding years (Art. 52, No. 1). This limit applies to the level of debt on 31 December of each year and comes with two specifications. First, if a municipality has debt exceeding the limit, it must reduce its debt by at least 10 percent of the excess amount in the following budget year. This leaves municipalities ample time to correct the situation. Second, if a municipality complies with the debt limit, it cannot increase its debt ratio by more than 20 percent of the difference between the maximum allowable and the actual ratio of its debt to its average current revenues in the previous three years.

For parishes, the debt limit is fixed at 10 percent of their FFF transfers for short-term debt and at 50 percent of their total revenues in the preceding year for “other debts”. **There is no date specified for the applicability of the limit for parishes** (is it 31 December of every fiscal year?). If their liabilities to suppliers exceed the latter limit, the amount of such “other debts” (which include liabilities to suppliers) must be reduced by 10 percent in every subsequent year until the limit is met. **Intermunicipal entities, finally, are not subject to debt limits at all. Thus, again, there are inconsistencies in the way municipalities, parishes and intermunicipal entities are treated**. The CFP **suggests that these inconsistencies should be avoided** to make sure that they do not cause adverse incentives and to improve the transparency and controllability of the local debt regime.

At the same time, it might be a good idea to **apply the very same definition of debt coverage to PPL 122 and PPL 121, again for the sake of interpretation**. Art. 39 of the latter uses a precise accrual accounting notion, *demandable liabilities* (“passivo exigível”), whereas Art. 52, No. 1 of the former relies on the less standard notion of *total debt of budgetary operations* and relies on enumeration (No. 2) to design the ring. We also point out an apparent source of confusion in PPL 121. As demandable liabilities have a specific and clear understanding in accounting manuals, the CFP does not understand why the bill needs to enumerate in Art. 39, No. 5 their content. By doing so, it apparently leaves standing bond issues away from the debt indicator, which is highly undesirable. This enumeration, by the way, has two flaws in both bills: **standing bond issues are not listed**, as mentioned, **and “other liabilities to third parties arising from budgetary operations” are unclear.** Indeed, the latter item needs densification; otherwise, its implementation is likely to be open to interpretation conflicts. If the accrual accounting concept of “demandable liabilities” is not crystal clear, something the auditing authorities may enlighten, then we suggest that the enumeration should exist and make use of more solid notions with feasible content. The notion of “assumed and unpaid liabilities”, as defined in Ministry of Finance (2012), is one possibility to operationalize “other liabilities to third parties arising from budgetary operations”.

For autonomous regions, the debt limit is set at 150 percent of their average net current revenues during the preceding three budget years, and it applies to the debt on 31 December of each year. If the debt of an autonomous region exceeds the limit, it must reduce its debt by, at least, 5 percent of the excess debt annually.

In both PPL, the denominator of the debt indicator is: average of current revenue net collections in the last three fiscal years. Everything else constant, **this narrow definition of funds incentives a subnational authority in shortage of indebtedness capacity to manipulate the current/capital definition of its revenues**. In other words, a given nominal amount of debt can place the authority above or below the numerical limit according to the manipulation possibilities. Allocating 90 percent of the FEF transfer to current revenues is just one way. Note that the *real* funds to guarantee the debt sustainability are independent of the accounting gymnastics. Total effective revenues are what matters for this purpose. Hence, it might be a good idea **to consider the average of total effective revenue net collections in the last three years as the denominator for the debt limits**. This squares well with the alternative budget balance and spending rules the CFP proposes in Subsection 3.2. Naturally, the numerical target will have to be adjusted appropriately. It would no longer pay off to make purely arbitrary and opportunistic classifications of received or paid transfers and other accounting tricks.

Finally, **PPL 122 has to require the appropriate consolidation of debts and revenues that enter the numerator and the denominator of the debt indicator, respectively.** Art. 52, No. 1 expressly requires each municipality to aggregate the debt of all entities listed in Art. 54 to its own debt amount. Firstly, in order to avoid multiple counting, the article should require the use of consolidated debt. The sum (appropriately consolidated) in the numerator is then divided by the three-year average of current revenues net collection and the result compared to the 150 percent threshold. So, secondly, current revenues should be replaced by total effective revenues, for the reason explained above. Thirdly, the actual wording of Art. 52 says the denominator is the revenue of the municipality alone and this is not correct. If the numerator adds up the debt of a multitude of entities, the denominator should be constructed in the same way, for the sake of consistency. Moreover, as revenues of any entity typically comprise transfers received from other units that count for the debt limit, Art. 52 should include a new number requiring the consolidation of total revenues across participating entities, *i.e.*, the removal of transfers which are internal to the set of entities bound by Art. 54.

3.3.1 Are the numerical targets reasonable? Tentative exercises

Before deciding on the specific numerical targets for the debt indicators, it is wise to understand how they affect the subnational sectors on the aggregate and also the individual governments. The Technical Secretariat may have performed appropriate numerical simulations but they were not shown to the Accompanying Commission. Hence, the CFP ran two quantitative exercises on its own initiative. Details, as well as other exercises, can be found in a companion CFP document to be published in April 2013—CFP (2013b).

The first exercise attempts to evaluate how close from the debt ceilings were subnational authorities in the last three years of available data (2009 to 2011) if the 150% debt limits were in place at that time. Certainly, the results must be interpreted with care. First, if the limits had been already in place, they would have induced a different behaviour on the part of subnational entities and, naturally, the outcomes would have been different. Secondly, for reasons spelled out in the companion document, data unavailability precluded the inclusion of all eligible local entities in revenue and debt calculations: only municipalities in strict sense and municipalised services (one part of autonomous services and funds) were accounted for. Thirdly, there were no data to account for possible exceptions (calamities) for all entities considered.

With these limitations, demandable liabilities for the sum of 308 municipalities exceed the three-year mean value of current revenue net collections at least since 2009; they pass the ceiling (the 150 percent threshold) in 2011 by 193 M€, or 3.3 percent of total net current revenues (previous three-year average). Remember the debt limit applies to individual municipal units and not to their aggregate. The fact that, on aggregate and without considering other entities besides municipalities and municipalised services, we found a relatively small excessive debt position in 2011 in a retroactive exercise does not represent a generalised default. Yet, it suggests that **some municipalities may be in trouble to cope with the new debt rule that will be in force from 1 January 2014.** Legislators may wish to review the data on individual accounts to appraise the adjustment effort the new law will impose at the individual level. Not only on account of that warning but also because municipalities below the debt ceiling under the current law may turn into an excessive debt classification simply because the legal target has changed.

For regions, it was possible to simulate the applicability of debt limits in the same period. If the debt limit rule was in place since 2009, the Autonomous Region of Azores would attain in 2011 only a warning situation because its demandable liabilities would surpass, by 30 M€, the three-year mean value of current revenue net collections. The Autonomous Region of Madeira, however, would find itself in an excessive debt position since 2009, as its demand liabilities would be surpassing the 150% threshold. Indeed, the debt level in 2011 (5,790 M€) would have exceeded by more than four times the proposed ceiling (1,420 M€). Again, it was not possible to estimate the amount of debt to exempt on account of the calamities escape clause. Anyway, **the magnitudes found in the companion publication allow the CFP to anticipate that that region will hardly be able to meet on its own effort the 150% target by 2014**.

The second exercise assumes both subnational sectors are at the border of their debt constraint. In this scenario, how many GDP percentage points would their debts represent? This figure will immediately tell what is the State's slack if Portugal were to comply with the 60 percent debt limit set by the European legislation.[23] Please note that the debt concept relevant in this legislation is narrower that the one used in PPLs 121 and 122; only debt from financial liabilities counts. In 2011, the amounts would be: 8,650.3 M€ in the case of municipalities, 1,048.7 M€ in the case of Azores and 1,419.7 M€ in the case of Madeira. On the aggregate, the subnational Maastricht debt would represent 6.5 percent of national GDP. Thus, the remaining public subsectors could attain a Maastricht debt of 91,538.9 M€

[23] Art. 126 of the Treaty on the Functioning of the European Union and Protocol (No. 12) on the Excessive Deficit Procedure.

or 53.5 percent of GDP, if the 60 percent limit were to be met. By the way, actual Maastricht debt amounts—INE (2013)—in 2011 are: 5,684.1 M€ from municipalities, 690.9 M€ from Azores, 3,735.8 M€ from Madeira and 175,129.9 M€ from the other subsectors.

In order to strengthen the credibility and the effectiveness of the debt limits, the proposed laws foresee the creation of corrective mechanisms for cases of severe violations. We now turn to their analysis.

3.3.2 Corrective mechanism for municipalities

Art. 56 of PPL 122 foresees an early warning signal issued by DGAL to a municipal government whenever its debt surpasses 100 percent of its average current revenues in the three preceding years. The usefulness of this early warning depends on the volatility of the ratio of debt to current revenues. If this ratio varies strongly from year to year, the warning may be appropriate. If the ratio is very persistent, however, the warning comes very early before the debt limit is actually hit. In that case, a premature early warning may lose its character as an alarm bell and simply be ignored by the authorities. Again, **a careful review of past data may suggest a more balanced numerical target**. If the debt of a municipality exceeds the debt limit, DGAL issues a notification to the local government concerned and to the Bank of Portugal.

A municipality in excess of its debt limit is subject to a financial sanitation process or a financial recovery process (Art. 57, No. 1). A sanitation process consists of consolidating and refinancing the debt of a municipality in order to obtain more favourable borrowing conditions (Art. 58). Sanitation can be undertaken whenever the debt exceeds the debt limit, but it is compulsory when the debt falls between 225 and 300 percent of the average current revenues of the preceding three years, except if the municipality chooses to begin a financial recovery process (Art. 58, No. 3). Sanitation must not increase the total amount of debt and sanitation loans cannot exceed 14 years of maturity and must not have more than one year of no debt service. Municipalities must present a detailed study of their financial situation and a sanitation plan covering the entire period of the sanitation loan when asking for a sanitation loan and they are subject to especially careful monitoring during the sanitation process. Failing to initiate a sanitation process or failing to comply with the sanitation plan results in penalties in the form of withholding a maximum of 20 percent of the transfers from the State (Art. 60). These withholdings are paid into the Municipal Regularization Fund (FRM, Art. 76), which uses them to repay the municipality's debts *vis-à-vis* its suppliers, debts which are overdue, or amortization of medium and long-term loans (Art. 78).

An important open question in this context is: **who will be the lender for municipalities that need to go through financial sanitation?** The bill seems to assume that a suitable lender will always be available and offer loan conditions that meet the requirement of leading to an improvement in the financial situation of a municipality in distress. Based on past experience, the expectation seems to be that private banks will be offering the loans needed. While this may be true in cases where individual municipalities are in financial distress, things may be very different in the case of a local public finance crisis or a banking crisis or a combination of both. In such cases, the financing of financial sanitation may not be provided by the banking sector. Local governments may then interpret the requirement to enter into financial sanitation (Art. 58, No. 1) as a basis for pressuring the State to come forth with the necessary funds. The Government would then face the demand for bailing out municipalities based on its own rules. **The CFP suggests that the current proposal should be amended in a way to avoid such bailout demands**. This could be achieved by stating explicitly that sanitation loans must be contracted with private institutions and that the requirement for sanitation holds up only to the point that this is possible under market conditions. Alternatively, the Municipal Support Fund (FAM, Art. 61 No. 3) could be extended to a point that it can also provide financial sanitation loans when such loans cannot be found in the market.[24]

A municipality must enter a financial recovery process if its debt exceeds 300 percent of the average current revenues in the three preceding years. In this case, it turns to the Municipal Support Fund (FAM), which is described in more detail in Subsection 3.4. FAM negotiates an adjustment programme with the municipality and extends a loan to the municipality concerned. A technical commissioner can be appointed to watch over the technical and financial aspects of the adjustment programme (Art. 73, No. 3). If the municipality concerned does not fulfil the conditions necessary to service its debt, FAM can refuse granting the loan (Art. 73, No. 4). If the municipality concerned fails to meet the conditions, the programme may be cancelled (Art. 73, No. 5).

The financial recovery process complements and gives credibility to the no bailout provision of Art. 57, No. 3. The CFP regards this as an important step in strengthening the responsibility of the local government sector for its finances and the protection of the State against the consequences of a lack of fiscal discipline at the local level.

3.3.3 Corrective mechanism for Autonomous Regions

Art. 43 of PPL 121 requires the Supervision Council of Financial Policies[25] to inform the Region's legislative council and government and the minister of Finance (Government) whenever its debt ratio exceeds the debt limit. The same article requires the regional government to present an adjustment programme in such cases. According to Art. 44, the central government can withhold transfers to the Region concerned in such circumstances and use the funds withheld to pay down the Region's debt

[24] Art. 58, No. 3 requires a municipality whose debt falls between 225 and 300 percent of its average current revenues in the preceding three years to undergo *financial sanitation or financial recovery*. This could be interpreted as saying that financial recovery must be undertaken if financial sanitation is impossible under market conditions. This would solve the issue raised here. **The CFP would welcome a clarification in the current proposal**.

[25] This is a technical forum of regional and central government representatives to help monitoring regional finances and give advice to both government layers (Art. 15).

until it complies with the debt limit. Art. 46 states that an autonomous region in economic or financial difficulty may turn to the Government for financial assistance. In order to obtain such assistance, it has to present an adjustment plan. The member of the Government responsible for finances monitors the region's compliance with the adjustment programme. Non-compliance with the programme constitutes sufficient reason for terminating State assistance or demanding additional corrective measures (Art. 46, No. 5). As long as the adjustment programme is in force, the budget balance and debt limit rules of Arts. 16 and 39 are suspended and the Region is subject to special monitoring by the General-Inspectorate of Finances of the State (Art. 47).

The rules of the corrective mechanism for Autonomous Regions are much less specific and less forward-looking than those applying to municipalities. On the one hand, this reflects the status of greater autonomy of the regions. On the other hand, it leaves the specifics of how an autonomous region regains financial stability open to negotiations between that region and the Government and, therefore, to what seems economically and financially expedient in a given situation. In particular, it is not obvious that the Government will stick consistently to the no bailout rule, which can be rendered ineffective by granting financial assistance to an autonomous region. **More specific rules guiding such assistance could be helpful** to strengthen the no bailout rule and protect the State more effectively against the consequences of eventual fiscal laxity on the part of the autonomous regions.

3.4 A subnational rescue fund

As a resolution mechanism for financial distress of local governments, the creation of FAM marks the principle that the local sector is collectively responsible for its own financial situation. FAM will be financed by contributions from the municipalities and own revenues of the Fund (Art. 65, No. 1). In 2014 and 2015, the additional IMI revenue due to the 2012-2013 general reassessment of the tax base (urban units only) is earmarked for the Fund (Art. 65, No. 4). During the first years, the State lends money to the Fund with a maximum 20 year maturity; capital and interest are to be paid with municipal contributions to the Fund as they materialize (Art. 96). As soon as 50 percent of the State loan is paid back, the FAM will be governed by representatives of the municipal sector (Arts. 71 and 96).

As in the case of financial sanitation, the provisions of financial recovery silently assume that situations of severe financial distress requiring recovery will only occur in individual municipalities at a time. According to Art. 64, FAM's capital amounts to the value of standing loans granted to municipalities plus a buffer up to 10 percent of the remaining demandable liabilities ("passivos exigíveis") of the municipalities.[26] **While this seems like a comfortable capital cushion to resolve situations of individual financial distress, it may not be if a systemic problem arises at the local level**. Again, this

[26] To be rigorous, the wording of Art. 64 is ambiguous. "Demandable liabilities" may refer either to the financed municipalities only or to all Portuguese municipalities. **A clarification is worthwhile.**

may eventually become a ground for bailout demands of local governments with regard to the Government.

A related issue regards the question of how the FAM will invest the fraction of its capital that is not engaged in loans to municipalities. The current proposal has no provisions for this. A natural assumption would be that the capital is invested in Portuguese government bonds as these can be regarded as safe and liquid in normal times. However, this might not be acceptable for the municipalities as it would constitute a form of lending by the latter to the State. Furthermore, the recent debt crisis in Europe has shown that government bonds may become illiquid in times of fiscal distress affecting the whole country. Since the FAM has to guard against these, **investment in crisis-safe assets would be necessary**. This could be deposits at the ECB, but this would have the disadvantage of low interest income.

Rescue funds like the FAM create difficult incentive problems at the local level. They are designed to resolve situations of severe financial distress *ex post*, but they change the incentives of local governments to guard against such situations *ex ante*. Specifically, if a municipal government knows that financial help is available in times of severe distress, it may decide to engage in more risky fiscal policies than it would otherwise. Furthermore, if the conditions under which financial help is provided by the FAM are more advantageous than market conditions, local governments that have already accumulated a large amount of debt may be induced to relax fiscal discipline even more in order to obtain bailouts. Experience shows that such incentives are particularly strong for small municipalities—von Hagen *et al.* (2000). Large municipalities, because of their larger share in the financing of FAM, will internalize the financial consequences of irresponsible behavior much more than small municipalities. As a result, experience shows that, in the public sector, bailouts typically fall on the small jurisdictions first. **This moral hazard problem suggests that the creation of FAM also requires that local debt developments should be carefully monitored**.

4. Conflicts between local and regional finance regimes

In this short section, we comment on some specific issues arising from intergovernmental fiscal relations that need further consideration.

Formally, PPL 122 sets a single public finance regime for the local subsector in the entire national territory. However, a careful cross examination with PPL 121 raises doubts about this understanding and **this uncertainty should be eliminated before the final legal versions are adopted**.

Art. 66 of PPL 121 states the independence principle between the finances of local authorities in the autonomous regions and the finances of the autonomous regions (No. 1). It also makes clear that, although the IRS collected in the islands is revenue of the regional governments, the island municipalities are entitled to the variable participation in IRS revenue just like mainland municipalities (No. 3). The assurance of the territorial continuity of the local finance regime is welcomed as it removes the doubts in the current legal framework with respect to the municipal access to IRS revenue in the archipelagos.

However, we found **two contradictions** with the uniqueness principle. First, Art. 67 of PPL 121 allows the regional governments to pay subsidies to local authorities in the islands while local authorities in the mainland have no access to this additional revenue source. In other words, island municipalities and parishes access grants from the central government, just like their homologous in the mainland territory, and can also get transfers from the regional governments. **This possibility runs against the principle of single local finance regime** and, in addition, **introduces an odd conditionality**. Regional government transfers are earmarked to reinforce the investment capacity of local authorities. This is a dated objective that runs against the new paradigm municipalities and parishes are entering, a model that no longer rests on the image of such governments as physical infrastructure providers. Second, these regional subsidies can be granted on a fully discretionary basis while equivalent transfers by the State are forbidden under Art. 22, No. 1 of PPL 122. The technical soundness of non-discretion is space blind, which **raises the need for legislators to discuss why should not all local authorities benefit from the same regime everywhere**.

By the way, discretionary subsidies by the central government to parishes and municipalities are explicitly ruled out by Art. 22, No. 1 in PPL 122. Yet, there is no such clause for intermunicipal entities. In order to avoid unintended indirect subsidisation of municipalities through those entities, **a similar clause could be added to Art. 82**.

5. Concluding remarks

This Report provided an economic analysis of the proposed new laws on local and regional public finance. They address many of the issues raised by the CFP in earlier documents and represent a considerable progress with respect to the laws in force.

As the new laws are still under discussion at the Parliament, the analysis focused on signalling problems and suggesting possible remedies the legislators, the stakeholders and citizens at large may wish to consider before the final voting is passed. The Report should thus be understood as a constructive contribution towards a better fiscal environment in Portugal.

On balance, the CFP expects that the new approach taken in the local finance bill will strengthen the accountability of local governments to their electorates and strengthen the coordination of public finances between the local sector and the State. In both ways, it will strengthen the sustainability of local public finances. However, more substantial work is recommended at the regional level to obtain the same results.

All recommendations are highlighted by expressions in bold in the preceding sections and the most important ones were summarised in the executive summary and will not be repeated here. As the reader understood, many observations require a closer look at data before the legislative process comes to its end. Local and regional finance laws are structural pillars of the public finance environment in Portugal and should not be subject to frequent changes. The CFP thus calls for the creation of a technical group at the Parliament, possibly with representatives of the subnational governments and the Technical Secretariat that drafted the bills, to help fine tuning the envisaged solutions, including those put forward now by the Council. The CFP is ready to participate in such group.

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