Principles for Revising Subnational Public Finance Laws

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Corrigenda

The table below describes the errors that have been corrected since the preliminary version of the document identified above was published. Page and paragraph numbers in the table refer to the preliminary version. Editorial changes with no impact on text meaning are not listed.

Page No.	Paragraph No.	Where it was read	It should read
Cover	3	Preliminary version—18 September 2012	18 September 2012
v	10	(trade debt and government fragmentation)	(debt to suppliers, government fragmentation, exceptions)
7	1	assignment of individual taxes	assignment of particular taxes
11	1	opportunities for hiding	opportunities for neglecting
18	4	merely nine percent	merely 14 percent
21	1	of which 94%	of which 64%
21	1	trade debt represented	trade debt (*i.e.*, debt to suppliers) represented
24	14	(trade debt and government fragmentation)	(debt to suppliers, government fragmentation, exceptions to the rule comprehensiveness)

Executive Summary

The Portuguese Government has announced its commitment to submit to the Parliament until the end of 2012 draft laws on local public finance and regional public finance. A technical Working Group has been created to propose the new legal instruments. In this Report, the *Portuguese Public Finance Council* (CFP), which is represented at the Accompanying Commission branch of this group, aims at providing the public at large and political stakeholders in particular with an updated synthesis of the state of local and regional public finances, together with a set of economic principles that should help framing the subsequent discussion on policy options by citizens and legislators.

Subnational governments play a crucial role in the economic development by providing a large variety of collective goods and services. Their fiscal responsibilities correspond chiefly to the allocative function, which recommends a strong connection easily perceived by voters and taxpayers between the quality and quantity of services they get and the resources they pay. In order to make that connection, transparency of subnational public finances is of key importance. Furthermore, these are the government levels where differences in economic conditions across jurisdictions are most visible. Transfers from the central government to subnational governments are important to reduce the consequences of the large differences across subnational economies and achieve an acceptable degree of equity. Such transfers must be designed to preserve the incentives for good policies at the local and regional levels and they must be stable and reliable to facilitate rational planning at these layers of government. Finally, subnational governments should follow medium-term budgeting rules to avoid financial distress and excessive debt.

By combining normative guidelines and empirical background, at least three critical areas for reform emerge in this Report:

(1) Weaknesses and inconsistencies in subnational government accounting, reporting and monitoring imply a low degree of transparency at these levels of government, which makes it hard to monitor fiscal developments, to hold subnational governments accountable for their performance and to disentangle responsible from irresponsible conduct.

(2) The strong dependence of subnational governments on transfers from the central government and the very narrow room for manoeuvre they have to adjust their revenues to changing circumstances imply a lack of political ownership of subnational government revenues and their uses. As a result, the respective voters neither have the incentive nor the possibility to hold subnational policy makers accountable for their fiscal performance.

(3) Medium-term budgeting barely exists at the subnational levels. As a result, the consistency of local and regional public finances with Portugal’s commitment as a country to maintaining sustainable public finances is hardly assured and rational, forward-looking public sector management is difficult at these government levels.

Regarding the first area, sustainability requires that each unit of government run effective accounting systems on both cash and accruals bases. In order to deliver the right information for sound, forward-looking management decisions, and to monitor the compliance with fiscal rules in force, accounting information should be i) consistent, ii) comparable across time and government units, iii) comprehensive and iv) transparent. Current shortcomings recommend changes in the following directions:

- 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 replaced by a comprehensive view of the entire set of entities held by each government unit (a municipality or a regional government): municipalised services, autonomous funds and services, local and regional companies. The idea is to evolve towards true consolidated accounts as has been the case of firms for many years;
- data pooling—a unified public finance warehouse would minimise compliance costs for reporting entities, improve transparency, reduce data discrepancies and facilitate analytical work by monitoring agencies, thus improving common knowledge on subnational public finance. Conditional on results, this experience could later be expanded to the other public subsectors;
- treasury account unification—with the aims of optimising the management of treasury surpluses or shortages and enabling the integrated control of cash flows by the top political level within each municipal or regional group, all entities making up such group should share an integrated structure of banking accounts allowing for their consolidation.

An important prerequisite for maintaining sound public finances is that political constituents perceive the exact cost of the public spending they benefit from and their own contribution to it. This helps to align public with private preferences, induces greater accountability of incumbents to voters, and reduces the margin for blaming funding difficulties at subnational levels on higher government levels; as a result, the public budget constraint gets harder. Portuguese subnational governments rely heavily on transfers from higher government layers, which are important to reduce inequalities in the access capacity to own resources due to the large degree of economic heterogeneity. But the resulting high level of vertical imbalance may mislead subnational policy-makers and their constituents about the true relative cost of public services, leading to a transfer system that lacks consistency with the allocative function. To enhance the political ownership of subnational public revenues and their uses, without increasing the national tax burden, the upcoming legal reforms might consider changes in the following directions:

- for municipalities
  - to increase the ceiling of the Variable Participation in the personal income tax (IRS) substantially (in exchange for lower central government transfers), at least for municipalities with fiscal capacity above a threshold to be determined politically;
  - as an alternative to the current variable participation, to introduce a visible local surcharge on the net IRS collection in exchange for a reduction in central government transfers;

    - to increase the taxpayers' perception about the consolidated intertemporal local budget constraint by changing the layout of municipal tax invoices to display the municipality's logo and basic numerical information on local public finance;
    - to grant municipal parliaments some autonomy to set parameters in the transfer-like taxes (on automobile and rural real estate ownership, for example);
    - to consider a credible calendar to reassess the base of the rural real estate property tax;
    - to consider the elimination of the real estate transfers tax (IMT) so as to reduce the discrimination of real estate against other assets not subject to a sales duty and to cancel any increases in the tax burden arising from the reassessment of property tax bases;

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

It is important to reinforce a forward-looking stance of public finance management at the local and regional levels of government. Stable fiscal rules embedded in a medium-term framework could serve this purpose. Current laws already have fiscal rules but they need to be revisited. On the one hand, they contain some loopholes (debt to suppliers, government fragmentation, exceptions). On the other hand, they tend to be replaced every year by new centrally-imposed constraints, with the result that discretion prevails over the rules. The strong bias towards annual budget management in the current framework hides important intertemporal effects of fiscal decisions and, therefore, fails to provide policy-makers and managers with a proper long-term outlook, consistent with the dynamic public budget constraint. The budgetary framework law currently in place already sets a medium-term framework for central administration (art. 12-D). This could be extended to the local and regional subsectors, taking into consideration lessons from the on-going implementation and the CFP recommendations in its Report of 21 May 2012.

The medium-term framework should contain rules for some fiscal indicators. Debt limits would help each government unit to adopt fundable annual budgets (*i.e.*, to secure financial sustainability). For reasons spelled out in the Report, current 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, as the Eurostat criterion is insufficient. Spending limits defined for a fiscal cycle of several years would serve the double purpose of helping to enforce fiscal discipline and to provide focal points for a public debate over the size of government and its major activities. Generally, fiscal targets and limits should be mandatory, with deviations allowed only under well defined, exceptional circumstances.

A medium-term budgeting framework with debt and spending limits would also strengthen fiscal coordination across and within government layers. If the general government as a whole fails to meet its targets under the European fiscal framework and faces penalties imposed on the country as a whole, all government units failing their targets should be obliged to contribute to the penalty payment in proportion to their failures to meet the respective fiscal targets. Also, predefined adjustment mechanisms for governments violating their fiscal discipline rules (see below) should be designed so as to help the general government as a whole to restore its compliance with targets. This approach would reward responsible behaviour, make failures at the country level less likely and improve fiscal sustainability.

Finally, fiscal targets must be credible to be effective. They must come with both penalties for violating the targets and mechanisms of adjustment to bring governments back on track. While financial sanctions against deviating from fiscal targets have been foreseen in the Portuguese public finance laws for years, some rethinking of the effectiveness of the existing arrangements, under which financial penalties take the form of temporary withholdings of central government transfers to the relevant subnational government, seems advisable. Predefined mechanisms of adjustment are necessary to assure both the general public and the creditors that a speedy return to target will occur.

Other policy measures may be envisaged to solve the challenges in the above areas. Obviously, this Report does not intend to exhaust the subject. With its publication, the CFP wishes to stimulate the debate over the necessary changes and the appropriate policy options for their implementation.

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 local and regional governments is one of its tasks—article 6. The Government has announced its commitment to submit to the Parliament until the end of 2012 draft laws on local public finance and regional public finance—third review to the *Memorandum of Economic and Financial Policies*, MEFP (2012). A technical Working Group was set by the Government (Resolution No. 8/2012, of 13 February) to propose the new legal instruments. CFP is represented at the Accompanying Commission branch of this group, whose role it is to issue opinions and make recommendations on the proposals to be drafted by the Technical Secretariat branch.

More recently, the Government has stressed the need to adapt subnational finance laws to the Budgetary Framework Law, which itself will also be subject to a review (see Ordinance/"Portaria" No. 103/2012, of 17 April). The *Fiscal Strategy Document* (DEO, 2012, p. 46) stated the will to cover multiple issues and made a specific reference to reducing government fragmentation and introducing political responsibility mechanisms for financial decision-makers.

Under these circumstances, this Report aims at giving citizens at large and policy makers in particular some guidance and information to consider in their decision-making process. At this early stage of the debate, the CFP covers the relevant economic principles for structuring a sound public finance environment for local and regional governments in Portugal. It also reviews the current institutional, economic and fiscal realities of subnational jurisdictions.

By combining normative guidelines and empirical data, a number of critical areas for reform emerge. This Report highlights three areas in particular:

(1) Weaknesses and inconsistencies in local and regional government accounting, reporting and monitoring imply a low degree of transparency at these levels of government, which makes it hard to monitor fiscal developments, to hold subnational governments accountable for their performance and to disentangle responsible from irresponsible conduct.
(2) The strong dependence of local and regional governments on transfers from the central government and the very narrow room for manoeuvre they have to adjust their revenues to changing circumstances imply a lack of political ownership of subnational government revenues and their uses. As a result, local and regional voters neither have the incentive nor the possibility to hold their policy makers accountable for their fiscal performance.
(3) Medium-term budgeting is weak at the subnational levels. As a result, the consistency of subnational public finances with Portugal's commitment as a country to maintaining sustain-

able public finances is hardly assured and rational, forward-looking public sector management is difficult at these government levels.

Many policy measures may be envisaged to solve the challenges in these areas. Obviously, this Report does not intend to exhaust the subject. With its publication the CFP wishes to stimulate the debate over the necessary changes and the appropriate policy options for their implementation.

The Report makes use of information available up until 16 July 2012. No further information on the authorities' intentions was known at this time. A first meeting of the CFP with the Technical Secretariat is scheduled for next September.

The Report is organised as follows. Section 2 discusses the principles underlying the efficient allocation of public functions across government tiers. The need to finance the expenditure responsibilities of subnational authorities is considered in Section 3, together with the normative guidelines that help to structure the possible revenue tools. A bird's eye view over Portuguese regional and local economies and their institutional background is offered in Section 4, which helps to understand the requirements and constraints of actual subnational public finance design. Section 5 offers a fiscal state of play of local and regional governments, with an analysis of aggregate and individual data. Section 6 concludes and proposes a number of policy options the political decision-makers may wish to consider during the legal revision process. For the sake of space and arguments, most numerical information is deferred to a statistical appendix. For the same reasons, the discussion in subsequent sections refers explicitly to "local" governments and "local" constituencies but, unless otherwise noticed, the arguments apply, *mutatis mutandis*, to "regional" authorities and electorates as well.

2. The Assignment Problem in Designing Local Public Finances

2.1 Basic principles

Following Musgrave's (1959) famous classification, the three main economic functions of public finances are: *stabilisation* of the business cycle, *redistribution* of incomes and wealth, and *allocation*, *i.e.*, determining which and how much goods and services the public sector provides. The assignment problem in public finance refers to the questions of which level of government should fulfil which of these functions and which level of government should be responsible for collecting the revenues to finance them. The basic approach to solving this problem is the *fiscal equivalence* principle (Olson, 1969).[1] It says that the geographical incidence of the benefits of a public policy should coincide as much as possible with the jurisdiction of the government operating and financing it.

Fiscal equivalence rules out both "externalities" and "internalities." Externalities occur when some of the benefits or costs of a policy fall on citizens of other jurisdiction(s). Assuming that it cares only for

[1] Musgrave (1986) calls this the principle of reciprocity.

the welfare of citizens in its own jurisdiction, the government operating the policy would not take such externalities into account and fail to achieve a welfare optimum for the country as a whole.[2] Internalities occur when the benefits of a policy fall on the citizens of an area which is smaller than the jurisdiction of the government administering it. In this case, those who benefit from the policy do not fully pay for it and demand more of it than they would otherwise.[3] If the government responds to such demands, it again fails to achieve a welfare optimum. Thus, the exact correspondence of the region benefitting from a program and the region paying for it assures efficient outcomes in the provision of public goods and services. Fiscal equivalence demands that public policies with important regional externalities should be administered and financed by higher-level governments, while policies with no or small externalities should be administered by lower-level governments. The principle establishes a preference neither for centralised nor for decentralised government *per se*. On the contrary, it implies that too much centralisation is just as inefficient as too much decentralisation.

It is generally recognized that macroeconomic stabilization should be assigned entirely to a country's central government. Similarly, redistributive policies aiming at a greater degree of economic equity, such as those dealing with employment, health and pension insurance, are generally recognized to belong to the central government. This leaves the broad range of allocative policies—reaching, for example, from local roads to national highways and from local schools to universities— and the revenue sources needed to finance them, which must be assigned to the local, regional and central levels of government.

Many of the public goods and services considered under the assignment problem are produced with significant economies of scale, *i.e.*, unit costs are smaller if a larger number of citizens or a larger area is served by the same provider. Economies of scale create a trade-off between increasing cost efficiency due to a larger geographical area of incidence and decreasing allocative efficiency due to deviations from fiscal equivalence and a balance of these two counteracting forces must be found.

The welfare gains fiscal equivalence seeks to achieve can only be reaped if governments at all levels respond to the desires of their citizens regarding the quality and level of the provision of public goods and services. This requires that politicians have sufficiently strong political incentives to deliver what voters demand and voters must be able to judge the performance of their governments. Assignment rules must be transparent and stable over time to create such conditions. Voters must understand which policies are determined at which level of government and under what kind of financing and administrative constraints. Otherwise, they cannot hold politicians accountable to the promises they

[2] For example, if national defence were left to local government to organize, local governments would disregard the fact that protecting themselves protects neighbouring cities. Some would spend too little, others would try to free-ride on big cities and there would be no hope to achieve an efficient level of national defence.

[3] For example, if local infrastructure projects are paid for from the national budget, local citizens will overestimate the economic return and demand more bridges and streets than they would otherwise.

make when running for election. Similarly, democratic accountability deteriorates, if the responsibilities of subnational governments or their financial constraints change frequently.

2.2 Political ownership and accountability

Fiscal equivalence makes local governments responsible for local public goods and services and regional governments for regional public goods and services. The close correspondence between those who benefit from a local policy and those who pay for it strengthens the motivation of voters in local elections to hold their local governments accountable for their performance in delivering public goods and services. The fact that local governments are responsible for the provision of local public goods and services to their local citizens promotes their political interest in high quality and efficiency in this area. Thus, fiscal equivalence promotes political ownership of and democratic accountability for the provision of local public goods and services.

In contrast, when most local public spending is the result of political decisions taken at some higher level and local governments are merely executing these policies, they lose the incentive to do so responsibly, knowing that they will not be held accountable for bad results, and voters lose the incentive to monitor the behaviour of local governments. Similarly, when local governments have no control over their revenues and depend entirely on transfers from above, voters will see no connection between their tax bills and the provision of local public goods and services. Instead, they will perceive local spending on such services as a *free lunch* and demand ever more of it, with ultimate pressures on the higher-level government for larger transfers. Thus, it is important that local governments have enough autonomy on both sides of their budgets. *Mutatis mutandis*, the same applies to regional governments and regional constituencies.

2.3 Fiscal framework stability

Financial provisions for local governments that change frequently and at the discretion of higher level governments make it hard for local governments to pursue consistent policies and achieve a high degree of efficiency. The more higher-level governments intervene in local government budget constraints and the more volatility they create in doing so, the more they weaken the incentives and the capacity of local governments to conduct responsible and sustainable policies. Therefore, budget constraints of subnational governments and the rules governing their development over time should be clearly defined and foreseeable.

Furthermore, unstable local fiscal frameworks can lead to problems of soft budget constraints. If the resources they receive from the central government change frequently and in unforeseeable ways, local governments will be tempted to overspend their financial allocations when the latter are low and then turn to the central government for additional resources, threatening to close down sensitive public services unless they obtain more funds. The more financially dependent local governments are from the central government, the more they can take the central government hostage, leaving it with no choice but to come forward with additional transfers. Thus, the dark side of volatile and discretionary transfers from the central governments is the development of soft budget constraints at the local level. But soft budget constraints encourage local governments to regularly spend beyond their initial budgetary allocations. A pervasive culture of soft budget constraints makes the trade-off between the benefits and costs of public goods and services at the local level increasingly irrelevant for local decision makers and their political constituencies, with the consequence of growing and increasingly inefficient spending at the local level. What seems to be a regime of tight central government control over local finances turns into its opposite.

2.4 Expenditure assignment

The efficiency principle behind fiscal equivalence requires that public policies respond to the preferences of the citizens. In fact, the possibility of responding to differences in local preferences is a key justification for the decentralisation of government. This view is the essence of Oates' (1972) *Decentralisation Theorem,* which says that, in the absence of externalities and economies of scale, decentralized government in which local and regional governments provide different packages of taxes and public goods and allow citizens to choose the combination they like best, cannot do worse than centralized government. In the presence of strong differences in local preferences over public goods and services, decentralized government is likely to do much better than centralized government.[4]

Externalities create a trade-off between the efficiency gained by moving policies to higher levels of government and the welfare lost by not responding to preference or cost heterogeneity at the local level. The presence of economies of scale in the provision of public services leads to a similar trade-off between adjusting to preference heterogeneity and reducing provision costs. As long as preferences are homogenous, economies of scale suggest assigning the policy to a higher-level jurisdiction to exhaust all possible cost advantages. But if preferences differ, the welfare costs of uniformity can exceed the efficiency gains from centralisation. This provides a criterion for deciding on the adequate level of provision of public services. Taking into account externalities and economies of scale, this argument leads to a version of the *principle of subsidiarity* which, for example, underlies the assignment of public tasks in the European Union: *public policies for which regional preferences are heterogeneous should be allocated to the lowest level of government that can provide these goods efficiently.*[5]

Since the upcoming reform of local and regional public finances in Portugal will focus primarily on the revenues of subnational governments leaving expenditure assignment largely unchanged, we do not want to dwell on this subject more than spelling out these principles.

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[4] Local idiosyncrasies in technology or input prices may also call for decentralisation of the allocative function.

[5] Pisani-Ferry and von Hagen (2003).

3. Revenue Assignment

3.1 Principles

Fiscal equivalence demands that, at all levels of government, citizens are charged the full cost of the public goods and services they receive. This suggests a decentralized system of taxation in which all governments have enough own resources to cover their expenditures from taxes collected in their own jurisdictions. This implies that local governments should not use taxes the incidence of which falls outside their own jurisdictions such as corporate profit taxes. For example, a local tax on an electrical power plant whose output is consumed in other jurisdictions does not qualify as an eligible local tax because its burden is mainly borne by non-residents (*tax export*).

However, if tax payers are mobile, decentralized taxation entails important externalities: a reduction in the tax rate set by one local government attracts tax payers from other jurisdictions. As a result, the tax base and tax revenues of other local governments fall. The combination of tax payer mobility and decentralized taxation thus exposes local governments to tax competition, which, in a *race to the bottom*, may lead to excessively low tax rates and, as a result, insufficient quantities and quality of local public goods and services everywhere. In addition, tax distortions arise if some tax bases are mobile while others are not, and governments tax mobile factors less than immobile ones.

Furthermore, local governments should use taxes with revenues which are not too volatile over time, as this would expose their budgets to region-specific economic ups and downs without the benefit of stabilization. Local land and property taxes are probably the most preferable local taxes from this perspective.

Finally, we must take into account the need to ensure the political ownership of revenues, which requires local governments to have adequate decision-making power over levies visibly enough before the pockets of their constituents.

All these arguments recommend policy makers to find out an appropriate balance between the conflicting forces. The traditional response to these problems combines tax harmonisation among local governments with vertical grants from higher to lower-level governments (Olson, 1969; Break, 1980), along with the introduction of other own revenues, such as user charges. Limiting regional differences in tax rates reduces inefficient competition for tax resources. Vertical grants can be designed to achieve a greater degree of horizontal equity among citizens in different local jurisdictions, reducing the differences between fiscal needs (the *per capita* local government expenditures necessary to achieve a desired standard of public goods and services) and tax capacity (the potential *per capita* tax revenues that can be collected at standard tax rates) and paying larger transfers to local governments in poorer regions. Furthermore, they can be designed to induce local governments to produce public goods at cost-minimising levels.

Once this role of vertical transfers has been acknowledged, fiscal equivalence has no implications for the assignment of particular taxes to specific levels of government at all. What matters is that each government owns enough resources to finance the activities it is responsible for, in the sense that it can make real choices regarding the goods and services it provides. Economies of scale in the collection and administration of taxes suggest assigning the responsibility for tax collection to the central government but they are entirely compatible with assigning local governments some autonomy to set tax parameters, such as rates and exemptions.

Vertical transfers from the central government to local governments raise a number of issues. First, they can be designed as unconditional (block) grants calculated on a *per capita* basis for the residents belonging to each local jurisdiction, or as conditional grants requiring the local government to undertake the provision of certain goods or services. Block grants allow local governments to choose their optimal combination of public goods and services in accordance with the preferences of their citizens. In contrast, by paying conditional grants the central government induces the local governments to provide more of a certain public good or service which they consider less desirable than the central government.

Second, conditional grants can be designed as matching or non-matching grants. In addition to raising the local government's total revenues, matching grants change the relative cost of the public good or service in question, which can be used to compensate the local government for positive externalities benefitting other local governments. However, a wide-spread use of conditional grants implies a large degree of intervention of the central government into the choices of local governments with the result that the latter lose political ownership of and accountability for the policies they implement. This becomes even more problematic if the conditions are defined in terms of inputs into a given policy rather than outputs. For example, an input-based conditional grant might subsidize the number of teachers in a city, while an output-based grant would pay a subsidy based on the number of successful graduates from its schools, leaving the local government the choice of how many teachers and other personnel are needed to achieve this goal. Input-based conditional grants weaken the local government's interest in and accountability for efficient provision of public goods and services.

Assigning the responsibility for tax collection to the central government while keeping the responsibility for the provision of many public goods and services at the local level implies a large degree of *vertical imbalance*, *i.e.*, lower-level governments become financially very dependent on the central government. This is indeed true in many unitary states. Such a high degree of vertical imbalance can have important negative consequences. On the one hand, it can destroy the principle that citizen-voters pay for the services they receive, thereby reducing transparency and political accountability. On the other hand, it can make local governments too dependent on the discretion of the central government and weaken their political ownership of and accountability for the policies they pursue. Vertical transfer systems should be designed in a way that preserves transparency, political ownership and democratic accountability of local governments as much as possible. On this respect, transfer programmes should not disincentive beneficiary governments to resort to own revenues.

Furthermore, international experience suggests that a high degree of vertical imbalance invites strategic behaviour on the part of the local governments. Local governments may be tempted to overspend their budgets and then turn to the central government for more transfers. Clearly, the less own resources local government have (as a percentage of total expenditure), the more effectively they can threaten the central government with closing down essential and highly politically sensitive local services – such as local schools or hospitals – and the central government may be unable to refuse additional transfers for fear of the political consequences of closing down such services. Thus, a high degree of vertical imbalance may result in "soft budget constraints" at the local level, which invite irresponsible fiscal behaviour. A sufficiently strong own revenue base of local governments together with the possibility to adjust tax rates and other parameters at the local level protects the central government against the emergence of soft budget constraints and preserves the accountability of local governments for their fiscal performance to the respective voters.

3.2 User charges

User charges are the most faithful illustration of the fiscal equivalence principle on the revenue side. They can be imposed on all goods and services where the operator can physically prevent the access of an individual user—if payment is not received, service is not delivered. Piped water delivery and museum entrances are good examples of such services. However, there are services where it is hard or even technically unfeasible to restrain the consumer's access. Street cleaning and street lighting are examples. Individual consumption levels are not observable and the provision costs cannot be charged to individual users as a result.[6] User charges help promoting efficient resource allocation inasmuch as they give municipal and regional managers information about the demand for subnational public goods and services.

Surprisingly perhaps, many services typically provided by local governments throughout the world do not meet the non-rivalry in consumption property of public goods. Indeed, some of the most visible local services look very much like private goods. Piped water and gas distribution, car parking lots, housing and primary education are prominent examples. Several kinds of market failures can justify government intervention in such cases. First, substantial scale economies preclude competition in the distribution of piped water, gas, or electrical power, causing local authorities to run these services directly or to regulate their private operation. Second, important externalities may be at stake.

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[6] Technical progress changes over time the set of goods subject to consumers' excludability. Some years ago, physical tolls were necessary to make highways such a good. The unfeasibility of physical tolls on urban streets prevented their direct financing by car drivers. Nowadays, electronic metering and payment of car passages can be applied to virtually any road segment, such as an urban street, thus enforcing payment as the facility is used.

For example, the under provision of piped water, garbage collection, sewage and similar services may result in the spread of diseases. Here, a concern for public health makes society willing to pay more for the provision of such services than individual consumers. Similarly, society as a whole benefits from primary education over and above the private benefit of each pupil, which justifies public intervention. In these cases, public provision amounts to public production of inherently private goods or the public regulation of their private production. Either way, local governments get involved in pricing these goods and services.

It is essential to bear in mind that there is a *right* price or user charge for goods and services when consumers are excludable. Efficient pricing requires that the user charge equals the marginal cost of producing the good or service under consideration. Consumers then individually choose their optimal levels of consumption such that the user charge equals the marginal benefit they enjoy.

When consumers are not excludable, all consumers are by definition provided with the same quantity of the good or service. Efficient resource allocation requires choosing the quantity for which the marginal cost of providing the good or service equals the sum of the marginal benefits of all consumers.[7] If each consumer pays a charge exactly equal to the marginal benefit she derives from the efficient quantity, the resulting revenue matches total cost. This optimal pricing rule is known as *Lindahl taxation*. However, it is difficult to implement in practice, since consumers have every incentive to understate their marginal benefits to pay a lower user charge.[8] In view of this, uniform user charges have to be set for all consumers such that the full cost of production is recovered.[9]

Local and regional authorities often introduce redistributive criteria into the setting of user charges. Take Lisbon piped water pricing as an illustration. The charge for each m^3 per month evolves as follows: € 0.1929 for the first 5 m^3, € 0.6338 between 6 and 20 m^3, € 1.4650 between 21 and 25 m^3, and € 1.8380 above 25 m^3.[10] The underlying motivation is that wealthier households consume more wa-

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[7] This is known as the *Samuelsonian rule* for the efficient output determination in the case of a public good.

[8] This problem is not exclusive to user charges. In general, any tax system whose individual rates are based on the willingness to pay fail sto reveal the true demand for non-rival goods—Barbosa (1997), pp. 61–63.

[9] Specific goods or services may present particular challenges, such as scale economies and externalities, whose adequate consideration in terms of pricing requires detailed analysis and additional recommendations. There is a vast literature on these issues. On transportation, see Button (1993), Fisher (1996), Ch. 19 and, for a spatial economics approach, consult Pontes (2001); on education, see Fisher (1996), Ch. 19; on urban water services, see Bahl and Linn (1992), Ch. 10; on air traffic control, see Bryant (1996) for a newspaper account of changes in US charging; on electricity, telephone services, social housing, and collection and disposal of solid waste, see Bahl and Linn (1992), Ch. 11; on health care in developing countries, see Tibandebage (1999); on roads and rural transport infrastructure, with an emphasis in developing countries, see Calvo (1998) and Heggie and Vickers (1998).

[10] Price structure in force in June 2012 for common household consumers, value added tax (VAT) included. Prices are higher for business customers. Recently, the service provider introduced an additional tariff structure that adjusts the price for the size of the household while keeping a progressive block structure. There is also a monthly flat rate per size of meters (ranging from 4.10 euros for a 15 mm calibre to 2,064.29 euros for a 300

ter than poorer ones and so the above charge structure acts like a progressive tax. However, household water consumption may be a weak proxy for income. A family of eight poor people may consume more than a family of two wealthy people. Furthermore, income distribution is inherently an interpersonal income allocation matter and should not be mixed with the issue of providing public goods and services. If the political aim is to *redistribute income*, governments should *redistribute income,* using the appropriate policy instruments such as social security measures.

As indicated in Section 2, income redistribution should not be assigned to local or regional governments. In addition, the redistributive capacity of user charges on typical local public services is very low, since they account for a very small fraction only of household expenditures. For example, in a survey of large cities in developing countries, the share of piped-water charges in household expenditures was shown to be below three per cent in most low-income households.[11] With such small tariff burdens, the equity gain of tariff reductions for the poor is rather low, while the efficiency loss can be significant.

3.3 Government fragmentation

Over the last two decades, a growing number of governments at all levels have set up specialised entities to undertake the provision of particular goods and services. From bureaucratic bodies empowered with administrative, financial and asset autonomy to companies fully owned by a government unit, to concessions partially or fully granted to private partners, to public, private or mixed property foundations, a vast array of institutional solutions now exists in many countries. This variety is often called *government fragmentation*. Quite frequently, central governments pioneered this route but regional and local governments rapidly followed the lead.

From an efficiency point of view, there are good and bad reasons for delegating public functions to such entities. The operational requirements of public provision, even in the case of most public goods, parallels very much those faced by private provision. Focus on customers, flexibility to contract in goods and factor markets, accrual accounting with rigorous monitoring of cost and revenue centres, capacity to attract and retain talented workers, all these elements are easier to implement in firm-like organisations than in a traditional civil service unit.

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mm calibre, in the case of household consumers).The water consumption in Lisbon is also used as a proxy for sewerage use. Hence, two additional, uniform rates are included in piped water invoices: a monthly flat rate of 0.3151 euros per m^3 and a daily rate of 0.0410 euros. The central government uses the water invoice to charge an environmental tax of 0.0294 euros plus VAT earmarked for regional water basin management.

[11] Shares decrease as household income rises. The data were computed by K. Hubbel and are quoted in Bahl and Linn (1992). The surveyed cities were São Paulo (Brazil), Bogotá and Cartagena (Colombia), Addis Ababa (Ethiopia), Kingston (Jamaica), Nairobi (Kenya), Seoul (Rep. of Korea), Mexico City (Mexico), Lima (Peru), Manila (Philippines), and Bangkok (Thailand). Although dated (period 1970–1972), the figures provide “a good indication of the order of magnitude and degree of variation commonly observed”—Bahl and Linn (1992), p. 286, footnote 1.

For the purpose of this Report, what matters are the implications of this development for the sustainability of subnational public finances. On the positive side, delegating activities away from traditional administration units may lead to lower provision costs as a result of a more efficient organisation. The presence of different operators doing the same thing for different geographies and disclosing public information about their operations provides benchmarks to assess best practices. Competition, at least for the award of a concession, may help to offer consumers better commercial deals. On the negative side, the resulting fragmentation of government can reduce the transparency of public finances, especially when the newly created entities are not fully included in the accounts of the governments operating them. This creates opportunities for neglecting public sector deficits and debts which undermines the effectiveness of deficit and debt limits and makes monitoring the finances of the general government sector more difficult.

3.4 Subnational debt and sustainability

The fiscal equivalence principle implies that expenditures whose benefits are spread over many years and whose costs are concentrated in the first few years should not be financed entirely out of current taxes. Future tax payers should contribute to their financing. This can be achieved by financing part of today's expenditures with public debt. A bridge, for example, requires capital expenditures during the construction phase and delivers services for many years afterwards. Future generations will benefit from it and, therefore, should pay for part of it. Otherwise, current tax payers will resist public capital expenditures, resulting in under-provision of public investment. This reasoning leads to the *golden rule of public finance—e.g.*, Eichengreen and von Hagen (1995), p. 30—according to which public debt should be used to finance public investment spending but not current expenditures which mainly generate benefits today alone. Although this rule is rather coarse in practice, as some current expenditures, such as teachers' and doctors' salaries, have long-term benefits, too, it yields a useful guideline for financing decisions. In practice, it requires a rigorous definition of capital expenditures, which is not simple and is subject to accounting manipulation.

Arguing that local public investment should be partly financed by debt is not the same as arguing that local governments should be allowed to issue debt in their own right, since the central government might borrow on their behalf. This would make sense especially if the central government, due to its larger size and the greater stability of its tax base, can borrow at better terms than local governments. One might think that it would be useful to subject local governments to the disciplinary forces of financial markets. However, local governments are often too small to issue bonds at reasonable terms, and experience shows that borrowing through (local) banks results in much weaker discipline than borrowing through competitive bond markets. If the central government borrows on behalf of local governments, it should charge them the same interest rate it has to pay itself. Subsidizing local borrowing by the central government will lead to excessive local public investment and, ultimately, too much borrowing by the central government.

Whether or not local governments should be allowed to borrow in their own right is also a question of fiscal governance. On the one hand, local governments can use debt strategically to extract more resources from the central government. They may run up debts which they are unable to pay back given their own tax resources and force the central government to bail them out. The less own resources local governments have and the less discretion they have over the parameters of their revenues and expenditures, the less the central government can deny bailouts to local governments in financial distress and hold them accountable for their fiscal profligacy, and the more restricted local governments should be in their ability to borrow. On the other hand, restricting local public debt requires not only formal debt limits but also tight monitoring of local public accounts to assure that local governments do not accumulate hidden debts through payment arrears and off-budget entities. If local governments are allowed to borrow in their own right, institutional rules and mechanisms should exist to rectify situations of excessive borrowing and hold the local governments accountable. For example, under chapter 9 of the U.S. Bankruptcy Code municipal governments can be put under a form of receivership and protection against their creditors similar to private corporations. In Germany, cities with excessive debts can be put under the financial and administrative control of their state governments, depriving the mayor and the city council of their executive powers.

Local economies and the tax bases of local governments' are necessarily more volatile than the national economy and the central governments' tax base. This implies that local government borrowing must adhere to stricter standards of prudency than central government borrowing. Inadequate control over spending aggregates or unrealistic revenue forecasts ultimately end up on debt stock increases.

Take the case of arrears in public procurement payments. Invoices corresponding to goods or services delivered to a government unit stand unpaid after the overdue date and add to short-term debt. Although there may still exist some reliability problems with accrual accounting in Portuguese municipalities, it is interesting to note the high correlation and large proximity between unpaid commitments and short-term debt in Table 1. This is a problem found typically in government units lacking important features of sound fiscal management. At least four reasons seem to favour the emergence of payment arrears. First, fiscal decision-making procedures that fail to acknowledge intertemporal budget relations. If a trade order in placed in year *t* with due date in year *t+1* is not accounted for at the time when the payment commitment is assumed (*i.e.*, year *t*), it is likely to land as a surprise in next year's implementation when the invoice is presented for payment. Failure to reserve enough cash in year *t+1* to honour the previous commitment triggers an arrear.

Second, even when there is a record of previous payment commitments, there may be failures to reserve adequate funding, if it is not integrated within the accounting software. This is typically the case of accounting systems that operate on a cash basis only. Ideally, all government units should adopt accounting rules enabling full integration of cash and accrual accounting. Both provide useful information and together they give managers and policy-makers an insightful view of the dynamic fiscal interactions. Differences between the two perspectives can be substantial. For example, according to Carvalho *et al*. (2012, p. 71), payments in 2010 by all Portuguese municipalities amounted to 7.9 billion euros, whereas commitments in that year were 10.7 billion euros.

Third, the absence of multi-annual expenditure ceilings reduces managers' and politicians' attention to monitor unpaid commitments.

Fourth, even when fiscal rules such as limits for expenditure, deficit, or debt exist, there may be slippages, if the definition of the relevant budgetary aggregates is incomplete. For example, a debt limit that does not include bills unpaid by governments creates an incentive for them to accumulate arrears as a form of debt which would be prohibited otherwise. European experiences with creative accounting since the beginning of the euro suggest that this is a widespread problem in most countries (von Hagen and Wolff, 2006).

Finally, if local governments are allowed to borrow in their own right, they should share in the responsibility for national obligations regarding limits on public debt. In Poland, for example, local governments are not allowed to increase the local budget deficit relative to local revenues, if the country's aggregate debt-to-GDP ratio exceeds 50 percent. In Germany, state governments are subject to a rule balancing the budget over the business cycle in the same way the central government is. This assures that subnational government debt does not undermine the central government's efforts to comply with international obligations.

4. Institutional and Economic Background of Portuguese Subnational Jurisdictions

There are two tiers of subnational government in Portugal. The regional tier consists of the two archipelagos, Azores and Madeira, through a political authority on each, directly elected and with jurisdiction over the respective territory. The local tier comprises four levels: districts, supra-municipal, municipal and parochial. The first is under extinction and the second is formed by voluntary clubs of municipalities. Their finance and responsibilities emanate very much from the participating municipalities. The political bodies of these associations are made of municipal politicians. Only municipalities and parishes have their political representatives directly elected.[12] There are 308 territorial units ("concelhos") subject to municipal jurisdiction, of which 278 are on the mainland and 30 on the two archipelagos. The following paragraphs highlight some important economic facts of local and regional jurisdictions, as the economy constrains substantially the range of viable public finance configurations. Statistical data referred to in this and the following sections are documented in the Appendix.

[12] For the year 2000, Baleiras (2005) estimated the following shares of each level on total local consolidated expenditure (revenue): 0.02% (0.01%) for districts, 7.76% (4.41%) for parishes, and 92.22% (95.58%) for municipalities. Substantial changes over time on these weights are not expected. So, the municipal tier is the local government layer this Report focuses on.

Table 2 reports *per capita* GDPs for Portuguese NUTS-2[13] regions. There is a considerable degree of heterogeneity across regions. *Per capita* GDP ranges from € 12,600, or 64 percent of the EU-27 average, in the Norte region to € 22,300, or 112 percent of the EU-27 average, in the Lisbon region. The geographical features suggest how physical heterogeneity goes hand in hand with economic asymmetries, particularly as we move downwards along territorial disaggregation. In Table 3, we see how population across NUTS-2 regions varies a lot, too, with 3.75 million individuals in the Norte region but only 0.76 and 0.43 million in Alentejo and Algarve, respectively. Populations are even smaller in the archipelagos, with nearly 0.25 million on each. Population density, an important variable for agglomeration effects and economies of scale, both in economic development and in the provision of many public services, ranges from 23.8 people per km^2 in Alentejo to 944.5 people per km^2 in Lisbon.

Moving down to the level of “concelho”, Figure 1 illustrates the distribution of population density across Portugal. There are 106 “concelhos” with a population density below 40% of the mainland average of 113.8 individuals. These locations amount to 60.5% of the mainland surface and house only 10.8% of the aggregate population of 10.1 million residents. 58 “concelhos” have less than 20 inhabitants *per* km^2; they are mainly located in the northeast, along the border with Spain or all over the Alentejo region. Most “concelhos” in Azores and Madeira are of this nature too, although the regional averages there are relatively high (105.4 in Azores and 308.5 in Madeira). This spatial demographic asymmetry translates into an economic asymmetry as well. Jobs are fewer and less qualified in low population-density territories and, not surprisingly, incomes *per capita* are lower.

Figure 2 shows the distribution of purchasing power per inhabitant.[14] Purchasing power is smaller in central and northern mainland, where 19 “concelhos” are below 50% of the national average. The (unweighted) purchasing power mean in the 106 “concelhos” below 40% of the mainland population density corresponds to 64.0 % of the national average. The role of urbanisation is evident, with higher *per* capita purchasing power in district capital cities (marked in the map) and, of course, in the metropolitan areas of Lisbon and Oporto. The more urbanised “concelhos” in Azores and Madeira also outperform the average but clearly not as much as in terms of population density.

Finally, Figure 3 indicates the regional distribution of the overall level of economic development. Economic development is measured by a synthetic indicator—the *Regional Development Composite Index* (ISDR)—which weighs equally three development dimensions: competitiveness, cohesion and

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[13] “Nomenclature of Territorial Units for Statistics” classifies the EU territory into regions at three different levels of aggregation.

[14] Purchasing power is a proxy for private spending at the “concelho” level; it is a composite indicator produced by the official statistical office of Portugal (INE—Statistics Portugal) out of a factor analysis model and combining variables correlated with income, such as taxable income, amount of ATM cash withdrawals, housing mortgage loans, expenditure on restaurants and number of registered motor car ownerships. The national (mainland plus archipelagos) average is normalised to 100 and Figure 2 depicts each “concelho” *per capita* purchasing power as a percentage of the national average. See more data and methodological details at Statistics Portugal (2009).

environmental quality.[15] Life quality, or economic development, in one place is higher the more competitive, cohesive and environmentally sound the site is and this is what ISDR aims at measuring. Three regions only (NUTS level 3) stand above the national average: Grande Lisboa, Pinhal Litoral and Minho-Lima, all along the coastline. However, contrary to conventional wisdom, there is no clear coast-border asymmetry in the mainland. Intermediate development cases are found in border territories in Centro and Alentejo, along with Algarve, as well as in regions close to the ocean. The most problematic cases lie in the Azores archipelago, Northern interior (Tâmega, Alto Trás-os-Montes and Douro) and Central interior (Pinhal Interior Sul and Pinhal Interior Norte).

5. Public Finance State of Play of Portuguese Subnational Governments

5.1 Overall financial positions

Table 4 compares the 2011 aggregate finances of regional and local governments to general government finances. Taken together, regional and local governments accounted for 13 percent of effective revenues and 12 percent of effective public spending of Portuguese general government. Within the subnational sector, all local governments together are much larger than the two regional governments; they account for 75 percent of subnational government effective revenues and 74 percent of subnational government effective expenditures.[16] In 2011, regional and local governments had balanced budgets on aggregate.

Table 5 reports the aggregate annual net lending of regional and local governments based on accruals rather than cash accounting as in Table 4. Of the two regional governments, Madeira had moderate deficits in 2008 and 2009 and quite large deficits in 2010 and 2011.[17] As a result, Madeira's public debt increased to € 3.7 billion in 2011. In contrast, the regional government of Azores maintained budgets close to balance over this period and, with € 0.7 billion, a much lower level of debt. According to the same table, the aggregate deficit of local governments peaked at € 922 million in 2009 and

[15] See Stiglitz *et al*. (2009), for example, on the importance of departing from GDP to complementary measures of economic performance. Each dimension in the ISDR is itself a synthesis of several indicators. Territorial competitiveness aggregates the impact of variables that contribute to market shares of activities located in the territory (human capital endowment, advanced infrastructure level, agglomeration economies, etc.). Territorial cohesion measures the population access to goods and services provided out of collective facilities (health, education, water, sewerage, mobility) and social inclusion (ethnical integration, unemployment, crime, income inequalities, longevity). Finally, the environmental quality index intends to express the quality and sustainability of natural resources use (air, soil and noise pollutant emissions, water quality, ecological reserve areas, energy efficiency). The unweighted average of the three partial indices provides an overall assessment of each region's state of economic development. The ISDR and the evolution of all partial indices are described in Vala and Pinho (2001).

[16] Data for seven municipalities are missing in Table 4 but they are too small to change these shares.

[17] These high deficits reflect mostly item reclassifications (of unrecorded expenditure in previous years and of guaranteed debt to regional enterprises).

then turned quickly into a surplus of € 420 million in 2011. Thus, local governments achieved a fiscal adjustment of 19 percent of 2011 effective revenues in just two years. Nevertheless, local governments had built up a considerable stock of debt reaching € 5.7 billion by the end of 2011.

Chart 1 shows the development of aggregate debt at the local level from 2006 to 2010 and its composition by maturity. In 2006, two thirds of municipal debt was medium to long term. By 2010, this share had fallen to 62 percent. Indeed, short-term debt shows a substantial growth of 44% until 2010, against 15% for medium-and long-term debt. This is in line with earlier indications about arrears. On this point, the CFP recommends the national authorities to study how debt affects large and small municipalities. Remembering the correlation between size and prosperity of municipalities pointed out above, it is not indifferent (in terms of financial sustainability) to conclude that the *per capita* debt amount or the share of debt on revenues is larger the smaller the municipality is because access to own revenues to pay debt back is very unevenly distributed. This remark is very important for sustainability reasons. Also, it may be very useful to understand how effective the current arrangements have been to deal with local governments in financial distress. Lessons from this analysis may provide hints to reinforce the incentives of local administrations to regain and maintain sustainable financial positions.

5.2 Expenditures

Table 6 presents the policy areas for which regional governments are responsible. Broadly speaking, they have legislative autonomy over their jurisdictions on almost all expenditure areas. Spending responsibilities are assigned in the Constitution and the Politico-Administrative Statute of each region—EPA-A (2009) for Azores and EPA-M (1999) for Madeira. The assignment of responsibilities to the regional governments generally conforms to what one would expect from economic principles.

The expenditure assignment of municipalities is summarised in Table 7. Broadly speaking, the allocation of expenditure responsibilities again corresponds to economic principles. Local governments are solely responsible for some expenditure domains (primary education buildings, urban road network, etc.) whereas in other areas responsibilities are shared with either regional or central authorities.[18]

Chart 2 illustrates the distribution of public spending across concelhos, by showing the top 10 and the lowest 10 local governments in 2009. Heterogeneity is large across the entire distribution. With € 626 million, Lisbon had the highest amount of public spending, more than six times that of the 10th largest local government, Matosinhos. The lowest level of spending was € 1.5 million in Corvo. The relative differences among the lowest ten concelhos are somewhat smaller than that among the top ten.

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[18] Comprehensive information on expenditure assignment can be found in Baleiras (2009, pp. 755–760).

This large degree of heterogeneity is also clearly visible in Table 8, which gives some statistical measures of municipal spending in 2009. Local spending differs a lot on size. The 10 largest concelhos accounted for 23 percent of total spending at the municipal level. The median says 154 concelhos spent € 14.4 million or less, whereas Lisbon alone spent € 626 million. Generally speaking, absolute size is the larger the higher is the urbanisation ratio. *Per capita figures*, however, are much less heterogeneous. The maximum expenditure (€ 3,499, at Lajes das Flores) was 3.2 times larger than the mean value, while the same ratio in absolute units was 24.4.[19] Thus, heterogeneity in terms of spending per individual is much less significant than heterogeneity in terms of absolute spending levels. This also becomes clear by comparing Chart 2 with Chart 3, which gives the top 10 and the bottom 10 concelhos in terms of *per capita* spending. For example, Lisbon does not figure in the top 10 in Chart 3, nor does Corvo in the bottom 10, with low-density jurisdictions exhibiting the highest positions. This different profile is due to transfer programmes.

Chart 4 presents a break-down of municipal spending according to economic functions. With 30 percent of total spending, personnel expenditures are the largest part, followed by purchases of capital goods (26 percent) and purchases of goods and services (24 percent). At the local level, transfers make up only 15 percent of total spending.

Chart 5 shows aggregate municipal spending according to different concepts. The top line presents (initially) budgeted expenditures, slightly above € 13 billion in 2009 and 2010. In contrast, spending outturn on an accruals basis was only about € 11 billion and falling more strongly than budgeted spending in 2010.[20] Curiously, as discussed below, initially budgeted revenues tend to far exceed revenue outturns. These long-known differences are not independent from the composition of local parliaments. All parish incumbents seat at the municipal assembly and together they account up to 50%, minus one, of total seats. Very often, the budget and investment plan approval requires at least one flagship spending for each parish in the forecasting documents, even if revenue outturn shortage will later render impossible to provide that activity. The practice, until the 2012 adoption of the commitments law, of expenditure authorisation subject to spending appropriateness but irrespective of revenue appropriateness, also helps to explain the substantial difference between budget forecast and budget outturn. Increasing funding difficulties in recent years on top of these budgeting practices may have contributed to the payment arrear problem currently very acute. To understand this

[19] The coefficient of variation provides another view about the dispersion of these distributions. On average, deviations of the absolute size to the mean represent 168% of the latter. In the *per capita* size distribution, deviations are, on average, 51% of the mean value.

[20] There is strong evidence in favour of political business cycles with municipal expenditure and debt [Veiga and Veiga (2007) and Baleiras and Costa (2004)], which may help to explain the decrease in the post-electoral year (2010).

point, note that the execution rate of committed expenditure[21] exceeded the execution rate of invoiced revenue[22] by 16% on average from 2006 to 2010. Thus, municipalities have found increasing difficulties to finance spending commitments in recent years. The evolution of short-term debt displayed in Table 1 squares well with this assertion. Cash expenditures are even lower compared to budgeted expenditures. The differences between budgeted and out turned expenditures point to serious weaknesses in the framework of local budgeting and raise questions about the relevance of local budgets in the presence of heavy central government intervention. Strong central government intervention may result in weak political ownership of local public spending at the very level where it occurs and contribute for local financial sustainability troubles, as clearly stressed in Sections 2 and 3.

5.3 Regional government revenues

In terms of revenue assignment, Azores and Madeira enjoy considerable autonomy. Each region is entitled to all tax revenues collected in its jurisdiction and the regional parliaments can define exemptions and set rates lower than those prevailing in the mainland (a reduction of up to 30 percent for VAT and income taxes, variable limits in other taxes according to their specific legislation).[23] Although the law allows regions to adopt new taxes, with exclusive incidence in their territory, none has been created so far. Structural public finance elements are defined in the regional finance law as it sets debt limits, defines the tax powers of regional administration in detail and designs the transfer programmes in favour of regions.

5.4 Local government revenues

Chart 6 compares local government revenues according to the same concepts as Chart 5. It shows that initially budgeted revenues in 2006 and 2010 represented 159 percent and 165 percent, respectively, of actually collected revenue. The execution rate of invoiced revenues at the local level was only 62 percent in 2010, the lowest in the last five years. As in the case of local public spending, this suggests that there are serious weaknesses in the local budgeting process; the initial budget is not a safe track to guide spending outturn or revenue collection.

Chart 7 presents a break-down of local revenues by economic function. Most local revenues come from municipal funds (34 percent),[24] followed by local tax revenues (26 percent) and other transfers (20 percent). License fees and revenues from selling goods and services contribute merely 14 percent

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[21] Execution rate of committed expenditure: the ratio of committed expenditure to (initially) forecasted expenditure, in percentage.

[22] Execution rate of invoiced revenue: the ratio of invoiced revenue (“receita liquidada”) to (initially) forecasted revenue, in percentage.

[23] Following the 2012 memorandum of understanding between the government of Madeira and the central government, tax rate differences *vis-à-vis* the mainland have been strongly narrowed.

[24] Correspond to the bulk of central government transfers to municipalities.

to local government revenues. It is worth mentioning that this distribution is likely to be influenced by government fragmentation as many mercantile activities have been off budgeted to external entities over the years.

Some indirect taxes, the proceeds of which accrue to local authorities, are in fact exogenous to local governments because the tax parameters are set by higher-level governments. These include the tax on automobile ownership (Imposto Único de Circulação, IUC; the share assigned to municipalities), the tax on real estate transfers (Imposto Municipal sobre as Transmissões Onerosas de Imóveis, IMT), the tax on real estate ownership (Imposto Municipal sobre Imóveis, IMI) applied to non-urban properties ("prédios rústicos"), as well as the old real estate transfer tax ("Sisa") and the old tax on vehicles ("IMV"), which were abolished in the past but still produced revenues in 2009. Since local governments cannot influence the revenues from these taxes, one may also regard them as transfers from the central government. A similar argument holds for consumption and gambling taxes. At the same time, the official classification of the so-called *variable participation on the personal income tax* as a transfer to municipalities is unjustified, because local governments can return the proceeds from this levy to their taxpayers. Municipal assemblies decide each year how much they will pay back to local taxpayers and, thus, how much revenue they obtain from this tax. In view of this, we reclassify taxes and transfers to account for these arguments. This yields the "alternative classification" in Chart 7, which reduces the share of taxes in local government revenues from 32 to 26 percent and increases the share of Other Transfers by six percentage points.

Using this alternative classification, Table 9 shows that, on average of the municipal distribution, transfers from the higher-level governments (autonomous regions, State and EU) account for 69% of local (effective) revenues. Half of the municipalities rely on transfers for 73% or more of their total revenue.[25] In 2001, the corresponding mean and median were 77.2% and 80.3%, respectively. The 2007 revision to the Local Finance Law, LFL (2007), has contributed slightly to reduce the overall dependence on transfers, mainly through the introduction of the variable participation in the personal income tax (paradoxically recorded as a transfer in the official classification). The own revenue share distribution is symmetrical and, therefore, also portrays large heterogeneity. Typically, the more urbanised a jurisdiction is, the larger is its own tax capacity and the smaller its dependence on higher-level government transfers. On the one hand, this indicates that the central government uses transfers to municipal governments to reduce the economic inequalities among the municipalities and achieve a more even distribution of public finances.

On the other hand, it means that the smaller and the poorer municipalities are, the less capacity they have to adjust to changes in local and overall economic conditions or to situations of financial distress. The high degree of dependence on the central government emphasizes the need for stable,

[25] The interested reader may wish to look at Baleiras (1997, 2005) for earlier accounts of these statistics.

reliable, and transparent rules of intergovernmental transfers to provide local governments with a basis for sustainable and efficient public management.

5.5 Accounting at the subnational government levels

All public entities should use cash and accrual accounting systems. They complement each other with very useful information. Focusing on accrual accounting only can mislead managers, particularly about the actual revenue raising capacity. Relying on cash basis only can also be misleading, particularly with respect to spending commitments and the need to provide in advance for their financing. Careful use of both standards minimises the risk of leaving aside useful information for sound public finance management. Although some reliability problems with accrual accounting still need to be addressed, it is instructive to note how misleading figures about the policy stance can be if public finance management relies on one basis only. For the years 2006 to 2010, cash (accrual) basis effective balances for the 308 municipalities were (billion euros): +0.3 (-1.8), +0.4 (-1.5), +0.0 (-1.4), -0.4 (-2.4) and +0.2 (-2.3).[26]

Related to this subject, is the use of multiple bank accounts by public entities. The fewer accounts in use by an entity, the easier it is for its manager to follow the money and keep control of cash balances. Also, a consolidated management of cash surpluses and shortages optimises the financial returns for the holder. These basic ideas prove very useful in the light of the significant government fragmentation at the regional level and in many localities. We thus suggest that each regional, municipal and parochial group should move to a *treasury single account* system. Under this system, each entity could run an own 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. This (single) bank could either be the State's Treasury (*Instituto de Gestão da Tesouraria e do Crédito Público*) or a commercial bank. The recent IMF paper by Pattanayak and Fainboim (2011) explains what a treasury single account is and can inspire a model for Portuguese subnational authorities.

Most municipalities maintain off-budget operations in the form of municipalised services and local companies. These units basically provide specialised services within the remit of municipalities (*i.e.* the holding units). Carvalho *et al.* (2012) compiled the most comprehensive publicly available information on satellite debt, whose highlights come up in Table 10 (municipalised services) and Table 11 (municipal companies). The data are not consolidated across municipal groups, so summation over the three local subtotals must be interpreted with care. Debt of all municipalised services amounted

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[26] Figures from Carvalho *et al.* (2012).

to 147 M€ in 2010, of which 64% was due within a year. The Local Enterprise Sector owed 1,787 M€ in the same year, of which trade debt (*i.e.*, debt to suppliers) represented 0.03% only.

5.6 Data discrepancies

To maintain sound public finances at the local level, it is necessary to monitor local developments in a timely and comprehensive way. Currently, this is difficult, because the relevant data are dispersed over a variety of sources which are often not consistent, as the preparation of this Report has demonstrated to the CFP.

Official local public finance data are available at the websites of the *Directorate-General of the Budget* (DGO) and the *Directorate-General of Local Governments* (DGAL)—"Portal Autárquico". Both provide only cash-based, ex-post data. DGO publishes aggregate monthly data, while DGAL provides end-year outturns by individual municipalities. Initial budgets are disclosed by neither agency. Further information on individual governments is available from their own websites and in a yearbook published by a consortium of two research centres funded by the chamber of chartered accountants.[27] The preparation of this Report benefited a lot from these statistical sources and CFP acknowledges the notable work of their staff. Thus, the following examples of some shortcomings should not be read as a criticism; instead, they just reinforce our arguments in favour of a national effort to improving the transparency and quality of public finance information.

The DGO's *Budget Outturn Summary Report* aims at disclosing fresh (monthly) information on all subsectors with a minimum delay. Yet, this goal comes at the price of a lack of comprehensiveness of the data. In almost all months, the outturns of some local governments are missing. For example, the June 2012 report presents the May account of local administration on the basis of only 238 municipalities. Either municipalities respond too late or in an inaccurate manner or the response deadlines are too short to allow for full reporting. The DGAL tables are supposed to represent the closed annual accounts. Yet, municipalities are allowed to report their final accounts to the *Court of Auditors* (CA) at a later date, which is a source of discrepancy between information at CA and DGAL.

Further examples of data discrepancies are shown in Table 12. They reinforce the argument that the revision of the subnational public finance laws is an opportunity to review the reporting and monitoring mechanisms with a view to streamlining procedures and improving the transparency and quality of information on these subsectors.

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[27] This publication, *Financial Yearbook of Portuguese Municipalities*, is a joint venture between two research centres affiliated with the *Minho University's School of Economics and Business Administration* and the *Polytechnic Institute of Cávado and Ave* and is sponsored by OTOC ("Ordem dos Técnicos Oficiais de Contas"). The latest edition is referred to in this Report as Carvalho *et al.* (2012). It gathers and analyses the cash and accrual accounts of all municipalities.

6. Concluding Remarks

The Portuguese government has stated its will to submit new local and regional public finance laws to the Parliament by the end of the current year. This Report aims at contributing to the thinking on which the future legal framework will be based. Sections 2 and 3 have given some normative guidelines. Sections 4 and 5 have reviewed the institutional and economic context of subnational authorities as well as the current state of public finance at these layers of government. Bringing together the normative principles and the empirical developments, a number of critical areas for reform emerge. They can be grouped in three categories: (1), accounting, reporting and monitoring, (2), political ownership of revenues, and, (3), medium-term budgeting. The rest of this section elaborates on these and puts forward ideas on how to improve the current situation. The CFP does not wish to make detailed proposals at this stage, as this Report's intent is to prepare the public debate on the directions of change. The CFP intends to comment on the specific proposals made during that debate at a later point in time. The CFP hopes that this Report will help the decision making process by stakeholders and legislators in the months to come, seeking to assure both the sustainability and a high quality of subnational public finances in Portugal.

6.1 Accounting, reporting and monitoring

It is important for sustainability that each unit of government run accounting systems on effective cash and accrual bases. Although municipalities were the first layer of government to complete the implementation of an accrual system of accounts 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, if it is to deliver the right information for sound, forward-looking management decisions and to monitor the compliance with fiscal rules in force. Domains 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 replaced by a comprehensive view of the entire set of entities held by each government unit (a municipality or a regional government): municipalised services, autonomous funds and services, local and regional companies. The idea is to evolve towards true consolidated accounts as has been the case of firms for many years;
- data pooling—a unified public finance warehouse would minimise compliance costs for reporting entities, improve transparency, reduce data discrepancies and facilitate analytical work by monitoring agencies, thus improving common knowledge on subnational public finance. Conditional on results, this experience could later be expanded to the other public subsectors;
- treasury account unification—with the aims of optimising the management of treasury surpluses or shortages and enabling the integrated control of cash flows by the top political level

within each municipal or regional group, all entities making up such group should share an integrated structure of banking accounts allowing for their consolidation.

The suggestion on data pooling needs an explanation. Currently, each subnational government reports data, sometimes the same variables, to different central government entities (*Directorate-General of Local Governments*, *Directorate-General of the Budget*, *Inspectorate-General of Finance*, *Court of Auditors*, *Statistics Portugal*, and probably others) in different formats and at different dates. This requires subnational units to allocate scarce time and human resources to this end and is a source of information inconsistency. A few years ago, the government created IES—*Simplified Enterprise Information*— to solve a similar problem with firms' reporting of accounting, statistical and tax information. IES is a very large data warehouse fed online directly by firms according to a stipulated calendar. Agencies whose remits require monitoring of enterprise information can access this common pool of data and extract the information they need to carry out their duties. Scale economies in data management by the public sector are obvious, as well as the compliance cost savings for reporting entities. To begin with, a *Simplified Fiscal Information* (IOS) could be launched for the subnational subsectors. Parishes and intermunicipal associations, whose accounts are not easily available to the public, could also contribute to the data warehouse. Later, with lessons from this experience, the idea could be extended to the other public subsectors.

Effective implementation of these suggestions takes time, persistence and skilful resources as the accuracy and reliability of information systems are an endless exercise by definition. The increasing scarcity of qualified personnel in many areas of public administration is a serious challenge to overcome. Perhaps it would be a good idea to identify in the coming months a detailed task list for future implementation and set a realistic schedule for its delivery, clearly ascertaining who will be responsible for what and when. The forthcoming laws should set the targets and deadlines in order to create the necessary commitments and application momenta.

6.2 Political ownership of subnational revenues and their uses

An important prerequisite for maintaining sound public finances is that political constituents perceive the exact cost of the public spending they benefit from and their own contribution to it. 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 and their uses, without increasing the national tax burden, the upcoming legal reforms might consider the following measures:

- for municipalities
    - to increase the ceiling of the Variable Participation in the personal income tax (IRS) substantially[28] (in exchange for lower central government transfers), at least for municipalities with fiscal capacity above a threshold to be determined politically;
    - as an alternative to the current variable participation, to introduce a visible local surcharge on the net IRS collection 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 municipal tax invoices to display the municipality's logo and basic numerical information on local public finance;
    - 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 rural real estate property tax;
    - to consider the elimination of the real estate transfers tax (IMT) so as to reduce the discrimination of real estate against other assets not subject to a sales duty and to cancel any increases in the tax burden arising from the reassessment of property tax bases;

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

For both layers of government, it is important to look carefully at the economic incentives lying behind central government transfer rules. In particular, apportionment formulæ should not create incentives for recipient governments to reduce their tax efforts. Indeed, the partial replacement of central government transfers with subnational taxation, without increasing the tax burden, may provide an opportunity to streamlining the current formulæ (reducing the number of weights), maintaining their overall redistributive stance and incorporating therein an inverse function of the effective taxable capacity of each jurisdiction.

6.3 Medium-term budgeting

It is important to reinforce a forward-looking stance of public finance management in all layers of government. Stable fiscal rules embodied in a medium-term framework could serve this purpose. Current laws already have fiscal rules but they need to be revisited. On the one hand, they contain some loopholes (debt to suppliers, government fragmentation, exceptions to rule comprehensiveness). On the other hand, they tend to be replaced every year by new centrally-imposed constraints,

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[28] 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 revenue.

with the result that discretion prevails over the rules. The strong bias towards annual budget management in the current framework hides important intertemporal effects of fiscal decisions and, therefore, fails to provide policy-makers and managers with a proper long-term outlook, consistent with the dynamic public budget constraint. The budgetary framework law currently in place already sets a medium-term framework for central administration (art. 12-D). This could be extended to the local and regional subsector, taking into consideration lessons from the on-going implementation and the CFP recommendations in its Report of 21 May 2012.

The medium-term framework should consist of a stable multiannual fiscal environment with compatible targets for debt and spending. Limits on the stock of debt would help each government to adopt fundable annual budgets (*i.e.*, to secure financial sustainability) while annual (primary) expenditure ceilings would assist in fitting the government group size to the size of the respective economy. The definition of these indicators would have to be sufficiently comprehensive to minimize the scope for window dressing and creative accounting. Furthermore, they should be defined in a way assuring that any government has control over the relevant fiscal aggregates. This would call for replacing the current ceilings on debt service with ceilings for the stock of debt or the ratio of debt to revenues. The debt definition would have to comprehend all kinds of liabilities, regardless of their uses, thus going beyond what the Eurostat currently demands. Spending limits defined for a budgetary cycle of several years serve the double purpose of helping to enforce fiscal discipline and to provide focal points for a public debate over the size of government and its major activities. Generally, fiscal targets and limits should be mandatory, with deviations allowed only under well defined, exceptional circumstances.

Such a medium-term budgeting framework can only be effective if budgeting at the local and regional levels is serious and realistic. The large differences between forecasted and effective municipal spending and revenues pointed out in Section 5 suggest that local frameworks for forecasting revenues and expenditures should be strengthened.

A medium-term budgeting framework with debt and spending limits would also strengthen fiscal coordination across and within government layers. If the general government as a whole fails to meet its targets under the European fiscal framework and faces penalties imposed on the country as a whole, all government units failing their targets should be obliged to contribute to the penalty payment in proportion to their failures to meet the respective fiscal targets. Also, predefined adjustment mechanisms for governments violating their fiscal discipline rules (see below) should be designed so as to help the general government as a whole to restore its compliance with international targets. This approach would make failures at the country level less likely, improve fiscal sustainability and would be more equitable. Indeed, the current arrangement under which all government units have their funding reduced by the State budget law irrespective of their fiscal performance fails to reward responsible behaviours, looks unfair and, ultimately, weakens the incentives for fiscal prudence at the subnational levels.

Finally, fiscal targets must be credible to be effective. They must contain both penalties for violating the targets and mechanisms of adjustment to bring governments back on track. While financial sanctions against deviating from fiscal targets have been foreseen in the Portuguese public finance laws for years, some rethinking of the effectiveness of the existing arrangements, under which financial penalties take the form of temporary withholdings of central government transfers to the relevant subnational government, seems advisable. Predefined mechanisms of adjustment are necessary to assure both the general public and creditors that a speedy return to target will occur. In this context, it seems useful to examine the effectiveness of the correction mechanisms embodied in the current local public finance law (arts. 37, 41 and 42).

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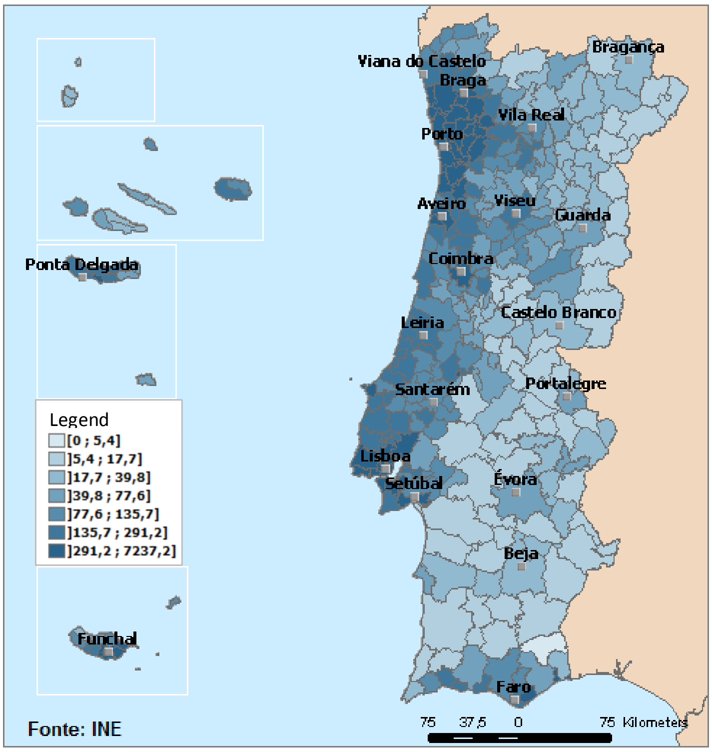
Appendix: Statistical Information

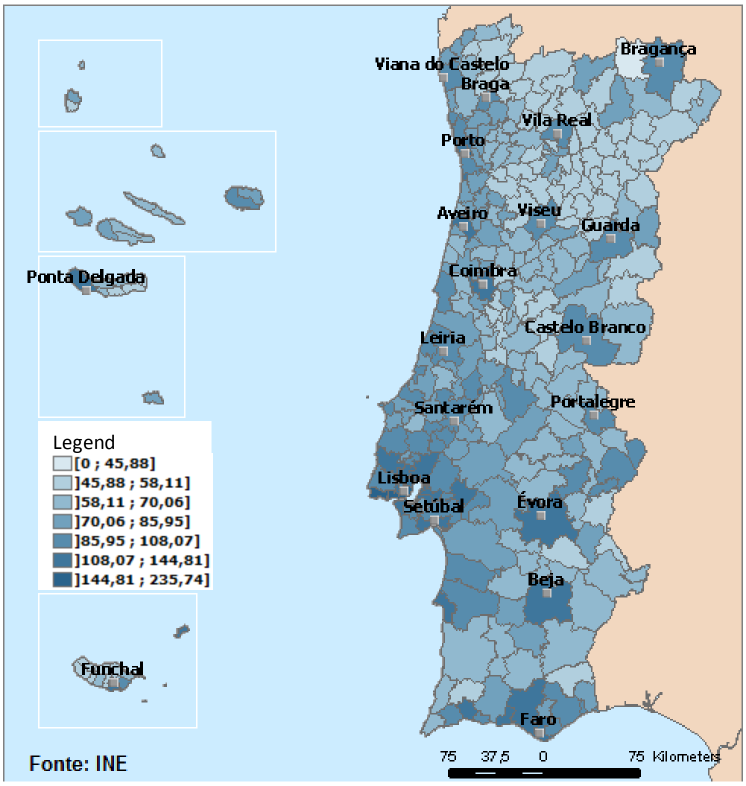
A1. Figures

Figure 1—Resident population density (Inhab/Km^2) in Portugal, by "concelhos", 2008



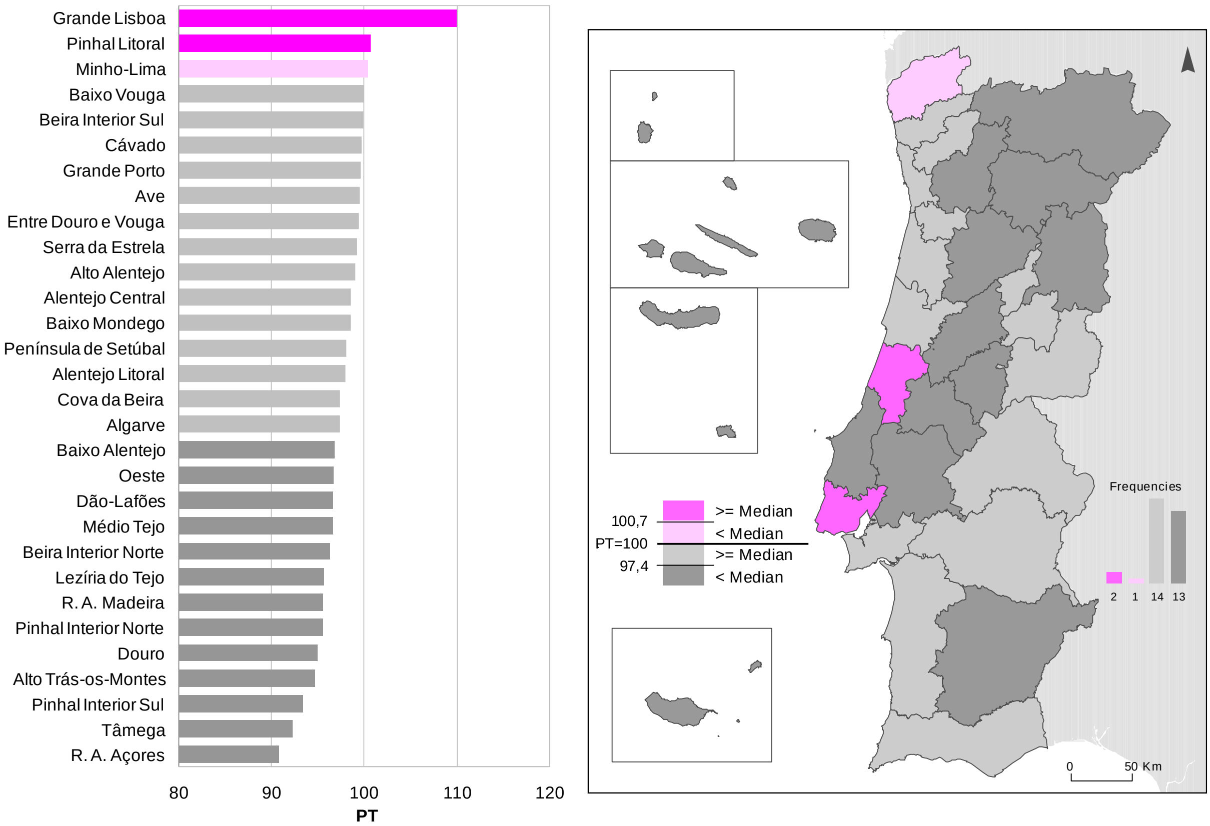
Source: Baleiras (2011), based in Statistics Portugal (2011).

Figure 2—*Per capita* purchasing power index in Portugal, by "concelhos", 2007



Source: Baleiras (2011), based in Statistics Portugal (2011).

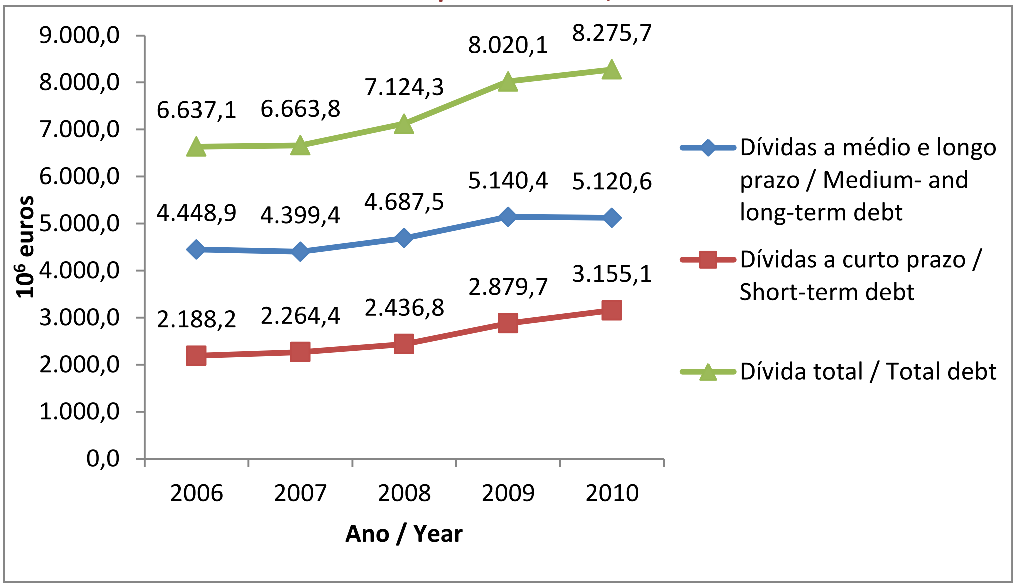
Figure 3—Overall index of regional development (Portugal = 100), NUTS 3, 2008



Source: Vala and Pinho (2011).

A2. Charts

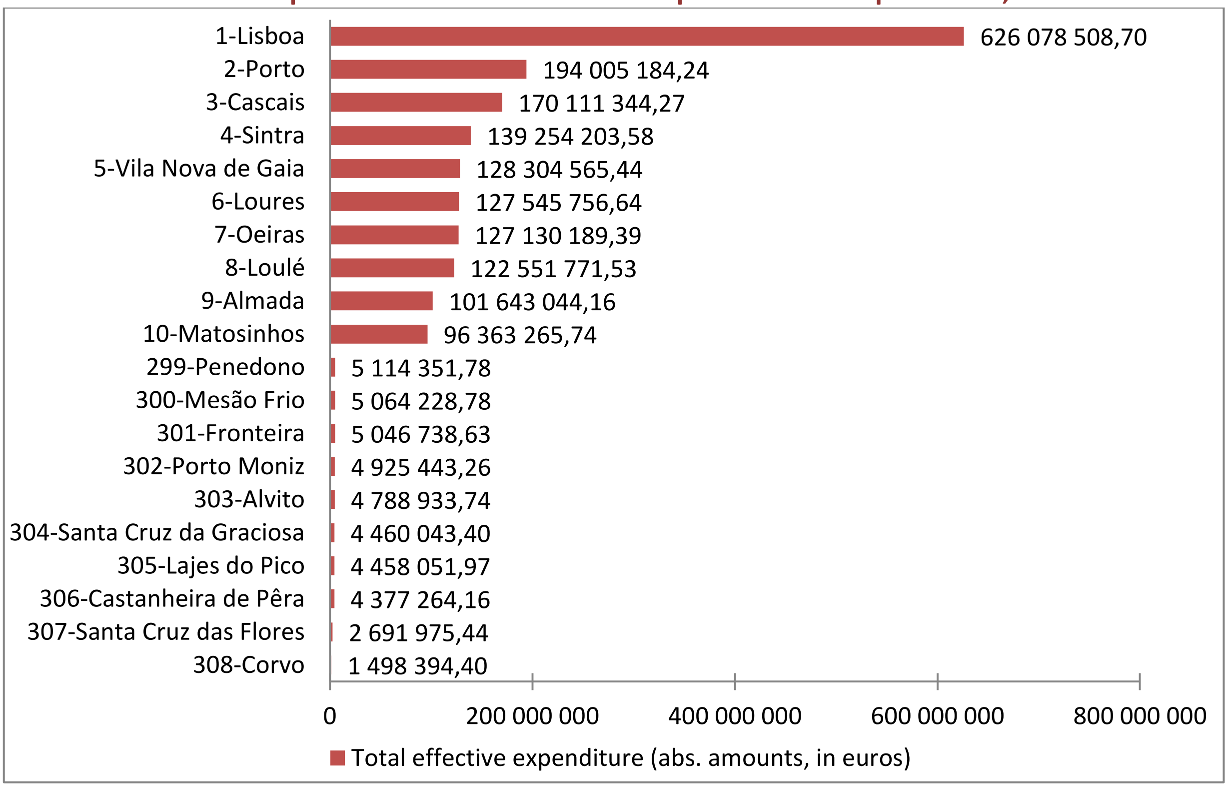
Chart 1—Municipalities' debt, 2006 to 2010



Notes
- Comma (dot) is used as the decimal (thousand) separator.
- Balance sheet debt records.

Source: CFP calculations based in Carvalho *et al.* (2012, p. 106).

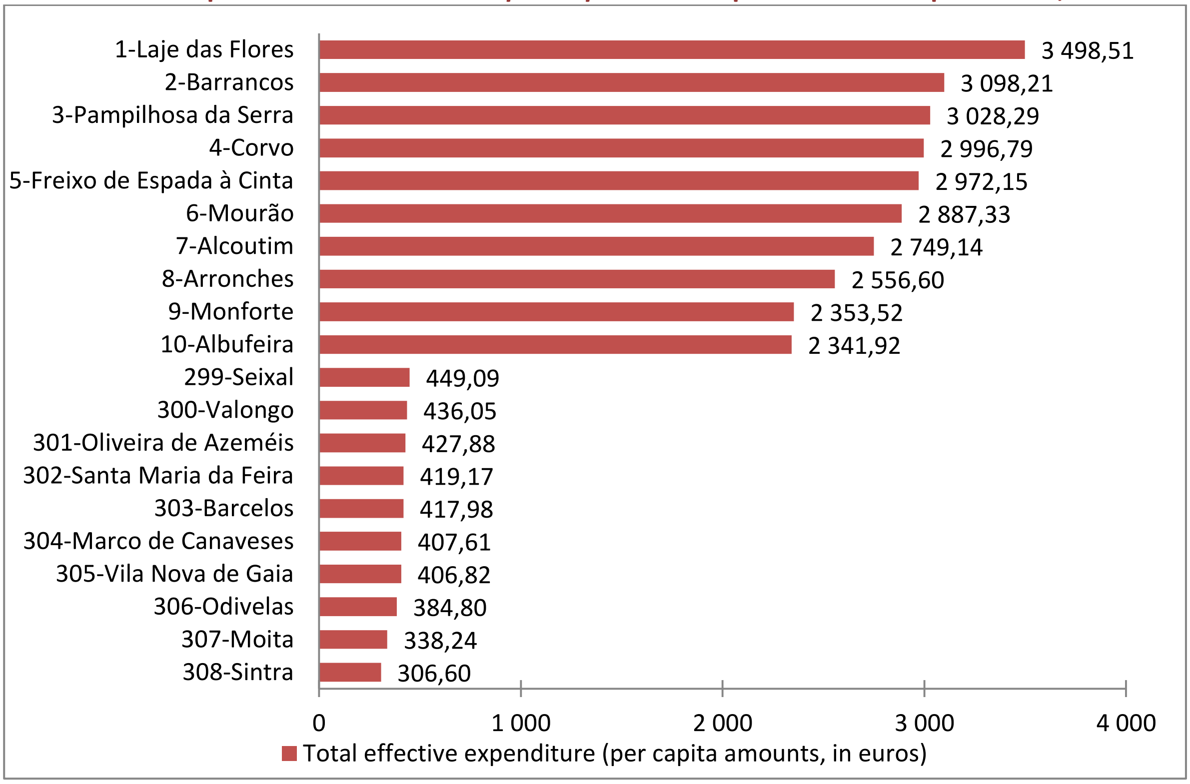
Chart 2—Top-10 and Bottom-10 of municipal effective expenditure, 2009



Note: comma (dot) is used as the decimal (thousand) separator.

Source: CFP calculations based on municipal accounts provided by Portal Autárquico (2012).

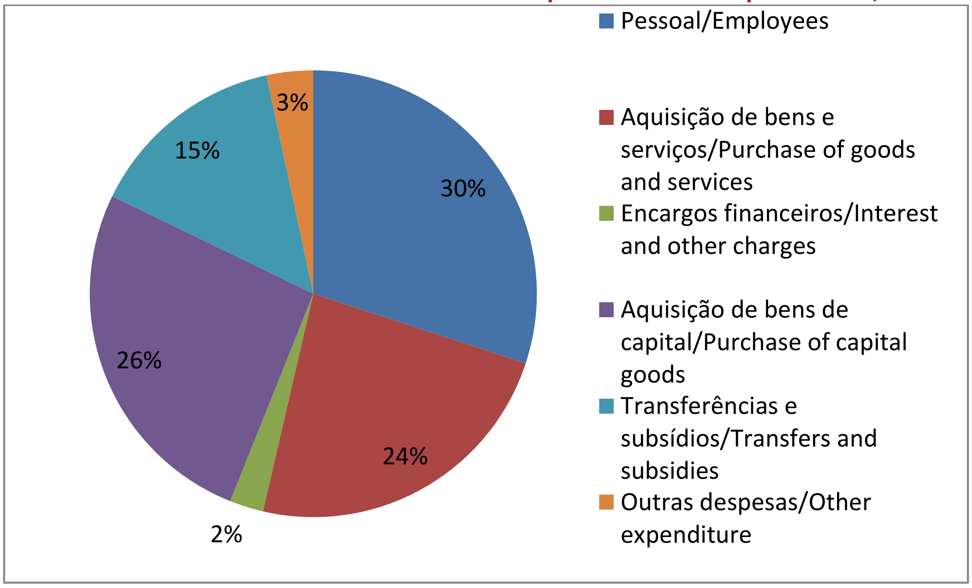
Chart 3—Top-10 and Bottom-10 of *per capita* municipal effective expenditure, 2009



Note: comma (dot) is used as the decimal (thousand) separator.

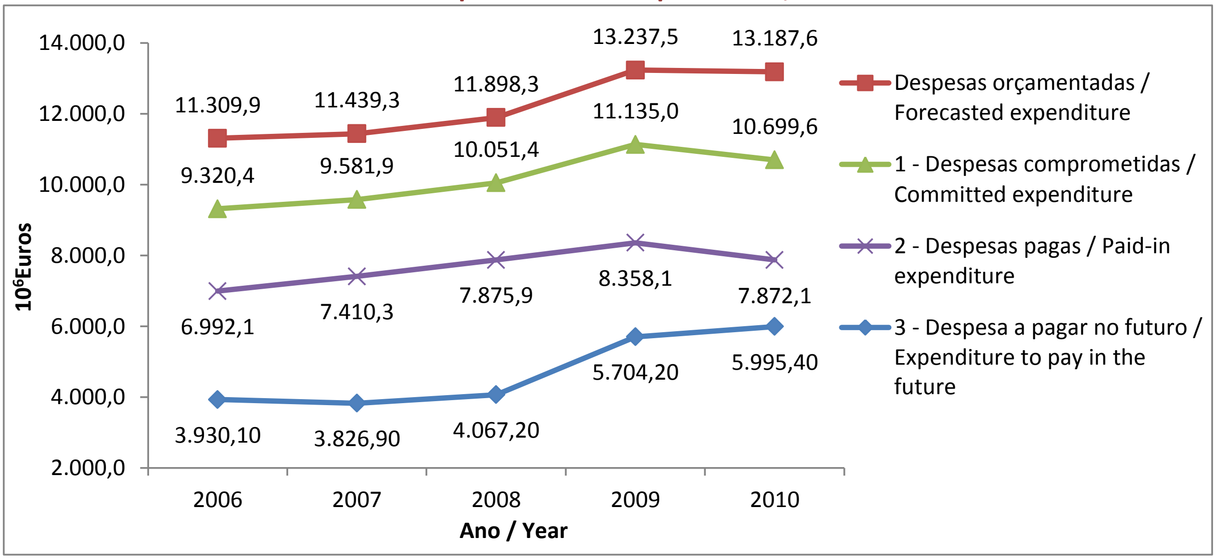
Source: CFP calculations based on municipal accounts provided by Portal Autárquico (2012).

Chart 4—Economic breakdown of municipal effective expenditure, 2009



Source: CFP calculations based on municipal accounts provided by Portal Autárquico (2012).

Chart 5—Municipal effective expenditure, 2006 to 2010



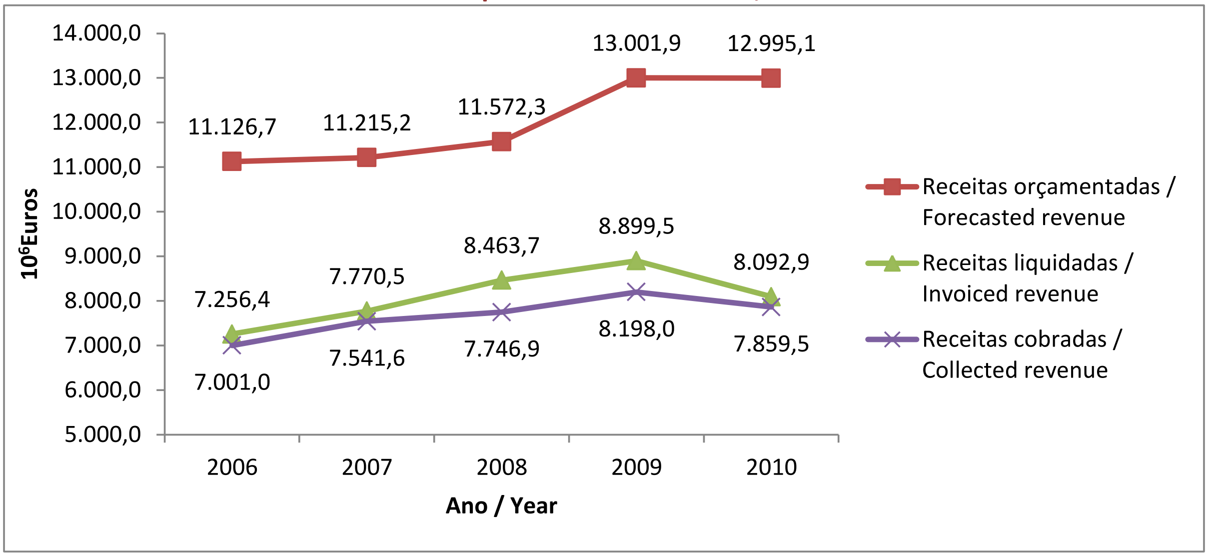
Notes

- Comma (dot) is used as the decimal (thousand) separator.
- Municipalities of Castro Marim and Fornos de Algodres are not considered in 2006.

1 – Current year commitments and unpaid commitments carried forward from previous years.
2 – Payment of commitments from current and previous years.
3 – Unpaid current year commitments (current year commitments net of paid expenditure from current and previous years) and future liabilities assumed in the current year (they are not debt in the current year).

Source: CFP calculations based in Carvalho *et al.* (2012, p. 64).

Chart 6—Municipal effective revenue, 2006 to 2010

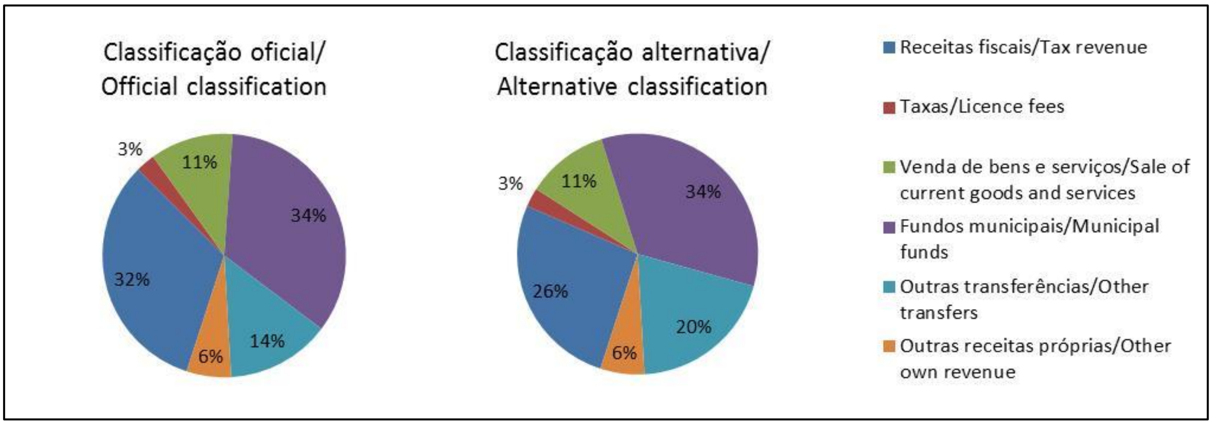


Notes

- Comma (dot) is used as the decimal (thousand) separator.
- Balance of previous year not included in the above revenue aggregates.

Source: CFP calculations based in Carvalho *et al.* (2012, p. 40).

Chart 7—Economic breakdown of municipal effective revenue, 2009



Note: transfers across municipalities (15.4 M€ in 2009) are included in the Other transfers aggregate in both classifications.

Source: CFP calculations based on municipal accounts provided by Portal Autárquico (2012).

A3. Tables

Table 1—Commitments to pay *versus* short-term debt: an illustration with Portuguese municipal data

Unidade / unit: 10^6 €

	Variable	2006	2007	2008	2009	2010
(1)	Compromissos não pagos (execução orçamental) / Unpaid commitments (budget outturn tables)	2.328,3	2.171,6	2.175,5	2.776,9	2.827,5
(2)	Dívida de curto prazo (dados do balanço) / Short-term debt (Balance sheet)	2.188,2	2.264,4	2.436,8	2.879,7	3.155,1
(3)=[(1)/(2)]*100	Peso / Share	106,4	95,9	89,3	96,4	89,6

Note: comma (point) is used as the decimal (thousand) separator.

Source: adapted from Carvalho *et al*. (2012, p. 74).

Table 2—GDP per capita in 2009, Portuguese NUTS levels 1 and 2 regions

Territórios / Territories	PIB por hab. / GDP per inhab.		Popul. Residente /	
	Em % UE-27, média PPC / As % EU-27, PPS average	€/hab. / €/inhab.	10^3 indiv. [1]	Densid. popul. / Pop. density
Continente / Mainland	79	15.700	10.135	
Norte	64	12.600	3.745	175,9
Centro	66	13.200	2.383	84,3
Lisboa	112	22.300	2.819	944,5
Alentejo	72	14.300	757	23,8
Algarve	85	16.800	430	87,2
Açores	75	14.900	245	105,8
Madeira	105	20.800	247	308,9
Portugal (NUTS 1)	80	15.800	10.627	

Notes
- Comma (point) is used as the decimal (thousand) separator.
- Population density: No. of inhabitants per km^2.

1- No. of inhabitants on 1 January 2009.

Source: Eurostat (2012).

Table 3—Geographic features of subnational administrations

Nível de adm. Pública / Government layer	N.º de jurisd. / No. of jurisd.	População / Population (2009)		Superfície / Surface (km^2)		Densidade popul. / Pop. density	
		Máx / Max	Mín / Min	Máx / Max	Mín / Min	Máx / Max	Mín / Min
Regional	2	247.399 Madeira	245.374 Açores	2.322,0 Açores	801,1 Madeira	308,8 Madeira	105,7 Açores
Municipal	308	479.884 Lisboa	500 Corvo	1.720,6 Odemira	7,9 São João da Madeira	7.183,3 Amadora	5,3 Alcoutim

Legend
- Population measures the number of resident individuals, annual estimate.
- Population density measures the number of resident individuals per km^2.

Notes
- Comma (point) is used as the decimal (thousand) separator.

Source: Statistics Portugal (2012).

Table 4—General Government consolidated account (cash basis), 2011

Unit: 10^6 €

Aggregado / Aggregate	Sector Púb. Admin. / General Government	Administração Regional / Regional Governments			Adm. Local / Local Governments [1]	Adm. Subnacional / Subnational Governments [2]	
		Açores	Madeira	Total			Em % SPA / As % of GGov
	(1)	(2)	(3)	(4)=(2)+(3)	(5)	(6)	(7)=[(6)/(1)]*100
Receita efectiva / Effective Revenue	71.878,50	1.033,28	1.079,68	2.112,96	7.152,40	9.581,55	13,3%
Despesa efectiva / Effective Expenditure	77.476,70	1.056,44	1.075,62	2.132,06	6.950,72	9.398,98	12,1%
Saldo global / Overall balance	-5.598,20	-23,16	4,06	-19,10	201,69	182,57	-3,3%
Saldo primário / Primary balance	667,00	-9,58	47,21	37,63	339,83	378,06	56,7%

Legend (according to the source)
- Regional Administration comprises regional government agencies and autonomous services and funds.
- Local Administration comprises municipalities, districts and autonomous services and funds.
- The General Government column excludes transfers from and to public administration subsectors.

Notes
- Comma (point) is used as the decimal (thousand) separator.

1- Seven municipalities are missing in the source (Alijó, Crato, Mértola, Mirandela, Montalegre, Paços de Ferreira, and Portalegre).
2- The subnational aggregates in columns (6) and (7) are copied from the general government consolidated account in the source document and do not correspond to the arithmetic summation of columns (4) and (5). This apparent inconsistency is not explained in the source document.

Source: DGO (2012).

Table 5—Subnational balance and debt in national accounts, 2008 to 2011

Unidade / unit: 10^6 €

Variáveis / Variables	2008	2009	2010	2011
Capacidade (+) ou necessidade (-) líquida de financiamento				
Net lending (+) or net borrowing (-)				
Adm. Regional / Regional Admin.				
Açores	-41,5	-82,1	-53,6	-36,4
Madeira	-216,6	-338,2	-1.191,5	-1.125,1
Soma / Sum	-258,1	-420,3	-1.245,1	-1.161,5
Adm. Local / Local Adm.	-593,6	-921,5	-196,1	419,6
Administrações Subnacionais / Subnational Administrations	*-851,7*	*-1.341,8*	*-1.441,2*	*-741,9*
p.m.:Conjunto das Adm. Públicas / General Government	-6.235,6	-17.103,3	-16.950,1	-7.262,5
Dívida bruta / Gross debt				
Adm. Regional / Regional Admin.				
Açores	536,7	600,5	652,5	690,9
Madeira	1.847,9	2.066,1	3.051,4	3.735,0
Total	2.384,6	2.666,6	3.703,9	4.425,9
Adm. Local / Local Adm.	5.303,1	5.866,3	5.897,5	5.709,3
Administrações Subnacionais / Subnational Administrations	*7.687,7*	*8.532,9*	*9.601,4*	*10.135,2*

Notes

- Data reported by Portuguese authorities to Eurostat under the *excessive deficit procedure*.
- Transfers from the central administration were recorded as subnational revenues to compute net lending/borrowing above. In 2011, these transfers amounted to: Reg. Adm. of Madeira, 300,7; Reg. Adm. of Azores, 386,7; Local Adm., 3.009,3—comma (dot) is the decimal (thousand) separator.
- The following reminders are important to interpret gross debt figures in this table. According to European legislation: trade debt is excluded; debt of public companies outside the Public Administration sector is excluded; debt of municipalities and parishes located in the archipelagos of Azores and Madeira is recorded in the Local Administration subsector.

Source: Statistics Portugal (2012).

Table 6—Own powers of the Autonomous Regions

Ref. legal / Legal refer. [1]		Matérias / Themes
Açores	Madeira	
49	b), c), v), qq)	Organiz. política e administ. regional / Regional political and administ. organis.
50	ff), gg)	Poderes tributários próprios / Own tax powers [2]
52	g), h)	Agricultura e desenvolvimento rural / Agriculture and rural development
53	f)	Pescas, mar e rec. marinhos / Fisheries, ocean and maritime resources
54	l), bb), ee)	Comércio, indústria e energia / Trade, industry and energy
55	t)	Turismo / Tourism
56	d), e), x), ll)	Infraestrut., transp. e comunicações / Infrastrut., transp. and comunnications
57	i), j), z), jj), mm), oo), pp)	Ambiente e ordenam. do território / Environment and spatial planning
58	m)	Solidariedade e segurança social / Solidarity and social security
59	m)	Saúde / Health
60	a)	Família e migrações Family and migrations
61	n), nn)	Trabalho e formação profissional / Labour and vocational education
62	o), u)	Educação e juventude / Education and Youth
63	p), q), r), aa)	Cultura e comunicação social / Culture and Media
64	cc), uu)	Investigação e inovação tecnológica / Research and technological innovation
65	s)	Desporto / Sport
66	hh), rr)	Segurança pública e protecção civil / Homeland security and civil protection
67	w)	Outras matérias com incidência regional específica / Other themes with specific regional incidence

Notes

1. Article number in the case of the EPA-A (2009) and paragraph letter in the case of art. 40 of EPA-M (1999).
2. Under the terms set in the Regional Finance Law.

Source: CFP analysis of art. 228 of the Portuguese Constitution, EPA-A (2009) and EPA-M (1999).

Table 7—Own powers of municipalities

Equipamento rural e urbano / Urban and rural facilities
Energia / Energy
Transportes e comunicações / Transports and communications
Educação / Education
Património, cultura e ciência / Heritage, culture and science
Tempos livres e desporto /Leisure and sport
Saúde / Health
Acção social / Social support
Habitação / Housing
Protecção civil / Civil protection
Ambiente e saneamento básico / Environment and sewerage
Defesa do consumidor / Consumer's defence
Promoção do desenvolvimento / Development boosting
Ordenamento do território e urbanismo / Spatial and urban planning

Note: Legal references are article 237 of the Portuguese Constitution and number 1 of art. 13 of the Law No. 159/99, of 14 September.

Source: Baleiras (2009, p. 745).

Table 8—Statistical features of municipal total effective expenditure distribution, 2009

Estatísticas descritivas / Descriptive statistics	Despesa efectiva / Effective expenditure		
	Valor absol. / Absol. amount	**Peso /Share**	**Valor por hab. / *Per cap.* amount**
	10^6 euros	%	euros
Total da Adm. Local / Local Adm total	7.910,6	100,0%	744
Máximo / Maximum	626,1 Lisboa	7,9%	3.499 Lajes das Flores
Mínimo / Minimum	1,5 Corvo	0,0%	307 Sintra
Média / Mean	25,7	0,3%	1.084
Mediana / Median	14,4	0,2%	946
Coef. de variação / Coef. of variation[1]	1,68		0,51
Mais-5 / Top-5	1.257,8	15,9%	
Mais-10 / Top-10	1.833,0	23,2%	
Menos-5 / Bottom-5	17,5	0,2%	
Menos-10 / Bottom-10	42,4	0,5%	

Note: comma (dot) is used as the decimal (thousand) separator.

Source: calculations based on municipal accounts provided by Portal Autárquico (2012).

Table 9—Own revenue and transfers as % of total effective revenue: municipal distribution parameters, 2009

	Máximo/ Maximum	**Mínimo/ Minimum**	**Médio/ Mean**	**Mediano/ Median**	**Coef. de variação/ Variation coef.**
Classificação oficial/ Official classification					
Receitas próprias/Own revenue	86,8% Lisboa	3,8% Corvo	35,3%	29,4%	54,3%
Transferências/Transfers	96,2% Corvo	13,2% Lisboa	64,7%	70,6%	29,6%
das quais: Fundos municipais/ of which: Municipal funds	95,2% Corvo	9,6% Albufeira	49,0%	49,8%	36,4%
Classificação alternativa/Alternative classification					
Receitas próprias/Own revenue	78,1% Lisboa	2,9% Nordeste	31,2%	27,0%	54,0%
Transferências/Transfers	97,1% Nordeste	21,9% Lisboa	68,8%	73,0%	24,5%

Source: CFP calculations based on municipal accounts provided by Portal Autárquico (2012).

Table 10—Municipalised Services' debt, 2008 to 2010

Variável / Variable	2008	2009	2010
N.º de entidades / No. of entities	31	29	29
Dívida total / Total debt, 10^6 €	132,1	148,2	146,9
Dívidas a médio e longo prazo / Medium- and long-term debt, 10^6 €	55,3	53,2	53,4
Dívidas a curto prazo / Short-term debt, 10^6 €	76,8	95,0	93,5

Notes

- Balance sheet debt records.
- Comma (dot) is used as the decimal (thousand) separator.
- Data cover 100% of the sectoral universe.

Source: CFP calculations based in Carvalho *et al.* (2012, p. 168).

Table 11—Liabilities of the Local Enterprise Sector, 2009 and 2010

Unidade / Unit: 10^6 €

Componentes do Passivo / Liability components	2009			2010		
N.º de entidades / No. of entities [1]	298			304		
	Passivo corrente / Current liabilities	Passivo não cor. / Non cur. liabilit.	Soma / Sum	Passivo corrente / Current liabilities	Passivo não cor. / Non cur. liabilit.	Soma / Sum
Fornecedores / Suppliers	211,1	0,2	211,3		0,6	0,6
Adiantamento de clientes / Customers' advancements	80,9		80,9	65,1		65,1
Provisões / Provisions		54,9	54,9		39,4	39,4
Financiamentos obtidos / Financing	237,1	845,1	1.082,2	246,8	790,6	1.037,4
Accionistas ou sócios / Stockholders or partners	22,1	11,0	33,1	17,1	10,2	27,3
Estado e outros entes públicos / State and other public entities	16,7	0,2	16,9	24,0	0,6	24,6
Passivos por impostos diferidos / Deferred tax liabilities		80,0	80,0		105,5	105,5
Diferimentos / Deferrals	61,1		61,1	57,3		57,3
Outras contas a pagar / Other accounts to pay	242,5	179,2	421,7	256,5	164,5	421,0
Outros passivos financeiros / Other financial liabilities	5,9		5,9	8,8		8,8
Total do passivo / Total liabilities	**877,4**	**1.170,6**	**2.048,0**	**675,6**	**1.111,4**	**1.787,0**

Notes

- Balance sheet data.
- Comma (dot) is used as the decimal (thousand) separator.

1- The 2010 number represents 90% of the sectoral universe. This sample comprises 180 municipal companies, 50 local corporate entities, 36 anonymous societies, 18 single personal societies and 20 intermunicipal entities.

Source: CFP calculations based in Carvalho *et al.* (2012, pp. 201 and 203).

Table 12—Further examples of data discrepancies

While DGAL's data explicitly confine their definition to municipalities, it is not clear whether DGO data cover the whole of local administration ("*distritos*", *intermunicipal associations*, *municipalities*, *municipalised services* and *parishes*) or municipal data only. In fact, the glossary that accompanies the budget execution summary report is misleading: The Portuguese version defines the local administration as the set of "municipalities, parishes and autonomous services and funds"). We assume that "autonomous funds and services" correspond to the legal concept of "municipalised services". Yet, the English version uses a different definition: set of "districts, municipalities and autonomous services and funds". Intermunicipal associations are nowhere (not even on DGAL's data). Moreover, when we look at the statistical tables on local accounts and read the missing data notice, we realise these notices only indicate municipalities; this leads us to conclude that DGO data, as DGAL's, do not cover the wholeness of the local administration subsector.
Balance sheet data are not available at DGAL's website, although there are inoperative links for such information.

Time coverage differs a lot across the two official sources. The most recent data on 23 June 2012 at DGO's website were May 2012, although with many missing observations, and at DGAL's the latest information on the same day corresponded to the year 2009.
At the same time, Carvalho *et al.* (2012) publishes and analyses more recent annual data, both in cash and accrual basis. That yearbook, published in February 2012, covers all municipal accounts for 2010.
How DGO consolidates accounts across subsectors is not clear. As mentioned in Table 4, note 2, the subnational aggregates do not correspond to the sum of regional and local subsectors.
Account consolidation across municipalities at DGAL's website provides no clue on whether transfers among municipalities are aggregated or cancelled out. Only after careful checks were the CFP able to conclude that DGAL's revenue tables include intermunicipal transfers, which led to the note in Chart 7.
Even for earlier years, DGO and DGAL data for the same variables do not match. For example, total effective expenditure in 2009 is 7,910.6 million € in DGAL's website and 7,866.7 in DGO's—Summary of February 2011; in this case, DGO says the table covers all 308 municipalities. DGO explained to the CFP that by 2009 municipalities reported to DGO through one electronic application and to DGAL through another and the absence of harmonised reporting tables did not ensure information compatibility. From 2010 onwards, DGO extracts the information it needs directly from DGAL's platform. CFP was not able to check if data inconsistency was already solved because 2009 is the most recent data available at the DGAL's website..
Very likely, Carvalho et. *al.*'s (2012) yearbook also extracts information from DGAL's platform, though via a privileged access. According to this source, total effective expenditure in 2009 is 7,855 M€ for the sum of all municipalities, and this source shows how much was spent on financial assets and on financial liabilities.
DGO explicitly states in the glossary that effective expenditure of subnational governments is total expenditure less expenditure on financial assets and liabilities; however, the expenditure table for recent years in DGAL's website does not consider expenditure on financial assets. So, apparently the two central government entities do not use the same variable definition and the unspoken analyst does not know how to interpret the differences among statistical sources. As the 2009 example above also shows, the unofficial yearbook by Carvalho *et al.* (2012) adds even more to this confusion: three sources, three different amounts for the same variable.