executive summary

Analysis of the Legal Proposals for New Subnational Finance Laws

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EXECUTIVE SUMMARY

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

i. Fiscal rules—a number of substantive problems with the multiannual budgetary framework and current balance equilibrium (also known as "golden rule") in both bills recommend a different setup. The CFP proposes a medium-term rule and an annual debt rule. The former is either a medium-term global balance equilibrium rule or a medium-term spending rule. In either case, the expenditure budget is adjusted to the actual financing capacity of the government, the risk of optimistic revenue projections is significantly reduced, annual budgets get framed in a medium-term perspective headed for fiscal sustainability and the measurement or application flaws of the golden rule are avoided. The debt rule proposed by the CFP is an upgrade to that prescribed in the bills; basically, the CFP recommends the adoption of the same debt definition for local and regional entities and the introduction of several important adjustments.

ii. Specific improvements to the debt rule—as with local governments, the set of entities exposed to the debt limit at the regional tier should comprehend all entities outside the Eurostat consolidation ring that are subject to the control of regional authorities and whose liabilities are ultimately borne by taxpayers. Also, the introduction of length limits to long-term loans and grace periods should be considered. For both government tiers, the denominator of the debt indicator should comprehend all effective revenue, and not only current revenue, and there are consolidation fixes to be made on both the numerator and the denominator. Several inconsistencies in the bill need to be removed.

iii. Transparency—with a minimum administrative cost, basic information on tax decisions and the fiscal position of each government, including its compliance with fiscal rules, can be mailed to the respective taxpayers, together with tax notifications. This would enhance the general awareness with public finance and the political ownership of subnational revenues, as well as it would help to reinforce the links between voters' preferences and government's fiscal choices.

iv. Stability of rules—both bills allow for discretionary suspensions of structural public finance principles on behalf of exceptional and transitory circumstances justifying stricter local and regional budget constraints. By invoking a similar principle, the central government used the annual State budget law in most of the last ten years to reduce, on a fully discretionary basis and across-the-board, transfer endowments and debt ceilings. The bills enlarge this possibility. Instead of hardening, these recurrent practices end up by softening subnational budget constraints; ultimately, discretion compromises the accountability of subnational governments and induces bailing out demands. Perhaps the requirement in PPL 121 and 122 of a qualified majority voting on the specific State budget law articles operating the changes in the rules of the game could avoid the banalisation of these discretionary practices. To eliminate the moral hazard problem of applying uniform reductions to all subnational governments irrespective of their financial performance, the CFP proposes that any reduction in the amount of transfers or the debt cap *vis-à-vis* the rules set in the subnational finance laws could only be applied to individual subnational governments in proportion to their failure to comply with the respective fiscal rules.

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

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

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

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

ix. Information requirements
   a. PPL 122 sets a complicated system of triple consolidation levels for the local subsector, although the principle of accounting and fiscal rules consolidation is very much welcome. Further technical work seems necessary to decide whether it makes sense to exempt services and funds with financial autonomy from account reporting obligations and submit subnational companies to a current balance rule, on top of specific accountability obligations set in subnational corporate sector legislation.
   b. Consolidation at the regional level requires more ambition. PPL 121 restricts its application to the set of entities enclosed in the regional subsector as defined by European legislation for purposes of national accounting reporting. All entities outside this set are exempted from fiscal rules in PPL 121 and do not consolidate their accounts with those inside. This arrangement is not sufficient to prevent the emergence of surprises with the financial performance of entities beyond the Eurostat ring. Hence, the bill should impose a broader accounting consolidation and, at least, the regular public disclosure of a broadly-consolidated debt stock so that a timely knowledge of the comprehensive regional public subsector may become publicly available.
   c. Accrual accounting credibility is at stake with the vague obligation of adopting the official chart of public accounting. A similar obligation, with a two-year enforcement deadline, was inscribed seven years ago in the current regional finance law and is now repeated and without deadline.

d. A minimum of monitoring obligations for central administration departments should be set, together with public disclosure duties. For example, the Directorate-General of Local Governments (DGAL) could publish individual and consolidated accounts broken down by the four-levels of local groups defined in PPL 122. The Directorate-General of the Budget (DGO) could publish along the year the position of each regional government with respect to the fiscal rule indicators defined in PPL 121.

e. Even with the obligations originally defined in the two bills, DGAL, DGO and possibly some inspection services of the central government will face a substantial increase on their activity. Fiscal rules whose monitoring is not timely and professional are not effective. Given the persistent deterioration of the technical capacity of these departments, the credibility of Portugal' budgetary framework at each government tier may become at stake if an appropriate recapitalisation of their capacity is not undertaken in the near future.

f. Earlier CFP suggestions to create a treasury single account system and a public finance data warehouse (IOS—Simplified Budgetary Information) are still valid and were not considered.

x. Taxation—political ownership of own revenues needs to be strengthened. As explained in the September 2012 Report, the CFP advocates larger responsibility at the local and regional levels to define tax parameters. This does not imply any tax burden increase; more responsibility for providing the financial resources leads to more responsible spending decisions.

a. There is scope in PPL 122: to increase the maximum IRS participation rate, taking into consideration the substantial decline in central government spending with transfers; to give municipal assemblies the responsibility to set the rates of the property tax on rustic units within a centrally defined interval; to give priority to a general reassessment of rustic units. Attention should be paid to the increasing tax capacity asymmetries between urban and rural municipalities, as the reduction on central government transfers will penalise municipalities in low population density territories much more than metropolitan ones in relative terms.

b. PPL 121 insists on setting an asymmetric regional adjustment margin for the tax rates of the three major taxes (IRS, IRC and IVA), allowing regional legislative assemblies to choose actual rates up to 20 percent below those prevailing in the mainland. The CFP proposes a symmetric "–20; +20" percent band around the mainland rates. Again, this does not imply any actual tax increase but reinforces the margin of manoeuvre of regional constituencies and their governments to cope with their financing needs in "rainy days" or to meet eventual regional preferences in favour of larger governments. The role of smaller tax rates as a compensation for the important economic handicap of outermost regions should not be exaggerated as PPL 121 provides several other tools to address this problem.

c. Linked to the transparency requirements mentioned above, the invoices of visible subnational taxes (perhaps the IMI at the municipal level and the IRS at the regional level) could contain the logo of the recipient government and the applicable tax rate as decided by the subnational government, along with information on compliance with fiscal rules.

xi. Transfers from central to local governments—a number of problems deserve attention.

a. PPL 122 states that municipalities whose average tax capitation is below 75 percent of the national average are lifted to 125 percent of that mean. This penalises municipalities whose capitation lies between 75 and 125 percent of the national average and creates a very strange and adverse incentive for municipalities close to but above the 75 percent threshold: if they destroy own tax capacity, they are compensated with a subsidy paid by taxpayers from all other jurisdictions. The legislators may wish to correct this mistake.

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

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

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