LOCAL FINANCE AND FISCAL CONSOLIDATION IN PORTUGAL*

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1. INTRODUCTION

According to the fiscal federalism theory,(1) the local government should gear its activity so as to ensure an efficient allocation of resources, through the provision of local goods and services. The promotion of equity and economic stabilization should be confined to the central government. Additionally, for public spending to be efficient at the local level, the budget constraint imposed on local authorities should make it possible to match the marginal social benefit of expenditure with the marginal social cost of raising revenue to finance such expenditure.

The legislation currently in force in Portugal concerning the tasks and powers of local authorities(2) establishes a distribution of powers that basically complies with the fiscal federalism theory, by concentrating the activity of the local government on the allocation function. The new Local Finance Law of 1998,(3) similarly to the previous one approved in 1987,(4) when defining how the local government can raise funds, envisages the use of borrowing according to rules that allow, in the current economic framework, a significant accumulation of public debt. In addition, the rules on local authority revenue established in both Laws do not allow these entities to have a significant influence on its amount. Consequently, the marginal social cost of raising this type of revenue is not taken into account by the local government when deciding the allocation of resources.

The Local Finance Law of 1998 introduced essentially changes in the calculation of transfers from the State to the local authorities. Taking into account these changes, the first objective of this article is to assess to what extent the approval of the Local Finance Law of 1998 had a positive or a negative impact on the overall general government deficit.

In the context of Economic and Monetary Union, the Stability and Growth Pact (SGP) requires all European Union Member States to achieve in the medium term a fiscal position close to balance or in surplus for the general government as a whole. Table 1 shows the fiscal targets set in the updated Stability and Convergence Programmes submitted to the European Commission between September and December 2001. As it can be seen, Portugal along with Germany, France and Italy, belongs to the group of countries that in 2001 still recorded a significant fiscal deficit and which, therefore, will have to make a greater consolidation effort to achieve a fiscal position close to balance or in surplus within the horizon of the Programmes. As the fiscal targets refer to the general government as a whole, their achievement depends on the consolidated fiscal balances of the several general government sub-sectors, including

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(1) See for example Musgrave, R. and Musgrave, P., Public finance in theory and practice, chapter 27, 5th edition, McGraw-Hill International Editions, 1989.

(2) Law no. 159/99, of 14 September.

(3) Law no. 42/98, of 6 August.

(4) Law no. 1/87, of 6 January.

Table 1

FISCAL BALANCE IN THE UPDATES OF THE STABILITY AND CONVERGENCE PROGRAMMES OF THE END OF 2001

As a percentage of GDP

	2001[(a)]	2002	2003	2004	2005
Stability Programmes					
Belgium	0.0	0.0	0.5	0.6	0.7
Germany	-2.5	-2.0	-1.0	0.0	0.0
Greece	0.1	0.8	1.0	1.2	-
Spain	0.0	0.0	0.0	0.1	0.2
France	-1.4	-1.4	-1.3 / -1.0	-0.5 / 0.0	0.0 / 0.3
Ireland	1.4	0.7	-0.5	-0.6	-
Italy	-1.1	-0.5	0.0	0.0	-
Luxembourg	4.1	2.8	3.1	3.4	-
Netherlands	0.7	0.4	0.2	0.5	1.0
Austria	0.0	0.0	0.0	0.2	0.5
Portugal	-2.2	-1.8	-1.0	0.0	0.4
Finland	4.7	2.6	2.1	2.6	-
Convergence Programmes					
Denmark	1.9	1.9	2.1	2.1	2.1
Sweden	4.6	2.1	2.2	2.3	-
United Kingdom	-0.2	-1.1	-1.3	-1.1	-1.0

Note:
(a) Excluding the receipts from the sale of UMTS licences.

the local government. However, a set of fiscal solidarity rules between general government sub-sectors ensuring the achievement of the objectives set in the Stability Programme for the sector as a whole has not been defined yet in Portugal. In addition, there is frequently a delay in the compilation of data on the budget outturn of some general government sub-sectors, namely the local government, rendering more difficult the monitoring and assessment of the fiscal position of the sector as a whole. Obviously, this situation raises a problem of credibility and feasibility of the targets assumed in the updates of the Stability Programme. Thus, the second purpose of this paper is to present a set of rules ensuring solidarity between all general government sub-sectors in the fiscal consolidation process.

This paper is organised as follows. Section 2 describes briefly the budget constraint of the local government sector in Portugal. Section 3 tries to assess how the Local Finance Law of 1998 contributed to the increase in public expenditure. Section 4 focuses on the changes in the institutional arrangements that will be necessary to ensure that the fiscal consolidation effort will be shared by all general government sub-sectors. Section 5 concludes. It should be highlighted that the problems concerning the recent creation of a significant number of municipal companies are not considered in the analysis.

2. THE BUDGET CONSTRAINT OF THE LOCAL GOVERNMENT

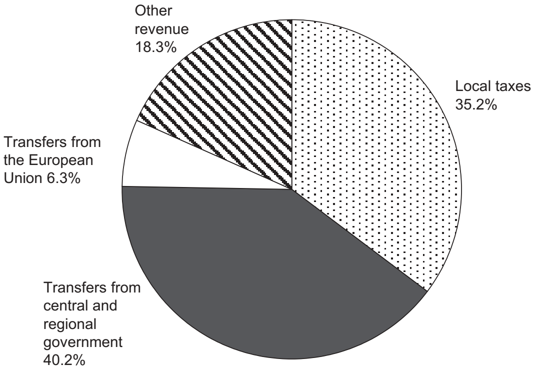
2.1. Revenue

The local authorities revenues are described in the Local Finance Law. Amongst the several sources of revenue established by Law, mention should be made to local taxes, transfers from the central and regional government[(5)] and transfers from the European Union to co-finance investment projects. In 2000 these three sources of revenue as a whole accounted for 81.7 per cent of the total revenue of local authorities (Chart 1 and Table 2). Amongst the local taxes, the most important revenues are the ones from the property transfer tax

(5) It should be noted that transfers from the central and regional government are almost exclusively composed by State transfers.

Chart 1

COMPOSITION OF LOCAL GOVERNMENT REVENUE IN 2000



Source: General Directorate of the Local Government.

Table 3

SHARE OF THE LOCAL GOVERNMENT[(a)] IN THE REVENUE OF THE GENERAL GOVERNMENT[(b)] BY ITEMS IN 2000

Percentage

Total revenue	**5.7**
Current revenue	**5.1**
Direct taxes	11.8
Indirect taxes	1.1
Other current revenue	7.2
Capital revenue	**15.0**

Sources: General Directorate of the Local Government and General Directorate of the Budget.
Notes:
(a) Excluding transfers received from other general government sub-sectors.
(b) Consolidated revenue.

Table 2

COMPOSITION OF LOCAL GOVERNMENT REVENUE IN 2000[(a)]

	Millions of euros	Share of the total
Total revenue	**4 896.7**	**100.0**
Current revenue	**3 513.0**	**71.7**
Direct taxes	1 548.8	31.6
Local property tax	507.8	10.4
Property transfer tax	673.9	13.8
Municipal surcharge	287.3	5.9
Other	79.8	1.6
Indirect taxes	177.1	3.6
Currents transfers	1 091.9	22.3
of which:		
Central and regional government	1 065.9	21.8
European Union	4.0	0.1
Sale of goods and services	379.1	7.7
Other current revenue	316.2	6.5
Capital revenue	**1 383.7**	**28.3**
Sale of investment goods	118.2	2.4
Capital transfers	1 250.5	25.5
of which:		
Central and regional government	901.8	18.4
European Union	303.8	6.2
Other capital revenue	15.0	0.3

Source: General Directorate of the Local Government.
Note:
(a) The revenue composition varies widely among municipalities; the weight of tax revenue is higher in the larger municipalities along the cost, while in the inland areas transfers from the State play a key role.

(*sisa*) (13.8 per cent), the local property tax (*contribuição autárquica*) (10.4 per cent) and the municipal surcharge (*derrama*) (5.9 per cent). Transfers from the central and regional government and from the European Union accounted for 40.2 and 6.3 per cent of total revenue, respectively.

Table 3 shows the share of the local government revenue, net of the transfers received from other sub-sectors, in the consolidated revenue of general government in 2000. It should be highlighted the small share of the local government in the total revenue of the general government (5.7 per cent) and the higher relative weight of the local government in capital revenue (15.0 per cent).

It should be noted that local authorities have a very limited ability to influence the amount of these revenues. Thus, in terms of taxes, it is the Portuguese Parliament that lays down the main rules regarding their implementation. In the case of the property transfer tax, the brackets and the tax rates applicable are set by the Portuguese Parliament, whereas for the local property tax it previously sets a range for the rate to be used by the municipalities.[(6)] With respect to the municipal surcharge, it is the municipality that defines the

(6) The tax rate of the local property tax to be used on urban property must be within 0.7 and 1.3 per cent, while the tax rate on rural property is 0.8 per cent.

tax to be levied, provided that its annual value does not exceed a maximum of 10 per cent of the corporate income tax (CIT) collection generated in the respective geographical area.

Transfers from the State, in turn, are calculated on the basis of rules derived from parameters, which are beyond the scope of the decision-making powers of local authorities. The total amount of resources transferred from the State Budget to the local authorities is defined according to the revenue from some taxes that are considered State revenue. The distribution of funds among local authorities is subsequently made according to several factors, which cannot be affected by their decisions. The method of calculation of this type of revenue is shown in detail in the following section. From the total transfers received by municipalities, 60 per cent are to be included in the respective budget as current revenue and 40 per cent as capital revenue.

Finally, in what concerns to transfers from the European Union, the power that local authorities have to influence the amount received is slightly higher. Indeed, the total amount of the transfers from the European Union is set in the Community Support Framework and its distribution among the several institutions, including the municipalities, depends on the quality and eligibility of the investment projects submitted for co-financing purposes.

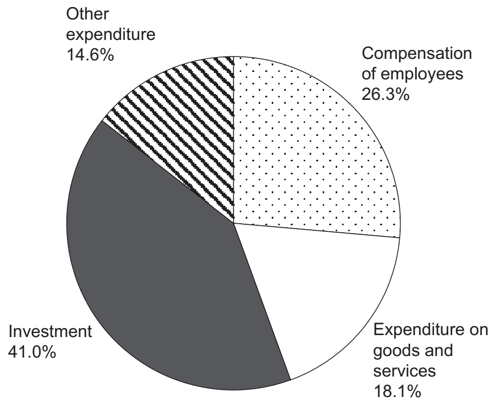
2.2. Expenditure

The expenditure made by local authorities is aimed at the carrying out of projects within the field of their functions and powers, as well as at the financing of the operation of local authority services and bodies. The composition of local authorities expenditure is conditioned by both the distribution of transfers from the State between current and capital revenue and the restraints on the purposes of short, medium and long-term loans. In addition, according to the fiscal rules and principles defined in Decree-Law no. 341/83, local authorities also have to ensure the existence of non-negative current balances. Provided that local authorities comply with these rules, they have full autonomy to decide on the amount and purpose of the resources spent. Chart 2 and Table 4 show the composition of local government expenditure in 2000. As it can be seen, expenditure on investment accounts for a large share of the total (41.0 per cent), followed by compensation of employees (26.3 per cent) and expenditure on goods and services (18.1 per cent).

Table 5 shows the share of the local government expenditure, net of transfers to other sub-sectors, in the consolidated expenditure of the general government in 2000. The share of the local government in the total expenditure of the general gov-

Chart 2

COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE IN 2000



Sources: General Directorate of the Local Government.

Table 4

COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE IN 2000

	Millions of euros	Share of the total
Total expenditure	**5 273.3**	**100.0**
Current expenditure	**2 781.8**	**52.8**
Compensation of employees	1 388.7	26.3
Goods and services	954.7	18.1
Interest	60.4	1.1
Current transfers	310.3	5.9
of which:		
Parishes	54.9	1.0
Other current expenditure	67.8	1.3
Capital expenditure	**2 492.0**	**47.3**
Investment	2 161.3	41.0
Capital transfers	324.2	6.1
Other capital expenditure	6.5	0.1

Source: General Directorate of the Local Government.

Table 5

SHARE OF THE LOCAL GOVERNMENT[(a)] IN THE EXPENDITURE OF THE GENERAL GOVERNMENT[(b)] BY ITEMS IN 2000

Percentage

Total expenditure	**10.0**
Current expenditure	**6.1**
Compensation of employees	8.3
Goods and services and other current expenditure	15.2
Interest	1.7
Subsidies	0.0
Current transfers	1.8
Capital expenditure	**37.9**
Investment	45.5
Capital transfers	19.5
Other capital expenditure	3.9

Sources: General Directorate of the Local Government and General Directorate of the Budget.
Notes:
(a) Excluding transfers to other general government sub-sectors.
(b) Consolidated expenditure.

ernment (10.0 per cent) highlights that the public expenditure decentralization in Portugal is still low, in opposition to the important share of the local government in the total investment of the general government (45.5 per cent). Concerning current expenditure, it should be noted the share of the expenditure associated to the provision local goods and services (compensation of employees and expenditure on goods and services).

2.3. Borrowing

The Local Finance Law also establishes the use of short or medium and long-term loans to finance the difference between local authorities expenditure and revenue. Short-term loans may be used to meet cash constraints, whereas medium and long-term loans, including bonds, are only allowed to finance investment spending or to face situations of structural financial imbalance or financial collapse. The amounts of short-term loans and the annual charges with capital and interest payments of medium and long-term loans are limited by law, depending on the total amount of funds transferred by the State to the local authority and past investment spending. These limits do not include medium and long-term loans contracted for carrying out projects co-financed by European structural funds, within the scope of the Community Support Framework, loans used for the repayment of other loans, loans to meet extraordinary expenditure resulting from public calamity situations, and loans for the acquisition, construction or repair of real estate for social housing purposes.

It should be noted that the setting of limits to the debt burden resulting from medium and long-term loans, in a context of low interest rates, is not a bidding constraint on the deficits and on the growth of the local government debt.

3. THE LOCAL FINANCE LAW OF 1998 AND THE GROWTH OF PUBLIC EXPENDITURE

The main change in the Local Finance Law of 1998 vis-à-vis the Law previously in force, approved in 1987, concerns the calculation of transfers from the State to local authorities. The rules regarding borrowing were also subject to some, albeit relatively minor, changes.

The Local Finance Law of 1987 established a transfer from the State Budget to municipalities, the so-called Financial Balance Fund (FBF) (*Fundo de Equilíbrio Financeiro*). The total amount of this transfer increased at the growth rate foreseen for the value-added tax (VAT) revenue, according to the following formula:

$$FBF_n = FBF_{n-1} \text{x} \frac{VAT_n}{VAT_{n-1}}$$

where n stands for the year to which the State Budget refers.

The allocation of the total amount of the FBF to the municipalities was made according to criteria related to their characteristics. These criteria have been subject to changes over time, but the number of inhabitants has always remained an important factor. In each year, the State Budget Law set the percentages of the FBF that corresponded to current and to capital transfers. The share of capital transfers could not stand below 40 per cent. The parishes did not receive transfers directly from the State, but were entitled to a share of the revenue of the municipalities.

With the new Local Finance Law, the FBF was abolished and the transfer from the State Budget to local authorities was set equal to 33 per cent of the average of the revenue from the personal income tax (PIT), the CIT[7] and the VAT, in the year prior to the draft of the State Budget. Therefore, the transfer from the State to local authorities in year is now calculated according to the following formula:

$$Transfer_n = 0.33 \text{ x } \frac{PIT_{n-2} + CIT_{n-2} + VAT_{n-2}}{3}$$

According to the initial version of the Law, the total transfer to be made was allocated to three different funds: the Municipal General Fund (MGF) (*Fundo Geral Municipal*), the Municipal Cohesion Fund (MCF) (*Fundo de Coesão Municipal*) and the Parishes Financing Fund (PFF) (*Fundo de Financiamento das Freguesias*). The first two funds were a revenue of the municipalities and corresponded, respectively, to 24.0 and 6.5 percentage points (p.p.) of that average. The remaining 2.5 p.p. out of the 33 per cent were directly transferred from the State Budget to the parishes, constituting the PFF. The structure of the transfers from the State to municipalities was subsequently changed[8] with the creation of the Municipal Base Fund (MBF) (*Fundo de Base Municipal*), which corresponds to 4.5 p.p. of the average of the revenue from the PIT, the CIT and the VAT, while the MGF and the MCF represent now 20.5 and 5.5 p.p., respectively. At a first stage, the MGF is allocated to the Autonomous Region of Madeira, the Autonomous Region of the Azores and the Mainland, according to the resident population, the number of municipalities and the area. Within each territorial unit, the allocation to municipalities is made according to two main factors: the resident population and the daily average of nights spent in hotels and camping sites, and the area, weighted by a factor relative to the altitude range of the municipality. The MCF is allocated to the municipalities on the basis of a comparison between the Tax Need Index (TNI) (*Índice de Carência Fiscal*)[9] and the Inequality of Opportunities Index (IOI) (*Índice de Desigualdade de Oportunidades*)[10] of the municipalities and the national average. The allocation of the MGF and the MCF to the municipalities should ensure an increase in the amount of each municipality vis-à-vis the previous year, equivalent to or higher than the forecasted inflation rate. The MBF is aimed at providing the municipalities with the minimum financial capacity for their functioning and is equitably allocated to all of them. From the total transfer received by the municipalities, 60 per cent is included in the municipalities budget as current revenue and 40 per cent as capital revenue. At a first stage, the PFF is also allocated to the three territorial units mentioned above in a way similar to the MGF and, at a second stage, the PFF is allocated to the parishes according to the number of inhabitants, the area and the number of parishes.

Table 6 compares the transfers from the State to local authorities, according to the Local Finance Law of 1998, with the transfers that would take place within the framework of the former Law, from 1999 to 2002. As illustrated in the table, the new rules on transfers from the State to the local government led to a loosening of the budget constraint of this sub-sector, which was not matched by a significant increase in its powers and tasks.[11] Thus, in 1999 transfers of the new funds (MGF, MCF and PFF) accounted for an increase of 19.7 per cent vis-à-vis the FBF transfer in 1998. If the previous legislation had remained in force, the State transfer to the local government would have increased only by 6.3 per cent. In the following years, the growth rates of the transfers to local authorities came closer to those that would have resulted from the FBF, although they are higher in

(7) It should be noted that the value considered for the CIT excludes the amounts related to the municipal surcharge.

(8) Law no. 94/2001, of 20 August.

(9) According to paragraph 2 of Article 13 of Law no. 42/98, of 6 August, the TNI of each municipality corresponds to the difference between the municipal taxes per capita at a national level and in each municipality.

(10) According to paragraph 3 of Article 13 of Law no. 42/98, of 6 August, the IOI represents the positive difference of opportunities for the inhabitants of each municipality, arising from the inequality of access to the required conditions for a longer life, with better standards of health, comfort, basic sanitation and acquisition of knowledge. The annex to Law no. 42/98, of 6 August, explains the formula used for the calculation of the IOI.

(11) The Law no. 159/99, of 14 September, in paragraph 2 of Article 3 establishes that the transfer of tasks and powers is accompanied by the human, financial and property resources needed to accomplish the function transferred, and in paragraph 3 of Article 4 states that the State Budget sets on an annual basis, according to the amount and conditions previously established between the central government and local authorities, the resources to be transferred in order to perform the new tasks. Therefore, these amounts are not included in the transfer from the State to the local government defined in the Local Finance Law.

Table 6

TRANSFERS FROM THE STATE TO THE LOCAL GOVERNMENT

		Millions of euros					Growth rates			
		1998	1999	2000	2001	2002	1999	2000	2001	2002
MGF+MCF+MBF[(a)]+PFF . . .	(A)		1 620.3	1 775.4	2 012.2	2 243.0	19.7[(c)]	9.6	13.3	11.5
FBF[(b)]	(B)	1 354.1	1 438.8	1 594.3	1 757.8	1 888.8	6.3	10.8	10.3	7.4
Difference	(C)=(A)-(B)		181.5	181.2	254.4	354.3				
(as a percentage of GDP) .			0.2	0.2	0.2	0.3				

Sources: State Budgets from 1998 to 2002 and estimates of the Banco de Portugal.

Notes:

(a) The MBF was created by Law number 94/2001, of 20 August.

(b) The figures estimated are based on the amount of the FBF in 1998 and on the macroeconomic estimates and projections of the VAT included in the State Budgets.

(c) Growth rate according to the amount of the FBF in 1998.

2001 and 2002, due to a slowdown in the economic activity. Indeed, in periods of deceleration in the economic activity, the new rule for the calculation of transfers tends to result in a higher amount of transfers from the State, since this rule is based on past values of tax revenue, conversely to the FBF, whose growth depended on the rate of change forecasted for the VAT. By contrast, in periods of economic growth acceleration, the transfer foreseen in the former Local Finance Law would tend to be higher than the total amount of the transfer resulting from the application of the Law currently in force. In 2002 transfers from the State to local authorities as a whole will be 0.3 p.p. of GDP higher than the figure that would have resulted from the application of the legislation in force until 1998, whereas in the previous years this difference stood at around 0.2 p.p. of GDP.

The limits set on borrowing by the local authorities, foreseen in the new and in the former Local Finance Laws, are identical as far as municipalities are concerned. According to the Law of 1987, the amount of short-term loans to municipalities could not exceed 10 per cent of the value of the FBF transfer. In addition, annual charges with capital and interest payments of medium and long-term loans could not exceed the highest of two limits: three twelfths of FBF allocated to the municipality or 20 per cent of the investment expenditure of the municipality in the previous year. The new Local Finance Law kept the limits set on borrowing by municipalities unchanged, using currently the MGF and the MCF instead of the FBF for their calculation, and extends to the parishes the possibility to use short-term loans, provided they do not exceed 10 per cent of PFF.

This naturally raises the question of whether the increase in resources placed at the disposal of local authorities reduced net additional borrowing by the local government or whether it was, by contrast, reflected in an increase in expenditure. Table 7 presents the recent evolution of net borrowing by local authorities from resident monetary financial institutions. Although the new Law only came into force very recently, there seems to be a drive to a higher borrowing by the local government from 1999 onwards, allowed not only by an increase in transfers from the State, resulting from the Law itself, but also by the fall in interest rates in recent years. Therefore, the increase in resources transferred by the State to local authorities has probably given rise to an increase in expenditure by the general government as a whole, thus contributing to a widening of the deficit.

Table 7

CHANGE IN GROSS AND NET OF DEPOSITS BANK BORROWING BY THE LOCAL GOVERNMENT

Millions of euros

		1995	1996	1997	1998	1999	2000	2001
Gross bank borrowing[(a) (b)]	(A)	724.8	790.4	987.8	1 237.6	1 427.9	1 744.8	2 381.7
Change in gross bank borrowing			65.6	197.4	249.8	190.3	317.0	636.8
Deposits[(a) (c)]	(B)	382.6	489.2	471.4	667.4	688.4	663.5	731.9
Net bank borrowing[(a)]	(C)=(A)-(B)	342.2	301.2	516.4	570.2	739.5	1 081.3	1 649.8
(as a percentage of GDP)		0.4	0.3	0.6	0.6	0.7	0.9	1.3
Change in net bank borrowing			-41.0	215.2	53.8	169.3	341.9	568.4
(as a percentage of GDP)			0.0	0.2	0.1	0.2	0.3	0.5

Source: Banco de Portugal estimates.
(a) Figures on 31 December.
(b) Borrowing from resident monetary financial institutions.
(c) Deposits in resident monetary financial institutions.

4. FISCAL TARGETS OF THE STABILITY AND CONVERGENCE PROGRAMMES AND FISCAL RULES FOR THE LOCAL GOVERNMENT

As already referred to in the introduction, the fiscal targets set in the SGP relate to the general government as a whole, i.e. not only to the central government and the social security. This calls for some co-operation among the various general government sub-sectors so as to ensure that the targets assumed in the Stability and Convergence Programmes are achieved. Most European Union Member States have implemented fiscal rules that serve this purpose, regardless of having been or not defined to take into account the implementation of the SGP. Those rules may be more or less comprehensive: in some countries they are actually internal stability pacts, while in others they merely provide for the limits to be set by the central government on the regional and local government borrowing.

In Portugal, the State Budget Law includes limits to the net additional borrowing by the Autonomous Regions of the Azores and Madeira. As to the local government, the limits on medium and long-term borrowing refer to the debt service (capital and interest payments), rather than to additional borrowing in each year or to the stock of the debt. In this context, it is possible that the local government reaches relatively high deficits, which has happened sometimes, in particular, in election years, without the Government having any control instrument. In addition, data on the budget outturn of municipalities are compiled with a lag, not allowing the central government to accommodate possible deviations of the local government deficit from the initial forecasts.[(12)]

With the current financing system of local authorities it is not possible to establish an adequate relationship between the decisions to increase expenditure and the responsibility for raising additional revenue (in particular through tax increases), with the ensuing political burden. This stems from the reduced powers of municipalities to change their revenue, including tax revenue. In fact, "automatic" revenue has a nil marginal cost for municipalities and is used to finance expenditure, regardless of its social utility. Within the current institutional framework, it will only be possible to ensure that the behaviour of local authorities does not jeopardise the fulfilment of the commitments assumed by the country within the scope of the Stability Pact, if annual limits to additional borrowing are set and very strict rules established on the timely compilation of data on the budget outturn. In both cases penalties must be defined

(12) Information on the local government financing calculated by the Banco de Portugal, though with a small lag, is only an approximation to the balance that would result from the financial and non-financial National Accounts.

for institutions that do not comply with the rules, in the form of a suspension or of a partial cut in transfers from the State and / or in the access to the structural funds.

The Public Expenditure Reform Programme, approved in last June, points in this direction, as in the summary of measures made public it includes the control of borrowing by the local government and the approval of a Fiscal Stability Law. The first measure would consist of defining in the State Budget Law, on an annual basis, the limits to the additional borrowing capacity of local authorities. The Fiscal Stability Law would be aimed at ensuring, by means of a legal requirement, solidarity among the various general government sub-sectors, in order to meet the fiscal targets defined for the sector as a whole. This co-operation would consist in the setting of fiscal balances for the various general government sub-sectors, compatible with the fiscal deficit assumed in the Stability Programme. In addition, the Law would also require a timely treatment of data on the budget outturn. In both cases, penalties would be imposed in the event of non-compliance.

The limits set for additional borrowing by the local government are already provided for in the State Budget for 2002, although only in the form of a legislative authorisation. In turn, the Fiscal Stability Law was presented in the updated Stability Programme sent by the Portuguese Government to the European Commission, in last December, as a key measure to the consolidation of public finances.

5. CONCLUDING REMARKS

Within the current institutional framework, increases in resources allocated to the local government, namely due to transfers from the State without a simultaneous transfer of powers, translates necessarily into an increase in general government total expenditure, with a direct impact on the deficit. The implementation of the Local Finance Law of 1998, which led to an increase in the transfers from the State to local authorities, not matched by a significant increase in their powers, resulted, ceteris paribus, in a 0.2-0.3 per cent of GDP increase in the total general government deficit.

The changes in the calculation of transfers from the State to local authorities, introduced in the 1998 Law, tend to increase the general government expenditure and deficit in periods of slowdown in economic activity, compared to what would have occurred under the implementation of the 1987 Law. The opposite occurs in periods of economic acceleration. This effect is due to the fact that the transfer from the State is now based on past values of tax revenue, conversely to the FBF, whose amount depended on the forecasted growth rate for the VAT.

In the Local Finance Laws of 1987 and 1998, constraints on medium and long-term borrowing by municipalities are similar, i.e. they set limits to the annual burden of capital and interest payments, rather than to the stock of the debt or its change. However, the decline in interest rates and the diversification of the methods of financing seen in recent years eased, to a large extent, the limits to borrowing based on the debt service, which can lead to an increase of the local government deficit and debt. This trend may have already started in the past three years.

Compliance with the fiscal targets for the general government as a whole set in the SGP requires a set of rules that ensure solidarity among the various sub-sectors in the process of fiscal consolidation. Those rules should include the setting of limits to additional borrowing by the local government in each year and compulsory deadlines for the compilation of data on its budget outturn. Effective compliance with these rules requires, in addition, the definition of the penalties to be imposed on non-compliant institutions, possibly in the form of a suspension of or a partial cut in transfers from the State or in the access to structural funds.

Turning to the present situation, from the point of view of economic efficiency it would be desirable to make the budget constraint of the local government more flexible in two ways. First, with an increase of the power of the local government to influence tax revenue, e.g. through the widening of the range of the local property tax rates. Second, by means of a reshaping of the transfers from the State to local authorities. On the one hand, the relative weight of the "automatic" transfer from the State should be reduced. On the other hand, it should be created a "non-automatic" transfer fund, whose total amount would be set by the Portuguese Parliament on a discretionary basis, taking into account the fiscal targets set for the general government as a whole. The allocation of this fund to municipalities should be carried out according to the submission of projects, as is currently the case with the European structural funds. Thus, expenditure decisions of local authorities would better reflect the assessment of the associated marginal social costs and benefits. This alternative framework for the local government financing would not put at risk, obviously, an increase of resources in the context of an eventual enlargement of tasks and powers of local authorities.