

LOCAL FINANCE IN PORTUGAL RULES AND PERFORMANCE*

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ABSTRACT

Calls for reform of the Portuguese local finance system have been made in recent years. Most of them address changes in individual items only, such as the equalisation transfers or the real estate taxation. We believe a sound and sustainable improvement of the *status quo* requires a global approach. This paper provides a first step forward in such direction by presenting a comprehensive diagnostic of the current system. The performance of any institution is bounded by rules and so we start by taking a look at the constitutional limits the local administration sub-sector faces. Later, a number of quantitative indicators regarding the actual activity of local governments are produced, focusing on budget discipline, revenue diversification and expenditure scope. The constitutional rules provide guidelines according to which these indicators of performance are evaluated. The assessment of the current state of affairs highlights the direction of required changes. We hope to address them in a future paper.

Keywords: budget rules, local public finance, Portugal.

JEL's codes: H71, H72, H74, H77, R51.

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LOCAL FINANCE IN PORTUGAL: RULES AND PERFORMANCE

The current paper is the first component of an on-going research project on the financing of cities and regions, sponsored by *Fundação Luso-Americana para o Desenvolvimento* (Portuguese-American Foundation for Development). It aims at describing the current state of the Portuguese public finance at the local level. On the one hand, we hope the information to convey may be interesting in itself, shedding light on important economic aspects of the local administration sub-sector, such as budget rules, fiscal size, composition of revenues and expenditures, debt evolution, investment structure and intergovernmental heterogeneity indicators. On the other hand, this informative digest will prove useful for later components of the research project. It provides a motivation for the international comparisons to be drawn in the next report and sets the background for any regime change to be discussed afterwards.

Being closer to the population, local authorities are the first link between the public administration and citizens. The latter trust local authorities a part of their resources; the perceived quality of their management will certainly underpin the community's view about the value for money added by the local administration as well as by all other public sub-sectors.

Thus, knowing the fiscal behaviour of local authorities becomes clearly pertinent. Their performance is constrained by policy rules set up by the central government, which ultimately aim at encouraging a sound financial conduct. Therefore, Section 1 below presents those *constitutional* parameters whereas Section 2 qualifies actual budgetary performance of local authorities in terms of several quantitative indicators. Detailed technical information on data displayed in this chapter is gathered in Section 3.

1 *Budgetary Control Framework*

The Portuguese Constitution (no. 1 of article 238) defines three types of local authorities in the mainland territory: "freguesias" (the lowest rank), municipalities (an intermediate rank) and administrative regions (the highest rank). For the moment, the latter

were not created yet, so local authorities in this chapter comprehend "freguesias" and municipalities only. However, the reader should bear in mind that the financial size of municipalities is overwhelming. In 1988, for instance, all "freguesias" together (over 3,900 units) accounted for just 6 per cent of total consolidated expenditure of the local administration, whereas the municipal share (made up by 275 municipal governments) was 93.6 per cent. District assemblies were responsible for the residual 0.4 per cent.²

Local administration in Portugal is a public sub-sector endowed with financial autonomy. This means local authorities have property of their own and are entitled the right to set up their own budgets and activity plans without permission from a higher-rank authority.

As part of the general government sector, local authorities are nevertheless subject to several control mechanisms monitored by central government agencies; by limiting both revenue access and expenditure choices, these mechanisms aim at assuring a sound fiscal behaviour. One may find three categories of fiscal control: *ex-ante*, *ex-post* and *on-going*. The control of any fiscal action is labelled *ex-ante* when it is performed before the budget exercise to which the action belongs; the control is said *ex-post* if it is exerted after that exercise; *on-going* control refers to central agency interventions performed during the budget exercise itself. This classification has merely expositional purposes.

1.1 *Ex-ante* control

The local authorities' freedom to draft their own budgets is constrained by a number of rules set up by the central government. These rules establish the financial environment within which budget autonomy can be exerted. Let us briefly highlight the main rules concerning the origin and use of local authorities' resources.

¹ The administrative regions are supposed to replace somewhere in the future the old-days district jurisdictions. However, until their instalment, the so-called district assemblies remain formally in force, being also considered as local authorities. In practice, however, most do not operate.

The autonomous services of municipalities belong also to the local administration concept. However, their revenues and expenditures are consolidated within the accounts of the local authorities to which they belong, as ruled by the unity and universality principles of local authorities' budgets (article 8 of Decree-Law no. 341/83, of 21st July).

² Figures worked out in Baleiras (1994) where a methodological introduction to statistical sources on Portuguese local public finance can also be found - on pp. 63-66.

a) Current balance

All local authorities face a non-negative current balance constraint. Each year, current expenditure cannot exceed current revenue (no. 2 of article 9 of Decree-Law No. 341/83, of 21st July). Failure to do so is detectable by *ex-post* control at the latest and is subject to legal action.

b) Debt

Municipalities may borrow under two debt instruments: bank loans and municipal bonds.

The use of these instruments is upper-limited by the Local Finance Act (LFA³ - article 15). Short-term borrowing (whatever its form) cannot exceed, at any moment, 10 per cent of the Financial Equilibrium Fund (*FEF*) transfer allocated on that year to the local authority at stake. Medium- and long-term debt service (*DS*) is subject to the following ceiling:

$$DS_t \leq \max\{0.25FEF_t, 0.2I_{t-1}\} \quad ,$$

where *t* indexes time (annual periods) and *I* stands for investment expenditure. Note, however, that a number of exceptions to this latter ceiling are legally foreseen. In fact, interest and capital repayments on debt issued exclusively to settle municipal liabilities with respect to *Electricidade de Portugal, E.P.* (the Portuguese public utility for electric power) do not count for the above debt service (several State Budget Acts). Loans borrowed to finance public calamity outlays are also excluded from that constraint (LFA - no. 10 of article 15). Likewise, the debt service required by loans contracted for urban renewal and social housing projects, developed by either the central government⁴ or the local authorities⁵, are irrelevant for the medium- and long-term debt service constraint [LFA - no. 9 of article 15; State Budget Act for 1997 (SBA97) - article 22].

³ There is a legal reference list at the end of this report where all legal text entries are fully detailed.

⁴ "PER - Programa de Erradicação de Barracas nas Áreas Metropolitanas de Lisboa e Porto": this is a joint-venture programme between the central government and municipalities to eradicate slums in the metropolitan areas of Lisbon and Oporto.

⁵ Building construction, repair and maintenance as well as symbolic sales of fully developed municipal lots zoned for social housing.

c) Receipts

The LFA (article 4) sets the revenue categories to which local authorities are entitled: local taxes, transfers from the central government and the European Union, user fees and capital goods sales, among less significant items. Local taxes and transfers are the major sources - in 1995, for instance, these categories accounted for 81 per cent of the sub-sector's total revenue.

The value of main receipts is almost insulated from discretionary action by local authorities. All parameters of local taxes are set by the national Parliament. There are only two minor exceptions to this rule: real estate tax ("Contribuição Autárquica") and corporate income tax surcharge ("Derrama sobre o IRC"). In the former case, individual municipalities are free to choose their own tax rate in a narrow band of 0.8 to 1 per cent of the tax base.⁶ The awkward exemption and assessment regimes render this freedom quite insignificant. In the surcharge case, each municipality's rate cannot exceed 10 per cent of the corporate income tax revenue collected in its jurisdiction. Given the minor impact on total receipt these options convey, we may conclude that tax proceedings are virtually insensitive to local policy-makers decisions concerning tax parameters.

FEF and European Union's structural funds are by far the largest transfers to local public budgets. Here again the discretionary autonomy of local policy-makers is very limited. The FEF's share accruing to each municipality results mechanically from an equalisation formula that is legally set up by the central government (LFA - article 10).⁷ The share depends on a number of local structural indicators (such as geographic size and number of residents) whose value is not subject (at least in the short and medium terms) to local discretion.⁸ One should note that at most 60 per cent of each municipality' share should be recorded as current revenue; the exact percentage is fixed annually by the national Parliament in the State Budget Act. This principle obviously matters for rule a) above and for the wage bill rule below. Money from structural funds (and the cohesion fund from 1993 onwards) is allocated to each jurisdiction by a central government agency

⁶ This applies to urban real estates only. The national Parliament sets up the nation-wide tax rate on rural real estate units (0.8 per cent at the present moment). Up to 1995, these rates were 1.1 to 1.3 per cent for urban units and 0.8 per cent for rural units.

⁷ This legal provision has been amended several times by State Budget Acts.

⁸ For an interesting general framework to assess intergovernmental grants, see Ahmad and Thomas (1997). The FEF's equalisation formula can be perceived as a particular case of that framework. Cohn and Costa (1986) provide measures on the equity and efficiency of FEF.

following the procedures set up in the community support framework; the chances of local authorities to influence the transferred amounts rest almost exclusively on their ability to submit eligible investment projects.

On the whole, these features point for a somewhat weak autonomous of local governments *vis-à-vis* the design of their own revenue sources.

d) Outlays

Given the funding constraints outlined in b) and c) above, total expenditure turns out indirectly restricted. Furthermore, the current surplus criterion presented in a) implies a minimum capital expenditure.⁹ Under this budgetary regime, the financial autonomy principle means that local authorities are free to decide "on what" to spend subject to the overall "how much" determined by rules on debt, revenue and current surplus. The scope for expenditure choices matches the list of public goods for whose provision local authorities are legally responsible.

There is, however, a direct expenditure rule to which every budgetary draft and execution must comply with: each year, the overall wage bill cannot exceed 75 per cent of previous year's current revenue (nos. 1 and 2 of article 10 of Decree-Law No. 116/84, of 6th April, as rewritten by Law No. 44/85, of 13th September and Decree-Law No. 198/91, of 29th May).

1.2 *Ex-post* control

The quality of all budget executions is subject to control after their closure. Three central agencies are held responsible for this type of control: *General-Inspectorate of Territory Administration* (GITA), *General-Inspectorate of Finance* (GIF) and *Court of Auditors* (CA).¹⁰

The GITA is part of the Ministry of Equipment, Planning and Territory Administration and investigates the lawfulness of administrative procedures associated with budget execution. The GIF is the Ministry of Finance's inspection agency; as far as

⁹ A non-negative current surplus requirement parallels very much the well-known golden rule concept of public finance [as defined, for instance, in Gaspar (1992)]. It entails a capital expenditure (net of capital revenue) at least equal to the overall deficit.

local authorities are concerned, the GIF examines the lawfulness of property and financial management, aiming at fiscal transparency and discipline. Most local authorities¹¹ are inspected at least once in every electoral tenure. Upon approval by the competent local government body, the accounts of most municipalities and "freguesias"¹² are sent to the CA for auditing. Contrary to the other inspection agencies, the CA, as a judicial institution, is government-independent. Sanctions may be imposed on authorities whose accounts fail to be certified by the Court.

1.3 On-going control

The CA performs also a lawfulness control during each and every budget execution as far as indebtedness, public procurement and wage bill are concerned. By engaging public expenditure, many decisions in these fields require a previous authorisation by the CA without which they are legally void. If permission is granted, the Court issues a Visa. Otherwise, the local authority's decision at stake becomes contractually worthless.

The Visa is not required to local authorities only. In fact, it aims at ensuring the lawfulness of contracts wherever the payer is any public sector body (at either the central, regional or local tier).

Each and every labour contract requires a Visa, whatever its value. All other public expenditure contracts ranging between 9.9 and 493.2 million escudos require a CA's Visa to become effective. All contracts whose amount exceeds 493.2 million escudos must be sent to the CA even before their signature. In these cases, the Visa applies to contract drafts. The thresholds referred to in this paragraph were in force during 1995 and are indexed to civil servant wages.

While assessing loan and labour contracts of the local administration, the Court checks the lawfulness of their form as well as their financial implications regarding the

Footnotes, continued from previous page

¹⁰ In Portuguese: GITA - "Inspeção-Geral da Administração do Território"; GIF - "Inspeção-Geral de Finanças"; CA - "Tribunal de Contas".

¹¹ To be precise, all local authorities whose recorded total outlays are at least two thousand times as higher as the general monthly minimum wage set in force are subject to this inspection (104 million escudos in 1995).

¹² That is, all local authorities referred to in footnote 11. For practical reasons, the CA only examines a random sample of them.

expenditure ceilings set up for these items in Subsection 1.1. Therefore, in these specific cases, the Visa performs also the role of an expenditure direct control instrument.

2 Local Finance Figures

The previous section has outlined the fiscal behaviour rules to which local governments must conform in Portugal. We now want to illustrate how the latter have actually performed in recent years.

The local administration data to be presented in this section refer exclusively to the mainland territory. This option assures statistical coherence with the official general government definition that has prevailed up to the 1995 State budget. According to this definition, the insular local authorities do not belong to the local administration sub-sector, just like the regional governments of Azores and Madeira are not a general government sub-sector.¹³ Anyway, Table 1 below shows the relative magnitude of insular municipalities in the national set.

Table 1 - Share of Azores and Madeira on national municipal finance (1995)

unit: %

	Total revenue	Total expenditure
Azores	2.7	2.7
Madeira	2.6	2.5

Source: Ministry of Planning and Territory Administration.

The public finance data gathered in this chapter have been recorded according to the *public accounting* standard. Local administration figures come from the municipal accounts as published by the (former) *Ministry of Planning and Territory Administration* and data on other sub-sectors originates in the *Ministry of Finance*, unless otherwise stated. At the time this chapter is being written, the municipal accounts of 1995 were already compiled and so the figures below referring to this year bear a definitive nature. However, references to other sub-sectors in 1995 are based on execution estimates because the

¹³ This classification has changed in 1994 with the State budget law for the following year. From then on, the general government definition comprehends the national territory in full.

respective accounts were not closed yet. More methodological information is conveyed in Section 3, where a detailed explanation for individual tables and charts below is also communicated whenever justified. We would recommend the reader to consult the general comments at the beginning of Section 3 before going through the rest of this section.

Subsection 2.1 gives an idea on the relative size of local finance and its soundness. The following subsections stress a few significant indicators regarding revenue, indebtedness and expenditure that might contribute to enhance the appraisal of the sub-sector's fiscal reality in the first half of the nineties.

2.1 Size and fiscal discipline of the local administration

Table 2 displays the local administration dimension in different bases. The sub-sector has never exceeded 10 per cent of the general government sector over the past fifteen years and in 1995 it is actually smaller, nearly 8 per cent. Given this rather little size, eventual general government unbalances are hardly attributable to the sub-sector's fiscal behaviour.

Table 2 - Local administration size in 1995

	Amount (10 ⁹ escudos)	As % of GG ^{a)}	As % of GDP ^{a)}
Total revenue	560.2	8.1	3.6
Total expenditure	553.4	7.3	3.6
a) Estimate. GG - General Government. Source: Ministry of Planning and Territory Administration, Ministry of Finance and Bank of Portugal.			

Moreover, generally speaking the fiscal performance of local authorities does not conceive too much concern. Table 3 brings up some evidence on this respect.

Table 3 - Local Administration surpluses

unit: 10⁹ escudos

	1990	1991	1992	1993	1994	1995
Current surplus	29.8	30.6	45.3	36.2	38.3	56.8
Primary surplus (as % of GDP)	-3.1 (0.0)	0.3 (0.0)	4.0 (0.0)	-22.8 (-0.2)	2.9 (0.0)	22.6 (0.2)
Global surplus (as % of total revenue) (as % of GDP)	-11.2 (-3.6) (-0.1)	-11.0 (-2.7) (-0.1)	-10.4 (-2.2) (-0.1)	-37.8 (-7.5) (-0.3)	-13.2 (-2.6) (-0.1)	6.8 (1.2) (0.0)
Global surplus incl. fin. assets operations (as % of GDP)	-11.3 (-0.1)	-11.9 (-0.1)	-13.9 (-0.1)	-39.6 (-0.3)	-15.9 (-0.1)	3.6 (0.0)

Source: adapted from *Ministry of Planning and Territory Administration and Ministry of Finance*.

In fact, the data reveal a reasonably sound fiscal behaviour in terms of major balances. The current surplus has always been positive, thus complying with the legal requirement mentioned in Subsection 1.1. Other balances, though negative in most years, are clearly small. It may be interesting to compare the size of local global balances with those of the general government. In terms of total revenue, the global surplus of the general government has been: -13.8 per cent in 1991, -9.6 in 1992, -17.7 in 1993, -12.4 in 1994 and -12.3 in 1995.

It is also curious to point out the peak deficit year. The worst unbalance so far in the nineties happened in 1993, which has been an electoral year for local governments. The 1995 balances are also worth notice because they have all been positive for the first time in the decade; the observed period is nevertheless too short to conclude whether the change is transitory or sustained.

To sum up, the fiscal performance of the local sub-sector seems restrained and quite sound on the whole. This gives credit to the budgetary control framework described in Section 1, which looks effective. Note however that this aggregate view on the local administration may be concealing some apprehensive individual performances.¹⁴

¹⁴ Reported figures in this text refer to budget execution, as already mentioned. In some municipalities, there are news of wide deviations between forecast and execution amounts which seem to be the result of systematic over-budgeting practices. The case of the Oporto municipality has been reported in the press several times - see, for instance, "Público" in 21 December 1995, p. 47, and "Expresso" in 13 July 1996, p. 8.

2.2 Revenue

The structure of the local administration revenue (operations with financial assets and liabilities excluded) in 1990, 1993 and 1995 can be assessed in Chart 1. The predominant categories are municipal taxes and the 'fundo de equilibrio financeiro (FEF)', whose joint share in 1995 is almost 69 per cent.



Chart 1 - Local revenue structure

Nominal total revenue grew over 79 per cent between 1990 and 1995 but the evolution has not been uniform in terms of individual items. Table 4 gives a more detailed account on the revenue structure. There are slow-growing categories, like transfers: their overall expansion was under 72 per cent and the rhythm was even weaker in the case of community grants, which have peaked in 1992. Tax proceeds grew at nearly the total revenue pace (79 percent) and the fast-growing categories are own revenue items: sale of services and investment goods augmented 98 per cent while 'other revenue' (which includes penalties and rental income among the main elements) grew 102 per cent. This development is probably the outcome of a deliberate effort by local authorities to compensate with own resources the slackening or income transferred from other public sub-sectors.

Table 4 - Local administration revenue

	Unit: 10 ⁷ escudos					
	1990	1991	1992	1993	1994	1995
Municipal taxes	100.0	114.2	136.6	144.2	152.8	178.9
Transfers	158.9	216.9	251.4	259.3	257.9	272.9
of which: FEF	119.7	148.4	168.4	182.1	186.0	204.9
European Union's Funds	*25.1	*53.1	57.4	50.7	43.4	38.5
Others from sub-sectors	13.5	15.5	25.6	26.5	*28.5	*29.6
Sale of services and investment goods	33.9	44.4	57.6	59.2	59.6	67.2
Own revenue of "freguesias"	-	-	10.8	7.4	-	-
Other revenue	20.4	25.8	34.7	33.1	35.2	41.2
Total revenue	312.6	401.4	481.0	503.0	505.6	560.2
a) Includes own revenue of "freguesias" because the Min. of Plan. and Ter. Adm. did not report EU Funds in this year.						
b) The Min. of Fin. discontinued the publication of this item in 1994; hence, the displayed figure refers to municipal accounts data as published by the Min. of Plan. and Ter. Adm.						
c) Unavailable estimate due to what is explained in note b).						
Total may differ from summation due to rounding.						
Source: adapted from <i>Ministry of Planning and Territory Administration and Ministry of Finance.</i>						

Chart 1, though illustrative of the sub-sector's wholeness, conceals a tremendous municipal heterogeneity. A few pertinent indicators are shown in Table 5. For instance, the tax contribution to total revenue barely exceeds 10 per cent in half of the 275 mainland municipalities, whereas the FEF accounts for at least 51 per cent of available resources in more than half of local jurisdictions. These two leading categories are indeed inversely distributed, as indicated by a negative correlation coefficient of 71 per cent in 1993. Generally speaking, taxes are relatively more important for coastal governments (as an illustration, note the top-share, 58 per cent, is found in Sintra - district of Lisbon), while FEF plays relative dominance among inland jurisdictions (the maximum share, 85 per cent, is reached in Ourique - district of Beja). The weight dispersion is clearly larger in the case of taxes.

Table 5 - Tax and FEF shares on total revenue: municipal distribution parameters (in 1993)

	Maximum	Minimum	Mean	Median	Variat. Coeffic.	Correl. coeffic.
Taxes/Tot. revenue	58.0	1.0	13.9	10.3	87.8	
FEF/Tot. revenue	84.5	12.1	51.0	51.2	31.3	-71.0

Turning back to an overall appraisal of the local sub-sector, we may find the municipal tax structure in Tables 6 and 7. There is a remarkable concentration in just two

out of eight items displayed: tax on transfer of real estate and real estate tax. Their legal incidence falls on immovable property and together they account in 1995 for roughly 65 per cent of collected levies. It is interesting to note how asymmetric has been the evolution of these instruments. The weight of the transfer tax, which is basically an excise tax, has decreased almost 8 percentage points from 1990 to 1995, whereas the share of the real estate tax (an immobile property tax) rose nearly 8 percentage points over the same period. Recent press reports announcing the political will of the Cabinet to extinguish the former and reformulate the latter will likely transform the real estate levy into the single major local tax.

Table 6 - Local taxes

unit: 10⁹ escudos

	1990		1991		1992	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Direct taxation	87.5	87.6	99.2	86.8	118.0	86.4
Tax on transfer of real estate	38.2	38.2	40.5	35.4	48.5	35.6
Real estate tax	26.2	26.2	33.0	28.9	38.0	27.8
Capital gains tax	2.0	2.0	1.3	1.2	0.9	0.7
Corp. income tax surcharge	16.8	16.8	19.8	17.3	23.2	17.0
Vehicle use tax	4.3	4.3	4.6	4.0	7.3	5.4
Other	0.1	0.1	0.0	0.0	0.0	0.0
Indirect taxation	12.4	12.5	15.0	13.2	18.5	13.6
VAT - tourism	5.2	5.2	4.9	4.3	5.3	3.9
Fees and gen. serv. paid by firms	7.2	7.2	10.2	8.9	13.3	9.7
Total tax revenue	100.0	100.0	114.2	100.0	136.6	100.0

Tax classification used by the *Ministry of Planning and Territory Administration*.
Total may differ from summation due to rounding.
Source: adapted from *Ministry of Planning and Territory Administration*.

Table 7 - Local taxes (continued)

unit: 10⁹ escudos

	1993		1994		1995	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Direct taxation	125.1	86.8	131.7	86.2	153.0	85.5
Tax on transfer of real estate	48.8	33.8	53.5	35.0	55.0	30.7
Real estate tax	43.5	30.1	48.5	31.8	61.0	34.1
Capital gains tax	0.6	0.4	0.2	0.2	1.4	0.8
Corp. income tax surcharge	23.5	16.3	21.5	14.1	25.2	14.1
Vehicle use tax	8.8	6.1	7.9	5.2	10.5	5.9
Other	0.0	0.0	0.0	0.0	0.0	0.0
Indirect taxation	19.1	13.2	21.1	13.8	25.9	14.5
VAT - tourism	5.2	3.6	5.6	3.7	5.8	3.2
Fees and gen. serv. paid by firms	13.8	9.6	15.5	10.1	20.1	11.3
Total tax revenue	144.2	100.0	152.8	100.0	178.9	100.0

Tax classification used by the *Ministry of Planning and Territory Administration*.
Total may differ from summation due to rounding.
Source: adapted from *Ministry of Planning and Territory Administration*.

As an already extinguished category, the capital gains tax shows naturally a very tiny and decreasing weight. The composite item "other direct taxes" is so meaningless that one should really consider the elimination of its components by balancing benefits against administrative costs.

The vehicle use tax revenue grew almost 150 per cent in the observed period but most of this raise is explained by the tax regime changes introduced in 1992 - 38 per cent increase in tax rates and an abnormal car sales expansion of 22 per cent due to the reform of the automobile excise tax. More important, we should underline the progression of the composite item "fees and general service payments": 180 per cent in the first half of the decade. The parameters of this category are much more flexible as far as local policy-making is concerned (remember most other tax parameters are set by the central government). This evolution is understandable in the light of the fiscal compensation effort we have alluded to above.

Before closing the subsection, a word about the fiscal size of Portuguese individual municipalities. Size is indeed extremely heterogeneous and exhibits a remarkable geographic concentration. Considering total revenue, we realise in Table 8 that 22 per cent of the sub-sector's overall is collected by just five jurisdictions, four located in the metropolitan area of Lisbon and one in the metropolitan area of Oporto. The top-ten municipalities belong all to metropolitan areas, seven to Lisbon's and three to Oporto's. The capital municipality has attracted resources worth over 63 billion escudos in 1993 whereas half of the 275 mainland jurisdictions had less than 1 billion escudos to manage. At the same time, the *average* municipality has absorbed roughly more than 1.8 billion escudos.

Table 8 - Top revenue municipalities in 1993

unit: 10⁹ escudos

	Amount	Share (%)
1 st Lisbon	63.0	12.5
2 nd Oporto	18.6	3.7
3 rd Oeiras	10.3	2.0
4 th Loures	9.5	1.9
5 th Sintra	9.4	1.9
Top five	110.7	22.0
6 th Cascais	8.5	1.7
7 th Vila Nova de Gaia	7.9	1.6
8 th Matosinhos	7.4	1.5
9 th Almada	6.9	1.4
10 th Setúbal	6.1	1.2
Top ten	147.5	29.3
Local administration total	503.0	100.0
Mean	1.8	
Median	1.0	
Total may differ from summation due to rounding.		

This pronounced concentration favours the conduct of fiscal surveillance exercises. In fact, the timely monitoring of budget execution in larger municipalities may provide a reliable estimation of the evolution in the whole sub-sector.

2.3 Indebtedness

The financial position of the local administration before the domestic monetary sector is briefly described in Table 9. One can see the sub-sector has not always been a net debtor over the observed fifteen years - net debt is the difference between issued debt (commercial and bond loans) and deposits on the monetary sector. Up until 1987, the series of this table are probably undervalued. In fact, many municipalities were paying their goods and services suppliers with considerable delays which, in rigour, were longer than the routine maturity of commercial (short-term) credit. These liabilities were not recorded as formal debt. The public utility for electricity production and distribution, *Electricidade de Portugal, E.P.*, was among those creditors. Interest payments on this particular debt were eliminated for local governments adhering to a specific pay-back protocol and this facility led actually many of them to borrow from the banking system to settle such liability. The incentive to adhere to this protocol was even reinforced in 1989 when

sanctioning procedures addressed to outstanding debtors¹⁵ were set forth by the central government (Decree-Law No. 103-B/89, of 4th April). Moreover, as explained in Subsection 1.1, p. 3, these loans do not matter for the medium- and long-term debt service ceilings set up in the LFA. The 1988 and 1989 jumps in the debt stock (both gross and net) are thus basically justified by a generalised movement towards the formal assumption of a debt stock which was only implicitly acknowledged up until then.

Table 9 - Nominal debt of the local administration

unit: 10⁹ escudos

Year (in Dec.)	Gross debt ^{a)}	Net debt ^{b)}
1979	2.5	-7.1
1980	3.5	-7.2
1981	8.7	-3.9
1982	18.4	4.7
1983	21.8	8.8
1984	24.0	7.5
1985	28.6	8.8
1986	26.8	-0.8
1987	29.1	-7.2
1988	45.4	5.0
1989	51.9	24.2
1990	61.5	26.6
1991	69.2	26.7
1992	86.1	31.5
1993	112.8	72.5

a) Loans and financial investments of the monetary sector.
b) Gross debt net of deposits and other investments of the local administration.
Source: *Bank of Portugal*.

A number of other debt ceiling exemptions have been added in more recent years to stimulate politically high-rewarded local expenditure (slum eradication and other social housing projects - recall the list in p. 3). Furthermore, as will be noticed in Chart 4 below, investment expenditure has experienced a strong impetus since the mid-eighties. Therefore, considering all these factors, the debt acceleration recorded from 1988 onwards is hardly surprising.

As stated before, municipalities can issue two debt instruments. In practice, however, the bond debt is meaningless for the sub-sector as a whole, though it may matter for a few (large) jurisdictions. As an illustration, monetary sector claims on municipal

¹⁵ Municipalities which have not agreed upon a protocol with *Electricidade de Portugal, E.P.*.

bonds live in December 1993 were less than 1.6 billion escudos or just 1.4 per cent of total gross debt.¹⁶

Despite the acceleration we have just mentioned, net indebtedness has never been (at least, so far) a major funding source to most local governments. This fact is brought to our attention in Chart 2, if we compare the shares of indebtedness and total revenue (operations with financial assets and liabilities excluded). Between 1980 and 1993, indebtedness has accounted, on average, for just 2.3 per cent of total funding, which is probably the result of both the constitutional bounds imposed by the LFA and the lacking credibility to access the capital market.¹⁷

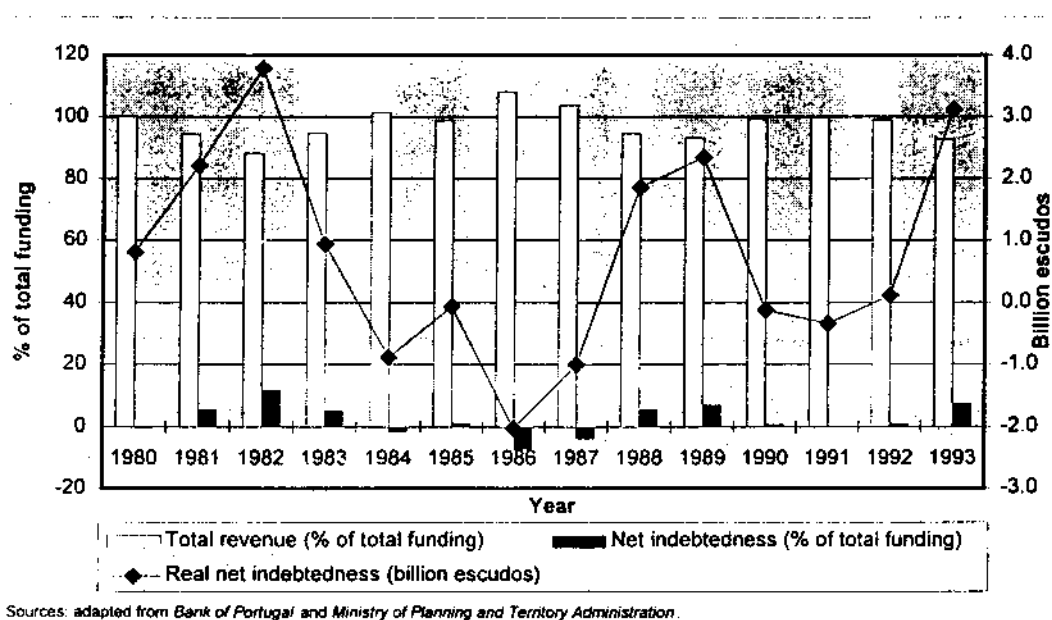


Chart 2 - Net indebtedness and funding shares

An attentive look at the real net indebtedness path reveals a curious matching between peaks and electoral years for local governments (1982, 1985, 1989 and 1993). This seems to suggest the existence of a political business cycle in the local indebtedness pattern.

¹⁶ And note that 1993 is not at all a representative year. Typically, the bond stock has been under 0.4 billion escudos from 1979 to 1993.

¹⁷ Insufficient credibility arises from small size and lack of collaterals, among other reasons.

24 Expenditure

The local administration expenditure in the nineties is exhibited in Table 10 below. Total payments have grown almost 71 per cent at current prices, thus slightly less than total revenue (whose progression of 79 per cent was commented in Subsection 2.2). In fact, we should expect the two series to move closely as total outlays are constrained by the *constitutional rules* on current surplus, revenue and indebtedness we have reviewed in Subsection 1.1. A formal look at the association between spending and receipts from 1978 to 1991 is offered by Barbosa (1992, pp. 10-12).

Table 10 - Local administration expenditure

	Unit: 10 ⁹ escudos					
	1990	1991	1992	1993	1994	1995
Current expenditure	183.8	225.9	263.5	289.3	306.5	333.4
of which: Public consumption	164.6	201.4	233.9	256.7	272.6	293.9
Public debt interest	8.1	11.3	14.5	14.9	16.1	15.8
Capital expenditure	140.0	186.4	228.0	251.5	212.4	220.0
of which: Investment	129.7	171.5	203.2	233.5	197.1	201.9
Total expenditure	323.8	412.4	491.4	540.8	518.8	553.4
Total may differ from summation due to rounding.						
Source: adapted from <i>Ministry of Planning and Territory Administration</i> .						

During most of the observed period (from 1992 to 1995, to be precise), the central government had in force a macroeconomic convergence programme, approved by the Council of Ministers of the European Community (labelled as *Q2* until 1993 and as *Q2 Reviewed* afterwards). These programmes set a nominal ceiling for total expenditure net of public debt interest. This ceiling was compulsory for the central government (State only) and indicative for the general government. However, the central government was committed to do its very best to compensate with reductions in its own expenditure any excessive deviations by other sub-sectors that could jeopardise the general government indicative ceiling. Hence, it is interesting to compare the nominal interest-free expenditure in the two sub-sectors. The yearly average growth rate of this variable between 1992 and 1995 was 4.0 per cent at the local level and 9.2 per cent at the State level,¹⁸ which means that the local administration cannot be blamed for adding major pressure to expenditure ceiling fulfilment.

¹⁸ For 1990-95, the annual average growth rates were 11.2 and 13.7 per cent, respectively. The significant slowdown of local expenditure progression after 1992 is worth mentioning.

Capital expenditure, basically determined by investment outlays, falls after the electoral year of 1993. Curiously, public consumption keeps on expanding afterwards. Besides the eventual political motivation, this asymmetric evolution may also be the outcome of a transitory phenomenon associated to European Union's investment grants; the first community support framework peaked in 1992 and the ensuing framework, initiated in 1994, revealed significant execution lags up to 1996 at least. Certainly, the period in Table 10 is too short and price information is lacking to allow for any grounded comment here. We just wish to note one more coincidence between the electoral calendar and the path of public finance variables.

The structure of local expenditure can be more easily appraised in Chart 3. Despite the drop we have just mentioned, investment is still the major category in 1995 (36 per cent). The next larger expenditure component is the wage bill (33 per cent). Interest payments kept their share (3 per cent) during the whole period albeit the growing indebtedness noticed in Subsection 2.3 - interest rates reduction has mitigated the impact of the debt stock increase.



Chart 3 - Local expenditure structure

Turning back to capital outlays, one should note they distinguish the local from the State sub-sectors. They are clearly a more important item for local budgets. On average, during the six-year period from 1990 to 1995, capital expenditure accounted for about 44 per cent of total disbursements within the local administration and just 11 per cent at the State level, a striking contrast that reflects the different functional assignment of each administration tier.

Chart 4 plots together nominal and real investment. Looking at the nominal path first, we notice a significant increase from 1985 onwards. However, when prices are brought into the picture, the disparity with pre-1985 levels is definitely not so remarkable. More interestingly, the real investment line describes a somewhat regular pattern that, once again, overlaps the electoral cycle.

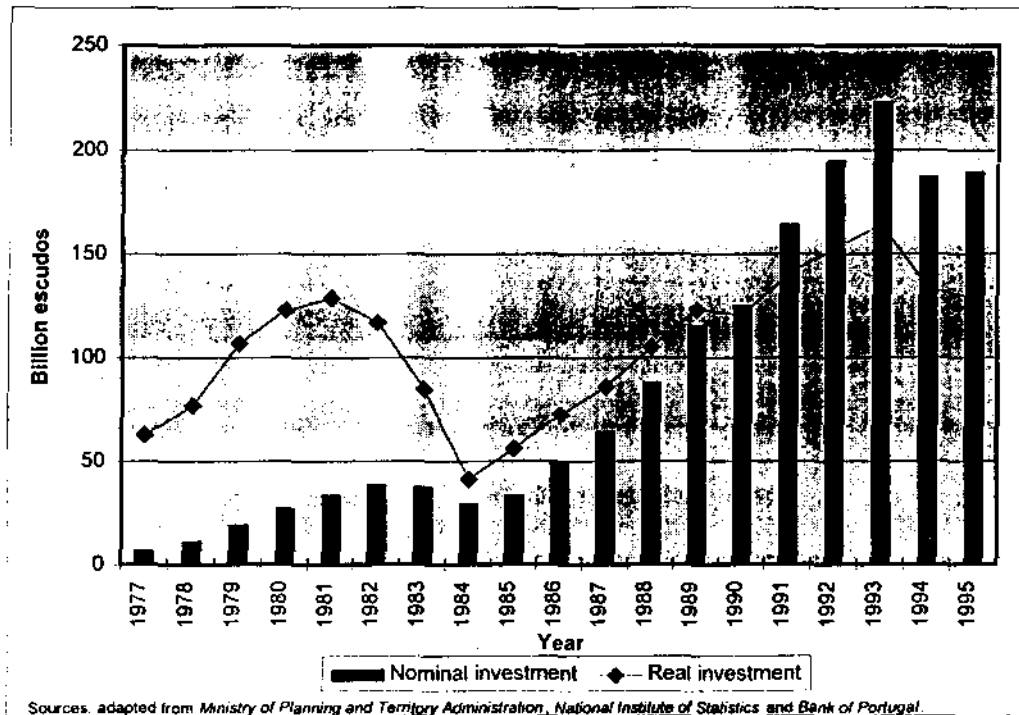


Chart 4 - Municipal investment paths

The structure of municipal investment in 1995 is captured in Table 11. Clearly, in terms of large classes, most capital accumulation comes from public works (84 per cent) whereas land acquisitions take the smallest share (4 per cent only). Proceeding to a breakdown of the public works class, we realise that conveyance network infrastructure absorbed 30 per cent of total investment, building activity accounted for another 30 per cent share (including 12 per cent on housing) while the provision of basic sanitation conditions explains 11 per cent. A finer breakdown is offered in Table 11 below.

Table 11 - Municipal investment structure
(1995 - total of 189.8 billion escudos)

	% in total investment
Buildings and constructions	84.2
Viaducts, streets and complementary works	18.0
Rural conveyance	11.9
Water captation, treatment and distribution	4.9
Sewerage	5.2
Leisure, sporting and school plants	8.8
Housing	12.4
Other buildings and constructions	23.0
Machinery and equipment	6.7
Land	4.4
Other investments	4.8
Total	100.0

Total may differ from summation due to rounding.
Source: adapted from *Ministry of Planning and Territory Administration*.

Table 12 - Top expenditure municipalities in 1993

unit: 10⁹ escudos

	Amount	Share (%)
1 st Lisbon	71.0	13.1
2 nd Oporto	23.3	4.3
3 rd Oeiras	11.5	2.1
4 th Loures	11.0	2.0
5 th Sintra	9.4	1.7
Top five	126.2	23.3
6 th Cascais	8.4	1.6
7 th Matosinhos	8.0	1.5
8 th Almada	8.0	1.5
9 th Vila Nova de Gaia	8.0	1.5
10 th Setúbal	7.7	1.4
Top ten	166.3	30.8
Local administration total	540.8	100.0
Mean	2.0	
Median	1.0	

Total may differ from summation due to rounding.

We close the subsection with a reference to individual size variety. Municipal distribution in terms of total expenditure exhibits a tremendous heterogeneity. In 1993, 23 per cent of total expenditure was incurred by just five out of 275 jurisdictions. The Lisbon municipality alone spent nearly 71 billion escudos whereas the *average* jurisdiction managed just 2 billion. Half of the mainland governments have used up even less, 1 billion escudos at the maximum. Moreover, as reported in Table 12, we find precisely the same geographic concentration we did trace in Table 8, p. 14, for the case of total revenue. The ten largest municipalities belong all to the metropolitan areas, seven to Lisbon's and three

to Oporto's. The top-five list is an exact replica of that in Table 8. The top-ten contains the very same municipalities, though with a different ranking from the 7th to the 9th positions.

3 Further Remarks on Data Series

This section aims at providing technical information which seems necessary to fully understand the contents of tables and charts inserted in Section 2. We present some general remarks first, which regard most data, and then list specific notes pertaining to individual objects.

First of all, the monetary unit used everywhere is the Portuguese escudo.¹⁹ Most amounts are expressed in billion escudos, where 1 billion equals 10^9 .

We use local public finance data produced by three institutions:

- *Ministry of Planning and Territory Administration*²⁰ - Directorate-General of Local Administration ("Direcção-Geral da Administração Autárquica"- henceforth, *DGAA*);
- *Ministry of Finance* - Agency for the Analysis of State and State-Owned Firms Financing ("Gabinete para a Análise do Financiamento do Estado e das Empresas Públicas" - henceforth, *GAFEEP*);
- *Bank of Portugal* - Department of Statistics and Economic Studies (Departamento de Estatísticas e Estudos Económicos").

The local administration definition differs across these institutions. According to *DGAA*, local administration is made up of municipalities only. For *GAFEEP* and the Bank of Portugal, local administration comprehends municipalities and "freguesias". The geographic coverage of their definitions has also changed overtime. Up to 1988, *DGAA* have published data of mainland governments only.²¹ *GAFEEP* and Bank of Portugal have excluded the autonomous regions of Azores and Madeira from the general government definition up until 1994, thus ignoring all insular municipalities and "freguesias" on their local administration sub-sector's scope. As our quantitative digest in Section 2 gathers information from 1979 to 1995, we restricted our attention to local administration in the

¹⁹ Indicative exchange rates in March 1997 for 100 escudos are 0.513 ECU and 0.588 USD.

²⁰ Changed in 1996 to *Ministry of Equipment, Planning and Territory Administration*.

mainland territory only for the sake of statistical coherence. Moreover, in order to provide a comprehensive outlook, we have stuck to the wider local administration definition used by GAFEEP and Bank of Portugal whenever appropriate.

We decided to disentangle financial operations from revenue and expenditure items. Hence, there is a separate subsection devoted to indebtedness and financial investments of the local administration (Subsection 2.3). Consequently, flows associated to financial assets and liabilities are excluded from the revenue sources examined in Subsection 2.2 and the expenditure categories observed in Subsection 2.4 (unless otherwise noticed).

We now present explanatory notes applying to some tables and charts only. They are listed by order of appearance in Section 2.

Table 2

The general government account and the gross domestic product (GDP) were not definitely established at the time this chapter was written. Hence, the shares of the local administration sub-sector bear an estimate nature.

The sub-sector amounts reported refer to mainland only whereas both the general government amounts and the GDP refer to national aggregates, thus comprising mainland and the autonomous regions of Azores and Madeira. Moreover, the general government definition includes the regional and local administrations of Azores and Madeira, which were not the case before 1994 (this is due to methodological changes introduced by the Ministry of Finance in this year). Taking out the insular regional and municipal accounts, the general government revenue and expenditure estimates in 1995 become 6663.3 and 7375.8 billion escudos, respectively. The shares of the (mainland) local sub-sector relative to this narrower (old) set, are 8.4 per cent for revenue and 7.5 per cent for expenditure. These shares have already been larger in the past: for instance, in 1992 they were 9.2 and 8.5 per cent, respectively.

The data processed in this table come from *DGAA* (local administration definitive account), *GAFEEP* (general government account estimates) and *Bank of Portugal* (GDP estimate).

Footnotes, continued from previous page

²¹ DGAA have published recently national aggregates of municipal accounts going back to 1986 - see *Ministério do Planeamento e da Administração do Território* (1995, vol. 1) - but, to our best knowledge, they

Continues on next page

Chart 1

Data for this Chart come directly from Table 4, though with a different breakdown.

Table 4

Comments to Chart 3 below explain why total current expenditure and total capital expenditure of the local administration sub-sector computed by GAFEEP perfectly match those computed by DGAA for the set of municipalities. As a consequence of the assumptions therein justified to consolidate the sub-sector, so too the total revenue of GAFEEP's local administration concept must coincide with the municipal total revenue recorded by DGAA. The revenue consolidation is done as if the "freguesias" were transferring their *other revenue* to municipalities, *i.e.* their total revenue net of transfers received from municipal authorities. Basically, the *other revenue* item is made of central government transfers and own resources (namely, property income, user taxes and permit fees - listed in articles 18 to 20 of the Local Finance Act). Unfortunately, the GAFEEP does not publish these receipts as a single item; they are dispersed by the categories *other current revenue* and *capital revenue* of the local administration; incidentally, this procedure explains why total current revenue and total capital revenue computed by GAFEEP coincide with the homologous figures recorded by DGAA.

We wished to offer in Table 4 a finer breakdown of local administration revenue, namely by sorting out the "freguesias" own revenue (that is, their total revenue net of all public transfers received). A somewhat more complex procedure was deemed necessary.

"Municipal taxes" as well as "FEF" and "Structural Funds" transfers were collected directly from the municipal accounts published by DGAA. Likewise, "Sale of services and investment goods" and "Other revenue" were computed as rearrangements of DGAA's original data. In other words, all these items are municipal receipts. The item "Other transfers from public sub-sectors" was built up on GAFEEP's own information on each sub-sector's outflows. Their collection "Análise do Sector Público Administrativo e Empresarial" has published until 1993 the total amount transferred to the local administration set (note this figure includes transfers to municipalities and "freguesias" as well)²² by the other sub-sectors together. Therefore, item "Other transfers from public sub-

Footnotes, continued from previous page

have no published data on the individual municipalities of Azores and Madeira up until 1988.

²² And, probably, includes also the central government transfers to district assemblies.

sectors" in Table 4 consists on the difference between total transfers to the local administration made by other public sectors (as published by GAFEEP), and the FEF and European Union's Funds (as published by DGAA).²³ Finally, the item "Own revenue of 'freguesias'" stands as total revenue of "freguesias" net of any transfers received from either municipalities or other public sub-sectors and was derived as a residual in Table 4.²⁴ Note this residual category is an estimate whose reliability hinges on the plausibility of GAFEEP's assumptions regarding the finance of "freguesias" - listed as notes on Chart 3 below.

Tables 5, 8 and 12

The reported figures were computed by the authors out of the municipal accounts database created by DGAA and published in their collection "Finanças Municipais". Though available at the time this chapter has been written, the databases referring to 1994 and 1995 were not published so far and, contrary to previous behaviour, the agency did not disclose the magnetic files to the authors.

Table 9

Most notes to Chart 2 below apply here too. In particular, gross debt is therein defined as the sum of two stocks: banking loans (l_t) and issued bonds (b_t). Net debt is gross debt less deposits and other municipal investments (m_t) for which the monetary sector of the economy is liable. The statistical source has discontinued data publication in 1993.

Chart 2

Total revenue refers to all local authorities' collected income but the receipts generated by financial assets and liabilities. The series is drawn from DGAA (see the notes to Chart 4 for full reference).

Total funding adds net indebtedness to total revenue.

²³ Unfortunately, GAFEEP has discontinued the publication of their information in 1993; hence, the figures shown in Table 4 for 1994 and 1995 are drawn from DGAA's data and so they exclude transfers to "freguesias" and districts.

²⁴ Due to GAFEEP's discontinuation noticed in footnote 23, it is not feasible to estimate the "Own revenue of 'freguesias'" from 1994 onwards.

Net indebtedness is defined as the annual change on the net debt stock of local governments. As explained in Subsection 1.1, municipalities may borrow under two instruments: commercial bank loans (denote them as l_t , where t indexes the year) and bond issues (b_t). The latter have been very limited during the observed period and all issues have been subscribed by the domestic banking system. At the same time, local governments hold deposits and other investments in the domestic banking system (m_t). So, the net debt in a given year t is

$$d_t = (l_t - m_t) + b_t$$

Therefore, net indebtedness is simply $\Delta d_t \equiv d_t - d_{t-1}$. Real net indebtedness ($r\Delta d_t$) refers to the change on the net debt stock corrected for price changes. The price series retained for this purpose is the deflator of gross domestic product at market prices (p_t). Hence,

$$r\Delta d_t = \frac{d_t}{p_t} - \frac{d_{t-1}}{p_{t-1}}$$

All data required to set these series up come from *Bank of Portugal's* sources. The financial variables introduced above are reported on the consolidated balance sheet of the monetary sector and are available on a monthly basis. As all other statistical information on local public finance is available on an annual basis only, we have just retained the December figures reported by the central bank. This table has been published in the Quarterly Bulletin up to Vol. 16, Nos. 3/4 (September/December 1994) and discontinued from then on. Therefore, the series in Chart 2 end in 1993.

The GDP deflator (1977=1) is drawn from a central bank's working paper, Santos *et al.* (1992). However, their series ends in 1991. To extend it up to 1993, we resorted on another central bank's publication, the "Relatório do Conselho de Administração", issues of 1993 to 1995, where annual growth rates of the general price index implicit in the GDP at market prices are published. Thus, we have assumed that the price deflator produced by Santos *et al.* (1992) grew in 1992 and 1993 at those rates.

Table 10

The remarks to Chart 3 below apply here too.

Chart 3

All expenditure items come from the local governments' accounts published by DGAA in "Finanças Municipais", several issues. As explained before, this source only gathers municipal data and there are no collected accounts of "freguesias" for recent years. So, to derive figures for the whole local administration sub-sector, we had to make some assumptions. Actually, the Ministry of Finance (GAFEEP) uses them to produce the central government budget. The procedure is detailed in Baleiras (1994, Annex). Basically, it consists on supposing that the "freguesias" accounts balance every year such that the local administration disequilibria are those actually reported on municipal accounts. Furthermore, municipal transfers to "freguesias" are assumed to be spent by them according to a particular key, regularly checked up and updated. For the years displayed in Chart 3, the key in use is:

- 50 per cent of current transfers are used by "freguesias" to pay the wage bill and the remaining 50 per cent are spent on the purchase of goods and services;
- 100 per cent of capital transfers are allocated by "freguesias" to investment.

Consequently, both the current and the capital expenditure overalls of the local administration sub-sector (shown on Table 10) perfectly match those reported by DGAA.

Besides this care for the freguesias' expenditure, the items displayed in Chart 3 proceed from a rearrangement of the information published by DGAA.

Chart 4

Data on nominal investment expenditure is taken from local governments' accounts as published by DGAA on several issues of their collections of "Finanças Municipais" and "Administração Local em Números" as well as on their paper "Despesas de Capital dos Municípios em 1977", October 1979. This agency, however, has no record of local governments' accounts in the years of 1984 and 1985. So, to complete the series, we resorted to the general government accounts (local administration column) published by the *Bank of Portugal* on "Relatório do Conselho de Administração", issues of 1985 and 1986.

The series has been deflated with the gross fixed capital formation deflator implicit in the quarterly national accounts published by the *National Institute of Statistics*. The base period to which constant prices refer is the year of 1990.²⁵ We have retained the fourth quarter of each year as the relevant period to deflate our annual series of nominal investment.

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²⁵ The *National Institute of Statistics* uses the annual national accounts to set base periods for the quarterly national accounts.

Legal entries

Decree-Law No. 341/83, of 21st July (sets the budgetary documents of local authorities).

Decree-Law No. 116/84, of 6th April, as amended by Law No. 44/85, of 13th September, and Decree-Law No. 198/91, of 29th May (sets the organisation of municipal departments).

Decree-Law No. 103-B/89, of 4th April (sets the settlement mechanism of municipal debt to *Electricidade de Portugal, E.P.*).

LFA - Local Finance Act ("Lei das Finanças Locais"): Law No. 1/87, of 6th January, as amended by Decree-Law No. 470-B/88, of 19th December, Correction to Decree-Law No. 470-B/88, of 28th February 1989, Law No. 101/89, of 29th December, Law No. 65/90, of 28th December, Law No. 2/92, of 9th March, and Decree-Law No. 37/93, of 13th February.

SBA97 - State Budget Act for 1997 ("Orçamento do Estado para 1997"): Law No. 52-C/96, of 27th December.