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**TOWARDS THE REFORM OF LOCAL  
FINANCE: THE CASE OF PORTUGAL**

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### ABSTRACT

This paper deals with the main characteristics of a good system of local fiscal institutions and takes into account the contributions of local finance literature. Given that it is a normative issue, the first part starts with a brief review of the three main ethical criteria of efficiency, equity and liberty. There follow some implications of the normative framework for the definition of characteristics which a system of local fiscal institutions should have. Finally a critical appraisal of the Portuguese system is developed. The main conclusions are: (i) the present situation where mobile factors are taxed differentially across jurisdictions and immobile factors more or less uniformly, should be reversed; (ii) the current tax on the purchase of state property (*siza*) should be either suppressed or its distortionary effects minimised; (iii) the creation of special local authorities providing single *merit* goods (such as education) should be seriously considered; (iv) local taxes are mainly based on property and should search for other tax bases that are more elastic in relation to GDP so that economic growth does not lead to increased centralisation of revenues.

# Towards the Reform of Local Finance: the Case of Portugal

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A government which attempts to do everything is aptly compared by M. Charles de Rémusat to a schoolmaster who does all the pupils' tasks for them; he may be very popular with the pupils, but he will teach them little.

J. Stuart Mill

## 1. Introduction

When considering fiscal reform at a local government level, some simple questions come to mind which economists should be able to give an answer to or at least clarify.

Among the relevant issues which need a clarification are the following: which goods and services should be provided by the local public sector ? What are the expenditure and fiscal responsibilities that should be allocated to each tier of government ? Which institutions should be in place to provide local public goods? How should these institutions be financed ?

These issues, being normative, assume a previous clarification of the relevant *normative* criteria underlying an answer to these problems. On the other hand the

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comprehensive development of the literature on local public finance and fiscal federalism over the last thirty years has also produced some empirical findings (sometimes in contradiction to predictions from theoretical models) which are also crucial elements for an understanding of the questions stated above.

Usually economists deal with these issues *one at a time*. Division of labour between economists, and the wide development of the literature in this area indicates that it is wiser to use this strategy and in reality it yields the usual benefits associated with the division of labour. On the other hand the complexity of most fiscal systems also supports a *partial* analysis.

However, it is useful at some stage to address these issues all together in a unique framework: what does the local public economics literature suggest regarding the choice of local fiscal institutions and how can this drive local fiscal reform ?

This paper tries to give an answer to this problem and deals with fiscal and institutional design at a local government level. It is structured in three main parts. Firstly, developments in local public finance are considered in order to clarify major contributions towards local fiscal reform. In this context section 2 deals with three important trends in the literature (the Tiebout tradition, the median voter framework and the equalization approaches). Secondly, the "optimal" characteristics of a local tax system in a unitary state are discussed in section 3. Finally, the Portuguese case is analysed taking into account the characteristics of a "good" tax system. Section 4 introduces the main features of local government finance in Portugal and section 5 discusses local fiscal choice for this particular case.

## **2. Efficiency, Equity and Liberty**

Literature on local public economics can be related to the three main normative criteria of efficiency, equity and liberty. The former two were the traditional criteria used in the literature from mainly the late sixties on and the latter was considered from the early eighties onwards.

Efficiency in the local public sector followed two main strands of literature which it is possible to label as the Tiebout and the median voter traditions. These consider

respectively an *interjurisdictional* and *intrajurisdictional* approach to efficiency in the local public sector.<sup>2</sup>

Tiebout-like approaches consider a *decentralized* economy with local public goods, provided by competing jurisdictions with individuals who migrate mainly with fiscal motivations (i.e. searching a "package" of tax/expenditures that suits their preferences). Citizens reveal their preferences mainly through their *exit* option, i.e. through the threat or the real option of leaving the jurisdiction. On the other hand within the median voter tradition, a *decentralized* government is also assumed where local governments are able to set tax rates and also the pattern of local expenditures. Further assumptions are the existence of local political competition and symmetric information between local politicians, bureaucrats and voters. Therefore, in this case citizens may reveal their preferences *within* the jurisdiction.

Overall efficiency implies considering simultaneously intra and interjurisdictional efficiency and prior to that proving the existence and stability of an interjurisdictional equilibrium (i.e. no individual can increase his utility by moving to another jurisdiction) and political equilibria within each jurisdiction. The general conclusion of the literature that addresses the problem of existence, stability and uniqueness of an equilibrium (or equilibria) in a decentralized economy with competing local jurisdictions, local public goods and migrant individuals is that under reasonable assumptions such an equilibrium does not exist. It only exists and is stable if strong assumptions are made (i.e. the ability of local governments to impose perfect zoning regulations or to use Lindahl taxes).<sup>3</sup>

As far as political equilibria in each jurisdiction are concerned, the median voter model has been increasingly criticized in respect of its ability to explain local political decision-making. Monopolistic and bureaucratic models taking into account the asymmetric information between politicians, bureaucrats and voters have received increasing attention in the literature.

Therefore even if an interjurisdictional equilibrium and intrajurisdictional equilibria exist, the provision of local public goods is likely to be inefficient, i.e. only under

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<sup>2</sup>For a survey of local public economics emphasizing this distinction see Rubinfeld (1987). The empirical median voter literature is discussed in Inman (1979) and approaches following Tiebout are reviewed in Zodrow (ed.) (1983).

<sup>3</sup>On the existence and stability of an equilibrium see among others: Rose-Ackerman (1979), Bewley (1981) and Epple, Filimon and Romer (1984).

very unrealistic assumptions will the Pareto efficient conditions on consumption and production be satisfied simultaneously.

The Tiebout and median voter models might have a limited scope in so far as a *positive* approach to local public economy is concerned, although their *normative* implications are still valid and useful. With Tiebout the majority of economists agree that lowering the costs of mobility between jurisdictions and improving the information to residents on the tax-benefits "package" offered by each jurisdiction will *improve* efficiency at a local level. On the other hand the role of voters within each jurisdiction would be increased whenever the fiscal institutions at a local level were shaped according to the institutional framework implicit in the median voter model.

While the previous literature emphasizes allocative efficiency at a local government level, another strand of literature has been addressing the issue of intergovernmental relations between different tiers of government in what has come to be known as fiscal federalism issues. A sub-topic of this literature, which is particularly relevant here is the normative analysis of intergovernmental grants with equalization purposes and the concept of equity underlying grants design.

The usual approach to equalization considers that the upper tier government should equalize the ability of each lower tier jurisdiction to provide a certain bundle of local services with similar quality and having the same tax effort. Intergovernmental grants with equalization purposes aim at offsetting disparities among communities in their tax bases, production function of local services, prices of production factors and "needs". It is clear that the equity concept involved here is organic in the sense that it relates to communities and not to individuals.

The idea of equalization is relatively simple and straightforward, although its application in real grants design is much more problematic. Municipalities provide different bundles of goods and there is therefore the problem of defining the bundle of goods which should be the target of equalization. Production functions of local *services* are functions of local public *goods* produced with public sector inputs and also functions of the characteristics of the communities. In which sense does equalization take this problem into account? Are there economies of community size (or economies of agglomeration) so that equalization should also consider community size? This leads to another problem which is to know the nature of local public goods. If they are publicly provided private goods (and assuming constant returns to scale in

production) there are no economies of agglomeration. On the other hand if they are mixed goods with a considerable degree of "publicness" then community size should be considered in equalization .<sup>4</sup>

Economists are far from reaching a definitive answer to these problems and therefore systems of grants design have very different properties across countries.<sup>5</sup>

However, the equity approach underlying almost any system of intergovernmental grants has embedded in it two main ideas. Firstly, that there should be a redistribution of revenues from rich jurisdictions to poor ones and secondly an implicit assumption that the goods/services provided by local governments are merit goods, i.e. goods that every citizen should be able to consume independently of his preferences, income or "tax-price". Only the merit goods argument seems to justify the need to use the grant system to redistribute income between communities. In fact if the aim of policy is to make income redistribution (between individuals) it would be more efficient to use the tax system and not the grants system.<sup>6</sup>

Therefore, there is an important conflict between allocative efficiency in the local public sector and equity as incorporated in the general philosophy of intergovernmental grants with equalization purposes.

Under the efficiency rationale local public goods are envisaged as goods/services where consumption is non rival and the pattern of benefits is limited to a infranational geographic area with no spillovers to its neighbourhood.<sup>7</sup> This indicates the existence of a local market failure and suggests public provision of the goods, the demand for which (assuming a median voter model) would be a function of the income, "tax-price" and preferences of the median voter in each jurisdiction. In this context the wide variation in the level and composition of expenditures across local governments would be explained by these factors and other particular communities' characteristics.

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<sup>4</sup>The issue of the "publicness" of local public goods has been widely discussed in the literature and will not be addressed in here. On this topic see Oates (1988), Edwards (1990) and Pereira (1994a).

<sup>5</sup>It is being assumed that normative criteria (such as equalization) play an important role in grants design. Nevertheless, several authors (Faith (1979), Inman (1988), Alperovich (1984), Pereira (1994b)) who developed positive approaches to intergovernmental grants pointed out that there are other factors (namely political) which are important in explaining grants design.

<sup>6</sup>Empirical evidence even suggests that intergovernmental lump-sum grants to a local government are *not* tantamount to a set of lump-sum grants to the residents of the community given their respective tax-shares (the *flypaper* effect). This effect still reinforces the argument that grants should not be used to operate income redistribution.

<sup>7</sup>This is the definition of *pure* local public goods which has been used widely by Stiglitz. As he acknowledges this is the case limit in local public goods which is the parallel to the concept of pure public goods. In reality local public goods do not fall into this polar category.

It is also important to point out that in the traditional approach to fiscal federalism (Oates (1972)) it is allocative efficiency which justifies political decentralization either in a federation or in a unitary state. The argument is that federal (or central) government provision of local public goods would mean a *uniform* provision which would imply efficiency losses since the diversity of local preferences would not be taken into account. However, to associate political decentralization with an increase in efficiency it is necessary to assume either a Tiebout *effect* or a median voter *effect*, i.e. it is necessary to assume that citizens reveal their preferences for local public goods either through migration (being sorted out in communities by preference affinities) or through the vote in local political processes (assuming that the median voter drives local politicians). As a consequence if it is assumed that there are significant costs of mobility<sup>8</sup> and if the median voter model is *not* a good approach to explain local political decision-making, the argument for political decentralization *on efficiency grounds* breaks down.

The equalization approach and its implications for local public economics are quite different and may be in conflict with the efficiency approach stated above. Under the equalization approach local public goods are seen as *constitutional* merit goods<sup>9</sup> and in this sense local governments should provide either a *uniform* level of quality of these services or at least a minimum level of services. Under this framework there is much less scope for political decentralization since local preferences are respectively either irrelevant or not very important.

This difference in approach to the provision of local public goods (either the result of *local* preferences or the result of *general* constitutional provisions) introduces some important issues of fiscal and institutional design. One problem is to know whether merit goods and other local public goods should be provided by the *same* local authority or by different authorities. Another issue concerns the finance of these goods according to the specific institutional framework chosen.<sup>10</sup> We will return to these problems in the last section.

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<sup>8</sup>It can also be assumed that migration is not mainly a function of fiscal variables but employment opportunities for example. If this is the case only within metropolitan areas the Tiebout model may have some good explanatory capacity.

<sup>9</sup>When Musgrave defined *merit goods* it was not clear who in society gives the *merit* attribute to a particular good. Since merit goods can be either public or private, and in theory any goods can be considered in that category it seems important to clarify how and where is the *merit* defined. The proper place is in our opinion the Constitution. That is why the *constitutional* label was introduced.

<sup>10</sup>An example of this problem is the finance of education in U.S.A. school districts. The debate concerning the desirability (and the Constitutionality) or not of using the property tax to finance local education illustrates the opposition between the efficiency and equalization rationales.



For the time being it is worth considering a third approach to the role of local governments in a multi-tier system of government related to a concept of liberty and one which is distinct from the efficiency and equalization rationales.

The issue of fiscal responsibilities at a local level has also been addressed from a more politico-constitutional framework and authors who have adopted this approach usually support political decentralization grounded in some form of the principle of subsidiarity, i.e. that only those functions that can not be dealt with by the lower tier governments should be left to upper tier governments. J. Stuart Mill (1910) and De Tocqueville (1835) believed that political decentralization is a necessary condition for building responsible citizens. Contemporary political scientists also see in federalism a structure to balance and spread power in society avoiding an excessive concentration in the single entity of federal or central government.

However, the major influence on local public finance literature has come from public choice scholars who give particular importance to *liberty*, which is the basic normative criterion justifying political federalism and is also instrumental in achieving efficiency.

Liberty, in the Wicksellian sense of absence of external coercion<sup>11</sup>, is increased by political decentralization since it enlarges citizens ability to express their *voice* and *exit* options and therefore to constrain potential monopolistic or "Leviathan" governments. On the other hand, it is suggested that decentralization may constrain the overall size of government since competition among local governments can be a substitute for constitutional fiscal constraints on federal governments.

From the contractarian and libertarian approaches the central problem is to appraise the *characteristics* of the institutional arrangements in order to see if they enable citizens to constrain their governments using their *voice* or *exit* options.<sup>12</sup>

### 3. Some characteristics of a "good" local tax system

A good system of local finances within a multi-tier system of government should have the property of what might be called federalism stability. By this it is meant that *relative* fiscal revenues of different tiers of government should be stable, i.e. the

<sup>11</sup>Public choice scholars (e.g. Buchanan, Wiseman) like to establish their research program in the tradition of Wicksell who argues that just taxation would imply absence from coercion. However, it is very seldom said that Wicksell assumed that society had a reasonably acceptable income distribution *prior* to the parliamentary stage where political decision-making was about mere efficiency issues.

<sup>12</sup>Approaches to fiscal federalism from a public choice perspective are developed in Wiseman (1990) and Brennan and Buchanan (1980) chapt. 9.

structure of revenues should not automatically change with either economic growth, inflation or any other change of the macroeconomic environment. In this context it is important that the elasticity of the main central government tax revenues in relation to GDP is not dramatically different (e.g. superior) from the revenue elasticities of the main sources of local governments revenues. In fact, if this was the case there would be an automatic increase in the centralization of revenues within the fiscal system towards a greater share of central government revenues in periods of economic growth.

A second characteristic of a good local tax system has to do with efficiency both in the sense of allocative efficiency in the provision of local public goods and of minimizing the excess burden of taxation to finance them.

Allocative efficiency alone would suggest that for each relevant local public good there should be a different local authority providing it with open political competition and totally or partially financed by local revenues so that marginal changes in expenditures are financed by marginal changes in local revenues. The geographic boundaries of the local authority should match the spatial nature of benefit incidence from the local public good. In this case there are neither benefit "spillovers" or "spillins", and the beneficiary citizens reveal their preferences and share (at least marginally) the costs of provision of local public goods. In this case the median voter in each jurisdiction could have an important role.

On the other hand, to minimize distortions in the local economy suggests that there should not be a differential treatment of capital across jurisdictions since this would impair the optimal location of economic activities. Taxes should be broad-based with no (or few) exemptions or incentives unless they are intentionally designed to correct problems of market failure.

Another characteristic which should be considered is the simplicity of the tax system (small number of revenue sources) and the low costs in running the fiscal system and the local political institutions. The existence of several local authorities providing each one a different service, will naturally increase administrative costs and there are economies of scope which are not realized. Therefore when considering unifunctional authorities it is necessary to be aware of the allocative efficiency benefits but also the administrative costs ( and costs of foregone economies of scope) associated with such institutional arrangement.

Related to the efficiency criterion is the comprehensiveness of the local system in the sense that every economic agent which uses in the same way local services (including the infrastructure) should be liable to contribute to local revenues either through the tax system or through user charges. In this context it is important to consider residents, non-residents (commuters and tourists) and business. On efficiency grounds there is some presumption in favour of user charges and providing local goods in the *form* of club goods<sup>13</sup>. Whenever this is not possible or desirable allocative efficiency suggests the use of "benefit" taxes.<sup>14</sup>

Considering now the provision of *merit goods*, institutional design should aim at an easy monitoring of the level of quality of these services and provision should not depend essentially on the particular tax bases of the jurisdiction. This indicates a greater role for intergovernmental grants in the finance of these goods as compared to other local public goods.

A system of local finance can not leave redistribution at the discretion of *each* local authority particularly when considering redistribution through local taxation and through the differential incidence of social expenditures (e.g. welfare programs). In fact if any jurisdiction implements several redistributive programs it will attract those more in need, which will be mainly low income people. They will put an extra pressure on the local fisc and will contribute much less to local revenues (assuming finance through the property tax)<sup>15</sup> so that this community will find itself sooner or later in a difficult financial situation. However, it can have a redistributive character in so far as expenditures on local public goods are considered since the pattern of incidence of benefits from expenditures is much less evident than the incidence of local taxation or of welfare programs.

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<sup>13</sup>Assuming the consumption is rival, there is possibility of exclusion at a low cost and a more or less competitive market in the provision of the service. Only under these conditions would clubs have efficiency enhancing properties. To provide a local good in the form of a club suggests usually privatization, although public ownership of a club is also possible (e.g. public swimming-pools).

<sup>14</sup>The problem is to identify which taxes are "benefit" taxes. Hamilton (1976, 1983) has been considering the property tax a benefit tax, when supplemented with appropriate zoning regulations. However, Mieszkowski and Zodrow (1989) argue that it is a tax on capital.

On the other hand, the introduction of the community charge ("poll tax") in Scotland, England and Wales was supported with the "benefit tax" argument. It is also highly controversial that the poll tax is a benefit tax.

<sup>15</sup>This is the main reason why Oates (1972) and Musgrave (1984) suggest that the redistributive function should be allocated to central government.

#### 4. Local institutions and local finance in Portugal

In comparison with European countries members of the OECD, Portugal is one of the most centralized countries. In order to have a better understanding of the political and economic centralization of the Portuguese fiscal system it is important to bear in mind that Portugal had almost fifty years of dictatorship. This ended in a dramatic but peaceful revolution in 1974 which established a democratic regime in the continental territory (and Atlantic islands of Azores and Madeira) and brought to an end the colonial period. The fact that there are no deep linguistic, cultural or ethnic divisions in its population, that Portugal is one of the oldest European countries with stable borders, led to a preservation of a unitary state where political centralization remained even after the transition to democracy.<sup>16</sup>

There are two tiers of government, central and local, and only one kind of local authority - the municipalities (*municípios*) - which are non overlapping jurisdictions which cover all the country. The municipality is therefore the traditional and unique local institution<sup>17</sup> which is composed of two political bodies each of them elected by popular suffrage: the council (*câmara municipal*), which has the executive power, and the local parliament (*assembleia municipal*).

Political centralization brings with it economic and fiscal centralization and we have already argued elsewhere (Pereira 1993) that Portugal is one of the more (if not the most) centralized of European countries (members of OECD). There are several criteria under which centralization can be analysed and measured, but of them the centralization of current consumption expenditures by levels of government seems a good indicator. Another important factor is the legal framework and in particular whether or not local governments are able to raise autonomous revenues.

Considering the expenditure dimension of centralization, it is possible to have some useful information from table 1 which shows the ratio of final consumption expenditures by levels of government to general government expenditures. It can easily be seen that Portugal leads the more centralized countries with central

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<sup>16</sup>It is useful to compare the situation of Portugal with neighbouring Spain, which also had a long period of dictatorship and started the transition to democracy roughly at the same time. In Spain, cultural differences grounded on different idioms (particularly in the Basque country and Catalonia) brought about the emergence of autonomy and political decentralization after the end of dictatorship.

<sup>17</sup>There are other two local institutions considered in the Constitution: *freguesia* and *regiões administrativas*. The former is also a local political authority with elected members but with very small responsibilities and budgets. The jurisdiction of each municipality incorporates several *freguesias*. The regions, although considered in the Constitution, were not created yet.

government being responsible for 89% of final consumption expenditures<sup>18</sup> and followed at some distance by Greece (71%), Belgium (67%) and the United Kingdom (61%). On the other hand Scandinavian countries (Sweden, Norway, Finland and Denmark) and federal or confederal countries (Germany, Austria and Switzerland) form a group of the more decentralized countries being the only ones where central government expenditures do not reach 40% of general government final consumption expenditures.

	1	2	3	4	5	6
	Gen.Gov. GDP	Cent.Gov. Gen.Gov.	Loc.Gov. Gen.Gov.	Prov.+Loc. Gen.Gov.	Soc.Sec. Gen.Gov.	CG+S.S. Gen.Gov.
Belgium	17,07%	66,66%	27,01%		6,33%	72,99%
Denmark	25,28%	31,14%	68,15%		0,71%	31,85%
France	19,37%	57,95%	21,96%		20,10%	78,04%
Germany (W.)	20,06%	18,87%	17,81%	49,00%	32,18%	51,06%
Greece	20,40%	70,56%	19,93%		9,51%	80,07%
Ireland	18,56%	49,65%	48,62%		1,73%	51,38%
Italy	16,44%	54,37%	42,95%		2,68%	57,05%
Luxemburg	15,74%	66,10%	28,14%		5,76%	71,86%
Netherlands	16,18%	46,19%	49,19%		4,61%	50,81%
<b>Portugal</b>	<b>15,52%</b>	<b>87,62%</b>	<b>8,80%</b>		<b>3,57%</b>	<b>91,20%</b>
Spain	14,72%	46,97%		32,00%	21,03%	67,99%
United Kingdom	20,80%	60,92%	37,82%		1,26%	62,18%
Austria	18,91%	37,48%	19,36%	41,36%	21,16%	58,64%
Finland	20,36%	30,30%	66,43%		3,27%	33,57%
Norway	43,48%	37,26%	61,32%		1,41%	38,68%
Sweden	27,62%	27,17%	71,50%		1,33%	28,50%
Switzerland	13,35%	24,23%	30,85%	71,98%	3,80%	28,02%

Source: Calculations based on OECD's National Accounts 1978-1990, Paris

Note: CG+S.S. means central government and social security.

Table 1 Final Consumption Expenditures by Levels of Government in OECD European Countries (1985)

The centralization of expenditures within the government structure is only one relevant issue of the Portuguese case. The other, which is related to the legal framework, is that local governments have a low degree of ability to raise local revenues. As can be seen from table 2 local receipts in 1992 come from three main sources: half from intergovernmental grants (from European Union and Central Government), a quarter from taxes and the rest from a miscellany of user charges,

<sup>18</sup>Considering the ratio of gross fixed capital formation by levels of government the share of central government is smaller (60%). However, even in this case Portugal is only surpassed by Belgium as far as centralization is concerned (Pereira (1993) pag. 165).



fees, penalties, other minor revenues and borrowing. The real degree of autonomy is mainly within this last group of revenues as it will become apparent below.

First, it is worth making some remarks on the evolution of fiscal revenues since Portugal joined the EEC (1986). Local taxes jumped in 1987 since in that year a new *local* tax was introduced - the *sis*a - which is a selective expenditure tax on the acquisition of immobile property (housing included) and immediately became the major source of local taxation.<sup>19</sup> This expenditure tax on property and the property tax are the two main sources of local taxation followed by a surcharge on corporation income tax.

	1986	1987	1988	1989	1990	1991	1992
Taxes	18%	25%	30%	29%	30%	27%	27%
Property Tax*	na	8%	9%	8%	8%	8%	7%
Tax on Capital Transactions*	-	7%	10%	11%	12%	10%	9%
Surch. Inc. Tax (Corporat.)***	na	4%	5%	4%	5%	5%	5%
Other Corporation Taxes	3%	3%	4%	3%	4%	4%	4%
Other Individual Taxes	na	3%	2%	2%	2%	1%	2%
Intergovernmental Grants	63%	56%	49%	48%	48%	51%	49%
Central Governm.	na	47%	39%	37%	36%	35%	33%
Europ. Union	na	na	na	na	na	na	11%
Other Gov. Trf.	na	9%	11%	11%	12%	16%	5%
Fees, Penalties and oth.	3%	3%	3%	3%	3%	3%	3%
Services	6%	6%	6%	6%	6%	6%	6%
Borrowing	4%	3%	4%	6%	6%	5%	6%
Other Revenues	7%	7%	8%	9%	8%	8%	9%
Total Revenues	100%	100%	100%	100%	100%	100%	100%
Tot. Rev./GDP	2,67%	3,05%	3,19%	3,36%	3,41%	3,76%	3,94%

Source: DGAA Finanças Municipais (1986, 1987, 1988, 1989, 1990, 1991, 1992)

\* *Contribuição Autárquica*, \*\* *Sisa*, \*\*\* *Derramas*

Table 2 The Structure of Revenues for Portuguese Local Governments

Intergovernmental grants have been losing importance since European membership and within intergovernmental grants, lump-sum grants from central government (*FEF*) have been decreasing while grants from the European Union have been increasing<sup>20</sup>. This suggests that after joining the EU there has been a progressive shift

<sup>19</sup>The *sis*a used to be a central government revenue. The OECD classifies it under the sub-heading of "taxes on financial and capital transactions" and this label is used in table 2.

<sup>20</sup>Note that grants from the EEC/EU were initially consolidated with other central government grants into "other intergovernmental grants" and amounted to 9% in 1987. The same two categories totalled 16.4% in 1992, EU transfers being only 11.2%.



of fiscal responsibilities from the state to the union particularly concerning the finance of capital expenditures to which most European funds are allocated.

Since local tax revenues are relatively exogenous to local authorities and the same is happening with intergovernmental transfers, it is mainly through other revenues (including borrowing) that local governments finance their increasing expenditures.

The reason why local taxes are mainly exogenous is basically that tax *rates* are in a great degree defined by central government. This is totally the case with the expenditure tax on property ( *sisa* ) which is designed to introduce some progressiveness into the tax system since it has the same pattern as the income tax (exemption up to a minimum value and increasing marginal rates). There is a unique schedule of rates common to all municipalities and defined by central government. In fact this tax was before 1987 a central government revenue and it maintains the structure of a central government tax.

As far as property tax is concerned the degree of legal ability to change rates is very limited since the rate for rural property is fixed and the rates for urban property can only change within a narrow range. An important problem with the property tax is the uneven assessment of property values, since there has been no direct assessment for many years and similar houses are assessed differently according to the year when they were on the market. This characteristic of the property tax together with the existence of the expenditure tax on property creates important distortions in the housing market which will be discussed in the next section.

Turning now to the third major source of local taxation, surcharges on corporation income taxes (*derrama*), it is here where there is a greater degree of rate flexibility. The *derrama* is an optional local tax which can only be used for financing investments or when the municipality has financial difficulties. The local authority can set the rate up to 10% of the local corporation income tax yields and it is interesting to note that (in 1993) 60% of authorities have a nil rate, 38% apply the *maximum* rate and only the remaining 2% set the rate at an intermediate level. This suggests that local authorities are still in a learning process regarding the manipulation of local rates and are not completely aware of tax competition between municipalities and the fact that high rates can drive investment out of the jurisdiction. This is so much so that among the municipalities that apply the maximum rates are some of the more underdeveloped and depressed areas (e.g. municipalities from the region of *Alentejo* ).

Finally the other business taxes, are mainly a fixed proportion from the value added tax (VAT) in specific sectors of activity (e.g. tourism) and therefore rates are not under the control of the municipality.

## **5. Towards institutional and fiscal reform in Portugal**

It is not the aim of this paper to present a comprehensive proposal of fiscal reform in Portugal but to present some principles that should drive that reform (or the research in the direction of reform) taking into account the characteristics of a "good" system of local finance and the particularities of the present Portuguese system.

The main direction for fiscal and institutional reform seems to be political and economic decentralization which implies mainly a shift of central government functions (and thus expenditure responsibilities) towards local governments. Three possible dimensions of decentralization are: (i) an increased capacity on the part of local governments for raising their own revenues (ii) the creation of new special authorities providing single services (a major candidate being education) and (iii) a greater diversification of tax bases (not so much relying on property), which is a necessary condition for federalism stability.

The approach to institutional and fiscal reform will be made in two stages. Firstly, the general constitutional and institutional framework will be discussed and secondly more specific issues concerning local fiscal design will be analysed.

The Portuguese Constitution is ambiguous as far as the structure of government is concerned since it seems to favour political decentralization but on the other hand does not create the institutional framework to make decentralization operative. In fact the Constitution establishes three levels of government or more precisely three tiers of political authorities, including an intermediate level (the administrative regions) to be created by law. Moreover, it is relatively flexible regarding institutional design since it allows for the creation of new local authorities and for changing boundaries of existing ones. On the other hand the fundamental law disallows the existence of regional parties (or political parties which have regional aims) and perhaps more importantly creates real barriers to entry in local political "markets" since only national parties can present candidates at local elections. This has obvious

implications for the functioning of local democracies and restricts the potential role of the median voter in each jurisdiction.

Another constitutional provision which is important is the definition of which local services can be considered *constitutional merit goods*. Basic education is certainly a service which falls into this category since consumption is compulsory and free of charge to those who do not want to enrol in the private sector. Health services to a lesser degree could also be considered meritorious goods since the Constitution establishes that they are to be provided almost free of charge.

Bearing these provisos in mind it is possible to address now the issue of institutional design. The main issue is to know whether there should be a *unique* local authority providing several local services (as is presently the case<sup>21</sup>) or if for certain services special organizations (public or private) should be created providing single functions (e.g. education, road maintenance). The main advantage in having multi-purpose authorities is related to economies of scale and particularly with economies of scope in the production of local public goods. In low density areas the economies of joint production suggest the superiority of the plurifunctional arrangement. As we move to larger and more populated communities the case for having unifunctional authorities providing special services becomes stronger.

There are several arguments developed earlier which support unifunctional authorities or special districts. The first advantage is informational since there is a better understanding of the real cost and output associated with a particular service. Moreover, the institutional framework in this case would be more appropriate for giving a greater role to the median voter in each jurisdiction and therefore efficiency gains could be expected. Another advantage is that it enables the earmarking of revenues to expenditures in particular services, which is not possible under Portuguese law.<sup>22</sup> In particular when the local service is a constitutional merit good monitoring becomes easier and there is independence between allocative decisions regarding the provision of merit goods and other local public goods. This independence is important since it means that there can be no increase in the provision of local public goods at the expense of merit goods. Moreover, together with an appropriate choice of revenue structure it will imply that provision of merit goods by a special authority will not be affected by the financial situation of the plurifunctional authority providing other local public goods in the community. In

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<sup>21</sup>The only exception is the existence of local public firms (*serviços municipalizados*) dealing with the provision of water and the maintenance of the water and sewage infrastructure.

<sup>22</sup>See Bill 1/87, *Lei das Finanças Locais*, artigo 2º.

particular it will not be negatively affected by a situation of fiscal stress in that jurisdiction. We have argued elsewhere (Pereira 1993, 1994b) that due to an inappropriate scheme of intergovernmental grants design, urban communities in Portugal are in a relatively weak fiscal position compared to medium or small communities and that as a consequence of fiscal stress they tend to underprovide local services particularly those less "visible", as is the case with education. In this context and given the arguments put forward above a strong case seems to exist for the development of special education authorities.

In relation to other local services a more detailed analysis would have to be made taking into account benefits and costs associated with *three* alternative arrangements: provision within a multifunctional *political* authority, provision by a special political authority and provision by a special organization (private or public firm).

Whether political decentralization means only the creation of new special authorities with the same hierarchic level<sup>23</sup> (although with geographic boundaries wider than the municipalities) or also the creation of an intermediate tier of government is still an open issue. One way or the other there is, however, a strong case for decentralization on efficiency and equalization grounds but also on a political constitutional basis.

Addressing now the reform of local fiscal revenues it is worth starting with the main weaknesses of the Portuguese local fiscal system. Firstly, the more important sources of tax revenues are related to the property tax base, which is relatively inelastic in relation to GDP, so that an increase in revenue centralization is to be expected with economic growth. Secondly, capital is taxed by local governments with more flexibility while property is subject to similar tax rates, which contradict the characteristics of a "good" local tax system discussed above as regards the distortionary effects of local taxes. This suggests that we should move in the opposite direction of taxing capital more or less uniformly across jurisdictions and allowing more discretion concerning property tax rates. In particular the surcharge on business income tax (*derramas*) should become more uniform, at a positive rate and exemptions or deductions could be considered only in particularly depressed areas to encourage new investment. If the harmonization of the *derramas* was achieved near the maximum rate used at present (10%) this would increase tax revenue from this

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<sup>23</sup>As Musgrave points out (1984 pg. 503) "While some services call for nationwide, others for statewide, and still others for metropolitan-area-wide or local units, *the argument so far does not call for an ordering of "higher level" and "lower-level" governments.* Rather, we are faced with coordinate units covering regions of different sizes." (our italics).

source which would be desirable according to the *federalism stability* criterion. The importance of business income taxes in local taxation is due not only to the benefit principle (firms are usually using the local infrastructure) but also to the fact that it creates correct incentives for local governments to develop their regions and attract new investment with a view to increasing revenues in the future.<sup>24</sup>

As regards the taxation of property the situation is more complex since there are two important taxes (property tax and expenditure tax) with different effects and rationales. Although both taxes have distortionary effects in the housing market the expenditure tax has much deeper negative consequences. In the first place it penalizes buyers of new houses (except low budget ones which are exempt) and therefore depresses the housing market. Secondly, distorts consumption and production leading to an oversupply of cheap houses and underproduction of medium range and expensive property. Last but not least it is an invitation to fiscal evasion since everyone (but the fisc) benefits from undervaluation of the market price.

Of course the main argument supporting this tax is not related to efficiency but to equity, given the somewhat redistributive nature of the tax, and therefore the problem could be seen as increasing equity at the expense of efficiency. If this were the case we would have the familiar efficiency/equity tradeoff and the solution would depend on ethical judgements (or the social welfare function). However, the expenditure tax does not satisfy the horizontal and vertical equity criteria and therefore even on equity grounds does not seem defensible. In fact identical individuals (in incomes, etc.) having preferences for houses with the same value will pay different taxes if one (for whatever reason) changes house more frequently. On the other hand a rich household living in a wonderful location pays no expenditure tax while a relatively poor household who is trying to increase its standard of living (and therefore changing house) will pay the tax.

Therefore there is a strong argument either for the suppression of the expenditure tax (*sisä*) or if this is not possible for a change in the structure of rates. Tax harmonization within the European Union seems to suggest that under the former hypothesis a value added tax would have to be introduced at a normal rate. Considering that housing is a basic need of the population this could be very unpopular and politically unfeasible.<sup>25</sup> As a second best measure, the expenditure tax (*sisä*) could be maintained but with a

<sup>24</sup> Even if business income tax exemptions are granted for new investments for some initial years local governments should be compensated by foregone revenues.

<sup>25</sup> Note that if a low rate of VAT could be introduced there would be no problem at all.

progressive alignment of the marginal tax rates towards more uniform rates. This would be a rough substitute for VAT at a low rate and in this way distortions in the housing market could be minimized.

As regards the property tax, moves towards greater rate flexibility would have to be cautious and proceed in two major steps. The first and most delicate one is to reassess property values, a measure that has been repeatedly postponed due to the political sensitivity of the issue. Only after the assessment is done, the housing market adjusted and the incidence on households and firms of the "new" property taxes understood is it possible to proceed to the second stage of implementing a progressive liberalization of the local tax rates.

Finally, we have mentioned the importance of local taxation not being based mainly on taxes related to the property tax base and the consequential desirability of considering *also* other tax bases. The possibility of increasing the surcharge on business income taxes (fixing a unique rate) has already been suggested and another possibility is to increase the number of services where a proportion of VAT goes to local governments.<sup>26</sup>

A comprehensive reform of the institutions of local government finance would have to consider also the design of intergovernmental grants. Although this topic is beyond the scope of this paper, the discussion so far suggests that whenever institutions that provide merit goods are independent of institutions that provide other local public goods grants to the former institutions should have a predominantly equalizing aim while grants to the latter institutions should have a mere revenue sharing objective.

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<sup>26</sup>At present it is only a percentage of the VAT on touristic related activities which is directed to local governments.

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