

## Chapter 1

# Solid foundations for a sustainable fiscal consolidation

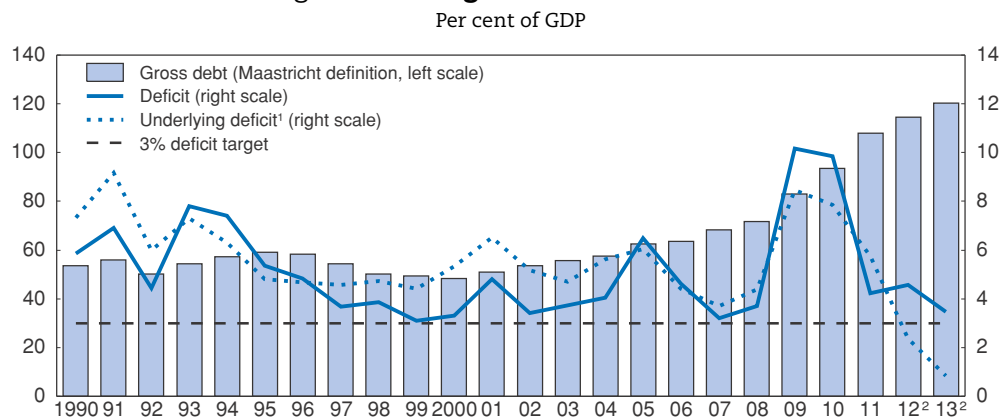
Owing to slow growth and a relatively weak fiscal position, Portugal's public debt had been rising for almost a decade when the global crisis struck, sharply increasing the deficit. The loss of confidence in Portuguese and other euro area sovereign bonds required international financial support. Weak fiscal performance reflects a wide range of fiscal structural problems resulting in poor control of expenditure. At both the central and local levels, this was compounded by the non-transparent accumulation of payment arrears, future spending obligations via public-private partnerships (PPPs) and off-balance sheet debt in state-owned enterprises (SOEs). In line with the EU-IMF programme, the government is steadfastly implementing an ambitious front-loaded consolidation plan underpinned by a wide range of structural reforms. In a context of weak private sector demand, the government's ability to regain control over public debt dynamics depends crucially on avoiding spending overruns. This will require reinforcing the fiscal framework to improve expenditure control, tackling payment arrears and avoiding further negative surprises from loss-making SOEs, PPPs and local governments. The success of the programme will also require maintaining social consensus around it, notably through continuous attention to its implications for the poorest. If growth is far lower than projected in the programme, the automatic stabilisers could be allowed to operate at least partially to reduce the risks of a deeper recession and higher unemployment.

## Introduction

Portugal has a long record of fiscal deficits. In the past two decades, the fiscal deficit never fell significantly below 3% of gross domestic product (GDP), despite resort to one-offs to improve headline figures. This situation, combined with weak growth, resulted in a gradual but sustained rise in public debt since 2000. In 2009, debt increase shifted to a much steeper path as the deficit deteriorated dramatically to 10.2% of GDP (Figure 1.1). Rising debt, weakening growth prospects and turmoil in the euro area led to a loss of investor confidence and access to long-term market finance at sustainable interest rates. Portugal entered an European Union-International Monetary Fund (EU-IMF) financial assistance programme (hereafter referred as the programme) in May 2011.

This chapter discusses Portugal's fiscal situation and progress in dealing with the underlying drivers of the weak fiscal position. The first section analyses the risks around debt sustainability, and how consolidation should be designed to minimise harm to medium-term growth and maintain public support for the programme. This is followed by a discussion of the fiscal framework including measures to improve expenditure control. A final section covers efforts to deal with the large off-balance sheet liabilities and inefficiencies built up in state-owned enterprises (SOEs), public-private partnerships (PPPs) and local government and with the use of EU structural funds.


Figure 1.1. **Long-run fiscal indicators**



1. Cyclically adjusted less one-offs.

2. Projections.

Source: OECD (2011), OECD Economic Outlook: Statistics and Projections (database), May.

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## The consolidation programme: how fast and with which instruments?

### The speed of consolidation and risks around achieving debt sustainability

The government aims to reduce the public deficit to 4½ per cent of GDP in 2012 and 3% in 2013 as part of the EU-IMF programme, and projects the public debt ratio to peak at 116% of GDP in 2013 and then start declining (Table 1.1). Due to the need to make up for the large

Table 1.1. **Stability programme targets and assumptions**Per cent of GDP<sup>1</sup>

	2010	2011	Targets and assumptions				
			2012	2013	2014	2015	2016
<b>Public balance</b>	<b>-9.8</b>	<b>-4.2</b>	<b>-4.5</b>	<b>-3.0</b>	<b>-1.8</b>	<b>-1.0</b>	<b>-0.5</b>
Expenditure	51.3	48.9	47.5	45.9	44.6	43.8	43.0
Revenue	41.4	44.7	42.9	42.9	42.8	42.7	42.5
Public debt (Maastricht definition)	93.3	107.8	113.1	115.7	113.4	109.5	103.9
Real GDP growth (%)	1.4	-1.5	-3.0	0.6	2.0	2.4	2.8

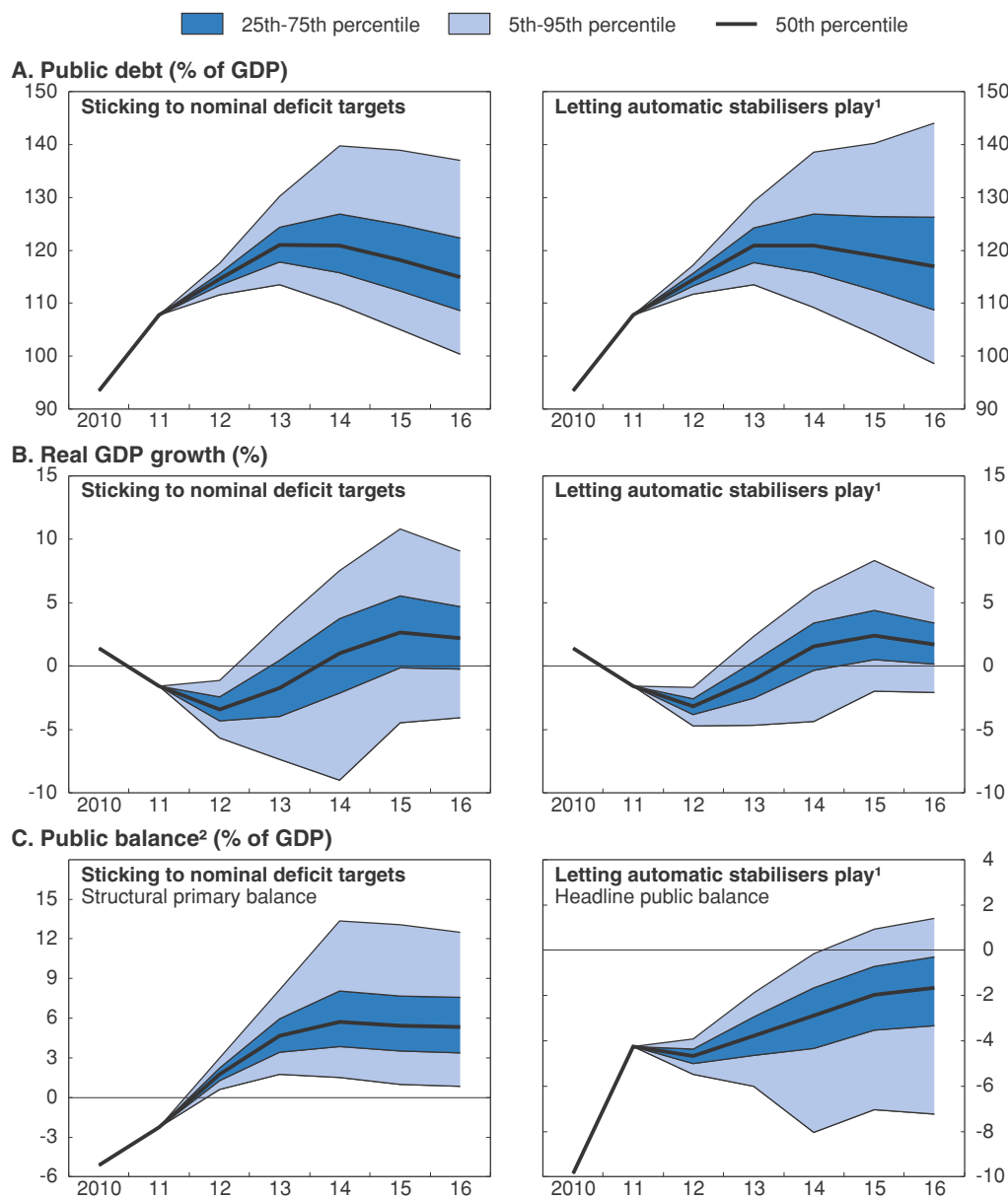
1. Revenue and balance include a number of one-offs of which the most notable is a positive one in 2011 of 3½ per cent of GDP corresponding to the transfer to the government of the assets of banks' pension funds, in exchange for overtaking future pension liabilities.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May for historical series of 2010-11 and Ministry of Finance (2012), *Documento de Estratégia Orçamental 2012-16* for targets and assumptions of 2012-16.

one-offs in 2011, such targets will require a large underlying fiscal consolidation of about 3½ per cent of GDP in 2012 – almost twice as much as in 2011 – and about 1½ per cent of GDP in 2013. Under the OECD's central scenario of a gradual economic recovery beginning in 2013, the ambitious fiscal stance envisaged by the authorities would allow to rapidly regain control over public debt dynamics. However, there are risks of a deeper than projected recession, notably because of the ongoing credit contraction (Chapter 2). First data for 2012 show a budget deficit of 7.9% for the first quarter on a seasonally unadjusted basis because of lower indirect tax revenues and higher social transfers. In such a case, the question is whether the government should stick to nominal deficit targets, which risks further amplifying the recession and being potentially self-defeating, or let automatic stabilisers play, which would delay public debt stabilisation, with a risk to investor confidence.

Stochastic simulations carried out by the OECD illustrate the trade-off between sticking to nominal deficit targets and letting automatic stabilisers play in an uncertain macroeconomic environment (Sorbe, 2012), (Figure 1.2). These simulations rely on a small-sized stylised macroeconomic model inspired by Lenain *et al.* (2010), in which random shocks affect macroeconomic variables following the approach developed by Celasun *et al.* (2006). The model captures the mutual interdependences between the fiscal position, financial conditions and activity and notably the impact of public debt developments on investors' confidence and interest rates. The fiscal multiplier, which has a large influence on the results, is assumed to be one – a level that would be considered rather high in normal times, reflecting that depressed private demand and tight credit may amplify the impact of fiscal consolidation (Corsetti *et al.*, 2012).

The simulation results suggest that sticking to nominal deficit targets would put debt on a declining path, but with a significant risk of a deep recession and an associated sharp rise in unemployment. In this case, meeting nominal deficit targets would require large additional consolidation measures, which would risk undermining social support for the programme in a context of high and rising unemployment. In contrast, letting automatic stabilisers play would limit the risk of an extreme recession, but at the cost of abandoning certainty over debt control. On balance, this suggests that the government should aim at meeting its nominal fiscal targets (without resorting to one-offs) as long as growth does not deviate substantially from the programme to reap the associated credibility gains.

Figure 1.2. **Stochastic simulation results**

1. Respecting the structural primary deficit targets.
2. In the “nominal targets” strategy, the headline public balance is always equal to the targets presented in Table 1.1. Similarly, in the “automatic stabilisers” strategy, the structural primary balance always follows targets implied by the programme.

Source: S. Sorbe (2012), “Portugal: Assessing the Risks about the Speed of Fiscal Consolidation in an Uncertain Environment”, OECD Economics Department Working Papers, forthcoming.

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Nevertheless, should output fall substantially more than projected, the automatic stabilisers should be allowed to play, at least partially. Debt simulations also show that risks around the fiscal consolidation programme would be minimised by stimulating potential growth through structural reforms (Chapter 2) and by choosing “growth friendly” fiscal consolidation instruments that would lower the fiscal multiplier (Annex 1.A1).

### **Consolidation instruments, growth, equity and the environment**

After a fiscal stimulus of around 1% of GDP in late 2008 and 2009, as part of the European economic recovery plan, Portugal resumed fiscal consolidation in 2010 that gathered pace in 2011 and 2012. Two-thirds of measures in 2011 and 2012 are on the expenditure side, largely through reductions in the public sector wage bill via staff reductions as well as cuts in public sector wages. In addition the indexing of pensions to inflation was suspended except for the lowest pensions. In early July 2012 the Portuguese Constitutional Court ruled that the suspension of the 13th and 14th months paid to civil servants and pensioners through to 2014 (accounting for approximately 1.1% of GDP of the consolidation package for 2012) violated the constitution because it does not apply to all citizens. Given the country's deficit target commitments, the Court has nonetheless accepted that the suspension, as currently defined, can be applied in 2012. The government is currently analysing the possible alternatives scenarios to incorporate the Court decision into the budgetary plans beyond 2012. On the revenue side, amongst other measures, a personal income tax surcharge was imposed on higher incomes (those in the highest tax bracket), the state surcharge on corporate profits was increased, social security contributions were raised and value-added tax (VAT) increased both by lifting the main rate and abolishing a concessionary rate on electricity and many other items in 2012 (e.g. restaurants). Tax expenditures have been further reduced by cutting and capping tax allowances for health, mortgage and rent expenditure and abolishing all concessionary corporate tax rates. User charges including road tolls and public transport fares have been increased.

Consolidation instruments should be chosen so as to ensure a lasting improvement in the fiscal balance, minimise negative effects on activity, spread fairly the burden of adjustment across the population and, when relevant, help preserve the environment. In this respect, on the one hand, concentrating consolidation measures on the expenditure side would have a stronger negative effect on short-run activity as the impact of expenditure cuts is generally considered higher than tax increases (OECD, 2009a). On the other hand, international experience shows that expenditure based consolidations tend to be more successful, notably in terms of sustainability (Guichard *et al.*, 2007).

On balance, the government will need to rely on both tax increases and expenditure restraints. Relying on the least-distortive taxes will minimize the short-term cost of the adjustment. From that perspective, the current consolidation package has a number of attractive features including raising revenue through indirect tax increases (Arnold, 2008), broadening the tax base through reducing tax expenditures rather than raising tax rates, and harmonising tax rates by suppressing certain concessionary rates. However, consolidation should put greater weight on expenditure measures since excessive growth in expenditure has been the main source of poor fiscal performance. In times of fiscal restraint, the emphasis should be on improving spending efficiency, notably concerning SOEs and local governments, and, as has been the case, on cutting current rather than capital expenditures as short and medium-term negative growth effects are lower.

The burden of adjustment needs to be spread fairly to maintain social consensus around the programme. In particular, continuing attention should be paid to its implications for the poorest. By design, the reduction of certain tax credits, public sector pay cuts and income tax changes have affected high income earners more, having clauses

to protect the lowest income brackets. However, consolidations tend to have adverse impacts on income distribution (Ahrend *et al.*, 2011). Recent research suggests that (excluding increases in indirect tax other than VAT and cuts in public services), between 2009 and mid-2011, Portugal's package may have been more regressive than in five other EU countries examined (Callan *et al.*, 2011). Indeed, the combined effect of the measures considered in this study reduced disposable incomes of the two lowest income deciles in Portugal proportionally more than those of higher income deciles, mainly as a result of pension and benefit cuts which hit the poorest hardest.

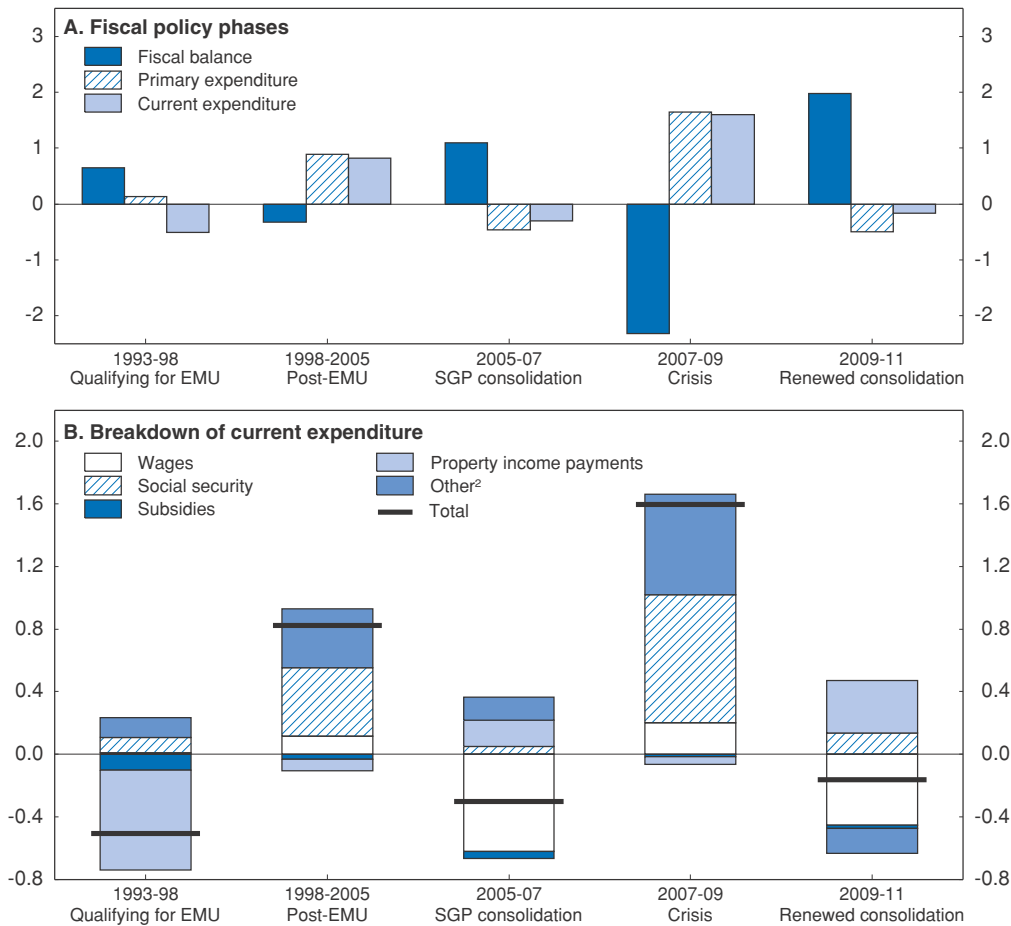
The decision to impose tolls on formerly free highways is welcome as it raises revenue while also benefiting the environment. The government is also planning, in tandem with municipalities, to develop a package of measures to promote the use of public transport. Measures include extending bus lanes as well as increasing parking restrictions and the cost of individual transport. The last is particularly welcome as planned metro price increases would otherwise lead to passengers moving to other, more polluting, transport forms. The authorities should be ambitious in this area, by for example widening the coverage of and increasing parking fees, introducing congestion charges in Lisbon and making greater use of road tolls. This would even up the competitive playing field between metro, rail and individual road transport, help to reduce pollution and congestion, provide a source of funding for public transport and increase market efficiency by bringing user costs closer to the social costs of individual road transport. Tolls should be set as a part of a wider transport strategy that takes into account the environmental costs as well as the overall costs and revenues arising from all transport state-owned enterprises including the rail companies.

### Improving the fiscal framework

Portugal has a relatively poor record of achieving its budget targets, especially medium-term ones, largely owing to a failure to adequately control expenditure. With the exception of the 2005-07 consolidation, public expenditure has been allowed to rise more rapidly than GDP since 1998, when Portugal's entry to the euro was confirmed, undermining the fiscal position (Figure 1.3). The failure to control expenditure is partly a result of over-optimistic economic and revenue forecasts, which is a widespread source of budgeting problems (OECD, 2011a), and assumptions on capital revenue (Figure 1.4). It also reflects spending overruns, compounded by a failure to minimise risks arising from local and regional government, the state-owned enterprise sector and public-private partnerships, as discussed below.

A stronger fiscal framework would help to solve these problems. By enhancing credibility, it can also help to reduce the need for sharp fiscal corrections that increase volatility of GDP growth in the short-run, which in turn undermines the economy's long-run growth rate (Brzozowski and Siwinska-Gorzalak, 2010). Portugal is overhauling its fiscal framework via the Budget Framework law of May 2011 and subsequent legislation. The main elements include: a medium-term framework of budget planning that annually sets expenditure ceilings for the central government for the next four years (November 2011); a general government budget balance rule in line with European level requirements to have a structural deficit of no more than 0.5% of GDP (after a transition period until 2014, during which the government will follow the programme targets); establishing an independent


Figure 1.3. **Fiscal policy phases and breakdown of current expenditure**  
Change in percentage points of GDP, annual average<sup>1</sup>



1. Based on national accounts definition. EMU: Economic and Monetary Union; SGP: Stability and Growth Pact.

2. Non-wage expenditure and other current payments.

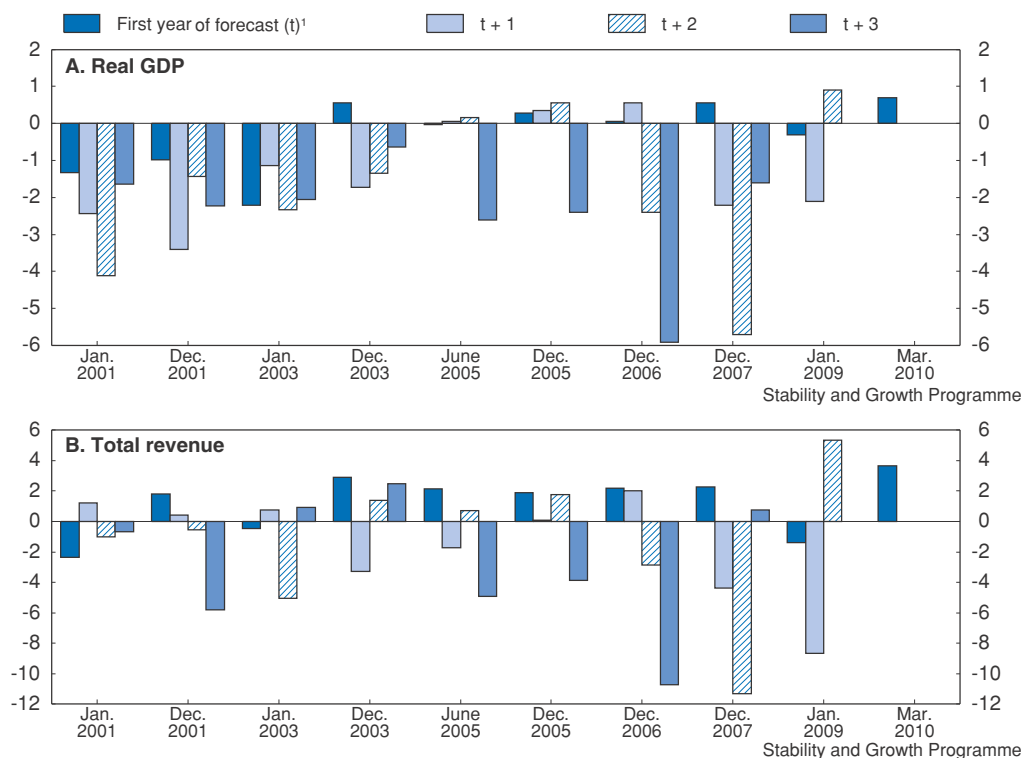
Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

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fiscal council (October 2011); programme budgeting; and expanding the State Budget to the whole of general government as defined in the national accounts. Reforms of regional and local finances laws will also be presented before the end of 2012.


While implementation challenges still lie ahead, the new framework is a major step forward and is consistent with international best practice. Notably, the move towards a more medium-term focus is welcome given that Portugal has hitherto been relatively weak in this area by international standards (OECD, 2011a). However, ensuring that the framework really contributes to fiscal sustainability will require meeting important implementation challenges. In addition, the framework would be more transparent and easier to monitor if it were reinforced by a spending rule consistent with the structural balance rule and the new European fiscal framework. An expenditure rule is easy to monitor, addresses directly a major weakness of Portuguese fiscal policy, and would help to guide fiscal consolidation by providing an overall expenditure envelope within which to plan programmes.

Figure 1.4. **Forecast errors for real GDP and general government revenue**  
Actual growth less projections from Stability and Growth Programmes, percentage points



1. The first year of forecast is the same year as that of the programme except for the following: December 2001 t = 2002, December 2003 t = 2004 and January 2009 t = 2008.

Source: Portuguese Republic (1998-2010), *Stability and Growth Programmes* and OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

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### **Budget control and financial management**

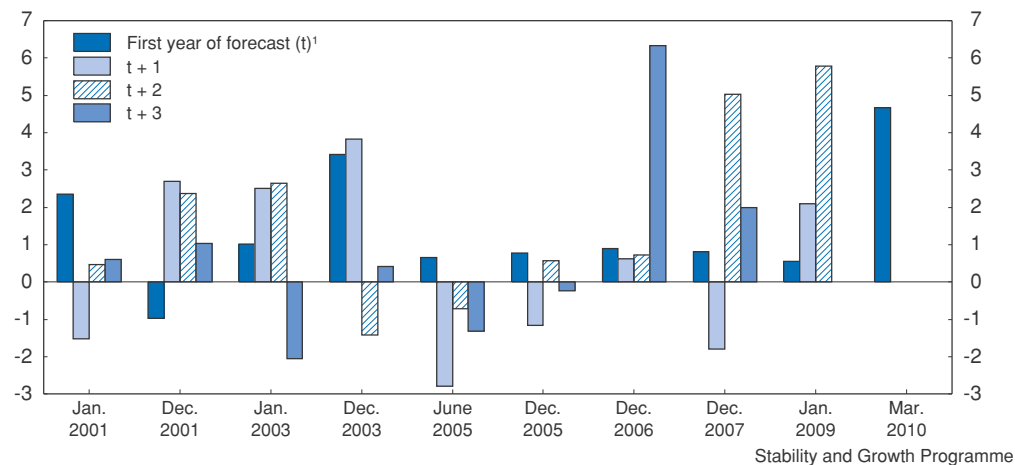
The new framework will only be effective if the government is able to implement its budget plans and prevent slippages (Figure 1.5). In the past, inadequate monitoring has undermined the government's ability to achieve its targets, as evidenced by the generation of various contingent liabilities and payment arrears, as well as the frequent need to pass supplementary budgets to cover expenditure overruns despite the existence of a central budget contingency fund. Spending control efforts are hampered by the highly fragmented nature of financial reporting even at the central government level. Over 500 individual central government spending units report to the Ministry of Finance. The detailed monitoring and control of so many spending units leaves very little resources for the Ministry of Finance to get an overall view of individual ministries and major spending areas and therefore exercise effective budget control (OECD, 2008a).

Fragmentation of reporting has been amplified by an incomplete accounts reporting system. Reporting has been long, confusing and often repetitive. In addition, the accounts are cash based and have not used the same definition of the general government as that used in the national accounts produced by the National Statistics Institute (Ministry of Finance, 2011a). The Ministry of Finance has also in the past not had sufficient information about the sources of potential liabilities including SOEs and PPPs (particularly at the local




Figure 1.5. **Expenditure growth forecast errors**

Actual expenditure growth less projections from Stability and Growth Programmes, percentage points



1. The first year of forecast is the same year as that of the programme except for the following: December 2001 t = 2002, December 2003 t = 2004 and January 2009 t = 2008.

Source: Portuguese Republic (1998-2010), *Stability and Growth Programmes* and OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

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level) and local and regional government finances on a sufficiently frequent basis (OECD, 2008a). Additionally, data on health spending and local and regional government accounts was previously only available quarterly. This has prevented the government from being able to get a timely picture of the overall general government position and risks to it.

Information flows are improving. The move to monthly reporting for all parts of general government is welcome. The broadening of the reporting universe in the State Budget to all entities included in the general government will also help the monitoring of the overall state of the government sector and improve international comparability. The government also plans to overhaul the accounting system, moving to a set of accrual based accounts containing results that can be compared across expenditure areas, which is welcome. More recently the Ministry of Finance has produced annual and quarterly reports on SOEs and PPPs at the central government level and some basic financial and operational information about individual SOEs is also provided. In addition, in line with programme requirements, the government produced a range of new reports including ones covering arrears, the 36 most important PPP contracts as well as 24 concessions. This excluded the PPP programme in the autonomous region of Madeira, which ran into serious difficulties in 2011 with one of the three PPPs in the region having been reclassified within general government resulting in fiscal implications at the general government level.

As recommended by the 2008 *OECD Review of Budgeting in Portugal*, the government is moving towards a programme budgeting approach. The State Budget will be structured around 14 programmes, each with a single implementing ministry. Also in line with *OECD Budgeting Review* recommendations, each minister will be responsible for strict compliance with the budgetary limits set for their respective ministry. Importantly, ministers will be liable for correcting any shortfall and failure to do so will result in lower budget allowances in the following year. In addition, each minister has appointed a programme financial controller to interact with the Ministry of Finance in monitoring and controlling budget implementation (Ministry of Finance, 2011a).

The move to programme budgeting will help tackle the problem of fragmentation and assist the Ministry of Finance to move away from detailed control of budget execution, which should reside with individual ministries, towards more strategic global oversight and reviews of financial performance. Programme budgeting will also complement the new medium-term expenditure framework discussed below by providing a better system for ensuring spending remains within the framework limits.

Once programme budgeting is fully embedded, the government should move towards improving performance information. A new OECD index shows that Portugal has a relatively under-developed budget performance information system by international standards (OECD, 2011a). Initial efforts should concentrate on developing a small set of internationally comparable output and outcome indicators that can be monitored over time against benchmarks in key expenditure areas such as health and education. This information can be used to go beyond just controlling expenditure within set limits but assist in reallocating expenditure to increase efficiency.

It is also important that the authorities fully implement the new system of intra-annual expenditure commitment controls based around the 14 new budget programmes. In the past, spending slippage occurred because spending units were allowed to spend excessively on the basis of over-optimistic forecasts of their own revenues, while no corrective action was taken when these revenues failed to materialise. The new system aims to remedy this. If spending exceeds the forecast revenue envelope in a three month period, this will have to be offset by more ambitious spending targets to correct this over the budget year. A potential issue is that the technical capability of programme financial controllers to carry out these oversight functions and interact with the Ministry of Finance varies a lot across other ministries. To instil a greater sense of responsibility, financial controllers should be appointments assigned to named individuals rather than simply a function assigned to the head of the planning unit for example. In addition, they should have sufficient time to properly carry out these functions and have access to analytical support staff, which is not the case for all ministries.

Further efforts are also needed to reduce payment arrears. Arrears of the general government sector, as well as the SOEs outside the general government sector, are high by international standards. The 2011 European Payments Index showed that the average payment delay by the public sector was the fourth highest out of 25 countries (Intrum Justitia, 2011). In early 2012, total arrears including those of SOE hospitals were around 3.2% of GDP. Controlling arrears is important as they are part of government debt in the wider sense (although they are not directly accounted in Maastricht debt) and, are a burden on private sector capital resources and thus on economic activity. The 2012 Supplementary Budget allocated EUR 1.5 billion (0.9% of GDP) for the settlement of existing arrears for the hospital sector, which is expected to be paid out by August. To prevent the build up of new arrears in 2012, the government has concentrated on providing adequate allocations to the health sector, where around 40% of the arrears have been concentrated. In addition, incentives are built into the newly introduced commitment control system to pay back arrears, as entities with spending arrears are forced to adopt more ambitious spending targets. The government has also committed to help local governments settle part of their existing arrears via a EUR 1 billion (0.6% of GDP) credit line, as discussed below.

### **Medium-term budgeting and anchoring the framework**

Medium term budgeting has been insufficient, as Portugal was ranked second lowest on this issue out of 30 OECD countries in 2007 (OECD, 2009b; OECD, 2011a). This ranking takes into account a set of variables including the presence of multi-year expenditure estimates in the annual budget. The government's move to a comprehensive medium-term expenditure framework is therefore welcome. The medium-term expenditure framework can help to improve transparency in fiscal policy by showing how targets will be achieved as well as the multi-year consequences of spending and revenue plans. The latter restricts the scope to use expenditure shifting across years to hide unfavourable trends.

In the new framework, the government has committed to submit to parliament annually expenditure ceilings for the following four years. In the first year (the budget year) these ceilings will be expressed by the individual 14 programmes, for the second year they will be grouped by policy intervention areas, while only an overall ceiling will apply for the third and fourth years. The government should extend the period of individual programme ceilings beyond the first year. The extended ceilings could in addition be linked to specific measures, thereby giving the framework more credibility. The medium-term expenditure framework should be part of a broader medium-term economic and fiscal plan. Such a plan should include estimates for expenditure and revenue year by year and the specific measures that will be used to achieve targets. It is also important that the assumptions underpinning the plan are transparently laid out to give it credibility and allow effective monitoring by the Fiscal Council, the Parliament and the wider public.

### **Fiscal rules**

In the same way as an annual budget, a medium-term expenditure framework can be adjusted every year, which limits its scope to discipline fiscal policy decision making. Thus, fiscal rules would be a useful complement that could be used to enforce the framework and achieve a medium-term fiscal target. They may also help to increase financial market confidence in the government's commitment to its medium-term plan. However, a poor track record of compliance with fiscal rules so far (the Stability and Growth Pact) means that the latter benefit may take some time to materialise for Portugal.

Recent and on-going decisions at the EU level in the context of the euro sovereign debt crisis have increased the number and overall strictness of common fiscal rules. There is now a complex web of four partially overlapping rules: the excessive deficit rule that requires the deficit to be below 3% of GDP; a debt convergence rule requiring the gross debt in excess of 60% of GDP to be reduced on average by at least 1/20th per year; an expenditure rule which constrains expenditure to increase by no more than the growth of potential GDP (with a lower reference rate for countries with a structural deficit below the medium-term objective – benchmark is a structural deficit of no more than 0.5% of GDP) unless there are explicit revenue raising measures; and a structural balance rule to reduce the annual structural deficit to below 0.5% of GDP in steps to be determined by the European Commission. In the case of Portugal these steps are already pre-determined through to 2014 by the EU-IMF programme.

Which rule is the binding constraint depends on circumstances, but recent EU communication has mainly focused on the structural balance rule (see European Council, 2011), which Portugal has enshrined in the new 2011 Budget Framework law. The new rule will apply from 2015 with the programme targets governing the path for the fiscal balance

up until 2014. Rules should tackle as directly as possible the underlying source of the weak fiscal position (Sutherland *et al.*, 2012), which in the case of Portugal is a failure to control primary expenditure (Hauptmeier *et al.*, 2011). Rules also need to be not unduly rigid (Schick, 2010), easily understood and monitored by the parliament and public, have broad coverage and be operationalised easily. On this basis, Portugal should also legislate an explicit expenditure rule that limits public expenditure growth relative to the estimated growth rate of potential nominal GDP (as estimated *ex ante*), and use this to set enforceable nominal expenditure ceilings for general government to facilitate monitoring.

Historical experience suggests countries with multiple rules have been more successful in carrying out consolidations and stabilising debt (Guichard *et al.*, 2007; IMF, 2009; Sutherland *et al.*, 2012). Concerns about over-determining fiscal policy with multiple rules can be mitigated by parameterising such a numerical expenditure rule to be consistent with the structural balance rule obligation – the change in the balance being approximately equal to the difference between the growth rate of expenditure and potential nominal GDP weighted by the expenditure share in GDP.<sup>1</sup> With the current need to consolidate the fiscal position, this would require setting expenditure growth below potential nominal GDP growth for many years, which would be in line with the EU level expenditure rule obligation.

An expenditure rule provides a way of making the structural balance rule operational because performance against the expenditure rule can be judged against a simple observable target, expenditure, whereas the structural balance cannot be observed, but only estimated, with estimates typically revised significantly over time. Experience elsewhere suggests that the ease of observing compliance becomes an important issue in practice. For example, the Swedish Fiscal Policy council found it difficult to assess compliance with the government's target of a 1% surplus over the cycle (Calmfors, 2010). Disputes over when the cycle started and finished were among the most contentious aspects of the "over the cycle" rule that operated in the United Kingdom until the end of 2008 (OECD, 2009c). The potential gains from an expenditure rule are demonstrated by simulations showing that, if Portugal had followed this type of rule from 1999 to 2009 using real time data and limited primary expenditure growth to an estimate of potential nominal GDP growth, the debt-to-GDP ratio would have been 17 percentage points of GDP lower by 2009 (Hauptmeier *et al.*, 2011).

### **Establishing a fiscal council**

A fiscal council can complement fiscal rules by providing a body to assess whether the government is complying with them. A council can also help to give flexibility to fiscal rules and suggest improvements to them (Calmfors and Wren Lewis, 2011). In October 2011, the government passed legislation establishing an independent fiscal council. This is welcome, as it will bring independent, intellectually rigorous scrutiny to fiscal policy. The Council comprises five senior council members of which two may be non-Portuguese citizens, as well as a secretariat of analytical support staff. The board members were appointed by the end of 2011 with analytical staff appointments taking place in 2012. A first report was issued in May 2012, focusing on the broad aspects of the government's budgetary strategy (Portuguese Public Finance Council, 2012). The Council's main recommendations were for the government to hand over responsibility for macroeconomic forecasts to an independent institution and, as recommended in this *Survey*, set expenditure ceilings for general government.

The Council has a very wide remit. In addition to what are becoming standard tasks for these institutions internationally of assessing central government macroeconomic and fiscal forecasts and compliance with fiscal rules, the Council also has responsibility for assessing the financial position of local governments and state owned enterprises and analysing existing commitments including, pensions, health care, public-private partnerships and tax expenditures. The government is required by law to provide to the Council in a timely manner all economic and financial information it requires to complete its mission. The law also requires the Council's reports to be sent to the President of the Republic, the government, the parliament, the Court of Auditors and the central bank. The Council is a complementary fiscal institution to the Parliamentary technical budget support unit (UTAO) set up in 2006. In this context, it will be important to ensure regular information exchanges with this unit. The design of the fiscal council has already drawn on this unit's experience and should continue to do so, particularly in interacting with the parliament which will be a key client of the Council.

The provision to allow for up to two non-Portuguese citizens on the board will widen the range of perspectives. However, the government should relax the prohibition on board members having other paid activity. Other countries allow board members to hold concurrent positions and the prohibition is a serious constraint on recruitment where some of the potential candidates could be academics or economists in policy organisations who would be reluctant to fully give up their current jobs.

The Council's broad remit appropriately recognises that fiscal problems at the general government level can often arise outside the central government as has occurred in Portugal in recent years. However, it will be important to ensure resources available to the Council are commensurate with its wide remit. The Council will require significant analytic and specialised resources to meet the challenge of giving advice across such a broad range of areas. In the first instance the Council should prioritise core functions, including assessing the macroeconomic and fiscal projections, compliance with fiscal rules and giving fiscal policy recommendations to the government. Assessing the forecasts is an important task as international experience shows that over-optimistic macroeconomic forecasts are a notable source of deficit bias (Hagemann, 2010). Furthermore, there is evidence that Fiscal Councils that provide policy recommendations rather than just analysis are more effective (Debrun *et al.*, 2009). Concentrating efforts will also help the Council to establish a reputation for high quality non-partisan work and therefore cement its role in the national debate and policy process.

Giving the Council strong power to request information from the government is also welcome, as limited access to important fiscal information has reduced the effectiveness of councils elsewhere (Kopits, 2011). The Council's role should be further embedded in the policy debate by requiring the Minister of Finance to provide a formal response, including appearing before the Parliamentary Finance Committee, to Fiscal Council reports. Finally, the Council should engage early in developing communication channels, particularly with the media which are the main channel of influence of the Council as it can only persuade and not coerce (Kopits, 2011).

The budgetary process provides only short periods for scrutiny of the Budget (OECD, 2008a). This is inconsistent with OECD guidelines on budget transparency (OECD, 2002), which suggest that the parliament should have three months to scrutinise the budget rather than the current one and a half months. This meant that the Parliamentary

technical budget support unit (UTAO) had only ten calendar days to analyse the State Budget and eight days for the Stability Programme annual update. This constraint will also affect the new Fiscal Council as there have been no changes to extend the parliamentary timetables to approve the budget. Given the complexity of the budget and the severe implications of mistakes, the government should extend the time available to the Fiscal Council to analyse and report on the budget beyond that which was available to UTAO. This will help to ensure the Council can properly fulfil its functions.

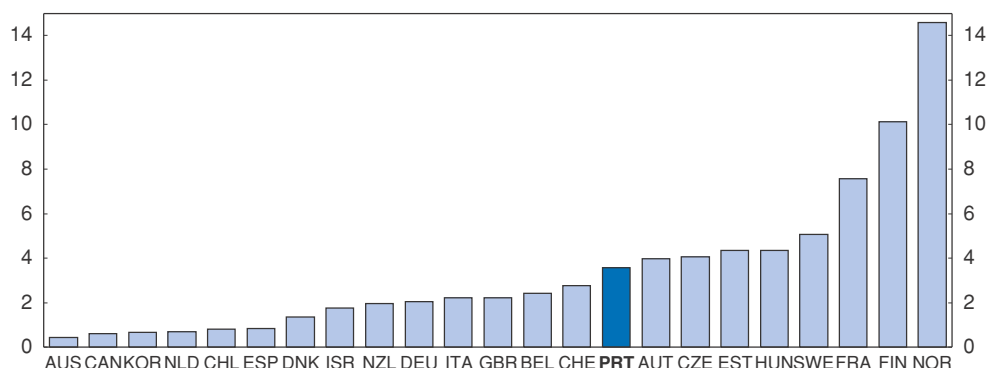
## Public sector efficiency and off-balance sheet liabilities

### Raising the game of the SOE sector

Although previous privatisations have reduced the size of the state-owned enterprise (SOE) sector, in 2010 it still accounted for 4.5% of GDP and 3.5% of employment (DGTF, 2011a), (Figure 1.6). The corporatisation of a high proportion of hospitals partly explains this, as they represent more than half of SOE employees. More recently restructuring in the SOE sector has seen staff levels decline in areas such as the transport sector where personnel declined by 12% in the second half of 2011. The poor performance of the SOE sector overall is illustrated by the EUR 1.9 billion (1.1% of GDP) loss by the sector in 2011 on total assets of EUR 55.8 billion (32% of GDP). Poor performance of enterprises classified inside the general government sector, which account for most of the losses, directly affects the government's accounts. Those located outside general government represent a contingent liability, which may move on budget in the case of their reclassification to the general government sector or trigger a need to support them with debt guarantees or capital injections.


Figure 1.6. **Employment in state-owned enterprises**

Employees in SOEs in per cent of total employment, 2009<sup>1</sup>

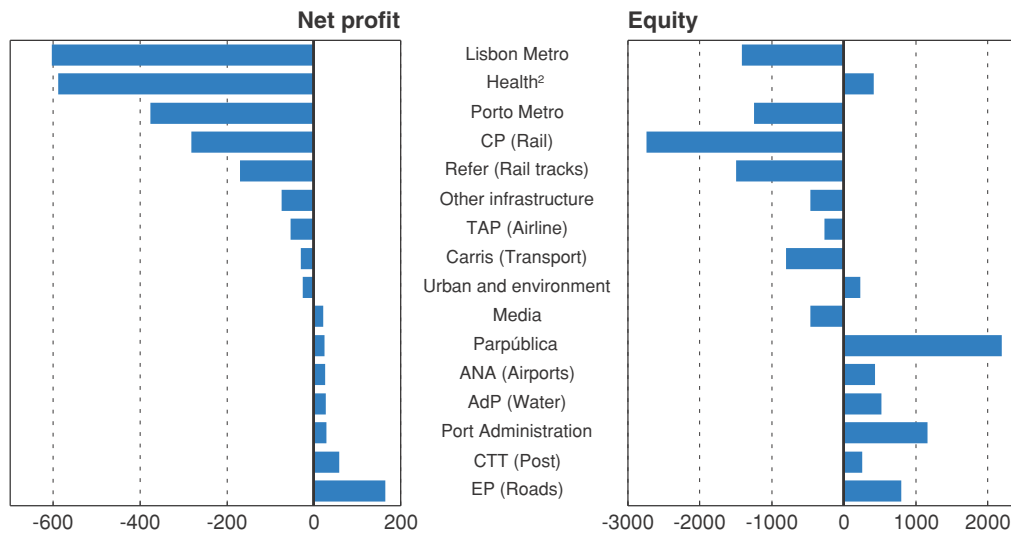


1. Or latest year available. State-owned enterprises (SOEs) cover firms that are majority owned by the government or those where the government owns at least 10% of the common share capital listed.

Source: H. Christiansen (2011), "The Size and Composition of the SOE Sector in OECD Countries", *OECD Corporate Governance Working Papers*, No. 5.


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Many SOEs have been financially underperforming. Losses have been large in the urban passenger transport, rail and hospital sub-sectors (Figure 1.7). This partly reflects extremely high debt and associated debt servicing costs. Several of these companies are technically insolvent and the SOE sector as a whole has negative equity of EUR 2 billion. Nearly all of these loss-making companies (Carris, a public transport company, is an exception) are also making losses on an EBITDA (earnings before interest taxes, depreciation and amortisation) indicating that they are also operationally weak.

Figure 1.7. **State-owned enterprise performance**By industry/company, in million euros at end 2011<sup>1</sup>

1. 2010 for TAP.

2. Losses in the health sector include those of a new hospital whose revenue was not fully recorded in 2011.

Source: Ministry of Finance (2012), *Boletim Informativo Sobre o Sector Empresarial do Estado: 4.º Trimestre 2011* and Parpública (2011), *Documentos de Prestação de Contas 2010*.StatLink  <http://dx.doi.org/10.1787/888932669819>

The reclassification by Eurostat of three SOEs as part of the general government sector has increased the urgency of solving these problems as their losses now have an immediate impact on the fiscal balance and debt. The reclassified companies are among the largest loss making SOEs (the rail track company, REFER, and the Lisbon and Porto metro companies), adding around ½ per cent of GDP to the fiscal deficit between 2007 and 2010 (Statistics Portugal, 2011; Ministry of Finance, 2011b). Occasional capital transfers from government to SOEs have been used to prop up ailing enterprises and prolong this process. However, experience shows this former strategy is not sustainable in the medium-run as Eurostat will reclassify particularly bad loss making enterprises as part of the general government sector, in which case the liability is immediately made explicit.

Running SOEs at a loss in sectors such as urban transport and health care and building up off balance sheet liabilities, including in the case of hospitals through payment arrears, reflected a non-transparent subsidisation of government services. In the short-run, lower priced but potentially inefficient services are delivered to the population without recognising explicitly the associated public cost. Alternatively, the debt of the SOE may become so large that it does not have enough free cash flow to pay suppliers and creditors and therefore to operate commercially. Operating the SOE sector in this way has also had negative externalities in the form of creating government guaranteed debtors that crowd out private sector borrowing and investment (Chapter 2).

Both the operation of SOEs and the policy framework that surrounds them should continue to be reformed. At issue are which enterprises the government should continue to own and how the performance and governance of these remaining companies can be improved. Part of the programme conditions are to privatise a number of enterprises including Aeroportos de Portugal (ANA), the national airline (TAP), the national postal service, Correios de Portugal (CTT), railway freight branch (CP Cargo), the insurance arm of

a government bank (Caixa Seguros). The sale timetable is ambitious, with all of these assets programmed to be sold by early 2013. By mid-2012, the government had already executed the partial sale of REN and the sale of its remaining stake in the former electricity generating incumbent (EDP) and initiated the sale of ANA and TAP. The government had also announced that it intends to grant concessions to run the newly merged Lisbon metro and road public transport services companies as well as rail services. A partial sale of the television channel (RTP) along with a concession to run the water company Águas de Portugal (AdP) is being considered.

With the exception of the airline, TAP, the companies that are to be sold are profitable, which should increase the chances of prompt sales. In addition, they are engaged in commercial activities that the private sector can be expected to provide. The government should prioritise maximising the contribution to Portugal's long-term growth potential from the sale of these assets over a quick sale, especially at a time of crisis, when conditions for asset sales may not be the best. In any case, these are complex assets operating in industries where a healthy competitive market cannot be taken for granted due to natural monopoly characteristics and other barriers to entry. This means that a straight sale of these assets risks transforming public monopolies into private ones, with no real possibility of competition entering the market. An important part of privatisation will therefore be to ensure that the company structure and the regulatory framework are pro-competitive prior to any sale. For example, the government should consider splitting some of these firms into competing companies before selling them, even if this may delay sales. The government should also involve the competition authority in the design of the sale and the regulatory framework.

In terms of operational performance the government is developing a strategy for all SOEs with commercial activities (excluding the rail track company REFER and the health sector) to achieve operational balance by the end of 2012. Part of this are plans to reduce operational costs by at least 15% through decreasing the cost of supplies, external services and labour (DGTF, 2011a). The elimination of the 13th and 14th month salaries for all public sector employees including those in SOEs plays a major role in the latter. In the short-run redundancy costs resulting from cuts in staff will temporarily slowdown improvement. Despite this, data for the first quarter of 2012 point to an improvement in the operational balance of many SOEs compared with the previous year.

The losses of the Lisbon and Porto metro companies are so large that they are noticeable at an overall government budget level, with a combined net financial loss of EUR 980 million (0.5% of GDP) in 2011, of which more than half represented an operational loss. For the Lisbon metro a fundamental problem is that payments to suppliers and particularly staff have been increasing faster than sales revenue. From 2005 to 2010 staff payments rose by 18% and revenue from sales only rose by 7%. To prevent further deterioration in operational results, payments to staff will need to be far more tightly controlled. The Porto metro has had more success in cutting supplier costs and operational revenue coverage of costs improved between 2009 and 2010. To help close the gap between revenue and costs further, prices were significantly increased (by around 20%) for urban public transport in 2011 and the government's strategy is to increase them over time to comparable EU levels.

The national rail track company, REFER and the national operator of train services, Comboios de Portugal (CP), are also making large operational losses. Durably improving their operational performance may require further rationalising networks by closing underutilised and unprofitable lines and replacing them with bus services (where these are

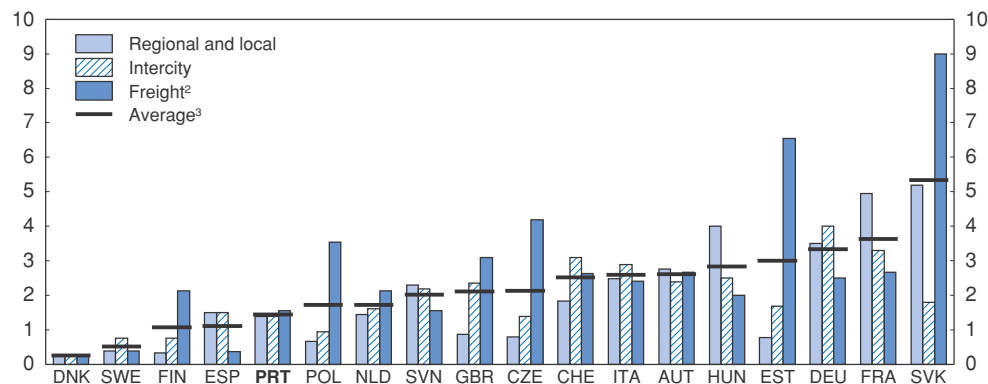


viable). Indeed, most of CP passenger's past operational losses have been incurred by CP regional in providing only 20% of CP's total available seat kilometres. Train services should only be provided on lines with high traffic density as the large fixed costs incurred in providing rail services mean the combined costs of CP and REFER per passenger kilometre rise drastically as total passenger kilometres on a line fall. On this basis, four lines were closed in 2009 and replaced with bus services that can be provided at a small fraction of the cost of train services (Ministry of the Economy, 2011). From 2011 through to mid 2012 a further 410 kilometres of underperforming parts of the network were deactivated. The government should continue to rationalise the network to eliminate remaining high cost lines to further reduce operational losses. Improving CP operational performance would also give more scope to raise infrastructure charges paid by the freight operation (scheduled for privatisation) to REFER and thereby reduce the losses of REFER.

Currently the revenue REFER earns from train operators is far below the costs of providing rail infrastructure and does not even cover staff costs. By international comparison, REFER's charges for utilising and managing infrastructure are below average overall and particularly for freight (Figure 1.8). A constraint on improving the bottom-line are EU network access pricing rules which prevent REFER from raising track access charges to recover the large investment costs it has incurred in recent times to modernise the network. The company has announced it wants to reduce losses through a 35% cut in staff and also other expenses in 2012. To help ensure this cost cutting is sustainable the government should continue to close the most unprofitable tracks in tandem with the rationalisation of train services by CP.

Figure 1.8. **Rail infrastructure access charges**

Euro per train kilometre, 2008<sup>1</sup>




1. 2007 for Poland.

2. For a 960 ton freight train.

3. Unweighted average.

Source: OECD (2008), *Charges for the Use of Rail Infrastructure 2008*, International Transport Forum.

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However, cutting costs and raising prices may not close the financial gap of certain public transport companies, meaning that they would have to rely on subsidies. This may be economically justifiable as those travelling on public transport generate positive externalities relatively to travelling by car. Nevertheless, in line with *OECD Guidelines on Corporate Governance of State-Owned Enterprises*, it is important that this subsidy is explicitly set and shown in the government's accounts in return for an agreed level of services, rather

than via an accumulation of non-transparent losses. The public transport companies should be required to achieve at least operational balance after subsidies under such an agreement or face immediate corrective actions to restore balance.

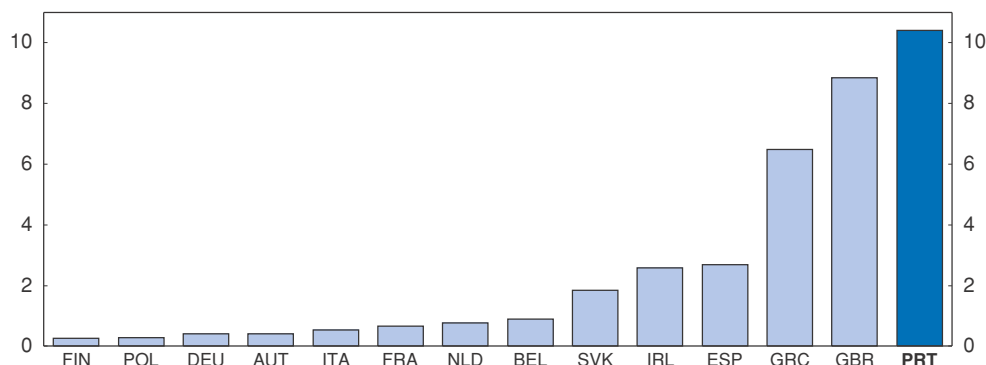
Even if operational balance is achieved in loss making SOEs, the legacy of past recurrent losses has left them with a heavy debt burden that will continue to hinder financial performance. In some cases the debt has reached such high levels that it cannot easily be repaid. To put these SOEs back in a commercially viable position, their debt needs to be reduced to serviceable levels while avoiding future moral hazard through a better governance regime. The government is preparing a plan to tackle the debt burden issue that is due in July. To ensure this process is transparent the government should consider a one-off transfer of part of SOE debt to a government entity charged with repaying it from government revenues assigned to this entity for this purpose.

The government is introducing a new legal framework for SOEs and has plans to improve SOE governance. A new law changing the way SOE managers are recruited and remunerated was passed in January 2012 and further reforms are planned. A draft law to be considered by the parliament and applying to central and local SOEs envisages a new technical unit to monitor SOEs and to *inter alia* advise *ex ante* on whether establishing new SOEs is in the public interest. The government's plan to ensure the new framework also tackles the capability and authority of SOEs to enter into derivative contracts is welcome as a large contributor to the losses of the metro companies is from bets on interest rate derivatives which should have been used exclusively as a hedging tool.

### **Public-private partnerships have created a significant future drain on fiscal resources**

From 1990 to 2010 Portugal was the third biggest user of public-private partnerships (PPPs) in Europe, after the United Kingdom and Spain and the highest user relative to GDP (Kappeler and Nemoz, 2010; EPEC, 2010; Figure 1.9). Accumulated investment in PPPs increased from EUR 9.3 billion in 2005 to EUR 16.2 billion (9.5% of GDP) in 2011 (DGTF, 2011a). As elsewhere in continental Europe, the vast bulk (79%) of these projects were roads, with rail (18%) and health (2%) accounting for most of the remainder (Kappeler and Nemoz, 2010).


Figure 1.9. **Public-private partnership contracts reaching financial close**<sup>1</sup>  
Contracts for 1990-2009 as a percentage of 2011 GDP<sup>2</sup>



1. Financial close: project contract and financing documentation is signed.

2. The Czech Republic, Hungary and Sweden are not shown as their share is less than 0.02%.

Source: A. Kappeler and M. Nemoz (2010), "Public-Private Partnerships in Europe – Before and During the Recent Financial Crisis", *Economic and Financial Report*, No. 2010/04, European Investment Bank and OECD (2012), *OECD Economic Outlook: Statistics and Projections* (database), May.

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Concerning roads, a variety of private-partnership models were introduced in three main waves (Table 1.2). Estradas de Portugal (EP), a 100% state-owned company that is classified within general government, is the government's principal road concessionaire. EP has in turn granted sub-concessions to private partners. In 2010 and 2011, the government negotiated with private partners to convert all the "shadow" toll roads – where the government paid tolls on behalf of users – to standard toll roads where users are charged a toll. This resulted in reclassification of the road investment as part of the general government expenditure because the tolls paid by users to the government are greater than 50% of the availability payments made to the private sector by the central government. In essence the central government is carrying most of the risk in the project and therefore the road is treated as a public asset.

Table 1.2. **Road sector public-private partnership models**

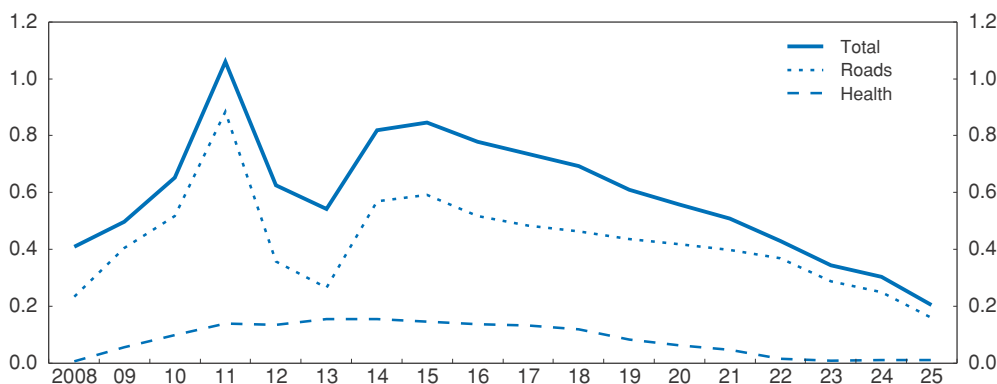
Model	Road length (kms)	Payments	Notes	Principal government risks
Wave 1: launched late 1980s. Private concession from the government (tolls paid by users).	1 300	Private partner bears the costs of running the highway and obtains the toll revenue.	After 2028 these assets will progressively move to Estradas de Portugal (EP).	Limited, but returns conceded to the private sector are very high.
Wave 2: Launched end 1990s. Private concession from the government. Seven shadow tolls paid by the government on behalf of users, highways now converted to EP sub-concessions with user tolls.	900	Originally: EP made payments to private partner and no user toll. Now: EP makes availability payments to keep the road open in good condition to private partner. State receives tolls collected by the private partner from users.	Tolls introduced in 2010 and 2011. These assets will eventually move to EP.	Demand risk.
Wave 3: launched 2007-08 to open 2013-14 EP sub-concession.	2 000 of which 1 000 are under construction, of which 430 are highways that could be tolled.	EP makes availability payments to private partner and receives tolls collected by the private partner.	Only 240 km of the new highways are tolled.	Demand risk.

Source: Estradas de Portugal.


The large PPP programme has created a significant and growing payment obligation for the government (Figure 1.10). The PPP payment obligations have a net present value of EUR 10.7 billion (6.3% of GDP) in 2012 and yearly payments are projected to rise from EUR 1 billion in 2012 to EUR 1.5 billion by 2015 as new roads currently under construction are completed. The payment problem has become more acute with the sovereign debt crisis as EP can no longer access market finance (despite being operationally profitable) and is therefore fully reliant on financing from the central government.

Significant risk surrounds these net payment projections. Net payments by the government were 20% higher than forecast in both 2011 and 2010 albeit essentially due to one-off factors. The largest risks lie in transport PPPs (road and rail) arising from assumptions such as traffic flows (DGTF, 2011b). Indeed, there are some signs that toll revenue projections could prove too optimistic. Although this is difficult to separate from recessionary effects, demand appears to have reacted strongly to the introduction of real tolls on former shadow toll roads, with traffic declining by half on one of them. The allocation of risk between public and private parties is complex and depends on the particular PPP. In general, for road design, building and maintenance, availability and raising finance risk usually lie with the private sector as well as demand for private concessions for real toll roads (DGTF, 2011b).

Figure 1.10. **Net public-private partnership payments by the government**  
Per cent of GDP



Source: DGTF (2010), "Public Private Partnerships and Concessions 2010 Report" and DGTF (2011), *Boletim Informativo Parcerias Público-Privadas e Concessões 4.º Trimestre 2011*, Direcção – Geral do Tesouro e Finanças; and Ministry of Finance (2011), *Orçamento do Estado para 2012, Relatório*.

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The government carries demand risk in the case of EP sub-concessions where the government receives toll revenue from users, which are now the dominant concession model. In addition, under contracts signed prior to 2003 the government carried the risk of extra costs of having to relocate to different land for a road corridor, for example due to environmental reasons, which was part of the reason PPP payments exceeded forecasts in both 2010 and 2011. Generally the government should only transfer risks to the private sector that the private sector can control such as construction risk (Araújo and Sutherland, 2010). In the case of roads it is arguable that the private partner can influence demand, for example through road quality, and therefore should bear at least some of this risk rather than transferring all of it to the government as has been done with the EP concessions.

As part of the programme, no new PPP contract will be signed in the short term and the pressing policy issue is to reduce future costs and risks arising from existing PPPs. The government has already taken action to start reducing its obligations. In the rail area, the three high speed train (TGV) projects (Lisbon-Porto and Porto-Vigo and the link to Spain) have been cancelled. In the roads area, the conversion of former shadow toll roads to toll roads is a welcome addition to revenue for these projects and the government should extend coverage to the approximately 200 kilometres of highway that is currently not designated for tolls yet. The government has also engaged an international accounting firm to report in June in more detail the contingent liabilities under the PPPs and the probability of these materialising. It also assessed the costs and benefits of further renegotiation of the PPP contracts. To resolve existing PPPs, a mixture of measures could be taken, depending on the exact circumstances of each PPP including: renegotiating terms; cancelling projects when still at an early stage; or the buying back of PPP roads (Reis, 2012).

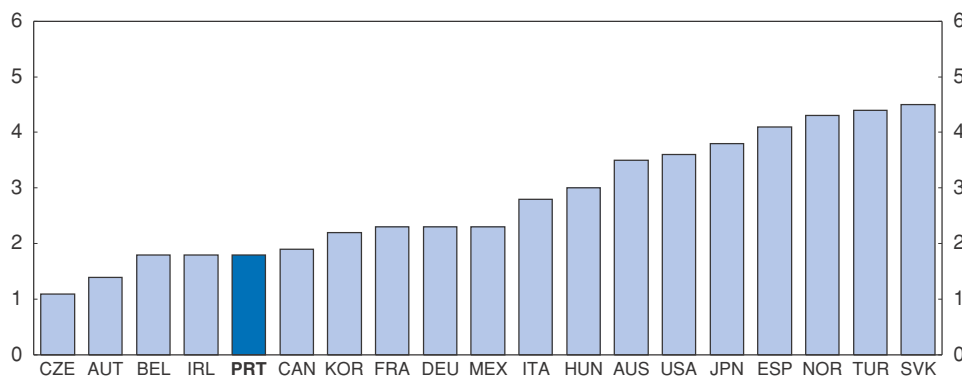
In the future, PPPs can still potentially be a useful model for delivery services, particularly when there is a positive externality between the construction and operating phases, which gives incentives for the private sector to internalise the costs of service provision and asset maintenance in its decisions at the construction phase (Araújo and Sutherland, 2010). However, they should be chosen because they represent good value for money and not to postpone expenditure. The literature and international experience suggest a number of factors that can help to ensure that a PPP is the right delivery model and maximises value for money.

These include specifying contracts in terms of outputs instead of inputs in order to maximise the benefits of private sector technical expertise and management skills; an *ex ante* evaluation of PPP versus public procurement; a public body obtaining planning and environmental permissions in advance of tender to avoid delays; and proper fiscal accounting for PPPs including recording them in contingent liabilities (Araújo and Sutherland, 2010).


By international standards, the efficiency enhancing features of Portugal's PPP framework appear relatively strong on paper and the government is intending further improvements (Figure 1.11). It is setting up a technical unit of around ten PPP experts in the Ministry of Finance to advise the minister on all aspects of launching, designing and monitoring PPP projects where investment exceeds EUR 25 million. This is welcome, as expertise is a key constraint on getting the most out of the PPP model. Similar units exist in Ireland and Italy. Such a unit can also have useful role in spreading knowledge to local government, which has less experience in managing PPPs.

Figure 1.11. **Indicator of efficiency constraining features of public-private partnership frameworks**

Index scale of 0-6 from least to most restrictive, 2008



Source: S. Araújo and D. Sutherland (2010), "Public-Private Partnerships and Investment in Infrastructure", OECD Economics Department Working Papers, No. 803.

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However, past experience shows that it is important that the new framework is actually implemented and in particular that analysis done by the unit is fully taken into account by political decisions. In this regard, the government's intention that all PPP project proposals will be compared against an ordinary public procurement alternative and the results made publicly available and presented to the parliament is welcome. In addition, there is a need for a proper assessment of the full implications for the budget position of PPPs over their whole life-cycle and the government should further reform how PPPs are included in the budget planning by accounting for capital expenditure on them on the same basis as the alternative of an ordinary public investment.

### **Local and regional governments' debt issues are leading the central government to step in**

Portugal is a fairly centralised country (Box 1.1), but subnational government nevertheless poses important fiscal issues. Since 2009, local and regional authorities have faced declining revenues, due to cuts in central government transfers and depressed tax receipts, particularly on housing transactions. They reacted by cutting spending, but not rapidly enough to prevent

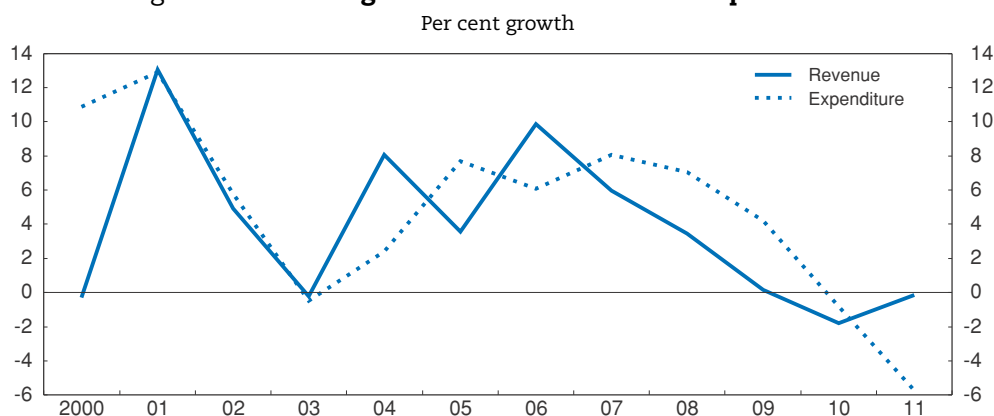
the accumulation of debt (Figure 1.12). The total deficit of local government (including autonomous regions) reached 0.8% of GDP in 2009-10, before halving in 2011. Local debt has risen to a high international level (Figure 1.13) and local governments have lost access to long-term bank credit in the wake of the sovereign debt crisis. As a result, a large number of municipalities as well as the region of Madeira have accumulated unsustainable short-term debt and payment arrears, notably through local public companies. This makes it difficult to assess the total extent of their liabilities, although audits carried out by the central government in the first half of 2012 resulted in significant progress in this direction.

### Box 1.1. The structure of Portuguese subnational government

There are no elected regional governments on the mainland, meaning that local government is essentially concentrated at the municipal level and in the two autonomous regions of the Azores and Madeira. Municipalities are relatively large by European standards (34 000 inhabitants on average) and are subdivided into civil parishes in charge of lower administrative functions. More precisely, Portugal is subdivided into:

- **2 autonomous regions:** the Azores and Madeira, which enjoy a large autonomy guaranteed by the Portuguese Constitution, elect their own regional government and legislative assembly and keep tax receipts collected in their jurisdiction. In addition, the mainland is subdivided in five regions, which were originally created to manage EU structural funds, and whose role has grown to include wider regional development issues. Mainland regions have no elected government and are directly administered by central government representatives – the so-called Commissions for Regional Coordination and Development (CCDR).
- **308 municipalities** – mainly in charge of basic infrastructure and primary education. They are run by an executive council and a municipal assembly, both elected for four years. In the past few years, municipalities have been encouraged to associate into inter-municipal communities, which have the right to collect certain taxes and have a bigger role in the management of EU funds.
- **4 259 civil parishes (*freguesias*)** – in charge of local current administration and maintenance of certain basic infrastructure. The number of parishes per municipalities (14 on average) varies widely, from 1 to 89. Parishes are managed by a local assembly and an elected local council, the president of which also sits in the municipal assembly. Their economic weight is relatively small, with an overall budget of around EUR 450 million (0.3% of GDP).

Figure 1.12. Local government revenue and expenditure<sup>1</sup>



1. Includes autonomous regions.

Source: OECD (2012), "General Government Accounts", OECD National Accounts Statistics (database), May.


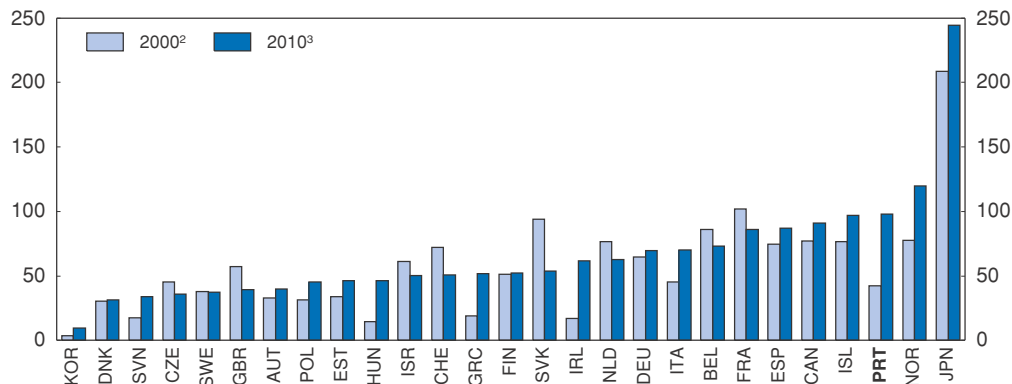
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Figure 1.13. **Local government debt**<sup>1</sup>  
Per cent of local government revenue




1. Total liabilities of subnational authorities excluding insurance technical reserves. Non-consolidated debt except for Israel.

2. 2001 for Israel and Slovenia, 2002 for Korea.

3. 2009 for Korea and Switzerland.

Source: OECD (2012), OECD National Accounts Statistics (database), June.

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### Supporting local governments involves a trade-off

Faced with severe fiscal problems in the autonomous region of Madeira, the central government decided to step in with a EUR 1.5 billion (0.9% of GDP) financial assistance plan (Box 1.2). The government also agreed to support distressed municipalities with a EUR 1 billion (0.6% of GDP) credit line. This will allow municipalities to pay back part of their short-term debt and arrears, the total of which for all local and regional authorities reached EUR 4 billion (2.3% of GDP) by the end of 2011.<sup>2</sup> In exchange for this support, municipalities have notably committed to cut spending and increase taxes (where possible) and fees. The government expects more than half of municipalities to apply for the credit line. Applications will be examined by the government in mid-2012. In this context, it is important that the conditions under which municipalities receive support, and how much support each municipality is entitled to, follow strict and transparent guidelines, as envisaged, to ensure equal treatment of municipalities and avoid political interference.

#### Box 1.2. The financial assistance plan to Madeira

Once Portugal's poorest region, Madeira has become the country's second richest over recent decades, thanks notably to large subsidies from the central government and the EU. In 2008, regional GDP per capita was 30% higher than the national average. Large infrastructure works have helped develop tourism – the island's main activity (20% of regional GDP) – while a low-tax business zone has attracted important off-shore business activities (20% of regional GDP). Over the past few years, subsidies have become less abundant as a result of the region's economic progress. However, public spending has not slowed accordingly, leading to the rapid accumulation of debts as large construction projects were still undertaken, including a marina and a heliport (both of which are out-of-use because of flawed design).

**Box 1.2. The financial assistance plan to Madeira (cont.)**

Unsustainable debt dynamics resulted in Madeira's regional government looking for financial support. The central government agreed in January 2012 to provide EUR 1.5 billion (0.9% of national GDP, 30% of regional GDP) of loans to the region, with an interest rate comparable to the central government's financing costs. The fiscal consolidation plan aimed at reducing the regional public deficit from 6% of regional GDP in 2011 (excluding negative one-offs of 11% of regional GDP) to 3% of regional GDP in 2012, 1% in 2013 and to balance the budget by 2014. However, the 2011 deficit turned out higher than expected by 3½ per cent of regional GDP, putting these objectives at risk. The consolidation relies mainly on the revenue side (two thirds of the adjustment).<sup>\*</sup> Income tax and general corporate tax rates will be aligned with mainland levels and the value-added tax rate will be raised from 16% to 21%, one percentage point below the mainland level. The privileges of the low-tax business zone will be reduced, with a corporate tax rate raised from 0% to 4%. On the spending side, measures include a cap on public investment at EUR 150 million per year – roughly its underlying level in 2010-11 after correcting for one-offs – and lower public wages, mainly as a result of the national level cut in the 13th and 14th month of civil servants' salary.

Financial assistance is conditional on a strong reinforcement of the fiscal framework. The budget will be subject to central government approval before it is voted and its execution will be closely monitored. An audit on arrears, which amount to 40% of regional GDP has been carried out in early 2012. However, the size of the region's total liabilities, i.e. including all liabilities of local public companies, is still uncertain. These companies are planned to be restructured and partly privatised. No new public-private partnership (PPP) can be contracted until existing PPPs are audited and renegotiated. Disbursements of the central government loans will be spread over 2012-15 and conditional to the region complying with the programme. Compliance will be assessed through quarterly mission reviews, starting in April 2012. Such a strict conditionality is important, as the constitutional autonomy of the region otherwise restricts the central government's ability to influence the region's policy, as illustrated by its inability in 2011 to stop construction projects judged too costly.

<sup>\*</sup> However, against a no-policy change scenario, the programme contains more measures on the spending side than on the revenue side, reflecting that a large planned increase in public investment in 2012 (EUR 400 million, excluding one-offs) was cancelled as part of the programme, meaning that public investment will remain broadly stable between 2011 and 2012 (excluding one-offs).

The central government does not explicitly guarantee local debts and faces a trade-off between supporting distressed local authorities and letting them default. On the one hand, financial support to local governments could generate significant fiscal costs for the central government at a time of scarce fiscal resources. These costs would also risk increasing in the future if the economic outlook (and thus local revenues) deteriorates further. Another drawback is moral hazard, as the possibility of financial assistance could undermine prudence in future local policymaking, as occurred in Sweden in the 1970s-80s (Pettersson-Lidbom and Dahlberg, 2003). On the other hand, a wave of local defaults would impose losses on Portuguese banks, thus augmenting already significant recapitalisation needs. In the current context, it could also affect investors' confidence in other public borrowers, including the central government itself. Overall, this suggests that financial assistance should be provided to distressed local government in cases of liquidity problems, i.e. when limited and temporary support would suffice to restore debt sustainability, but that the government should be ready to accept defaults of insolvent authorities in some instances, so as to reduce moral hazard issues.



In the case of Madeira, there are significant risks to the programme as the 2011 deficit turned out higher than expected and the region's total liabilities (including arrears and debt from local public companies) are still unknown, but may be as high as 150% of regional GDP. In addition, the programme assumption that the region will grow at the same pace as the country as a whole appears to be relatively fragile, especially given the traditionally high reliance on public demand in the region. The programme's success will depend on the region's capacity to find new sources of private growth despite the increase in taxes and to respect expenditure targets, notably on public investment. This will require a strong reinforcement of the regional fiscal framework. The central government should carefully monitor the solvency of the region as there is a significant risk that the region may not be able to pay back all of its debt, thereby making debt restructuring inevitable.

### ***Measures are needed to improve the local and regional fiscal framework***

It is also important that financial support to municipalities be accompanied by an enhanced local and regional fiscal framework to ensure debt reduction in the medium-term. To this end, the government is committed to presenting revised local and regional financing laws by the end of 2012. Important steps in this area were already taken in the 2007 reform of the local finance law, which notably requires municipalities to consolidate their accounts with those of local public companies and to submit them to external auditing. However, implementation of these measures has been delayed by municipal opposition (Blöchliger and Vammalle, 2012). In the current context, implementing them rapidly should be a priority. The 2007 reform also introduced limits on municipal total debt (125% of annual revenues) and short-term debt (10% of annual revenues). In order to prevent any circumventing of these rules, their scope should be broadened to include all liabilities of local authorities, such as payment arrears, debts of local public companies and discounted future payments in PPP contracts. Additionally, a balanced budget rule could be introduced, a relatively common feature across OECD local governments (Sutherland et al., 2005) that would offer the benefit of consistency with the general government's broader deficit rule.

The local fiscal framework should also give incentives for local and regional authorities to pay back arrears, which had accumulated to almost EUR 2.8 billion (1.6% of GDP) by the end of 2011 and were still increasing in the first months of 2012. To this end, the government intends to apply to municipalities the budgetary "commitment control" framework which has been put in place at the central level. In this framework, entities are not allowed to spend more money than they project to receive and entities with spending arrears are forced to adopt more ambitious spending limits. To make the framework fully efficient, it will be necessary to prevent municipalities from relying on over-optimistic revenue forecasts, a frequent practice in the past. This will require giving the Ministry of Finance a supervisory role in this area, while the Fiscal Council could also be involved in monitoring tasks. In addition, municipalities should be required to keep their funds in a dedicated account at the Treasury (instead of a private bank account), as a way to facilitate monitoring and to reduce general government gross public debt (via more debt consolidation).

### ***The cyclical nature of local revenues should be reduced***

Local revenues are particularly cyclical and their abrupt decline in the last few years has been an important factor behind the accumulation of local debt. Local revenues include a housing transaction tax and a corporate tax, both of which are by nature very

sensitive to the economic cycle (Box 1.3). For example, transaction tax revenues have declined by 40% between 2007 and 2009 (Figure 1.14). Moreover, transfers from the central government also decline in economic downturns. This revenue volatility is problematic because local governments are generally less well-equipped to cope with revenue swings than central governments (Norregaard, 1997). In the eventuality a balanced budget rule for local authorities was introduced, reducing this volatility would be even more important as local governments would otherwise be forced into a very pro-cyclical spending behaviour.

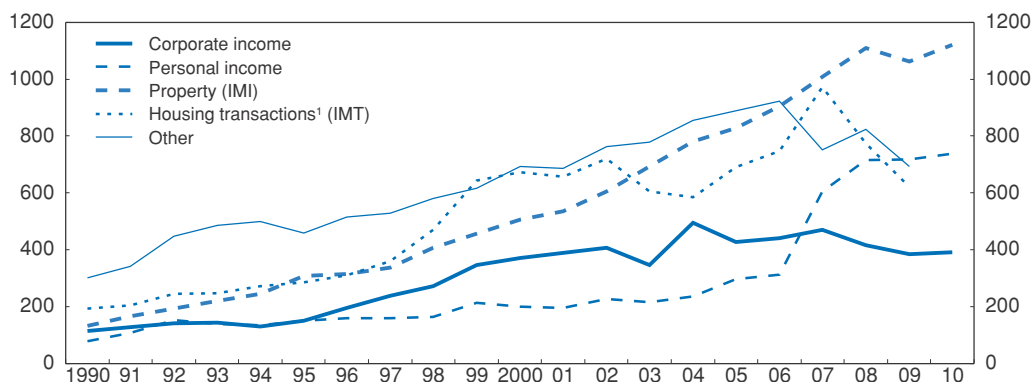
### Box 1.3. Municipalities have cyclical resources and little fiscal autonomy

Municipalities draw roughly half of their resources from local taxes and fees and the other half from transfers from the central government and from EU structural funds. The poorest municipalities tend to be more dependent on transfers as they have lower tax revenues. Local taxes are mainly housing related, concerning both property (30% of local tax revenues) and transactions (20% of local tax revenues). Municipalities set rates for the former, within a centrally defined range, but not for the latter. Other tax resources include a local corporate income tax (*derrama*) and a fraction of the vehicle tax. Municipalities' relatively low fiscal autonomy was slightly increased in 2007, by allowing them to claim up to 5% of their residents' personal income tax, the principle being that unclaimed receipts remain with taxpayers.

Concerning transfers from the central government, municipalities receive a quarter of personal income tax, corporate income tax and value-added tax national revenues. These revenues are distributed on the basis of demographic, geographic and environmental criteria with an equalisation scheme ensuring strong redistribution towards the poorest municipalities. There is no mechanism to smooth these transfers, meaning that a fall in national tax revenues is directly translated into falling transfers to municipalities, albeit with a two year lag. Transfers from the central government to municipalities also include earmarked funds to finance specific spending on education, health and social policy.


Figure 1.14. **Local government tax revenue in Portugal**

Million euros



1. Since 1995 this tax is collected by central government but then transferred to local government.

Source: OECD (2012), "Revenue Statistics: Portugal", OECD Tax Statistics (database), May.

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Several measures would help to reduce the cyclicity of local revenues. Firstly, housing taxation should be shifted from transactions to recurrent taxation of immovable property, as recommended in the 2010 *Survey*. Such a measure would make local revenues less volatile but also foster labour mobility, thus stimulating potential growth. Secondly, transfers from central to local governments should be set in advance on a multi-year basis. This would reduce their volatility and give municipalities more certainty about their future resources, which would represent a fair counterpart to stricter monitoring being imposed by the central government. Another benefit of this would be that it would limit the scope for higher transfers to local governments in election years, as there is evidence that, despite the existing rules, electoral motives currently lead to such a bias (Veiga and Veiga, 2011). A third option would be to increase local authorities' fiscal autonomy, which is low by international standards, to enable them to cope with revenue declines by increasing local taxes. This could also lead to more efficient public service by increasing local government's accountability to taxpayers (Blöchliger and Pinero-Campos, 2011; Joumard and Kongsrud, 2003). However, this option should only be considered once local efforts to rationalise spending have been completed as the prospect of additional tax resources may undermine these efforts. Finally, a common practice is that municipalities levy "compensations" from businesses (*e.g.* wind turbine farms, retailers) establishing in their jurisdiction. This possibility should be reduced to make municipalities less dependent on this uncertain revenue source, which is also harmful for the business environment.

### ***There is large scope to make local spending more efficient***

Enhancing the efficiency of local spending will be crucial to achieving successful consolidation as heavy spending cuts are needed to balance local budgets in a context of declining revenues. Empirical work suggests that there is large scope for efficiency gains, as high as 40% on the sample of municipalities constituted by the Lisbon region (Afonso and Fernandes, 2003). Indeed, municipalities have had few incentives for efficiency over the past decade as a result of dynamic revenue growth, cheap credit and a weak fiscal framework, notably in terms of local public companies, which has allowed them to pile up debts. Excessive fragmentation is also a source of inefficiencies, with certain parishes containing only a few hundred people and inter-municipal cooperation still nascent. Rigidities in terms of labour contracts, which are required to be similar to central government contracts, may also have limited municipalities' flexibility in terms of staffing. However, this feature will now probably help reduce local spending as the central government is implementing large cuts in public wages. Finally, local governments have a tendency to invest excessively in infrastructure, despite basic needs in this area being already largely satisfied (da Silva, 2008, Chapter 2), which suggests that in the eventuality a local balanced budget rule is introduced, it should include capital expenditures.

To improve spending efficiency, the authorities are committed to presenting new laws, before the end of 2012, concerning both municipalities and autonomous regions. Measures will include an assessment and a restructuring of local public companies, a 30% cut in the number of parishes (with a stronger focus on urban areas) and a facilitation of inter-municipal cooperation (Portuguese Government, 2011). These welcome measures should be complemented by the generalisation of benchmarking and performance indicators, which can be powerful tools to foster local spending efficiency (Mizell, 2006; OECD, 2009d) as illustrated *e.g.* by the success of the "Kostra" system in Norway (OECD,

2008b, Box 3.11). In this area, first efforts could concentrate on the domains of water, wastewater and waste management, where indicators would facilitate efforts to streamline the local public corporate sector, while also bringing environmental benefits (OECD, 2011b). In addition, a purchasing cooperative could be created to take advantage of economies of scale when purchasing supplies.

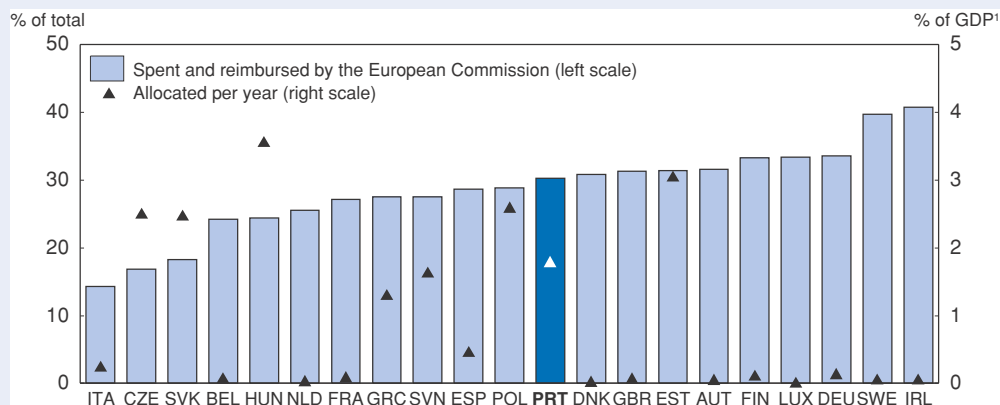
### **Making better use of EU structural funds would mitigate fiscal consolidation**

EU structural and cohesion funds are a significant resource for the Portuguese economy, amounting to around 2% of GDP per year (Box 1.4). Spending them efficiently is now all the more important that they are one of the few remaining sources of financing for the economy in the current context of deleveraging and fiscal consolidation. The first challenge is to ensure that all available funds are spent despite the serious financing constraints faced by national partners, which have notably led to the cancellation of large infrastructure projects (new Lisbon airport, high-speed Lisbon-Madrid train). The second and most important challenge is to put funds to their most productive use. This notably implies reinforcing governance to prevent efforts to absorb funds from undermining careful project selection and to reduce scope for political interference as there is empirical evidence of electoral motivations influencing funds' allocation to municipalities (Veiga, 2010).

#### **Box 1.4. EU structural and cohesion funds in Portugal**


Portugal is the biggest recipient of EU structural and cohesion funds among “old” EU member States, with an allocation of 1.8% of GDP per year for 2007-13 (Figure 1.15). Funds allocated to Portugal are split roughly evenly between three priorities: “territorial enhancement” (mainly infrastructure investment), “competitiveness” (support to companies and innovation) and “human potential” (education and training, including school infrastructures). When compared with past programmes and other countries, this implies more focus on education and less on infrastructure, reflecting that Portuguese basic infrastructure needs are now broadly satisfied while the lack of education remains an important bottleneck to growth.

**Figure 1.15. Absorption of EU structural and cohesion funds by end 2011**  
Funds allocated over 2007-13



1. Average for the period 2007-13, Eurostat projections.

Source: QREN (2012), “Indicadores Conjunturais de Monitorização”, Boletim Informativo 14, Comissão Técnica de Coordenação do Qren and Eurostat (2012), “Economy and Finance”, Eurostat Database, May.

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**Box 1.4. EU structural and cohesion funds in Portugal (cont.)**

The selection of projects financed by EU funds is carried out by national and regional authorities within a framework of operational programmes reflecting the three national priorities. Each programme can receive financing from one or several of the three EU funds: the European Regional Development Fund for activities such as infrastructure investment and support to small and medium-sized enterprises, the European Social Fund mostly for education, and the Cohesion Fund for transport and environment related activities. In Portugal, private projects are chosen by selection committees after public calls for projects, while public projects are either directly integrated into public policy programmes (e.g. school building programmes) or selected by national authorities in accordance with publicly disclosed guidelines agreed upon with local stakeholders. Large infrastructure projects (exceeding EUR 50 million) also require *ex ante* cost-benefit analyses and explicit approval by the European Commission. Monitoring is mainly a national responsibility, with the European Commission only in charge of monitoring national governance frameworks and dedicating relatively low means to combat fraud.\*

\* Financial Times (2010), "Net That Fails to Catch EUR 700m Errors", In-depth Report on EU Structural Funds, 30 November.

In terms of the absorption of EU funds, Portugal is doing better than in the preceding cycle (Marzinetto, 2011) and than most other big recipients of funds (Figure 1.15). By the end of 2011, 80% of the funds allocated for 2007-13 – which have to be spent no later than 2015 – had already been committed to selected projects, 40% had been effectively spent and 30% had already been reimbursed by the European Commission (Portuguese Government, 2012). To stimulate absorption, the Portuguese authorities are progressively shifting money from transport and environment infrastructure programmes, where many projects have been cancelled, to other programmes, notably related to education. To this end, an assessment of inactive projects was carried out in April 2012, aiming to free up to EUR 1.5 billion of funds for reallocation. The absorption of funds will also be increased by the EU decision in December 2011 to reduce local co-financing rates in crisis countries, which, for Portugal, could bring it from an average 30% down to 15%. This lower co-financing will apply for 2010-13, but only retroactively, i.e. on projects already selected, to avoid attracting lower quality projects.

In this context, available EU funds should be strategically shifted towards two of Portugal's most pressing economic priorities: alleviating the credit squeeze on small and medium-sized enterprises (SME) and avoiding high unemployment becoming structural. Regarding the former, additional resources should be devolved to provide financing or guarantees to viable SMEs, which may require further approval by the European Commission to reallocate funds across programmes. In addition, measures should be taken to facilitate SMEs' participation in EU funded projects, e.g. by clarifying tender processes, providing SMEs with support to comply with (cumbersome) administrative procedures and giving SMEs more say about the strategic allocation of funds. To tackle the unemployment problem better, funds should be further shifted towards active labour market policies such as targeted training programmes for (especially young) unemployed, a move also encouraged by the European authorities (European Council, 2012).

In addition, further efforts are needed to improve governance, especially in a context of lower co-financing rates. At the macro level, a ministerial coordination committee, chaired by the Finance Minister, has recently been created. It may help address the need for high-level arbitration in the strategic allocation of funds both across sectors and across

regions (Barca *et al.*, 2012). A strategic monitoring process is also being introduced to assess the efficiency of policies and reorient funds if needed. This is welcome as continuous evaluation and benchmarking are essential to make an efficient use of funds (OECD, 2009d). Such evaluation should be generalised, carried out by an independent body and its results should be published. At a more micro level, there is also scope to rationalise the allocation of funds by generalising *ex ante* economic analyses and by delegating the selection of public projects to more independent and more accountable agencies in order to reduce political interference. In addition, more means should be dedicated to combat fraud as “soft” investment projects such as training programmes tend to be more difficult to monitor than infrastructure projects. Finally, more dialogue should be encouraged at the regional level between central government representatives and local stakeholders in order to stimulate the emergence of bottom-up projects taking better into account regional interests (OECD, 2008b).

#### Box 1.5. **Summary of recommendations for restoring fiscal sustainability and lifting public sector efficiency**

##### **Fiscal policy and fiscal framework**

- The government should aim to meet headline deficit targets in the programme, notably through abiding by the budgeted expenditure at all levels of general government. If risks materialise significantly and growth is far lower than projected in the programme, the automatic stabilisers could be allowed to operate at least partially.
- Introduce an explicit and easily enforceable public expenditure rule consistent with revenue projections and medium-term fiscal objectives and in line with the European fiscal framework.
- The Fiscal Council should prioritise core functions, including assessing the macroeconomic and fiscal projections, compliance with fiscal rules and giving fiscal policy recommendations to the government. Fiscal council board members should be allowed to have other paid employment.
- The Minister of Finance should be required to provide a formal response to fiscal council reports to embed the fiscal council’s role in the policy debate.

##### **State-owned enterprises and public-private partnerships**

- To improve transparency around state-owned enterprises (SOE), explicitly set and show in the government’s accounts the subsidy paid to urban transport companies in return for an agreed level of services and at least operational balance.
- Continue to rationalise the rail network and services replacing less frequented lines with bus services to improve SOE performance.
- Future public-private partnerships (PPP) should be budgeted for in the same way as other investment to avoid PPPs being used as a way to push expenditure into the future.

##### **Local government and EU structural funds**

- As envisaged, support to local and regional governments should come only under strict and transparent guidelines and be accompanied by improvements in the fiscal framework. Municipalities should notably be required to keep their funds in a dedicated account at the Treasury.
- Local government revenues should be made less volatile by shifting from taxing housing transactions to higher recurrent taxation of immovable property and by setting government transfers on a multi-year basis.
- Local spending efficiency should be encouraged by the generalisation of benchmarking and performance indicators.
- Absorption of EU structural funds should be further stimulated by shifting available funds towards credit to SMEs and targeted training programmes, while governance should be reinforced to enhance efficiency.

## Notes

1. More exactly, assuming a constant elasticity of revenue to GDP:

$$\Delta sb_t = \left( \frac{\frac{EXP_t - 1}{GDP_t - 1} + \frac{EXP_t}{GDP_t}}{2} \right) \times (\alpha - g_t) \times \frac{1}{1 + (\alpha - (g_t - \alpha)/2)}$$

where  $\Delta sb$  is the change in the structural balance,  $EXP$  is expenditure,  $GDP$  is nominal potential GDP,  $g$  is the growth rate of nominal potential GDP and  $\alpha$  is the growth rate of total expenditure.

2. Combined arrears of local and regional governments reached EUR 2.8 billion by the end of 2011 (European Commission, 2012), while their short term debt (less than one year) was EUR 1.3 billion (Bank of Portugal, 2012).

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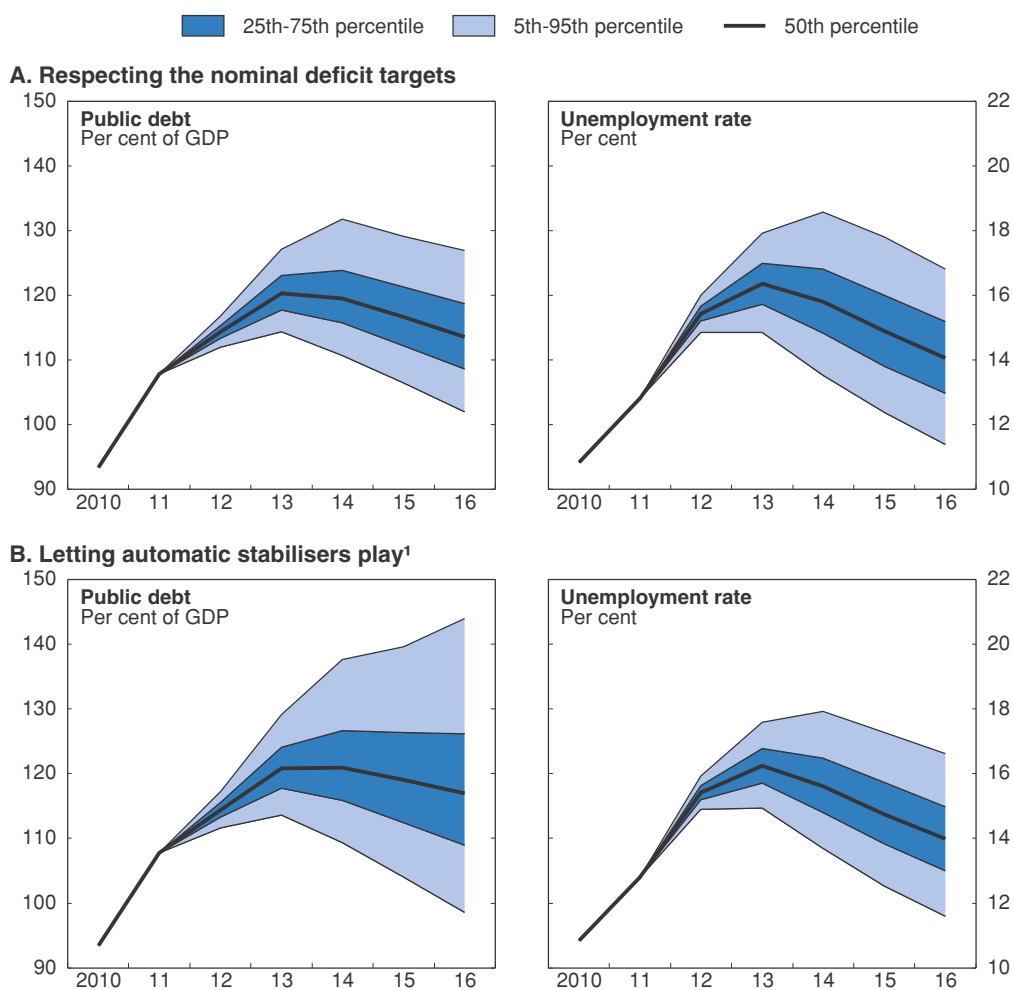
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## ANNEX 1.A1

## Sensitivity of stochastic simulation results

This annex presents the sensitivity of the stochastic simulation results shown in Figure 1.2 and in Figure 6 of the Assessment and Recommendations to different assumptions regarding the fiscal multiplier and potential growth.

Figure 1.A1.1. **Sensitivity analysis: Fiscal multiplier of 0.5 (instead of 1)**



1. Respecting the structural primary deficit targets.

Source: S. Sorbe (2012), "Portugal: Assessing the Risks about the Speed of Fiscal Consolidation in an Uncertain Environment", OECD Economics Department Working Papers, forthcoming.


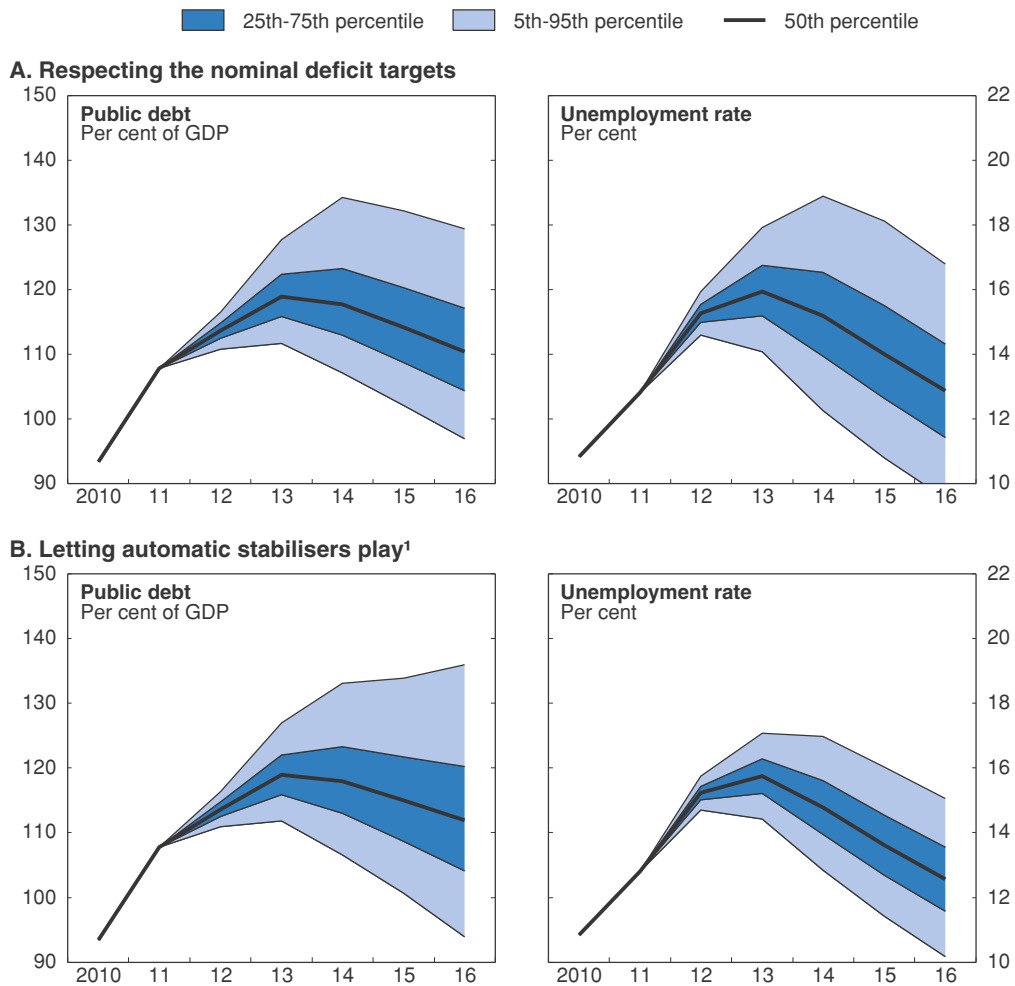

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Figure 1.A1.2. **Sensitivity analysis: Average potential growth over 2012-16 of +1% (instead of +0.3%)**



1. Respecting the structural primary deficit targets.

Source: S. Sorbe (2012), "Portugal: Assessing the Risks about the Speed of Fiscal Consolidation in an Uncertain Environment", OECD Economics Department Working Papers, forthcoming.

StatLink  <http://dx.doi.org/10.1787/888932670009>



**From:**  
**OECD Economic Surveys: Portugal 2012**

**Access the complete publication at:**  
[https://doi.org/10.1787/eco\\_surveys-prt-2012-en](https://doi.org/10.1787/eco_surveys-prt-2012-en)

**Please cite this chapter as:**

OECD (2012), "Solid foundations for a sustainable fiscal consolidation", in *OECD Economic Surveys: Portugal 2012*, OECD Publishing, Paris.

DOI: [https://doi.org/10.1787/eco\\_surveys-prt-2012-5-en](https://doi.org/10.1787/eco_surveys-prt-2012-5-en)

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