

*Research Paper*

## **The impact of fiscal competitiveness on Portuguese Municipalities: An analysis based on the municipal dimension**

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### **ABSTRACT**

**Purpose:** The aim of this study is to understand the relationship between the value of rates and the size of Portuguese municipalities, with the legal requirements of the General Regime for Local Authority Rates playing a moderating role in the relationships under study.

**Methodology:** A qualitative study was carried out, using methodological triangulation by combining different methods, namely national statistical data and the theoretical perspectives of different authors.

**Results:** By having the freedom to set lower rates municipalities seek to make themselves more attractive to investment, although municipalities with lower fiscal capacity tend to have lower rates, since the political cost of having high rates does not correspond to the marginal financial benefit associated with them.

**Research limitations:** We have only analysed the fees, fines and other penalties charged, taking into account the information available. The unavailability of more detailed data on all fees, tariffs and prices means that we cannot draw any conclusions about the standardisation of information in the different tax instruments.

**Practical implications:** This study contributes to the reflection on political weight as a reason for the territorial distribution of local taxes and fees, highlighting that municipalities with less fiscal capacity tend to have lower rates, since the political cost of having high rates does not correspond to the marginal financial benefit associated with them.

**Originality:** Financial autonomy and the strategic use of local taxes remain key success factors. Strengthening local financial capacity, combined with the implementation of effective fiscal policies, could contribute to a more balanced regional development.

**Keywords:** *Municipal Revenues, Local Government Authority, Fiscal Autonomy*

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## 1. Introduction

Local authorities, namely parish councils and town councils, are a level of government close to the communities they represent and are responsible for the local social and economic development of each parish or town they represent.

In turn, the policies that local authorities implement have a direct impact on the lives of their citizens or parishioners, depending on whether they are municipalities or parish councils, and it is particularly important that they maintain a strategy focused on the performance of public financial management (Silva and da Costa Marques, 2021).

An important institutional framework that defines local government authority is the fact that municipalities generally have fiscal autonomy, which can lead to better public financial management practices (Zhang and Nguyen-Hoang, 2023; Hendrick and Crawford, 2014; Jimenez, 2017).

A significant relationship is also expected between citizen ideology and the adoption of local tax policies, as tax policies that reduce services may cause dissatisfaction among citizens who do not want to see a reduction in service levels, so their opinions are important in defining strategies to increase or decrease revenues (Dye, McGuire, & McMillen, 2005; Park, Park & Maher, 2018).

The implementation of effective tax policies contributes to a more balanced regional development. Fiscal competitiveness in municipalities is an essential tool for attracting investment, retaining population and stimulating local economic development. In Portugal, the fiscal management of municipalities has evolved in the context of the decentralisation of powers and changes to the Local Finance Law (Zhang and Nguyen-Hoang, 2023; de Moraes and Soares, Reis, & Catarino, 2023).

This study aims to contribute to the discussion on the standardisation of relevant information to assess the costs underlying the setting of fees, tariffs and prices and the results of public incentive or disincentive policies, the results obtained, and the comparability of the indicators obtained by different entities.

Therefore, the aim of this study is to understand the relationship between the value of fees and the size of Portuguese municipalities, with the legal requirements of the General Regime for Municipal Fees playing a moderating role in the relationships under study (Jordan, Neves & Rodrigues, 2015).

This study begins with a review of the literature on municipal organisation, autonomy and fiscal competitiveness. We then introduce the discussion of own revenues and municipal self-financing. Next, we look at fiscal competitiveness in Portuguese municipalities. Finally, we discuss the main theoretical contributions of the study and point out the practical implications for evaluating the results of public policies (Silva & da Costa Marques, in the press).

## **2. Literature Review**

### ***2.1. Own revenues and municipal self-financing***

Despite the gap in the evolution of the local finance regime since 25 April 1974, the successive local finance laws that have emerged have contributed to reducing the financial dependence of local authorities on transfers from the general state budget. Thus, from the first local finance law - Law No. 1/79 of 2 January - to Law No. 73/2013 of 3 September, which is currently in force, there has been a significant increase in the financial autonomy of local authorities (Monteiro, 2016; Silva, Góis and Marques, 2021; Teles, 2021).

Local authorities have their own regulatory powers (Canotilho & Moreira, 2014) and taxing powers, according to Article 238(4) of the Constitution of the Portuguese Republic. These tax powers attributed to local authorities are powers that they exercise by setting rates, namely the municipal property tax (MPT), levying surcharges and granting tax benefits in return for the establishment of projects of particular interest for the development of the municipality (Canotilho & Moreira, 2014; Baleiras, Dias & Almeida, 2017; Teles, 2021).

In addition to their own assets and finances, local authorities have fiscal powers conferred on them by their own legislation, which regulates the legal and fiscal relationships that give rise to the obligation to pay local taxes. Municipalities' own revenues must include those generated by the management of their assets and those charged for the use of their services, namely: the proceeds from the collection of the municipal property tax (MPT); the proceeds from the collection of the municipal surcharge; the portion of the proceeds of the single circulation tax that goes to the municipalities; the proceeds from the collection of fees and prices resulting from the granting of licences and the provision of services by the municipality and (Tiebout, 1956; Canotilho & Moreira, 2014).

Municipalities have taxing powers in relation to taxes and other levies to which they are entitled. To this end, under the General Regime for Municipal Fees, municipalities may establish fees, in accordance with the principles of legal equivalence, fair distribution of public burdens and publicity, to be levied on utilities provided to individuals, generated by the activity of municipalities or resulting from the realisation of municipal investments (Silva & da Costa Marques, in press; Baleiras, Dias & Almeida, 2018).

Revenues from fees, tariffs and prices are those that municipalities have the opportunity to modify with greater discretion, and their increase may prove opportune in terms of leveraging municipal revenues (Teles, 2021).

It should also be noted that in this area, municipalities with scarce resources and political conflicts are more likely to implement strategies to 'cut' internal financial resources, such as taxes, fees and charges (Park, Park and Maher, 2018; Jimenez, 2014).

## ***2.2 Local government and fiscal autonomy***

An important institutional framework that defines a local government is its own governance, which generally provides municipalities with greater fiscal autonomy than other public administrations (Tiebout, 1956; Nelson, 2012; Zodrow, 2023).

According to Pegano & Hoene (2010), fiscal autonomy for municipalities reflects the normative position that leverages increased revenues, as municipal autonomy gives them the benefits of different fiscal instruments in a more favourable way from a fiscal perspective. Thus, municipalities are more likely to adopt fiscal policies that increase their revenues, as their autonomy allows them to do so (Pagano & Hoene, 2010).

Hendrick and Crawford (2014) conclude that because they are granted this fiscal autonomy, they can levy other taxes, have additional powers in terms of regulation and economic development, in other words, they have a broader fiscal toolbox that allows them to solve financial problems, which is not the case for other public sector entities. According to the authors, the impact of fiscal decentralisation on the adoption of fiscal policies is associated with less recourse to central government funds, which frees up public funds to deal with revenue volatility in crisis years, so we can positively associate the degree of fiscal decentralisation with the adoption of local fiscal policies (Hendrick and Crawford, 2014).

In times of crisis, local governments increase and create local taxes when faced with fiscal pressures, despite the political difficulties of doing so (Wolman, 1980). Although municipalities depend on their own revenues, their economic development is strongly linked to external economic conditions, such as their size, wealth level, unemployment rate, ideological characteristics of their inhabitants and population size (Jimenez, 2017).

In other words, wealthier and larger municipalities are able to avoid adopting policies to reduce spending, such as cutting services or setting more taxes and fees, and municipalities with high unemployment and unfavourable economic and social conditions shape fiscal behaviour, i.e. there is a negative relationship with the number of fiscal policies adopted (Dye, McGuire, & McMillen, 2005; Park, Park & Maher, 2018).

Jimenez (2017) infers a significant difference in the adoption of fiscal policies between municipalities with good public managers and those with less qualified managers (Jimenez, 2017).

### ***2.3 Fiscal competitiveness***

The financial and fiscal autonomy that characterises local authorities translates into favourable conditions for people and companies to settle and promotes the development of these territories, which is reflected in the differences in tax rates applied (Baleiras, Dias & Almeida, 2018). However, several factors condition the ability to formulate policies, namely government restrictions, political culture, demand for services, economic and fiscal conditions (Shi, Aydemir & Wu, 2018).

When deciding to locate in a particular geographical area, economic agents consider the optimal combination of public goods and services provided and the tax burden offered and choose the location according to the satisfaction of their needs, in their best interest, taking into account the goods offered and the tax prices set by the municipalities (Tiebout, 1956). However, municipalities are free to set lower rates in order to make themselves more attractive for investment (Baleiras, Dias & Almeida, 2018; Nelson, 2012). The choices made by municipalities, through lower taxes or even their non-existence, with the aim of increasing competitive advantages over other areas in order to attract new economic agents, represent a framework of fiscal competition (Teles, 2021).

Thus, authors such as Park, Park and Maher (2017) state that municipalities with a shortage of resources are more likely to implement strategies to reduce internal financial resources, such as taxes and fees (Park, Park and Maher, 2017). However, Baleiras, Dias & Almeida, (2018) and Teles (2021) argue that differences in the value of taxes between municipalities are not the only element of competition between municipalities to attract and retain investment and people. According to these authors, agents also value the conditions offered by territories that meet their needs and whose quality and municipal actions are influential, such as hygiene and health conditions, safety and employment, among others. However, political weight is a reason for the territorial distribution of local taxes and fees, pointing out that municipalities with less fiscal capacity tend to have lower rates, since the political costs of high rates do not correspond to the marginal financial benefits associated with them (Baleiras, Dias & Almeida, 2018, Teles 2021).

An important institutional framework that defines a local authority is local governance, which generally provides municipalities with greater fiscal autonomy. Considering that municipalities have their own assets and finances, and that the management of these own resources is the responsibility of the respective municipal bodies, we will analyse the reality of setting fees, tariffs and prices in Portuguese municipalities (Canotilho & Moreira, 2014; Zhang and Nguyen-Hoang, 2023).

#### ***2.4 Fiscal competitiveness in Portuguese municipalities***

The fiscal competitiveness of municipalities is an essential tool for attracting investment, retaining population and promoting local economic development. In Portugal, the fiscal management of municipalities has evolved in the context of the decentralisation of powers and changes to the Local Finance Law. The ability to generate own revenues is an important indicator of the financial independence of municipalities (Park, Park & Maher, 2018).

Portuguese municipalities have a solid budgetary performance, with a low debt burden, which represents only 33 per cent of operating revenues in 2022. This stability allows municipalities to face budgetary challenges related to inflation and the real estate market without significantly compromising their financial health (de Moraes, Soares, Reis and Catarino, 2023).

According to the *Anuário Financeiro dos Municípios Portugueses* (Financial Yearbook of Portuguese Municipalities, 2023), larger municipalities continue to lead on this indicator, with own revenues accounting for an average of 67 per cent of total revenues. Small municipalities come second with 29 per cent of total revenues, showing a significant dependence on transfers from the central government (OCC, 2023).

Municipal taxes, such as the MPT (Municipal Property Tax) and the Municipal Surcharge, are fundamental tools for fiscal competitiveness. Municipalities such as Sintra and Albufeira have stood out for their ability to balance tax rates in order to attract companies and residents. The growth in RETT (Real Estate Transfer Tax) revenues also reflects the favourable dynamics of the property market in certain areas, reinforcing the role of taxation as an element of competitiveness (OCC, 2023; Tribunal de Contas, 2023; DGAL, 2018).

Although Portuguese municipalities receive a smaller share of public revenues (15.2 per cent, below the European average of 33.4 per cent), they play a crucial role in public investment, accounting for 50 per cent of the national total, above the European average of 45.9 per cent. In 2023, local government revenues accounted for only 15.2 per cent of total public revenues, well below the European average of 33.4 per cent. This situation limits the ability of municipalities to intervene in areas essential for local development. However, the share of Portuguese municipalities in public investment is relatively high, with a weight of 50 per cent in total national investment, above the European average of 45.9 per cent. This underlines the strategic role of local authorities in the implementation of public policies (Tribunal de Contas, 2023; de Moraes et al., 2023).

Although larger municipalities have a greater capacity for financial autonomy, smaller municipalities face significant structural difficulties. Dependence on state transfers limits their fiscal flexibility and ability to attract investment. Reforms in fiscal decentralisation, combined with innovative local policies, will be crucial to increase the competitiveness of smaller municipalities (Nelson, 2012; Park, Park and Maher, 2017; Zhang and Nguyen-Hoang, 2023; Hendrick and Crawford, 2014).

### **3. Methodology**

The methodological approach should describe in detail and with precision all the stages of the research work, as well as the analytical techniques applied, the tools used to obtain the relevant information and the way in which the data were treated in order to carry out the relevant data analyses (Hoepfl, 1997; Patton, 2002; Bogdan & Biklen, 2003; Sampieri, Collado & Lucio, 2022).

This study is of a qualitative nature and is characterised by being mainly theoretical, with a critical evaluation of previously published studies. Through an integrative approach to previous studies, we sought to analyse the state of the art regarding the relationship between the value of fees and the size of Portuguese municipalities, assuming that the legal imperatives of the General Regime of Municipal Fees play a moderating role in the relationships under study.

As this is mainly a theoretical study, it uses a literature review of scientific articles, books, current legislation on the regulation of fees, tariffs and prices, municipal regulations, reports from the Court of Auditors and other studies, such as the Yearbook of Portuguese Municipalities for 2023 and the Survey of Municipal Fees 2018, prepared and published by the Order of Certified Accountants (OCC) and the General Directorate of Local Authorities (DGAL), respectively (Sampieri, Collado & Lucio, 2022). A methodological triangulation was adopted, combining different methods, namely data sources and the theoretical perspectives of different authors, in order to obtain the most complete understanding of the phenomenon of rate setting by municipality and by size. This approach sought to increase the validity and reliability of the study's findings, allowing for a more complete analysis and better substantiation of the conclusions. Multiple sources of evidence develop converging lines of inquiry as a process of data triangulation (Yin, 2017).

Taking into account the municipal revenue data of the 308 Portuguese municipalities, by size and in relation to the fees, fines and other penalties that are the subject of our study, and taking into account the study published by DGAL in 2018, specifically on the value of municipal fees collected by Portuguese municipalities, and the Financial Yearbook of Portuguese Municipalities 2023 published by the OCC, which reports identically on the year 2017 and the years 2020 and 2022, we attempted to analyse the impact of municipal size on the value of revenues collected.



However, due to COVID-19 and generalised tax incentives, we decided to examine the year 2022 in order to confirm the 'chain of evidence' conclusion. It should be noted that the end of the pandemic was not decreed until May 2023, but the latest data available refer to 2022, when the decrees published under COVID-19 had largely expired (OCC, 2023; Decreto-Lei N. ° 66-A/2022, 2022).

#### 4. Results

Bearing in mind that of the 308 Portuguese municipalities, around 70% are predominantly rural, 24% predominantly urban and 6% intermediate, and that the realities are so different, let's reflect here on the values associated with municipal rates and establish the appropriate correspondence with the requirements in force and the adjustment to the size of each municipality, which we present in the following table (Pato & Teixeira, 2020; DGAL, 2018; Censos 2021; OCC, 2023).

**Table I: Size of Portuguese municipalities versus revenue collected**

	<b>Small Municipality</b>	<b>Medium-sized municipality</b>	<b>Large Municipality</b>
<b>Number of municipalities</b>	188	95	25
<b>Population weight resident</b>	15%	39%	45%
<b>Weight of Total Municipal Revenue</b>	23,2%	37,4%	39,5%

*Source: INE (2022); OCC (2023)*

We therefore sought to analyse the increase in the amount collected, taking into account the size of the municipality, and to do this we analysed the 35 municipalities with the highest and lowest amounts collected in fees, fines and other penalties in 2017, 2020 and 2022.

**Table II: Fees, fines and other penalties collected from the 35 municipalities with the highest revenue collected, taking size into account**

	<b>Small Municipality</b>	<b>%</b>	<b>Medium-sized municipality</b>	<b>%</b>	<b>Large Municipality</b>	<b>%</b>
<b>Year 2017</b>	1 021 912,00 €	0,52%	23 601 820,00 €	11,93%	173 136 799,00 €	87,55%
<b>Year 2020</b>	2 644 905,00 €	1,27%	33 289 552,00 €	16,02%	171 864 790,00 €	82,71%
<b>Year 2022</b>	2 956 431,00 €	0,009%	54 783 951,00 €	17,36%	257 824 493,00 €	81,70%

*Source: DGAL (2018); OCC (2023)*

An analysis of the evolution of the amount collected by the 35 municipalities with the highest revenue collection shows that the pandemic led to a decrease in the amount collected by large municipalities, while medium and small municipalities increased the amount of revenue collected despite the pandemic, although there is only one small municipality among the 35 municipalities with the highest revenue collection, Vila Real de Santo António, which in percentage terms represents 0.009% of the total revenue of the municipalities with the highest revenue collection in 2022 (DGAL, 2018; OCC, 2023).

### 5. Discussion

The results show that municipalities with fewer resources are more likely to implement strategies to reduce internal financial resources, such as taxes and fees (Dye, McGuire & McMillen, 2005; Park, Park and Maher, 2017; Teles 2021).

Despite this, small municipalities show a reduction in the amount collected compared to large municipalities, with the exception of Vila Real de Santo António, since it is a "rich" municipality, which shapes fiscal behaviour. The main source of revenue for small municipalities is current and capital transfers, which together account for 67.0% of the revenue collected, while large municipalities account for 29% of their revenue from current and capital transfers and medium-sized municipalities 45.0% (Park, Park & Maher, 2018; OCC, 2023).

Looking at Table 3, which shows the 35 municipalities with the lowest revenue collection, we can see that this figure has decreased by more than 55% since 2017, and all of them are small, which leads us to conclude that taxes are based on greater incentive criteria than in medium and large municipalities. Municipal decisions, through lower taxes or even the absence of them, seek to increase competitive advantages over other areas with the aim of attracting new economic agents, a framework of fiscal competition (Nelson, 2012; Park, Park and Maher, 2017; Zhang and Nguyen-Hoang, 2023; Hendrick and Crawford, 2014).

**Table III: Fees, fines and other penalties collected from the 35 municipalities with the lowest revenue collected according to size**

	<b>Small Municipality</b>	<b>%</b>	<b>Medium-sized municipality</b>	<b>%</b>	<b>Large Municipality</b>	<b>%</b>
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<b>Year 2017</b>	1 746 015,00€	-	0 €	0	0 €	0
<b>Year 2020</b>	1 038 684,00 €	59	0 €	0	0 €	0
<b>Year 2022</b>	968 034,00 €	55	0 €	0	0 €	0

Source: DGAL (2018); OCC (2023)

However, in addition to the principle of proportionality, i.e. not exceeding the cost of local public activity, the creation of taxes must respect the principle of the pursuit of local public interest and seek to meet the financial needs of local authorities and promote their social objectives and urban, territorial and environmental development. However, given the landlocked nature of these municipalities and the small number of negative and especially ageing municipalities, the charges are based on greater incentive criteria than in medium and large municipalities (Tribunal de Contas, 2019; Canotilho & Moreira, 2014; DGAL, 2018; OCC, 2023; Teles 2021; Shi, Aydemir & Wu, 2018).

Political weight is thus one reason for the territorial distribution of local taxes and fees, highlighting that municipalities with less fiscal capacity tend to have lower rates, as the political costs of high rates do not match the marginal financial benefits associated with them (Baleiras, Dias & Almeida, 2018; Teles 2021; Park, Park and Maher, 2017; Zhang and Nguyen-Hoang, 2023; Hendrick and Crawford, 2014).

To allow this comparability, and given the vicissitudes that characterise small municipalities, which are reflected in a tax incentive, these should be taken into account when analysing the results of public policies, in order to allow comparability of the indicators obtained by municipalities of different sizes, since unfavourable economic and social conditions will shape fiscal behavior, i.e. they will have a negative relationship with the number of fiscal policies adopted. (Tribunal de Contas, 2023; Park, Park & Maher, 2018; Teles, 2021).

## 6. Conclusion

Bearing in mind that when the political decision-makers of a given territory approve a set of fiscal policies, they generally tend to seek to leverage competitive advantages over other territories (Teles, 2021; Shi, Aydemir & Wu, 2018).

However, the policies that local authorities implement have a direct impact on the lives of their citizens or parishioners, depending on whether they are municipalities or parish

councils, and it is particularly important that they maintain a strategy focused on the performance of public financial management by strengthening the transparency and quality of the financial information provided (Silva & da Costa Marques, in press).

The reality of local authorities is very heterogeneous, both in terms of size and in terms of the activities they carry out and the services they provide, which increases the degree of complexity in the development of the management accounting system. Final outputs may include goods and services provided, for which a fee or price is charged, indicating the respective income and economic results obtained (Tribunal de Contas, 2023; Canotilho, 2014).

However, the results obtained allow us to conclude that by having the freedom to set lower rates, municipalities try to become more attractive for investment, although municipalities with less fiscal capacity tend to have lower rates, as the political costs of high rates do not correspond to the marginal financial benefits associated with them (Baleiras, Dias & Almeida, 2018; Nelson, 2012; Teles, 2021; Shi, Aydemir & Wu, 2018; Zhang and Nguyen-Hoang, 2023; Hendrick and Crawford, 2014; Jimenez, 2017).

As this is mainly a theoretical study, there is no empirical evidence on the relationship between the increase in the value of fees in large and medium-sized municipalities and the decrease in the value of fees in small municipalities. Future research should carry out an exploratory study with explanatory elements to obtain information on the relationship between the tax levied by small municipalities, the creation of taxes and the evaluation of the results of public policies to encourage or discourage taxes, in order to be able to compare the indicators obtained by municipalities of different sizes.

A limitation of the study is the unavailability of more detailed data on fees, tariffs and prices by municipality and by size, as we are looking at fees, fines and other penalties levied as a macro indicator. An analysis of the differences in fees, tariffs and prices by municipality and by size would give us a picture of the institutional framework and best practices in public finance management. We therefore believe that the process of analysis will include an analysis of municipal taxes by municipality and by size, and at the same time establish a relationship with public policies to encourage taxes and look for mechanisms to increase revenues in small municipalities.

In turn, administrative procedures for collecting and processing internal information and defining production units, measurement criteria and the harmonised adaptation of

information systems and the comparability of indicators obtained by different entities will have to be restructured in order to assess the results of public policies, so that indicators obtained by municipalities of different sizes can be compared (Silva & da Costa Marques, in press).

Reforms in fiscal decentralisation, combined with innovative local policies, will be crucial to increase the competitiveness of smaller municipalities.

Future studies should use a correlational study to analyse the relationship between tax rates, size and municipal debt, calculating correlation coefficients to see if there is a significant relationship between these variables. Another avenue for future research could be to analyse tax policy and its impact on attracting businesses and individuals.

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