

## **7. The debt management conditions of local government units in Poland**

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### **Introduction**

Operating in Poland since 1999 the three-tier administrative division of the country (communes, districts and provinces) has helped to increase the financial independence of these units. The main objective of introducing Poland with a system of country division into individual local government units was essentially the pursuit of efficient, and therefore, the effective functioning of the state in all spheres of public activity. This primarily involved the establishment of a range of criteria, rights and obligations which different parties have accepted. Due to the significant amount of a wide range of tasks that result from the functioning of local government, it is difficult now to imagine the existence of the state without taking into account such a segmentation of these entities. Local

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government units, which are included in the local government sector due to the large range of tasks assigned to them, play an extremely important role when it comes to the management of public funds. This is related to the broader decentralization of public tasks and also to some extent of autonomy in shaping their own fiscal policies. Since the introduction of local government reform a large number of operators in the sector are facing a growing debt problem which is also reflected in the increase of the public debt level. In the main extent this is the result of the aforementioned decentralization of tasks, in other words, the transfer of a substantial part of the state's obligations related to the functioning of the country to the level of local government (Marchewka and Bartkowiak, 2012). Due to the limited amount of funds it significantly contributes to reducing opportunities for the entity of local government, and as a consequence it forces local government authorities to use debt instruments such as credits, loans and issuance of debt securities. However, the debt results from the lack of stable budgetary policy in the sense of its possibilities. Sometimes, from the moment of creation of the budget for the next year we can see some kind of lack of vision and planning to continue the development of the unit in the future, which could contribute to stabilizing its finances. You could say that for the governing bodies of local government units 'it's all about the here and now'. A key element contributing to the debt growth of the local government sector over the last few years was also the possibility to use funds from the European Union and other non-refundable external funds. Unfortunately, this is conditioned by the necessity of bringing their own contribution, which in turn imposes the use of debt instruments. Because of the fact that the debt, which is generated by local government, affects the growth of the state debt level and involves a risk of exceeding the legally adopted restrictions in this area, it is also connected to the so-called safety thresholds. The problem of local government debt is mainly linked with all activities relating to the analysis of the debt. This man itself through the introduction of appropriate indicators that determine the situations enabling the occurrence of debt, as well as the designation of mechanisms for debt monitoring. In Poland so far lacked strict financial rules, which would help to gradually reduce the borrowing of local government entities. Constantly increasing in the indebtedness of local governments sector entities contributed significantly to the increase in debt at the national level. This was particularly relevant when it came to managing public finance sector debt. Introduced regulations in Poland are expected to contribute to a gradual reduction of the debt of local government units. The following article attempts to bring the issues of control and reduction of local government debt in connection to new restrictions implemented at the Polish local government level.

## 7.1. The indebtedness of local government units

According to Article 72 of the Act from 29/08/2009 on public finance, public debt includes the obligations of the public finance sector. Due to the fact that local government units and their unions have been classified as the entities making up the sector, debts arising from their activities will be included in the overall level of public debt. Debts created by local governments undergo the numerous legal limitations designed to prevent over indebtedness and the problems connected with the timely settlement of obligations. Notwithstanding, there is no doubt that because of local government debt included into public debt, the legal conditions to reduce the level of local government debt have to limit the gradual increase in the debt of the country (Dobrzyński, 2014).

The implementation of a number of public tasks conducted by local government units and improving the standards in, inter alia, technical and social infrastructure requires extended costs. The source of income for self-government units is not sufficient to fully meet the needs of local communities and, correspondingly, to make up the civilization delay that is associated with the decisions of local government bodies about the acquisition of additional resources, often of payable character. The existing literature emphasizes that there are two main reasons for incurring liabilities by local government units. The first one relates to the lack of adequacy between the tasks performed by the entity and the financial resources which are at its disposal. The second one is related to the mismanagement of its own budget. As a consequence, there is shortage of funds for task implementation, which leads further to using all kinds of debt instruments. Loans and advances are the most commonly used financial instruments classified as public debt. Also, it increases the interest of local government units with the possibility of issuing securities and bonds, which so far were mostly identified as the domain of large cities, to finance the borrowing needs of smaller local government units (Ruśkowski, 2008).

Local government units may take loans and issue securities for specific purposes in accordance with the provisions of the Article 89 Paragraph 1 of the Act on Public Finances (APF). External funds proceeded this way can be spent only on (Ciak, 2012):

- the coverage of budget deficits that occur during a transition year,
- the financing of planned budget deficits,
- the repayment of earlier obligations due to the issue of securities and loans and borrowings,
- the pre-financing of financial activities with funds from the European Union budget.

Credits, loans and securities incurred or issued in order to finance the budget deficits transition are characterized by the repayment compulsion or redemption in the same year in which they are incurred or issued. These instruments enable the balancing of the budget during its execution, in situations of periodic budgetary imbalance, i.e. transition deficit. They are not associated with a permanent shortage of financial means for spending included in the budget plan, but only with the lack of synchronization between the sources coming into and flowing from that account. Due to their venues and expenses in this area, they are not planned in the budget of local government units. The expenditure plan covers only expenses related to debt repayment. Bank credits, loans, and securities issued for the purpose of financing the deficit are subject to be revealed in the relevant budget reports (Kosikowski, 2010).

Financing of the planned deficit is another situation envisaged by the legislature, in which local governments have the right to enlist the commitment that increases public debt. According to the APF, local government budget deficit can be financed by revenues derived from (Lipiec and Warzecha, 2010):

- the sale of securities issued by local government units,
- loans,
- privatization of the assets of local government units,
- local government budget surpluses from previous years,
- free cash, as cash surplus on the current account of the budget of local government units resulting from the settlement of issued securities, loans and credits from previous years.

The condition for incurring debt obligation for financing the expected deficit is to plan expenses that exceed revenues and to include in the budget a resolution limit to incur debt instruments with such use. If the limit is set separately, it can't exceed the amount of the planned deficit.

Yet another situation that allows the realization of revenue is the repayment of debt instruments, previously contracted liabilities arising from the issue of securities, and loans. The level of income received by local government is usually not enough to finance spending, including other potential finance expenditures related to the previously contracted debt. The condition for incurring obligations for the purpose of debt repayment obligations with respect to the issue of securities and loans and credits is to determine the amount of the expenditure budget plan and to include in the budget the resolution limits on incurring debt instruments with such use. If the limit is set separately, it can't exceed the amount of planned expenditures. The constitutional organ can authorize

the executive authority of local government units to incur liabilities allocated for the repayment of earlier loans and borrowings and the redemption of securities (Walczak, 2014).

The next situation indicated by the legislature, which allows the increase of debt, relates to liabilities arising from loans and securities designated for leading finance activities funded from the budget of the European Union. Revenues obtained in this way are closely connected to the agreements between the local government and the institutions managing the operational programs on the granting of financial assistance from European Union funds, in connection with the execution of a specific project. The condition for incurring such obligations is to include an amount of revenues in the budget plan as well as the limit to incur debt instruments in the budget resolution. If the limit is set separately, it can't exceed the amount of planned expenditure financed from European funds for the entire period of the project. The constitutional organ can authorize the executive authority of local government units in the budget resolution to take out credits, loans, and issue securities held for leading finance activities funded from the budget of the European Union (Walczak, 2014).

According to the regulation of Article 90 of the Act on Public Finance, local government units to finance expenditure on investments and investment purchases may borrow in state-appropriated funds, as long as the law establishing the fund that is. Costs related to long-term liabilities contracted by the local government must be paid at least once a year. Discounts on securities issued by local government units cannot exceed 5% of the nominal value. In the case of issuing securities or contracting loans with a maturity longer than one year, it is also acceptable to capitalize the interest. Moreover, Article 93 Section 1 of the Public Finance Act does not allow it to entities from the public sector, with the exception of the Treasury, to take out loans or credits and issued securities and guaranteed loans, whose nominal value payable at maturity denominated in zloty, they have not been determined at the conclusion of the transaction. In addition to the statutory restrictions relating to the purpose of local governments liabilities from loans, borrowings and issuance of securities, the legislature has included the principle according to which the sum of the borrowings and liabilities of the issued securities referred to in Article 89 Paragraph 1 and Article 90 of the Act on Public Finances may not exceed the amount specified in the budget resolution of a local government unit.

## 7.2. The level of local government debt in the context of growth of public debt in Poland

Polish local government sector consists of (as of 1/01/2015):

- local governments of 2479 municipalities, including 66 cities with county status, 314 counties, and 16 voivodeships,
- local government budgetary units and local government budgetary establishments,
- associations of municipalities and associations of counties,
- local legal entities (including local government cultural institutions, independent public health care centers, provincial traffic centers, provincial agricultural advisory centers, and provincial funds for environmental protection and water management).

As shown in the table below, the local government sector debt in the years of 2012 – 14 constituted about 8% of the debt of public finance sector after consolidation<sup>1</sup>. The main factor contributing to the country's debt was the government sector with almost 92% share.

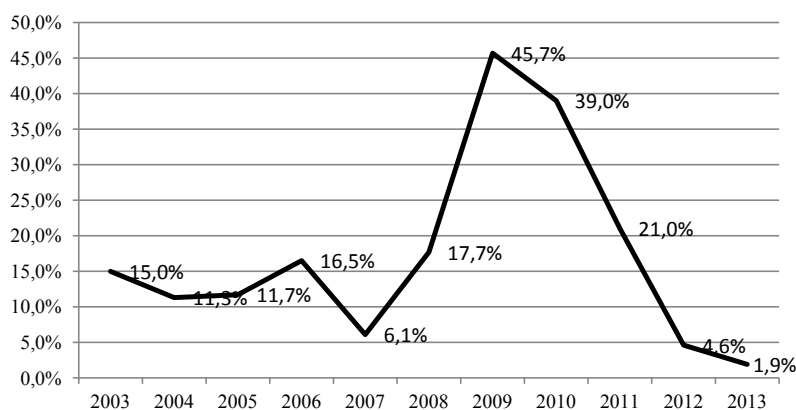
Public Finance Sector Debt	2012		2013		2014	
	XII	Structure	XII	Structure	VI	Structure
	mln zł	%	mln zł	%	mln zł	%
After a total of consolidation	<b>840 476.8</b>	<b>100</b>	<b>882 293</b>	<b>100</b>	<b>793 565.5</b>	<b>100</b>
The central government subsector debt	770 819.5	91.7	813 515.3	92.2	726 538.7	91.6
The local government subsector debt	<b>67 398.2</b>	<b>8</b>	<b>68 397.6</b>	<b>7.8</b>	<b>66 859.8</b>	<b>8.4</b>
The social insurance subsector debt	2 259.1	0.3	380.1	0	167	0

**Table 7.1.** Public debt in Poland in 2012–2014 (after consolidation)

**Source:** own study based on data from: Debt Management Strategy of the public finance sector in the years 2015–2018.

1 By consolidating public finances (as determined in accordance with the domestic methodology) or sector general government (presented in accordance with EU methodology) we understood as a statement of income and expenditure after eliminating the transfers within the sector among its elements. It eliminates the double counting of some quantities and ensures the correct calculation of the deficit (or surplus budget) of the whole sector and its sub-sectors from the point of view of the employed methodology. According to the European System of Integrated Economic Accounts (ESA),

Local government debt at the end of 2013 was equal to 68.3 billion PLN in comparison to 67.3 billion at the end of 2012. After the first half of 2014 it dropped to the level of 66.8 billion PLN. In 2009 the annual growth rate of debt recorded a significant increase (of 45.7% after consolidation). In subsequent years, the growth rate was gradually reduced and in 2013 years it was equal to 1.9% (Figure 7.1).



**Figure 7.1.** The annual growth of local governments' debts and their associations in Poland in the years 2003–2014 (after consolidation)

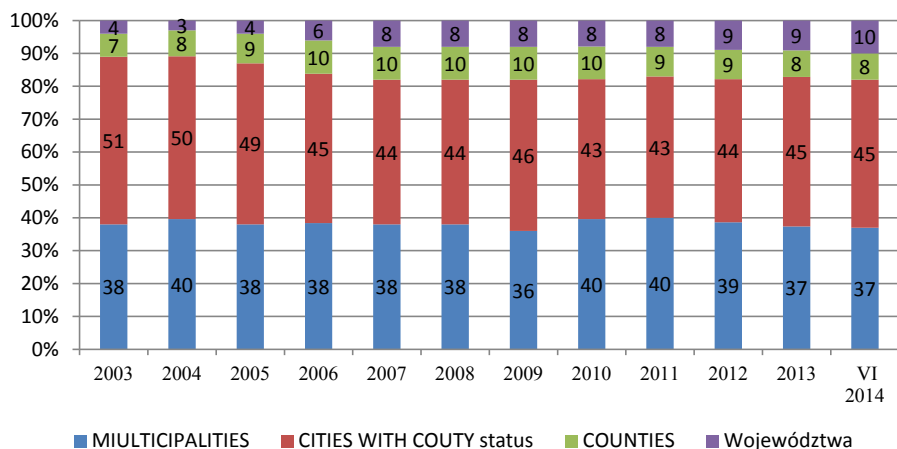
**Source:** own study based on data from: Debt Management Strategy of the public finance sector in the years 2015–2018.

Poniatowicz (2010) presents the following reasons for that:

- decline in local government own revenues caused by the economic crisis, which negatively affected the overall financial position of local government,
- launching of local investments co-financed with European Union assistance funds for which debt instruments increase the absorption capacity of EU funds,
- mobilizing the local governments to borrow according to the principles applicable to the end of 2013, in the fear of losing formal creditworthiness due to new rules that define local government debt limits by the size of the operating surplus earned for the last 3 years.

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consolidation refers to the elimination of transactions occurring between entities belonging to the group, from both expenditures as well as from revenues, and to the elimination of reciprocal financial assets and liabilities (<http://www.sejm.gov.com>).



**Figure 7.2.** The debt structure of local government units in Poland in the years of 2003–2014 (according to levels)

**Source:** own study based on data from: Debt Management Strategy of the public finance sector in the years 2015–2018.

Of the total liabilities of local government units the largest share of liabilities belonged to the cities with county status (45.3% in 2013 and 44.9% in the first half of 2014). The share of liabilities of municipalities in the years 2003–2014 remained at a relatively stable level of approx. 36–40% (at the end of 2013 the share was 37% and remained at the same level at the end of June 2014), and the shares of counties and province after several years of growth stabilized at approx. 8–10% (at the end of the second quarter of 2014 years it was equal to 9.7% and 8.5%).

### 7.3. Legal conditions for the commitments of local government units

In 2006–2013 the elements that fundamentally affected the level of local government debt were statutory limits of incurring debt, that were expressed in two indicators in Article 169 and 170 of the APF from 2005. According to these regulations, the total amount of local government debt during the financial year could not exceed 60% of the planned revenue of the unit during the financial year, and at the end of the financial year it could not exceed 60% of the total executed revenues. Also, the total amount of loans and credits repayments with accrued interest, the redemption of issued securities with interest and discount, and the potential payments under guarantees issued by local government units and sureties



that occur in a year, could not exceed 15% of the yearly planned income of local government unit. The new and currently binding definition of the indicator is described in Article 243 Paragraph 1 UFP from 2009. According to this provision, “the organ of a local government cannot accept a budget which implementation will cause that in the budget year and each year following the budget year, the ratio of the total amount falling within a given budget year repayments of borrowings together with accrued interest in a given year, redemptions of securities with accrued interest and discount, potential payments resulting from sureties and guarantees granted to the planned total revenues will exceed the arithmetic mean, calculated for the last 3 years of the relation of its current income plus the income from the sale of assets, minus current expenditures to total revenues” (Walczak, 2014).

The above relation is presented with the formula:

$$\left(\frac{R+O}{D}\right)_n \leq \frac{1}{3} \chi \left( \frac{Db_{n-1} + Sm_{n-1} - Wb_{n-1}}{D_{n-1}} + \frac{Db_{n-2} + Sm_{n-2} - Wb_{n-2}}{D_{n-2}} + \frac{Db_{n-3} + Sm_{n-3} - Wb_{n-3}}{D_{n-3}} \right) \quad (7.1)$$

In which the individual symbols stand for:  $R$  – total amount of repayment installments loans and redemptions of securities planned for the financial year,  $O$  – interest on credits and loans, interest and discount on securities issued for the purposes specified and payments resulting from sureties and guarantees granted planned for the financial year,  $D$  – total budget income in a particular financial year,  $Db$  – current revenue,  $Sm$  – the revenue from the sale of assets,  $Wb$  – current expenditure,  $N$  – financial year for which the relation is established,  $n-1$  – the year preceding the financial year for which the relation is established,  $n-2$  – the year preceding the financial year for two years,  $n-3$  – the year preceding the financial year for three years.

By adopting the structure-limiting repayment of liabilities expressed in Article 243 of the APF, the legislator resigned from a fixed rate formula that was used by all local governments and functioned for many years. The new formula, which determines the limit of planned repayments of liabilities specified in the regulation, in the financial year is based on the category of operating surplus that substantially characterizes the financial situation of local governments. For greater reliability of the result, it has been determined that data from the three years preceding the financial year, for which the maximum rate of repayments are fixed, will be accepted in order to calculate the ability of local governments to repay its

liabilities. It limits the level of repayments of the titles listed by the legislature in a given year, but does not limit the size of local government debt. This debt, with a proper schedule of loans and credits repayments and the redemption of issued securities, can achieve significantly high values that exceed already known from the previous limit of 60% APF made at the end of the year for the local government budget revenues (Salachna, 2011).

Individual local government debt ratios started taking effect from 2014. With the new construction of barriers it is important to prevent over-indebtedness and loss of local government units, according to long-term financial liquidity regulations contained in Article 242 of the APF. Under this rule, the current expenditure planned within local government budget cannot be higher than planned current revenues of the budget surplus from previous years and free funds. Also, executed current expenditures cannot be higher than executed current revenues of surplus from previous years and free funds at the end of the financial year. The part of Article 242 of the APF, which concerns revenue and current expenditure, expresses the principle of balancing the budget. This rule is only limited by the possibility of planning and implementation of the current budget deficit, as long as it covers revenues from available funds or surplus from previous years. Repayable revenues such as those arising from the borrowing, loans or issued bonds by local governments cannot be the source of financing for the part of current deficit. Article 242 of the APF introduces rational rule, from the point of view of the economy, which prohibits long-term debt incurring for current expenses that found the basic tasks carried out by local government, and at the same time it orders the financing of these expenditures from current income. The purpose of those regulations was also to prepare local governments to meet the requirements of new debt ratio. In the case of the inability of the Long-term Financial Plan (LFP) resolution or deciding about the local government budget. According to that provision, if it is not possible to pass the local government budget or LFP with the principles set out in the regulations from Articles 242–244 of the APF, and if there is a threat to further implementation of public tasks, the Regional Chamber of Audit (RCA) orders local governments to develop and adopt a proper recovery program (Walczak, 2014).

The recovery program is a formalized document and its regulations define its minimum range. According to APF designed recovery program should include at least the following:

- analysis of local government finances, with determining the cause of the risk of public tasks completion,

- plan of recovery projects, including a timetable for their implementation, in order to remove the threats, as referred in Article 240 Section 1 of the APF and to preserve a relation specified in Articles 242–244,
- anticipated financial effects of individual recovery projects with the ways to calculate them.

The constitutional organ of the local government will be able to adopt the budget and LFP, which do not maintain a relation specified in Articles 242–244 of the APF only during the implementation of a recovery program when the document obtains a favorable opinion of the RCA.

During the recovery procedure, a unit of local government:

- cannot make new investments financed with credit, loan or issue of securities,
- cannot grant financial assistance to other local government units,
- cannot give sureties, guarantees and loans,
- cannot spend on its promotion,
- cannot create hamlet fund,
- reduces implementation of tasks other than obligatory, financed from its own funds.

Those limits are applicable from the month following the month in which the program was adopted until the completion of recovery proceedings. Local government failure to prepare a recovery program or to obtain a positive opinion of the RCA results in the fixing of the budget by RCA. RCAs are state-nominated supervisors of financial management and control for local governments, municipalities associations, local government agencies, and other entities benefiting from grants from the budgets of local governments. Given the statutory powers of the RCAs and their ability to use all sorts of tools to assess the financial situation of local authorities, those organs play a special role in the system of local government debt level control. While carrying out supervisory tasks the RCA examines the resolutions and directives adopted by local government in the following matters (Sawicka, 2011):

- budget resolution procedures and its changes,
- commitments that affect the level of public debt of local governments and its ability to provide loans,
- principles and scope of grants from the local government budget,
- local taxes and fees controlled by the tax regulations,
- discharge,
- long-term financial forecast and its changes.

The list of issues that need RCA's opinion is formulated in Article 13 of the Act from 7.10.1992. According to that regulation, the tasks of the chamber include:

- to issue the opinions about the ability to repay the loan or redemption of securities at the request of the executive body of local government units,
- to issue the opinions on the draft resolutions submitted to the local government budget,
- to issue the opinions on progress reports on budget implementation during the first half of the year submitted by the boards of counties and voivodeships, and heads of municipalities (mayors),
- to issue the opinions on reports on budget implementation, submitted by the boards of counties and voivodeships as well as by heads of municipalities (mayors), along with information about the state of local government property and commentary,
- to issue the opinions on audit committees applications that represent local government bodies during discharge; and opinions on the resolution on not providing the mayor with discharge by municipal council,
- to investigate the issues that relate to the treasurer notifications of countersignature cases on the written supervisor request, that is consistent with separate laws,
- to consider other issues defined in separate rules,
- to provide explanations for the requests of the entities described in Article 1.

In case of monitoring and evaluating the financial condition, there is a particular importance in the obligation imposed on the executive body of local governments to take action in order to obtain the opinion of the RCA regarding the ability to repay borrowings or redemption of securities, especially when the local government seeks to obtain repayable revenue for the following purposes (Dobrzyński, 2014):

- financing of planned budget deficits,
- repayment of earlier obligations with respect to the issued securities, loans and credits,
- pre-financing the financial activities with funds from the European Union budget,
- expenditure on investments and investment purchases included in the list of projects described in the appendix to the resolution on LFP.

As can be seen from the above directory, the study covers resolutions and orders made by the local government in terms of budget, LFP, as well as their liabilities shaping the amount of local government debt, as well as borrowing, lending, and issuing securities.

## Conclusion

The local government sector, which includes government entities, is an important element of the state functioning due to a number of actions implemented in the framework of top-down defined tasks. Unfortunately, excessive borrowing in the scope of local government financial policy has recently become a quite common tendency. Debt management is a key area when it comes to the smooth functioning of the country. The new law on public finance debt repayment that introduces the rate outlines solution designed to discipline and reduce the indebtedness of local governments. This is especially important from the point of view of dynamically changing government debt level. The new indicator used by local government units for repayment of liabilities and based on the adopted law on public finance, in the long term should contribute to slow the pace of indebtedness of local governments. Numerous of legal conditions enclosed in the Public Finance Act regarding the conduct of local government fiscal policies are designed to outline the limits of the financial management which, if exceeded, could lead to financial difficulties. There is also a big importance of the RCA, which controlling activity meaningfully regulates the proper execution of local government financial policy. All of these legal tasks should indirectly affect the gradual debt reduction and improvement of the financial situation of local governments in Poland.

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