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THE RESULT OF THE LGU BUDGET IN THE CONTEXT OF THE MISSION OF LOCAL GOVERNMENTS

Summary: Since the very beginning of their establishment, municipalities, counties and regions (*voivodeships*) have been struggling with financial problems. Unfortunately, these problems affect the performance of the tasks assigned to these administrative units, including the standard of provided services and investment activities. Although extensive, the scale of the unsatisfied needs in LGUs varies between individual units, including municipalities. Thus, the positive financial results (the balance at the closure of the fiscal year) achieved by local government units in Poland in the recent years, as well as their future, offer an intriguing topic of research.

The purpose of this paper is to identify the causes that: 1) underpin the re-evaluation of the LGU goals (from the implementation of the local government mission to achieving a budget surplus), and 2) allow the positive result of the LGU budget to finance goals other than investment-related ones. In order to achieve this, the study covers and illustrates, using the empirical data from the years 2007-2016, the types of possible LGU budget results, LGU activities that could contribute to the closure to LGU budgets with a positive result, directions of using budget surpluses and the so-called uncommitted funds, as well as local governments' debt in terms of the intergenerational solidarity concept of its repayment and its perceived optimal structure.

Keywords: local development, the result of LGU budgets, local government debt

Apart from the state, territorial self-government is usually the second public-legal union that carries out public tasks. The rank and scope of these tasks determine how many levels and units of this relationship are responsible for their fulfilment. In Poland, there are three tiers (municipality, county, and voivodeship) with 2808 local government units altogether (2479, 313, 16, respectively).

From the very beginning of the re-establishment of local government in Poland, i.e. since 1990, municipalities, and later the remaining local government units (hereinafter referred to as LGUs), have been struggling with financial problems caused by a number of factors. These include: inefficient financial system, limited financial autonomy (especially regarding income) and progressive decentralisation of public tasks without the adequate decentralisation of public finances. Unfortunately, these problems affect the performance of the tasks assigned to these units, including the standard of provided services and investment activities. Although extensive, the scale of unsatisfied needs in LGUs varies between

individual units, including municipalities. Thus, the positive financial results (the balance at the fiscal year closure), achieved by local government units in Poland¹ in the recent years, as well as their future, offers an intriguing topic of research.

The purpose of this paper is to identify the causes that: 1) underpin the re-evaluation of the LGU goals (from the implementation of the local government mission to achieving a budget surplus), and 2) allow the positive result of the LGU budget to finance goals other than investment-related ones. In order to achieve this, the study covers and illustrates, using the empirical data from the years of 2007-2016, the types of possible LGU budget results, LGU activities that could contribute to the closure to LGU budgets with a positive result, directions of using budget surpluses and the so-called uncommitted funds, as well as local governments' debt in the aspect of the intergenerational solidarity concept of its repayment and its perceived optimal structure.

The result of the LGU budget

A correct annual financial plan of a local government unit, that is the budget, has four basic items: income, expenses, revenues and expenditure. These values should be defined to produce the equation:

$$\text{income} + \text{revenues} = \text{expenses} + \text{expenditure (outgoings)}.$$

The result of the budget is determined by comparing two figures: the income and the expenses. It can be positive (surplus) or negative (deficit). Because both the income and the local government expenses may fall into one of two categories (asset-related), it is possible to determine the result of the current budget (surplus or operating deficit) and wealth (surplus or deficit of assets/investment or development). The sum of these partial results will determine the final outcome of the LGU budget. A hypothetical question can be posed here, namely, is – in the light of the laws applicable in a given country – each variant of the LGU budget result possible, both for its part and for the whole?

In Poland, pursuant to the provisions of the Public Finance Act,² the adverse imbalance between income and current expenses is possible only in exceptional cases. This happens when (Art. 242): 1) the local government unit will cover the expenses not financed by the current income with the budget surplus from the previous years or from uncommitted funds,³ 2) the imbalance arises due to the LGU not transferring the non-refundable aid funds from abroad, which were supposed to provide financing for the current expenses in a given budget year.

Balancing the current budget was made mandatory in Poland in 2010 under the provisions of the Public Finance Act of 27 August 2009. Did the lack of this

¹ Local government units close budgets with a surplus, leaving the current needs of the local communities unmet, and also abandon or limit the investment activity.

² Act of 27 August 2009 on Public Finances, *Journal of Laws* of 2016, item 1870, as amended.

³ The surplus of cash resources in the current account of the local government unit, resulting from the settlement of the issued securities, loans and advances from previous years (Art. 217(2) (6) of the Public Finance Act).

obligation lead to LGUs having no operational surplus previously? The answer to this question is negative. The data presented in Fig. 1 show that, in the years 2007-2016, all LGUs, in particular municipalities and cities with the county status having the greatest scope of tasks, achieved an operational surplus every year. In the years 2007-2008, when Poland's economic situation was very favourable, the operational surplus in all LGUs was at a level of about PLN 17.5 billion, of which the municipalities and cities with the county status accounted for about PLN 7.5 billion. In the following years the operational surplus in LGUs was on the increase, recording the lowest values post 2010. In 2016, which was the best year from the discussed point of view, its level in all LGUs exceeded PLN 20 billion, and in municipalities – over PLN 10 billion. The total operating surplus in LGUs does not mean that there were no local government units in the years covered by the study which would close the year with an operational deficit. The data presented in Fig. 2 show that such units could be found in each year of the analysed period. They were the most numerous in 2010 (almost 17%), and the least numerous (slightly over 0.5%) in 2016. A significant drop in LGUs with such an operating budget result has been noted since 2013.

The data from Fig. 3 also lead to interesting observations. They demonstrate that the number of units closing the operational budget with a deficit in municipalities and cities with the county status showed a similar trend as the cumulative data for all LGUs. However, it is worth noting that, in the years 2009-2010, relatively more cities with the county status than municipalities maintained an operational deficit (respectively, 13.85% and 20% cities with the county status, and 6.96% and 16.58% municipalities). These years were not accidental. It was then

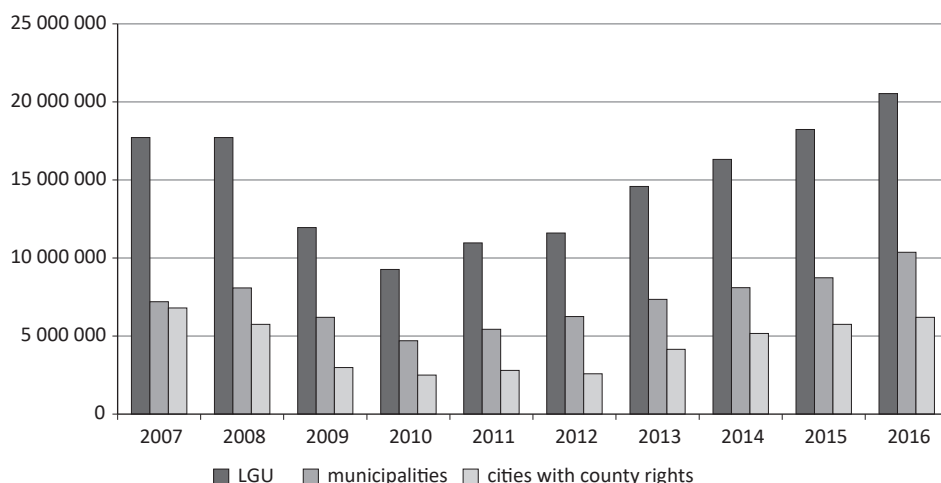


Figure 1. The operating budget result of selected LGUs in Poland in 2007-2016 (in thousand PLN)

Source: author's own study based on reports of regional activities of the accounting chambers and budget performance by local government units for the years 2007-2016 (www.rio.gov.pl – accessed on 7.07.2017).

that in many local government units in Poland, including municipalities and cities with the county status, current expenses were financed from the surplus from the years of economic boom,⁴ and their projects, including the ongoing ones, were financed from non-refundable resources from abroad. In the subsequent years, the number of units with an operational deficit decreased, and in 2015 and 2016 it reached unprecedented levels. In both these years, no city with the county status recorded an operational deficit, and in the case of municipalities it was only accumulated by, respectively, 1.82% and 0.54% such units.

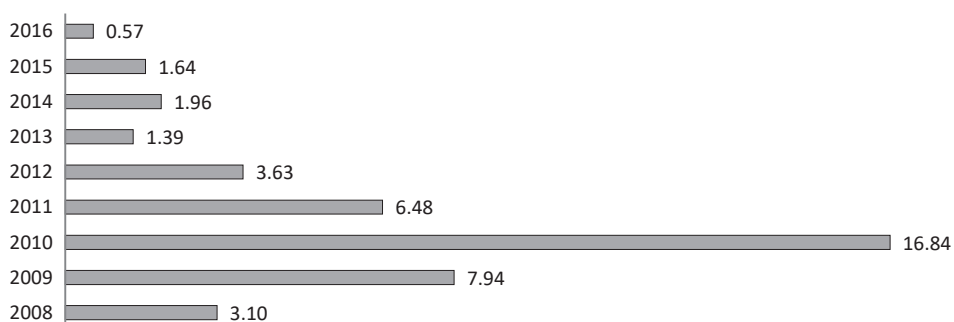


Figure 2. Local government units with operational deficit in Poland in 2008-2016 (% of the units)

Source: cf. Fig. 1.

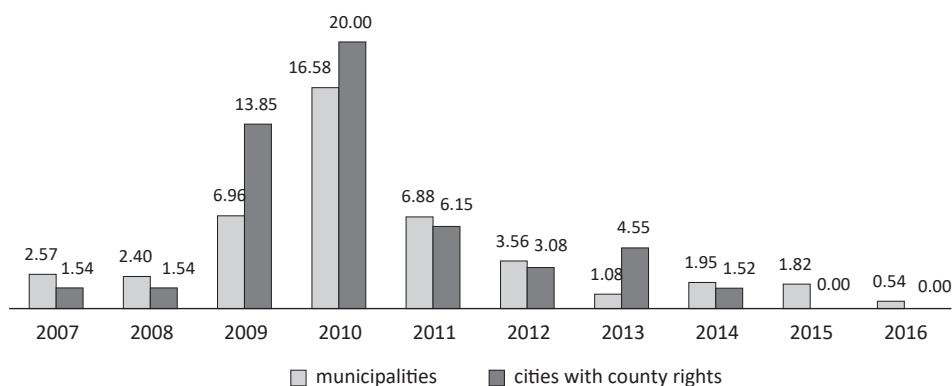


Figure 3. Municipalities and cities with county rights with the operational deficit in Poland in the years 2007-2016 (% of the analysed local government units)

Source: cf. Fig. 1.

⁴ The LGU revenues clearly increased in these years due to their shares in state taxes and sale of local government-owned real estate.

The asset-related budget in each LGU that has development plans should close with a deficit (the wealth income⁵ is lower than the wealth expenses⁶), which is proof of its investments. Other scenarios are basically impossible because: 1) not all LGUs earn income from the sale of assets,⁷ 2) revenues from the conversion of perpetual usufruct are low,⁸ 3) funds from investment grants can be transferred to the local government budget, and 4) investment expenses are usually considerable and long-term. The deficits of such an “asset-related budget” should, therefore, determine the final outcome of the entire LGU budget in a given year, which in such a situation should also be negative. Is it actually the case? No.

The data presented in Fig. 4 show that in the 10 years covered by the study, LGUs in Poland recorded a total budget deficit of about PLN 15 billion in six of these years (2008-2012 and 2014). Importantly, however, this deficit was related to investments financed in most of LGUs, with a significant share of non-refundable financial resources from abroad, from the EU budget and the financing perspective for the years 2007-2014. In this context, the situation of LGU budgets in

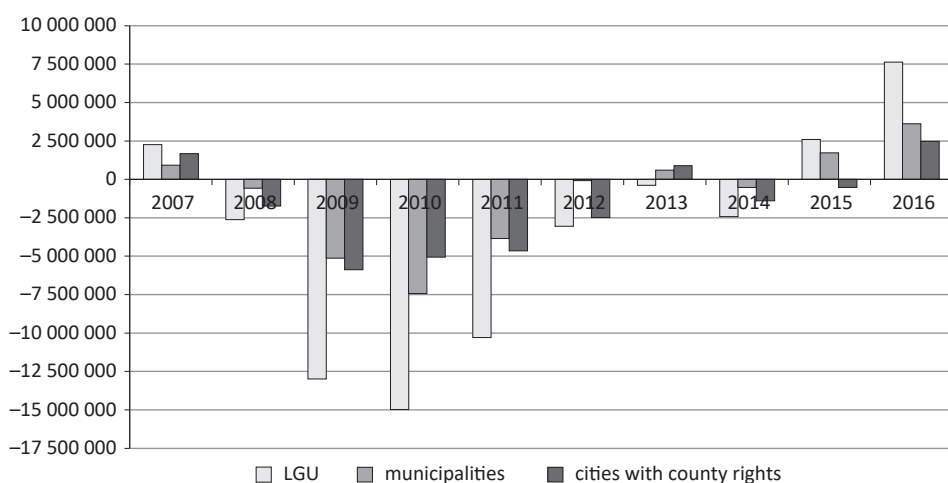


Figure 4. The result of LGU budgets in Poland in 2007-2016 (in thousand PLN)

Source: cf. Fig. 1.

⁵ In Poland, these include such income as: subsidies and funds for investments, income from the sale of property, income from the conversion of perpetual usufruct into ownership title (Art. 235 of the Public Finance Act).

⁶ In Poland, these include expenditure on: investments and investment purchases, purchase and acquisition of shares, contributions to commercial law companies (Art. 236 of the Public Finance Act).

⁷ The level of income earned from the sale of real estate is significantly different from the planned amount. This is confirmed by empirical research carried out by the author for a municipality in Wielkopolskie for the years of 2009-2013. For more on this subject, see: Kotlińska 2016a.

⁸ In the budgets of big cities, this is about 2-7% of income from the sale of municipal real estate in general (Kotlińska 2009, p. 324, Tab. A.16).

Poland seems interesting in the years 2013, 2015 and, above all, in 2016.⁹ In the latter year, all LGUs recorded a total of PLN 7.5 billion of budget surplus, including ca. PLN 3.0 billion in municipalities.

The positive result of an LGU budget – unlike the result of an economic entity, in particular in the private sector – does not have to leave us happy or optimistic. The fact of its appearance before it is planned is puzzling and very distressing as this is a signal that something wrong is happening not only in a given LGU, but also in the entire local self-governance system. Informed budget planning, which assumes closing of the fiscal years with a surplus, given an increasing, and not a decreasing scale of unsatisfied needs of the local community, may point to certain near-sightedness on the part of the local authorities which limit the current expenses and, to a limited scope or in general, do not incur asset-related expenses, including investment outlays. Or is it the opposite?

Local government practice shows that local government authorities operate very prospectively. However, the motives for these actions are different. For some, closing the budget year with a surplus may be due to the desire to win more local government elections¹⁰ (with the slogan: Our LGU was in debt, and we took it out of debt), for others, due to the change in the approach to debt management. Since these activities are widespread (Fig. 5), the reasons for this situation may also be sought in the legal regulations applicable in Poland since 2014, regarding individually defined possibilities for incurring liabilities by LGUs.¹¹

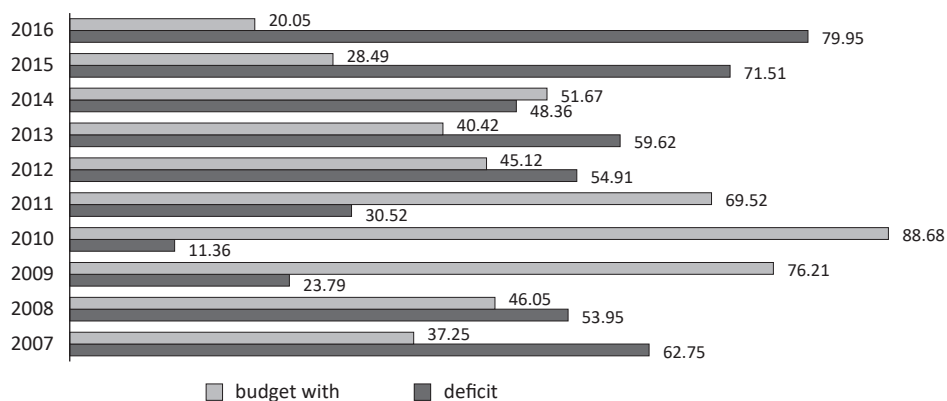


Figure 5. Types of LGU budget results in Poland in 2007-2016 (in % of LGUs)

Source: cf. Fig. 1.

⁹ The surplus in 2007 was due to the economic boom and increased LGU income due to their share in state taxes.

¹⁰ The years in which the local elections were or will be held in Poland: 2006, 2010, 2014, 2018.

¹¹ As of 2014, in Poland, the individual debt limit is calculated for each LGU, in accordance with Art. 243 of the Public Finance Act. This is not a perfect indicator, however. For more on this subject, see e.g.: Kotlińska 2001, 2013, 2014.

The data presented in Fig. 5 show that, after an initial increase in the number of LGUs closing the budget with a deficit, since 2010 (2014 was the exception) this trend was reversed. In 2016, only one fifth of all LGUs (that is 562 units) closed the budget with a negative result, while only 319 closed the budget with a surplus in 2010. In the case of municipalities and cities with the county status (Fig. 6), these figures are even more polarised. In the case of cities with the county status, in 2009 only about 3% of them (19) closed the budget with a surplus, compared to about 74% (48) in 2016. The year 2010 was a breakthrough year for municipalities. At that time, only about 11% of them (268) closed the budget with a surplus, compared to about 80% (1976) in 2016.

To sum up this part of the discussion, a question should be asked whether the observed trend will accelerate, with all the consequences, or whether we should expect, after a period of intense repayment of previously incurred liabilities, years of intensive investment activities of LGUs and attempts to make up for “the lost time, opportunities and benefits” in that respect? Time will tell, although, for every member of the local government community, undoubtedly the latter scenario option seems to be more attractive. However, if it takes place, local authorities should approach the choice of sources of financing their projects and debt management in general in a different way, more rational from the point of view of justice and intergenerational solidarity.

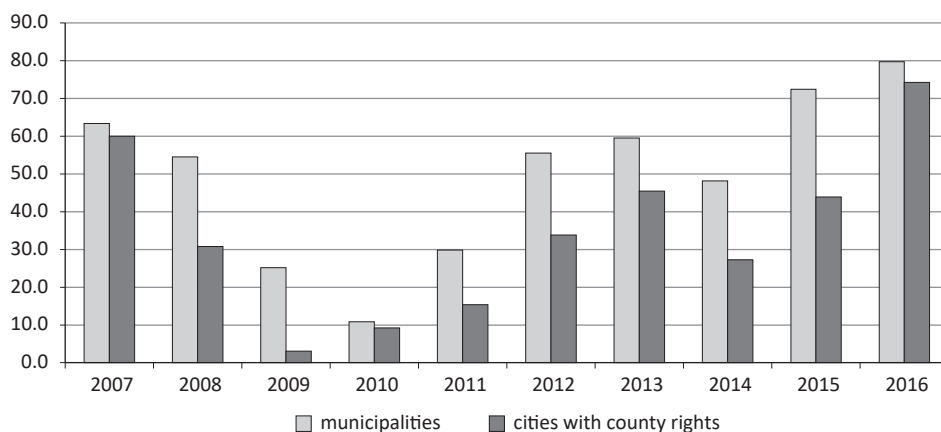


Figure 6. Municipalities and cities with county status closing the budget with a surplus in Poland in 2007-2016 (in % of the analysed LGUs)

Source: cf. Fig. 1.

The “costs” of a positive budget result (using the example of municipalities)

The positive financial result of an LGU budget may be due to several potentially concurrent reasons such as: 1) a faster growth of income than current expenses, 2) decreased current expenses (as a result of their rationalisation or cuts, despite the existing needs), 3) limitation or elimination of asset-related expenses,

in particular investment ones. Due to the fact that the widest range of public tasks are carried out by municipalities in Poland, including cities with the county status,¹² an analysis of the indicated values will be presented using their example.

In the years 2008-2016, compared to the previous year (Fig. 7), current expenses increased faster than current income only in 2009 (by 4.31%), 2010 (by 3.64%), and slightly in 2016 (by 0.36%). This can mean a limitation in current expenses being imposed by the local government authorities, improved efficiency of collecting charges and levies due to the municipality, limited use of the entitlements resulting from their financial autonomy by the local government authorities, including certain autonomy regarding taxes and levies.¹³ Due to the limited scope of the study, attention will be focused only on changes in expenditure.¹⁴

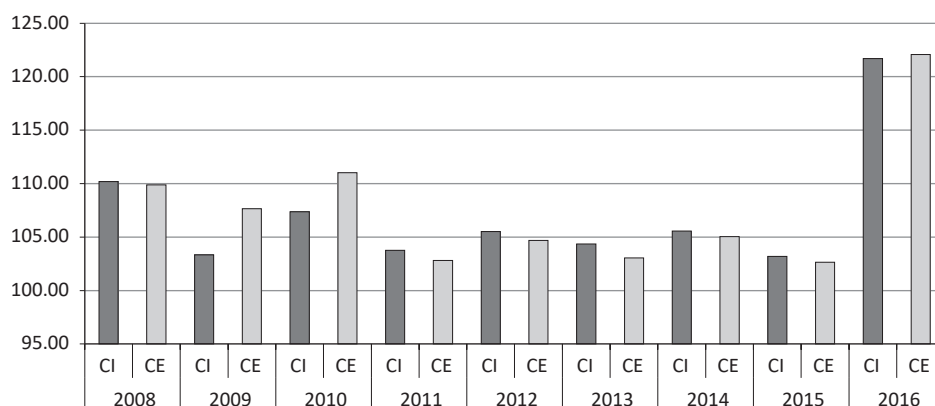


Figure 7. Changes in current income and expenses in municipality budgets in Poland in 2008-2016 (in %, the previous year = 100)

Source: author's own study based on the data from the Local Data Bank (www.stat.gov.pl – accessed on 10.07.2017).

Were the expenses reduced in the municipalities in Poland in the years 2009-2016 for different, previously indicated reasons? The data presented in Fig. 8 show that, although the total expenses in all municipalities in the analysed years had increased compared to the previous year, especially in the years 2009-2010,

¹² This is due to the principle of subsidiarity, the principle of presumption of competence and the universally defined range of matters to be dealt with, and which was defined by the laws of the system, or the spheres in which they may pursue economic activity (Wojciechowski 1997, p. 13); Art. 7(1) of the Act of 8 March 1990 on Municipal Government, *Journal of Laws* of 2016, item 446; Art. 4(1) of the Act of 5 June 1998 on County Government, *Journal of Laws* of 2016, item 814; Art. 10 of the Act of 20 December 1996 on Municipal Economy, *Journal of Laws* of 2017, item 827.

¹³ The use of this right by the local authorities results in principle only in the reduction of LGUs' budgetary income.

¹⁴ The scope of financial independence regarding income, enjoyed by local authorities, unlike the spending side, is frequently discussed in the literature. See e.g.: Surówka 2013; Brzozowska, Kogut-Jaworska 2016.

2014 and 2016, in the case of individual types of municipalities and given units, these changes looked entirely different. The largest increase in total expenditure concerned rural municipalities in 2010 (a nearly 17% increase), and the biggest decrease – in 2012 (by over 2%). In the case of other types of municipalities, these increases were lower than the increases of current expenses, which points to a reduced share of investments in these units. This fact is corroborated by the data on changes in investment expenditure in LGU and municipality budgets in Poland in the years 2007-2016 (Fig. 9).

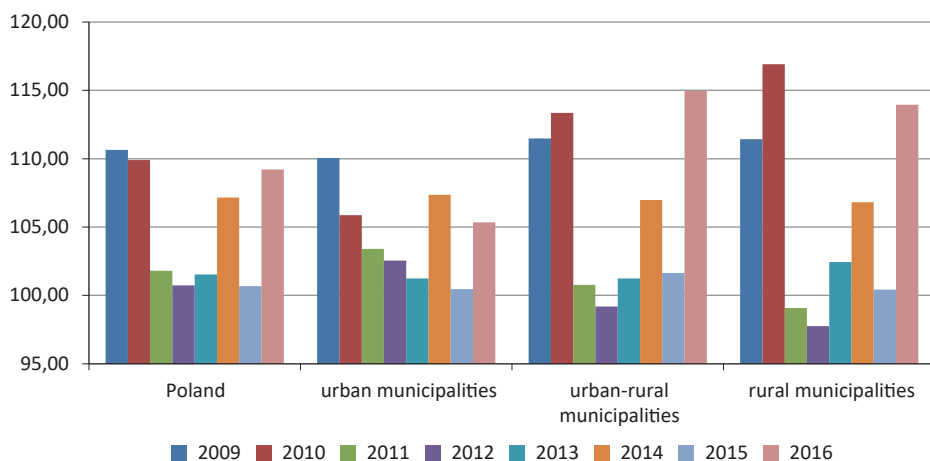


Figure 8. Changes in total expenditure in municipality budgets in Poland in 2009-2016 (in %, the previous year = 100)

Source: cf. Fig. 7.

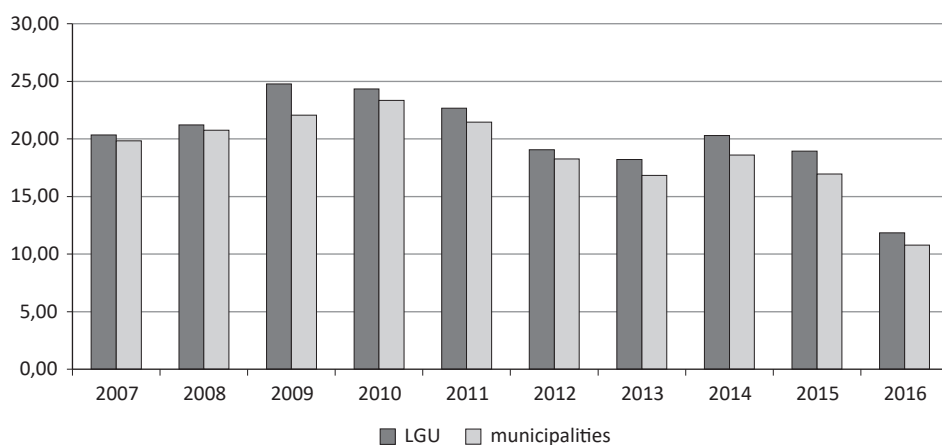


Figure 9. The share of investment expenses in total LGU expenses, including municipalities, in Poland in 2007-2016 (in %)

Source: cf. Fig. 7.

In the years 2008-2016, the aggregate investment expenses were growing from year to year in all LGUs, in particular including municipalities and cities with the county status. However, these increases had a different impact, indicating the scale of local government activity in this regard and the debt service capacity of a given LGU, determined in the years 2007-2016 according to two different methodologies.¹⁵

The data shown in Fig. 9 correspond to those from Figs 4, 5 and 6 because they indicate in which periods Polish local government units in general, including municipalities, actively invested. It was the case when their investment expenses oscillated within 20-25% of their total expenditure. Since 2012, however, this activity has dwindled considerably. The lowest level of such activity could be observed in 2016, when the discussed category of expenditure in LGU budgets in Poland amounted to nearly 12% of their total expenses, and nearly 11% of municipalities' budgets. Taking into account the data from the previous years, it can be stated that the global scale of the investment activity of local government units fell by half in most of them in the analysed period. As regards the needs of individual local government communities, it seems reasonable to pose a question about the scope and standard of meeting such needs, as well as the level of LGU liabilities, the results of which are likely to affect the present and future members of these communities. An analysis of changes in the expenditure level of the selected budget classification departments may provide an answer to that question. It is about expenditure which concern sensitive – from the point of view of the local government's mission – directions of municipal expenses related to technical and social infrastructure.

Figures 10 and 11 show selected types of municipality expenses which are most exposed to cuts in terms of technical and social infrastructure. Thus, since 2012 (except 2014), nationwide, the expenses of municipalities on road infrastructure have been decreasing (in 2016 such expenses reached a level of slightly over 85% compared to the previous year), which, as mentioned above, was undoubtedly related to the curbing of investment expenses, including LGUs. In the case of expenditure on the tasks of municipalities related to housing (section 700 of budgetary classification), it fell below the level of the previous year in 2013, and above all in 2016. In the case of tasks related to municipal management and environmental protection (section 900), such a situation occurred in 2011-2012 and in 2016.

Taking into account the unsatisfied needs in municipalities as regards the discussed sections, the limitation of expenses in them may be puzzling, so as the presence of budget surpluses in LGUs which were not reflected in increased expenditure in these sections in the subsequent years. The type of policy pursued in

¹⁵ Until 2013, the maximum limit of a given LGU debt and the cost of its servicing resulted from the regulations provided in Articles 170 and 169 of the Act of 30 June 2005 on Public Finances (*Journal of Laws*, No. 249, item 2104, as amended). These amounts could not exceed, respectively: 15% and 60% of the income of a given LGU. There has been one limit since 2014. It is set up individually, based on the regulations of Art. 243 of the Public Finance Act, and defines the maximum amount of funds which can be spent on debt (instalments + interest) in a given year.

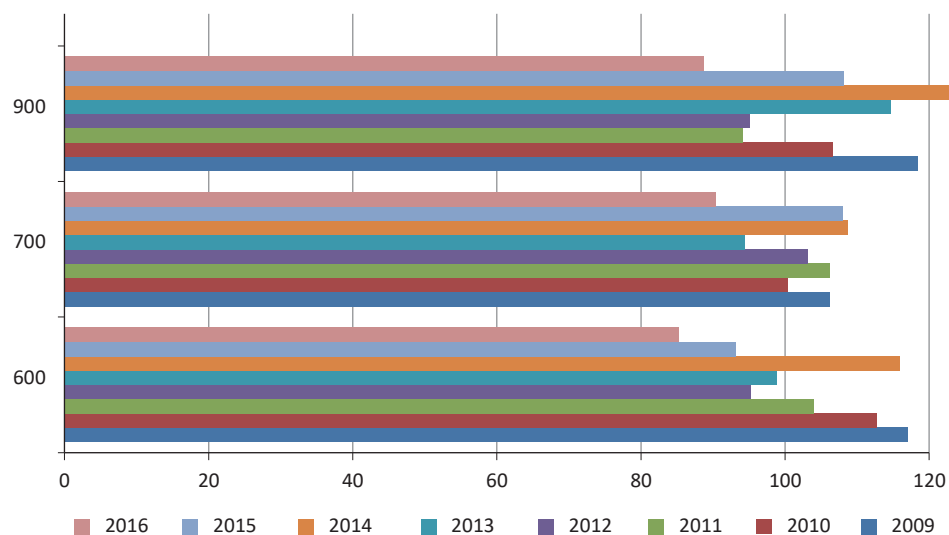


Figure 10. Changes in expenditure on technical infrastructure tasks in the budgets of municipalities in Poland in 2009-2016 (in %, the previous year = 100)

Legend: 900 – Municipal management and environmental protection, 700 – Housing management, 600 – Transport and communication

Source: cf. Fig. 7.

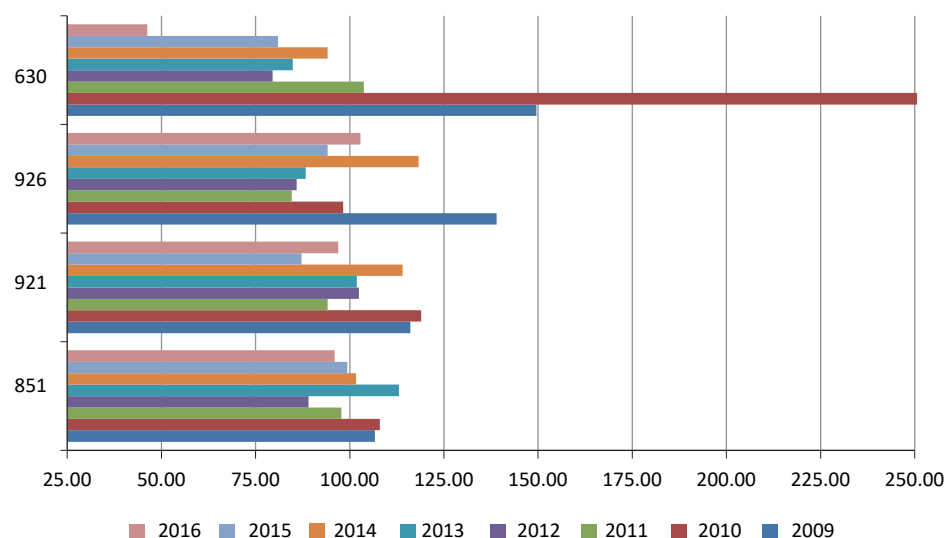


Figure 11. Changes in expenditure on social infrastructure tasks in municipalities in Poland in the years 2009-2016 (in %, the previous year = 100)

Legend: 630 – Tourism, 926 – Physical fitness and sport, 921 – Culture and national heritage protection, 851 – Health care. Fig. 11 does not show the expenditure in section 801 – Education, because during the surveyed period, it annually increased by 3-8% compared to the previous year.

Source: cf. Fig. 7.

municipalities undoubtedly gives rise to ideas and questions about the causes of this peculiar irrationality of local government authorities.

Interesting observations on the reduction of expenditure in municipalities over the last few years can also be made based on the data from Fig. 11, which showed the changes in the total expenditure of municipalities on selected tasks related to infrastructure and social services. The expenses in the analysed sections were at a higher level than in the previous year only in certain years (an example includes the expenditure incurred in sections 630 and 926, which was very high in the years when they were co-financed from EU funds). In most of the analysed years, such expenses were at a lower level (85-95% of the previous year), and in 2016 they were significantly reduced everywhere (e.g. in section 630 they fell to the level of slightly over 46% of the previous year). However, it is worth pointing out that these are aggregated data. The values of expenses and trends in individual municipalities and LGUs can be different depending on their location, local conditions and needs, as well as the “debt history” of the local government unit (i.e. debt level and titles, terms and conditions of its repayment).

In summary of the considerations discussed, one should pose a question about the reasons and purposefulness of budgetary surpluses in local government units. The mission of local government is to meet the needs of members of the self-governing community. In the actual situation of LGUs which we are all witnessing (there is no LGU in which all needs of the residents are met at the optimal level), the existence of budget surpluses resembles the condition of “tightening the belt by the ones already starving”. As it seems from the presented point of view, the permanent condition of the LGU budgets should be the properly financed negative imbalance (deficit). This is the case in Poland, and the reasons for such a state of affairs should be sought both in the concept of distribution of public revenues between the state and local government¹⁶ and the construction of the financing system of local government entities in general.

Directions for using the budget surplus and uncommitted funds and LGU development

Budget surpluses are obtained as a result of cost reductions. Therefore, they affect the amount, type and standard of services provided by local government entities and the amount, type and technical condition of the local infrastructure. If these funds are not used to finance development in the coming years, and the figures indicate that this will be the case, they are either “consumed” to meet the current needs, or earmarked for debt repayment. The situation is similar to the so-called uncommitted funds, although the causes for their presence (e.g. not using all long-term liabilities incurred on investments), have a drastically different effect for LGUs (since the debt has to be repaid). The data presented in Fig. 12 show that surpluses and uncommitted funds can represent significant items in the total revenues of all LGUs. In Poland, in the years 2007-2013 the level of budget

¹⁶ More on this topic in.: Kotlińska 2015.

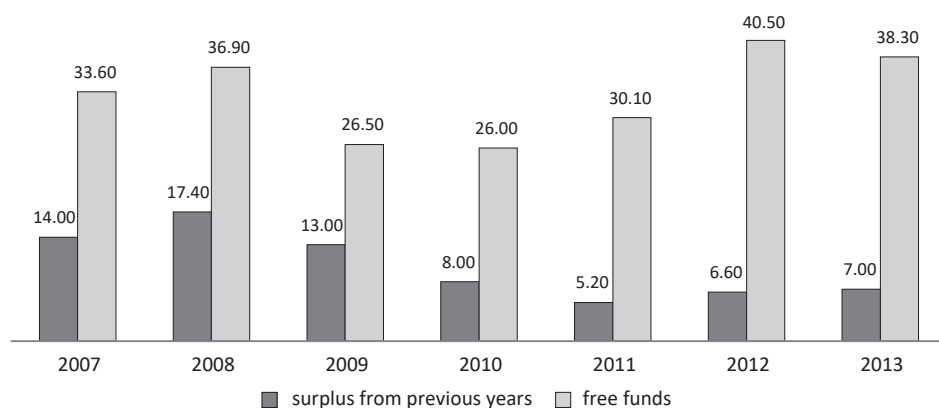


Figure 12. The share of surplus from previous years and uncommitted funds in LGU revenues in Poland in 2007-2013 (in %)

Source: cf. Fig. 7.

surplus did not exceed 18% of all LGU revenues, while uncommitted funds in 2012 might reach a level even of slightly over 40% of their total pool.¹⁷

Unfortunately, the presented data on the level of uncommitted funds indicate that local government units in Poland not only curb expenses but also incur liabilities in amounts that exceed their needs. Liabilities are incurred at the beginning of the financial year in amounts higher than the cost estimates,¹⁸ for projects that are not implemented at all or are implemented only partially in a given year. Moreover, LGU authorities do not react to this situation while assessing the budget execution for a given year. When granting a discharge on the fulfilment of their duties, they accept explanations of the executive bodies regarding lower investment expenditure than planned regardless of the costs caused by the unnecessarily borrowed funds. “Rolling the debt” has become a common practice in LGUs instead of consolidating and converting it, or reaching for debt instruments of shadow banking institutions, more expensive than typical bank loans, or the issuance of securities.¹⁹ Why do LGUs do that? Are there no suitable bank offers addressed to them? These are the questions that the people responsible in the banks for servicing local government units should ask themselves.

Not all the funds from the budgetary surplus from the previous years and uncommitted funds are allocated by LGUs to finance the deficit in a given year. The

¹⁷ Unfortunately, there are no relevant data for the years 2014-2016 but, unsurprisingly, there were items more significant in the income than before.

¹⁸ The supervisory authorities, that is the regional accounting chambers, and the adjudicating boards which issue opinions on repaying the liabilities they contract, do so based on the criterion of legality.

¹⁹ Examples include the municipality of Ostrowice and the municipality of Rewal. For more on the causes of huge debt of these local government units, including the types of instruments and shadow banking institutions in which these units are indebted see: Jane, Kotlińska, Kotliński 2017.

figures presented in Fig. 13 show that only a portion of these funds finances the deficit. Thus, in the case of a budget surplus, only in 2007 in LGUs its bigger part (slightly over 64%) was used for this purpose. Similarly, in the years 2009-2010, approximately 34-35% of its pool financed the deficit. In the remaining years (unfortunately, the data are only up to 2013), these figures did not exceed 17%. In the case of uncommitted funds, only over 20% of them financed the LGU deficit in 2009, 2010 and 2012. In the remaining years, it was much less (in 2013 slightly more than 11%). The data obtained from the reports submitted by the National Board of Regional Chambers of Auditors²⁰ to the Ministry of Finance show that, in the years 2014-2016, the budget deficit was financed by the surplus from the previous years and uncommitted funds by, respectively, 37, 28 and 9 LGUs in Poland. A question can be posed here how the resources from these sources were ultimately allocated.

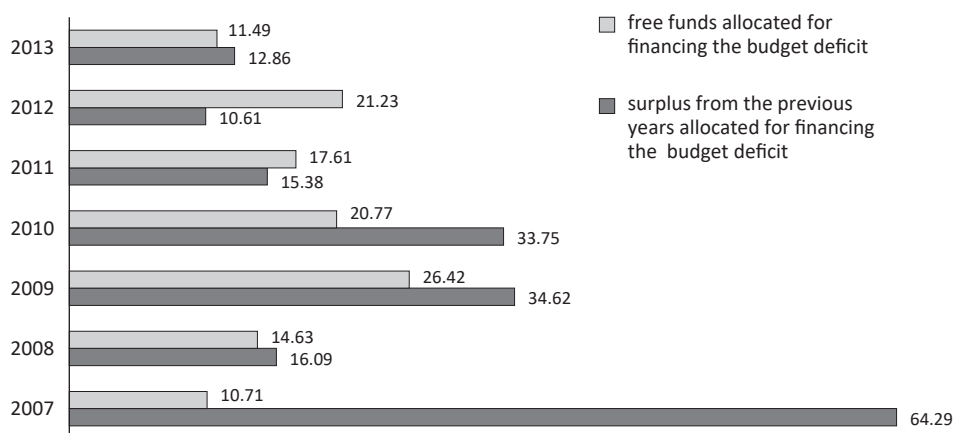


Figure 13. Surplus from the previous years and uncommitted funds allocated for financing LGU budget deficits in Poland in 2007-2013 (in % of these figures)

Source: cf. Fig. 7.

According to the provision already mentioned in this study, that is Art. 242 of the Public Finance Act, the surplus from the previous years and uncommitted funds can be used for the financing of current LGU expenses. Although a large number of local government units in Poland has benefited from this possibility, it should nevertheless be open to criticism precisely because of the sources these amounts come from (asset-related budget surplus and unused returnable revenues).²¹ However, on top of that, in local government units in Poland, especially in the recent years, budget surpluses from the previous years and uncommitted funds have been allocated for the repayment of the previously incurred liabilities. These were effective measures, as will be shown in the further part of

²⁰ KR RIO.

²¹ Only the allocation of the operational surplus from the previous years for the financing of current expenditure seems justified (apart from current incomes).

the study, but – as it seems – doubtful in the face of the stability of LGU operation and the mission of the local government in general.

Local government debt and intergenerational justice

Over the years 2007-2016, two trends and several periods (Fig. 14) could be observed at the LGU debt level in Poland, indicating the intensity not only of investment processes in these units, but also efforts aimed to raise funding other than non-returnable assistance. In the years 2007-2008, the level of indebtedness of all LGUs in Poland did not exceed PLN 29 billion. Then, as a result of increased investment activities co-financed by non-repayable funds from the EU, it almost tripled in 2010 compared to 2008. The upward trend of debt accumulation took place in the following years, i.e. 2014, although its intensity (as measured by the increase in the nominal value of debt) was decreasing. Since 2015, the nominal debt of LGU in Poland has been on the decrease. Relatively, i.e., with respect to GDP values, the debts trends in the entire analysed period appeared somewhat more favourable (Fig. 15).

In the years 2007-2016, the LGU debt in Poland achieved the highest level in relation to GDP in 2014 (4.21% of the GDP). In the past two years, despite the growing nominal debt, its level – due to GDP growth – has dropped significantly. Since 2014, the fall in the nominal LGU debt, supported by a steadily growing GDP, has led to the debt falling below 4% GDP. In turn, in 2016 its value was lower than in 2010. Nevertheless, should the process of the decreasing nominal and real LGU debt be evaluated unequivocally positively?

Undoubtedly, having debt is not a desirable situation. Still, should its existence be equally evaluated for every financial entity on the market and from each sector of the economy? Probably not, because the entities are different. For example, they have different sources of influence, the outcome of their activity either determines or not their functioning on the market, lending them financial resources is more or less risky.

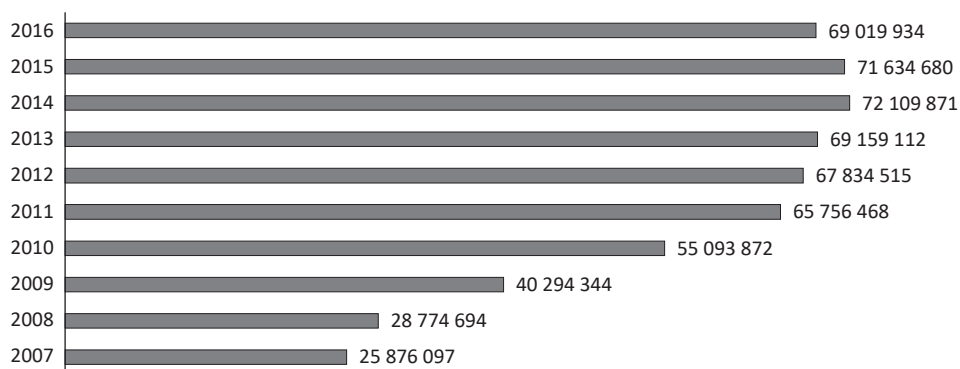


Figure 14. The debt level of LGUs in Poland in 2007-2016 (in thousand PLN)

Source: cf. Fig. 7.

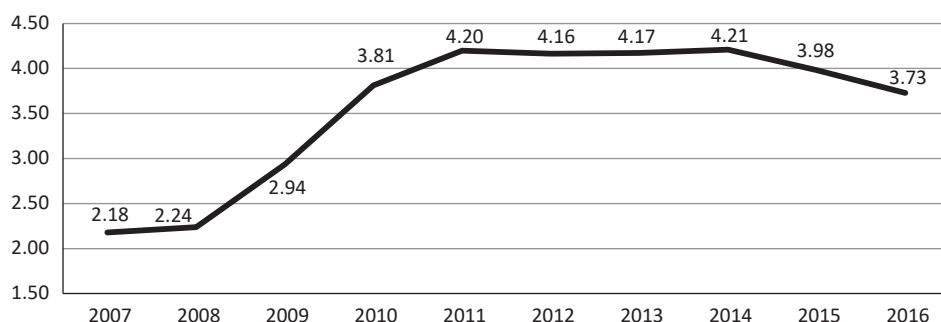


Figure 15. The debt level of LGUs in relation to GDP in Poland in 2007-2016 (in %)

Source: cf. Fig. 7.

LGU activities are permanently incorporated into the state structure and their existence does not depend on their financial condition (although it is undoubtedly important) or achievement of a positive financial result in a given year. These units have legally guaranteed sources of income (own and complementary), so there is no fear that they will not have financial resources in the following years. These entities cannot go bankrupt, which means that lending them money practically does not entail any risk. Moreover, they have assets, including real estate, which can be used as a collateral for the liabilities incurred.

In the literature, the concept of *New Public Management (NPM)* has been extensively discussed, transferring what is best from the private sector to the public sector, measuring the efficiency of spending public money, rational management in the public sector.²² However, LGUs cannot be judged only from the perspective of the budget result they achieve in a given year. One should not forget that the purpose of their functioning is to meet the needs of the local community, and not the budget surplus.

The mission of local government, including broadly understood development of a given area, entails an unfavourable budget imbalance and requires LGUs to use their financial resources. However, this should be done within reasonable limits.²³ Whether or not they are determined by individual debt ratios today is doubtful. Debt should be long-term in nature, not only – as already mentioned – due to the sustainability of LGUs' operation, but above all, due to the type of expenditure financed by debt and the period of benefiting from the investment effects.

The effects of the investment should be used for one entire generation and, for some investments, maybe for two generations.²⁴ What would a building be worth, or a road, which would not have the features of permanence, immanently associated with real estate? The duration of benefits of the completed investments, and not the duration of the mandate, or the offer of the institution lending financial

²² Cf. e.g.: Jeżowski 2002; Zalewski 2005.

²³ J. M. Keynes based his theory on the benefits from the budget deficit financed by long-term commitments (cyclical budget theory).

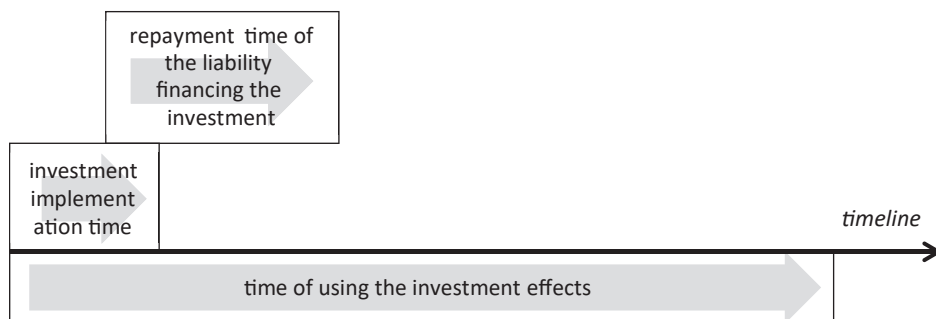
²⁴ In statistics, one generation is 30 years.

resources to LGUs, should in principle set the deadline for the repayment of such a liability (Diagram 1). Such a distribution of debt repayment in LGUs, and also in the entire public sector, would seem fair, consistent with the “weight to benefit” principle. It would express the intergenerational solidarity in public finances, i.e., include the debtor’s future income in the payments.

The concept of intergenerational solidarity in debt repayment of a public entity refers to what works best in the private sector, namely mortgage loans offered by banks to individuals. The question remains whether the banks would be willing to grant a loan to LGUs which is repaid over such a long period of time? Why do they not have such loans on their offer, is it because local governments are not interested in it? Similarly, would the buyers of local government securities be willing to accept such long maturity periods? What is the situation in that regard in Polish local government units? What are the repayment deadlines for the liabilities incurred by them?

In principle, in Poland there are no data on the structure of LGU indebtedness according to its maturity date. Only the long-term financial projections of LGUs can be the source of such information, where the debt amount projection is an integral part, prepared – in accordance with Art. 227(2) of the Public Finance Act – for the period for which the liabilities were contracted and are planned to be contracted.

local government practice



and it could be

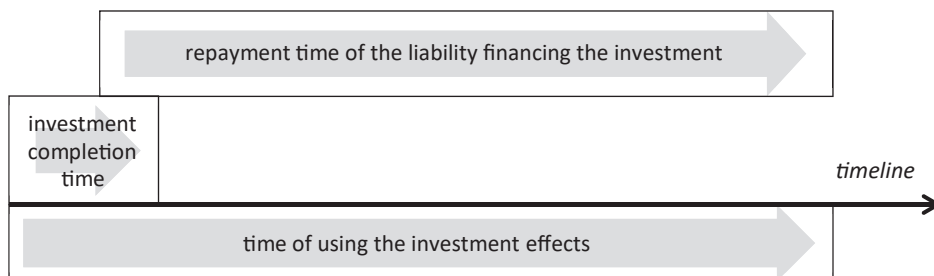


Diagram 1. Repayment period of the liability financing the investment, and time of using the investment effects

Source: author's own study.

The data presented in Figs 16 and 17 show that the largest number of local government units in Poland incur a debt for up to 10 years. In the years 2015-2017, liabilities in such a period were repaid, respectively, by: 1,781 (63.5%), 1,746 (62.2%) and 1,665 (59.3%) units. In the period five years longer, the number of LGUs repaying debt is, respectively, 637, 670 and 715. The truly long-term liabilities (repaid in over 21 years), were had in those years only by 51 units in 2015, 49 in 2016 and 61 in 2017 (respectively: 1.8%, 1.7% and 2.2% of all LGUs).²⁵

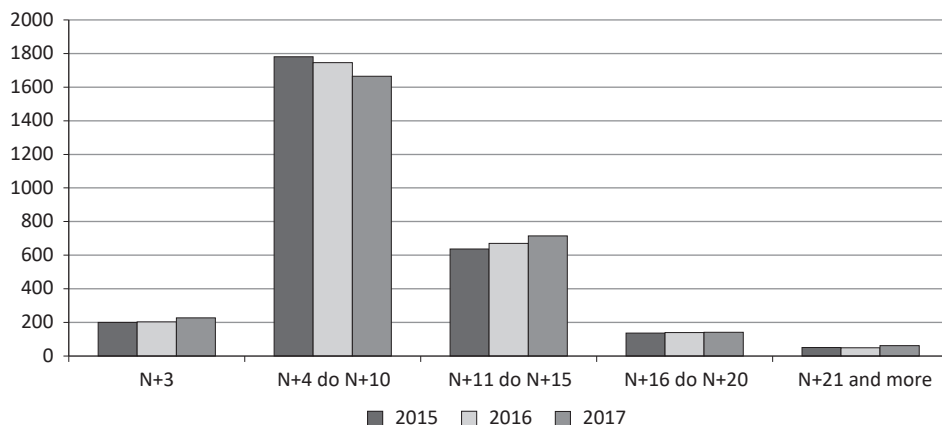


Figure 16. LGU indebtedness maturity period in Poland in 2015-2017 (according to the number of LGUs)

Source: cf. Fig. 1.

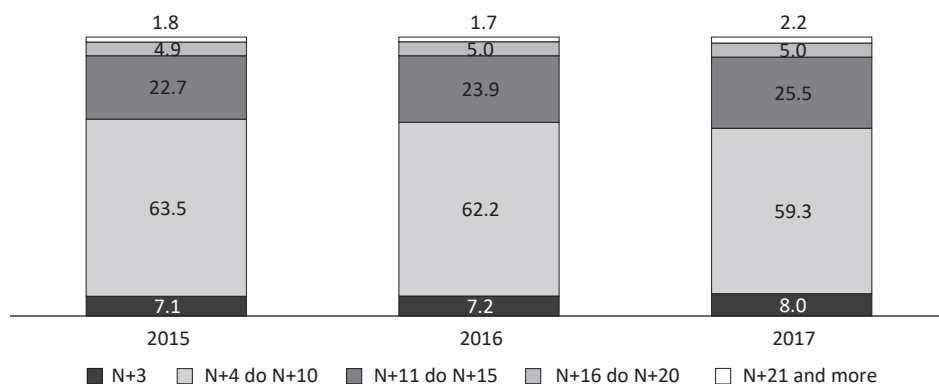


Figure 17. LGU structure in Poland according to the debt maturity periods in 2015-2017 (in %)

Source: cf. Fig. 1.

²⁵ Similar trends were observed by the author during the research conducted in 2014 in all municipalities of the Wielkopolskie Voivodeship. For more on this subject, see: Kotlińska 2016b, pp. 239-240.

In Poland, most local government entities which can contract liabilities for a period of over one year,²⁶ repay these liabilities (about 75-80% units, depending on the year of analysis) within 10 years, which is a huge burden for individual LGUs. It involves many of the previously described limitations and cuts which are experienced by people or entities that witness the incurring of the liability, the investment process and only partly the effects of these undertakings. What is the desirable LGU debt structure be in Poland from the perspective of this study? Is the existing one satisfactory?

Based on the above-mentioned arguments, it seems that the desirable debt structure of local government units which is not aimed to secure their current financial liquidity should be consistent with the “LGU debt pyramid”, as shown in Diagram 2.

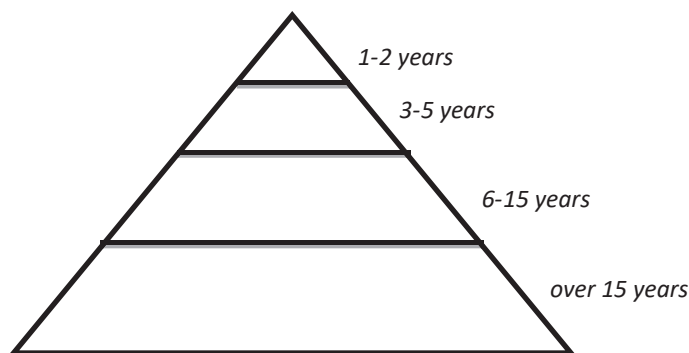


Diagram 2. LGU debt pyramid (according to the maturity period)

Source: author's own study.

Local government units, when implementing investment projects aimed to produce new buildings and structures (new real estate) or modernise the existing ones in order to meet the needs of more than one generation, should incur liabilities which are repaid over a long period of time (over 15 years). These liabilities should be dominant in the structure of LGUs' debt. Debt instruments incurred for projects the effects of which are addressed to the current members of the local government community can – depending on the type of this undertaking – be taken up for shorter time periods.

From the point of view of the maturity of debt securities, the presented structure of the correct LGU debt structure allows to meet the needs of the members of the local government community in such a way that will not burden them in two different ways because of the debt incurred. Otherwise (and this is the current situation), in the existing legal system, meeting the current needs of the local

²⁶ In accordance with Art. 89 of the Public Finance Act, such commitments are made for: financing the planned budget deficit (i.e. investments), repayment of previously incurred liabilities and anticipatory financing of activities financed from the European Union budget.

government community optimally and the development of a given area is impossible. These local government units that wanted to prove that it was possible with the use of EU non-returnable funds, failed to do so.

In the initial period, in order to raise funds for their own contribution, they contracted loans in financial institutions based on a broad range of offers, at the costs which, as it seemed at that time, they thought they both could bear and service the debt. Unfortunately, not all local government units have succeeded. In some, the earned income was not enough to service and pay off the debt within a specified time, which proved to be too short, and meant the need to roll the debt. The LGUs that were forced to do it, however, did not seek typical loans or credits, but debt instruments or other structures, from non-banking institutions. The circumstances in which these units (e.g. the Ostrowice municipality, the Rewal municipality) were forced to apply for funds from these institutions, and their amount and repayment schedule resulted in a situation in which the price of these instruments (fees, commissions) proved excessive to bear over time, even over a longer period than it was predicted by the repayment schedule of the rolled liabilities. Due to the fact that the situation in these units is really difficult, various scenarios of events can be considered. Thus, in the case of the Ostrowice municipality, the considerations include: 1) its merger with the Drawsko Pomorskie municipality (but this raises the objections of the authorities in both municipalities), 2) debt relief, by taking over the debt by the state (the debt costs will be visible in the state budget, which will be a burden all of us).

Summary

The observations presented in this paper tackle: 1) the legal status which defines the rules of budget management and obtaining external resources by local government units in Poland, 2) activities undertaken by local government authorities to meet these rules, and 3) consequences of these actions and necessary – in the author's opinion – changes in the approach to debt structure and debt management in LGUs. The conclusions from them can be presented in several points.

First of all, it should be emphasised that in Poland, in principle (apart from two situations), it is not possible for LGUs to have an operating deficit in the budget. However, the existence of the deficit is certain in the so-called asset-related budget in these LGUs which carry out investment projects. The way in which the results of both these parts of the LGU budget will be reflected in a given year in the result of the whole budget depends on their value.

Secondly, in the recent years in Poland, local authorities have undertaken (and still do) a number of activities²⁷ aimed at obtaining a budget surplus. Importantly, such a surplus is spent in the subsequent years on financing current expenditure that is not covered by the current income, and above all on repaying the debt. The situation is similar as regards the so-called uncommitted funds. However, in this

²⁷ These include, e.g.: limiting taxation, improving enforcement of revenue due, rationalising and cutting current expenditure, limiting or sometimes even abandoning investment expenditure.

case, their growing value (resulting from not using debt-related resources for investments) raises objections as to their purpose²⁸ and undermines the legitimacy of incurring debts by LGUs at this level.

Thirdly, the local government debt in Poland – after a sharp increase – has been falling since 2014, both in nominal and real terms. Is such an accelerated repayment (such actions are taken by many LGUs, in particular municipalities and cities with the county status) an element of the previously planned strategy or a necessity?

Given the numbers presented, including the scale of local government actions, in terms of repayment of liabilities, it can be stated that these actions were certainly related to: 1) the adoption of individual debt limits for LGUs, in force in Poland since 2014, 2) the period for which LGUs contract liabilities. The existing formula for determining the individual debt ratio of a given LGU forced those that had contracted relatively short-term liabilities to repay them faster, in order to be able to contract subsequent loans for investments. Unfortunately, these measures have temporarily halted investment activity in these LGUs which did not finance their projects with non-refundable funds from abroad.²⁹ Could this have been prevented? The answer seems positive. The LGU debt structure is “responsible” for this.

LGUs in Poland have an unfavourable debt structure in operating terms, closely linked to the intergenerational solidarity of debt repayment with regard to the period of obtaining benefits from the projects financed by the debt. Will stepping up activities in LGUs in the subsequent years allow to “catch up” with the years when these investments were not undertaken? Time will tell, and members of local communities will judge. However, it is to be hoped that further investment commitments will be made in LGUs for longer time periods, allowing local authorities to manage them without the need to halt development, and that financial institutions will be able to prepare offers that are suitable for them in that regard.

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²⁸ Unfortunately – as indicated – this is legally sanctioned (art. 242 of the Public Finance Act).

²⁹ LGUs co-finance their investments with non-repayable resources from abroad using the exclusions of the amount of debt from the debt limits, as set out in the provisions of Art. 243 of the Public Finance Act.

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