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MAŁGORZATA CILAK*

Nicolaus Copernicus University in Toruń

FINANCIAL STABILITY OF LOCAL GOVERNMENT UNITS — LEGAL AND ECONOMIC APPROACH

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J E L Classification: K39, H72, H74.

Abstract: The legislator introduced solutions conducive to the financial stability of local government units in the form of Articles 242 and 243 of the Public Finance Act of 2009. They force the reduction of deficit in the so-called current part of the local government budget and limit the amount of funds allocated for the repayment of financial liabilities. The aim of this article is to examine the impact of the obligation to comply with these regulations on the finances of local government units. The article will examine the content of both regulations and statistical data from the Reports on Budget Execution by Local Government Units, provided by the National Council of Regional Chambers of Audit. The summary will present a conclusion that Articles 242 and 243 of the Public Finance Act have a significant impact on the financial management of local governments, obliging them to maintain appropriate proportions between the amounts of income and current expenditure. However, the legal structure of both rules provides for certain exceptions to their absolute observance, which weakens their impact on the finances of local governments.

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* Contact information: mcilak@umk.pl, Institute of Budgetary Law and Local Government Finances, Faculty of Law and Administration, Nicolaus Copernicus University in Toruń, Bojarskiego 3, 87-100 Toruń, Poland, phone: +48 56 611 40 86; ORCID ID: <https://orcid.org/0000-0003-1429-8429>.

■■■ INTRODUCTION

The budget of a local government unit (L.G.U.) is not only an instrument of the current management of its finances, but also of its development through planning and financing investments from public funds. These investments are for the benefit of the residents who, through taxes and other contributions to local government budgets, cover the costs of those bodies' day-to-day operation and the costs of liabilities incurred for these investments.

This is all linked to the issues of budget deficit and public debt. On the one hand, they are necessary to finance local government investments, but on the other, they are sometimes used to cover current expenses. There is also the problem of excessive debt of an L.G.U., beyond its financial capabilities.

The problem is whether the amount of expenditures or expenses planned in the budget should be limited. The lack of limitations enables a flexible response in situations requiring the involvement of public funds. On the other hand, it creates the risk of irresponsible budgetary policy, planning deficit when it could be avoided, and delaying its effects to subsequent years.

The legislator has decided to introduce statutory restrictions on the planning of the budget deficit to cover current expenditure and on the amount of funds that local governments may plan to repay the debt already incurred in the form of Articles 242 and 243 of the Public Finance Act¹. Failure to comply with the above requirements leads to the impossibility of adopting the budget by the decision making body of the L.G.U. and its establishment by the council of the relevant regional chamber of audits.

The reason for limiting the allowed amount of planned or executed expenditures or the amount of debt is the lack of bankruptcy capacity of local governments (see: Babczuk & Ziolo, 2014, p. 18 et seq.; Klupczyński, 2015b, pp. 108–110). The purpose of these regulations is, therefore, to prevent a situation in which the local government assumes more liabilities than it is able to service in the budget year (Klupczyński, 2015b, p. 106). They should refer to the factors determining the financial capabilities of local governments. Otherwise, they may become an unnecessary barrier in the development of local governments or fail to prevent their insolvency (Klupczyński, 2015b, p. 104).

¹ Act of 27 August 2009, Journal of Laws of 2017, item 2077, as amended, hereinafter also referred to as: P.F.A.

THE RESEARCH METHODOLOGY AND THE COURSE OF THE RESEARCH PROCESS

The article aims to analyse how the rules set out in the Articles 242 and 243 P.F.A. impact financial stability of L.G.U.s.

In the first part we examine the legal structure of above mentioned rules. We will use formal-dogmatic method.

The second part contains the financial analysis of all local government units in Poland over the period 2008–2017. The analysis is based on data provided annually by the National Council of Regional Chambers of Audit. Presented statistical data refer to budget balance and the debt of L.G.U.s.

In the third part we will indicate the legal exceptions to the application of regulations under Articles 242 and 243 of the P.F.A., that potentially may affect the financial stability of L.G.U.s. We will use formal-dogmatic method.

Presented conclusion proves that Articles 242 and 243 of the Public Finance Act have a significant impact on the financial management of local governments, resulting in reduction of their operating deficits and debt.

CONSTRUCTION OF THE RULES UNDER ART. 242 AND 243 OF THE P.F.A. CONSTRUCTION OF THE RULES UNDER ART. 242 AND 243 OF THE P.F.A.

The Public Finance Act of 2009 introduced two rules: the rule concerning the operating deficit in Article 242 and the rule concerning the amount of funds allocated for the repayment of liabilities in Article 243. They replaced the previously binding Articles 169 and 170 of the P.F.A. of 2005.

The legislator, while creating the two examined rules, referred to the categories of current and property income and expenditure. According to Article 235 of the P.F.A., the property income of the budget includes the following 1) subsidies and funds allocated for investments, 2) income from the sale of property, and 3) income from the transformation of the right of perpetual usufruct into ownership right. All other income is current income. The catalogue of property income includes investment funds and one-off funds, which should be used for investment purposes. The nature of property income is therefore similar to public income from loans and borrowings, issue of securities, and the privatisation of property. According to the legislator, revenues belong to the investment funds (Borodo, 2007, pp. 15–16), as well as property income.

The L.G.U. budget expenditure includes current and property expenses. Property expenses include: 1) investments and investment purchases, 2) expenditure on the purchase or acquisition of shares, and 3) expenditure on contributions to commercial law companies (Article 236 of the P.F.A.). Property expenditure results in the acquisition (creation) of fixed assets (Trykozko, 2007, p. 291).

Art. 242 of the P.F.A. first entered into force in the planning of the budgets for 2011². According to its paragraph 1, the decision-making body of an L.G.U. cannot adopt a budget in which the planned current expenses are higher than the planned current income increased by: the budgetary surplus from previous years, repayment of loans granted from the budget of L.G.U. in previous years, and unused funds coming from income and expenditure settlements resulting from special rules for the execution of local government budgets and settlements of funds from the EU budget. In the light of this provision, the operating deficit related to current expenditure is limited to the amount of current income. However, it is possible for current expenses to exceed current revenues by the amount of the budgetary surplus from previous years, repayments of loans granted from the budget of an L.G.U. in previous years and unused funds from income and expenditure settlements resulting from special rules of executing self-government budgets and settlements of funds from the EU budget. The introduced principle refers to the so-called golden rule of the balanced budget, which states that current expenditure should be covered by current income (Owsiak, 2017, p. 74; Kornberger-Sokołowska, 2012, p. 199). This principle also applies to the implemented budget (Article 242(2) of the P.F.A.).

Article 243 of the P.F.A. (which introduced the so-called Individual Indicator of Liability Servicing – ILS) was applied for the first time in 2014. According to its paragraph 1, the decision-making body of an L.G.U. cannot adopt a budget whose implementation will, in a budget year or in any subsequent year, cause the ratio of expenditures on debt servicing to total budget income, to exceed the ratio of current income, less current expenditures, to total budget income calculated for the last seven budget years. The total amount of repayments and redemptions referred to in Article 243(1) for a given financial year shall be supplemented by the amount of liabilities of the association co-founded by a given local government unit to be paid in the same financial year. The amount of

² Article 121(1) of the Act of 27 August 2009. Provisions introducing the Public Finance Act, Journal of Laws No. 157, item 1241 as amended.

funds allocated for the repayment of debt, together with the costs of its servicing, refers to the concept of the so-called operating surplus, i.e. the surplus of current income over current expenditure of the budget. This means that local governments that plan to incur liabilities, or already have incurred liabilities to be repaid, cannot be satisfied by the achievement of an operating balance, but must plan an operating surplus (Salachna, 2011, pp. 525–528).

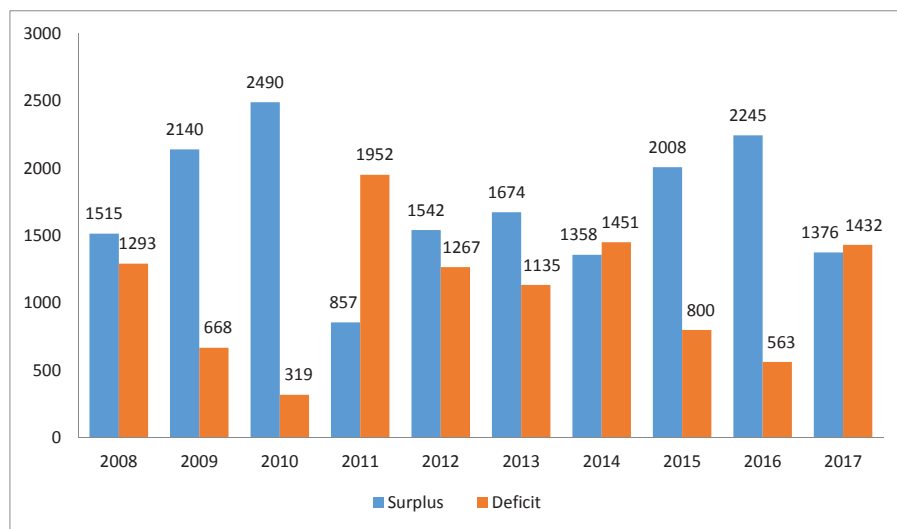
The solutions adopted in Articles 242 and 243 of the P.F.A. result in local governments being motivated to maximise current income and minimise current expenditure. This will allow them to achieve an operating balance or, even more beneficially, operating surpluses, which they will be able to use for their development. Sometimes it is also important to achieve a surplus in the total budget (not only an operating surplus). It enables the property expenses to be covered in subsequent years, or the current expenses not covered by current revenues.

**INFLUENCE OF THE REGULATIONS UNDER ARTICLE 242 AND 243
OF THE P.F.A. ON THE FINANCES OF LOCAL GOVERNMENTS IN THE LIGHT
OF THE REPORTS OF THE NATIONAL COUNCIL OF REGIONAL CHAMBERS OF AUDIT**

In the light of data from the National Council of Regional Chambers of Audit (NCRCA), the vast majority of L.G.U.s construct their budgets in compliance with both of the examined regulations. Observance of these regulations is essential for the possibility of adopting the budget. The cases of failure to adopt a budget due to the lack of possibility to meet the requirements of Articles 242 and 243 are few and far between. In 2017, NCRCA determined budgets for 9 local governments (including 3 cases that can be considered to be directly related to the rule under Article 243 of the P.F.A.; NCRCA, 2018, p. 33). In 2016, there was a total of 9 determined L.G.U. budgets. (excluding municipal associations; NCRCA, 2017, p. 33), and in 2015, there were 11 cases of determining L.G.U. budgets (including 2 directly related to the lack of possibility of complying with Article 242–244 of the P.F.A.; NCRCA, 2016, p. 36). In previous years, the replacement budget arrangements also covered individual cases.

The data below demonstrates that in the years 2008–2017 in the majority of cases L.G.U.s had budgetary surpluses. The advantage of units with a budget deficit can be observed in 2011, 2014 and 2017.

Figure 1. Number of local government units ending the budget year with a surplus and a deficit in 2008–2017



Source: author's own elaboration based on: (NCRCA, 2008–2017).

The data presented in table 1 indicates the number of local government units with an operating surplus – planned in the budget and achieved at the end of the budget year, and unplanned, but nevertheless, achieved at the end of the budget year, as well as with an operating deficit – planned and achieved at the end of the budget year and unplanned but achieved at the end of the budget year. In view of the presented data, a large majority of local governments are planning operating surpluses in the budget. The number of local governments planning an operating deficit has clearly been falling from 2011 onwards (the entry into force of Article 242 of the P.F.A.). Operating surpluses were achieved at a level higher than assumed (in 2017 by 72.7%), while operating deficits were achieved at a level lower than assumed (in 2017 by 59.7%). Most of the local governments that planned an operating balance achieved operating surpluses. The presented data indicates that the deficit in local governments is primarily of an investment nature. The operating deficit is rarely planned and achieved. It is worth paying attention to large discrepancies in planned and executed operating surpluses or deficits. They may indicate an unpredictable economic situation or a need to improve the planning accuracy by an L.G.U.

Table 1. The number of L.G.U.s with an operating surplus and operating deficit in 2009–2017

	Year	2009	2010	2011	2012	2013	2014	2015	2016	2017
The number of L.G.U.s with an operating surplus	planned and achieved	2256	1759	2182	2450	2627	2600	2633	2708	2651
	planned deficit, achieved surplus	329	576	432	243	138	150	125	84	140
The number of L.G.U.s with an operating deficit	planned and achieved	217	461	136	77	26	40	29	9	14
	planned surplus, achieved deficit	6	12	40	25	11	13	16	7	3
Planned operating balance	achieved operating surplus	0	1	13	14	5	4	4	0	0
	achieved operating deficit	0	0	6	0	2	2	1	0	0

Source: author’s own elaboration based on: (NCRCA, 2011–2017).

The amount of current income in the structure of the total income of L.G.U. budgets exceeds the amount of current expenditure in the structure of the total expenditure of L.G.U. budgets. On the other hand, the amount of property income in the structure of the total income of L.G.U. budgets is lower than the amount of property expenditure in the structure of the total expenditure of L.G.U. budgets: in 2017 property income amounted to 6% of total income and property expenditure to 15.3% of total expenditures. In the previous years, the share of property income in total income amounted to: 6.1% in 2016, 11.5% in 2015 and 11.6% in 2014. In the same years, the share of property expenditure in total expenditure amounted to 12.5%, 19.6%, and 21%, respectively. Observably, the share of property expenditure in local government budgets is higher than in the state budget (Ziółkowska, 2012, pp. 265–267; see also Jurewicz, 2017a, p. 112). Thus, property income is not sufficient to cover property expenditure, and it is necessary to cover part of property expenditure with revenue.

NCRCA data indicate that the individual indicator of liability servicing (ILS) introduced in Article 243 of the P.F.A. reduced the ability of local governments to service them. In 2010 it would have been more advantageous than the ear-

lier limit for 721 L.G.U.s, in years 2011–2018 respectively for: 437, 227, 162, 135, 149, 173, 180 and 172 L.G.U.s (NCRCA, 2012, p. 184; NCRCA, 2014, p. 212; NCRCA, 2016, p. 279; NCRCA, 2018, p. 294). This means that so many local government bodies could have planned to pay their liabilities at a level higher than 15% of the budget's planned income (as such a value was 'granted' by the limit under Article 169 of the P.F.A. of 2005). According to the ILS, most of the local governments are capable of servicing liabilities at the level of 6–9% of the planned budget income. There is also the phenomenon of negative repayment limits. It should be noted, however, that the number of L.G.U.s whose ILS goes up, is systematically increasing³.

Since 2012 onwards, the debt of L.G.U.s has been decreasing in relation to their income. In years 2012–2014, the ratio of liabilities included in the state public debt to the income of L.G.U.s amounted to 38.2%, 37.7% and 37.1%, respectively. In years 2015–2017, this ratio decreased, amounting respectively to 36%, 32.3%, 30% of income, which was caused by the increase in the amount of income in the absence of an increase in the amount of debt (NCRCA, 2015, p. 153; NCRCA, 2018, p. 184). The presented data indicates a reduction in the use of repayable funds by the L.G.U.

EXCEPTIONS TO THE APPLICATION OF REGULATIONS UNDER ARTICLES 242 AND 243 OF THE P.F.A.

The legislator provided for exceptions to the obligation of applying expenditure and debt regulations. They weaken the influence of the examined regulations on the financial discipline of local governments.

In certain circumstances, an operating deficit may be planned in the L.G.U. budget. Pursuant to Art. 242(1) of the P.F.A., the amount of current expenditure should not exceed the amount of current income increased by the budget surplus from previous years, repayment of loans granted from the L.G.U. budget in previous years, and unused funds from income and expenditure settlements resulting from special rules of the execution of local government budgets and settlements of funds from the EU budget. In this way, it is possible to create an

³ In the light of the Reports quoted above, the number of those L.G.U. increases, for example, whose indicator under Article 243(1) is within 12–15% of the planned income: in 2015 it was 272 L.G.U., in 2016 – 303 L.G.U., in 2017. – 304 L.G.U., in 2018 – 320 L.G.U.

operating deficit, provided, however, that its amount is limited to the amounts derived from the above-mentioned titles.

However, in accordance with Article 242(3) of the P.F.A. the incurred current expenditure may be higher than the executed current income increased by the budget surplus from previous years, the repayment of loans granted in previous years, and unused funds from income and expenditure settlements resulting from special rules of the execution of local government budgets and settlements of funds from the EU budget, only by the amount related to the execution of current expenditure with the participation of funds from the EU budget and non-reimbursable funds from the aid granted by the Member States of the European Free Trade Association (EFTA), if the funds have not been transferred in the given budget year. This is an opportunity to increase the operating deficit compared to the one planned in accordance with paragraph 1.

Local governments have avoided planning the operating deficit, but have made use of the possibility to accumulate spare funds from past and undischarged loans and credits (Trykozko, 2007, p. 305; Babczuk & Cyrankiewicz, 2016). The lack of precise regulations regarding the allocation of funds has opened up a possibility to L.G.U.s to create reserves, while at the same time planning to take out loans or credits (Dziedziak, 2017). As a result of the amendment to the P.F.A., the legislator eliminated the possibility of using spare funds as a reference point for planning the operating deficit⁴. Article 242(3) of the P.F.A. was amended accordingly.

Article 243(1) in its original wording assumed that income from the sale of property would be included in the operating surplus (a positive difference between income and current expenditure). This made it possible for L.G.U.s to achieve a positive value of the indicator, not through the predominance of current income over current expenses, but through the planning of income from the sale of property. It was therefore possible for an L.G.U. to plan funds to service its liabilities even with the planned operating deficit (of course, the income from the sale of the property had to be sufficiently high⁵). This was an unjustified solution. Income from the sale of the property is not current income. Its inclusion in the operating surplus led L.G.U.s to make irrational business deci-

⁴ Act of 14 December 2018 amending the Act on public finance and certain other acts, Journal of Laws of 2018, item 2500.

⁵ It is assumed that few local governments will be able to 'improve' their indicator under Article 243(1) by planning income from this source (Salachna, 2011, pp. 527–528).

sions in order to obtain a positive value of the indicator under Article 243(1) of the P.F.A.⁶. The legislator amended Article 243(1) in such a way as to exclude this income from the construction of the operating surplus⁷. This solution, however, right as it is in principle, will make it difficult for the least affluent local governments to achieve a positive value of ILS.

The restrictions provided for in Article 243(1) of the P.F.A. exclude funds which constitute the proceeds from the issue of revenue bonds even if the local government (issuer) does not exercise its right to limit its own liability for the obligations arising from such bonds. In the opinion of the representatives of the doctrine, this regulation may have increased the interest of local governments in issuing this type of bonds (Klupczyński, 2015a, p. 84; Ostańska, 2013, p. 75). This regulation encourages local governments to make financial decisions which are not based on a general rationale, but according to the criterion of the possibility of raising funds without restrictions of the conditions under Article 243(1) of the P.F.A.

The expenses and expenditure related to financing tasks from EU funds (Article 243(3)) were also excluded from the indicator under Article 243(1) of the P.F.A.

The legislator also excluded certain types of expenditure and liabilities from the construction of the rules in Articles 242 and 243 of the P.F.A. In the years 2013–2015, the local governments which took over the repayment of the liabilities of the Independent Public Health Care Institution (hereinafter also referred to as the 'IPHCI') transformed on the basis of the rules resulting from the Healthcare Institutions Law, when calculating the ratio under Article 242, did not include current expenses incurred to repay these liabilities in the amount in which they were not subject to financing from subsidies from the state budget (the Act on amending certain acts in connection with the implementation of the Budget Act 2012, Article 36(1)). This exclusion made it possible for the local governments that could benefit from it, to take over the obligations of health care institutions (Rabiej, 2014, pp. 181–182).

⁶ The execution of income from the sale of the property is at a lower level compared to the plan, than the execution of current income. This demonstrates that in reality the sale of the property, the plans of which were used to plan operating surplus, did not always take place (NCRCA, 2018, p. 171).

⁷ Act of 14 December 2018 amending the Act on public finance and certain other acts, Journal of Laws of 2018, item 2500.

However, in the years 2014–2018, by determining the ratio of repayment of liabilities, L.G.U.s excluded current expenses incurred on the repayment of the liabilities assumed from the independent public health care institution transformed under the rules specified in the Healthcare Institutions Act, in the amount in which they are not subject to financing by a subsidy from the state budget. In the years 2014–2018, L.G.U.s did not apply the ILS to the repayment of liabilities (excluding interest) incurred by them for the repayment of the assumed liabilities of transformed independent public health care institutions (Article 36(1) and (2) of the Act on amending certain acts in connection with the implementation of the Budget Act).

According to NCRCA data, the liabilities of independent public health care institutions constitute 90% of the liabilities of organisational units having legal personality, supervised by L.G.U., (excluding commercial companies). If these entities were not able to cover the negative financial result, the need to pay their liabilities would be borne by the local government unit. In 2017, the debt of local government units having legal personality (mainly IPHCI) constituted 2% in relation to the income of L.G.U.⁸ The debt of IPHCI would potentially have the smallest impact on the debt ratio of municipalities. Greater debt would be present in country districts (districts' own debt – 22.2%, debt cumulated with the debt of district legal persons – 27.8% in relation to the income of districts), and the largest in voivodeships (voivodeships' own debt – 41.2% of income, debt cumulated with the liabilities of voivodeship legal persons – 57.6% of the income of voivodeships) (KRRIO, 2018, p. 298).

One of the reasons for the financial problems that local governments were faced with was their use of the so-called hidden forms of debt (see Jastrzębska, 2017, p. 126; Babczuk & Gonet, 2013, p. 38). The use of these opportunities posed a threat to the financial stability of L.G.U.s. Yet another way to maintain appropriate levels of ratios is to transfer debt to municipal companies with legal personality (Langer, 2014, p. 80). The possibility of using the so-called hidden forms of debt has been limited by the legislator. They are now included in the obligations covered by the regulation under Article 243(1) of the P.F.A. (Ar-

⁸ Own debt of L.G.U. amounted to 30.0% in relation to their income, and the debt cumulated with the debt of legal persons – 32% in relation to the income of L.G.U. (NCRCA, 2018, p. 298).

ticle 72(1a))⁹. However, the possibility of 'transferring' expenses or liabilities to municipal companies has not been limited.

■■■ CONCLUSION

The establishment of legal rules that limit the amount of public expenditure and debt seems justified after the legislator adopted the principle of a lack of bankruptcy capacity of local governments. This objective is currently implemented by two provisions: Article 242 and 243 of the P.F.A. They force the local government budget to be balanced in the so-called current part, and also limit the amount of funds planned by local governments for the repayment of financial liabilities. At the same time, the rules do not limit the planning of income and property expenses, but affect only the so-called current part of the budget and the amount of payments of local government liabilities.

The presented statistical data indicate that the examined regulations have an impact on the finances of local governments. This influence is generally positive: it increases discipline in terms of budget expenditure planning, especially current expenditure, and increases the financial security of L.G.U.s (Jurewicz 2017b, p. 57). Although the presented statistical data may be affected by various factors, not necessarily related to any of the rules, the convergence of the dates on which the regulations entered into force, and changes in statistical quantities, especially the amount of debt, are noticeable. Despite the fact that many local governments, also before the analysed regulations entered into force, achieved total and operating budget surpluses and conducted a rational policy of incurring liabilities, the regulations under Article 242 and 243 of the P.F.A. impose such an action on each L.G.U. that wants to maintain the possibility of adopting a budget.

However, the problem for the stability of local government finances may be the exemptions from the obligation to apply the regulations of Article 242 and 243 of the P.F.A. They enable a parallel existence of two types of current expenditures and expenses: those covered by the regulations and those excluded from this scope. As a result, the obligation to apply the regulations is limited and does not guarantee the full financial stability of local governments.

⁹ Act of 14 December 2018 amending the Act on public finance and certain other acts, Journal of Laws of 2018, item 2500.

The limitation resulting from Article 243(1) of the P.F.A. showed the actual ability of local governments to service debt, which in most cases is at a lower level than the 15% of the planned L.G.U. budget income resulting from the earlier regulation. Therefore, the acquisition of revenues is limited. The possibility of financing investments from property income does not always help to solve this problem owing to a narrow catalogue of such income, in which two items are one-off income, and it is difficult to plan investments in the long term on such a basis. In this situation, further 'sealing' of the provisions of the P.F.A. will result in the inhibition of local government investments. However, this problem requires solutions, not only at the level of expenditure and debt regulations, but also at the level of the income system of local governments and their being burdened with the costs of implementing public duties.

It is essential to develop the institutions of the current and property budget so that the regulations that govern its functioning are conducive to the rational financial management of local governments to the highest possible extent. It is also necessary to provide local governments with stable and efficient sources of income, which would meet their financial needs.

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