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LOCAL GOVERNMENT DEBT CONTROL METHODS BY REGIONAL CHAMBERS OF AUDIT

The aim of this paper was to evaluate the system of control over local government debt exercised by the Regional Chambers of Audit (RCA) and to present the conclusions and expectations resulting from this assessment both generated by the RCA and applicable to the RCA within the scope of conducted debt audits. The method applied to assess legal regulations included analysis of legislative documents, i.e. primarily the Constitution, the Public Finance Act of 27 August 2009, Act of 7 October 1992 on Regional Chambers of Audit and the Regulation of the Minister of Finance of 28 December 2011 on the detailed manner of classifying debt titles classified as public debt. The analyses contained in this paper cover the period from 2014, when the Individual Debt Ratio defined in art. 243 of the Public Finance Act came into force, until 2018. The presented data and regulations confirm the correct functioning of the extensive control system in this respect. Every year, the number of negative assessments of local government debts decreases. However, it seems necessary to eliminate negative phenomena, such as: extending debt repayment period, use of unlimited types of debt titles and falsification of reporting data. The elimination of these negative phenomena may be achieved through amendments to the currently binding law regulating obtaining funding by local governments.

Keywords: debt, deficit, budget, Regional Chamber of Audit, local government, opinion, supervision, audit.

JEL Classification Codes: H63, G28.

Introduction

Local governments (hereinafter: LGs) and their unions are part of the public finance sector, which follows from the provision of art. 9 sec. 2 of the Public Finance Act (here-

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inafter: PFA) of 27 August 2009 (Journal of Laws of 2017, item 2077, as amended). Entities in this sector have specific rights and obligations in the field of financial management, including those related to obtaining funding and debt management. The debt incurred by a local government as an entity of the public finance sector is part of the state public debt, limited by the legislator in accordance with art. 216 sec. 5 of the Constitution of the Republic of Poland. According to art. 72 sec. 1 of the PFA, state public debt includes liabilities of the public finance sector from the following titles:

- 1) issued securities for cash receivables;
- 2) taken out loans;
- 3) accepted deposits;
- 4) due liabilities:
 - resulting from separate acts and final court decisions, or final administrative decisions,
 - considered indisputable by the competent unit of the financial sector being a public debtor.

The detailed classification of debt titles included in the state public debt was provided by the regulations of the Minister of Finance of December 28, 2011 on the detailed manner of classifying debt titles classified as public debt (Journal of Laws 2011 No. 298, item 1766), (hereinafter: the Regulation).

The state public debt after consolidation at the end of 2017 amounted to PLN 965.84 billion, including the debt of the local government sub-sector, which was PLN 69.5 billion. The debt of territorial self-governments and their unions after consolidation at the end of 2017 amounted to PLN 65.8 billion (Data of the Ministry of Finance, 2018). Therefore, the debt incurred by local governments directly affects the state public debt. For this reason, the processes related to incurring debt liabilities by these entities become crucial aspect of the financial management of these entities.

The financial management of local government units is subject to the supervision and control of specialized control bodies which are the Regional Chambers of Audit (hereinafter: RCA). According to art. 171 sec. 1 and 2 of the Constitution of the Republic of Poland (Journal of Laws of 1997 No. 78, item 483, as amended), the activities of a local government are subject to supervision from the point of view of legality, and the authorities supervising financial matters are RCAs. However, pursuant to the provision of art. 1 sec. 1 of the Act of 8 March 1990 on Regional Chambers of Audit (Journal of Laws of 2016, item 561) RCAs exercise supervisory and control power over financial management in local governments on behalf of the state. The aforementioned provision of the Constitution of the Republic of Poland and art. 5 sec. 1 of the Act on RCAs provides that the supervision and control over the processes of incurring debt liabilities by local government entities are exercised by these authorities taking into account only the criterion of legality. Legality should be understood as compliance with the legal or-

der, but it is necessary to take into account this legal norm which was the basis for the taken action (Zimmerman, 2009).

The aim of this paper was to evaluate the current control system over local government debt exercised the Regional Chambers of Audit and to present the conclusions and expectations resulting from this assessment, which are generated by the RCA and applicable to the RCA within the scope of conducted debt audits. The method applied to assess legal regulations included analysis of legislative documents, primarily the Constitution of the Republic of Poland, the Public Finance Act, the Act on the Regional Chambers of Audit as well as the cited Regulation. The analyses contained in the paper cover the years from 2014 when the Individual Debt Ratio came into force under art. 243 of the PFA (see also Art. 121 sec. 1 and 2 of the Act Provisions introducing the Public Finance Act of 27 August 2009 – Journal of Laws No. 157, item 1241). The assessment of the actual functioning of the regulations was made for the period from the introduction of the Individual Debt Ratio until the first quarter of 2018.

Legal basis for local government debt

The control system of local government debt is based on the criterion of legality, i.e. the legality of actions undertaken by LGs in the area of financial management. The general principles of incurring debt obligations by local governments are regulated in art. 89-94 of the Public Finance Act:

1. Purposes for which local government entities may incur debts and issue securities are defined in the *numerus clauses* manner. The list includes: 1) covering the budget deficit of LGs occurring during the year, while debt obligations incurred for this purpose are repayable or bought back in the same year in which they were incurred or issued, 2) financing of the planned LG budget deficit, 3) repayment of previously incurred liabilities related to the issue of securities and taken out loans, 4) pre-financing of tasks co-financed from funds from the European Union budget - art. 89 sec.1 of the PFA.
2. The sum of debt liabilities incurred for the purposes mentioned in art. 89 and 90 of the PFA cannot exceed the amount specified in the LG budget – art. 91 sec. 1 of the PFA.
3. Local government is obliged to obtain prior opinion of RCA on the feasibility of repayment of loans or redemption of securities when it intends to incur liabilities from these titles (with the exception of funding obtained to cover the temporary budget deficit) – Art. 91 sec. 2 of the PFA.
4. Local governments only incur financial liabilities whose servicing costs are incurred at least once a year – art. 92 of the PFA.
5. Local government entities were prohibited from taking loans, issuing securities and granting sureties and guarantees whose nominal value due to be paid on the ma-

turity date, expressed in PLN, was not determined on the day the transaction was concluded - art. 93 of the PFA.

6. Local and regional authorities are allowed to issue sureties and guarantees provided that they have maturity date, are granted up to a specified amount and do not exceed the limit set in the budget resolution- art. 94 of the PFA.

Detailed regulations introducing restrictions on the local government debt were included in the provisions of art. 242 and 243 of the PFA. The art. 242 of the PFA sets out the principle that, at the stage of adopting and executing the budget, local governments are obliged to maintain the balance in the operating part of the budget in terms of current expenditure. According to the provision of art. 242 of the PFA, the LG cannot approve the budget in which the planned current expenditure is higher than the planned current income increased by the budget surplus from previous years and the free funds referred to in art. 217 sec. 2 subsec. 6 of the PFA (cash surplus on the current account of the budget resulting from settlements of loans from previous years). In turn, at the end of the financial year, current expenditure cannot be higher than current income, increased by the budget surplus from previous years and free funds. However, an exception has been made to this rule (article 242, sec. 3) according to which the actual current expenditure may exceed actual current income plus a budgetary surplus from previous years and free funds only by the amount needed to cover current expenditure on projects co-financed from the funds from the European Union and the Member States of the European Free Trade Agreement (EFTA), if these funds have not been transferred in a given financial year.

Regulations included in art. 242 PFA are aimed at counteracting financial management, in which LGs could take out loans or issue securities to cover current expenditure (Owsiak, 2005). However, it should be emphasized that the legislator, setting out the abovementioned expenditure rule was not completely consistent. Permission to balance the operating part of the budget with free funds, (as defined in art. 217 sec. 2 subsec. 6 of the PFA), is a *de facto* consent to finance current expenditure with funding from loans taken out in previous years and unused securities (Walczak, 2017). In practice, this means that a local government may for example inflate the planned amount of investment expenditure in one year, take out a loan at the end of this year to finance this type of expenditure, fail to implement the investments and, as a consequence, generate free funds that will balance the budget in the operational part in the next years.

Another restriction on local government debt results from art. 243 of the PFA. In this provision, the legislator defined the method of calculating the Individual Debt Ratio. The rationale for the change says: 'On the one hand, the new construction of the ratio abolishes limitations restricting local governments with considerable development potential, for whom incurring even significant financial obligations may be an instrument of safe development policy; on the other hand, it disciplines the entities who are significantly burdened with repayment of liabilities and should be extremely cautious when taking

out new credits and loans.’ (Rationale for the draft Public Finance Act. Sejm Paper No. 1181, VI term of the Sejm).

According to art. 243 of the PFA, the local government constitutive body (council), cannot adopt a budget in which, in the budget year and in each subsequent year following the budget year, the total amount of the following liabilities:

- repayment of loan instalments referred to in art. 89 section 1 items 2–4 and art. 90 of this Act together with interest due in the given year on these loans,
- redemption of securities issued for the purposes specified in art. Article 89 paragraph 1 items 2–4 and art. 90 of this Act together with interest due and a discount on securities issued for these purposes,
- potential repayment of amounts resulting from granted sureties and guarantees to the planned total budget revenues,

divided by the total budget revenue in a given financial year will exceed the arithmetic average from the calculation of its current income for the last three years increased by the income from the sale of assets less current expenses divided by the total budget revenue.

This rule is expressed in a formula often referred to as the Individual Debt Ratio (hereinafter: IDR) set out in art. 243 sec.1 of the PFA:

$$((R + O)/D)_n \leq 1/3 \cdot ((Db_{n-1} - Wb_{n-1} + Sm_{n-1})/D_{n-1} + (Db_{n-2} - Wb_{n-2} + Sm_{n-2})/D_{n-2} + (Db_{n-3} - Wb_{n-3} + Sm_{n-3})/D_{n-3})$$

where:

R – Planned for the financial year total amount due for the repayment of loan and credit instalments and redemption of securities - payments to debt incurred to maintain liquidity and repaid by the end of the financial year are not included in the expenditure on this account;

O – Planned for the financial year interest on loans and interest and discount on issued securities as well as repayment resulting from the granted sureties and guarantees;

D – Total budget income in the financial year;

Db – Current income;

Sm – Asset sale gains;

Wb – Current expenditures;

n – Financial year for which the relationship is determined;

n-1 – Year prior to the financial year for which the relation is determined;

n-2 – Year two years prior to the financial year;

n-3 – Year three years prior to the financial year

When calculating these ratios for the year preceding the budget year, we use the estimated values presented in the LG budget implementation report for the third quarter,

whereas for the calculation of the previous two years – the actual values based on the annual reports. However, these restrictions do not apply to:

- repayment of credits and loans and redemptions of securities together with the interest due or discounts respectively taken out or issued in connection with the implementation of projects co-financed from EU funds;
- sureties and guarantees granted to self-government legal entities implementing the tasks of local governments within the framework of programmes co-financed from EU funds;
- within no more than 90 days after the completion of the co-financed project and receiving a refund;
- redemption of securities, repayment of loan and loan instalments, with interest and discount due, respectively issued or incurred in connection with the agreement concluded for the implementation of a project co-financed in at least 60% from EU funds, in the part corresponding to the expenditure incurred as national contributions financed by these liabilities.

In the case when the funds specified in the grant agreement have not been transferred or have been returned after their transfer, LGs cannot issue securities, take out loans or grant sureties and guarantees until the principle defined by the Individual Debt Ratio is fulfilled.

The rule of balanced current budget and the individual debt ratio are fiscal rules for local government (Owsiak, 2017).

However, the practice proves that the regulations included in art. 243 and art. 242 of the PFA contain a number of drawbacks. One of the drawbacks of the adopted solutions is including in the calculation the income from the sale of assets. As a rule, the budgets and Multiannual Financial Forecasts (hereinafter: MFF) enacted by local governments estimate unrealistic revenue from the sale of assets, which artificially increases the acceptable debt limit. The fact that the calculation of the Individual Debt Ratio is based on the operating surplus understood as the difference between current income and current expenditure carries the risk that the estimated values may be difficult to achieve taking into consideration the cyclical financial crises in the economy. Additionally, the IDR has been criticised for the fact that it is calculated solely on the basis of historical data. Furthermore, the entry into force of the IDR forced some LGs to change their debt repayment schedules, e.g. by renegotiating loan agreements and extending the repayment period or transferring repayment to the end of the loan maturity period (Jastrzębska, 2017).

The scope of debt control by RCA – current status

The principles of incurring debt obligations by local governments set the general framework for controlling the indebtedness of territorial self-governments by RCAs.

Pursuant to the provisions of the Act on Regional Chambers of Audit, there are several basic functions exercised by these authorities, i.e.: supervision, consultation, controlling and education (Wójcik, 2003). One of the tasks of the RCA is also reporting on the state of financial management of local governments. The control of local government debt is part of the supervisory function fulfilled by the RCA Colleges (Dubiel, 1997), the opinion-giving function - performed by the adjudicating panels of the RCA Colleges and the control function - carried out by inspectors of the control department and employees of the analysis and training department. According to art. 11 of the Act on Regional Chambers of Audit when exercising their supervisory power, RCAs have the institutional competence to review resolutions and orders of local self-government bodies regarding: budget and its changes, incurring liabilities affecting the amount of public debt and granting loans, MFFs and changes to MMFs.

This paper will only focus on those categories of resolutions subject to the supervision of the chambers, which directly or indirectly relate to local government debt. The basis for planning local government debt is a budget resolution or a resolution amending the budget. Credits, loans or funds from the sale of securities are budget revenues within the meaning of art. 5 sec. 1 subsec. 4 of the PFA and as such, in accordance with the provisions of art. 212 sec. 1 subsec. 4 of this Act are included in the total amount of planned budget revenues. On the other hand, the repayment of loans and redemption of securities are defined as expenditure (article 6 sec. 2, subsec. 1-3 of the PFA) and are included in the budget expenditure plan (article 12 sec. 1 subsec. 5 of the PFA). In addition, the budget resolution sets a limit on liabilities such as loans and issued securities, as referred to in art. 89 sec. 1 and art. 90 of the PFA (and article 212 sec. 1 subsec. 6 of the PFA). The budgetary resolution may also include authorizations for the executive body to incur these obligations (article 212 sec. 2 subsec. 1 of the PFA).

A resolution regarding the Multiannual Financial Forecast or its amendments also includes content referring to local government debt. The provisions of art. 226 sec. 1 subsec. 6 and 6a of the PFA create the obligation to determine in the MFFs the amount of local government debt and the method of financing its repayment. This document includes information on compliance with the debt limit regulations referred to in art. 242-244, or the degree of non compliance with these regulations in the cases referred to in art. 240 a sec. 4 and art. 240b of the PFA.

The supervisory body of RCA is a College. Pursuant to art. 18 sec. 1 of the Act on RCA, Colleges are entitled to annul resolutions which infringe the law and, in a situation where the infringement is irrelevant, they only state that the resolution was passed in violation of the law. A special procedure concerns the annulment in whole or in part of the budget resolution (article 12 of the Act on RCA). In this case, the RCA College is required to indicate irregularities in the budget resolution and to determine the manner and time of their removal. In the event when the abovementioned irregularities are not rectified within the prescribed period, the RCA College decides that the resolution is

invalid in whole or in part and sets the budget or its invalid part. The competences of the RCA College also include setting the local government budget in the event of failure to pass a budgetary resolution by the LG constitutive body by January 31st of the budget year. In this situation, in accordance with art. 240 sec. 3 of the PFA, the RCA College sets the LG budget in the scope of mandatory and ordered tasks by the end of February of the budget year.

According to art. 240a of the PFA, if it is not possible to pass the Multiannual Financial Forecast or the local government budget in accordance with the principles set out in art. 242-244 of the PFA a RCA College calls on LG Council to develop and adopt a corrective action plan and submit this plan to RCA for opinion, within 45 days of receipt of the request. In the event of failure to prepare, by the requested entity, a corrective action plan or in the absence of a positive opinion of the RCA on this plan, the budget is drawn up by the RCA College and may not comply with the debt limit formula from art. 242-244 of the PFA.

The LG constitutive body may pass the MFF and the budget without complying with the debt limit (IDR) from art. 242-244 PFA during the implementation of a corrective action plan, under the following conditions: 1) the corrective action plan received a positive opinion from RCA; 2) failure to comply with the debt limit (IDR) may only refer to the repayment of liabilities existing as of the date of adopting the corrective action plan.

The provision of art. 240b of the PFA allows the RCA to determine the LG budget without complying with the debt limit formula referred to in art. 242-244 of the PFA also in a situation where a local government does not have the possibility to pass the MFF or the budget while complying with the abovementioned provisions, however, at the same time there is no threat to the implementation of public tasks. Additionally, according to article 240a, sec. 9 a territorial self-government may make changes to the budget drawn up by the RCA College on the basis of art. 240a sec.8 or 240b of the PFA, on condition that the amendments do not further undermine the debt ratio balance specified in art. 242-244.

The above-mentioned review of the supervisory competences of the RCA College regarding the resolutions of local governments pertaining to debt leads to the conclusion that supervision exercised as control and the possibility of imperious interference in the activities of the supervised authorities is one of the most powerful and effective pillars of the local government debt control system.

The next pillar of the debt control system applied by RCA is giving opinions. As far as local government debt is concerned, the most relevant types of opinions are defined in art. 13 sec. 1, 3, 12 and 3 of the Act on Regional Chambers of Audit and include: opinions on the possibility of repayment of a loan or redemption of securities, opinions on submitted draft budget resolutions, draft Multiannual Financial Forecasts and opinions on corrective action plans.

The Chambers also give opinions on the possibility of financing the deficit presented by local governments, which is issued twice, i.e. on the basis of a draft budget resolution and on the basis of the adopted budget resolution. The obligation to issue these opinions results from the provision of art. 246 of the PFA. It should be noted here that, pursuant to the provision of art. 217 sec. 2 subsec. 1-3 PFA, the LG budget deficit may be financed by revenues from the sale of securities issued by this entity or by funding obtained from loans and credits. For these reasons, the assessment of the feasibility of financing the budget deficit, in the case when the budget includes estimated revenues from these sources, plays an important role. One should also mention opinions on the accuracy of the estimated amount of LG debt resulting from planned and incurred liabilities issued on the basis of a draft budget and based on the provision of art. 230 sec. 4 of the PFA.

The abovementioned opinions are issued by three-person adjudication panels, appointed from among the members of the RCA College. Appeals against the resolutions of the adjudication panels are considered by the RCA College. Opinions issued by adjudicating panels are not supervision acts and have a non-binding character (Ofiarska M., Ofiarski Z. 2013). However, in the case of a negative opinion on the accuracy of the planned amount of debt, the local government is obliged – by virtue of the provision of art. 230 sec. 5 - to make such changes to the budget and the MFF, to comply with the debt limit specified in art. 243 of the PFA. The number and type of opinions issued by the RCA Colleges are presented in Table 1.

Table 1. Number and type of opinions regarding local government debt issued by adjudicating bodies of RCAs in years 2014 – 2017

Opinions regarding	Total number of opinions				Negative opinions			
	2014	2015	2016	2017	2014	2015	2016	2017
the ability to repay a loan, a loan or buy back securities	4 057	2 925	2 186	3 452	7	13	11	10
draft budgets	3 017	2 987	2 971	2 978	55	33	26	21
the possibility of financing the deficit presented in the draft budget	1 410	1 463	2 001	2 363	25	7	19	11
the possibility of financing the deficit presented in the approved budget	1 947	1 689	1 762	2 367	4	3	3	4
draft Multiannual Financial Forecast	3 014	2 983	2 970	2 968	72	45	33	25
the accuracy of the planned amount of debt	2 866	2 903	2 894	2 842	13	24	15	4
corrective action plan	26	23	18	6	6	5	4	1

Source: Reports on the activities of Regional Chambers of Audit and implementation of local government budgets in 2014–2017.

When analysing the data from Table 1, one should note the decreasing number of negative opinions, especially regarding the accuracy of the planned amount of debt. There is also a clear difference between the number of negative opinions about the possibility of financing the budget deficit issued at the draft budget stage and the much smaller number of opinions issued at the adopted budget stage - which proves that comments on the submitted draft budget papers made by RCA adjudicating bodies were taken into account by local government councils. According to the author, the presented data show that the applied form of debt control in local governments is effective despite its 'soft' character.

Weaknesses in the control and supervision system exercised by the RCA over local government debt

The control over local government debt exercised by the RCA Colleges within their supervisory competence and by adjudicating panels as part of their advisory function may still turn out to be ineffective because it relies solely on documents presented by local governments. Only the audit performed by inspectors at the local government premises allows them to state unequivocally whether the processes related to incurring debt obligations and debt management are performed in compliance with the law and whether the documentation is consistent with the actual state of affairs. Unfortunately, there are cases when local governments drew up documents regarding debt, which included data inconsistent with the actual situation. As a result of these illegal practices, the actual indebtedness of LG was disguised even for a longer period of time. As a consequence, such local governments are unable to repay the debt, need to implement corrective action plan and ultimately may be placed into receivership.

Comprehensive audits of the financial management of local governments are carried out at least once every four years (article 7 sec. 1 of the Act on RCA). In addition, RCAs also perform problem-related, ad-hoc audits and check the implementation of post-audit recommendations. The reviews of quarterly budget implementation reports submitted by local governments are performed by the employees of the analysis and training department. Although they are carried out only in accounting and formal terms (article 9a of the Act on RCA), they undoubtedly monitor the processes in the field of financial management and reveal irregularities.

The control of local government debt carried out by RCAs brings - according to the author of the article - expected effects, but does not completely eliminate the risk of excessive debt mounting. The risk is generated primarily by these local governments who undertake effective attempts to circumvent the binding regulations limiting their borrowing capacity. They resort to extra-budgetary forms of raising funding. The category of unnamed contracts includes, for example, revenue bonds, securitization, forfeiting,

factoring and assignment of receivables, while named contracts comprise – e.g. return sale, lease back and subrogation (Langer, 2014). Liabilities under these agreements are not included in public debt, but they fall into the category of current expenditure (in the case of subsidies) or capital expenditure (in the case of acquisition of new shares and stocks) (Konberger-Sokołowska, 2015). The burden of debt is also transferred to companies where local governments are shareholders. The excessive debt load of local governments is generated mainly by disguised debt, as well as the tendency to extend the debt repayment period, which generates high servicing costs.

Expected changes in the local government debt control system

The RCAs' expectations of regarding the current system of LG debt control boil down to 'sealing' the existing law.

Firstly, the most urgent action, which should be taken by the legislator, is to amend the Individual Debt Ratio formula under art. 243. Local governments should be obliged to include in the calculation of IDR all debt titles which are not loans or redemption of securities but fall into the public debt category specified by the Regulation of the Minister of Finance of 28 December 2011 on the detailed manner of classifying debt items classified as public debt. Such a solution will make it impossible to burden the budgets of the future LGs with unlimited debt.

Secondly, the period for which a debt can be incurred should be limited. Lack of restriction in this area results in rescheduling debt repayments over long periods, which generates higher debt servicing costs.

Thirdly, it is necessary to introduce a uniform control file in the budget reporting. The possibility of analyzing the accounts entries reflected in the reports will enable a much faster response from the RCAs and will prevent falsification of data presented in the reports.

Finally, the Regional Chambers of Audit should anticipate future problems and increase the number of ad hoc debt audits in those local governments whose debt load poses a threat to their financial health.

Summary

The Polish legislator provided Regional Chambers of Audit with a wide range of legislative tools to control the local government debt. This control is carried out through the following functions: supervision, opinion-giving, control and, to a certain extent, education. So far, these tools have proved to be effective, although they have not erased certain negative phenomena, such as the use of unlimited types of debt, extending debt

repayment periods, or falsification of reported data to hide the actual size of debt. In individual cases, this led to an economic collapse (e.g. Ostrowice commune).

It seems that the introduction of minor adjustments in the system of control over local government debt could 'seal' the system. The recommended changes include: changes in the debt limit formula (art. 243 of the PFA) to include all debt titles, restriction on the period for which debt may be incurred, as well as the introduction of new methods of debt control, e.g. a remote audit of actual entries in the ledgers.

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