CONTROVERSIES OVER NON-CONVENTIONAL INSTRUMENTS OF FINANCING BUDGET NEEDS OF LOCAL GOVERNMENT UNITS

Summary

Local government units resort to external repayable sources of financing their own activity, mainly those connected with investments, when the financial sources they have at their disposal are insufficient. However, owing to an unfavorable financial situation, some of them lose their creditworthiness because their debts exceed the legal limit. In such a situation, they decide to use the so-called unconventional instruments, which, although they provide certain long-term benefits, in a longer time perspective lead to negative consequences, connected mainly with diminished financial liquidity and the necessity to bear inflated costs of debt service.

The aim of the paper is to present the reasons for using unconventional instruments of financing budget needs by decision-makers, as well as their specific character and economic effects, particularly as regards the financial stability and security of LGUs, the transparency of local finances and the related hazards. The achievement of this aim required analysis of the literature devoted to the subject, reports of controlling institutions and statistical data regarding the debt level of LGUs.

Key words: subnational debt, debt limit, unconventional debt financing instruments

JEL Classification: H71, H72, H74

1. Introduction

The increasingly widespread use of unconventional instruments of financing the budget by local government units (LGUs) – above all, in the form of non-bank financial operations and shifting of debt outside the local budget – is a new phenomenon in
Polish local finances. The dangers of this situation were described in two reports from 2016. The first one was published by the Council of the Regional Chambers of Audit in Poland (KRRIO) and the second by the Supreme Audit Office [Wpływ operacji finansowych..., 2016]. It was the study of these documents that inspired the authors of this paper to undertake the subject.

The aim of the paper is to present the reasons for using unconventional instruments of financing budget needs by decision-makers, as well as their specific character and economic effects, particularly as regards the financial stability and security of LGUs, the transparency of local finances and the related hazards. In order to accomplish this goal, the authors have employed various research methods: the method of descriptive analysis, inductive and deductive reasoning, as well as the basic methods of financial analysis.

2. Debt of local government units: the conventional approach

Local government debt is one of the most dynamic categories of local finances in Poland. This dynamism involves a certain risk, not only for the system of local finances, but also for the entire sector of public finances. This is owing to the fact that the debt of the local government sub-sector is an integral element of the debt of the public finance sector, apart from the debt of the government subsector and the subsector of social insurances.

In fact, it is difficult to imagine a local government unit “separated from” debt instruments (credits, loans, municipal securities, etc.). Attention needs to be drawn to the fact that their usage in a local financial economy is dependent on many legislative and economic conditions that, in Poland, are changing very rapidly. Some of these conditions are of both a systemic and external nature, which means that they are independent of local decision-makers. They include, for example, the following: no possibility for LGUs to declare bankruptcy under the Polish legal system; the tightening of fiscal rules curbing local government debt; the necessity to use debt instruments to compensate for decreased budget revenues of LGUs, resulting not only from business cycle phases (e.g. economic crisis), but also from the typically Polish phenomenon of local government units being burdened by the state authorities with additional public tasks without being provided adequate financial resources for their accomplishment; the EU-imposed obligation demanding that local government beneficiaries guarantee the so-called own financial contribution – in this context the local debt is used by LGUs as an absorption instrument. Some of the conditions which affect the changes in the public debt of the LGUs clearly have an external character: they result from local finance policies adopted by individual LGUs. This also includes decisions regarding the use of non-conventional tools for financing budget needs, which are crucial from the perspective of this paper.

The economic doctrine mentions the following premises that justify incurring of debt by local government units [King, 1984] [Swianiewicz, 2011, pp. 157-159]:

1. revenues (e.g. from taxes and local payments, municipal assets, etc.) which are insufficient for fulfilment of local public tasks by an LGU,
2. necessity to comply with the principle of intergenerational equity (investment outlays are incurred during the realization of an investment, whereas the benefits are derived after its completion; therefore, credit repayment by future generations is definitely justified – the formula: “pay as you use”),
3. cost-effectiveness of infrastructure investments – if a local government is incapable of making necessary investments due to insufficient revenues, it is obliged to use external sources of financing,
4. time-effectiveness of investment implementation – a local government investment implemented over a long period of time is more expensive, whereas the use of debt instruments usually considerably accelerates implementation, thus reducing costs,
5. instability of investment outlays – the value of these outlays varies from one period to another, e.g. in one year it can increase incrementally, while in another, it can decrease; if LGUs financed investments solely from their own revenues (e.g. from local taxes), the value of the fiscal burden for the local taxpayers would fluctuate to an extent which might be unacceptable for them.

Most of the above arguments justify why LGUs incur debts for investment purposes. Hugh Dalton distinguishes two categories of public debt: reproductive debt, used for the financing of investment expenses, and deadweight debt, which is only an instrument for budget balancing [Dalton, 1948, pp. 215-216]. A similar view is expressed by Sergio Rossi and Bernard Dafflon, who emphasize that local governments ought not to incur debt for the realization of operational purposes (bad debt), while it is recommended that they do so in order to perform investment tasks (good debt) [Rossi, Dafflon, 2002, p. 5]. Gian Maria Milesi-Ferretti justifies the use of debt instruments by public authorities in order to realize investment programs in the following way: “Public debt redistributes the tax burden across time and can therefore be a vehicle for intergenerational redistribution” [Milesi-Ferretti, 1997, p. 8].

The classification of debt proposed by Adam Borodo is also related to the issue of local debt in a normative perspective. Borodo distinguishes administrative and financial debt, as well as profitable and unprofitable debt [Borodo, 2006, pp. 217-218]. The first two types are associated with the current operations of LGUs. Financial debt is connected with the accumulation of funds for certain undertakings by separately signing formal contracts for credit, loan or bond emission. The term ‘profitable debt’ denotes a debt by means of which obtained funds enable the financing of investment undertakings that may constitute the source of additional income allowing for debt repayment (e.g. investments in technical infrastructure). And conversely, an unprofitable debt is one that does not generate additional revenue in a direct way and needs to be repaid entirely from the overall budget receipts.

Taking into consideration the effects of incurring local debt, it is necessary to note the related threats. According to the economic doctrine, they include, above all: excessive burden on future budgetary revenue by the costs of debt service, which, as is often

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1 The normative approach to public finances lies in the analysis of phenomena as they ought to be.
2 Expenses related to debt service constitute one of the so-called current budget expenses of LGUs. However, they are not allocated for the repayment of particular installments of credits or loans, but
stressed in the literature on the subject, may cause considerable reductions in the range of optional tasks performed by an LGU; hazards related to the worsening of the financial situation of an LGU, or even lack of fluidity in the case of incompetent debt management (e.g. improper selection of instruments, inconvenient schedules of debt-serving payments, etc.) [Bitner, Cichocki, Sierak, 2013, p. 33; Filipiak, 2014, pp. 27-28].

Interestingly, in the theory of finances, the concept of local debt is not defined unambiguously. Neither is there an unequivocal definition of the term in the Polish legislation. For the purposes of this paper, it is assumed that this concept denotes the nominal indebtedness of local government subsector units that is specified following the elimination of shared obligations of these entities. Taking the aforementioned obligations into consideration makes it possible to establish the so-called consolidated indebtedness of the local government subsector (in other words – local debt after consolidation).

From the perspective of the value of the debt, it is crucial to identify the entities whose financial obligations are taken into account in the calculation of its value. In accordance with the current legislative regulations of the Act of 29 August 2009 on Public Finances [Ustawa z dnia 27 sierpnia 2009 r. o finansach publicznych, 2009, art. 9], in the Polish conditions the aforementioned debt includes financial obligations incurred by the following entities:

- municipalities (in 2017 their total number was 2478), counties (314) and provinces (16) [Register TERYT, 2017];
- municipal associations, functioning as associations of municipalities (211 – in 2016) and associations of counties (5) [Sprawozdanie…, 2017, pp. 255, 263];
- public health care institutions (1082 – in 2015) for which the founding body is a local government [Buletyn Statystyczny Ministra Zdrowia, 2016, p. 95];
- local cultural institutions (4597 – in 2016) [Wyniki finansowe instytucji kultury…, 2017, p. 3];
- other local legal persons established on the basis of separate acts with the aim of performing public tasks, excluding companies, banks and commercial companies (it also regards local municipal companies).

According to the data obtained from the Ministry of Finance (MF), at the end of 2016 the total debt of the local subsector in Poland amounted to 74.4 bn PLN (debt before consolidation), which constituted approx. 8% of the total debt of the public finance sector (87% of the debt was related to the government subsector, 5% – to the subsector of social insurance) [Zadłużenie sektora finansów publicznych, 2017, p. 7].

Taking into consideration the fact that the debt of LGUs and their associations is by far the highest in the total debt of the local government sector (approx. 93%), it is recommended that the structure of debt obligations is analyzed, according to particular categories of LGUs, as presented in Figure 1. The data included in the Figure imply that 82% of the local government debt is owed by cities with county rights and municipalities.
Another important issue is the scope of local debt. In fact, here it is a question of identifying the categories of financial obligations taken into consideration for the calculation of the value of debt. Apparently, in accordance with Art. 72 of the Public Finance Law, which regards the category of the so-called state public debt3 (debt of the local government subsector is considered one of its components), the following types are taken into consideration:

- securities (in the case of LGUs, e.g., municipal bonds, municipal vouchers, etc.);
- credits and loans;
- accepted deposits;
- due liabilities, i.e. ones past payment deadline.

This is the framework in which the debt of Polish LGUs is monitored, whereas the changes in its value and structure are presented in Figure 2.

The data presented here imply that the most dynamic increase in debt obligations of Polish LGUs was observed in 2010 (increase by 37% when compared to the previous year) and in 2011 (increase by 19%). In the subsequent years, the rate of debt growth decelerated considerably, whereas the local authorities concentrated mostly on the improvement of financial results in terms of complying with new debt limits that came into effect in 2014. In 2016, for the first time in several years, a decrease was recorded in the value of obligations in comparison to the previous year (by approx.

3 In accordance with the Polish law, the term 'state public debt' denotes the debt of the entire sector of public finances. However, taking into consideration the fact that it also includes the obligations of the local government subsector, the word 'state' does not seem perfectly accurate or justified.
Characteristically, the majority of total obligations are ones related to credits and loans (in recent years their share has remained around 94%). The decrease in the value of due liabilities shown in the above Figure should be regarded as a positive trend. A high share of this category of obligations would indicate problems with fluidity and would mean a higher risk connected with late settlement of payments by LGUs.

**FIGURE 2.**

LGU obligations depending on debt type in years 2008-2016 (in mln PLN)

The data presented above are based on the official statistics regarding debt. Meanwhile, it has become an increasingly more common practice among LGUs to use unconventional and non-standard sources of financing their budget needs, which results in the formation of a new category of financial obligations that have similar consequences as credits and loans, but are not reflected in the official statistics of public debt. The most frequently used instruments include: capital financing, refundable leasing, repurchase transaction, installment payment, subrogation, or the increasingly frequent situations when local governments have financial obligations to non-bank loan institutions, i.e. the so-called quasi-banks. It is a characteristic feature of these instruments that by using them, local government authorities manage to “evade” the laws which set limits to debt levels. Therefore, in the first place, it advisable to present both formal and legislative mechanisms of reducing local government debt that are valid in Poland. It needs to be mentioned that in the last few years these mechanisms have been considerably tightened in Poland, as a result of which LGUs have become more interested in unconventional financing instruments.
3. Reduction of local debt as reason for using unconventional financial instruments

The use of returnable financing enables LGUs to operate without adjusting revenues to increasing current expenses, while maintaining investment outlays on a high level [Krzemińska, 2011, p. 174]. It is, however, difficult to determine the safe level of debt that makes it possible for an LGU to maintain financial fluidity and ensure effective management of the existing debt.

Reduction of LGU debt is frequently justified by the introduction of fiscal rules that refer to state public debt. Fiscal rules aim at maintaining a stable budget in accordance with the adopted strategy in the medium and long term, and also at reducing the negative political impact [Marchewka-Bartkowiak, 2010, p. 1]. It has already been observed that LGU debt is a component of state public debt, thus its level ought to be a subject of constant interest to public authorities.

Therefore, in most EU states, apart from the naturally existing economic, political and organizational restrictions, legislative measures are implemented to prevent local governments from incurring excessive debt [Jastrzębska, 2006, pp. 18-30]. Taking into consideration the subject of influence, the restrictions to returnable sources of financing LGUs may regard: purpose, type, satisfaction of additional conditions of contractual obligations, supervision of incurred debt, as well as both the level and costs of debt service. While analyzing the type and character of instruments of impact on debt level, it is possible to distinguish the following [Poniatowicz, 2006, pp. 125-131]:

- formal legislative regulations related to the level of LGU debt;
- institutional and administrative regulations regarding supervision of LGU debt;
- economic regulations;
- advisory and informative regulations.

Despite the fact that the restrictions on LGU debt have been subject to debate for many years, no uniform principles in this field have been developed in the EU as yet [Jastrzębska, 2006, p. 21]. In practice, in order to prevent excessive use of debt by LGUs, EU member states separately analyze the problems of debt incurred for financing operational activity and investment activity. In some countries, local governments are given a free hand in this respect (e.g. in the Czech Republic, Finland and Sweden), while elsewhere considerable formal and legislative restrictions exist (e.g. in Ireland, Germany and Denmark) [Swianiewicz, 2004, pp. 10-13]. In several countries, there are also additional restrictions in this sphere [Skuza, 2003, pp. 55-69; Wiewióra, 2009, pp. 13-15].

Apart from quality limitations, some EU countries also use the so-called numerical debt rules, i.e. quality limitations [Schick, 2010, p. 10]. They can be divided into the following two groups [Swianiewicz, 2004, p. 10]:

- regulations regarding debt level and balance of current budget that guarantees the possibility to generate funds allocated for the service of previously incurred debt;
- regulations related to control of contracting liabilities (e.g. individual debt limits, permits from supervisory bodies) [Misterek, 2008, pp. 75–86].

The first of the above regulations is in force in France, Finland, the Netherlands and Sweden. LGUs in these countries may incur debt while remembering that they need...
to comply with the principle of budget balancing. Therefore, they are allowed to incur debt only when the current surplus is sufficient for covering the repayment of installments and interest.

The other solution is used when a government sets the maximum levels of debt that constitute a certain percentage of incomes or expenses (e.g. in Slovakia, Hungary, Denmark and Italy), the share of debt service costs in revenues (e.g. in Spain and Estonia), overall value of investments (in Portugal), or the total sum of obligations (e.g. in Great Britain) [Poniatowicz, 2006, p. 129]. The debt reduction methods used in some countries (e.g. Austria) combine using the operational (current) surplus indicator and, additionally, the indicator defining other debt relations, e.g. the debt-to-current-revenues ratio. Furthermore, in certain countries there exist special regulations related to situations where LGUs have problems with debt service (e.g. in Hungary and Slovakia) and to the possibility of implementing a corrective procedure, taking into consideration the fact that in accordance with the law, no LGU may go bankrupt [Swianiewicz, 2003, pp. 49-73; Swianiewicz, 2004, pp. 385-419]. In the Czech Republic and Greece, no debt limits have been imposed for LGUs [Wiewióra, 2009, pp. 24-26]

In Poland, a new way of limiting LGU debt level, the so-called Individual Debt Indicators (IDIs), has been in force since 2014. In accordance with Art. 243 of the Public Finance Law, the decision-making bodies of LGUs may not pass budgets whose implementation would lead to the situation where, in the budget year or in any other year following the budget year, the ratio of the total sum of this year's:

- repayment of credit and loan installments including interest for the given year,
- purchase of securities including due interest and discount,
- potential repayments of sums resulting from offered warranties and guarantees over planned total revenues in the budget would exceed the arithmetic mean from the calculated three-year current revenues increased by the revenues from the sale of assets and decreased by the current expenses to the total budget revenues. The following formula is used for the calculation of IDI:

\[
\left( \frac{R + O}{D} \right) \leq \frac{1}{3} \left( \frac{D_{b_{n-1}} + S_{m_{n-1}} - W_{b_{n-1}}}{D_{n-1}} + \frac{D_{b_{n-2}} + S_{m_{n-2}} - W_{b_{n-2}}}{D_{n-2}} + \frac{D_{b_{n-3}} + S_{m_{n-3}} - W_{b_{n-3}}}{D_{n-3}} \right),
\]

where:

- \( R \) – total sum of repayment of credit and loan installments and purchase of securities, planned for the budget year,
- \( O \) – interest from credits and loans, interest and discount from securities, repayment of sums resulting from provided warranties and guarantees, planned for the budget year,
- \( D \) – total budget revenues in given budget year,
- \( D_{b} \) – current income,
- \( S_{m} \) – income from selling assets,
- \( W_{b} \) – current expenses,
- \( n \) – budget year for which the relation is established,
- \( n-1, n-2, n-3 \) – years preceding the budget year.

The legislator excluded some categories of debt from indicator limitation, e.g. debt incurred for the implementation of projects co-financed from EFTA or EU non-returnable funds within legally specified time periods.
Additionally, in order to prevent financing of operational activity from returnable financing sources, in accordance with the regulation mentioned in Art. 242 of the Public Finance Law, LGUs may not pass budgets in which the planned current expenses are larger than the planned current incomes plus budget surplus from previous years and available funds.

The introduced debt-curbing measures are not diversified as regards various types of LGUs (municipalities, towns with county rights, counties and self-governing provinces), which is frequently viewed as a disadvantage of the new way of limiting debt. Various authors have observed the noticeable diversity among the income potential of particular types of LGUs, as well as among the range of the tasks assigned to them and their financial needs.

Another disadvantage of the introduced limitation is too narrow a definition of debt instruments adopted for calculating the value of debt service. LGUs which conduct, e.g., investment policies quite often decide to use instruments that are not mentioned in the law. It is difficult to evaluate the use of these instruments because of inaccessibility of data regarding the scale and range of their application. The Ministry of Finance reveals that at the end of 2016, the debt of LGUs, only in quasi-banks, was larger than 200 mln PLN (in 2015 – 164 mln PLN) [Żółciak, 2017]. Taking into consideration the scale of the total debt of LGUs, it can seem an insignificant amount (0.3%), but in the case of an individual LGU, such a sum may be a problem. For instance, the municipality of Ostrowice, using this type of instruments, in 2016 incurred a debt exceeding 400% of the total value of the annual budget [Żółciak, 2017]. In the same year, the debt owed by this municipality to quasi-banks amounted to approx. 28 mln PLN, which constituted 80% of its entire financial obligations [Mayer, 2016, p. 8].

Therefore, it is possible to imagine an LGU that in its financial report declares either lack of debt or very low debt in the formal dimension, whereas in practice it finances its operations using instruments which, in the light of legal rules, do not constitute debt instruments but cause financial effects that are similar to these instruments.

4. Unconventional instruments of financing budget needs of local government units

Table 1 presents the basic features and construction of the unconventional financing instruments most frequently used by Polish LGUs, taking into consideration the way local budgets reflect the burdens related to their usage. The instruments included in the set are examples of the increasingly popular (in the local government subsector) allocation of local debt without using conventional debt instruments. Thanks to them, LGUs can obtain financing of both current activities and investments in a fast and relatively simple manner, without additional difficulties. These solutions are particularly attractive to those LGUs which, having exceeded their debt limits, cannot count on typical returnable financing and regard the aforementioned methods as temporary instruments of financial engineering directed at improvement (unfortunately, usually short-term) of parameters describing their financial situation.
### TABLE 1.

Unconventional instruments of financing LGU budget

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Characteristic and construction of instrument</th>
<th>Way of recording expenses associated with given instruments in LGU budget</th>
</tr>
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<tbody>
<tr>
<td>Capital financing</td>
<td>Municipality establishes a municipal company¹ and brings in the capital (e.g. by purchasing stocks in a limited liability company or shares in a joint stock company), which enables it to accomplish certain public local tasks (e.g. ones connected with water supply and sewage system, heating, municipal waste management, etc.).</td>
<td>Expenses related to this sphere are included in the municipal budget as asset-related spending, not as debt obligations. Thus, they are neutral from the perspective of IDI.</td>
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<tr>
<td></td>
<td>The company may fund municipal investments from incurred loans or by issuing municipality bonds, which helps 'shift' debt outside the local budget.</td>
<td>The debts of municipal companies are not visible in the budgets of LGUs (except when a municipality offers warranties or guarantees to a company) because companies are not units of the public finance sector. Thus, the debt of companies does not constitute a burden for an LGU. It is, therefore, a hidden debt, not visible in budget reports or in multi-year financial forecasts, but at the same time constituting a burden for the local government [Körber-Sokolowska, 2015, p. 42]. When strategic municipal companies are in debt and have problems with debt service and repayment, the so-called moral hazard can occur – under the influence of political pressures and public opinion, an LGU might be forced to take action to save an indebted company from bankruptcy [Nawrocki, 2016, p. 68]. Thus, the debt of municipal companies ought to be considered as a potential debt of LGUs. The funds expended from an LGU budget on the repayment of the debt of a municipal company are referred to as operational expenses in municipal budgets. The instrument's construction is neutral from the perspective of the IDI indicator.</td>
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</table>

¹ Municipal joint-stock companies, in fact, function in all large cities in Poland. At the end of 2015, LGUs declared that they were in possession of shares in 2,324 limited liability companies and in 273 joint stock companies [MSP, 2016, pp. 8 and 10].
| Refundable leasing | An LGU sells its own fixed asset to a lessor and signs with them a leasing contract on the basis of which this fixed asset is used by the LGU afterwards. Refundable leasing is a transaction comprising two agreements: the sale of certain elements of the assets and leasing them by the purchaser to the seller. In the first stage, the subject of the agreement is sold by its previous owner, i.e., an LGU (the financing entity). In the second stage, the seller (the same LGU) is granted the right to use the sold object. In most cases, it is just the owner of the assets which changes [Cichocki, Moser, 2016, p. 145]. | As a result of the temporary disposal of a property item by the LGU, a considerable increase in budget revenue occurs. A one-off positive budget result may considerably improve the IDI indicator (this regards only operational leasing, not financial leasing). Simultaneously, the possibility to repay a large part of the liabilities at the end of the leasing term causes a reduction in the current financial burden, although the payment connected with the purchase is treated as a property expenditure, neutral from the perspective of the IDI indicator [Cichocki, Moser, 2016, p. 151]. |
| Repurchase transaction | A repurchase transaction is often referred to as an apparent sale because, in fact, neither of the parties is truly interested in the sale (transfer of ownership) but rather in the transfer of monetary assets which results from the trading of specified property elements [KR RIO, 2016, p. 25]. It involves the purchase of property from an LGU by a financial institution by means of signing a preliminary contract for the sale of this property. For the entire financing period, the LGU pays the so-called rent which corresponds to the price of financing. The capital corresponding to the price of repurchase is repaid in full at the end of the period, and the local government reacquires its property. This formula is based on three contracts (sale, hire, and preliminary sale contract). The disposal of the item of property by the seller (LGU) allows it to acquire monetary assets, retaining at the same time the possibility to use the property. As regards the purchaser, the transfer of the item means forfeiting the benefits resulting from ownership, but in return the purchaser receives remuneration in the form of a rent. Until the moment of repurchase, the seller (LGU) does not lose control of the sold item, whereas the purchaser receives compensation (rent) along with the guarantee of repurchase [KR RIO 2016, p. 25]. | The price of the sale is an LGU revenue, recorded in budget documents as income from the sale of property; the repurchase of the property by the LGU is, in fact, the repayment of the lent capital, i.e., an expenditure, but in budget this operation is termed as property expense. The payment of a rent, in fact, constitutes an expense related to debt service, but in the budget it is listed as an expense related to rental [KR RIO, 2016, p. 25], thus this expense is neutral from the perspective of the IDI indicator. |
| Installment scheme | This instrument involves rescheduling payment for invoices issued to an LGU by service contractors, suppliers or construction contractors. A financial institution purchases claims from the supplier. The cost of financing is included in the burdens related to installment payment when the invoice regards construction works, supply of fixed assets, are not recorded in LGU budgets as debt obligations, but as property expenditures, neutral from the perspective of the IDI indicator. | |

2 In Poland, the first case when an LGU used the instrument of refundable (operational) hire of municipal properties regarded the buildings of Wroclaw town council (2012). The funds obtained in this way (82 mln PLN) bolstered the budget of the city, depleted by the expenses associated with the Euro 2012 tournament.
the service cost. The instrument's structure is similar to public-private partnership (PPP) financing.

| Subrogation | This instrument allows LGUs to restructure some of the incurred debt. It is based on the construction of the so-called entering in the place of a satisfied creditor. It involves acquisition of a claim by a third party that, with the consent of the debtor (invalid unless written), will be repaid by the creditor up to the value of the repayment made. An additional condition is that a third party subrogates the rights of the creditor [Renke, 2016, p. 320]. The LGU signs a contract with a bank or another financial institution and, on its basis, these institutions repay the debt to the local government creditors. This instrument may be applied for both LGU obligations towards suppliers of goods and services and with the aim of restructuring of debt, e.g. resulting from the previously taken out credits and loans, emitted municipal bonds, etc. [Wpływ operacji finansowych..., 2016, p. 17]. | In fact, this process is similar to debt 'roll-over', which enables LGUs to 'make room' for new obligations. The adopted solutions cause extension of repayment period and consequently generate higher service costs. Interestingly, this operation takes place outside the 'regime' of the IDI indicator. It is not necessary to obtain an opinion from a Regional Accounting Chamber (RIO). |

| Contracting financial obligations in quasi-banks | Quasi-banks\(^3\) are non-bank financial institutions that function similarly to banks, but are not subject to legislative regulations characteristic of banks or financial supervision. Neither are they part of a deposit guarantee scheme. They are ready to finance those LGUs which are in a worse financial situation, but due to greater risk, they expect higher compensation [Jastrzębska, 2016, pp. 189-190]. The interest on the loans offered by these institutions to LGUs is usually 2-3 times higher than the cost of commercial loans offered by the bank sector. | Under current law, it is not possible to unequivocally classify LGU debt in quasi-banks as public debt. Moreover, there is no legal requirement to formally report this type of obligations in budget documents. An opinion from a RIO as regards capacity for obligation repayment is not necessary. |

Source: authors' own work.

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\(^3\) A survey study conducted by the Regional Accounting Chambers reveals that (in April 2016) the number of LGUs with debt in non-bank institutions (quasi-banks) was relatively small (39 LGUs), whereas the value of the debt stood around 240 mln PLN (excluding the costs of interest and the costs of obtaining the funds). [Dylag, 2016].
5. Economic consequences of using Unconventional financial instruments by local governments

Local government units resort to precarious practices related to the use of unconventional instruments for numerous reasons. They include the desire to escape debt, the need to finance a deficit, as well as the wish to promote local development despite inability to obtain refundable financing from conventional sources. Some LGUs may not undertake development activities owing to the lack of operational surplus, the value of which constitutes the basic indicator of the possibility to incur debt. Therefore, local authorities defend these debt instruments because they appear to them to be the only way to finance investments, especially in view of the constant pressure to obtain non-returnable funds from the EU budget.

Using unconventional financial instruments by local government units does not affect the IDI indicator. On the contrary, the indicator can even improve, which results in increased permissible level of debt. Local governments receive from non-bank institutions products that enable them to make municipal investments without worsening the ratio of debt service to total revenues, specified in the aforementioned IDI formula. This takes place when the used products cause an increase in revenues, for example, during a repurchase transaction when refundable leasing is used to help an LGU obtain funds for financing new projects thanks to increased revenues from the sale of property or from recapitalization of a municipal company by means of taking up shares in the company by a financial institution provided that a local government has the right to buy them back on the basis of certain principles at a specified date [Wpływ operacji finansowych..., 2006, pp. 14].

Taking into consideration the imperfections of the numerical principle of LGU debt (formulated in the Public Finance Law), reasonable application of the described instruments appears to be justified in some cases. The use of returnable funds with the aim of financing investments by local governments, irrespective of their legislative character, may contribute to socio-economic development of the unit and the expansion of its revenue basis in the long-term, provided that the criterion of cost-effectiveness and the capacity of regulating the increased debt are also borne in mind [Zawora, 2013, p.132]. If adequate consideration is given to the matter, debt incurred for financing investments may be favorable for the development of an LGU and for better satisfaction of the needs of the local community [Jastrzębska, 2009, pp. 11-12].

However, the fact that LGUs incur debts by means of unconventional instruments is associated with certain pitfalls. They result chiefly from exceeding a safe level of debt, which consequently leads to considerable worsening of the financial condition of the units, and generally (when all of the LGUs are considered) to increasing the value of the public debt [Zawora, 2013, p.132].

Although unconventional instruments are numerous, there is one characteristic that they share. They are not subject to the principles of public finances that introduce mechanisms reducing the debt of LGUs and, therefore, pose a threat to the stability of finances of local governments and to the solvency of units, not to mention the fact that they are very expensive. Thanks to them an LGU which, in fact, has an excessive
debt level, in its financial report can present an unrealistic image of its financial status, which clearly has a negative impact on the openness and transparency of public finances. Only detailed audits conducted by institutions responsible for the state of local governments’ finances (RIOs) is capable of disclosing the actual financial situation of such a unit, which, in extreme cases, can be made to adopt a corrective program entailing considerable restrictions to new investment activities for a number of years. The Rewal municipality can serve as an example here, which for many years managed to conceal a major part of its debt, using unconventional financing instruments.

Since LGUs in Poland do not have the possibility to declare bankruptcy, even in a very difficult financial situation, they still need to fulfill their statutory public tasks while struggling with serious difficulties (for example, in terms of finding potential suppliers or service providers). Problems with solvency can also affect the range and level of the supplied goods and provided public services or, worse still, lead to a complete withdrawal from any investment activity aimed at development, which might ultimately have a negative influence on the living standards of the local population. In the long-term, the image of an LGU facing solvency problems can be tarnished, which, in turn, may also inflate the costs of conventional debt instruments once it is again capable of using them.

Failure to faithfully report the effects of using unconventional instruments in long-term financial forecasts (LFFs) leads to excessive optimism in planning prudential indicators. In fact, in order to preserve the acceptable level of debt limits, local government units present in their LFFs unrealistic values of anticipated incomes, expenses and incorrect debt values. This additionally undermines the already doubtful reliability of this type of documents. The use of the analyzed instruments, and the frequent omission to include them in financial reports, has a negative influence on the openness and transparency of public finances and may become a source of uncontrolled worsening of the financial situation of LGUs [Wpływ operacji finansowych..., 2016, p. 6].

Before deciding to apply unconventional debt instruments, local government units usually do not perform analyses of the financial conditions, effects or the security of using them before signing agreements and contracts. Such behavior leads to negative measurable consequences related to the inflated costs of servicing the instruments in question. This kind of situation can be regarded as an indication of mismanagement on the part of local authorities and ought to constitute a basis for legal proceedings on the grounds of violation of the discipline of public finances, and in extreme cases, for initiating criminal investigation against the culpable LGU authorities.

The results of an audit conducted by the NIK proved that the costs incurred by LGUs owing to unconventional instruments were higher by 22.8% than the costs that would have been incurred if the entities had used, for example, a bank mortgage loan taken out on commercial terms. In individual LGUs, the difference ranged from 7% to 52%. For the analyzed instruments, e.g. repurchase transaction concerning urban infrastructure in Ostrowice, the difference reached 70.5%. The juxtaposition of differences in the described costs of servicing the instruments for the LGUs controlled by NIK is presented in Figure 3 [NIK, 2016, p. 26].
Increased use of unconventional instruments is most frequently caused by unfavorable financial situation of an LGU. The instruments of this type are used mostly by entities that have either constant or temporary problems with maintaining fluidity and have considerable due liabilities. Being burdened by the costs of repaying subsequent obligations, including the costs of amortization, such an LGU is overwhelmed by problems that result chiefly from uncontrolled debt from the preceding years and inefficient debt management. This leads to a vicious circle related to the necessity to incur more debt (usually very costly) in order to repay the previous loans. In fact, one needs to be aware that eventually the debt needs to be repaid from the operational surplus or from the funds obtained as a result of activity related to property.

It needs to be emphasized that the scale of the analyzed phenomenon is not clearly recognized because LGUs do not specify in the reports (including those submitted to Regional Audit Chambers) the range or scale of using unconventional instruments of financing their budget needs. For this reason, it is impossible to obtain information on what the real debt of LGUs is, and thus assess it in the context of the financial situation of LGUs. It is, moreover, difficult to fully grasp the scale of the problems ensuing from the use of the investigated instruments.

6. Conclusion

In view of the fact that the legislators have recently tightened the limits of debt in the Polish local government subsector, the “grey market” as regards the local debt has been observed to expand. Because of this, the range of financial obligations that fall outside
the scope of the statutory mechanisms for reducing and monitoring debt is increasing. This diminishes the transparency of local government finances and the financial operations performed there. Large-scale use of unconventional financing instruments may lead not only to falsification of the real financial situation of LGUs, but also to uncontrollable increases in the local debt. Therefore, certain systemic changes are indispensable in this field. Above all, it is necessary to:

– broaden the statutory catalogue of types of debt included in the public debt by adding the financial obligations resulting from unconventional instruments of financing LGU budgets (in this sphere, the present legal status does not keep pace with the dynamically changing economic reality and with the creativity of financial institutions);

– extend the consultative functions of RIOs as regards delivering opinions regarding the possibility of repaying debt resulting from using unconventional financing instruments by LGUs;

– make changes in the present system of budget reporting in terms of including data related to unconventional instruments of financing used by LGUs (this also regards debt of municipal companies);

– legally restrict the ability of LGUs to resort to non-bank lending.

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Marzanna Poniatowicz, PhD, Professor of the University of Bialystok – development of the research concept, carrying out the research, developing results, of the introductory section (theoretical), formulation of the summary and conclusions – 35%

Dorota Wyszkowska, PhD – development of the research concept, carrying out the research, developing results, preparation of economic consequences of using unconventional financial instruments, formulation of the conclusions; 35%

Ewelina Piekarska, MA – conducting research, developing results, preparing a description of unconventional instruments for financing budget needs local government units – 30%

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