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The “Golden Rule” as a New Financial Management Tool for Local Governments

Abstract: The implementation of the so-called “golden rule” regarding the fiscal management of the sub-sector of the local-self-government (LSG) constituted a reaction to the growth of the debt within the sector of public finances and an attempt to curb the LSG deficit. In this manner the Legislator wanted to balance the budget regarding operating revenues and the operating expenditures and to allow for the use of public loans, thus permitting the generation of the debt only in regard to capital expenditures. The authors of the article evaluate the validity of introducing the new regulations, subjecting the “golden rule” to a positive critique and forming requirements for changes and improvements based on solutions to this problem utilized in other countries. An empiric data is presented that shows the consequences of overloading the LSG with the effects of the growing level of public debt in a situation when the responsibility for the majority of the debt (more than 90%) rests with the public governance at the government level. The authors also put forth the thesis that the implementation of the more restrictive rules on the central level is also necessary to optimize the entire system of public finances.

Keywords: *golden rule; deficit; local government units; fiscal rule; limiting debt*

Introduction

The increased intensity regarding adhering to the fiscal criteria concerning the deficit and public debt within the sector of national and local governance as set forth by the Maastricht Treaty along with the introduction of additional rules in reference to early warnings in the midterm period constituted the reaction to the financial crisis that began in the EU in 2008. After affirmation by the Economic and Financial Affairs Council (ECOFIN) on July 7, 2009 of excessive public debt, the government of Poland was mandated to reduce the deficit.

The activities, undertaken as result of the said mandate, were divided among the two main sub-sectors of public finances namely the government and the local self-governance. Given, the rapid growth of debt and existence of a deficit occurring at the local self-governance level, it became necessary to undertake additional activities aimed at curb the negative, from the point of view of the stability of the public finances, effects.

The establishment of regulations increasing limits regarding deficit of the budgets for self-governance sector constituted an essential element of the said additional activities (Błażuk, 2014, p. 11). Further mechanism toward limiting deficit of the self-governance sub-sector and the introduction of the new management system at the self-governance level were formulated in the Act on Public Finance of August 27, 2009 (from herein u.f.p.)¹. Particularly encompassed were issues of long-term multi-annual financial planning, expanding the control over the execution of the budget, prohibition of deficit spending on on-going regular activities (implementation of the “golden rule” concerning the operating budget) and/or generating of new deficit by introducing new indicators limiting the assumption of new financial liabilities. A full listing of the changes is contained in Sawicka (2012).

The aim of this article is to assess the functioning of the “golden rule” at the local government level in Poland. The authors evaluate the validity of introducing the new regulations, subjecting the “golden rule” to a positive critique and forming requirements for changes and improvements based on solutions to this problem utilized in other countries. The writers also put forth the thesis that the implementation of the more restrictive rules on the central level is also necessary to optimize the entire system of public finances.

In order to achieve the research goals, statistical data were employed. A dogmatic-legal method basing on an analysis of the binding law and legal doctrine was applied. The achievements of the doctrine and case law of broadly understood LSG financial management were also considered. The article is in line with the legal situation as of May 2018.

The Golden Rule for the Finances of the Local Self-Governance – The Concept and Purposefulness

The unmatched in the previous Act on Public Finance “golden rule”, provided for in art 242 u.f.p., had been introduced for the first time in reference to budgetary resolution of self-governances for the FY 2011². This rule, otherwise known as the rule for balancing the operating budget, although such interpretation rises some controversy within the doctrine (Smoleń, 2012, p. 1071)³. Consistent with the provisions of the “golden rule” the self-governance body

¹ Journal of Laws No. 157, position 1240 with later amendments.

² Consistent with art. 121, pos.1 of the Act on Public Finance of August 27, 2009, Enabling regulations for the Act on Public Finance, journal of Laws No. 157, pos. 1241, with all later amendments.

³ In the opinion of the author the aim of the said regulation is not to balance the self-governance budgets in relation to both revenues and the expenditures or even partial balance within the area of

can neither pass nor execute budgetary resolution in which current expenditures are in excess of the current revenues enlarged by the budget surplus from previous years and free resources received from the settlement of liabilities⁴ and a violation of this rule can occur only as a result of delays in re-funding of expenditures under the EU funded programmes. The discussed restrictions pertain to both the stage of planning of the budget (passage 1) and budget execution (passage 2 and 3).

In the opinion of Lipec-Warzecha (2011, p. 1082) the discussed herein regulation is related to the division of the revenues and expenditures of the self-governance budget for the operating and capital (art. 235 and 236 u.f.p.) with the provision that the restrictions do not apply to the capital budget.

In the opinion of the authors of the said legislation the discussed restrictions were to contribute to a rational economic management by the local government units⁵. The aim of the introduced changes was also to safeguard the State against uncontrolled growth of public debt and to prepare the local self-governance for complying with the new indicator of the public debt to which end the Legislator provided the local self-governances with 3-year (2011–2013) adaptation period for the restructuring of debt and optimization of expenditures. The implementation of the “golden rule” could be also perceived as an attempt to resolve one of the pressing problems that had surfaced at the point of implementation of the measures to curb the deficit as the local self-governances were using the method of reduction of the capital expenditures while continuing with the unaltered level of the operating expenditures, which in practice had negatively impacted the public infrastructure (Panfil, 2011).

Consistent with the “golden rule” the operating deficit cannot be covered by income return (thus creating or adding to the public debt) and/or by income derived from the privatization of the self-governance assets. The public debt incurred by local self-governances shall be “productive” and not wasteful (eaten up by operating expenditures), particularly on salaries and/or wages. Increasing of acquiring public debt for the purpose of financing operating expenditures may lead self-governances into the “spiral of debt” that affects cash

financing of the current, on-going tasks. Within a balanced budget the expenditures are covered by the revenues and not by the income (PL: so-called *przychody*). The budget may be imbalanced by a surplus or deficit. The Legislator, clearly lists the budget surplus of the previous years as one of the potential sources of covering the operating expenditures. The author points out that the comprehensive interpretation art. 242 u.f.p. leads to the conclusion, that it limits the level of self-governance deficits through limiting the sums of the planned and the actually expended operating expenditures. A different point of view regarding this issue is presented by other doctrine experts (Karlikowska et al., 2010) and (Dobrzyński, 2014, p. 46). In the opinion of Dobrzyński (2014, p. 46) the art. 242 u.f.p. expresses the rule for balancing the budget in the part of operating revenues and operating expenditures.

⁴ Free resources understood as the surplus of financial resources in the current account of the budget that is the result of the settlement of emitted securities, credits and loans from previous years.

⁵ Justification to the project of the Act on Public Finance, parliamentary printed matter no. 1181, p. 39.

flow and financial solvency⁶. In situations of significant escalation of such a phenomenon it may result in financial instability of the local self-governance sub-sector and with time to instability of the entire public sector. Incurring liabilities to cover the operating expenditures leads also to a false growth of the local public sector which can, in turn, result in a tax illusion, understood as a false growth of demand regarding public services financed via debt rather than local taxes (Wiewióra, 2009, p. 11). Furthermore, the use of credits and loans by the local self-administration may result in “pushing” private investors out of the local market since the banks perceive the local self-administration as more trustworthy clients with a minimal risk for the money box in terms of losing the loaned funds. In case when the local self-government would not be capable to re-pay, it is expected also that the State would step in and compensate the debt. There may also be an increase in interest rates on credits and loans, resulting in higher private investment costs. The most often presented arguments for the balanced operating budget are presented by Dafflon (2002).

There is an agreement within the subject literature that the use of debt instruments to provide funding for current activities shall be allowed only in extraordinary circumstances and shall be restricted to resolve temporary problems with cash flow. The resulting debt shall be paid off as soon as possible and no later than within 12 months (Swianiewicz, 2011). The Polish Legislator foresaw such eventuality, allowing for the local self-governance to take up a credit and loans or emit securities to cover short-term, transitional deficit within the fiscal year (art. 89, pos.1, point 1, u.f.p.), with the provision that the debt shall be paid off or redeemed within the same year. Whereas credit and/or loans can be paid off within the same year, it is procedurally rather impossible regarding redemption of securities.

A significant body of jurisprudence and case-law interpretation by the organs of financial control has been developed regarding the prohibition of assuming debt liabilities for financing current activities. The RIO Council in Zielona Góra in 2011: “The current legal system does not allow self-governances to acquire an income return- taking up credit for financing current budget expenditures. (...) the budget deficit of local self-governance units that is being covered by return income i.e. from long-term credits can refer only to capital expenditures”⁷.

Acquisition of liabilities thereby generated by the local self-governance of budget deficit can be allocated only for capital expenditures and planned expenditures (PL: *planowane*

⁶ As it were occurring in Italy, where until 1978 it was allowed take up credit and/or loans for current activities. In the year prior in Italy, the public debt of the self-governance sector exceeded 11% of GDP of which more than a half resulted from the imbalance of the current expenditures. In Italian local government units in 1977 approximately 70% of new credits was secured for the purpose off paying off credits from previous years (Wiewióra, 2009, p. 11).

⁷ Resolution of the Zielona Góra RIO Council, No. 102/2011 of 16.2.2011, Lex Polonica No. 2504757, and the resolution of the Zielona Góra RIO Council, No. 101/2011 of 16.2.2011, Lex Polonica No. 2504756.

rozchody). Financing expenditures out of acquired liabilities shall contribute to the creation of productive and self-funding investments.

The “golden rule” shall also contribute to ensuring the generational justice according to which the generations that will be benefited by the investment shall bear the financial burden associated with the investment. However, it may be problematic to precisely define the point in time when the capital expenditures shall begin to bring in the benefits and to relate it to paying off the liabilities acquired for the investment.

According to Jastrzębska (2012, p. 187) the “golden rule” is designated to make possible financing of all of the cyclic and stable expenditures out of same character revenues. At the same time, it disciplines the economic management of self-governances forcing these entities to search for additional sources of revenues while curbing the expenditures.

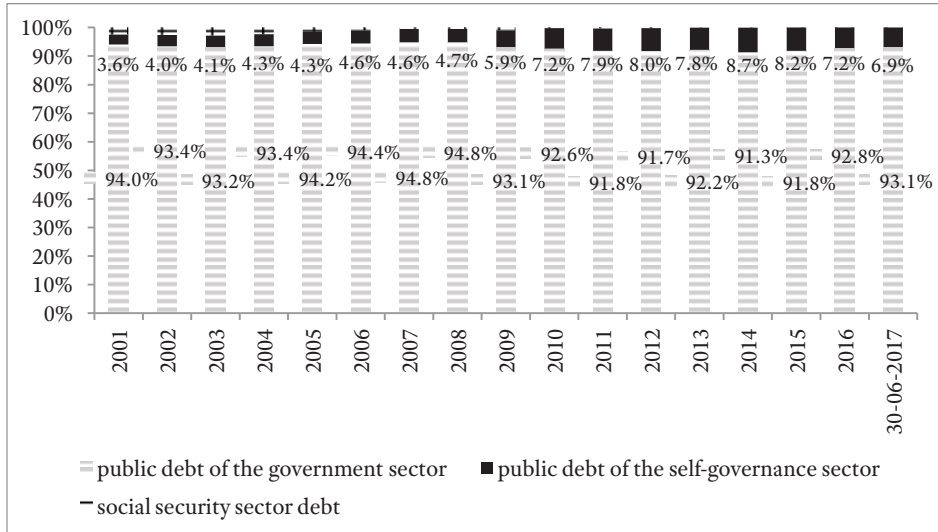
A Critical Evaluation of the Existing Solutions

The discussed herein “golden rule” is not flawless. The inclusions of free resources derived from credits or loans from prior years into the funding of current expenditures so to say breaks that very rule, in conformity to which the return income cannot be applied to financing the budget operating deficit in regard to current expenditures. As for Dobrzyński (2014) this break may have an adverse impact on the debt capacity ratio of local government units involving free funds for current expenditures.

As for Jastrzębska (2012, p. 187) the rule does not consider unforeseen events, which result in increase of the level of current expenditures related to the alleviation of the effects of the said events. The Authoress, rightfully so, points away that self-governance entities are specified in their abilities for rationalization of its economic management since the fixed expenditures (i.e. social assistance, education, etc.) constitute a sizable portion of the current expenditures and the limited ability of self-governances to affect the construction of the received revenues.

In the opinion of many scientists and representatives of the self-governance communities, significant doubts are raised by not imposing the “golden rule” onto the sub-sector of government and the entire sector of public finances. Particularly, when considering that in the years 2001–2016 the public debt of the government sector accounted for 93%, on an average, of the entire public debt, while the debt of the self-governances accounted only for less than 6% of the total public debt as illustrated in the graph 1. At the central and social welfare funds level, spending rules (limiting public spending) are most often set instead of “golden rules”. This is related to the need to limit the growing pressure on, among other things, increasing social welfare spending. The EU Member States are also bound by fiscal rules relating to the level of budget deficit and public debt.

The results of the research conducted by the European Commission (European Commission, 2007) based on data provided by the EU countries for the years 1990–2005 confirm



Graph 1. The structure of the public debt in Poland, by sectors, in 2001–2017

Source: Authors' own calculations based on the data provided by the Ministry of Finance, Quarterly data regarding the debt of public finances (sfp) in the form of time series, MS Excel. Retrieved from: <http://www.finance.mf.gov.pl/szeregi-czasowe>

that a correlation exists between the rules of fiscal management and the results of budget implementation. It is proven that applying the principles of fiscal management over a fuller range of public finances lowers the degree of deficit. However, necessary are also mechanism for proper execution of these rules and safeguarding against violation of these rules. Said rules have to be clear, transparent and manipulation proof and shall be equipped with effective monitoring mechanisms. Rodden (2002) observed that self-governances with freedom of acquiring credits and loans (without debt limiting rules) and dependent on government funding demonstrated higher and more permanent deficits.

Polish Regulations versus Solutions Existing in Other EU Countries

The regulations existing within the Polish legal system are not most restrictive when compared to other EU countries. At the time of the adoption of the Polish “golden rule” (2011) the fiscal rule of the balanced budget was most popular among the EU countries amid the self-governance entities. Twelve countries had some variations of the balanced budget rule regarding the self-governance sector and some were applying the balanced budget rule equally to the current and capital expenditures. It should be emphasized, however, that in the countries of Western Europe the clear separation of the current and the capital budgets is mandatory, so it is comparatively easy to carry out the formula of the balanced budget

in each of the categories (Wiewióra, 2009, p. 12). The importance of the separation of the current budget from the capital budget for the proper implementation of the “golden rule” was also underscored by Musgrave (Musgrave, 1959). However, (in Finland) the rule of the balanced budget is applied and carried out over several fiscal years and not over one fiscal year (Wiewióra 2009, p. 12). Such solutions are, however, used sparsely and the term of office of local self-governances shall be identical to the number of fiscal years over which the rule is applied to ensure the success of the model.

Conclusions

From 1999, as provided for in the Act on Public Finances⁸, the debt of public governance bodies, including the self-governance, is included into the State public debt⁹. The linking of the self-governance debt with the debt of the State Treasury and other entities considered elements of the public sector is frequently criticized within the subject literature (Poniatowicz, 2000), mainly from the point of view that the debt of the self-governance sector contributes minimally to the creation and growth of the State public debt.

However, in a situation of a very significant debt of the entire sector (dangerously approaching the threshold for activating the procedures to be applied when the first safety level is crossed) even the smallest growth of the self-governance debt (as it happened in 2008–2012) impacts the financial condition of the entire sector of public finances. More importantly, the empiric research shows, that even prior to the adoption of the regulation prohibiting the generation of deficit regarding the current expenditures, the deficit generated by the self-governances did not stemmed out “being eaten up” or otherwise generated by the current (operating) expenditures. In 2010 the capital expenditures of the self-governances accounted for 24.3% of all budget expenditures and in total were three (3) times higher than the deficit. The deficit of Polish local government units was at 1% of GDP, while the investments at 3% of GDP. The aforementioned investments (representing more than half of total public sector investment) were and still are the main channel for securing the EU funding. They were also very important in supporting and sustaining the Polish economy during the “slow-down” of the European economy and the reluctance of economic entities toward new investments. The remaining entities of the public sector realized less investment expenditures while demonstrating 6-time higher levels of the deficit.

Based on the results of the analysis, conducted by the authors of the article herein, of the statistical data from the Ministry of Finance for each of the fiscal years between 2004–2009, the self-governances as a whole, generated the operating surplus (understood as

⁸ Act on Public Finances of 26 November, 1998 (Journal of Law No. 155, pos.1014, with all later amendments.)

⁹ There is certain exception to the said rule, these, however, do not impact the conclusions of the article herein.

the in plus difference between the total current revenue and the total current expenditures) constituted on the average approximately PLN 13.3 billion. The average operating gross surplus (understood as the positive difference between the total revenue and total current expenditures) was even higher. In comparison the State budget in the years 2000–2005 did not generate an operating surplus. It only generated current deficits at the level of PLN 25 billion, on an average. It should be added that within the years 2006–2009 the government sector generated a minimal operating surplus in one fiscal year only.

The local self-governances, by a majority, assume financial liabilities in a careful and rational manner. As it is pointed out by Swianiewicz (2011, p. 204) borrowing, by the self-governances, in the form of a credit is done most often as the result of well thought out strategy rather than the necessity for the reduction of the current budget shortfall. This is further confirmed by the results of empirical research which demonstrate that it is the wealthier communes that show the higher level of debt than the “poorer” communes, but there is also a positive correlation between the level of financial debt instruments being utilized by the wealthy communes and their level of the investment expenditures.

The local government investments positively impact the State revenue. Based on conservative assumptions it could be said that each PLN billion of capital outlay by the local self-governance in 2011 resulted in bringing in PLN 250 million to the public finance sector (including VAT and CIT taxes).

Thus, it could be said that the self-governance sector is doubly responsible for its obligations: first, as the result of linking of the debt generated by the self-governance sector with the debt generated by other entities of the sector of the Public Finances (in particular with the State Treasury, the Social Security and the State Medical Fund), and second, because of the mandate to apply additional safety measures against debt generation.

Irrespective of the relatively long transition period preceding the implementation of the planned changes, numerous self-governances still struggle with overcoming the problems related to meeting the individual debt ratio and with the lack of funds for investments. Even though, the solutions introduced in the u.f.p., would undoubtedly contribute to increase of the stability of the self-governance sector, these cannot heal the entire public sector. Nonetheless, it appears that adopting the more restrictive rules also for the budget planning and execution for the entire public sector constitutes a condition necessary for the optimization of the whole system of the public finances.

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