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INCOME BONDS AS A NEW SOURCE OF FINANCING THE ACTIVITIES OF LOCAL GOVERNMENT AUTHORITIES

1. Introduction

Income bonds,¹ commonly known as communal bonds, are bonds which can be emitted by:

1) a local government organisation, a union of local government organisations, the capital city Warsaw.

2) a share company or company with limited liability, in which one of the organisations mentioned in point 1) possesses such a number of shares guaranteeing more than 50% of the votes at a shareholders' meeting or meeting of the partners, as long as the activities of such a company are directed at realising the needs of the local community or carrying out tasks in the realm of public utility

3) a share company or a company with limited liability, whose only field of activity is carrying out tasks in the realm of public utility based on an agreement with a local government organisation, union of local government organisations or the capital city, Warsaw, such that these tasks will be carried out for a period which covers the validity of the bonds.

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¹The issue of income bonds is regulated by the act of 29 June 1995 on bonds [Dziennik Ustaw, 2001], in particular in Art. 23a, 23b and 23c. The possibility of emission of income bonds was introduced by, among others, Art. 1 Item 17 of the act of 29 June 2000 on the change of the act on bonds [Dziennik Ustaw, 2000c]. This act came into force on 27 August 2000.

4) a share company, which on the basis of a legal right, permit or concession is to carry out tasks in the realm of public utility, or carry out services in the field of transport or communication, as well as the maintenance and development of a transport or communication network, for a period which covers the validity of the bonds.

The emission of obligations gives such organisations the opportunity of obtaining additional finance in a relatively quick, cheap and easy way and spreading out repayments over a period of many years. In addition, the emission of such obligations creates a significant field of manoeuvre in harmonising the inflow of funds according to the requirements and the timetable of the expenditure plan. The characteristics of income bonds distinguishing them from other types of bond result from the nature of the emitter, which in general is an organisation active in the realm of public utility understood in a broad sense [Jastrzębska, 1999, 119–20].

Reasons for and gains from the emission of communal bonds can be summarised as [Babczuk, 1998]:

- the possibility of obtaining repayable financing of local government tasks, particularly those of an investment nature,
- generally greater effectiveness than the most common competitive form of finance – bank loans on commercial terms
- avoiding constraints on the level of external financing in the case of using a part or the whole of the permissible level of borrowing
- enabling the acceleration of the privatisation of communal assets
- avoiding concentration limits used in commercial bank loans
- the flexibility of bonds.

The following should be treated as negative aspects of the emission of bonds [Babczuk, 1998]:

- the passing on of the responsibility of payment to the next generation
- limiting the future possibilities of the funding of present activities to a level beneath 85% of the budget income of a local government organisation,
- increased risk of not being able to pay back debts in the future.

The first problem has not been encountered in practice up to now. However, there is no reason why local governments cannot finance their investments using 15–20 year bonds, or even bonds of longer term. At present debts are rather passed on to the next elected council. The uncertainty of the development of the economy (both at the macro and microeconomic scale) means that an emission of bonds could be a potential problem for the next council.

The choice of goals, which a local government wishes to finance, is highly important. One can put forward the hypothesis that a local government cannot afford to realise a project, which does not produce any gains. The idea of gains here is not confined simply to financial gains. Funds obtained from the emission of bonds must be spent in order to increase the possibility of local development as much as possible by creating the appropriate conditions for inhabitants and firms. This should mainly concern infrastructure understood in a wide sense (the maintenance and repairing of roads and bridges, sewage disposal, local transport, purchase of land for investment purposes, developing unused terrain etc.)

The problem raised regarding the relation between the costs and benefits ensuing from a bond emission seems to be a key problem in the process of decision making about financing a project by means of a public debt. Buchanan states that a public debt should be undertaken, if there are controls ensuring that the debt is used only for projects, which will bring benefits [Kosek-Wojnar, 1996, 80 ff.]. A project should be so defined, that the local authorities must pay the debt incurred before the time horizon used at the planning stage (assuming that the authority knows its planned income) [Buchanan, 1997]. However, this demands that local authorities carry out a long-term projection of their income and expenditure, which is related to an appraisal of the credit potential of a local government authority in the long-term. Such projections must take into account the following sequence of actions connected with the assessment of credit potential:²

- projection of budget income with respect to the nominal expected income, taking inflation into account,
- projection of budget expenditure with respect to the nominal value of planned expenditure, taking inflation into account,
- projection of free budget funds resulting from budget surpluses in certain years above the present expenditure, ignoring the expenditure of servicing deficits,
- projection of the planned level of investment, taking into account the initially planned level of investment in particular years according to the nominal value taking inflation into account,
- projection deficits taking into account the difference between free budget funds and the planned level of investment,

²Gorczyński, K., *Obligacje jako źródło finansowania zadań jednostek samorządu terytorialnego w Polsce* (Bonds as a source of financing projects of local governments in Poland), in: S. Dolata (ed.), *Prawne i finansowe aspekty funkcjonowania samorządu terytorialnego w Polsce*, vol. 2, *Finanse i budżety samorządów*, Opole 2000, s. 452-453.

- projection of the costs of servicing debts financing the budget deficit, taking into account the expenditure connected with servicing deficits from the present and past years,
- projection of the maximal level of investment, taking into account the difference between the planned level of investment and the costs of servicing debts financing deficits,
- projection of the proportion of the debt limit that is used, taking into account the predicted costs of servicing the debt plus the potential payments of debts guaranteed by the local government minus the payments of instalments and interest on credit and loans, which has been secured by communal assets – accounted for in each successive year,
- variants of the model enabling changes in the planned level of investment with the goal of optimising the relation between deficits and maximum investment expenditure, taking advantage of the credit limit at a level no greater than set in the budget for a given year and harmonising the period of debt financing deficits with respect to the level of instalments and the total costs of servicing the debt.

The credit appraisal of a local government could be an important element of its rating, since it expresses (as a synthetic indicator) the degree of credit trustworthiness from the point of view of the risk of non-payment [Solarz, 1996, 44].

The goal of income bonds is to ensure their bearers priority to payment from defined assets of the issuer. The realisation of these rights is to be ensured by constraints on the issuer regarding the means in which the funds are spent and the selling off of assets.

2. Different types of investment using funds from the emission of income bonds

The type of investments carried out using the funds obtained from the issue of income bonds is defined by the domain of operations of the issuer. In general, it can be stated that these are investments, which satisfy needs in the field of public utility. The number of types of investment depends on the organisation entitled to issue income bonds.

The first group of potential investors are local government authorities (municipalities, districts, regions (provinces)), unions of local government authorities, as well as the capital city, Warsaw. Such investors can carry out the widest range of investments covering the satisfying of the needs of the community, that is to say carrying out their own tasks. Matters of a local nature, unless there are legislatively ascribed to other authorities, belong to the field of activity of a municipal government.

In particular, the tasks of municipal authorities include the following fields:³

- spatial planning, use of land and environmental protection,
- municipal roads, streets, bridges, squares and traffic control,
- water pipes and supply, sewage removal and cleansing, maintaining cleanliness and order, sanitation installations, rubbish dumps and waste disposal, supply of heat, electricity and gas,
- local public transport,
- health care,
- social care, including care centres and organisations,
- municipal housing,
- education, including nursery and primary education and other centres of learning/education,
- culture, including municipal libraries and other cultural centres,
- physical recreation, including recreational areas and sporting facilities,
- markets and market halls,
- municipal greenery and trees,
- municipal cemeteries,
- public order and fire service,
- maintenance of municipal assets and public utility installations, as well as administrative buildings,
- ensuring pregnant women obtain social, medical and legal care.

Districts carry out legislatively defined tasks at a level above the municipal level in the fields of:⁴

- public education,
- health promotion and care,
- social care,
- pro-family policies,
- supporting disabled people,
- transport and public roads,
- culture and protection of the cultural inheritance,
- physical recreation and tourism,
- local surveying, cartography and cadastral surveys,
- real estate,
- administration of architecture and building,
- water management,

³Art. 7 Item 1 of the act of 8 March 1990 on municipal self-government [Dziennik Ustaw, 2001b, 2002, 2002a].

⁴Art. 4 Item 1 of the act of 5 June 1998 on district self-government [Dziennik Ustaw, 2001c, 2002, 2002a].

- nature and environmental protection,
- agriculture, forestry and fresh water fishing,
- public order and safety,
- flood and fire protection and the prevention of other disasters threatening the natural environment, as well as human health and life,
- job creation and activating the local job market,
- protection of consumer rights,
- maintaining district assets, installations of public utility, as well as administration buildings,
- defence,
- promotion of the district,
- co-operation with non-governmental organisations.

Regional government carries out tasks of a regional nature, as described in the legislature, in particular in the fields of:⁵

- public education, including higher education,
- health care and promotion,
- culture and protection of the cultural inheritance,
- social care,
- pro-family policies,
- modernisation of rural areas,
- spatial planning,
- environmental protection,
- water management,
- public roads and transport,
- physical recreation and tourism,
- protection of consumer rights,
- defence,
- public safety,
- job creation and activating the local job market.

Share companies or limited liability companies, in which local government organisations (municipal, district or regional governments), unions of local government organisations, or the capital city, Warsaw, possess such a number of shares ensuring more than 50% of the total number of votes at a shareholders' or partners' meeting and whose only field of activity is satisfying the needs of the local community or carrying out tasks in the domain of public utility, most commonly realise projects in the following fields:

- local transport,
- water pipes and sewers,

⁵Art. 14 Item 1 of the act of 5 June 1998 on regional self-government [Dziennik Ustaw, 2001a, 2002, 2002a].

- cleaning sewage,
- collecting and disposing rubbish,
- exploitation of rubbish dumps,
- heating energy,
- maintenance of greenery,
- maintenance of communal cemeteries etc.

Share companies or limited liability companies, whose only field of activity is the carrying out of tasks in the domain of public utility based on an agreement made with a local government authority, a union of local government authorities, or the capital city, Warsaw, where in accordance with these agreements, these tasks will be carried out for a period covering the validity of the obligations, most commonly realise projects in the following fields:

- local transport,
- water pipes and sewers,
- cleaning sewage,
- collecting and disposing rubbish,
- exploitation of rubbish dumps,
- heating energy,
- maintenance of greenery,
- maintenance of communal cemeteries etc.

Share companies, who on the basis of a legislative agreement, concession, or permit carry out or will carry out tasks in the domain of public utility, or provide services in the domain of transport or communication, as well as the maintenance or development of transport or communication infrastructure for a period covering the validity of the bonds, realise the projects resulting from the relevant concession or permit.

3. Methods of appraising the effectiveness of projects

Many theoretical and practical models of assessing the effectiveness of an investment project exist. Both theory and practice indicate, that there is no universal method or formula, which can be applied in the making of business decisions, including investment decisions. The investment decisions of organisations can be split into the following categories from the point of view of their role in business processes [Sobczyk, 1995, 169-70]:

- renewal, which is based on replacing worn out or out of date capital goods with new ones,
- modernisation, which is mainly directed at reducing the costs of production and improving the quality of goods,

- innovations, which serve to modify goods which have been produced up to now and also to introduce new goods into production,
- development, which is intended to increase the production potential of an organisation, as well as to introduce new goods into production,
- strategic, with the goal of protecting an organisation against the negative influences of the surrounding business environment, together with maintaining and strengthening the position of an organisation on the market.

Of the types of investment highlighted here, investments pertaining to environmental protection should be counted as strategic investments, regardless of their particular character, which may be categorised in another group.

Amongst the categories of investment considered, investments of a strategic nature are associated with the highest level of risk. This means that an appraisal of their economic effectiveness is greatly complicated and non-measurable factors must be included in the economic calculations, including constraints, which appear with a large probability at some point in time during the exploitation of capital goods purchased as part of investments of this nature.

Regardless of the nature of the investment, the most commonly used criterion of appraising their effectiveness at the microeconomic level is the increase in value of a firm (the assets of its owner). When this method of appraising investments is applied it can be assumed that effective investments are those which guarantee a greater than average profit in that field of business. The choice of the optimal investment is based on the choice of the investment that brings the greatest profit from the capital invested. However, the application of the profit criterion in the appraisal of the effectiveness of investments is not sufficient, since this criterion does not give enough weight to some important factors, such as risk and time [Sierpińska and Jachna, 1997, 1991], as well as the effects of external investments.

Every decision connected with the running of a business is accompanied by risk. This risk is connected with the possibility of not achieving the expected profits or spending more than planned, and even making a loss. This is a function of the quantity and quality of the available information regarding market and social-political processes, the degree of variability, as well as contradictions in the internal and external conditions of operation [Borowiecki, 1996, 74]. The risk of achieving results different from those planned must thus be taken into consideration in the decision process. Sometimes firms characterised by a higher level of expected profit face a higher level of risk. This is connected with the fact that various possible operations, characterised by differing levels of ex-

pected profit, also show differing probabilities of achieving a profit [Czekaj, 1991, 8]. Thus, it is crucial to take the risk factor into account in the analysis of the effectiveness of a development investment.

The time factor is connected with the spreading out over successive years of the costs incurred in the realisation of given investments. Thus, a planned flow of investments and effects resulting from these investments occurs over time.

The external effects of an investment are most commonly not measurable and due to this not taken into account in the analysis of the effectiveness of an investment. This problem is particularly related to investments in the field of environmental protection, whose role and meaning is often of a macroeconomic nature.

In general, the methods of appraising the effectiveness of investments can be categorised into those taking the time factor into account and those which do not take the time factor into account, *i.e.* into dynamic methods using a discount factor and static methods not using a discount factor.

Static methods, which are also known in the literature as simple methods, are normally used in the early phase of an investment. They normally play an orientation role in initially assessing the effectiveness of an investment. They can also be applied to the assessment of minor investments, which have a relatively short period of realisation and exploitation. Such methods do not take into account the distribution of costs and gains in time, which is of great importance in an economic analysis. Their advantage lies in their simplicity and clarity. A characteristic trait of these methods is an appraisal of the effectiveness of an investment by defining the relationship between the annual income from the investment (either expected or planned) and the total costs incurred in order to carry out the investment.

In general, static methods do not take into account the influence of the time factor on the value of money, which is a measure of both effects and costs. The changing value of money in time is connected with the following factors [Borowiecki, 1996, 44]:

- **uncertainty** regarding the achieving future income, it is only possible to assess expected income, in connection with this income in the near future should have a greater weight than income in the distant future, due to its greater certainty,
- **costs of not taking advantage of the opportunity** of obtaining a guaranteed income in the present, which prevents the chance of obtaining an increased income in the future,
- **inflation**, which influences the loss of the value of money and thus lowers the value of future income.

The following can be classified as the most important static methods:

- the period of return on an investment,
- the rate of return,
- analysis of the threshold of profitability, usually accompanied by an analysis of sensitivity.

Dynamic methods of appraising investment projects take into account the distribution in time of the predicted income and expenditure related to the project, unlike the static methods considered earlier. A discount factor is used to take into account the time factor, which enables a realistic comparison of the income achieved and expenditure made at different times. Dynamic methods of appraising investments are also known as discount methods. The use of discount methods permits taking the entire time horizon of the investment project into account, that is to say the period of realisation and exploitation, in the economic analysis. Such an approach increases the precision of the appraisal of effectiveness, but also requires an analysis of income and expenditure throughout the period covered in the analysis. As the time horizon increases, then the appraisal becomes more difficult and less accurate [Sobczyk, 1995, 189].

The most commonly used discount methods are:

- Net present value (NPV),
- Internal rate of return (IRR),
- Modified internal rate of return (MIRR),
- Profitability index (PI).

The most realistic method of assessing an investment is NPV. Its advantage over the other methods results from the fact that it:

- enables an analysis of the flow of income and expenditure in the whole period of the realisation and exploitation of an investment,
- it takes into account the time factor, that is to say enables the comparison of income obtained and expenditure incurred at different moments during the period of realisation and exploitation of the investment,
- making a decision between mutually incompatible projects and choosing the project which leads to the greatest increase in value of the firm.

None of the remaining methods simultaneously solves all of these problems. This does not mean that these methods should be rejected. They can also prove to be useful in practice.

In the initial phase of considering investment projects, when we do not yet possess sufficient information to carry out NPV, one of the methods which does not require such an amount of data could be applied. Since the carrying out of a full analysis based on NPV is time consuming

and costly, the elimination of the least effective projects in the initial stages of the analysis can be a source of significant saving.⁶

All of the methods of the appraisal of economic effectiveness of investments used in practice are based on the analysis of the relation between the necessary expenditure and the expected income. These methods permit the appraisal of simple investments aimed at creating a final product. However, in practice firms are dealing more and more often with investments, which are integrated into some already existing technological process. In effect, the appraisal of a project's economic effectiveness is made more difficult, since it is not possible to categorically state the expected income. As a result of this, it is necessary to state that this result is often expressed, for example, as a decrease in costs or as increased costs incurred in previously used technological phases, or a decrease in costs in the technological phases following the phase connected with the investment. However, most commonly one must deal with the phenomenon of an increase in costs of the entire technological process. This is due to the introduction of a new element into an existing technological process, which causes a rise in running costs and additionally leads to an increase in costs resulting from the technical and economic use of funds gathered due to the investment.

Investments of such a nature are normally aimed at improved product quality, which guarantees market survival. Investments in the field of public utility are of a similar nature.

However, investments in the field of public utility are of a specific nature, due to the fact that they are not directly forced by the laws of the market, but by the needs of society expressed by acts of law in force, as well as new acts. In consequence, one should consider the appraisal of the effectiveness of such projects from the point of view of the exploitation costs per unit, taking into account the practical effectiveness of the solution. In the case of the possibility of applying various solutions of varying practical effectiveness and exploitation costs, one should treat the difference in costs resulting from a higher level of practical effectiveness as socially useful costs.

However, the laws of the market and the present financial system of economic actors favour the realisation of investment projects of maximum economic efficiency at the scale of the given organisation.

It should be stated that investments, which are the most effective from the point of view of public utility, are not in general the most effective economically and can in fact be economically ineffective.

⁶Czekaj, J., et. al., *Podstawy zarządzania finansami firm* (The bases of financial management of firms), Warszawa 1995, p. 87.

The economic ineffectiveness of the most practically effective investments in the field of public utility, considered at the level of organisations, is caused by the impossibility of taking into account an economic analysis of all the effects of a given investment, and in particular those effects which are not economically measurable, especially those of an external character. As a result, in order to appraise the effectiveness of a given investment project in the field of public utility, one should not simply apply classical methods of the appraisal of economic effectiveness, but also use models which take into account the nature of such investments and their practical effectiveness in particular.

4. Risk control in connection with investments and the purchase of income bonds. The freedom of the emitter of income bonds

Income bonds may give the holder priority over other creditors in obtaining debt payments from the issuer:

- from the whole or a part of the income or from the whole or a part of the assets of the investments, which were financed from funds gained by the issue of those bonds, and/or
- from the whole or a part of the income from other investments defined by the emitter.

The emitter may constrain its liability from the debts resulting from the bonds in the written contents of the bond by a limit on the income or value of the assets of an investment, to which the holders have priority.

Resolutions on the emission of income bonds should state:

- the type and purpose of the investment,
- the method of calculating income from the investment,
- indicate to which part of the income and/or assets of the investment a holder has priority.

A resolution on the emission of income bonds can relate to more than one investment. Bonds should contain the contents of the resolution on their emission. The emitter of income bonds is obliged to provide information regarding the investment, just as the emitter of any other type of bond. This is to be done at least two weeks before the payment dates resulting from the bond, with the condition that this information is provided at least once a year:

- a financial report containing information regarding the total income obtained from the investment account,
- a report covering the payments to bond holders and issuer from the investment account over the period from the last specified payment date,

– a description of the income structure from the investment, as well as the structure of expenditure of the issuer in financing the investment over that period.

After the emission of income bonds the issuer is obliged to announce the total amount of the debt resulting from the issue and describe the nature of the investment, which is to be financed by the emission, in at least two newspapers, one of which must be a national newspaper. The issuer of income bonds cannot sell off or burden the investment assets, except in the case that a sale is carried out on market terms and does not cause a significant fall in the value of the investment.

The assets creating the income, to which the bondholders have priority, cannot be used to obtain a mortgage loan or as part of a take-over.

In the case of giving the bondholders priority to payments from the income of a specific investment, income from such an investment should be paid into a bank account, specifically assigned to collecting income from and carrying out expenditure on that investment.

The issuer may carry out payments from such an account for other purposes than the payment of debts to bondholders, as long as the value of the account stays above the value of the payments due in the next 12 months according to the bond, if such a possibility is contained in the conditions of the emission. In regard to funds in such an account:

- the right of deduction does not apply,
- funds are not subject to execution of the issuer's account up to the value of the debt of the issuer with respect to the bondholders.

In the case of execution of the assets of the investment, the amount required to satisfy the debts to the bondholders is not subject to execution. This amount is transferred to a bank account and this account can only be used to satisfy the debts to bondholders. This is not applied when the execution of the account has satisfying the debts to the bondholders as its goal.

The funds obtained by means of an emission of income bonds and the debts of the issuer to the bondholders resulting from the bonds are not taken into account when calculating the constraints on the permissible level of debt of a local government authority.⁷

The funds collected in such accounts are not included in the calculation of a firm's assets in the case of bankruptcy. However, debts arising from the issue of income bonds become immediately payable:

- at the moment of the opening of bankruptcy procedures or of the liquidation of the organisation which issued the income bonds,

⁷ Paragraph 113 on the act from 26th October 1998 regarding public finances [Dziennik Ustaw, 1999, 1999a, 1999b, 1999c, 1999d, 2000, 2000a, 2000b].

– in the case of the splitting up of the local government authority that issued the income bonds, the payments are made according to the relevant regulations.

Satisfaction of the debts to the holders of income bonds is carried out from the assets of the investment, with bondholders having priority over other creditors.

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ANNEX 1

Organisations entitled to finance investments from an emission of income bonds

Group	Type of Organisation	Condition I	Condition II
1	Local government organisation (municipality, district, province), union of local government authorities, the capital city, Warsaw.	None	None
2	Share company or limited liability company	A local government authority, union of authorities or the capital city, Warsaw, possess a number of shares ensuring more than 50% of the total number of votes at a shareholder's meeting or meeting of partners.	The only activity of the firm is satisfying the needs of the local society or carrying out tasks in the field of public utility.
3	Share company or limited liability company	The only activity of the company is the carrying out of tasks in the field of public utility on the basis of an agreement with a local government authority, a union of authorities, or the capital city, Warsaw.	The company will carry out these tasks over a period covering the validity of the bonds.

ANNEX 2

Types of investment carried out with the funding of income bonds
Groups I, II and III

No.	Type of task of the local government authority	Examples
1	Municipal roads, streets, bridges, squares and traffic organisation	Road and bridge construction
2	Water pipes and water supply, sewage systems, removal and cleansing of sewage, maintaining cleanliness and order, as well as sanitary installations, rubbish heaps, disposal of communal waste, supply of heat, electricity and gas	Constructing a network of water pipes, sewage systems, rubbish heaps, gas and energy networks
3	Local public transport	Purchase of vehicles - buses, trams and trolley-buses
4	Municipal housing	Land development
5	Education	Building of schools, nursery schools, cultural centres, sporting facilities for schools
6	Physical recreation, including recreation areas and sporting facilities	Building of sport centres

ANNEX 2. cont

No.	Type of task of the local government authority	Examples
7	Markets and market halls	Building of markets, market halls
8	Municipal cemeteries	Building (extension) of cemeteries, building of crematoria

Group IV

No.	Type of task of the local government authority	Examples
1	Public utility	As for groups I-III
2	Services in the field of transport of communication	Purchase of aeroplanes, buses, wagons, locomotives
3	Maintenance and development of transport or communication infrastructure or services in these fields	Building of airports, railway lines, motorways, expressways