Factors influencing local government debt policy in Poland in 1999-2009
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Abstract
In 2004 Local Finance Law gave Polish municipalities and cities extended possibilities to finance their development. Important element of new revenues was higher (then in previous years) share of PIT and CIT (central taxes). This higher share accompanied with higher value of the taxes during economic boom made the financial situation of “average” local unit very strong and pushed it to important investment activities. The situation seemed to be stable and even the lowering of PIT rates established early in 2008 by parliament was not terrifying for local government officials. However world economic crisis coming in the end of 2008, changed the situation dramatically. Despite lowered incomes local governments had to carry on planned investments started from EU grants and particularly these, which are obligatory because of accession protocols. That situation influenced local debt policy. The aim of this paper is to analyze the local government debt policy during period 1999-2009 with special focus on the first year of crises. Statistical data related with debt, revenues and spending (especially investment) will be analyzed throughout the years. The paper presents the most important factors which influenced local governments debt policy in 2009, new legal framework for local indebtedness, level of public debt and election cycle.

1. Introduction
Polish local governments (LGs) almost from the beginning of its history had power to use debt instruments in its financial policy. However in the first half of 1990s they were very reluctant to borrow money (Levitas, Kopanska 2004). Situation changed in the beginning of XXI century. In 1999 the amount of sub-sovereign governments’ debt was approx 9 bln PLN, and ten years later it was more than 40 bln PLN. The communal debt market is growing very fast- averagely 15% every year. But this growth is not linear, there were years when calculated year to year changes in level of indebtedness were about 1% and in others years it was 30%. The aim of this paper is to analyze the local government debt policy in Poland, with special focus on changes which occurred in 2009- the first year of world economic crisis.

According to economic theory institutional framework is the most important tool which influence local spending and debt policy (Inman; 2001). In the first chapter of this paper basic information about Polish LG will be given. It will be presented how and why its financial and legal situation changed in 1999-2009.

In second chapter, the legal framework of local indebtedness in Poland will be presented.

The last part will study statistical data- related with debt and its correlation with revenues and spending (especially investment). Factors, which are important for local debt policy: financial statement and its perspectives, investments needs and EU grants and finally election cycle, will be presented and analyzed

In our paper we will especially focus on local units - gminas (municipalities) and cities with poviat’s rights (66 cities which work as gmina and poviat).

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2. **Polish LGs financial situation in years 1999-2009**

The present local government structure in Poland is a result of two phases of decentralisation reform. The first phase took place in 1990, when local government system was introduced and about 2500 municipalities (gmina) were established. The second stage of the reform was introducing two new tiers of elected sub-sovereign governments in 1999, 315 counties (powiat) (plus 65 the largest cities which works as powiat and gmina) and 16 regions (województwo) were created.

The responsibilities of gminas have been broadly defined as „all matters that are not reserved to other entities under existing laws”, while the Gmina Local Government Act enumerates the most important tasks. Powiat is responsible for public tasks of supra-gmina nature. Primary responsibilities of voivodships are aimed toward region’s development by defining measures and development goals in so-called “voivodship development strategy”. Furthermore, voivodships are responsible for public tasks of regional nature that gminas or poviat are unable to fulfill.

Nowadays (2008 data) sub-sovereign governments spend 35% of total public expenditures. Almost 79% of sub-sovereign budgets are spent on a municipal level (including cities with poviat status), 12% by a county level and 9% by a regional self-government. It is also worth to add, that sub-sovereign authorities are the most important public investor, and on municipal level more than 50% of public investment is made. (see Fig. 1)

Figure 1 Structure of capital and operational expenditures by the levels of government in 2008

Source: Own calculation based on Ministry of Finance and GUS (Statistical Office) data

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2 Warsaw (capital) is organized on special Act which were changed in 2002. Today Warsaw is one city- municipality, which operate as a poviat (like other 65 cities with poviat status) it has 16 districts (dzielnica). These districts were independent gminas before 2002. This reform influences statistical data, because before 2002 Warsaw is visible in gminas data, while from 2002 in cities statistics.

3 such as spatial planning, health care, social care, primary education; municipal housing, culture, physical culture, construction and maintenance of local roads, streets, bridges, the local public transport, planning for and financing of lighting in public areas, restoring good environmental conditions, the creation and protection of parks and forests, protection against flood, solid waste management, maintenance of public areas, the construction and maintenance of sanitary facilities, landfills, wastewater treatment plants, the construction and operation of water supply and sewerage systems, the provision of power and heat supply.


Such a huge capital investment effort by municipalities is associated with serious underdevelopment of the communal infrastructure inherited from the past. Due to the magnitude of existing needs, the amount allocated to capital projects is relatively stable however, there are visible changes in the expenditure structure.

Figure 2 Amount and structure of local (gminas+ cities) expenditures in 1999-2009 (in prices as of 2009)

In years 2000-2003 capital expenditures decreased (in 2003 they were 23% lower than in 1999). This decrease can be explained by a worse financial situation of LGs. The administrative reform from 1999 was only one of four big reforms in public finance which were organized in 1999 in Poland. The pension found and health sector reforms heavily influenced public finance and in years 2001-2002 (3) there was public finance crisis in Poland (Owsiak 2006; p. 701). The idea of administrative reform, was not to change revenue situation of “old” local units, but mentioned crisis was reason, that Act on Local revenues, which were established for years 1999-2003 did not fulfil that idea. Although, LGs’ revenues increased in real terms, but at the same time their burden from new operational responsibilities (specially related with social spending) grew even faster. It is also worth to mention that there was mistake in calculation of education subvention which occurred in 2000 and caused important problems in spending related with teachers salaries (RIO; 2002)

In 2004 Poland accessed to European Union (EU), which among others, caused very important obligations for communal infrastructure. For example according to the directive 91/271/EEC adopted by Poland and concerning treatment of communal sewage, such treatment is essential for all types of sewage. As a consequence of this decision in years 2004-2015 about 30 bln PLN (app 8 bln EUR) have to be spent for water and sewage systems. The special EU grants were established to help Poland to fulfill these obligations, but still LGs needed their own money to co-finance these grants. This forced important changes in Polish LGs revenues. The financial situation of sub-national government was radically modified in 2003 with the introduction of a new financing system (Act on Local Government Revenues) put into force in the 2004. (see Fig 3)

6 (to avoid problem of dramatic changes in capital spending and debt for new tiers of sub-sovereign governments, which are related with close to zero amount of these categories in 1999; in our paper it will be mostly analyzed local units which operated since 1990- gminas (municipalities) and cities with poviat’s rights (66 cities which work as gmina and poviat))
The local revenues in Poland may be divided into four major groups:

1. Revenues from own sources – such as local taxes, fees for services, revenues from local governments’ property (selling, leasing).
2. Local government shares in revenues from central taxes (Personal Income Tax and Corporate Income Tax) which are allocated due to revenues collected from particular territory.\(^7\)
3. General purpose grants.
4. Specific grants coming mainly from the state budget, but also from special funds (such as environment protection), other local governments and from EU.

New Act on Local Government Revenues, did not create any new sources of local revenues. It is worth to add, that only tier collecting own taxes is municipality (and cities). Local property tax is the most important local tax (covering about 35-40% of own local revenues). It is calculated based on area and category of the property, and thus revenues from that tax are not influenced by economic situation. For cities, the important portion of own revenues comes from tax on civil law transactions which is calculated (among others) based on value of transaction on property market. In years 2006-2007 the revenues from that tax has grown rapidly and covered 7% (in 2006) and 10% (in 2007) of own revenues of cities, but visible on figure 3 decline in own sources in 2009 was caused by decline in this tax (which decrease about 25% compared with 2008, and 40% compared with 2007 when it had the highest level).

Important change in New Act on Local Government Revenues was increase of shares in central taxes This affected mostly revenues of the biggest cities, but also made their budget (and generally local budget) more vulnerable to the economic condition. That correlation is visible in 2009- when, shared taxes decreased 4% comparing with 2008\(^8\).

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\(^7\) In the Polish budget classification „tax sharing” is a part of „own source revenue”. However, local governments have no discretion over decisions on these revenues and only parliament decide about structure of PIT and CIT. That is why, shared taxes will be presented in this paper as a separate category.

\(^8\) It is worth to add that this decline was related not only with crisis, but also changes in PIT tax rates established by parliament.
Table 1. Local government shares in central taxes

<table>
<thead>
<tr>
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<th>PIT</th>
<th>CIT</th>
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<tbody>
<tr>
<td>Municipalities</td>
<td>27.6%</td>
<td>Progressively increasing up to 39.34%</td>
<td>5%</td>
<td>6.71%</td>
</tr>
<tr>
<td>Counties</td>
<td>1%</td>
<td>10.25%</td>
<td>0%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Regions</td>
<td>1.5%</td>
<td>1.6%</td>
<td>0.5%</td>
<td>15.9%</td>
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</table>

The increase tax-sharing effected also grants policy, because the horizontal balancing started to be more important. In addition, the idea of revenue’s reform was to decrease special grants from central budget. In practice, as visible on fig. 3, this idea did not work for two main reasons:

1) new social obligation of local units are financed from specific grants, which were given to them in 2004.

2) specific grants from EU, especially related with investments.

Started from 2004 capital spending was growing in some years even faster than operational expenditures and covered averagely about 20% of local budgets. (see fig. 2) But there were units, where that effort was extremely high. For example in 2006, 200 gminas spent more on investments then on operational tasks, and in one unit it was 70%. (RIO; 2006)

These expenditures are mostly related with obligation taken by Polish government in EU accession process. The most important are spendings related with investment in transport (roads) (about 20% of gminas and cities capital spending) and also water systems and sewage plants (30% of local capital expenditures). EU grants and other foreign source covered important part of these spending (see table 2)

Table 2 Share of EU grants in financing of local (cities and gminas) investment expenditures in 2005-2008

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<tbody>
<tr>
<td>Gminas</td>
<td>13.5%</td>
<td>16.1%</td>
<td>11.1%</td>
<td>5.8%</td>
</tr>
<tr>
<td>Cities</td>
<td>16.8%</td>
<td>28.5%</td>
<td>22.1%</td>
<td>14.6%</td>
</tr>
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</table>

Source: RIO reports

The other significant law, which influence local government financial situation and policy is Public Finance Law. This act was published in 1999 but was modified several times. In August 2009 new Act was published, the most important changes are related with local and public debt limits and policy.

3. **Sub-sovereign borrowing in Poland – legal framework and its modifications**

Important method of regulating indebtedness of local units, is to set limits for purpose of debt; amount of indebtedness; method of borrowing. The first two were changed in Poland in previous years.

The most important limits, for local borrowing is related, to purpose of debt. In Poland, Public Finance Law in years 1999-2003 defined two types of debt that LG units are authorized to contract. First, the debt associated with local budget deficit occurring during a year, which has to be repaid within the current year. Second, the debt contracted to cover budget deficit of a LGs unit that has to be specified in that unit’s budget.
From 2003 in that part of debt, is worth to distinguished debt related with EU projects and grants, because this debt is not included in debt limits related with amount of indebtedness.

The laws distinguish between short-term current debt and long-term debt. It should be noted, however, that aforementioned regulations do not provide limitations for the purpose of long-term debts. Both capital and current expenses are eligible under existing legal framework. Polish regulation are not in line with “golden rule” of local government finance. This rule says that borrowing is allowed for capital projects but prohibited for current purposes (pay-as-you-use finance, in contrary to pay-as-you-go) (Musgrave, 1989).

In 2003 new type of debt was allowed - repayment of old debt. On one hand, it gives local units possibility to restructure old debts, but potentially it also create problem of accumulating of debt.

In Poland there are two limits, for the amount of debt. The Law states that “Total amount of loan/credit installments to be repaid in a particular budgetary year and potentially payable amounts under any collaterals extended by LG unit, including interest on credits/loans, and the amount of LG’s securities with maturity falling in that year, may not exceed 15% of the planned LG unit’s revenues” (Art. 113 of Public Finance Act). Furthermore, total indebtedness as of budgetary year end may not exceed 60% of revenues in that particular budgetary year.

From 2003 these limits do not cover debt related with EU grants. This is one of effects of mentioned above investment commitments on accession to EU, but also political (and social) pressure to consume “all UE grants”

These statutory limits fail to be related to real financial situation of LG units. For more affluent units exceeding of the statutory 60% or 15% limits is not a problem, but in others, even a small debt may impair seriously their solvency. The critics of these limits caused modification, which were published in new Public Finance Law in 2009. According to that law the repayment of debt planned in particular year as a % of planned revenues, cannot exceed the 3 years average of sources calculated as below:

\[
\left( \frac{R + O}{D} \right) \leq \frac{1}{3} \left( \frac{Dh_{n-1} + Sm_{n-1} - Wb_{n-1}}{D_{n-1}} + \frac{Dh_{n-2} + Sm_{n-2} - Wb_{n-2}}{D_{n-2}} + \frac{Dh_{n-3} + Sm_{n-3} - Wb_{n-3}}{D_{n-3}} \right)
\]

- \( R \) - planned repayment of debt which need to be pay in year \( n \)
- \( O \) - planned rates of debt + LG guarantees which need to be pay in year \( n \),
- \( D \) - budgetary revenues,
- \( Db \) - current budgetary revenues,
- \( Sm \) - revenues from selling of LG actives,
- \( Wb \) - current expenditures,
- \( n \) - year for which is calculated equation,
- \( n-1; n-2; n-3 \) – year (2;3 years) before year for which is calculated equation,

The discussion on details of above calculation of local creditworthiness is out of scope of this paper. It should be stressed that new limits estimate individual situation of LGs and for weaker local units it could limit their ability of borrowing. That is why local units were against these changes in local debt limits and finally it was agreed that that limit will be in force starting 2014.

It is also worth to add, that the limit which tie local debt with central debt is established in Polish law. That regulation is intended to be a tool to avoid potential macroeconomic problems of local debt. Total amount of public debt is calculated as the nominal amount of liabilities other than mutual liabilities of public sector.
entities.\(^9\) Minister of Finance is responsible for ensuring compliance with thus calculated indebtedness level and in the event that the amount of public debt exceeds 50% of GDP, so-called prudential and improvement measures are enacted. Till 2009 the mechanism of these measures was that once the 50% level is exceeded, the planned deficit amount (planned debt) of each local government unit may not be higher than the planned deficit of State budget for that particular year. This seemed to be too restrictive and unfair for LGs in situation, when sub-sovereign government debt covered (in 2000-2008) about 4% of whole public debt. In 2009, new Public Finance Law resigned from this obligation for local budgets when public debt is between 50% and 55% of GDP. But according to new law, when public debt is higher than 55%, then every local units is allowed to plan deficit only for projects financed from EU grants. When public debt exceeds 60%, then no public deficit could be planned.

Second group of limits, are limits linked to method of borrowing. As postulated by European Charter of Local Self-government (Art. 9) “…local authorities shall have access to the national capital market within the limits of the law”. Generally it mean, that local units, could borrow, like other entities- on commercial terms- contract credits in banks and issue bonds -in Poland all these methods are accessible for local units.

In most countries, the specific regulations, are related to foreign currency debt. In Poland, Law says: the zloty-expressed debt value must be known on the day of transaction. Only loans extended by international financial institutions of which Poland is a member or cooperation agreement signatory (e.g. the World Bank, EBRD), as well as by banks and other corporate entities extending loans from credit lines opened by such institutions, are exempted from these restrictions.

At the end of discussion of local government debt limits in Poland it is worth to add, that according to Polish law, local unit cannot go bankrupt. From 1999, according to Public Finance Law, state budget may provide a loan for local government for a recovery program. Every year there was 30 million PLN in the budget for this goal, but until 2004 this provision was never used in practice. In 2004 first time, several local units received loan to fulfil their liabilities- so the bail-out problems are present in Poland

4. Local government borrowing in Poland in 1999-2009

In the first half of 1990s local governments where very reluctant to borrow money but later many municipalities developed their activity on the capital market.

Figure 3 Outstanding debt of Poland’s sub-sovereign governments in 1999-2009 (in prices as of 2009)

![Figure 3](image)

Source: Own calculation based on Ministry of Finance reports

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9 Public Finance Law, Art. 10. 1 and Art. 36.1.; these limits were added in 1998
During the years local debt increased and in 2009 it was 4 times higher than in 1999. But still the general level of indebtedness is far from “old” debt limits (averagely in 2009 debt to revenues ratio was 26% in all units, 37% in cities and 22% in gminas). The most important “players” on capital market are gminas and cities. (see Fig 3)

Presence on borrowing market is correlated with the population size of local government. Every year amount of new credits and loans of 66 biggest cities is comparable to credits and loans taken by almost 2500 gminas. (see Table 3)

Table 3 Amount of new debt issued by cities and gminas in 2002-2009* (in prices as of 2009)

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</thead>
<tbody>
<tr>
<td>cities credits and loans</td>
<td>5161</td>
<td>3506</td>
<td>2571</td>
<td>2795</td>
<td>2744</td>
<td>2414</td>
<td>1735</td>
<td>2282</td>
</tr>
<tr>
<td>cities bonds</td>
<td>2691</td>
<td>220</td>
<td>355</td>
<td>356</td>
<td>352</td>
<td>299</td>
<td>524</td>
<td>477</td>
</tr>
<tr>
<td>gminas credits and loans</td>
<td>5552</td>
<td>3367</td>
<td>3325</td>
<td>4332</td>
<td>3293</td>
<td>3243</td>
<td>2579</td>
<td>2613</td>
</tr>
<tr>
<td>gminas bonds</td>
<td>961</td>
<td>448</td>
<td>296</td>
<td>433</td>
<td>278</td>
<td>154</td>
<td>96</td>
<td>221</td>
</tr>
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* during years 1999-2002 Warsaw is visible in gminas statistics, later in cities, that is why the analyses when cities and gminas are studied separately, it will be presented data from 2002

Amount of local debt is increasing, but this growth is not linear. In years 2000-2002, 2006 and in 2009 the growth was stronger, while in years 2003-2005 and 2007-2008 weaker. (see. Table 4)

Table 4 Changes (year to year) in gminas and cities indebtedness (1999-2009)

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<tbody>
<tr>
<td>Cities + gminas</td>
<td>32,2%</td>
<td>22,1%</td>
<td>20,2%</td>
<td>8,9%</td>
<td>7,0%</td>
<td>6,1%</td>
<td>11,9%</td>
<td>-0,9%</td>
<td>6,7%</td>
<td>36,5%</td>
</tr>
<tr>
<td>Gminas</td>
<td>8,71%</td>
<td>10,26%</td>
<td>4,63%</td>
<td>17,65%</td>
<td>1,35%</td>
<td>4,28%</td>
<td>30,46%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cities</td>
<td>9,09%</td>
<td>4,53%</td>
<td>7,25%</td>
<td>7,38%</td>
<td>-2,76%</td>
<td>8,90%</td>
<td>41,65%</td>
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</table>

Source: Own calculation based on Ministry of Finance reports

Nonlinearity is also visible, when we analyze deficit. Figure 4 presents deficit to revenue ratio, and in years 2002-2002 it was more than 4% (in absolute values), in next periods (2003-2005) this ratio was decreasing and was close to 0 % in 2005, increased in 2006 to 2%, “backed to” decrease line in 2007, when local budgets had surplus and increased in 2008-2009 to very high level (almost 10% in 2009).

Figure 4 Deficit to revenues ratio in gminas and cities (1999-2009)

Source: Own calculation based on Ministry of Finance reports
Comparing above trends with information about LGs financial statement presented in first chapter, it is visible, that in years of prosperity local units used less debt than in crisis time what could be explained by necessity to fulfill obligation. Especially it was visible in years 2000-2002, when as was presented LGs in Poland were in bad financial situation and received new tasks without proper revenues. But as it was mentioned, these tasks were mostly related with social- operational spending. It could mean that LGs used debt instrument to finance everyday expenditures- what is bad policy, and could cause significant financial problems. There are no precise data on purpose of local borrowing, but in whole analyzed period new debt was smaller than capital spending (in average)- so in general debt was used only for investment projects. On the other hand in 2000 when national legislation increased teachers’ salaries, but central budget did not provide sufficient funds for this purpose, over 700 of local governments decided to take commercial credits in order to pay their teachers (RIO 2002, Jerzmanowska 2001).

The dramatic shift of debt and deficit is visible in 2009. The crisis on one hand with lowering revenues, and on other hand investment obligation could be explanation – the situation visible in 2000-2002 is repeated. But still the question why the change is so dramatic remains.

The other part of the answer for this question could be legal debt limits. As it was presented in this paper in August 2009 new debt limits were published in Public Finance Law. The discussion about that limits started almost year earlier, and every local unit had the possibility to check, how it would influence its own debt. As it was mentioned the weaker units, according to new limits will need to resign from any new debt (and investments). Also richer units, could have problems, because new limits are calculated on historical data- it means that even after crisis, bad financial situation from previous years would influence “legal creditworthiness”. Taking that into account, for many local units it could be rational to take more debt under “old” rules.

Another potential problem for new borrowing of local units in close future could be the level of public debt. As it was mentioned when this debt reaches 55% GDP, then only deficit for EU projects could be planed. According to Ministry of Finance estimation in years 2010-2012 the public debt will be 54,5-54,8% of GDP (Ministerstwo Finansów; 2009)- once again rational local units decide to take debt before law abolish it.

Finally the electoral business cycle could be explanation for dramatic changes in level of debt in 2009. Political or electoral business cycle (Nordhouse; 1975; Rogoff 1987), suggests that public authorities spend more on items visible for voters (and increase deficit and indebtedness) in pre-election period and generally spend less after election. (analysis for local level, was presented e.g by Veiga 2004; Pettersson 2003). It is difficult to observe this cycle on general data, especially when we take into account changes in economic situation and legal framework, but still we could find some aspects of this trend. In Poland the local election were in 2002, 2006 and it will be in 2010. It is visible, that in years after election (2003, 2007) deficit is lower than in previous years. In election year 2002, deficit counted for gminas and cities together was smaller comparing with previous year (what is contrary to election cycle idea) but in 2006 was higher. 2009 – year before election is good time to start investments, which will be finished in 2010- election time.

Finally it is worth to noticed that in 2009 most banks needed to stop its credit activity for private firms and individual clients. Public entities- the less risky in economy, start to be almost the solely customer.
Conclusion

As it was presented in the paper year 2009 was the year when local debt grown drastically. One of the explanations is that with stable high investment costs, lack of revenues from central taxes was covered by higher indebtedness. However compared to the situation from years 2000-2003, when previous crisis took place, this rise of local indebtedness needs additional explanations.

In this paper another factors which influenced local government debt policy in 2009 were presented. The first important cause is the new law related with amount of local indebtedness. The new calculation of “legal creditworthiness” of local units, which is more restrictive pushed local governors, to take more debt under “old”-less restrictive rules.

Second reason is level of public debt, planned for years 2010-2012 by Ministry of Finance. This debt will be very close to 55%. According to Polish law, when that level is greater than 55% than LGs could plan deficit only related with EU projects. Once again local governors decided to take more debt before this problem will occur.

Finally, the election cycle idea, suggest that local governments realized more investments and take new debt in years before election which will be in 2010.

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